Croatia's Economic Outlook for 2023 and Beyond

Kristijan Kotarski, Assistant Professor
Faculty of Political Science, University of Zagreb, Croatia

2022: Coping with the year of European energy crisis

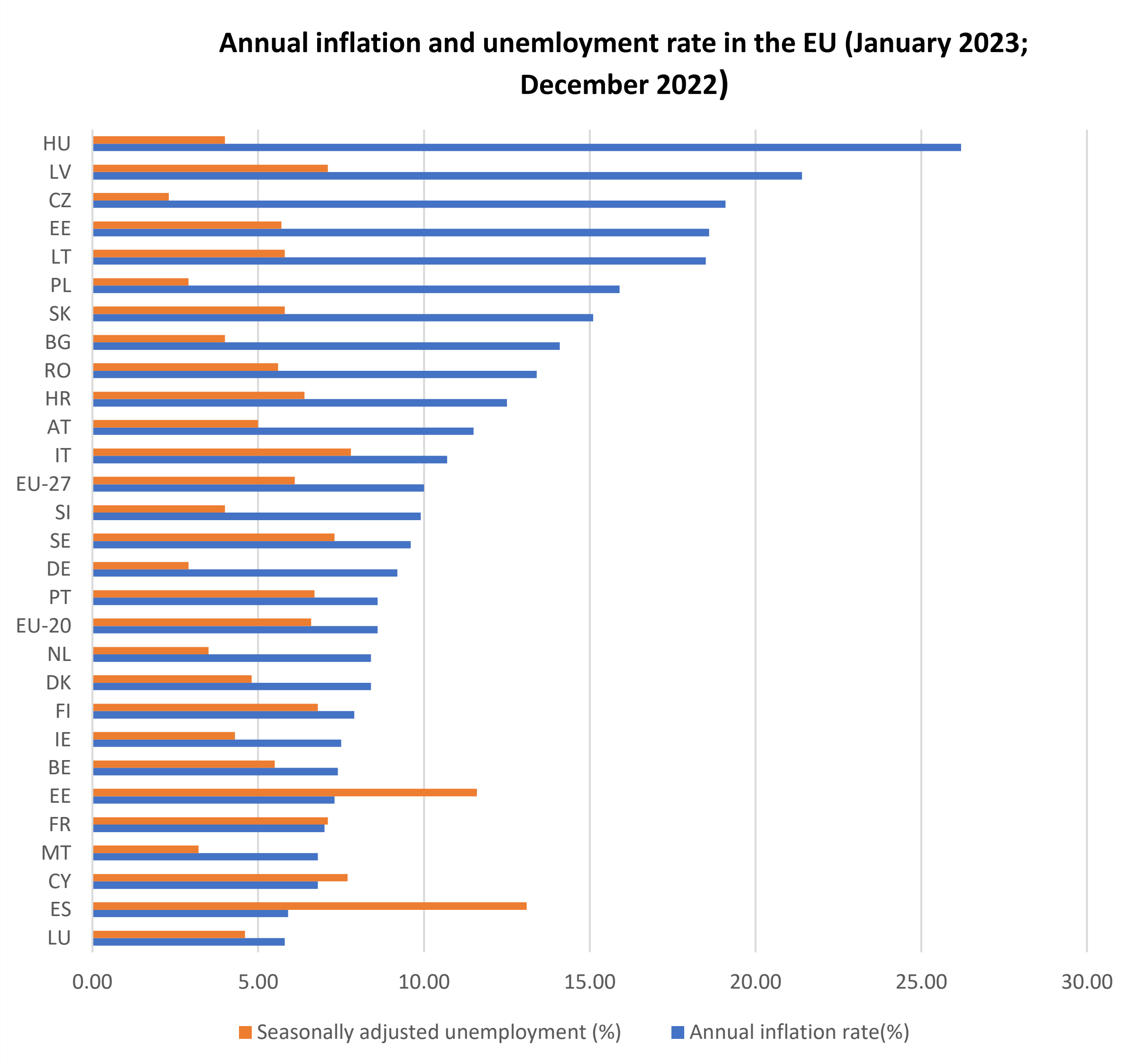
In spite of the continent-wide impact of the European energy crisis, caused by the War in Ukraine, it is estimated that Croatia's growth rate for 2022 was at 6.3%, the fourth highest in the EU-27 after Ireland, Malta and Portugal (Eurostat, 2022a). This score is a continuation of the very favourable growth trend dating from 2021, when Croatia boasted the second highest growth rate in the EU. The main factors responsible for this growth trajectory are: a good pandemic management which did not rely on excessive epidemiological restrictions, enviable tourism results in comparison to its Mediterranean peers, record financial transfers from the EU budget, rising export of goods as a consequence of shortening supply-chains and a major influx of remittances from Croatian diaspora living abroad. All of this enabled Croatia to reach pre-pandemic GDP level already in 2021, much faster than the EU as a whole (Eurostat, 2023b).

