IMF Country Report No.12/302

THE REPUBLIC OF CROATIA

2012 ARTICLE IV CONSULTATION

November 12, 2012

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 2012 Article IV consultation with Croatia, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 2, with the officials of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 23. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its November 7 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Croatia.

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

Selected Issues Paper (Non-bundle publication)

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

October 23, 2012

KEY ISSUES

Context. Economic growth stagnated in 2011 after two years of contraction. With unfavorable external conditions and subdued domestic demand, GDP is expected to contract further by 1½ percent in 2012, only modestly picking up by ¾ percent in 2013. Risks are large and tilted to the downside, mainly related to possible setbacks in Croatia's external partners in the EU and the Balkans. Despite a significant narrowing of the current account deficit, external vulnerabilities remain high.

Fiscal policy. The authorities are committed to fiscal consolidation as implied by the Fiscal Responsibility Law and, in due course, the EU economic governance mechanisms. The targeted budget deficit in 2012 will likely be achieved. However, further efforts are needed in 2013 and beyond to return to fiscal sustainability and retain market access in a way that minimizes headwinds to growth.

Monetary and financial sector policies. Within their framework centered on a broadly stable exchange rate, the CNB has appropriately allowed in recent years increased two-way exchange rate flexibility, which has facilitated macroeconomic adjustment and limited speculation. Continuing to allow increased exchange rate flexibility while accumulating reserves during periods of ample foreign exchange liquidity would improve the economy's resilience to external shocks. The largely foreign-owned banking system remains stable, well capitalized and resistant to shocks, although growing NPLs, indirect credit risk stemming from vulnerable borrowers, and sizeable dependence on parent banks for funding require careful monitoring.

Structural reforms. Only limited progress has been made in recent years to improve Croatia's structural weaknesses that have severely affected competitiveness, limiting export and productivity growth. The government's new structural reform program is a good start, but many key reforms remain to be developed to return to reasonable medium-term GDP growth.

Approved By
Aasim Husain and Masato Miyazaki

Staff team: Mr. Gueorguiev (head), Ms. Mahieu, Mr. Heinz, Mr. Omoev (all EUR). Ms. Martinis (Advisor, OED) joined most discussions. Mission dates: September 19–October 2, 2012.

CONTENTS

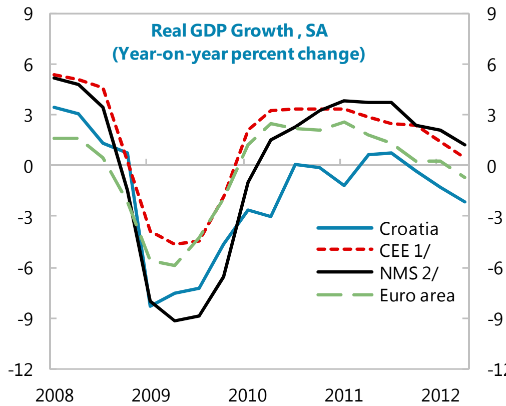
TABLES

ANNEXES

CONTEXT

A. Recent Developments

1. The economy is struggling to restart growth after the 2009 recession, lagging behind most European economies. After a second year of contraction in 2010, output stagnated in 2011. Private sector deleveraging and high unemployment (14.5 percent in Q2 2012) weighed on domestic demand, while exports remained subdued due to weak competitiveness, narrow export base, and unfavorable external environment. Output contracted by 1.7 percent in the first half of 2012, as both consumption and investment fell strongly (Figure 1).



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.
1/ Simple average. Includes Czech Republic, Hungary, Poland, and Slovak Republic.
2/ Simple average. Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

2. A sizeable output gap has kept inflation contained. Weak domestic demand and deteriorating labor market conditions kept core inflation low (Figure 2). However, headline inflation rose to 3½–4 percent in mid-2012 due to the impact of a VAT increase and the rise in food and energy prices. Nominal and real annual wage growth remained subdued.

3. A new government is in office. A center-left coalition won the December 2011 elections. EU accession is expected for mid-2013.

B. Outlook and Risks

4. GDP is projected to contract further in 2012, while medium term prospects are constrained by deep-rooted competitiveness problems. High-frequency indicators suggest negative growth of about -1½ percent, with expanding tourism only partly offsetting weak industrial production and construction. Low confidence, high unemployment, and feeble credit growth will keep domestic demand subdued in the near term. GDP is projected to rise only modestly in 2013 by ¾ percent on the back of the expected sizeable public investments. Further on, growth is expected to pick up slowly as domestic demand recovers and the external environment improves, with inflation hovering around 3 percent and the external current account deficit widening to 4¼ percent of GDP in 2017. Barriers to investment and employment growth, if not forcefully addressed, will keep potential growth modest and the negative output gap will close only gradually. Private sector deleveraging should slowly reduce external debt with new borrowing remaining subdued (Table 6).

5. Risks to the outlook are large and clearly tilted to the downside. Significant setbacks in Croatia's main external partners in the EU and the Balkans are a near-term key risk to economic prospects and financial stability (see ¶32). In the medium term, should fiscal consolidation and structural reforms stall, sluggish growth and elevated vulnerabilities will further weaken the economy's ability to withstand shocks (Annex I). On the upside, the forthcoming EU accession can spur official and private capital inflows, but the experience of other new member states suggests that concerted efforts are needed to strengthen EU funds absorption capacity.

POLICY DISCUSSIONS

A. Fiscal Consolidation to Shore Up Macroeconomic Stability

6. The authorities have launched a significant consolidation in 2012, equally split between revenue and expenditure. The 2012 budget planned significant cuts in the wage bill, subsidies, and health spending (table). The budget also reflected a VAT increase of 2 percentage points, only partly offset by a 2 percentage points cut in health insurance contributions. In addition, the authorities provided some personal income tax relief, paid for by the introduction of a 12 percent tax on dividends and profit distribution. These measures aimed at reducing the deficit to 4 percent of GDP (ESA 95) under staff's macroeconomic projections.

Change in fiscal balance (Percent of GDP)[1]	Budget 2012 - 2011	Proj 2012 - 2011
Revenue	0.6	0.7
of which:		
Change in income taxes	0.1	0.1
Reduction in health insurance contributions	-0.5	-0.3
Increase in VAT	0.8	0.7
Expenditure	-0.6	-0.5
of which:		
Reduction in compensation of employees	-0.4	0.0
Reduction in subsidies	-0.3	-0.5
Savings in social benefits	-0.3	0.0
o/w Indexation of pensions	0.1	0.1
Net acquisition of nonfinancial assets	0.2	-0.2
Overall Balance	1.2	1.2

Sources: Croatia's 2012 Pre-Accession Economic Programme and IMF staff
1/ For 2012, staff's projected GDP

7. Staff expects that the 2012 budget deficit target will be reached, provided the collective agreements for public servants are amended to eliminate bonuses and other entitlements, as the government proposes. This success would, however, be achieved in a sub-optimal way, with overruns in the wage bill and social security benefits partly offset by underexecution of capital expenditure. On the positive side, revenue is expected to overperform, bolstered by improved tax and arrear collection.

8. Despite the good start, fiscal sustainability remains at risk. On current policies, staff projects that the budget deficit will remain above 3½ percent of GDP throughout the medium term, as the moderate savings from the reforms enacted so far will be offset by sluggish revenue and growing interest expenditure (table below). Public debt would eventually exceed 60 percent of GDP (and 75 percent including publicly guaranteed debt). Failure to deliver significant consolidation risks sovereign and corporate rating downgrades, deterioration in market sentiment, higher interest rates, and possible loss of external market access.

9. Against this background, staff recommended gradual but steady fiscal consolidation for a number of years. In the short run, the imperatives of establishing credibility, satisfying the requirements of the Fiscal Responsibility Law (FRL), and maintaining market access call for a structural adjustment of about 1¼ percent of GDP in 2012 and ¾ percent in 2013.[1] Further on, a gradual but steady adjustment path of about ½ percentage point of GDP a year in structural terms

[1] The FRL calls for expenditure cuts of 1 percentage point of GDP a year until a primary balance is achieved.

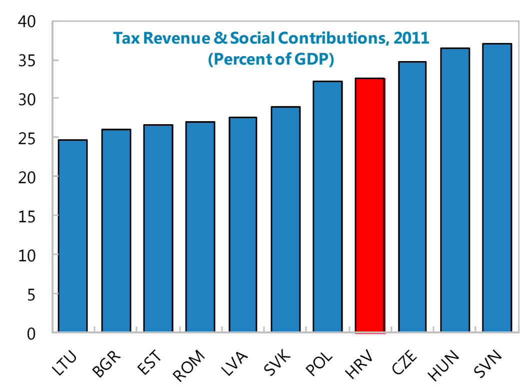
strikes the right balance between lukewarm growth prospects and shrinking fiscal space. The boost in investors' confidence, the fall in borrowing costs for both the public and the private sector, and the resulting increase in investment that such a policy would trigger should largely offset its drag on growth, especially if the savings focus on unaffordable entitlements (see ¶10). Staff recommended that consolidation be continued until the structural deficit reached zero. This policy would lower debt, vulnerabilities, and borrowing costs to a manageable level—particularly in view of the sizable contingent liabilities—and create fiscal space for countercyclical policies. It is also consistent with the EU Fiscal Compact, which calls for a structural deficit of at most ½ percent of GDP adjusted down for the fiscal costs of ageing. Furthermore, it will reduce the total financing requirement in 2014–17 when the amortization needs rise sharply and financing constraints could become binding (Figure 6).

Selected Fiscal Indicators of the General Government (Percent of GDP)

	2010	2011	2012		2013	2014	2015	2016	2017
			Budget	Proj.			Proj.		
Revenue	37.8	36.8	37.4	37.5	37.7	37.6	37.6	37.4	37.4
Total expenditure	42.9	42.0	41.4	41.5	41.0	41.3	41.0	41.0	40.9
Of which: interest expenditures	2.0	2.3	2.4	2.4	2.9	3.0	3.1	3.2	3.2
Overall balance	-5.1	-5.2	-4.0	-4.0	-3.3	-3.7	-3.4	-3.6	-3.6
Primary balance	-3.0	-2.9	-1.5	-1.5	-0.4	-0.7	-0.3	-0.4	-0.3
Structural balance 1/	-3.8	-4.5	-3.2	-3.2	-2.8	-3.3	-3.2	-3.4	-3.6
Public sector direct debt	42.2	46.7	53.8	53.8	55.4	56.9	57.8	58.7	59.2
Public sector guaranteed debt	18.2	17.9	15.2	15.2	15.2	15.2	15.2	15.2	15.2
Output gap	-3.0	-1.6	-2.3	-2.3	-1.7	-1.1	-0.6	-0.5	0.0
Memorandum Items									
Overall Balance (staff advice)				-4.0	-3.0	-2.5	-1.8	-1.2	-0.5
Structural balance (staff advice)				-3.2	-2.5	-2.0	-1.5	-1.0	-0.5
Public sector direct debt (staff advice)				53.8	55.0	55.3	54.6	53.4	51.0

Sources: Ministry of Finance; IMF staff estimates. It is assumed that shipyard debt will be taken over as explicit debt in 2012.
1/ Adjusted for one-off effects and expressed as percent of potential GDP.

10. The expenditure-based consolidation required by the FRL is appropriate given Croatia's high tax burden and unsustainable expenditure levels. With a tax-revenue-to-GDP ratio well exceeding the CESEE average, policies should continue to focus on rationalizing bloated public employment and remuneration, revamping the unaffordable pension and health systems, and reducing overly generous subsidies (*Selected Issue* paper I). Such cuts are likely to have less damaging effect on growth than capital expenditure cuts, also as they are likely to boost labor force participation and competition. The government should launch a wide-ranging social dialogue on the need to reform these sensitive areas and identify early on the measures that will make the FRL targets in 2013–15 credible**.**



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

11. Additional efforts appear needed in 2013. On currently contemplated policies, staff projects that the 2013 general government budget deficit will amount to 3.3 percent of GDP, with expenditure adjustment of ½ percentage point relative to 2012 and a revenue increase of ¼ percentage point, mainly due to one-off effects. To comply with the spirit of the FRL and minimize the risk of losing market access in the face of rapidly rising public debt (projected to exceed 55 percent of GDP in 2013), staff advised cutting expenditure further by ½ percentage point of GDP and targeting a headline deficit of no more than 3 percent of GDP, after accounting for the revenue loss from further rebalancing of the tax mix (see ¶12). The recommended expenditure cuts can be achieved by preventing a rise in subsidies from their 2012 level and strengthening pension and health care entitlement reforms (table).

