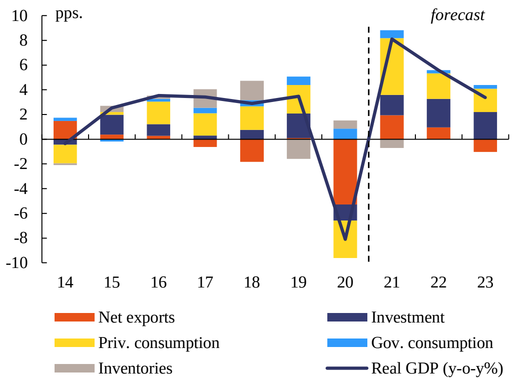
23. CROATIA

The recovery of Croatia's economy continued in 2021, mostly supported by strong private consumption and a better-than-expected performance of the tourism sector. Favourable economic developments spilled over to the labour market, which experienced strong employment dynamics. With the general government deficit also improving after the deterioration in 2020, the debt is set to steadily decline. Although the outlook is favourable, several risks could weigh on the growth trajectory.

Strong rebound in the first half of 2021

In the first half of 2021, Croatia's economy continued to rebound strongly from the significant drop in output recorded in 2020. The recovery was mostly driven by strong household consumption growth, although other components also provided support. Short-term indicators point to a continuation of positive developments in the rest of the year, with tourism and goods exports showing notably strong performances.

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



Favourable outlook, but risks persist

Domestic demand should be the main engine of growth throughout the forecast period. Household consumption growth is expected to remain robust, supported by favourable labour market developments, high accumulated savings, and growth in consumer loans. Government consumption should also remain supportive of the expansion although its contribution to growth is expected to decline. Investment is expected to accelerate, supported by the Recovery and Resilience Facility (RRF), the previous and current Multiannual Financial Frameworks and the Solidarity fund disbursements to support post-earthquake reconstruction. In particular, the RRF total absorption in the period 2020-2023 is expected to stand at 5.2% of 2019 GDP. With time, these funds are likely to crowd-in additional private investments, which should also continue to be supported by favourable financing conditions. Moreover, the reforms set to be implemented under the Recovery and Resilience Plan (RRP) are bound to sustain business confidence.

As for the external sector, goods exports should rise in line with the improving economic conditions in Croatia's main trading partners. After surprising positively in 2021, tourism-dominated services exports should remain on a solid growth path throughout the forecast horizon. The main supportive factors should be favourable economic conditions in main origin markets and the gradual normalisation of travel. Despite the expected solid performance of goods exports, the merchandise trade balance is expected to gradually deteriorate due to the pronounced import dependence of final demand, while the current account balance should record mild surpluses.

Overall, real GDP is forecast to grow by 8.1% in 2021, followed by 5.6% and 3.4% growth in 2022 and 2023. Consequently, the volume of GDP should reach its 2019 level during 2022. Key downside risks stem from Croatia's relatively low vaccination rates, which could lead to stricter containment measures, and continued delays of the earthquake-related reconstruction. On the upside, potential entry into the Schengen area and euro adoption towards the end of the forecast period could benefit investment and trade.

Dynamic labour market

After reaching 7.5% in 2020, the unemployment rate is expected to gradually decline throughout the forecasting period. Employment is expected to reach its pre-crisis level already in 2021, as administrative data points to strong performance in the first seven months of this year. In the forecast horizon, labour market dynamics are expected to be driven by the overall expansion of economic activity, the expected acceleration of the investment cycle and RRF-sponsored active labour market policies.

Inflation is expected to pick-up

HICP inflation is expected to accelerate, reaching 2.2% in 2021, followed by a gradual stabilisation. Key factors behind this surge in prices are rising energy and food prices, triggered by global and European-specific factors. Although these are deemed transitory, risks of more persistent inflation are still present.

Public finances on the adjustment path

In 2021, the general government deficit is set to narrow to 4.1% of GDP from 7.4% in 2020, thanks largely to the strong economic recovery and the gradual phasing out of support measures. Value-added tax revenues are forecast to record strong growth amidst rising household and tourist consumption. Overall revenues are expected to continue increasing consistently with nominal GDP in 2022 and 2023. However, revenue aggregates will evolve differently.

