

CROATIA

Recent developments

Table 1 2017

Population, million	4.1
GDP, current US\$ billion	55.2
GDP per capita, current US\$	13383
Lower middle-income poverty rate (\$3.2) ^a	13
Upper middle-income poverty rate (\$5.5) ^a	5.5
Gini index ^a	31.1
School enrollment, primary (% gross) ^b	95.4
Life expectancy at birth, years ^b	78.0

Source: WDI, Macro Poverty Outlook, and official data.

Notes:

(a) Most recent value (2015), 2011 PPPs.

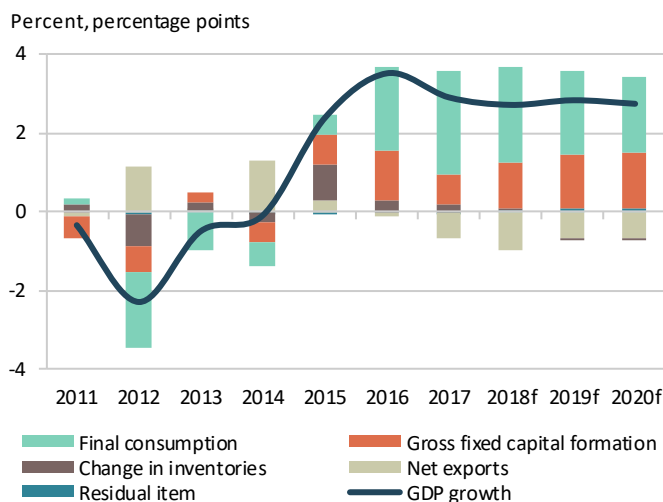
(b) Most recent WDI value (2016)

Economic growth remained solid in the first half of 2018 at 2.7 percent. The poverty rate has continued trending downwards to 4.6 percent (at \$5.5/day PPP) as the labor market improved and real net wages and disposable income increased. A small general government deficit is expected for 2018 and public debt is firmly on a downward path. However, accelerated outmigration of labor and the slow pace of structural reforms risk undermining Croatia's growth potential and hampering the medium-term convergence process.

The Croatian economy continued its growth in 2018, albeit at a slower pace compared to 2017. In the first half of the year GDP growth slightly slowed to 2.7 percent compared to 2.9 percent in 2017, mainly as exports of goods and services decelerated. Private consumption was the main driver of growth contributing 2.2 percentage points (pp), mainly due to the rise of disposable income as favorable labor market developments continued. Although both exports and imports of goods and services decreased, exports decelerated faster, which resulted in a negative 1.4 pp contribution of net exports to growth in the first half of 2018. Investment contributed positively to growth (0.8 pp), but solid private investment was partly offset by a reduction in government investment driven by weak absorption of EU funds. Robust fiscal consolidation was recorded in 2017 with a general government surplus of 0.8 percent of GDP down from a deficit of 0.9 percent in 2016. In 2018, general government sustained a surplus of 0.7 percent of GDP by March (on a quarter-basis). However, moderate growth of expenditures in Q1 (by 1.6 percent y-o-y) was due to a plunge in government investment by 36 percent y-o-y, while current expenditures including wage bill and current transfers increased. Public debt continued to decline to 73 percent of GDP in May 2018. Inflation accelerated to 1.5 percent by July y-o-y mainly due to the further rise of international

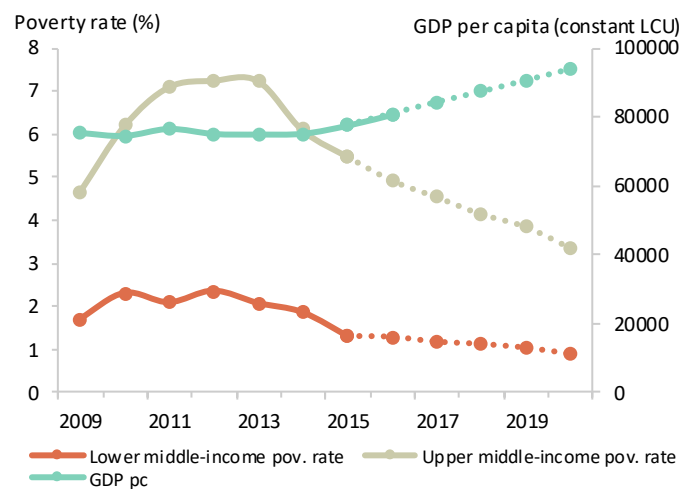
oil prices. The current account surplus declined to 2.6 percent of GDP in 2018 (March, four-quarter basis) compared to 3.9 percent in 2017, due to the further deterioration of the trade balance. Exports of goods declined by 2 percent and imports of goods surged by 6 percent y-o-y in Q1 2018. External debt declined slightly below 80 percent of GDP in May 2018, around 2 percentage points below the end of 2017 level, driven by continued deleveraging of the banks and private corporate sector. Net FDI slightly increased to 2.6 percent of GDP in 2018 by March (four-quarter basis) from 2.5 percent of GDP in 2017 as the banking sector increased reinvested earnings due to recovery of banks' profits following conclusion of a settlement agreement for Agrokor Group. Economic recovery and negative migration flows led to a further decline of survey-based unemployment to 10 percent in 2018 by March (on four-quarter basis), down by 1 percentage point from 2017. On the other hand, the survey-based employment rate slightly increased to 46.4 percent, while the participation rate stagnated at 51.7 and remained one of the lowest in the EU. Real per capita income has returned to the 2008 pre-crisis level, though this seems related to the negative demographic trend, as output is still about 4 percent lower. Economic recovery and labor market improvements further decreased absolute poverty, after its increase in six subsequent years of economic recession. The poverty rate measured at the upper middle-income class poverty line of \$5.5 at 2011 PPP per capita fell from 7.3 percent in 2013 to 5.5 percent in 2015,

FIGURE 1 Croatia / Real GDP growth and contributions to real GDP growth



Source: World Bank.

