CONTEXT

1. **The economy has performed well for five consecutive years.** Growth has hovered around 3 percent, supported by strong consumption, tourism, and a modest recovery in investment. Fiscal performance has remained strong reflecting buoyant revenues and declining interest payments. Private and public debt are falling but remain elevated. The country submitted its formal application to enter ERM II in July 2019. The authorities expect SSM/SRM membership by mid-2020 and currently see 2023 as the earliest time for euro accession.

2. **The commitment to reforms and fiscal discipline is being tested.** Parliamentary elections are to be held in the autumn of 2020, amid indications of increasing political fragmentation. Croatia has assumed the rotating presidency of the EU Council in the first half of 2020. Bowing to social pressures, the government repealed recent pension reforms, which would have increased the retirement age and penalized early retirement. Other reforms have also stalled (Annex I). The government has also agreed to generous public sector wage increases, which could make balancing budgets more challenging.

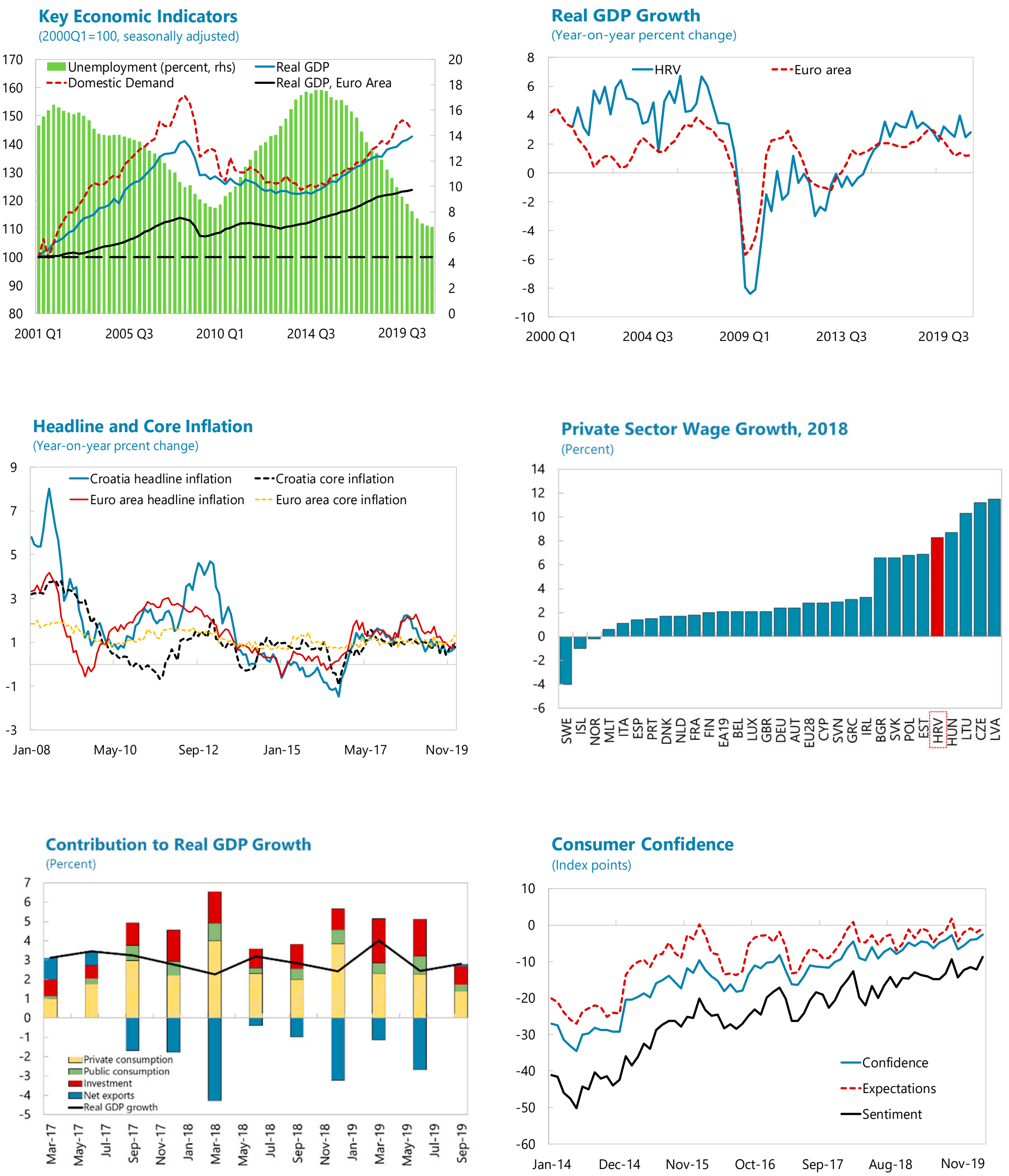
RECENT DEVELOPMENTS

3. **Growth remains solid and inflation subdued.** Growth for 2019 is expected at 2.9 percent, up from 2.7 percent last year, driven by consumption and tourism. The current account is estimated to have remained in surplus. Unemployment continued to fall to about 6.7 percent and is now near the EU average. Despite wages in the private sector growing at above 8 percent (including an increase of 9 percent in the minimum wage), average inflation remained low, in line with import prices, at 0.8 percent in 2019 (Figure 1, Table 1).

4. **Continued fiscal consolidation has aided further debt reduction.** General government registered a fiscal surplus of 0.3 percent of GDP in 2018. Revenues increased mainly due to strong VAT and profit tax collection. Lower interest payments helped absorb the increases in the wage bill, and further payments of legacy shipyard guarantees. For 2019, staff projects a balanced budget, as these same factors seem once again to have cushioned increases in current spending. Public debt is projected to fall at end-2019 to a still elevated 71.5 percent of GDP (Figure 2, Annex II).

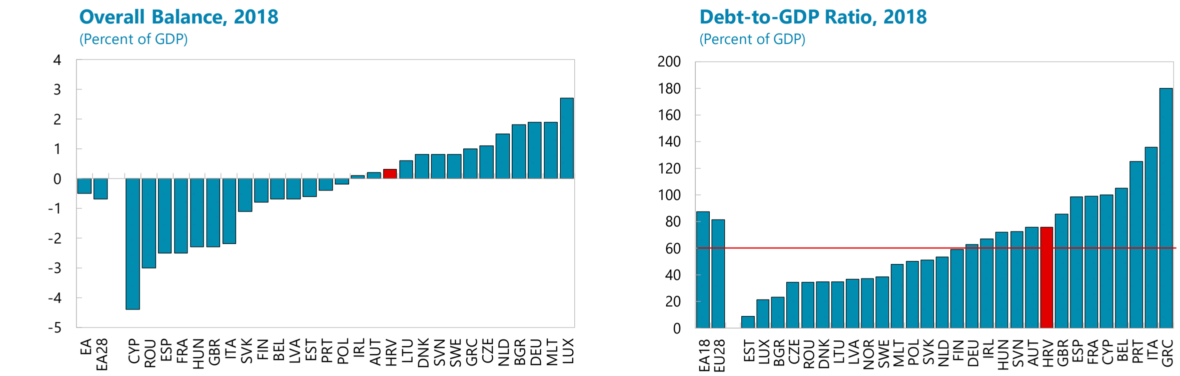
5. **The CNB has continued to accumulate international reserves.** Tourism inflows, and higher EU funds absorption have maintained official reserves above the ARA metric. Thus far in 2019 (end-November), gross reserves increased by €1.1 billion. The CNB purchased €1.1 billion to reduce appreciation pressures on the exchange rate peg, compared to €1.8 billion during 2018. In 2019, gross external debt is projected to decline to 75.9 percent of GDP from 82.7 percent in 2018 (Annex III). The external position in 2019 remains broadly in line with fundamentals and desirable policy settings. Structural reforms are needed to improve competitiveness and attract FDI (Annex IV).

Figure 1. Selected Real Sector Indicators



Sources: Croatian National Bank, Croatian Bureau of Statistics/Haver Analytics; Eurostat; and IMF staff calculations.

Figure 2. Fiscal Sector Indicators



Sources: Eurostat; and IMF staff calculations.

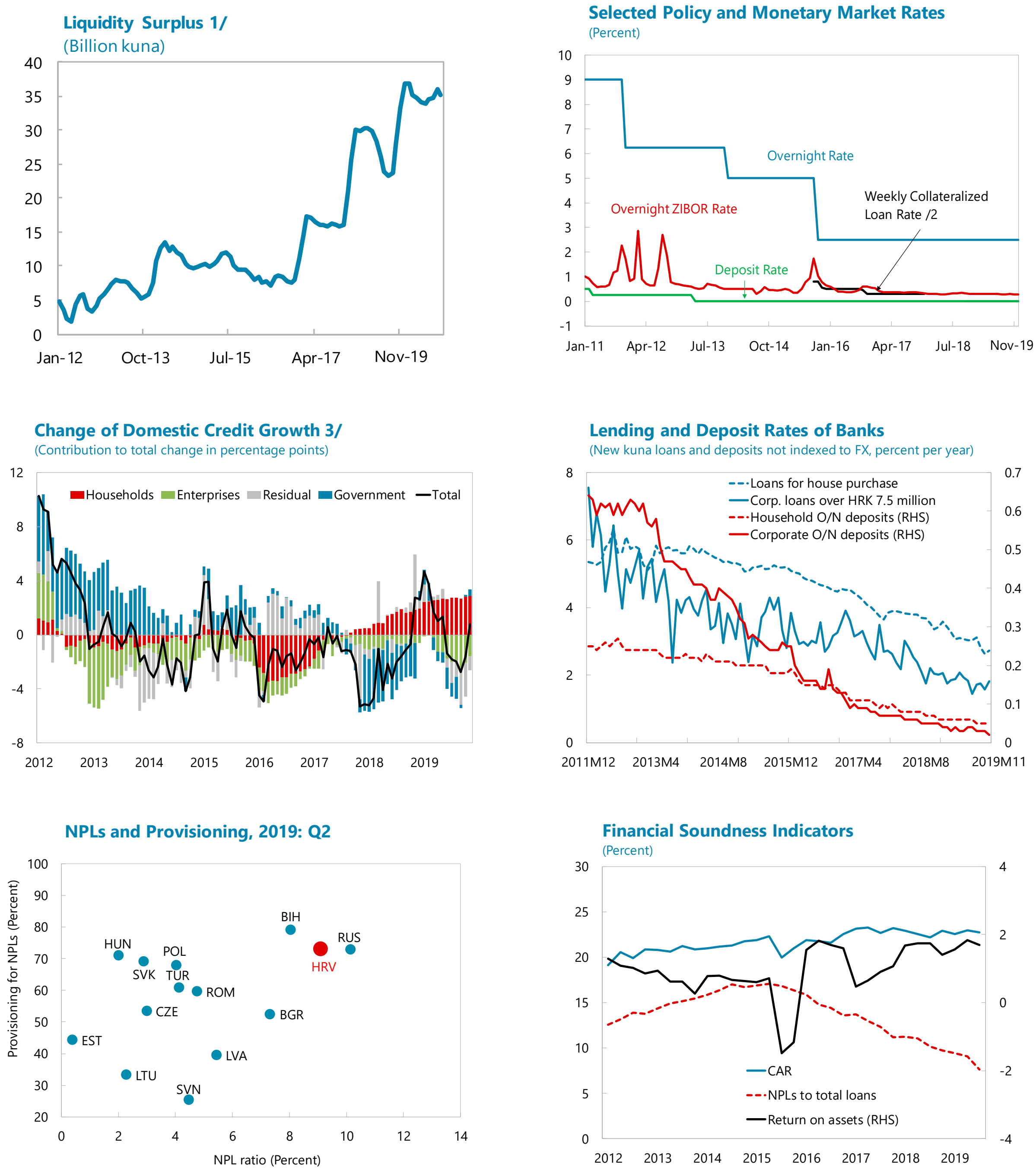
6. **Monetary conditions are appropriately accommodative given the exchange rate anchor.** Inflation remains contained, international reserves continue to grow, and the banking system is awash with liquidity (Figure 3). Headline credit growth to the private sector has decelerated in 2019, largely due to dwindling legacy issues related to the collapse of Agrokor, and the call of state guarantees of shipbuilder Uljanik. In contrast, bank lending to households has remained strong driven by general-purpose cash loans (Figure 3). Sales of non-performing loans (NPLs) have helped to further reduce the NPL ratio from 10.2 percent in September 2018 to 7.6 percent (September 2019). Moreover, the provision coverage has increased, but largely due to a large sale of less provisioned loans of non-financial corporations in Q3 2019 (Table 5).

OUTLOOK AND RISKS

7. **The current sunny picture masks significant medium-term challenges.** Tourism will support the economy's potential in the next few years. However, aging trends exacerbated by migration will pressure employment growth and potential output will depend on productivity growth (Figure 4). Yet, there are crucial areas for productivity growth such as human and technological capital where Croatia lags the EU. These deficiencies can further spur outward migration of the young, causing labor shortages, "brain drain", and serious challenges to the sustainability of healthcare and pension systems.

8. **Near-term risks are also plentiful.** External risks from global trade tensions remain elevated with Italy and Germany as significant trading partners (Annex V). External debt in percent of exports remains the second highest in the CESEE region (Figure 5). Reform standstill and fiscal risks have been exacerbated as elections approach, and further realization of contingent liabilities related to shipyards or SOEs cannot be discounted. Public and private debt remain sensitive to GDP growth and interest rate risks (Annex II and III). With the output gap having closed (or very nearly so), further loosening of spending risks turning the overall fiscal stance more procyclical and could lead to more volatile growth than in the baseline.

Figure 3. Banking Sector Developments



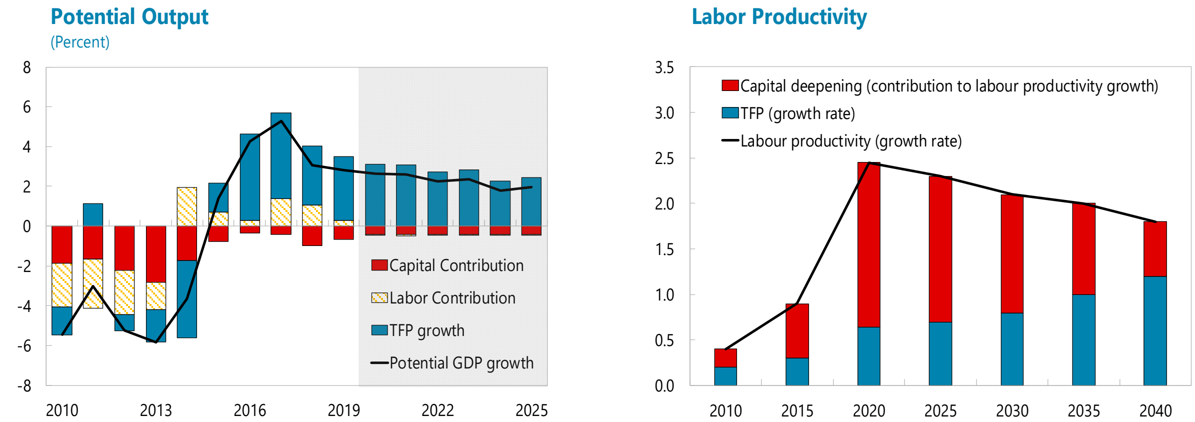
Sources: National Bank of Croatia; and IMF staff estimates and calculations.

1/ Liquidity surplus is the difference between the balance in bank settlement accounts with the CNB and the amount that banks are required to hold in their accounts after the calculation of reserve requirement.

