

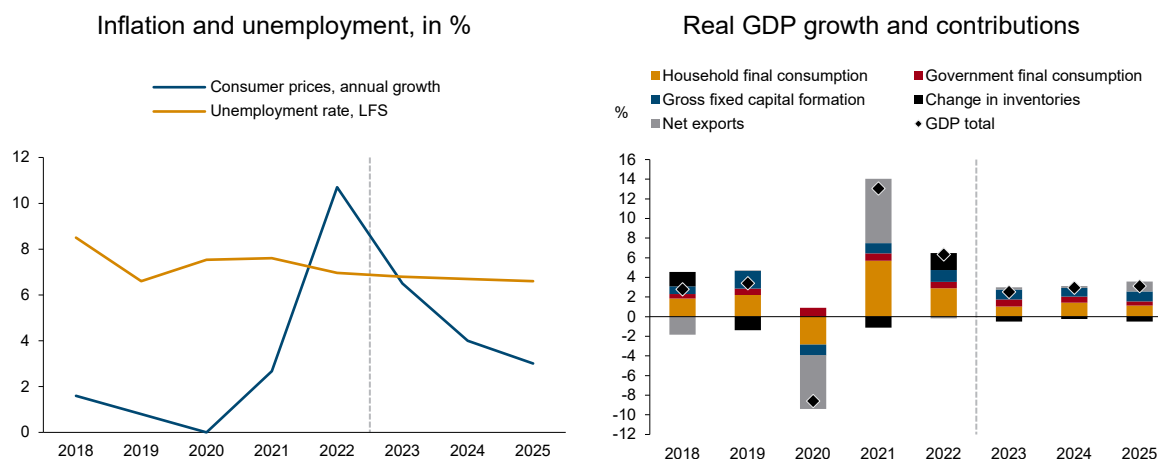


CROATIA: Uncertainty persists in the wake of the euro introduction

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Thanks to robust household consumption and a stellar summer tourist season, as well as better-than-expected growth in Q4 2022, Croatia's economy grew by 6.3% in 2022. In January 2023, the country adopted the euro and joined the EU's border-free Schengen Area, which will likely boost trade, tourism and investment in the long term. Nevertheless, given the high rate of inflation, the deteriorating funding conditions and the uncertainty (which will act as a drag on private consumption and investment), we expect the economy to grow by only 2.5% in 2023.

Figure 5.5 / Croatia: Main macroeconomic indicators



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

Croatia's economy performed remarkably well in 2022, despite the cost-of-living crisis. GDP grew by 6.3% for the whole year. The drivers of growth were strong investment and public consumption, as well as a remarkable summer tourist season. At the same time, inflation surged to record levels, averaging 10.7%. The soaring cost of energy, processed food and non-energy industrial goods was the main driver behind this figure for inflation, which was higher than the EU average of 8.4%, but still substantially lower than in most of the neighbouring countries.

The first day of January 2023 was a milestone in Croatia's history, as the country adopted the euro and simultaneously joined the Schengen Area. The benefits to Croatia of joining the euro area are clear cut: participation in the euro means greater resilience to external shocks and better access to financial markets. As a result, Croatia will now be able to acquire loans at lower interest rates. Another benefit arising from adoption of the euro is a boost in investor confidence. Moreover, the removal of EU

border controls as a result of joining Schengen and the elimination of foreign exchange risks will benefit the country's vital service and tourism sector over the long term.

Introduction of the euro in January led to an immediate surge in the price of certain goods. The Croatian consumer protection association warned that people were reporting marked price rises during the two-week transition period when both the kuna and the euro were in circulation: coffee and baked goods, especially, seem to have been affected. Sudden price surges were felt across the country, as retailers, contractors and various service providers substantially hiked their prices. The Croatian government threatened retailers and service providers with countermeasures in January 2023, including fines and the cancellation of energy subsidies. The State Inspectorate and the Tax and Customs Administration were tasked with ensuring that prices returned to the level of 31 December 2022. They carried out 103 inspections in January 2023, during which they discovered that the prices of certain foodstuffs – in particular bread and other bakery products – had risen by up to 15% since 31 December 2022.

EU funding will support Croatia's economic growth in 2023. Prime Minister Plenković announced that the government would use up all the funds from the EU Solidarity Fund for post-earthquake reconstruction by the end of June 2023: so far, the government has managed to absorb some EUR 800m from the Solidarity Fund's EUR 1.3bn. Total EU funding for 2023 is capped at some EUR 4bn (5.9% of GDP). According to government estimates, projects financed by money from the EU's Recovery and Resilience Facility, including the reconstruction of earthquake-damaged infrastructure in the Zagreb, Krapina-Zagorje, Sisak-Moslavina and Karlovac counties, will contribute 1.4 percentage points to headline GDP growth in 2023.

