



CROATIA

Highlights

- **The six-year recession is ending in 2015, but long-term growth prospects remain weak.** A slightly positive growth (0.9 per cent) is expected for 2015 as the economy is benefiting from lower oil prices, a good tourist season and some improvement in eurozone demand.
- **Some steps have been taken towards improving the investment climate, but long-standing difficulties remain.** The Act on Strategic Investments provides simplified procedures for specific large investments but cross-country surveys point to a continuing need to improve competitiveness and tackle barriers to doing business.
- **Privatisation has advanced in some areas but remains slow in others.** The leading insurance company and largest port were sold to private investors, but efforts to sell key assets in the transport, chemical and banking sectors have been unsuccessful.

Key priorities for 2016

- **The fiscal deficit should be reduced sustainably.** In order to put the worryingly high public debt on a sustainable path, public expenditures should be reduced rather than taxes increased, accompanied by greater efforts to use EU funds.
- **Business environment reforms are proceeding slowly and need to be accelerated to attract much-needed investment.** A pilot project assessing and reducing parafiscal charges is welcome, but broader and faster implementation of reforms would be needed.
- **Tackling high non-performing loans (NPLs) and corporate restructuring should be high on the agenda in order to revive credit and economic growth.** NPL levels (especially for corporates) are high and NPL resolution is progressing slowly, limiting the range of creditworthy borrowers and constraining bank resources for new lending.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	-0.3	-2.2	-1.1	-0.4	0.9
Inflation (average)	2.3	3.4	2.2	-0.2	-0.3
Government balance/GDP	-7.8	-5.3	-5.4	-5.6	-5.1
Current account balance/GDP	-0.8	-0.1	0.8	0.7	1.9
Net FDI/GDP [neg. sign = inflows]	-2.7	-2.7	-2.0	-2.7	-2.2
External debt/GDP	96.6	105.7	109.3	112.4	n.a.
Gross reserves/GDP	25.1	25.5	29.6	29.5	n.a.
Credit to private sector/GDP	70.3	67.9	69.9	69.4	n.a.

Macroeconomic performance

The long-lasting recession may come to an end in 2015. The country has been in recession for the past six years. Over this period, the Croatian economy declined by a cumulative 12 per cent, the second largest contraction in the European Union after Greece. The recession has also taken its toll on labour market performance – unemployment increased sharply over the period, standing at 15.5 per cent as of August 2015, with a particularly high rate of youth unemployment. In 2014 GDP fell by 0.4 per cent, but the pace of recession slowed over the course of the year. A positive contribution from net exports could not offset weak domestic demand, as consumer and business confidence remained weak, with investment being the largest negative contributor to growth in 2014. GDP growth of 0.9 per cent (year-on-year) in the first half of 2015 was driven by exports and consumption. Despite some improvement in business sentiment, investments remained subdued, pointing to long-standing structural weaknesses. Due to weak domestic demand and declining oil prices, inflation remained flat, standing at -0.8 per cent as of September 2015.

Fiscal sustainability remains one of the key issues to be tackled. The fiscal deficit reached 5.7 per cent of GDP in 2014, while public debt was 85 per cent of GDP. Croatia has been under the European Union's excessive deficit procedure since January 2014. So far, the government has focused mainly on the revenue side of the budget (that is, raising the intermediate VAT rate from 10 to 13 per cent, abolishing certain tax reliefs, increasing excises on cigarettes and gasoline and introducing a 12 per cent savings tax), avoiding large spending cuts and structural reforms. Tenders for motorway concessions were cancelled and part of the motorway company will undergo an initial public offering (IPO) instead, which is expected to raise significantly less revenue. The weakening fiscal position has resulted in all three main credit agencies downgrading Croatia's sovereign debt rating to below investment grade.

Growth prospects remain weak in the absence of reforms addressing the weak business environment. Under current projections, GDP would increase by 0.9 per cent this year, on the back of a good tourist season, an improvement in eurozone demand and lower global oil prices. Growth is expected to remain weak in 2016 (at 0.5 per cent), due to strong pressure for fiscal adjustment under the EU's excessive deficit procedure, weaker contribution from external factors, as well as the protracted speed of large-scale reforms aimed at improving the business environment.

