

Economist Intelligence Unit

Croatia at a glance: 2007-08 Updater: August 15th 2007

OVERVIEW

With the next parliamentary election due in November 2007, post-election attempts at coalition-building are likely to determine whether the next government is led by the centre-right, ruling Croatian Democratic Union (HDZ) or by the main opposition party, the centre-left Social Democratic Party (SDP). Although the SDP's popularity appears to have risen in sympathy for the death of its former leader, Ivica Racan, and also owing to the appointment of Zoran Milanovic as president, a recently formed centrist alliance is set to play a decisive role after the election as a third force in Croatian politics. There is an outside chance that the election results could contribute to the emergence of an unstable ruling coalition that is beholden to single-issue parties, minority representatives, regional groupings or even the far right to stay in power. Robust domestic demand growth will aid economic expansion in 2007-08 and, despite impediments to competitiveness, average annual real GDP growth will comfortably exceed 4%. The Economist Intelligence Unit forecasts that the current-account deficit will decline as a percentage of GDP in 2007-08.

Key changes from last month

Political outlook

Mr Milanovic has been appointed as the new president of the SDP following the death of Mr Racan, the former prime minister, from cancer in April. Mr Milanovic wants to attract a new generation of voters to the SDP. Ljubo Jurcic, a former economy minister, will be nominated as the party's prime ministerial candidate.

Economic policy outlook

Although Croatia has made encouraging progress in EU accession talks, the European Commission has affirmed that concerns over social spending, competition policy and state subsidies still present obstacles to Croatia's compliance with the *acquis communautaire* (the body of EU law).

Economic forecast

Industrial output has been on a strong upward trajectory in the year to April. We expect real GDP growth to exceed 5% year on year in the first quarter of 2007 before moderating in the second half of the year.

Croatia at a glance: 2007-08 Updater: July 12th 2007

OVERVIEW

Ahead of the parliamentary election in November 2007, the centre-left opposition Social Democratic Party (SDP) appears to have taken the lead in the polls from the centre-right ruling Croatian Democratic Union (HDZ). However, with neither party capable of securing a parliamentary majority, post-election attempts at coalition-building will determine whether the next government is led by the SDP or the HDZ. A recently formed centrist alliance is set to play the decisive role after the election.

There is a chance that the election results could contribute to the emergence of an unstable ruling coalition that is beholden to single-issue parties, minority representatives, regional groupings or even the far right to stay in power. Robust domestic demand growth will aid economic expansion in 2007-08 and average annual real GDP growth is now expected to exceed 5%. The Economist Intelligence Unit forecasts that the current-account deficit will decline as a percentage of GDP over the forecast period.

Key changes from last month

Political outlook

Zoran Milanovic's strong individual popularity and questions over the responsibility of HDZ-appointed officials for financial irregularities at the state privatisation fund have helped the SDP to raise its public support to 5 percentage points above that for the government (27% of the electorate now supports the SDP).

Policy trends

Croatia has provisionally closed talks on two of the 33 chapters of the EU acquis (science and research, and education and culture), and is close to completing negotiations on another four where closing benchmarks have been set (intellectual property law; economic and monetary policy; enterprise and industrial policy; and customs union). Despite this progress, chapters dealing with the judiciary, social spending, competition policy and state subsidies are likely to present significant obstacles to Croatia's completing the technical aspects of EU membership negotiations. In its November 2006 assessment of Croatia's progress towards EU membership, the European Commission criticised the pace of structural reform, the inefficiency of the judiciary and a lack of progress in fighting corruption. The Commission will prepare annual reports every October on Croatia's progress in complying with the acquis. The political sensitivity of economic reform in several areas, as well as the approach of an election, warns against expectations of accelerated structural reforms this year. EU pressure may assist greater reform progress in 2008 as Croatia's accession negotiations gather more momentum.

Croatia has no active IMF lending programme, but consultations with the IMF continue to take place in the context of the annual Article IV review process. The IMF gave its most recent Article IV assessment in a report published in February 2007, in which it praised Croatia's economic growth and price stability, but called for deeper and faster structural reform, action to correct external imbalances, and the use of prudential rules rather than administrative controls to restrict commercial bank lending growth. Croatia has a country assistance strategy (CAS) in place for 2005-08 as part of an agreement with the World Bank. The Bank's latest assessment of Croatia's performance under the CAS called on the authorities to continue reform of the healthcare sector and transport sectors and to reduce the fiscal burden of social spending and subsidies.

