



REPUBLIC OF CROATIA

January 2018

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF CROATIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 10, 2018 consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 10, 2018, following discussions that ended on October 27, 2017, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 20, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for the Republic of Croatia.

The documents listed below have been or will be separately released

Selected Issues

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International Monetary Fund
Washington, D.C.



Press Release No. 18/03
FOR IMMEDIATE RELEASE
January 16, 2018

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with the Republic of Croatia

On January 10, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Republic of Croatia.

In 2017, Croatia continued its third year of positive economic growth supported by strong tourism and private consumption, trade partner growth, and improved confidence. Growth is expected to stay at similar levels in the near future but to decelerate over the medium term. Consumer prices increased at a moderate pace and wage growth was also moderate as unemployment remained high. The external current account is expected to record another strong surplus, underpinned by robust performance of exports and tourism and lower repatriation of profits as banks absorbed losses from Agrokor. The balance of risks has improved but vulnerabilities remain sizable as public and external debt levels are still high and the full impact of the Agrokor restructuring is yet unknown.

Fiscal consolidation progressed at a faster pace than planned and Croatia exited the European Union's Excessive Deficit Procedure in June. Preliminary information indicates that the fiscal position will be in a small surplus in 2017.

Domestic monetary conditions remained accommodative and banks' financial positions strengthened. Money market rates have been modest and liquidity ample. Although continued deleveraging resulted in a negative overall credit growth on a stock basis, transaction data suggest that bank lending has resumed. There has been moderate upward pressure on the exchange rate and the Croatian National Bank accumulated international reserves. On average, the banking system, remained well capitalized and liquid. The still high NPL ratio to total loans has been declining despite the Agrokor crisis.

The pace of structural reforms slowed down after the EU accession in 2013. Croatia's GDP per capita stands at about 60 percent of the EU average and the business environment remains less favorable than peers.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment²

Executive Directors welcomed Croatia's continued economic recovery and favorable fiscal performance. Nonetheless, output has not yet fully recovered to its pre-recession level and per capita income remains well below the EU's average. In addition, public debt, elevated unemployment, and structural impediments continue to weigh on medium term growth prospects. With this background, Directors underscored the need to implement policy measures and expedite structural reforms to boost growth and reduce vulnerabilities.

Directors were encouraged by the commitment to fiscal discipline, and noted the overperformance of recent years. The favorable cyclical position provides an opportunity for growth friendly consolidation and a faster reduction in public debt. In this context, Directors emphasized the need to improve the structure of revenue and expenditure. They supported a streamlining of VAT rates and an introduction of a modern real estate tax. Directors encouraged the authorities to resist pressures to increase the wage bill and untargeted benefits. They stressed the need for reforms to enhance the efficiency of public services. Directors also underscored the importance of an ambitious reform of the pension and health care systems.

Directors noted that monetary policy has been appropriately accommodative within the limits of the exchange rate anchor. They encouraged the Croatian National Bank (CNB) to maintain such a stance as long as risks to inflation and financial stability remain low. Directors stressed that the ambition to adopt the euro raises the importance of pressing ahead with reforms to maximize the benefits from joining the currency union while enhancing the ability of the economy to respond to adverse shocks.

Directors commended the CNB for its conservative prudential policies which have thus far helped banks withstand the Agrokor crisis. They stressed that it is vital to maintain these policies and vigilant supervision. Directors encouraged the authorities to build on recent improvements in bankruptcy legislation to address remaining gaps in corporate governance.

Directors urged the authorities to advance structural reforms to remove impediments to sustained growth. They highlighted the need to improve the business environment by streamlining public administration, and enhancing the legal process and property rights. In addition, they encouraged the authorities to ease regulations on temporary employment, and the hiring and retrenchment of labor. Directors stressed the need to improve productivity and resource allocation by raising the efficiency of SOEs and divesting underutilized state assets.

It is expected that the next Article IV consultation with the Republic of Croatia will be held on the standard 12-month cycle.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Croatia: Selected Economic Indicators, 2012–18

	2012	2013	2014	2015	2016	2017	2018
						Proj.	
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)						
Real GDP growth	-2.2	-1.1	-0.5	2.2	3.0	3.1	2.8
Contributions:							
Domestic demand	-3.3	-1.0	-1.8	1.9	3.0	3.4	3.1
Net exports	1.1	0.0	1.2	0.3	0.1	-0.3	-0.3
Unemployment	18.9	20.2	19.6	17.0	14.8	...	...
CPI inflation (avg.)	3.4	2.2	-0.2	-0.5	-1.1	1.1	1.5
Saving and investment	(Percent of GDP)						
Domestic investment	19.3	19.1	18.6	19.8	19.8	19.7	20.2
<i>Of which:</i> fixed capital formation	19.6	19.8	19.4	19.8	20.1	20.6	21.3
Domestic saving	19.2	20.1	20.6	24.4	22.4	23.4	23.1
Government	-1.4	-0.7	-0.7	0.3	2.4	2.9	2.9
Nongovernment 1/	20.5	20.8	21.3	24.1	20.0	20.5	20.1
Government sector (ESA 2010 definition)							
General government revenue	41.8	43.0	43.1	45.0	46.8	46.6	46.8
General government expenditure	47.1	48.3	48.5	48.4	47.6	47.2	47.3
General government balance	-5.3	-5.3	-5.4	-3.4	-0.9	-0.6	-0.5
Structural balance 2/	-3.4	-3.0	-2.8	-2.1	-0.4	-0.6	-0.6
General government debt	70.7	82.2	86.6	86.3	83.7	80.4	77.5
Money and credit	(End of period, change in percent)						
Broad money (M4)	3.6	4.0	3.2	5.1	4.7	...	...
Claims on other domestic sectors 3/	-6.2	-1.3	-2.2	-3.0	-3.4	...	...
Interest rates							
Average 3-month T-bill interest rate (in kuna) 4/	1.3	0.8	0.3	0.4	0.4	...	...
Kuna credit rate (unindexed, outstanding amount)	8.2	7.8	7.5	7.1	6.6	...	...
Balance of payments	(Billions of euros, unless otherwise indicated)						
Current account balance	-0.1	0.4	0.9	2.0	1.2	1.8	1.4
Percent of GDP	-0.1	1.0	2.0	4.6	2.5	3.7	2.8
Capital and financial account	0.5	2.3	-0.8	-0.8	-0.8	0.9	-0.6
FDI, net (percent of GDP)	2.8	1.9	1.6	0.6	4.2	1.6	2.0
Overall balance	0.0	1.8	-0.5	0.7	-0.3	2.0	0.8
Debt and reserves	(End of period, billions of euros, unless otherwise indicated)						
Gross official reserves	11.2	12.9	12.7	13.7	13.5	15.5	16.2
Percent of short-term debt (by residual maturity)	98.9	100.1	108.3	115.5	140.4	155.2	155.0
Gross official reserves in months of imports in goods and services (based on next year level)	7.4	8.3	8.1	8.0	7.6	7.9	7.6
Total external debt (percent of GDP)	103.1	105.3	108.0	103.0	90.9	84.3	78.7
Net external debt (percent of GDP)	65.7	64.5	65.1	57.6	48.7	39.2	33.4
Exchange rate							
Kuna per euro, end of period	7.5	7.6	7.7	7.6	7.6	...	...
Real effective exchange rate (CPI-based, y-o-y change) (negative sign = appreciation)	-1.9	1.4	-1.1	-3.0	-1.5	...	...
Memorandum items:							
Nominal GDP (billions of euros)	43.9	43.5	43.0	44.1	45.8	47.8	49.8

Sources: Croatian authorities; and IMF staff estimates.

1/ Includes state-owned enterprises.

2/ In percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015.

3/ Comprises claims on households and non-financial corporations.

4/ Weighted monthly average of daily interest rates for auctions of Treasury bills issued by the Ministry of Finance.



REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

December 20, 2017

KEY ISSUES

Context: Near-term growth prospects are favorable, supported by strong tourism and private consumption, and a significantly improved fiscal position and external environment. The economy is operating close to potential. Growth is expected to decelerate if enduring structural constraints are not addressed. The largest private company, Agrokor, has been facing a financial crisis and put under caretaker management. The impact of this crisis on the economy has been contained thus far. Risks to the outlook are two sided, with downside risks dominating over the medium term. The pace of structural reform implementation has been slow and additional delays constitute a downside risk.

Policies: To ensure faster income convergence and job creation while reducing vulnerabilities, it is necessary to expedite the implementation of structural reforms and growth-friendly fiscal measures that speed up public debt reduction. These reforms have become even more urgent in view of the authorities' ambition to join the Euro Area.

- **Creating fiscal space while reducing the tax burden on investment and labor:** The current upswing should be utilized to rapidly reduce the still high public debt and create fiscal buffers that would guard against risks and be used during future downturns. The structure of revenue and expenditure needs to be improved by reducing the large wage bill and better targeting social benefits. A modern real estate tax would allow a revenue-neutral reduction in income taxes. Reforming the healthcare and pension systems would reduce contingent liabilities.
- **Improving the business environment:** Reducing red tape and boosting investment and employment require streamlining the very large public administration, increasing labor market flexibility, privatizing and reforming SOEs, and enhancing property rights and the legal process.
- **Safeguarding financial stability and improving corporate governance:** It is important to continue to (i) closely monitor banks' health in the wake of Agrokor's restructuring; (ii) maintain conservative prudential policies and supervisory vigilance as the economy fully recovers; and (iii) build on the new bankruptcy provisions by identifying and addressing any remaining gaps in corporate governance.

Approved By
Jörg Decressin (EUR)
and Yan Sun (SPR)

Discussions were held in Zagreb during October 17-27, 2017. The team comprised Messrs. Sakr (head), Harrison, Lybek, Mulas Granados, and Mses. Hassine and Vtyurina (all EUR). Mr. Josic (OED) joined several meetings. Mses. Borisova and Samuel (EUR) assisted in the preparation of the staff report.

The staff team met with Deputy Prime Minister and Minister of Economy Dalić; Minister of Finance Marić, Minister of Demography, Families, Youth, and Social Policies Murganić; Governor of the Croatian National Bank Vujčić; the Fiscal Policy Committee of the Parliament; and other officials and representatives of the business community, banks, labor unions, and academia.

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CONTEXT

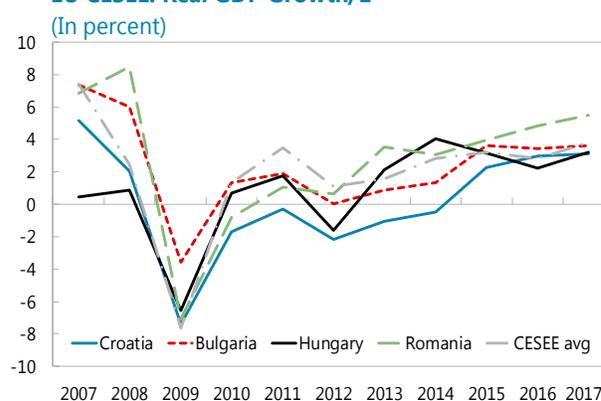
1. Croatia's recovery continued into a third year after a prolonged recession.

Over 2015-16, real GDP growth averaged 2.5 percent, reflecting strong tourism and private consumption, trade partners' growth, higher absorption of EU funds, and improved confidence (Figure 1, Tables 1-2). Sizable fiscal consolidation since 2014 allowed Croatia to exit the EU's Excessive Deficit Procedure (EDP) in June 2017. Croatia's GDP per capita now stands at about 60 percent of the EU average.

2. The main challenge is to transform the current momentum into high sustainable medium- and long-term growth.

Croatia's output, employment, and total factor productivity remain below their pre-2008 levels. Income convergence with the EU has slowed after the global financial crisis (GFC) for various reasons, including delays in implementing structural reforms (Annex I). The balance of risks facing the economy has improved, but vulnerabilities remain significant. Supporting faster income convergence, while reducing vulnerabilities, will require growth-friendly fiscal measures and productivity-enhancing structural reforms.

EU CESEE: Real GDP Growth/1



2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017p

1/ EU CESEE: Central, Eastern, and Southeastern European countries include Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia and Slovakia.

Source: IMF, *World Economic Outlook*.

Growth Differential Before and After the Global Financial Crisis

(Difference in average PPP GDP per capita growth with Germany)



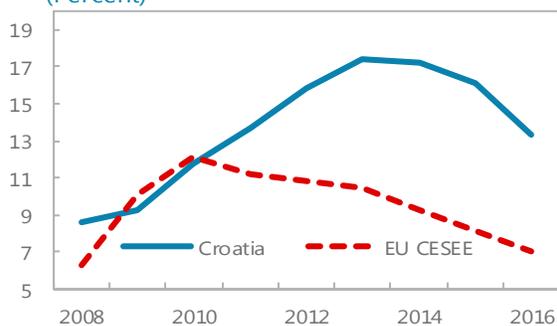
Sources: World Bank Development Indicators; and IMF staff calculations.

RECENT DEVELOPMENTS

3. The economy is estimated to be operating close to potential.

The output gap appears to be closing. However, although unemployment has declined from its post-GFC highs, it remains elevated (11.6 percent at end-October 2017) and, in staff's view, seems mostly structural. Labor supply continues to be affected by unfavorable demographics, emigration, untargeted social benefits, and rigidities in the labor market. Wage pressures are still moderate and inflation is low.

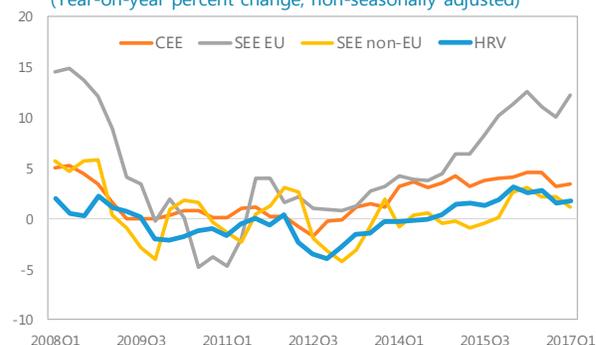
Survey Unemployment Rate
(Percent)



Sources: Eurostat, and IMF staff calculations.

Real Wage Growth

(Year-on-year percent change, non-seasonally adjusted)



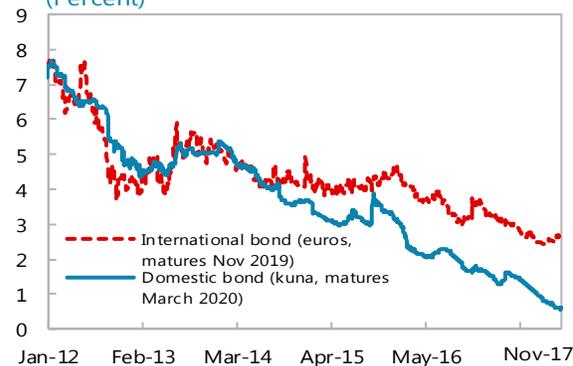
Source: Haver.

4. Large fiscal consolidation has been achieved over the past few years

(Figure 2, Table 3). There was a significant fiscal overperformance once again in 2016, with the deficit at 0.9 percent of GDP compared to the budget target of 2.6 percent. This mainly reflected stronger-than-projected tax revenue and an effective freeze of expenditures other than those related to EU funds. The structural deficit improved by close to 2 percent of potential GDP and public debt fell to about 83 percent of GDP (Annex II). Refinancing needs were met on very favorable terms as Croatia's risk premium declined significantly.¹

Bond Yields

(Percent)



Source: Bloomberg.

5. Domestic monetary conditions remain accommodative and banks' financial positions have strengthened. Intrabank liquidity is ample and money market rates are at modest levels (Figure 3). Although the continuing widespread deleveraging resulted in a negative overall credit growth, transaction data indicate that bank lending began to pick up in mid-2016 (Table 4). Furthermore, the share of kuna lending, particularly to households, has been increasing gradually since 2015. The banking sector remains on average well capitalized and liquid, and profitability has been bolstered by lower provisions, one-off items, and a modest increase in net interest income (Table 5). The still high NPL-to-total loans ratio has been declining. The Agrokor

¹ In 2017, the interest rate on a large Eurobond (€1.25 billion in 2017) was cut by more than half (from 6.25 to 3 percent).

crisis has not reversed this trend, but slowed it down. NPLs are well- provisioned, and the un-provisioned part is, on average, fully covered by capital exceeding the minimum requirement.

6. The external position remains broadly in line with fundamentals.

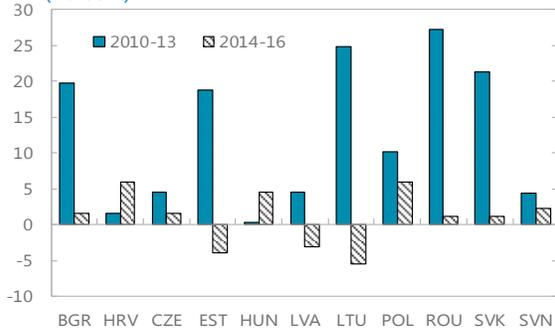
Tourist arrivals have been increasing steadily, reflecting both adverse geopolitical conditions in competing destinations and efforts to increase capacity and expand the tourism season (Figure 5, Table 6). Merchandise exports growth moderated, but remained buoyant. Croatia continued to gain market share in the EU since its entry in mid-2013. External debt declined further, and the real exchange rate remained broadly in line with fundamentals (Annexes III and IV). However, non-price indicators continue to suggest broader competitiveness challenges. The Croatian National Bank (CNB) made foreign exchange purchases in 2016, but gross international reserves declined slightly by year-end due to the abolishment of the requirement for banks to maintain part of their statutory reserves in FX with the CNB. Moderate upward exchange rate pressures continued throughout most of 2017, and the CNB has been accumulating sizable reserves.

Bank Claims on Private Sector
(Annual percentage change)



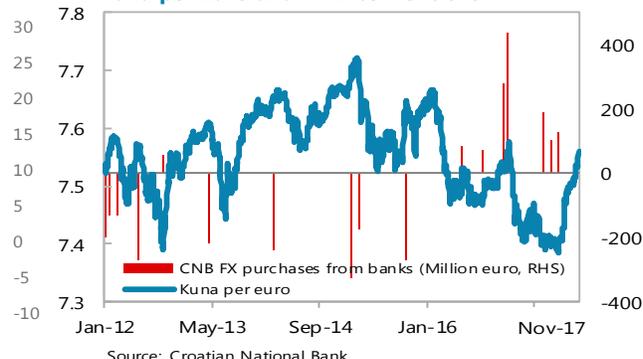
Sources: Croatian National Bank and IMF staff estimates.
Note: Claims on private sector include claims on households, non-financial corporations, and local governments. The decline in late 2015 is partially explained by the conversion of Swiss franc-indexed household loans into euros. 1/ Dotted line is based on transaction data, i.e. adjusted for exchange rate changes, sales and write-offs of NPLs. For details, see Annex 1 in *CNB Monthly Bulletin No. 221*, February 2016, Croatian National Bank.

CESEE EU: Change in Export Market Share
(Percent)



Source: European Commission.

Kuna per Euro and FX Interventions



Source: Croatian National Bank.

OUTLOOK AND RISKS

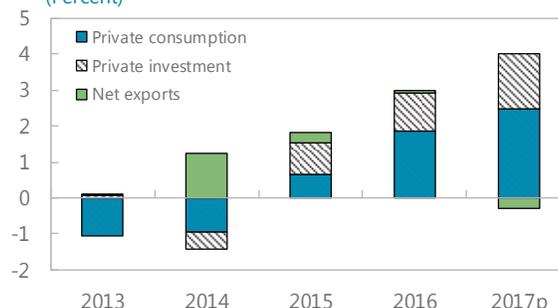
7. Growth is expected to gradually decelerate over the medium term. Growth is projected to reach 3.1 percent in 2017, mostly due to strong tourism and private consumption. Investment has been lagging but is envisaged to increase in the near term as the absorption of EU structural and investment funds improves and overall deleveraging (on stock basis) gradually comes to an end. The strong current account surplus—projected at 3.7 percent of GDP in 2017—is expected to steadily decline as export and tourism growth moderates. Inflation is envisaged to

slowly pick-up but to remain low and in line with regional trends. Growth is projected to converge towards 2 percent by 2022, mostly due to structural impediments (Annex V).

8. While the balance of risks has improved, it remains tilted to the downside over the medium term (Annex VI).

- *Upside risks include:* (i) more favorable conditions in trading partners, which could spill over into higher exports; (ii) lower GDP and employment compared to pre-2008 levels may point to more cyclical slack; and (iii) the recent history of fiscal overperformance could contribute to increased confidence and activity.
- *Downside domestic risks* are mostly related to Agrokor. There is a risk that in 2018 the Agrokor restructuring could have a higher-than-expected impact on domestic investment, export capacity, and consumption (Annex VII).² Private consumption may slow down if there are significant layoffs in the affected companies, and this could also reduce tax revenue and increase unemployment benefits. At 80 percent of GDP, public debt is still high and subject to currency and interest rate risks. Financing needs also remain elevated, and the debt path over the medium term is vulnerable to growth shocks and the materialization of contingent liabilities (Annex II).
- Regarding *downside external risks*, a sudden tightening in global financial conditions could put pressure on public finances and borrowers with variable rate loans. Corporate balance sheet FX mismatches are the highest in the region. Furthermore, despite the recent progress in reducing euroization of banks' balance sheets, it remains high.³

Contribution to Growth
(Percent)



Source: Croatian Central Bureau of Statistics.

Sectoral Net FX Balance Sheet Exposures/1
(In percent of GDP, December 2016)



1/ Calculated as foreign currency assets less foreign currency liabilities of each sector based on reporting by domestic depository institutions, BIS banks and data on outstanding foreign currency debt instruments.
Sources: Regional Economic Issues (IMF April 2017) based on IMF Monetary and Financial Survey Database; IMF Vulnerabilities Exercise Securities Database; BIS Locational Bank Statistics; World Economic Outlook database; and IMF staff calculations.

² A 0.3-0.5 percent of GDP decline in growth due to Agrokor is already incorporated in the baseline projections for 2018 (Annex VI).

³ At end-September 2017, the share for FX deposits in broad money (M4) and the share of FX placements to total placements amounted to about 55 percent each. However, the difference between banks' FX deposits and FX loans to other domestic sectors and total FX loans amount to 12 and 1.5 percent of GDP, respectively at end-September 2017.

Vulnerability, especially of unhedged borrowers, could, therefore be substantial in case of significant exchange rate volatility.

Authorities' Views

9. The authorities project slightly stronger growth over the short- and medium-term, based on the assumption of higher private consumption and investment. They consider the risks to be broadly balanced. While investment by companies in the Agrokor conglomerate has been affected by its debt crisis, the authorities expect its restructuring to proceed in an orderly manner thanks to the adoption of the new law on systemic companies. The caretaker management's plan envisages the impact on employment to be minimal as Agrokor's core companies are broadly sound, and intends to offer creditors debt-to-equity swaps rather than cash repayment from their sale. The authorities believe that this approach is less likely to result in an imminent downsizing and job loss. They noted that the banking system has thus far withstood well the Agrokor crisis and are confident that it will be able to withstand further write-offs that may arise from the conglomerate's restructuring, as indicated by the CNB's stress tests.

POLICY DISCUSSIONS

A. Fiscal Policy: Utilizing the Upturn

10. **A small fiscal deficit is expected for both 2017 and 2018.** Staff projects the 2017 general government deficit at about 0.6 percent of GDP, well below the budget target of 1.6 percent. This overperformance is due to robust cyclical revenues, lower than budgeted interest payments, and ongoing tax administration reforms that helped mobilize revenues and contain the expected losses from recent tax cuts (Annex I). Virtually all expenditures were executed as planned, including the wage increases.⁴ Nonetheless, staff estimates that the cyclically-adjusted balance deteriorated by about 0.2 percent of potential GDP, pointing to a mildly procyclical fiscal stance. The 2018 budget is targeting a deficit of 0.5 percent of GDP. The authorities' plan further consolidation towards a small surplus starting in 2019.⁵ Staff believes that the 2018 target is feasible and that a small surplus could be achievable starting 2020. This would lead to a reduction in public debt to about 65 percent of GDP. Such a scenario is feasible within current policies. It is, however, contingent on resisting political pressure for a rapid reduction in taxes or raising expenditure, including for further increases in benefits for war veterans and public wages.⁶

⁴ The agreement with state employees, after a long wage freeze, stipulates an increase in three steps by a total of 6 percent in nominal terms in 2017-18.

⁵ These targets reflect the authorities' November 2017 revisions to the fiscal path presented in the Convergence Program (May 2017) in response to the better-than-expected outcome in 2017.

⁶ From 2018, tax revenues for personal income taxes will be collected by local governments to strengthen their financing capacity to co-finance the EU-financed investment projects. On the expenditure side, an increase in veteran benefits as per the War Veterans Act, adopted in November 2017, is incorporated in the baseline.

11. Given the current positive growth dynamics, and existing debt vulnerabilities, staff advocated a faster reduction in public debt over the medium term. This would help reduce the government's financing needs, cushion the effect of any tightening of global financial conditions, and create additional fiscal space that can be used during future downturns.

Recommended Fiscal Savings, 2018-22 (In percent of GDP)	
Revenue	
Adoption of property tax	1.0
Possible reduction of tax burden	-1.0
Expenditure	
Compensation of employees	0.5
Savings on social benefits	1.0
Total	1.5
Public debt ratio	59

The size of the recommended additional adjustment is guided by (i) adopting a mildly counter-cyclical fiscal policy that would preserve the ongoing recovery, and (ii) bringing debt below 60 percent of GDP by the end of the medium term, which would also be in line with the Stability and Growth Pact's threshold. To achieve these two objectives, staff recommended implementing additional cumulative measures of 1.5 percent of GDP during 2018-22. This would result in a sizable reduction in debt over the 5 years of around 20 percent of GDP.

