June 2011
IMF Country Report No. 11/159

Republic of Croatia: 2011 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Croatia

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 2011 Article IV consultation with Croatia, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 16, 2011, with the officials of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 8, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of June 24, 2011 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 24, 2011 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for the Republic of Croatia.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Staff Report for the 2011 Article IV Consultation

Prepared by the European Department in Consultation with Other Departments

Approved by Juha Kähkönen and Claire Waysand

June 8, 2011

Background: Croatia's recovery is lagging behind most other emerging economies in Europe. EU accession negotiations are in final stages, but to fully utilize the benefits of EU membership, the economy needs to be significantly revamped. Yet strong social opposition and upcoming parliamentary elections to be held by early 2012 have constrained implementation of reforms.

Challenges: (i) Addressing deep-rooted structural rigidities and competitiveness problems to improve medium-term growth prospects; (ii) reducing vulnerabilities arising from rapidly increasing public debt, high external indebtedness, and balance sheet exposures to foreign currency risks; and (iii) mitigating credit and funding risks in the banking sector.

Staff views: A consistent set of macroeconomic, structural, and financial sector policies is needed to boost confidence and competitiveness, and create foundations for sustained economic growth. Priority needs to be given to internal devaluation, in light of the stable exchange rate policy, through reduction in wages and prices, comprehensive structural reforms, and an expenditure-based fiscal consolidation. Structural reforms should focus on increasing labor market flexibility, reducing state participation in the economy, and improving the business environment. Additional fiscal measures are needed to prevent a rise in the deficit in 2011 and preserve market confidence. In the medium term, an expenditure-based consolidation of about one percent of GDP annually is required to reverse the rise in the public debt. Monetary policy should aim to gradually strengthen foreign exchange reserves, unless sustained depreciation pressures occur, while continued strong regulatory and supervisory measures are needed to contain risks in the banking sector.

Authorities' views: The authorities broadly agreed with staff on the need to address structural problems, and pointed out that the Economic Recovery Program outlined measures needed to tackle these issues, and was being implemented. Some contingency measures have already been identified to contain the 2011 budget deficit. The authorities see the need for substantial expenditure-based consolidation over the medium term to ensure fiscal sustainability. The Croatian National Bank argued that the reserve coverage was adequate, particularly when taking into account the commitment of foreign banks to maintain their exposures, but agreed that the external position was vulnerable and saw merit in higher buffers to fend off potential pressures. The authorities concurred with staff about risks to the banking system, but pointed out that the sector is sufficiently resilient to withstand possible shocks.

Exchange rate. *De jure* managed float with no predetermined path; *de facto* crawl like arrangement under the Fund's classification. Croatia has accepted the obligations under Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

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I. CONTEXT

1. **Against the backdrop of weak growth prospects and high vulnerabilities, the Article IV discussions focused on the appropriate policy mix to improve the growth outlook and enhance the resilience of the Croatian economy.**[1]

- *Promoting recovery and sustainable medium-term growth.* After a prolonged downturn, growth prospects are mired by weak competitiveness and pervasive structural rigidities. With a stable exchange rate policy, the challenge is to adjust incomes and prices to more competitive levels, and to undertake comprehensive structural reforms and an expenditure-based fiscal consolidation.
- *Reducing vulnerabilities and enhancing resilience to shocks.* With significant vulnerabilities arising from high external and foreign currency indebtedness and deteriorating public finances, the challenge is to create space for macroeconomic management by reversing the rise in public debt and building up foreign exchange buffers.

2. **The upcoming accession of Croatia to the European Union (EU) presents a tremendous opportunity**. Croatia should use the intervening period to improve its competitiveness that would facilitate FDI inflows and ultimately boost income convergence to EU levels. Implementation of critical but socially-sensitive reforms is likely to be influenced by a lack of consensus and the political environment, with general elections to be held by early 2012.

II. BACKGROUND—ECONOMIC RECOVERY IS DELAYED

3. **Croatia's recovery is lagging behind most other European countries (Figure 1 and Table 1).** In 2010, investment plummeted due to low confidence, private consumption was constrained by household deleveraging and falling employment, while inventories were drawn down further. Exports rebounded strongly, but given their narrow base, were insufficient to pull Croatia out of the recession. As a result, GDP declined by 1¼ percent in 2010, and by 0.9 percent in first quarter of 2011.

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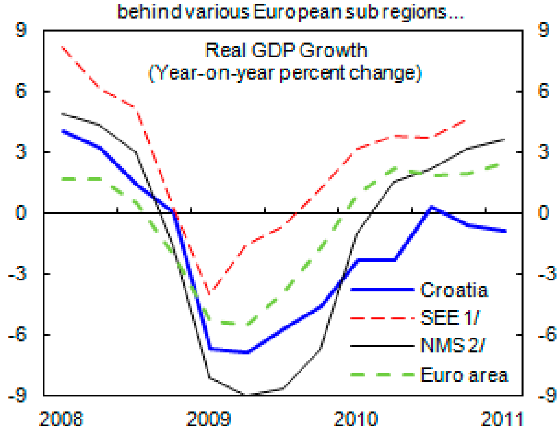
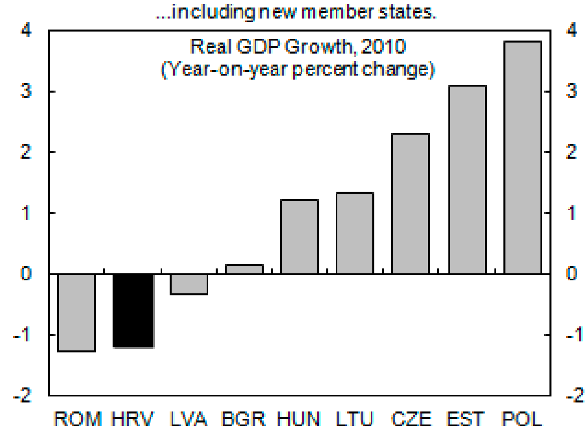
[1] The Article IV discussions took place in Zagreb during May 5-16, 2011. The mission team included Ms. Murgašová (head), Mr. Darius and Ms. Rahman (all EUR), and Mr. Prokopenko (MCM). Mr. Lambregts (Advisor to the Executive Director) joined the discussions. The mission met with Prime Minister Kosor, Croatian National Bank Governor Rohatinski, Finance Minister Dalić, other senior officials, as well as representatives of the Parliament, financial and business sectors, and trade unions.

Croatia's recovery is lagging behind various European sub regions...



Sources: Haver; and IMF staff estimates.
1/ Simple average. Includes Albania, Macedonia, Serbia, and Turkey.
2/ Simple average. Includes Bulgaria, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Rep., and Slovenia.

...including new member states.

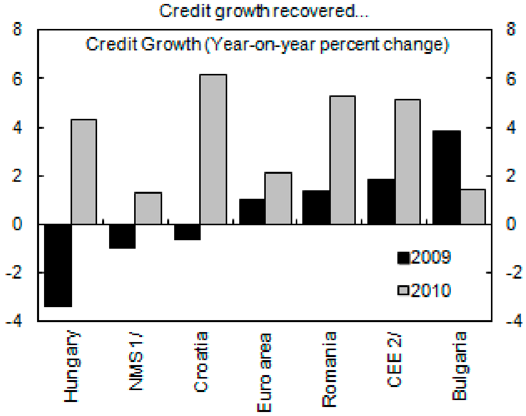


Sources: Crostat; IMF, *World Economic Outlook*; and IMF staff estimates.

4. **Economic slack has contained price and wage inflation (Figures 2 and 3).** Consistent with a large and widening negative output gap and a significant deterioration in labor market conditions, core inflation and nominal wage growth remain subdued. However, rising food and fuel prices have led to a rise in producer prices and headline inflation since late 2010.

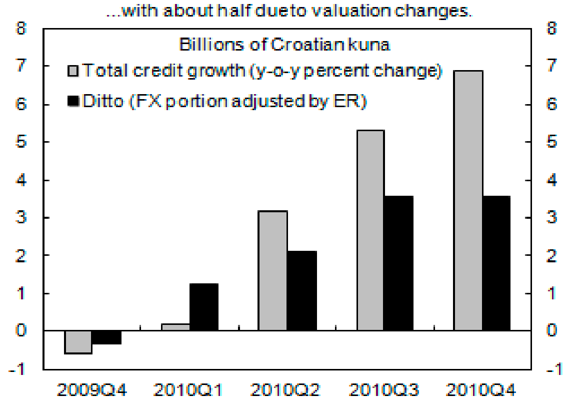
5. **The slight credit recovery was aided by official credit-support schemes and accommodative monetary policy (Figure 4 and Table 2).** With inflation contained, the Croatian National Bank (CNB) maintained a high level of liquidity in the banking system, part of which was channeled into credit-support schemes which helped reduce corporate lending rates. Corporate lending grew faster than elsewhere in the region, but given that a substantial portion of it was used to finance working capital or to refinance the existing loans, it failed to boost economic activity.

Credit growth recovered...



Sources: IMF, *International Financial Statistics*; and IMF staff estimates.
1/ Simple average. Includes Bulgaria, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Rep., and Slovenia.
2/ Simple average. Includes Czech Rep., Hungary, Poland, and Slovak Rep.

...with about half due to valuation changes.

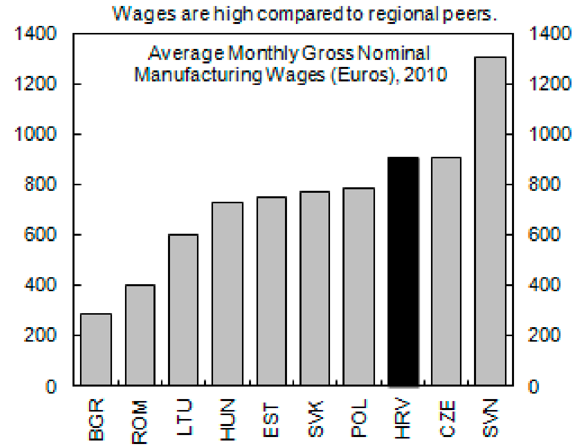


Sources: Croatian National Bank; and IMF staff calculations.

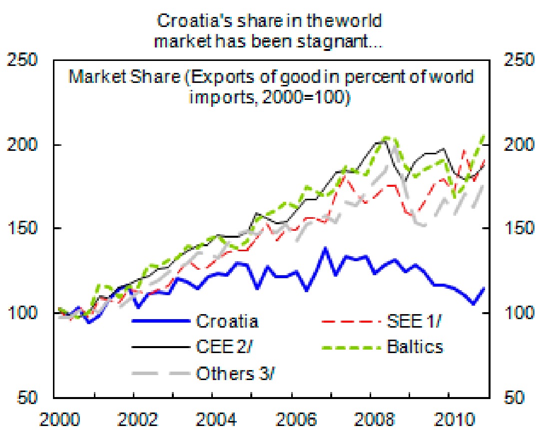
6. **Implementation of structural reforms to address competitiveness problems has been mixed.** In early 2010, the government outlined comprehensive fiscal and structural reforms in the Economic Recovery Program (ERP). These reforms aimed at promoting recovery and creating a competitive economy, and were supported by staff in the 2010 Article IV consultation. Important progress was achieved in several areas. The pension law was amended to gradually harmonize the retirement age between men and women at 65 years by 2030, increase penalty for early retirement, and introduce incentives to delay retirement. The unemployment law was changed to reduce benefits and duration. Judicial reforms were instituted to strengten bankruptcy procedures for companies. Business registration procedures were streamlined, and non-tax fees, which act as a deterrent to private investment, were reduced by 25 percent. Yet implementation of other reforms, which are key to resolving long-standing competitiveness problems, such as greater flexibility in wage setting mechanisms, privatization, and reduction of public administration, has been hampered by strong social resistance (Box 1).

Box 1: Croatia's Competitiveness

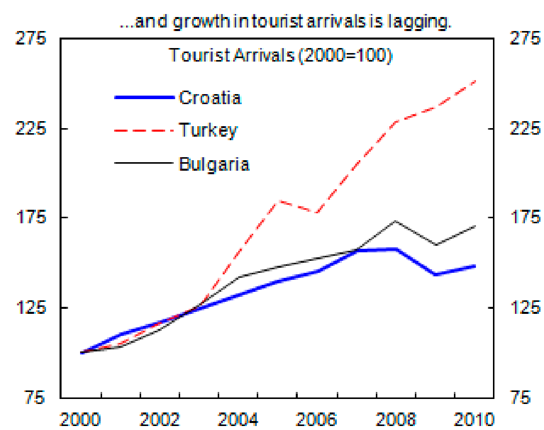
Croatia has deep-rooted competitiveness problems (Figure 5). CGER based estimates suggest that the real exchange rate is broadly in line with equilibrium (Annex 1).Yet wages are high compared to both income and productivity levels (particularly as aggregate productivity is likely to be overestimated given the public sector's higher wages and large share in the economy). In addition, there are substantial non-price competitiveness weaknesses. Government's involvement in economic activities in Croatia is greater than in many of its peer European countries. Delays in large-scale privatization and enterprise restructuring have led to low competition and relatively high state subsidies. Strict labor regulations, combined with generous social benefits, have kept labor force participation low. Despite recent improvements, many aspects of business cost are several times higher than in regional peers, including due to intrusive regulations and cumbersome fees imposed on the private sector. Croatia benefited less than its peers from productivity enhancing greenfield FDI inflows into the tradable sector during the pre crisis period. Consequently, Croatia's export growth and penetration in the EU market have been among the slowest in emerging Europe during the last decade.



Sources: Haver; DXTime; Bloomberg; and IMF staff estimates.



Sources: IMF, *Direction of Trade Statistics*; and IMF staff calculations and estimates.
1/ Includes Albania, Bosnia and Herzegovina, and Macedonia.
2/ Includes Bulgaria, Czech Rep., Hungary, Poland, Romania, Slovak Rep., and Slovenia.
3/ Includes Russia, Turkey, and Ukraine.



Sources: DXTime; Haver; and IMF staff estimates.

7. **The authorities' efforts did not prevent further fiscal deterioration in 2010 (Table 3).** Despite substantial positive contributions from measures undertaken in 2009 and 2010, the general government's deficit widened to 5 percent of GDP in 2010 on the back of falling revenues. This was largely caused by declining profit and income taxes and social contributions, as corporate profitability and employment plunged, and reduction in income tax rates (contrary to staff's previous advice) also contributed. Public debt reached 41 percent of GDP.

Fiscal Developments of the General Government, 2008–10

(Percent of GDP)

	2008	2009	2010 Est.
Revenue	39.5	38.4	37.2
Expenditure	40.7	42.5	42.2
Overall balance	-1.3	-4.1	-5.0
Primary balance	0.1	-2.4	-3.0
Cyclically-adjusted balance	-2.3	-2.9	-3.2
Broader public sector balance 1/	-2.3	-5.4	-5.2
Public sector direct debt	29.0	35.2	41.2
Public sector guaranteed debt	13.0	15.2	17.5

Sources: Ministry of Finance; and IMF staff estimates.

1/ Includes Croatian Bank for Reconstruction and Development (HBOR) and Croatian Motorways (HAC) balances.

Measures Taken During 2009–10 and Their Fiscal Impact in 2010 1/

(Percent of GDP)

2009 measures	1.7
VAT rate increase	0.4
Imposition of solidarity tax	0.5
Excise tax on mobile phone use	0.1
Wage and pension freeze	0.6
2010 measures	0.1
Income tax rate reduction	-0.2
Reduced previleged pensions	0.1
Hospital network rationalization	0.1
Cancellation of Christmas bonus	0.1

Sources: Ministry of Finance; World Bank; and IMF staff estimates.

1/ Indicates the size of reduction (-) or increase (+) in actual fiscal outcome relative to unchanged policies.

8. **The authorities remain strongly committed to the stable exchange rate policy.** The broadly stable nominal exchange rate provided an anchor for inflation expectations and financial stability, but also contributed to the accumulation of vulnerabilities. The stable exchange rate regime reduced perceptions of risk and contributed to the overleveraging in foreign currencies. This build-up of vulnerabilities acts as a constraint on exchange rate policy.[2]

9. **Vulnerabilities remain high despite substantial external adjustment (Figures 6 and 7, Tables 4 and 5).** Rising exports and a contraction in imports reduced the current account deficit to about 1¼ percent of GDP in 2010 from just under 9 percent of GDP in 2008. Capital inflows slowed down correspondingly due to excess capacity and weak economic prospects. Nevertheless, with external debt at 100 percent of GDP, and foreign currency gross indebtedness of the public and non-financial private sectors even larger, balance sheet vulnerabilities are high (Box 2).

[2] According to staff estimates, a 10 percent depreciation of the kuna would increase the net foreign currency indebtedness of public and non-financial private sectors by 8 percent of GDP.

Box 2: Balance Sheet Vulnerabilities

Vulnerabilities were built up during the boom years of 2002–07, when large capital inflows were channeled to the economy through the financial and corporate sectors, against the backdrop of a stable exchange rate, high euroization, and pro-cyclical fiscal policies. Key sector-specific risks include:

- Public sector. A large debt stock constrains policy space. High financing needs expose Croatia to adverse developments in international markets—if met externally—and to potential crowding out—if met domestically. Exchange rate risk is significant, as two thirds of the debt stock is held or linked to foreign currency.
- Non-financial private sector. High indebtedness has held back economic recovery. Households are deleveraging, and a downturn in investor sentiment could trigger corporate sector's deleveraging. Risks arise from foreign currency loans held by unhedged borrowers in case of depreciation, and a rise in interest rates due to mostly variable-rate lending.
- Financial sector. The sector's dependence on foreign borrowing exposes it to roll-over and contagion risks. In addition, it faces foreign currency induced credit risks.

For more details, see "An Assessment of Balance Sheet Risks in Croatia", 2011 *Selected Issues Paper*.

Vulnerability Indicators, 2010

	Gross External Debt (Percent of GDP)	Gross External Debt (Percent of Exports)	Gross Public Sector Debt (Percent of GDP)	Overall Fiscal Balance (Percent of GDP)	Gross International Reserves (Percent of Short-term Debt at Remaining Maturity)	Total External Financing Requirment (Percent of GDP)
Croatia	101.1	260.1	40.6	-5.0	70.9	23.9
Bulgaria	102.3	179.3	17.9	-4.0	91.7	49.5
Hungary	143.9	165.9	79.5	-4.0	94.6	32.4
Romania	74.2	207.4	36.0	-6.8	129.0	28.1
Serbia	81.6	236.3	43.5	-4.9	194.0	26.9
NMS 1/	106.4	191.9	44.7	-6.4	86.6	38.1

Source: IMF staff.

1/ Simple average of Bulgaria, Hungary, Latvia, Lithuania, Poland, and Romania.

10. **The year 2010 brought no improvement in market confidence (Figure 8).** After recovering from the peak of the crisis, financial markets remained relatively stable. However, confidence and equity prices have not begun to recover, real estate prices continued to fall, and Croatia's spreads have not improved over the past year as in most other emerging markets in the region. S&P downgraded Croatia's long-term sovereign credit to the lowest investment grade in late 2010, in line with the other major rating agencies. The kuna weakened during the second half of 2010, triggered by bank profit repatriation, and the CNB used a mix of foreign exchange interventions and moral suasion to counter depreciation pressures. Nonetheless, the government issued a ten-year Eurobond (2½ percent of GDP, with a 340 bps spread over US treasury benchmark) in early 2011.

11. **The largely foreign-owned banking sector has weathered the economic downturn relatively well (Figure 4 and Table 8)**. System-wide liquidity pressures have

abated, and the aggregate capital adequacy ratio (CAR) significantly exceeded the required minimum of 12 percent at end-2010. Yet the recession eroded asset quality, with the overall nonperforming loan (NPL) ratio reaching 11 percent and the corporate sector's NPL ratio 18 percent in December 2010. While aggregate profitability indicators started to recover in recent months, several small banks reported losses. One state-owned bank was recapitalized using cash injections from the government's supplementary budget (0.1 percent of GDP), which was the method previously recommended by staff.

12. **The nonbank financial institutions are slowly recovering from the crisis**. Pension funds have managed to avoid a sharp downturn due to their conservative investment strategy. Assets of investment funds have increased in 2010, but remain well below pre-crisis levels. Insurance companies continue to struggle, partly reflecting a drop in motor vehicle sales. Some consolidation among the nonbank financial institutions is currently under way.

Financial Soundness Indicators, 2010

(Percent, unless otherwise indicated)

	Capital to risk-weighted assets	Nonperforming loans to total loans	Bank return on assets	Bank return on equity
Croatia	18.8	11.2	1.1	6.6
Bulgaria	17.5	11.9	0.9	7.9
Hungary	14.1	9.1	0.1	1.3
Romania	14.7	11.9	-0.1	-1.0
NMS average 2/	15.2	10.2	0.3	3.3

Source: IMF, *Global Financial Stability Report.*

1/ Simple average. Includes Bulgaria, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Rep., and Slovenia.