Estimated Savings from Possible Expenditure Reform Options compared to the baseline (Percent of GDP)

Policy Measures	2013	2014	2015
Reduce the budgetary wage bill by 5 percent a year	0.5	1.0	1.4
Pension reforms			
Increase the penalty for early retirement	0.1	0.1	0.1
Increase retirement age faster and raise it to 67	0.1	0.2	0.3
Reduce pension tax exemption	0.1	0.2	0.3
Health Expenditure			
Reduce co-payment exemptions	0.5	0.5	0.5
Tighten elibigility for sick leave	0.2	0.2	0.2
Reduce subsidies to 1 percent of GDP by 2015	0.3	0.5	1.0
Resulting estimated savings	1.8	2.7	3.8

Sources: IMF, "Croatia – Expenditure Rationalization in the Context of EU Accession", April, 2008; The World Bank, "Croatia: Policy Options for Further Pension System Reform," July, 2011; and IMF staff estimates.

12. **Staff welcomed the efforts to rebalance the tax structure away from labor in a revenue-neutral way and encouraged the authorities to pursue them further**. The 2012 health contributions-VAT rebalancing, a.k.a. fiscal devaluation, should improve competitiveness and underpin demand for labor. To reduce the revenue loss from the intended further 1 percentage point cut in health contributions in 2013, staff recommended increasing the zero VAT rate on certain domestic sales to 10 percent rather than the minimum admissible 5 percent under EU requirements, with part of the additional revenue used to augment targeted social assistance. Furthermore, introducing a modern value-based property tax, accompanied by transferring additional spending responsibilities to local governments, would also help. However, the proceeds of such tax are likely to be low in the short term given the need to improve the land and property registers.

13. **Staff agreed that the planned large investment projects by state-owned enterprises could support growth, but warned that they should be accompanied by efficiency-raising enterprise restructuring and subjected to a careful cost-benefit analysis.** The projects in the energy sector, water supply, education, and health care could underpin growth, reduce costs and energy dependency, and raise the economy's potential. They should, however, be accompanied by restructuring of the involved state-owned enterprises to ensure efficient implementation. Moreover, given that these investments will raise the debt of the broader public sector, staff recommended a careful assessment of their benefits for long-term growth versus financial cost. In this context, the authorities appropriately plan to rely as much as possible on the forthcoming EU structural and cohesion funds and private borrowing in a PPP context; care should be taken in the latter case, however, to ensure the proper division of the associated benefits, costs, and risks.

14. **Staff advised considerable strengthening of the Fiscal Council.** Created to monitor compliance with the FRL, the Council needs a clarification of its mandate, resources to implement it, and independence from the executive. In particular, it should be made clear that the Council is expected to assess compliance with the FRL both on an ex-post and ex-ante basis, with the technical parameters of these assessments unambiguously defined and written reports required.

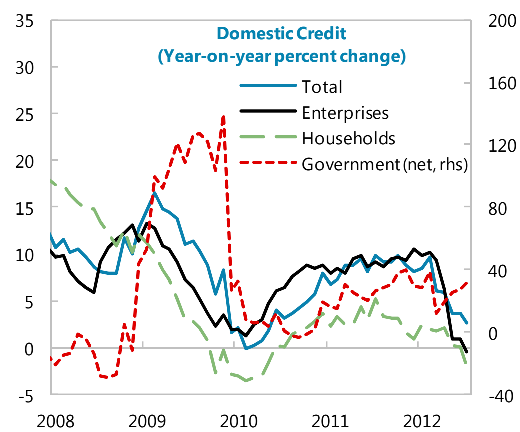
Authorities' Views

15. The authorities underscored their commitment to credible and sustained consolidation in line with the FRL. They noted that delays in implementing their plans for wage reform were caused by the need to achieve buy-in from the labor unions. Moreover, the late approval of the 2012 budget affected the pace of public investment. Going forward, they broadly agreed with staff's recommendations for the deficit and expenditure adjustment in 2013, indicating that they were already developing similar plans. In particular, the authorities outlined their plan to gradually introduce a modern and equitable property tax, while transferring some health expenditures to the local governments. Regarding the medium term, the authorities viewed staff's advice as consistent with the EU Stability and Growth Pact and the Fiscal Compact, noting that they would develop the necessary reforms to comply with these mechanisms after extensive social dialogue.

B. Monetary Policy: Defending the Nominal Anchor

16. The CNB continues to pursue its long-standing stable exchange rate policy within the de jure managed float framework. The CNB fended off depreciation pressures in 2011–12 with foreign exchange interventions and relaxation of foreign currency reserve and liquidity requirements, while allowing increased exchange rate flexibility (Figure 4). In September 2012 the CNB intervened to accumulate reserves and fight seasonal appreciation pressures. At present, there is ample liquidity on domestic markets, both in kuna and foreign currency (Figure 3).

17. With inflation contained, the CNB attempted to support credit growth while maintaining broad exchange rate stability. The CNB took a number of measures in early 2011 to stimulate credit (Figure 3).[2] However, when depreciation pressures emerged in late 2011, the CNB tightened back, raising the reserve requirements. When the pressures subsided, the CNB again eased the reserve and foreign currency liquidity requirements in April 2012. They also reached an agreement with commercial banks to channel the released liquidity together with additional bank funds toward cheap loans to the economy in a scheme involving risk-sharing with the state-owned Development Bank (HBOR). Despite these initiatives, credit growth slowed down markedly in 2012 mainly reflecting weak demand.



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

18. Staff encouraged the CNB to continue allowing increased exchange rate flexibility, while agreeing that large exchange rate movements would be harmful. Since 2009, the CNB has appropriately allowed increased two-way exchange rate flexibility, which has facilitated macroeconomic adjustment and limited speculation. At the same time, the extensive liability euroization suggests that large exchange rate

[2] Foreign currency liquidity of 1.8 percent of GDP was injected into the system by lowering the foreign currency liquidity requirement; the overnight deposit rate was reduced by 25 basis points; the borrowing terms of various credit stimulating schemes were relaxed, and new schemes were introduced.

fluctuations could severely affect banks' and borrowers' balance sheets.[3] Staff noted that in this context strong fiscal and structural policies are indispensable to improve competitiveness and restart growth, as the experience of regional peers indicates.

19. Staff noted that pursuing two goals with one instrument was difficult. The CNB aims at keeping the exchange rate stable, while trying to boost credit growth. These two objectives often require opposite changes in domestic liquidity conditions, making monetary policy prone to confidence-damaging reversals.

20. Credit support schemes could mitigate the ongoing credit slowdown, but caution is needed to avoid potential side effects. Staff agreed that credit schemes aimed at boosting credit growth (¶17) could serve as a second best tool to help underpin economic activity in an environment of weak credit demand and high bank risk aversion. However, staff advised caution to avoid compromising HBOR's balance sheet or banks' credit standards, which would raise future NPLs.

Authorities' views

21. The CNB reaffirmed their commitment to a broadly stable exchange rate policy, while recognizing the benefits of some exchange rate flexibility. They noted the substantial contractionary impact of exchange rate depreciation in a euroized economy, while pointing out that the associated competitiveness gains would be limited given the small export base, the capacity constraints in tourism, and the large pass-through to domestic inflation. The CNB concurred that fiscal and structural reforms are the only way to restart growth while stressing that the exchange rate anchor allows such reforms to proceed in a stable macroeconomic environment.

22. The CNB argued it was possible to balance between maintaining a stable exchange rate and supporting credit. The authorities agreed that excessive volatility in prudential requirements should be avoided but stressed the importance of maintaining high reserve requirements and foreign liquidity ratios given the fact that CNB is not the lender of last resort in foreign currency. They stressed that the strict criteria for granting loans under the credit support schemes should prevent deterioration of credit standards, while pointing out that the impact on credit will unfortunately be limited this year given the slow disbursement of funds.

C. Preserving Financial Stability

23. Despite the slow deterioration in asset quality, the largely foreign-owned banking sector is stable, well-capitalized, and resilient to shocks. The ongoing recession is affecting the nonperforming loan (NPL) ratio, which reached 13 percent in June 2012, with corporate NPLs at 23 percent. Profitability has started to decline from relatively high levels, in part owing to a pick-up in specific NPL provisions, which still remain low relative to neighbors and history (text table and Table 8). Nevertheless, high capital adequacy and liquidity ratios—even if somewhat flattered by low

[3] Household and corporate loans in foreign exchange (including indexed loans) are 70-75 percent of their total loans, respectively, and this exposure is only partially hedged, subjecting banks to significant indirect credit risks.

provisions—indicate sufficient buffers to ensure the system's stability. Notably, the CNB stress tests suggest that most banks could absorb the effects of an increase in the NPL ratio to 20 percent (34 percent for corporates), and only a few banks would need additional capital totaling about 0.6 percent of GDP.[4] Liability deleveraging has been proceeding gradually, averaging about 3 percent of the outstanding stock per quarter in 2011 Q3–2012 Q2.

Financial Soundness Indicators, 2012 Q2
(Percent)

	Capital to risk-weighted assets	Nonperforming loans to total loans	Bank return on assets	Bank return on equity	Share of foreign currency denominated loans in total loans	Loan-loss provision to non-performing loans
Croatia	20.2	13.2	1.1	7.8	73.6	42.1
Czech Republic	15.7	5.1	1.5	22.2	22.2	49.5
Hungary	15.1	15.8	0.3	3.1	57.7	45.5
Poland	13.6	4.8	1.2	15.2	32.1	70.8
Romania	14.7	16.8	-0.1	-1.0	63.7	55.6
CESEE average[1]	16.4	11.9	0.8	7.6	50.9	58.9

Source: IMF, Financial soundness indicators

1/ Simple average of CESEE economies includes Slovenia and Slovak Republic and excludes Albania, Estonia, Montenegro, and Serbia due to data unavailability. For the share of FX loans, excludes euro area economies.

24. Nevertheless, staff argued that risks to systemic financial stability remain, mainly from external spillovers. The low coverage of NPLs by specific loan-loss provisions may adversely impact capital adequacy in case of further deterioration of the loan portfolio. The large exposure of borrowers to currency and interest rate risk creates significant credit risk for banks. In addition, the strong dependence of subsidiaries on euro area parent banks for funding exposes them to the risk of contagion, with potentially substantial impact on growth.[5] [6]

25. In this context, staff stressed the importance of safeguarding financial stability through strong regulation and enhanced supervision, including close cooperation with home supervisors. Staff advised the CNB to maintain high statutory capital buffers, to continue close monitoring of liquidity and credit developments, and call for raising banks' capital if needed. Staff also recommended ensuring realistic loan classification and valuation of collateral as well as adequate provisioning for NPLs. Staff strongly encouraged coordination with home supervisors to foresee and limit deleveraging pressures. In this regard, the recently launched Host Country Cross Border Forum under the auspices of the Vienna 2.0 initiative is timely.

26. Staff also urged the authorities to ensure swift resolution of NPLs. If not addressed, the high level of NPLs is likely to drag economic growth down by limiting credit supply. Fast NPL resolution requires cooperation between creditors and debtors as well as elimination of regulatory, tax, and legal obstacles. In particular, speeding up the bankruptcy process, removing the difficulties to foreclose collateral, and resorting more to out of-court restructuring should help.

[4] The stress tests assumed a 10 percent depreciation of the exchange rate along with a 4 percent drop in real GDP.

[5] Liabilities to nonresidents represent a quarter of total bank liabilities, 90 percent of which are to parent banks, mainly from Italy and Austria.

[6] GFSR (October 2012) estimates that deleveraging in Western Europe could reduce credit growth in emerging Europe by about 5 percent. Staff estimates for Croatia suggest that each percentage point reduction in real credit growth subtracts about 0.15 percentage point from GDP growth.

