INTERNATIONAL MONETARY FUND

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REPUBLIC OF CROATIA

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CROATIA

September 2021

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its August 30, 2021, consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on August 30, 2021, following discussions that ended on June 21, 2021, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 29, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Croatia.

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

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Washington, D.C.

IMF Executive Board Concludes 2021 Article IV Consultation with Croatia

FOR IMMEDIATE RELEASE

Washington, DC – **September 10, 2021:** On August 30, 2021 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Croatia.

The Croatian economy has been subjected to severe stress, but is showing its resilience. The pandemic and two devastating earthquakes led to a 8.0 percent drop in activity in 2020, reflecting lower domestic and external demand—particularly, a drop of some 60 percent in tourism receipts (yoy). Ample support of fiscal and monetary policy, coupled with appropriate relaxation of supervisory requirements, helped to contain the effects of the pandemic. The financial position of the government was somewhat alleviated by the EU funds (loans, transfers) that have financed most of the fiscal support measures. The CNB intervened in the currency market and mitigated tensions in the domestic bond market through purchases of government securities (about 5.5 percent of GDP). It also lowered reserve requirements and conducted repo operations. Markets calmed, not least after a €2 billion SWAP arrangement with the ECB was announced in mid-April 2020. External indicators held up relatively well, the current account posted a small 0.4 percent deficit in 2020, despite the collapse in tourism receipts. However, gross public and external debt climbed by almost 16 and 6 percentage points, respectively, causing a reversal of earlier gains. Inflation has remained benign, despite a recent uptick.

A robust bounce back is projected for 2021 and 2022, of 5.4 and 5.8 percent growth respectively driven by a rebound in the services sector (assuming ⅔ and nearly full recovery of tourist arrivals in 2021, and 2022 respectively), and investment which will be bolstered by large EU investment grants over the medium-term. Over the medium term, growth is projected to ease closer to 3 percent. Inflation is projected to pick up and stay at 2 percent through 2023, in line with the ECB inflation target. There are large risks on both sides, including from virus mutations in the near-term which could result in significant economic scarring. Medium-term growth would be substantially lower if the pace of recovery in EU trading partners is lower than expected, if EU funds are not effectively absorbed and/or if promised complementary reforms remain challenging to deliver. On the upside, a more rapid and successful vaccination campaign would enable a quicker return to the health of the population and the economy. Over the medium-term, the positive effects of green investments and digitalization may be greater than projected.

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

Executive Board Assessment[2]

Executive Directors welcomed the swift measures taken to combat the COVID-19 pandemic thus building the foundations for the projected recovery, underpinned by tourism and investment.

Directors welcomed the authorities' efforts to balance the pandemic recovery with fiscal prudence while remaining vigilant to support the nascent recovery as needed. They stressed that it will be important to avoid further tax cuts to conserve fiscal resources and to firmly place public debt levels on a downward trajectory over the medium term.

Directors called for an accelerated implementation of structural reforms and the need to increase the capacity to absorb EU structural funds, in particular in the area of public investment management. Such reforms are essential to make progress toward the goal of closing the income gap to the EU average and to achieve the desired decarbonization, digitalization, and diversification of the economy. In this context, they also welcomed the authorities' plans to implement a civil service remuneration system that rewards productivity, as well as the merging of healthcare services across sub-national governments.

Directors considered that monetary policy had been appropriately accommodative within the limits of the exchange rate anchor and ample global liquidity. They welcomed ERM II membership in July 2020, in the context of the authorities' strategic priority of euro adoption. Noting the benefits of euro adoption, Directors welcomed the authorities' strong commitment to observe the convergence criteria and to improve the AML/CFT framework and SOE governance.

Directors stressed the need to remain vigilant to financial and banking sector risks with the expiration of the regulatory easing introduced in line with the European Banking Authority guidelines to mitigate the impact of the pandemic. They welcomed the decision to facilitate write-offs of NPLs and efforts to strengthen the insolvency framework. Directors urged the authorities to remain particularly vigilant over credit developments in the real estate market and stand ready to absorb excess liquidity and impose adequate macroprudential measures if needed.