III. Macroeconomic Outlook and Risks

13. **Growth is expected to remain sluggish due to low confidence and weak competitiveness (Table 6).** Staff project GDP growth of 1 percent in 2011, mainly driven by net exports. Domestic demand is expected to remain sluggish. Higher cost of living, considerable labor market slack, and consumer deleveraging are likely to dampen consumption growth, while fixed investment is projected to remain tepid in light of weak confidence. The widening output gap is expected to contain core inflation, while headline CPI inflation is projected to reach 3¼ percent due to increased commodity and food prices. Without addressing the structural problems of the economy, GDP growth is expected to rise to 3 percent by 2015 in line with a gradual recovery in domestic demand (Table 5), with the output gap closing by then. The authorities broadly shared staff's assessment of the outlook.

14. **External vulnerabilities will remain high due to large financing needs over the medium term (Table 5).** The current account deficit is expected to widen to 2¼ percent of GDP in 2011, reflecting rising import volumes and prices. External financing requirements are estimated to reach over 33 percent of GDP in 2011, highlighting dependence on rollover of banking and corporate sector debt and a rebound in FDI. The CNB considered that the Croatian economy remains vulnerable, but indicated that based on capital inflows so far this year, the external rollover needs will almost certainly be met in 2011. Over the medium term, the current account deficit is expected to widen gradually to 5½ percent of GDP as imports accelerate. Capital inflows are projected to rise only gradually and remain below pre-crisis levels, with a modest pickup in FDI flows, while rollover of maturing debt is assumed to be around 100 percent. External deleveraging is expected to reduce debt to about 90 percent of GDP by 2016.

GDP Forecast, 2011

	Real growth (year-on-year percent change)
IMF	1.0
World Bank	1.5
European Bank for Reconstruction and Development	1.4
European Commission	1.2
Ministry of Finance	1.5
Croatian National Bank	1.1
Consensus (simple average of all respondents) 1/	1.4

Sources: Consensus Forecasts; EBRD; and IMF staff estimates.

1/ Respondents include: IHS Global Insight, Kopint-Tarki, Econ Intelligence Unit, Dun & Bradstreet, GKI Econ Research, Econ Institute Zagreb, Hypo Alpe-Adria-Bank, Raiffeisen Research, and Vienna Institute - WIIW.

15. **Risks to the outlook are tilted to the downside**. In the near term, downside risks arise from high commodity prices. Absence of direct financial linkages and limited trade with the euro periphery countries mitigate spillover risks, though Croatia is susceptible to contagion through higher cost of funding. In light of the high financing requirements, a shift in investor sentiment could trigger lower rollover of external debt and balance of payments pressures. Upside risks include a more robust global growth, and success in attracting investor interest for infrastructure projects recently announced by the government. Over the medium term, the authorities anticipate that EU accession will boost growth. Staff pointed out that this would require additional efforts to enhance Croatia's absorptive capacity to utilize EU funds.

IV. Policy Discussions—Addressing the Mounting Challenges

Discussions focused on policies to increase competitiveness, facilitate fiscal consolidation, boost reserves, and preserve financial sector stability. In the near term, staff recommended an accommodative monetary policy and no further widening of the fiscal deficit, despite the sizable output gap, due to limited policy space and the need to maintain market confidence.

A. Growth-Enhancing Structural Policies

16. **The authorities recognize the need to pursue growth-enhancing reforms.** They pointed out that the ERP outlined measures needed to tackle these issues and was being implemented, but noted the lack of broad-based support for some reforms. Staff recognized

that notable progress was made in some areas, but argued that overall it has not been sufficient to significantly improve Croatia's economic prospects. Staff therefore urged forceful implementation of the remaining key reforms. Priority should be given to: (i) changing labor laws to induce a more competitive wage setting environment; and (ii) reducing the size of public administration. Other critical actions include: (i) improving the business environment through further reductions of entry and exit costs and of non-tax fees; and (ii) completing privatization of companies with majority and minority government stakes. Croatia's broadly-stable exchange rate policy makes these reforms all the more necessary to achieve adjustment of domestic wages and prices to more competitive levels. Staff acknowledged that pursuing these reforms is challenging and could slow down growth in the short term, but see them as necessary to reap maximum benefits from EU accession and to boost medium-term growth. The authorities agreed with most of the priority actions, and pointed to the recent modification of the civil service law and the modalities of privatization as groundwork needed to move ahead in critical areas.

B. Developing a Credible Fiscal Consolidation Path

17. **The authorities and staff agreed that a substantial medium-term consolidation is needed to ensure fiscal sustainability (Figure 9, Table 3, and Table 9).** Measures implemented so far are expected to yield savings of 2 percent of GDP cumulatively over the medium term.[3] In staff calculations, without further measures, the overall deficit of the general government will remain sizable, gradually decreasing to 3½ percent of GDP by 2016, with public debt reaching 54 percent GDP.[4] In the long term, population aging is likely to add further fiscal pressures through higher transfers to the health and pension sectors.[5] Thus, fiscal consolidation is necessary to create policy space, halt the rise in public debt, accommodate ageing-related fiscal costs, and facilitate internal adjustment of the economy.

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[3]Staff's baseline projections for 2012-16 incorporate savings from fiscal measures already in place: (i) parametric changes in the pension system; (ii) hospital network rationalization and reduction of pharmaceuticals costs; (iii) reduction of subsidies to the agriculture and railway sectors; and (iv) savings in social assistance expenditures from implementation of the Personal Identification Number (PIN) and revisions in unemployment benefits.

[4] Debt Sustainability Analysis shows that public debt would exceed 60 percent under several stress scenarios (Figure 4).

[5]By 2050, the share of elderly population (65 years and above) is projected to increase to 27 percent from the existing 17 percent. The pension and health sectors currently have deficits of 4.7 percent and 1.6 percent of GDP, respectively, which together exceed the general government's overall deficit.

Medium-term Fiscal Developments of the General Government: Unchanged Policy Scenario, 2010–16

(Percent of GDP)

	2010	2011			2012	2013	2014	2015	2016
	Est.	Proj.	Budget				Proj.		
Revenue	37.2	35.5	35.7		35.4	35.4	35.5	35.3	35.3
Expenditure	42.2	41.3	41.1		40.5	40.0	39.7	39.3	38.8
Overall balance	-5.0	-5.7	-5.5	1/	-5.1	-4.6	-4.2	-3.9	-3.5
Primary balance	-3.0	-3.6	-3.3		-2.7	-2.2	-1.7	-1.4	-0.9
Cyclically-adjusted balance	-3.2	-4.1	...		-3.9	-3.9	-4.0	-3.9	-3.5
Broader public sector balance 2/	-5.2	-6.0	...		-5.4	-4.8	-4.5	-4.2	-3.7
Public sector direct debt	41.2	47.4	...		50.0	51.8	53.1	53.9	54.1
Public sector guaranteed debt	17.5	13.3	...		14.0	14.5	15.0	15.3	15.6

Sources: Ministry of Finance; and IMF staff estimates.

1/ Percent of staff's 2011 projected GDP, and includes shipyard payments, and pensioner's debt (these two items represent 0.5 percent of GDP).
2/ Includes HBOR and HAC balances.

18. **The authorities indicated their intention to execute the 2011 budget as approved.** Staff acknowledged that this would represent a change compared to past years, when fiscal plans were modified mid-course through supplementary budgets. Nevertheless, staff urged the authorities to undertake additional measures to avoid further deterioration of the fiscal position in 2011. Staff project a general government deficit of 5¾ percent, as reduction of spending envisaged in the budget will not be sufficient to offset the revenue deterioration. This would imply a widening of the cyclically adjusted deficit by about 1 percent of GDP. Higher than budgeted payments for shipyards' guarantees (Box 3) and pre-election spending pressures could increase the deficit further. Public debt is projected to rise to 47 percent of GDP (including assumed debt of shipyards)—a level considered high for an emerging market.[6] This heightens the risk of changes in market sentiment, which could result in a sharp interest rate rise for the public and private sectors, or curtailment of financing and BOP pressures. Therefore, staff recommend additional spending measures of ¾ percent of GDP to keep the deficit at its 2010 level, as a share of GDP and broadly on a cyclically adjusted basis. This could be achieved by lower capital expenditures (which are budgeted to increase by 32 percent in 2011) and continuing under-execution of expenditures in other categories experienced during the first quarter. The authorities indicated that they have identified some contingency measures, including dividends from public enterprises, to contain the deficit.

Change in Fiscal Balance, 2010–11

(Percent of GDP)

Overall balance	-0.8
Of which: revenues	-1.7
Abolishment of solidarity tax	-0.6
Profit tax collections	-0.3
Reduction in income tax rates	-0.3
Other	-0.5
Of which: expenditures	0.9
Streamlining of social expenditure	0.6
Other	0.3

Source: IMF staff estimates.

[6] Public sector's financing needs at 15 percent of GDP this year are sizeable, but should be manageable assuming full roll-over of domestic T-bills, and given ample liquidity in the banking system the recent issuance of a Eurobond, and no more external payments falling due in 2011.

Box 3: Restructuring of Shipyards

Croatian shipbuilding industry, with around 1½ percent of the global market share, has been heavily dependent on state aid. Shipyards have received subsidies (about ¼ percent of GDP per year) as well as financial and performance guarantees which constitute contingent liabilities for the government (the stock amounted to 3⅓ percent of GDP as of end-2010). A portion of the guarantees have been regularly called in recent years, resulting in higher fiscal deficits. The industry has been in decline since the beginning of transition due to loss of its traditional markets and lack of structural reforms.

Successful privatization and restructuring of the shipyards constitutes a critical requirement to close the competition chapter of EU accession negotiations. The restructuring plans for four of the five major shipyards are currently under the consideration of the European Commission. The restructuring will also require a resolution of the stock of guarantees. In staff's baseline projections, the government is expected to assume most (if not all) of these guarantees as explicit debt.

19. **The authorities see the medium-term fiscal adjustment anchored in a new Fiscal Responsibility Law (Figure 9).** Staff welcomed the introduction of the FRL, but indicated that the fiscal rule implied insufficient adjustment over the medium term. The FRL envisages reduction in expenditures by 1 percent of GDP annually until a primary balance is reached (Box 4). In staff's view, this would keep debt elevated and would not create adequate policy space. Staff therefore advocated that the pace of fiscal adjustment envisaged under the FRL continue until an overall cyclically-adjusted balanced budget is achieved, likely by 2016. The authorities indicated that they view expenditure reductions envisaged under the FRL as a minimum and intend to halve the fiscal deficit between 2011 and 2013.

Box 4: The Fiscal Responsibility Law

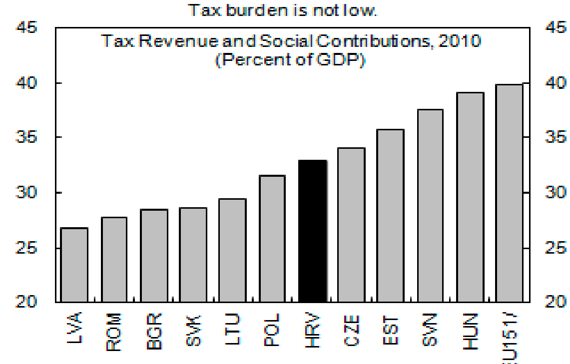
Parliament adopted a Fiscal Responsibility Law (FRL) in November 2010, with the objective to ensure fiscal responsibility, transparency, and sustainability of public finance. The fiscal rule underlying the law aims to reduce expenditures as a share of GDP by no less than one percentage point annually from 2011 until a primary balance is reached, and a cyclically-adjusted primary fiscal balance would be targeted thereafter. The rule encompasses the general budget, which includes the central government, extra-budgetary units, and the local and regional self-government units. More recently, the authorities have established a Fiscal Policy Committee to monitor implementation of the FRL. The committee, yet to become functional, is expected to meet periodically and make its assessments of compliance with fiscal targets publicly available.

For a country like Croatia, where fiscal policy serves as the main macroeconomic policy tool and public debt stock is relatively high, a fiscal rule has the dual purpose of output stabilization and debt reduction. A rule that targets the primary balance risks maintaining public debt at too high a level, servicing of which may come at a cost of reduced social or capital spending. Also, it would not create enough policy space to make room for EU accession related expenditures and expected rise in social expenditures from population ageing.

There are also some weaknesses in the reporting and sanctioning mechanisms which may undermine effectiveness of the FRL. For example, while the FRL contains provisions about the Ministry of Finance's oversight over budget users, an issue usually tackled in standard public financial management law, it does not cover the parliamentary oversight over the government's budget.

20. **Staff urged the authorities to identify and implement reform measures early to make the FRL credible.** Given that the overall tax burden in Croatia is not low, tax rates are high, and public expenditures have numerous inefficiencies, staff and the authorities agree that fiscal consolidation should be pursued through expenditure reductions.[7] In addition, cross-country experience shows that expenditure-based fiscal consolidations tend to be more durable than revenue-based consolidations. Staff therefore proposed the following measures; (i) reduction of public sector employment and wages, and (ii) completing pending reforms in

Tax burden is not low.



Sources: Eurostat; and IMF staff estimates.
1/ Includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and U.K.

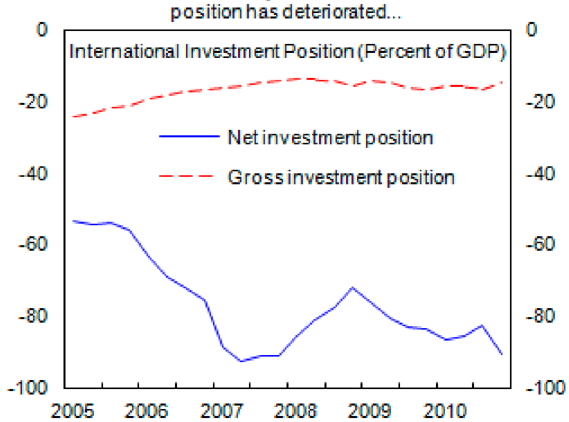
[7] Croatia's tax rates (VAT at 23 percent, and income tax rates in the range of 12-40 percent) are among the highest in the region. However, low labor force participation reduces overall tax collection.

pension, health, and social assistance expenditures. The authorities agreed with the need to reduce public sector employment and social expenditure, but do not see the feasibility or the need to reduce wage levels.

C. Building Buffers

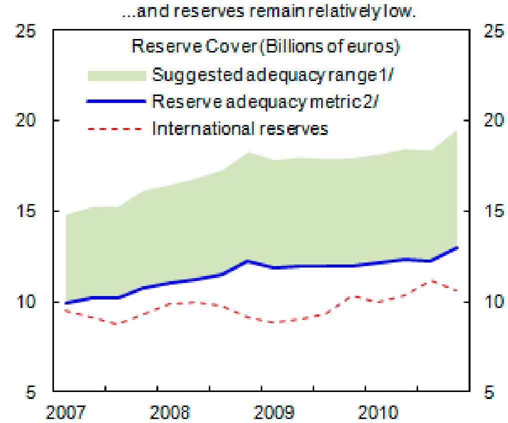
21. **The authorities and staff agreed that the foreign currency buffers of the economy should be maintained (Table 7).** During the peak of the crisis in 2008–09 and again in late 2010, the CNB resisted exchange rate depreciation through sales of foreign exchange reserves and relaxation of foreign currency related prudential measures. Going forward, staff see limited scope for the use of such measures given that official reserves are relatively low, and large prudential foreign currency buffers, which were built up before the crisis, have been significantly reduced.[8] The CNB argued that the reserve coverage was adequate, particularly when taking into account the commitment of foreign banks to maintain their exposures, but concurred that the external position was fragile and saw merit in higher buffers to fend off potential pressures.

The economy's net investment position has deteriorated...



Sources: Croatian National Bank; and IMF staff calculations.

...and reserves remain relatively low.



Sources: Croatian National Bank; and IMF staff estimates.
1/ 100 to 150 percent of reserve adequacy metric.
2/ Weighted four-quarter rolling sum of exports, broad money, and medium and long-term portfolio and other investment liabilities less short-term debt.

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[8] Reserve coverage of short-term maturing liabilities (including equity and portfolio liabilities), a key indicator for emerging market economies, of about 70 percent is below the accepted rule of thumb of at least 100 percent. Reserve coverage of over 6 months of imports and about 100 percent of money supply (M1) appear adequate. However, a weighted reserve metric tailored to a stable exchange rate regime which considers sources of exchange rate pressure (including short-term debt, domestic assets, and export earnings) shows that Croatia is below the minimum threshold.

22. **Staff recommended that the CNB should aim to gradually strengthen foreign exchange reserves to counter risks from external vulnerabilities (Figure 9).** One way to achieve this in a transparent manner would be through small daily preannounced purchases of foreign currency, unless sustained depreciation pressures occur. This would imply an accommodative monetary policy, which is appropriate in the presence of a large output gap and low core inflation. If inflationary pressures emerge, monetary policy will need to be tightened. The CNB expressed concerns about changing the modalities for interventions, as the current system (unannounced interventions in both directions) has been effective, and any changes could undermine the credibility of the stable exchange rate policy and create confidence problems in the banking sector. Nevertheless, the CNB pointed out that reserves have already increased by about euro 670 million (between end-2010 and end-April 2011) through the purchase of proceeds of the government euro bond.

D. Preserving Financial Sector Stability

23. **The CNB and staff concurred that the Croatian banking sector faces risks (Table 8)**. The main risk arises from weak growth prospects and further deterioration in asset quality which would put pressures on profitability and capitalization. Further weakening of the kuna, including against the Swiss franc, poses another risk for asset quality, since close to 75 percent of loans are denominated in or linked to foreign currency (almost 16 percent of which are linked to the Swiss franc). Staff recommend paying close attention to the provisioning of NPLs, which has shown a declining trend in the last few years. There is also liquidity risk related to significant dependence on parent banks for financing. While the absence of subsidiaries with parents in debt-distressed Euro zone periphery reduces Croatia's exposure to contagion risks, dependence on external financing exposes local banks to third-party risks through higher funding costs or lower inflows.

24. **The authorities pointed out that the banking sector is sufficiently resilient to withstand possible shocks**. According to the CNB's latest stress tests, profits of most banks should be more than sufficient to fully absorb losses from an increase in the NPL ratio to 13 percent, with the remaining profits allowing banks to increase their capital adequacy rate by 2 percentage points in the baseline scenario.[9] Even in the event of scenario seen as highly unlikely but plausible by the authorities, of more severe deterioration in credit quality (arising from a 2 percent GDP contraction and a 10 percent depreciation of the kuna against the euro), the CNB stress tests suggest that the system-wide capitalization ratio would remain above the prudential minimum, with the exception of some smaller banks. Staff supports the authorities' intention to maintain sufficient capital buffers above the regulatory minimum. Staff advised that if there is a need to recapitalize any of the state-owned banks, which are small, this should be accompanied by comprehensive restructuring programs. With respect to

[9] January 2011 Financial Stability Report of the CNB.

the liquidity risk, banks' resilience would largely depend on parent banks maintaining open credit lines, as experienced during the crisis.

25. **The CNB and staff agreed that systemic financial stability should continue to be safeguarded through strong regulation and supervision**. Staff welcomed the proactive approach of the CNB to ensure effective bank regulation, and the CNB's plans to gradually introduce counter-cyclical capital buffers in the medium term, when the economic recovery reaches a sustainable path. Both the CNB and HANFA (non-bank financial institutions supervisor) were satisfied with the degree of supervisory cooperation, and the CNB also indicated good level of cooperation with most home supervisors.

26. **Staff cautioned against certain official schemes which would increase contingent liabilities of the public sector and undermine lending standards (Box 5)**. The scheme involving the swap of debt of troubled private companies to the government into equity should be limited only to corporates with viable restructuring plans. Staff recommended that the scheme to subsidize mortgage interest payments should be temporary, and expressed concerns that interest-payment guarantees on housing loans could lead to lowering of credit standards. The authorities pointed out that this scheme was set up for one year and its overall amount is very small.

Box 5: Credit Schemes

Croatia's experience with credit stimulating schemes has been disappointing. Only about one half of the amount (1.4 percent of GDP) allocated under the scheme to finance working capital (Model A) was approved for disbursement in 2010, equivalent to 17 percent of the increase in the stock of credit to private sector. There was essentially no demand for the scheme to finance long-term investments (Model B). Only one small debt-to-equity swap was approved (Model C).*

In early 2011, the authorities attempted to enhance the design of these schemes. The interest rate on the subsidized portion of the loans (accounting for 40 percent) was reduced by 1 percentage point to 2.8 percent, and borrowers were allowed to refinance up to 40 percent of their debt (instead of 20 percent). The maturity of lending under Model B was extended from 10 to 15 years, and the fees for obtaining government guarantees were significantly reduced.

The authorities also launched a new initiative to support the real estate market by subsidizing first-time home buyers. Interest rate on such mortgages would not exceed 4.95 percent in the first four year of loan repayments, and 5.5 percent in the following two years. Moreover, the government will guarantee interest payments for one year in case the borrower loses job. The total amount of fiscal subsidy allocated for this scheme is limited.

