



REPUBLIC OF CROATIA

February 2019

2018 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 2018 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 February 8, 2019 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 February 8, 2019, following discussions that ended on December 7, 2018, 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 January 23, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Croatia.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND



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IMF Executive Board Concludes 2018 Article IV Consultation with the Republic of Croatia

On February 8, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the 2018 Article IV consultation¹ with the Republic of Croatia.

In 2018, Croatia continued its fourth year of positive economic growth supported by strong private consumption, and exports of goods and services. Wages are growing, employment is rising, and inflation remains benign. Over the next few years, growth is expected to moderate, as the economy moves closer to its potential. The current account is projected to decline but remain in surplus, while external indebtedness is expected to continue to decline.

Fiscal consolidation continued in 2018 but at a slower pace. While revenue performance remained strong, public spending also grew, in part due to an increase in public sector employment outlays. The activation of state guarantees issued for a troubled shipyard also reduced the overall fiscal surplus. Public investment remained below programmed. The government has reiterated its commitment to improving the quality of budgetary spending and continue public debt reduction going forward.

Monetary policy has remained accommodative within the limits of the exchange rate anchor. Intrabank liquidity has remained ample, and money market and commercial interest rates are low. Bank lending to households has been growing. Credit to the non-financial corporate sector, however, has remained subdued. The CNB has utilized the current conditions to build reserves, and further accumulation may occur over the coming period as the country enters ERM-II. The banking system is, on average, very liquid, well-capitalized, and has continued to gradually reduce the NPL ratio.

Croatia is currently targeting ERM II entry (in 2020), joining the Banking Union, and eventually the Euro Area.

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, which has helped further reduce indebtedness and build external buffers. Directors commended the attainment of the first fiscal surplus in 2017 since independence. They encouraged the authorities to seize the opportunity presented by favorable macroeconomic conditions to advance the reform agenda by stimulating more inclusive growth, persevering with fiscal consolidation and debt reduction, and fully implementing structural reforms.

Directors welcomed the authorities' commitment to fiscal discipline, and stressed the importance of pursuing growth-friendly fiscal consolidation, while improving the structure of revenues and the quality of expenditure. To this end, they encouraged the authorities to broaden the tax base and take measures to reduce the informal economy. To improve growth prospects, they urged the authorities to shift the balance of expenditures toward public investment. Directors welcomed the passage of the Fiscal Responsibility Law, and encouraged the authorities to enact the Budget Act which would integrate the analysis of contingent liabilities as part of the budget process and facilitate medium-term planning. They considered that, as circumstances permit, further fiscal consolidation would be desirable to rebuild fiscal space. Directors called for more ambitious restructuring of public administration including by reducing high public employment outlays and reducing the fragmentation in sub-national levels of government. While welcoming the passage of pension reform, as well as recent measures to improve the efficiency of the healthcare system, they underscored that the elimination of the healthcare system's arrears as well as ensuring long-term sustainability of the pension system would require further reforms.

Directors considered that monetary policy has been appropriately accommodative within the limits of the exchange rate anchor. With preliminary discussions regarding ERM II about to commence, they underscored the need to complete wide-ranging reforms to harness the maximum benefits from envisaged euro adoption, as well as the need to retain strong buffers to withstand any negative asymmetric shocks.

Directors commended the Croatian National Bank for its conservative prudential policies, and encouraged the authorities to consider additional measures to prevent excessive household borrowing if needed. They welcomed efforts to continue to reduce the stock of non-performing loans, and stressed the need to closely monitor corporate indebtedness. Directors encouraged continued improvements in bankruptcy legislation, and advised a comprehensive review to ensure that the insolvency framework aligns fully with international best practice.

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>.

Directors highlighted the need to improve the business environment by further reducing administrative and tax burdens, and welcomed recent initiatives to reduce parafiscal fees. They advised rationalizing the state-owned enterprise sector, divesting under-utilized state assets, and improving the efficiency of legislative and judicial processes. Directors underscored the importance of pursuing a balanced approach to increasing labor market flexibility that guards against the creation of a dual labor market which would further encourage the emigration of the young, to the detriment of medium-term growth prospects.

Croatia: Selected Economic Indicators

	2014	2015	2016	2017	2018	2019
					Proj.	
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)					
Real GDP growth	-0.1	2.4	3.5	2.9	2.7	2.6
Contributions:						
Domestic demand	-1.4	2.2	3.7	3.6	3.6	3.0
Net exports	1.2	0.3	-0.1	-0.7	-0.8	-0.4
Unemployment	19.3	17.1	15.0	12.4	...	...
CPI inflation (avg.)	-0.2	-0.5	-1.1	1.1	1.5	1.5
Saving and investment	(Percent of GDP)					
Domestic investment	18.8	20.0	20.8	20.9	20.6	20.6
Domestic saving	20.8	24.5	23.4	25.0	23.5	22.7
Government	-0.7	0.3	2.4	4.0	4.2	3.4
Nongovernment	21.5	24.2	20.9	21.0	19.4	19.3
Government sector (ESA 2010 definition)						
General government revenue	42.6	44.4	46.1	46.7	47.6	46.9
General government expenditure	48.0	47.8	46.9	45.8	47.2	46.9
General government balance	-5.3	-3.3	-0.8	0.9	0.4	0.0
Structural balance 1/	-2.8	-2.1	-0.3	0.8	1.1	0.0
General government debt 2/	85.7	85.3	82.3	77.7	73.9	71.1
Balance of payments						
Current account balance	2.0	4.5	2.6	4.0	2.9	2.1
Capital and financial account	-1.8	-1.9	-2.1	2.1	0.5	-1.1
FDI, net	1.6	0.5	4.1	2.4	2.8	2.8
Debt and reserves						
Gross official reserves (billions of euros)	12.7	13.7	13.5	15.7	17.4	18.0
Percent of short-term debt (by residual maturity)	97.3	113.8	140.9	164.6	167.5	163.0
In months of imports in goods and services (based on next year level)	8.1	8.0	7.6	7.8	8.0	7.6
Total external debt (percent of GDP)	106.9	101.7	89.3	81.8	75.4	71.9
Money and credit	(End of period, change in percent)					
Broad money (M4)	3.2	5.2	4.7	2.1	...	...
Claims on other domestic sectors 3/	-2.2	-3.0	-3.4	-0.8	...	...
Interest rates						
Average 12-month T-bill interest rate (in kuna)	1.9	1.5	1.0	0.4	...	...
Kuna credit rate (unindexed, outstanding amount)	7.5	7.1	6.5	6.0	...	...
Exchange rate						
Kuna per euro	7.7	7.6	7.6	7.5	7.4	...
Real effective exchange rate (percent, "-" = appreciation)	-1.1	-3.0	0.2	1.4	1.9	...
Memorandum items:						
Nominal GDP (billions of euros)	43.4	44.6	46.7	48.6	50.6	52.7

Sources: Croatian authorities; and IMF staff estimates.

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

2/ Gross debt as defined by the EU under the Maastricht Treaty

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



REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

January 23, 2019

KEY ISSUES

Context: The economic expansion continues, driven primarily by private consumption and exports of goods and services. Fiscal performance has been strong, but the materialization of contingent liabilities from government guarantees is likely to reduce the overall surplus. Low public and private investment, and continued emigration weigh on medium-term growth prospects. Downside risks in the near-term stem from possible changes in regional or global economic and financial conditions, and the further realization of contingent liabilities.

Policies: As the country moves closer to ERM II entry, focus needs to be on increasing fiscal space, reviving the momentum of structural reforms, and boosting investment.

Reduce debt and invest more: Accelerating the pace of debt reduction would build fiscal space and help reduce downside risks. To achieve this in a growth-friendly way, increasing public investment, reducing the total public employment outlays, and better targeting of social benefits to the most vulnerable in society are the top priorities. Tax policy should aim at securing a more stable and progressive revenue base over time to create room to reduce high and distortionary taxes in some areas.

Make the state more dynamic: Public service reform, reduction of red tape, better use of scale economies at sub-national levels of government, and greater discipline with state-owned enterprises will make the state more efficient. Lower parafiscal fees, as well as more agile judicial and legal processes are key to enabling higher private investment and more sustainable job creation. Labor market regulation needs to be reshaped to increase the participation of the young and women, and to incentivize on-the-job-training.

Anchor stability through monetary and financial sector policies: The CNB may need to address potentially tighter external conditions while continuing with strong bank supervision and macroprudential policies. Additional measures to prevent excessive household borrowing could be considered if needed. Further corporate sector deleveraging should be facilitated, including through further efficiency enhancements to bankruptcy procedures.

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

Discussions were held in Zagreb from November 28–December 7, 2018. The team comprised Messrs. Seshadri (head), Sakr (former head), Harrison, Lybek, Mulas-Granados, and Ms. Vtyurina (all EUR). Mr. Josic and Mr. Doornbosch (OED) joined several meetings. Mses. Batog and Samuel (EUR) assisted in the preparation of the staff report.

The staff team met with Deputy Prime Minister Tolušić, Minister of Finance Marić, Minister of Labor and Pension System Pavić, Minister of Demography, Families, Youth, and Social Policy 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 and academia.

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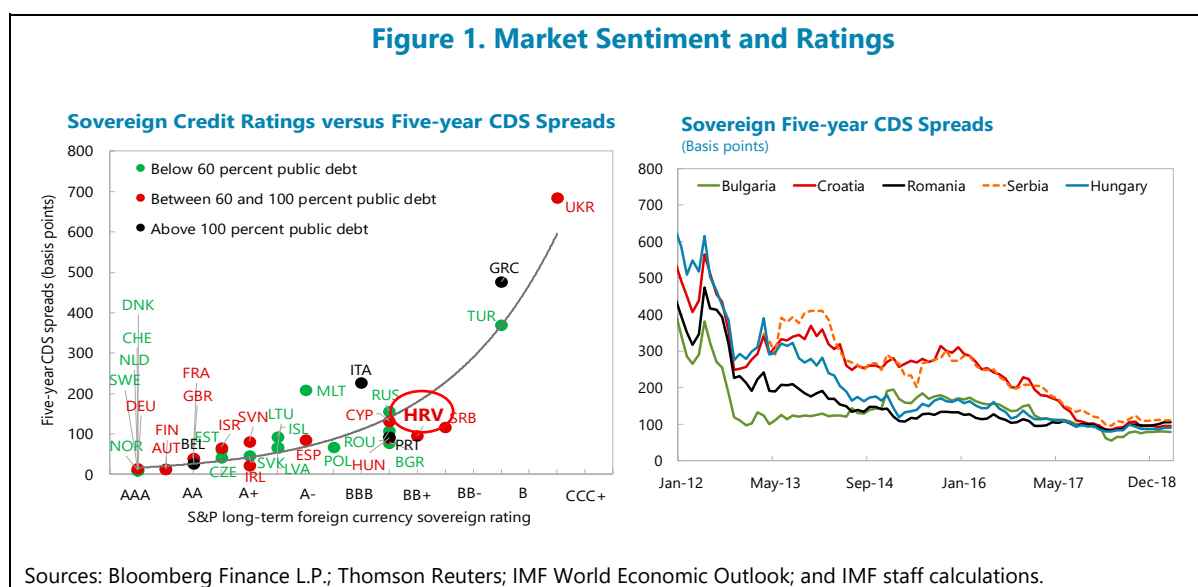
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CONTEXT

1. **Macroeconomic developments have been favorable.** After reaching a post-recession high of 3.5 percent in 2016, growth has started to gradually moderate below 3 percent, as expected. Strong private consumption and tourism remain the main drivers of growth. Investment, while slowly recovering, has been hampered by low absorption of EU funds and administrative bottlenecks. Fiscal performance has been strong reflecting buoyant revenues. Both public and private debt have been on a downward trajectory but remain elevated. Debt refinancing needs were met on favorable terms as Croatia's risk premium declined significantly (Figure 1). Against an overall benign backdrop in 2018, Croatia has come closer to achieving investment grade status.

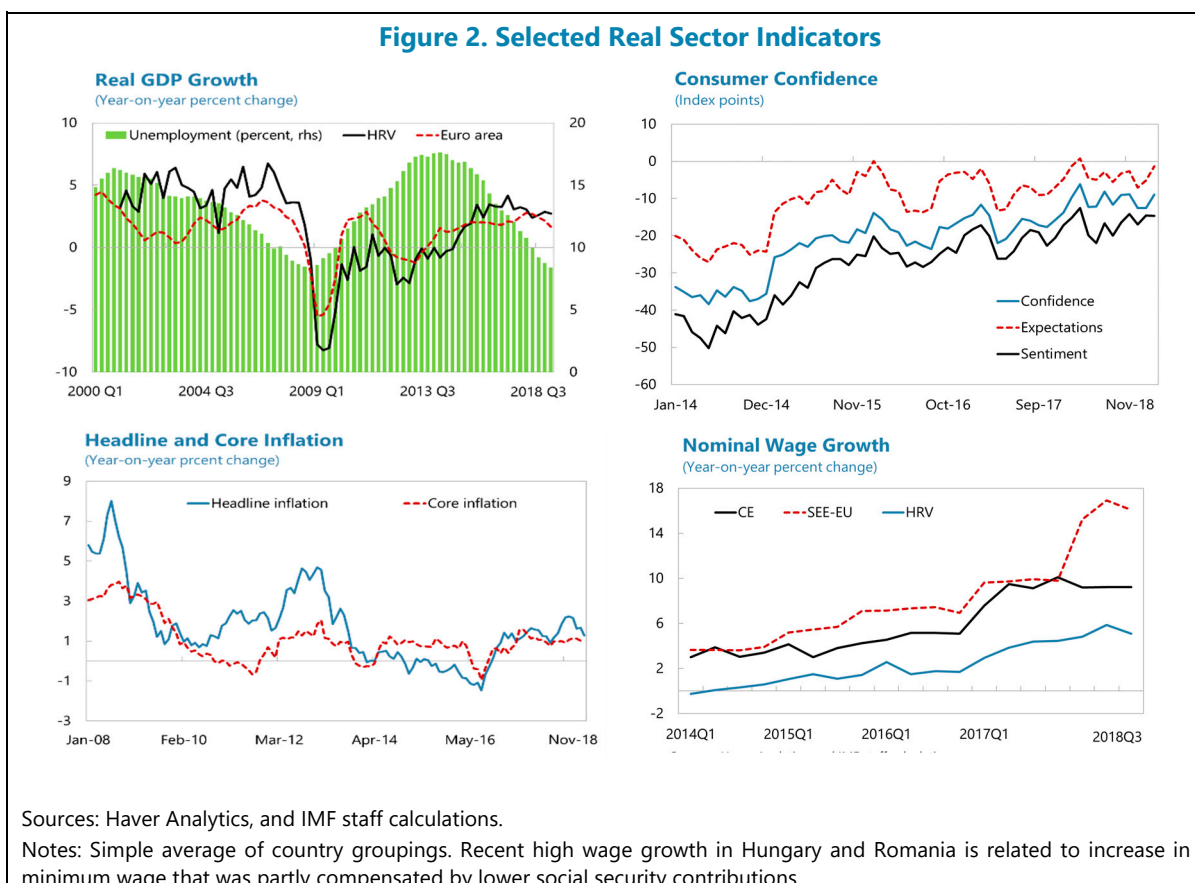


2. **As the cyclical recovery matures, structural rigidities are more apparent.** It took Croatia a full decade to get its output and employment to pre-crisis levels, preventing faster income convergence with the EU-15. The country experienced a severe recession, prolonged by reform inertia. Parliamentary elections are due by late 2020. A renewed commitment and focus on implementing reforms is needed (Annex I). Given the structural bottlenecks and remaining vulnerabilities, domestic and external risks to the outlook persist.

RECENT DEVELOPMENTS

3. **Inflation, wage, and employment dynamics signal that the output gap may be closing.** Real GDP grew 2.8 percent in 2018:Q3, y-o-y. Inflation has been hovering around 1.5 percent (Figure 2), mostly on the account of higher energy prices in the beginning of 2018. Wage growth has picked up after being suppressed for years (the average real wage (net of contributions, taxes and surtaxes) rose by 2.8 percent y-o-y, October 2018). The unemployment rate has also declined from 12.5 to 9.4 percent between January and November 2018. However,

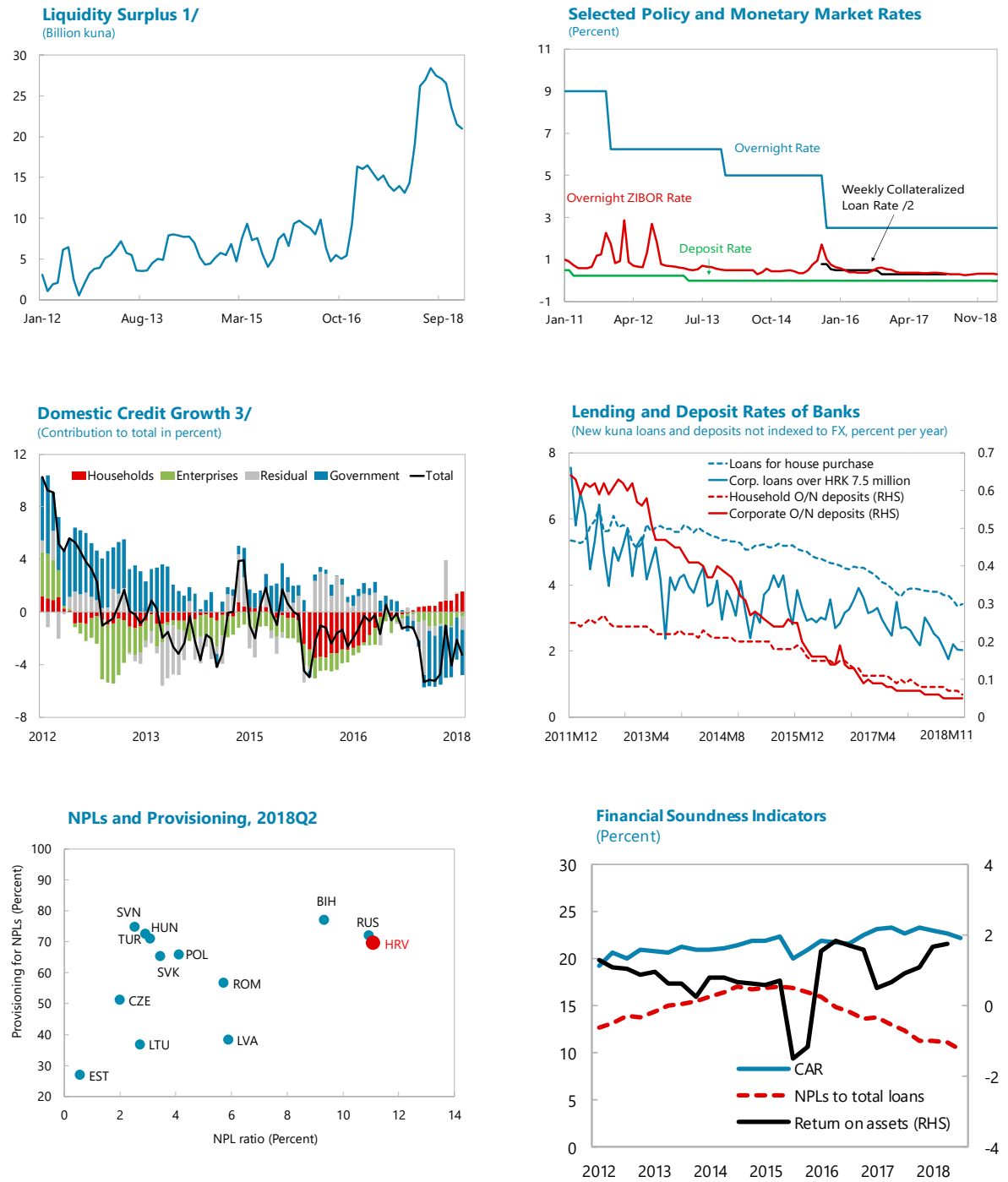
the labor force is drained by continuing migration and aging, which has led to labor shortages in certain professions.



4. Significant fiscal consolidation continued. In 2017, amid strong economic growth, Croatia commendably recorded the first surplus since independence (0.9 percent of GDP). This outcome was achieved due to strong tax revenue, expenditure control, and lower than budgeted interest payments. Fiscal performance has been strong in 2018 as well. However, execution of public investment was well below the budget, requiring improvement in implementation capacity. The structural balance improved from -2.1 to 0.8 percent of GDP over 2015–17. Public debt is projected to have fallen below 75 percent of GDP in 2018 (Annex II).

5. The Central Bank (CNB) has effectively utilized appreciation pressures to accumulate reserves. Inflows from buoyant tourism coupled with healthy growth of goods exports in 2017 and 2018 brought official reserves moderately above the reserve adequacy (ARA) metric. In 2018, the CNB purchased 1.8 billion euros to reduce appreciation pressures, similar in magnitude to 2017. Gross external debt is expected to have declined to 77 percent of GDP in 2018 from 82 percent in 2017 (Annex III). In 2018, the external position remained broadly in line with fundamentals (Annex IV).

Figure 3. Banking Sector Developments



Sources: Croatian National Bank (CNB); IMF Financial Soundness Indicators Database; and IMF staff calculations.

1/ Including overnight deposits with the CNB.