Authorities' views

27. Both the authorities and banks pointed out that bank liability deleveraging was prompted by Croatian banks taking advantage of rising domestic deposits to reduce external credit lines in view of stagnating credit demand. They acknowledged that real estate market illiquidity hampered collateral valuation. The CNB stated, however, that the required general provisions of 0.85-1.2 percent of performing loans to cover latent losses provided an additional buffer against capital losses.

28. Concerning the impact of new regulations, the authorities explained that the new law on financial operations intends to speed up the resolution of NPLs by increased reliance on out of court settlements and restructuring. A key objective is to resolve the long standing corporate illiquidity problem and thus spur lending to companies with viable projects. The authorities explained that Basel III requirements could be easily met by the major banks. In fact, Basel III would allow lower capital adequacy rates than the current Croatian requirements; however, the CNB intends to explore the option of requiring more capital if needed from individual banks.

D. Mitigating External Vulnerabilities and Spillover Risks

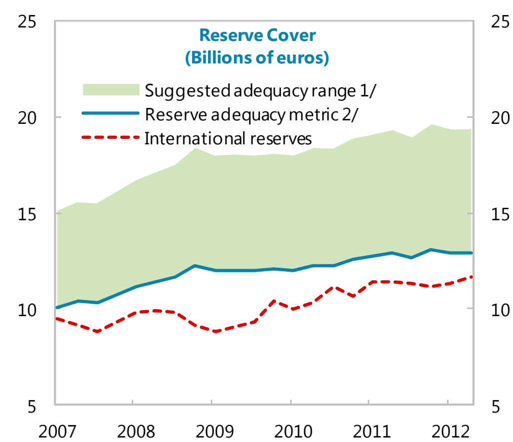
29. Despite the narrow current account deficit, competitiveness is weak. Since 2009, the current account has stayed close to 1 percent of GDP, largely reflecting strong import contraction (Table 4). Accordingly, model-based estimates suggest that the REER is close to equilibrium (table) and the underlying current account deficit is not far from its estimated sustainable level of about 2¾-3 percent of GDP that would eventually stabilize net foreign liabilities at 55-60 percent, the average level in emerging Europe. However, a range of alternative gauges of competitiveness, notably high wages relative to productivity, declining market shares, and substantial non-price weaknesses stemming from the inhospitable business environment and the rigid labor market suggest competitiveness problems that have severely limited export growth performance (Box 1).

Assessement of Croatia's Real Exchange Rate

	Estimated overvaluation (percent)
Macroeconomic balance approach	4.5
External sustainability approach	
Stabilizing NFA at -84 percent of GDP	0.4
Stabilizing NFA at -55 percent of GDP	5.8
Equilibrium exchange rate approach	2.2 to 7.2

Source: IMF staff's estimates.

30. External vulnerabilities remain high and the international reserve buffer should improve. Debt rollover risks are significant with external (mostly private) debt of about 100 percent of GDP, and an external financing requirement of about 30 percent of GDP (Figure 10). Cross-border claims of BIS reporting banks on Croatia's borrowers are the highest in the CESEE countries at about 60 percent of GDP (half of which to banks). Net capital inflows to the private sector have continued to slow down significantly and maturities are shortening; the increase in portfolio investment in recent years reflects government bond issuance and some repatriation of banks' foreign assets (Figure 5). Furthermore,



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

despite some recent increase reserves remain low relative to various reserve adequacy metrics and are not projected to rise further under the baseline scenario (Table 4).[7] The CNB should therefore continue to use periods of ample foreign exchange liquidity to accumulate international reserves, aiming for at least 100 percent coverage of short-term debt.

Croatia: Reserve adequacy measures

	2011	2012	2013	2014
Gross official reserves (millions of euros)	11,187	11,211	11,098	10,996
Months of imports of good and services	7.2	7.0	6.6	6.2
Percent of short-term debt at remaining maturity	80.0	87.3	89.2	86.1
Percent of short-term debt at remaining maturity plus current account deficit	76.7	83.8	82.7	78.0
Percent of IMF composite measure (fixed) 1/	85.6	88.4	84.6	80.0

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

1/ The suggested adequacy range is 100 to 150 percent of the reserve adequacy metric.

31. However, market confidence has improved lately. Bond and CDS spreads have declined, influenced by external factors and Fitch's raising the sovereign outlook to stable, although they remain elevated compared to peers (Figure 4). The government has maintained access to international markets, issuing a US$1.5 billion bond in 2012. Yields on domestic issues benefitted from large liquidity in the market, and have been decreasing in the course of 2012.

32. A strong intensification of the euro area crisis would significantly affect Croatia via real and financial channels. Lower exports combined with net capital outflows would strongly pressure the exchange rate.[8] The likely reduction and higher cost of external bank and corporate financing would lead to a credit crunch, while growing NPLs are likely to weigh on banks' profitability. Dwindling fiscal revenue and increasing expenditure needs would significantly widen the fiscal deficit. Given the reduced liquidity, domestic financing of the fiscal deficit would become challenging and would further crowd out private sector financing, while the deteriorating fiscal position and growth outlook could lead to a rating downgrade, sharply raising the cost of external financing.

33. In this scenario, the policy response should aim to mitigate the shock while facilitating adjustment and continuing with fiscal and structural reforms. Fiscal policy should allow automatic stabilizers to work on the revenue side, but planned expenditure adjustment measures should continue and may even need to be frontloaded if access to financing becomes an issue. The focus of monetary and financial policies should be on resisting large exchange rate depreciation and supporting financial stability. The CNB could relax prudential measures to increase the provision of foreign currency liquidity and seek official financing, e.g. through swap lines.

[7] The projected reserve coverage of short-term debt at remaining maturity in the 85-90 percent range is below the accepted rule of thumb of at least 100 percent for emerging market economies. In addition, reserves seem also low based on a weighted metric tailored for stable exchange rate regime (text table).

[8] The euro area and the EU account respectively for about 50 and 60 percent of exports and imports on Croatia and about 80 and 90 percent of FDI inflows.

Authorities' views

34. The CNB agreed with the need to build international reserves further to alleviate investors' perception of Croatia's risk, although they stressed that the large share of intra-company debt should be taken into account when assessing reserve adequacy. The authorities concurred with staff on the main policy responses in case of significant deterioration of the external environment.

E. Structural Reforms to Raise Growth

35. Croatia's rigid labor market and difficult business environment hamper medium-term growth. Recent years have seen some reforms in pension and unemployment benefits, but only limited measures have been taken to foster labor market flexibility, improve business climate, and reduce the size of the public sector (Box 1). Far reaching reforms are therefore needed to return to a reasonable medium-term GDP growth and reverse the sharp increase in unemployment.

36. Staff urged the authorities to implement a strong reform agenda to address these weaknesses. The government's program, adopted in August, is a good start and some measures have already been taken. However, many key reforms remain to be developed. Staff recommended that priority be given to measures aiming to: (i) raise labor force participation via a faster increase in the retirement age for women to 65, a further increase to 67 for both men and women, higher penalty for early retirement, and tighter control over the apparently abused system of disability retirement; (ii) improve labor market flexibility by reducing hiring and dismissal costs, including for poor performance, ensuring that the envisaged single open-ended contract does not impede flexibility, and allowing firms to opt out from onerous sector-level collective agreements; (iii) following the best examples in the region, foster competition and reduce barriers to market entry by relaxing the licensing and administrative requirements to open a business (notably at the local level) and speeding up privatization. Staff estimates that these reforms could lift GDP growth by about 2 percentage points in the medium to long term by improving labor force participation, productivity and export growth (Box 2).

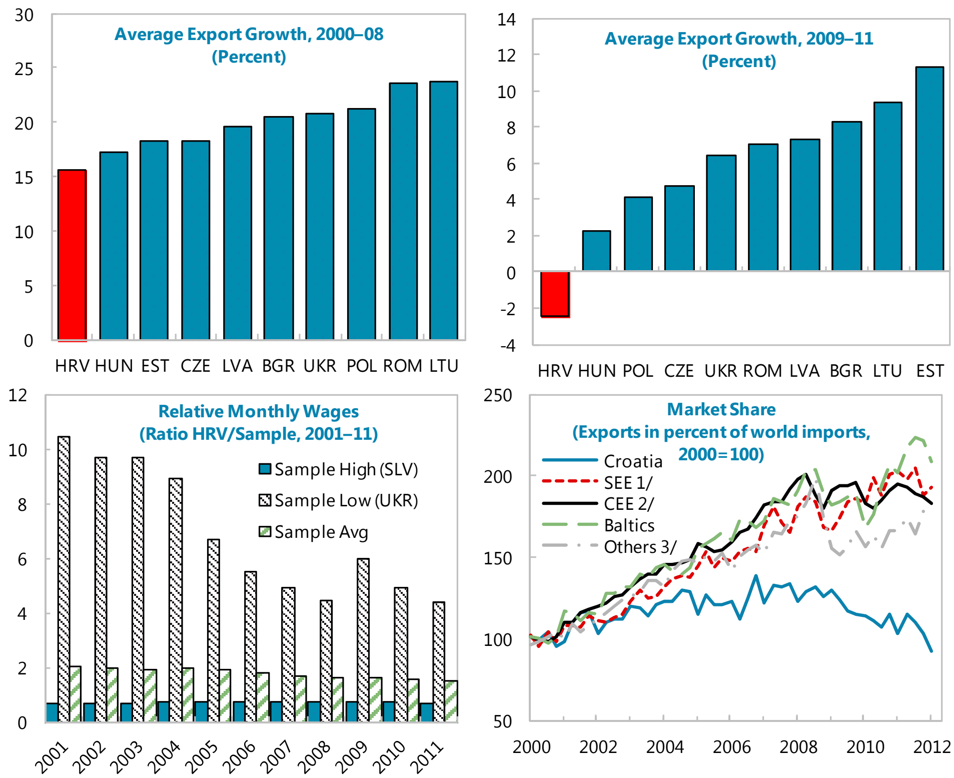
37. Staff stressed the importance of taking full advantage of Croatia's forthcoming accession to the EU. Potential official and private capital inflows triggered by EU accession could significantly boost medium-term growth if oriented to productivity-enhancing projects. This, however, requires designing a coherent development strategy with clear project prioritization, strengthening the administrative capacity to develop those projects, reducing barriers to investment, and creating fiscal space for Croatia's co-financing of EU-funded projects.

Authorities' views

38. The authorities largely agreed with staff's diagnostics and reform priorities. They stressed their commitment to rapid implementation of the recently adopted structural agenda, with a new Pension Act and Labor Law planned to be adopted by mid-2013, although they noted that raising the retirement age to 67 is a task for the future. They also pointed out that Croatia's inclusion in EU economic governance mechanisms would spur further institutional and structural reforms.

Box 1. Obstacles to Croatia's Export Performance

High wage level has been hurting export performance. Croatia's world export market share has remained stagnant over the past decade, in marked contrast with its peers. A detailed sectoral assessment of Croatia's export competitiveness suggests that Croatia has made limited strides in increasing its presence in some markets but lost market share in major export products, despite relatively low ULC growth for many export goods, in particular in manufacturing. This is partly because the wage level in Croatia remains well above the average level in peer countries and high compared to productivity levels (Figure 7), despite a decline in the wage differential between Croatia and comparator countries over the past decade. (*Selected Issues* paper II).

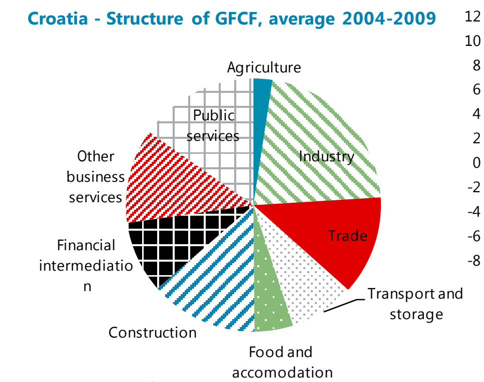


Source: WEO, Direction of Trade Statistics, IMF Staff Estimates. 1/ Includes Albania, Bosnia and Herzegovina, and Macedonia. 2/Includes Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, and Slovenia. 3/Includes Russia, Turkey, and Ukraine.