*Details of the schemes are provided in Annex III of the Staff Report for the 2010 Article IV consultation.

27. **Staff cautioned against any potential tax changes of the financial sector that could undermine its stability or endanger macroeconomic recovery**. The introduction of any additional taxation on the banking sector should be coordinated with the EU, and would need to be carefully designed to avoid triggering capital outflows. Staff acknowledged that a bank levy was currently not considered by the government, but noted that periodic reemergence of talk on this issue created uncertainty about the banks' operating environment.

V. Staff Appraisal

28. **Croatia's economy has yet to show signs of a sustained recovery.** With continued domestic demand contraction and a narrow export base, Croatia was unable to take full advantage of the growth rebound in its trading partner countries. GDP therefore declined further in 2010 and in the first quarter of 2011, and the recovery is lagging behind most other European emerging market economies.

29. **Croatia faces major economic challenges.** Structural impediments and weak competitiveness hamper medium-term growth prospects, and large external and foreign-currency debt as well as deteriorating public finances implies that vulnerabilities are high. Without tackling these challenges, Croatia is likely to face a protracted period of low growth and rising risks of balance of payments pressures.

30. **Comprehensive structural reforms need to be implemented expeditiously to boost the growth potential of the economy.** While progress has been made over the past year in some areas of the government's Economic Recovery Program (ERP), a critical mass of reforms remains to be undertaken to revamp the economy and put it on a more sustainable footing. In light of the stable exchange rate policy, priority needs to be given to internal devaluation via reduction of prices and wages to more competitive levels. Structural reforms should focus on making labor markets more flexible, increasing labor force participation, reducing the size of public administration, privatizing minority and majority stakes in public companies, and further improving the business climate.

31. **Fiscal consolidation is required to prevent deterioration of market confidence.** The adjustment process should commence in 2011, for example by curbing the rise in capital spending, to avoid a further widening of the deficit. Delays could result in a change in sentiment and a rise in interest rates for the public and private sectors, and potentially detrimental consequences for growth and the balance of payments. In the medium term, expenditure-based consolidation envisaged in the FRL should continue until the overall budget is balanced, in order to create sufficient fiscal space and reduce public debt to safer levels. The government needs to outline early on the measures underlying the fiscal targets, to give the FRL credibility.

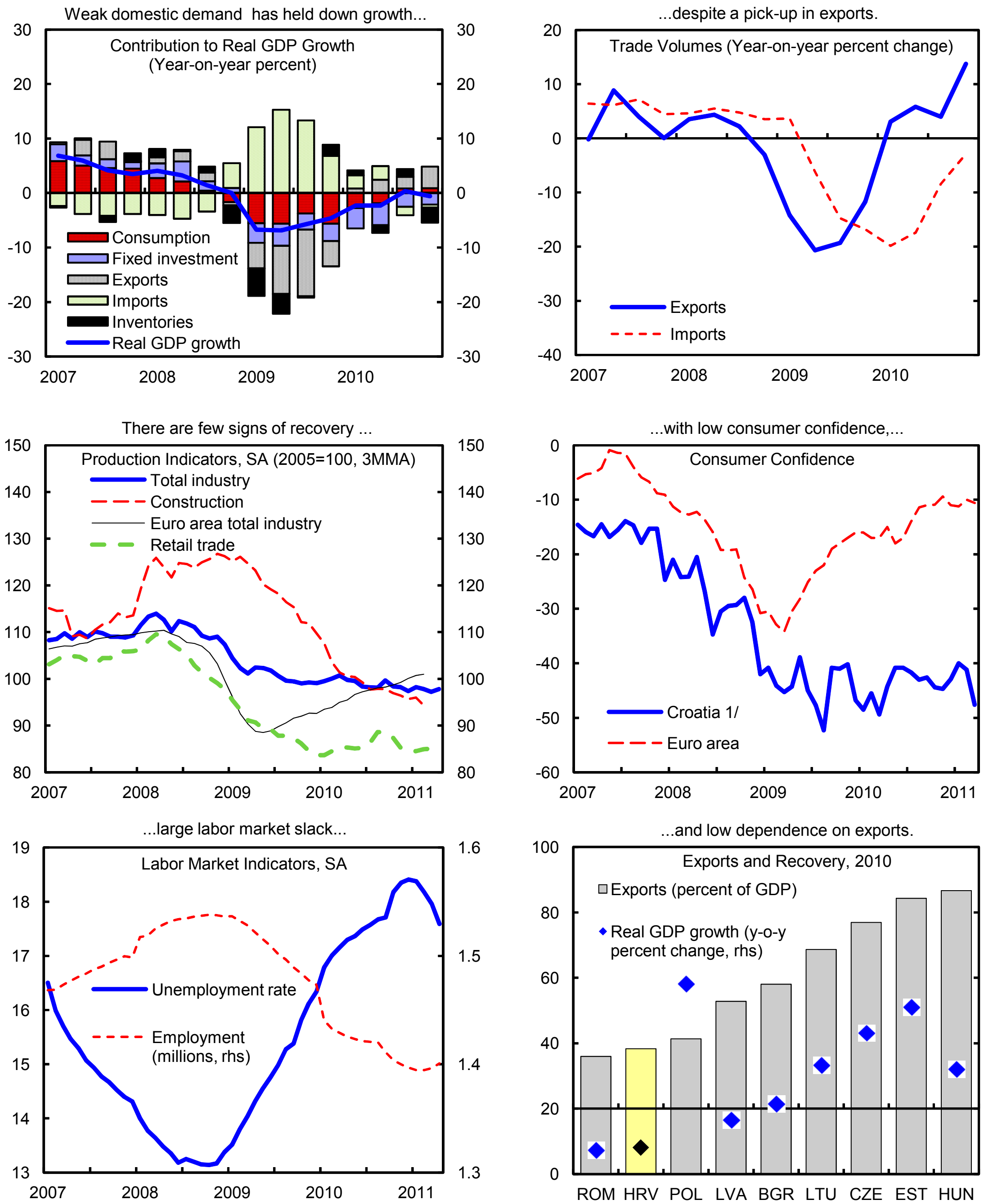
32. **Foreign currency buffers of the economy need to be enhanced to counter risks arising from high external vulnerabilities.** Room for further reducing official foreign exchange reserves is limited due to relatively low reserve coverage, and additional relaxation

of prudential buffers would not be appropriate in light of the high degree of euroization in the financial sector. Monetary policy should aim to gradually build up official reserves, unless sustained depreciation pressures occur, and tightening will be needed if inflationary pressures increase.

33. **Risks in the banking sector require continued strong regulatory and supervisory measures.** While the financial sector appears resilient due to significant capital and liquidity buffers, it faces credit risks arising from weak growth prospects and liquidity risks due to reliance on financing from parent banks. Continued monitoring and supervision and close coordination with home supervisors will be needed to contain these risks.

34. **It is proposed that the next Article IV Consultation with Croatia be held at the standard 12-month cycle.**

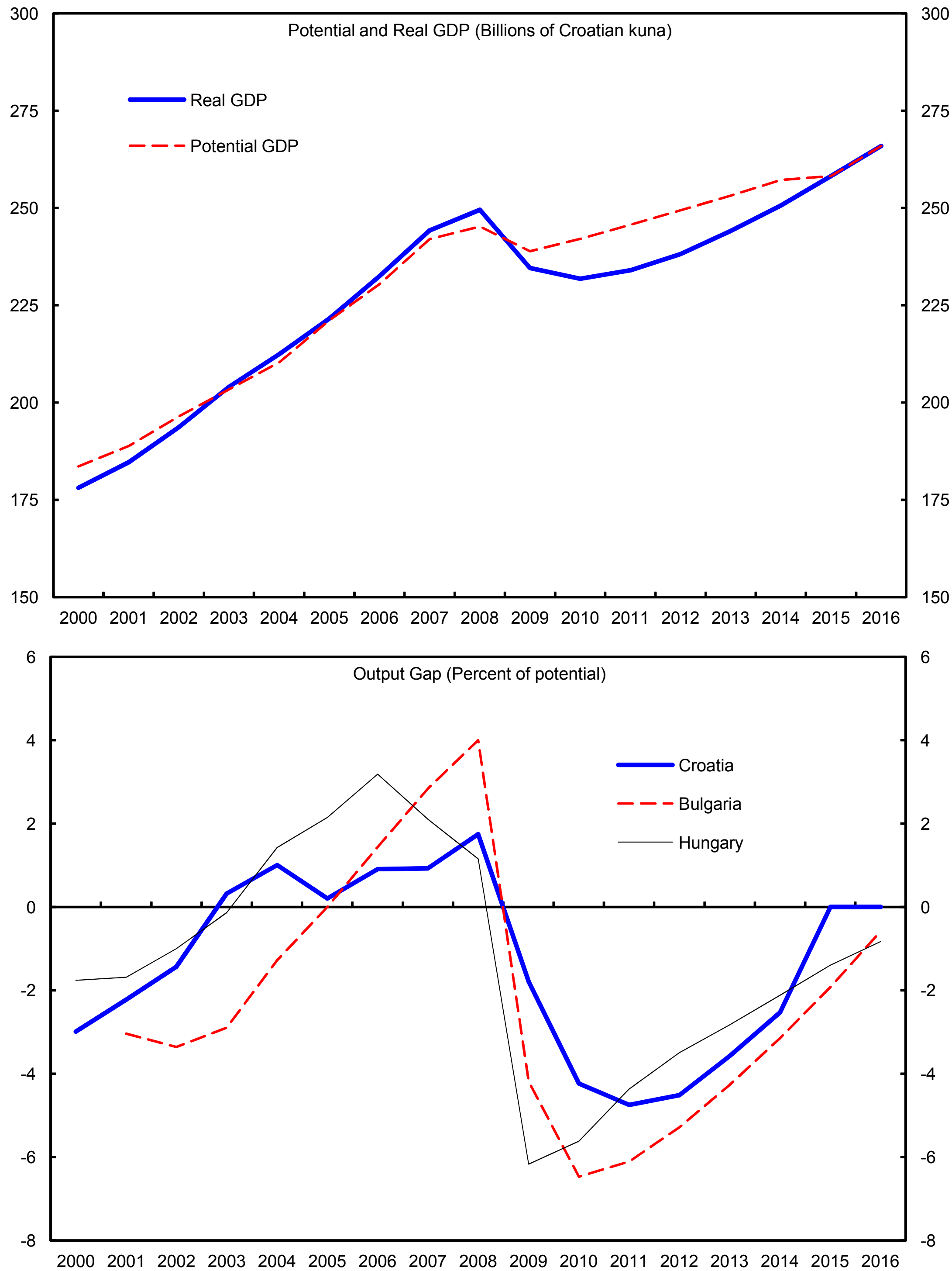
Figure 1. Croatia: Real Sector Developments, 2007–10



Sources: Crostat; Eurostat; Trading Economics; IMF, *World Economic Outlook*; and IMF staff estimates.

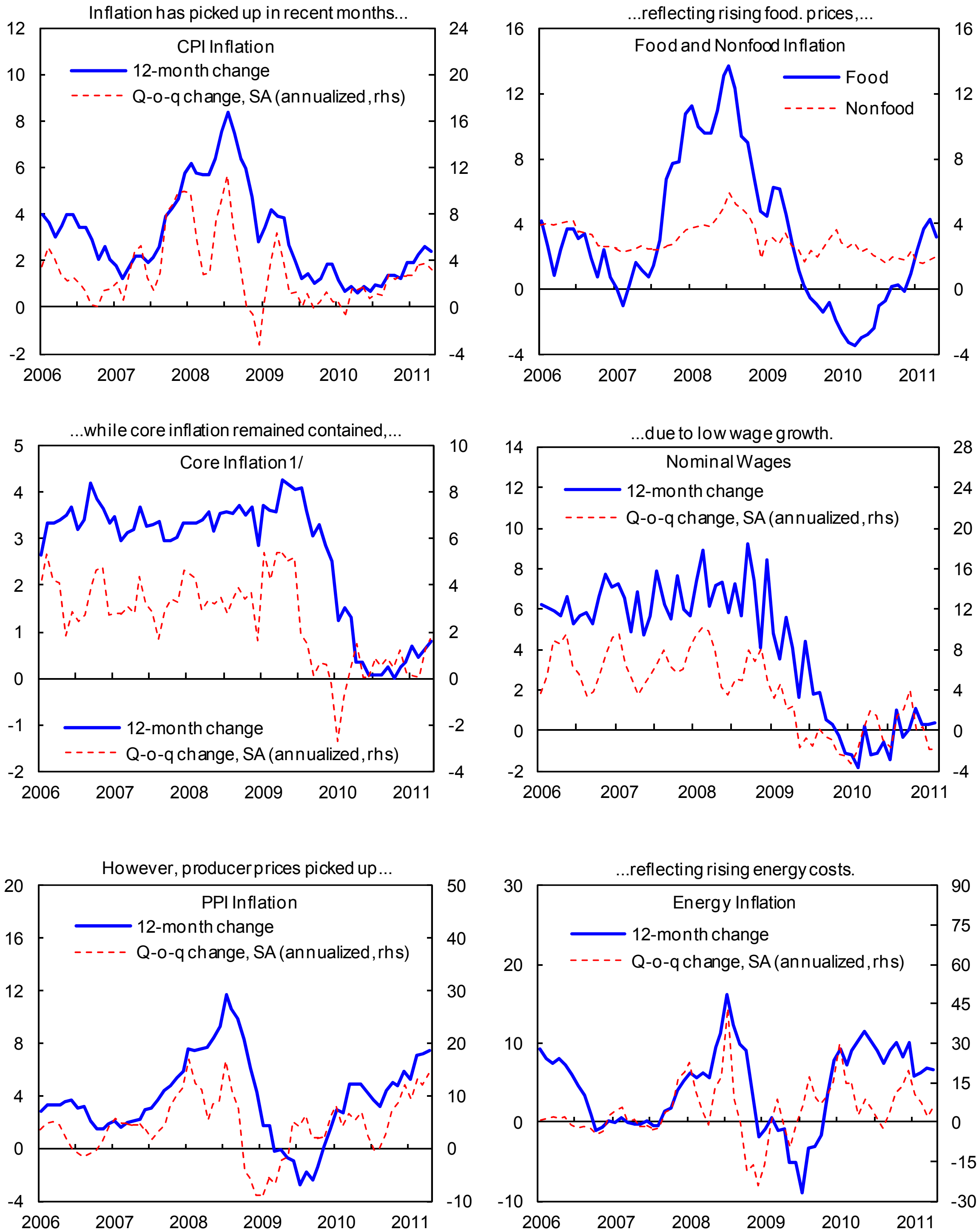
1/ The questionnaire contains 23 questions, examining consumer perception of the changes in every-day economic issues. The value of the response index is based on the responses to the questions from the Consumer Confidence Survey. The value of the indices ranges –100<Ii<100. Higher index values than those recorded over the previous period point to an increase in expectations (optimism).

Figure 2. Croatia: Potential Output, 2000–16



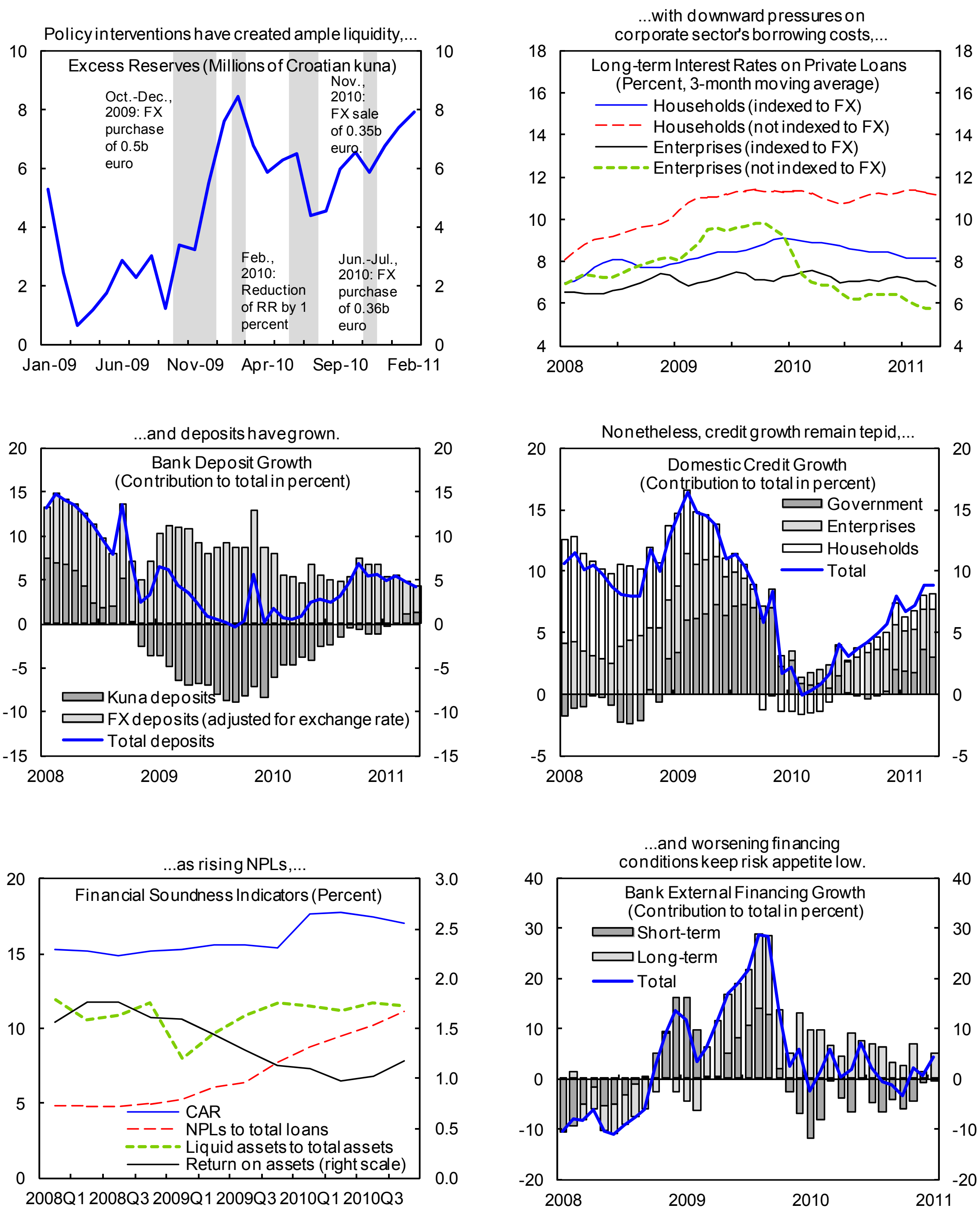
Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

Figure 3. Croatia: Inflation Developments, 2006-2011
(Year-on-year percent change, unless otherwise indicated)



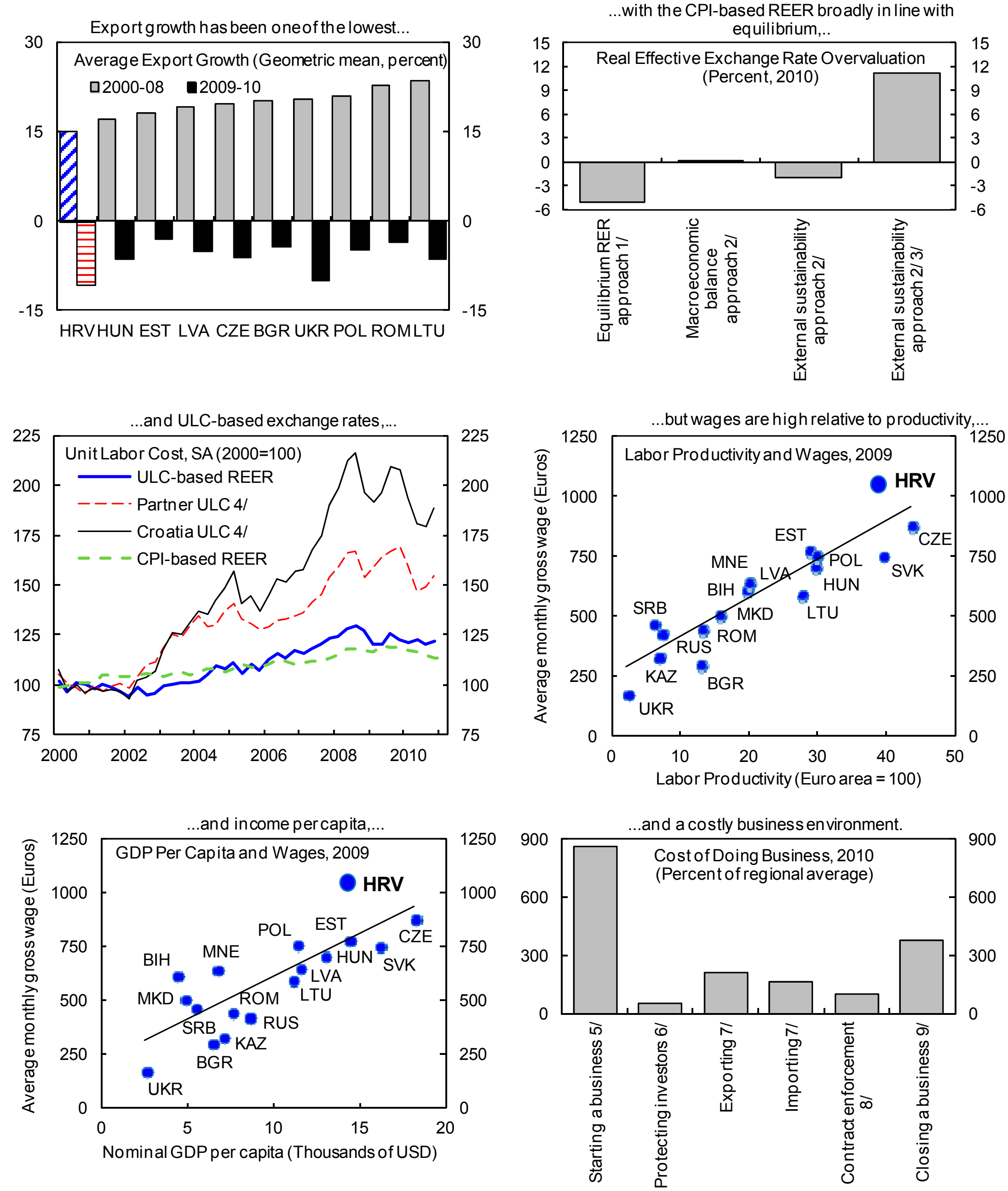
Sources: Central Bureau of Statistics; and IMF staff calculations.
1/ Excludes food and energy.

