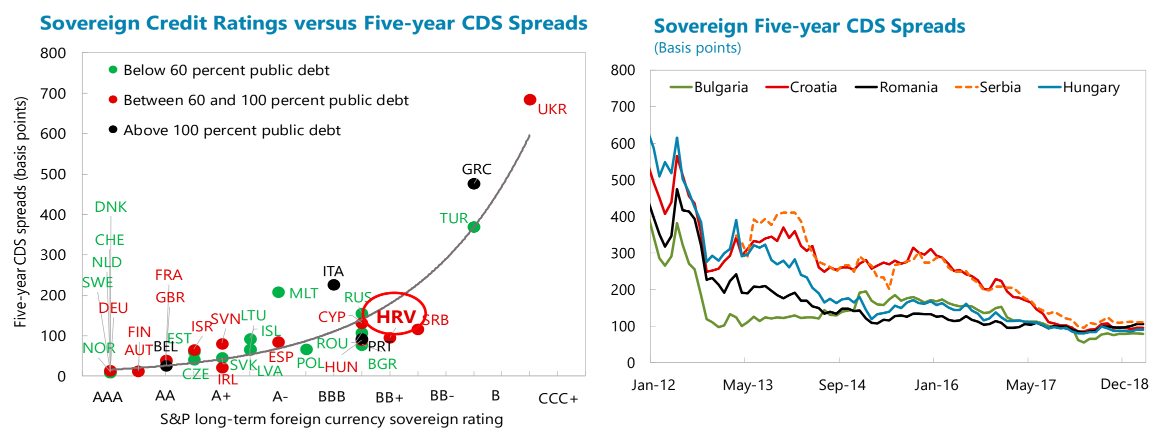
TABLES

ANNEXES

CONTEXT

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

Figure 1. Market Sentiment and Ratings



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

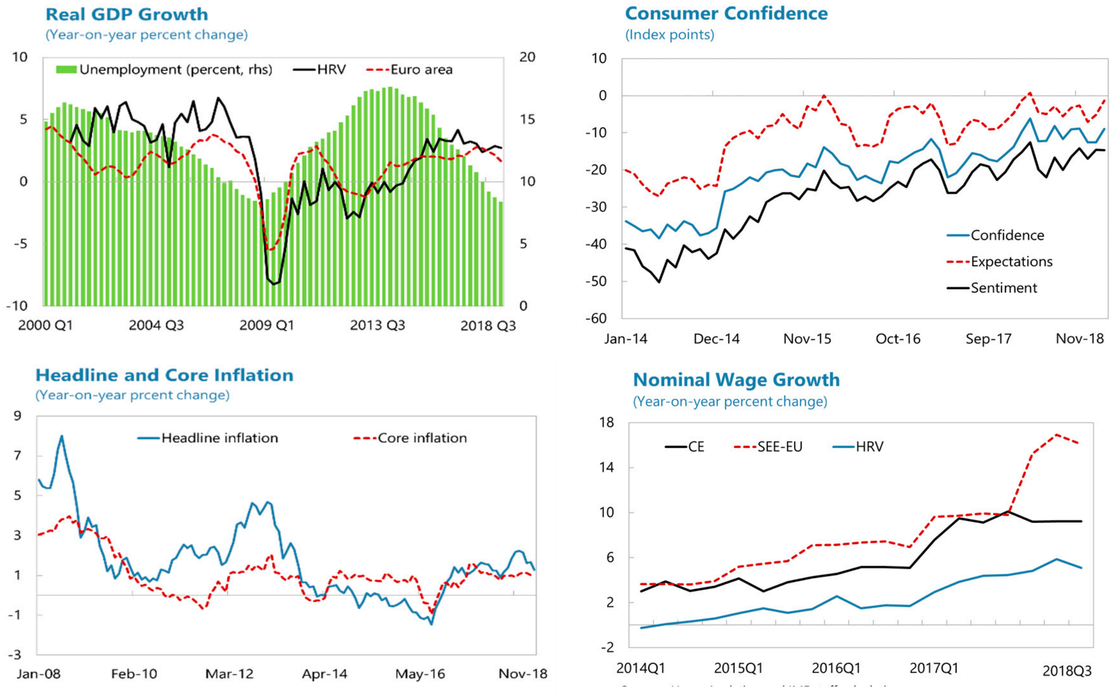
2. **As the cyclical recovery matures, structural rigidities are more apparent.** It took Croatia a full decade to get its output and employment to pre-crisis levels, preventing faster income convergence with the EU-15. The country experienced a severe recession, prolonged by reform inertia. Parliamentary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

RECENT DEVELOPMENTS

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

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

Figure 2. Selected Real Sector Indicators



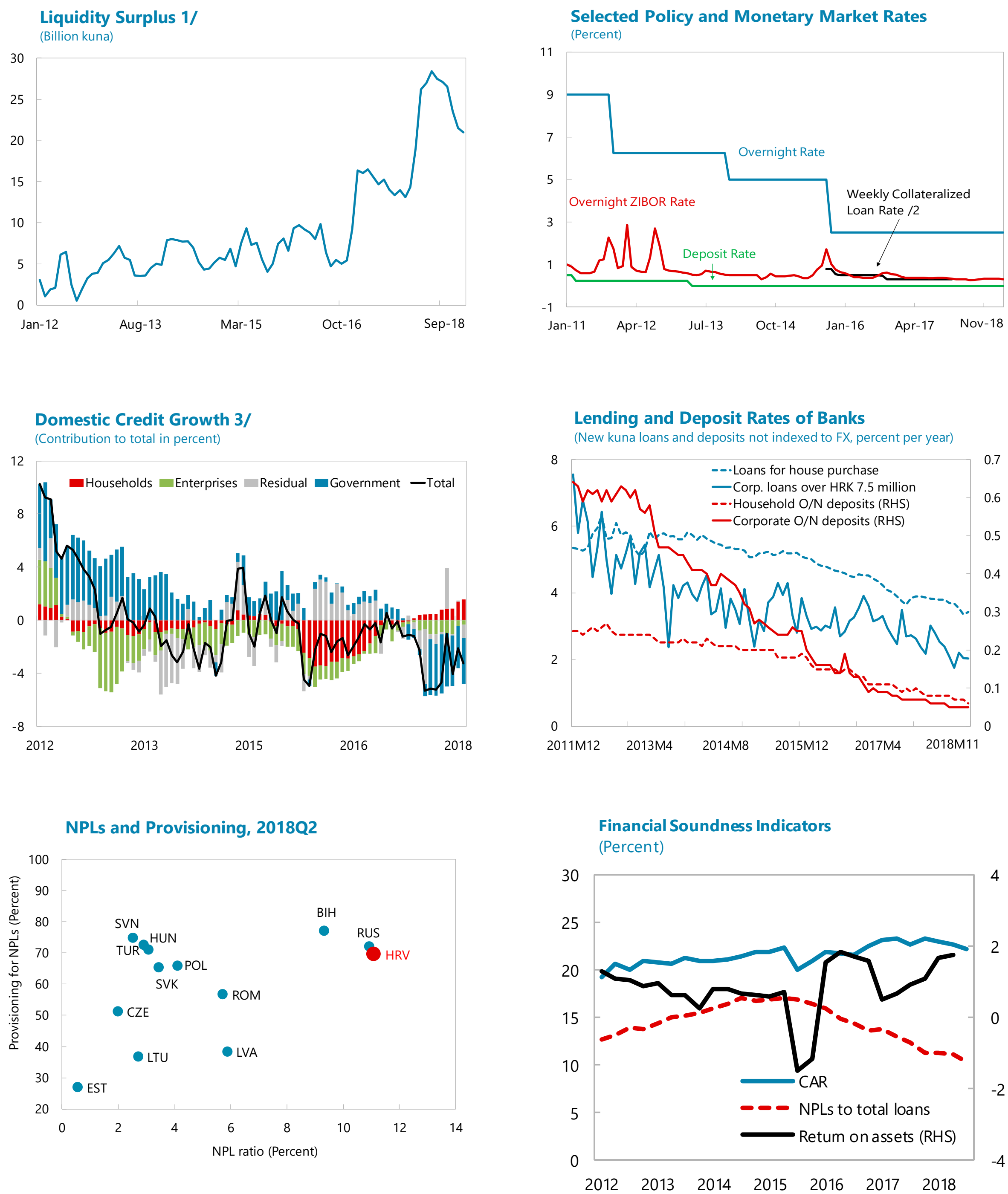
Sources: Haver Analytics, and IMF staff calculations.

Notes: Simple average of country groupings. Recent high wage growth in Hungary and Romania is related to increase in minimum wage that was partly compensated by lower social security contributions.

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

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

Figure 3. Banking Sector Developments



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

1/ Including overnight deposits with the CNB.

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

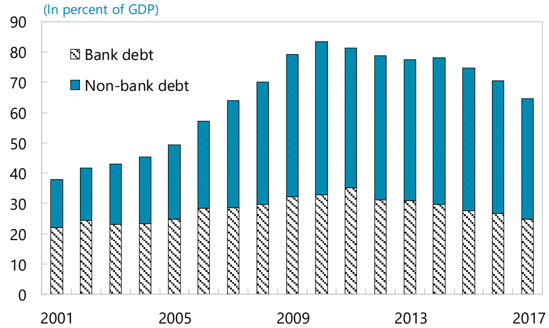
3/ Based on change in stock of credit.

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

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

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

Corporate Debt 1/
(In percent of GDP)



Sources: Croatian National Bank; and IMF staff calculations.
1/ Consolidated basis; non-bank debt include loans and debt securities.

