CROATIA

Highlights

- **Growth accelerated in 2016.** GDP grew by 3.0 per cent in 2016 after 2.3 per cent in 2015, supported by a good tourism season, stronger external demand and lower oil prices. Growth is expected to remain at a similar rate in 2017.
- **The general government deficit fell from 5.1 per cent of GDP in 2014 to 0.9 per cent of GDP in 2016.** The fiscal consolidation was helped by lower public investments, subsidies and wage bills as well as increasing revenues on the back of stronger economic growth. Public debt started to decrease in 2016, but was still high at 82.9 per cent of GDP.
- **The 2017 National Reform Programme reinforced a wide-ranging reform agenda.** The programme focuses on boosting competitiveness, as well as employment, through better linking education with labour market needs, and enhancing the sustainability of public finances.

Key priorities for 2018

- **Fiscal discipline needs to be sustained and underpinned by further structural measures,** as envisaged in the Convergence Programme. Sustainable reduction of the public debt requires targeted public expenditure cuts, increased efforts to tap European Union (EU) funds, and improvements in the efficiency of state-owned enterprises (SOEs).
- **Business environment reforms should be accelerated to attract much-needed investment.** The announced measures, including a gradual reduction of administrative costs and para-fiscal charges, improvement in the cadastre and land registry systems, enhancement of the management and monitoring of SOEs, and making court procedures more efficient are welcome.
- **Further resolution of (corporate) non-performing loans (NPLs) and corporate restructuring are needed to sustain long-term economic growth.** NPL levels have fallen and sales of NPL portfolios by banks have picked up recently but the levels of corporate NPLs and long-term debt of overleveraged companies remain high by regional standards.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	-0.6	-0.1	2.3	3.0	2.9
Inflation (average)	2.2	-0.2	-0.5	-1.1	1.1
Government balance/GDP	-5.3	-5.1	-3.3	-0.9	-1.2
Current account balance/GDP	1.0	2.1	4.8	2.6	4.0
Net FDI/GDP [neg. sign = inflows]	-1.9	-1.6	-0.6	-4.2	-2.7
External debt/GDP	105.3	108.0	103.0	90.9	n.a.
Gross reserves/GDP	29.7	29.5	31.1	29.5	n.a.
Credit to private sector/GDP	70.0	69.3	65.5	61.7	n.a.

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Macroeconomic performance

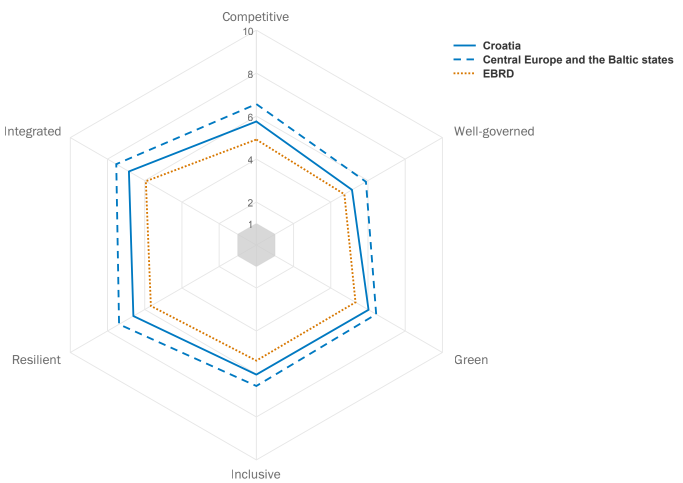
Growth accelerated in 2016, backed by several cyclical factors. After 2.3 per cent growth in 2015, the recovery continued in 2016 with 3.0 per cent GDP growth, driven by strong exports and domestic demand. The economy expanded by 2.7 per cent in the first half of 2017 on the back of strong consumption and exports growth. Unemployment decreased from 13.1 per cent in September 2016 to 10.8 per cent in September 2017. As the economy is recovering inflation has started to pick up, reaching 1.4 per cent year-on-year in September 2017.

Agrokor's financial problems have not resulted in significant adverse economic effects, but some risks remain. Agrokor is the largest private Croatian company, a concern that (in)directly employs more than 60,000 employees in the region, of whom around 30,000 are in Croatia. It is also the biggest food producer and retailer in the Western Balkans with annual revenues of some HRK 50 billion (€6.7 billion) and liabilities of around €6 billion. Credit ratings of the company have been downgraded in the past 12 months due to the high level of indebtedness, potentially jeopardising its long-term future and the jobs of current employees. As a consequence, the parliament has adopted a law aimed at protecting the sustainability of business operations of systemically important companies (including Agrokor), allowing the government to appoint a trustee to manage them for up to 15 months with the ultimate goal of reaching a settlement with creditors and eventually restructuring the company.