Figure 4. Croatia: Monetary and Banking Sector, 2008–11



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

Figure 5. Croatia: Competitiveness Indicators, 2000–10



Sources: Croatian authorities; Haver; OECD; World Bank, *Doing Business Indicators*; IMF, *International Financial Statistics*; IMF, *World Economic Outlook*; and IMF staff estimates and calculations.

1/ IMF staff estimates are based on the model reported in SM/08/168.

2/ IMF staff estimates are based on CGER methodology and correct for multilateral consistency (see "Methodology for CGER Exchange Rate Assessments, IMF Report No. 06/283).

3/ Assumes net foreign assets stabalize at -55 percent of GDP.

4/ U.S. dollar basis.

5/ Measured as cost as a share of income per capita.

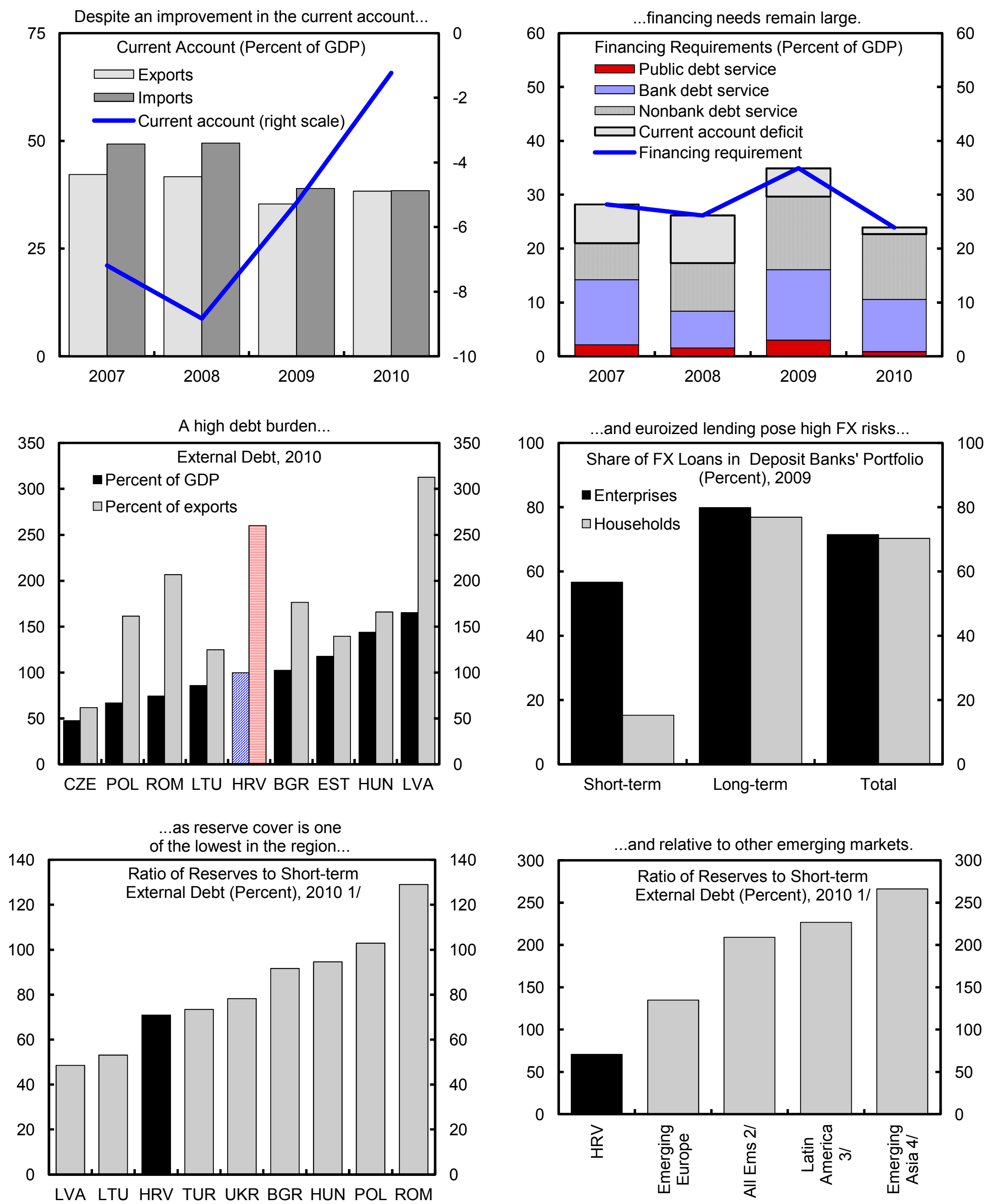
6/ Measured as an index.

7/ Measured as cost to trade (U.S. dollars per container).

8/ Measued as cost in percent of claim.

9/ Measured as cost in percent of estate.

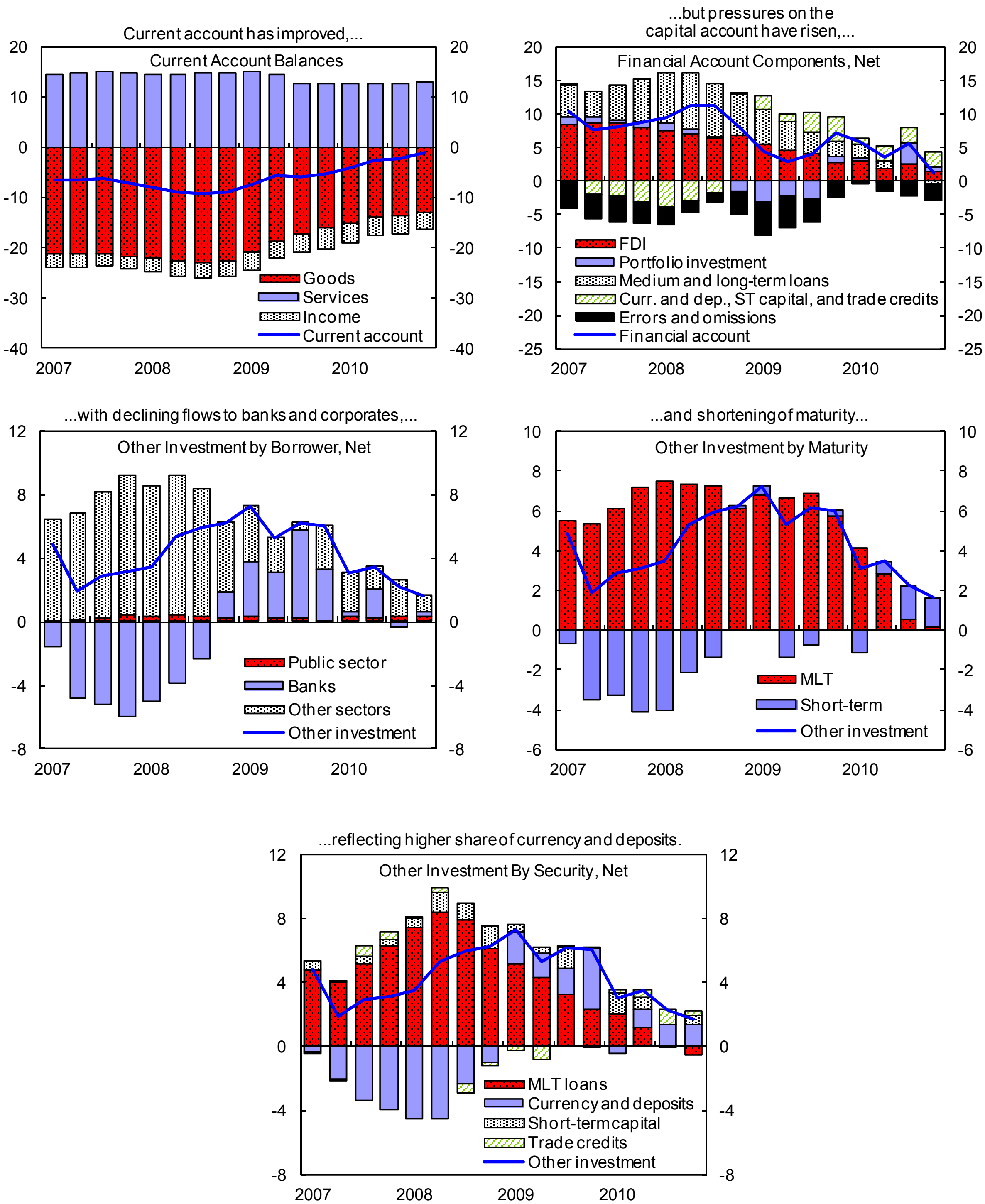
Figure 6. Croatia: Vulnerability Indicators, 2007–10



Sources: Croatian National Bank; IMF, *World Economic Outlook*; and IMF staff estimates.
1/ Projections for 2010. Source is Spring, 2010 Vulnerability Exercise. Debt falling due in 2010. Gross international reserves are end-2010 stocks. Short-term debt at original maturity (end -2010) plus amortization of medium and long-term debt (end-2011).
2/ Excludes Brazil, China, and MENA.
3/ Excludes Brazil.
4/ Excludes China.

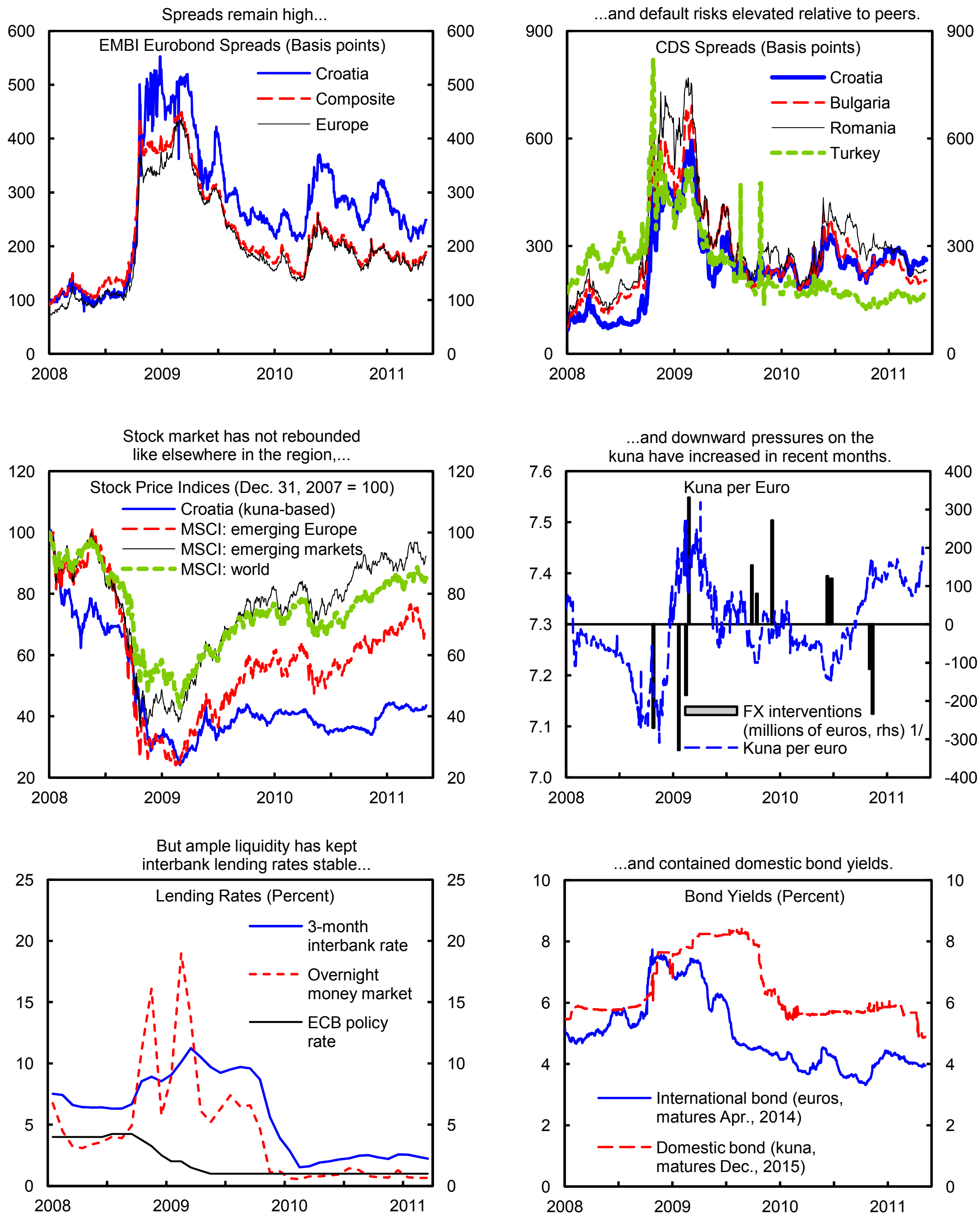
Figure 7. Croatia: Balance of Payments, 2007–10

(4-quarter moving sum in percent of GDP)



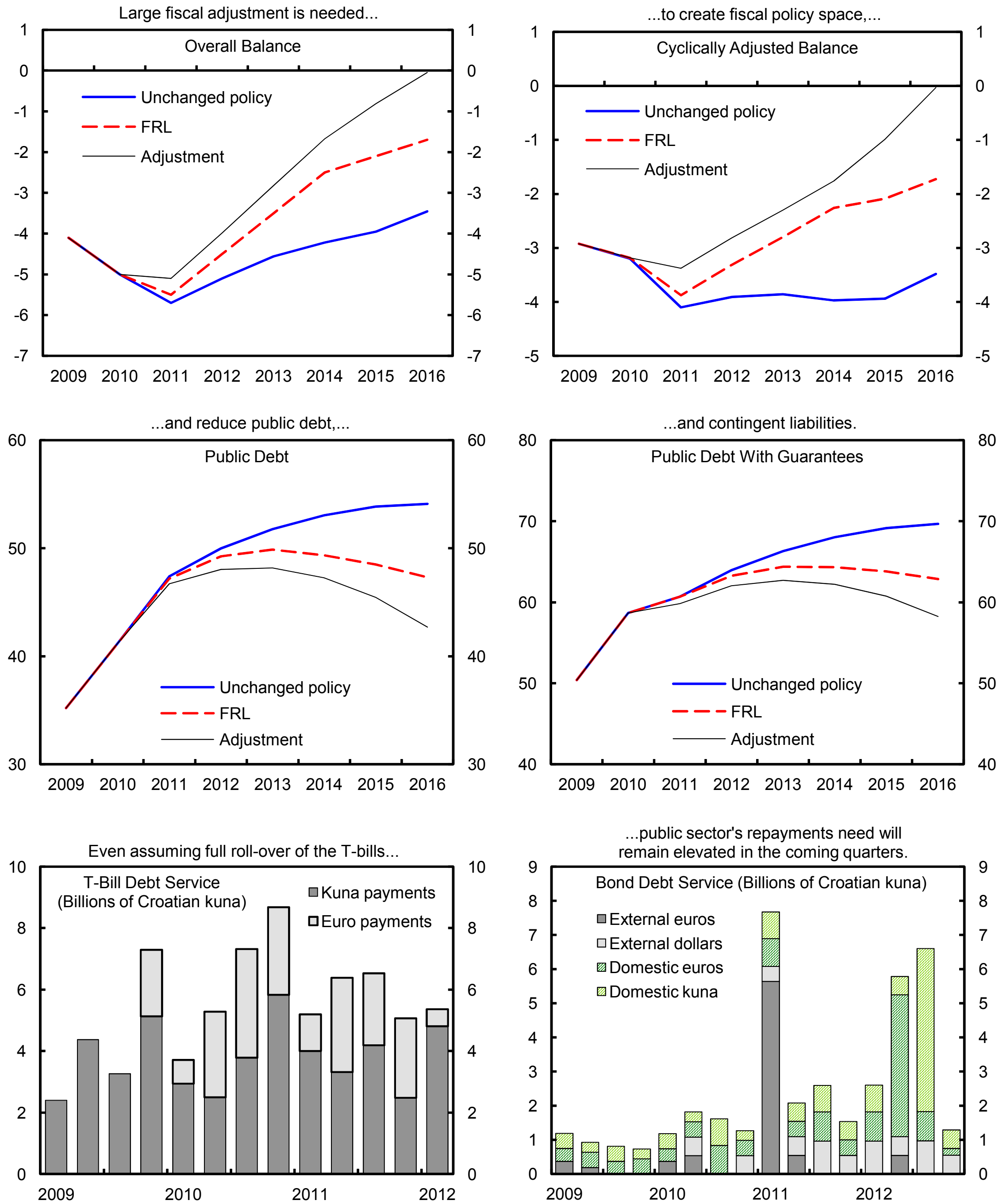
Sources: Croatian National Bank; and IMF staff estimates.

Figure 8. Croatia: Financial Market Developments, 2008–11



Sources: Bloomberg; Croatian National Bank; and IMF staff calculations.
1/ Positive (negative) sign indicates purchase (sale)of FX.

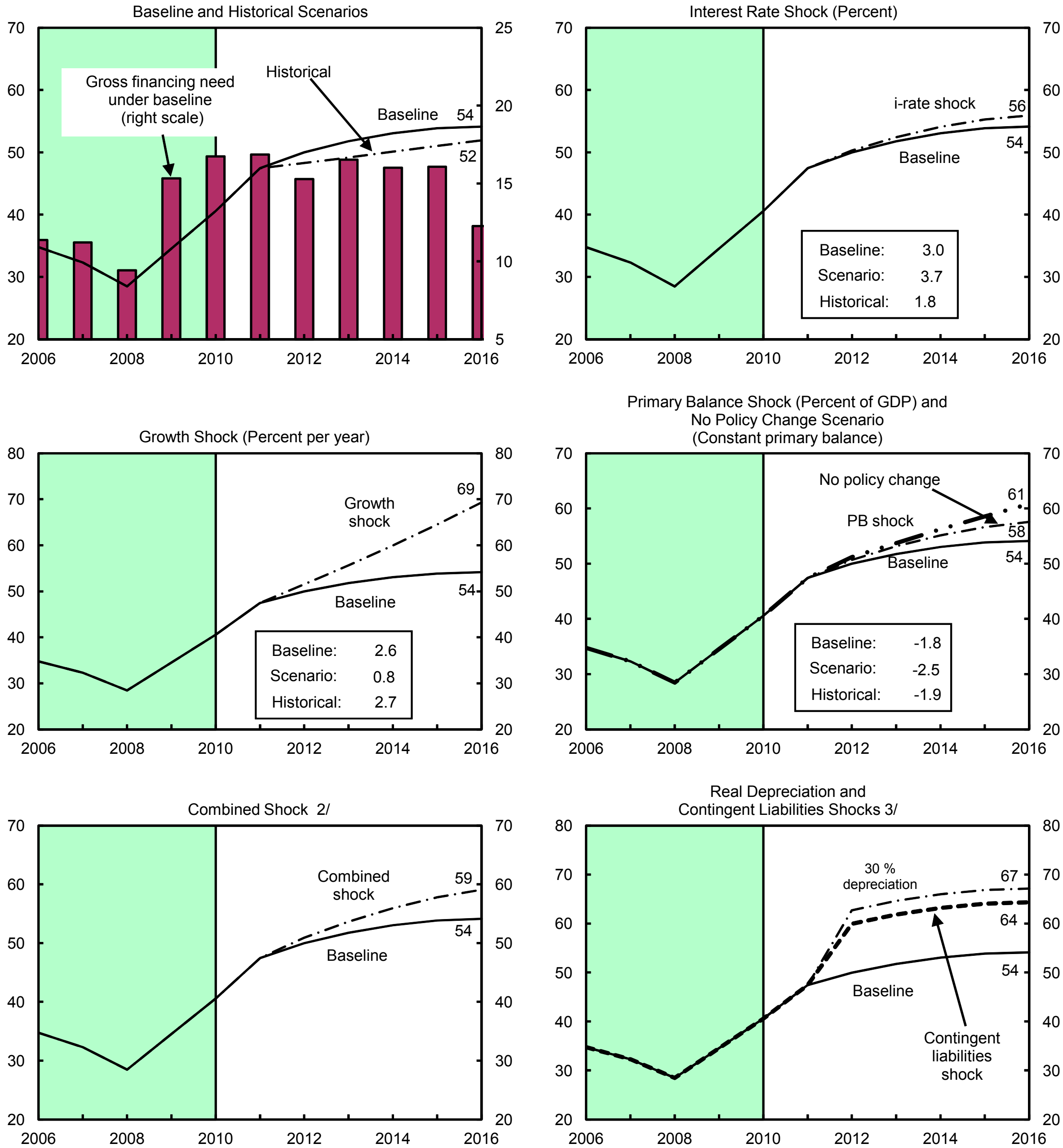
Figure 9. Croatia: Fiscal Developments, 2009–16 1/
(Percent of GDP)



Sources: Croatian authorities; Bloomberg; and IMF staff estimates.

