The impact of a superelection year on the growth outlook of the Croatian economy

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Croatia in the midst of a global superelection year

In 2024 there is a record-breaking number of states worldwide facing elections, 73 to be more precise. In a global superelection year Croatia is no exception to this electoral cycle, but certainly is an outlier in terms of the quantity of the electoral process consumed by Croatian voters. First, on 17th of April Croatia had parliamentary elections. Second, on 9th of June Croatia held elections for the European Parliament. Third, at the very end of 2024 Croatia will also have presidential elections. Finally, in Spring 2025 Croatia will host local elections. All four elections are symbolically important but the ones in which Croatian electorate has the biggest stake in charting its economic future are definitely parliamentary elections held this April.

The aforementioned elections have confirmed electoral dominance of the centre-right Croatian Democratic Union (HDZ), which holds sway over Croatian politics for almost a full decade, with Prime Minister (PM) Andrej Plenković being the longest-serving Croatian PM in history. In the face of disunited and fragmented centre-left opposition, HDZ scored 34.4% of votes and won 61 seats in Sabor, the Croatian Parliament made up of 151 MPs. The right-of-centre Domovinski pokret, consisting of many renegades from the HDZ won 9.6% of the votes and 14 seats. On the other side of the political spectrum, the centre-left Socialdemocratic Party (SDP) and eco-leftist Možemo won 25.4% and 9.1% of the votes which secured them 42 and 10 MPs respectively. The remaing votes 24 seats were divided among smaller parties (Croatian State Electoral Commission, 2024)

In spite of acrimonious campaign between HDZ and Domovinski pokret, the two parties forged a coalition pact much faster than had been expected and formed the ruling majority, together with 8 MPs from the ranks of national minorities, which regulary pivot to the electoral winner. Hence, only a month later, Croatia had a new Government composed of 18 ministers. The centre-right Domovinski pokret got three ministries under stewardship (the Ministry of Economy, the Ministry of Demographics and Diaspora and the Ministry of Agriculture). The remaining ministries were all assigned to HDZ, which represents a very dominant senior coalition partner. This emanates not only from HDZ's electoral results but also from the political persona of Andrej Plenković, who is a political heavyweight and has a great deal of reputation in the EPP (European People's Party), the strongest political groupation in the European Parliament after the recent europarliamentary elections.

The economic programme of the new Croatian Government

The economic programme of the new Croatian Government for the period between 2024-2028 envisages the continuation of an increase in the employment rate from 70% to 75%, as well as the reduction in rate of unemployment from 6% to 5%. Additionally, 19% youth unemployment should be slashed to less than 10%. In terms of fiscal policy, the Ministry of Finance, a traditionally strong player in all Governments led by PM Andrej Plenković, set a course of continued cutting down on public debt which is now 63.3% of GDP, slightly below Germany's level. At the same time, the goal is to obtain the prized A credit rating from S&P and Fitch, up from the current rating of BBB+. Namely, the goal is to achieve an even greater degree of creditworthiness in the eyes of financial markets and profit from lower risk premia on sovereign debt. The goal is to lift the average wage from €1,300 to €1,600, in parallel to raising the minimum gross wage from €840 to €1,250. In terms of pensions, the Government will strive to increase average pension from the €577 to €750 in 2028 (Government of the Republic of Croatia, 2024).

In terms of economic convergence, a concept which measures the extent to which the development gap between richer and poorer member states has narrowed, the goal of reaching 80% of EU average GDP per capita in purhcasing power standard (PPS) by 2028 seems as not overly ambitious. Finally, since Croatia managed to become a member of the Eurozone and of the border-free Schengen Area in 2023, Croatian Government set its sight on joining the OECD to gain additional reputation in the eyes of financial markets and investors. The latter EU integration steps were very important for Croatia as tourist country, while the adoption of a common EU currency enabled lower interest rates both on public and private debt due to significant reduction in risk premium.

