

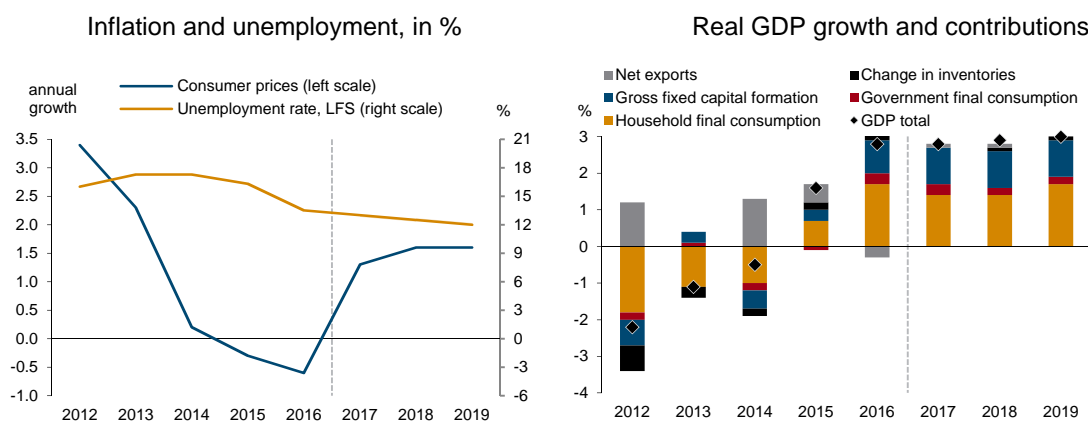


CROATIA: Robust growth expectations, at last

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Croatia's economy returned to a stable path of growth in 2016. Prospects are favourable as well, with annual GDP growth of up to 3% until the end of the forecasting period in 2019. The upswing will primarily be driven by a rise in domestic demand, both private consumption and investments. EU funding will play a major role in stimulating investments. Apart from fiscal consolidation, demographic changes will become a major challenge in the future.

Figure 37 / Croatia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Croatia's GDP continued its path of recovery, and the economy expanded at an estimated 2.8% in 2016. Growth was backed by domestic demand, both private consumption and rising investments. Private consumption growth was at its highest since the onset of the 2009 crisis, gaining momentum thanks to an improvement in the labour market, combined with real wage increases. Gross fixed capital formation continued growing and translated – after seven years of steady decline – into an increase in construction activities. In 2016, industrial production reported its highest growth (5.4% compared to a year earlier) since 2001. The best performers among the branches of industry were the manufacture of electrical equipment, chemicals and basic pharmaceutical products, while the output of shipbuilding continued to shrink.

The situation in the labour market improved, but challenges remain. According to pension insurance data, employment rose by 2% in the first three quarters of 2016; Labour Force Survey data

report an increase of less than 1%, with the unemployment rate falling by 3.8 percentage points to 13.5%, as against a year earlier. Also youth unemployment fell considerably, to an estimated 28% in 2016. However, both the overall and youth unemployment rates are still among the highest in the EU. The reduction in unemployment is only partly a result of rising employment; other factors include increasing inactivity and continued outward migration – mainly to Germany, but to a lesser extent to Austria. For example, since Croatia's EU accession in July 2013, the number of Croatian workers in Germany has risen steadily: from 83,500 to 136,500 in June 2016. In particular, the opening up of the German labour market in 2015 contributed to an increased influx of Croatian citizens to Germany. In Austria, the inflow of Croatian workers has remained fairly limited, with the employment stock increasing by about 6,400 persons in the period 2013-2016. Despite an improved economic environment, combined with rising wages, the out-migration trend continues. The results of a recent survey (conducted across 11 European countries) suggest that 77% of the Croatian respondents would be ready to move abroad for a new job; of these, more than half would go for a better job in the same profession and more than 40% would move for any job. The vast majority of these are young people aged up to 34, and they want to go abroad for more than one year. On the other hand, Croatian employers complain about labour and skills shortages in certain branches, such as shipbuilding, construction, tourism, transport and IT; they are calling for an increase in the number of work permits issued for foreign labour.

External trade in goods performed less dynamically than a year earlier, with exports and imports growing at 4.4% in euro terms in 2016. The trade deficit was about EUR 350 million higher than in 2015, while the surplus in the services trade rose, thanks to increased earnings from tourism. Revenue from tourism reached a record high in 2016, benefiting from political uncertainties in competitor countries like Turkey and Tunisia. Thus, the current account is in surplus again, at an estimated 3.7% of GDP. Foreign debt declined in 2016, owing to higher than expected GDP growth and continued deleveraging, particularly by the government and by banks.