Croatia earned EUR 13.1bn from foreign tourists in 2022. In Q4 2022, there was a 44% rise in revenue from foreign tourists, compared to the same period of 2021 – and the figure was even 24% higher than the record-breaking pre-COVID-19 levels of 2019. The Tourism Ministry estimates that the total income from tourism, including revenue from domestic tourists, reached EUR 15bn in 2022 (22.2% of GDP). In light of the country's introduction of the euro and its accession to the Schengen Area, it looks set fair to match those figures in 2023.

In March 2023, the government presented its fourth state aid package to mitigate the cost-of-living crisis. This is worth EUR 1.7bn (2.5% of GDP) and is designed to aid local households, institutions and companies in managing the surge in energy prices. The package will also introduce price caps on foodstuffs in order to counter inflation. In addition, the government has confirmed that it will maintain the lower 5% VAT rate on natural gas consumption and on heating products, such as wood and pellets. Given the government's new support package and the fact that supply-chain normalisation will bring a steeper decline in energy and food prices, inflation looks set to cool this year, to an estimated 6.5%.

The unemployment rate will fall to roughly pre-COVID-19 levels. According to the national statistical office, there were 1.72m employed persons in Croatia in Q4 2022 (27,000 more than in Q4 2021), while the number of jobseekers increased by only 9,000 (to 124,000). In anticipation of a bountiful tourist season, we expect Croatia's unemployment rate to decline to 6.8% in 2023 – almost the level seen before COVID-19.

Croatia is still faced with labour shortages, due to mass emigration to other EU countries over the past decade. The country's shrinking labour force is problematic, as is the demographic outlook. The Croatian Central Bank has revealed that an average of 2% of Croatia's population emigrated each year from 2014 until 2017, following the country's EU accession. In addition, the results of the 2021 population census showed that Croatia's population had contracted by some 10% (roughly 400,000 people) over the previous ten years. The government is attempting to address the persistent labour shortages in tourism, construction, transportation, the metal and food industries, and the agriculture sector by hiring foreign workers. In a bid to limit labour shortages, it abolished its annual quota for the employment of foreign nationals in 2021 and decided to drop the legal requirement for domestic companies to look into hiring locals before taking on foreigners.

Croatia is successfully transitioning to become an energy powerhouse in the Western Balkan region. In 2022, the country decided to invest EUR 155m in developing the Zlobin-Bosiljevo gas pipeline and EUR 25m in expanding capacity at the liquefied natural gas (LNG) terminal on the Adriatic island of Krk, to turn it into an energy hub for the region's gas supplies. To strengthen Croatia's role as an energy exporter and to contribute to energy security, the government decided that Croatia should increase its production of hydrocarbons by some 30% between 2022 and 2024. In March 2022, the INA state-owned oil and gas company embarked on drilling for natural gas in the Adriatic's Ika gas field, with the aim of producing 55m cubic metres of additional gas per year (some 7% of INA's total annual output). Despite those investments, Croatia is still planning to keep to its National Energy Development Strategy of achieving carbon neutrality by 2030. To meet this goal, it can only utilise LNG as a transitional energy solution. Additional investment in renewable energy sources, especially in the country's underutilised solar power capacities, is therefore essential.

For 2023, we are expecting Croatia's economy to grow by 2.5%. We are sticking with our previous forecast for this year's GDP growth. High inflation, paired with deteriorating funding conditions and uncertainty, will further depress real wages and hamper investor sentiment. Because of that, private investment (apart from in tourism) and household consumption will remain subdued this year. We expect public investment to act as the main driver of this year's economic growth, thanks to the allocation of generous EU funds.

