
Country Report

Croatia

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The Economist Intelligence Unit

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Symbols for tables

"0 or 0.0" means nil or negligible; "n/a" means not available; "-" means not applicable

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Briefing sheet

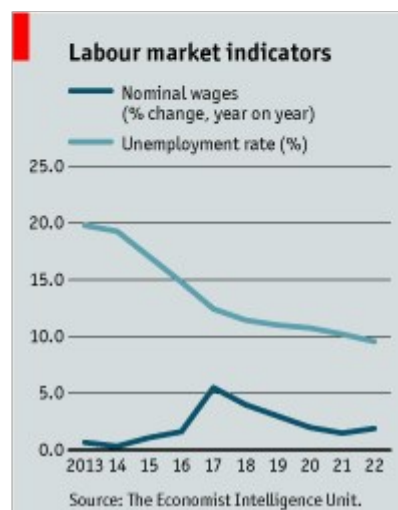
Editor: **Maximilien Lambertson**

Forecast Closing Date: **February 13, 2018**

Political and economic outlook

- A coalition government, led by the conservative Croatian Democratic Union (HDZ), has the support of several members of parliament from the liberal Croatian People's Party (HNS). It could prove unstable, and an early election is possible.
- Relations with Bosnia and Hercegovina (BiH) and Serbia will fluctuate between hostile and cool. However, relations will not break down completely.
- Progress on structural reforms, particularly concerning healthcare and pensions, will remain slow. The crisis at the Agrokor conglomerate, Croatia's largest company, poses a significant risk to the investment climate and political stability.
- The Economist Intelligence Unit forecasts annual average real GDP growth of 2.7% per year in 2018-22—a significantly improved outlook compared with the years after the global financial crisis. EU fund absorption is improving and investment is recovering.
- Croatia's recent success in reducing the fiscal deficit has enabled it to exit the EU's excessive-deficit procedure. We expect the deficit to remain well within the 3% of GDP ceiling over the 2018-22 forecast period.
- We expect inflation to average 1.8% per year in 2018-22, up from an estimated 1.1% in 2017.
- Public debt will decline to an average of about 72% of GDP in 2018-22—still a high level for an emerging market such as Croatia. Large financing needs leave the country vulnerable to a downturn in foreign investor sentiment.

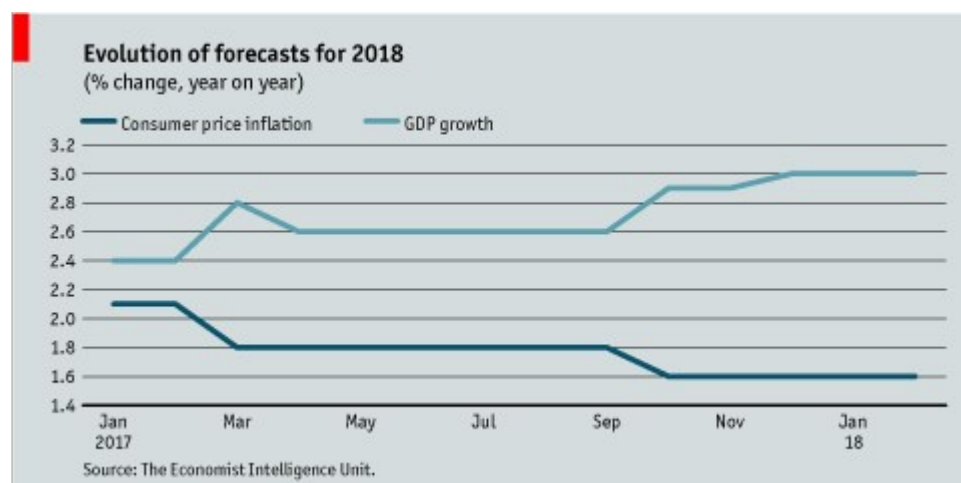
Market opportunities



Key indicators

	2017 ^a	2018 ^b	2019 ^b	2020 ^b	2021 ^b	2022 ^b
Real GDP growth (%)	3.0 ^c	3.0	2.7	2.5	2.6	2.7
Consumer price inflation (av; %)	1.1	1.6	1.8	1.7	1.9	1.9
Government balance (% of GDP)	0.4 ^c	-0.3	-0.5	-0.8	-0.6	-0.8
Current-account balance (% of GDP)	3.6 ^c	2.1	1.2	-0.4	-0.8	-1.2
Money market rate (av; %)	0.6	0.4	0.5	0.8	1.0	1.1
Unemployment rate (%)	12.4	11.5	11.0	10.8	10.2	9.6
Exchange rate HRK:US\$ (av)	6.62	6.23	6.30	6.19	6.17	5.99

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Economist Intelligence Unit estimates.



Key changes since January 17th

- Nominal net monthly wage growth picked up in October and November 2017, to 6.6% year on year. We have revised up our 2017 nominal wage growth estimate to 5.5%, from 5% previously, and our real wage growth estimate to 4.3%, from 3.8%.
- With the three-month money market rate falling to a record-low 0.5% in January 2018 despite increased talk of monetary tightening in developed markets, we have revised down our 2018 average money market rate forecast to 0.4%, from 0.6% previously.

The month ahead

- **February 23rd—Labour force data (January):** The seasonally adjusted unemployment rate has been falling steadily, but this has been driven by a declining labour force rather than by employment growth. This trend is likely to have continued in January.
- **February 23rd—Consumer price inflation (January):** The January inflation figure will indicate whether food and fuel prices—the main drivers of price growth in 2017—have picked up in 2018. We do not expect a significant acceleration in overall inflation.
- **February 27th—Real GDP growth (Q4 2017, first estimate):** High-frequency indicators—particularly a slowdown in industrial production in November and December—suggest that real GDP growth decelerated in the fourth quarter, to just under 3% year on year.

Major risks to our forecast

Scenarios, Q4 2017

Probability Impact Intensity

Chaotic restructuring of Agrokor causes recession	Moderate	Very high	15
The authorities make frequent changes to tax policy	Moderate	Very high	15
Loan growth to the private sector fails to recover	High	Moderate	12
Political pressures and disagreements prevent administrative reform	High	Moderate	12
Tight fiscal policy and weak absorption of EU funds forces a cut in infrastructure investment	High	Moderate	12

Note. Scenarios and scores are taken from our Risk Briefing product. Risk scenarios are potential developments that might substantially change the business operating environment over the coming two years. Risk intensity is a product of probability and impact, on a 25-point scale.

Source: The Economist Intelligence Unit.

Outlook for 2018-22

Political stability

Following the collapse of the coalition government comprising the conservative Croatian Democratic Union (HDZ) and Most (Bridge) in June 2017, the HDZ managed to form a new coalition with the support of several members of parliament (MPs) from the liberal Croatian People's Party (HNS). This support has given the prime minister, Andrej Plenkovic, a small parliamentary majority (77 out of 151 MPs), but he may struggle to maintain consensus without making significant concessions to independent MPs and other small groupings, mainly on the right.

Disputes surrounding historical issues related to the Yugoslav period or the second world war flare up periodically, testing Mr Plenkovic's ability to satisfy the demands of right-wing HDZ MPs while attempting to maintain his image as a more centrist HDZ leader than those in the past. Despite its small parliamentary majority and struggle in balancing the various wings of its party and coalition, the HDZ retains its lead in opinion polls. It appears to have maintained its broad base of support while drawing back some of its supporters who voted for Most in previous elections.

The main opposition, the Social Democratic Party (SDP), under the leadership of Davor Bernardic, appears unable to mount a serious challenge. In November 2017 it called for a vote of no confidence in the government in response to the controversy surrounding the restructuring of Agrokor, an indebted food retailer and Croatia's largest company. The vote failed, attracting 59 votes in favour and 78 against. The failure of the opposition to come close to threatening the government's majority suggests that the coalition government is likely to survive in the short term, unless new damaging revelations emerge in the Agrokor affair, an eventuality that cannot be discounted.

The chances of the HDZ/HNS coalition remaining stable over the longer term are low. There is little common ground on policy, and the two parties do not have a shared ideological position. Many ordinary party members are disappointed with the coalition deal, and the HNS risks splitting. Although Mr Plenkovic appears to have bought himself some time, it is unclear whether this will create the space for a stable, reform-minded government to work on tackling the country's economic challenges, including the problems with Agrokor. Continued instability and horse trading until a new election are more likely.

Election watch

In the 2017 local elections the HDZ performed better than expected, winning the Split mayoral election, and defeating its former coalition partner, Most, in Dubrovnik-Neretva County, Most's heartland. In the mayoral election for the capital, Zagreb, Milan Bandic—whose party, Milan Bandic 365, supports the HDZ government—narrowly defeated Anka Mrak Taritas, representing the centre-left opposition. Bolstered by these results, the HDZ secured the support of a majority of MPs—enough to form a new coalition government and avoid an early parliamentary election. The next presidential election is due to be held in December 2019 and the next parliamentary election in 2020.

International relations

Croatia's foreign policy is oriented towards its former Yugoslav neighbours, in particular Bosnia and Hercegovina (BiH) and Serbia, in which historical grievances and the status of ethnic Croats play major roles.

Relations with BiH have deteriorated over the past two years, with Bosniak (Bosnian Muslim) leaders accusing the Croatian government of trying to influence affairs in BiH. The Croatian president, Kolinda Grabar-Kitarovic, has expressed support for Bosnian Croats in their efforts to reform the BiH electoral law, and even to pursue the creation of a third entity in BiH—an idea strongly opposed by Bosniak leaders. In addition, Croatian plans to build a bridge connecting the Croatian mainland to the Peljesac Peninsula are opposed by BiH, which insists that this will jeopardise its access to international waters. Ms Grabar-Kitarovic visited BiH in January 2018 bearing a message of goodwill, but the disagreements surrounding the BiH electoral law and the Peljesac Bridge remain unresolved.

Croatia's relations with Serbia fluctuate based on Croatia's involvement in Serbia's EU accession talks and its rhetoric related to historical grievances. Tensions increased on several occasions in 2016, when Croatia blocked the opening of certain chapters in Serbia's EU accession process, but Croatia eventually lifted its opposition. On the positive side, the Serbian president, Aleksandar Vucic, visited Croatia in early February at Ms Grabar-Kitarovic's invitation. The two leaders agreed to work on border issues, minority rights, and sharing information on missing persons from the 1990s war.