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

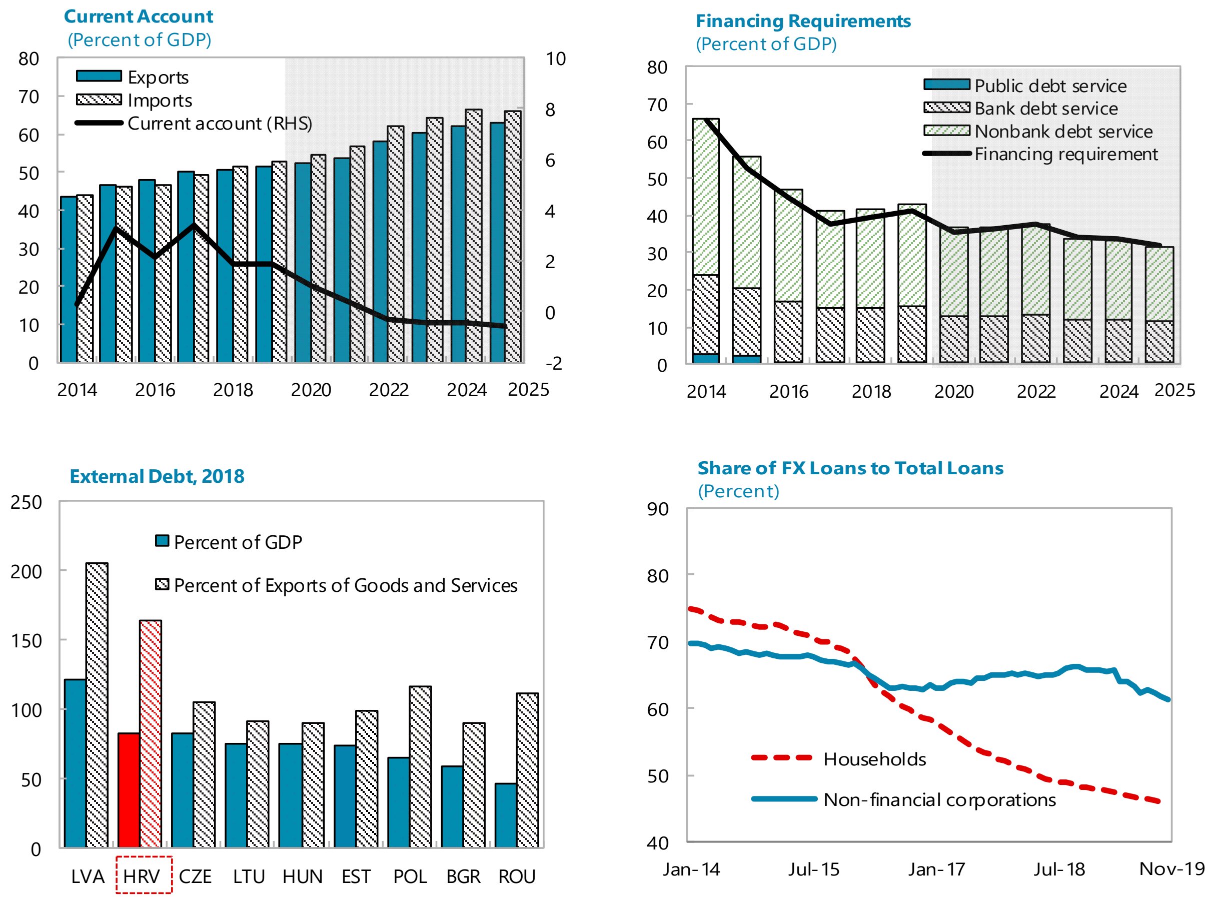
3/Based on change in stock of credit.

Figure 4. Potential Output



Sources: Aging Report, European Commission; and IMF staff calculations.

Figure 5. Vulnerability Indicators



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

Authorities' Views

9. **The authorities project slightly higher growth rates over 2020–22 assuming higher investment and better export performance.** The authorities broadly agreed with staff on the balance of risks. They view most near-term risks as stemming from a sharp slowdown in Europe.

POLICY DISCUSSIONS

10. **Discussions primarily focused on medium-term challenges.** Following the consideration of near-term risks, and keeping in mind the political calendar, policy discussions focused on reaping the full benefits of euro adoption—enshrining fiscal discipline, improving budget quality, and investing for the future. Staff encouraged authorities to align their priorities for the next programming period of EU funds with these medium-term objectives.

A. Fiscal Policy and the State's Footprint: Quality, not (only) Quantity

11. **Maintaining a balanced budget will become more challenging**. Given growing spending pressures (notably a general hike of public salaries by about 6 percent), the government postponed the reduction of the VAT rate from 25 to 24 percent (which would have cost an additional 0.4 percent of GDP). Still, for 2020, the government maintained other changes in income (especially for the young), profit, and excise taxes. Additional spending increases are expected, including from salary supplements to teachers, police, customs inspectors, and doctors. Promised extension of parental leave, additional pension spending and the cost of the EU presidency will have a combined impact of around HRK 5 billion, or 1.2 of GDP. Staff currently projects that these measures will turn the budget balance for 2020 into a deficit to 0.3 percent of GDP, thus turning fiscal policy procyclical (Figure 6). Contingent liabilities related to legacy issues in shipyards and state-owned enterprises represent another risk that are difficult to quantify (and therefore not in the baseline).

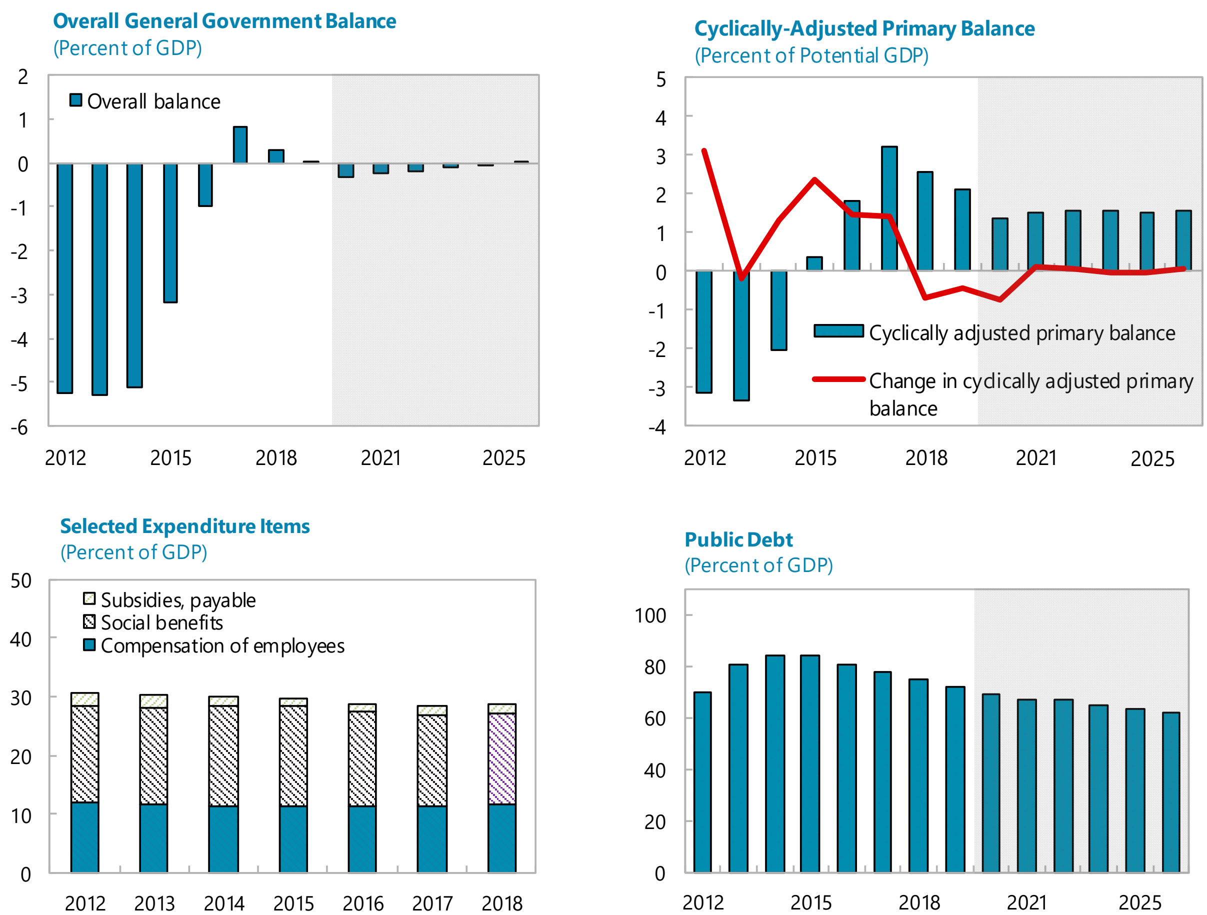
Fiscal Measures in 2020 Baseline Projection	**Million kuna**	**Percent of GDP**
Revenues		
Income tax cuts for the young	-750	-0.18%
Profit tax exemption	-200	-0.05%
Increase in income tax threshold	-500	-0.12%
VAT reduction for food and restaurants	-900	-0.22%
Additional excise taxes on tobacco, alcohol and sugar	400	0.10%
Expenditures		
Additional wage increase (from 5 to 6.12 percent)	-1,120	-0.27%
Increase in teachers' salary coefficients	-400	-0.10%
Other salary increases (police, customs, doctors)	-390	-0.10%
Pension reform roll back	-430	-0.10%
Increase in parental leave benefits	-160	-0.04%
Cost of EU Presidency	-600	-0.14%
Total	-5,050	-1.22%

12. **The rhythm of public debt consolidation is likely to slow down**. Looking ahead, assuming no new or further offsetting policy measures, staff projects that revenue and expenditure ratios will remain constant in percent of GDP (except for declining interest payments and minor changes in public investment related to EU fund's disbursement calendar) until the budget balances

again in 2025. As a result, the pace of public debt reduction is likely to slow between now and 2025, when public debt will reach 61.8 percent of GDP (Table 3).

13. Staff urged resistance to further fiscal pressures. Stronger than expected social pressures now render the previously recommended extra 1.5 percent of GDP in fiscal efforts (that Staff had recommended in the past) unrealistic. Under the current circumstances, the key short-term priority is to unwaveringly target balanced budgets and avoid procyclicality. For this reason, staff advised against any additional tax cuts at this stage. Should external downside risks materialize, allowing automatic stabilizers to play freely should be the first line of action. Given the high debt ratio, limited discretionary stimulus would be appropriate only in a severe downturn.

Figure 6. Fiscal Developments and Projections



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

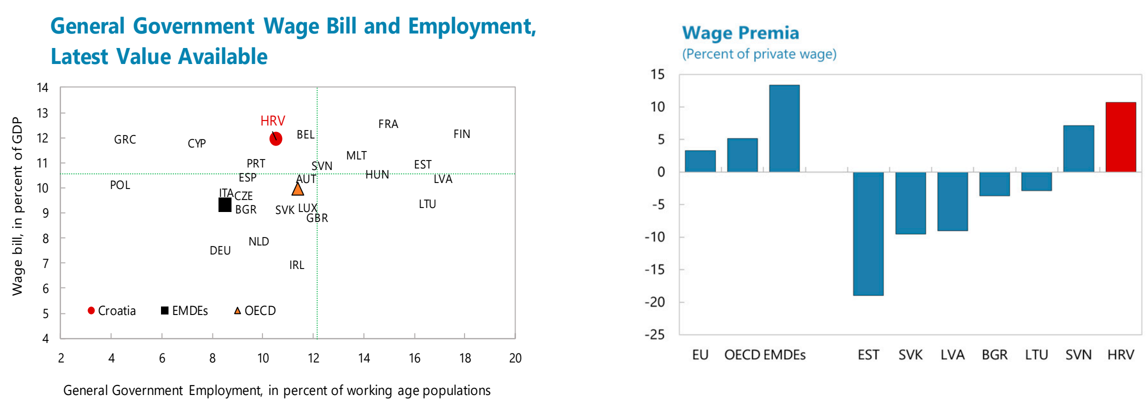
14. For the medium-term, staff recommended a structurally balanced budget. To this end, wage bill pressures must be contained, the quality of the budget needs to be enhanced. Through

steady education and information campaigns, social consensus needs to be built for fiscal reforms in politically charged areas, such as pensions, and healthcare.

- *Hold the line on further wage bill pressures*. The public wage bill and the public "wage premium" (nearly 10 percent), exceed EU averages (Figure 7). Staff encouraged authorities to resist further wage pressures and revise the public wage grid to reward merit. Any additional wage increases should come with simultaneous optimization of staffing levels.

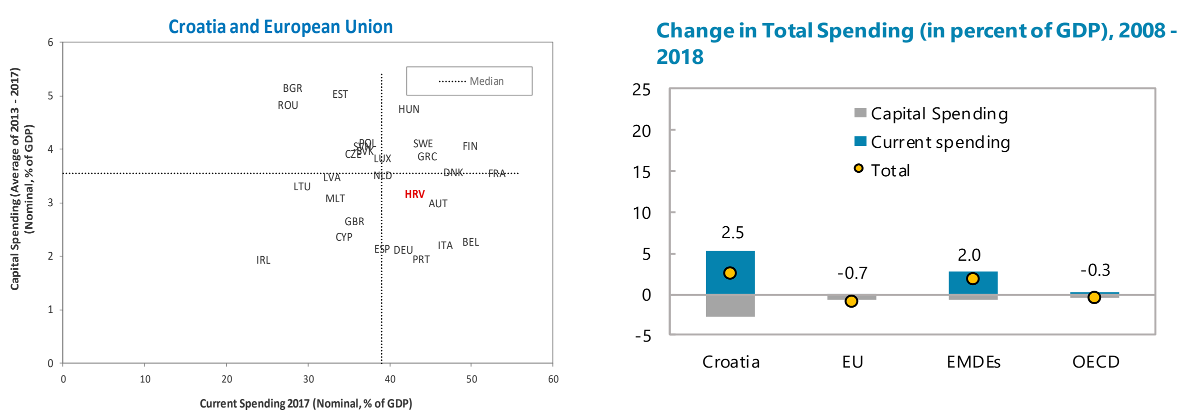
- *Improve the quality of the budget: more flexibility.* Public expenditures have notably tilted toward rigid current expenditures over the last ten years (Figure 8). Despite recent improvement in fiscal balances, Croatia remains among the countries with highly rigid expenditures (Figure 9).

Figure 7. Public Wage Bill Indicators



Sources: IMF FAD Expenditure Assessment Tool (EAT); IMF, FAD Government Wage Bill and Employment Dataset.

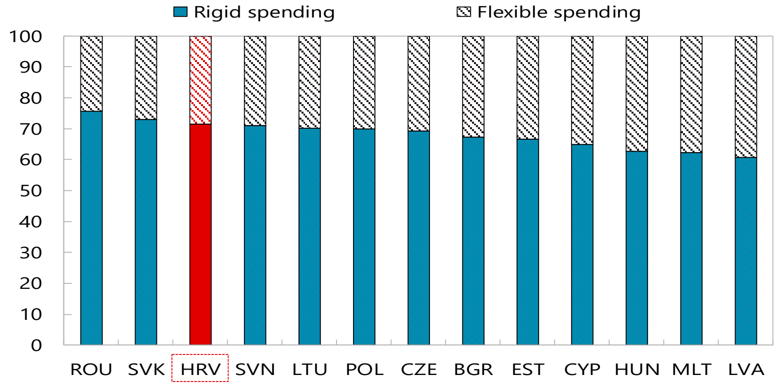
Figure 8. Current Spending vs. Capital Spending



Source: IMF FAD Expenditure Assessment Tool (EAT).

Figure 9. Composition of Government Expenditure in EU's New Member States, 2018 1/ 2/

(Percent of total revenues)



1/ Rigid spending includes: wages, social contributions, subsidies, interest payments, and intermediate consumption.

2/ Flexible spending includes: fixed capital expenditure and other current transfers.

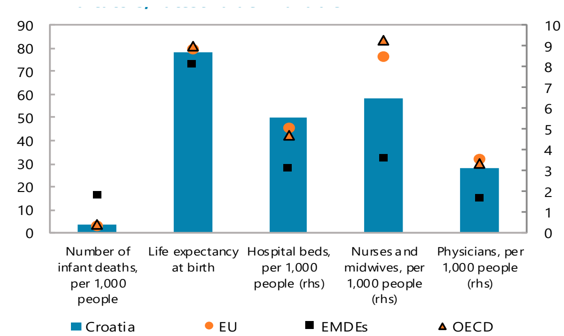
Sources: European Commission, AMECO database.

