

Croatia

Highlights

- **Economic growth remained strong in the first half of 2022, but is showing signs of a slowdown.** Gross domestic product (GDP) maintained its momentum from 2021 and expanded by 7.4 per cent year on year in the first two quarters of 2022, while a successful tourist season alleviated the growth slowdown in the third quarter.
- **Implementation of the country's Recovery and Resilience Plan (RRP) is well under way.** Croatia was among the first countries in the European Union (EU) to receive a disbursement – a grant of €700 million in July 2022 – as the authorities met all 34 milestones and targets by the end of 2021.
- **Croatia will adopt the euro from 2023.** In July 2022 the country received the final positive assessment it needed to join the eurozone in January 2023. The government and the Croatian National Bank are implementing the requisite operational changes to ensure a smooth transition. Croatia is also preparing to join the Schengen area, pending final approval by the European Council.

Key priorities for 2023

- **Political commitment and effective implementation of more complex reforms included in the RRP will be needed to address structural issues.** RRP implementation has been adequate so far, but the next disbursements will be conditional on more challenging reforms, such as changes to recruitment and pay in the public sector, state-owned enterprise (SOE) governance and privatisations.
- **Support for households in the current inflation and energy crisis should shift towards more market-based measures.** Some announced measures, such as price caps, including for basic foods and fuels, provide short-term relief, but they can restrict markets, disincentivise consumption cuts and carry additional fiscal costs. Moreover, the cap on energy prices will put a financial strain on state-owned utility HEP and its ability to invest in new capacity.
- **The government needs to prioritise the green transition.** The focus should be on more medium-term solutions, such as investment in renewables, boosting energy efficiency and limiting subsidies only to those in need. While investor interest in Croatia's renewable potential is high, further administrative improvements and investments in the grid are needed to speed up the integration of new capacity.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	2.9	3.5	-8.1	10.2	6.5
Inflation (average)	1.5	0.8	0.1	2.6	9.8
Government balance/GDP	-0.1	0.2	-7.3	-2.6	-1.5
Current account balance/GDP	1.8	2.8	-0.5	3.2	2.2
Net FDI/GDP [neg. sign = inflows]	-1.6	-6.2	-1.4	-4.9	-2.0
External debt/GDP	80.8	72.5	79.8	77.4	n.a.
Gross reserves/GDP	33.1	33.4	37.7	43.7	n.a.
Credit to private sector/GDP	53.0	52.2	58.8	52.8	n.a.

Macroeconomic developments and policy response

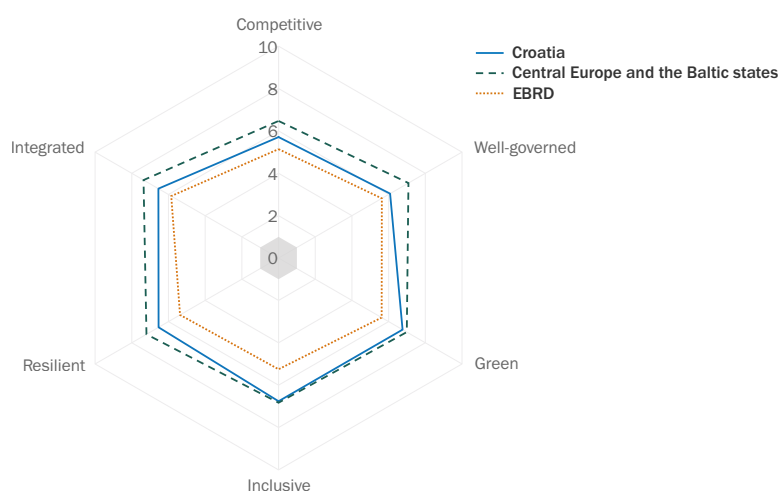
Robust domestic demand and strong exports have supported high growth rates since early 2021. The Croatian economy expanded by 10.2 per cent in 2021 in a broad-based recovery, bringing GDP above pre-pandemic levels. The strong growth continued in the first half of 2022, as GDP grew 7.4 per cent year on year. Despite rising inflation, private consumption and investment both increased in the second quarter of 2022 in yearly terms, while stock building slowed. A highlight since early 2021 has been the performance of goods exports, which in the first half of 2022 grew 28 per cent year on year in real terms, or 55 per cent relative to 2019. On top of this, service exports expanded 66 per cent on the year in the second quarter of 2022 and exceeded the levels recorded in the corresponding period of 2019. Despite strong import growth, net exports contributed positively to growth in the second quarter of 2022, highlighting Croatia's deeper integration into the EU economy.

Inflation has reached double-digit levels. Consumer prices grew 12.8 per cent annually in September 2022, with food prices up 14.9 per cent and catering and accommodation prices up 17.3 per cent. Labour-market conditions remained tight in the first half of the year, with unemployment below pre-pandemic levels, while real wages dropped by an average 1.9 per cent in the period, contributing to a slowdown in consumption and demand-side inflation.

