APRIL 2020.

REPUBLIC OF CROATIA

Convergence Programme of the Republic of Croatia for 2020 and 2021

Table of Contents

List of Tables

List of Charts

List of Annexes

1. INTRODUCTION

According to the provisions of the Stability and Growth Pact, member states of the European union (hereinafter referred to as: EU) are obliged to submit their stability programmes, i.e. convergence programmes by the end of April each year, in line with the format and the provisions defined by the relevant ordinance, Code of Conduct of the Stability and Growth Pact. However, the outbreak of the Coronavirus pandemic has had a significant impact on the member states, intensifying the uncertainty and burdening their economies.

Consequently, on March 13, 2020, the European Commission (hereinafter referred to as: EC) adopted the Communication on the coordinated economic response to the COVID-19 outbreak, emphasizing the importance of flexibility within the fiscal framework of the Stability and Growth Pact (hereinafter referred to as: the Pact). Then, on March 20, 2020, the EC adopted the Communication on the activation of the general escape clause of the Stability and Growth Pact. Although this clause does not suspend the provisions of the Pact, the member states are allowed temporarily to depart from the previously defined fiscal targets. For example, within the framework of the preventive arm of the Pact, the member states may be allowed to temporarily depart from the defined adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. After the Council endorsed such approach, in April the EC issued the guidelines on the preparation of the adjusted format of the 2020 stability and convergence programmes. In this context, the format of the convergence programme has been significantly streamlined and adjusted to the requirements and needs of solving the economic consequences of the pandemic. Such adjusted programmes reflect exceptional circumstances and severe economic burden that EU member states are currently facing.

Therefore, and in accordance with the EU guidelines, 2020 Convergence Programme of the Republic of Croatia contains 3 chapters. The first one is an introduction with a description of the economic policy response to the challenges linked to the pandemic. Then, the following chapter deals with macroeconomic trends, including the description of cyclical trends and current macroeconomic projections, while the last chapter is about the general government budget and public debt trends for the current and the following year. This document was adopted by the Government of the Republic of Croatia at its session held on April 30, 2020.

2. IMPACT OF COVID–19 ON INTERNATIONAL ENVIRONMENT AND CROATIAN ECONOMY

2.1. COVID-19 and International Environment

The world is facing the materialization of economic consequences of the global healthcare crisis caused by the COVID-19 pandemic that has struck the global economy at the time of already present weakening of global activity, especially in international trade. The proportions and duration of the economic disturbances are still quite uncertain, but it is likely that the cumulative impact on the global output will be larger than the one of the global financial crisis in 2008. The specificity of this economic crisis is its fully exogenous and symmetrical character, unrecorded intensity of the initial strike in the extremely short time period, and simultaneity and global spread of effects, since all world countries will bear economic consequences in relatively short period of time. However, as opposed to the 2008 global financial crisis, the impact of which was extended over a relatively longer period, a stronger initial recovery is likely to happen. Although we are dealing with a unique and synchronized global pattern, the characteristics of the crisis and the form and the duration of the recession in certain countries will still depend, to a certain extent, on idiosyncratic features of particular economies, as well as on specificities of epidemiological strategies and macroeconomic policy measures.

Economic materialization of the crisis has features of a symmetrical supply-demand shock, whereby the impact of the demand will, in a short period of time, prevail, so the occurrence of the deflationary pressures is likely along with the strong decline in primary commodity prices, especially energy products, under the conditions of already present pronounced decline in the prices of oil backed up by the existing surplus of the supply. The initial shock on the supply side has been manifested through the disturbances in global supply chains, closures of businesses for some, mostly service, activities, isolation and social distancing measures for workers, and closing down of borders. The shock on the demand side has been conditioned by the physical impossibility of consumption or postponement of the purchase of consumer and investment goods due to low sentiment and expectations of economic agents. As a consequence of the loss of income and jobs, reduction in liquidity, but also in the solvency of enterprises, retaining of uncertainties and distorted expectations of consumers and businesses, successive circles of additional impacts on the economic activity could lead, in the short term, to the so far unrecorded total multiplicative effect on the economic growth.

Given the gap of about a month between the onset of the epidemic, the global macroeconomic expectations were first focused on China and some other Asian economies. After restraining the spread of the infection and transition to the economic activity normalization phase, these economies published certain unexpectedly favourable indicators, particularly regarding the industrial production. However, since the Chinese economic is still highly oriented towards exports, it is still expected that the lack of demand in the rest of the world will disable stronger recovery in the second quarter of 2020. In relation to the expected dynamics of the recovery in the developed western countries, following the expected sharp decline in the second quarter of 2020, the degree of the spillover of negative trends onto the rest of the year remains uncertain. However, it is likely that the majority of countries have already irreversibly departed from the desired ideal V-shape of the recession curve with the minimal loss of output. The increased government deficits are mostly "monetized" by central banks for the purpose of fighting the crisis so the more pronounced financing through the regular government debt is not expected, especially because the stronger wave of government bonds emission under the prevailing conditions would endanger long-term interest rates and the fiscal sustainability of many countries, potentially lead to the debt crisis and thus undermine the recovery.

2.2. Croatian Economy under COVID-19 Pandemic Conditions

In the short term, healthcare and economic effects of the crisis are opposed, leading to the problem of managing the overall crisis, with not all countries opting for the same strategies, although epidemiological measures to the great extent overlap everywhere. The epidemiological reaction in the Republic of Croatia was timely, while, in terms of the strategy, the approach of relatively strict restriction measures regarding social gatherings and economic activity has been chosen, with an aim of flattening the curve of the number of the infected as much as possible in order to minimize negative healthcare consequences. Since this has led to the desired results, at the end of April it was decided to ease the measures in three phases. However, on the economic side, the aforementioned approach has unfortunately and inevitably been accompanied by the large decrease in the economic activity in the very short period of time. Considering the prevailing expectation of the temporary character of this threat to healthcare system, but also of the most of economic disturbances, as well as timely and proper Croatian epidemiological and economic measures, the cumulative negative economic effect of the crisis in case of the Republic of Croatia should still be less than the one of the global financial crisis, since the consequences of the 2008 crisis were extended over six recession years.

The fact is that the Republic of Croatia is facing this crisis much more prepared than it was for the global financial crisis in 2008, with less external as well as internal imbalances. This primarily refers to the long-lasting process of deleveraging of domestic sectors induced by the previous crisis, to larger share of tradeable sector, as well as to the decreased size of certain domestic sectors of lower productivity oriented exclusively towards the internal market that were, before 2008, financed mostly by debt and thus burdened the economy. These processes were backed by the responsible fiscal policy and by the accession to the EU, and resulted in significantly more favourable indicators of debt sustainability and net international investment position. We would like to add that a more favourable situation on the labour market is present, with the record low unemployment rate just before the outbreak of the COVID-19 crisis. However, the growth potential is lower than it was before 2008, with low productivity growth and unfavourable demographic perspective, but its structure is now more favourable.

The Croatian economy is characterized by relatively low share of industry in the value added, and by high share of the service sector, along with still low share of the export of goods in GDP, significant direct and indirect contribution of the tourism sector, and high import dependency, partly induced exactly by tourism. Taking into consideration the relatively low share of products of higher complexity degree and the low position of domestic sectors in global value chains, the initial shock of supply in the Republic of Croatia to the great extent refers to the restrictions referring to business activities and labour force. Besides that, as a result of the described economic structure and along with the below-average share of occupations that support working from home, the Croatian economy as a whole is characterized by relatively pronounced vulnerability to epidemiological situation. The recession that started in the domestic economy has such effect primarily through the demand channel, both domestic and foreign ones. The activity in the large part of the economy has been suspended and all sectors have been affected, but to varying degrees. Since non-discretionary household consumption and activities with include social aspect primarily suffer, catering, retail trade, excluding retail trade of food products, real-estate sector, as well as the majority of the remaining service sector are considered especially affected. The suspension of travelling strongly affects the tourism sector (accommodation, catering, transport, but also the related micro industries) for which there is a special threat of extended duration of disturbance and recovery. Under the conditions of the expected decline in the foreign trade, domestic agricultural producers, backed up by economic measures for the agriculture sector as well as by the logistic assistance, should not suffer from the significant demand reductions. Together with the domestic food industry, they have been facing the intensified demand for essential food consumer goods, particularly in the beginning phase of the epidemiological "lock-down" measures. Many industries significant for the Croatian economy are facing the substantial decrease in demand, especially manufacturing of wood , textiles, clothing and footwear. When demand enters the normalization phase, the disturbances of certain supply chains linked with the Croatian export products might become evident. We should also mention here the so-called "demand creation" during the beginning phase of the business operation suspension, whereby the domestic economy has shown certain adaptability (particularly courier delivery services, online trade, drive-in market, etc.). It is certain that the crisis will have an impact on the changes in consumers' behavior in the direction of the increase in the savings rate, especially in the short-term, which is unfavourable for Croatia, taking into account the tertiary structure of economy. In relation to the business sector, the reduced inclination towards investment and new employment is also expected in the short term.

