Statement by Paul Hilbers, Executive Director for the Republic of Croatia and Darjan Milutinovic, Advisor to the Executive Director
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On behalf of the Croatian authorities, we thank Mr. Seshadri and his team for the insightful report and the fruitful policy discussions during the Article IV mission. The authorities broadly agree with staff's appraisal and appreciate their valuable policy recommendations.

Amid the pandemic and two large earthquakes, the Croatian economy showed resilience. Although the 2020 economic contraction of 8.0% was one of the largest in Croatian history, it has not been as severe as those experienced by many other economies with an equally strong tourism component. This was mainly due to the swift and ample policy support, including subsidy and job retention schemes, tax relief and deferrals, the opt-in limited time debt service moratorium, and guarantees and grants given to businesses. Thus, the highly expansionary fiscal and monetary policy stance successfully mitigated negative consequences of the pandemic as reflected in the mild effects on the labor market, the stable exchange rate, and the return to pre-pandemic low yields.

EU funds support the authorities' ambitious reform agenda to kickstart a green and digital recovery. The European Commission has recently approved Croatia's National Recovery and Resilience Plan (NRRP), unlocking 12% of GDP of EU grants to be utilized until 2026. 40% of the available funds will be utilized to foster a green transition, 20% for digitalization, and the remainder for reconstruction after the earthquakes, and public administration, labor market and healthcare reforms. Structural reforms complement the authorities' primary strategic priority – the euro adoption, which is planned for the beginning of 2023.

<u>Recent Economic Developments and Outlook</u>

The authorities expect a strong rebound of the economy, driven by an uptick of domestic demand and tourism. After sizeable growth in the second half of 2020, the better-than-expected GDP growth in Q1 2021 and the high-frequency indicators for Q2 point to a robust expansion of the economy in the first half of 2021. Furthermore, recent data show encouraging signs of a recovery in tourism. This would, together with the rebound of private consumption and strong public investment for the reconstruction after the earthquakes, drive the growth rate well above 5% in 2021, higher than the staff forecast. Employment could return to pre-crisis levels without having a lasting impact on inflation. The projected inflation rate of 1.7% reflects an increase in energy prices, with core inflation subdued at around 0.5%.

The authorities forecast a slightly higher growth path over the medium term than that of staff. The macroeconomic impact of the NRRP is assessed to be strongest in 2022 and 2023, adding 1.4 percentage points to the GDP growth each year. As a result, economic activity would intensify and reach the pre-crisis level in 2022 (+6.6%), also supported by continued domestic demand and a recovery in tourism. Growth rates would continue to be solid in 2023 (+4.1%) and 2024 (+3.4%). However, COVID-19 continues to be a downside risk to the outlook in particular because of its negative consequences on tourism.

<u>Fiscal Policy</u>

The robust growth momentum supports the gradual phasing out of policy support. The authorities share staff's view that recovery is a top priority. Therefore, job retention subsidies for vulnerable sectors

have been extended to at least till July 2021, in addition to continuing the short-work scheme until the end of 2021. Support measures are conditional upon firms' performance, and, given the dropping number of applicants, the current growth momentum should support their withdrawal. However, if the epidemiological situation worsens, the support will be extended by budget reallocations.

The policy focus would gradually shift from employment support to workers' support. While keeping the targeted support to viable firms, the authorities agree with staff that active labor market policies (ALMPs) have a crucial role in supporting workers' sector reallocation. Therefore, in addition to the current ALMPs, the NRRP would add new measures, including additional skills training.

Tax reforms were aimed at reducing the fiscal burden and boosting economic growth. The 2021 tax changes were the fifth round of the pre-pandemic tax reform package (2017-2019). Tax cuts were mainly directed toward PIT and CIT to reduce the tax wedge and increase private investments, improve incentives to work and support lower-income households. In addition, the tax reform reduced the administrative burden and made the tax administration process more transparent and efficient.

The authorities are strongly committed to medium-term fiscal consolidation. In recent years, the budgetary discipline put public debt on a firm downward trajectory, allowing a sizeable COVID-19 policy response with support from the EU funds. However, an increase in policy support and decreasing fiscal revenues led to a deficit of 7.4% of GDP, with public debt increasing from 72.8% of GDP in 2019 to 88.7% in 2020. However, with the phasing out of support measures and revenues picking up, the authorities expect the deficit to halve in 2021. On the back of the strong growth momentum, public debt would be expected to resume its pre-pandemic downward trajectory reaching 76.8% at end-2024.

