Croatia

Highlights

- **Economic growth in 2024 remains robust, outperforming regional peers.** Real gross domestic product (GDP) growth expanded by 3.6 per cent year on year in the first half of 2024, driven by rebounding private consumption and strong investments.
- **Improving economic fundamentals and progress in integration are supporting credit rating upgrades.** Since late 2023, Croatia has a positive outlook from all three main rating agencies, with Fitch the first to upgrade the rating to A-, further driving down financing costs as Croatia continues to deepen its integration in the eurozone.
- **Croatia is a frontrunner in implementing the Recovery and Resilience Plan (RRP).** The authorities submitted the fifth payment request in April 2024, which led to a swift disbursement by the European Commission in July 2024. Croatia has already received €4.5 billion out of the planned €10.5 billion.

Key priorities for 2025

- **Improvements in the state-owned enterprise (SOE) sector could bring productivity gains.** SOE performance remains weak despite recent progress and commitments related to RRP implementation and Organisation for Economic Co-operation and Development accession. A new single law on SOEs to strengthen corporate governance is expected to be adopted by the end of 2024, and implementation will be key to boosting productivity.
- **Labour market tightness requires additional reforms to improve labour supply.** While recent reforms aim to address skills mismatches via improved vocational education, the private sector increasingly relies on foreign workers.
- **The government needs to address barriers to renewables.** Despite strong investor interest, the failure to approve a grid connection fee and the often lengthy procedures needed to enable investments continue to hamper the pace of installing renewables.

Main macroeconomic indicators (per cent)

	2020	2021	2022	2023	2024 proj.
GDP growth	-8.3	12.6	7.3	3.3	3.6
Inflation (average)	0.0	2.7	10.7	8.4	3.5
Government balance/GDP	-7.2	-2.5	0.1	-0.7	-2.1
Current account balance/GDP	-1.0	1.0	-2.8	1.1	0.4
Net FDI/GDP [neg. sign = inflows]	-1.4	-5.1	-5.3	-1.9	-1.8
External debt/GDP	81.1	80.2	72.9	83.7	na
Gross reserves/GDP	37.2	42.5	44.8	na	na
Credit to private sector/GDP	57.8	51.1	49.1	47.4	na

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Macroeconomic developments and policy response

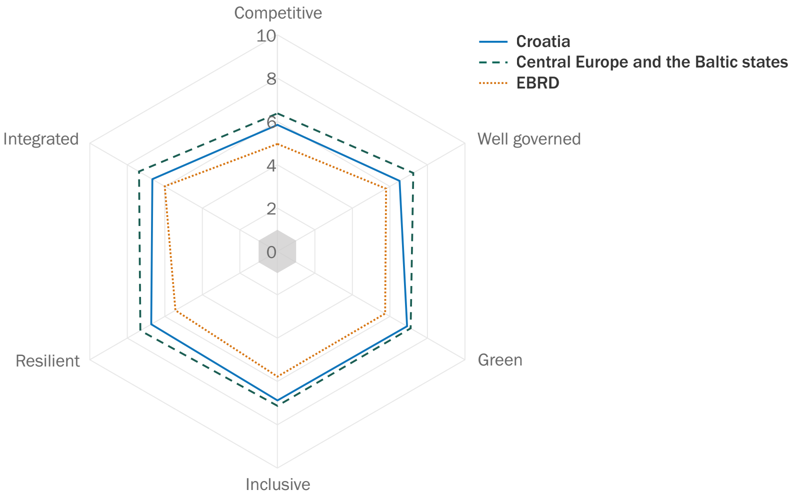
Economic growth remains robust, outperforming regional peers. While real GDP growth slowed to 3.3 per cent in 2023, the economy was still among the best performers in the European Union (EU). Strong domestic demand contributed to 3.6 per cent growth year on year in the first half of 2024. Private consumption accelerated to 5.8 per cent growth year on year in this period, and investment rose by 12.0 per cent over the same period, reflecting the accelerated pace of post-earthquake reconstruction and the implementation of EU funds. External trade remained weak, however; goods exports expanded by 3.0 per cent year on year, albeit coming from a drop in 2023, but service exports were 6.2 per cent lower in the first half of 2024, leading to an increase in the trade deficit. The country is enjoying another excellent tourism season in 2024, with arrivals up 8 per cent year on year in the first half and revenues boosted by price increases.