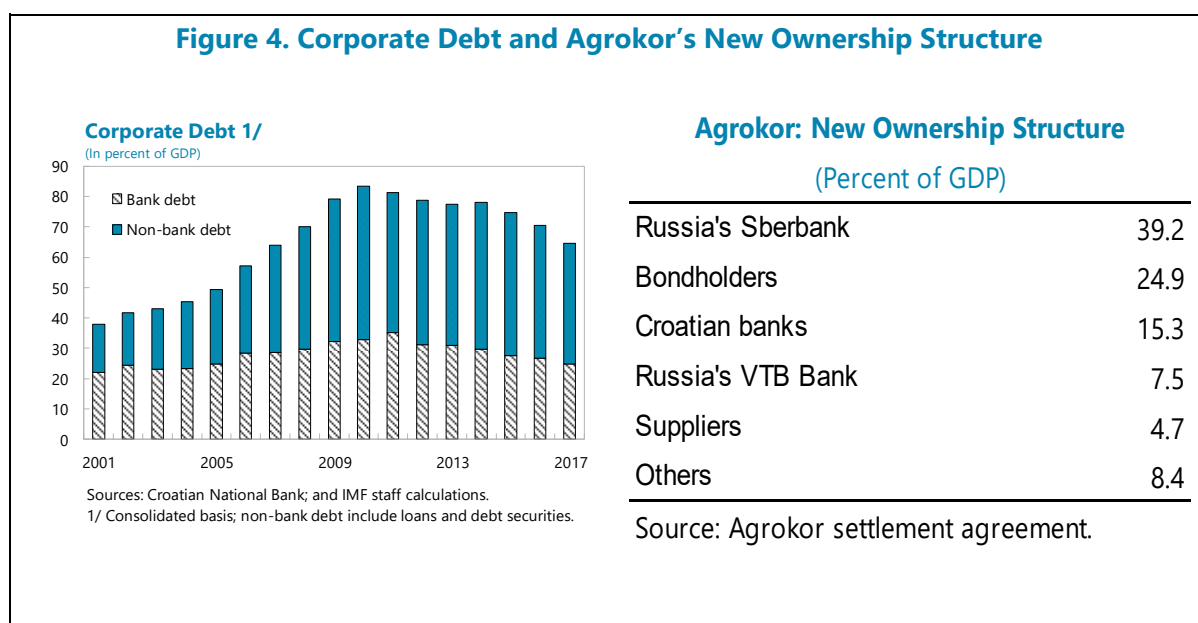
2/ Reverse repo re-introduced in 2015 due to mandated retroactive conversion of Swiss franc-indexed household loans into euros.

3/ Based on change in stock of credit.

6. Bank credit to the private sector has picked up as accommodative monetary conditions continued. Intrabank liquidity has remained ample, and money market and commercial interest rates are low (Figure 3). Bank lending to households (HH) has been growing (in stock terms since late 2017). General cash loans have picked up notably, and the new lending has increasingly been kuna denominated and at fixed interest rates. Credit to the non-financial corporate sector (NFCS), however, has remained subdued, in part due to the lingering effects of the Agrokor bankruptcy.¹ Lending to NFCS has remained negative in stock terms, albeit positive in transaction terms since mid-2016. Overall credit growth to the private sector in stock terms turned positive in 2018:Q2. Sales of non-performing loans (NPLs) have helped reduce the NPL ratio (10.3 percent in September 2018), but it is still high by regional comparisons.

7. NFCS balance sheets remain vulnerable despite deleveraging. NFCS consolidated debt stood at about 65 percent of GDP in 2017, declining from its peak of 83 percent in 2010 (Figure 4).² The reduction reflects NPL write-downs and repayments, as well as denominator effects as liabilities grew in nominal terms. Corporate net worth was -118 percent of GDP in 2017. A debt settlement agreement for Agrokor has been reached. The deal included a debt-to-equity swap and loan write-offs. The new (mostly bank) shareholders are likely to seek a buyer right away, as it is not their intention to run a conglomerate.

Figure 4. Corporate Debt and Agrokor's New Ownership Structure



¹ See Annex VII on Agrokor in 2017 Article IV Staff report.

² Martinis and Ljubaj (CNB 2017) estimate, based on firm-level data, that as of 2014, that the debt overhang (the difference between the total debt and the sustainable debt) is about a third of the corporate debt, concentrated in about 2,000 large companies (out of 36,000), particularly in construction.

OUTLOOK AND RISKS

8. Medium-term projections are broadly unchanged since the last staff report. Near-term growth momentum is likely to remain supported by strong tourism and domestic demand. Both private and public investment are expected to increase marginally on higher EU funds absorption and some investment climate improvements. Over the medium term, growth is expected to gradually converge towards 2 percent assuming continued slow structural reform implementation. Low labor utilization and productivity growth continue to weigh on Croatia's growth potential.³ Reflecting trends in trading partners' prices, VAT reduction in 2019, and lower energy prices, inflation is projected to gradually rise toward 2 percent over the next five years.⁴

9. Risks persist both on domestic and external fronts. Protectionism, sharply higher interest rates, and slower growth in the Eurozone are the main external risks (Italy is the largest trade partner and has the highest foreign ownership share in the banking system) tilted to the downside (Annex V).⁵ Public and private corporate debt remain high and subject to currency and interest rate risks (Figure 5).⁶

Authorities' views

10. The authorities project slightly higher growth rates over 2019–21 on the assumption of higher investment. Inflation and current account balance projections are aligned with staff's. The authorities agreed with staff on the balance of risks. They view most near-term risks as stemming from the overall market sentiment towards Emerging Markets, which could affect Croatia's borrowing costs. Due to the supervisory authorities' efforts, the risk of contagion from foreign parent banks is contained as the intercompany lending has been significantly reduced. Moreover, Croatian subsidiaries are quite profitable and constitute an important revenue source for the parent banking groups.

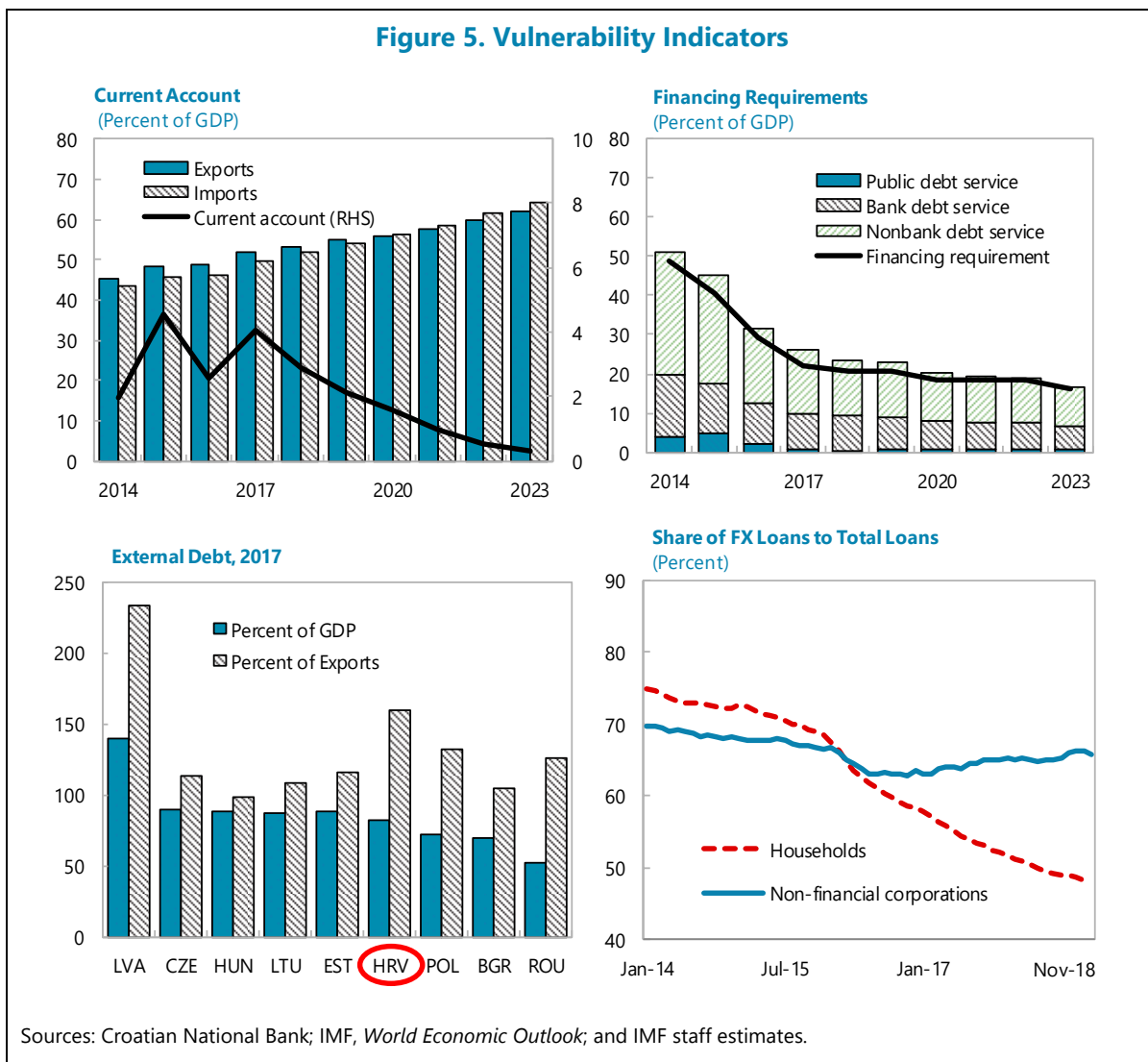
³ See Annex V on Potential Output Developments in 2017 Article IV Staff Report; EC Country Report (2018).

⁴ The 9 percent increase in the minimum wage in 2019 is expected to be absorbed by the economy without a significant rise in an overall average wage because there is not a high percent of employees at a minimum wage and there is still slack in the labor market.

⁵ Exports to Italy constitute about 13.5 percent of total exports (Annex IV, Figure 1). Export of goods to the Euro area accounts for around 54 percent of total. Majority Italian-owned banks account for over 46 percent of total bank assets (about 51 percent of GDP), but direct parent-subsidiary exposures (e.g., funding) have been reduced in recent years. Banks moved from having net foreign liabilities to having net foreign assets in mid-2016.

⁶ The 2018 Selected Issues Paper covers balance sheets and cross-sectoral exposures of the public, banking and private sectors. Drawing lessons from the Agrokor crisis, the analysis shows that cross sectoral balance sheet exposures remain high and need to be reduced to mitigate the transmission of negative shocks across the economy.

Figure 5. Vulnerability Indicators



POLICY DISCUSSIONS

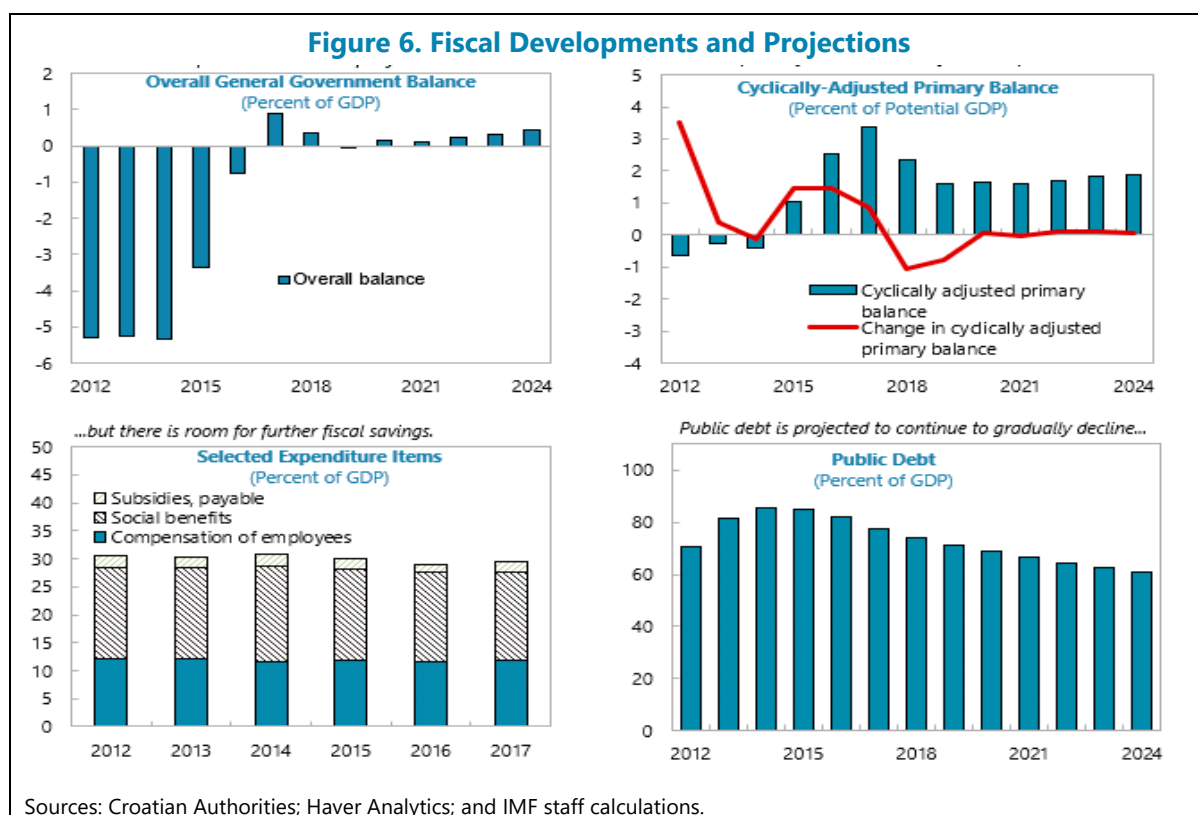
11. Discussions primarily focused on increasing the economy’s flexibility and resilience. Croatia is currently targeting ERM II entry (in 2020), joining the Banking Union, and eventually the Euro Area.⁷ Given the high degree of euroization, the authorities view the benefits of joining the currency union as large and long term, and the costs as small and one-off in nature. Staff underscored that slow progress on structural reforms has weighed heavily on Croatia’s competitiveness and income levels. Further reduction of public debt to increase fiscal space, as well as higher public investment and structural reforms to enhance growth potential are essential for deriving the full benefits of integration with the eurozone. It is important that the current

⁷ See Annex IV of 2017 staff report on Euro adoption considerations.

positive economic conditions are effectively utilized to advance reforms, otherwise a vital window of opportunity would close.

A. Fiscal Policy: Rebuilding Space and Enhancing Growth Prospects

12. Fiscal consolidation in 2018 continued but at a slower pace. In the first half of 2018, the general government balance remained in surplus, with revenues overperforming conservative budget assumptions. The activation of state guarantees issued for the shipyard Uljanik, a one-off contingent liability, erased some of the overall fiscal surplus, which is still expected to end at 0.4 percent of GDP.⁸ For 2019, the government's budget targets a deficit target of -0.4 percent of GDP, but again staff expects a better outcome—a balanced budget. Staff's projection includes the increase in public sector wages of 5 percent agreed with the trade unions, and an expected revenue loss from the 2019 tax reform. The latter reflects a reduction in excises and VAT rates, and social security contributions (somewhat off-set by an increase in health contributions).⁹



⁸ Total Uljanik shipyard guarantees are worth 4.2 billion kuna. On December 31st, 2018, the Ministry of Finance paid 2.5 billion kuna in guarantees. Authorities expect additional payments in 2019. Final figures for 2018 are pending a decision by the Eurostat on how to record them. Disbursements in 2019 may be lower if the shipyard delivers on time a ship worth about 1 billion kuna.

⁹ Amendments to the VAT Act foresee expanding the application of a lower 13 percent VAT rate as of 2019 on children's nappies, livestock, fresh meat, fish, fruits and vegetables and eggs which had the standard 25 percent VAT rate. The expected impact of these tax cuts is 2.6 billion kuna.

13. Looking ahead, fiscal policy should be motivated by two equally important medium-term goals—to rebuild room for fiscal policy maneuver that can be used in the event of another recession and to improve medium-term growth prospects.

14. Weaknesses in the quality of spending could endanger the achievement of these goals. Spending on compensation of employees, subsidies, and social benefits (most of which need improved targeting to the most vulnerable) continues to grow. Given the electoral calendar, pressures to spend more on these categories could continue. Yet, public investment remains significantly under-executed, which hampers medium-term growth prospects. Under current policies (staff

baseline), the medium-term fiscal goals discussed above may not be achieved and thus public debt would remain above the Stability and Growth Pact (SGP) threshold of 60 percent of GDP.

15. Staff advocated for a moderately faster fiscal adjustment. Steadily raising the surplus to about 1 percent of GDP by 2024 (Figure 7) would build fiscal space and thereby bring public debt below the SGP threshold. The path recommended by staff would allow for greater expenditure on public investment by reducing current expenditures, while also providing cushions during future downturns.

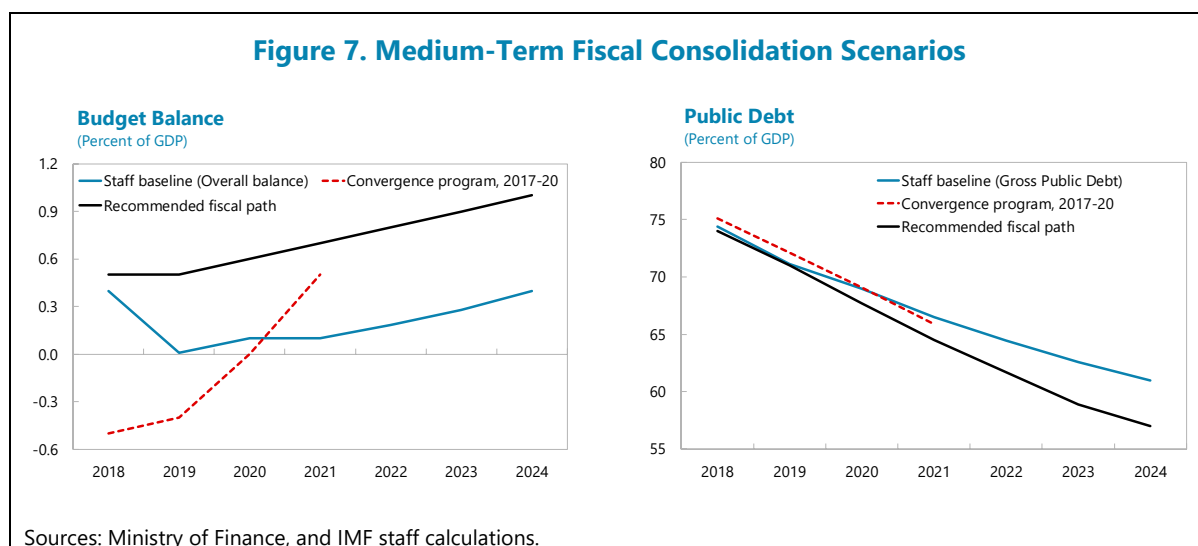
Baseline vs. Recommended Fiscal Effort
(Percent of GDP)

	2018	2019	2020	2021	2022	2023	2024
Croatia's Convergence program							
Overall Budget Balance	-0.5	-0.4	0.0	0.5	--	--	--
Public Debt	75.1	72.1	69.1	65.9	--	--	--
Staff's baseline							
Overall Budget Balance	0.4	0.0	0.1	0.1	0.2	0.3	0.4
Structural Primary Balance	3.5	2.1	1.9	1.9	2.0	2.1	2.2
Public Debt	73.9	71.1	69.0	66.5	64.4	62.6	61.0
Recommended fiscal effort							
Overall Budget Balance	0.4	0.5	0.6	0.7	0.8	0.9	1.0
Structural Primary Balance	3.5	2.4	2.3	2.2	2.2	2.3	2.3
Public Debt	73.9	71.0	67.7	64.5	61.7	58.9	57.0

Recommended Cumulative Fiscal Effort, 2019-24
(Percent of GDP)

Revenue	
Adoption of property tax	1.0
Possible reduction of tax burden	-0.5
Expenditure	
Control wage bill growth	-0.5
Reform of social benefits	-1.0
Increase efficient investment	0.5
Total	
	1.5

Figure 7. Medium-Term Fiscal Consolidation Scenarios

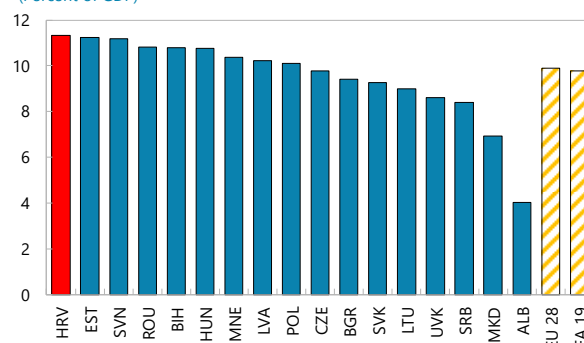


16. To achieve the recommended fiscal path, staff suggested measures that entail a broader revenue base and higher quality spending.

