11. CROATIA

Towards a broad-based recovery

Croatia's economy is expected to grow 2.6% this year on the back of a rebound in consumption, strong investment growth and a record tourist season. Domestic demand is expected to remain strong but net trade is set to continue detracting from growth in 2017 and 2018, due to strong demand for imports. Unemployment is projected to fall sharply due to employment growth and a shrinking labour force. The general government deficit is forecast to decline further, setting the debt-to-GDP ratio on a declining path already this year.

Expectations of a strong third quarter support the growth outlook for 2016

Domestic demand grew buoyantly in the first half of the year, with investment and consumption rising by 4.8% and 2.3% respectively. Exports of goods performed well, hinting at further gains in export market shares, mainly within the EU.

Both, industrial production and retail trade signal a continuation of the positive trends in the third quarter, while confidence indicators are at record highs. Most importantly, a sharp increase in tourist arrivals (7.0% y-o-y up to August) confirms a new record tourist season, with exports of services set to grow this year by another 5.6%. Despite this, the net contribution of external demand is expected to turn slightly negative and the current account surplus to decrease to 3.0% of GDP, as growth of imports outpaces that of exports.

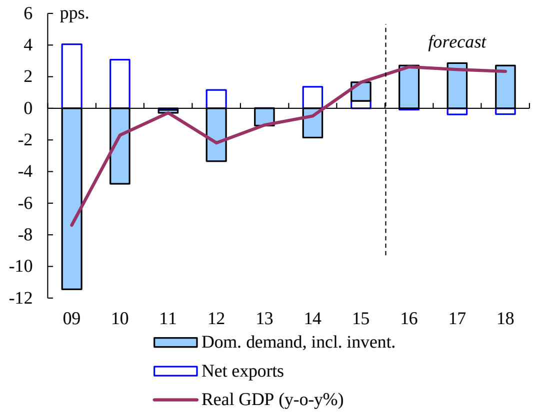
Overall, GDP is projected to expand by 2.6% in 2016. The acceleration of economic activity is set to have a positive impact on the labour market, with employment expected to increase by 1.8%. The fall in the unemployment rate is forecast to be much sharper (nearly 3 pps.), as the labour force keeps contracting on the back of adverse demographic dynamics and net migration outflows. Prices continued to decrease faster than the EU average up to September. As a result, average inflation is projected to fall to -0.9% this year, on the back of falling oil price and a reduction in gas tariffs and subdued core inflation.

Low interest rates and increased EU fund absorption support the recovery of investment

Following a significant increase in 2016 of almost 3%, on the back of negative inflation, real growth of average compensation per employee is set to slow down in 2017 and 2018, while employment is forecast to keep expanding. Despite the expected turnaround in inflation dynamics (0.8% in 2017 progressively accelerating to 1.5% in 2018) and the fading-out of the impact of last year's tax reform, household consumption is projected to continue growing moderately.

Over the next two years, investment growth is expected to remain strong. Easing credit standards for the corporate sector, decreasing non-performing loans and solid deposit growth are set to support the recovery of private investment. Public investment is also expected to recover, following its collapse in 2015, also thanks to the continued rise in Croatia's absorption of EU funds.

Graph II.11.1: **Croatia - Real GDP growth and contributions**



Croatia's ongoing integration into the EU single market is expected to further benefit exports, but the growth in exports of goods is projected to slow down, as the boost from EU accession fades out. Exports of services are also set to grow more moderately, as tourist arrivals are expected to stabilise with oil prices recovering. All in all, external demand is expected to detract from growth in 2017 and 2018, as vibrant domestic demand pushes up imports. On account of these developments, GDP growth is set to progressively ease to 2.3% in 2018, while the current account surplus is set to shrink to 1.8% of GDP.

Risks to the forecast are broadly balanced. A deterioration of external conditions in 2017 could result in a sharper deceleration of exports. By contrast, the new government might resume the structural reform agenda and implement the tax reductions which are still being considered. These developments would have a positive impact on investment and consumption.

Fast declining general government deficit and debt

Following substantial consolidation efforts in 2015, the general government balance is projected to further improve to -2.1% of GDP in 2016. The improvement is to a large extent driven by the acceleration of the economic activity, resulting in windfall revenues. In the first three quarters, revenues from corporate income tax were especially strong and VAT performed well, as rising private consumption and a strong tourist season more than offset the effects of deflation. Growth in government expenditure has been restrained, owing more to under-execution during the caretaker government than to structural consolidation measures. Provisional data suggest that public investment is no longer bearing the brunt of consolidation: after a series of sharp decreases (totalling a cumulative reduction of 48% in 2008-2015), it is now projected to increase by 16.5%, on the back of higher take-up of EU funds.

