

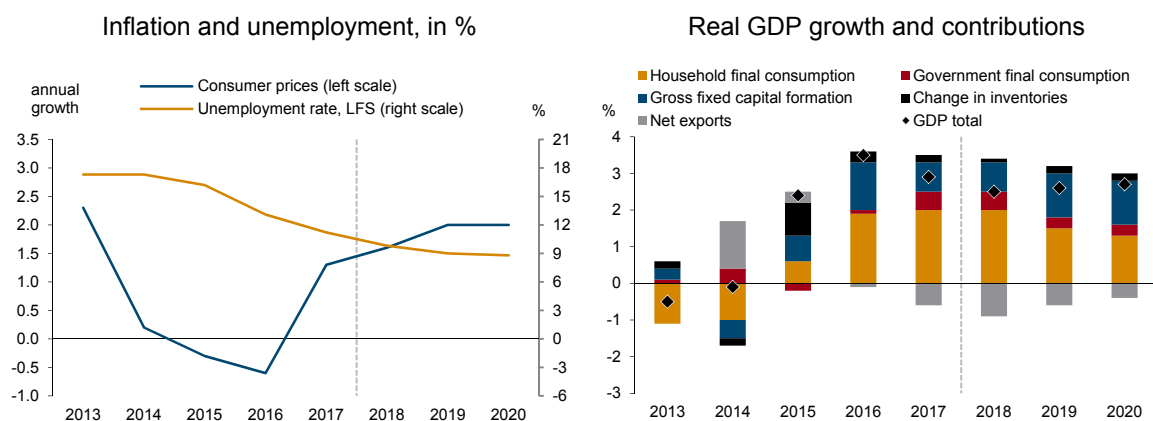


CROATIA: Low absorption of EU funds holding back growth

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Croatia's economy will continue its path of moderate growth, with annual GDP growth of slightly below 3% in the period 2018-2020; increasing the absorption of EU funds will be an important precondition for achieving this growth rate. Demographic changes, coupled with continued emigration of young and educated people and rising labour shortages in crucial sectors, will become a major challenge in the future.

Figure 40 / Croatia: Main macroeconomic indicators



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

Croatia's real GDP grew by 2.7% year on year in the first half of 2018 on the back of rising domestic demand. Private consumption growth was mainly due to rising disposable income, i.e. growing real wages and pensions as well as increasing remittances from abroad. Gross fixed capital formation grew only moderately, indicating still low absorption of EU funds. Hence, the output growth in construction was only modest, at 2.2%. The contribution of net exports to GDP growth was negative due to rising imports. Industrial production growth was almost stagnant (0.5%) during the first six months of 2018, with most pronounced output declines in the production of fabricated metal products and of chemicals and chemical products. In shipbuilding, which has been on a downward trend for years, production shrank by one third compared to the first half of 2017. Difficulties in the shipbuilding sector became evident at the beginning of 2018 when the Croatian government gave a guarantee for a loan (EUR 96 million) to help the Uljanik shipyard stay afloat. The crisis became even more acute when the workers of the shipyard went on strike in summer because of delayed wage payments. The latter could

be secured only through a government guarantee to a state-owned bank, so that the company could pay out the salaries. But the future of the company remains uncertain. So far the restructuring plan submitted by Uljanik's management at the beginning of the year has not been approved by the European Commission. The restructuring of the shipyards was a key condition of Croatia's EU accession in 2013.

The labour market situation has continued to improve. According to Pension Insurance data employment increased by 1.8% during the first half of the year, while based on the Labour Force Survey employment went up by 3.4% and the unemployment rate fell to 9%. Despite these improvements the unemployment rate is still 2pp above the EU average and youth unemployment stand at about 23%, representing the third highest rate in Europe, after Spain and Cyprus. The reduction in unemployment is only partly a result of rising domestic employment. Despite improving economic conditions, outward migration continues. In Germany alone, the number of Croatian workers increased from 75,800 in July 2013, when Croatia joined the EU, to 178,000 in September 2018. The stock of Croatian employees in Austria, the second most important destination country for Croatian migrants, rose in the same period from 19,000 to 32,500 persons. Despite still high unemployment Croatia has experienced labour shortages, particularly in the tourism and construction sectors, which are mainly covered by foreign labour, especially from Bosnia and Herzegovina. In 2018 over 30,000 work permits to foreign nationals were issued. Real net wages continued to increase and were up by 3% during the first half of 2018.

