Croatia Amidst the European Energy Crisis

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Croatian Macroeconomic Outlook at the End of 2022

The autumn is here with us and the European continent is bracing itself for politically challenging weeks and months ahead. The energy crisis and spiralling inflation, fuelled by the War in Ukraine, are slowly chipping at the initial resolve of European nations to channel their support for the Ukrainian fight against Russian aggression. Russia used to be the major provider of imported energy to EU. According to Eurostat, in 2020 29% of imported oil, 43% of natural gas and 54% of imported coal were of Russian origin. In Croatia approximately 30% of energy was Russian origin. After the war in Ukraine, the supply of Russian energy interrupted, which caused to energy crisis in the continent.

Unlike the experience of some previous crises in its contemporary history, such as the global financial crisis of 2008, Croatia fortunately faces the pending crisis with far less internal and external imbalances. Although the surplus on current and capital account in 2022 is expected to decline slightly to 5.2% of GDP due to rising costs of energy imports, and to fall further to 3.8% of GDP next year, Croatia is far away from the precarious state of having large external imbalances (Tsoneva, 2022).

Public debt-to-GDP ratio has been steadily declining since the first quarter of 2021, in contrast to the trajectory of public debt-to-GDP ratio for the EU as a whole (Eurostat, 2022a). As of this writing the ratio amounted to 77.3% of GDP in Croatia and 87.8% in the rest of EU. Furthermore, Croatia's growth momentum is strong thanks to outstanding tourist season and in the third quarter it will definitely surpass the growth rate recorded in the second quarter of 2022, which was the fourth highest in the EU, compared with the same quarter of the previous year (Eurostat, 2022b).

Finally, since Croatia has been gradually diversifying from the heavy reliance on tourism, it is noteworthy to mention that industrial production growth has been consistently outperforming that of the EU-27 ever since February 2021 (Ibid.) To sum it up, the indicators presented above are well-embodied in the Eurostat's Economic Sentiment Indicator for the second quarter of 2022, which shows far more optimism on the part of Croatian businesses and consumers compared to the EU average.

However, not everything is rosy and Croatia faces one of the highest inflation rates measured in the EU. While the annual inflation rate in the eurozone reached a staggering 10.1% in August, in Croatia it climbed up even further by 12.1% (Eurostat, 2022c). Runaway inflation and security of energy supply have become the most pressing issues facing Croatian citizens and businesses. In that regard, Croatian Government needed to act forcefully to alleviate hardship for the most vulnerable citizens and businesses. On average, natural gas, transport fuels, electricity and coal make up 14.3% of total household consumption, the second-highest share in the EU (Financial Times, 2022). In addition, comparison of energy prices for the first seven months of 2022 with the same period in 2021 shows that prices for businesses shot up on average by 81%, while households faced only a 19% increase (Vizek, 2022).

Government's Reaction to the European Energy Crisis

In order to boost social cohesion and dampen the economic impact of skyrocketing energy prices on the European market, the Government of Croatia decided to opt for a full set of interventionist measures. The first package worth € 636 million in February consisted of: reduced food and energy VAT (e.g. a temporary decrease in VAT from 13 to 5% for natural gas), income transfers to vulnerable groups such as pensioners, intervention in the price formation on the gasoline and diesel market, and support to businesses being adversely hit by large spikes in gas prices (Vlada Republike Hrvatske, 2022a).

Then, on 16th of September, the second package worth € 2.8 billion was passed by the Government of Croatia. Approximately 28.1% of that amount is aimed at capping the price of electricity and of heat energy, 13.3% covers tax cuts and reduction in excise taxes, 11.9% targets vulnerable households and individuals, 9.5% refers to subsidies aimed at facilitating energy transition for businesses, 32.9% encompasses loans, subsidised interest rates and guarantees for businesses and finally, 4.8% will help households to improve energy efficiency and insulation of their homes (author's calculation based on Vlada Republike Hrvatske, 2022b).

