CROATIA

Highlights

- **Croatia has been severely affected by the coronavirus crisis.** In 2020, a sharp recession is under way, largely because of disruption in tourism, a mainstay of the Croatian economy, but a recovery is expected in 2021.
- **The authorities have employed considerable fiscal and monetary measures to mitigate the effects of the crisis.** Despite the country's high public debt, the government responded to the crisis with a sizeable and comprehensive crisis package, while the Croatian National Bank (CNB) focused on stabilising the kuna and providing liquidity to the banking sector.
- **Croatia has joined the Exchange Rate Mechanism II (ERM 2) and Banking Union.** This is one stage ahead of joining the eurozone, which may happen in two years at the earliest – contingent on the country meeting the Maastricht criteria.

Key priorities for 2021

- **The authorities should implement the key structural reforms needed to improve the country's competitiveness.** While important reforms have been undertaken so far, more progress is needed, particularly with regard to improving the overall quality of institutions and governance.
- **Business environment reforms should be prioritised.** Eliminating unnecessary red tape and facilitating doing business is important for economic recovery.
- **Additional efforts should be devoted to diversifying the economy.** The current pandemic has exposed the danger of relying on one or two key sectors. Supporting the development of, for instance, the export-oriented tradeable sector could decrease Croatia's dependence on tourism.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.5	3.4	2.8	2.9	-8.5
Inflation (average)	-0.6	1.3	1.6	0.8	0.4
Government balance/GDP	-0.9	0.8	0.2	0.4	-7.1
Current account balance/GDP	2.1	3.5	1.8	2.8	-3.2
Net FDI/GDP [neg. sign = inflows]	-4.3	-2.3	-1.6	-1.9	-0.6
External debt/GDP	91.4	94.6	80.3	75.7	n.a.
Gross reserves/GDP	27.6	34.0	32.8	34.4	n.a.
Credit to private sector/GDP	57.7	55.2	54.1	53.8	n.a.

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Covid-19: macroeconomic implications

Economic activity has been severely affected by the coronavirus crisis. After five years of economic recovery (2015-19), with average annual growth of 3 per cent, a sharp decline is under way in 2020 because of the coronavirus pandemic. GDP inched up by 0.4 per cent year-on-year in the first quarter, but in the second quarter, the crisis took full hold as the government introduced a strict lockdown in mid-March, with tough restrictions on travel and economic activity, to fight the pandemic. Output in the second quarter contracted by the highest decrease on record, of 15.1 per cent year-on-year. The resulting economic decline in the first half of 2020 was -7.8 per cent year-on-year, with private consumption expenditure falling by 7 per cent, investments by 6 per cent and exports by 26 per cent (driven by a 50 per cent drop of exports of services).

A key channel for disruption is tourism, a mainstay of the Croatian economy. Tourist activity has been badly hit by the travel restrictions and the lockdown imposed to curb the pandemic in Croatia and across the European Union (EU) and elsewhere. Tourist spending normally accounts for more than 20 per cent of GDP. There was a drop of more than 75 per cent in tourist arrivals in March year-on-year, and a near halt to tourism in April and May. A partial recovery followed in the third quarter, as travel within the EU was relaxed on 15 June, mitigated by the nature of Croatia's tourism industry, which is based on private accommodation and easily reachable by roads from the tourists' main countries of residence such as Germany, Austria, Slovenia, Hungary and the Czech Republic. In July tourist arrivals were down 40 per cent compared with 2019, and 30 per cent year-on-year in August. Spillover effects were felt in the labour market, with the unemployment rate rising to 8.6 per cent in July 2020 from about 6.2 per cent in February.

The fiscal accounts have deteriorated. As the 2020 recession has curbed fiscal revenue, due to the lockdown imposed in response to the pandemic and measures to tackle the crisis (see below), the budget deficit is expected to substantially increase in the short term. The government revised the 2020 budget in mid-May, keeping expenditures unchanged (but reallocating funds for new priorities), and thus projecting a deficit of 6.8 per cent of GDP rather than a near-balanced budget as originally planned (assuming a recession of 9.4 per cent). However, the country remains at investment grade with the main credit ratings agencies, and access to funding seems satisfactory so far. In June 2020, the government successfully issued an 11-year Eurobond, raising €2 billion with an annual coupon rate of 1.5 per cent. The bond was heavily oversubscribed, implying that investors valued the confirmation of Croatia's investment rating and its progress in the euro adoption process.

Economic performance is expected to recover in 2021. We expect GDP to fall by 8.5 per cent in 2020 but recover partially with 3.5 per cent growth in 2021. This is based on the assumption of a gradual normalisation of economic activity in Croatia and among its main economic partners. Nevertheless, the risks are strongly to the downside, including through a possible resurgence of Covid-19 infections.

Policy response to Covid-19

The government has adopted a considerable crisis response package. Despite the country's high public debt, the government responded to the Covid-19 pandemic with a relatively strong set of stimulus measures, costing about 7 per cent of GDP. Preserving jobs, keeping businesses in operation and improving the social position of vulnerable categories were at the core of the crisis response measures. Some of the key government measures adopted in the first months of the crisis included: (i) interest-free loans to local governments, health and pension insurance funds to cover deferred payments; (ii) salary increases in the healthcare sector; (iii) full subsidisation of net minimum wages and social contributions for the first three months of the crisis in the affected sectors; (iv) an increase in the minimum wage of 23 per cent (to €530), (v) early refund of taxes; (vi) deferral (or full exemption) of public obligations (that is, taxes and social contributions) for three months (or more) for firms, depending on their revenue impact and size; (vii) a loan repayment moratorium for three months; and (viii) further state support, including from the Croatian Bank for Reconstruction and Development (HBOR), in the form of liquidity loans and guarantees. In late June 2020, the government announced that it would support the preservation of jobs through part-time work for the second half of the year.

