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REPUBLIC OF CROATIA

May 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF 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 2014 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 14, 2014, following discussions that ended on March 4, 2014, 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 April 23, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 14, 2014 consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- A **Statement by the Executive Director** for the Republic of Croatia.

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

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REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

April 23, 2014

KEY ISSUES

Reviving Growth. Croatia remains stuck in an unusually drawn out recession, with real GDP contracting for the 5th consecutive year in 2013. Domestic demand is depressed as corporations and households struggle with excessive debts accumulated in the 2000s. Exports and FDI are also weak, reflecting poor trading partner growth and structural weaknesses. With traditional fiscal and monetary policy responses out of reach (see below), private sector debt restructuring and measures to attract FDI provide the best prospect to revive growth in the short to medium term. Further, labor market reforms are critical to strengthen the economy's capacity to adapt to external conditions.

Restoring Fiscal Sustainability. High fiscal deficits, rapidly increasing public debt and elevated risk spreads demand sustained fiscal consolidation. Adjustment should be stretched over several years, with an emphasis on low multiplier measures—including on the revenue side–during the early phase of consolidation.

Safeguarding Monetary and Financial Stability. Monetary policy aims at stability of the kuna-euro exchange, to prevent that a depreciation trigger a contractionary revaluation of FX-indexed debts. The central bank has defended the arrangement with limited but effective instruments, notably FX liquidity and required reserves regulation. The banking system has remained stable in spite of the protracted recession, owing in large measure to the central bank's aggressive capitalization policy.

Previous Staff Advice. Since the 2012 Article IV consultation, the authorities have made progress with reforms to strengthen the legal and regulatory framework for investments and to enhance the labor market's adaptive capacity. Fiscal policy slipped in 2013, but a renewed effort at consolidation has been made recently with a revised 2014 budget. The 2014 effort remains to be integrated into a coherent, multi-year strategy.

Approved By
Jörg Decressin and Athanasios Arvanitis

Discussions were held in Zagreb, February 20–March 4. The mission met with Deputy Prime Minister Branko Grčić, Minister of Finance Slavko Linić, Central Bank Governor Boris Vujčić, other ministers, senior officials, private sector representatives, and envoys representing the international community. Follow-up discussions were held during the IMF/World Bank Spring Meetings in Washington D.C. on April 11 and 12.

The staff team comprised Messrs. Wiegand (head), Lybek, Omoev, Heinz (all EUR) and Kinda (FAD). Ms. Ćudina (OED) attended most meetings. Mmes. Nguyen and Blasco (both EUR) assisted with the preparation of the document.

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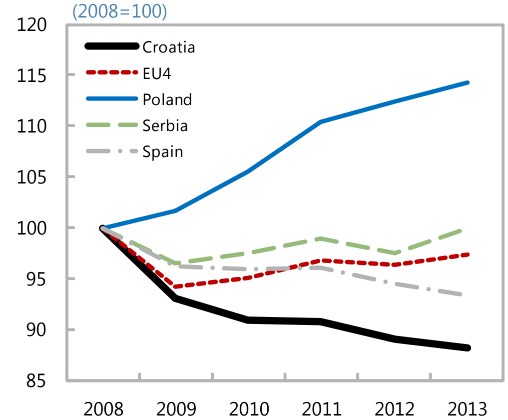
BACKGROUND

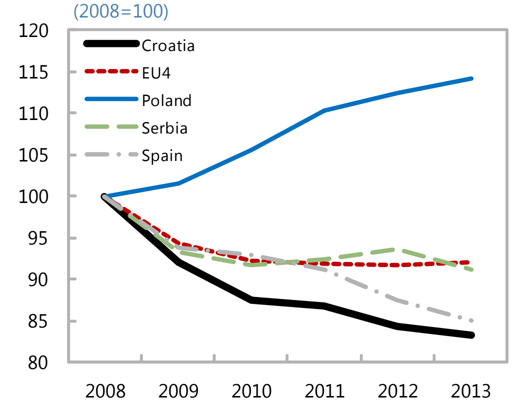
A. The Setting

1. **Croatia remains stuck in an unusually drawn out recession** (Tables 1–4, Figures 1–4). In 2013, real GDP contracted for the 5th consecutive year, and stands now at less than 90 percent of the end-2008 level. Unemployment has risen to 17 percent. Domestic demand remains depressed as corporations and households focus on reducing excess debt levels accumulated in the 2000s; a task that is being complicated by the re-emergence of deflation in early 2014. Exports and FDI are also feeble, reflecting deep-seated structural weaknesses and poor trading partner growth. Macro-policies that could revive growth rapidly are beyond reach: fiscal policy has run out of space (see below), while monetary policy is constrained by the need to keep the kuna-euro exchange rate stable, lest a depreciation cause a revaluation of euro-indexed debts.

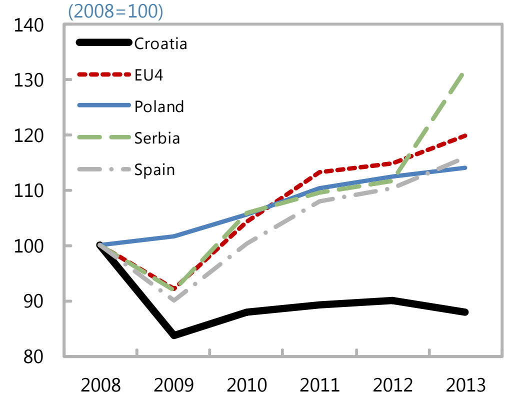
Real GDP
(2008=100)



Real Domestic Demand
(2008=100)



Real Exports
(2008=100)



EU4: Bulgaria, Czech Republic, Hungary, Romania.
Sources: WEO, and IMF staff calculations.

2. **The recession is putting pressure on the public finances.** In 2013 the deficit (cash basis) widened to around 5½ percent of GDP, owing to weak revenues and the assumption of debts and arrears from state-owned enterprises. Public debt now exceeds 60 percent of GDP and is increasing rapidly. Reflecting these developments, all major rating agencies have downgraded Croatia to sub-investment grade.

3. **The government has started tackling long-standing structural issues,** with many measures in line with previous IMF advice (Appendix I). Steps include the restructuring and/or privatization of state-owned enterprises, passage of laws that facilitate investments, the introduction of an out-of-court settlement procedure for insolvent corporations, the reduction of work force restructuring costs, and the easing of hiring restrictions.

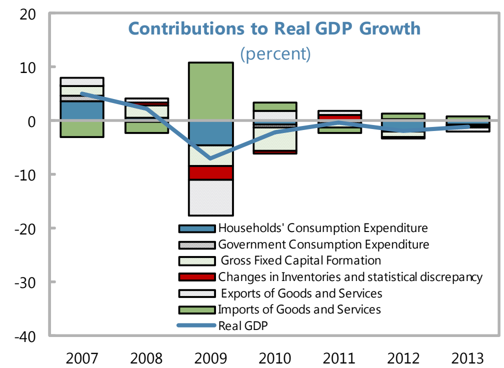
4. **Croatia's EU membership—since July 2013—holds the prospect of large medium-term benefits, but also comes with challenges in the short term.** Membership opens the large EU market to Croatian firms and creates potential for trade and investment, but in the short term Croatia loses trade with traditional partners in CEFTA (such as Bosnia). While Croatia should eventually be able to benefit from substantial EU structural funds, EU membership fees have an immediate impact on the budget, and the financial balance for 2014 is barely positive (Appendix

II). Further, from this year Croatia is subject to both the EC's excessive deficit procedure (EDP) and its macroeconomic imbalances procedure.

B. Recent Economic and Financial Developments

5. Growth has continued to disappoint.

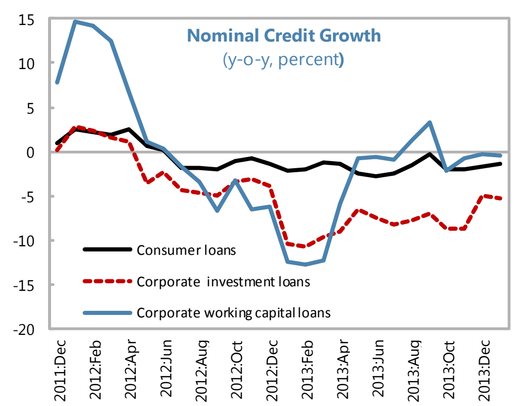
- ***Real GDP*** contracted by one percent in 2013, owing to both falling domestic demand and weak exports. Private sector efforts to reduce debt, rising unemployment, and policy uncertainty weighed on investment and consumption. Despite a good tourist season, exports were also weak, reflecting feeble trading partner growth and the restructuring of the shipbuilding industry. Forward-looking indicators hold little hope for an imminent recovery.



Sources: Haver and IMF staff calculations.

- Notwithstanding the weakness in exports, feeble domestic demand has triggered a swing in the ***current account*** to a surplus of 1.3 percent of GDP in 2013, from large deficits in the mid-2000s.

- Amid weak demand, headline ***inflation*** has fallen into negative territory (-0.4 percent y-o-y at end-March), while core inflation is around zero. Disinflation is broad based, with price declines in clothing, communications, transport, and food the main drivers.

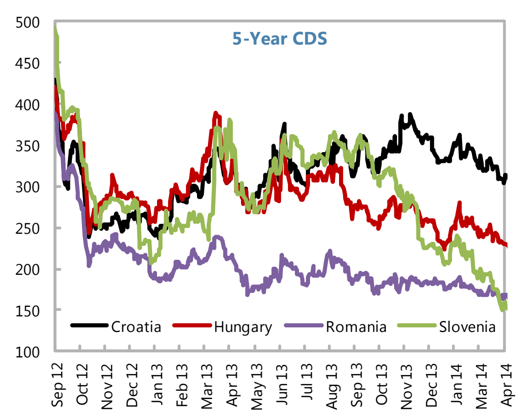


Sources: Croatian National Bank and IMF staff calculations.

- ***Credit to the private sector*** is weak. Borrowing for new investments has continued to decline, while demand for working capital and consumer loans has stabilized at a low level.

6. External financing conditions have remained manageable thus far, and Croatia has been only mildly affected by recent bouts of emerging market turbulence.

- ***Country risk spreads*** have hovered in a range of 300–350 bps for most of 2013 and early 2014. In 2013, Croatia lost significant ground relative to peers.



Sources: Datastream and Bloomberg.

- ***The kuna-euro exchange*** rate depreciated marginally in the past 12 months (by 1 percent).

- The ***banking system*** has remained stable, well capitalized and profitable, the difficult economic environment notwithstanding (see section III.C below).

OUTLOOK AND RISKS

7. Growth prospects are for another contraction in 2014, followed by a gradual recovery from 2015.

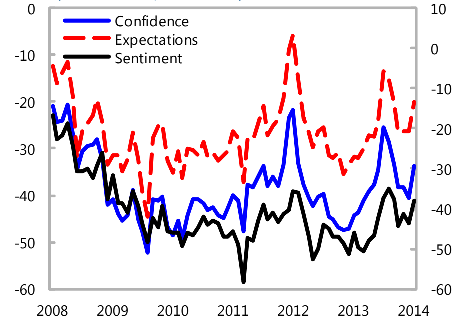
- Staff forecasts another ***real GDP decline of 0.8 percent in 2014***. Domestic demand would remain feeble, reflecting both weak private sector demand and fiscal consolidation, while exports would benefit somewhat from the projected pick up in the euro area. In 2015 a tepid recovery would set in, as the impact of private sector deleveraging would begin to recede and external demand recovers further.

- ***Long-term potential growth*** is projected at around 2 percent (2.3 percent in per-capita terms), but this estimate is subject to large uncertainties.

- The ***current account*** would shift further into surplus in 2014, reflecting weak domestic demand and, as a result, import compression.

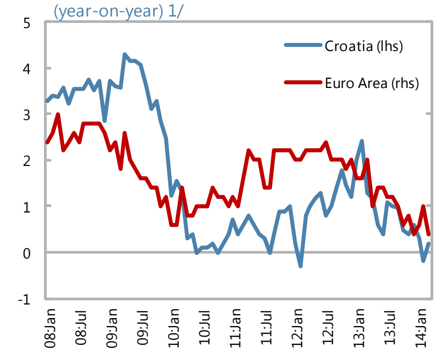
- ***Inflation*** would remain subdued, reflecting feeble activity and disinflation in both the euro area and global commodities markets.

Consumer Confidence
(Index Points, 0=neutral)



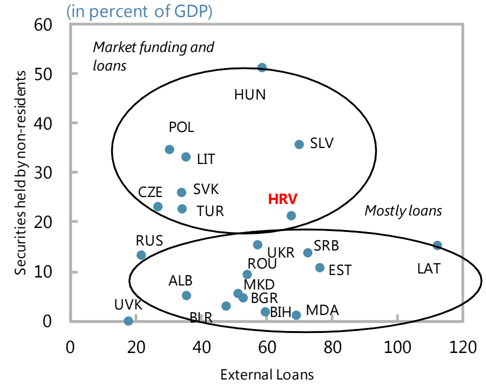
Source: Haver Analytics.

Core Inflation
(year-on-year) 1/



Sources: Croatian Bureau of Statistics and Eurostat.
1/ Excluding energy and food.

External Financing: Loans and Market Funding
(in percent of GDP)



Sources: IMF and BOPS database.

8. Risks to this forecast are substantial and, in the short term, mostly tilted to the downside (Box 1).

- ***Private sector deleveraging*** could remain a drag on demand for longer than projected—triggered, for example, by sustained deflation raising real debt servicing costs. The euro area recovery could disappoint and fail to support exports.

- ***Fiscal adjustment*** could trigger a larger private demand compression than projected. Conversely, insufficient fiscal progress could reinforce concerns about fiscal sustainability.

- ***External financing pressures.*** Given its relatively high degree of financial openness and integration into global financial markets, Croatia is susceptible to changes in global funding conditions. Higher interest rates and re-pricing of risk would raise funding costs, including for Croatian sovereign debt (Box 2). Bank deleveraging pressures could be triggered by the ECB's Asset Quality Review and/or less ample ECB liquidity.

- ***Foreign direct investment.*** On the upside, FDI could pick up more rapidly than foreseen, reflecting in part recent policy initiatives to facilitate investments.

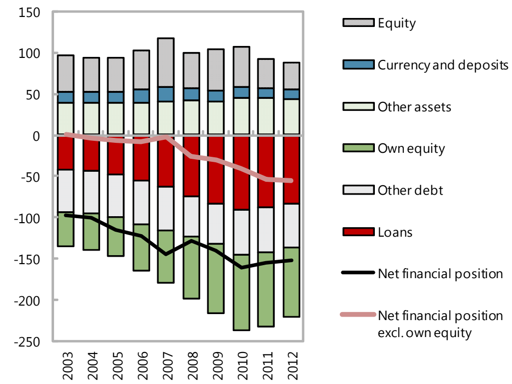
POLICY DISCUSSIONS

A. Reviving Growth

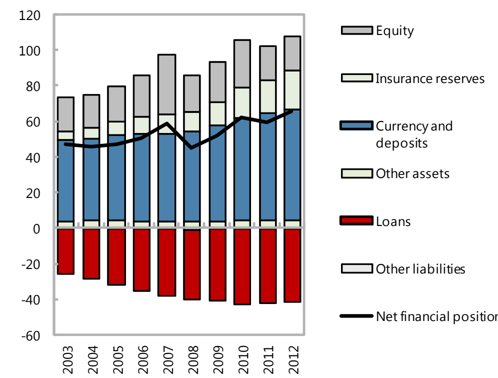
Diagnostic

9. **The debt overhang that accumulated in the mid- to late 2000s continues to weigh on demand**. Corporations have reduced debt levels somewhat from the peak reached in 2010, amid a sharp decline in private investment. Household debt has also started to recede, and some households have accumulated substantial assets, notably bank deposits. Amid high unemployment, private consumption has remained feeble, however.

Corporations, Aggregate Net Financial Position
(in percent of GDP)



Households, Aggregate Net Financial Position
(in percent of GDP)

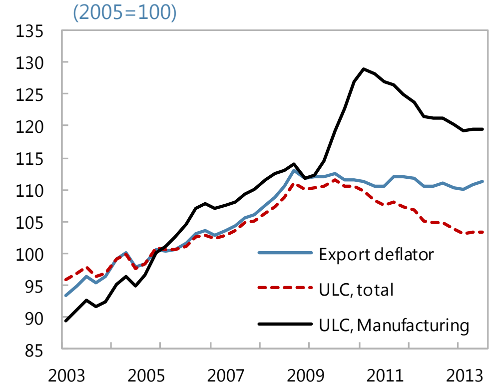


Sources: Croatian National Bank and IMF staff calculations.

10. **In contrast to many of its peers, Croatia has not been able to take advantage of stronger exports and foreign direct investment (FDI).**

- ***Exports:*** Sub-par export performance owes in large part to weak trading partner growth, as three out of four of Croatia's main trading partners—Italy, Bosnia and Herzegovina, and Slovenia—went through economic difficulties of their own in recent years (Appendix III). Difficulties have been exacerbated by export industries in structural decline, such as ship building. The quasi-peg to the euro and a rigid labor market—preventing adjustment of unit labor cost through wages—have stood in the way of a rapid price response to these shocks. Staff estimates that the REER is overvalued by about 10 percent, based on a cross-country comparison of unit labor cost (Box 3).
- Weak ***FDI*** owes much to a poor business environment, as evidenced by Croatia's chronically low ratings in business climate surveys. Anecdotal evidence suggests that a large part of the problem is with ineffective government at the municipal level. Large state-owned enterprises (SOE)—a legacy issue of Yugoslavian times—also hamper investment and productivity growth, and leave Croatia with an outdated infrastructure in sectors such as rail transport. As a result, Croatia has thus far been unable

REER vs. EU 27
(2005=100)

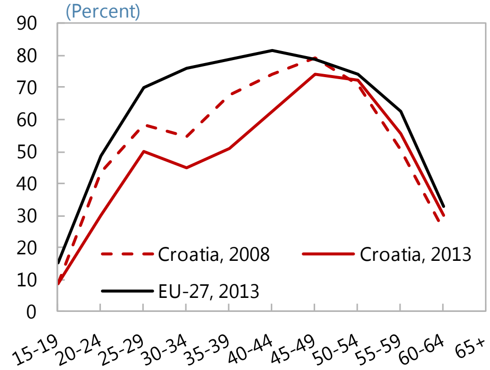


Source: European Commission.

to take advantage of its unique geographic location: at the sea and yet close to Central European markets.

- As regards ***longer-term obstacles to growth***, low labor market participation—the second lowest in the EU after Greece—stands out (Appendix IV). A plethora of factors—including generous early retirement schemes, work disincentives from poorly targeted benefits, and skill mismatches—contribute to this outcome. The low employment ratio puts pressure on pension systems, even though replacement rates are not particularly high.

Employment by Age Group, 2008 and 2013
(Percent)



Sources: ILO, Eurostat, Croatian Statistical Bureau, and IMF staff calculations.

Policy Discussion

11. The authorities broadly shared staff's diagnostic, although the central bank argued that household balance sheets had strengthened enough to support a recovery. It saw the core of the problem in weak investment. The authorities also agreed that Croatia's economy continues to face considerable competitiveness challenges.

12. There was agreement that standard macro-policy responses to weak demand are out of reach.

- ***Monetary policy*** is constrained by the use of the kuna-euro exchange rate as nominal anchor. The central bank argued forcefully that the quasi-peg needs to be maintained, as the contractionary impulse of a revaluation of FX-indexed debts and its impact on the financial system would far outweigh any stimulus from depreciation on the (relatively small) tradable sector. It also pointed to experiences in the 1990s, when devaluations had harmed financial stability without sustained improvements in competitiveness. Staff agreed that large exchange rate fluctuations are undesirable, but noted that exchange rate rigidity increased the pressure on structural and wage policies to adjust.[1]

- ***Fiscal policy*** space is exhausted—the challenge ahead is to advance fiscal consolidation without unduly harming growth (see below).

13. The authorities and staff agreed that private debt restructuring was the main available tool to accelerate a recovery in domestic demand. The authorities pointed to the pre-bankruptcy settlement procedure introduced in 2012 to speed up the restructuring of corporate debt, and argued that after some early difficulties, the procedure was working smoothly. Thus far, it has allowed writing off of corporate debts of 2 percent of GDP (Appendix V). Staff agreed that the pre-bankruptcy procedure was a useful tool, and suggested a similar mechanism for private households,

[1] With three quarters of corporate debt denominated in or linked to foreign currency, and corporate non-equity liabilities already exceeding 130 percent of GDP, a sizeable devaluation would reinforce the sector's debt overhang, curtailing further domestic demand (a similar argument applies to households, although arguably to a lesser degree as debt levels are lower and some households are hedged due to sizeable FX deposits). There would also be knock-on effects on the financial sector, and a difficult-to-quantify impact on confidence from abandoning Croatia's long-standing monetary anchor. At the same time, with Croatia's goods exports accounting for only 15 percent of GDP, a relatively small portion of the economy would immediately benefit from better competitiveness.

while being mindful of fair burden sharing between creditors and debtors. The authorities explained that they are working on a personal bankruptcy regime for implementation later in 2014.

14. Staff commended the authorities for substantial progress with growth enhancing structural reforms. Many of these have been taken in the context of a World Bank Development Loan (DPL).

- A ***strategic investment law*** enacted in late 2013 and accompanying regulatory measures remove administrative hurdles at the local level and shift responsibility to the central government. Further, an investment promotion law improves investment incentives. The authorities noted that these reforms were already having an impact, pointing to a pipeline of projects—mostly prepared by non-resident investors—that were expected to materialize the latest from 2015. Staff argued that additional steps to strengthen the investment climate should include swift implementation of judicial reform and further restructuring of state-owned enterprises (see below).
- A ***labor market reform*** currently in front of the assembly would lower the cost of work force restructuring and enhance working hour flexibility. According to World Bank computations, the reform—together with legislation enacted earlier in 2013 to ease hiring restrictions—would place Croatia in the mid-range of the OECD's employment protection ranking, from displaying one of the highest levels of rigidity in 2011. The authorities and staff agreed that the reform is critical to enhance the economy's ability to adapt to external conditions, although it would arguably take some time until benefits materialize in terms of higher growth and employment.[2]
- A ***welfare reform*** enacted in December 2013 merged several social benefits administrated by the Ministry of Youth and Social Welfare, and capped total benefit receipt at the gross minimum wage. Staff argued that the reform could only be a first step to reduce disincentives to work from the design of benefit schemes. Further measures were needed, such as eliminating overlap of transfers granted by the central and local governments, and extending means-testing to other programs, including for war veterans. More progress was also called for in reducing incentives for early retirement.

B. Regaining Control over Fiscal Policy

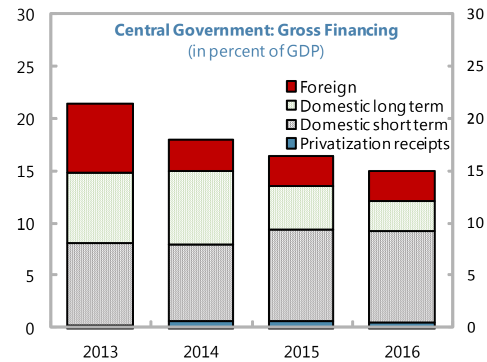
Diagnostic

15. Attempts to control the fiscal deficit have been frustrated by the recession and costly initiatives to support the economy. After a good attempt at consolidation in 2012, the deficit (cash basis) widened again in 2013 to around 5½ percent of GDP, reflecting weak revenues and the break on re-invested earnings turned out more costly than anticipated, without boosting investment

[2] In the short term, the reform increases uncertainty for some employees and is therefore understandably contested, notably by labor unions. The employers' association considered the labor reform a modest step, although in the right direction.

as expected.[3] Public debt—below 30 percent of GDP as recently as 2008—now exceeds 60 percent of GDP (75 percent including guarantees) and is increasing rapidly.

16. The government is largely pre-financed for 2014. More than 80 percent of the central government's financing needs are expected to be covered from domestic sources, in particular banks and pension funds. As for external financing, the government issued a US$1.75 million bond (3 percent of GDP) in November 2013 at a relatively high yield (6.2 percent, 10 years). Issuance of another €750 million–1 billion is scheduled for later in 2014.

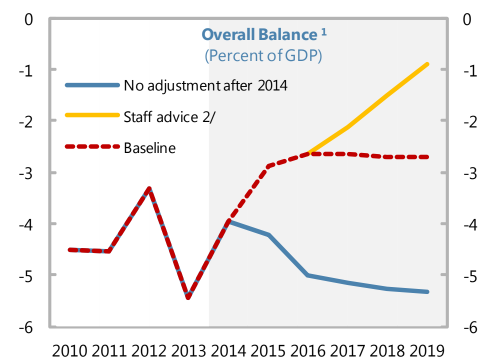


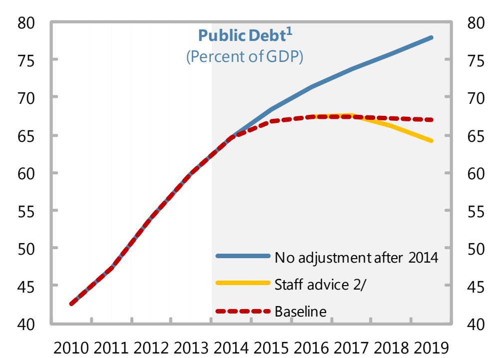
Source: Ministry of Finance.