External trade in goods performed disappointingly with exports up by a mere 3% in euro terms during the first half of the year, reflecting the poor industrial performance. The trade deficit was about EUR 370 million higher than in the same 2017 period, while the surplus in the services trade remained unchanged at EUR 2.7 billion. Earnings from tourism reached again a record high in 2018, still benefiting from political uncertainties particularly in Northern Africa, one of Croatia's main competitors. Hence, the current account will remain in surplus in 2018, at an estimated 2.7% of GDP. The inflow of FDI was by EUR 200 million higher than in 2017, at close to EUR 900 million.

After reporting the first general government surplus in 2017 since gaining independence, fiscal consolidation continues in 2018. The general government budget closed again with a surplus in the first half of 2018 mostly on account of rising tax revenues (VAT in particular) as well as lower expenditures, e.g. on subsidies and interest payments. For the whole year the government expects a 0.4% surplus-to-GDP ratio. This will also translate into a further reduction in public debt to about 74% of GDP. Only recently the government has proposed a package of tax changes to be implemented at the beginning of 2019. The proposal includes the lowering of the VAT rate from 25% to 13% for fresh meat, fish, fruits and eggs, reducing the income tax rate from 36% to 24% for monthly wages up to HRK 30,000 as well as abolishing contributions for work safety, while increasing the contributions for health insurance. The overall VAT rate is supposed to be reduced from 25% to 24% in 2020.

The absorption of EU funds is still very low, due to limited administrative capacities and strategic planning as well as insufficient information of potential recipients. Although this circumstance has been known for years little has been done solving this problem so far. Only recently the Minister of Regional Development, Gabrijela Žalac, emphasised (again) the need for strengthening administrative capacities on the ground, in order to increase the absorption of EU funds. A more effective and efficient use of these funds would be the key to supporting investments and stimulating GDP growth. Up to now contracts worth 54% within the current financial perspective worth EUR 10.7 billion were signed – particularly for projects in Slavonia and the Pelješac Bridge, an important prestige project.

In September S&P affirmed Croatia's long- and short-term local and foreign currency rating at BB+ and revised the outlook from stable to positive. The main reasons behind this decision are expectations of further fiscal consolidation and the continuation of economic growth as well as a reduction of the risks related to Agrokor after having reached a settlement deal with a large majority of the company's creditors in July.

Assuming that absorption of EU funds will accelerate, GDP growth may come close to 3% p.a. in the forecasting period. Household consumption should benefit from a further gradual improvement in the labour market, while a more pronounced increase in investments should be spurred by better absorption of EU funds. The strengthening of domestic demand will lead to rising imports and consequently result in higher trade deficits. The services trade surplus, by contrast, may remain at high levels due to high earnings from tourism. Thus, the current account will remain in positive territory, but is expected to decline along with higher trade deficits. Assuming further improvement in the general government budget, public debt is expected to continue its downward path in the coming two years, but downside risks are related to guarantees provided to the Uljanik shipyard and to spending on the health sector. Demographic changes coupled with ageing of the population, continued emigration of young educated people and rising labour shortages in crucial sectors such as tourism and construction but also IT will become the major future challenges.

