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

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Croatia at last out of the recession

- 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 ...
... And than suddenly back ahead of the peers?
Time to rejoice and celebrate?

- 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

- 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

HR capital and current account balance

Current account balance, % GDP

Source: CNB

Source: Eurostat
Withdrawal of EU funds intensified

*Sum of last four available quarters
Source: HNB
Competitiveness effect on EU markets

Croatia

NMS12

Source: HNB
Credit activity picking-up, but stil muted

Placements to households

Placements to corporates

Source: HNB
## Macroeconomic imbalances scoreboard – some progress

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

Source: Eurostat, CNB
Gaining speed on an old track? (i)

- 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)

- 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

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
Confidence indicators close to all-time high

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

- Consumer confidence indicator
- Economic sentiment index
- Long term average = 100

Source: IPSOS, CNB

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

- Construction
- Industry
- Trade
- Services

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 FDIs in industry are modest in Croatia.

**Greenfield investment projects, annual average**

**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

<table>
<thead>
<tr>
<th></th>
<th>Potential output growth rate</th>
<th>TFP contributions to potential output growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003-2008</td>
<td>5.36</td>
<td>2.22</td>
</tr>
<tr>
<td>2008-2012</td>
<td>0.82</td>
<td>-0.01</td>
</tr>
<tr>
<td>2013-2015</td>
<td>1.66</td>
<td>0.63</td>
</tr>
<tr>
<td>Czech Republik</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003-2008</td>
<td>3.60</td>
<td>2.51</td>
</tr>
<tr>
<td>2008-2012</td>
<td>1.15</td>
<td>0.71</td>
</tr>
<tr>
<td>2013-2015</td>
<td>1.89</td>
<td>1.11</td>
</tr>
<tr>
<td>Croatia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003-2008</td>
<td>3.12</td>
<td>0.70</td>
</tr>
<tr>
<td>2008-2012</td>
<td>-0.74</td>
<td>-0.45</td>
</tr>
<tr>
<td>2013-2015</td>
<td>-0.15</td>
<td>-0.22</td>
</tr>
<tr>
<td>Hungary</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003-2008</td>
<td>2.53</td>
<td>1.06</td>
</tr>
<tr>
<td>2008-2012</td>
<td>0.40</td>
<td>-0.15</td>
</tr>
<tr>
<td>2013-2015</td>
<td>1.83</td>
<td>0.18</td>
</tr>
<tr>
<td>Poland</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003-2008</td>
<td>4.02</td>
<td>1.94</td>
</tr>
<tr>
<td>2008-2012</td>
<td>4.01</td>
<td>0.98</td>
</tr>
<tr>
<td>2013-2015</td>
<td>2.77</td>
<td>0.95</td>
</tr>
<tr>
<td>Romania</td>
<td></td>
<td></td>
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<tr>
<td>2003-2008</td>
<td>4.92</td>
<td>3.83</td>
</tr>
<tr>
<td>2008-2012</td>
<td>0.83</td>
<td>0.06</td>
</tr>
<tr>
<td>2013-2015</td>
<td>2.46</td>
<td>2.20</td>
</tr>
</tbody>
</table>

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?

- 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

[Graph showing Real GDP from 2007 to 2015 for Portugal, Italy, Ireland, Greece, and Spain.]

Source: Eurostat

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

[Graph showing the Global Competitiveness Index for various factors such as Institutions, Infrastructure, Macroeconomic environment, Health and primary education, Higher education and training, Goods market efficiency, Labor market efficiency, Financial market development, Technological readiness, Innovation, Business sophistication, Market size.]

Note: Lower ranking indicates that country is more competitive.
Global Competitiveness Report

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.

Doing Business Indicator

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.
Product market regulation

PMR index components

- Public Ownership
- Invovlement in business operations
- Complexity of regulatory procedures
- Administrative burdens on start-ups
- Explicit barriers to trade and investment
- Regulatory protection of incumbents
- Other barriers to trade and investment

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

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?

- 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

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

Source: OECD analysis.

- example from OECD Competition Assessment Review of Greece (2013)
Example of a structural reform in Croatia: Labour Act

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

- 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
Thank you!