With the goal to cushion the impact of energy crisis on households and businesses Croatian Government has showered more than 4% worth of GDP in fiscal support from September 2021 to September 2022 (Sgavaratti *et al.* 2022), thanks to fiscal capacity created by post-pandemic recovery. Furthermore, additional 2% of GDP support comes in the form preferential loans and mandates to state-owned enterprises. Croatian Government essentially capped electricity prices for small households and businesses for six months, while allowing for higher prices for big consumers and businesses. In that regard, national energy company HEP (state-controlled) and its balance sheet will carry most of the burden. This package also announced windfall profit tax but there is a lack of precise information whether and to what extent will the Government push forward with the proposal.

Overall, this fits into the larger trend as a consequence of which energy prices have risen by only 20% since 2015, compared to whopping 52.5% increase in the rest of EU. There are several reasons for this divergence: 1) Croatia does not subsidize industrial sector with cheap energy 2) Croatia does not have a strong industrial lobby 3) Only a very limited share of population is willing to sacrifice material standard of living as a price of support for the Ukrainian cause 4) Croatia does not have a well-developed system of social protection that can alleviate economic hardship for vulnerable citizens in a targeted manner (Šonje, 2022). All of this is responsible for the fact that businesses in Croatia pay higher prices than citizens, while in the majority of other EU member states there is an inverse situation.

Croatian policy-makers plan to cope with the energy shock by a combination of: increased domestic natural gas production, the rapid filling of gas storages, the enlargement of the existing LNG terminal capacity, the reduction in demand (primarily by crafting incentives aimed at consumers of different size) and the expansion of renewables.

First, the increased domestic natural gas production has some potential since in 2021 Croatia reached the lowest production point in the last four decades. The abandoment of this policy of under-exploatation plans to boost domestic production by 20% until 2024 (self-sufficiency target of 40%). Second, Croatia's gas storage is currently 85% full (4.25 TWh of gas) and is progressing rapidly, which makes up for 14.3% of gas consumption recorded in 2021, and is on track to be full by November (ENTSSOG, 2022; Ministry of Economy and Sustainable Development, 2021).

Third, the expansion of the Croatian LNG terminal on the island Krk, an investment worth € 180 million, is to be completed by the end of 2024. This should double the capacity from 2.9 to 6.1 bcm. In that way, Croatia will establish itself as an important regional hub. Croatia also plans to reduce demand by limiting heating and cooling in public builidings to 21 and 25 degrees Celsius, according to the REPowerEU plan. Finally, Croatia plans to boost production of renewables and increase energy efficiency, which will be elaborated in the next section.

Similarly to the EU at large, Croatia has increased its energy import dependency in the period 2000-2020, from 48.5% to 53.6% (Eurostat, 2022d). Nevertheless, unlike Germany and Austria, since the crisis had erupted Croatia displayed far more more flexibility to energy flow disruption in the course of Russian weaponisation of gas infrastructure. In terms of Croatia's dependency on energy imports from Russia in gross available energy, things have rapidly changed since 2020. In 2020 approximately 30% of gross available energy was of Russian origin. Nevertheless, the opening up of the LNG termin on the island of Krk in 2021 was a milestone. If one tracks gas imports in the first six months of 2022, the share of gas coming from Russia has become negligible (Hall and Romei, 2022).

Good news can be also found in statistics covering energy intensity of the economy (measured in kg of oil equivalent per € thousand). In the period between 2010 and 2020 Croatia has significantly reduced its energy intensity of the economy, which was lower than in all comparable post-socialist member states (Eurostat, 2022d). To wrap it up, IMF's recent anaysis shows that Russia's potential gas supply cut-off would have manageable consequences for Croatian economy (Flanagan *et al.*, 2022).

The Crucial Task Ahead: Boosting Long-term Resilience by Crowding-in Investment in Renewables

In order to lend a helping hand to EU's REPowerEU plan geared towards ending Europe's dependence on Russian fossil fuels by 2030, as well as to provide competitive and clean sources of energy supply, Croatian Government will have to take several decisive steps besides aforementionedd short-term interventionist measures.