Agrokor: New Ownership Structure
(Percent of GDP)

Russia's Sberbank	39.2
Bondholders	24.9
Croatian banks	15.3
Russia's VTB Bank	7.5
Suppliers	4.7
Others	8.4

Source: Agrokor settlement agreement.

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

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

OUTLOOK AND RISKS

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

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

Authorities' views

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

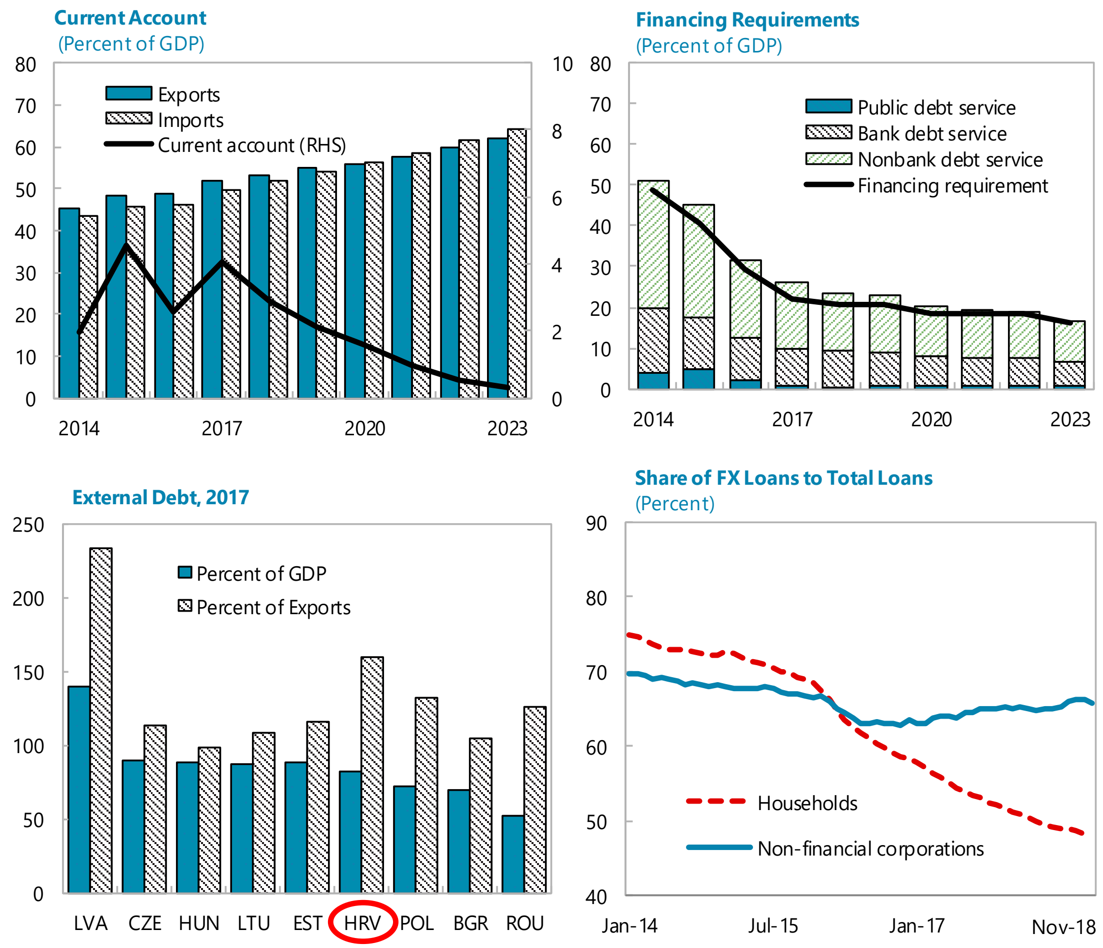
[3] See Annex V on Potential Output Developments in 2017 Article IV Staff Report; EC Country Report (2018).

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

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

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

Figure 5. Vulnerability Indicators



Sources: Croatian National Bank; IMF, *World Economic Outlook*; and IMF staff estimates.

POLICY DISCUSSIONS

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

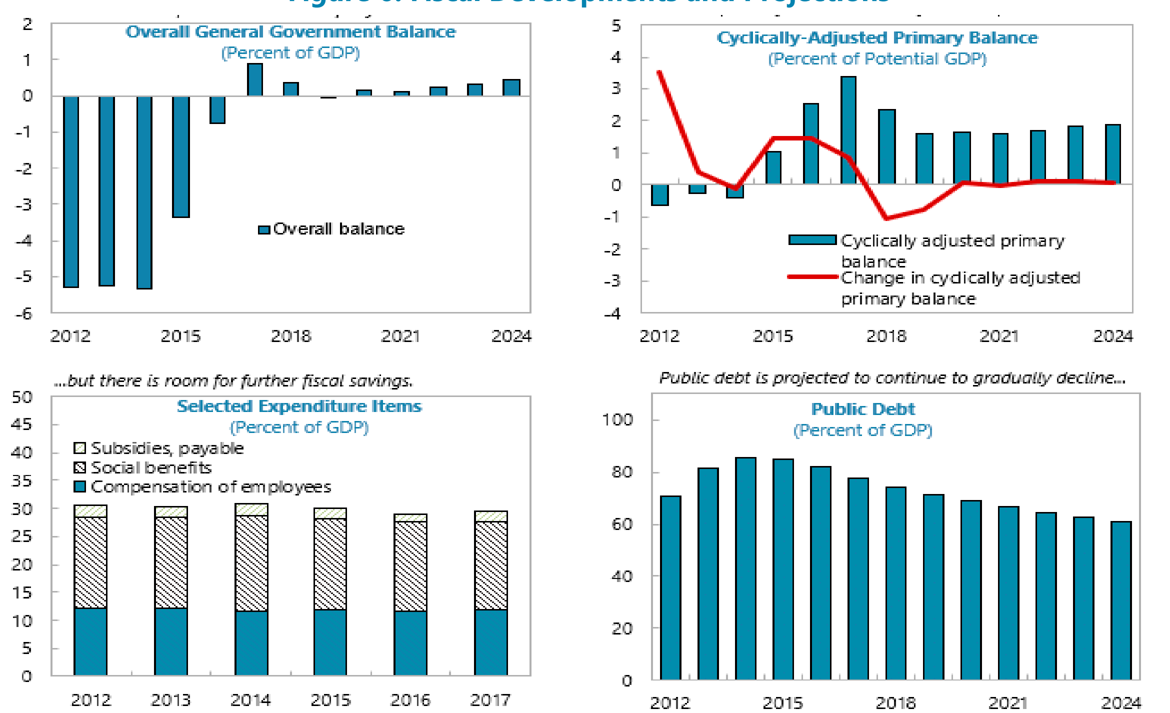
[7] See Annex IV of 2017 staff report on Euro adoption considerations.

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

A. Fiscal Policy: Rebuilding Space and Enhancing Growth Prospects

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

Figure 6. Fiscal Developments and Projections



Sources: Croatian Authorities; Haver Analytics; and IMF staff calculations.

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

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

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

14. Weaknesses in the quality of spending could endanger the achievement of these goals. Spending on compensation of employees, subsidies, and social benefits (most of which need improved targeting to the most vulnerable) continues to grow. Given the electoral calendar, pressures to spend more on these categories could continue. Yet, public investment remains significantly under-executed, which hampers medium-term growth prospects. Under current policies (staff baseline), the medium-term fiscal goals discussed above may not be achieved and thus public debt would remain above the Stability and Growth Pact (SGP) threshold of 60 percent of GDP.

Baseline vs. Recommended Fiscal Effort
(Percent of GDP)

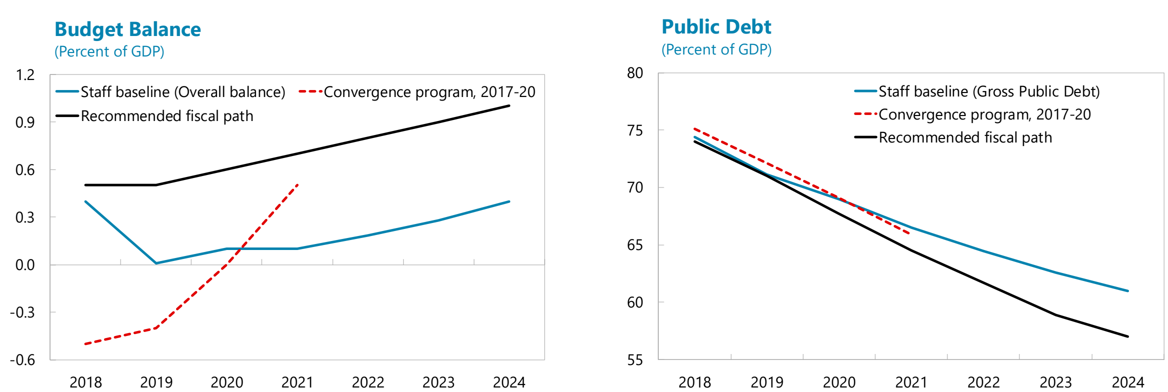
	2018	2019	2020	2021	2022	2023	2024
Croatia's Convergence program							
Overall Budget Balance	-0.5	-0.4	0.0	0.5	--	--	--
Public Debt	75.1	72.1	69.1	65.9	--	--	--
Staff's baseline							
Overall Budget Balance	0.4	0.0	0.1	0.1	0.2	0.3	0.4
Structural Primary Balance	3.5	2.1	1.9	1.9	2.0	2.1	2.2
Public Debt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

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

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

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

Figure 7. Medium-Term Fiscal Consolidation Scenarios



Sources: Ministry of Finance, and IMF staff calculations.

