INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/187

REPUBLIC OF CROATIA

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF CROATIA

June 2016

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 2016 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 22, 2016 consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 22, 2016, following discussions that ended on May 10, 2016, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 8, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Croatia.

The documents listed below have been or will be separately released.

Selected Issues

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

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June 28, 2016

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IMF Executive Board Concludes the 2016 Article IV Consultation with the Republic of Croatia

On June 22, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Croatia.

Croatia has been gradually recovering from a six year recession, mostly on the back of strong exports, tourism activity, and private consumption. These factors, as well as better absorption of EU structural and investment funds are expected to give a further moderate boost to economic growth in 2016. However, GDP remains well below its pre-crisis level and unemployment is very high. Inflation was negative over the past two years, mainly due to lower energy and food prices. The current account surplus increased significantly in 2015, but almost half of this increase was due to a one-off decline in profits of foreign-owned banks related to the conversion of Swiss franc loans. Vulnerabilities remain high due to elevated public and external debt levels.

The 2015 general government deficit was substantially smaller than anticipated. This was due to a cyclical upturn in revenue, under-execution of public enterprise investment in the fourth quarter during the care-taker government, and some consolidation efforts. A further reduction in the deficit is targeted in 2016, reflecting a combination of a cyclical revenue upturn and across-the-board freeze of expenditure, excluding items that are funded by the EU.

Monetary policy has remained relatively accommodative within the limitations of the quasi-peg, which does not have a viable alternative at this juncture given the high degree of euroization. The Central Bank has continued to reduce its key policy rates and ensure ample liquidity in the banking system. Bank lending, nevertheless, has contracted further, as enterprises and particular households continued to deleverage.

[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.

The banking sector has remained stable and, on average, liquid and well-capitalized. The system remained profitable during the recession, with the exception of 2015 due to losses from the Swiss franc loan conversion. The non-performing loan ratio seems to have stabilized, albeit at a still high level. In 2015, one small, but regionally important, bank began the resolution process in accordance with the EU Bank Recovery and Resolution Directive.

Although some modest structural reforms have been implemented in recent years, Croatia is still lagging most EU countries, when comparing standard business environment indicators.

Executive Board Assessment[2]

Executive Directors welcomed Croatia's ongoing economic recovery and the reduction of the fiscal deficit in 2015. Nonetheless, important challenges remain, including high public and external debts and elevated unemployment. Directors emphasized that decisive and timely implementation of the new National Reform Program will be crucial to further reduce vulnerabilities and boost growth and job creation.

Directors encouraged the authorities to continue fiscal consolidation in a more growth-friendly manner. They suggested avoiding reliance on across-the-board expenditure cuts and focusing on durable and targeted measures. They welcomed the plan to simplify the tax system, but stressed that any tax reduction should be implemented after making progress on fiscal consolidation. Directors supported plans to introduce a modern real estate tax, implement pension reforms, streamline social benefits, improve the efficiency of the healthcare system, and make part of civil servants' compensation performance-based. Directors encouraged the authorities to increase the absorption of EU structural and investment funds to mitigate any adverse effect of fiscal consolidation on growth.

Directors agreed that monetary policy is appropriately accommodative within the limitations of the quasi-peg exchange regime, which remains an adequate monetary anchor at this juncture in the context of euroization. They called for continued efforts to achieve gradual de-euroization and to safeguard financial stability until the euro can be adopted. Directors encouraged the Croatian National Bank (CNB) to smooth any sharp fluctuations in the foreign exchange market and look for opportunities to boost reserves. Directors underlined the importance of preserving the central bank's independence.

Directors commended the CNB for maintaining banking system stability and stressed the need for continued supervisory vigilance. They recommended additional efforts to clear impaired bank assets to improve credit creation. Directors noted that across-the-board bailouts similar to the conversion of the Swiss franc loans in 2015 should be avoided in the

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

future, as they increase the risk of moral hazard and could adversely affect investor confidence.

Directors urged the authorities to accelerate structural reforms to boost growth and employment creation and facilitate income convergence with the EU. They highlighted the need to advance privatization and enhance the efficiency of the public sector, while removing bureaucratic impediments to doing business. In this regard, they underscored the need to reduce red tape and streamline overlapping layers of government and public agencies. Other priorities include further enhancing labor market flexibility to increase labor participation. Directors noted the importance of building political consensus to ensure broad support for the reforms.

Croatia: Selected Economic Indicators, 2010–17

	2010	2011	2012	2013	2014	2015 Est.	2016 Proj.	2017 Proj.
Output, unemployment, and prices	(Percent change, unless otherwise indicated)							
Real GDP	-1.7	-0.3	-2.2	-1.1	-0.4	1.6	1.9	2.1
Contributions:								
Domestic demand	-4.7	-0.2	-3.4	-1.1	-1.7	1.2	1.9	2.2
Net exports	3.1	-0.1	1.1	0.0	1.3	0.4	0.0	-0.1
Unemployment (percent) 1/	11.5	13.3	15.2	17.0	17.1	16.9	16.4	15.9
CPI inflation (average)	1.0	2.3	3.4	2.2	-0.2	-0.5	0.4	1.3
Growth in average monthly nominal wages	-0.4	1.5	1.0	0.8	0.2	1.3	...	...
Saving and investment	(Percent of GDP)							
Domestic investment	21.3	20.6	19.3	19.1	18.2	18.3	18.7	19.3
Of which: fixed capital formation	21.3	20.3	19.6	19.8	19.1	19.1	19.2	19.4
Domestic saving	20.2	19.8	19.1	19.9	19.0	23.5	21.7	21.5
Government	0.1	-1.5	-1.4	-0.7	-0.8	0.0	1.1	1.4
Nongovernment	20.1	21.3	20.5	20.6	19.8	23.5	20.7	20.1
Government sector 2/								
General government revenue	41.3	41.0	41.7	42.5	42.6	43.7	44.1	43.7
General government expenditure	47.5	48.8	47.0	47.8	48.1	46.9	46.9	46.3
General government balance 3/	-6.2	-7.8	-5.3	-5.3	-5.5	-3.2	-2.8	-2.6
Structural balance (IMF calculation)	-5.5	-7.2	-4.2	-4.0	-4.2	-2.4	-2.2	-2.2
General government debt	57.0	63.7	70.7	82.2	86.5	86.7	86.5	86.1
Money and credit	(End of period; change in percent)							
Claims on other domestic sectors 4/	2.4	4.4	-6.2	-1.3	-2.2	-3.0	...	...
Broad money (M4)	1.9	5.7	3.6	4.0	3.2	5.1	...	...
Interest rates	(End of period; percent)							
T-bill rate (3-Month, kuna denomiated) 5/	2.3	4.6	1.3	0.8	0.3	0.4	...	...
Kuna credit rate (unindexed) 6/	9.9	8.6	8.2	7.8	7.5	7.1	...	...
Real kuna credit rate (unindexed) 6/ 7/	8.8	6.2	4.6	5.5	7.7	7.6	...	...
Kuna credit rate, foreign currency-indexed 6/	7.8	7.0	6.8	6.6	6.1	5.8	...	...
Balance of payments	(Millions of euros, unless otherwise indicated)							
Current account balance	-503	-360	-61	341	368	2,293	1,360	1,004
Percent of GDP	-1.1	-0.8	-0.1	0.8	0.9	5.2	3.0	2.2
Capital and financial account	1,490	1,872	484	2,333	-341	-1,113	-357	-226
FDI, net (percent of GDP)	2.1	2.7	2.7	2.0	3.1	0.3	1.9	2.0
Overall balance	84	401	46	1,845	-530	745	1,004	778
Debt and reserves	(End of period; millions of euros, unless otherwise indicated)							
Gross official reserves	10,660	11,195	11,236	12,908	12,688	13,707	14,711	15,489
Percent of short-term debt (by residual maturity)	86	85	95	99	95	97	98	111
Months of following year's imports of goods and nonfactor services	7.0	7.4	7.3	8.1	7.3	7.4	7.3	7.1
Net international reserves	9,269	10,006	10,195	10,491	10,590	11,731	12,735	13,513
Reserves (Fixed, percent of RAM) 8/	72.7	74.5	76.5	85.9	82.9	88.7	93.3	98.0
External debt service to exports ratio (percent)	39.7	34.6	29.5	37.9	36.9	45.4	44.5	57.4
Total external debt (percent of GDP)	104.2	103.7	103.0	105.6	108.4	103.7	101.3	96.9
Net external debt (percent of GDP)	65.9	66.6	65.6	64.8	65.5	59.1	55.2	50.2
Exchange rate								
Kuna per euro, end of period	7.3	7.4	7.5	7.6	7.6	7.6	...	...
Kuna per euro, period average	7.3	7.4	7.5	7.6	7.6	7.6	...	...
Real effective rate (CPI, percent change) 9/	-2.6	-2.1	-1.9	1.4	-1.1	-3.0	...	...
Memorandum items:								
Nominal GDP (millions of euros)	45,025	44,744	43,962	43,522	43,051	43,921	44,922	46,388
Per capita GDP (2015): $11,556	Poverty rate : 9.8 percent (World Bank, 2014)							
Quota (2015): SDR 365.1 million (510.4 million U.S. dollars)								

Sources: Croatian authorities; and IMF staff estimates.
1/ Croatian Bureau of Statistics.
2/ ESA 2010 definition.
3/ The figure for 2016 is staff's projection. The authorities target fiscal deficit of 2.6 percent of GDP in 2016.
4/ Comprises claims on households and enterprises. Excludes other banking institutions (household savings banks, savings and loan cooperatives, and investment funds) and other financial institutions.
5/ Weighted monthly average daily interest rates at treasury bill auctions at the Ministry of Finance.
6/ Weighted monthly averages for outstanding amounts. Change of definition November 2011.
7/ Nominal interest rate deflated by past year's change in the CPI.
8/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.
9/ Positive change means an appreciation and vice versa.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 8, 2016

KEY ISSUES

Context: The economy is gradually recovering from a six year recession, mostly on the back of strong exports, tourism activity, and private consumption. Public and external debt levels and financing needs remain high. Real GDP is still about 11 percent lower than in 2008, unemployment is high at about 16 percent, and merchandise exports are low, although improving following EU accession. A new coalition government was formed in January with a narrow majority and has passed a tight budget and announced a wide-ranging *National Reform Program* (NRP) that will require decisive implementation to achieve Croatia's economic potential.

Key policy recommendations: Economic priorities in the period ahead are to: (i) reduce vulnerabilities through fiscal consolidation; and (ii) boost growth and employment creating by accelerating structural reforms and utilization of EU structural and investment funds.

- **Fiscal policy:** Adopt a growth-friendly fiscal consolidation strategy to put public debt firmly on a downward path, advance privatization, and improve the efficiency of the bloated public sector.
- **Monetary policy:** At this juncture, given the high degree of both deposit and loan euroization, there is no viable alternative to the quasi-peg to the euro. Within the limits of this framework, continue to maintain an accommodative monetary policy stance as long as inflationary pressures and financial stability risks remain subdued. Ensure adequate international reserve coverage to safeguard monetary and financial stability and consider options to gradually reduce euroization.
- **Structural policies:** Improve the business climate and further reform the labor market to strengthen competitiveness and reduce unemployment. Enhance policy predictability to help improve confidence and investment. Streamline social benefits that are inefficient and poorly targeted. Address overlaps between different layers of ministries, agencies, regions, and municipalities to reduce red tape.

Previous staff advice: Deficit reduction in 2015 exceeded staff's advice, largely due to a stronger than projected recovery and lower investment in the fourth quarter under the care-taker government. No major additional progress has been made on structural reforms since the 2015 Article IV consultation, with the exception of the new Consumer Bankruptcy Law that came into force in January 1, 2016.

Approved By
James Gordon (EUR) and Masato Miyazaki (SPR)

Discussions took place in Zagreb during April 27 to May 10, 2016. The staff team comprised Messrs. Sakr (Head), Crivelli, Lybek, Omoev (all EUR), and Ms. Shi (FAD). Mr. Gordon (EUR) and Mr. Manchev (OED) attended some of the meetings. Ms. Samuel, Ms. Borisova, and Ms. Rhee (all EUR) assisted in the preparation of the staff report.

The staff team met with Prime Minister Orešković, Deputy Prime Minister Petrov, Minister of Finance Marić, Minister of Social Policy and Youth Juretić, Minister of Health Nakić, Minister of Tourism Kliman, Governor of the Croatian National Bank Vujčić, Chairman of the Commission on Fiscal Policy and of the Finance and Central Budget Committee of the Parliament Marić, other officials, and representatives of the banking sector, business community, labor unions, and academia.

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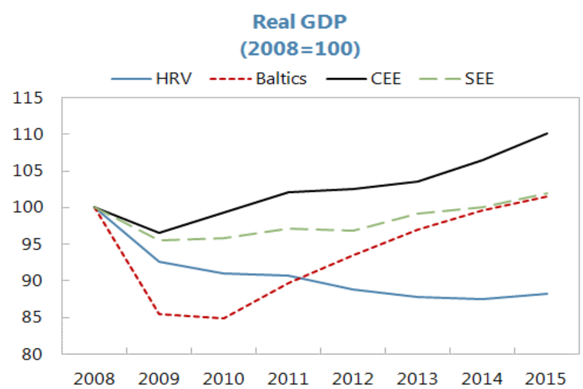
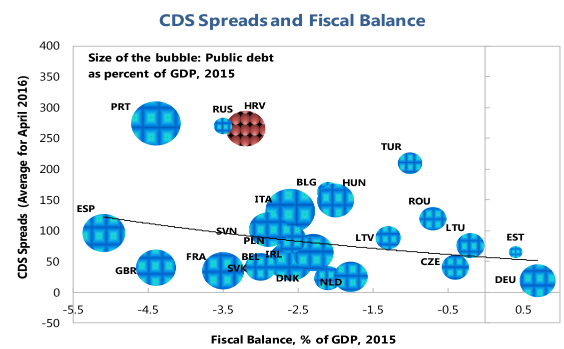
BACKGROUND

A. Context

1. Croatia has begun since the last quarter of 2014 to gradually recover from a six-year recession. In 2015 real GDP grew by 1.6 percent, driven by strong exports and tourism, a revival of private consumption, and higher public investment.[1] Private investment growth also finally turned positive. The general government deficit narrowed due to both a cyclical upturn in revenues and some consolidation efforts. The external current account balance also improved due to strong export growth, a record tourism season, and low oil prices. Since February 2014, CPI inflation has largely been in low negative territory, mostly due to declining energy and food prices.

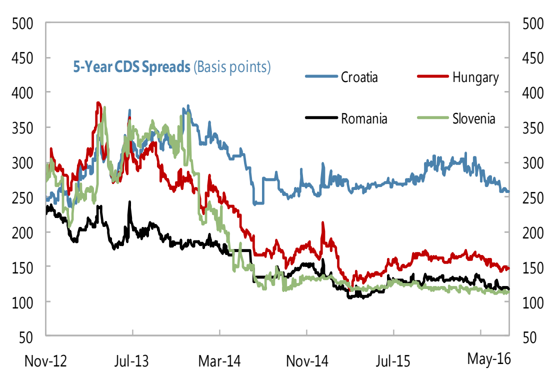


2. Nevertheless, the economy remains rigid and vulnerabilities are high. Both public and external debt financing needs are large (about 16 and 19 percent of GDP, respectively in 2016). Structural reforms have been lagging. Unemployment remains high and the participation rate low. Medium-term annual growth is projected at 2 percent, significantly lower than peers, and per capita income has a long way to catch up with the EU average.



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

3. The announced objectives of the new ruling coalition are to reduce vulnerabilities and boost growth. In late January—almost three months after the parliamentary elections—a cabinet, headed by a technocrat Prime Minister with strong corporate credentials, was established with a narrow majority (initially 78, now 76 of 151 seats in parliament) and is facing persistent political challenges. Nonetheless, the government was able to achieve its first task of passing the 2016 budget that broadly freezes expenditures with a view to reduce the deficit to well-



[1] Total public sector investment is larger than what is included in the budget under the ESA2010 definition.

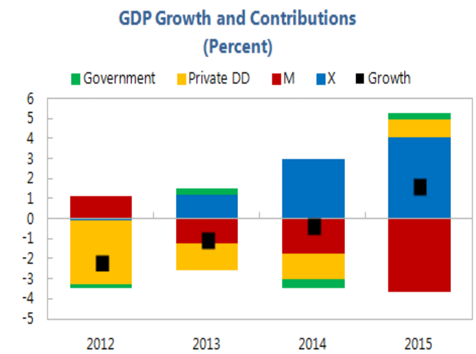
below 3 percent of GDP, contain public debt, and thus ultimately exit the Excessive Deficit Procedure (EDP). The coalition's election platform included numerous structural reforms as well as populist measures, although the latter have been scaled back. The recently launched National Reform Program (NRP) includes wide-ranging reforms, many of which will require political consensus.[2]

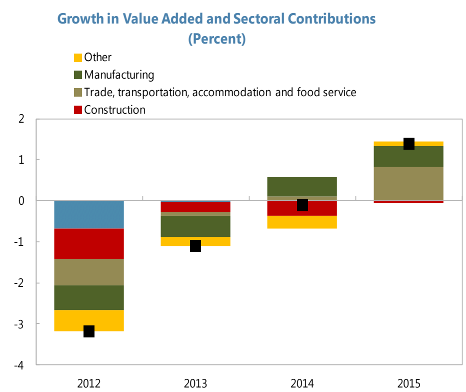
B. Recent Developments

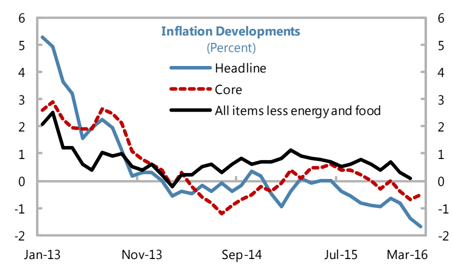
4. **The fledgling recovery has gained traction during 2015, notwithstanding a slowdown in the last quarter** (Figure 1 and Table 1). The external environment was supportive with strong trading partner growth, particularly in Italy, Slovenia, and Germany; lagged effects of full access to EU markets; low energy prices; and ample global liquidity. Private consumption also began to recover, aided by an increase in disposable income due to an upward shift in the income tax thresholds and low energy costs. Public investment grew, in particular in SOEs, while private investment growth finally turned positive, in part reflecting a mild improvement in business confidence. Growth was broad based with relatively strong performance across many sectors, including manufacturing, trade, transportation, and accommodation and food services.

5. **Consumer prices have largely been declining over the past two years,** mainly due to lower energy and food prices. Non-food and non-energy inflation has been steady, although low by historical standards.

6. **Unemployment declined only slightly since 2014 and remains very high**. Both structural and cyclical unemployment rates—estimated at 11½ percent and 5 percent respectively—are much worse than in peers. Unemployment is particularly high among the youth and low-skilled workers, and in less-developed regions. The participation rate (close to 50 percent) is also lower than in most peers. Nevertheless, some employers reportedly have difficulties in attracting seasonal workers, particularly in retail and catering.







Sources: Croatian National Bank and Croatian Central Bureau of Statistics.

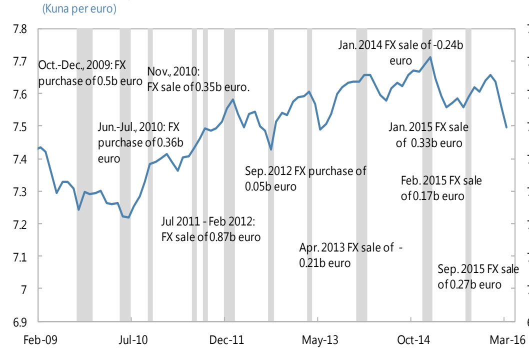
[2] In May 2016, the EC published its country-specific recommendations to address Croatia's macroeconomic imbalances (http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm) and its assessment of the Convergence Program (http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm).

7. The external current account moved further into surplus in 2015, and external debt declined somewhat (Figure 2). Export growth was about 12 percent in real terms and was broad based. Moreover, Croatia experienced a record tourist season—with an increase in the number of tourist arrivals and nights of 9.1 percent and 7.6 percent, respectively. Although import growth accelerated toward end-2015, the current account surplus increased from 0.9 percent of GDP in 2014 to 5.2 percent of GDP. However, almost half of this increase was due to a one-off decline in profits of foreign-owned banks (about 2 percent of GDP) related to the conversion of Swiss franc loans (Annex I). Deleveraging continued and contributed to a reduction in external debt to about 104 percent of GDP from 108 percent of GDP a year earlier.[3]

8. The 2015 general government deficit was substantially smaller than anticipated. The deficit declined to 3.2 percent of GDP in 2015 from 5.5 percent of GDP in 2014 (ESA2010 definition). This was due to a cyclical upturn in revenue (estimated at 0.5 percent of GDP) and under-execution of public enterprise investment in the fourth quarter during the care-taker government (estimated at 0.8 percent of GDP). There were also some consolidation efforts, including an increase in excises on fuel and tobacco, the full-year effect of the 2014 increase in health insurance contributions, and improved tax administration. On the expenditure side, measures were taken to contain the wage bill (mainly amending seniority bonuses) and subsidies (as some agricultural subsidies are now being paid directly by the EU Agricultural Guarantee Fund). As a result, public debt finally stabilized at close to 87 percent of GDP.

9. The kuna exchange rate to the euro has remained stable, with a slightly stronger than usual seasonal appreciation since February 2016 (Figure 3). The quasi-peg continued to be preserved through tight FX liquidity regulation and occasional FX interventions[4]. The conversion of Swiss franc household loans to euros necessitated FX intervention amounting to €0.27 billion to close banks' net open positions.[5] Nonetheless, gross international reserves increased by €1 billion to €13.7 billion (equivalent to 102 percent of short-term debt by remaining maturity) during 2015—benefitting from the government's issuance of €1.5 billion 10-year Eurobond in March, which was over-subscribed, at a yield of 3.25 percent.

Nominal Exchange Rate and FX Interventions
(Kuna per euro)



Sources: Croatian National Bank and Bloomberg.

10. The Croatian National Bank (CNB) maintained a relatively accommodative monetary stance within the limitations of the quasi-peg by ensuring ample excess liquidity, but bank

3 About 12 percentage points of the debt are account for by intercompany debt.

4 Croatia's de jure exchange rate regime is classified by the Fund as a managed float without a predetermined path, and its de facto regime is classified as a crawl-like arrangement.

