CROATIA

Highlights

- **The economic recovery of recent years has continued but at a slower pace.** The growth rate decelerated to below 3 per cent in 2017, mainly on the back of the slow-down in investment and catch-up in imports, and a further slight moderation of growth has continued into 2018.
- **The fiscal framework is being strengthened.** Fiscal performance improved significantly in 2017, with the government recording a surplus, and new fiscal laws are being introduced in 2018, in line with the European Union's (EU's) Stability and Growth Pact.
- **Croatia has approved a euro adoption strategy.** The strategy outlines the costs and benefits of euro adoption as well as the importance of prudent macroeconomic policies in the run-up to this event. The date of the introduction of the euro has not been fixed, however.

Key priorities for 2019

- **Public sector reforms, including privatisation and improving state-owned enterprise (SOE) corporate governance, should be progressing faster.** The government should step up implementation of its public administration strategy and address persistent weaknesses in the system such as territorial fragmentation, political influence in recruitment and inadequate training and salary systems.
- **Acute shortages in skilled labour need to be addressed sustainably.** Several sectors (tourism, construction, shipbuilding, IT) have long been experiencing a lack of qualified staff. Increased quotas for foreign workers are helping to provide a short-term fix, but a longer-term solution is needed, including improvements in education and training, and a further reduction in labour market rigidities.
- **Corporate deleveraging and restructuring need to be stepped up in order to support long-term growth.** Besides business environment reforms, faster long-term growth would demand corporate restructuring, further decreasing non-performing loans (NPLs) and over-indebtedness; an increased use of EU funds, as well as diversification of the economy away from tourism.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-0.1	2.4	3.5	2.9	2.7
Inflation (average)	-0.2	-0.5	-1.1	1.1	1.6
Government balance/GDP	-5.1	-3.4	-0.9	0.8	0.3
Current account balance/GDP	2.0	4.5	2.6	3.9	2.5
Net FDI/GDP [neg. sign = inflows]	-1.6	-0.5	-4.1	-2.4	-1.0
External debt/GDP	106.8	101.7	89.3	81.8	n.a.
Gross reserves/GDP	29.2	30.7	29.0	32.1	n.a.
Credit to private sector/GDP	68.1	64.6	60.5	57.7	n.a.

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Macroeconomic performance

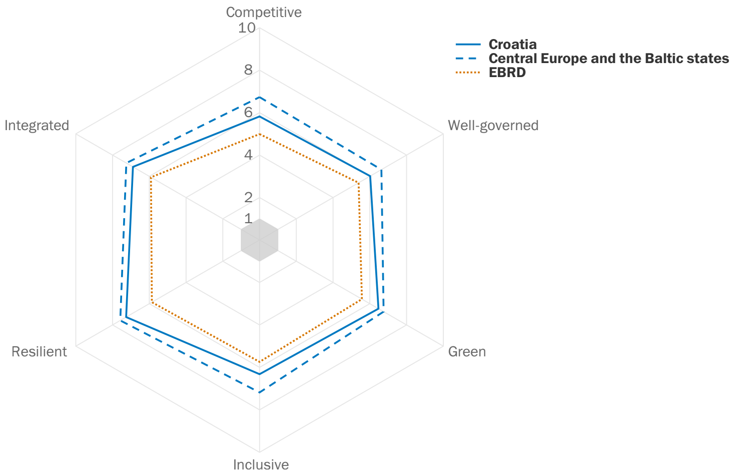
Growth has been gradually slowing down. After a 3.5 per cent rise in 2016, GDP growth slowed to 2.9 per cent in 2017 due to lower investment growth and faster catch-up in imports as the economy entered its third year of recovery. Private consumption, which has continued to recover on the back of a tightening labour market and low inflation, and exports, were the main contributors to GDP growth. A further slow-down to 2.7 per cent year-on-year occurred in the first half of 2018 as exports of goods and services grew more slowly. Unemployment has decreased to 9.0 per cent, still a relatively high level, but labour shortages in sectors such as tourism and construction act as a drag on growth.

Fiscal adjustment has continued but excessive macroeconomic imbalances persist. The fiscal balance moved to a surplus in 2017 (at 0.9 per cent of GDP), primarily on the back of higher profit and value-added tax revenues, as well as increased social security contributions. As a result, the public debt continued trending down and reached 76 per cent of GDP at the end of June 2018 (10 percentage points lower than the peak three years earlier). However, in May 2018 the European Commission concluded that, although reduced, excessive macroeconomic imbalances are still present in Croatia. These imbalances are primarily linked to the still-high levels of public, private and external debt, all of which are largely denominated in foreign currencies. In September 2018 Standard & Poor's upgraded Croatia's BB+ credit rating outlook from stable to positive on the basis of an expected strengthening of the country's fiscal and economic performance.

Inflation has returned to positive territory. After three years of deflation, the inflation rate turned positive in 2017, reaching an annual average of 1.1 per cent. The rise in prices primarily reflected an increase in food and energy prices, and was supported by stronger domestic demand. In the first nine months of 2018, inflation continued to increase, mainly due to rising crude oil prices in the global market, but it is expected to stay below 2 per cent for the year as a whole. Inflationary pressures are partially alleviated by the appreciation of the currency, which is due to favourable macroeconomic developments, reduced fiscal risks and stronger foreign currency inflows on account of robust tourist revenues and higher EU funds inflows.