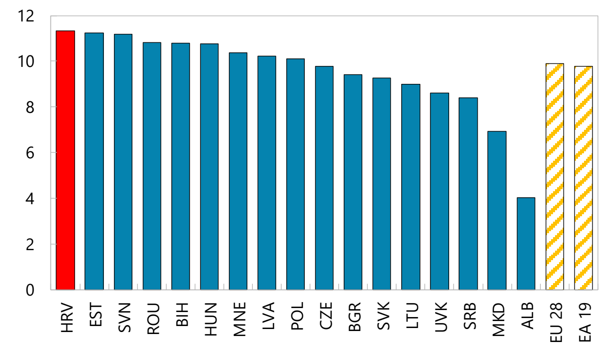
16. To achieve the recommended fiscal path, staff suggested measures that entail a broader revenue base and higher quality spending.

- On the revenue side, staff highlighted the advantages of a well-designed real estate tax. This can make revenue collection more stable, help finance a reduction in more distortionary taxation (Box 1), reduce the grey economy, and have a positive impact on the overall fairness of the tax system.[10] Staff acknowledged that this requires extensive preparatory groundwork and public communication. Staff also discussed alternative options, such as a wealth tax which other EU countries have implemented.

- On the expenditure side, reducing the total outlays on public employment, improving the targeting of social benefits and increasing public investment are top priorities, which dovetail with structural reform goals.

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

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



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

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

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

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

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

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

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

- *Health spending needs to be made more efficient*—first and foremost, with the objective of reducing administrative costs and improving the quality of health services. There is also a need to reduce the drain on the budget caused by health sector arrears (nearly 2 percent of GDP), which the Ministry of Finance is trying to contain through ad hoc repayments. It is encouraging to note some positive developments. The functional integration of hospitals, initiated in July 2017, is proceeding apace; some savings have been achieved from the centralization of drug purchases. Also, employment growth has led to new entrants contributing to the healthcare system, while non-paying participants for supplementary benefits are declining (though this is partly due to emigration). The health contribution rate will increase from 15 to 16.5 percent under the 2019 tax reform. Staff emphasized that such a hike needs to be accompanied with further reform. A comprehensive transformation of the system requires a more rational premium and co-payment structure, ensuring that exceptions are minimized to protect only the most vulnerable, and improving IT systems to enable more rigorous income-testing.

- *The recently passed pension reform is a significant step in the right direction.* It makes the system more sustainable and equitable across generations by putting it more in tune with the reality of increasing life-spans. This reform increases the statutory retirement age for both men and women to 67 years of age by 2033 and hardens existing penalties for early retirement. It also allows the retirees to work half a day, which could increase the participation rate. However, the reform increases spending on those retirees whose pensions under the second pillar did not generate the expected returns, giving them the option to return to the first pillar after retirement, with a 27 percent increase of their pensions. Staff commended the authorities for passing the reform but noted that the

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

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

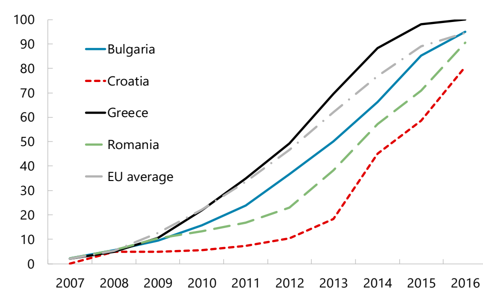
18. Some welcome steps have been taken to enhance fiscal governance and State-Owned Enterprise (SOE) performance. A new Fiscal Responsibility Law was adopted in September 2018 after several delays. In line with staff recommendations, it introduces three new concrete fiscal rules governing the structural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

Main Parameters of Fiscal Responsibility Law

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

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

EU Funds Absorption Rates
(Percent)



Sources: European Commission; and IMF Staff calculation.

Authorities' views

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

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

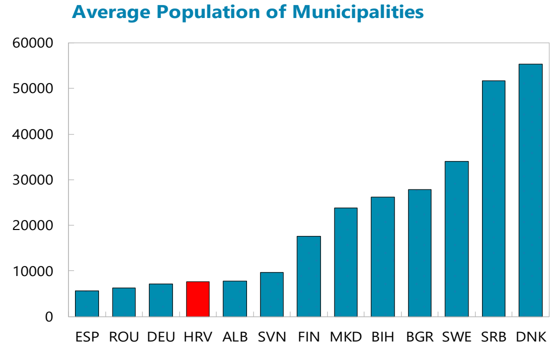
B. Structural Reforms: The Lever of a More Dynamic State

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

Figure 8. Number of Subnational Governments and Population, 2014

Country	Levels of SNG	Number of municipalities	Average population of municipalities
Croatia	**2**	**556**	**7717**
Selected South-Eastern Europe			
Albania	2	373	7764
Bosnia and Herzegovina	3	143	26253
Bulgaria	1	264	27896
Macedonia	1	81	23795
Romania	2	2181	6326
Serbia	2	145	51710
Slovenia	1	212	9727
Selected highly decentralized countries in the EU			
Denmark	2	98	55300
Finland	2	313	17634
Germany	3	11313	7200
Spain	3	8124	5687
Sweden	3	290	33993

Average Population of Municipalities



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

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

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

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

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

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

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

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

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

- *Financial support to apprenticeships*: More scholarships are being encouraged by providing financial coverage for apprenticeships to allow employers to train young workers in accordance with their needs. Consideration could be given to securing greater retention of young personnel after the apprenticeships, perhaps through continuing with partial financial coverage supported by EU funds.

- *Facilitating civil servants filling private sector vacancies*. Some retrenchment of the public service and mergers of agencies had led to employees leaving for the private sector. More such moves could be encouraged at all skill levels, including by nudging public-sector workers who are interested in private sector employment but fear losing the relative safety of their jobs to try their hand in the private sector with suitable safeguards for a limited period, to induce some risk-taking.

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

Authorities' views

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

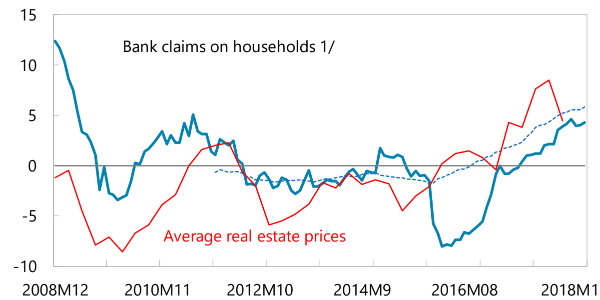
C. Anchoring Stability Through Monetary and Financial Sector Policies

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

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

Figure 9. Real Estate Prices and Bank Claims on Households

(Annual percentage change)



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

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

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

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

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

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

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

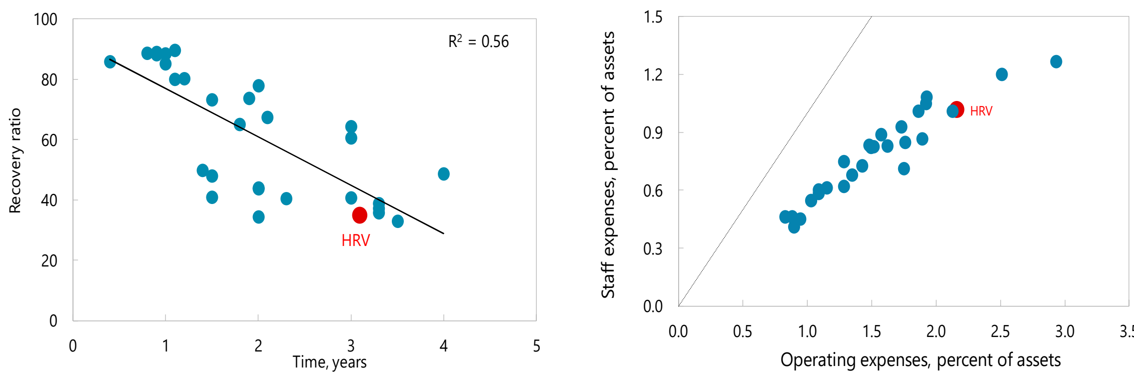
that they are issued quickly and only at a slightly higher interest rates compared to collateralized loans. The real estate market is also picking up, albeit from a low base and the recovery is rather segmented. Should both household borrowings and real estate prices further accelerate, additional macro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

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

Figure 10. Insolvency Costs and Operating Costs of EU Banks

EU Countries: Resolving Insolvency, 2018

Operating and Staff Expenses of EU Banks, 2017
(Percent of assets)



Source: Doing Business 2018, World Bank.

Sources: European Central Bank; and IMF staff calculations.

