



# REPUBLIC OF CROATIA

June 2015

## 2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF CROATIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 24, 2015 consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 24, 2015, following discussions that ended on May 6, 2015, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 9, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Croatia.

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

On June 24, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with the Republic of Croatia.

After six years of persistent recession, Croatia's economy is showing first signs of recovery. Robust retail sales and Value-Added Tax receipts suggest that private consumption has bottomed out. Employment has stabilized and corporate profits are recovering. Tailwinds from a favorable external environment have helped, notably lower energy prices, stronger euro area growth, and ample domestic and external liquidity that contain debt servicing costs. However, stronger exports, industrial production and foreign direct investment also suggest that the economy's shift from inward orientation towards the tradable sector is making progress.

This said, the economy is not yet out of the woods, with several structural impediments weighing on the recovery. Corporate investment is still contracting, as many companies struggle with high debt levels. State-owned enterprises continue to tie up a disproportionate part of economic resources. Together with a chronically weak business environment and relatively high wages, this increases the costs of operation for private corporations, complicating the strengthening of competitiveness and the re-orientation toward markets with growth potential. Policy uncertainty—especially high in face of parliamentary elections that are due within the next nine months—weighs on sentiment.

In the wake of the long recession, large fiscal vulnerabilities have built up. Public debt has increased from 35 percent of GDP in 2008 to 85 percent at end-2014, reflecting fiscal deficits averaging almost 6.5 percent of GDP since 2009—due in part to the assumption of debts from state-owned enterprises—and the economic contraction. At around 20 percent of GDP, public annual gross financing needs are large.

Still, macro-economic and financial risks appear contained. The government covers more than 80 percent of financing needs from domestic sources, notably banks. Risks of capital outflows

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<sup>1</sup> 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.

and currency instability are contained by prudential regulation compelling banks to maintain large liquidity surpluses in Croatia, the absence of foreign investors in the domestic currency securities market—limiting the risk of a destabilizing sell-off—and thin futures markets that render it difficult to build up positions against the kuna.

For 2015, the economy is projected to grow by 0.5 percent. Domestic demand is expected to stagnate as two effects broadly offset one another: continued corporate balance sheet repair constraining investment, and lower oil prices that support consumption. Net exports are expected to make a modest positive contribution to growth. From 2016, a more robust recovery is expected, as better corporate profits facilitate dealing with high debt levels, exports strengthen further in line with the external environment, and the government increasingly offsets a contractionary impulse from fiscal adjustment with absorption of European Union structural and cohesion funds.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors welcomed signs that Croatia's economy is recovering, supported by a favorable external environment. Directors noted, however, that fiscal vulnerabilities, incomplete corporate balance sheet repair, and structural weaknesses pose risks to the outlook. In particular, they underscored that the severity of the last recession points to the need to address decisively the entrenched rigidities that still hamper the economy's growth potential and resilience.

Directors commended the authorities for the progress made on structural reforms, but noted that key issues remain to be tackled. Specifically, the large and inefficient state owned enterprise sector is in need of overhaul and the overlap between different layers of government undermines the business climate. Directors agreed that prompt actions on these fronts should top the policy agenda for the period ahead.

Directors welcomed Croatia's ongoing fiscal consolidation under the European Commission's Excessive Deficit Procedure. They encouraged the authorities to flesh out a comprehensive medium term plan of fiscal adjustment that focuses on growth friendly measures. In particular, Directors recommended a shift to less distortionary taxation, including a modern property tax. They also saw a strong case for rationalizing transfers and subsidies while protecting public investment. Directors welcomed the adoption of EU standards for fiscal statistics, which will allow a more accurate reflection of risks to the government's balance sheet.

Directors considered that, in view of the prevalence of euro denominated loans, safeguarding the kuna-euro exchange rate anchor remains without a viable alternative for monetary policy. They underscored, however, that the quasi-peg requires adequate international reserves and a more active use of policies to safeguard competitiveness.

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

Directors commended the central bank for maintaining financial stability through a long recession, but stressed that continued supervisory vigilance is needed in light of the risks associated with elevated nonperforming loans. Directors looked forward to a prompt resolution of the issues related to Swiss franc denominated debt in a manner that would safeguard financial and monetary stability. Addressing these vulnerabilities is also key to removing impediments to new bank credit.

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

## Croatia: Selected Economic Indicators, 2009–16

	2009	2010	2011	2012	2013	2014	2015	2016
							Proj.	Proj.
Output, unemployment, and prices	(Percent change, unless otherwise indicated)							
Real GDP	-7.4	-1.7	-0.3	-2.2	-0.9	-0.4	0.5	1.0
Contributions:								
Domestic demand	-11.1	-4.7	-0.2	-3.4	-0.9	-1.9	-0.4	0.4
Net exports	3.8	3.1	-0.1	1.1	0.0	1.4	0.9	0.6
Unemployment (percent) /1	14.9	17.6	17.8	19.1	20.3	19.7	20.0	19.8
CPI inflation (average)	2.4	1.0	2.3	3.4	2.2	-0.2	-0.4	1.1
Growth in average monthly nominal wages	2.2	-0.4	1.5	1.0	0.8	0.2	...	...
Saving and investment	(Percent of GDP)							
Domestic investment	25.0	21.4	20.6	19.3	18.9	17.9	17.4	17.4
Of which: fixed capital formation	25.2	21.3	20.3	19.6	19.3	18.6	17.7	17.1
Domestic saving	19.9	20.2	19.8	19.1	19.6	18.5	19.2	19.0
Government	1.3	2.3	1.4	-0.1	0.4	0.2	0.6	1.0
Nongovernment	18.7	17.9	18.4	19.2	19.2	18.3	18.6	18.1
Government sector 2/								
General government revenue	41.2	40.8	41.0	41.7	42.4	42.3	43.3	44.3
General government expenditure	47.2	46.8	48.5	47.0	47.7	48.0	48.5	48.7
General government balance	-5.9	-6.0	-7.5	-5.3	-5.4	-5.7	-5.1	-4.4
Structural balance (IMF calculation)	-5.4	-5.1	-6.6	-3.8	-3.7	-4.0	-3.6	-3.2
General government debt	44.5	52.8	63.7	69.2	80.6	85.0	89.5	92.1
Money and credit	(End of period; change in percent)							
Claims on other domestic sectors	-0.6	3.6	4.4	-6.2	-1.0	-1.9	...	...
Broad money	0.2	2.0	4.8	3.6	3.5	2.8	...	...
Interest rates 3/	(Period average; percent)							
Average kuna deposit rate (unindexed)	3.2	1.8	1.7	1.6	1.4	1.2	...	...
Average kuna credit rate (unindexed)	11.6	10.4	9.7	9.6	9.2	8.5	...	...
Average real kuna credit rate (unindexed) 4/	9.0	9.2	7.3	6.0	6.9	8.7	...	...
Average credit rate, foreign currency-indexed loans	8.1	8.1	7.4	7.3	6.7	6.6	...	...
Balance of payments	(Millions of euros, unless otherwise indicated)							
Current account balance	-2,304	-503	-360	-61	341	286	768	716
Percent of GDP	-5.1	-1.1	-0.8	-0.1	0.8	0.7	1.8	1.6
Capital and financial account	4,714	1,490	1,872	484	2,333	-230	277	329
FDI, net (percent of GDP)	3.0	2.1	2.7	2.7	2.0	2.7	2.0	2.3
Overall balance	1,228	84	401	46	1,845	-530	50	50
Debt and reserves	(End of period; millions of euros, unless otherwise indicated)							
Gross official reserves	10,376	10,660	11,195	11,236	12,908	12,688	12,738	12,788
Percent of short-term debt (by residual maturity)	85	85	85	95	100	105	113	89
Months of following year's imports of goods and nonfactor services	7.3	7.0	7.4	7.3	8.1	7.9	7.4	7.0
Net international reserves	9,035	9,286	10,019	10,199	10,506	10,595	10,765	10,815
Reserves (Fixed, percent of RAM) 5/	72.7	72.7	75.1	77.1	86.8	84.3	84.1	81.8
External debt service to exports ratio (percent)	59.0	39.7	33.6	29.5	37.9	38.1	38.4	31.1
Total external debt (percent of GDP)	101.1	104.2	103.8	103.0	105.4	105.5	104.0	100.0
Net external debt (percent of GDP)	63.2	65.9	66.7	65.6	64.7	62.7	61.1	57.7
Exchange rate								
Kuna per euro, end of period	7.3	7.4	7.5	7.5	7.6	7.7	...	...
Kuna per euro, period average	7.3	7.3	7.4	7.5	7.6	7.6	...	...
Real effective rate (CPI, percent change) 6/	1.2	-2.6	-2.1	-1.9	1.4	-1.0	...	...
Memorandum items:								
Nominal GDP (millions of euros)	45,083	45,009	44,712	43,938	43,559	43,083	43,141	44,039
Output gap (percent of potential)	-1.6	-2.9	-2.7	-4.4	-5.0	-5.0	-4.4	-3.5

Per capita GDP (2012, WEO): \$12,829

Percent of population below poverty line (2004): 11.1

Quota (2010): SDR 365 million (508 million U.S. dollars)

Sources: Croatian authorities; and IMF staff estimates.

1/ Croatian Bureau of Statistics.

2/ ESA 2010 definition.

3/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.

4/ Nominal interest rate deflated by past year's change in the CPI.

5/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.

6/ Positive change means depreciation and vice versa.



# REPUBLIC OF CROATIA

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

June 9, 2015

### KEY ISSUES

**Removing structural obstacles to growth.** After six years of persistent contraction, Croatia's economy is showing signs of a tentative recovery, supported by a favorable environment—the last economy in emerging Europe to exit the post-Lehman recession of 2008/09. Deep-seated structural factors have impeded the economy's capacity to adjust, many of them relating to incomplete transition of Croatia's corporate sector toward market orientation. While the authorities have made progress with some structural reforms in previous years, others remain incomplete—notably reform of the bloated, inefficient state-owned enterprise sector and of Croatia's opaque governance system, characterized by much overlap between different layers of government. Unless addressed, these factors are bound to weigh on activity going forward.

**Restoring Fiscal Sustainability.** Large fiscal vulnerabilities have built up in the wake of the recession. In the face of high fiscal deficits and public debt, policy has started to move in the right direction under the auspices of the European Commission's Excessive Deficit Procedure. However, it requires more of a long-term orientation: a comprehensive consolidation plan should aim not only at reducing the deficit, but also at restructuring the budget to render it more growth and employment friendly.

**Safeguarding Monetary and Financial Stability.** The kuna-euro exchange rate anchor remains without viable alternative for the time being, given the high degree of loan euroization. The banking system has remained resilient despite the drawn-out recession. Continued supervisory vigilance is needed to preserve this record.

**Previous Staff Advice.** No major additional progress has been made on structural reforms since the 2014 Article IV consultation. Fiscal consolidation has advanced gradually, although efforts to reduce the headline deficit have been frustrated by revenue underperformance in a deflationary environment.

Approved By  
**James Gordon (EUR)**  
**and Masato Miyazaki**  
**(SPR)**

Discussions were held in Zagreb, April 22–May 6. The mission met with President Kolinda Grabar-Kitarović, Deputy Prime Minister Branko Grčić, Minister of Finance Boris Lalovac, Central Bank Governor Boris Vujčić, other ministers, senior officials, private sector representatives, and envoys representing the international community.

The staff team comprised Messrs. Wiegand (head), Crivelli, Lybek, Omoev (all EUR) and Ms. Shi (FAD). Ms. Ćudina (OED) attended most meetings. Mmes. Ftomova, Niman and Samuel (all EUR) assisted with the preparation of the document.

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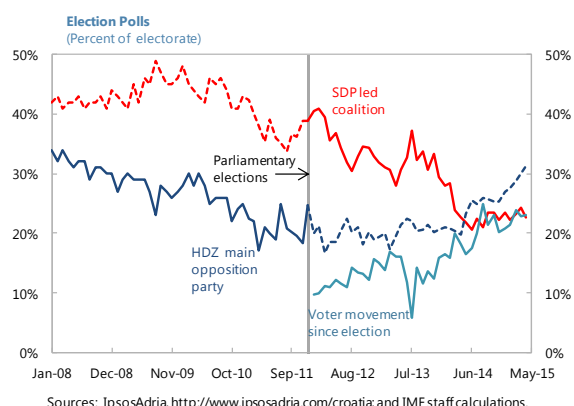
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## BACKGROUND

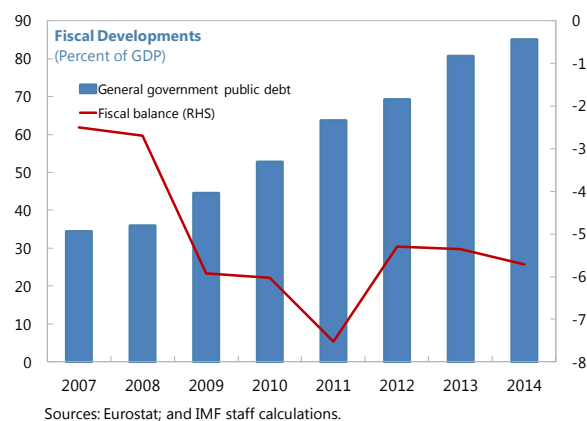
### A. Context

**1. After six years of persistent recession, Croatia's economy is finally showing signs of recovery.** Robust retail sales, VAT receipts, and better consumer confidence suggest that private consumption has bottomed out. Employment has stabilized and corporate profits are recovering. Tailwinds from a favorable external environment have helped, notably lower energy prices, stronger euro area growth, and ample domestic and external liquidity that contain debt servicing costs. However, better exports, industrial production and foreign direct investment also suggest that the economy's shift from inward orientation towards the tradable sector is making progress.

**2. This said, the economy is not yet out of the woods, with several structural impediments weighing on the recovery.** Corporate investment is still contracting, as many companies struggle with high debt levels; and an end to this process is not yet in sight. State-owned enterprises (SOEs) continue to tie up a disproportionate part of economic resources. Together with a chronically weak business environment and wages that remain relatively high compared to peers (i.e., other new EU member states), this increases the costs of operation for private corporations, complicating the strengthening of competitiveness and the re-orientation toward markets with growth potential. Policy uncertainty—especially high in face of parliamentary elections that are due within the next nine months—weighs on sentiment (Box 1).



**3. In the wake of the long recession, large fiscal vulnerabilities have built up.** Public debt has increased from 35 percent of GDP in 2008 to 85 percent at end-2014, reflecting fiscal deficits averaging almost 6½ percent of GDP since 2009—due in part to the assumption of debts from state-owned enterprises—and the economic contraction. At around 20 percent of GDP, public annual gross financing needs are large.



**4. Still, macro-economic and financial risks appear contained.**

- **Government financing.** The government covers more than 80 percent of financing needs from domestic sources, notably banks. Ample global liquidity has kept risk spreads compressed.

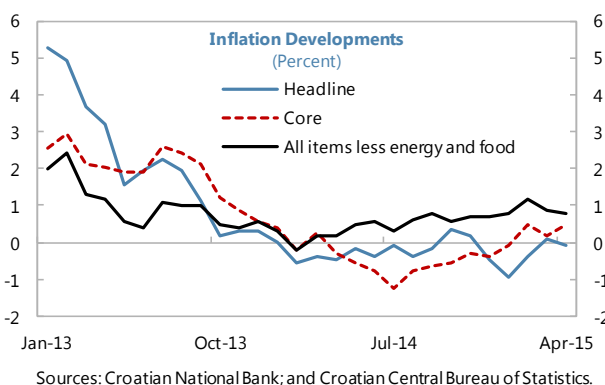
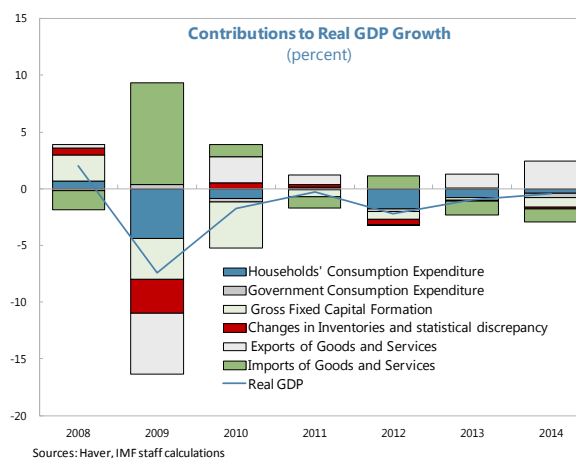
- Risks of **capital outflows and currency instability** are contained by (i) prudential regulation compelling banks to maintain large liquidity surpluses in Croatia; (ii) the absence of foreign investors in the domestic currency securities market, limiting the risk of a destabilizing sell-off, and (iii) thin futures markets that render it difficult to build up positions against the kuna.

**5. Croatia is under both the EU’s Excessive Deficit (EDP) and the Macroeconomic Imbalances Procedures (MIP).** Implementation of the EDP started in 2014. For 2015, the European Commission (EC) has confirmed that the fiscal plan submitted in the context of Croatia’s convergence program meets EDP requirements. As for the MIP, the EC considers Croatia to have excessive imbalances. However it has not yet opened a formal corrective procedure, as some progress has been made with structural reforms (see below).

## B. Recent Economic and Financial Developments

**6. While still depressed in the first half of 2014, the economy started showing signs of improvement in the second half** (Table 1, Figure 1).

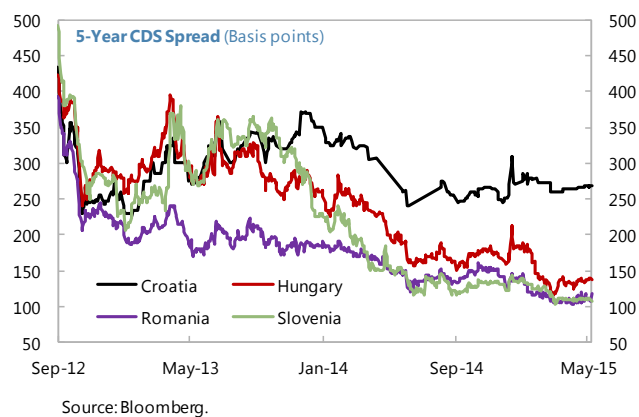
- **Growth.** In H1 2014, most indicators were still in negative territory. However, from H2, exports, tax revenue, retail sales, and industrial production all showed signs of recovery. For the entire year, the economy contracted by 0.4 percent (annual average). Private investment was the main drag on activity, while exports contributed positively to growth. The economy maintained positive momentum in the early months of 2015, with real growth in Q1 estimated at 0.5 percent (y-o-y).
- **Output gap.** Staff estimates that at end-2014, the output gap stood at close to 5 percent of potential output, using a state-dependent GDP-filter that incorporates financial variables (Box 2).
- **Deflation.** Monthly CPI inflation dropped into negative territory in late 2013 and has remained there for much of 2014, reflecting mostly lower prices for imported food and energy. With non-food, non-energy inflation stable and nominal wages growing slightly, there appears limited spillover of deflation into expectations.



- The **current account** has shifted further into surplus, reflecting better exports, import compression and the lower energy import bill (Figure 2).

## 7. The financial environment has remained benign (Figure 3).

- **Country risk spreads** have remained contained in a range of 250–300 bps, even though Croatia has continued to lose ground relative to peers.



- The central bank has kept **the kuna-euro exchange** in a narrow range, by means of a tight regime of prudential regulation limiting banks' capacity to move FX out of Croatia, moral suasion, and occasional FX interventions. In early 2015, depreciation pressures were somewhat stronger than usual, reflecting in part the one-year de-facto conversion of CHF loans into domestic currency loans (see below). Since then, the kuna has recovered ground.
- The **banking system** has remained stable, and is, on average, liquid and well-capitalized (Figure 4). Non-performing loans (NPLs) are high at almost 17 percent, but are covered by provisions and large capital buffers.

## OUTLOOK AND RISKS

### 8. Staff projects modest but positive growth for 2015, and a more robust recovery from 2016 (Table 2).

- **For 2015**, staff projects domestic demand to stagnate, as two effects broadly offset one another: (i) continued corporate balance sheet repair constraining investment, and (ii) lower oil prices that support consumption—the price drop is equivalent of an annual transfer of 0.6 percent of GDP to the Croatian economy. Despite solid growth rates, net exports are expected to make only a modest contribution to growth, given the small tradable sector.
- **From 2016**, staff projects a strengthening recovery, as better corporate profits facilitate dealing with high debt levels, exports strengthen further in line with the external environment, and the government increasingly offsets the contractionary impulse from fiscal adjustment with absorption of EU structural and cohesion funds. Staff forecasts that by 2018, real growth would return to long-term potential, estimated at 1¾ percent.
- **Deflation** is projected to persist in 2015, reflecting mainly lower prices for energy imports. Core inflation would remain near zero.

- The **current account** is expected to move further into surplus in 2015 and 2016, reflecting better exports and low commodity prices compressing the import bill (Table 3), and triggering a relatively rapid reduction in external debt (Annex I).

**9. Risks to this forecast are substantial and, in the short term, mostly tilted to the downside** (Box 3).

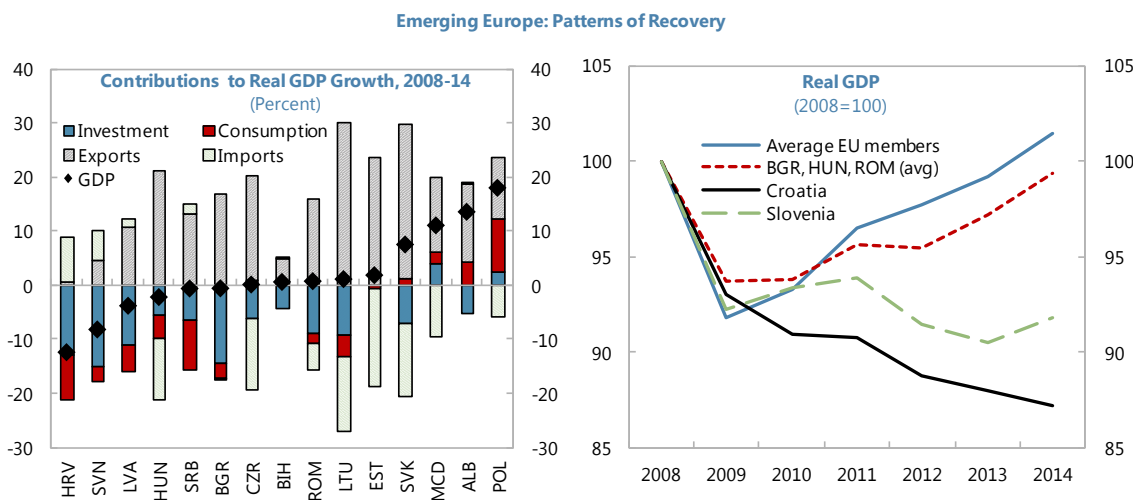
- **Domestic political** risks feature prominently ahead of parliamentary elections, with popular but destabilizing policies a distinct possibility. This could contribute further to policy uncertainty and depress sentiment.
- **Private sector balance sheet repair** could drag on for longer—or end earlier—than projected. Similarly, oil prices may rebound, and/or staff may over-/underestimate the impact of lower oil prices on domestic demand.
- **The euro area economy** could falter once again, harming exports and intensifying deflationary pressures. While trade and financial linkages with Russia/Ukraine are minor, the unsettled situation can affect the Croatian economy through sentiment. Liquidity conditions may tighten, especially if financial stress in Europe reemerges, making financing for both the public and private sectors more challenging. Exposure to Greece is limited, however, limiting the risk of direct contagion from Greece-related events.

## POLICY DISCUSSIONS

### A. Removing Structural Obstacles to Growth

#### Diagnostic

**10. Croatia’s poor growth record—and policy options to improve it—were at the core of the consultation.** With macro-economic policy space constrained—fiscal policy due to high and rising public debt levels, monetary policy because of Croatia’s long-standing peg to the euro and



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

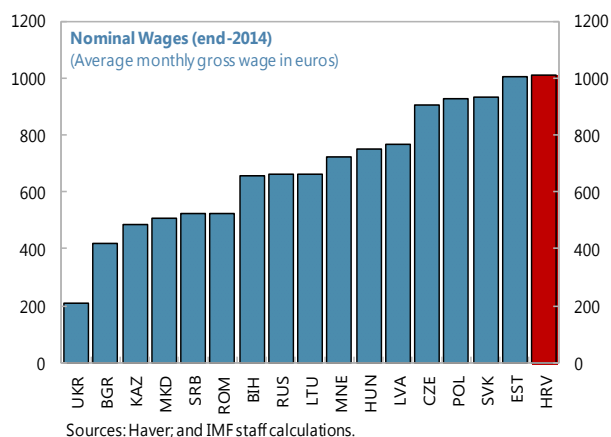
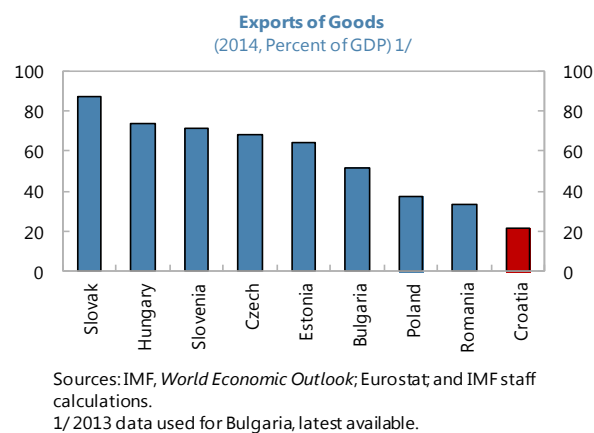
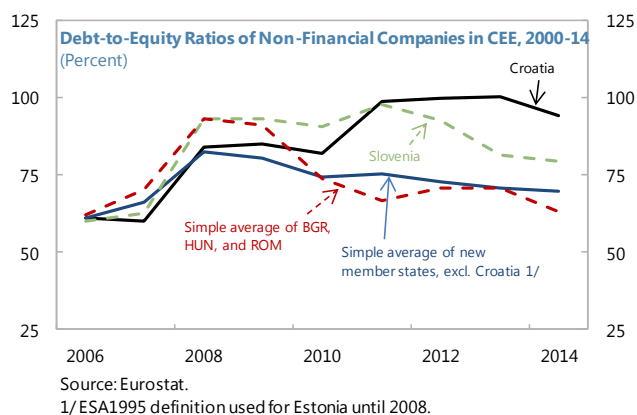
high loan euroization (see below)—discussions focused on growth enhancing structural reforms. These fall into three broad categories:

- policies that provide **short-term support for the economy**—notably debt restructuring;
- policies that **enhance the economy’s capacity to adjust**, such as restructuring state-owned enterprises and reducing their role in the economy; and
- measures that **increase long-term potential growth**, such as pension reform to raise labor market participation.

