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CROATIA'S CHALLENGE: SWITCHOVER TO EXPORT-LED ECONOMIC DEVELOPMENT

Introduction

Croatia is scheduled to join the European Union (EU) in 2013. After the system change in the early 1990s, in the same way as other post socialist countries, Croatia has implemented liberalization, stabilization and privatization in accordance with prescriptions by the IMF based on the Washington Consensus. Since 2000, apparently the Croatian economy was steadily developing, but in the same way as with other countries in the Western Balkans, it was consumption-led economic development which was primarily financed by foreign savings. The 2008 global financial crisis revealed how Croatia's economic development heavily relying on foreign capital was vulnerable to external shocks. This paper discusses why Croatia's model of economic development has become unsustainable, focusing on the chronic deficit in the current account balance. Taking the shipbuilding industry as an example, the necessity for export-led development is discussed.

Chronic Deficit in the Current Account Deficit

From the balance of payments in 2005–2010 we can find the following characteristic points. Firstly, Croatia has continuously recorded a deficit in goods trade with the export/import ratio being around 50 percent. Its trade balance deficit reached over 20 percent of the GDP (21.2 percent in 2007 and 22.7 percent 2008). Looking at the breakdown of the trade balance, although a huge amount of deficit in goods trade has been substantially covered by surplus in service trade, the trade balance as a whole has recorded a deficit. The share of tourism has been predominantly large in the service trade. In this way, a huge amount of deficit in merchandized trade balance has been compensated mainly by revenues from travel (tourism) and current transfer. Still the country has been recording considerable amount of current account deficit every year, with it reaching 9.2 percent of GDP in 2008. Although deficits in the trade balance and the current account decreased considerably in 2009 and 2010 under the influence of the global financial crisis, the improvement in both accounts seems to be only temporary.

Secondly, the amount of financial account has been rather large, of which a substantial amount of direct investment has been recorded every year. In 2007, net FDI inflow reached

8.1 percent of GDP, well beyond the current account deficit in that year. In 2010, however, due to the influence of the global financial crisis net FDI inflow drastically decreased to only 17 percent of the level recorded in 2007 (it was only 1.3 percent of the GDP).

Thirdly, during the period 2005–2010 portfolio investment shows a sharp fluctuation in amount, but its absolute amount has been small compared with FDI. The amount of financial derivatives has been negligible.

Croatia's external deficit as percentage of GDP reached 85 percent at the end of 2003, an almost unsustainable level. The report of the World Bank Development Finance 2005 degraded Croatia to a „severely indebted middle-income country"[1] from a „moderately indebted middle-income country". This ratio reached almost 100 percent (98.5 percent) in 2009. In order to grasp the actual situations of the chronic trade deficit, let us examine the structure of exports and imports.

Structure of Exports and Imports and a Decline in International Competitiveness

In 2005 food and feed, agricultural raw materials, and ore and metals account for 10.5 percent, 3.4 percent and 3.8 percent of total Croatian exports respectively. The share of fuels in total exports was rather high and increased from 9.2 percent in 1996 to 13.9 percent in 2005[2]. All manufactured products account for about 70 percent (72.4 percent in 1996 and 68.2 percent in 2005) of the total exports[3].

Let us now focus our discussion on foreign trade in manufacturing. Buturac[4] analyzes the structure of exports and imports of Croatian manufacturing during the period 1993–2007. According to him, in 2007 manufacturing of other transport equipment (mostly shipbuilding) has the highest share in total manufacturing exports of (12.6 percent), followed by manufacture of coal, refined petroleum products (10.7 percent), manufacture of chemicals and chemical products (9.7 percent), manufacture of machinery and equipment n.e.c. (8.3 percent) and manufacture of food products and beverages (8.1 percent). In the same year the highest shares in total imports were occupied by the three sectors of manufacturing: manufacture of chemicals and chemical products (11.9 percent), manufacture of machinery and equipment (11.8 percent) and manufacture of motor vehicles, trailers and semi-trailers

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[1] The World Bank criterion for a country being „severely indebted" is that either the debt to GDP ratio is above 80 percent or that the ratio of debt to exports of goods and services is above 220 percent. Either condition is sufficient. The case of Croatia corresponds to the former: H. Vidovic, V. Gligorov: *Croatia: Growth Slowdown and Policy Alternatives*, wiiw Research Reports, No.324, 2006, p. 23.

