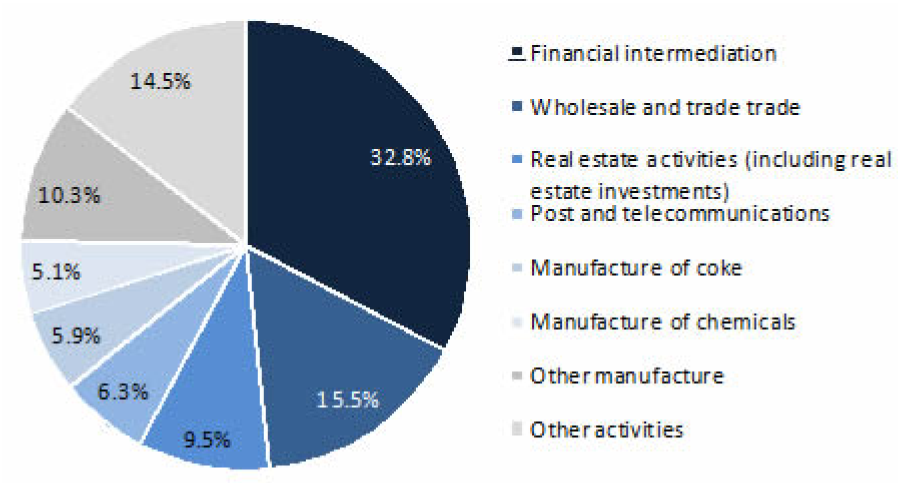
EU accession to activate Croatia’s competitive advantages - manufacturing FDIs and structural reforms are major tasks ahead

- **Challenge to attract FDIs especially into productive sectors that are crucial for job generation, exports and sustainable growth**
- **Tourism is a safe bet, high expectations from energy and transportation sectors – however structural reforms must be the number one priority**
- **CEFTA exit would likely weigh on export performance on short term, but EU membership offers access to strong and competitive market**
- **Croatia was allocated EUR 11.7bn in EU funds but a significant impact on the economy is only expected in the mid run**
- **EU membership set to be key anchor to fiscal stability, resulting in improved environment for investors**

Croatia is set to join the European Union on 1 July 2013, at a time when both are struggling to kick-start the economy. However, Erste Group’s special report “Croatia: success story despite hard times?” published today finds that EU entry is a good catalyst for reviving the country’s growth potential. “After prolonged growth problems over the last years, it is no surprise that there are optimistic expectations when it comes to the benefits of EU membership. Although the achievements of previous enlargement rounds seem a demanding target to match, Croatia has several competitive advantages, such as its geographical position, underused tourism potential, well-developed road infrastructure and an emerging energy sector. Provided that it plays well the cards it was dealt and accelerates reforms, we expect EU membership to activate these advantages in the mid-run," explains Alen Kovac, Chief Economist of Erste Bank Croatia.

FDI structure (cumulative annual flows 1993-2012)



Source: CNB, Erste Research

Intensified capital flows related to EU membership are seen as an important channel to foster new growth opportunities via fresh capital, know-how transfer and access to new markets. FDI inflows in Croatia were substantial over the last decade. However, Croatia trailed its CEE peers in terms of the structure of these investments, with services dominating, while manufacturing FDIs remained very scarce. While this definitely supported the robustness of the banking sector for example, manufacturing, job generation and exports were less buoyant. Thus the challenge will be to start the same growth pattern as in other countries of the region: encouraging FDIs especially into productive sectors and then developing more tradable goods which can be exported. Furthermore, the acceleration of the privatization process, which is emphasized as one of the government targets, would ensure fresh capital, higher efficiency and know-how transfer.

Tourism is a safe bet, high expectations from energy and transportation sectors – however structural reforms are major task ahead

While sector picking is difficult, Erste analysts see tourism as the one to attract solid interest, amid a robust tourist performance since the outbreak of the crisis and still available unutilized potential. Transportation also looks promising, given the strong comparative geographical advantage. Furthermore, the well developed road infrastructure allows for more room for maneuver in terms of EU funds to focus on other infrastructure, most notably railways and ports. Agriculture and food processing remain dependent on economies of scale, where government efforts to increase the utilization of state-owned uncultivated land are a step in the right direction. There is a lot of hype regarding the energy sector, with the goal of import substitution. To give all of these sectors a boost structural reforms are the major task ahead.

A more business-friendly enviroment is a must in order to attract new investors. “By international benchmarks such as the Global Competitiveness Index, Corruption Perceptions Index or Ease of Doing Business ranking, Croatia scores lower versus its regional peers. Problems are particularly manifest in terms of the public sector size and efficiency, rigid labor market legislation and weak investor protection. There is no alternative to accelerating reforms, and we see encouraging signals on the ground as policy-makers recognize they need to step up reforms. This is the right moment to improve the business climate, eliminate investment bottlenecks and win investors’ trust,” highlights Alen Kovac.