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

Croatia: Selected Economic Indicators, 2016-26	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
								Proj.			
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)										
Real GDP growth	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
Contributions:											
Domestic demand	3.2	4.2	4.6	2.7	-2.3	3.9	6.5	4.9	3.1	1.7	1.7
Net exports	0.3	-0.7	-1.9	0.2	-5.8	1.5	-0.7	-0.9	0.2	1.5	1.4
Unemployment	15.0	12.4	9.9	7.8	9.0	8.5	8.0	7.7	7.2	7.0	6.8
CPI inflation (avg.)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
Saving and investment (percent of GDP)											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Government	3.5	4.4	5.0	5.7	-1.1	1.4	2.6	3.5	4.3	4.9	5.1
Nongovernment	19.7	21.1	20.2	20.0	26.3	24.4	23.4	23.2	23.4	22.3	21.7
Government Sector (ESA 2010 definition)											
General government revenue	46.5	46.0	46.2	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
General government expenditure	47.4	45.2	46.0	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
General government balance	-1.0	0.8	0.2	0.4	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Structural balance 1/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4
General government debt 2/	80.8	77.5	74.2	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Balance of payments (percent of GDP)											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Debt and reserves											
Gross official reserves (billions of euros)	13.5	15.7	17.4	18.6	18.9	22.3	24.0	25.4	26.1	26.4	26.6
IMF metric (percent) 3/	88.5	102.0	112.4	103.4	125.6	138.9	143.2	147.2	146.9	145.7	144.4
In months of imports in goods and services (based on next year level)	7.5	7.8	7.9	7.9	9.3	9.7	8.8	8.6	8.3	8.0	7.6
Total external debt (percent of GDP)	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
Money and credit	(End of period, change in percent)										
Broad money (M4)	4.7	2.1	5.5	2.9	9.3	7.0	5.0	4.5	4.0	4.0	4.0
Claims on other domestic sectors 4/	-3.4	-0.8	1.8	2.6	3.3	--	--	--	--	--	--
Interest rates											
Average 12-month T-bill interest rate (in kuna)	1.0	0.4	0.1	0.1	0.1	--	--	--	--	--	--
Kuna credit rate (unindexed, outstanding amount)	6.5	6.0	5.7	5.2	4.8	--	--	--	--	--	--
Exchange rate											
Kuna per euro	7.6	7.5	7.4	7.4	7.5	--	--	--	--	--	--
Real effective exchange rate (percent, "-" = appreciation)	0.3	0.7	1.9	-1.4	--	--	--	--	--	--	--
Memorandum items:											
Nominal GDP (billions of euros)	46.6	49.3	52.0	54.3	49.3	52.4	56.2	59.8	63.0	66.0	69.1

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.

1/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015. The 2020 overall budget balance (-7.4 percent of GDP) minus the cyclical component (-1.7 percent of GDP) results in a cyclically adjusted budget balance of -5.7 percent of GDP. Includes the one-offs related to the COVID-19 package of -3.8 percent of GDP. For 2021, the overall budget balance (-4.1 percent of GDP) minus the cyclical component (-0.9 percent of GDP) results in a cyclically adjusted budget balance of -3.2 percent of GDP. Includes the one-offs related to the COVID-19 package of -2.5 percent of GDP.

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

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

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

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REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

July 27, 2021

KEY ISSUES

Context: As other emerging economies reliant on tourism (about 25 percent total contribution of tourism-related industries in GDP and employment), Croatia has been hit hard by the pandemic and two devastating earthquakes, leading the economy to contract by 8.0 percent in 2020. Vaccinations have been rolled out to about 38 percent of the population (end-June 2021). Staff projects growth to bounce back to 5.4 percent in 2021, driven by a rebound in the services sector and investment, aided by fiscal and monetary policies, and bolstered by large EU grants over the medium-term.

Policies:

- **Rebuild resilient and sustainable tourism:** Near term, policies should focus on still-affected businesses and workers. Policies that foster the green and digital transition of existing public tourism infrastructure, the development of tourism beyond established destinations will help reduce scarring and rebuild sustainable tourism.

- **Balance short term support with medium-term discipline:** Once the recovery is on a firm footing, fiscal deficits and the public debt need to resume their pre-pandemic downward trajectory. Successful absorption of substantial forthcoming EU funds accompanied by full implementation of reforms promised under the latest National Recovery and Resilience Plan (NRRP), as well as by strengthening public investment management, are essential to facilitate higher growth, and to lower debt.

- **Anchor stability through exchange rate, monetary, and financial policies: The highly** expansionary monetary stance, within the exchange rate anchor and ample global liquidity, has been appropriate for the pandemic. Supervisory vigilance should be continued. Efforts to facilitate more efficient debt restructuring should be furthered.

Approved By
Jörg Decressin (EUR) and Martin Sommer (SPR)

Virtual discussions were held from June 7–18, 2021. The team comprised Mr. Seshadri (head), Mses. Bunda and B. Li, and Mr. Lybek (all EUR). Mr. Milutinović (OED) joined several meetings. Mses. Zhang and Gonzales (EUR) assisted in the preparation of this report. The staff team met with Deputy Prime Minister and Minister of Finance Mr. Marić, the Governor of the Croatian National Bank Mr. Vujčić, the Fiscal Policy Committee of the Parliament; officials from key economic ministries, and representatives of the business community, banks, think-tanks, and academia.

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