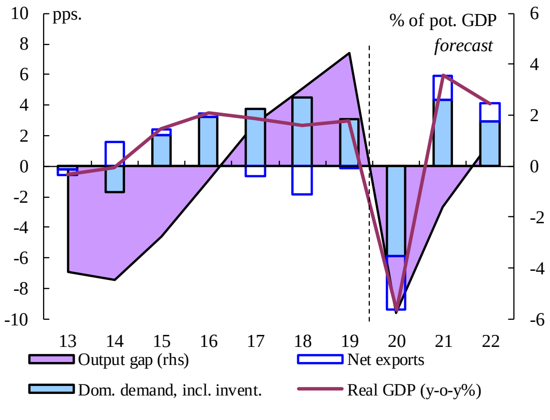
23. CROATIA

Croatia's economy is expected to contract sharply in 2020 due to the impact of the COVID-19 pandemic. Output should partially recover in 2021, thanks to private consumption and investment, but is not expected to reach its pre-crisis level by 2022. Uncertainty and lingering travel restrictions weigh on exports, including tourism. The labour market is expected to recover slowly over the forecast period. Following a sharp deterioration, public finances should improve in 2021 and 2022.

Record contraction in the first half of 2020

Croatia's economy declined sharply in the first half of 2020 due to the impact of the COVID-19 and the introduction of strict containment measures. Real GDP fell by 1.3% q-o-q in the first quarter due to disruptions in supply chains and increased uncertainty. A two-month lockdown caused GDP to drop in the second quarter by a record 14.9% q-o-q. Domestic demand drove the fall as households deferred or cancelled spending and businesses delayed investment decisions. External demand collapsed, especially for services, as travel restrictions choked the tourism sector in those months. According to high frequency indicators, economic activity reached a trough in April and began to recover gradually thereafter, as containment measures were eased.

Graph II.23.1: **Croatia - Real GDP growth and contributions, output gap**



Uncertain and uneven recovery

Domestic demand should be the main engine of the recovery throughout the forecast period. Household consumption is expected to have begun recovering in the second half of 2020, supported by low inflation, and accumulated involuntary savings due to deferred spending. As large-scale layoffs appear to have been avoided, household consumption should be underpinned by a gradual increase in employment and changes in income tax rates. After strong growth in 2020, the contribution of government consumption is expected to taper off. Investment is set to benefit from the implementation of projects financed by EU funds, including for reconstruction after the Zagreb earthquake in March. Private investment should benefit from favourable financing conditions and continued liquidity support measures.

With significant uncertainties surrounding the outlook for trade and tourism, the rebound of exports is expected to be slower. While goods exports should rise in line with the recovery in Croatia's main trading partners, service sector exports, dominated by tourism, are expected to remain under the pressure of travel restrictions, disruptions in air travel, and changes in consumer preferences in favour of domestic travel. Imports of goods and services are expected to largely follow domestic demand. Overall, the trade balance is expected to deteriorate sharply in 2020. Despite expected improvements thereafter, it should remain negative in both 2021 and 2022. The current account, however, is expected to remain in deficit only in 2020 and 2021.

Overall, real GDP is forecast to contract by 9½% in 2020, and to grow by 5¾% and 3¾% in 2021 and 2022. Potential introduction of stricter COVID-19 suppression measures presents a negative risk to this scenario in the short term. In the latter part of the forecasting period, investment supported by the Resilience and Recovery Facility constitutes an upside risk, as it is not included in this forecast due to scarce available information.

Labour market takes a hit

The labour market responded quickly to the disruption earlier in the year with unemployment on the rise since April. Furthermore, the seasonal rise in employment due to the tourist season was less pronounced than in recent years. Labour market conditions are expected to deteriorate further in the second part of 2020, as government wage support measures are largely set to expire.

The recovery should be slow as neither employment nor unemployment are likely to reach their 2019 levels by the end of 2022. Nominal wage growth should be subdued in 2021 and 2022, which should help offset the negative impact of the sizeable GDP drop in 2020 on unit labour costs.

Energy prices should drive consumer prices in the short term as core inflation is expected to stay low stable. The HICP inflation rate is forecast to drop to 0.1% in 2020 and pick up to 1.5% by 2022.