In order to cushion the impact of energy crisis on households and businesses the Croatian Government showered 1.8 billion euro (3.2% of 2021 GDP) in fiscal support from September 2021 to January 2023 (Sgavaratti *et al*. 2022). If we add to this sum the most recent set of measures worth 1.7 billion euro announced in early March 2023, the cumulative support climbs to 6% of GDP and is among the highest in the EU. This intervention was largely made possible by increased fiscal capacity created by post-pandemic recovery, accompanied by one of the steepest declines in public-debt to GDP ratio among EU member states. The cumulative effect of those interventions is that personal consumption, the biggest driver of GDP growth, did not fall as much as had been expected, and was still positive for all four quarters in 2022.

Robust growth is also reflected in good labour market statistics. In terms of unemployment Croatia had 6.4% unemployment rate, slightly above the average for the EU-27 of 6.1% and slightly below the average of 6.6% for the eurozone (Eurostat, 2022c). More comparative insight can be obtained from *Figure 1*. On the reverse side, during the summer of 2022 the number of employed persons was with 1.635 million at its highest point since 2008 (HNB Eurosystem, 2022).[1] However, this picture is tarnished a bit by Croatia's employment rate of 68.2%, which is below the EU-27 average of 73.1%. On that metric only Spain, Romania, Italy and Greece fared worse than Croatia (Eurostat, 2022d).

[1] The slight decrease is attributed to seasonality stemming from tourism.

Figure 1



Source: Eurostat, 2023c; Eurostat, 2023f

Eurostat's job vacancy rate (Eurostat, 2023e) is still at manageable level but the rising demand for workers in retail, construction and service sectors is being satisfied by record import of foreign workers from Nepal, Bangladesh, Phillipines and India, since the regional pool of workforce from the Western Balkans has been mostly drained. There were 115.000 foreign workers in Croatia at the beginning of 2023 and the large majority of them has a temporary status, with no plans to become residents and looking further afield to Germany and Austria for better opportunities (Grgas, 2023). Workforce shortage is already palpable and this has contributed to the record rise in nominal wage of 8.2% in January 2023 (year-on-year). Hence, the average salary climbed at 1046 euro (Šonje, 2023a). Nevertheless, this increase did not suffice to produce real wage growth due to inflation and 2022 was the first year since 2014 that real wages plummeted by 4% (Ibid.).

A less rosy picture could be observed also in the statistics measuring price increases. Over the last decade the HICP (Harmonised Index of Consumer Prices) in Croatia had been moving in tandem with the HICP for the eurozone. However, a significant divergence between those two rates emerged in April 2022 for the first time since 2008. In the following months inflation had continued to strongly accelerate and it only started to fall gradually in December 2022 (European Central Bank, 2023).

The euro adoption on the 1st of January did not cause a significant jump in prices and it is expected that this event will be responsible for maximally 0.5 percentage point increase in the HIPC. However, Croatian Government could have done more to promote market competition and transparency of prices, as well as to inform consumers (Šonje, 2023b). In January 2023 Croatian annual inflation rate amounted to 12.5% and it was above the EU-27 average, as shown in *Figure 1* (Eurostat, 2023f). Therefore, the bi-annual cumulative inflation rate climbed to 19.1% (DZS, 2023a).