Considering the decline in all components of the domestic demand on the side of the private sector, as well as in the foreign demand, and taking into consideration the relatively unfavourable domestic economic structure, the expected trajectory of the recovery (described below in the document), as well as the medium-term Croatian economic outlook, are based on the provided fast and strong economic support to the private sector and on the fast and successful easing of the epidemiological measures. Both groups of measures are giving results for now. The support provided to the private sector refers primarily to the fiscal support, and then to the broader financial aid, but also to the legislative and logistic solutions aiming at, at the first place, the sectors of micro and small enterprises and threatened households, and they try to effectively enable the "freezing" of the economy along with the least possible permanent loss of output. This primarily refers to overcoming liquidity disturbances as well as to the prevention of problems with solvency of otherwise healthy and potentially productive economic entities and limiting the decline in employment (along with the use of other measures on the side of the supply directed towards the preservation of job positions such as shortening of working hours, work organized in shifts, etc.). Taking into account the balance sheet indicators of the Croatian business sector, first of all the relatively low indicators of liquidity and high indicators of indebtedness, the already mentioned support to the liquidity in the economy through open channels of the banking sector, use of guarantee funds, re-programmes and debt moratoriums represent an extremely important part of the strategy of macroeconomic assistance in the short term. Regarding the household sector, it is crucial that the measures are designed in such a way so that final effects target the segments with the highest marginal propensity to consume. The Croatian economic measures, taking into account the relative size of the economy as well as other objective limitations of the Croatian state and financial sector, are comparable with all published international packages (those from the group of more robust ones), which was possible due to the creation of the fiscal space during previous years. Besides, according to the so-far available data and analyses, the measures are achieving the expected results.

3. MEASURES TO ASSIST THE ECONOMY DUE TO COVID-19 PANDEMIC

The COVID-19 pandemic has an exceptionally negative healthcare, social and economic impact at the global level and in the Republic of Croatia, whereby in the short term the potential healthcare and economic effects are opposed. As of March 2020, at the level of the whole Republic of Croatia, there are epidemiological measures being implemented, including social isolation measures with very unfavourable impact on the economic activity which has been reduced or suspended in almost all areas, except those essential for the functioning of the society. In the first phase, key efforts were primarily directed towards the halting of the spread of the Coronavirus and the prevention of unsustainable pressures on the public healthcare system. Furthermore, on March 22, 2020, Zagreb was hit by the strongest earthquake in the last 140 years causing large infrastructural damages and additional pressure on the functioning of public services. The urgent response to the challenges of the pandemic as well as to the reduced economic activity, has also led to strong challenges for the fiscal policy and, until then, positive fiscal indicators.

Since it became certain that the COVID-19 pandemic has a very negative impact on the economic activity, on March 17, 2020 and then on April 2, 2020, the Government of the Republic of Croatia adopted two comprehensive and targeted packages of economic measures. The goal thereof was primarily to help the private sector as the bearer of the economic activity to as successfully as possible overcome the crisis through the job preservation, payment of salaries, i.e. to solve the non-liquidity problems of those the business activity of which has been reduced. In addition, the aim was to safeguard the income of the most vulnerable groups of population and to set the foundations for the quick economic recovery. In this context, the horizontal measures were adopted for assisting the economy and population, as well as a series of measures directed towards the mitigating of negative consequences in individual sectors. The Government of the Republic of Croatia continues to diligently monitor the trends in the economy and will, if necessary, suggest the adoption of new measures.

3.1. Horizontal Measures

Postponement and write-off of direct taxes and contributions for entrepreneurs facing difficulties in their business operations

Pursuant to the Amendments to the General Tax Act[1] and the Ordinance on the Amendments to the Ordinance on the Implementation of the General Tax Act[2], the entrepreneurs that have had or have estimated they will have decline in their revenues higher than 20%, are allowed the interest-free postponement of direct taxes and contributions and payment thereof in instalments. In addition, this

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[1] Official Gazette, numbers: 115/2016, 106/2018, 121/2019, 32/2020 and 42/2020

[2] Official Gazette, number: 35/2020

measure was strengthened by the April package of economic measures within which the entrepreneurs with the annual revenue less than HRK 7.5 million (which account for 93%), with the decline in revenues higher than 50%, will be fully exempt from paying public levies that are due during April, May and June 2020. In the same period, the companies that realize the revenue higher than HRK 7.5 million, with the decline in revenues higher than 50%, will be partially exempt from paying these levies depending on the decline in revenues. Furthermore, the possibility of paying VAT upon invoices that have been paid and invoices the payment of which has been collected has also been introduced, with an aim of ensuring additional liquidity of economic operators.

Subsidies for the job preservation

In order to preserve jobs in the most vulnerable sectors affected by Coronavirus, the subsidy measure by which the cost of salary in the amount of HRK 3,250 per an employee was adopted for March, while that amount was increased for April and May to HRK 4,000, whereby the cost of contributions for pension and health insurance will be borne by the state budget. Currently, about 84 thousand employers are encompassed by this measure for 485 thousand job positions. Furthermore, the conditions for the use of the "permanent seasonal worker" measure were changed in a way that the time of the extended pension insurance and the rights to financial aid are extended for the time of the duration of these exceptional circumstances conditioned by this crisis. This measure is available to the employers from the industries that during the year have periods of the reduced scope of work due to the seasonal character of their business operations, and it is mostly used in the tourism and catering sectors.

Measure directed towards micro, small and medium-sized entrepreneurs

These measures are financed with the support from ESIF funds, carried out by HAMAG-BICRO. Thus, the allocation for the financial instrument ESIF Micro loans for working capital is increased, while interest rates to investment loans are reduced and the maximum guarantee rate for ESIF individual guarantees for loans for working capital is increased from 65% to 80% of the loan principal. The moratorium to all instalments of ESIF loans and loans for agriculture and rural development was also introduced until December 31, 2020, as well as the extension of the repayment/deadline for the use of loans for which the guarantee has been issued. In addition, new financial instruments are being established. The first one is Covid-19 loan for working capital. This programme provides additional liquidity of micro, small and medium-sized entities to the business operations of which the Coronavirus has had a negative impact. The amounts of the loan are up to HRK 750,000 for working capital, with the interest rate of 0.25%, grace period of up to 12 months and maximum repayment deadline of 5 years, with the shortened procedure of the application processing. The second one is Micro loan for rural development. It is intended for working capital for entities in agricultural, manufacturing and forestry sectors. The amounts of the loans are between EUR 1,000 and 25,000. The deadline of the repayment is up to 3 years with the interest rate of 0.5% and grace period of up to 12 months.

Loans of the Croatian Bank for Reconstruction and Development (HBOR) and commercial banks

The entrepreneurs that were approved the loan directly from HBOR or via a commercial bank have the possibility of moratorium in the duration of three months to liabilities due after February 29, 2020, with an option of the extension thereof. Furthermore, the users of HBOR loans are provided with the possibility of reprogramming of the existing loan liabilities along with the introduction of the grace period within the repayment of the loan principal. In addition, HBOR will, in cooperation with commercial banks, approve to the entrepreneurs new loans for liquidity by favourable interest rates, while the funds will be intended for the financing of basic operating costs (so-called, overhead expenses). Two new HBOR programmes for the support to the economy are also approved by the EC. The first programme will be used for financing of the liquidity of exporters through the insurance policies, while the total credit potential amounts to HRK 6 billion. The second programme is based on the instruments of more favourable HBOR loans with the subsidies for interests provided by the state, and it will be carried out via three basic models: framework loans to banks, whereby the state funds will be placed via HBOR along with the zero percent of interest rate of the half of the total interest rate, while the second half will account for interest rate of banks that will be limited in its highest amount, loans in cooperation with banks according to the risk-sharing model, and direct HBOR loans to entrepreneurs. Total credit potential for this measure is estimated at HRK 7.6 billion. In addition, commercial banks have adopted a series of measures that will provide entrepreneurs and citizens with the right to moratorium, re-programme to the payment of loan liabilities, but also new loans for liquidity and working capital.

Functioning of the public finance system and of sustainability of public services financing

A series of measures has also been adopted the aim of which is, along with the reactivation of the economy and the protection of vulnerable layers of society, to facilitate the functioning of the public finance system and of the sustainability of public services financing. Therefore, the Act on the Execution of State Budget for 2020 was amended in a way that it allows additional borrowing of the state as well as additional borrowing of extra-budgetary users even above previously established limits, with the consent of the Government of the Republic of Croatia. Furthermore, since due to the different dynamics of the inflow of funds and maturity of liabilities, the revenues of local and regional self-government units, Croatian Health Insurance Fund and Croatian Pension Insurance Institute will be reduced, the Republic of Croatia will provide the funds of interest-free loan for bridging such situation. This interest-free loan may be disbursed up to the level of income tax, surtax to income tax and contributions the payment of which is exempt or postponed, i.e. up to the level of the executed return.

As a consequence of the occurrence of exceptional circumstances that are recognized by the provisions of the Fiscal Responsibility Act and the Stability and Growth Pact, the Decision on the temporary postponement of the application of fiscal rules, i.e. of the structural balance rule, expenditure rule and debt rule, was adopted. In the period in which fiscal rules are not going to be applied, temporary and short-term deviation from the medium-term budgetary objective is made possible, for the purpose of faster solving of the consequences of the epidemic. This will enable the implementation of measures that will be directed towards the removal of healthcare, social, economic and other consequences of this epidemic.

