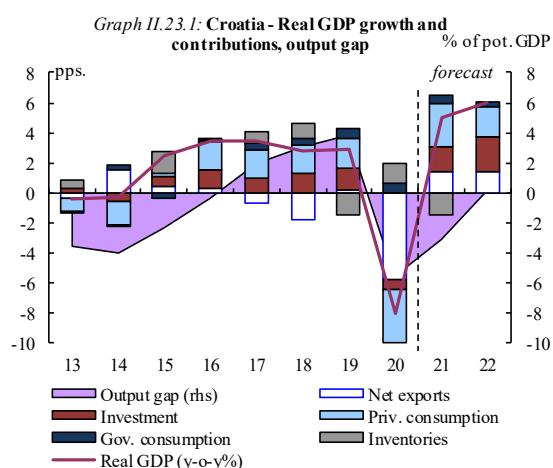


23. CROATIA

After a sharp contraction of economic output in 2020 brought about by the COVID-19 pandemic, Croatia's GDP is set to grow strongly in 2021 and exceed its pre-crisis level in 2022. The recovery is expected to be broad-based, driven primarily by growing exports of services (tourism), private consumption and investment. Employment, which performed rather well during the crisis, is also expected to increase, albeit slowly. Public finances, which bore the brunt of the crisis, are set to recover gradually in 2021 and 2022, moderately reducing the public debt ratio from its elevated levels.

A swift rebound after an unprecedented drop

In 2020, Croatia's economy contracted by 8%, the steepest drop on record and among peer countries. The severity of the contraction can be attributed to the particular difficulties of the tourism sector, which used to contribute as much as 16% to Croatia's GDP. Private consumption also took a strong hit, largely due to the constraints imposed on the consumption of services, rather than decreasing incomes. The labour market performed very well, given the loss in output, as it was well shielded by emergency support measures. While deep, the drop in output was concentrated in the first half of 2020, followed by strong growth in the last two quarters. This pattern was particularly pronounced for investments and goods exports, which overall only marginally declined in 2020, as the steep drop in the second quarter gave way to a surge in the third and fourth quarters.



Recovery set to be quick and broad-based

Fuelled by pent-up demand and the accumulation of involuntary savings, household consumption is set to provide a boost to growth as constraints on the consumption of services ease. This trend should be supported by moderately positive labour market developments. Investment is set to provide

a steady impetus to growth, supported by reconstruction after the 2020 earthquakes, stronger take-up of European Structural Investment funds and, particularly as of 2022, the Recovery and Resilience Facility (the impact of which is aligned with the absorption profile envisaged in Croatia's draft Recovery and Resilience Programme available at the cut-off date). Furthermore, despite evidence of stress in the hardest-hit sectors, the share of non-performing loans has thus far increased only marginally and credit is growing as banks remain well capitalised and liquid.

Although services exports (mainly tourism) are forecast to remain below pre-crisis levels by end-2022, their recovery is expected to be the key driver of growth. Exports of goods are set to benefit from strong demand in Croatia's key trading partners and exceed their pre-pandemic level already in 2021. Consequently, after plummeting in 2020, the trade balance is set to improve, yet remain well below its pre-pandemic level in 2022. The current account balance should remain mildly negative by end-2022.

On aggregate, real GDP is forecast to grow by 5% in 2021 and 6.1% in 2022. This trajectory is subject to high uncertainty and both positive and negative risks. Downside risks most notably include the extent to which the pandemic is curbed in both Croatia and its key emissive tourist markets in time for the tourist season. Low administrative capacity presents a risk for a swift absorption of the funds available to Croatia. Key upside risks include a stronger growth in exports of goods and a faster recovery of services.

Labour market on good footing to recover

The unemployment rate rose by less than 1 pp to reach 7.5% in 2020. Job losses were recorded in the first three quarters of 2020, after which job creation resumed. The relatively modest increase considering the magnitude of the loss in output suggests that labour market scarring has for now

largely been avoided. Such outcomes can be attributed to the nature of the shock and the relatively brief and mild nature of containment. Most notably, the emergency measures adopted by the government effectively incentivised employers to retain their workforce. As economic output increases, a period of labour hoarding is expected to give way to job creation, pushing the unemployment rate back to 6.6% by 2022. Wage growth is expected to be moderate as expected labour shortages are offset by companies' limited capacity to increase wages. This should bring unit labour costs down after a spike in 2020.