Monetary Policy and Financial Stability

The targeted monetary policy response successfully mitigated the negative effects of the pandemic. The CNB introduced a series of monetary policy measures to ensure a stable exchange rate, sustain lending to domestic banks and stabilize the government securities market. The line of FX interventions and the 2 billion EUR swap agreement with the ECB quickly diminished FX pressures at the beginning of the crisis. At the same time, purchases on the secondary government securities market abated the brief market disruptions and contributed to the decline of bond yields. Furthermore, structural repo operations and reduced reserve requirement created additional liquidity that enabled banks to continue lending under favorable financing conditions.

While the CNB continues to pursue highly expansionary monetary policy, the need for exceptional measures has diminished. Short money market rates close to zero, a stable exchange rate, and historically ample liquidity in the banking system imply that large FX interventions and government securities transactions are no longer required. Nevertheless, in case of a significant negative shock, the CNB would deploy appropriately tailored temporary measures.

The banking sector has proven to be stable and sound during the pandemic. The well-capitalized banking sector shows sizable resilience to a severely adverse scenario, as reflected in the outcome of the CNB's stress testing exercise. Nonetheless, the expected deterioration of credit quality due to expiration of moratoria and the growth of housing loans call for close monitoring. The CNB would reduce excess liquidity in the banking system and use available macroprudential tools, recently enhanced by newly collected granular data on lending, in case of excessive lending or rising housing price imbalances.

The authorities are ready to implement the euro in the beginning of 2023. Croatia joined the ERM II in July 2020, and the convergence criteria for euro adoption are likely to be assessed in mid-July 2022. Notwithstanding the pandemic-caused deterioration of fiscal indicators during 2020, the budget deficit and public debt are set to return to a steady downward path as of this year. Furthermore, as Croatia would satisfy the applicable quantitative convergence criteria, the euro could be introduced as early as 2023. Prior to adoption, the authorities have committed to (i) strengthening the AML framework, (ii) reducing administrative burden for business, (iii) improving SOE governance, and (iv) strengthening the national insolvency and restructuring framework, and the required reforms in these areas are firmly underway.

Structural Policies

The authorities are committed to strengthening administrative capacity for the use of the generous EU funding. With the largest allocation of the NextGen EU grants and regular structural EU funds, Croatia will receive historically high levels of the available EU funds, close to 36% of GDP over the next six years. Therefore, the authorities have recognized the importance of increasing absorption capacity by improving the Public Investment Management (PIMA) with the IMF's assistance and introducing the Act on the institutional framework for EU funds at end-2021.

The NRRP is introducing steps to improve public sector governance. The public sector salary system will be modernized to become more merit based and mergers of sub-national government entities will be promoted. Regarding the health sector, the authorities plan to tackle the accumulation of arrears by functional integration of hospitals, joint procurement procedure for health institutions and the amendment of the healthcare legal framework. In addition, the NRRP measures would increase social benefits efficiency and pensions adequacy.

Transformation to a green and digital economy is at the heart of the government's economic policy. The green transition consists of substantial investment and a set of measures focused on: (i) buildings renovation, (ii) renewable energy and energy efficiency including investment in electricity, the distribution grid for renewable energy sources, geothermal energy, and geological carbon storage, (iii) waste and water management and (iv) sustainable mobility including investment in rail transport, advanced biofuels, renewable hydrogen, refuel infrastructure, and autonomous vehicles for one of the first capital city with robotaxi services. At the same time, significant digital infrastructure investments are planned in public administration, judiciary, transport, healthcare, and energy sector, together with digital subsidies for firms. In addition, building more sustainable tourism is a key policy focus.

Supported by a favorable political environment, productivity-enhancing reforms allow for Croatia's rapid convergence to EU levels. Educational reforms, parafiscal charges and a reduction of regulatory constraints, a reduction in the duration of court proceedings and case backlogs in the judiciary, and measures to support investment in science, R&D, and innovation would all lift the potential growth. The authorities are keen to front-load a significant share of the reforms over the next three years to deliver on the comprehensive reform agenda.