



CROATIAN NATIONAL BANK

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# **Semi-rational exuberance: Gaining speed on an old track?**

Vedran Šošić

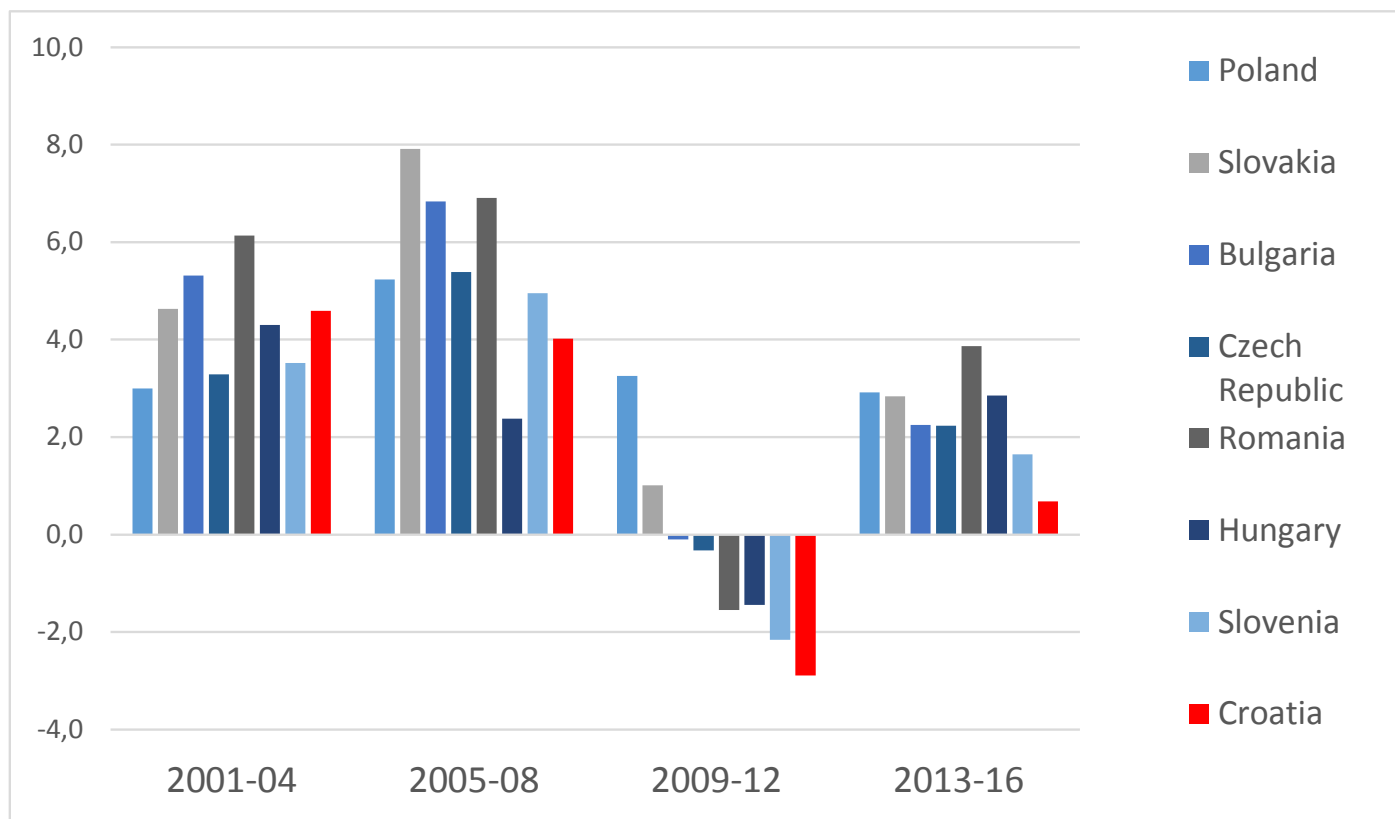
e-mail: [vedran.sosic@hnb.hr](mailto:vedran.sosic@hnb.hr)

# Croatia at last out of the recession

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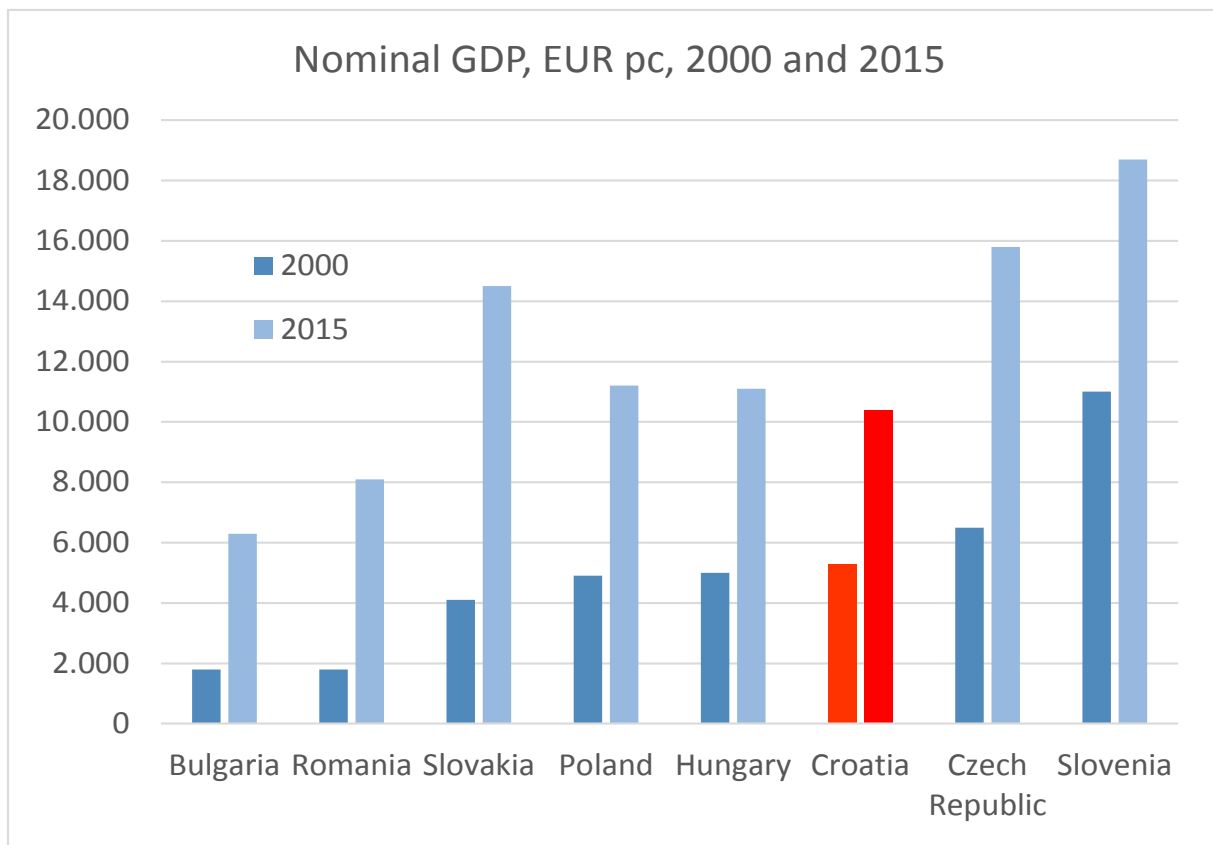
- GDP growth event of the year
- „Finally the best where it really matters!”
  - Croatian headlines after the last GDP data release, 30 Nov 2016.
- With 2.9% year-on-year GDP growth in Q3.2016 Croatia ranked in the upper half of EU members ranked by growth.
- At the same time, the quarter-on-quarter growth, 1.7%, was the **highest** among all 28 member states.

# Croatia –from leader to back of the pack



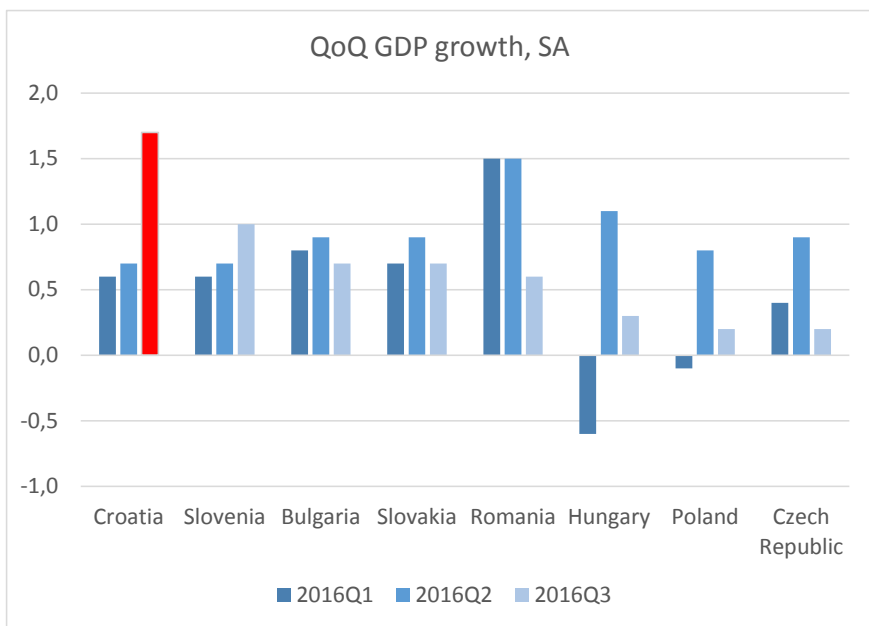
Source: Eurostat

# ... As income lags behind most peers ...

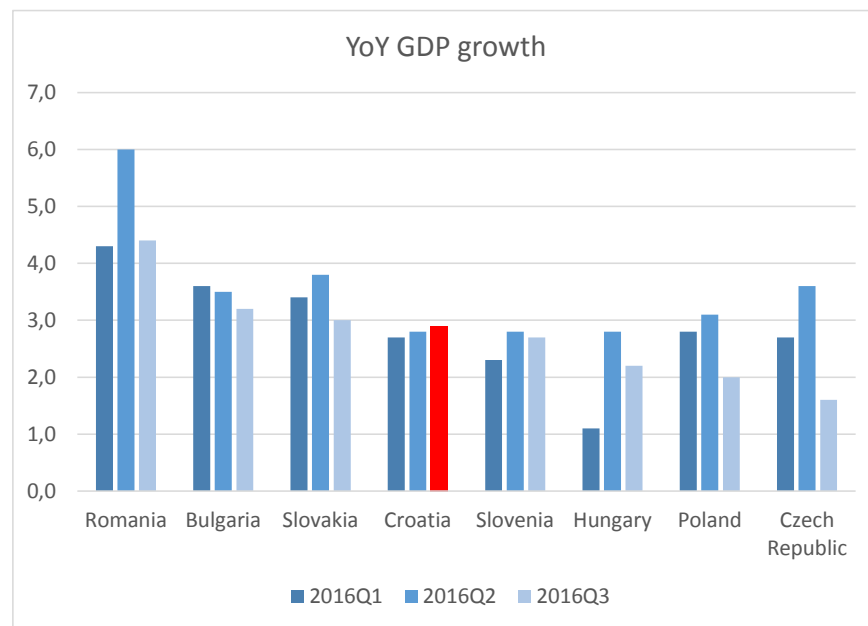


Source: Eurostat

# ... And than suddenly back ahead of the peers?



Source: Eurostat



Source: Eurostat

# Time to rejoice and celebrate?

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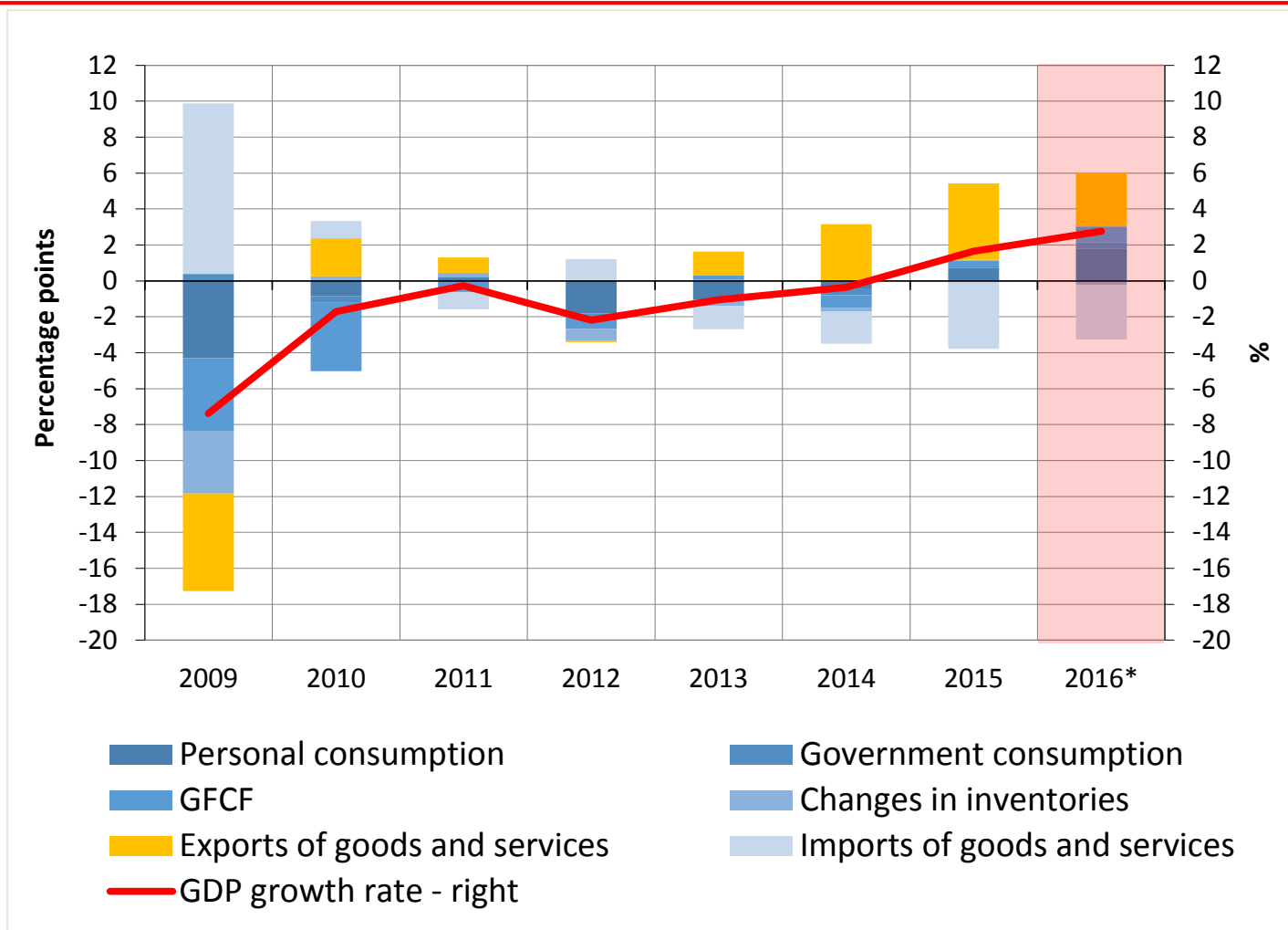
- Cyclical vs. Structural view:
  - Is the Croatian economy growing due to closure of the output gap after a deep recession (train gaining speed on an old track), or
  - Has economic growth arisen due to structural factors (the train has taken a structurally better track)?
  