- On the revenue side, staff highlighted the advantages of a well-designed real estate tax. This can make revenue collection more stable, help finance a reduction in more distortionary taxation (Box 1), reduce the grey economy, and have a positive impact on the overall fairness of the tax system.¹⁰ Staff acknowledged that this requires extensive preparatory groundwork and public communication. Staff also discussed alternative options, such as a wealth tax which other EU countries have implemented.
- On the expenditure side, reducing the total outlays on public employment, improving the targeting of social benefits and increasing public investment are top priorities, which dovetail with structural reform goals.

At 11.3 percent of GDP, Croatia has the largest wage bill in the region. This is partly due to a highly fragmented public administration (see para 20).¹¹ While the transition to a merit-based system of public employee compensation is a step in the right direction, staff suggested the authorities to consider additional measures to reduce public employment spending by 0.5 percent of GDP over the medium term to bring it down to the EU average. Staff underscored that the current favorable macroeconomic conditions (combined with emigration) have generated labor shortages across the private sector making it an opportune time to reduce employment outlays.¹²

General Government: Compensation of Employees, 2018 1/
(Percent of GDP)



Sources: Haver Analytics; and IMF staff calculations.
1/ Latest available data for ALB, BIH, MNE, SRB, UVK 2017.

¹⁰ See Annex I on Tax Mobilization in 2017 Staff Report regarding additional measures to broaden the tax base. The real estate tax was postponed as it lacked popular support.

¹¹ Croatia's marked territorial fragmentation and complex relations across levels of government are not conducive to the efficient utilization of resources and delivery of public services (EC Country Report, 2018).

¹² Similar public sector reforms have taken place in Sweden, UK, France and Portugal, with the purpose of making the public sector more dynamic and an agent for growth. See: Stoesz, D. (2016) "The Dynamic Welfare State, London": Oxford University Press; IMF (2016) "Managing Government Compensation and Employment-Institutions, Policies and Reform Challenges"; OECD (2011) "Public Servants as Partners for Growth: Toward a Stronger, Leaner, and More Equitable Workforce"; and OECD (1998) "Public Sector Workforce Adjustments in OECD Countries: Interim Report."

Staff reiterated that social benefits, should be better targeted in consultation with the World Bank.¹³ As efforts in this area have been slow in making progress, staff continued to call for rationalizing spending programs, while increasing transparency and targeting benefits for the most vulnerable through rigorous means-testing.

Given the ongoing underperformance of capital spending, staff recommended increasing efficient public investment by 0.5 percent of GDP over the projection horizon. This should take place in tandem with concrete steps to improve the absorption capacity of EU-related projects (see para 19). Staff discussed the main impediments to capital expenditure execution and suggested that Croatia could consider Technical Assistance on public investment management.

17. Long-term fiscal sustainability also requires addressing contingent liabilities from health and pension systems. Both the health and pension system are sources of sizable fiscal risks, since they remain underfunded and recent reforms need to be further strengthened.

- *Health spending needs to be made more efficient*—first and foremost, with the objective of reducing administrative costs and improving the quality of health services. There is also a need to reduce the drain on the budget caused by health sector arrears (nearly 2 percent of GDP), which the Ministry of Finance is trying to contain through ad hoc repayments. It is encouraging to note some positive developments. The functional integration of hospitals, initiated in July 2017, is proceeding apace; some savings have been achieved from the centralization of drug purchases. Also, employment growth has led to new entrants contributing to the healthcare system, while non-paying participants for supplementary benefits are declining (though this is partly due to emigration). The health contribution rate will increase from 15 to 16.5 percent under the 2019 tax reform. Staff emphasized that such a hike needs to be accompanied with further reform. A comprehensive transformation of the system requires a more rational premium and co-payment structure, ensuring that exceptions are minimized to protect only the most vulnerable, and improving IT systems to enable more rigorous income-testing.
- *The recently passed pension reform is a significant step in the right direction.* It makes the system more sustainable and equitable across generations by putting it more in tune with the reality of increasing life-spans. This reform increases the statutory retirement age for both men and women to 67 years of age by 2033 and hardens existing penalties for early retirement. It also allows the retirees to work half a day, which could increase the participation rate. However, the reform increases spending on those retirees whose pensions under the second pillar did not generate the expected returns, giving them the option to return to the first pillar after retirement, with a 27 percent increase of their pensions. Staff commended the authorities for passing the reform but noted that the

¹³ World Bank estimates that only 10 percent of Croatia's social programs are well-targeted, and many need to be replaced with alternatives that are (1) more consolidated across areas of extended unemployment and veterans' benefits; and (2) better income and means-tested to protect the vulnerable.

current package will not reduce the system's deficit (around 4 percent of GDP) significantly. Thus, there is still room to eliminate group-specific pension provisions and strengthening the second pillar of the system.

18. Some welcome steps have been taken to enhance fiscal governance and State-Owned Enterprise (SOE) performance.

A new Fiscal Responsibility Law was adopted in September 2018 after several delays. In line with staff recommendations, it introduces three new concrete fiscal rules governing the structural balance, budget expenditure and public debt. It also strengthens the autonomy of the Fiscal Policy Commission in the Parliament. The Budget Act, delayed and to be approved in 2019, envisages the recognition and analysis of contingent liabilities as part of the budget process as well as a three-year spending limit, while ensuring appropriate flexibility. While some modest progress has been made in depoliticizing SOE management and divesting some minority shares, further strengthening their governance and hardening their budget constraints would help improve their efficiency and financial discipline.

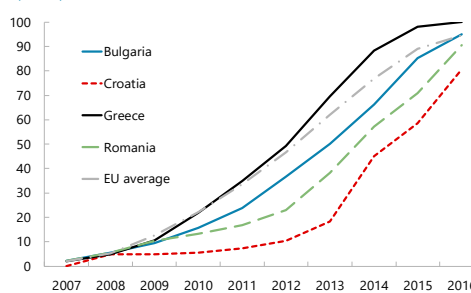
Main Parameters of Fiscal Responsibility Law

- The structural balance will be a medium-term budgetary objective that will be realized according to the adjustment plan prescribed by the SGP.
- Growth of the general government budget expenditure must not exceed a referential potential growth rate of the economy. Exceptions are possible in case that the higher growth rate stems from legislative changes.
- General government debt may not exceed 60 percent of GDP.
- Temporary postponement of the application of the rules will be permitted in the case of extraordinary circumstances and if this does not endanger the fiscal sustainability in the medium term.
- The role and tasks of the Fiscal Policy Commission have been strengthened.

19. Enhancing the capacity to absorb EU funds would help narrow investment gaps.

Administrative capacity remains weak and hinders the implementation of public policies and a more effective use of funds. Croatia contracted 62 percent of the EU funds under the 2014–2020 program period (with only 14 percent disbursed, including advance payments, as of November 2018). Staff encouraged the authorities to: (i) further improve administrative capacity, especially at line ministries; (ii) enhance the resolution of claims practices; and (iii) ensure that hiring of the needed personnel is in line with the needs of the projects.

EU Funds Absorption Rates
(Percent)



Sources: European Commission; and IMF Staff calculation.

Authorities' views

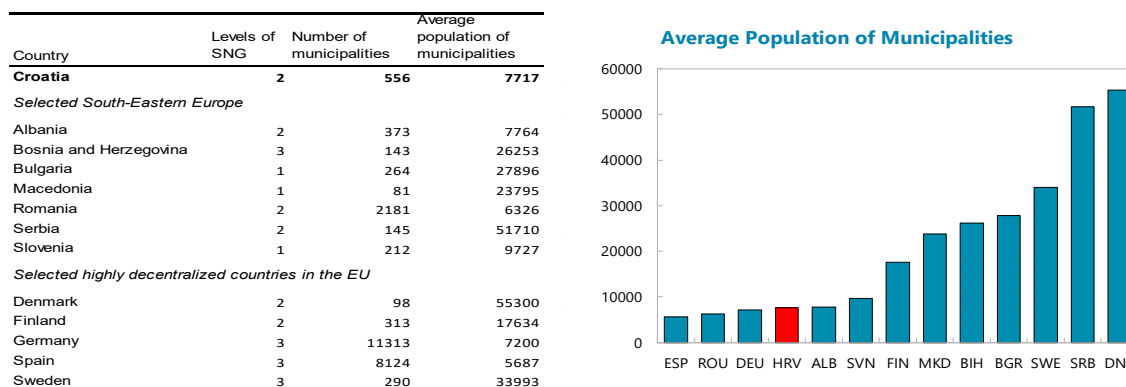
20. The authorities highlighted progress made in reducing public debt while successfully implementing tax reforms in 2017 and 2019. According to the Ministry of Finance, strong fiscal performance, partly based on a spending restraint, generated surpluses in the last two years, which facilitated the absorption of contingent liabilities from the health sector arrears and Uljanik

shipyard guarantees. Authorities agreed with the staff's recommended fiscal path and acknowledged the need to improve the composition of public spending to boost productive investment. They did not, however, consider that the introduction of a real estate tax would be politically feasible at the current juncture. The authorities recognized that reducing overall employment outlays would facilitate salary increases where needed and the new merit-based remuneration system would help retain talent. Rather than legislating significant changes on this front, the authorities, however, expressed their preference for gradual reductions in public employment linked to attrition and restructuring of SOEs and governmental bodies. While authorities agreed that better targeting of social benefits is needed, they hoped that forthcoming improvements in IT systems would help in this regard. Finally, authorities agreed that the pension reform could have been more ambitious but highlighted that this was the best of the politically feasible options.

B. Structural Reforms: The Lever of a More Dynamic State

21. Institutional quality and business environment remain significant areas for improvement. Numerous overlapping regulations and permit requirements create a challenging environment for the private sector. As noted above, part of the problem lies in the very high number of counties, municipalities, and public agencies, particularly in relation to the size of population and administrative capacity (Figure 8).¹⁴ The 2016–18 National Reform Programs (NRP) envisaged important steps to simplify this complex and multilayered system, but the strategy and timetable is drawn-out. Consolidation of the system will also help achieve the recommended fiscal savings discussed above. Staff called for renewed efforts to revive these aspects of the NRP, and thereby increase scale efficiencies in providing services, while lowering the associated administrative burden.¹⁵

Figure 8. Number of Subnational Governments and Population, 2014



Sources: Eurostat and The Council of European Municipalities and Regions (CEMR).

¹⁴ See 2016 Selected Issue Paper on reducing fragmentation and improving fiscal decentralization in Croatia.

¹⁵ 2017 NPR objective: Reducing the fragmentation and improving the functional allocation of competencies in public administration to improve efficiency and reduce territorial disparities in the provision of public services.

22. Further reductions in parafiscal charges—a prominent concern of the business community—have taken effect. Steps to lessen the burden on business included eliminating some administrative fees (non-tax payments), introducing an e-procedure for business permits, and an assessment of health and safety at work to be based on actual business-relevant risk. A Small and Medium Size Enterprise (SME) test is being conducted to assess the impact of proposed regulation on SME activity. Staff strongly encouraged the authorities to further eliminate the remaining barriers hindering access to regulated professions, and to progressively eliminate numerous parafiscal fees charged to businesses. Staff also welcomed the unification of inspection services as long as this increases the efficiency of inspections.

23. Improvements have been introduced to judicial processes, but bottlenecks remain. Insolvency procedures have been revised, there are ongoing efforts to modernize the cadaster and land registry, and there is some progress in reducing case backlogs which are still very high. The number of first instance courts is being optimized to ensure a more even case load. Efforts are also being made to ensure more uniform verdicts in similar cases. While IT is being introduced, the digitalization of court procedures is proceeding slowly, procedures for small claims and out-of-court settlements are still cumbersome, and dispute resolution mechanisms are weak. Staff emphasized the need to tackle all those issues and to improve the organization and management of judicial bodies, resolving uncertainties that stem from varied interpretation of existing laws across jurisdictions.

24. Labor markets need to better balance flexibility and job security with innovative solutions. The participation rate remains one of the lowest in the EU and structural unemployment, especially among youth and women, is high (Box 1). Labor market reforms were last seriously tackled in 2014, aiming to improve flexibility of the market. Since then some promising changes have been made and staff discussed and encouraged further steps:¹⁶

- *Hybrid contracts to reduce duality:* Contracts became more flexible through the introduction of fixed-term options. However, if uniformly implemented for younger entrants to the labor force, such reform risks the creation of a two-tiered system wherein employers invest little in workers on temporary contracts and offer them less security relative to those on open-ended contracts. Such a situation could encourage further emigration of the young, to the detriment of medium-term growth prospects. A solution

¹⁶ See Blanchard, O. J. and J. Tirole (2008), “The Joint Design of Unemployment Insurance and Employment Protection: A first pass”, *Journal of the European Economic Association* 6(1): 45–77; Blanchard, O., F. Jaumotte, and P. Loungani (2013) “Labor Market Policies and IMF Advice in Advanced Economies during the Great Recession,” *IMF Staff Discussion Note 13/02*; García Pérez, J.I. and V. Osuna (2014) “Dual Labour Markets and the Tenure Distribution: Reducing Severance Pay or Introducing a Single Contract”, *Labour Economics* 29, 1-13; IMF (2015) Spain: Staff Report for Article IV Consultation, Selected Issues Paper: Recent Labor Market Reform, A Preliminary Assessment; IMF (2017) Spain: Staff Report for Article IV Consultation, Annex I: Taking Stock of the 2012 Labor Market Reforms. Stoesz, D. (2016) “The Dynamic Welfare State *Oxford University Press*”; IMF (2016) “Managing Government Compensation and Employment—Institutions, Policies, and Reform Challenges”; OECD (2011) “Public Servants as Partners for Growth: Toward a Stronger, Leaner, and More Equitable Workforce”.

could be a, single type of contract, which would be a “hybrid” between the current fixed and open-ended contracts for an initial probationary period, to be followed by a mandatory conversion to the full open-ended contract, upon completion.

- *Financial support to apprenticeships:* More scholarships are being encouraged by providing financial coverage for apprenticeships to allow employers to train young workers in accordance with their needs. Consideration could be given to securing greater retention of young personnel after the apprenticeships, perhaps through continuing with partial financial coverage supported by EU funds.
- *Facilitating civil servants filling private sector vacancies.* Some retrenchment of the public service and mergers of agencies had led to employees leaving for the private sector. More such moves could be encouraged at all skill levels, including by nudging public-sector workers who are interested in private sector employment but fear losing the relative safety of their jobs to try their hand in the private sector with suitable safeguards for a limited period, to induce some risk-taking.

25. Better targeting of social benefits and increased child care access could incentivize greater labor force participation. Improved targeting of all social benefits and more retraining programs for long-term unemployed can induce greater labor force participation. Female integration in the labor market is likely to increase with more accessible child-care facilities and expanded education programs for 0–3 years old. There is also merit in further reviewing social security contributions, so long as this is strictly aimed at increasing the participation in the system and without endangering its overall solvency.

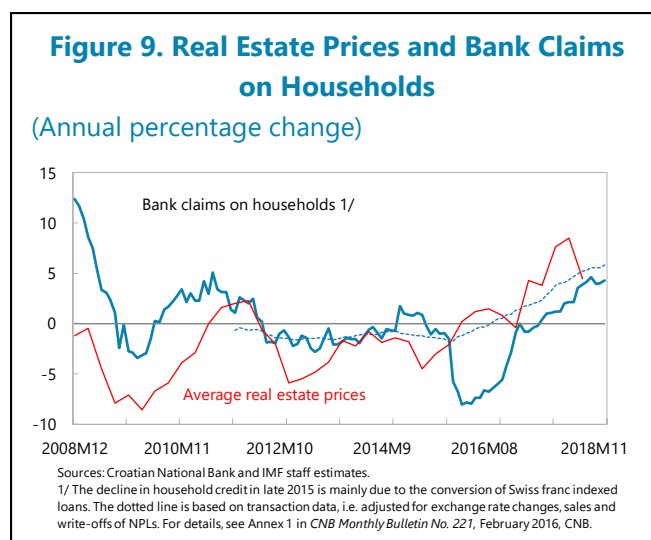
Authorities’ views

26. The authorities highlighted progress made in improving the business environment and intend to continue their efforts, including an extensive review of administrative measures. They agreed on the importance of reinvigorating other structural reforms but felt that initiatives needed to match the degree of political support—particularly in areas such as reducing national fragmentation and public service reform. The idea of facilitating civil servants’ exchanges with the private sector was also well received. They noted good experience with creating employment opportunities through the Active Labor Market Programs, especially training apprenticeships, in part supported through the EU funds. However, they do not have a clear timetable to review the structure of labor contracts. They agreed that simplification of the judiciary processes is essential for an effective economy and hope that further digitalization will help improve the system.

C. Anchoring Stability Through Monetary and Financial Sector Policies

27. Monetary policy has remained appropriately accommodative within the limits of CNB’s exchange rate anchor. The exchange rate anchor has served Croatia well over the years, helping to ensure financial and price stability. Recently, the CNB has intervened to contain appreciation pressures to maintain a stable exchange rate vis-à-vis the euro. The level of FX reserves has just reached ARA metric. Further reserve accumulation may occur over the coming

period as the country enters ERM II, assuming global risks do not materialize (Annex IV). The inflation outlook continues to be benign, helped by recent declines in energy prices, and despite emerging wage pressures. There is ample liquidity in the banking system, evidenced by the fact that there has been no demand at the *regular* weekly reverse repo auctions since December 2017. Going forward, the CNB may need to address potentially tighter external conditions and harness inflation expectations, within the exchange rate anchor.



28. The banking system is, on average, very liquid, well-capitalized, and has continued to gradually consolidate. The banking system has had a positive net foreign asset position since 2016:Q2. The comfortable average capital adequacy ratio eased the introduction of IFRS 9 and the gradual increase of risk-weights on FX sovereign debt beginning 2018 (Table 5).¹⁷ The NPL ratio (90 days overdue) has continued to decline (to 10.3 percent in September 2018), largely due to NPL sales.¹⁸ Given the still high corporate indebtedness and the level of NPLs, provisioning remains high, although the coverage ratio declined somewhat (to 59 percent) due to NPL sales. Beginning 2018, the monitoring of loans overdue between 30 and 90 days has intensified, and banks are required to develop strategies to lower their NPL ratio. Agrokor adversely affected bank profitability in 2017, but the system's profitability has grown since then.

29. Financial intermediation costs of Croatian banks are still relatively high. Factors like the relatively low level of digitalization, retroactive contract enforcement or regulatory cushions, may have contributed to the relatively high financial intermediation costs of Croatian banks. Recent research shows that better governance practices are conducive to more predictable contract enforcement and would help reduce costs, risks, and uncertainty of doing business, and thus ultimately lower financial intermediation costs (Box 2).

30. The CNB's strong supervisory and macroprudential policies have contained potential pressure points. Effective 2018, the appraisals of household housing loans were tightened, giving more emphasis to income indicators.¹⁹ The growth of general cash loans is gathering speed, and this needs to be carefully watched. The likely cause for the rapid growth is

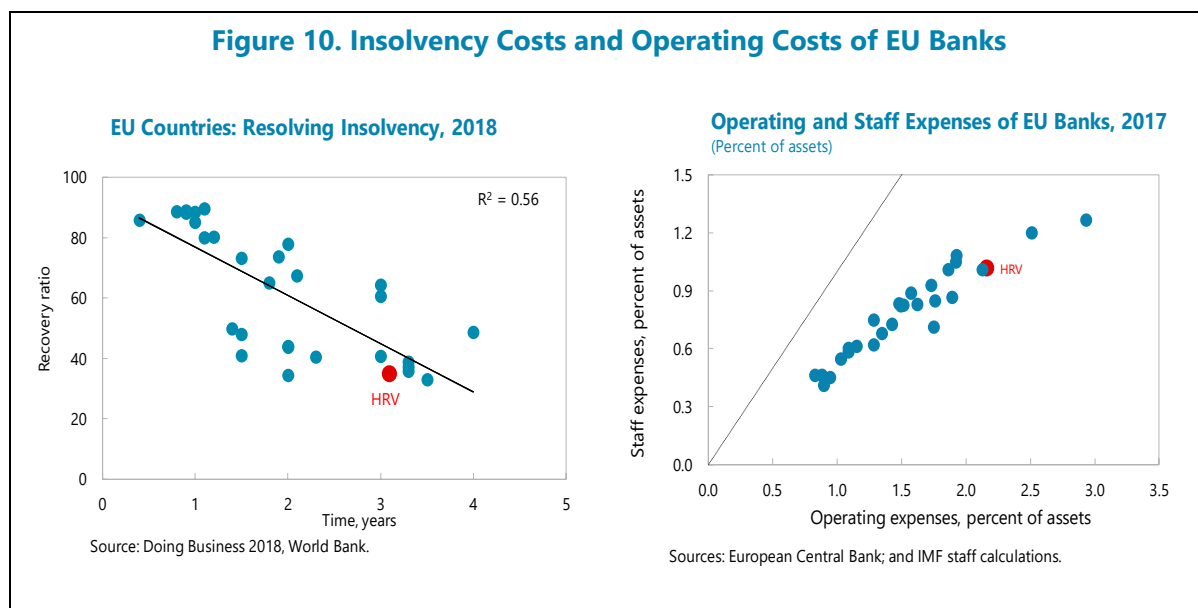
¹⁷ As of September 2018, the average Tier I capital ratio was 21.1 percent, while the lowest (11.5 percent) was of small housing savings bank.

¹⁸ The 2017 one-off special tax treatment to enable write-offs of provisioned bank loans was not widely used. Banks found it more profitable and operationally easier to sell the NPLs.