Policy Discussions

17. Staff argued—and the authorities agreed—that fiscal consolidation was critical to strengthen confidence in macro-economic management and retain the economy's access to financing at acceptable conditions. Given the deterioration in Croatia's standing in credit markets and the prospect of tighter global financing conditions ahead, adjustment could not be delayed further. Consolidation would have to be designed in a way that would both signal clearly that Croatia was getting its public finances under control and limit the short-term contractionary impact on an already weak economy. Specifically, staff advocated the following parameters:

- ***Overall adjustment.*** A structural reduction in the general government deficit of about three percent of GDP within a foreseeable timeframe was called for to ensure the return to a sustainable fiscal stance.
- ***Phasing.*** The government argued strongly against excessively frontloaded adjustment lest to harm the incipient recovery. Staff recommended stretching adjustment over three years in roughly equal annual portions.
- ***Composition.*** Staff advocated an emphasis on the revenue side in 2014—in view of the lower short-term growth multiplier of revenue measures—and a gradual switch to expenditure consolidation in 2015 and 2016.[4]





Sources: Croatian authorities; and IMF staff estimates.
1/ The baseline assumes fiscal adjustment between 2014 and 2016 in the context of the EDP. No adjustment after 2014 implies unchanged policies (no fiscal adjustment) after 2014.
2/ Staff advice assumes continued fiscal adjustment after the EDP to put debt on a downward trajectory.

[3] Anecdotal evidence suggests that some state-owned enterprises used the tax break to pay higher bonuses.

[4] While the authorities and staff broadly agreed on the composition of adjustment, parts of Croatia's academic community—such as the Institute for Public Finance—saw the revised 2014 budget as a lost opportunity to curtail wasteful spending. The employers' association took a similar view.

- For the ***medium term***, staff recommended restoring structural balance gradually, to achieve a sustained reduction in public sector debt and regain flexibility to react to economic shocks.

18. Staff noted that the revised 2014 budget currently under the assembly's consideration frontloads adjustment relative to these parameters.

- ***Amount of adjustment.*** Staff estimates *net* structural adjustment contained in the government's first draft of a revised budget presented in early March at 0.6–0.8 percent of GDP (full-year impact 0.8–1.1 percent), with two-thirds of adjustment on the revenue side (Box 4). Staff assessed that this pace of adjustment struck an adequate balance between the need to nurture the recovery and restore credibility. Since then, the government has announced a second revision containing an additional 0.4 percent of GDP in measures (full-year impact 0.5. percent), in order to comply with the EDP. The authorities and staff agreed that the additional tightening front-loaded adjustment risked a further weakening of activity in an already contractionary environment. The authorities argued, however, that the benefits from staying within the EDP and, more generally, the EC's policy support framework would ultimately outweigh the negative impact of a somewhat stronger short-term contraction.

Net Structural Adjustment in the Revised 2014 Budget

(in percent of GDP)

	Impact in 2014	12-month impact
Initial revision, March 2014	0.6 to 0.8	0.8 to 1.1
Second revision, April 2014	1.0 to 1.2	1.3 to 1.6
Difference	0.4	0.5

Source: IMF staff estimates.

- ***Composition.*** Staff argued that the largest adjustment measure—a hike in health contributions that reverses a reduction enacted in 2012—was suboptimal, as it raises labor cost and thus undermines efforts to strengthen cost competitiveness. Alternative revenue measures that the government had considered at some point—such as introducing a modern property tax, revoking the tax credit for reinvested profits, taxing interest income, or broadening the base for personal income tax—would have been superior. The authorities argued that for a property tax, more preparatory work was required.

19. More generally, staff advocated embedding the revised 2014 budget into a comprehensive three-year plan, so as to render consolidation predictable and maximize the impact on confidence. This would help counter a perception that fiscal measures were taken often only in reaction to external pressure (such as the EDP), chosen on the basis of political expediency, and subject to frequent reversals. Expenditure reductions and tax reforms to be implemented in 2015/16 should, at least in broad terms, be identified already now. In some areas, structural reforms should support sustained reductions in spending; for example, local government reform to permanently reduce the government wage bill (Box 5). The authorities replied that their convergence program—to be published in due course—would specify measures for the entire period of 2014–16, including, on the revenue side, a tax on savings in 2015 and a full-fledged property tax in 2016.

20. Staff stressed that the health sector and state-owned enterprises (SOEs) required immediate attention to avoid contingent fiscal liabilities.

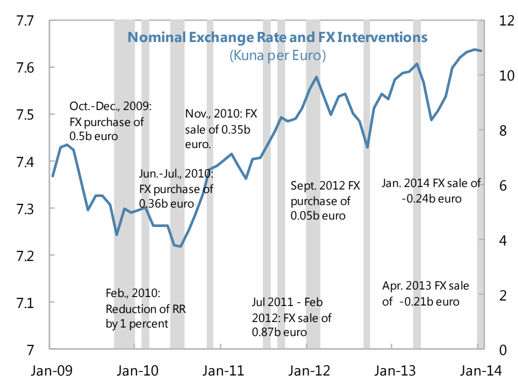
- ***State-owned hospitals*** have accumulated sizeable arrears in recent years that required clearance by the central government. The authorities argued that they had taken steps to prevent the problem from reemerging, notably taking over the administration of hospitals whose arrears were cleared, and developing a hospital master plan to restructure the sector. Staff voiced doubts, however, whether administrative steps alone would suffice to restore the sector's financial balance, and recommended considering revenue measures—such as boosting receipts from co-payments and/or expenditure cuts—including by increasing the efficiency of health services.
- As for loss-making ***SOEs***, staff commended the authorities for progress with tackling some of the most difficult cases, such as shipyards, railways, and air and road transportation—even though restructuring and privatization has often been possible only at substantial costs to the government, notably the assumption of SOE debts. Staff urged to continue with restructuring and resolution efforts, based on a comprehensive review of state-owned enterprises' finances.

C. Maintaining Monetary and Financial Stability

Diagnostic

21. Monetary policy is anchored by the kuna-euro exchange rates and conducted with a relatively limited but effective set of instruments.

- ***Variations in reserves and liquidity regulations***. The Croatian National Bank (CNB) has repeatedly lowered mandatory reserve requirements and thus created substantial excess liquidity in the banking system to keep kuna financing conditions accommodative. Banks have invested much of the additional liquidity in government paper.
- ***Macro-prudential tools***. The CNB has conditioned some reductions in reserve requirements on higher corporate lending. With weak aggregate demand, credit to the private sector has remained subdued, however.
- ***Foreign exchange interventions.*** Occasional interventions react to larger-than-usual movements in the exchange rate, to keep expectations anchored. There is no announced exchange rate level or tolerance band for exchange rate variability.



Sources: Croatian National Bank and Bloomberg.

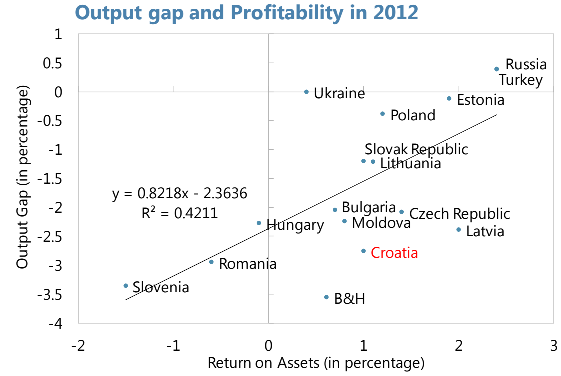
22. Notwithstanding the protracted recession, Croatia's banking system—which is mostly foreign owned—has remained stable, liquid and well-capitalized. However, financial strength varies across banks.

- At end-2013, the banking system's ***aggregate capital adequacy ratio*** was, at almost 21 percent, the region's highest.[5] Non-performing loans stood at 15.6 percent, are concentrated in the corporate sector, and, amid weak growth, are still rising.

- Specific **loan-loss provisions** are modest compared to peers. However, staff computations suggest that even in an extreme scenario—where all non-provisioned non-performing loans would have to be written off in full—losses could be absorbed out of capital buffers (Appendix VII).

- ***Profitability*** has remained positive throughout the recession, reflecting in part the near-doubling of banks' holdings of government securities since 2008. In 2013, return-on-equity halved, however, reflecting inter alia changes to loan classification rules and correspondingly higher provisioning cost. Profitability is likely to remain subdued going forward, reflecting higher loan-loss provisions, the difficult operating environment, and fewer options to invest in government paper in the context of fiscal consolidation.

Output gap and Profitability in 2012



Sources: GFSR tables, WEO database

- The Croatian subsidiary of ***Hypo Alpe Adria*** (HAA)—Croatia's 5th largest bank by assets—is awaiting the modalities of the dissolution HAA group in line with EC requirements. The CNB underscored that HAA Croatia is a viable bank for which a new owner can be found.

Policy Discussion

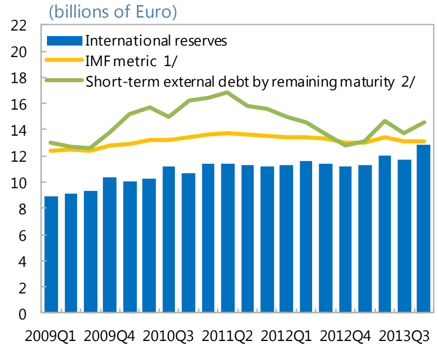
23. Staff acknowledged that CNB's set of monetary policy instruments is appropriate at this juncture, but encouraged the central bank to adapt its toolkit going forward as needed. In particular, in case financial or inflationary pressures were to reemerge at some stage, fine-tuning of liquidity could be conducted more flexibly and accurately through open market operations than regulatory instruments. The CNB broadly agreed.

24. Further, staff noted that FX reserves remain below standard adequacy metrics, with sat oddly with the importance of the exchange rate for Croatia's monetary policy framework. The CNB argued that it was able to control all main FX pressure points regardless, and that this was well understood by the markets. The potential for shortening the kuna was limited by the small size of the FX market, and corresponding attempts easily combated by modest FX interventions if needed. Parent bank funding was subject to tight FX liquidity regulations. Further, there was no sizeable

[5] The CNB explained that it would be able to safeguard high capitalization levels also under the EU's Capital Directive IV, in effect from January 2014.

participation of non-resident investors in kuna asset markets, nor FX mismatches in the banking system exposing banks to the FX swap market—both phenomena that in other countries had given rise to FX pressures in times of financial strain. This said, the CNB recognized the value of being in line with standard reserves adequacy metrics, and noted that to this end it was purchasing FX from government debt issuances. Staff raised the possibility of buying FX in the market—either pre-announced or opportunistic—but the CNB argued that the existing intervention technique had proven successful in both anchoring exchange rate expectations and accumulating reserves.

International Reserves Cover
(billions of Euro)



Sources: Croatian National Bank and IMF staff calculations.
1/ Reserve metric according to *Assessing Reserve Adequacy*, IMF, February 2011.
2/ Short-term debt at remaining maturity, including FDI debt and parent banks' loans and deposits.

25. Staff commended the CNB for safeguarding high capital and liquidity buffers in the financial system, providing assurances that risks to the sovereign from the banking sector are contained, although some smaller banks require careful monitoring. The CNB and staff agreed that legal amendments in effect since October 2013 to tighten loan classification rules are a welcome step to encourage banks to build gradually more specific provisions. At the same time, banks' ample capital buffers were already providing loss-absorbing capacity. Staff argued that caution was warranted regarding the recent increase in bank loans to state-owned enterprises, lest to under appreciate risks to both banks and the government.

STAFF APPRAISAL

26. Croatia's short-term economic outlook remains difficult, with no immediate signs of economic recovery after five consecutive years of real contraction. Domestic demand remains depressed as the repair of private sector balance sheets from the excesses of the 2000s is still ongoing—a task that is being complicated by the re-emergence of deflation in early 2014—while the economy has been unable to benefit from stronger exports, related in part to unfavorable developments in trading partner countries. Looking ahead, headwinds from fiscal consolidation and the prospect of more challenging external financing conditions are bound to complicate macro-economic management further.

27. Reviving growth is a priority, given that many of Croatia's economic problems are rooted in the protracted recession. With traditional fiscal or monetary policy responses beyond reach, the best prospect for reviving growth is via accelerated private sector debt restructuring to revive domestic demand, and measures steps to attract foreign direct investment. The establishment of a pre-bankruptcy settlement procedure is an important and innovative step to facilitate the write-off of unrecoverable loans and allow over-indebted but viable corporations a fresh start. Plans to establish a similar regime for over-indebted households are well placed. As for the investment climate, a first step has been made with the investment legislation passed last year.

28. Reforms need to enhance the economy's ability to adjust to external shocks. Given the rigid exchange rate regime, much of the adjustment burden falls on the labor market and improving the still weak investment climate. The labor legislation currently with the assembly could mark a breakthrough to render Croatia's labor market more adaptable. The economy also needs to make better use of its labor force: Croatia's chronically low level of employment curtails not only living standards, it also amplifies pressures on tax, pension and other social welfare systems. The social welfare act passed last year can only be a first step to enhance the targeting of benefits and strengthen work incentives. Tasks ahead are eliminating incentives for early retirement, reducing benefits for privileged groups, and eliminating overlap between benefits granted by different levels of government. Such efforts would best be placed in the context of a reform of Croatia's local government finances. More progress is also needed on strengthening the business climate, including through judicial reform, and on restructuring state-owned enterprises.

29. Credible and sustained fiscal consolidation is critical to strengthen confidence in macro-economic management. Consolidation should not be delayed any further, given the deterioration in Croatia's sovereign credit and the prospect of a more challenging external financing environment ahead. Given the protracted economic weakness, it is adequate to stretch adjustment and start with steps least harmful to demand, such as revenue measures. Against this yardstick, the revised 2014 budget front-loads the adjustment. While a more balanced consolidation path would have been preferable on economic grounds, the authorities' decision is understandable in order to preserve the benefits from staying within the EC's policy support framework.

30. To reduce policy uncertainty and maximize the impact on confidence, the government should embed this year's fiscal effort should into a coherent medium-term plan. This plan would usefully be spelled out in the authorities' convergence and national reform programs, and feature measures and a concrete timetable for accompanying steps, such as preparations for a modern property tax and a reform of municipalities. Steps to restore financial balance in the health sector as well as restructure or resolve state-owned enterprises are key to ensuring that consolidation would not be undermined by contingent government liabilities.

31. The quasi-peg to the euro reflects the authorities' concern about contractionary balance sheet effects that a depreciation would trigger, given the high degree of liability euroization. The rigid arrangement prevents addressing competitiveness gaps through devaluation, however, increasing pressure for labor markets and structural policies to adjust. The central bank has maintained confidence in exchange rate stability through a set of effective, direct instruments, keeping a tight grip over possible FX pressure points and discouraging position-taking against the kuna. The central bank should seek to accumulate more FX reserves, however, until coverage is fully in line with standard adequacy metrics. Further, it should stand ready to expand its toolkit to indirect instruments once financial or inflationary pressures reemerge.

32. The stability of Croatia's banking system is impressive against the background of the protracted recession. Relative strength owes much to the central bank's aggressive bank capitalization policy, ensuring that banks possess ample cushions against shocks to profitability and credit quality. Looking ahead, risks to banks and the government from loans to state-owned enterprises need to be watched carefully.

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

Box 1. Croatia Risk Assessment Matrix[6]

(Scale—high, medium, or low)

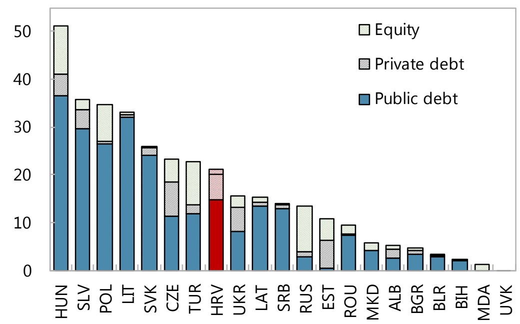
Source of Risks	Relative Likelihood	Impact if Realized	Recommended Policy Response
Surges in global financial market volatility (related to UMP exit), leading to economic and fiscal stress	**High**	**Medium-High** Strains in financial markets would affect in particular Croatia's sovereign bond market, increasing funding costs.	Strengthen fiscal anchor, seek external assistance if necessary
Protracted period of slower growth in advanced and emerging economies	**High**	**Medium** Slower growth in advanced Europe would delay the recovery in exports and FDI. Deflation pressures spreading from the euro area could complicate efforts by the private sector to reduce debts.	Accelerate private sector debt restructuring and structural reforms
Insufficient progress on fiscal consolidation No recovery in private domestic demand	**Medium-High**	**High** Market perception of Croatian sovereign debt would deteriorate further.	Strengthen fiscal anchor Accelerate private sector debt restructuring and structural reforms
Financial stress in the euro area re-emerges	**Medium**	**Medium** Under funding or capital pressures, parent banks could exert pressure on their subsidiaries to restrict lending, impeding the recovery.	As in baseline
Increasing geopolitical tensions surrounding Russia/Ukraine, leading to disruptions in financial, trade and commodity markets	**Medium**	**Medium** Direct economic linkages are limited, but Croatia would be affected by a re-pricing of risk.	Strengthen fiscal anchor, seek external assistance if needed

[6] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline.

Box 2. External Financing

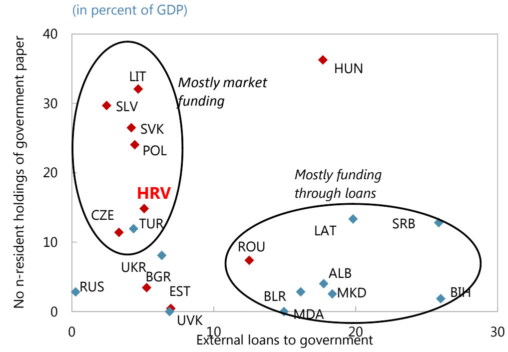
Croatia belongs to the financially more open economies in Emerging Europe, using both foreign loans and external market funding to cover financing needs. This structure renders Croatia vulnerable to both *changes in conditions in global securities markets*—that could, e.g., be triggered by a re-pricing of risk—and *changes in the funding conditions of foreign banks*. As most banks that lend to Croatia are located in the euro area, the ECB's liquidity policy is a key determinant.

Non-Resident Holdings of Securities
(in percent of GDP)



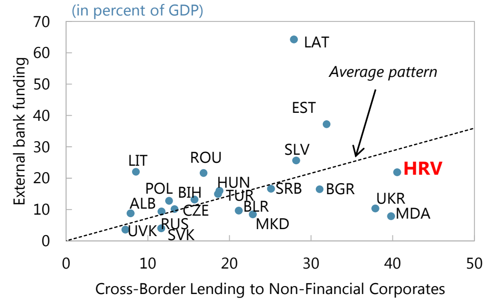
External *market* financing consists largely of non-residents' holdings of government bonds—a common feature in Emerging Europe. In fact, bonds are the main instrument for external government financing. This pattern is found in many EU member states, although in Croatia foreign participation in the government bond market is still less than in countries like Hungary, Poland, or Slovenia, reflecting that the government covers a large portion of its financing needs from domestic sources.

External Government Funding
(in percent of GDP)



Non-resident participation in Croatia's stock market is minimal. Econometric evidence suggests that foreign interest in equity markets correlates strongly with market size. Consistent with this, large countries like Russia, Turkey, and Poland absorb the bulk of foreign equity investment in emerging Europe. There are some external holdings of Croatian corporate bonds, however.

External Loans to the Private Sector
(in percent of GDP)



Direct cross-border loans play a large part in private sector borrowing. This pattern sets Croatia apart from most EU member states, where a higher portion of lending tends to be channeled through domestically incorporated banking subsidiaries. Prevalence of cross-border lending correlates negatively with governance quality indicators, suggesting that lack of confidence by foreign lenders in domestic institutions is a key determinant. In Croatia, however, constraints put on subsidiary lending during the credit boom of 2005-08 arguably also play a part, triggering regulatory arbitrage on behalf of lenders.

Source: IMF, IFS/BOPS database

Box 3. Real Exchange Rate Assessment

The assessment of Croatia's Real Exchange Rate through the CGER methodology does not yield a clear result. Different estimation methods yield results between 9½ percent overvaluation and 7 percent undervaluation.

Assessment of Croatia's Real Exchange Rate

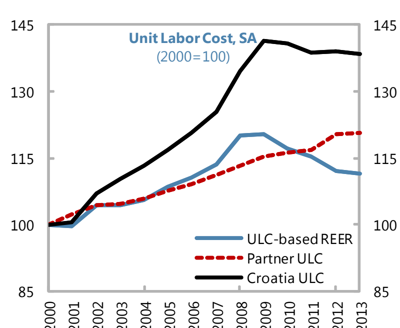
	Estimated overvaluation (percent)
Macroeconomic balance approach	-0.7
External sustainability approach	
Stabilizing NFA at -40 percent of GDP	0.2
Stabilizing NFA at -89 percent of GDP	-6.9
Equilibrium exchange rate approach	-3.1 to 9.4

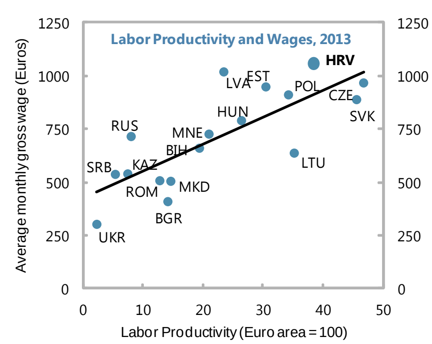
Source: IMF staff's estimates.

In Croatia's specific situation, all CGER approaches have flaws.

- The *macroeconomic balance* approach compares staff's projected current account balance with a current account norm. A strong projected external balance is interpreted as a sign of strong exports, and therefore a competitive real exchange rate. However, at this juncture Croatia's current account is in surplus because of private sector debt reduction, and this will put upward pressure on the external position also throughout the projection period. Thus, the relatively strong external position reflects weak demand and correspondingly compressed imports rather than strong exports.
- Similarly, the *external sustainability* approach compares Croatia's projected net foreign asset position with a sustainable NFA. As private sector deleveraging is expected to restore a sustainable NFA eventually, the approach shows broadly fair valuation.
- Finally, the *equilibrium exchange rate* approach is not robust to the inclusion of different explanatory variables (such as the current and lagged NFA position). As a result, it delivers a broad range of estimates.

Staff's preferred competitiveness estimate is instead based on a comparison of unit labor cost relative to peers. These data suggest that Croatia's REER remains some 10 percent overvalued. While some adjustment has taken place since 2008/09, it is not enough to correct the loss in competitiveness in the preceding years.





Source: Haver Analytics, DxTime, Croatian National Bank, European Commission, and IMF staff calculations.

Box 4. Parameters of the Revised 2014 Budget

The cabinet approved a revised budget in early March. The budget still has to be approved by the assembly. Further, it does not yet include possible restructuring cost for the state cargo railway company, as the restructuring plan is subject to EU approval.

With these caveats, staff estimates net structural adjustment contained in the revised budget at 0.8–1.1 percent of GDP (annual impact) [1/], resulting in a projected 2014 cash deficit of around 4½ percent of GDP. Specifically, the budget contains:

- ***Structural (i.e. durable) adjustment*** measures of 1.1–1.3 percent of GDP (full-year impact 1.3–1.6 percent), two-thirds of which are on the revenue side. The largest individual measure is an increase in health insurance contributions; others include cuts in subsidies and rationalization measures in public hospitals. These structural savings need to be assessed against ***arrears in the health sector***, however, that are accumulating at a pace of about ½ of a percent of GDP per year and represent permanent spending, unless addressed through a reform restoring financial balance within the sector.
- ***Measures whose structural character is less clear*** of 0.7–0.9 percent of GDP, such as cuts in capital and material expenditures, and the repatriation of dividends from state-owned enterprises. Again, these savings need to be reduced by the one-off clearance of additional health sector arrears amounting to ½ of a percent of GDP.
- The ***transfer of assets of the pillar II pension fund*** in an amount 0.9 percent of GDP into the budget. The transfer is related to privileged pensions.[2/] While the transfer is formally recorded as revenue and thus reduces the headline cash deficit, it is substantially a financing operation.

A second revision of the 2014 budget is currently under preparation, with revenue measures of 0.2 percent of GDP (0.3 percent full-year impact) consisting of higher fuel excises and a tax on telecommunications services; and expenditure cuts of another 0.2 percent, mostly subsidies and capital spending. While the revenue measures should be structural, this is less clear for the expenditure component.

1/ Some measures take effect only from the second quarter, hence the net structural impact for 2014 is estimated at 0.6–0.8 percent.

2/ According to the government, the transfer corrects a financial imbalance within the pension system: privileged pensions are typically paid out at a younger age than standard pensions, creating a disproportionate burden for the budget. Previously, this imbalance was accounted for by transferring money from the Pillar II fund into the budget at retirement. Under the new regime, privileged pensioners pay a larger portion of their contributions into the Pillar I scheme from the start; the budget transfer of 0.9 percent of GDP in 2014 serves to correct for past “excess” payments into the Pillar II fund. A second (and final) transfer of assets of about 0.7 percent of GDP is planned for 2015.

Box 5. Options for Fiscal Adjustment

Croatia's fiscal adjustment need is large, amounting to close to 3 percent of GDP to bring public debt on a sustained downward path, and around 5 percent of GDP to restore a balanced budget. With adjustment starting in an environment of contracting private demand, proper sequencing of adjustment and a focus, in the short-term, on measures with a low multiplier are critical. The measures below could be considered in addition to those already included in the planned 2014 budget revision.