FIGURE 2 Croatia / Actual and projected poverty rates and real GDP per capita



Source: World Bank. Notes: see table 2.

which is still higher than the rates observed during the pre-crisis period. The poverty rate for 2017 is estimated to stand at 4.6 percent, suggesting that the reduction in poverty has for the most part levelled off in recent years.

Outlook

Growth is expected to decelerate to 2.7 percent in 2018 almost entirely on the account of slower growth of exports of goods and services. This reflects slower growth in Croatia's main trading partners. Also, available indicators point to a poorer performance of the tourism sector in 2018 compared to the previous year. This reflects rising competition on the market, especially from Turkey and Greece, as well as the fact that hotels in Croatia have raised their prices expecting strong demand as seen in the 2015-2017 period. On the other hand, a slowdown in imports is much less pronounced due to robust growth of personal consumption and capital investment. For 2019-2020, average annual growth is forecasted at 2.8 percent. While this is only marginally above 2018, the composition of growth is expected to change, with higher contribution of capital

investment due to better absorption of EU funds, and slightly lower contribution of final consumption. General government finance is expected to be around balance in 2018-2020, returning to a slight surplus of 0.2 percent of GDP in 2020, leading to a further decline of public debt to around 67 percent of GDP. The overall fiscal stance will become moderately pro-cyclical, as government announced a tax reform package for 2019 including a lower VAT rate for specific food items and a reduction of income tax and social security contributions. 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 long-term unemployed and NEETs, supports the decline of unemployment and it is expected that the absolute poverty rate measured at the US\$5.5 at PPP 2011 will decline further to 4.2 percent in 2018 and 3.4 percent in 2020.

Risks and challenges

Risks are slightly skewed to the downside. Exports of goods are exposed to the risk of faster slowdown in external demand from

the EU. Furthermore, exports of tourist services are expected to slow down in the projection period, due to the strengthening of competition on the Mediterranean market and capacity constraints in higher quality accommodation. Persistently high public debt, despite being on a declining path, makes Croatia vulnerable to interest rate shocks. Finally, the cyclical upturn and the sounder fiscal position may strengthen the pro-cyclical fiscal stance and further delay structural reforms, with adverse effects on growth over the medium term. Croatia's prospects for higher and more inclusive growth remain weak. Both low potential growth and relative high poverty rates call for a strong reform agenda, including raising the quality of human and physical capital. Tackling institutional weaknesses and modernizing public services should be addressed to boost private sector productivity and competitiveness. This would boost economic activity and employment, which are crucial for a further reduction in poverty.

TABLE 2 Croatia / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2015	2016	2017	2018 e	2019 f	2020 f
Real GDP growth, at constant market prices	2.4	3.5	2.9	2.7	2.8	2.8
Private Consumption	1.1	3.5	3.6	3.6	3.1	2.7
Government Consumption	-1.0	0.7	2.7	2.5	1.6	1.0
Gross Fixed Capital Investment	3.8	6.5	3.8	6.7	6.5	6.5
Exports, Goods and Services	9.4	5.6	6.4	5.0	4.6	4.3
Imports, Goods and Services	9.2	6.2	8.1	7.1	6.0	5.5
Real GDP growth, at constant factor prices	2.3	3.5	2.1	2.7	2.8	2.8
Agriculture	3.8	7.3	-2.1	2.2	2.2	2.2
Industry	2.7	5.0	1.3	2.8	2.8	2.8
Services	2.0	2.8	2.6	2.7	2.9	2.8
Inflation (Consumer Price Index)	-0.5	-1.0	1.5	2.0	2.3	2.8
Current Account Balance (% of GDP)	4.5	2.7	4.3	2.4	2.0	1.2
Net Foreign Direct Investment (% of GDP)	0.5	4.0	1.3	2.6	2.7	2.9
Fiscal Balance (% of GDP)	-3.4	-0.9	0.8	-0.1	0.1	0.2
Debt (% of GDP)	83.7	80.2	77.5	74.2	70.9	67.6
Primary Balance (% of GDP)	0.0	2.1	3.4	2.4	2.2	1.7
Lower middle-income poverty rate (\$3.2 in 2011 PPP)^{a,b}	1.3	1.3	1.2	1.1	1.0	0.9
Upper middle-income poverty rate (\$5.5 in 2011 PPP)^{a,b}	5.5	4.9	4.6	4.2	3.9	3.4

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2015-EU-SILC. Actual data: 2015. Nowcast: 2016-2018. Forecast are from 2019 to 2020.

(b) Projection using neutral distribution (2015) with pass-through = 0.87 based on GDP per capita in constant LCU.