Fiscal consolidation is continuing, despite crisis support measures. The government has set a target deficit for 2022 of 1.5 from 2.8 per cent of GDP after a budget revision in October 2022, as budget execution data for the first half of 2022 show a deficit of just 1.3 per cent of GDP, lower than the 2.6 per cent recorded in 2021. The main measures that the government adopted in April 2022 to compensate for rising inflation were: i) increases in household electricity prices were capped at 9.6 per cent and at 20 per cent for gas; ii) the value added tax (VAT) rate on heating was reduced for a year from 25 per cent to 5 per cent, then permanently to 13 per cent (including for heating, wood and pellets), while VAT on food products was cut to 5 per cent; iii) vouchers were given to vulnerable persons and pensioners; iv) de minimis support was provided to firms for gas consumption; and v) temporary fuel price caps were announced in some months.

Growth will moderate towards the end of 2022 and in 2023. We expect GDP growth to reach 6.5 per cent in 2022, supported by robust domestic demand and a strong tourist season, as overnight stays were 96 per cent of 2019 levels as of the middle of August. In the last quarter of 2022, a slowdown is likely amid the intensification of the energy crisis in Europe more broadly. Downside risks include a further acceleration in inflation, uncertain global growth prospects and persistent supply-chain issues. In 2023 high base effects related to tourism, in particular, weakening consumer confidence and slow or negative eurozone growth are likely to limit Croatian growth to 2 per cent. In terms of a potential gas shutdown, Croatia is among the most resilient countries in the region thanks to the Krk liquefied natural gas (LNG) terminal and robust domestic energy production.

CHART Assessment of transition qualities (1-10)



Structural reform developments

Croatia will adopt the euro in January 2023. Prior to eurozone entry, the authorities are focused on ensuring a smooth technical transition. In August 2022 the government announced that it had sent to parliament 65 amendments to relevant bills, while another 20 changes will be adopted by the end of the year. The government has prioritised a smooth transition to the euro to avoid potential price increases, although opinion polls among the population suggest a risk that businesses will convert prices at an unfair rate. Planned euro adoption has also led to credit-rating upgrades of two notches by Moody's and S&P and one notch by Fitch Ratings.

Earthquake reconstruction efforts have started after delays. The EU Solidarity Fund allocated slightly over €1 billion to tackle the consequences of the 2020 earthquakes, and the deadline for accessing it was prolonged by one year to June 2023 as the government got off to a slow start in implementing the mechanism. To quicken reconstruction, the authorities have implemented faster procurement, undertaken a reorganisation of the Reconstruction Fund, centralised reconstruction oversight and introduced more flexible price-setting. Moreover, procurement is to be adapted for small and medium-sized enterprises in order to activate the entire construction industry. The authorities also put in place a one-stop shop for reconstruction efforts, a milestone in the RRP. By the end of August 2022 the authorities reported that all houses covered by the programme of non-structural reconstruction in the earthquake-affected areas of Petrinja and Glina will be renovated before the heating season, while the construction of new homes is under way. However, only a small share of the funds have been disbursed so far.

Croatia is becoming a regional energy hub, thanks to the expansion of the Krk LNG terminal's capacity. The LNG terminal's annual capacity of natural gas will be raised to 6.1 billion cubic metres from the current 2.6 billion thanks to a €25 million investment. Another €180 million has been allocated to the expansion of the pipeline network. The significant expansion of the terminal should make Croatia a hub for the supply of gas to countries in central and south-eastern Europe.

Energy-efficiency programmes have been launched, but interest in renewable auctions is low. In December 2021 the government adopted the Energy Efficiency Programme for decarbonising the energy sector. Similarly, it launched the energy renovation programmes for multi-apartment and public buildings, with planned investments of €133 million, mostly in the latter category. Two additional programmes were also adopted at the end of 2021, namely, for the energy renovation of buildings with cultural value and a programme to reduce energy poverty by 2025. Renewable auctions were unlocked in 2021, but investor interest has been far lower than auctioned capacity. This is down to higher electricity wholesale prices and investors agreeing to power purchase contracts with prices set above the offered market premiums.

A reform of the waste management sector has commenced. Water and wastewater infrastructure was earmarked at €863 million in the initial plan, the largest amount out of all RRP components. In line with this priority, at the end of 2021 the government adopted several acts and strategic documents to frame future activity. These include the amendment of the Waste Management Act, a revision of the Waste Management Plan of the Republic of Croatia for the period 2017-22, and the adoption of the Multiannual Water and Wastewater Construction Programme. In the coming years, the government will need to modernise a number of waste and wastewater facilities across the country, funded from the RPP.

Improvements in public governance are being targeted. Measures introduced so far have focused on budgeting, anti-corruption and EU funds management. Given the significant amount of EU funds allocated to Croatia up to 2027, a priority is improving the governance framework to allow efficient implementation. This started with the strengthening of capacity for EU project management, including an assessment of administrative capacity, an audit and control system for the RRP, and the adoption of an act on the institutional framework for EU funds. On top of this, the government adopted a new anti-corruption strategy for 2021-30 and an act amending the Law on Prevention of Conflict of Interest. Fiscal planning was strengthened by improvements to the functionality of the Fiscal Policy Commission and by amending the Budget Act.

The authorities are addressing inclusion issues. As part of the RRP milestones, at the end of December 2021 the government adopted the National Plan for the Equalisation of Opportunities for Persons with Disabilities 2021-27 and the National Plan for the Fight against Poverty and Social Exclusion 2021-27, together with their respective action plans to 2024. In a similar vein, the authorities also adopted the National Plan for the Development of Social Services 2021-27.