With an aim of optimal using of the limited fiscal space, the Government of the Republic of Croatia adopted the Decision on the restriction of the usage of funds planned by the State Budget of the Republic of Croatia and financial plans of extra-budgetary users of the state budget for 2020. This Decision rationalizes the public procurement procedures, giving of donations and grants and limits the employment in the public sector, whereby the funds for financing the measures and activities in fighting the epidemic are provided.

Furthermore, the conclusion was adopted which limits the expenses of budgetary and extra-budgetary users of the state budget as a consequence of the change in economic circumstances. In this context, the negotiations with social partners were initiated on the topic of the level of the basis for the calculation of salaries of civil servants and other civil employees and of those working in the public services for 2020, as well as the negotiations on the payment of certain material rights agreed upon by collective agreements and the rights linked with the increase in the coefficient of the complexity of job positions and supplements to basic salary. The guidelines for the rationalization of business operations of companies majority-owned by the state will also be prepared. Local and regional self-government units will also carry out the measures from within this conclusion in an appropriate way.

Pursuant to the Amendments to the Accounting Act, the deadline for the submission of financial statements for 2019 was also extended from April 30, 2020 to June 30, 2020. The entrepreneurs are also exempt from paying the fee to the Financial Agency for the publication of financial statements.

The Amendments to the Act on the Implementation of the Enforcement of Monetary Funds provides the suspension of the implementation of the enforcement during the following three months, with an aim of providing the support to citizens whose accounts have been blocked. During this time period no default interests on the due liabilities will be accrued.

The Draft Act on the Intervention Measures in the Enforcement and Bankruptcy Procedures During the Exceptional Circumstances was forwarded to the Parliament procedure. Its purpose is to facilitate the situation for citizens who have the enforcement imposed on their salaries or pensions or other permanent financial income as well as the position of economic entities facing the bankruptcy, and of users of grants for the implementation of projects.

3.2. Sector Measures

A series of measures was also adopted directed towards the mitigation of negative consequences in individual sectors that are particularly threatened by Coronavirus epidemic. In the **agriculture sector,** there are measures being carried out that are directed towards the provision of liquidity, i.e. of the existing level of the employment of farmers, fishermen and wood-processing sector worth approximately HRK 400 million. Besides the provision of liquidity via EU funds for the affected sectors, additional measures were introduced referring to the postponement of due liabilities for the Croatian Forests for wood assortments, postponement of payment of rent and concession fees for agricultural land and for the fishery sector. The national online platform has also been introduced –

digital market where it will be possible to buy and sell local agricultural and food products among farmers and purchasers. The decision on the extraordinary intervention purchase of the surplus of milk from small dairy farms was also adopted. In addition, the decision on the Programme of the support to primary agricultural producers in the sectors of plant production and livestock farming in 2020 worth HRK 53 million was adopted.

In the **tourism sector**, the postponement or exemption from paying the tourist board membership fee for economic operators and private renters was provided as well as the postponement or exemption from paying tourist fee for private renters (flat-rate tax). Furthermore, the support for programmes of financing working capital and improvement of liquidity of affected entrepreneurs in tourism was also provided, while special attention was given to small hotels. The Amendments to the Act on the Provision of Services in Tourism[3] introduced the moratorium on the termination of the contract for tourist agency packages in the duration of 180 days after the end of these special circumstances, whereby the possibility of the return of money for non-used travel package is also given. The amendments to the regulations linked with the concessions, on the tourist land in camping sites co-owned by the Republic of Croatia, the variable part of the concession fee for such land will not be charged.

By establishing the crisis fund, the subsidies to the liquidity in the **culture sector** are provided in the amount of HRK 70 million – to independent artists, self-employed and other natural and legal persons that are left without any revenue due to the restrictions of gatherings and closing-down of theatres, cinemas, museums, concert halls. Via this crisis fund, the funds will also be disbursed to natural and legal persons in the area of culture for the extended period of preparatory activities for approved projects in culture the realization of which is postponed until further notice due to the epidemic. In addition, the Amendments to the Act on the Protection and Preservation of Culture Goods[4] allow the suspension of payment of monument annuity during the course of special circumstances in the Republic of Croatia caused by the Coronavirus epidemic.

3.3. Measures for Initiating Economic and Other Industries and Activities under the Conditions of Declared COVID-19 Pandemic

Under the conditions of the acceptable epidemiological situation, it has been estimated that the assumptions for reactivating the part of economic and social industries and activities in the Republic of Croatia have been created and they will be carried out in three phases, along with the adherence to the special epidemiological measures. In the first phase that started on April 27, 2020, the opening of all business entities that perform the trade activity, except those operating within the shopping malls, public city and inter-city transport within the county, part of service activities and physical trainings, were enabled. The second phase that is scheduled as of May 4, 2020, involves full work load organization of the healthcare system and of the remaining service activities. The third phase

[3] Official Gazette, numbers: 130/2017, 25/2019, 98/2019 and 42/2020

[4] Official Gazette, numbers: 69/1999, 151/2003, 157/2003, 100/2004, 87/2009, 88/2010, 61/2011, 25/2012, 136/2012, 157/2013, 152/2014, 98/2015, 44/2017, 90/2018 and 32/2020

anticipated to start as of May 11, 2020, introduces the start of work for shopping malls, catering facilities, national parks and nature parks, kindergartens, elementary one-teacher school education and gatherings of up to 10 people in one place. All three phases assume the application and strict adherence to all prescribed epidemiological measures.

4. MACROECONOMIC TRENDS

4.1. Macroeconomic Projections

The macroeconomic framework described in this document was drafted in April of this year[5]. The external assumptions for the preparation of macroeconomic projections are taken from the latest projections of the International Monetary Fund[6] and EC[7].

According to the latest projections of international institutions, as a consequence of the global Coronavirus epidemic, in 2020 a significant worsening of the global economic trends is expected. Thus, after the growth of 2.9% in 2019, in 2020 the global economy decline of 3.0% is expected and then the recovery of 5.8 in 2021. A particularly strong decline in the economic activity in 2020 of 7.1% is expected in the economy of EU, followed by a recovery at the rate of 4.8% in 2021. In addition a strong decline in global trade of 11.0% is expected in 2020, followed by the growth of 8.4% in 2021. The average exchange rate of euro against the US dollar is expected to amount to 1.09 USD/EUR in 2020 and in 2021. Regarding the commodity prices on the global market, it is expected that the oil price will register strong decrease in 2020 and a slight recovery in 2021, while the commodity prices excluding oil are expected to slightly decrease in both forecast years.

[5] Based on the data available by April 24, 2020
[6] World Economic Outlook, April 2020.
[7] Spring 2020 forecast assumptions.

Table 4.1: Projection of Gross Domestic Product for Croatia

	2019	2020 projection	2021 projection
GDP - real growth (%)	**2.9**	**-9.4**	**6.1**
Personal consumption	3.5	-7.0	5.8
Government consumption	3.3	2.7	2.5
Gross fixed capital formation	7.1	-9.0	5.6
Exports of goods and services	4.6	-30.0	32.5
Imports of goods and services	4.8	-23.4	27.6
Contribution to real GDP growth (percentage points)	**2.9**	**-9.4**	**6.1**
Final domestic demand	4.1	-5.3	5.2
Changes in inventories	-1.0	-0.9	0.1
External balance of goods and services	-0.1	-3.3	0.8
Contribution to real GDP growth (percentage points)	**2.9**	**-9.4**	**6.1**
Personal consumption	2.0	-4.0	3.5
Government consumption	0.7	0.5	0.6
Gross fixed capital formation	1.4	-1.9	1.2
Exports of goods and services	2.3	-15.4	12.4
Imports of goods and services	-2.5	12.1	-11.6

Note: Data for 2019 are preliminary.

Source: Croatian Bureau of Statistics, Ministry of Finance

By observing the quarterly dynamics of GDP in the Croatian economy, although the domestic business sector has started incorporating the altered expectations already in February, and households during the first half of March, and in spite of the strong expected slow-down of the consumption and the decline in the export of services, in the first quarter of 2020 GDP could retain positive quarterly increase (seasonally adjusted). The fundamental assumption which this document is based on is that the main impact on domestic, but also global, economy will be of short-term nature, and the most pronounced in the first half of the second quarter. Thus, the economic activity according to the scenario incorporated in this document, will reach the bottom in the second quarter, whereby in the majority of sectors, already by the end of the second quarter, there will be changes in trends and the beginning of gradual recovery, which will start by the initial more pronounced jump in activity, accompanied by easing the epidemiological measures in phases. Furthermore, the recovery according to this scenario will not have the ideal V-shape, i.e. it is expected that there will be certain permanent losses of output and that some time period will be needed until the economy returns to the pre-crisis level. The trajectory of the economic activity still has a V-shape, particularly due to relatively strong initial jump in recovery that compensates for a large part of the initial shock. However, the right side of the letter V has been, after that initial jump in recovery, extended until 2022. We would like to point out that the strongest year-on-year GDP decrease in Croatia in 2020 is not expected in the second but in the third quarter, which covers the majority of the tourist season, since tourism and transport are among the most affected sectors in this crisis. It is certain that the year-on-year rate of decrease in the second and the third quarter of 2020 will be twice as high compared to the ones from 2009. The gradual recovery will, after the second half of 2020, be extended to the whole 2021. In general, reaching the pre-crisis level of activity (from the end of 2019 and the beginning of 2020) is not anticipated until 2022 and in certain sectors even later.