**11. The drawn-out 2008–14 recession holds important lessons** (Figure 5). As most countries in the region, Croatia was left by the pre-2008 boom with an appreciated real effective exchange rate, a bloated non-tradable sector (especially construction) and impaired private sector balance sheets. As others, Croatia suffered a sharp initial contraction. However, in contrast to most peers, Croatia failed to emerge from recession in 2009–11. Instead, its slump lasted a full six years, driven primarily by a sustained contraction in private investment. Further, and again in contrast to peers, Croatia’s corporate sector made little progress with balance sheet repair during this period, but instead continued to leverage up until 2013 (Figure 6, Box 4).

**12. Staff’s analysis suggests that several structural factors delayed Croatia’s recovery.** If unaddressed, they are likely to hamper economic performance going forward.

- **Limited export orientation** left Croatian corporations without alternative sources of income as domestic demand contracted. In this regard, Croatia contrasts sharply with central European economies that benefitted from large export boosts after 2009. **Rigid labor markets** slowed workforce restructuring and wage adjustment. **An inefficient judicial system** stood in the way of debt workouts. **High wages and red tape**, especially at the local government level, discouraged FDI.
- Several weaknesses appear related to the **dominant position of state-owned enterprises**



in Croatia's economy (Box 5). SOEs account for almost one-third of corporate assets and one-fifth of total corporate employment. Several studies show that SOEs operate at lower productivity and higher cost levels than private companies, and spread inefficiencies through trade linkages. SOEs also contribute to Croatia's high wage level, by raising domestic prices and hence reservation wages.

- **The crisis exposed the un-sustainability of many SOEs' business models, forcing restructuring, downsizing and deleveraging**—or put differently, a structural transition of Croatia's corporate sector from SOEs toward market orientation; a shift that in Central Europe had typically occurred already in the 1990s. Croatia's experience is part of a broader pattern: contraction in real investment after 2008 correlates strongly with the degree of corporate transition that had taken place by that time.

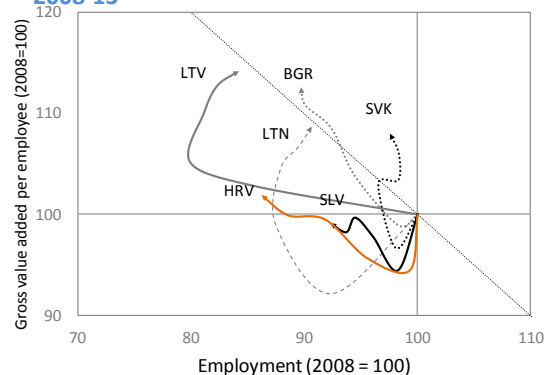
**13. The authorities have advanced some important structural reforms in recent years**, even though frequent policy reversals and stop-and-go implementation have often contributed to policy uncertainty, limiting the positive impact on confidence. The revised labor law passed in 2014 reduces costs of workforce restructuring and increased flexibility of working hours. The Investment Promotion Act of 2013 aims at facilitating FDI and is showing first results. A pre-bankruptcy settlement procedure (PBSP) introduced in 2012 helped restructure some corporate debts. Some central government social benefits were streamlined, the regime for special pensions was tightened, and the penalty for early retirement increased somewhat. The authorities claim that stricter government oversight of SOE operations and restructuring has improved some SOEs' performance.

### Policy Discussion

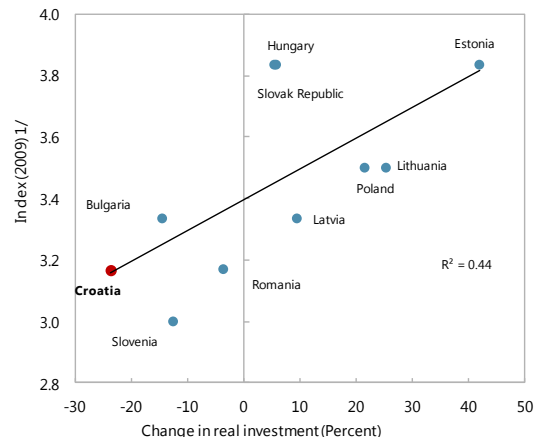
**14.** While welcoming the progress achieved, **staff argued that many structural obstacles remained and would need to be addressed forcefully.**

- **Debt restructuring framework.** The PBSP was halted in 2014 after problems arose relating to minority creditor rights. Staff argued that the revised procedure as is currently in front of the parliament should be passed swiftly, to allow debt restructuring to continue and to increase legal certainty surrounding the process. The envisaged consumer bankruptcy act should also be enacted. Judicial reform to enhance the capacity of commercial courts remained critical.

### Employment and Labor Productivity, 2008-13



### EU New Member States: Corporate Sector Reform and Investment, 2009-2014



- **State-owned enterprises.** Staff noted that several problem cases persist, including the fertilizer company Petrokemija, and the state highway and railroad companies. In many cases—especially corporations operating in areas other than public infrastructure, and including currently profitable SOEs—sale was the better option than restructuring, as it would allow attracting professional expertise and overcome constraints from the public sector’s limited administrative capacity. Meanwhile, chronic governance issues in SOEs needed to be addressed. A positive step was the planned professionalization of SOE management and supervisory boards, including through public tenders for executive positions, and by holding management accountable to clear performance criteria.
- **Governance and business climate** (Figure 7). Staff argued that red tape, especially at the local government level, would best be addressed by comprehensive governance reform that clearly defines municipalities’ responsibilities and regulates access to central government funding in line with municipalities’ capacity to provide public services. As for the central government, better coordination of regulatory activities by different line ministries and agencies was called for. Staff emphasized that the planned rationalization of para-fiscal charges and the envisaged reduction in state agencies were commendable steps.
- **Social benefits.** Staff underscored that streamlining of benefits should encompass the entire central government and extend also to the myriad of transfers granted at the local level that often overlap with central government benefits, creating employment and poverty traps.
- **Pensions.** Staff argued for a further increase in the penalty for early retirement—beyond that already enacted—and reductions in privileged pensions, with a view to increase chronically low labor market participation.

**15. The authorities broadly agreed with staff’s recommendations, but emphasized that the turnaround in economic performance owed much to structural reforms already taken,** including better performance of state-owned enterprises and the investment laws that had resulted in an increase in FDI. They noted that additional structural reforms were envisaged after the elections, including further streamlining and rationalization of benefits. The authorities argued, however, that another push for pension reform had to wait until the economy was stronger and the labor market better able to absorb additional workers.

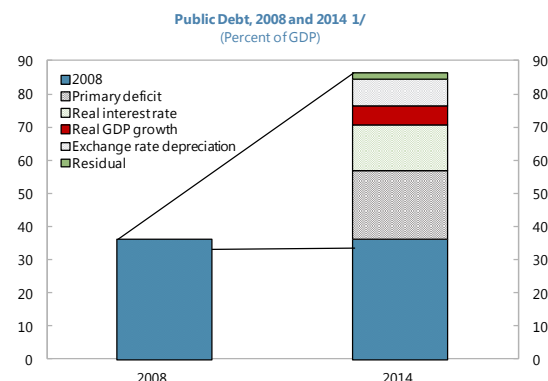
## B. Restoring Fiscal Sustainability

### Diagnostic

**16. The analysis of fiscal policy is at this juncture complicated by methodological changes and shifts in the coverage of the public sector,** reflecting Croatia’s adoption of the European Union’s statistical standards (Tables 4a-c, Figure 8). While these changes should eventually greatly improve the quality of fiscal statistics—including by reflecting fiscal risks more accurately than the



cash-based central government statistics used thus far—they trigger large revisions to fiscal aggregates in the short term.<sup>1</sup> The 2014 general government deficit is now reported at 5.7 percent of GDP—a significantly larger number than was expected to result from these revisions—while public debt stands at 85 percent of GDP. The widening reflects inter alia the inclusion of additional agencies in the deficit computation, and the calling of a state guarantee by Croatian railroads. In terms of policies, expenditure-side consolidation efforts in 2014 were neutralized by weak revenue performance in the face of GDP contraction and deflation, especially in the first half of 2014.



Sources: Croatian Ministry of Finance; and IMF staff calculations.  
1/ Includes assumption of SoE debt

**17. Domestic financing is expected to be the main funding source going forward,** insulating the government somewhat from external market pressures. About 80 percent of the central government’s funding needs are covered from domestic issuance, of which more than half are short-term instruments such as t-bills that are mostly bought by Croatian institutional investors. As for external funding, in early 2015 the government issued a €1.5 billion bond with 10-year maturity at a low yield (3.3 percent), with no immediate plans for further issuance.

## Policy Discussions

**18. Staff and the authorities agreed that the challenge for fiscal policy remained striking a balance** between sending a credible signal of consolidation on the one hand—even more important now in the face of the upward revisions of government deficits and debt—and the need not to overburden the still weak economy on the other (Box 6).

- **Overall adjustment need and phasing.** Staff’s analysis suggests that adjustment of close to 3 percent of GDP is needed to reach a structural deficit of about 1 percent of GDP, motivated by the general minimum balance in the EU’s fiscal framework. Stretching adjustment over three years appears appropriate, lest to overburden the still weak economy. In this case, the public debt ratio would peak at about 93 percent of GDP in 2017, before embarking on a sustained downward path (Annex II). The sustainability of this path is robust to a wide variety of shocks, including a delay in the recovery, and the drawing of additional state guarantees. For 2015, the path applies a (net) annual adjustment need of ½-1 percent of GDP.
- **Adjustment in 2015.** Given the fragility of the recovery, staff advocated measures with limited spillovers to private demand in 2015. In view of the dearth of structural expenditure measures that could be implemented right away (i.e., without accompanying structural reforms that require preparation), most of these should be on the revenue side, such as

<sup>1</sup> Further revisions are likely, as by end-2015 SOEs linked to local governments will be included into the general government. This is bound to increase reported public debt further.

reducing exemptions from personal income tax and limiting a tax break for reinvested corporate earnings. Better absorption of EU structural and cohesion funds would also help mitigate the impact of consolidation.

- **For 2016 and beyond**, staff argued that the priority was to restructure expenditures, so as to render public spending more growth and employment friendly. In this regard, a comprehensive approach was called for, which should be based on a recent expenditure review conducted by the Croatian authorities. In particular, subsidies and transfers in Croatia are higher than in comparable countries, and are often poorly targeted, while public investment is low. Further, on the revenue side a shift to less distortionary taxation is called for, such as introduction of a modern property tax.

**19. Against this yardstick, staff argued that the amount of fiscal adjustment contained in the authorities' 2015 fiscal plan was broadly appropriate, but the composition was not.** The 2015 budget contains an income tax cut of about 0.6 percent of GDP (through the realignment of tax brackets). In the 2015 convergence program submitted to the EC, part of the cut is offset by a couple of high-quality but low-yielding revenue measures, notably higher excises for gasoline and tobacco, and a new tax on interest earnings. But the larger portion is compensated by ad-hoc and incompletely specified spending cuts in line ministries and—especially—SOEs, concentrated in material expenditures and public investment. Overall, the program contains net consolidation measures of ½–1 percent of GDP (a precise assessment was not possible, as several measures are not yet fully specified), although few of them appear structural. The measures yield a headline deficit of 5–5½ percent of GDP. There are risks to the deficit forecast, as the projection for dividends collected from SOEs appears optimistic, while tax revenue could also disappoint in view of continued deflationary pressures.

**Identified Fiscal Measures for 2015 1/**  
(percent of GDP)

<b>Revenue measures</b>	<b>0.14</b>
Personal income tax, threshold adjustment	-0.60
Tax on interest from savings, and lottery tax	0.15
Excise increases 2/	0.22
Health Fund contribution rate change 2/	0.24
Other	0.13
<b>Expenditure measures</b>	<b>0.55</b>
Subsidies	0.10
Compensation	0.08
Other current expenditures	0.11
Capital formation	0.06
Savings from SOEs and Extra-budgetary Institutions	0.20

1/ As included in staff's baseline.

2/ Includes carry-over from measures taken in mid-2014.

Source: Croatian authorities, and staff computations.

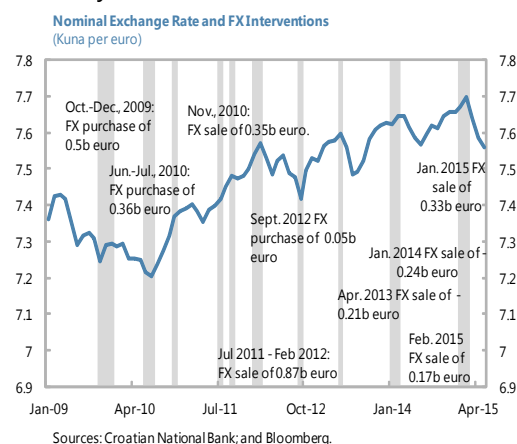
**20. The authorities defended the income tax cut, arguing that it was needed to stimulate the economy.** In this context, they claimed that the improvement in private consumption thus far in 2015 owed significantly to tax relief. The authorities also defended the emphasis on expenditure side consolidation in 2015, pointing to Croatia's elevated level of government spending relative to peers.

**21. Staff followed up on health sector reform, especially efforts to reign in the persistent accumulation of arrears.** Since the beginning of this year, the public health insurance fund operates outside the central government. Staff saw fiscal risks from loosening treasury control over health spending. The authorities underscored, however, that the health insurance fund was using the autonomy to engage in an ambitious reform that strengthens performance incentives and increases

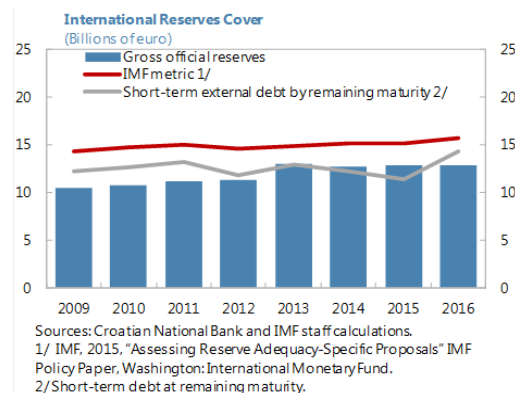
pressures on hospitals to stay within their budgets. Staff and the authorities agreed that the test for success would be whether the envisaged reduction in health arrears materializes.

### C. Maintaining Monetary and Financial Stability

**22. The central bank and staff agreed that Croatia’s long-standing quasi-peg to the euro remains key for financial stability** (Table 5). While the peg means that monetary and exchange rate policy cannot be employed to mitigate macro-economic shocks, Croatia’s large share of foreign currency (FX) denominated loans—about  $\frac{3}{4}$ —rules out unconstrained exchange rate flexibility, as large depreciations would trigger potentially devastating contractionary balance sheet effects for corporations and households.<sup>2</sup> Staff suggested considering prudential regulation to encourage de-euroization—such as stricter provisioning requirements for FX loans—but the central bank responded that the EU’s regulatory framework rendered such efforts difficult.<sup>3</sup> Further, Croatia’s eventual adoption of the euro would mostly eliminate currency mismatches. Staff estimates that at this juncture, Croatia’s REER remains modestly overvalued by 3-10 percent, as Croatia’s real appreciation during boom of the mid-2000s has not yet been fully reversed (Box 7, Figure 9).



**23. Staff encouraged the central bank to accumulate more foreign currency reserves**, as reserves remain modest compared to standard IMF adequacy metrics. However, staff acknowledged that related risks are mitigated by the absence of foreign investors in kuna securities markets—reducing the risk of destabilizing sell-offs—and a tight regulatory regime that obliges banks to maintain sizeable FX liquidity buffers as a complement to central bank reserves (Figures 10, 11). The central bank emphasized that it continued to accumulate reserves by purchasing FX from external government bond issuances. In line with the advice given in previous years, staff



<sup>2</sup> The central bank argued that at a deeper level, euroization reflected distrust in a domestic monetary anchor, following experiences with hyperinflation in the 1990s. The distrust was reflected in deposit euroization, which banks then sought to match on the asset side of their balance sheets with FX lending. In this regard, Croatia was different from some Central European economies, where deposits were denominated mostly in domestic currency, and loan euroization was to benefit from carry trade (taking advantage of lower FX borrowing rates).

<sup>3</sup> In particular, the central bank noted that upon EU entry it had to substitute one of the most effective de-euroization measures—higher risk weights for unhedged borrowers—with a less efficient alternative—capital buffers as permitted under the second pillar of Basel II. The central bank also underscored that other measures remained in effect, such as FX liquidity buffers, information requirements on currency risks to borrowers, and guidelines for banks on managing risks from FX exposures to unhedged borrowers.

encouraged the central bank to consider alternative means for accumulating reserves, especially as opportunities to obtain FX from the government may become less frequent as fiscal consolidation advances.

**24. The banking system has remained stable, and is, on average, liquid and well-capitalized (Table 6).** Staff argued that continued supervisory vigilance was needed to preserve this record.

- **NPLs.** While non-performing loans (NPLs) are high at almost 17 percent, banks' large capital buffers and provisions contain risks to financial stability (Box 8). Some pockets of vulnerability in smaller banks are addressed in the context of standard supervisory operations. Still, staff argued—and the authorities agreed—that clearing out NPLs at a faster pace was desirable, not least to allow borrowers a fresh start. To this end, staff recommended forming a task force with representatives from tax authorities, the accounting and legal professions, banks, and regulators that should seek to identify and remove possible obstacles to NPL write-offs and sales.
- **State development bank.** In line with a recent EC recommendation, staff proposed tighter supervision of the state development bank HBOR, in particular with respect to loan classification. The central bank was reluctant to step in as a supervisor, however, claiming that supervision of an institution that was not a credit institution went beyond its mandate.

**25. Staff warned against potentially destabilizing steps in reaction to the Swiss Franc (CHF) appreciation in early 2015** (Box 9). The appreciation has affected a sizeable portion of borrowers indebted in CHF, especially for mortgages. In response, the government froze the applicable kuna/CHF exchange rate for one year, during which creditors and debtors are supposed to seek a permanent solution (see the Informational Annex for details). Staff urged negotiations to proceed swiftly, as the unsettled situation produces policy uncertainty. Further, staff advocated that negotiations should focus on needy borrowers that lack capacity to pay; according to Central Bank estimates about one-quarter of CHF borrowers owing about 5 percent of CHF debt. By contrast, across-the-board bailouts should be avoided, as (i) any such solution would result in a de facto conversion of CHF loans into kuna, putting pressure on already modest FX reserves, and (ii) relief to non-needy borrowers in response to political pressure could generate a perilous perception that politicization was a means of avoiding contractual obligations. Staff discussed this issue with various stakeholders. While most counterparts agreed with staff in principle, they emphasized that in a pre-election environment, finding differentiated solutions may be difficult.

## STAFF APPRAISAL

**26. Croatia's economy appears to have entered a tentative recovery,** allowing for cautious optimism that much overdue relief for Croatian households may finally be on its way. The return to sustained growth is not yet assured, however: the exceptionally favorable external environment may not last; and the continued contraction in private investment suggests that the process of corporate balance sheet repair is not yet complete.

**27. The depth and unusual length of Croatia’s 2008–14 slump is troubling, however, and points to deep-seated structural factors that impede the economy’s capacity to adjust.** Many of these impediments relate to incomplete transition of Croatia’s corporate sector toward market orientation, as evidenced by the continued large role of SOEs in the economy. The recession exposed that corporate structure to be unsustainable, setting in motion a transition of the corporate sector away from SOEs toward competitive markets that in many transition countries occurred already in the 1990s.

**28. The authorities have made progress with some structural reforms, but have shied away from tackling some of the most critical issues** in the face of well-organized vested interests. Key unfinished reforms relate in particular to state-owned enterprises and to Croatia’s governance structure. The latter is characterized by much overlap between different layers of government (central government ministries, state agencies, and local governments), giving rise to lack of transparency and red tape, and undermining Croatia’s business climate. While major progress in these areas is unlikely prior to the parliamentary elections, these issues should be tackled forcefully thereafter.

**29. Fiscal policy has started to move in the right direction under the auspices of the EC’s Excessive Deficit Procedure, but requires more of a long-term orientation.** Efforts at gradually reducing the deficit are continuing, even though the ad-hoc nature of adjustment in 2015 is sub-optimal. Looking ahead, a comprehensive consolidation plan is needed that aims not only at reducing the deficit, but also at restructuring the budget to render it more growth and employment friendly. On the revenue side, a shift to less distortionary taxes is called for, such as a modern property tax. On the expenditure side, there is a strong case for reducing unproductive transfers and subsidies—areas where Croatia overspends substantially relative to peers—while preserving public investment. An expenditure review that the government conducted in early 2015 provides a helpful basis for such an endeavor, and should be published. The shift to EU statistical standards should eventually lead to a significant improvement in the quality of fiscal statistics, reflecting risks to the government’s balance sheet more accurately than the previously used central government cash concept.

**30. The focus of monetary policy on financial stability is adequate.** Given the high degree of euroization, the kuna-euro exchange rate anchor remains without viable alternative for the time being—though it implies more pressure on structural and income policies to adjust in the face of shocks. Supervisory policies have been successful in maintaining banking system stability despite the drawn out recession—an impressive achievement. Continued vigilance is needed to preserve this record. However, the debate surrounding the revaluation of CHF loans harbors potential for undermining financial stability, especially if the call for de-facto currency conversion would gain traction, as such a step would undermine an already modest FX reserves position.

**31. It is recommended that the next Article IV consultation with Croatia be held on the standard 12-month cycle.**

### Box 1. Economic Policy Uncertainty

**Economic policy uncertainty** can affect economic outcomes by changing expectations. For example, policy uncertainty may incline companies and households to reduce debt and build precautionary balances instead of investing and consuming. Economic policy uncertainty has many dimensions, including: uncertainty about: (i) who will be in power; (ii) the policies to be implemented; and, (iii) the quality of these policies.

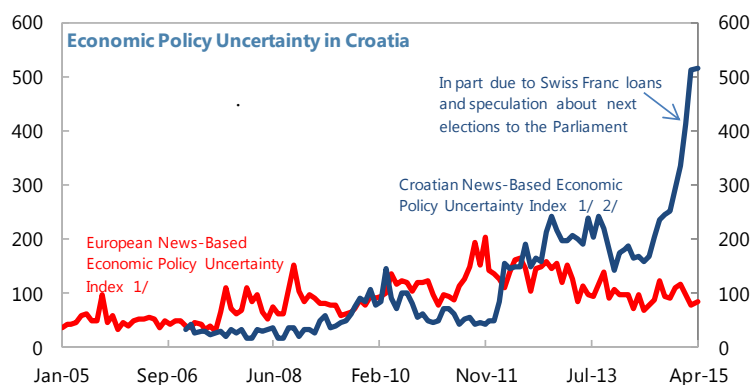
To provide a measure for this concept, Baker, Bloom and Davis (BBD, 2013)<sup>1</sup> have developed an *economic policy uncertainty index* (EPU). Their news-based EPU for Europe can be used as a proxy for global and regional uncertainty, but there is no established EPU yet for Croatia. To fill the gap, staff has compiled a simplified news-based EPU index based on BBD's methodology. The index counts the monthly frequency of the words

"uncertain/uncertainty/risk/risky" in combination with "economic/economy" in the online editions of two leading newspapers, Jutarnji list and Večernji list. The index may be somewhat unreliable in the early years, when the newspapers may have put fewer articles online.

The index shows three periods of increasing policy uncertainty:

- the intensification of recession in late 2009/10;
- 2013—the year when Croatia entered into the EU and was placed under the EC's Excessive Deficit Procedure; and
- the most recent period, which is arguably related to the revaluation of Swiss Franc loans in January 2015.

Further, from 2013 the Croatian and the European EPU index diverge: the Croatian index has increased, while the European index has moderated. While reasoning about forces behind economic policy uncertainty is to some degree speculative, a survey among foreign investors<sup>2</sup> suggests that uncertainty is fueled by the lack of legal certainty, frequent and unexpected changes in legislation, incomplete implementation of EU acquis, unclear responses to requests for clarifications from tax authorities, etc.



Sources: Baker, Scott, Bloom, and Davies, 2013 (<http://www.policyuncertainty.com/>); and IMF staff calculations.

1/ Average of January 2007 to 2014 is set to 100 for the news-based economic policy indices.

2/ Simplified index based on Google search of certain words in the electronic versions of two Croatian news papers.

<sup>1</sup> Baker, S., N. Bloom, and S. Davies, 2013, *Measuring Economic Policy Uncertainty*, available on <http://www.policyuncertainty.com/>.

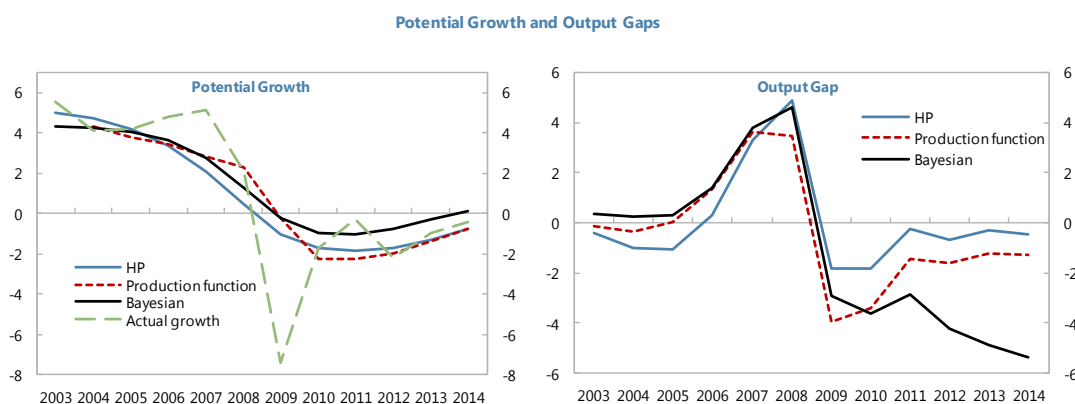
<sup>2</sup> The 2014 *White Book* by the Croatian Foreign Investors Council (<http://www.ficc.hr/?action=news&lang=en>).