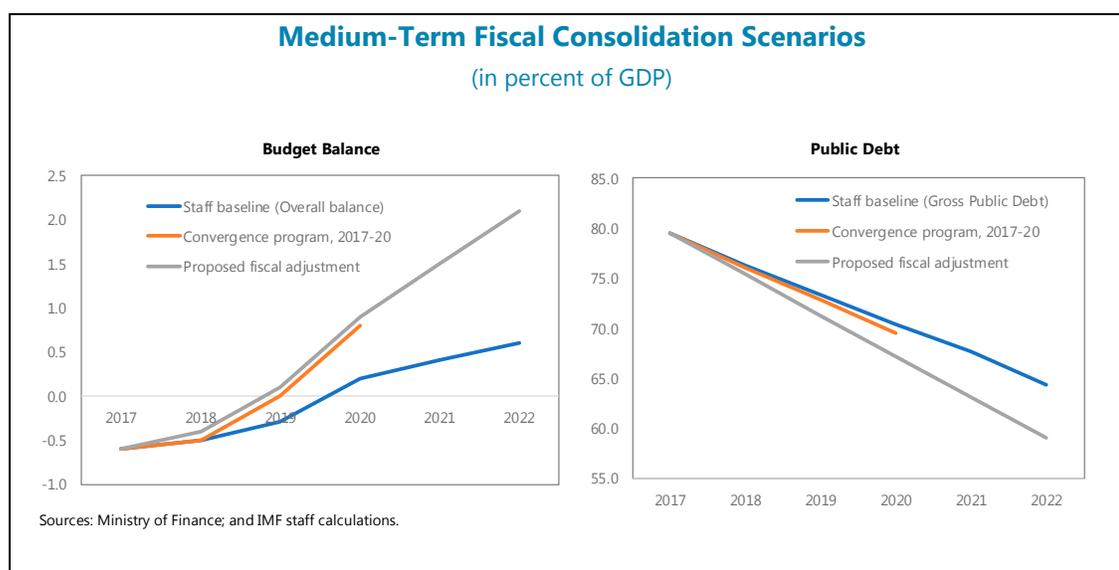
12. To achieve the recommended fiscal consolidation, while supporting activity and job creation, staff advocated the following improvements in the structure of both revenues and expenditures over the 2018-2022 period:

- *On the revenue side*, staff estimates that adopting a modern real estate tax could generate additional revenue of around 1 percent of GDP. A well-designed real estate tax that is based on objective criteria would be more equitable and would yield more revenue than the existing communal fees. This revenue would allow for a further reduction in less growth-friendly taxes, such as income taxes. Staff also sees room for further streamlining the VAT rates in line with the original VAT reform proposal, while ensuring that the measures are revenue neutral.⁷
- *On the expenditure side*, staff encouraged the authorities to build on, and implement, the measures contained in the Convergence Program and the NRP. In particular:
 - Social benefits could be reduced by 1 percent of GDP while protecting vulnerable groups. Currently, there is no strategy to coordinate the different types of social benefits (which are provided by 7 different ministries and vary between municipalities) and there is a clear need to improve targeting. Staff recommended that the social benefits reform be designed in consultation with the World Bank and

⁷ The original VAT reform proposal for 2017 included the elimination of one of the two preferential VAT rates, which would have partly compensated for the expected decline in income tax collection. The final package kept both preferential rates, and featured only a few items moving from them to the standard rate (Annex I).

focus on better targeting and monitoring, including through reviving the plan to introduce a one-stop shop for benefits.⁸

- The growing wage bill could be reduced by 0.5 percent of GDP, including through streamlining public administration and government agencies. Plans to make compensation more performance-based should be advanced in order to improve public service delivery.⁹



13. Two other reforms are also necessary to ensure fiscal sustainability:

- *Reforms in the healthcare sector* are critical to stop the perpetual accumulation of arrears. Legacy arrears are about 2 percent of GDP, and new arrears amount to an estimated 110 million kuna per month, half of which could be eliminated by removing exemptions and enforcing the collection of premiums for supplementary health insurance. Consideration should be also given to raising premiums and introducing co-payments for such supplementary benefits.¹⁰ In addition, the efficiency of the sector should be improved by reducing the large number of specialized centers and centralizing procurement.

⁸ The fiscal cost of Croatia's social benefits is about 1 percent of GDP higher than peers. Its poverty rate is 8 percent and is declining. According to World Bank estimates, only 10 percent of Croatia's social programs are well-targeted. Recent measures, including the expansion of veteran benefits, are not means-tested. However, the assessment of disability claims was harmonized and moved to a new Single Expert Evaluation Body.

⁹ See structural reforms in Section B, particularly regarding streamlining public administration and reducing disincentives to work.

¹⁰ The premium of supplementary benefits, which exceed the basic standard of care, is only 70 kuna per month, equivalent to about €10.

Consideration should also be given to moving the health insurance fund back under the Treasury to strengthen monitoring and control of expenditures.

- The *pension system* needs to be put on a sustainable path.¹¹ Essential reforms include: (i) tightening early retirement rules, (ii) accelerating the transition to the higher statutory retirement age, and (iii) expediting convergence of special regimes and privileged pensions with the general system.

14. Staff supported the authorities' recent effort to strengthen fiscal governance and debt management. The Fiscal Responsibility Law, which is being finalized, includes the creation of a Fiscal Council with seven non-political members and its own staff. The Budget Act, also to be approved soon, will include an analysis of contingent liabilities as part of the budget process as well as a three-year spending limit, while ensuring appropriate flexibility. Staff welcomed measures to reduce debt vulnerabilities in the updated debt strategy, published in 2017, and especially encouraged further expansion of kuna-based borrowing to reduce FX exposure and develop the local bond market (Annex II).

Authorities' Views

15. The authorities intend to continue to improve tax administration and are contemplating reforms to further alleviate the high tax burden. They intend to use any yearly fiscal savings to pay off some of the health sector arrears. To increase the efficiency, there are plans for a functional integration of hospitals in 6 pilot cases, a reduction of the excessive number of inpatient procedures, and consolidation of procurement. However, currently there is no intention to raise contributions to the supplementary insurance as the authorities prefer to make it attractive for a larger pool of healthy participants. The public administration reform is being phased in through mid-2018 in order to allow for careful preparation. Negotiations on changes in the pay grade system have started, and the reform will first encompass civil servants as more time is needed to design the parameters of the merit-based system for the more diverse public sector workforce. With respect to social benefits, the authorities plan to implement the virtual one-stop shop by 2020, but there are no plans at this point to reduce the number of benefits. The change in the retirement age could be brought forward after other elements of the reform are worked out.

B. Removing Impediments to Growth: It's Mostly Structural

16. Since the global financial crisis, Croatia's potential growth, competitiveness, and job creation have been hampered by low investment and productivity as well as adverse demographics. Past overleveraging and a low level of absorption of EU funds resulted in subdued domestic investment and especially FDI, thereby limiting technological advances (Annex

¹¹ "Croatia Policy Notes: Pension System Reform" (World Bank 2016); European Semester Country Report for Croatia (European Commission 2017); The 2018 Ageing Report (European Commission 2017).

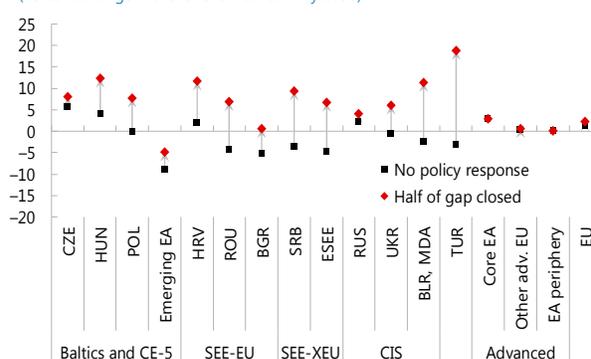
VIII). Emigration of high skilled workers has led to a declining labor force and lower productivity. Indicators of competitiveness and the ease of doing business suggest that there is significant room to raise potential growth by improving productivity, attracting investment, and increasing employment through implementing structural reforms (Annexes IV, V and VIII).¹²

17. Given these considerations, staff advocated reforms in the following areas:

➤ **Public administration:** Croatia has a very complex and multilayered public administration. The number of counties, municipalities, and public agencies is very high, especially in relation to the size of population and administrative capacity. It is, therefore, crucial to streamline this structure in order to reduce red tape and disparities in regulation and in the scope and quality of public services. Costly para-fiscal fees, still high administrative and permits barriers, frequent changes to legislation, and over-regulation of businesses and professions create a cumbersome and confusing environment for businesses and citizens as well as opportunities for corruption.¹³ Further reducing para-fiscal fees, increasing the use of electronic hubs, and simplifying administrative processes and required documentation would go a long way in improving the ease of doing business.

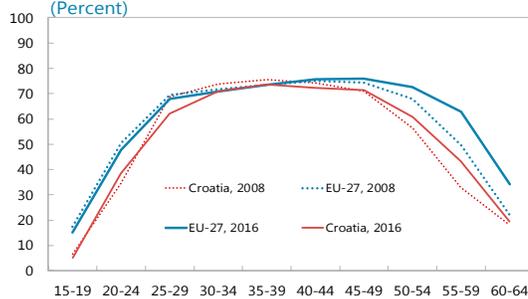
➤ **Labor market:** The participation rate remains one of the lowest in the EU and structural unemployment, especially among youth and women, is high. Nonetheless, some businesses report that they find difficulty in filling skilled and even unskilled vacancies. To increase flexibility, staff encouraged the authorities to ease the regulations on temporary and

Impact of Increasing Labor Force Participation on Emigration-Induced Real GDP Reduction
(Percent change in the level of real GDP by 2030)



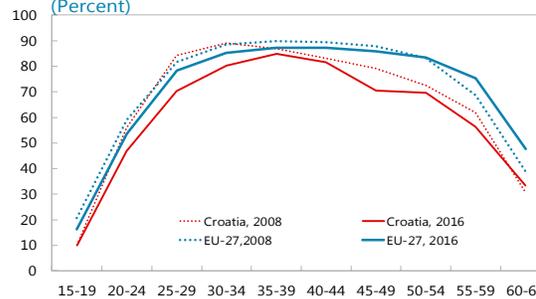
Source: IMF Staff Discussion Note 16/07.

Female Employment by Age Group, 2008 and 2016
(Percent)



Sources: Eurostat; and IMF staff calculations.

Male Employment by Age Group, 2008 and 2016
(Percent)



Sources: Eurostat; and IMF staff calculations.

¹² See for example the 2017 World Bank’s Doing Business Report, EC’s Croatia’s Country Report (2017), the Global Competitiveness Report (World Economic Forum), and the Heritage Foundation’s Economic Freedom Index.

¹³ See the 2016 Selected Issues paper on fragmentation of public administration.

part-time employment, and on hiring and retrenchment of labor.¹⁴ This would also help bring jobs out of the informal sector. Incentives to accept jobs could also be increased by streamlining and better-targeting social benefits, and by increasing the number of child care facilities. Recent IMF staff analysis shows that well-designed active labor market policies in CESEE could also help mitigate the adverse effects of emigration.¹⁵ Furthermore, enhancing education and vocational training in line with the NRP intentions would go a long way in improving productivity and employment, especially among the youth and war veterans.

- **SOEs reform:** State-owned enterprises operate in almost all sectors. They suffer from low efficiency and generate substantial fiscal costs and contingent liabilities for the state, thus weighing on growth and contributing to vulnerabilities. Too many of these enterprises are classified as strategic, which impedes their privatization. While some modest progress has been made in depoliticizing their management, further strengthening their governance and hardening their budget constraint would help improve their efficiency and financial discipline. In this regard, staff welcomed the authorities' intention to remain engaged with the World Bank on the operational restructuring of the highway companies after a part of their old debt has been successfully refinanced (Annex II). Divesting scattered and underutilized state assets, such as real estate and minority shares, would also improve the use of resources in the economy.
- **Corporate governance:** It would be important to enhance corporate governance in general. The bankruptcy legislation for large corporates has been recently improved in response to the Agrokor crisis, and the recent changes to the 2015 Bankruptcy law should help facilitate orderly restructuring.¹⁶ It would be useful to build on this progress by identifying and addressing any remaining gaps in corporate governance, including with respect to the role of supervisory boards and trends in ownership consolidation, accounting and auditing standards, payment culture, and insolvency and creditor rights.¹⁷
- **The legal process and property rights:** Recent IMF staff research highlights the adverse impact of shortcomings in judicial systems and in property rights on productivity.¹⁸ EU accession has been instrumental in motivating past judicial reforms in Croatia.

¹⁴ See the 2016 Selected Issues paper on reservation wage.

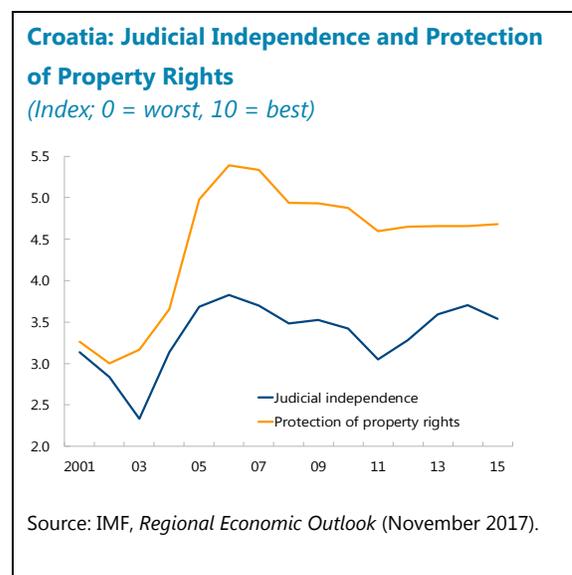
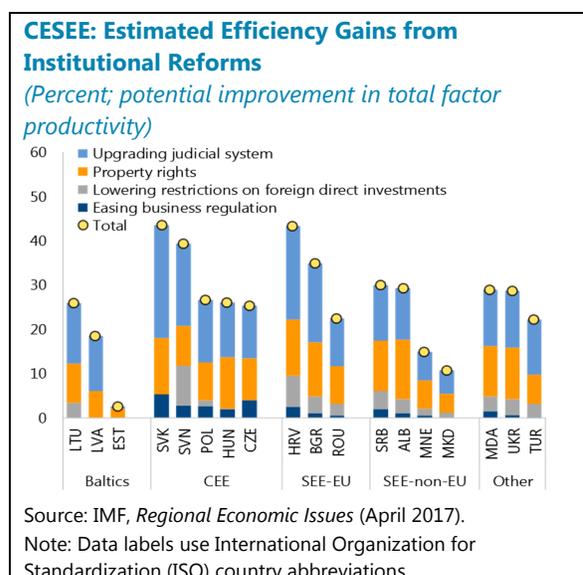
¹⁵ "Emigration and Its Economic Impact on Eastern Europe," IMF Staff Discussion Note 16/07.

¹⁶ The amendments include the pre-bankruptcy procedure that may be initiated by debtors even if bankruptcy conditions are not met but failure is likely. Restructuring plans would be a method to avoid fire sales of assets and preserve business continuity when businesses still show a positive cash flow.

¹⁷ The Croatian Financial Services Supervisory Agency is currently considering to tightening its "comply or explain requirements" of the voluntary Corporate Governance Code, requiring companies listed on the Stock Exchange to provide a clearer explanation if they have deviated from the Code.

¹⁸ "Regional Economic Issues: Central, Eastern, and Southeastern Europe," IMF (April 2017).

Nonetheless, judicial proceedings are still very lengthy and there is scope to improve consistency in court rulings.¹⁹ Staff encouraged the authorities to make timely progress in these areas. Other improvements, including digitalization of court procedures, streamlining procedures for small claims, further facilitating out-of-court settlement, and enhancing dispute resolution mechanisms, would also help expedite the legal process and reduce the cost to businesses and citizens. Furthermore, a modernization of land registry and the cadaster would go a long way in enhancing property rights and, thus, facilitating a better utilization of assets.



Authorities Views

18. The authorities indicated that several elements of the above reforms have been introduced to the NRP (Annex I). They stated that some of the changes from the previous NRP's more ambitious objectives, and delays in implementation, were due to the need for recalibrating the reform strategy to achieve the most effective outcomes.

C. Monetary and Financial Sector Policies: Preserving Stability

19. **Given the benign inflation outlook, the CNB has appropriately kept interest rates low and ensured ample liquidity.** Staff encouraged the CNB to maintain an accommodative monetary stance within the limits of the overriding objective of preserving exchange rate and financial stability. The existing CNB lending facilities are adequate and should remain available, especially given the lingering uncertainties surrounding the restructuring of Agrokor. Staff welcomed the recent changes permitting banks to pool collateral for the CNB's various lending

¹⁹ European Commission Country Report (2016).

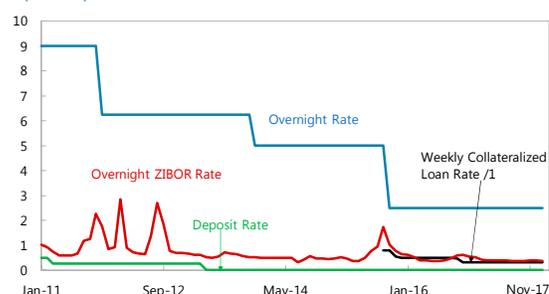
facilities instead of ear-marking eligible securities, including for the long-term structural kuna funding facility, which made them more appealing to banks.

20. CNB's conservative prudential policies have thus far paid-off with regards to banks' ability to withstand the Agrokor crisis. The CNB has closely monitored exposure limits and assessed clients' direct and indirect exposure to the company. The results of CNB's stress-testing of banks' exposure showed that the banking system could absorb significant write-offs of Agrokor's debt due to the system's high capital buffers.²⁰ With respect to NPLs, the authorities have over time taken various measures to incentivize their reduction, including through the facilitation of write-offs of fully provisioned NPLs during 2017 via amended tax legislation. However, market-based solutions, such as NPL sales, seem to be the preferred option to banks thus far.

21. There is no immediate need to tighten macroprudential measures (MPMs) absent signs of overheating in the real estate market. The CNB used various MPMs prior to the adoption of the EU's Capital Requirement Directive IV.²¹ Currently, the main MPMs include the capital conservation buffer, structural systemic risk buffers, higher capital charge on other systemically important institutions (O-SII), strict definition of residential property, and higher risk-weights on exposures secured by mortgages on commercial real estate.²² Going forward, it is vital to continue to maintain conservative prudential policies and banking supervisory vigilance, including by considering revisiting MPMs should the pace of real estate price increases accelerate.

22. The authorities have launched a public debate about the pros and cons of euro adoption.²³ The government aims for Croatia to enter into the European Exchange Rate Mechanism II in 2020. Croatia's monetary policy is already closely linked to the Euro Area (EA) as

Selected Policy and Monetary Market Rates
(Percent)



Sources: Croatian National Bank; and IMF calculations.
1/ Reverse repo re-introduced in 2015 due to mandated retroactive conversion of Swiss franc-indexed household loans in to euros.

Real Estate Prices and Bank Claims on Households
(Annual percentage change)



Sources: Croatian National Bank and IMF staff estimates.
1/ The decline in household credit in late 2015 is mainly due to the conversion of Swiss franc indexed loans. The dotted line based on transaction data, i.e. adjusted for exchange rate changes, sales and write-offs of NPLs. For details, see Annex 1 in *CNB Monthly Bulletin* No. 221, February 2016, Croatian National Bank.

²⁰ A couple of banks might have to modestly increase their capital in the CNB's stress test's worst-case scenario.

²¹ For details on Croatia's experience, see "Increasing Resilience to Large and Volatile Capital Flows—The Role of Macroprudential Policies—Case Studies" (IMF, 2017).

²² For details see Table 2 in *Macroprudential Diagnostics*, No. 3, CNB, October 2017.

²³ For details see "Strategy for The Adoption of The Euro in Croatia, Government of The Republic of Croatia and the Croatian National Bank," October 2017.

the exchange rate moves closely with the euro and in view of the high euroization. Euro adoption would eliminate the current limited monetary policy independence and allow full participation in the EA decision making. Exchange rate risk and transaction costs would also be significantly reduced. Staff emphasized that it would be essential to increase the dynamism and resilience of the economy by accelerating structural reforms to maximize the benefits and minimize the risks of joining the currency union. Furthermore, it would be important to continue to maintain conservative bank supervision and macroprudential policies in preparation for the membership in the Banking Union. It is also necessary to rapidly reduce public debt in order to create fiscal space that can be used to support growth in future downturns. This is particularly important to enable adequate policy response, especially in case future shocks affect Croatia and the EA in asymmetric ways (Annex IX).

Authorities' Views

23. The CNB believed that its strategy of smoothing exchange rate fluctuations has worked well. The CNB published a comprehensive cost-benefit analysis suggesting that Croatia would largely benefit from adopting the euro. To reduce current risks, the CNB will continue to encourage kuna-based lending, although this is somewhat less important given the intention to eventually adopt the euro. The CNB noted that it consistently warns of the risks associated with lending in euros at variable interest rates and actively advocates that consumers seek fixed-rate financing. Banks that are unable to offer kuna-denominated loans with a fixed interest rate are required to inform their clients about competitors who offer such products. The CNB pointed out that there was presently little pressure in the real estate market, but that it was closely monitoring developments and stood ready to apply relevant MPMs.

STAFF APPRAISAL

24. Croatia's economic recovery continues at a brisk pace, but sustaining it will require substantial reforms. Real GDP growth is expected to reach about 3 percent for a second year in a row, supported by strong tourism and private consumption. However, output remains below its 2008 level, and per capita income is only at about 60 percent of the EU's average. Although unemployment has declined substantially, it remains in double digits. Furthermore, labor participation is low and demographic trends are unfavorable. Although private investment is recovering, it is still subdued. The fiscal accounts continued to strengthen and the external position is assessed to be in line with fundamentals. Thus, the key challenge is to expedite implementation of structural reforms to sustain strong growth and employment generation, while rebuilding fiscal space and further reducing vulnerabilities.

25. Notwithstanding the impressive progress in fiscal consolidation over the past few years, public debt remains high. Improvements in tax administration and favorable cyclical conditions have both resulted in strong revenue. This, along with expenditure restraint, has led to a rapid reduction in the deficit and facilitated exit from the Excessive Deficit Procedure in June 2017. Nonetheless, the fiscal stance remains mildly procyclical and public debt is still high. While the intention to further advance fiscal consolidation in the near term is welcome, it would be

important to adopt additional measures to reduce public debt below 60 percent of GDP by 2022. This would reverse the currently procyclical stance, reduce the government financing cost, and create fiscal space that can be used in future downturns.

26. Fiscal reforms should be growth-friendly and aim at improving the structure of both expenditure and revenue. A key measure would be to introduce a modern real estate tax and streamline the VAT rates, which would allow for a revenue-neutral further reduction in the income tax burden. Rationalizing current expenditure by advancing civil service reform, better-targeting social benefits, and reducing early retirement incentives would support debt reduction, and also stimulate private sector labor participation. It is also essential to improve the sustainability of the healthcare system by enhancing its efficiency, centralizing procurement, as well as removing exemptions for subscribers to supplementary insurance and raising co-payments for its added services.

27. Monetary policy has remained appropriately accommodative within the limits of the exchange rate anchor. Maintaining such a stance would support growth as long as risks to financial stability and inflation remain low. The authorities' detailed studies on the pros and cons of euro adoption are welcome as they point out the need to expand the fiscal space and advance structural reforms to maximize the benefits of joining the currency union while enhancing the ability of the economy to respond to adverse shocks.

28. Conservative macroprudential policies and effective bank supervision have helped preserve financial sector stability. Progress has been made in reducing NPLs, and the financial system remains generally sound despite the Agrokor crisis. Maintaining effective supervision and robust macroprudential framework will continue to be critical as the economy recovers fully. It is also important to build on recent improvements in bankruptcy legislation for large corporations by identifying and addressing any remaining gaps in corporate governance.

29. The current upswing should be used to advance structural reforms in order to remove impediments to sustained growth. In particular, it is critical to improve the business environment by streamlining the complex and overlapping levels of public administration, and by enhancing the legal process and property rights. To maximize the impact on job creation, it would be important to make the regulations on temporary employment and the hiring and retrenchment of labor less restrictive, and to increase the availability of childcare centers. Furthermore, raising the efficiency of SOEs and divesting scattered and underutilized state assets would go a long way in improving productivity and resource allocation.

30. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Selected Real Sector Indicators, 2012–17

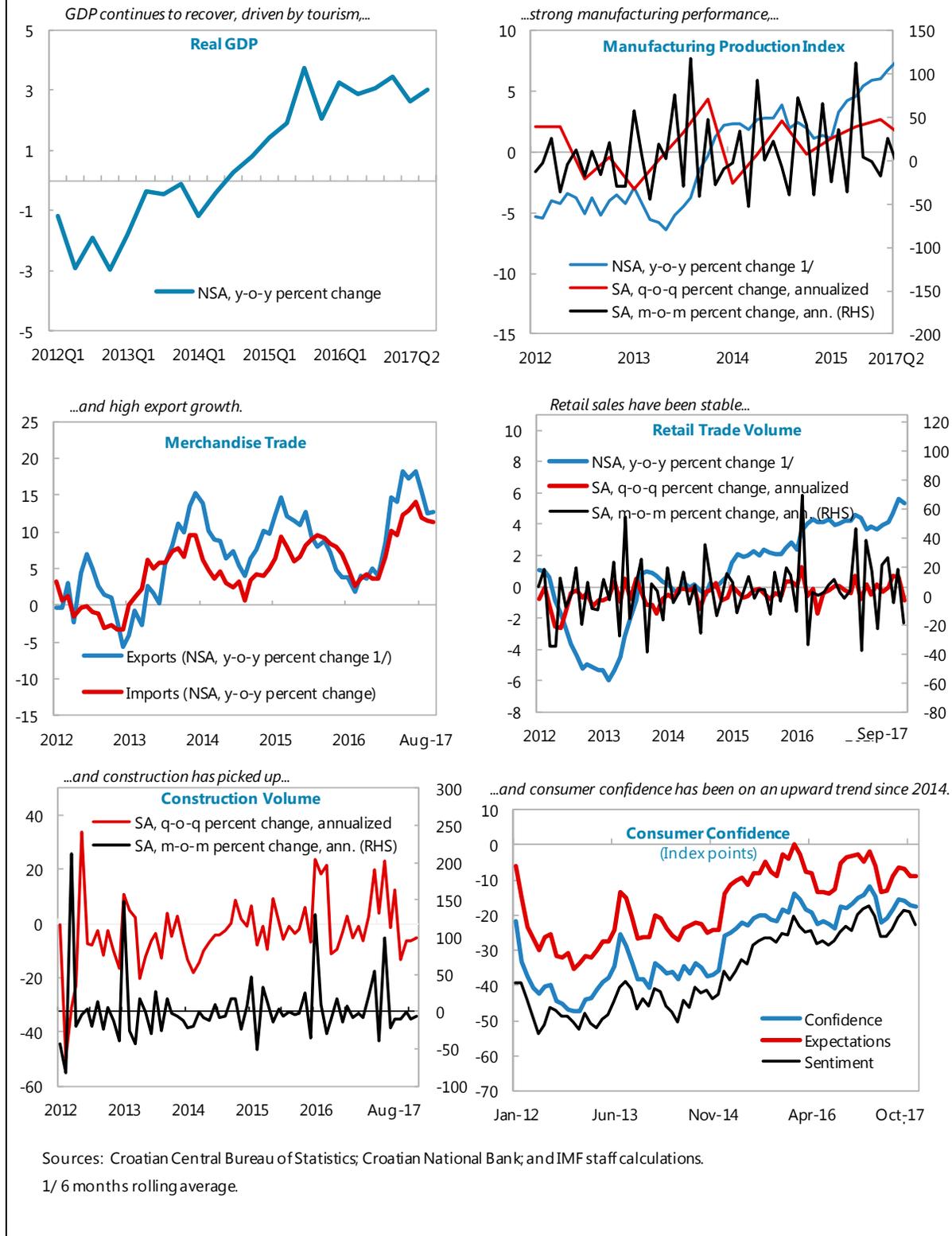
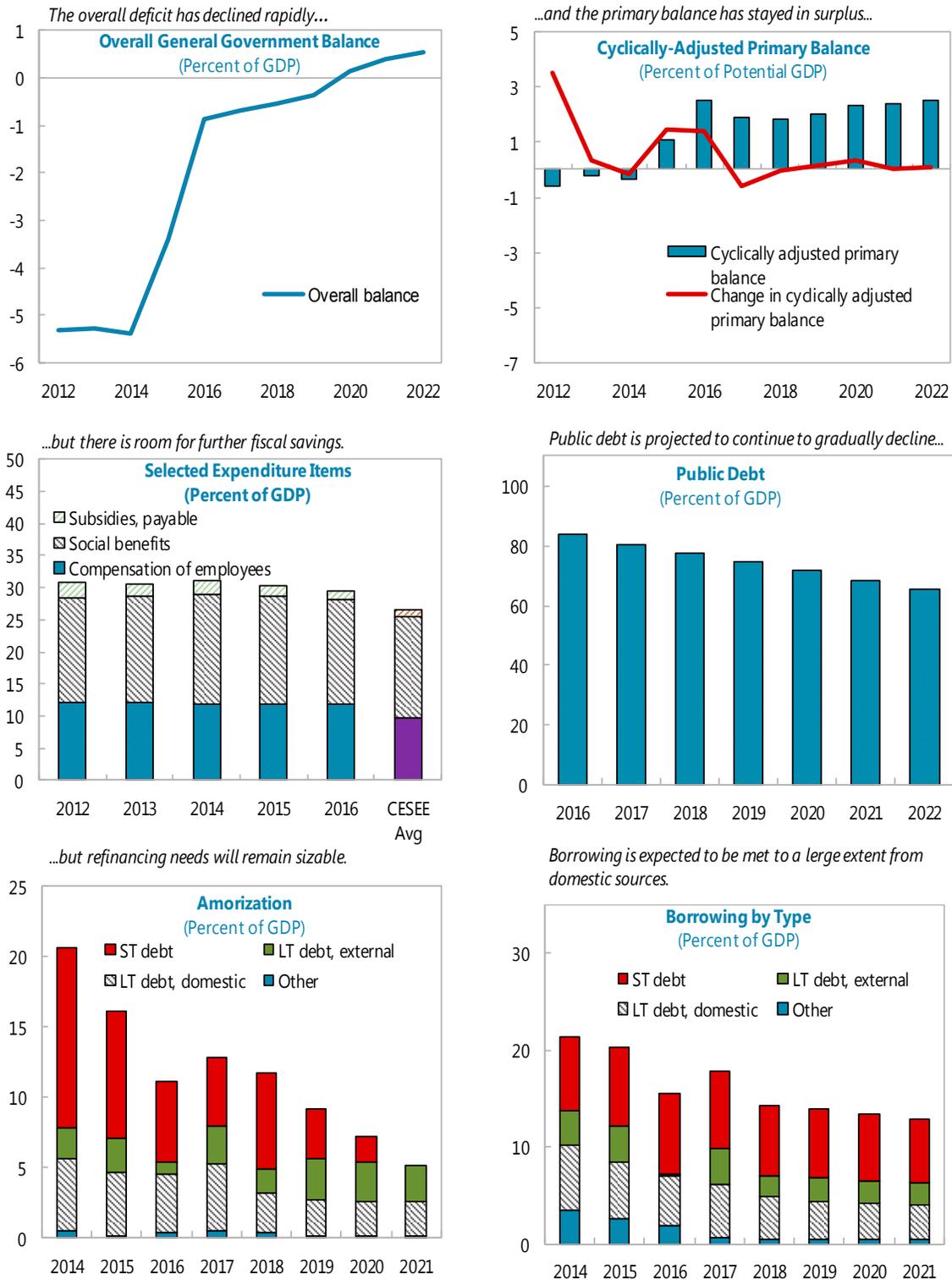
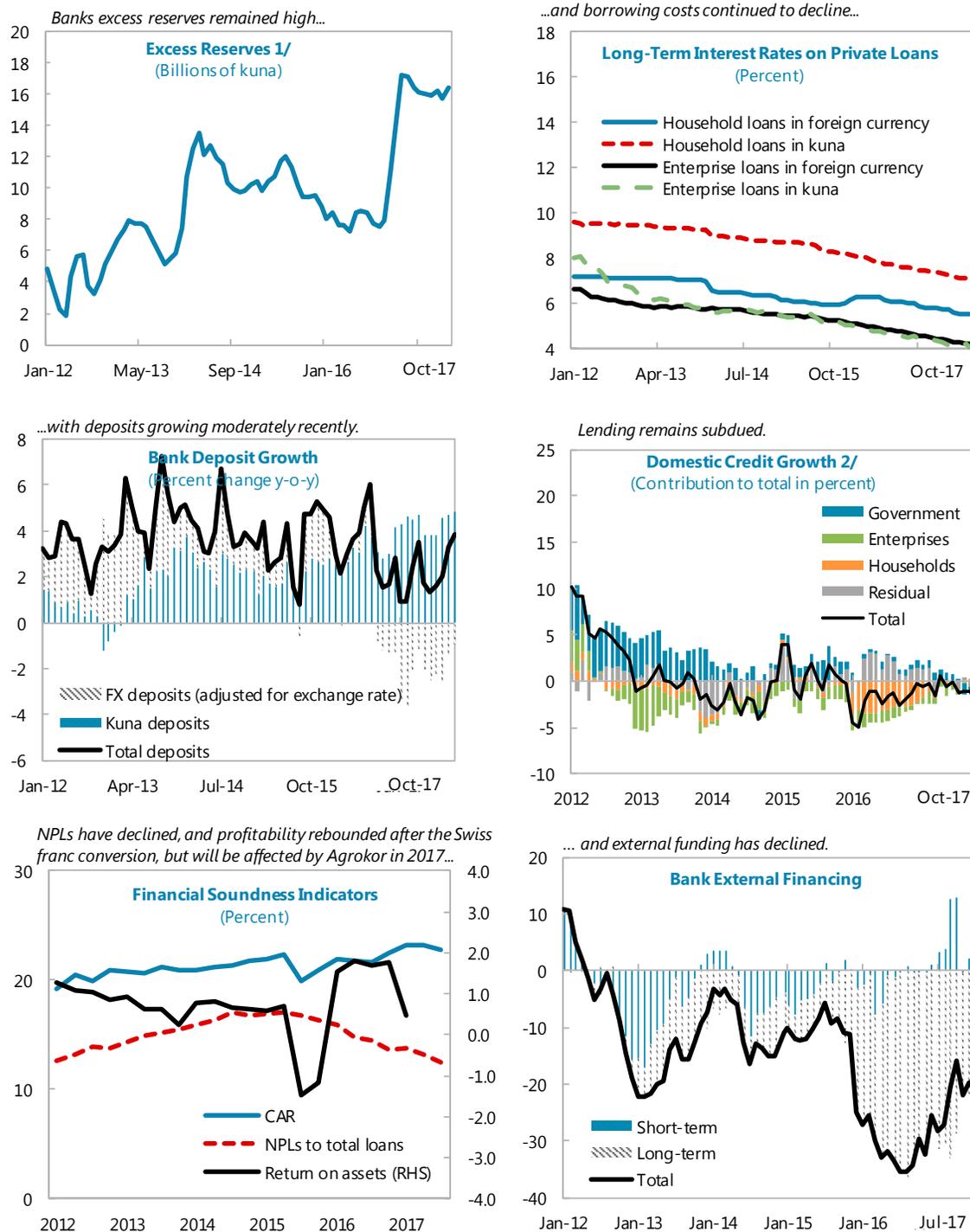


Figure 2. Fiscal Developments and Projections, 2012–22



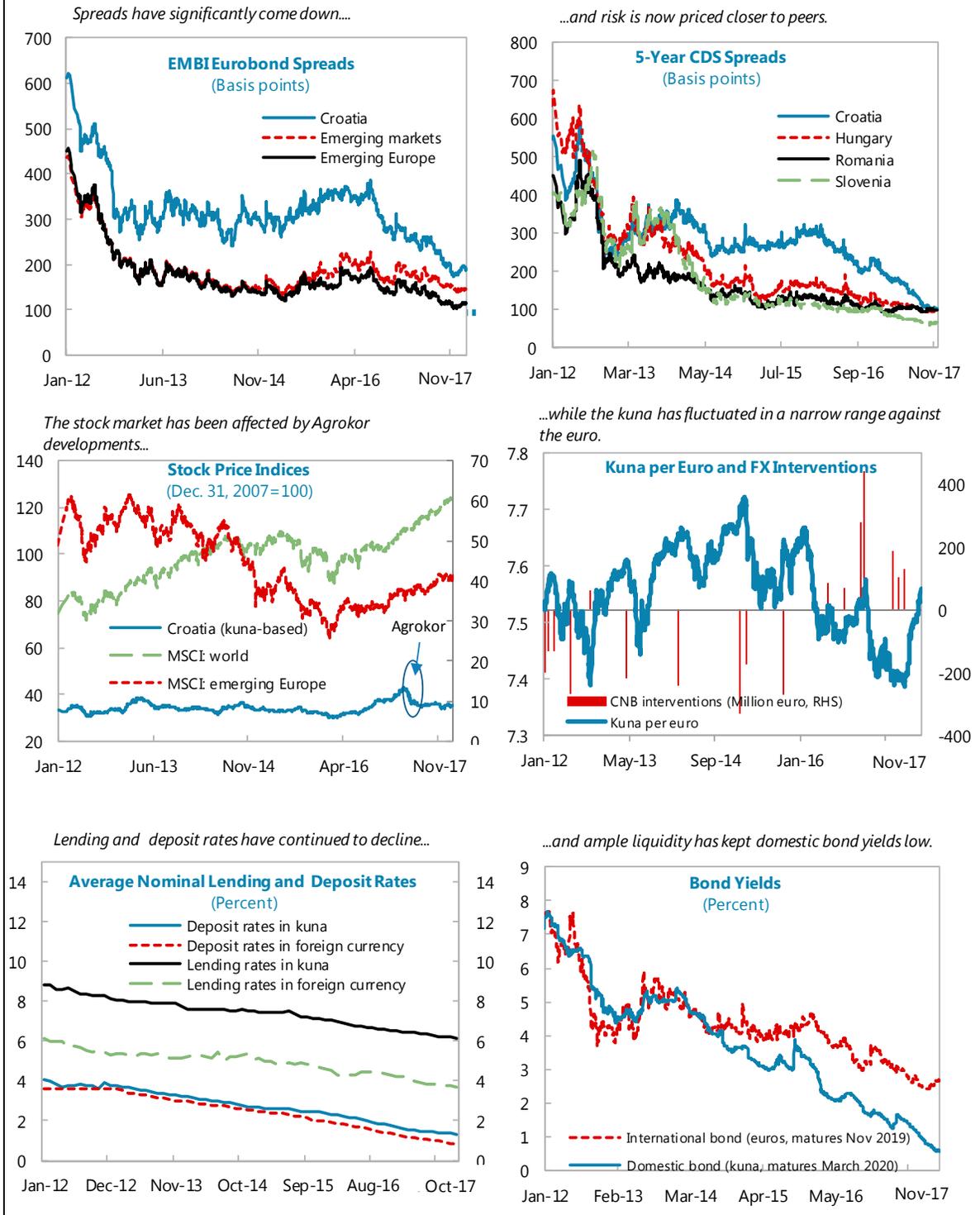
Sources: Croatian authorities; and IMF staff estimates.

Figure 3. Monetary and Banking Sector Developments, 2012–17



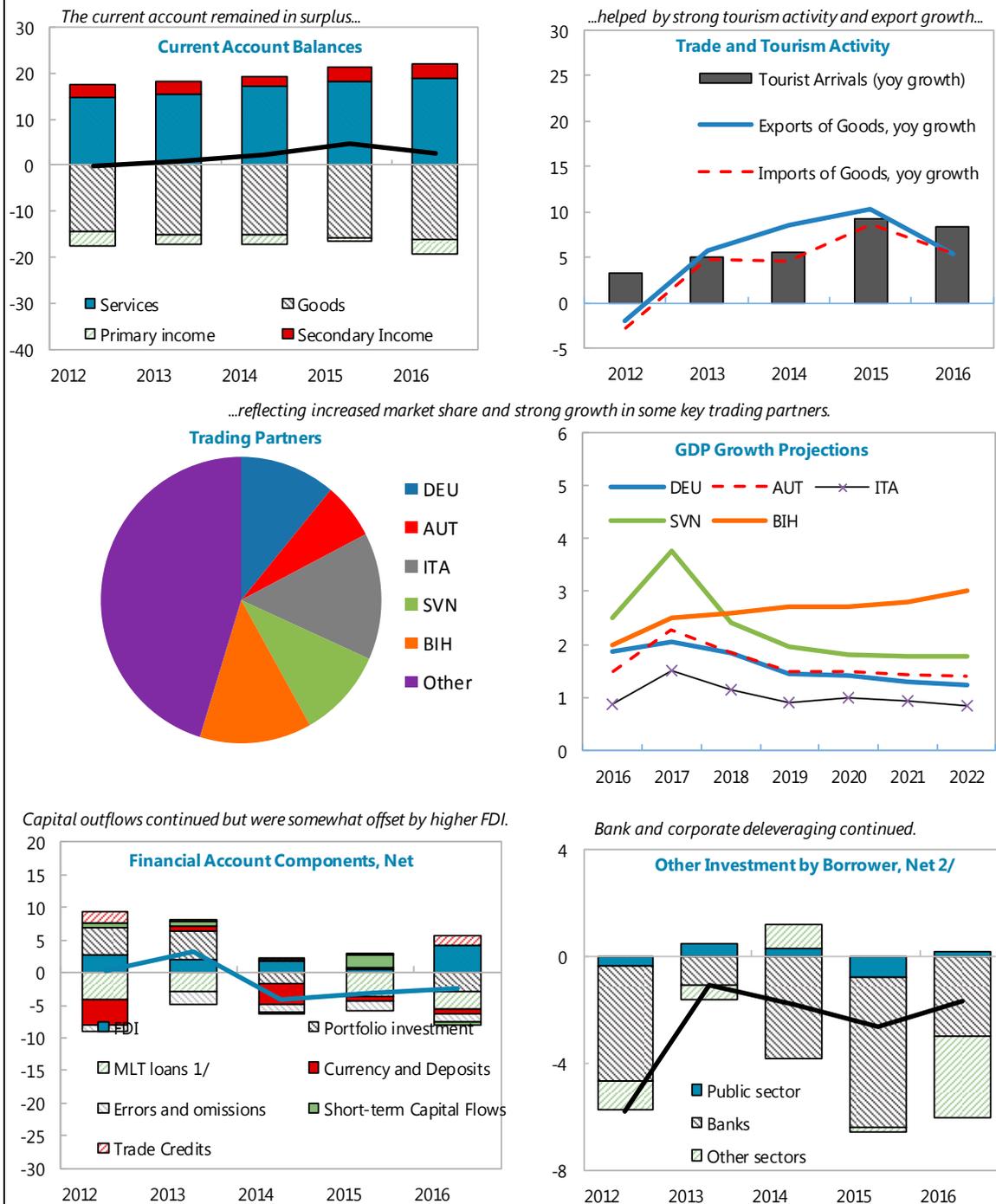
Sources: National Bank of Croatia; and IMF staff estimates and calculations.
 1/ Reserves are a 3-month moving average, in billions of kuna.
 2/ Based on change in stock of credit.

Figure 4. Financial Market Developments, 2012–17



Sources: Bloomberg; Croatian National Bank; and IMF staff calculations.

Figure 5a. Balance of Payments, 2012–16
(Percent of GDP)

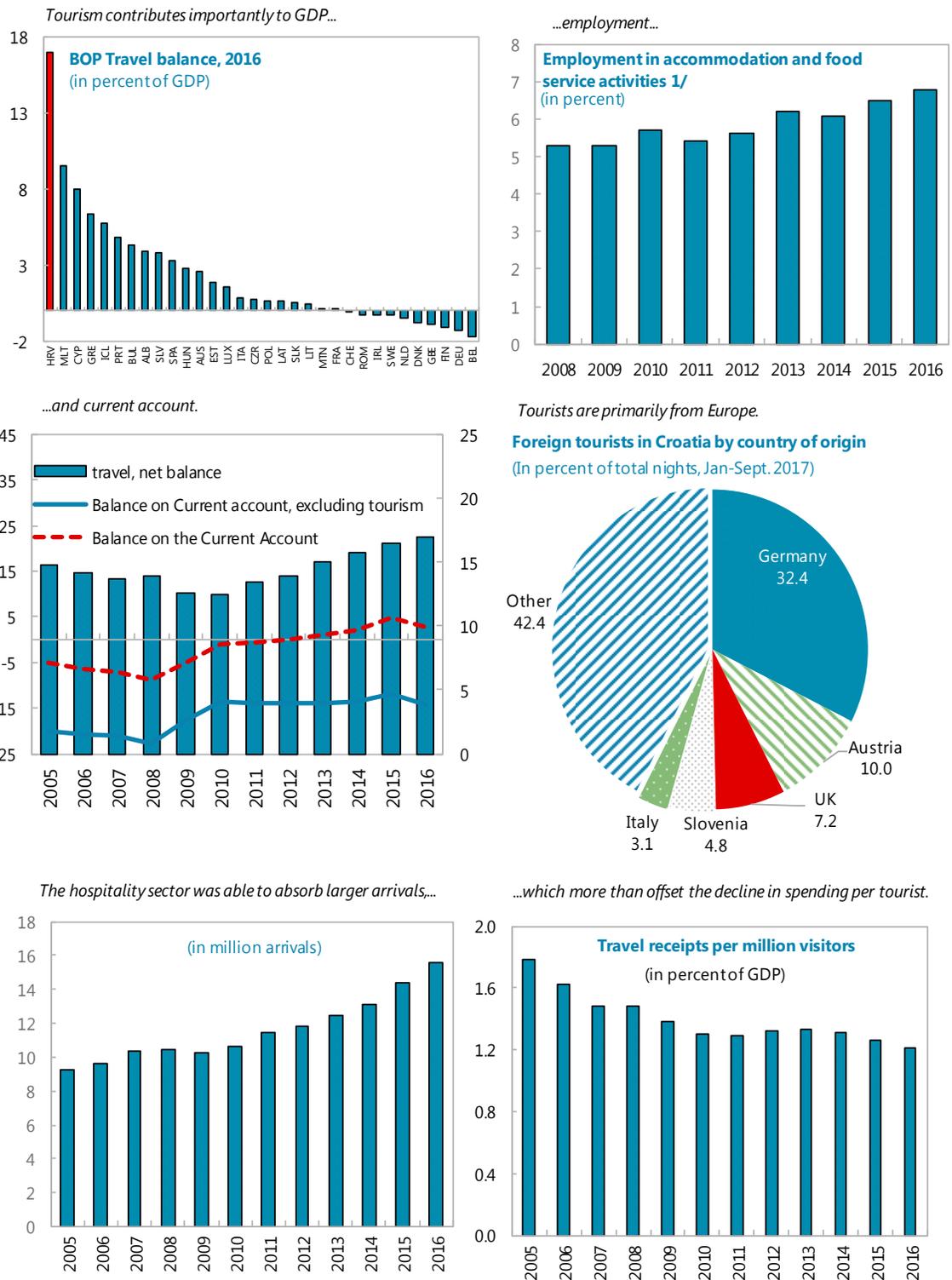


Sources: Croatian National Bank; and IMF staff estimates.

1/ MLT loans - Medium and long-term loans.

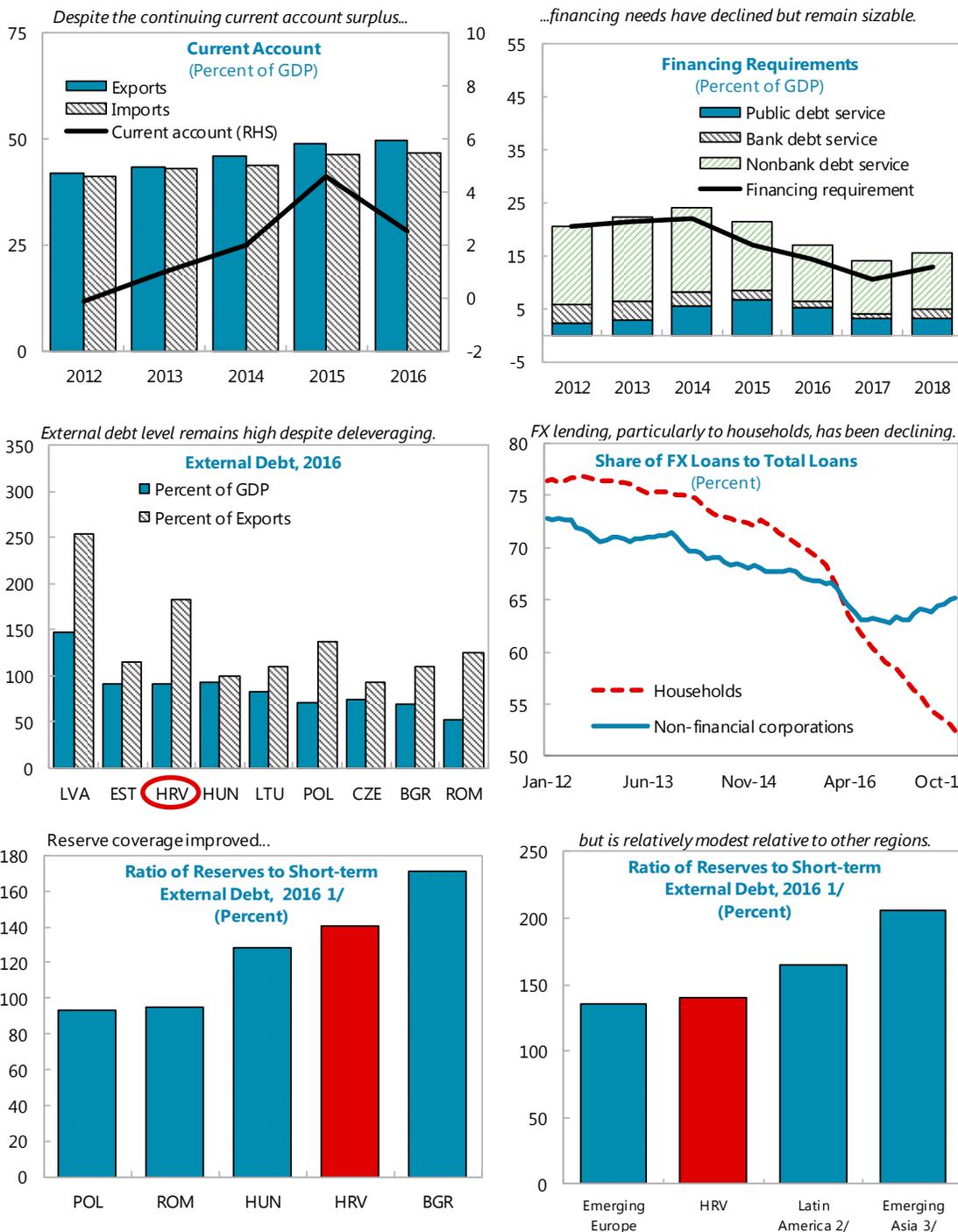
2/ Other investments consists of the of currency and deposits, loans, short-term capital flows, medium and long-term flows, and trade credits.

Figure 5b. Tourism



Sources: Eurostat; Croatia statistical office; Croatian National Bank; and IMF staff calculations.