The consolidated general government deficit continued to narrow in 2016, mostly on account of higher than expected (tax) revenue, coupled with lower expenditure, particularly on subsidies, intermediate consumption and spending on employees. The expenditure cut is partly due to provisional budget financing in the first quarter of the year, limiting state expenditure. According to preliminary results, the general government deficit declined to 2.2% of GDP in 2016. The reduction in the deficit has also translated into a reduction in public debt to 84% of GDP. Public debt fell for the first time after six years of steady increase. In view of the favourable results, Croatia hopes to exit the EU's excessive deficit procedure (EDP) this year. The 2017 budget anticipates a further reduction in the general government deficit to 1.9% of GDP, based on a 3.2% increase in GDP and taking into account the effects of the tax reform. At the end of January 2017, the government adopted the Public Debt Management Strategy 2017-2019, with the very ambitious goal of reducing the fiscal deficit to 0.6% of GDP and total public debt to 75.3% of GDP by the end of 2019. The debt reduction strategy consists of three pillars: economic growth, a further reduction in the budget deficit and better use of state assets. Positive economic results and a more stable government are also reflected in an improvement in the credit outlook from negative to stable by Standard & Poor's in December 2016 and by Fitch in January 2017. But despite this upgrading, Croatia's credit rating remains two notches below investment grade rating. In 2017, Croatia will have to repay almost EUR 4 billion of maturing bonds and interest, which should be financed via the issuing of domestic and international bonds. Already at the beginning of February, the Croatian Ministry of Finance issued two Croatian kuna bonds on the domestic market, a HRK 3 billion bond, maturing in 2022, issued at an interest rate of 2.25% and a yield of 2.29%, and a

HRK 5.5 billion bond issued at an interest rate of 2.875% and a yield of 3.09%, maturing in 2028. The issuing of bonds on the international financial markets is envisaged in March.

The introduction of the euro, for several years a major goal of the Croatian National Bank (CNB), is again in the focus of public debate. At the beginning of January, the Croatian press announced that the government and the CNB would develop a common strategy to introduce the euro. Given the current situation, Croatia fulfils three of the four Maastricht criteria (it does not yet fulfil the public debt criterion). According to Boris Vujčić, governor of the CNB, the procedure will take some time, since the procedure to introduce the euro can only start once Croatia leaves the EDP (the date of which is still uncertain). So far there has been no statement on this by the European Central Bank.

Following early elections, a new government came to office in October 2016. In mid-June 2016, the Croatian parliament dismissed Prime Minister Tihomir Orešković in a vote of no confidence. As this action also marked the end of the coalition government formed of the Croatian Democratic Union (HDZ) and its junior partner Most (in office since January 2016), early elections became necessary. HDZ, the winner of the snap elections in September, again formed a coalition with Most and representatives of smaller parties, including the representatives of minorities. The new government is led by Andrej Plenković, the newly elected more liberal head of HDZ and a former Member of the European Parliament. Compared to his predecessor as party head, Tomislav Karamarko, Mr Plenković is more centrist and capable of compromise. He is also better at understanding local politics than Mr Orešković, the former technocratic prime minister, who had spent most of his life abroad. Therefore, the government appears more stable and likely to last longer than the previous one. This also reduces the political risk in Croatia (considered quite high in the past) and should be helpful in reducing borrowing costs and increasing investor confidence. The government has a solid majority in the country's parliament (91 out of 151 seats).

A tax reform was introduced on 1 January 2017. Accordingly, personal income tax now has two tax brackets – 24% and 36% – instead of three (12%, 25% and 40%); 24% is envisaged for all incomes below HRK 17,500 a month. The personal tax allowance was increased from HRK 2,600 to HRK 3,800 a month. In addition, the overall corporate income tax was reduced from 20% to 18%, and for farmers from 20% to 12%. Furthermore, the rate of VAT on certain goods and services (e.g. agricultural raw materials, electricity supply, waste collection) was reduced from 25% to 13%.

Only recently it was announced that Croatia intends to buy back the stake of Hungarian MOL in INA, the country's oil company. Croatia, which owns about 45% of INA, and the energy group MOL, which has almost 50%, have been at odds for years over management rights and investment policy in INA. In order to raise funding for the deal, the government came up with the idea of selling 25% of the Croatian electricity company HEP in an initial public offering. However, the proposal is still at an early stage and requires the approval of the coalition parties.

wiiw expects Croatian GDP to grow by up to 3% a year in the period 2017-2019. Growth will be driven by domestic demand: private consumption will continue to grow at comparatively high levels in 2017, thanks to the impact of the tax reform on wages, along with rising employment. Also government consumption is expected to increase as a result of local elections due to be held in the first half of 2017. Consumption will remain a driver of growth in the 2018-2019 period, as the labour market situation continues to improve. Credit activities may gradually recover. Investment growth should gain momentum

in the public and the private sectors alike, supported by EU funding. Given the rise in domestic demand, imports, too, will increase in the forecasting period, while goods exports will remain at a low level owing to the weak competitiveness of the industrial sector. By contrast, exports of services – tourism in particular – will remain at high levels, since security risks in the main competitor markets will continue. As a result, the current account surplus will gradually decrease from an estimated 3.7% in 2016 to 0.9% in 2019. Assuming further reductions in the general government deficit, public debt is expected to continue its downward path in the coming three years. Demographic challenges – ageing of the population, coupled with a steady decline in the working-age population and more emigration – are also becoming increasingly apparent.

