

11. CROATIA

Growth set to remain strong, but risks widen

The economic recovery is set to remain strong and broad-based. The troubles facing Croatia's largest private company, Agrokor, are expected to weigh on growth, but real GDP is still projected to expand by a solid 2.9% this year and slightly decelerate thereafter. Unemployment is projected to continue falling, although at a slower pace, as the labour force shrinks more moderately. After another record reduction in 2016, the general government deficit is projected to increase mildly, but with output growing well above potential, the structural balance is set to deteriorate significantly.

Pace of expansion expected to have weakened in the beginning of the year

In the fourth quarter of 2016, real GDP increased by a higher-than-expected 3.5% (y-o-y), resulting in an annual growth of 2.9%. In the first quarter of 2017, retail and tourism remained strong, and confidence was at a record high. Industrial production, however, deteriorated somewhat – particularly in the consumer goods segment. This was possibly related to the distressed food-processing and retail group Agrokor – Croatia's largest employer – which faced severe difficulties in (re)financing its liabilities earlier this year.

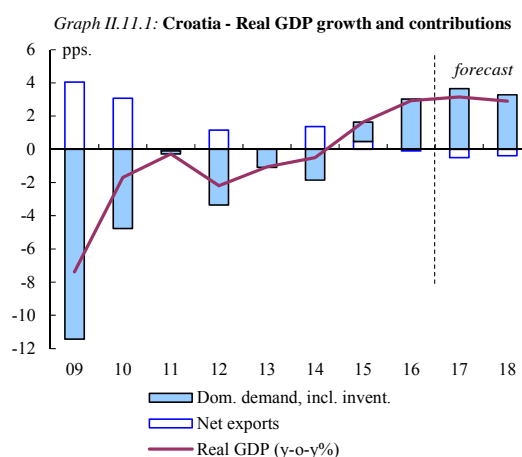
Growth expected to remain robust over the forecast horizon

The continuity of Agrokor's operations should be ensured by the recently activated measures on emergency receivership in systematically important companies. Disruptions experienced in the first part of the year may hold back consumption and especially investment, as well as affect confidence. These difficulties notwithstanding, the positive trends registered in 2016 are set to continue. The personal income tax reform, coupled with further gains in employment and real wages, should sustain the acceleration of private consumption. After a solid rebound already last year, investment is expected to continue rising.

Croatian firms are expected to further improve their export market shares, with exports of goods expanding above 6%. As the tourist season appears to progressively extend beyond the traditional summer months and investment in the sector intensifies, exports of services are also expected to remain strong, although short of the record growth rates registered over the last two years. Strong domestic and external demand are nevertheless set to sustain import growth above that of exports.

This, coupled with the rebound in energy prices, is projected to lead to a deterioration of the balance

of trade in 2017. Conversely, reduced repatriated earnings in the banking sector, due to the ongoing provisioning and possible write-offs of irrecoverable loans related to the Agrokor crisis, are expected to improve the traditionally negative income balance and thus the overall current account surplus, which is expected to increase to 2.9% of GDP.



In 2018 export growth is projected to slow down further. Whereas private consumption is set to decelerate to around 3%, fixed capital formation is projected to further accelerate – underpinned by strong public sector investment. On the whole, GDP growth is set to remain strong and broad-based at about 2.6%.

Upcoming wage hikes and higher energy prices drive up inflation

Sustained economic growth is projected to boost employment growth, while the labour force is set to keep shrinking, although at a more moderate pace than in 2016. As a result, the unemployment rate is projected to decrease more mildly, but still fall below 10% by the end of 2018. The tightening labour market and wage increases in the public sector are set to push labour costs up by 2.5% in both 2017 and 2018. As wages grow and energy

prices rebound, inflation is expected to hit 1.6% in 2017 before subsiding slightly thereafter, as the effects of higher energy prices fade.

Risks to the forecast have turned more negative. The forthcoming restructuring of Agrokor could have stronger-than-expected spillover effects on the economy, also through weakening economic sentiment. Unusually long queues at land border crossings might negatively affect the tourism sector, where revenues are estimated at around 20% of GDP. Upside risks relate to continued gains in export market shares, both in terms of goods and services.