Public finances bear the brunt of the crisis

In 2020, the general government balance is expected to plummet to -6½% of GDP because of the strong economic contraction and measures aimed at preserving employment and businesses. The most significant among these measures (which collectively add up to 3% of GDP) concerns subsidies for employee wages. Tax revenues should contract strongly as household and tourist consumption decrease, particularly affecting VAT revenues. The drop in contributions and personal income tax revenue should be less pronounced as government measures have protected employment and wages. Wage subsidies and the public wage bill should drive strong expenditure growth while previously agreed collective agreements are implemented. Interest spending should decrease in spite of substantial new borrowing as maturing debt is refinanced at very low rates.

In 2021-2022, tax revenue is expected to recover strongly on account of household consumption, employment and wages. The rebound should be relatively sharp for contributions and VAT and somewhat softer for income taxes, as personal income tax rate cuts take effect in 2021 and companies carry forward their losses. The take-up of EU funds should boost revenues in 2021 before moderating in 2022. Expenditure growth should subside in 2021, after a strong 2020, and pick up in 2022. Additional savings on debt servicing are expected. Overall, the deficit is expected to be less than 3% in 2021 and deteriorate in 2022, based on a no-policy-change assumption.

The debt ratio is set to spike in 2020 due to both the large drop in GDP and the accumulation of new debt to finance the deficit. After reaching 86.6% in 2020, it should resume its pre-crisis downward path in 2021 and 2022.

Table II.23.1:

Main features of country forecast - CROATIA

	2019		Annual percentage change						
	bn HRK Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	402.3	100.0	1.7	3.4	2.8	2.9	**-9.6**	**5.7**	**3.7**
Private Consumption	232.8	57.9	1.5	3.1	3.3	3.5	**-6.7**	**4.3**	**2.9**
Public Consumption	79.4	19.7	1.5	2.2	2.3	3.4	**3.5**	**1.5**	**1.0**
Gross fixed capital formation	84.6	21.0	2.9	5.1	6.5	7.1	**-8.2**	**5.5**	**4.5**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	209.1	52.0	4.0	6.8	3.7	6.8	**-29.5**	**29.2**	**5.7**
Imports (goods and services)	210.1	52.2	4.0	8.4	7.5	6.3	**-22.0**	**22.4**	**3.9**
GNI (GDP deflator)	400.3	99.5	1.7	5.2	2.7	2.9	**-10.1**	**5.3**	**3.7**
Contribution to GDP growth: Domestic demand			2.0	3.3	3.7	4.1	**-4.9**	**4.1**	**2.9**
Inventories			0.1	0.8	1.0	-1.4	**-0.8**	**0.0**	**0.0**
Net exports			-0.3	-0.6	-1.8	0.2	**-3.8**	**1.6**	**0.8**
Employment			0.1	2.4	2.6	3.1	**-1.4**	**0.3**	**0.6**
Unemployment rate (a)			13.5	11.2	8.5	6.6	**7.7**	**7.5**	**6.9**
Compensation of employees / head			2.7	0.2	3.8	1.5	**2.1**	**1.2**	**1.2**
Unit labour costs whole economy			1.1	-0.7	3.6	1.7	**11.4**	**-4.0**	**-1.9**
Real unit labour cost			-1.3	-1.9	1.6	0.2	**10.6**	**-5.3**	**-3.0**
Saving rate of households (b)			-	8.1	8.5	8.6	**-**	**-**	**-**
GDP deflator			2.5	1.2	2.0	1.5	**0.7**	**1.4**	**1.2**
Harmonised index of consumer prices			2.3	1.3	1.6	0.8	**0.1**	**1.2**	**1.5**
Terms of trade goods			0.4	-1.3	-0.5	0.3	**-0.8**	**-0.2**	**-0.5**
Trade balance (goods) (c)			-18.2	-17.1	-18.6	-19.3	**-13.2**	**-18.9**	**-18.8**
Current-account balance (c)			-3.9	3.9	2.4	3.1	**-1.7**	**-0.4**	**0.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-3.1	6.1	5.2	7.3	**0.5**	**2.1**	**3.3**
General government balance (c)			-4.3	0.8	0.2	0.4	**-6.5**	**-2.8**	**-3.2**
Cyclically-adjusted budget balance (d)			-4.2	-0.1	-1.3	-1.7	**-4.0**	**-1.9**	**-3.2**
Structural budget balance (d)			-	-0.1	-1.4	-1.7	**-4.0**	**-2.0**	**-3.2**
General government gross debt (c)			55.0	77.5	74.3	72.8	**86.6**	**82.4**	**81.7**

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