Authorities' views

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

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

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

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

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

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

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

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

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

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

Box 1. Labor Market Taxation: Considerations

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

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

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

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

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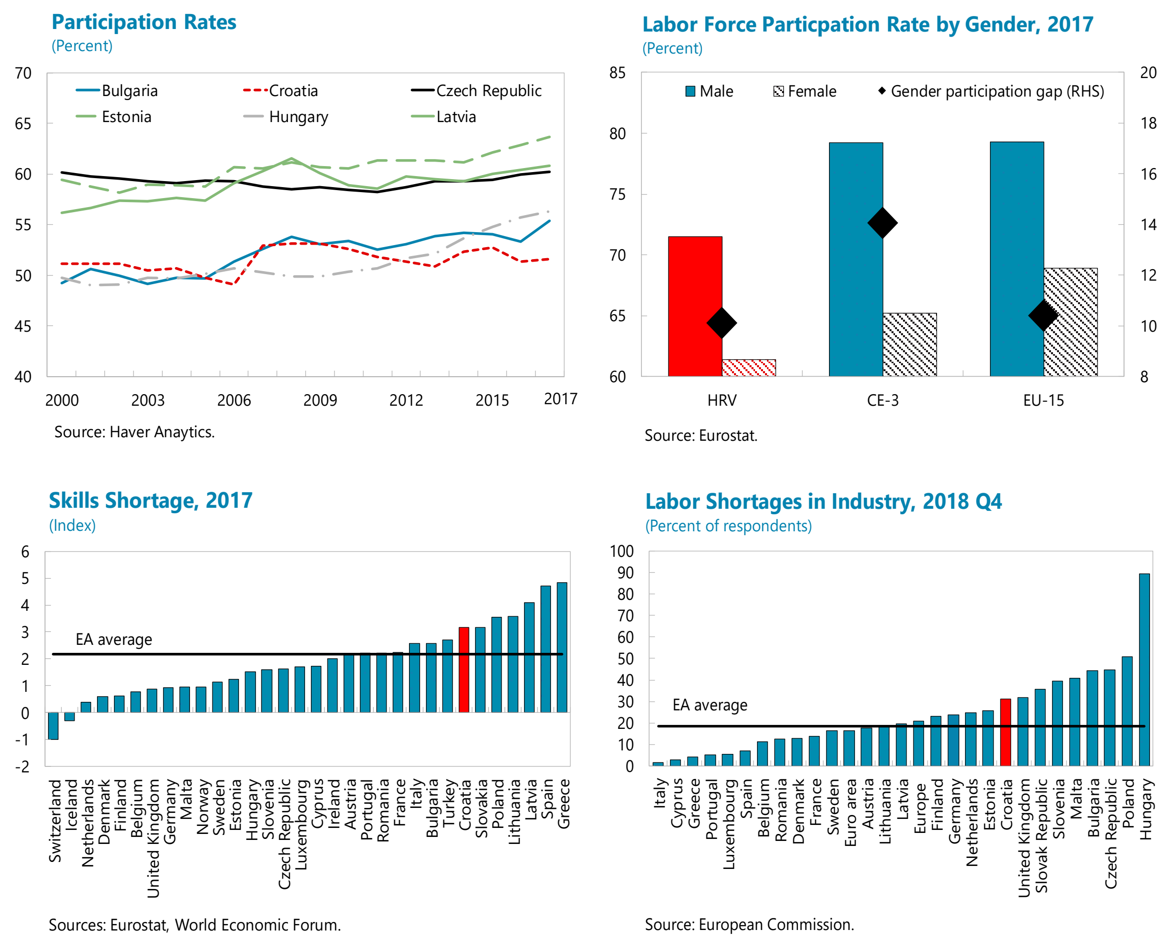
[1]Forthcoming Working Paper "Structural Determinants of Hours Worked in EU New Member States: The Role of Taxation", by A. Velasquez and S. Vtyurina.

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

Figure 11. Labor Market Outcomes



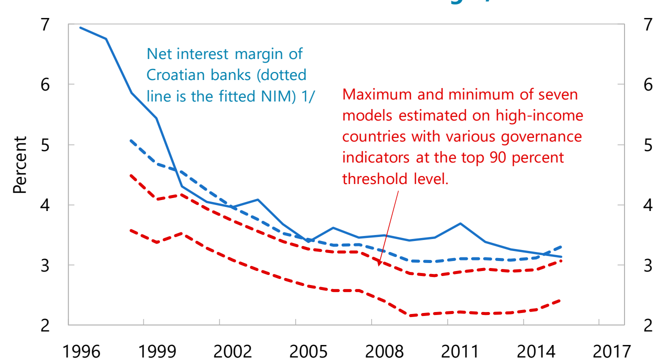
Box 2. Governance Practices and Bank Intermediation Costs

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

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

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

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



Sources: Beck et al (2017), and IMF staff estimates.
1/ Net interest margin as calculated by Beck et al. (2017).

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

Table 1. Croatia: Selected Economic Indicators

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

Sources: Croatian authorities; and IMF staff estimates.

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

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

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

Table 2. Croatia: Medium-Term Baseline Scenario

(Percent of GDP, unless otherwise indicated)

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

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

Table 3. Croatia: Statement of Operations of General Government

(Percent of GDP, ESA 2010)

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

Sources: Eurostat; and IMF staff estimates.

1/ Mostly EU structural and investment funds.

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

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

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

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

Table 4. Croatia: Monetary Accounts

(End of period, billions of Kuna, unless otherwise indicated)

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

Sources: Croatian National Bank; and IMF staff estimates.

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

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

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

3/ Excludes statutory reserves in foreign currency.

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

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

Table 5. Croatia: Financial Soundness Indicators

(Percent, unless otherwise indicated)

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

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

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

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

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

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

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

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

Sources: Croatian National Bank; and IMF staff estimates.
1/ Based on BPM5.
2/ Since end-2008, external debt is reported based on the new reporting system (INOK).

Annex I. Implementation of IMF Recommendations

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

Annex II. Public Debt Sustainability Analysis[1]

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

Definitions, debt profile and vulnerabilities

- *Definitions and coverage*: Croatia's gross debt statistics cover the general government (central, local, social security funds and state-owned enterprises), and consists of liabilities in the following instruments: cash and deposits, debt securities and credits and loans.
- *Debt profile and developments:* Central government debt accounts for 80 percent of general government gross debt. More than 93 percent of outstanding debt matures beyond one year, although Croatia still does not borrow very long-term in sovereign bond markets (mostly 5–10 years). About 40 percent of public debt is denominated in foreign currency (mostly euro-denominated), and debt denominated in euro has increased gradually during the last few years due to the result of the issuance of domestic and foreign bonds denominated in euro, borrowing in domestic market via syndicated loans, and use of project loans of international financial institutions. Since its peak in 2014, public debt has declined more than 9 percentage points; and significant progress was made in the financial restructuring of the road sector which had contributed significantly to the build-up of debt in the past. However, in 2019 at above 70 percent of GDP, debt will remain high and gross financing needs elevated at 11 percent of GDP (almost a third of general government revenues). While financing conditions have improved resulting in lower risk premia, the interest rate on Croatia's sovereign debt still exceeds its medium-term growth rate under a reasonable scenario, highlighting debt sustainability concerns.
- *Debt management strategy*: High financing needs and exposure of its sovereign debt to FX risks call for a strengthening of the debt management framework. The authorities have updated its debt management strategy for the period 2018–2020. This strategy continues to recognize that public debt represents a key macroeconomic risk for the economy, and thus emphasizes the need to accelerate the fiscal adjustment. The objective is to reduce the debt-to-GDP ratio by 10 percentage points of GDP by 2020, not least through further reducing short-term debt and currency and interest rate risks.

[1] Prepared by Carlos Mulas Granados.

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

The baseline scenario incorporates

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

Risks to the baseline come mainly from potentially less favorable growth prospects but past track record of fiscal overperformance mitigates the balance of risks.

- While Croatia's real GDP growth forecast has been optimistic since 2009, errors have diminished in magnitude in recent years, and growth has even surprised on the upside. The growth shock could come from external risks identified in the RAM (Annex IV), reflecting reduced demand from trading partners and a slowdown of tourism activity.
- A neutral interest rate-growth differential and the consolidation efforts could result in much faster debt contraction than previously projected. Gross financing needs are also projected to decline due to lower deficits and recent refinancing of debt at longer maturities and favorable interest rates, resulting in lower effective rates even after accounting for a gradual normalization of global monetary conditions.

Shocks and Stress Tests

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

Figure 1. Croatia Public Sector Sustainability Analysis (DSA) – Baseline Scenario

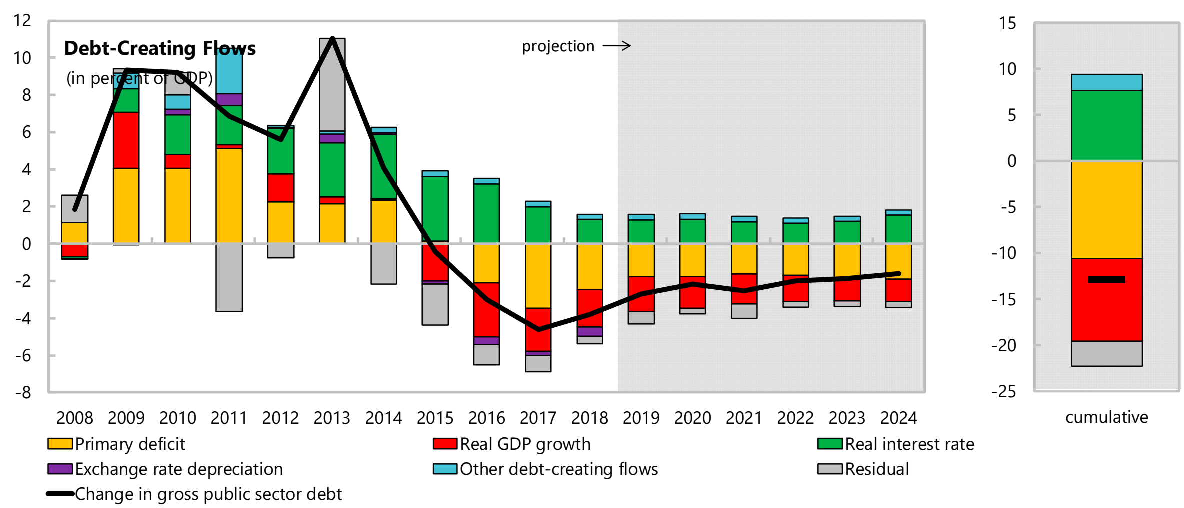
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

