Croatia: Table of Common Indicators Required for Surveillance

(As of December 31, 2018)

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

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

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

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

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

5/ Including currency and maturity composition.

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

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

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

Recent Economic Development and Outlook

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

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

Fiscal Policy and Debt Management

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

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

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

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

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

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

Monetary Policy and Financial Stability

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

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

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

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

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

Structural reforms and Competitiveness

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

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

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

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

- The Action Plan for Administrative Relief of the Economy resulted in savings to employers in 2018 and 2019 of about HRK 1.3 billion. These measures will not only make businesses more cost efficient, but also simplify their operations with the state administration, which is usually identified as an impediment to doing business. In addition, 24 professions, like pharmacists and physicists, will be fully liberalized during 2019. Lastly, tax reform applied on January 1, 2019 will decrease the overall cost of gross salaries for employers, while increasing net salaries for highly educated and skilled people.

- Measures to improve the financial sustainability of the **health sector** have also been applied. Significant progress has been made with the functional integration of the hospitals and with a central procurement system, where almost one third of all joint public procurement will be done centrally by Summer 2019, resulting in substantial savings. In addition, amendments to the Pharmaceutical Act, that will enable the authorities to define the highest possible price and make it public, is estimated to save around HRK 300 million per year. Lastly, contribution to health insurance increased by 1.5 percentage points, which will help the system to stop accumulating new arrears.

- The authorities believe that the **pension reform,** introduced on January 1, 2019, strikes the right balance between creating a long-term sustainable system and addressing the issue of aging. It addresses demographic challenges by increasing the legal age for retirement and penalizing early retirement, while enabling retirees to stay active in the labor market, thus contributing to a higher labor participation rate, which is in line with previous staff's recommendations.

- On the **state-owned enterprises**, the authorities share staff's view that improving their efficiency would contribute to public financial and public investment management, as well as to increase overall productivity. In this regard, the authorities have introduced at the beginning of 2018 the Corporate Governance Code fully in line with OECD standards, which established internal auditing in all public companies and enabled the authorities to have a detailed insight in their liabilities and plans. Parallel to this, the authorities have pushed forward the process of divesting non-strategic state assets, particularly real estates and shares in touristic companies, which is line with staff's recommendations. Challenges remain with the companies in which Croatia's share is lower than 20 percent.

- The authorities share staff's view that **EU funds** can play a significant role in boosting investment and productivity levels in the medium term. At the same time, they recognized that the current level of utilization is lower than the EU average, mostly due to capacity constraints. This was partly addressed by employing close to 1,000 people directly working on EU projects, as well as outsourcing part of the work to the private sector. At the moment, 58 percent of the total allocation from the 2014-2020 financial