INTERNATIONAL MONETARY FUND

IMF Country Report No. 24/246

REPUBLIC OF CROATIA

2024 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

July 2024

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 2024 Article IV consultation with Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 26, 2024, following discussions that ended on June 7, 2024, with the officials of Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 26, 2024.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for 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
Washington, D.C.

IMF Executive Board Concludes 2024 Article IV Consultation with Republic of Croatia

FOR IMMEDIATE RELEASE

Washington, DC – July 29, 2024: On July 26, 2024, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Croatia.

The economy has performed strongly despite consecutive external shocks. The impressive post-pandemic growth during 2021-22 moderated to 3.1 percent in 2023, still among the highest in the euro area. Inflation has decelerated considerably since early 2023 but still persists above the euro area average, owing to elevated food and services inflation amid a tight labor market. The fiscal balance deteriorated to a deficit of 0.7 percent of GDP in 2023 and thanks to robust nominal GDP growth public debt declined further to 63 percent of GDP. The financial sector has weathered well the recent monetary tightening, with high bank capital and liquidity. Staff projects continued robust growth at 3.4 percent in 2024 and 2.9 percent in 2025, led by strengthening household real incomes and investment supported by EU funds. Inflation is stickier, reflecting robust wage growth, and is expected to gradually return to about 2 percent in late 2025.

Risks to the outlook are broadly balanced. Downside risks to growth include heightened regional conflicts, commodity price volatility, and a global or regional recession. Faster implementation of structural reforms could raise actual and potential growth, which is constrained by subdued productivity and labor market shortages. Supply shocks could affect inflation on both sides. Stronger-than-expected wage growth poses an upside risk to inflation while Croatia's openness could play a mitigating factor.

Executive Board Assessment[2]

Executive Directors commended Croatia's significant strides in catching up with more advanced European peers. Directors noted that growth prospects remain favorable, supported by buoyant domestic demand, and disinflation is expected to continue albeit gradually. Given external and domestic risks to the outlook, they encouraged the authorities to focus on building buffers, safeguarding financial stability, and advancing structural reforms to address labor shortages, enhance productivity, and boost potential growth.

Directors underscored the need to reduce the fiscal stimulus in 2024 and welcomed the authorities' plan to meaningfully cut the deficit in 2025 and return to a structural primary balance by 2027. They stressed that fiscal prudence and decisive reforms are warranted to build buffers for future shocks and create space for long-term spending needs. Directors saw

[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.

[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.

scope for broadening the tax base, including by introducing a value-based property tax and removing the excessively favorable taxation on short-term rental income. On spending, they highlighted the need to rationalize the public wage bill and ensure sustainable pension and healthcare systems. Directors also encouraged the authorities to strengthen the medium-term fiscal framework and continue to improve public investment management and strengthen corporate governance and fiscal risk management of state-owned enterprises.

While welcoming the resilience of the financial system, Directors emphasized the need to closely monitor banks’ credit risks and the potential buildup of risks in the real estate sector. They concurred that the tight stance of capital-based macroprudential measures is appropriate. Directors encouraged the authorities to continue to assess the need for introducing explicit borrower-based measures and stand ready to do so as warranted.

Directors underscored the importance of ambitious and comprehensive reforms to boost potential growth, leveraging the progress in implementing the National Recovery and Resilience Plan. They encouraged tackling labor shortages through coordinated policies to foster labor participation, facilitate labor mobility, and reduce skills mismatches and net emigration. Reviving productivity requires broad-based reforms to reduce barriers to entry, improve institutional quality, and expand financing options for innovation. Directors encouraged the authorities to sustainably address housing affordability by boosting housing supply. They highlighted the need to accelerate the green transition and keep the momentum in addressing AML/CFT deficiencies in line with FATF recommendations.

Table 1. Croatia: Selected Economic Indicators, 2019-2029

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Prel.			*Projections*			
Output, unemployment, and prices	*(Percent change, annual average, unless otherwise indicated)*										
Real GDP growth	3.4	-8.5	13.0	7.0	3.1	3.4	2.9	2.7	2.6	2.6	2.6
Contributions:											
Domestic demand	3.5	-3.2	8.1	7.5	1.3	3.6	2.8	2.7	2.7	2.7	2.7
Net exports	0.0	-5.3	5.0	-0.5	1.7	-0.2	0.1	0.1	0.0	-0.1	-0.1
Unemployment rate	7.8	9.0	8.1	6.8	6.2	5.6	5.5	5.5	5.5	5.5	5.5
HICP inflation (avg.)	0.8	0.0	2.7	10.7	8.4	4.2	2.8	2.2	2.2	2.2	2.2
Saving and investment	*(Percent of GDP)*										
Domestic investment	22.4	23.8	22.6	26.7	22.0	21.5	21.4	22.0	22.7	23.3	23.7
Domestic saving	24.9	22.9	23.6	24.0	23.1	23.1	22.2	22.2	22.8	23.3	23.6
Government	6.9	-2.0	1.8	4.7	4.1	3.2	3.3	3.4	3.1	3.2	3.3
Nongovernment	18.1	24.9	21.8	19.3	18.9	19.9	18.9	18.8	19.7	20.1	20.3
Government sector (ESA 2010 definition)											
General government revenue	45.9	46.0	45.2	44.5	46.7	46.3	47.3	47.3	45.9	45.3	45.5
General government expenditure	43.6	53.3	47.7	44.4	47.4	48.7	49.1	48.8	47.3	46.6	46.7
General government balance	2.3	-7.2	-2.5	0.1	-0.7	-2.4	-1.8	-1.5	-1.4	-1.3	-1.2
Structural balance [1/]	2.2	-5.6	-3.2	-1.1	-1.7	-3.3	-2.4	-1.8	-1.5	-1.3	-1.2
Structural primary balance	4.2	-3.7	-1.9	0.1	-0.4	-1.9	-1.2	-0.6	0.0	0.1	0.0
Structural primary balance excl. net EU grants	1.9	-7.6	-5.7	-3.1	-4.4	-4.6	-4.7	-4.4	-2.3	-1.6	-1.9
General government debt [2/]	70.4	86.1	77.5	67.8	63.0	59.7	58.4	57.5	56.7	55.9	55.0
Balance of payments	*(Percent of GDP)*										
Current account balance	2.5	-1.0	1.0	-2.8	1.1	1.6	0.8	0.2	0.1	0.0	-0.1
Capital account	1.6	2.1	2.4	2.4	2.9	2.3	2.6	2.9	2.5	2.2	1.9
Financial account	-4.4	-1.0	-2.8	1.5	-1.6	-3.8	-3.4	-3.2	-2.6	-2.2	-1.9
Debt and reserves											
Gross official reserves (*billions of euros*)	18.6	18.9	25.0	27.9	…	…	…	…	…	…	…
IMF metric [3/]	13.3	13.0	15.1	17.1	…	…	…	…	…	…	…
IMF metric (percent) [3/]	139.5	146.1	165.9	163.4	…	…	…	…	…	…	…
In months of imports in goods and services (*based on next year level*)	7.8	9.3	9.8	7.5	…	…	…	…	…	…	…
Total external debt (*percent of GDP*) [4/]	73.4	81.0	80.3	72.9	83.7	77.5	73.0	69.2	66.2	63.5	61.0
Total external debt excl. CNB share (percent of GDP)	71.2	79.3	74.2	66.7	57.9	53.6	50.4	47.8	45.8	44.0	42.4
Money and credit	*(End of period unless otherwise indicated, change in percent)*										
Broad money (*M3*)	3.8	11.5	15.0	10.7	21.3	…	…	…	…	…	…
Claims on other domestic sectors [5/]	2.6	3.3	2.6	10.0	7.7	…	…	…	…	…	…
Interest rates											
12-month average T-bill rate (*in kuna until 2023, then euros*)	0.1	0.1	0.0	0.1	3.1	…	…	…	…	…	…
10-year government bond yield	0.7	0.6	0.1	2.8	3.7	…	…	…	…	…	…
Exchange rate											
Real effective exchange rate (*percent, "-" = appreciation*)	-1.3	-1.3	-0.1	0.2	3.5	…	…	…	…	…	…
Memorandum items:											
Nominal GDP (*billions of euros*)	55.3	51.0	58.9	68.4	76.5	82.5	87.7	92.3	96.8	101.5	106.5

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.
1/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP. Includes the one-offs related to the COVID-19 package in 2020-2021 and the energy crisis in 2022-2024.
2/ Gross debt as defined by the EU under the Maastricht Treaty.
3/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.
4/ With the entry of Rep. of Croatia into the euro area in January 2023, there was an increase in gross foreign debt for the amount of liabilities related to the distribution of euro banknotes within the Eurosystem.
5/ Comprises claims on households and non-financial corporations.

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION

June 26, 2024

KEY ISSUES

Context and outlook. Croatia is the newest euro area (EA) member. Following a very strong recovery in 2021–22, growth moderated to 3.1 percent in 2023, still among the highest in the EA. Inflation has decelerated considerably since early 2023 but remains above the EA average, while the labor market remains tight. Growth is expected to stay robust in 2024–25, led by strengthening household real incomes and investment supported by EU funds. Inflation is expected to gradually approach 2 percent in late 2025. Risks to the outlook are broadly balanced. Subdued productivity and labor shortages are the main obstacles to potential growth.

Fiscal policy. The authorities should immediately withdraw broad-based cost-of-living measures and implement their plan to meaningfully reduce the deficit from 2025 and return to a structural primary balance by 2027. Prudence and decisive reforms are warranted to build buffers for future shocks and long-term spending needs. There is scope to broaden the tax base while strengthening the tax system's efficiency and fairness. Addressing Croatia's large investment and social needs also calls for reducing spending rigidity and enhancing efficiency, by (i) modernizing the public sector and reducing the wage bill; (ii) ensuring sustainable healthcare and pension systems; and (iii) strengthening public investment management. The authorities should continue to strengthen corporate governance and fiscal risk management of SOEs.

Financial policy. The financial sector has weathered well the recent monetary tightening, and systemic risks appear manageable. Close monitoring of potential buildup of risks in the real estate sector is warranted. Banks should maintain adequate capital buffers and diligently monitor credit risks. The tight stance of capital-based macroprudential measures is appropriate. The authorities should continue to assess the need for introducing explicit borrower-based measures and stand ready to do so as warranted.

Structural policy. The multidimensional nature of labor shortages requires coordinated policies to foster labor participation, reduce skills mismatch, facilitate labor mobility, and reduce net emigration. Reviving productivity calls for broad-based reforms to reduce barriers to entry, improve the regulatory framework and the quality of institutions, and expand financing options for innovative projects. Policies to boost housing supply, including better use of the sizable existing vacant stock and modernizing and streamlining regulations, are crucial to sustainably addressing housing affordability. Croatia also needs to accelerate the green transition and to address AML/CFT deficiencies to exit the FATF's grey list.

Approved By
Uma Ramakrishnan (EUR) and Anna Ivanova (SPR)

Discussions were held in Zagreb during May 27-June 7, 2024. The team comprised Mses. Y. Sun (head), I. Bunda, W. Shi and M. Comunale, and Mr. D. Bartolini (all EUR). Mses. E. Cohn Bech and N. Gonzales (both EUR) assisted in the preparation of the report. Mr. Milutinovic (OED) attended some meetings. The mission met with Minister of Finance Mr. Primorac, the Governor of the Croatian National Bank Mr. Vujčić; the Fiscal Policy Commission; officials from key ministries; representatives of the City of Zagreb, and of the business community, trade unions, and banks.

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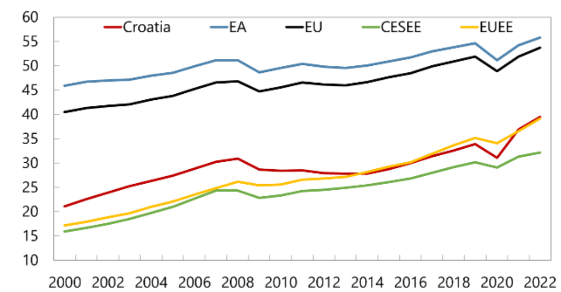
ANNEXES

CONTEXT

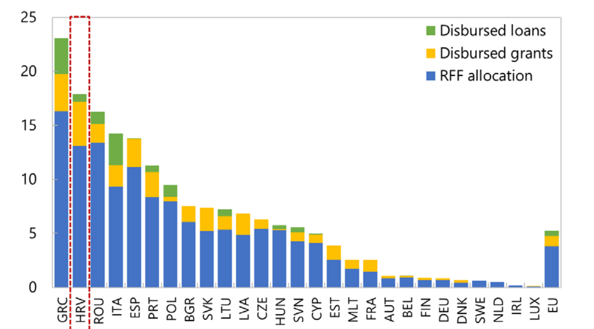
1. **Croatia has made significant strides in catching up with more advanced European economies, and continued progress could help sustain the convergence.** The past decade has been marked by the successful integration to the European Union (EU) in 2013 and the euro adoption in January 2023. These landmark achievements have been secured through reforms and socio-economic development. Still, Croatia's income gap with more advanced economies is sizable, and further major reforms are necessary to close the gap.[1] Good progress has been made in the implementation of the National Recovery and Resilience Plan (NRRP). But Croatia's productivity is still low compared to the EU average and significant shortages in labor supply amid an aging population hinder economic growth. Leveraging the NRRP, more ambitious and comprehensive structural reforms could help ease supply side constraints and boost potential growth.

GDP Per Capita
(PPP 2021 thousand international dollars)



Sources: World Development Indicators; and IMF staff calculations.
Note: CESEE=Central, Eastern and Southeastern Europe; includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, and Ukraine; EA=Euro Area; EU=European Union; EUEE=selected emerging economies from European Union group includes Bulgaria, Hungary, Poland, and Romania.

RRF Allocated and Disbused Funds
(Percent of GDP)

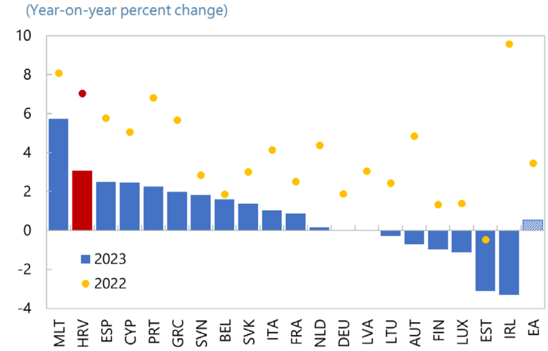


Sources: European Commission; AMECO database; and IMF staff calculations.
Note: Disbursed funds as of early-June 2024. Values against 2023 GDP from AMECO database.

RECENT DEVELOPMENTS

2. **Following a very strong post-pandemic recovery, the economy moderated in 2023 and remains on a relatively favorable trend.** Following an average growth of 10 percent in 2021–22, growth normalized to 3.1 percent in 2023, among the highest in the euro area (EA), as strong wage growth, fiscal policy, and receding inflation supported real household income and consumption (Figure 1). EU funds also helped boost fixed capital formation, including earthquake-related reconstruction. This fostered

Real GDP Growth Comparison
(Year-on-year percent change)



Source: Eurostat; and Haver Analytics.

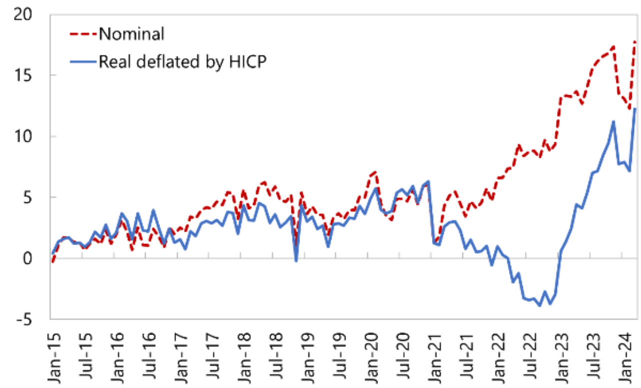
[1] According to the World Bank's Long-term Growth Model, in the absence of major reforms growth would progressively decline to 1.1 percent and income per capital would stabilize at around 80 percent of the EU27 average. (World Bank, 2023, Croatia Country Economic Memorandum)

activities in the construction sector, which, along with transport, accommodation, and professional services, supported growth. Tourism continued to improve, whereas goods exports were weak reflecting slow growth of major trading partners. High frequency indicators suggest some improvement in consumers' confidence and retail trade, pointing to continued positive prospects.

3. **The labor market remains tight with elevated wage pressures.** The employment rate rose further to 66.5 percent at the end of 2023, still lower than that of its peers (Figure 3). The declining unemployment rate (6 percent in 2023:Q4) together with an increasing job vacancy ratio point to a tight labor market. Wage grew strongly in 2023, with real wage growth peaking at just above 10 percent. The large public sector wage increases raised the growth of average wage so far in 2024. While the economy's strong cyclical position contributes to the labor shortages, structural trends, notably population aging, skills mismatches, and emigration, continue to weigh on labor supply. Rising inflows of foreign workers have helped ease the shortages.

Wage Growth

(Year-on-year percent change)

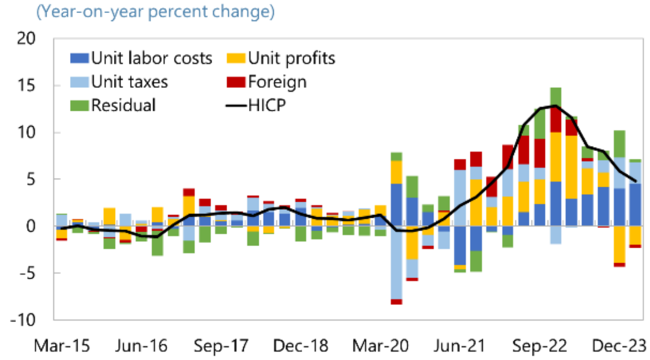


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

4. **Inflation has decelerated considerably but remained higher and stickier than the EA average.** Despite fast normalizing energy prices, headline inflation has declined gradually to 4.3 percent (y-o-y) in May reflecting elevated food and services inflation (Figure 2). The disinflation in recent quarters is supported by lower growth of business profits while the contribution of unit labor costs has been stable, underlying the sticky core inflation (4.6 percent excl. energy and unprocessed food, y-o-y in May). Inflation expectations remain well anchored.

Decomposition of HICP

(Year-on-year percent change)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
Note: The private consumption deflator is decomposed into the GDP deflator, the import deflator ("Foreign"), and a residual via ordinary linear regression (R-square of 0.923). Then the GDP deflator is decomposed into unit labor cost (change of nominal compensation of employees in percent of real GDP), unit profits (change of nominal operating surplus and mixed income in percent of real GDP), and unit taxes.

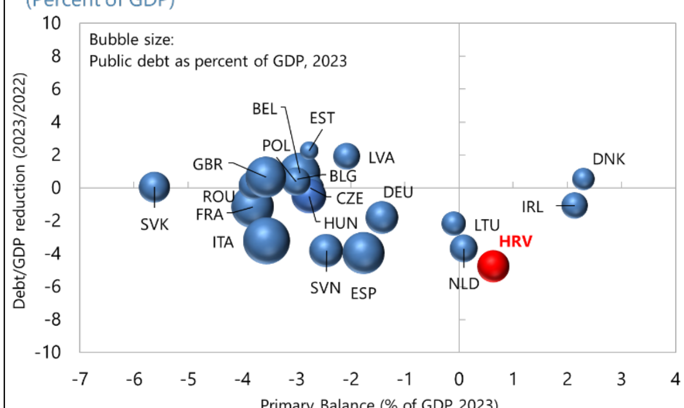
5. **Financing costs have increased faster for corporates than households; household loans have continued to grow robustly while corporate loan growth has normalized.** Lending rates to corporates are near the full pass-through of the ECB's policy rate increases and corporate loan

growth decelerated from its end-2022 peak of 22 percent to 3.8 percent in April 2024 (Figures 8 and 9). The pass-through to household lending rates has been more gradual, reflecting the predominance of fixed-rates loans, legal restrictions linking the growth of household borrowing rates to banks' cost of funding, and the subdued national reference rate given ample liquidity. Housing loan growth has remained strong at about 10 percent in 2023 and growth of cash loans has picked up considerably. The pass-through to deposit rates was more modest, largely due to the high share of overnight deposits, though the government's retail bond issuances raised competition for banks to raise their term deposit rates.

6. **The financial sector has weathered well the recent monetary tightening.** The banking system has among the highest capital levels in the EA and maintains stable deposit funding and sizable excess liquidity, further boosted by the regulatory changes related to the euro adoption. Banks' profitability reached record highs owing to favorable net interest margins, although this may be temporary as deposit rates continue to catch up.[2] The non-performing loans have further declined to 2.6 percent at end-2023, thanks to the resilient economy. Nonbanks—mainly pension funds and insurance companies—experienced losses in value initially as rising policy rates negatively affected the valuation of financial assets globally. Their profitability has recovered to varying degrees on the back of their new investment in government bonds paying higher yields and stablizing global sentiment. Available data suggests that the nonbank sector as a whole appears well capitalized and liquid.

7. **Fiscal balance widened to a deficit of 0.7 percent of GDP in 2023, reflecting higher spending than in 2022.** Fiscal stance, expressed as the change in the structural primary balance excluding EU grants (net), is assessed to be expansionary. Thanks to robust growth and lower risk premium, public debt declined to 63 percent of GDP (Figure 4). Budget support measures, mostly broad-based (energy price caps, subsidies, transfers, and tax reductions), have been extended in 2024 to alleviate cost-of-living pressures, despite declining inflation. Their direct budgetary impact is about 2.0 percent of GDP in 2023 and 0.5 percent in 2024 (Text Table 1).

Primary Balance and Debt Ratio Reduction, 2023
(Percent of GDP)



Sources: IMF World Economic Outlook; and IMF staff calculations.

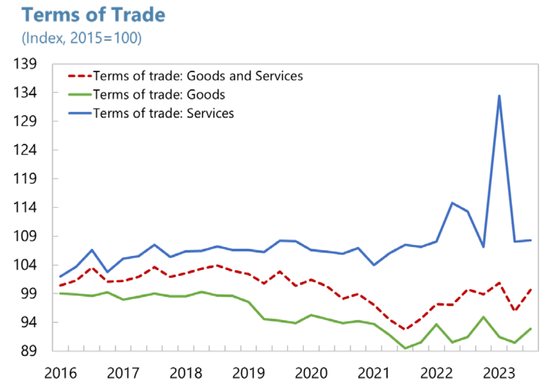
[2] Debt securities held to maturity by banks accounted for less than 10 percent total assets as of end-2023. Bonds held to maturity but included in the liquidity coverage ratio (LCR) are valued at mark-to-market in the LCR.

Text Table 1. Croatia: Support Measures Adopted in Response to Increases in the Cost-of-Living

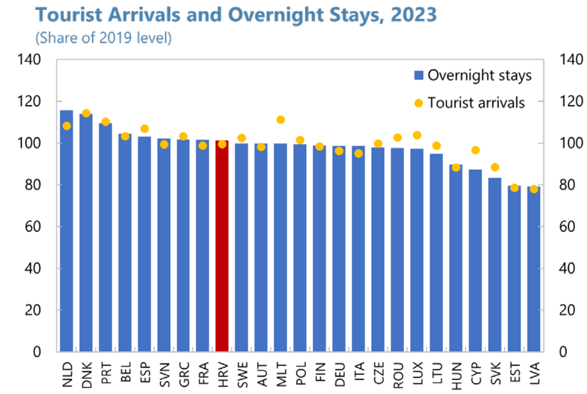
Description of the measure	Fiscal effect in millions of EUR			
	in 2022	in 2023	in 2024	in 2025
Total effect on fiscal revenue (million euro)	**-105**	**-316**	**-33**	**-12**
Percent of GDP	**-0.2**	**-0.4**	**0.0**	**0.0**
Reduced VAT rate on certain food products, gas and thermal energy, hygiene items, tickets for sports and cultural events from March 2022	-207	-69		
Temporarily reduced VAT rate of 5 percent on the delivery of gas, heating from thermal stations, firewood, pellets, briquettes and wood chips until end-March 2025	-13	-52	-33	-12
Reduction of excise duty on motor fuels (gasoline and diesel) to lower fuel retail price	-134	-150		
One-time excess profit tax	250			
Higher income threshold (from HRK 15,000 to HRK 24,000) up to which someone can be considered a dependent for PIT		-33		
Other revenue measures	-1	-12		
Total effect on fiscal expenditure (million euro)	**1131**	**1237**	**399**	**0.0**
Percent of GDP	**1.7**	**1.6**	**0.5**	**0.0**
One-time benefit to pensioners, payment of cash benefits to the unemployed, and fees for vulnerable buyers of energy products	215	268	113	
One-time monetary payment to social welfare system beneficiaries	20	46		
One-time increase in children's allowance and student grants based on socio-economic status	17	26	7	
Reimbursement of heating costs and part of housing costs to guaranteed minimum benefit users	3	4	7	
Support for offseting the increase in energy prices in agro-processing sectors		10	7	
Subsidies for mitigating the negative effects of rising electricity prices (distributors outside HEP Group)	12	54	8	
Subsidies to mitigate the negative effects of rising electricity prices (HEP Group)	412	555	178	
Subsidies to mitigate the negative effects of rising thermal energy prices	63	69	31	
Subsidies to mitigate the rise in natural gas prices for entrepreneurs	11	15	8	
Acquisition and withdrawals of gas reserves	294	-68	-68	
Small value support to agricultural producers for the purchase of mineral fertilizer	12	3	3	
Reimbursement of the cost of diesel fuel used in commercial road passenger transport	2	13	16	
Subsidies to airlines, shippers, and farmers	28	95	25	
Subsidies to moderate the rise in household gas prices for households, public and non profit	35	98	37	
Energy renovation of houses and residential buildings		26	18	
Other expenditure measures	7	23	9	
Total fiscal effect on the budget	**1236**	**1553**	**432**	**12**
Percent of GDP	**1.8**	**2.0**	**0.5**	**0.0**
Measures financed by EU funds (million euro)				
Energy renovation of houses and apartment buildings, and public sector buildings	66	599	534	
Measures financed by the environmental fund (million euro)				
Energy renovation of houses and residential buildings		29	66	
Non-reimbursable grants to entrepreneurs for the energy transition	126	126		
Guarantees/subsidized lending via HBOR (million euro)				
Loans for working capital with subsidized interest for companies in difficulty	252	252		
HBOR guarantees for loans to exporters in difficulty	206	206		

Source: Croatian Ministry of Finance.

8. **The external position in 2023 is moderately stronger than the level implied by fundamentals and desirable policies** (Annex IV). Following a sizable deficit in 2022, the current account balance improved to a surplus of 1.1 percent of GDP in 2023, reflecting robust tourism revenues, improved terms of trade, and record disbursements from structural EU funds (Figure 7). The CPI-based real effective exchange rate (REER) has slightly appreciated.



Sources: Croatian Bureau of Statistics; Croatian National Bank; and IMF staff calculations.



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

OUTLOOK AND RISKS

9. Staff projects continued disinflation while growth remains robust.

- Growth is expected to remain robust at 3.4 percent in 2024 and 2.9 percent in 2025, well above the EA average. Amid a still weak albeit improving external environment, growth is expected to be supported mainly by buoyant domestic demand; the expected wage growth and subsiding inflation strengthen household real income and EU funds reinforce domestic investment. The output gap is expected to narrow but remains positive in 2024-26. Over the medium term, growth is expected to approach its potential level of 2½ percent, as productivity-enhancing investment under the NRRP balances the drag from demographic headwinds.

- Inflation is expected to continue to decelerate but remains above the EA average and approaches the ECB's target of 2 percent only in late 2025, while inflation expectations would remain well anchored. Supply shocks are expected to dissipate, inflation in Croatia's key trading partners continues to decline, and still restrictive financial conditions should work their way into the economy to ease demand pressures. Services inflation is expected to stay elevated and sticky in 2024 given strong wage growth, tourism demand, and the expected fiscal loosening. However, wage pressure is expected to moderate going forward as inflation normalizes and given well-anchored inflation expectations. After surging profits in 2022–23, firms have room to accommodate the expected wage increase in 2024 and a wage-price spiral is unlikely.

10. Risks are broadly balanced for growth and inflation (Annex II). An intensification of regional conflicts, commodity price volatility, and a global or regional recession could pose downside risks to growth. In contrast, faster implementation of reforms to ease supply side constraints could raise actual and potential growth. Supply shocks could affect inflation on both sides. Stronger-than-expected wage growth poses an upside risk to inflation while Croatia's openness could play a mitigating factor.