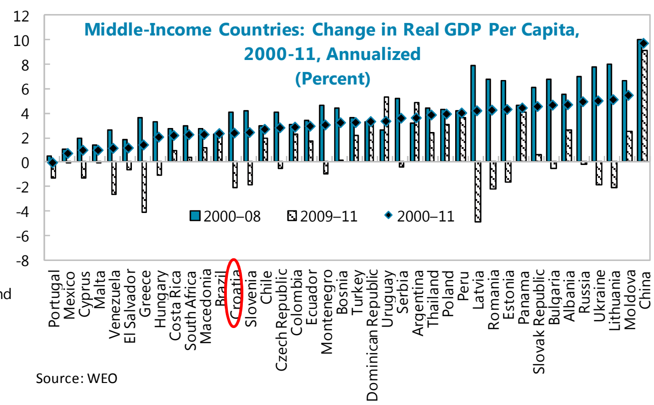
In addition, there are substantial non-price competitiveness weaknesses. Many indicators point to lack of labor market flexibility (notably high hiring and firing costs, numerous administrative loops for dismissals, low flexibility to adjust the hours worked, as well as pervasive and constraining collective agreements) as key obstacles for doing business in Croatia (Figure 8). These, combined with generous social benefits, have led to a very low labor force participation (57 percent). In addition, there are many obstacles for starting or conducting a business, including the slow procedures for obtaining a construction permit or registering a property, local barriers to investment, and an inefficient legal framework with slow resolution of insolvency. Finally, a slow process of privatization and enterprise restructuring has led to low competition and productivity levels and relatively high subsidies.

Box 2. What has Kept Croatia's Growth Low and How to Boost it?

Croatia's capital-flow-driven growth has lagged behind most of its peers in the last decade, as capital went mainly in nontradable sectors. Croatia's GDP growth per capita in 2000–11 averaged 2½ percent, below most middle-income countries and Croatia's emerging Europe peers. Croatia's underperformance is particularly notable in 2009–11. Capital flows in the pre-crisis period were mostly directed towards nontradable sectors (finance, construction, and public services), which generally show lower productivity growth than tradables. Industrial investment averaged only 20 percent, significantly less than in the rest of emerging Europe.



Source: Croatia National statistics



Source: WEO

This shows that Croatia's far-from-perfect pre-crisis growth model has run its course. The borrow-and-invest-in-nontradables growth model did not generate significant productivity gains and did not create many jobs, questioning its sustainability given the growing external debt. Growth plummeted in 2009 and has not yet returned.

Empirical evidence suggests that the impact of reforms could be substantial, raising annual GDP growth by about 2 percentage points in the medium to long term. If Croatia's labor participation rate were to increase to 70 percent as in the Czech Republic, GDP growth would increase by about 1 percent.[9] Growth regressions show that structural reforms to improve labor market flexibility and business environment to the average level in emerging Europe or that of the leader Estonia could boost growth by about 0.4-0.9 percentage point. If the investment to GDP ratio would as a result increase to 25 percent (the average level in Slovakia, Slovenia, Czech Republic, Bosnia, and Latvia in 2000–08), growth would rise by an additional 0.3 percentage point. While the quantification of the impact of structural reforms on growth is subject to large uncertainties, this exercise nevertheless suggests that Croatia could substantially boost growth via such reforms (*Selected Issues* paper I).

Impact on medium-term annual growth rate	
Macroeconomic reforms	1.4
Higher participation rate (target: 70%, as CZE)	1.1
o/w: Increase in employment growth	1
Increase in capital to keep K/L ratio constant	0.1
Higher domestic investment (from 23 to 25% of GDP)	0.3
Structural reforms (target: level of CEEC/EST)	0.4 - 0.9
Total effects	**1.8 - 2.3**

References: Vamvakidis (2008), Moore and Vamvakidis (2007)

[9] Policies targeted to women and older workers appear particularly useful in this regard (IMF Policy Paper, June 15, 2012). For instance, in New Zealand, the rapid increase in retirement age from 60 to 65 during the 1990s led to an increase in the labor force participation of the 55-64 age group by over 15 percentage points (R. Duval, OECD, 2003).

STAFF APPRAISAL

39. Croatia's short and medium-term growth prospects are lackluster and threatened by significant vulnerabilities. With unfavorable external conditions and subdued domestic demand, GDP is set to contract once again in 2012, while structural impediments and weak competitiveness hamper medium-term prospects. In addition, large external and foreign-currency debt imply high vulnerability to external shocks, especially since a large part of the export and banking sectors is exposed to vulnerable EU countries. The authorities need to act rapidly to reduce vulnerabilities and spur growth.

40. Significant and sustained fiscal consolidation is required to restore debt sustainability and retain market confidence. Staff welcomes the authorities' commitment to fiscal consolidation and the expenditure retrenchment in 2012 despite the suboptimal composition of the adjustment. The additional expenditure adjustment that appears needed in 2013 can be achieved by preventing a rise in subsidies from their 2012 level and strengthening pension and health care entitlement reforms. Rebalancing the tax structure further away from labor in a revenue-neutral way would support labor demand and competitiveness. The consolidation should be continued until the structural deficit is brought to zero to lower debt, vulnerabilities, and borrowing costs to a manageable level and create fiscal space for countercyclical policies.

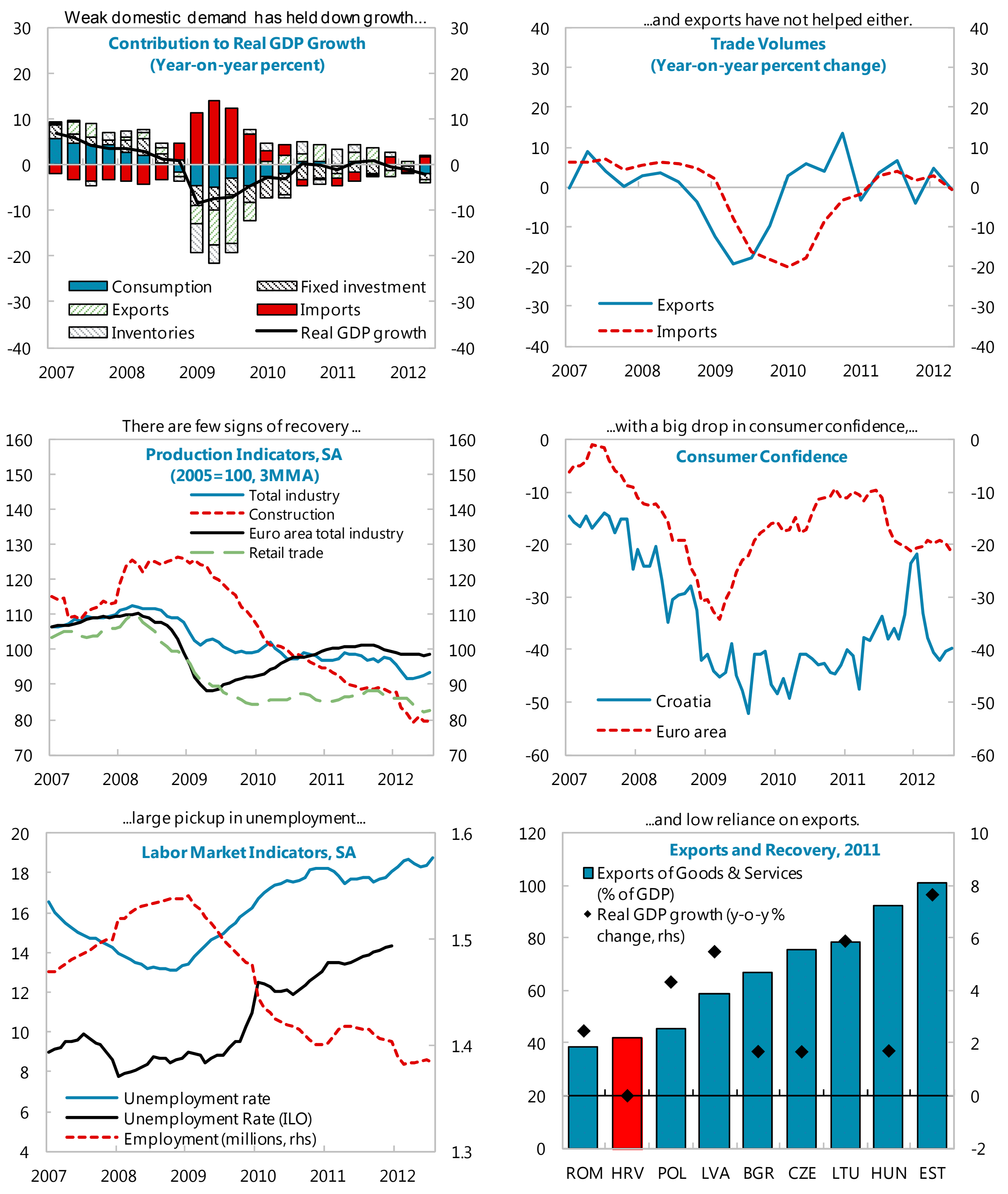
41. The authorities should continue allowing increased exchange rate flexibility and gradually accumulate international reserves. Increased two-way exchange rate flexibility improves the economy's resilience to shocks. Moreover, accumulating international reserves would build further an important buffer against external shocks.

42. Strong regulation, supervision, and cooperation with other supervisory authorities remain essential to preserve financial stability. The CNB should maintain high statutory capital buffers, call for raising banks' capital early on if needed, ensure adequate provisioning for NPLs, and further strengthen cross-border supervisory cooperation. Obstacles to quick resolution of NPLs should be swiftly removed as well.

43. Rapid implementation of a broad and ambitious structural agenda is critical to boost medium-term prospects. The government's structural reform program, adopted in August, is a good start, but many key reforms need further development in terms of specific policies and desired effects. Priorities should be given to measures aiming to (i) raise labor force participation; (ii) enhance labor market flexibility; (iii) improve the business environment and product market competition.

44. It is recommended that the next Article IV consultation with Croatia be held on the standard 12-month cycle. Croatia is an Article VIII country, and data provision is adequate for surveillance (Informational Annex)**.**