- *<u>Fiscal reforms: Inadequate to date, but essential for budget flexibility.</u>*

  - *State-Owned Enterprises (SOEs):* Studies by the IMF (2019)[1] and the Ministry of State Assets[2] document that Croatian SOEs span a large spectrum beyond natural monopolies and include manufacturing for retail markets, construction, and hotels. State ownership is fragmented and heterogenous. Despite recent improvement in the 39 SOEs considered by the government to be of "special interest", other SOEs generally show low productivity and profitability relative to peer countries due to inefficient use of labor, and weak governance. Staff encouraged additional measures centered around: (a) improving financial transparency; (b) continuing to separate core from non-core state assets; (c) improving the management of essential SOEs; and (d) divesting non-core assets. Some progress is likely to be made with (b) and (d) in order to meet ERM II commitments. However, much more is needed, and political conditions have not been supportive.

  - *Healthcare:* Health sector arrears continue at nearly 2 percent of GDP and they constitute a significant fiscal risk. While the current political context does not bode well for near-term improvement, staff reiterated previous recommendations to

Figure 10. Health System Indicators



Source: IMF FAD Expenditure Tool (EAT).

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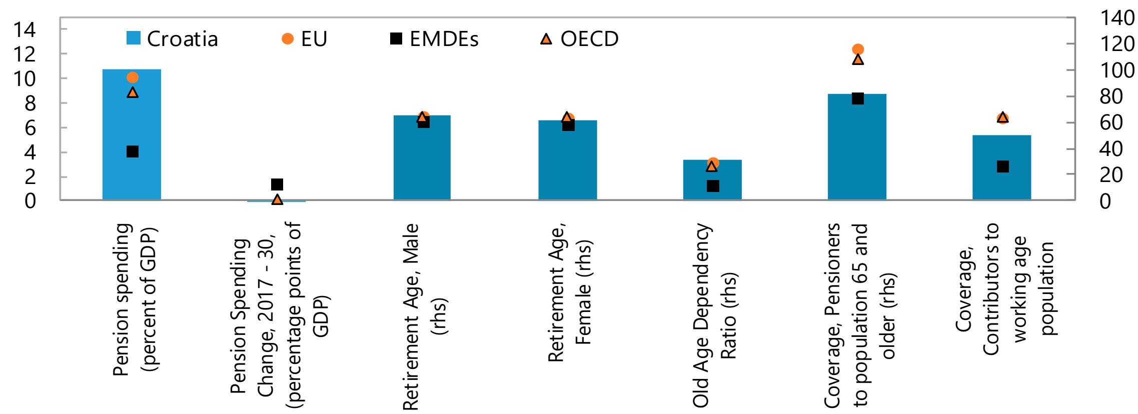
[1] Richmond, C., P. Dohlman, J. Miniane and J. Roaf (2019) "Reassessing the Role of State-Owned Enterprises in Central, Eastern and Southeastern Europe", Departmental Paper No. 19/11. International Monetary Fund (Washington D.C.).

[2] https://imovina.gov.hr/

increase efficiency, reduce costs associated to overcapacity, and explore new permanent sources of revenue while closing healthcare gaps in the medium-term (Figure 10).

- *Pension reform reversal:*[3] In the short-term, the repeal of pension reform passed in 2018 will not significantly affect fiscal balances, but the reversal may have medium-term effects as more people could retire early. Pension spending is already high despite low coverage ratios (Figure 11). The authorities should continue strengthening the second pillar of the pension system and facilitate voluntary stay in the work force beyond the age of 65. Measures to improve female labor participation rates, and to reduce the "push" factors driving emigration now assume even greater importance.

Figure 11. Pension Indicators, Latest Value Available



Source: IMF FAD Expenditure Assessment Tool (EAT).

Authorities' Views

15. The authorities highlighted their commitment to prudent fiscal policy, as exemplified by the recent reversal of the announced VAT reduction in view of growing spending pressures. They emphasized that wage demands occurred in the context of strong growth, elections and Unions' mobilization capacity—factors which were also crucial to reverse the pension reform. Yet, the authorities forecast fiscal surpluses until 2022, assuming reduced spending-to-GDP ratios for the wage bill and social benefits. The authorities saw merit in improving the quality of the budget and increasing public investment as a part of a wider strategy to accelerate Croatia's real income convergence with more advanced Europe. The authorities concurred that there could be room for efficiency gains in some SOEs. However, any major reforms would have to wait till parliamentary elections have been completed.

[3] On October 10, 2019, the government repealed the pension reform adopted late-2018. The statutory retirement age now reverts to 65 years from 67 years. The penalty for early retirement reduces to 0.2% of the pension for each month of early retirement (from 0.3%). Moreover, the early retirement age reduces to 60 years from 62 years (with 35 years of service).

B. Structural Reforms: Capital Stock Renovation and Business Climate

16. Deep reforms are needed for the economy to optimize the benefits of currency union. Delivering on commitments included in the ERM II application will prepare the country for the transition period and the banking union.[4] Yet, much deeper reforms are needed for which a strong anchor remains elusive. Croatia's convergence with the EU average has stagnated in the last decade (Box 1), and given demographic trends and emigration, relative macroeconomic performance—particularly in comparison to other new member states—is likely to lag behind without a more dynamic economy. Therefore, the country needs to create the conditions for a broader economic base, beyond tourism. Absent vibrant employment prospects and the right balance between hardware (e.g., broadband connectivity, and other "hard" technology infrastructure) and software (e.g., human capital, quality and access of education), the young are likely to continue emigrating and income convergence with Europe could prove difficult to realize.

- <u>*Reforms will help fuller integration with Europe*</u>

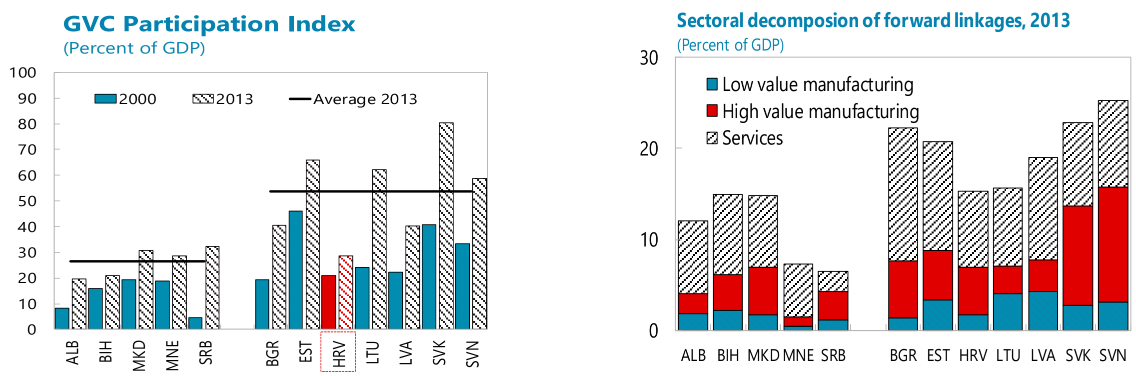
  - *Business environment:* Croatia has made some progress in improving business regulations and administrative burden, although barriers to regulated professions and remaining parafiscal fees are still high. The recently launched "START" initiative, which allows for simple electronic procedures to start a business, is a welcome development. More needs to be done to effectively implement recent changes on construction permits and adapt legislation to facilitate Croatia's integration in the EU's Digital Single Market. Croatia also needs to improve business digitization, and the digitization of broader public services.

  - *Recovering "lost opportunities":* Croatia's low integration in Global Value Chains (GVCs, Figure 12), is commonly attributed to later EU accession, compared with other economies in the region. Staff recommended enhancing the attractiveness of inward necessary conditions for further attracting FDI.

- <u>*An investment push to rejuvenate the capital stock*</u>. Staff recommended a public investment push to raise productivity and accelerate real income convergence with the EU average. A gradual increase of public investment could help Croatia bridge around 10 percentage points of the current average per person income gap with the EU by 2030 (Box 1). Staff encouraged the prioritization of EU funds of the next Programing Period (2020–2027) in areas where larger gaps exist, while also cautioning against potential pitfalls of PPPs, including in relation to the control and transparency of local government finances.

[4] On July 4, 2019, a letter was sent to the EC and ECB with six commitments: (i) strengthen banking supervision; (ii) develop a macroprudential framework beyond existing capital-based measures; (iii) strengthen the AML framework; (iv) improve national statistics; (v) enhance public sector governance, particularly state-owned assets; and (vi) ease burdens on entrepreneurs and professional services.

Figure 12. GVCs Participation and Linkages



Sources: World Development Indicators, World Bank; World Economic Outlook, IMF; Eurostat; Cheng et al. (2015), and IMF staff calculations.

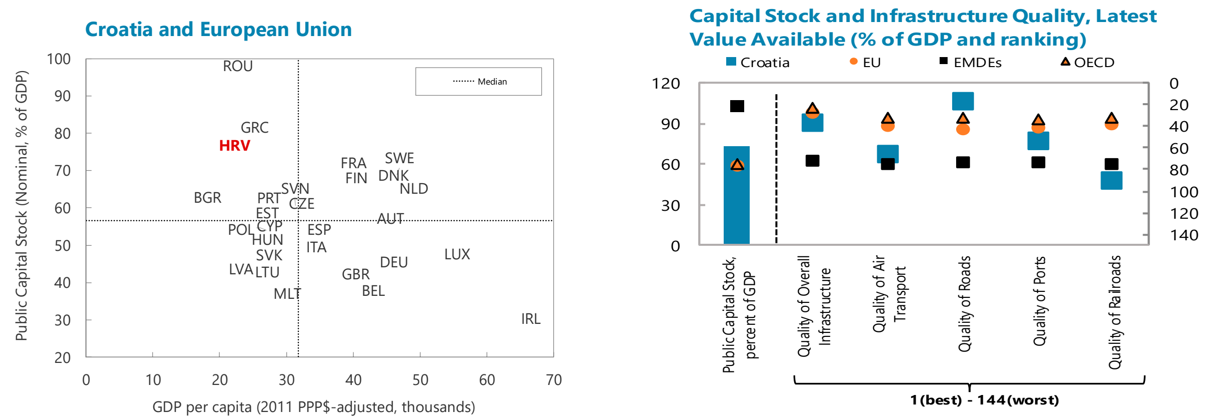
- *Closing gaps in physical infrastructure*. Croatia has a high per capita stock of public capital (Figure 13). This is due to good transportation infrastructure (especially roads), and an ongoing renovation of ports. However, to make these ports fully productive, investment in railways—particularly for freight purposes—also needs to occur. Investments in both solid waste and waste-water treatment are also high priority areas. Delivering these investments efficiently and cost-effectively will require improvements in public investment assessment and management across all levels of government and strengthening of the Public-Private Partnership (PPP) framework.

- *Boosting investment in ICT and new technologies*. Croatia places well in terms of availability of currently "mainstream" technologies (e.g., fixed broadband and mobile phones) but needs to improve readiness for newer technologies. Croatia therefore ranks low in the DESI-connectivity index (Figure 14) which measures the deployment of broadband infrastructure and its quality, including access to fast and ultrafast broadband-enabled services necessary for gaining competitiveness. "Near-shoring" in manufacturing that is partially enabled by these better technologies and more capital-intensive factories represents a good opportunity for Croatia to integrate itself in the next generation of European value chains. Staff encouraged more public investment in ICT, fiber internet access, and ultra-fast broadband to enhance digital competitiveness. Digitalizing the public sector, improving the business climate for IT startups, and prudent tax-credits for R&D are other useful measures to advance.

- *Human capital:* Upgrading technologies needs to be matched by updating workers' skills. Here, Croatian progress is uneven in two respects. First, despite one of the lowest pupil-to-teacher ratios in Europe, mathematical, problem-solving, and natural science skills are stagnating. There is also high likelihood of excess capacity in a context of a declining population (Figure 15). Second, although Croatia does produce a stratum of highly qualified

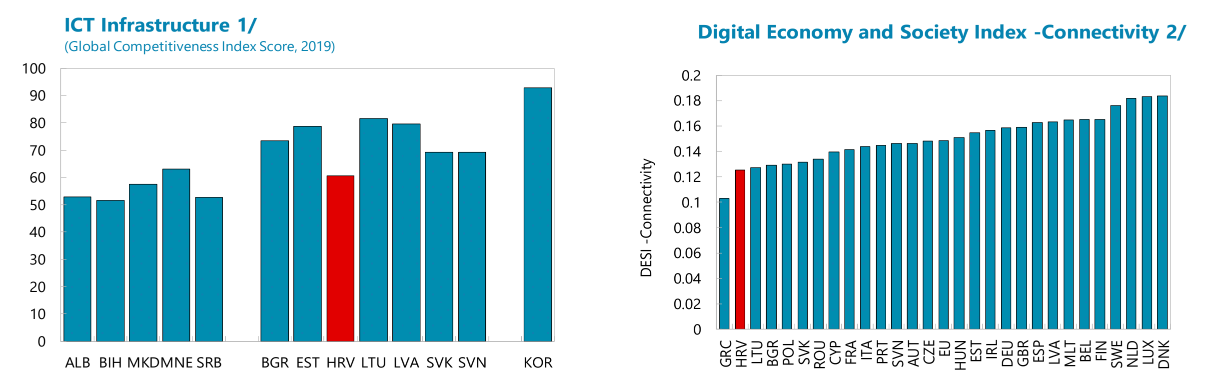
STEM university graduates, it still ranks low in skills of the current and future labor force. On-going educational curriculum reform should be complemented with expanded access to vocational training, to improve the efficiency of secondary education.[5] At the tertiary level, Croatia needs to produce a larger share of STEM university graduates to position itself successfully as a hub in next generation manufacturing, ICT, and business services.

Figure 13. Quality and Physical Public Capital Stock, 2017



Sources: IMF FAD Expenditure Assessment Tool (EAT); IMF FAD Public Investment Template, and IMF staff calculations.

Figure 14. ICT and Exports

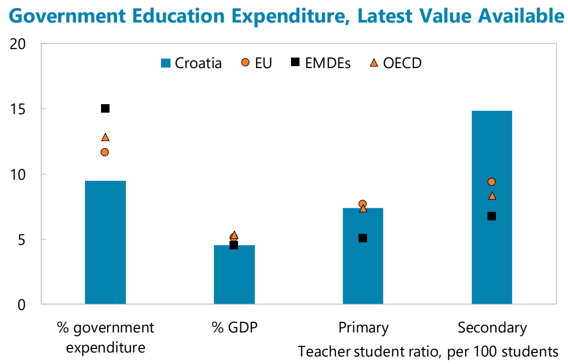


Sources: The Digital Economy and Society Index (DESI); Global Competitiveness Index Database, World Economic Forum; and IMF staff calculations.

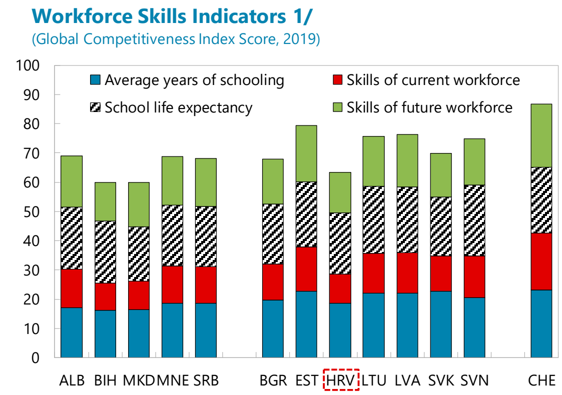
1/ The scores are out of 100, the highest score is 92.8 for South Korea, showing there is still room for further improvements.
2/ The DESI-connectivity index measures the deployment of broadband infrastructure and its quality, including access to fast and ultrafast broadband-enabled services.

[5] See: http://www.oecd.org/education/skills-beyond-school/vet.htm; and https://www.hgk.hr/documents/report-analysis-of-the-current-status-of-the-apprenticeship-scheme-in-croatia59bba5a66e184.pdf

Figure 15. Public Investment in Education and Skills of the Workforce



Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank.