Croatia's current economic momentum and potential headwinds

In the summer of 2024 Croatia can boast with the third highest growth rate in the EU, after Malta and Cyprus. Croatia’s GDP is forecast to grow by 3.3% in 2024 and 2.9% in 2025 (European Commission, 2024). The growth is primarily underpinned by strong personal consumption and investments financed by EU transfers. Strong personal consumption is the result of two factors. First, Croatia has a tight labour market which powers real wage growth in spite of the annual inflation rate that amounted to 3.4% in July, the fourth highest rate among the 27-nation economic block (Eurostat, 2024a). Part of this wage pressure has been alleviated by record immigration of workers from non-EU states, especially in the construction sector, trade and tourism. Second, in the electoral year the ruling HDZ decided to enhance the economy and raise the prospects of party's electoral success by increasing the salaries for 240.000 public employees by a whopping 31.9% (Lider, 2024a).

Overall, the decline of exports in goods from €24 to €23 billion in 2023, which was caused by weak growth in some of Croatia's key trading partners such as Germany and Austria, especially in light of industrial recession plaguing Germany's economy for several years was more than offset by the growth in services exports and lower imports. Regardless of having a large trade deficit in goods to the tune of €17 billion, the export of tourism services and net inflows of personal transfers from a large Croatian diaspora has compensated the difference (Croatian Bureau of Statistics, 2024). The latter type of infows amounting to 7.5% of GDP represents the biggest share of all EU member states (Eurostat, 2024b). Those developments enabled current account surplus slightly above 1% of GDP, which is also projected to remain at this level in 2025.

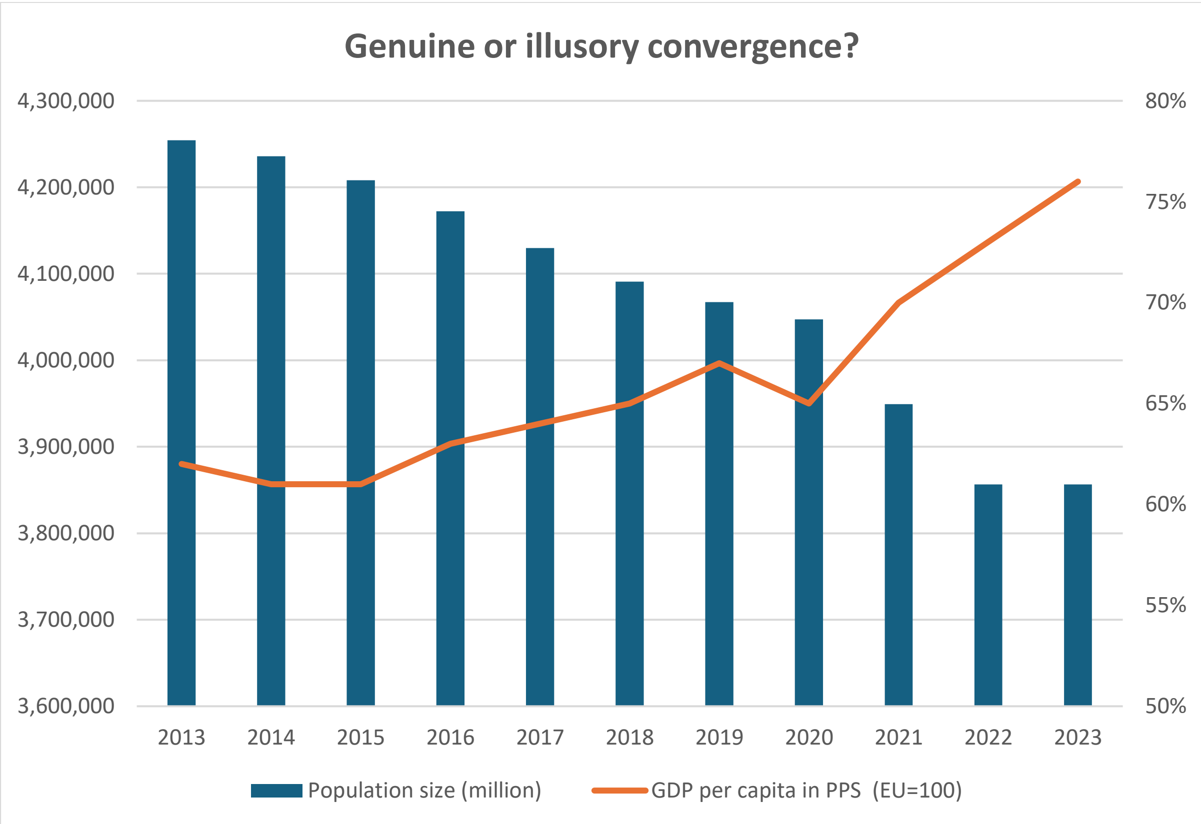
In the short term things look very positive but they also hide important obstacles that prevent boosting potential growth rate and increase Croatia's vulnerability to economic shocks. The most profound impact of the superelection year is unsustainable trajectory of public expenditures due to political business cycle. The aforementioned increase of salaries in the public sector constitute the largest increase in Croatian history and the compensation of public sector employees now surpasses 13% of GDP, the second biggest share in the EU, only behind wealthy Denmark (Eurostat, 2024c). Unwittingly, this will raise public deficit from 0.7% of GDP in 2023 to 2.6% in 2024, at a time of strong economic growth. This will have several negative implications (European Commission, 2024a).