Table 5.5 / Croatia: Selected economic indicators

	2019	2020	2021	2022 ¹⁾	2023	2024 Forecast	2025
Population, th pers., average ²⁾	4,067	4,047	3,958	3,885	3,883	3,880	3,880
Gross domestic product, EUR-HRK m, nom.	54,784	50,451	58,207	67,390	74,000	79,000	84,000
annual change in % (real)	3.4	-8.6	13.1	6.3	2.5	2.9	3.1
GDP/capita (EUR at PPP)	20,830	19,450	22,560	25,810	.	.	.
Consumption of households, EUR-HRK m, nom.	30,469	29,092	32,726	38,128	.	.	.
annual change in % (real)	4.0	-5.1	9.9	5.2	1.8	2.5	2.0
Gross fixed capital form., EUR-HRK m, nom.	11,662	11,217	12,068	13,839	.	.	.
annual change in % (real)	9.0	-5.0	4.7	5.8	5.0	4.3	5.0
Gross industrial production ³⁾							
annual change in % (real)	0.6	-2.7	6.3	1.2	2.8	2.5	3.0
Gross agricultural production							
annual change in % (real)	-1.2	1.1	-3.4	-8.6	.	.	.
Construction output ³⁾							
annual change in % (real)	8.3	4.4	9.3	4.0	.	.	.
Employed persons, LFS, th, average ⁴⁾	1,680	1,657	1,678	1,707	1,730	1,760	1,790
annual change in %	1.5	-1.3	1.3	1.7	1.3	1.5	1.5
Unemployed persons, LFS, th, average ⁴⁾	119	135	138	128	130	130	130
Unemployment rate, LFS, in %, average ⁴⁾	6.6	7.5	7.6	7.0	6.8	6.7	6.6
Reg. unemployment rate, in %, eop	7.8	9.3	7.3	6.7	.	.	.
Average monthly gross wages, EUR-HRK ⁵⁾	1,163	1,223	1,274	1,380	1,500	1,600	1,700
annual change in % (real, gross)	3.0	2.4	1.6	-2.3	2.0	2.5	2.3
Average monthly net wages, EUR-HRK ⁵⁾	857	898	946	1,016	1,100	1,200	1,300
annual change in % (real, net)	2.6	2.6	2.7	-3.1	2.0	2.5	2.5
Consumer prices (HICP), % p.a.	0.8	0.0	2.7	10.7	6.5	4.0	3.0
Producer prices in industry, % p.a.	0.8	-3.2	11.6	25.5	10.0	4.0	2.2
General governm. budget, EU def., % of GDP							
Revenues	46.3	46.7	46.0	49.1	46.0	46.0	47.0
Expenditures	46.1	54.0	48.5	51.0	48.4	48.0	48.8
Net lending (+) / net borrowing (-)	0.2	-7.3	-2.6	-1.9	-2.4	-2.0	-1.8
General gov. gross debt, EU def., % of GDP	71.0	87.0	78.4	69.5	66.5	64.0	62.0
Stock of loans of non-fin. private sector, % p.a.	3.9	3.5	2.3	11.2	.	.	.
Non-performing loans (NPL), in %, eop ⁶⁾	5.5	5.4	4.3	3.0	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	3.0	3.0	3.0	3.0	.	.	.
Current account, EUR m	1,571	-262	1,798	-2,209	-1,960	-1,660	-530
Current account, % of GDP	2.8	-0.5	3.1	-3.3	-2.6	-2.1	-0.6
Exports of goods, BOP, EUR m	12,810	12,005	15,605	20,770	22,640	24,290	25,870
annual change in %	5.0	-6.3	30.0	33.1	9.0	7.3	6.5
Imports of goods, BOP, EUR m	23,298	20,845	26,244	38,488	43,100	47,100	51,300
annual change in %	6.5	-10.5	25.9	46.7	12.0	9.3	9.0
Exports of services, BOP, EUR m	15,362	8,916	14,301	18,033	21,800	24,400	28,000
annual change in %	10.9	-42.0	60.4	26.1	21.0	12.1	14.9
Imports of services, BOP, EUR m	5,084	3,618	4,491	5,229	5,500	5,600	5,700
annual change in %	9.4	-28.8	24.1	16.4	4.9	2.5	2.5
FDI liabilities, EUR m	3,509	1,108	3,929	3,562	.	.	.
FDI assets, EUR m	82	409	1,152	-323	.	.	.
Gross reserves of CB excl. gold, EUR m	18,560	18,943	25,022	27,771	.	.	.
Gross external debt, EUR m	40,589	41,285	47,213	49,554	49,600	51,400	53,800
Gross external debt, % of GDP	72.9	81.9	81.0	73.5	67.0	65.0	64.0
Average exchange rate HRK/EUR	0.9845	1.0005	0.9992	1.0001	1.0	1.0	1.0

Note: Croatia has introduced the Euro from 1 January 2023. Up to and including 2022 all time series in HRK as well as the exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 7.5345 (HRK per EUR) to achieve euro-fixed series (EUR-HRK).

1) Preliminary and wiiw estimates. - 2) From 2021 based on census 2021. - 3) Enterprises with 20 and more employees. - 4) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) From 2020 employees expressed in full-time equivalents (FTE). - 6) Loans more than 90 days overdue and those unlikely to be paid. - 7) Discount rate of CB.

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