Sources: IMF; World Bank; World Economic Forum; and IMF staff estimates.

1/ Global Competitiveness Index Score (2019). The maximum points in the workforce skills indicators are 100 (the highest score is for Switzerland 86.7). The current workforce indicator consists of average years of schooling and skills of current workforce, future workforce consists of school life expectancy and skills of future workforce.

Authorities' Views

17. The authorities highlighted the 2020 Doing Business index where Croatia advanced by 7 positions (to 51st out of 190 ranked economies). The government intends to put additional efforts to facilitate starting a company and implement recent legislative changes to smooth the processing of construction permits. They agreed on the importance of reinvigorating other structural reforms particularly in areas such as reducing national fragmentation and public service reform. The authorities welcomed the mission's recommendation to rebalance public expenditures towards investment.

C. Anchoring Stability through Monetary and Financial Policies

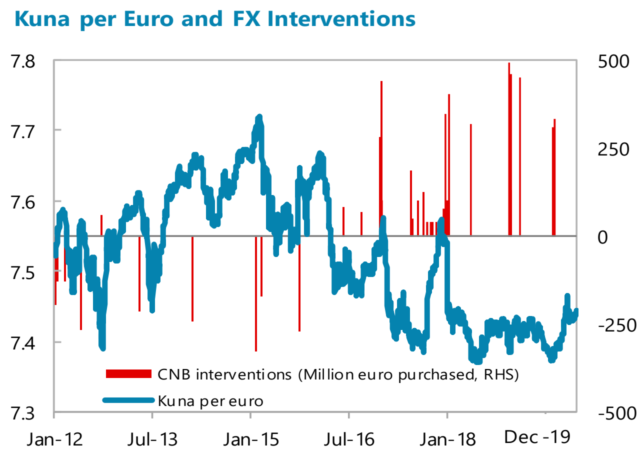
18. The preparations for ERM II and Banking Union membership are advancing. The legislative amendments to allow the asset quality review (AQR) have been adopted and amendments are expected to come into force in May 2020.[6] Four large foreign-owned banks and the state-owned Postal Bank are currently subject to an AQR. The authorities envisage ERM-II and Banking Union membership by mid-2020, and euro-adoption no earlier than 2023.

19. Monetary policy has been appropriately accommodative given the exchange rate anchor. The exchange rate has remained stable and international reserves have continued to grow. Thus far in 2019, the CNB has purchased foreign exchange three times to keep appreciation pressures at bay and reduce exchange rate volatility, (Figure 16). Inflation has been low and is

[6] The Credit Institutions Act, National Bank Act, Act on the Resolution of Credit Institutions and Investment Firms, and the Act on Ratification of the Intergovernmental Agreement will be amended. The 5th Anti-Money Laundering Directive was transposed in 2019. The register of beneficial owners will become operational beginning 2020. The scope of the unified account register (in existence as of 2011) will be expanded.

expected to remain subdued. As in many other EU countries, the banking system is awash with liquidity. There are no immediate plans to reduce required reserves and the obligation to maintain 17 percent of all foreign currency (FX) denominated liabilities in liquid FX assets, as they are not currently constraining lending. Both deposit and lending rates have declined a little further with respect to previous years (Figure 3).

Figure 16. CNB's FX Interventions



Source: Croatian National Bank.

Authorities' Views

20. All the 19 commitments for ERM-II and Banking Union membership are currently expected by the authorities to be fully met by June 2020. The central parity of the Kuna and its band will only be determined shortly before ERM-II entry.

Banking System

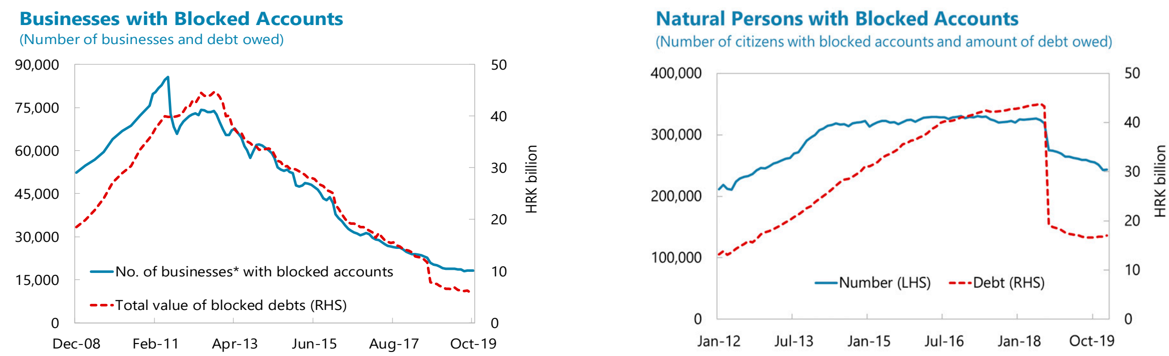
21. The banking system, on the whole, remains profitable, liquid, and well-capitalized, but is subject to lingering uncertainties. The industry has continued to consolidate from 30 credit institutions at end-2017 to 23 in early December 2019. NPLs have further declined, mainly due to NPL sales. The CNB is monitoring deposit concentration and interest rate risk, as low rates on savings deposits is increasing the share of demand deposits. Profitability has thus far remained comfortable but is subject to further lawsuits by Swiss franc borrowers following a recent decision on nullification.[7] Much will depend on the Supreme Court ruling of a model case in early March

[7] In 2015, per client wishes, banks were legally required to retroactively calculate Swiss franc indexed loans, as euro indexed loans with a variable interest rate, costing banks about 2 percent of GDP. Some banks have sued Croatia at the *International Center for Settlement of Investment Disputes* and at the *Court of Justice of the European Union*. These cases are still pending. The Croatian Supreme Court has since allowed borrowers to individually sue for unfair exchange rate charges and interest calculations.

2020. The average capital base currently remains strong with a capital adequacy ratio (CAR) of 22.7 percent (September 2019).[8]

22. Bank lending to non-financial corporations (NFCs) is expected to modestly pick-up following a period with legacy problems. The number of companies with blocked accounts due to overdue payments has decreased (Figure 17), and aggregate debt of NFCs has diminished in percent of GDP. Bank lending to NFCs has declined to about 22 percent of GDP. Banks expect their lending to NFCs to growth moderately in 2020.

Figure 17. Number of Blocked Accounts has Declined



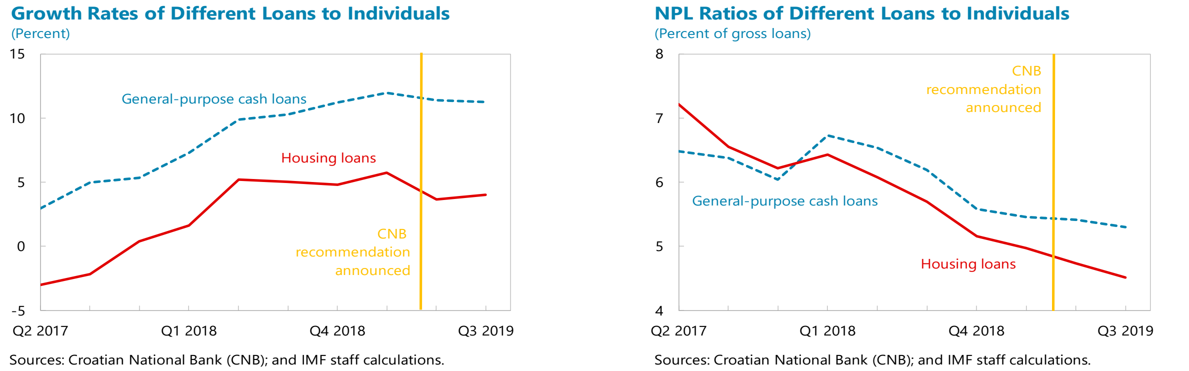
Sources: FINA; and IMF staff calculations.
Note: Quarterly 2009–2010, monthly from 2011 onwards.

23. Bank lending to households is expected to remain strong. Bank lending to households has stabilized around 33 percent of GDP, but the composition has changed. New lending is mainly driven by general-purpose cash loans. They are typically Kuna denominated, long-term and with long interest rate fixation periods. While this reduces indirect exchange rate and interest rate risk of households, the loans are uncollateralized. They are more expensive than standard housing loans but granted quickly. Given the rapid growth of these loans, it is noteworthy that their NPL ratio has not declined faster due to "denominator effects" (Figure 18). In February 2019, the CNB recommended that the debt service of general-purpose cash loans with maturities over five years should follow similar rules as housing loans.[9] The recommendation was accompanied with supervisory measures, including higher provisions and risk-weights as well as claw-back of management bonuses, if these loans prove riskier.

[8] See chapter 7 the CNB's *Financial Stability Report No. 20, May 2019*.

[9] The Foreclosure Act was amended effective mid-2017, to stipulate the amount that a creditor cannot seize. For below average net salary (published by the Croatian Bureau of Statistics) debtors, this is ¾ of their net salary. For other debtors, the salary exempt from seizure is ⅔ of the average net salary. The CNB began to require banks to apply the same *indirect* debt-service-to-income-ratio but only for housing loans. The CNB has since recommended that it also apply to general-purpose cash loans with a maturity of five years or longer.

Figure 18. Developments of Various Loan Types to Households, 2017:Q2–2019:Q3



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

24. Continued strong supervisory and macroprudential policies are required to contain potential pressure points for household lending.

- ***The credit registry of banks should promptly be made fully operational.*** It stopped operating when some banks expressed ostensible concerns regarding frivolous lawsuits following the transposition of the EU's General Data Protection Regulation in May 2018. In August 2019, limited information about defaulted borrowers began to be shared. The lack of more comprehensive information could pose future increased systemic risks at a time of strong consumer lending growth. The amendments to the Credit Institution Act, to become effective in May 2020, are expected to provide additional assurances to banks, and then the registry will become fully operational. Staff recommended that the coverage of the credit registry be broadened to include non-bank debt.

- ***General-purpose cash loans should be monitored closely.*** Recent recommendations and supervisory measures by the CNB for banks to be more careful with long-term uncollateralized cash lending have coincided with a slowdown of their growth rates. Staff cautioned that if there is a migration to other forms of household lending, additional supervisory responses warrant close consideration, including capturing all loans under the indirect debt-service-to-income rule. It is a welcome development that the CNB is building its own comprehensive database, which will start collecting data in September 2020, to better calibrate possible macro-prudential measures.

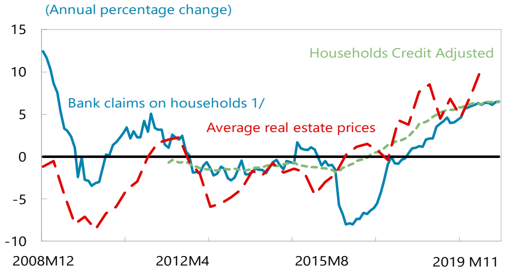
25. Housing prices have begun to accelerate, mainly in the capital and coastal areas. Average housing prices grew 8.0 percent, but 12.2 percent in Zagreb (yoy, September 2019; Figure 19). This increase should be seen in context of higher real wages, better employment prospects, growing consumer confidence, as well as declining interest rates. Tourism is the main driver of real estate price developments in Zagreb and the coast. Investment properties for short-term rentals have grown rapidly. This is facilitated by a favorable flat-tax on short-term rentals compared to higher taxation on long-term rentals. Market observers note that some of these purchases are not loan-financed, but they still assume that the majority is financed by bank loans. The market has also

been supported by the government's housing loan subsidy program for young first-time house buyers introduced in 2017[10] and the reduction of the real estate transfer tax since 2019. According to the CNB's housing price index, real estate prices are now beginning to reach pre-crisis levels.[11] Staff recommended that housing prices should be monitored with a holistic approach taking into account mortgage lending, general purpose loans that might be diverted to real estate, as well as government housing subsidies on the demand side. Also, the impacts that the current tourism boom and tourism rental taxation policies have on the supply of housing for purchase need to be taken into consideration. The mission welcomed current research efforts of the CNB to better gauge housing affordability.

26. Financial intermediation costs are still high compared to peers. Croatian Banks are digitalizing, closing branches, and reducing staff in order to reduce costs. However, costs related to uncertain contract enforcement, including debt recovery, are still high. A case in point is the lingering lawsuits of Swiss franc loans. Nevertheless, gradual improvements are being made. The backlog of old cases is slowly being reduced. The merging of local and municipal courts and increased use of e-communication has helped optimize the case load. The personal insolvency law of 2016 has not been widely used, but the streamlined procedure introduced in 2018 has been more successful. In 2017, the general insolvency law was amended to facilitate a restructuring of viable companies to avoid liquidation. The 2018 amendments to the enforcement Law and the government facilitating the write-off of debt up to HRK 10,000 may also have contributed to fewer individuals having blocked accounts. The authorities are closely following EU initiatives in these areas. Finally, some progress is also being made in accelerating the registration of titles at the property registry and the cadaster. Despite this progress, insolvency costs and operating costs of Croatian banks remain high.

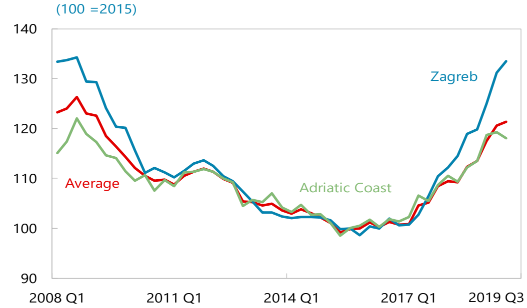
Figure 19. Housing Prices, 2008–2019

Real Estate Prices and Bank Claims on Households
(Annual percentage change)



Sources: Croatian National Bank (CNB); 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 based on transaction data, i.e. adjusted for exchange rate changes, sales and write-offs of NPLs. For details, see Annex 1 in CNB Monthly Bulletin No. 221, February 2016, Croatian National Bank.

Real Estate Price Index
(100 =2015)

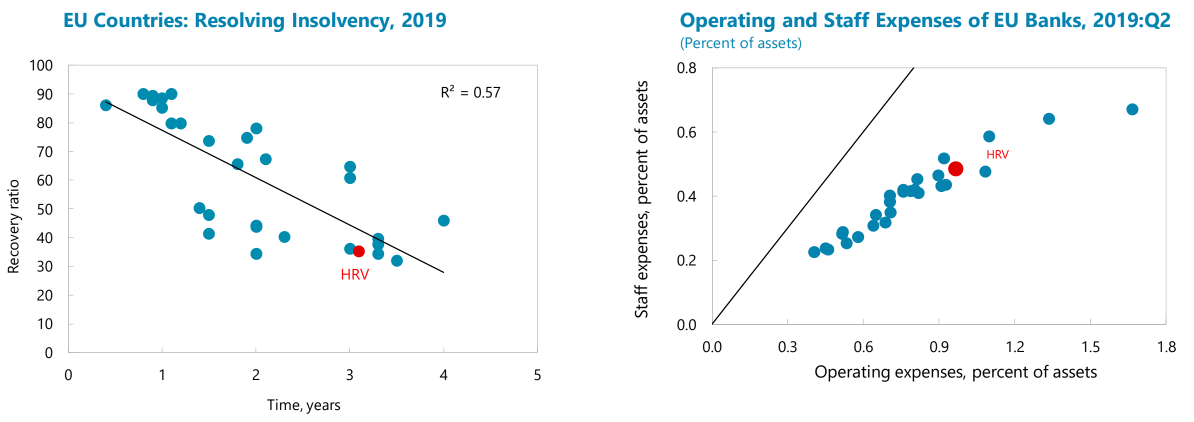


Sources: Croatian National Bank (CNB); and IMF staff estimates.

10 The Government's home subsidy program was introduced in 2017 to support young families. The amount of the subsidized loan cannot exceed €100,000, and the maturity cannot be shorter than 15 years. In 2017, the subsidy was originally limited to four years, but later extended to five years, extendable by two years for each additional child. The budgeted subsidy for the entire period amounted to HRK 178 and 168 million in, respectively, 2017 and 2018. In 2018, the rules were amended to promote less developed areas. The program still continues.

