



## Croatia

### Highlights

- **Growth moderated in the first half of 2023 but was still above that of regional peers.** Gross domestic product (GDP) growth slowed towards the end of 2022 as headwinds strengthened, but remained resilient in the first half of 2023, helped by strong tourism figures.
- **Euro adoption and Schengen membership are boosting the country's integration with other European Union (EU) economies.** Export growth has been very strong since 2019, and euro adoption in January 2023 and the removal of border controls in the Schengen area have further cut trade and investment costs.
- **Measures are being taken to make the labour market more efficient and inclusive.** Croatia has introduced a voucher system to support green and digital skills development as one of its Recovery and Resilience Plan (RRP) milestones.

### Key priorities for 2024

- **Challenging reforms are needed to implement the RRP.** The RRP schedule envisages a pipeline of more complex and politically difficult reforms, such as updating the public pay system and introducing a new law on state-owned enterprises (SOEs).
- **Inclusion issues and labour market outcomes need to improve.** The effectiveness of the Croatian social protection system and long-term care still lags behind that of its peers. Reforms need to go beyond narrow RRP commitments.
- **Efforts to attract foreign direct investment would boost long-term growth potential.** Historically, Croatia has not been a preferred destination for foreign direct investment, thanks to its higher labour costs and relatively unattractive business environment. Amid ongoing reforms and enhanced EU integration, the authorities and the private sector should grasp the opportunity to attract high-value-added investments.

#### Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	3.4	-8.6	13.8	6.3	2.5
Inflation (average)	0.8	0.0	2.7	10.7	8.6
Government balance/GDP	0.2	-7.3	-2.5	0.1	-0.8
Current account balance/GDP	2.9	-0.5	1.8	-1.9	-0.2
Net FDI/GDP [neg. sign = inflows]	-6.2	-1.4	-4.8	-5.7	n.a.
External debt/GDP	72.9	81.8	81.0	74.0	n.a.
Gross reserves/GDP	33.4	37.5	42.9	41.6	n.a.
Credit to private sector/GDP	52.1	58.5	51.9	49.8	n.a.

## Macroeconomic developments and policy response

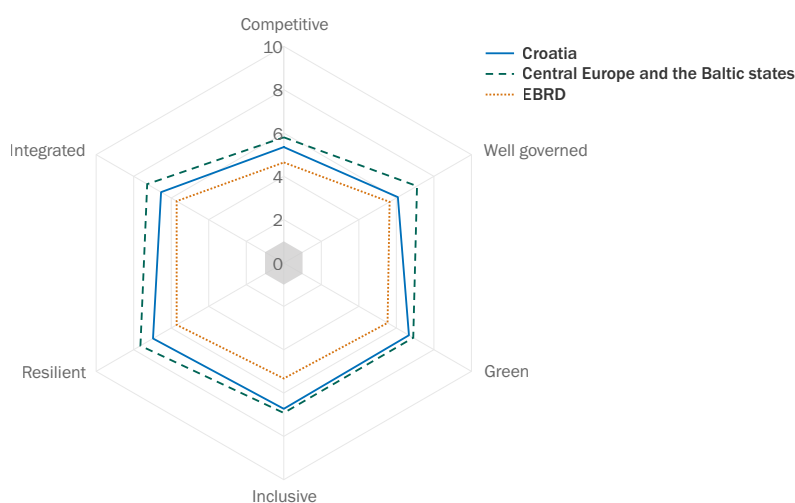
**The economy is cooling after another year of strong growth.** GDP growth was among the highest in the EU in 2022, at 6.3 per cent, driven by strong domestic demand, including an accumulation of inventories. In the first two quarters of 2023, GDP growth slowed to 1.6 per cent and 2.6 per cent year on year, respectively. However, quarter-on-quarter growth of more than 1 per cent in the second quarter, with private consumption accelerating amid declining inflation, suggests that the economy retains significant momentum. Still, exports recorded an annual decline in April and May 2023, largely owing to lower exports of fuels and crude materials. Industrial production also fell for six consecutive months up to May 2023, reflecting weak foreign demand and supply-side shocks. In the first half of 2023, tourist nights were 5 per cent higher than in the record year of 2019.

