11. CROATIA

End of recession in sight, but recovery set to be muted

Croatia has spent six years in recession but the pace of contraction in 2014 was slower than it was in the previous year. A mild recovery is now forecast for 2015, with growth set to reach 1% in 2016, spurred by EU-funded investments. With the fall in energy and commodity prices, price dynamics are expected to be negative in 2015, though inflation is set to regain positive ground in 2016. Labour market conditions are set to improve marginally in 2015 and 2016. Fiscal consolidation needs and limited structural reforms, however, continue to hold back potential growth.

Six years of recession

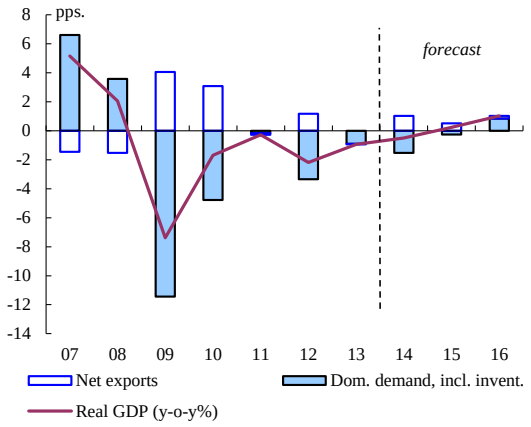
In the third quarter of 2014, real GDP contracted by 0.6% y-o-y, a rate which is set to have abated in the fourth quarter. Croatia's economy contracted for its sixth year in a row in 2014, but the pace of the recession weakened over the course of the year, bringing real GDP growth for the year to an estimated -0.5%. According to the forecast, positive demand from abroad was not enough to offset the effect of weak domestic demand, which fell as a result of a 3.6% fall in investment and decreases in private and public consumption of 0.6% and 2.1% respectively.

A muted recovery expected to start in 2015…

Croatia's recession is forecast to come to an end in 2015, but real GDP is forecast to grow only moderately by 0.2%. Domestic demand growth is set to remain negative, as a result of a further contraction of investment and government consumption. Private consumption is now forecast to stagnate as the negative impact of the weak labour market and uncertainties related to the final settlement of Swiss-franc indexed loans is broadly offset by the positive impact of the income tax reform and of lower oil prices. Although indicators suggest that the labour market may have bottomed out in 2014, employment is still expected to stagnate in 2015, due to adverse demographic trends, while the unemployment rate is set to decrease to 16.8%, on the back of the contracting labour force. Wages are expected to grow moderately, due to the strong deceleration of inflation in 2014 and the negative price dynamics expected for 2015.

The feeble growth set to be achieved in 2015 is set to come exclusively from net exports. After the strong performance in 2014, partly reflecting large one-off effects related to Croatia's accession to the EU, the restoration of trade links with former partners from the CEFTA and the recovery of the neighbouring Slovenian economy, exports of goods and services are set to increase at a more moderate rate of 2.8%. At the same time, imports are forecast to increase by 1.8%. Overall, the current account surplus is set to expand to 2.4% of GDP.

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



…and gain ground in 2016.

In 2016, the recovery is expected to attain a tepid 1.0% thanks to an increase in domestic demand, driven largely by EU-linked investments. Private consumption should also add to growth as the labour market stabilises. In particular, employment is expected to increase on the back of a rise in the activity rate and a decrease in the unemployment rate to 16.4%. As a result of acceleration in core inflation and attenuating private sector deleveraging pressures, inflation is forecast to pick-up to 1.0%.

Relatively stronger growth in the EU should further stimulate exports, which are expected to grow by 4.7%. Imports, meanwhile, are set to rise by 4.5%, leading to a mild deterioration of the trade balance, although the current account will further improve on the back of current transfers from the EU budget.

Risks to growth projections are mainly negative and related to uncertainties about fiscal policy and structural reforms.

Consolidation efforts hindered by personal income tax rebate

The general government deficit in 2014 is expected to stand at 5.0% of GDP. Expenditure appears to have evolved mostly in line with the authorities' plans, but some additional outlays from flood-related reconstruction costs materialised in the second half of 2014. The downward revision from the previous forecast is mainly the result of a better revenue outturn (in particular VAT).