## Box 2. Potential Growth and Output Gap

Traditional statistical methods of separating cyclical fluctuations from trend growth yield misleading results when applied to non-cyclical phenomena, such as Croatia's drawn-out balance sheet recession. Standard tools like the popular Hodrick-Prescott (HP) filter tend to underestimate the length of the recession. As one implication, potential (or trend) growth converges toward actual growth so as to close the output gap within the standard length of a business cycle. The "production function" approach to de-trending—which filters GDP components rather than GDP—suffers from similar shortcomings.

To remedy this shortcoming, staff experimented with a Bayesian filter developed in-house and oriented on Borio et. al. (2014).<sup>1</sup> It incorporates financial information into the filtering procedure—in this case house prices and credit growth. Depressed house prices/credit growth signal that GDP remains below potential.

The Bayesian filter shows a far smaller decline in potential growth post-2008, and, consequently, a larger output gap. This has inter alia implications for the estimated fiscal effort during recession: with the Bayesian filter, fiscal effort is substantially larger.



Potential GDP used in the macro-framework complements the Bayesian approach by some judgment. It shows negative total factor productivity growth already before the 2008/09 crisis, reflecting that much of the pre-crisis investment boom was concentrated in the non-tradable sector, especially real estate.

<sup>1</sup> Borio, C., P. Disyatat and M. Juselius, 2014, "A parsimonious approach to incorporating economic information in measures of potential output," *BIS Working Papers 442*, Bank for International Settlements.

**Box 3. Risk Assessment Matrix<sup>1</sup>**  
(Scale—high, medium, or low)

Source of Risks	Relative Likelihood	Impact if Realized	Recommended policy response
A surge in financial volatility: as investors reassess underlying risk and move to safe-haven assets given slow and uneven growth as well as asymmetric monetary exit, with poor market liquidity amplifying the effect on volatility.	<b>High</b>	<b>Medium in the short-term, high in the longer-term</b>	Strengthen fiscal policy, including by developing a coherent 3-year fiscal adjustment plan.
Weak demand and persistently low inflation in the euro area from a failure to fully address crisis legacies and appropriately calibrate macro policies, leading to “new mediocre” rate of growth.	<b>High</b>	<b>Medium</b> Slower growth in advanced Europe would delay the recovery in exports and FDI. Deflation pressures spreading from the euro area could complicate efforts by the private sector to reduce debts.	Accelerate private sector debt restructuring and structural reforms.
Insufficient progress on fiscal consolidation.  No recovery in private domestic demand.	<b>Medium-High</b>	<b>High</b>  Market perception of Croatian sovereign debt would deteriorate further.	Strengthen fiscal policy.  Accelerate private sector debt restructuring and structural reforms.
Sovereign stress in the euro area re-emerges due to policy uncertainty, faltering reforms, and political and social upheaval, particularly in Greece.	<b>Low</b>	<b>Medium</b>	Strengthen fiscal policy.
The mounting conflict surrounding Russia/Ukraine depresses business confidence and heightens risk aversion, amid disturbances in global financial, trade and commodity markets.	<b>Medium</b>	<b>Medium</b> Direct economic linkages are limited, but Croatia would be affected by risk re-pricing.	Strengthen fiscal policy.

<sup>1</sup> The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed 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 of 30 percent or more). The RAM reflects staff views on the source of risks at the time of discussions with the authorities.

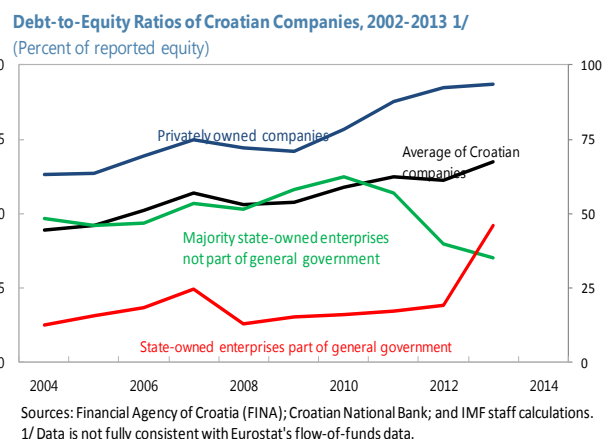


### Box 4. Debt Overhang and Balance Sheet Repair

Croatia’s level of private sector debt is both very high compared to peers and has been receding only very slowly in recent years. Debt overhang is a concern in particular for the corporate sector, whose aggregate debt-to-equity ratio is the highest in the region.<sup>1</sup> Analysis by the Croatian National Bank suggests that *private* non-financial corporations have not deleveraged at all through 2014, in contrast to many state-owned enterprises (SOEs).

A recent staff study analyzes private sector debt relative to fundamentals in emerging Europe, i.e., the deviation of debt from its long-run relationship with GDP per capita, interest rates, etc.<sup>2</sup> The study suggests that at end-2013, Croatian private sector debt was some 20 percent of GDP above its fundamentals-consistent value. Another finding is that corporations operating in rigid labor markets—such as Croatia’s—are more likely to adjust to falling revenues by cutting investment.

Firm-level data show that corporate debt distress—defined as debt-to-income and/or debt-to-equity ratios above long-term averages—is widespread across sectors (Figure). Especially in whole and retail sales, construction, real estate, and market services, corporate leverage appears excessive. Further, exporters tend to do better than firms in the non-tradable sector, a finding that is consistent with a recent World Bank study.<sup>3</sup> This suggests that the small size of Croatia’s export sector has been a hindrance for normalizing corporate leverage, prolonging the recession.



**Corporate Debt Distress Indicators by Sector**  
(Share of companies in distress, in percent, 2013)

	Liquidity risk: Debt-to-Income						Solvency risk: Debt-to-Equity					
	CR	MS	WR	MF	AM	UT	CR	MS	WR	MF	AM	UT
Croatia	97	89	81	63	90	73	52	68	57	35	39	61
Estonia	67	69	54	50	65	56	43	42	30	23	37	17
Latvia	84	74	62	54	46	80	89	68	58	50	35	24
Lithuania	62	53	46	59	59	76	22	16	13	22	10	9
Czech Rep	59	65	62	49	45	26	32	29	32	17	36	11
Hungary	88	76	63	51	39	68	76	66	26	12	8	48
Poland	88	78	45	33	55	42	76	33	21	20	46	10
Slovakia	72	66	72	69	72	27	57	52	51	24	31	13
Slovenia	87	87	78	61	92	70	56	19	32	22	6	1
Bulgaria	74	79	64	67	42	43	64	48	44	32	30	32
Romania	72	47	54	65	62	41	60	34	39	42	36	11
Serbia	88	72	66	75	69	72	12	15	21	22	9	1
Turkey	78	67	54	44	44	49	17	42	45	28	48	21

Source: REI, Spring 2015

Note: Industrial sectors are Agriculture and Mining (AM), Manufacturing (MF), Utility (UT), Construction and real estate (CR), Wholesale and retail trade (WR), and Market services (MS).

<sup>1</sup> For an in-depth analysis of Croatian NFCs, see “An Overview and Structure of the Debt of Non-Financial Corporations in 2013,” Box 3 in *Monthly Bulletin July 2014*, Croatian National Bank, Zagreb. (<http://www.hnb.hr/eindex.htm>).

<sup>2</sup> Iossifov, P.; J. Podpiera; and J. Yoo, 2015, “CESEE: weighed down by debt or turning the level cycle? *Central, Eastern, and Southeastern Europe: Regional Economic Issues*, April 2015, International Monetary Fund, Washington DC.

<sup>3</sup> Iooty, M.; P. Correa; S. Radas; and B. Škrinjarić, 2014, “Stylized Fact on Productivity Growth: Evidence from Firm-Level Data in Croatia,” *Policy Research Working Paper No. 6990*, World Bank, Washington DC. <https://openknowledge.worldbank.org/handle/10986/19387>.

### Box 5. State-Owned Enterprises

State-Owned Enterprises (SOEs) continue to play a large role in Croatia's economy. At end-2013, SOEs accounted for 18 percent of non-financial corporate (NFC) employment and administered more than one-third of NFC assets. The average SOE employs more than 10 times more workers than private enterprises and is highly unionized. Given Croatia's uncoordinated and decentralized wage bargaining system, this grants SOE unions much influence over labor

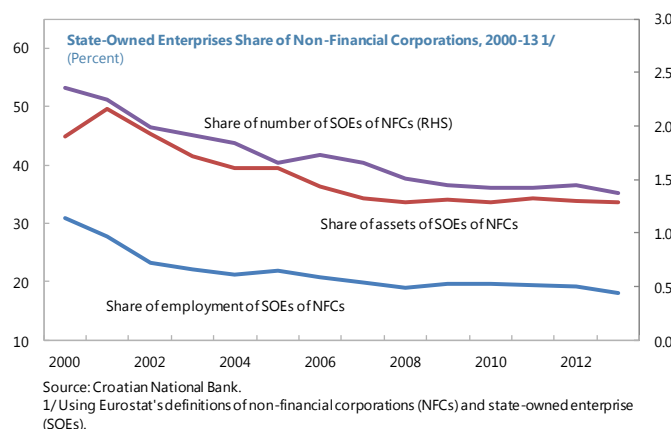
conditions in the entire economy (EU, 2015).

Nestic et. al. (2014) find that wages in SOEs are 20 percent higher than in the private sector, and 7 percent when controlling for employee characteristics.<sup>1</sup> SOE profitability is about half that of the private NFCs, while productivity is significantly lower.<sup>2</sup>

Governance of SOEs suffers from chronic weaknesses. At end-2013, the *State Office for State Property Management* monitored 59

strategically important SOEs with 80,124 employees. Several are loss-makers and receive subsidies, particularly in the transport sector, while profitable SOEs are mainly energy firms and the state lottery. The *Center for Restructuring and Sale* manages stakes in 538 other companies owned by the central government with 5,711 employees (October 2014). Subsidiaries of SOEs and SOEs attached to local governments are without central oversight. Efforts to restructure and privatize loss-making SOEs have advanced at a slow pace: Croatia's shipyards and the majority of Croatian Insurance is now in private hands; but attempts to privatize the Postal Bank, Croatian Airlines, and the Cargo Railway Company failed.

Comparable cross-country data on SOEs are hard to come by, but the EBRD transition indicators provide some insight. The depth and length of the slump in investment following the 2008/09 crisis correlates strongly with the degree of transition from a centralized to a market-based non-financial corporate sector. While far from conclusive, the evidence is consistent with SOEs hampering corporate adjustment and delaying the recovery.



<sup>1</sup> Nestic, D., I. Rubil, and I. Tomic, 2014, "An Analysis of Public and Private Sector Wages in Croatia," Ekonomski Institut, Zagreb: <http://www.eizg.hr/en-US/An-Analysis-of-Public-and-Private-Sector-Wages-in-Croatia-1353.aspx>.

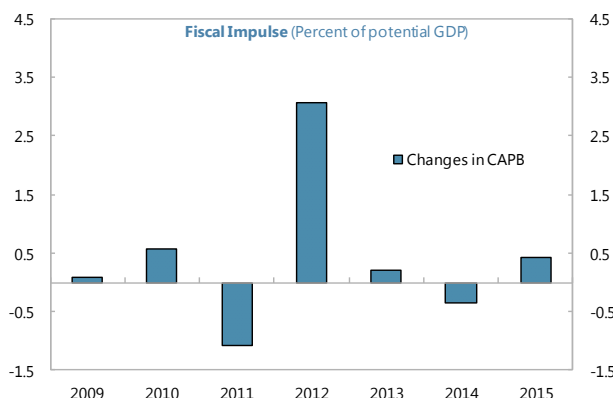
<sup>2</sup> Iooty, M., P. Correa, S. Radas and B. Škrinjarić, 2014, "Stylized Fact on Productivity Growth: Evidence from Firm-Level Data in Croatia," *Policy Research Working Paper* No. 6990, World Bank, Washington DC. <https://openknowledge.worldbank.org/handle/10986/19387>.

### Box 6. Fiscal Adjustment and Domestic Demand

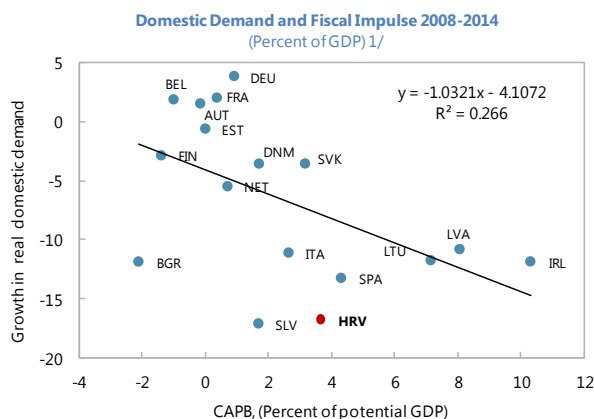
Fiscal policy has not followed a clear path since the onset of the crisis in 2008. Between 2008–11, the cumulative fiscal impulse was negative, indicating a slightly expansionary stance. However, fiscal policy tightened afterwards, especially sharply in 2012. This raises the question to what extent Croatia’s poor growth performance since 2008 is related to fiscal policy.

The broad cross-country pattern in the EU suggests a modest, statistically significant relationship between fiscal adjustment and private demand contraction. However, the slump in Croatia has been far larger relative to the fiscal impulse than the average pattern would suggest—a feature that Croatia shares with countries such as Slovenia, Bulgaria, Spain, and Italy. Hence, other factors are required for a full explanation of these countries’ contractions in private demand.

This said, the correlation between the fiscal policy stance and demand appears to have intensified over time. Statistical analysis suggests that fiscal policy can explain only one-third of Croatia’s demand contraction in 2008–14, but one-half for 2011–14. This is in line with findings in the literature that fiscal multipliers increase with the size of the output gap. In terms of policy, it suggests that fiscal adjustment should not be overdone as long as the economy is weak.



Source: IMF, *World Economic Outlook*; and IMF staff calculations.



Source: IMF, *World Economic Outlook*; and IMF staff calculations.  
1/ Euro area members and EU members with currencies pegged to

### Box 7. Real Exchange Rate Assessment and Competitiveness

Most methods suggest modest overvaluation of Croatia’s real effective exchange rate (REER). The *macroeconomic balance approach* under the CGER methodology—that compares staff’s projected current account with a current account norm—suggests overvaluation by 3.7 percent. Similarly, the *external sustainability* approach—that compares Croatia’s projected net foreign asset position with a sustainable level, and computes the REER revaluation needed for this—signals overvaluation of about 3 percent. The *equilibrium exchange rate* approach lacks robustness to the inclusion of different explanatory variables (such as the current and lagged NFA position) and hence delivers a wide range of estimates.

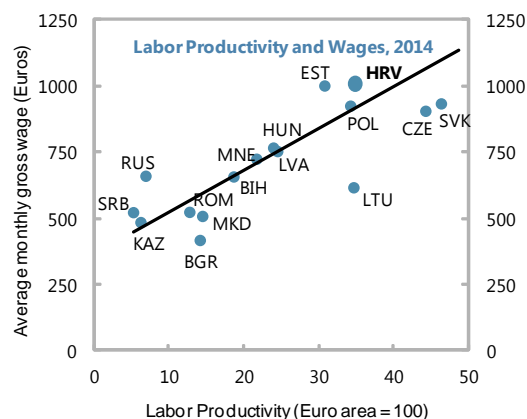
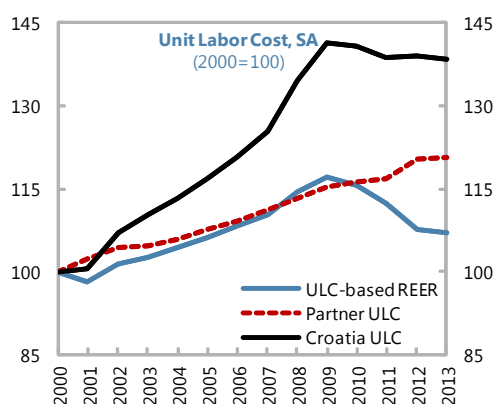
	Estimated overvaluation (percent)
Macroeconomic balance approach	3.7
External sustainability approach	
Stabilizing NFA at -40 percent of GDP	3.1
Equilibrium exchange rate approach	-2.8 to 5.8

Source: IMF staff's estimates.

With the EBA-lite methodology, overvaluation is estimated at 5 percent. EBA-lite estimates a country’s CA norm based on economic fundamentals (similar to the *MB* approach), cyclical factors, and desirable medium-term policy levels. The present-year current account is adjusted for temporary factors, in particular import compression in response to extraordinarily weak demand while Croatia’s private sector draws down excess debt levels. Exchange rate misalignment is defined as the adjustment necessary to bring the current account back to its norm.

A simple measure comparing Croatia’s unit real labor cost (ULC) with peers points to even higher overvaluation of around 10 percent. It is unclear, however, to what extent this differential reflects misalignment, and to what extent an unfavorable real equilibrium outcome due to high reservation wages (inter alia from the tourism sector). The measure also suggests that Croatia has made some progress in reducing its ULC-malus in recent years.

Croatia’s export market share has developed unfavorably in recent years, although this is mostly due to weak growth of trading partners (Italy, Slovenia, Bosnia—see the 2014 Article IV report).



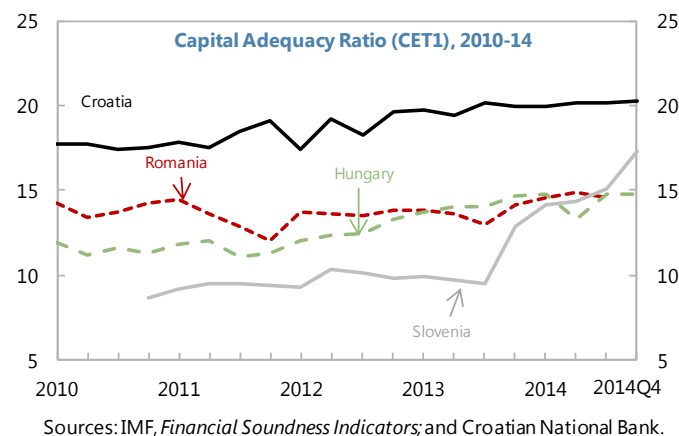
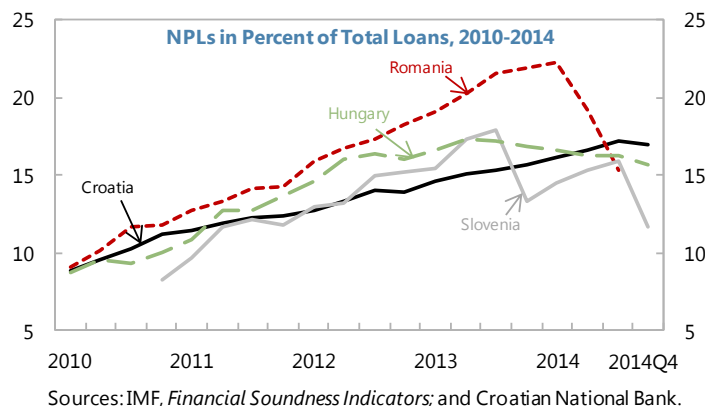
Sources: Haver Analytics, DxTime, Croatian National Bank, European Commission, and IMF staff calculations.

### Box 8. Non-Performing Loans and Bank Capital Adequacy

At end-2014, Croatia's NPL ratio stood at 17 percent, up from 15.7 percent at end-2013. NPLs are higher in the corporate sector—at 30.5 percent of total loans—than in the household sector, with construction companies particularly affected. Non-indexed kuna denominated loans have a higher share of NPLs than loans denominated in or indexed to euro. Croatia is lagging peer countries whose NPL ratios have begun to decline (Chart).

About half of NPLs are provisioned. Regulation implemented in mid-2013 aims at bringing provisioning in line with the average for the region. The Croatian subsidiary of Hypo-Alpe Adria (HAA)—the fifth largest bank in terms of assets—has in recent years sold part of its bad loan portfolio to a special purpose vehicles owned by HAA Austria. This step was taken in preparation of HAA Croatia's sale, which is expected to be finalized by mid-2015. Banks' capital cushions are, on average, large enough to cover the unprovisioned part of NPLs, with an average CAR of 21.5 percent at end-2014.<sup>1</sup> There are pockets of insufficient capitalization in some smaller banks, however.

Unaudited preliminary data suggest that the trend for NPLs may be about to turn, as inflows of new NPLs are slowing. While growth and new credit remain subdued, new measures are being contemplated to deal with the stock of NPLs. A working group—in the context of the Vienna II Initiative—is trying to identify obstacles in the prudential, accounting, tax, and legal frameworks that impede the sales of non-performing assets, and the write-offs of fully provisioned NPLs.



<sup>1</sup> At end-June 2014, one small bank (Nava banka) did not observe minimum capital requirements. Bankruptcy procedures were initiated in July 2014. Another small bank (Karlovačka banka) did not observe the 6 percent minimum tier I requirement.

### Box 9. CHF Appreciation and CHF Loans

Loans denominated in or indexed to Swiss francs became popular during the 2000s in Emerging Europe, providing a cheaper alternative to euro or domestic currency loans. CHF loans were extended mostly to households, especially for mortgages, and typically to wealthier clients. Until recently, CHF loans were most wide-spread in Hungary, followed by Poland and Croatia, although Hungary converted most CHF loans to domestic currency, effective November 2014.<sup>1</sup>

Swiss Franc Exposures in Selected Central and Eastern European Countries

	Bosnia & Herzegovina		Croatia		Hungary		Poland		Romania <sup>2/</sup>		Serbia	
	2008	2014	2010	2014	2008 <sup>2/</sup>	2014	2008	2014	2008	2014	2008	2014
In percent of GDP												
Total CHF exposure	3.4	1.3	11.0	7.3	23.3	2.9	...	...	3.0	1.9	4.8	2.9
Household loans in CHF	1.9	0.9 <sup>1/</sup>	9.5	6.7	18.1	1.2	...	...	2.1	1.5	3.6	2.6
Housing loans in CHF	...	...	7.9	6.3	...	0.0	10.3	7.6	0.7	0.5	...	...

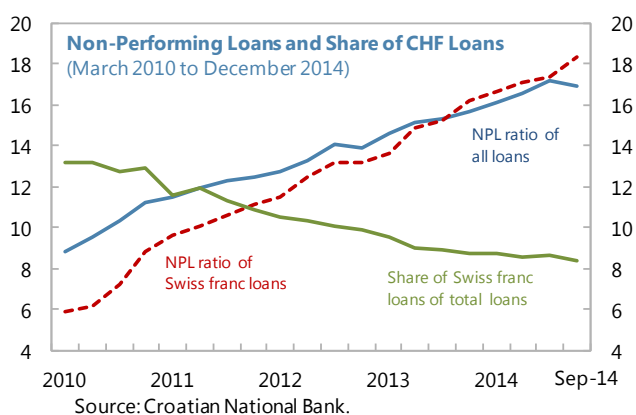
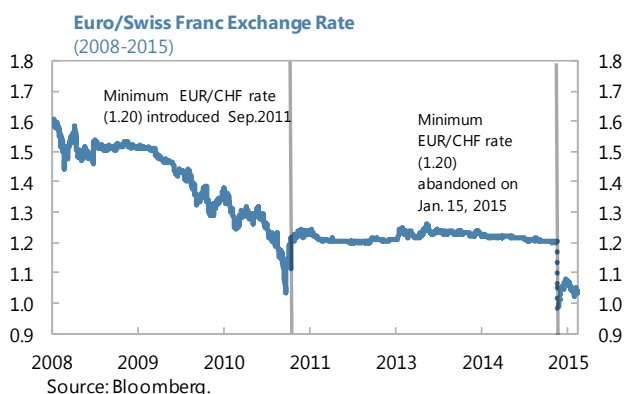
Source: National central banks and supervisory agencies, and IMF staff calculations.

1/ Estimate based on partial data.

2/ Loans in currencies other than domestic currency or euro.

CHF loans came under scrutiny when the franc began to appreciate in 2009. In 2010, Croatian borrowers set up an NGO—called Franak—that initiated a collective action lawsuit, claiming banks had mis-informed about currency and interest risk. A first level court ruled in favor of Franak, but in July 2014, the High Commerce Court dismissed the currency complaint. It upheld the interest complaint, but it is unclear how borrowers would be compensated. These rulings were confirmed in May 2015 by the Supreme Court. Further, in 2014 the government imposed interest ceilings on CHF loans.

Until the sharp appreciation of the CHF on January 15, 2015, the CHF loan problem seemed to fizzle out, as banks had largely stop offering such loans. The CHF's renewed appreciation in January 2015 has brought the issue back to the forefront. Total revaluation since 2007 is now almost 50 percent, although more than two-thirds of the impact on loan servicing cost has been offset by lower CHF interest rates.



<sup>1</sup> The impact on loan servicing cost was offset by separately-legislated principal reductions, allegedly to compensate for past unfair lending practices.