Despite strong real wage growth, inflation is close to target. After peaking in November 2022 at 13.5 per cent, inflation steadily declined and reached 2.2 per cent by July 2024. Real wage growth averaged 12.0 per cent in the first half of 2024, almost double the average recorded in 2023, posing upside risks to inflation via stronger consumption. The latter was mainly driven by the 20 per cent boost in the minimum wage, alongside higher public-sector wages. Housing prices increased by 12 per cent in 2023, the highest growth rate in the EU, posing challenges to housing affordability.

Increased spending and tax cuts require offsetting fiscal measures. The public budget recorded a deficit of just 0.7 per cent of GDP in 2023, much lower than the EU average. The deficit target was revised to 2.6 per cent of GDP in mid-2024, driven by further decreases of the tax base, the adoption of public pay reform and higher social spending. Proposed offsetting measures include a new property tax and potential spending adjustments, particularly the phasing-out of cost of living crisis support measures. The budget deficit is expected to stay within the limit of 3 per cent of GDP in the medium term, although the level of public debt relative to GDP will decline at a slower pace than in the past three years.

Growth will remain robust in the short term. Considering the positive dynamics in the first half of the year, real GDP is forecast to grow by 3.6 per cent in 2024, with risks tilted to the upside as robust domestic demand will likely offset the weaker demand of key trading partners. In 2025, accelerated implementation of absorbed EU funds will support overall investment and thus growth, while further income and labour tax easing will continue to support consumption. We therefore forecast real GDP growth at 3 per cent in 2025.

Assessment of transition qualities (1-10)



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Structural reform developments

Croatia is among the EU frontrunners in its implementation of the Recovery and Resilience Plan. As of May 2024, 28 per cent of deliverables under the RRP had been implemented, with another 28 per cent in progress. According to the authorities, €5.6 billion has been disbursed or is being absorbed through various tenders, calls, direct awards and financial instruments, with an additional €2.4 billion in preparation. Most of the investments in the Croatian RRP are concentrated in the later stages, and making sure there is sufficient capacity to deliver them on time will be a challenge. Croatia has an allocation of close to 25 per cent of GDP from the RRP and the new cohesion policy budget.

The authorities are continuing fiscal reforms to ease the burden on the private sector. A process that began in 2016 has continued in 2024, with further increased deduction thresholds and income tax rates being replaced with new two-bracket rates set by local authorities within prescribed ranges. In addition, the city surtax on income has been abolished. Future potential changes announced by the authorities include tax relief for Croatians returning from abroad and the introduction of a value-based property tax, which was long recommended by international partners. Rental taxes were raised from 10 per cent to 12 per cent in 2024.

Public pay reform was adopted, resulting in a sizeable fiscal cost. One of the key reforms in the RRP is the reform of the salary-setting mechanism in the public sector, which entered into force in April 2024. After a period of preparation and negotiation with unions and stakeholders, which included strikes, the government adopted a law increasing public-sector wages by an average of 13.5 per cent, with some segments of the workforce receiving much higher raises. The entire reform cost around 2 per cent of GDP. The reform simplified the salary-setting formula, replacing it with 16 pay grades and increasing performance bonuses. The government also increased the base pay for state officials by 83 per cent in July 2024, as it had been unchanged since 2016.

Changes to the labour law target the recent surge in temporary employment. Croatia's labour market has tightened significantly in recent years, largely on the back of increased temporary employment. This followed deregulation efforts aimed at making the labour market more flexible and imposing measures against informal employment. Following pressure from trade unions, the government updated the legislation to limit the circumstances for offering fixed-term employment, with higher penalties for breaches of the new rules. Aside from certain cases, fixed-term contracts will not be able to exceed three years.

Renewable-energy installations are accelerating, but administrative issues remain. Croatia has historically underperformed in installing solar capacity, with the share of solar in electricity production one of the lowest in the EU. Recent reforms are starting to bear fruit, including the use of market support mechanisms, streamlining procedures, regulating energy communities and the introduction of auctions in 2020. In 2023, installed solar capacity more than doubled, while in July 2024, the Croatian energy market operator awarded premiums for 420 MW of solar and hydropower projects. Around 800 MW of mostly small-scale solar capacity has been installed so far in 2024, according to the authorities. Still, relevant associations point to the lengthy administrative procedures that delay construction, with the main issue being the grid connection fee, which is yet to be set despite an original deadline of December 2022. Another issue concerns the powers granted to the transmission system operator to disconnect capacity, which is undermining investor interest in large-scale projects.