In 2015, changes to the personal income taxes are expected to push the budget deficit up to 5.5% of GDP, as potential offsetting measures are still largely unknown. In 2016, the deficit is forecast to remain at around the same level, in spite of the moderate pick-up in growth expected. The structural deficit is expected to have reached 3½% of GDP in 2014, and to deteriorate in 2015 and 2016, by about 1 and ½ pp. of GDP respectively.

The ratio of general government debt to GDP is expected to have reached 81.4% in 2014, mainly as result of the achieved budget deficit, continued subdued nominal GDP growth and a pre-financing operation planned before the end of the year. In 2015 and 2016 public debt is forecast to increase further to 84.9% and 88.7% of GDP as a result of the underlying deficit trends.

Negative fiscal risks are still present, including from the accumulation of arrears in the hospital sector and possible additional expenditure slippages in 2015 in some other sectors, such as education and transport. On the other hand, the general government deficit forecast could be revised downward if the government substantiates its fiscal deficit targets by credibly announced and sufficiently detailed measures.

Table II.11.1:

Main features of country forecast - CROATIA

	2013			Annual percentage change					
	bn HRK	Curr. prices	% GDP	95-10	2011	2012	2013	2014	2015	2016
GDP		330.1	100.0	-	-0.3	-2.2	-0.9	**-0.5**	**0.2**	**1.0**
Private Consumption		200.2	60.6	-	0.3	-3.0	-1.2	**-0.6**	**0.0**	**0.6**
Public Consumption		66.1	20.0	-	-0.3	-1.0	0.5	**-2.1**	**-0.1**	**0.6**
Gross fixed capital formation		63.7	19.3	-	-2.7	-3.3	-1.0	**-3.6**	**-1.0**	**2.1**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		141.8	42.9	-	2.2	-0.1	3.0	**6.1**	**2.8**	**4.7**
Imports (goods and services)		140.2	42.5	-	2.5	-3.0	3.2	**3.8**	**1.8**	**4.5**
GNI (GDP deflator)		321.8	97.5	-	-0.2	-2.4	-0.5	**-0.5**	**0.6**	**1.1**
Contribution to GDP growth:		Domestic demand		-	-0.4	-2.7	-0.8	**-1.5**	**-0.2**	**0.9**
		Inventories		-	0.3	-0.7	-0.1	**0.0**	**0.0**	**0.0**
		Net exports		-	-0.1	1.2	0.0	**1.0**	**0.5**	**0.2**
Employment				-	-2.3	-3.9	-1.0	**0.0**	**0.0**	**0.5**
Unemployment rate (a)				-	13.9	16.1	17.3	**17.0**	**16.8**	**16.4**
Compensation of employees / head				-	1.8	1.3	1.5	**1.8**	**1.2**	**1.5**
Unit labour costs whole economy				-	-0.3	-0.5	1.5	**2.3**	**0.9**	**1.0**
Real unit labour cost				-	-1.9	-2.0	0.6	**2.5**	**0.8**	**-0.3**
Saving rate of households (b)				-	9.3	10.6	10.1	**11.9**	**13.4**	**13.3**
GDP deflator				-	1.7	1.6	0.9	**-0.2**	**0.2**	**1.2**
Harmonised index of consumer prices				3.4	2.2	3.4	2.3	**0.2**	**-0.3**	**1.0**
Terms of trade goods				-	4.3	-0.4	-1.5	**-0.9**	**0.2**	**0.0**
Trade balance (goods) (c)				-19.2	-14.3	-14.3	-15.1	**-15.6**	**-15.6**	**-16.0**
Current-account balance (c)				-4.7	-0.6	0.1	0.4	**0.9**	**2.4**	**3.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-4.7	-0.6	0.1	0.4	**0.7**	**2.2**	**3.3**
General government balance (c)				-	-7.7	-5.6	-5.2	**-5.0**	**-5.5**	**-5.6**
Cyclically-adjusted budget balance (c)				-	-7.1	-4.4	-3.9	**-3.5**	**-4.3**	**-4.8**
Structural budget balance (c)				-	-7.1	-4.4	-3.6	**-3.4**	**-4.3**	**-4.8**
General government gross debt (c)				-	59.9	64.4	75.7	**81.4**	**84.9**	**88.7**

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