Authorities' Views

11. **The authorities broadly share staff's assessment on the outlook and risks, except that their projected inflation in 2024 is somewhat lower.** They expect robust growth and see little risk of the economy overheating, pointing to still restrictive monetary policy and subdued growth in Croatia's key trading partners. They project continued disinflation but noted that services inflation will be elevated and sticky due to the impact of strong wage growth and tourism demand. Given the strength of services inflation in Croatia, headline inflation measured by HICP is likely to remain above the EA average in 2024-25. The authorities expect profits to further accommodate part of wage increases and given the well-anchored inflation expectation, consider the risk of a wage-price spiral low. They concurred with staff's external sector assessment.

POLICY DISCUSSIONS

A. Fiscal Policy

12. **The authorities should reduce the fiscal stimulus in 2024.** Staff projects an overall deficit of about 2½ percent of GDP in 2024, driven by generous increases in social payments[3] and compensation of public employees.[4] This implies a further fiscal loosening relative to the already expansionary stance in 2023 (Text Table 2), which could fuel domestic demand and risks hurting competitiveness and hampering the ongoing disinflation. Promptly reversing the broad-based cost-of-living support measures, which could itself generate ⅓ percent of GDP in savings, will not only reduce the fiscal impulse but also restore price signals. Any remaining support measures should be temporary and target the most vulnerable, while revenue over-performance should be saved. In the remainder of the year, raising revenue and/or cutting discretionary non-priority current spending should be explored to reduce the stimulus.

Text Table 2. Croatia: Indicators of Fiscal Performance

(Percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Level											
Overall balance	2.3	-7.2	-2.5	0.1	-0.7	-2.4	-1.8	-1.5	-1.4	-1.3	-1.2
Structural balance	2.2	-5.6	-3.2	-1.1	-1.7	-3.3	-2.4	-1.8	-1.5	-1.3	-1.2
Structural primary balance	4.2	-3.7	-1.9	0.1	-0.4	-1.9	-1.2	-0.6	0.0	0.1	0.0
Structural primary balance excl. net EU funds	1.9	-7.6	-5.7	-3.1	-4.4	-4.6	-4.7	-4.4	-2.3	-1.6	-1.9
Public Debt	70.4	86.1	77.5	67.8	63.0	59.7	58.4	57.5	56.7	55.9	55.0
Change											
Overall balance	2.0	-9.5	4.7	2.7	-0.8	-1.7	0.6	0.3	0.1	0.1	0.1
Structural balance	1.9	-7.8	2.4	2.2	-0.6	-1.6	0.9	0.6	0.3	0.2	0.1
Structural primary balance	1.8	-7.9	1.8	2.0	-0.5	-1.5	0.7	0.6	0.6	0.0	0.0
Structural primary balance excl. net EU funds	0.8	-9.5	1.8	2.7	-1.3	-0.3	-0.1	0.4	2.1	0.6	-0.3
Public Debt	-2.2	15.7	-8.5	-9.8	-4.8	-3.3	-1.2	-1.0	-0.8	-0.8	-0.9

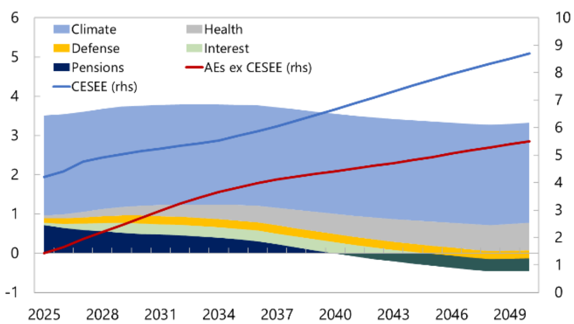
Sources: Eurostat; and IMF staff calculations.

[3] Larger social benefits mostly for public sector employees (€1.5 billion in education and public administration) and pensioners (€1.1 billion).

[4] The latter is associated with the implementation of a comprehensive public wage reform (a major NRRP milestone), which introduced equal pay for jobs of equal complexity, greater fairness for all employees in state and public services, and more competitive pay to attract skilled labor.

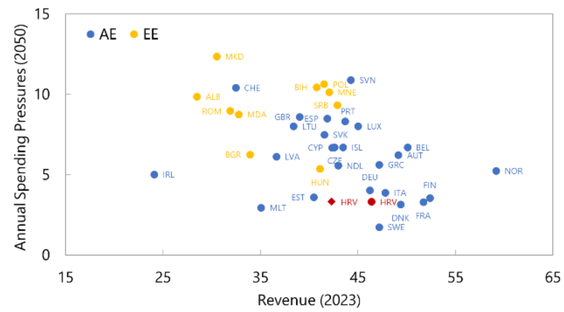
13. Staff supports the authorities' plan to meaningfully reduce the overall deficit from 2025 and return to a structural primary balance by 2027. Recurrent fiscal expansion during a period of robust economic growth could damage Croatia's hard-won fiscal credibility. Prudence and decisive fiscal structural reforms are also warranted to build buffers for future shocks and create space for long-term spending needs. Croatia faces large investment needs, including from the green and digital transitions, and rising fiscal costs from an aging population. Currently, a large share of public investment is financed by the EU. It is important to generate and reserve fiscal space for future investment as the importance of the EU funding recedes and to ensure that any additional debt accumulation is used to finance high-return public investment. Buffers are also needed for a more uncertain and shock-prone world. The expected reduction of the deficit by ⅔ percent of GDP in 2025 is achievable, as the planned restoration of healthcare contribution rates for the young should generate about ½ percent of GDP. Under this fiscal consolidation path, staff projects public debt to further decline to 55 percent of GDP in 2029 and assess Croatia's sovereign stress risk to be low (Annex III).

Spending Pressures in Croatia, 2025-2050
(Percent of GDP)



Sources: European Commission; European Investment Bank; IMF World Economic Outlook; Eble et al. (2024), forthcoming; and IMF staff calculations.
Note: Annual spending needs beyond baseline. Weighted by GDP. Excludes AND, ISR, and SMR.

EUR: Spending Pressures and Revenue
(Percent of GDP)

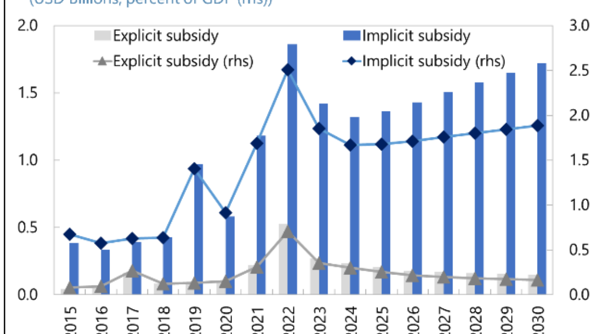


Sources: European Commission; European Investment Bank; IMF World Economic Outlook; Eble et al. (2024), forthcoming; and IMF staff calculations.
Note: Excludes AND, BLR, ISR, KOS, RUS, SMR, TUR, and UKR. For Croatia, the red dot shows share of total revenues and the red diamond shows the share of revenues excluding grants.

14. To prepare and successfully implement the medium-term structural fiscal plan required by the new EU rules, Croatia needs to strengthen its medium-term fiscal framework. In this context, the authorities should consider preparing and publishing a Fiscal Risk Statement, covering all aspects of risks to the budget. There is also scope to improve the role of the Fiscal Policy Commission in promoting sustainable public finances. The Commission should continue to build its capacity to assess the robustness of macroeconomic and fiscal forecasts, e.g., through scenario analysis. It can also play a useful role in assessing fiscal risks such as contingent liabilities, as well as long term fiscal sustainability including analysis of aging and climate costs.

15. There is considerable scope to broaden the tax base while improving the system's efficiency and equity. Croatia's tax revenue is moderately below the EA average, but the gap is

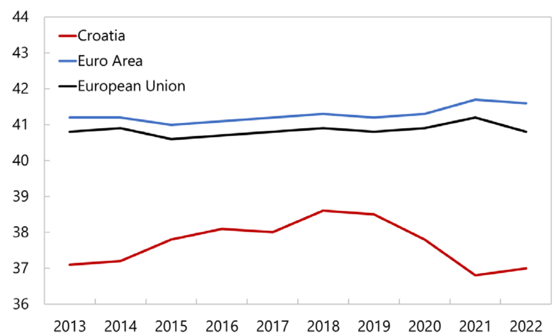
Total Subsidies by Year
(USD Billions; percent of GDP (rhs))



Sources: Simon Black ; Antung A. Liu ; Ian W.H. Parry ; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.

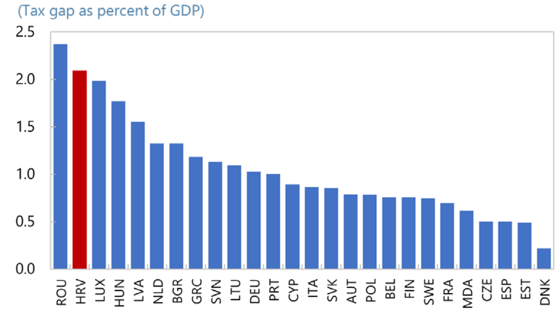
widening (Figure 5). A series of tax changes in recent years risk weakening revenue collection. Property and income taxation favoring residential real estate investments and short-term rental, as well as limited environmental taxation (e.g., on vehicles) reduce the tax base and create distortions. Frequent tax changes also erode tax predictability and compliance and hinder investment decisions. Staff reiterates our recommendation for a modern value-based property tax and alignment of the treatment of different forms of income, including notably removing the excessively favorable taxation of short-term rental income.[5] Furthermore, removing explicit and implicit subsidies on fossil fuels can raise revenue (estimated at 2 percent of GDP annually) while promoting the green transition, conditional on targeted support to protect the most vulnerable and a good communication strategy.

Total Receipts from Taxes and Social Contributions
(Percent of GDP; general government)



Source: Eurostat.

Revenue Mobilization Potential in Europe: Gains from Tax System Reform and Institutional Capacity Building
(Tax gap as percent of GDP)



Source: IMF Regional Economic Outlook (Europe), October 2023; and IMF staff calculations.
Note: Tax gains are estimated by closing the gap between the country's observed level of tax collection and its potential, which is the highest observed level controlling for country characteristics.

16. Addressing Croatia's large investment and social needs also calls for reducing spending rigidity and enhancing efficiency.

- **A modern public sector:** Further reforms are needed to reduce the size of public wage bills in the coming years. There is scope to rationalize the workforce based on a functional review of the public sector and to develop the internal market to improve mobility. Best practices suggest that a position-based employment system would allow greater flexibility in adjusting employment levels and composition over the medium term.[6] The attrition rule currently in place needs to be more strictly enforced except for essential functions.

- **Sustainable pension and healthcare systems:** Ongoing measures to tighten early retirement and fully align the retirement age of women (63.5 years in 2024) with that of men (65 years) could be strengthened, by increasing the statutory retirement age and/or increasing minimum contribution years and indexing the retirement age to life-expectancy. The second pillar pension should be strengthened by expanding its coverage and building trust, while improving the adequacy of the PAYG system. Albeit declining, health sector arrears remain at about 0.7 percent

[5] See the 2023 Croatia Article IV consultation staff report and the accompanying 2024 Selected Issues Paper on housing affordability.

[6] Thévenot C. and S. Walker, 2024, How to Set Compensation for Government Employees; IMF, 2016, Managing Government Compensation and Employment - Institutions, Policies, and Reform Challenges.

of GDP in 2023. Beyond the reforms in the NRRP,[7] co-payments designed to directly reduce costs could be introduced while seeking to broaden healthcare access, which may save costs by providing less expensive primary care or reducing reliance on old-age homes.

- **Efficient public investment management (PIM)** is crucial for ensuring value for money for investment, including debt-financed investment. The main weakness identified by the 2021 Public Investment Management Assessment was the lack of overarching central framework to prioritize public investment projects nationally and consistently. Recommendations hence focused on a more centralized framework for appraisal, processing, and monitoring of all public investments. Progress has been achieved in implementing these recommendations, supported by a follow-up FAD capacity development (CD) mission in 2023 and a two-year CD on state treasury modernization started in 2024. A dedicated PIM unit at the Ministry of Finance was set up and a PIM manual and an action plan were drafted. The authorities need to implement the action plan to strengthen the PIM, which should also reflect climate change adaptation and mitigation considerations.

17. The authorities should continue to strengthen corporate governance of SOEs and enhance fiscal risk management. Associated with its OECD accession preparation, Croatia is undertaking significant reforms to its SOE ownership, governance, monitoring, and oversight practices. Under the NRRP, the authorities plan to adopt a new single law on SOEs to address key OECD recommendations, including introducing a new centralized ownership model for strategically important SOEs and strengthening board autonomy and independence. Croatia has received FAD CD on managing fiscal risks emanating from SOEs in 2023. The current structure of SOE performance analysis should be strengthened to ensure timely and effective SOE oversight function. Regular assessment, reporting, and disclosure of fiscal risks stemming from SOEs need to be introduced.

Authorities' Views

18. The authorities reaffirmed their commitment to fiscal prudence. They explained that the expansionary 2024 Budget was adopted in anticipation of an economic slowdown, which did not materialize. They are examining ways to prioritize spending and raise revenues to cut the stimulus this year. The use of NRRP loans will boost public investment while raising fiscal deficit during 2024–27. The authorities stressed that their fiscal consolidation plan starting from 2025 is underpinned by concrete measures, including phasing out cost-of-living support measures and restoring healthcare contribution rates by the young. A comprehensive fiscal risk statement will also be included in the 2025 Budget Act. The authorities agreed with staff that favorable taxation on real estate investment and short-term rental reduces the tax base and creates distortions in the economy. Pointing to their previous failed attempts to introduce a value-based property tax, they stressed that reforms in this area need to proceed gradually and take into account Croatia's unique economic and social context such as high homeownership. The harmonization of the cadaster and land registry as well as a fully

[7] See Annex VII in 2021 Croatia Article IV consultation staff report.

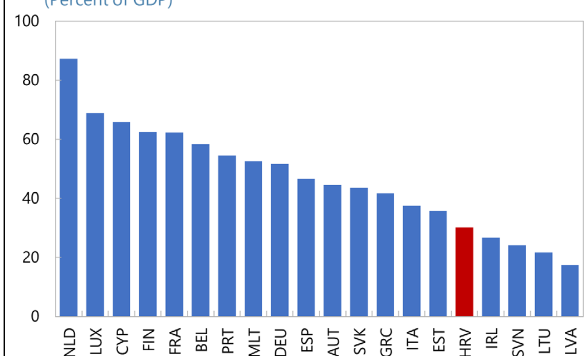
functional household registry by 2026 will facilitate broadening the tax base. On the spending side, the authorities highlighted that the recent public wage reform was necessary to attract and retain competent workforce and that important progress has been made in relation to management of SOEs and public investment. At end-2023, a new Directorate for SOEs was set up at the Ministry of Finance. The draft SOE Law, in line with OECD recommendations, has been finalized and is expected to be adopted in fall 2024. The 2025 budgetary cycle will see the implementation of the new PIM system, including elements of green budgeting and spending reviews. A working group analyzing the pension system with the participation of the World Bank will make proposals to strengthen the system and improve pension adequacy in 2024:Q4.

B. Financial Sector Policies

19. Systemic risks have remained broadly unchanged from last year and appear manageable. While easing inflation and resilient growth have contained systemic risks and there are mitigating factors and buffers, solid growth of bank credit and house prices in the context of higher financing costs could lead to pockets of vulnerabilities. Thanks to the abundant excess liquidity, adequate capital, and higher profits, the banking sector is shown to be reasonably resilient to credit and liquidity shocks in the Croatian National Bank's (CNB) recent stress tests.

- **Households:** Despite the continued expansion in housing and cash loans, household indebtedness in Croatia remains relatively low, and the share of loans with high loan-to-value (LTV) or debt-service-to-income (DSTI) ratios has been stable. Households have been largely shielded from the recent monetary tightening by the high share of fixed-rate loans, with 70 percent of non-housing loans and 54 percent of housing loans either completely fixed or fixed for at least three years as of end-2022. Moreover, the slow transmission arising from legal mortgage caps and loan pricing linked to the national reference rate which has remained low given the excess liquidity in the banking system has also helped. Going forward, the continued strong labor market would help mitigate the impact of higher borrowing costs and debt servicing.

Household Indebtedness, 2023Q4
(Percent of GDP)



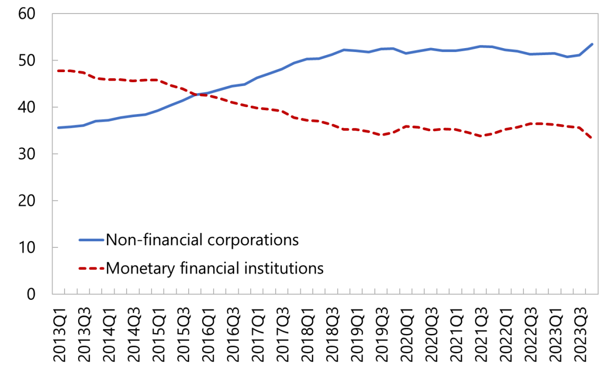
Sources: Eurostat; and IMF staff calculations.

- **Non-Financial Corporations (NFCs):** The NFC sector has improved its financial strength since the Global Financial Crisis with reduced leverage, higher profitability, and improved liquidity.[8] The borrowing costs facing NFCs have also declined even prior to the euro adoption, likely reflecting the market's positive sentiment towards Croatia's integration into the EA. In parallel,

[8] See the accompanying 2024 Selected Issues Paper on NFC balance sheets analysis.

the NFC sector has been steadily reducing its reliance on bank financing, and instead resorting to intercompany loans. Staff's analysis suggests that though NFCs' earnings and debt servicing capacities would be adversely affected by negative growth shocks or higher interest rates, the overall impact on NFCs and the banking system appears broadly manageable.

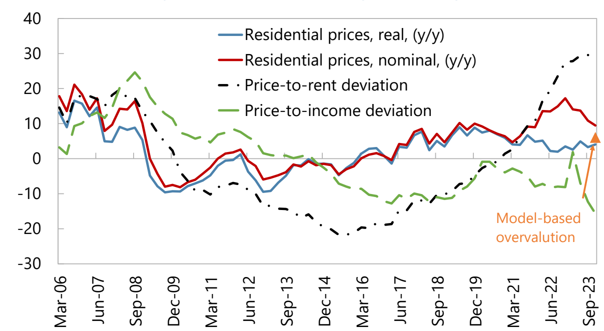
Loan to Non-Financial Corporations by Major Sources
(Percent of total)



Sources: Eurostat; and IMF staff calculations.

- **The residential real estate (RRE) sector:** Housing prices showed significant nominal growth throughout 2022, fueled by strong income growth, ample liquidity, extra demand stimulated by housing subsidies (ended in 2023), and foreign demand (accounting for 20 percent of transaction value in 2022). Staff assesses that the residential housing prices are moderately overvalued by 6 percent, in line with the average assessment of the ECB. Transaction volumes declined during 2022-23, in part reflecting the decrease in foreign demand, and prices have shown signs of stabilization in 2023.

Residential House Prices and Valuation
(Percent; percentage point deviation from long-term average)



Sources: OECD; and IMF staff calculation.
Note: IMF model is based on IMF Real Estate Module for House Price Overvaluations, February 2024. Long-term average refers to 2005Q1-2023Q4.

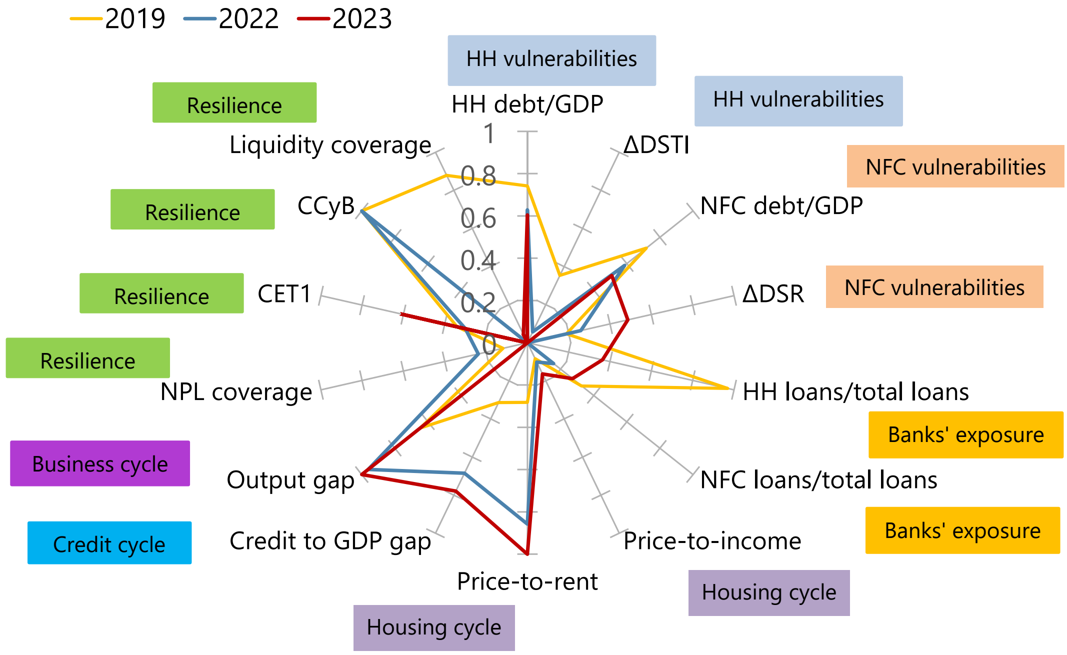
- **The commercial real estate (CRE) sector:** The direct exposure of the financial sector to CRE appears rather limited: Less than 10 percent of banks' loan portfolios are related to the CRE sector, and non-banks also have a small exposure to CRE on their balance sheets, though insurance companies are more exposed.[9] Granular loan-level data from AnaCredit suggest that about half of banks' loans to the NFC sector are either for investment in CRE or secured by CRE, and that these loans have on average higher non-performing ratios and some are also of high LTV—around one-eighth of these loans have LTV above 100 percent. Nonetheless, so far only a small share of CRE that serves as collateral has experienced some loss in value, and the overall risks from the CRE sector seem moderate.

- **Other challenges to the financial sector** are associated with climate change including risks from extreme weather events and stranded assets as the economy de-carbonizes, increasing competition from Fintech businesses, and cyber-attacks as financial activities become more reliant on digital means.

[9] As of 2022, around 6 percent of banks' loans are secured by commercial real estate. The nonbank sector as a whole invests less than 3 percent of its portfolio in real estate in 2023:H1, but the insurance sector invests more at 12.5 percent, higher than the EU average (8.4 percent).

Heatmap of Systemic Risk in Croatia

(Indicator: 1 = high risk (low resilience); 0 = low risk (high resilience)



Sources: Croatian National Bank; Eurostat; Organization for Economic Co-Operation and Development (OECD); and IMF staff calculation.

Note: The chart shows quantitative measures of each component of systemic risk (upper, right, bottom, and bottom left), as well as resilience (left, upper left). Each relevant indicator has been normalized between 0 and 1 using the relative distance from the historical minimum (maximum for resilience indicators) to allow for comparison. Low values signal low risk (or high resilience) and high values are suggestive of high risk (or low resilience). DSTI and DSR stand for debt-service-to-income ratio for households and debt-service-to-gross-operating-surplus ratio for NFCs, respectively.

20. Continued vigilance and close monitoring are warranted to safeguard financial stability. Increased financing costs coupled with a more normal economic growth could pose challenges to some households and NFCs. Supervisors should continue to ensure that banks maintain adequate capital buffers and diligently monitor credit risks. The buoyant albeit stabilizing real estate market against tighter financial conditions also calls for continued scrutiny for signs of overheating and risk buildup. Despite the limited direct exposure, more efforts are needed to investigate indirect exposures and potential spillovers from the CRE sector to banks and nonbanks. In the unlikely event of an abrupt real estate price correction, banks should have enough buffers to absorb losses from deteriorating loan quality, but the negative valuation effect could hit borrowers and dampen their activities and demand for credit. Finally, given the significant intercompany loans, relevant agencies should gather more granular information and step up efforts to monitor associated vulnerabilities.

21. The tight stance of capital based macroprudential measures is appropriate; the authorities should continue to assess the need for introducing explicit borrower-based macroprudential limits and stand ready to do so as warranted. Staff supports the phased increase of the counter-cyclical capital buffer (CCyB) to 1.5 percent in June, as well as the increase in the total capital buffer rates for domestic systemically important banks, given the maturing expansionary phase for both the credit and housing cycles. Given banks' high capital levels, these increases are unlikely to adversely affect credit provision. Furthermore, the authorities should continue assessing the adequate level of CCyB and consider the merits of a positive neutral framework, which is irrespective of the credit gap estimates and could facilitate communication. Although currently there are signs of market cooling, the RRE may face renewed pressures, given favorable taxation, growth of disposable incomes, and high bank liquidity. Explicit borrower-based measures (BBMs) can be used to preempt future financial stability risks from the RRE sector. The welcome expiration of housing loan subsidies and the decline of foreign demand have also eased structural obstacles for implementing effective BBMs. Should strong market momentum begin to resume, the authorities should stand ready to introduce explicit BBMs. To alleviate inequality or other social concerns, first-time buyers could be subject to different thresholds, coupled with measures to improve housing affordability and bearing in mind that BBMs should be used predominantly to contain systemic risks.

Authorities' Views

22. The authorities emphasized that the financial system remains sound and systemic risks are manageable. The CNB indicated that the recent high growth of general-purpose cash loans to households could be underpinned by the strong wage growth and has stepped up its monitoring of bank lending standards. As the housing market is stabilizing, the CNB considers that introducing explicit BBMs at this juncture could be procyclical and will continue to assess the evolving situation. It has the legal basis and detailed data to calibrate the BBM limits quickly if warranted. The CNB stressed that their current framework to set the CCyB buffer is based on a broader set of cyclical risk indicators, in addition to credit gap estimates, and has enabled timely buildup of the CCyB in a risk-based manner as well as facilitated communication with banks. It does not see a need to change the existing framework in Croatia at this juncture and has been participating in discussions of the positive-neutral CCyB approach at the EA level. The CNB finds the idea of gathering more granular data on inter-company exposures interesting, but given the operational challenges involved, a review of best international practices on collecting and using such data is warranted before any further steps are taken.

C. Structural Policies

23. Despite the authorities' efforts, labor shortages remain a key challenge. Under the NRRP several reforms have been implemented, including a voucher scheme for adult learning and better targeted active labor market policies. In addition, the amendments to the Labor Act provide the legal framework to modernize the labor market.[10] Still, skills mismatch, net emigration, low domestic labor mobility, and pockets of inactivity among young and older adults represent major sources of labor shortages. Furthermore, technological progress (e.g., digitalization, AI) is rapidly changing the nature of work, with a decline of employment opportunities in middle-skill occupations[11] and an increase in both high-skill and low-skill occupations (so called "job polarization"). The education and adult learning system need to prepare students and workers to adapt to new skill requirements and working conditions. In this context, the NRRP's focus on promoting digitalization represents a step in the right direction.

24. The multidimensional nature of labor shortages requires coordinated policies to foster higher labor participation and reduce skills mismatch.[12]

- **Strengthening vocational education and training to ease school-work transition.** Although inactivity among young people has been declining, it is still above the EU average and the European Commission's target of below 9 percent by 2030.[13] Strengthening vocational education and training with a closer interaction with the world of work can help students transition from school or inactivity to the labor market. Similarly, improving the quality of the education system would help develop the skillset required by the labor market.[14]

- **Improving the quality of adult learning.** The share of workers in low-skill occupations is higher than the EU average and the gap has widened. Expanding the range of programs offered and allowing customization of curricula to better suit individual needs may boost participation in adult training (OECD, 2023). Developing distance learning could also boost participation in adult learning programs, especially in rural areas where participation is low, provided that digitalization efforts are accelerated.[15] In addition, raising elderly participation rates and extending working life can not only help reduce labor shortages but also strengthen pension sustainability (¶16).

[10] The amendments took effect in January 2023 and included the transposition of two EU directives (on life-work balance and fair working conditions) and the recognition of the status of permanent seasonal workers, to address the growing employment in the tourism sector.