Croatia has refused to recognise a ruling brought on June 29th 2017 by the Permanent Court of Arbitration in The Hague that was meant to settle a long-standing dispute regarding the sea border with Slovenia. Although both sides had agreed to arbitration after bilateral talks failed, allowing Slovenia to withdraw its objections to Croatia's EU membership, Croatia effectively pulled out of the talks in mid-2015 after Croatian media revealed that a Slovenian official had tried to influence one of the judges, who then withdrew from the case. The court's decision, which Croatia did not adhere to by the December 2017 deadline, effectively awards three-quarters of the Bay of Piran to Slovenia and allows Slovenia a sea corridor within Croatian territorial waters. The dispute does not bode well for the resolution of other border disputes, particularly between Croatia and aspirant EU members BiH, Montenegro and Serbia. In addition, Slovenia is likely to block Croatia's candidacy to join the Schengen area, which Croatia had hoped to access by 2019.

Policy trends

The economy finally returned to relatively robust growth in 2015-17, but it faces several challenges in the medium term, including hefty public and external debt, an ageing and shrinking population, and an uncertain external environment. Before the collapse of the HDZ-Most coalition the government had adopted a reform package of 15 tax laws and an administrative relief action plan, and announced plans to allocate HRK1.5bn (US\$230m) to boost employment among the young and long-term unemployed. However, given the collapse of this coalition government and the fragility of the new HDZ-HNS coalition, there is a significant risk that the government will struggle to pass far-reaching reforms in other areas, such as the healthcare and pension systems, owing to opposition from powerful interest groups. In addition, the challenge of restructuring Agrokor's debt has the potential to pose policy challenges by putting pressure on the fiscal deficit and public debt levels.

So far in 2018 the government has ruled out a previously expected cut in the value-added tax (VAT) rate and allocated a further HRK1.6bn to try to stem the drop in the labour force from emigration. It has also boosted the amount of permits available to hire third country nationals, in order to address growing labour shortages.

Fiscal policy

In June 2017 the European Council closed its excessive-deficit procedure (EDP) for Croatia, confirming that the country's deficit had shrunk to within the EU's 3% of GDP limit. Croatia had been subject to an EDP since January 2014, when it was found to be in breach of both deficit and debt criteria. Its public debt (estimated at 80% of GDP at end-2017) remains larger than the EU's 60% of GDP limit, but its projected downward trajectory (The Economist Intelligence Unit expects it fall to 67.5% of GDP by 2022) meets EU requirements.

Full-year fiscal data for 2017 are not yet available, but according to Zdravko Maric, the finance minister, the budget is likely to have ended the year in surplus for the first time. This will have been driven by strong revenue growth, boosted by corporate and VAT revenue, which outpaced higher expenditure on increased public-sector salaries, defence and EU co-financed capital expenditure.

We expect the fiscal balance to slip back into a small deficit in 2018 (of 0.3% of GDP), owing to higher spending on pensions, public-sector salaries and defence. We expect deficits of less than 1% of GDP in 2019-22, assuming moderate current spending increases and only a few measures to improve revenue collection. That the government will enact few such measures was shown most recently by its postponement of a new property tax, which had been originally scheduled to be implemented from January 2018. The biggest fiscal risks stem from the indebted healthcare sector, the ability of the government to secure EU financing to fund capital expenditure and possible costs related to the restructuring of Agrokor.

Monetary policy

In 2017 the government and the Croatian National Bank (CNB, the central bank) started discussions on eventually joining the euro zone, given the high level of euroisation of the economy. Owing to Croatia's elevated level of public debt, which we do not expect to fall back to 60% of GDP until after 2022, we do not expect the country to enter the euro zone during our forecast period (2018-22).

Foreign-exchange interventions are the CNB's main monetary policy instrument, which requires a high level of foreign reserves. These are robust, at US\$18.8bn at end-2017, up from US\$14.2bn a year earlier. In the light of banks' subdued lending activity, which reflects caution on the part of lenders and borrowers, the CNB has pursued an expansive monetary policy stance, including weekly reverse repurchase (repo) auctions. A significant improvement in credit growth in 2018 is unlikely, and we expect only a moderate pick-up by the end of the forecast period.

International assumptions

	2017	2018	2019	2020	2021	2022
Economic growth (%)						
US GDP	2.3	2.5	2.3	0.8	1.9	1.8
Euro area GDP	2.5	2.2	1.9	1.7	1.7	1.7
World GDP	3.0	3.0	2.9	2.4	2.8	2.8
World trade	4.6	4.3	3.9	2.8	3.8	3.7
Inflation indicators (% unless otherwise indicated)						
US CPI	2.1	2.2	2.3	1.3	1.8	1.9
Euro area CPI	1.5	1.5	1.6	1.7	1.7	1.8
Manufactures (measured in US\$)	3.4	5.4	4.0	2.5	3.8	3.3
Oil (Brent; US\$/b)	54.4	63.0	60.0	57.8	60.6	63.3
Non-oil commodities (measured in US\$)	7.6	3.1	1.4	-1.2	0.8	0.2
Financial variables						
US\$ 3-month commercial paper rate (av; %)	1.1	1.8	2.7	2.6	1.7	2.0
Exchange rate HRK:US\$ (av)	6.62	6.23	6.30	6.19	6.17	5.99
Exchange rate US\$:€ (av)	1.13	1.20	1.18	1.21	1.21	1.24

Economic growth

Real GDP growth in 2016-17 represented an exceptional performance for the Croatian economy by recent standards, following a six-year recession in 2009-14. In 2017 we estimate that real GDP growth remained reasonably strong, at 3%, only slightly slower than 3.2% in 2016. Growth was driven by private consumption, aided by a slew of tax cuts and increases in minimum and public-sector wages. Fixed investment also contributed to growth, benefiting from low interest rates, improved absorption of EU funds and Croatia's continuing integration into EU supply chains. A record tourism season drove growth in Croatia's important services exports.

In 2018 we expect the structure of growth to look quite similar, with many of the same supporting factors in place. Private consumption will be supported by a tight labour market (the unemployment rate was high at 12.4% in 2017, but vacancies have shot up alongside wage growth) and increases to the minimum wage, pensions and public wages. Investment will grow owing to continued absorption of EU funds, and construction of transport and tourism infrastructure projects. Interest rates, even if they pick up later in the year, will remain near record lows. The tourism sector should again perform strongly, driven by arrivals from nearby Austria and Germany, boosting demand for Croatia's services exports. In January 2018 Croatia's seasonally adjusted economic sentiment indicator reached 118.5, an all-time high. We forecast 3% real GDP growth in 2018.

The outcome of Agrokor's restructuring continues to present a downside risk to growth. A poorly implemented restructuring would increase the dangers to the banking sector, and cut into economic growth this year. In the medium term Croatia will benefit from a further reorientation of its trade towards the EU, integration into European supply chains and industrial productivity gains. In addition, €11.7bn (US\$14.3bn) in EU funds is potentially available to Croatia until 2020. Croatia's relatively poor absorption capacity has shown signs of improvement.

We forecast annual average growth of 2.6% in 2019-22. The main contributions to growth will come from private consumption and investment. However, faster growth will be held back by the rising level of emigration and labour shortages in industries such as construction and tourism. Real GDP will reach its 2008 level only in 2019. Croatia is still at a relatively early stage in the reform process and is working off the excesses of the pre-crisis years. The need to pay down large public- and private-sector debt, a deteriorating demographic picture and poor competitiveness will contribute to the weak trend growth rate.

Economic growth

%	2017 ^a	2018 ^b	2019 ^b	2020 ^b	2021 ^b	2022 ^b
GDP	3.0	3.0	2.7	2.5	2.6	2.7
Private consumption	3.6	3.0	2.5	2.2	2.3	2.6
Government consumption	1.8	1.5	1.3	1.0	1.5	0.5
Gross fixed investment	5.0	6.5	4.0	2.0	5.5	5.8
Exports of goods & services	6.3	4.8	5.0	4.5	3.5	3.7
Imports of goods & services	6.8	6.0	5.0	3.5	4.0	4.1
Domestic demand	3.2	3.5	2.7	2.0	2.8	2.9
Agriculture	-0.3	1.0	0.5	-1.0	1.0	1.0
Industry	2.5	2.0	1.8	2.0	3.0	3.0
Services	3.3	3.4	3.1	2.9	2.5	2.7

^a Economist Intelligence Unit estimates. ^b Economist Intelligence Unit forecasts.

Inflation

After consumer price deflation of 1.1% year on year in 2016 owing to falling global energy prices, consumer prices returned to growth in 2017, rising by an average of 1.1%. This was driven mainly by growth in food (meat, dairy and vegetables) and fuel prices. In 2018 we expect weak external price pressures (global food and non-oil commodity prices), with some growth in oil prices and wage increases providing inflationary pressure. We forecast inflation of 1.6% in 2018 and 1.8% per year on average in 2019-22 as global oil and food prices grow only moderately on average.

Exchange rates

Given the substantial euroisation of the economy, Croatia runs a heavily managed float, supported by regular foreign-exchange interventions from the CNB. The CNB purchased €405.5m (US\$500.3m) on January 4th 2018 to prevent excessive appreciation. Interventions are typically in response to appreciatory pressures stemming from the tourist season and euro inflows into banks stemming from EU projects. We expect these factors (tourist and EU fund inflows) to support a modest appreciation over the forecast period, from an average rate of HRK7.46:€1 in 2017 to HRK7.41:€1 in 2022.

External sector

The current-account surplus fell to 2.4% of GDP in 2016. Inward foreign direct investment flows rose to US\$1.9bn (3.7% of GDP), from US\$214m in 2015. Recent export data have been encouraging. Goods exports grew by 12% in kuna terms in 2017, up from 5.7% in 2016. Croatia again registered strong tourist numbers last year; visitor arrivals reached 17.4m, a 12.7% increase on 2016. German tourist numbers were especially strong, with a 15.3% increase in 2017, to 2.6m. The current account recorded a surplus of US\$4.5bn in the third quarter, compared with US\$3.7bn in the same quarter of 2016.

After rising in 2017 to an estimated 3.6% of GDP, we expect the current-account surplus to decline gradually, before moving into deficit from 2020 as import volumes expand on the back of growing domestic demand. We expect no significant change in the structure of the external accounts, with a hefty goods deficit (reflecting weak competitiveness and a small manufacturing base) offset by a sizeable services surplus resulting from the dominance of the tourism sector.