On the revenue side, staff sees scope in the following areas:

- The re-introduction of the ***tax on retained profit*** and a ***new tax on interest earnings*** to tap savings could yield together 1 percent of GDP.
- A full-fledge ***value-based property tax*** could yield up to 1 percent of GDP.
- ***Broadening the base for personal income tax***—including by means-testing child allowance, and taxing contractual income at the same rate as normal salaries—could yield around 0.5 percent of GDP.
- Reducing the C-inefficiency in ***VAT*** by bringing the reduced rates closer to the full rate could also support fiscal adjustment at a relatively low cost for growth. Increasing the reduced VAT rate from 13 to 15 percent would bring about 0.2 percent of GDP.
- ***Excise rates on fuel and tobacco*** could be aligned with EU minimum requirements, yielding at least 0.1 percent of GDP.

On the expenditure side, rationalization of current spending should be the priority.

- Possible measures include ***better targeting of social benefits*** through stronger means-testing and a ***reduction of public sector employment*** through attrition and a reform of local governments
- A continued ***reduction of subsidies*** in areas such as agriculture and transport could complete rationalization.

At the same time, spending adjustment should ***protect much needed capital expenditures***.

Potential Fiscal Measures
(in percent of GDP)

Policy measures	Fiscal impact
Revenue Measures	
Re-introduce the tax on retained profit	0.5
Introduce a tax on interest income	0.5
Introduce a full-fledge property tax	1.0
Broaden the base for personal income tax	0.5
Raise reduced VAT rates from 13 to 15 percent	0.2
Align excise rates with EU minimum requirements	0.1
Expenditure measures	
Align the wage bill with peers average	Up to 2 percent of GDP
Streamline and better target social benefits	Up to 1 percent of GDP
Further reduce subsidies	Up to 0.7 percent of GDP
Total potential savings	Up to 6.5 percent of GDP

Source: IMF staff estimates.

Table 1. Croatia: Selected Economic Indicators, 2007–15 1/

	2007	2008	2009	2010	2011	2012	2013	2014	2015
							Est.	Proj.	Proj.
Output, unemployment, and prices	(Percent change, unless otherwise indicated)								
Real GDP	5.1	2.1	-6.9	-2.3	-0.2	-1.9	-1.0	-0.8	0.5
Contributions:									
Domestic demand	6.6	3.4	-11.2	-5.3	0.0	-3.3	-1.1	-1.3	0.2
Net exports	-1.5	-1.3	4.2	3.1	-0.2	1.5	0.1	0.5	0.3
Unemployment (ILO, percent)	9.4	8.3	9.0	12.1	13.6	16.1	16.6	16.8	17.1
CPI inflation (average)	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.5	1.1
Average monthly nominal wages	6.2	7.1	2.2	-0.4	1.5	1.0	0.8	...	...
Saving and investment	(Percent of GDP)								
Domestic investment	31.4	33.4	27.6	23.6	22.8	21.9	21.3	20.1	20.3
Of which: fixed capital formation	26.2	27.4	24.5	20.8	19.6	18.6	18.4	18.3	18.7
Domestic saving	24.2	24.5	22.4	22.4	21.9	21.8	22.6	21.7	21.3
Government	3.9	3.2	0.2	-1.5	-1.9	-0.8	-2.6	-1.0	0.2
Nongovernment	20.3	21.3	22.3	23.9	23.8	22.7	25.2	22.7	21.1
Government sector 2/									
General government revenue	39.8	39.2	39.0	38.2	37.4	38.4	37.9	40.3	40.7
General government expenditure	40.8	40.1	42.2	42.7	42.0	41.7	43.4	44.2	44.4
Unspecified measures (EDP)	...	...	...	...	...	...	...	...	0.8
General government balance	-1.0	-0.9	-3.3	-4.5	-4.6	-3.3	-5.4	-4.0	-2.9
General government balance (broad definition) 3/	-3.1	-2.3	-5.5	-5.4	-5.2	-4.2	-5.9	-4.5	-3.3
Cyclically adjusted balance	-2.3	-2.6	-2.3	-3.4	-3.9	-2.1	-4.5	-3.0	-2.0
Structural balance (IMF calculation)	-2.3	-2.6	-2.3	-3.4	-3.9	-2.1	-4.5	-3.4	-2.6
General government debt	32.9	29.3	35.8	42.6	47.4	54.0	60.0	64.7	66.8
Money and credit 4/	(End of period; change in percent)								
Bank credit to the nongovernment sector	15.4	13.3	0.4	4.4	4.6	-5.4	-2.2	-2.1	...
Broad money	18.5	4.7	0.1	3.0	1.6	3.2	2.9	3.8	...
Interest rates 5/ 7/	(Period average; percent)								
Average kuna deposit rate (unindexed)	2.3	2.8	3.2	1.8	1.7	1.9	1.5	1.4	...
Average kuna credit rate (unindexed)	9.3	10.1	11.6	10.4	9.7	9.5	9.2	8.6	...
Average credit rate, foreign currency-indexed loans	6.3	7.5	8.1	8.1	7.3	7.0	6.8	6.9	...
Balance of payments	(Millions of euros, unless otherwise indicated)								
Current account balance	-3,151	-4,255	-2,408	-582	-389	-40	564	695	444
Percent of GDP	-7.3	-9.0	-5.1	-1.1	-0.9	-0.1	1.3	1.6	1.0
Capital and financial account	5,192	5,399	4,418	1,804	1,882	397	2,268	363	634
FDI, net (percent of GDP)	8.0	6.9	3.3	1.3	2.4	2.5	1.3	1.8	2.1
Overall balance	722	-330	896	84	401	46	1,844	71	90
Debt and reserves	(End of period; millions of euros, unless otherwise indicated)								
Gross official reserves	9,307	9,121	10,376	10,660	11,195	11,236	12,908	12,978	13,068
Percent of short-term debt (by residual maturity)	106	67	75	66	72	88	89	107	104
Months of following year's imports of goods and nonfactor services	4.7	6.1	7.0	6.8	7.2	7.4	8.4	8.1	7.6
Net international reserves	7,349	7,967	9,365	9,644	10,374	10,483	12,205	12,275	12,365
Reserves (Fixed, percent of RAM) 6/	89.5	72.2	81.3	79.1	82.8	86.4	98.3	100.0	100.8
External debt service to exports ratio (percent)	58.4	53.7	85.6	71.6	77.6	76.3	66.1	76.8	65.9
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	103.9	102.9	106.1	104.3	101.0
Net external debt (percent of GDP)	40.6	51.4	62.7	66.1	66.5	65.6	68.7	67.0	63.6
Exchange rate									
Kuna per euro, end of period 8/	7.3	7.4	7.3	7.4	7.5	7.6	7.6	7.6	...
Kuna per euro, period average 8/	7.3	7.2	7.3	7.3	7.4	7.5	7.6	7.7	...
Real effective rate (CPI, percent change) 4/ 9/	0.7	4.6	1.2	-2.6	-2.1	-1.9	2.5	1.9	...
Memorandum items:									
Nominal GDP (millions of euros)	43,380	47,537	44,770	44,428	44,195	43,686	43,645	43,518	44,203
Output gap (percent of potential)	3.2	4.2	-2.2	-2.6	-1.6	-2.8	-2.3	-2.2	-2.1

Per capita GDP (2012, WEO): $12,829 — 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/ Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). National account data for 1995-2008 were revised in 2009 and data for 2008-2011 were revised in 2012.
2/ Cash definition.
3/ Includes the balances of HBOR and HAC (net of budget transfers).
4/ Latest data as of January 2014.
5/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.
6/ IMF, 2011, "Assessing Reserve Adequacy" IMF Board Paper 11/31, Washington: International Monetary Fund.
7/ Latest data as of February 2014.
8/ Latest data as of March 2014.
9/ Positive change means depreciation and vice versa.

Table 2. Croatia: Balance of Payments, 2008–19

(Millions of euros, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
						Prel.	Proj.					
Current account	-4,255	-2,293	-502	-389	-40	564	695	444	239	-295	-782	-1,041
Merchandise trade balance	-10,632	-7,207	-5,746	-6,148	-6,031	-6,247	-6,416	-6,811	-7,482	-8,139	-9,070	-9,858
Exports f.o.b.	9,753	7,675	9,064	9,774	9,807	9,194	9,231	9,425	9,944	10,627	11,411	12,351
Imports f.o.b.	-20,385	-14,882	-14,809	-15,922	-15,838	-15,442	-15,647	-16,236	-17,426	-18,766	-20,480	-22,209
Services and income	5,307	3,910	4,181	4,614	4,834	5,708	5,829	5,848	6,274	6,357	6,698	7,090
Transportation	404	288	299	282	273	257	252	246	247	258	263	283
Travel	6,694	5,656	5,601	5,985	6,137	6,517	6,900	7,306	7,787	8,097	8,592	9,150
Other services	-245	-253	-125	-64	20	33	-134	-163	-251	-283	-336	-368
Compensation of employees	564	587	621	635	719	757	665	489	517	540	592	632
Interest and investment income	-2,110	-2,367	-2,215	-2,224	-2,315	-1,856	-1,855	-2,031	-2,026	-2,256	-2,413	-2,607
Current transfers	1,070	1,004	1,062	1,146	1,156	1,104	1,282	1,407	1,447	1,487	1,590	1,727
Capital and financial account	5,399	4,343	1,709	1,882	397	2,268	363	634	825	1,374	1,864	2,120
Capital account 1/	22	61	60	38	42	33	256	256	256	256	256	256
Financial account 1/	5,377	4,282	1,650	1,844	355	2,234	107	378	569	1,118	1,608	1,864
Direct investment	3,276	1,492	484	1,053	1,083	578	768	941	961	1,321	1,658	1,620
Portfolio investment	-841	454	407	585	1,738	1,881	1,024	986	918	885	618	438
Medium- and long-term loans	2,900	665	-333	-490	-1,794	-1,031	-1,515	-1,376	-1,105	-1,027	-598	-233
Assets	-64	-8	-46	-24	43	-129	0	0	0	0	0	0
Liabilities	2,965	673	-288	-466	-1,837	-902	-1,515	-1,376	-1,105	-1,027	-598	-233
Disbursements	7,640	5,930	5,556	4,310	4,223	5,223	6,246	4,440	4,806	4,351	4,323	3,409
Amortization	-4,676	-5,257	-5,843	-4,776	-6,060	-6,125	-7,761	-5,816	-5,911	-5,378	-4,921	-3,642
Currency and deposits	-552	1,709	486	1,237	-1,631	418	-138	-125	-162	-28	-48	42
Short-term capital flows (net)	696	-31	262	21	317	378	118	60	57	65	67	81
Trade credits	-104	-18	348	-553	673	-38	-150	-108	-100	-98	-89	-85
Other liabilities (long-term)	1	10	-4	-9	-31	48	0	0	0	0	0	1
Net errors and omissions 1/	-1,475	-1,154	-1,124	-1,092	-311	-988	-988	-988	-988	-988	-988	-988
Overall balance	-330	896	84	401	46	1,844	71	90	76	91	94	92
Financing	330	-889	-89	-410	-46	-1,844	-71	-90	-76	-91	-94	-92
Gross reserves (-= increase)	330	-896	-84	-401	-46	-1,844	-71	-90	-76	-91	-94	-92
IMF (net purchases)	0	0	0	0	0	0	0	0	0	0	0	0
Exceptional financing	0	8	-6	-9	0	0	0	0	0	0	0	0
Memorandum items:												
Current account (percent of GDP)	-9.0	-5.1	-1.1	-0.9	-0.1	1.3	1.6	1.0	0.5	-0.6	-1.6	-2.0
Export goods volume growth (excluding ships)	0.1	-14.2	9.5	0.9	-1.5	0.9	-0.2	1.5	4.6	5.2	5.4	6.0
Import goods volume growth	-2.7	-16.8	-18.0	-5.2	2.0	6.8	-2.0	2.4	5.1	5.3	6.3	6.4
Gross official reserves	9,121	10,376	10,660	11,195	11,236	12,908	12,978	13,068	13,141	13,230	13,320	13,407
Reserves: Gross Official Reserves (percent of short-term debt by remaining maturity)	67	75	66	72	88	89	107	104	105	112	112	112
Months of next year's imports of goods and nonfactor services	6.1	7.0	6.8	7.2	7.4	8.4	8.1	7.6	7.1	6.6	6.1	n.a.
Outstanding debt 2/	40,316	45,269	46,527	45,901	44,974	46,297	45,404	44,634	44,039	43,610	43,300	43,366
External debt to GDP ratio 2/	84.8	101.1	104.7	103.9	102.9	106.1	104.3	101.0	96.4	91.6	86.9	83.2
External debt in percent of exports of goods and nonfactor services 2/	203.2	277.5	262.6	244.6	235.6	247.1	237.1	225.3	210.6	197.3	183.3	170.8
External debt service	-6,823	-8,247	-7,753	-7,410	-8,077	-8,231	-10,985	-10,027	-11,080	-10,952	-10,405	-9,961
GDP (millions of euros)	47,537	44,770	44,428	44,195	43,686	43,645	43,518	44,203	45,676	47,586	49,849	52,117
GDP (millions of kuna)	343,412	328,672	323,806	328,737	328,562	328,252	327,291	332,447	343,523	357,892	374,910	391,968

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 3. Croatia: Medium-Term Baseline Scenario, 2008–19 1/

(Percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
						Prel.			Proj.			
Real sector (percent change)												
Real GDP	2.1	-6.9	-2.3	-0.2	-1.9	-1.0	-0.8	0.5	1.4	2.1	2.2	2.0
Domestic demand	3.1	-10.2	-5.0	0.0	-3.2	-1.1	-1.2	0.2	1.6	2.7	2.8	2.6
Consumption, total	0.9	-5.6	-1.5	-0.1	-2.4	-1.1	-0.5	-0.7	0.1	1.9	2.1	2.1
Of which: private	1.3	-7.6	-1.3	0.3	-3.0	-1.0	-0.6	1.4	2.0	2.4	2.5	2.6
Gross fixed capital formation, total	8.7	-14.2	-15.0	-3.4	-4.7	-1.0	-2.3	2.2	4.7	4.8	4.9	5.3
Of which: non-government	15.6	-14.1	-14.6	-3.9	-4.4	-2.9	-2.8	1.7	4.9	5.1	5.4	5.6
GDP deflator	5.7	2.9	0.8	1.8	1.9	0.9	0.5	1.1	1.9	2.0	2.5	2.5
CPI inflation (average)	6.1	2.4	1.0	2.3	3.4	2.2	0.5	1.1	1.9	2.1	2.3	2.5
CPI inflation (end-of-period)	2.8	1.9	1.9	2.0	4.7	0.3	1.0	1.4	1.9	2.1	2.3	2.5
Saving and investment												
Domestic investment	33.4	27.6	23.6	22.8	21.9	21.3	20.1	20.3	20.5	21.5	22.1	22.3
Of which: fixed capital formation	27.4	24.5	20.8	19.6	18.6	18.4	18.3	18.7	19.3	19.8	20.2	20.8
Domestic saving	24.5	22.4	22.4	21.9	21.8	22.6	21.7	21.3	21.0	20.9	20.5	20.3
Government	3.2	0.2	-1.5	-1.9	-0.8	-2.6	-1.0	0.2	0.4	0.4	0.4	0.3
Nongovernment	21.3	22.3	23.9	23.8	22.7	25.2	22.7	21.1	20.6	20.4	20.2	20.0
General government finances 2/												
Revenue	39.2	39.0	38.2	37.4	38.4	37.9	40.3	40.7	40.3	40.4	40.5	40.6
Expenditure	40.1	42.2	42.7	42.0	41.7	43.4	44.2	43.6	43.0	43.0	43.2	43.3
Balance	-0.9	-3.3	-4.5	-4.6	-3.3	-5.4	-4.0	-2.9	-2.7	-2.7	-2.7	-2.7
Government debt	29.3	35.8	42.6	47.4	54.0	60.0	64.7	66.8	67.3	67.4	67.2	67.0
Balance of payments 3/												
Current account balance	-9.0	-5.1	-1.1	-0.9	-0.1	1.3	1.6	1.0	0.5	-0.6	-1.6	-2.0
Exports of goods, f.o.b.	20.5	17.1	20.4	22.1	22.4	21.1	21.2	21.3	21.8	22.3	22.9	23.7
Imports of goods, f.o.b.	-42.9	-33.2	-33.3	-36.0	-36.3	-35.4	-36.0	-36.7	-38.2	-39.4	-41.1	-42.6
Capital and financial account	11.4	9.7	3.8	4.3	0.9	5.2	0.8	1.4	1.8	2.9	3.7	4.1
Of which: FDI, net	6.9	3.3	1.1	2.4	2.5	1.3	1.8	2.1	2.1	2.8	3.3	3.1
Gross official reserves	19.2	23.2	24.0	25.3	25.7	29.6	29.8	29.6	28.8	27.8	26.7	25.7
Gross external debt	84.8	101.1	104.7	103.9	102.9	106.1	104.3	101.0	96.4	91.6	86.9	83.2
Net external debt	51.4	62.7	66.1	66.5	65.6	68.7	67.0	63.6	59.1	54.3	49.5	45.9
Memorandum items:												
Nominal GDP (millions of kuna)	343,412	328,672	323,806	328,737	328,562	328,252	327,291	332,447	343,523	357,892	374,910	391,968
Nominal GDP (millions of euros)	47,537	44,770	44,428	44,195	43,686	43,645	43,518	44,203	45,676	47,586	49,849	52,117
Output gap	4.2	-2.2	-2.6	-1.6	-2.8	-2.3	-2.2	-2.1	-1.9	-1.1	-0.4	0.0
Potential GDP growth	1.3	-0.8	-1.9	-1.2	-0.7	-1.5	-0.9	0.4	1.2	1.3	1.5	1.7

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

1/ Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). National account data for 1995-2008 were revised in 2009 and data for 2008-2011 were revised in 2012. Revised nominal GDP figure for 2011 is about 2.7 percent lower than the previous estimate.

2/ Croatian authorities' definition.

3/ Based on fifth edition of the Balance of Payments Manual, 1993.

Table 4. Croatia: Consolidated General Government Finances, 2009–19

(Percent of GDP; cash basis)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Est.			Proj.			
Revenue	39.0	38.2	37.4	38.4	37.9	40.3	40.7	40.3	40.3	40.5	40.6
Taxes	22.4	22.2	21.4	22.6	21.8	21.8	22.1	22.2	22.2	22.3	22.3
Taxes on income, profits, and capital gains	6.0	4.8	5.0	5.3	4.7	4.6	4.7	4.6	4.6	4.6	4.7
Payable by individuals	3.2	2.8	2.8	3.0	2.8	2.9	2.9	2.9	2.9	2.9	2.9
Payable by corporations and other enterprises	2.9	2.0	2.2	2.3	1.9	1.8	1.7	1.7	1.7	1.7	1.7
Taxes on property	0.3	0.3	0.3	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3
Taxes on goods and services	15.1	15.9	15.4	16.3	16.4	16.7	16.9	17.0	17.1	17.0	17.0
Of which:											
VAT	11.3	11.6	11.5	12.4	12.3	12.4	12.6	12.7	12.8	12.8	12.8
Excises	3.3	3.7	3.4	3.4	3.6	3.7	3.7	3.7	3.7	3.7	3.7
Taxes on international trade and transactions	0.5	0.5	0.5	0.5	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes 1/	0.4	0.7	0.1	0.1	0.0	0.1	0.2	0.2	0.2	0.2	0.2
Social security contributions 2/	12.2	12.0	11.7	11.5	11.3	12.5	12.9	12.4	12.4	12.5	12.6
Grants	0.2	0.2	0.3	0.3	0.6	1.3	1.3	1.3	1.3	1.3	1.3
Of which: from EU					0.8	1.3	1.3	1.3	1.3	1.3	1.3
Other revenue	4.2	3.9	4.0	4.0	4.3	4.7	4.4	4.4	4.4	4.4	4.4
Expenditure	42.2	42.7	42.0	41.7	43.4	44.2	44.4	44.6	44.6	44.7	44.9
Expenses	40.3	41.2	40.4	40.3	41.7	42.5	42.5	42.7	42.7	42.9	43.1
Compensation of employees	10.7	10.8	10.8	10.8	10.3	10.3	10.3	10.3	10.3	10.3	10.3
Use of goods and services	4.6	4.7	4.7	4.6	4.7	4.8	4.8	4.8	4.8	4.8	4.8
Interest	1.7	2.1	2.3	2.7	3.1	3.5	3.6	3.7	3.8	3.9	3.9
Subsidies	2.5	2.4	2.3	2.1	2.0	1.8	1.8	1.8	1.8	1.8	1.8
Grants	0.7	0.6	0.5	0.6	1.0	1.8	1.8	1.8	1.8	1.8	1.8
Of which: from EU					0.5	1.0	1.0	1.0	1.0	1.0	1.0
Social benefits	17.3	17.8	17.4	17.3	18.3	18.1	18.0	18.1	18.1	18.2	18.3
Other expense	2.8	2.8	2.4	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Net acquisition of nonfinancial assets	1.9	1.5	1.5	1.4	1.7	1.7	1.9	1.9	1.9	1.9	1.9
Acquisition	2.2	1.7	1.8	1.6	1.9	1.9	2.1	2.1	2.1	2.0	2.0
Disposal	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gross operating balance	-1.3	-3.0	-3.0	-1.9	-3.8	-2.2	-1.0	-0.8	-0.8	-0.8	-0.9
Overall balance	-3.3	-4.5	-4.6	-3.3	-5.4	-4.0	-2.9	-2.7	-2.7	-2.7	-2.7
Unspecified measures	…	…	…	…	…	…	0.8	1.6	1.6	1.6	1.6
ESA 95 deficit 3/	-5.3	-6.4	-7.8	-5.0	…	…	…	…	…	…	…
Financing Requirement	-3.3	-4.5	-4.6	-3.3	-5.4	-4.0	-2.9	-2.7	-2.7	-2.7	-2.7
Financing	3.3	4.5	4.6	3.3	5.4	4.0	2.9	2.7	2.7	2.7	2.7
Net acquisition of financial assets	2.0	0.8	0.0	0.0	0.3	0.4	0.0	0.0	0.0	0.0	0.0
Domestic	2.0	0.8	0.0	0.0	0.3	0.4	0.0	0.0	0.0	0.0	0.0
Privatization	0.0	0.0	-0.1	-0.4	-1.0	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	6.2	5.9	4.6	3.3	5.8	4.4	2.9	2.6	2.7	2.7	2.7
Domestic	4.0	4.6	2.0	0.9	0.4	3.6	3.0	0.8	2.7	2.8	2.8
Foreign	2.2	1.3	2.6	2.5	5.4	0.8	-0.2	1.8	-0.1	-0.1	-0.1
Memorandum items:											
Primary balance	-2.4	-3.1	-3.0	-1.2	-2.5	-0.5	0.8	1.1	1.2	1.2	1.2
Cyclically adjusted balance	-2.3	-3.4	-3.9	-2.1	-4.5	-3.0	-2.0	-1.8	-2.2	-2.5	-2.7
Structural balance	-2.3	-3.4	-3.9	-2.1	-4.5	-3.4	-2.6	-1.8	-2.2	-2.5	-2.7
Broader measure of fiscal balance 4/	-5.5	-5.4	-5.2	-4.2	-5.9	-4.5	-3.3	-3.1	-3.1	-3.2	-3.0
General government debt	35.8	42.6	47.4	54.0	60.0	64.7	66.8	67.3	67.4	67.2	67.0
General government guarantees	15.5	18.3	18.2	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7
Total general government net investment 5/	3.4	3.0	2.7	2.5	2.9	2.9	3.1	3.1	3.1	3.1	3.1

Sources: Ministry of Finance; and IMF staff estimates.

1/ For 2009-2010, includes revenue from the "solidarity tax."

2/ Includes the transfer of pillar II accumulated contributions to pillar I in 2014 (2.8 billion) and 2015 (2.2 billion).

3/ ESA 95 deficit is on commitment basis. It mainly adjusts for floats and payments of called guarantees.

4/ Includes the balances (net of budget transfers) of the Croatian Bank for Reconstruction and Development (HBOR) and the Croatian Motorways Ltd (HAC) .

5/ Amounts to the sum of the net acquisition of non financial assets, net capital grants and other expenses in capital.