5 The conversion of Swiss franc household loans into euro triggered a temporary net open position of banks, which the CNB partially alleviated by selling foreign currency.

lending has nevertheless remained subdued (Figure 4). The interest rates of some standing facilities were reduced[6] and several measures were taken to ensure ample liquidity. These measures included broadening the list of securities eligible for CNB facilities, adjusting required reserves,[7] and a quarterly four-year structural reverse repo facility was introduced in February 2016. However, banks' claims on non-financial enterprises and households declined further by 4.7 percent and 8.0 percent from March 2015 to March 2016.[8]

11. The stability of the banking sector has been maintained despite the drawn-out recession. On average, the banking system, which is primarily foreign-owned (Austrian and Italian), is liquid and well-capitalized (21.0 percent CAR at end-2015). Banks remained profitable during the recession, with the exception of 2015 due to losses from the Swiss franc loan conversion. With the continued buildup of deposits and subdued lending, deleveraging has continued. The non-performing loan (NPL) ratio seems to have stabilized, but remains high (16.3 percent of loans). Nonetheless, NPLs are fairly provisioned. In 2015, one small, but regionally important, bank began the resolution process in accordance with the EU Bank Recovery and Resolution Directive.

OUTLOOK AND RISKS

A. Outlook

12. Staff projects growth to strengthen slightly to about 1.9 percent in 2016 and then stabilize around 2–2¼ percent over the medium term. The growth projections are based on an anticipated solid export and tourism performance and a continued recovery in domestic demand (Table 2). Private consumption is expected to be aided by recovering wages, better employment prospects, and the deleveraging process gradually coming to an end. Both private and public investment will benefit from larger EU funds absorption. Reduced policy uncertainty, following the ongoing fiscal consolidation and the launch of the NRP, is expected to encourage both domestic and foreign investment. Export growth is anticipated to remain strong, but to decelerate, as benefits from EU accession peter out (Annex II). However, net exports will only contribute moderately to growth given the increasing imports. Inflation is projected to return to positive territory in late 2016, with the anticipated increase in energy prices.

[6] In 2015, effective October 31, the Lombard rate was halved from 5.0 percent to 2.5 percent, the CNB discount rate reduced from 7.0 percent to 3.0 percent, the rate on short-term CNB liquidity credits cut from 6.0 percent to 4.0 percent, and the penalty rate on required reserves was lowered from 12.0 percent to 8 percent. The CNB overnight deposit rate has been zero since April 24, 2013.

[7] Effective October 7, 2015, the CNB revoked the regulation relating to compulsory CNB bills. Effective January 13, 2016, the requirement to maintain part of the statutory reserves in foreign exchange was abolished hence providing banks more flexibility in managing their liquidity and reducing their regulatory costs.

[8] However, adjusted for exchange rate movements and write-offs of non-performing loans, the decline of bank claims on non-financial enterprises and households were much smaller (1.3 and 1.1 percent, respectively).

13. Staff projects the 2016 general government deficit at 2.8 percent of GDP, with a further steady decline to 2.3 percent of GDP over the next few years (baseline scenario). The 2016 budget targets a deficit of 2.6 percent of GDP. The targeted deficit reduction in 2016 reflects a combination of a cyclical revenue upturn and across-the-board freeze of expenditure, excluding items that are funded by the EU. However, absent concrete measures to underpin some of the planned reforms, staff projects a slightly higher deficit in 2016 and a slower pace of consolidation over the medium term. The cyclically-adjusted primary balance is estimated to improve in 2016 by about 0.3 percent of potential GDP.

14. Vulnerabilities remain high due to elevated debt levels:

- *Public debt*, which stood at only 37 percent of GDP in 2007, is projected to stay high at over 86 percent of GDP during 2016–17, although the recent increase is exaggerated due to definitional changes.[9] It will then slowly decline to 82 percent of GDP over the medium term, aided by fiscal consolidation, low interest rates, and sustained GDP growth (Annex III).

- *External debt* is expected to substantially decline from about 104 percent of GDP in 2015 to a still high 84 percent of GDP in the medium term, aided by the ongoing private sector deleveraging and fiscal consolidation. The current account surplus is projected to decline gradually over the next few years, while foreign reserves would continue to grow slowly (Annex IV).

B. Risks to the Outlook

15. The risks to the forecast continue to be tilted to the downside (Annex V). Upside risks include a return to very low energy prices that would have a favorable impact on production costs and purchasing power. An acceleration of reforms could also further support growth and competitiveness, as well as reduce vulnerabilities, and help to unleash the large unutilized potential of the economy. However, there are substantial downside risks. External demand could slow due to remaining economic uncertainties in the EU. A normalization of global monetary conditions could lead to higher costs for the large public and private financing needs. Border disruptions associated with the refugee crisis could hamper trade and tourism. Fiscal risks include delays in reforms, including of the public wage system and social benefits, as well as slower absorption of EU structural and investment funds. Furthermore, domestic political conditions remain challenging with possible adverse implications for the implementation of the NRP.

[9] In 2014, for instance, the inclusion of HBOR (Croatian Bank for Reconstruction and Development) into the general government added 4.4 percent of GDP to the public debt. Further widening of the general government debt coverage would likely be limited.

POLICY DISCUSSIONS

A. Fiscal Policy

16. The authorities' reform program contemplates steady consolidation to reduce the headline deficit to 2.6 percent of GDP in 2016 and 1.0 percent of GDP by 2019. The authorities expressed their strong commitment to achieve their deficit target to facilitate exiting the EDP. The NRP includes key fiscal reforms, such as introducing a modern real estate tax, making part of public servants' compensation performance based, streamlining social benefits, reforming the pension system, and privatization (Annex V). The 2016 Convergence Program (CP) is based on many of the reforms listed in the NRP. However, the authorities' fiscal effort this year is mostly focused on expenditure control, while working on building sufficient support for the structural measures planned under the NRP.

Composition of Fiscal Adjustment Under the Convergence Program
(in percent of GDP)

	2015	2016	2017	2018	2019
Revenue	43.7	44.1	43.7	43.7	43.1
of which					
Taxes	25.4	25.1	24.9	24.6	24.3
Social contributions	11.9	11.8	11.6	11.4	11.2
Expenditure	46.9	46.8	45.7	45.3	44.2
of which					
Wages	11.4	11.2	11.0	10.8	10.5
Intermediate consumption	8.1	7.8	7.6	7.6	7.4
Social payments	16.4	16.2	16.0	15.7	15.5
Subsidies	1.7	1.6	1.5	1.3	1.2
Overall balance	-3.2	-2.6	-2.0	-1.6	-1.0

Source: Croatian authorities and European Commission.

17. Staff noted that the NRP will require implementation of specific measures, many of which involve legislative changes. Furthermore, the CP projects a gradual decline in revenue as a result of an anticipated lowering of some of the existing high taxes.[10] Staff stressed that any tax reduction should be contingent on progress in expenditure consolidation and success in achieving the targeted fiscal deficit. Given the substantial downside risks outlined earlier, and absent concrete measures to fully support the NRP, staff's baseline scenario reflects only partial implementation of reforms. Accordingly, staff projects that in this scenario the fiscal deficit would decline to 2.8 percent of GDP in 2016 and to 2.3 percent of GDP starting in 2019 (Table 3).

18. Staff viewed the NRP adjustment path as adequate, and encouraged them to achieve it by decisive implementation of the required reform measures. Staff, therefore, recommended an adjustment scenario that is similar to the NRP's path of fiscal consolidation, but that is somewhat different in the composition of that consolidation. Most importantly, staff recommended less reliance on across-the-board expenditure reduction and that more focus be placed on streamlining the high social spending. Staff also stressed that achieving the targeted deficit path would only be possible by decisively implementing the needed underlying reforms in a timely fashion. In addition, staff encouraged the authorities to achieve their 2016 deficit target (2.6 percent of GDP), including by implementing components of the NRP that can be readily introduced in the short run such as making part of civil servants' compensation performance based and streamlining some of the overlapping social benefits. Furthermore, preparatory work for some of the more substantial reforms

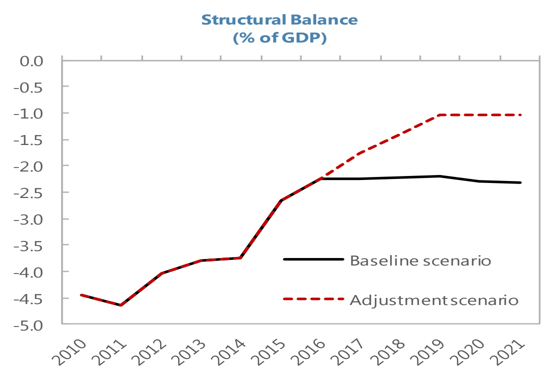
[10] The size of government in Croatia has necessitated high tax rates. The standard VAT rate is 25 percent, and the income tax rate on earnings starting at about €1,800 monthly net of personal allowances is 40 percent. In addition there are pension, health care, unemployment, and injuries insurance contributions.

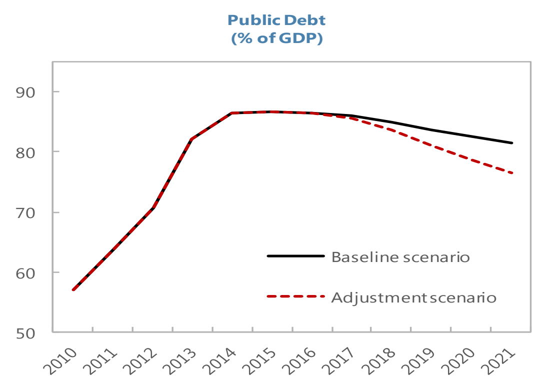
(such as improving land registration and the cadastre, which are required for a modern real estate tax) could start immediately.

19. Staff estimates that full implementation of the NRP reforms could yield up to 3 percent of GDP. Phasing-in this adjustment over the next few years would result in the 1.0 percent of GDP targeted deficit by 2019, while still creating space for reducing the high tax rates as committed in the CP. If necessary, the space could also be used to secure a faster exit from the EDP.[11] With this strong adjustment path, public debt would be on a faster downward path and could decline to below 80 percent of GDP over the medium term. Furthermore, the NRP reforms would also improve the quality of fiscal revenue and expenditure, with a view to supporting growth, efficiency, and equity.

Key Fiscal Savings, 2016-21
(In percent of GDP)

Revenue	
Adopting property tax	1.0 - 1.5
Health sector additional income	0.3
Other revenue measures	0.2
Expenditure	
Savings on public sector wage bill	0.2
Savings on social spending	0.6
Other expenditure savings	0.5
Total	3.0





20. Advancing civil service and social benefits reforms would be essential to achieve the fiscal targets, which improve both efficiency and equity. Staff welcomed the consensus reached between the authorities and social partners to contain the relatively large public sector wage bill and further postpone increases in public wages.[12] Staff also welcomed the plan to make part of the

[11] Staff's advice, including improving the quality of consolidation and an annual deficit reduction of about 0.6 percent of GDP (which translates to 1.5 percent of GDP total adjustment in the structural balance), are broadly in line with those of the EC, both with regards to the recommended adjustment path and reform measures. Assuming a smaller output gap than that estimated by staff, the EC recommends fiscal adjustment that is above 0.5 percent of GDP.

[12] In 2009, in reaction to the recession, the authorities and the public sector unions reached an agreement to postpone public sector wage increases until growth recovered. The trigger was supposed to be activated in the third quarter of 2015. The estimated budget impact of the wage increase is about 0.5 percent of GDP. An agreement was recently reached to further postpone any wage increase in view of the lack of fiscal space.

compensation performance-based in order to improve efficiency and the quality of public services. With regards to social benefits, staff noted the large size of social spending in relation to GDP (16.5 percent) and recommended accelerating the implementation of the one-stop shop for the numerous benefits to avoid duplication, while enhancing means-testing to improve targeting. Furthermore, staff pointed out that reforming the health sector—which currently suffers from large arrears,[13] inefficient use of some hospitals, etc.—is key to reduce costs, while improving the quality of service. Staff welcomed the recent announced reform of the pension system, which has expedited the phasing of the increase in the retirement age and raised the early retirement penalty, in line with EC recommendations.

21. The authorities expressed their determination to improve the absorption of EU structural and investment funds to boost growth. This will require improving implementation capacity and simplifying administrative procedures. Staff supported this intention and highlighted the need to maintain transparency to reduce the risk of irregularities. Staff also encouraged the authorities to expedite the transposition of the procurement directive in order to facilitate faster absorption of EU structural and investment funds.

22. A determined effort to strengthen public sector management and advance the planned privatization—specially of inactive assets—in a transparent and fair fashion would help improve the efficiency of the economy and also put the large public debt on a steeper downward path. Staff noted that past experience would suggest that receipts from privatization might take longer to materialize than what is projected under the CP. In addition, staff pointed out that amending the Fiscal Responsibility Law, in line with best international practice, would be useful, including strengthen the link between annual budget planning and the multi-year fiscal strategy.

B. Monetary Policy

23. The Central Bank and staff agreed that at this juncture there is no viable alternative monetary anchor to the quasi-peg to the euro, given the high degree of euroization. Staff encourages the CNB to continue to smooth sharp exchange rate fluctuations, while expediting structural reforms in order to enhance competitiveness. Staff estimated that the REER remains marginally overvalued by about 3 percent (Annex VI).

International Reserves Cover
(Billions of euro)

Sources: Croatian National Bank and IMF staff calculations.
1/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.
2/ Short-term debt at remaining maturity.

24. Staff encouraged the CNB to continue to accumulate international reserves to cushion potential shocks. The reserve coverage is still somewhat below the IMF's ARA (Assessing Reserve Adequacy) metric. The authorities noted that the virtual absence of foreign investors in the kuna securities market reduces the risk of destabilizing sell-offs. Moreover, the regulatory regime still

[13] The health sector arrears stood at kuna 2.5 billion (0.76 percent of GDP) as of end-2015, a slight decline from kuna 2.8 billion at end-2014.

mandates banks to maintain sizable FX liquidity buffers, which also alleviate risks. The CNB rarely purchases FX in the spot market except receipts from eurobonds issued by the government. Staff welcomes the CNB's openness to look for further opportunities to boost reserves—given the strong current account surplus and the recent appreciation of the kuna/euro rate (about 2.8 percent from February 2015 to April 2016).

25. Staff supports the CNB's relatively accommodative stance within the limitations of the monetary regime. The CNB has adequately responded to the drawn-out recession and the loose global monetary conditions by gradually reducing interest rates and easing of required reserves. Staff welcomed the introduction, in February 2016, of a four-year structural reverse repo facility that is intended to provide stable long-term kuna funding. In principle, this should contribute to a gradual reduction of the high degree of euroization.

26. Staff explored with the authorities the reasons behind the traditional high degree of euroization. Both loans and deposits denominated in foreign currency (FX) or indexed to FX have for decades fluctuated around 70 percent. The high degree of euroization is primarily supply driven by persistent preferences to save in FX—likely reflecting the experiences of hyperinflation in the 1990s—in spite of interest differentials. Banks, with a view to avoid having a net open position, have accordingly issued FX loans, including to un-hedged borrowers. Over time, the authorities have taken several measures to reduce euroization, including macro-prudential tools, some of which were given up with EU accession. Since mid-2015, banks have been required to offer alternative kuna loans to un-hedged households and to illustrate the potential impact of exchange rate changes. Staff pointed out that differentiating macro-prudential tools or increased capital requirements for more risky lending practices (pillar II) could prove beneficial for financial sector stability until Croatia adopts the euro in line with its intention.

27. Staff stressed the importance of preserving the independence, accountability, and transparency of the CNB in line with Croatia's commitment to the *Statute of the European System of Central Banks*. The Parliament has been seeking to increase its oversight of the CNB, including by considering amendments to the Law on the CNB.[14] The authorities concurred with staff that the independence of the CNB must be protected, while maintaining its accountability and transparency. Staff underlined that the wording of the proposed amendments to the Law on the CNB need to be carefully calibrated to avoid any unintended consequences.

C. Financial System

28. Staff encouraged the CNB to continue its conservative prudential policies and supervisory vigilance. The CNB has used the flexibility of the EU rules to maintain high capital buffers, which, on average would be sufficient to cover the un-provisioned part of NPLs.

[14] The current proposal includes three amendments: (i) the Parliament may approve the annual report of the CNB, rather than only discuss it; (ii) the six-year terms for board members would be limited to two terms; and, (iii) in addition to the current requirement of an independent external audit, the CNB would also be audited by the State Auditor.

29. The apparent stabilization of NPL levels is encouraging. The CNB noted that the strengthened provision requirements, introduced in 2013, have encouraged banks to sell NPLs or write them off. However, tax issues remain an obstacle, but the NRP includes measures to address these concerns and thus facilitate resolving the debt-overhang of many corporations. Staff also welcomed the objective of the new Consumer Bankruptcy Act, which came into force in January 1, 2016, and the incorporation of the Pre-Bankruptcy Settlement Law into the bankruptcy legislation. However, it is too early to tell if these changes will reduce the costs and uncertainty about future debt recoveries.

30. Staff expressed concerns about the handling of the conversion of Swiss franc household loans into euros and advised against future across-the-board bailouts. As argued in the 2015 Article IV consultation, staff would have preferred that pertinent parties would have found a more balanced solution with a view to prevent moral hazard problems, while seeking other means to assist the neediest borrowers.

31. Staff explored with the authorities underlying factors that may explain the continued subdued bank lending. The CNB and market observers believe that subdued lending is primarily a demand rather than a supply challenge. An exception to this view concerns small and medium-sized companies without sufficient collateral or a long track record to mitigate their, typically, higher risk.

32. The Croatian Development Bank (HBOR) is filling an important gap in supporting exporters and SMEs, but is not subject to the CNB's supervision. The authorities stressed that HBOR does not accept deposits from the general public and should thus not be subject to supervision by the CNB. Moreover, HBOR is subject to audits by independent external auditors and the State Audit Office. Staff acknowledged that HBOR's main activities are different from commercial banks—it functions as an export credit agency, export bank, and as a development bank—but also noted that its direct lending is growing and may merit supervision similar to commercial banks. The authorities are considering an independent asset quality review of HBOR's credit portfolio, which would be an important step to address this concern.

D. Structural Reforms

33. Advancing structural reforms is crucial to boost growth and employment creation and to enhance competitiveness. Staff welcomed the progress made with implementing structural reforms in recent years. The labor law was amended to reduce the cost of workforce restructuring and increase the flexibility of working hours. Furthermore, some central government social benefits were streamlined and became means-tested, and the regime for special pensions was tightened. In addition, the performance of some SOEs improved following restructuring and stricter oversight. The government also started a pilot program to review the administrative burden on businesses with a view to reduce it in the services sector by at least 20 percent by end-2016.

34. Standard business environment indicators suggest significant room for further improvement (Figures 6 and 7). Although real labor market productivity has improved, peers have performed better. In addition, SOEs continue to play a substantial role in the economy; red tape remains substantial, especially at the local government level; and a weak business environment has been discouraging private investment, including FDI. Business surveys and interviews have highlighted the need for: (i) improving policy transparency and predictability; (ii) strengthening anti-corruption efforts and the judiciary system in general; (iii) reducing the regulatory burden and the large number and multiple layers of municipalities and public agencies; (iv) and further improving the ease of paying taxes. Implementing such reforms would be crucial to help increase Croatia's ease of doing business compared to other EU countries. Streamlining the large number of municipalities and public agencies would also help reduce red tape and the high administrative burden on businesses, while facilitating an improvement in the capacity to provide higher quality public services.

35. Given the high unemployment and low participation rates, more ambitious labor market reforms are needed. Recent gradual reforms have increased flexibility and reduced restructuring costs. However, some areas of employment protection, including the regulation on temporary forms of employment and the amount of severance payments and notification period for dismissal, remain restrictive compared to peers. Furthermore, there is a need for achieving a better balance between social protection and incentives to work. Staff encouraged the authorities to address these issues in order to increase labor force participation rates, which remains significantly below EU averages.

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36. Croatia's recent economic recovery is encouraging, but the return to a sustained and strong growth path is not yet assured. Real GDP is still about 11 percent lower than it was in 2008, and the medium-term growth prospects remain shy of converging towards EU average income levels. Unemployment and regional disparities within Croatia also remain high.

37. Structural rigidities and the large public and external debt increase the economy's vulnerability. Substantial structural and fiscal reforms have been lagging, undermining the business climate and placing Croatia on an unsustainable debt path. The recent fiscal consolidation and the newly launched NRP set the stage for promising reforms. Decisive implementation of these reforms will be critical to reduce vulnerabilities and boost growth and employment creation, as well as to facilitate an earlier exit from the EDP.

38. Fiscal policy has been reoriented with the firm intention to reduce the deficit and large public debt. However, the largely ad-hoc nature of the structural fiscal adjustment in 2015 is suboptimal. Furthermore, the 2016 budget's across-the-board expenditure control should be clearly viewed as a second-best approach. It is important that a more growth-friendly consolidation start next year.

39. The plan to simplify the tax system and possibly reduce some of the high taxes, is welcome, but would be premature if implemented before making progress in fiscal consolidation. The ongoing comprehensive tax review will also help design reforms to simplify the tax system. The adoption of a modern real estate tax in line with past TA recommendations would also be crucial to create fiscal space. Its success is contingent on timely implementation of required improvements in land registration and the cadastre.

40. The intentions to reduce inefficient public expenditures and to streamline the extensive and overlapping system of local government and public agencies are also encouraging. Reforming the public sector wages system and the complex regime of the various transfers and subsidies would help promote efficiency and equity, while generating fiscal savings. Advancing such reforms in the health sector in cooperation with the World Bank is particularly important in view of its large arrears and existing inefficiencies. Accelerating the absorption of EU funds would also support growth and employment creation in the context of the fiscal consolidation.

41. Monetary policy has been appropriately accommodative within the limitations of the exchange rate anchor. Maintaining an accommodative stance would be useful to support growth, as long as risks to financial stability and inflation remain subdued. At this juncture, there is no viable alternative to the quasi-peg given the high degree of euroization. The CNB is encouraged to smooth sharp fluctuations in the foreign exchange market and to look for further opportunities to boost reserves, in view of the relatively low level and strong balance of payments position.

42. The banking sector has remained robust throughout the long recession. To preserve this impressive record, it would be important to continue to exercise conservative prudential policies and supervisory vigilance, and to take prompt action when capital requirements are breached. Across-the-board bailouts similar to the conversion of the Swiss franc loans should be avoided in the future as they increase the risk of moral hazard and can affect Croatia's investor confidence. It is also critical to preserve the independence of the Central Bank, while maintaining transparency and accountability.

43. Decisive implementation of structural reforms is crucial to reduce the high unemployment and raise income levels towards the EU average over time. Key reforms include enhancing the efficiency of public administration and SOEs, and removing bureaucratic impediments to doing business. In this regard, it is very important to streamline the overlapping layers of government and public agencies. Strengthening the targeting of social benefits and improving the regulations governing seasonal hiring may reduce the reservation wage and increase labor market flexibility, which would help reduce unemployment and increase the low labor participation rate.

