



REPUBLIC OF CROATIA

2019 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

February 2020

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 2019 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on lapse of time basis, following discussions that ended on December 13, 2019, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 30, 2020.
- An **Informational Annex** prepared by the IMF staff.

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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February 19, 2020

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IMF Executive Board Concludes 2019 Article IV Consultation with the Republic of Croatia

On February 14, 2020, The Executive Board of the International Monetary Fund (IMF) concluded the 2019 Article IV consultation¹ with the Republic of Croatia, and considered and endorsed the staff appraisal without a meeting.²

In 2019, Croatia experienced its fifth consecutive year of solid economic growth, once again driven largely by private consumption and tourism. Employment gains have been robust, wages have continued to rise, while import prices have helped to keep inflation muted. Increased absorption of EU funds is likely to raise public investment in the coming years. In conjunction with continued strong consumption, the current account surplus is expected to decline, and turn into a moderate deficit, while economic growth moderates. Both public and external indebtedness are expected to continue their declining trajectories.

The pace of fiscal consolidation in 2019 continued to slow, with the budget estimated to be close to balance. Recently agreed wage increases in the public sector are expected to increase current spending in 2020. Even though revenues will remain buoyed by economic activity, the budget balance is expected to turn into a small deficit in 2020, in part due to additional tax cuts. Contingent liabilities could also pressure budget balances in the coming years.

Monetary policy remains appropriately accommodative within the limits of the exchange rate anchor. Excess liquidity in the banking system continues to rise, and interest rates remain low. Bank lending to households has continued to grow. The Croatian National Bank (CNB) has issued recommendations to banks to be more cautious with long-term uncollateralized consumer lending. The banking system, on the whole, remains well capitalized and liquid, and the NPL ratio continues to decline. The CNB continues to utilize the current conditions to build reserves.

Croatia is currently targeting ERM II entry in mid-2020, and eventually the Euro Area.

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

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Executive Board Assessment

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.

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.

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.

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.

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.

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.



REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

January 30, 2020

KEY ISSUES

Context: The economy continues to expand; fiscal performance has been strong and public debt continues to decline. Ahead of the 2020 elections social demands have precipitated strongly, causing the government to reverse recent pension reforms and promise large public wage increases. Downside risks arise from changes in global conditions, contingent liabilities, further reform standstill, and adverse demographics. The country submitted its ERM II and the Banking Union entry request in July 2019. The authorities currently expect SSM/SRM membership by mid-2020 and see 2023 as the earliest time for euro adoption.

Policies: Preserve fiscal gains, enhance the flexibility and quality of the budget. Place renewed focus on structural reforms and increasing investment and productivity.

- **Improve the quality of the budget:** Continue debt reduction, resist further pressures on the wage bill, and target structurally balanced budgets. Evaluate long-term public investment priorities and rebalance spending to areas of relative deficiency. Improve the efficiency of essential State-Owned Enterprises.
- **Renovate the capital stock and create conditions for a broader economic base:** Continue improvements to the business environment to create ripe conditions for deeper economic integration with Europe. Increase EU funds absorption to close remaining gaps in physical and technological infrastructure. In parallel, the skills of students at all levels, as well as those of workers, need to keep pace with technological change.
- **Anchor stability through monetary and financial policies:** Monetary policy remains appropriately accommodative. Remain vigilant regarding growth of household borrowing and facilitate corporate sector deleveraging. Make the credit registry fully operational again.

Approved By
Jörg Decressin (EUR)
and Yan Sun (SPR)

Discussions were held in Zagreb from December 3–13, 2019. The team comprised Messrs. Seshadri (head), Harrison, Lybek, and Mulas-Granados (all EUR). Mr. Jost and Mr. Doornbosch (OED) joined several meetings. Mses. Batog and Samuel (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 economy related ministries, and representatives of the business community, banks, think-tanks, and academia.

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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.

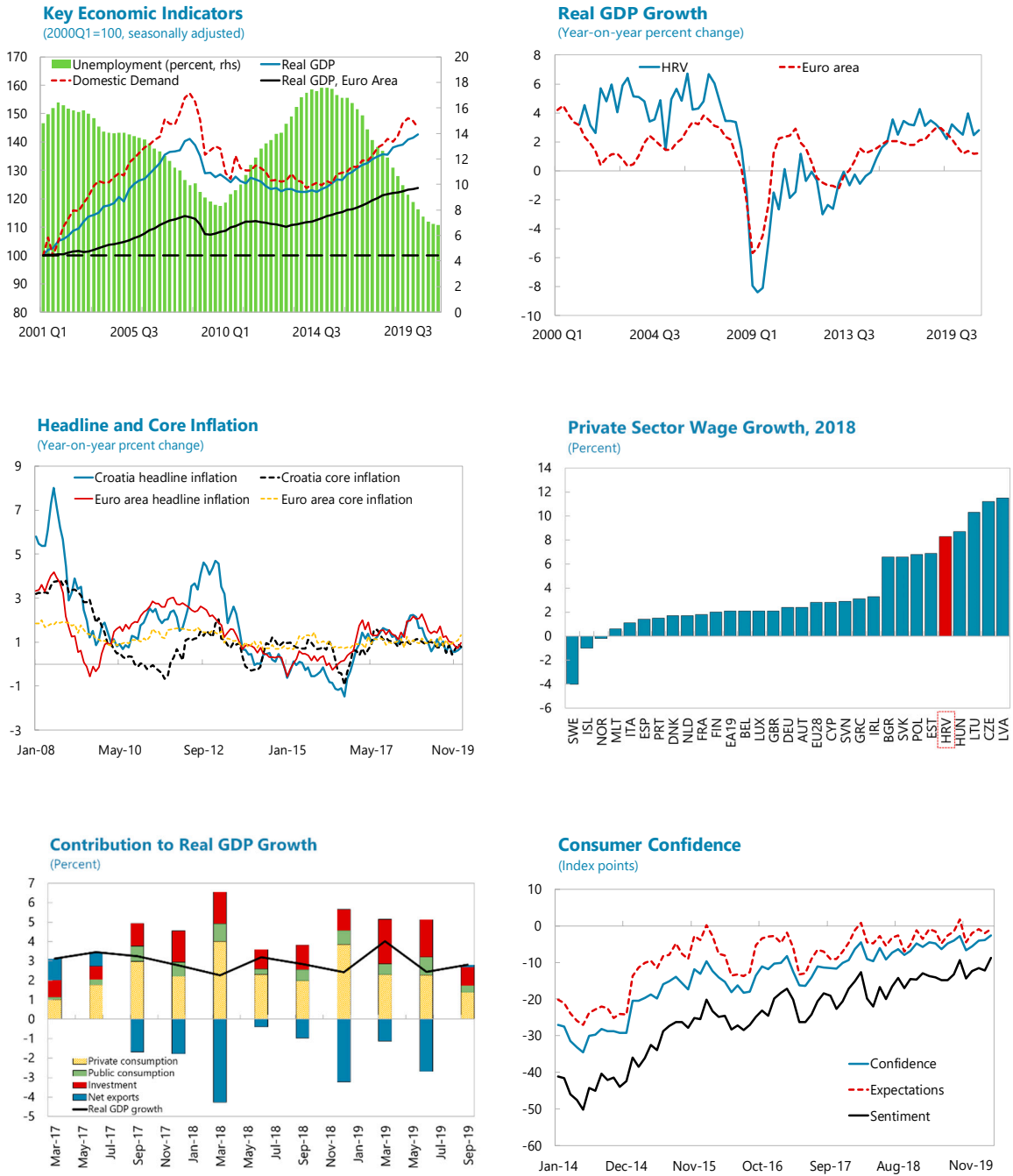
RECENT DEVELOPMENTS

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).

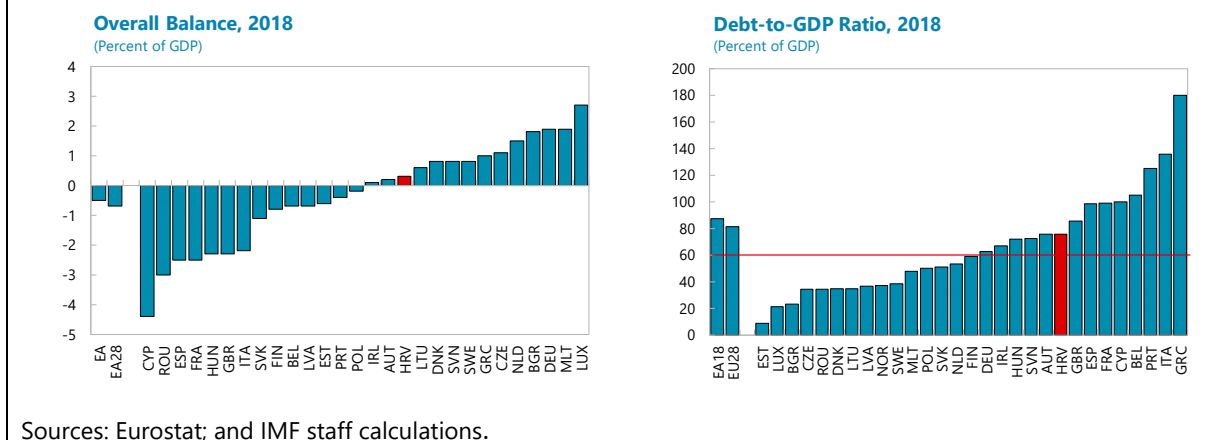
5. The CNB has continued to accumulate international reserves. Tourism inflows, and higher EU funds absorption have maintained official reserves above the ARA metric. Thus far in 2019 (end-November), gross reserves increased by €1.1 billion. The CNB purchased €1.1 billion to reduce appreciation pressures 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