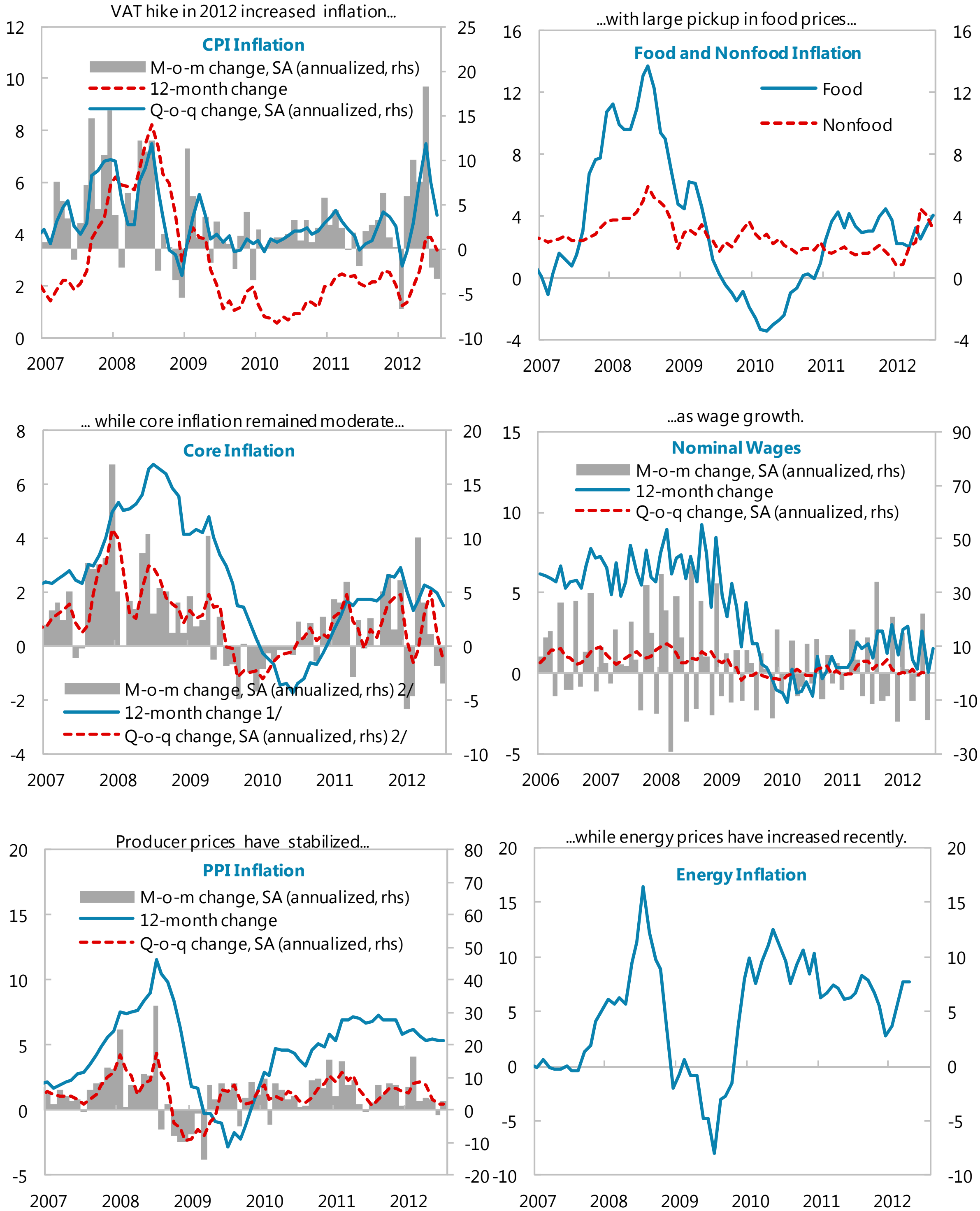
Figure 1. Croatia: Real Sector Developments, 2007–12



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

Figure 2. Croatia: Inflation Developments, 2007–12

(Year-on-year percent change, unless otherwise indicated)

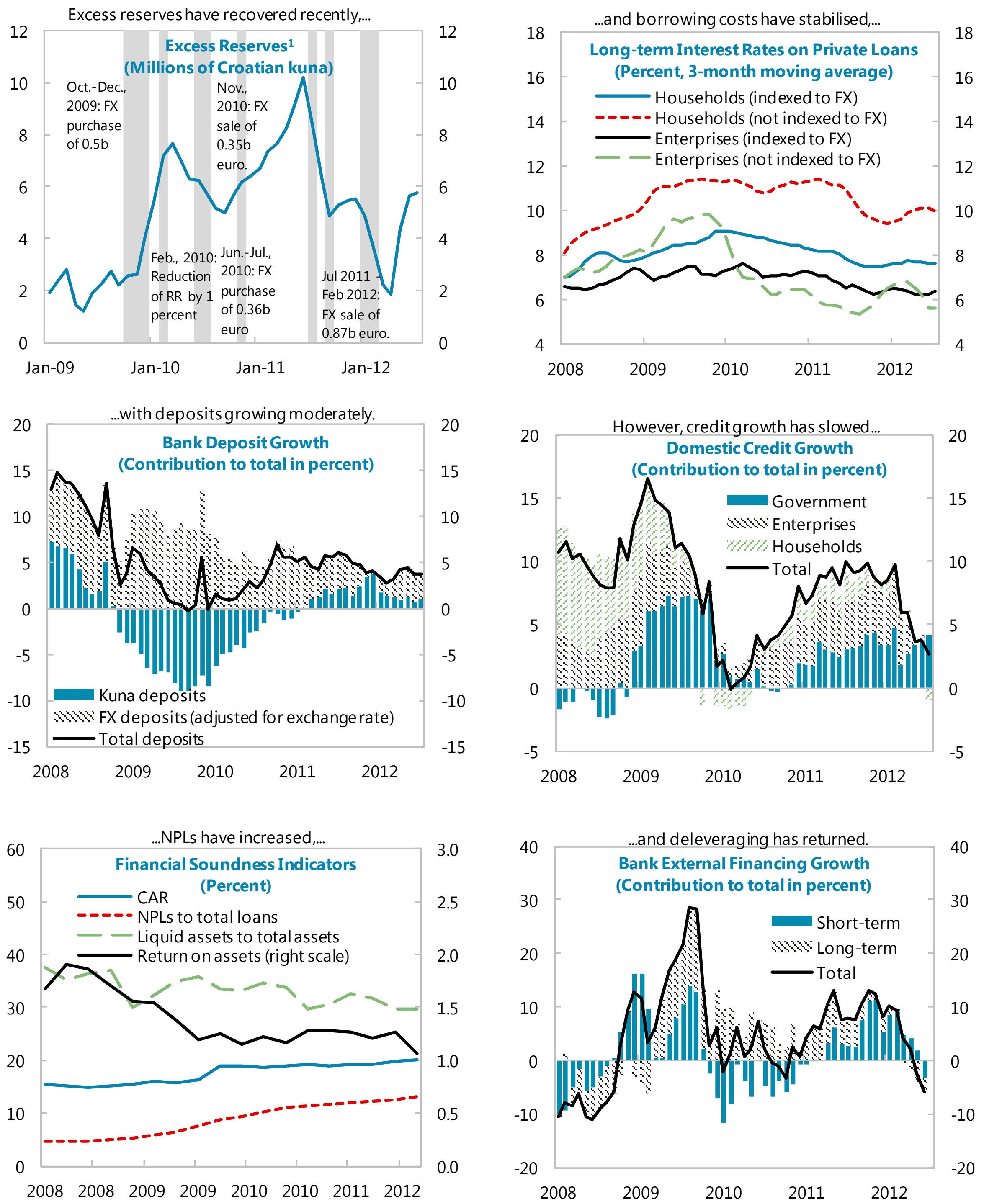


Sources: Central Bureau of Statistics; and IMF staff calculations.

1/ Excludes food and energy.

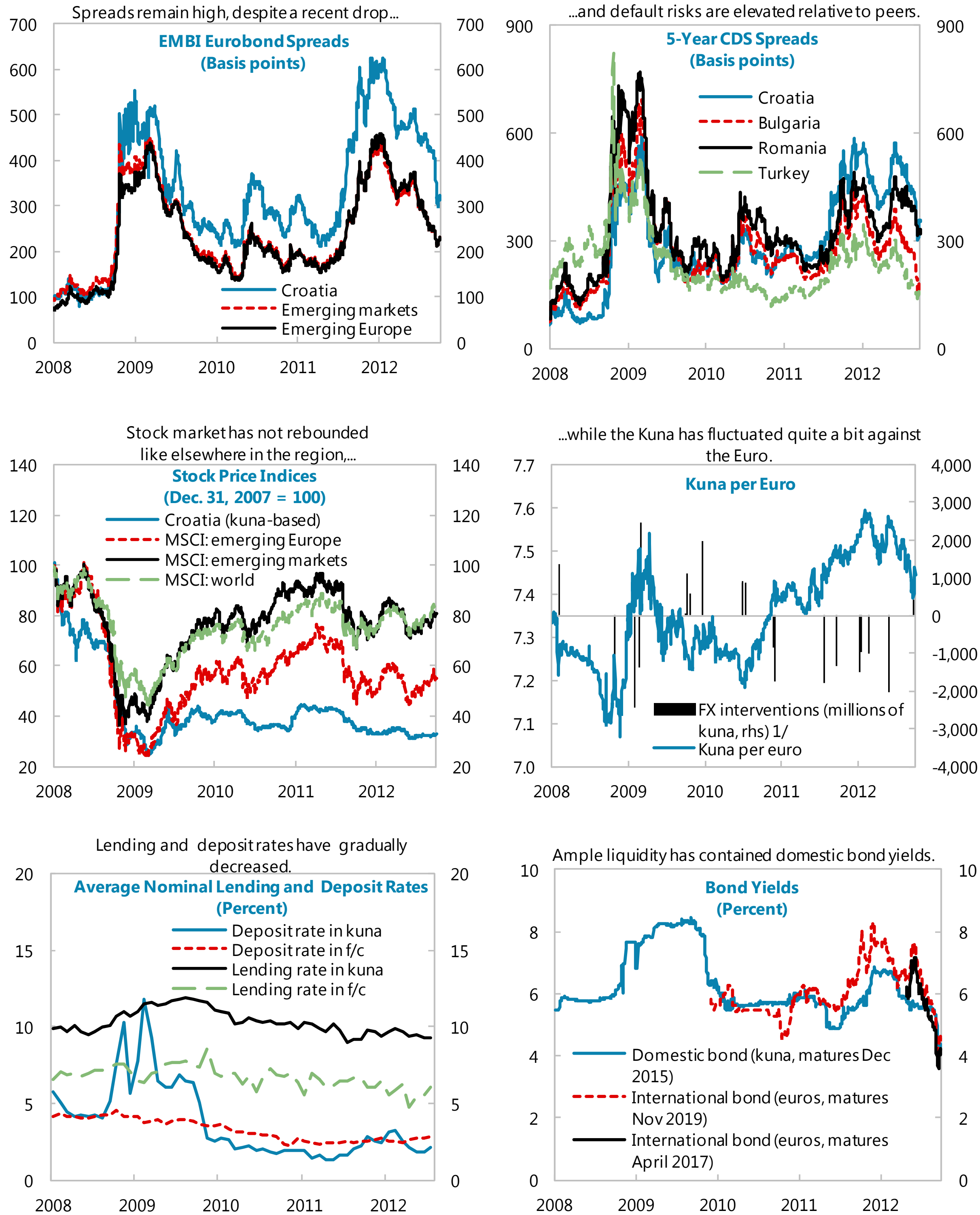
2/ Broader measure.

Figure 3. Croatia: Monetary and Banking Sector Updates, 2008–12



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

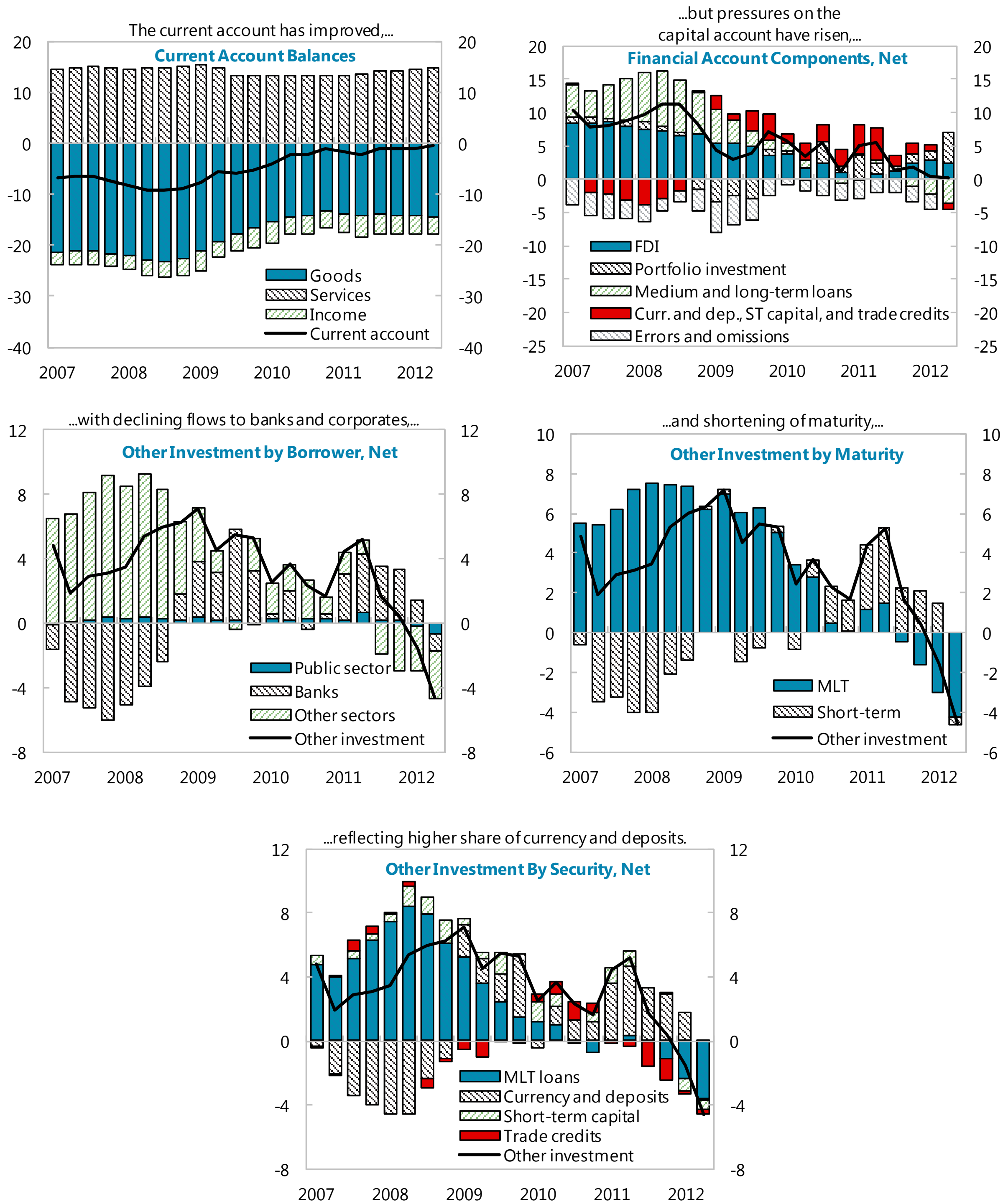
Figure 4. Croatia: Financial Market Developments, 2008–12