Forecast summary

Forecast summary

(% unless otherwise indicated)

	2017 ^a	2018 ^b	2019 ^b	2020 ^b	2021 ^b	2022 ^b
Real GDP growth	3.0	3.0	2.7	2.5	2.6	2.7
Industrial production growth	1.4 ^c	3.0	2.8	2.0	2.5	3.0
Gross fixed investment growth	5.0	6.5	4.0	2.0	5.5	5.8
Unemployment rate (av)	12.4 ^c	11.5	11.0	10.8	10.2	9.6
Consumer price inflation (av)	1.1 ^c	1.6	1.8	1.7	1.9	1.9
Consumer price inflation (end-period)	1.2 ^c	1.7	1.7	1.8	2.0	1.9
Short-term lending rate	4.4	4.1	5.1	5.5	5.6	5.7
General government balance (% of GDP)	0.4	-0.3	-0.5	-0.8	-0.6	-0.8
Exports of goods fob (US\$ bn)	13.2	14.6	15.5	16.6	17.7	19.2
Imports of goods fob (US\$ bn)	22.1	24.9	26.4	28.6	30.7	33.4
Current-account balance (US\$ m)	1,950	1,301	735	-284	-593	-886
Current-account balance (% of GDP)	3.6	2.1	1.2	-0.4	-0.8	-1.2
External debt (end-period; US\$ bn)	44.6	45.6	45.9	47.1	48.6	51.7
Exchange rate HRK:US\$ (av)	6.62 ^c	6.23	6.30	6.19	6.17	5.99
Exchange rate HRK:€ (av)	7.46	7.44	7.43	7.45	7.43	7.41
Exchange rate HRK:€ (end-period)	7.54	7.53	7.52	7.54	7.52	7.50

^a Economist Intelligence Unit estimates. ^b Economist Intelligence Unit forecasts. ^c Actual.

Data and charts

Annual data and forecast

	2013 ^a	2014 ^a	2015 ^a	2016 ^a	2017 ^b	2018 ^c	2019 ^c
GDP							
Nominal GDP (US\$ bn)	58	58	49	51	55	61	63
Nominal GDP (HRK bn)	331	331	339	349	364	381	398
Real GDP growth (%)	-0.6	-0.1	2.3	3.2	3.0	3.0	2.7
Expenditure on GDP (% real change)							
Private consumption	-1.8	-1.6	1.1	3.5	3.6	3.0	2.5
Government consumption	0.6	0.8	-0.9	1.9	1.8	1.5	1.3
Gross fixed investment	1.4	-2.8	3.8	5.3	5.0	6.5	4.0
Exports of goods & services	3.1	6.0	9.4	5.6	6.3	4.8	5.0
Imports of goods & services	3.1	3.1	9.2	6.2	6.8	6.0	5.0
Origin of GDP (% real change)							
Agriculture	-0.1	-4.0	1.3	0.6	-0.3	1.0	0.5
Industry	-2.4	1.0	2.6	4.4	2.5	2.0	1.8
Services	-0.2	0.5	2.3	2.3	3.3	3.4	3.1
Population and income							
Population (m)	4.3	4.3	4.2	4.2	4.2 ^a	4.2	4.1
GDP per head (US\$ at PPP)	21,687	22,160	23,042	24,205	25,517	27,039	28,350
Recorded unemployment (av; %)	19.8	19.3	17.0	14.8	12.4 ^a	11.5	11.0
Fiscal indicators (% of GDP)							
Public-sector balance ^d	-5.3	-5.1	-3.3	-0.9	0.4	-0.3	-0.5
Public-sector debt interest payments	3.2	3.4	3.5	3.2	3.1	3.0	2.8
Public-sector primary balance	-2.1	-1.7	0.2	2.3	3.5	2.7	2.3
Prices and financial indicators							
Exchange rate HRK:US\$ (end-period)	5.55	6.30	6.99	7.17	7.00 ^a	6.38	6.32
Consumer prices (end-period; %)	0.3	-0.5	-0.6	0.2	1.2 ^a	1.7	1.7
Producer prices (av; %)	-0.2	-2.5	-3.8	-4.3	2.0 ^a	4.5	3.0
Stock of money M1 (% change)	11.5	9.6	11.4	18.2	19.1 ^a	9.0	5.6
Stock of money M2 (% change)	4.0	3.2	5.2	4.7	2.1 ^a	5.4	4.2
Lending interest rate (av; %)	6.8	6.8	6.2	5.0	4.4	4.1	5.1
Current account (US\$ m)							
Trade balance	-8,729	-8,643	-7,747	-8,121	-8,909	-10,308	-10,932
Goods: exports fob	11,841	12,527	11,317	11,633	13,152	14,596	15,510
Goods: imports fob	-20,571	-21,170	-19,064	-19,754	-22,061	-24,903	-26,442
Services balance	8,924	9,719	8,844	9,566	10,676	11,621	11,858
Income balance	-1,180	-1,143	-323	-1,689	-1,615	-1,948	-2,133
Current transfers balance	1,508	1,190	1,417	1,495	1,798	1,935	1,942
Current-account balance	524	1,123	2,191	1,250	1,950	1,301	735
External debt (US\$ m)							
Debt stock	63,176 ^b	56,572 ^b	49,333 ^b	44,102 ^b	44,628	45,592	45,926
Debt service paid	7,426 ^b	9,634 ^b	9,801 ^b	9,538 ^b	14,360	9,970	9,750
Principal repayments	6,000 ^b	8,000 ^b	8,000 ^b	7,525 ^b	12,000	8,000	8,000
Interest	1,426 ^b	1,634 ^b	1,801 ^b	2,013 ^b	2,360	1,970	1,750
International reserves (US\$ m)							
Total international reserves	17,767	15,424	14,967	14,244	18,818	19,016	19,324

^a Actual. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts. ^d Proceeds from privatisation have been excluded from revenue. GDP data from Central Bureau of Statistics.

Sources: Croatian Bureau of Statistics; Croatian National Bank, Bulletin; Eurostat; IMF, International Financial Statistics; UN; World Bank, International Debt Statistics.

Quarterly data

	2016				2017			
	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr
General government finance (HRK bn)								
Revenue	34.9	41.6	41.4	40.1	35.8	42.3	42.6	–
Expenditure	35.4	39.1	37.4	40.9	36.9	38.4	36.9	–
Balance	-0.4	2.5	4.0	-0.8	-1.1	3.9	5.6	–
Output								
GDP at current prices (US\$ bn)	11.18	13.16	14.50	12.56	11.36	13.43	16.14	–
GDP at constant 2010 prices (HRK m)	74,701	83,876	93,183	84,141	76,677	86,408	96,298	–
GDP at constant 2010 prices (% change, year on year)	3.3	2.9	3.1	3.5	2.6	3.0	3.3	–
Industrial production index (2010=100)	95.9	100.3	97.0	107.8	98.1	101.5	99.8	107.2
Industrial production index (% change, year on year)	7.9	5.1	1.2	7.1	2.3	1.2	2.9	-0.6
Employment, wages and prices								
Employment ('000)	1,356	1,391	1,426	1,389	1,334	1,367	1,398	1,363
Employment (% change, year on year)	-0.3	0.2	-0.2	0.1	-1.6	-1.7	-1.9	-1.9
Unemployment (av; '000)	286.4	235.5	214.1	231.5	235.7	184.7	170.1	185.3
Unemployment rate (% of the labour force)	17.4	14.5	13.1	14.3	15.0	11.9	10.8	12.0
Average nominal monthly wages (HRK)	5,673	5,675	5,630	5,762	5,937	5,981	5,960	–
Average nominal monthly wages (% change, year on year)	2.1	1.2	1.3	1.9	4.6	5.4	5.9	–
Consumer prices (% change, year on year)	-1.3	-1.7	-1.3	-0.2	1.1	1.1	1.0	1.3
Producer prices (% change, year on year)	-4.7	-6.1	-4.7	-1.8	2.1	1.8	1.9	2.2
Financial indicators								
Exchange rate HRK:US\$ (av)	6.92	6.64	6.71	6.96	7.02	6.76	6.32	6.40
Exchange rate HRK:US\$ (end-period)	6.65	6.79	6.70	7.17	6.93	6.49	6.35	6.27
Deposit rate (av; %)	2.9	2.8	2.6	2.5	2.3	2.3	–	–
Lending rate (av; %)	5.2	4.8	5.0	4.9	4.6	4.3	4.2	–
Money market rate (av; %)	0.9	0.8	0.8	0.9	0.7	0.6	0.6	–
M1 (end-period; HRK m)	67,605	75,613	79,315	83,469	81,867	89,313	95,957	99,436
M1 (% change, year on year)	11.0	12.7	14.3	18.2	21.1	18.1	21.0	19.1
M2 (end-period; HRK m)	280,440	288,217	299,717	300,897	291,098	296,516	309,635	307,244
M2 (% change, year on year)	3.4	4.6	4.3	4.7	3.8	2.9	3.3	2.1
Crobex stockmarket index (end-period; Jul 1st 1997=1,000)	1,670	1,676	1,941	1,995	1,989	1,866	1,811	1,843
Crobex stockmarket index (% change, year on year)	-2.5	-3.5	15.2	18.1	19.1	11.3	-6.7	-7.6
Balance of payments (US\$ m)								
Exports fob	2,577	2,973	2,937	3,149	2,972	3,132	3,401	–
Imports fob	-4,524	-5,323	-5,072	-4,856	-5,094	-5,690	-5,913	–
Trade balance fob-fob	-1,947	-2,350	-2,135	-1,707	-2,121	-2,558	-2,512	–
Services balance	411	2,337	6,183	758	374	2,580	6,971	–
Income balance	-393	-421	-686	-198	-273	-459	-378	–
Net transfer payments	194	549	346	412	390	598	456	–
Current-account balance	-1,735	115	3,708	-736	-1,631	161	4,537	–
Reserves excl gold (end-period)	14,936	14,310	14,618	14,244	17,256	16,008	17,642	18,818

Sources: Croatian Bureau of Statistics; Croatian National Bank, Bulletin; Eurostat; IMF, International Financial Statistics Ministry of Finance; Zagreb Stock Exchange.