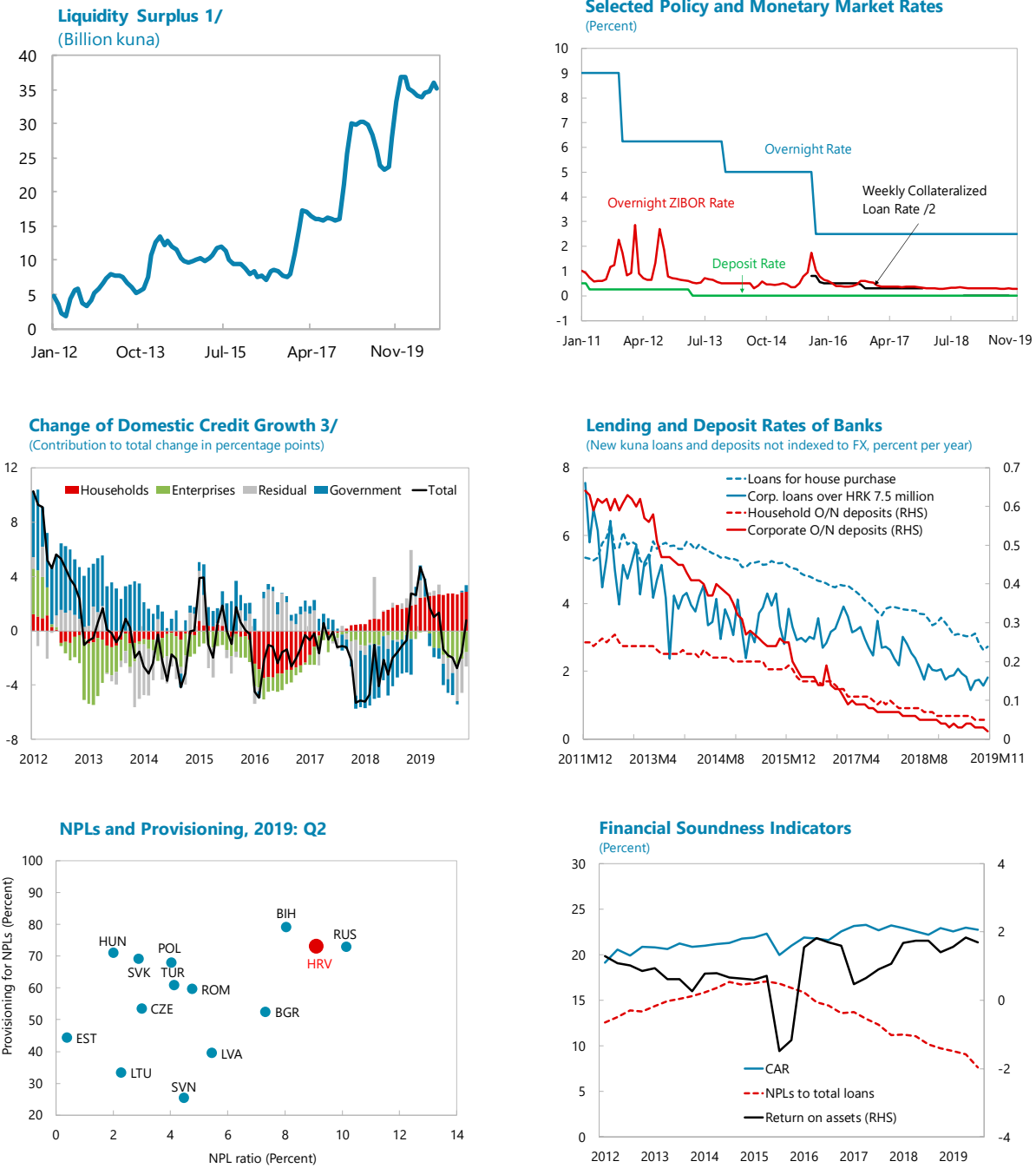
6. Monetary conditions are appropriately accommodative given the exchange rate anchor. Inflation remains contained, international reserves continue to grow, and the banking system is awash with liquidity (Figure 3). Headline credit growth to the private sector has decelerated in 2019, largely due to 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

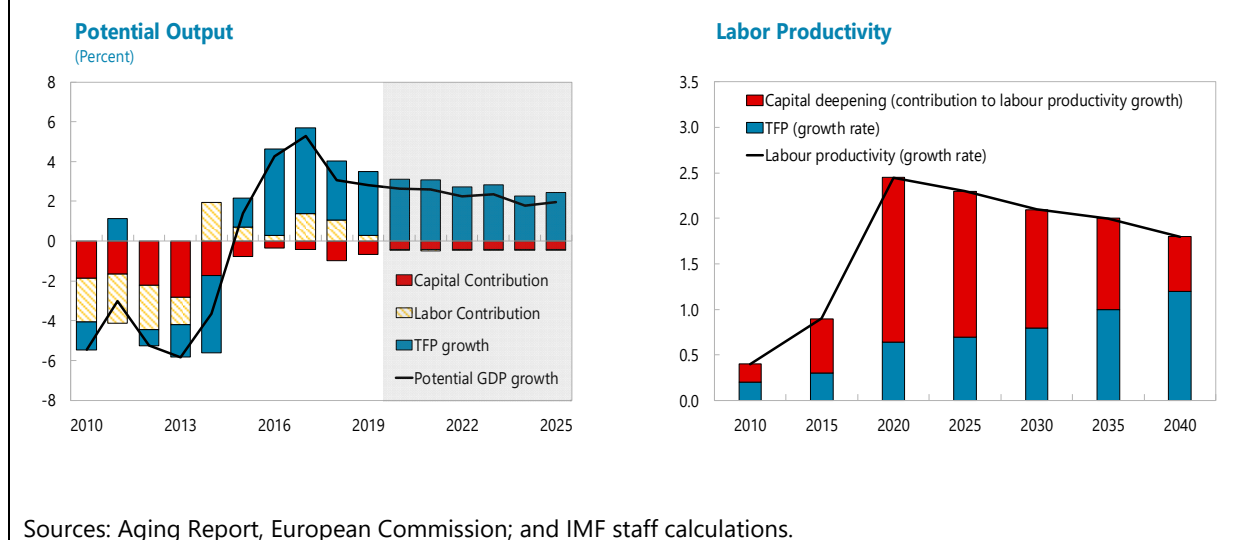
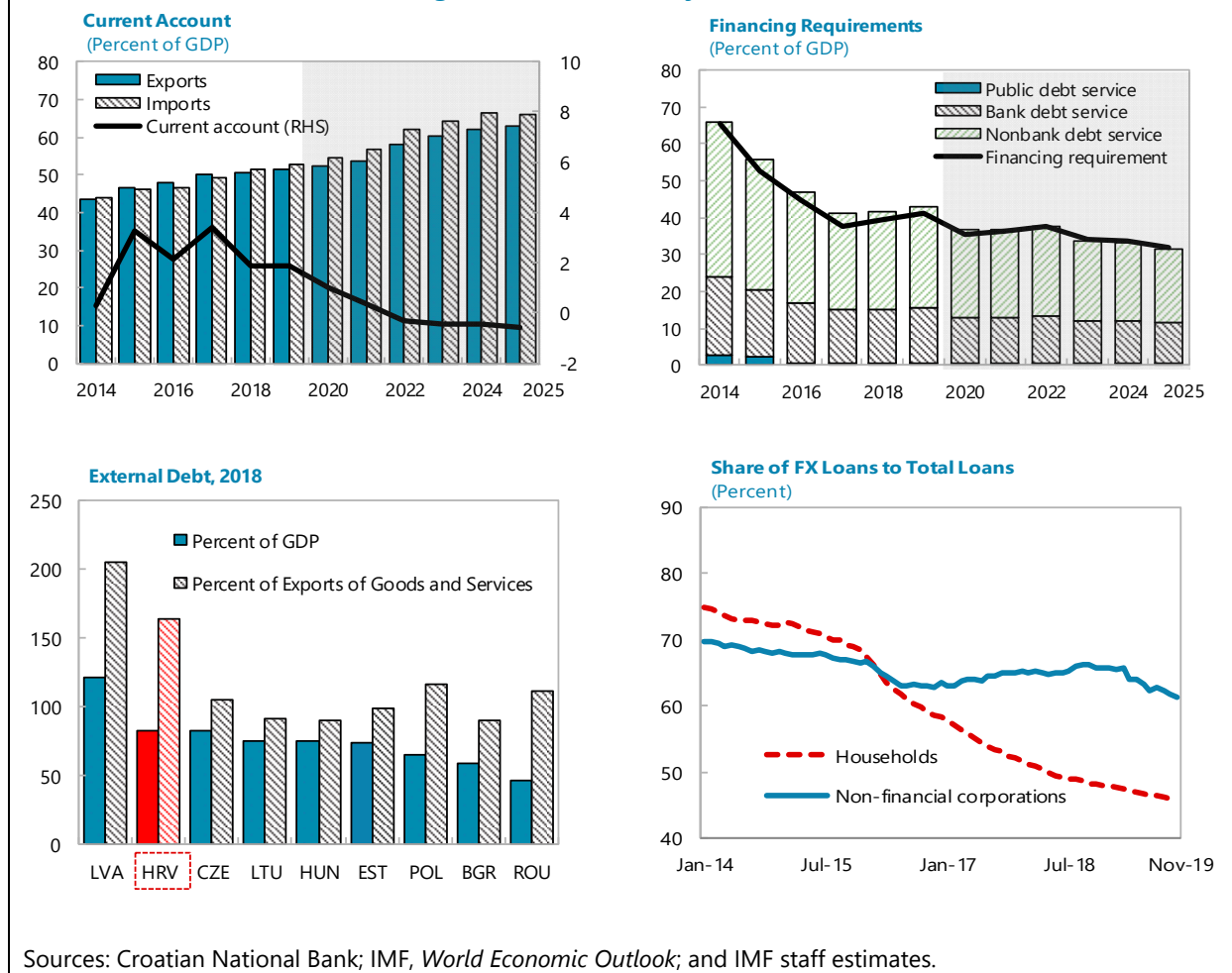


Figure 5. Vulnerability Indicators



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

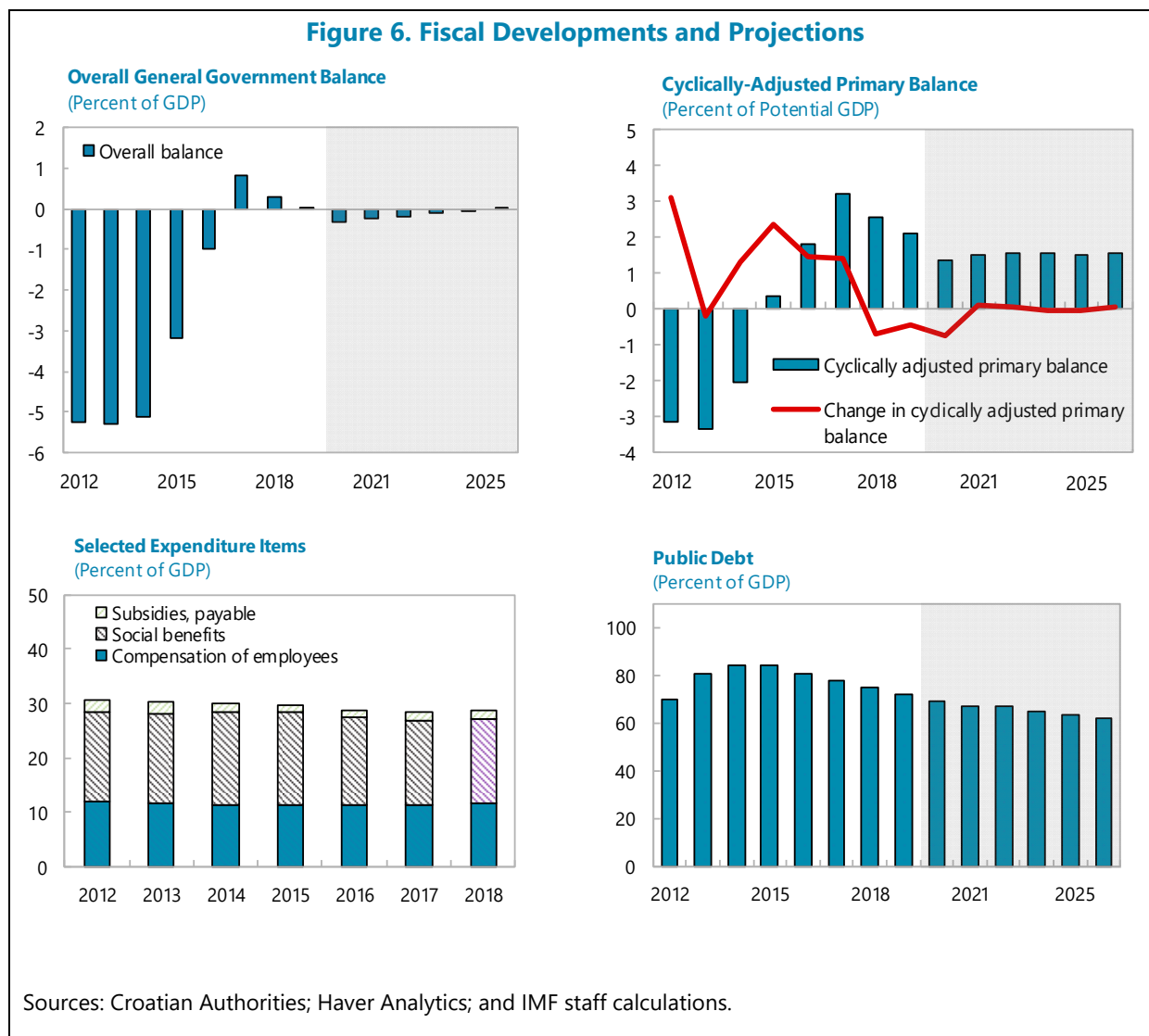
| Fiscal Measures in 2020 Baseline Projection | Million kuna | Percent of GDP |
|---|---------------|----------------|
| Revenues | | |
| Income tax cuts for the young | -750 | -0.18% |
| Profit tax exemption | -200 | -0.05% |
| Increase in income tax threshold | -500 | -0.12% |
| VAT reduction for food 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% |

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).