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

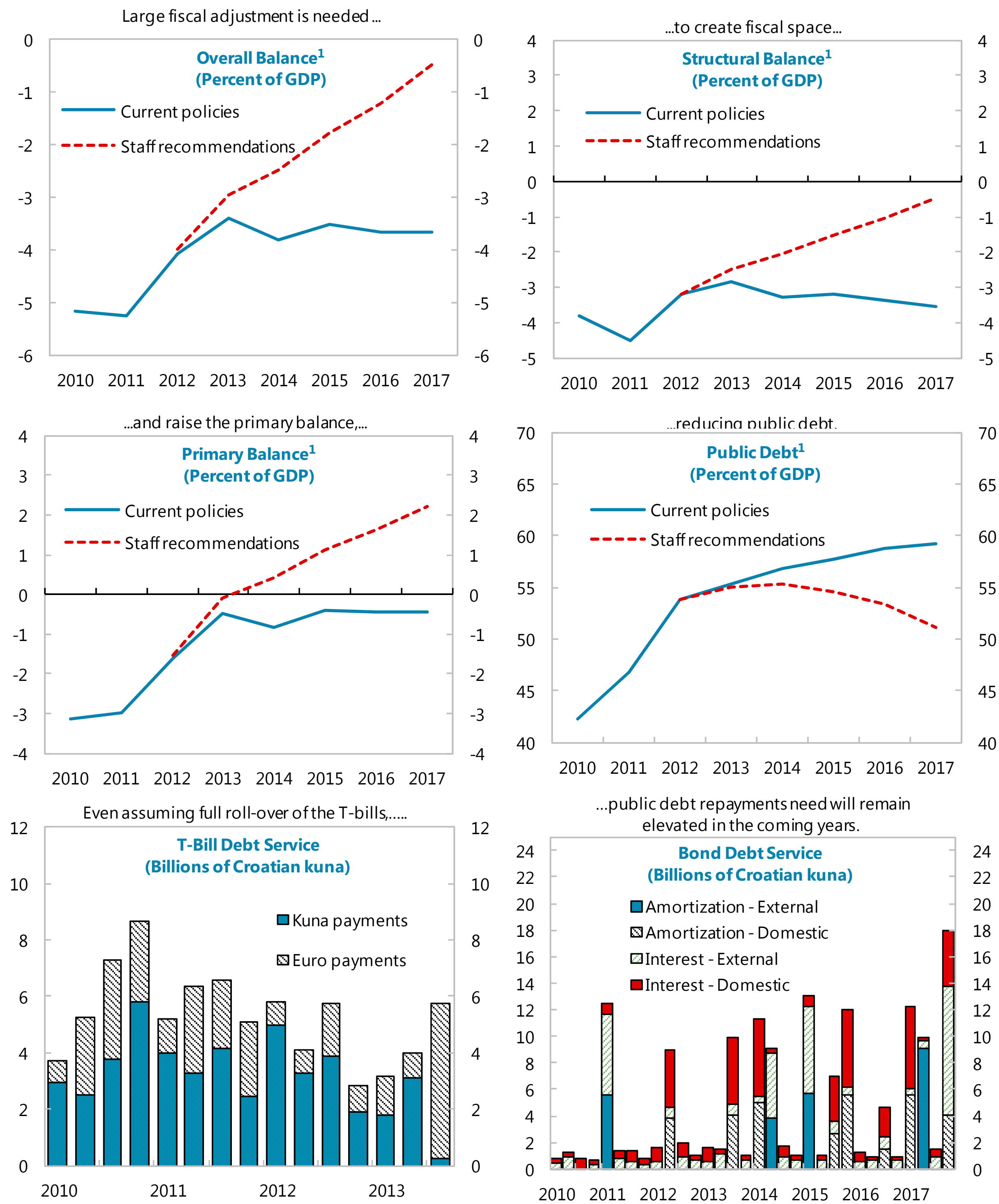
Figure 5. Croatia: Balance of Payments, 2007–12

(4-quarter moving sum in percent of GDP)



Sources: Croatian National Bank; and IMF staff estimates.

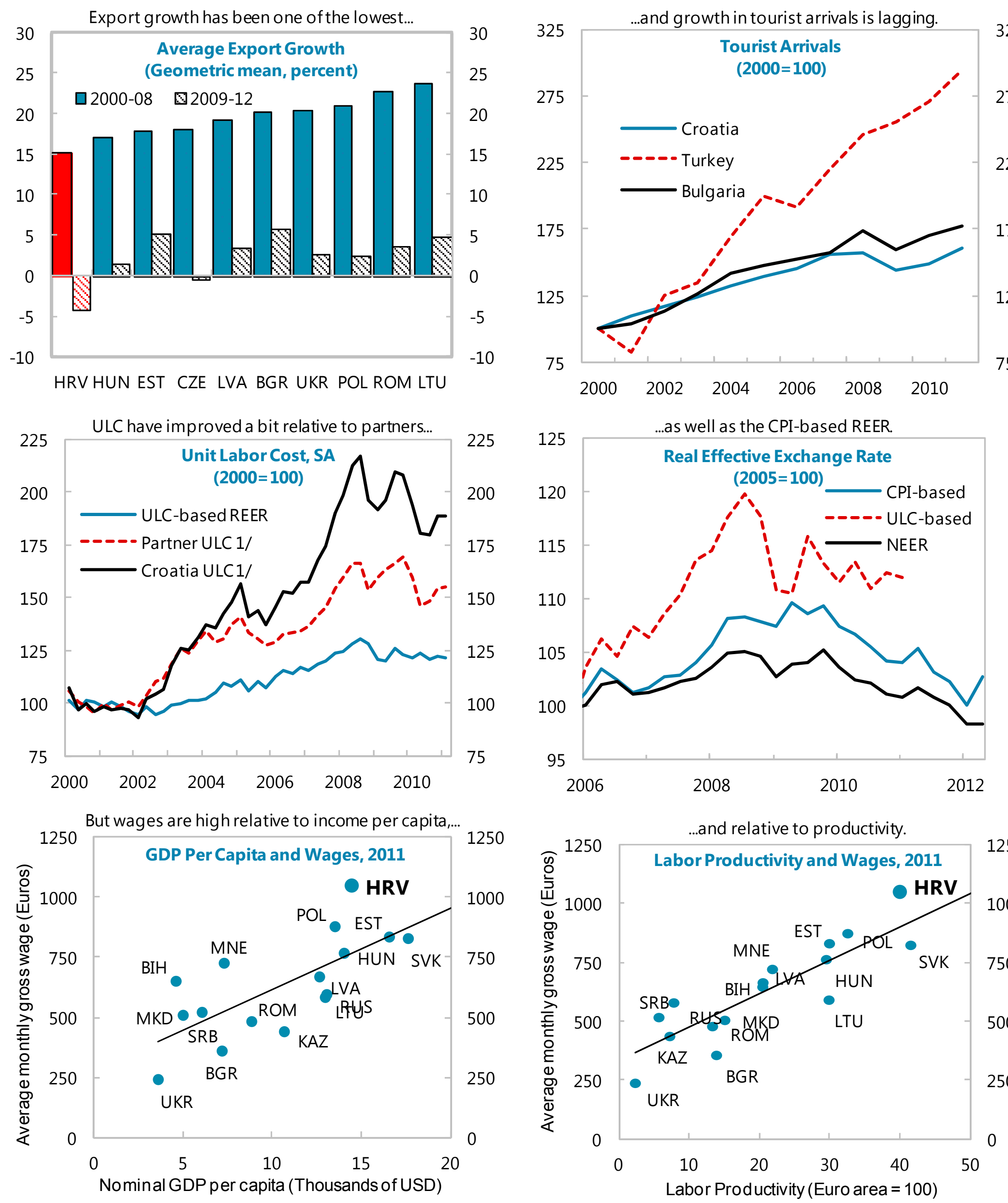
Figure 6. Croatia: Fiscal Developments, 2010–17



Sources: Croatian authorities; and IMF staff estimates.

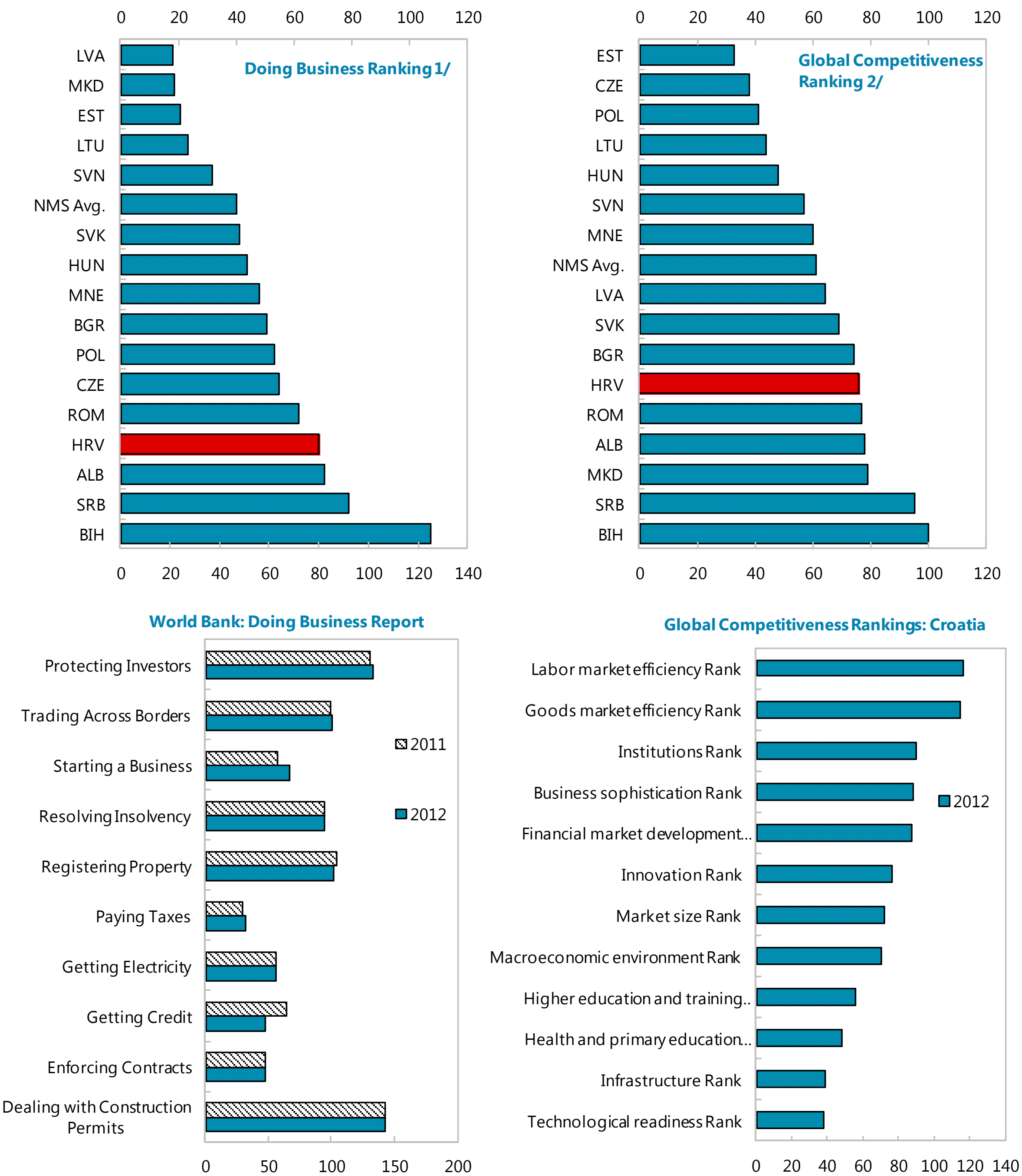
1/ Current policies implies unchanged policies taking into account reforms that have already been implemented. Staff recommendations imply reaching a zero structural balance in 2018, a pace consistent with the spirit of the EU Fiscal Compact.

