CROATIA

Highlights

- **The economy returned to growth in 2015 after six years of recession.** GDP grew by 1.6 per cent in 2015 supported by a good tourism season, stronger external demand and lower oil prices. However, medium-term growth prospects remain weak because of long-standing structural weaknesses.
- **Despite a lower-than-expected fiscal deficit, public debt remains high.** The fiscal deficit declined to 3.3 per cent of GDP in 2015 (from 5.5 per cent in 2015), reflecting a sharp contraction in public investments; lower public subsidies and wage bill; and growing revenues on the back of recovering demand. However public debt remains high at 86.7 per cent of GDP.
- **Much-needed structural reforms have been delayed.** Implementation of a wide-ranging reform agenda, presented in the national reform programme, has been postponed due to the collapse of the coalition government only several months after its formation.

Key priorities for 2017

- **The fiscal deficit should be sustainably reduced.** In order to ensure that the worryingly high public debt is on a sustainable path, the new government should opt for targeted public expenditure cuts, increased efforts to tap EU funds, and curb the subsidies and contingent liabilities of state-owned enterprises (SOEs).
- **Business environment reforms are proceeding slowly and should be accelerated to attract much-needed investment.** A reduction in para-fiscal charges, which amount to 2.6 per cent of GDP and add considerably to the administrative burden on companies, is welcome, but broader and faster implementation of business-friendly reforms is needed.
- **Supporting the resolution of non-performing loans (NPLs) and corporate restructuring should be high on the agenda in order to revive productivity and long-term growth.** NPL levels (especially for corporates) are high when compared regionally and NPL resolution is progressing slowly, limiting the range of creditworthy borrowers and constraining bank resources for new lending.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	-2.2	-1.1	-0.4	1.6	2.3
Inflation (average)	3.4	2.2	-0.2	-0.5	-1.0
Government balance/GDP	-5.3	-5.3	-5.4	-3.3	-2.8
Current account balance/GDP	-0.2	1.0	0.8	5.0	3.8
Net FDI/GDP [neg. sign = inflows]	-2.7	-1.9	-3.1	-0.4	-2.0
External debt/GDP	103.1	105.7	108.6	103.8	n.a.
Gross reserves/GDP	26.2	30.8	27.0	30.6	n.a.
Credit to private sector/GDP	67.9	70.0	69.3	65.5	n.a.

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Macroeconomic performance

The economy returned to growth in 2015 after six years of recession. GDP grew by 1.6 per cent in 2015, driven by export growth on the back of a strong tourism season, pick-up in EU demand and increases in both private and public consumption. Growth in exports and low oil prices contributed to the high current account surplus. The recovery continued in the first half of 2016 with 2.8 per cent year-on-year GDP growth driven by strong exports and domestic demand. Croatia would need persistently high growth rates to reduce unemployment, which stood at 13.4 per cent in the second quarter of 2016 (seasonally adjusted) with a particularly high rate of youth unemployment of 29.5 per cent. The slow recovery of domestic demand and subdued commodity prices resulted in continuing deflation, at -0.9 per cent year-on-year in September 2016.

Despite recent improvements, fiscal sustainability remains a key challenge. The general government deficit was reduced to 3.3 per cent of GDP in 2015 down from 5.5 per cent in 2014, reflecting a sharp contraction in public investments, lower public subsidies, wage bills and revenue growth on the back of recovering demand. Public debt surpassed 85 per cent of GDP in 2015 with potential negative impact on private sector financing as the share of government financing in bank balance sheets almost doubled to 33.1 per cent between 2008 and 2015. Risks to fiscal sustainability include continuing pressure for wage increases in the public sector; litigation risks associated with the conversion of Swiss franc-denominated loans; subsidies to SOEs; and high gross financing needs (above 20 per cent of GDP) which make the country sensitive to interest rate changes. Croatia's sovereign debt rating remains two notches below investment grade at each of the three main credit rating agencies. In July 2016 Fitch downgraded Croatia's long-term local currency rating to BB from BB+.

Weak long-term growth prospects reflect the difficult business environment. The EBRD forecast foresees 2.3 per cent growth in 2016, supported by recovering private consumption due to lower oil prices and continuing disinflation. Export growth is to remain strong on further trade integration in the EU market and higher tourist inflows due to sustained security issues in competing tourist destinations. In 2017, growth may slow to 2.0 per cent, reflecting the lower contribution of net exports as consumption and investments are expected to recover, and continuing fiscal adjustment to put the public debt on a sustainable path. Despite some improvement in the business sentiment, private investments are to remain weak, pointing to persistent structural weaknesses. Public investments may pick up gradually along expected improvements in the absorption capacity of EU funds. Long-term growth prospects may improve if the government consistently implements the major structural reforms envisaged in the National Reform Programme and focuses on resolving the high level of non-performing (corporate) loans as well as reducing household and corporate leverage. High labour costs may be one of the factors making Croatia less attractive for new investments and negatively affecting export competitiveness.

