23. CROATIA

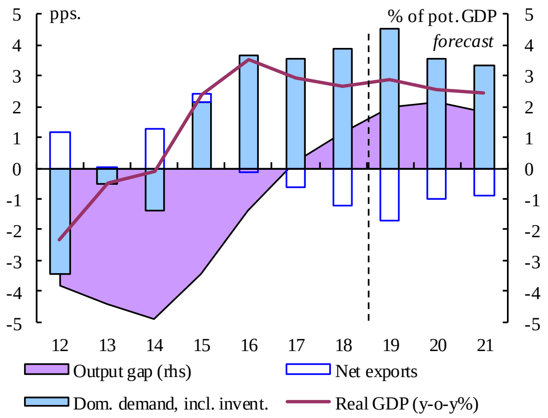
Moderate growth under external pressures

As growth in Croatia's main trading partners moderates, domestic demand will remain the main driver of economic activity. Household consumption remains strong, driven by growing employment and wages as well as low inflation. Investment is set to continue growing strongly, backed by EU funds, and government consumption is also expected to support growth. The economy should continue adding jobs, but at a slower pace as labour shortages appear in some sectors. The debt ratio is set to continue declining steadily as the general government balance turns from mildly positive to neutral.

Growth recovery in the first half of 2019

Economic activity in Croatia regained momentum in the first half of 2019, after a weaker-than-expected performance towards the end of 2018. Real GDP rose sharply in the first quarter, by 1.5% quarter-on-quarter, followed by more moderate growth in the second quarter, at 0.2%. Based on high frequency indicators, growth is expected to remain moderate in the second half of the year, bringing the forecast for 2019 to 2.9%. Domestic demand is driven by strong household consumption and is supported by public consumption and investment, which benefits from increasing use of EU funding. Despite a recovery in exports, net exports are set to negatively contribute to growth due to the strong performance of imports.

Graph II.23.1: **Croatia - Real GDP growth and contributions, output gap**



Growth driven by domestic demand

Throughout the 2019-2021 period, domestic demand is forecast to remain the main driver of GDP growth. Ongoing improvements in the labour market, rising wages and low inflation will continue to drive household consumption. A stronger contribution from public consumption is expected, driven by rising intermediate consumption and an increasing public sector wage bill. Together with pension increases, public sector wage hikes are expected to support disposable incomes and boost household consumption. Driven by the rising uptake of EU funds by both the public and private sectors, investment growth is expected to record growth rates above those observed since 2015 throughout the forecast period. Furthermore, favourable financing conditions should remain supportive of private investment.

After growing at an average rate of almost 8% since 2013, Croatia's goods exports grew significantly less in 2018, thus ending a period of rapid market share gains. In addition, uncertainties surrounding global trade and the weakening economic performance expected in some of Croatia's main trading partners are expected to slow down growth in goods exports throughout the 2019-2021 period. Exports of services, dominated by the tourism sector, are also expected to grow more moderately. With rising competition in the tourism sector and high capacity utilisation in the busiest months of the season, it would take an increase in both the number of visits outside the peak season and in per-capita spending to boost export growth in the service sector. Import growth, by contrast, is expected to remain strong in 2020 and 2021, in line with domestic demand. Overall, the trade balance is expected to deteriorate throughout the forecast period. The current account balance is expected to gradually decrease to 0.3% of GDP by 2021.

With real GDP growth at 2.9% in 2019, GDP is set to finally surpass its pre-crisis level. Going forward, GDP growth is expected to moderate to 2.6% and 2.4% in 2020 and 2021, respectively.

Labour market conditions improve amid low inflation

Labour market conditions continue improving, although labour shortages are becoming more apparent in some sectors. Moderate employment growth is expected to continue throughout the forecast period. The number of unemployed and the unemployment rate are both already at their lowest recorded levels and are projected to continue decreasing. At the same time, the activity rate is projected to pick up marginally, largely due to negative demographic dynamics, particularly Croatia's high level of emigration. Strong labour demand and the planned increase in public sector wages should support real wage growth. Still, unit labour costs are set to increase only moderately.

In the first half of 2019, headline inflation declined compared to 2018, mainly due to a significant reduction in the VAT rate on selected unprocessed foods. The HICP inflation rate should thus drop to just below 1% in 2019. Inflation is projected to pick up in 2020 and 2021, to 1.3% and 1.5% respectively.