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.



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).

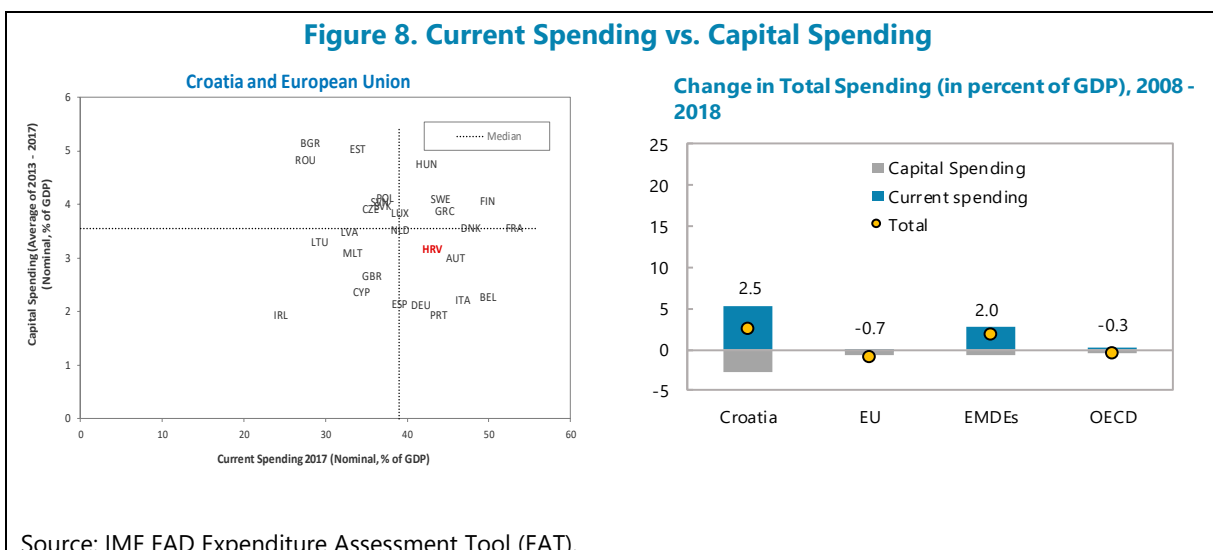
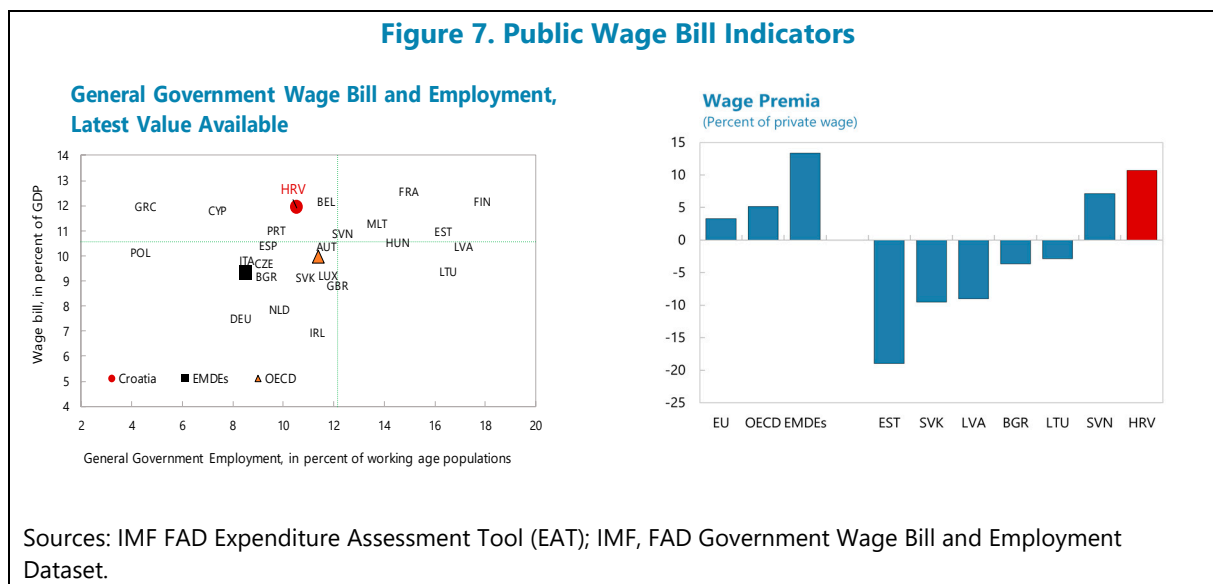
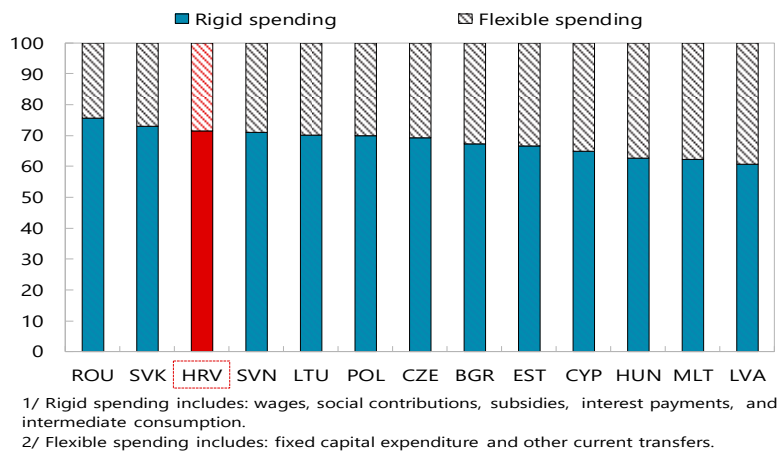
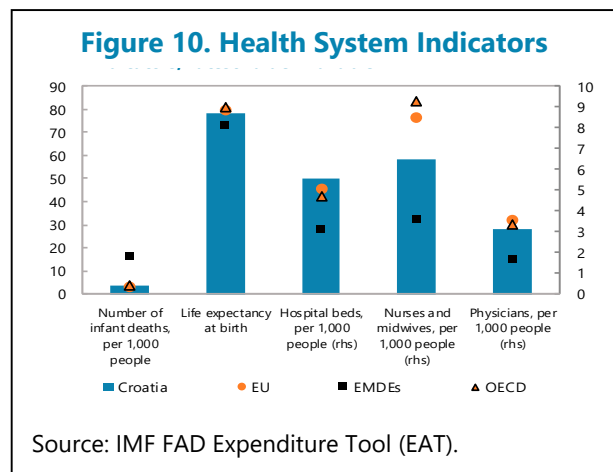


Figure 9. Composition of Government Expenditure in EU's New Member States, 2018 1/ 2/
(Percent of total revenues)



Sources: European Commission, AMECO database.

- Fiscal reforms: Inadequate to date, but essential for budget flexibility.
 - **State-Owned Enterprises (SOEs):** Studies by the IMF (2019)¹ and the Ministry of State Assets² 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

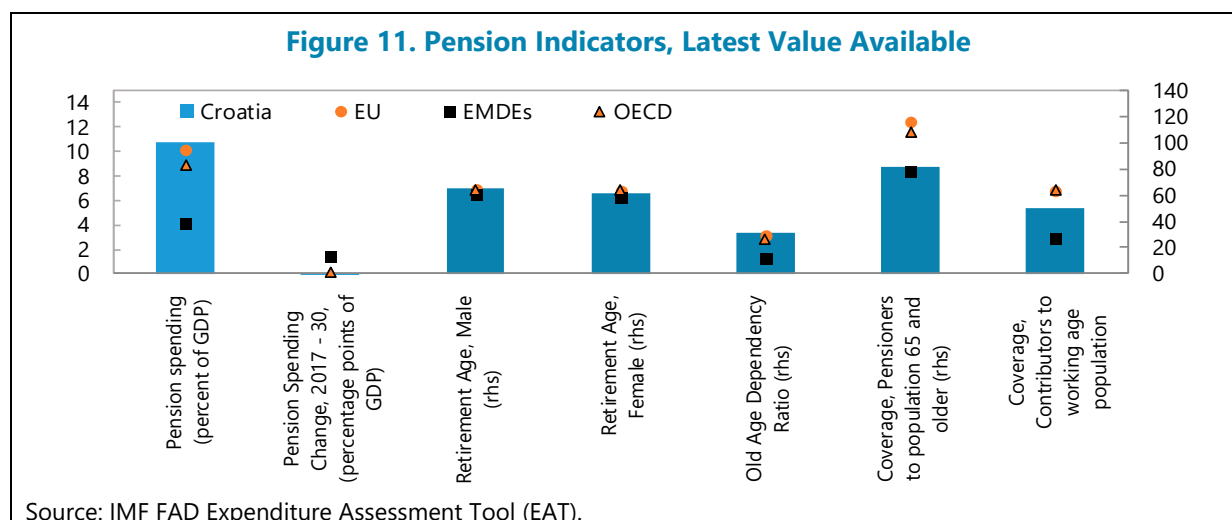


¹ Richmond, C., P. Dohman, J. Miniane and J. Roaf (2019) “Reassessing the Role of State-Owned Enterprises in Central, Eastern and Southeastern Europe”, Departmental Paper No. 19/11. International Monetary Fund (Washington D.C.).

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.



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).

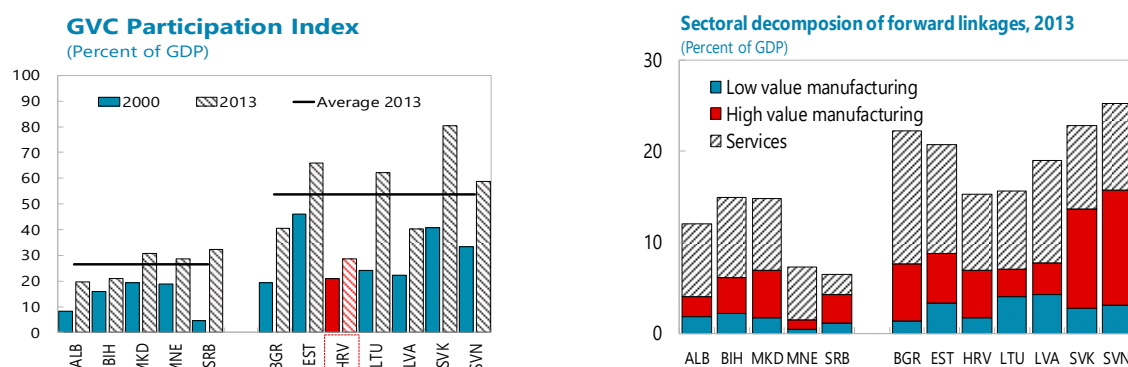
B. Structural Reforms: Capital Stock Renovation and Business Climate

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.