11 The *ESRB Risk Dashboard, December 2019*, found, using four different evaluation methods, that residential property prices generally were not yet over-valuated (Q1 2019 data).

Figure 20. Insolvency and Intermediation Costs



Sources: European Central Bank/Haver Analytics; and IMF staff calculations.

27. Staff recommended reforms to boost the quality of financial intermediation. Intensified efforts in the areas of improving the debt restructuring framework, insolvency, and improving the predictability and efficiency of court procedures will enhance needed trust in contracts, so that borrowers and lenders can interact smoothly and at a lower cost to raise private investment.

Authorities' Views

28. The authorities are committed to closely monitor general-purpose cash loans and housing prices. The main reason for introducing the recommendation for general purpose cash loans over five years was because they were being used to substitute housing loans or top-up housing loans. If necessary, the CNB is willing to extend the debt-service to income ratio to all loans. Currently, the CNB is enhancing its analytical tools, by developing a more comprehensive database, in order to better calibrate macro-prudential measures. The authorities expect that further digitalization will help reduce financial intermediation costs, including by more efficient legal procedures.

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29. The Croatian economy has performed well, but convergence with the EU needs to accelerate. The Croatian economy has become stronger over the last five years. This is significantly because of strong budget management and skillful policies by the Central Bank. As a result, public debt has fallen along with interest rates, creating room for a robust consumption-led private sector expansion. Strong tourism has helped the external accounts. Unemployment is down, wages are growing, and inflation remains subdued. Yet, Croatia has barely reduced its distance with the EU average in terms of income per capita in the last decade, and emigration of the young continues to pose challenges. The external position of Croatia is broadly consistent with fundamentals and desirable policy settings.

30. Hard-won fiscal gains are fragile and should be carefully preserved. While public debt ratios continue to decline due to buoyant activity, fiscal performance has recently become encumbered by numerous spending demands. For this reason, staff supports the government's decision to withhold the planned reduction in the overall VAT rate. Indeed, staff would recommend holding back on any other tax reductions at this stage, as they could reignite deficits and undermine recent gains.

31. A more dynamic state is vital for future economic prospects. The budget is currently too rigid and losing its capacity to spark economic growth. Staff recommends shifting spending priorities towards more and better public investment. Better absorption of EU funds could ease this shift in priorities but cannot substitute for deeper reforms to the cost structure of public administration, pensions and healthcare systems, and the fiscal and territorial relationships between different levels of government. State-owned enterprise management and performance needs more modernization, so that enterprises in core areas do more to support the productivity of the economy. Accelerating the digitalization of public administration and using technological improvements to better target social-benefits would also help make the state more dynamic.

32. Renovating the capital stock and enhancing the business climate will help raise potential growth. Recent improvements in streamlining the administrative and fiscal burdens on the business sector are welcome. Staff encourages further progress in the areas of enhancing digital public services and adapting legislation to facilitate Croatia's integration in the EU's Digital Single Market. Barriers to regulated professions and remaining parafiscal fees should be eliminated. Yet, business activity will not thrive unless the capital stock is renovated. Croatia needs to focus on areas where its "hard" physical infrastructure needs improvement (e.g., railways for freight purposes, solid, and waste water treatment), while also upgrading its "soft" technological infrastructure to position itself attractively in the next generation of European value chains and broaden its economic base in the areas of ICT and business services. Education policies in the primary, secondary, tertiary, and continuing areas need to work hand-in-glove with these changes.

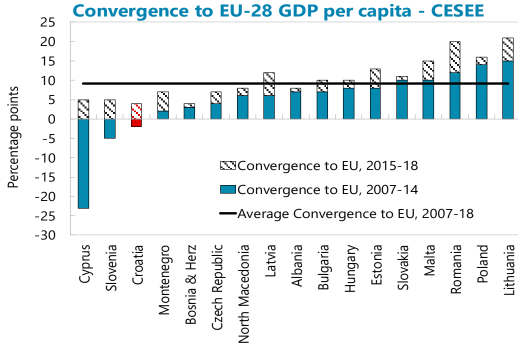
33. Macroprudential action warrants constant consideration to prevent excessive lending. Bank lending to the private sector—primarily to households—is strong. House prices are picking up in the capital and coastal areas. Although there is little immediate cause for concern, it is important to prevent potential future problems. Recent recommendations by the CNB for banks to be more careful with longer-term uncollateralized consumer lending seem to be having the desired effects. If real estate prices accelerate, or there is a migration to other forms of household lending, stronger supervisory responses merit close consideration. The credit register needs to become fully operational again to prevent a build-up of systemic risk. Consideration should be given to include all debt in an extended debt-service-to-income ratio. Enhancements to the efficiency of bankruptcy procedures (e.g., by facilitating out-of-court settlements) would help further private sector deleveraging.

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

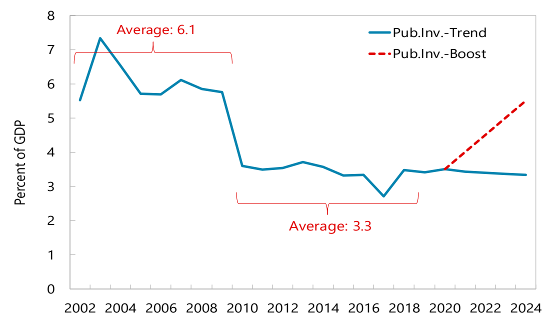
Box 1. Investment Push for Faster Convergence

Croatia's convergence with the EU's average has stagnated in the last decade. In 2018, Croatia's income per capita stood at 61 percent of EU average, only 2 points better than in 2007. This was the third slowest among CESEE countries, with the average "catch-up" during the last decade at nearly 10 percentage points. This has coincided with a reduction of capital spending coupled with sharply increased current spending. Average public investment before the crisis was around 6 percentage points of GDP, but in the aftermath of the recession, it came down to about 3.5 percent. A gradual investment push equivalent to 2 percentage points between 2021 and 2024 would bring the level of public investment close to pre-crisis levels.

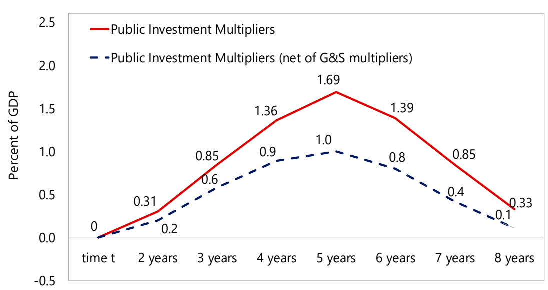
Convergence to EU-28 GDP per capita - CESEE



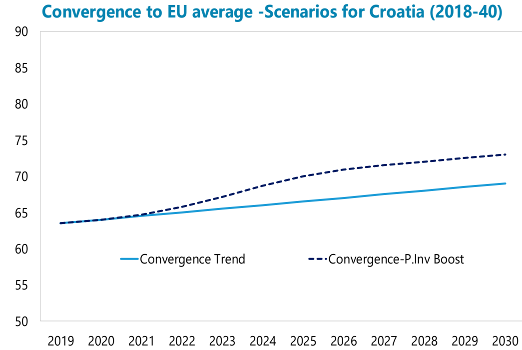
Public Investment - Scenarios for Croatia (2002-24)



Croatia - Public Investment Multipliers, Cumulative



Convergence to EU average -Scenarios for Croatia (2018-40)



A public investment push could help Croatia bridge around 10 percentage points of the current average per person income gap with the EU by 2030. Croatia spends comparatively more than the EU average in three areas of current spending such as goods and services (2.4 percent more), public wages (1.4 percent more), and social benefits (1.3 percent more). A public investment push of 2 percentage points of GDP (or 4 percent of overall government revenues) could be financed by reductions in current spending, and without issuing additional public debt or increasing taxes. Also, the public investment management system should be strengthened to secure efficient investment implementation. Under such assumption, based on historical public investment multipliers during normal times, and considering Croatia's initial level of capital stock, staff calculates that a gradual public investment push of 2 percentage points of GDP spread over 4 years, financed from cuts in spending on goods and services, could help Croatia reach a level of income per capita of approximately 73 percent the EU average by 2030, almost a decade earlier than the current trend. However, progress of this magnitude cannot be realized if public investment is not delivered carefully and cost-effectively. In turn, public investment management capacities need to improve at all levels of government. It should also be noted that this scenario only estimates demand-side effects and not permanent supply-side effects which could have a longer-term impact.

Table 1. Croatia: Selected Economic Indicators

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
							Proj			
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)									
Real GDP growth	3.5	3.1	2.7	2.9	2.7	2.5	2.2	2.1	2.0	2.0
Contributions:										
Domestic demand	3.2	3.8	4.4	3.6	3.4	3.5	2.6	2.6	2.5	2.5
Net exports	0.3	-0.7	-1.9	-0.5	-0.7	-0.9	-0.3	-0.5	-0.5	-0.5
Unemployment	15.0	12.4	9.9	...	...	...	...	...	...	...
CPI inflation (avg.)	-1.1	1.1	1.5	0.8	1.2	1.2	1.2	1.3	1.4	1.4
Saving and investment	(Percent of GDP)									
Domestic investment	21.0	21.8	23.2	25.0	24.8	24.7	25.7	25.2	24.8	24.8
Domestic saving	23.2	25.2	25.1	26.9	25.8	25.0	25.4	24.8	24.3	24.2
Government	3.3	4.4	5.0	4.7	4.0	4.0	4.1	4.1	4.2	4.3
Nongovernment	19.8	20.8	20.1	22.2	21.8	20.9	21.3	20.6	20.1	20.0
Government sector (ESA 2010 definition)										
General government revenue	46.3	46.0	46.5	46.8	46.2	46.3	46.4	46.3	46.1	46.0
General government expenditure	47.3	45.2	46.2	46.8	46.5	46.5	46.5	46.4	46.1	46.0
General government balance	-1.0	0.8	0.3	0.0	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Structural balance 1/	-1.0	0.8	1.6	0.3	-0.4	-0.2	-0.2	-0.1	-0.1	0.0
General government debt 2/	80.5	77.6	74.7	71.5	69.1	67.0	67.1	65.0	63.3	61.8
Balance of payments										
Current account balance	2.1	3.4	1.9	1.9	1.0	0.3	-0.1	-0.2	-0.3	-0.4
Capital and financial account	-2.2	1.5	0.9	-0.2	1.3	1.4	1.5	2.0	1.9	2.2
FDI, net	4.3	2.3	1.4	1.4	2.3	2.3	2.3	2.3	2.3	2.3
Debt and reserves										
Gross official reserves (billions of euros)	13.5	15.7	17.4	18.3	20.2	21.7	23.1	25.0	26.7	28.6
Percent of short-term debt (by residual maturity)	110.1	117.3	121.6	161.5	166.2	175.4	202.3	217.4	226.4	248.7
In months of imports in goods and services (based on next year level)	7.5	7.8	7.9	7.7	7.9	7.8	7.6	7.6	7.5	7.8
Total external debt (percent of GDP)	95.9	88.9	82.7	75.9	72.2	68.2	67.3	64.8	62.2	60.0
Money and credit	(End of period, change in percent)									
Broad money (M4)	4.7	2.1	5.5	...	...	...	...	...	...	...
Claims on other domestic sectors 3/	-3.4	-0.8	1.8	...	...	...	...	...	...	...
Interest rates										
Average 12-month T-bill interest rate (in kuna)	1.0	0.4	0.1	0.1	...	...	...	...	...	...
Kuna credit rate (unindexed, outstanding amount)	6.5	6.0	5.7	...	...	...	...	...	...	...
Exchange rate										
Kuna per euro	7.6	7.5	7.4	7.4	...	...	...	...	...	...
Real effective exchange rate (percent, "-" = appreciation)	0.3	0.7	1.8	...	...	...	...	...	...	...
Memorandum items:										
Nominal GDP (billions of euros)	46.6	49.1	51.7	53.9	56.2	58.7	58.9	61.5	64.0	66.6

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)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
					Proj.					
Real GDP (percent change)	3.5	3.1	2.7	2.9	2.7	2.5	2.2	2.1	2.0	2.0
CPI inflation (average)	-1.1	1.1	1.5	0.8	1.2	1.2	1.2	1.3	1.4	1.4
CPI inflation (end-of-period)	0.2	1.2	0.9	1.2	1.1	1.2	1.2	1.2	1.3	1.3
Real sector (percent change)										
Domestic demand	3.2	3.8	4.4	3.6	3.3	3.3	2.5	2.5	2.4	2.4
Consumption, total	2.5	2.9	2.8	1.1	3.4	3.5	2.4	3.0	2.7	2.2
Gross fixed capital formation, total	6.5	5.1	4.1	6.2	3.8	4.2	4.1	3.9	3.9	3.5
Saving and investment										
Domestic investment	21.0	21.8	23.2	25.0	24.8	24.7	25.7	25.2	24.8	24.8
Domestic saving	23.2	25.2	25.1	26.9	25.8	25.0	25.4	24.8	24.3	24.2
Balance of payments										
Current account balance	2.1	3.4	1.9	1.9	1.0	0.3	-0.1	-0.2	-0.3	-0.4
Exports of goods, f.o.b.	22.5	23.8	23.7	23.9	24.9	26.0	28.2	29.6	31.2	32.8
Imports of goods, f.o.b.	38.8	41.0	42.3	43.4	44.6	46.0	49.6	51.4	53.0	52.7
Capital and financial account	-2.2	1.5	0.9	-0.2	2.3	2.3	2.5	3.3	3.0	3.2
Of which : FDI, net	4.3	2.3	1.4	1.4	2.3	2.3	2.3	2.3	2.3	2.3
Gross official reserves	29.0	32.0	33.8	34.0	35.9	37.0	39.2	40.7	41.8	43.0
Gross external debt	95.9	88.9	82.7	75.9	72.2	68.2	67.3	64.8	62.2	60.0
General government finances										
Revenue	46.3	46.0	46.5	46.8	46.2	46.3	46.4	46.3	46.1	46.0
Expenditure	47.3	45.2	46.2	46.8	46.5	46.5	46.5	46.4	46.1	46.0
Balance	-1.0	0.8	0.3	0.0	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Government debt	80.5	77.6	74.7	71.5	69.1	67.0	67.1	65.0	63.3	61.8
Memorandum items:										
Nominal GDP (billions of kuna)	351.2	366.4	383.0	399.8	417.0	434.9	436.7	455.7	476.3	495.4
Output gap	0.0	0.0	-0.5	0.1	0.1	0.1	0.0	0.0	0.2	0.0
Potential GDP growth	2.4	3.2	3.2	2.3	2.6	2.5	2.3	2.0	1.9	2.1

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)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
							Proj.			
Revenue	46.3	46.0	46.5	46.8	46.2	46.3	46.4	46.3	46.1	46.0
Taxes	25.9	25.9	26.5	26.7	26.2	26.2	26.2	26.2	26.1	26.1
Income tax	5.9	5.7	5.7	5.8	5.5	5.5	5.5	5.5	5.5	5.5
VAT	12.9	13.3	13.8	13.8	13.6	13.6	13.6	13.6	13.6	13.6
Excise	4.4	4.4	4.4	4.4	4.5	4.5	4.5	4.5	4.4	4.4
Import duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.6	2.4	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Social contributions	11.9	11.9	12.0	11.8	11.8	11.8	11.8	11.8	11.7	11.7
Other revenue	4.1	4.1	3.9	4.2	4.1	4.2	4.2	4.1	4.1	4.0
Grants 1/	2.8	2.8	2.7	3.0	2.8	2.9	3.0	2.9	2.8	2.8
Property income	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
of which interest receivable:	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Sales of goods and services	4.5	4.2	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Expenditure	47.3	45.2	46.2	46.8	46.5	46.5	46.5	46.4	46.1	46.0
Expense	44.0	42.5	42.8	43.4	43.3	43.3	43.2	43.2	42.9	42.9
Compensation of employees	11.4	11.4	11.6	11.7	12.1	12.1	12.1	12.1	12.1	12.1
Use of goods and services	8.3	8.1	8.1	8.1	8.3	8.3	8.3	8.3	8.2	8.2
Interest, payable	3.1	2.7	2.3	2.3	2.0	2.0	2.0	1.9	1.8	1.8
Subsidies	1.5	1.4	1.5	1.4	1.4	1.3	1.3	1.3	1.3	1.3
Current grants 2/	2.1	2.1	1.9	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Social benefits	16.0	15.6	15.5	15.6	15.6	15.6	15.6	15.6	15.6	15.6
Other expenses	1.7	1.3	1.7	2.1	1.8	1.8	1.8	1.8	1.8	1.8
Net acquisition of nonfinancial assets	3.3	2.7	3.5	3.4	3.3	3.3	3.3	3.2	3.2	3.1
Overall Balance	-1.0	0.8	0.3	0.0	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Memorandum item:										
General government gross debt 3/	80.5	77.6	74.7	71.5	69.1	67.0	67.1	65.0	63.3	61.8
General government net debt 4/	68.6	65.7	…	…	…	…	…	…	…	…
Structural balance 5/	-1.0	0.8	1.6	0.3	-0.4	-0.2	-0.2	-0.1	-0.1	0.0