Table 1. Selected Economic Indicators, 2009–16

	2009	2010	2011	2012	2013	2014	2015	2016
							Proj.	Proj.
<b>Output, unemployment, and prices</b>								
(Percent change, unless otherwise indicated)								
Real GDP	-7.4	-1.7	-0.3	-2.2	-0.9	-0.4	0.5	1.0
Contributions:								
Domestic demand	-11.1	-4.7	-0.2	-3.4	-0.9	-1.9	-0.4	0.4
Net exports	3.8	3.1	-0.1	1.1	0.0	1.4	0.9	0.6
Unemployment (percent) /1	14.9	17.6	17.8	19.1	20.3	19.7	20.0	19.8
CPI inflation (average)	2.4	1.0	2.3	3.4	2.2	-0.2	-0.4	1.1
Growth in average monthly nominal wages	2.2	-0.4	1.5	1.0	0.8	0.2	...	...
<b>Saving and investment</b>								
(Percent of GDP)								
Domestic investment	25.0	21.4	20.6	19.3	18.9	17.9	17.4	17.4
Of which: fixed capital formation	25.2	21.3	20.3	19.6	19.3	18.6	17.7	17.1
Domestic saving	19.9	20.2	19.8	19.1	19.6	18.5	19.2	19.0
Government	1.3	2.3	1.4	-0.1	0.4	0.2	0.6	1.0
Nongovernment	18.7	17.9	18.4	19.2	19.2	18.3	18.6	18.1
<b>Government sector 2/</b>								
General government revenue	41.2	40.8	41.0	41.7	42.4	42.3	43.3	44.3
General government expenditure	47.2	46.8	48.5	47.0	47.7	48.0	48.5	48.7
General government balance	-5.9	-6.0	-7.5	-5.3	-5.4	-5.7	-5.1	-4.4
Structural balance (IMF calculation)	-5.4	-5.1	-6.6	-3.8	-3.7	-4.0	-3.6	-3.2
General government debt	44.5	52.8	63.7	69.2	80.6	85.0	89.5	92.1
<b>Money and credit</b>								
(End of period; change in percent)								
Claims on other domestic sectors	-0.6	3.6	4.4	-6.2	-1.0	-1.9	...	...
Broad money	0.2	2.0	4.8	3.6	3.5	2.8	...	...
<b>Interest rates 3/</b>								
(Period average; percent)								
Average kuna deposit rate (unindexed)	3.2	1.8	1.7	1.6	1.4	1.2	...	...
Average kuna credit rate (unindexed)	11.6	10.4	9.7	9.6	9.2	8.5	...	...
Average real kuna credit rate (unindexed) 4/	9.0	9.2	7.3	6.0	6.9	8.7	...	...
Average credit rate, foreign currency-indexed loans	8.1	8.1	7.4	7.3	6.7	6.6	...	...
<b>Balance of payments</b>								
(Millions of euros, unless otherwise indicated)								
Current account balance	-2,304	-503	-360	-61	341	286	768	716
Percent of GDP	-5.1	-1.1	-0.8	-0.1	0.8	0.7	1.8	1.6
Capital and financial account	4,714	1,490	1,872	484	2,333	-230	277	329
FDI, net (percent of GDP)	3.0	2.1	2.7	2.7	2.0	2.7	2.0	2.3
Overall balance	1,228	84	401	46	1,845	-530	50	50
<b>Debt and reserves</b>								
End of period; millions of euros, unless otherwise indicated								
Gross official reserves	10,376	10,660	11,195	11,236	12,908	12,688	12,738	12,788
Percent of short-term debt (by residual maturity)	85	85	85	95	100	105	113	89
Months of following year's imports of goods and nonfactor services	7.3	7.0	7.4	7.3	8.1	7.9	7.4	7.0
Net international reserves	9,035	9,286	10,019	10,199	10,506	10,595	10,765	10,815
Reserves (Fixed, percent of RAM) 5/	72.7	72.7	75.1	77.1	86.8	84.3	84.1	81.8
External debt service to exports ratio (percent)	59.0	39.7	33.6	29.5	37.9	38.1	38.4	31.1
Total external debt (percent of GDP)	101.1	104.2	103.8	103.0	105.4	105.5	104.0	100.0
Net external debt (percent of GDP)	63.2	65.9	66.7	65.6	64.7	62.7	61.1	57.7
<b>Exchange rate</b>								
Kuna per euro, end of period	7.3	7.4	7.5	7.5	7.6	7.7	...	...
Kuna per euro, period average	7.3	7.3	7.4	7.5	7.6	7.6	...	...
Real effective rate (CPI, percent change) 6/	1.2	-2.6	-2.1	-1.9	1.4	-1.0	...	...
<b>Memorandum items:</b>								
Nominal GDP (millions of euros)	45,083	45,009	44,712	43,938	43,559	43,083	43,141	44,039
Output gap (percent of potential)	-1.6	-2.9	-2.7	-4.4	-5.0	-5.0	-4.4	-3.5
Per capita GDP (2012, WEO): \$12,829	Percent of population below poverty line (2004): 11.1							
Quota (2010): SDR 365 million (508 million U.S. dollars)								

Sources: Croatian authorities; and IMF staff estimates.

1/ Croatian Bureau of Statistics.

2/ ESA 2010 definition.

3/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.

4/ Nominal interest rate deflated by past year's change in the CPI.

5/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.

6/ Positive change means depreciation and vice versa.

**Table 2. Medium-Term Baseline Scenario, 2009–20**  
(Percent of GDP, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Prel.			Proj.			
<b>Real sector (percent change)</b>												
Real GDP	-7.4	-1.7	-0.3	-2.2	-0.9	-0.4	0.5	1.0	1.7	2.0	2.0	1.8
Domestic demand	-10.4	-4.5	-0.2	-3.4	-0.9	-1.9	-0.4	0.4	1.1	1.9	2.4	2.3
Consumption, total	-5.1	-1.5	0.2	-2.5	-0.8	-1.0	-0.4	0.2	0.8	1.3	1.6	1.5
<i>Of which: private</i>	-7.4	-1.5	0.3	-3.0	-1.2	-0.7	0.3	0.8	1.8	1.8	1.9	1.9
Gross fixed capital formation, total	-14.4	-15.2	-2.7	-3.3	-1.0	-4.0	-1.0	0.9	1.5	2.5	4.0	4.0
<i>Of which: non-government</i>	-15.6	-8.3	-4.8	-4.2	-2.5	-4.3	-1.3	0.9	1.4	2.5	4.3	4.4
GDP deflator	2.8	0.8	1.7	1.6	0.9	0.0	0.3	1.1	1.6	1.9	2.2	2.2
CPI inflation (average)	2.4	1.0	2.3	3.4	2.2	-0.2	-0.4	1.1	1.4	1.9	2.2	2.2
CPI inflation (end-of-period)	1.9	1.9	2.0	4.7	0.3	-0.5	0.4	1.3	1.7	1.9	2.2	2.2
<b>Saving and investment</b>												
Domestic investment	25.0	21.4	20.6	19.3	18.9	17.9	17.4	17.4	17.4	17.8	18.2	18.8
<i>Of which: fixed capital formation</i>	25.2	21.3	20.3	19.6	19.3	18.6	17.7	17.1	17.3	17.6	18.1	18.7
Domestic saving	19.9	20.2	19.8	19.1	19.6	18.5	19.2	19.0	18.7	18.0	17.5	17.6
Government	1.3	2.3	1.4	-0.1	0.4	0.2	0.6	1.0	1.7	2.5	2.6	2.6
Nongovernment	18.7	17.9	18.4	19.2	19.2	18.3	18.6	18.1	17.0	15.5	14.9	15.0
<b>General government finances</b>												
Revenue	41.2	40.8	41.0	41.7	42.4	42.3	43.3	44.3	45.0	45.7	46.3	46.6
Expenditure	47.2	46.8	48.5	47.0	47.7	48.0	48.5	48.7	48.6	48.6	49.2	49.5
Balance	-5.9	-6.0	-7.5	-5.3	-5.4	-5.7	-5.1	-4.4	-3.6	-2.9	-2.9	-2.9
Government debt	44.5	52.8	63.7	69.2	80.6	85.0	89.5	92.1	92.8	92.1	91.2	90.6
<b>Balance of payments 1/</b>												
Current account balance	-5.1	-1.1	-0.8	-0.1	0.8	0.7	1.8	1.6	1.3	0.2	-0.7	-1.2
Exports of goods, f.o.b.	14.6	17.9	19.6	19.7	20.5	22.6	22.6	23.8	24.9	25.6	26.3	27.1
Imports of goods, f.o.b.	31.2	31.1	33.8	34.1	35.6	37.3	37.8	40.1	42.1	44.1	45.5	46.5
Capital and financial account	10.5	3.3	4.2	1.1	5.4	-0.5	0.6	0.7	1.0	2.0	2.9	3.2
<i>Of which: FDI, net</i>	3.0	2.1	2.7	2.7	2.0	2.7	2.0	2.3	2.2	2.2	2.2	2.2
Gross official reserves	23.0	23.7	25.0	25.6	29.6	29.4	29.5	29.0	28.2	27.3	26.2	25.3
Gross external debt	101.1	104.2	103.8	103.0	105.4	105.5	104.0	100.0	94.8	90.4	87.2	84.8
Net external debt	63.2	65.9	66.7	65.6	64.7	62.7	61.1	57.7	53.5	50.3	48.5	47.2
<b>Memorandum items:</b>												
Nominal GDP (billions of kuna)	331.0	328.0	332.6	330.5	330.1	328.9	331.4	338.3	349.3	363.2	378.6	394.0
Nominal GDP (billions of euros)	45.1	45.0	44.7	43.9	43.6	43.1	43.1	44.0	45.5	47.3	49.3	51.3
Output gap	-1.6	-2.9	-2.7	-4.4	-5.0	-5.0	-4.4	-3.5	-2.2	-0.8	-0.1	0.0
Potential GDP growth	0.5	-0.3	-0.5	-0.4	-0.4	-0.3	-0.2	0.1	0.3	0.6	1.2	1.7

Sources: Crostat; Croatian National Bank; Ministry of Finance; and IMF staff estimates.

1/ Based on BPM6 manual.



**Table 3. Balance of Payments, 2009–2020 1/**  
(Millions of euros, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Proj.											
Current account	-2,304	-503	-360	-61	341	286	768	716	574	118	-369	-614
Merchandise trade balance	-7,456	-5,922	-6,382	-6,298	-6,589	-6,334	-6,563	-7,189	-7,833	-8,740	-9,462	-9,962
Exports f.o.b.	6,594	8,058	8,743	8,673	8,923	9,754	9,730	10,486	11,325	12,120	12,950	13,914
Imports f.o.b.	-14,049	-13,980	-15,124	-14,970	-15,512	-16,088	-16,293	-17,675	-19,158	-20,860	-22,412	-23,876
Services Trade Balance	5,797	5,761	6,190	6,516	6,792	7,234	7,925	8,480	8,954	9,356	9,646	9,951
Export of services	8,984	8,928	9,358	9,636	9,824	10,184	10,823	11,344	11,752	12,071	12,273	12,498
Imports of services	-3,186	-3,167	-3,169	-3,120	-3,032	-2,950	-2,898	-2,864	-2,797	-2,714	-2,627	-2,547
Primary income balance	-1,650	-1,403	-1,317	-1,441	-933	-1,396	-1,484	-1,515	-1,565	-1,627	-1,696	-1,765
Secondary income balance	1,004	1,062	1,149	1,161	1,071	782	890	940	1,018	1,128	1,143	1,162
Capital and financial account	4,714	1,490	1,872	484	2,333	-230	277	329	471	927	1,414	1,659
Capital account	61	60	38	48	51	72	193	294	448	670	699	736
Financial account	4,652	1,430	1,834	436	2,282	-302	84	35	23	257	715	923
Direct investment	1,333	943	1,205	1,197	858	1,180	871	993	1,021	1,050	1,080	1,110
Portfolio investment	455	402	582	1,744	1,891	-706	1,095	843	739	715	712	699
Financial derivatives	0	-253	-75	55	-9	-15	-15	-15	-15	-15	-15	-15
Medium- and long-term loans	852	-995	-760	-1,860	-1,221	205	-1,108	-793	-726	-552	-468	-497
Assets	8	46	24	-43	129	-32	0	0	0	0	0	0
Liabilities	860	-950	-736	-1,903	-1,092	173	-1,108	-793	-726	-552	-468	-497
Disbursements	6,713	5,894	4,547	4,682	5,471	6,482	4,038	3,039	2,700	1,577	2,085	1,368
Amortization	-5,853	-6,844	-5,284	-6,584	-6,563	-6,309	-5,146	-3,832	-3,426	-2,130	-2,553	-1,866
Currency and deposits	1,834	496	1,242	-1,637	341	-1,335	-707	-940	-944	-888	-541	-322
Short-term capital flows (net)	-76	478	139	395	348	-78	-1	-1	-1	-1	-1	-1
Trade credits	-89	348	-598	671	78	168	-51	-51	-51	-51	-51	-51
Other liabilities (long-term)	343	11	100	-127	20	307	0	0	0	0	0	0
Net errors and omissions 2/	-1,182	-903	-1,111	-377	-830	-586	-995	-995	-995	-995	-995	-995
Overall balance	1,228	84	401	46	1,845	-530	50	50	50	50	50	50
Financing												
Gross reserves (= increase)	-1,228	-84	-401	-46	-1,845	530	-50	-50	-50	-50	-50	-50
IMF (net purchases)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing	8.0	-6.0	-9.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:												
Current account (percent of GDP)	-5.1	-1.1	-0.8	-0.1	0.8	0.7	1.8	1.6	1.3	0.2	-0.7	-1.2
Export goods volume growth	-11.7	18.8	-0.6	-2.1	5.7	11.1	7.1	7.0	6.8	6.0	6.0	6.0
Import goods volume growth	-22.2	-2.3	3.5	-2.7	4.8	4.1	5.7	6.0	5.9	6.4	6.9	6.9
Gross official reserves	10,376	10,660	11,195	11,236	12,908	12,688	12,738	12,788	12,838	12,888	12,938	12,988
Reserves: Gross Official Reserves (percent of short-term debt by remaining maturity)	85.2	84.6	85.4	95.0	100.3	104.7	112.5	89.4	110.1	91.5	102.0	...
Months of next year's imports of goods and nonfactor services	7.3	7.0	7.4	7.3	8.1	7.9	7.4	7.0	6.5	6.2	5.9	...
Outstanding debt 2/	45,600	46,908	46,397	45,297	45,958	46,664	46,075	45,249	44,317	43,943	44,207	44,701
External debt to GDP ratio 2/	101.1	104.2	103.8	103.1	105.5	108.3	106.8	102.7	97.4	92.9	89.7	87.1
External debt in percent of exports of goods and nonfactor services 2/	180.6	186.1	196.6	218.9	292.7	276.2	256.3	247.4	245.1	234.0	224.2	207.3
GDP (millions of euros)	45,083	45,009	44,712	43,938	43,559	43,083	43,141	44,039	45,483	47,288	49,288	51,293
GDP (millions of kuna)	330,966	328,041	332,587	330,456	330,135	328,927	331,359	338,251	349,344	363,211	378,572	393,968

Sources: Croatian National Bank; and IMF staff estimates.

1/ BPM6 data are presented in an analytical format consistent with previous staff reports. The signs on flows follow the analytical format. Further, changes in gross reserves are reported below the line.

2/ Errors and omissions are explicitly projected to reflect persistent unrecorded capital outflows.

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

**Table 4A. The Statement of Operations of General Government, 2009–2020**  
(Percent of GDP, ESA 2010)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Staff Projections											
Revenue	41.2	40.8	41.0	41.7	42.4	42.3	43.3	44.3	45.0	45.7	46.3	46.6
Taxes	24.3	24.3	23.6	24.5	25.2	24.6	24.2	24.5	25.0	25.5	25.8	25.8
Taxes on Income	n.a.	n.a.	n.a.	5.7	5.9	5.5	5.1	5.3	5.5	5.7	5.9	5.9
VAT	11.2	11.6	11.3	12.3	12.6	12.5	12.5	12.6	12.8	13.1	13.2	13.2
Excise	3.3	3.6	3.4	3.4	3.5	3.9	4.0	4.0	4.0	4.0	4.0	4.0
Import Duties	0.5	0.5	0.5	0.5	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Property tax	0.3	0.3	0.3	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other taxes	n.a.	n.a.	n.a.	2.3	2.1	1.9	1.8	1.8	1.8	1.8	1.8	1.8
Social contributions	12.1	11.8	11.6	11.5	11.3	11.8	12.1	12.2	12.3	12.4	12.4	12.4
Other revenue	1.9	1.6	2.3	2.4	2.2	2.3	3.4	3.9	4.1	4.2	4.5	4.8
Grants 1/	1.0	1.0	1.5	1.6	1.2	1.1	2.1	2.7	3.0	3.1	3.4	3.7
Property income	1.0	0.6	0.8	0.8	1.0	1.1	1.2	1.2	1.1	1.1	1.1	1.1
o/w: interest, receivable	0.1	0.1	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Sales of goods and services	2.9	3.0	3.4	3.4	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Expenditure	47.2	46.8	48.5	47.0	47.7	48.0	48.5	48.7	48.6	48.6	49.2	49.5
Expense	41.7	43.5	45.0	43.5	44.0	44.4	44.9	45.0	44.7	44.0	44.0	44.0
Compensation of employees	12.3	12.2	12.4	12.2	12.1	11.7	11.6	11.5	11.3	11.2	11.2	11.2
Use of goods and services	6.9	7.2	7.5	7.3	7.8	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Interest, payable	2.1	2.4	3.0	3.4	3.5	3.5	3.6	3.8	3.9	3.9	4.2	4.2
Subsidies	2.5	2.5	2.4	2.2	2.1	2.0	1.9	1.9	1.9	1.9	1.9	1.9
Current grants 2/	1.0	1.1	0.6	0.8	1.6	1.3	2.1	2.4	2.4	1.9	1.7	1.7
Social benefits	15.9	15.7	16.1	16.3	15.9	16.5	16.5	16.5	16.3	16.2	16.2	16.2
Other expenses	0.9	2.6	2.8	1.2	1.1	1.3	1.2	1.0	1.0	1.0	1.0	1.0
Net acquisition of nonfinancial assets	5.5	3.3	3.5	3.5	3.7	3.6	3.6	3.6	4.0	4.6	5.1	5.5
o/w: from own sources	...	...	...	...	...	...	3.4	3.4	3.4	3.4	3.4	3.5
o/w: from EU structural funds	...	...	...	...	...	...	0.2	0.3	0.6	1.2	1.7	2.0
Gross Operating Balance	-0.4	-2.8	-4.0	-1.8	-1.6	-2.1	-1.6	-0.8	0.3	1.8	2.3	2.6
Net lending/borrowing (overall balance)	-5.9	-6.0	-7.5	-5.3	-5.4	-5.7	-5.1	-4.4	-3.6	-2.9	-2.9	-2.9
Net financial transactions	-6.9	-5.9	-8.1	-5.7	-5.1	-5.7	-5.1	-4.4	-3.6	-2.9	-2.9	-2.9
Memorandum items:												
General government debt	44.5	52.8	63.7	69.2	80.6	85.0	89.5	92.1	92.8	92.1	91.2	90.6
Net interest expense	-2.0	-2.2	-2.7	-3.0	-3.1	-3.0	-3.2	-3.3	-3.5	-3.5	-3.7	-3.7
Primary balance	-3.9	-3.8	-4.8	-2.3	-2.3	-2.7	-2.0	-1.0	-0.2	0.6	0.9	0.8
Structural balance 3/	-5.3	-4.9	-6.5	-3.6	-3.5	-3.8	-3.5	-3.1	-2.8	-2.6	-2.8	-2.9
Cyclically adjusted primary balance 3/	-3.3	-2.8	-3.8	-0.8	-0.5	-0.9	-0.4	0.2	0.6	0.9	0.9	0.8
Change in cyclically adjusted primary balance 3/	0.1	0.6	-1.1	3.1	0.2	-0.3	0.4	0.6	0.4	0.3	0.0	-0.1
Capital transfers to public enterprises (debt assumptions, capital transfers, called guarantees).	0.0	-1.0	-2.3	-0.1	-0.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance 3/ 4/	-5.3	-3.9	-4.2	-3.5	-3.3	-3.4	-3.5	-3.1	-2.8	-2.6	-2.8	-2.9
Cyclically adjusted primary balance 3/4/	-3.3	-1.8	-1.6	-0.6	-0.4	-0.5	-0.4	0.2	0.6	0.9	0.9	0.8
Change in cyclically adjusted primary balance 3/4/	0.1	1.6	0.2	0.9	0.3	-0.2	0.1	0.6	0.4	0.3	0.0	-0.1

Sources: Eurostat and IMF staff estimates. ESA 2010 (changed from cash basis in previous staff reports).

1/ Mostly EU structural funds.

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

3/ In percent of potential GDP.

4/ Excluding payments toward debt assumptions, capital transfers, and guarantees of the public enterprises outside of the general government (ESA 2010).

**Table 4B. Unconsolidated Central Government Budget, 2009–14**  
(Percent of GDP, cash basis)

	2009	2010	2011	2012	2013	2014
						Est.
Revenue	33.3	32.8	32.2	33.2	32.9	34.5
Taxes	19.2	19.2	18.5	19.6	19.1	19.0
Taxes on income, profits, and capital gains	3.3	2.3	2.6	2.7	2.3	2.2
Payable by individuals	0.4	0.4	0.4	0.4	0.4	0.4
Payable by corporations and other enterprises	2.9	2.0	2.2	2.3	1.9	1.7
Taxes on property	0.2	0.1	0.1	0.1	0.1	0.1
Taxes on goods and services	14.9	15.5	15.1	16.1	16.2	16.6
Of which:						
VAT	11.2	11.5	11.3	12.3	12.2	12.3
Excises	3.3	3.6	3.4	3.4	3.5	3.9
Taxes on international trade and transactions	0.5	0.5	0.5	0.5	0.4	0.1
Other taxes 1/	0.4	0.7	0.1	0.1	0.1	0.1
Social security contributions 2/	12.1	11.8	11.6	11.5	11.3	12.8
Grants	0.2	0.2	0.3	0.3	0.5	0.7
Other revenue	1.8	1.6	1.9	1.8	2.0	2.0
Expenditure	36.2	37.1	36.4	36.2	37.8	38.3
Expenses	35.6	36.7	36.1	35.9	37.4	38.0
Compensation of employees	9.5	9.5	9.5	9.5	9.2	9.4
Use of goods and services	2.2	2.3	2.4	2.2	2.3	2.1
Interest	1.6	1.9	2.1	2.5	2.8	3.0
Subsidies	2.0	2.0	2.0	1.7	1.7	1.6
Grants	1.7	1.8	1.5	1.5	2.0	2.5
Social benefits	17.0	17.3	17.0	17.0	17.9	17.8
Other expense	1.7	1.8	1.5	1.5	1.6	1.6
Net acquisition of nonfinancial assets	0.6	0.4	0.3	0.3	0.4	0.3
Acquisition	0.7	0.5	0.4	0.3	0.5	0.5
Disposal	0.1	0.1	0.1	0.1	0.1	0.2
Gross operating balance	-2.3	-3.9	-3.9	-2.8	-4.5	-3.6
Overall balance	-2.9	-4.3	-4.2	-3.0	-4.9	-3.9

Sources: Ministry of Finance and IMF staff estimates.

**Table 4C. Concordance Between Cash and ESA 2010 Central Government Fiscal Balances 1/**  
(Percent of GDP)

	2010	2011	2012	2013	2014
Working balance=Overall Balance	-4.3	-4.2	-3.0	-4.9	-3.9
Financial transactions included in the working balance	0.0	0.0	0.0	0.0	0.0
Difference between interest paid (+) and accrued (-)	-0.1	-0.3	-0.2	0.0	-0.1
Other accounts receivable/Other accounts payable included in the working balance	0.2	0.2	-0.3	0.5	-0.4
Other accounts receivable	0.1	0.1	-0.4	0.7	-0.2
Other accounts payable	0.1	0.1	0.1	-0.2	-0.2
Net lending (+) /net borrowing (-) of other bodies of the central government	-0.4	-0.4	-0.7	-0.9	-0.2
Capital transfers to corporations and debt assumptions	-1.0	-2.3	-0.1	-0.2	-0.3
Capital transfer to public corporations-debt assumptions	-0.5	-2.2	-0.1	-0.1	-0.3
Capital transfer to public corporations-guarantees called less repayments	-0.2	0.0	0.0	0.0	0.0
Capital transfer to non-public corporations-capital injections	0.0	-0.1	0.0	0.0	-0.1
Capital transfer to public corporations-capital injections	-0.3	0.0	0.0	0.0	0.0
Other adjustments (+/-) included in the working balance	-0.3	-0.4	-0.7	-0.3	-1.2
ESA 2010:					
Central Government, Net lending (+) /net borrowing (-)	-6.0	-7.3	-5.0	-5.8	-6.1
Local Government, Net lending (+) /net borrowing (-)	0.0	-0.1	0.1	0.0	0.1
Social Security, Net lending (+) /net borrowing (-)	0.0	-0.1	-0.3	0.5	0.3
General Government, Net lending (+) /net borrowing (-)	-6.0	-7.5	-5.3	-5.4	-5.7

Sources: Eurostat.

1/ Based on ESA 2010, and reflecting the latest developments contained in the April 2015 EDP notification.