- *Reforms will help fuller integration with Europe*
 - *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.
- *An investment push to rejuvenate the capital stock.* 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 Programming 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.

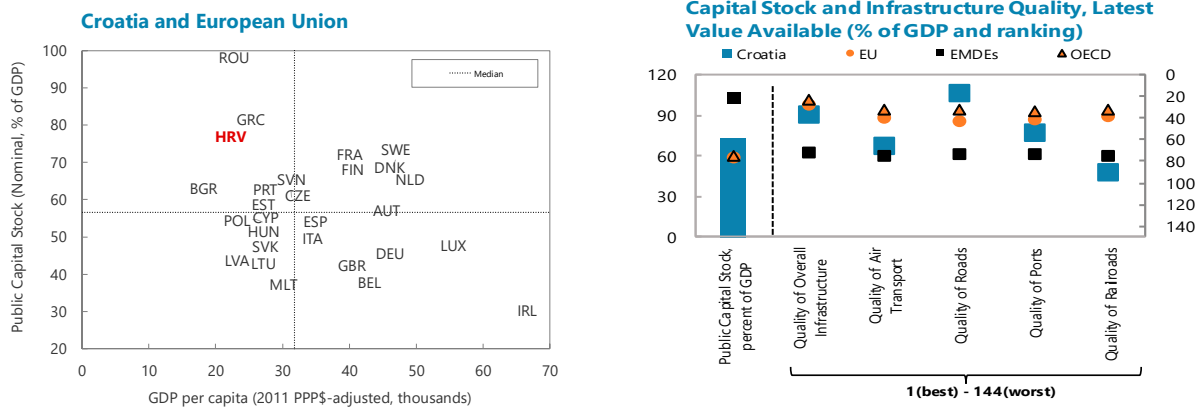
Figure 12. GVCs Participation and Linkages

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

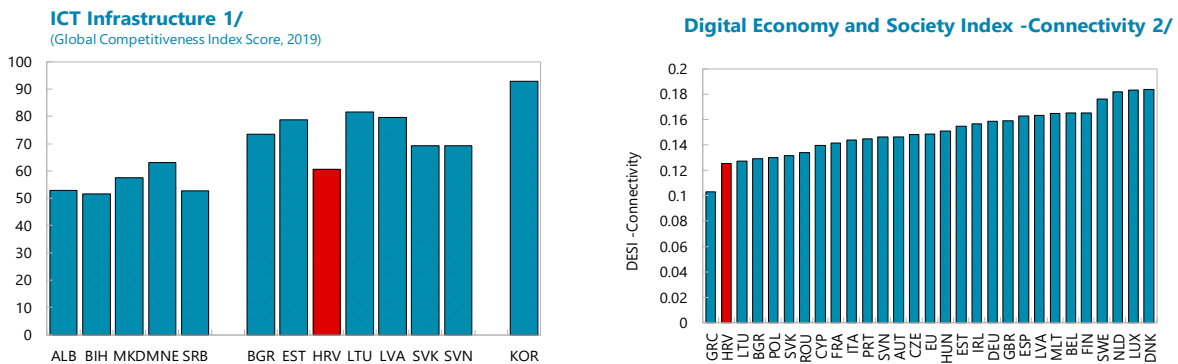
STEM university graduates, it still ranks low in skills of the current and future labor force. Ongoing educational curriculum reform should be complemented with expanded access to vocational training, to improve the efficiency of secondary education.⁵ At the tertiary level, Croatia needs to produce a 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

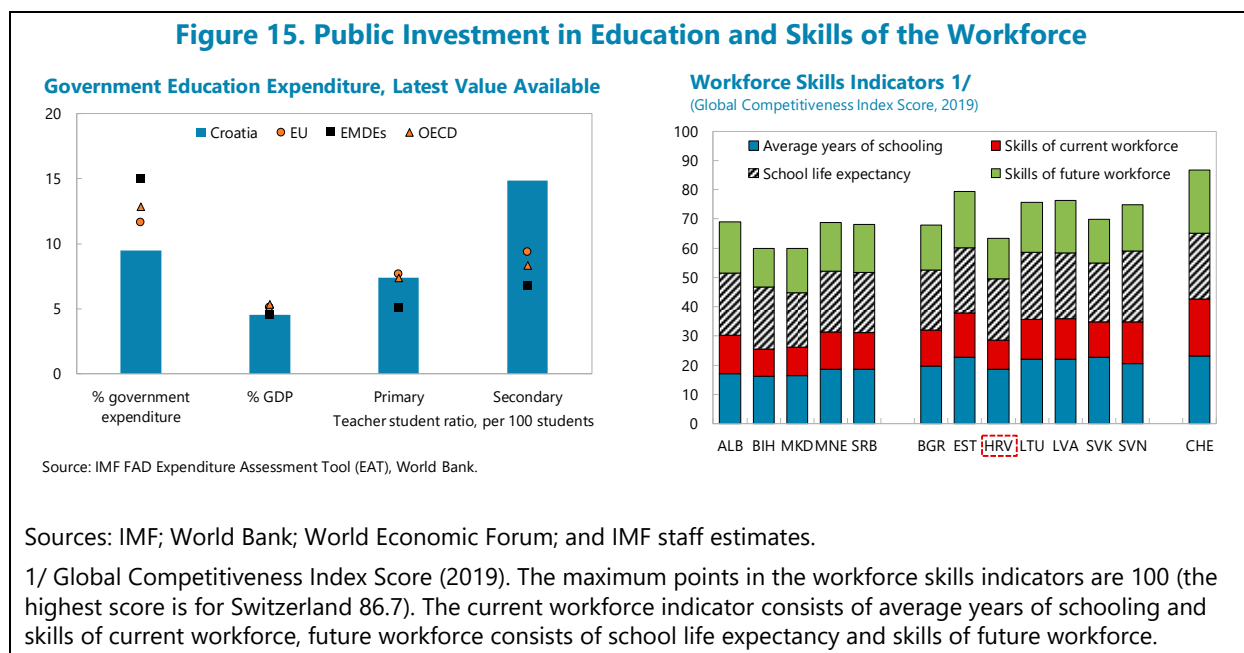


Sources: The Digital Economy and Society Index (DESI); Global Competitiveness Index Database, World Economic Forum; and IMF staff calculations.

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

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.

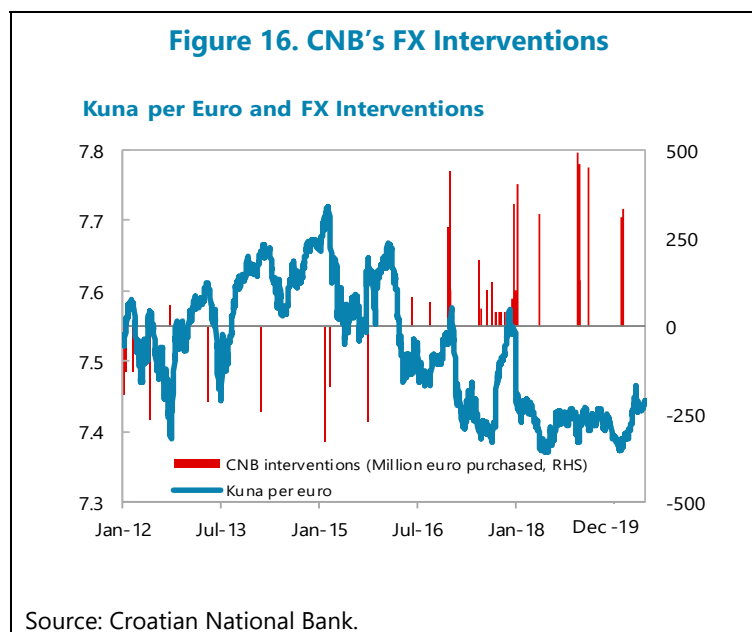
C. Anchoring Stability through Monetary and Financial Policies

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).



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.

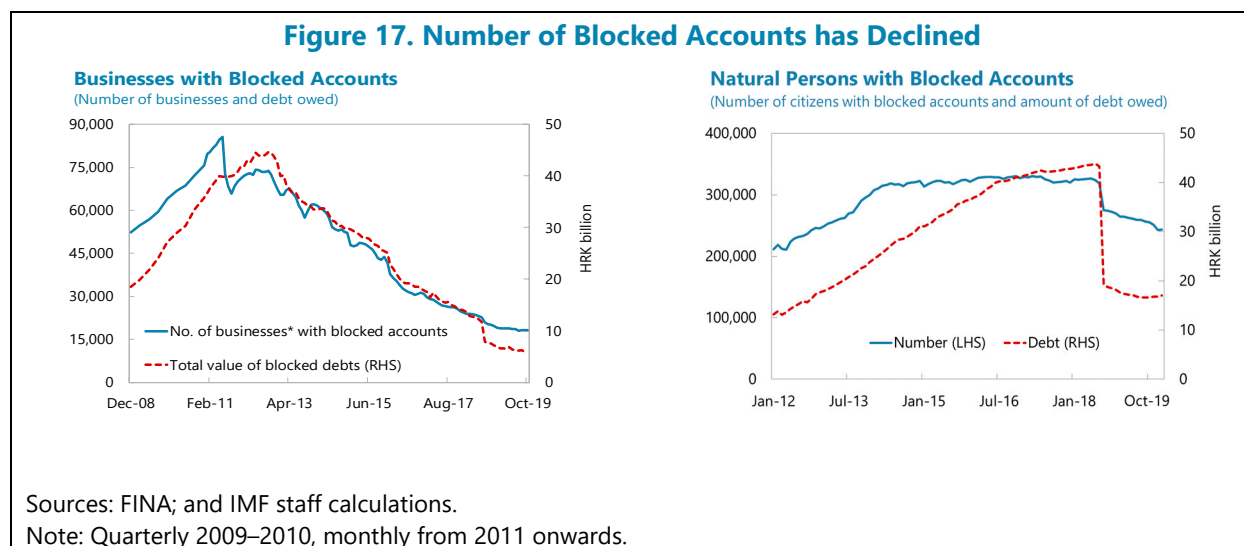
Banking System

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 grow moderately in 2020.



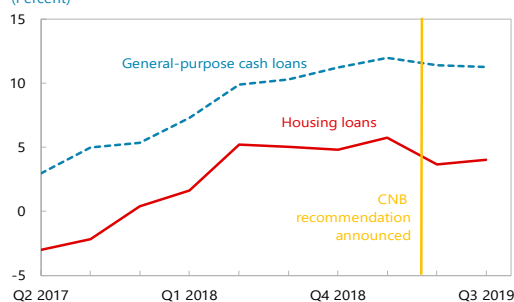
23. Bank lending to households is expected to remain strong. Bank lending to households has stabilized around 33 percent of GDP, but the composition has changed. New lending is mainly driven by general-purpose cash loans. They are typically Kuna denominated, long-term and with long interest rate fixation 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 $\frac{3}{4}$ of their net salary. For other debtors, the salary exempt from seizure is $\frac{2}{3}$ 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**Growth Rates of Different Loans to Individuals**

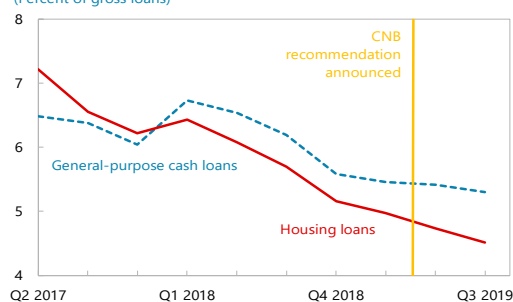
(Percent)



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

NPL Ratios of Different Loans to Individuals

(Percent of gross loans)



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

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.

