CROATIA: EU funds will support recovery

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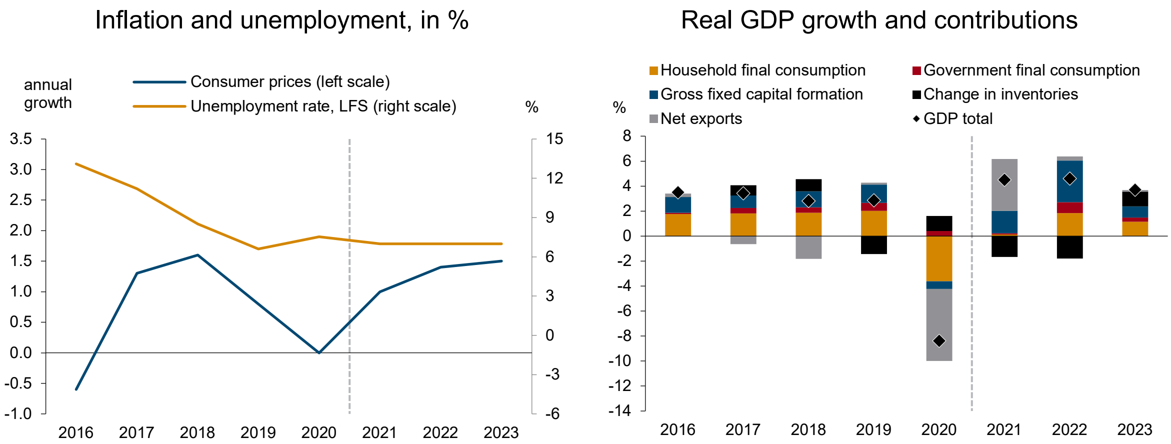
After 2015, Croatia witnessed an economic recovery; however, the COVID-19 pandemic stopped it in its tracks. GDP contracted by 8.4% in 2020, due largely to the pandemic's devastating impact on the tourism sector, but also because the country was rocked by two earthquakes in March and December. EU aid will likely mitigate the earthquakes' adverse effects on Croatia's economic recovery, which is why we expect solid growth of 4.5% in 2021.

Figure 4.5 / Croatia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Croatia's GDP is set to bounce back in 2021 as its tourism industry recovers. The deterioration in consumer sentiment and the sharp reduction in private consumption and service exports due to COVID-19 contributed to an 8.4% contraction in Croatia's GDP in 2020. The restrictions imposed on travel and freedom of movement as a result of the pandemic had a particularly pernicious impact on Croatia: while goods exports recovered somewhat toward the end of 2020, the sharp slump in services continued throughout the year, due to the crash in revenue from tourism. On top of the pandemic, the two earthquakes that shook the country in 2020 contributed further to Croatia's economic woes. In 2021, we expect economic recovery, with GDP bouncing back to 4.5% in the wake of an anticipated recovery in tourism earnings, as well as an increase in foreign demand.

COVID-19 vaccination efforts and the maximisation of revenue from tourism will remain major challenges for policy makers in 2021. The extent of the country's economic recovery in 2021 depends on whether the government can limit the spread of COVID-19 without imposing additional hard lockdowns in Q2-Q3 2021 (beyond the measures that the health authorities introduced in Q1). With Croatia set to receive 700,000 doses of COVID-19 vaccines by the end of March, the government will launch a proper nationwide vaccination campaign in Q2. From an appalling 2020, the country is likely to see a rebound in tourist numbers in 2021; however, because of the possible virus-related travel restrictions imposed in EU member states, its tourism sector will also depend on arrivals from other countries of Central, Eastern and Southeastern Europe (CESEE). The country's reliance on tourist revenue means that the pandemic will dominate as the key policy driver in 2021. Next to COVID-19 and the earthquake reconstruction efforts, the government will focus on adopting the euro by 2023; this will require certain conditions to be met and could result in cuts to public spending for the next two years. An important milestone toward adoption of the euro was Croatia's entry into the Exchange Rate Mechanism (ERM II), one of the few uplifting events for the country in 2020.

As well as tackling the pandemic, the government needs to roll out spending in order to deal with the 2020 earthquakes. The earthquake that hit the capital Zagreb in March caused on its own an estimated EUR 11.5bn in damage (around 45% of the state budget for 2020). The country was rocked by a second earthquake in December, which also brought devastation to villages and cities in central Croatia. The European Parliament approved EUR 683.7m to help the country address earthquake-related structural damage. In March 2021, the government sent a request to the EU for the allocation of an additional EUR 319.1m in earthquake relief grants under the EU Solidarity Fund mechanism. It remains to be seen, however, what proportion of those funds will actually be mobilised by policy makers in 2021.