- Extremely hard to tell in real time, even with a bit of a time-lag
  - Estimates of potential output prone to major ex-post revisions

# Structural view

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- Growth is in large part driven by exports of goods and services
  - Gains in non-price competitiveness
  - Goods exports getting more diversified, more firms enter the ranks of exporters
  - Sizeable CA surplus
  - Also absorption of EU funds
- Growth not driven by excessive credit and debt
  - Bank lending picking-up, but credit activity still muted
  - Household and corporate deleveraging facilitated by debt restructuring
  - Imbalances correcting in general, and particularly external imbalances

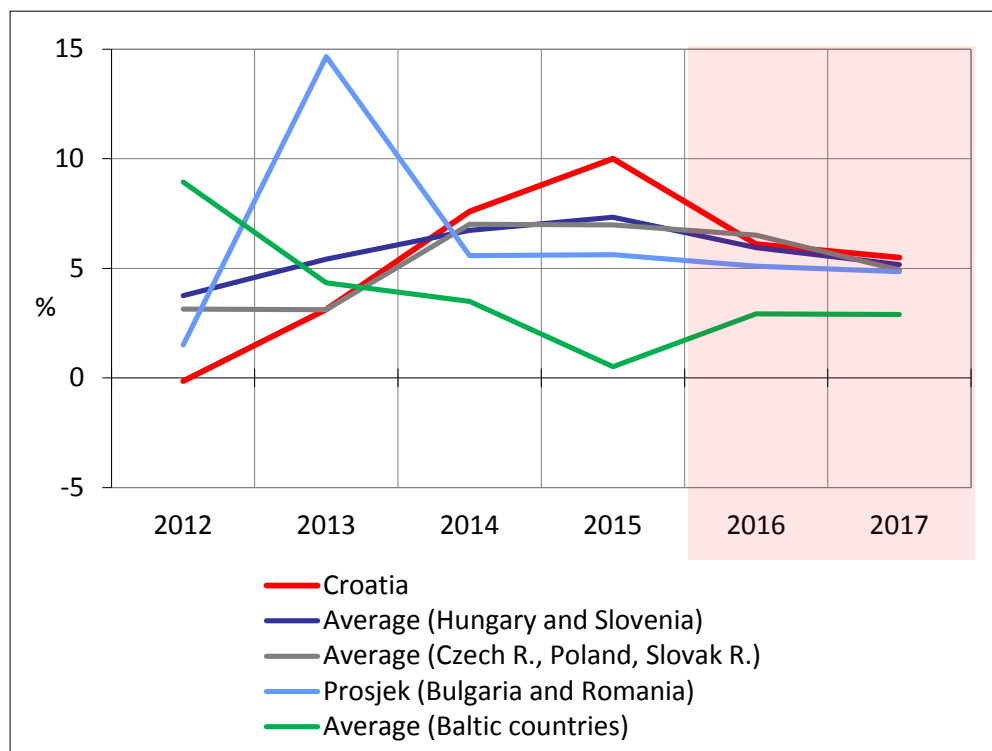
# Exports of goods and services major contributor to GDP growth