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

Table 1. Croatia: Selected Economic Indicators, 2010–17

Table 1. Croatia: Selected Economic Indicators, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
						Est.	Proj.	Proj.
Output, unemployment, and prices	(Percent change, unless otherwise indicated)							
Real GDP	-1.7	-0.3	-2.2	-1.1	-0.4	1.6	1.9	2.1
Contributions:								
Domestic demand	-4.7	-0.2	-3.4	-1.1	-1.7	1.2	1.9	2.2
Net exports	3.1	-0.1	1.1	0.0	1.3	0.4	0.0	-0.1
Unemployment (percent) /1	11.5	13.3	15.2	17.0	17.1	16.9	16.4	15.9
CPI inflation (average)	1.0	2.3	3.4	2.2	-0.2	-0.5	0.4	1.3
Growth in average monthly nominal wages	-0.4	1.5	1.0	0.8	0.2	1.3	...	...
Saving and investment	(Percent of GDP)							
Domestic investment	21.3	20.6	19.3	19.1	18.2	18.3	18.7	19.3
Of which: fixed capital formation	21.3	20.3	19.6	19.8	19.1	19.1	19.2	19.4
Domestic saving	20.2	19.8	19.1	19.9	19.0	23.5	21.7	21.5
Government	0.1	-1.5	-1.4	-0.7	-0.8	0.0	1.1	1.4
Nongovernment	20.1	21.3	20.5	20.6	19.8	23.5	20.7	20.1
Government sector 2/								
General government revenue	41.3	41.0	41.7	42.5	42.6	43.7	44.1	43.7
General government expenditure	47.5	48.8	47.0	47.8	48.1	46.9	46.9	46.3
General government balance 3/	-6.2	-7.8	-5.3	-5.3	-5.5	-3.2	-2.8	-2.6
Structural balance (IMF calculation)	-5.5	-7.2	-4.2	-4.0	-4.2	-2.4	-2.2	-2.2
General government debt	57.0	63.7	70.7	82.2	86.5	86.7	86.5	86.1
Money and credit	(End of period; change in percent)							
Claims on other domestic sectors 4/	2.4	4.4	-6.2	-1.3	-2.2	-3.0	...	...
Broad money (M4)	1.9	5.7	3.6	4.0	3.2	5.1	...	...
Interest rates	(End of period; percent)							
T-bill rate (3-Month, kuna denomiated) 5/	2.3	4.6	1.3	0.8	0.3	0.4	...	...
Kuna credit rate (unindexed) 6/	9.9	8.6	8.2	7.8	7.5	7.1	...	...
Real kuna credit rate (unindexed) 6/ 7/	8.8	6.2	4.6	5.5	7.7	7.6	...	...
Kuna credit rate, foreign currency-indexed 6/	7.8	7.0	6.8	6.6	6.1	5.8	...	...
Balance of payments	(Millions of euros, unless otherwise indicated)							
Current account balance	-503	-360	-61	341	368	2,293	1,360	1,004
Percent of GDP	-1.1	-0.8	-0.1	0.8	0.9	5.2	3.0	2.2
Capital and financial account	1,490	1,872	484	2,333	-341	-1,113	-357	-226
FDI, net (percent of GDP)	2.1	2.7	2.7	2.0	3.1	0.3	1.9	2.0
Overall balance	84	401	46	1,845	-530	745	1,004	778
Debt and reserves	(End of period; millions of euros, unless otherwise indicated)							
Gross official reserves	10,660	11,195	11,236	12,908	12,688	13,707	14,711	15,489
Percent of short-term debt (by residual maturity)	86	85	95	99	95	97	98	111
Months of following year's imports of goods and nonfactor services	7.0	7.4	7.3	8.1	7.3	7.4	7.3	7.1
Net international reserves	9,269	10,006	10,195	10,491	10,590	11,731	12,735	13,513
Reserves (Fixed, percent of RAM) 8/	72.7	74.5	76.5	85.9	82.9	88.7	93.3	98.0
External debt service to exports ratio (percent)	39.7	34.6	29.5	37.9	36.9	45.4	44.5	57.4
Total external debt (percent of GDP)	104.2	103.7	103.0	105.6	108.4	103.7	101.3	96.9
Net external debt (percent of GDP)	65.9	66.6	65.6	64.8	65.5	59.1	55.2	50.2
Exchange rate								
Kuna per euro, end of period	7.3	7.4	7.5	7.6	7.6	7.6	...	...
Kuna per euro, period average	7.3	7.4	7.5	7.6	7.6	7.6	...	...
Real effective rate (CPI, percent change) 9/	-2.6	-2.1	-1.9	1.4	-1.1	-3.0	...	...
Memorandum items:								
Nominal GDP (millions of euros)	45,025	44,744	43,962	43,522	43,051	43,921	44,922	46,388
Per capita GDP (2015): $11,556	Poverty rate : 9.8 percent (World Bank, 2014)							
Quota (2015): SDR 365.1 million (510.4 million U.S. dollars)								

Sources: Croatian authorities; and IMF staff estimates.

1/ Croatian Bureau of Statistics.

2/ ESA 2010 definition.

3/ The figure for 2016 is staff's projection. The authorities target fiscal deficit of 2.6 percent of GDP in 2016.

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

5/ Weighted monthly average daily interest rates at treasury bill auctions at the Ministry of Finance.

6/ Weighted monthly averages for outstanding amounts. Change of definition November 2011.

7/ Nominal interest rate deflated by past year's change in the CPI.

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

9/ Positive change means an appreciation and vice versa.

Table 2. Croatia: Medium-Term Baseline Scenario, 2010–21
(Percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Est.			Proj.			
Real sector (percent change)												
Real GDP	-1.7	-0.3	-2.2	-1.1	-0.4	1.6	1.9	2.1	2.2	2.3	2.3	2.0
Domestic demand	-4.5	-0.2	-3.4	-1.1	-1.7	1.2	2.0	2.4	2.6	2.9	2.9	2.9
Consumption, total	-1.5	0.2	-2.5	-1.3	-1.0	1.1	1.5	1.7	1.9	2.3	2.5	2.6
Of which: private	-1.5	0.3	-3.0	-1.8	-0.7	1.2	1.7	1.9	1.9	2.3	2.5	2.6
Gross fixed capital formation, total	-15.2	-2.7	-3.3	1.4	-3.6	1.6	2.0	3.0	4.0	4.2	5.0	5.0
Of which: private 1/	-8.3	-4.8	-4.2	0.4	-4.1	1.1	1.3	2.4	3.5	3.5	4.2	4.2
GDP deflator	0.8	1.7	1.6	0.8	0.0	0.1	0.4	1.1	1.5	1.7	1.9	2.0
CPI inflation (average)	1.0	2.3	3.4	2.2	-0.2	-0.5	0.4	1.3	1.7	1.9	2.0	2.0
CPI inflation (end-of-period)	1.9	2.0	4.7	0.3	-0.5	-0.7	0.8	1.5	1.8	1.9	2.0	2.0
Saving and investment												
Domestic investment	21.3	20.6	19.3	19.1	18.2	18.3	18.7	19.3	20.0	20.4	20.6	20.7
Of which: fixed capital formation	21.3	20.3	19.6	19.8	19.1	19.1	19.2	19.4	19.9	20.1	20.4	20.7
Domestic saving	20.2	19.8	19.1	19.9	19.0	23.5	21.7	21.5	21.5	21.1	20.5	20.0
Government	0.1	-1.5	-1.4	-0.7	-0.8	0.0	1.1	1.4	1.5	1.6	1.5	1.5
Nongovernment	20.1	21.3	20.5	20.6	19.8	23.5	20.7	20.1	20.0	19.4	19.0	18.5
General government finances												
Revenue	41.3	41.0	41.7	42.5	42.6	43.7	44.1	43.7	43.6	43.1	43.1	43.1
Expenditure	47.5	48.8	47.0	47.8	48.1	46.9	46.9	46.3	46.0	45.4	45.4	45.4
Balance	-6.2	-7.8	-5.3	-5.3	-5.5	-3.2	-2.8	-2.6	-2.4	-2.3	-2.3	-2.3
Government debt	57.0	63.7	70.7	82.2	86.5	86.7	86.5	86.1	85.1	83.6	82.6	81.6
Balance of payments 2/												
Current account balance	-1.1	-0.8	-0.1	0.8	0.9	5.2	3.0	2.2	1.5	0.7	-0.1	-0.7
Exports of goods, f.o.b.	17.9	19.6	19.7	20.5	22.7	24.4	25.5	26.6	27.5	28.4	29.3	30.3
Imports of goods, f.o.b.	31.1	33.8	34.1	35.7	37.5	39.6	40.9	43.3	45.6	47.8	50.0	52.2
Capital and financial account	3.3	4.2	1.1	5.4	-0.8	-2.5	-0.8	-0.5	-0.1	0.7	1.7	2.6
Of which: FDI, net	2.1	2.7	2.7	2.0	3.1	0.3	1.9	2.0	2.1	2.2	2.3	2.6
Gross official reserves	23.7	25.0	25.6	29.7	29.5	31.2	32.8	33.4	33.6	33.7	33.9	34.5
Gross external debt	104.2	103.7	103.0	105.6	108.4	103.7	101.3	96.9	92.7	89.5	86.2	84.0
Net external debt	65.9	66.7	65.7	64.9	65.6	59.1	55.2	50.2	45.9	42.5	39.0	36.2
Memorandum items:												
Nominal GDP (billions of kuna)	328.0	332.6	330.5	329.6	328.4	334.2	341.9	352.9	366.0	380.8	396.9	413.1
Nominal GDP (billions of euros)	45.0	44.7	43.9	43.5	43.0	43.9	44.9	46.3	48.1	50.0	52.1	54.3
Output gap	-2.9	-2.7	-4.4	-5.1	-5.1	-3.3	-2.2	-1.5	-0.9	-0.5	-0.1	0.0
Potential GDP growth	-0.3	-0.5	-0.4	-0.4	-0.3	-0.2	0.7	1.3	1.7	1.8	1.9	2.0

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

1/ Private investments encompass investments outside of the general government, and public enterprises that are not included in the general government (ESA 2010 definition).

2/ Based on BPM6 manual.

Table 3. Croatia: The Statement of Operations of General Government, 2010–21
(Percent of GDP, ESA 2010)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
							Proj.					
Revenue	**41.3**	**41.0**	**41.7**	**42.5**	**42.6**	**43.7**	**44.1**	**43.7**	**43.6**	**43.1**	**43.1**	**43.1**
Taxes	24.3	23.6	24.5	25.3	24.8	25.5	25.6	25.3	25.1	24.8	24.7	24.6
Income tax	6.0	5.8	5.7	5.9	5.7	5.5	5.5	5.4	5.3	5.3	5.3	5.2
VAT	11.6	11.3	12.3	12.7	12.5	13.0	13.0	12.9	12.8	12.6	12.6	12.6
Excise	3.7	3.4	3.4	3.8	4.0	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Import duities	0.5	0.5	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.9	2.8	2.8	3.3	3.2	3.5	3.5	3.5	3.5	3.4	3.3	3.3
Social contributions	11.8	11.6	11.5	11.3	11.8	11.9	11.9	11.8	11.6	11.4	11.3	11.3
Other revenue	2.1	2.3	2.4	2.2	2.3	2.3	2.5	2.6	2.8	2.8	3.1	3.2
Grants 1/	1.2	1.5	1.6	1.3	1.2	1.2	1.4	1.5	1.7	1.7	1.9	2.0
Property income	0.9	0.8	0.8	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
of which interest receivable:	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Sales of goods and services	3.0	3.4	3.4	3.7	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Expenditure	**47.5**	**48.8**	**47.0**	**47.8**	**48.1**	**46.9**	**46.9**	**46.3**	**46.0**	**45.4**	**45.4**	**45.4**
Expense	43.9	45.2	43.5	44.0	44.4	44.0	43.2	42.5	42.2	41.7	41.7	41.7
Compensation of employees	12.2	12.4	12.3	12.1	11.8	11.4	11.3	11.0	11.0	10.9	10.9	10.9
Use of goods and services	7.2	7.5	7.3	7.8	8.0	8.1	7.8	7.7	7.7	7.6	7.6	7.6
Interest, payable	2.6	3.0	3.4	3.5	3.5	3.6	3.5	3.5	3.4	3.3	3.3	3.3
Subsidies	2.5	2.4	2.2	2.1	2.0	1.7	1.6	1.5	1.3	1.3	1.3	1.3
Current grants 2/	0.9	0.6	0.8	1.6	1.3	1.9	1.8	1.7	1.7	1.6	1.6	1.6
Social benefits	15.7	16.1	16.3	15.9	16.6	16.4	16.2	16.1	16.1	16.0	15.9	15.9
Other expenses	2.9	3.0	1.3	1.1	1.4	1.0	1.0	1.1	1.1	1.1	1.1	1.1
Net acquisition of nonfinancial assets 3/	3.6	3.6	3.5	3.7	3.7	2.9	3.7	3.8	3.8	3.8	3.8	3.8
Overall Balance	**-6.2**	**-7.8**	**-5.3**	**-5.3**	**-5.5**	**-3.2**	**-2.8**	**-2.6**	**-2.4**	**-2.3**	**-2.3**	**-2.3**
Memorandum item:												
General government debt	57.0	63.7	70.7	82.2	86.5	86.7	86.5	86.1	85.1	83.6	82.6	81.6
Structural balance 4/	-4.3	-4.5	-3.9	-3.6	-3.6	-2.6	-2.2	-2.2	-2.2	-2.2	-2.3	-2.3

Sources: Eurostat and IMF staff estimates.

1/ Mostly EU structural funds.

2/ Non-capital transfers financed by the EU structrual funds and national co-financing.

3/ Data in 2015 are preliminary and subject to revision.

4/ In percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015.

Table 4. Croatia: Balance of Payments, 2010–21 /1
(Millions of Euros, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Est.	Proj.					
Current account	-503	-360	-61	341	368	2,293	1,360	1,004	701	349	-54	-353
Merchandise trade balance	-5,922	-6,382	-6,298	-6,589	-6,355	-6,635	-6,909	-7,747	-8,679	-9,677	-10,772	-11,859
Exports f.o.b.	8,058	8,743	8,673	8,923	9,761	10,730	11,452	12,312	13,237	14,227	15,294	16,446
Imports f.o.b.	-13,980	-15,124	-14,970	-15,512	-16,116	-17,365	-18,361	-20,059	-21,916	-23,904	-26,066	-28,305
Services Trade Balance	5,761	6,190	6,516	6,792	7,228	7,869	8,140	8,613	9,240	9,814	10,378	11,031
Export of services	8,928	9,358	9,636	9,824	10,218	11,261	11,876	12,594	13,390	14,260	15,227	16,386
Imports of services	-3,167	-3,169	-3,120	-3,032	-2,990	-3,391	-3,736	-3,981	-4,150	-4,446	-4,849	-5,355
Primary income balance	-1,403	-1,317	-1,441	-933	-1,402	-297	-1,159	-1,189	-1,230	-1,300	-1,306	-1,306
Secondary income balance	1,062	1,149	1,161	1,071	898	1,357	1,288	1,327	1,370	1,512	1,645	1,781
Capital and financial account	1,490	1,872	484	2,333	-341	-1,113	-357	-226	-56	369	886	1,388
Capital account	60	38	48	51	85	174	424	562	648	742	845	916
Financial account	1,430	1,834	436	2,282	-427	-1,288	-780	-788	-704	-374	41	472
Direct investment	943	1,205	1,197	858	1,314	145	856	914	988	1,079	1,190	1,385
Portfolio investment	402	582	1,744	1,891	-718	66	619	522	535	600	500	450
Financial derivatives	-253	-75	55	-9	-36	16	16	16	16	16	16	16
Medium- and long-term loans	-995	-760	-1,860	-1,221	134	-1,463	62	-320	-316	-144	-35	-38
Assets	46	24	-43	129	35	38	0	0	0	0	0	0
Liabilities	-950	-736	-1,903	-1,092	169	-1,425	62	-320	-316	-144	-35	-38
Disbursements	5,894	4,547	4,682	5,471	6,478	5,100	6,192	6,326	6,455	6,668	6,892	7,187
Amortization	-6,844	-5,284	-6,584	-6,563	-6,309	-6,487	-6,130	-6,646	-6,771	-6,811	-6,928	-7,224
Currency and deposits	496	1,242	-1,590	364	-1,429	-642	-1,557	-1,558	-1,540	-1,519	-1,256	-1,000
Short-term capital flows (net)	478	139	395	348	-78	685	-855	-466	-519	-568	-568	-568
Trade credits	348	-598	671	78	96	11	179	204	232	262	294	327
Other liabilities (long-term)	11	100	-127	25	289	-107	-100	-100	-100	-100	-100	-100
Net errors and omissions	-903	-1,111	-377	-830	-557	-435	0	0	0	0	0	0
Overall balance	84	401	46	1,845	-530	745	1,004	778	646	717	832	1,035
Financing												
Gross reserves (-= increase)	-84	-401	-46	-1,845	530	-745	-1,004	-778	-646	-717	-832	-1,035
Memorandum items:												
Current account (percent of GDP)	-1.1	-0.8	-0.1	0.8	0.9	5.2	3.0	2.2	1.5	0.7	-0.1	-0.7
Export goods volume growth	18.8	-0.6	-2.1	5.7	12.1	12.1	9.4	8.5	8.3	8.1	7.9	7.5
Import goods volume growth	-2.3	3.5	-2.7	4.7	5.6	8.8	8.8	8.9	8.9	8.9	8.9	9.0
Gross official reserves	10,660	11,195	11,236	12,908	12,688	13,707	14,711	15,489	16,135	16,852	17,684	18,719
Reserves: Gross Official Reserves (percent of short-term debt by remaining maturity)	85.8	85.4	95.0	98.7	95.0	97.1	97.6	110.8	111.3	112.2	112.6	...
Months of next year's imports of goods and nonfactor services	7.0	7.4	7.3	8.1	7.3	7.4	7.3	7.1	6.8	6.5	6.3	...
Outstanding debt 2/	46,908	46,397	45,297	45,958	46,664	45,534	45,502	44,955	44,617	44,819	45,004	45,625
External debt to GDP ratio 2/	104.2	103.7	103.0	105.6	108.4	103.7	101.3	96.9	92.7	89.5	86.2	84.0
External debt in percent of exports of goods and nonfactor services 2/	276.2	256.3	247.4	245.1	233.6	207.1	195.1	180.5	167.6	157.3	147.5	139.0
GDP (millions of euros)	45,025	44,744	43,962	43,522	43,051	43,961	45,007	46,509	48,270	50,254	52,517	54,263
GDP (millions of kuna)	328,040	332,587	330,455	329,572	328,431	334,219	341,903	352,857	366,029	380,843	396,915	413,134

Sources: Croatian National Bank; and IMF staff estimates.

1/ BPM 6 definition.

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

Table 5. Croatia: Monetary Accounts, 2010–15

(End-period; billion of Kuna, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016 Q1
Monetary survey							
Net foreign assets	41.9	31.2	47.5	62.3	75.1	92.9	84.9
(Millions of euros)	5.7	4.2	6.3	8.2	9.8	12.2	11.1
Croatian National Bank	76.1	81.6	82.1	95.4	93.5	91.7	85.3
(Millions of euros)	10.3	10.9	10.9	12.5	12.2	12.0	11.2
Deposit money banks	-34.2	-50.4	-34.7	-33.0	-18.4	1.2	-0.4
(Millions of euros)	-4.6	-6.7	-4.6	-4.3	-2.4	0.2	0.0
Net domestic assets	190.9	214.8	207.3	202.6	198.2	194.5	194.8
Domestic credit (CNB definition)	245.6	257.4	242.1	240.8	237.0	230.0	224.8
Claims on government, net 1/	31.0	46.5	58.8	56.2	60.0	65.9	66.6
Claims on other domestic sectors 2/	237.9	248.4	232.9	229.9	224.9	218.1	213.0
Other items (net)	-54.6	-42.6	-34.8	-38.2	-38.8	-35.6	-29.9
Broad money (M4)	232.8	246.0	254.7	264.9	273.3	287.4	280.4
Narrow money	48.0	51.5	51.9	57.9	63.4	70.7	67.6
Currency outside banks	15.3	16.7	16.9	17.4	18.5	20.1	19.8
Demand deposits	32.7	34.8	35.0	40.5	44.9	50.5	47.8
Quasi money	184.8	194.5	202.8	207.0	209.9	216.7	212.8
Kuna-denominated	30.1	42.3	42.4	44.4	45.0	45.4	45.7
Foreign currency-denominated	154.7	152.2	160.4	162.7	164.9	171.3	167.1
Balance sheet of the Croatian National Bank							
Net foreign assets	76.1	81.6	82.1	95.4	93.5	91.7	85.3
Of which: banks' reserves in foreign currency	4.8	5.5	5.1	4.4	3.7	3.8	0.0
Net international reserves	68.6	75.5	77.0	80.3	81.2	84.8	83.3
Net domestic assets	-13.8	-13.7	-12.9	-26.3	-26.3	-24.1	-23.8
Claims on government (net)	-4.2	-1.6	-0.7	-13.8	-11.6	-8.1	-8.3
Claims on banks	0.01	0.14	0.01	0.01	0.01	0.17	0.06
Claims on other domestic sectors	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	-9.7	-12.2	-12.2	-12.5	-14.8	-16.2	-15.5
Reserve money (CNB definition) 3/	56.3	62.4	61.3	62.7	63.3	63.7	62.7
Of which:							
Currency outside credit institutions	15.3	16.7	16.9	17.4	18.5	20.1	19.8
Kuna deposits of credit institutions	36.9	41.4	39.6	40.7	40.2	38.4	37.7
Of which:							
Settlement accounts	10.2	12.7	11.5	15.1	15.1	16.1	16.1
Statutory reserves in kuna	22.7	25.8	24.6	22.0	21.9	22.3	21.6
Year-on-year percent changes							
Monetary survey:							
Net domestic assets	-5.4	12.5	-3.5	-2.3	-2.2	-1.9	-0.4
Domestic credit (CNB definition)	4.7	4.8	-5.9	-0.5	-1.6	-2.9	-6.1
Claims on government, net 1/	26.5	50.0	26.5	-4.4	6.7	9.8	11.8
Claims on other domestic sectors 1/	2.4	4.4	-6.2	-1.3	-2.2	-3.0	-6.6
Broad money (M4)	1.9	5.7	3.6	4.0	3.2	5.1	3.4
Quasi money	1.9	5.2	4.3	2.1	1.4	3.3	1.2
Balance sheet of the Croatian National Bank:							
Reserve money (CNB definition) 3/	0.2	10.9	-1.8	2.3	1.0	0.7	-3.1
Memorandum items:							
Nominal GDP (yearly total)	328.0	332.6	330.5	329.6	328.4	334.2	336.0
Narrow money multiplier	0.77	0.76	0.75	0.84	0.94	1.04	1.08
Broad money multiplier	3.74	3.61	3.68	3.83	4.07	4.25	4.47
Broad money (percent of GDP)	71.0	74.0	77.1	80.4	83.2	86.0	83.5
Foreign currency (percent of broad money)	66.5	61.9	63.0	61.4	60.3	59.6	59.6
Credit to other domestic sectors: stock (% of GDP)	72.5	74.7	70.5	69.8	68.5	65.3	63.4
Credit to other domestic sectors: 12-month flow (percent of GDP)	1.7	3.2	-4.7	-0.9	-1.5	-2.0	-4.5

Sources: Croatian National Bank; and IMF staff estimates.