Outlook for 2007-08: Domestic politics Main report: June 4th 2007

Ahead of the parliamentary election in November 2007, the ruling centre-right Croatian Democratic Union (HDZ) and the main opposition party, the centre-left Social Democratic Party (SDP), look set to win the largest shares of the vote. Although the SDP appears to have pulled clear of the HDZ in terms of public support, no party will have an overall majority. The composition of the next government will be determined by efforts at post-election coalition-building by the HDZ and the SDP.

The present HDZ-led government—which continues to rely on the support of its smaller partners, the Croatian Pensioners' Party (HSU) and the Independent Democratic Serb Party (SDSS), as well as the Croatian Social Liberal Party (HSLs)—is increasingly concentrating its resources on the forthcoming election. War-crimes investigations in Croatia and the trial of former general Ante Gotovina at the International Criminal Tribunal for former Yugoslavia (ICTY) in The Hague threaten to weaken party unity by setting the HDZ's nationalist fringe against its moderate core. Moreover, the local press and the opposition have made several allegations of political impropriety—the latest, centring on the state privatisation fund, culminating in an unsuccessful vote of no-confidence in the government in July.

The SDP has appointed a new leadership following the death of former prime minister Ivica Račan. At an extraordinary congress in early June, the SDP appointed Zoran Milanovic as its new leader. Despite his limited political experience, the 40-year-old Mr Milanovic is hoping to modernise the SDP in order to attract a new generation of voters to the party. His individual popularity has risen in tandem with the SDP's in the months since his appointment. The SDP has nominated Ljubo Jurcic, an economics professor and former economy minister, as its candidate for prime minister.

Outlook for 2007-08: Election watch

A parliamentary election will be held in Croatia in November 2007. The election result is highly uncertain owing to a number of factors. Until the SDP has its new leadership in place and is ready to put forward its election platform, support for the party is difficult to predict. Despite the apparent popularity of Mr Milanovic, Mr Jurcic's ability to win the public's trust under the rigours of a national campaign remains to be proven. Moreover, efforts at pre-election coalition-building are continuing, particularly at the centre of the political spectrum. There are additional uncertainties related to the votes of Croatians overseas. The diaspora tends to support the HDZ, but a combination of revised electoral rules and appeals to this constituency from other parties could reduce the HDZ's dominance.

Opinion polls consistently suggest that a hung parliament will be the outcome of the November election and a good deal of political manoeuvring has taken place in anticipation of this. The Croatian Social Liberal Party (HSLs)—which supports the present minority government—and the Croatian Peasants' Party (HSS) have agreed to campaign jointly in the election, creating a powerful, potentially decisive third force in Croatian politics. The HSS-HSLs alliance could emerge as a kingmaker after the election, but it is not yet clear which way the HSS-HSLs will align itself. Both parties have previously participated only in governing coalitions led by the SDP, but the HSLs has given legislative support to the current HDZ-led government. The main risk is that the election results could contribute to the emergence of an unstable ruling coalition that is beholden to single-issue parties, minority representatives, regional groupings or even the far right to stay in power.

International relations

Croatia's progress in the technical aspects of accession negotiations has been slow, and EU membership is unlikely before 2010. In this context, the resolution on Croatia's EU accession effort passed by the European Parliament in April 2007, which mentioned the possibility of accession in 2009, should be regarded more as a symbol of the institution's strong support for Croatia's membership than as a definite entry date. There has been greater progress with respect to securing NATO membership, and firm backing from existing members suggests that Croatia is on course to join the alliance in 2009.

Unresolved maritime border issues with Slovenia have prevented the opening of talks between the EU and Croatia on the fisheries chapter of the *acquis communautaire* (the body of EU law). There is disagreement on whether to resolve outstanding issues through bilateral diplomacy (the preferred option of Slovenia) or through international arbitration (which is preferred by Croatia). Nevertheless, EU pressure for progress in membership talks is likely to elicit some willingness to compromise.