Source: Eurostat

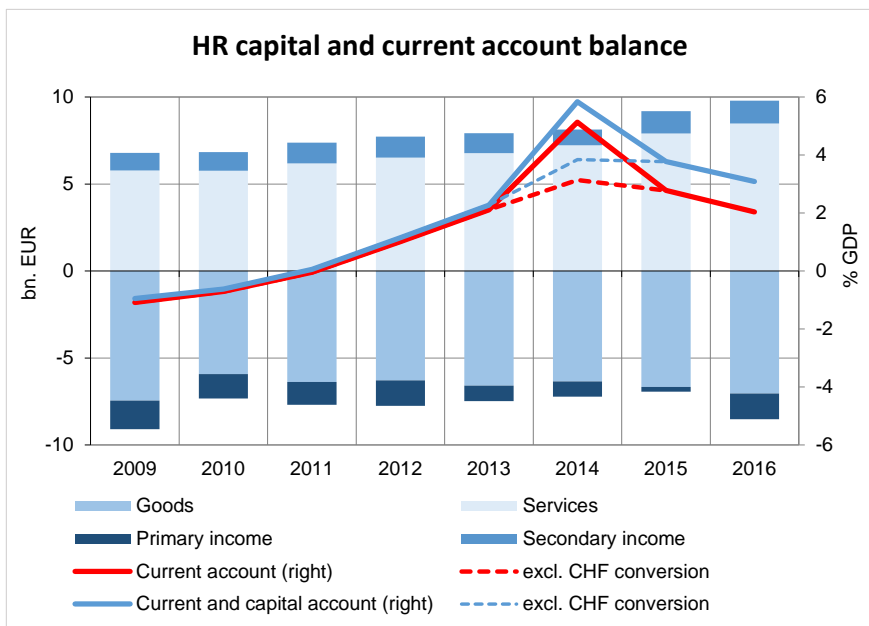


# Relatively favourable developments in exports of goods and services compared to peers

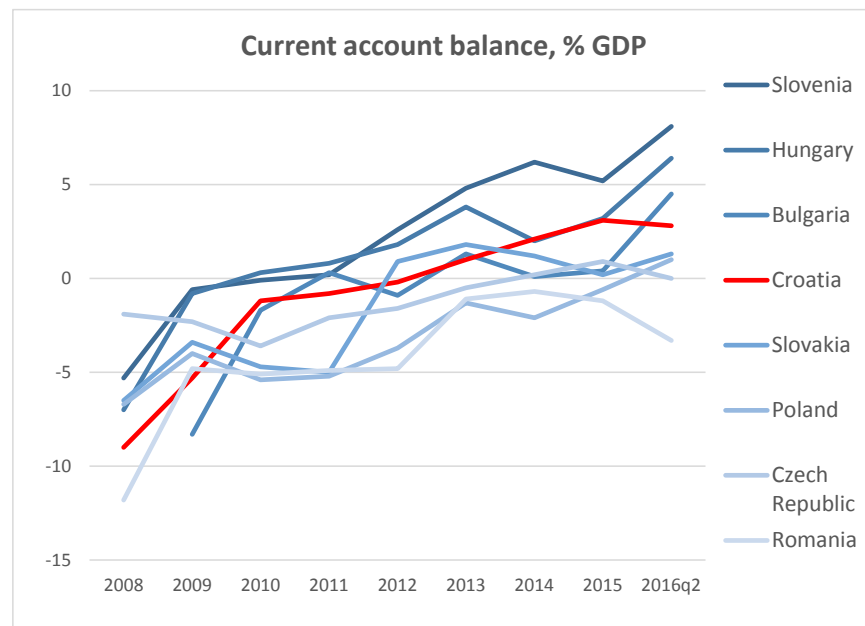


Source: AMECO

# Sizeable current account surplus

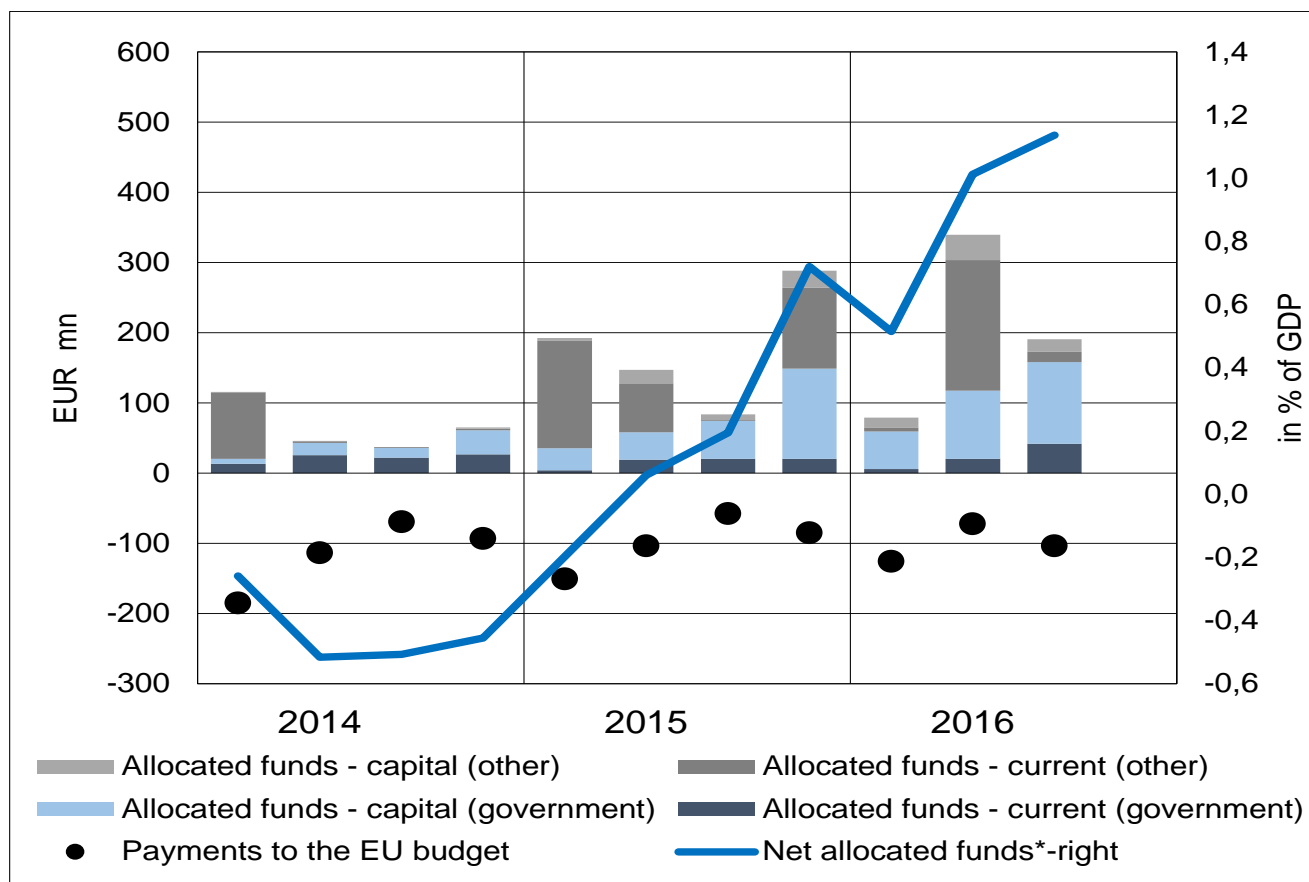


Source: CNB



Source: Eurostat

# Withdrawal of EU funds intensified

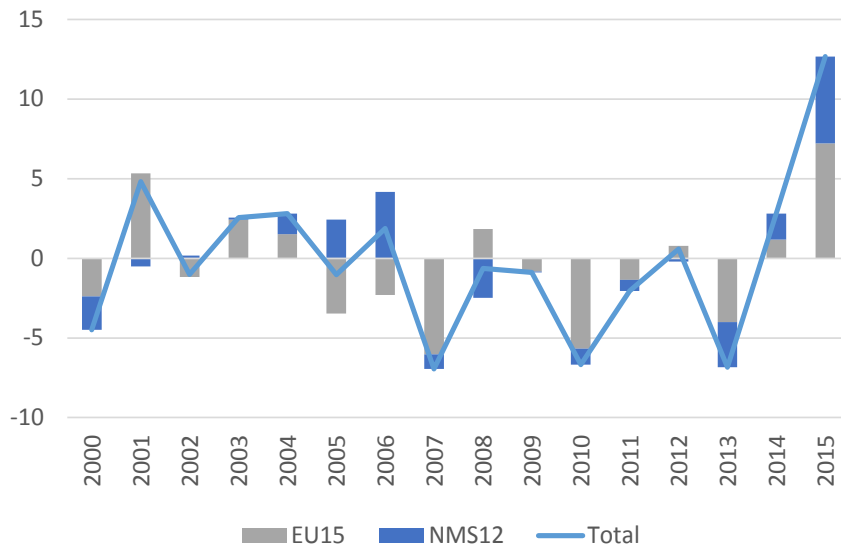


\*Sum of last four available quarters

Source: HNB

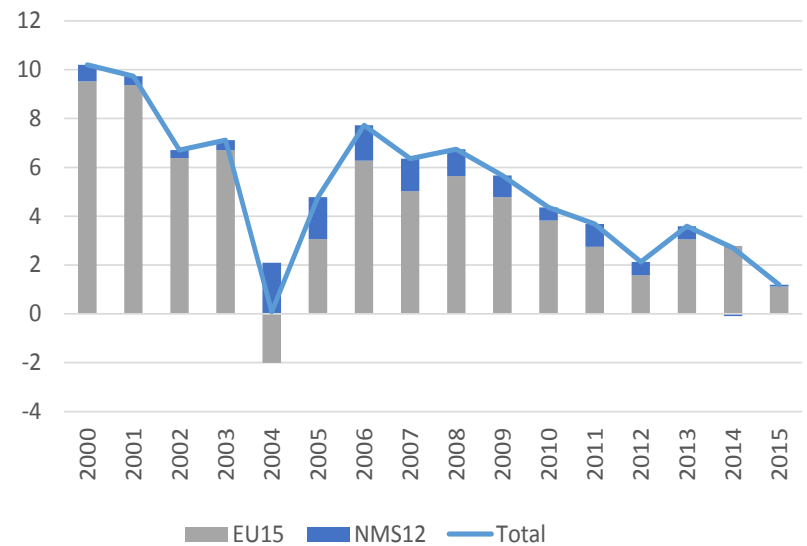
# Competitiveness effect on EU markets

## Croatia



Source: HNB

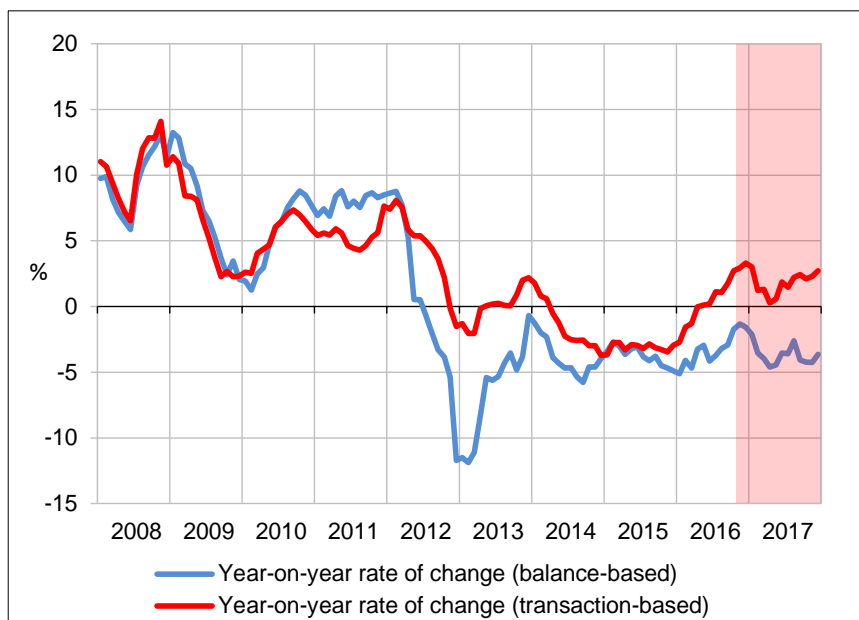
## NMS12



Source: HNB

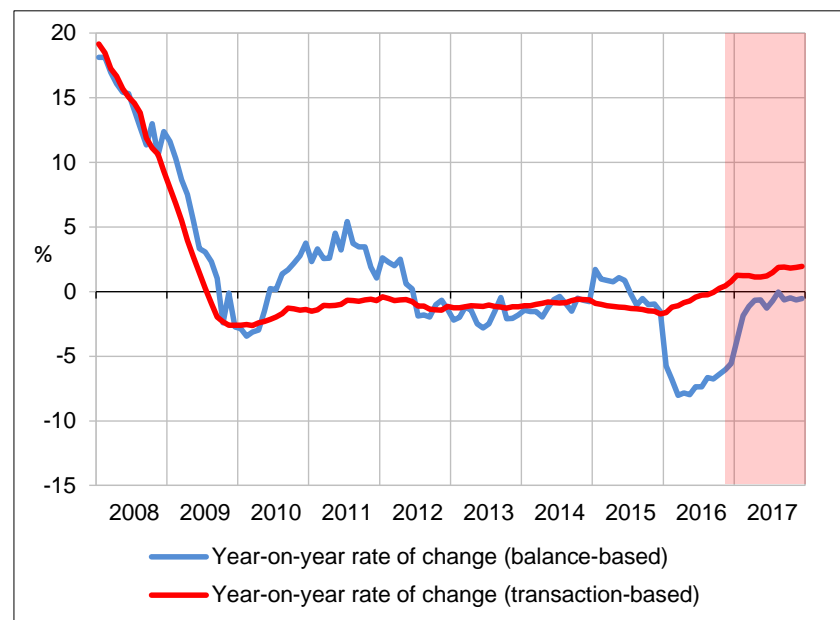
# Credit activity picking-up, but stifle muted

## Placements to households



Source: HNB

## Placements to corporates



Source: HNB

# Macroeconomic imbalances scoreboard

## – some progress

Indicator	Reference value		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Current account balance - % of GDP, 3 years average	-4	6	-5,4	-6,4	-7,6	-7,2	-5,2	-2,4	-0,7	0,0	1,0
Net international investment position - % of GDP	-35		-73,6	-89,1	-73,8	-86,9	-94,3	-91,7	-90,8	-88,9	-86,8	-77,7
Real effective exchange rate, 42 trading partners - 3 years % change	-11	11	2,8	1,8	5,3	5,8	2,0	-4,4	-8,3	-4,0	-1,0	0,1
Export market shares - 5 years % change	-6		18,8	12,9	-5,7	-5,0	-12,9	-15,8	-23,5	-22,8	-18,6	-3,5
<i>Export market shares - 1 year % change</i>			-2,8	1,9	1,5	-0,7	-12,7	-6,0	-7,5	2,5	4,7	3,5
Nominal unit labour cost index - 3 years % change	12		6,1	18,7	22,2	27,8	12,5	7,6	-0,6	-3,0	-5,8	-5,0
House price index, deflated - 1 year % change	6		13,9	8,8	-2,5	-8,0	-7,8	-2,2	-4,6	-5,7	-1,1	-2,4
Private sector credit flow, consolidated - % of GDP	14		18,0	16,7	16,0	2,6	4,9	-2,3	-3,0	-0,6	0,4	-1,3
Private sector debt, consolidated - % of GDP	133		91,1	100,7	110,3	118,6	125,2	122,6	119,7	118,4	119,5	115,0
General government sector debt - % of GDP	60		38,9	37,7	39,6	49,0	58,3	65,2	70,7	82,2	86,6	86,7
Total financial sector liabilities, non-consolidated - 1 year % change	16,5		27,1	24,2	-9,1	5,0	3,3	2,4	1,7	2,8	0,9	2,1
Unemployment rate - 3 years average	10		12,8	11,5	10,0	9,2	9,8	11,5	13,8	15,7	16,9	17,0

Source: Eurostat, CNB

# Gaining speed on an old track? (i)

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- Recession unusually deep – cyclical recovery was due to take place
  - Pick-up driven by optimism, both consumer and business
- Benign international financial environment
- Low oil price
- Supportive monetary and as of recently fiscal policy

## Gaining speed on an old track? (ii)

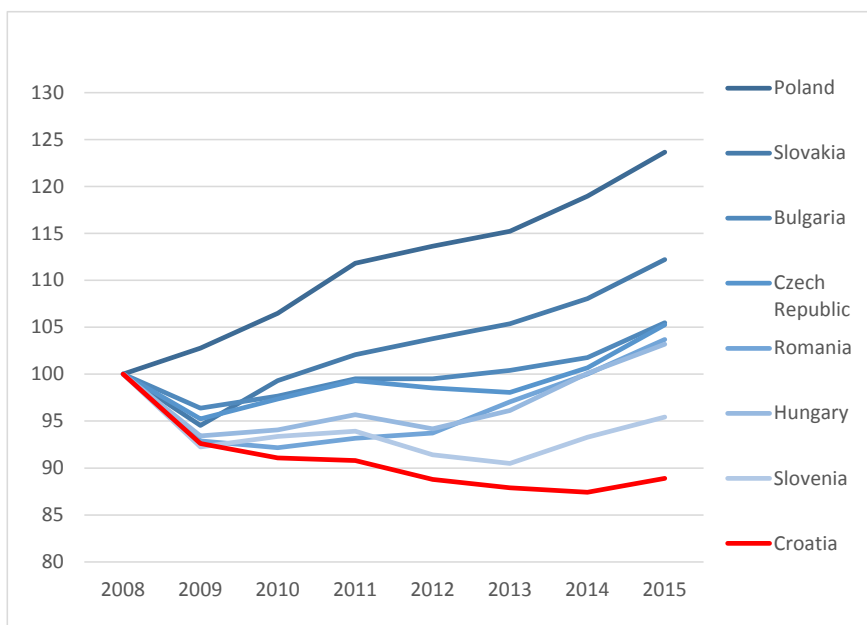
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- Recovery still heavily reliant on trade, transport and hospitality – tourism windfall from geopolitical situation
- Little integration in cross-border production chains, economy not poised to take advantage of integration
- Hardly any reform effort taken – crisis went into the waste
- All potential growth estimates low, TFP growth recently became non-existent
- Imbalances still elevated, public debt in particular



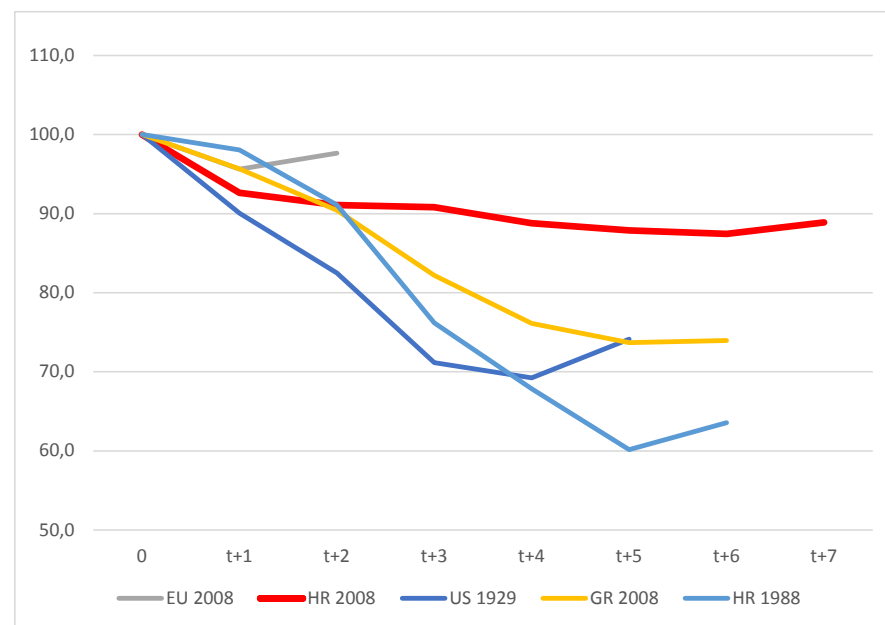
# The fact – Croatia was hit by the crisis which was deep and particularly long!