In accordance with the aforementioned, in 2020 the decline in GDP is expected of 9.4%, which will then be followed by a relatively strong recovery of 6.1% in 2021. In terms of the projections of the expenditure components of GDP, under the influence of the described trends, the personal consumption will fall sharply in the second quarter, and will be recovering until the end of the projection period. We would like to emphasize that a pronounced jump in recovery is expected in May and June, which will, to the great extent, compensate for the initial decline in personal consumption from March and April. However, the recovery in the remaining of the projection period will be relatively slow and extended, under the influence of the anemic trends in the disposable household income and deteriorated consumers' confidence the fast recovery of which is, however, not certain. All components of the investment activity except the construction sector were slowing down strongly in 2019 and will, under the influence of the COVID-19 crisis, register a strong decline at the end of the first and the beginning of the second quarter. Current cycle of strong construction activity, including large infrastructure projects, will continue at the beginning of the second quarter, taking into consideration the time lag characteristic for this activity, but also the priority of the continuation of large projects. In addition, the dynamics of the investments in the government sector will be shifted towards the end of 2020. The gross fixed capital formation, as well as the personal consumption, will not reach its pre-crisis level until 2022, whereby the investments will experience a more pronounced decline in 2020, while the recovery will be further postponed. The government consumption will not significantly change its short-term trajectory since the increased consumption linked to the COVID-19 crisis and weaker dynamics of the market output will be replaced by numerous savings of less productive expenses within the framework of the intermediary consumption, as well as by weaker increase in the compensations of employees in comparison to previous expectations. In 2020, exports of goods will realize somewhat stronger decline than the fixed capital formation, with a much stronger initial decline in the second quarter, but will also experience a faster recovery. However, we would like to highlight here that the economic activity of the main Croatian trade partners, after a strong decline in the second quarter, is exposed to a significant level of uncertainty in the third quarter. In spite of the somewhat faster recovery throughout the whole projection period, exports of goods will also not reach their pre-crisis level until 2022 and will be limited by a weak growth in foreign demand and by generally subdued dynamics of global goods trade. In 2020, the biggest decrease among all components from the expenditure side will be registered by exports of services which will be almost halved under the influence of the decline in the tourist activity. This projection also contains the assumption of the decrease in the foreign tourists' overnight stays, somewhat weaker than 70% (at the level of the whole year), due to all latest specific activities directed towards the increase in the number of tourists' arrivals in 2020, but also to a favourable epidemiological outlook. Besides, a slight decline in the average consumption per tourist is expected as well. The export of services is the only component of GDP that will probably not reach its pre-crisis level even in 2022. The trends in imports of goods and services will follow the decline in final consumption, whereby the components of demand with the most pronounced total (direct and indirect) share of the import component will register the biggest declines in 2020. The high import dependency still limits more favourable realization of net foreign demand under the present recession circumstances.

Table 4.2: Price Developments

	2019	2020 projection	2021 projection
GDP deflator, change (%)	**1.5**	**0.1**	**1.1**
Personal consumption	0.8	-0.3	0.9
Government consumption	2.1	0.7	1.8
Gross fixed capital formation	0.7	-0.3	0.8
Exports of goods and services	1.2	-3.6	2.0
Imports of goods and services	0.4	-3.7	1.9
Consumer price index, change (%)	**0.8**	**-0.3**	**0.9**

Note: Data for 2019 are preliminary

Source: Croatian Bureau of Statistics, Ministry of Finance

It is anticipated that after the increase of 0.8% in 2019, the consumer prices in 2020 will register a slight decrease of 0.3% at year-on-year level. The main determinants of consumer prices in 2020 will be a substantial fall in oil prices on the world market[8], strong decline in domestic demand and slow-down of the inflation in the euro area. The effect of the fall in oil prices on the world market on domestic consumer price index will be mitigated by the depreciation of kuna to US dollar exchange rate. The increase in excise duties on tobacco products and alcoholic beverages, as well as in a special tax on non-alcoholic beverages from April this year, will record a positive contribution to inflation in 2020, in the amount of 0.2 percentage points. As a consequence, the pronounced decline in the energy prices is expected in 2020, as well as the stagnation of consumer prices without energy, food, beverages and tobacco, while the positive contribution to the consumer price trend will come from the increase in the prices of food, beverages and tobacco. In 2021, the inflation of the consumer prices is expected at the level of 0.9% as a consequence of the recovery of domestic demand, under the conditions of a mild increase in commodity prices on global markets, and of the stronger, although still subdued, inflation in the euro area.

After an increase of 1.5% in 2019, the increase in the GDP deflator is expected to significantly slow-down in 2020 to the level of 0.1%, mostly as a consequence of the dynamics in the household consumption deflator trend which will, in line with consumer price trend, register a mild decrease in 2020. Sustainably slower increase in the government consumption deflator in comparison to the previous year will also contribute to the slow-down in the GDP deflator, first of all due to the negative correction of the increase in salaries at the level of the general government, as well as to the decrease in the investment deflator, where the stronger cyclical decrease is mitigated by the effect of the transfer from the end of 2019. Under the influence of a significant decrease in commodity prices on global markets, decrease in the global export demand and unfavourable developments in the tourism sector, a pronounced decline of the deflator of exports of goods and services is expected in 2020, as well as of the deflator of imports of goods and services, whereby the decrease of the imports deflator will be only slightly more pronounced in comparison to the exports deflator.

[8] According to the projections of the International Monetary Fund, in 2020 the fall in the price of oil, type Brent is expected at the level of 42.4, while in 2021, the increase thereof is expected at the level of 6.9%

Table 4.3: Labour Market Developments

	2019	2020 projection	2021 projection
Unemployment rate, level (%)	6.6	9.5	9.0
Employment, change (%) [1]	1.4	-3.3	1.5

[1] According to the definition of the domestic concept of national accounts
Source: Croatian Bureau of Statistics, Ministry of Finance

The first effects of the Coronavirus pandemic on the decrease in the employment can already be seen in the data on the insurers of the Croatian Pension Insurance Institute available for the end of March. In the following months the intensification of negative trends is expected, whereby the losses of employment will be concentrated in the second quarter and then followed by a gradual recovery. The more pronounced decrease in the number of employees will be present in a smaller number of sectors such as accommodation, catering and transport. The introduction of the Croatian Employment Bureau subsidy for the job preservation will significantly mitigate the influence of the shock on the employment, and in 2020 the fall in the number of the employed of 3.3% is expected. Furthermore, the first available data indicate that this measure has not initially had a pronounced impact on the trends in salaries either. As a consequence of all this, assuming that the crisis caused by the Coronavirus is temporary, as well as the described trajectory of economic activity, only moderate decrease in salaries is expected in 2020. The immigration inflow of the part of the Croatian nationals working abroad is expected in 2020, which will, together with exits from the employment, lead to the increase in the number of inactive and unemployed persons, with the survey unemployment rate in 2020 increasing to 9.5%. In 2021, a moderate recovery of the employment is expected as well as somewhat more pronounced recovery of gross salaries. As a consequence of the described trends in economic activity and employment, in 2020 there will be a somewhat more pronounced unit labour cost growth caused by a strong fall in the average productivity, while in 2021 a mild unit labour cost decrease is expected under the influence of the increase in average labour productivity.

High liquidity of the Croatian banking system and of other financial institutions (pension, insurance and investment funds), are essential for providing liquidity of the whole Croatian economy affected by the Coronavirus pandemic. Considering the large quantity of financial funds and quasi-fixed exchange rate regime, interest rates on the domestic financial market should remain at low levels as long as favourable financial conditions prevail in the international environment. It is expected that financial institutions will continue to provide credit to the economy and the general government to the extent that exposure limits will allow. Considering the character of the existing crisis and the stability and the capitalized position of the Croatian banking system, stronger shocks are not expected within the domestic financial system.

It is expected that the monetary policy of the Croatian National Bank (CNB), in the following period, will be focused on maintaining stable kuna to euro exchange rate. At the beginning of the crisis caused by the Coronavirus pandemic there were certain depreciation pressures on kuna exchange rate, to which the CNB reacted to by implementing several foreign exchange interventions. This pressure was not caused by economic fundamentals, but by aligning foreign exchange positions of banks due to the issuance of three new tranches of Croatian bonds on the domestic market, as well as the altered expectations on the foreign exchange inflows from tourism. Furthermore, the establishment of the currency swap has been agreed with the European Central Bank in the amount of EUR 2 billion, which will, if necessary, be used for the provision of additional euro liquidity to Croatian financial institutions.