Table 15 / Croatia: Selected economic indicators

	2014	2015	2016	2017 ¹⁾	2017 January-June	2018	2018 Forecast	2019 Forecast	2020
Population, th pers., average	4,236	4,208	4,172	4,150	4,174	4,125	4,100	4,050	4,000
Gross domestic product, HRK bn, nom.	331.6	339.6	351.3	365.6	172.4	180.2	380.9	398.5	417.3
annual change in % (real)	-0.1	2.4	3.5	2.9	3.0	2.7	2.5	2.6	2.7
GDP/capita (EUR at PPP)	16,300	17,200	17,600	18,400	.	.	.	.	.
Consumption of households, HRK bn, nom.	191.4	192.3	196.4	205.5	100.9	105.8	.	.	.
annual change in % (real)	-1.6	1.0	3.4	3.6	3.6	3.7	3.5	2.6	2.4
Gross fixed capital form., HRK bn, nom.	63.8	66.4	70.4	73.3	36.3	37.7	.	.	.
annual change in % (real)	-2.8	3.8	6.5	3.8	4.8	3.3	4.0	6.0	6.0
Gross industrial production ²⁾									
annual change in % (real)	1.2	2.7	5.3	1.4	1.7	0.5	1.0	2.5	2.5
Gross agricultural production									
annual change in % (real)	-6.9	2.9	6.9	-6.0	.	.	.	.	.
Construction output ²⁾									
annual change in % (real)	-6.9	-0.5	3.3	1.7	2.2	3.0	.	.	.
Employed persons, LFS, th, average	1,566	1,585	1,590	1,625	1,589	1,644	1,650	1,670	1,690
annual change in %	2.7	1.3	0.3	2.2	0.8	3.4	1.5	1.0	1.0
Unemployed persons, LFS, th, average	327	306	240	205	227	161	180	170	160
Unemployment rate, LFS, in %, average	17.3	16.2	13.1	11.2	12.6	9.0	9.8	9.0	8.8
Reg. unemployment rate, in %, eop	19.4	17.6	14.7	12.0	10.5	8.8	.	.	.
Average monthly gross wages, HRK ³⁾	7,953	8,055	7,752	8,055	8,014	8,441	8,470	8,880	9,300
annual change in % (real, gross)	0.4	1.8	3.0	2.8	2.3	3.8	3.5	2.8	2.8
Average monthly net wages, HRK ³⁾	5,533	5,711	5,685	5,985	5,959	6,236	6,260	6,580	6,900
annual change in % (real, net)	0.5	3.7	2.7	4.1	3.9	3.2	3.0	3.0	3.0
Consumer prices (HICP), % p.a.	0.2	-0.3	-0.6	1.3	1.1	1.5	1.6	2.0	2.0
Producer prices in industry, % p.a.	-2.7	-3.8	-4.3	2.0	1.9	1.8	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP									
Revenues	42.9	44.8	46.0	45.7	.	.	44.9	44.0	43.9
Expenditures	48.1	48.3	46.9	45.0	.	.	44.5	44.0	43.4
Net lending (+) / net borrowing (-)	-5.1	-3.4	-0.9	0.8	.	.	0.4	0.0	0.5
General gov.gross debt, EU def., % of GDP	84.0	83.7	80.2	77.5	.	.	74.0	72.0	70.0
Stock of loans of non-fin.private sector, % p.a.	-2.0	-3.1	-4.3	-0.1	-1.3	2.2	.	.	.
Non-performing loans (NPL), in %, eop	17.1	16.7	13.8	11.4	13.2	11.2	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	7.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR mn	858	2,018	1,206	1,963	-1,357	-1,791	1,400	800	700
Current account, % of GDP	2.0	4.5	2.6	4.0	-5.9	-7.4	2.7	1.5	1.2
Exports of goods, BOP, EUR mn	9,440	10,193	10,511	11,713	5,651	5,818	12,100	12,600	13,400
annual change in %	5.8	8.0	3.1	11.4	13.8	3.0	3.0	4.5	6.0
Imports of goods, BOP, EUR mn	15,952	17,168	17,896	19,966	10,000	10,539	21,300	23,000	24,700
annual change in %	2.8	7.6	4.2	11.6	13.3	5.4	6.5	8.0	7.5
Exports of services, BOP, EUR mn	10,237	11,280	12,273	13,411	4,568	4,849	14,100	15,100	16,200
annual change in %	4.0	10.2	8.8	9.3	12.8	6.2	5.0	7.0	7.0
Imports of services, BOP, EUR mn	2,900	3,274	3,561	4,093	1,828	2,104	4,600	5,000	5,400
annual change in %	-6.1	12.9	8.8	14.9	14.5	15.1	14.0	8.0	7.0
FDI liabilities, EUR mn	2,298	191	1,757	1,762	677	868	1,300	.	.
FDI assets, EUR mn	1,608	-43	-177	582	282	206	300	.	.
Gross reserves of NB excl. gold, EUR mn	12,688	13,707	13,514	15,706	14,028	16,694	.	.	.
Gross external debt, EUR mn	46,416	45,384	41,668	40,069	40,260	40,142	40,400	40,400	41,200
Gross external debt, % of GDP	106.9	101.7	89.3	81.8	82.2	78.0	78.5	75.0	73.0
Average exchange rate HRK/EUR	7.6344	7.6137	7.5333	7.4637	7.4488	7.4181	7.4	7.4	7.4

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) From 2016 data are based on tax records (survey JOPPD); prior to that data are based on a monthly survey covering 70% of persons in employment. - 4) Discount rate of NB.

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