**Inflation is declining while wage growth is picking up.** Consumer price growth peaked at 13.5 per cent in November 2022, largely driven by food prices. Since then, inflation has been on a downward path, dipping to 6.7 per cent in September 2023. The adoption of the euro in January 2023 had only a marginal effect on inflation, according to estimates by the European Central Bank. Meanwhile, nominal wage growth has been brisk in 2023, averaging 12 per cent year on year. This has translated into relatively strong real wage growth (6.1 per cent year on year in July 2023), supporting household demand. The labour market remains tight, although the employment rate went down from a record high at the end of 2022, with unemployment rising to 7.3 per cent in the first quarter of 2023. Real-estate prices have risen significantly, posting a 17.3 per cent increase on the year in the fourth quarter of 2022.

**The fiscal position is strong despite energy and cost-of-living support schemes.** Strong economic growth, high inflation and an improving structural balance led to a fiscal surplus of 0.1 per cent of GDP in 2022. Government debt was down to 69 per cent of GDP at the end of 2022, below pre-pandemic levels. The 2023 budget is projected to post a small deficit of up to 0.3 per cent of GDP, according to the latest budget revision. The European Commission estimated the cost of energy support measures in 2023 at 1.5 per cent of GDP. In March 2023 the government introduced a lower value-added tax (VAT) rate on energy products, reduced excise duties on fuel, allocated additional social transfers and prolonged price caps on electricity and gas to October 2023 and March 2024, respectively. Hrvatska Elektroprivreda, the state-owned energy company, bore the financial impact of the price caps, for which the government approved a capital transfer of up to €900 million in March 2023.

**Growth will moderate in the short term.** We forecast GDP to grow by 2.5 per cent in 2023, as weak external demand and tighter financial conditions take a toll. Upside potential to the forecast comes from a strong tourism season, a recovery in domestic demand supported by a tight labour market, and an acceleration in investment driven by EU funds. GDP could expand by 2.3 per cent in 2024, as a moderation in domestic demand is offset by the recovery of key trading partners.

### Assessment of transition qualities (1-10)



## Structural reform developments

**Croatia is benefiting from euro adoption and Schengen membership.** Croatia joined the eurozone and the Schengen area in January 2023. As a result, the economy is benefiting from decreased trade and transaction costs, more foreign investment and greater inflows of tourists, some of whom are buying property. Consequently, there is a risk of faster real-estate price growth in the short to medium term.

**RRP implementation and associated reforms are advancing.** With three payment requests already submitted, Croatia is progressing well on RRP implementation. Most of the reforms required in these initial stages pertain to updating and adopting national strategies and programmes around key transition topics, such as the green transition, good governance and competitiveness. Moreover, the authorities have also adopted a new hydrogen strategy and amended legislation on biofuels. The challenge now is to channel the available resources effectively into impactful projects and ensure that the legislative improvements translate into tangible outcomes. In addition, the upcoming payment requests will include more difficult reforms, such as updating the public pay system, launching a new procurement platform and adopting a new law on SOEs.

**Additional efforts were made to strengthen competitiveness and improve the business environment.** Under its second RRP payment request, Croatia committed to implementing an action plan set out in 2020 for reducing non-tax and para-fiscal charges, which the European Commission confirmed had been completed at the end of 2022. Moreover, the promised digital platform for firms to pay business fees online is now operational. Targeting specific sectors, the authorities updated the regulation to enable the digital single market to function, adopted a new law on agricultural land consolidation to increase productivity in the sector and launched a new sustainable tourism development strategy.

**Several of the adopted measures target labour-market inefficiencies and skills development.** A key objective of the Croatian RRP is to improve employment outcomes by increasing labour-market flexibility and addressing inequalities. Notable reforms so far include the adoption of the Labour Act, in force since January 2023, which clarifies fixed-term and remote work, and the Act on Elimination of Unregistered Work, which targets informal employment. An educational voucher system was introduced to promote digital and green skills. The government is also easing policy on seasonal workers in light of current labour shortages.

**Gas infrastructure is being developed as Croatia becomes a regional hub.** The energy crisis in 2022 accelerated plans for Croatia to develop its gas infrastructure. Key projects include the expansion of the Krk liquefied natural gas terminal, the Zlobin-Bosiljevo gas pipeline and the Southern Gas Interconnection with Bosnia and Herzegovina as part of the Ionian Adriatic Pipeline connecting Greece and Türkiye to central Europe. A potential gas interconnector between Croatia and Slovenia is also being discussed.

**A corporate windfall tax was introduced in 2022.** The one-off tax applied to companies with revenue of more than €40 million, to subsidise smaller firms and households struggling with the increased cost of living. The marginal 33 per cent rate was levied on any profits that were 20 per cent higher than a company's 2018-21 average. The additional tax brought in €230 million in 2022. The authorities are considering extending the levy to 2024.