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, Billion of Kuna, unless otherwise indicated)

	2016	2017	2018	2019 Q1	2019 Q2	2019 Q3
Monetary survey						
Net foreign assets	104.7	121.8	129.9	125.6	135.9	158.1
Croatian National Bank	95.1	110.6	119.1	119.9	129.8	138.2
Deposit money banks	9.6	11.2	10.8	5.6	6.0	19.9
Net domestic assets	196.2	185.4	194.1	191.6	187.4	178.6
Domestic credit (CNB definition)	221.5	218.9	223.2	226.6	226.9	225.2
Claims on government, net 1/	73.2	60.1	62.6	60.3	50.6	47.7
Claims on other domestic sectors 2/	210.6	208.9	212.7	215.9	215.5	213.9
Other items (net)	-25.3	-33.5	-29.2	-34.9	-39.5	-46.6
Broad money (M4)	300.9	307.2	324.0	317.2	323.3	336.7
Narrow money (M1)	83.5	99.4	120.0	119.6	127.4	133.7
Currency outside banks	22.5	25.6	28.1	28.3	31.0	31.5
Demand deposits	61.0	73.9	91.9	91.3	96.4	102.1
Quasi money	217.4	207.8	204.0	197.7	195.9	203.0
Kuna-denominated	47.7	43.7	41.8	38.1	37.7	35.1
Foreign currency-denominated	169.7	164.1	162.2	159.6	158.1	167.9
Balance sheet of the Croatian National Bank						
Net foreign assets	95.1	110.6	119.1	119.9	129.8	138.2
Of which: banks' reserves in foreign currency	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves	95.0	110.6	119.1	119.6	124.6	131.0
Net domestic assets	-21.7	-24.1	-17.2	-16.8	-26.2	-33.2
Claims on government (net)	-3.5	-4.2	-3.7	-2.9	-12.1	-17.3
Claims on banks	1.1	1.3	2.0	2.0	2.0	2.0
Claims on other domestic sectors	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	-19.3	-21.2	-15.4	-15.9	-16.1	-17.9
Reserve money (CNB definition) 3/	73.3	86.4	101.8	103.0	103.3	104.7
Of which:						
Currency outside credit institutions	22.5	25.6	28.1	28.3	31.0	31.5
Kuna deposits of credit institutions	45.3	54.7	66.8	68.0	63.6	65.1
Of which:						
Settlement accounts	23.8	32.6	43.3	44.3	39.6	40.4
Statutory reserves in kuna	21.6	22.1	23.5	23.7	24.0	24.6
Year-on-year percent changes						
Monetary survey:						
Net domestic assets	1.1	-5.5	4.7	1.1	-0.7	-4.4
Domestic credit (CNB definition)	-3.7	-1.2	2.0	3.5	1.8	1.1
Claims on government, net 1/	10.6	-17.8	4.1	-5.0	-14.1	-17.9
Claims on other domestic sectors 2/	-3.4	-0.8	1.8	3.2	1.1	0.3
Broad money (M4)	4.7	2.1	5.5	4.4	4.1	3.6
Quasi money	0.3	-4.4	-1.8	-2.4	-2.5	-3.1
Balance sheet of the Croatian National Bank:						
Reserve money (CNB definition) 3/	14.9	17.9	17.8	12.7	10.7	18.2
Memorandum items:						
Nominal GDP (yearly total) 4/	351.2	366.4	383.0	387.7	391.4	396.1
Broad money (percent of GDP)	85.7	83.8	84.6	81.8	82.6	85.0
Foreign currency (percent of broad money)	56.4	53.4	50.1	50.3	48.9	49.9
Credit to other domestic sectors: stock (% of GDP)	60.0	57.0	55.5	55.7	55.1	54.0
Claims on private sector (transactions, annual change,%) 2/ 5/	1.6	3.2	4.1	4.4	4.5	4.3

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 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 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 their value adjustments.

Table 5. Croatia: Financial Soundness Indicators

(Percent, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019		
						Q1	Q2	Q3
Regulatory capital to risk-weighted assets	21.8	21.0	22.5	23.2	22.9	22.6	23.0	22.7
Regulatory Tier I capital to risk-weighted assets	20.6	19.2	20.9	21.8	21.8	21.6	22.0	21.9
Nonperforming loans net of loan-loss provisions to capital	41.1	34.2	19.4	14.2	12.9	11.5	11.8	7.2
Nonperforming loans to total gross loans 1/	16.7	16.3	13.6	11.2	9.7	9.4	9.1	7.6
Total loan-loss provision to nonperforming loans 2/	51.0	61.9	70.1	70.1	70.3	71.9	71.4	78.9
Return on assets	0.6	-1.2	1.6	1.1	1.4	1.6	1.8	1.7
Return on equity	4.6	-8.7	11.8	7.4	9.6	11.2	13.2	12.2
Interest margin to gross income	58.1	62.1	57.7	60.1	56.6	58.8	56.6	54.3
Noninterest expenses to gross income	57.3	61.9	53.4	56.5	54.3	53.3	51.8	52.1
Liquid assets to total assets 3/	27.3	27.7	29.6	33.0	34.4	34.1	34.0	34.7
Liquid assets to short-term liabilities 3/	42.7	41.9	42.6	47.3	47.1	47.0	46.4	47.1
Net open position in foreign exchange to capital	2.9	12.5	3.8	3.3	5.1	3.4	…	…
Residential real estate prices (annual percentage increase)	-1.4	-2.1	0.8	7.6	4.7	7.4	10.4	…

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/ According to national definition. Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims. According to the EU definition, NPLs amounted to 6.0 percent in September 2019.

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)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
							Proj.			
Current account	994	1,679	973	1,028	567	194	-74	-105	-174	-294
Merchandise trade balance	-7,607	-8,448	-9,639	-10,492	-11,074	-11,711	-12,588	-13,386	-13,964	-13,245
Exports f.o.b.	10,511	11,712	12,234	12,909	14,030	15,265	16,609	18,215	19,938	21,824
Imports f.o.b.	18,118	20,160	21,873	23,401	25,104	26,976	29,197	31,601	33,902	35,069
Services Trade Balance	8,171	8,792	9,221	9,660	9,846	9,923	10,290	10,696	10,992	10,938
Export of services	11,735	12,904	13,862	14,772	15,447	16,278	17,573	18,671	19,627	19,874
Imports of services	3,564	4,112	4,641	5,111	5,601	6,355	7,283	7,975	8,635	8,937
Primary income balance	-1,386	-721	-806	-705	-935	-921	-697	-519	-487	-1,106
Secondary income balance	1,816	2,056	2,197	2,564	2,730	2,903	2,920	3,104	3,285	3,118
Capital account	715	538	730	754	786	821	824	860	896	932
Financial account	-1,762	214	-290	-877	486	531	632	1,152	1,000	1,228
Direct investment	1,987	1,136	743	776	1,299	1,355	1,360	1,420	1,478	1,537
Portfolio investment	-1,360	-392	-885	-620	-962	-1,153	-773	-564	-763	-582
Financial derivatives	149	371	-96	-142	-45	94	31	-27	-33	10
Other investment	-2,539	-902	-51	-892	193	234	14	323	317	263
Net errors and omissions	-211	163	132	0	0	0	0	0	0	0
Gross reserves (-= increase)	265	-2,593	-1,545	-904	-1,840	-1,546	-1,382	-1,907	-1,722	-1,866
Memorandum items:										
Current account (percent of GDP)	2.1	3.4	1.9	1.9	1.0	0.3	-0.1	-0.2	-0.3	-0.4
Export goods volume growth	5.2	9.0	3.2	7.9	7.4	7.3	7.3	7.2	7.0	7.0
Import goods volume growth	6.1	7.4	6.7	6.2	5.8	5.8	5.8	5.8	5.8	5.8
Gross official reserves	13,514	15,706	17,439	18,343	20,183	21,729	23,111	25,018	26,739	28,605
Percent of short-term debt	110.1	117.3	121.6	161.5	166.2	175.4	202.3	217.4	226.4	248.7
Months of next year's imports	7.5	7.8	7.9	7.7	7.9	7.8	7.6	7.6	7.5	7.8
External debt to GDP 2/	95.9	88.9	82.7	75.9	72.2	68.2	67.3	64.8	62.2	60.0
GDP (millions of euros)	46,637	49,113	51,656	53,923	56,241	58,661	58,901	61,466	64,000	66,554

Sources: Croatian National Bank; and IMF staff estimates.

1/ Partially based on BMP5.

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

Annex I. Implementation of IMF Recommendations

	2018 Article IV Advice	Actions since 2018 Article IV
Reduce debt and invest more	Accelerating the pace of debt reduction;	**(a) Progress.** The public debt continues to decline at 3 percentage points per year since 2015, but the rhythm of deficit reduction has slowed down.
	Increase public investment;	**(b) Some progress.** Public investment in percent of GDP has increased since 2017, thanks to greater absorption of EU funds, but also partly by incorporating investment by shipyards to general government accounts.
	Reform health and pension systems and better target social benefits.	**(c) No progress.** Pension reform has been reversed, health arrears continue to accumulate and no action on better targeting of social benefits.
Make the state more dynamic	Public service reform	**(a) No progress**. Draft laws on public service scales and wage grid have stalled. The Budget Act's approval keeps being postponed.
	Increase discipline of SOEs	**(b) No progress.** SOEs governance reform remains pending and no major assets divestitures have occurred.
	Improve business environment	**(c) Progress.** Croatia has improved 7 positions in the Ease of Doing Business ranking, by abolishing the requirements to reserve a company name, obtain director signatures for company registration and reducing the paid-in minimum capital requirement.
	Lower parafiscal fees	**(d) Some progress**. Real estate transfer tax has decreased. Other parafiscal fees remain.
	More agile judicial and legal processes	**(e) No progress**. The backlog of cases has declined slightly but is still high. The perception of judicial independence is the lowest of the EU.
Anchor stability through monetary and financial sector policies	Prepare for ERM and banking union	**(a) Progress.** Letter with commitments has been sent to EC and ECB. Also, the legislative amendments to allow the asset quality review (AQR) have been adopted.
	Measures to prevent excessive household borrowing	**(b) Some progress.** The CNB passed a recommendation for banks to apply the indirect debt-service-to-income rule for housing loans also to general-purpose consumer loans with maturities of 5-year or more.
	Credit registry	**(c) No progress.** The credit register has stopped operating.

Annex II. Public Debt Sustainability Analysis[1]

The pace of fiscal consolidation has slowed down, but public debt remains on a declining path. *Public debt has declined almost 12 percentage points since its peak in 2014, and gross financing needs are now below the high-risk threshold but remain elevated. Under the baseline scenario, debt is expected to be at 71.5 percent of GDP at end-2019. It will continue to gradually decline over the medium term and reach 61.8 percent of GDP in 2025, 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 for shipyards, 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.[2]

- *Debt profile and developments:* Central government debt accounts for 80 percent of general government gross debt. More than 95 percent of outstanding debt matures beyond one year, although Croatia still does not borrow in very long maturities in sovereign bond markets (mostly 5–10 years). About 38 percent of public debt is denominated in foreign currency (mostly euro-denominated). Debt denominated in euro has increased gradually during the last few years due to 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 12 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, at nearly 72 percent of GDP, public debt remains high and gross financing needs remained at 9 percent of GDP in 2019 (more than third of general government tax revenues), due to the payment of state guarantees to Uljanik shipyards. Financing conditions have improved resulting in lower risk premia, and the interest rate on Croatia's sovereign is approaching its medium-term growth rate and its likely to close at the end of the projection period.

- *Debt management strategy*: High financing needs and exposure of sovereign debt to FX risks require sustained efforts to strengthen the debt management framework. The authorities' 2017–2020 debt management strategy recognized that public debt is a key risk for the economy. It aimed to reduce the debt-to-GDP ratio below 60 percent of GDP by 2022, not least through further reducing short-term debt and currency and interest rate risks.

[1] Prepared by Carlos Mulas-Granados.

[2] All SOE's debt is included in the statistics as they are part of the General Government definition.

- *Realism of projections*. Croatia's projected fiscal adjustment in the cyclically-adjusted primary balance-to-GDP ratio over the medium term is similar in magnitude to adjustments of other countries.

- *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 2019 general government budget balance at around 0 percent of GDP, including the second payment of state guarantees of Uljanik shipyards of about 0.3 percent of GDP.

- *Growth*: Real GDP growth is estimated at 2.9 percent for 2019. 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 V), 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 in 2022 to about -0.9 percent of GDP and debt sharply increasing to over 76.7 percent, before improving thereafter. Gross financing needs would be around 13.8 percent of GDP in 2021 and decline slowly going forward.

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 nearly 77 percent of GDP (or about 165 percent of public revenues) at its peak, and gross financing needs would be close to 14 percent of GDP in 2021–22.