**Table 5. Monetary Accounts, 2009–15**  
(End-period; billions of kuna, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014				2015
						Q1	Q2	Q3	Q4	Q1
<b>Monetary survey</b>										
Net foreign assets	42.5	41.9	31.2	47.5	62.3	56.2	61.2	79.6	75.1	75.6
(Millions of euros)	5.8	5.7	4.1	6.3	8.2	7.4	8.1	10.4	9.8	9.9
Croatian National Bank	73.4	76.1	81.6	82.1	95.4	89.3	90.6	88.6	93.5	99.1
(Millions of euros)	10.0	10.3	10.9	10.9	12.5	11.7	12.0	11.6	12.2	13.0
Deposit money banks	-30.9	-34.2	-50.4	-34.7	-33.0	-33.0	-29.4	-9.1	-18.4	-23.4
(Millions of euros)	-4.2	-4.6	-6.7	-4.6	-4.3	-4.3	-3.9	-1.2	-2.4	-3.1
Net domestic assets	201.9	207.3	229.8	222.9	217.5	222.8	216.9	208.9	212.4	209.4
Domestic credit (CNB definition) 1/	234.6	247.7	259.4	247.4	244.3	242.7	239.9	238.9	237.9	240.2
Claims on government, net 2/	40.2	45.1	59.5	69.1	67.6	74.3	70.8	67.5	73.4	72.5
Claims on other domestic sectors 3/	232.8	241.3	252.0	236.4	234.1	234.0	231.6	230.8	229.6	232.5
Other items (net)	-32.7	-40.4	-29.6	-24.5	-26.7	-20.0	-23.1	-29.9	-25.5	-30.8
Broad money	244.4	249.1	261.0	270.3	279.8	279.0	278.1	288.5	287.6	285.0
Narrow money	47.2	48.0	51.5	52.0	58.2	56.7	60.5	62.9	63.5	61.2
Currency outside banks	15.3	15.3	16.7	16.9	17.4	17.1	18.9	19.3	18.5	18.4
Demand deposits	31.9	32.7	34.8	35.1	40.8	39.6	41.6	43.6	45.0	42.8
Quasi money 4/	197.2	201.2	209.5	218.3	221.7	222.3	217.6	225.6	224.1	223.9
Kuna-denominated	61.7	46.5	52.2	51.7	52.3	52.8	52.3	52.9	52.8	52.9
Foreign currency-denominated	135.5	154.7	157.3	166.6	169.4	169.6	165.3	172.7	171.2	170.9
<b>Balance sheet of the Croatian National Bank</b>										
Net foreign assets	73.4	76.1	81.6	82.1	95.4	89.3	90.6	88.6	93.5	99.1
Of which: banks' reserves in foreign currency	5.0	4.8	5.5	5.1	4.4	4.4	4.4	4.4	3.7	3.8
Net international reserves	66.0	68.6	75.5	77.0	80.3	78.5	79.3	80.7	81.2	84.3
Net domestic assets	-12.1	-13.8	-13.7	-12.8	-26.0	-20.7	-23.1	-22.0	-26.2	-30.2
Claims on government (net)	-4.2	-4.2	-1.6	-0.7	-13.5	-8.3	-11.3	-8.4	-11.5	-14.1
Claims on banks	0.01	0.01	0.14	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Of which: Open market operations	...	...	...	...	...	...	...	...	...	...
Claims on other domestic sectors	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other items (net)	-8.0	-9.7	-12.2	-12.2	-12.5	-12.4	-11.9	-13.6	-14.8	-16.1
Base money	61.2	62.2	68.1	69.3	69.4	68.6	67.5	66.6	67.3	68.8
Currency	15.3	15.3	16.7	16.9	17.4	17.1	18.9	19.3	18.5	18.4
Deposits	46.0	47.0	51.4	52.3	51.9	51.5	48.6	47.3	48.7	50.5
Of which:										
Settlement accounts	12.0	10.2	12.7	11.5	15.1	16.8	13.4	12.6	15.1	17.2
Statutory reserves in kuna 5/	23.6	22.7	25.8	24.6	22.0	21.8	21.8	22.0	21.9	21.9
Statutory reserves in foreign currency	5.0	4.8	5.5	5.1	4.4	4.4	4.4	4.4	3.7	3.8
Reserve money (CNB definition) 6/	56.2	56.3	62.4	61.3	63.0	63.9	63.0	62.1	63.4	64.9
<b>Year-on-year percent changes</b>										
<b>Monetary survey</b>										
Net domestic assets	-0.2	2.7	10.9	-3.0	-2.4	-2.0	-5.1	-6.6	-2.3	-6.0
Domestic credit (CNB definition) 1/	-0.9	5.6	4.7	-4.6	-1.3	-2.4	-3.1	-3.8	-2.6	-1.0
Claims on government, net 2/	14.7	12.1	32.0	16.1	-2.1	-0.9	-4.1	-5.6	8.5	-2.5
Claims on other domestic sectors 3/	-0.6	3.6	4.4	-6.2	-1.0	-1.6	-2.0	-2.8	-1.9	-0.6
Broad money	0.2	2.0	4.8	3.6	3.5	2.7	1.6	2.4	2.8	2.2
Quasi money	4.5	2.0	4.1	4.2	1.5	1.0	0.3	0.6	1.1	0.7
<b>Balance sheet of the Croatian National Bank</b>										
Base money	5.9	1.6	9.5	1.7	0.1	-1.9	-4.5	-2.5	-3.0	0.4
Reserve money (CNB definition) 6/	12.9	0.2	10.9	-1.7	2.7	2.3	-0.8	1.5	0.7	1.7
<b>Memorandum items:</b>										
Nominal GDP (yearly total)	331.0	328.0	332.6	330.5	330.1	329.3	328.4	328.4	328.9	329.5
Narrow money multiplier	0.77	0.77	0.76	0.75	0.84	0.83	0.90	0.94	0.94	0.89
Broad money multiplier	3.99	4.00	3.83	3.90	4.03	4.07	4.12	4.33	4.28	4.14
Broad money (percent of GDP)	73.8	76.0	78.5	81.8	84.8	84.7	84.7	87.8	87.4	86.5
Foreign currency (percent of broad money)	55.4	62.1	60.3	61.6	60.5	60.8	59.4	59.9	59.5	60.0
Credit to other domestic sectors: stock (% of GDP)	70.4	73.5	75.8	71.5	70.9	71.1	70.5	70.3	69.8	70.6
Credit to other domestic sectors: 12-month flow (percent of GDP)	-0.4	2.6	3.2	-4.7	-0.7	-1.2	-1.4	-2.0	-1.4	-0.4

Sources: Croatian National Bank; and IMF staff estimates.

Note: As of January 2015, the Croatian National Bank started publishing monetary statistics in line with ESA 2010. Historical figures may thus have changed.

1/ Comprises net claims on central government, gross claims on local government, and claims on other domestic sectors.

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

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

4/ Staff estimate (including currency breakdown).

5/ From 2007, includes obligatory CNB bills.

6/ Excludes statutory reserves in foreign currency.

**Table 6. Financial Soundness Indicators, 2009–14**  
(Percent, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014
<b>Core set</b>						
Regulatory capital to risk-weighted assets	16.4	18.8	20.5	20.9	20.9	21.5
Regulatory Tier I capital to risk-weighted assets	15.8	17.5	19.1	19.6	19.9	20.3
Nonperforming loans net of loan-loss provisions to capital	22.0	34.5	37.8	39.2	42.8	41.1
Nonperforming loans to total gross loans 1/	7.7	11.1	12.3	13.8	15.4	16.7
<b>Sectoral distribution of loans to total loans</b>						
Nonfinancial corporations	36.8	37.5	38.5	34.1	35.4	34.9
Households	47.2	46.0	44.3	44.8	44.2	46.2
Other sectors	15.4	15.7	16.6	20.2	19.5	17.7
Nonresidents	0.6	0.7	0.6	0.9	0.9	1.1
Return on assets	1.2	1.2	1.2	0.9	0.3	0.7
Return on equity	8.8	8.3	8.7	6.1	2.4	5.0
Net interest income to gross income	56.7	64.3	66.1	65.6	62.9	61.1
Noninterest expenses to gross income	56.6	55.7	55.1	57.8	59.2	57.1
Liquid assets to total assets 2/	35.8	33.7	31.7	31.3	30.7	33.0
Liquid assets to short-term liabilities 2/	53.5	50.6	48.2	48.2	46.6	51.7
Net open position in foreign exchange to capital	5.4	2.9	1.7	2.3	2.9	2.9
<b>Encouraged set</b>						
<b>Deposit takers 3/</b>						
Capital to assets	13.8	13.8	13.6	14.2	13.9	14.0
Large exposures to capital	44.8	39.0	48.6	43.0	52.5	65.8
<b>Geographical distribution of loans to total loans</b>						
Residents	99.4	99.3	99.4	99.1	99.1	98.9
Nonresidents	0.6	0.7	0.6	0.9	0.9	1.1
Gross asset position in derivatives to capital	0.4	0.3	1.2	1.6	2.8	2.4
Gross liability position in derivatives to capital	0.8	2.7	2.5	3.0	3.3	2.1
Trading income to total income	15.5	8.0	6.8	6.9	4.6	7.3
Personnel expenses to noninterest expenses	39.8	40.6	40.6	40.5	40.3	41.2
Spread between domestic lending and deposit rates	4.1	4.7	4.5	4.7	4.7	4.9
Noninterbank loans to noninterbank deposits	78.1	80.0	77.5	81.3	83.5	83.8
Foreign currency-denominated loans to total loans 4/	72.3	74.3	75.1	73.7	74.1	73.5
Foreign currency-denominated liabilities to total liabilities 4/	79.0	77.0	77.2	77.8	67.7	67.8
Net open position in equities to capital	4.8	4.9	6.7	6.2	7.1	6.1
<b>Other financial corporations (OFCs)</b>						
OFCs' assets to total financial system assets	24.7	24.8	24.4	26.1	27.0	28.5
OFCs' assets to GDP	37.7	39.9	40.0	43.0	44.7	48.2
<b>Households</b>						
Bank loans to households to GDP	39.0	40.7	40.5	40.0	39.1	37.2
<b>Real estate markets</b>						
Residential real estate prices (annual percentage increase)	-4.3	-9.0	-1.7	-4.3	-14.4	1.2
Residential real estate loans to total loans	21.5	22.2	21.8	22.3	22.1	22.4
<b>Other indicators</b>						
Loan-loss provisions to nonperforming loans	42.5	38.8	41.3	42.5	46.3	51.0
Change in credit to GDP ratio	4.4	6.0	6.6	-0.2	-1.5	0.2
Net interest income to average total assets	2.5	2.8	2.8	2.6	2.5	2.5
Noninterest expenses to average total assets	2.5	2.4	2.4	2.3	2.3	2.3
Loans to assets	13.8	13.8	13.6	14.2	13.9	14.0
Liquid assets to total deposits	66.4	60.1	57.5	54.6	51.2	56.0

Source: Croatian National Bank.

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

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

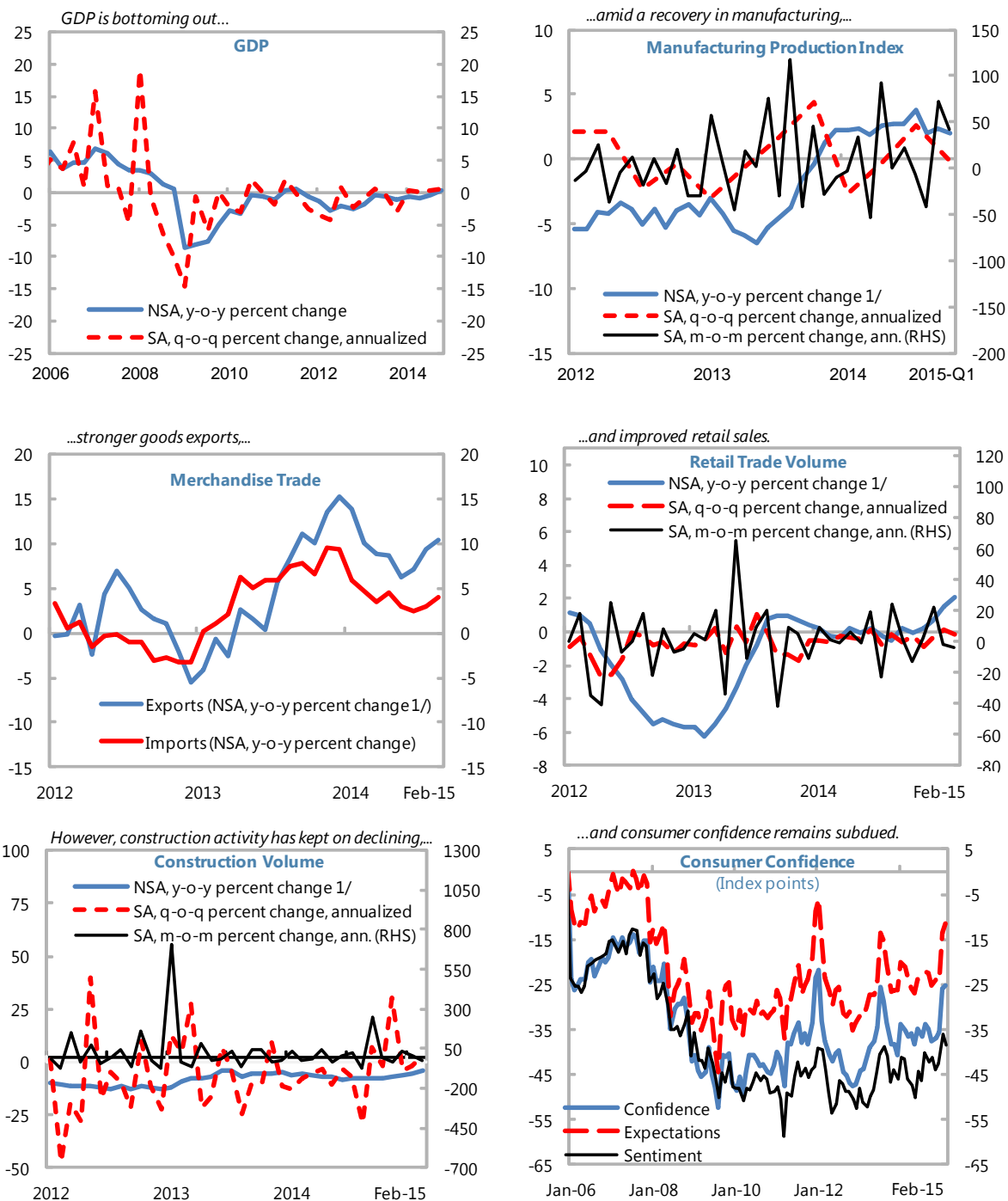
2/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper, and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans

3/ Commercial banks only. End-year FSIs, based on audited annual financial statements, can differ slightly from quarterly data.

4/ Includes kuna-denominated instruments linked to foreign currencies.

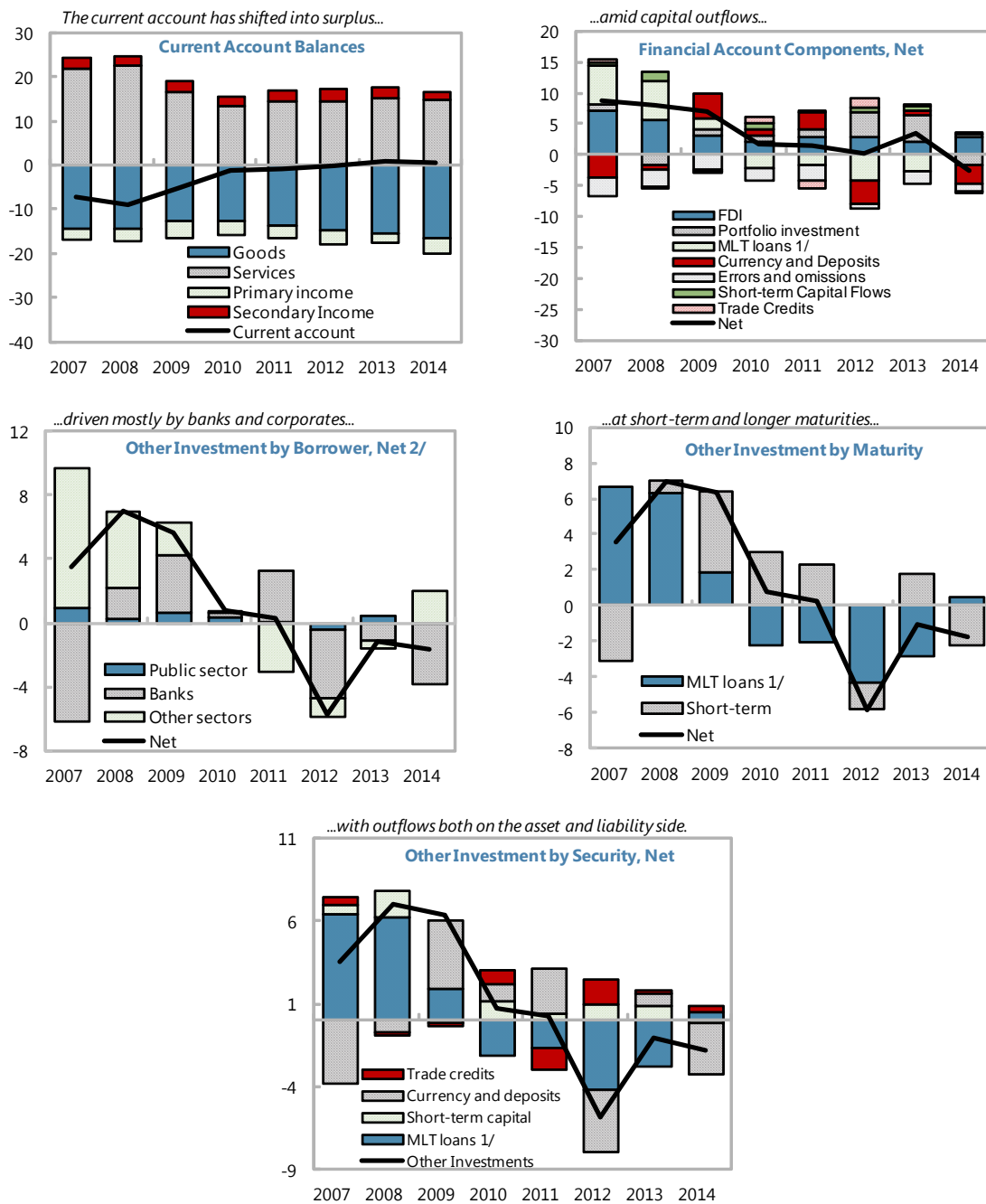
5/ Based on unconsolidated audited financial statements following IAS; not in line with the IMF FSI Compilation Guide.

Figure 1. Short-term Indicators



Sources: Central Bureau of Statistics; Croatian National Bank; and IMF staff calculations.  
1/6 months rolling average.

**Figure 2. Balance of Payments, 2007–2014**  
(Percent of GDP)

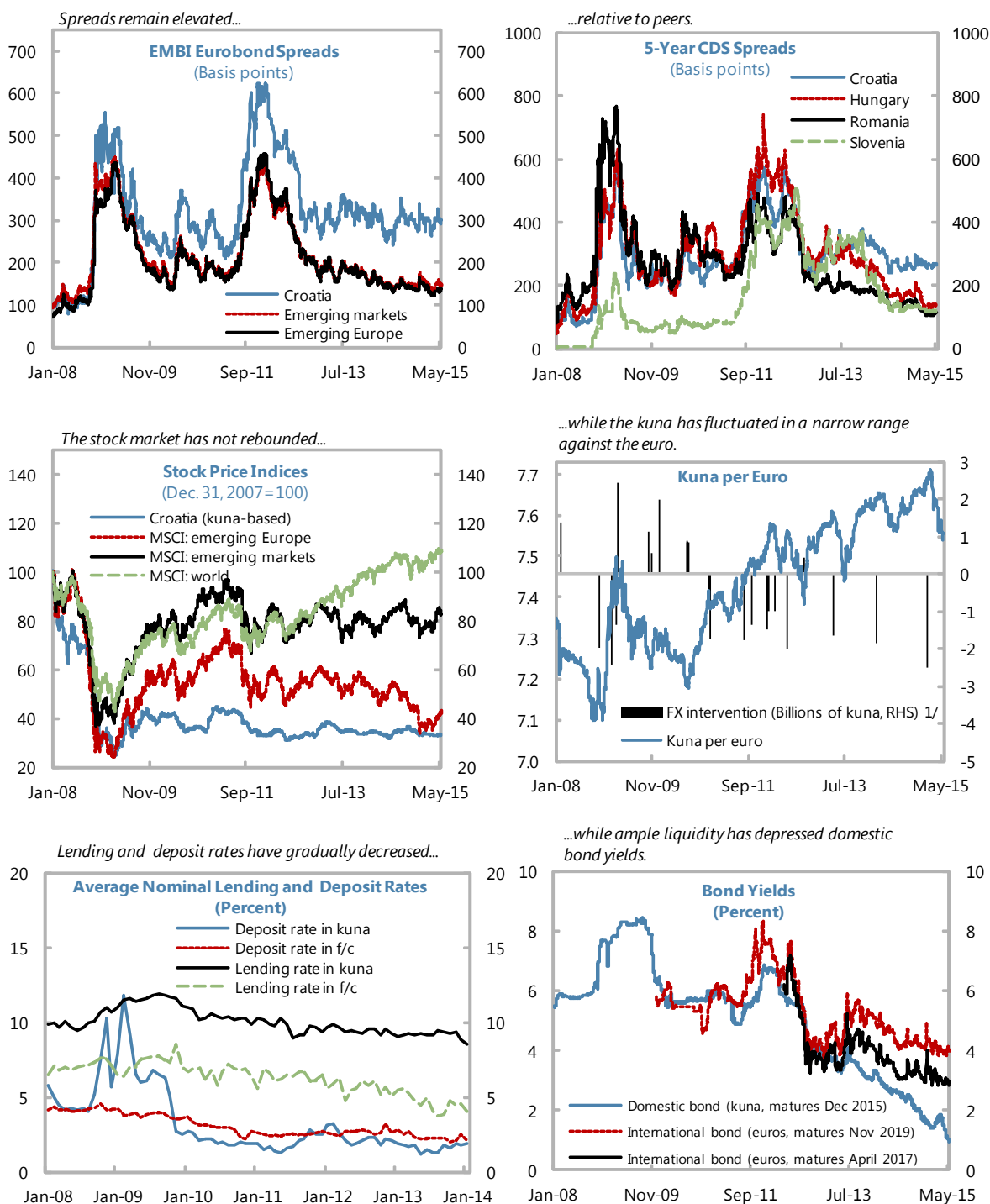


Sources: Croatian National Bank; and IMF staff estimates.

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

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

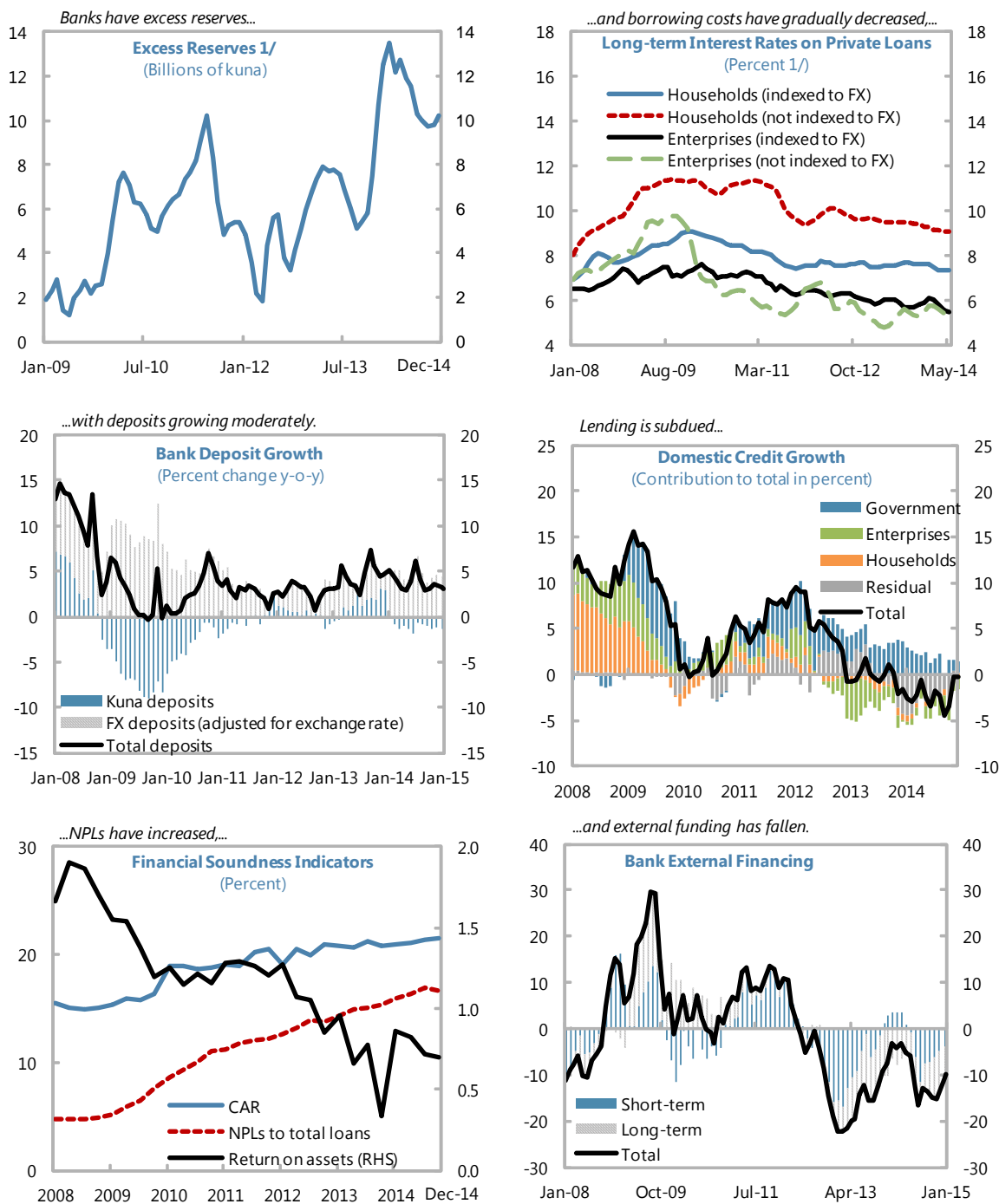
**Figure 3. Financial Market Developments, 2008–2015**



Sources: Bloomberg; Croatian National Bank; and IMF staff calculations.  
1/ Positive (negative) sign indicates purchase (sale) of FX.