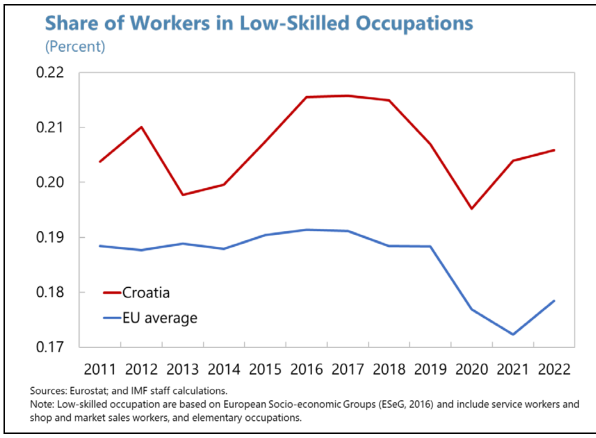
[11] Middle-skill occupations mainly involve routine tasks that can be easily automated.

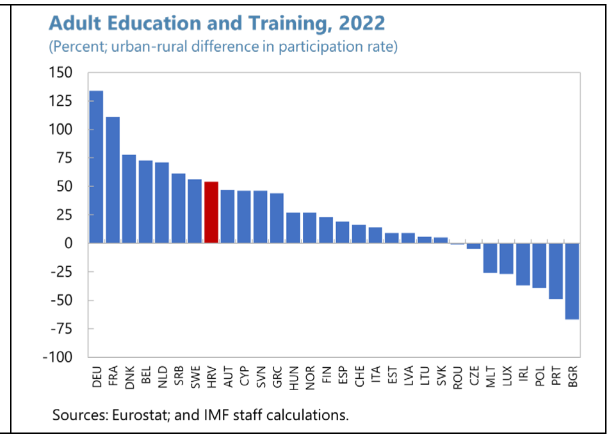
[12] See the accompanying 2024 Selected Issues Paper on labor shortages.

[13] The European pillar of social rights action plan sets targets in several social domain, including equal opportunities and access to the labor market.

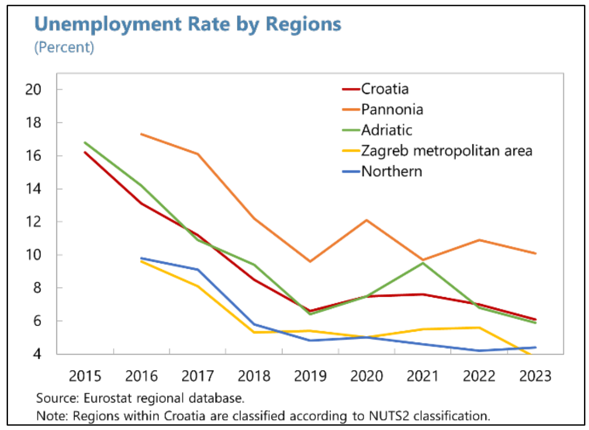
[14] According to 2022 OECD PISA Scores, students in Croatia lag the OECD average in reading, science, and especially mathematics.

[15] €130 million in the NRRP is devoted to enhancing broadband connectivity in rural areas.





- **Improving labor mobility and reducing net emigration.** The tightness of the labor market differs across the country. The region of Pannonia with an unemployment rate of more than 10 percent in 2022 is well above the national average of 6 percent. By contrast, the labor market is tighter in the metropolitan area of Zagreb and the Northern region where unemployment is below average. Promoting a more efficient rental and housing market would facilitate workers' mobility. Improving the quality of institutions (¶26) and housing affordability (¶27) may also help slow emigration and integrate foreign workers.



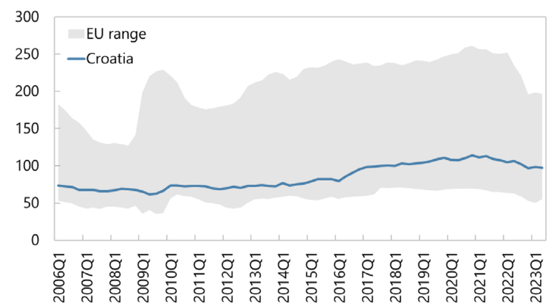
25. Reviving productivity represents another priority. Staff analysis on firm-level data for the period of 2008-21 indicates stagnant productivity and points to a decline in innovative start-ups and financial constraints as obstacles to productivity growth (Annex V). In the sample considered, start-ups, exporting firms, and firms with a large market share tend to be more productive, but the share of start-ups has declined considerably, negatively impacting aggregate productivity growth. At the same time, employment in the least productive firms has been rising in recent years. Furthermore, productivity growth is associated with increasing leverage, but the most productive firms in the analysis appear to have reduced their financial leverage faster than other firms. This suggests that innovative firms may face financing constraints, given Croatia's reliance on bank financing and weak capital market ecosystem. Innovative firms, like start-ups, can find it difficult to access bank financing given their large share of intangible assets and low cash flows that represent poor collaterals.

26. Enhancing productivity requires comprehensive reforms to encourage innovation, strengthen business dynamism, and facilitate access to financing. Barriers to entry and excessive regulatory burdens weaken business dynamism, thus reducing the capacity of new, more productive firms to displace unproductive incumbents. Policies need to facilitate firm entry and exit by removing barriers to entry, including regulatory barriers in services, and improving insolvency procedures.[16] Strengthening the quality of institutions[17] will also improve the business environment and incentivize firms to invest. Furthermore, boosting public financing for R&D, which is low in Croatia, developing capital markets with the creation of a capital markets union for Europe, and encouraging equity financing can broaden financing options for innovative investment. The NRRP has included many of the right priorities, with some initiatives already being implemented. Along with the EU funds, a set of ambitious, broad-based reforms with careful design, implementation, and evaluation are needed to ensure lasting success.

27. Policies to boost housing supply, including better use of the sizable existing vacant stock and modernizing and streamlining regulations, are crucial to address housing affordability. Croatia's housing affordability has worsened in recent years and scores among the worst in the EA. The longer-term rental market is thin, reflecting a lack of regulation, high home ownership, and the widespread practice of short-term rental for tourism. Policies to address affordability need to tackle the underlying supply gap in housing rather than helping demand.[18] Demand-side measures such as subsidies to home buyers or renters, even if well targeted, tend to be effective only in the short term, as they at least partially contribute to higher house prices or rental costs over the medium term. Reducing or removing the favorable tax treatment of residential real estate investment and short-term rental would help reduce speculative demand and activate idle housing. Policy action is also warranted to accelerate the modernization of the legal cadaster, develop the long-term rental market, and invest in infrastructure and green social housing for low-income households.

Housing Affordability Index

(Index)



Sources: Biljanovska et al., 2023, Housing Affordability: A New Dataset, IMF WP 2023/247.
Note: An index value of 100 indicates that the median-income household has exactly enough income to qualify for a mortgage loan on an average-priced home- a value below 100 indicates that a household does not have the sufficient income to qualify for a mortgage on an averaged- priced house.

28. Croatia needs to accelerate the green transition. Reaching the mitigation goals requires economy-wide carbon pricing, reinforced by sectoral policies and targeted support to the vulnerable. A carbon tax that progressively increases for sectors not covered by the existing EU Emissions Trading System (ETS) should be phased in through the current excise regime ahead of the EU-wide ETS for buildings and transportation.[19] Croatia submitted its draft National Energy and Climate Plan (NECP) in July 2023, which is an important step towards the more ambitious 2030 energy and climate objectives.[20] The plan sets out targets and measures to increase the security of Croatia's energy supply and resilience with increased use of renewables. However, the EC's

[16] See World Bank (2023), and Leidecker T. and T. Bulman (2023), Improving the business environment to accelerate converge in Croatia.

[17] Croatia's institutions are relatively weak in the areas of public sector, business, and trade (World Bank, 2023).

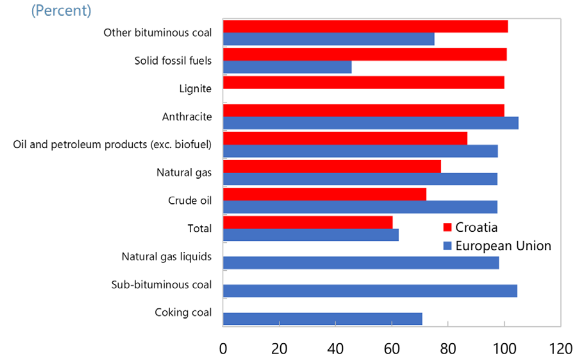
[18] See the accompanying 2024 Selected Issues Paper on housing affordability.

[19] See 2023 Article IV Consultation Selected Issues Paper. Carbon pricing will help reduce implicit subsidies on fossil fuels.

[20] See the NECP tracker.

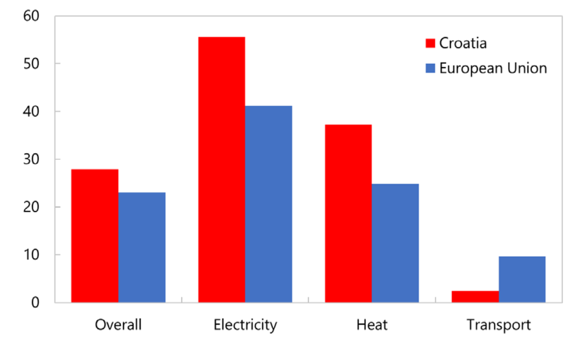
assessment identified several deficiencies, especially on energy efficiency. The NECP should be integrated with other strategic documents and decisions[21] and be subject to public consultation.

Energy Imports Dependency by Fuel, 2022
(Percent)



Source: Eurostat.

Share of Renewable Energy in Gross Final Energy Consumption: Sectors
(Percentage, 2022)



Source: Eurostat.

29. Efforts to address deficiencies in the AML/CFT regime should continue. In June 2023, Croatia was added to the list of countries under increased monitoring (the so-called grey list) by FATF, given deficiencies in the country's AML/CFT regime. Although progress has been made in addressing areas of strategic deficiencies, including the adoption of the National Risk Assessment of AML/CFT, authorities should keep the momentum in strengthening the effectiveness of its AML/CFT framework.

Authorities' Views

30. The authorities acknowledged the challenges that slow productivity growth, labor shortages, and housing affordability pose to Croatia's medium-term growth prospects and highlighted policy measures taken in this regard. They plan to leverage the funds under the NRRP to finance several projects to boost private investments and business dynamics. Financial instruments designed by the Croatia Development Bank target start-ups, and female and youth entrepreneurship. In collaboration with the European Investment Bank, the authorities are strengthening equity financing with the development of venture capital funds. They have also taken measures to attract and integrate foreign workers, including through streamlining the process to obtain work permits and extending the voucher scheme for learning Croatian. A "Job Plus" program was introduced in 2024 to provide support to people with only primary school education via employment counseling and social mentoring. An external evaluation of active labor market policies is planned for this year. The authorities see housing affordability as an important economic and social issue and are preparing a National Housing Policy Plan for 2030 to address the underlying supply gap. In particular, they are examining ways to activate the sizable existing vacant stock. The authorities consider energy efficiency and the decarbonization of transportation and industry as

[21] National and sectoral public investment plans (e.g., transport strategy, water management, digitalization) should be consistent with Croatia's climate objectives. Climate change should be included in central government guidelines prepared by the MOF and other ministries and the decision-making process on capital spending by SOEs and subnational governments should include climate change criteria.

priorities in preparation for the 2027 rollout of the new EU-wide Fit-for-55 rules. Finally, they have been implementing measures agreed with FATF to address deficiencies in the AML/CFT regime and expect to conclude the action plan according to the set timeline.

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31. The economy is expected to remain robust with gradual disinflation. Real GDP growth will be supported by buoyant domestic demand. Disinflation is expected to continue albeit gradually, as strong wage growth and tourism demand continue to exert pressures on services inflation. Inflation is projected to approach the ECB's target of 2 percent only in late 2025. Risks to the outlook are broadly balanced. The external position in 2023 is moderately stronger than the level implied by fundamentals and desirable policies. Subdued productivity and labor shortages pose challenges to Croatia's potential growth.

32. The authorities should reduce the fiscal stimulus in 2024 and implement their plan to meaningfully cut the overall deficit from 2025 and return to a structural primary balance by 2027. Recurrent fiscal expansion during a period of robust economic growth could fuel domestic demand and risks hampering disinflation and undermining competitiveness, as well as damaging Croatia's hard-won fiscal credibility. Prudence and decisive reforms are also warranted to create space for large long-term spending needs and build buffers for future shocks. The planned reduction of the headline deficit by about ⅔ percent of GDP in 2025 is achievable. Under this consolidation path, Croatia's public debt is projected to remain on a solid downward path with a low risk of sovereign stress risk. Meanwhile, the authorities need to strengthen the medium-term fiscal framework and the Fiscal Policy Commission can play a stronger role in promoting sustainable public finances.

33. Addressing Croatia's large investment and social needs calls for broadening the tax base, reducing spending rigidity, and increasing spending efficiency. Staff reiterates the recommendation to introduce a modern value-based property tax and remove the excessively favorable taxation on short-term rental income. Removing explicit and implicit subsidies on fossil fuels would raise revenue while supporting the green transition, conditional on targeted support to protect the most vulnerable and a good communication strategy. Though the recent wage reform could enhance the fairness and competitiveness of the public remuneration system, further measures are needed to reduce the size of public wage bill in the coming years, including by rationalizing the public workforce through a functional review. Reforms to contain fiscal costs and ensure sustainability of the pension and healthcare systems also need to be undertaken to prepare for the pending demographic pressures. The authorities should stay the course to improve public investment management and strengthen corporate governance and fiscal risk management of SOEs.

34. Continued vigilance and close monitoring are warranted to safeguard financial stability. The financial sector has weathered well the monetary tightening and systemic risks appear manageable, with the banking system well-capitalized and highly liquid. Supervisors should continue to ensure that banks maintain adequate capital buffers and diligently monitor credit risks.

Staff supports the tight stance of capital-based macroprudential measures and encourages the authorities to continue assessing adequate level of CCyB. The RRE market remains buoyant albeit stabilizing, and the authorities should continue close monitoring for signs of overheating and risk buildup. Should strong market momentum begin to resume, the authorities should stand ready to introduce explicit borrower-based measures to preempt future financial stability risks.

35. Boosting Croatia's medium-term growth prospects calls for addressing labor shortages, revitalizing productivity, improving housing affordability, and accelerating the green transition. The multidimensional nature of labor shortages requires coordinated policies to foster higher participation, reduce skills mismatch, facilitate labor mobility, and reduce net emigration including through integrating foreign workers. Enhancing productivity also requires comprehensive reforms to reduce barriers to entry, improve the regulatory framework and the quality of institutions, and expand financing options for innovative investment. Croatia should keep the momentum in strengthening the AML/CFT regime to exit FATF's grey list. Furthermore, policies to boost housing supply, including better use of the sizable existing vacant stock and modernizing and streamlining regulations, are crucial to sustainably address housing affordability. Finally, more efforts are needed to accelerate the green transition. Reaching the EU's climate mitigation goals requires economy-wide carbon pricing, reinforced by sectoral policies and targeted support to the vulnerable.

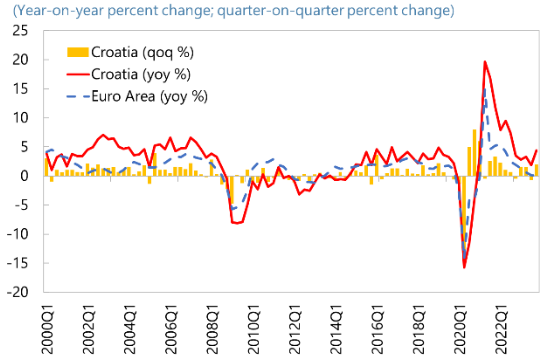
36. It is expected that the next Article IV consultation will take place on the standard 12-month cycle.

Figure 1. Croatia: Real Sector Developments

Growth moderated from the strong post-COVID rebound…

Real GDP Growth

(Year-on-year percent change; quarter-on-quarter percent change)

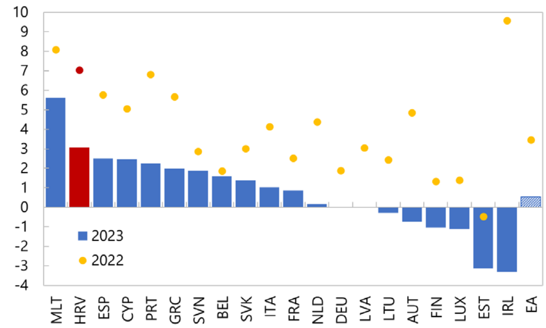


Sources: Eurostat; and Haver Analytics.

…but continued to outperform many eurozone countries.

Real GDP Growth Comparison

(Year-on-year percent change)

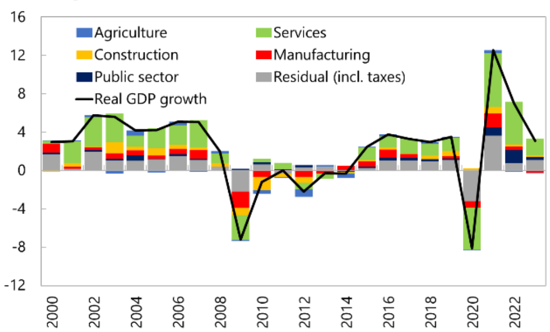


Source: Eurostat; and Haver Analytics.

Services and public sector activities were the main growth driver, while manufacturing lagged.

Real GDP Growth: Production Side

(Percent, gross value added)

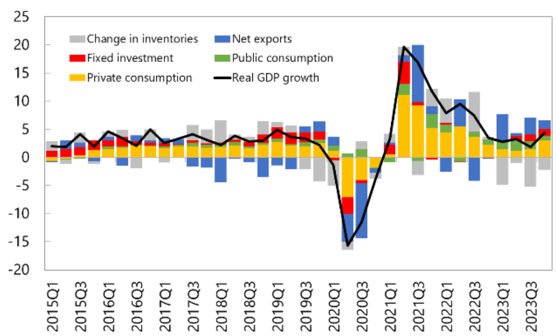


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Growth was supported by resilient domestic demand and net exports given improved terms of trade.

Contribution to Real GDP Growth

(Year-on-year percent change)

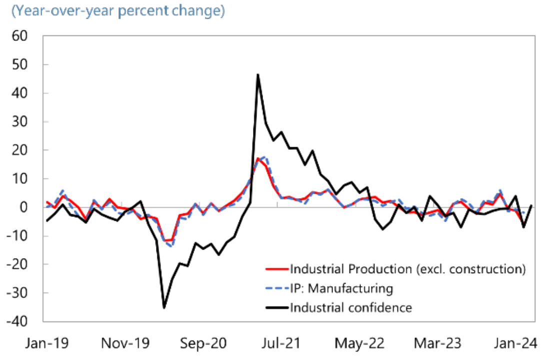


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Industrial production indicated subdued activities…

Industrial Production and Confidence

(Year-over-year percent change)

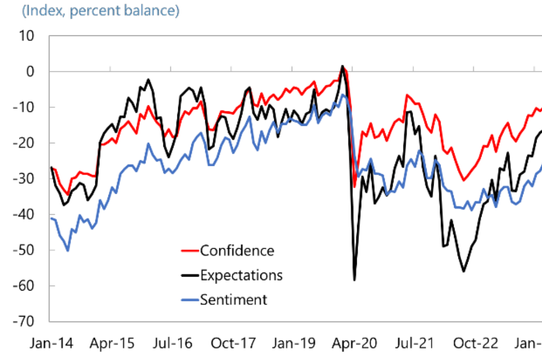


Sources: Eurostat; Croatian Bureau of Statistics; Haver Analytics; and IMF staff calculations.

…but consumer confidence improved considerably.

Consumer Confidence

(Index, percent balance)



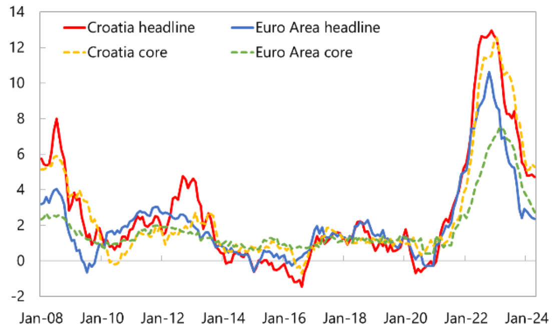
Sources: European Commission; Ipsos Puls; Croatian National Bank; and Haver Analytics.

Figure 2. Croatia: Inflation Developments

Croatia's headline and core inflation decelerated considerably but remained above the Eurozone average.

HICP Headline and Core Inflation

(Year-on-year percent change)

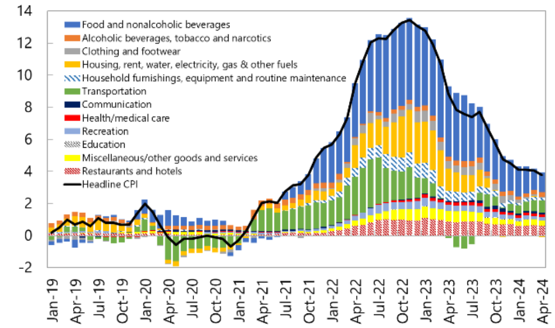


Sources: Eurostat; and Haver Analytics.

The headline inflation was kept at elevated levels by food and tourism-related inflation…

Contribution to CPI Inflation

(Year-on-year percent change)

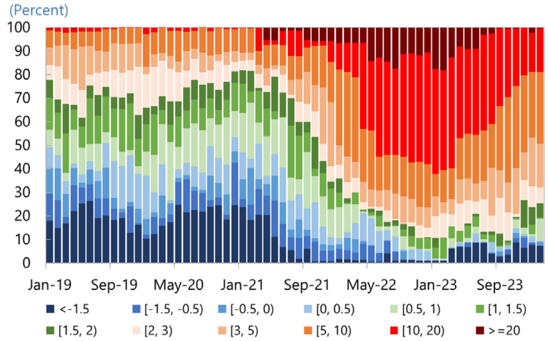


Sources: Croatian Bureau of Statistics; Haver Analytics; and IMF staff calculations.

…but the high-inflation segments started to narrow since 2023.

HICP Inflation Dispersion 1/

(Percent)

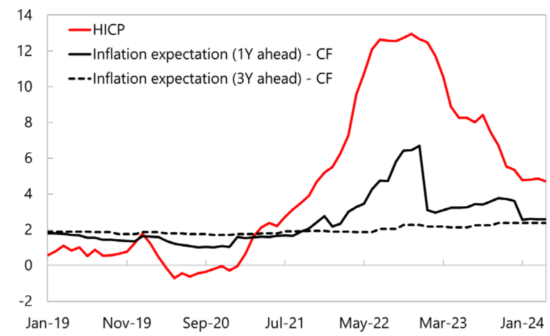


Sources: Eurostat; Haver Analytics; and IMF staff calculations.
1/ Share of consumption basket within each inflation band.

Both short-term (1-year-ahead) and medium-term (3-year-ahead) inflation expectations remained stable.

HICP Headline Inflation vs. Inflation Expectations

(Year-on-year percent change)

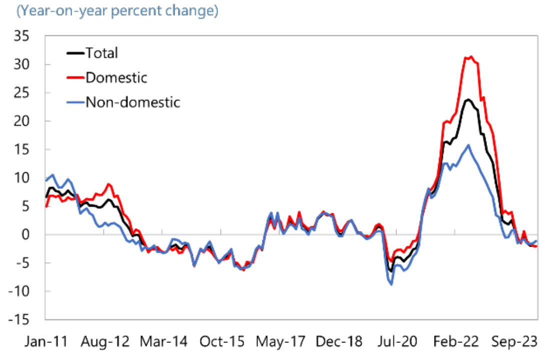


Sources: Consensus Forecast (CF); Eurostat; Croatian Bureau of Statistics; and Haver Analytics.

Producer price indices largely normalized as of end-2023…

Producer Price Index

(Year-on-year percent change)

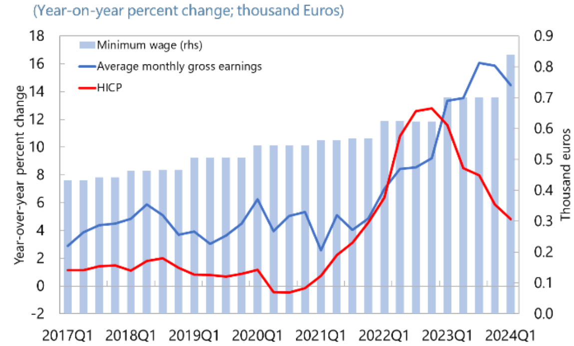


Sources: Croatian Bureau of Statistics; Haver Analytics; and IMF staff calculations.

…however, wages picked up fast and real wage growth turned positive in early 2023.

Inflation and Wages

(Year-on-year percent change; thousand Euros)

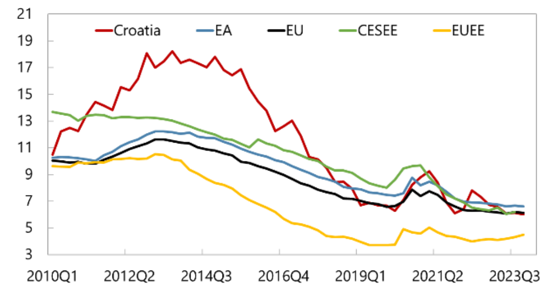


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Figure 3. Croatia: Labor Market Developments

Unemployment has fallen to its lowest level since Croatia joined the EU.

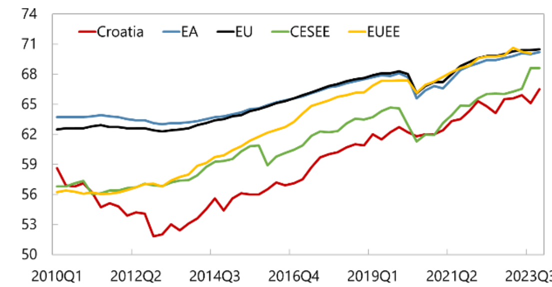
Unemployment Rate
(Percent; seasonally adjusted)



Sources: Haver Analytics; and IMF staff calculations.
Note: CESEE=Central, Eastern and Southeastern Europe; includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, and Ukraine; EA=Euro Area; EU=European Union; EUEE=selected emerging economies from European Union group includes Bulgaria, Hungary, Poland, and Romania.

The employment rate has continued to grow, but it is still lower than the EU average.

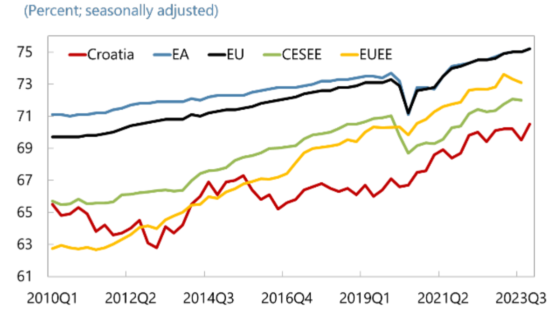
Employment Rate
(Percent; seasonally adjusted)



Sources: Haver Analytics; and IMF staff calculations.
Note: CESEE=Central, Eastern and Southeastern Europe; includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, and Ukraine; EA=Euro Area; EU=European Union; EUEE=selected emerging economies from European Union group includes Bulgaria, Hungary, Poland, and Romania.

Labor force participation has increased since the pandemic, although still lower than in peer countries.

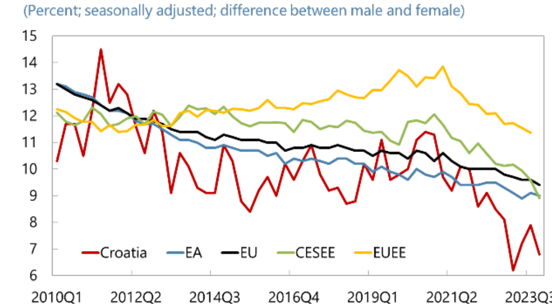
Labor Force Participation Rate
(Percent; seasonally adjusted)



Sources: Haver Analytics; and IMF staff calculations.
Note: CESEE=Central, Eastern and Southeastern Europe; includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, and Ukraine; EA=Euro Area; EU=European Union; EUEE=selected emerging economies from European Union group includes Bulgaria, Hungary, Poland, and Romania.