In the absence of a budget for 2017, the headline deficit should continue shrinking on the back of economic growth, bringing the general government balance to -1.8% and -1.4% of GDP in 2017 and 2018, respectively. However, the structural balance, which improved by some 1½ pps. from 2013 to 2016, is set to deteriorate by about ¾ pps. of GDP by 2018.

Croatia's debt-to-GDP ratio is expected to fall to 85% in 2016, largely due to stronger GDP growth and the appreciation of the HRK against the EUR, as the majority of the debt is in EUR. The debt ratio is projected to further decline over the forecast horizon to 82.8% in 2018, as growth continues and prices recover.

Risks to the fiscal forecast include the outcome of public sector wage negotiations and the dispute with banks over plans to convert CHF-denominated loans, as well as the comprehensive tax reform currently under consideration.

Table II.11.1:

Main features of country forecast - CROATIA

		2015		Annual percentage change						
bn HRK		Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		333.8	100.0	2.1	-1.1	-0.5	1.6	**2.6**	**2.5**	**2.3**
Private Consumption		196.2	58.8	2.0	-1.8	-1.6	1.2	**2.7**	**2.5**	**2.4**
Public Consumption		65.8	19.7	1.6	0.3	-0.8	-0.3	**0.9**	**1.0**	**0.9**
Gross fixed capital formation		65.1	19.5	3.5	1.4	-2.8	1.6	**4.8**	**6.1**	**5.3**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		166.8	50.0	4.0	3.1	7.6	10.0	**6.0**	**3.5**	**4.0**
Imports (goods and services)		157.7	47.2	3.7	3.1	4.5	9.4	**6.6**	**4.6**	**5.0**
GNI (GDP deflator)		334.3	100.1	1.9	0.2	-1.8	4.5	**-0.3**	**2.5**	**2.4**
Contribution to GDP growth:	Domestic demand			2.5	-0.7	-1.7	1.0	**2.7**	**2.9**	**2.7**
	Inventories			0.0	-0.3	-0.2	0.2	**0.0**	**0.0**	**0.0**
	Net exports			-0.3	0.0	1.4	0.5	**-0.1**	**-0.4**	**-0.4**
Employment				-0.2	-2.7	2.7	1.5	**1.8**	**1.5**	**1.2**
Unemployment rate (a)				-	17.3	17.3	16.3	**13.4**	**11.7**	**10.3**
Compensation of employees / head				6.3	-0.6	-5.4	-0.3	**1.7**	**1.9**	**2.0**
Unit labour costs whole economy				3.9	-2.3	-2.4	-0.5	**0.8**	**1.0**	**0.9**
Real unit labour cost				0.0	-3.0	-2.4	-0.6	**0.6**	**0.1**	**-0.3**
Saving rate of households (b)				-	10.5	12.8	14.5	**14.6**	**14.5**	**13.4**
GDP deflator				3.9	0.8	0.0	0.1	**0.2**	**0.9**	**1.2**
Harmonised index of consumer prices				-	2.3	0.2	-0.3	**-0.9**	**0.8**	**1.5**
Terms of trade goods				1.3	-1.6	-0.9	-0.8	**0.2**	**-0.5**	**-0.8**
Trade balance (goods) (c)				-19.0	-15.1	-14.8	-15.2	**-15.4**	**-15.6**	**-16.2**
Current-account balance (c)				-4.4	1.6	1.1	5.3	**3.0**	**2.4**	**1.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-4.4	1.6	1.1	5.8	**3.9**	**3.5**	**3.1**
General government balance (c)				-	-5.3	-5.4	-3.3	**-2.1**	**-1.8**	**-1.4**
Cyclically-adjusted budget balance (d)				-	-3.5	-3.5	-2.1	**-1.7**	**-2.2**	**-2.5**
Structural budget balance (d)				-	-3.3	-3.7	-2.2	**-1.8**	**-2.3**	**-2.5**
General government gross debt (c)				-	82.2	86.6	86.7	**85.0**	**84.3**	**82.8**

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