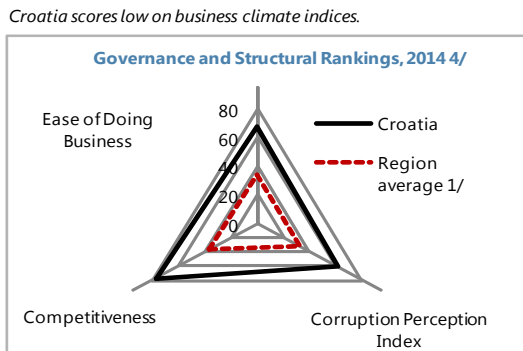
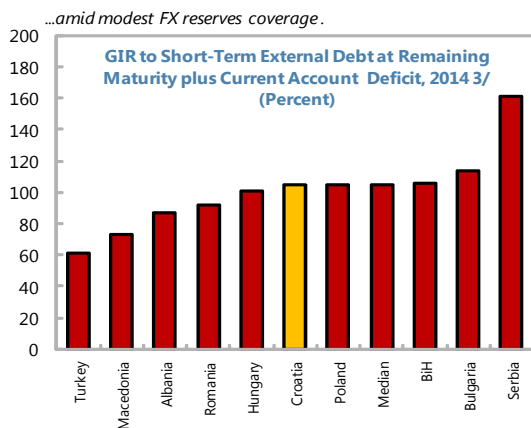
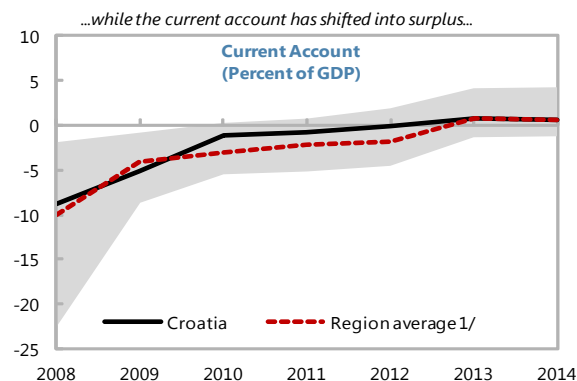
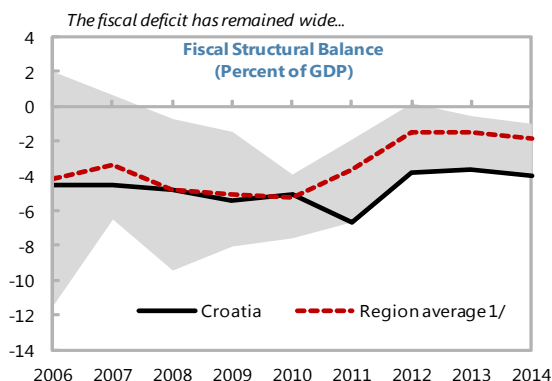
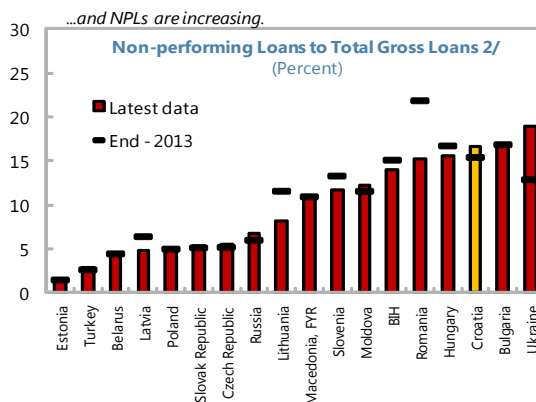
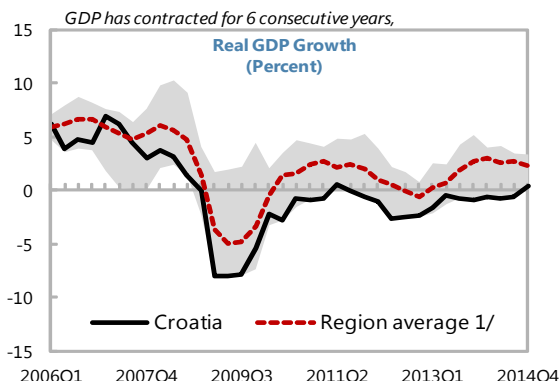


**Figure 4. Monetary and Banking Sector Updates, 2008–2015**



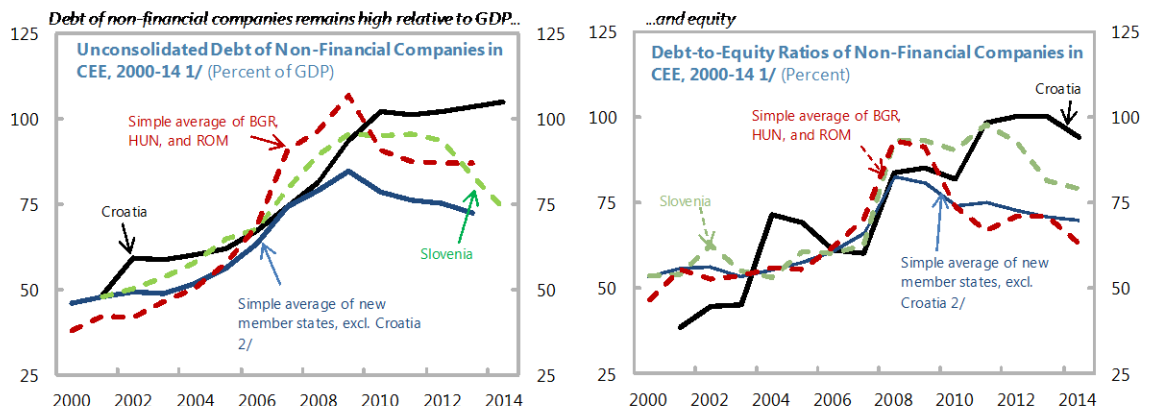
Sources: National Bank of Croatia; and IMF staff estimates and calculations.  
1/ 3-months moving average.

Figure 5. Croatia Compared to Peers



Sources: Transparency International; World Bank; World Economic Forum; IMF, *Financial Soundness Indicators*; and WEO.  
 1/ Region average weighted by GDP includes Bulgaria, Czech Republic, Hungary, Poland, and Romania. Shaded regions show range between the minimum and maximum values in the region.  
 2/ NPL definitions differ across countries. Data are from the IMF Financial Soundness Indicators database.  
 3/ GIR (end of current year) in % of ST debt at original maturity (end current year) plus amortization of MLT debt and current account deficit (following year). The current account is set to zero if it is in surplus.  
 4/ Out of 183 countries, except for competitiveness where 139 countries were ranked.

Figure 6. Private Sector Debt, 2000–2014

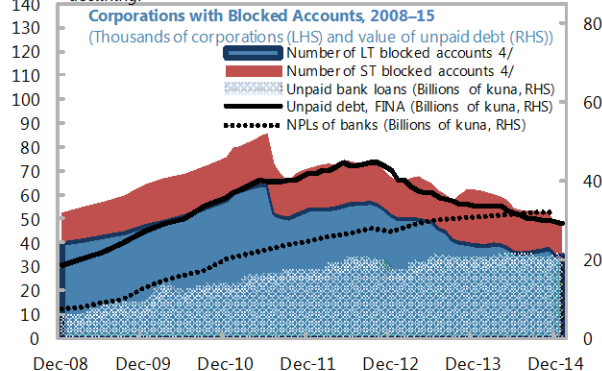


...with distress in many sectors...

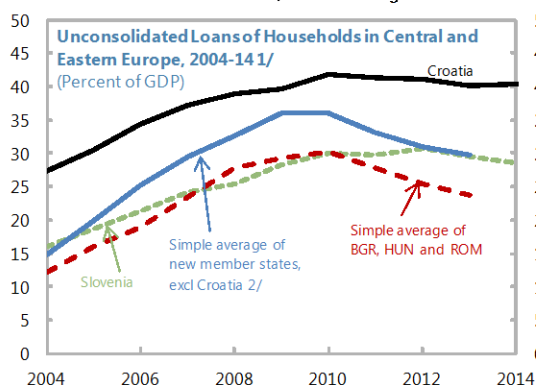
Corporate Debt Distress Indicators by Sector 3/ (Percent of companies in distress, 2013)

	Liquidity risk: Debt-to-Income						Solvency risk: Debt-to-Equity					
	CR	MS	WR	MF	AM	UT	CR	MS	WR	MF	AM	UT
Croatia	97	89	81	63	90	73	52	68	57	35	39	61
Estonia	67	69	54	50	65	56	43	42	30	23	37	17
Latvia	84	74	62	54	46	80	89	68	58	50	35	24
Lithuania	62	53	46	59	59	76	22	16	13	22	10	9
Czech Rep	59	65	62	49	45	26	32	29	32	17	36	11
Hungary	88	76	63	51	39	68	76	66	26	12	8	48
Poland	88	78	45	33	55	42	76	33	21	20	46	10
Slovakia	72	66	72	69	72	27	57	52	51	24	31	13
Slovenia	87	87	78	61	92	70	56	19	32	22	6	1
Bulgaria	74	79	64	67	42	43	64	48	44	32	30	32
Romania	72	47	54	65	62	41	60	34	39	42	36	11
Serbia	88	72	66	75	69	72	12	15	21	22	9	1
Turkey	78	67	54	44	44	49	17	42	45	28	48	21

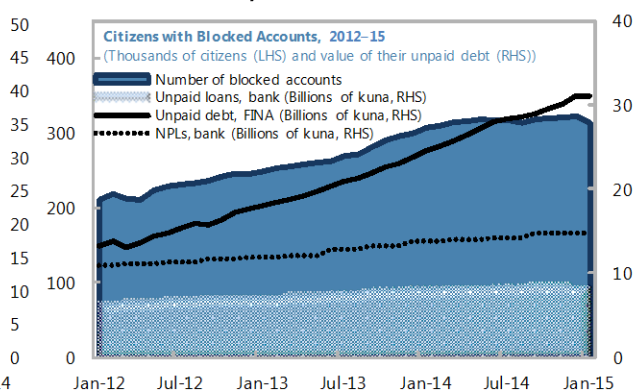
...though the number of companies with blocked accounts is declining.



Household debt has stabilized, but remains high...



...as does the number of individuals with blocked accounts.



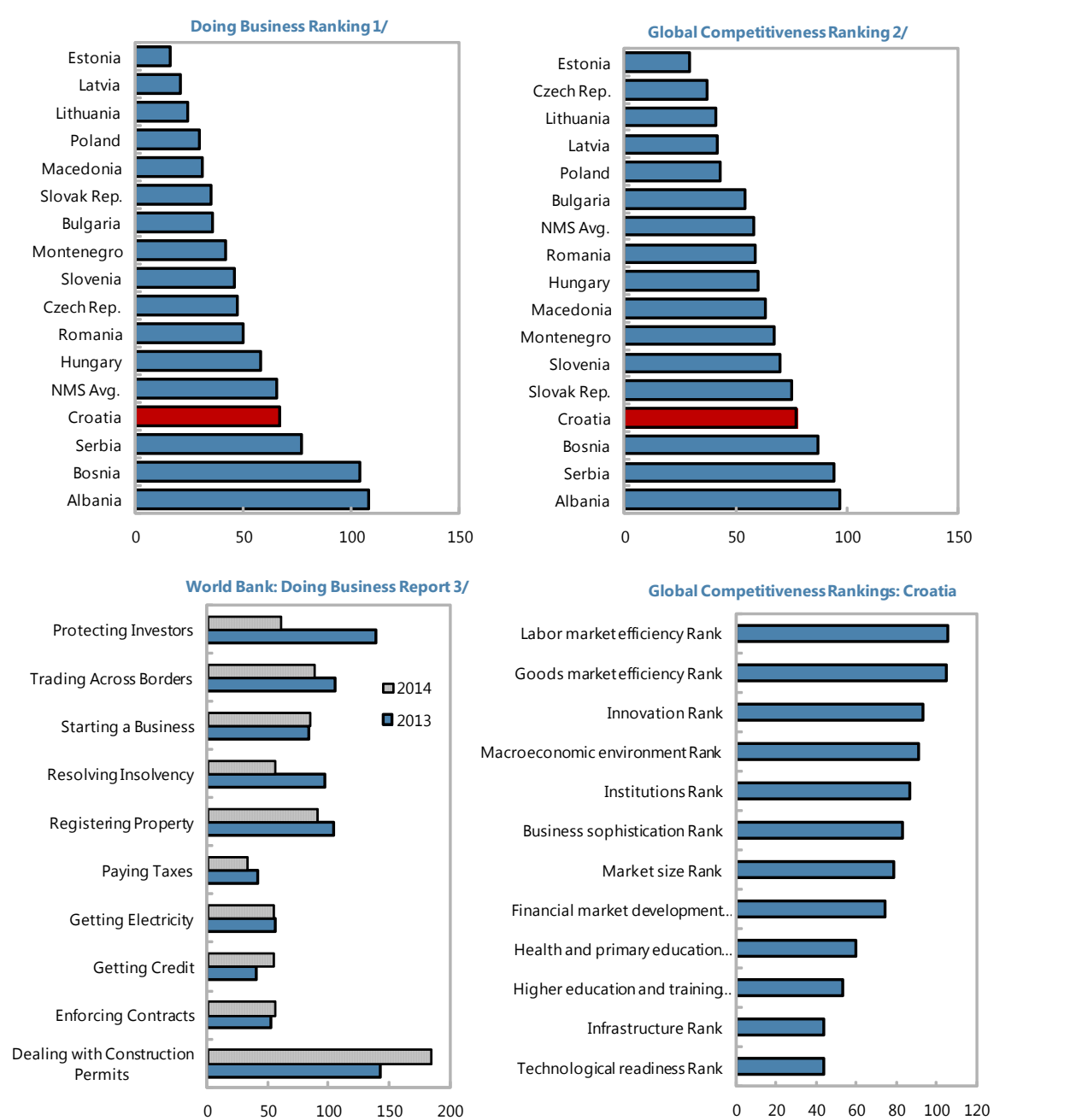
Source: Eurostat; Financial Agency of Croatia (FINA); Croatian National Bank; IMF, *Regional Economic Issues, Spring 2015* 1/ ESA2010 definition used, except for Estonia, which uses ESA1995 until 2008.

2/ New EU Member States, excluding Cyprus, comprise Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

3/ Industrial sectors are: agriculture and mining (AM), Manufacturing (MF), utility (UT), construction and real estate (CR), wholesale and retail trade (WR), and market services (MS).

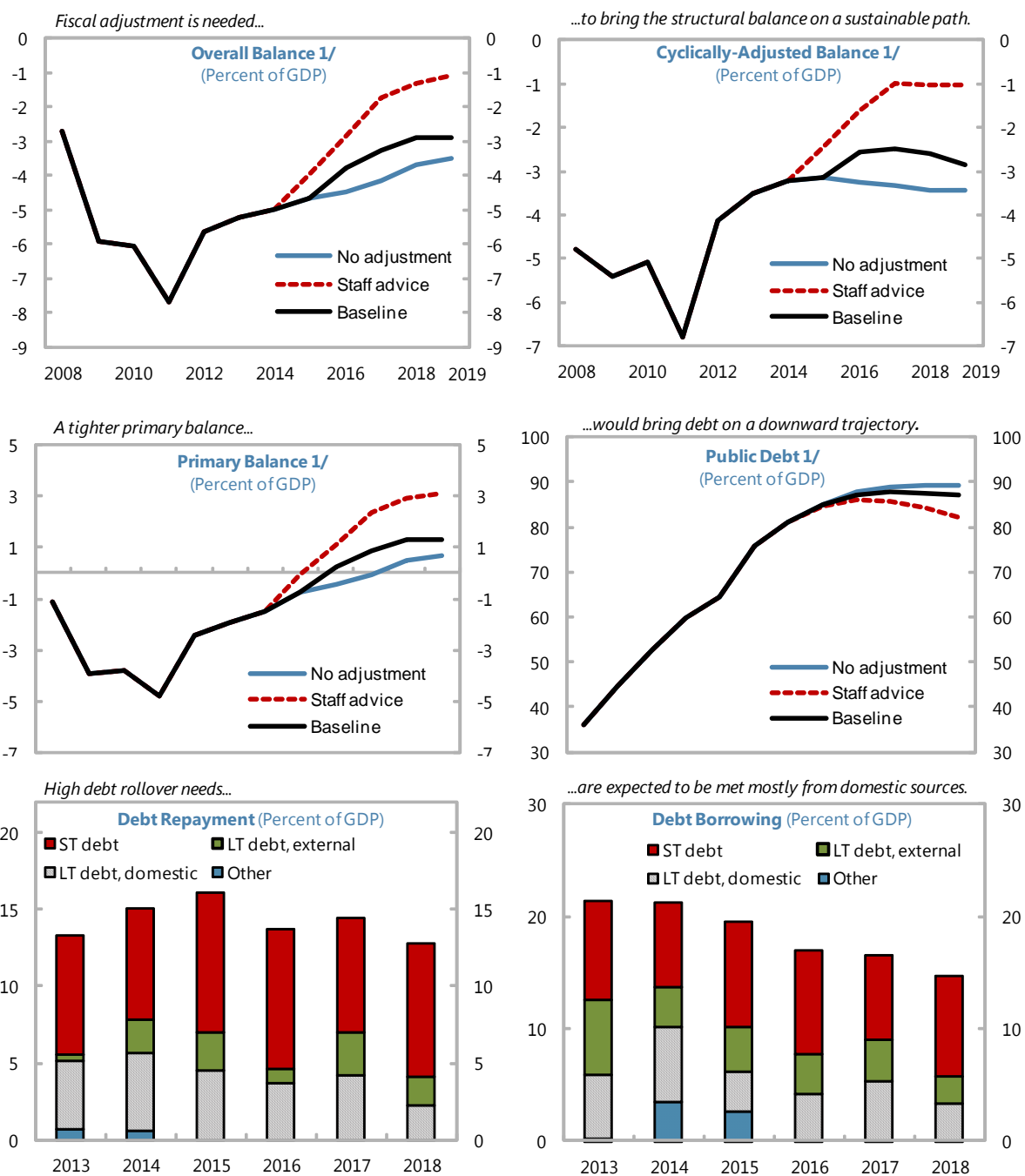
4/ LT is long-term, ST is short-term. Long-term defined as 360 days or more.

Figure 7. Business Environment, 2014



Sources: World Bank, *Doing Business*; World Economic Forum, *Global Competitiveness Report*; Heritage Foundation, *Economic Freedom Index*; and IMF staff calculations.  
 1/ Covers the period 2014. Rank out of 189 countries.  
 2/ Rank for 2014–15. Ranking out of 148 countries.  
 3/ The data for Getting Credit, Protecting Minority Investors and Resolving Insolvency are not comparable between 2013 and 2014 due to methodological changes.

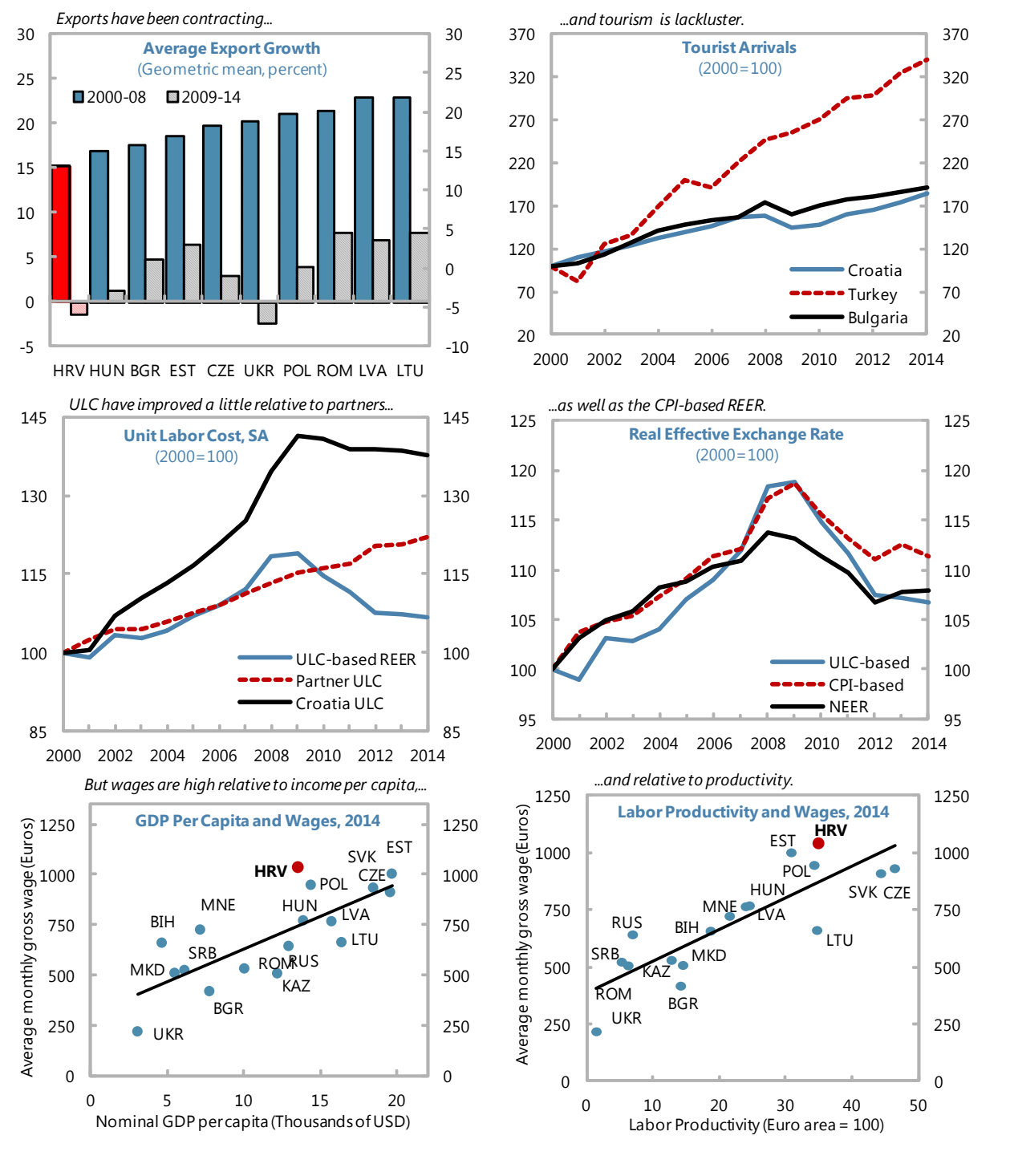
**Figure 8. Fiscal Developments, 2008–2019**



Sources: Croatian authorities; and IMF staff estimates.

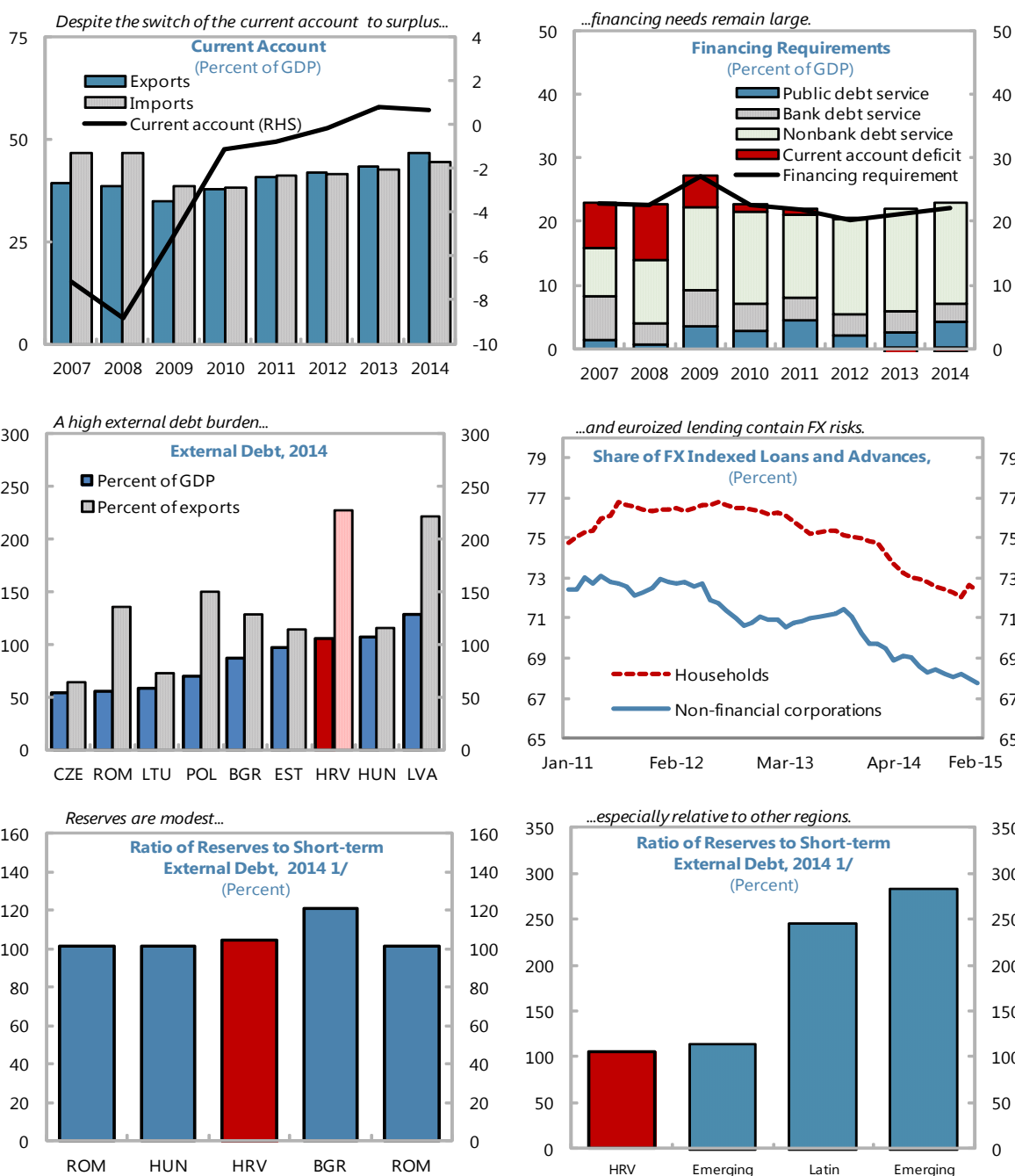
1/ The "No adjustment" scenario has the cyclically adjusted primary balance remaining at 2015 level. The "Staff advice" scenario has 0.8 percent consolidation until the structural balance is at -1 percent of GDP. The "Baseline" scenario shows the 2015 deficit as in the consolidation plan, and going forward EDP implementation until the headline deficit is below 3 percent.