First, it will create a pressure on additional growth of wages in the private sector, which are lower than in the public sector, contrary to the prevailing experience of most other states. Additional wage growth will stoke inflation and hurt Croatian export competitivness, which is already visible in the tourism. Namely, Croatia has had the biggest EU-wide price increase in the category „Restaurants and hotels“ over the last three years (European Central Bank, 2024). Simply, there is not much room for the continuation of this approach. Second, the strong increase in public sector salaries tends to become sticky. Once granted, it is politically difficult to freeze or cut them, regardless of changing circumstances. In mid-July the Minister of Finance Marko Primorac showed awareness that government largesse is not financially sustainable and that it risks bringing Croatia on a collision course with the European Commission, an EU institution responsible for upholding fiscal discipline. Therefore, he demanded from his colleagues to trim down expenditures by 10%, as slowing inflation has also meant lower tax revenues (Lider, 2024b). Unfortunately, political patronage elaborated above will come certainly at the expense of public investments, which is detrimental to long-run growth.

Lack of long-term vision for ensuring genuine economic convergence

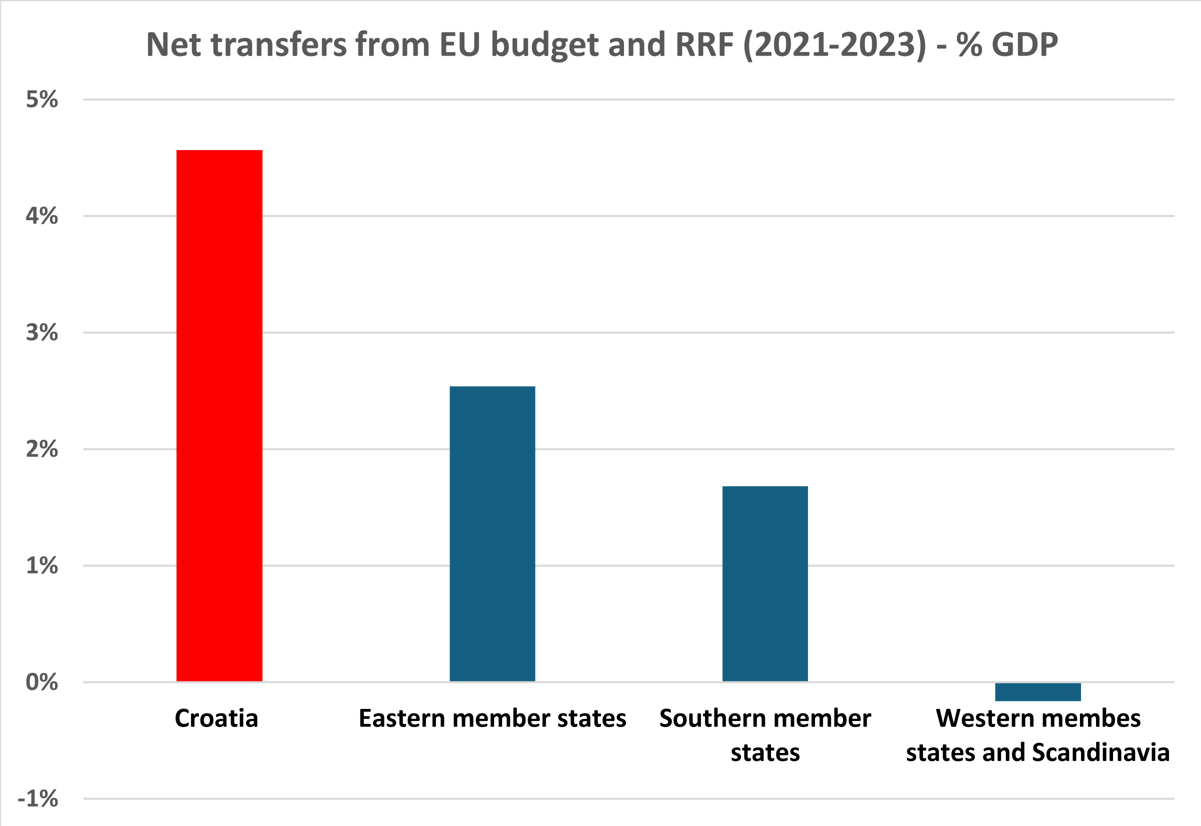
Over the last few years Croatia has managed to narrow the development gap. Figure 1 shows that it has lifted its GDP per capita measured in PPS from 62% of the EU average in 2013, when it joined the EU, to 76% in 2023 (Eurostat, 2024d). However, the convergence has been of a mixed record. In the period between 2013-2020 the convergence was illusory due to large emigration which reduced denominator of the GDP per capita ratio. However, since 2021 one can witness signs of a genuine convergence, while population size has stabilized. This was induced by several factors. First, Croatia had a faster loosening of pandemic-related restrictions, which was favourable to tourism. Second, foreign direct investment (FDI) started to recover as in the 2013-2019 period the cumulative value of FDI had totalled 10.3 billion USD, while the cumulative value for the 2020-2023 period climbed to 12.26 billion USD (World Bank, 2024). Third, last but not least important factor has been a major spike in EU transfers or handouts from the EU budget. The latter come primarily in the form of EU cohesion and agricultural policy and are aimed at less-developed regions of the EU which are net recipients. Croatia has been the biggest beneficiary of EU transfers over the past few years, as shown in Figure 2. The average for Croatia has been far bigger than that for Southern and Eastern member states, traditionally large net receivers (European Commission, 2024b).