[2] Croatia produces natural gas and crude petroleum, but cannot satisfy domestic needs. The country has been importing them from foreign countries. However, as Croatia was placed as a base for refining gas and petroleum during the former Yugoslav era, it has more than enough refining capacity. Now the country imports natural gas and crude petroleum well over its domestic needs and exports refined gas and petroleum to neighboring countries.

[3] *Western Balkan Integration and the EU: An Agenda for Trade and Growth*, ed. S. Kathuria, World Bank, 2008, p. 40.

[4] G. Buturac: *Structural Characteristics of Exports and Imports of Croatian Manufacturing*, "Ekonomski Pregled", 60 (9–10), 2009, p. 432–457.

(10.8 percent). These sectors account for one third of total manufacturing imports. Looking at changes in export structure from 1993 and 2007, the greatest changes were recorded by manufacture of clothing. The share of this activity of the total import of manufacturing decreased by 13.7 percentage points from 17.3 percent in 1993 to 3.5 percent in 2007. Next to the manufacture of clothing, tanning and dressing of leather and manufacture of luggage, and the manufacture of chemicals and chemical products decreased significantly during the same period by 10.1 percentage points and 3.3 percentage points respectively. It is manufacture of other transport equipment that greatly increased its share in the total manufacturing exports during the same period. This activity increased its share by 8.9 percentage points, followed by manufacture of machinery and equipment n.e.c. (4.8 percentage points)[5].

Buturac analyzes the export competitiveness of manufacturing, using the Lafay index (LFI). Concerning the share in the export structure and value of the LFI index, the shipbuilding industry is the most important, followed by manufacture of petroleum products and manufacture of electrical machinery and apparatus n.e.c.[6]

According to Vidovic and Gligorov, Croatian manufacturing exports to the EU increased only moderately between 1995 and 2002 and Croatian market share on the EU market (excluding intra-EU trade) declined significantly, from 0.42 percent to 0.29 percent[7]. This means that the international competitiveness of Croatian manufacturing has declined. Why has it declined gradually? The following reasons can be considered: Firstly, factors of the exchange rate regime. In the same way as Serbia, Croatia adopts the regime of managed floating, but it is in practice very close to Euro peg. As Jurcic and Vojnic point out, the exchange rate has been too high[8].

Secondly, there are factors on the supply side. As mentioned above, there has been a process of de-industrialization. Due to insufficient investment in manufacturing its technology has been lagging behind that of other countries, especially East Asian countries. In this connection, inadequate structure of FDI inflow should be mentioned. Let us look at the breakdown of the FDI stock by activities in order to find in which activities foreign investors have invested in. Financial intermediary occupies first place (53.2 percent), followed by manufacturing (23.0 percent), transportation, storage and communication (10.9 percent), wholesale, retail trade, repair of vehicles, etc. (5.3 percent), hotels and restaurants (2.7 percent), real estate, renting and business activities (1.8 percent)[9]. According to Vidovic and

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[5] G. Buturac: *op.cit.*, p. 441–443.

[6] *Ibidem*, p. 444–445.

[7] H. Vidovic, V. Gligorov: *Croatia's Delayed Transition: Competitiveness and Economic Challenges*, wiiw Research Reports, No. 304, 2004, p. 30.

[8] Jurcic and Vojnic argue that the exchange rate has been too high for the Croatian economy, using indices of deviation of an exchange rate from a rate based on purchasing power parity: Lj. Jurcic, D. Vojnic, *Quo Vadis Croatia – Neke karakteristike momenta razvoja u svijetlu turbulentnih dogadjana u zemlji i svijetu – Kako dalje? – Hrvatska na putu Europsku uniju*, "Ekonomski Pregled" 2009, 60 (12), p. 766–767.

[9] G. Hunya, *FDI in the CEECs under the Impact of the Global Crisis: Sharp Declines*, wiiw Database on Foreign Direct Investment in Central, East and Southeast Europe 2009, p. 44.

Gligorov, in contrast to other transition countries, FDI was linked to privatization activities (two thirds of the total). Greenfield investment, which the government and business circles desired earnestly, has been negligible (only 16 percent of the total FDI stock). Although data is old (as of 2003), among manufacturing branches which attracted FDI the export-oriented branches are pharmaceuticals (Pliva), other non-metallic products (i.e. cement industry), food and beverages (Coca Cola), rubber and plastics and electrical and optical equipment (Siemens). The remaining branches are oriented toward domestic markets. Foreign investment enterprises account for only 16 percent of total Croatian export. The situation is quite different from Hungary, the Czech Republic and Poland where foreign investment enterprises have been the driving force behind their exports with the share of foreign investment enterprises in exports being 89 percent, 60 percent and 60 percent respectively[10].