The gender gap has been declining and is now below EU average.

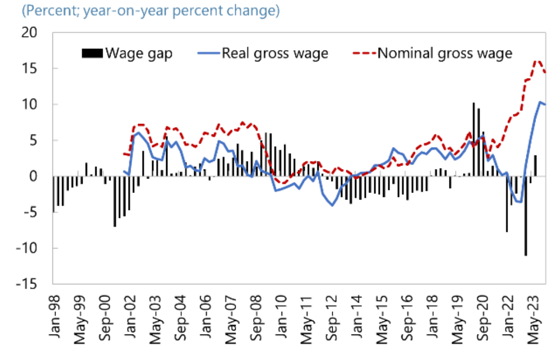
Gender Gap for Labor Force Participation Rate
(Percent; seasonally adjusted; difference between male and female)



Sources: Haver Analytics; and IMF staff calculations.
Note: CESEE=Central, Eastern and Southeastern Europe; includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, and Ukraine; EA=Euro Area; EU=European Union; EUEE=selected emerging economies from European Union group includes Bulgaria, Hungary, Poland, and Romania.

Real wages grew faster than productivity in the third quarter of 2023.

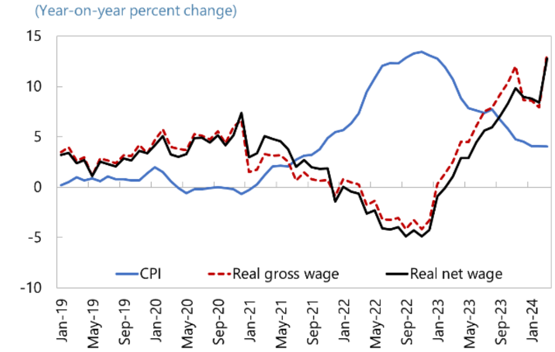
Wage Growth and Wage Gap
(Percent; year-on-year percent change)



Sources: Haver Analytics; and IMF staff calculations.

Real wages have been steadily growing since 2023, reflecting the decline in inflation and nominal wage growth.

Changes of Real Wage and CPI
(Year-on-year percent change)

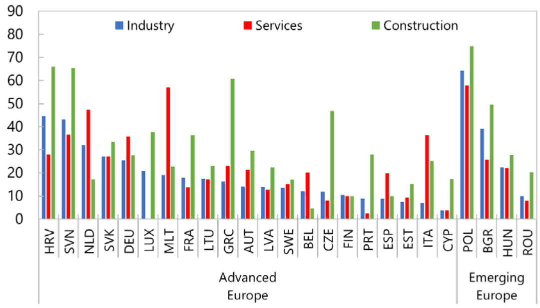


Sources: Haver Analytics; and IMF staff calculations.

Figure 3. Croatia: Labor Market Developments (Concluded)

The labor market remains tight, especially in the construction sector.

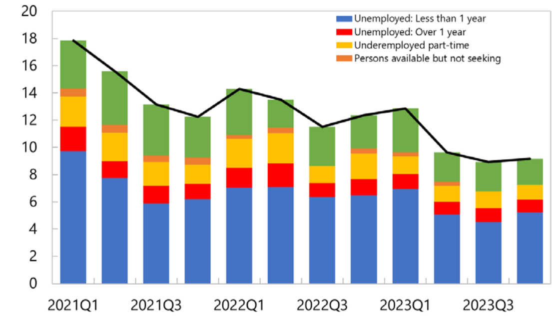
Labor Shortages, 2024Q2
(Percent balance; seasonally adjusted)



Source: European Commission Business and Consumer Survey; and IMF staff calculations.
Note: Percent balance corresponds to the percent of respondents claiming that labor is a factor limiting production/business minus the percent of respondents reporting that it is not.

Labor market slack has been steadily declining reflecting an increasing tight labor market.

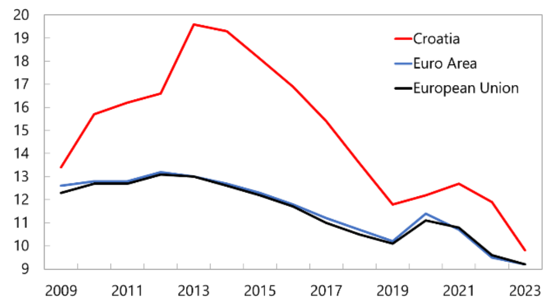
Labor Market Slack
(Percent of labor force)



Sources: Croatian Bureau of Statistics; Eurostat; Haver Analytics; and IMF staff calculations.
Note: Data not available for category Persons available to work but not seeking in 2023Q3 and 2023Q4.

However, youth unemployment is still larger than the EU average, although much lower than in 2013.

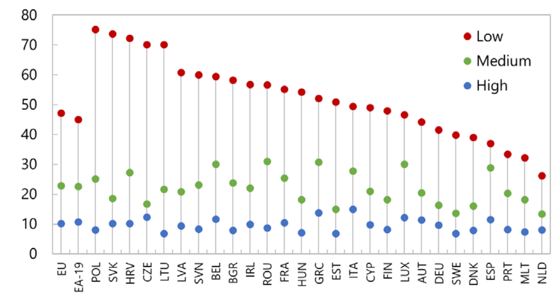
Youth Neither in Employment Nor in Education or Training
(Percent of total population; youth group: 15-24 years of age)



Source: Eurostat.
Note: Chart shows not employed youth population (15-24 years of age) neither in employment nor in education or training (NEET).

Croatia has a large share of inactive population among the low educated workers.

Share of Inactive Population by Educational Attainment, 2023
(Percent of total population aged 15-64 for each level of education)

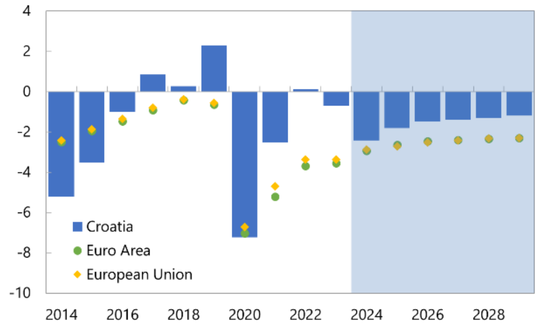


Sources: Eurostat; and IMF staff calculations.
Note: Inactive population refers to people outside the labor force. Low level: less than primary, primary and lower secondary education; Medium level: upper secondary and post-secondary non-tertiary education; and High level: tertiary education.

Figure 4. Croatia: Fiscal Developments and Projections

Overall fiscal balance worsened in 2023 after recording a small surplus in 2022.

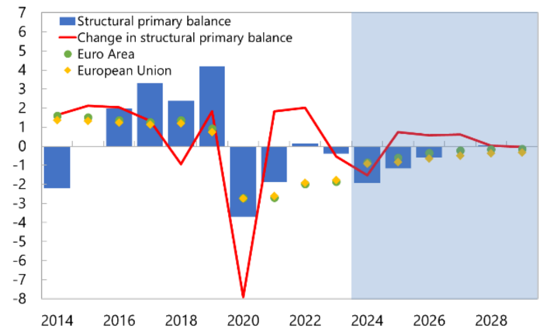
General Government Overall Balance
(Percent of GDP)



Source: IMF World Economic Outlook.

Structural primary balance also deteriorated in2023, by ½ ppts of GDP, after recording a small surplus in 2022. .

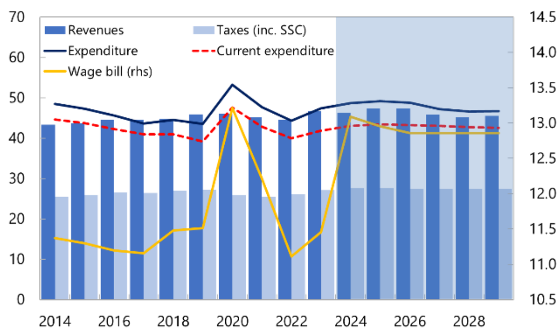
Structural Primary Balance
(Percent of Potential GDP)



Sources: IMF World Economic Outlook; and IMF staff calculations.

As cost-of-living support measures phase out eventually, expenditure is expected to come down to pre-pandemic levels except for compensation of employees.

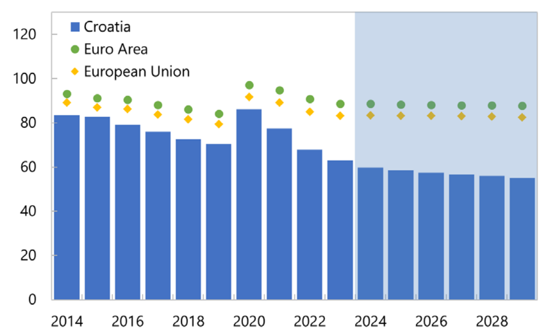
Revenues and Expenditures
(Percent of GDP)



Sources: IMF World Economic Outlook; and IMF staff calculations.

…and government debt continues to decline.

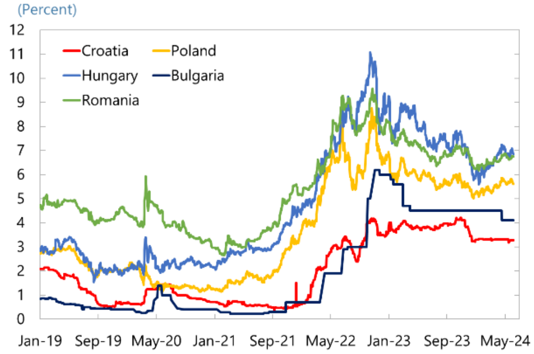
General Government Gross Debt
(Percent of GDP)



Sources: Eurostat; IMF World Economic Outlook; and IMF staff calculations.

Government bond yields have remained lower than those of peer EU countries…

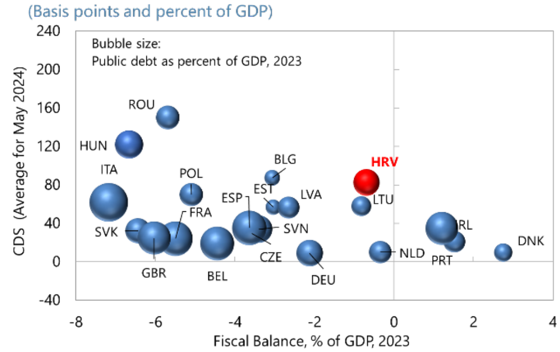
Benchmark Government Bond Yields (10-year)
(Percent)



Sources: Refinitiv; and Haver Analytics.

…and so have credit default swaps.

Sovereign 5Y CDS and Fiscal Balance
(Basis points and percent of GDP)

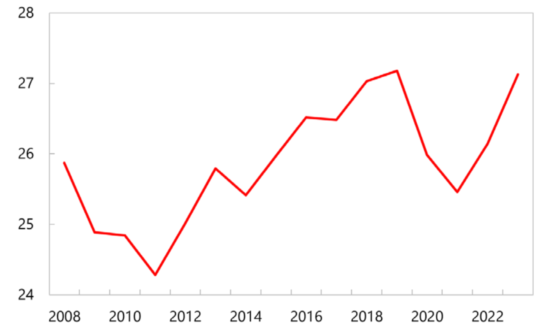


Sources: IMF World Economic Outlook; Bloomberg Finance L.P.; and IMF staff calculations.

Figure 5. Croatia: Tax Revenues

Total tax revenue has been around 25 percent of GDP on average during 2008-2023…

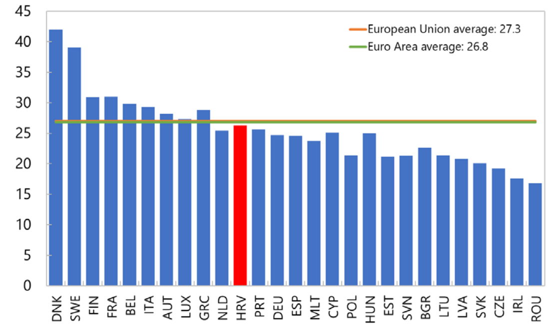
General Government Revenue: Taxes
(Percent of GDP)



Sources: Eurostat; and IMF staff calculations.

…with the tax-to-GDP ratio slightly falling below the EU and EA average following the tax reforms in recent years.

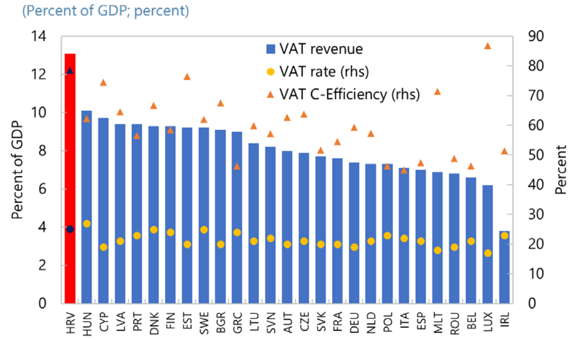
General Government Total Tax Receipts, 2022
(Percent of GDP)



Source: Eurostat.

VAT accounts for about ¾ of total tax revenues in Croatia with high c-efficiency.

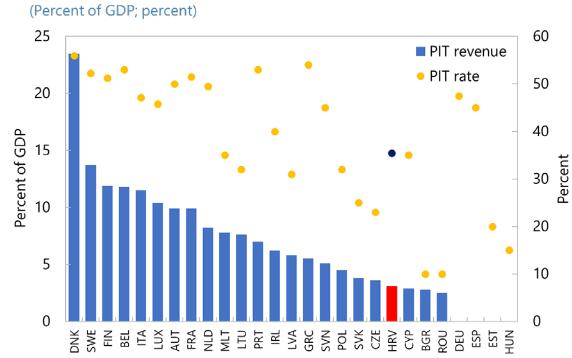
VAT Revenue, Standard Rate and C-Efficiency, 2022
(Percent of GDP; percent)



Sources: Eurostat; European Commission; IMF World Economic Outlook; and IMF staff calculations.
Note: C-Efficiency is calculated as (VAT revenue) / [(VAT rate) * (Total consumption)].

Revenues from the taxation of income and wealth are considerably lower than peers', with lower productivity.

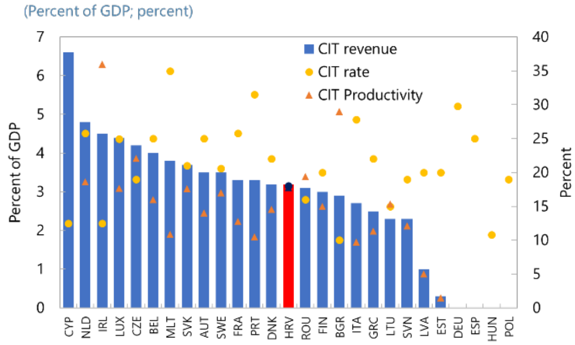
PIT Revenue and Top Combined Rate, 2022
(Percent of GDP; percent)



Sources: Eurostat; European Commission; IMF World Economic Outlook; and IMF staff calculations.

Corporate income tax also has low productivity, reflecting multiple rates and exemptions.

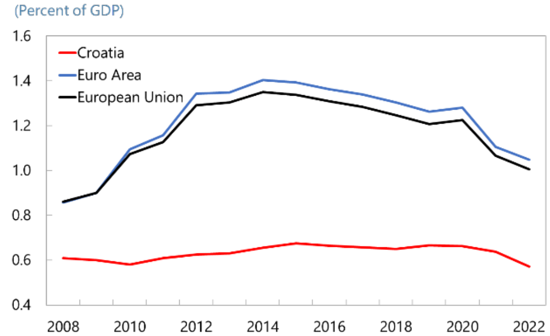
CIT Revenue, Top Combined Rate and Productivity, 2022
(Percent of GDP; percent)



Sources: Eurostat; European Commission; IMF World Economic Outlook; and IMF staff calculations.
Note: CIT productivity is calculated as (CIT revenue) / [(CIT rate) * (GDP)].

The current fragmented system of volume-based property taxation has relatively low revenue-raising capability.

Taxes on Property
(Percent of GDP)

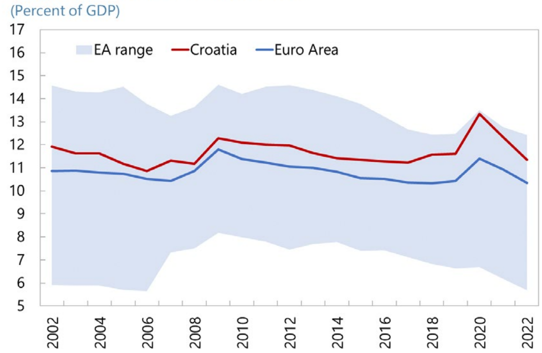


Source: Eurostat; and European Commission.
Note: Recurrent taxes on immovable property.

Figure 6. Croatia: Government Wage Bill and Employment

Croatia has a high public wage bill in percent of GDP…

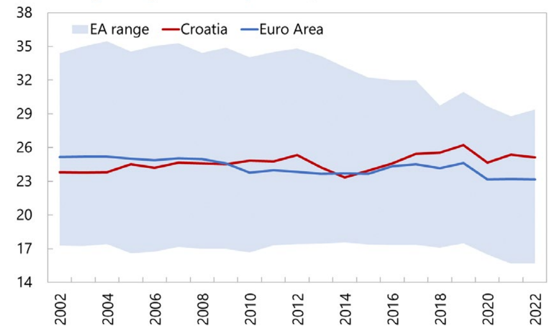
Wage Bill: Croatia vs. Euro Area
(Percent of GDP)



Source: IMF FAD Government Compensation and Employment Dataset.

…and of total public spending.

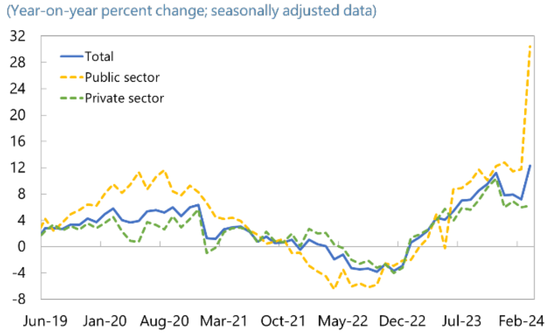
Wage Bill: Croatia vs. Euro Area
(Percent of general government expenditure)



Source: IMF FAD Government Compensation and Employment Dataset.

Public sector has led the recent wage increase…

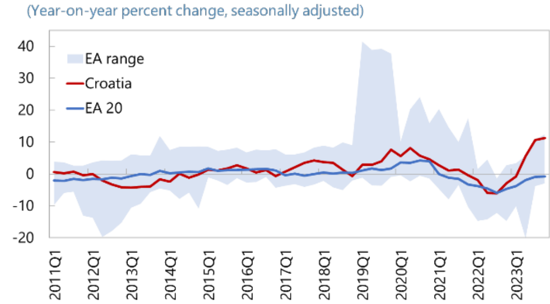
Average Real Wage Growth
(Year-on-year percent change; seasonally adjusted data)



Sources: Croatian Bureau of Statistics; Eurostat; Haver Analytics; and IMF staff calculations.
Note: Public sector refers to public administration and defense, compulsory social security, education, and human health and social work activities.

…with public real wage growth among the highest in the euro area since 2022.

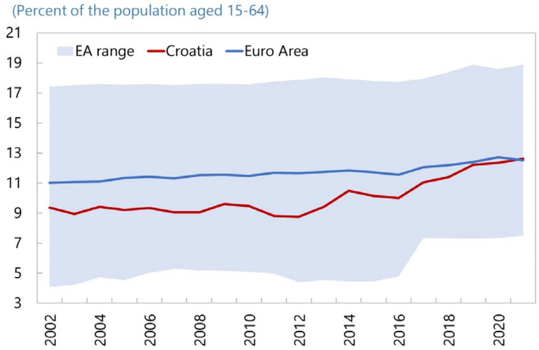
Real Wages and Salaries Growth, Public Sector
(Year-on-year percent change, seasonally adjusted)



Sources: Croatian Bureau of Statistics; Eurostat; Haver Analytics; and IMF staff calculations.
Note: Public sector refers to public administration and defense, compulsory social security, education, and human health and social work activities. From 2019Q1, some of Lithuania's social contributions that used to be payable by the employer are now due to be paid by the employee. The payslip includes those social contributions under the gross earnings paid to the employee.

Employment in the general government (as a share of the working age population) has gone up steadily since 2016 and caught up with the average of the euro area in 2021.

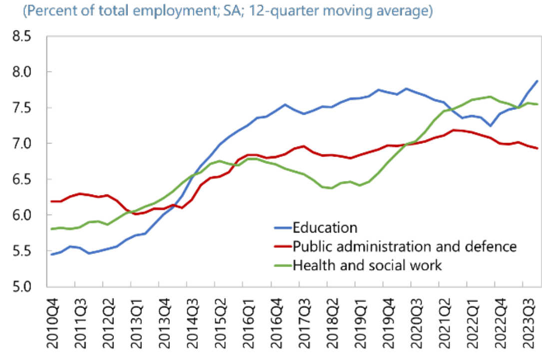
Government Employment: Croatia vs. Euro Area
(Percent of the population aged 15-64)



Source: IMF FAD Government Compensation and Employment Dataset.

The rise in public employment is driven by the education and healthcare sectors.

Government Employment in Selected Sectors
(Percent of total employment; SA; 12-quarter moving average)



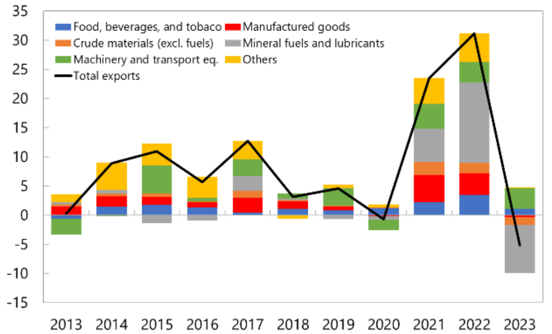
Sources: Haver Analytics; and IMF staff calculations.

Figure 7. Croatia: External Sector Developments

Goods exports declined in 2023, given the slowdown in main trading partners, but less than…

Contribution to Export Goods Growth

(Year-on-year percent change; percent)

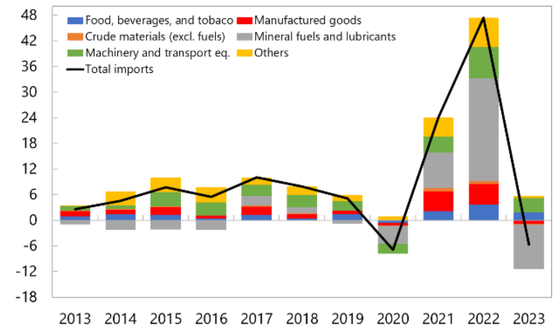


Sources: Croatian Bureau of Statistics; Haver Analytics; and IMF staff calculations.

…the contraction of imports.

Contribution to Import Goods Growth

(Year-on-year percent change; percent)

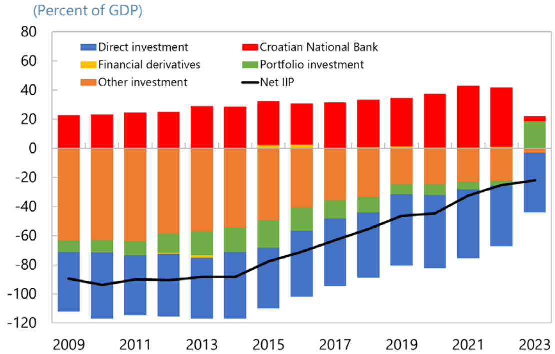


Sources: Croatian Bureau of Statistics; Haver Analytics; and IMF staff calculations.

The NIIP continues to improve as the holdings of foreign assets increase while portfolio liabilities narrow…

Net International Investment Position

(Percent of GDP)

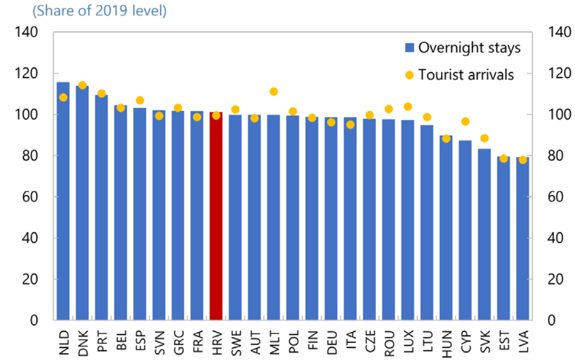


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

…strong inbound tourism continued to support services exports.

Tourist Arrivals and Overnight Stays, 2023

(Share of 2019 level)

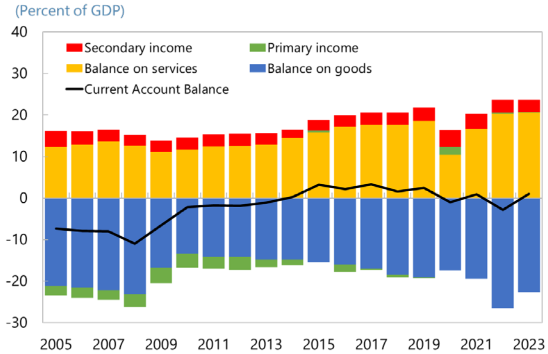


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Narrowing trade deficits led to an improvement in the current account balance…

Current Account Balance

(Percent of GDP)

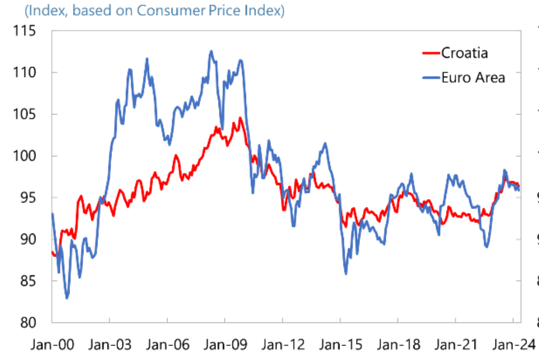


Sources: IMF World Economic Outlook; and IMF staff calculations.

…while the consumer price-based REER has slightly appreciated.

Real Effective Exchange Rate

(Index, based on Consumer Price Index)



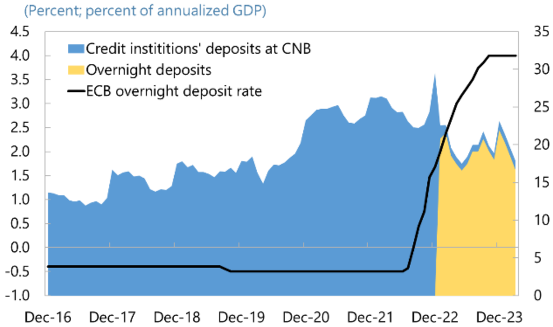
Sources: IMF Information Notice System database (INS).

Figure 8. Croatia: Monetary Stance and Bank Lending to the Private Sector

Banks have continued to maintain significant liquidity …

Overnight Interest Rate and Bank Liquidity

(Percent; percent of annualized GDP)

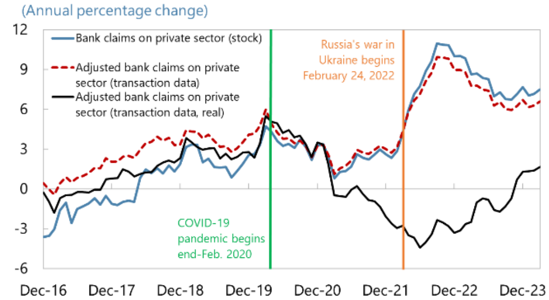


Sources: Croatian National Bank (CNB); Haver Analytics; and IMF staff calculations.
Note: Credit insititutions' deposits at CNB include both the required and excess reserves. Annualized GDP is 12 months cumulated GDP of quarterly GDP split equally into month.

…which facilitated solid bank lending to the private sector in nominal term.

Bank Claims on Private Sector, 2016-March 2024

(Annual percentage change)

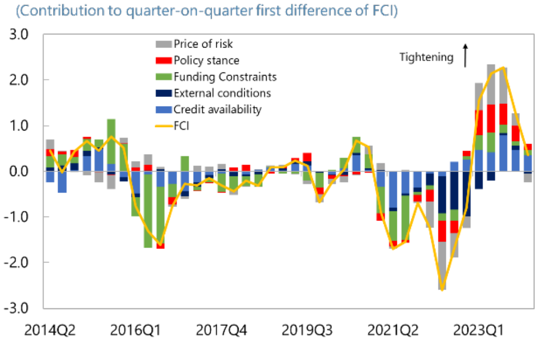


Sources: Croatian National Bank; and IMF staff calculations.
Note: Claims on private sector include claims on households, non-financial corporations, and local governments. Dotted line based on transaction data, i.e. adjusted for exchange rate changes, sales and write-offs of NPLs. For details, see Annex 1 in *CNB Monthly Bulletin No. 221*, February 2016, Croatian National Bank. The real series is deflated by HICP.