Table 8 / Croatia: Selected economic indicators

	2012	2013	2014	2015	2016 ¹⁾	2017	2018	2019
						Forecast		
Population, th pers., average	4,269	4,254	4,236	4,208	4,190	4,190	4,190	4,190
Gross domestic product, HRK mn, nom.	330,456	329,571	328,109	333,837	341,200	355,200	371,400	388,500
annual change in % (real)	-2.2	-1.1	-0.5	1.6	2.8	2.8	2.9	3.0
GDP/capita (EUR at PPP)	16,000	15,900	16,100	16,700	17,400	.	.	.
Consumption of households, HRK mn, nom.	195,623	195,623	191,407	192,745	197,300	.	.	.
annual change in % (real)	-3.0	-1.9	-1.6	1.2	3.0	2.5	2.5	3.0
Gross fixed capital form., HRK mn, nom.	64,820	65,257	63,797	65,068	67,600	.	.	.
annual change in % (real)	-3.3	1.4	-2.8	1.6	4.5	5.1	5.2	5.0
Gross industrial production ²⁾								
annual change in % (real)	-5.6	-1.8	1.2	2.7	5.4	3.5	3.5	3.5
Gross agricultural production								
annual change in % (real)	-9.4	4.2	-7.0	2.9	-2.9	.	.	.
Construction output ²⁾								
annual change in % (real)	-12.6	-4.6	-7.3	-0.6	3.0	.	.	.
Employed persons, LFS, th, average	1,566	1,524	1,566	1,589	1,600	1,620	1,640	1,660
annual change in %	-3.6	-2.7	2.7	1.5	0.7	1.0	1.5	1.5
Unemployed persons, LFS, th, average	297	318	327	309	250	240	230	230
Unemployment rate, LFS, in %, average	16.0	17.3	17.3	16.3	13.5	13.0	12.5	12.0
Reg. unemployment rate, in %, end of period	21.1	21.6	19.6	17.9	14.8	.	.	.
Average monthly gross wages, HRK ³⁾	7,875	7,939	7,953	8,055	7,800	8,100	8,400	8,700
annual change in % (real, gross)	-2.3	-1.4	0.4	1.8	3.6	2.0	2.0	2.0
Average monthly net wages, HRK ³⁾	5,478	5,515	5,533	5,711	5,700	5,900	6,100	6,400
annual change in % (real, net)	-2.6	-1.5	0.5	3.7	3.0	2.5	2.5	2.5
Consumer prices (HICP), % p.a.	3.4	2.3	0.2	-0.3	-0.6	1.3	1.6	1.6
Producer prices in industry, % p.a.	5.0	-0.4	-2.7	-3.9	-4.3	-1.0	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	41.8	43.0	42.9	43.6	44.1	43.6	43.3	43.3
Expenditures	47.1	48.3	48.3	46.9	46.3	45.6	45.1	45.0
Net lending (+) / net borrowing (-)	-5.3	-5.3	-5.4	-3.3	-2.2	-2.0	-1.8	-1.7
Public debt, EU-def., % of GDP	70.7	82.2	86.6	86.7	84.0	82.5	81.0	80.0
Stock of loans of non-fin.private sector, % p.a.	-6.9	-1.5	-2.0	-3.1	-4.0	.	.	.
Non-performing loans (NPL), in %, Dec	13.9	15.7	17.1	16.6	14.7	.	.	.
Central bank policy rate, % p.a., end of period ⁴⁾	7.0	7.0	7.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR mn	-22	441	906	2,236	1,670	970	730	460
Current account, % of GDP	-0.1	1.0	2.1	5.1	3.7	2.1	1.5	0.9
Exports of goods, BOP, EUR mn	8,673	8,924	9,761	10,695	11,120	11,700	12,300	13,000
annual change in %	-0.8	2.9	9.4	9.6	4.0	5.0	5.5	5.5
Imports of goods, BOP, EUR mn	14,969	15,511	16,257	17,522	18,290	19,600	21,000	22,500
annual change in %	-1.0	3.6	4.8	7.8	4.4	7.0	7.0	7.0
Exports of services, BOP, EUR mn	9,643	9,841	10,222	11,256	12,160	12,900	13,600	14,300
annual change in %	2.9	2.1	3.9	10.1	8.0	6.0	5.5	5.5
Imports of services, BOP, EUR mn	3,128	3,062	2,857	3,195	3,420	3,600	3,800	4,000
annual change in %	-1.4	-2.1	-6.7	11.8	7.0	6.0	6.0	6.0
FDI liabilities, EUR mn	1,145	728	2,281	187	1,200	.	.	.
FDI assets, EUR mn	-87	-111	1,600	-69	-200	.	.	.
Gross reserves of NB excl. gold, EUR mn	11,236	12,908	12,688	13,707	13,514	.	.	.
Gross external debt, EUR mn	45,297	45,803	46,416	45,384	43,500	44,100	45,100	46,200
Gross external debt, % of GDP	103.1	105.3	108.0	103.5	96.0	94.0	92.0	90.0
Average exchange rate HRK/EUR	7.5217	7.5786	7.6344	7.6137	7.5333	7.57	7.57	7.57

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) Data for 2016 according to new data sources. - 4) Discount rate of NB.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.