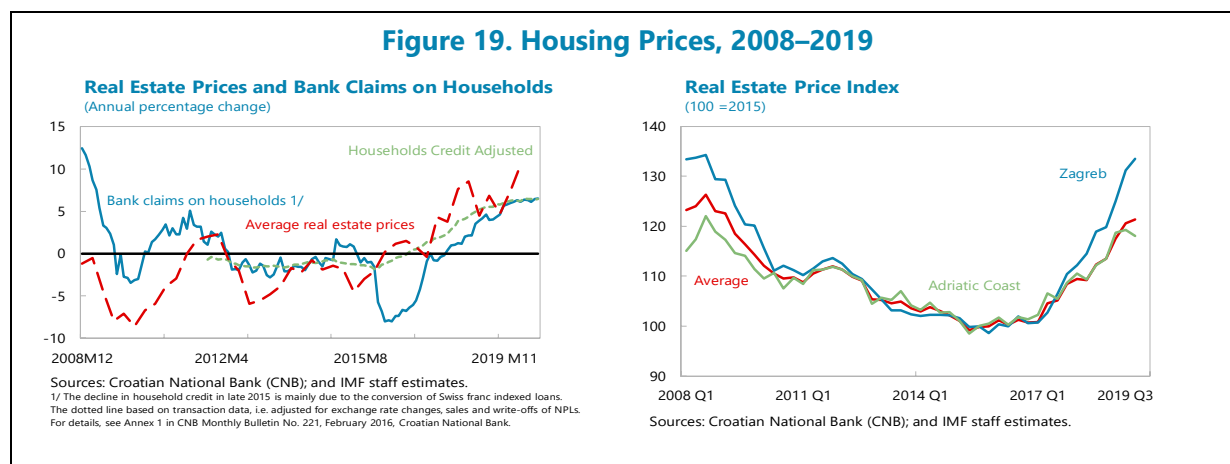
- **The credit registry of banks should promptly be made fully operational.** It stopped operating when some banks expressed ostensible concerns regarding frivolous lawsuits following the transposition of the EU's General Data Protection Regulation in May 2018. In August 2019, limited information about 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

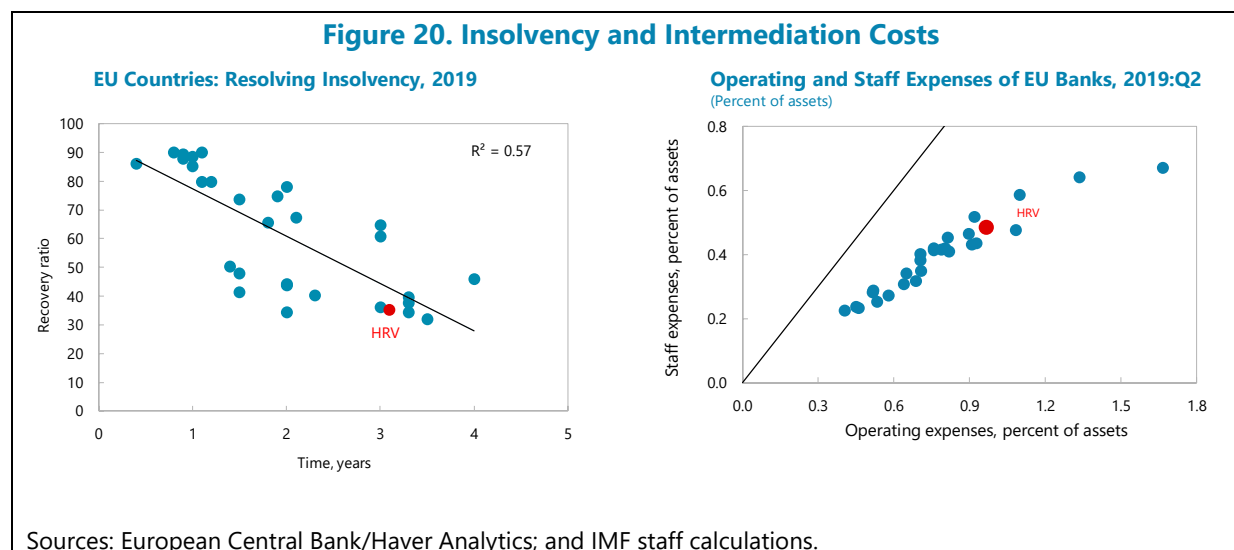
been supported by the government's housing loan subsidy program for young first-time house buyers introduced in 2017¹⁰ and the reduction of the real estate transfer tax since 2019. According to the CNB's housing price index, real estate prices are now beginning to reach pre-crisis levels.¹¹ Staff recommended 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.



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-valued (Q1 2019 data).

Figure 20. Insolvency and Intermediation Costs

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.

STAFF APPRAISAL

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.

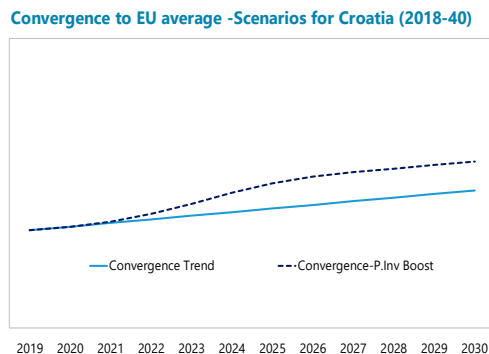
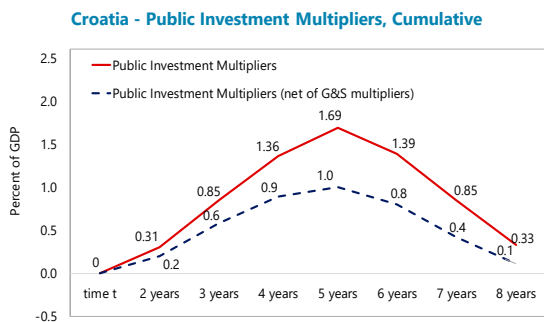
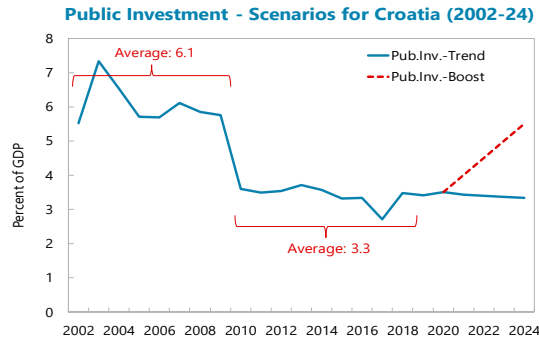
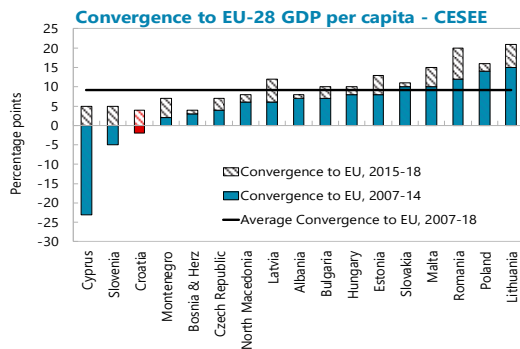
32. Renovating the capital stock and enhancing the business climate will help raise potential growth. Recent improvements in streamlining the administrative and fiscal burdens on the business sector are welcome. Staff encourages further progress in the areas of enhancing digital public services and adapting 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.



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 |
| <i>Of which</i> : 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 structural 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 | Q2 | 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 Analysis¹

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

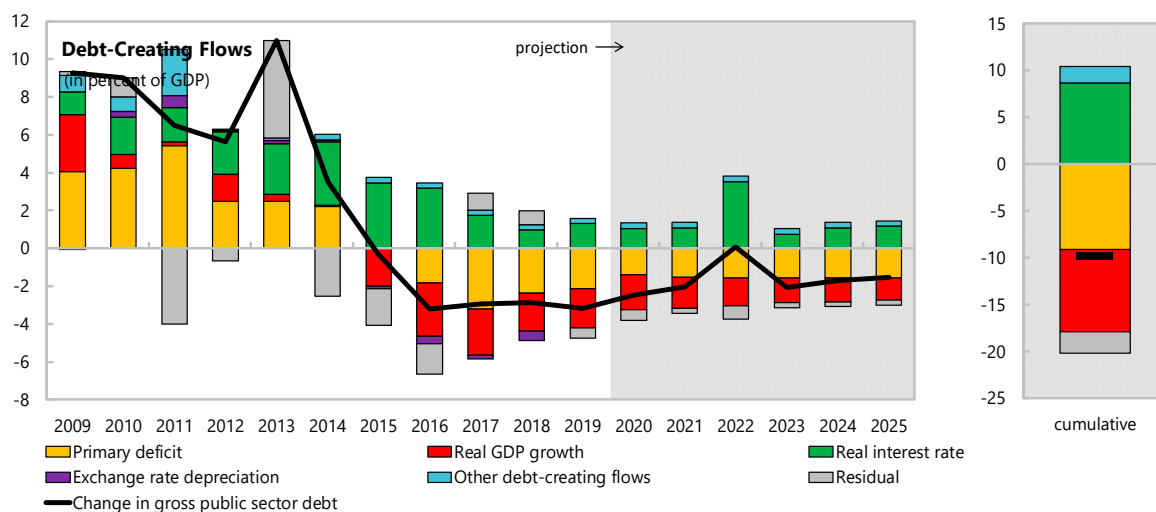
- **Slower output growth is the main risk to debt sustainability.** Underperformance of real GDP growth by one standard deviation results in the primary deficit deteriorating in 2022 to about -0.9 percent of GDP and debt sharply increasing to over 76.7 percent, before improving thereafter. Gross financing 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/} | | | | | | | | | | As of January 24, 2020 | | |
|--|-------------------------|------|------|-------------|------|------|------|------|------|--------------------------|-------------|-------|
| | Actual | | | Projections | | | | | | Sovereign Spreads | | |
| | 2009-2017 ^{2/} | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | EMBIG (bp) ^{3/} | 5Y CDS (bp) | |
| Nominal gross public debt | 71.7 | 74.7 | 71.5 | 69.1 | 67.0 | 67.1 | 65.0 | 63.3 | 61.8 | 93 | | |
| Public gross financing needs | 15.3 | 6.5 | 8.9 | 11.4 | 11.5 | 8.4 | 8.5 | 8.1 | 9.8 | 46 | | |
| Real GDP growth (in percent) | -0.3 | 2.7 | 2.9 | 2.7 | 2.5 | 2.2 | 2.1 | 2.0 | 2.0 | Ratings | Foreign | Local |
| Inflation (GDP deflator, in percent) | 1.0 | 1.8 | 1.4 | 1.6 | 1.7 | 1.7 | 2.0 | 2.1 | 2.0 | Moody's | Ba2 | Ba2 |
| Nominal GDP growth (in percent) | 0.6 | 4.5 | 4.4 | 4.3 | 4.3 | 3.9 | 4.1 | 4.2 | 4.0 | S&Ps | BBB- | BBB- |
| Effective interest rate (in percent) ^{4/} | 4.5 | 3.1 | 3.3 | 3.2 | 3.4 | 3.4 | 3.5 | 3.7 | 3.8 | Fitch | BBB- | BBB- |

| Contribution to Changes in Public Debt | | | | | | | | | | | |
|---|-----------|------|------|-------------|------|------|------|------|------|------------|--|
| | Actual | | | Projections | | | | | | cumulative | debt-stabilizing primary balance ^{9/} |
| | 2009-2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | | |
| 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 | |
| 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 | 0.3 |



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 $[(r - \pi(1+g) - g + ae(1+r)] / (1+g+\pi+g\pi)$ 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).