**Figure 9. Competitiveness Indicators, 2000–2014**



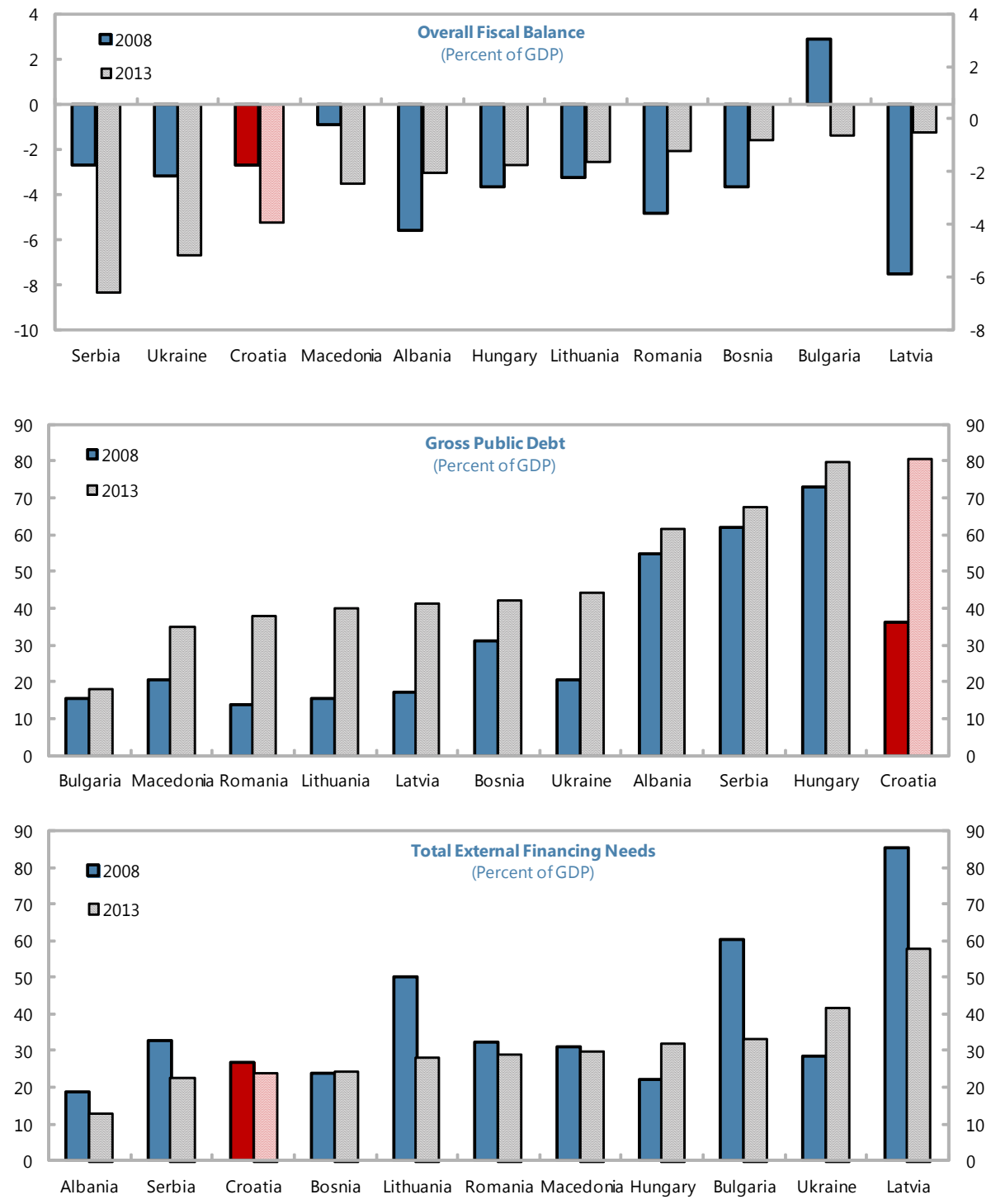
Sources: Croatian authorities; Haver; OECD; World Bank, *Doing Business Indicators*; IMF, *IFS*; DxTime; IMF, *World Economic Outlook*; and IMF staff estimates and calculations.

**Figure 10. Vulnerability Indicators, 2007–2015**



Sources: Croatian National Bank; IMF, *World Economic Outlook*; and IMF staff estimates.  
 1/ Gross international reserves are end-2014 stocks. Short-term debt at original maturity (end -2014) plus projected amortization of medium and long-term debt (end-2015).  
 2/ Excludes Brazil.  
 3/ Excludes China.

**Figure 11. Vulnerability Indicators vs. Regional Peers, 2008–2013**





## Annex I. External Debt Sustainability Analysis

Table A1. Croatia: External Debt Sustainability Framework, 2009–20  
(Percent of GDP, unless otherwise indicated)

	Actual						Projections						Debt-stabilizing noninterest current account
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: external debt	101.1	104.2	103.8	103.0	105.4	105.5	104.0	100.0	94.8	90.4	87.2	84.8	-2.1
Change in external debt	16.8	3.1	-0.5	-0.7	2.4	0.1	-1.5	-4.0	-5.2	-4.4	-3.1	-2.4	
Identified external debt-creating flows (4+8+9)	13.7	3.1	4.2	5.0	-2.0	-2.3	-4.3	-4.9	-5.1	-4.4	-3.2	-2.5	
Current account deficit, excluding interest payments	1.7	-1.8	-2.4	-3.5	-4.1	-4.2	-5.3	-5.2	-4.8	-3.8	-2.8	-2.3	
Deficit in balance of goods and services	-72.8	-75.8	-81.4	-82.8	0.5	2.1	3.2	2.9	2.5	1.3	0.4	0.0	
Exports	34.6	37.7	40.5	41.7	43.0	46.3	47.6	49.6	50.7	51.2	51.2	51.5	
Imports	-38.2	-38.1	-40.9	-41.2	-42.6	-44.2	-44.5	-46.6	-48.3	-49.9	-50.8	-51.5	
Net non-debt creating capital inflows (negative)	2.9	1.8	2.7	3.0	-2.1	-2.8	-2.1	-2.3	-2.3	-2.3	-2.2	-2.2	
Automatic debt dynamics 1/	9.1	3.1	3.9	5.4	4.2	4.7	3.1	2.5	1.9	1.7	1.8	2.0	
Contribution from nominal interest rate	3.4	2.9	3.2	3.6	3.3	3.5	3.5	3.5	3.5	3.5	3.5	3.5	
Contribution from real GDP growth	6.6	1.7	0.3	2.3	1.0	0.4	-0.5	-1.0	-1.6	-1.9	-1.7	-1.5	
Contribution from price and exchange rate changes 2/	-1.0	-1.6	0.4	-0.5	-0.1	0.7	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.1	0.0	-4.6	-5.7	4.3	3.1	2.8	0.9	-0.1	0.0	0.1	0.1	
External debt-to-exports ratio (percent)	292.7	276.2	256.3	247.3	244.9	228.0	218.3	201.7	186.8	176.7	170.5	164.7	
Gross external financing need (billions of Euros) 4/	14.7	10.2	10.0	9.1	8.7	9.3	8.8	7.8	10.8	9.5	12.4	11.4	
Percent of GDP	32.7	22.6	22.5	20.6	20.0	21.7	20.5	17.6	23.7	20.1	25.2	22.3	
Scenario with key variables at their historical averages 5/					105.4	105.6	105.1	104.2	102.8	101.7	100.8	99.9	-3.6
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (percent)	-7.4	-1.7	-0.3	-2.2	-0.9	-0.4	0.5	1.0	1.7	2.0	2.0	1.8	
GDP deflator in Euro dollars (percent change)	1.1	1.6	-0.4	0.5	0.1	-0.7	-0.3	1.1	1.6	1.9	2.2	2.2	
Nominal external interest rate (percent)	3.8	2.9	3.0	3.4	3.2	3.3	3.4	3.5	3.7	3.9	4.1	4.2	
Growth of exports (Euro terms, percent)	-16.0	9.0	6.6	1.2	2.4	6.3	3.1	6.2	5.7	4.8	4.3	4.7	
Growth of imports (Euro terms, percent)	-23.0	-0.5	6.7	-1.1	2.5	2.7	0.8	7.0	6.9	7.4	6.2	5.5	
Current account balance, excluding interest payments	-1.7	1.8	2.4	3.5	4.1	4.2	5.3	5.2	4.8	3.8	2.8	2.3	
Net nondebt creating capital inflows	-2.9	-1.8	-2.7	-3.0	2.1	2.8	2.1	2.3	2.3	2.3	2.2	2.2	

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

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

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

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

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

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

**Figure A1. Croatia: External Debt Sustainability:  
Bound Tests of the Baseline Scenario 1/ (External debt in percent of GDP)**



Source: IMF staff estimates.

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

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

3/ One-time real depreciation of 30 percent occurs in 2015.

## Annex II. Public Debt Sustainability Analysis

**Public debt stood at 85 percent of GDP at end-2014.** Gross financing needs are high at about 20 percent of GDP, reflecting mostly rollover of existing debt. Under the baseline, debt will stabilize at around 90 percent of GDP in the medium term. However, this projection is vulnerable to growth prospects turning out less favorable than expected.

### Baseline and Realism of Projections

**The baseline assumes implementation of fiscal policies as envisaged in 2015 Convergence Program, and thereafter adjustment broadly consistent with the EC's Excessive Deficit Procedure (EDP) until the headline deficit is below 3 percent of GDP.**

- *Fiscal consolidation:* Preliminary data put the 2014 general government deficit at 5.7 percent of GDP. The deficit is projected at slightly above 5 percent of GDP in 2015 declining to 4½ percent of GDP in 2016.
- *Growth:* real GDP growth shows signs of recovery in 2014Q4, though the economy contracted by 0.4 percent for the whole year. Going forward, the economy is expected to gradually regain momentum, converging to a long-term real growth rate of about 1¾ percent.

### Risks to the baseline are tilted to the downside.

- Croatia's real GDP growth forecast has been optimistic since 2009—reflecting mostly premature expectations of recovery—and the median forecast error is in the top decile of surveillance countries with market access. This points to a need for growth shocks in the stress tests.
- The 3-year adjustment of the cyclically-adjusted primary balance in Croatia is moderate relative to the historical experience for high-debt market access countries. While the EDP provides a much needed anchor for fiscal adjustment, there are risks that it may not be implemented as foreseen. This may lead to better growth in the short-term, but continuously rising public debt and concern about fiscal sustainability would likely undermine confidence and increase country risk (see alternative scenarios).

**There are risks to debt sustainability.** Staff projects that the debt-to-GDP ratio will increase to nearly 93 percent in 2017 before starting to decline after 2018. This deterioration mainly reflects a positive interest rate-growth differential and still wide deficits in the near term. Gross financing needs stay elevated and are projected at 21 percent of GDP in 2020, due to large fiscal deficits accumulated since 2009 and the relatively short maturity of public debt (around five years).

## Shocks and Stress Tests

**Slower output growth is the main risk to debt sustainability.** Underperformance of real GDP growth by one standard deviation in 2016 and 2017 would lead to a deterioration of the primary balance, as nominal revenues fall against unchanged spending. The primary deficit would deteriorate to close to 5 percent of GDP in 2017 before improving over the medium-term. The worse primary balance leads to a slight increase in risk premiums and a sharp increase in public debt, which stabilizes at almost 110 percent of GDP after 2017. Gross financing needs also rise to around 25 percent of GDP in 2016–2017.

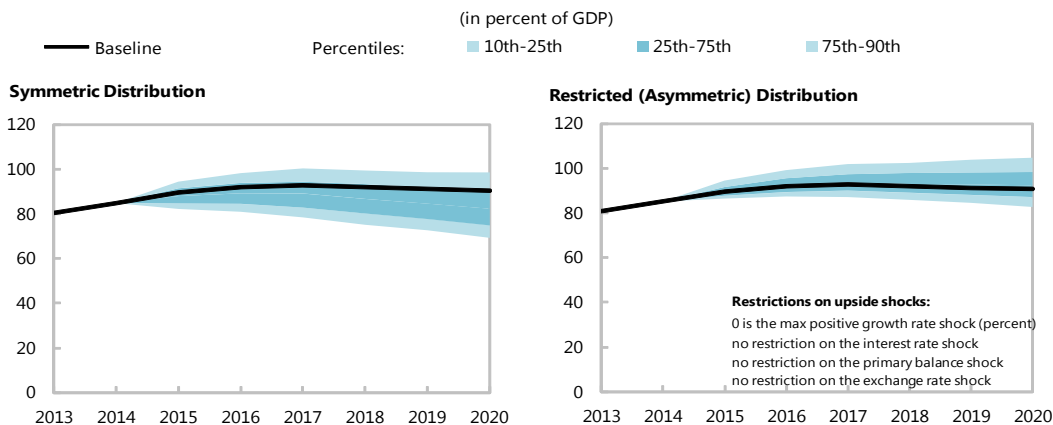
**A combination of macro-fiscal shocks further highlights the sensibility of public debt and gross financing needs to adverse scenarios.** Assuming that shocks to real GDP growth, the primary balance, real exchange rate, and real interest rate occur simultaneously, public debt would increase sharply and stabilize above 119 percent of GDP. Gross financing needs would approach 30 percent of GDP in 2020.

### Croatia Public DSA Risk Assessment

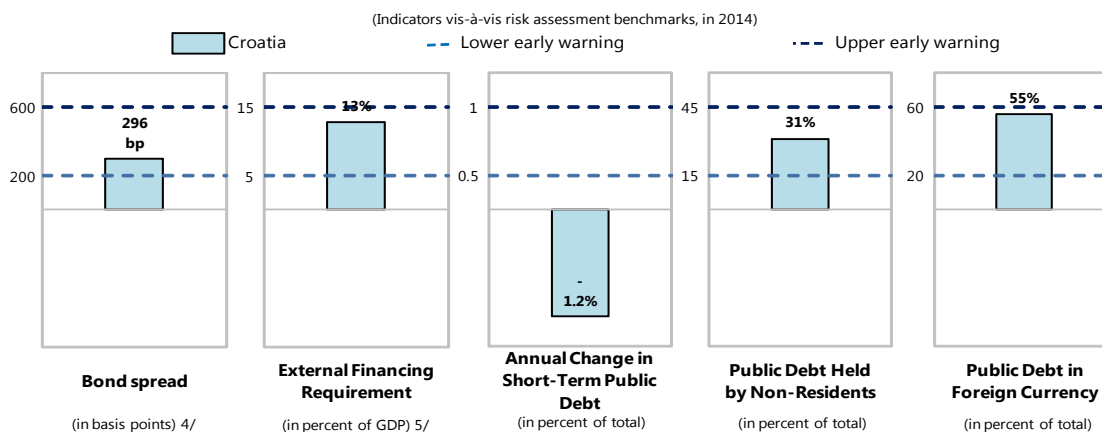
#### Heat Map

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

#### Evolution of Predictive Densities of Gross Nominal Public Debt



#### Debt Profile Vulnerabilities



Source: IMF staff.

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

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

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

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 09-Dec-14 through 09-Mar-15.

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

### Croatia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

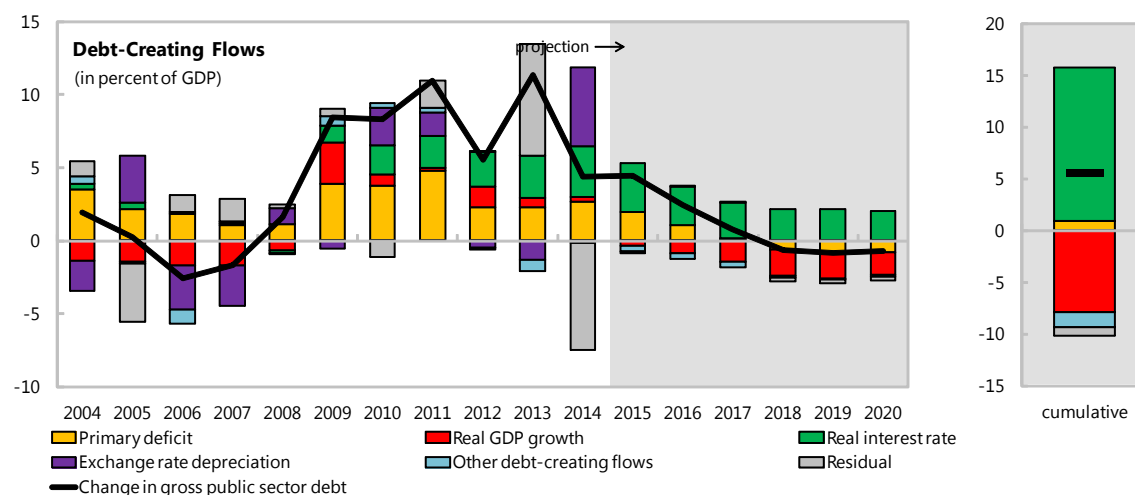
(in percent of GDP unless otherwise indicated)

#### Debt, Economic and Market Indicators <sup>1/</sup>

	Actual			Projections						As of March 09, 2015		
	2004-2012 <sup>2/</sup>	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	46.0	80.6	85.0	89.5	91.9	92.7	92.1	91.3	90.6	EMBIG (bp) <sup>3/</sup>	282	
Public gross financing needs	14.9	18.0	20.2	21.9	19.2	19.1	17.0	18.4	21.3	5Y CDS (bp)	257	
Real GDP growth (in percent)	1.0	-0.9	-0.4	0.5	1.0	1.7	2.0	2.0	1.8	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.1	0.9	0.0	0.3	1.1	1.6	1.9	2.2	2.2	Moody's	Ba1	Ba1
Nominal GDP growth (in percent)	4.1	-0.1	-0.4	0.7	2.1	3.3	4.0	4.2	4.1	S&P's	BB	BB
Effective interest rate (in percent) <sup>4/</sup>	5.2	5.0	4.3	4.3	4.1	4.4	4.3	4.7	4.6	Fitch	BB	BB+

#### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2004-2012 <sup>2/</sup>	2013	2014	2015	2016	2017	2018	2019	2020		
Change in gross public sector debt	3.7	11.4	4.4	4.5	2.5	0.8	-0.6	-0.8	-0.7	5.6	
Identified debt-creating flows	3.5	3.7	11.7	4.5	2.5	0.8	-0.4	-0.5	-0.4	6.4	
Primary deficit	2.7	2.3	2.7	2.0	1.0	0.2	-0.6	-0.9	-0.8	0.9	0.3
Automatic debt dynamics <sup>5/</sup>	0.7	2.2	9.2	3.0	1.8	1.0	0.3	0.4	0.4	7.0	
Interest rate/growth differential <sup>6/</sup>	0.8	3.6	3.8	3.0	1.8	1.0	0.3	0.4	0.4	7.0	
Exchange rate depreciation <sup>7/</sup>	-0.1	-1.3	5.4	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.1	-0.8	-0.1	-0.4	-0.4	-0.4	-0.1	-0.1	-0.1	-1.5	
Residual, including asset changes <sup>8/</sup>	0.1	7.7	-7.3	-0.1	0.0	0.0	-0.3	-0.3	-0.3	-0.9	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

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

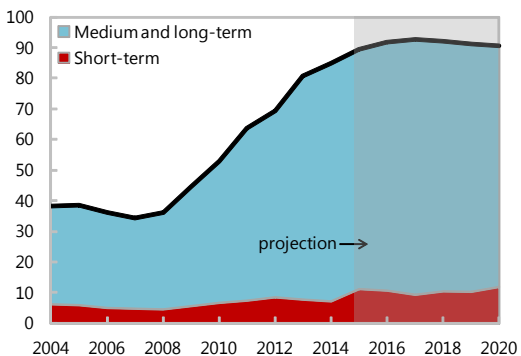
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

### Croatia Public DSA - Composition of Public Debt and Alternative Scenarios

#### Composition of Public Debt

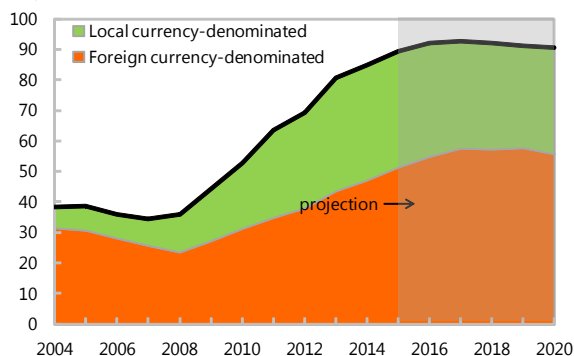
##### By Maturity

(in percent of GDP)



##### By Currency

(in percent of GDP)



#### Alternative Scenarios

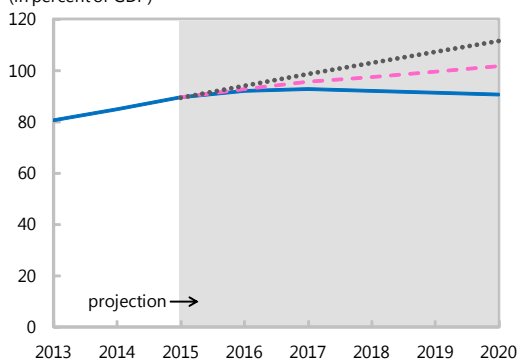
— Baseline

..... Historical

- - - Constant Primary Balance

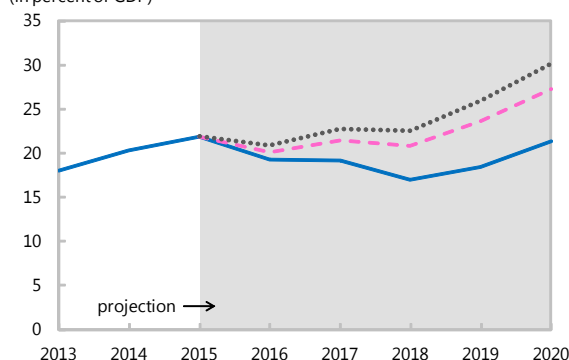
##### Gross Nominal Public Debt

(in percent of GDP)



##### Public Gross Financing Needs

(in percent of GDP)



#### Underlying Assumptions

(in percent)

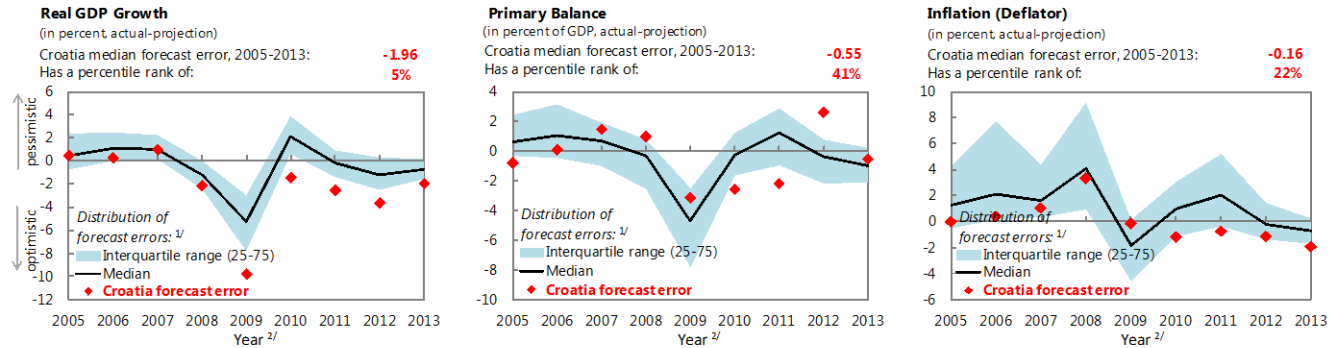
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.5	1.0	1.7	2.0	2.0	1.8
Inflation	0.3	1.1	1.6	1.9	2.2	2.2
Primary Balance	-2.0	-1.0	-0.2	0.6	0.9	0.8
Effective interest rate	4.3	4.1	4.4	4.3	4.7	4.6
<b>Constant Primary Balance Scenario</b>						
Real GDP growth	0.5	1.0	1.7	2.0	2.0	1.8
Inflation	0.3	1.1	1.6	1.9	2.2	2.2
Primary Balance	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	4.3	4.1	4.3	4.3	4.6	4.5

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.5	0.3	0.3	0.3	0.3	0.3
Inflation	0.3	1.1	1.6	1.9	2.2	2.2
Primary Balance	-2.0	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	4.3	4.1	4.3	4.2	4.5	4.3

Source: IMF staff.

## Croatia Public DSA – Realism of Baseline Assumptions

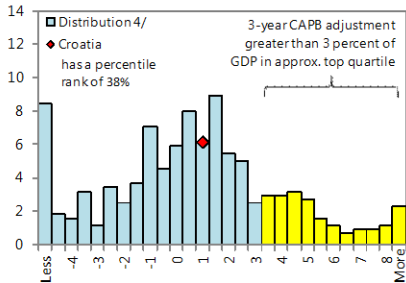
### Forecast Track Record, versus surveillance countries



### Assessing the Realism of Projected Fiscal Adjustment

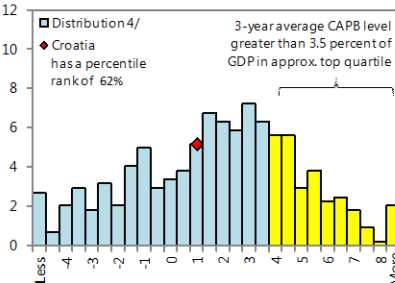
#### 3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)



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

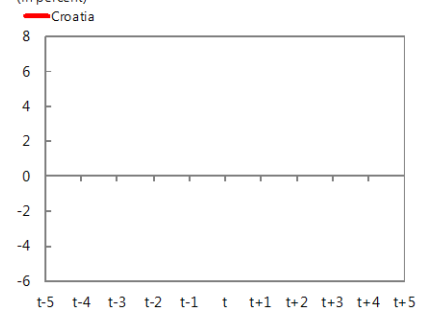
(Percent of GDP)



### Boom-Bust Analysis<sup>3/</sup>

#### Real GDP growth

(in percent)



Source : IMF Staff.