House prices have increased much faster than in the majority of EU member states. The annual rate of change in 2022Q4 was 14.8%, twice the rate of change for the EU-27 (Eurostat, 2023g). Nevertheless, housing market is not poised to cause a sharp cost of living crisis since 85% of households own their dwellings (without mortgage), which is the second highest percentage in the EU. In addition, homeownership rates are almost equally distributed across all five income quintiles (OECD, 2022). Finally, rising house prices are not supported by potentially destabilising mortgage debt, since almost third of buyers are non-residents, while well-off residents pay in cash.

Economic forecast for 2023

In its economic forecast for 2023 the European Commission's expects 1.2% growth rate in Croatia, which is much lower in absolute terms but still above the projection for the 27 member states block and the majority of member states. Moreover, GDP growth in 2024 is projected to reach 1.9%, which is an upward revision from 1.7% in November 2022 (European Commission, 2023). This forecast is based on the expectation of falling global inflation rate and the corresponding local rise in real wages, boosted by tight labour market, with job vacancies on the rise in tourism and construction sectors. Investments are also expected to grow, primarily on the back of government investments in transportation and wastewater treatment infrastructure, private investments in energy efficiency measures, mostly financed from European Structural and Investment Funds. On the other hand, weaker global aggregate demand should weigh on the Croatian export of goods and negatively affect its trade balance, due to slightly worsening terms of trade for a country whose energy import dependency stood at 54.53% in 2021 (Eurostat, 2023g). However, in 2023 Croatia will still post a current-account suficit.

Besides state support aimed at mitigating the impact of the European energy crisis, the biggest boost to short-run growth and long-run policy credibility is to be found in the successful adoption of the euro and the Schengen Area accesssion at the beginning of 2023. These are extremely important milestones for Croatia since the country is now member of the second biggest currency block in the world, as well as a member of the European border free area.

Namely, in 2022 the share of foreign tourist overnight stays from member states sharing the common European currency, the euro, amounted to 59.03% (DZS, 2023b). This share is even higher with 76.41% when tourists from all EU member state are taken into account. In addition, the share of imports from the eurozone as a percentage of total imports equaled 53.83%, while the share of exports destined to the eurozone made 50.95% of total exports (DZS, 2023c).

Overall, the elimination of exchange rate risk and border controls shall additionally support growth due to reduced costs and frictions to trade and travel. Furthermore, less hurdles to inward FDI is also a welcome development but other more important policy reforms will have to take place in order to boost Croatia's attractiveness, which will be the subject of the last section of this policy brief.

Croatia's growth beyond 2023: some adverse trends

As Croatia will enter a more mature phase of its EU membership, a steady inflow of EU transfers will diminish in size and importance. In that regard, Croatia will have to lay new foundations for rising economic prosperity. However, there are two big obstacles to Croatia's economic dynamism in the years beyond 2023, notwithstanding recent good performance.

The first big obstacle is to be found in the slow embrace of green transition, which was the subject of this author's last analysis for the Korea Institute for International Economic Policy. Over last last four months Croatian Government has not managed to streamline procedures and protocols for getting renewable energy projects much faster and cheaper online. The increase in renewables production significantly lagged behind the comparable EU member states over the last decade, as shown by the annual change in solar and wind energy production since 2019 (Our World in Data, 2023).

Instead of predominantly concentrating on the supply-side of the equation, wherein the only sustainable solution to the challenges of green transition lie, Croatian Government opted for propping up demand in anticipation of a super-electoral year. Namely, in 2024 europarliamentary, parliamentary and presidential elections shall take place. The decision to prolong market-suppressing measures covering electricity prices until September 2023 and gas prices until April 2024 sends a wrong signal to households and market participants. Only in the first half of 2022 the financial loss to HEP is estimated at 150 million euro (N1 Biznis, 2022). Indeed, the Government plans to cover the aforementioned loss by recapitalization with 700-900 million euro, at cost very dear to taxpayers (Brnić, 2023). If we take the lower bound and divide this number with Croatia's population this amounts to 185 euro per capita.

Apart from sending the wrong signal on the need of achieving energy conservation, as well as neglecting the topic of fair burden sharing, the imposed price controls will negatively impact HEP's capacity to kick-off the next investment cycle in renewables. At the moment, Croatia generates 46.1% of electricity from hydropower, which is heavily dependent on the precipitation. With only 0.5% of electricity being generated from solar power, Croatia will be increasingly at the mercy of changing weather circumstances, unless it strongly commits to expanding the nuclear power plant in Krško, a jointly owned power plant by Slovenia and Croatia. While Slovenia has moved ahead with ongoing preparations, Croatia is lagging behind.