Figure 7. Croatia: Competitiveness Indicators, 2000–12



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

Figure 8. Croatia: Business Environment, 2011–12

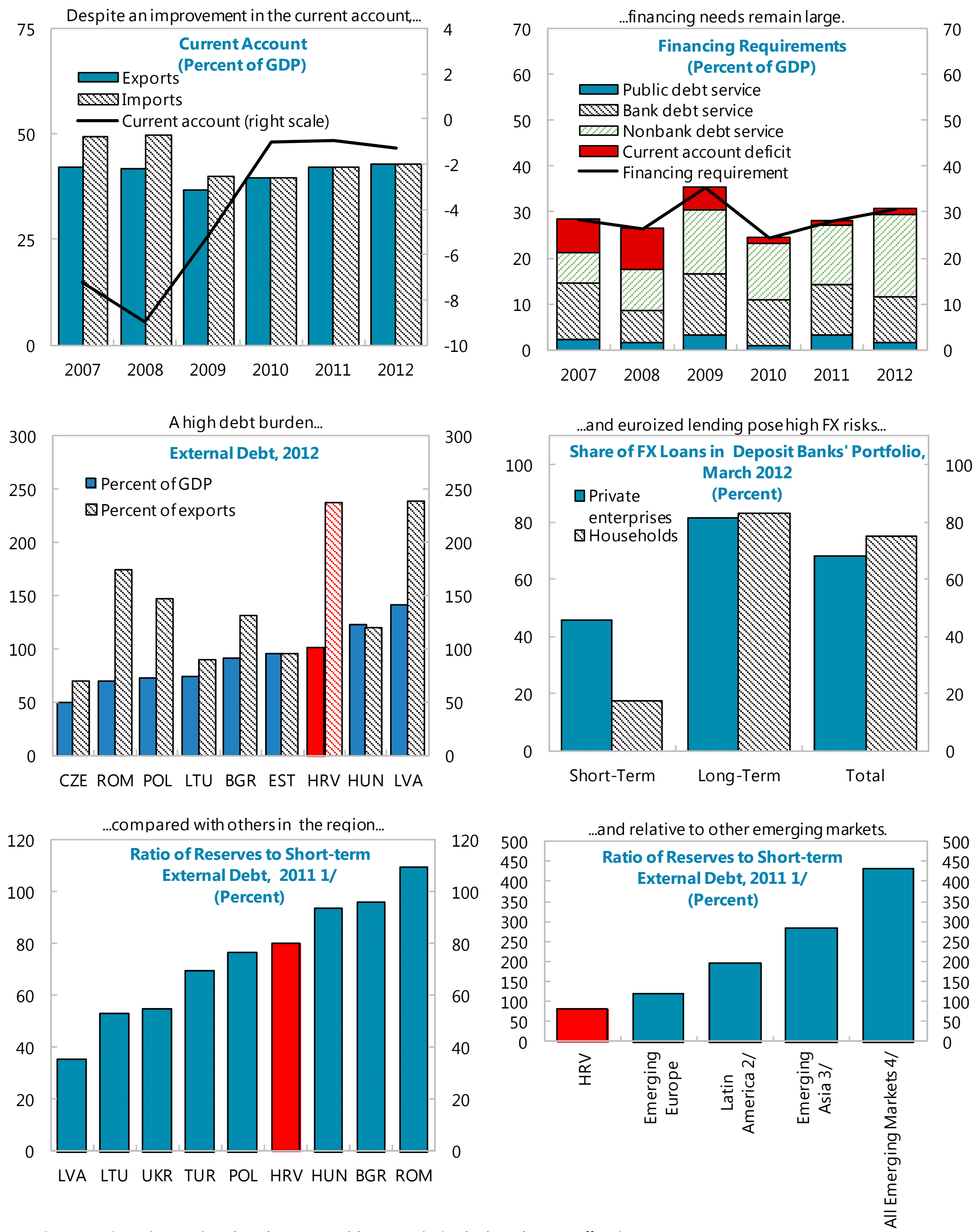


Sources: World Bank, *Doing Business*; World Economic Forum, *Global Competitiveness Report*; Heritage Foundation, *Economic Freedom Index*; and IMF staff calculations.

1/ Covers the period June, 2010 through May, 2011. Rank out of 183 countries.

2/ Rank for 2011–12. Ranking out of 142 countries.

Figure 9. Croatia: Vulnerability Indicators, 2007–12



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

1/ Gross international reserves are end-2011 stocks. Short-term debt at original maturity (end -2011) plus projected amortization of medium and long-term debt (end-2012).

2/ Excludes Brazil.

3/ Excludes China.

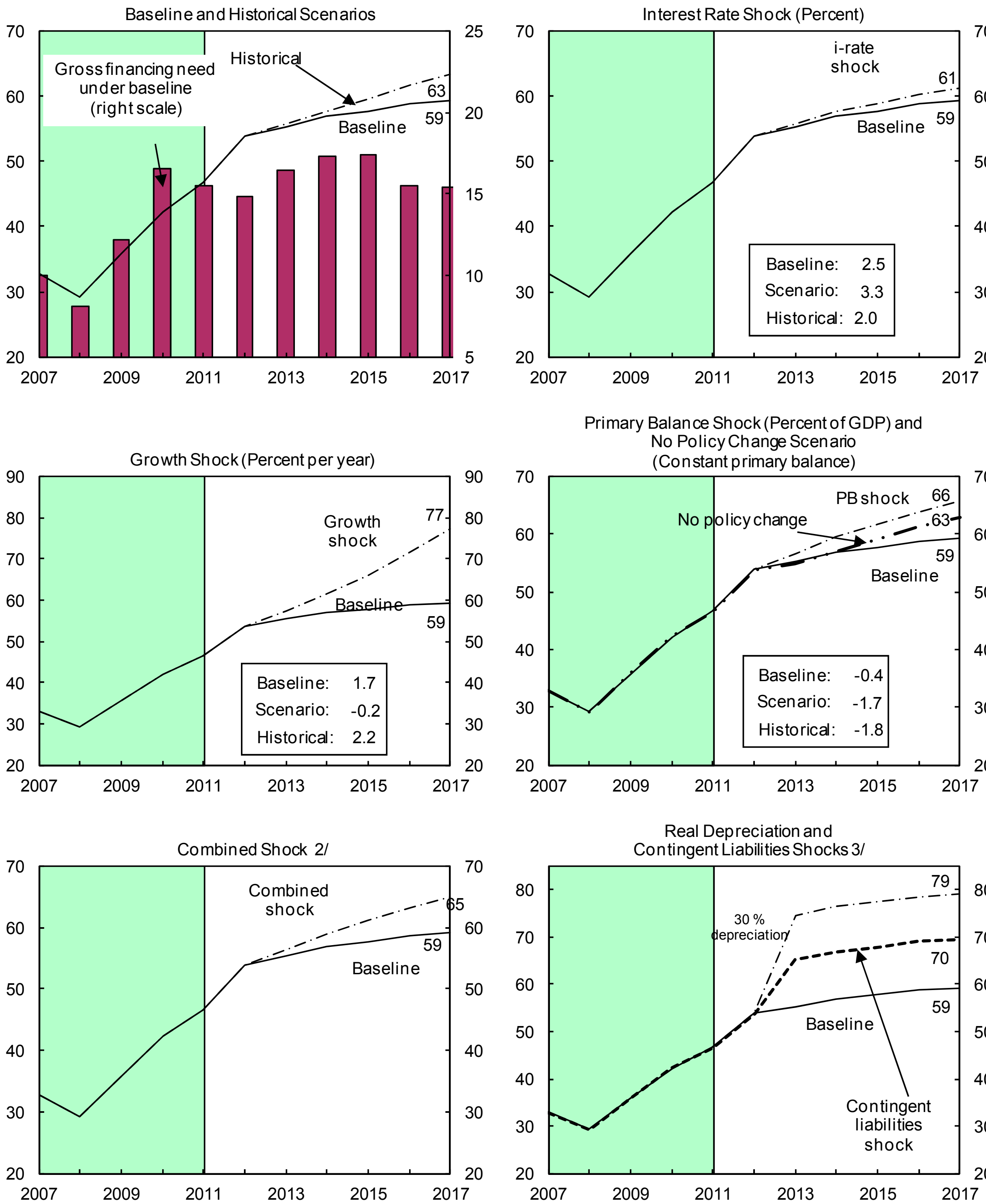
4/ Excludes Brazil and China.

Figure 10. Croatia: Vulnerability Indicators vs Regional Peers, 2011–12

Source: IMF Staff Estimates, WEO

Figure 11. Croatia: Public Debt Sustainability: Bound Tests 1/

(Public debt in percent of GDP)



Source: IMF staff estimates.