Major structural reform developments

Some steps have been taken towards improving the investment climate, but long-standing difficulties have not yet been addressed. Due to the pre-election campaign and the long time taken to form a new government, progress in reforms was slow in 2015. In April 2016 the new technocratic government outlined a broad reform agenda in its National Reform Programme, but was not able to push through major reforms as new elections were called in June. During its relatively short reign, the government abolished certain para-fiscal charges (estimated to be worth 0.1 per cent of GDP), amended the law on inspections enabling firms to correct minor irregularities and avoid the judicial process, and introduced e-services in public administration.

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The government tried to improve absorption of the EU funds. Up to now, Croatia has under-utilised EU funds in comparison to other new member states for the same period following EU accession. In order to speed up absorption, the government simplified and shortened the procedures for the drawing of EU funds. In March 2016 the smart specialisation strategy, one of the prerequisites to tap the European Structural and Investment Funds, was adopted to support research and development and innovation. Croatia also initiated the first project under the Investment Plan for Europe, a guarantee facility for loans to micro, small and medium-sized enterprises (MSMEs) and mid-cap firms.

Privatisation and restructuring of SOEs are advancing slowly. With an average return on assets of 0.7 per cent over 2012-14, the profitability of SOEs is well behind central and eastern European peers (at 3.9 per cent). The persistently weak performance of SOEs weighs on public finances as subsidies amount to 2.2 per cent of GDP, significantly above the EU average. Efforts to enhance the operational efficiency of SOEs have been slow, with the exception of the motorway operator HAC, where the restructuring of Motorway Maintenance and Tolling Company (HAC-ONC) is under way. Despite ambitious plans, privatisation in the past year remained limited to small-scale sales, mostly targeted at tourism companies. The controlling stake in Imperial Hotels and a minority stake in Hotel Suncani Hvar were sold in July 2016. The government also granted a concession on the Kupari tourism site near Dubrovnik in October 2015. The minority stake in the electrical company Koncar was sold to private investors through a competitive bidding processes on the Zagreb Stock Exchange (ZSE) in June 2016 and binding bids have been called for a minority stake in the HTP Korcula tourism company, while a sale of a controlling stake in the Dubrovnik-based hotel Hoteli Maestral failed due to lack of private sector interest.

Financial market development was supported by the regional integration of stock exchanges. Earlier in 2016 the ZSE joined the SEE Link platform (with Bulgaria, Serbia, FYR Macedonia and Slovenia also participating), allowing improved access for companies to the Croatian equity market.

The banking sector has solid capital buffers but high corporate NPLs are hindering growth. The banking system's capital buffers are strong (the capital adequacy ratio stood at 21.8 per cent in June 2016) but the high level of NPLs (15.0 per cent as of June 2016) and weak economic prospects have kept credit growth negative since mid-2012. Over the past two years, the central bank has introduced certain measures to address the problem, including changes in provisioning, compulsory minimum haircuts and collection periods for real estate and movable property. These measures have contributed to lowering NPLs, but NPL resolution would require a holistic approach focusing on all factors that impede resolution including tax regulations, efficiency of pre-insolvency and insolvency frameworks and other factors affecting the transferability of NPLs.

Litigation risks for the state increased following the adoption of the law on the conversion of Swiss franc-denominated mortgage loans into euros. Both the European Commission and the European Central Bank have warned the Croatian authorities that the retroactive application of preferential exchange rates jeopardises the principle of legal security. Several banks have also initiated international arbitration over the case and UniCredit Bank filed the first lawsuit in September. These actions, if they succeed, may put additional strains on the budget. The cost of the conversion (around €1 billion according to the central bank) does not jeopardise banking sector stability, because there are high capital buffers, but it may negatively affect bank lending.

Croatia's competitiveness and business environment rankings remain low relative to EU peers. Croatia ranks 43rd (out of 190 economies) in World Bank's *Doing Business 2017* report (39th in 2016)[1] Croatia scores the lowest in dealing with construction permits (128th) and with low ratings in starting a business, getting credit and electricity, registering property, and resolving insolvency. Despite an improvement in the macroeconomic environment, Croatia's competitiveness also remains low according to the *Global Competitiveness Index* published by the World Economic Forum, as it ranks 74th among 138 countries (moving up three places from last year's 77th out of 140 countries). The main obstacles are weak innovation capacity, labour and goods market inefficiencies, underdeveloped financial markets and weak institutions.

[1] The rating for 2016 reflects the change in the methodology. According to the old methodology Croatia was ranked 40th in 2016.