Public finances continue to surprise positively

In 2016, the general government deficit was notified to have sharply decreased to 0.8% of GDP, from 3.4% the year before. Revenues benefited from the acceleration of growth, especially through household consumption, employment and corporate profits. Additionally, primary expenditure growth was contained well below nominal GDP growth.

The headline deficit is projected to increase in 2017 to 1.1% of GDP, mostly due to the impact of the tax reform, but improve again in 2018.

In 2017, revenue is expected to grow largely in line with nominal GDP. Growth in VAT revenue and social contributions is expected to be strong, driven by rising personal consumption and employment growth. The direct negative effect of the tax reform is estimated at 0.6% of GDP in 2017 and 0.2% in 2018, mainly through personal income taxation. The impact, however, is expected to be partially offset by strong growth. At the same time, the Agrokor crisis is expected to weigh on revenue from corporate income taxation. The expenditure side is projected to grow more strongly, with compensation of employees set to increase on the back of wage hikes; while interest expenditure is expected to decrease again due to the favourable refinancing environment.

Following a strong improvement in 2016, the structural balance is forecast to deteriorate in 2017, and again in 2018. The debt ratio is set to continue declining to 79.4% by 2018.

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	2.9	2.9	2.6
Private Consumption	196.2		58.8	2.0	-1.8	-1.6	1.2	3.3	3.2	2.8
Public Consumption	65.8		19.7	1.6	0.3	-0.8	-0.3	1.7	2.3	1.4
Gross fixed capital formation	65.1		19.5	3.5	1.4	-2.8	1.6	4.6	5.2	5.7
of which: equipment	-		-	-	-	-	-	-	-	-
Exports (goods and services)	166.8		50.0	4.0	3.1	7.6	10.0	6.7	5.2	4.6
Imports (goods and services)	157.7		47.2	3.7	3.1	4.5	9.4	7.3	6.6	5.7
GNI (GDP deflator)	331.7		99.4	1.9	0.2	-1.8	3.7	0.0	4.4	1.2
Contribution to GDP growth:		Domestic demand		2.5	-0.7	-1.7	1.0	3.2	3.3	3.1
		Inventories		0.0	-0.3	-0.2	0.2	-0.1	0.0	0.0
		Net exports		-0.3	0.0	1.4	0.5	-0.1	-0.5	-0.5
Employment				-0.2	-2.7	2.7	1.5	0.7	1.9	1.5
Unemployment rate (a)				-	17.4	17.2	16.1	13.3	11.6	9.7
Compensation of employees / head				6.3	-0.6	-5.4	-0.3	1.2	2.5	2.5
Unit labour costs whole economy				3.9	-2.3	-2.4	-0.5	-0.9	1.5	1.4
Real unit labour cost				0.0	-3.0	-2.4	-0.6	-0.8	0.2	-0.3
Saving rate of households (b)				-	10.5	12.8	12.0	10.8	10.4	9.8
GDP deflator				3.9	0.8	0.0	0.1	-0.1	1.4	1.6
Harmonised index of consumer prices				-	2.3	0.2	-0.3	-0.6	1.6	1.5
Terms of trade goods				1.3	-1.6	-0.9	-0.8	-0.7	0.0	0.5
Trade balance (goods) (c)				-19.0	-15.1	-14.8	-15.2	-15.5	-16.5	-17.1
Current-account balance (c)				-4.4	1.6	1.1	5.0	2.6	2.9	1.3
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-4.4	1.6	1.1	5.7	3.7	4.2	2.5
General government balance (c)				-	-5.3	-5.4	-3.4	-0.8	-1.1	-0.9
Cyclically-adjusted budget balance (d)				-	-3.6	-3.4	-2.0	-0.2	-1.6	-2.1
Structural budget balance (d)				-	-3.4	-3.5	-2.0	-0.3	-1.7	-2.1
General government gross debt (c)				-	82.2	86.6	86.7	84.2	81.9	79.4

(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.