1/ Baseline implies unchanged policies taking into account reforms that have already been implemented; FRL implies successful implementation of the Fiscal responsibility Law starting in 2012; Adjustment implies staff's recommended fiscal path with expenditure consolidation of 1 percent of GDP starting in 2011.

Figure 10. Croatia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



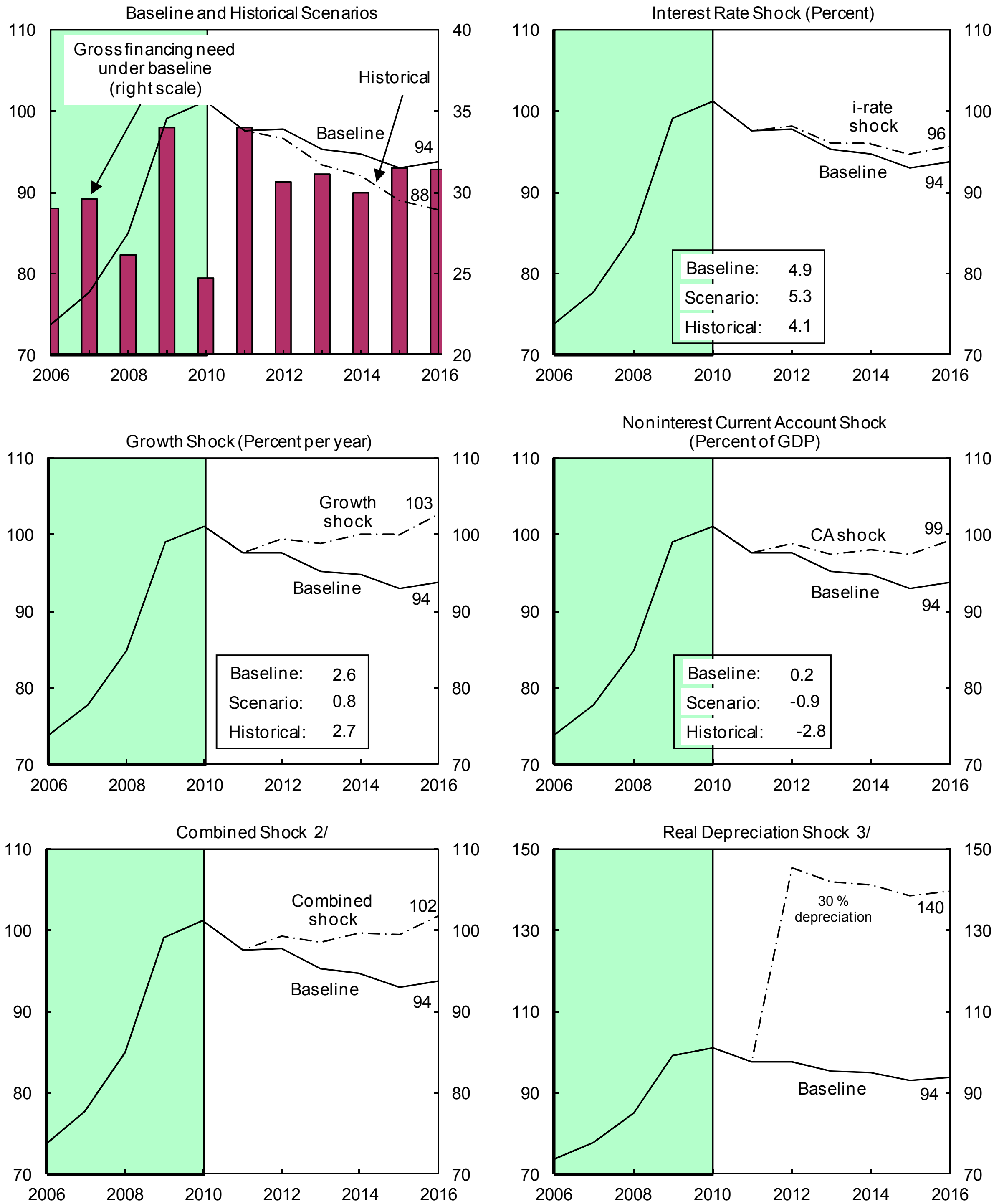
Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent 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 primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 11. Croatia: External Debt Sustainability: Bound Tests of the Baseline Scenario 1/ (External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent 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 2010.

Table 1. Croatia: Selected Economic Indicators, 2007–12 1/

	2007	2008	2009	2010	2011	2012
				Est.	Proj.	
Output, unemployment, and prices	(Percent change, unless otherwise indicated)					
Real GDP	5.1	2.2	-6.0	-1.2	1.0	1.8
Contributions:						
Domestic demand	6.4	2.9	-7.7	-3.5	0.5	0.9
Net exports	-1.9	-0.9	4.3	3.0	0.8	0.1
Unemployment (labor force survey, percent)	9.6	8.4	9.1	11.8	12.7	12.2
CPI inflation (average)	2.9	6.1	2.4	1.0	3.2	2.4
Average monthly nominal wages	6.2	7.1	2.2	-0.4	...	...
Saving and investment	(Percent of GDP)					
Domestic investment	31.0	32.8	28.7	25.0	26.0	27.4
Of which: fixed capital formation	26.2	27.7	24.9	21.6	22.1	21.8
Domestic saving	23.8	23.9	23.4	23.7	23.9	24.1
Government	3.7	3.2	0.0	-1.5	-2.5	-2.6
Nongovernment	20.1	20.8	23.4	25.2	26.5	26.7
Government sector 2/						
General government revenue	40.2	39.5	38.4	37.2	35.5	35.4
General government expenditure	42.4	40.7	42.5	42.2	41.3	40.5
General government balance	-2.1	-1.3	-4.1	-5.0	-5.7	-5.1
General government balance (broad definition) 3/	-3.1	-2.3	-5.4	-5.2	-6.0	-5.4
HBOR balance (net of budget transfers)	-0.5	-0.1	-0.6	-0.1	-0.1	-0.1
General government debt	32.8	29.0	35.2	41.2	47.4	50.0
Money and credit 4/	(End of period; change in percent)					
Bank credit to the nongovernment sector	15.0	10.6	-0.6	6.8	6.6	...
Broad money	18.3	4.3	-0.9	4.4	3.1	...
Interest rates 4/ 5/	(Period average; percent)					
Average kuna deposit rate (unindexed)	2.3	2.8	3.2	1.8	1.6	...
Average kuna credit rate (unindexed)	9.3	10.1	11.6	10.4	9.7	...
Average credit rate, foreign currency-indexed loans	6.3	7.5	8.1	8.1	7.4	...
Balance of payments	(Millions of euros, unless otherwise indicated)					
Current account balance	-3,119	-4,217	-2,408	-582	-1,037	-1,494
Percent of GDP	-7.2	-8.8	-5.3	-1.3	-2.2	-3.0
Capital and financial account	5,247	5,470	4,418	1,804	1,958	3,143
FDI, net (percent of GDP)	8.0	6.8	2.6	1.3	1.6	2.0
Overall balance	722	-330	896	84	-299	328
Debt and reserves	(End of period; millions of euros, unless otherwise indicated)					
Gross official reserves	9,307	9,121	10,376	10,660	10,362	10,691
Percent of short-term debt (by residual maturity)	109	70	95	71	76	75
Months of following year's imports of goods and nonfactor services	4.7	6.2	7.1	6.7	6.2	6.1
Net international reserves	7,349	8,020	9,365	9,644	9,715	10,043
External debt service to exports ratio (percent)	57.2	52.3	86.1	68.8	90.7	81.2
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	97.6	97.7
Net external debt (percent of GDP) 6/	40.6	50.9	60.0	62.5	60.4	60.5
Exchange rate						
Kuna per euro, end of period 7/	7.3	7.3	7.3	7.4	7.4	...
Kuna per euro, period average 7/	7.3	7.2	7.3	7.3	7.4	...
Real effective rate (CPI, percent change) 4/	0.7	4.6	1.1	-2.4	-1.5	...
Memorandum items:						
Nominal GDP (millions of euros)	43,391	47,769	45,668	45,919	47,132	49,406
Output gap (percent of potential)	0.9	1.7	-1.8	-4.2	-4.7	-4.5
Per capita GDP (2010): € 10,356 (WEO)			Percent of population below poverty line (2004): 11.1			
Quota (2010): SDR 365 million (563 million U.S. dollars)						

Sources: Croatian authorities, and IMF staff estimates.

1/ National account data for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). Revised nominal GDP figure for 2008 is about 14 percent higher than the previous estimate.

2/ ESA 95 presentation.

3/ Includes the balances of HBOR and HAC (net of budget transfers).

4/ Latest data as of end-April, 2011.

5/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.

6/ Net of official reserves and commercial bank foreign assets.

7/ Latest data as of end-May, 2011.

Table 2. Croatia: Monetary Accounts, 2007–11

(End-period; millions of kuna, unless otherwise indicated)

	2007	2008	2009				2010				2011
			Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
Monetary survey											
Net foreign assets	49,447	41,739	26,544	30,116	39,369	45,011	37,752	36,985	54,088	44,025	36,581
(Millions of euros)	6,746	5,699	3,554	4,138	5,417	6,170	5,200	5,145	7,417	5,962	4,958
Croatian National Bank	68,161	66,789	66,128	66,277	67,902	75,800	72,644	74,121	81,338	78,720	84,337
(Millions of euros)	9,300	9,119	8,855	9,106	9,343	10,390	10,007	10,311	11,153	10,660	11,432
Deposit money banks	-18,714	-25,049	-39,584	-36,161	-28,533	-30,788	-34,891	-37,135	-27,250	-34,695	-47,757
(Millions of euros)	-2,553	-3,420	-5,301	-4,968	-3,926	-4,220	-4,806	-5,166	-3,737	-4,698	-6,473
Net domestic assets	166,376	183,279	192,083	188,300	184,717	178,083	184,291	187,596	178,595	188,845	192,381
Domestic credit (CNB definition) 1/	226,076	254,570	264,320	258,820	259,044	253,524	262,293	267,863	259,873	272,601	276,901
Claims on government, net 2/	14,118	20,475	28,504	27,578	29,640	22,031	28,570	30,165	19,078	25,817	29,422
Claims on other domestic sectors 3/	208,688	230,905	232,862	228,924	226,933	229,588	231,790	235,858	238,721	245,107	245,556
Other items (net)	-59,701	-71,291	-72,237	-70,520	-74,326	-75,440	-78,002	-80,267	-81,277	-83,756	-84,520
Broad money	215,822	225,018	218,627	218,416	224,087	223,095	222,043	224,581	232,683	232,870	228,961
Narrow money	57,878	55,222	46,637	47,699	45,559	47,182	47,726	49,716	51,734	49,152	48,835
Currency outside banks	16,007	17,051	15,826	16,915	16,013	15,282	14,775	16,048	16,001	15,263	14,998
Demand deposits	41,871	38,171	30,810	30,784	29,547	31,900	32,951	33,667	35,734	33,889	33,836
Quasi money	157,944	169,796	171,990	170,717	178,527	175,913	174,317	174,866	180,948	183,718	180,127
Kuna-denominated	54,854	52,601	49,125	46,828	45,101	40,502	36,992	38,408	37,155	36,161	37,656
Foreign currency-denominated	103,090	117,195	122,865	123,889	133,426	135,411	137,325	136,458	143,793	147,557	142,470
Balance sheet of the Croatian National Bank											
Net foreign assets	68,161	66,789	66,128	66,277	67,902	75,800	72,644	74,121	81,338	78,720	84,337
Of which: banks' reserves in foreign currency	14,257	8,008	4,582	4,669	4,778	5,042	4,711	4,648	4,618	4,773	4,787
Net international reserves	53,830	58,745	61,539	60,901	63,104	68,426	67,900	69,453	70,786	71,220	70,282
Net domestic assets	-1,951	-8,982	-8,775	-6,454	-10,282	-14,566	-13,183	-13,560	-20,783	-17,637	-21,916
Claims on government (net)	-198	-205	-383	-961	-278	-4,169	-2,188	-1,978	-9,756	-5,356	-10,703
Claims on banks	4,178	14	1,397	2,426	14	14	13	13	13	13	13
Of which: Open market operations	2,815	0	1,359	2,412	0	0	0	0	0	0	0
Claims on other domestic sectors	68	64	64	4	4	4	4	4	4	4	4
Other items (net)	-5,999	-8,855	-9,853	-7,923	-10,022	-10,414	-11,012	-11,599	-11,044	-12,297	-11,230
Base money	66,210	57,807	57,352	59,823	57,620	61,233	59,461	60,560	60,554	61,083	62,421
Currency	16,007	17,051	15,826	16,915	16,013	15,282	14,775	16,048	16,001	15,263	14,998
Deposits	50,202	40,756	41,526	42,908	41,607	45,951	44,686	44,512	44,554	45,820	47,423
Of which:											
Settlement accounts	7,554	9,520	9,308	11,098	9,689	12,025	10,630	9,882	8,982	10,246	9,834
Statutory reserves in kuna 4/	22,276	19,223	24,080	23,493	23,662	23,601	22,055	22,089	22,407	22,705	23,121
Statutory reserves in foreign currency	14,257	8,008	4,582	4,669	4,778	5,042	4,711	4,648	4,618	4,773	4,787
Reserve money (CNB definition) 5/	51,924	49,743	52,718	55,101	52,791	56,142	54,694	55,858	55,882	56,249	57,570
Year-on-year percent changes											
Monetary survey											
Net domestic assets	7.4	10.2	14.3	10.3	7.3	-2.8	-4.1	-0.4	-3.3	6.0	4.4
Domestic credit (CNB definition) 1/	12.9	12.6	14.4	10.3	8.2	-0.4	-0.8	3.5	0.3	7.5	5.6
Claims on government, net 2/	-16.7	45.0	93.7	110.9	127.1	7.6	0.2	9.4	-35.6	17.2	3.0
Claims on other domestic sectors 3/	15.0	10.6	9.3	4.9	2.0	-0.6	-0.5	3.0	5.2	6.8	5.9
Broad money	18.3	4.3	3.3	1.1	-1.2	-0.9	1.6	2.8	3.8	4.4	3.1
Quasi money	17.9	7.5	8.3	5.6	3.1	3.6	1.4	2.4	1.4	4.4	3.3
Balance sheet of the Croatian National Bank											
Base money	5.2	-12.7	-14.4	-12.1	-8.7	5.9	3.7	1.2	5.1	-0.2	5.0
Reserve money (CNB definition) 5/	12.1	-4.2	5.5	7.7	6.1	12.9	3.7	1.4	5.9	0.2	5.3
Memorandum items:											
Nominal GDP (yearly total)	318,309	345,014	343,658	341,058	336,974	335,189	333,975	332,782	334,086	334,564	...
Narrow money multiplier	0.87	0.96	0.81	0.80	0.79	0.77	0.80	0.82	0.85	0.80	0.78
Broad money multiplier	3.26	3.89	3.81	3.65	3.89	3.64	3.73	3.71	3.84	3.81	3.67
Broad money (percent of GDP)	67.8	65.2	63.6	64.0	66.5	66.6	66.5	67.5	69.6	69.6	...
Foreign currency (percent of broad money)	47.8	52.1	56.2	56.7	59.5	60.7	61.8	60.8	61.8	63.4	62.2
Credit to other domestic sectors: stock (percent of GDP)	65.6	66.9	67.8	67.1	67.3	68.5	69.4	70.9	71.5	73.3	...
Credit to other domestic sectors: 12-month flow (percent of GDP)	8.5	6.4	5.8	3.1	1.3	-0.4	-0.3	2.1	3.5	4.6	...

Sources: Croatian National Bank; and IMF staff estimates.

1/ Comprises net claims on central government, gross claims on local government, and claims on other domestic sectors.

2/ Comprises claims on central government and funds, and local government and funds, net of their deposits in the banking system. Central government funds include the Croatian Bank for Reconstruction and Development (HBOR).

3/ Comprises claims on households, enterprises, other banking institutions (housing savings banks, savings and loan cooperatives, and investment funds), and other financial institutions.

4/ From 2007, includes obligatory CNB bills.

5/ Excludes statutory reserves in foreign currency.

Table 3. Croatia: Consolidated General Government Finances, 2007–16

(Percent of GDP; ESA 95 presentation)

	2007	2008	2009	2010	2011		2012	2013	2014	2015	2016
				Est.	Proj.	Budget			Proj.		
Revenue	40.2	39.5	38.4	37.2	35.5	35.7	35.4	35.4	35.5	35.3	35.3
Taxes	23.1	23.1	21.9	21.4	20.1	20.1	20.1	20.0	20.1	19.8	19.8
Taxes on income, profits, and capital gains	5.9	6.2	5.9	4.7	4.1	4.2	4.2	4.2	4.2	4.3	4.3
Payable by individuals	3.1	3.1	3.1	2.8	2.5	2.5	2.5	2.6	2.6	2.6	2.7
Payable by corporations and other enterprises	2.8	3.1	2.8	1.9	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Taxes on property	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Taxes on goods and services	16.2	15.9	14.8	15.4	15.1	15.1	15.1	14.9	15.0	14.8	14.7
Of which:											
VAT	11.9	12.0	11.1	11.3	11.3	11.3	11.3	11.2	11.3	11.3	11.3
Excises	3.8	3.4	3.3	3.6	3.3	3.3	3.3	3.1	3.1	2.9	2.9
Taxes on international trade and transactions	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.5
Other taxes 1/	0.1	0.1	0.4	0.7	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	11.7	11.8	11.9	11.6	11.2	11.3	11.2	11.2	11.3	11.3	11.3
Other revenue and grants	5.1	4.2	4.3	4.0	4.0	4.0	3.9	4.0	4.0	4.0	4.0
Capital revenue	0.4	0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditure	41.2	40.3	41.6	41.6	40.8	40.6	40.3	39.9	39.7	39.3	38.8
Current expenditures	37.3	37.8	39.5	39.9	38.6	38.5	38.5	38.0	37.7	37.1	36.4
Compensation of employees	9.8	9.7	10.5	10.5	10.3	10.3	10.2	10.2	10.2	10.1	10.1
Use of goods and services	4.8	4.8	4.5	4.6	4.5	4.5	4.7	4.7	4.7	4.7	4.7
Interest	1.7	1.5	1.7	2.0	2.1	2.1	2.4	2.4	2.5	2.5	2.6
Subsidies	2.4	2.4	2.4	2.4	2.1	2.1	2.1	1.9	1.8	1.7	1.7
Grants	0.5	0.7	0.7	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.5
Social benefits	15.3	15.4	17.0	17.2	16.6	16.4	16.2	15.8	15.5	15.1	14.6
Other expense	2.8	3.3	2.7	2.7	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Capital expenditure	3.9	2.6	2.1	1.7	2.1	2.1	1.8	2.0	2.1	2.2	2.3
Payment of called guarantees	0.1	0.1	0.6	0.3	0.3	0.3	0.0	0.0	0.0	0.0	0.0
Repayment of “pensioners' debt”	1.1	0.3	0.2	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.0
Overall balance	-2.1	-1.3	-4.1	-5.0	-5.7	-5.5	-5.1	-4.6	-4.2	-3.9	-3.5
Financing	2.1	1.3	4.1	5.0	5.7	5.5	5.1	4.6	4.2	3.9	3.5
Privatization and disposal of fixed assets	1.2	0.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
External financing	-0.1	-0.1	1.5	2.3	-1.1	-1.1	1.6	1.2	0.4	-0.4	1.1
Disbursements	-0.1	2.0	3.6	3.9	2.1	2.1	1.9	1.7	1.5	1.4	1.2
Amortization	0.0	-2.1	-2.2	-1.6	-3.2	-3.2	-0.4	-0.6	-1.2	-1.7	-0.2
Domestic financing	1.0	0.9	2.4	2.5	6.7	6.4	3.4	3.3	3.7	4.2	2.3
Memorandum items:											
Primary balance	-0.4	0.1	-2.4	-3.0	-3.6	-3.3	-2.7	-2.2	-1.7	-1.4	-0.9
Cyclically adjusted balance	-2.8	-2.3	-2.9	-3.2	-4.1	...	-3.9	-3.9	-4.0	-3.9	-3.5
HBOR balance (net of budget transfers) 2/	-0.5	-0.1	-0.6	-0.1	-0.1	...	-0.1	-0.1	-0.1	-0.1	-0.1
HAC balance 2/	-0.5	-0.9	-0.7	-0.1	-0.1	...	-0.1	-0.1	-0.1	-0.1	-0.1
Broader measure of fiscal balance 3/	-3.1	-2.3	-5.4	-5.2	-6.0	...	-5.4	-4.8	-4.5	-4.2	-3.7
General government debt	32.8	29.0	35.2	41.2	47.4	...	50.0	51.8	53.1	53.9	54.1
General government guarantees	8.5	13.0	15.2	17.5	13.3	...	14.0	14.5	15.0	15.3	15.6

Sources: Ministry of Finance; and IMF staff estimates.