Monthly data

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exchange rate HRK:US\$ (av)												
2015	6.60	6.79	7.05	7.06	6.76	6.76	6.88	6.78	6.75	6.78	7.06	7.03
2016	7.04	6.88	6.83	6.61	6.62	6.69	6.77	6.67	6.68	6.80	6.95	7.14
2017	7.10	7.00	6.95	6.95	6.73	6.60	6.45	6.27	6.25	6.38	6.43	6.38

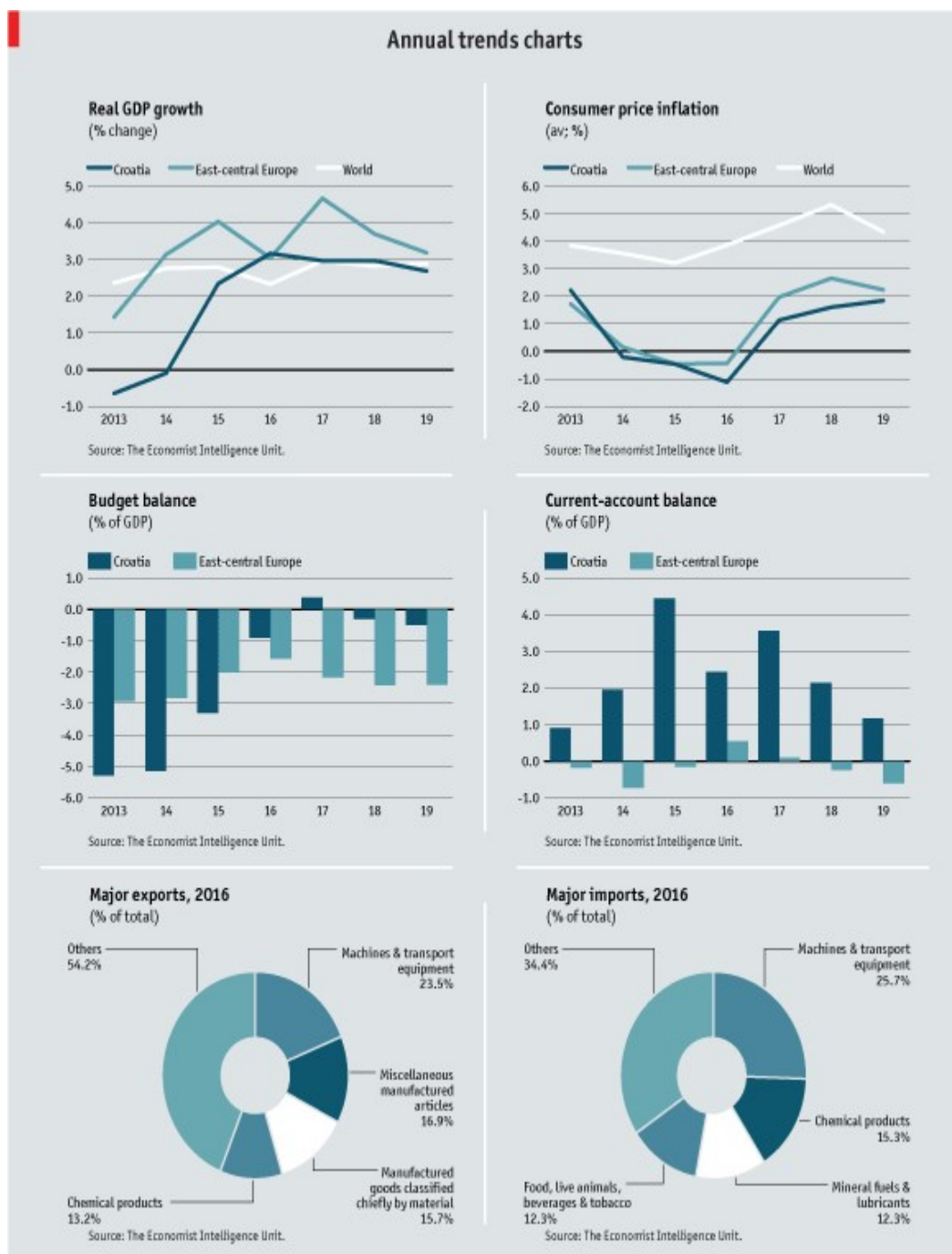
Exchange rate HRK:US\$ (end-period)												
2015	6.78	6.84	7.05	6.90	6.90	6.83	6.92	6.69	6.79	6.91	7.20	6.99
2016	7.02	6.92	6.65	6.57	6.73	6.79	6.73	6.69	6.70	6.87	7.10	7.17
2017	7.00	7.02	6.93	6.83	6.64	6.49	6.32	6.20	6.35	6.45	6.37	6.27
Real effective exchange rate (1997=100; CPI basis)												
2015	108.3	106.6	105.9	105.9	108.2	107.3	106.5	106.9	107.3	106.6	105.4	104.4
2016	104.7	105.2	105.5	107.4	107.3	106.3	105.9	106.2	106.6	106.2	105.6	103.8
2017	104.2	105.4	105.7	105.4	106.6	107.1	107.4	108.3	109.1	108.3	107.6	n/a
M1 (% change, year on year)												
2015	7.7	9.9	8.4	8.9	10.0	11.6	9.7	8.1	10.4	12.8	14.1	11.4
2016	12.4	11.1	11.0	11.5	13.2	12.7	16.0	14.9	14.3	14.3	14.0	18.2
2017	19.4	21.1	21.1	22.7	18.9	18.1	17.9	20.0	21.0	20.5	20.2	19.1
M2 (% change, year on year)												
2015	2.9	4.6	2.8	3.0	3.2	4.8	2.6	1.9	4.6	5.1	5.3	5.2
2016	4.8	3.6	3.4	4.6	4.6	4.6	6.3	7.0	4.3	3.6	3.5	4.7
2017	3.5	3.3	3.8	3.8	2.8	2.9	2.1	2.4	3.3	3.6	2.6	2.1
Industrial production (% change, year on year)												
2015	-6.5	0.3	5.2	1.3	2.8	3.1	3.9	4.3	5.5	4.7	4.4	2.5
2016	7.2	9.8	6.9	4.9	2.2	8.2	-2.4	4.9	1.8	1.9	8.4	11.3
2017	7.3	-1.9	2.2	-4.2	7.0	0.8	2.5	5.2	1.2	4.8	-1.6	-4.7
Retail sales (% change, year on year)												
2015	2.7	2.0	1.9	1.5	1.9	2.1	4.7	1.1	1.2	1.8	3.9	4.1
2016	2.1	8.1	4.3	3.2	3.3	3.7	3.6	5.8	4.5	4.5	3.4	5.8
2017	2.6	1.0	5.8	3.4	5.0	7.0	5.9	6.4	4.3	3.3	5.7	0.5
Unemployment rate (%)												
2015	19.4	19.6	19.1	17.9	16.6	15.6	15.3	15.2	15.5	16.4	17.0	17.2
2016	17.7	17.6	17.0	15.7	14.3	13.4	13.2	13.0	13.0	13.8	14.3	14.7
2017	15.4	15.3	14.4	13.2	11.7	10.8	10.8	10.9	10.8	11.6	12.1	12.2
Average monthly wages (% change, year on year)												
2015	0.0	1.4	2.0	1.8	1.6	1.5	0.4	1.1	1.9	1.8	1.0	-1.2
2016	1.7	2.7	1.9	0.7	2.1	0.8	0.8	1.8	1.4	0.2	2.0	3.4
2017	4.4	4.3	5.2	5.0	5.6	5.6	5.6	6.1	5.9	6.6	6.6	n/a
Deposit rate (av; %)												
2015	2.4	2.3	2.3	2.2	2.2	2.2	2.1	2.1	2.0	2.0	1.9	1.8
2016	1.8	1.7	1.6	1.6	1.5	1.5	1.4	1.3	1.2	1.1	1.1	1.0
2017	1.0	0.9	0.8	0.8	0.7	0.7	n/a	n/a	n/a	0.6	0.6	n/a
Lending rate (av; %)												
2015	6.5	6.4	6.4	6.1	6.2	6.4	6.2	6.3	6.0	6.0	5.9	5.8
2016	5.6	5.2	4.9	4.8	4.7	4.9	5.0	5.1	4.9	5.0	4.8	4.8
2017	4.7	4.7	4.5	4.3	4.3	4.2	4.1	4.2	4.2	4.1	3.7	n/a
Crobex stockmarket index (end-period; % change, year on year)												
2015	-2.1	-2.8	-2.6	1.8	1.6	-3.0	-0.9	-6.1	-12.1	-6.2	-6.2	-3.2
2016	-8.6	-7.5	-2.5	-3.6	-1.4	-3.5	-1.4	4.6	15.2	13.6	18.9	18.1
2017	32.9	37.6	19.1	12.6	9.4	11.3	6.3	4.1	-6.7	-4.3	-6.1	-7.6
Consumer prices (% change, year on year)												
2015	-0.9	-0.4	0.1	-0.1	0.0	0.0	-0.4	-0.6	-0.8	-0.9	-0.9	-0.6
2016	-0.8	-1.4	-1.7	-1.7	-1.8	-1.6	-1.5	-1.5	-0.9	-0.5	-0.2	0.2
2017	0.9	1.4	1.1	1.4	1.1	0.7	0.8	1.0	1.4	1.4	1.4	1.2
Producer prices (% change, year on year)												
2015	-5.6	-4.0	-2.6	-3.1	-2.4	-2.1	-3.1	-4.1	-4.8	-4.5	-4.1	-4.0
2016	-3.1	-5.4	-5.5	-6.2	-6.4	-5.5	-5.5	-5.1	-3.2	-2.3	-2.9	0.0
2017	2.2	3.0	1.2	3.3	1.8	0.3	1.0	2.6	1.9	1.1	3.6	1.7
Total exports fob (US\$ m)												
2015	858	994	1,046	1,038	1,048	1,161	1,199	872	1,230	1,165	1,188	993
2016	831	1,036	1,110	1,095	1,197	1,176	1,125	1,047	1,251	1,237	1,282	1,246
2017	1,065	1,173	1,373	1,055	1,320	1,308	1,326	1,295	1,432	1,518	1,560	1,321
Total imports cif (US\$ m)												
2015	1,340	1,626	1,828	1,738	1,737	1,822	1,912	1,561	1,884	1,793	1,690	1,578
2016	1,384	1,693	1,862	1,944	1,930	1,907	1,831	1,783	1,946	1,801	1,869	1,888
2017	1,593	1,789	2,193	1,917	2,205	2,095	2,199	2,038	2,306	2,186	2,095	1,797
Trade balance fob-cif (US\$ m)												
2015	-482	-632	-781	-700	-689	-661	-714	-690	-654	-628	-503	-585
2016	-553	-656	-752	-848	-733	-731	-706	-735	-694	-564	-587	-642
2017	-528	-615	-820	-862	-886	-787	-873	-742	-874	-668	-535	-476

Foreign-exchange reserves excl gold (US\$ bn)