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

(In percent of GDP, unless otherwise indicated)

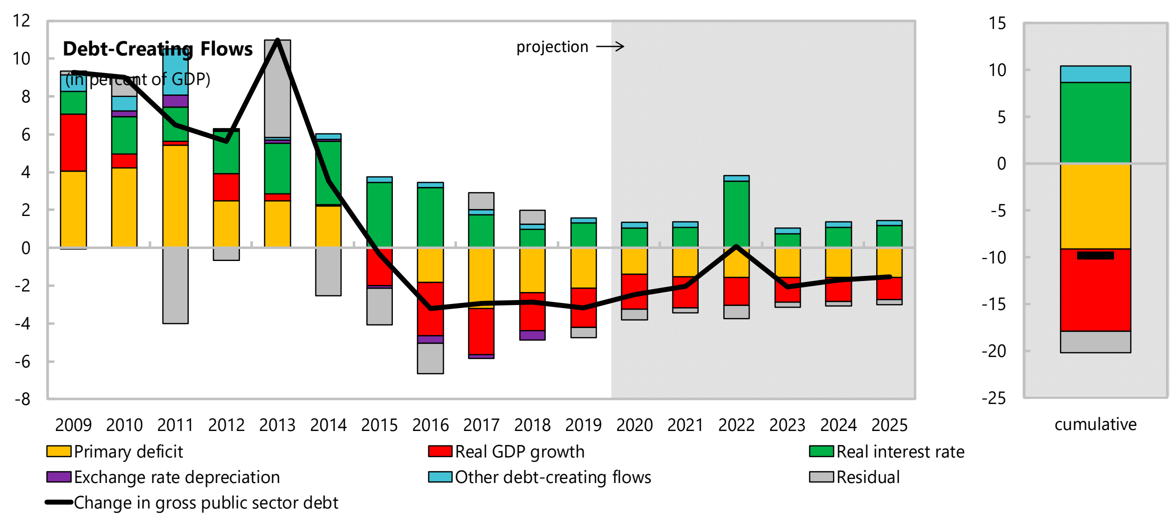
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2009-2017 [2/]	2018	2019	2020	2021	2022	2023	2024	2025
Nominal gross public debt	71.7	74.7	71.5	69.1	67.0	67.1	65.0	63.3	61.8
Public gross financing needs	15.3	6.5	8.9	11.4	11.5	8.4	8.5	8.1	9.8
Real GDP growth (in percent)	-0.3	2.7	2.9	2.7	2.5	2.2	2.1	2.0	2.0
Inflation (GDP deflator, in percent)	1.0	1.8	1.4	1.6	1.7	1.7	2.0	2.1	2.0
Nominal GDP growth (in percent)	0.6	4.5	4.4	4.3	4.3	3.9	4.1	4.2	4.0
Effective interest rate (in percent) [4/]	4.5	3.1	3.3	3.2	3.4	3.4	3.5	3.7	3.8

As of January 24, 2020		
Sovereign Spreads		
EMBIG (bp) 3/		93
5Y CDS (bp)		46
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2017	2018	2019	2020	2021	2022	2023	2024	2025	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.3	-2.9	-3.2	-2.5	-2.1	0.1	-2.1	-1.7	-1.5	-9.8	
Identified debt-creating flows	4.7	-3.6	-2.6	-1.9	-1.8	0.8	-1.8	-1.5	-1.3	-7.5	
Primary deficit	1.8	-2.4	-2.1	-1.4	-1.5	-1.6	-1.6	-1.6	-1.6	-9.1	0.3
Automatic debt dynamics [5/]	2.3	-1.5	-0.8	-0.8	-0.6	2.0	-0.6	-0.2	0.0	-0.1	
Interest rate/growth differential [6/]	2.2	-1.0	-0.8	-0.8	-0.6	2.0	-0.6	-0.2	0.0	-0.1	
Exchange rate depreciation [7/]	0.1	-0.5	0.0	…	…	…	…	…	…	…	
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/]	-0.4	0.7	-0.5	-0.6	-0.2	-0.7	-0.2	-0.2	-0.2	-2.3	



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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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

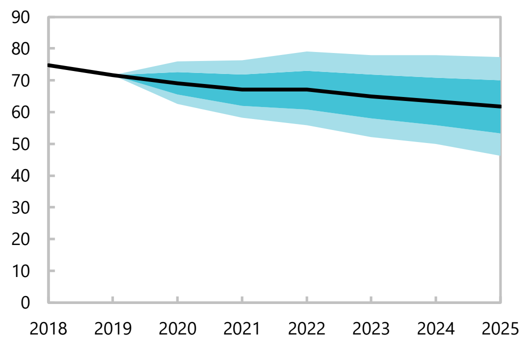
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	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

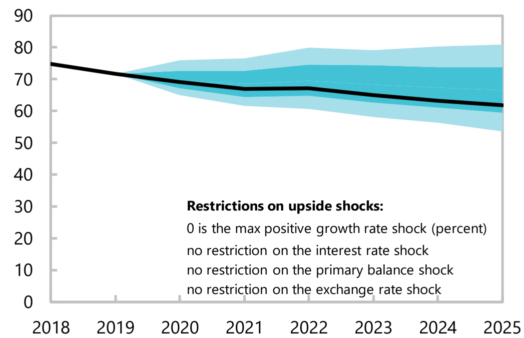
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution



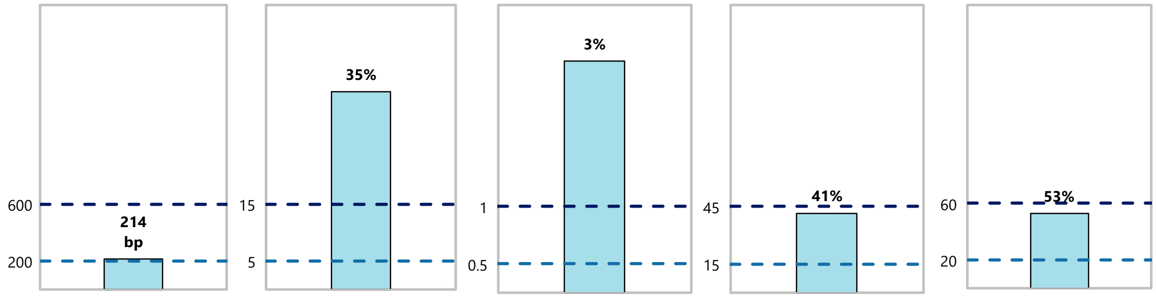
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2019)

Croatia Lower early warning Upper early warning



Bond spread	External Financing Requirement	Annual Change in Short-Term Public Debt	Public Debt Held by Non-Residents	Public Debt in Foreign Currency
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

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, 26-Oct-19 through 24-Jan-20.

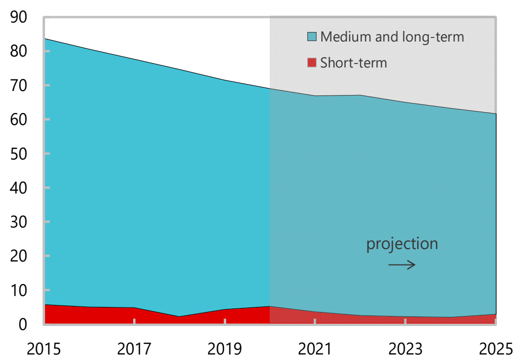
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

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

Composition of Public Debt

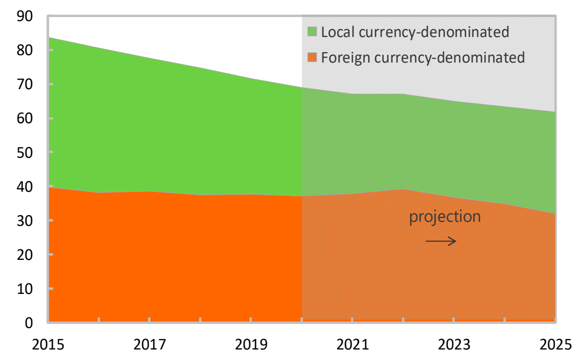
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

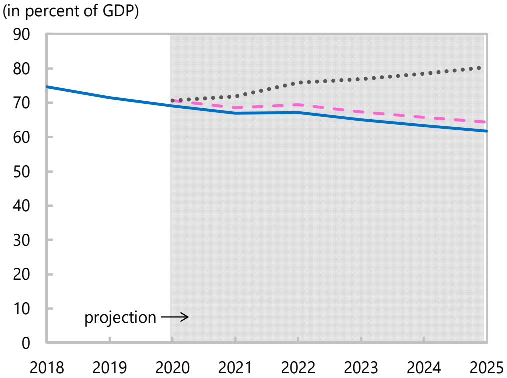


Alternative Scenarios

Baseline Historical Constant Primary Balance

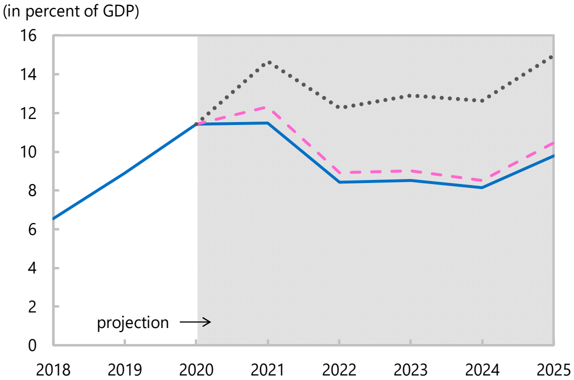
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

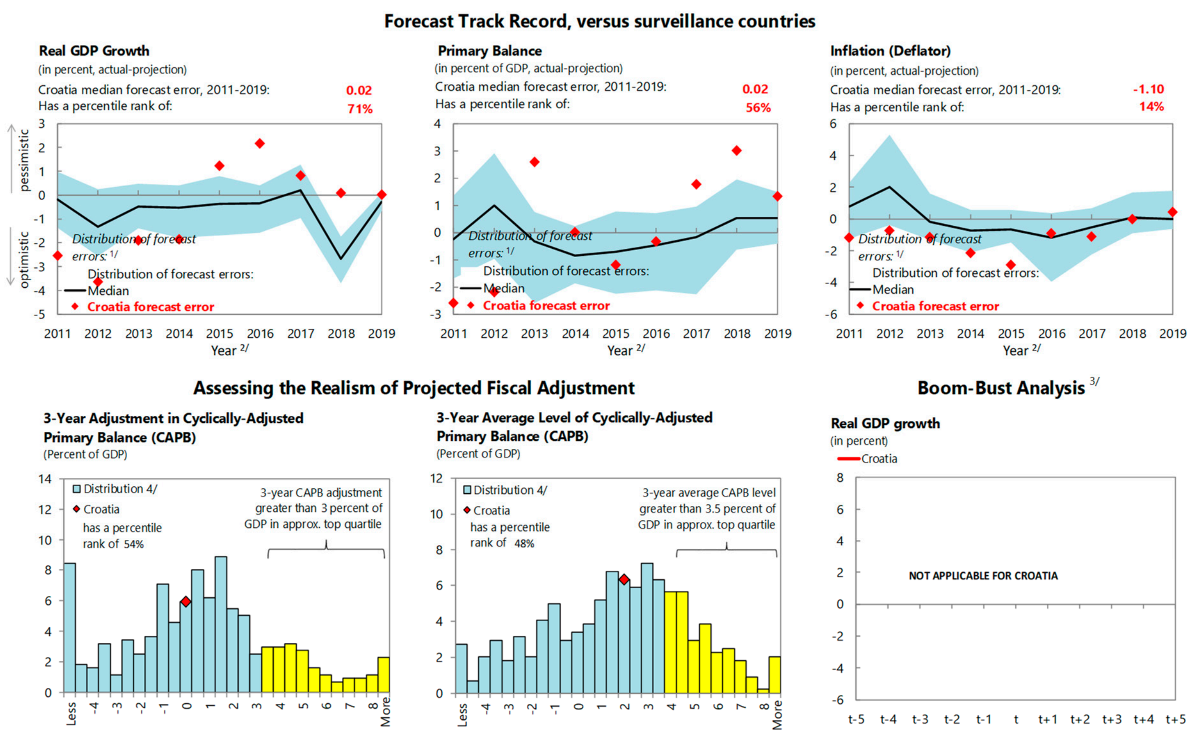
(in percent)

Baseline Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	2.7	2.5	2.2	2.1	2.0	2.0
Inflation	1.6	1.7	-1.8	2.2	2.0	2.0
Primary Balance	1.4	1.5	1.6	1.6	1.6	1.6
Effective interest rate	3.2	3.4	3.4	3.5	3.7	3.8
Constant Primary Balance Scenario						
Real GDP growth	2.7	2.5	2.2	2.1	2.0	2.0
Inflation	1.6	1.7	-1.8	2.2	2.0	2.0
Primary Balance	1.4	1.4	1.4	1.4	1.4	1.4
Effective interest rate	3.2	3.4	3.4	3.5	3.8	4.0

Historical Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	2.7	1.0	1.0	1.0	1.0	1.0
Inflation	1.6	1.7	-1.8	2.2	2.0	2.0
Primary Balance	1.4	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	3.2	3.4	3.6	3.8	4.2	4.5

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.

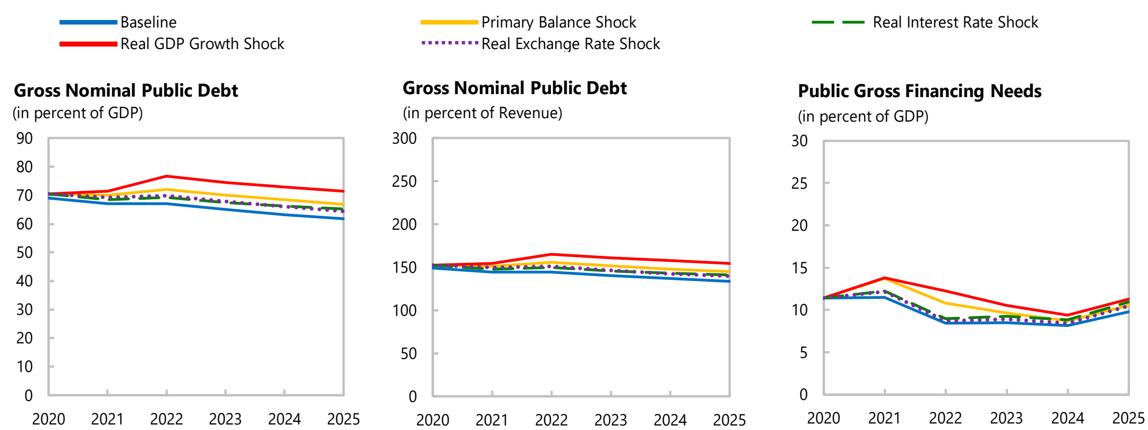
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not Applicable for Croatia

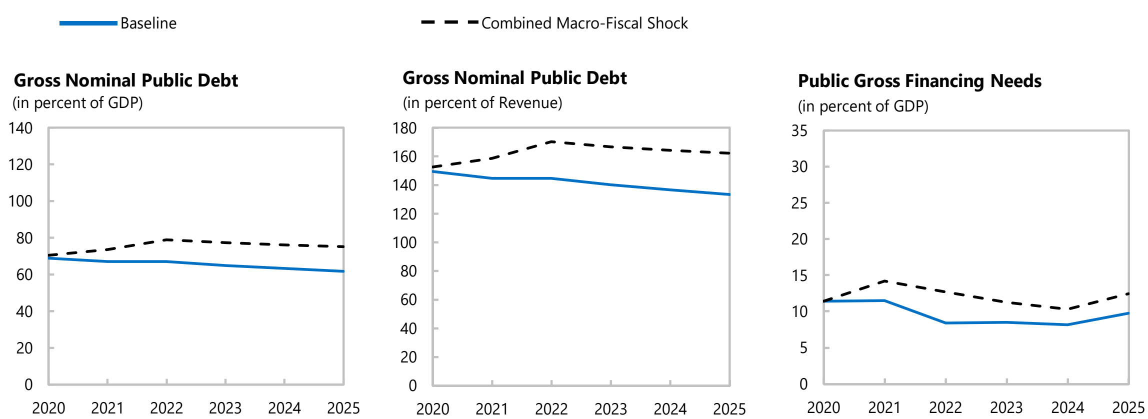
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 5. Croatia: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	2.7	2.5	2.2	2.1	2.0	2.0
Inflation	1.6	1.7	-1.8	2.2	2.0	2.0
Primary balance	1.4	0.0	0.0	1.6	1.6	1.6
Effective interest rate	3.2	3.4	3.5	3.6	3.9	4.0
Real Interest Rate Shock						
Real GDP growth	2.7	2.5	2.2	2.1	2.0	2.0
Inflation	1.6	1.7	-1.8	2.2	2.0	2.0
Primary balance	1.4	1.5	1.6	1.6	1.6	1.6
Effective interest rate	3.2	3.4	3.8	4.0	4.5	4.8
Combined Shock						
Real GDP growth	2.7	0.4	0.1	2.1	2.0	2.0
Inflation	1.6	1.2	-2.3	2.2	2.0	2.0
Primary balance	1.4	0.0	-0.9	1.6	1.6	1.6
Effective interest rate	3.2	3.4	3.8	4.0	4.5	4.8

Real GDP Growth Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	2.7	0.4	0.1	2.1	2.0	2.0
Inflation	1.6	1.2	-2.3	2.2	2.0	2.0
Primary balance	1.4	0.3	-0.9	1.6	1.6	1.6
Effective interest rate	3.2	3.4	3.5	3.6	3.9	4.0
Real Exchange Rate Shock						
Real GDP growth	2.7	2.5	2.2	2.1	2.0	2.0
Inflation	1.6	2.9	-1.8	2.2	2.0	2.0
Primary balance	1.4	1.5	1.6	1.6	1.6	1.6
Effective interest rate	3.2	3.4	3.4	3.4	3.8	3.9

Source: IMF staff.