Figure 6. Short-Term Vulnerability Indicators, 2012–18



Sources: Croatian National Bank; IMF, *World Economic Outlook*; and IMF staff estimates.
 1/ Gross international reserves are end-2016 stocks. Short-term debt at original maturity (end -2016) plus projected amortization of medium and long-term debt (end-2016).
 2/ Excludes Brazil.
 3/ Excludes China.

Table 1. Croatia: Selected Economic Indicators

	2012	2013	2014	2015	2016	2017	2018
	Proj.						
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)						
Real GDP growth	-2.2	-1.1	-0.5	2.2	3.0	3.1	2.8
Contributions:							
Domestic demand	-3.3	-1.0	-1.8	1.9	3.0	3.4	3.1
Net exports	1.1	0.0	1.2	0.3	0.1	-0.3	-0.3
Unemployment	18.9	20.2	19.6	17.0	14.8	...	...
CPI inflation (avg.)	3.4	2.2	-0.2	-0.5	-1.1	1.1	1.5
Saving and investment	(Percent of GDP)						
Domestic investment	19.3	19.1	18.6	19.8	19.8	19.7	20.2
<i>Of which</i> : fixed capital formation	19.6	19.8	19.4	19.8	20.1	20.6	21.3
Domestic saving	19.2	20.1	20.6	24.4	22.4	23.4	23.1
Government	-1.4	-0.7	-0.7	0.3	2.4	2.9	2.9
Nongovernment 1/	20.5	20.8	21.3	24.1	20.0	20.5	20.1
Government sector (ESA 2010 definition)							
General government revenue	41.8	43.0	43.1	45.0	46.8	46.6	46.8
General government expenditure	47.1	48.3	48.5	48.4	47.6	47.2	47.3
General government balance	-5.3	-5.3	-5.4	-3.4	-0.9	-0.6	-0.5
Structural balance 2/	-3.4	-3.0	-2.8	-2.1	-0.4	-0.6	-0.6
General government debt	70.7	82.2	86.6	86.3	83.7	80.4	77.5
Money and credit	(End of period, change in percent)						
Broad money (M4)	3.6	4.0	3.2	5.1	4.7	...	...
Claims on other domestic sectors 3/	-6.2	-1.3	-2.2	-3.0	-3.4	...	...
Interest rates							
Average 3-month T-bill interest rate (in kuna) 4/	1.3	0.8	0.3	0.4	0.4	...	...
Kuna credit rate (unindexed, outstanding amount)	8.2	7.8	7.5	7.1	6.6	...	...
Balance of payments	(Billions of euros, unless otherwise indicated)						
Current account balance	-0.1	0.4	0.9	2.0	1.2	1.8	1.4
Percent of GDP	-0.1	1.0	2.0	4.6	2.5	3.7	2.8
Capital and financial account	0.5	2.3	-0.8	-0.8	-0.8	0.9	-0.6
FDI, net (percent of GDP)	2.8	1.9	1.6	0.6	4.2	1.6	2.0
Overall balance	0.0	1.8	-0.5	0.7	-0.3	2.0	0.8
Debt and reserves	(End of period, billions of euros, unless otherwise indicated)						
Gross official reserves	11.2	12.9	12.7	13.7	13.5	15.5	16.2
Percent of short-term debt (by residual maturity) and services (based on next year level)	7.4	8.3	8.1	8.0	7.6	7.9	7.6
Total external debt (percent of GDP)	103.1	105.3	108.0	103.0	90.9	84.3	78.7
Net external debt (percent of GDP)	65.7	64.5	65.1	57.6	48.7	39.2	33.4
Exchange rate							
Kuna per euro, end of period	7.5	7.6	7.7	7.6	7.6	...	...
Real effective exchange rate (CPI-based, y-o-y change) (negative sign = appreciation)	-1.9	1.4	-1.1	-3.0	-1.5	...	...
Memorandum items:							
Nominal GDP (billions of euros)	43.9	43.5	43.0	44.1	45.8	47.8	49.8

Sources: Croatian authorities; and IMF staff estimates.

1/ Includes state-owned enterprises.

2/ In percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015.

3/ Comprises claims on households and non-financial corporations.

4/ Weighted monthly average of daily interest rates for auctions of Treasury bills issued by the Ministry of Finance.

Table 2. Croatia: Medium-Term Baseline Scenario
(Percent of GDP, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real GDP (percent change)	-2.2	-1.1	-0.5	2.2	3.0	3.1	2.8	2.6	2.4	2.3	2.2
CPI inflation (average)	3.4	2.2	-0.2	-0.5	-1.1	1.1	1.5	1.5	1.6	1.7	1.8
CPI inflation (end-of-period)	4.6	0.3	-0.5	-0.6	0.2	1.4	1.1	1.6	1.7	1.8	1.9
Real sector (percent change)											
Domestic demand	-3.3	-1.0	-1.8	2.0	3.0	3.5	3.2	3.0	2.7	2.7	2.6
Consumption, total	-2.5	-1.2	-1.4	0.5	2.8	3.4	2.4	2.2	2.0	1.8	1.6
Gross fixed capital formation, total	-3.3	1.4	-2.8	3.8	5.2	6.6	6.8	6.1	5.8	5.5	5.2
Saving and investment											
Domestic investment	19.3	19.1	18.6	19.8	19.8	19.7	20.2	20.9	21.3	21.8	22.4
Domestic saving	19.2	20.1	20.6	24.4	22.4	23.4	23.1	22.9	22.8	22.7	22.8
Balance of payments											
Current account balance	-0.1	1.0	2.0	4.6	2.5	3.7	2.8	2.0	1.5	0.9	0.4
Exports of goods, f.o.b.	19.7	20.5	22.0	23.1	22.9	24.5	25.6	26.7	27.8	29.1	30.5
Imports of goods, f.o.b.	34.1	35.7	37.1	39.0	38.9	41.5	43.2	44.7	46.1	47.4	48.8
Capital and financial account	1.2	5.4	-1.9	-1.8	-1.7	1.8	-1.3	-0.8	-0.5	-0.1	0.1
Of which: FDI, net	2.8	1.9	1.6	0.6	4.2	1.6	2.0	3.0	3.0	3.0	2.9
Gross official reserves	25.6	29.7	29.5	31.1	29.5	32.4	32.6	32.5	32.2	31.7	31.0
Gross external debt	103.1	105.3	108.0	103.0	90.9	84.3	78.7	75.0	71.0	67.8	65.8
Net external debt	65.7	64.5	65.1	57.6	48.7	39.2	33.4	29.8	26.1	23.4	22.2
General government finances											
Revenue	41.8	43.0	43.1	45.0	46.8	46.6	46.8	46.8	46.8	46.9	46.9
Expenditure	47.1	48.3	48.5	48.4	47.6	47.2	47.3	47.1	46.6	46.5	46.3
Balance	-5.3	-5.3	-5.4	-3.4	-0.9	-0.6	-0.5	-0.3	0.2	0.4	0.6
Government debt	70.7	82.2	86.6	86.3	83.7	80.4	77.5	74.1	71.0	67.7	64.4
Memorandum items:											
Nominal GDP (billions of kuna)	330.5	329.6	328.1	335.5	345.2	359.8	375.0	390.2	405.8	422.1	439.3
Output gap	-4.4	-5.1	-5.2	-3.4	-1.3	0.2	0.3	0.1	0.0	0.0	0.0
Potential GDP growth	-0.4	-0.4	-0.3	0.3	0.8	1.6	2.7	2.8	2.5	2.3	2.2
Potential GDP per capita (percent change)	-0.1	-0.1	0.1	1.1	1.6	2.1	3.5	3.1	2.9	2.8	2.7

Sources: Croatian Central Bureau of Statistics; Croatian National Bank; Ministry of Finance; and IMF staff estimates.

Table 3. Croatia: Statement of Operations of General Government
(Percent of GDP, ESA 2010)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue	41.8	43.0	43.1	45.0	46.8	46.6	46.8	46.8	46.8	46.9	46.9
Taxes	24.5	25.3	24.9	25.5	26.3	26.5	26.6	26.5	26.5	26.5	26.5
Income tax	5.7	5.9	5.7	5.6	5.6	5.7	5.7	5.6	5.6	5.6	5.6
VAT	12.3	12.7	12.5	12.9	13.2	13.2	13.2	13.2	13.2	13.2	13.2
Excise	3.4	3.8	4.1	4.4	4.6	4.7	4.7	4.7	4.7	4.7	4.7
Import duties	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.5	2.6	2.6	2.6	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Social contributions	11.5	11.3	11.8	11.9	11.8	11.9	11.9	11.9	11.9	11.9	11.9
Other revenue	2.5	2.8	2.6	3.5	4.4	3.9	4.1	4.2	4.2	4.3	4.3
Grants 1/	1.7	1.8	1.5	2.5	3.5	3.0	3.1	3.2	3.2	3.3	3.3
Property income	0.8	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
of which interest receivable:	0.4	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Sales of goods and services	3.4	3.7	3.8	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Expenditure	47.1	48.3	48.5	48.4	47.6	47.2	47.3	47.1	46.6	46.5	46.3
Expense	43.6	44.6	44.9	45.2	44.4	44.0	44.0	43.7	43.3	43.2	43.0
Compensation of employees	12.3	12.1	11.8	12.0	11.8	11.9	12.1	12.0	12.0	11.9	11.8
Use of goods and services	7.3	7.8	8.0	8.0	7.9	8.1	8.0	7.8	7.7	7.7	7.7
Interest, payable	3.4	3.5	3.5	3.6	3.2	3.0	2.8	2.7	2.5	2.3	2.2
Subsidies	2.2	2.1	2.0	1.8	1.6	1.8	1.7	1.7	1.6	1.7	1.7
Current grants 2/	0.9	1.5	1.0	1.7	2.3	1.6	1.6	1.6	1.5	1.5	1.5
Social benefits	16.3	16.5	17.2	16.7	16.2	16.2	16.3	16.4	16.5	16.6	16.7
Other expenses	1.3	1.1	1.4	1.6	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Net acquisition of nonfinancial assets 3/	3.5	3.7	3.6	3.1	3.2	3.2	3.3	3.5	3.3	3.3	3.3
Overall Balance	-5.3	-5.3	-5.4	-3.4	-0.9	-0.6	-0.5	-0.3	0.2	0.4	0.6
Memorandum item:											
General government debt	70.7	82.2	86.6	86.3	83.7	80.4	77.5	74.1	71.0	67.7	64.4
Structural balance 4/	-3.4	-3.0	-2.8	-2.1	-0.4	-0.6	-0.6	-0.4	0.2	0.4	0.6

Sources: Eurostat; and IMF staff estimates.

1/ Mostly EU structural and investment funds.

2/ Non-capital transfers financed by the EU structural funds and national co-financing.

3/ Data in 2016 are preliminary and subject to revisions.

4/ In percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015.

Table 4. Croatia: Monetary Accounts
(End of period, billions of Kuna, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017		
						Q1	Q2	Q3
Monetary survey								
Net foreign assets	47.5	62.3	75.1	93.2	104.7	102.9	97.6	119.8
Croatian National Bank	82.1	95.4	93.5	91.7	95.1	100.9	93.9	99.1
Deposit money banks	-34.7	-33.0	-18.4	1.4	9.6	2.1	3.7	20.7
Net domestic assets	207.2	202.5	198.1	194.2	196.2	188.2	198.9	189.8
Domestic credit (CNB definition)	242.1	240.8	237.0	230.0	221.5	220.9	219.5	220.1
Claims on government, net 1/	59.3	56.7	60.4	66.2	73.2	65.1	72.7	64.8
Claims on other domestic sectors 2/	232.9	229.9	224.9	218.0	210.6	209.5	209.5	210.3
Other items (net)	-34.9	-38.3	-38.9	-35.8	-25.3	-32.7	-20.6	-30.2
Broad money (M4)	254.6	264.8	273.2	287.3	300.9	291.1	296.5	309.6
Narrow money (M1)	51.9	57.9	63.4	70.6	83.5	81.9	89.3	96.0
Currency outside banks	16.9	17.4	18.5	20.1	22.5	22.3	25.1	26.1
Demand deposits	34.9	40.4	44.9	50.5	61.0	59.5	64.2	69.8
Quasi money	202.8	207.0	209.8	216.7	217.4	209.2	207.2	213.7
Kuna-denominated	42.3	44.3	45.0	45.4	47.7	45.6	44.9	44.6
Foreign currency-denominated	160.4	162.7	164.9	171.3	169.7	163.7	162.3	169.1
Balance sheet of the Croatian National Bank								
Net foreign assets	82.1	95.4	93.5	91.7	95.1	100.9	93.9	99.1
Of which: banks' reserves in foreign currency	5.1	4.4	3.7	3.8	0.0	0.0	0.0	0.0
Net international reserves	77.0	80.3	81.2	84.8	95.0	92.3	93.9	98.8
Net domestic assets	-12.9	-26.3	-26.3	-24.1	-21.7	-26.7	-17.6	-23.2
Claims on government (net)	-0.7	-13.8	-11.6	-8.1	-3.5	-12.3	-4.6	-8.0
Claims on banks	0.0	0.0	0.0	0.2	1.1	1.0	1.0	1.0
Claims on other domestic sectors	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	-12.2	-12.5	-14.8	-16.2	-19.3	-15.4	-14.0	-16.2
Reserve money (CNB definition) 3/	61.3	62.7	63.3	63.7	73.3	74.0	76.2	75.9
Of which:								
Currency outside credit institutions	16.9	17.4	18.5	20.1	22.5	22.3	25.1	26.1
Kuna deposits of credit institutions	39.6	40.7	40.2	38.4	45.3	46.1	44.5	43.4
Of which:								
Settlement accounts	11.5	15.1	15.1	16.1	23.8	24.9	23.5	21.7
Statutory reserves in kuna	24.6	22.0	21.9	22.3	21.6	21.2	21.0	21.7
Year-on-year percent changes								
Monetary survey:								
Net domestic assets	-3.5	-2.3	-2.2	-2.0	1.1	-3.4	1.0	-0.9
Domestic credit (CNB definition)	-5.9	-0.5	-1.6	-3.0	-3.7	-1.7	-1.5	-0.7
Claims on government, net 1/	26.2	-4.4	6.5	9.6	10.6	-2.1	4.7	-2.5
Claims on other domestic sectors 2/	-6.2	-1.3	-2.2	-3.0	-3.4	-1.6	-1.1	-0.1
Broad money (M4)	3.6	4.0	3.2	5.2	4.7	3.8	2.9	3.3
Quasi money	4.3	2.1	1.4	3.3	0.3	-1.7	-2.5	-3.1
Balance sheet of the Croatian National Bank:								
Reserve money (CNB definition) 3/	-1.8	2.3	1.0	0.7	14.9	18.0	15.0	20.2
Memorandum items:								
Nominal GDP (yearly total) 4/	330.5	329.6	328.1	335.5	345.2	350.3	355.0	357.4
Broad money (percent of GDP)	77.1	80.4	83.3	85.6	87.2	83.1	83.5	86.6
Foreign currency (percent of broad money)	63.0	61.4	60.3	60.8	56.4	56.2	54.8	54.6
Credit to other domestic sectors: stock (% of GDP)	70.5	69.8	68.5	65.0	61.0	59.8	59.0	58.9
Claims on private sector (transactions, annual change,%) 2/ 5/	-5.7	-0.4	-2.0	-2.3	1.6	1.0	2.2	2.5

Sources: Croatian National Bank; and IMF staff estimates.

Note: As of January 2015, the Croatian National Bank started publishing monetary statistics in line with ESA 2010.

1/ Comprises claims on central government and funds, and local government and funds, net of their deposits in the banking system. Central government funds include the Croatian Bank for Reconstruction and Development (HBOR).

2/ Comprises claims on households and enterprises. Excludes other banking institutions (household savings banks, savings and loan cooperatives, and investment funds) and other financial institutions.

3/ Excludes statutory reserves in foreign currency.

4/ Quarterly annualized GDP is the sum of nominal GDP the last four quarters, not seasonally adjusted.

5/ Transaction data exclude the effects of exchange rate changes, securities price adjustments and write-offs, including sale of placements in the amount of their value adjustments.

Table 5. Croatia: Financial Soundness Indicators
(Percent, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017		
						Q1	Q2	Q3
						Prel.	Prel.	
Regulatory capital to risk-weighted assets	20.9	20.9	21.8	21.0	22.5	23.2	23.3	22.7
Regulatory Tier I capital to risk-weighted assets	19.6	19.9	20.6	19.2	20.9	21.6	21.8	21.3
Nonperforming loans net of loan-loss provisions to capital	39.2	42.8	41.1	34.2	19.3	19.0	19.3	...
Nonperforming loans to total gross loans 1/	13.8	15.4	16.7	16.3	13.6	13.7	13.0	12.5
Total loan-loss provision to nonperforming loans 2/	42.5	46.3	51.0	61.9	70.1	70.6	67.5	...
Return on assets	0.9	0.3	0.6	-1.2	1.8	0.5	0.7	...
Return on equity	6.2	1.8	4.6	-8.7	13.1	3.4	4.6	...
Interest margin to gross income	65.6	62.9	61.1	64.5	59.6	70.2	67.5	...
Noninterest expenses to gross income	57.8	59.2	57.1	94.4	94.9	96.2	96.5	...
Liquid assets to total assets 3/	31.3	30.7	33.0	34.2	34.7	33.8	33.3	...
Liquid assets to short-term liabilities 3/	48.2	46.6	51.7	51.7	50.1	48.6	47.9	...
Net open position in foreign exchange to capital	2.3	2.9	2.9	12.5	3.8	2.8	3.2	...
Residential real estate prices (annual percentage increase)	-5.9	-1.7	-1.4	-2.1	0.8	-0.4	4.3	...

Source: Croatian National Bank and the IMF's *Financial Soundness Indicators*.

Note: The classifications used in the table are consistent with the IMF's Financial Soundness Indicators Database.

1/ Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims.

2/ Total loan-loss provisions in percent of gross loans as defined by the Financial Soundness Indicators.

3/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper, and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans received.

Table 6. Croatia: Balance of Payments
(Millions of euros, unless otherwise indicated) 1/

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-51	415	862	2,019	1,159	1,770	1,406	1,012	792	505	229
Merchandise trade balance	-6,296	-6,587	-6,512	-6,974	-7,337	-8,147	-8,786	-9,362	-9,863	-10,232	-10,677
Exports f.o.b.	8,673	8,924	9,440	10,194	10,511	11,703	12,732	13,812	14,998	16,334	17,823
Imports f.o.b.	14,969	15,511	15,952	17,168	17,848	19,850	21,518	23,174	24,861	26,566	28,500
Services Trade Balance	6,490	6,740	7,341	8,007	8,684	9,486	9,860	10,171	10,449	10,716	10,975
Export of services	9,645	9,832	10,238	11,279	12,265	13,238	13,842	14,460	15,051	15,633	16,250
Imports of services	3,155	3,092	2,897	3,272	3,581	3,753	3,983	4,289	4,601	4,917	5,275
Primary income balance	-1,460	-891	-863	-291	-1,542	-1,124	-1,125	-1,367	-1,377	-1,581	-1,670
Secondary income balance	1,216	1,137	896	1,277	1,354	1,555	1,458	1,568	1,583	1,602	1,602
Capital and financial account	533	2,348	-814	-792	-788	868	-645	-436	-278	-65	69
Capital account	47	56	165	321	598	526	543	560	578	597	616
Financial account	486	2,292	-979	-1,112	-1,386	342	-1,188	-996	-856	-662	-547
Direct investment	1,240	848	697	250	1,942	780	976	1,533	1,593	1,656	1,713
Portfolio investment	1,746	1,927	-718	115	-1,300	-1,024	-417	-782	-788	-796	-61
Financial derivatives	39	-41	-36	16	82	343	-147	-93	-35	91	12
Medium- and long-term loans	-1,860	-1,221	134	-1,606	-1,239	-1,829	-1,639	-1,216	-1,383	-1,291	-1,660
Assets	-43	129	35	38	-17	0	0	0	0	0	0
Liabilities	-1,903	-1,092	169	-1,568	-1,255	-1,829	-1,639	-1,216	-1,383	-1,291	-1,660
Disbursements	4,682	5,471	6,478	4,214	4,090	3,051	1,394	1,786	1,864	1,930	1,466
Amortization	-6,584	-6,563	-6,309	-5,781	-5,345	-4,881	-3,033	-3,002	-3,247	-3,221	-3,127
Currency and deposits	-1,637	336	-1,403	-372	-354	342	187	208	310	328	429
Short-term capital flows (net)	395	348	-78	766	-239	1,298	116	223	210	299	401
Trade credits	690	88	104	11	621	101	273	371	383	399	422
Other liabilities (long-term)	-127	33	289	-189	-531	598	-196	-898	-830	-1,015	-1,469
Net errors and omissions	-434	-918	-578	-481	-635	-669	0	0	0	0	0
Overall balance	46	1,844	-530	745	-265	1,969	761	576	514	440	298
Financing											
Gross reserves (-= increase)	-46	-1,844	530	-745	265	-1,969	-761	-576	-514	-440	-298
Memorandum items:											
Current account (percent of GDP)	-0.1	1.0	2.0	4.6	2.5	3.7	2.8	2.0	1.5	0.9	0.4
Export goods volume growth	-2.1	5.7	8.6	10.2	5.4	8.4	7.5	7.2	7.3	7.4	7.4
Import goods volume growth	-2.7	4.7	4.7	8.6	5.4	8.3	6.8	6.0	5.8	5.8	5.8
Gross official reserves	11,236	12,908	12,688	13,707	13,514	15,483	16,244	16,820	17,334	17,774	18,072
Percent of short-term debt by remaining maturity)	98.9	100.1	108.3	115.5	140.4	155.2	155.0	151.1	156.1	168.6	165.1
Months of next year's imports of goods and nonfactor services	7.4	8.3	8.1	8.0	7.6	7.9	7.6	7.3	7.1	6.8	6.4
Outstanding debt 2/	45,297	45,803	46,416	45,384	41,668	40,275	39,197	38,843	38,267	37,994	38,412
External debt to GDP ratio 2/	103.1	105.3	108.0	103.0	90.9	84.3	78.7	75.0	71.0	67.8	65.8
External debt in percent of exports of goods and nonfactor services 2/	247.3	244.1	235.9	211.4	183.0	161.5	147.5	137.4	127.4	118.9	112.7
GDP (millions of euros)	43,938	43,484	42,976	44,069	45,840	47,781	49,805	51,822	53,886	56,052	58,344

Sources: Croatian National Bank; and IMF staff estimates.

1/ Based on BPM5.

2/ Since end-2008, external debt is reported based on the new reporting system (INOK).

Annex I. Reform Implementation

A. Progress in Implementation of IMF Recommendations

Croatia has made substantial progress in fiscal consolidation and debt reduction. In contrast, the pace of structural reforms moderated since the EU accession in 2013, and reforms have more recently been largely paused due to political challenges. Two governments were formed in 2015-16. The Croatian Democratic Union (HDZ), a majority party winning both elections, had to assemble two coalitions, first with a group of independent parliamentarians (MOST), and then with the Croatian People's Party (HNS) and minorities, ensuring only a thin majority. Structural reforms taken since the 2016 Article IV have only been partially aligned with the authorities' ambitious National Reform Program (2016 Article IV report, Annex V) and Fund advice.

	2016 Article IV Advice	Actions since 2016 Article IV
Fiscal consolidation	Continue fiscal consolidation but make it more growth-friendly.	Achieved. Annual fiscal consolidation in 2015-17 exceeded staff advice although partly due to strong economic recovery.
Structural tax reform	Reduce income tax rates and implement off-setting revenue, including eliminating one of the two preferential VAT rates. Introduce in 2018-19 a modern real estate tax, in line with past TA recommendations.	Limited progress. Improvements were introduced to both the VAT and income tax systems, but the original tax reform proposal package included a somewhat more ambitious VAT reform. ¹ The introduction of the real estate tax was postponed.
Streamlining public expenditures	(a) Contain the growth of the wage bill by linking remuneration to performance, introducing a single salary framework, and streamlining the multi-layered and fragmented public administration.	(a) Delayed. The decision on prohibiting new recruitment of civil servants and employees in special administrative units, professional services and offices of the government was adopted in July 2016. An Action Plan for the Implementation of the Public Administration Development Strategy for the period 2017-20 envisages establishing a unified competence framework for the classification and systematization of jobs of civil servants and state employees. A pilot project will be launched in five ministries to test the process and allow a choice of possible models. (b) No progress. The establishment of a one stop shop for all benefits has been postponed

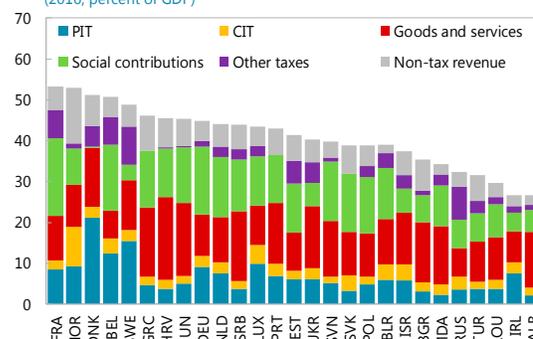
¹ The general corporate (profit) tax rate was reduced from 20 to 18 percent (for small businesses to 12 percent) while corporate tax exemptions were reduced. For personal income tax, the minimum tax-exempt income was increased from 2,600 to 3,800 kuna and the tax rates were changed from 12, 25 and 40 percent to 24 and 36 percent. The proposed VAT Act reduced the number of tax rates from three (25 percent, 13 percent and 5 percent), to only two (25 percent and 13 percent), with some goods and services being reallocated in those tranches, but the adopted Act maintained the three rates. The period for voluntary registration in the VAT system decreased from five to three years, and the threshold increased to 300,000 Kuna (about €40,000). In addition, it will now be possible to apply a tax deduction of 50 percent to advance VAT payments for the acquisition or lease of motor vehicles when the value does not exceed HRK 400,000. Other VAT modifications relate to real estate transactions, import and customs operations, reciprocity in refunding VAT to third parties, and new measures to deter VAT ID fraud, including important changes in penalties.