## Real GDP, 2008 = 100



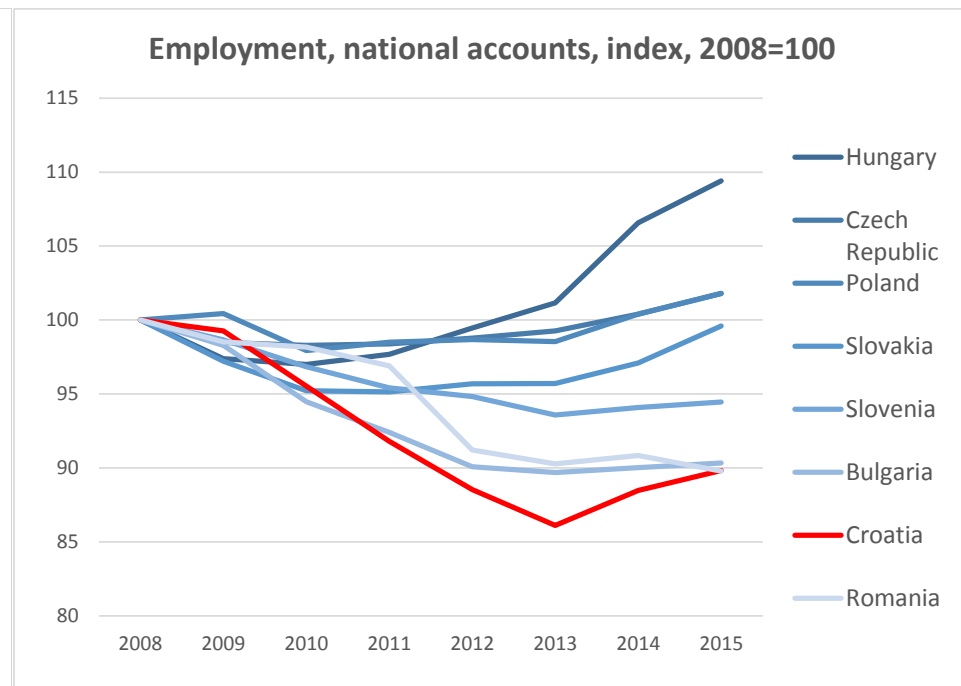
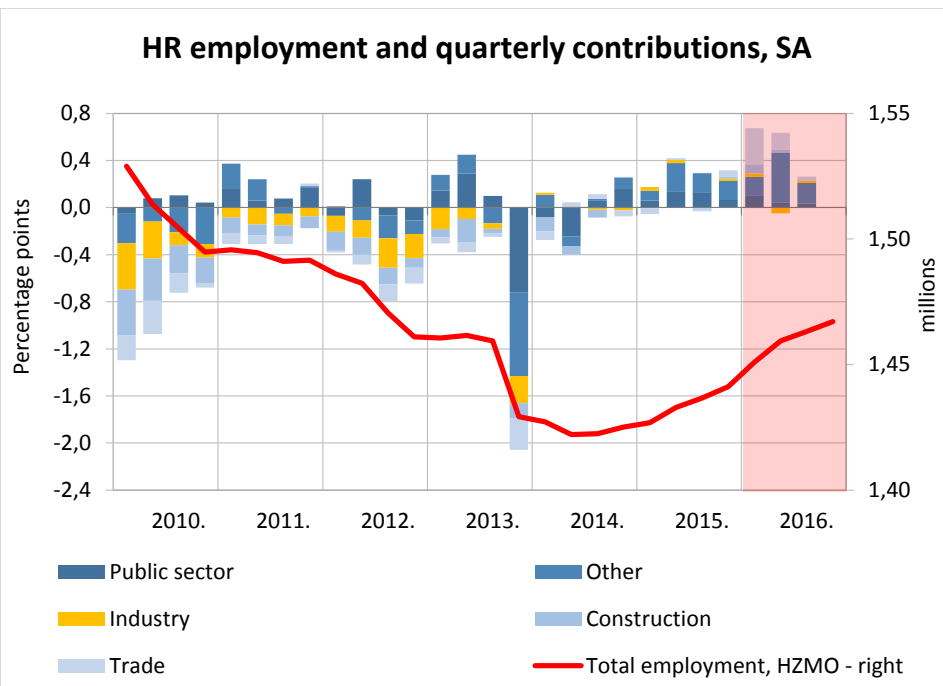
Source: Eurostat, CNB

## Duration of Recession



Source: Eurostat; The Maddison-Project, <http://www.ggd.net/maddison/maddison-project/home.htm>, 2013 version

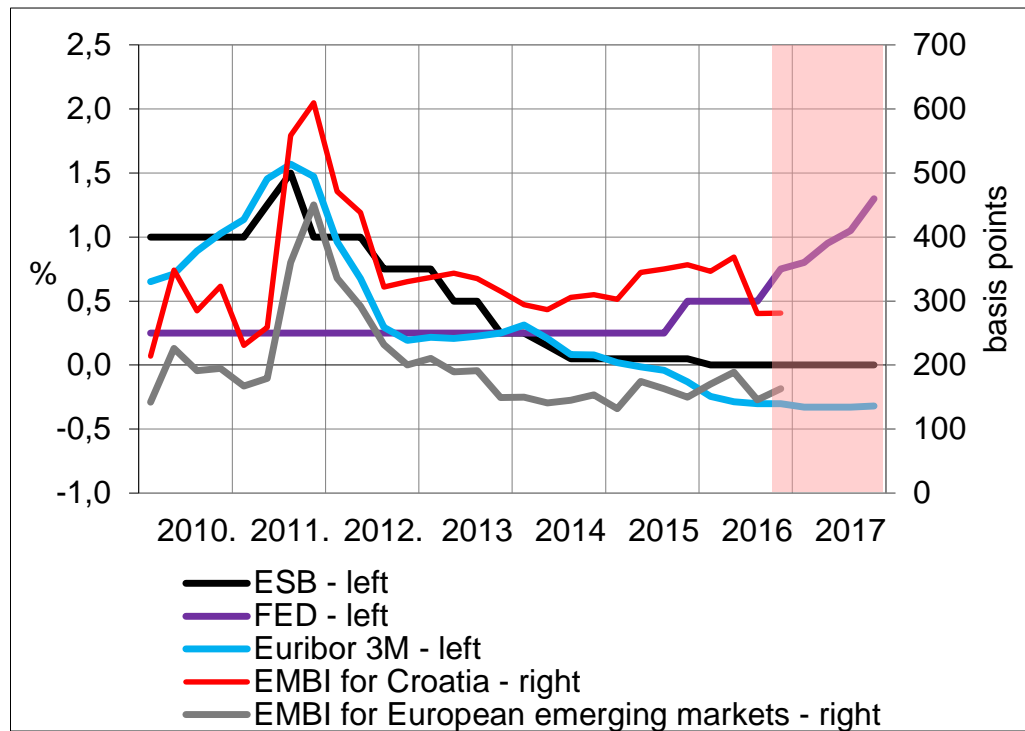
# Employment



Source: Eurostat, CNB

Source: Eurostat, CNB

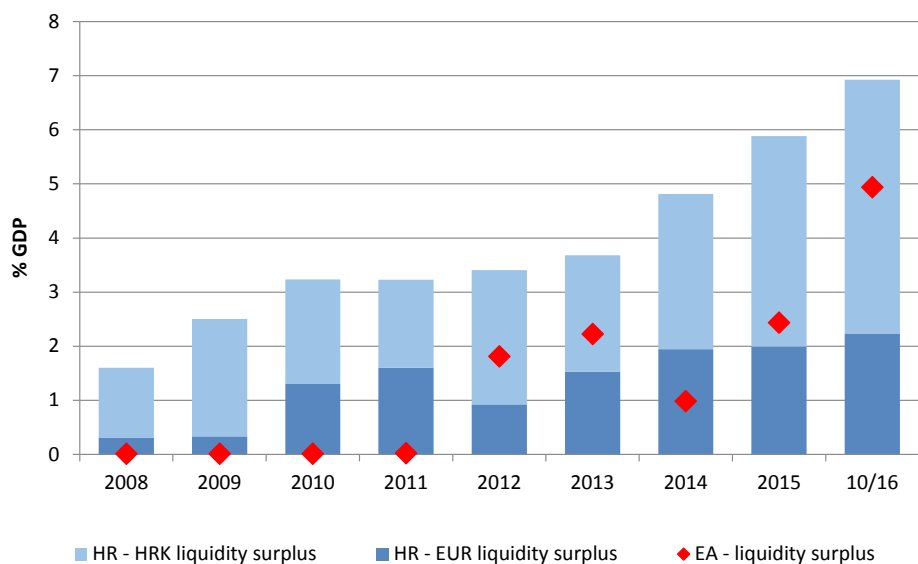
# Interest rates developments



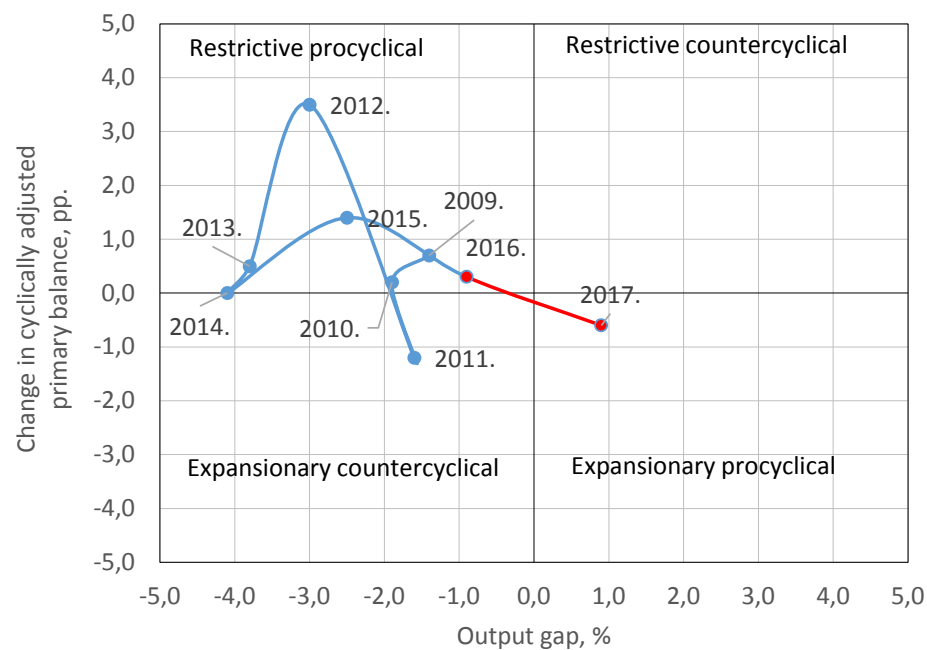
Source: Bloomberg, December 2016

# Monetary policy supportive, fiscal policy less of a drag on growth

## Liquidity surplus in Croatia and EA

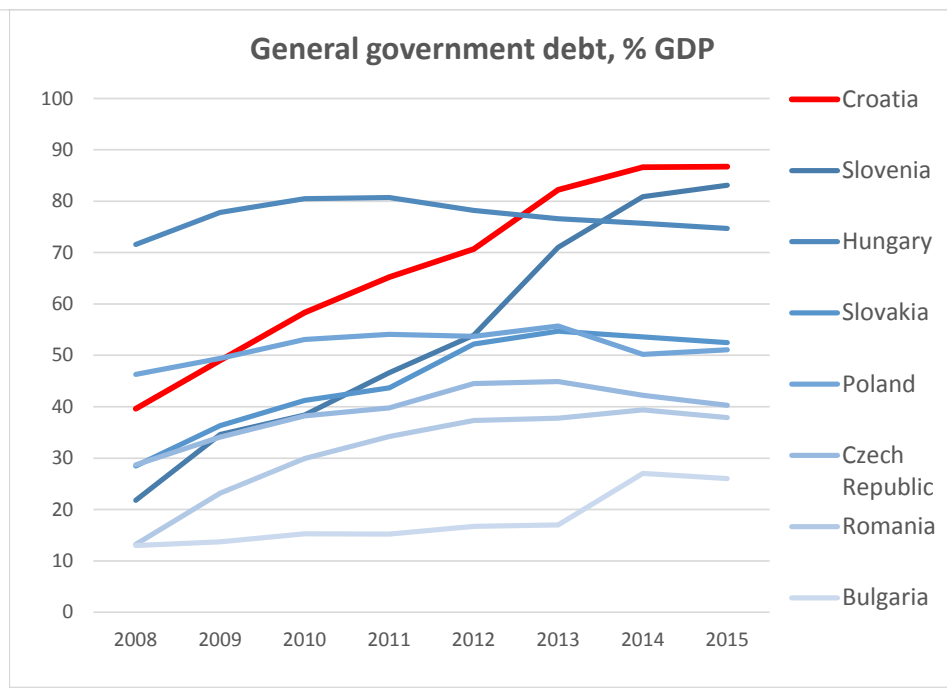
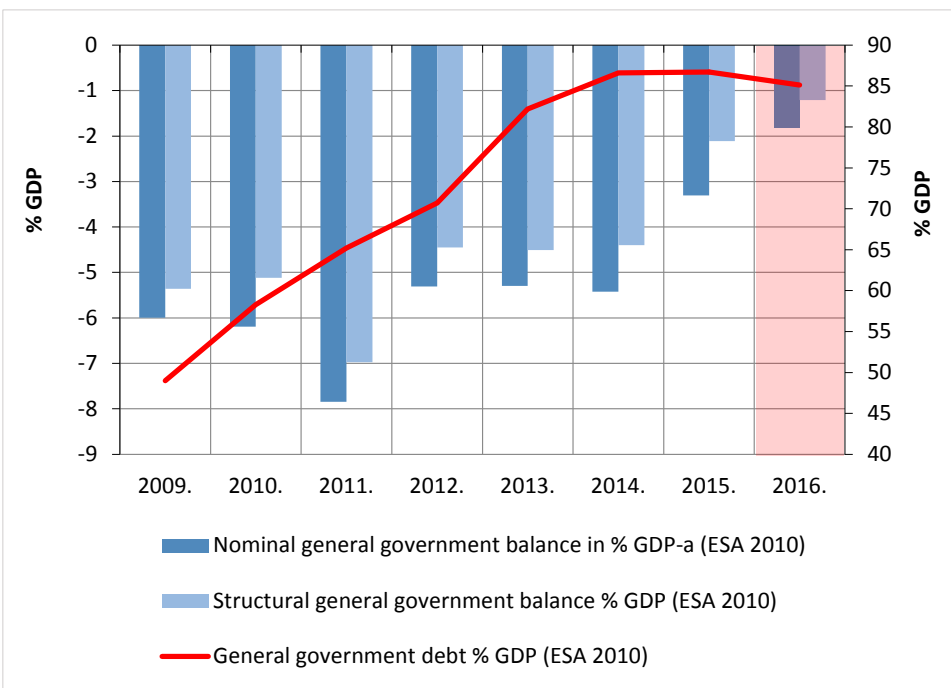