Thirdly, due to ongoing globalization, products made in East Asian countries, especially China have been increasingly flowing into European markets. It is noteworthy that the labor cost in Croatia is not only the highest of all the countries in the Western Balkans, but also higher than even some new EU member states such as Bulgaria and Poland. Even after 2005 till Q2 2008 the unit labor cost in Croatia kept soaring.

Manufacturing industries incline heavily toward labor intensive industries. Textile and clothing industries in Croatia have been chased by counterparts in China and other Asian countries with their lower wages as a weapon, and the Croatian industries have had to fight in a tough game in European markets. Croatia finds itself in the „middle-income country's trap"[11].

Necessity for Export-led Economic Development: Case of Shipbuilding Industry

If Croatia continues to depend heavily on tourism, someday the country might face a danger of becoming a second Greece. It is urgent for Croatia to convert its model of economic development to that of export-led economic development with an emphasis on manufacturing industries. As labor costs in Croatia have already been substantially high, it is very difficult for Croatia to compete with Asian countries in the area of labor-intensive industries. There will be no way other than to compete in the area of more technology-intensive and knowledge-based industry. Among the manufacturing industries, shipbuilding has been the most important. This industry has a long tradition since the period of rule by the Austro-Hungarian Empire.

During the period of the former Yugoslav era, Croatia had 80 to 90 percent of the total production capacity of the whole shipbuilding industry. Now in Croatia there are 6 big shipyards, 14 medium-sized shipyards and 352 small-sized shipyards[12]. In the world shipbuilding

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[10] H. Vidovic, V. Gligorov: *Croatia's Delayed Transition...*, p. 15.

[11] *Western Balkan Integration and the EU...*

[12] I. Kersan-Skabic: *Brodgradnja u Europskoj Uniji i Hrvatskoj – Realnost i Izazovi*, Ekonomska Misao Praksa, God XVIII., Broj 2, 2009, p. 385.

deliveries, in 1989 former Yugoslavia recorded 503 thousand GT (Gross tons), occupying fourth place with its share being 3.5 percent (Japan occupied first place, followed by South Korea and West Germany). After 1990, however, the Croatian shipbuilding industry has been stagnating due to the fact that it lost an important market like the COMECON countries. In addition, as the Croatian economy declined due to wars resulting from the breakup of the Yugoslav Federation, the shipbuilding industry found itself in difficulties.

After the system change and independence, shipyards were transformed from socially-owned enterprises into state-owned joint stock companies. Although a part of their stocks were sold to private persons (including managers and employees of each shipyard), the state remains the majority stock holder. The Croatian shipbuilding industry gradually recovered and came to record deliveries of 765 thousand GT in 2004 with its share in the world shipbuilding deliveries being 1.9 percent. It has been producing mainly ships of medium complexity including tankers. In this segment, shipyards from the Far East are strong competitors.

Still, shipbuilding is a very important industry which earns 5 percent of the GDP, accounting for more than 11 percent of total exports of the country[13]. It employs 12,000 workers, and a further 35,000 jobs are directly linked to the industry. Of six big shipyards only the Uljanik (Pula) shipyard is profitable. It has been oriented to produce ships for special purpose, realizing positive results with a high level of technological development and rationalization of the number of employees[14].

The remaining shipyards are loss-making and continue their operations under the government's support[15]. State support (subsidy and state guarantee) as a percentage of GDP in 2006 and 2007 was 0.88 percent and 0.84 percent respectively. The EUn has tolerated state support of the shipbuilding industry in Europe to a certain extent in order to protect the shipbuilding industry in the EU from dishonest competition, which offers damping prices and maintain the level of shipbuilding activities in areas where the shipbuilding industry can be competitive in the present conditions. The 7th Directive of 1990 specifies forms of state support to the shipbuilding industry. There are two kinds of state support: support for production (operating aid) and support for restructuring. Support for production is fixed as a percentage of the contract price of a ship before obtaining support and the ceiling is established by a comparison between the most competitive shipyard in the EU and three competitors in the Far East[16].

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[13] G. Buturac, E. Rajh, I. Teodorovic: *Hrvatsko Gosdarstvo u Svijetlu Globalne Recesije*, "Ekonomski Pregled" 2009, 60 (12), p. 683.

[14] I. Kersan-Skabic: *op.cit.*, p. 386.