Financial conditions became more restrictive in 2023 driven by rising price of risk and the ECB's tightening…

FCI Changes, 2014Q2-2024Q1

(Contribution to quarter-on-quarter first difference of FCI)

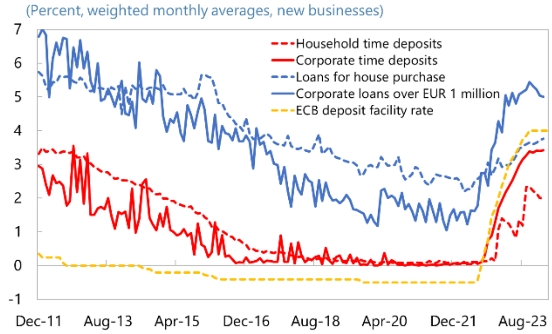


Sources: IMF staff calculations and projections.
Note: FCI is not scaled. 2023Q4 and 2024Q1 are forecasts.

…demonstrated by rising interest rates, with faster pass-through for corporates than households.

Lending and Deposit Rates of Banks

(Percent, weighted monthly averages, new businesses)

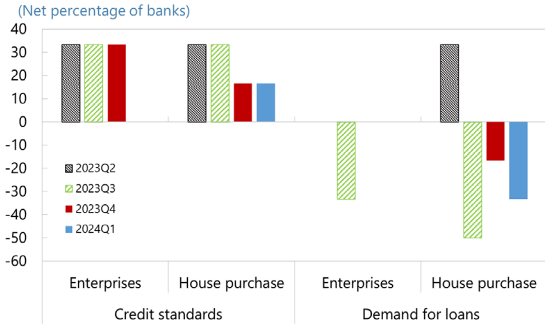


Source: Croatian National Bank.
Note: Starting on January 2023, all data refer only to deposits and loans in euro. Deposit rates are the weighted average of rates applied to short-term and long-term deposits.

Banks have generally tightened their lending standards to both households and firms…

Credit Standards and Demand for Loans, Past 3-Month

(Net percentage of banks)

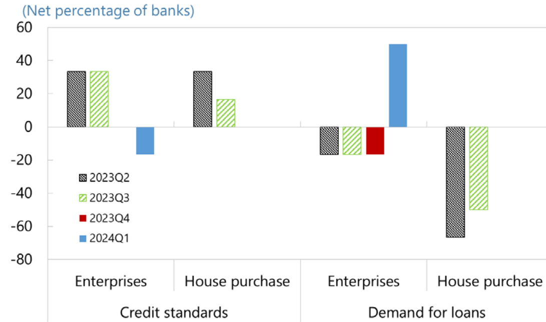


Source: Croatian National Bank: Bank Lending Survey.
Note: For credit standards, positive value = tightening, negative value=easing. For demand for loans, positive value=increased demand, negative value=decreased demand.

…but the short-term expected credit conditions seemed to have stabilized by end-2023.

Credit Standards and Demand for Loans, Next 3-Month

(Net percentage of banks)



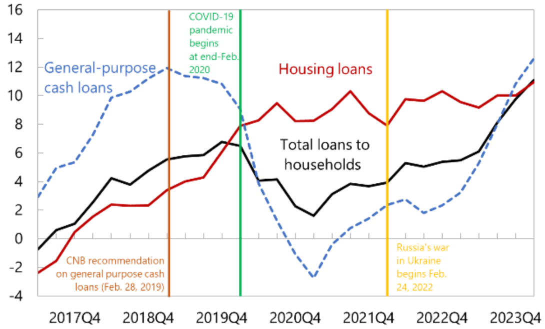
Source: Croatian National Bank: Bank Lending Survey.
Note: For credit standards, positive value=tightening, negative value=easing. For demand for loans, positive value=increased demand, negative value=decreased demand.

Figure 9. Croatia: Balance Sheets of Households and Non-Financial Corporations

Lending to households accelerated in 2023 driven by rising cash loans while housing loans remained strong.

Growth Rates of Different Loans to Households, 2017-2024Q1

(Annual percentage change, stocks)

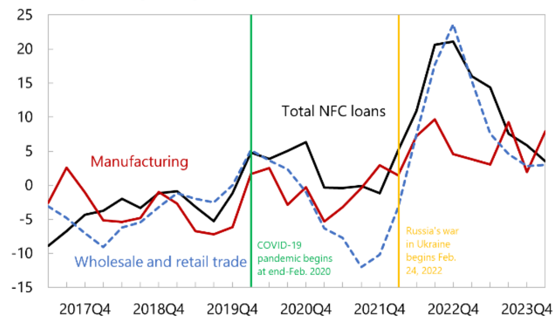


Sources: Croatian National Bank (CNB); and IMF staff calculations.

Growth of credit to NFCs receded from their peak in 2022 triggered by the energy crisis but remained solid.

Growth Rates of Different Loans to NFCs, 2017-2024Q1

(Annual percentage change, stocks)

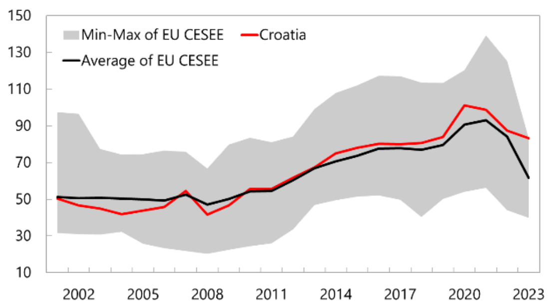


Sources: Croatian National Bank (CNB); and IMF staff calculations.
Note: Loans to manufacturing and trade account for 20% and 19% of total NFC loans, respectively.

Households have maintained positive net financial positions with notable improvement since the GFC.

Net Financial Assets of Households

(Percent of GDP)

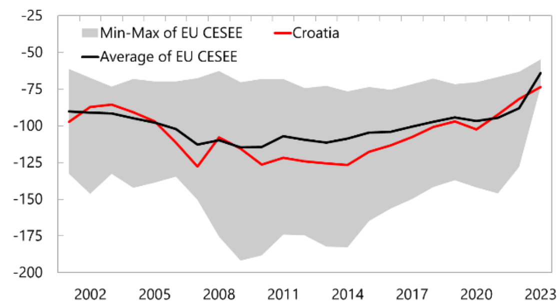


Sources: Eurostat; and IMF staff calculations.
Note: Occasional data breaks, as indicated by Eurostat. Data from 2022 and 2023Q3 are preliminary. EU CESEE countries include Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, and Slovakia. Round dot show quarterly value.

NFCs have maintained negative yet improving net financial positions in recent years.

Net Financial Assets of Non-Financial Corporations

(Percent of GDP)

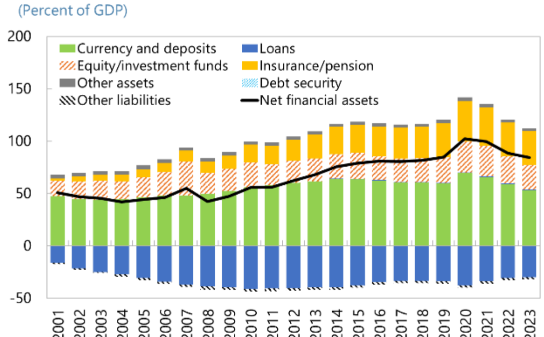


Sources: Eurostat; and IMF staff calculations.
Note: Occasional data breaks, as indicated by Eurostat. Data from 2022 and 2023Q3 are preliminary. EU CESEE countries include Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, and Slovakia. Round dot show quarterly value.

The improvement of households have come from rising deposits and pension savings, and some deleveraging of long-term loans.

Balance Sheet Decomposition of Households

(Percent of GDP)

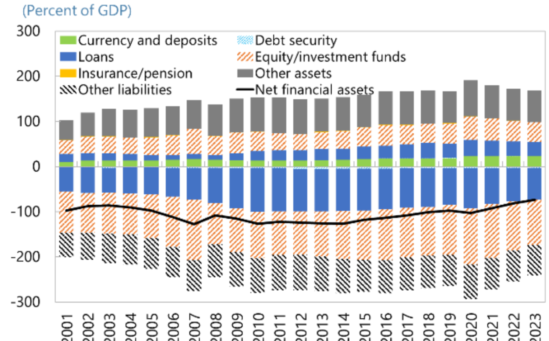


Sources: Eurostat; and IMF staff calculations.
Note: Positive values denote assets; negative values denote liabilities.

NFCs have also relied on equity and other liabilities (e.g., trade credits) for financing in addition to bank funding.

Balance Sheet Decomposition of NFCs

(Percent of GDP)

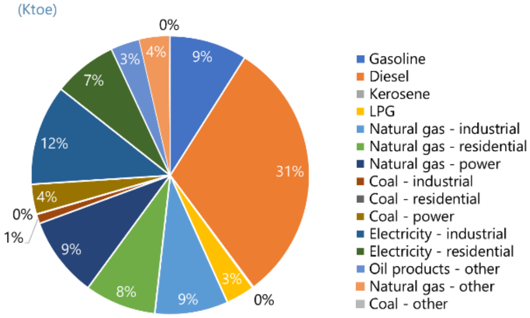


Sources: Eurostat; and IMF staff calculations.
Note: Positive values denote assets; negative values denote liabilities.

Figure 10. Croatia: Energy Subsidies Overview

Croatia is still heavily reliant on fossil fuels.

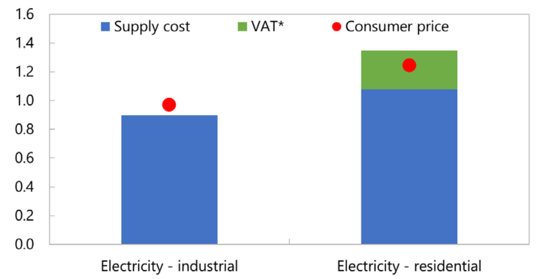
Consumption by Fuel and Sector
(Ktoe)



Sources: Simon Black; Antung A. Liu; Ian W.H. Parry; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.

There are implicit subsidies, for instance on electricity for households...

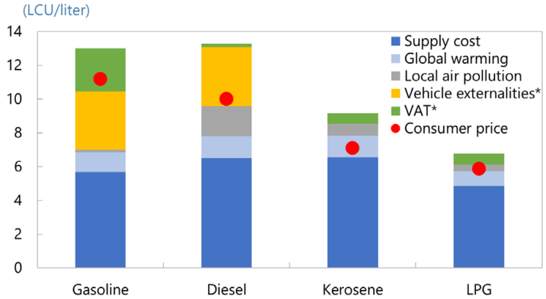
Electricity Pricing, 2022
(LCU/kWH)



Sources: Simon Black; Antung A. Liu; Ian W.H. Parry; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.
Note: * weighted by share of consumption relavent for the externality (e.g., VAT is only applied to final consumption).

...and all liquid fuels.

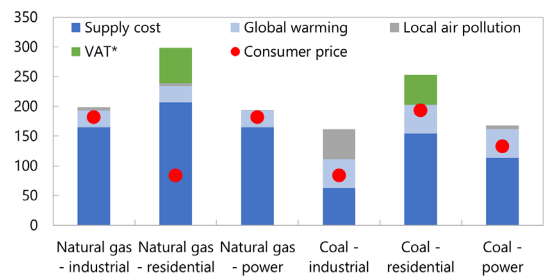
Liquid Fuels Pricing, 2022
(LCU/liter)



Sources: Simon Black; Antung A. Liu; Ian W.H. Parry; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.
Note: * weighted by share of consumption relavent for the externality (e.g., VAT is only applied to final consumption).

Natural gas prices do not capture all externalities, with the final price even lower than the supply cost for natural gas for households (explicit subsidies)...

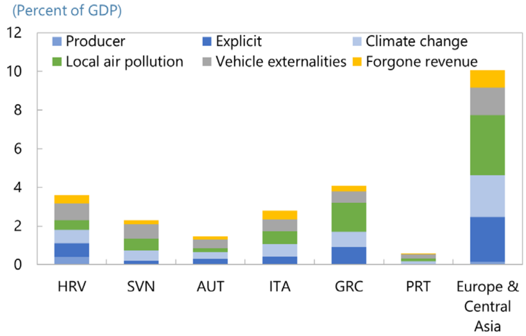
Natural Gas and Coal Pricing, 2022
(LCU/GJ)



Sources: Simon Black; Antung A. Liu; Ian W.H. Parry; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.
Note: * weighted by share of consumption relavent for the externality (e.g., VAT is only applied to final consumption).

*Croatia's subsidies of fossil fuels are significant despite larger potential in renewables. **

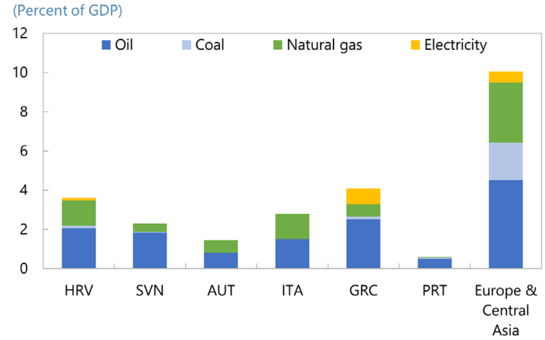
Subsidies by Component, 2022
(Percent of GDP)



Sources: Simon Black; Antung A. Liu; Ian W.H. Parry; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.

Oil and natural gas subsidies are larger than in neighboring EA countries.

Subsidies by Fuel, 2022
(Percent of GDP)



Sources: Simon Black; Antung A. Liu; Ian W.H. Parry; Nate Vernon, 2023, IMF Fossil Fuel Subsidies Data: 2023 Update, Working Paper No. 2023/169, August.

*See 2023 Article IV Consultation Selected Issues Paper.

Table 1. Croatia: Selected Economic Indicators, 2019–2029

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Prel.			*Projections*			
Output, unemployment, and prices				*(Percent change, annual average, unless otherwise indicated)*							
Real GDP growth	3.4	-8.5	13.0	7.0	3.1	3.4	2.9	2.7	2.6	2.6	2.6
Contributions:											
Domestic demand	3.5	-3.2	8.1	7.5	1.3	3.6	2.8	2.7	2.7	2.7	2.7
Net exports	0.0	-5.3	5.0	-0.5	1.7	-0.2	0.1	0.1	0.0	-0.1	-0.1
Unemployment rate	7.8	9.0	8.1	6.8	6.2	5.6	5.5	5.5	5.5	5.5	5.5
HICP inflation (avg.)	0.8	0.0	2.7	10.7	8.4	4.2	2.8	2.2	2.2	2.2	2.2
Saving and investment (*percent of GDP*)											
Domestic investment	22.4	23.8	22.6	26.7	22.0	21.5	21.4	22.0	22.7	23.3	23.7
Domestic saving	24.9	22.9	23.6	24.0	23.1	23.1	22.2	22.2	22.8	23.3	23.6
Government	6.9	-2.0	1.8	4.7	4.1	3.2	3.3	3.4	3.1	3.2	3.3
Non-government	18.1	24.9	21.8	19.3	18.9	19.9	18.9	18.8	19.7	20.1	20.3
Government sector (*ESA 2010 definition*)											
General government revenue	45.9	46.0	45.2	44.5	46.7	46.3	47.3	47.3	45.9	45.3	45.5
General government expenditure	43.6	53.3	47.7	44.4	47.4	48.7	49.1	48.8	47.3	46.6	46.7
General government balance	2.3	-7.2	-2.5	0.1	-0.7	-2.4	-1.8	-1.5	-1.4	-1.3	-1.2
Structural balance 1/	2.2	-5.6	-3.2	-1.1	-1.7	-3.3	-2.4	-1.8	-1.5	-1.3	-1.2
Structural primary balance	4.2	-3.7	-1.9	0.1	-0.4	-1.9	-1.2	-0.6	0.0	0.1	0.0
Structural primary balance excl. net EU grants	1.9	-7.6	-5.7	-3.1	-4.4	-4.6	-4.7	-4.4	-2.3	-1.6	-1.9
General government debt 2/	70.4	86.1	77.5	67.8	63.0	59.7	58.4	57.5	56.7	55.9	55.0
Balance of payments (*percent of GDP*)											
Current account balance	2.5	-1.0	1.0	-2.8	1.1	1.6	0.8	0.2	0.1	0.0	-0.1
Capital account	1.6	2.1	2.4	2.4	2.9	2.3	2.6	2.9	2.5	2.2	1.9
Financial account	-4.4	-1.0	-2.8	1.5	-1.6	-3.8	-3.4	-3.2	-2.6	-2.2	-1.9
Debt and reserves											
Gross official reserves (*billions of euros*)	18.6	18.9	25.0	27.9	...	...	...	...	...	...	...
IMF metric 3/	13.3	13.0	15.1	17.1	...	...	...	...	...	...	...
IMF metric (percent) 3/	139.5	146.1	165.9	163.4	...	...	...	...	...	...	...
In months of imports in goods and services (*based on next year level*)	7.8	9.3	9.8	7.5	...	...	...	...	...	...	...
Total external debt (*percent of GDP*) 4/	73.4	81.0	80.3	72.9	83.7	77.5	73.0	69.2	66.2	63.5	61.0
Total external debt excl. CNB share (*percent of GDP*)	71.2	79.3	74.2	66.7	57.9	53.6	50.4	47.8	45.8	44.0	42.4
Money and credit				*(End of period unless otherwise indicated, change in percent)*							
Broad money (*M3*)	3.8	11.5	15.0	10.7	21.3	...	...	...	...	...	...
Claims on other domestic sectors 5/	2.6	3.3	2.6	10.0	7.7	...	...	...	...	...	...
Interest rates											
12-month average T-bill rate (*in kuna until 2023, then euros*)	0.1	0.1	0.0	0.1	3.1	...	...	...	...	...	...
10-year government bond yield	0.7	0.6	0.1	2.8	3.7	...	...	...	...	...	...
Exchange rate											
Real effective exchange rate (*percent, "-" = appreciation*)	-1.3	-1.3	-0.1	0.2	3.5	...	...	...	...	...	...
Memorandum items:											
Nominal GDP (*billions of euros*)	55.3	51.0	58.9	68.4	76.5	82.5	87.7	92.3	96.8	101.5	106.5

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.

1/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP. Includes the one-offs related to the COVID-19 package in 2020-2021 and the energy crisis in 2022-2024.

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

3/ IMF, 2015, “Assessing Reserve Adequacy-Specific Proposals” IMF Policy Paper, Washington: International Monetary Fund.

4/ With the entry of Rep. of Croatia into the euro area in January 2023, there was an increase in gross foreign debt fro the amount of liabilities related to the distribution of euro banknotes within the Eurosystem.

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

Table 2. Croatia: Medium-Term Baseline Scenario, 2019–2029

(Percent of GDP, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Prel.	*Projections*					
Real GDP (*percent change*)	3.4	-8.5	13.0	7.0	3.1	3.4	2.9	2.7	2.6	2.6	2.6
HICP inflation (*average*)	0.8	0.0	2.7	10.7	8.4	4.2	2.8	2.2	2.2	2.2	2.2
HICP inflation (*end-of-period*)	1.4	-0.3	5.2	12.7	5.4	3.3	2.2	2.2	2.2	2.2	2.2
HICP Core inflation (*average*)	1.1	0.8	1.8	9.1	9.5	5.1	3.8	2.5	2.2	2.2	2.2
GDP deflator (*percent change*)	1.9	0.9	2.2	8.5	8.6	4.3	3.3	2.5	2.2	2.2	2.2
Real sector (*percent change*)											
Domestic demand	3.4	-3.2	7.5	7.3	1.3	3.6	2.8	2.6	2.6	2.6	2.7
Consumption, total	3.7	-2.8	8.4	5.6	3.6	3.7	2.6	1.8	1.6	1.6	1.7
Gross fixed capital formation, total	9.0	-5.0	6.6	0.1	4.1	8.2	7.2	6.2	6.3	5.7	5.1
Saving and investment											
Domestic investment	22.4	23.8	22.6	26.7	22.0	21.5	21.4	22.0	22.7	23.3	23.7
Domestic saving	24.9	22.9	23.6	24.0	23.1	23.1	22.2	22.2	22.8	23.3	23.6
Balance of payments											
Current account balance	2.5	-1.0	1.0	-2.8	1.1	1.6	0.8	0.2	0.1	0.0	-0.1
Exports of goods, f.o.b.	23.2	23.6	25.2	30.1	25.1	23.4	23.7	24.0	24.5	25.0	25.5
Imports of goods, f.o.b.	42.2	41.0	44.5	56.6	47.7	44.3	44.6	45.0	45.6	46.3	47.0
Capital and financial account	-2.7	1.1	-0.5	4.0	1.3	-1.6	-0.8	-0.2	-0.1	0.0	0.1
Of which: FDI, net	6.2	1.4	5.1	5.3	1.9	2.0	2.1	2.2	2.3	2.4	2.5
Gross official reserves	33.6	37.2	42.5	40.8	...	...	...	...	...	...	...
Gross external debt	73.4	81.0	80.3	72.9	83.7	77.5	73.0	69.2	66.2	63.5	61.0
General government finances											
Revenue	45.9	46.0	45.2	44.5	46.7	46.3	47.3	47.3	45.9	45.3	45.5
Expenditure	43.6	53.3	47.7	44.4	47.4	48.7	49.1	48.8	47.3	46.6	46.7
Balance	2.3	-7.2	-2.5	0.1	-0.7	-2.4	-1.8	-1.5	-1.4	-1.3	-1.2
Government debt	70.4	86.1	77.5	67.8	63.0	59.7	58.4	57.5	56.7	55.9	55.0
Memorandum items:											
Nominal GDP (*billions of euros*)	55.3	51.0	58.9	68.4	76.5	82.5	87.7	92.3	96.8	101.5	106.5
Output gap	0.3	-4.2	2.0	3.4	2.8	2.3	1.5	0.8	0.2	0.0	0.0
Potential GDP growth	3.0	-4.2	6.1	5.7	3.7	3.9	3.7	3.4	3.3	2.8	2.6

Sources: Central Bureau of Statistics; Croatian National Bank; Ministry of Finance; and IMF staff estimates.
Note: Core inflation excludes energy and unprocessed food.

Table 3a. Croatia: Statement of Operations of General Government, 2019–2029

(Percent of GDP, ESA 2010)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Prel.	*Projections*					
Revenue	**45.9**	**46.0**	**45.2**	**44.5**	**46.7**	**46.3**	**47.3**	**47.3**	**45.9**	**45.3**	**45.5**
Taxes	27.2	26.0	25.5	26.1	27.1	27.6	27.6	27.5	27.5	27.5	27.5
Income tax	6.0	5.9	5.2	6.4	6.6	6.5	6.4	6.3	6.3	6.3	6.3
VAT	13.2	12.4	13.0	13.0	13.7	14.4	14.4	14.4	14.4	14.4	14.4
Excise	4.6	4.4	4.3	3.8	3.8	3.8	4.0	4.0	4.0	4.0	4.0
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	3.4	3.3	3.0	2.9	3.0	3.0	2.8	2.8	2.8	2.8	2.8
Social contributions	11.2	11.5	11.0	10.7	10.9	11.3	11.7	11.7	11.7	11.7	11.7
Other revenue	4.1	5.5	5.6	4.8	5.9	4.6	5.3	5.5	4.0	3.4	3.6
Grants 1/	3.3	4.7	4.9	4.2	5.0	3.8	4.6	4.8	3.3	2.7	2.9
Property income	0.8	0.8	0.7	0.6	0.9	0.8	0.8	0.7	0.7	0.7	0.7
Of which : interest receivable	0.2	0.2	0.1	0.2	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Sales of goods and services	3.4	3.0	3.1	2.9	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Expenditure	**43.6**	**53.3**	**47.7**	**44.4**	**47.4**	**48.7**	**49.1**	**48.8**	**47.3**	**46.6**	**46.7**
Expense	39.2	47.6	42.9	40.0	41.9	43.1	43.4	43.2	43.1	42.8	42.5
Compensation of employees	11.5	13.2	12.2	11.1	11.5	13.1	13.0	12.9	12.9	12.9	12.9
Use of goods and services	8.0	8.4	8.1	7.5	7.8	7.8	7.9	8.0	8.0	8.0	8.0
Interest, payable	2.2	2.0	1.5	1.4	1.7	1.7	1.6	1.5	1.8	1.7	1.5
Subsidies	1.2	3.4	2.2	1.9	2.0	1.6	1.6	1.6	1.4	1.3	1.3
Current grants 2/	1.9	2.3	2.3	2.0	2.4	2.2	2.6	2.4	2.1	2.0	2.0
Social benefits	12.9	16.8	15.1	13.9	14.3	14.8	14.8	14.8	14.8	14.8	14.8
Other expenses	1.5	1.5	1.5	2.1	2.3	1.9	2.1	2.1	2.1	2.1	2.1
Net acquisition of nonfinancial assets	4.4	5.7	4.8	4.4	5.5	5.6	5.7	5.6	4.2	3.8	4.2
Overall Balance	**2.3**	**-7.2**	**-2.5**	**0.1**	**-0.7**	**-2.4**	**-1.8**	**-1.5**	**-1.4**	**-1.3**	**-1.2**
Memorandum items:											
General government gross debt 3/	70.4	86.1	77.5	67.8	63.0	59.7	58.4	57.5	56.7	55.9	55.0
General government net debt 4/	57.5	69.2	62.5	52.8	45.6	47.2	46.7	46.4	46.1	45.8	45.3
Structural balance 5/	2.2	-5.6	-3.2	-1.1	-1.7	-3.3	-2.4	-1.8	-1.5	-1.3	-1.2
Primary balance	4.3	-5.5	-1.1	1.3	0.6	-1.0	-0.6	-0.3	0.1	0.0	0.0
Structural primary balance 5/	4.2	-3.7	-1.9	0.1	-0.4	-1.9	-1.2	-0.6	0.0	0.1	0.0
Structural primary balance excl. net EU grants	1.9	-7.6	-5.7	-3.1	-4.4	-4.6	-4.7	-4.4	-2.3	-1.6	-1.9

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/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, includes capital transfers to public enterprises, one-off investment retrenchment in 2015, payment of guarantees of Uljanik shipyards in 2018-19, the COVID-19 package in 2020-21 and the energy crisis in 2022-24.

Note: Components of expenditures and revenues may not add to the total due to rounding.