4.2. Risks to Macroeconomic Projections

The described macroeconomic scenario is exposed to high and prevailingly negative risks. The first part of these risks are the ones arising from uncertainties linked with the duration and intensity of the Coronavirus epidemic, such as possible recurrence of epidemic, new unfavourable mutations and its sensitivity to high temperatures (which would be beneficial for Croatian tourism having a high seasonal feature), as well as linked with potential further epidemiological measures necessary for the prevention of the infection. Of course, the inventions of efficient medicines or faster development of vaccine, for the development of which it is expected that it will take between a year and year and a half, represent positive epidemiological risks.

The second group of risks refers to the economic sphere. First of all, in the short run, the assumed intensity of the initial jump in the recovery incorporated in the projections could be absent, it might turn out that a much larger part of output has been lost or, in the worst case scenario, that the potential growth is endangered to the greater extent and that the return to the pre-crisis trend is impossible in the short term. This also refers to both the global GDP and the Croatian one. The part of the risk for the Republic of Croatia is naturally linked to global risks via various channels of impact, starting from the flows of capital and financial conditions, then price developments, and foreign demand for domestic goods and services. The Coronavirus pandemic has exposed some vulnerabilities of the global economy, amplified some unfavourable occurrences or negative risks. First of all, the crisis caused due to the pandemic has significantly strengthened global risk aversion, financial investors turn to maximum safe and liquid asset which increases a broad spectre of balance-of-sheet risks. Thus, although the expectations that economic disturbances in the real sector should not lead to the crisis in the financial sector (generally characterized by stronger balance sheets in relation to the situation before 2008) still prevail, the risk linked to the vulnerabilities of the global markets of corporate debt is significantly increased, taking into account the indicators of indebtedness of non-financial enterprises, but also the overestimation of bonds. More precisely, after a decade of record growth in almost all forms of private debt, in comparison with the situation before the 2008 crisis, today's debt is characterized by lower average quality, longer maturity, higher repayment amounts and lower degree of contractual protection. In addition, the Coronavirus pandemic has induced the outflow of capital from certain developing countries, while at the same time even some developed countries are facing debt sustainability problems which might result in the deterioration of favourable financing conditions, and the cycle of more pronounced settlement of debt followed by the correction of the economic activity. Besides, all medium-term risks on the supply side which were present before the beginning of the pandemic, mostly of geopolitical nature linked to the dynamics of global trade in goods that even before the pandemic had an exceptionally low growth, are additionally increased to the great extent.

Negative risks linked to the specificities of the domestic economy structure are especially pronounced in the tourism sector. The development of tourist indicators in the summer months will be conditioned by both the epidemiological situation and the measures in the Republic of Croatia and in the main emissive markets. In addition, on one hand it will depend on the coordination with the main emissive markets, special arrangements, activities of advertisement, etc. Besides exports of services, exports of goods are also exposed to the prevailingly negative risks, partly linked with the global risks through the impact on the foreign demand, and partly with the structural weaknesses of the domestic export of goods in terms of a high share of slowly-growing export markets and production niches, products of low added value, as well as consequently relatively strong dependence on the price competitiveness.

The main risks that could cause a different realization of the inflation rate than the forecast one are linked with different trend in the price of oil and other primary commodities on the world market than currently expected, more pronounced influence of the demand shock on the decline in prices, while the disturbances in supply chain due to epidemic could lead to a stronger increase in prices of certain products. The shortages of labour force in the agriculture sector due to the restrictions in migration because of epidemic could have an impact on the increase in agricultural products in EU.

Since currently a limited amount of data is available, that show only initial impacts of the Coronavirus epidemic on the economy, the estimation of its economic effects in 2020 and 2021 is subject to significant uncertainty and in this moment it is hard to estimate more precisely the implications of the Coronavirus epidemic on the consumers and economic agents' behavior and confidence.

5. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT

5.1. Fiscal Policy

In the last four years, there were significant efforts made in the area of consolidation of public finance. After exiting the excessive deficit procedure in June 2017, in the following three years the Republic of Croatia registers a surplus and strong reduction in the public debt share in GDP for more than 11 percentage points in relation to the end of 2015. Such fiscal results also had an impact on the reduction in the expense for interests in the amount of HRK 2.8 billion. This created the fiscal space for fast and strong fiscal support for the maintenance of employment and the whole economic activity as a response to the crisis caused by the Coronavirus pandemic. Besides, positive fiscal results enabled the Republic of Croatia to get back to the investment credit rating and at the same time were a precondition for the acceleration of the process of the accession of the Republic of Croatia to the European exchange rate mechanism (ERM II).

5.2. Budget Implementation in 2019

In 2019, total general government budget revenue register the level of 47.5% of GDP as a result of positive macroeconomic developments, effects of the tax reform from 2018 and 2019, strengthened absorption of resources from EU funds.

Taxes on production and imports amounted to 20.3% of GDP and registered a year-on-year increase of 6%. Within their structure, the largest revenue is the value added tax which was by 6.8% higher than in the previous year. The collected revenues from VAT are the result of the increased personal consumption due to the growth of disposable income of households, supported by favourable labour market trends and a successful tourist season.

The revenues from social contributions also register a significant increase of 3.2%, which in 2019 amounted to 11.8% of GDP, as a result of favourable labour market trends. Current income and wealth taxes, which include personal and corporate income tax, are up 7.6% due to the aforementioned positive trends in the labour market and good results of businesses operations of enterprises and banks. In addition to tax revenues, there are also significant revenues from other current and capital transfers, including resources from EU funds, and in 2019 they amounted to 3.3% of GDP, whereby the revenues from EU funds register an increase by 64.2% at the annual level.

Total expenditure of the general government budget were executed at the level of 47.1% of GDP in 2019.

Compensations of employees register the level of 11.9% of GDP. In relation to the previous year they register an increase of 5.2%. This increase is the result of the increase in the basis for the calculation of salaries of 5% for public and civil servants based on collective agreements (3% as of January and 2% as of September 2019), corrections for years of service by 0.5%, and the effect of the change of sector collective agreements in certain public service activities. In addition, these expenditures also include increased allocations for the purpose of the presidency of the Republic of Croatia of the EU Council that the Republic of Croatia took over as of January 1, 2020, and for which a certain number of employees were already in 2019 assigned to the Permanent Representation of the Republic of Croatia in Brussels.

Intermediate consumption expenditure were realized at the level of 8.3% of GDP. This category includes material expenditures of all units of the general government sector, including, *inter alia*, the costs of healthcare institutions for medicines and medical and sanitary materials. Major allocations were also registered on expenditures on materials and energy and on expenditures for services.

Expenditure for subsidies registers the level of 1.6% of GDP. The significant part of subsidies of 0.7% of GDP refers to subsidies of the Croatian Energy Market Operator ltd. (hereinafter referred to as: HROTE) for producers of energy from renewable sources, which are funded from the fee for stimulating electrical energy from renewable sources. This category also includes subsidies for direct payment in agriculture and measures for the arrangement of the agricultural products market, allocations for the implementation of concession contracts, stimulation of maritime and air passenger transport, and allocations for the labour market active policy programme.

Expenditure for the property income, that are determined by the trends in the expenditure for interests, were executed with the share of 2.2% of GDP, and in relation to the previous year they decreased by 0.1 percentage points of GDP. Such trends are the result of the continuation of the responsible fiscal policy management, followed by active policy of public debt management, which had an impact on the reduction in the public debt servicing costs.

Social benefits and social transfers represent the most significant category of total general government expenditure and record the level of 15.6% of GDP. These expenditures are, to the greatest extent, determined by the trends in expenditure for pensions, expenditure for prescription medications, maternity benefits, social welfare benefits, child allowance and unemployment benefits. Expenditure for pensions and retirement benefits were realized at the level of 10.2% of GDP, which is primarily the result of the adjustment of pensions realized under the general regulations and special regulations as of January 2019 by 1.15% and as of 1 July 2019 by 2.44%. Allocations for child allowance amount to 0.3% of GDP, maternity benefits were realized at the level of 0.7% of GDP, while unemployment benefits were realized at the level of 0.2% of GDP. Social welfare benefits were realized at the level of 0.6% of GDP. This group also includes, along with guaranteed minimum benefit, the implementation of the Act on the Amendments to the Social Care[9], pursuant to which the amount of personal disability allowance and allowance for help and care was increased. In addition, through the implementation of the Act on the Amendments to the Housing Loan Subsidies Act[10], the subsidizing of loans for the purchase of a flat or a house, i.e. for the house construction, was enabled.

Other expenditure, mostly related to current and capital transfers, were realized at the level of 3.2% of GDP. They mostly refer to the activities financed from EU funds as well as the payment of own contribution of the Republic of Croatia to the EU budget. The expenditure for the implementation of

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[9] Official Gazette, numbers: 157/2013, 152/2014, 99/2015, 52/2016, 16/2017 and 130/2017

[10] Official Gazette, number: 61/2018

electoral activities were also realized within this category, of which the most significant ones are the elections for the European Parliament and the election for the president of the Republic of Croatia. In addition, a one-off expense in the name of protested guarantees for the Uljanik Group was also included in the category of capital transfers, in the amount of HRK 2 billion, i.e. 0.5% of GDP, paid during 2019. Furthermore, the financing of the first phase of the project of the floating terminal for liquefied natural gas on the island of Krk was executed in the amount of 0.1% of GDP.