CEFTA exit would likely weigh on export performance on short term, but EU membership offers access to strong and competitive market

On the cusp of a new chapter opened by EU membership, an additional important factor is the fact that Croatia would exit the Central European Free Trade Agreement (CEFTA). This will result in a loss of competitiveness on the CEFTA market, in terms of trading with Bosnia & Herzegovina and Serbia, due to increasing customs duties.

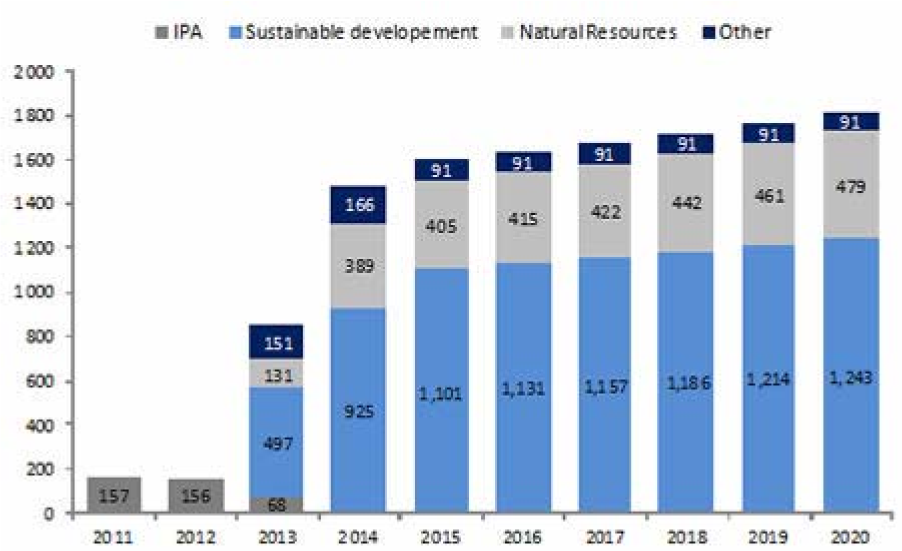
“We expect some short-term negative effects from exiting CEFTA markets, but the EU market, with its 500 million people, is offering more potential in the mid-run. Additionally, EU membership would put competitive pressure on domestic production amid intensified imports from the EU, which will hopefully drive efficiency gains, but will also imply a demanding operating environment for a large number of companies,” points out Alen Kovac.

Croatia major exports partners	2008	2012	Cumulative GDP growth 2008-2012
Top 10 countries:	**71.8%**	**67.3%**	
Italy	19.2%	15.3%	-5.8%
Bosnia and Herzegovina	15.3%	12.8%	-0.5%
Germany	10.7%	10.3%	2.6%
Slovenia	7.8%	8.6%	-8.3%
Austria	5.8%	6.5%	1.7%
Serbia	5.5%	4.3%	-2.7%
Russian Federation	1.3%	3.7%	0.3%
Hungary	2.4%	2.5%	-5.7%
Netherlands	1.3%	1.7%	-2.2%
United Kingdom	2.4%	1.6%	-1.0%
Total CEFTA:	**23.5%**	**21.0%**	

Source: CBS, Eurostat

The total funds available for Croatia in the period 2014-20 will amount to EUR 11.7bn (approx. 25% of 2013e GDP). Contracting and spending such considerable amounts is definitely important for the country's growth potential in the mid-run. However, Croatia's track record in the implementation of the IPA pre-accession funds has often been criticized as mediocre. Coupled with the fact that, at the beginning of the programming period, contracting and payments are usually somewhat slower and pick up after approximately a year, it seems that Croatia could expect a more significant impact from the EU funds only in the mid term. This means that it needs to strenghten the institutional framework and accelerate structural reforms if it is to fully reap the benefits of the significant EU funds it was allocated.

EU programs in Croatia – 2011-2020
(EUR mn)



Source: Erste estimate based on the Revised IPA MIFF 2012-2013, Proposal of the EU Multiannual Financial Framework 2014-2020 of 6 July 2012 and conclusions of the European Council of 8 February 2013.

EU membership set to be key anchor to fiscal stability, resulting in improved environment for investors

Once it joins the EU, Croatia faces the activation of the Excessive Deficit Procedure (EDP) on the basis of a budget deficit in excess of 3% of GDP, though the public debt trajectory also rings alarm bells with respect to the 60% of GDP threshold. While some may argue that EDP activation would deliver negative signals, Erste analysts see the EDP as more of an opportunity. The implied call for corrective action and for Croatia to pursue mid-term fiscal consolidation may be perceived as quasi-IMF, in the sense that it should support fiscal policy soundness and ensure more commitment to fiscal targets.

Furthermore, Croatia will have to comply with The Reinforced Stability and Growth Pacts, in the form of the six-pack, which set the stage for additional fiscal measures, but also macroeconomic and surveillance actions, with the focus shifting away from nominal targets towards structural ones.

"An important pillar of the EU six-pack is the debt reduction rule demanding excess debt to be reduced by 1/20, which practically implies stabilizing the currently upward-leaning public debt trajectory. All in all, the six-pack will be a key anchor to fiscal stability in the mid run, resulting in a less risky environment for investors”, concluded Alen Kovac.

Special Report [pdf; 614.9 KB]