The World Bank in Croatia

Country Snapshot

An overview of the World Bank's work in Croatia

October 2017

CROATIA	2016
Population, million	4.2
GDP, current US$ billion	50.7
GDP per capita, current US$	12,069
School Enrollment, primary (% gross) (2015)	98.0
Life Expectancy at birth, years (2015)	77.4

At a Glance

- At 2.7%, growth remained strong in 2017, on the back of a record-high tourist season and supported by fiscal easing and personal consumption. However, the country faces high state and corporate debt levels, and a low employment rate, especially among youth.

- Prospects for reinvigorating growth are limited without further reforms to sustain macroeconomic stability, boost productivity, liberalize the business environment, and modernize public services.

- The International Bank for Reconstruction and Development (IBRD) portfolio comprises eight investment projects, one regional Global Environment Facility (GEF) grant, and two guarantees.

- The World Bank is helping Croatia's transport sector become more competitive and deal with accumulated high debt levels. Croatia aims also to improve its competitiveness through structural, institutional, and governance reforms so that it can diversify its sources of growth, catch up with its European Union (EU) peers, and use EU funds more efficiently.

Country Context

Croatia became a member of the EU in July 2013. After a protracted six-year recession, Croatia returned to growth in 2015, but weaknesses remain as the country faces high state and corporate debt levels of state and corporates, a low employment rate, unfavorable demographic trends, and a cumbersome investment climate.

Access to the EU internal market has helped connect the thriving part of the economy to global value chains, and tourism is experiencing a historical high. Yet these factors are not enough to deliver pre-crisis growth rates. GDP is roughly 1% lower than in the pre-crisis period, and youth unemployment remains high at 33%. The absolute poverty rate at US$5.5 at 2011 purchasing power parity (PPP) per capita increased from 4.7% in 2009 to 5.6% in 2016.

Croatia's economic challenges include maintaining macroeconomic stability while promoting exports and private sector productivity and competitiveness to create jobs and growth.

The projected population decline, due in part to out-migration, and the aging population present big risks to growth and higher living standards, as well as to fiscal sustainability.

Croatia also needs to continue modernizing public services, the judiciary, and the governance of state-owned enterprises (SOEs), including the network industries.

The World Bank and Croatia

The World Bank's activities in Croatia are guided by the Country Partnership Strategy (CPS) launched in June 2013.

The Bank's activities are centered on supporting Croatia's economic convergence with the EU. The current engagement focuses specifically on promoting key reforms in support of fiscal adjustment, helping competitiveness, and maximizing the economic benefits of EU membership. The Bank has also been emphasizing institutional capacity building related to EU membership, particularly relevant to Croatia's ability to absorb EU funds.

The Bank's current financial commitment focuses on the transport sector, with projects in health, social protection, innovation, and land administration. These projects incorporate significant support to public administration through building capacity and preparing the public sector for EU funds absorption. The CPS program finances the development of an EU funds project pipeline worth €500 million. The focus of the advisory services program is twofold: helping to improve the business climate and the competitiveness of the economy and creating an evidence base for cross-sectoral policies and interventions to address social and regional disparities.

Key Engagement

Situated along three pan-European transport corridors between the EU and Southeast Europe, Croatia has an important geopolitical advantage. For over a decade and with more than half of its portfolio, the World Bank has been helping Croatia's transport sector become more competitive and develop into an important engine of growth.

Most recently, the World Bank, the Ministry of the Sea, Transport and Infrastructure, and various roads companies launched the Modernization and Restructuring of the Roads Sector Project.

WORLD BANK PORTFOLIO

8 Projects, 1 regional GEF and 2 guarantees

Lending IBRD: $604.5 million (investments); $627.1 million (guarantees)

Designed as a blend of an investment loan and a guarantee, this intervention is aimed at supporting the operational and financial restructuring of roads companies in Croatia. It is envisaged that the loan portion will fund the companies' operational restructuring, while the guarantee will help restructure liabilities to better match road-asset cash flows, reduce interest costs, and lengthen maturities.

Since mid-2015, the Bank has been working with three Croatian railway companies to improve their operational efficiency in order to deliver better services in a financially sustainable way. The Sustainable Croatian Railways in Europe Project complements major investments in infrastructure on international corridors funded by the EU by focusing on overall sector restructuring and the sustainability of the public companies.

This includes select financing of critical bottlenecks in railway infrastructure and safety measures, the modernization of IT systems, the rehabilitation of the rolling stock fleet, the separation and management of assets, and staff right-sizing.

Recent Economic Developments

Growth strengthened to 3% in 2016 on the back of a record high tourist season, accelerated private consumption, and a rebound of investment after six years of decline. Growth continued in the first half of 2017 at 2.7% on a four-quarter basis. The recovery was broad based, with a surge in industrial production and construction and record-high tourism contributing the most to the accelerated growth.

The performance of the labor market improved and unemployment declined to 10.8% in July 2017, due both to job creation and also higher net migration outflows. A high level of emigration and continued outflows from inactivity into early retirement led to declines in labor force participation. Thus, the participation and employment rates remained low at 51 and 45%, respectively, far below the EU average. Real net wages increased by 3.9% by June 2017 due to personal income taxation reliefs, a 2% rise in public sector wages, and increased labor market pressures within? from? the hospitality sector.