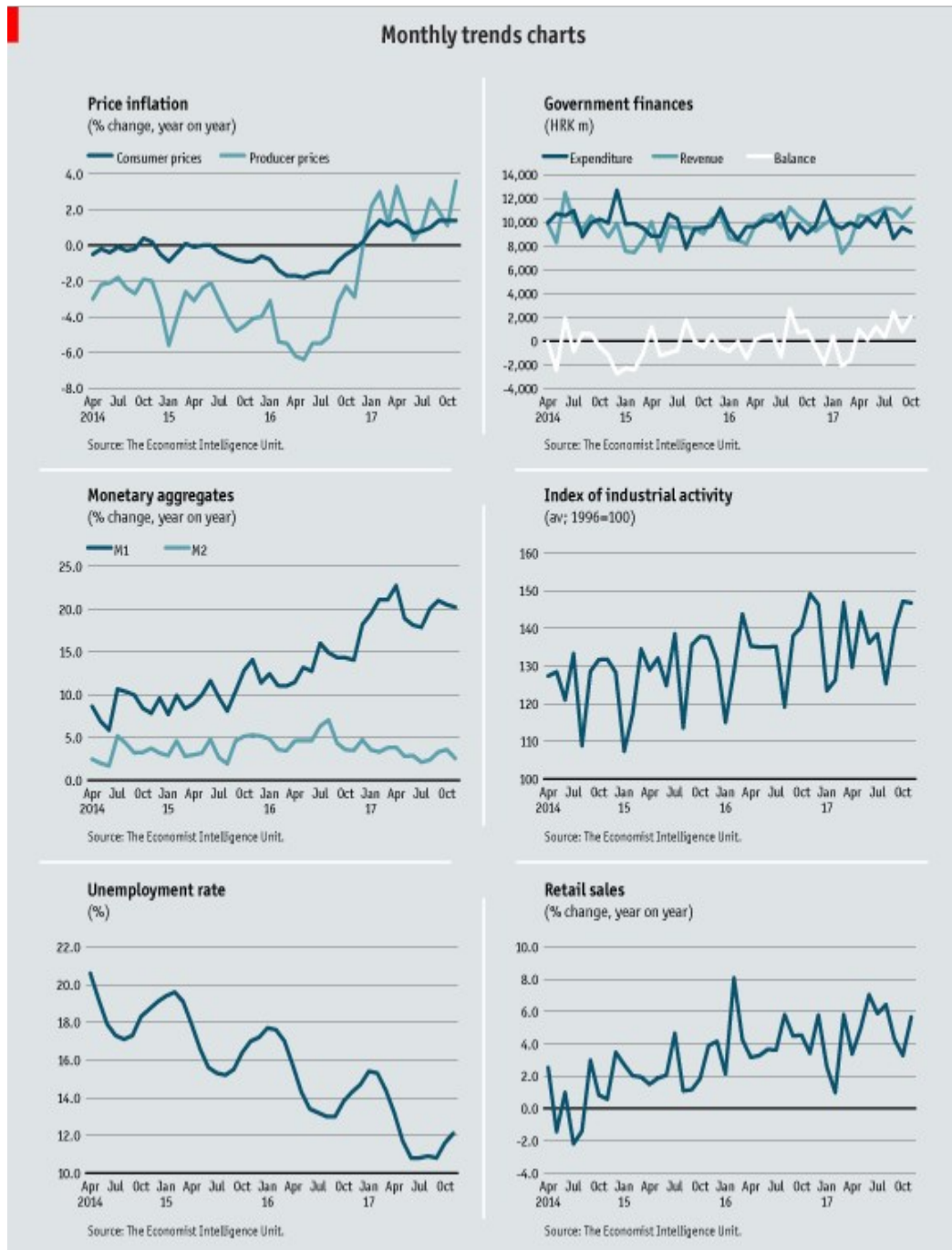
2015	13.2	14.5	15.4	16.2	15.6	15.2	16.5	16.3	15.1	15.7	14.9	15.0
2016	14.8	14.3	14.9	15.0	14.3	14.3	15.4	15.7	14.6	14.2	14.8	14.2
2017	15.6	15.0	17.3	15.8	15.8	16.0	17.2	17.5	17.6	17.5	19.2	18.8

Sources: Croatian Bureau of Statistics; Croatian National Bank, Bulletin; IMF, International Financial Statistics; Zagreb Stock Exchange; Haver Analytics.

Annual trends charts



Monthly trends charts



Comparative economic indicators



Basic data

Population

4.23m (2016, UN)

From the 2011 census:

City of Zagreb (capital): 790,197

County of Split-Dalmatia: 454,798

County of Osijek-Baranja: 305,032

County of Primorje-Gorski Kotar: 296,195

County of Istria: 208,055

County of Vukovar-Sirmium: 179,521

Climate

Mediterranean on the coast, continental inland

Weather in Zagreb

Hottest month, July, 21.7°C (daily average temperature); coldest month, January, 0.9°C; driest month, November, 45.4 mm rainfall; wettest month, October, 195.8 mm rainfall

Weather in Split

Hottest month, July, 26.9°C (daily average temperature); coldest month, January, 6.4°C; driest month, July, 0.5mm rainfall; wettest month, December, 235.5 mm rainfall

Language

Croatian

Measures

Metric system

Currency

Croatian kuna (HRK), subdivided into 100 lipas

Time

One hour ahead of GMT in winter; two hours ahead in summer

Fiscal year

Calendar year

Public holidays

January 1st (New Year's Day), January 6th (Epiphany), April 2nd (Easter Monday), May 1st (Labour Day), May 31st (Corpus Christi), June 22nd (Day of Anti-fascist Struggle), June 25th (Croatian National Day), August 5th (National Thanksgiving Day), August 15th (Assumption), October 8th (Independence Day), November 1st (All Saints' Day), December 25th (Christmas Day), December 26th (St Stephen's Day)



Political structure

Official name

Republic of Croatia

Form of state

Democratic republic

Legal system

Based on constitution of December 1990, amended in 1992, 2000 and 2001

National legislature

Parliament (Hrvatski Sabor) is unicameral and comprises 151 seats. Both the Chamber of Representatives and the Chamber of Counties were abolished when their mandate expired in April 2001

National elections

Last elections: September 2016 (parliamentary); December 2014-January 2015 (presidential). Next parliamentary election 2020; next presidential election 2019-20

Head of state

Kolinda Grabar-Kitarovic was sworn in as president on February 19th 2015, following her victory in the presidential election on January 11th

National government

Appointed by the president and confirmed by parliament. A new government, led by the centre-right Croatian Democratic Union (HDZ) and supported by parts of the Croatian People's Party (HNS), was appointed in June 2017

Main political parties

Croatian Democratic Union (HDZ), Social Democratic Party (SDP), Most (Bridge), Zivi Zid (Human Wall), Croatian People's Party (HNS), Istrian Democratic Assembly (IDS), Croatian Pensioners' Party (HSU), Croatia Labourists-Labour Party, Croatian Democratic Alliance of Slavonia and Baranja (HDSSB), Croatian Citizens Party (HGS), Democratic Centre (DC), Croatian Peasants' Party (HSS), Croatian Pure Party of Rights (HCSP), Independent Democratic Serbian Party (SDSS)

Leading members of the government

Prime minister: Andrej Plenkovic (HDZ)

Deputy prime ministers:

Construction & spatial planning: Predrag Stromar (HNS)

Defence: Damir Krsticevic (HDZ)

Economy, entrepreneurship & trades: Martina Dalic (HDZ)

Foreign & European affairs: Marija Pejcinovic Buric (HDZ)

Key ministers

Agriculture: Tomislav Tolusic (HDZ))

Culture: Nina Obuljen Korzinek (ind)

Demography, families, youth & social politics: Nada Murganic (HDZ)

Environment: Tomislav Coric (HDZ)

Finance: Zdravko Maric (ind)

Health: Milan Kujundzic (HDZ)

Interior: Davor Bozinovic (HDZ)

Justice: Drazen Bosnjakovic (HDZ)

Labour & pension system: Marko Pavic (HDZ)

Maritime affairs, transport & infrastructure: Oleg Butkovic (HDZ)

Public administration: Lovro Kuscevic (HDZ)

Regional development & EU funds: Gabrijela Zalac (ind)

Science, education & sports: Blazenska Divjak (HNS)

State property: Goran Maric (HDZ)

Tourism: Gari Cappelli (HDZ)

Veterans' affairs: Tomo Medved (HDZ)

Central bank governor

Boris Vujcic

Recent analysis

Generated on March 6th 2018

The following articles have been written in response to events occurring since our most recent forecast was released, and indicate how we expect these events to affect our next forecast.

Politics

Forecast updates

European Commission says border dispute “bilateral issue”

March 1, 2018: International relations

Event

The president of the European Commission, Jean-Claude Juncker, has said that [the border dispute between Croatia and Slovenia surrounding the Bay of Piran](#) is a "bilateral issue" and that no further Balkan accessions to the EU will take place without the resolution of outstanding border disagreements.

Analysis

As the contentious and politically fraught disagreement over the maritime border between Croatia and Slovenia continues, the European Commission's top official has indicated his expectation that it will fall to the two states to resolve the issue. In December 2017 Slovenia began implementing the decision issued by the Permanent Court of Arbitration, which granted most of the contested maritime area to the country. Slovenian police have started fining Croatian fisherman active in the waters. The Croatian prime minister, Andrej Plenkovic, has said that the fishermen will not pay the fines, and that Croatian police will issue similar fines to Slovenian fishermen. Both countries are now issuing fines of about €1,300 (US\$1,600) against the accused fishermen from the other country.

The Slovenian foreign minister, Karl Erjavec, has expressed surprise at Mr Juncker's recent statement and called the dispute "a problem of the European Union and the rule of law". Mr Erjavec has indicated that Slovenia's next step will be to file a complaint with the European Commission in Brussels. If the European Commission declines to intervene, Slovenia will seek enforcement of the ruling from the European Court of Justice. Mr Plenkovic has called Slovenia's unilateral implementation of the ruling "unacceptable".

Mr Juncker's comments represent a small victory for Croatia. Slovenian officials had counted on support from European institutions arguing in favour of adopting the arbitration court's ruling that grants Slovenia two-thirds of the bay and access to international waters. With Mr Juncker calling the dispute a "bilateral issue," Croatia may be in a position to approach Slovenia with a less favourable alternative than the arbitration court's ruling. However, it seems unlikely that Slovenia will accept anything short of the full award, especially as the issue has become politicised in both countries. We expect Croatia to maintain its position that the arbitration court's ruling is unacceptable.

Impact on the forecast

The ongoing dispute is in line with our forecast that relations between Croatia and Slovenia will remain tense for the duration of our forecast period and that the border issue will have consequences for other EU-aspirant countries in the Balkans.

Analysis

Serbian president pays controversial visit to Croatia

February 23, 2018

The visit of the Serbian president, Aleksandar Vucic, to Croatia on February 12th-13th may have eased tensions between the two countries. His meetings with Croatian leaders signalled a willingness to continue a dialogue on contentious issues, notably disputed borders, the rights of minorities in Croatia and Serbia, and the importance of Serbia's accession to the EU as a factor contributing to regional stability. However, the visit is unlikely to result in a substantive improvement in relations between the two countries, which we expect to remain susceptible to periodic flare-ups over the forecast period (2018-22).