1/ For 2009-2010, includes revenue from the "solidarity tax."
2/ The balances of HBOR and HAC for 2011-16 are assumed to remain at their 2010 levels.
3/ Includes the balances of HBOR and HAC (net of budget transfers).

Table 4. Croatia: Balance of Payments, 2007–16

(Millions of euros, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Est.			Proj.			
Current account	-3,119	-4,217	-2,408	-582	-1,037	-1,494	-1,885	-2,082	-2,894	-3,410
Merchandise trade balance	-9,434	-10,794	-7,387	-5,945	-6,605	-6,916	-7,287	-7,850	-8,614	-9,243
Exports f.o.b.	9,193	9,814	7,703	9,099	9,674	10,273	10,792	11,325	11,947	12,680
Imports f.o.b.	-18,626	-20,608	-15,090	-15,045	-16,279	-17,189	-18,079	-19,175	-20,561	-21,924
Services and income	5,272	5,507	3,943	4,284	4,411	4,182	4,078	4,353	4,209	4,220
Transportation	641	625	349	400	417	446	468	485	503	531
Travel	6,035	6,694	5,656	5,607	6,072	6,197	6,370	6,544	6,715	6,889
Other services	-310	-245	-235	-114	-177	-178	-189	-219	-264	-290
Compensation of employees	494	564	587	621	470	485	502	519	536	556
Interest and investment income	-1,589	-2,132	-2,413	-2,230	-2,370	-2,766	-3,072	-2,977	-3,281	-3,466
Current transfers	1,043	1,070	1,036	1,079	1,157	1,240	1,324	1,415	1,511	1,614
Capital and financial account	5,247	5,470	4,410	1,804	1,958	3,143	3,320	3,488	4,459	4,963
Capital account 1/	28	15	43	36	35	35	35	36	37	37
Financial account 1/	5,219	5,456	4,367	1,768	1,923	3,108	3,285	3,452	4,422	4,926
Direct investment	3,468	3,246	1,207	593	770	988	1,037	1,222	1,431	1,658
Portfolio investment	391	-782	398	399	100	248	1,369	-145	1,112	155
Medium- and long-term loans	2,718	2,900	1,042	-257	537	1,274	-14	1,067	862	1,970
Assets	3	-64	-8	-29	0	0	0	0	0	0
Liabilities	2,715	2,965	1,049	-228	537	1,274	-14	1,067	862	1,970
Disbursements	7,700	7,640	6,330	5,650	8,726	8,836	8,164	8,792	9,209	11,035
Amortization	-4,985	-4,676	-5,280	-5,878	-8,190	-7,562	-8,178	-7,725	-8,347	-9,065
Currency and deposits	-1,743	-511	1,742	606	519	431	708	1,114	819	969
Short-term capital flows (net)	168	696	-31	280	160	94	98	103	108	114
Trade credits	214	-95	7	146	-163	73	87	89	89	60
Other liabilities (long-term)	3	1	2	1	0	0	0	0	0	0
Net errors and omissions 1/	-1,407	-1,584	-1,106	-886	-1,220	-1,320	-1,120	-1,195	-1,195	-1,195
Overall balance	722	-330	896	336	-299	328	315	211	369	358
Financing	-722	330	-896	-84	299	-328	-315	-211	-369	-358
Gross reserves (-= increase)	-722	330	-896	-84	299	-328	-315	-211	-369	-358
IMF (net purchases)	0	0	0	0	0	0	0	0	0	0
Exceptional financing	0	0	0	0	0	0	0	0	0	0
Memorandum items:										
Current account (percent of GDP)	-7.2	-8.8	-5.3	-1.3	-2.2	-3.0	-3.6	-3.8	-4.9	-5.5
Export goods volume growth (excluding ships)	9.0	2.2	-16.1	8.6	2.9	4.7	4.1	3.5	4.0	4.5
Import goods volume growth	11.3	-1.8	0.9	-15.8	1.3	1.6	3.6	4.5	4.9	5.3
Gross official reserves	9,307	9,121	10,376	10,660	10,362	10,691	11,006	11,216	11,585	11,943
Months of next year's imports of goods and nonfactor services	4.7	6.2	7.1	6.7	6.2	6.1	5.9	5.6	5.4	5.4
Outstanding debt 2/	33,721	40,590	45,244	46,440	45,978	48,264	49,657	52,297	54,463	58,251
External debt to GDP ratio 2/	77.7	85.0	99.1	101.1	97.6	97.7	95.2	94.8	93.0	93.8
External debt in percent of exports of goods and nonfactor services 2/	184.2	203.9	280.0	263.9	245.8	246.2	242.7	245.1	244.0	248.3
Short-term debt by remaining maturity (percent of GIR)	91.5	142.0	105.2	141.1	131.6	134.1	131.1	138.5	138.4	135.2
External debt service	-6,956	-6,848	-8,295	-7,324	-11,411	-10,185	-11,024	-10,860	-12,086	-12,656
GDP (millions of euros)	43,391	47,769	45,668	45,919	...	...	...	...	...	...
GDP (millions of kuna)	318,309	345,014	335,189	334,564	347,071	363,816	384,099	406,304	431,048	457,298

Sources: Croatian National Bank; and IMF staff estimates.

1/ Errors and omissions are explicitly projected to reflect persistent unrecorded capital outflows.

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

Table 5. Croatia: External Financing Requirement, 2007-12

(Millions of euros, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012
				Est.	Proj.	
Financing requirements	-12,236	-12,500	-15,952	-11,003	-15,511	-15,134
Current account deficit	-3,119	-4,217	-2,408	-582	-1,037	-1,494
Amortization of medium and long-term debt	-5,698	-5,412	-7,667	-6,395	-10,660	-9,481
Public	-940	-776	-1,350	-405	-1,434	-723
Private	-4758	-4636	-6318	-5989	-9226	-8758
Banks 1/	-1,879	-914	-2,182	-1,361	-1,829	-2,640
Nonbanks 2/	-2,879	-3,722	-4,136	-4,628	-7,398	-6,118
Repayment of short-term debt (including deposits and trade credit)	-3,419	-2,871	-5,877	-4,026	-3,815	-4,159
Public	0	32	-33	0	-1	0
Private	-3,419	-2,903	-5,844	-4,026	-3,814	-4,159
Banks	-3,362	-2,357	-3,791	-3,091	-3,214	-3,541
Nonbanks	-57	-546	-2,053	-935	-600	-619
Financing sources	12,236	12,500	15,952	11,003	15,511	15,134
Capital transfers	28	15	43	36	35	35
FDI, net	3,468	3,246	1,207	593	770	988
Disbursements on bonds and MLT loans	9,367	7,953	10,949	6,460	10,632	11,559
Public	1,209	478	2,122	866	2,144	2,338
Private	8,158	7,475	8,827	5,594	8,489	9,221
Banks	1,558	597	3,481	1,038	2,035	2,605
Nonbanks	6,599	6,878	5,346	4,556	6,454	6,616
Short-term financing	3,240	4,514	5,319	4,414	4,050	4,367
Public	0	0	0	0	0	0
Private	3,240	4,514	5,319	4,414	4,050	4,367
Banks 1/	2,424	3,654	3,076	3,202	3,432	3,718
Nonbanks 2/	816	860	2,243	1,212	619	650
Other flows	-3,146	-3,558	-670	-417	-276	-1,487
Gross international reserves (- = increase)	-722	330	-896	-84	299	-328
Financing gap	0	0	0	0	0	0
Memorandum items						
Current account deficit (percent of GDP)	-7.2	-8.8	-5.3	-1.3	-2.2	-3.0
Gross official reserves	9,302	9,121	10,391	10,662	10,362	10,691
Months of imports	4.7	6.2	7.1	6.7	6.2	6.1
Percent of short-term debt by remaining maturity	109	70	95	71	76	75
GDP	43,391	47,769	45,668	45,919	...	...

Sources: Croatian National Bank; and IMF staff projections.

1/ Includes longer-term currency and deposits.
2/ Includes longer-term trade credits.

Table 6. Croatia: Medium-Term Baseline Scenario, 2007–16 1/

(Percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Est.			Proj.			
Real sector (percent change)										
Real GDP 2/	5.1	2.2	-6.0	-1.2	1.0	1.8	2.5	2.7	3.0	3.0
Domestic demand	6.4	2.9	-7.7	-3.5	0.5	0.9	2.3	2.7	3.0	3.1
Consumption, total	6.1	1.1	-6.3	-0.8	0.0	1.0	2.1	2.2	2.5	2.5
Of which: private	6.3	0.8	-8.5	-0.9	0.1	0.5	2.0	2.1	2.5	2.5
Gross fixed capital formation, total	7.1	8.2	-11.8	-11.3	2.1	0.4	3.0	4.4	4.6	4.7
Of which: private	5.2	15.2	-11.0	-11.0	0.4	1.5	2.5	4.0	4.3	4.4
CPI inflation (average)	2.9	6.1	2.4	1.1	3.2	2.4	2.2	2.5	3.0	3.0
Saving and investment										
Domestic investment	31.0	32.8	28.7	25.0	26.2	27.3	27.9	29.0	30.3	31.2
Of which: fixed capital formation	26.2	27.7	24.9	21.6	22.1	21.9	22.0	22.3	22.7	23.0
Domestic saving	23.8	23.9	23.4	23.7	24.0	24.3	24.3	25.2	25.3	25.7
Government	3.2	0.0	-1.5	-2.4	-2.1	-1.6	-1.2	-0.8	-0.2	0.0
Nongovernment	20.1	20.8	23.4	25.2	26.4	26.4	26.0	26.4	26.2	25.9
General government finances 3/										
Revenue	40.2	39.5	38.4	37.2	35.5	35.4	35.4	35.5	35.3	35.3
Expenditure	42.4	40.7	42.5	42.2	41.3	40.5	40.0	39.7	39.3	38.8
Balance	-2.1	-1.3	-4.1	-5.0	-5.7	-5.1	-4.6	-4.2	-3.9	-3.5
Government debt	32.8	29.0	35.2	41.2	47.4	50.0	51.8	53.1	53.9	54.1
Balance of payments										
Current account balance	-7.2	-8.8	-5.3	-1.3	-2.2	-3.0	-3.6	-3.8	-4.9	-5.5
Exports of goods, f.o.b.	21.2	20.5	16.9	19.8	20.5	20.8	20.7	20.5	20.4	20.4
Imports of goods, f.o.b.	-42.9	-43.1	-33.0	-32.8	-34.5	-34.8	-34.7	-34.8	-35.1	-35.3
Capital and financial account	12.1	11.5	9.7	3.9	4.2	6.4	6.4	6.3	7.6	8.0
Of which: FDI, net	8.0	6.8	2.7	1.2	1.6	2.0	2.0	2.2	2.4	2.7
Gross official reserves	21.5	19.1	22.7	23.2	22.0	21.6	21.1	20.3	19.8	19.2
Gross external debt	77.7	85.0	99.1	101.1	97.6	97.7	95.2	94.8	93.1	93.8
Net external debt	40.6	50.9	60.0	62.5	60.4	60.6	58.1	57.6	55.9	56.7
Memorandum items:										
Nominal GDP (millions of kuna)	318,309	345,014	335,189	334,564	347,071	363,816	384,099	406,304	431,048	457,298
Nominal GDP (millions of euros)	43,391	47,769	45,668	45,919	…	…	…	…	…	…

Sources: Crostat; Croatian National Bank; Ministry of Finance; and IMF staff estimates.

1/ National account statistics for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). On average, revised nominal GDP figures are 15.6 percent higher than the previous estimates.

2/ Assumes an increase in total factor productivity and potential growth as EU accession approaches.

3/ ESA 95 presentation.

Table 7. Croatia: Indicators of External and Financial Vulnerability, 2007–11

	2007	2008	2009	2010	2011	Latest observation
External indicators						
Current account deficit (millions of euros)	-3,119	-4,217	-2,408	-582	...	2010Q4
Percent of GDP	-7.2	-8.8	-5.3	-1.3	...	2010Q4
Capital and financial account (percent of GDP)	12.1	11.5	9.7	3.9	...	2010Q4
FDI, net (percent of GDP)	8.0	6.8	2.6	1.3	...	2010Q4
Export goods volume growth (excluding ships, percent)	9.0	2.2	-16.1	8.6	...	2010Q4
Import goods volume growth (percent)	11.3	-1.8	0.9	-15.8	...	2010Q4
Real effective exchange rate (CPI-based, 2005=100)	102.8	107.5	108.6	106.0	105.8	1-Apr-11
Gross official reserves (millions of euros)	9,307	9,121	10,376	10,660	...	2010Q4
Percent of broad money	31.6	29.7	33.9	33.8	...	2010Q4
Percent of reserve money	131.4	134.3	134.8	139.9	...	2010Q4
Months of following year's imports of goods and nonfactor services	4.7	6.2	7.1	6.7	...	2010Q4
Percent of domestic FX deposits	66.1	57.0	55.9	53.3	...	2010Q4
Net international reserves (millions of euros)	7,349	8,020	9,365	9,644	...	2010Q4
Months of current year's imports of goods and nonfactor services	4.1	4.1	6.3	6.6	...	2010Q4
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	...	2010Q4
Short-term debt (by remaining maturity, percent of NIR)	115.8	161.5	116.8	156.0	...	2010Q4
Short-term debt and current account deficit net of FDI (percent of NIR)	129.0	176.4	116.6	158.8	...	2010
External debt service to export ratio	38.0	34.4	51.3	41.6	...	2010Q4
Financial indicators						
General government debt (percent of GDP)	32.3	28.5	34.5	40.6	...	2010
Broad money (year-on-year percent change)	18.3	4.3	-0.9	4.4	3.1	1-Apr-11
Claims on private sector (year-on-year percent change)	14.6	11.8	-0.7	6.1	5.2	1-Apr-11
3-month interbank rate (period average)	5.7	7.2	8.9	2.2	1.3	2-Jun-11
Stock market CROBEX index (1000 at July 1, 1997, e.o.p.)	5,239	1,722	2,004	2,111	2,272	2-Jun-11
Zagreb Stock Exchange, capitalization (stocks, percent of GDP)	123.8	51.3	51.2	57.9	59.6	2-Jun-11
Bond yield spreads (EMBI Global, e.o.p.)	...	...	195	298	303	2-Jun-11
Long-term foreign currency sovereign debt ratings						
Domestic currency (Fitch)	BBB+	BBB+	BBB	BBB	BBB	21-May-09
Foreign currency (Fitch)	BBB-	BBB-	BBB-	BBB-	BBB-	28-Jun-01
Domestic currency (Moody's)	Baa1	Baa2	Baa3	Baa3	Baa3	17-Apr-09
Foreign currency (Moody's)	Baa3	Baa3	Baa3	Baa3	Baa3	27-Jan-97
Domestic currency (Standard and Poor's)	BBB+	BBB+	BBB	BBB-	BBB-	21-Dec-10
Foreign currency (Standard and Poor's)	BBB	BBB	BBB	BBB-	BBB-	21-Dec-10

Sources: Croatian National Bank; Crostat; Ministry of Finance; and IMF staff estimates.

Table 8. Croatia: Financial Soundness Indicators, 2007–10

(Percent, unless otherwise indicated)

	2007	2008	2009				2010			
			Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Core set										
Regulatory capital to risk-weighted assets	16.9	15.4	15.6	16.1	16.2	16.6	18.9	19.0	18.7	18.8
Regulatory Tier I capital to risk-weighted assets	16.6	15.2	15.3	15.6	15.6	15.3	17.7	17.8	17.5	17.5
Nonperforming loans net of loan-loss provisions to capital	11.3	12.8	14.1	17.1	17.2	22.2	25.1	28.4	30.5	34.8
Nonperforming loans to total gross loans 1/	4.8	4.9	5.2	6.1	6.4	7.8	8.8	9.5	10.2	11.2
Sectoral distribution of loans to total loans										
Nonfinancial corporations	38.5	38.2	37.4	37.3	37.0	37.5	38.1	38.2	38.3	38.2
Households	50.7	49.8	47.9	47.2	46.7	46.7	46.3	45.8	45.6	45.5
Other sectors	10.8	12.1	14.7	15.4	16.3	15.8	15.6	15.9	16.1	16.4
Return on assets	1.6	1.6	1.6	1.4	1.3	1.1	1.1	1.0	1.0	1.1
Return on equity	10.9	9.9	9.4	8.4	7.4	6.4	6.1	5.4	5.7	6.6
Net interest income to gross income	60.5	60.0	57.6	57.7	55.5	55.4	58.1	60.4	62.1	62.6
Noninterest expenses to gross income	68.9	65.4	66.8	69.5	72.6	75.5	76.1	78.2	77.3	75.1
Liquid assets to total assets 2/	12.7	11.7	7.9	9.6	10.9	11.7	11.5	11.2	11.7	11.5
Liquid assets to short-term liabilities 2/	49.3	51.9	40.4	48.2	55.1	58.9	57.8	56.1	56.3	57.4
Net open position in foreign exchange to capital	4.3	3.6	5.1	5.1	7.3	5.5	4.2	2.9	4.9	5.2
Encouraged set										
Deposit takers 3/										
Capital to assets	12.5	13.5	13.9	14.0	14.0	13.9	14.4	14.1	14.2	13.9
Large exposures to capital	58.4	45.7	33.6	33.7	40.0	53.6	…	…	…	…
Geographical distribution of loans to total loans										
Residents	99.3	99.2	99.3	99.3	99.3	99.4	99.4	99.4	99.4	99.3
Nonresidents	0.7	0.8	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.7
Gross asset position in derivatives to capital	0.6	0.2	1.1	1.0	0.7	0.4	0.3	0.5	0.5	0.3
Gross liability position in derivatives to capital	0.9	3.2	1.1	0.6	0.6	0.8	1.1	2.6	2.1	2.7
Noninterest income to total income	44.5	40.0	42.4	42.3	44.5	44.6	41.9	39.6	37.9	37.4
Personnel expenses to noninterest expenses	34.4	35.9	34.5	33.0	31.0	29.0	28.9	28.6	28.8	29.1
Spread between domestic lending and deposit rates	7.0	7.2	7.5	7.9	8.1	8.4	8.7	8.7	8.7	8.6
Spread between foreign exchange lending and deposit rates	3.2	3.8	3.6	3.8	3.9	4.0	4.3	4.2	4.4	4.5
Noninterbank loans to noninterbank deposits	105.6	114.2	121.6	120.9	116.0	116.1	116.7	118.5	117.8	120.0
Foreign currency-denominated loans to total loans 4/	59.8	65.4	68.3	69.4	71.0	72.7	73.1	72.8	73.2	73.6
Foreign currency-denominated liabilities to total liabilities 4/	73.6	75.8	76.1	76.5	77.5	78.8	77.3	75.7	76.3	76.7
Net open position in equities to capital	0.2	0.0	0.0	0.0	0.0	0.0	...	...	...	...
Other financial corporations (OFCs)										
OFCs' assets to total financial system assets	26.9	23.4	23.6	24.4	24.6	24.6	25.7	24.8	24.7	24.7
OFCs' assets to GDP	39.8	32.7	33.1	34.9	36.1	36.9	38.7	37.7	37.7	38.5
Nonfinancial corporations 5/										
Total debt to equity	50.6	58.0	…	…	…	…	…	…	…	…
Return on equity	5.8	3.9	…	…	…	…	…	…	…	…
Net foreign exchange exposure to equity	9.6	10.4	…	…	…	…	…	…	…	…
Households										
Bank loans to households to GDP	39.0	40.1	40.4	39.7	39.9	40.1	40.1	40.7	40.6	41.3
Household debt service (interest) payments to income	5.5	…	...	...	...	...	...	...	...	...
Real estate markets										
Residential real estate prices (annual percentage increase)	8.9	4.7	...	-4.7	...	-3.1	...	-3.0	...	-9.4
Residential real estate loans to total loans	20.7	21.1	20.6	20.4	20.6	20.8	20.9	21.1	21.1	21.4
Commercial real estate loans to total loans	...	...	...	...	...	...	...	...	...	...
Other indicators										
Loan-loss provisions to nonperforming loans	54.4	48.7	47.3	44.2	46.0	42.5	40.9	39.5	39.3	38.8
Change in credit to GDP ratio	8.0	9.0	10.3	7.0	5.3	1.7	-0.1	3.0	4.1	6.1
Net interest income to average total assets	2.6	2.8	2.8	2.7	2.6	2.6	2.7	2.7	2.8	2.9
Noninterest expenses to average total assets	3.0	3.0	3.2	3.3	3.4	3.5	3.5	3.5	3.5	3.4
Loans to assets	62.7	66.6	69.6	68.4	67.5	66.7	67.9	68.3	67.8	68.3
Liquid assets to total deposits	18.8	17.4	11.8	14.4	15.9	17.3	16.9	16.5	17.0	16.7
Net claims on government to total assets	4.1	5.6	8.0	7.9	8.1	7.2	7.7	8.0	7.7	7.9
Foreign currency deposits to total deposits	57.2	59.7	63.7	64.0	66.9	67.7	68.8	68.0	68.9	69.1

Source: Croatian National Bank.

