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# REPUBLIC OF CROATIA

February 2019

## 2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF CROATIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 8, 2019 consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 8, 2019, following discussions that ended on December 7, 2018, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 23, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Croatia.

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

Selected Issues

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

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

On February 8, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the 2018 Article IV consultation[1] with the Republic of Croatia.

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

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

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

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

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

**Executive Board Assessment**[2]

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

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

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

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

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

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