Growth may decelerate somewhat in 2018 and 2019. Economic growth is projected to slow to 2.7 per cent in 2018 and 2.5 per cent in 2019. Risks to the projection are relatively balanced. While upside risks relate to stronger tourism revenues (as 2018 is on course to be another record-breaking year) and faster utilisation of EU funds, the main downside risks are related to skilled labour shortages and the country's ailing food and retail giant, Agrokor. In July 2018, Agrokor creditors approved the debt settlement, but there are still uncertainties surrounding the restructuring of the company, and negative spillovers to the rest of the economy cannot be excluded.

Assessment of transition qualities (1-10)



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Major structural reform developments

Over the past year, the business environment has worsened somewhat. In the latest World Bank *Doing Business 2019* report, Croatia ranks 58th out of 190 countries, seven places down from the year before. The largest deterioration has been reported in the areas of starting a business and dealing with construction permits, in which it also has the lowest ranking (123rd and 159th, respectively). On the other hand, an improvement has been made in registering property, thanks to the digitisation of the land registry. Croatia also worsened its position in the World Economic Forum *Global Competitiveness Report 2018*, sliding down two places from the year before,[1] to 68th out of 140 countries. According to this report, the main issues remain market inefficiencies, weak institutions and innovation capacity.

Croatia has approved a euro adoption strategy. The new strategy was formally adopted in May 2018. Besides clarifying the benefits and costs of introducing the euro, the strategy envisages prudent macroeconomic and structural policies before the euro adoption. These policies include: the continuation of the fiscal consolidation as well as a strong focus on increasing the productivity of the Croatian economy. The strategy, however, does not fix a date of adoption. The government also set up a national council to monitor the key macroeconomic criteria before formally starting the process of joining the eurozone. The European Central Bank assessed that Croatia fulfils three out of four economic conditions necessary for euro adoption (namely, the criteria relating to price stability, public finances and long-term interest rates). The exchange rate criterion is not fulfilled since the country is not yet a member of the Exchange Rate Mechanism II.

The fiscal framework is being strengthened. In September 2018, the parliament adopted at first reading a new law on fiscal responsibility. The draft law introduces three new rules (on structural balance, budget expenditure and the public debt) in line with the Stability and Growth Pact and the goal of strengthening the independence of the Fiscal Policy Commission. The main task of this commission is to evaluate the implementation of fiscal rules.

The government started tax and pension system reforms. In September 2018, the parliament approved in the first reading a tax reform package comprising amendments to nine tax laws (including laws on VAT, profit tax, income tax, social contributions, real estate tax, excise duties, and the general tax code). It is expected that the changes will affect primarily retailers and employers. In October 2018, the government approved the pension reform pack, with amendments to six laws aimed at the enhancement of pension system sustainability, and sent it to the parliament for approval. Among the rest, the amendments envisage raising the retirement age to 67 years for both men and women as of 2033 (from the current retirement age of 65 years for men and 62 for women), and higher penalties for early retirement.

There has been limited progress in reforming SOEs. The list of companies of special interest was reduced to 39 in 2018, signalling potentially intensified privatisation efforts, but no significant privatisation deal has been announced or concluded since then. However, efforts have been made to strengthen reporting standards and medium-term business planning as well as enhancing the competencies of supervisory boards at SOEs, with the support of the EU's Structural Reform Support Service and the EBRD. In addition, in December 2017 a new SOE corporate governance code was adopted, followed in May 2018 by a new law on state asset management. The restructuring of the highly indebted road sector has started with a seasonal (summer) increase in tolls and financial restructuring (envisaging the extension of the maturity and a cut in interest rates on the existing debt). In November 2017, the government placed a €1.275 billion Eurobond to refinance the road sector debt, while in April 2018 the three road companies (HC, HAC and ARZ) signed a €1.8 billion jumbo loan with eight local banks to re-programme the debt. These financial restructuring measures should result in savings of over €50 million a year.

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[1] The rating for 2017 reflects the change in the methodology. According to the old methodology, Croatia ranked 74th in 2017.

Public administration reforms are progressing quite slowly. According to the European Commission, the Strategy of Public Administration Development 2015-2020 remains largely unimplemented. The main public administration weaknesses to be addressed are: territorial fragmentation (which hinders the implementation of public policies, increases costs and leads to an inefficient use of resources); political influence in the recruitment process; poor design of working positions; lack of in-service training; subjective appraisals; and inconsistencies in the salary system. In June 2018 the government tabled a bill on electronic invoices in public procurement. The bill should reduce administrative costs and facilitate tax control. In August 2018, the government decided to reduce the number of entities with public powers (agencies, institutes, funds, companies, institutions, foundations and others) in order to downsize the state administration. Work on changes in the pay grade system for civil servants has started, but adoption of the announced legislation has been postponed further.

Non-performing loans have continued to decline but at a sluggish pace. The NPL ratio fell to 11.2 per cent at the end of June 2018 (down by two percentage points from the year before), mostly on the back of NPL portfolio sales in the market. NPL sales accelerated in 2017, exceeding €1 billion (an increase by a third from 2016). However, the NPL ratio remains very high for the corporate sector at 22 per cent of total corporate loans.