1/ Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims.

2/ 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. The sharp decline in liquidity in 2005 coincided with the start of reverse repo operations by the CNB that gave banks market-based access to liquidity when needed.

3/ Commercial banks only. End-year FSIs, based on audited annual financial statements, can differ slightly from quarterly data.

4/ Includes kuna-denominated instruments linked to foreign currencies.

5/ Based on unconsolidated audited financial statements following IAS; not in line with the IMF FSI Compilation Guide.

Table 9. Croatia: Public Sector Debt Sustainability Framework, 2006–16

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	
Baseline: public sector debt 1/	34.8	32.8	29.0	35.2	41.2	47.4	50.0	51.8	53.1	53.9	54.1	0.5
Of which: foreign-currency denominated	28.5	26.1	23.8	25.9	28.3	26.2	26.5	26.3	25.2	23.4	23.1	
Change in public sector debt	-2.7	-2.0	-3.8	6.2	6.0	6.2	2.5	1.8	1.3	0.8	0.3	
Identified debt-creating flows (4+7+12)	-1.9	-1.5	2.9	7.7	10.3	4.6	3.6	2.8	2.2	1.7	1.2	
Primary deficit	0.7	0.6	-0.1	2.4	3.0	3.6	2.7	2.2	1.7	1.4	0.9	
Revenue and grants	39.0	40.2	39.5	38.4	37.2	35.5	35.4	35.4	35.5	35.3	35.3	
Primary (noninterest) expenditure	39.7	40.9	39.4	40.8	40.2	39.1	38.1	37.6	37.2	36.8	36.2	
Automatic debt dynamics 2/	-4.4	-4.2	-0.2	2.1	4.6	0.9	0.5	0.2	0.1	0.0	0.0	
Contribution from interest rate/growth differential 3/	-1.3	-1.2	-1.1	2.6	2.1	0.9	0.5	0.2	0.1	0.0	0.0	
Of which: contribution from real interest rate	0.4	0.4	-0.4	0.8	1.7	1.3	1.3	1.4	1.4	1.5	1.5	
Of which: contribution from real GDP growth	-1.7	-1.6	-0.7	1.8	0.4	-0.4	-0.8	-1.2	-1.3	-1.5	-1.5	
Contribution from exchange rate depreciation 4/	-3.2	-2.9	0.9	-0.5	2.5	...	...	...	...	...	...	
Other identified debt-creating flows	1.8	2.0	3.2	3.2	2.7	0.1	0.4	0.4	0.4	0.4	0.3	
Privatization receipts (negative)	-1.4	-1.0	-0.3	-0.2	0.0	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	
Recognition of implicit or contingent liabilities	0.5	0.1	0.1	0.6	0.0	0.3	0.5	0.5	0.5	0.5	0.4	
Other (specify, e.g. bank recapitalization)	2.8	2.9	3.4	2.7	2.7	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-0.8	-0.5	-6.7	-1.5	-4.3	1.6	-1.0	-1.0	-0.9	-0.9	-0.9	
Public sector debt-to-revenue ratio 1/	89.1	81.6	73.4	91.6	110.7	133.5	141.0	146.2	149.3	152.4	153.3	
Gross financing need 6/	11.4	11.2	9.4	15.3	16.7	16.9	15.3	16.5	16.0	16.1	12.3	
Billions of U.S. dollars	4520.4	4865.4	4500.1	6997.3	7688.0	7943.9	7552.5	8620.2	8836.3	9403.6	7618.9	
Scenario with key variables at their historical averages 7/						46.8	47.7	48.5	49.5	50.4	51.3	0.0
Scenario with no policy change (constant primary balance) in 2011–16						47.4	50.6	53.1	55.6	57.9	60.2	-0.2
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (percent)	4.9	5.1	2.2	-6.0	-1.2	1.0	1.8	2.5	2.7	3.0	3.0	
Average nominal interest rate on public debt (percent) 8/	5.5	5.5	4.9	5.7	5.8	6.0	6.0	6.0	6.0	6.0	6.0	
Average real interest rate (nominal rate minus change in GDP deflator, percent)	1.5	1.4	-1.2	2.4	4.7	3.2	3.0	3.0	3.0	3.0	3.0	
Nominal appreciation (increase in U.S. dollar value of local currency, percent)	11.7	11.9	-3.3	1.8	-8.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, percent)	4.0	4.1	6.1	3.3	1.0	2.8	3.0	3.0	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, percent)	4.7	8.1	-1.5	-2.5	-2.7	-1.7	-1.0	1.2	1.7	1.7	1.4	
Primary deficit	0.7	0.6	-0.1	2.4	3.0	3.6	2.7	2.2	1.7	1.4	0.9	

1/ Gross debt of general government (including guarantees) and of monetary authorities.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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.

Table 10. Croatia: External Debt Sustainability Framework, 2006–16

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing noninterest current account
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	
Baseline: external debt	73.7	77.7	85.0	99.1	101.1	97.6	97.7	95.2	94.8	93.1	93.8	-3.7
Change in external debt	2.2	4.1	7.3	14.1	2.1	-3.6	0.1	-2.5	-0.4	-1.7	0.8	
Identified external debt-creating flows (4+8+9)	-7.3	-7.7	-4.9	6.5	-0.7	-0.4	-0.6	-0.7	-0.9	-0.2	0.2	
Current account deficit, excluding interest payments	4.2	4.2	5.5	2.0	-1.5	-1.9	-1.5	-1.1	-0.4	0.6	1.1	
Deficit in balance of goods and services	6.5	7.1	7.8	3.5	0.1	0.6	0.9	1.2	1.9	2.8	3.4	
Exports	42.7	42.2	41.7	35.4	38.3	39.7	39.7	39.2	38.7	38.1	37.8	
Imports	49.2	49.3	49.5	38.9	38.4	40.3	40.6	40.5	40.6	41.0	41.2	
Net non-debt creating capital inflows (negative)	-7.3	-8.7	-6.6	-2.7	-1.4	-1.6	-2.0	-2.0	-2.2	-2.4	-2.7	
Automatic debt dynamics 1/	-4.2	-3.2	-3.8	7.1	2.2	3.1	2.9	2.4	1.8	1.6	1.7	
Contribution from nominal interest rate	2.5	3.0	3.3	3.2	2.8	4.1	4.5	4.7	4.2	4.3	4.4	
Contribution from real GDP growth	-3.2	-3.4	-1.5	5.3	1.2	-0.9	-1.6	-2.3	-2.4	-2.7	-2.6	
Contribution from price and exchange rate changes 2/	-3.5	-2.8	-5.6	-1.4	-1.7	…	…	…	…	…	…	
Residual, incl. change in gross foreign assets (2-3) 3/	9.5	11.8	12.2	7.6	2.8	-3.2	0.8	-1.8	0.5	-1.6	0.6	
External debt-to-exports ratio (percent)	172.3	184.2	203.9	280.0	263.9	245.8	246.2	242.7	245.1	244.0	248.3	
Gross external financing need (billions of U.S. dollars) 4/	11.5	12.9	12.5	15.5	11.3	16.0	15.1	16.2	16.5	18.5	19.5	
Percent of GDP	29.0	29.6	26.2	34.0	24.7	34.0	30.6	31.1	30.0	31.5	31.4	
Scenario with key variables at their historical averages 5/						97.6	96.7	93.3	92.1	89.0	87.9	-7.0
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	4.9	5.1	2.2	-6.0	-1.2	1.0	1.8	2.5	2.7	3.0	3.0	
GDP deflator in U.S. dollars (percent change)	5.1	3.9	7.8	1.7	1.8	1.7	3.0	3.0	3.0	3.0	3.0	
Nominal external interest rate (percent)	3.8	4.5	4.7	3.6	2.8	4.1	4.8	5.1	4.7	4.8	5.0	
Growth of exports (U.S. dollar terms, percent)	11.2	7.8	8.7	-18.8	8.9	6.3	4.8	4.4	4.3	4.6	5.1	
Growth of imports (U.S. dollar terms, percent)	12.3	9.3	10.5	-24.8	-0.7	7.7	5.6	5.2	6.1	7.2	6.6	
Current account balance, excluding interest payments	-4.2	-4.2	-5.5	-2.0	1.5	1.9	1.5	1.1	0.4	-0.6	-1.1	
Net nondebt creating capital inflows	7.3	8.7	6.6	2.7	1.4	1.6	2.0	2.0	2.2	2.4	2.7	

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.

ANNEX I. ASSESSING CROATIA'S REAL EXCHANGE RATE

Staff's quantitative estimates of misalignment suggest that Croatia's real effective exchange rate is broadly in line with equilibrium.

- *Macroeconomic balance approach suggests the kuna is broadly in line with equilibrium*.[1] The underlying current account balance—proxied by the medium-term projected current account deficit under an assumption of unchanged polices—is estimated to be about 5.5 percent of GDP. Based on the Consultative Group on Exchange Rate Issues (CGER) estimates of panel regression coefficients, the current account deficit norm is estimated to be 4.6 percent of GDP. Upward adjustment of the real effective exchange rate in the order of 1.0 percent would be required to close the gap between the sustainable level of the current account balance and the underling current account balance.

Macroecoomic Balance Approach

Projected medium-term current account balance (percent of GDP)	-5.5
Current account norm (percent of GDP) 1/	-4.6
Elasticity 2/	0.3
RER gap (percent)	-1.0
Multilaterally consistent RER gap (percent)	1.0

1/ Estimated based on CGER methodology.

2/ Current account elasticity is computed based on standard elasticities for exports (-0.71) and imports (0.92) and exports and imports of goods and services (percent of GDP) in 2000–10.

- *The external sustainability approach suggests that the kuna is undervalued assuming stabilization of NFA at -90 percent of GDP*.[2] The gap between the underlying current account and the NFA-stabilizing balance suggests that Croatia's real effective exchange rate is undervalued by 2 percent.

[1] The macroeconomic balance approach tries to pinpoint an equilibrium relationship (the current account norm) between the current account balance and a set of fundamentals using panel data.

[2] The external sustainability approach focuses on the relationship between the sustainability of a country's external stock position and its flow current account position.

External Sustainability Approach

Real growth rate	3.0
NFA-stabilizing current account balance (percent of GDP) 1/	-1.5
RER gap (percent)	-1.7
Multilaterally consistent RER gap (percent)	-2.0
Memorandum items	
Projected medium-term current account balance (percent of GDP)	-5.5
Baseline NFA 2 /	-90.0
Elasticity 3/	0.3

1/ Estimated based on CGER methodology.
2/Stabilizing NFA at the current high negative levels may not be appropriate due to the high levels of indebtedness, alternatively stabilizing NFA at -55 of GDP would imply and overvaluation of 11 percent.
3/ Current account elasticity is computed based on standard elasticities for exports (-0.71) and imports (0.92) and exports and imports of goods and services (percent of GDP) in 2000–10.

- *The equilibrium exchange rate approach suggests a small undervaluation of the currency.* Real exchange rate undervaluation is estimated at below 4 percent in the full sample but wider in the smaller sample, which only includes EU member countries.

Equilibrium Real Exchange Rate Approach

	Full sample 1/	EU sample
	(Percent)	
REER overvaluation (average, 2010)	-0.4	-5.0
REER overvaluation (December, 2010)	-3.8	-8.2

Note: Based on the model reported in (SM/08/168)

1/ Includes OECD-Eurostat and CIS countries.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Staff Report for the 2011 Article IV Consultation—Informational Annex

Prepared by the European Department
(In consultation with other departments)

June 8, 2011

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Annex I. Croatia: Fund Relations

(as of April 30, 2011)

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

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	365.10	100.00
Fund holdings of currency (Exchange Rate)	364.94	99.96
Reserve Tranche Position	0.16	0.04

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	347.34	100.00
Holdings	303.25	87.31

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
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

VI. Projected Payments to Fund [1/]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/Interest	0.17	0.24	0.24	0.24	0.24
Total	0.17	0.24	0.24	0.24	0.24

[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.

VII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and 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 by the CNB. Croatia's *de facto* exchange rate arrangement is classified as "crawl like arrangement" from April 30, 2011. The CNB transacts only in euros, U.S. dollars, and SDRs. On May 23, 2011 the official exchange rate was kuna 7.41564 per euro (middle rate).

VIII. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of 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).

IX. Article IV Consultation:

The previous **Article IV consultation** with Croatia was concluded on June 21, 2010 (IMF Country Report No. 10/143 available at: http://www.imf.org/external/country/hrv/index.htm). Croatia is on the 12-month consultation cycle.

X. FSAP:

An FSAP Update mission took place in October–November 2007. The FSSA Update was published (IMF Country Report No. 160 available 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).

XI. Technical Assistance 2000–10:[1]

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

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

		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
STA	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Real Sector Statistics
	April 2001	Monetary and Banking Statistics
	March 2002	Accounting and Budgetary Classification (FAD)
	October 2002, June 2004	Government Finance Statistics
	September 2006	Monetary and Financial Statistics
	December 2007	LTE: Government Finance Statistics
MCM	May–June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March–April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
	April 2003	Stress Testing and Foreign Exchange Reserve Management
	February 2004	Monetary Policy Instruments
	January 2007–	Macro-Financial Modeling and Forecasting
	continuing	Macro-Financial Modeling and Forecasting

	May 2007	Modeling and Forecasting
	June 2007	Modeling and Forecasting
	September 2007	FSAP Update
	October 2007	Modeling and Forecasting
	November 2007	Modeling and Forecasting
	March 2008	Macro-Financial Modeling and Forecasting
	August 2008	Macro-Financial Modeling and Forecasting
	February 2009	Modeling
	July 2009	Monetary Policy and Modeling
	May 2010	Modeling
	March 2011	
LEG	April 2010	AML/ CFT
	August 2010	AML/ CFT
	February 2011	AML/ CFT
	May 2011	AML/ CFT

XII. Resident Representative: The post closed in June 2007.

Annex II. Croatia: Statistical Issues

1. Data provision is broadly adequate for effective surveillance, though some improvements would be desirable. While remedial action has been taken to improve data coverage and reliability in most cases, progress in some instances has been impeded by insufficient resources and issues regarding coordination among government agencies. Croatia subscribes to the Special Data Dissemination Standard.

A. National Accounts

2. The national accounts have undergone substantial improvements in the last few years. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the 1995 ESA. Quarterly GDP estimates are disseminated at current prices and at constant (2000) prices for the main categories of expenditure and main industry groupings. Nonetheless, shortcomings remain. Significant discrepancies exist between expenditure-based and value-added-based GDP data, stemming from: (i) problems of coordination between the CBS and the Croatian National Bank (CNB) in reconciling tourism receipts estimates; (ii) incomplete coverage of unincorporated businesses and the self-employed (farmers, traders, and craftsmen); (iii) inadequate data for measuring changes in inventories; (iv) incomplete coverage of the informal sector; and (v) a lack of quarterly data for the seasonally volatile agricultural sector.

B. Prices

3. The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from a 2005 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 all cases between the thirteenth and the twenty-first day of each month. 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. A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology, but is not released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the 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.

C. Wages and Employment

4. The CBS produces data on average net and gross earnings per person and employment by sector. Earning data include bonuses, sick pay, and meal allowances, and are based on monthly surveys covering 70 percent of workers in permanent employment in each

industrial category. They do not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, farmers, and the military and police.

5. The number of registered unemployed overstates the actual level of unemployment. 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. The CBS released semi-annual results from 1998, and began releasing quarterly results in 2007 with a lag of about four months.

D. Government Finance Statistics

6. The authorities have started presenting budget plans based on the ESA 95 framework, but government finance statistics produced on a monthly basis on the GFSM framework (GFS) have been available in the *Monthly Statistical Review* of the Ministry of Finance (MoF). Data normally come with a lag of about one quarter. 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 the budgetary funds. The data on central government financing in the MoF reports are not reconciled with those in the CNB's monetary survey and balance of payments data, with substantial discrepancies owing partly to different methodologies and definitions of government. Following the recommendations of the October 2002 GFS mission, a task force, comprising staff from the MoF, CNB, and CBS was formed to reconcile central government financing data produced by these institutions.

7. The detailed data on domestic public bonds published in the *Monthly Statistical Review* are now augmented by a central government debt table in the CNB *Monthly Bulletin*, which also reports stocks of central government guaranteed debt. The MoF prepared a database with government guarantees in July 2003 that has been used to monitor developments in the stock and flows of guarantees.

8. Data on the operations of local governments and consolidated general government are available on a quarterly basis. Local government data are partial as they include the operations of the 53 largest municipalities.

E. Monetary Data

9. Compilation of monetary statistics published by the CNB is consistent with the recommendations of the IMF's 2000 *Monetary and Financial Statistics Manual* (*MFSM*). Data on the monetary survey, including separate records for deposit money banks and the balance sheet of the CNB, are published monthly with four- and two-week lags, respectively. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies. In March 2002, the CNB started collecting financial information (balance sheets and investment structure) from investment and pension funds; the data are not yet published, but used for internal purposes. According to the CNB, the inclusion of other financial corporations in monetary statistics depends on the

harmonization process of the monetary statistics with the statistical reporting requirements of the European Central Bank. In November 2006, the CNB reported monetary data in the format of Standardized Report Forms for December 2001 to the present. These data accord with the concepts and definitions in *MFSM* and were published, along with the corresponding metadata, in *IFS* and the *IFS Supplement on Monetary and Financial Statistics*.

F. External Sector Statistics

10. Quarterly balance of payments data are compiled broadly in accordance with the fifth edition of the IMF's *Balance of Payments Manual*. Data are generally available with a lag of three months and are subject to substantial revisions in subsequent releases; trade data are available with a lag of one month and data on international reserves are available the next day on request. Travel survey methodologies were modified in 2002, 2004, and again in 2005, while the method for estimating the cost of insurance and freight was modified in early 2004. Net errors and omissions have ranged from 2½ to 3¾ percent of GDP since 2003, and are negative. The coverage and quality of portfolio investment data are reasonably complete and accurate.

11. A large part of external debt was contracted prior to the dissolution of the former Socialist Federal Republic of Yugoslavia and Croatia's share was agreed with Paris and London Club creditors in 1995 and 1998, respectively. The CNB compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2003*, and began disseminating external debt data in the second quarter of 2003. The inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals and arrears has caused an upward adjustment in the external debt series compared to previously released data. Quarterly data on the international investment position are available on the CNB website up to 2010:Q4.

