CROATIA

Highlights

- **Economic recovery has continued.** The growth rate decelerated from a post-recession high of 3.5 per cent in 2016 to 2.6 per cent in 2018, but rose again in the first half of 2019.
- **Croatia is back to investment grade.** The country is rated BBB-/Positive by Fitch (June 2019) and BBB-/Stable by Standard & Poor's (March 2019), following significant macroeconomic improvements in recent years.
- **Plans for joining the eurozone have advanced.** The authorities have sent a letter of intent, representing the first formal step towards joining the Exchange Rate Mechanism II (ERM II) in 2020, which would be one stage ahead of joining the eurozone.

Key priorities for 2020

- **Reforms aiming to prepare the country for joining ERM II and the banking union should be stepped up.** While Croatia has improved its macroeconomic conditions to become part of ERM II, the authorities should speed up key structural reforms, focusing in particular on improving public-sector governance.
- **Acute shortages in skilled labour need to be addressed sustainably**. Several sectors (tourism, in particular) 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 a further reduction in labour market rigidities.
- **Business environment reforms should continue to be prioritised.** Despite improvements, bureaucratic processes remain an obstacle to doing business. In addition, state-owned enterprises remain dominant in some sectors, and privatisation of these enterprises, including through initial public offerings, would attract investors and increase the competitiveness of the economy.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.4	3.5	3.1	2.6	3.0
Inflation (average)	-0.3	-0.6	1.3	1.6	1.0
Government balance/GDP	-3.3	-1.1	0.8	0.3	0.1
Current account balance/GDP	4.5	2.6	3.9	2.7	2.3
Net FDI/GDP [neg. sign = inflows]	-0.5	-4.3	-2.6	-1.4	-1.4
External debt/GDP	100.1	85.1	87.4	73.2	n.a.
Gross reserves/GDP	30.2	27.6	34.1	32.9	n.a.
Credit to private sector/GDP	62.3	57.7	55.4	54.4	n.a.

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Macroeconomic performance

Growth has somewhat moderated in the past year, but remains solid. The economy experienced growth of 2.6 per cent in 2018, its fourth consecutive year of recovery following a six-year recession from 2009-14. Private consumption remained the main driver of growth, fuelled by increased earnings, a higher employment rate and an increasing pace of household lending. The unemployment rate as of June 2019 was about 7.0 per cent, down from 18.3 per cent in 2014 (the final year of recession). Investment continued along its recovery path from 2015, helped by the growing disbursement of funds from the European Union (EU), rising economic sentiment and low interest rates, rising 4.0 to 5.0 per cent per year on average ever since, and thus contributing around one percentage point to growth per year. Gross domestic product (GDP) grew by 3.1 per cent year-on-year in the first half of 2019, driven again by broad-based domestic demand. Inflation turned positive in 2017 but remained low in 2018, averaging 1.6 per cent. The current account was in surplus in 2018 (2.9 per cent of GDP), despite stronger imports.

Fiscal adjustment has continued in 2018, albeit at a slower pace. The 2018 budget surplus is estimated at 0.3 per cent of GDP, following a budget surplus of 0.8 per cent in 2017, and is underpinned by expenditure restraint, lower interest costs and higher revenues from favourable macroeconomic developments. A balanced budget is expected in 2019, despite an increase of 5.0 per cent in the public wage bill. Also expected are revenue losses from reductions in excises, value added tax (VAT) rates on some products and social security contributions. Public debt ratios have come down from a peak of 85.0 per cent of GDP in 2014 to an estimated 75.0 per cent by the end of 2018. The government's commitment to joining the ERM II, as part of the euro adoption strategy, should serve as an anchor for prudent fiscal policy in the coming years.

Croatia's credit rating was raised to investment grade. In June 2019, Fitch raised the country's credit rating from "BB+" to "BBB-", with a positive outlook. This follows Standard & Poor's upgrade in March 2019, which also raised Croatia to investment grade "BBB-". In June 2019, the government successfully issued a 10-year Eurobond, raising €1.5 billion with an annual coupon interest rate of 1.125 per cent. In August 2019, the government issued a one-year Eurobond with a negative interest rate of 0.05 per cent. For shorter maturities, average yields in local currency have remained close to zero.

Economic performance is expected to stay at solid levels in the short term. We expect GDP growth of 3.0 per cent in 2019, in line with that of the first half, and light moderation to 2.5 per cent in 2020, broadly in line with the country's current growth potential, as supply side constraints for the tourism sector become apparent. Growth is expected to be driven by private consumption and supported by positive labour market developments, low inflation and steadily increasing remittances. Risks to the projection come from possibly weaker demand from Croatia's main economic partners, such as the eurozone. While convergence prospects remain high, with GDP per capita (in power purchasing standards) standing at just 63.0 per cent of the EU average, a further tightening of labour market conditions and an increasingly difficult demographic profile are making it challenging for employers to fill highly qualified positions amid emigration and an ageing population, which could weigh on long-term growth prospects.

