CROATIA

Highlights

- **The economy is recovering well after a deep shock in 2020.** After recording an 8.1 per cent decline in gross domestic product (GDP) in 2020, the economy expanded by 7.8 per cent year-on-year in the first half of 2021, followed by a better-than-expected tourist season in July and August.
- **The Recovery and Resilience Facility (RRF) plan has been approved.** Croatia was among the front runners, as the European Commission approved the plan relatively early, with the first tranche of €818 million already disbursed in September 2021.
- **Renewables deployment has advanced.** Following the fully aligned premium model for renewables and new quotas, investor appetite for capitalising on Croatia's high potential in this area is rising.

Key priorities for 2022

- **The reforms outlined in the RRF plan need to be implemented in a timely manner.** The RRF plan has multiple reform components tied to investments, ranging from business environment measures to education reforms, which will require additional efforts from the authorities. In light of the significant total allocation up to 2027 (38 per cent of 2020 GDP), European Union (EU) funds absorption capacity in general will need to improve.
- **Improvements to the corporate governance of state-owned enterprises (SOEs) should continue.** A recent Organisation for Economic Co-operation and Development (OECD) review of the existing corporate governance framework pointed to weaknesses in ownership policy, disclosure practices and board independence. Upcoming reforms to tackle these problems are part of the post-exchange rate mechanism (ERM) II accession commitments.
- **A more structured approach to reconstruction efforts in earthquake-affected areas should be developed.** Amending legal frameworks and improving institutional coordination will be major preconditions to removing the legal and financial barriers to the full implementation of post-earthquake reconstruction activities in Croatia.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.4	2.9	3.5	-8.1	8.0
Inflation (average)	1.1	1.5	0.8	0.1	2.0
Government balance/GDP	0.8	0.2	0.3	-7.4	-4.1
Current account balance/GDP	3.4	1.8	2.7	-0.8	-0.1
Net FDI/GDP [neg. sign = inflows]	-2.2	-1.6	-1.9	-1.9	-2.0
External debt/GDP	87.3	80.8	72.5	79.9	n.a.
Gross reserves/GDP	31.5	33.1	33.4	37.7	n.a.
Credit to private sector/GDP	54.4	53.0	52.2	58.8	n.a.

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Covid-19: macroeconomic implications

The economy is bouncing back strongly after a deep recession in 2020. In 2020 GDP fell by 8.1 per cent, one of the biggest drops in output in the EU. The tourism sector was the main channel of disruption, as arrivals decreased by 64 per cent versus 2019. However, in the first half of 2021 growth was broad-based and reached 7.8 per cent year-on-year. The recovery is also reflected in the labour market, as the registered unemployment rate reached 7.3 per cent in August 2021, down from a peak of 9.8 per cent in January 2021 and already below the value recorded at the end of 2019.

Tourism and goods exports have recorded significant growth rates. Preliminary data are exceeding the authorities' initial expectations in 2021. By the end of August 2021 tourist overnight stays were 74 per cent of the record 2019 levels for the same period, with a longer season expected this year than in 2020. Moreover, in the first three weeks of August, overnight stays were around 90 per cent of the corresponding period in 2019, while total receipts from July to mid-August were 9 per cent higher than in 2019. Goods exports have also grown strongly in the first half of 2021, with volumes in this period being 21 per cent higher than in 2019. These two important components of the economy are supporting the accelerated recovery.

Public finances also improved in 2021. In the first half of 2021 the fiscal deficit inched down towards 2.6 per cent of GDP, with a target for the year as a whole of 4.5 per cent of GDP. The increase in revenues has been broad-based, while the spending increase has been milder. Public debt is projected to decrease to 83 per cent of GDP in 2021, after a significant increase from 73 per cent at the end of 2019 to 89 per cent at the end of 2020. The euro adoption plan could serve as an anchor to fiscal consolidation in the medium term, even if the final shape of the EU fiscal rules post-Covid-19 remains uncertain.

The economic outlook continues to be positive but significant risks remain. We forecast the economy to recover by 8.0 per cent in 2021, followed by a normalisation of growth towards 4.2 per cent in 2022. Considering the good performance of the tourism sector in the third quarter as well as the overall performance in the first half of the year, risks to the current forecast are oriented towards the upside. The main downside risk is the evolution of the Covid-19 pandemic, especially in light of the slow vaccination rate, although strict containment measures are unlikely to be reintroduced. In the medium term, EU fund absorption and associated reforms will define the extent to which growth increases above relatively low historical values.