Source: Eurostat, CNB



Source: European Commission

# Still, public debt at the highest level amongst the CEE countries

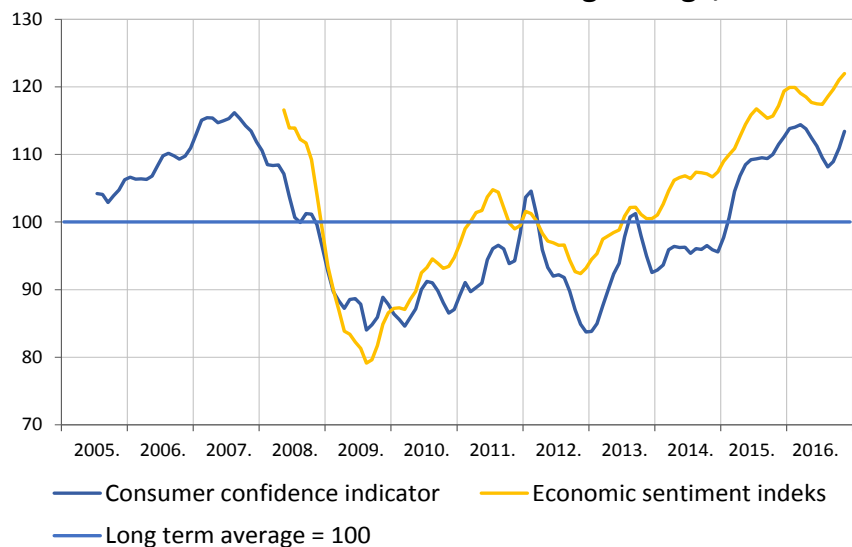


Source: Eurostat, CNB

Source: Eurostat, CNB

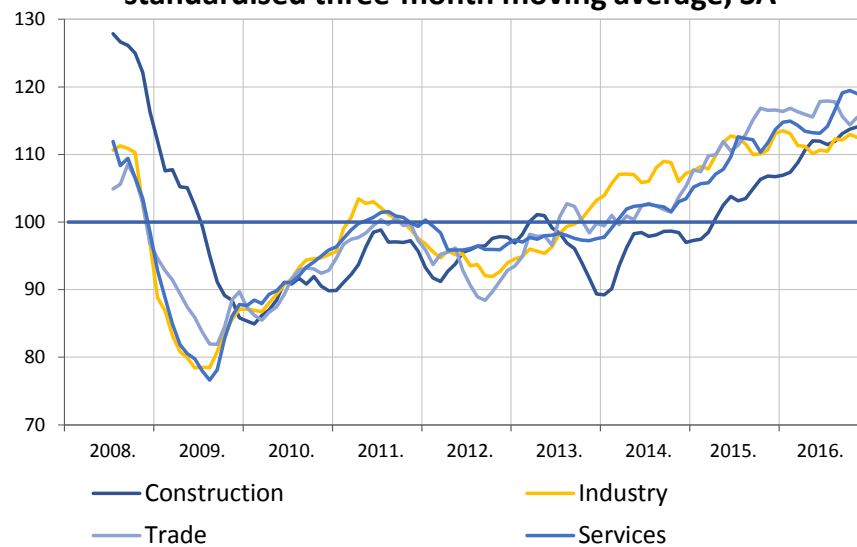
# Confidence indicators close to all-time high

**HR consumer confidence and economic sentiment, standardised three-month moving average, SA**



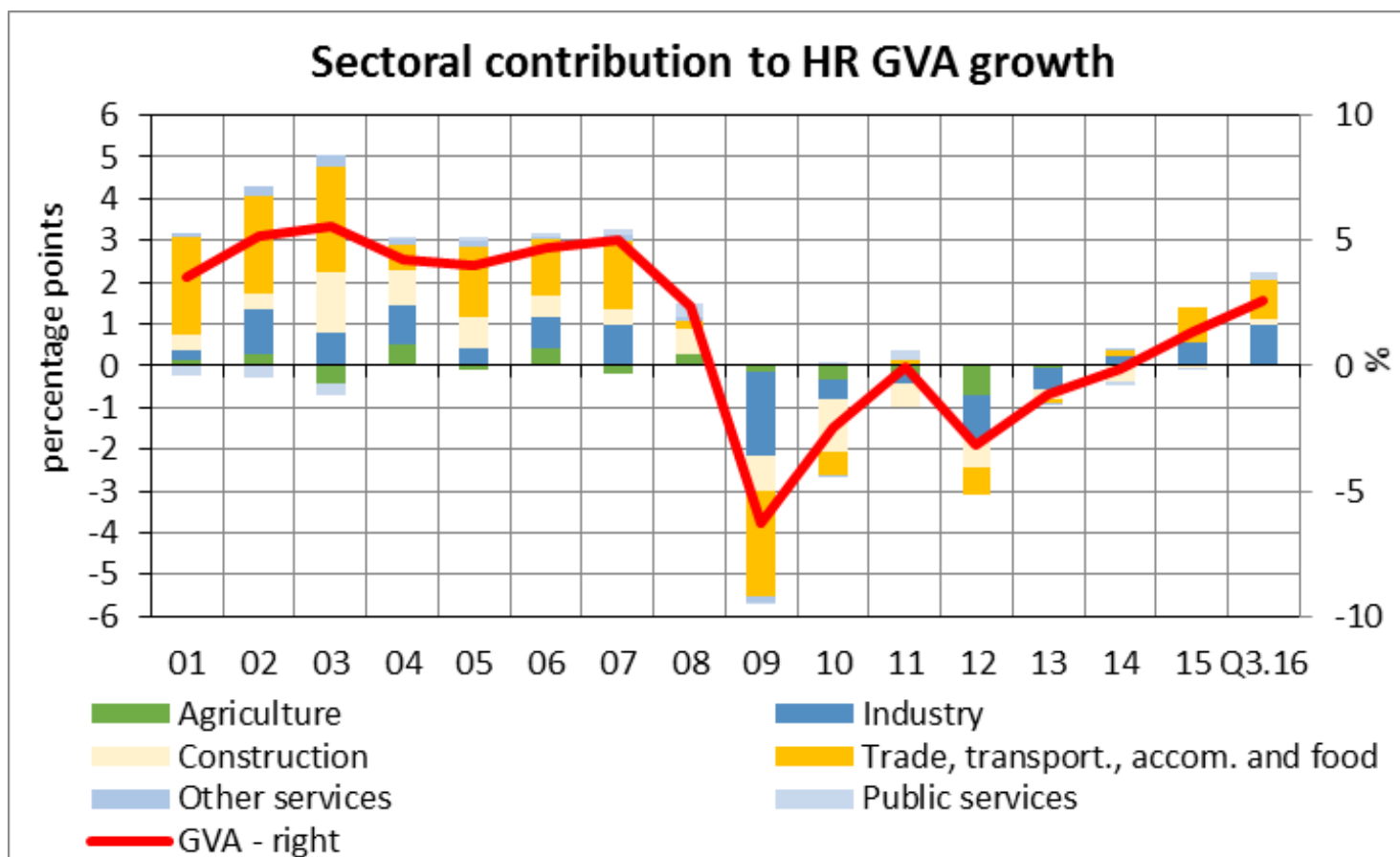
Source: IPSOS, CNB

**HR business confidence indicators, standardised three-month moving average, SA**



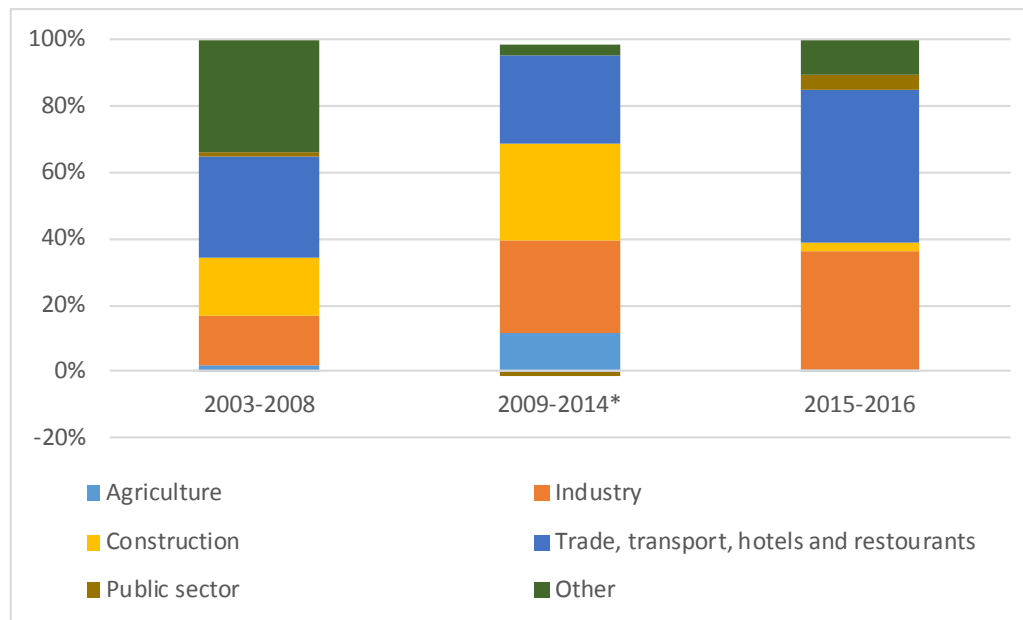
Source: IPSOS, CNB

# Drivers of growth similar to pre-crisis period – Construction, Trade, Tourism!



Source: Eurostat, CNB

# ... And in relative terms even more important than before the crises

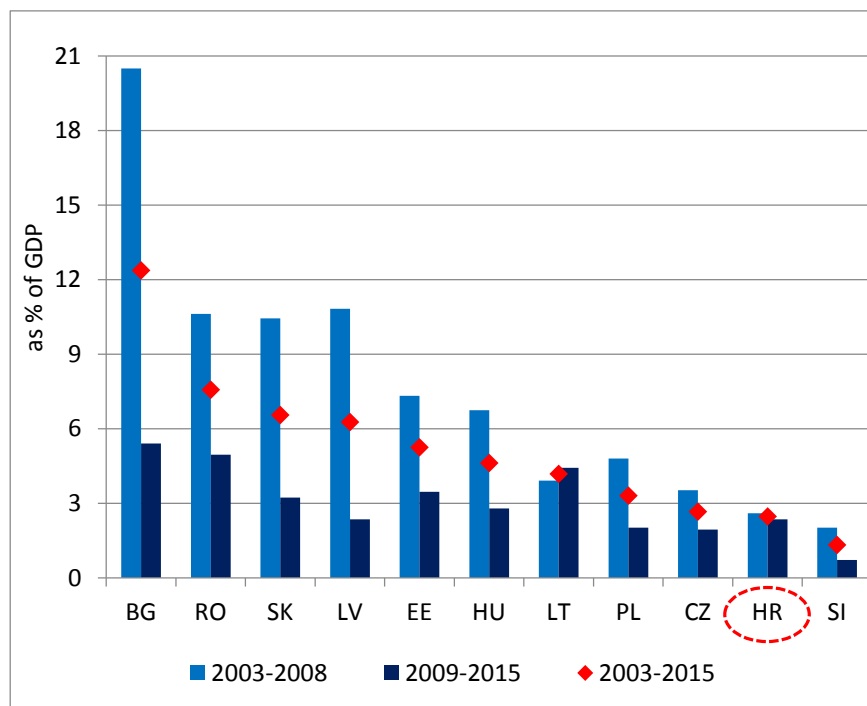


\*Average gross value added in this period was negative with negative contribution coming from all sectors



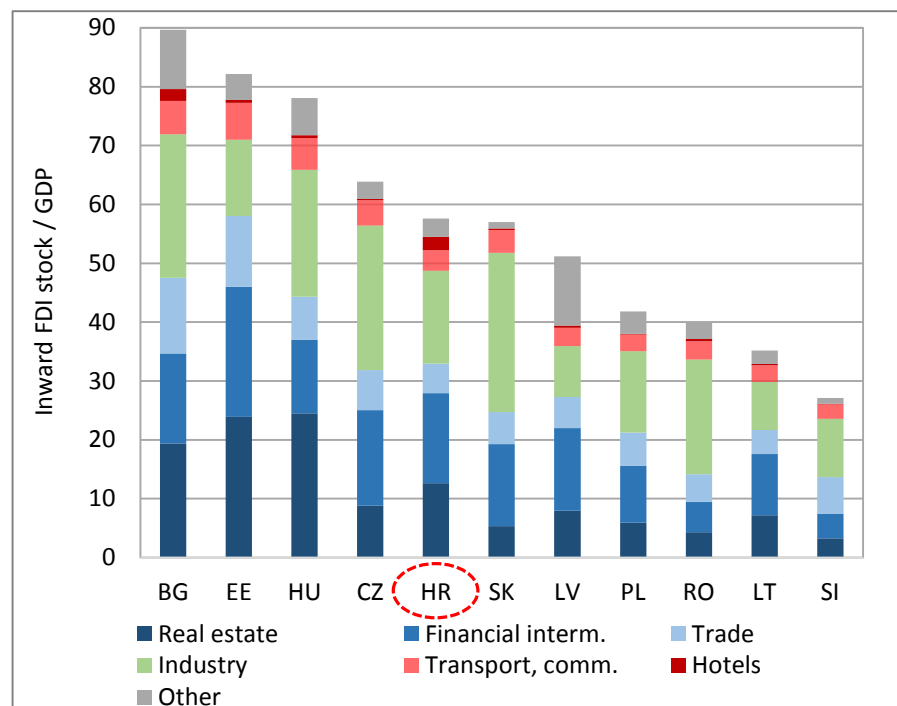
# Although stock of FDI is relatively high, *greenfield* and FDI in industry are modest in Croatia

## Greenfield investment projects, annual average



Source: UNCTAD, World Investment Report 2016

## FDI composition by sectors, inward FDI stock at the end of 2014



Note: Data for Slovakia refer to the end 2013. Industry includes mining and quarrying, manufacturing, electricity, gas and water supply.