Gross fixed capital formation expenditure registers the level of 4.3% of GDP, and the year-on-year increase of 27.6%. This category of expenditure refers to the funds spent on the construction of road, utility and railway infrastructure, whereby the significant part was financed with resources from EU funds.

As a consequence of the realized revenues and executed expenditures, the general government budget in 2019 registered a surplus of HRK 1.6 billion or 0.4% of GDP.

5.3. General Government Budget in 2020

Before the outbreak of the Coronavirus pandemic, the fiscal policy of the Government of the Republic of Croatia, primarily oriented towards the economic growth, was focused on further strengthening of fiscal sustainability which is reflected in the realization of budget surpluses and strong decrease in the share of public debt in GDP. Such policy creates fiscal space for tax unburdening of citizens and entrepreneurs, which is, along with the improvement of the structure and efficiency of public expenditures, an additional stimulus for strengthening the economic growth. Becoming aware that the Coronavirus pandemic will lead to the significant negative social-economic consequences, the Government of the Republic of Croatia used the created fiscal space to provide fast and strong fiscal support for maintaining the employment and the entire economic activity.

In this context, we would like to repeat, two packages of measures were adopted, intended, primarily, for the aids to the economy and citizens, along with a series of measures directed towards the mitigation of negative consequences in individual sectors. Thus, entrepreneurs having a decline in their profits higher than 20% or having estimated that they will have such a decline, were provided, by the amendments to tax regulations, with a possibility of interest-free postponement and instalment payment of direct taxes and contributions. In addition, the April package of economic measures strengthened this measure and thus the entrepreneurs with an annual revenue of less than HRK 7.5 million (accounting for 93%), having a decline in their revenue higher than 50%, will be completely exempt from paying direct taxes and contributions that are due in April, May and June 2020. In the same period, the companies realizing the revenue higher than HRK 7.5 million, having a decline in their revenue higher than 50%, will be partially exempt from paying these levies depending on the decline in revenues. Currently, the tax liability has been postponed for almost 70 thousand taxpayers in the amount of HRK 1.4 billion. The largest part of the postponed tax liability refers to pension insurance (42%), health insurance (30%) and the income tax (15%). Furthermore, the possibility of paying VAT upon invoices that have been paid and invoices the payment of which has been collected has also been introduced, with an aim of providing additional liquidity of economic operators.

In order to preserve jobs in the most vulnerable sectors affected by the Coronavirus, the subsidy measure was adopted with which the cost of salary is financed in the amount of HRK 3,250 per employee in March, while the amount for April and May is increased to HRK 4,000, and the cost of the contributions for pension and health insurance will be borne by the state budget. Currently, there are 84 thousand employers covered by this measure for 485 thousand job positions.

In addition, besides direct budget subsidies through the postponement or write-off of public levies or through subsidies for the job preservation, there are over HRK 15 billion provided for as favourable as possible crediting of entrepreneurs through HBOR and HAMAG BICRO programmes.

Table 5.1: Fiscal effects of the most significant measures due to the Coronavirus pandemic in 2020

List of measures	ESA category	Adoption Status	Fiscal effect, % of GDP	Fiscal effect, HRK 000
1. Deferral of direct taxes and contributions				
personal income tax	D.5R	adopted	0.1	450,000
pension insurance contributions	D.61R	adopted	0.3	949,409
healhcare insurance contributions	D.61R	adopted	0.2	889,588
corporate income tax	D.5R	adopted	0.1	350,578
1. Writte-offs of direct taxes and contributions		**adopted**		
personal income tax	D.5R	adopted	0.1	450,000
pension insurance contributions	D.61R	adopted	0.3	949,409
healhcare insurance contributions	D.61R	adopted	0.2	889,588
corporate income tax	D.5R	adopted	0.1	233,719
3. Postponement of corporate income tax payments according to annual calculation for 2019 to July 31, 2020	**D.5R**	**adopted**	**0.6**	**2,000,000**
4. Subsidies to preserve employment	**D.3P**	**adopted**	**1.9**	**6,800,714**
	D.62P	**adopted**	**0.1**	**312,128**
5. Acquisition of medical and protective equipement for combating COVID-19	**P.2**	**implemented**	**0.2**	**600,000**
TOTAL			**4.1**	**14,875,132**

Source: Ministry of Finance

Consolidated General Government Revenues

In 2020, total general government budget revenues are planned at the level of 46.4% of GDP. They are based on the expected decline in economic activity due to the Coronavirus pandemic, tax policy measures implemented by the Government of the Republic of Croatia in order to provide support to the economy and citizens, and fiscal effects of the tax unburdening in 2019, having their full-year effect in 2020, as well as tax amendments in 2020. These amendments refer primarily to the tax unburdening within the system of VAT, personal income tax, corporate income tax, while some changes were also made in the system of excise duties.

Taxes on production and imports represent the most significant category of total revenue. They are projected at the level of 18.4% of GDP. Value-added tax revenue is projected in the amount of 12.1% of GDP based on previously described macroeconomic projections. Besides that, the effects of the decrease in the general VAT rate from 25% to 13% for the preparation and servicing of food within the catering activity have also been included in the calculation. Along with VAT, the expected revenues from excise duties, customs duties and other taxes on consumption are also included in the category of taxes on production and imports. Revenues from excise duties amount to 4.4% of GDP, and they include the expected decrease in the consumption of excise products, and the effects of changes in regulations within the excise system, first of all in excise duties on tobacco, alcohol and non-alcoholic beverages.

The second most significant group of general government budget revenues are social contributions, projected at a level of 12% of GDP. Their dynamics is determined by currently unfavourable trends in the labour market, but also by the estimated effects of the write-off of the contributions on pension and health insurance as one of the measures for assisting the economy.

Estimated revenue from current taxes on income and wealth will register the level of 6.1% of GDP. The personal income tax revenue is planned based on expected labour market trends, taking into account the effects of the adopted measure of the write-off of income tax as well as the increase in the basic personal deduction from HRK 3800 to 4000 as of January 1, 2020. Corporate income tax revenue is projected at the level of 1.7% of GDP, taking into account the expectations for the entrepreneurs' business operations in 2020 and the measures adopted by the Government of the Republic of Croatia in order to mitigate negative consequences for the economy.

The category of other current and capital transfers, that are projected at the level of 4.2% of GDP and are expected to increase by 13.3%, also includes the revenue from grants provided by the EU institutions and bodies, that are directly linked with the projects financed from the EU budget, but also with the resources allocated to the Republic of Croatia from EU funds within the framework of the support for financing the consequences of the Coronavirus. It should be pointed out here that the part of the resources will be redirected to the supply of the healthcare material and equipment, financing of the measure for the job preservation and ensuring the liquidity of entrepreneurs through HBOR-a and HAMAG BICRO programmes.

Consolidated General Government Expenditure

In 2020, total general government expenditure are planned at a level of 53.3% of GDP.

Compensations of employees are projected at the level of 13.3% of GDP as a result of the increased basis for the calculation of salaries in civil and public services since the beginning of 2020, increased coefficient and bonuses in certain civil and public services and the increase for the regular years of services. In addition, the projection of this category takes into account the Conclusion of the Government of the Republic of Croatia limiting the expenditures of budgetary and extra-budgetary users of the state budget due to the changes in economic circumstances.

Intermediate consumption expenditure are planned at the level of 9.5% of GDP. The increase in this category of expenditure is primarily a result of the increased allocations for medicines and consumables and sanitary material of healthcare institutions, but also of the supply of medical and protection equipment for the fight against the Coronavirus epidemic.

In 2020, expenditure for subsidies projected at the level of 3.5% of GDP. This category of expenditure also includes the subsidies to the entrepreneurs for the preservation of job positions in the amount of HRK 6.8 billion. Furthermore, a significant part of subsidies of 0.9% of GDP refers to the subsidies of the Croatian Energy Market Operator (*HROTE*) for the producers of energy from renewable sources, which are financed from the fee for stimulating electricity production from renewable sources. In addition, this category also includes the subsidies in agriculture that are financed from national funds, concession contracts, as well as subsidies for the promotion of maritime and air passenger transport.

Property income expenditure, which is largely determined by the trends in interest expenditure in line with the conditions on financial markets, i.e. the costs of public debt service, registers a level of 2.1% of GDP in 2020.

Social benefits and social transfers are planned at the level of 17.7% of GDP, whereby the expenditure for pensions and pension receipts account for 11.7% of GDP. The development thereof in 2020 is affected by the transferred cumulative effect of changes in the number and structure of pension beneficiaries and the adjustment of pensions. Maternity benefits are planned at the level of 0.8% of GDP, the allocations for child allowances amount to 0.4% of GDP, and unemployment benefits at the level of 0.3% of GDP. Social welfare benefits are planned at a level of 0.7% of GDP. The payment of contributions for the second pension pillar to the amounts of the subsidies for the job preservation is calculated in this category.