The large fiscal adjustment was supported by the economic recovery. The general government deficit fell from 5.1 per cent of GDP in 2014 to 0.9 per cent of GDP in 2016, on the back of lower public investments, subsidies and wage bills as well as increasing revenues. As a result, Croatia exited the Excessive Deficit Procedure in June 2017. Public debt, while still high, started to decrease in 2016, reaching 82.9 per cent of GDP by the end of 2016. The 2017 fiscal deficit is estimated at 1.2 per cent of GDP, based on the assumption of accelerating growth boosted by the planned tax reform, which includes the reduction of personal income and corporate profit taxes. Given the expectations that economic growth will support further improvements on the fiscal side, in September 2017 Standard & Poor's upgraded its outlook on Croatia's sovereign rating (BB/B) to positive from stable.

Growth may decelerate somewhat in 2018 as key drivers face capacity constraints. Economic growth is projected to reach 2.6 per cent in 2018 after 2.9 per cent in 2017. The slight slow-down is partly due to the tourism sector again experiencing a record year, making it unlikely to be repeated next year without capacity increases and upgrades. High corporate over-indebtedness, a potential slow-down in investment and a potentially disruptive restructuring process at Agrokor are all risk factors that could hold back growth.

Assessment of transition qualities (1-10)



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Major structural reform developments

Some steps have been taken towards improving the investment climate, but long-standing difficulties have not yet been addressed. Croatia ranks 51st (out of 190 economies) in the World Bank's *Doing Business 2018* report (down eight places from the previous year). The country's ranking worsened significantly in paying taxes, due to lower efficiency of post-filing processes. While dealing with construction permits remains an important obstacle (ranking 126th), transferring property has become less costly. Croatia's competitiveness remains low according to the Global Competitiveness Index published by the World Economic Forum, as it ranks 74th among 137 countries (unchanged from last year). Despite improvements in some areas (the macroeconomic environment, technological readiness, health and primary education), Croatia has worsened its standings in others (higher education, innovation, institutions). The main obstacles for doing business remain unchanged from last year (inefficient government bureaucracy, tax rates and regulations, policy instability and corruption).

The government has taken steps to reduce the administrative burden and barriers for doing business. A new regulation, effective from January 2017, cuts some state administration charges by 30 per cent, including those payable for issuing passports and driving licences, as well as establishing a company. The government has promised to introduce 104 measures in 2017 to reduce the administrative burden on enterprises, which are projected to result in savings for businesses amounting to HRK 1.5 billion (€200 million).

Tax reform has advanced. The tax reforms for 2017 include: cutting the corporate income tax rate from 20 to 18 per cent (and to 12 per cent for small and medium-sized enterprises), adopting two rates of personal income tax (36 and 24 per cent instead of 12, 25 and 40 per cent), and increasing non-taxable income to HRK 3,800 from HRK 2,600 (around €510 and €350, respectively). Rates for the value added tax (VAT) were also adjusted to make the VAT system less regressive, and excise taxes on fuels were aligned with EU legislation. The expected direct budgetary effect is a revenue reduction of 0.6 per cent of GDP in 2017 and an additional 0.2 per cent in 2018.

Privatisation has been moving ahead, albeit slowly. In 2016, the sale of stakes in (non-strategic) companies yielded income of only 0.2 per cent of GDP in 2016. No significant steps were taken in the first half of 2017, but the government has announced the potential renationalisation of the local oil and gas company INA through a buy-back of MOL's share in the company (49 per cent, including the management rights), and the recapitalisation of defence-to-construction company Djuro Djakovic, which will reduce the state share below 50 per cent. In addition, the state-controlled chemical producer Petrokemija is in the process of privatisation.

The highly indebted road sector is to be restructured. In March 2017 the government announced that state-owned road companies are to be merged and their debt is to be restructured, with World Bank support. The reforms are expected to be completed by 2020. The three road companies (HC, HAC and ARZ) have amassed a debt of €5.2 billion (more than 10 per cent of GDP), due to the fast expansion and modernisation of the road infrastructure in the past 20 years, which has been supported by state guarantees.

NPL resolution has progressed, mostly through market transactions. According to the Croatian National Bank, NPLs amounting to HRK 6 billion (around €800 million) were sold in 2016 (up from €240 million the year before), while the purchase price improved to 30.1 per cent of total sold claims, from 21.6 per cent in 2015. In the first quarter of 2017, another HRK 1 billion (around €130 million) was sold at the purchase price of 26.9 per cent. As a result, the NPL ratio fell from 16.7 per cent at the end of 2015 to 13.2 per cent in June 2017. The tax reform allows one-off deductibility of NPL write-offs, which may facilitate their faster resolution in 2017.