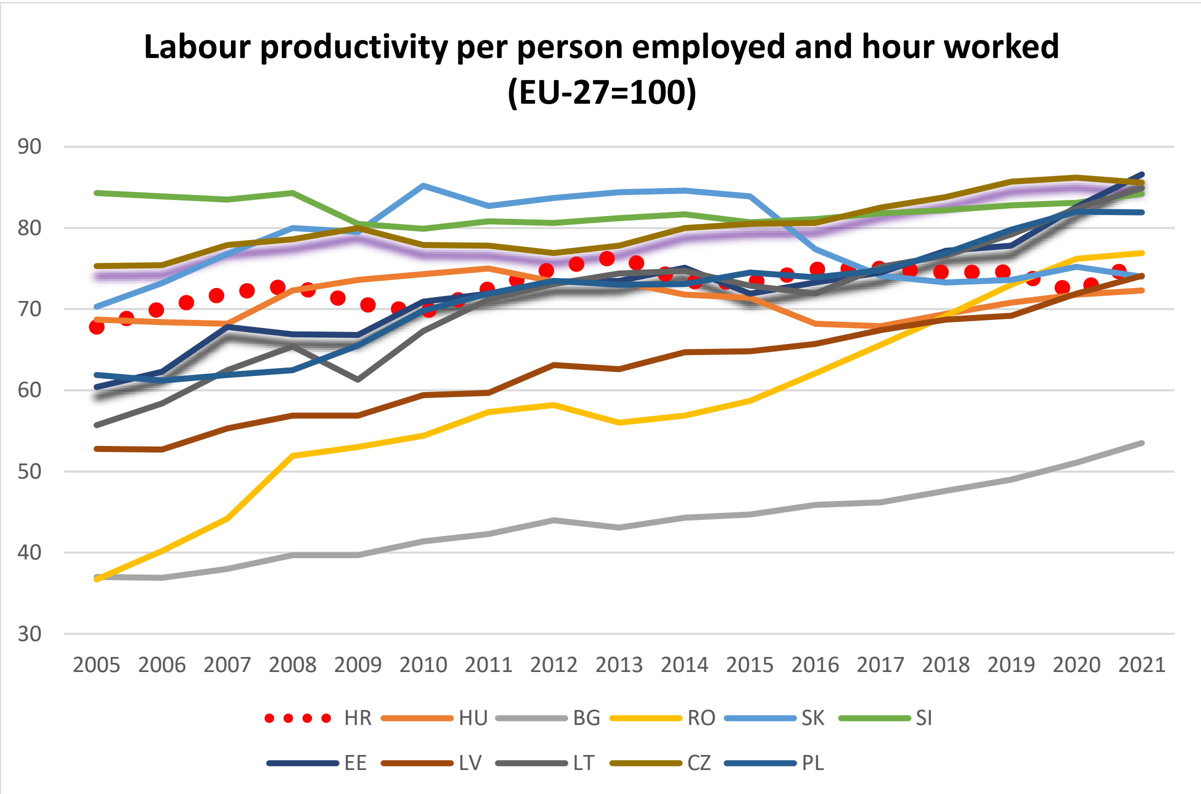
Therefore, there are only two option on the table over the long-run, either rapidly expanding the supply of renewables and nuclear in the energy mix or privatising the national energy company HEP, since the Government cannot recapitalize HEP over and over with tax-payers money or price controls. Of course, the latter option would imply spiralling costs for Croatian househoulds and businesses and reduce international competitiveness.

The second obstacle mentioned above is related to the subpar productivity and its institutional origins. If one compares productivity in Croatia and Germany, regardless of some catch-up over the last decade, a German worker still produces three times more in terms of value-added than the Croatian worker (The World Bank, 2022). This is attributed to the lower level of human capital, poor management practices, less intense competition structures and the insufficient use of technology.