Source: WiiW

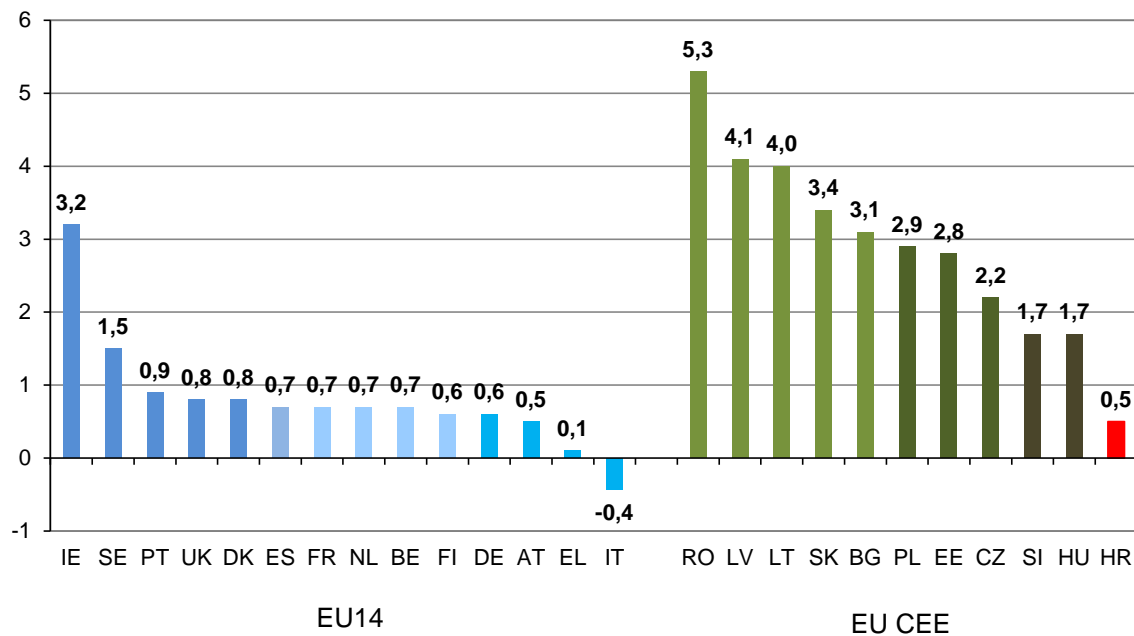
## Potential GDP growth – still significantly lower contribution of TFP compared to peers

	Potential output growth rate	TFP contributions to potential output growth rate
<b>Bulgaria</b>		
2003-2008	5,36	2,22
2008-2012	0,82	-0,01
2013-2015	1,66	0,63
<b>Czech Republik</b>		
2003-2008	3,60	2,51
2008-2012	1,15	0,71
2013-2015	1,89	1,11
<b>Croatia</b>		
2003-2008	3,12	0,70
2008-2012	-0,74	-0,45
2013-2015	-0,15	-0,22
<b>Hungary</b>		
2003-2008	2,53	1,06
2008-2012	0,40	-0,15
2013-2015	1,83	0,18
<b>Poland</b>		
2003-2008	4,02	1,94
2008-2012	4,01	0,98
2013-2015	2,77	0,95
<b>Romania</b>		
2003-2008	4,92	3,83
2008-2012	0,83	0,06
2013-2015	2,46	2,20

Source: ESCB

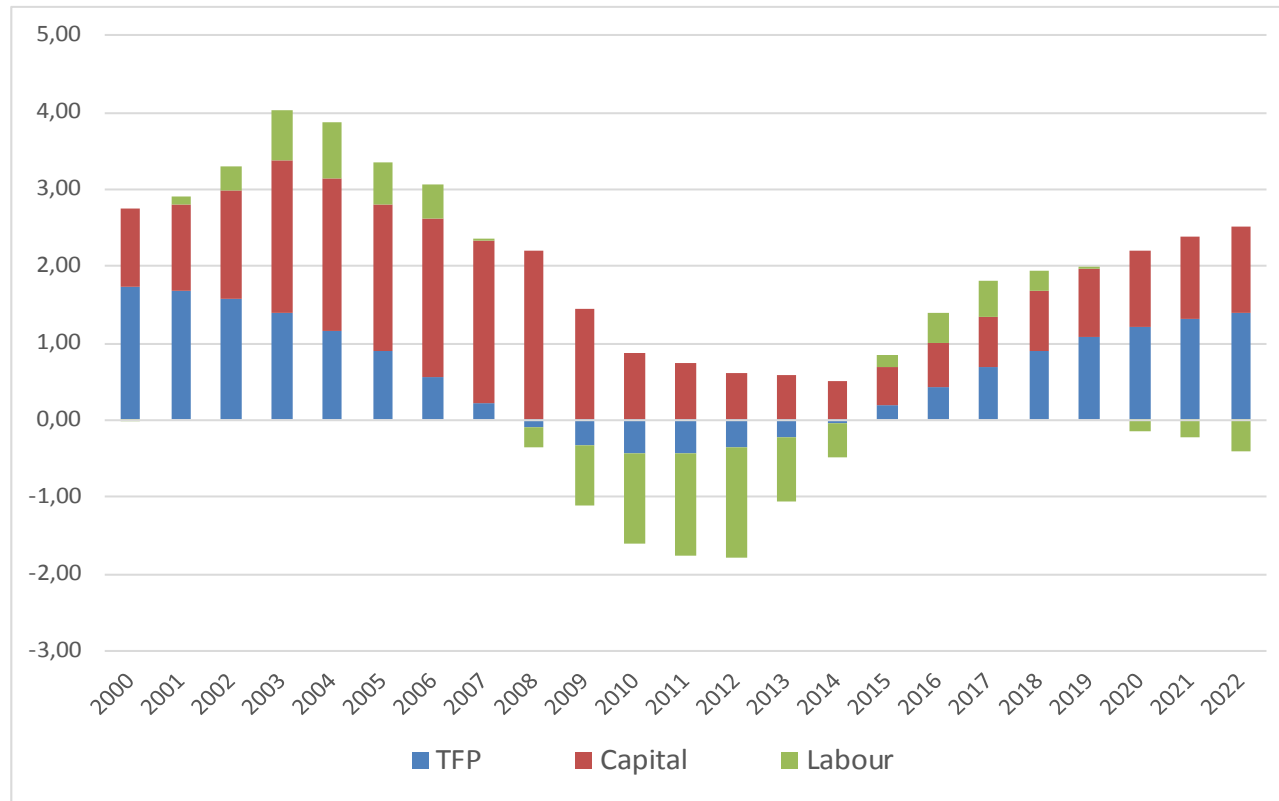
# Also dismal labour productivity performance

Labour productivity growth, 2002–2015 average of annual rates of change

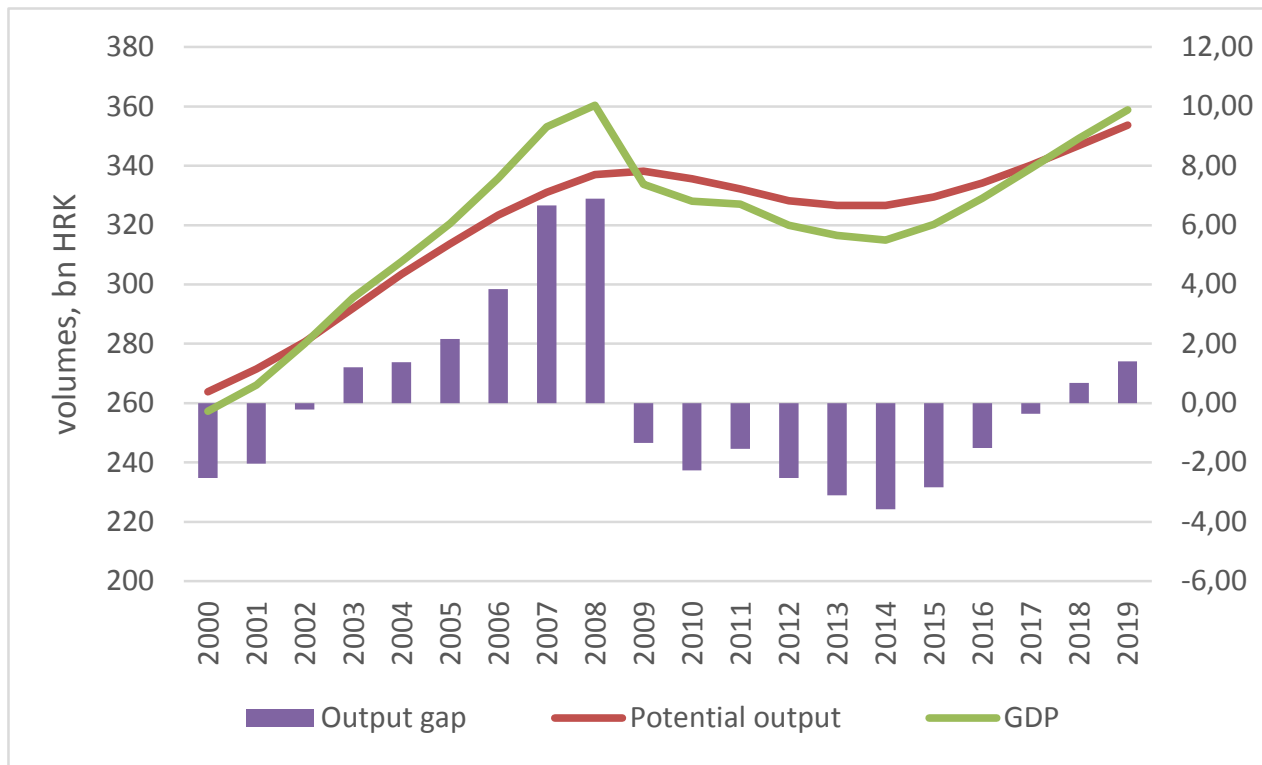


Izvor: Eurostat

# Potential output growth modest even under acceleration of the TFP growth



# Output gap is closing



# What to do to improve growth and resilience?

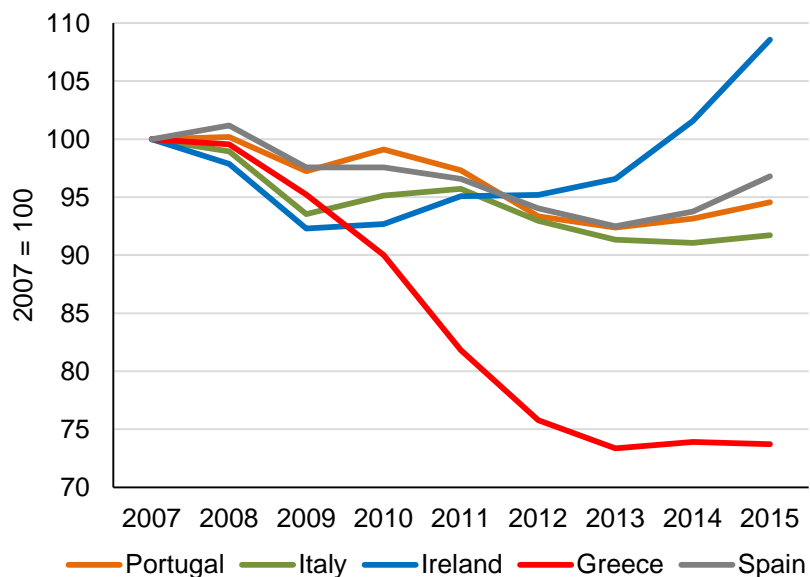
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- First how come some countries recover soon and other are hit much more hard by the crisis?
- Second, How to increase medium-term growth prospects?

# Why some countries recover sooner than others – GIIPS

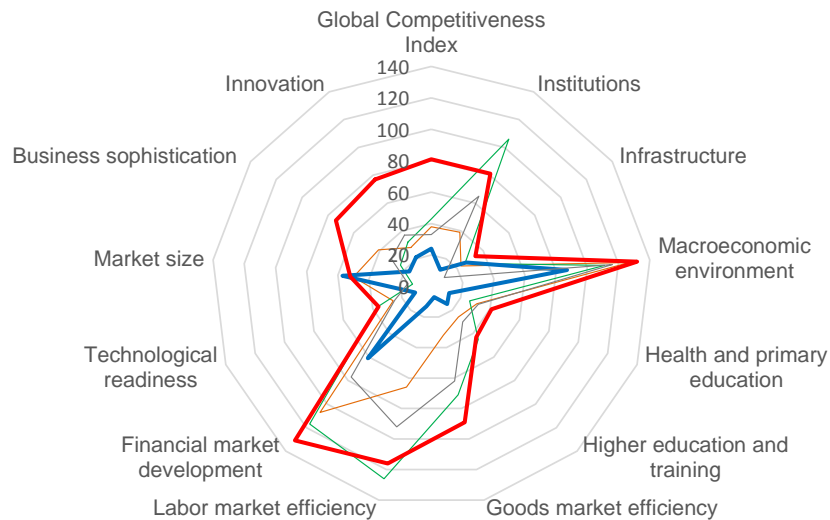
## The fastest post-crises recovery in Ireland...