Other expenditure, mostly related to current and capital transfers, are planned at the level of 3.1% of GDP, and are largely determined by the payment of the own contribution of the Republic of Croatia to the EU budget as well as by activities financed from EU funds.

Gross fixed capital formation expenditure are planned at the level of 4.1% of GDP. Large part of investment is financed from EU funds, and the most significant projects are the continuation of the construction of the Pelješac Bridge and the construction of road, railway, water management and utility infrastructure.

Net Lending/Borrowing

Following the projected revenue and expenditure, the general government budget is expected to register a deficit of 6.8% of GDP in 2020, which is the result of the implementation of economic measures on both the revenue and the expenditure side of the budget. Besides, due to the unfavourable economic trends, a significant decline in the revenues from indirect taxes is expected, mostly from VAT and excise duties having a direct impact on the level of the budget deficit.

5.4. General Government Budget in 2021

In 2021, the decrease of the general government budget deficit is projected to 2.4% of GDP. The revenues increased in relation to the previous year have the largest impact on such development, that are at the first place determined on the basis of macroeconomic projections, continuation of the absorption of EU funds and the effect of fading of measures for assisting the economy. Total revenue are projected at the level of 47.8% of GDP. On the other hand, total expenditure are anticipated at the level of 50.2% of GDP, and they are mostly determined by compensations of employees in civil and public services, intermediate consumption, social benefits and transfers, subsidies, that do not include any more subsidies for the job preservation, expenses for property income, and increase in gross fixed capital formation, especially at extra-budgetary users and public companies. In 2021, the emphasis will be on the provision of a larger space for more productive expenditure that are necessary for strengthening long-term growth and productivity, which particularly refers to education, lifelong learning and properly directed effective public investments. At the same time, the strict control of the expenditure side of the budget will continue, and the entire revenue windfall will be used for the reduction of public debt. This will provide the conditions for the continuation of positive fiscal trends that were present until 2020.

5.5. Stock and Projection of Trends of Public Debt and Stock of Guarantees

Stock of Public Debt and Guarantees

According to the data of the Croatian National Bank, at the end of 2019 public debt amounted to HRK 293 billion, i.e. 73.2% of GDP. Total public debt at the end of 2019 was higher by HRK 6.7 billion in relation to the end of 2018, i.e. by 2.4%. This nominal increase in public debt is primarily the result of the increase in deposits of the central government units which, at the end of 2019, were increased by exactly the same HRK 6.9 billion at the year-on-year level. In addition, the nominal increase in public debt at the end of 2019 in relation to the end of 2018 was also caused by a mild depreciation of kuna exchange rate, whereby kuna exchange rate against euro amounted to 7.44258 on December 31, 2019, while on December 31, 2018 it amounted to 7.41758, representing a depreciation of 0.34%.

At the end of 2019, the share of public debt in GDP fell by 1.5 percentage points compared to the end of 2018. Such trends are the result of prudent fiscal policy and the continuation of positive fiscal trends, i.e. of the realized general government budget surplus in the amount of HRK 1.6 billion or 0.4% of GDP. In addition, in the environment of high liquidity and low interest rates, borrowing conditions in the domestic and international financial markets improved, which had an impact on the trends in the interest expenditure. The domestic component of public debt increased by 8.7% in relation to 2018 and amounted to HRK 197.2 billion, accounting for 67.3% of total public debt, while the foreign component recorded a decrease of 8.6% and amounted to HRK 95.8 billion or 32.7% of total public debt.

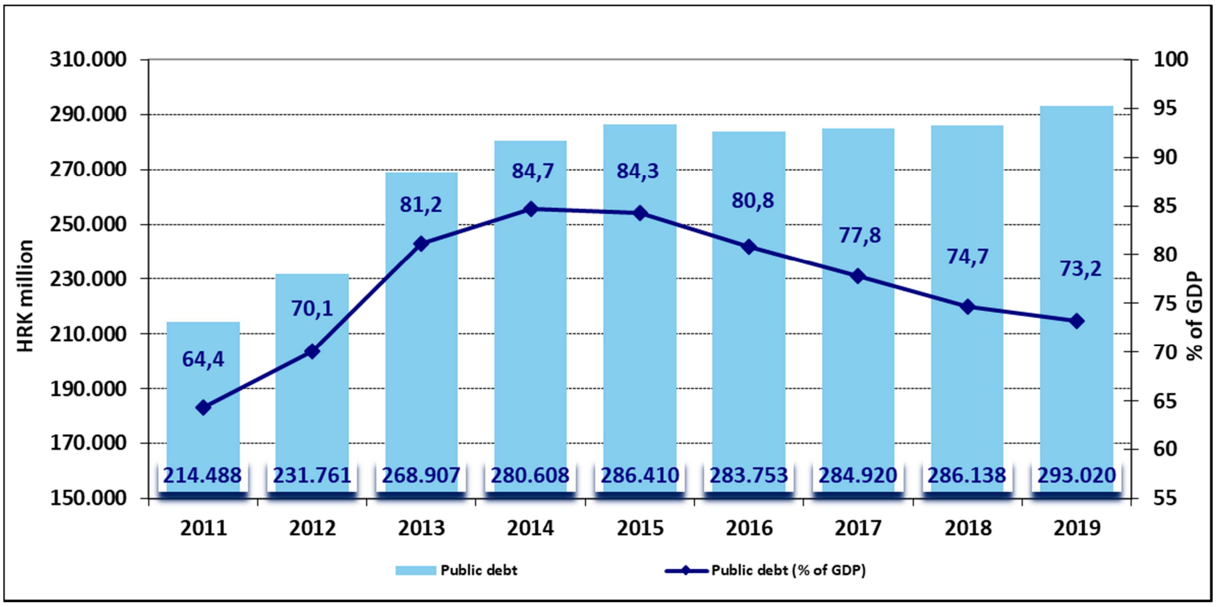
As observed according to the state government levels, the majority of public debt refers to the central government sector in the amount of HRK 286.7 billion, while the rest of the debt of HRK 7 billion refers to the local government sector and HRK 5.7 million to the debt of social security funds.

Regarding the borrowing mechanisms, the largest part of public debt occurred by borrowing via long-term securities, i.e. bonds (66.4%), and then by borrowing via loans (29.4%) and short-term securities (4.2%).

The currency structure of public debt shows that still a significant part of the debt was denominated in a foreign currency, whereby the debt denominated in EUR accounts for 71.4%, the debt denominated in HRK for 28.4%, and the debt denominated in USD for 0.2% of total debt. An insignificant part of the debt (0.03%) was denominated in Swiss francs. In 2019, the share of the debt denominated in EUR increased by 2.8 percentage points, while the share of the debt denominated in kuna registers an increase by 15.8 percentage points in relation to 2018. The increase in the share of the debt denominated in kuna shows a growing orientation towards the borrowing on the domestic market.

The maturity structure of public debt shows that the share of public debt with the maturity of up to 1 year amounted to 4.6% of total debt at the end of 2019. The share of public debt with the maturity of 1 to 5 years amounted to 8.3%, while the share of debt with the maturity of 5 to 10 years amounted to 37.4%. The debt with the maturity of over 10 years accounted for 49.7% of total public debt.

Chart 5.1: Public Debt Trends in the Period 2011 - 2019



Source : Croatian National Bank , Croatian Bureau of Statistics

At the end of 2019, total issued guarantees of the Republic of Croatia amounted to HRK 4.4 billion, i.e. 1.1% of GDP and, in relation to the end of 2018, they were decreased by HRK 908 million.

According to the latest available data of the Croatian Bureau of Statistics on the potential liabilities of the general government sector in line with the Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, at the end of 2018, the liabilities of public enterprises that are under the state control but are not within the statistical scope of the general government, amounted to only 9.1% of GDP, which puts the Republic of Croatia near the bottom in terms of the level of these potential liabilities in comparison with other EU Member States. Such a relatively low level of potential liabilities is primarily the result of the earlier alignment with the ESA 2010 methodology and of the reclassification of a large part of state-owned enterprises into the general government sector, i.e. into the public debt.

Financing the General Government Budget and Projection of Trends in the Public Debt

The total level of required funding will be determined by the trends in the fiscal balance, financial assets and general government budgetary liabilities that are falling due in the observed period, as well as by a negative fiscal effect due to the decline in the economic activity caused by the Coronavirus pandemic and tax policy measures implemented by the Government of the Republic of Croatia with an aim of providing support to the economy and citizens. The need for financing the total budget deficit and matured liabilities will be settled on domestic and foreign financial markets, while in terms of borrowing instruments in the observed period, the focus will be on instruments with a longer maturity, primarily on bonds. Borrowing by loans will primarily focus on domestic financial market, while foreign financing pertains to project loans of international financial institutions, as well as to the planned issuance of bonds on the international capital market.