Not only that Croatia lags behind Germany as the frontier economy, but it also has one of the lowest potential growth rates in the Central and Eastern European region, primarily due to weak productivity contribution. Interestingly, in contrast to the often proclaimed statement that Croatia suffers from the Dutch disease as a consequence of the very high share of tourism and travel in GDP's sectoral composition, the new data do not support this view. While overreliance on one economic sector is bad from the standpoint of economic resilience, Croatia's low productivity is not the fault of economy's sectoral composition. In contrast, it is the result of large differences in productivity within sectors. The biggest gap between Germany and Croatia is to be found in the following sectors: water supply, sewage, waste treatment; manufacturing, mining and ICT. On the other hand, the lowest gap is the feature of sectors such as: real estate, accommodation and restaurants, professional, scientific and technical services (Ibid.).

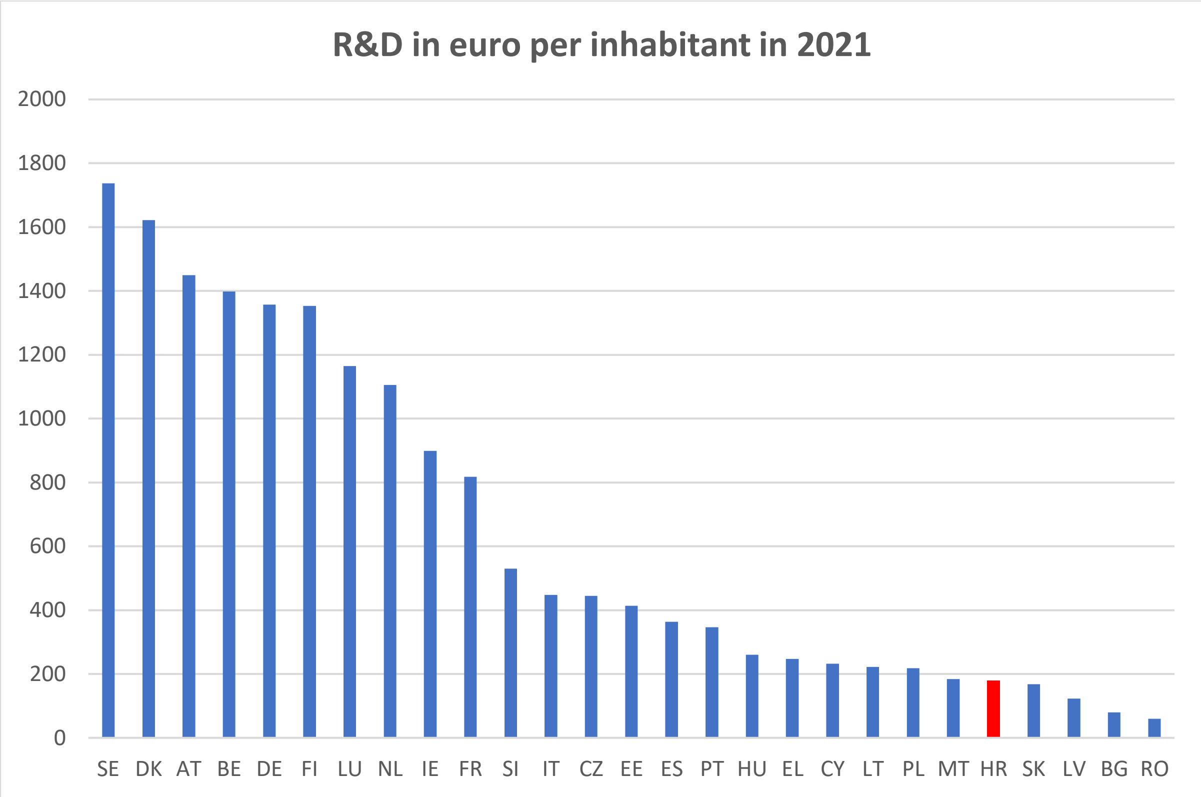
Figure 2 shows that labour productivity per person employed and hour has grown much faster in comparable EU member states than in Croatia. One of the underlying reasons for this is the very low level of spending on R&D, besides its unsatisfactory efficiency, as shown in *Figure 3*. Therefore, the FDI inflows as a major driver of long-term growth and knowledge transfer have been embrassingly low over the last ten years, as shown in *Figure 4*. The recent study by the World Bank named *Laying foundations: boosting productivity to ensure future prosperity* also confirms this view and shows that tax rates, inadequately educated workforce, courts and corruption represent the biggest obstacles to business operation in Croatia (The World Bank, 2022).