¹⁹ Credit institutions must consider the minimum living costs of a client when granting a housing loan. For details, see Table 2 in *Macprudential Diagnostics*, No. 6, CNB, October 2018.

that they are issued quickly and only at a slightly higher interest rates compared to collateralized loans. The real estate market is also picking up, albeit from a low base and the recovery is rather segmented. Should both household borrowings and real estate prices further accelerate, additional macro prudential measures may need to be considered, including a comprehensive debt-service-to-income ratio capturing all debts, not just debts related to housing loans. Since May 2018, new loans are no longer reported to the credit register run by the Croatian Banking Association due to concerns of some banks about the implementation of the General Data Protection Regulation (GDPR). Staff recommended to shortly resolve these legal issues.

31. Debt recovery is time-consuming and costly compared to other EU countries. A comprehensive review of bankruptcy legislation to ensure that it serves the changing structure of the economy as well as accelerate the ongoing modernization of the judiciary warrants close consideration.²⁰ Speeding up insolvency processes would likely also catalyze a faster deleveraging of some indebted companies.²¹



Authorities' views

32. Efforts to make households aware of interest rate risk appear to have been effective, as the share of fixed-rate kuna lending has increased. The CNB said it is closely monitoring the recent acceleration in general cash loans to households as well as real estate prices. The CNB

²⁰ Recent changes to the bankruptcy legislation have been triggered by urgent challenges rather than a forward-looking vision. In 2017, after the Law on Systemically Important Companies was adopted, the general bankruptcy legislation was amended to facilitate restructuring of companies. In 2018, new initiatives were introduced to reduce the number of physical persons with blocked bank accounts due to small overdue loans.

²¹ See, for instance, "Corporate Debt Overhang in Croatia: Micro Assessment and Macro Implications" by Ana Martinis and Igor Ljubaj, *Working Paper W-51*, Croatian National Bank, Zagreb, June 2017.

does not yet see a need to introduce additional macroprudential measures. The authorities are preparing a legislation that should address the legal uncertainties related to the transposition of the GDPR. The authorities plan to amend the general bankruptcy legislation when the envisaged business insolvency directive will be transposed. The authorities noted that the relatively high financial intermediation costs are not so much a function of governance issues (Box 2) as several other factors, including a low level of digitalization, and regulatory costs that have been critical in maintaining a stable banking system. The CNB is expected to initiate the preliminary procedures and discussions for ERM II entry in 2019.

STAFF APPRAISAL

33. The short-term picture is benign, but medium-term prospects hinge on the completion of deep structural changes. The Croatian authorities have skillfully utilized the recent economic upturn to reduce indebtedness and further build external buffers. Yet, important challenges remain. Relatively low public and private investment hamper medium-term growth prospects. Emigration and population aging are generating labor shortages and limiting Croatia's growth potential. This calls for a smartly focused transformation to a more dynamic economy, and a more efficient State. A sizable restructuring of public administration and reforming the judicial system are central to this effort. Reducing duality in the labor market and increasing the efficiency of SOEs would also improve productivity. The time to make focused progress on the structural agenda is now, as economic conditions are favorable. Should these reforms remain incomplete, a vital window of opportunity will close, and the country may not derive the full intended benefits of its envisaged integration with the eurozone.

34. Fiscal policy choices can do more for growth and better match structural priorities. Recent fiscal surpluses are commendable, but the speed of public debt reduction could be faster to rebuild fiscal space. The composition of the budget is excessively tilted towards current spending. Shifting the focus towards better public investment would improve medium-term growth prospects, while broadening the tax base would make revenues more stable and make taxation fairer and more progressive. Increasing labor force participation and private investment will also go a long way towards improving growth prospects, job creation and living standards. Dealing with healthcare arrears and growing pension costs will require additional reforms.

35. Monetary policy may face new challenges. The Central Bank is still operating in an environment of low interest rates and ample liquidity. Going forward, these conditions may change, and the Central Bank may need to address potentially tighter external conditions. Harnessing inflation expectations, preparing for ERM II and Banking Union membership will be the main agenda items for the authorities to focus on.

36. Macroprudential policies can contain possible pressure points. If real estate prices accelerate or high growth of cash loans persists, authorities could consider the introduction of additional measures to prevent excessive household borrowing (e.g., more comprehensive use of debt-service-to-income limits). Enhancements to the efficiency of bankruptcy procedures (e.g., by

facilitating out-of-court settlements) would help further private sector deleveraging. Despite recent changes in the bankruptcy legislation, a comprehensive review to ensure that the insolvency framework aligns with best practices merits strong consideration.

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

Box 1. Labor Market Taxation: Considerations

As of 2017, around 12 percent of Croatia's active population is unemployed compared with the EU27 (excluding Greece, Italy and Croatia) average of 7 percent. Moreover, Croatia continues to have one of the lowest labor force participation and employment rates across Europe (Figure 11). These outcomes may have their origins in various structural rigidities that have existed since independence. On the supply side, the participation rate has been low because of the loopholes in the social benefits system, including pensions, which allow widespread recourse to early retirement (EC, 2018). Shortcomings in aligning education with labor market needs and few lifelong learning opportunities limit the labor's ability to adapt to technological and organizational changes. On the demand side, despite the tax wedge being lower compared to peers (depending on the bracket), tax regulations and tax rates in Croatia rank in top five most problematic areas for doing business. Effect of taxation on incentives to work is ranked particularly low in international comparisons (133 out of 137); while restrictive labor regulations and inadequately educated labor force (skills mismatch) are also a concern for investors (WEF, 2017–18).

Staff analysis (2018), examining structural determinants of hours worked in New Member States over 1995–2017, finds that taxation plays an important part in explaining changes in labor supply, supporting other studies, including on Croatia.¹ Augmenting a standard neoclassical growth model with taxes (consumption and labor) helps in predicting hours worked. In a panel regression staff also tested potential importance of other factors on two broad dimensions of the labor market: average annual hours worked per employed person (the *intensive margin*) and the employment rate (the *extensive margin*).² Higher taxes are associated with lower hours worked (elasticity of close to -0.5 is slightly above the range of coefficients found in studies for OECD countries (-0.46 to -0.12). When distilling taxes into consumption, personal income tax (PIT) and social security contributions (SSC), SSC was highly significant, while PIT marginally significant, depending on the specification and the tested margin. The effect of SSC on women's employment decision/status was somewhat higher than that for men. Social benefits and business regulation also had significant association with lower hours worked.

Since rigidities in the labor market, to a large extent, stem from policy making, there must be a holistic approach to reform implementation. To be clear, there is no simple link between taxes and employment. With the population living longer in the region, spending pressures—especially in pensions and health—are likely to increase. Thus, while taxes matter, broader fiscal implications, including for the solvency of the health and pension systems should be considered before deciding on any changes to labor taxation.

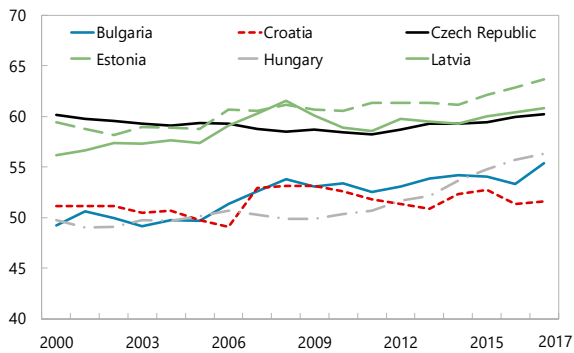
To that end, policy options for Croatia could include: (i) shifting the income tax burden to less distortive taxes, such as property and environmental taxes; (ii) revisiting the composition of SSC, while reforming health and pension insurance systems; and (iii) streamlining poorly targeted systems of social benefits.

¹Forthcoming Working Paper "Structural Determinants of Hours Worked in EU New Member States: The Role of Taxation", by A. Velasquez and S. Vtyurina.

²Deskar-Škrbić et al (2018), Dolenc et al (2011), Nestić (1998), Obadić (2004), Kesner Škreb (2007).

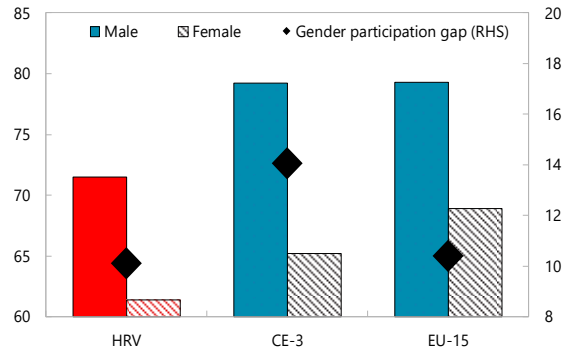
Figure 11. Labor Market Outcomes

Participation Rates
(Percent)



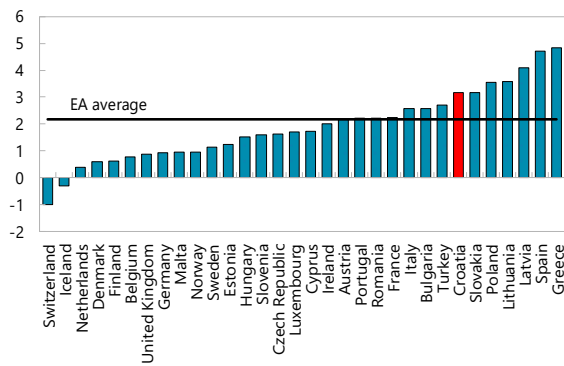
Source: Haver Analytics.

Labor Force Participation Rate by Gender, 2017
(Percent)



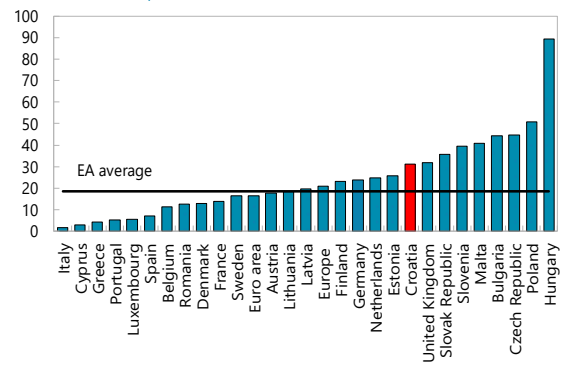
Source: Eurostat.

Skills Shortage, 2017
(Index)



Sources: Eurostat, World Economic Forum.

Labor Shortages in Industry, 2018 Q4
(Percent of respondents)



Source: European Commission.

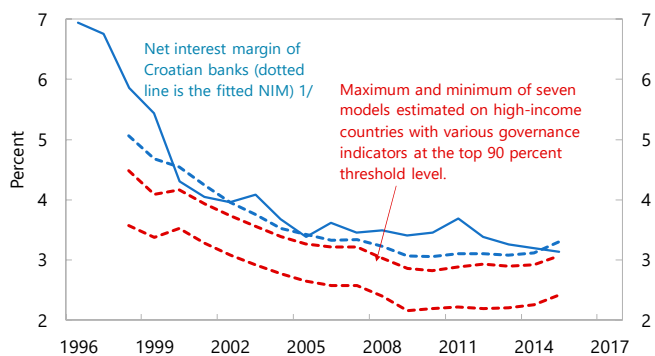
Box 2. Governance Practices and Bank Intermediation Costs

Governance quality affects financial intermediation costs across countries, including in Croatia. Good governance here means clear legislation, formal and informal rules governing behaviors of society, organizations, institutions, firms, individuals, as well as networks and markets with a view to achieve the official objective(s) of these entities, which are effectively enforced and observed. Good practices evidently reduce costs, risks, as well as uncertainty, as they enhance trust. Competition among banks should help reduce excessive profits, but it can only reduce financial intermediation costs to levels merited by the costs, risks and uncertainty of doing business.

An empirical cross-country study suggests that in addition to banking sector characteristics and macroeconomic indicators, improved perception of governance practices is also associated with lower net interest margins of banks.¹ Net interest margins (NIM) are here defined as net interest income in percent of interest-bearing assets (NIM). Banking characteristics include competition, operating cost, transaction size or financial deepening, risk aversion, and not least credit risk. Macroeconomic indicators include inflation and real GDP growth. A broad range of indicators capture various aspects of perceived governance. They include proxies for the rule of law, quality of regulation, insolvency framework, contract enforcement, government effectiveness, control of corruption, and ethical behavior of private firms. Robustness tests were conducted using interest spreads, other governance indicators, instrument variables, lagged dependent variables, accounting for cross-sectional dependence, a probit model to address possible non-linearity, as well as sensitivity to outliers.

If governance practices were improved, the same amount of financial intermediation could be done at lower costs—simulations suggest gains of up to ¼ percent of GDP per year. The NIM of seven models using different governance indicators were estimated for high-income countries to the extent data were available. The simple *average fitted* NIM of these models was calculated using Croatian data (blue dotted line). Then the average fitted NIM was calculated assuming that the respective governance variable instead had been at the top 10 percent threshold. The difference between these two averages shows how much lower the NIM could have been, if governance were stronger—on average it amounts to almost 50 basis points per year. However, it declined to about 35 basis points toward the end of the period, suggesting some progress. The estimated improvements were multiplied by bank credit to the private sector in percent of GDP to evaluate the potential gains, or savings of about ¼ percent of GDP per year during the analyzed period. These results are only illustrative and need to be interpreted with caution. For instance, banking characteristics may not be independent of the governance indicators. Nevertheless, this simulation lends credence to the intuition that better perceived governance practices should reduce costs, risks and uncertainty.

Potential Impact of Selected Governance Indicators on Croatian Banks' Net Interest Margin, 1996-2015



Sources: Beck et al (2017), and IMF staff estimates.

1/ Net interest margin as calculated by Beck et al. (2017).

¹For details, see "Can Better Governance Lower Financial Intermediation Costs?" by M. Jarmuzek and T. Lybek, *IMF Working Paper WP/18/279*. An unbalanced panel with 100 countries during the 1996–2015 period was used.

Table 1. Croatia: Selected Economic Indicators

	2014	2015	2016	2017	2018	2019
					Proj.	
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)					
Real GDP growth	-0.1	2.4	3.5	2.9	2.7	2.6
Contributions:						
Domestic demand	-1.4	2.2	3.7	3.6	3.6	3.0
Net exports	1.2	0.3	-0.1	-0.7	-0.8	-0.4
Unemployment	19.3	17.1	15.0	12.4	...	...
CPI inflation (avg.)	-0.2	-0.5	-1.1	1.1	1.5	1.5
Saving and investment	(Percent of GDP)					
Domestic investment	18.8	20.0	20.8	20.9	20.6	20.6
Domestic saving	20.8	24.5	23.4	25.0	23.5	22.7
Government	-0.7	0.3	2.4	4.0	4.2	3.4
Nongovernment	21.5	24.2	20.9	21.0	19.4	19.3
Government sector (ESA 2010 definition)						
General government revenue	42.6	44.4	46.1	46.7	47.6	46.9
General government expenditure	48.0	47.8	46.9	45.8	47.2	46.9
General government balance	-5.3	-3.3	-0.8	0.9	0.4	0.0
Structural balance 1/	-2.8	-2.1	-0.3	0.8	1.1	0.0
General government debt 2/	85.7	85.3	82.3	77.7	73.9	71.1
Balance of payments						
Current account balance	2.0	4.5	2.6	4.0	2.9	2.1
Capital and financial account	-1.8	-1.9	-2.1	2.1	0.5	-1.1
FDI, net	1.6	0.5	4.1	2.4	2.8	2.8
Debt and reserves						
Gross official reserves (billions of euros)	12.7	13.7	13.5	15.7	17.4	18.0
Percent of short-term debt (by residual maturity)	97.3	113.8	140.9	164.6	167.5	163.0
In months of imports in goods and services (based on next year level)	8.1	8.0	7.6	7.8	8.0	7.6
Total external debt (percent of GDP)	106.9	101.7	89.3	81.8	75.4	71.9
Money and credit	(End of period, change in percent)					
Broad money (M4)	3.2	5.2	4.7	2.1	...	...
Claims on other domestic sectors 3/	-2.2	-3.0	-3.4	-0.8	...	...
Interest rates						
Average 12-month T-bill interest rate (in kuna)	1.9	1.5	1.0	0.4	...	...
Kuna credit rate (unindexed, outstanding amount)	7.5	7.1	6.5	6.0	...	...
Exchange rate						
Kuna per euro	7.7	7.6	7.6	7.5	7.4	...
Real effective exchange rate (percent, "-" = appreciation)	-1.1	-3.0	0.2	1.4	1.9	...
Memorandum items:						
Nominal GDP (billions of euros)	43.4	44.6	46.7	48.6	50.6	52.7

Sources: Croatian authorities; and IMF staff estimates.

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

2/ Gross debt as defined by the EU under the Maastricht Treaty

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

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

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Proj.						
Real GDP (percent change)	-0.1	2.4	3.5	2.9	2.7	2.6	2.5	2.4	2.2	2.0	2.0
CPI inflation (average)	-0.2	-0.5	-1.1	1.1	1.5	1.5	1.6	1.7	1.8	1.9	1.9
CPI inflation (end-of-period)	-0.5	-0.6	0.2	1.2	0.9	1.2	1.5	1.6	1.8	1.9	1.9
Real sector (percent change)											
Domestic demand	-1.4	2.3	3.8	3.6	3.6	3.0	3.0	3.3	2.5	2.3	2.7
Consumption, total	-0.7	0.5	2.7	3.4	4.1	3.2	3.0	3.0	2.4	2.2	1.9
Gross fixed capital formation, total	-3.0	4.5	6.5	3.8	5.5	5.8	5.6	4.9	4.5	4.6	3.9
Saving and investment											
Domestic investment	18.8	20.0	20.8	20.9	20.6	20.6	20.5	20.7	20.5	20.6	21.2
Domestic saving	20.8	24.5	23.4	25.0	23.5	22.7	22.1	21.6	21.1	20.9	21.5
Balance of payments											
Current account balance	2.0	4.5	2.6	4.0	2.9	2.1	1.6	0.9	0.6	0.3	0.3
Exports of goods, f.o.b.	21.7	22.9	22.5	24.1	25.3	26.5	27.7	29.0	30.3	31.9	33.7
Imports of goods, f.o.b.	36.7	38.5	38.4	41.1	42.8	44.3	45.7	46.9	48.5	50.5	52.4
Capital and financial account	-1.8	-1.9	-2.1	2.1	0.5	-1.1	0.0	0.5	0.8	0.5	0.8
Of which: FDI, net	1.6	0.5	4.1	2.4	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Gross official reserves	29.2	30.7	29.0	32.0	34.0	33.7	34.0	34.1	34.2	33.7	33.7
Gross external debt	106.9	101.7	89.3	81.8	75.4	71.9	67.7	65.4	63.6	62.2	61.3
General government finances											
Revenue	42.6	44.4	46.1	46.7	47.6	46.9	46.6	46.7	46.5	46.5	46.2
Expenditure	48.0	47.8	46.9	45.8	47.2	46.9	46.5	46.6	46.3	46.2	45.8
Balance	-5.3	-3.3	-0.8	0.9	0.4	0.0	0.1	0.1	0.2	0.3	0.4
Government debt	85.7	85.3	82.3	77.7	73.9	71.1	69.0	66.5	64.4	62.6	61.0
Memorandum items:											
Nominal GDP (billions of kuna)	331.6	339.6	351.3	365.6	381.1	396.6	412.8	429.9	447.3	465.2	481.8
Output gap	-5.2	-3.3	-1.2	0.3	0.4	0.5	0.3	0.0	0.0	0.0	0.0
Potential GDP growth	0.1	0.4	1.4	1.4	2.6	2.5	2.7	2.7	2.2	2.0	2.0
Potential GDP per capita (percent change)	0.5	1.3	2.1	2.6	3.7	3.3	3.2	3.1	2.9	2.7	2.7

Sources: 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)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
	Proj.										
Revenue	42.6	44.4	46.1	46.7	47.6	46.9	46.6	46.7	46.5	46.5	46.2
Taxes	24.6	25.2	26.0	26.9	27.5	27.0	26.8	26.8	26.7	26.7	26.6
Income tax	5.7	5.5	5.6	5.8	5.9	5.8	5.7	5.7	5.6	5.6	5.6
VAT	12.4	12.8	13.0	13.3	13.8	13.3	13.3	13.4	13.4	13.3	13.2
Excise	4.0	4.3	4.5	4.7	4.7	4.6	4.6	4.6	4.6	4.6	4.7
Import duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.5	2.6	2.9	3.2	3.2	3.2	3.1	3.1	3.1	3.1	3.1
Social contributions	11.7	11.7	11.6	11.7	12.0	11.7	11.7	11.8	11.7	11.7	11.8
Other revenue	2.6	3.4	4.4	3.9	3.9	4.0	3.9	4.0	3.9	3.9	3.7
Grants 1/	1.5	2.4	3.4	3.0	3.0	3.0	3.0	3.0	3.0	3.0	2.8
Property income	1.1	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
of which interest receivable:	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Sales of goods and services	3.8	4.1	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Expenditure	48.0	47.8	46.9	45.8	47.2	46.9	46.5	46.6	46.3	46.2	45.8
Expense	44.4	44.7	43.7	43.0	44.2	43.8	43.4	43.4	43.2	43.1	42.8
Compensation of employees	11.7	11.8	11.6	11.7	11.9	12.1	12.1	12.0	11.8	11.6	11.4
Use of goods and services	7.9	7.9	7.9	7.7	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Interest, payable	3.4	3.5	3.2	2.9	2.4	2.1	1.9	1.8	1.8	1.8	1.8
Subsidies	2.0	1.7	1.5	1.7	2.1	2.1	2.1	2.1	2.1	2.1	2.0
Current grants 2/	0.9	1.7	2.3	1.7	1.6	1.6	1.5	1.5	1.4	1.4	1.3
Social benefits	17.0	16.5	16.0	16.0	16.1	16.3	16.4	16.6	16.7	16.8	16.9
Other expenses	1.4	1.6	1.4	1.4	2.0	1.7	1.4	1.4	1.4	1.4	1.4
Net acquisition of nonfinancial assets	3.6	3.1	3.1	2.8	3.0	3.1	3.1	3.1	3.1	3.1	3.0
Overall Balance	-5.3	-3.3	-0.8	0.9	0.4	0.0	0.1	0.1	0.2	0.3	0.4
Memorandum item:											
General government gross debt 3/	85.7	85.3	82.3	77.7	73.9	71.1	69.0	66.5	64.4	62.6	61.0
General government net debt 4/	70.9	72.3	70.5	...	...	...	...	...	...	...	...
Structural balance 5/	-2.8	-2.1	-0.3	0.8	1.1	0.0	0.0	0.1	0.2	0.3	0.4

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/ Gross debt as defined by the EU under the Maastricht Treaty

4/ Net debt is calculated as gross debt minus deposits, loans and debt securities as reported by Eurostat.