Annex III. External Debt Sustainability Analysis

Table 1. Croatia: External Debt Sustainability Framework, 2014–25
(Percent of GDP, unless otherwise indicated)

	Actual					Projections							Debt-stabilizing noninterest current account 6/
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	
Baseline: external debt	113.1	108.1	95.9	88.9	82.7	75.9	72.2	68.2	67.3	64.8	62.2	60.0	-3.6
Change in external debt	2.2	-5.0	-12.2	-6.9	-6.3	-6.7	-3.7	-4.1	-0.9	-2.5	-2.6	-2.2	
Identified external debt-creating flows	-1.1	-6.4	-10.0	-8.5	-5.6	-5.6	-5.2	-4.4	-3.7	-3.4	-3.3	-3.0	
Current account deficit, excluding interest payments	-3.7	-6.7	-4.9	-5.7	-3.8	-4.0	-2.7	-2.0	-1.5	-1.3	-1.2	-1.0	
Deficit in balance of goods and services	-0.4	0.3	1.2	0.7	-0.8	-1.5	-2.2	-3.0	-3.9	-4.4	-4.6	-3.5	
Exports	43.4	46.5	47.7	50.1	50.5	51.3	52.4	53.8	58.0	60.0	61.8	62.7	
Imports	-43.7	-46.2	-46.5	-49.4	-51.3	-52.9	-54.6	-56.8	-61.9	-64.4	-66.5	-66.1	
Net non-debt creating capital inflows (negative)	-1.7	-0.5	-4.2	-2.2	-1.4	-1.4	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	
Automatic debt dynamics 1/	4.2	0.7	-0.8	-0.6	-0.4	-0.2	-0.2	-0.1	0.1	0.2	0.2	0.2	
Contribution from nominal interest rate	3.5	3.4	2.8	2.3	1.9	2.1	1.7	1.7	1.6	1.5	1.5	1.4	
Contribution from real GDP growth	0.1	-2.7	-3.6	-2.9	-2.3	-2.3	-1.9	-1.7	-1.5	-1.3	-1.3	-1.2	
Contribution from price and exchange rate changes 2/	0.7	...	...	...	...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	4.0	1.4	-2.3	1.6	-0.7	-1.1	1.6	0.3	2.8	0.9	0.7	0.9	
External debt-to-exports ratio (percent)	260.9	232.7	201.0	177.5	163.7	147.9	137.8	126.8	116.0	108.0	100.6	95.8	
Gross external financing need (billions of Euros) 4/	19.5	17.8	19.1	18.0	21.5	24.1	20.1	21.0	21.4	20.6	21.1	20.9	
Percent of GDP	45.0	40.0	41.0	36.7	41.6	44.7	35.7	35.8	36.4	33.5	32.9	31.5	
Scenario with key variables at their historical averages 5/	113.1	108.1	95.9	88.9	82.7	75.9	75.4	73.7	71.9	71.0	69.8	68.5	-0.6
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (percent)	-0.1	2.4	3.5	3.1	2.7	2.9	2.7	2.5	2.2	2.1	2.0	2.0	
GDP deflator in Euros dollars (percent change)	-0.6	0.4	1.0	2.1	2.4	1.4	1.6	1.7	1.7	2.0	2.1	2.0	
Nominal external interest rate (percent)	3.1	3.1	2.7	2.5	2.2	2.6	2.4	2.4	2.4	2.3	2.4	2.3	
Growth of exports (Euro terms, percent)	6.2	10.2	7.3	10.7	6.0	6.1	6.5	7.0	8.4	7.9	7.3	5.4	
Growth of imports (Euro terms, percent)	2.1	8.6	5.3	11.9	9.2	7.5	7.7	8.6	9.4	8.5	7.5	3.5	
Current account balance, excluding interest payments	3.7	6.7	4.9	5.7	3.8	4.0	2.7	2.0	1.5	1.3	1.2	1.0	
Net nondebt creating capital inflows	1.7	0.5	4.2	2.2	1.4	1.4	2.3	2.3	2.3	2.3	2.3	2.3	

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.

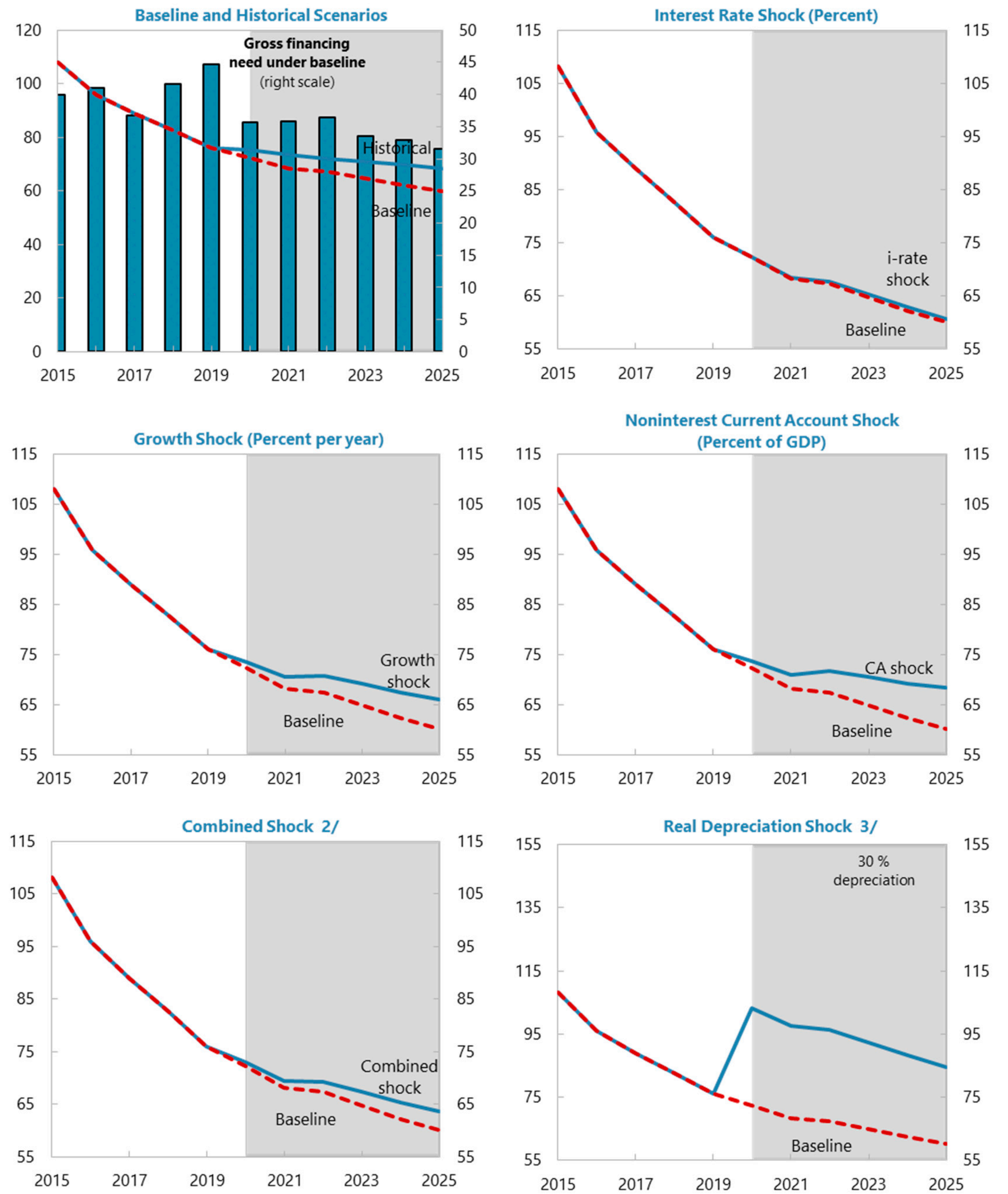
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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/ Non-Shaded areas represent actual data except for 2019. Individual shocks are permanent one-half standard deviation shocks. Shaded areas contain 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.

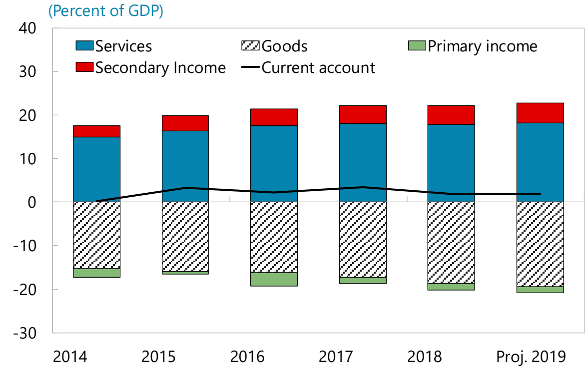
3/ One-time real depreciation of 30 percent occurs in 2020.

Annex IV. External Sector Assessment[1]

The external position of Croatia in 2019 is broadly consistent with fundamentals and desirable policy settings. The current account is projected to remain in surplus in 2019, buoyed by strong tourism receipts and solid goods exports. In the medium-term, the external balance is expected to decline to a deficit of around -0.4 percent of GDP, due to strong imports and as tourism growth tapers off. Non-price indicators confirm the need for structural reforms to boost productivity.

1. Current Account. The current account (CA) has been in surplus since 2014, driven by buoyant tourism receipts, which more than offset the rising goods trade deficit. Overall trade continues to grow strongly since EU accession in 2013, with exports of goods (plus services) projected at 23.9 (51.6) percent of GDP and import of goods (plus services) at 43.4 (52.9) percent of GDP in 2019, both at record highs. Croatia's current account surplus increased to 3.4 percent of GDP in 2017—which is mostly explained by one-off bank provisions for losses associated with their exposure to Agrokor—but has since waned. In 2020, the current account surplus is projected to decline from 1.9 percent of GDP in 2019 (the same as in 2018), as imports increase due to strong domestic demand and bank transfer of profits to foreign parent banks are projected to increase. Over the medium term, the current account is projected to move towards small deficit, 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. The capital and financial account are projected to decline by 1.1 percentage points of GDP in 2019. The capital account increased by 0.5 percent of GDP while the financial account deteriorated by 1.3 percent of GDP. The reduction in external debt continued, supported by fiscal consolidation and lower interest rates, and is projected to end 2019 at 75.9 percent of GDP, down from 82.7 percent of GDP in the previous year. The government has been able to borrow on favorable terms given ample global liquidity and better ratings.

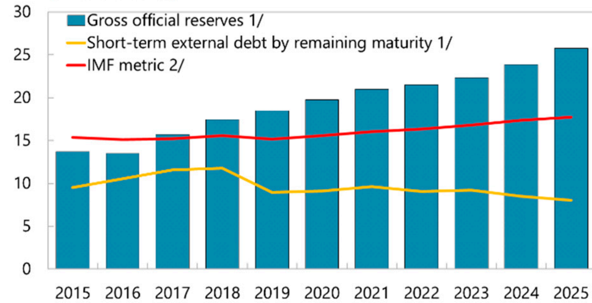
3. External Balance Sheets. Overall external indebtedness is projected to continue to decrease in 2019. This decrease was mainly due to the general government and central bank, as both banks and other sectors increased their gross external debt in nominal terms, although intercompany lending for direct investment declined somewhat. The NIIP declined from -65 percent of GDP in 2017 to -58 percent in 2018, which is substantially stronger than in 2010 when the NIIP stood at around -94 percent of GDP. The improvement was due to sustained current account surpluses, EU funds absorption, and GDP growth. The NIIP is projected to remain around -53 percent of GDP by

[1] Prepared by Olamide Harrison and Tonny Lybek.

2019. Thus, the current path of the NIIP does not imply risks to external sustainability or a need for substantial adjustment.

4. Reserve Adequacy. In 2019, gross official reserves continued to increase gradually to €18.5 billion (34 percent of GDP) in part due to the current account surplus, EU funds, and interventions. This increase kept official reserves above the ARA metric in 2019 and improved the already comfortable margins relative to short-term debt as well as a ratio of months of next year's imports of goods and nonfactor services. Reserves are projected to increase to nearly €28 billion in 2025 under the baseline scenario.

International Reserve Cover
(Billions of euros)



Sources: Croatian National Bank; and IMF staff calculations.
1/ Staff projections for 2019-25.
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 2019. The CA is projected to register a surplus of 1.9 percent of GDP against the initial EBA-lite derived CA norm of -2.4 percent. The residual was small (-1.1 percent). Accounting for booming tourism and some modest further external deleveraging, staff estimates a cyclically-adjusted CA balance of 0.2 percent of GDP. The EU accession adjustment to the CA norm[2] implies a multilaterally-consistent cyclically-adjusted CA norm of -0.1 percent of GDP. The CA gap is thus computed as 0.3 percent of GDP.

Model Results, 2019
(Percent of GDP, unless stated otherwise)

	CA	ES 3/	REER
Adjusted CA norm 1/	-0.1		
Adjusted CA balance	0.2		
CA gap	0.3	4.4	
REER gap (in percent)2/	-0.7	-11.6	1.0

Source: IMF staff calculations.

1/ Multilaterally-consistent cyclically-adjusted current account norm, including staff adjustemtn for EU accession.
2/ Positive value indicates overvaluation.
3/ ES result is based on stabilizing the NIIP at the end-2018 level.

6. The various models yield mixed empirical results regarding the kuna's valuation. The REER gap implied by the CA model implies a slight undervaluation of 0.7 percent (after adjustments). The REER index model suggests a slight overvaluation of 1.0 percent with an estimated residual of zero percent. The external sustainability (ES) approach assesses the REER to be undervalued by almost 11.6 percent. However, since the NIIP is higher than -60 percent of GDP and headed to -53 percent of GDP over the medium-term, staff does not view external sustainability as a concern. Croatia's external position in 2019 is therefore judged 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**. Labor costs increased less than in comparator countries, partially reflecting real per worker compensation, while productivity growth continues to improve mildly. FDI inflows remain low relative to peers, and non-price indicators such as from the Doing Business Report and the World Economic Forum's Global Competitiveness Report point to the need for structural reforms.

Annex V. Risk Assessment Matrix[1]

	Source of Risks/Time Frame/Relative Likelihood	Impact if realized	Recommended policy response
Global	**Rising protectionism and retreat from multilateralism/Short to medium term/High**	***Medium to Low*** Global imbalances and fraying consensus about the benefits of globalization lead to escalating and sustained trade actions and spreading isolationism. This threatens the global trade system, regional integration, labor mobility, as well as global and regional policy and regulatory collaboration. Croatia's goods trade is not large and therefore the impact would not be as high as in countries with larger goods exports.	Growth-friendly fiscal consolidation; Continue to improve competitiveness and reduce non-price trade costs.
	Sharp tightening of global financial conditions/Short term/High	***Medium to High*** This will cause higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn.	Continue fiscal consolidation; Use FX intervention if necessary to counter disorderly market conditions; Encourage further development of hedging instruments; Encourage lowering unhedged borrowing.
	Weaker-than-expected global growth/Short to medium term/ High	***Medium to High*** Weaker economic growth in key trading partners, Italy and Germany, weaker goods exports and tourism, would weigh on economic growth and perpetuate economic vulnerabilities.	Allow automatic stabilizers to operate; Diversify the economy; Accelerate structural reforms; Improve competitiveness; Build reserve buffers.
	Intensification of geopolitical tensions and security risks/Short term/High	***Upside risk as Croatia may benefit*** Leads to social and economic disruption in these regions. If tensions happen in nearby competitors, this would promote tourist flows to more stable regions like Croatia.	Continue fiscal consolidation and build buffers.

[1] 1The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Global	**Lower and inefficient absorption of EU funds/Medium term/Medium**	***Low*** Growth will be impacted by slow absorption of growth-enhancing investment.	Accelerate reforms to improve absorption and invest on new technologies and improve labor force skills.
	Erosion of the fiscal stance/Short term/High	***High*** Add to deficit in structural forms, lead to slowdown in reducing public debt and prolong the convergence gap.	Resist call from trade and labor union to increase wages and benefits; Avoid extending further tax exceptions and concessions.
Domestic	**Further reform standstill/ Medium term/High**	***High*** Busy political calendar in 2020 has complicated implementation of reforms. Lack of meaningful reform will affect growth through lower investment, and labor productivity.	Use the opportunity ahead of the ERMII accession and strengthen national commitments to reform.
	Negative demographics/Short to medium term/High	***High*** This will continue to impact the labor force, wages, and the sustainability of social welfare system.	Further reform the labor market; Increase the labor force participation; Invest in improving the human capital.