Major structural reform developments

The privatisation process remains slow due to low investor interest. On the large-scale privatisation agenda, the largest Croatian port, Luka Rijeka, received a capital increase via the Zagreb Stock Exchange (ZSE) in July 2015, reducing the state's share from 85 to 38 per cent. Some small companies were also sold in the past year, but several other attempts failed. The concession of the state-owned road management company, HAC, was abandoned in early 2015 due to strong public objections. Its subsidiary, HAC ONC, which deals with road maintenance and tolls, is expected to be offered for an IPO in late 2015. The government has also invited binding bids for the concession on the Kupari tourism site near Dubrovnik, and it plans to put Croatia Airlines up for sale despite previous failed attempts. Petrokemija and Hrvatska Poštanska Banka (the latter was recapitalised in June 2015 to meet regulatory capital adequacy requirements) will most likely undergo restructuring before being offered again to investors. Minority stakes in the electrical company Končar and leading telecommunications provider T-HT will be sold through the ZSE to support capital market development.

A new bankruptcy law has been introduced. The new law, adopted in June 2015, aims to shorten the notoriously long bankruptcy procedures and strengthen creditors' control over the process. The new legislation enforces these procedures within eight days if a company's bank accounts are blocked for more than 120 days. It speeds up the transition from pre-bankruptcy to bankruptcy. The government also introduced personal bankruptcy for citizens and entrepreneurs who are unable to meet liabilities for three consecutive months.

Capital market reforms are advancing. In July 2015 the ZSE signed an agreement with the CEE Stock Exchange Group to take over 100 per cent of the shares of the Ljubljana Stock Exchange, which is expected to have a positive impact on the development of regional capital markets. The Ministry of Finance, in close cooperation with the EBRD, is developing a legal framework that would facilitate the development of the market for covered bonds backed by mortgages or public sector receivables, with the aim of enabling access to long-term funding for banks and decreasing their reliance on parent funding.

Deleveraging and the rising levels of NPLs continue to restrict credit growth. While capital adequacy ratios (at 22.3 per cent as of June 2015) provide strong shock-absorbing capacity to the banking system, the high level of NPLs (17.3 per cent as of June 2015) and weak economic prospects have kept credit growth negative since mid-2012. Over the past two years the central bank has introduced certain measures to address the problem, including changes in provisioning, treatment of restructured loans, compulsory minimum haircuts and collection periods for real estate and moveable property. These steps are yielding some results as NPL growth has slowed since the end of 2014, but consistent efforts to remove remaining tax, legal and regulatory obstacles are still needed to create a well-functioning market for NPLs and support faster resolution.

The government adopted a controversial law on Swiss franc mortgage loans conversion. Following the abandonment (on 15 January 2015) by the Swiss central bank of the currency cap against the euro, the subsequent appreciation of the Swiss franc increased debt repayments for approximately 55,800 households in Croatia holding Swiss franc-denominated mortgages.¹ Recent legislative changes in the Consumer Credit Act and the Credit Institutions Act, adopted in September and deemed by the banks as violating EU laws and bilateral investment treaties, stipulate the conversion of Swiss franc-denominated mortgage loans to the euro using historical exchange rates and interest rates that were effective when the loans were extended. The conversion forces banks to write-off principal worth €1 billion. According to the calculations by the central bank, this will decrease the banks' capital adequacy ratio by an estimated 3.8 percentage points to 19.7 per cent. It will also reduce the country's foreign exchange reserves as the write-offs open the banks' foreign currency position, exerting pressure on the kuna. Exchange rate risk from euro-linked mortgages for unhedged household borrowers will still remain after the conversion.

Croatia's competitiveness and business environment rankings remain low relative to EU peers. Croatia ranks 40th (out of 189 economies) in the World Bank's *Doing Business 2016* report, down from 39th in 2015.² Croatia is scoring the lowest in dealing with construction permits (129th) and with low ratings in registering property, starting a business, resolving insolvency and getting credit and electricity. Croatia's competitiveness is also low according to the *Global Competitiveness Index* published by the World Economic Forum, as it ranks 77th among 140 countries (unchanged compared with the previous report). The main obstacles are labour and goods market inefficiencies, lack of innovation, an unstable macroeconomic environment and weak institutions.

¹ Swiss franc-denominated loans comprised 8.5 per cent of total loans as of the first quarter of 2015 or €2.7 billion, down from 16 per cent in 2008.

² The rating for 2015 reflects the change in the methodology. According to the old methodology Croatia was ranked 65th in 2015.