Note: As of January 2015, the Croatian National Bank started publishing monetary statistics in line with ESA 2010. Historical figures may

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

2/ Comprises claims on households and enterprises. Excludes other banking institutions (household savings banks, savings and loan financial institutions.

3/ Excludes statutory reserves in foreign currency.

Table 6. Croatia: Financial Soundness Indicators, 2010–15

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015			
						Mar.	Jun.	Sep.	Dec. Prel.
Core set									
Regulatory capital to risk-weighted assets	18.8	20.5	20.9	20.9	21.8	21.9	22.3	20.0	21.0
Regulatory Tier I capital to risk-weighted assets	17.5	19.1	19.6	19.9	20.6	20.6	20.8	18.5	19.2
Nonperforming loans net of loan-loss provisions to capital	34.5	37.8	39.2	42.8	41.1	41.4	36.5	38.2	34.2
Nonperforming loans to total gross loans 1/	11.1	12.3	13.8	15.4	16.7	16.9	17.1	16.8	16.3
Sectoral distribution of loans to total loans									
Nonfinancial corporations	37.5	38.5	34.1	35.4	34.9	34.9	35.0	34.0	33.8
Households	46.0	44.3	44.8	44.2	46.2	46.6	47.1	46.3	46.4
Other sectors	15.7	16.6	20.2	19.5	17.7	17.1	16.5	18.0	17.7
Nonresidents	0.7	0.6	0.9	0.9	1.1	1.1	1.2	1.3	1.8
Return on assets	1.2	1.2	0.9	0.3	0.7	0.7	0.8	-1.4	-1.1
Return on equity	8.3	8.7	6.1	2.4	5.0	5.2	6.0	-10.2	-7.8
Net interest income to gross income	64.3	66.1	65.6	62.9	61.1	70.5	66.7	65.7	64.5
Noninterest expenses to gross income	55.7	55.1	57.8	59.2	57.1	62.1	75.7	93.2	94.4
Liquid assets to total assets 2/	33.7	31.7	31.3	30.7	33.0	31.3	33.0	37.7	34.2
Liquid assets to short-term liabilities 2/	50.6	48.2	48.2	46.6	51.7	48.9	51.0	56.4	51.7
Net open position in foreign exchange to capital	2.9	1.7	2.3	2.9	2.9	2.0	1.8	3.9	12.5
Encouraged set									
Deposit takers 3/									
Capital to assets	13.8	13.6	14.2	13.9	14.0	13.9	13.8	12.2	12.7
Large exposures to capital	39.0	48.6	43.0	52.5	65.8	…	…	…	…
Geographical distribution of loans to total loans									
Residents	99.3	99.4	99.1	99.1	98.9	98.9	98.8	98.7	98.2
Nonresidents	0.7	0.6	0.9	0.9	1.1	1.1	1.2	1.3	1.8
Gross asset position in derivatives to capital	0.3	1.2	1.6	2.8	2.4	5.4	4.5	4.9	4.8
Gross liability position in derivatives to capital	2.7	2.5	3.0	3.3	2.1	13.9	13.8	12.2	12.7
Trading income to total income	8.0	6.8	6.9	4.6	7.3	-20.7	-5.5	3.8	5.2
Personnel expenses to noninterest expenses	40.6	40.6	40.5	40.3	41.2	40.2	32.9	24.8	24.4
Spread between domestic lending and deposit rates	4.7	4.5	4.7	4.7	4.9	4.7	4.7	5.0	4.9
Noninterbank loans to noninterbank deposits	80.0	77.5	81.3	83.5	83.8	82.7	84.6	88.8	90.4
Foreign currency-denominated loans to total loans 4/	74.3	75.1	73.7	74.1	69.1	68.8	68.2	74.0	75.0
Foreign currency-denominated liabilities to total liabilities 4/	77.0	77.2	77.8	67.7	73.5	67.5	66.9	65.5	65.3
Net open position in equities to capital	4.9	6.7	6.2	7.1	6.0	5.9	6.4	10.0	9.9
Other financial corporations (OFCs)									
OFCs' assets to total financial system assets	24.8	24.4	26.1	27.0	27.2	27.7	28.0	27.3	28.2
OFCs' assets to GDP	39.9	40.0	43.0	44.7	45.7	47.0	47.5	46.9	47.2
Households									
Bank loans to households to GDP	40.7	40.5	40.0	39.1	37.2	41.7	41.3	40.4	…
Real estate markets									
Residential real estate prices (annual percentage increase)	-9.0	-1.7	-4.3	-14.4	1.2	1.2	3.0	*-3.1*	*-2.1*
Residential real estate loans to total loans	22.2	21.8	22.3	22.1	22.4	22.9	23.0	22.5	22.2
Other indicators									
Loan-loss provisions to nonperforming loans	38.8	41.3	42.5	46.3	51.0	51.9	57.9	59.4	61.9
Change in credit to GDP ratio	6.0	6.6	-0.2	-1.3	-4.2	-1.3	0.7	-1.0	-1.8
Net interest income to average total assets	2.8	2.8	2.6	2.5	2.5	0.6	1.3	1.9	2.7
Noninterest expenses to average total assets	2.4	2.4	2.3	2.3	2.3	0.6	1.4	2.7	3.9
Loans to assets	13.8	13.6	14.2	13.9	14.0	13.9	13.8	12.2	12.9
Liquid assets to total deposits	60.1	57.5	54.6	51.2	56.0	53.3	55.8	62.2	54.3

Source: Croatian National Bank.

Note: The classifications used in the table are consistent with the IMF's Financial Soundness Indicators Database.

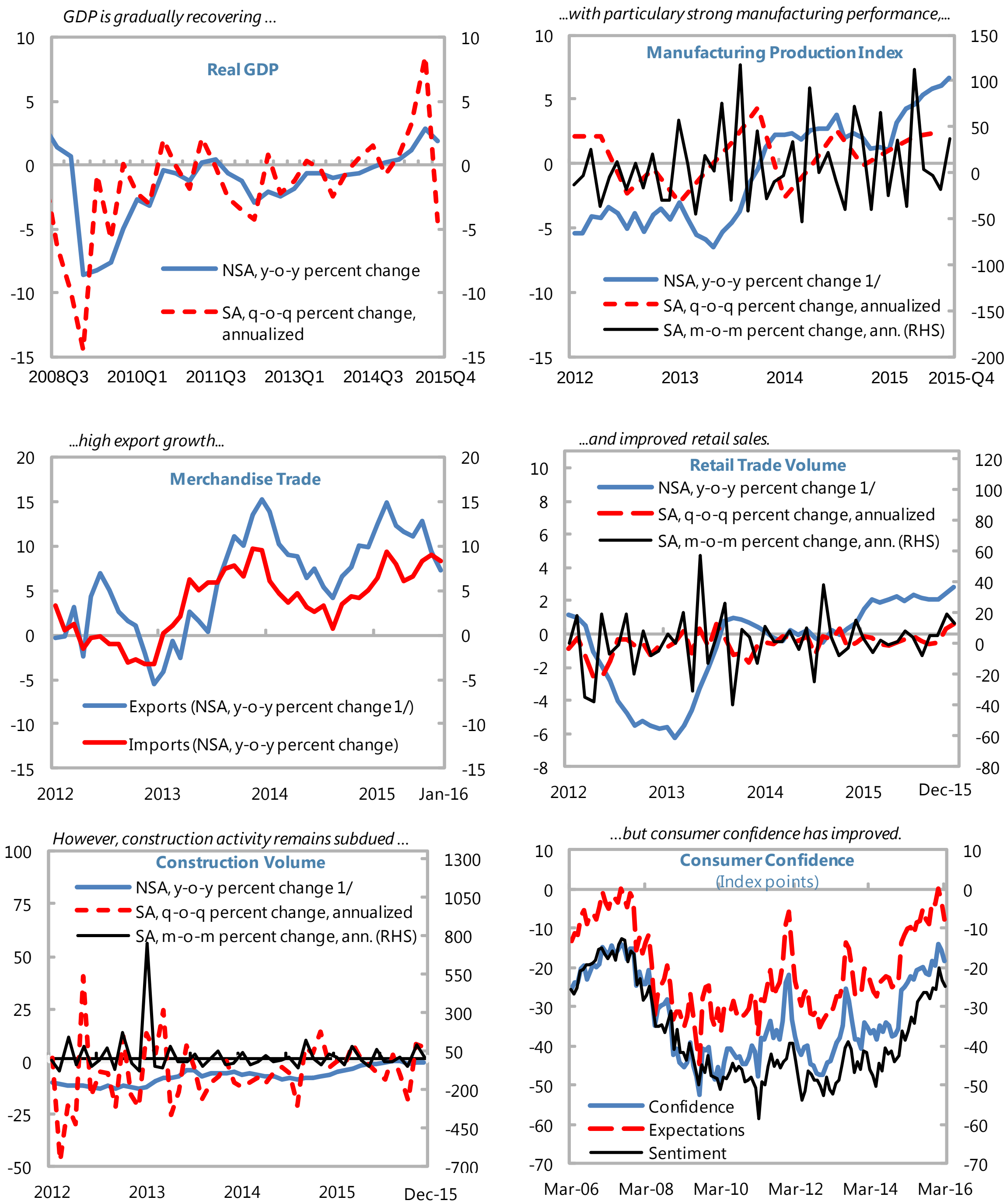
1/ Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims.

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.

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.

Figure 1. Croatia: Short-Term Indicators

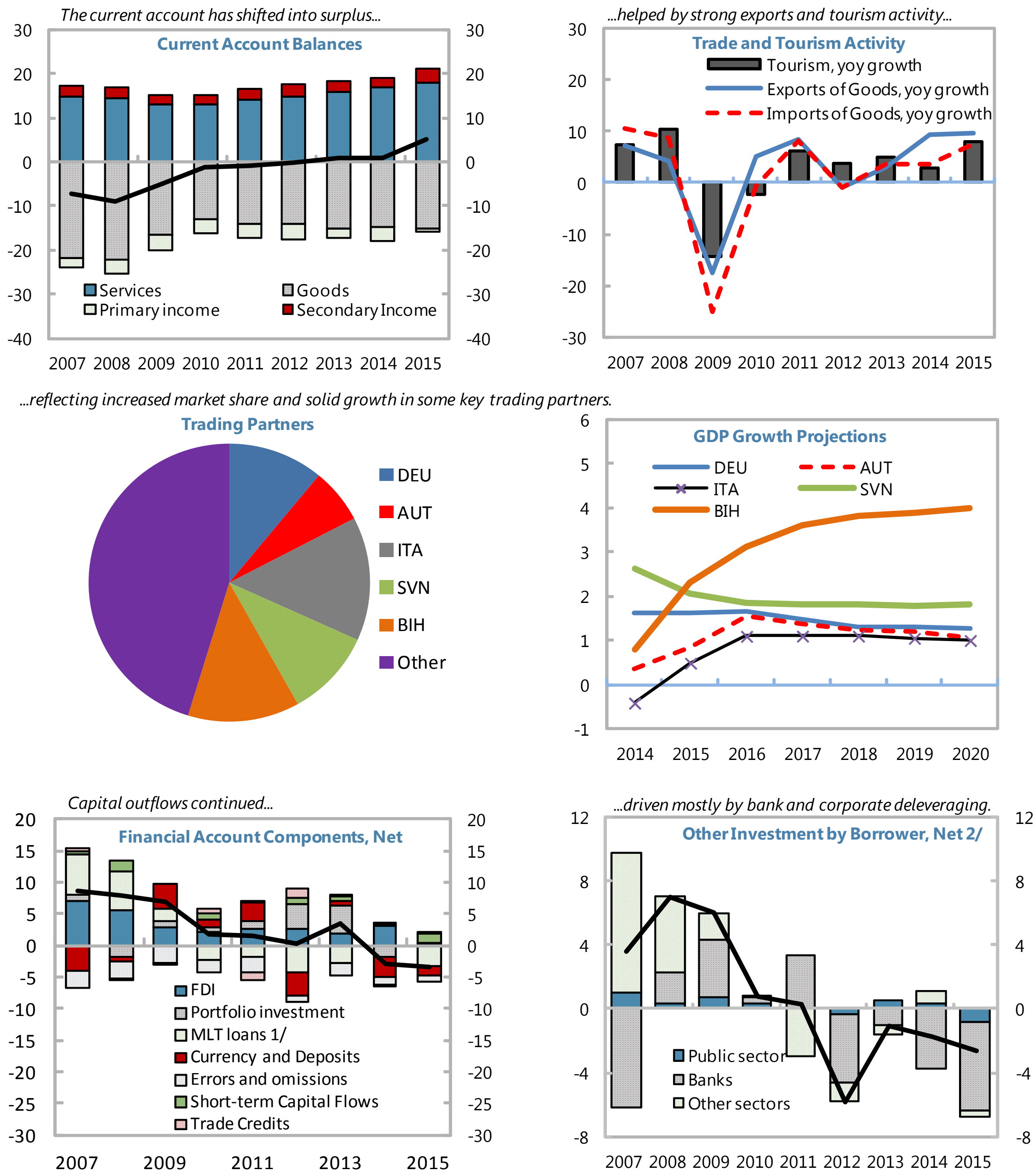


Sources: Croatian Central Bureau of Statistics; Croatian National Bank; and IMF staff calculations.

1/ 6 months rolling average.

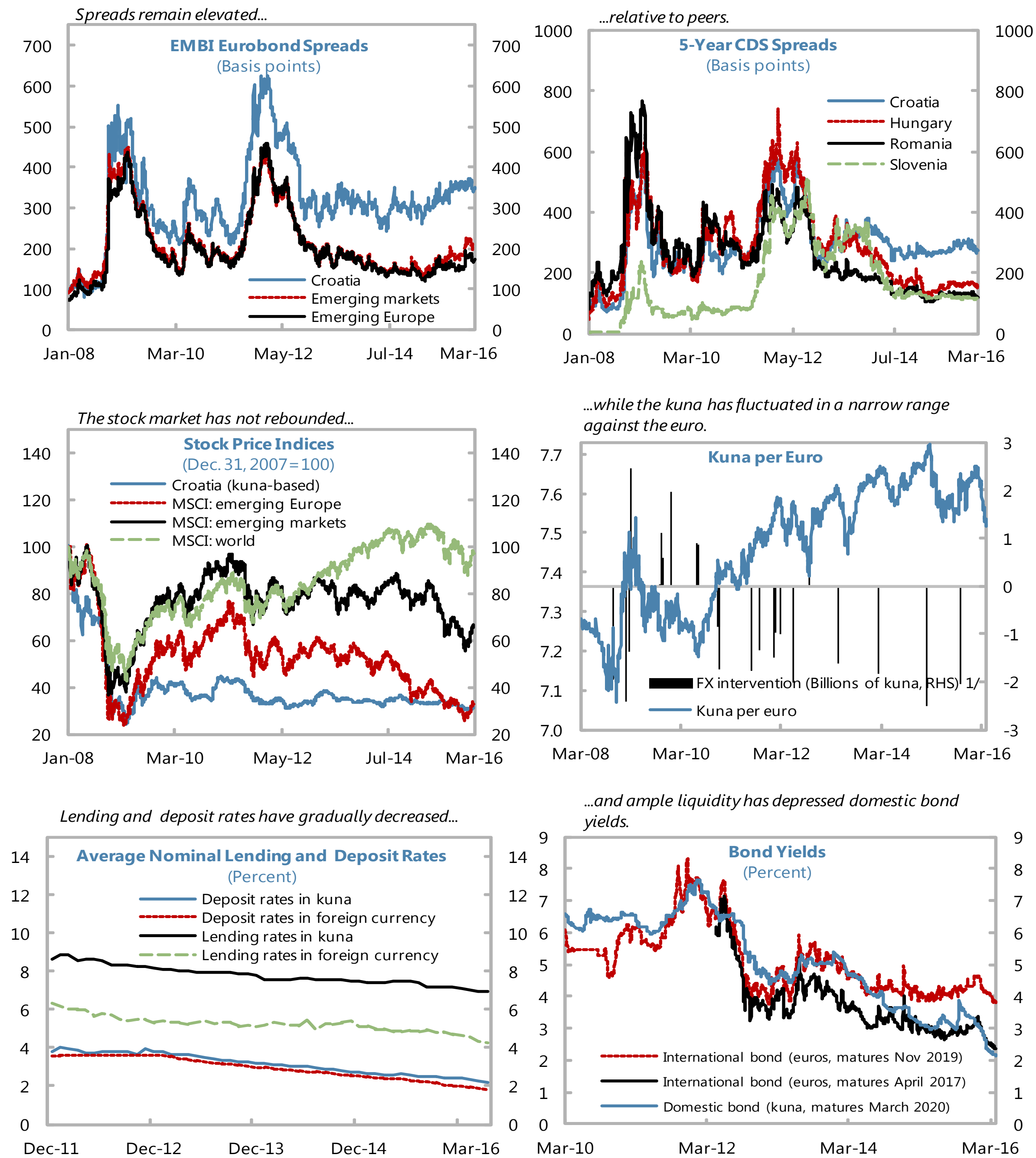
Figure 2. Croatia: Balance of Payments, 2007–15

(Percent of GDP)



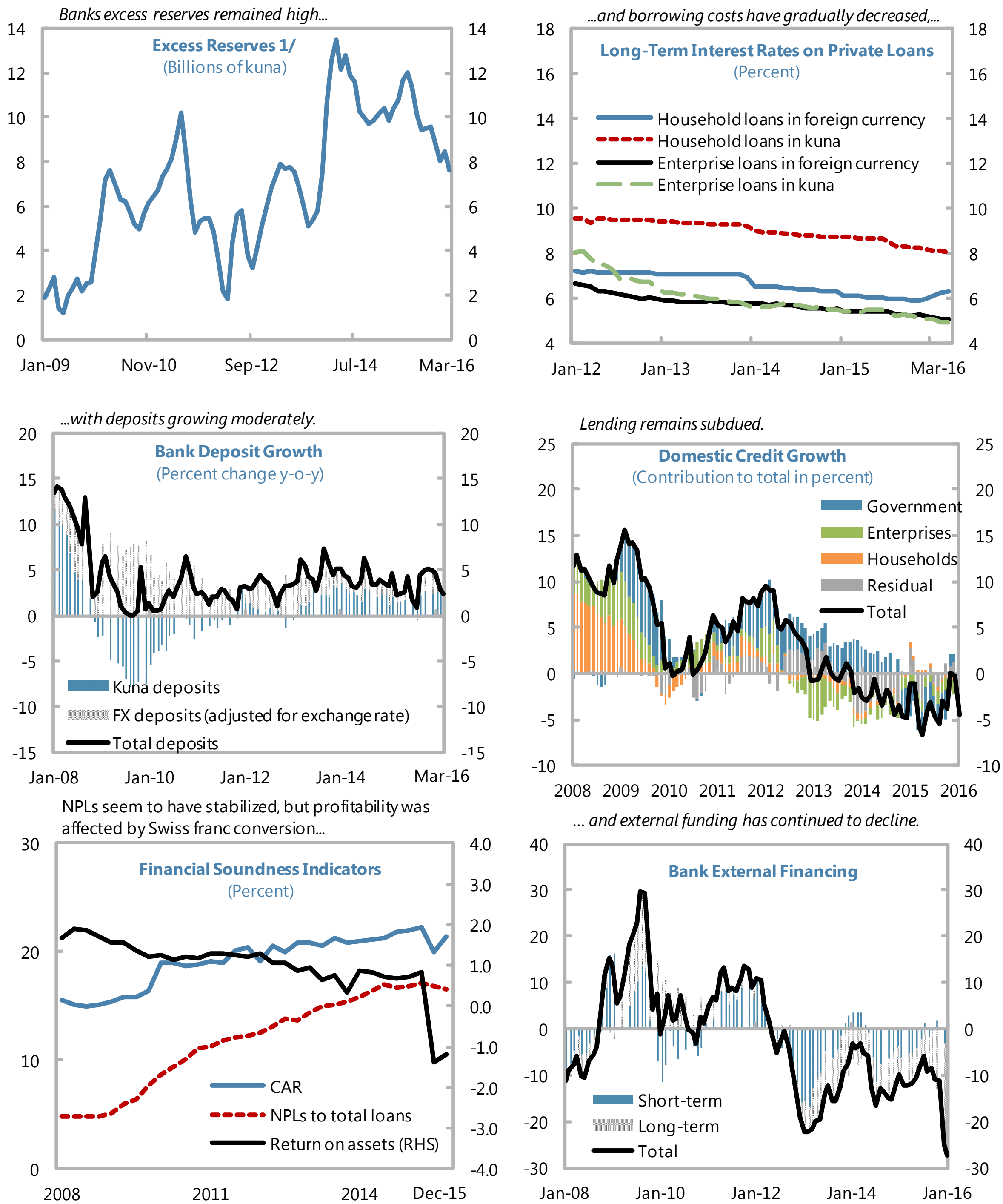
Sources: Croatian National Bank; and IMF staff estimates.
1/ MLT loans - Medium and long-term loans.
2/ Other investments consists of the of currency and deposits, loans, short-term capital flows, medium and long-term flows, and trade credits.