Table 5. Croatia: Monetary Accounts, 2008–13

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

	2008	2009	2010	2011	2012	2013			
						Q1	Q2	Q3	Q4
Monetary survey									
Net foreign assets	41,658	44,925	44,498	33,998	50,225	47,370	48,021	60,992	65,284
(Millions of euros)	5,650	6,157	6,025	4,512	6,646	6,236	6,446	8,012	8,569
Croatian National Bank	66,789	75,800	78,720	84,302	84,782	85,552	88,622	88,644	97,945
(Millions of euros)	9,058	10,389	10,659	11,187	11,218	11,262	11,896	11,644	12,856
Deposit money banks	-25,131	-30,875	-34,221	-50,303	-34,557	-38,183	-40,601	-27,651	-32,662
(Millions of euros)	-3,408	-4,232	-4,634	-6,676	-4,572	-5,026	-5,450	-3,632	-4,287
Net domestic assets	202,476	199,521	207,240	221,733	213,563	215,827	215,915	213,635	206,232
Domestic credit (CNB definition) 1/	273,358	275,504	291,321	312,861	304,822	308,409	305,864	306,310	297,285
Claims on government, net 2/	31,225	33,737	39,115	49,213	55,104	60,315	58,666	56,817	52,329
Claims on other domestic sectors 3/	238,942	239,836	250,428	261,849	247,840	245,536	244,943	246,582	242,398
Other items (net)	-70,882	-75,983	-84,081	-91,128	-91,259	-92,582	-89,949	-92,675	-91,053
Broad money	244,134	244,446	251,738	255,731	263,789	263,197	263,936	274,627	271,516
Narrow money	55,238	47,196	48,301	51,935	52,781	51,926	57,125	57,938	58,533
Currency outside banks	17,051	15,282	15,263	16,689	16,947	16,919	18,511	18,359	17,421
Demand deposits	38,187	31,914	33,039	35,246	35,834	35,006	38,613	39,580	41,112
Quasi money	188,896	197,250	203,437	203,796	211,008	211,271	206,812	216,689	212,983
Kuna-denominated	71,305	61,741	56,117	59,309	58,359	58,540	58,257	59,378	58,062
Foreign currency-denominated	117,591	135,509	147,321	144,487	152,649	152,731	148,554	157,312	154,921
Balance sheet of the Croatian National Bank									
Net foreign assets	66,789	75,800	78,720	84,302	84,782	85,552	88,622	88,644	97,945
Of which: banks' reserves in foreign currency	8,008	5,042	4,773	5,538	5,095	5,067	4,976	4,998	4,419
Net international reserves	58,745	68,426	71,220	78,174	79,609	64,117	80,586	81,453	82,868
Net domestic assets	-8,972	-14,554	-17,637	-16,573	-18,282	-15,754	-17,860	-20,038	-28,500
Claims on government (net)	-195	-4,157	-5,356	-1,772	-3,457	-335	-4,158	-5,023	-13,447
Claims on banks	14	14	13	139	12	12	11	21	11
Of which: Open market operations	0	0	0	0	0	0	0	0	0
Claims on other domestic sectors	64	4	4	4	3	2	2	2	2
Other items (net)	-8,855	-10,415	-12,297	-14,943	-14,839	-15,433	-13,715	-15,038	-15,067
Base money	57,817	61,246	62,333	68,314	69,812	69,904	70,762	68,606	69,445
Currency	17,051	15,282	15,263	16,689	16,947	16,919	18,511	18,359	17,421
Deposits	40,766	45,963	47,070	51,625	52,865	52,984	52,251	50,247	52,025
Of which:									
Settlement accounts	9,520	12,025	10,246	12,705	11,509	9,848	15,829	13,319	15,081
Statutory reserves in kuna 4/	19,223	23,601	22,705	25,755	24,556	24,130	24,263	24,662	22,025
Statutory reserves in foreign currency	8,008	5,042	4,773	5,538	5,095	5,067	4,976	4,998	4,419
Reserve money (CNB definition) 5/	49,753	56,154	56,354	62,560	61,857	62,421	63,521	61,496	63,044
Year-on-year percent changes									
Monetary survey									
Net domestic assets	21.7	-1.5	3.9	8.4	3.1	-3.9	-1.6	-0.4	-3.4
Domestic credit (CNB definition) 1/	20.9	0.8	5.7	10.5	4.6	-2.4	-1.3	0.3	-2.5
Claims on government, net 2/	121.2	8.0	15.9	27.8	40.9	16.8	14.0	12.6	-5.0
Claims on other domestic sectors 3/	14.5	0.4	4.4	7.9	-1.0	-6.6	-4.6	-2.4	-2.2
Broad money	13.1	0.1	3.0	5.6	4.8	4.4	3.4	5.1	2.9
Quasi money	19.6	4.4	3.1	4.8	3.7	2.9	1.1	3.5	0.9
Balance sheet of the Croatian National Bank									
Base money	-12.7	5.9	1.8	11.1	12.0	4.1	0.3	-0.8	-0.5
Reserve money (CNB definition) 5/	-4.2	12.9	0.4	14.4	9.8	2.2	2.9	1.4	1.9
Memorandum items:									
Nominal GDP (yearly total)	343,412	328,672	323,806	331,754	328,562	329,091	329,736	329,476	328,252
Narrow money multiplier	0.96	0.77	0.77	0.76	0.76	0.74	0.81	0.84	0.84
Broad money multiplier	4.22	3.99	4.04	3.74	3.78	3.77	3.73	4.00	3.91
Broad money (percent of GDP)	71.1	74.4	77.7	77.1	80.3	80.0	80.0	83.4	82.7
Foreign currency (percent of broad money)	48.2	55.4	58.5	56.5	57.9	58.0	56.3	57.3	57.1
Credit to other domestic sectors: stock (% of GDP)	69.6	73.0	77.3	78.9	75.4	74.6	74.3	74.8	73.8
Credit to other domestic sectors: 12-month flow (percent of GDP)	8.8	0.3	3.9	5.8	-4.3	-5.2	-3.6	-1.9	-1.7

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 6. Croatia: External Financing Requirement, 2008-15

(Millions of euros, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015
						Est.	Proj.	
Financing requirements	-13,007	-16,056	-12,417	-13,892	-13,370	-10,658	-13,885	-11,676
Current account balance	-4,255	-2,293	-502	-389	-40	564	695	444
Amortization of medium and long-term debt	-5,412	-7,644	-6,861	-7,349	-7,582	-7,663	-10,743	-9,024
Public	-776	-1,367	-914	-1,462	-407	-794	-1,628	-2,531
Private	-4636	-6277	-5947	-5887	-7175	-6868	-9115	-6494
Banks 1/	-914	-2,178	-1,361	-1,870	-1,945	-1,744	-2,050	-1,103
Nonbanks 2/	-3,722	-4,099	-4,586	-4,017	-5,230	-5,125	-7,065	-5,391
Repayment of short-term debt (including deposits and trade credit)	-3,340	-6,119	-5,055	-6,154	-5,748	-3,559	-3,838	-3,096
Public	-84	-26	-170	-469	-158	-33	-117	-117
Private	-3,256	-6,094	-4,884	-5,685	-5,590	-3,526	-3,720	-2,979
Banks	-2,357	-3,791	-3,091	-3,148	-3,816	-1,986	-1,994	-1,079
Nonbanks	-899	-2,302	-1,794	-2,537	-1,774	-1,540	-1,726	-1,901
Financing sources	13,007	16,056	12,417	13,892	13,370	10,658	13,885	11,677
Capital transfers	22	61	60	38	42	33	256	256
FDI, net	3,276	1,492	484	1,053	1,083	578	768	941
Disbursements on bonds and MLT loans	7,997	10,809	7,439	6,624	7,856	8,469	10,587	8,650
Public	551	2,385	1,727	1,852	1,561	2,641	863	2,621
Private	7,446	8,424	5,712	4,772	6,295	5,828	9,724	6,028
Banks	594	3,481	1,252	2,046	1,671	1,182	2,240	1,186
Nonbanks	6,852	4,943	4,460	2,726	4,624	4,646	7,484	4,842
Short-term financing	4,972	5,557	5,227	6,926	4,546	3,838	3,096	2,699
Public	116	70	170	468	158	117	117	117
Private	4,857	5,487	5,057	6,457	4,388	3,720	2,979	2,581
Banks 1/	3,654	3,038	2,988	3,826	1,840	1,994	1,079	497
Nonbanks 2/	1,202	2,449	2,069	2,631	2,548	1,726	1,901	2,084
Other flows	-3,591	-967	-709	-348	-111	-416	-751	-778
Gross international reserves (- = increase)	330	-896	-84	-401	-46	-1,844	-71	-90
Financing gap	0	0	0	0	0	0	0	0
Memorandum items								
Current account deficit (percent of GDP)	-9.0	-5.1	-1.1	-0.9	-0.1	1.3	1.6	1.0
Government inflows, net	-193.9	1062.8	812.8	389.8	1154.1	1931.0	-765.0	90.5
Bank inflows, net	977.6	549.2	-211.9	854.0	-2250.4	-553.4	-725.4	-498.1
Nonbank inflows, net	3433.6	990.6	149.9	-1197.4	167.7	-292.9	593.7	-364.9
Gross official reserves	9,121	10,376	10,660	11,195	11,236	12,908	12,978	13,068
Months of imports	6.1	7.0	6.8	7.2	7.4	8.4	8.1	7.6
Percent of short-term debt by remaining maturity	67	75	66	72	88	89	107	104
GDP	47,537	44,770	44,428	44,195	43,686	43,645	43,518	44,203

Sources: Croatian National Bank; and IMF staff projections.

1/ Includes longer-term currency and deposits.

2/ Includes longer-term trade credits.

Table 7. Croatia: Financial Soundness Indicators, 2008–13

(Percent, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013			
						Mar.	Jun.	Sep.	Dec.
Core set									
Regulatory capital to risk-weighted assets	15.1	16.4	18.8	20.5	20.9	20.8	20.6	21.3	20.9
Regulatory Tier I capital to risk-weighted assets	14.9	15.8	17.5	19.1	19.6	19.7	19.4	20.2	19.9
Nonperforming loans net of loan-loss provisions to capital	12.8	22.0	34.5	37.8	39.2	41.3	44.0	43.7	42.9
Nonperforming loans to total gross loans 1/	4.9	7.7	11.1	12.3	13.8	14.4	14.9	15.1	15.4
Sectoral distribution of loans to total loans									
Nonfinancial corporations	37.5	36.8	37.5	38.5	33.8	34.4	36.5	36.3	35.1
Households	50.3	47.2	46.0	44.3	44.4	44.5	43.9	44.4	43.8
Other sectors	11.4	15.4	15.7	16.6	20.1	19.9	18.2	17.5	19.5
Nonresidents	0.8	0.6	0.7	0.6	0.9	0.6	0.7	0.9	0.9
Return on assets	1.7	1.2	1.2	1.2	1.0	1.0	0.7	0.8	0.3
Return on equity	12.8	8.8	8.3	8.7	6.1	6.8	4.6	5.4	2.4
Net interest income to gross income	62.1	56.7	64.3	66.1	71.0	61.3	64.5	62.0	62.9
Noninterest expenses to gross income	61.0	56.6	55.7	55.1	62.5	56.8	60.2	75.7	87.7
Liquid assets to total assets 2/	37.0	35.8	33.7	31.7	31.3	30.2	30.8	32.0	30.7
Liquid assets to short-term liabilities 2/	54.6	53.5	50.6	48.2	48.2	46.9	45.6	48.4	46.6
Net open position in foreign exchange to capital	3.6	5.4	2.9	1.7	2.3	1.7	1.7	1.8	1.7
Encouraged set									
Deposit takers 3/									
Capital to assets	13.3	13.8	13.8	13.6	14.2	14.5	14.0	14.0	13.9
Large exposures to capital	46.7	44.8	39.0	48.6	43.0	40.3	45.1	47.0	46.8
Geographical distribution of loans to total loans									
Residents	99.2	99.4	99.3	99.4	99.1	99.4	99.3	99.1	99.1
Nonresidents	0.8	0.6	0.7	0.6	0.9	0.0	0.0	0.0	0.9
Gross asset position in derivatives to capital	0.2	0.4	0.3	1.2	1.6	1.7	2.7	2.0	7.1
Gross liability position in derivatives to capital	3.1	0.8	2.7	2.5	3.0	2.8	2.5	3.0	3.3
Trading income to total income	7.1	15.5	8.0	6.8	7.4	8.5	3.7	4.4	4.6
Personnel expenses to noninterest expenses	40.0	39.8	40.6	40.6	40.5	43.5	42.6	31.5	27.2
Spread between domestic lending and deposit rates	3.8	4.0	4.5	4.1	3.7	3.7	3.6	3.5	3.6
Noninterbank loans to noninterbank deposits	81.0	78.1	80.0	77.5	81.3	81.5	80.1	79.5	83.5
Foreign currency-denominated loans to total loans 4/	65.5	72.3	74.3	75.1	73.7	73.3	73.8	74.0	74.0
Foreign currency-denominated liabilities to total liabilities 4/	76.1	79.0	77.0	77.2	77.8	77.2	66.6	67.6	67.7
Net open position in equities to capital	4.8	4.8	4.9	6.7	6.2	6.6	6.8	6.8	7.1
Other financial corporations (OFCs)									
OFCs' assets to total financial system assets	23.2	24.7	24.8	24.4	26.2	26.8	26.7	26.6	27.2
OFCs' assets to GDP	32.6	37.7	39.9	39.8	43.1	44.3	44.2	44.1	44.5
Households									
Bank loans to households to GDP	38.3	39.0	40.7	40.4	39.8	39.6	38.9	39.2	38.6
Real estate markets									
Residential real estate prices (annual percentage increase)	1.9	-4.3	-8.9	-1.6	-4.4	-15.3	-19.7	-16.9	-14.6
Residential real estate loans to total loans	21.9	21.5	22.2	21.8	22.3	22.2	21.9	22.1	22.1
Other indicators									
Loan-loss provisions to nonperforming loans	48.7	42.5	38.8	41.3	42.5	41.6	42.0	43.0	46.2
Change in credit to GDP ratio	17.9	7.8	9.8	10.0	7.1	9.1	-7.7	-7.0	9.0
Net interest income to average total assets	2.7	2.5	2.8	2.8	2.6	0.6	1.2	1.8	2.5
Noninterest expenses to average total assets	2.6	2.5	2.4	2.4	2.3	0.5	1.1	2.2	3.4
Loans to assets	13.3	13.8	13.8	13.6	14.2	14.5	14.0	14.0	13.2
Liquid assets to total deposits	67.1	66.4	60.1	57.5	54.6	52.1	53.9	56.6	51.2

Source: Croatian National Bank.

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

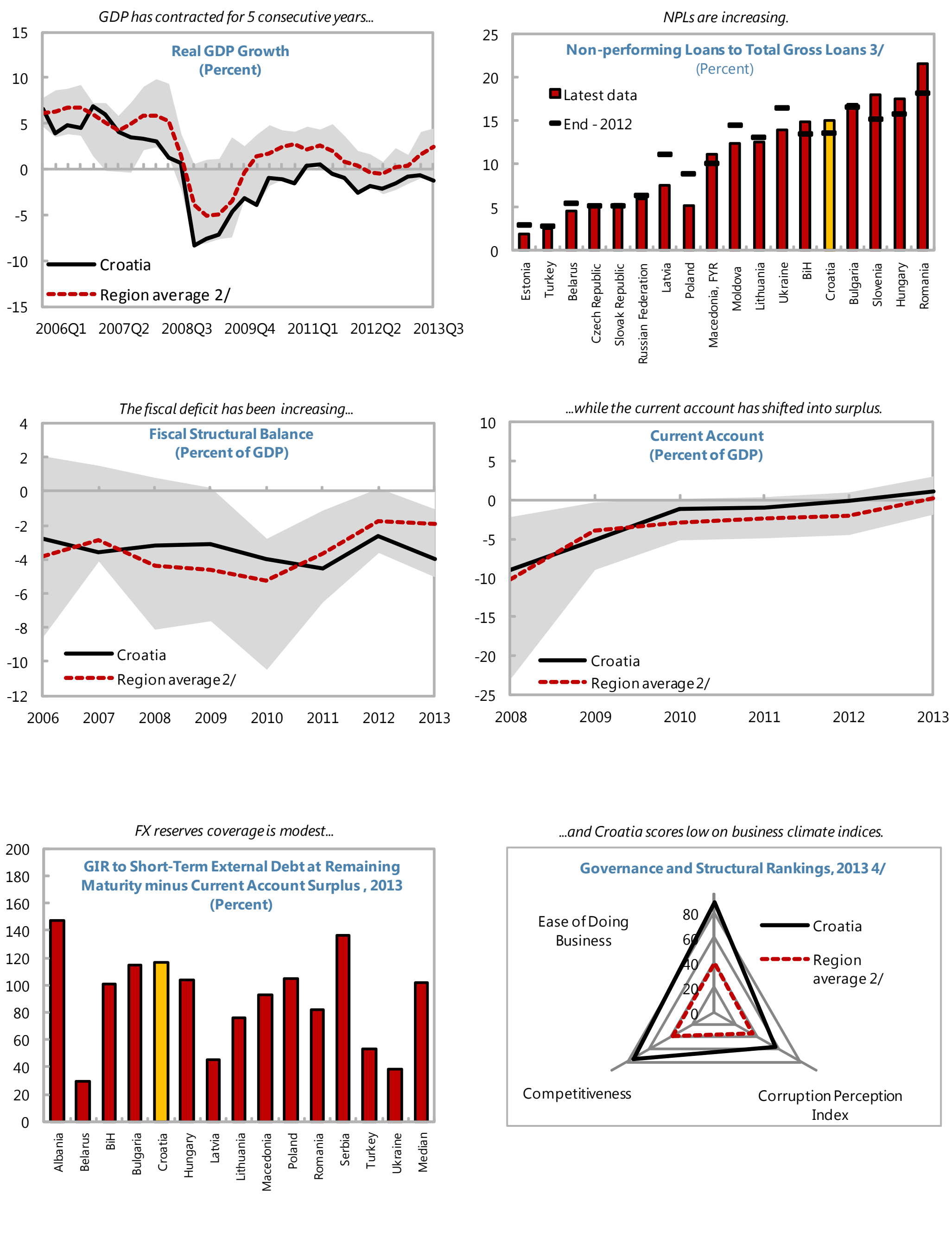
2/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper, and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans received. The sharp decline in liquidity in 2005 coincided 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.

Figure 1. Croatia Compared to Peers



Sources: Transparency International; World Bank; World Economic Forum; IMF Financial Soundness Indicators datase; and WEO.

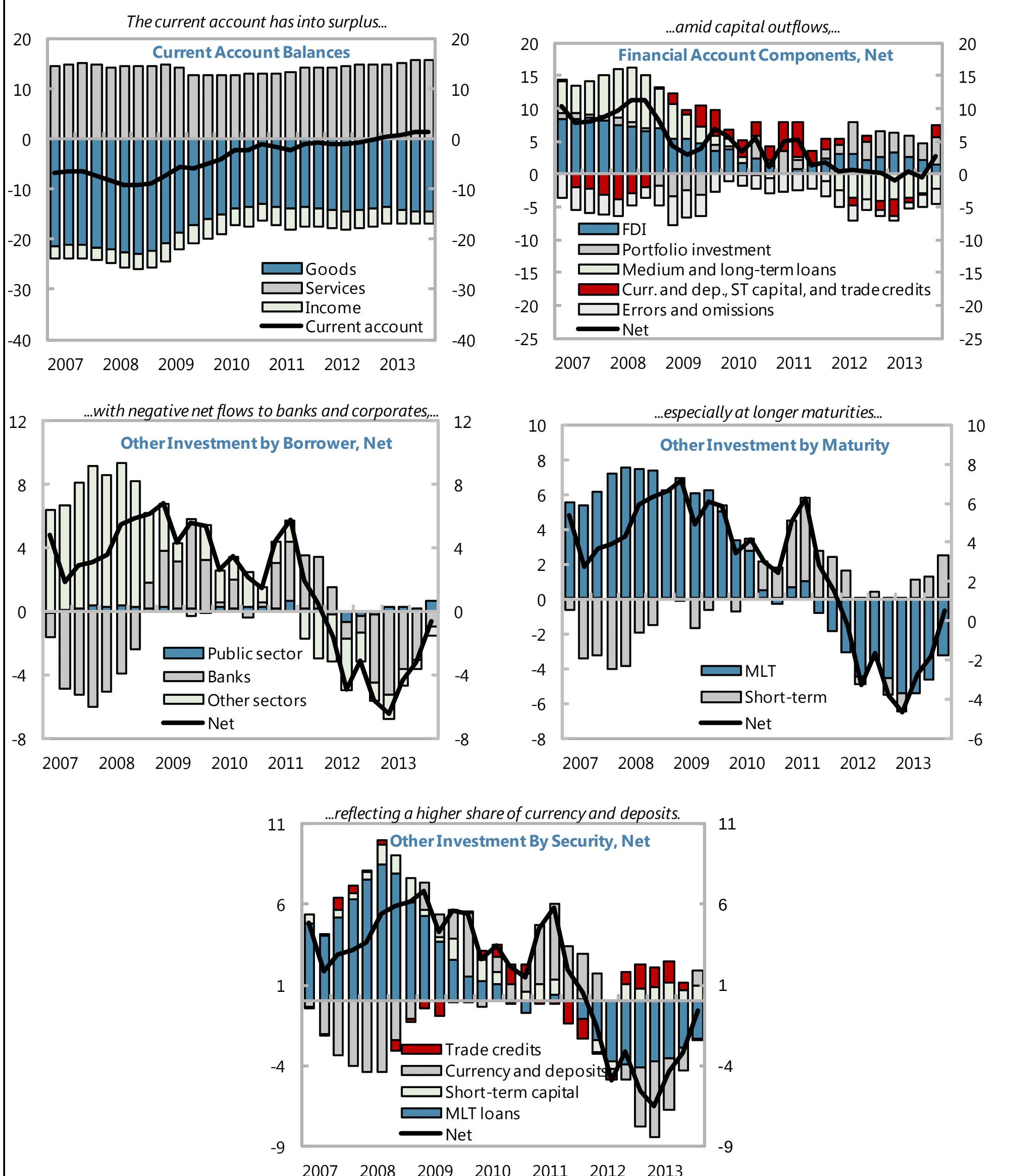
1/ Projections used for second half of 2013 and 2014 are from September 2013 WEO.

2/ Region average weighted by GDP includes Bulgaria, Czech Republic, Hungary, Poland, and Romania. Shaded regions show range between the minimum and maximum values in the region.

3/ NPL definitions differ across countries. Data are from the IMF Financial Soundness Indicators database.

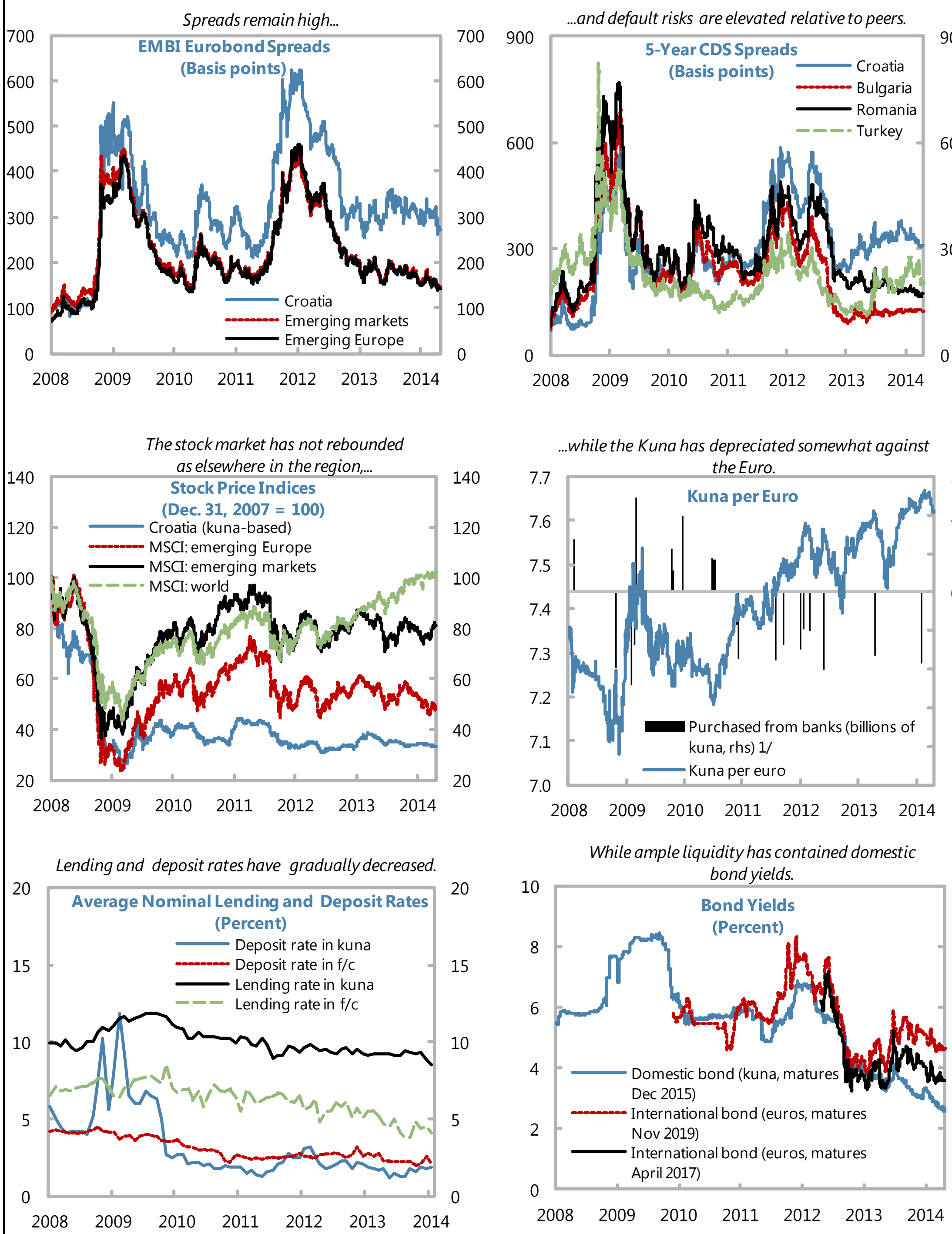
4/ Out of 183 countries, except for competitiveness where 139 countries were ranked.