Figure 2



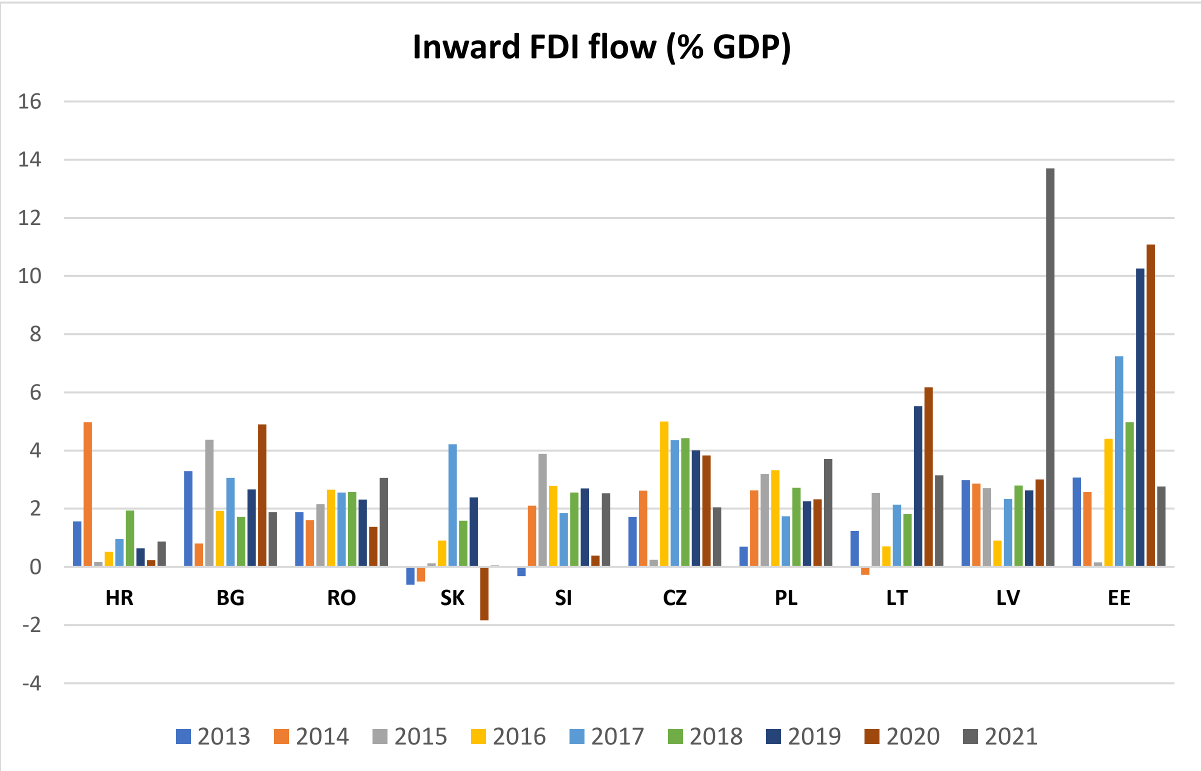
Source: Eurostat (2023i)

Figure 3



Source: Eurostat (2023j)

Figure 4



Source: UNCTAD (2023)

Conclusion

The growth beyond 2023 and the ensuing economic convergence with the club of the richest countries in the world crucially depends on the implementation of major structural and institutional reforms. On the condition of embarking on a path of ambitious reforms Croatia could lift potential growth rate to 3% until 2050, a threefold increase over the current projections. Those reforms must include: decisive fight against corruption, strengthening of the rule of law by making court cases more expedient and impartial, making regulatory framework more conducive for private businesses, dramatically increasing abysmally low R&D expenditure, reducing the economic footprint of state-owned enterprises, establishing enhanced voice and accountability mechanisms between the body politic and members of the political elite and improving the effectiveness of public policies. One reform at the time is not a small feat, let alone the whole package. Let's hope that after the super-electoral 2024, which will be preceded by some populist economic measures, the next Government won't go back to old bad habits and will do some serious economic heavy-lifting. Living on borrowed prosperity ends sooner or later.

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