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

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

3/ Not applicable for Croatia.

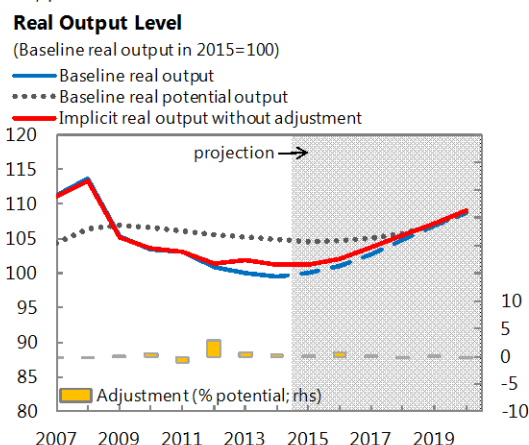
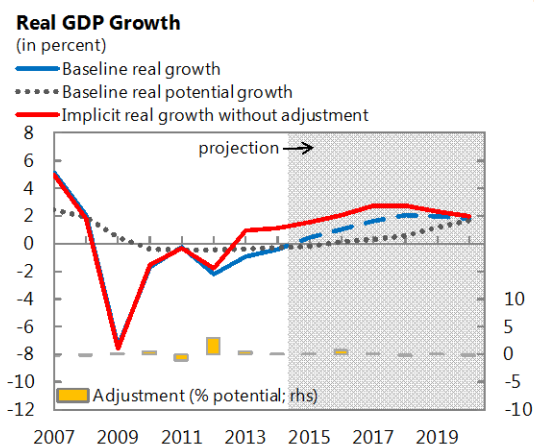
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.



## Croatia Public DSA – Realism of Baseline Assumptions (continued)

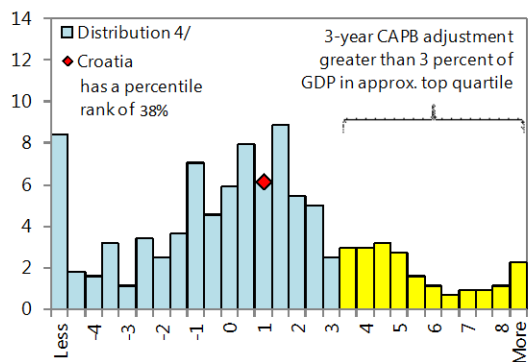
### Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 0.7, persistence of 0.6

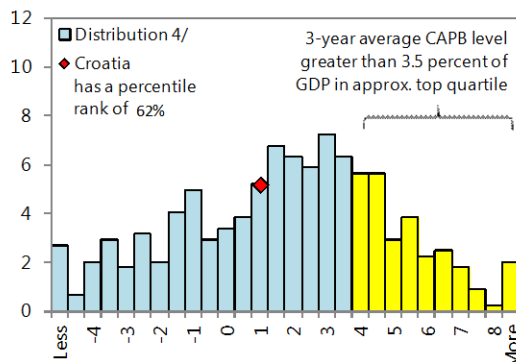


### Assessing the Realism of Projected Fiscal Adjustment

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



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

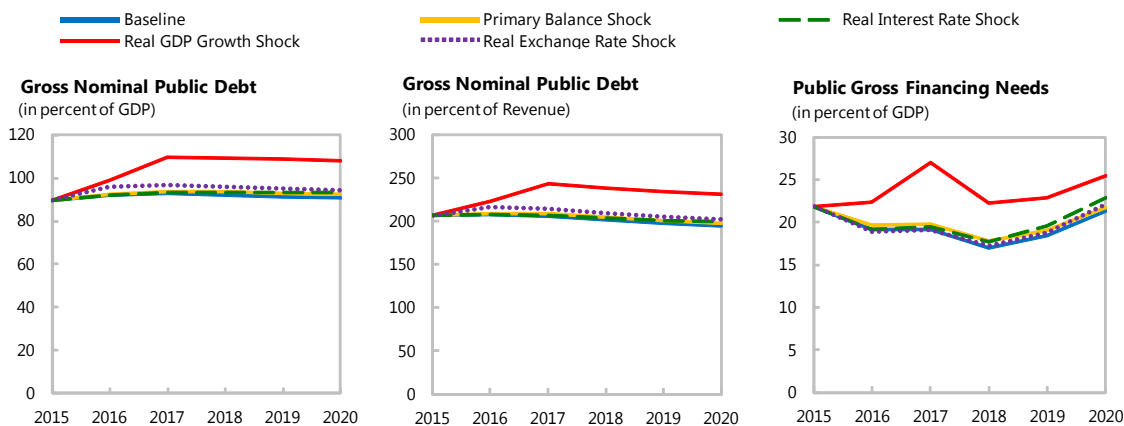


Source : IMF staff.

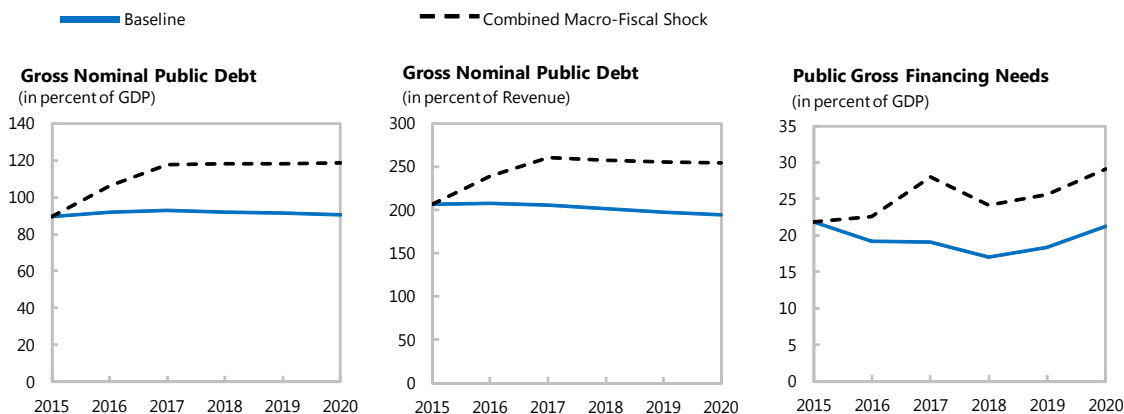
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

### Croatia Public DSA – Stress Tests

#### Macro-Fiscal Stress Tests



#### Additional Stress Tests



#### Underlying Assumptions (in percent)

	2015	2016	2017	2018	2019	2020		2015	2016	2017	2018	2019	2020
<b>Primary Balance Shock</b>							<b>Real GDP Growth Shock</b>						
Real GDP growth	0.5	1.0	1.7	2.0	2.0	1.8	Real GDP growth	0.5	-2.9	-2.2	2.0	2.0	1.8
Inflation	0.3	1.1	1.6	1.9	2.2	2.2	Inflation	0.3	0.1	0.6	1.9	2.2	2.2
Primary balance	-2.0	-1.5	-0.6	0.2	0.7	0.8	Primary balance	-2.0	-3.3	-4.7	0.6	0.9	0.8
Effective interest rate	4.3	4.1	4.4	4.4	4.7	4.6	Effective interest rate	4.3	4.1	4.4	4.6	4.8	4.7
<b>Real Interest Rate Shock</b>							<b>Real Exchange Rate Shock</b>						
Real GDP growth	0.5	1.0	1.7	2.0	2.0	1.8	Real GDP growth	0.5	1.0	1.7	2.0	2.0	1.8
Inflation	0.3	1.1	1.6	1.9	2.2	2.2	Inflation	0.3	4.5	1.6	1.9	2.2	2.2
Primary balance	-2.0	-1.0	-0.2	0.6	0.9	0.8	Primary balance	-2.0	-1.0	-0.2	0.6	0.9	0.8
Effective interest rate	4.3	4.1	4.8	5.0	5.5	5.5	Effective interest rate	4.3	4.3	4.3	4.3	4.6	4.5
<b>Combined Shock</b>													
Real GDP growth	0.5	-2.9	-2.2	2.0	2.0	1.8							
Inflation	0.3	0.1	0.6	1.9	2.2	2.2							
Primary balance	-2.0	-3.3	-4.7	0.2	0.7	0.8							
Effective interest rate	4.3	4.3	4.7	4.9	5.4	5.4							

Source: IMF staff.



# REPUBLIC OF CROATIA

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 9, 2015

Prepared By

European Department in Consultation with Other  
Departments

### CONTENTS

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## FUND RELATIONS

(As of April 30, 2015)

**Membership Status:** Joined: December 14, 1992

Article VIII

<b>General Resources Account:</b>	<b>SDR Million</b>	<b>%Quota</b>
<u>Quota</u>	365.10	100.00
<u>Fund holdings of currency (Exchange Rate)</u>	364.92	99.95
<u>Reserve Tranche Position</u>	0.19	0.05

<b>SDR Department:</b>	<b>SDR Million</b>	<b>%Allocation</b>
<u>Net cumulative allocation</u>	347.34	100.00
<u>Holdings</u>	304.93	87.79

**Outstanding Purchases and Loans:** None

**Latest Financial Arrangements:**

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

**Projected Payments to Fund <sup>1/</sup>**

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

	<u>Forthcoming</u>				
	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Principal					
Charges/Interest	0.02	0.03	0.03	0.03	0.03
<b>Total</b>	<u>0.02</u>	<u>0.03</u>	<u>0.03</u>	<u>0.03</u>	<u>0.03</u>

<sup>1/</sup>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:**

In December 1991, Croatia adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with tight management of the

kuna-euro exchange rate by the Croatian National Bank (CNB). Croatia's *de jure* exchange rate is a managed float without a predetermined path. Croatia's *de facto* exchange rate arrangement is classified as a crawl like arrangement from April 30, 2011. The CNB transacts only in euros, U.S. dollars, and SDRs. On May 19, 2015, the official exchange rate was kuna 7.537332 per euro (middle rate).

### **Exchange Restrictions:**

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions, except for restrictions that Croatia maintains solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51).<sup>1</sup>

### **Article IV Consultation:**

The previous Article IV consultation with Croatia was concluded on May 14, 2014 (IMF Country Report No. 14/124: <http://www.imf.org/external/pubs/cat/longres.aspx?sk=41565.0>). 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).

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<sup>1</sup> On January 23, 2015, the Croatian Parliament amended the Consumer Credit Act, temporarily freezing for one year the HRK/CHF exchange rate for interest and installment payments on consumer loans indexed to or denominated in Swiss Francs. The Croatian National Bank informed-Fund staff that interest and installment payments of CHF-denominated loans are always made in kuna, and accordingly that the frozen exchange rate is used only for accounting purposes and not for actual foreign exchange transactions. Accordingly, staff does not find this amendment to give rise to a multiple currency practice subject to Article VIII, Section 3.

**Technical Assistance 2000–14:<sup>2</sup>**

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

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

	April–May 2013	Fiscal Rules
	June 2013	Strengthening Tax Administration Governance
	December 2014	Workshop on Public Expenditure Review (Expert visit)
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
	September 2006	Monetary and Financial Statistics
	December 2007	LTE: Government Finance Statistics
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

**Resident Representative:** The post closed in June 2007.

## WORLD BANK RELATIONS

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

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

**2.** The CPS envisages an indicative base-case lending envelope of about US\$800 million. For the FY14–17 lending program, DPLs will continue to play an important role based on the need to combine policy reform with budget finance. At the same time, Croatia and the Bank, explored the use of new investment financing instruments like results-based operations, as the share of traditional investment financing should decrease during the CPS period. The lending program has been based on and complemented by analytical work, particularly in the areas of public expenditure reform, governance, EU preparedness, investment climate, higher education, and trade competitiveness.

**3.** In FY14, the Bank's Board approved two loans and one grant amounting to US\$315 million, including the Second Economic Recovery DPL (EUR150 million in April 2014), Health System and Quality Efficiency Improvement Program-for-Results (EUR75 million in May 2014), and GEF Adriatic Sea Environmental Pollution Control Project (US\$4.3 million in June 2014). Projects delivered or under preparation for FY15–16 are Social Protection System Modernization Project (EUR70 million in September 2014), Sustainable Croatian Railways in Europe (EUR163.5 million in April 2015), and Innovation and Entrepreneurship Venture Capital (EUR20 million scheduled for the Board in July 2015). Currently, the World Bank finances 13 operations in a wide range of sectors with a commitment of about US\$1083 million. In FY14, IFC invested US\$142 million in Croatia. IFC's investments have financed projects across a variety of sectors including in the financial sector, renewable energy, infrastructure, agribusiness, life sciences, and general manufacturing. Across all sectors, IFC prioritizes investment in Croatia's less-developed regions and in projects that contribute to greater economic diversification and regional integration. MIGA's outstanding gross exposure in Croatia as of June 30, 2014 was US\$976 million in support of financial institutions and a retail sector.



## STATISTICAL ISSUES

### Croatia—Statistical Issues (As of April 30, 2015)

#### I. Assessment of Data Adequacy for Surveillance

**General:** Data provision is broadly adequate for surveillance, with shortcomings related to data coverage and reliability, especially for national and fiscal accounts. Progress to resolve these shortcomings are impeded by insufficient resources and a lack of coordination among government agencies.

**National Accounts:** The national accounts have undergone substantial improvements in recent years. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the ESA 2010 standard. However, a breakdown of gross fixed capital formation into private and public components is not yet published. Quarterly GDP estimates are disseminated at current prices and at prices of the previous year for the main categories of expenditures and main economic activities. Nonetheless, shortcomings remain. Discrepancies exist between expenditure-based and value-added-based GDP data, stemming from: (i) incomplete coverage of unincorporated businesses and the self-employed (farmers, traders, and craftsmen); (ii) inadequate data for measuring changes in inventories; (iii) incomplete coverage of the informal sector; and (iv) a lack of quarterly data for the seasonally volatile agricultural sector.

**Wages and Employment:** The CBS produces data on average net and gross earnings per person and employment by sector. Currently, the CBS is in the process of reviewing the data series. Earnings data include bonuses (in sums that are subjects to contributions, taxes, and surtaxes), sick pay, and meal allowances. They are based on monthly surveys covering 70 percent of workers in permanent employment in each division of NKD 2007 (NACE Rev. 2). They do not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, and farmers.

The number of registered unemployed overstates the actual level of unemployment. However, the discrepancy has significantly diminished in 2014. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample was subsequently expanded and the survey is now being conducted on a regular basis. Semi-annual results have been released since 1998, and quarterly results since 2007, with a lag of about four months.

**Price Statistics:** The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from a Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups, but in most cases between the thirteenth and the twenty-third day of each month. (Prices of agricultural products sold in market places are recorded on the first and third Friday in a month and prices of fuel for passenger cars weekly.) The indices are released around the fifteenth day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country.

## Croatia—Statistical Issues (Continued)

(As of April 30, 2015)

A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology. A core CPI is calculated based on a methodology developed by the Croatian National Bank (CNB). The CBS also releases a monthly producer price index (PPI), usually on the eighth day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year.

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

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

Cash data for the operations of local governments and the consolidated general government are available on a quarterly basis, but for end-of-year data with long lags. Local government data are partial, as they only include the operations of the 53 largest units (20 counties, the City of Zagreb, and 32 largest cities). Cash data reporting will be abolished in 2015, and a modified accrual concept will be applied instead. The coverage of local governments is going to be extended to all 576 local units and 20 local extra-budgetary users (county road authorities).

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

Data showing the level of central government guaranteed debt are presented as a part of the reporting table in the CNB Monthly Bulletin.

**Monetary and Financial Statistics:** Beginning 2015, the CNB has started published monetary statistics using the ESA 2010 framework, with some backward revisions of historical data series. Since June 2013, the IMF's Statistics Department receives monetary statistics on Croatia directly from the European Central Bank.

### Croatia—Statistical Issues (Continued)

(As of April 30, 2015)

Previously, the CNB compiled and reported monetary data for publication in *International Financial Statistics (IFS)* in accordance with the 1995 ESA standards and the European Central Bank's framework for monetary statistics using the national residency approach. For December 2001 to June 2013, monetary statistics in *IFS* were based on the Standardized Report Forms developed by the IMF's Statistics Department, in accordance with the concepts and definitions in the *Monetary and Financial Statistics Manual, 2000*. For December 2010 through June 2013, the CNB has reported revised data for other depository corporations covering money market funds in addition to the licensed banks, savings banks, and housing savings banks, which represent other monetary financial institutions in accordance with the 1995 ESA standards.

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

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

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

Croatia participates in the *Coordinated Direct Investment Survey (CDIS)* and plans to participate in the *Coordinated Portfolio Investment Survey (CPIS)* after the new security database becomes operational toward the end of 2015. Data on the International Reserves and Foreign Currency Liquidity (Reserve Data Template) are available with a lag of one to two months.

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

**Croatia—Statistical Issues (Concluded)**

(As of April 30, 2015)

**II. Data Standards and Quality**

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

No data ROSC has been published.

## Croatia: Table of Common Indicators Required for Surveillance

(As of April 30, 2015)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	4/30/15	4/30/15	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Feb. 2015	4/16/15	M	M	M
Reserve/Base Money	Feb. 2015	4/16/15	M	M	M
Broad Money	Feb. 2015	4/16/15	M	M	M
Central Bank Balance Sheet	Feb. 2015	4/16/15	M	M	M
Consolidated Balance Sheet of the Banking System	Feb. 2015	4/16/15	M	M	M
Interest Rates 2/	Feb. 2015	4/16/15	M	M	M
Consumer Price Index	Mar. 2015	4/15/15	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2014:Q3	Nov. 2014	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/— Central Government	Nov. 2014	Jan. 2015	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2014:Q4	4/16/15	M	M	M
External Current Account Balance	2014:Q4	3/31/15	Q	Q	Q
Exports and Imports of Goods and Services	2014:Q4	3/31/15	Q	Q	Q
GDP/GNP	2014:Q4	3/6/15	Q	Q	Q
Gross External Debt	2014:Q4	4/16/15	M	M	M
International Investment Position	2014:Q4	4/16/15	Q	Q	Q

1/ Reserve assets that are pledged or otherwise encumbered are specified separately. Data comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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

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

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

5/ Including currency and maturity composition.

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

**Statement by Menno Snel, Executive Director for Republic of Croatia  
and Andrijana Cudina, Advisor to Executive Director  
June 24, 2015**

The Croatian authorities thank staff for very constructive policy discussions and their insightful analysis, with which they broadly agree. They believe that staff's report rightly recognizes recent positive developments in the country, but also raises awareness about the fiscal vulnerabilities and remaining structural challenges. Despite the uncertainty ahead of parliamentary elections the authorities are keeping pace with reforms to address these challenges and accelerate the rebalancing of the economy.

**Economic developments and outlook**

After six years of recession, the Croatian economy has entered into positive territory at the turn of last year. The pace of economic contraction abated already in the second half of 2014 and the positive developments continued into the first quarter of 2015. However, the recovery is still very delicate as it mostly relies on external factors, primarily low energy prices, favorable financing conditions and stronger euro area growth. The internal demand is still very weak as the corporate sector debt overhang and balance sheet repair continue to weigh on investments. Private consumption, however, has picked up reflecting not only the lower oil prices, but also the income tax relief that was introduced at the beginning of the year. According to the latest labor market indicators it seems that the fall in employment is also bottoming out. CPI inflation has moved back into positive territory, partly on account of consumer food prices and the depreciation against the US dollar, which has mitigated the impact of low oil prices.

Looking ahead, the authorities assume that the growth will continue and further strengthen in 2016. Like staff, they also see that the additional fiscal consolidation, needed to bring the public debt under control, will continue to be a drag on growth. On the other hand, the external demand will remain strong and the contribution from domestic demand could also become marginally positive, if trends in private consumption continue and EU funds spur the recovery of investments. The authorities anticipate that the rebound in energy prices could push inflation higher, although it will remain well below its long-term average. The pick-up of growth is set to bring about a gradual reduction in unemployment. However, the risks to the outlook are substantial and tilted to the downside, especially in light of possible adoption of additional fiscal consolidation measures, worsening of the external environment and suboptimal use of EU funds.

**Fiscal policy**

The authorities share staff's concerns about the fiscal vulnerabilities that have built up during the recession. In a difficult environment of economic contraction and low inflation, they have pursued fiscal consolidation in order to set the deficit below 3 percent of GDP by 2017 and stabilize the public debt trajectory. Moreover, the fiscal effort of 2.5 percent of GDP achieved in 2014 was somewhat stronger than the requirements under the Excessive Deficit

Procedure (EDP). However, despite these efforts, the general government deficit ended at 5.7 percent of GDP, much above the projected level, as revenues underperformed but also as the coverage was broadened with the adoption of European ESA 2010 accounting standards. These methodological changes affected the level of public debt, which reached 85 percent of GDP at end-2014.

In light of these developments, the authorities have reinforced their consolidation efforts for 2015. The Convergence Program that was submitted to the European Commission in April anticipates a fiscal effort of 1.5 percent of GDP, aiming for headline deficit of 5.0 percent of GDP. The European Commission has assessed that the proposed measures would probably yield a somewhat smaller structural adjustment, but has nevertheless confirmed that due to an over-achieving effort in 2014, the cumulative fiscal effort over 2014–2015 meets the target implied by the EDP requirements. The focus of consolidation in 2015 would be more on the expenditure than on the revenue side. Significant savings across different categories of expenditures, including subsidies and transfers, as well as across different levels of government, are expected. Capital investments, especially in the health sector, would also be rationalized and oriented more towards EU funding. The government plans to boost revenues mainly by withdrawing profits from SOEs, but also through increased excise taxes on tobacco and gasoline, and a recently introduced tax on interest earnings.

The fiscal consolidation in 2016 will focus on further rationalization of current spending to provide sufficient space for growth-enhancing expenditures. Tax compliance would be further enhanced, especially through strengthening of the tax administration. Regarding the property tax, the government will focus on the harmonization and better collection of local communal fees. More broadly, the consolidation process in the coming period will be underpinned by improvements in budget planning and expenditure control, as well as through strengthening of fiscal rules. In the authorities' views, the implementation risks to their consolidation plan are relatively contained, especially given the realism in growth and revenue projections, and their engagement in the enforcement of savings. Risks stemming from the accumulation of arrears in the health sector are also being addressed through comprehensive reforms, including tighter cost control and a new management model.

### **Monetary policy and financial system**

In the context of widespread euroization and sizable foreign currency exposure of both private and public sector, maintaining exchange rate stability is instrumental in preserving both macroeconomic and financial stability. The monetary authorities remain strongly committed to this goal, as the contractionary impulse from a revaluation of FX-indexed debts and its impact on the financial system would outweigh any stimulus for the tradable sector. While preserving exchange rate stability, the monetary policy has maintained its accommodative stance, creating favorable financing conditions and supporting the credit activity.

Mainly thanks to sound macro-prudential regulation the banking sector has been coping well with the prolonged recession. The banks are well-capitalized, with an adequacy ratio over 21 percent, much above the required minimum. Their profitability has also improved over the

last year, and NPLs have stabilized at around 17 percent. However, a weak macroeconomic outlook and uncertainty over the outcome of negotiations related to Swiss Franc-indexed loans remain the most important risks for the performance of the banking system. Against this background, the authorities are actively engaged in finding a socially acceptable solution which would not jeopardize the financial stability and legal certainty.

The existing external vulnerabilities require adequate reserve buffers and the authorities continue to be dedicated to enhance them. In the authorities' view the current level of reserves is adequate. Having in mind recent efforts to reform the RAM framework with the aim to capture country specifics in a more comprehensive way, one should not assess reserve adequacy solely on the basis of RAM metric's results. Hence, the authorities point to a few country specifics which ought to be taken into account while making an overall assessment of the reserve adequacy. The first is related to the CNB's macro-prudential regulation, under which the commercial banks in Croatia are prescribed to hold minimum required foreign currency claims (MRFFC), which serve as a complement to the central bank's reserves. The second factor is related to a sizable affiliated bank debt and FDI-related short-term liabilities, which are both known to be a more stable source of funding, and which serve as a mitigating factor against risks of capital outflows. If the aforementioned two factors would be accounted for, the RAM coverage for Croatia would increase by some 30 percentage points up to the adequacy requirement limit.

### **Structural reforms and competitiveness**

Despite recent improvements, Croatia's export sector is clearly lagging behind its peers and lacks competitiveness. In search for underlying factors, staff finds that the REER is modestly overvalued based on the results in the range from -2.8 to 10 percent. The upper bound of this range comes from the comparison of unit labor costs, while the two standard methods of ER assessment - CGER and EBA (in the range from -2.8 to 5.8) - clearly indicate that the REER is broadly in line with fundamentals. With such ambiguous results and minor deviations from the equilibrium, the authorities would not expect a conclusion on the exchange rate overvaluation. Also, unlike CGER and EBA, the results based on the comparison of unit labor costs are subject to arbitrariness in sample selection and data sources, and are usually not taken as a benchmark for ER assessment in IMF country reports. In that regard, evenhandedness in the application of the ER assessment methodology is warranted.

The authorities attribute the export underperformance more to non-price structural factors. In response, they have embarked on an ambitious structural reform agenda, with the emphasis on the business climate, labor market flexibility, debt restructuring and public sector reform. Significant improvements have already been made in some areas. The second phase of the labor market reform was fully implemented, resulting in lower costs of work force restructuring and increased flexibility of working hours. The pre-bankruptcy settlement procedure is also being strengthened with the objective to facilitate earlier access to the debt restructuring process. The consumer bankruptcy act is currently in the parliamentary procedure.



In the context of the business environment, the authorities are further reducing para-fiscal charges for the private sector. The restructuring of SOEs has progressed and now the governance issues are being tackled through professionalization of management, which should underpin the ongoing privatization endeavors. Streamlining of social benefits and tightening of special pensions should support the chronically low labor market participation.

Despite these efforts, the Croatian authorities see that their reform agenda has only recently started to bear fruit. Now, that the economy has finally bottomed out, there should be more space and broader public support to push the reform agenda further. They understand that structural reforms are key to increasing competitiveness and unlocking the growth potential.