Figure 3. Croatia: Financial Market Developments, 2008–15



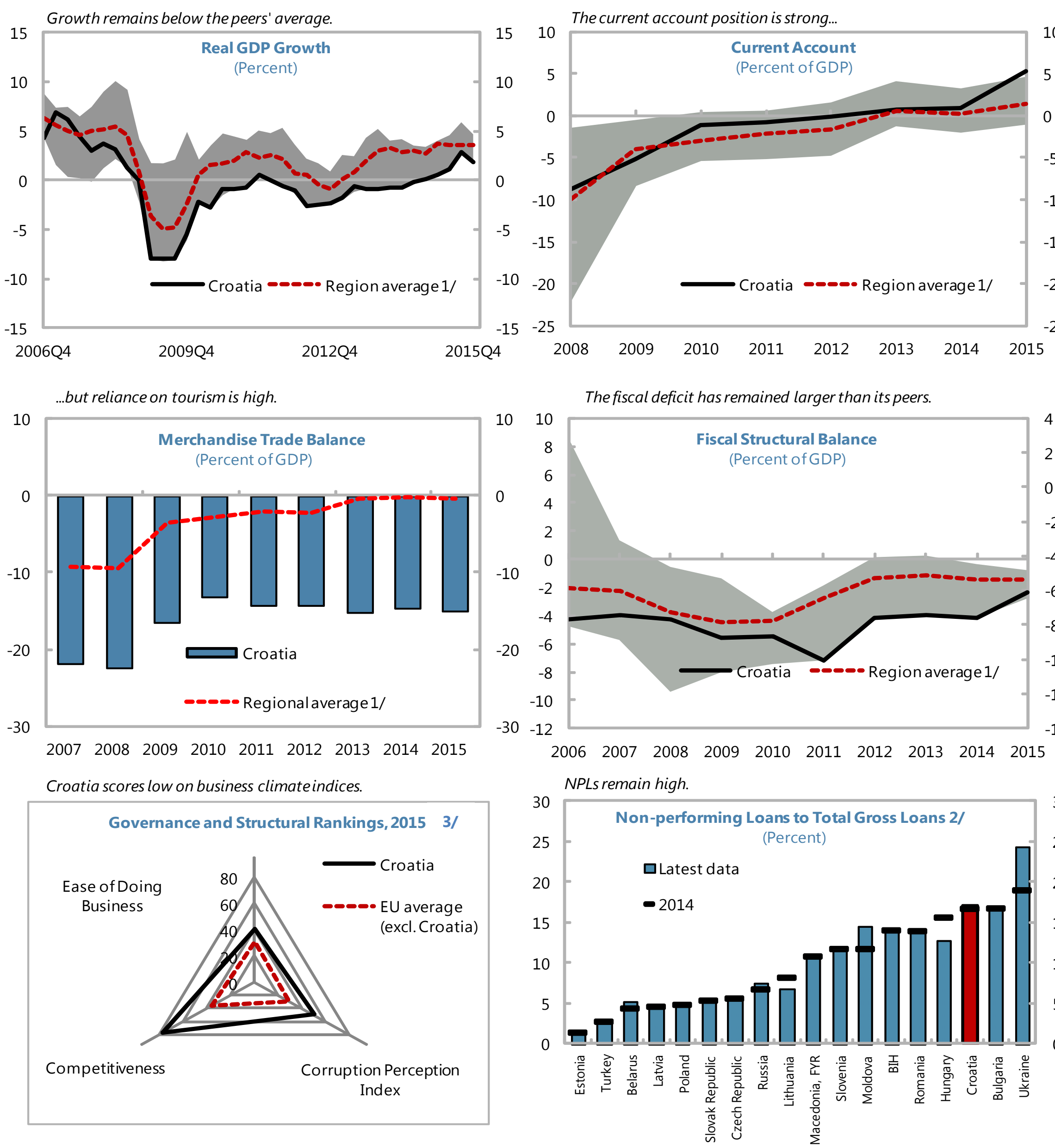
Sources: Bloomberg; Croatian National Bank; and IMF staff calculations.
1/ Positive (negative) sign indicates purchase (sale) of FX.

Figure 4. Croatia: Monetary and Banking Sector Updates, 2008–15



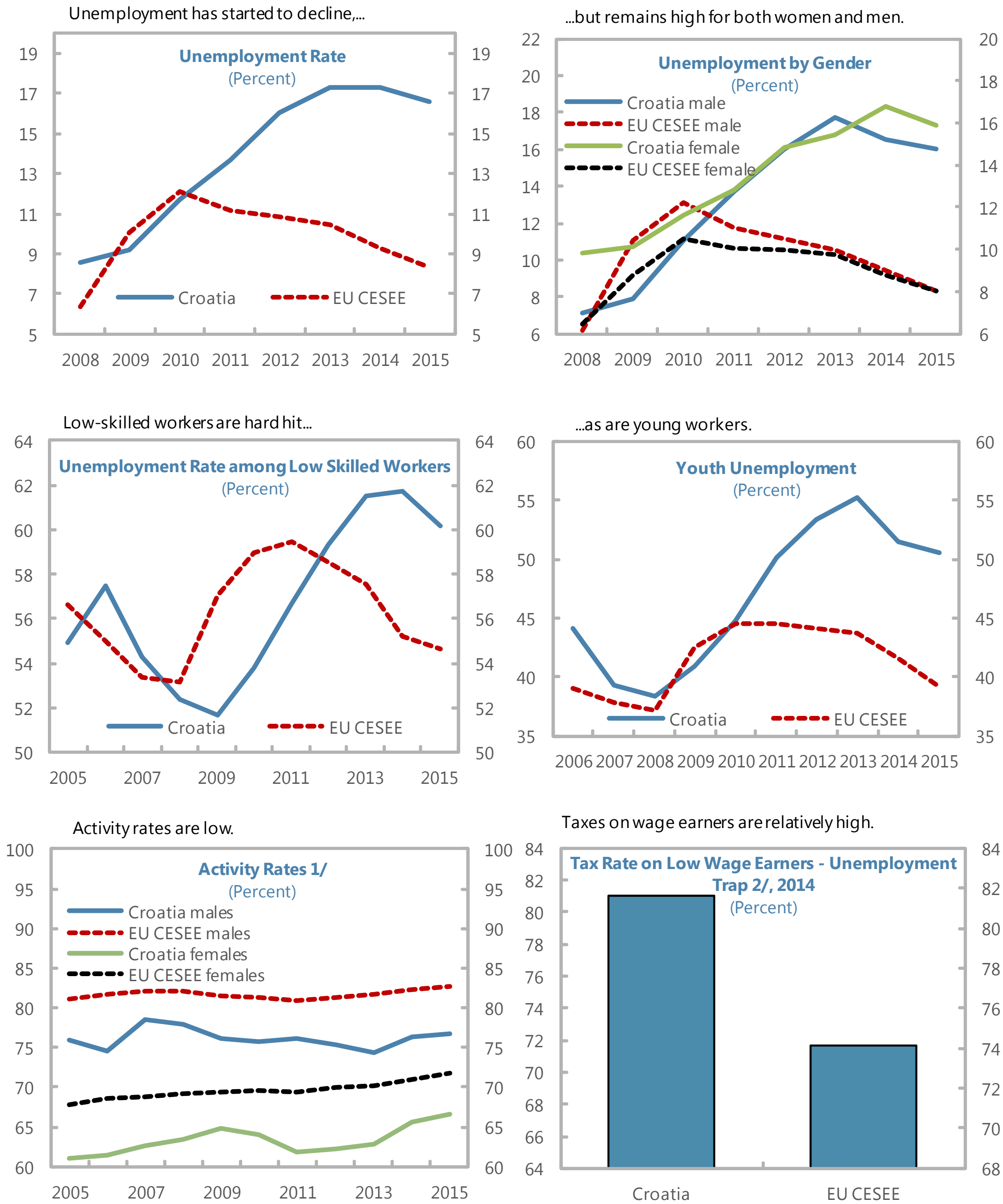
Sources: National Bank of Croatia; and IMF staff estimates and calculations.
1/ Reserves are a 3-month moving average, in billions of kuna.

Figure 5. Croatia Compared to Peers



Sources: Transparency International; World Bank; World Economic Forum; IMF, *Financial Soundness Indicators*; and WEO.
1/ 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.
2/ NPL definitions differ across countries. Data are from the IMF Financial Soundness Indicators database.
3/ Out of 189 countries for Ease of Doing Business, 168 countries for Corruption Perception, and 144 countries for Competitiveness.

Figure 6. Croatia: Labor Market Developments, 2008–15

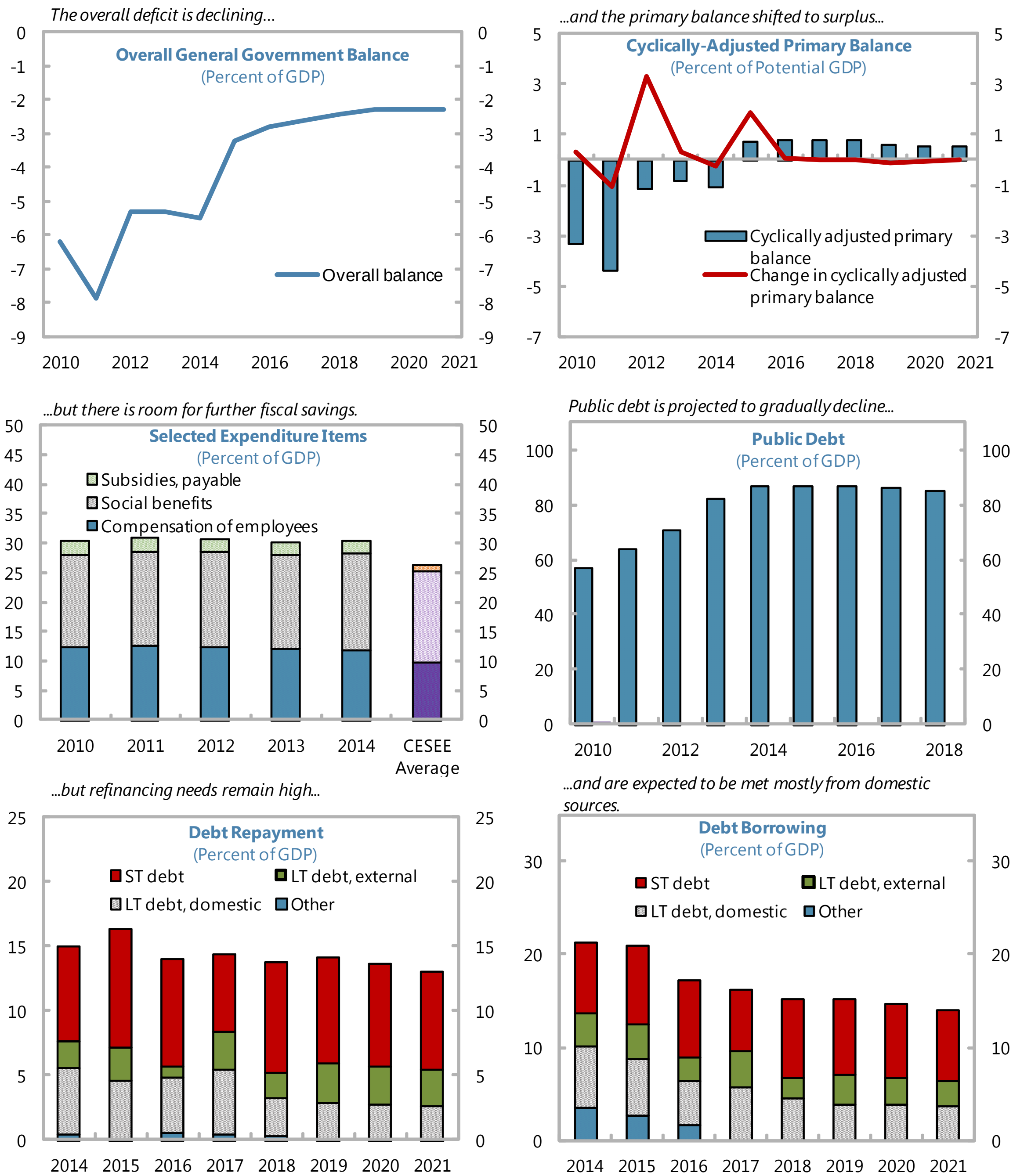


Sources: Eurostat; IMF staff calculations.
1/ Activity rates among the population ages 20 to 64. This measure is different from the participation rate, reported by the World Bank database for 2014 at 51.2 percent and defined as the proportion of the population aged 15 and older that is employed or seeking employment.
2/ Unemployment trap measures percentage of gross earnings which is taxed away through higher tax and social security

Figure 7. Croatia: Business Environment, 2015–16

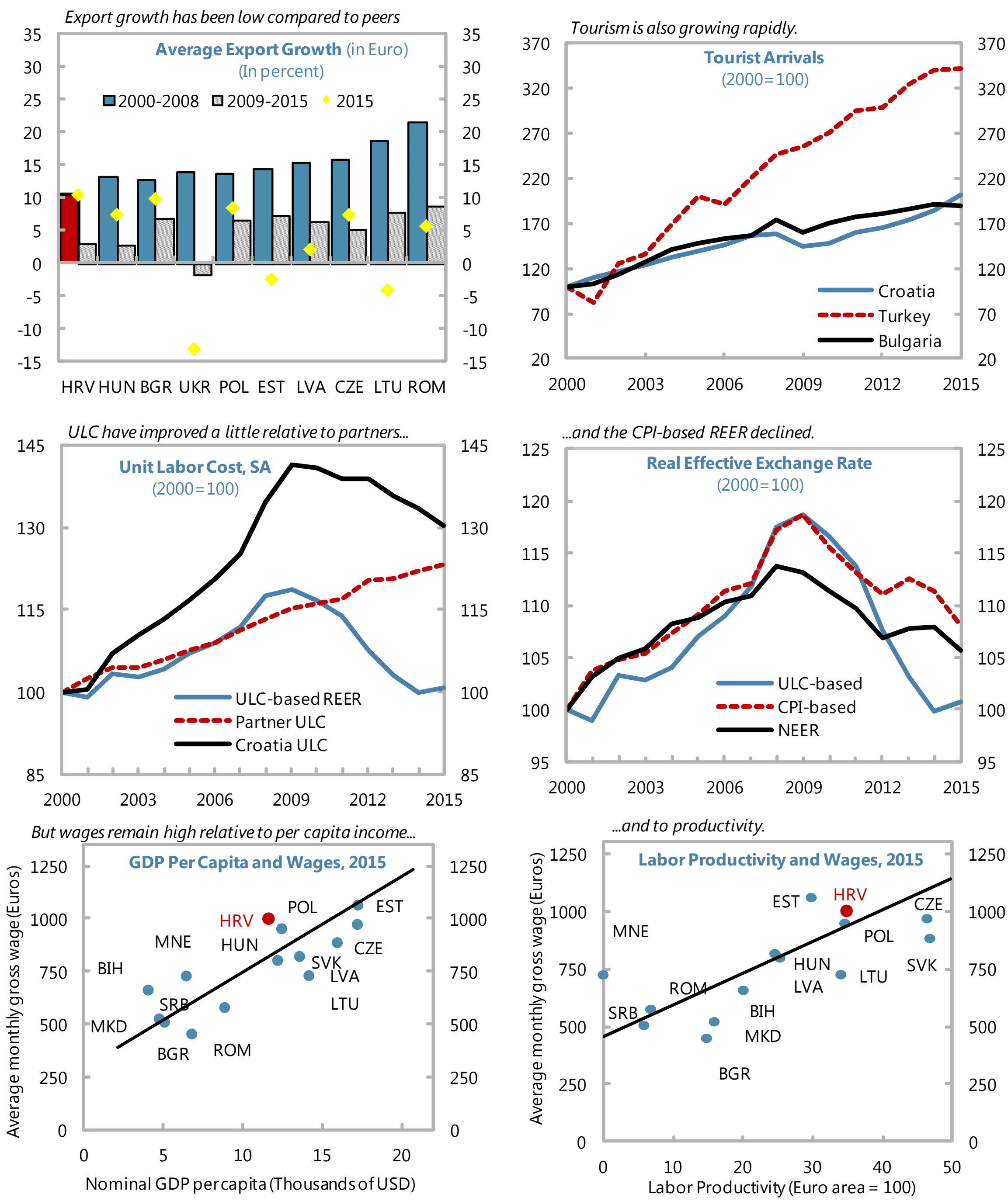
Sources: World Bank, *Doing Business*; World Economic Forum, *Global Competitiveness Report*; Heritage Foundation, *Economic Freedom Index*; and IMF staff calculations.
1/ Ranking out of 189 countries. Rankings are benchmarked to June 2015.
2/ Ranking out of 144 countries. Rank for 2014-15.

Figure 8. Croatia: Fiscal Developments, 2010–18



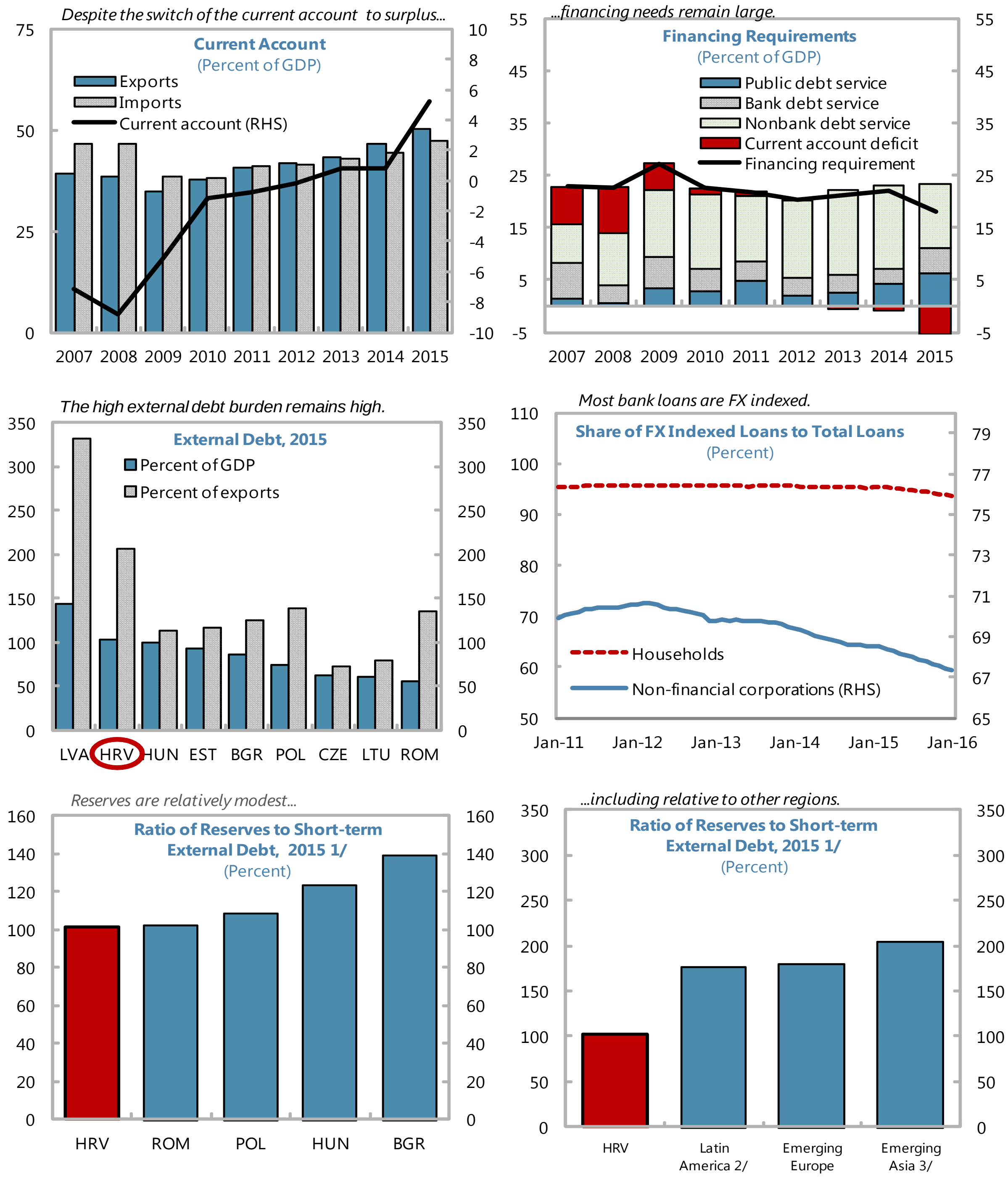
Sources: Croatian authorities; and IMF staff estimates.

Figure 9. Croatia: Competitiveness Indicators, 2000–15



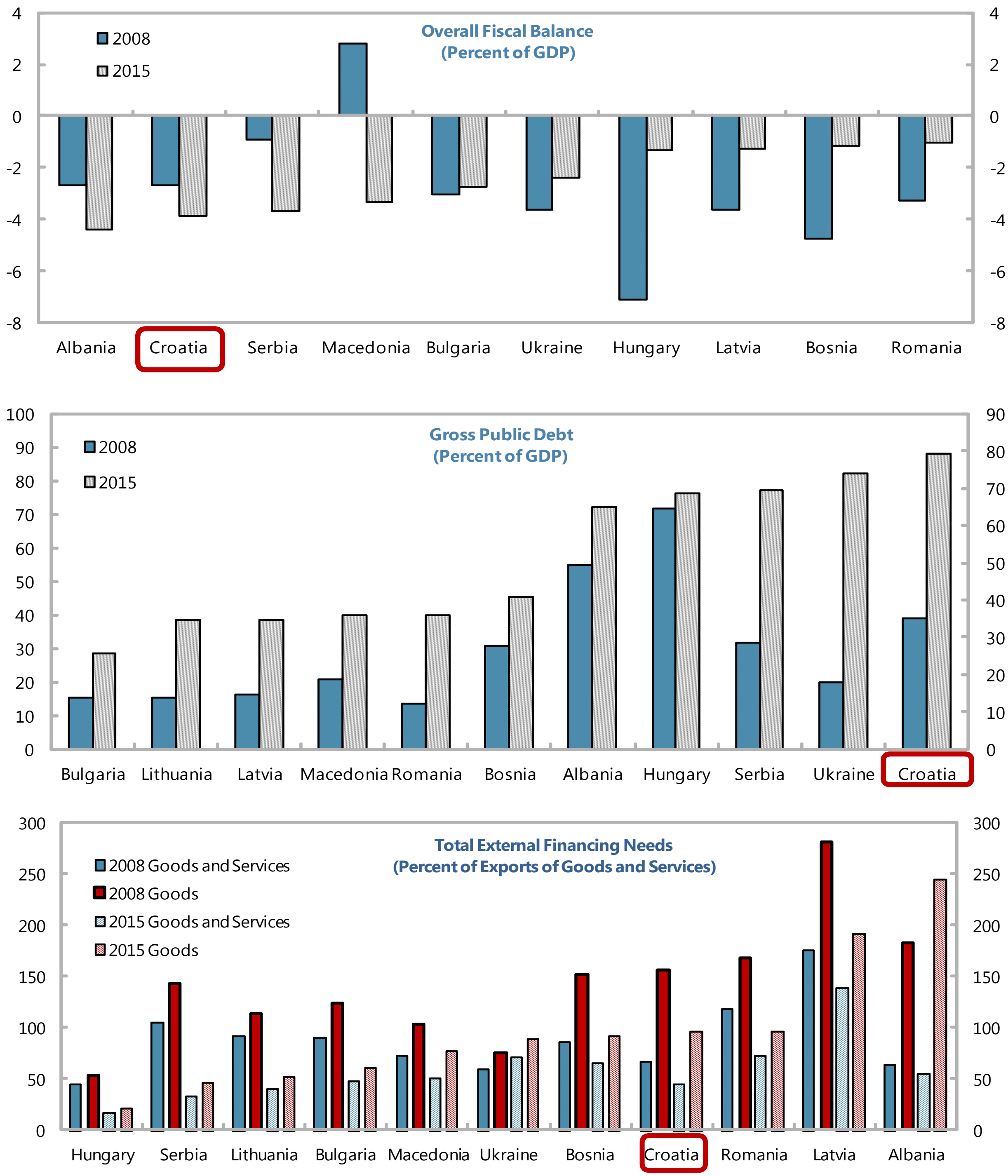
Sources: Croatian authorities; Haver; OECD; World Bank, *Doing Business Indicators*; IMF, *IFS; DxTime*; IMF, *World Economic Outlook*; and IMF staff estimates and calculations.