NATO membership is on the horizon

After his meeting with the US under-secretary of state for political affairs, Nicholas Burns, at the SEECP summit, the Croatian prime minister, Ivo Sanader, confirmed that he expected Croatia to receive an invitation to join NATO at the alliance's next summit, scheduled for April 2008 in Bucharest. This would enable actual membership in 2009. Croatia also received strong backing for its membership bid from the German Chancellor, Angela Merkel. In June 2007 Mr Sanader met the US president, George W Bush, in Tirana, where the NATO membership aspirations of Albania, Croatia and Macedonia were high on the agenda. There had been some expectation that Mr Bush would visit Croatia in view of the generally positive state of Croatian-US relations. However, the absence of Croatian troops from Iraq and Croatia's refusal to sign an agreement on the non-extradition of US soldiers to the International Criminal Court (ICC) probably constrain prospects for even closer bilateral ties. The US was also reportedly concerned by the visit of Croatia's president, Stjepan Mesic, to Cuba, and his meeting with Fidel Castro, during a summit of the Non-Aligned Movement in Havana.

EU supports Croatia's accession but progress is slow

In April 2007 the European Parliament endorsed a report on Croatia's progress towards EU membership, prepared by the European Parliament's committee on foreign affairs and Croatia's rapporteur Hannes Svoboda. The report called on Croatia to accelerate reform in order to conclude accession negotiations by the next European Parliament election in mid-2009. Concerns were raised regarding the slow pace of civil service reform and the need for more environmental action, alongside familiar concerns over judicial reform, sectoral economic restructuring and strengthening administrative capacity to handle pre-accession funds. Although more a sign of support from within the EU for Croatia's eventual membership than a firm target date for entry, news of the report was received rapturously by Croatian politicians and local media.

The hosting of the South-East European Co-operation Process (SEEC) summit in Zagreb in May was an opportunity for senior European politicians, including the head of the European Commission, José Manuel Barroso, and the enlargement commissioner, Olli Rehn, to affirm their support for Croatia's EU membership. During the summit, the minister for foreign affairs and European integration, Kolinda Grabar-Kitarovic, said that membership should be possible by 2010. Ms Grabar-Kitarovic was encouraged by a meeting with her Portuguese counterpart who said that efforts would be made to speed up accession negotiations as part of Portugal's six-month presidency of the EU from July 2007. A forthcoming visit from the EU commissioner for freedom, security and justice, Franco Frattini, will help to clarify the EU's view on progress achieved in reforming the judiciary, which is a potential stumbling-block in membership negotiations.

In March 2007 Croatia opened formal negotiations on the intellectual property law chapter of EU negotiations. This is the sixth chapter to be opened, with two having been provisionally closed. Croatia will have to meet two benchmarks before closing the negotiations on the intellectual property law chapter, regarding the approval of new legislation and its implementation. The government has submitted its negotiating position on two additional chapters, financial services, and consumer and health protection. Nevertheless, the large number of chapters requiring fulfilment of opening benchmarks before formal negotiations can begin—currently ten—is an indication of the challenges that Croatia's accession progress still faces.

Developments in war-crimes and corruption trials

Three, unrelated, criminal cases have captured the public's attention and could have wider political significance, not least in terms of Croatia's EU accession. The much-anticipated trial of three Croatian generals, Ante Gotovina, Ivan Cermak and Mladen Markac, has been delayed by the International Criminal Tribunal for former Yugoslavia (ICTY) in The Hague. The delay follows the decision to prevent Croatian lawyer Miroslav Separovic from joining Mr Markac's defence team on the grounds of a potential conflict of interest—Mr Separovic was a former minister of justice who could be called to give evidence. A recent report by the European Parliament's committee on foreign affairs expressed concern about the government's decision to pay the defence costs of the generals and to seek to act as *amicus curiae* (friend of the court) in the cases.

Former HDZ deputy Branimir Glavas was re-arrested and taken to Osijek prison on April 17th, charged along with six others of war crimes against civilians. On April 27th Mr Glavas began a hunger strike in protest at his detention and on May 10th he was transferred to the Zagreb prison hospital. This is the second time Mr Glavas has been imprisoned in connection with alleged war crimes. He was first arrested in late 2006 before being released from custody after a deterioration in health, brought on by a month-long hunger strike.