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

Contribution to Changes in Public Debt

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



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

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

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

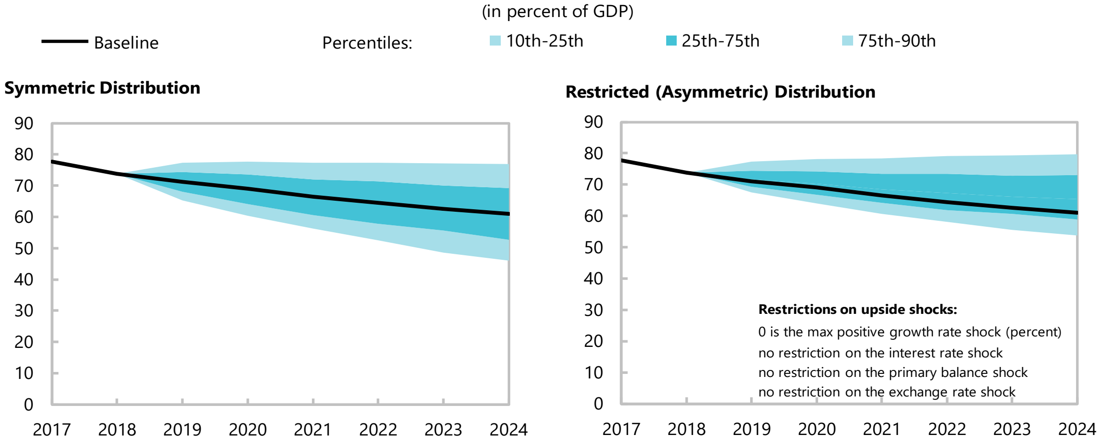
Figure 2. Croatia Public DSA Risk Assessment

Heat Map

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

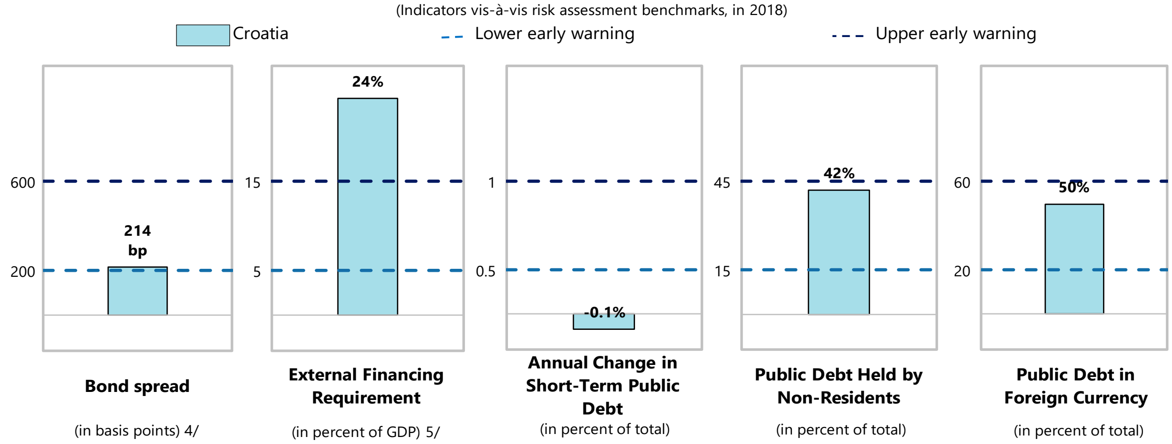
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

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



Source: IMF staff.

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

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

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

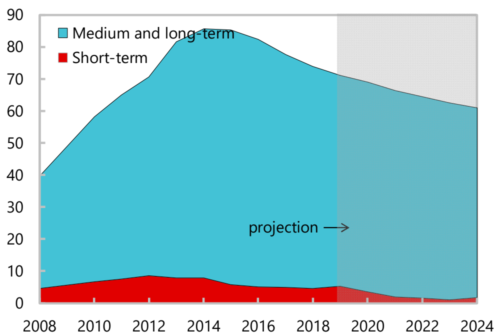
4/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Jul-18 through 30-Sep-18.

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

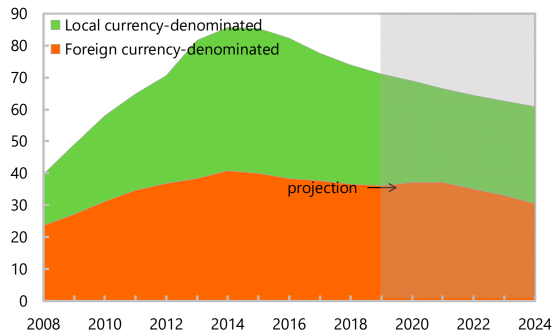
Figure 3. Croatia Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



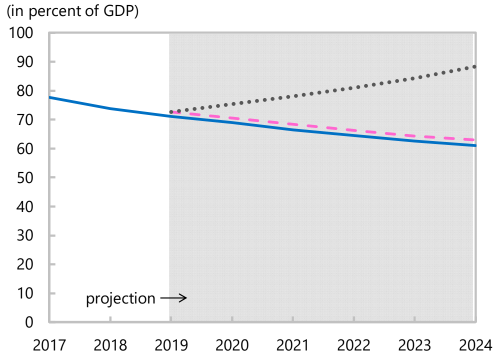
By Currency
(in percent of GDP)



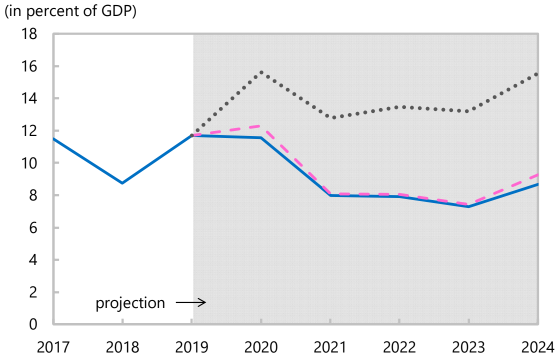
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



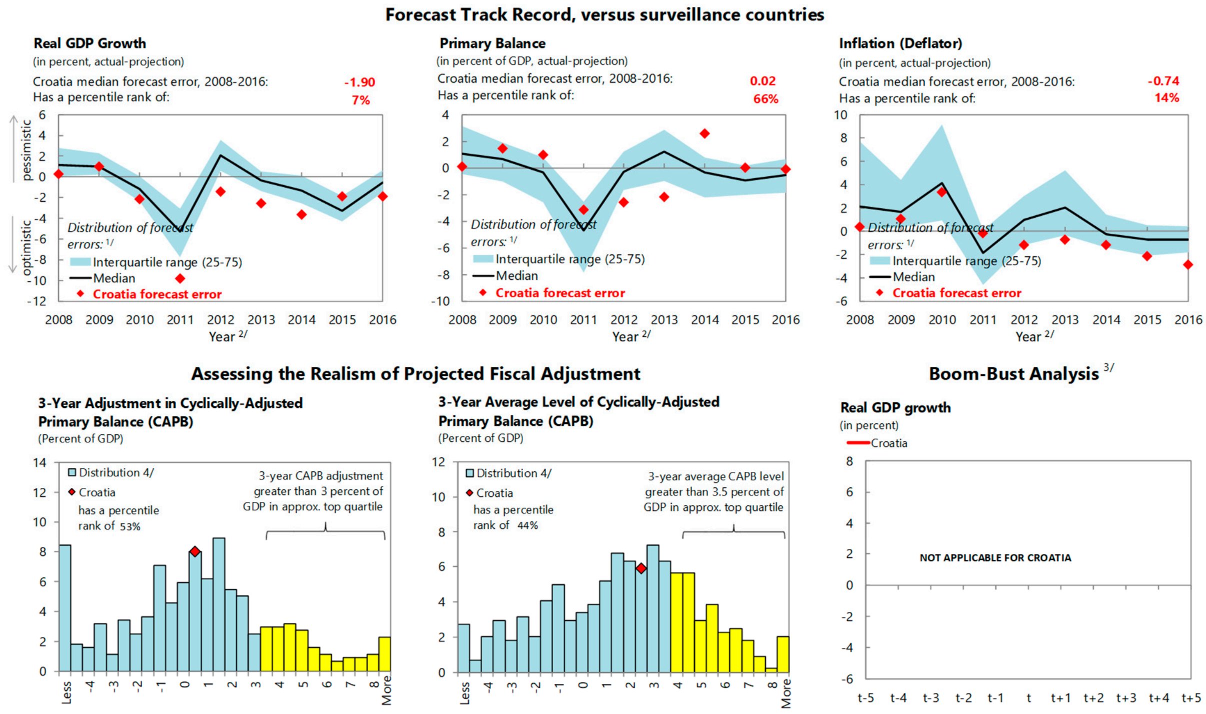
Underlying Assumptions
(in percent)

Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary Balance	1.8	1.8	1.6	1.7	1.8	1.9
Effective interest rate	3.3	3.5	3.5	3.6	3.8	3.9
Constant Primary Balance Scenario						
Real GDP growth	2.6	2.5	2.4	2.2	2.0	2.0
Inflation	1.4	1.5	1.7	1.8	1.9	1.5
Primary Balance	1.8	1.8	1.8	1.8	1.8	1.8
Effective interest rate	3.3	3.5	3.5	3.6	3.9	4.1

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

Source: IMF staff.

Figure 4. Croatia Public DSA – Realism of Baseline Assumptions



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.