Figure 1



Source: Eurostat

Figure 2



Source: European Commission

Regardless of the currently favourable economic environment Croatia risks getting stuck at the level of development below 85% of the EU average. There are basically two potential pathways ahead, the Irish and the Portuguese scenario. Portugal and Ireland started from the same level of development in the early 1990s but their trajectories have largely differed (Šonje, 2024a). While Portugal has been one of the largest beneficiaries of EU transfers over the last four decades, it failed to leverage them to grow significantly. On the other hand, while also receiveing substantial EU transfers when joining the EU, Ireland has managed to find other engines of growth and to enhance productivity remarkably. From being an emigration country historically, Ireland has completely changed its fortunes.

Conclusion

In order to achieve genuine economic convergence and economic resilience, Croatian Government will have to embrace a strong pro-growth agenda. Croatia does not have the problem of skewed economic structure too dependent on tourism. However, it has an across the board problem of lagging productivity compared to its EU peers. Unfortunately, the incumbent Government does not deal in its programme with a major drag on productivity in the form of poor governance of state-owned enterprises, as shown by the OECD's recent Product market liberalisation data (Šonje, 2024b). The indicator ranks Croatia far below the OECD average in terms of pro-competition regulation. Furthemore, there is a lack of awareness on the need to develop capital market, which facilitates enterprise formation and cuts financing costs. The financial system is still too bank-dependent. Third, educational and pension system reform have been left untouched, in spite of *status quo* being untenable. Croatian state consistently spends 5% of GDP more than its development level would suggest.

The political economy literature shows that to avoid adverse electoral effects, timing reform early in the electoral term and when business-cycle conditions are favourable is critical (Furceri et al., 2024). Both preconditions are currently satisfied. However, on the other hand there is a very large constituency of pensioners, state-owned enterprises and public sector workers, willing to block major reforms. Given the fact that the ruling HDZ governed Croatia for 24 out of 32 years of country's independence, and presided over the creation of powerful veto-players in the system, it will have to do away with some of its key political allies. The incumbent Government enjoys the necessary conditions for reform, but does it have the willpower?

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