Table 3b. Croatia: Statement of Operations of General Government, 2019–2029

(Billion of Euros, ESA 2010)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Prel.	*Projections*					
Revenue	**25.4**	**23.5**	**26.6**	**30.4**	**35.7**	**38.1**	**41.5**	**43.7**	**44.4**	**46.0**	**48.5**
Taxes	15.0	13.2	15.0	17.9	20.7	22.8	24.2	25.4	26.6	27.9	29.2
Income tax	3.3	3.0	3.0	4.4	5.1	5.3	5.6	5.8	6.1	6.4	6.7
VAT	7.3	6.3	7.6	8.9	10.5	11.8	12.7	13.3	14.0	14.7	15.4
Excise	2.6	2.2	2.6	2.6	2.9	3.1	3.5	3.7	3.8	4.0	4.2
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	1.9	1.7	1.7	2.0	2.3	2.5	2.5	2.6	2.7	2.8	3.0
Social contributions	6.2	5.9	6.5	7.3	8.4	9.3	10.3	10.8	11.3	11.9	12.5
Other revenue	2.3	2.8	3.3	3.3	4.5	3.8	4.7	5.1	3.9	3.5	3.9
Grants 1/	1.8	2.4	2.9	2.9	3.8	3.1	4.0	4.4	3.2	2.7	3.1
Property income	0.5	0.4	0.4	0.4	0.7	0.7	0.7	0.7	0.7	0.7	0.8
Of which : interest receivable	0.1	0.1	0.1	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Sales of goods and services	1.9	1.6	1.8	2.0	2.1	2.2	2.4	2.5	2.6	2.7	2.9
Expenditure	**24.1**	**27.2**	**28.1**	**30.3**	**36.2**	**40.1**	**43.1**	**45.1**	**45.8**	**47.3**	**49.7**
Expense	21.7	24.3	25.3	27.3	32.1	35.5	38.1	39.9	41.7	43.4	45.3
Compensation of employees	6.4	6.7	7.2	7.6	8.8	10.8	11.4	11.9	12.4	13.1	13.7
Use of goods and services	4.4	4.3	4.8	5.1	6.0	6.4	6.9	7.3	7.7	8.1	8.5
Interest, payable	1.2	1.0	0.9	0.9	1.3	1.4	1.4	1.4	1.7	1.7	1.6
Subsidies	0.7	1.7	1.3	1.3	1.5	1.3	1.4	1.4	1.4	1.4	1.3
Current grants 2/	1.1	1.2	1.4	1.4	1.8	1.8	2.3	2.2	2.0	2.0	2.1
Social benefits	7.2	8.6	8.9	9.5	10.9	12.2	13.0	13.7	14.3	15.0	15.8
Other expenses	0.8	0.8	0.9	1.4	1.8	1.6	1.9	2.0	2.1	2.2	2.3
Net acquisition of nonfinancial assets	2.4	2.9	2.8	3.0	4.2	4.6	5.0	5.2	4.1	3.9	4.5
Overall Balance	**1.3**	**-3.7**	**-1.5**	**0.1**	**-0.5**	**-2.0**	**-1.6**	**-1.4**	**-1.4**	**-1.3**	**-1.3**
Memorandum items:											
General government gross debt 3/	38.9	43.9	45.6	46.3	48.2	49.2	51.2	53.1	54.9	56.7	58.5
General government net debt 4/	31.8	35.3	36.8	36.1	34.9	38.9	41.0	42.8	44.6	46.5	48.3
Structural balance 5/	1.2	-2.9	-1.9	-0.7	-1.3	-2.7	-2.1	-1.7	-1.4	-1.3	-1.3
Primary balance	2.4	-2.8	-0.7	0.9	0.5	-0.8	-0.5	-0.2	0.1	0.0	0.0
Structural primary balance 5/	2.3	-1.9	-1.1	0.1	-0.3	-1.6	-1.0	-0.5	0.0	0.1	0.0
Structural primary balance excl. net EU grants (*percent c*	1.9	-7.6	-5.7	-3.1	-4.4	-4.6	-4.7	-4.4	-2.3	-1.6	-1.9

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/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, includes capital transfers to public enterprises, one-off investment retrenchment in 2015, payment of guarantees of Uljanik shipyards in 2018-19, the COVID-19 package in 2020-21 and the energy crisis in 2022-24.

Table 4. Croatia: Monetary Accounts, 2019–2024 1/

(Million of Euros, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024
Monetary survey						
Net Foreign Assets:	23.7	24.8	31.9	35.6	52.0	50.7
Croatian National Bank	18.9	19.7	26.6	30.2	45.0	41.3
Other monetary financial institutions	4.8	5.1	5.2	5.3	7.0	9.5
Net domestic assets	45.0	49.7	50.7	54.7	58.3	58.4
Claims on domestic sectors	42.0	46.8	47.8	51.1	53.6	54.4
Of which: Claims on general government, net	12.1	15.9	16.1	16.2	16.1	16.4
Claims on other domestic sectors	29.9	30.9	31.7	34.9	37.5	38.0
Broad money (M3)	39.2	43.7	50.3	55.6	67.5	65.3
Narrow money (M1)	30.1	35.6	42.0	47.4	53.6	49.6
Currency in circulation	4.1	4.5	4.8	1.9	10.3	9.6
Overnight deposits by domestic residents	25.6	30.6	36.7	44.9	42.7	39.5
Balance sheet of the Croatian National Bank						
Net foreign assets	18.9	19.7	26.6	30.2	45.0	41.3
Of which: Net international reserves	10.7	11.2	11.2	12.9	12.7	14.2
Claims on domestic sectors	0.3	3.3	2.9	2.6	2.4	2.3
Claims on general government (net)	0.0	2.7	2.5	2.2	2.0	2.0
Claims on banks	0.3	0.6	0.4	0.4	0.4	0.4
Claims on other domestic sectors	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.2	0.2	0.1	0.1	0.4	0.4
Liabilities	19.3	23.1	29.6	32.9	47.7	44.0
Of which:						
Banknotes and coins in circulation	5.1	5.5	5.9	3.5	12.4	11.2
Credit institutions' deposits	9.9	11.8	15.5	20.2	17.7	13.9
General government deposits	0.9	2.6	2.5	2.8	3.9	4.5
Foreign liabilities	1.2	0.9	3.6	4.2	11.6	11.5
Year-on-year percent changes						
Monetary survey:						
Net domestic assets	3.2	10.4	1.9	8.0	6.6	3.4
Claims on domestic sectors	2.7	11.3	2.2	6.9	5.1	4.2
Of which: Claims on general government, net	3.0	31.1	1.3	0.6	-0.6	-2.7
Claims on other domestic sectors	2.6	3.3	2.6	10.0	7.7	7.5
Broad money (M3)	3.8	11.5	15.0	10.7	21.3	5.0
Narrow money (M1)	13.8	18.1	18.2	12.7	13.0	-5.5
Memorandum items:						
Nominal GDP 2/	55.3	51.0	58.9	68.4	76.5	82.5
Broad money (percent of GDP)	70.9	85.7	85.4	81.4	88.2	79.2
Claims on other domestic sectors: stock (percent of GDP)	76.0	91.7	81.2	74.7	70.1	66.0
Claims on private sector (transactions, annual change, percent) 3/ 4/	4.1	3.2	3.1	9.6	6.6	6.5

Source: Croatian National Bank

1/ Based on new definition in conformation with the ECB following the adoption of euro on January 1, 2023. Data for 2024 refers to end-March.

2/ Quarter GDP for 2024 is staff projection.

3/ Comprises claims on households and enterprises. Excludes other banking institutions (household savings banks, savings and loan cooperatives, and investment fu

4/ 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, 2019–2023

(Percent, unless otherwise indicated)

	2019	2020	2021	2022	2023			
					Q1	Q2	Q3	Q4
Regulatory capital to risk-weighted assets	22.4	24.3	25.6	24.6	23.5	23.2	23.3	23.6
Regulatory Tier I capital to risk-weighted assets	22.4	24.3	25.1	24.0	23.0	22.6	22.7	23.0
Nonperforming loans to total gross loans	7.4	7.6	5.7	4.3	4.1	3.8	3.5	3.6
Provisions to Non-performing Loans	81.8	83.3	88.0	101.7	102.7	67.0	68.7	69.0
Nonperforming loans to total gross loans 1/	5.5	5.4	4.3	3.0	3.2	3.0	2.7	2.6
Coverage ratio of non-performing loans and advances 1/	68.0	64.1	63.2	67.0	67.8	67.0	68.8	69.0
Return on assets	1.6	0.7	1.4	1.2	1.9	2.3	2.3	2.1
Return on equity	9.8	4.5	8.7	8.2	14.0	16.8	16.9	15.5
Interest margin to gross income	52.5	61.2	54.1	53.5	68.1	67.1	67.9	68.5
Noninterest expenses to gross income	51.8	59.2	54.3	58.0	51.4	47.0	45.7	46.6
Liquid assets to total assets 2/	34.3	36.1	32.1	38.1	34.7	34.4	36.5	37.8
Liquid assets to short-term liabilities 2/	46.7	48.1	37.5	43.6	40.0	44.9	47.3	50.1
Liquidity Coverage Ratio	…	…	202.5	242.4	226.2	233.7	235.4	238.1
Net Stable Funding Ratio	…	…	173.5	179.0	171.5	173.3	173.9	173.4
Residential real estate prices, end of period (*annual increase*)	9.0	7.7	7.3	14.8	14.9	15.0	14.0	…
Commercial Real Estate Loans to Total Loans	…	…	13.1	13.7	13.2	12.3	12.2	12.4
Residential Real Estate Loans to Total Loans	…	…	20.0	21.3	21.0	21.1	21.1	22.1

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

1/ As defined by the CNB.

2/ 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, 2019–2029 1/

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Prel.	*Projections*					
					(Million of Euros)						
Current Account	**1,376**	**-487**	**572**	**-1,895**	**825**	**1,296**	**727**	**216**	**59**	**23**	**-67**
Goods trade balance	-10,494	-8,850	-11,403	-18,123	-17,303	-17,214	-18,341	-19,326	-20,462	-21,612	-22,947
Exports f.o.b.	12,819	12,029	14,803	20,563	19,196	19,331	20,748	22,181	23,675	25,352	27,138
Imports f.o.b.	23,313	20,879	26,206	38,685	36,499	36,545	39,090	41,507	44,137	46,964	50,085
Services trade balance	10,289	5,306	9,823	13,930	15,762	16,489	17,155	17,797	18,987	20,259	21,560
Export of services	15,376	8,928	14,317	19,702	22,327	23,493	24,580	25,605	26,669	27,791	28,945
Imports of services	5,087	3,622	4,494	5,771	6,565	7,004	7,424	7,808	7,682	7,533	7,385
Primary income balance	-150	999	18	164	70	-232	-159	-250	-364	-427	-391
Credit	2,856	2,884	3,341	4,098	5,172	4,645	4,658	4,652	4,625	4,651	4,778
Debit	3,006	1,885	3,323	3,933	5,102	4,877	4,817	4,902	4,989	5,078	5,169
Secondary income balance	1,731	2,057	2,134	2,134	2,296	2,253	2,071	1,995	1,899	1,804	1,710
Credit	3,487	3,827	4,119	4,299	4,743	4,852	4,880	5,010	5,124	5,245	5,372
Debit	1,755	1,769	1,985	2,165	2,447	2,599	2,809	3,015	3,226	3,441	3,662
Capital Account	**904**	**1,068**	**1,395**	**1,669**	**2,181**	**1,865**	**2,286**	**2,694**	**2,442**	**2,191**	**2,069**
Financial Account	**2,420**	**493**	**1,662**	**-1,052**	**1,210**	**3,161**	**3,013**	**2,910**	**2,502**	**2,214**	**2,002**
Direct investment	-3,438	-736	-3,010	-3,651	-1,453	-1,667	-1,872	-2,071	-2,272	-2,483	-2,705
Assets	70	373	942	-242	1,261	1,360	1,446	1,523	1,597	1,675	1,757
Liabilities	3,509	1,109	3,952	3,409	2,714	3,027	3,317	3,594	3,869	4,158	4,461
Portfolio investment	1,337	-131	-75	1,801	-779	1,445	1,590	1,655	1,540	1,589	1,603
Assets	1,192	558	1,150	661	-1,028	797	847	892	935	981	1,029
Liabilities	-144	689	1,225	-1,140	-250	-649	-744	-763	-605	-609	-574
Other investment	3,631	1,085	-1,044	-1,691	5,474	3,950	3,957	4,048	3,873	3,778	3,777
Assets	-417	1,372	2,592	1,912	20,488	1,050	1,428	1,034	1,171	1,512	1,440
Liabilities	-4,048	286	3,636	3,603	15,013	-2,901	-2,529	-3,014	-2,703	-2,267	-2,337
Financial derivatives	-99	-328	-240	-461	-1,014	-572	-682	-756	-670	-703	-710
Reserve assets (-= increase)	-990	-603	-6,031	-2,949	1,018	-4	-19	-35	-30	-33	-36
Net Errors and Omissions	**141**	**-87**	**-305**	**-826**	**-1,796**	**0**	**0**	**0**	**0**	**0**	**0**
Net International Investment Position	**-26,041**	**-22,821**	**-19,020**	**-17,273**	**-16,712**	**-13,838**	**-10,874**	**-7,982**	**-5,496**	**-3,286**	**-1,284**
External Debt (incl CNB share) 2/	**40,582**	**41,293**	**47,260**	**49,826**	**63,999**	**63,946**	**63,955**	**63,900**	**64,069**	**64,454**	**64,918**
					(Percent of GDP)						
Current Account	**2.5**	**-1.0**	**1.0**	**-2.8**	**1.1**	**1.6**	**0.8**	**0.2**	**0.1**	**0.0**	**-0.1**
Goods trade balance	-19.0	-17.4	-19.4	-26.5	-22.6	-20.9	-20.9	-20.9	-21.1	-21.3	-21.5
Exports f.o.b.	23.2	23.6	25.2	30.1	25.1	23.4	23.7	24.0	24.5	25.0	25.5
Imports f.o.b.	42.2	41.0	44.5	56.6	47.7	44.3	44.6	45.0	45.6	46.3	47.0
Services trade balance	18.6	10.4	16.7	20.4	20.6	20.0	19.6	19.3	19.6	20.0	20.2
Export of services	27.8	17.5	24.3	28.8	29.2	28.5	28.0	27.7	27.5	27.4	27.2
Imports of services	9.2	7.1	7.6	8.4	8.6	8.5	8.5	8.5	7.9	7.4	6.9
Primary income balance	-0.3	2.0	0.0	0.2	0.1	-0.3	-0.2	-0.3	-0.4	-0.4	-0.4
Credit	5.2	5.7	5.7	6.0	6.8	5.6	5.3	5.0	4.8	4.6	4.5
Debit	5.4	3.7	5.6	5.8	6.7	5.9	5.5	5.3	5.2	5.0	4.9
Secondary income balance	3.1	4.0	3.6	3.1	3.0	2.7	2.4	2.2	2.0	1.8	1.6
Credit	6.3	7.5	7.0	6.3	6.2	5.9	5.6	5.4	5.3	5.2	5.0
Debit	3.2	3.5	3.4	3.2	3.2	3.2	3.2	3.3	3.3	3.4	3.4
Capital Account	**1.6**	**2.1**	**2.4**	**2.4**	**2.9**	**2.3**	**2.6**	**2.9**	**2.5**	**2.2**	**1.9**
Financial Account	**4.4**	**1.0**	**2.8**	**-1.5**	**1.6**	**3.8**	**3.4**	**3.2**	**2.6**	**2.2**	**1.9**
Direct investment	-6.2	-1.4	-5.1	-5.3	-1.9	-2.0	-2.1	-2.2	-2.3	-2.4	-2.5
Assets	0.1	0.7	1.6	-0.4	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Liabilities	6.3	2.2	6.7	5.0	3.5	3.7	3.8	3.9	4.0	4.1	4.2
Portfolio investment	2.4	-0.3	-0.1	2.6	-1.0	1.8	1.8	1.8	1.6	1.6	1.5
Assets	2.2	1.1	2.0	1.0	-1.3	1.0	1.0	1.0	1.0	1.0	1.0
Liabilities	-0.3	1.4	2.1	-1.7	-0.3	-0.8	-0.8	-0.8	-0.6	-0.6	-0.5
Other investment	6.6	2.1	-1.8	-2.5	7.2	4.8	4.5	4.4	4.0	3.7	3.5
Assets	-0.8	2.7	4.4	2.8	26.8	1.3	1.6	1.1	1.2	1.5	1.4
Liabilities	-7.3	0.6	6.2	5.3	19.6	-3.5	-2.9	-3.3	-2.8	-2.2	-2.2
Financial derivatives	-0.2	-0.6	-0.4	-0.7	-1.3	-0.7	-0.8	-0.8	-0.7	-0.7	-0.7
Reserve assets (-= increase)	-1.8	-1.2	-10.2	-4.3	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Net Errors and Omissions	**0.3**	**-0.2**	**-0.5**	**-1.2**	**-2.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net International Investment Position	**-47.1**	**-44.8**	**-32.3**	**-25.3**	**-21.9**	**-16.8**	**-12.4**	**-8.6**	**-5.7**	**-3.2**	**-1.2**
External Debt (incl CNB share) 2/	**73.4**	**81.0**	**80.3**	**72.9**	**83.7**	**77.5**	**73.0**	**69.2**	**66.2**	**63.5**	**61.0**

Sources: Croatian National Bank; and IMF staff estimates.

1/ Based on BPM6.

2/ Since end-2008, external debt is reported based on the new reporting system (INOK). With the entry of the Republic of Croatia into the euro area in January 2023, there was an increase in gross foreign debt for the amount of liabilities related to the distribution of euro banknotes within the Eurosystem.

Annex I. Implementation of 2023 Article IV Recommendations

	2023 Article IV Advice	Actions since 2023 Article IV
Achieving a growth-friendly fiscal consolidation to preserve macro stability and build buffers	Tighten fiscal policy to complement monetary tightening via better targeted support	The 2023 fiscal outturn implies a sizable fiscal loosening. Some energy measures (reduced VAT rates on gas, income support to the vulnerable) have been extended to 2024-25 and the targeting could be improved. Public debt further declined to 63 percent of GDP at end-2023 and is projected to remain on a downward path.
	Improve tax policy, reduce spending rigidity, and enhance spending efficiency	Preferential tax treatment of real estate investment remains. A follow-up Public Investment Management Assessment (PIMA) focused on the implementation of the 2022 PIMA recommendations was undertaken in 2023. A new law on public wage setting was adopted, which addressed several structural issues (notably fragmentation and pay differentials among similar jobs). The law also brings a significant fiscal cost, which accounts for a large share of the loosening in the 2024 Budget.
	Improve the monitoring and corporate governance of SOEs	The authorities are making progress to enhance the monitoring and management of fiscal risks of SOEs, with the help of an IMF FAD mission. A new SOE law is expected to be adopted by end-2024 that will include main OECD recommendations.
Maintaining financial stability	Closely monitor the buildup of risks amid growth slowdown and higher interest rates	Diligent monitoring continues. The impact of monetary tightening has been mitigated by the gradual transmission given banks' ample excess liquidity and resilient economic growth.
	Remain vigilant over credit developments in the real estate market and stand ready to deploy additional macroprudential measures if necessary	The counter-cyclical capital buffer was raised to 1 percent at end-2023 and was further increased to 1.5 percent at end-June 2024. Though implicit limits are applied by banks, explicit borrower-based measures are under consideration and analysis.
	Address housing affordability	The housing loan subsidy program was ended at end-2023. A national housing strategy is being prepared to lay the ground for policy actions to enhance housing affordability.

	2023 Article IV Advice	Actions since 2023 Article IV
Advancing structural reform implementation	Maintain a good pace of the absorption of EU funds and reforms under the NRRP	Croatia has been allocated additional resources (including €4.2 billion loans) under the RRF 2.0. Four tranches of RRF funds—about 1/3 percent of the total allocations—have been disbursed, with the 5th tranche expected in the second half of 2024.
	Raise productivity and make the best of an aging population	The authorities are advancing the rolling out of the voucher scheme for adult learning and promoting active labor market policies with a focus on vulnerable groups.
	Accelerate the green transition	In July 2023, the authorities published the draft integrated National Energy and Climate Plan (NECP). Several good points and deficiencies were identified by the EC. Croatia is on track to resubmit the final NECP draft.

Annex II. Risk Assessment Matrix[1]

Source of Risks and Likelihood	Impact on Croatia	Recommended Policy Response
Global Conjunctural risks		
Intensification of regional conflict(s). Escalation or spread of the conflict in Gaza and Israel, Russia's war in Ukraine, and/or other regional conflicts or terrorism disrupt trade (e.g., energy, food, tourism, critical supply chains), FDI and financial flows, payment systems, and increased refugee flows. **High**	Croatia has limited direct trade and financial exposure to the epicenters of the conflicts but is indirectly exposed via higher global energy prices and weaker trading partners' growth. **Medium**	Provide temporary targeted fiscal support to protect the most vulnerable; moderately tighten overall fiscal policy stance if inflation remains high; strengthen structural reforms to improve competitiveness.
Social discontent. High inflation, real income loss, spillovers from conflicts (including migration), worsening inequality, and disputed elections cause social unrest and detrimental populist policies. This exacerbates imbalances, slows growth, and triggers market repricing. **Medium**	Decelerating inflation and strong wage growth have been restoring household dispensable income and supporting consumption. **Low**	Closely monitor inflation development; provide temporary targeted support to the most vulnerable while ensure fiscal policy stance consistent with the need to reduce inflation; clearly communicate the pros of policy measures and seek broad buy-in; further strengthen institutions and rule of law.
Commodity price volatility. A succession of supply disruptions (e.g., due to conflicts, export restrictions, and OPEC+ decisions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures, cross-border spillovers, and social and economic instability. **High**	Croatia's energy external dependence is below the EU average. However, high volatility of international energy prices could affect domestic inflation expectation and increase uncertainty which could dampen household consumption and firm investment. **Medium**	Provide temporary targeted fiscal support to protect the most vulnerable; tighten overall fiscal policy stance if higher inflation threatens second-round effects and risks de-anchoring inflation expectations; speed up the green transition to increase energy efficiency and renewable energy.
Abrupt global slowdown or recession. In Europe, intensifying fallout from Russia's war in Ukraine, supply disruptions, tight financial conditions, and housing market corrections exacerbate economic downturn. **Medium**	A sharp recession in Europe would significantly impact Croatia's tourism and exports and lead to a contraction of consumption and investment. **High**	Provide temporary targeted fiscal support for the most vulnerable; allow automatic stabilizer to fully work; continue with good implementation of RRF investment and reforms; closely monitor and manage financial stability risks, including through recalibrating macroprudential policy stance; advance structural reforms to strengthen competitiveness.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. 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. The conjunctural shocks and scenarios highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Source of Risks and Likelihood	Impact on Croatia	Recommended Policy Response
Global Structural risks		
Deepening geo-economic fragmentation. Broader conflicts, inward-oriented policies, and weakened international cooperation result in a less efficient configuration of trade and FDI, supply disruptions, technological and payments systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth. **High**	Geo-economic fragmentation may cause some economic disruptions to trade, investment, and financial flows, disorderly migration, and higher energy insecurity. **Medium**	Advance structural reforms to diversify the economy and strengthen competitiveness; build fiscal buffers; continue with good implementation of RRF and RepowerEU investment and reforms.
Extreme climate events and disorderly energy transition. Extreme climate events driving by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability. A disorderly shift to net-zero emissions and climate policy uncertainty cause supply disruptions, stranded assets, market volatility, and subdued investment and growth. **Medium**	More severe and extreme climate events hurt economic activities and can cause severe economic damage. A disorderly energy transition disrupts domestic economic activities and could give rise to social discontent. **Medium**	Build fiscal buffers; implement the RRF green investments to mitigate and adapt to climate change; continue to invest in climate transition and resilience; build social consensus regarding climate mitigation and transition benefits and risks; implement the recommendations of Climate-PIMA.
Cyberthreats. Cyberattacks on physical or digital infrastructure (including digital currency and crypto assets) or misuse of AI technologies trigger financial and economic instability. **Medium**	Risks on critical infrastructure, institutions, and financial systems that trigger systemic financial instability or widespread disruptions in socio-economic activities are **Medium**	Continue to enhance infrastructure and reduce cyber risks; strengthen preparedness.
Domestic risks		
Delays in public investment and reforms. Capacity constraints combined with supply disruptions and labor shortages delay the implementation of key public investment projects and reforms. **Medium**	The execution of NGEU-funded projects is an important contributor to raising potential growth. **High**	Accelerate reforms to improve absorption and avoid reform fatigue, invest in new technologies, and improve labor force skills.
Negative demographics. The declining and aging population will likely put downward pressure on the potential growth via insufficient labor and talent supply and strain future fiscal position. **High**	Aging will continue to impact the labor force, wages, and the sustainability of social welfare and healthcare system. **Medium**	Implement structural reforms to increase productivity; further labor market reform; increase labor force participation; invest in improving human capital; and build fiscal buffers for ageing-related spending.
Real estate market correction. A sharp correction of housing prices could temporarily weaken households and banks' balance sheets and trigger abrupt real estate market correction. **Medium**	A large decline in house prices could adversely affect banks' asset quality, leading to tighter lending standards to the rest of the economy. An abrupt market correction could adversely affect selected households' balance sheets, hit construction activity, and weaken confidence and domestic demand. **Medium to low**	Continue close monitoring of housing market developments and implement necessary macro prudential policies as needed; build fiscal buffers.

Annex III. Sovereign Risk and Debt Sustainability Assessment

Annex III. Figure 1. Croatia: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	…	Low	The overall risk of sovereign stres is low, reflecting low level of vulnerability in the near- and medium-term horizons on the basis of strong economic performance, relatively solid economic fundamentals, a sound debt management strategy to lower interest rates and extend maturities, as well as the euro adoption in 2023, and moderate level of vulnerability in the long-term horizon due to age-spending on health.
Near term 1/			
Medium term	Low	Low	Medium-term risks are assessed as low, consistent with the mechanical low signals.
Fanchart	Moderate	…	
GFN	Low	…	
Stress test		…	
Long term	…	Moderate	Long-term risks are moderate as aging-related expenditures on health and social security as well as on climate mitigation feed into debt dynamics. At the current juncture, Croatia is better placed, relative to other EU countries, to withstand pressures from public pension spending (2024 Ageing Report). With the addition of Pillar 2 pensions (defined contributions mandatory, funded) in 2002, Croatia has issued debt upfront for its funding, as reflected in net assets accumulated in Pillar 2 about 30 percent of GDP in 2023. Pillar 3 pensions (voluntary, funded, privately- managed) will provide additional support. However, pensions in Croatia are inadequate (World Bank, 2019, Pavkovic, A., 2022) and any measures aimed at improving pension adequacy, in presence of unfavorable demographic trends driven by population aging and shrinking prime-age workforce, should preserve the fiscal and social sustainability of the system. Public expenditure on health care in Croatia is at EU average (7.7 percent of GDP in 2022). According to the 2024 Ageing Report, under the baseline, health care expenditure is projected to increase by about 0.7 pps of GDP by 2070, faster than the EU average. Spending on health care is likely to continue to grow with the increase in GDP per capita. Its size and growing importance is driven by population ageing, innovations in health technology and the need to improve the resilience of the healthcare system. Under the “risk scenario”, which reflects the impact of excess cost growth from technological innovations in the health care sector as well as increased access and improved quality to health services, public health care spending in Croatia would increase by 2 pps of GDP by 2070, relative to its 2022 level. Finally, climate mitigation will put additional pressures on long run sustainability of public finances (EIB Investment report, 2020/2021).
Sustainability assessment 2/	Not required for surveillance countries	Sustainable	
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: After increasing at the onset of the pandemic, Croatia's debt-to-GDP ratio declined sharply in 2021-2023 as the economy recovered strongly and inflation surprised on the upside. With funding costs below peers and strong macroeconomic performance, near-term sovereign stress risks remain low. Going forward, public debt is expected to remain on a downward path and gross financing needs are low, conditional on staying the course with fiscal policy consolidation. Medium-term risks are low based on the GFN Financiability Module. Long-term risks are assessed as moderate. Over the longer run, Croatia should continue with reforms to tackle risks arising from population aging on healthcare and long term care, social security, and the pension system. However, the long time horizon at which these risks would materialize and the authorities' planned reforms under the NRRP will help contain risks.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Annex III. Figure 2. Croatia: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	
2. Subsectors included in the chosen coverage in (1) above:						

	Subsectors captured in the baseline	Inclusion	Comments
CPS / NFPS / GG: expected / CG	1 Budgetary central government	Yes	
	2 Extra budgetary funds (EBFs)	Yes	Not applicable
	3 Social security funds (SSFs)	Yes	
	4 State governments	Yes	
	5 Local governments	Yes	
	6 Public nonfinancial corporations	No	
	7 Central bank	No	
	8 Other public financial corporations	No	

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct payable 2/	IPSGSs 3/
4. Accounting principles:	Basis of recording		Valuation of debt stock		
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/
5. Debt consolidation across sectors:		Consolidated		Non-consolidated	

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on Intra-Government Debt Holdings

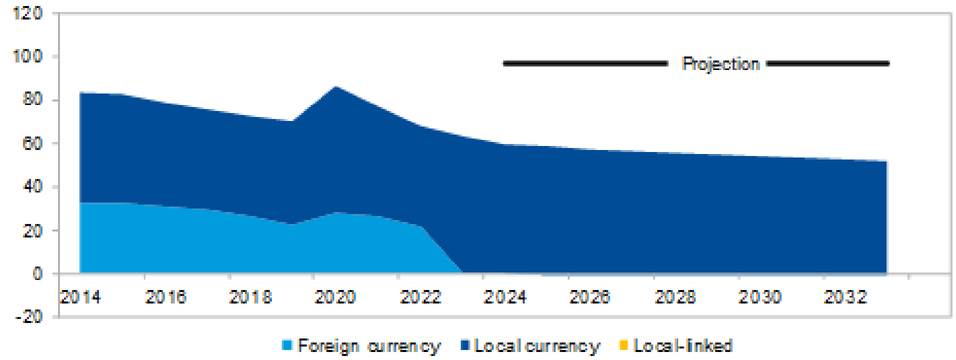
Issuer \ Holder	Budget central govt	Extra-budget funds (EBFs)	Social security funds (SSFs)	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
1 Budget. central govt									0
2 Extra-budget. funds									0
3 Social security funds									0
4 State govt.									0
5 Local govt.									0
6 Nonfin pub. corp.									0
7 Central bank									0
8 Oth. pub. fin. corp									0
Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: Croatia's debt coverage and disclosure are consistent with standard recommendations. Debt guaranteed by the government is not included in public debt.