Figure 10. Croatia: Vulnerability Indicators, 2007–15



Sources: Croatian National Bank; IMF, *World Economic Outlook*; and IMF staff estimates.
1/ Gross international reserves are end-2015 stocks. Short-term debt at original maturity (end -2015) plus projected amortization of medium and long-term debt (end-2015).
2/ Excludes Brazil.
3/ Excludes China.

Figure 11. Croatia: Vulnerability Indicators vs. Regional Peers, 2008–15

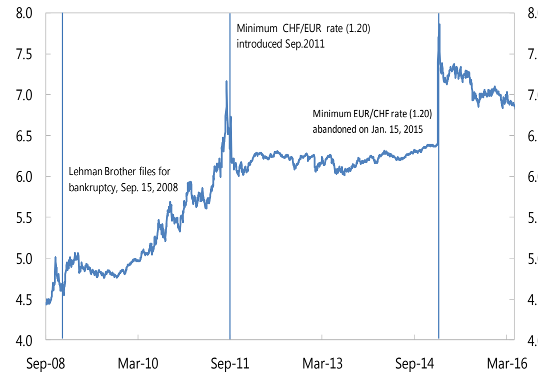


Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

Annex I. Conversion of Swiss Franc Loans to Euro[1]

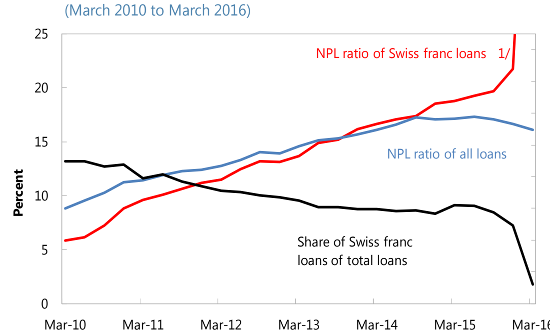
1. **The Swiss franc appreciation vis-à-vis the kuna (about 55 percent from September 2008 to September 2015) caused problems for many un-hedged Croatian households**. Loans indexed to Swiss franc loans were often preferred by wealthier households for mortgages due to lower interest rates. The burden on the approximately 53,000 households with these loans increased with the appreciation of the franc, the share of these loans declined (to 7.4 percent of GDP at end-2014, i.e. before conversion measures were taken). The non-performing-loan ratio increased and several law suits were filed against banks, arguing that they had not properly been informed about the risks. When the Swiss National Bank abandoned the CHF/EUR floor on January 15, 2015, the Croatian Parliament temporarily froze the exchange rate for repayments of Swiss franc household loans, but the scope was quickly broadened to cover individual entrepreneurs. The intention was to find a negotiated resolution between debtors and banks during the one-year freeze, but this did not happen.

Croatian Kuna/Swiss Franc Exchange Rate
(2008-2016)



Source: Bloomberg

Croatia: Non-Performing Swiss Franc Loans
(March 2010 to March 2016)



Source: Croatian National Bank.
Note: Non-performing loans (NPL) mean 90 days overdue and classified B or C.
1/ Increased from 22 percent at end-2015 to 55 percent at end-March 2016, due to the conversion.

2. **Instead, in September 2015, the Parliament adopted legislation requiring banks to offer their clients to retroactively convert their clients' Swiss franc denominated or indexed loans to euro**. Past principal and interest payments on Swiss franc loans were recomputed as if borrowers had been indebted in variable rate euro loans. By April 2016, about 5,000 loans were reportedly still in the process of conversion, although almost 94 percent (amount) had been converted. The cost to banks has been estimated at about 2 percent of GDP by the CNB. Banks have on average remained profitable, even during the prolonged recession, but the conversion resulted in their making a loss in 2015. Although sizable, this was manageable from a financial stability perspective due to the high bank capitalization (CAR of 20.9 percent at end-2015). Households with Swiss franc loans reduced their debt and substantial uncertainty was removed. Currency risk, however, has been substituted by

[1] Prepared by Tonny Lybek.

interest risk. Following the decision, the CNB intervened in the FX market (€268 million) and provided domestic liquidity with a view to prevent excess volatility. The government is also facing a revenue loss, as banks can deduct these losses from future profits.[2] Moreover, the decision has been challenged in the Constitutional Court and some banks are contemplating filing complaints at the International Centre for Settlement of Investment Disputes. The EC is closely following the situation and is encouraging a balanced solution.

[2] The estimated revenue losses in 2016 (0.2 percent of GDP) has been included in the baseline fiscal projection. Further losses in 2017 and onwards are not expected by the authorities and staff.

Annex II. Public Debt Sustainability Analysis[1]

Public debt has started to stabilize, albeit at a still elevated level. *It stood at 86.7 percent of GDP at end-2015. The gross financing needs are also high, almost 19 percent of GDP, reflecting large rollovers of existing debt. Under the baseline, debt will begin to gradually decline starting 2016, and will continue declining at a moderate pace over the medium term. However, this projection is vulnerable to growth prospects turning out to be less favorable than expected. The most recently available data reveal that the outstanding government guarantees to state-owned enterprises (SOEs) amount to 3–4 percent of GDP. These are not included in the public debt statistics, and could be another source of risks to debt sustainability. On the other hand, the authorities announced intentions to sell state assets for the purpose of public debt reduction. The analysis includes a conservative estimate for the expected proceeds.*

1. The baseline scenario incorporates the newly passed 2016 budget, the most recent Convergence Program and the National Reform Program.

- *Fiscal consolidation*: Preliminary data put the 2015 general government deficit at around 3.2 percent of GDP. The deficit is projected to further decline to 2.8 percent of GDP in 2016, and to 2.3 percent of GDP over the medium term.

- *Growth*: Real GDP growth is estimated at 1.6 percent for 2015, with Croatia finally exiting the six year-long recession. Going forward, the recovery is expected to gradually gain momentum, converging to a potential real growth rate of about 2 percent.

2. Risks to the baseline come mainly from less favorable growth prospects

- Croatia's real GDP growth forecast has been optimistic since 2009—reflecting mostly premature expectations of recovery—and the median forecast error is in the top decile of surveillance countries with market access. This points to a need for growth shocks in the stress tests.

- The 3-year adjustment of the cyclically-adjusted primary balance in Croatia is relatively sizable, but far from extreme in cross-country comparison. Going forward, fiscal consolidation is also assisted by the ongoing economic recovery, thus the risks that consolidation is not carried out with sufficient pace become less significant compared to previous assessment.

[1] Prepared by Wei Shi.

3. There are risks to debt sustainability. Staff projects that the debt-to-GDP ratio will start to gradually decline in 2016, and be slightly below 82 percent of GDP by 2021. This development mainly reflects a neutral interest rate-growth differential and the consolidation efforts. Gross financing needs are projected at 17 percent of GDP in 2021, due to the large fiscal deficits accumulated since 2009, and the relatively short maturity of public debt.

4. Shocks and Stress Tests

- **Slower output growth is the main risk to debt sustainability.** Underperformance of real GDP growth by one standard deviation in 2016 and 2017 would lead to a deterioration of the primary balance, as nominal revenues fall against unchanged spending. The primary deficit would deteriorate to about 3½ percent of GDP in 2017, before improving over the medium-term. The primary balance leads to a slight increase in risk premia and a sharp increase in public debt, which peaks at over 100 percent of GDP in 2018 before heading downwards. Gross financing needs will also increase to close to 23 percent of GDP in 2018.

- **A combination of macro-fiscal shocks further highlights the sensibility of public debt and gross financing needs to adverse scenarios**. Assuming that shocks to real GDP growth, the primary balance, real exchange rate, and real interest rate occur simultaneously, public debt would increase sharply and reach almost 105 percent of GDP at its peak. Gross financing needs would approach 22½ percent of GDP in 2021.

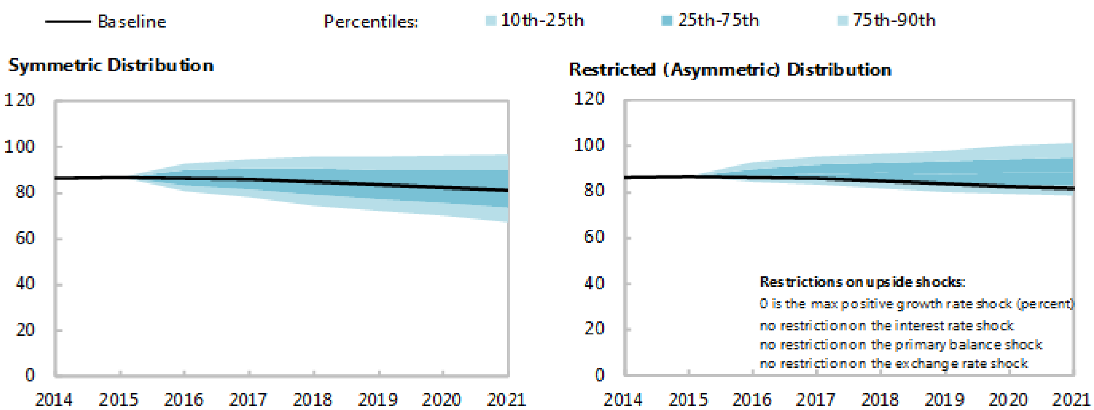
Croatia Public DSA Risk Assessment

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

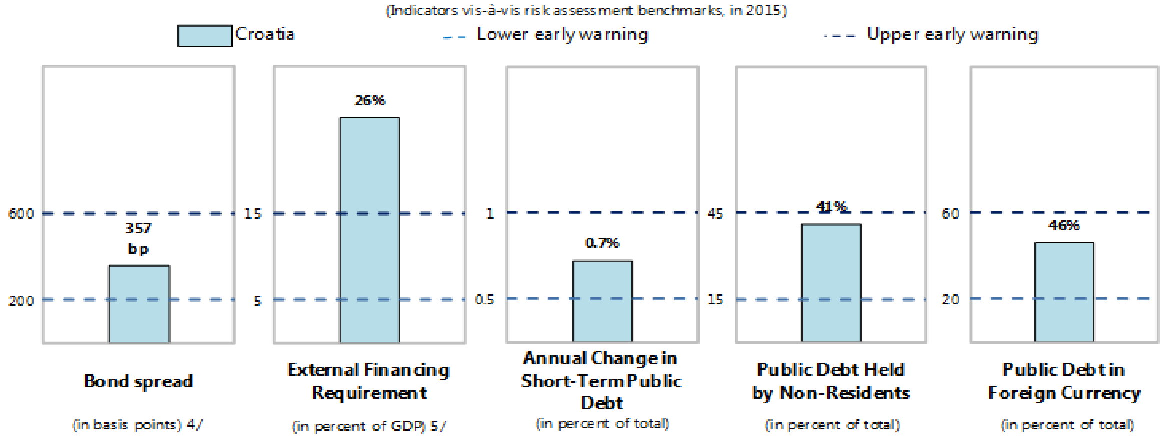
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



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, 16-Dec-15 through 15-Mar-16.

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)

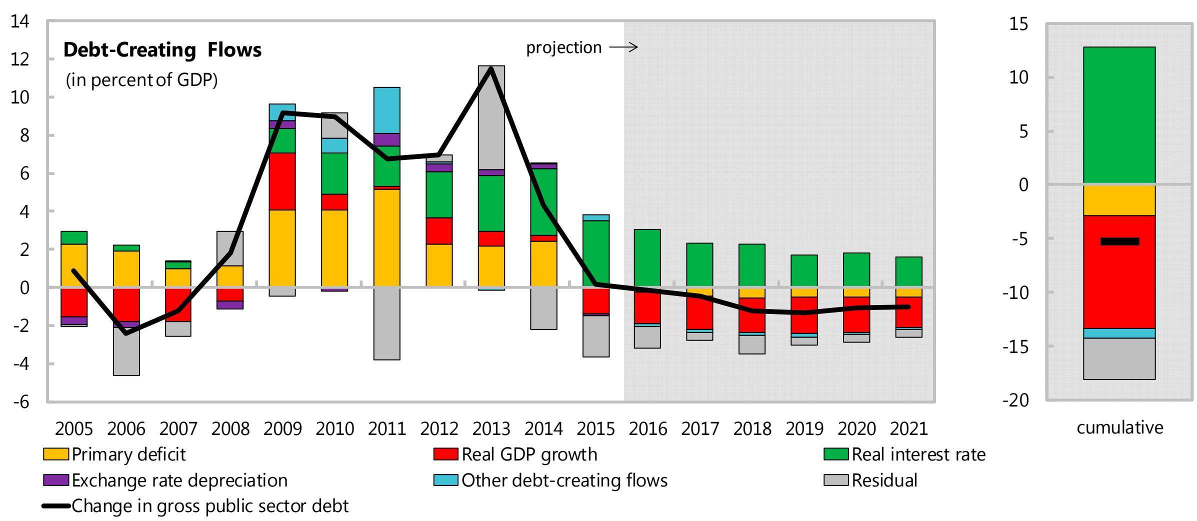
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	52.9	86.5	86.7	86.5	86.1	84.9	83.5	82.4	81.4
Public gross financing needs	18.1	20.7	18.7	15.9	16.5	15.7	15.6	15.4	16.9
Real GDP growth (in percent)	0.4	-0.4	1.6	1.9	2.1	2.2	2.3	2.3	2.0
Inflation (GDP deflator, in percent)	2.8	0.0	0.1	0.4	1.1	1.5	1.7	1.9	2.0
Nominal GDP growth (in percent)	3.2	-0.3	1.8	2.3	3.2	3.7	4.0	4.2	4.1
Effective interest rate (in percent) [4/]	5.3	4.2	4.2	4.0	3.9	4.3	3.8	4.2	4.1

As of May 18, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		364
5Y CDS (bp)		258
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BB	BB
Fitch	BB	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.7	4.3	0.1	-0.1	-0.4	-1.2	-1.4	-1.1	-1.0	-5.3	
Identified debt-creating flows	4.6	6.5	2.3	1.0	0.0	-0.3	-0.9	-0.7	-0.6	-1.5	
Primary deficit	2.7	2.4	0.1	-0.3	-0.5	-0.6	-0.5	-0.5	-0.5	-2.9	-0.1
Automatic debt dynamics [5/]	1.5	4.1	2.0	1.4	0.6	0.4	-0.2	0.0	0.0	2.3	
Interest rate/growth differential [6/]	1.4	3.8	2.1	1.4	0.6	0.4	-0.2	0.0	0.0	2.3	
Exchange rate depreciation [7/]	0.1	0.3	-0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.4	0.0	0.3	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.9	
Residual, including asset changes [8/]	0.1	-2.2	-2.2	-1.1	-0.4	-1.0	-0.4	-0.4	-0.4	-3.8	



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).

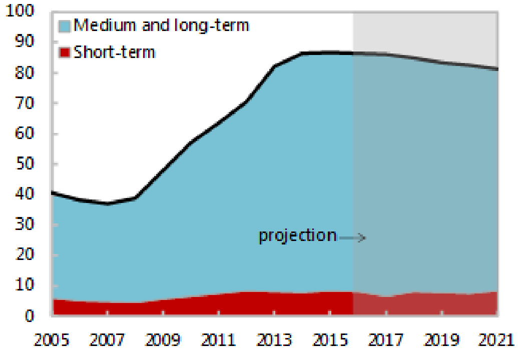
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

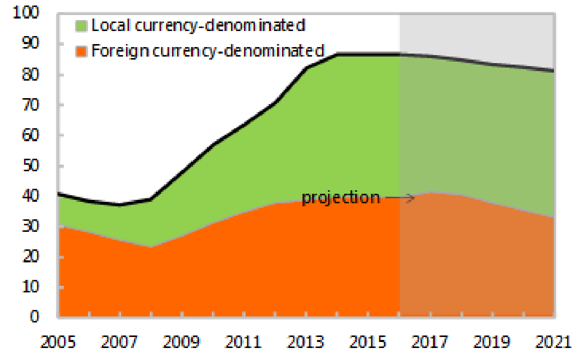
Croatia Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



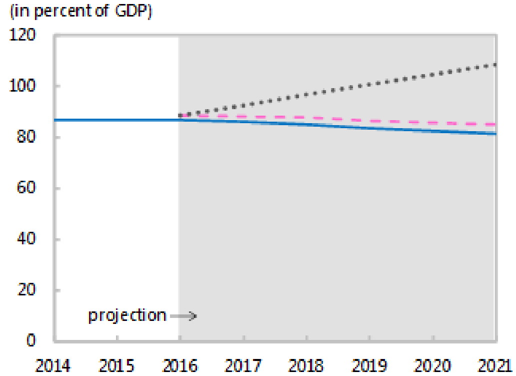
By Currency
(in percent of GDP)



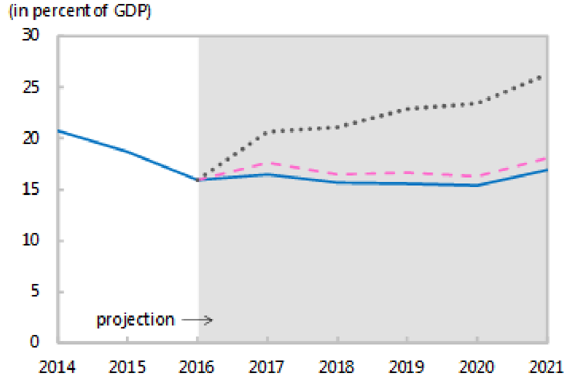
Alternative Scenarios

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	2016	2017	2018	2019	2020	2021
Real GDP growth	1.9	2.1	2.2	2.3	2.3	2.0
Inflation	0.4	1.1	1.5	1.7	1.9	2.0
Primary Balance	0.3	0.5	0.6	0.5	0.5	0.5
Effective interest rate	4.0	3.9	4.3	3.8	4.2	4.1
Constant Primary Balance Scenario						
Real GDP growth	1.9	2.1	2.2	2.3	2.3	2.0
Inflation	0.4	1.1	1.5	1.7	1.9	2.0
Primary Balance	0.3	0.3	0.3	0.3	0.3	0.3
Effective interest rate	4.0	3.9	4.2	3.8	4.2	4.1

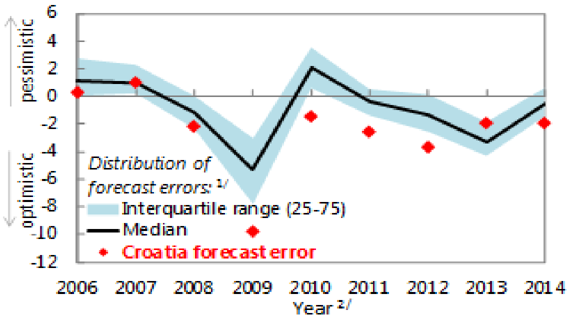
Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.9	0.1	0.1	0.1	0.1	01
Inflation	0.4	1.1	1.5	1.7	1.9	20
Primary Balance	0.3	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	4.0	3.9	4.2	3.8	4.2	42

Source: IMF staff.

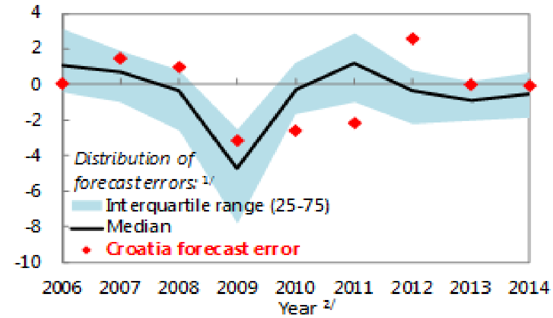
Croatia Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

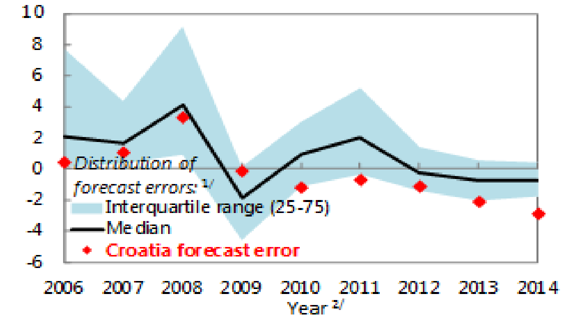
Real GDP Growth
(in percent, actual-projection)
Croatia median forecast error, 2006-2014: -1.90
Has a percentile rank of: 7%



Primary Balance
(in percent of GDP, actual-projection)
Croatia median forecast error, 2006-2014: 0.02
Has a percentile rank of: 66%

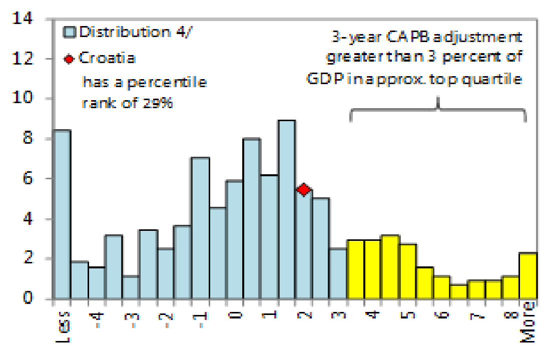


Inflation (Deflator)
(in percent, actual-projection)
Croatia median forecast error, 2006-2014: -0.74
Has a percentile rank of: 14%

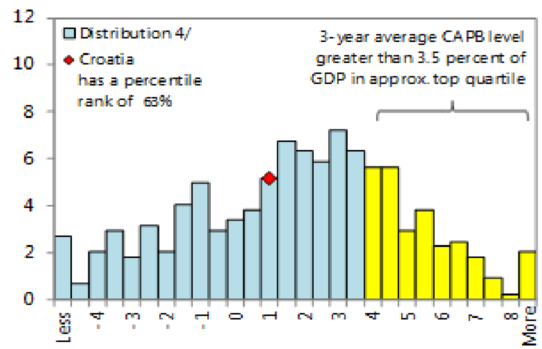


Assessing the Realism of Projected Fiscal Adjustment

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

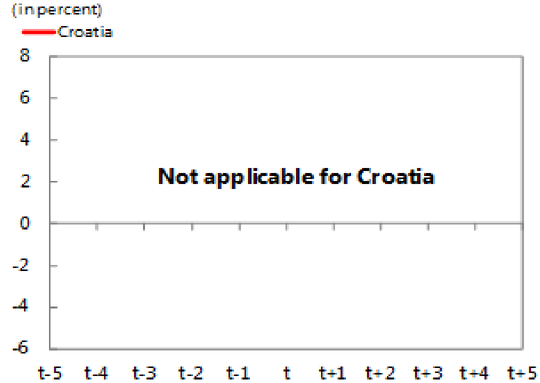


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



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, as it meets neither the positive output gap criterion nor the private credit growth criterion.
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.