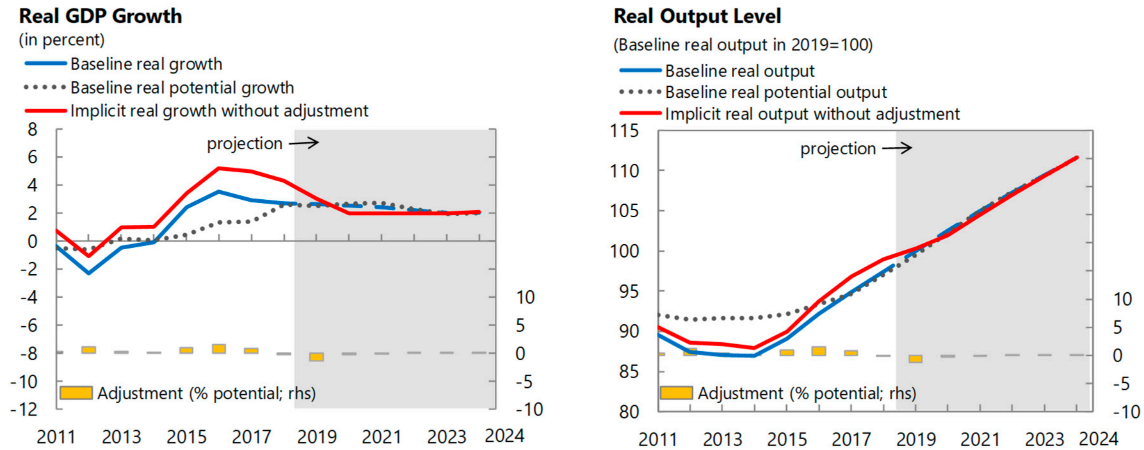
3/ Not Applicable for Croatia

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

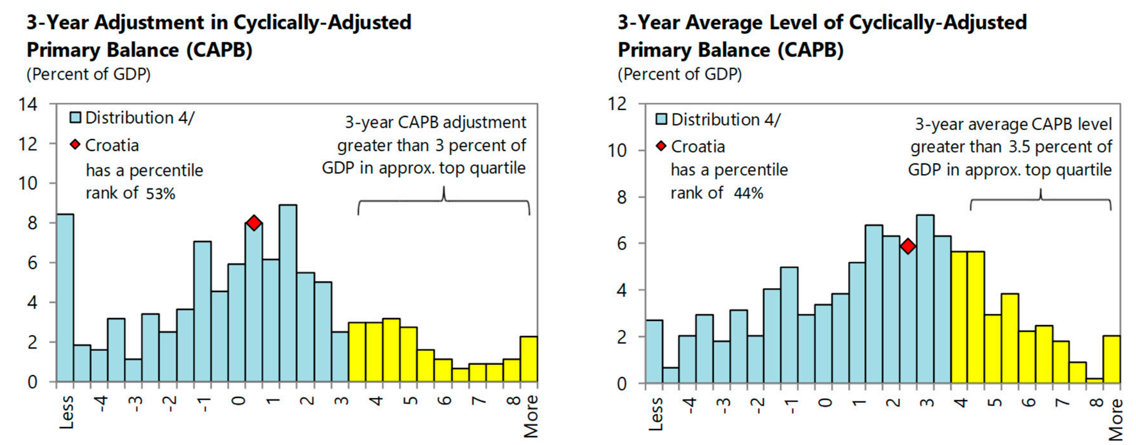
Figure 4. Croatia Public DSA – Realism of Baseline Assumptions (concluded)

Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 0.7, persistence of 0.6



Assessing the Realism of Projected Fiscal Adjustment

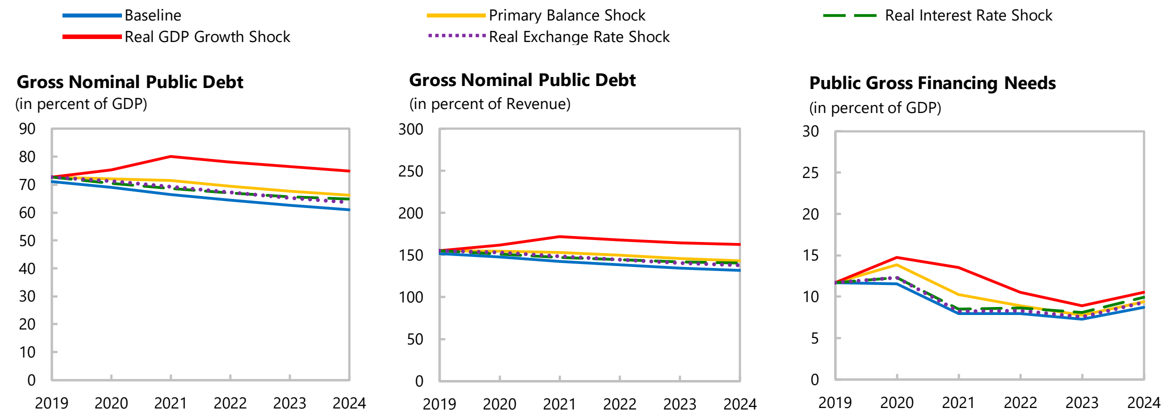


Source : IMF staff.

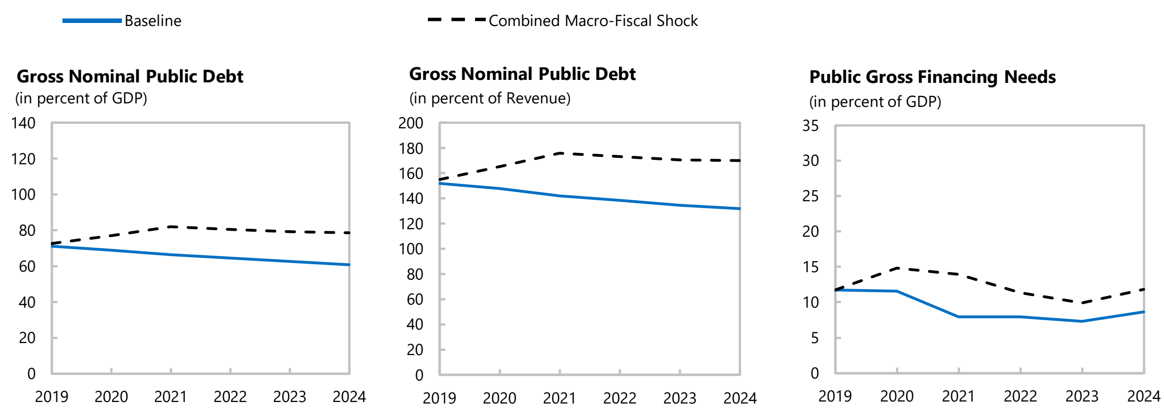
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 5. Croatia Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

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

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

Source: IMF staff.

Annex III. External Debt Sustainability Analysis

Table 1. Croatia: External Debt Sustainability Framework, 2014–24

(Percent of GDP, unless otherwise indicated)

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

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

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

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

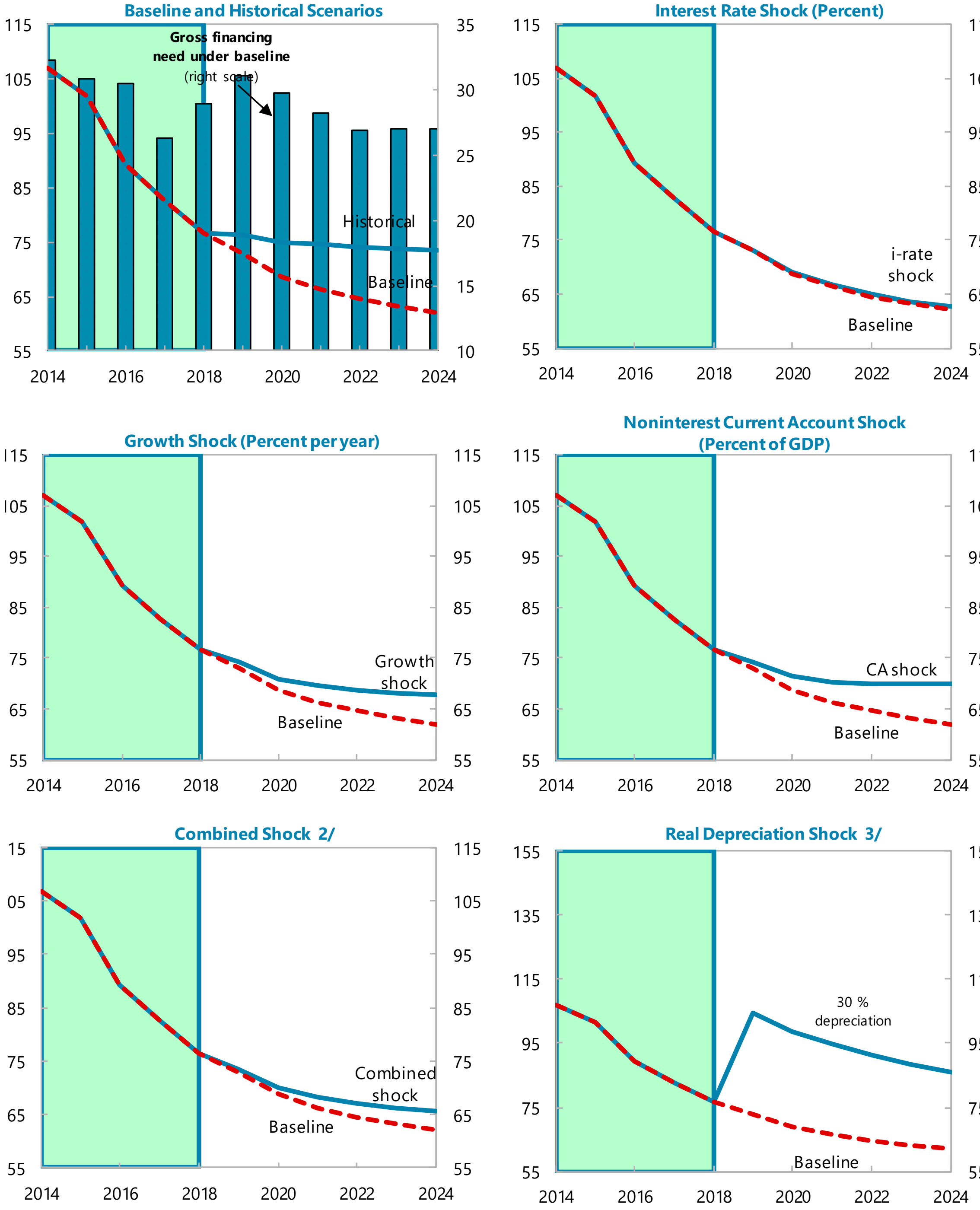
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Figure 1. External Debt Sustainability: Bound Tests of the Baseline Scenario 1/