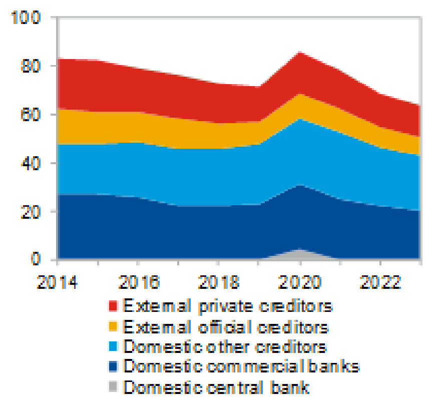
Annex III. Figure 3. Croatia: Public Debt Structure Indicators

Debt by Currency (percent of GDP)



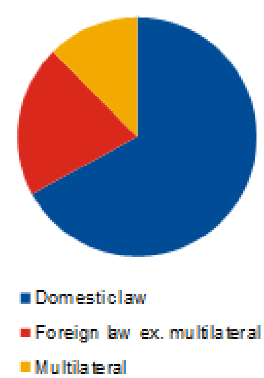
Note: The perimeter show n is consolidated public sector.

Public Debt by Holder (percent of GDP)



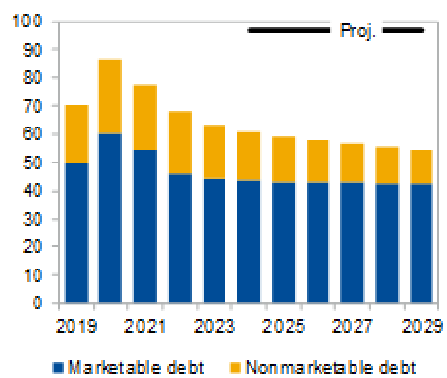
Note: The perimeter show n is general government.

Public Debt by Governing Law, 2023 (percent)



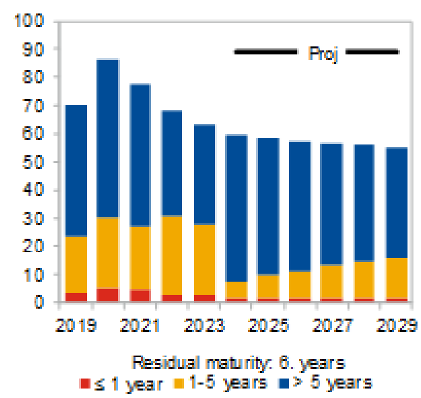
Note: The perimeter show n is general government.

Debt by Instruments (percent of GDP)



Note: The perimeter show n is general government.

Public Debt by Maturity (percent of GDP)



Note: The perimeter show n is general government.

Commentary: The majority of public debt is owned by EU residents. In recent years, the authorities succeeded in extending the average maturity of public debt, and this is expected to continue going forward. More than 95 percent of outstanding debt matures beyond one year (the average maturity of domestic bonds placed since 2019 has been more than 6 years and more than 11 years for eurobonds). Unlike the past, Croatia has borrowed at longer maturity in sovereign bond markets since 2019, as the February 2022 11-19 year €2 billion Eurobond, 20-year April 2022 €1.25 billion Eurobond, and, since joining the euro area, the March 2024 €1.5 billion Eurobond have shown.

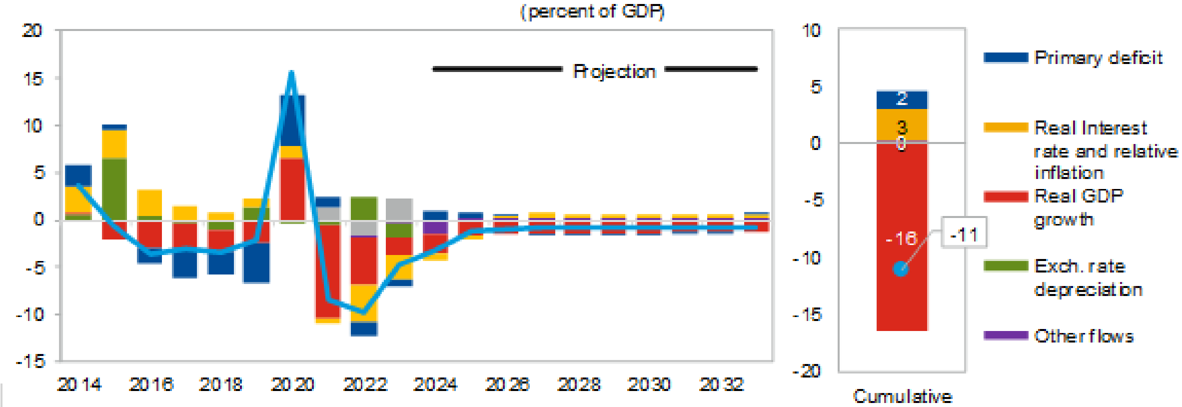
Annex III. Figure 4. Croatia: Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Public debt	63.0	59.7	58.4	57.5	56.7	55.9	55.0	54.2	53.4	52.7	52.0
Change in public debt	-4.8	-3.3	-1.2	-1.0	-0.8	-0.8	-0.9	-0.8	-0.7	-0.7	-0.7
Contribution of identified flows	-7.0	-3.3	-1.2	-1.0	-0.8	-0.8	-0.9	-0.8	-0.7	-0.7	-0.7
Primary deficit	-0.6	1.0	0.6	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Noninterest revenues	46.3	45.9	47.0	47.0	45.5	45.0	45.2	45.7	44.9	46.2	46.8
Noninterest expenditures	45.7	46.9	47.6	47.3	45.5	44.9	45.2	45.7	44.8	46.2	46.8
Automatic debt dynamics	-6.0	-2.8	-2.0	-1.4	-0.9	-1.0	-1.1	-1.0	-0.9	-0.9	-0.9
Real interest rate and relative inflation	-2.6	-0.7	-0.3	0.1	0.6	0.5	0.3	0.4	0.5	0.5	0.4
Real interest rate	-3.5	-0.7	-0.3	0.1	0.6	0.5	0.3	0.4	0.5	0.5	0.4
Relative inflation	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-2.0	-2.1	-1.7	-1.6	-1.5	-1.4	-1.4	-1.4	-1.4	-1.4	-1.3
Real exchange rate	-1.4	...	...	...	...	...	...	...	...	...	...
Other identified flows	-0.4	-1.5	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other transactions	0.0	-1.2	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Contribution of residual	2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	1.8	3.4	3.1	3.2	3.6	3.9	4.6	5.2	5.5	5.9	6.2
of which: debt service	2.8	2.7	2.9	3.2	4.0	4.3	4.9	5.5	5.9	6.2	6.5
Local currency	2.1	2.6	2.9	3.3	4.1	4.4	5.1	5.7	6.1	6.4	6.7
Foreign currency	0.7	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Memo:											
Real GDP growth (percent)	3.1	3.4	2.9	2.7	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Inflation (GDP deflator; percent)	8.6	4.3	3.3	2.5	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Nominal GDP growth (percent)	11.8	7.8	6.3	5.3	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Effective interest rate (percent)	2.8	3.0	2.9	3.0	3.6	3.5	3.3	3.6	3.7	3.7	3.6

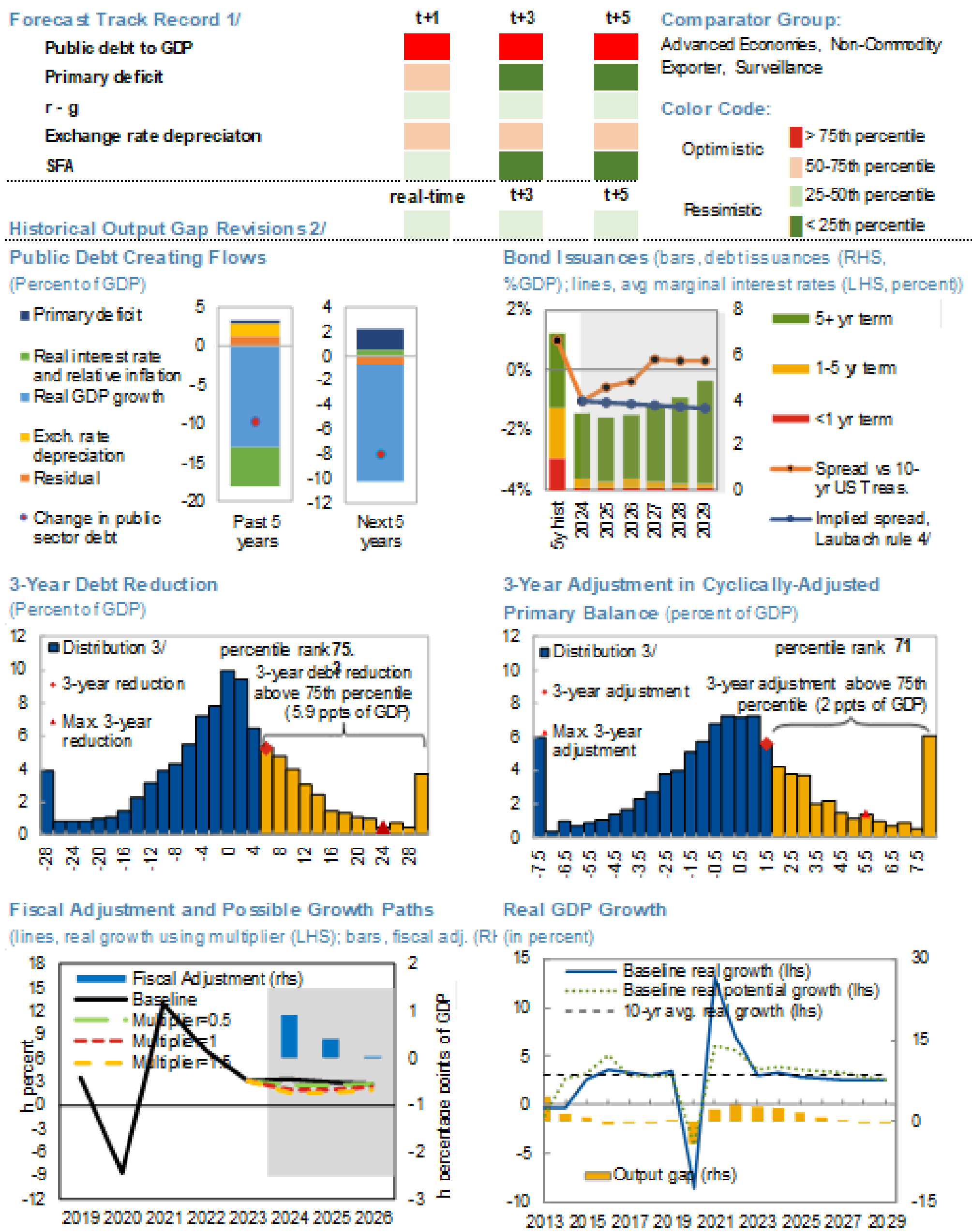
Contribution to Change in Public Debt

(percent of GDP)



Staff commentary: Public debt is projected to remain on a firm downward path, driven by continued growth and contained funding costs, reflecting expectations of a narrowing of primary deficits and stable economic conditions.

Annex III. Figure 5. Croatia: Realism of Baseline Assumptions



Commentary: The realism analysis does not point to major concerns: past forecast errors do not reveal any systematic biases and the projected fiscal adjustment and debt reduction are well within norms. Baseline assumptions of most debt drivers do not point to a systematic bias in the forecast track record, which is broadly in line with those observed in peer surveillance countries. Debt reduction projections are in the 30th percentile of cross-country database. The projected decline in public debt relies on continued growth, fiscal prudence, and favorable financing conditions.

Source: IMF Staff.

1/ Projections made in the October and April WEO vintage.

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates).

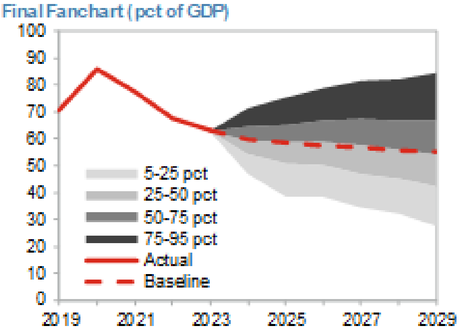
3/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Annex III. Figure 6. Croatia: Medium-Term Risk Assessment

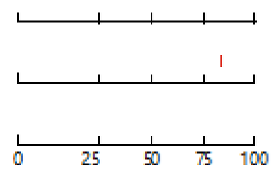
	Value	Contrib [1/]	Percentile in peer group [2/]

Final Fanchart (pct of GDP)

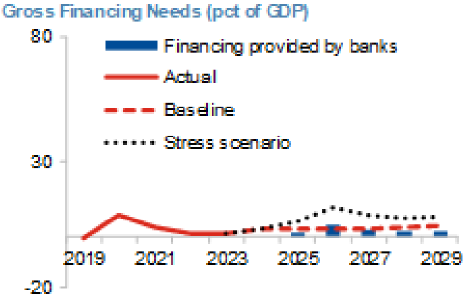


Debt Fanchart Module

	Value	Contrib [1/]
Fanchart width *(percent of GDP)*	56.6	0.8
Probability of debt non-stabilizing *(percent)*	28.8	0.2
Terminal debt-to-GDP x institutions index	33.7	0.7
Debt Fanchart Index (DFI)		1.8
Risk Signal: [3/]		Moderate

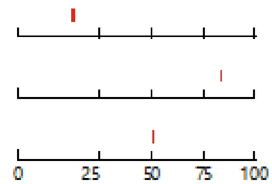


Gross Financing Needs (pct of GDP)



Gross Financing Needs (GFN) Module

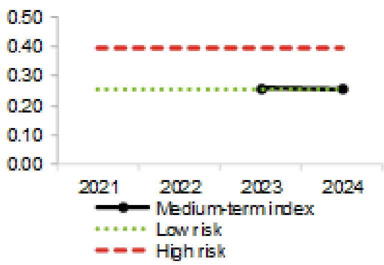
	Value	Contrib [1/]
Average baseline GFN *(percent of GDP)*	3.6	1.2
Initial Banks' claims on the gen. govt *(pct bank assets)*	10.7	3.5
Chg. In banks' claims in stress *(pct banks' assets)*	3.7	1.2
GFN Financeability Index (GFI)		5.9
Risk Signal: [4/]		Low



Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-Term Index (Index Number)



Medium-term risk analysis

	Value	Value (normalized)	Weight	Contribution
Debt fanchart index	1.8	0.4	0.5	0.2
GFN finaceability index	5.9	0.1	0.5	0.1
Medium-term index		0.3		
Risk signal: 5/		Low		
Final assessment:		Low		

Prob. of missed crisis, 2024-2029, if stress not predicted: 18.2 pct.

Prob. of false alarms, 2024-2029, if stress predicted: 42.0 pct.

Commentary: Of the two medium-term tools, the Debt Fanchart Module is pointing to medium level of risk, while the GFN Financeability Module suggests a low level of risk. Public guarantees are estimated at 3 percent of GDP.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
2/ The comparison group is advanced economies, non-commodity exporter, surveillance.
3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.
4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.
5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

Annex III. Figure 7. Croatia: Long-Term Risk Analysis

Croatia: Triggered Modules

Large amortizations	Pensions	Climate change: Adaptation	Natural Resources
	Health	Climate change: Mitigation	

Croatia: Long-term Risk Assessment: Large Amortization

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Historical average assumptions	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Overall Risk Indication		

Commentary: Public expenditure on health care in Croatia is at EU average (7.7 percent of GDP in 2022); the system is characterized by persistent indebtedness of about 3 percent of GDP and regular clearance of arrears from the budget (60 million in 2023 out of 563 mn (0.7 percent of GDP) accummuated at end-2022). According to the 2024 Ageing Report (European Commission), under the baseline, health care expenditure is projected to increase by about 0.7 pps of GDP by 2070, faster than the EU average. Spending on health care is likely to continue to grow with the increase in GDP per capita. Its size and growing importance is driven by population ageing, innovations in health technology and the need to improve the resilience of the healthcare system. Under the "risk scenario", which reflects the impact of excess cost growth from technological innovations in the health care sector as well as increased access and improved quality to health services, public health care spending in Croatia would increase by 2 pps by 2070, relative to its 2022 level.

Annex IV. External Sector Assessment

Overall Assessment: Staff's preliminary assessment is that the external position of Croatia in 2023 is moderately stronger than the level implied by fundamentals and desirable policies. The current account (CA) balance turned positive in 2023, renewing a pre-pandemic trend,[1] reflecting strong tourism revenues and improved terms of trade. Over the medium term, the current account is set to decline.

Potential Policy Responses: Advancing structural reforms to raise private investment and potential growth, including by strengthening labor force participation, reskilling, and upskilling the labor force, and extending working lives would enable a decline in the CA. Productivity-enhancing policies with greater public sector investment in areas such as infrastructure, digitization, and green transition would also help boost corporate investment, thus supporting external rebalancing and a further reduction of the CA balance toward its norm. The 2021-26 NRRP foresees investments and reforms in these areas and continued good implementation will help ensure the success.

Foreign Assets and Liabilities: Position and Trajectory

Background. Overall external indebtedness, excluding those of the CNB,[2] as a share of GDP decreased to 57.9 percent in 2023, while the gross external debt, excluding those of the CNB, stood at €44.2 billion in nominal terms. The gross debt of the government and banking sector declined in nominal terms, while it has only slightly increased for other sectors. All in all, the level as a share of GDP, for sectors other than the central bank, decreased due to the sharp rise in nominal GDP. The NIIP improved significantly to -21.9 percent of GDP.

Assessment. External vulnerabilities have been reduced with the strengthening of the NIIP in recent years. The NIIP is substantially stronger than in 2010 when the NIIP stood at around -97.0 percent of GDP. The improvement was due to sustained current account surpluses (with the notable exception of 2020 and 2022, when the current account recorded a negative balance because of worsening of the terms of trade), EU funds absorption, and strong GDP growth before the pandemic and during 2021-23. The current path of the NIIP does not imply risks to external sustainability or a need for substantial adjustment.

2023 (% GDP)	NIIP: -21.9	Gross Assets: 103.4	Debt Assets: 81.1	Gross Liab.: 125.2	Debt Liab.: 83.7

Current Account

Background. The overall current account (CA) balance moved from a deficit in 2022 to a surplus of 1.1 percent of GDP in 2023. Strong tourism revenues and terms of trade improvement are the main factors behind the reversal. In 2024, the current account balance is projected to continue to improve to about 1.6 percent of GDP, reflecting a rebound in exports (given the projected economic recovery of trading partners) and improved terms of trade. In 2025 and 2026, the surplus is anticipated to narrow on the back of higher imports of goods related to NRRP implementation. Over the medium term, the current account balance is projected to move towards a broadly balanced position. However, Croatia's current account remains susceptible to external shocks, including to a slowdown in Europe.

Assessment. The current account in 2023 is moderately stronger than medium-term fundamentals and desirable policies. Adjusting for cyclical contributions, the adjusted CA is estimated to be 1.5 percent against the EBA-lite derived CA norm of -0.2 percent. This implies a positive CA gap of 1.6 percent of GDP. The difference with the norm is driven by a variety of factors, although these estimates are subject to uncertainty.

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[1]Croatia recorded 2.6 percent of GDP current account surplus on average during 2015-19.

[2] With Croatia's entry into the euro area, there was an increase in gross foreign debt for the amount of liabilities related to the distribution of euro banknotes within the Euro system. External debt of the central bank (short term: credits, currency and deposits) went up from 6.0 percent of GDP at end-2022 to 25.8 percent of GDP as of 2023.

Croatia: EBA-Lite Model Results, 2023

	CA model 1/	REER model
	(in percent of GDP)	
CA-Actual	**1.1**	
Cyclical contributions (from model) (-)	-0.4	
Additional temporary/statistical factors (-)		
Adjusted CA	**1.5**	
CA Norm (from model) 2/	**-0.2**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**-0.2**	
CA Gap	**1.6**	**-2.9**
o/w Relative policy gap	1.2	
Elasticity	-0.4	
REER Gap (in percent)	**-4.5**	**8.1**

1/ Based on the EBA-lite 3.0 methodology

2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The real effective exchange rate has remained relatively stable in recent years. In 2023, the CPI-based REER appreciated by 3.5 percent y-o-y in 2023 because of modestly higher inflation in Croatia compared to its trading partners.

Assessment. Using standard elasticities of -0.37 of trade to the REER, the REER gap implied by the CA model points to a 4.5 percent REER undervaluation (after adjustments). Separately, the REER model suggests an overvaluation of 8.1 percent. Since the NIIP has improved sizably and is considerably above -60 percent of GDP, staff does not view external sustainability as a concern.

Capital and Financial Accounts: Flows and Policy Measures

Background. The capital and financial account stood at -1.3 percent of GDP in 2023. Rising disbursements of NGEU funds have underpinned the capital account movements. Inward FDI flows, averaging 3.5 percent of GDP over 2016-23, reflect rising real estate activities and profits of banks and non-financial corporations in foreign ownership. The banking and corporate sectors accumulated assets and reduced investment liabilities. Nominal gross external debt, excluding the CNB's share, declined slightly.

Assessment. Owing to the significant growth in nominal GDP, the external debt, excluding the CNB's share, decreased by almost 9 ppts to 57.9 percent of GDP and is projected to continue the downward trajectory. The government has been able to borrow on favorable terms benefiting from euro adoption and improved credit ratings. Croatia remains in the position of low financial vulnerability.

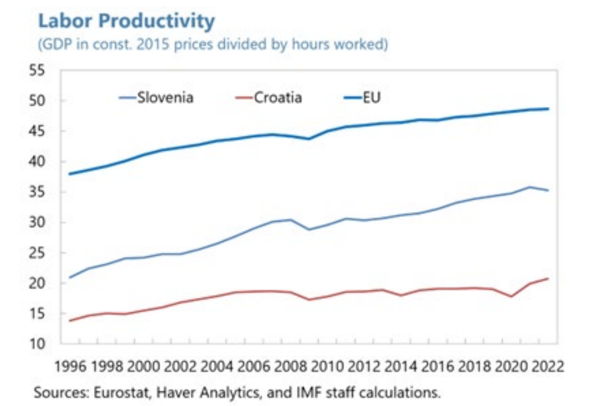
FX Intervention and Reserves Level

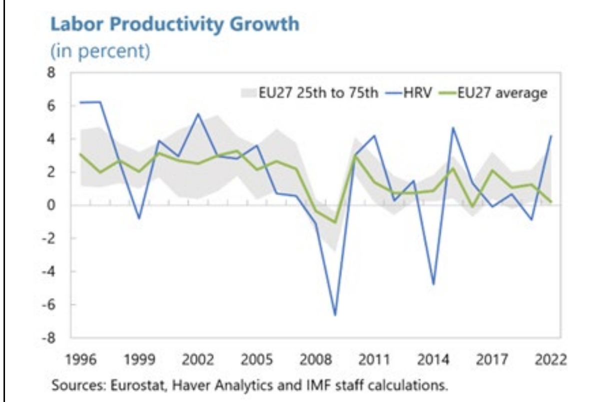
Background. The euro has the status of a global reserve currency.

Assessment. Reserves held by the euro area are typically low relative to standard metrics. The currency floats freely.

Annex V. Firm Productivity in Croatia[1]

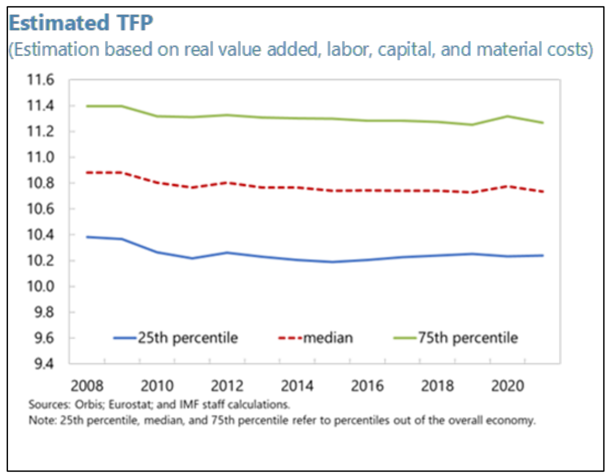
1. **Employing a large micro database, this annex focuses on Croatia's firm-level total factor productivity (TFP) and investigates constraints to productivity growth.** TFP is a key driver of labor productivity and a crucial factor for income convergence. Measured by real GDP per hours worked, labor productivity in Croatia has gradually increased over time, yet it still significantly trails the EU average. Moreover, Croatia's labor productivity growth has exhibited large fluctuations, with impressive performance relative to its peers post-pandemic.





A. Stylized Facts

2. **Firm-level TFP has been stagnant in Croatia**. We use the Orbis Bureau Van Dijk (BvD) database for the period of 2008–21 and construct an unbalanced panel for firm-level TFP estimation.[2] The main results are based on value-added measures, which are constructed following Gal (2013) due to the lack to sufficient value-added observations in the original Orbis database. The estimation of firm-level TFP follows the seminal work of Olley and Pakes (OP, 1992), Levinsohn and Petrin (LP, 2012), and Ackerberg, Caves and Frazer (ACF, 2015). We construct LP and OP measures of TFP for each firm with ACF adjustments as robustness checks. We find that Croatia's firm-level TFP has been stagnant from 2008 to 2021. Correlations among different TFP estimation methodologies



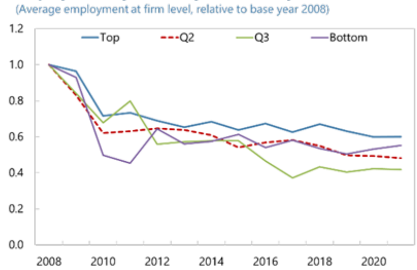
[1] Prepared by Xuege Zhang with the help of Wei Shi and under the guidance of David Bartolini.

[2] TFP estimation and real values are based on deflated levels by using firm-level financial statements from Orbis and producer prices at the industry level from Eurostat.

are consistently high, ranging from 0.94 to 0.99.[3] Moreover, the stagnation in firm-level TFP is found to be broad-based, across the firm productivity distribution.

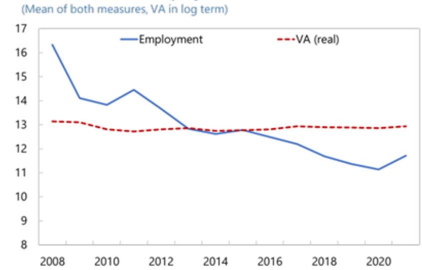
3. **The increase in labor productivity is mainly driven by a widespread reduction in firm-level employment across all TFP levels**. During 2008–21, average employment has declined across the firms, irrespective of their productivity levels. By 2021, it is just 60 percent of the 2008 level in the top quartile, 48 percent in the second quartile, 42 percent in the third quartile, and 55 percent in the bottom quartile of the productivity distribution. At the same time, there has been little change in value added, suggesting that the observed increase in labor productivity is predominantly attributable to the decline in employment. Moreover, employment in the least productive firms has risen in recent years.

Employment Dynamics by Productivity
(Average employment at firm level, relative to base year 2008)



Sources: Orbis; Eurostat; and IMF staff calculations.
Note: Top, Q2, Q3, and bottom refer to productivity quartiles out of the overall economy.