5/ In percent of potential GDP, excluding capital transfers to public enterprises, one-off investment retrenchment in 2015, and payment of guarantees of Uljanik shipyards in 2018/19

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

	2014	2015	2016	2017	2018		
					Q1	Q2	Q3
Monetary survey							
Net foreign assets	75.1	93.2	104.7	121.8	114.3	122.0	138.2
Croatian National Bank	93.5	91.7	95.1	110.6	106.9	115.0	110.9
Deposit money banks	-18.4	1.4	9.6	11.2	7.4	7.0	27.3
Net domestic assets	198.1	194.2	196.2	185.4	189.5	188.6	186.9
Domestic credit (CNB definition)	237.0	230.0	221.5	218.9	218.9	222.8	222.8
Claims on government, net 1/	60.4	66.2	73.2	60.1	63.5	58.9	58.0
Claims on other domestic sectors 2/	224.9	218.0	210.6	208.9	209.3	213.1	213.2
Other items (net)	-38.9	-35.8	-25.3	-33.5	-29.4	-34.2	-35.9
Broad money (M4)	273.2	287.3	300.9	307.2	303.8	310.6	325.1
Narrow money (M1)	63.4	70.6	83.5	99.4	101.3	109.7	115.5
Currency outside banks	18.5	20.1	22.5	25.6	25.3	27.9	29.1
Demand deposits	44.9	50.5	61.0	73.9	76.1	81.8	86.4
Quasi money	209.8	216.7	217.4	207.8	202.4	200.9	209.6
Kuna-denominated	45.0	45.4	47.7	43.7	43.3	42.5	43.1
Foreign currency-denominated	164.9	171.3	169.7	164.1	159.1	158.4	166.5
Balance sheet of the Croatian National Bank							
Net foreign assets	93.5	91.7	95.1	110.6	106.9	115.0	110.9
Of which: banks' reserves in foreign currency	3.7	3.8	0.0	0.0	0.0	0.0	0.0
Net international reserves	81.2	84.8	95.0	110.6	106.9	109.6	110.8
Net domestic assets	-26.3	-24.1	-21.7	-24.1	-15.3	-21.5	-22.2
Claims on government (net)	-11.6	-8.1	-3.5	-4.2	-2.4	-8.3	-7.6
Claims on banks	0.0	0.2	1.1	1.3	1.1	1.1	1.1
Claims on other domestic sectors	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	-14.8	-16.2	-19.3	-21.2	-14.0	-14.2	-15.6
Reserve money (CNB definition) 3/	63.3	63.7	73.3	86.4	91.5	93.4	88.6
Of which:							
Currency outside credit institutions	18.5	20.1	22.5	25.6	25.3	27.9	29.1
Kuna deposits of credit institutions	40.2	38.4	45.3	54.7	60.5	58.0	52.2
Of which:							
Settlement accounts	15.1	16.1	23.8	32.6	38.3	35.6	28.9
Statutory reserves in kuna	21.9	22.3	21.6	22.1	22.2	22.4	23.3
Year-on-year percent changes							
Monetary survey:							
Net domestic assets	-2.2	-2.0	1.1	-5.5	0.7	-5.2	-1.5
Domestic credit (CNB definition)	-1.6	-3.0	-3.7	-1.2	-0.9	1.5	1.2
Claims on government, net 1/	6.5	9.6	10.6	-17.8	-2.4	-19.0	-10.5
Claims on other domestic sectors 2/	-2.2	-3.0	-3.4	-0.8	-0.1	1.7	1.4
Broad money (M4)	3.2	5.2	4.7	2.1	4.4	4.7	5.0
Quasi money	1.4	3.3	0.3	-4.4	-3.3	-3.0	-1.9
Balance sheet of the Croatian National Bank:							
Reserve money (CNB definition) 3/	1.0	0.7	14.9	17.9	23.6	22.4	16.7
Memorandum items:							
Nominal GDP (yearly total) 4/	331.6	339.6	351.3	365.6	371.7	377.0	378.3
Broad money (percent of GDP)	82.4	84.6	85.6	84.0	81.7	82.4	85.9
Foreign currency (percent of broad money)	60.3	60.8	56.4	53.4	52.4	51.0	51.2
Credit to other domestic sectors: stock (% of GDP)	67.8	64.2	59.9	57.1	56.3	56.5	56.4
Claims on private sector (transactions, annual change,%) 2/ 5/	-2.0	-2.3	1.6	3.2	3.7	4.1	4.4

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)

	2014	2015	2016	2017	2018		
					Q1	Q2	Q3 Prel.
Regulatory capital to risk-weighted assets	21.8	21.0	22.5	23.2	22.9	22.6	22.2
Regulatory Tier I capital to risk-weighted assets	20.6	19.2	20.9	21.8	21.7	21.4	21.1
Nonperforming loans net of loan-loss provisions to capital	41.1	34.2	19.4	14.2	14.0	14.6	
Nonperforming loans to total gross loans 1/	16.7	16.3	13.6	11.2	11.3	11.1	10.3
Total loan-loss provision to nonperforming loans 2/	51.0	61.9	70.1	70.1	70.8	69.7	
Return on assets	0.6	-1.2	1.6	1.1	1.7	1.7	
Return on equity	4.6	-8.7	11.8	7.4	11.4	11.8	
Interest margin to gross income	58.1	62.1	57.7	60.1	61.4	59.2	
Noninterest expenses to gross income	57.3	61.9	53.4	56.5	56.8	54.1	
Liquid assets to total assets 3/	27.3	27.7	29.6	33.0	33.3	32.9	
Liquid assets to short-term liabilities 3/	42.7	41.9	42.6	47.3	47.2	45.8	
Net open position in foreign exchange to capital	2.9	12.5	3.8	3.3	1.5	1.5	
Residential real estate prices (annual percentage increase)	-1.4	-2.1	0.8	7.6	8.5	4.5	

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

Note: The classifications used in the table are consistent with the IMF's FSIs 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 FSIs.

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 1/
(Millions of euros, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
	Proj.										
Current account	858	2,019	1,206	1,963	1,468	1,115	859	538	328	196	167
Merchandise trade balance	-6,512	-6,974	-7,385	-8,254	-8,842	-9,375	-9,861	-10,242	-10,849	-11,485	-11,923
Exports f.o.b.	9,440	10,194	10,511	11,713	12,801	13,978	15,193	16,530	17,985	19,724	21,590
Imports f.o.b.	15,952	17,168	17,896	19,966	21,644	23,353	25,054	26,772	28,835	31,209	33,513
Services Trade Balance	7,338	8,006	8,712	9,318	9,399	9,667	9,773	9,700	9,965	10,331	10,617
Export of services	10,238	11,280	12,273	13,411	14,019	14,859	15,462	16,286	17,580	18,669	19,613
Imports of services	2,900	3,274	3,561	4,093	4,620	5,192	5,690	6,585	7,615	8,339	8,996
Primary income balance	-859	-292	-1,490	-888	-879	-871	-861	-848	-836	-824	-818
Secondary income balance	891	1,279	1,369	1,786	1,790	1,694	1,807	1,927	2,049	2,174	2,290
Capital account	166	321	667	308	318	329	339	350	361	373	385
Financial account	-954	-1,162	-1,631	734	-47	-905	-320	-59	124	-43	155
Direct investment	690	235	1,933	1,180	1,431	1,489	1,550	1,615	1,680	1,747	1,809
Portfolio investment	-718	115	-1,300	-303	-401	-306	-367	-359	-427	-501	-485
Financial derivatives	-36	16	82	317	-138	-87	-31	85	11	-22	-25
Other investment	-891	-1,528	-2,346	-460	-938	-2,001	-1,473	-1,400	-1,139	-1,267	-1,145
Net errors and omissions	-599	-432	-507	-412	0	0	0	0	0	0	0
Gross reserves (= increase)	530	-745	265	-2,593	-1,739	-540	-877	-828	-814	-526	-707
Memorandum items:											
Current account (percent of GDP)	2.0	4.5	2.6	4.0	2.9	2.1	1.6	0.9	0.6	0.3	0.3
Export goods volume growth	8.6	10.2	5.2	8.7	8.0	7.9	7.4	7.3	7.3	7.2	7.0
Import goods volume growth	4.7	8.6	5.5	7.2	6.8	6.2	5.8	5.8	5.8	5.8	5.9
Gross official reserves	12,688	13,707	13,514	15,706	17,445	17,985	18,862	19,691	20,504	21,030	21,737
Percent of short-term debt	97.3	113.8	140.9	164.6	167.5	163.0	168.7	174.7	175.0	176.3	176.8
Months of next year's imports	8.1	8.0	7.6	7.8	8.0	7.6	7.4	7.1	6.8	6.4	6.1
External debt to GDP 2/	106.9	101.7	89.3	81.8	75.4	71.9	67.7	65.4	63.6	62.2	61.3
GDP (millions of euros)	43,430	44,607	46,661	48,559	50,607	52,664	54,817	57,096	59,405	61,774	63,989

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. Implementation of IMF Recommendations

	2017 Article IV Advice	Actions since 2017 Article IV
Fiscal consolidation	Continue fiscal consolidation but make it more growth-friendly.	Achieved with caveats. Annual fiscal consolidation in 2018 was smaller than staff advice, and was mostly due to strong economic activity. The activation of one-off shipyard guarantees reduced the overall surplus.
Structural tax reform	Implement off-setting revenue measures, including eliminating one of the two preferential VAT rates. Introduce a modern real estate tax, in line with past TA recommendations.	Some progress. Preferential rates have not been reduced, and the introduction of the real estate tax has been deemed politically infeasible at this time. At the same time, a new round of tax cuts will reduce VAT for selected products, excises and social security contributions starting in January 2019.
Streamlining public expenditures	(a) Link remuneration to performance, introducing a single salary framework, and streamlining the multi-layered and fragmented public administration. (b) Better target social expenditures by accelerating the one-stop shop for the numerous benefits while enhancing means testing.	(a) Progress. Draft law has been prepared. (b) No progress. The establishment of a one stop shop for all benefits has been postponed to 2020. Child allowance (calculated per member of household) was raised by 40 percent. Number of users will increase by approximately 150 thousand.
Improving absorption of EU funds	Improve implementation capacity and simplify administrative procedures. Expedite the transposition of the procurement directive.	Limited progress.
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. (b) Completed. The Fiscal Responsibility 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. Para-fiscal fees have been further reduced. (b) Limited progress. Reducing the court case backlog will take a long time, despite some improvement.

Annex II. Public Debt Sustainability Analysis¹

Given significant fiscal consolidation, public debt has been on a declining path, but remains high.

Public debt has declined almost 9 percentage points since its peak in 2014, and gross financing needs are now below the high-risk threshold but remained elevated. Under the baseline scenario, debt is expected to be at around 74 percent of GDP at end-2018. It will continue to gradually decline over the medium term and reach 61 percent of GDP in 2024, still above the threshold of the Stability and Growth Pact. However, these projections remain vulnerable to growth prospects and the materialization of contingent liabilities, such as state guarantees, including for shipyards and SOEs, or the payment of healthcare arrears. On the other hand, there could be some gains if more state assets were divested, with the proceeds being used for public debt reduction.

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. More than 93 percent of outstanding debt matures beyond one year, although Croatia still does not borrow very long-term in sovereign bond markets (mostly 5–10 years). About 40 percent of public debt is denominated in foreign currency (mostly euro-denominated), and debt denominated in euro has increased gradually during the last few years due to the result of the issuance of domestic and foreign bonds denominated in euro, borrowing in domestic market via syndicated loans, and use of project loans of international financial institutions. Since its peak in 2014, public debt has declined more than 9 percentage points; and significant progress was made in the financial restructuring of the road sector which had contributed significantly to the build-up of debt in the past. However, in 2019 at above 70 percent of GDP, debt will remain high and gross financing needs elevated at 11 percent of GDP (almost a third of general government revenues). While financing conditions have improved resulting in lower risk premia, the interest rate on Croatia's sovereign debt still exceeds its medium-term growth rate under a reasonable scenario, highlighting debt sustainability concerns.
- *Debt management strategy:* High financing needs and exposure of its sovereign debt to FX risks call for a strengthening of the debt management framework. The authorities have updated its debt management strategy for the period 2018–2020. This strategy continues to recognize that public debt represents a key macroeconomic risk for the economy, and thus emphasizes the need to accelerate the fiscal adjustment. The objective is to reduce the debt-to-GDP ratio by 10 percentage points of GDP by 2020, not least through further reducing short-term debt and currency and interest rate risks.

¹ Prepared by Carlos Mulas Granados.

- *Realism of projections:* Croatia's projected fiscal adjustment of about 2.4 percentage points in the cyclically-adjusted primary balance-to-GDP ratio over the medium term is similar to other countries' adjustments.
- *Vulnerabilities:* The heat map shows that the stock of debt remains high. At the same time, the gross financing needs have declined since 2015, and they are no longer above the 15 percent high-risk threshold. The debt profile has also improved in terms of longer maturity, market perception, change in the share of short-term debt, and the share of public debt held by non-residents.

The baseline scenario incorporates

- *Fiscal path:* Preliminary data put the 2018 general government surplus at around 0.4 percent of GDP, including a payment of guarantees of about 0.4 percent of GDP. Considering that the payment of guarantees will extend two years, a balance budget is projected for 2019, converging into a surplus of 0.4 percent of GDP by 2024.
- *Growth:* Real GDP growth is estimated at 2.7 percent for 2018. Going forward, growth is expected to converge towards its potential rate of about 2.0 percent.

Risks to the baseline come mainly from potentially less favorable growth prospects but 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 even surprised on the upside. The growth shock could come from external risks identified in the RAM (Annex IV), reflecting reduced demand from trading partners and a slowdown of tourism activity.
- A neutral interest rate-growth differential and the consolidation efforts could 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 accounting for a gradual normalization of global monetary conditions.

Shocks and Stress Tests

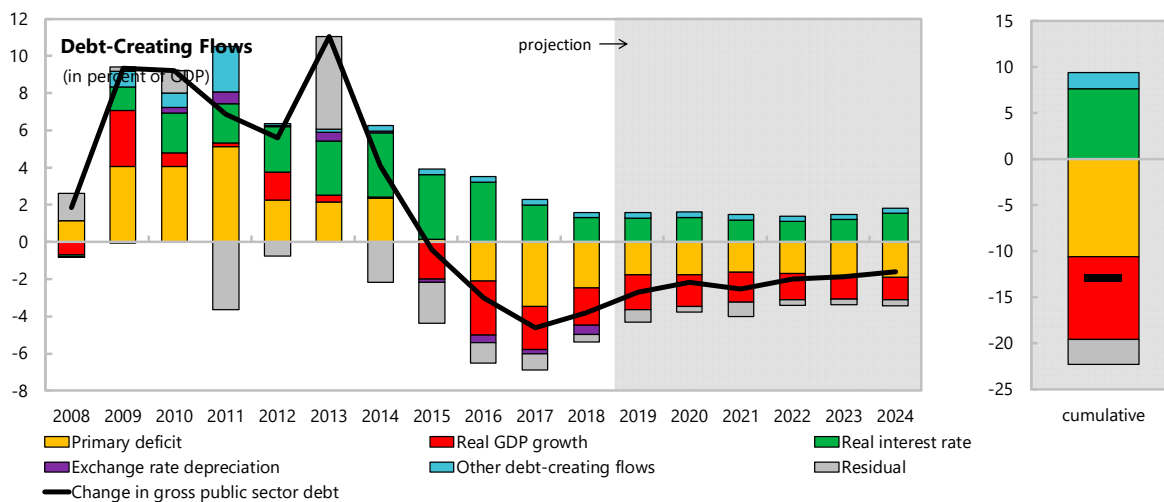
- **Slower output growth is the main risk to debt sustainability.** Underperformance of real GDP growth by one standard deviation results in the primary deficit deteriorating to about -0.1 percent of GDP and debt approaching 80 percent in 2020, before improving thereafter. Gross financing needs would be around 15 percent of GDP in 2020.
- **A combination of macro-fiscal shocks further highlights the sensitivity of public debt and gross financing needs to adverse scenarios.** If shocks to real GDP growth, the primary balance, real exchange rate, and real interest rate were to occur simultaneously, public debt would increase sharply and reach close to 85 percent of GDP (or 170 percent of public revenues) at its peak, and gross financing needs would be close to 16 percent of GDP in 2020.

Figure 1. Croatia Public Sector Sustainability Analysis (DSA) – Baseline Scenario
(In percent of GDP, unless otherwise indicated)

	Actual			Projections						As of September 30, 2018		
	2008-2016 ^{2/}	2017	2018	2019	2020	2021	2022	2023	2024			
Nominal gross public debt	68.6	77.7	73.9	71.1	69.0	66.5	64.4	62.6	61.0	Sovereign Spreads		
Public gross financing needs	16.3	11.5	8.8	11.7	11.6	8.0	7.9	7.3	8.7	EMBIG (bp) ^{3/} 177		
Real GDP growth (in percent)	-0.4	2.9	2.7	2.6	2.5	2.4	2.2	2.0	2.0	5Y CDS (bp) 85		
Inflation (GDP deflator, in percent)	1.5	1.1	1.5	1.4	1.5	1.7	1.8	1.9	1.5	Ratings	Foreign	Local
Nominal GDP growth (in percent)	1.0	4.1	4.2	4.1	4.1	4.2	4.0	4.0	3.6	Moody's	Ba2	Ba2
Effective interest rate (in percent) ^{4/}	4.9	3.7	3.3	3.3	3.5	3.5	3.6	3.8	3.9	S&P's	BB+	B+
										Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024		
Change in gross public sector debt	4.9	-4.6	-3.8	-2.7	-2.2	-2.5	-2.0	-1.9	-1.6	-12.9	
Identified debt-creating flows	5.2	-3.7	-3.4	-2.0	-1.8	-1.7	-1.7	-1.6	-1.3	-10.2	
Primary deficit	2.1	-3.5	-2.5	-1.8	-1.8	-1.6	-1.7	-1.8	-1.9	-10.6	
Automatic debt dynamics ^{5/}	2.5	-0.6	-1.2	-0.6	-0.4	-0.4	-0.3	0.0	0.3	-1.4	
Interest rate/growth differential ^{6/}	2.4	-0.3	-0.7	-0.6	-0.4	-0.4	-0.3	0.0	0.3	-1.4	
Exchange rate depreciation ^{7/}	0.1	-0.2	-0.5	...	...	...	...	...	...	...
Other identified debt-creating flows	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.7	
Residual, including asset changes ^{8/}	-0.2	-0.9	-0.4	-0.7	-0.3	-0.8	-0.3	-0.3	-0.3	-2.7	0.6



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.