Croatia: Table of Common Indicators Required for Surveillance
(as of May 20, 2010)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	5/19/10	5/19/10	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Mar 2010	4/15/10	M	M	M
Reserve/Base Money	Mar 2010	4/30/10	M	M	M
Broad Money	Mar 2010	4/30/10	M	M	M
Central Bank Balance Sheet	Mar 2010	4/30/10	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 2010	4/30/10	M	M	M
Interest Rates 2/	Mar 2010	4/30/10	M	M	M
Consumer Price Index	Mar 2010	4/30/10	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2010:Q4	3/31/10	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	Jan 2010	4/30/10	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	Dec 2010	5/15/10	M	M	M
External Current Account Balance	2010:Q4	4/23/10	Q	Q	Q
Exports and Imports of Goods and Services	Mar 2010	4/30/10	Q	Q	Q
GDP/GNP	2010:Q4	3/29/10	Q	Q	Q
Gross External Debt	Jan 2010	3/31/10	M	M	M
International Investment Position	2010:Q4	3/31/10	Q	Q	Q

1/ Reserve assets that are pledged of otherwise encumbered are specified separately. Data comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

Annex III. Croatia: World Bank Relations

1. The World Bank's Board endorsed the Country Partnership Strategy (CPS) for Croatia for FY09–12 in September 2008, just before the full onset of the global financial crisis. The goal of the CPS is to support the completion of Croatia's EU accession process, the rapid convergence of its income level with that of current EU member states in a fiscally, socially and environmentally sustainable fashion. This overarching goal is in line with the Government's priorities expressed in various government programs. In pursuing this goal, the Bank Group program aims at contributing in the following four areas:

- sustaining macroeconomic stability;
- strengthening private sector-led growth and accelerating convergence with the EU;
- improving the quality and efficiency in the social sectors; and
- increasing the sustainability of long-term development.

2. The EU accession agenda remains a cross-cutting theme in the design and implementation of the Bank Group program. In the selection and design of operations, primary consideration is given to the assessment of proposed projects' support of Croatia's EU accession agenda. In the case of social sectors not covered under the EU *acquis*, consideration is also given to how projects complement the EU accession efforts. Project components that enhance Croatia's capacity to absorb EU funds, especially following the accession, have high priority.

3. The CPS envisages an indicative base-case lending envelope of about US$1.0–1.4 billion for investment operations over the four-year period. The CPS also includes an upside scenario, with possible development policy lending amounting to some US$1.4–1.8 billion. The lending program will be based on and complemented by analytical work, particularly in the areas of public expenditure reform, governance, investment climate, and climate change.

4. In FY10, the Bank's Board has approved three loans amounting to US$475 million, to help mitigate the impact of the global economic crisis and provide funding for the private sector, through a credit line of about EUR100 million for exporters, and through a Fiscal, Social and Financial Sector Development Policy Loan of EUR200 million. In addition, an investment operation for judicial sector has been approved. In FY11, the Bank's Board approved two loans amounting to USD242 million: (i) an Economic Recovery Development Policy Loan of EUR150 million to support the authorities in implementing Economic Recovery Program from April 2010 aiming to address the vulnerabilities and competitiveness issues of the economy; and (ii) investment loan EU Natura 2000 Integration to support adjustment to EU Species and Habitats Directives.

5. Currently, the World Bank finances 15 operations in a wide range of sectors with a net commitment of about US$1.3 billion. IFC's portfolio amounts to about US$279 million, and MIGA guarantees gross exposure amounts to US$649 million in the financial sector.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/84
FOR IMMEDIATE RELEASE
July 1, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes the 2011 Article IV Consultation with the Republic of Croatia

On June 24, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Croatia.[1]

Background

Croatia's economy has yet to show signs of a sustained recovery from the effects of the economic crisis. Domestic demand continued to contract in 2010, as household deleveraging and falling employment constrained private consumption, and low confidence hampered investment. Exports rebounded strongly, but given the narrow export base, were insufficient to pull Croatia out of the recession. Real GDP thus fell by 1¼ percent in 2010. The near-term outlook remains subdued, and growth is expected to reach 1 percent in 2011, while medium-term growth is likely to be curtailed by weak competitiveness.

The authorities made some progress in implementing the reforms outlined in the government's 2010 Economic Recovery Program (ERP), aimed at addressing deep-rooted structural rigidities and competitiveness problems. The pension law was

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

amended to gradually harmonize the retirement age between men and women at 65 years, and discourage early retirement. The unemployment law was changed to reduce benefits and duration. Judicial reforms were instituted to strengthen bankruptcy procedures for companies and business registration procedures were streamlined. However, implementation of other reforms needed to improve competitiveness, such as increasing labor market flexibility and reducing the size of the public sector, has been hampered by strong social resistance.

The authorities’ efforts did not prevent fiscal deterioration in 2010. Despite substantial positive contributions from measures undertaken in 2009 and 2010, the general government’s deficit widened to 5 percent of GDP in 2010 on the back of falling revenues. This was largely caused by declining profit and income taxes, and social contributions, as corporate profitability and employment plunged. Public debt stock rose to 41 percent of GDP.

External vulnerabilities remain elevated despite substantial adjustment in the current account. Rising exports and a contraction in imports reduced the current account deficit to about 1¼ percent of GDP in 2010 from just over 5 percent of GDP in 2009. Capital inflows slowed down correspondingly due to excess capacity and weak economic prospects. Yet external debt amounts to 100 percent of GDP, and foreign currency debt of the public and non-financial private sector is even higher.

The largely foreign-owned banking sector has weathered the economic downturn relatively well. The banking system has ample liquidity and is sufficiently capitalized. Nevertheless, asset quality deteriorated, with the overall nonperforming loan (NPL) ratio reaching 11 percent at end-2010. While aggregate profitability indicators started to recover in recent months, several small banks reported losses. Credit growth to corporates recovered somewhat, aided by official credit support schemes and accommodative monetary policy.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Croatia’s progress towards EU accession. At the same time, Directors noted that its narrow export base has prevented the country from taking full advantage of the growth rebound in its trading partners, and that significant challenges remain to be addressed to secure a sustained recovery. To improve the medium-term growth prospects of the economy, Directors stressed the need to tackle structural rigidities and weak competitiveness. Action is also needed to reduce the vulnerabilities arising from large external and foreign-currency debt and deteriorating public finances.

Directors emphasized that the implementation of comprehensive reforms to restore competitiveness and put the economy on a more sustainable footing is a priority. In light of the stable exchange rate policy, Directors generally agreed on the need for internal devaluation via reduction of prices and wages to more competitive levels. A few Directors cautioned that such devaluation could weaken growth prospects, stressing that it would need to be complemented by productivity-enhancing measures. Directors welcomed the progress made in some areas of the government's Economic Recovery Program. However, a more decisive reform effort is needed, focusing on increasing labor market flexibility and labor force participation, reducing the size of public administration, privatization of public companies, and further improving the business climate.

Directors stressed that the authorities should undertake substantial fiscal consolidation, especially by identifying additional spending cuts, to preserve market confidence and keep interest rates in check. For the medium term, they saw a need for continued expenditure-based consolidation, as envisaged in the Fiscal Responsibility Law (FRL), until an overall cyclically-adjusted balanced budget is achieved. This will create sufficient fiscal space and ensure debt sustainability. To make the FRL more credible, Directors encouraged the authorities to outline early on the measures underlying the fiscal targets.

Executive Directors considered the current accommodative monetary policy to be appropriate given the large output gap and low core inflation. While a few Directors considered the reserves adequate, many noted Croatia's relatively low reserve coverage. Directors underscored the need for adequate buffers in light of the high degree of euroization in the financial sector. They therefore generally agreed that monetary policy should aim at gradually building up reserves in order to increase Croatia's resilience to external vulnerabilities, while exercising caution toward shifts in market perception.

Directors noted that the financial sector appears resilient because of significant capital and liquidity buffers. Nevertheless, challenges arise from weak growth prospects, rising non-performing loans, and liquidity risks due to reliance on financing from parent banks. Directors therefore called for continued strong regulatory and supervisory measures and close coordination with home supervisors.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with Croatia is also available.

Croatia: Selected Economic Indicators, 2007–12 1/

	2007	2008	2009	2010 Est.	2011 Proj.	2012
Output, unemployment, and prices			(Percent change, unless otherwise indicated)			
Real GDP	5.1	2.2	-6.0	-1.2	1.0	1.8
Contributions:						
Domestic demand	6.4	2.9	-7.7	-3.5	0.5	0.9
Net exports	-1.9	-0.9	4.3	3.0	0.8	0.1
Unemployment (labor force survey, percent)	9.6	8.4	9.1	11.8	12.7	12.2
CPI inflation (average)	2.9	6.1	2.4	1.0	3.2	2.4
Average monthly nominal wages	6.2	7.1	2.2	-0.4	...	...
Saving and investment			(Percent of GDP)			
Domestic investment	31.0	32.8	28.7	25.0	26.0	27.4
Of which: fixed capital formation	26.2	27.7	24.9	21.6	22.1	21.8
Domestic saving	23.8	23.9	23.4	23.7	23.9	24.1
Government	3.7	3.2	0.0	-1.5	-2.5	-2.6
Nongovernment	20.1	20.8	23.4	25.2	26.5	26.7
Government sector 2/						
General government revenue	40.2	39.5	38.4	37.2	35.5	35.4
General government expenditure	42.4	40.7	42.5	42.2	41.3	40.5
General government balance	-2.1	-1.3	-4.1	-5.0	-5.7	-5.1
General government balance (broad definition) 3/	-3.1	-2.3	-5.4	-5.2	-6.0	-5.4
HBOR balance (net of budget transfers)	-0.5	-0.1	-0.6	-0.1	-0.1	-0.1
General government debt	32.8	29.0	35.2	41.2	47.4	50.0
Money and credit 4/			(End of period; change in percent)			
Bank credit to the nongovernment sector	15.0	10.6	-0.6	6.8	6.6	...
Broad money	18.3	4.3	-0.9	4.4	3.1	...
Interest rates 4/ 5/			(Period average; percent)			
Average kuna deposit rate (unindexed)	2.3	2.8	3.2	1.8	1.6	...
Average kuna credit rate (unindexed)	9.3	10.1	11.6	10.4	9.7	...
Average credit rate, foreign currency-indexed loans	6.3	7.5	8.1	8.1	7.4	...
Balance of payments			(Millions of euros, unless otherwise indicated)			
Current account balance	-3,119	-4,217	-2,408	-582	-1,037	-1,494
Percent of GDP	-7.2	-8.8	-5.3	-1.3	-2.2	-3.0
Capital and financial account	5,247	5,470	4,418	1,804	1,958	3,143
FDI, net (percent of GDP)	8.0	6.8	2.6	1.3	1.6	2.0
Overall balance	722	-330	896	84	-299	328
Debt and reserves			(End of period; millions of euros, unless otherwise indicated)			
Gross official reserves	9,307	9,121	10,376	10,660	10,362	10,691
Percent of short-term debt (by residual maturity)	109	70	95	71	76	75
Months of following year's imports of goods and nonfactor services	4.7	6.2	7.1	6.7	6.2	6.1
Net international reserves	7,349	8,020	9,365	9,644	9,715	10,043
External debt service to exports ratio (percent)	57.2	52.3	86.1	68.8	90.7	81.2
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	97.6	97.7
Net external debt (percent of GDP) 6/	40.6	50.9	60.0	62.5	60.4	60.5
Exchange rate						
Kuna per euro, end of period 7/	7.3	7.3	7.3	7.4	7.4	...
Kuna per euro, period average 7/	7.3	7.2	7.3	7.3	7.4	...
Real effective rate (CPI, percent change) 4/	0.7	4.6	1.1	-2.4	-1.5	...
Memorandum items:						
Nominal GDP (millions of euros)	43,391	47,769	45,668	45,919	47,132	49,406
Output gap (percent of potential)	0.9	1.7	-1.8	-4.2	-4.7	-4.5
Per capita GDP (2010): € 10,356 (WEO)			Percent of pop. below poverty line (2004): 11.1			
Quota (2010): SDR 365 million (563 million U.S. dollars)						

Sources: Croatian authorities, and IMF staff estimates.

1/ National account data for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). Revised nominal GDP figure for 2008 is about 14 percent higher than the previous estimate.

2/ ESA 95 presentation.

3/ Includes the balances of HBOR and HAC (net of budget transfers).

4/ Latest data as of end-April, 2011.

5/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.

6/ Net of official reserves and commercial bank foreign assets.

7/ Latest data as of end-May, 2011.

Statement by the Staff Representative on the Republic of Croatia
Executive Board Meeting
June 24, 2011

This statement provides information that has become available since the issuance of the staff report (SM/11/114). The new information does not alter the thrust of the staff appraisal.

- **On June 10, 2011 the European Commision proposed to the EU Council of Ministers to close the final chapters in the accession negotiations with Croatia.** This outcome was broadly anticipated, and paves the way for Croatia's EU membership as of mid-2013 if the Commision's recommendations are retained by the Council.

- **The Croatian National Bank reduced the discount rate, but left the Lombard rate, which sets the ceiling to the interest rate corridor on the money market, unchanged.** On June 8, 2011, the discount rate was reduced from 9 to 7 percent. From July 1, 2011, this will result in a proportional reduction in the statutory default rates, and a largely proportional reduction in the maximum contractual interest rates. However, this change will have no direct impact on bank lending rates, as current rates are below the maximum threshold.

- **The enhancements introduced in early 2011 to the official credit support scheme (Model A) have accelerated its utilization (Box 5, SM/11/114).** As of early June 2011, the total amount of funds originally allocated for this scheme of about 1.4 percent of GDP was approved for disbursement, and just over half was disbursed.

- **The government announced measures aimed at reducing the financial burden on foreign currency borrowers.** The government signed a memorandum on June 17, 2011, with representatives of eight banks to enable extension of loan maturities on mortgages in Swiss francs, while taking into account regulatory and banks' internal procedures. At this point, staff is not in a position to make an assessment of the possible impact on bank profitability and loan classification.

- **The parliament passed amendments to the labor law which allow for more flexible working hours.** Companies can now manage temporary changes in work load without having to hire or fire extra workers.

Statement by Mr. Age Bakker, Executive Director for Croatia
June 24, 2011

General

The authorities continue to appreciate the close cooperation with the Fund. They valued the frank discussions with staff on the 2011 Article IV Consultation. The authorities broadly share the staff's views in the report, although they would like to nuance some of the findings. In line with their long-standing practice, the authorities consent to publication of the paper.

Economic Developments and Outlook

Since the 2008-09 crisis, the Croatian economy has been undergoing a painful but necessary internal adjustment. GDP growth contracted in 2009 and 2010 as a result of a slump in domestic demand. In the face of lower capital inflows, private sector balance sheets have started to deleverage. Amid the growing negative output gap and rise in unemployment, average nominal monthly wages declined and inflation came practically to a halt last year. Due to a contraction in imports and increase in exports, the current account deficit reduced sharply from almost 9 percent in 2008 to slightly more than 1 percent of GDP in 2010.

Given the ongoing internal devaluation, the authorities broadly share staff's assessment of the outlook. As regards the balance of risks to the outlook, the authorities agree that these are tilted to the downside in the short run. Developments in the periphery of Europe could affect Croatia through higher funding costs, but the impact has so far been relatively limited. Staff argues that in light of high financing needs, a shift in investor sentiment could trigger lower rollovers of external debt and BOP pressures. However, the authorities consider the likelihood of such a scenario very small, given the intercompany nature of the debt inflows. These inflows have proven to be very stable. Even at the peak of the global crisis, rollover rates exceeded 100 percent. Based on the inflows so far, external rollover needs will almost certainly be met in 2011.

Policies

The authorities have been working arduously towards EU accession, involving a wide range of far-reaching reforms. These efforts have been rewarded, as the Commission recently proposed to the EU Council of Ministers to close the last four chapters in the accession negotiations with Croatia. This will pave the way for Croatia to join the EU as of 1 July 2013. While EU accession is expected to increase growth, partly through higher capital investment, the authorities are fully aware that EU accession in itself will not lead to miracles. They share staff's view that through enhancing competitiveness and securing macroeconomic policy space Croatia could obtain much larger benefits of EU accession.

Steadfast implementation of the Economic Recovery Program (ERP) and fiscal consolidation will therefore be required going forward.

Monetary and Exchange Rate policies

The authorities remain strongly committed to the broadly stable exchange rate regime. This policy has served the country well, by providing an anchor for inflation expectations and financial stability in the context of high financial euroization. Staff argues that the exchange rate regime has also contributed to overleveraging in foreign currency. According to the authorities, exactly the opposite is true. In Croatia, foreign currency credit is mostly driven by foreign currency deposits. Currency substitution was as high as 90 percent in the eighties and early nineties; reflecting a protracted period of unstable exchange rate developments and high inflation. Since the establishment of the actual exchange rate regime end-1993, liability and thus asset euroization in banks' balance sheets have actually decreased. This process was only partly reversed since the crisis.

In view of the sizable foreign currency exposure of both the private and public sectors, the authorities recognize that even moderate exchange rate depreciation would cause strong negative balance sheet effects and credit losses. The broadly stable exchange rate regime is also key to retain the country's investment grade rating, as was recently stated by Moody's. In this regard, they agree with staff that exchange rate policy is constrained. At the same time, the benefits in terms of improving competitiveness through a more flexible exchange rate should not be exaggerated for a relatively small and open economy as Croatia. Even with nominal exchange rate depreciation, competitiveness in the broader sense would be helped only marginally, if the required real adjustments in fiscal policy and particularly labor and product markets would lag behind. In the view of the authorities, the benefits of the current regime therefore clearly outweigh the costs. The appropriateness of the regime was also recognized by the Board last year.

Given the broadly stable exchange rate policy and the existing external vulnerabilities, the authorities underscore the importance of having adequate foreign currency buffers. While reserves are relatively low compared to many other emerging markets in relation to maturing short-term liabilities, reserves are adequate in relation to imports and money supply. Assessing reserve adequacy goes further than merely looking at a few metrics, or a weighted metric, and requires taking into account country-specific circumstances, including the nature of liabilities. Croatia's short-term debt consists largely of intercompany bank debt and FDI-related short-term liabilities that have proven to be less volatile than regular external bank debt or portfolio investments.

That being said, the authorities see merit in gradually increasing reserves, as they have been doing both before the crisis and again since 2010. However, the authorities see no merit in the staff's suggested intervention technique. In the authorities' view, such an asymmetric preannounced intervention technique could lead markets to suspect that the authorities are altering the exchange rate regime through the backdoor. Therefore the authorities fear it could backfire on the goal of building up reserves.

Financial Sector policy

The banking system has weathered the downturn well, owing to conservative regulatory and prudential policies. Despite the rise in nonperforming loans, the banking system remains profitable and resilient, as illustrated by the report's financial soundness indicators. Banking profitability is likely to remain subdued amid weak growth prospects. However, stress tests indicate that profits of most banks should be more than sufficient to fully absorb provisioning costs arising from an increase in NPLs ratio to roughly 18 percent, which is highly unlikely to materialize. Even in the event of a more severe worsening of asset quality, the system-wide capital adequacy ratio, currently almost 19 percent, would remain above the prudential minimum. The authorities are of the view that the experience of the crisis has demonstrated that the dependence of foreign parent banks turned out to be a factor mitigating liquidity risks.

Fiscal policy

The authorities agree to the need of fiscal consolidation to facilitate further internal adjustment, reduce debt, secure adequate policy space to address future economic shocks and absorb a rise in ageing-related spending. They are fully aware that this consolidation should be led by expenditure cuts in view of the high social security and tax rates. The authorities also aim to step up efforts in tax collection.

Despite having taken measures of almost 2 percent of GDP over 2009–10, the fiscal deficit has widened to 5 percent of GDP due to a slump in tax revenues. For this year, the authorities are strongly committed to contain the deficit. Public wages and pensions will again be frozen and subsidies reduced. In the event revenues fall short of what is expected, the authorities are committed to take compensatory measures. Their ambition is to reduce the fiscal deficit to around 2 percent of GDP by the end of 2013.

Guided by the recently established Fiscal Responsibility Law, the authorities will seek further consolidation, particularly through savings in the areas of public administration and social security. Rationalization of the public administration remains a priority for the government. Headcount reduction is progressing, although slower than expected, and steps have been taken that make the public work force more flexible. A new law is also being prepared to make the public sector wage system more merit-based. With respect to social security, the authorities have adopted several measures to curtail hospital and pharmaceutical spending by introducing more co-payments. Pension laws were also amended to equalize the retirement age between genders and a mix of penalties and incentives have been introduced to discourage early retirement. The fiscal impact of these steps is expected to increase over the medium to long run.

Wage and other structural policies

Croatia needs to boost competitiveness. While the real exchange rate is broadly in line with fundamentals according to CGER, the country has lagged many of its regional peers in gaining market share in the world's good markets. Some progress was made in stimulating labor market participation and flexibility. Benefits after 3 months of unemployment were reduced, and the law on civil service employment was modified to allow for easier dismissal of unsatisfactory workers. The authorities agree that wage setting needs to be made more competitive. Equally important is to improve the business environment by reducing the administrative and regulatory barriers to entry and exit of firms. In this context, non-tax fees were cut by 25 percent. Yet there is more room for improvement. In September 2010 they adopted an action plan for eliminating investment barriers, covering business registration, issuance of permits and taxation. Amendments have also been made to the bankruptcy act, allowing for more speedy procedures. The authorities agree to the need to reduce the state involvement in the economy. Clear progress is being made to restructure and privatize the country's shipyards.

All in all, the authorities recognize that, going forward, implementation of the reforms agreed in the context of EU accession and the ERP as well as further structural reforms are key to increase competitiveness and potential growth in a sustainable manner.