	(b) Better target social expenditures by accelerating the one-stop shop for the numerous benefits while enhancing means testing.	to 2020. Moreover, a new allowance for parents of small children starting at six month after birth were introduced. The budget already pays out allowances from 6 to 12 months after birth, and these allowances were increased by 5 percent.
Improving absorption of EU funds	Improve implementation capacity and simplify administrative procedures. Expedite the transposition of the procurement directive.	Limited progress. Croatia has contracted 29 percent from the €10.7 billion EU funds available under the 2014-20 programming period. The national priority Action Plan for Increasing the Efficiency of EU Fund Use for the period 2016-2018 was adopted in June 2016.
Strengthening public sector management	(a) Advance privatization especially of inactive assets in a transparent way. (b) Amend the Fiscal Responsibility Law to strengthen the link between annual budget planning and the multi-year fiscal strategy.	(a) Limited progress. Eight SOEs were divested in 2016. The development of methodological operational guidelines to make SOEs more efficient is underway. Some of the non-core assets have been sold, but behind schedule, while a draft proposal of the decision on further sales of apartments owned by the state (about 4,000 apartments) has been drafted. (b) Some progress. A new draft of the Fiscal Responsibility Act, which is being finalized, aims to enhance the autonomy and role of the Fiscal Policy Commission.
Reducing administrative procedures to improve business environment	(a) Reduce parafiscal fees. (b) Enhance the judiciary framework.	(a) Some progress. In January 2017, an Action Plan for Reduction of Administrative Burden on the Economy was adopted, with the aim to stimulate investment and competitiveness. In total, 104 measures have been identified as creating most of administrative burden: health and safety at work, trade, energy efficiency in construction, business registration, and real estate trade. Para-fiscal fees have been already reduced by 30 percent in 2017. In May 2017, the government introduced the mandatory application of the Test on Small and Medium-Sized Enterprises (SME test). All primary and secondary pieces of legislation have to be assessed from the viewpoint of their possible administrative and cost effect on business, especially small and medium-sized companies. (b) Limited progress. The court case backlog remains very high despite some improvement.

B. Progress in Domestic Revenue Mobilization²

Croatia’s public revenues are at the level of advanced European countries. This high level of public revenues is both the result of historically high tax rates and continuous efforts to improve tax administration. Croatia raises almost 46 percent of GDP in public revenues, only slightly below Scandinavian countries. It has the highest indirect tax (on goods and services) ratio among European countries, at 20 percent of GDP. Direct taxes, on the contrary, are comparably low. They are largely eroded by large tax exemptions, barely raising 5.5 percent of GDP. Tax collection through social contributions remains slightly above the EU average, at almost 12 percent of GDP in 2016 (Figure 1).

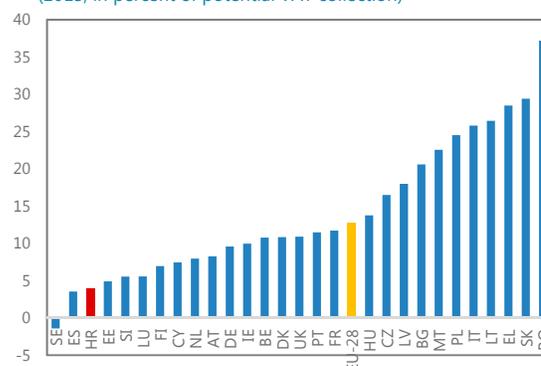
Figure 1. Public Revenue in Europe
(2016; percent of GDP)



Source: IMF, WEO database.

Several tax administration reforms were undertaken during the past decade. In the last ten years, Croatia’s Tax Administration (CTA) was restructured with the help of the World Bank at the regional and central levels. Major reforms occurred in 2013. For example, the CTA opened a Large Taxpayers Office along with a Taxpayer’s Service Unit and a unit for Sector Strategy and Development. The introduction of a taxpayer identification number (OIB) became the centerpiece of the new e-citizen initiative. To increase tax compliance and reduce fraud, the CTA introduced fiscal registers for cash-based services and a public listing of tax delinquents. A strengthened tax administration code gave new powers to collect tax-related information from taxpayers and third-parties, and to enforce the payment of tax arrears. These tax administration changes implemented in the middle of a strong recession had a significant impact on tax collection going forward. For example, today Croatia is the EU country with the third smallest VAT tax gap, measured as the overall difference between the expected VAT revenue and the amount actually collected (Figure 2).³

Figure 2. VAT tax gap
(2015; in percent of potential VAT collection)



Source: European Commission (2017).

The authorities conducted a comprehensive review of the tax system in 2016 and introduced a major tax reform in 2017. The conclusions of the review pointed to a higher tax burden than in neighboring countries on labor and profit, a failure to meet certain tax

² Prepared by Carlos Mulas-Granados.

³ European Commission. 2017. “Study and Reports on the VAT Gap in the EU-28 Member States: 2017 Final Report.” https://ec.europa.eu/taxation_customs/sites/taxation/files/study_and_reports_on_the_vat_gap_2017.pdf

expenditures, and still a high level of bureaucracy in tax administration despite previous modernization efforts. As part of the National Reform Program, the authorities engaged in a major tax reform, which aimed at cutting tax rates (Annex I), simplifying tax administration further, and increasing the legal certainty for taxpayers. Thus, in July 2017, a new reorganization of CTA was approved, which (i) empowered regional offices with legal departments for audit, enforcement, and other support, (ii) increased the automation of their tasks, and (iii) introduced a special Taxpayer Information and Education Department to better liaise with individual taxpayers, chambers, employers, and professional associations.

The growing use of technology is at the center of improved taxpayer compliance. The gradual introduction of e-VAT, e-PIT, e-audit, e-learning, and compliance risk-management tools in the past decade notably improved the CTA's results. For example, the percentage of e-filing by the corporate sector increased from less than 3 percent in 2007 to more than 99 percent in 2016. In addition, the CTA also upgraded its website several times, making it one of the most popular government websites, with nearly 30 million visits per year. The 2017 reforms also introduced personal tax cards for e-filing of taxes to reduce the administrative burden further. Until June 2017, only businesses could file taxes electronically, but thanks to recent upgrades funded by EU programs, the CTA has considerably deepened customer-centered services, so that all citizens can now interact electronically with the tax administration. New electronic services, introduced in 2017, include: user mail box, tax payer profile, and e-requests. The CTA's strategy for 2016-20 aims at achieving paperless tax administration by the period-end.

Challenges remain in fully implementing a risk-based management system, improving capacity building in the CTA, and reducing administrative burden further. The introduction of the risk-management system is underway but is advancing slowly. It consists of a risk management module that will select taxpayers for audit based on risk analysis, a data warehouse, and general audit support. Once implemented, the system should enhance the CTA's ability to detect fraudulent practices and, thus, optimize the effectiveness of the audit system. Building capacity in the Large Taxpayers Office is also a high priority for improving revenue collection further. The CTA's strategy emphasizes the need for continuous training of civil servants, including through 12 e-learning modules developed with the help of the World Bank.⁴ It is important that these pilot efforts be mainstreamed into a permanent structure of capacity building. Finally, according to a World Bank/PwC report (PwC, 2018) additional efforts would be required to reduce the number of transactions/administrative steps taxpayers need to go through before settling their obligations with the CTA. In this regard, Croatia ranks well in terms of both the number of transactions and time required to pay corporate and income taxes. However, when other taxes are also considered, Croatia moves to the last position, averaging 35 transactions per tax payment compared to the European average of 12 transactions per payment (PwC, 2018).⁵

⁴ "Croatia Policy Notes: Restoring Macroeconomic Stability, Competitiveness and Inclusion. Tax Policy and Tax Administration" (World Bank February, 2016).

⁵ "Paying Taxes 2018" (Price Waterhouse Coopers and the World Bank, November 2018). https://www.pwc.com/gx/en/paying-taxes/pdf/pwc_paying_taxes_2018_full_report.pdf

Annex II. Public Debt Sustainability Analysis¹

Public debt has been declining since 2014, although it remains high. It is projected to be around 80 percent of GDP at end-2017. The gross financing needs also remain elevated at about 13 percent of GDP in 2017. Under the baseline, debt will continue to gradually decline over the medium term. However, this projection remains vulnerable to growth prospects and materialization of contingent liabilities, such as guarantees to SOEs, which are not included in the public debt statistics.² On the other hand, there could be some gains if more state assets are divested, with the proceeds used for public debt reduction. The analysis includes a conservative estimate for privatization proceeds.

Definitions, debt profile, and vulnerabilities

- *Definitions and coverage:* Croatia's gross debt statistics cover the general government (central, local, social security funds, and state-owned enterprises), and consists of liabilities in the following instruments: cash and deposits, debt securities, and credits and loans.
- *Debt profile and developments:* Central government debt accounts for 80 percent of general government gross debt. About half of public debt is denominated in foreign currency (mostly euro), and more than 90 percent of outstanding debt matures beyond one year. The debt denominated in euro has increased gradually during the last few years due to the issuance of domestic and foreign bonds denominated in or indexed to euro, borrowing in the domestic market via syndicated loans, and use of project loans from international financial institutions. Since its peak in 2014, public debt has declined more than 5 percentage points, but remains high at almost 80 percent of GDP. Gross financing needs have been high, but met on favorable terms due to lower risk premia because of the pick-up in economic activity and better than expected fiscal performance.
- *Debt management strategy:* The authorities have published an updated Debt Management Strategy (2017-2019), which recognizes that public debt represents a key macroeconomic challenge. As a consequence, the strategy emphasizes the need to accelerate the fiscal adjustment and aims at reducing the debt-to-GDP ratio by 10 percentage points by 2020. Key objectives of this strategy are to further reduce short-term debt, mitigate currency and interest rate risks, and increase the transparency of public debt and borrowing. Staff supported this strategy, but recommending additional adjustment to expedite the reduction in public debt.
- *Realism of projections.* Croatia's projected fiscal adjustment of about 2.5 percentage points in the cyclically-adjusted primary balance over the medium term is similar to other countries' past adjustments.
- *Vulnerabilities:* As illustrated by the heat map, the stock of debt remains high. At the same time, the gross financing needs are no longer above the 15 percent high-risk threshold. The debt

¹ Prepared by Carlos Mulas Granados.

² In November 2017, Croatia refinanced part of the debt of highway companies through issuing a Eurobond (€ 1.3 billion bond with a 12-year maturity at a yield of 2.95 percent) under a state. The total debt of the road companies is €5.2 billion, or 11.2 percent of GDP.

profile has also improved in terms of longer maturity, but external financing requirements remain high.

The baseline scenario incorporates staff's medium-term deficit and growth projections

- *Fiscal path:* Preliminary data put the 2017 general government deficit at around 0.6 percent of GDP. The deficit is projected to register -0.5 percent of GDP in 2018, and to move towards a small surplus in the medium term.
- *Growth:* Real GDP growth is estimated at 3.1 percent for 2017. Going forward, growth is expected to converge towards its potential rate of about 2 percent.

Risks to the baseline arise mainly from lower growth, but the past track record of fiscal overperformance mitigates the balance of risks

- While Croatia's real GDP growth forecast has been optimistic since 2009, errors have diminished in magnitude in recent years, and growth has surprised on the upside. The growth shock in the coming years could come from uncertainties with the restructuring of Agrokor and abrupt changes in the external environment, but the risk has diminished as Croatia and its external partners have regained growth momentum.
- A neutral interest rate-growth differential and the consolidation efforts will result in much faster debt contraction than previously projected. Gross financing needs are also projected to decline due to lower deficits and recent refinancing of debt at longer maturities and favorable interest rates, resulting in lower effective rates, even after assuming gradual increases in international interest rates.

Shocks and Stress Tests

- **Slower output growth is the main risk to debt sustainability.** Underperformance of real GDP growth by one standard deviation results in the primary deficit deteriorating to about 1.9 percent of GDP and public debt sharply increasing to over 90 percent in 2019, before improving thereafter. Gross financing would approach the 15 percent of GDP mark in 2019.
- **A combination of macro-fiscal shocks further highlights the sensitivity of public debt and gross financing needs to adverse scenarios.** Assuming that shocks to real GDP growth, the primary balance, real exchange rate, and real interest rate occur simultaneously, public debt would increase sharply and become close to 100 percent of GDP at its peak and gross financing needs would become close to 17 percent of GDP in 2019.

Croatia Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

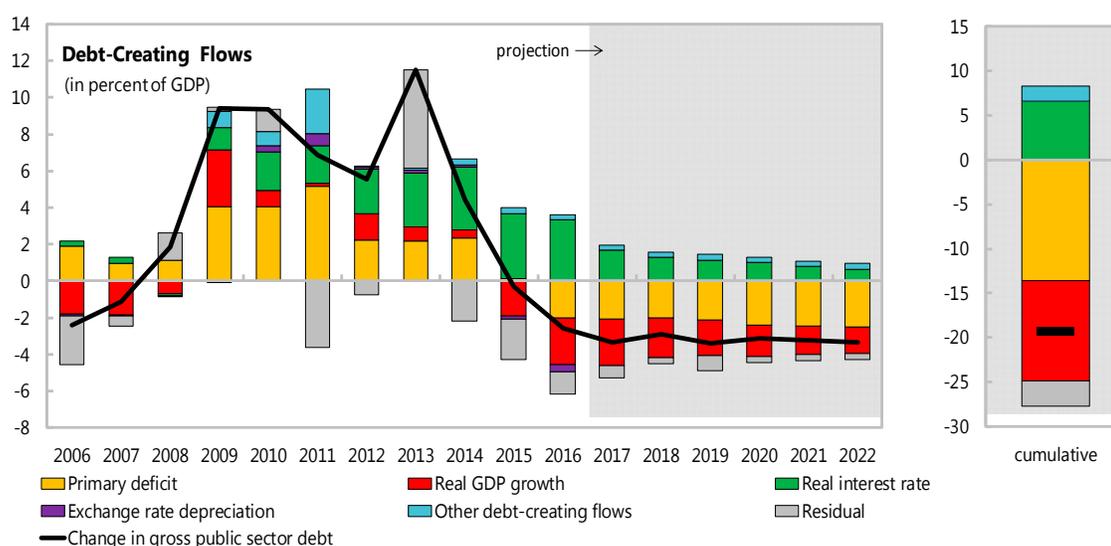
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of September 30, 2017		
	2006-2014 ^{2/}	2015	2016	2017	2018	2019	2020	2021	2022			
Nominal gross public debt	58.7	86.3	83.7	80.4	77.5	74.1	71.0	67.7	64.4	Sovereign Spreads		
Public gross financing needs	19.4	16.1	11.1	12.8	11.5	8.7	6.6	4.2	3.3	EMBIG (bp) ^{3/} 189		
Real GDP growth (in percent)	-0.1	2.2	3.0	3.1	2.8	2.6	2.4	2.3	2.2	5Y CDS (bp) 106		
Inflation (GDP deflator, in percent)	2.4	0.0	-0.1	1.1	1.4	1.4	1.5	1.7	1.8	Ratings Foreign Local		
Nominal GDP growth (in percent)	2.3	2.3	2.9	4.2	4.2	4.0	4.0	4.0	4.1	Moody's Ba2 Ba2		
Effective interest rate (in percent) ^{4/}	5.1	4.2	3.8	3.2	3.1	3.0	3.0	2.9	2.9	S&Ps BB BB		
										Fitch BB BB		

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022		
Change in gross public sector debt	5.0	-0.3	-2.6	-3.3	-2.9	-3.4	-3.1	-3.2	-3.3	-19.3	
Identified debt-creating flows	5.2	1.9	-1.3	-2.6	-2.6	-2.6	-2.8	-2.9	-3.0	-16.5	
Primary deficit	2.7	0.1	-2.0	-2.1	-2.0	-2.1	-2.4	-2.4	-2.5	-13.6	-0.5
Automatic debt dynamics ^{5/}	2.0	1.5	0.4	-0.8	-0.9	-0.8	-0.7	-0.8	-0.8	-4.7	
Interest rate/growth differential ^{6/}	1.9	1.6	0.8	-0.8	-0.9	-0.8	-0.7	-0.8	-0.8	-4.7	
Exchange rate depreciation ^{7/}	0.1	-0.1	-0.4	...	...	...	...	...	...	...
Other identified debt-creating flows	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.8	
Residual, including asset changes ^{8/}	-0.2	-2.2	-1.2	-0.7	-0.3	-0.8	-0.3	-0.3	-0.3	-2.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

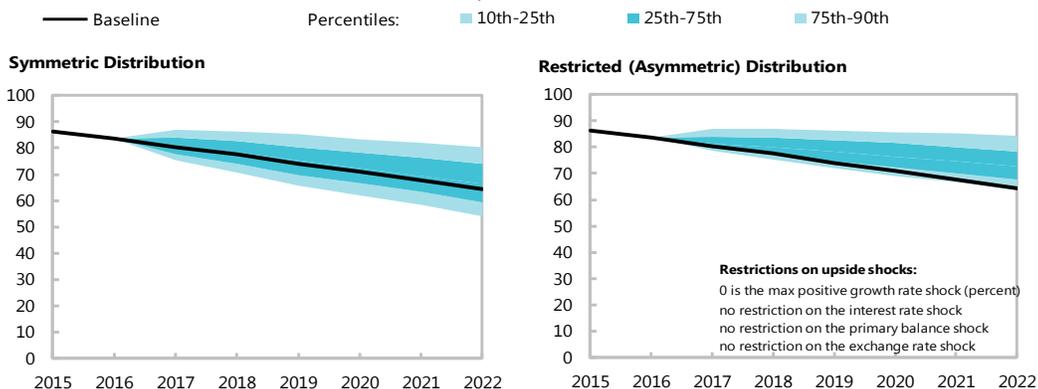
Croatia Public DSA Risk Assessment

Heat Map

Debt level ^{1/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs ^{2/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile ^{3/}	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

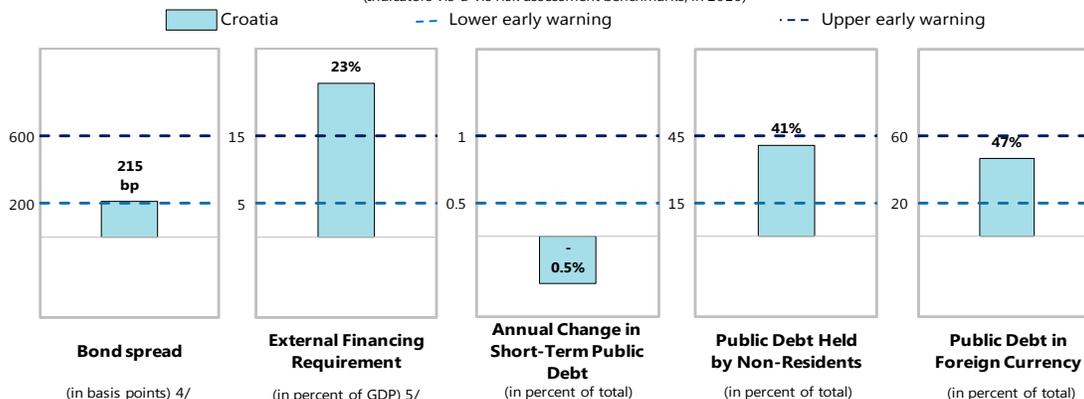
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Jul-17 through 30-Sep-17.

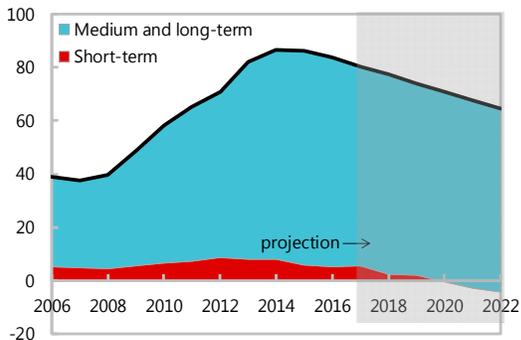
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Croatia Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

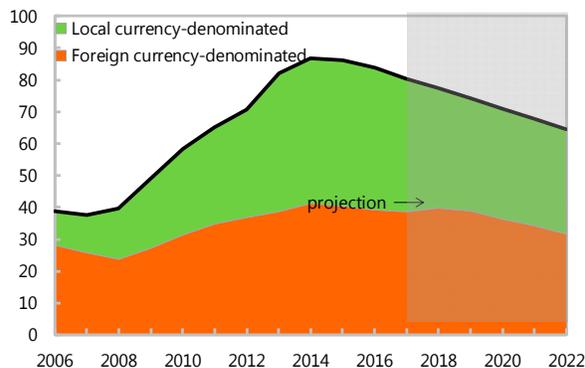
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios

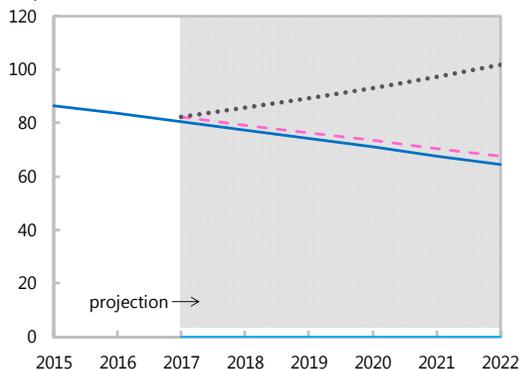
— Baseline

..... Historical

- - - Constant Primary Balance

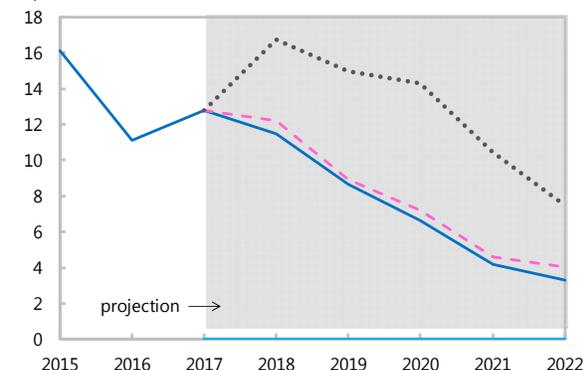
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario

	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	2.8	2.6	2.4	2.3	2.2
Inflation	1.1	1.4	1.4	1.5	1.7	1.8
Primary Balance	2.1	2.0	2.1	2.4	2.4	2.5
Effective interest rate	3.2	3.1	3.0	3.0	2.9	2.9

Constant Primary Balance Scenario

	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	2.8	2.6	2.4	2.3	2.2
Inflation	1.1	1.4	1.4	1.5	1.7	1.8
Primary Balance	2.1	2.1	2.1	2.1	2.1	2.1
Effective interest rate	3.2	3.1	3.0	3.0	2.9	3.0

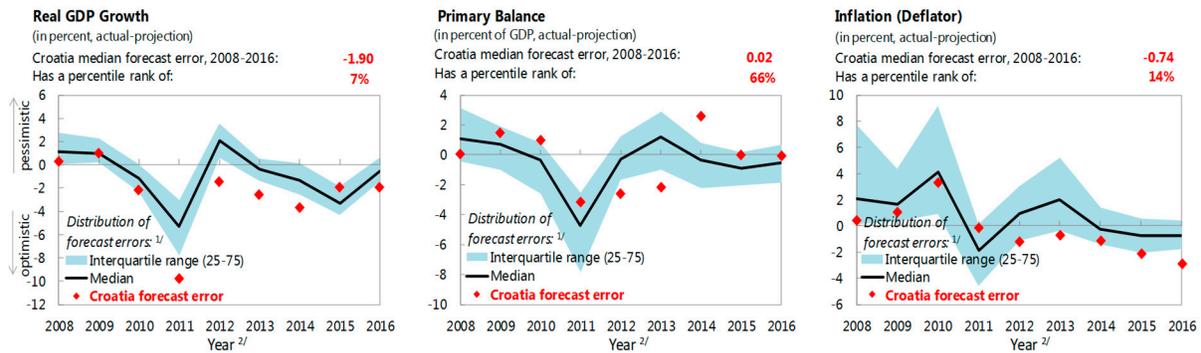
Historical Scenario

	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.1	1.4	1.4	1.5	1.7	1.8
Primary Balance	2.1	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	3.2	3.1	3.3	3.6	3.9	4.3

Source: IMF staff.