[15] The shipbuilding industry has been heavily supported by the state, with subsidies accounting for a massive 10 percent of any ship's contract prices. The accumulated losses were in excess of € 719 million as of February 2006 (Croatian Online, Wednesday Column – Croatia Business 3: Shipbuilding Part One, http://croatiaonline.blogspot.com/2006/02/wednesday-column-croatia-business-3.html). Accessed on December 5, 2010.

[16] I. Kersan-Skabic: *op.cit.*, p. 381.

Now the EU encourages horizontal support, rather than vertical support, which is directed to specific industries. Privatization of shipyards was a precondition for opening the negotiation on Chapter of market competition. Taking into account the fact that two Polish shipyards (Gdynia and Szczecin) were instructed by the European Commission to return subsidies, which they have received from the government even after the Polish accession to the EU, Croatian shipyards will no longer be able to rely on vertical support by the state.

There is an excessive production capacity in the shipbuilding industry worldwide. In addition, with cheap labor costs as a weapon, South Korea rapidly increased orders for ships at one time and China also does so in recent years. In 2003 the European Commission announced an important document LeaderSHIP 2015, a development strategy for the shipbuilding industry in the EU till 2015. The document points out the necessity to maintain position as a leader in the segment of complex and expensive ships (passenger ships and specialized ships) in order to survive competition in world shipbuilding arena. The Croatian shipbuilding industry must follow this line. The European Commission proposed the Croatian government a decrease in production capacity by 40 percent along with privatization and a decrease in state support.

In mid July 2009 the Croatian government made a decision to sell 5 shipyards for one kuna each, while for the Uljanik shipyard a specific model was prepared. After the European Commission accepted the specific model for the Uljanik shipyard, the Croatian government proposed that this shipyard should be privatized in such a way that 59.35 percent of the total stocks should be sold for 300 kuna for one stock while 25 percent should be held for sale to the employees under special conditions. Although 5 shipyards were to be sold for one kuna each, it is considered that the real prices which buyers must pay will amount to 20 to 40 million Euro as these shipyards have accumulated losses, credit obligations and restructuring plans[17]. In the face of the global financial crisis and subsequent recession, it has been difficult to find buyers[18] and it would take a time.

It is not sufficient for Croatia to invigorate the shipbuilding industry. It will be necessary for this country to bring up and develop some other manufacturing industries, which should be knowledge-based.

Conclusion

It is very important for Croatia to develop manufacturing industries, including shipbuilding. As we have seen, labor costs in Croatia are already notably high, and consequently, it is very difficult to for Croatia to compete with Asian countries in the area of labor-inten-

[17] *Ibidem*, p. 390.

[18] The government announced a tender on August 1, 2009 for the sale of its six shipyards. Since then, there has been a little progress, but due to the global financial crisis the government has not succeeded in the sale yet. *Emerging Europe Monitor*, October, December 2009 and other issues).

sive industries. Therefore, the country should endeavor to develop more technology-intensive and knowledge-based industries.

EU accession may compound Croatia's woes. Once inside the EU, it will not be able to subsidize shipbuilding industry, which has been one of the economy's mainstays. Perhaps, it will find a white knight, or strategic partners. But if not, the entire industry may disappear.

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Summary

Since 2000, apparently the Croatian economy was steadily developing, but it was consumption-led economic development, which was primarily financed by foreign savings. The 2008 global financial crisis revealed how Croatia's economic development heavily relying on foreign capital was vulnerable to external shocks. If Croatia continues to depend heavily on tourism, someday the coun-

try might face a danger of becoming a second Greece. It's very urgent for Croatia to switchover to export-led economic development and develop manufacturing industries, including shipbuilding.

WYZWANIE DLA CHORWACJI – PRZEJŚCIE NA GOSPODARKĘ ZORIENTOWANĄ NA EKSPORT

Streszczenie

Od 2000 roku chorwacka gospodarka stale się rozwijała, ale był to rozwój spowodowany konsumpcją, która była finansowana głownie przez kapitał zagraniczny. Globalny kryzys finansowy w 2008 roku ujawnił, jak bardzo rozwój gospodarczy Chorwacji, który opierał się na zagranicznym kapitale, był narażony na wstrząsy zewnętrzne. Jeśli Chorwacja nadal w dużym stopniu będzie uzależniona od turystyki, kiedyś kraj może stanąć w obliczu niebezpieczeństwa zostania drugą Grecją. Dla Chorwacji, przejście na gospodarkę zorientowaną na eksport i rozwój przemysłu wytwórczego, w tym przemysłu stoczniowego, jest sprawą priorytetową.