Mr Vucic and the Croatian president, Kolinda Grabar-Kitarovic, have met on a number of occasions, but Ms Grabar-Kitarovic's invitation to Mr Vucic was the first official meeting between Croatian and Serbian heads of state in five years. The run-up to the visit saw rising tensions amid a series of controversies relating to the second world war, including the opening in January 2018 of an exhibition on the Jasenovac concentration camp at the UN headquarters, and to the wars that followed the breakup of Yugoslavia in the 1990s, so much so that the visit was in doubt until the last minute and Mr Vucic's itinerary was kept secret for security reasons.

Meeting takes place amid protests

Mr Vucic was met by a few hundred protesters following a call by a group representing war widows to disrupt the visit. The protesters demanded that Mr Vucic apologise for Serbia's role in the 1990s war and be open on the issue of war reparations. They largely confined themselves to the main square in Zagreb, the Croatian capital, and were kept at a distance from the meetings Mr Vucic attended in the government and parliament buildings.

Mr Vucic spoke of his willingness to put the past behind him and to focus instead on a better future for the region. (He has previously stated on a number of occasions that he is not ashamed about his role in the 1990s wars and his time as part of a radical Serbian group that called for the integration of parts of Croatia into a Greater Serbia.) He promised to do more to provide information on the fate of the many Croats still unaccounted for after the war.

Ms Grabar-Kitarovic upsets protesters

The visit posed difficulties for Ms Grabar-Kitarovic, not least in terms of potentially alienating a significant part of her electoral base ahead of the presidential election due to be held by early 2020. Her hosting of Mr Vucic will not have gone down well with her voter base, nor will her remarks about the protesters being from the fringes of the political spectrum. The position of president of Croatia is largely ceremonial, but by meeting Mr Vucic (whose position is also meant to be ceremonial, although in reality Mr Vucic is the dominant political leader in Serbia) Ms Grabar-Kitarovic has boosted her international status. Along with the Serbian president, she was joint guest speaker at the Serbian National Council in Croatia on February 13th.

In contrast to Ms Grabar-Kitarovic, the Croatian prime minister, Andrej Plenkovic, kept a low profile during the visit. He met with Mr Vucic on February 12th but left abruptly for Brussels immediately afterwards, saying that a number of important issues had been left off the agenda and that very little progress had been made. Mr Plenkovic has to play a balancing act between the right wing of his party, the Croatian Democratic Union (HDZ), and the more liberal parties supporting the coalition government, which include representatives of the Serbian minority.

Croatia-Serbia relations likely to be subject to periodic strains

Mr Vucic's visit was a step forward in addressing some still unresolved issues, such as the two countries' border dispute, the status of minorities in both countries and the fate of those missing from the 1990s wars. However, the suggestion by a Serbian journalist ahead of the meeting that Croatian politics appear to be stuck in the 1990s while Serbian politics pretends the 1990s never happened sums up the difficulties in establishing more friendly relations. We continue to expect that relations between the two countries will remain strained, with periodic flare-ups related to historical grievances and to Croatia potentially opposing Serbia's EU accession process (as it has in the past).

Croatia and Serbia trade accusations over Holocaust memorial

February 26, 2018

Officials from Croatia and Serbia have traded public accusations over an exhibition commemorating victims of the Jasenovac concentration camp in Croatia during the second world war. At the camp, Serbs, Jews, Roma and anti-fascists died at the hands of the Ustasha fascist regime in what was then the Independent State of Croatia (NDH). Croatia and Serbia have long disputed the number who died at Jasenovac, with some Serbian historians saying the death toll came to about 700,000, and the Croatian-run Jasenovac Memorial Site estimating the number killed at between 80,000 and 100,000. The issue has received considerable media attention in both countries and has contributed further to tensions that periodically flare up on issues related to the second world war.

On January 27th, Holocaust Memorial Day, Serbia's foreign minister, Ivica Dacic, opened an exhibit at the UN headquarters in New York commemorating those who died at the Jasenovac concentration camp during the second world war. In response, the Croatian mission to the UN issued a protest note about the exhibit, accusing Mr Dacic of misusing the Holocaust memorial for political purposes and denigrating Croatia's international image. Mr Dacic said that he was outraged at Croatia's "hypocrisy and impertinence" over the issue. The Serbian president, Aleksandar Vucic, said that Croatia's protest was the same as if Germany had objected to Jews commemorating the Holocaust. Mr Vucic's comments were echoed by Ana Brnabic, Serbia's prime minister. Andrej Plenkovic, the Croatian prime minister, rejected the association of the wartime Croatian state with the modern Republic of Croatia, saying that modern Croatia was founded on different values.

Historical disagreements feature frequently in Croatia-Serbia relations

Debates about the second world war fuelled nationalist politics in the 1980s and 1990s, resulting in severe political tension between Serbs and Croats in Croatia. During the dissolution of Yugoslavia in the early 1990s, Serb nationalists invoked the genocide against Serbs perpetrated by the Ustasha regime in world war two as a justification to break off Serb majority areas in Croatia and link them to Serbia. In the same period, Croatian nationalists downplayed the actions of the Ustasha government during the war, and some lauded its effort to create an independent Croatian state.

The number of victims at Jasenovac, the largest of the Ustasha concentration camps, has been highly politicised for decades and has strained Croatia-Serbia relations since the collapse of Yugoslavia. The resurgence of the argument following the opening of the exhibition at the UN indicates that the issue remains contentious and divisive. The revival of historical debates, such as the present one, tends to favour conservative and nationalist parties in both countries. The strong positions espoused by mainstream politicians indicate how entrenched views on certain aspects of the region's history are in the two countries.

Although the dispute over the exhibition has subsided, allowing [Mr Vucic's visit to Croatia to take place](#), recurrent controversies over matters such as this are problematic for Serbia's accession to the EU. In 2016 Croatia used its position as an EU member to block Serbia from opening chapters in its accession process, before eventually relenting. As Croatia's [current disagreement with Slovenia](#) demonstrates, historical disputes and border issues are hardly uncommon in the region. Other areas of conflict, such as the dispute over Jasenovac and Croatia's reckoning with the legacy of the NDH, are likely to crop up again, complicating co-operation on broader regional issues—something the EU is keen to avoid. Croatia has strained international relations with many of its neighbours in the Balkan region. The recent spat over the Jasenovac commemoration suggests that future political and economic co-operation with neighbours may become jeopardised over contentious points in the region's troubled past.

Budget negotiations will test EU cohesion

March 1, 2018: International relations

- **On February 23rd EU leaders began informal discussions on a range of policy options to**

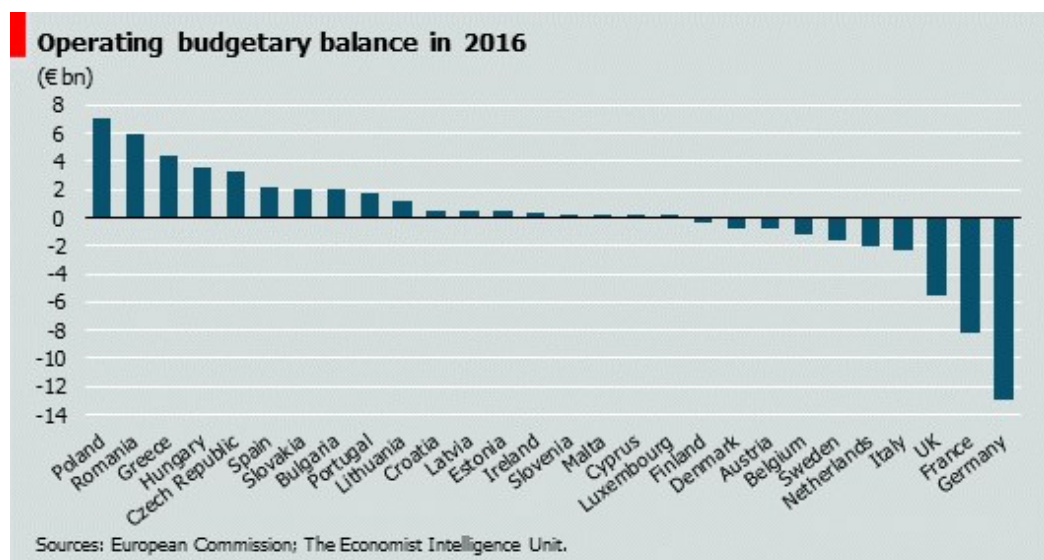
include in the next seven-year budget framework, for 2021–27.

- Tensions over the proposal to increase financial contributions to meet the shortfall in the budget created by the withdrawal of the UK, the fourth-largest contributor, are already evident.
- Germany and eight central and east European countries are willing to pay more into the budget, whereas others would prefer to reduce the budget post-Brexit.
- A German proposal to make EU funding conditional on the rule of law and/or migrant quotas may exacerbate divisions, and is likely to be vetoed by east European states.
- As well as larger national contributions, new sources of tax revenue will be used to fund spending on migration, border controls, security, and research and innovation.
- However, there are also likely to be spending cuts, which could be partly achieved through reform of agricultural subsidies.
- Budget tensions will hamper EU reform efforts, of which the new fiscal framework is an important part.

As with the negotiations on the 2014–20 budget framework, which took almost 18 months to agree, the forthcoming negotiations on the funding period starting in 2021 will be contentious, exposing tensions among the member states. A key dilemma is how to fill the hole in the budget left by the UK's withdrawal from the EU, particularly given new spending priorities. The current round of negotiations is likely to be a protracted process and we do not expect the new multiannual financial framework (MFF), as the budget is called in EU parlance, to be finalised before the second half of 2019.

A post-Brexit budget

The UK's EU membership formally expires at the end of March 2019, but the country has committed to contributing to the final two years of the current EU budget period, in 2019–20, and will pay its share of outstanding liabilities incurred before the end of 2020. If Brexit negotiations break down before then, the UK may cease its payments in 2019, although this is not our baseline forecast. Either way, from the beginning of the EU's next funding period, starting in 2021, the UK will not be making the sizeable financial contributions that it is now. In 2016 the UK's gross national contribution (after its rebate) totalled €12.8bn (US\$15.7bn)—almost 9% of the total EU budget in that year. The UK has been one of the main contributors, providing the fourth-largest contribution in 2016, after Germany (€23.3bn), France (€19.5bn) and Italy (€13.9bn), and ahead of Spain (€9.6bn). In 2016 the UK was also the third-largest net contributor to the budget (meaning that it pays in more than it receives), after France and Germany.