HICP-measured inflation is expected to pick up mildly, reaching 1.3% in 2021 and 2022, driven by energy and processed food prices.

Public finances under strain to spur recovery

The general government deficit recorded a level of 7.4% of GDP in 2020 as the drop in economic activity shrunk the revenue side (-6.5% year-on-year), while creating new needs on the expenditure side (+8.6% year-on-year). The most significant among the support measures (which add up to 3% of GDP) concerns the subsidy for wages, which was extended into 2021.

In 2021 and 2022, tax revenue is expected to recover strongly as household consumption and tourism rebound and the economy creates jobs. This should particularly benefit VAT revenues and social contributions, whereas revenue from taxes on income and wealth will remain subdued due to tax cuts and low profits. The absorption of RRF and ESI funds should boost both non-tax revenues and spending in 2021 and 2022. After spiking in 2020, expenditure growth should moderate in 2021 and 2022. The growing wage bill, a rebound of intermediate consumption and, above all, strong investment are forecast to outweigh the expenditure-reducing effects of the phasing out of subsidies introduced during the pandemic and further savings on debt servicing costs. Overall, the deficit is projected at 4.6% of GDP in 2021 and 3.2% of GDP in 2022.

Having reached a new high of 88.7% of GDP in 2020, the debt ratio should resume its downward path, albeit more slowly than in the pre-crisis period, as the government continues to accumulate deficits to support the recovery. The debt is expected to dip below 83% of GDP by 2022.

Table II.23.1:

Main features of country forecast - CROATIA

	2019			Annual percentage change						
	bn HRK	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	402.3	100.0		1.7	3.4	2.8	2.9	-8.0	5.0	6.1
Private Consumption	232.8	57.9		1.5	3.1	3.3	3.5	-6.2	4.9	3.4
Public Consumption	79.5	19.7		1.5	2.2	2.3	3.4	3.4	2.5	1.5
Gross fixed capital formation	84.6	21.0		2.9	5.1	6.5	7.1	-2.9	7.3	10.2
of which: equipment	0.0	:		:	:	:	:	:	:	:
Exports (goods and services)	209.1	52.0		4.0	6.8	3.7	6.8	-25.0	16.3	12.2
Imports (goods and services)	210.1	52.2		4.0	8.4	7.5	6.3	-13.8	11.0	8.2
GNI (GDP deflator)	400.3	99.5		1.7	5.2	2.7	2.9	-7.2	3.6	5.4
Contribution to GDP growth:										
Domestic demand				2.0	3.3	3.7	4.1	-3.5	5.1	4.7
Inventories				0.1	0.8	1.0	-1.5	1.3	-1.5	0.0
Net exports				-0.3	-0.6	-1.8	0.2	-5.8	1.4	1.4
Employment				0.1	2.4	2.6	3.1	-1.2	0.6	1.4
Unemployment rate (a)				13.5	11.2	8.5	6.6	7.5	7.2	6.6
Compensation of employees / head				2.7	0.2	3.8	1.5	2.1	1.4	0.9
Unit labour costs whole economy				1.1	-0.7	3.6	1.7	9.7	-2.9	-3.5
Real unit labour cost				-1.4	-1.9	1.6	0.2	9.3	-4.5	-5.1
Saving rate of households (b)				5.8	8.1	8.5	8.6	:	:	:
GDP deflator				2.5	1.2	2.0	1.5	0.4	1.7	1.7
Harmonised index of consumer prices				2.3	1.3	1.6	0.8	0.0	1.3	1.3
Terms of trade goods				0.4	-1.3	-0.5	0.3	-3.8	-0.5	0.0
Trade balance (goods) (c)				-18.2	-17.1	-18.6	-19.3	-17.3	-18.8	-19.1
Current-account balance (c)				-3.9	3.9	2.4	3.1	-1.1	-2.0	-0.7
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.5	5.0	3.8	5.2	1.5	0.5	2.8
General government balance (c)				-4.3	0.8	0.2	0.3	-7.4	-4.6	-3.2
Cyclically-adjusted budget balance (d)				-4.2	-0.1	-1.2	-1.4	-5.0	-3.2	-3.3
Structural budget balance (d)				-2.4	-0.1	-1.2	-1.4	-5.0	-3.2	-3.3
General government gross debt (c)				55.0	77.6	74.3	72.8	88.7	85.6	82.9

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