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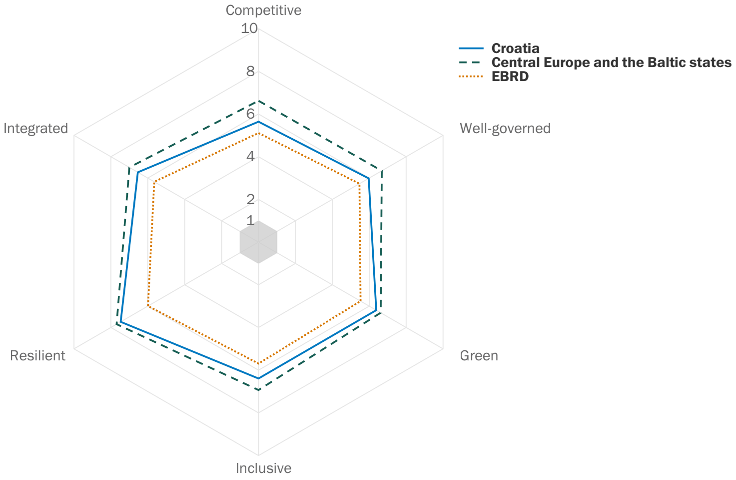
Assessment of transition qualities (1-10)



Major structural reform developments

Croatia's business environment has improved over the past year. Croatia has made a number of reforms over the past year making it easier to do business. The country made starting a business easier by abolishing certain requirements for company registration, and by reducing the paid-in minimum capital requirement. Also, it made dealing with construction permits less costly by reducing the water contribution for building a warehouse. Transferring property has been facilitated by a decrease in the real estate transfer tax and a reduction in the time to register property title transfers. However, Croatia made accessing credit information more difficult by ending the distribution of individual credit data. The overall sum of reforms and reversals helped Croatia to rise by seven places, ranking 51st (out of 190 economies) in the World Bank's *Doing Business 2020* report.

The restructuring of Agrokor continues. The company was, at one point, Croatia's biggest employer but almost collapsed in 2017 due to a debt crisis. Following the agreement between Agrokor and its creditors in July 2018 on a debt-for-equity settlement deal, implementation started in April 2019, when the management of the company was transferred from emergency administration to a new company called Fortenova Group. The biggest shareholder in the new company is Russia's Sberbank, with a 39.0 per cent stake.

Croatia has sent a letter of intent to join the ERM II. The letter was sent by the authorities to the European Commission in July 2019. It represents the first formal step towards joining ERM II, intended for 2020, which would be one stage ahead of joining the eurozone. Croatia has committed to implementing reforms in six areas in the following ways: (i) further strengthening the supervision of the banking system by establishing close cooperation between the Croatian National Bank and the European Central Bank; (ii) strengthening the framework for implementing macroprudential policies; (iii) strengthening the framework for the prevention of money laundering; (iv) improving the system for collecting, processing and publishing statistical data; (v) improving public-sector governance; and (vi) reducing the administrative and financial burden on the economy.

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New pension reforms, designed to make the pension system more sustainable, have been partly reversed. In December 2018, the parliament approved changes to the pension system which were meant to make the system more sustainable. Among other measures, it was envisaged that the statutory retirement age of 67 years for both men and women would be introduced as of 2033, from the current 65 for men and 62 for women. But following a widespread campaign against the changes, in September 2019 the government agreed to reinstate the retirement age to 65 and change the law accordingly. However, all pensioners will now be allowed to hold part-time jobs (of up to four hours a day) without losing their pensions. In addition, measures were introduced to boost population growth by allowing additional months of service for parents when they fulfil the retirement conditions.

Tax reforms have advanced. A new package introduced in January 2019 includes: lowering the VAT rate on a number of food products and cultural professions (for example, writers, composers and artists) to 13.0 per cent from the standard rate of 25.0 per cent, and on both non-prescription and over-the-counter drugs to 5.0 per cent; raising the salary range to which the lower income tax rate of 24.0 per cent is applied, from the current monthly HRK 17,500 (€2,350) up to HRK 30,000 (€4,000), with the higher rate of 36.0 per cent remaining for higher salaries; and raising the tax-free amount of annual bonuses for employees to HRK 7,500 (€1,000) from HRK 2,500 (€340).

Oil and gas sector production capacity is being enhanced. According to the Croatian Hydrocarbon Agency, in July 2019 four companies placed bids for six (of the seven) offered sites in the Pannonian Basin, in northern Croatia. As a result of the first onshore tender, two new drilling wells have been opened in Croatia's eastern region of Slavonia by Canada-based Vermilion. In addition, in February 2019 the government launched a tender for gas and oil exploration in the southern part of the country, with a deadline for September 2019. Croatia is also in the process of building a liquefied natural gas terminal on its island of Krk, and is participating in the Ionian-Adriatic Gas Pipeline, which is a continuation of the Trans Adriatic Pipeline that brings natural gas from Azerbaijan's gas field of Shah Deniz to Bosnia and Herzegovina, Croatia and Montenegro. Both of these plans should have an important role in diversifying the natural gas supply as well as ensuring security of a natural gas supply not only for Croatia, but also for the wider region. In addition, the Croatian natural gas transmission operator Plinacro announced that two-way gas flow between Croatia and Slovenia has been enabled, thus fulfilling its obligation under EU regulations regarding gas supply security measures.

Rail transport infrastructure is being enhanced. Croatia has received 10 bids for the construction of its €297 million 43-kilometre rail project on the Krizevci-Koprivnica-Hungarian border. This is the largest railway infrastructure project in Croatia's recent history and will help modernise the rail line shipping cargo from the Adriatic port of Rijeka to central Europe through the capital, Zagreb. The EU is financing 85 per cent of the total cost of the project. The implementation of this project will raise the capacity of railroads, increase the speed of traffic with a modern two-lane line and enhance the level of safety in the corridor.