Figure 2. Croatia: Balance of Payments, 2007–13



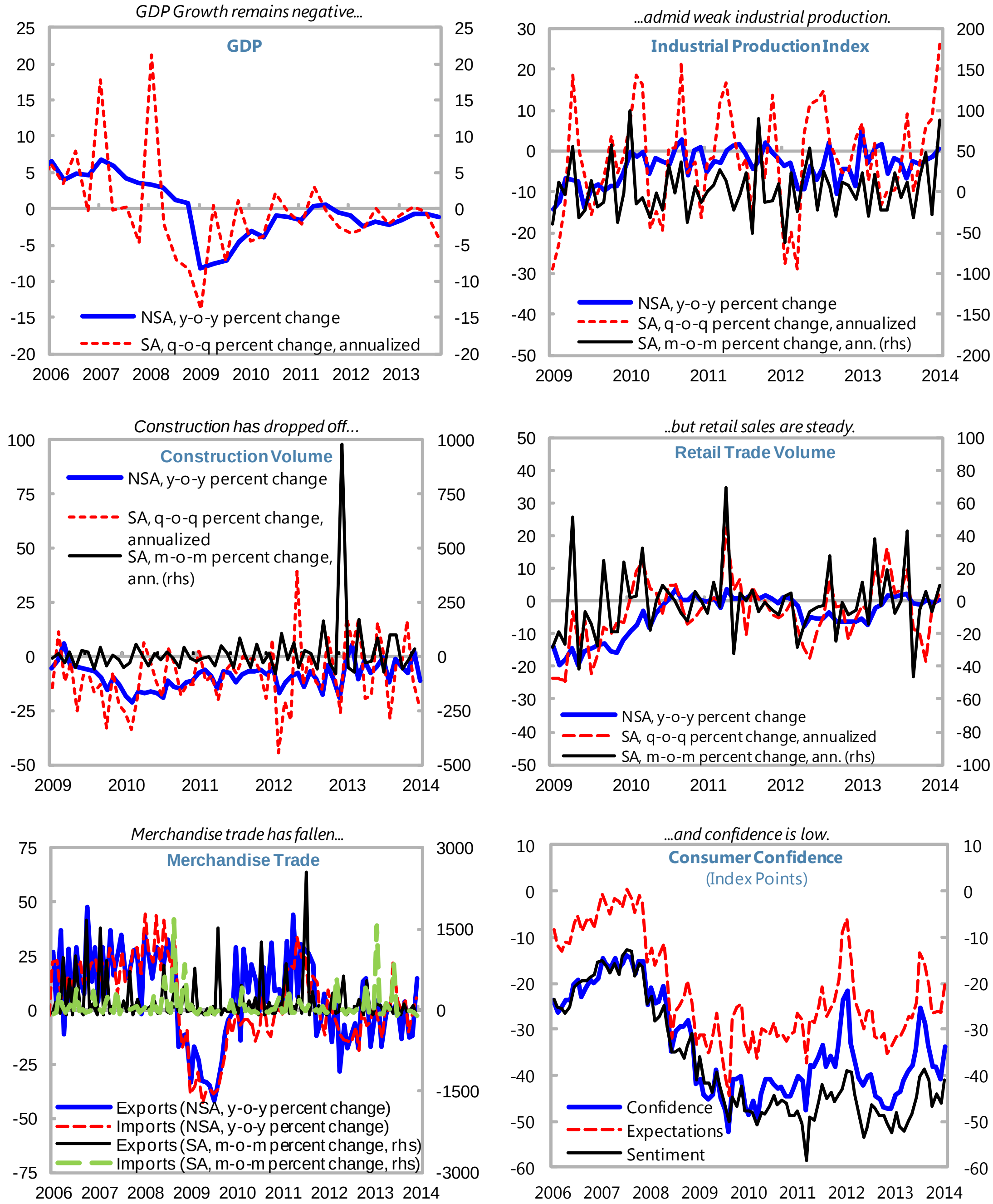
Sources: Croatian National Bank; and IMF staff estimates.

Figure 3. Croatia: Financial Market Developments, 2008–13



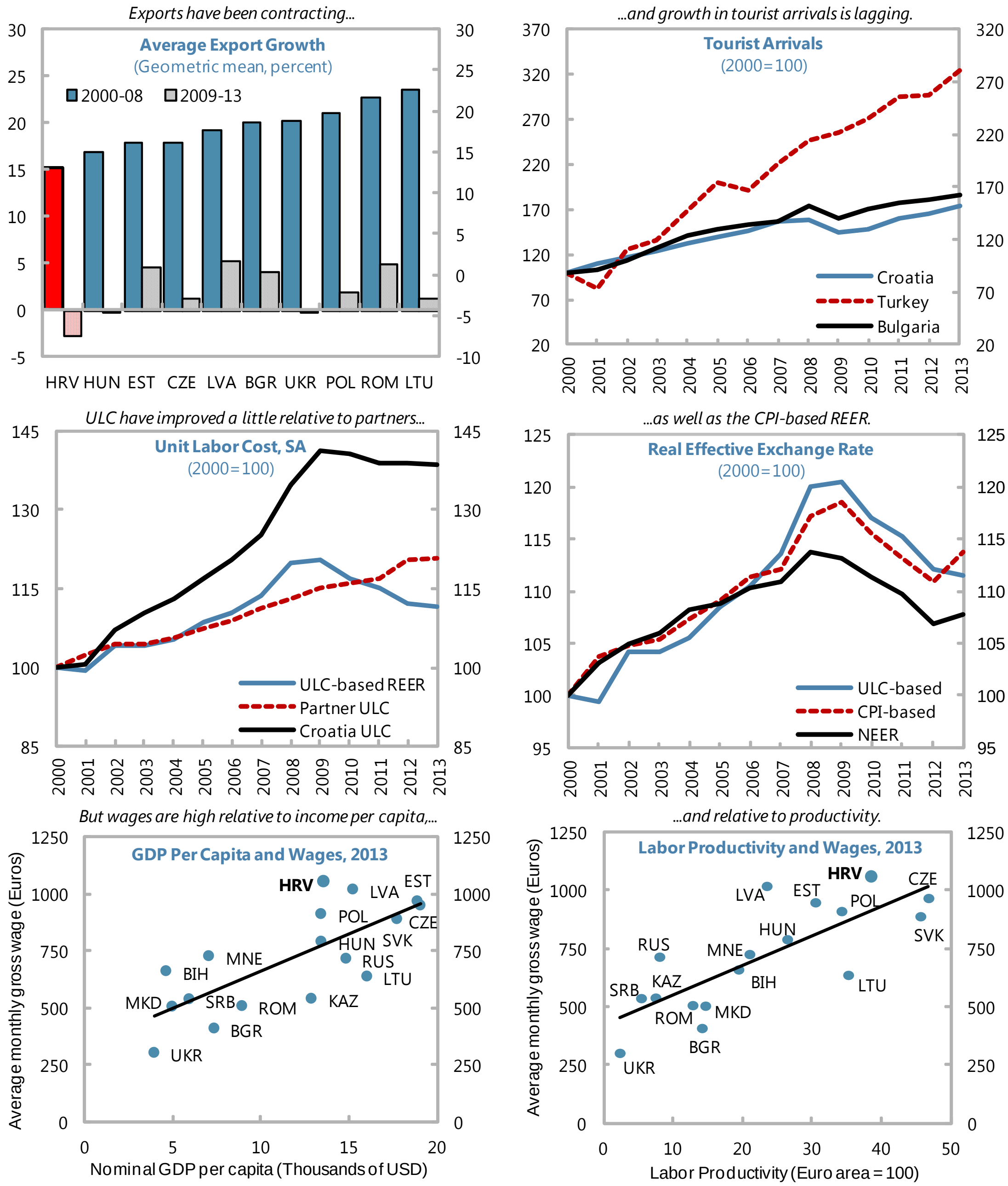
Sources: Bloomberg; Croatian National Bank; and IMF staff calculations.
1/ Positive (negative) sign indicates purchase (sale) of FX.

Figure 4. Short-term Indicators



Sources: Central Bureau of Statistics; Croatian National Bank; and IMF staff calculations.

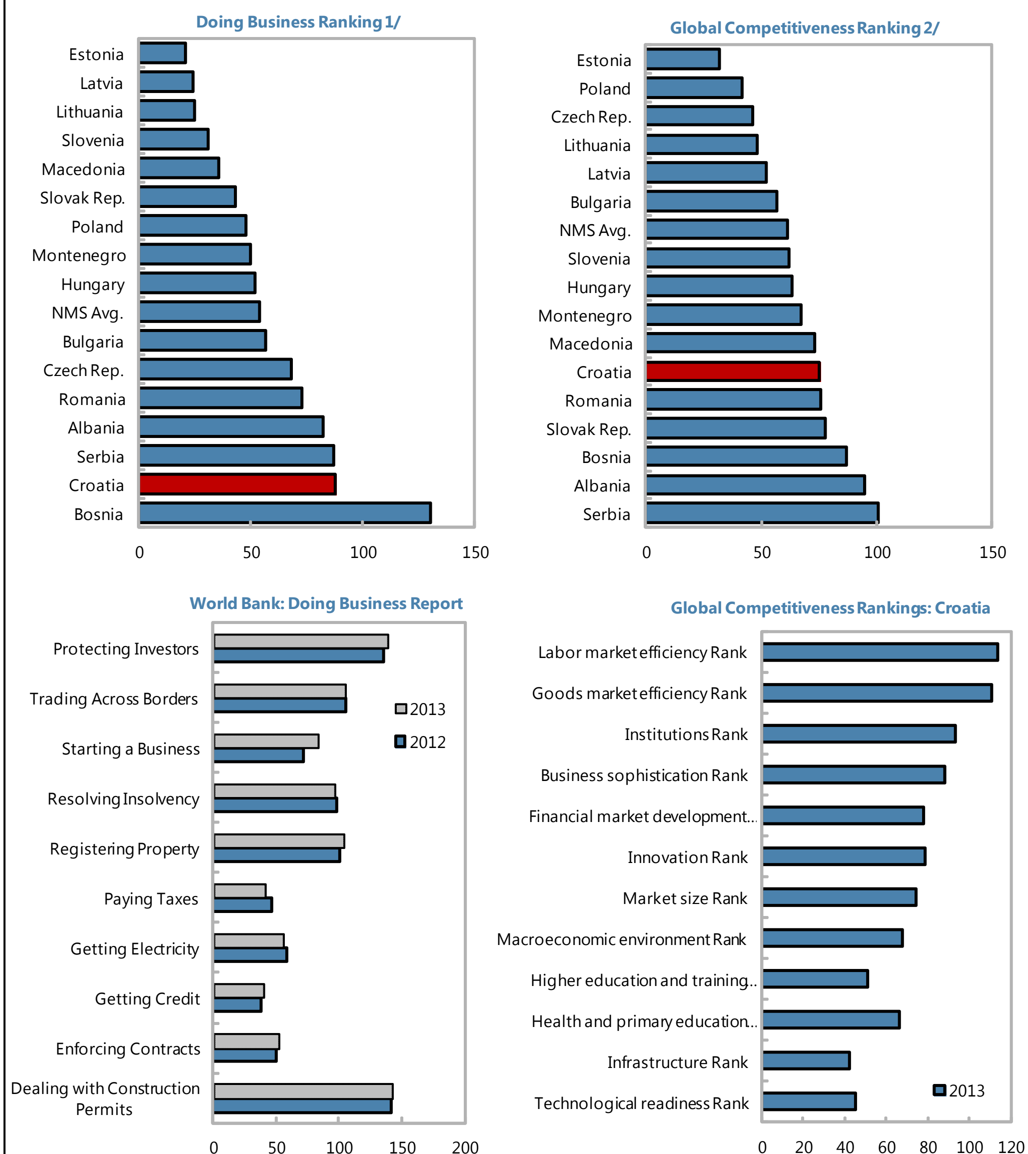
Figure 5. Croatia: Competitiveness Indicators, 2000–13



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

1/ U.S. dollar basis.

Figure 6. Croatia: Business Environment, 2013

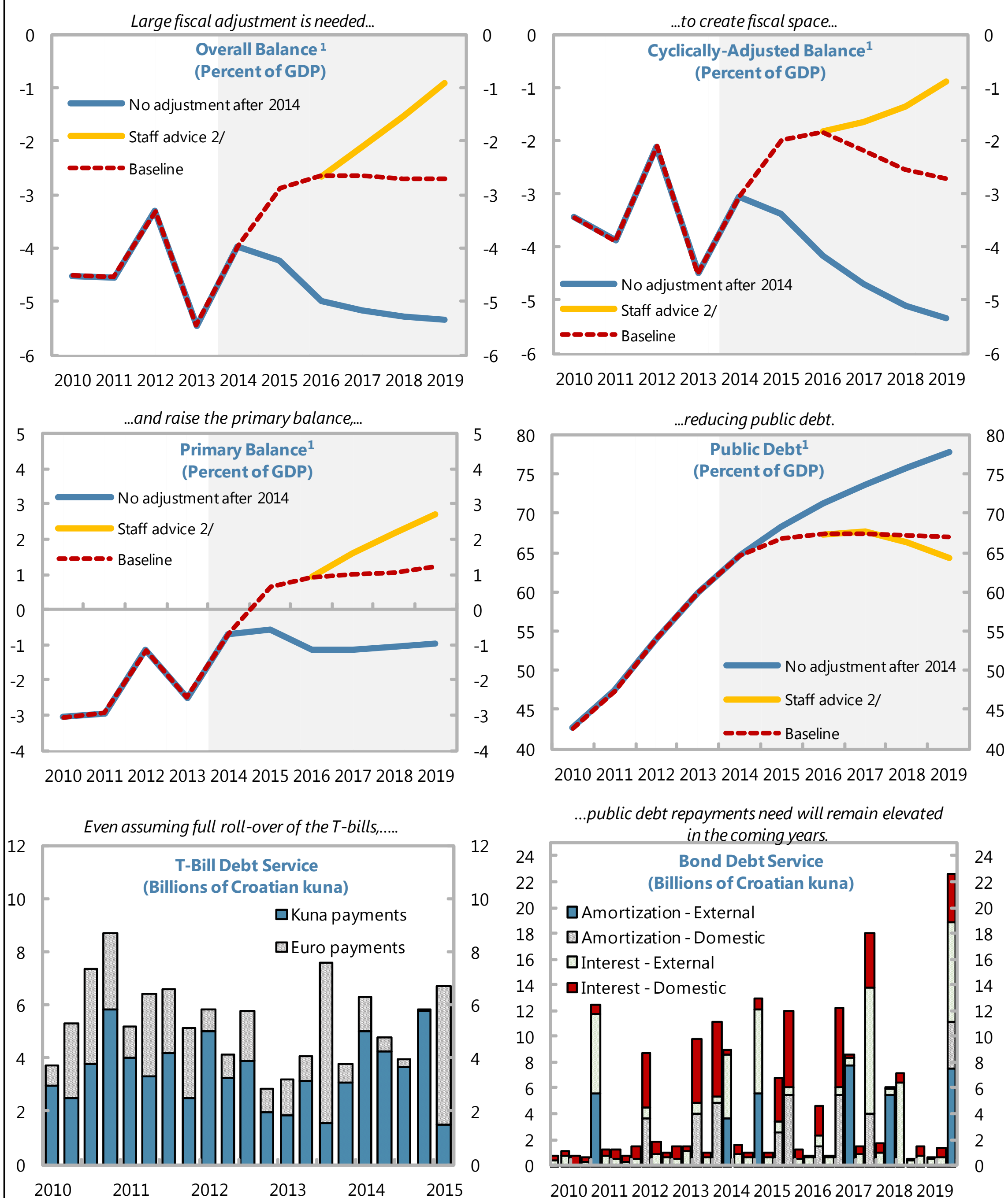


Sources: World Bank, *Doing Business*; World Economic Forum, *Global Competitiveness Report*; Heritage Foundation, *Economic Freedom Index*; and IMF staff calculations.

1/ Covers the period June, 2013. Rank out of 189 countries.

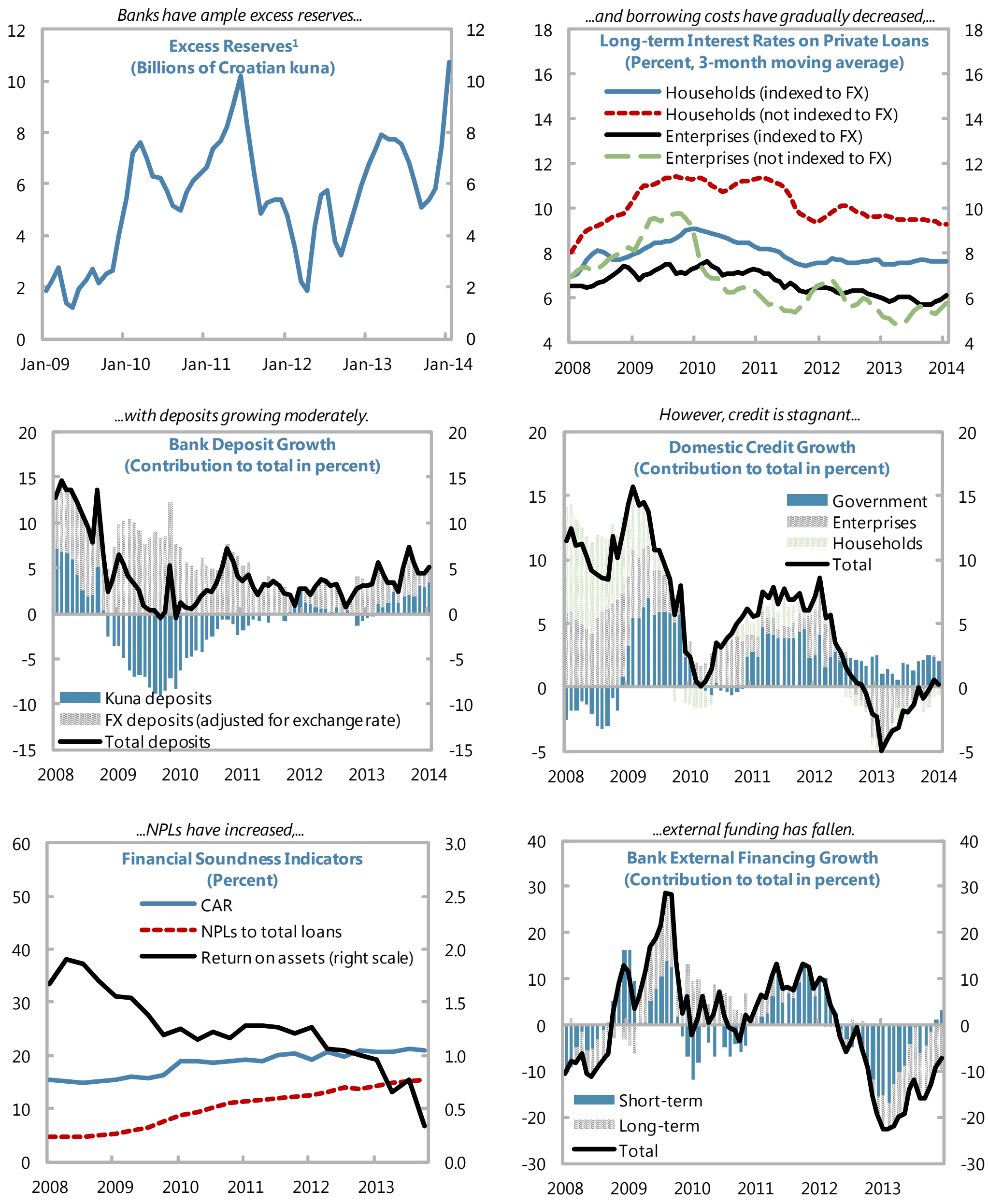
2/ Rank for 2013–14. Ranking out of 148 countries.

Figure 7. Croatia: Fiscal Developments, 2010–19



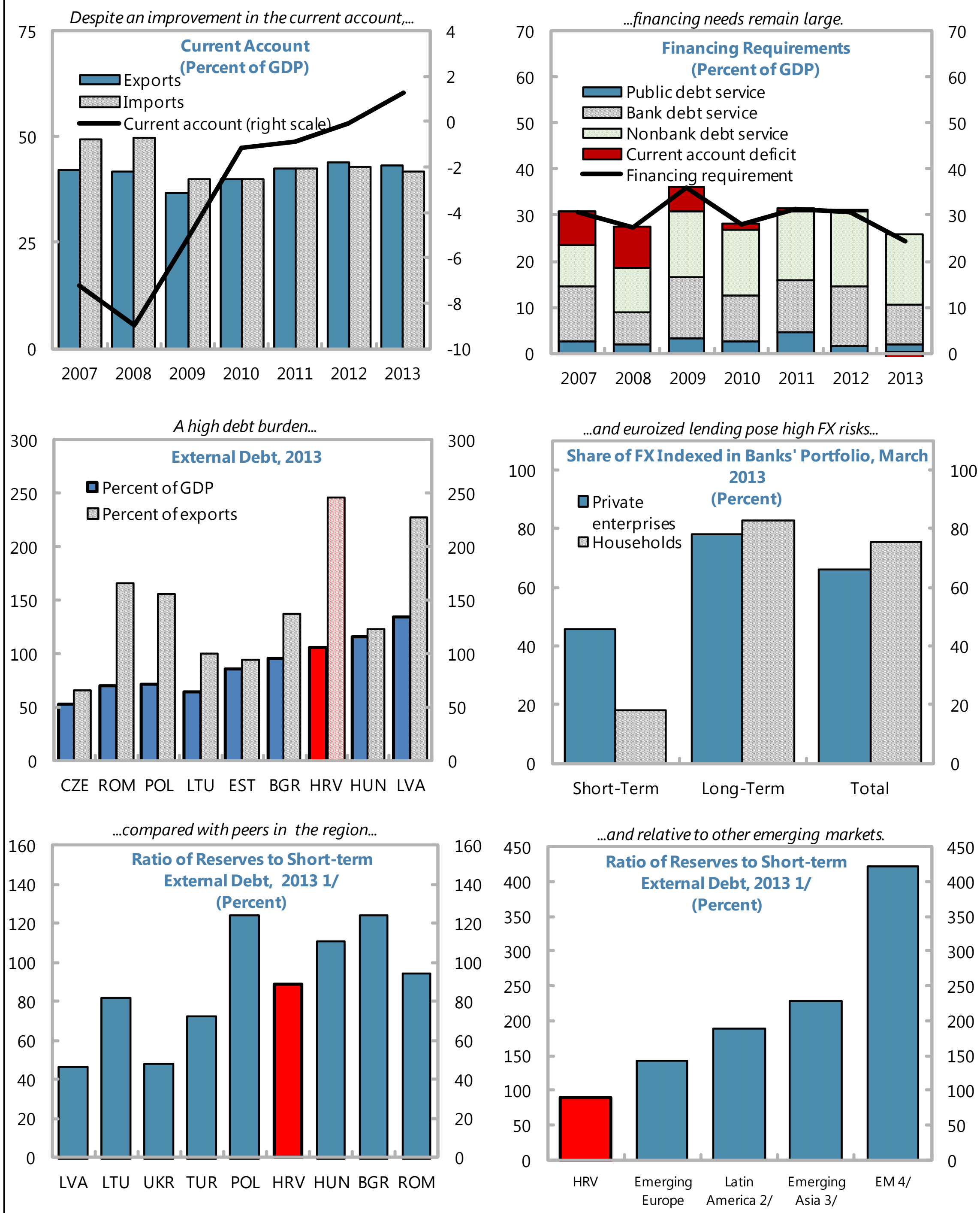
Sources: Croatian authorities; and IMF staff estimates.
1/ The baseline assumes fiscal adjustment between 2014 and 2016 in the context of the EDP. No adjustment after 2014 implies unchanged policies (no fiscal adjustment) after 2014.
2/ Staff advice assumes continued fiscal adjustment after the EDP to put debt on a downward trajectory.

Figure 8. Croatia: Monetary and Banking Sector Updates, 2008–13



Sources: National Bank of Croatia; and IMF staff estimates and calculations
1/ 3-months moving average.

Figure 9. Croatia: Vulnerability Indicators, 2007–13



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

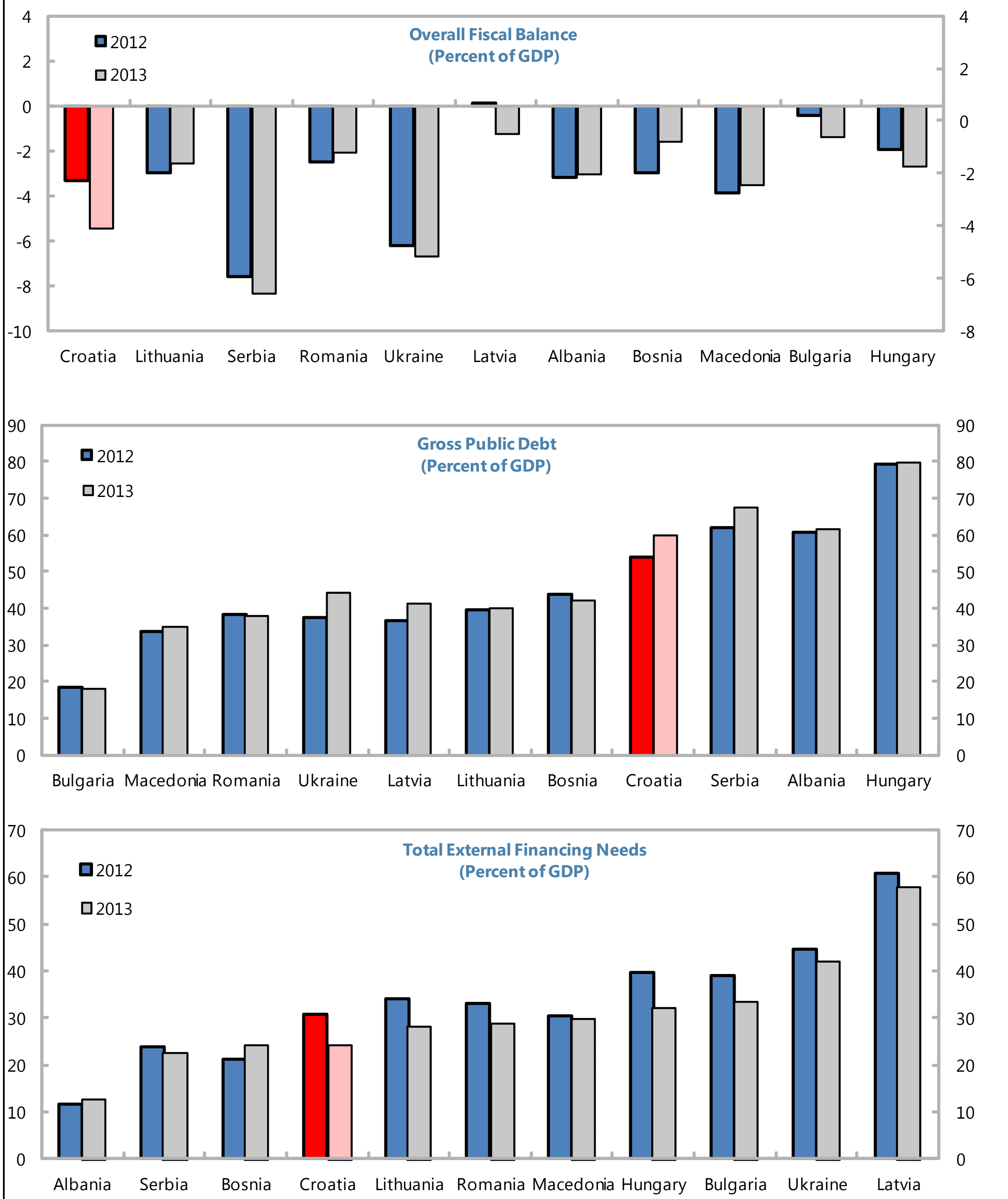
1/ Gross international reserves are end-2013 stocks. Short-term debt at original maturity (end -2013) plus projected amortization of medium and long-term debt (end-2014).