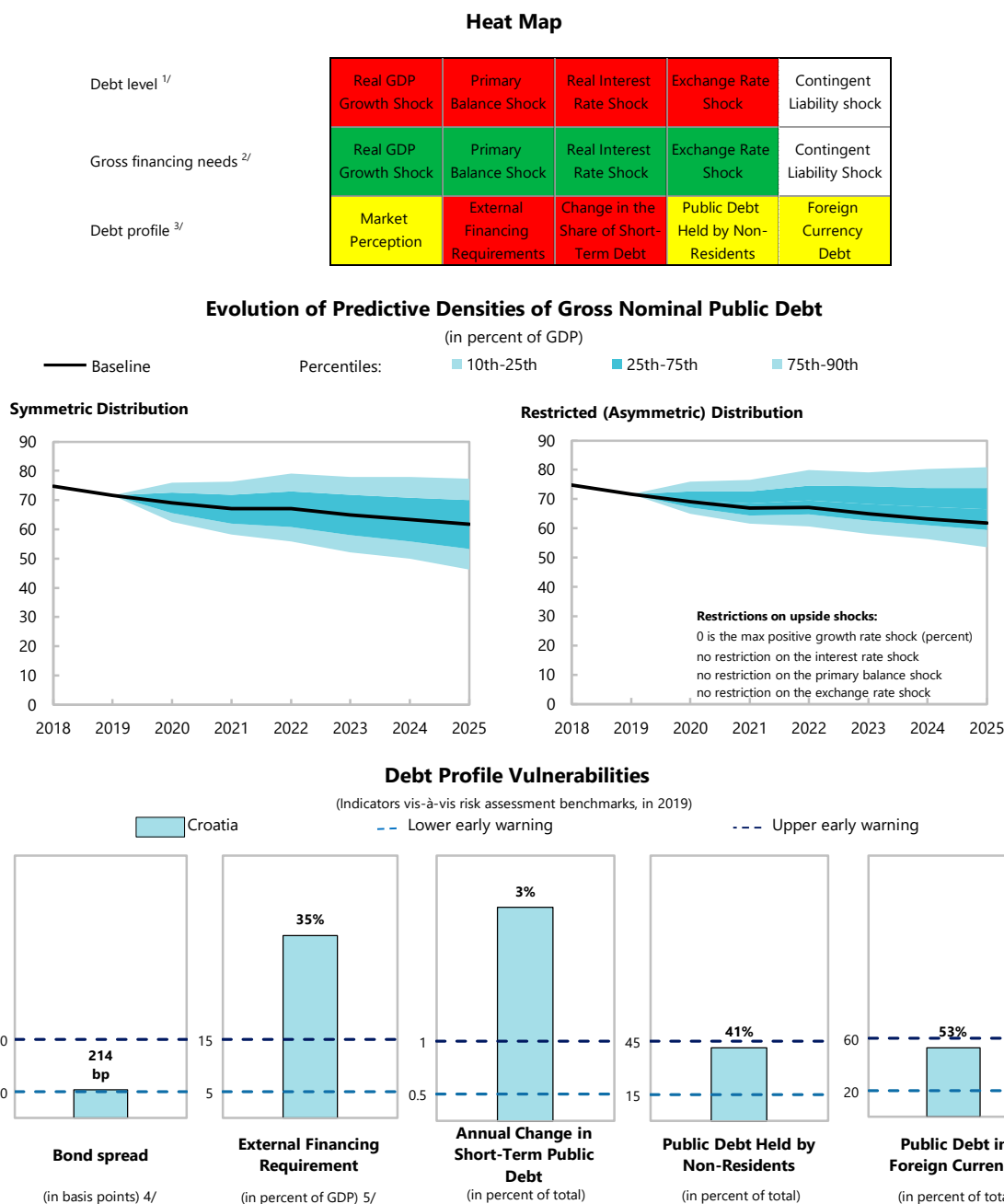
6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

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



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.

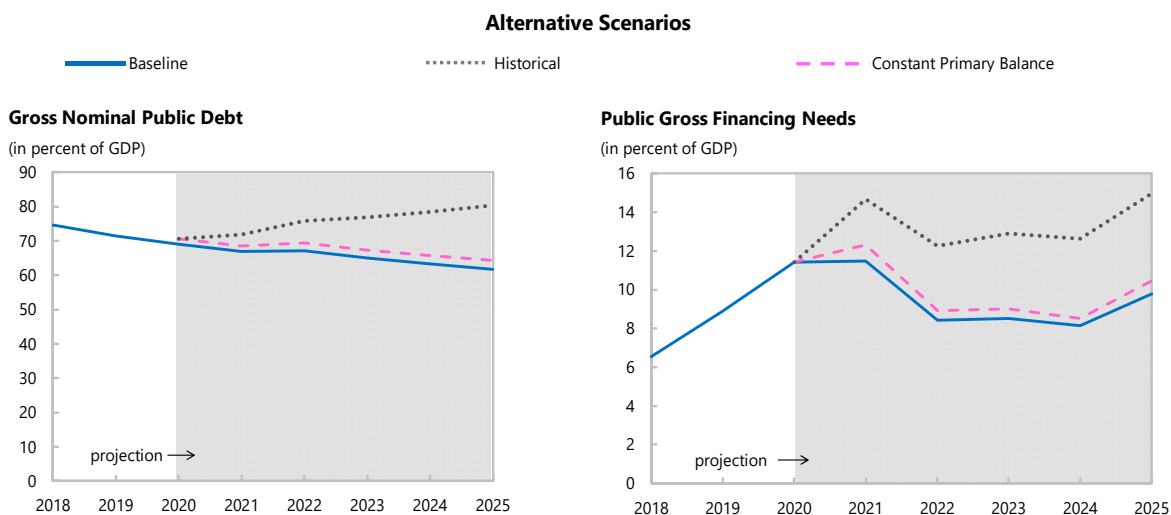
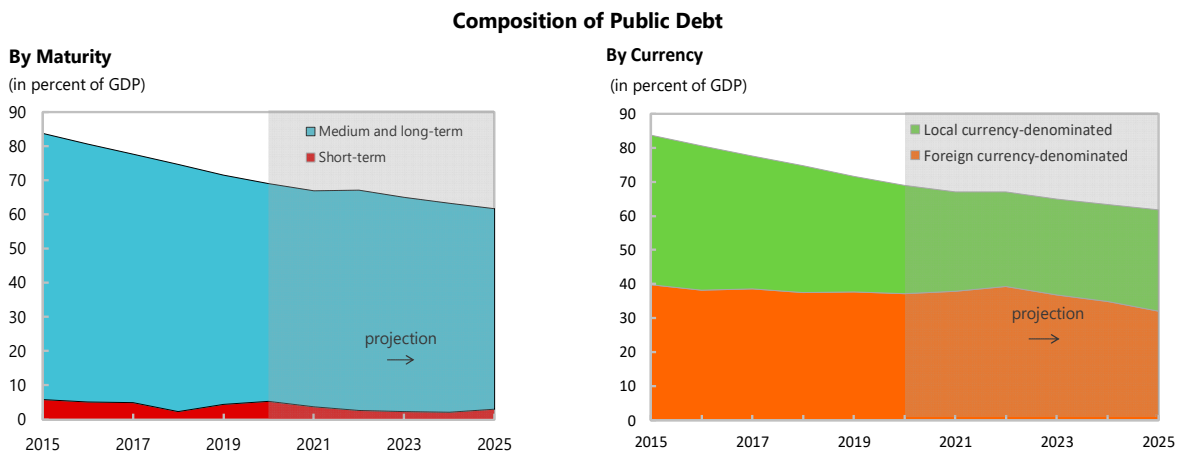
2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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



Underlying Assumptions

(in percent)

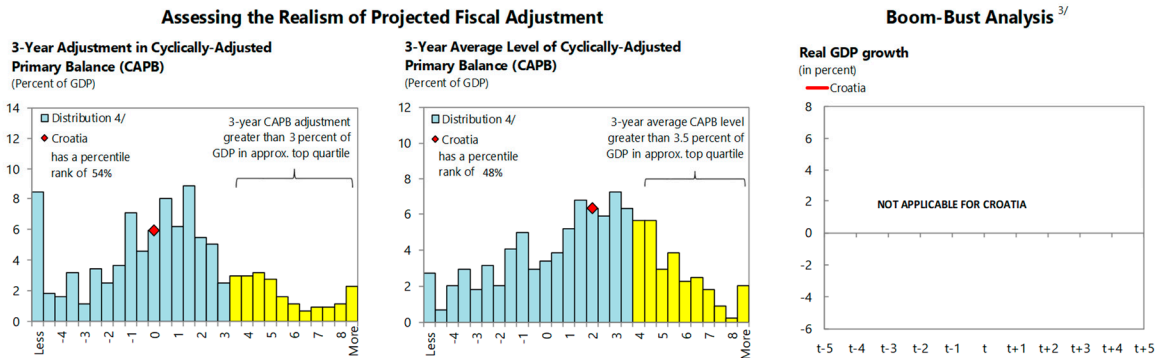
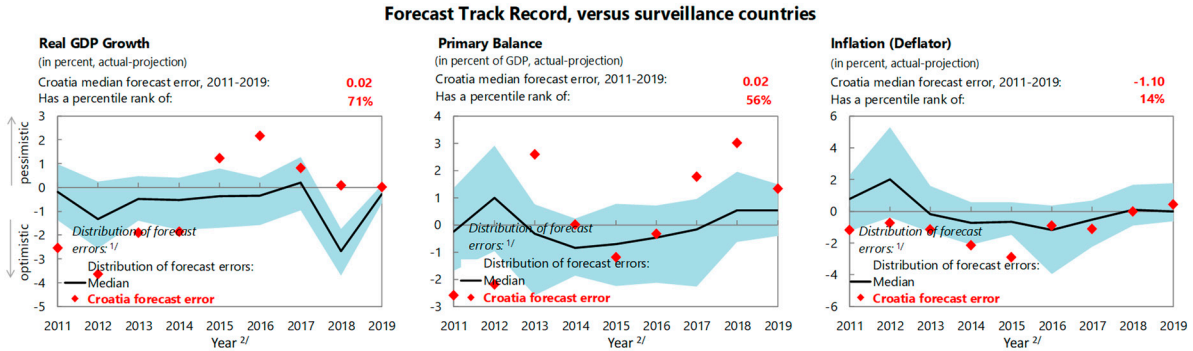
| Baseline Scenario | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|-------------------------|------|------|------|------|------|------|
| Real GDP growth | 2.7 | 2.5 | 2.2 | 2.1 | 2.0 | 2.0 |
| Inflation | 1.6 | 1.7 | -1.8 | 2.2 | 2.0 | 2.0 |
| Primary Balance | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 |
| Effective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

| 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 |

| Constant Primary Balance 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 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| Effective interest rate | 3.2 | 3.4 | 3.4 | 3.5 | 3.8 | 4.0 |