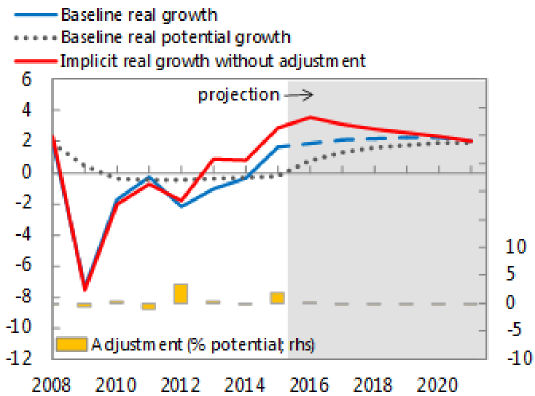
Croatia Public DSA – Realism of Baseline Assumptions (continued)

Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 0.7, persistence of 0.6

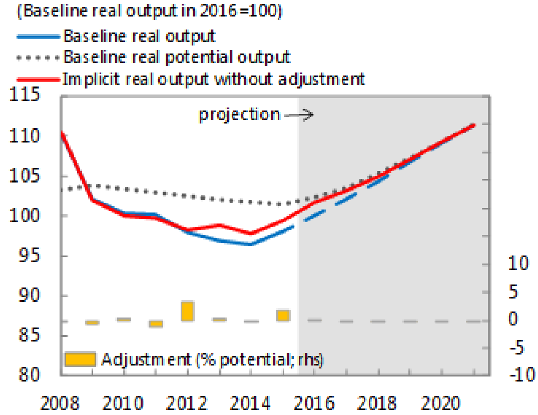
Real GDP Growth

(in percent)



Real Output Level

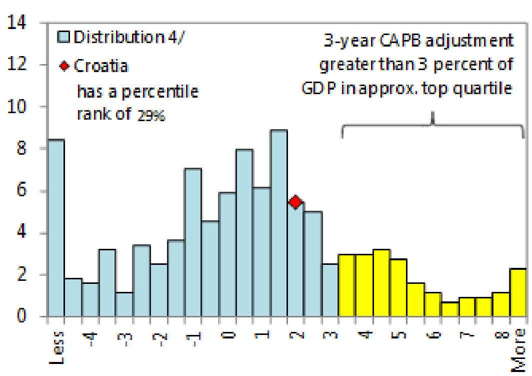
(Baseline real output in 2016=100)



Assessing the Realism of Projected Fiscal Adjustment

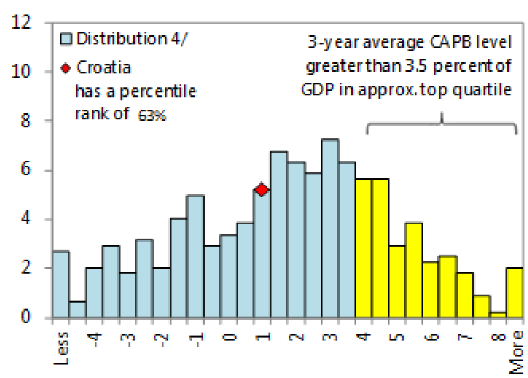
3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)



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

(Percent of GDP)

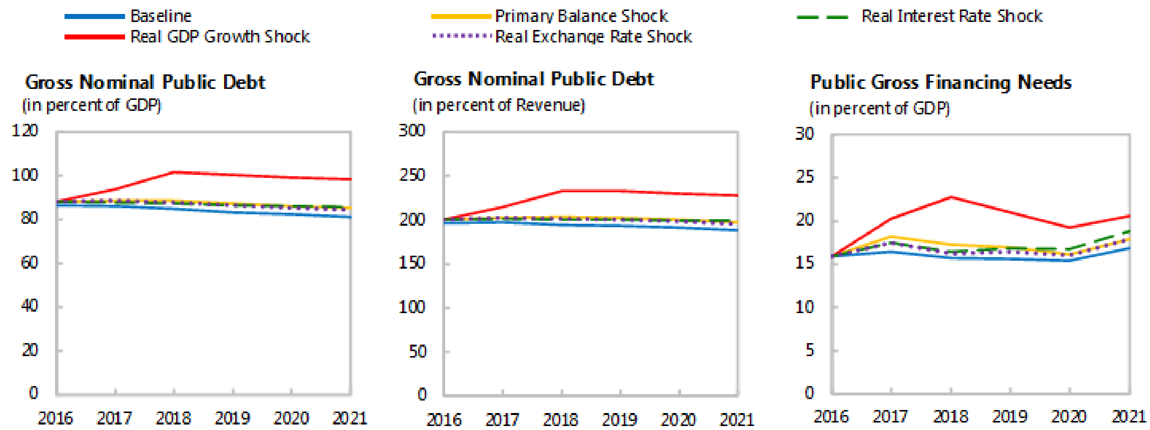


Source: IMF staff.

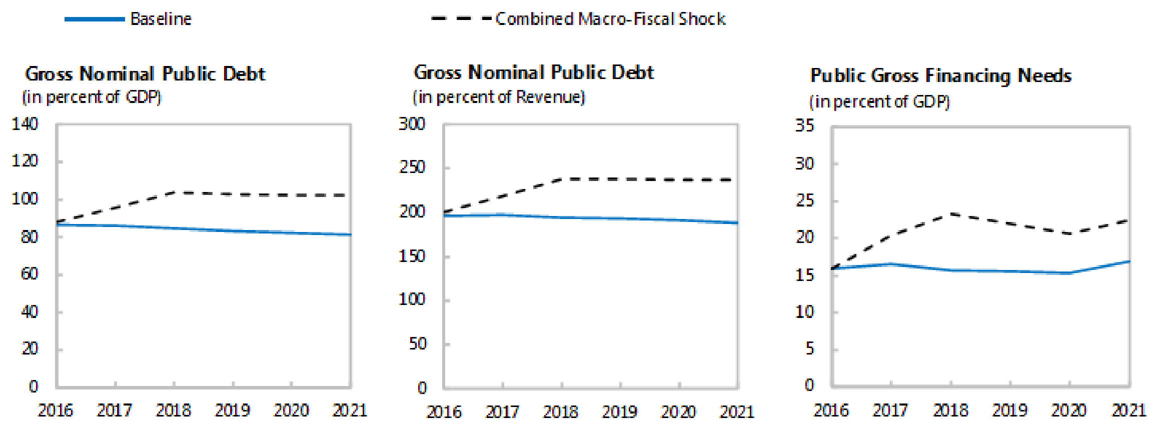
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Croatia Public DSA –Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.9	2.1	2.2	2.3	2.3	2.0
Inflation	0.4	1.1	1.5	1.7	1.9	2.0
Primary balance	0.3	-0.3	-0.2	0.5	0.5	0.5
Effective interest rate	4.0	3.9	4.2	3.8	4.2	4.1
Real Interest Rate Shock						
Real GDP growth	1.9	2.1	2.2	2.3	2.3	2.0
Inflation	0.4	1.1	1.5	1.7	1.9	2.0
Primary balance	0.3	0.5	0.6	0.5	0.5	0.5
Effective interest rate	4.0	3.9	4.6	4.4	4.9	5.0
Combined Shock						
Real GDP growth	1.9	-1.5	-1.4	2.3	2.3	2.0
Inflation	0.4	0.2	0.6	1.7	1.9	2.0
Primary balance	0.3	-1.5	-3.5	0.5	0.5	0.5
Effective interest rate	4.0	3.9	4.6	4.4	4.9	5.0

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.9	-1.5	-1.4	2.3	2.3	2.0
Inflation	0.4	0.2	0.6	1.7	1.9	2.0
Primary balance	0.3	-1.5	-3.5	0.5	0.5	0.5
Effective interest rate	4.0	3.9	4.3	4.0	4.3	4.2
Real Exchange Rate Shock						
Real GDP growth	1.9	2.1	2.2	2.3	2.3	2.0
Inflation	0.4	2.1	1.5	1.7	1.9	2.0
Primary balance	0.3	0.5	0.6	0.5	0.5	0.5
Effective interest rate	4.0	3.9	4.2	3.8	4.2	4.1

Source: IMF staff.

Annex III. External Debt Sustainability Analysis

	Actual						Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Baseline: external debt	104.2	103.7	103.0	105.6	108.4	103.7	101.3	96.9	92.8	89.6	86.3	84.0
Change in external debt	3.1	-0.5	-0.7	2.6	2.8	-4.7	-2.4	-4.3	-4.2	-3.2	-3.3	-2.2
Identified external debt-creating flows (4+8+9)	3.1	4.1	5.0	-1.9	-2.8	-6.3	-5.8	-5.7	-5.2	-4.4	-3.6	-3.1
Current account deficit, excluding interest paymer	-1.8	-2.4	-3.5	-4.1	-4.4	-8.7	-6.5	-5.6	-4.9	-4.2	-3.4	-2.8
Deficit in balance of goods and services	-75.8	-81.3	-82.8	0.5	2.0	2.8	2.7	1.9	1.2	0.3	-0.8	-1.5
Exports	37.7	40.5	41.6	43.1	46.4	50.1	51.9	53.7	55.4	56.9	58.5	60.5
Imports	-38.1	-40.9	-41.1	-42.6	-44.4	-47.3	-49.2	-51.8	-54.2	-56.6	-59.3	-62.0
Net non-debt creating capital inflows (negative)	1.8	2.7	3.0	-2.1	-3.1	-0.3	-1.9	-1.9	-2.0	-2.1	-2.2	-2.2
Automatic debt dynamics 1/	3.1	3.8	5.5	4.3	4.7	2.7	2.5	1.9	1.7	1.9	1.9	1.9
Contribution from nominal interest rate	2.9	3.2	3.6	3.3	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Contribution from real GDP growth	1.7	0.3	2.3	1.1	0.4	-0.7	-0.9	-1.6	-1.8	-1.6	-1.6	-1.6
Contribution from price and exchange rate chan	-1.6	0.4	-0.5	-0.1	0.8	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	0.0	-4.6	-5.6	4.4	6.4	1.6	3.4	1.3	1.1	1.2	0.4	0.9
External debt-to-exports ratio (percent)	276.2	256.3	247.4	245.1	233.6	207.1	195.1	180.5	167.6	157.3	147.5	139.0
Gross external financing need (billions of Euros) 4/	10.3	10.0	9.1	8.7	9.3	7.7	9.6	12.6	10.7	13.2	12.2	13.4
Percent of GDP	23.0	22.4	20.6	20.0	21.7	17.5	21.4	27.1	22.2	26.3	23.4	26.8
Scenario with key variables at their historical averages 5/				105.6	108.4	110.0	101.6	98.9	96.2	94.0	91.3	88.9
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	-1.7	-0.3	-2.2	-1.1	-0.4	1.6	1.9	2.1	2.2	2.3	2.3	2.0
GDP deflator in Euros dollars (percent change)	1.6	-0.3	0.5	0.1	-0.7	0.4	0.4	1.1	1.5	1.7	1.9	2.0
Nominal external interest rate (percent)	2.9	3.0	3.4	3.2	3.3	3.3	3.4	3.5	3.7	3.9	4.0	4.2
Growth of exports (Euro terms, percent)	9.0	6.6	1.2	2.4	6.6	10.1	6.1	6.8	6.9	7.0	7.1	7.6
Growth of imports (Euro terms, percent)	-0.5	6.7	-1.1	2.5	3.0	8.6	6.5	8.8	8.4	8.8	9.0	8.9
Current account balance, excluding interest payment	1.8	2.4	3.5	4.1	4.4	8.7	6.5	5.6	4.9	4.2	3.4	2.8
Net nondebt creating capital inflows	-1.8	-2.7	-3.0	2.1	3.1	0.3	1.9	1.9	2.0	2.1	2.2	2.2

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

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).

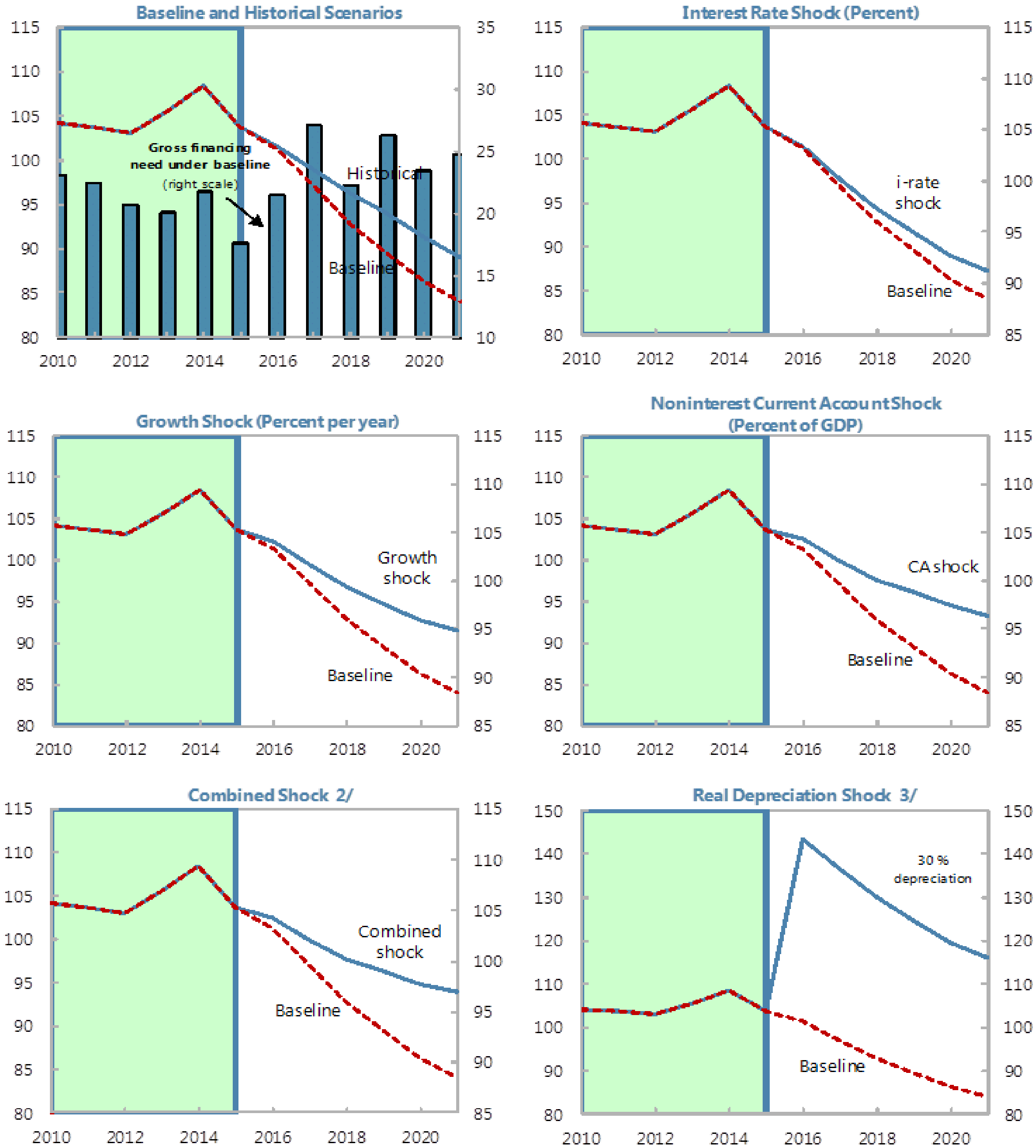
3/ For projection, line includes the impact of price changes.

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 2016.

Annex IV. Risk Assessment Matrix[1]

Source of Risks	Relative Likelihood	Impact if realized	Recommended policy response
More volatile global financial conditions:			
Sharp asset price decline and decompression of credit spreads as investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, Fed policy rate path, and increases in U.S. term premia, with poor market liquidity amplifying volatility.	Medium	**Medium in the short-term, high in the longer term**	Growth-friendly fiscal consolidation.
Surge in the US dollar. Improving U.S. economic prospects versus the rest of the world leads to a further dollar surge, boosting non-U.S. trade but creating balance sheet strains.	High	**Low** The share of US dollar denominated debt is low, while US share in exports of services is sizable.	Take advantage of higher export and tourism revenues to boost buffers.
Structurally weak growth in key advanced and emerging economies. Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persisting financial imbalances in the Euro area and Japan. Easy global financial conditions coming to an end and insufficient reform progress undermining medium-term growth prospects in emerging markets and suppress commodity prices.	High Medium	**Medium** Slower growth in advanced Europe would delay the recovery in exports and FDI. Deflation pressures spreading from the euro area would increase disposable income but could also complicate efforts to reduce debts.	Accelerate private sector debt restructuring and structural reforms.
Heightened risk of fragmentation/security dislocation in part of the Middle East, Africa, and Europe, leading to a sharp rise in migrant flows, with negative global spillovers	High	**Medium** Migrant flows could reduce the attractiveness of tourist destinations and complicate trade. Uncoordinated border closures could force migrants to stay in Croatia. In contrast, tourism could also benefit from increased security concerns in competing markets.	Provide logistical support and humanitarian aid. Coordinate the management of border controls with other transit and destination countries.
Persistently lower energy prices, triggered by supply factors reversing only gradually.	High	**Low in short term, Medium in medium term** Persistence in lower energy prices threatens to spill into inflation expectations, and bring core inflation lower, but also boost disposable income.	Continue accommodative monetary within the existing tight monetary regime.
Domestic political risks: further delays of fiscal consolidation and structural reforms depressing business and consumer confidence.	High	**High** Growth recovery would falter and country risk premiums increase.	Strengthen national commitment to accelerate overdue reforms, underpinned by frontloaded measures.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex V. National Reform Program[1]

1. The objectives of the 2016 National Reform Program (NRP) are to: (i) maintain macroeconomic stability and fiscal sustainability; (ii) improve the business environment; (iii) increase the effectiveness and transparency of the public sector; and, (iv) enhance education and training to better support the labor market. Key measures are summarized below.

- **Perform a comprehensive review of the tax system in 2016,** with a view to simplify administration and compliance, as well as to consider lowering some of the high rates over the medium term, while compensating part of the potential tax revenue loss by broadening the tax base.

- **Introduce a modern value-based real estate tax.** During the first phase (2018), the land registry and cadastre will be modernized, and the coverage broadened, while replacing tax breaks granted by local governments with ones regulated by national law. During the second phase (2020), a tax based on property valuation (rather the physical characteristics and location) will be introduced.

- **Strengthen expenditure control.** This would be achieved mainly through introducing a freeze on new hires, reducing of bonuses for years of service, introducing performance-based compensation for civil servants, and improving public procurement procedures.

- **Streamline social benefits.** This will involve systematic introduction of means/income testing, unification of all social benefits records at the national level, and establishing a guaranteed minimum standard for the various benefits/services. The authorities plan to start expanding means testing to child allowances by September 2016 and adopt a new Social Welfare Act that establishes a one-stop-shop for benefits administration by March 2017.

- **Reduce healthcare costs and arrears.** Emergency medicine will be reformed with a view to reduce the number of unnecessary visits, the hospital network will be rationalized, and procurement procedures for medicine, equipment, and services will be improved.

- **Improve the sustainability of the pension system.** The authorities will speed up the planned increase of the minimum retirement age for women by 6 months in each of the coming years until 2023 (instead of the originally planned 3 months in each year until 2030). Between 2024 and 2027, the minimum retirement age for both men and women will increase by six months per

[1] Prepared by Murad Omoev.

year, up to 62 years for early retirement and 67 years for normal retirement (instead of the originally planned 3 months per year until 2038). In addition, the authorities plan to further increase the penalty for early retirement.

- **Reduce administrative barriers to doing business.** This will be achieved by developing electronic procedures for starting a business and introducing as a pilot standard administrative cost assessment system with a view to cutting regulatory burden on businesses by 20 percent for the pilot sectors by the end-2016, and by 25 percent by mid-2018. Furthermore, the NRP aims to reduce the number of administrative bodies at the central government level and improving the organizational model of local self-government operations.

- **Harmonize educational programs with needs of the labor market** at both vocational and higher education levels.

Annex VI. Real Exchange Rate Assessment and Competitiveness[1]

1. Most assessment methods suggest a marginal overvaluation of Croatia's real effective exchange rate (REER). According to the EBA-lite methodology, the overvaluation is estimated at about 3.1 percent. EBA-lite estimates a country's current account (CA) norm based on economic fundamentals (similar to the macro balance approach), cyclical factors, and desirable medium-term policy levels. The present-year CA was adjusted to account for a one-off decline in profits of foreign-owned banks related to the conversion of Swiss franc loans affecting the primary income balance (2.0 percent).[2] The exchange rate misalignment is defined as the adjustment necessary to bring the CA back to its norm. Using the EBA approach, the adjusted CA balance in 2015 is somewhat below the norm, with the policy gap mostly explained by the large fiscal deficit in 2015.

EBA-lite Methodology

Summary Table			
CA-Actual	5.2%	CA-Fitted	2.4%
CA-Actual (adjusted)	3.2%		
CA-Norm	4.2%	Residual	2.8%
		o/w one-off primary income	2.0%
CA-Gap (adjusted)	**-1.0%**	Policy gap	-1.8%
Elasticity	-0.31		
Real Exchange Rate Gap (adjusted)	**3.1%**	Cyclical Contributions	0.2%
		Cyclically adjusted CA	2.9%
		Cyclically adjusted CA Norm	3.9%

Source: IMF staff's estimates.

2. In addition, the *index REER EBA-lite model* (that compares staff's projected REER in 2015 with its norm, both expressed in logs) signals an overvaluation of about 2.6 percent. Finally, the *EBA-lite External Sustainability (ES) approach*—that compares Croatia's projected net IIP position with a sustainable level, and computes the REER revaluation needed for this—points to an overvaluation of about 3.2 percent in a scenario stabilizing the net IIP at 40 percent.