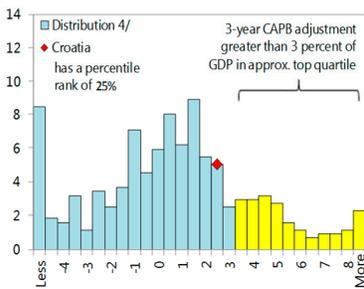
Croatia Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

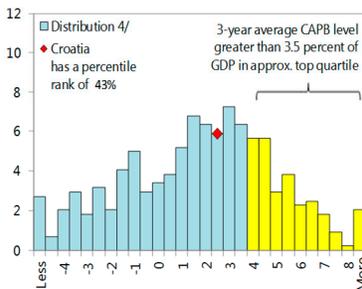


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)

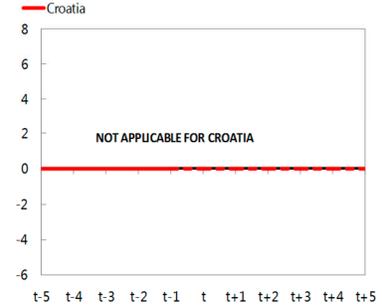


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)



Boom-Bust Analysis^{3/}

Real GDP growth (in percent)



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

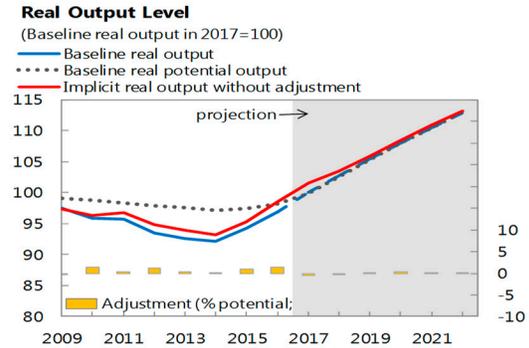
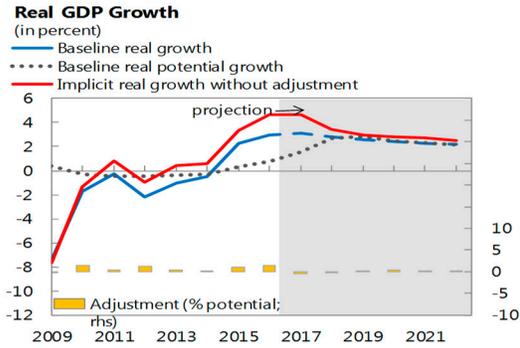
3/ Not Applicable for Croatia

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Croatia Public DSA – Realism of Baseline Assumptions (concluded)

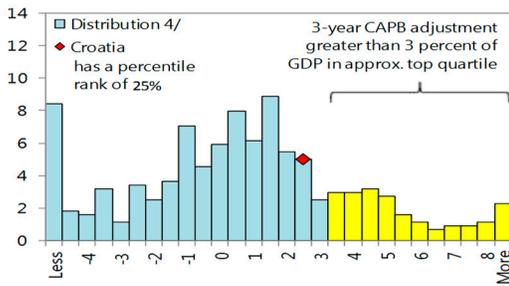
Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 0.7, persistence of 0.6

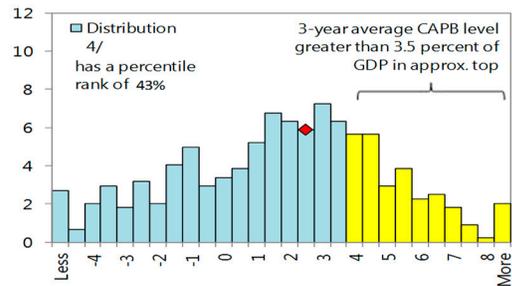


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)

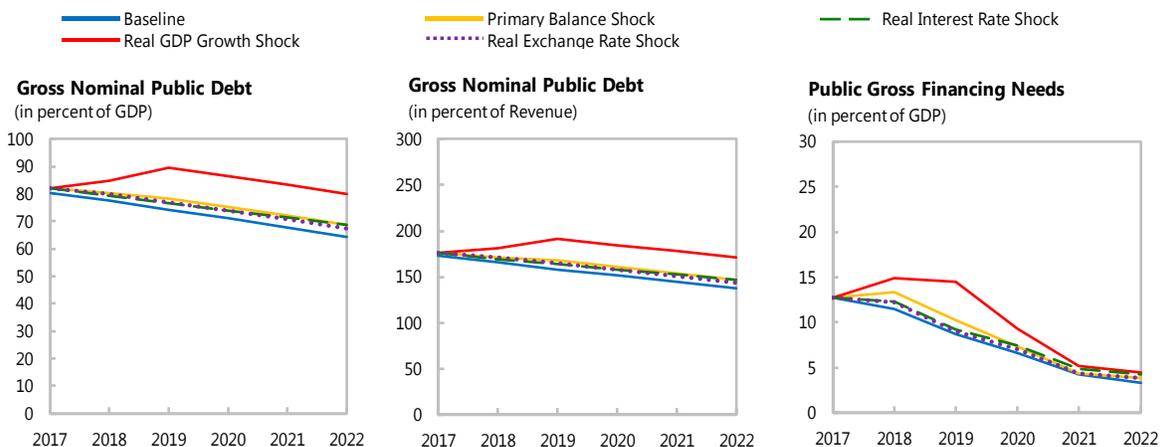


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)

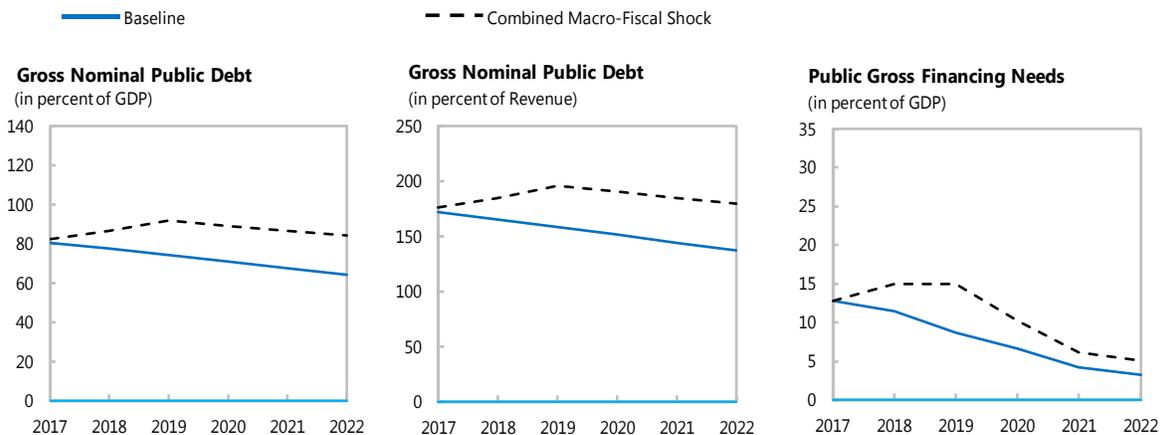


Croatia Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions (in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022	Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	2.8	2.6	2.4	2.3	2.2	Real GDP growth	3.1	-0.7	-0.9	2.4	2.3	2.2
Inflation	1.1	1.4	1.4	1.5	1.7	1.8	Inflation	1.1	0.5	0.5	1.5	1.7	1.8
Primary balance	2.1	1.0	1.1	2.4	2.4	2.5	Primary balance	2.1	0.1	-1.9	2.4	2.4	2.5
Effective interest rate	3.2	3.1	3.0	3.1	3.0	3.0	Effective interest rate	3.2	3.1	3.1	3.3	3.2	3.2
Real Interest Rate Shock							Real Exchange Rate Shock						
Real GDP growth	3.1	2.8	2.6	2.4	2.3	2.2	Real GDP growth	3.1	2.8	2.6	2.4	2.3	2.2
Inflation	1.1	1.4	1.4	1.5	1.7	1.8	Inflation	1.1	2.6	1.4	1.5	1.7	1.8
Primary balance	2.1	2.0	2.1	2.4	2.4	2.5	Primary balance	2.1	2.0	2.1	2.4	2.4	2.5
Effective interest rate	3.2	3.1	3.4	3.7	3.8	4.1	Effective interest rate	3.2	3.1	2.9	3.0	2.9	2.9
Combined Shock													
Real GDP growth	3.1	-0.7	-0.9	2.4	2.3	2.2							
Inflation	1.1	0.5	0.5	1.5	1.7	1.8							
Primary balance	2.1	0.1	-1.9	2.4	2.4	2.5							
Effective interest rate	3.2	3.1	3.4	3.8	4.0	4.3							

Source: IMF staff.

Annex III. External Debt Sustainability Analysis

Table 1. Croatia: External Debt Sustainability Framework, 2010–21
(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing noninterest current account 6/
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	
Baseline: external debt	103.1	105.3	108.0	103.0	90.9	84.3	78.7	75.0	71.0	67.8	65.8	-4.8
Change in external debt	-0.7	2.2	2.7	-5.0	-12.1	-6.6	-5.6	-3.7	-3.9	-3.2	-1.9	
Identified external debt-creating flows (4+8+9)	-0.5	-1.7	-2.4	-7.5	-9.7	-8.0	-7.0	-6.8	-6.1	-5.4	-4.7	
Current account deficit, excluding interest payments	-3.4	-4.2	-5.5	-8.0	-3.3	-4.5	-3.6	-2.7	-2.2	-1.7	-1.2	
Deficit in balance of goods and services	0.4	0.4	1.9	2.3	2.9	2.8	2.2	1.6	1.1	0.9	0.5	
Exports	41.0	42.7	45.8	48.7	49.7	52.2	53.4	54.6	55.8	57.0	58.4	
Imports	-40.5	-42.3	-43.9	-46.4	-46.7	-49.4	-51.2	-53.0	-54.7	-56.2	-57.9	
Net non-debt creating capital inflows (negative)	-2.5	-1.8	-1.7	-0.5	-4.2	-1.6	-1.9	-2.9	-2.9	-2.9	-2.9	
Automatic debt dynamics 1/	5.4	4.4	4.8	1.1	-2.2	-1.9	-1.5	-1.2	-1.0	-0.8	-0.7	
Contribution from nominal interest rate	3.6	3.3	3.5	3.4	0.8	0.8	0.8	0.8	0.8	0.8	0.8	
Contribution from real GDP growth	2.3	1.1	0.5	-2.4	-3.0	-2.7	-2.3	-2.0	-1.7	-1.6	-1.4	
Contribution from price and exchange rate changes 2/	-0.5	0.0	0.7	...	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-0.6	3.9	5.8	2.5	-2.4	1.4	1.4	3.1	2.2	2.2	2.8	
External debt-to-exports ratio (percent)	251.6	246.6	235.9	211.4	183.0	161.5	147.5	137.4	127.4	118.9	112.7	
Gross external financing need (billions of Euros) 4/	14.1	12.6	12.8	12.2	13.6	12.6	15.9	16.4	16.7	16.8	16.4	
Percent of GDP	32.1	29.0	29.7	27.8	29.6	26.4	32.0	31.6	30.9	30.0	28.1	
Scenario with key variables at their historical averages 5/		105.3	108.0	103.0	90.9	89.5	88.3	88.7	88.2	87.8	88.0	-2.7
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	-2.2	-1.1	-0.5	2.2	3.0	3.1	2.8	2.6	2.4	2.3	2.2	
GDP deflator in Euros dollars (percent change)	0.5	0.0	-0.7	0.3	1.0	1.1	1.4	1.4	1.5	1.7	1.8	
Nominal external interest rate (percent)	3.4	3.2	3.3	3.3	0.8	0.9	0.9	1.0	1.1	1.1	1.2	
Growth of exports (Euro terms, percent)	1.1	2.5	4.8	9.1	6.1	9.5	6.5	6.4	6.3	6.4	6.6	
Growth of imports (Euro terms, percent)	-1.0	2.6	1.3	8.4	4.8	10.1	8.0	7.7	7.3	6.9	7.3	
Current account balance, excluding interest payments	3.4	4.2	5.5	8.0	3.3	4.5	3.6	2.7	2.2	1.7	1.2	
Net nondebt creating capital inflows	2.5	1.8	1.7	0.5	4.2	1.6	1.9	2.9	2.9	2.9	2.9	

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

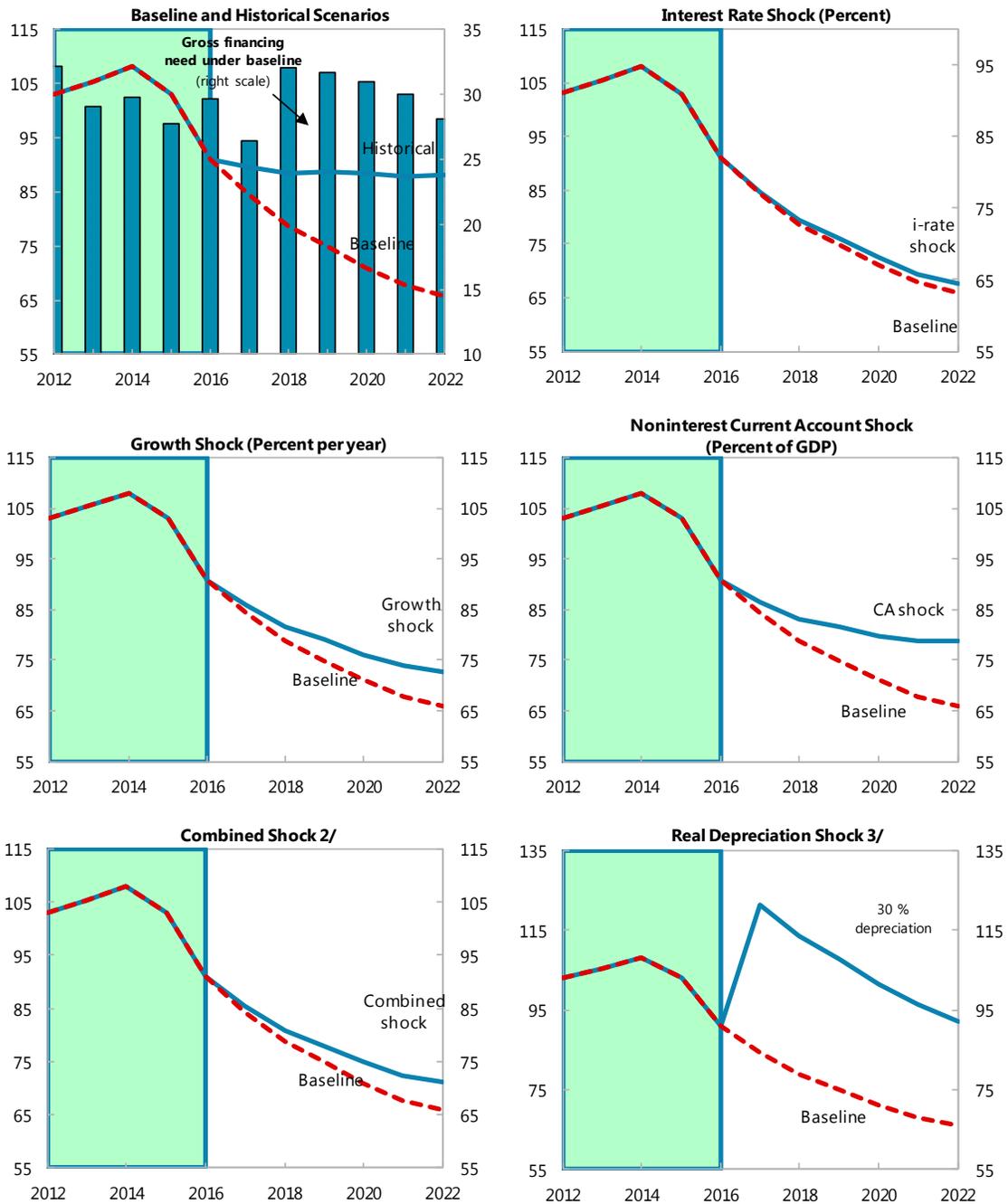
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Croatia: External Debt Sustainability: Bound Tests of the Baseline Scenario 1/
(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

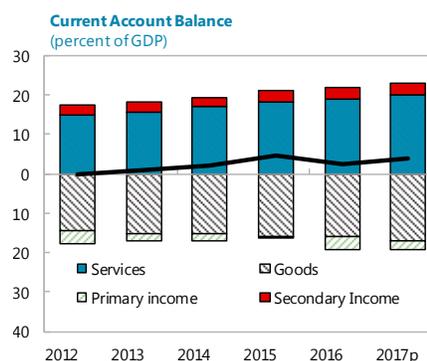
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2016.

Annex IV. External Sector and Competitiveness Assessment¹

Croatia's external position in 2016 was broadly consistent with fundamentals and desirable policy settings. In 2017, the current account is projected to remain in surplus, helped by buoyant tourism receipts and strong goods exports. Despite recent relative declines in unit labor costs, non-price indicators continue to suggest broader competitiveness challenges.

Current account. Croatia's current account has been in substantial surplus since 2013. Although the goods trade balance has traditionally been in deficit, this has been more than offset by the large and rising tourism receipts (averaging 18 percent of GDP in 2015-16). Exports of goods have also been growing strongly, especially since accession to the EU in 2013. The current account surplus declined in 2016 to 2.6 percent of GDP from a record high 4.8 percent a year earlier. This was largely due to foreign banks' resuming profit after a temporary pause caused by losses related to the mandated Swiss franc household loan conversion in 2015. The projected increase in the current account in 2017 is due to losses (increased provisioning) by banks, which is expected to be a one-off event and will reverse as banks absorb losses from Agrokor. This one-off event would therefore not alter the assessment. Over the medium term, the current account is projected to remain in surplus but to gradually move towards balance as the growth of tourism revenue moderates and imports growth remains buoyant, in line with investment and consumption projections.



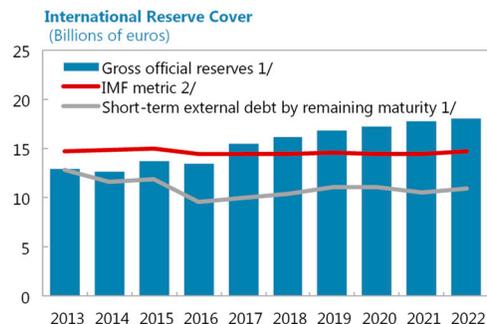
Sources: Croatian National Bank; and IMF staff estimates.

Capital and financial flows. Outflows largely reflect (i) repayment of external public debt which is facilitated by the rapid progress in fiscal consolidation, and (ii) continued deleveraging by the banking sector, which is tapering off. The government has been obtaining part of its financing needs externally with no difficulty and at favorable rates. There is some downside risk related to tightening global monetary conditions. Continued progress in fiscal consolidation would provide a useful cushion, and advancing structural reforms would help further improve market perception.

Foreign assets and liabilities. External indebtedness has gradually declined since the GFC but remains high. Over 2009-16, gross external debt declined by 10 percentage points to 91 percent of GDP, reflecting repayments of cross-border loans and lower foreign parent bank funding, and, more recently, a growing current account surplus, large EU funds, and positive GDP growth. External financing needs also declined but remained elevated around 16 percent of GDP in 2016. The net international investment position improved substantially, from -90 percent of GDP in 2009 to -67 percent in 2016, which largely reflected deleveraging. However, this position is still much worse than the Euro Area average of -13 percent of GDP.

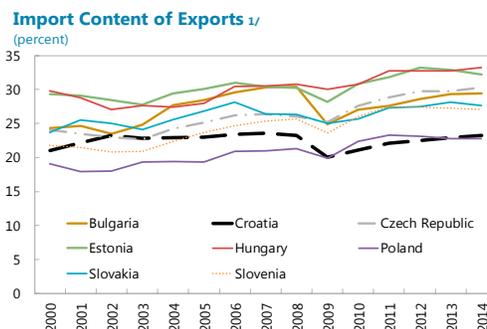
¹ Prepared by Olamide Harrison.

Reserve adequacy. Gross official reserves have been growing slowly over the past few years. However, they declined slightly in 2016 to €13.5 billion in part due to abolishment of the requirement to maintain part of banks' required reserves in FX with the CNB. Official reserves were moderately below the ARA metric in 2016 although there is a comfortable margin relative to the benchmark of 100 percent of short-term debt. Furthermore, the metric excludes banks' obligation to maintain liquid FX assets (minimum 17 percent of FX liabilities), which serve as an additional buffer. Official reserves are projected to exceed the metric starting in 2017. This improvement is due, inter alia, to the strong current account surpluses and EU funds inflows.



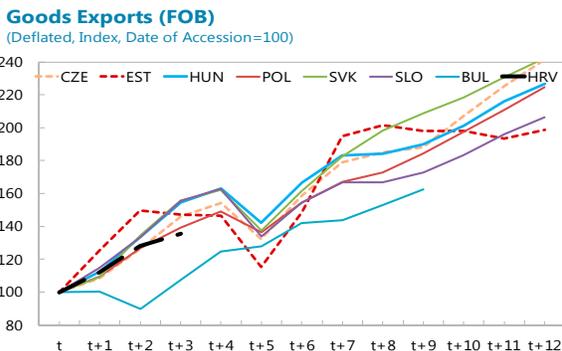
Sources: Croatian National Bank; and IMF staff calculations.
1/ Staff projections for 2017-22.
2/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.

Croatia's external position appears to be broadly in line with medium-term fundamentals. EBA-lite yields somewhat mixed empirical results that indicate a slight exchange rate undervaluation for one approach and a slight overvaluation for the other two approaches.

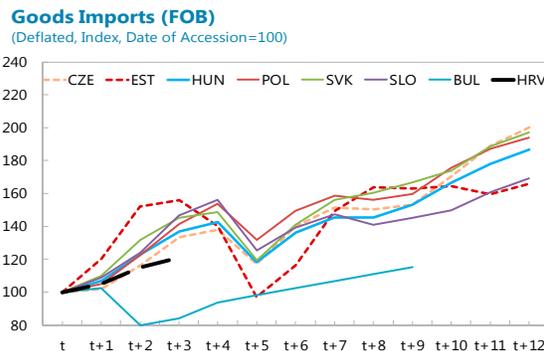


Sources: WIOD, Kovac et al, "Croatia in Global Value Chains", Manuscript (2017).
1/ Foreign value added share of gross exports.

The current account (CA) approach yields a CA norm that seems too low given Croatia's need to reduce its still-elevated external indebtedness. Unadjusted, this approach initially suggests an undervaluation of the exchange rate of about 11 percent, but leaves a large residual (up to 5 percent) that is not explained by the policy variables. The CA regression might have difficulty in explaining the current account swing to surplus after the GFC, which was due to reduced consumption (and hence imports) in response to the lengthy recession and high external debt, and later to the positive effect of EU accession.² Staff estimates the CA level effect of this external deleveraging to be between 1 and 2 percent of GDP, which implies an adjusted CA-balance of 1.1 percent of GDP. Also, EU accession resulted in increased net exports. To illustrate, exports



Sources: Haver, AMECO



Sources: Haver, AMECO

² Ranilović analyzes the impact of EU accession on trade using a gravity model and finds positive and significant effects on both exports and imports ("The effects of Economic Integration on Croatian Merchandise Trade: A Gravity Model Study," *Comparative Economic Studies* 59, no.3 (2017)).

grew 35 percent cumulatively between 2013 and 2016, three years after accession, while imports grew 21 percent over the same period. This effect was further magnified by the relatively low foreign value added share of Croatian exports (23.2 percent in 2014). Staff estimates this effect to be about 2.2 percent of GDP. Adjusting for this factor yields an adjusted CA norm of 0.9 percent of GDP, which implies a slight real effective exchange rate undervaluation of -0.5 percent.

Model Results, 2016

(In percent of GDP, unless stated otherwise)

	CA	ES	REER
Adjusted CA norm	0.9		
Cyclically Adjusted CA balance	1.1		
CA - stabilizing NIIP at 52 percent in 5 years		0.5	
CA gap /1	0.2	0.1	
REER gap (in percent) /2	-0.5	0.3	1.8

Source: IMF staff calculations.

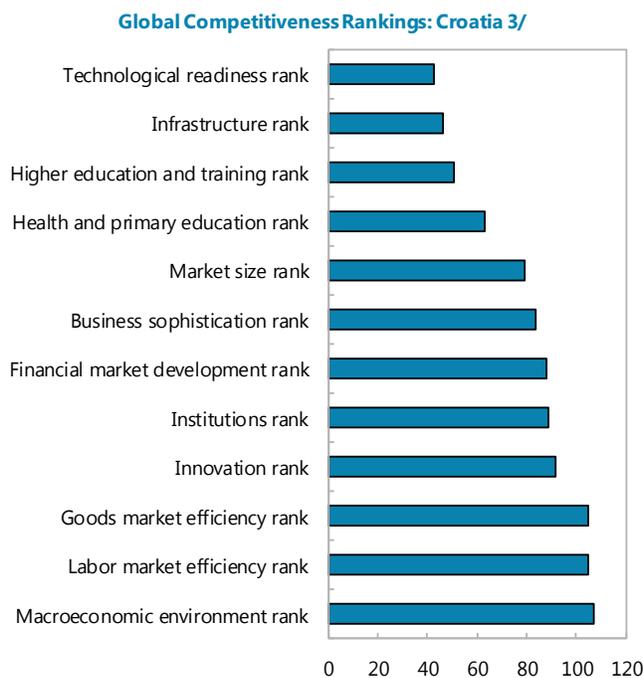
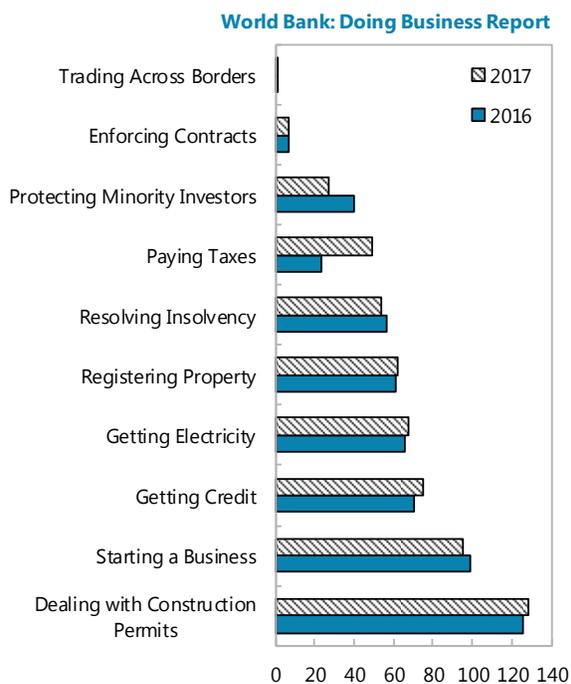
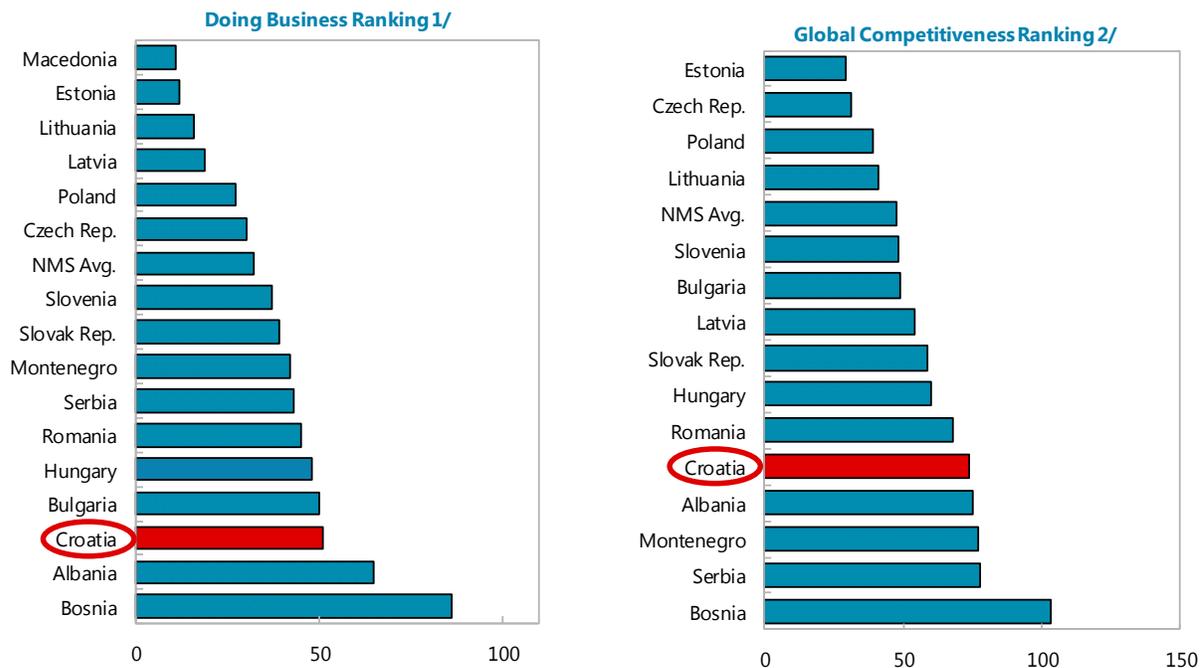
1/ For ES approach, CA gap is relative to medium-term CA balance.