The majority of maturing state budget liabilities in the period 2020-2021 refers to five maturities of bonds, of which three are domestic and two are foreign. Among domestic bonds, one is denominated in EUR, in the amount of EUR 1 billion, while two bonds are denominated in HRK, in total amount of HRK 11 billion. Foreign maturities pertain to two Eurobonds. The first Eurobond in the amount of EUR 1.25 billion is due in 2020, and the second Eurobond in the amount of USD 1.5 billion matures in 2021. On the side of loans, most maturities in the observed period refer to loans issued in the domestic financial market and to the loans of international financial institution. Thus, total state budget loan maturities range from HRK 5.4 billion in 2020 and HRK 6.9 billion in 2021.

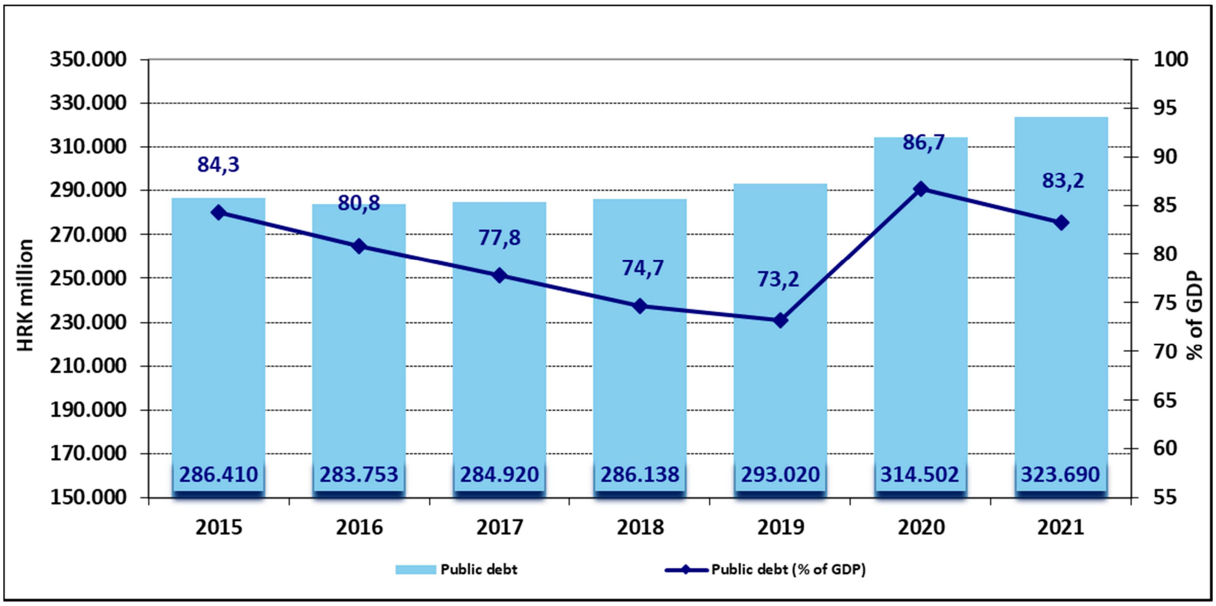
Table 5.2: Overview of the Bonds Maturity of the Republic of Croatia in the Period 2020 – 2021

Bond	Date of issue	Currency	Amount (in million)	Intrest rate	Date of maturity
Domestic bonds					
Series 13 D-20	05.03.2010.	HRK	5.000	6,750%	05.03.2020.
Series 14 D-20	05.03.2010.	EUR	1.000	6,500%	05.03.2020.
Series 22 D-21	08.07.2016.	HRK	6.000	2,750%	08.07.2021.
Foreign bonds					
Euro-USD II D 2020 (swap)	14.07.2010.	USD	1.250	6,625%	14.07.2020.
Euro-USD III D 2021 (swap)	24.03.2011.	USD	1.500	6,375%	24.03.2021.

Source: Ministry of Finance

On the basis of the trends in the fiscal balance of the general government budget, it is expected that in 2020 the share of public debt in GDP will register an increase by 13.5 percentage points in relation to 2019 and will amount to 86.7% of GDP, mostly because of the increased needs for borrowing due to the negative effect caused by the Coronavirus pandemic. Furthermore, public debt trends projection also includes the amounts of additional needs for liquidity that are based on the amount of the postponed public levies, while the public debt projection includes as well the projected decrease in the deposits at the level of the general government in the amount of HRK 6 billion. In 2021, due to the decrease in the general government budget deficit to 2.4% of GDP and strong economic growth, it is expected that the share of public debt in GDP will amount to 83.2% of GDP which represents a decline by 3.5 percentage points in relation to 2020.

Chart 5.2: Overview of Public Debt Trends by 2021



Source: Croatian Bureau of Statistics, Croatian National Bank, Ministry of Finance

ANNEXES

Annex 1a. Macroeconomic Prospects

	ESA Code	2019 (level)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)
1. Real GDP	B1*g	394.2	2.9	-9.4	6.1
2. Nominal GDP	B1*g	400.1	4.5	-9.3	7.2
Components of real GDP					
3. Private consumption expenditure[1]	P.3	230.6	3.5	-7.0	5.8
4. Government consumption expenditure	P.3	77.0	3.3	2.7	2.5
5. Gross fixed capital formation	P.51	82.2	7.1	-9.0	5.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	8.2	2.1	1.4	1.4
7. Exports of goods and services	P.6	202.3	4.6	-30.0	32.5
8. Imports of goods and services	P.7	206.0	4.8	-23.4	27.6
Contribution to real GDP growth					
9. Final domestic demand	P.3 + P.51	389.8	4.1	-5.3	5.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	8.2	-1.0	-0.9	0.1
11. External balance of goods and services	B.11	-3.8	-0.1	-3.3	0.8

Note: GDP and all of its components expressed in real terms are in constant previous year prices, HRK billion.

[1] Includes final consumption expenditure of non-profit institutions serving households.

Note: Data for 2019 is preliminary.

Source: CBS, Ministry of Finance

Annex 1b. Price developments

	2019 (level)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)
1. GDP deflator	104.4	1.5	0.1	1.1
2. Private consumption deflator[1]	102.0	0.8	-0.3	0.9
3. CPI[2]	102.3	0.8	-0.3	0.9
4. Public consumption deflator	106.9	2.1	0.7	1.8
5. Investment deflator	99.9	0.7	-0.3	0.8
6. Export price deflator (goods and services)	104.7	1.2	-3.6	2.0
7. Import price deflator (goods and services)	101.5	0.4	-3.7	1.9

[1] Includes final consumption expenditure of non-profit institutions serving households.

[2] Inflation as measured by consumer price index.

Note: Levels for 2019 are expressed as index 2015=100

Note: Data for 2019 is preliminary.

Source: CBS, Ministry of Finance

Annex 2a. General government budgetary prospects

	ESA Code	2019 (level, HRK billion)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
Net lending (EDP B.9) by sub-sector					
1. General government	S.13	1.6	0.4	-6.8	-2.4
2. Central government	S.1311	2.1	0.5	n.a.	n.a.
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	-1.4	-0.4	n.a.	n.a.
5. Social security funds	S.1314	0.9	0.2	n.a.	n.a.
General government (S13)					
6. Total revenue	TR	190.1	47.5	46.4	47.8
7. Total expenditure	TE	188.5	47.1	53.3	50.2
8. Net lending/borrowing	EDP B.9	1.6	0.4	-6.8	-2.4
9. Interest expenditure	EDP D.41	8.9	2.2	2.1	2.0
10. Primary balance		10.4	2.6	-4.7	-0.4
11. One-off and other temporary measures		0.0	0.0	0.0	0.0
Selected components of revenue					
12. Total taxes (12=12a+12b+12c)		108.0	27.0	24.5	26.4
12a. Taxes on production and imports	D.2	81.3	20.3	18.4	20.2
12b. Current taxes on income, wealth, etc	D.5	26.7	6.7	6.1	6.2
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0
13. Social contributions	D.61	47.4	11.8	12.0	12.3
14. Property income	D.4	3.5	0.9	0.9	0.7
15. Other		31.3	7.8	9.1	8.5
16=6. Total revenue	TR	190.1	47.5	46.4	47.8
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		155.3	38.8	36.4	38.6
Selected components of expenditure					
17. Compensation of employees + intermediate consumption	D.1+P.2	80.8	20.2	22.8	22.1
17a. Compensation of employees	D.1	47.5	11.9	13.3	12.8
17b. Intermediate consumption	P.2	33.3	8.3	9.5	9.4
18. Social payments (18=18a+18b)		62.2	15.5	17.7	17.1
***of which* Unemployment benefits**		0.9	0.2	0.3	0.2
18a. Social transfers in kind supplied via market producers	D632	9.0	2.2	2.6	2.5
18b. Social transfers other than in kind	D.62	53.2	13.3	15.1	14.6
19=9. Interest expenditure	EDP D.41	8.9	2.2	2.1	2.0
20. Subsidies	D.3	6.2	1.5	3.5	1.6
21. Gross fixed capital formation	P.51	17.2	4.3	4.1	4.4
22. Capital transfers	D.9	7.5	1.9	1.6	1.7
23. Other		5.7	1.4	1.5	1.4
24=7. Total expenditure	TE	188.5	47.1	53.3	50.2
p.m.: Government consumption (nominal)	P.3	79.3	19.8	22.6	21.9

Source: CBS, Ministry of Finance