Public finances to remain in check

In 2019, the general government balance is expected to remain in surplus for the third year in a row. Revenues are performing strongly in spite of tax cuts, which particularly affected revenue from VAT and social contributions. Expenditure grows primarily due to wage hikes in the public sector, investment and intermediate consumption.

In 2020-2021, tax revenue is expected to grow at a slower pace than nominal GDP, due to further tax cuts. EU funds are projected to continue supporting revenues as the programming period enters its most mature stage. Expenditure growth should continue in 2020 and moderate somewhat in 2021, largely due to the strong base effect of the rising wage bill, investment and capital transfers in 2018-2019. Additional savings are expected in interest payments, most notably in 2020, as a sizable portion of maturing debt is refinanced at lower rates. Overall, the budget is expected to remain balanced.

In structural terms, the general government deficit is expected to increase from 0.3% of GDP in 2018 to 1% of GDP in 2020 and decrease slightly in 2021. The debt ratio is set to continue declining strongly on the back of surpluses and nominal GDP growth, dipping below 65% of GDP in 2021.

Table II.23.1:

Main features of country forecast - CROATIA

	2018			Annual percentage change						
bn HRK	Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021	
GDP	381.8	100.0	1.7	3.5	2.9	2.6	**2.9**	**2.6**	**2.4**	
Private Consumption	219.6	57.5	1.4	3.5	3.6	3.5	**3.6**	**3.1**	**2.9**	
Public Consumption	75.3	19.7	1.2	0.7	2.7	2.9	**3.3**	**2.9**	**1.3**	
Gross fixed capital formation	76.7	20.1	2.3	6.5	3.8	4.1	**8.8**	**7.5**	**7.2**	
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**	
Exports (goods and services)	195.6	51.2	4.6	5.6	6.4	2.8	**3.2**	**2.7**	**2.6**	
Imports (goods and services)	190.4	49.9	4.0	6.2	8.1	5.5	**6.3**	**5.3**	**4.6**	
GNI (GDP deflator)	375.0	98.2	1.9	0.9	4.4	2.6	**2.8**	**2.5**	**2.4**	
Contribution to GDP growth: Domestic demand			1.7	3.4	3.3	3.4	**4.5**	**3.9**	**3.5**	
Inventories			0.1	0.3	0.2	0.5	**0.0**	**0.0**	**0.0**	
Net exports			0.0	-0.1	-0.6	-1.2	**-1.5**	**-1.3**	**-1.1**	
Employment			0.1	0.3	2.2	1.8	**1.3**	**1.1**	**1.1**	
Unemployment rate (a)			13.7	13.4	11.0	8.4	**6.9**	**5.8**	**4.9**	
Compensation of employees / head			3.2	1.3	-1.1	2.2	**2.6**	**2.5**	**2.2**	
Unit labour costs whole economy			1.5	-1.8	-1.8	1.4	**1.0**	**1.0**	**0.8**	
Real unit labour cost			-1.2	-1.8	-2.8	-0.3	**-0.9**	**-1.4**	**-1.6**	
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**	
GDP deflator			2.8	-0.1	1.1	1.7	**1.9**	**2.4**	**2.5**	
Harmonised index of consumer prices			2.6	-0.6	1.3	1.6	**0.9**	**1.4**	**1.5**	
Terms of trade goods			0.8	-0.6	-1.3	-0.5	**0.4**	**0.7**	**0.6**	
Trade balance (goods) (c)			-18.2	-15.7	-16.6	-17.6	**-18.7**	**-19.3**	**-19.8**	
Current-account balance (c)			-	2.5	4.1	2.9	**1.6**	**0.7**	**0.3**	
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-	4.0	4.7	4.4	**3.6**	**2.6**	**2.2**	
General government balance (c)			-	-1.1	0.8	0.3	**0.1**	**0.0**	**0.0**	
Cyclically-adjusted budget balance (d)			-	-0.5	0.7	-0.3	**-0.8**	**-1.0**	**-0.8**	
Structural budget balance (d)			-	-0.6	0.7	-0.3	**-0.8**	**-1.0**	**-0.8**	
General government gross debt (c)			52.2	81.0	78.0	74.8	**71.2**	**67.7**	**64.4**	

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

Note: The macroeconomic forecast for Croatia is based on the latest comprehensive national accounts data release available at the cut-off date of the forecast.