Real GDP



Source: Eurostat

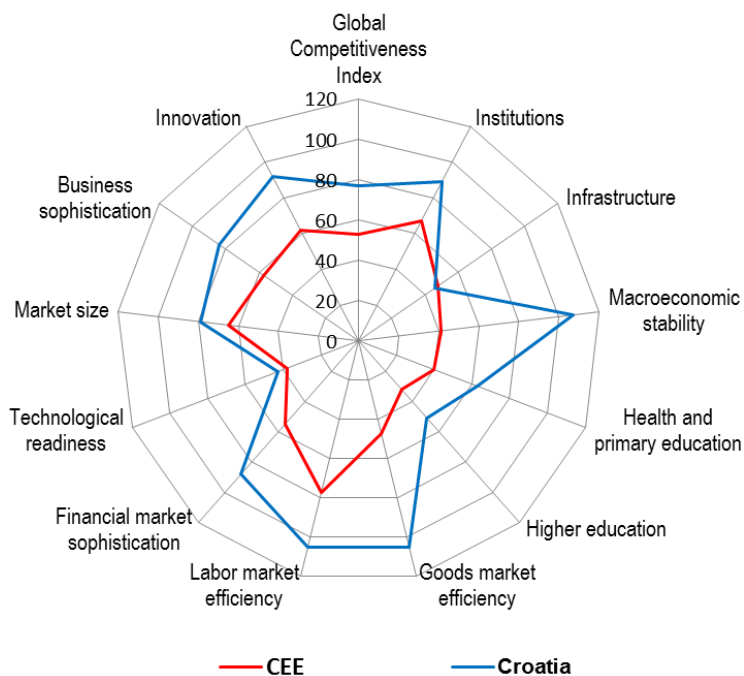
... could be explained by a relatively good initial position



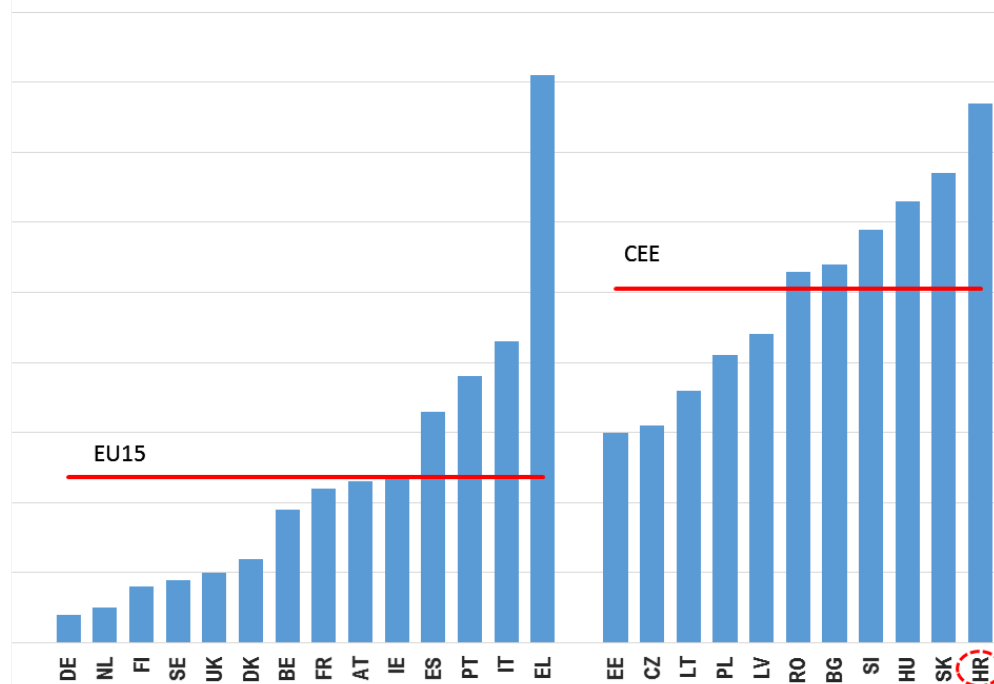
Portugal Italy Ireland Greece Spain

Note: Lower ranking indicates that country is more competitive.  
Source: World Economic Forum, Global Competitiveness Report 2015–2016

# Global Competitiveness Report



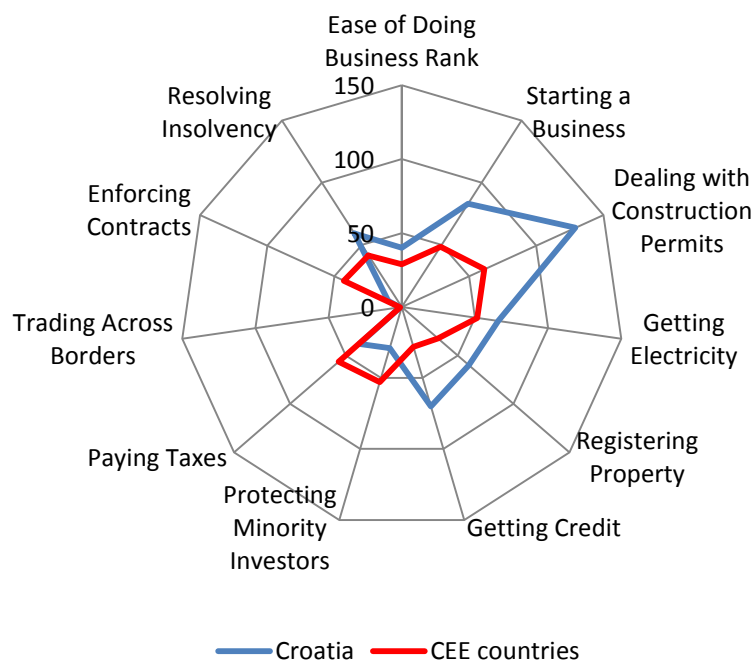
Global Competitiveness Index



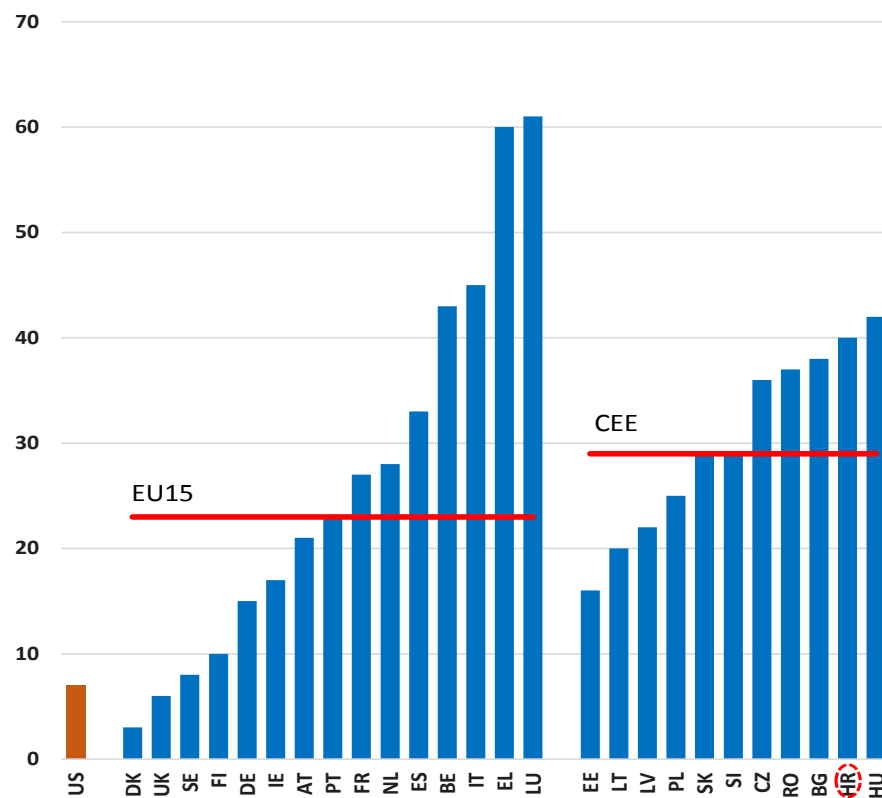
Note: High ease of Global Competitiveness Index (a low numerical rank) means higher degree of competitiveness. EU-15 stands for average of “old” EU member countries. CEE includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.  
 Source: World Economic Forum, Global Competitiveness Report 2015–2016



# Doing Business Indicator



**Ease of doing business**

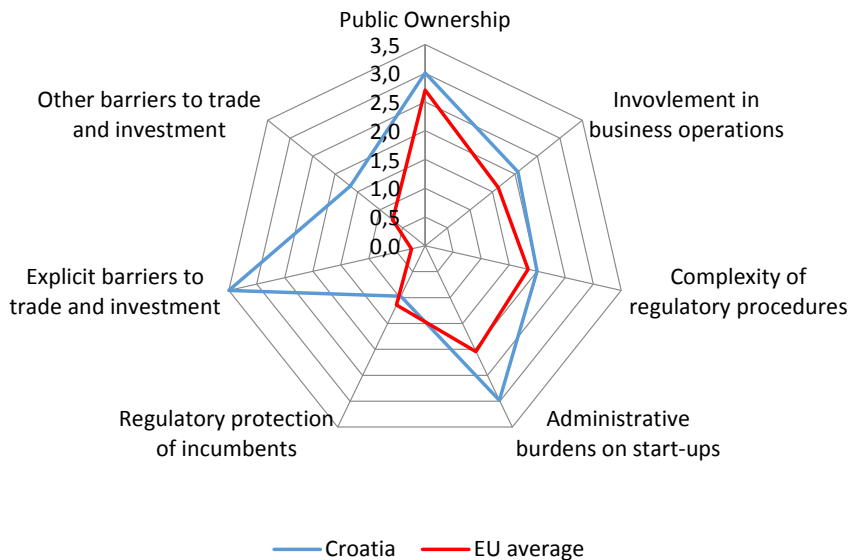


Note: A high ease of doing business (a low numerical rank) means that the regulatory environment is conducive to business operation. EU-15 stands for average of “old” EU member countries.

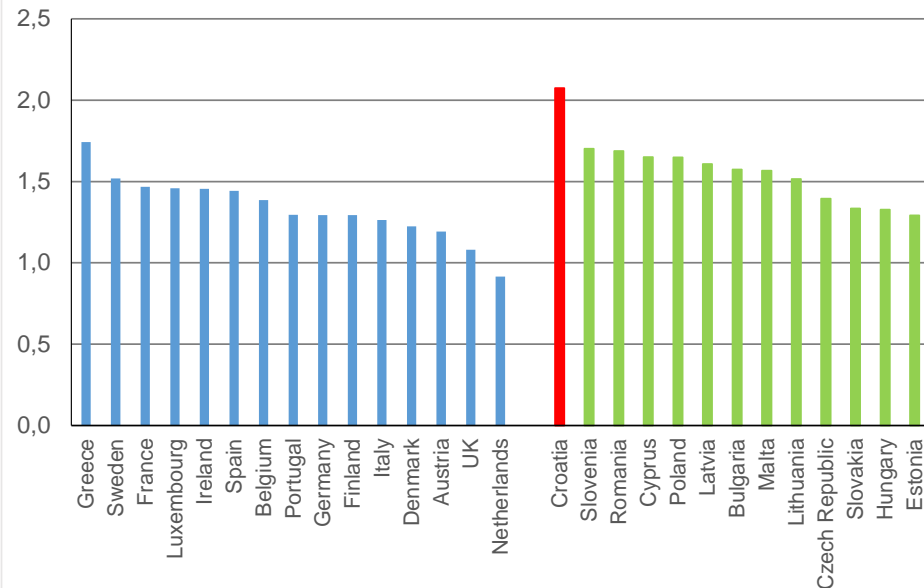
Source: World Bank, Doing Business 2016

# Product market regulation

PMR index components



PMR index, 2013



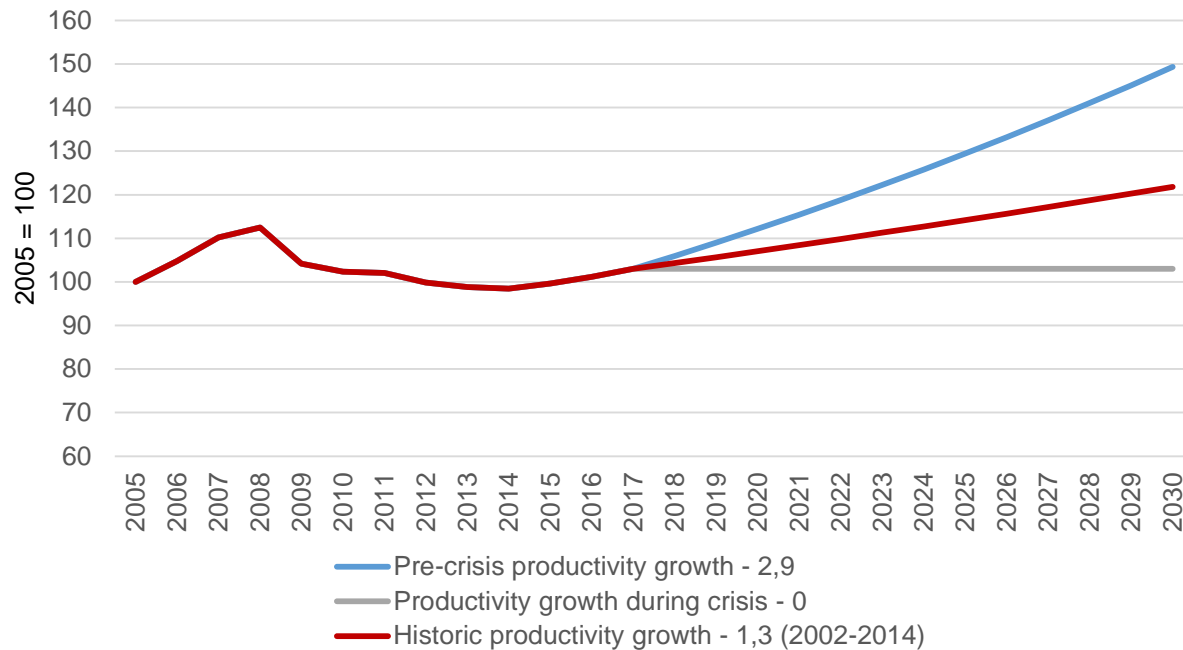
Note: Lower value of the index means that the regulatory environment is more conducive to business operation.