EBA-lite Index REER Approach

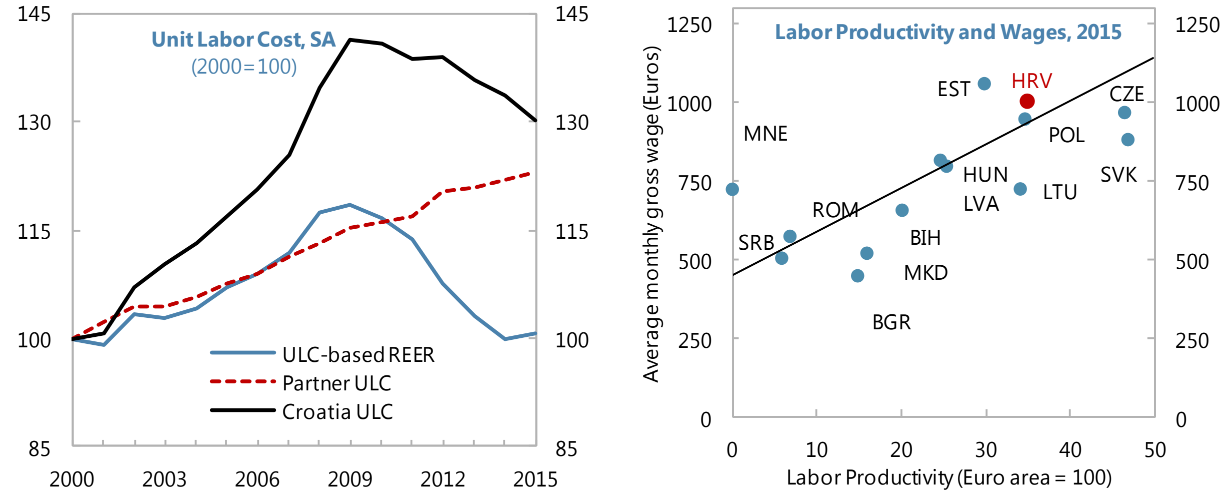
Summary Table			
In(REER)-Actual	4.54	In(REER)-Fitted	4.52
In(REER)-Norm	4.51	Residual	0.01
REER-Gap	2.6%	Policy gap	0.01

Source: IMF staff's estimates

3. A measure comparing Croatia's unit real labor cost (ULC) with peers points to an overvaluation of about 5.8 percent, suggesting that Croatia has made progress in reducing its ULC in recent years. Although real labor market productivity per hour has improved, peers have performed better. While Croatian goods exports are no longer losing market share, the current account remains highly dependent on tourism. This together with red tape, especially at the local government level, and a weak business environment has discouraged FDI, which has been instrumental to develop export-oriented sectors in peer countries.

[1] Prepared by Ernesto Crivelli.

[2] As in the 2015 Art IV assessment, an adjustment was done for temporary factors due to import compression in response to extraordinary weak demand while Croatia's private sector draws down excess debt levels.



Sources: Haver Analytics, Croatian Bureau of Statistics, European Commission, and IMF staff calculations.

Annex VII. Reducing Fiscal Fragmentation[1]

1. **Despite the limited degree of expenditure and revenue decentralization, fragmentation of the subnational government structure in Croatia is high.** Croatia has a two-tier subnational government structure consisting of 21 counties and 555 municipalities. All municipalities and cities are assigned the same spending responsibilities regardless of their fiscal and administrative capacity to provide a comparable range and quality of public service and social protection. Subnational government spending has been increasingly tilted towards wages and operational costs, which results in low public investment compared to peers. Subnational governments have limited own revenue, constituting only one third of their total revenue. The rest of their revenue comes from the shared taxes and grants provided by the central government. Subnational governments are not allowed to borrow freely, but their financial linkages with the local utility companies pose fiscal risks.

Country	Levels of SNG	Number of municipalities	Average population of municipalities
Croatia	**2**	**556**	**7717**
Selected South-Eastern Europe			
Albania	2	373	7764
Bosnia and Herzegovina	3	143	26253
Bulgaria	1	264	27896
Macedonia	1	81	23795
Romania	2	2181	6326
Serbia	2	145	51710
Slovenia	1	212	9727
Selected highly decentralized countries in the EU			
Denmark	2	98	55300
Finnland	2	313	17534
Germany	3	11313	7200
Spain	3	8124	5687
Sweden	3	290	33993

2. **While there is no "one size-fits-all" model for the optimal subnational government structure, there are established good practices.** It is necessary from an ex ante perspective to broadly match the spending responsibilities to the overall resources available at each level of government. Revenue arrangements should conform to the general principle that funds follow functions. The specific design of the fiscal decentralization should take into account the geographic, historical, socio-political, and economic setting. However, a sound and transparent public financial management (PFM) framework is always necessary to support successful decentralization. Such framework usually includes an

Advantages	Disadvantages
• Improves *allocative efficiency*: better match of public service delivery with local preferences • Increases *competition* between local governments, which may lead to better quality of services • Increases *political participation*, as the government gets closer to the people	• May be technically inefficient if *economies of scale* in public service provision are important • Creates *administrative duplication* and weakens the *technical capacity* for the provision of public goods • Increases *information costs* for citizens and voters, reduces transparency and accountability

Source: Boex and others, 2004.

[1] Prepared by Ernesto Crivelli and Wei Shi.

adequate accounting system, a timely and realistic budgeting procedure, and an effective audit and control mechanism.

3. **Croatia's fiscal decentralization structure lacks a clear concept and a regional development strategy.** The number of municipalities in Croatia is on the high side, in view of the size of population and implementation capacity as well as the equally large size of public agencies. It would be useful to review this structure to take into account the administrative capacity and to avoid excessive disparities in the scope and quality of the various services and to reduce the red tape they create and quasi fiscal charges they levy on businesses and citizens. Furthermore, some form of shared provision of public services between municipalities and closer collaboration with the central should be encouraged. Subnational governments should also increase their reliance on a limited and well-defined number of own-source taxes such as a modern property tax, and the ability to freely impose charges or require local permits should be limited.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 8, 2016

Prepared By	European Department in Consultation with Other Departments

CONTENTS

FUND RELATIONS

(As of April 30, 2016)

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

General Resources Account:	**SDR Million**	**%Quota**
Quota	717.4	100.00
Fund holdings of currency (Exchange Rate)	717.2	99.97
Reserve Tranche Position	0.2	0.03

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	347.34	100.00
Holdings	304.90	87.78

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				
	2016	2017	2018	2019	2020
Principal					
Charges/Interest	0.03	0.03	0.03	0.03	0.03
Total	0.03	0.03	0.03	0.03	0.03

[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 adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with tight management of the kuna-euro exchange rate by the Croatian National Bank (CNB). 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 May 26, 2016, the official exchange rate was kuna 7.489778 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).[1]

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on June 24, 2015 (IMF Country Report No. 15/163: http://www.imf.org/external/pubs/cat/longres.aspx?sk=43037.0). Croatia is on the 12-month consultation cycle.

FSAP:

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

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

[1] On January 23, 2015, the Croatian Parliament amended the Consumer Credit Act, temporarily freezing for one year the HRK/CHF exchange rate for interest and installment payments on consumer loans indexed to or denominated in Swiss Francs. The Croatian National Bank informed Fund staff that interest and installment payments of CHF-denominated loans are always made in kuna, and accordingly that the frozen exchange rate is used only for accounting purposes and not for actual foreign exchange transactions. Accordingly, staff does not find this amendment to give rise to a multiple currency practice subject to Article VIII, Section 3.

Technical Assistance 2000–15:[2]

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

[2] 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
	December 2014	Workshop on Public Expenditure Review (Expert visit)
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 FX Reserve Management Monetary Policy Instruments
	February 2004	Macro-Financial Modeling and Forecasting
	January 2007–continuing	Macro-Financial Modeling and Forecasting
	May 2007	Modeling and Forecasting
	June 2007	Modeling and Forecasting
	September 2007	FSAP Update
	October 2007	Modeling and Forecasting
	November 2007	Modeling and Forecasting
	March 2008	Macro-Financial Modeling and Forecasting
	August 2008	Macro-Financial Modeling and Forecasting
	February 2009	Macro-Financial Modeling
	July 2009	Monetary Policy and Modeling
	May 2010	Macro-Financial Modeling and Forecasting
	November 2011	Macro-Financial Modeling and Forecasting
	March 2013	Macro-Financial Modeling and Forecasting
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.

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 WBG 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; and,
- 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. 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, explored the use of new investment financing instruments like results-based operations, as the share of traditional investment financing should decrease 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, higher education, and trade competitiveness.

3. In FY15, the Bank's Board approved two loans amounting to US$278 million including Croatia Railway project (US$183.35 million) and Social Protection System Modernization Project (US$95.55 million). In FY16, the Board approved a loan toward Entrepreneurship Venture Capital project (US$21.92 million). Currently, the World Bank finances 11 operations in a wide range of sectors totaling US$876.27 million. In FY15, IFC invested up to US$45million in Rudine Wind Power Plant in Croatia. Currently, IFC's investments portfolio consists of 7 projects across a variety of sectors including in the financial sector, renewable energy, infrastructure, agribusiness, life sciences, and general manufacturing. Across all sectors, IFC prioritizes investment in Croatia's less-developed regions and in projects that contribute to greater economic diversification and regional integration. MIGA's outstanding gross exposure in Croatia as of June 30, 2015 was US$525 million in support of financial institutions and a retail sector.

STATISTICAL ISSUES

Croatia—Statistical Issues (As of April 30, 2016)
I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance, with shortcomings related to data coverage and reliability, especially for national and fiscal accounts. 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 recent years. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the ESA 2010 standard. However, a breakdown of gross fixed capital formation into private and public components is not yet published. Discrepancies exist between nominal government consumption in national accounts and government consumption reported in government ESA 2010 accounts. Quarterly GDP estimates are disseminated at current prices and at prices of the previous year for the main categories of expenditures and main economic activities. Nonetheless, shortcomings remain. Discrepancies exist between expenditure-based and value-added-based GDP data, stemming from: (i) incomplete coverage of unincorporated businesses and the self-employed (farmers, traders, and craftsmen); (ii) inadequate data for measuring changes in inventories; (iii) incomplete coverage of the informal sector; and (iv) 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. Currently, the CBS is in the process of reviewing the data series. Earnings data include bonuses (in sums that are subjects to contributions, taxes, and surtaxes), sick pay, and meal allowances. They are based on monthly surveys covering 70 percent of workers in permanent employment in each division of NKD 2007 (NACE Rev. 2). They do not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, and farmers. The number of registered unemployed overstates the actual level of unemployment. However, the discrepancy has significantly diminished in 2014. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample was subsequently expanded and the survey is now being conducted on a regular basis. Semi-annual results have been released since 1998, and quarterly results since 2007, with a lag of about four months.
Price Statistics: The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from a Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups, but in most cases between the thirteenth and the twenty-third day of each month. (Prices of agricultural products sold in market places are recorded on the first and third Friday in a month and prices of fuel for passenger cars weekly.) The indices are released around the fifteenth day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country.

Croatia—Statistical Issues (Continued) (As of April 30, 2016)
A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology. A core CPI is calculated based on a methodology developed by the Croatian National Bank (CNB). The CBS also releases a monthly producer price index (PPI), usually on the eighth day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year.
Government Finance Statistics: The authorities have started presenting some budget plans based on the ESA 2010 framework. However, the State Budget and the local budgets are based on the national Chart of Accounts. Historical general government data based on ESA 2010 definitions are published nationally by the Croatian Bureau of Statistics and by Eurostat, but are frequently revised due to methodological and data source improvements. Additional analysis has been initiated in order to assess whether some enterprises owned by local government units should be included in the government sector according to the ESA 2010 criteria. Budget execution (cash) data are produced on a monthly basis on the GFSM framework (GFS 2001) and are available in the *Monthly Statistical Review* of the Ministry of Finance (MOF) and in the time-series database, both published on the website of the MOF. Central government data normally come with a lag of about six weeks, but end-of-year data often with much longer lags. Revenue data are reliable, and expenditure data on a cash basis are available according to GFS classifications (economic and functional) for the central budget and extra-budgetary funds. However, changes of institutions included in the central government are not always clearly indicated, hence central government figures are not fully comparable over time. Cash data for the operations of local governments and the consolidated general government are available on a quarterly basis, but for end-of-year data with long lags. Starting from the January-March 2015 period, data for local and regional self-government units (local units), instead of former 53 largest, include all 576 local units and the local units' extra-budgetary users - county road administrations. According to the latest *Agreement on cooperation in the field of national accounts of general government and related statistics* (signed on July 31, 2013 between the Croatian Bureau of Statistics, Croatian National Bank (CNB), and Ministry of Finance), the CNB took over the responsibility for the compilation of general government debt statistics. The CNB is compiling general government debt according to ESA 2010 and EDP definitions and publishes these data in the *CNB Monthly Bulletin*. Data showing the level of central government guaranteed debt are presented as a part of the reporting table in the CNB Monthly Bulletin.
Monetary and Financial Statistics: Beginning 2015, the CNB has started published monetary statistics using the ESA 2010 framework, with some backward revisions of historical data series. Since June 2013, the IMF's Statistics Department receives monetary statistics on Croatia directly from the European Central Bank.

Croatia—Statistical Issues (Continued) (As of April 30, 2016)
Previously, the CNB compiled and reported monetary data for publication in *International Financial Statistics (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* were based on the Standardized Report Forms developed by the IMF's Statistics Department, in accordance 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, reports to the IMF's *Financial Soundness Indicator Database*, and provides IMF staff with a broad range of FSIs. A general description of the stress testing methodologies used on the Croatian banking system is included in the *Financial Stability Report,* published by the CNB 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 lag of six to nine months. The Croatian Financial Services Supervisory Agency (HANFA) publishes monthly reports and monthly summary statistics on the sectors it regulates and supervises (capital markets, investment funds, private pension sector, insurance, leasing, and factoring companies).
External Sector Statistics: Quarterly balance of payments and international investment position data are compiled broadly in accordance with the sixth edition of the IMF's *Balance of Payments Manual (BPM6)*. Data are generally available with a lag of three months and are subject to revisions in subsequent releases. Net errors and omissions have ranged from 1 to 3½ percent of GDP since 2005, 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. Data on the International Reserves and Foreign Currency Liquidity (Reserve Data Template) are available with a lag of one to two months. Croatia compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2013.*

Croatia—Statistical Issues (Concluded) (As of April 30, 2016)	
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 April 30, 2016)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	4/30/16	4/30/16	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Mar. 2016	4/16/16	M	M	M
Reserve/Base Money	Mar. 2016	4/16/16	M	M	M
Broad Money	Mar. 2016	4/16/16	M	M	M
Central Bank Balance Sheet	Mar. 2016	4/16/16	M	M	M
Consolidated Balance Sheet of the Banking System	Mar. 2016	4/16/16	M	M	M
Interest Rates 2/	Mar. 2016	4/16/16	M	M	M
Consumer Price Index	Mar. 2016	4/15/16	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2015:Q4	Apr. 2016	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	Dec. 2015	Apr. 2016	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2015:Q4	4/16/16	M	M	M
External Current Account Balance	2015:Q4	3/31/16	Q	Q	Q
Exports and Imports of Goods and Services	2015:Q4	3/31/16	Q	Q	Q
GDP/GNP	2015:Q4	4/21/16	Q	Q	Q
Gross External Debt	2015:Q4	4/21/16	M	M	M
International Investment Position	2015:Q4	4/21/16	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).

Statement by Menno Snel, Executive Director for the Republic of Croatia and Tsvetan Manchev, Advisor to Executive Director June 22, 2016

The Croatian authorities highly appreciate the constructive policy dialogue with the IMF mission during the 2016 Article IV Consultation, and thank staff for the appraisal and policy recommendations. They also welcome the staff analyses in the Selected Issues paper. The authorities are committed to prudent macroeconomic policies which properly address vulnerabilities in line with the country specifics and promote sustainable growth. They believe that the policy discussions with the Fund will help to set the appropriate policy mix needed to strengthen the economic recovery and achieve goals of the Government's National Reform Program (NPR) presented in May.

Recent economic developments and outlook

Staff and the authorities share views on the recent developments, outlook and risks. The economy has finally bottomed out in 2015, which is expected to strengthen public support for the reform agenda. The recovery has gained some more traction in Q1 2016 when GDP growth reached 2.7 percent y-o-y. Growth also becomes more broad-based since all the elements of final demand have registered a positive contribution for the first time in many years. Exports grew by 7.1 percent y-o-y, gross fixed capital formation by 4.3 percent, personal consumption by 3.1 percent, and the government consumption by 0.6 percent. In April, adjusted industrial output was up by 4.9 percent y-o-y and retail trade growth was positive for the 21st consecutive month, with nominal sales growth at 0.7 percent y-o-y.

The recovery of economic activity in 2015 and early 2016 reflected a favorable labor market. The positive trends will continue, although at slower pace, along with projected employment growth and a decreased unemployment rate. The number of unemployed declined and is trending below the 2015 minimum ahead of the peak of the tourist season. Despite unfavorable demographic trends, economic recovery will also have certain positive effects on the rate of labor force participation.

Fiscal policy and debt management

Like staff, the authorities see that growth recovery provides an excellent window of opportunity to progress with the additional fiscal consolidation and debt restructuring, successfully exit from the EU's Excessive Deficit Procedure, and put the public debt on a sound footing over the medium term. In line with macroeconomic projections for the period 2016-19, and based on the implementation of structural reform measures, the fiscal consolidation strategy of the new government launched with the NRP aims to reduce the planned budget deficit on a consolidated basis to 1 percent of GDP in 2019. These positive trends regarding the significant reduction of the budget deficit, and taking into account the privatization incomes and a change of government deposits, will lead to a reduction of the public debt to GDP ratio in 2016 to 85.9 percent, after several years of strong increase. It is expected that the public debt to GDP ratio will be gradually reduced to 80 percent of the GDP by 2019.

A balanced approach to the fiscal consolidation for the 2016-2019 is envisaged, including measures on both the revenue and expenditure side in order to minimize the negative impact on growth. The recently updated NRP presents in details the key fiscal reforms which are focused on: (1) introduction of a modern real estate tax by January 2018; (2) reform in public administration by making part of public servants' compensation performance-based; (3) streamlining social benefits; (4) reforming the pension system; and (5) activation of state property. The NPR implementation, however, requires important legislative changes and in the current domestic political juncture, and some more time is needed to build the necessary consensus to reforms. In line with that, the largest structural measure in 2016 on the revenues side is to further enhance the tax system and strengthen the tax administration, while implementing the required improvements in land registration and the cadaster to lay ground for successful introduction of the property tax in January 2018. On the expenditure side, the fiscal consolidation in 2016 will focus on further rationalization of current spending to provide sufficient space for growth-enhancing expenditures in the medium term. The government is advancing with the introduction of performance based public servants' compensation scheme.

In consultation with the European Commission, a new Fiscal Responsibility Act is proposed to strengthen the independence of the existing Fiscal Policy Committee and ensure the full compliance of national fiscal rules with the relevant EU framework. Among other things, the Act establishes mechanisms for compliance and the sanctioning of non-compliance with the planned budget limits for all the layers of the government. Adoption of the Act is planned by September 2016.

Monetary policy and financial stability

The monetary authorities remain firmly committed to exchange rate stability as a proven policy anchor for inflation expectations and financial stability. This exchange rate regime has served the country well and the authorities welcome staff recognition in this regard. They agree with staff that gradual de-euroization would be desirable. However, irrespective of the authorities' continuous efforts to increase the attractiveness of savings in domestic currency, including maintaining the positive interest differential on domestic currency deposits and informing the public about potential risks of FX borrowing, deposit euroization has remained deeply entrenched against the background of past episodes of monetary instability in the 1980's and early 1990's.

In the given environment, the monetary authorities have managed to maintain a highly accommodative monetary policy stance, thus creating favorable financing conditions for all domestic sectors and supporting the economic activity. Since the beginning of the year, banks' credit activity has started to recover following a pick-up in economic activity. In particular, credit to the corporate sector increased by 3.8 percent in the first four months of this year. An accommodative stance was further strengthened with the introduction of a new instrument: a four-year structural reverse repo facility, which provides banks with long-term funding in local currency. Although still high, the NPL's started declining, and their provisioning increases, reaching almost 60 percent thanks to the earlier CNB policies. The planned changes in the tax treatment of write-offs, as outlined in the authorities' NRP, could additionally help the swifter unwinding of the banks' stock of NPLs, as well as, the reinforcement of the pre-insolvency and insolvency frameworks for businesses and adopting a personal insolvency procedure.

Concerning the international reserves, the authorities agree that the existing external vulnerabilities require adequate buffers and they continue to be dedicated to their enhancement.

However, they emphasize that aside from the CNB's international reserves, the commercial banks also hold an additional buffer in line with the CNB's prescribed macro-prudential regulation. When these two are taken together, Croatia's reserve buffer is comfortably in the recommended range of 100-150 percent of the IMF's RAM metric. The sizable share of affiliated bank debt and FDI-related short-term liabilities in total debt liabilities also serves as a mitigating factor against risks in times of financial distress. Nevertheless, CNB remains open to look further for opportunities to continue accumulating international reserves, as was the case in May 2016, when 84 million euros were purchased through the FX interventions.

The Croatian banking system continues to demonstrate high resilience thanks to the solid fundamentals and sound macroprudential policies of the CNB. The system-wide capital adequacy ratio remains robust, close to 21 percent at end-2015. In 2015, the profit and loss accounts of banks were temporarily, but strongly affected by the legislative amendments aimed at facilitating the position of debtors with loans in Swiss francs and with foreign currency clauses in Swiss francs. Banks' operational profitability was, however, even slightly higher than a year before. As a result of that operation, the total capital adequacy ratio declined by 0.5 percentage points compared to the end of 2014.

Competitiveness and structural reforms

The Croatian authorities are well aware that the productivity-enhancing fiscal and structural reforms are essential to improving competitiveness. Starting from the premise that the public administration reform is a key prerequisite for creating a supportive institutional framework for the implementation of all relevant reforms, the government is taking steps to improve the efficiency of the public sector, while reducing overlaps between different layers of the administration, improving the management practices and revising the wage policy.

The restructuring and preparation for privatization of the state-owned enterprises is also progressing. The government is redefining their policy on public companies by setting harsher requirements on the quality of operations, planning and realization of business objectives, and improving operational control to facilitate ongoing privatization endeavors. In particular, the government is examining the justification of ownership over companies of strategic interest in order to reduce their number. Privatization of the government minority stockholdings is also being stepped up. As part of these efforts, in May 2016, 20.4 percent of the government shares in electronic industries Končar were sold to the institutional investors.

A comprehensive set of measures to streamline social benefits, reform the pension system, and improve the healthcare system is also being considered. Significant progress has been made with regards to the establishment of a single center for social welfare benefits with integrated data and benefit administration (one-stop-shop). Measures to encourage a longer working life and increase penalization for early retirement are also considered. The government also seeks a consensus to implement the necessary changes in the primary healthcare and health insurance system, emergency medicine reform, and hospital network reorganization, including rationalization and reorganization of non-medical services in the hospitals. In the context of improving the business environment, the authorities are re-examining the para-fiscal charges for the private sector. Despite the many challenges ahead, the Croatian authorities are confident that these measures will help improve competitiveness, and pave the road to sustainable and more inclusive growth.