Fiscal consolidation continued in 2016 with the general government deficit (European System of Accounts [ESA] methodology) narrowing to below 0.8% of GDP from 3.4% in 2015. Due to the robust primary surplus, public debt decreased to 83.7% of GDP from 86.7% at end-2015. Croatia exited the Excessive Deficit Procedure (EDP) in June 2017.

Despite recent fiscal consolidation efforts, fiscal debt and risks remain high. Public sector wages are set to increase by 6% in 2017, and a mini tax reform adopted in late 2016, while contributing to a rise in disposable incomes, also reduced the revenue base. Delayed social sector reforms and the planned expansion of veterans benefits will continue to create spending pressures on social sectors. Debt refinancing needs remain high at 11% of GDP, or 27% of general government revenues over the next three years, requiring tight fiscal policy.

Economic Outlook

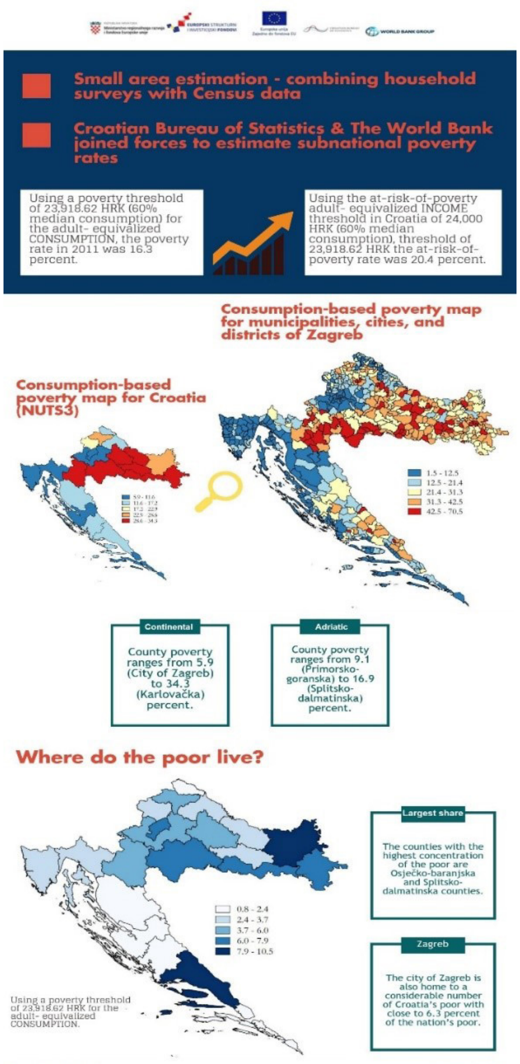
The economy is expected to grow by 2.9% in 2017 and around 2.7% in 2018–19. Growth will be led by strengthened personal consumption, tourism, service exports, and investments, all? benefiting from EU funds absorption. Personal consumption is expected to intensify, reflecting personal tax reform, a labor market recovery, and a pickup in lending activity.

The fiscal deficit is expected to increase to 1.3% in 2017, as fiscal easing with tax reliefs and spending relaxation comes to fruition. The deficit should decline afterward to an average of 1.0% in 2018–19, which would lead to a further gradual public debt decline to 76.4% of GDP by 2019. Positive labor market developments are expected to support the growth of disposable income for all segments of the welfare distribution. The continued recovery of the economy, including a decline in the share of the long-term unemployed and NEETs (young people between 15 and 24 not in employment, education, or training), supports the overall decline in unemployment, and it is expected that the absolute poverty rate, measured at the US$5.5 at PPP 2011, will decline to 5.2% in 2019.

Downside risks have moderated but are still present. Although fiscal outcomes are better than expected, the new fiscal expansion and domestic policy uncertainty add to the risks associated with slowing the pace of structural reforms and achieving the sustainability of public debt. Remaining high levels of private and public sector indebtedness, the ongoing pre-bankruptcy proceeding of Croatia's largest firm Agrokor, and the possibility of a further rise in the risk premium for emerging markets are all mounting concerns as the country faces the large refinancing of its public debt. Sustained fiscal consolidation and competitiveness reforms are needed to reduce macroeconomic imbalances and protect the nascent recovery.

Project Spotlight

Croatia Poverty Mapping - Small-Area Estimation of Consumption-Based Poverty



Croatia is committed to combating poverty and social exclusion. Achieving that goal depends on developing the right policies and programs and targeting them effectively. This requires having detailed knowledge on the disparities in living standards within the country.

To help policy makers, the Ministry of Regional Development and European Union Funds (MRDEUF), and the Ministry of Demography, Family, Youth and Social Policy (MDFYSP), acquire the knowledge on the geographical distribution of poverty, at the municipal level, the World Bank and the Croatian Bureau of Statistics (CBS) developed Income and Consumption-Based Poverty Maps for subnational levels. These Poverty Maps consist of a detailed geo-referenced database that provides estimates of poverty data at the level of counties, cities and municipalities, while previously this data was only available at the national level.

The poverty maps can also help policy makers decide where limited funds can be distributed among the population that needs assistance. Poverty profiles analysis can be used for better detection of poverty causes and for creation of more effective cross-sectoral policies and interventions for poverty eradication.

The Poverty Maps and the Multiple Deprivation Index will also help the authorities achieve better and faster absorption of EU funds by allocating funds for regional development and combating deprivation.

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