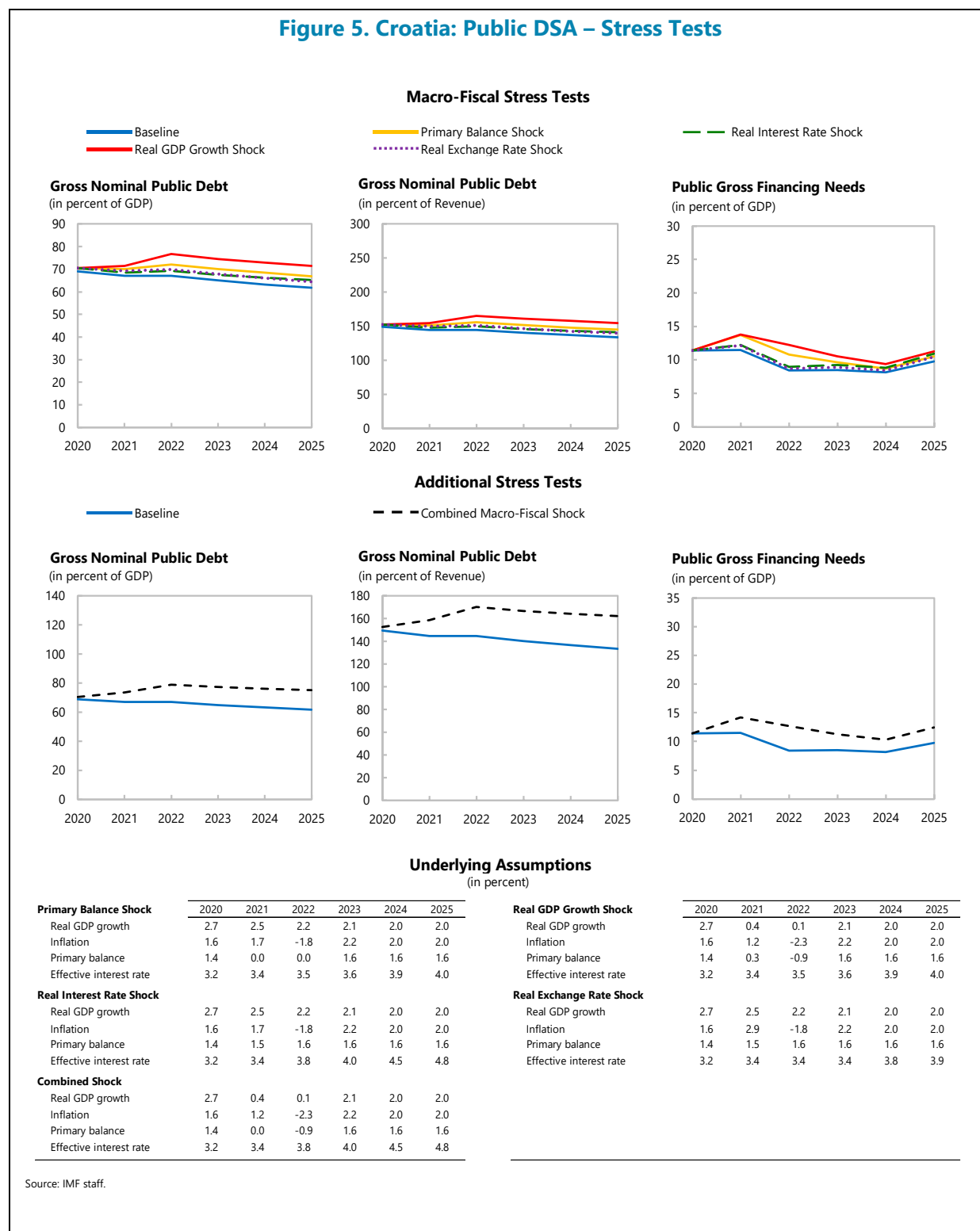
Source: IMF staff.

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 observations 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



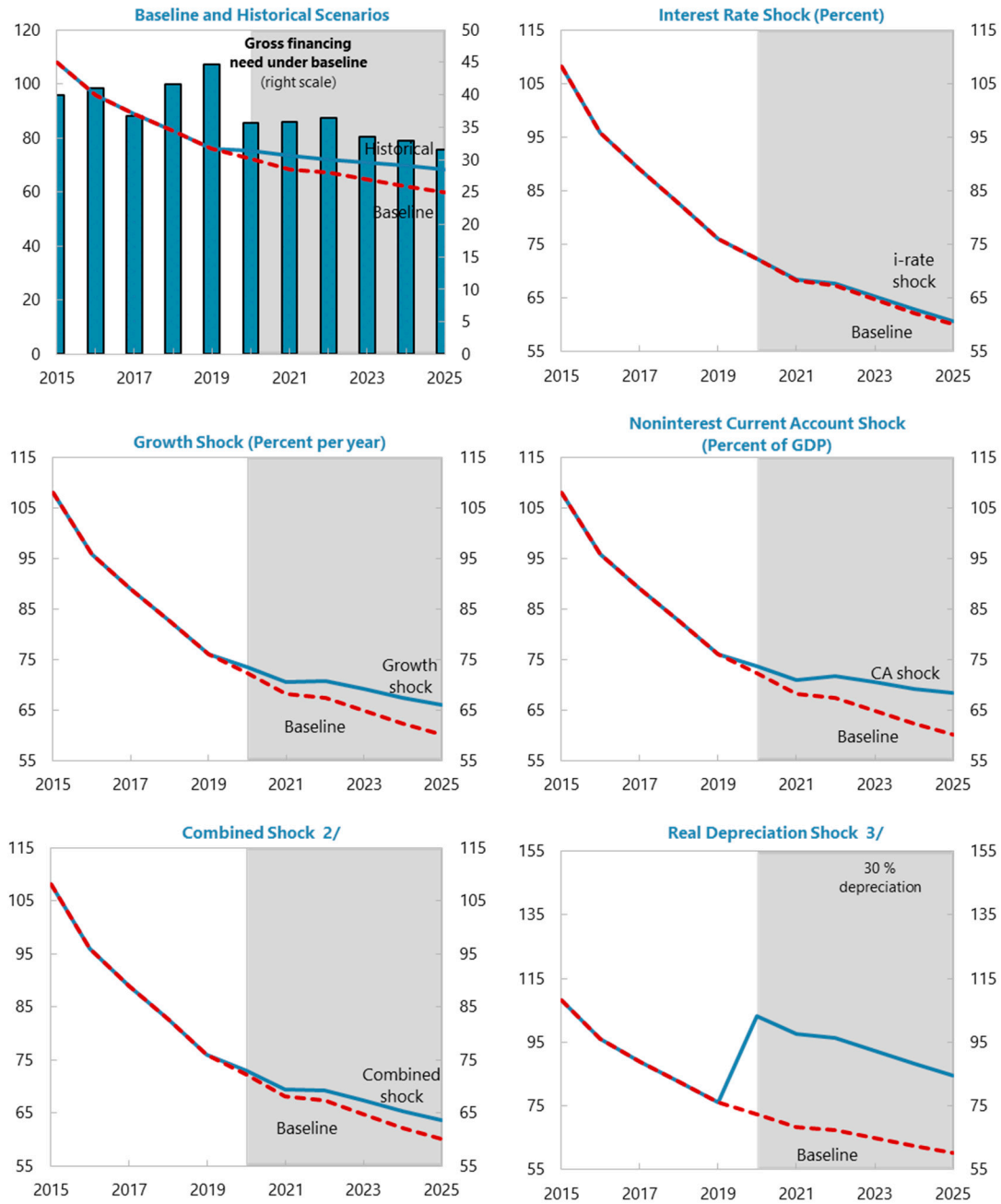
Annex III. External Debt Sustainability Analysis

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.

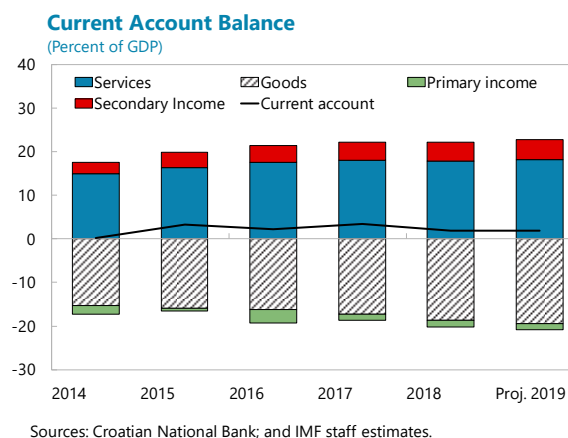
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

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

Annex IV. External Sector Assessment¹

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.

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.



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 norm² 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 adjustment 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 Matrix¹

| | 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 The 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. |



REPUBLIC OF CROATIA

January 30, 2020

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department in Consultation with Other
Departments

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FUND RELATIONS

(As of December 31, 2019)

Membership Status: Joined: December 14, 1992; Article VIII

| General Resources Account: | <u>SDR Million</u> | <u>%Quota</u> |
|--|---------------------------|----------------------|
| <u>Quota</u> | 717.4 | 100.00 |
| <u>Fund holdings of currency (Exchange Rate)</u> | 717.14 | 99.96 |
| <u>Reserve Tranche Position</u> | 0.27 | 0.04 |

| SDR Department: | <u>SDR Million</u> | <u>%Allocation</u> |
|----------------------------------|---------------------------|---------------------------|
| <u>Net cumulative allocation</u> | 347.34 | 100.00 |
| <u>Holdings</u> | 303.85 | 87.48 |

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

| <u>Type</u> | <u>Date of Arrangement</u> | <u>Expiration Date</u> | <u>Amount Approved (SDR Million)</u> | <u>Amount Drawn (SDR Million)</u> |
|-------------|----------------------------|------------------------|--------------------------------------|-----------------------------------|
| Stand-By | Aug 04, 2004 | Nov 15, 2006 | 99.00 | 0.00 |
| Stand-By | Feb 03, 2003 | Apr 02, 2004 | 105.88 | 0.00 |
| Stand-By | Mar 19, 2001 | May 18, 2002 | 200.00 | 0.00 |

Projected Payments to Fund¹

(SDR Million; based on existing use of resources and present holdings of SDRs):

| | Forthcoming | | | | |
|------------------|-------------|-------------|-------------|-------------|-------------|
| | 2020 | 2021 | 2022 | 2023 | 2024 |
| Principal | | | | | |
| Charges/Interest | 0.33 | 0.33 | 0.33 | 0.33 | 0.33 |
| Total | 0.33 | 0.33 | 0.33 | 0.33 | 0.33 |

Exchange Rate Arrangement:

In December 1991, Croatia adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with tight management of the kuna-euro exchange rate by the Croatian National Bank (CNB). The *de jure* exchange rate arrangement is a managed float without a predetermined path. Since April 2016, the kuna has stabilized within a 2 percent band

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

against the euro. Accordingly, the de facto exchange rate arrangement is classified as a stabilized arrangement. The CNB transacts only in euros, U.S. dollars, and SDRs. On November 30, 2019, the official exchange rate was kuna 7.4 per euro (middle rate).

Exchange System:

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of multiple currency practices and restrictions on payments and transfers for current international transactions, except for restrictions that Croatia maintains solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51). There are no capital account restrictions.

Anti-Money laundering and Financing of Terrorism:

In October 2017, a new Law on Prevention of Money Laundering and Terrorism Financing was adopted to transpose the 4th AML EU Directive (2015/849) and FATF (2012) recommendations.