2/ Excludes Brazil.

3/ Excludes China.

4/ EM: All emerging markets excluding Brazil and China.

Figure 10. Croatia: Vulnerability Indicators vs Regional Peers, 2012-13



Source:s IMF Staff Estimates, WEO

Appendix I. Authorities' Response to Past IMF Recommendations

IMF 2012 Article IV Recommendations	Authorities' Response
Fiscal policy Significant and sustained fiscal consolidation	**Somewhat consistent** After good efforts at consolidation in 2012, the general government deficit widened in 2013, reflecting a mix of cyclical (weaker-than-expected revenues), one-off (arrears clearance) and structural factors (costly tax policy initiatives). The revised 2014 budget contains significant fiscal adjustment but remains to be integrated into a coherent, multi-year strategy.
Monetary policy Allow increased exchange rate flexibility and gradually increase foreign currency reserves	**Broadly consistent** While the central bank has continued to allow some exchange rate flexibility, it has been roughly at the same degree as in previous years, arguably reflecting low underlying volatility. International reserves have increased but remain below standard metrics.
Financial sector policy Strong regulation, supervision, and cooperation with other supervisory authorities	**Consistent** The banking system is highly capitalized and liquid. While provisioning levels are modest, large capital buffers provide loss-absorbing capacity.
Structural reforms Rapid implementation of a broad and ambitious structural agenda	**Broadly consistent** Reforms have been launched to enhance the adjustment capacity of the labor market and to strengthen the business climate, although with significant delays compared to the original schedule.

Appendix II. EU Funds

As a new member of the EU, Croatia can expect to benefit from substantial financial assistance in the years ahead. EU grants—mainly structural and cohesion funds, and support through the common agricultural policy—could eventually exceed 3 percent of GDP per year. This compares to an annual contribution to the EU budget of 1 percent of GDP. However, in the short-term the financial balance with the EU is less favorable, as time is required to prepare projects and gain sufficient experience with EU procedures. To reduce the risk of new member states becoming net contributors, the EU has established a special "Cash Flow Facility".

Some EU grants have to be used within a specified time period, or they may be lost. At end-January 2014, Croatia had contracted 73 percent of its pre-accession funds (in total €1.1 billion). Due to membership (July 1, 2013) late in the EU's 2007–13 Program Period, structural, cohesion and rural development funds for this program period can be used until end-2016.

EU grants entail fiscal costs. Structural funds are subject to the *"additionality principle"*—funds finance projects in addition to what would anyway be in the budget. However, this principle has been interpreted leniently recently. Further, many projects from EU funds require *national co-financing*, to ensure commitment to the project. Co-financing is typically around 15 percent. In addition, some project costs are not eligible for EU reimbursement. As a result, the effective domestic contribution can be as high as 40–50 percent.

Croatia: Absorption of EU Funds and Contribution to the EU Budget, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Prel.	Projected						
					– In percent of GDP –						
Planned absorption of EU funds: 1/	**0.2**	**0.2**	**0.3**	**0.6**	**1.2**	**1.4**	**2.1**	**3.0**	**3.5**	**3.5**	**3.5**
Pre-accession funds 2/	0.2	0.2	0.3	0.6	0.4	0.2	0.1	0.1	0.0	…	…
Structural and Cohesion Funds 3/	…	…	…	…	0.6	0.6	1.1	1.8	2.3	2.3	2.3
Agricultural funds 4/	…	…	…	…	0.3	0.6	0.8	1.1	1.1	1.1	1.2
Rural development and fisheries' funds	…	…	…	…	0.0	0.2	0.4	0.7	0.6	0.6	0.6
Agricultural Guarantee Fund	…	…	…	…	0.2	0.4	0.4	0.4	0.5	0.5	0.6
Croatia's contribution to EU budget	**…**	**…**	**…**	**0.5**	**1.1**	**1.0**	**1.0**	**1.0**	**1.0**	**1.0**	**1.0**
Projected net EU payment to Croatia 1/	**0.2**	**0.2**	**0.3**	**0.1**	**0.1**	**0.4**	**1.1**	**2.0**	**2.5**	**2.5**	**2.5**
Memorandum item:											
Total absorb. incl. public and priv.contribution	0.2	0.3	0.4	0.7	2.1	2.6	4.0	5.8	6.5	6.4	6.3

Sources: Croatian Ministry of Finance, Ministry of Regional Development and EU Funds, and IMF staff estimates.

1/ The projections may differ from actual absorption, in case there are delays of the approval and implementation and hence in the re-imbursement. Croatia will also receive advances for some programs when certain conditionality is observed that affects the timing.

2/ In addition to IPA funds, this line also includes the Cash Flow Facility and the Schengen Facility.

3/ €3.3 billion of the €8.2 billion structural and cohesion funds available during the 2014-20 program period will be spent during 2021-23, in line with the N+3 rule.

4/ €3 billion of EU funds for agriculture and fisheries will be spent during the 2014-20 program period, while the remaining €0.9 billion will be spent during 2021-23, according to the N+3 rule for rural development. Pillar I agricultural support for 2013 will be paid in 2014.

Appendix III. Explaining the Decline in Croatia's Exports

Between 2008 and 2012, Croatia's share in the worlds' exports of goods fell from 0.045 to 0.038 percent— one of the highest declines in a sample of 13 emerging European economies.[1/] There are several possible explanations: weak trading partner growth, an unfavorable structure of goods exports, and/or a further deterioration in competitiveness compared to 2008.

This box uses shift-share analysis and UN Comtrade data to distinguish between these factors, exploiting the following decomposition: 2/

$$V' - V = \underbrace{rV}_{World\ trade} + \underbrace{\sum_i (r_i - r)V_i}_{product\ composition} + \underbrace{\sum_i \sum_j (r_{ij} - r_i)V_{ij}}_{trading\ partners} + \underbrace{\sum_i \sum_j (V'_{ij} - V_{ij} - r_{ij}V_{ij})}_{competitiveness}$$

With $V' - V$ - the change in the value of country A's export between periods 1 and 2

$V'_{ij} - V_{ij}$ - the change in the value of country A's export of product i to country j between periods 1 and 2

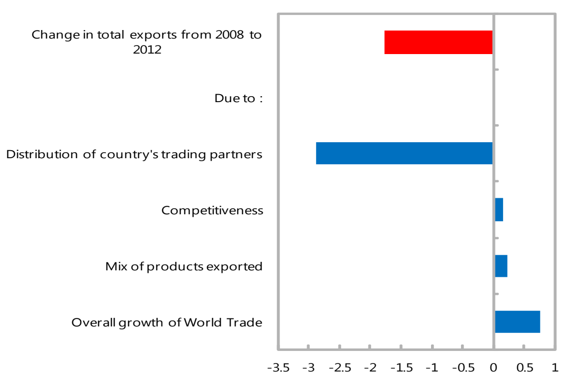
r - the percentage change in world exports between period 1 and 2

r_i - the percentage change in world exports of product i between period 1 and 2

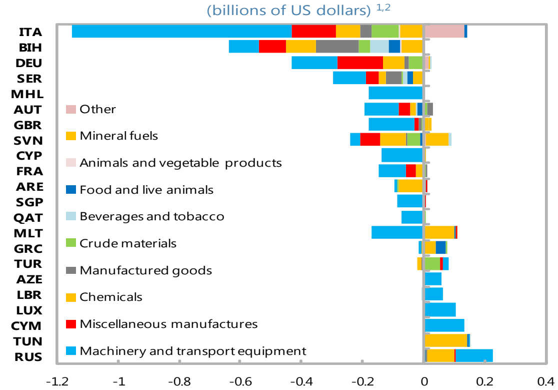
r_{ij} - the percentage change in world exports of product i to country j between periods 1 and 2

The *drop in the trading partners' demand* emerges as the principal factor behind the fall in Croatia's exports, led by Italy and Bosnia. For Italy, it reflects in particular falling demand for transport goods such as ships. Interestingly, Croatia has been unable to benefit from stronger German demand, in contrast to other countries in the region.

Change in total goods exports 2008-2012 and contributions
(billions of dollars)



Changes due to the Distribution of Country's Trading Partners by Export Markets, 2008-2012
(billions of US dollars) [1,2]

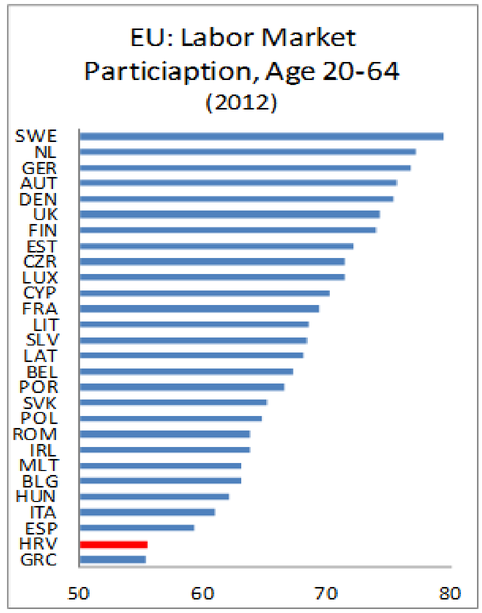


Source: WITS/Comtrade and IMF staff calculations.
1/ Partner countries with less than 0.05 billion US dollar changes are excluded.
2/ ITA: Italy; BIH: Bosnia & Herzegovina; DEU: Germany; SER: Serbia; MHL: Marshall Islands; AUT: Austria; GBR: United Kingdom; SVN: Slovenia; CYP: Cyprus; FRA: France; ARE: United Arab Emirates; SGP: Singapore; QAT: Qatar; MLT: Malta; GRC: Greece; TUR: Turkey; AZE: Azerbaijan; LBR: Liberia; LUX: Luxembourg; CYM: Cayman Islands; TUN: Tunisia; RUS: Russia.

1/ The sample includes Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Serbia, Slovak Republic, Slovenia, and Ukraine.

2/ Piezas-Jerbi, Ninez, and Nee, Colman, 2009 , "Market Shares in the Post-Uruguay Round Era: A Closer Look using Shift-Share Analysis", WTO Staff working paper ERSD-2009-14.

Appendix IV. Labor Market Reforms prior to 2013



Croatia's labor market is characterized by very low participation—second in the EU after Greece—and high structural unemployment, estimated at around 13–15 percent according to EC methodology. Reportedly, more than half of the unemployed have been without work for more than a year. A number of factors account for these outcomes: strong work disincentives emanating from poorly targeted social benefits, generous special pensions and early retirement scheme, rigid employment protection legislation, qualification mismatches, and informal activity. 1/

However, since 2010 various reforms have been enacted to strengthen the labor market. In 2010, the *cap on unemployment benefits* after 90 days of unemployment was reduced from 50 percent to 35 percent of the national average net salary. In the first 90 days of unemployment, the unemployment benefit is 70 percent of insured's average wage in the last three months, up to a maximum of 70 percent of the national average net salary. Also in 2010, the government limited the *receipt of unemployment benefits prior to retirement* to 5 years, from unlimited duration for men with 32 years of service and women with 30 years of service. Changes in pension legislation gradually increased the retirement age for women.

In 2012, several legal amendments changed collective bargaining and reduced labor market rigidity. The unlimited duration of collective agreements was abolished and the legislation now allows for unilateral cancellation of agreement under special conditions. The government has since renegotiated collective agreements in the public sector to reduce fringe benefits and bonuses. Rules were put in place which unions are entitled to negotiate, a step that may have reduced the influence of smaller trade unions. The Employment Incentives Law was amended to facilitate the formalization of seasonal employment in agriculture.

1/ Based on "Employment Protection Legislation and Labor Market Outcome: Theory, Evidence and Lesson for Croatia", *Croatia Policy Notes 70226*, World Bank, July 2011. See also "An Analysis of Indicators of Labor Market Flexibility in Croatia", Box 1 in *Croatian National Bank Bulletin*, Number 194, 2013. For an overview of employment and wage developments, see *Employment and Employment Characteristics during the Current Crisis in Croatia*, by Goran Vukšić, Newsletter No. 86, Institute for Public Finance, Zagreb, 2014. For a critical view, see *The Crisis and National Labor Reforms: A Mapping Exercise*, Country Report Croatia, by S. Clauwaert and I. Schömann, updated January 2013.

Appendix V. The Corporate Pre-Bankruptcy Settlement Procedure (PBSP)

A Pre-Bankruptcy Settlement Law came into force on October 1, 2012 to permit prompt reorganization of potentially viable companies—similar to the Chapter 11 legislation in the US.

Under the law, a company is required to initiate pre-bankruptcy settlement proceedings within 60 days of the onset of illiquidity and 21 days of the onset of insolvency. During *the first phase*, which is typically completed within 120 days, creditors are requested to submit their claims for verification. A restructuring plan is proposed that the creditors need to agree to; otherwise the regular bankruptcy procedure is initiated.[1/] During the *second phase*, commercial courts need to approve the plan. If the plan is not approved, the regular bankruptcy procedure is initiated. Thus far, creditors have agreed on a restructuring plan for approximately one quarter of the businesses participating in the procedure. In the process, corporate debts of about 2 percent of GDP have been written off.

Pre-Bankruptcy Settlement Cases

October 1, 2012 - February 19, 2014

	Cases	Liabilities		Employees
	#	HRK Billion	Percent of GDP	#
Cases submitted	6,105	54.9	16.7	46,614
Restr. plan approved by committee	1,550	26.4	8.0	24,490
Restr. plan approved by com. court	795	15.8	4.8	16,650
Restr. plan pending court approval	755	10.6	3.2	7,840
Cases transferred to regular procedure	3,281	8.7	2.6	4,627

Source: Croatian Ministry of Finance and Financial Agency.

Note: Debt of HRK 7.2 billion–about 2 percent of GDP–has been written off.

Staff encountered various criticisms of the procedure. These include:

- *Too little participation by banks.* A recent modification of the *regulation on asset classification and provisioning*, however, increases incentives for banks to participate by facilitating the transition to performing category for restructured loans under this procedure.
- *Too large a cut on tax-debt owed to the government.* Staff was not able to verify the substance of these claims. However, it seems relevant that with full bankruptcy, companies are less likely to be restructured and the government loses typically a larger portion of tax debt.
- *Many companies participating in the procedure operate in real estate,* a sector with significant excess capacity. The procedure would thus save companies that should not be saved and stood in the way of corporate reorientation toward the tradable sector. However, anecdotal evidence suggests that many restructured corporations under this procedure started outside real estate, but expanded into the sector during the real estate boom of the 2000s. Restructuring allows these companies to re-focus on their core business. This said, staff agrees that companies without a viable business model should be closed instead of restructured—as has indeed been the case in the majority of cases.
- *Involvement of the commercial courts at a too late stage.* Amendments to the law that are currently being prepared involve the commercial courts at the initiation stage, leading to a minor prolongation of the first phase (by about a month).

1/ There are three groups of creditors: public authorities and state-owned companies, financial institutions, and other creditors. Approval requires either more than half of creditors' votes within each category, or more than two-thirds of all creditors' votes.

Appendix VI. Conversion of Government Balances from Cash to ESA 95

The Ministry of Finance produces budget figures using its chart of accounts. These figures are converted into GFS 2001 classification (cash basis).

Since 2013, past budget figures are also converted into accrual terms (ESA 95) for surveillance purposes with the European Commission. There are conceptual two differences to cash figures. First, the definition of the government is slightly different: under ESA 95 a unit is classified as part of the government sector only if (i) it performs a government function or it is controlled by another public unit and (ii) it charges prices that cover less than 50 percent of its production costs. Second, the ESA 95 methodology records transactions on an accrual basis, i.e., when claims and obligations arise, are transformed or are cancelled. For instance, interest payments are recorded in the accounting period when they accrue, regardless of whether or not they are actually paid in that period. Tax payments are also time-adjusted, in order to record taxes when the activity took place to generate the tax liability or when the tax amount was determined for some income taxes.

Given the recent and on-going restructuring of public companies, the assumption of debt, including through called guarantees, is a critical issue in Croatia. ESA 95 records debt assumptions when the liability is actually removed from the debtor's balance sheet to the government's balance sheet. The full amount of the outstanding debt that is assumed is recorded as capital expenditure. The table below illustrates the conversion of the government cash deficit into the ESA 95 classification.1/

Table. Conversion of Fiscal Figures from Cash to ESA 95
(in percent of GDP)

	2009	2010	2011	2012
	Central Government			
Cash deficit	-2.9	-4.4	-4.2	-3.0
Financial transactions included in the working balance	0.0	0.0	0.0	0.0
Difference between interest paid (+) and accrued (-)	-0.2	-0.1	-0.3	-0.3
Other accounts receivable (time adjusted taxes)	0.4	0.1	0.2	-0.1
Other accounts payable (floats, arrears)	-0.4	-0.3	-0.1	-0.1
Balance of extrabudgetary funds and public corporations	-0.3	-0.3	-0.4	-0.7
Capital transfer (debt assumptions, called guarantees)	-1.2	-1.5	-2.8	-0.5
ESA 95 deficit	-4.6	-6.3	-7.6	-4.6
ESA 95 deficit (General government)	**-5.3**	**-6.4**	**-7.8**	**-5.0**

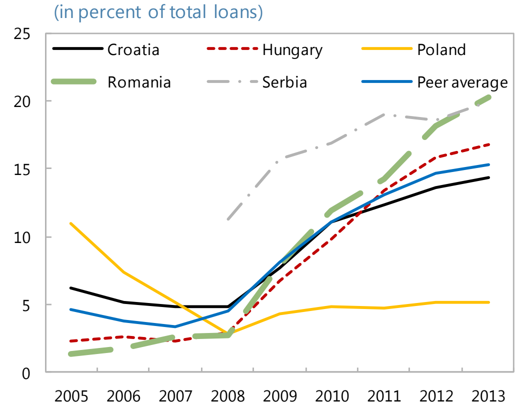
Source: Eurostat and IMF staff estimates.

1/ From September 2014 EU Member States will be required to transmit their data under a new European System of National and Regional Accounts (ESA 2010). The ESA 2010 differs in scope and concepts from its predecessor (ESA 95). For instance, super dividends paid by public corporations will be treated as exceptional payments and withdrawals from equity. New rules will also be introduced to record pension entitlements at a set date.

Appendix VII. Non-Performing Loans

High Non-performing loans (NPLs) are a legacy of the credit boom prior of the 2000s. The NPL rate has increased from close to 5 percent prior to the crisis (Q3 2008) to around 15 percent in Q3 2013, broadly in line with the Croatia's peers. The increase was especially pronounced for corporate loans (27 percent NPL rate in Q3, 2013), accounting for roughly 70 percent of all NPLs. The construction sector has a disproportionately high NPL ratio of around 50 percent. By contrast, NPL rates are much lower in the household sector (10.6 percent).

Non-Performing Loans
(in percent of total loans)

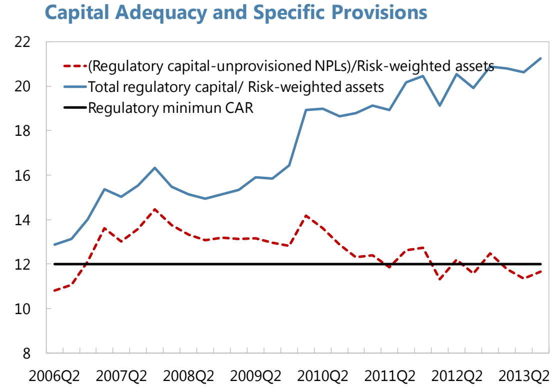


Source: IMF staff calculations.

NPLs denominated in CHF are especially high, reflecting the appreciation of the CHF in 2010/11. By September 2013, the NPL rate of CHF denominated home loans was 11.3 percent , while the NPL rate of euro denominated home loans was only 4.5 percent. As a result, the government took steps in 2013 to assist CHF borrowers by ex-post adjusting interest rates. Corpoate loans denominated in CHF fared even worse (NPLs of 53 percent in September 2013). However, the overall impact of CHF denominated loans on asset quality has been limited by their modest market share (around 9 percent of the total NPLs, September 2013).

While banks' specific provision are relatively low, banks' capital buffers compensate. At around 43 percent of impaired loans in Q3 2013, specific provisions are below peers. However, capital net of unprovisioned NPLs is around 12 percent of assets, simlar to Poland (13.5 percent) and Romania (12 percent), and higher than in Hungary (9.5 percent). Further, new asset classifcation rules that came into effect in October should bring provisions closer in line with peers.