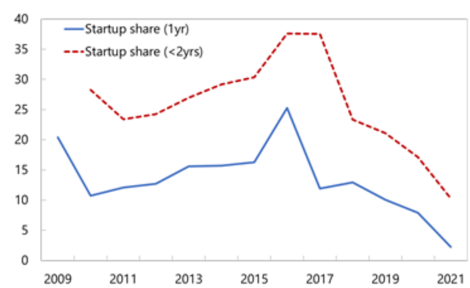
Value-added and Employment in Croatia
(Mean of both measures, VA in log term)



Sources: Orbis; and IMF staff calculations.

4. **The share of startups in our sample has decreased in the past decade.**[4] Startups are defined as firms less than one year old,[5] with an additional robustness measure set at less than two years. We observe an increase in the share of startups during 2010-16, reaching 25 percent in 2016 (or 38 percent using the robustness measure). However, this share

Startup Share
(Percent)



Sources: Orbis; and IMF staff calculations.
Note: Firms first shown up in the dataset was identified as age 1.

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[3] As a robustness check, we also use revenue-based measure for productivity estimation. The result of trend does not change significantly. The median and mean of LP with value-added measure declined to 98.6 percent and 98.8 percent with 2008 as base year respectively, and the revenue measure declined to 96.5 percent and 97.3 percent compared to the level in 2008. In the rest of the annex, we refer TFP as value-added measure as standard in the literature.

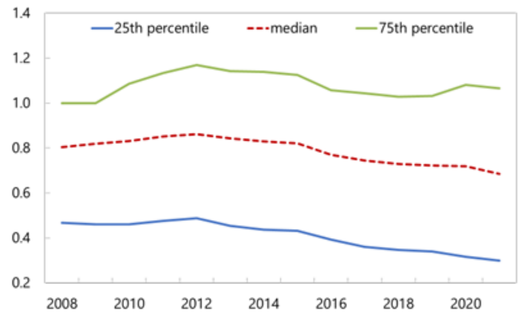
[4] According to CNB's firm data based on court registry, the share of start-ups has not declined. The difference might be explained by the better coverage of small and individual firms in the CNB's database. Therefore, we cannot infer a decline in business dynamism, but our conclusion about productivity is still relevant given that the startups in our sample drive productivity growth and their number has declined.

[5] We acknowledge the issue of underrepresentation of micro and small firms, which is well-documented in Kalemli-Ozcan et al. (2015) and is a general concern across countries in the Orbis dataset. We retain these micro and small firms and identify firm ages based on their first appearance in the cleaned dataset from Orbis. However, this approach may render a concern that the age of firms in the first couple of years after the GFC is less informative. Regardless, the observed decline in the startup share emerges from the mid-2010s. The jump in the share in the mid-2010s is mainly due to the expansion of the Orbis database.

has plummeted to 2 percent in 2021 (10 percent using the robustness measure). The decline is similar across all sectors of the economy.

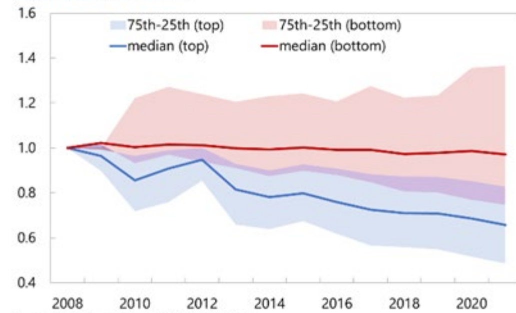
5. Firms have de-leveraged over time, especially the most productive ones. The median leverage ratio in Croatia has decreased from 80.4 percent in 2008 to around 68.6 percent in 2021. This trend is driven by the lower leverage in the most productive firms. Compared to 2008, the median leverage ratio in the bottom productivity group has barely changed. However, the median leverage ratio has significantly declined for the top productivity group, dropping to ⅔ of the 2008 level.

Leverage in Croatia NFCs
(Total liability over total asset)



Sources: Orbis; and IMF staff calculations.
Note: 25th percentile, median, and 75th percentile refer to percentiles out of the overall economy.

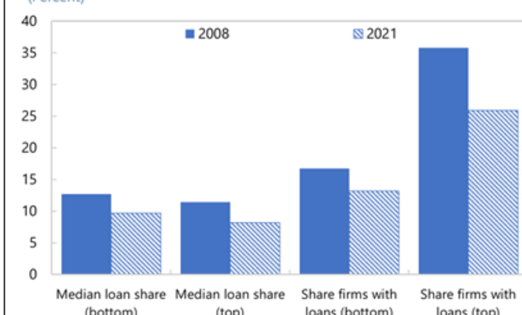
Leverage in Top and Bottom Quartile Productivity Groups
(Relative to base year 2008)



Sources: Orbis; Eurostat; and IMF staff calculations.
Note: The 25th, median, 75th refer to persontiles out of each productivity group.

6. Access to loans has declined over time, particularly among the most productive firms. Using loan data from Orbis, we calculate "loan share" as loans over total liabilities. Many firms in the dataset do not have loans. Among those firms with loans, the median loan share has declined in both top and bottom productivity groups. However, the share of the most productive firms taking loans has declined from 35.8 percent in 2008 to 25.9 percent in 2021, much larger than the decline observed in firms in the least productive quartile (from 16.7 percent in 2008 to 13.2 percent in 2021).

Access to Loans in Top and Bottom Productivity Groups
(Percent)



Sources: Orbis; Eurostat; and IMF staff calculations.
Note: Loan share= loan/total liability; shares firms with loans = NFCs with loan>0.

B. Determinants of Productivity and Conclusions

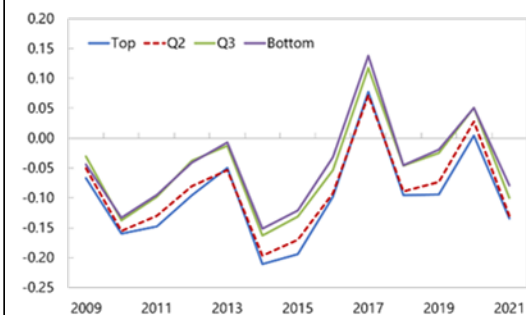
7. To investigate the determinants of productivity, we regress the estimated firm-level TFP (both levels and growth) on a set of standard variables while controlling for firm characteristics.[6] TFP represents the ability of firms to transform inputs into outputs, and therefore it

[6] Both value-added and revenue-based measures of TFP and TFP growth are used in the regressions. Although the level of VA-based TFP and revenue-based TFP are different in levels, the calculated TFP growth from both measures are very close to each other. Our baseline results reflect the conventional value-added measure, and the dynamic panel is estimated using GMM technique to control for possible estimation biases.

can be affected by firms' capacity to introduce innovative processes and technologies. We include as regressors the stock of fixed assets, the return on assets, the cash ratio (measured by cash and cash equivalent over total sales), and the leverage ratio (measured by total liability over total assets) and control for time, industry, and firm fixed effects. Dummies for firm characteristics include startups, exporting firms (defined as those with positive exports revenue), and firms with large market shares (classified as those in the top 10 percent of sales in their respective sectors).

8. **As investment is crucial to productivity growth, we also examine the determinants of firm-level net investment rates in tangible and intangible assets.** Net investment is defined as the percentage change in capital stock.[7] In addition to the standard control variables and fixed effects used in the abovementioned productivity regressions, we include future revenue growth, lagged loan share, and change in loan share as indicators of firms' financial capacity to invest, as well as lagged TFP level and future TFP growth. Robustness checks are conducted to confirm key findings.[8]

Net Investment
(Change in capital over lag capital)



Sources: Orbis; Eurostat; and IMF staff calculations.
Note: Top, Q2, Q3, and bottom refer to quartiles out of the overall economy.

9. **Our findings point to weak business dynamism and financial constraints for innovative projects as obstacles to productivity growth.**

- **Startups and exporting firms are found to be the ones with higher TFP levels and growth.**[9] The sizable decline of the share of startups has negatively affected aggregate productivity growth. The share of exporting firms has increased slightly from 14.2 percent in 2008 to 17.5 percent in 2021.

- **Access to finance is important for productivity growth**. Regressions indicate that productivity levels and growth are positively associated with leverage. Firms with lower leverage may be financially constrained and thus not able to carry out innovative projects that are conducive to productivity growth. This finding, coupled with the observed trend that more productive firms have deleveraged more than their less productive peers, suggest that difficulty in access to financing may have impeded productivity growth in Croatia. This finding aligns with the existing

[7] Using the gross investment rate, which accounts for depreciation, reveals similar trend and volatility for the overall sample and across TFP groups.

[8] Robustness checks consider TFP measured by revenue, different profitability and leverage measures, and different percentiles of market shares, as well as standard winsorization (winsorized at top and bottom 1 percent and 2.5 percent are both tested).

[9] The top market share picks up the significance of large firms in regression results, suggesting the larger correlation between market share and TFP than that of the size of a firm. Firm size is measured by number of employees with standard threshold. Firms with employees greater than or equal to 250 are large firms. (Micro: 0–9, small: 10–49, medium: 50–249.)

literature which suggests that Croatia needs to enhance access to financing for innovative projects.

- **Startups show lower investment rates.** Firms with large market shares and exporting firms demonstrate higher investment, through investment in tangible assets. In contrast, startups exhibit lower investment rates, and this negative correlation predominantly stems from their limited investment in tangible assets, which may suggest financing constraints in this regard.

Annex V. Table 1. Croatia: Regression Results for TFP

	(1)	(2)	(3)	(4)
VARIABLES	TFP (VA)	TFP (VA)	TFPG (VA)	TFPG (VA)
TFP = L,	0.241***	0.269***	-0.759***	-0.731***
	(0.010)	(0.010)	(0.010)	(0.010)
Leverage = L,	-0.019**	-0.018**	-0.019**	-0.018**
	(0.008)	(0.008)	(0.008)	(0.008)
Capital (ln) = L,	0.083***	0.039***	0.083***	0.039***
	(0.002)	(0.002)	(0.002)	(0.002)
ROA = L,	-0.024***	-0.056***	-0.024***	-0.056***
	(0.007)	(0.009)	(0.007)	(0.009)
Cash Ratio = L,	0.000***	0.000***	0.000***	0.000***
	(0.000)	(0.000)	(0.000)	(0.000)
Startup (D)		0.079***		0.079***
		(0.005)		(0.005)
Export firm (D)		0.202***		0.202***
		(0.006)		(0.006)
Large Firm (D)		0.019		0.019
		(0.013)		(0.013)
Top Market Share (D)		0.476***		0.476***
		(0.008)		(0.008)
Observations	164,444	164,444	164,444	164,444
Number of id	41,446	41,446	41,446	41,446
Sector FE	YES	YES	YES	YES
Time FE	YES	YES	YES	YES
Firm FE	YES	YES	YES	YES

Sources: Orbis; Eurostat; and IMF staff calculations.
Note: Standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1
"=L" stands for lagged and future variables.

Annex V. Table 2. Croatia: Regression Results for Investment

	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	Net Inv	Net Inv	Net Inv	Net Inv	Intangible	Tangible
Leverage = L,	-0.662***	-0.113	-0.131*	-0.132*	0.010	-0.136**
	(0.167)	(0.077)	(0.070)	(0.070)	(0.007)	(0.068)
Capital (ln) = L,	-12.242***	-6.091***	-6.205***	-6.272***	-0.240***	-5.488***
	(0.436)	(0.094)	(0.083)	(0.084)	(0.008)	(0.081)
ROA = L,	-7.859***	-0.369	-0.138	-0.089	-0.035	-0.011
	(0.242)	(0.288)	(0.256)	(0.256)	(0.026)	(0.247)
Revenue Growth = F,	-0.001	-0.004	-0.004	-0.003	-0.000	-0.002
	(0.002)	(0.006)	(0.005)	(0.005)	(0.001)	(0.005)
TFP = L,		1.314***	1.440***	1.289***	0.075***	1.182***
		(0.180)	(0.160)	(0.162)	(0.016)	(0.156)
TFP Growth = F,		0.548***	0.620***	0.681***	0.019*	0.595***
		(0.126)	(0.111)	(0.112)	(0.011)	(0.108)
Loan Share = L,			1.203	1.113	0.109	0.804
			(1.004)	(1.004)	(0.101)	(0.969)
Change in Loan Share			0.192	0.183	0.014	0.135
			(0.370)	(0.370)	(0.037)	(0.357)
Cash Ratio = L,			-0.005	-0.006	-0.000	-0.004
			(0.028)	(0.028)	(0.003)	(0.027)
Startup (D)				-1.038***	-0.011	-0.846***
				(0.332)	(0.034)	(0.320)
Export firm (D)				0.839***	0.007	0.816***
				(0.304)	(0.031)	(0.293)
Top Market Share (D)				2.480***	0.044	2.159***
				(0.379)	(0.038)	(0.365)
Large Firm (D)				1.584**	0.062	1.287*
				(0.735)	(0.074)	(0.710)
Observations	290,409	114,465	110,271	110,271	110,271	110,271
R-squared	0.257	0.379	0.318	0.319	0.175	0.315
Sector FE	YES	YES	YES	YES	YES	YES
Time FE	YES	YES	YES	YES	YES	YES
Firm FE	YES	YES	YES	YES	YES	YES

Sources: Orbis; Eurostat; and IMF staff calculations.
Note: Standard errors in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.1$
"=L" and "=F" stand for lagged and future variables.
“Net Inv”, "Intangible" and "Tangible" stand for net, intangible, tangible investment rates respectively.

Annex VI. Data Issues

Annex VI. Table 1. Croatia: Data Adequacy Assessment for Surveillance

Data Adequacy Assessment Rating 1/							
A							
Questionnaire Results 2/							
Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	A	A	A	A	A	A	A
Detailed Questionnaire Results							
Data Quality Characteristics							
Coverage	A	A	A	A	A		
Granularity 3/	B		A	A	A		
			A		A		
Consistency			A	A		A	
Frequency and Timeliness	A	A	A	A	A		

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.
2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF *Review of the Framework for Data Adequacy Assessment for Surveillance*, January 2024, Appendix I).
3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.

A	The data provided to the Fund is adequate for surveillance.
B	The data provided to the Fund has some shortcomings but is broadly adequate for surveillance.
C	The data provided to the Fund has some shortcomings that somewhat hamper surveillance.
D	The data provided to the Fund has serious shortcomings that significantly hamper surveillance.

Rationale for staff assessment. Data provision to the Fund is adequate for surveillance purposes. National accounts have strengthened in recent years. The breakdown of gross fixed capital formation into private and public components is published on Eurostat (annual frequency). Various bases of reporting are used for budgetary, financial, and statistical reports. Croatia produces general government statement using the ESA10 framework; however, the State and Local budgets are still based on the national Chart of accounts. The consolidation process involves several adjustments to the source data.

Changes since the last Article IV consultation. The general assessment has improved from "broadly adequate" to "adequate". Since joined the euro zone, data have been timely, granular and systematic. In particular, Balance of Payment statistics are now fully in line with BPM6 and BD4 manuals and data is now accessible through the Eurostat portal. Minor discrepancies between nominal government consumption in national accounts and government consumption reported in government ESA 2010 accounts have been resolved.

Corrective actions and capacity development priorities. The authorities are working to expand the quarterly account coverage (public vs. private investment, income). Technical assistance financed by the European Commission and provided by the IMF during 2024-26 will cover the modernization of accounting and state budget execution processes. It will also enhance the reconcilability of the various datasets and enable the consolidation of general government data from a harmonized and standardized accounting framework.

Use of data and/or estimates different from official statistics in the Article IV consultation. Staff do not use data and/or estimates different from official statistics**.**

Other data gaps. Croatia has no major data gaps on climate or any other topic relevant for Fund surveillance not covered by the previous analysis (there are efforts to collect more granular data at the EU level); it regularly reports data to Eurostat when required to do so; there are no discrepancies in data reporting compared to other EU countries.

Annex VI. Table 2. Croatia: Data Standards Initiatives

Croatia subscribes to the Special Data Dissemination Standard (SDDS) since May 1996 and publishes the data on its National Summary Data Page. The latest SDDS Annual Observance Report is available on the Dissemination Standards Bulletin Board (https://dsbb.imf.org/).

Annex VI. Table 3. Croatia: Table of Common Indicators Required for Surveillance

As of June 6, 2024

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Expected Frequency[6,7]	Croatia[8]	Expected Timeliness[6,7]	Croatia[8]
Exchange Rates	May-24	May-24	D	D	D	D	...	1D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr-24	May-24	M	M	M	W	1W	1W
Reserve/Base Money	-	-	-	-	M	M	2W	2W
Broad Money	-	-	-	-	M	M	1M	1M
Central Bank Balance Sheet	Apr-24	May-24	M	M	M	M	2W	2W
Consolidated Balance Sheet of the Banking System	Apr-24	May-24	M	M	M	M	1M	1M
Interest Rates[2]	Jun-24	Jun-24	M	M	D	D	...	1D
Consumer Price Index	May-24	May-24	M	M	M	M	1M	NLT 3W
Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4]	2024Q1	May-24	Q	Q	A	Q	2Q	NLT 4M
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	2024Q1	May-24	M	Q	M	A	1M	NLT 5M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	-	-	-	-	Q	Q	1Q	1Q
External Current Account Balance	2023Q4	Mar-24	Q	Q	Q	Q	1Q	1Q
Exports and Imports of Goods and Services	Mar-24	May-24	M	M	M	M	8W	1M
GDP/GNP	2024Q1	May-24	Q	Q	Q	Q	1Q	1Q
Gross External Debt	2023Q4	Mar-24	Q	Q	Q	Q	1Q	1Q
International Investment Position	2023Q4	Mar-24	Q	Q	Q	Q	1Q	NLT 1Q

[1] Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.

[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] Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual.; ("SA") semiannual; ("I") irregular; ("NA") not available or not applicable; and ("NLT") not later than.

[7] Encouraged frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected. For those countries that do not participate in the IMF Data Standards Initiatives, the required frequency and timeliness under the SDDS are shown for New Zealand, and the encouraged frequency and timeliness under the e-GDDS are shown for Eritrea, Nauru, South Sudan, and Turkmenistan.

[8] Based on the information from the Summary of Observance for SDDS and SDDS Plus participants, and the Summary of Dissemination Practices for e-GDDS participants, available from the IMF Dissemination Standards Bulletin Board (https://dsbb.imf.org/). For those countries that do not participate in the Data Standards Initiatives, as well as those that do have a National Data Summary Page, the entries are shown as "..."

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 26, 2024

Prepared By | European Department in Consultation with Other Departments

CONTENTS

FUND RELATIONS

(As of May 31, 2024)

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

General Resources Account:	**SDR Million**	**%Quota**
Quota	717.40	100.00
Fund holdings of currency (Exchange Rate)	717.01	99.95
Reserve Tranche Position	0.42	0.06

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,034.94	100.00
Holdings	990.76	95.73

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
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 Fund[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2024	2025	2026	2027	2028
Principal					
Charges/Interest	0.91	1.82	1.82	1.82	1.82
Total	0.91	1.82	1.82	1.82	1.82

[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.

Exchange Rate Arrangement:

The currency of Croatia is the euro. The exchange rate arrangement of the euro area is free floating. Croatia participates in a currency union (EMU) with 19 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies. Croatia has accepted the obligations of Article VIII, Sections 2(a), 3, and 4 of the IMF's Articles of Agreement, and maintains an exchange system free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions, other than restrictions maintained solely for security reasons, which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Anti-Money laundering and Financing of Terrorism:

The 5th Anti-Money Laundering Directive of the EU was transposed in 2019. In June 2023, Croatia was added to the list of countries under increased monitory (the so-called grey list). The authorities are implementing the FATF action plan according to the agreed timeline, and measures are continuously being taken to strengthen enforcement and address the recommendations as in the most recent December 2023 Moneyval Report.

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on June 29, 2023 (IMF Country Report No. 2023/233: Republic of Croatia: 2023 Article IV Consultation-Press Release; Staff Report; and Staff Statement (imf.org). 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–present:[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)

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

Department	Timing	Purpose
FAD	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
	June 2013	Strengthening Tax Administration Governance
	December 2014	Workshop on Public Expenditure Review (Expert visit)
	October 2019	International Public Sector Accounting Standards Gap Analysis and Budgetary Linkages
	September 2021	Public Investment Management Assessment (PIMA) and Climate-PIMA pilot
		PIMA Follow Up
	September 2023 October-November 2023	State-owned enterprises (SOE) Oversight and Risk Management (HQ mission)

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

INTERNATIONAL FINANCIAL INSTITUTION

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

Statement by Mr. Paul Hilbers and Mr. Darjan Milutinovic on Republic of Croatia
Executive Board Meeting
July 26, 2024

On behalf of the Croatian authorities, we extend our sincere gratitude to Ms. Sun and her team for the insightful reports and the productive and candid policy discussions during the Article IV mission. The authorities broadly agree with the staff's appraisal and appreciate their valuable policy recommendations. Additionally, we thank IMF staff for their valuable technical assistance (TA) in supporting fiscal reforms.

The Croatian economy is firmly advancing on its convergence path. Croatia achieved a historical milestone by finalizing the EU integration process of becoming a member of the Euro Area (EA) and the Schengen Area in 2023. This significantly improved sovereign ratings and the trade and investment climate, eased access to capital markets, and eliminated exchange rate risks. In the same year, the IMF reclassified Croatia as an advanced economy. Moreover, by recording among the highest growth rates in the EU for the third consecutive year, the Croatian economy accelerated its convergence and reached 76 percent of the EU average income per capita. The authorities are determined to continue progressing on closing the income gap to at least 80 percent of the EU average by 2028 through leveraging structural reforms and public investment under the National Recovery and Resilience Plan (NRRP).

Recent Economic Developments and Outlook

Following a period of rapid economic expansion, the Croatian authorities anticipate continued robust growth, in line with staff projections. After the pandemic-induced slowdown, the Croatian economy expanded at more than twice the pace of the EU, achieving a cumulative real GDP increase of 23 percent in a three-year period from 2021 to 2023, the second highest in the EU. This growth was driven by strong household consumption, bolstered by real wage increases, robust tourism performance, and investment supported by EU funds. With growth moderating to 3.1 percent in 2023, the authorities, like staff, foresee continued robust economic performance, with expected growth of 3.5 percent in 2024 and 3 percent in 2025, fueled by buoyant domestic demand and investment boosted by EU funds.

Inflation is expected to decelerate further, approaching the ECB's 2 percent target. Inflation differential between Croatia and the EA narrowed this year, with a notable inflation decrease to 3.5 percent in June 2024. The authorities project slightly lower inflation in 2024 compared to staff, at 3.8 percent, and expect further slowdown to 2.6 percent in 2025 and 2.1 percent in 2026, close to the ECB's target of 2 percent. The authorities concur with staff that a wage-price spiral is unlikely, as the real wage growth following an increase in inflation appears to be a one-off event, and firms have sufficient profits to absorb wage increases in 2024. Furthermore, they agree with staff that inflation expectations remain firmly anchored.

Fiscal Policy

The authorities remain strongly committed to fiscal prudence. In the 2021-2023 period, Croatia recorded one of the steepest declines of public debt (by 23 percentage points of GDP) and one of the lowest average fiscal deficits in the EU (1 percent of GDP), which points to the authorities' prudent policies, reflected in Croatia's historically high investment rating. Furthermore, an expansionary fiscal policy in 2023 provided a counter-cyclical fiscal response in anticipation of the significant economic slowdown and protected the most vulnerable from the cost-of-living crisis. For 2024, the expected deficit of around 2 percent of GDP is mainly driven by the comprehensive public wage reform, a major milestone under the

NRRP. Yet, the authorities are set to reduce the fiscal stimulus and prioritize spending in 2024, including by the continuation of phasing out energy measures such as the electricity price cap and restoring excise duties on fuel and road tolls to their pre-pandemic levels.

Implementation of the fiscal consolidation plan will further strengthen the public debt profile. The authorities plan to implement the fiscal consolidation plan in 2025, including phasing out the remaining cost-of-living measures, except for the most vulnerable, and restoring healthcare contribution rates of young workers, lowering the overall deficit to 1.6 percent of GDP. Public debt is anticipated to fall under 60 percent of GDP in 2024, accompanied by a deficit below 3 percent of GDP, thereby making the new EU fiscal framework non-binding for Croatia. Going forward, public debt is expected to remain on a downward path and gross financing needs are low. Therefore, the authorities agree with staff's upgrade of the debt profile, assessing the medium-term risks as low.

The fiscal framework has notably improved compared to the last Article IV consultation. Building on the IMF PIMA TA, the authorities are establishing a framework for appraisal and prioritization of public investment which should be operational from 2025 onwards. Additionally, a 30-month IMF CD project on state treasury modernization started this year, encompassing upgrades to budget preparation, accounting processes, and IT systems. The Fiscal Policy Commission has notably increased its capacities compared to the previous Article IV. A comprehensive fiscal risk statement will also be included in the 2025 Budget Act. Furthermore, the development of a house registry by 2026 aims to enhance the targeting of social policies.

Financial sector policies

The financial sector remains resilient amidst monetary tightening and against systemic risks. The banking sector is very liquid, highly capitalized and profitable. The Croatian National Bank's (CNB) liquidity and insolvency stress tests further confirm the banking sector's robustness against highly unlikely and intensive shocks. The authorities agree with staff that systemic risks are manageable and mitigated by strong growth, disinflation, and a slower transition of higher interest rates to the economy. While commercial real estate (CRE) and residential real estate (RRE) risks are monitored closely, they appear moderate due to limited exposure in CRE and a stabilizing RRE market. In addition, the CNB has stepped up its monitoring of bank lending standards for growing general-purpose loans, bolstered by wage increases and strong consumer confidence.

The CNB has maintained high capital buffers to support the banking sector's resilience. The CNB has increased the total capital buffer rates for domestic systemically important banks at end-2023 and the counter-cyclical capital buffer (CCyB) to 1.5 percent in June 2024, given the maturing expansionary phase of the financial cycle. The CNB's CCyB framework is built upon a broad set of cyclical risk indicators and has enabled timely and gradual buildup of the CCyB, creating room for potential counter-cyclical action in the event of sudden shocks. Therefore, the authorities currently do not see the need to change the framework, while participating in discussions of the positive-neutral CCyB approach at the EA level. Furthermore, introducing explicit borrower-based measures (BBMs) at the current juncture could be procyclical and negatively affect housing affordability, but the CNB continuously assesses the situation.

Structural policies

As a forerunner in implementing the NRRP, Croatia is swiftly advancing its structural reform agenda. With the recent reception of the 5th tranche payment of the NRRP, Croatia continues to be one of the most effective EU members in its implementation. Some of the key NRRP milestones include (i) significant educational reform for the transition to the Whole-Day School system for primary schools, (ii) a new SOE law to strengthen corporate governance and fiscal risk management, and (iii) a comprehensive public wages reform that rewards merit and aims to attract skilled workers. The NRRP supports significant productivity-enhancing investment in physical and digital infrastructure, such as railways and broadband internet.

A broad-based set of measures aims to enhance productivity, alleviate labor shortages, and promote innovation. Active labor market policies (ALMPs) include vouchers for reskilling, employment counseling programs, and measures for foreign workers, such as streamlining procedures to obtain work permits and vouchers for learning Croatian. The authorities prioritize innovation and R&D with significant financial incentives for the rapidly expanding IT industry and private R&D projects like autonomous vehicles for robotaxi services. Other measures include financial instruments to support start-ups, reduction of parafiscal charges and the backlog of court cases, digitalization of the judiciary, and improving the health sector's efficiency. Acknowledging the socioeconomic impact of housing affordability challenges, the authorities are preparing a National Housing Policy Plan 2030 to address housing supply gaps.

The authorities are making steadfast progress in addressing AML/CFT framework gaps. The National Risk Assessment of AML/CFT has been adopted and the authorities have already implemented most of the measures in the action plan agreed with the Financial Action Task Force (FATF). The authorities expect to fully implement the action plan by September 2024 and receive a positive FATF assessment in the next evaluation cycle.

A new institutional setup and ample investment in renewables will facilitate Croatia's green transition. Following recent elections, the new government established a Ministry of Environment Protection and Green Transition. The authorities submitted the National Energy and Climate Plan (NECP) and plan to establish a national center for climate change adaptation and introduce guarantees for manufacturing firms that transition to zero carbon emission. Moreover, the authorities will continue scaling up investment in renewables, infrastructure for charging EVs, and hydrogen charging stations to decarbonize heavy transport. Finally, with a plan to double its LNG terminal's natural gas capacity, Croatia is set to become a regional energy hub, contributing to European energy security.