2/ Positive value indicates overvaluation.

The External Sustainability (ES) approach suggests that the exchange rate is in line with fundamentals. This approach allows staff to specify a long-term target at which Croatia's net international investment position (NIIP) is appropriately stabilized, Staff targets a gradual strengthening of Croatia's NIIP by roughly 3 percent of GDP per year to about -52 percent of GDP, the long-run average NFA of peer countries, in the medium term, with an underlying current account surplus of 0.5 percent. This is also in line with the authorities' projection of the NFA. The index Real Effective Exchange Rate approach points to a slight overvaluation of less than 2 percent. This approach, with its relative weight of country fixed effects, produces a small residual. In view of all the above factors and the overriding need of improving the NIIP, staff assesses that Croatia's external position is broadly in line with medium-term fundamentals.

The Croatian business environment remains less favorable than peers and non-price indicators continue to suggest that Croatia faces broader competitiveness challenges. Unit labor costs have declined in recent years relative to peers and trading partners, partly due to restrained compensation and some productivity growth. Nevertheless, indicators from the DB report and the World Economic Forum's Global Competitiveness Report point to the need for structural reforms. Croatia's overall ranking fell 8 spots to 51st, in the 2018 DB report with a considerable deterioration in the 'Paying Taxes' category. However, the recently-implemented tax reforms were not covered by the tax indicators as they went into effect after the report's cut-off date, therefore, the authorities expect an improvement in the next report. The report also notes that increased administrative fees for building and occupancy permits have raised the cost of construction permits. However, the report highlights some improvements in registering property due to lower real estate transfer tax (from 5 percent to 4 percent). Other recent steps taken to improve the business environment and competitiveness include the introduction of a regulatory impact assessment pilot with SMEs to measure the burden of regulatory changes on doing business, and removing the requirement of stamps on all documents. Nevertheless, starting a business is still cumbersome.

Figure 1. Croatia: The Business Environment, 2017



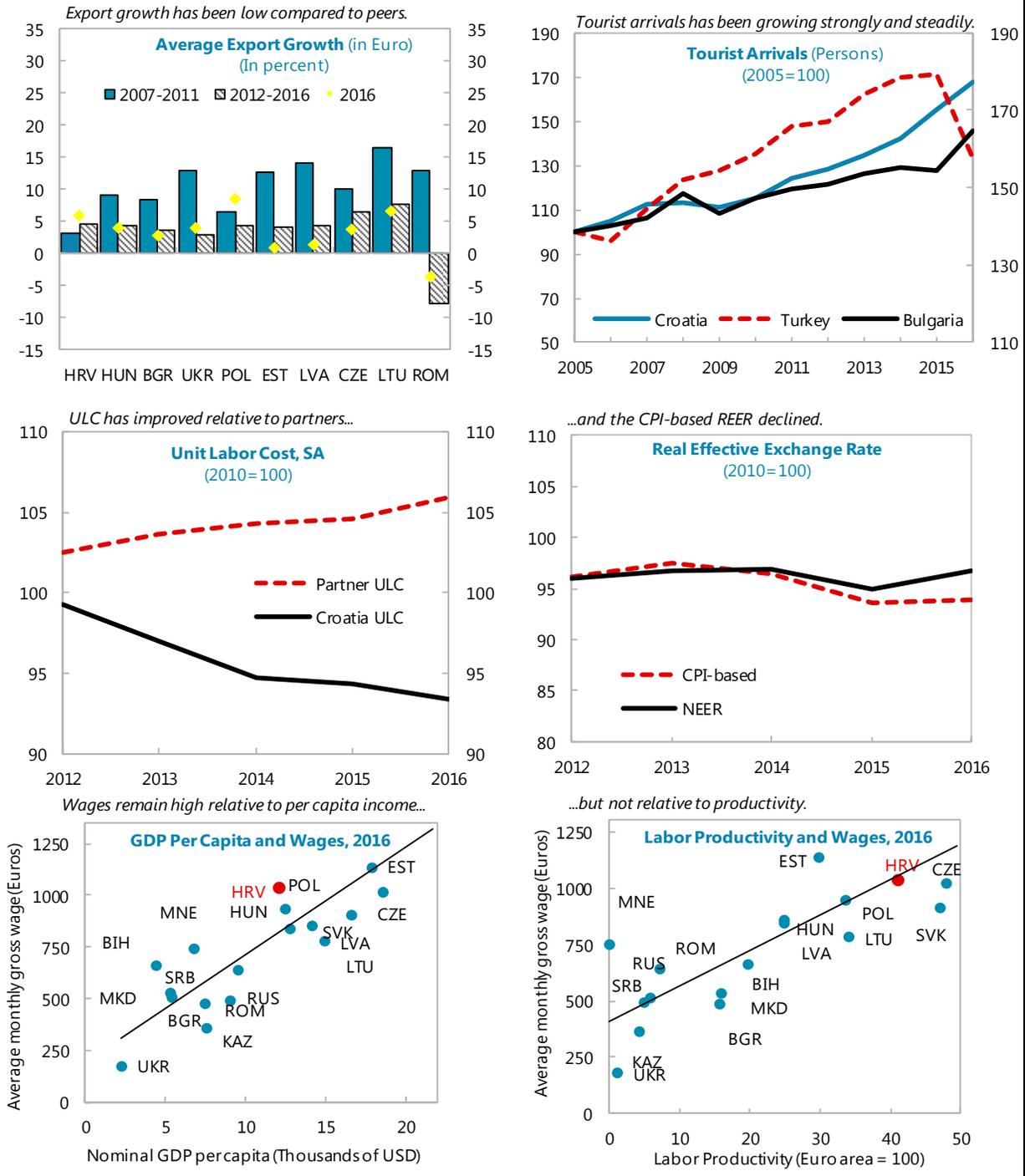
Sources: World Bank, *Doing Business*; World Economic Forum, *Global Competitiveness Report*; Heritage Foundation, *Economic Freedom Index*; and IMF staff calculations.

1/ Ranking out of 190 countries. Rankings are benchmarked to June 2016.

2/ Ranking out of 138 countries. Rank for 2016-17.

3/ Ranking out of 140 countries. Rank for 2015-2016.

Figure 2. Croatia: Competitiveness Indicators, 2012–16

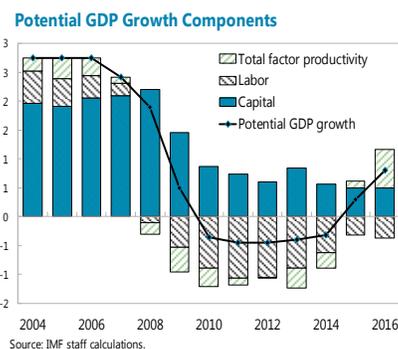


Sources: Croatian authorities; Haver; OECD; World Bank, *Doing Business Indicators*; IMF, *IFS*; DxTime; IMF, *World Economic Outlook*; and IMF staff estimates and calculations.

Annex V. Explaining Potential Growth Developments¹

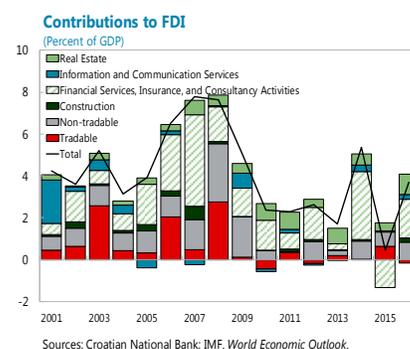
The estimated potential growth for Croatia has declined significantly after the Global Financial Crisis (GFC).

As the economy went into recession, estimates of potential growth rates dropped markedly, from around 4-4.5 percent during the peak in the mid-2000s to around 1–2 percent in recent years notwithstanding the buoyant cyclical growth since 2016.² This said, there remains a fundamental difficulty in disentangling the cyclical and structural components of a growth rebound, particularly after prolonged periods of subdued growth.^{3,4} The results of estimation methodologies vary somewhat and need to be interpreted with caution, however, the overall picture indicates that a significant decline in potential growth over the last 10 years in Croatia is in line with the trend in many of Central, Eastern and Southeastern European countries (CESEE).



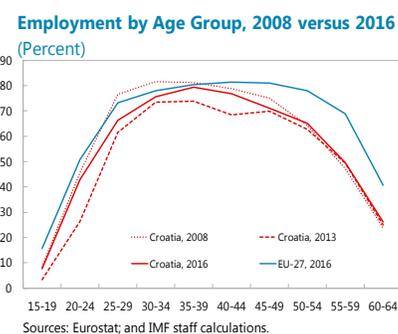
Prior to the GFC, capital accumulation has been driving potential growth in Croatia.

On the back of stability and external inflows, capital was the largest contributing factor, but its share decreased steadily at the onset of the financial crisis as the boom came to an end. It fell further as the economy started to deleverage but rebounded somewhat as Croatia joined the EU. FDI inflows, which include sizable reinvested earnings, have averaged only 3.4 percent of GDP since 2000. Moreover, large amounts of borrowing before the crisis went into sectors like real estate, thus contributing little to strengthening the economy's productive capacity and efficiency. In fact, the GFC and the accompanying deleveraging was a consequence of such unsustainable capital accumulation, which distorted the estimates of potential growth.



Contributions from labor turned negative in 2008, reflecting the crisis, demographic trends, and falling participation rates.

Labor contribution to potential growth peaked during the mid-2000s. Its subsequent negative contribution did not reverse as Croatia entered the EU in 2013. Unemployment has increased significantly as the crisis unfolded and the economy went into a prolonged recession. This was compounded by negative effects from the decline in the working-age population, low birth rates, and sizeable emigration, which accelerated with the EU accession. An increasing natural unemployment rate, measured as the nonaccelerating wage rate of unemployment (NAWRU), put additional pressure on labor contributions. Unemployment has mostly become structural, and is currently especially high



¹ Prepared by Svetlana Vtyurina.

² "Economic Growth in Croatia: Potential and Constraints," Selected Issues paper for the 2006 Article IV consultation.

³ "How to Get Back on the Fast Track," Regional Economic Issues: Central, Eastern, and Southeastern Europe (IMF 2016); "Europe Hitting Its Stride," Regional Economic Outlook: Europe (IMF 2017).

⁴ Podpiera et al, "A Fresh Look at Potential Output in Central, Eastern, and Southeastern European Countries," IMF Working Paper 17/37.

among younger and older segments of the population. This contrasts with the EU averages, especially in the latter category. The participation rate of 65.6 in 2016 is one of the lowest in the EU, and the activity rate after the age of 50 continues to decline rapidly, because of the loopholes in the social benefit system, including pensions, which allow widespread recourse to early retirement. Shortcomings in aligning education with labor market needs and few lifelong learning opportunities limit labor's ability to adapt to technological and organizational changes after 2-3 decades of work. Adult children's emigration allows parents aged over 50 to live off remittances. The gray economy (such as un/under-recorded tourism) may also provide enough income from property to allow exit from the labor force.

TFP growth stalled after the crisis, reflecting both global and country-specific factors. Recent IMF analysis shows that strong productivity growth before the crisis was broad-based across CESEE countries and largely associated with favorable external or common factors, notably growth in trading partners, expansion of global supply chains, and FDI. For Croatia, however, the TFP growth was not as strong as in some other CESEE countries, which could be partially explained by it joining the EU only in 2013. In terms of country-specific drivers of productivity, a number of structural and institutional obstacles may hamper efficiency in Croatia. As mentioned above, given the already negative TFP growth pre-crisis, much of the pre-crisis investment seems to have been concentrated in the sectors that did not improve the economy's efficiency. Furthermore, red tape, especially at the local government level, contributed to weak business environment that discouraged FDI, which often brings efficiency-improving technology. Continuing institutional weaknesses, widening skills mismatches, deteriorating quality of healthcare due to increased financial difficulties (reflected in relatively low life expectancy compared to the EU-15), among other factors, could have also likely added to a downward trend in TFP growth after the crisis. Recent CNB's research also concludes that the low growth of productivity may suggest that there are considerable structural problems in the domestic economy that hinder a more successful utilization of the existing resources. In this context, policies focusing on the identification and elimination of such problems may have a favorable impact on the long-term growth of the economy.⁵

Almost a decade after the GFC and deleveraging, boosting potential growth is still challenging. Deep structural reforms would help raise potential growth.^{6,7,8} In the baseline (slow reform) scenario, staff projects Croatia's potential growth to hover around 2 percent.⁹ It is assumed to be led by capital accumulation, not least due to expected absorption of the EU funds. TFP is projected to recover very gradually (benefiting from gradual reforms and tradable sector productivity gains from Single Market participation). However, the negative contribution from labor on the back of demographic trends, untargeted social benefits, and immigration will continue to weigh on potential growth.

⁵ Goran Jovičić (2017), "Estimating Potential Growth and Output Gap in Croatia," Survey S-29, Croatian National Bank.

⁶ IMF (2016).

⁷ "Emigration and Its Economic Impact on Eastern Europe," IMF Staff Discussion Note 16/07.

⁸ See "Reforming the Judiciary: Learning from the Experience of Central, Eastern, and Southeastern Europe," Chapter II in EUR Regional Economic Outlook, IMF, November 2017.

⁹ Potential GDP used in the macro-framework complements the HP filter, Production Function and Bayesian approaches by some judgment (Box 2 "Potential Growth and Output Gap," Staff Report for 2015 Article IV Consultation).

Annex VI. Risk Assessment Matrix¹

	Source of Risks/Time Frame/ Relative Likelihood	Impact if realized	Recommended policy response
Global	Retreat from cross-border integration/Short to medium term/ Medium	Medium to Low A fraying consensus about the benefits of globalization leads to protectionism and economic isolationism, affecting trade and investment. However, merchandise trade is not large and therefore the impact of this risk would not be as high as in countries with larger exports.	Growth-friendly fiscal consolidation; continue to reduce non-price competitiveness costs.
	Tighter global financial conditions/Short term/ High	Medium to High Higher debt service and refinancing risks could stress leveraged firms, households, and the sovereign.	Growth-friendly fiscal consolidation; use FX intervention to smooth excessive exchange rate volatility. Accelerate private sector debt restructuring. Encourage unhedged borrowers to shift to kuna loans at fixed rates, and ensure availability of kuna liquidity from the central bank. Encourage further development of a market for hedging instruments.
	Structurally weak growth in key advanced economies/ Medium term/High	Medium Weaker export performance would weigh on economic growth and perpetuate macroeconomic vulnerabilities.	Accelerate private sector debt restructuring and structural reforms.
Domestic	Disorderly Agrokor restructuring/Short to medium term/ Medium	Medium to High Creditor law suits, "surprises" identified in the audit, abrupt closure of companies and the created uncertainty will affect companies' profitability and domestic activity, including through higher unemployment.	Continue communication to align expectations; work with creditors on viable solutions; strengthen corporate governance.
	Lower and ineffective absorption of EU funds/ Medium term/Medium	Medium A lower level of investment would affect growth negatively.	Accelerate reforms to improve absorption by improving processes and cutting red tape.
	Further reform standstill/ Medium/High	Medium to High Thin majority of the coalition government pose additional challenges for the reform efforts. Lack of reforms will affect growth in the medium term through lower investment, further decline in TFP, and lower labor productivity.	Strengthen national commitment to reform by creating consensus. Reach for "low hanging fruit" first.

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex VII. The Agrokor Case¹

The Agrokor Group, established in 1989, is the largest joint stock privately owned company in Croatia. It is also one of the leading regional companies, mainly specializing in food production, processing, distribution and retail trade, with large regional operations.

Fast Facts: Agrokor's Balkan Reach

Countries of operation: Croatia, Bosnia and Herz., Hungary, Macedonia, Montenegro, Serbia (11, 400 employees), Slovenia (12,000 employees)

Total number of employees: 60,000

Percentage of Croatia's total workforce employed by Agrokor: 2.5 percent

Revenue from operations (2015): 14.7 percent of GDP (€6.6 billion)

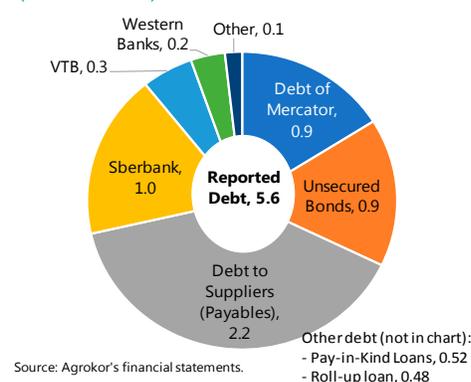
Source: Agrokor.

Agrokor's financial position has weakened in the last few years. Sales fell due to the decline of its exports to Russia since 2014 trade sanctions. This coincided with the acquisition of a Slovenian retailer *Mercator*, which now accounts for 40 percent of the Group's revenues, and which required deep restructuring to improve its profitability. Agrokor had accumulated large liabilities in the form of bank loans and bonds (€3.5 billion, or 7 percent of GDP and about 10 percent of non-financial corporate debt) and arrears to suppliers (€2 billion). Based on the deterioration in operating performance and concerns about liquidity and the upcoming large debt amortization in 2018, Agrokor was downgraded several times during January–April 2017 by Moody's and S&P, its financing cost skyrocketed, and it ultimately lost market access. On May 9, S&P downgraded Agrokor's credit rating to default following the company's failure to make a coupon payment on its €300 million senior secured notes that mature in 2019.

Given the company's large size, the Croatian authorities acted swiftly to prevent further deterioration and contagion. In early April, Parliament adopted a law on emergency receivership in systemically important companies, allowing the state to appoint a caretaker management. The law ("Lex Agrokor") aims at protecting the sustainability of business operations of vital companies, defined as those having more than 5,000 employees or liabilities exceeding €1 billion. The process can continue up to 15 months with the goal to ensure stable liquidity, while a settlement is worked out and the company is eventually restructured. If the settlement fails, the law stipulates that the company goes into a normal bankruptcy procedure. Agrokor is currently undergoing a restructuring process under this law.

While Agrokor's risk is primarily with large foreign banks, bond and equity holders, domestic creditors and suppliers are also exposed. Its direct exposure to the domestic banking sector is

Estimated Debt of Agrokor
(billions of euros)



¹ Prepared by Svetlana Vtyurina.

relatively limited. However, its suppliers may have difficulty servicing their bank debt if arrears persist. A chaotic restructuring has been avoided due to the application of the extraordinary law and temporary provision of liquidity. All debt repayments were frozen, trading in affiliated companies' shares was suspended for six months, and the caretaker management ensured liquidity for the immediate future through a €480 million loan that was provided to Agrokor in July by bondholders and some banks with the condition of a "roll-up" to the previous debt, i.e. the old debt gets seniority (2 units per 1 unit of the new debt). This primarily has been used to partly repay suppliers (and small ones in full). Smaller bondholders have not been invited to participate in a "roll-up" and the Russian state-owned Sberbank (the largest creditor) has not accepted to participate.

Substantial irregularities in financial statements have been identified by the special audit. A PricewaterhouseCoopers' audit, completed in September 2017, showed that in 2015-16, the company's consolidated capital was negative, and pointed to numerous accounting irregularities that could lead to arbitration processes.² In November, the extraordinary law was recognized by the legal system in the United Kingdom (UK), meaning that no lawsuit against Agrokor can be filed in the UK outside this law.

The effects of the restructuring on the economy thus far have been manageable.

In 2017, the effect on growth was overshadowed by buoyant economic activity. The preliminary estimate of the impact on growth in 2018 is in the range of 0.3-0.5 percent of GDP. Nonetheless, there is a risk that impact could be higher and reduce domestic investment, export capacity, and private consumption, especially, if there are significant layoffs in the affected companies. The situation will become more clear as the standstill under the current law comes to an end in September 2018, and when the recent rolled-up loan becomes due for payment in end-2018. According to the caretaker manager, the settlement process would ultimately include a debt-equity swap due to the lack of funds to repay the debt. Banks would likely become the owners of Agrokor, but some equity stakes also could be sold in an open market.

Agrokor Effect on Growth (2018)	
Consumption	0.2
Investment	0.1
Exports	0.2
Total	0.5
Sources: CNB estimates.	

Transaction data indicate that bank credit has been recovering in 2017 and NPLs have been declining despite the Agrokor impact. However, such positive developments will be set back by the increase in Agrokor-related NPLs. Combining the historical probability of losses, the CNB stress tests record potential losses at 50 percent in orderly restructuring ("an ongoing concern") for direct exposures, and 20 percent for indirect exposures towards companies within the Agrokor group. In the scenario of a disorderly restructuring, the potential losses would be 70 percent and 40 percent, respectively. Banks have already incurred losses in H1 2017 due to higher provisioning for Agrokor debt.

² Sberbank claims that the company has falsified financial data when loans were granted, and that its exposure to Agrokor was higher than officially stated. It has filed several law suits in the UK. The caretaker management has rejected Sberbank's claims till it withdraws from current litigation.

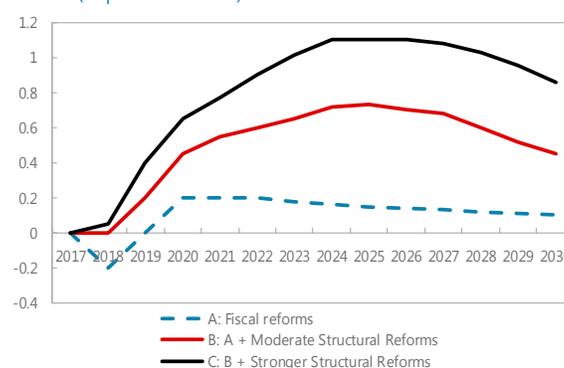
Annex VIII. The Macroeconomic Policy Mix—Implications for Growth—An Illustrative Framework

The Flexible System of Global Models (FSGM)^{1,2} provides a useful analytical tool to assess the impact on growth associated with the implementation of macro-economic policies. Using this illustrative tool, staff has gauged the standalone impact on output of the proposed fiscal adjustment measures over 2018-22, and then the combined impact of fiscal measures and selected structural reforms. Monetary conditions are assumed to move closely in line with the Euro Area.

- The *fiscal reform scenario* (blue line) reflects staff's recommendation of additional cumulative fiscal measures of 1.5 percent of GDP over the medium term. Given the improvement in the structure of revenue and expenditure, and that the output gap is closing, the fiscal tightening would have a fairly small negative effect on real growth in the near term. The medium-term impact would turn positive as a result of the reduced taxes and the positive spillovers from the improved fiscal and debt position to market confidence.
- The *structural reform scenarios* (red and black lines) reflect improvements, *inter alia*, in total factor productivity as a result of implementation of key structural reforms targeted at improving the business environment and allocation of resources, such as streamlining public administration, the legal process, and SOEs reforms (see para. 17 above).

Recommended Fiscal Savings, 2018-22 (In percent of GDP)	
Revenue	
Adoption of property tax	1.0
Possible reduction of tax burden /1	-1.0
Expenditure	
Compensation of employees	0.5
Savings on social benefits	1.0
Total	1.5
Public debt ratio	59
1/A possible combination can include a one-time permanent tax reduction of 1 percent of GDP equally shared among corporate income tax, personal income tax, and VAT rates.	

Output Growth Dividend 1/
(In percent of GDP)



1/ Relative to staff's baseline projections.

These illustrative scenarios suggest that growth could be higher than the staff's baseline scenario by 0.6-1.1 percentage points by the end of the medium term, depending on the strength and depth of the reforms. This reform dividend would continue after that point and gradually taper off over the long run. These estimates should only be used as illustrative as they are subject to a wide range of uncertainty and the outcome can be influenced by various factors, including the actual slack in the economy and the responsiveness of labor participation to the above reforms.

¹ Prepared by Zoltan Jakab (RES) and Michelle Hassine (EUR).

² The FSGM is a system of models developed by staff in the IMF Research Department. More details on this methodology can be found in "The Flexible System of Global Models—FSGM," IMF Working Paper 15/64, available at <http://www.imf.org/~media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2015/wp1564.ashx>

Annex IX. Euro Adoption Considerations¹

Croatia has benefited from the EU membership, including through trade, the EU funds, and reforms that improve governance. The convergence criteria play an important role in encouraging the adoption of sound macroeconomic and financial policies and frameworks. Both theory and country experience suggest that it would be important to increase the dynamism and resilience of the economy in order to facilitate internal adjustment and to reap the full benefits of joining the currency union.