Croatia's battered tourism industry will likely recover in 2021, despite the uncertainties surrounding COVID-19. The country witnessed a crash in tourist arrivals in Q2 2020, following the imposition of travel restrictions. The pandemic will likely continue to disrupt travel between EU member states well into Q2 2021. There are likely to be fewer tourist arrivals from EU countries, as people opt to holiday at home. However, the fact that Croatia can be reached in just a few hours by car from Austria, Italy and Germany – and without passing through more than two other countries – will benefit Croatian tourist arrivals this year. EU economic recovery in 2021 will inevitably support Croatia's service export side, despite the uncertainties created by COVID-19.

The government's measures imposed in 2020 to combat the COVID-19 pandemic will adversely affect Croatia's private consumption well into 2021. Uncertainty about economic recovery and employment developments in light of the 2020 economic downturn will likely dampen the population's propensity to consume. We still expect private consumption to gain some momentum in Q2 and Q3, as Croatia embarks on this year's tourist season.

The Croatian labour market was dealt a heavy blow by the pandemic in 2020. Nevertheless, the total number of unemployed persons in Q1 2021 continued to fall, compared to the end of 2020, thanks to the government's extensive job-retention measures, which have now been extended to the end of April. The rise in unemployment in 2020 particularly hit the country's younger population, since the seasonal workers who provide services in the country's dominant tourism industry are mostly younger people. The youth unemployment rate in Croatia stood at 22.2% in Q4 2020, with 31,000 young people out of work.

Croatia will be one of the biggest beneficiaries of the EU's Multiannual Financial Framework (MFF) scheme in the period 2021-2027, which will aim to support the country's economic recovery from the COVID-19 pandemic. The EU funds allocated under the MFF scheme – including financial aid equivalent to 35% of Croatia's 2019 GDP – will be used, in particular, to finance research and development, as well as digitalisation and infrastructure projects in the period 2021-2027. The country is very dependent on EU financing schemes: the EU allocated structural funding in the period 2014-2020 worth about 80% of all public investment in the country. Over the next seven years, Croatia will therefore seek to absorb as much of the EU funds as possible, in an effort to stop emigration and improve general living standards, by facilitating investment in its less-developed regions. The European Commission has, in addition, allocated EUR 510m to Croatia in state aid under the SURE instrument, as a means of supporting the government in financing job-retention schemes in the wake of COVID-19.

The austerity policies are likely to cause problems with recovery from COVID-19 and the earthquakes. In light of the government's support measures aimed at limiting the economic downturn caused by COVID-19, and the additional measures to deal with the aftermath of the 2020 earthquakes, the government can be expected to exceed its projected budget deficit of 2.9% in 2021. To finance general government expenditure, in February 2021 the government also placed two Eurobond issues worth some EUR 2bn on the international financial markets. Croatia's public debt ratio surged to 88.0% in 2020 on account of COVID-19, thereby wiping out years of fiscal consolidation and robust nominal GDP growth, which had succeeded in narrowing the debt-to-GDP ratio to 73% in 2019. In 2021, this ratio will likely fall to 85%.

A gradual pick-up in long-term investment projects is expected in 2021 and 2022. Goods exports will increase strongly in light of the improved global economic outlook this year. Investments will also increase in 2021, and especially in 2022, due to EU co-financing schemes. This should facilitate investment projects in the country's transport, waste, sewerage and energy sectors. The largest project co-financed by the EU in Croatia in 2021 is the construction of the Pelješac Bridge (valued at some EUR 550m), which should be completed in 2022.

Croatia's current account depends on the economic recovery of its most important economic partners. The country's current account was hit hard in 2020 by COVID-19, resulting in a steep decline in service revenue, following a collapse in tourist arrivals. Foreign demand will boost Croatia's economic growth in 2021, with goods exports rising in line with the economic recovery of Croatia's main trading partners – Germany, Austria and Italy. Service sector exports, dominated by tourism, will, however, remain under pressure from COVID-19. Boosted by an increase in the export of goods and services, we expect the country's current account to record a surplus of about 0.2% of GDP in 2021, following a deficit of 4.1% in 2020.

Triggered by an increase in energy prices, inflation will rise slightly in 2021. Inflation stood at 0% in 2020, due to lower transport and energy costs. In 2021, we expect it to pick up again to around 1%, as a result of an increase in energy prices and pandemic-related supply-chain disruptions.