Capital Adequacy and Specific Provisions



Annex I. External Debt Sustainability Analysis

Table A1. Croatia: External Debt Sustainability Framework, 2007–19

(Percent of GDP, unless otherwise indicated)

	Actual						Projections						Debt-stabilizing noninterest current account
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Baseline: external debt	84.8	101.1	104.7	103.9	102.9	106.1	104.3	101.0	96.4	91.6	86.9	83.2	-1.7
Change in external debt	8.2	16.3	3.6	-0.9	-0.9	3.1	-1.7	-3.4	-4.6	-4.8	-4.8	-3.7	
Identified external debt-creating flows (4+8+9)	-4.5	7.0	0.5	-1.0	-0.9	-1.4	-2.3	-3.5	-3.8	-4.0	-3.5	-2.6	
Current account deficit, excluding interest payments	5.6	1.9	-1.7	-2.4	-3.4	-4.5	-5.1	-4.4	-4.1	-2.7	-1.7	-3.1	
Deficit in balance of goods and services	7.9	3.4	-0.1	-0.1	-0.9	-1.3	-1.4	-1.3	-0.7	0.1	1.1	1.5	
Exports	41.7	36.4	39.9	42.5	43.7	42.9	44.0	44.8	45.8	46.5	47.4	48.7	
Imports	49.7	39.8	39.8	42.3	42.8	41.6	42.6	43.5	45.1	46.6	48.5	50.2	
Net non-debt creating capital inflows (negative)	-6.7	-3.4	-1.4	-2.4	-2.2	-1.1	-1.6	-2.0	-1.9	-2.6	-3.2	-3.0	
Automatic debt dynamics 1/	-3.4	8.5	3.6	3.8	4.7	4.2	4.3	2.9	2.2	1.4	1.3	3.4	
Contribution from nominal interest rate	3.3	3.2	2.8	3.3	3.5	3.2	3.5	3.4	3.5	3.4	3.2	5.1	
Contribution from real GDP growth	-1.5	6.3	2.3	0.2	2.0	1.0	0.8	-0.5	-1.4	-2.0	-1.9	-1.7	
Contribution from price and exchange rate changes 2/	-5.2	-1.0	-1.5	0.3	-0.8	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	12.6	9.3	3.1	0.1	0.0	4.5	0.6	0.1	-0.7	-0.8	-1.3	-1.0	
External debt-to-exports ratio (percent)	203.2	277.5	262.6	244.6	235.6	247.1	237.1	225.3	210.6	197.3	183.3	170.8	
Gross external financing need (billions of U.S. dollars) 4/	12.6	15.5	11.9	12.5	16.9	14.6	16.9	15.0	15.6	14.8	13.8	14.2	
Percent of GDP	26.6	34.7	26.8	28.2	38.6	33.6	38.9	34.0	34.2	31.2	27.7	27.3	
Scenario with key variables at their historical averages 5/						106.1	103.7	101.5	99.1	96.8	94.3	91.9	-4.5
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (percent)	2.1	-6.9	-2.3	-0.2	-1.9	-1.0	-0.8	0.5	1.4	2.1	2.2	2.0	
GDP deflator in U.S. dollars (percent change)	7.3	1.2	1.5	-0.3	0.7	0.9	0.5	1.1	1.9	2.0	2.5	2.5	
Nominal external interest rate (percent)	4.7	3.6	2.7	3.1	3.3	3.1	3.3	3.3	3.6	3.6	3.7	6.1	
Growth of exports (U.S. dollar terms, percent)	8.6	-17.8	8.6	6.0	1.7	-1.9	2.2	3.4	5.6	5.7	6.8	7.5	
Growth of imports (U.S. dollar terms, percent)	10.5	-24.5	-0.8	5.8	-0.1	-2.8	2.0	3.7	7.2	7.6	9.0	8.3	
Current account balance, excluding interest payments	-5.6	-1.9	1.7	2.4	3.4	4.5	5.1	4.4	4.1	2.7	1.7	3.1	
Net nondebt creating capital inflows	6.7	3.4	1.4	2.4	2.2	1.1	1.6	2.0	1.9	2.6	3.2	3.0	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

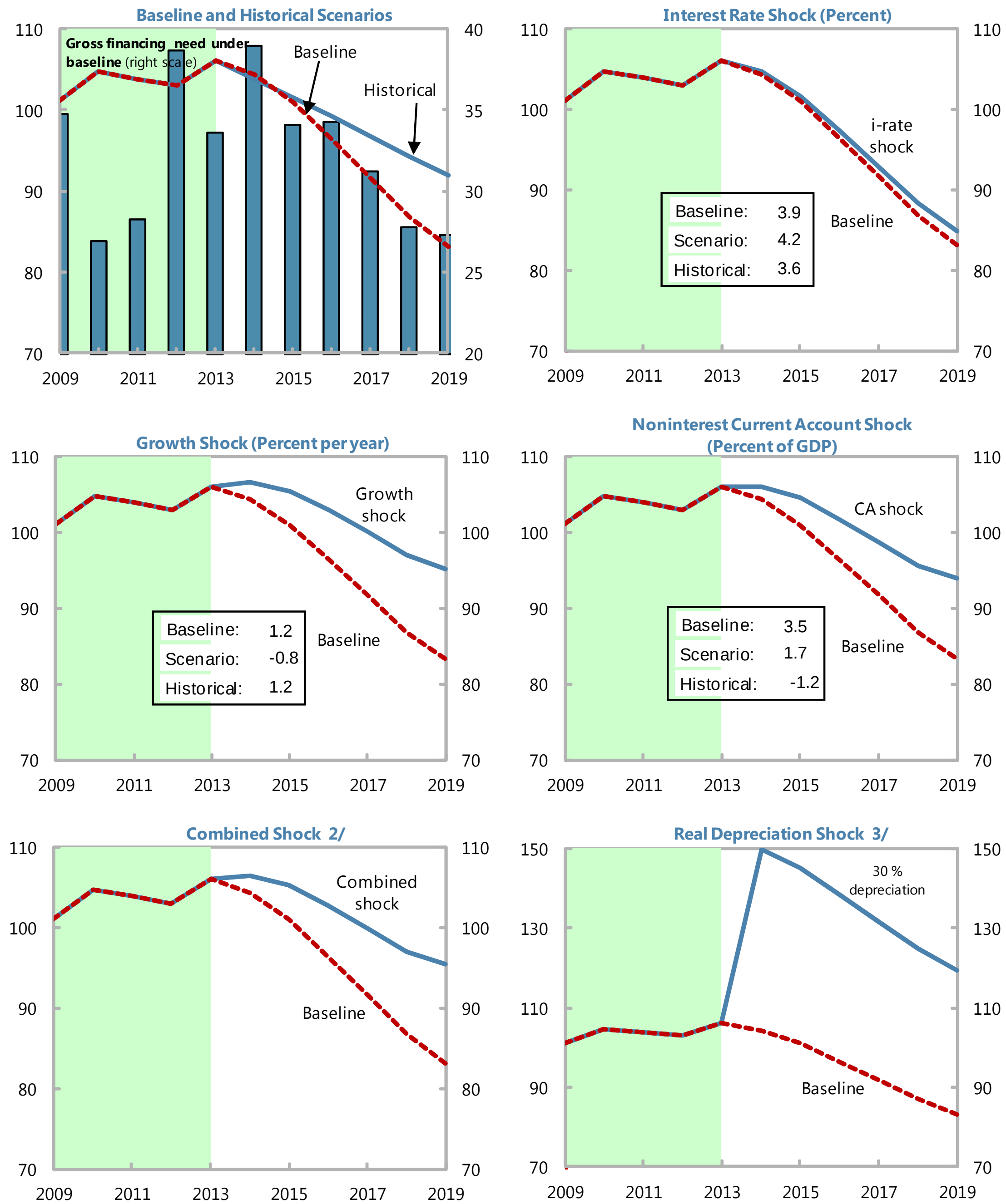
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A1. 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 2013.

Annex II. Public Debt Sustainability Analysis

Public Debt Sustainability Analysis

Public debt has increased rapidly in recent years, reflecting elevated deficits, Croatia's persistent economic contraction, and the assumption of debt from formerly state-owned enterprises such as shipyards. Gross financing needs are relatively large, at about 15 percent of GDP. Significant fiscal adjustment is needed to bring public debt as a share of GDP on a downward path. Public debt and gross financing needs are vulnerable to a variety of shocks, particularly growth shocks.

Baseline and Realism of Projections

The baseline scenario assumes a structural fiscal adjustment close to 3 percent of GDP during 2014–16. It is underpinned by the following assumptions:

- *Fiscal consolidation*: From around 5½ percent of GDP in 2013, the general government deficit is expected to decline to 4 percent of GDP in 2014, 2.9 percent in 2015, and 2.7 percent in 2016. This corresponds to structural adjustment of around 3 percent of GDP, distributed over the three years.
- *Growth*: Reflecting the implementation of adjustment and the corresponding impact on domestic demand, real GDP is projected to contract by 0.8 in 2014. From 2015, real GDP growth is projected to recover gradually, and to converge to around 2 percent in the medium to long term.

The fiscal path is challenging even under the baseline. Staff projects that the debt-to-GDP ratio will increase from 60 percent in 2013 to 67 percent in 2016, before starting to decline after 2017. The temporary deterioration reflects primarily a positive interest rate-growth differential. Gross financing needs are projected to exceed 23 percent of GDP in 2019 due to large fiscal deficits accumulated since 2009 and the relatively short maturity of public debt (around five years).

Risks are large and, in the short term, mostly tilted to the downside.

- The 3-year adjustment of the cyclically-adjusted primary balance as specified under the baseline is in the top quartile of the historical experience for high-debt market access countries. Implementation risks are significant. Significant deviations from the adjustment path would risk undermining confidence and increasing country risk (see alternative scenarios).

- Further, since 2009 real GDP growth forecast have erred on the upside, reflecting the unusually protracted slump in domestic demand. Staff projects currently that domestic demand would start normalizing in 2015, but this forecast is subject to large uncertainties.

Shocks and Stress Tests

Negative growth shocks are the main risk to debt sustainability. If real GDP growth were to undershoot the baseline by one standard deviation in 2015 and 2016, the primary deficit would deteriorate to around 3 percent—reflecting lower nominal revenues (while spending is assumed to remain unchanged)—before improving over the medium-term. The weaker primary balance would trigger a slight increase in risk premiums and a rapid increase in public debt, stabilizing at 82 percent of GDP after 2016. Gross financing needs would increase to 24 percent of GDP.

A combination of macro-fiscal shocks further illustrates the sensibility of public debt and gross financing needs to adversity. Assuming that shocks to real GDP growth, the primary balance, the real exchange rate, and the real interest rate would occur simultaneously, public debt would increase sharply and stabilize at 90 percent of GDP. Gross financing needs would also climb and exceed 26 percent of GDP in 2019.

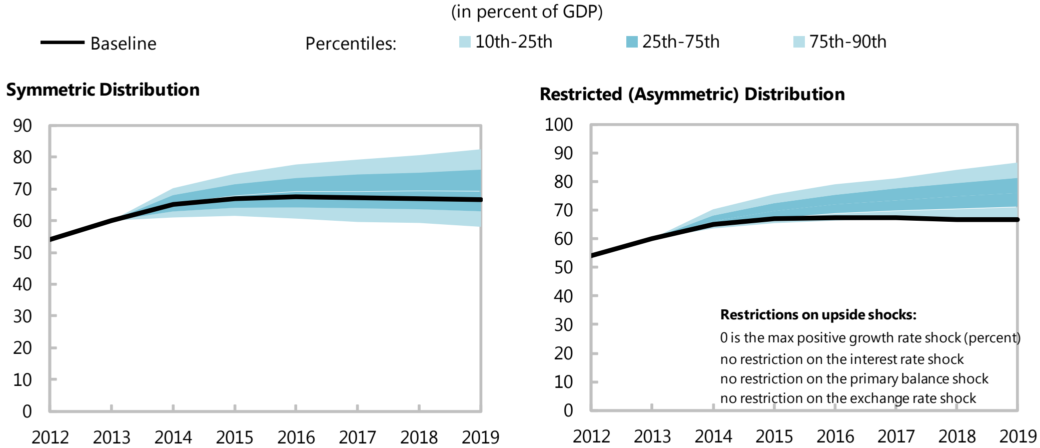
Croatia Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

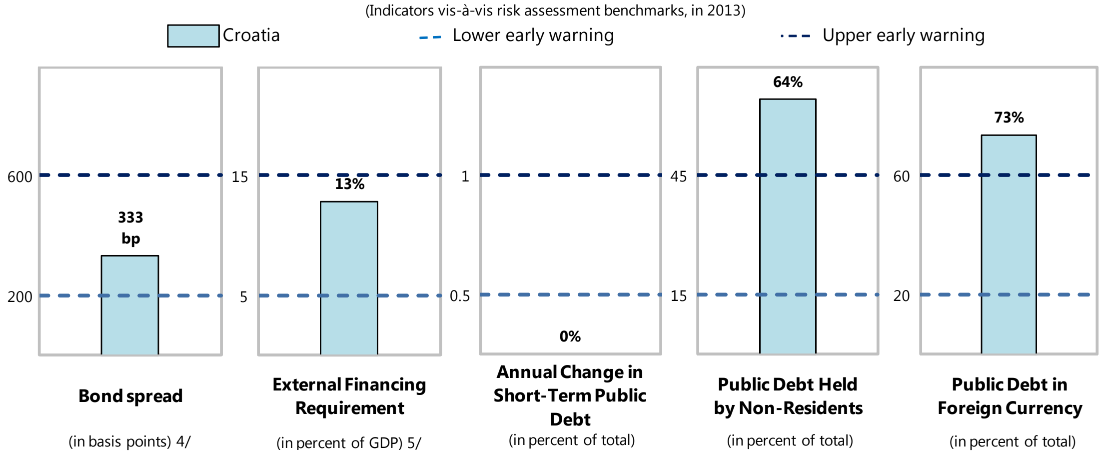
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 01-Nov-13 through 30-Jan-14.

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

Croatia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

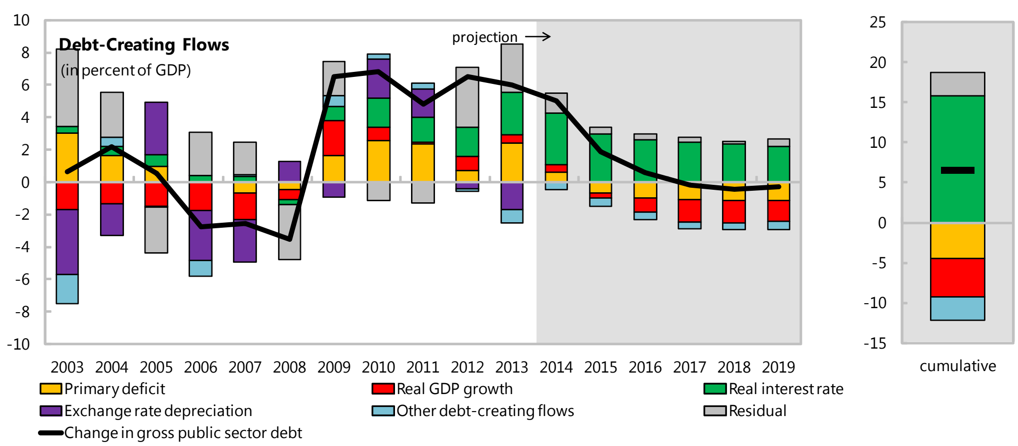
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2003-2011 2/	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	37.2	54.0	60.0	65.0	66.8	67.4	67.3	66.8	66.5
Public gross financing needs	11.2	13.3	17.5	16.3	15.2	12.2	14.4	14.4	20.0
Real GDP growth (in percent)	1.8	-1.9	-1.0	-0.8	0.5	1.4	2.1	2.2	2.0
Inflation (GDP deflator, in percent)	3.4	1.9	0.9	0.5	1.1	1.9	2.0	2.5	2.5
Nominal GDP growth (in percent)	5.3	-0.1	-0.1	-0.3	1.6	3.3	4.2	4.8	4.5
Effective interest rate (in percent) 4/	5.4	5.7	5.8	5.8	5.7	6.0	5.8	6.2	6.0

As of January 30, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		333
5Y CDS (bp)		337
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	1.4	6.5	6.0	5.0	1.9	0.6	-0.2	-0.4	-0.3	6.6	
Identified debt-creating flows	0.8	2.8	3.0	3.7	1.5	0.3	-0.5	-0.6	-0.7	3.7	
Primary deficit	1.2	0.7	2.4	0.6	-0.7	-1.0	-1.1	-1.1	-1.1	-4.5	0.4
Primary (noninterest) revenue and gra	38.7	38.3	37.8	40.2	40.6	40.2	40.3	40.4	40.5	242.3	
Primary (noninterest) expenditure	39.9	39.0	40.2	40.8	39.9	39.3	39.2	39.3	39.4	237.8	
Automatic debt dynamics 5/	-0.4	2.3	1.4	3.7	2.7	1.7	1.1	1.0	0.9	11.0	
Interest rate/growth differential 6/	0.1	2.7	3.2	3.7	2.7	1.7	1.1	1.0	0.9	11.0	
Of which: real interest rate	0.7	1.8	2.6	3.2	3.0	2.6	2.4	2.4	2.2	15.8	
Of which: real GDP growth	-0.6	0.9	0.5	0.5	-0.3	-0.9	-1.4	-1.4	-1.3	-4.8	
Exchange rate depreciation 7/	-0.4	-0.4	-1.7	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.1	-0.1	-0.8	-0.5	-0.5	-0.5	-0.4	-0.4	-0.5	-2.8	
#TSREF# (negative)	-0.5	-0.4	-1.0	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-3.6	
Contingent liabilities	0.4	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.7	
Please specify (2) (e.g., ESM and Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	0.6	3.7	3.0	1.3	0.4	0.3	0.3	0.1	0.4	2.9	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

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

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

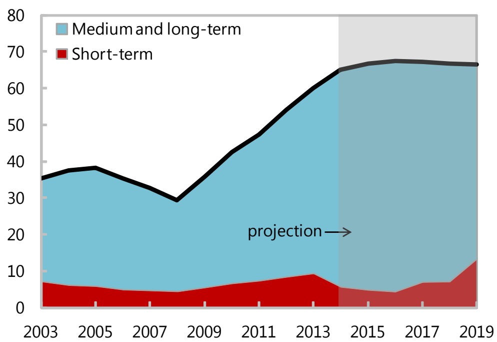
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

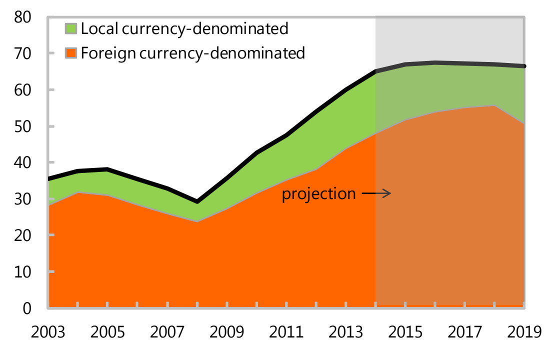
Croatia Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



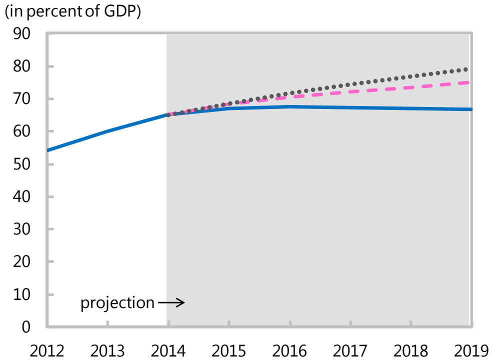
By Currency
(in percent of GDP)



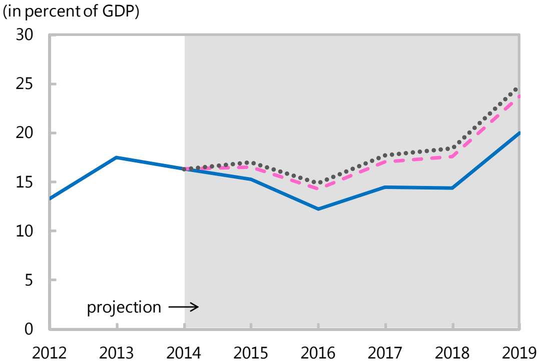
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



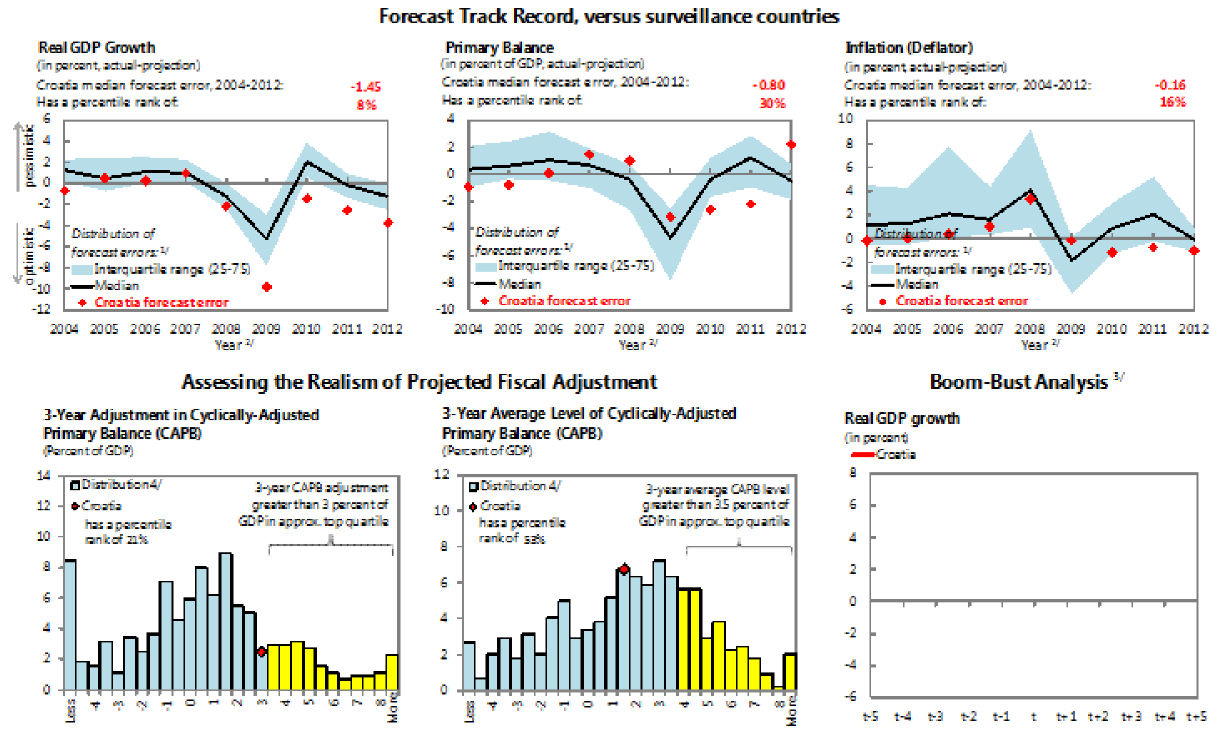
Underlying Assumptions
(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	-0.8	0.5	1.4	2.1	2.2	2.0
Inflation	0.5	1.1	1.9	2.0	2.5	2.5
Primary Balance	-0.6	0.7	1.0	1.1	1.1	1.1
Effective interest rate	5.8	5.7	6.0	5.8	6.2	6.0
Constant Primary Balance Scenario						
Real GDP growth	-0.8	0.5	1.4	2.1	2.2	2.0
Inflation	0.5	1.1	1.9	2.0	2.5	2.5
Primary Balance	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	5.8	5.7	6.0	5.8	6.2	6.1

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	-0.8	0.8	0.8	0.8	0.8	0.8
Inflation	0.5	1.1	1.9	2.0	2.5	2.5
Primary Balance	-0.6	-1.1	-1.1	-1.1	-1.1	-1.1
Effective interest rate	5.8	5.7	5.6	5.3	5.5	5.2

Source: IMF staff.

Croatia Public DSA - Realism of Baseline Assumptions



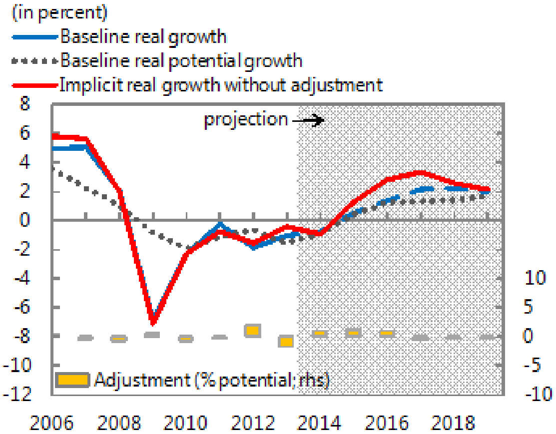
Source: IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Croatia.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Croatia Public DSA - Realism of Baseline Assumptions (concluded)

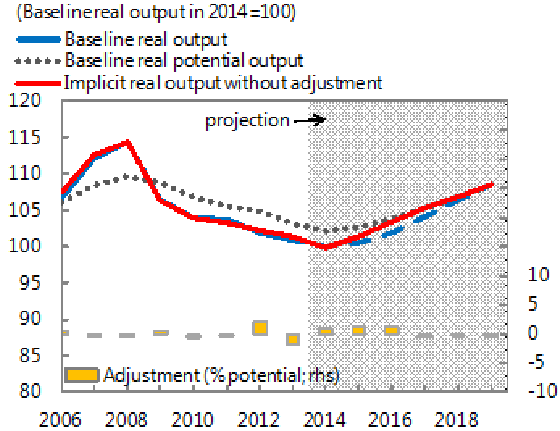
Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 0.7, persistence of 0.6

Real GDP Growth
(in percent)

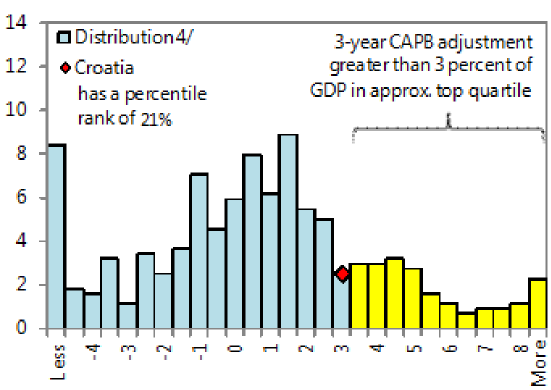


Real Output Level
(Baseline real output in 2014=100)

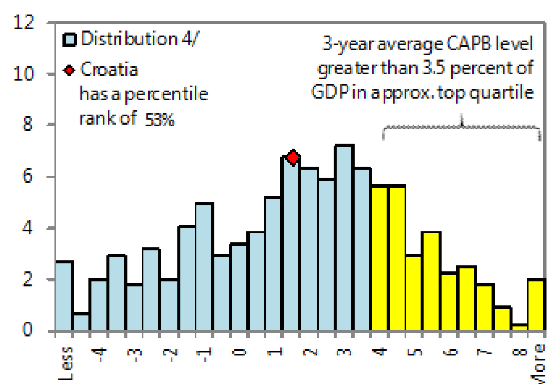


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



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

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

April 23, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department in Consultation with Other Departments

CONTENTS

FUND RELATIONS

(As of February 28, 2014)

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

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

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	347.34	100.00
Holdings	304.98	87.80

Outstanding Purchases and Loans: None

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

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

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.04	0.05	0.05	0.05	0.05
Total	0.04	0.05	0.05	0.05	0.05

[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.

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 jure* exchange rate is a managed float without a predetermined path. Croatia's *de facto* exchange rate arrangement is classified as a crawl like arrangement from April 30, 2011. The CNB transacts only in euros, U.S. dollars, and SDRs. On April 1, 2014 the official exchange rate was kuna 7.653406 per euro (middle rate).

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).

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on November 7, 2012 (IMF Country Report No. 12/302 available at: http://www.imf.org/external/country/hrv/index.htm). Croatia is on the 12-month consultation cycle.