One of the main problems is the fact that INA, a Croatian multinational oil company (49% owned by the Hungarian MOL and 44% owned by Croatian state), has been seriously mismanaged due to constant litigation and jockeying over management rights between the Hungarian and Croatian side. Years of underinvestment have taken toll, especially when it comes to natural gas production and diesel refining.[1] However, if Croatian Government is serious in its goals of ensuring competitive energy prices and the security of supply, then the control over INA has to be established by forced buying of free-float shares from pension funds and small owners at market prices in the first step. In the second step, professional management, independent of short-term political imperatives, needs to be appointed. Investments in biofuels and green hydrogen would be a reasonable market strategy.

Even more important, in spite of procuring 31% of energy consumed from the renewables (one of the highest shares in the EU and mostly due to hydropower), Croatia has a plenty of space for improvement, especially in using available solar and wind potential (PBZ, 2022). Solar potential of Croatia amounts to 3000 MW but currently it only exploits 100 MW (Agroklub, 2022; SOLARGIS, 2022).

Unfortunately, delays in adopting the implementing legislation and adopting new energy and climate strategies created uncertainty for several years and slowed both wind and solar development. Red tape and slow administration is still a major hurdle, despite Croatia obtaining € 5.8 billion in grants from the Next Generation EU, to foster green and digital transition.

For example, the projects comprising wind or solar farms face hurdles due to non-existence of the state's spatial plan as an overarching document that is hierarchical to the existing plans at the level of counties, cities, and municipalities. This prevents sending a clear signal to investors on the availability of land necessary to kick-start a project cycle. To make the matters worse, land registers are messy and opaque, while expropriation procedure can generate problems of its own and significantly slow down the project implementation. Everything combined aggravates the problem of legal certainty.

Furthermore, the environmental assessment procedure, as a prerequisite for starting the project, should be finished within 60 days since its submission by investor, but the average duration of this process has already climbed up to 245 days (Kotarski, 2022). In comparison to the prevailing experience of other EU member states that aim at fast-tracking and centralizing the process of environmental assessment, the Croatian experience does not conform to this reality.

Unless the aforementioned institutional constraints will not be alleviated soon, the planned addition of 1.4 GW of new renewables to the grid, until the targeted deadline at the end of

[1] It is no wonder then that Croatian political landscape was shattered as a consequence of corruption scandal involving INA at the end of August 2022. One mid-level Croatian director sold vast amounts of INA's natural gas significantly below the market price to foreign entities, effectively damaging the company to the tune of € 140 million, and impairing Croatian energy security in the process. Opposition's weakness has not resulted in snap elections or ministers being dismissed. However, the scandal rocked the ruling party in terms of deterioration in opinion polls.

2024, remains too ambitious and unrealistic, with negative consequences for the standard of living of Croatian citizens and for the competitiveness of Croatian businesses.

Conclusion

The nascent European energy crisis shows that Croatian economy displays some signs of resilience and flexibility to energy supply disruption. Fiscal capacity has been used wisely in the pandemic, while post-pandemic recovery has increased Government's leeway. There have been some praiseworthy interventionist measures so far, such as income transfers to vulnerable citizens and measures aimed at limiting price hikes for Croatian businesses. However, there are also some harmful short-term measures such as price controls targeting certain food staples, which had already caused periodic shortages. The announcement of a windfall profit tax does not go in the direction of promoting and attracting investments.

Regardless of the abovementioned short-term interventions, which are on balance good and will help Croatia weather the crisis in the short-term, the biggest challenge and the biggest prize lies in the promotion of long-term structural transformation of the Croatian economy. Boosting the production of renewables will be the greatest boon for competitiveness and social cohesion. Hopefully, the European energy crisis will propel hitherto inert body politic to switch from reactive to proactive mode of navigating the crisis and futureproof Croatian economy and society.

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