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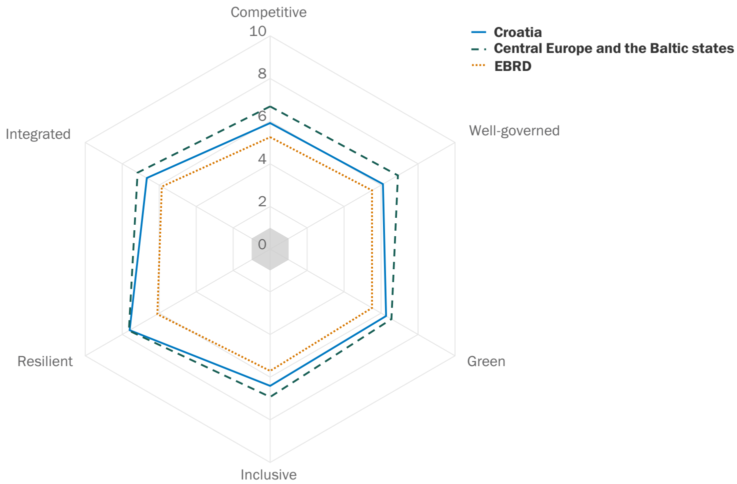
The Croatian National Bank (CNB) focused on stabilising the kuna and providing liquidity to the banking sector. The CNB has been using its foreign exchange reserves to intervene on the foreign exchange market to mitigate significant depreciation pressures and thus managed to preserve the stability of the kuna, which peaked at 7.62 HRK per euro in early April, compared with 7.45:1 during the pre-crisis period. In mid-April, the CNB agreed a precautionary currency swap line of €2 billion with the European Central Bank (ECB), to be in place until the end of the year and which can be activated if needed. The line allows the CNB quick access to euro liquidity, without using its own international reserves. In September 2020, the ECB's euro liquidity line was extended by six months. Liquidity was provided via: (i) the structural repurchase agreement (repo) facility (five-year HRK liquidity at 0.25 per cent); (ii) regular weekly repo (at 0.05 per cent); and (iii) a reduction of the reserve requirement ratio from 12 to 9 per cent. In addition, the CNB has introduced a repurchase of government bonds, in a quantitative easing-like move, to support the crisis response.

Assessment of transition qualities (1-10)



Structural reform developments

Croatia has been admitted into the Exchange Rate Mechanism (ERM) II. In July 2020 the ERM II parties, that is, the ECB together with the eurozone member states and Denmark, decided to include the Croatian kuna in ERM II, following the request sent by Croatia in July 2019. The central rate of the Croatian kuna is set at 1 euro = 7.53450 kuna, and the standard fluctuation band of plus or minus 15 per cent may be observed. After two years, a new assessment will be taken, and if positive, Croatia will join the eurozone. Before entering the ERM II, Croatia carried out a number of important reforms, including: (i) further strengthening the supervision of the banking system; (ii) strengthening the framework for implementing macro-prudential policies; (iii) strengthening the framework for anti-money laundering; (iv) improving the system for collecting, processing and publishing statistical data; (v) improving public sector governance; and (vi) reducing the administrative and financial burden of red tape on the economy.

Croatia has joined the EU's Banking Union. In parallel to joining the ERM II, Croatia also became a member of the Banking Union. From 1 October 2020, the ECB is in charge of the direct supervision of the major banks in Croatia, as well as the oversight of others. As part of Croatia's application to the Banking Union, the ECB had performed a comprehensive asset quality review and stress test of major systematically important banks, including Zagrebačka banka (Italian UniCredit), Privredna banka Zagreb (Italian Intesa), (Austrian) Erste & Steiermärkische Bank, (Hungarian) OTP banka and the locally owned Hrvatska poštanska banka. The results of the assessment were published in early June 2020, showing that these banks do not face any capital shortfalls.

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New energy capacities are being developed. The construction of a liquefied natural gas (LNG) terminal on the island of Krk has continued. This project, worth €234 million, is partially covered by a €101 million grant from the European Commission, which has listed it as an EU project of common interest. The Krk LNG terminal will have a capacity of 2.6 billion cubic metres of natural gas per year as of 2021, and should have an important role in diversifying the natural gas supply as well as ensuring its security not only for Croatia but also for the wider region. In June 2020, the Croatian power company Hrvatska elektroprivreda laid the cornerstone of the Cres solar power plant, which is meant to be the largest solar power plant in Croatia. It will strengthen the security of energy supply of the islands of Cres and Losinj in the northern Adriatic Sea, and increase their self-sufficiency especially during their peak tourist season.

Croatia has advanced on a number of social reforms. The country has started the incremental implementation of curricular reform in all primary and secondary schools. In addition, the experimental programme Dual Education in VET is being expanded. However, the adoption of occupation and qualification standards is proceeding slowly. Ongoing investments in early childhood education and care aim to increase availability and access. The package of active labour market policy measures has been refocused to make them more effective, while the Croatian Employment Service has developed a new IT tool aimed at improving mediation and referrals.

The moratorium on the sale of agricultural land to foreigners has been extended. In June 2020, the European Commission gave the go-ahead to Croatia for an extension to the moratorium of three years. Croatia joined the EU in July 2013, and its EU accession treaty granted a transitional period of seven years, during which a ban on the sale of agricultural land to citizens of other EU member states applied. This transition period was agreed to prevent growth in the prices of agricultural land in Croatia after EU accession.