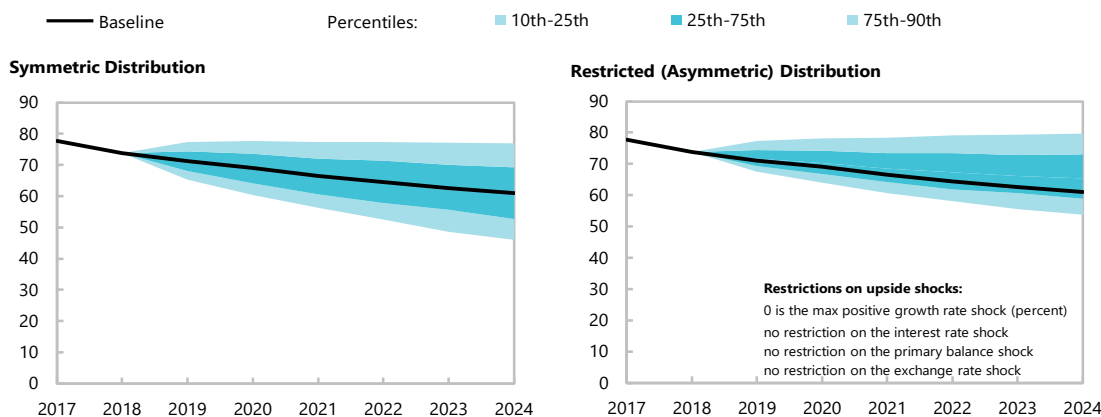
Figure 2. Croatia Public DSA Risk Assessment

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

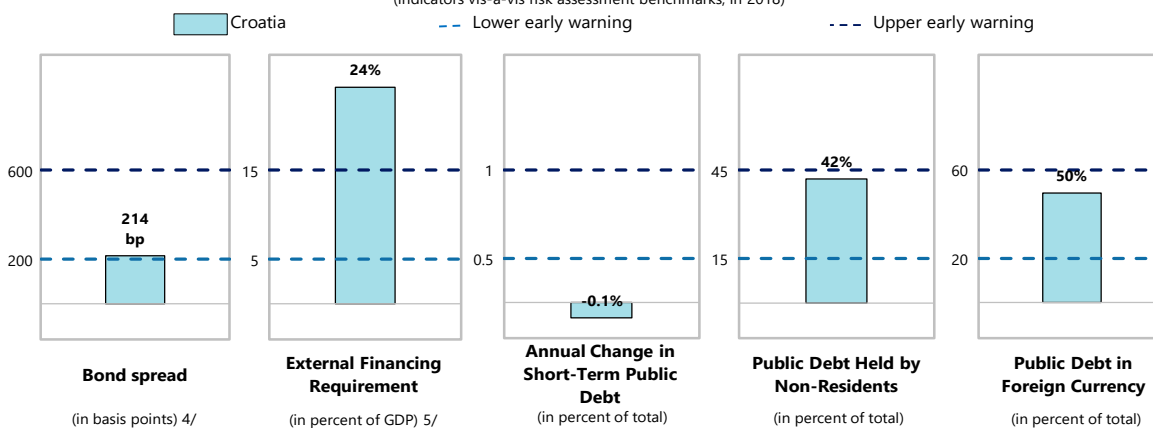
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



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.

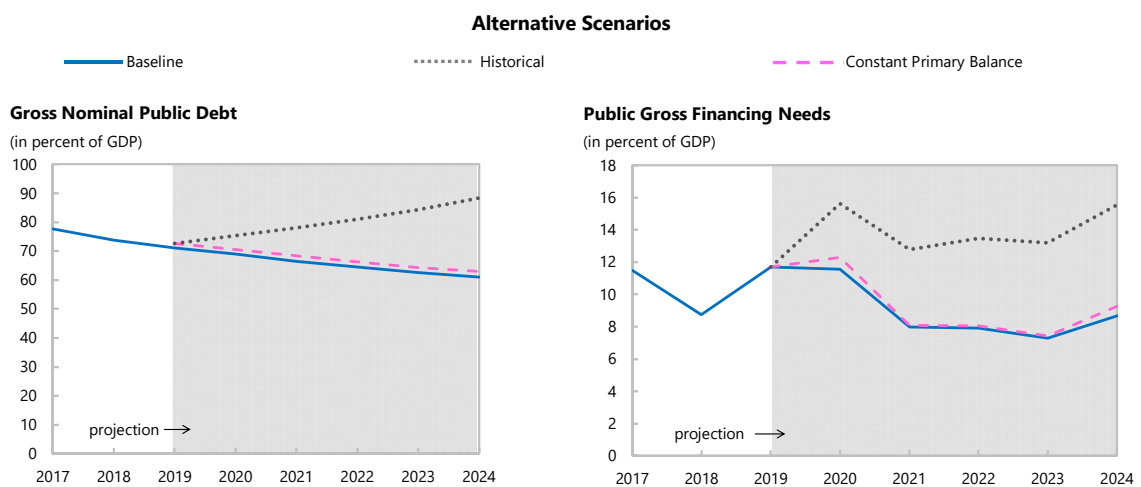
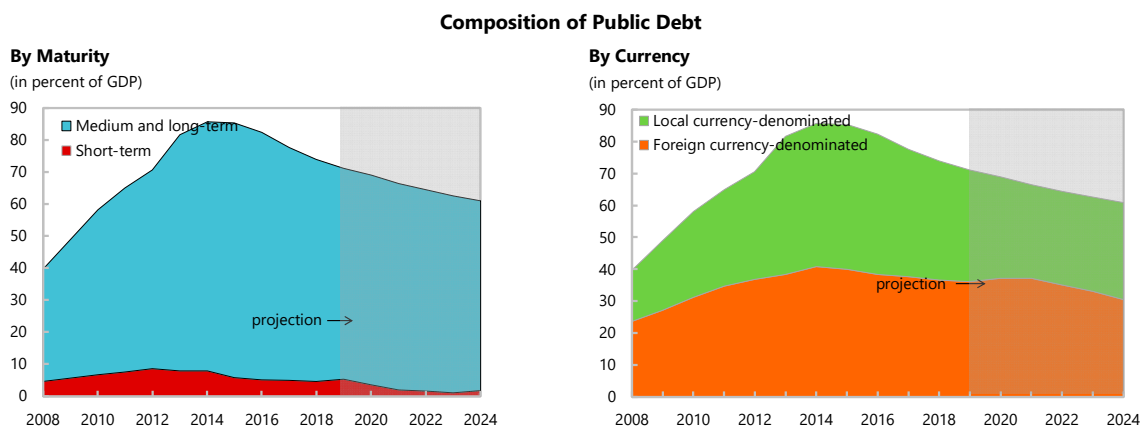
2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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-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-18 through 30-Sep-18.

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.

Figure 3. Croatia Public DSA – Composition of Public Debt and Alternative Scenarios



Underlying Assumptions (in percent)

Baseline Scenario

	2019	2020	2021	2022	2023	2024
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary Balance	1.8	1.8	1.6	1.7	1.8	1.9
Effective interest rate	3.3	3.5	3.5	3.6	3.8	3.9

Constant Primary Balance Scenario

	2019	2020	2021	2022	2023	2024
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary Balance	1.8	1.8	1.8	1.8	1.8	1.8
Effective interest rate	3.3	3.5	3.5	3.6	3.9	4.1

Historical Scenario

	2019	2020	2021	2022	2023	2024
Real GDP growth	2.6	0.0	0.0	0.0	0.0	0.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary Balance	1.8	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	3.3	3.5	3.8	4.0	4.6	4.9

Source: IMF staff.

Figure 4. Croatia Public DSA – Realism of Baseline Assumptions

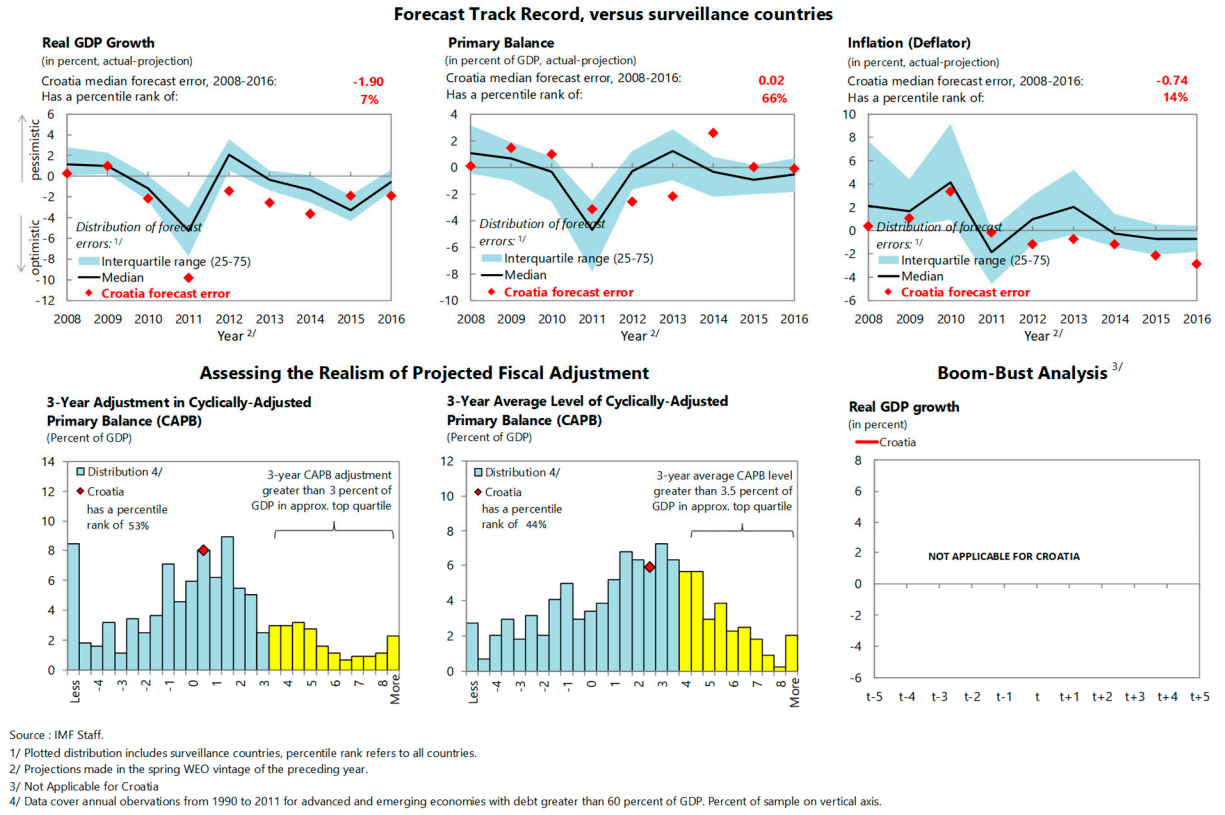
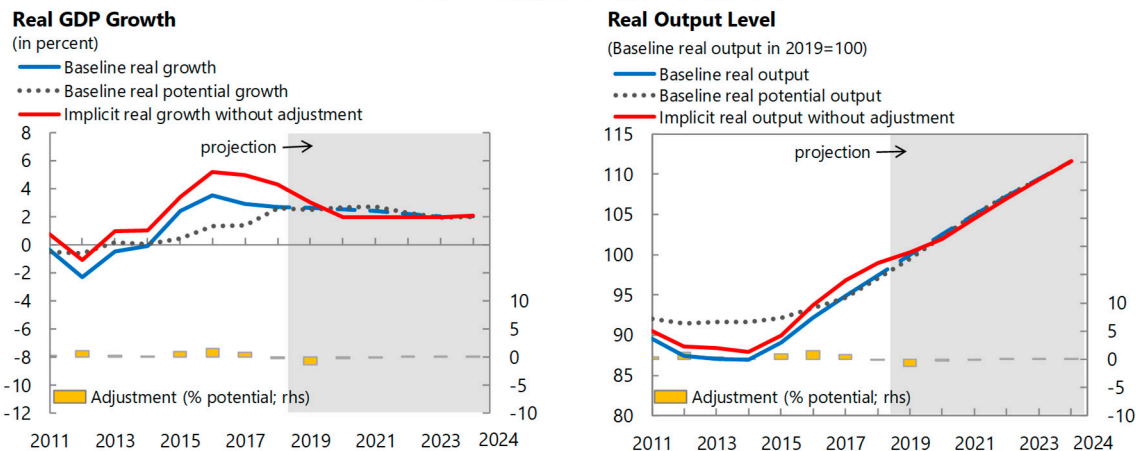


Figure 4. Croatia Public DSA – Realism of Baseline Assumptions (concluded)

Growth and Level of Output in Absence of Fiscal Adjustment

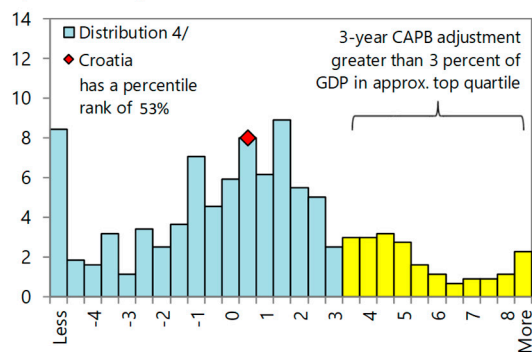
Assumed multiplier of 0.7, persistence of 0.6



Assessing the Realism of Projected Fiscal Adjustment

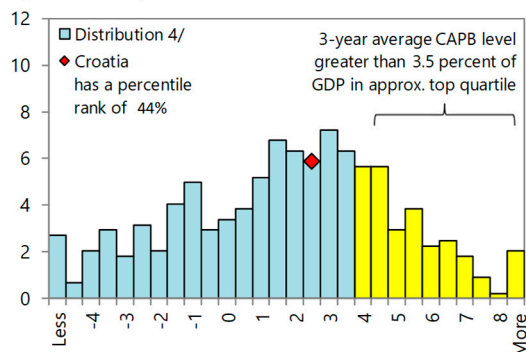
3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)



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

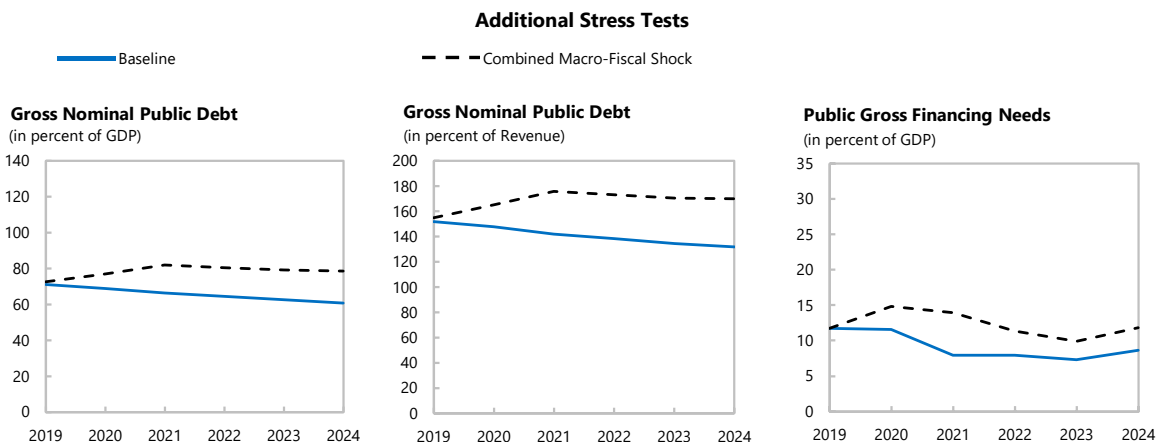
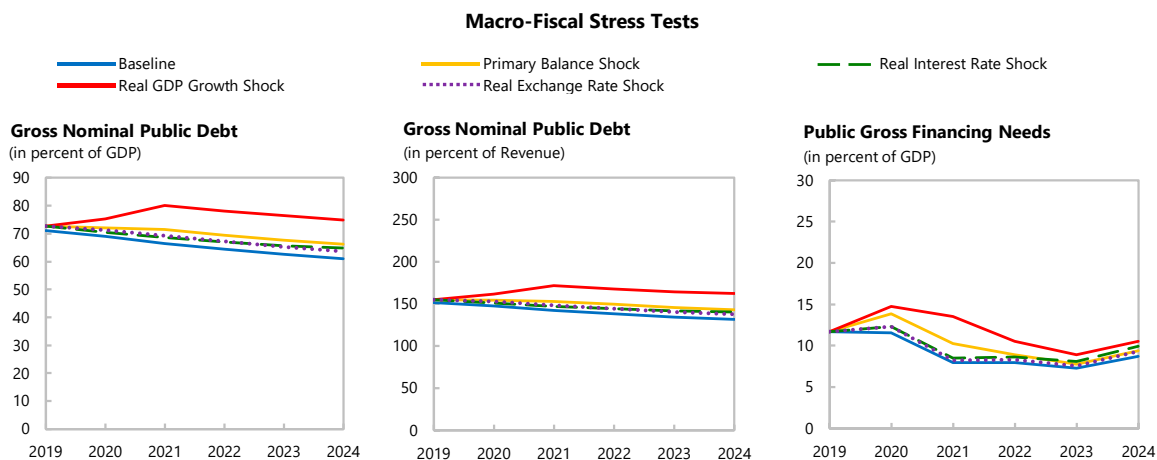
(Percent of GDP)



Source : IMF staff.

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.

Figure 5. Croatia Public DSA – Stress Tests



Underlying Assumptions (in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary balance	1.8	0.2	0.1	1.7	1.8	1.9
Effective interest rate	3.3	3.5	3.6	3.7	4.0	4.2
Real Interest Rate Shock						
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary balance	1.8	1.8	1.6	1.7	1.8	1.9
Effective interest rate	3.3	3.5	4.0	4.2	4.7	5.1
Combined Shock						
Real GDP growth	2.6	-0.8	-0.9	2.2	2.0	2.0
Inflation	1.4	0.7	0.9	1.8	1.9	1.5
Primary balance	1.8	-0.1	-2.1	1.7	1.8	1.9
Effective interest rate	3.3	3.5	3.9	4.2	4.8	5.2
Real GDP Growth Shock						
Real GDP growth	2.6	-0.8	-0.9	2.2	2.0	2.0
Inflation	1.4	0.7	0.9	1.8	1.9	1.5
Primary balance	1.8	-0.1	-2.1	1.7	1.8	1.9
Effective interest rate	3.3	3.5	3.6	3.8	4.1	4.2
Real Exchange Rate Shock						
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	2.7	1.7	1.8	1.9	1.5
Primary balance	1.8	1.8	1.6	1.7	1.8	1.9
Effective interest rate	3.3	3.5	3.5	3.5	3.9	4.1

Source: IMF staff.

Annex III. External Debt Sustainability Analysis

Table 1. Croatia: External Debt Sustainability Framework, 2014–24
(Percent of GDP, unless otherwise indicated)

	Actual				Projections								Debt-stabilizing noninterest current account
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024		
Baseline: external debt	106.9	101.7	89.3	81.8	75.4	71.9	67.7	65.4	63.6	62.2	61.3	-3.4	
Change in external debt	2.2	-5.1	-12.4	-7.5	-6.3	-3.6	-4.2	-2.3	-1.7	-1.4	-0.9		
Identified external debt-creating flows (4+8+9)	-2.8	-7.5	-10.1	-8.9	-7.8	-6.8	-6.1	-5.3	-4.7	-4.3	-4.3		
Current account deficit, excluding interest payments	-5.4	-7.9	-5.4	-6.3	-5.2	-4.6	-3.6	-2.8	-2.3	-1.9	-1.8		
Deficit in balance of goods and services	1.9	2.3	2.8	2.2	1.1	0.6	-0.2	-0.9	-1.5	-1.9	-2.0		
Exports	45.3	48.1	48.8	51.7	53.0	54.8	55.9	57.5	59.9	62.2	64.3		
Imports	-43.4	-45.8	-46.0	-49.5	-51.9	-54.2	-56.1	-58.4	-61.4	-64.1	-66.4		
Net non-debt creating capital inflows (negative)	-1.7	-0.5	-4.1	-2.3	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8		
Automatic debt dynamics 1/	4.3	0.9	-0.6	-0.2	0.2	0.6	0.3	0.3	0.3	0.3	0.3		
Contribution from nominal interest rate	3.5	3.4	2.8	2.3	2.3	2.5	2.1	1.9	1.7	1.6	1.6		
Contribution from real GDP growth	0.1	-2.5	-3.4	-2.5	-2.1	-1.9	-1.8	-1.6	-1.4	-1.2	-1.2		
Contribution from price and exchange rate changes 2/	0.7	...	...	...	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	5.8	2.4	-2.3	1.3	1.4	3.2	1.9	2.9	3.0	2.9	3.3		
External debt-to-exports ratio (percent)	235.9	211.4	182.9	158.0	142.4	131.2	121.0	113.7	106.3	99.9	95.2		
Gross external financing need (billions of Euros) 4/	14.0	13.7	14.2	12.8	14.6	16.4	16.3	16.1	16.0	16.6	17.3		
Percent of GDP	32.2	30.8	30.5	26.3	28.9	31.1	29.7	28.2	26.9	27.0	27.0		
Scenario with key variables at their historical averages 5/	106.9	101.7	89.3	81.8	75.4	75.1	73.5	72.9	72.4	71.9	71.5	-0.6	
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (percent)	-0.1	2.4	3.5	2.9	2.7	2.6	2.5	2.4	2.2	2.0	2.0		
GDP deflator in Euros dollars (percent change)	-0.7	0.3	1.0	1.1	1.5	1.4	1.5	1.7	1.8	1.9	1.5		
Nominal external interest rate (percent)	3.3	3.3	2.9	2.7	2.9	3.4	2.9	2.8	2.7	2.5	2.6		
Growth of exports (Euro terms, percent)	4.8	9.1	6.1	10.3	6.8	7.5	6.3	7.0	8.4	8.0	7.3		
Growth of imports (Euro terms, percent)	1.4	8.4	5.0	12.1	9.2	8.7	7.7	8.5	9.3	8.5	7.5		
Current account balance, excluding interest payments	5.4	7.9	5.4	6.3	5.2	4.6	3.6	2.8	2.3	1.9	1.8		
Net nondebt creating capital inflows	1.7	0.5	4.1	2.4	2.8	2.8	2.8	2.8	2.8	2.8	2.8		

1/ Derived as $[-g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ 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).