FSAP:

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

Technical Assistance 2000–11:[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 World Bank)
	May 2004	Public Expenditure Management
	May 2004	Fiscal ROSC
	April 2005	Review of Indirect Tax Performance and Tax Administration
	June 2006	Regional Public Financial Management (PFM) Advisor
	February–March 2007, July 2008, February-March 2009	Revenue Administration (with World Bank)
	April 2007	Public-Private Partnerships
	May 2007	Tax Policy (with World Bank)
	January–February 2008	Short-Term Expenditure Rationalization
	February 2010	PFM (long-term advisor visit)
	October 2010	Regional expert participation on seminar on Croatian budget management and fiscal policy
	March 2011	Short-term expert visit on Tax Administration Reform
	June 2011	Short-term expert participation at OECD meeting
	June 2012	Options for Modernizing the Property Tax
	July 2012	Government Opportunities for Strengthening the Tax Administration (HQ mission)
	October 2012	Short-term expert visit on phasing in a modern Compliance Risk Management Model
	October 2012	Short-term expert visit on improving tax administration governance and organization structures
	April 2013	Public Financial Management: Budget Procedure

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

	April-May 2013	Fiscal Rules
	June 2013	Strengthening Tax Administration Governance
STA	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Real Sector Statistics
	April 2001	Monetary and Banking Statistics
	November 2001	Regional Visit on Reserves Data Template
	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–continuing	Macro-Financial Modeling and Forecasting
	May 2007	Macro-Financial Modeling and Forecasting
	June 2007	Modeling and Forecasting
	September 2007	Modeling and Forecasting
	October 2007	FSAP Update
	November 2007	Modeling and Forecasting
	March 2008	Modeling and Forecasting
	August 2008	Macro-Financial Modeling and Forecasting
	February 2009	Macro-Financial Modeling and Forecasting
	July 2009	Modeling
	May 2010	Monetary Policy and Modeling
	March 2011	Modeling
LEG	January 2010 - April 2011	AML/ CFT - Risk based supervision in non-financial sectors
	May 2011 - April 2012	AML/ CFT – Strengthening the FIU and risk based supervision in non-financial sectors
	December 2011 – April 2013	AML/ CFT - Preliminary National Risk Assessment

Resident Representative: The post closed in June 2007.

STATISTICAL ISSUES

CROATIA—STATISTICAL ISSUES APPENDIX As of March 27, 2014
I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance with some shortcomings. The key data shortcomings are in national accounts and related to data coverage and reliability. Progress to resolve these shortcomings are impeded by insufficient resources and a lack of coordination among government agencies.
National Accounts: 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 prices of the previous year for the main categories of expenditure and main economic activities. 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.
Wages and Employment: 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. 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.
Price Statistics: 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

CROATIA—STATISTICAL ISSUES APPENDIX (CONTINUED)

As of March 27, 2014

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.

Government Finance Statistics: 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. According to the latest *Cooperation Agreement in the field of national accounts of general government and related statistics* (signed on July 31, 2013 between Croatian Bureau of Statistics, Croatian National Bank (CNB) and Ministry of Finance), the CNB took over the responsibility for the compilation of general government debt statistics. The CNB is compiling general government debt according to the ESA95 and EDP definitions and publishes these data in the *CNB Monthly Bulletin*. Also, data showing the level of central government guaranteed debt are presented as a part of the reporting table in the CNB Monthly Bulletin.

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.

Monetary and Financial Statistics: Starting with the data for July 2013, the CNB compiles and reports monetary data for publication in *IFS* in accordance with the *1995 ESA* standards and the European Central Bank's framework for monetary statistics using the national residency approach. For December 2001 to June 2013, monetary statistics in *IFS* are based on the Standardized Report Forms developed by the IMF Statistics Department, which accord with the concepts and definitions in the *Monetary and Financial Statistics Manual, 2000*. For December 2010 through June 2013, the CNB has reported revised data for other depository corporations covering money market funds in addition to the licensed banks, savings banks and housing savings banks, which represent other monetary financial institutions in accordance with the *1995 ESA* standards.

Financial sector surveillance: The CNB is the banking supervisor and publishes selected financial soundness indicators (FSI) on its website and provides IMF staff with a broad range of FSIs. A general description of the stress testing methodologies of the Croatian banking system is included in the *CNB' Financial Stability Report* published twice a year. Summary balance sheets and profit and loss statements of individual banks are reported in the *Banking Bulletin*, published twice a year, with a data lag of about six to nine months.

CROATIA—STATISTICAL ISSUES APPENDIX (CONCLUDED) As of March 27, 2014	
External Sector Statistics: Quarterly balance of payments and international investment position data are compiled broadly in accordance with the fifth edition of the IMF's fifth edition of the *Balance of Payments Manual (BPM5)*. Croatia plans to implement the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)* in 2014. Data are generally available with a lag of three months and are subject to revisions in subsequent releases. Net errors and omissions have ranged from 1 to 3½ percent of GDP since 2005, and are negative. The coverage and quality of portfolio investment data are reasonably complete and accurate. Croatia participates in the Coordinated Direct Investment Survey (CDIS) and plans to participate in the Coordinated Portfolio Investment Survey (CPIS) after the new security database becomes operational toward the end of 2014. Data on the International Reserves and Foreign Currency Liquidity (Reserve Data Template) are available with a lag of one to two months. Croatia compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2003*, and began disseminating external debt data in the first quarter of 2004.	
II. Data Standards and Quality	
Croatia has been a subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May 1996, and met all SDDS requirements in March 2001.	No data ROSC has been published.

Croatia: Table of Common Indicators Required for Surveillance
(as of March 25, 2014)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	Feb. 2014	3/10/14	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Jan. 2014	3/12/14	M	M	M
Reserve/Base Money	Jan. 2014	3/13/14	M	M	M
Broad Money	Jan. 2014	3/13/14	M	M	M
Central Bank Balance Sheet	Jan. 2014	3/13/14	M	M	M
Consolidated Balance Sheet of the Banking System	Jan. 2014	3/13/14	M	M	M
Interest Rates 2/	Jan. 2014	3/18/14	M	M	M
Consumer Price Index	Feb. 2014	3/18/14	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2013:Q3	Dec. 2013	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	2012	10/3/13	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2013:Q3	Dec. 2013	M	M	M
External Current Account Balance	2013:Q3	1/14/14	Q	Q	Q
Exports and Imports of Goods and Services	2013:Q3	1/14/14	Q	Q	Q
GDP/GNP	2013:Q4	3/10/14	Q	Q	Q
Gross External Debt	Dec. 2013	3/04/14	M	M	M
International Investment Position	2013:Q3	1/14/14	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).

WORLD BANK RELATIONS

1. The World Bank's Board endorsed the Country Partnership Strategy (CPS) for Croatia for fiscal years (FY) 2014–17 in June 2013, with the goal to assist Croatia's convergence with the EU through an engagement that is focused on key reform-based outcomes. For the World Bank Group (WBG), priority will be placed on aspects of the Europe 2020 "smart, sustainable and inclusive growth" strategy and the Government's new reform agenda that focuses on the economic management, state institutions, business environment, and responsibility toward shared regional assets. In pursuing these goals, the Bank Group program aims at contributing in the following three areas:

- Fiscal adjustment through reforms at the sector level;
- Innovation and trade competitiveness for growth and shared prosperity;
- Helping maximize the economic benefits of becoming an EU member state.

2. The CPS envisages an indicative base-case lending envelope of about US$800 million in lending**.** For the FY14-17 lending program, DPLs will continue to play an important role based on the need to combine policy reform with budget finance. At the same time, Croatia and the Bank, intend to explore the use of new investment financing instruments like results-based operations, as the share of traditional investment financing decreases during the CPS period. The lending program has been based on and complemented by analytical work, particularly in the areas of public expenditure reform, governance, EU preparedness, investment climate, education and social sector.

3. In FY 13, the Bank's Board has approved two loans amounting to US$87.6 million, to help mitigate the impact of ongoing recession and provide funding for the private sector, through a credit line of about EUR50 million for exporters, and through a Second Science and Technology Project of EUR20 million. In addition, the Bank approved Export Financing Guarantee Operation in an amount of EUR250 million to support exporters and foreign exchange earners in Croatia by enhancing Croatian Reconstruction and Development Bank's capability to mobilize medium and long-term financing**.** Projects under preparation for FY14 are the Second Economic Recovery DPL (EUR150 million with the Board set for April 29, 2014), Health System and Quality Efficiency Improvement Program-for-Results (EUR75 million, scheduled for Board Approval on May 7, 2014), and GEF Adriatic Sea Environmental Pollution Control Project ($6.8 million, scheduled for Board in May 2014). Projects under preparation for FY15 are Social Protection System Modernization Project (indicative EUR70 million) and

Sustainable Croatian Railways in Europe (EUR75 million). Currently, the World Bank finances 11 operations in a wide range of sectors with a commitment of about US$750 million. During the next four years, IFC expects to invest in Croatia up to US$600 million from its own account. MIGA's outstanding gross exposure in Croatia as of February 28, 2013 was US$943.6 million in support of financial institutions and a retail sector.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 14/232
FOR IMMEDIATE RELEASE
May 19, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Croatia

On May 14, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] with the Republic of Croatia.

Croatia remains stuck in an unusually drawn out recession. In 2013, real GDP contracted for the 5th consecutive year, and stands now at less than 90 percent of the end-2008 level. Unemployment has risen to 17 percent. Domestic demand remains depressed as corporations and households focus on reducing excessive debts accumulated in the 2000s. Exports and Foreign Direct Investment (FDI) are also feeble, reflecting deep-seated structural weaknesses and poor trading partner growth. Macro-policies that could revive growth rapidly are beyond reach: fiscal policy has run out of space, while monetary policy is constrained by the need to keep the kuna-euro exchange rate stable, lest a depreciation cause a revaluation of euro-indexed debts.

The recession is putting pressure on the public finances. In 2013 the deficit (cash basis) widened to around 5½ percent of GDP, owing to weak revenues and the assumption of debts and arrears from state-owned enterprises. Public debt now exceeds 60 percent of GDP and is increasing rapidly. Reflecting these developments, all major rating agencies have downgraded Croatia to sub-investment grade. From this year, fiscal policy is subject to the European Union's Excessive Deficit Procedure.

The government has started tackling long-standing structural issues, such as restructuring and/or privatization of state-owned enterprises, passage of laws that facilitate investments, the introduction of an out-of-court settlement procedure for insolvent corporations, the reduction of work force restructuring costs, and the easing of hiring restrictions.

The outlook is for another contraction in 2014 of almost 1 percent. Real domestic demand would remain feeble, reflecting both weak private sector demand and fiscal consolidation, while exports

[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.

would benefit somewhat from the projected pick up in the euro area. Inflation would remain low. In 2015 a tepid recovery would set in, as the impact of private sector deleveraging would begin to recede and external demand strengthens further. Long-term potential growth is projected at around 2 percent.

With traditional fiscal and monetary policy responses out of reach, private sector debt restructuring and measures to attract FDI provide the best prospect to revive growth in the short- to medium term. Credible and sustained fiscal consolidation is needed to strengthen confidence in macro-economic management. Given the protracted economic weakness, it is adequate to stretch fiscal adjustment and start with steps least harmful to demand. The central bank has maintained confidence in exchange rate stability through a limited but effective set of instruments, but should continue accumulating foreign exchange reserves until coverage is fully in line with standard adequacy metrics.

Executive Board Assessment[2]

Executive Directors noted that the Croatian economy remains in recession, unemployment is widespread, the fiscal position has worsened, and downside risks weigh on the near-term outlook. With countercyclical responses limited by the exchange rate regime and lack of fiscal space, Directors encouraged the authorities to rebuild fiscal buffers and to undertake deeper institutional and structural reforms to revive growth and reduce vulnerabilities, including by accelerating private sector debt restructuring.

Directors agreed that sustained fiscal consolidation is needed to secure debt sustainability. Noting the front-loaded adjustment in the context of the European Commission's Excessive Deficit Procedure, they stressed that fiscal policy for the period ahead needs to manage a difficult tradeoff between the speed of consolidation and its drag on economic activity. More broadly, Directors advised the authorities to develop comprehensive plans to frame fiscal adjustment over the medium term, in order to reduce policy uncertainty and maximize the impact of consolidation on confidence. Such a plan should give consideration to both revenues and expenditures measures, including a modern property tax and an overhaul of the public finances at lower levels of government.

Directors generally supported the authorities' plans to use monetary policy to safeguard their exchange rate objectives and to maintain adequate reserves. They also took note of the staff's assessment that the real effective exchange rate may be modestly overvalued but underscored the uncertainty surrounding such assessment.

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

Directors commended the central bank for its bank capitalization policy, which has bolstered the stability of the financial system by ensuring that banks possess ample loss-absorbing capacity. Nonetheless, Directors encouraged the authorities to remain vigilant against risks to both banks and the sovereign from loans to state-owned enterprises.

Directors welcomed the progress made in structural reforms but highlighted that further efforts are necessary to enhance external competitiveness and facilitate balance-sheet repair in the private sector. They underscored the need for reforms to raise labor force participation, address labor market rigidities, restructure state-owned enterprises, and improve the business and investment climate, particularly through judicial reform. The labor legislation currently under parliamentary consideration could strengthen the labor market's capacity to adapt to shocks. Continued efforts should also be made to ensure the rapid and efficient absorption of EU funds.

Table 1. Croatia: Selected Economic Indicators, 2007–15 1/

	2007	2008	2009	2010	2011	2012	2013	2014	2015
							Est.	Proj.	Proj.
Output, unemployment, and prices	(Percent change, unless otherwise indicated)								
Real GDP	5.1	2.1	-6.9	-2.3	-0.2	-1.9	-1.0	-0.8	0.5
Contributions:									
Domestic demand	6.6	3.4	-11.2	-5.3	0.0	-3.3	-1.1	-1.3	0.2
Net exports	-1.5	-1.3	4.2	3.1	-0.2	1.5	0.1	0.5	0.3
Unemployment (ILO, percent)	9.4	8.3	9.0	12.1	13.6	16.1	16.6	16.8	17.1
CPI inflation (average)	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.5	1.1
Average monthly nominal wages	6.2	7.1	2.2	-0.4	1.5	1.0	0.8	...	...
Saving and investment	(Percent of GDP)								
Domestic investment	31.4	33.4	27.6	23.6	22.8	21.9	21.3	20.1	20.3
Of which: fixed capital formation	26.2	27.4	24.5	20.8	19.6	18.6	18.4	18.3	18.7
Domestic saving	24.2	24.5	22.4	22.4	21.9	21.8	22.6	21.7	21.3
Government	3.9	3.2	0.2	-1.5	-1.9	-0.8	-2.6	-1.0	0.2
Nongovernment	20.3	21.3	22.3	23.9	23.8	22.7	25.2	22.7	21.1
Government sector 2/									
General government revenue	39.8	39.2	39.0	38.2	37.4	38.4	37.9	40.3	40.7
General government expenditure	40.8	40.1	42.2	42.7	42.0	41.7	43.4	44.2	44.4
Unspecified measures (EDP)	...	...	...	...	...	...	...	...	0.8
General government balance	-1.0	-0.9	-3.3	-4.5	-4.6	-3.3	-5.4	-4.0	-2.9
General government balance (broad definition) 3/	-3.1	-2.3	-5.5	-5.4	-5.2	-4.2	-5.9	-4.5	-3.3
Cyclically adjusted balance	-2.3	-2.6	-2.3	-3.4	-3.9	-2.1	-4.5	-3.0	-2.0
Structural balance (IMF calculation)	-2.3	-2.6	-2.3	-3.4	-3.9	-2.1	-4.5	-3.4	-2.6
General government debt	32.9	29.3	35.8	42.6	47.4	54.0	60.0	64.7	66.8
Money and credit 4/	(End of period; change in percent)								
Bank credit to the nongovernment sector	15.4	13.3	0.4	4.4	4.6	-5.4	-2.2	-2.1	...
Broad money	18.5	4.7	0.1	3.0	1.6	3.2	2.9	3.8	...
Interest rates 5/ 7/	(Period average; percent)								
Average kuna deposit rate (unindexed)	2.3	2.8	3.2	1.8	1.7	1.9	1.5	1.4	...
Average kuna credit rate (unindexed)	9.3	10.1	11.6	10.4	9.7	9.5	9.2	8.6	...
Average credit rate, foreign currency-indexed loans	6.3	7.5	8.1	8.1	7.3	7.0	6.8	6.9	...
Balance of payments	(Millions of euros, unless otherwise indicated)								
Current account balance	[illegible]	-4,255	-2,408	-582	-389	-40	564	695	444
Percent of GDP	-7.3	-9.0	-5.1	-1.1	-0.9	-0.1	1.3	1.6	1.0
Capital and financial account	5,192	5,399	4,418	1,804	1,882	397	2,268	363	634
FDI, net (percent of GDP)	8.0	6.9	3.3	1.3	2.4	2.5	1.3	1.8	2.1

Overall balance	722	-330	896	84	401	46	1,844	71	90
Debt and reserves	(End of period; millions of euros, unless								
Gross official reserves	9,307	9,121	10,376	10,660	11,195	11,236	12,908	12,978	13,068
Percent of short-term debt (by residual maturity)	106	67	75	66	72	88	89	107	104
Months of following year's imports of goods and nonfactor services	4.7	6.1	7.0	6.8	7.2	7.4	8.4	8.1	7.6
Net international reserves	7,349	7,967	9,365	9,644	10,374	10,483	12,20	12,275	12,365
Reserves (Fixed, percent of RAM) 6/	89.5	72.2	81.3	79.1	82.8	86.4	98.3	100.0	100.8
External debt service to exports ratio (percent)	58.4	53.7	85.6	71.6	77.6	76.3	66.1	76.8	65.9
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	103.9	102.9	106.1	104.3	101.0
Net external debt (percent of GDP)	40.6	51.4	62.7	66.1	66.5	65.6	68.7	67.0	63.6
Exchange rate									
Kuna per euro, end of period 8/	7.3	7.4	7.3	7.4	7.5	7.6	7.6	7.6	...
Kuna per euro, period average 8/	7.3	7.2	7.3	7.3	7.4	7.5	7.6	7.7	...
Real effective rate (CPI, percent change) 4/ 9/	0.7	4.6	1.2	-2.6	-2.1	-1.9	2.5	1.9	...
Memorandum items:									
Nominal GDP (millions of euros)	43,38	47,537	44,770	44,428	44,195	43,686	43,64	43,518	44,203
Output gap (percent of potential)	3.2	4.2	-2.2	-2.6	-1.6	-2.8	-2.3	-2.2	-2.1

Per capita GDP (2012, WEO): $12,829

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/ Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). National account data for 1995-2008 were revised in 2009 and data for 2008-2011 were revised in 2012.

2/ Cash definition.

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

4/ Latest data as of January 2014.

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

7/ Latest data as of February 2014.

8/ Latest data as of March 2014.

9/ Positive change means depreciation and vice versa.

Statement by Mr. Snel and Ms. Cudina on the Republic of Croatia
May 14, 2014

The Croatian authorities thank staff for the constructive and candid dialogue during their mission in Croatia. They appreciate staff's comprehensive and objective analysis of the macroeconomic situation and agree with their assessments and policy recommendations. Policy discussions have helped the authorities to set the right policy mix needed to support the economic recovery.

Economic developments and outlook

The Croatian economy has been in recession for five consecutive years. In 2013, GDP contracted by 1 percent, as domestic demand remained depressed by high unemployment and private debt overhang. The annual inflation slowed to 2.2 percent, and the declining commodity prices in the global market are likely to keep it subdued going forward.

The export performance has also been weak, reflecting structural weaknesses and adverse economic developments in the main trading partner countries. Also, exporters have still not taken full advantage of the EU membership, while the access to the traditional CEFTA markets has become more difficult after the EU accession. With large adjustments on the imports side over the last few years, the current account ended in surplus of about 1 percent of GDP in 2013. Previous imbalances, however, have hiked external debt in excess of 100 percent of current GDP.

With respect to the GDP forecast for 2014, the authorities are somewhat more optimistic than staff. Recent data show that the decline bottomed out in the second half of 2013 and high frequency data point to modest recovery in the first quarter of 2014. The structural reforms and debt restructuring will moderate the current negative trends, although the necessary fiscal consolidation will dampen the growth prospects in the short term. Looking forward, the gradual economic recovery will be based on the restoration of investment, financed largely through the EU funds, and the improvement in export of goods and services as the economy catches up in terms of competitiveness.

Fiscal policy

The prolonged recession has led to deep fiscal imbalances. Despite the government's consolidation efforts, the budget deficit remained high in 2013, contributing to a significant increase in public debt. Apart from the weak economic activity, the EU accession initially had a negative impact on the budget (revenues from custom duties were permanently lost, VAT collection was delayed, and the membership fee was paid). However, a positive impact of the EU membership on the budget will take place in the coming years when the EU funds bring positive growth effects. The overall fiscal discipline and tax collection have improved, due to a series of measures, including the introduction of the Fiscal Cash Register Act. Budget expenditures increased in 2013 due to the settlement of arrears in the healthcare sector and fiscal transfer to the EU budget. This was partly offset by nominal savings in most categories of expenditures, including the public wage bill and subsidies to companies.

In January 2014 the Council of the European Union opened the excessive deficit procedure (EDP) for Croatia, as the budget deficit and the public debt at end-2013 were above the reference values. The Council's recommendation was to impose structural measures in the amount of 2.3 percent of GDP in 2014 and 1 percent of GDP in both 2015 and 2016 in order to achieve the targeted levels of deficit. The Croatian authorities are committed to comply with these recommendations, despite a negative short-term impact of strong fiscal adjustment on economic activity. The EU policy framework will help to enhance fiscal governance and growth prospects, which will ensure fiscal sustainability and improve the financing conditions. To this end, the state budget was revised in March 2014, containing a comprehensive set of structural consolidation measures in the recommended amount.

In order to minimize the negative impact of strong fiscal consolidation, a balanced approach including measures on both the revenue and expenditure side is envisaged as the consolidation plan for 2014-2016. The largest structural measure in 2014 on the revenues side is restoring the rate of the compulsory health insurance contribution to 15 percent. Later on the authorities plan to introduce a tax on interest earnings and a property tax. They will also continue with the activities aimed at increasing fiscal discipline and tax collection. Measures on the expenditure side will aim at rationalizing the current expenditures, while maintaining adequate social protection and capital spending partly supported by the EU funds. Better targeting of social transfers and further rationalization of capital transfers is also envisaged.

Monetary policy and financial system

The monetary authorities continue to be firmly committed to maintaining exchange rate stability. This policy provided an anchor for inflation expectations and financial stability in the context of widespread euroization. In view of the sizable foreign currency exposure of both the private and public sector (150 percent of GDP), even a moderate exchange rate depreciation would cause strong negative balance sheet effects and credit losses. Though one can find Croatia's monetary policy constrained, it is important to note that such an exchange rate regime has been determined by specific economic circumstances, and has served the country well. Moreover, the benefits to competitiveness from a more flexible exchange rate (even if it would be possible) are uncertain in case of a small and open economy such as Croatia. Regardless of the exchange rate regime, the productivity enhancing fiscal and structural reform policies are essential to fix the competitiveness problem, and there is simply no alternative to that.

Such an exchange rate regime, combined with high euroization and the existing external vulnerabilities, requires adequate reserve buffers. The central bank has been steadily increasing international reserves over time, also during the recent times of lower capital inflows, and considers the current level of reserves adequate. With regards to the reserves adequacy matrix, international reserves currently exceed the amount of reserve money by a large margin (close to 160 percent) and cover more than 8 months of imports. The short-term debt coverage is somewhat lower (around 90 percent) than the IMF metric, but if intercompany bank debt and FDI-related short-term liabilities, which are significant in Croatia and have proven to be relatively stable, are excluded, then the coverage reaches 160 percent. Nonetheless, the central bank will continue to gradually accumulate reserves, depending on capital flows dynamics and in line with the underlying exchange rate policy.

The Croatian banking system continues to demonstrate high resilience, despite previous adverse external shocks (both the U.S. subprime crisis and the euro area crisis) and a 5-year long domestic recession, mainly thanks to sound fundamentals and macroprudential measures implemented in the pre-crisis period. The system-wide capital adequacy ratio remains robust, currently close to 21 percent, and is adequate. It can also hypothetically sustain the entire NPL's write-off (net of provisions), and still remain at about 12 percent. With regard to banks' profitability, although headline figures are pointing to a decline in profitability over the last year, banks' operational profitability on average has not changed at all, which can be explained by a more active provisioning policy encouraged by the central bank. Thanks to that, during 2013, the coverage of NPLs by specific loan-loss provisions increased by almost 4 percentage points to 46 percent, and it is expected that with such a provisioning policy in place, loan-loss provisions of the Croatian banking system will reach those of its peers on average over the next two years.

Competitiveness and structural reforms

Staff’s assessment of Croatia's real effective exchange rate points to a 10 percent overvaluation. The authorities, however, would like to point to methodological shortcomings of their approach (the comparability of the data and the countries in the sample can be questioned). The authorities’ own calculations, based on the application of the same methodology for a more comparable set of countries (EU member states), suggest a range from 2 percent overvaluation to 8 percent undervaluation. Therefore, no strong conclusion on the exchange rate misalignments could be made.

Nevertheless, Croatia’s competitiveness position is weak, although continuous improvements in the price-competitiveness became apparent in recent years, particularly in REER deflated by nominal unit labor costs. Regardless, Croatia is lagging behind in export performance, which is evident in the persistent erosion of market share of Croatian exporters on the world market. The underlying factors are not clear, while relative prices and costs might play a role, other non-price factors may be even more important. Some of these factors are long-existing structural problems, like the unfavorable product specialization and geographic orientation, labor market rigidities, weak business environment, and other bottlenecks that discourage investments (both domestic and foreign) and deter exports.

In this respect, the Croatian authorities see the need for a fast implementation of structural reforms to tackle the lack of competitiveness. They have already addressed some areas. More direct support is being provided from the central government to foreign direct investors to help revive FDI inflows. The pre-bankruptcy settlement procedures are being intensified, bringing debt relief to companies, and similar measures are being developed to help over-indebted households. As noted in the National Reform Program that was published in April

2014, the authorities will proceed with the restructuring and privatization process, prioritizing on the transportation sector. A comprehensive set of measures to improve the healthcare system and increase the labor market flexibility is also being implemented. Despite the many challenges ahead, the Croatian authorities believe that these measures will help improve competitiveness, and pave the road to sustainable and more inclusive growth.