In Austria, an extradition hearing continues in relation to Vladimir Zagorec, a former Croatian assistant minister of defence suspected of profiting personally from defence contracts signed by the government. The hearing is likely to be concluded in June, although Mr Zagorec, who has been living in Austria for seven years, will be able to appeal against an extradition decision before the Supreme Court in Austria. Any trial of Mr Zagorec is likely to focus on allegations of illegal arms-dealing and secret

foreign bank accounts during the wars of the Yugoslav succession, when a UN arms embargo was in place.

The SDP leads, but polls are unpredictable

Recent opinion polls probably continue to reflect some sympathy for the SDP following the death of Mr Racan. The latest poll published by the newspaper Vecernji List (published before the election of Mr Milanovic) credited the SDP with a slight lead over the ruling HDZ (with the support of 22.4% of the electorate, compared with 21.7% for the HDZ), although many voters remain undecided. Three political groupings are behind the SDP and the HDZ, each with support close to 9%. These are the coalition of the Croatian Peasants' Party (HSS), the Croatian Social Liberal Party (HSLs) and the Alliance of Primorje-Gorski Kotar (PGS); the left-of-centre Croatian People's Party (HNS); and the right-wing Croatian Party of Rights (HSP). The Croatian Pensioners' Party (HSU) commands the support of around 7% of the electorate.

Although poll results in recent months have varied greatly in their measurement of support for the two leading parties, the SDP does appear to be gathering some momentum at the expense of the HDZ (whether this is simply a temporary effect of sympathy for Mr Racan is unclear). Vecernji List reported that 68% of those it polled in its latest survey favour a change in government. The HDZ may have gradually won the support of the electorate for its commitment to EU and NATO integration, but the SDP appears more popular with voters on the basis of its economic and social policy.

SDP-affiliated analysts have suggested that, if the latest poll results were to be carried over into the November parliamentary election, the SDP would have more parliamentary seats than the HDZ for the first time. However, with polls indicating that both the HDZ and the SDP (even in coalition with the HNS) will fail to achieve a parliamentary majority, the SDP's optimism should be tempered. Co-operation with the HSLs-HSS-PGS coalition, and perhaps also with the HNS, the HSU and several smaller parties, could prove decisive in post-election efforts to build a ruling coalition.

The HNS is the most likely coalition partner for the SDP

The centre-left HNS is the most likely post-election partner for the SDP. However, the SDP has rejected a public offer to form a pre-election coalition with the HNS with the HNS's Radimir Cacic as candidate for prime minister. The HNS had earlier rebuffed an approach by the HSLs-HSS-PGS coalition to establish an even wider centrist alliance. The appointment of Mr Milanovic as SDP leader will keep hopes of HNS-SDP co-operation alive (the HNS had ruled out working with the SDP under Milan Bandic). But even though the parties' broad policy orientations are similar, there are significant differences on economic policy between Mr Cacic's free-market views and the SDP's more interventionist economic programme authored by Mr Jurcic.

Zoran Milanovic emerges from SDP leadership battle

The SDP held a special convention in Zagreb in June, at which some 1,600 delegates elected Zoran Milanovic as the next party president. Mr Milanovic defeated Zeljka Antunovic, the acting SDP president, in a second-round vote. Zagreb mayor Milan

Bandic and former foreign minister Tonino Picula failed to receive enough votes in the first round of voting, and were eliminated from the contest.

The forty-year-old Mr Milanovic was previously a member of the SDP's executive committee. As a politician he was the least experienced of all the SDP leadership candidates, having spent most of his career in the diplomatic service, including a spell as the first national co-ordinator for co-operation with NATO. Mr Milanovic's campaign exploited his youth, ambition and pragmatism as his main assets. Despite his relative inexperience, he appears to be very popular with the Croatian electorate, and his appointment seems to reflect a recognition within the SDP that the party needs to win over a new generation of supporters. Mr Milanovic's first challenge will be to put forward a policy platform for the parliamentary election in November.

The new SDP leader supports the appointment of a separate candidate for prime minister. It seems almost certain that Ljubo Jurcic, an economics professor at the University of Zagreb and a former economy minister, will be elected to fulfil this role for the SDP. Mr Jurcic was Mr Racan's preferred prime ministerial candidate. He has recently joined the SDP and is the author of the party's economic programme.