Table 4.5 / Croatia: Selected economic indicators

	2017	2018	2019	2020 1)	2021	2022 Forecast	2023
Population, th pers., average	4,130	4,091	4,067	4,000	4,000	3,995	3,990
Gross domestic product, HRK bn, nom.	367.5	385.4	402.3	370.2	391	415	437
annual change in % (real)	3.4	2.8	2.9	-8.4	4.5	4.6	3.7
GDP/capita (EUR at PPP)	18,380	19,350	20,300	18,970	.	.	.
Consumption of households, HRK bn, nom.	208.4	218.4	228.0	214.0	.	.	.
annual change in % (real)	3.2	3.3	3.6	-6.4	0.2	3.2	2.0
Gross fixed capital form., HRK bn, nom.	73.3	78.5	84.6	82.6	.	.	.
annual change in % (real)	5.1	6.5	7.1	-2.9	8.0	15.0	4.0
Gross industrial production 2)							
annual change in % (real)	1.4	-1.0	0.6	-2.7	3.0	2.0	2.0
Gross agricultural production							
annual change in % (real)	-4.9	6.4	-0.5	3.1	.	.	.
Construction output 2)							
annual change in % (real)	1.7	4.9	8.3	4.4	.	.	.
Employed persons, LFS, th, average	1,625	1,655	1,680	1,657	1,690	1,720	1,750
annual change in %	2.2	1.8	1.5	-1.3	2.0	1.5	1.5
Unemployed persons, LFS, th, average	205	152	119	135	130	130	130
Unemployment rate, LFS, in %, average	11.2	8.5	6.6	7.5	7.0	7.0	7.0
Reg. unemployment rate, in %, eop	11.2	8.9	7.8	9.5	.	.	.
Average monthly gross wages, HRK 3)	8,055	8,448	8,766	9,216	9,500	9,900	10,300
annual change in % (real, gross)	2.8	3.3	3.0	2.3	2.0	2.5	2.5
Average monthly net wages, HRK 3)	5,985	6,242	6,457	6,763	7,000	7,300	7,600
annual change in % (real, net)	4.1	2.8	2.7	2.6	2.1	2.2	2.2
Consumer prices (HICP), % p.a.	1.3	1.6	0.8	0.0	1.0	1.4	1.5
Producer prices in industry, % p.a.	2.0	2.2	0.8	-3.2	1.4	2.0	2.0
General governm.budget, EU-def., % of GDP							
Revenues	46.1	46.3	47.4	42.0	46.0	46.0	46.0
Expenditures	45.3	46.0	47.0	50.0	49.0	49.0	48.5
Net lending (+) / net borrowing (-)	0.8	0.2	0.4	-8.0	-3.0	-3.0	-2.5
General gov.gross debt, EU def., % of GDP	77.5	74.3	72.8	87.0	85.0	84.0	82.0
Stock of loans of non-fin.private sector, % p.a.	-0.1	2.3	3.9	3.5	.	.	.
Non-performing loans (NPL), in %, eop 4)	8.7	7.5	5.5	5.4	.	.	.
Central bank policy rate, % p.a., eop 5)	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR m	1,681	932	1,478	-1,990	120	520	840
Current account, % of GDP	3.4	1.8	2.7	-4.1	0.2	1.0	1.5
Exports of goods, BOP, EUR m	11,707	12,240	12,861	10,460	11,920	13,170	14,090
annual change in %	11.4	4.6	5.1	-18.7	14.0	10.5	7.0
Imports of goods, BOP, EUR m	20,152	21,882	23,305	19,250	20,500	22,500	24,800
annual change in %	11.2	8.6	6.5	-17.4	6.5	9.7	10.0
Exports of services, BOP, EUR m	12,881	13,847	15,341	9,960	12,000	13,300	15,200
annual change in %	9.9	7.5	10.8	-35.1	20.0	11.0	14.0
Imports of services, BOP, EUR m	4,108	4,639	5,013	4,760	5,100	5,300	5,500
annual change in %	15.3	12.9	8.1	-5.0	8.0	3.0	3.0
FDI liabilities, EUR m	445	1,074	1,278	1,000	.	.	.
FDI assets, EUR m	-673	231	175	200	.	.	.
Gross reserves of CB excl. gold, EUR m	15,706	17,438	18,560	18,943	.	.	.
Gross external debt, EUR m	43,683	42,710	40,877	42,700	43,700	45,300	47,200
Gross external debt, % of GDP	88.7	82.2	75.4	87.0	85.0	83.0	82.0
Average exchange rate HRK/EUR	7.4637	7.4182	7.4180	7.5384	7.6	7.6	7.6

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) From 2020 employees expressed in full-time equivalents (FTE). - 4) Loans more than 90 days overdue and those unlikely to be paid. - 5) Discount rate of CB.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.