(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data except for 2018. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

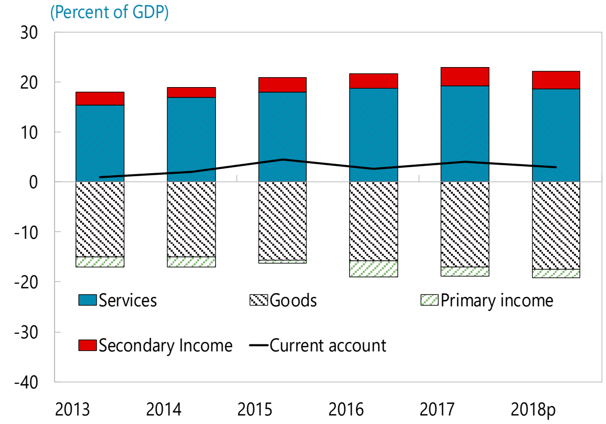
3/ One-time real depreciation of 30 percent occurs in 2019.

Annex IV. External Sector Assessment[1]

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

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

Current Account Balance
(Percent of GDP)



Sources: Croatian National Bank; and IMF staff estimates.

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

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

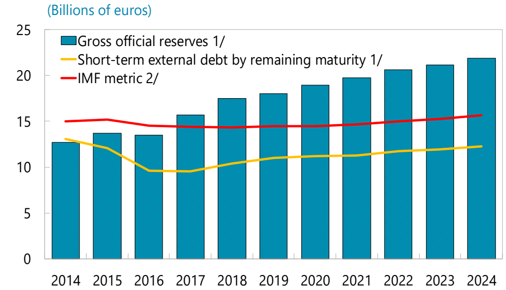
[1] Prepared by Olamide Harrison.

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

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

International Reserve Cover

(Billions of euros)



Sources: Croatian National Bank; and IMF staff calculations.
1/ Staff projections for 2018-24.
2/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.

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

Model Results, 2018

(In percent of GDP, unless stated otherwise)

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

Source: IMF staff calculations.

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

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

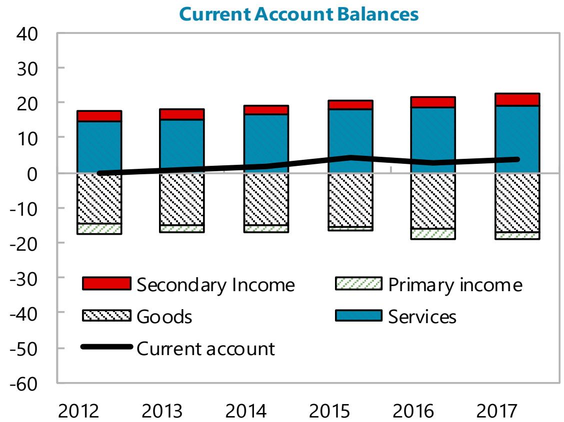
[2] See Annex IV of the 2017 Staff Report.

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

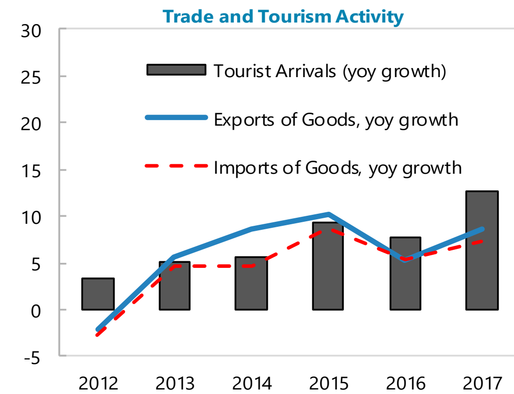
Figure 1. Balance of Payments

(Percent of GDP)

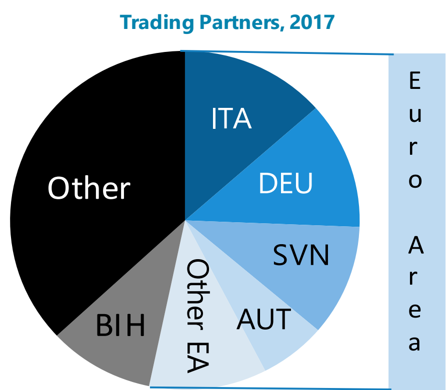
The current account remained in surplus...

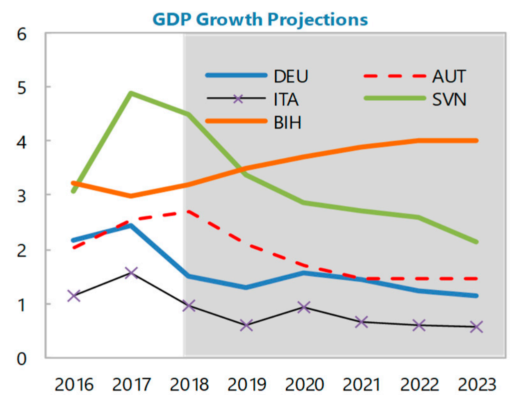


...driven by strong tourism activity and export growth...

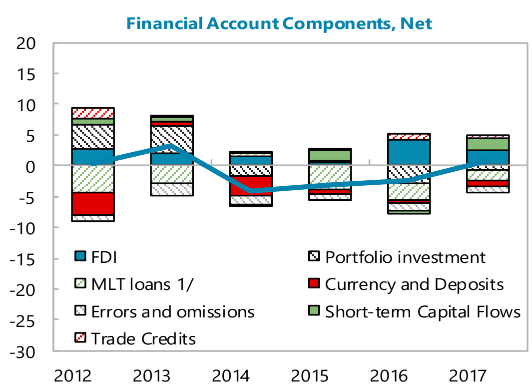


...and strong growth in most key trading partners.