Policy response to Covid-19

The authorities have continued the key job retention mechanism in 2021. After devising a fiscal support package of about 3.8 per cent of GDP in 2020, the authorities have partially wound down assistance in 2021, estimated by the International Monetary Fund (IMF) at 2.5 per cent of GDP. The main scheme operational in both 2020 and 2021 is the job retention mechanism, which covered HRK 4,000 (€530) per retained worker in affected firms and sectors. In July 2021 the European Commission transferred €530 million from the Recovery Assistance for Cohesion and the Territories of Europe (REACT-EU) package to support the scheme. Other support measures include grants to firms in affected sectors, including a dedicated scheme to support the tourism sector.

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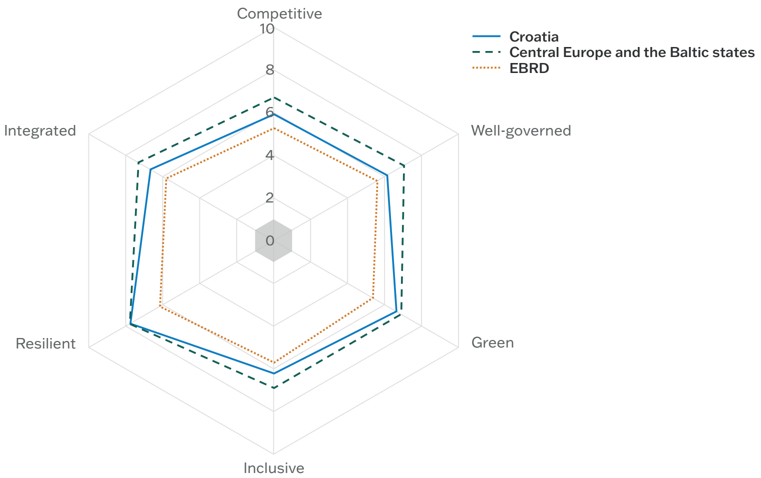
Assessment of transition qualities (1-10)



Structural reform developments

The RRF plan includes key structural reforms. The €6.3 billion in grants will be targeted towards raising the productivity of the economy, primarily by enhancing the green and digital transition. On top of these two priorities, the plan outlines structural reforms in public administration, the judiciary, education, the labour market and social policy.

The government adopted the National Development Strategy. The strategic long-term development document was adopted in February 2021 and provides a framework for long-term budget planning, the use of EU funds and key reforms up to 2030. The development goal for 2030 is to increase GDP per capita in purchasing power standards (PPS) from the current 63 per cent to 75 per cent of the EU average, as well as to increase the share of exports of goods and services to 70 per cent of GDP.

The government adopted a proposed anti-corruption strategy for the period 2021 to 2030. The new strategy sets five priorities in the area of public policy, with most of the measures related to strengthening the institutional and normative framework, as well as the transparency and openness of public authorities' work. In the 2020 Eurobarometer survey on corruption, 97 per cent of respondents said they believed that corruption was widespread, compared with an EU average of 71 per cent.

The European Competition Network Plus (ECN+) Directive regulating competition policy entered into force. Parliament transposed the EU Directive in April 2021 and amended other parts of the Competition Act to fully align it with EU standards. ECN+ aims to ensure a common framework for all member states by establishing minimum common investigative powers and decision-making procedures. The transposition is expected to give more autonomy and instruments to the Competition Authority, thus enabling a fairer and more competitive business environment.

Legislation to promote renewable energy has advanced. All relevant legislation has been adopted so that the premium model for renewables can be put into practice. This model was formally adopted in 2016, replacing the feed-in tariff scheme. However, to date, the project pipeline has not been very strong due to administrative, financial and legislative barriers. By the end of 2020 all relevant acts were aligned with each other, with the main change being the definition of quotas for premiums in May 2020. The authorities expect a significant increase in renewable projects in the coming years. The planned capacity of renewable projects to be tendered amounts to 2.3 GW, a significant amount compared with the 4.8 GW of installed capacity at the end of 2019.

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The New Foreigners Act includes a number of changes to employment regulation. Under the Act, which came into effect in January 2021, the government will no longer determine the annual quota of employment permits for foreigners. Employers will have to request the relevant labour market standard from the Croatian Employment Service before applying for residency and a work permit for foreigners. This aims to ease labour shortages, which are expected to increase once the economy fully recovers from the Covid-19 crisis. Croatia also introduced a scheme to attract so-called "digital nomads".

Further tax cuts have come into force in 2021. Given the plan in place to ease the tax burden since 2016, which resulted in four rounds of tax adjustments, this year the income tax rate has been lowered from 24 per cent to 20 per cent and from 36 per cent to 30 per cent for the higher bracket. The tax rate for small and medium-sized enterprises has been lowered from 12 to 10 per cent. These tax cuts are expected to support the recovery of private consumption in the short term.

Construction of the Krk LNG terminal is complete. The floating terminal started operations in January 2021, with the entire capacity of 2.6 billion cubic meters fully booked for the next three years. The facility is poised to balance the energy needs of Croatia and its neighbours in light of the accelerated green transition, with gas being viewed as a transition fuel from coal.