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on February 8, 2019 (IMF Country Report No. 19/46: <https://www.imf.org/en/Publications/CR/Issues/2019/02/12/Republic-of-Croatia-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-46594>). Croatia is on the 12-month consultation cycle.

FSAP:

An FSAP Update mission took place in October–November 2007. The FSSA Update was published (IMF Country Report No. 160: <http://www.imf.org/external/country/hrv/index.htm>).

The original FSAP was concluded with the completion of the 2002 Article IV consultation on August 5, 2002 on the basis of missions that took place in April 2001 and September 2001. The FSSA was published (IMF Country Report No. 02/180: <http://www.imf.org/external/country/hrv/index.htm>).

Technical Assistance 2000–13:²

| Department | Timing | Purpose |
|-------------------|--|---|
| FAD | April 2000 | Implementation of Single Treasury Account |
| | May 2000 | Tax Policy |
| | September 2001 | Fiscal Decentralization |
| | March 2002 | Fiscal Management (with STA) |
| | September 2003– March 2004 | A Resident Advisor on Fiscal Reporting |
| | February 2004 | Public Debt Management Program (with World Bank) |
| | May 2004 | Public Expenditure Management |
| | May 2004 | Fiscal ROSC |
| | April 2005 | Review of Indirect Tax Performance and Tax Administration |
| | June 2006 | Regional Public Financial Management (PFM) Advisor |
| | February–March 2007, July 2008, February– March 2009 | Revenue Administration (with World Bank) |
| | April 2007 | Public-Private Partnerships |
| | May 2007 | Tax Policy (with World Bank) |
| | January–February 2008 | Short-Term Expenditure Rationalization |
| | February 2010 | PFM (long-term advisor visit) |
| | October 2010 | Regional expert participation on seminar on Croatian budget management and fiscal policy |
| | March 2011 | Short-term expert visit on Tax Administration Reform |
| | June 2011 | Short-term expert participation at OECD meeting |
| | June 2012 | Options for Modernizing the Property Tax Government Opportunities for Strengthening the Tax Administration (HQ mission) |
| | October 2012 | Short-term expert visit on phasing in a modern Compliance Risk Management Model |
| | October 2012 | Short-term expert visit on improving tax administration governance and organization structures |
| | April 2013 | Public Financial Management: Budget Procedure |
| | April–May 2013 | Fiscal Rules |

² Technical assistance during 1992–99 is listed in Annex I of IMF Country Report No. 03/27.

| | | |
|-----|--|---|
| | June 2013 December 2014 | Strengthening Tax Administration Governance Workshop on Public Expenditure Review (Expert visit) |
| STA | March 2000 September 2000 October 2000 April 2001 November 2001 October 2002, June 2004 September 2006 December 2007 | Quarterly National Accounts Balance of Payments Real Sector Statistics Monetary and Banking Statistics Regional Visit on Reserves Data Template Government Finance Statistics Monetary and Financial Statistics LTE: Government Finance Statistics |
| MCM | May–June 2000 March–April 2001 December 2001 April 2003 February 2004 January 2007– continuing May 2007 June 2007 September 2007 October 2007 November 2007 March 2008 August 2008 February 2009 July 2009 May 2010 November 2011 March 2013 | Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets Central Bank Accounting Monetary Policy Instruments Stress Testing and FX Reserve Management Monetary Policy Instruments Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting Modeling and Forecasting Modeling and Forecasting FSAP Update Modeling and Forecasting Modeling and Forecasting Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting Macro-Financial Modeling Monetary Policy and Modeling Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting Macro-Financial Modeling and Forecasting |
| LEG | January 2010–April 2011 May 2011–April 2012 December 2011–April 2013 | AML/CFT—Risk based supervision in non- financial sectors AML/CFT—Strengthening the FIU and risk based supervision in non-financial sectors AML/CFT—Preliminary National Risk Assessment |

WORLD BANK RELATIONS

As of December 2019, Croatia has been collaborating with the World Bank Group.

Further information can be obtained from the following hyperlink.

| International Financial Institution | Hyperlink |
|--|---|
| The World Bank Group | https://www.worldbank.org/en/country/croatia |

STATISTICAL ISSUES

| Croatia—Statistical Issues (As of January 2020) |
|--|
| I. Assessment of Data Adequacy for Surveillance |
| <p>General: Data provision is broadly adequate for surveillance, with a few shortcomings related to data coverage and reliability.</p> |
| <p>National Accounts: The national accounts have strengthened in recent years but further improvement is needed. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the ESA 2010 standard. However, a breakdown of gross fixed capital formation into private and public components is not published as this is not required by the Eurostat. Minor discrepancies exist between nominal government consumption in national accounts and government consumption reported in government ESA 2010 accounts; and they are being resolved.</p> |
| <p>Wages and Employment: The CBS produces data on average net and gross earnings per person and employment by sector. Currently, the CBS is in the process of reviewing the data series. Earnings data include bonuses (in sums that are subjects to contributions, taxes, and surtaxes), sick pay, and meal allowances. They are based on data from the report on Income, Income Tax and Surtax as well as Contributions for Mandatory Insurances (JOPPD form).</p> <p>The number of registered unemployed overstates the actual level of unemployment. However, the discrepancy has significantly diminished in 2014. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample was subsequently expanded and the survey is now being conducted on a regular basis. Semi-annual results have been released since 1998, and quarterly results since 2007, with a lag of about four months.</p> |
| <p>Price Statistics: The CBS produces a monthly consumer price index, with expenditure weights (updated at least once in every five years) derived from the Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups, but in most cases between the thirteenth and the twenty-third day of each month. (Prices of agricultural products sold in market places are recorded on the first and third Friday in a month and prices of fuel for passenger cars weekly.) The indices are released around the fifteenth day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country.</p> |

A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology. A core CPI is calculated based on a methodology developed by the Croatian National Bank (CNB). The CBS also releases a monthly producer price index (PPI), usually on the eighth day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year. A quarterly house price index is also disseminated.

Government Finance Statistics: The authorities have started presenting some budget plans based on the ESA 2010 framework. However, the State Budget and the local budgets are based on the national Chart of Accounts. Historical general government data based on ESA 2010 definitions are published nationally by the Croatian Bureau of Statistics and by Eurostat, but are frequently revised due to methodological and data source improvements. Additional analysis has been initiated in order to assess whether some enterprises owned by local government units should be included in the government sector according to the ESA 2010 criteria.

Budget execution (cash) data are produced on a monthly basis on the GFSM framework (GFS 2001) and are available in the monthly *Statistical Review* of the Ministry of Finance (MOF) and in the time-series database, both published on the website of the MOF. Central government data normally come with a lag of about six weeks, but end-of-year data often with much longer lags. Revenue data are reliable, and expenditure data on a cash basis are available according to GFS classifications (economic and functional) for the central budget and extra-budgetary funds. However, changes of institutions included in the central government are not always clearly indicated, hence central government figures are not fully comparable over time.

Cash data for the operations of local governments and the consolidated general government are available on a quarterly basis, but for end-of-year data with long lags. Starting from the January-March 2015 period, data for local and regional self-government units (local units), instead of former 53 largest, include all 576 local units and the local units' extra-budgetary users - county road administrations.

According to the latest *Agreement on cooperation in the field of national accounts of general government and related statistics* (signed on July 31, 2013 between the Croatian Bureau of Statistics, Croatian National Bank (CNB), and Ministry of Finance), the CNB took over the responsibility for the compilation of general government debt statistics. The CNB is compiling general government debt according to ESA 2010 and EDP definitions and publishes these data on the CNB website. Data showing the level of general government guaranteed debt are presented as a part of the reporting table I.3 on the same website.

Monetary and Financial Statistics: Beginning 2015, the CNB started to publish monetary statistics using the *ESA 2010* framework and the national residency approach, with some backward revisions of historical data series. The IMF's Statistics Department receives monthly monetary statistics on

Croatia for the CNB and other depository corporations (ODCs) directly from the European Central Bank since July 2013, prior to this date, data were reported by the CNB. Data on other financial corporations (OFC) are currently not available.

Financial Sector Surveillance: The CNB is the banking sector supervisor and quarterly reports all core and 14 encouraged financial soundness indicators (FSI) to the IMF's *Financial Soundness Indicator Database*. A general description of the stress testing methodologies used on the Croatian banking system is included in the *Financial Stability Report*, published by the CNB once a year. Summary balance sheets and profit and loss statements of individual banks are reported in the *Bank Bulletin*, published once a year, with a lag of six to nine months.

The Croatian Financial Services Supervisory Agency (HANFA) publishes monthly reports and monthly summary statistics on the sectors it regulates and supervises (capital markets, investment funds, private pension sector, insurance, leasing, and factoring companies).

External Sector Statistics: Quarterly balance of payments and international investment position data are compiled broadly in accordance with the sixth edition of the IMF's *Balance of Payments Manual (BPM6)*. Data are generally available with a lag of three months and are subject to revisions in subsequent releases. Net errors and omissions have ranged from -1 to +3½ percent of GDP since 2005. The coverage and quality of portfolio investment data are reasonably complete and accurate.

Croatia participates in the *Coordinated Direct Investment Survey (CDIS)* and plans to participate in the *Coordinated Portfolio Investment Survey (CPIS)* after the new security database becomes operational. Data on the International Reserves and Foreign Currency Liquidity (Reserve Data Template) are available with a lag of one to two months.

Croatia compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2013*.

II. Data Standards and Quality

Croatia began subscription to the Fund's Special Data Dissemination Standard (SDDS) in May 1996 and met all SDDS requirements in March 2001.

No data ROSC has been published.

Croatia: Table of Common Indicators Required for Surveillance
(As of December 31, 2019)

| | Date of latest observation | Date received | Frequency of data 6/ | Frequency of reporting 6/ | Frequency of publication 6/ |
|---|----------------------------|---------------|----------------------|---------------------------|-----------------------------|
| Exchange Rates | 14/06/19 | 14/08/19 | D and M | D and M | D and M |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/ | Dec. 2019 | 01/13/19 | M | M | M |
| Reserve/Base Money | Nov. 2019 | 11/30/19 | M | M | M |
| Broad Money | Nov. 2019 | 11/30/19 | M | M | M |
| Central Bank Balance Sheet | Dec. 2019 | 01/13/19 | M | M | M |
| Consolidated Balance Sheet of the Banking System | Nov. 2019 | 11/30/19 | M | M | M |
| Interest Rates 2/ | Nov. 2019 | 11/30/19 | M | M | M |
| Consumer Price Index | Dec. 2019 | 01/17/19 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/ | 2019:Q3 | Nov. 2019 | Q | Q | Q |
| Revenue, Expenditure, Balance and Composition of Financing 3/— Central Government | 2019:Q3 | Nov. 2019 | M | M | M |
| Stocks of Central Government and Central Government-Guaranteed Debt 5/ | 2019:Q3 | Nov. 2019 | M | M | M |
| External Current Account Balance | 2019:Q3 | Nov. 2019 | Q | Q | Q |
| Exports and Imports of Goods and Services | 2019:Q3 | Nov. 2019 | Q | Q | Q |
| GDP/GNP | 2019:Q3 | Nov. 2019 | Q | Q | Q |
| Gross External Debt | 2019:Q3 | Nov. 2019 | M | M | M |
| International Investment Position | 2019:Q3 | Nov. 2019 | Q | Q | Q |

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

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

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

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

5/ Including currency and maturity composition.

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