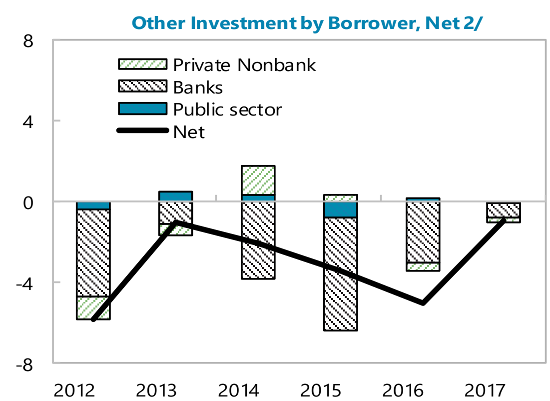




Capital flows turned slightly positive partly due to short-term flows



Bank and corporate deleveraging slowed but continued

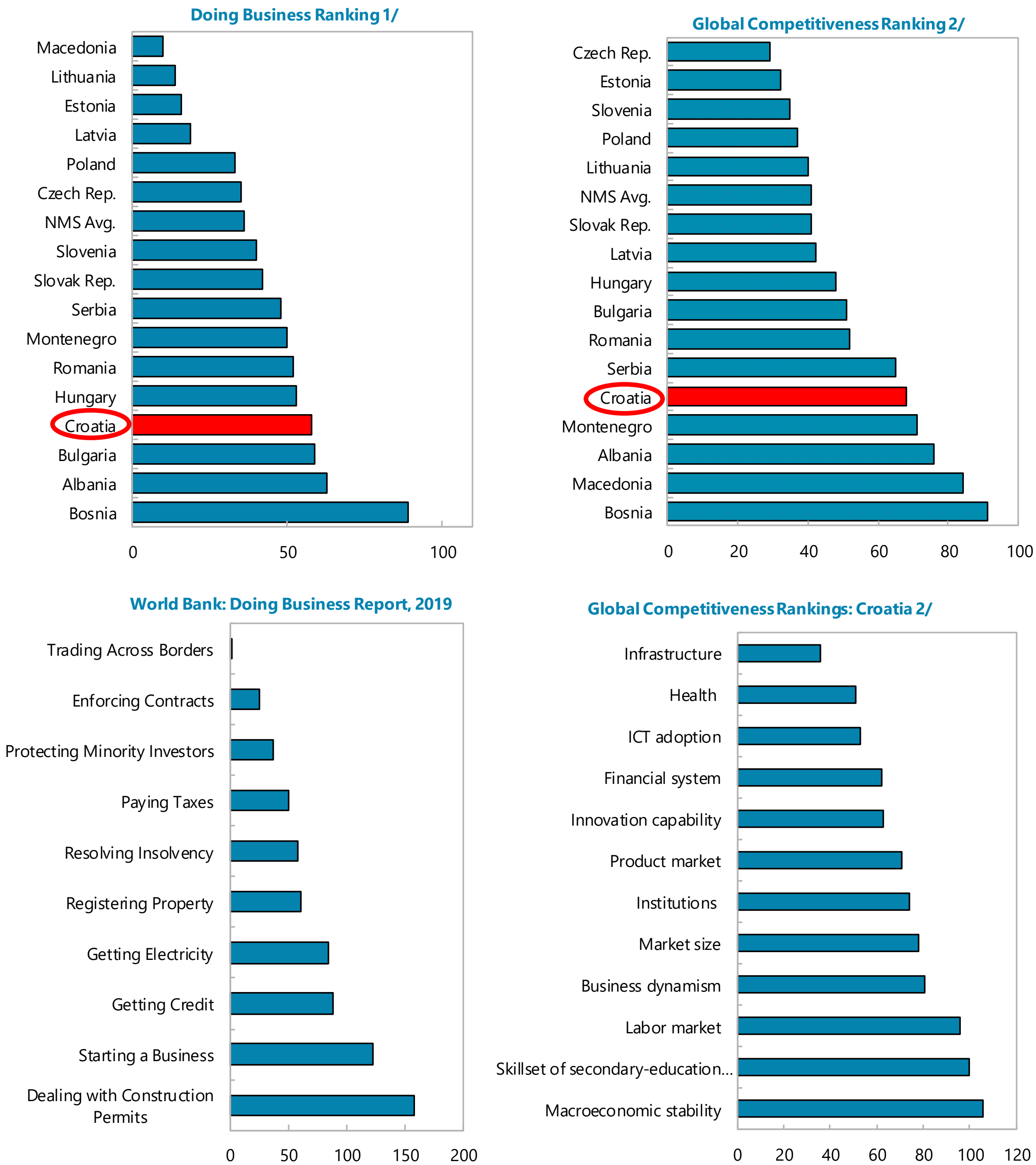


Sources: Croatian National Bank; and IMF staff estimates.

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

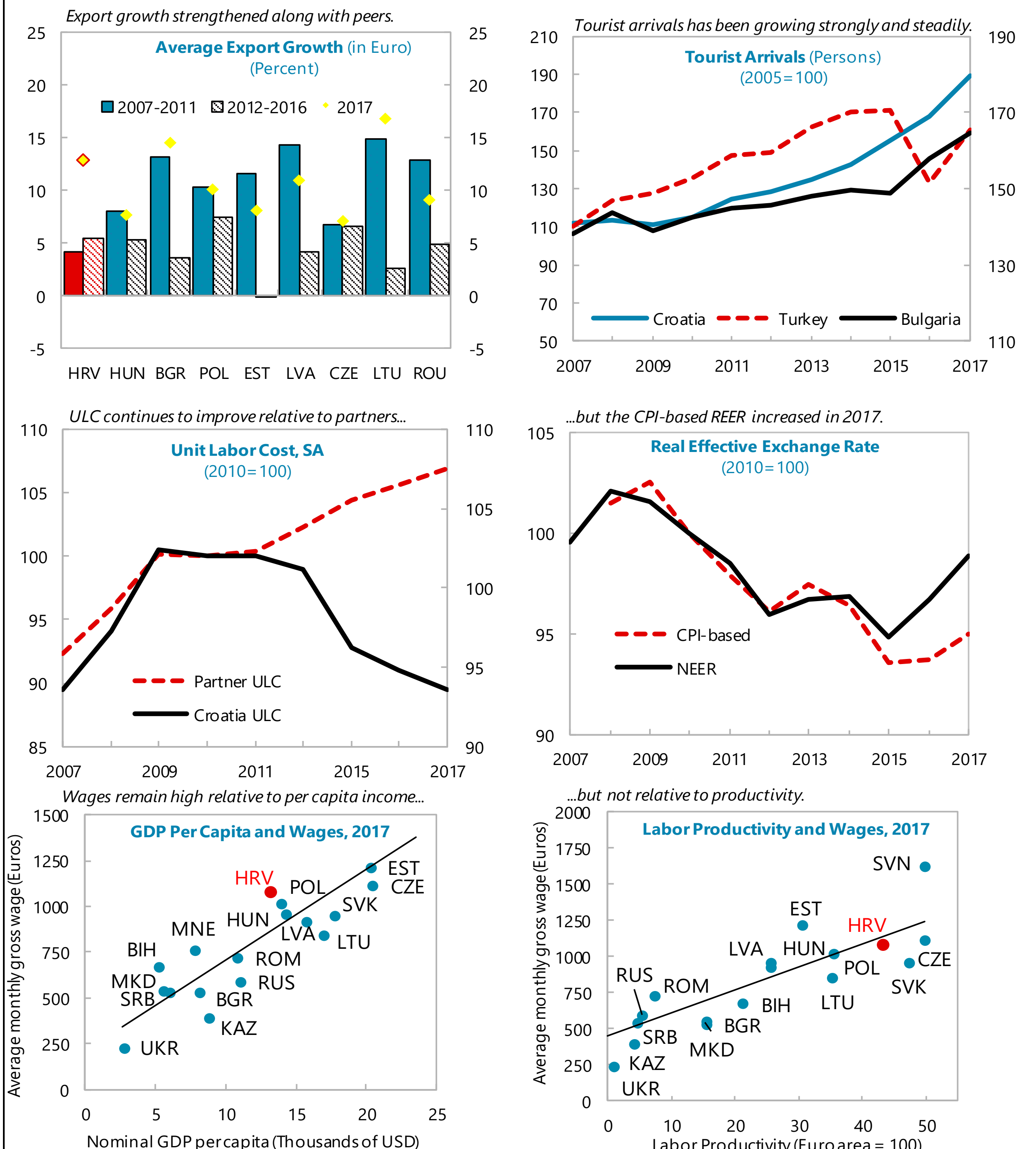
2/ Other investments consist of currency and deposits, loans, short-term capital flows, medium and long-term flows, and trade credits. Total includes CNB repo-related transactions.

Figure 2. The Business Environment



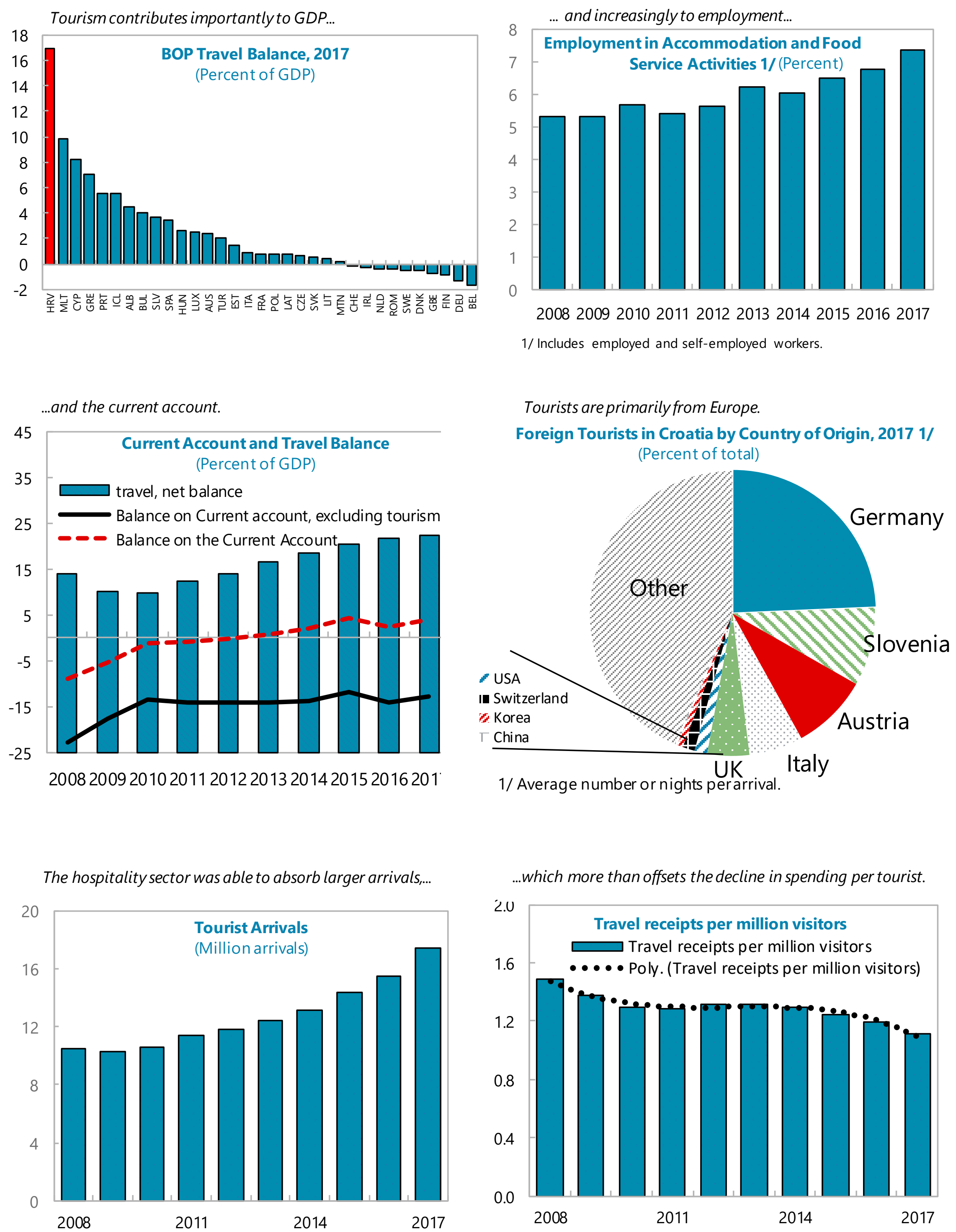
Sources: World Bank, 2019 *Doing Business;* World Economic Forum, *Global Competitiveness Report*; and IMF staff calculation.
1/ Ranking out of 191 countries.
2/ Ranking out of 140 countries. Rank for 2018.

Figure 3. Competitiveness Indicators



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

Figure 4. Tourism



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