Key considerations:

- **Structural policies:** Structural reforms have both growth and stability objectives, which should make the economy more efficient and thus support sustainable growth. They are also critical to facilitate smooth internal adjustment to cushion shocks, particularly those ones that affect Croatia and the Euro Area in asymmetric ways. This becomes particularly important when even modest exchange rate flexibility is no longer available. Given the delays in structural reforms, Croatia will need to revitalize them and expedite their implementation to make the economy more efficient, dynamic, and ready to withstand future shocks.
- **Fiscal policies:** The EU's Stability and Growth Pact (SGP) has been gradually strengthened to build adequate buffers during good times, but recently also to permit some country-specific flexibility.² Croatia already exited from the EDP in June 2017. If the envisaged fiscal reforms are implemented, euro adoption could further boost confidence and reduce public financing costs.
- **Banking union and financial policies:** Croatia, like all other non-euro EU countries, has so far decided not to join the banking union before adopting the euro.³ More than 2/3 of the assets of Croatian banks are owned by parent banks in the Euro Area. In this respect, banks would benefit from more uniform, and hence smaller, regulatory costs. Customers should, in principle, also benefit from stronger competition. Moreover, in case of a systemic crisis, the backing would be substantial. Capital market harmonization would also likely be facilitated by euro adoption.
- **Monetary and exchange rate policy:** Croatia's monetary policy is already closely linked to the ECB due to the quasi-peg to the euro and a high degree of euroization.⁴ Given this context, the

¹ Prepared by Tonny Lybek.

² Arguably, further refinements could be considered. See "Reforming Fiscal Governance in the European Union," IMF Staff Discussion Note SDN/15/09, International Monetary Fund, Washington DC.

³ The banking union has three pillars, the: Single Supervisory Mechanism (SSM); Single Resolution Mechanism (SRM); and European Deposit Insurance Scheme (EDIS). Membership is mandatory for euro countries, but voluntary for non-euro EU countries. See, for instance, "Central and Eastern Europe: New Member States (NMS) Policy Forum; Staff Report on Cluster Consultations—Common Policy Frameworks," IMF Country Report No. 15/97, International Monetary Fund, Washington DC.)

⁴ For more details on the many aspects to consider when deciding on monetary and exchange rate regime, see "Taking Stock of Monetary and Exchange Rate Regimes in Emerging Europe" by Nazim Belhocine, Ernesto Crivelli, Nan Geng, Tiberiu Scutaru, Johannes Wiegand, and Zaijin Zhan, European Department, International Monetary Fund, Washington DC, 2016.

biggest benefits of euro adoption would include: (i) elimination of currency mismatches; (ii) lower interest rates⁵ and elimination of the exchange rate risk; (iii) lower cost for kuna/euro transactions; (iv) ECB support of the anchor; and (v) potential influence on euro group decisions.

The timing for applying for ERM II membership and eventual euro adoption ultimately depends on domestic preferences and must be done in consultation with EU institutions. In the case of

Croatia, ERM II and Banking Union membership will be decided by the government in consultation with Parliament, since some legislation will likely need to be amended. Euro adoption does not formally require a referendum and will be decided by Parliament. The CNB has prepared a comprehensive report on the pros and cons of euro adoption as well as some technical background studies to inform the debate.⁶ The strategy has highlighted the key points above, including the need to prepare well for eventual euro adoption by creating fiscal space, further reducing the high public debt, and advancing structural reforms to accelerate convergence and facilitate internal adjustment in case of external shocks.



⁵ The euro premium disappeared in 2010, but has recovered to about half its crisis level since 2015. See “The Re-Emerging Privilege of Euro Area Membership, IMF Working paper 17/162,” by Johannes Wiegand, 2017.

⁶ The report is available on: <http://euro.hnb.hr>; and the background papers on the possible impact on trade, inflation, and costs of borrowing are available on: <https://www.hnb.hr/en/analyses-and-publications/occasional-publications/surveys>.



REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 20, 2017

Prepared By

European Department in Consultation with Other
Departments.

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FUND RELATIONS

(As of September 30, 2017)

Membership Status: Joined: December 14, 1992; Article VIII

General Resources Account:	<u>SDR Million</u>	<u>%Quota</u>
<u>Quota</u>	717.4	100.00
<u>Fund holdings of currency (Exchange Rate)</u>	717.2	99.97
<u>Reserve Tranche Position</u>	0.2	0.03

SDR Department:	<u>SDR Million</u>	<u>%Allocation</u>
<u>Net cumulative allocation</u>	347.34	100.00
<u>Holdings</u>	304.90	87.78

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

<u>Type</u>	<u>Date of Arrangement</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
Stand-By	Aug 04, 2004	Nov 15, 2006	99.00	0.00
Stand-By	Feb 03, 2003	Apr 02, 2004	105.88	0.00
Stand-By	Mar 19, 2001	May 18, 2002	200.00	0.00

Projected Payments to Fund¹

(SDR Million; based on existing use of resources and present holdings of SDRs):

	<u>Forthcoming</u>				
	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>
Principal					
Charges/Interest	0.06	0.24	0.24	0.24	0.24
Total	0.06	0.24	0.24	0.24	0.24

Exchange Rate Arrangement:

In December 1991, Croatia adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with tight management of the kuna-euro exchange rate by the Croatian National Bank (CNB). The *de jure* exchange rate arrangement is a managed float

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

without a predetermined path. The *de facto* exchange rate arrangement has been reclassified to stabilized from a crawl-like arrangement, effective April 14, 2016, and this has been communicated to the authorities during the regular update process of the 2017 AREAER. The CNB transacts only in euros, U.S. dollars, and SDRs. On November 30, 2017, the official exchange rate was kuna 7.54 per euro (middle rate).

Exchange System:

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of multiple currency practices and restrictions on payments and transfers for current international transactions, except for restrictions that Croatia maintains solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51). There are no capital account restrictions.

Anti-Money laundering and Financing of Terrorism:

The Law on Prevention of Money Laundering and Terrorism Financing was adopted by the parliament on October 27, 2017.

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on June 22, 2016 (IMF Country Report No. 16/187: <http://www.imf.org/en/Publications/CR/Issues/2016/12/31/Republic-of-Croatia-2016-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-44010>). Croatia is on the 12-month consultation cycle.

FSAP:

An FSAP Update mission took place in October–November 2007. The FSSA Update was published (IMF Country Report No. 160: <http://www.imf.org/external/country/hrv/index.htm>).

The original FSAP was concluded with the completion of the 2002 Article IV consultation on August 5, 2002 on the basis of missions that took place in April 2001 and September 2001. The FSSA was published (IMF Country Report No. 02/180: <http://www.imf.org/external/country/hrv/index.htm>).

Technical Assistance 2000–13:²

Department	Timing	Purpose
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Fiscal Management (with STA)
	September 2003– March 2004	A Resident Advisor on Fiscal Reporting
	February 2004	Public Debt Management Program (with World Bank)
	May 2004	Public Expenditure Management
	May 2004	Fiscal ROSC
	April 2005	Review of Indirect Tax Performance and Tax Administration
	June 2006	Regional Public Financial Management (PFM) Advisor
	February–March 2007, July 2008, February– March 2009	Revenue Administration (with World Bank)
	April 2007	Public-Private Partnerships
	May 2007	Tax Policy (with World Bank)
	January–February 2008	Short-Term Expenditure Rationalization
	February 2010	PFM (long-term advisor visit)
	October 2010	Regional expert participation on seminar on Croatian budget management and fiscal policy
	March 2011	Short-term expert visit on Tax Administration Reform
	June 2011	Short-term expert participation at OECD meeting
	June 2012	Options for Modernizing the Property Tax Government Opportunities for Strengthening the Tax Administration (HQ mission)
	October 2012	Short-term expert visit on phasing in a modern Compliance Risk Management Model
	October 2012	Short-term expert visit on improving tax administration governance and organization structures
	April 2013	Public Financial Management: Budget Procedure
	April–May 2013	Fiscal Rules

² Technical assistance during 1992–99 is listed in Annex I of IMF Country Report No. 03/27.

	June 2013 December 2014	Strengthening Tax Administration Governance Workshop on Public Expenditure Review (Expert visit)
STA	March 2000 September 2000 October 2000 April 2001 November 2001 October 2002, June 2004	Quarterly National Accounts Balance of Payments Real Sector Statistics Monetary and Banking Statistics Regional Visit on Reserves Data Template Government Finance Statistics Monetary and Financial Statistics LTE: Government Finance Statistics
MCM	September 2006 December 2007 May–June 2000 March–April 2001 December 2001 April 2003 February 2004 January 2007– continuing May 2007 June 2007 September 2007 October 2007 November 2007 March 2008 August 2008 February 2009 July 2009 May 2010 November 2011 March 2013	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets Central Bank Accounting Monetary Policy Instruments Stress Testing and FX Reserve Management Monetary Policy Instruments Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting Modeling and Forecasting Modeling and Forecasting FSAP Update Modeling and Forecasting Modeling and Forecasting Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting Macro-Financial Modeling Monetary Policy and Modeling Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting
LEG	January 2010–April 2011 May 2011–April 2012 December 2011–April 2013	AML/CFT—Risk based supervision in non- financial sectors AML/CFT—Strengthening the FIU and risk based supervision in non-financial sectors AML/CFT—Preliminary National Risk Assessment

WORLD BANK RELATIONS

1. The World Bank's Board endorsed the Country Partnership Strategy (CPS) for Croatia for fiscal years (FY) 2014–17 in June 2013, with the goal to assist Croatia's convergence with the EU through an engagement that is focused on key reform-based outcomes. The priority was placed on aspects of the Europe 2020 "smart, sustainable and inclusive growth" strategy; and the government's reform agenda that focused on the fundamentals of economic management, state institutions, and business environment. In pursuing these goals, the WBG program envisaged to contribute in the following three areas:

- Fiscal adjustment through reforms at the sector level;
- Innovation and trade competitiveness for growth and shared prosperity;
- Helping maximize the economic benefits of becoming an EU member state.

2. During this CPS period, the Bank's Board approved US\$1,010 million in lending compared to an indicative financial envelope of US\$800 million. The WBG program supported government efforts first with the Economic Recovery Development Policy Loan 2, an instrument that can help bring sectors together around common objectives and combine policy reform with budget finance. The rest of the program was delivered through investment projects in railways and roads sector, as well as results-based operations in health and social protection sectors. The lending program has been complemented by analytical work and technical assistance, including through reimbursable advisory services, particularly in the areas of public expenditure reform, governance, EU preparedness, investment climate, higher education, poverty mapping and trade competitiveness.

3. The WBG focused efforts in FY2017 on preparing the Systemic Country Diagnostic (SCD), to be completed by end-2017. The SCD will provide an input for informing national policies on how to achieve more inclusive and sustainable growth, lay the foundation for the future Country Partnership Framework (CPF), and better align the WBG program with the Twin Goals.

4. In FY17, the Bank's Board approved a loan and a guarantee for the Modernization and Restructuring of the Road Sector amounting to US\$23.3 million and US\$370.7 million respectively. At present, the World Bank finances 8 investment projects and one regional GEF grant (totaling US\$605 million), as well as two guarantees (amounting US\$627.1 million), with a large portion in the transport sector. Currently, IFC's investments portfolio consists of 7 projects amounting to approximately US\$153 million across a variety of sectors including in the financial sector, renewable energy, infrastructure, agribusiness, food retail, and general manufacturing. Across all sectors, IFC prioritizes investment in Croatia's less-developed regions and in projects that contribute to greater economic diversification and regional integration. Finally, as of June 30, 2017, MIGA has no outstanding gross exposure in Croatia.

STATISTICAL ISSUES

Croatia—Statistical Issues (As of September 30, 2017)
I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance, with a few shortcomings related to data coverage.
National Accounts: The national accounts have undergone substantial improvements in recent years. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the ESA 2010 standard. However, a breakdown of gross fixed capital formation into private and public components is not published as this is not required by the Eurostat. Minor discrepancies exist between nominal government consumption in national accounts and government consumption reported in government ESA 2010 accounts; and they are being resolved.
Wages and Employment: The CBS produces data on average net and gross earnings per person and employment by sector. Currently, the CBS is in the process of reviewing the data series. Earnings data include bonuses (in sums that are subjects to contributions, taxes, and surtaxes), sick pay, and meal allowances. They are based on monthly surveys covering 70 percent of workers in permanent employment in each division of NKD 2007 (NACE Rev. 2). They do not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, and farmers. The number of registered unemployed overstates the actual level of unemployment. However, the discrepancy has significantly diminished in 2014. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample was subsequently expanded and the survey is now being conducted on a regular basis. Semi-annual results have been released since 1998, and quarterly results since 2007, with a lag of about four months.
Price Statistics: The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from a Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups, but in most cases between the thirteenth and the twenty-third day of each month. (Prices of agricultural products sold in market places are recorded on the first and third Friday in a month and prices of fuel for passenger cars weekly.) The indices are released around the fifteenth day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country. A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology. A core CPI is calculated based on a methodology developed by the Croatian National Bank (CNB). The CBS also releases a monthly producer price index (PPI), usually on the eighth day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year.

Croatia—Statistical Issues (concluded)

(As of September 30, 2017)

Government Finance Statistics: The authorities have started presenting some budget plans based on the ESA 2010 framework. However, the State Budget and the local budgets are based on the national Chart of Accounts. Historical general government data based on ESA 2010 definitions are published nationally by the Croatian Bureau of Statistics and by Eurostat, but are frequently revised due to methodological and data source improvements. Additional analysis has been initiated in order to assess whether some enterprises owned by local government units should be included in the government sector according to the ESA 2010 criteria.

Budget execution (cash) data are produced on a monthly basis on the GFSM framework (GFS 2001) and are available in the *Monthly Statistical Review* of the Ministry of Finance (MOF) and in the time-series database, both published on the website of the MOF. Central government data normally come with a lag of about six weeks, but end-of-year data often with much longer lags. Revenue data are reliable, and expenditure data on a cash basis are available according to GFS classifications (economic and functional) for the central budget and extra-budgetary funds. However, changes of institutions included in the central government are not always clearly indicated, hence central government figures are not fully comparable over time.

Cash data for the operations of local governments and the consolidated general government are available on a quarterly basis, but for end-of-year data with long lags. Starting from the January-March 2015 period, data for local and regional self-government units (local units), instead of former 53 largest, include all 576 local units and the local units' extra-budgetary users - county road administrations.

According to the latest *Agreement on cooperation in the field of national accounts of general government and related statistics* (signed on July 31, 2013 between the Croatian Bureau of Statistics, Croatian National Bank (CNB), and Ministry of Finance), the CNB took over the responsibility for the compilation of general government debt statistics. The CNB is compiling general government debt according to ESA 2010 and EDP definitions and publishes these data in the *CNB Monthly Bulletin*. Data showing the level of central government guaranteed debt are presented as a part of the reporting table in the CNB Monthly Bulletin.

Monetary and Financial Statistics: Beginning 2015, the CNB has started published monetary statistics using the ESA 2010 framework, with some backward revisions of historical data series. Since June 2013, the IMF's Statistics Department receives monetary statistics on Croatia directly from the European Central Bank. Previously, the CNB compiled and reported monetary data for publication in *International Financial Statistics (IFS)* in accordance with the 1995 ESA standards and the European Central Bank's framework for monetary statistics using the national residency approach. For December 2001 to June 2013, monetary statistics in *IFS* were based on the Standardized Report Forms developed by the IMF's Statistics Department, in accordance with the concepts and definitions in the *Monetary and Financial Statistics Manual, 2000*. For December 2010 through June 2013, the CNB has reported revised data for other depository corporations covering

Croatia—Statistical Issues (Continued)

(As of September 30, 2017)

money market funds in addition to the licensed banks, savings banks, and housing savings banks, which represent other monetary financial institutions in accordance with the 1995 ESA standards.

Financial Sector Surveillance: The CNB is the banking supervisor and publishes selected financial soundness indicators (FSI) on its website, reports to the IMF's *Financial Soundness Indicator Database*, and provides IMF staff with a broad range of FSIs. A general description of the stress testing methodologies used on the Croatian banking system is included in the *Financial Stability Report*, published by the CNB twice a year. Summary balance sheets and profit and loss statements of individual banks are reported in the *Banking Bulletin*, published twice a year, with a lag of six to nine months.

The Croatian Financial Services Supervisory Agency (HANFA) publishes monthly reports and monthly summary statistics on the sectors it regulates and supervises (capital markets, investment funds, private pension sector, insurance, leasing, and factoring companies).

External Sector Statistics: Quarterly balance of payments and international investment position data are compiled broadly in accordance with the sixth edition of the IMF's *Balance of Payments Manual (BPM6)*. Data are generally available with a lag of three months and are subject to revisions in subsequent releases. Net errors and omissions have ranged from 1 to 3½ percent of GDP since 2005, and are negative. The coverage and quality of portfolio investment data are reasonably complete and accurate.

Croatia participates in the *Coordinated Direct Investment Survey (CDIS)* and plans to participate in the *Coordinated Portfolio Investment Survey (CPIS)* after the new security database becomes operational. Data on the International Reserves and Foreign Currency Liquidity (Reserve Data Template) are available with a lag of one to two months.

Croatia compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2013*.

II. Data Standards and Quality

Croatia has been a subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May 1996, and met all SDDS requirements in March 2001.

No data ROSC has been published.

Croatia: Table of Common Indicators Required for Surveillance
(As of December 7, 2017)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	12/05/17	12/07/17	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Oct. 2017	11/15/17	M	M	M
Reserve/Base Money	Oct. 2017	11/30/17	M	M	M
Broad Money	Oct. 2017	11/30/17	M	M	M
Central Bank Balance Sheet	Oct. 2017	11/30/17	M	M	M
Consolidated Balance Sheet of the Banking System	Oct. 2017	11/30/17	M	M	M
Interest Rates 2/	Oct. 2017	11/30/17	M	M	M
Consumer Price Index	Oct. 2017	11/15/17	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2017:Q3	Nov. 2017	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/— Central Government	2017:Q3	Nov. 2017	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2017:Q3	Nov. 2017	M	M	M
External Current Account Balance	2017:Q3	Nov. 2017	Q	Q	Q
Exports and Imports of Goods and Services	2017:Q3	Nov. 2017	Q	Q	Q
GDP/GNP	2017:Q3	Nov. 2017	Q	Q	Q
Gross External Debt	2017:Q3	Nov. 2017	M	M	M
International Investment Position	2017:Q3	Nov. 2017	Q	Q	Q
<p>1/ Reserve assets that are pledged or otherwise encumbered are specified separately. Data comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.</p> <p>2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.</p> <p>3/ Foreign, domestic bank, and domestic nonbank financing.</p> <p>4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.</p> <p>5/ Including currency and maturity composition.</p> <p>6/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).</p>					

Statement by the Staff Representative on Republic of Croatia
January 10, 2018

This statement provides information that has become available since the issuance of the staff report on December 22, 2017. The thrust of the staff appraisal remains unchanged.

1. The authorities have revised their preliminary projection for the 2017 fiscal balance from a deficit of 0.6 percent of GDP to a surplus of 0.6 percent. Public debt is now projected to be 78 percent of GDP at end-2017. Preliminary information indicates that this stronger fiscal outcome is a result of both higher-than-expected revenues and enhanced expenditure control. Detailed data are not yet available to delineate the cyclical and structural factors behind this outcome. The authorities have, thus far, not amended their planned fiscal path for the coming years.
2. Recent revisions of real GDP data for 2015 and 2016 shows slightly higher growth, at 2.3 percent and 3.2 percent, respectively. In addition, recent survey data indicate that unemployment has declined to a single digit for the first time since 2008. Inflation in November was 1.4 percent, y-o-y, in line with expectations.

**Statement by Richard Doornbosch, Alternative Executive Director for the
Republic of Croatia
and Miroslav Josic, Advisor to Executive Director
January 10, 2018**

On behalf of the Croatian authorities, we would like to thank staff, lead by Mr. Sakr, for their productive engagement during the Article IV mission and express our appreciation for the constructive policy findings and recommendations reflected in their report. The authorities broadly agree with staff's appraisal.

Recent Economic Developments and Outlook

Favorable economic developments continued in 2017, characterized by accelerated growth in economic activity and improved perception of the country's degree of risk. Real GDP growth reached 3.3 percent y-o-y in the third quarter of 2017, mostly driven by a successful tourism season and further recovery in personal consumption and government spending. The consumer confidence index has remained above its long-term average, despite the crises in the Agrokor Group. The increase in employment and in the average nominal gross and net wage continued during the third quarter, although at a somewhat slower pace. All this contributed to a steady recovery of credit growth, which is projected to be 3.0 percent y-o-y in 2017 (based on transactions).

In the medium term, real GDP is projected to slow down slightly to 2.8 percent, mainly due to the expected lower increase in tourism revenues and slowdown in personal consumption growth. At the same time, investments are expected to pick up owing to stronger use of EU funds. The authorities share staff's view that further implementation of structural reforms is needed to boost the potential growth. This should be addressed by the measures and activities defined in the new National Reform Programme (NRP) for 2018.

Fiscal Policy and Debt Management

The authorities are determined to use the positive growth momentum and to continue with the fiscal consolidation. In the last two years, strong fiscal adjustment brought the overall budget deficit to -0.9% of GDP in 2016 while the preliminary data for 2017 points to a surplus of 0.6% of GDP. As a result, public debt to GDP ratio shrank from 85.4% in 2015 and is projected to be around 78% by end-2017. Against this background Croatia exited from the Excessive Deficit Procedure (EDP) in June 2017.

The adopted State budget for the 2018-2020 period as well as the recent NRP envisages the continuation of prudent fiscal policy and an additional reduction in public finance imbalances. This encompasses measures on both the revenue and expenditure side as well as further improvement in tax administration and tax collection. The authorities share staff's view that the level of public debt is still high and are determined to gradually decrease it to close or below 60% of GDP. This is also in line with the authorities' commitment to start the official process of euro adoption.

Sustainability of public finance in the medium term will be based on four pillars, (1) strengthening the framework for public financial management and a further implementation of fiscal consolidation; (2) reduction of healthcare arrears and sustainability of the healthcare system; (3) improving the efficiency of the social benefits system; and (4) ensuring the long-term sustainability of the pension system. The new Public Debt Management Strategy for the 2017-2019 period adopted in January 2017 in combination with favorable market conditions, brought savings in interest rates payments of close to 0.3% of GDP.

As a wider measure to ensure public debt sustainability and improve the efficiency of state-owned enterprises (SOEs), the authorities have, under guidance of the World Bank, implemented financial and operational restructuring of the highway companies. However, the authorities share staff's assessment that a further increase in productivity and efficiency of SOEs is needed. A new Fiscal Responsibility Act is planned to be adopted in 2018 after consultation with the EU Commission and the members of the Fiscal Policy Committee, aimed at further improving the budgetary framework. The introduction of real estate tax planned for January 2018, will be postponed as more time is needed to design an efficient and fair system.

Monetary Policy and Financial Stability

The monetary authorities will continue to pursue an accommodative monetary policy taking into account the anchor of exchange rate stability and risks to financial stability. The kuna liquidity of the banking system was further strengthened during the entire 2017 by foreign exchange interventions that alleviated appreciation pressures on the domestic currency. At the same time, the monetary authorities enabled easier access to the favorable kuna funding of banks allowing the formation of a pool of eligible assets to be used as a collateral in all central bank credit operations. The highly accommodative policy stance continued to improve financing conditions of all domestic sectors, thus supporting credit recovery. The monetary authorities will remain prudent in ensuring quality credit growth by continuing to encourage kuna-based lending and to consistently warn off the risks associated with lending in euros at variable interest rates.

The banking system remained well capitalized, profitable and liquid owing to improved economic fundamentals as well as sound prudential policies. The total capital ratio mildly increased to above 23% by end-June 2017. At the same time, banks on average remained profitable, although provisioning for possible losses associated with the Agrokor Group had a significant impact on their overall result. The latest stress tests showed strong resilience of the entire banking sector with respect to this crisis. Despite short term impediments, the ratio of NPLs to total loans continued to be on a downward trend and stood at 12.5%, the lowest level in six years.

The authorities have initiated a public discussion on the adoption of the euro. In this respect, they have published a Strategy for the Adoption of the Euro which should serve as a platform for public discussion on the costs and the benefits of joining the common currency union. The authorities remain committed to support the euro adoption and leverage on benefits this process could bring.

Competitiveness and Structural Reforms

The authorities acknowledge and put high on their agenda the need to implement a wide range of structural reforms aimed at improving the business environment, labor market conditions and the quality of public administration. The authorities have strong ownership over the NRP and have already implemented many reforms, which was also acknowledged by staff. Tax reform was introduced in 2017 aimed at reducing the total tax burden, developing a stable and predictable tax system as well as simplifying and reducing the tax administration. At the same time, the Action plan for administrative relief of the economy adopted in January 2017, resulted in 104 measures of which the implementation in 2017 allowed for administrative savings to the economy of up to HRK 1.5 billion or 30%.

The Draft Law on the Management of State Assets has been introduced at the end of 2017 which should start exploiting vacant state-owned real estate, particularly in tourism. Combined with measures aimed at removing impediments to the business environment, this should result in attracting FDI. The divestment process of state assets has continued and some or parts of the companies in the state portfolio have been sold to private investors, like the Port of Rijeka. Revision of the salary determination system in public administration and public services is envisaged for 2018, which should stimulate expertise and reward the performance of employees.

Lastly, the authorities agree with staff that the large-scale reform of social benefits has been postponed for now. The system of social benefits is envisaged to be coordinated and centralized by 2020 when a one-stop shop is planned to be introduced. However, the authorities' view is that this part of reform should be performed to streamline the benefits to those in needs and to protect the safety net, but at the same time to address the demographic challenges to the country.