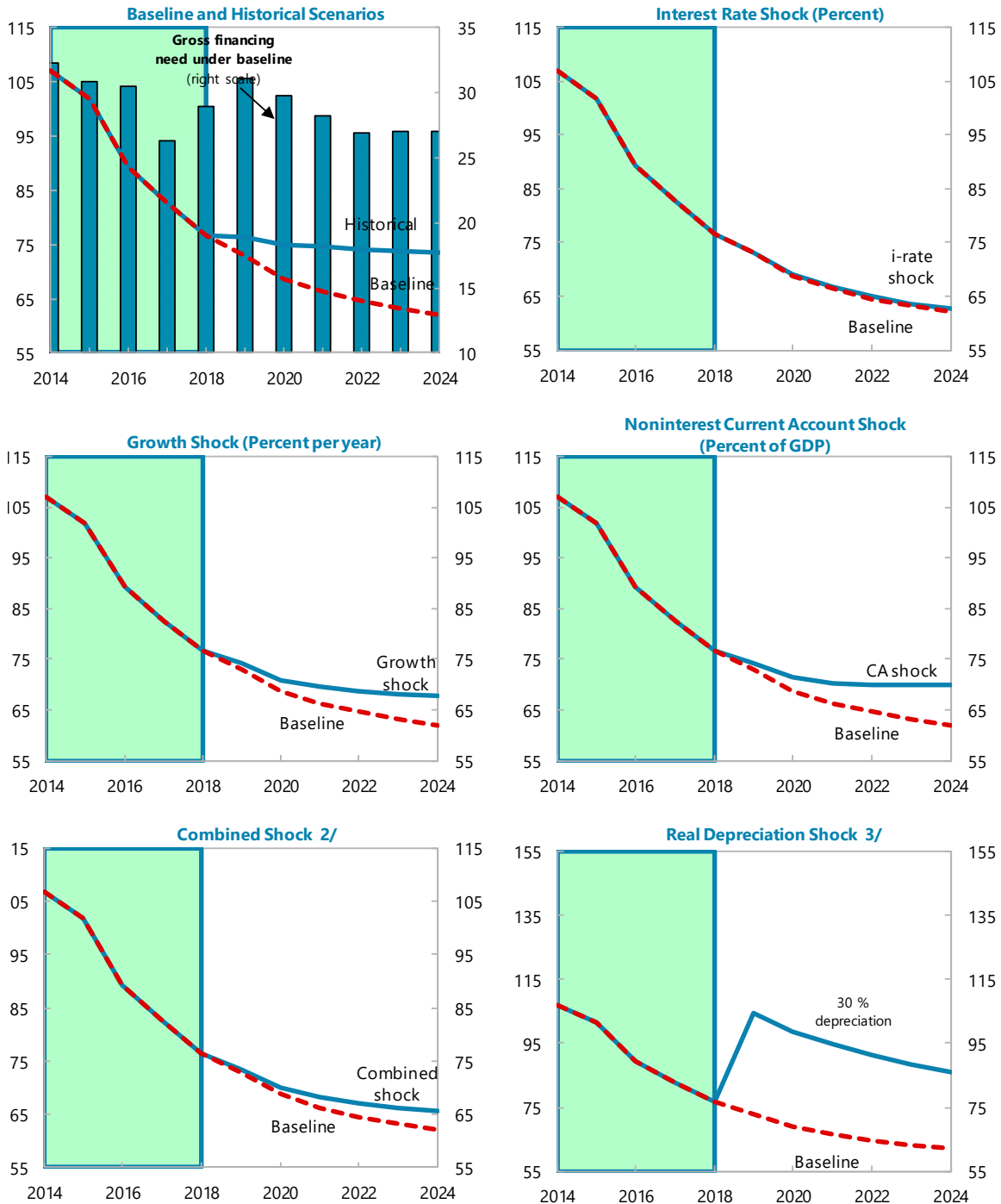
3/ For projection, line includes the impact of price and exchange rate changes.

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. 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 except for 2018. 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.

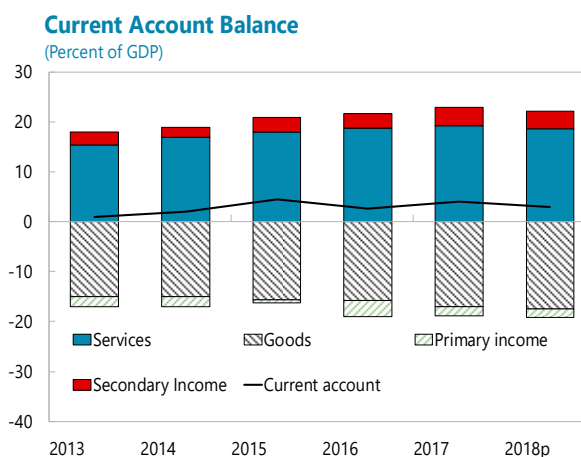
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2019.

Annex IV. External Sector Assessment¹

The external position of Croatia in 2018 is broadly consistent with fundamentals and desirable policy settings. The current account is projected to decline but remain in surplus in 2018, buoyed by strong goods exports and tourism receipts, and the external balance sheet is expected to strengthen as external deleveraging continues. Non-price indicators confirm the need for structural reforms to improve competitiveness and attract inward direct investment.

1. Current Account. The current account (CA) has been in surplus since 2013, driven by buoyant tourism receipts, which more than offset the rising goods trade deficit (Figure 1). Overall trade continues to grow strongly since EU accession in 2013, with exports now totaling 51.3 percent of GDP and imports at 49.1 percent of GDP, both at record highs. Croatia's current account surplus increased to 4.0 percent of GDP in 2017 from 2.6 percent of GDP in 2016, which is mostly explained by one-off banks' provisions for losses associated with their exposure to Agrokor. The current account surplus is projected to decline in 2018 as banks regain profitability. Over the medium term, the current account will move towards balance as growth in tourism receipts tapers off while imports remain strong in line with projections on consumption and investment.



Sources: Croatian National Bank; and IMF staff estimates.

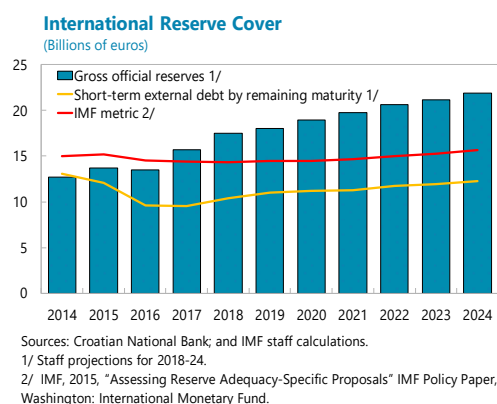
2. Capital and Financial Flows. Gross capital inflows stood at 2.3 percent of GDP in 2017 while gross capital outflows, excluding reserve assets, were 1.3 percent of GDP. Net capital inflows turned positive after consecutive years of outflows mainly due to short-term capital flows to the central bank from reverse repo transactions. At the same time, there was an increase in private sector external arrears (4.4 percent of GDP) related to Agrokor. Nevertheless, reduction in external public debt continued, supported by fiscal consolidation and deleveraging. Through 2018:Q3, capital inflows equaled -0.9 percent of GDP while outflows stood at 2.6 percent of GDP which implies negative net capital inflows. The government has been able to borrow on favorable terms though the expected tightening in global monetary conditions and increased turbulence pose downside risks.

3. External Balance Sheets. Overall external indebtedness continued to decrease in 2017 though the pace slowed. This slowdown in external deleveraging was primarily driven by growing intercompany lending for direct investment which was broad-based across industries. The NIIP declined to -62 percent in 2017 which is substantially stronger than in 2009 when the NIIP stood at

¹ Prepared by Olamide Harrison.

around -90 percent of GDP. The improvement was due to sustained current account surpluses, EU funds absorption, and GDP growth. The NIIP declined further to -53 percent of GDP by 2018:Q3. Thus, the current path of the NIIP does not imply risks to external sustainability or a need for substantial adjustment.

4. Reserve Adequacy. In 2017, gross official reserves increased moderately to 15.7 billion euros (32.4 percent of GDP) in part due to the central bank's reverse repo transactions as well as the strong current account surplus. This increase brought official reserves moderately above the ARA metric in 2017 and improved the already comfortable margins relative to short-term debt and as a ratio of months of next year's imports of goods and nonfactor services. Reserves are projected to increase to 17.4 billion euros in 2018 (34.3 percent of GDP) and continue to increase in the medium-term under baseline scenario.



5. The current account is broadly consistent with fundamentals and medium-term policies in 2018. The CA is projected to be in a surplus of 2.9 percent of GDP against the EBA-lite derived CA norm of -1.3 percent. The sum of domestic and external policy gaps represented 0.1 percent of GDP of the implied CA gap, which also included a large residual of 4.1 percent. Accounting for booming tourism (0.5 percent of GDP) and the need for further external deleveraging (1.5 percent of GDP), staff estimates an adjusted CA balance of 0.9 percent of GDP. Also, staff estimates the impact of EU accession on the CA at 1.4 percent of GDP.² Adjusting for this factor yields an adjusted CA norm of 0.1 percent of GDP which narrows the CA gap to 0.8 percent.

Model Results, 2018
(In percent of GDP, unless stated otherwise)

	CA	ES	REER
Adjusted CA norm	0.1		
Adjusted CA balance	0.9		
CA - stabilizing NIIP at 52 percent in 5 years		-1.4	
CA gap /1	0.8	1.6	
REER gap (in percent) /2	-2.0	-4.3	4.7

Source: IMF staff calculations.

1/ For ES approach, CA gap is relative to medium-term CA balance.
2/ Positive value indicates overvaluation.

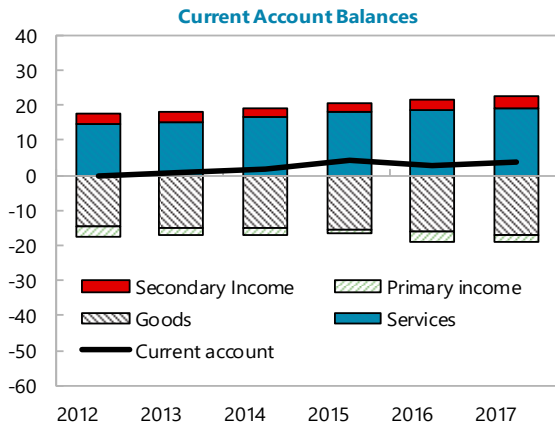
6. The EBA-lite models yield mixed empirical results regarding the kuna's valuation. The REER gap implied by the CA model is -2 percent (after adjustments). The REER index model suggests an overvaluation of 5 percent with an estimated residual of zero percent. The external sustainability (ES) approach assesses the REER to be slightly undervalued, by 4 percent, given that the projected CA for 2023 (0.3 percent) is larger than the level required (-1.3 percent) to stabilize the NIIP at -52 percent of GDP, the long-run average NIIP of peer countries. Therefore, on balance, staff assesses Croatia's external position in 2018 to be broadly in line with levels consistent with fundamentals and medium-term policies.

² See Annex IV of the 2017 Staff Report.

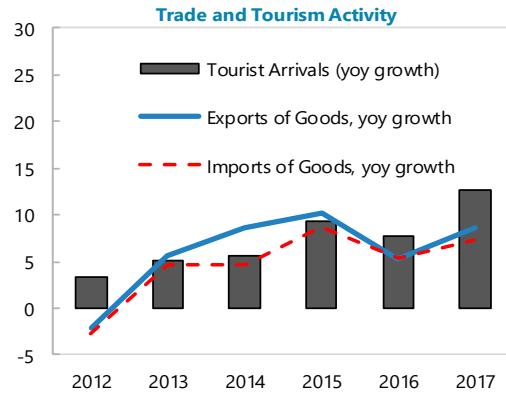
7. Broader competitiveness challenges persist and underscore the need for productivity-boosting structural reforms. Unit labor costs continued to decline relative to partner countries, partially reflecting declines in real per worker compensation as well as productivity growth. Nevertheless, FDI inflows remain low relative to peers, and non-price indicators such as from the DB report and the World Economic Forum’s Global Competitiveness Report point to the need for structural reforms.

Figure 1. Balance of Payments
(Percent of GDP)

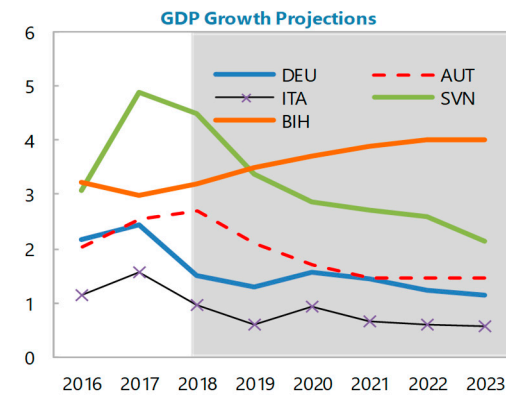
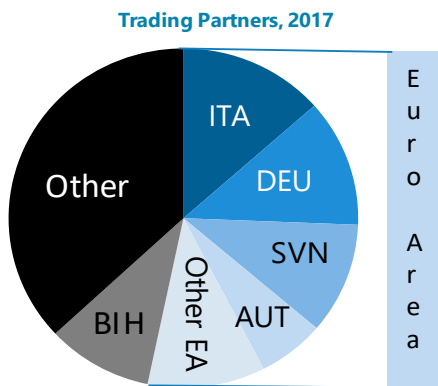
The current account remained in surplus...



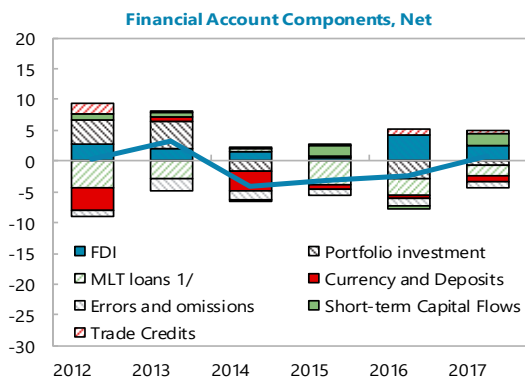
...driven by strong tourism activity and export growth...



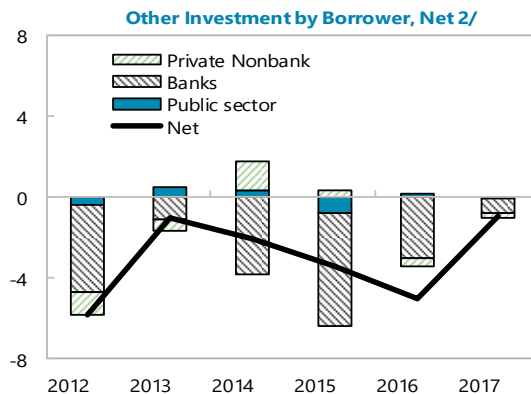
...and strong growth in most key trading partners.



Capital flows turned slightly positive partly due to short-term flows



Bank and corporate deleveraging slowed but continued

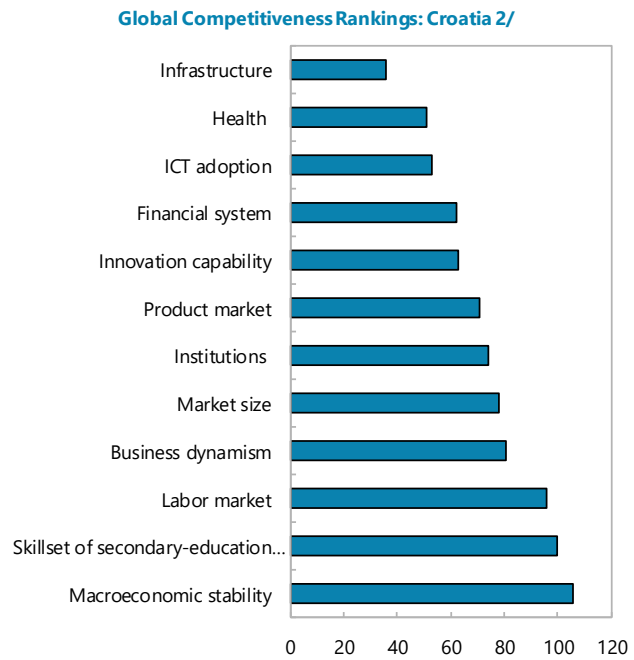
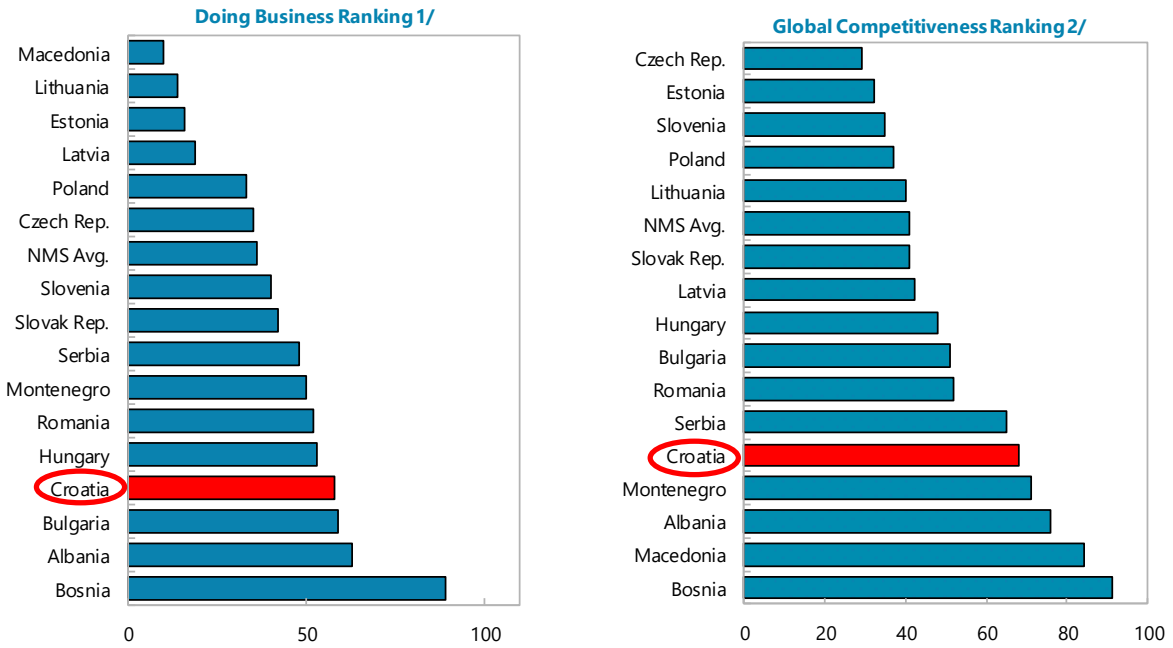


Sources: Croatian National Bank; and IMF staff estimates.

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

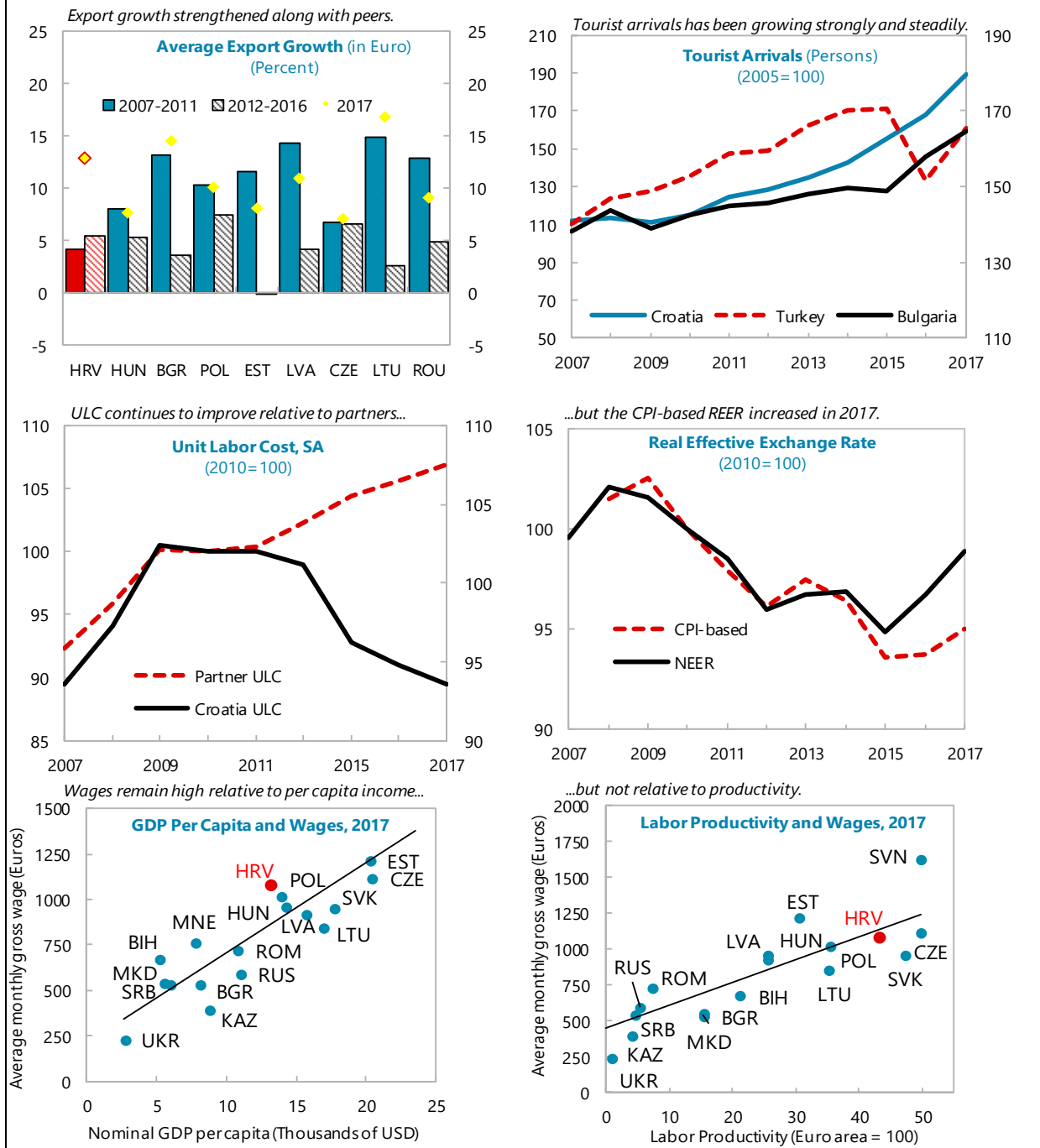
2/ Other investments consist of currency and deposits, loans, short-term capital flows, medium and long-term flows, and trade credits. Total includes CNB repo-related transactions.