EU-15 stands for average of all EU member countries.

Source: OECD, Indicators of Product Market Regulation, 2013

## ... means low growth perspective

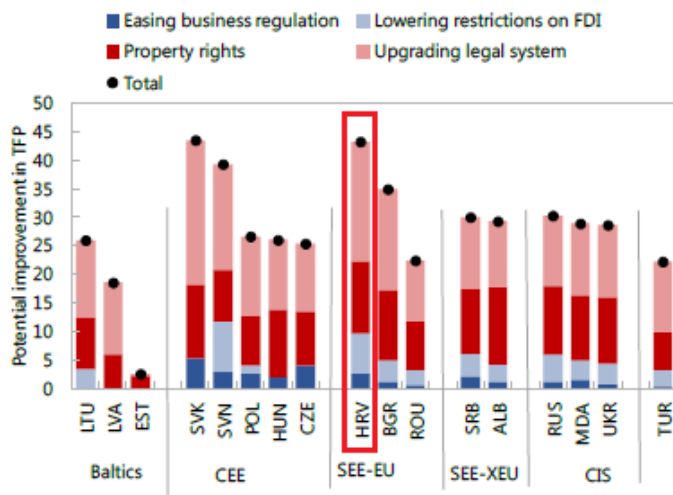
How much would GDP grow with constant employment and historic productivity growth?



Source: HNB

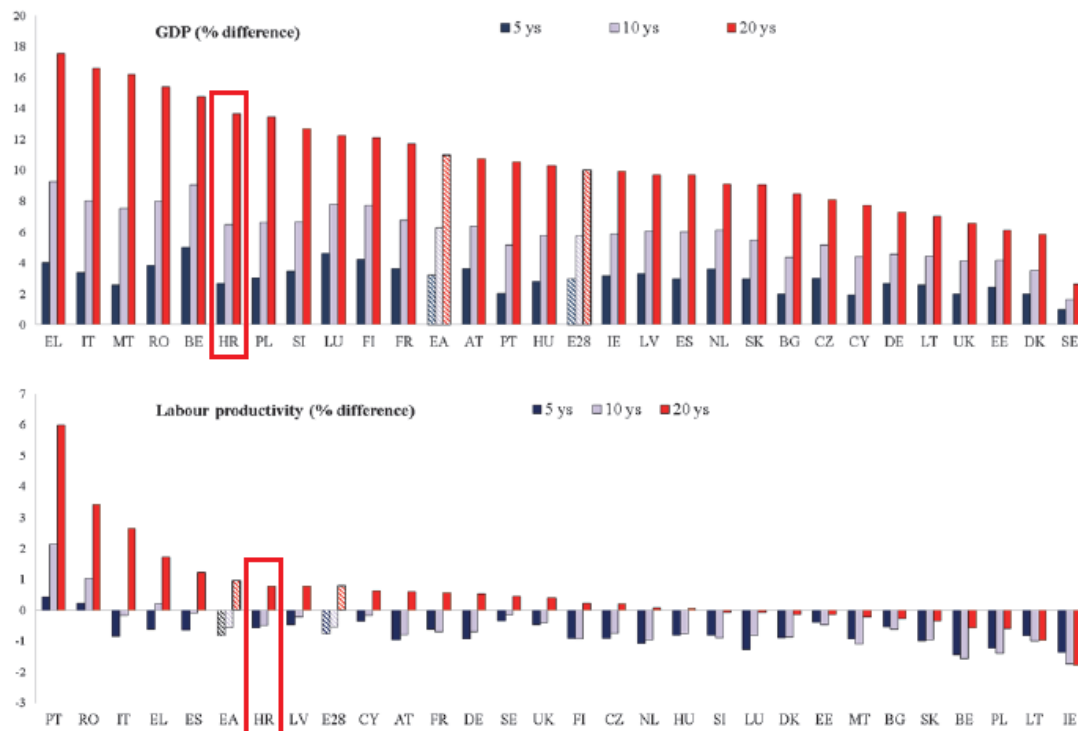
# IMF and EC consider that Croatia is one of the top gainers from structural reforms

Figure 2.18. Potential Efficiency Gains From Structural Reforms (Percent)



Source: IMF, CEESEE Economic Issues, May 2016

Figure 1: Macroeconomic impact structural reforms: Stand-alone reforms <sup>(1)</sup>



Source: EC (2014) The potential growth impact of structural reforms in the EU

# If all it takes is more structural reforms, where is the problem?

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- ❑ Implementation of structural reforms limited to those required by the EU?
- ❑ Even some low hanging fruits are not being picked.
- ❑ Who benefits from the non implementation of structural reforms (politicians, business)?
- ❑ What are the short run impacts of structural reforms?

# Structural reforms that ease business operations

Table 1. Summary of the legal provisions analysed by sector

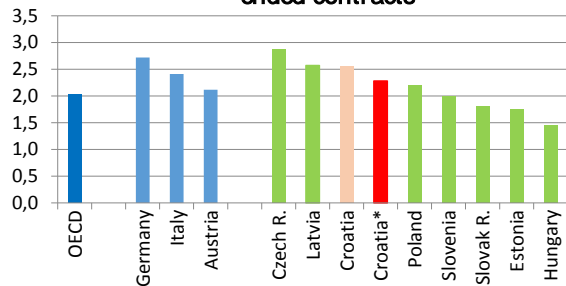
	Food processing	Retail trade	Building materials	Tourism	Horizontal legislation	Total
Recommendations made	54	129	32	76	38	329
Administrative burden	1	15	1	19	4	40
No recommendations for change	45	66	13	37	25	186
<b>Total</b>	<b>100</b>	<b>210</b>	<b>46</b>	<b>132</b>	<b>67</b>	<b>555</b>

Source: OECD analysis.

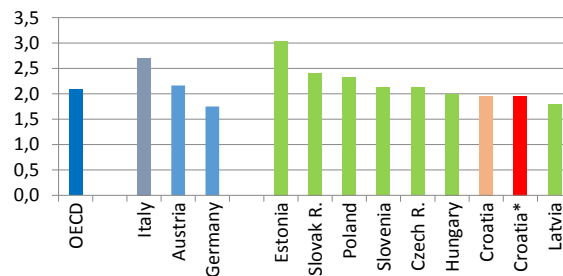
- example from OECD Competition Assessment Review of Greece (2013)

# Example of a structural reform in Croatia: Labour Act

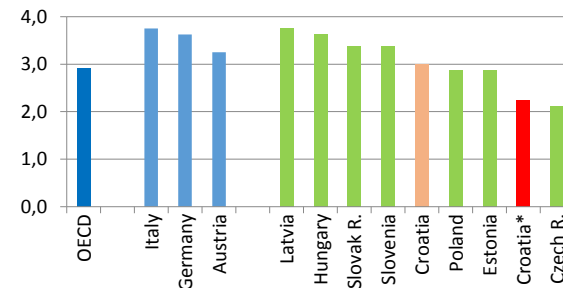
Employment protection for regular open-ended contracts



Employment protection for temporary contracts



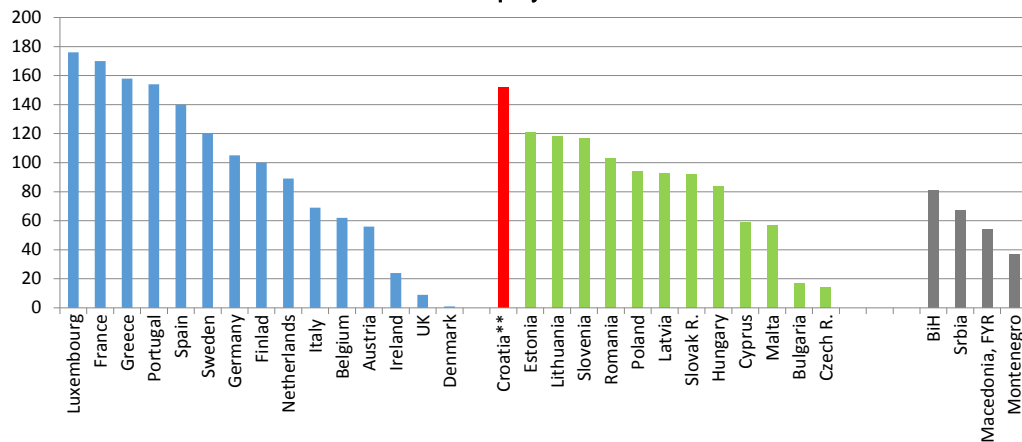
Employment protection for collective dismissals



Note: The value of 4 denotes extremely rigid and 0 extremely flexible labour legislation.

\*Including new Labour Act (2014)

Ease of employment index

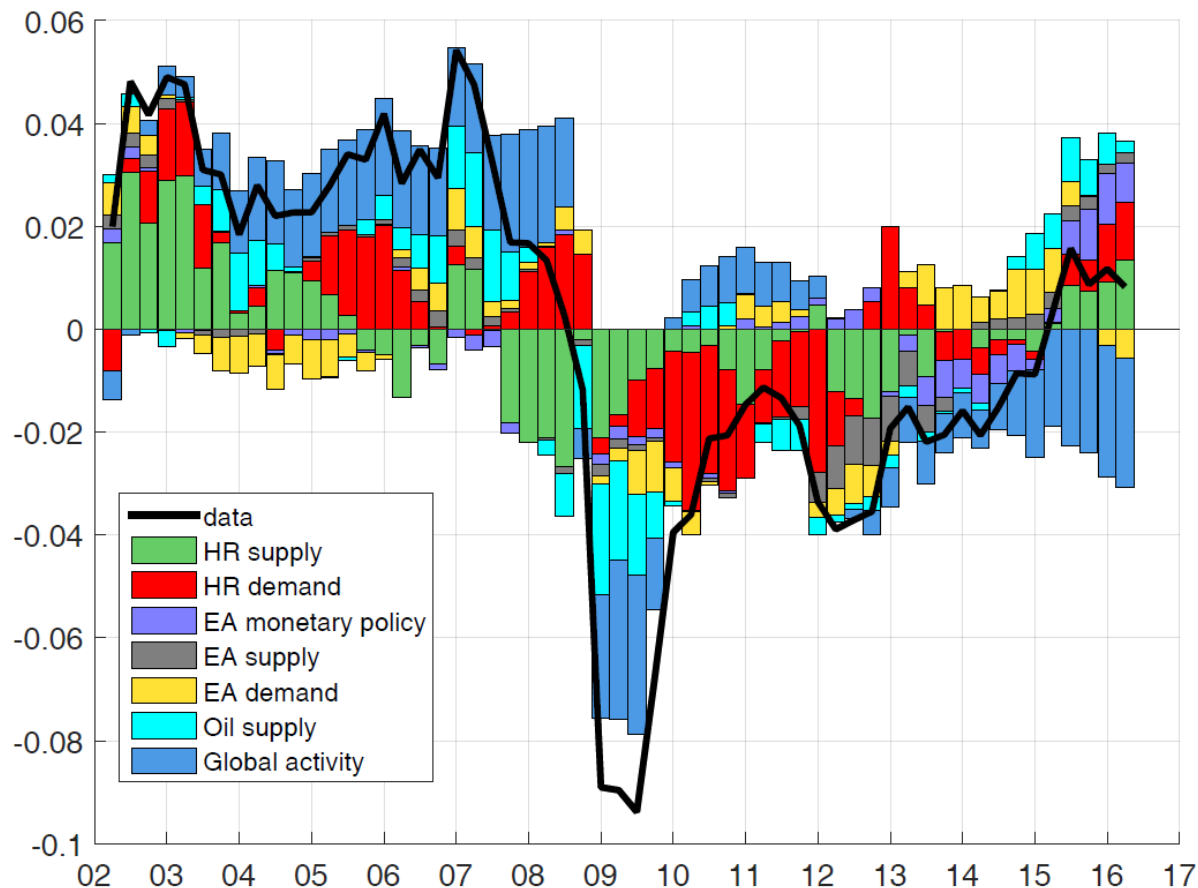


Note: Lower ranking indicates that country has a more flexible labour legislation.

\*\*Including only amendments to Labour Act (2013)

Source: CNB (2014)

# Results of VAR analysis – deviation from the long-term baseline projection



Source: CNB



# To recap

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- Growth of the Croatian economy is accelerating after deep prolonged recession
- Something has changed in the performance of the Croatian economy, visible in export performance and correction of imbalances
- Cyclical factors also important, but it is yet hard to tell the exact magnitude
- How to escape low potential growth compounded by unfavourable economic structure and weak pre-crisis growth fundamentals

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Thank you!