We expect the UK to maintain close ties on trade and defence with the EU in its future relationship with the bloc. The country has also stated a preference for continued participation in some EU programmes (including the Horizon 2020 research and innovation framework programme; Galileo, the EU's GPS system; and programmes related to nuclear power), for which it will continue to pay some contribution to the EU budget from 2021. However, these contributions (and the payment of outstanding liabilities, which will divide into small annual payments over the next decade or more) will be substantially smaller than the annual payments currently being made by the UK.

Pressure to increase contributions causes division

Filling this sizeable budget hole will be a source of political tension during the negotiations. Günther Oettinger, the EU budget commissioner, has recommended that all member states increase their financial contribution to between 1.1% and 1.2% of their gross national income, slightly above the traditional ceiling of 1%. Eight central and east European countries—Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovenia and Slovakia—all net recipients, have expressed a willingness to do so, as has Portugal (net recipient), Spain (which is expected to become a net contributor) and, significantly, Germany (the largest net contributor). Austria, the Netherlands, Sweden and Denmark all have strong objections to increasing their financial contribution and would prefer to shrink the size of the budget rather than make up the UK shortfall.

For some countries, the offer of a larger financial contribution could be used as leverage for other requests, as in the case of Germany, whose chancellor, Angela Merkel, has recently called for the allocation of EU funds to be linked to member states' acceptance of migrants under the EU's refugee relocation scheme. This position reflects tensions with two of the largest net recipients, Hungary and Poland, over their refusal to accept their quota of refugees, but also breaches of the rule of law. The EU initiated rule of law procedures against both countries, but owing to the limited leverage of Article 7, a discussion has begun about linking access to funds to a country's observance of rule of law standards.

Making funding conditional on the rule of law and migrant quotas is controversial and may not gain sufficient support within the bloc. Some east European countries might withdraw their offer of higher contributions if the proposal remains on the table. A concern is that beneficiaries who are not responsible for breaches (Erasmus students, researchers or civil society organisations) may be penalised by this conditionality. Another is that introducing such a "punishment clause" could encourage more Euroscepticism and a backlash against EU institutions.

New revenue sources will help fund big spending plans

Larger contributions from member states should fill at least half of the hole left in the budget by the UK, with the rest being made up from budget savings. However, there are also plans to increase spending across a range of areas, reflecting new priorities within the bloc. The Commission has proposed that more funds be directed towards upgrading the European Border and Coast Guard Agency (Frontex) and a full EU border management system. More funding for countries bearing the greatest burden of the migration crisis that erupted in 2015—particularly Greece and Italy—is likely to be well received.

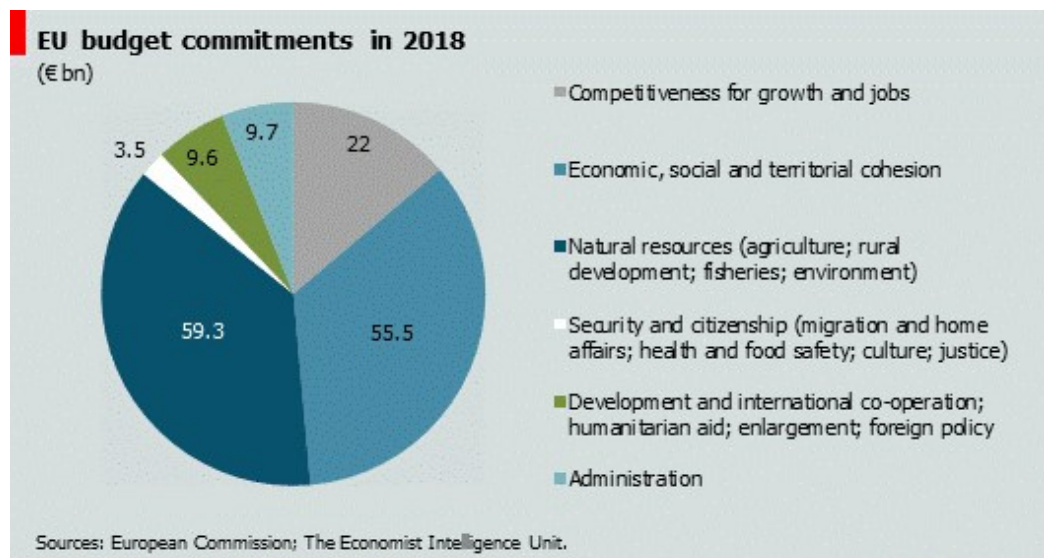
More funds will also go towards bolstering the European Defence Fund for research and defence industrial development; investing more in Erasmus+ (a student and worker exchange programme); doubling investment in the digital economy to support growth in data infrastructure, connectivity and cybersecurity; and spending more on Horizon 2020. A small amount will also go to the European Fund for Strategic Investments (EFSI), the so-called Juncker plan.

Mr Oettinger has said that 20% of these extra funds should come from restructuring, and 80% should come from the increase in national contributions, but also new sources of revenue. The Commission has proposed generating new revenue from the EU emissions trading scheme (ETS), recalibrating the value-added tax (VAT)-based own resource and setting up a common consolidated corporate tax base. Another possible new source of revenue is "seigniorage" that the European Central Bank (ECB) accrues from issuing the currency; a share of the net profits arising from national central banks' shares in euro area monetary income paid out to national treasuries could be made available for the EU budget as a form of national contribution. As part of the EU's new strategy for plastics, which aims to shift towards more sustainable consumption and production of plastic, an EU-wide tax on plastic bags has been proposed, as has a small increase in the fee paid by visa-free travellers from non-EU countries that are screened by the European Travel Information and Authorisation System (ETIAS).

CAP and cohesion funds will be targeted for cuts

Regarding budget savings, areas of focus will be reducing and/or recalibrating direct payments to farmers under the Common Agricultural Policy (CAP) and limiting support from regional

development and cohesion funds. The CAP and cohesion funds currently account for 70% of the EU budget, making them an obvious target for spending cuts. A number of options for reforming the CAP include limits on the amount of agricultural subsidies (favoured by the Netherlands and Italy, but not by most other countries, particularly those with large farms in central and eastern Europe); "convergence" in the way direct payments are calculated (favoured by the east European states that currently receive fewer funds because of the payment formula); and ending subsidies that are directed towards struggling sectors, known as "coupled payments", which are thought to artificially boost supply, weighing on prices (only the Netherlands, Denmark, Sweden and Ireland support this). Changes in its management are likely, but funding for the CAP is likely to remain significant.



Objections to a reduction in regional development and cohesion funds will be more broad based, and some countries have suggested as an alternative that increased spending on migration could come from these funds. However, we expect an end to budget rebates—first secured by the UK in 1984 but later granted to Germany, the Netherlands, Sweden, Denmark and Austria as a temporary correction mechanism.

Testing the potential for reform

Tensions arising from the budget negotiations are likely to play into the current debate on EU reform, and could hamper progress in this area. They also make agreement on the MFF unlikely until the second half of 2019, after the European Parliament elections in May 2019. The Commission will present a detailed budgetary proposal by early May at the latest, with the aim of reaching agreement on the budget from all member states in late 2019, after two progress reports in December 2018 and June 2019. We expect the Commission to secure larger budget contributions from all EU member states, but achieving this is likely to involve a reallocation (or "modernisation") of funds and will also reflect a shift in the balance of power within the EU post-Brexit, with the Netherlands, Sweden and Denmark having lost the UK as an ally.

Economy

Forecast updates

Industrial production grows by 1.4% in 2017

February 16, 2018: Economic growth

Event

According to data published by the Croatian Bureau of Statistics, industrial output rose by 1.4% year on year (unadjusted) in full-year 2017. However, year-on-year industrial production fell for two consecutive months, by 1.6% in November and 4.7% in December, slowing overall annual growth to 1.4%, from 5.3% in 2016.

Analysis

The slowdown in industrial output in 2017 was caused by contractions in the production of capital goods (-2.2%), consumer durables (-1.7) and energy (-0.2). Growth was driven by expansion in the production of intermediate goods (5.4%) and non-durable consumer goods (0.9%).

Year-on-year industrial production growth in 2017 was positive for every quarter other than the fourth, when it was -0.6%. This can be attributed to a very strong baseline fourth quarter in 2016 when the economic recovery picked up, and to an unusually high number of working days in December 2016. In addition, production of consumer durable goods has been on a steady decline (contracting by 1.7% in 2017), in part owing to the high base period in 2016, when consumer durable goods production rose by 4.1%.

Productivity in the industrial sector continued to improve in 2017, rising by 0.9% overall, and particularly in energy production (1.5%) and manufacturing (1.2%). This will have been boosted by falling employment in all sectors of industry. Employment in mining and quarrying industries fell by 8.6%, in manufacturing by 2.1%, and in the electricity, gas, steam and air conditioning supply industries by 1.1 %.

We expect industrial production to recover in 2018, supported by domestic and external factors. Domestic demand should remain robust, supported by strong net monthly wage growth of over 6% year on year in the final months of 2017 (compared with 1.6% in full-year 2016), and expected real GDP growth of 3%, the same as estimated in 2017. External demand will also be supportive, with continued growth in the euro zone providing markets for Croatian exports. We expect productivity growth and investment in the industrial sector to continue, improving competitiveness, and for Croatia to benefit from being further integrated into EU value chains.

Impact on the forecast

Our forecast for industrial production growth in 2018 remains unchanged at 3%.

Further tax reform ruled out in 2018

February 20, 2018: Fiscal policy outlook

Event

Statements from government officials in January and February indicate that the government will not introduce further tax reforms in 2018.

Analysis

On January 18th the finance minister, Zdravko Maric, said that the [government's 2017 tax reforms](#) had been successful, and that he hoped to introduce more reforms, including a reduction in the value-added tax (VAT) rate. However, he said that there would be no changes this year, and that the government would carry out an analysis before cutting taxes further. This could be a VAT rate cut, followed by the introduction of a property tax in 2019. On February 7th Predrag Stromar, the minister for construction and spatial planning, said that a real estate tax would not be introduced.

This means that the only significant tax change in 2018 is the removal of the vehicle tax for new-car sales of less than HRK150,000 (US\$2,500; including VAT), which accounts for about two-thirds of new cars sold.

The governing Croatian Democratic Union (HDZ) had discussed reducing the VAT rate in 2015-17, but has yet to deliver on its commitment. Given that the state collects 55% of its taxes through VAT (one of the highest proportions in the EU), it is a valuable revenue source. This mainly reflects the comparatively high standard rate of VAT (25%) and its broad coverage. Reducing the VAT rate would encourage consumer spending, which would particularly benefit the valuable tourism industry (accounting for almost 20% of GDP), but it would be a risk for the government to decrease collection of a critical funding source.