Figure 2. The Business Environment



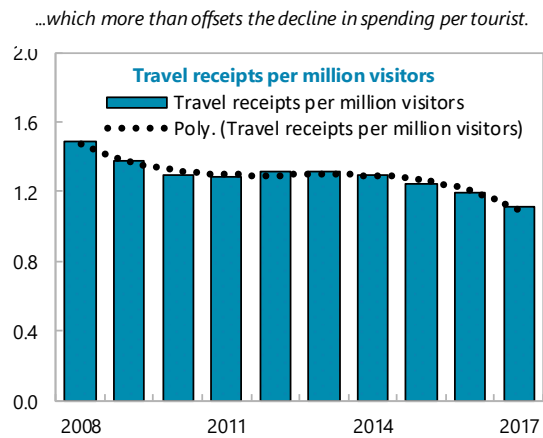
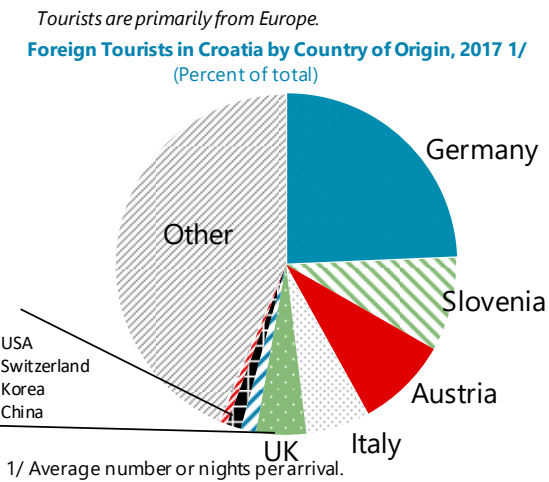
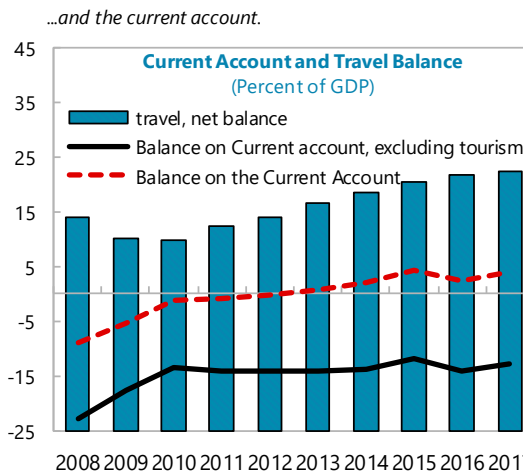
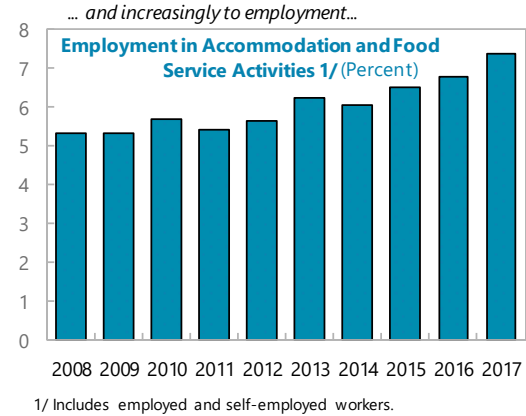
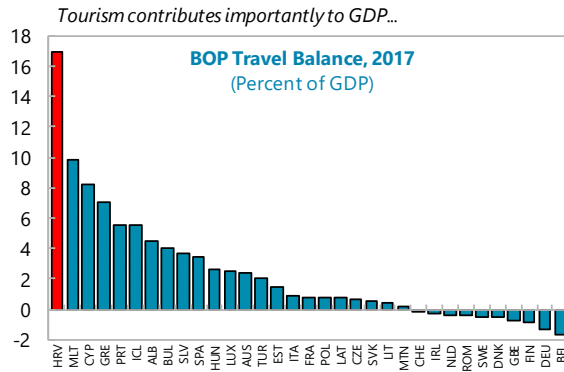
Sources: World Bank, 2019 *Doing Business*; World Economic Forum, *Global Competitiveness Report*; and IMF staff calculation.
 1/ Ranking out of 191 countries.
 2/ Ranking out of 140 countries. Rank for 2018.

Figure 3. Competitiveness Indicators



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

Figure 4. Tourism



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

Annex V. Risk Assessment Matrix¹

	Source of Risks/Time Frame/ Relative Likelihood	Impact if realized	Recommended policy response
Global	Rising protectionism and retreat from multilateralism/Short to medium term/ High	Medium to Low Global imbalances and fraying consensus about the benefits of globalization lead to escalating and sustained trade actions and spreading isolationism. However, Croatia's merchandise trade is not large and therefore the impact would not be as high as in countries with larger export shares.	Growth-friendly fiscal consolidation; continue to reduce non-price competitiveness costs.
	Sharp tightening of global financial conditions/Short term/ High	Medium to High This causes higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn.	Growth-friendly fiscal consolidation; use FX intervention to smooth excessive exchange rate volatility when encountering disorderly market conditions. 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.
	Weaker-than-expected global growth, especially Euro area/Medium term/ Medium	Medium to High Weaker export performance, for example, with the largest trading partner Italy, would weigh on economic growth and perpetuate macroeconomic vulnerabilities. Even though Italian owned subsidiaries do not rely heavily on their parents, the risk of contagion cannot be ruled out.	Diversify export base. Accelerate structural reforms. Build reserve buffers.
Domestic	Security dislocation in parts of the Middle East, and Europe/Short term/ Medium	Upside risk This leads to socio-economic and political disruptions in these regions, channeling tourist flows to more stable regions.	Croatia benefits from continuing high tourism inflows and revenue. Continue to pursue fiscal consolidation and build buffers.
	Lower and ineffective absorption of EU funds/Medium term/ Medium	Medium A lower level of investment would negatively impact growth.	Accelerate reforms to improve absorption by improving processes and cutting red tape.
	Further reform standstill/Medium term/ High	Medium to High Parliamentary elections in end-2020 add 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 and sense of urgency.

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.



REPUBLIC OF CROATIA

January 23, 2019

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department in Consultation with Other
Departments

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FUND RELATIONS

(As of December 31, 2018)

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>	717.14	99.96
<u>Reserve Tranche Position</u>	0.27	0.04

SDR Department:	<u>SDR Million</u>	<u>%Allocation</u>
<u>Net cumulative allocation</u>	347.34	100.00
<u>Holdings</u>	304.31	87.61

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>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>
Principal					
Charges/Interest	0.48	0.48	0.48	0.48	0.48
Total	0.48	0.48	0.48	0.48	0.48

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 without a predetermined path. Since April 2016, the kuna has stabilized within a 2 percent band

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.

against the euro. Accordingly, the de facto exchange rate arrangement is classified as a stabilized arrangement. The CNB transacts only in euros, U.S. dollars, and SDRs. On November 30, 2018, the official exchange rate was kuna 7.43 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:

In October 2017, a new Law on Prevention of Money Laundering and Terrorism Financing was adopted to transpose the 4th AML EU Directive (2015/849) and FATF (2012) recommendations.

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on January 10, 2018 (IMF Country Report No. 18/5: <https://www.imf.org/en/Publications/CR/Issues/2018/01/16/Republic-of-Croatia-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-45554>). 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 September 2006 December 2007	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	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

As of December 2018, Croatia has been collaborating with the World Bank Group.

Further information can be obtained from the following hyperlink.

International Financial Institution	Hyperlink
The World Bank Group	https://www.worldbank.org/en/country/croatia

STATISTICAL ISSUES

Croatia—Statistical Issues (As of January 2019)
I. Assessment of Data Adequacy for Surveillance
<p>General: Data provision is broadly adequate for surveillance, with a few shortcomings related to data coverage.</p>
<p>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.</p>
<p>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.</p> <p>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.</p>
<p>Price Statistics: The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from the 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.</p>

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. A quarterly house price index is also disseminated.

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 started to publish monetary statistics using the *ESA 2010* framework and the national residency approach, with some backward revisions of historical data series. The IMF's Statistics Department receives monthly monetary statistics on

Croatia for the CNB and other depository corporations (ODCs) directly from the European Central Bank since July 2013, prior to this date, data were reported by the CNB. Data on other financial corporations (OFC) are currently not available.

Financial Sector Surveillance: The CNB is the banking sector supervisor and quarterly reports all core and 14 encouraged financial soundness indicators (FSI) to the IMF's *Financial Soundness Indicator Database*. 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 persistently 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 began subscription to the Fund's Special Data Dissemination Standard (SDDS) in 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 31, 2018)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	12/05/18	12/07/18	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Dec. 2018	01/14/19	M	M	M
Reserve/Base Money	Nov. 2018	11/30/18	M	M	M
Broad Money	Nov. 2018	11/30/18	M	M	M
Central Bank Balance Sheet	Dec. 2018	01/14/19	M	M	M
Consolidated Balance Sheet of the Banking System	Nov. 2018	11/30/18	M	M	M
Interest Rates 2/	Nov. 2018	11/30/18	M	M	M
Consumer Price Index	Dec. 2018	01/16/19	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2018:Q3	Nov. 2018	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/— Central Government	2018:Q3	Nov. 2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2018:Q3	Nov. 2018	M	M	M
External Current Account Balance	2018:Q3	Nov. 2018	Q	Q	Q
Exports and Imports of Goods and Services	2018:Q3	Nov. 2018	Q	Q	Q
GDP/GNP	2018:Q3	Nov. 2018	Q	Q	Q
Gross External Debt	2018:Q3	Nov. 2018	M	M	M
International Investment Position	2018:Q3	Nov. 2018	Q	Q	Q

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.

2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

3/ Foreign, domestic bank, and domestic nonbank financing.

4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

5/ Including currency and maturity composition.

6/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

**Statement by Richard Doornbosch, Alternative Executive Director for the
Republic of Croatia
and Miroslav Josic, Advisor to Executive Director
February 8, 2019**

On behalf of the Croatian authorities, we thank Mr. Seshadri and his team for the set of candid reports and for the fruitful policy discussions during the Article IV mission. The authorities broadly agree with staff's appraisal and appreciate their useful policy recommendations.

Recent Economic Development and Outlook

Economic growth continued to be robust, inflation benign, and unemployment reached historical low levels. Real GDP growth was 2.8 percent y-o-y in the third quarter of 2018 and high frequency indicators point to a similar expansion in the last quarter. At the same time, fiscal consolidation continued, supporting the goal to reach the Stability and Growth Pact (SGP) threshold of 60 percent of GDP in the medium-term. The CNB continued to pursue an expansionary monetary policy, maintaining very high levels of liquidity in the domestic financial market, while further building international reserves and keeping the exchange rate stable. The level of NPLs continued to decrease.

In the medium term, growth is expected to moderate to its potential level. However, the authorities are strongly committed to address key bottlenecks and increase the level of public and private investment, which would offset the anticipated slowdown and increase potential output.

Fiscal Policy and Debt Management

During the last three years, the authorities have used the window of opportunity arising from a favorable cyclical position, which, combined with expenditure control and an adequate debt management strategy, resulted in a budget surplus of 0.9 percentage points of GDP in 2017, after a deficit of 5.1 percent of GDP in 2014.

Since the last consultations, the authorities have continued with fiscal consolidation and remained strongly committed to prudent fiscal policy in the medium-term. Based on the latest available data, a budget surplus of 0.2 percentage points will be recorded in 2018, including a one-off and unexpected payment of almost 0.7 percent of GDP for called guarantees on the Uljanik shipyard. Despite these challenging factors, the public debt-to-GDP ratio further decreased to 74.5% in the third quarter of 2018, putting Croatia in the top five EU economies with the largest decline in public debt in the last three years (total of 9.2 percentage points of GDP).

It is also worth noting that public debt has increased by almost 20 percent of GDP in the last 16 years because of the pension reform introduced in 2002 with the assistance of the World

bank. The reform strongly reduced future contingent liabilities by introducing a capital-based second pillar in the pension system.

The authorities share staff's view that the level of public debt, despite positive developments, is still high and vulnerable to several risks. Therefore, they stay committed to continue with fiscal consolidation and increase their efforts to further improve the sustainability of public finance, which is crucial to supporting the authorities' goal to enter the ERM-II during 2020. At the same time, the ongoing fiscal consolidation is in line with the SGP provisions, because the public debt-to-GDP ratio is decreasing at more than sufficient pace toward the reference value of 60 percent (over the previous three years at an average rate of three times more than the requested 1/20th per year). In order to support the overall goal, the authorities have adopted a new Fiscal Responsibility Law in December 2018, which clearly defines fiscal rules in line with SGP rules, while the Fiscal Policy Commission has been depoliticized and given financial autonomy which will allow for a better and independent control of the entire budget process.

On **the real estate tax**, the authorities believe that further work is needed to establish an adequate valuation and administration system before a real estate tax could be introduced. They support staff's recommendation to introduce this revenue measure but consider that it must be a multi annual project if large execution problems are to be avoided. In the broader context where almost 90 percent of the population owns real estate (for most of them it is their only property) and where a valuation system is not properly established, the authorities believe that further steps are needed to develop a fair system and remain committed to continue with the preparatory work. As a first step, the authorities started a project of data collection for real estate valuation.

Monetary Policy and Financial Stability

The monetary policy of the CNB remained expansionary and continued to support the economic recovery while working towards maintaining a stable kuna/euro exchange rate. Throughout 2018, the CNB has further supported the kuna liquidity of the banking system, which was predominantly spurred by the purchase of foreign exchange from banks, alleviating appreciation pressures on the domestic currency. This also contributed to a further build-up in gross international reserves, which reached EUR 17.4 billion at the end of 2018, enough to cover eight months of imports of goods and services. The highly accommodative policy stance continued to improve the financing conditions of both the households and corporate sector, bringing interest rates to historical low levels and further supporting credit recovery. The monetary authorities stand ready to react to tight external conditions, should these materialize. However, on the issue of harnessing inflation expectations, the monetary authorities would like to highlight that they have always been successful in using the anchor of a stable exchange rate to achieve the goal of price stability; that inflation developments in Croatia are largely determined by energy and food prices and, that the survey points to well-anchored inflation expectations.

The authorities share staff's assessment that the banking system is very liquid, well-capitalized, and adequately profitable. Against this background, the ratio of NPLs to total loans continued to decrease and stood at 10.3 percent at the end of the third quarter of 2018.

At the same time, more than 60 percent of NPLs has been adequately provisioned, while close to half of the NPLs was concentrated in one sector, namely construction. However, the authorities share staff's view that the level is still higher than desirable, particularly when compared to international standards. In this vein, the CNB remains committed to strong and prudent supervision, to being vigilant about deploying macroprudential measures for new loans, as well as to being supportive of banks' sales of NPLs. At the same time, the CNB will continue with education and delivery of tools and publications that promote financial literacy and raise awareness of currency and interest rates risks.

With respect to **the increased general cash loan for households**, this increase is assessed to be in line with the increase in personal consumption (evidenced by the Bank Lending survey) and with the households' increased optimism (evidenced by the Consumer Confidence Survey) and does not differ from the situation in the rest of Central and Eastern Europe. However, the authorities share staff's concerns about the potential risk to financial stability. They remain vigilant and stand ready to implement new macroprudential tools if needed. In the context of **house prices**, their increase was so far limited to certain geographical areas (the coast and the capital) and mostly in line with macroeconomic fundamentals. However, the authorities expressed their commitment to act timely and implement macroprudential policy instruments that could affect borrowers (households), pledged assets (collateral) and/or lenders (banks).

On the process of euro adoption, the authorities reiterated their commitment to enter the single currency union considering the high credit and deposit euroization and the dominance of foreign-owned banks in the domestic banking system. At the same time, they are economically and financially firmly integrated in the euro area (business cycle largely mimics developments in the euro area)¹. In this context, they have already initiated discussions with relevant European counterparts and are ready to enter the ERM-II during 2020.

Structural reforms and Competitiveness

The authorities appreciate and recognize the bottlenecks identified by staff and share their views on the need to implement a wide range of structural reforms to create a more dynamic state and further decrease the income gap with euro area countries. In this context, the authorities have updated the National Reform Program in April 2018 which is now fully in line with the EU2020 strategy of achieving smart, sustainable and inclusive growth. The authorities also recognize that the implementation of structural reforms will be crucial during the euro adoption process, and therefore reiterate their strong commitment.

- Changes in the Civil Servants' Employment Act and the adoption of the Single Wage Act are underway. This will harmonize salaries across different layers of the administration and enable promotions based on performance, which will, in combination with attrition, **contain the wage bill growth**. In addition, the authorities have already initiated the process of streamlining the network of 54 public agencies and institutions,

¹ More information about the authorities' Strategy for the Adoption of the Euro in the Republic of Croatia can be found [here](#).

and result in savings in staffing and operational costs, while improving the overall efficiency of the provided services.

- The Action Plan for Administrative Relief of the Economy resulted in savings to employers in 2018 and 2019 of about HRK 1.3 billion. These measures will not only make businesses more cost efficient, but also simplify their operations with the state administration, which is usually identified as an impediment to doing business. In addition, 24 professions, like pharmacists and physicists, will be fully liberalized during 2019. Lastly, tax reform applied on January 1, 2019 will decrease the overall cost of gross salaries for employers, while increasing net salaries for highly educated and skilled people.
- Measures to improve the financial sustainability of the **health sector** have also been applied. Significant progress has been made with the functional integration of the hospitals and with a central procurement system, where almost one third of all joint public procurement will be done centrally by Summer 2019, resulting in substantial savings. In addition, amendments to the Pharmaceutical Act, that will enable the authorities to define the highest possible price and make it public, is estimated to save around HRK 300 million per year. Lastly, contribution to health insurance increased by 1.5 percentage points, which will help the system to stop accumulating new arrears.
- The authorities believe that the **pension reform**, introduced on January 1, 2019, strikes the right balance between creating a long-term sustainable system and addressing the issue of aging. It addresses demographic challenges by increasing the legal age for retirement and penalizing early retirement, while enabling retirees to stay active in the labor market, thus contributing to a higher labor participation rate, which is in line with previous staff's recommendations.
- On the **state-owned enterprises**, the authorities share staff's view that improving their efficiency would contribute to public financial and public investment management, as well as to increase overall productivity. In this regard, the authorities have introduced at the beginning of 2018 the Corporate Governance Code fully in line with OECD standards, which established internal auditing in all public companies and enabled the authorities to have a detailed insight in their liabilities and plans. Parallel to this, the authorities have pushed forward the process of divesting non-strategic state assets, particularly real estates and shares in touristic companies, which is line with staff's recommendations. Challenges remain with the companies in which Croatia's share is lower than 20 percent.
- The authorities share staff's view that **EU funds** can play a significant role in boosting investment and productivity levels in the medium term. At the same time, they recognized that the current level of utilization is lower than the EU average, mostly due to capacity constraints. This was partly addressed by employing close to 1,000 people directly working on EU projects, as well as outsourcing part of the work to the private sector. At the moment, 58 percent of the total allocation from the 2014-2020 financial

perspective has been decided (EUR 7.3 billion), and the authorities remain committed and confident that considering the N+3 rule, the entire allocation will be utilized.

- Lastly, on the **social benefits**, the authorities share staff's view that a one-stop shop would provide better targeting but prefer a gradual approach to this reform. So far, the authorities have collected data from local entities, and the work of consultants on the IT solution that would be efficient and enable data exchange between various levels of the administration should conclude during the first quarter of 2019. After receiving the analysis and recommendations, the authorities will pursue further steps.