Against particularly stronger value-added tax revenues and social contributions growth, personal income tax and corporate income tax revenue growth will remain subdued as a result of personal income tax rate cuts taking effect in 2021 and companies offsetting taxable profits by carrying forward the losses incurred during the pandemic. Value-added tax and social contribution revenues are set to reach pre-pandemic levels in 2021, while income tax revenues should fully recover in 2023.

Expenditures are forecast to grow at 4.5% per year in the period 2021-2023 on average, as growth in gross fixed capital formation (supported by RRF funding) outweighs the expenditure-reducing effects of the phasing out of emergency subsidies to firms aimed at preservation of jobs introduced during the pandemic. In spite of substantial new accumulated debt during the crisis, interest expenditure is projected to decrease over the forecast horizon as maturing debt is refinanced at lower rates. The government deficit is expected to be slightly below 3% of GDP in 2022 and narrow to a ratio marginally above 2% in 2023.

After increasing by more than 16 pps. in 2020 the public debt-to-GDP ratio is set to decrease from 87.3% of GDP in 2020 to 77.9% in 2023. Debt dynamics will be affected by solid GDP and revenue growth, the phasing out of COVID-19 related measures and debt-reducing stock flow adjustments as well as other transactions recorded below the line.

Table II.23.1:

Main features of country forecast - CROATIA

		2020			Annual percentage change					
bn HRK		Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP		378.3	100.0	1.8	2.9	3.5	-8.1	**8.1**	**5.6**	**3.4**
Private Consumption		222.8	58.9	1.4	3.3	4.1	-5.3	**7.8**	**3.5**	**3.3**
Public Consumption		90.6	24.0	2.0	2.4	3.3	4.1	**2.7**	**1.1**	**1.4**
Gross fixed capital formation		84.4	22.3	1.9	3.8	9.8	-6.1	**7.4**	**10.5**	**9.5**
of which: equipment		0.0	:	:	:	:	:	**:**	**:**	**:**
Exports (goods and services)		159.0	42.0	3.8	3.7	6.8	-22.7	**22.1**	**15.0**	**9.0**
Imports (goods and services)		184.6	48.8	3.8	7.5	6.5	-12.3	**15.1**	**11.9**	**10.3**
GNI (GDP deflator)		386.3	102.1	1.9	2.8	4.0	-6.0	**6.4**	**4.2**	**3.6**
Contribution to GDP growth:	Domestic demand			1.8	3.2	5.0	-3.5	**6.9**	**4.6**	**4.4**
	Inventories			0.3	1.6	-1.6	0.7	**-0.7**	**0.0**	**0.0**
	Net exports			-0.3	-1.8	0.1	-5.3	**1.9**	**1.0**	**-1.0**
Employment				0.3	2.6	3.1	-1.2	**1.6**	**1.3**	**1.2**
Unemployment rate (a)				13.2	8.5	6.6	7.5	**6.7**	**6.2**	**5.8**
Compensation of employees / head				2.6	3.9	0.4	2.1	**2.0**	**3.3**	**2.4**
Unit labour costs whole economy				1.1	3.6	0.0	9.8	**-4.2**	**-0.9**	**0.2**
Real unit labour cost				-1.2	1.5	-1.9	10.0	**-6.4**	**-2.9**	**-1.6**
Saving rate of households (b)				7.2	9.9	9.5	13.4	**:**	**:**	**:**
GDP deflator				2.3	2.0	1.9	-0.1	**2.4**	**2.1**	**1.9**
Harmonised index of consumer prices				2.1	1.6	0.8	0.0	**2.2**	**2.0**	**1.5**
Terms of trade goods				0.4	-0.5	0.3	-3.8	**-0.2**	**0.2**	**0.1**
Trade balance (goods) (c)				-17.9	-18.3	-18.8	-17.3	**-18.8**	**-20.9**	**-23.1**
Current-account balance (c)				-3.6	1.9	2.8	-0.9	**0.8**	**0.8**	**0.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.1	3.2	4.5	1.3	**4.3**	**5.3**	**4.8**
General government balance (c)				-4.1	0.2	0.3	-7.4	**-4.1**	**-2.9**	**-2.1**
Cyclically-adjusted budget balance (d)				-4.1	-1.0	-1.3	-4.7	**-3.5**	**-3.4**	**-2.7**
Structural budget balance (d)				-1.7	-1.0	-1.3	-4.7	**-3.5**	**-3.4**	**-2.7**
General government gross debt (c)				57.0	73.3	71.1	87.3	**82.3**	**79.2**	**77.9**

(a) Eurostat definition. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.