The government's long-term aim is to narrow the substantial public debt burden (estimated at 80.2% of GDP at end-2017), and any reduction in the government deficit will need to be sustainable, which explains the postponement of further tax cuts this year. Furthermore, it is also unclear whether a reduction in the VAT rate would be offset by tax revenue generated from increased associated spending.

Impact on the forecast

The development is in line with our view that the government is committed to maintaining the country's improved fiscal position, and that it will tread carefully in making changes to the tax code that could reduce revenue collection. That said, a VAT rate cut targeted at boosting consumer spending and the seasonal tourism industry is possible later in the forecast period.

Agrokor to request three-month extension to reach settlement

February 20, 2018: Economic growth

Event

With the current deadline to reach a settlement agreement set for April 10th, the emergency management team of food retail conglomerate Agrokor has announced that it will request a three-month extension before submitting a final deal to the Commercial Court in Zagreb, the capital.

Analysis

Ante Ramljak, the government-appointed emergency administrator of Agrokor, has said that he does not think it is possible for Agrokor's creditors to be able to vote on a deal before the current deadline of April 10th, and so he will request a three-month extension, as allowed by law. The new deadline is expected to be July 10th, by when Mr Ramljak anticipates that the parties will reach a deal to restructure the €5.5bn (US\$6.9bn) debt without difficulty. Once the settlement is reached, the emergency administration will be ended. According to Mr Ramljak, the extension request comes not as a result of disagreements among creditors, but because of legal procedures that are delaying the vote.

The government-appointed management presented [a draft debt settlement plan in December 2017](#), which offered creditors and suppliers full control of a new holding company that would receive the assets and sustainable business segments of the Agrokor group. The deal would include a debt-for-equity swap and a debt write-off. The management has divided creditors into groups based on their claims and legal positions. The final settlement requires the backing of creditors holding at least 66% of claims.

Mr Ramljak also added that he regretted that the firm appointed to work on the restructuring process was one where he had previously worked as a consultant. The prime minister, Andrej Plenkovic, has said that the government will review the documents related to hiring consultants before taking action, and that he has some concerns about the ethics of the hiring decision.

Mr Plenkovic's government and Mr Ramljak's emergency administration have been under enormous political and media pressure to manage the restructuring effectively, and it appears that they are close to reaching a deal and avoiding the collapse of Agrokor (which is the largest company in Croatia). We expect the restructuring to proceed according to plan and that the required number of creditors will approve a settlement plan before the final deadline.

Impact on the forecast

We continue to consider the Agrokor crisis as one of the greatest downside risks to the economy. However, we expect the government-appointed emergency management committee to effectively resolve outstanding procedural and legal issues by July 2018.

Pension funds seek higher mandatory contributions

February 22, 2018: Fiscal policy outlook

Event

On February 13th Damir Grbavac, the head of the Association of Pension Fund Management Companies and Pension Insurance Companies (UMFO), Croatia's main pension fund association, made a statement to Reuters, a news agency, that the government must double the amount that citizens paid into pension funds, and that fund managers needed more opportunities to invest in the national economy.

Analysis

Mr Grbavac emphasised that there was a shortage of Croatian companies seeking funding in the capital market, and that the IMF and the World Bank had highlighted that Croatia must reform its pension system if it intended to adopt the euro. He added that to make the pension system sustainable, the government must gradually increase contributions to 10% of gross salaries. Currently tax-payers contribute 5% of their gross salary to mandatory pension funds, plus 15% to state funds as part of a pay-as-you-go system. Although past governments have committed to increasing contributions since the introduction of private pension funds in 2002, they have not implemented long-term changes.

Funds tend to invest most of their assets in local debt and just over 10% in foreign instruments. Mr Grbavac highlighted the importance of investing locally and expanding local capital markets to accommodate new, fast-growing information technology (IT) firms oriented towards international markets. He also stated an interest in investing in infrastructure projects and the energy sector.

About 36% of government spending on pensions comes from tax revenue. The pay-as-you-go system is insufficient owing to the high ratio of pensioners and children to working-age citizens (estimated at more than 50% in 2016). At the end of 2017 the assets of the four mandatory pension funds amounted to HRK91.9bn (US\$15.2bn)—about 26% of GDP and up by 9.5% year on year. Mr Grbavac quoted an OECD survey that found that the real yield of Croatian funds was among the highest for European and OECD countries.

The pension fund posted impressive growth, but there are significant structural problems in the Croatian economy, namely the ageing population and the relatively small pool of workers who can contribute to the pension system. As Croatia seeks to join the euro zone, which requires reducing the public debt burden, it will need to address these issues.

Impact on the forecast

We expect that the current government, like its predecessors, will struggle to make structural reforms on issues like pensions, and will fail to increase mandatory contributions by citizens to the pension fund in the short term.

European Commission finds education system among worst in EU

February 23, 2018: Policy trends

Event

An annual report by the European Commission has indicated that the education system is among the least effective in the EU, despite some positive indicators.

Analysis

The Commission's comparative report on the state of education systems in the EU has highlighted that basic skills in Croatia are significantly below the European average, which it attributes to the quality of teaching and the curriculum. At a presentation in Zagreb, the capital, a representative from the Commission's Directorate General for Education and Culture stated that Croatia's education system was relatively weak, and that the situation had deteriorated in recent years. Participation rates in both early childhood and adult education are among the lowest of the EU countries; however, the report also recognised that Croatia had the lowest rate of early leavers from education, highlighting a strength that the Croatian education system and society can rely on in the future.

The assessment was done based on a survey of 15-year-olds, and indicated that more Croatian students lacked proficiency in science and mathematics than the EU average; 32% of students had poor mathematics skills at age 15, compared with the European average of 22.1%. The education minister, Blazenko Divjak, stated that her ministry would take the report's findings into consideration and would respond to the remarks from the monitor.

The authorities are making efforts to address the main cause of the low rating and the quality of the curriculum and teaching. The 2.8% early leaving rate is far below the EU average of 10.7%, which suggests that if the Ministry of Education can improve the curriculum and the quality of teaching at secondary schools, Croatia will be able to produce more educated students per head of population than other EU countries. Ensuring basic skills in the workforce will be essential for Croatia as its leaders attempt to employ more of the labour force, especially young people. Currently Croatia ranks 112th out of 137 countries in quality of education and 57th out of 137 in quality of mathematics and science education. We expect the government to invest in increasing the basic skills level, as well as in improving other indicators such as science and mathematics skills.

Impact on the forecast

Education is another measure in which Croatia falls below the EU average, but as basic skills are closely tied to a capable labour force, and given the poor demographic outlook, this will limit Croatia's growth and catch-up potential.

Agrokor's extraordinary administration manager resigns

February 27, 2018: Economic growth

Event

On February 21st the prime minister, Andrej Plenkovic, announced that a new extraordinary manager for Agrokor, an indebted retailer and Croatia's largest private company, would be appointed shortly, following the resignation of Ante Ramljak amid accusations of a conflict of interest in hiring his previous employer as a consultant to the Agrokor settlement.

Analysis

Mr Plenkovic announced that he believed that Mr Ramljak did the right thing by resigning and that his move was unsurprising. Despite opposition members calling for the prime minister and the minister of economy to resign, [Mr Plenkovic stated that there would be no government reshuffle at this time](#).

Mr Ramljak had served as Agrokor's extraordinary manager since April 2017. In late January 2018 it was revealed that he had hired his former employer, Texo Management, to consult on the restructuring process for Agrokor. Texo received HRK250,000 (US\$42,000) per week for its services. The president, Kolinda Grabar-Kitarovic, described the consultancy fees as "deeply immoral". Media attention focused on the fact that Mr Ramljak was still an employee of Texo when the firm was hired, and on the potential conflict of interest arising from the contract and the fees.

Previously [Mr Ramljak had requested a three-month extension to reach a settlement agreement for Agrokor](#), pushing the deadline to July 2018. A representative of one of Agrokor's major suppliers, a Zagreb-based confectionary firm, Kras, stated that she thought that the final debt settlement would probably be delayed as a result of Mr Ramljak's resignation, adding that negotiations were at a sensitive phase. Mr Ramljak will continue working as Agrokor's extraordinary manager until a successor is named.

We do not expect Mr Ramljak's resignation to have a major effect on Agrokor's final settlement with its creditors, nor do we anticipate major political repercussions for Mr Plenkovic's government. Although negotiations at this stage are precariously poised, we expect that a new commissioner will be appointed soon and that the restructuring talks will proceed as scheduled.

Impact on the forecast

We maintain our forecast that the Agrokor restructuring poses a significant risk to political stability and economic growth in the short term. We expect that the restructuring process will continue and that the extraordinary management will meet the new July 2018 settlement deadline.

Croatia continues to lag EU peers in business environment

February 27, 2018: External sector

Event

Reports from international financial institutions and investor surveys in recent months suggest that Croatia's business environment remains in need of reform.

Analysis

In its 2017–18 *Transition Report*, the European Bank for Reconstruction and Development (EBRD) highlighted the need for Croatia to gradually reduce administrative costs and para-fiscal charges, improve the cadastre and land registry system, enhance the management and monitoring of state-owned enterprises, and make court procedures more efficient for businesses. The report further indicated that in order to reduce public debt, the authorities will need to implement targeted public expenditure cuts, and improve absorption of EU funds and the efficiency of state-owned enterprises. To sustain long-term economic growth Croatia must resolve the issue of corporate non-performing loans, which remain high by regional standards.

An association of foreign investors indicated in a separate report that legal uncertainties due to frequent changes in the regulatory framework, and administrative burdens, discourage foreign investment. Croatia has one of the lowest levels of greenfield investment among new EU member states in central and eastern Europe. The deputy prime minister and economy minister, Martina Dalic, has said that the association's recommendations will be taken into account in the government's 2018 economic policy.

According to a survey of 98 Austrian companies that do business in Croatia conducted by Advantage Austria, the country's trade promotion organisation, policy uncertainty, bureaucratic delays and labour shortages are the most significant obstacles to doing business in Croatia.

We expect the government to make limited progress in addressing these shortcomings. To address labour shortages, it has increased work permit quotas and aims to raise the employment rate. Regarding state-owned enterprises—which have a long history of inefficiency and corruption in Croatia, and represent 12% of employment and 30% of total assets and generate 18% of turnover—the government has opened up more firms to privatisation.

Despite these efforts, we expect the government to face significant opposition to privatisation from labour unions and interest groups. The government has ruled out tax reform this year, and further cuts will be difficult to reconcile with maintaining the country's improved fiscal position.

Impact on the forecast

In the 2018–22 forecast period we expect modest progress on regulatory and fiscal reforms, although with the economy beset by excessive imbalances and a weak institutional framework, implementation of far-reaching reforms will continue to pose a considerable challenge.