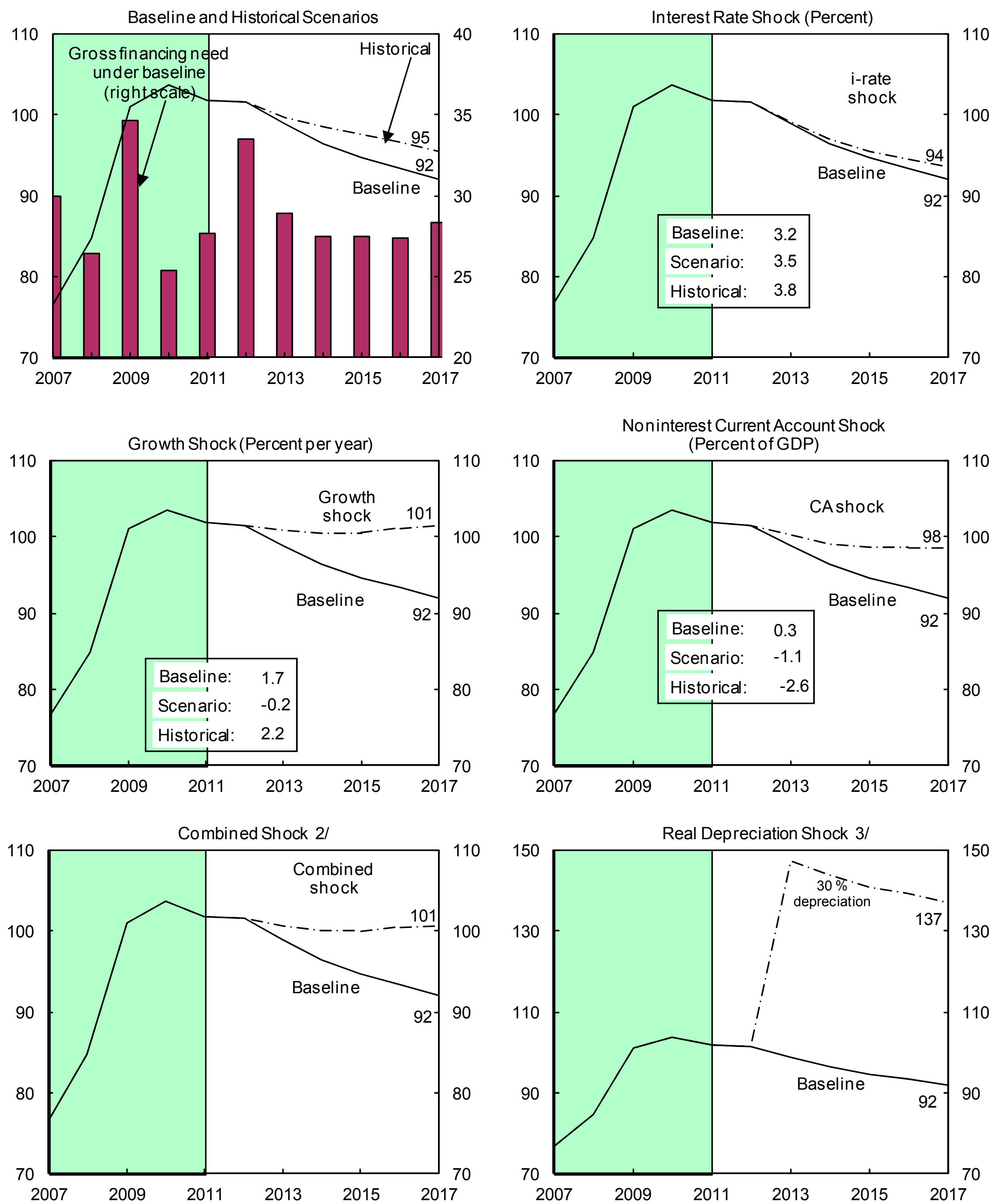
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except primary balance for which it is one standard deviation. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 12. Croatia: External Debt Sustainability: Bound Tests of the Baseline Scenario 1/

(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

3/ One-time real depreciation of 30 percent occurs in 2013.

Table 1. Croatia: Selected Economic Indicators, 2007–13 1/

	2007	2008	2009	2010	2011	2012	2013
					Est.	Proj.	
Output, unemployment, and prices	(Percent change, unless otherwise indicated)						
Real GDP	5.1	2.1	-6.9	-1.4	0.0	-1.5	0.7
Contributions:							
Domestic demand	6.6	3.4	-11.2	-4.0	-0.3	-2.6	0.6
Net exports	-1.5	-1.3	4.2	2.6	0.3	1.1	0.1
Unemployment (labor force survey, percent)	9.4	8.3	9.1	12.2	13.7	14.2	13.8
CPI inflation (average)	2.9	6.1	2.4	1.0	2.3	3.0	3.0
Average monthly nominal wages	6.2	7.1	2.2	-0.4	1.5	...	...
Saving and investment	(Percent of GDP)						
Domestic investment	31.4	33.4	27.6	24.3	23.3	23.0	24.2
Of which: fixed capital formation	26.2	27.4	24.5	20.6	18.8	18.2	18.9
Domestic saving	24.2	24.5	22.4	23.2	22.4	21.7	23.0
Government	3.9	3.2	0.2	-1.5	-1.8	-1.0	-0.4
Nongovernment	20.3	21.2	22.3	24.7	24.2	22.8	23.5
Government sector 2/							
General government revenue	39.8	39.2	39.0	37.8	36.8	37.5	37.7
General government expenditure	41.9	40.5	43.1	42.9	42.0	41.5	41.0
General government balance	-2.1	-1.3	-4.2	-5.1	-5.2	-4.0	-3.3
General government balance (broad definition) 3/	-3.1	-2.3	-5.5	-5.3	-5.2	-4.9	-4.2
HBOR balance (net of budget transfers)	-0.5	-0.1	-0.6	-0.1	0.1	-0.8	-0.8
Cyclically adjusted balance	-3.5	-3.0	-2.9	-3.8	-4.5	-3.2	-2.8
General government debt	32.9	29.3	35.8	42.2	46.7	53.8	55.4
Money and credit 4/	(End of period; change in percent)						
Bank credit to the nongovernment sector	15.0	10.6	-0.6	6.8	5.4	-1.6	...
Broad money	18.3	4.3	-0.9	4.4	3.5	3.2	...
Interest rates 4/ 5/	(Period average; percent)						
Average kuna deposit rate (unindexed)	2.3	2.8	3.2	1.8	1.7	1.9	...
Average kuna credit rate (unindexed)	9.3	10.1	11.6	10.4	9.7	9.5	...
Average credit rate, foreign currency-indexed loans	6.3	7.5	8.1	8.1	7.3	7.1	...
Balance of payments	(Millions of euros, unless otherwise indicated)						
Current account balance	-3,151	-4,258	-2,408	-582	-437	-591	-528
Percent of GDP	-7.3	-9.0	-5.1	-1.3	-1.0	-1.3	-1.1
Capital and financial account	5,159	5,444	4,418	1,804	1,877	1,654	1,373
FDI, net (percent of GDP)	7.9	6.8	3.4	1.3	2.3	2.1	2.0
Overall balance	722	-330	896	84	401	24	-113
Errors and Omissions (percent of GDP)	-3.0	-3.2	-2.6	-2.5	-2.3	-2.3	-2.1
Debt and reserves	(End of period; millions of euros, unless otherwise indicated)						
Gross official reserves	9,307	9,060	10,376	10,660	11,187	11,211	11,098
Percent of short-term debt (by residual maturity)	109	70	94	88	80	87	89
Months of following year's imports of goods and nonfactor services	4.7	6.1	7.0	6.8	7.0	6.7	6.2
Net international reserves	7,349	7,967	9,365	9,644	10,374	10,476	10,363
Reserves (Fixed, percent of RAM)	85.4	74.3	86.0	84.7	85.6	88.5	84.7
Reserves (Float, percent of RAM)	125.1	105.5	124.0	121.5	120.8	126.7	122.7
External debt service to exports ratio (percent)	58.4	53.3	85.3	68.7	77.1	83.1	72.0
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	101.9	101.6	98.8
Net external debt (percent of GDP)	40.6	51.4	62.7	65.6	65.3	65.0	62.3
Exchange rate							
Kuna per euro, end of period 6/	7.3	7.4	7.3	7.4	7.5	7.4	...
Kuna per euro, period average 6/	7.3	7.2	7.3	7.3	7.4	7.5	...
Real effective rate (CPI, percent change) 4/	0.7	4.6	1.2	-2.6	-2.1	-2.8	...
Memorandum items:							
Nominal GDP (millions of euros)	43,380	47,537	44,770	44,864	44,896	45,006	46,693
Output gap (percent of potential)	3.4	4.3	-2.8	-3.0	-1.6	-2.3	-1.7
Per capita GDP (2011, WEO): $13,999			Percent of population below poverty line (2004): 11.1				
Quota (2010): SDR 365 million (563 million U.S. dollars)							

Sources: Croatian authorities; and IMF staff estimates.

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

2/ ESA 95 presentation.

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

4/ Latest data as of end July 2012

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

6/ Latest data as of end September 2012

Table 2. Croatia: Monetary Accounts, 2008–12

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

	2008	2009	2010				2011				2012	
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Monetary survey												
Net foreign assets	41,739	45,011	37,752	36,985	54,088	44,025	36,583	31,621	41,939	33,475	27,087	35,318
(Millions of euros)	5,661	6,169	5,197	5,141	7,403	5,961	4,959	4,273	5,592	4,442	3,606	4,698
Croatian National Bank	66,789	75,800	72,644	74,121	81,338	78,720	84,337	84,227	84,838	84,302	85,129	87,382
(Millions of euros)	9,058	10,389	9,999	10,303	11,133	10,659	11,431	11,381	11,312	11,187	11,331	11,624
Deposit money banks	-25,049	-30,788	-34,891	-37,135	-27,250	-34,695	-47,754	-52,606	-42,899	-50,826	-58,042	-52,064
(Millions of euros)	-3,397	-4,220	-4,803	-5,162	-3,730	-4,698	-6,473	-7,108	-5,720	-6,745	-7,726	-6,926
Net domestic assets	183,279	178,083	184,291	187,596	178,595	188,845	192,761	200,837	199,261	207,582	208,443	204,689
Domestic credit (CNB definition) 1/	261,792	257,227	260,283	266,592	270,681	280,335	274,589	288,129	294,495	307,610	255,757	248,366
Claims on government, net 2/	20,475	22,031	28,570	30,165	19,078	25,817	29,422	33,457	30,953	38,592	40,568	43,846
Claims on other domestic sectors 3/	230,905	229,588	231,790	235,858	238,721	245,107	245,553	251,102	254,544	258,336	257,687	251,257
Other items (net)	-78,513	-79,143	-75,992	-78,995	-92,086	-91,490	-81,827	-87,292	-95,234	-100,029	-47,314	-43,677
Broad money	225,018	223,095	222,043	224,581	232,683	232,870	229,345	232,458	241,200	241,057	235,530	240,007
Narrow money	55,222	47,182	47,726	49,716	51,734	49,152	49,093	52,757	51,155	52,851	47,390	51,468
Currency outside banks	17,051	15,282	14,775	16,048	16,001	15,263	14,998	16,781	17,074	16,689	16,172	17,798
Demand deposits	38,171	31,900	32,951	33,667	35,734	33,889	34,095	35,976	34,080	36,162	31,218	33,669
Quasi money	169,796	175,913	174,317	174,866	180,948	183,718	180,252	179,701	190,046	188,206	188,141	188,539
Kuna-denominated	52,601	40,502	36,992	38,408	37,155	36,161	37,749	38,962	42,721	43,040	44,133	43,748
Foreign currency-denominated	117,195	135,411	137,325	136,458	143,793	147,557	142,503	140,739	147,325	145,166	144,007	144,792
Balance sheet of the Croatian National Bank												
Net foreign assets	66,789	75,800	72,644	74,121	81,338	78,720	84,337	84,227	84,838	84,302	85,129	87,382
Of which: banks' reserves in foreign currency	8,008	5,042	4,711	4,648	4,618	4,773	4,787	4,975	4,980	5,538	5,916	5,275
Net international reserves	58,745	68,426	67,900	69,453	70,786	71,220	70,282	76,466	76,598	78,174	77,423	81,044
Net domestic assets	-8,982	-14,566	-13,183	-13,560	-20,783	-17,637	-21,916	-16,200	-20,202	-16,573	-18,377	-20,436
Claims on government (net)	-205	-4,169	-2,188	-1,978	-9,756	-5,356	-10,703	-5,151	-6,728	-1,772	-4,593	-5,441
Claims on banks	14	14	13	13	13	13	13	13	13	139	62	12
Of which: Open market operations	0	0	0	0	0	0	0	0	0	0	0	0
Claims on other domestic sectors	64	4	4	4	4	4	4	4	4	4	3	3
Other items (net)	-8,855	-10,414	-11,012	-11,599	-11,044	-12,297	-11,230	-11,065	-13,490	-14,943	-13,849	-15,011
Base money	57,807	61,233	59,461	60,560	60,554	61,083	62,421	68,027	64,636	67,980	66,805	66,946
Currency	17,051	15,282	14,775	16,048	16,001	15,263	14,998	16,781	17,074	16,689	16,172	17,798
Deposits	40,756	45,951	44,686	44,512	44,554	45,820	47,423	51,246	47,562	51,291	50,633	49,147
Of which:												
Settlement accounts	9,520	12,025	10,630	9,882	8,982	10,246	9,834	10,193	9,168	12,705	10,298	9,945
Statutory reserves in kuna 4/	19,223	23,601	22,055	22,089	22,407	22,705	23,121	23,375	23,815	25,755	27,637	24,729
Statutory reserves in foreign currency	8,008	5,042	4,711	4,648	4,618	4,773	4,787	4,975	4,980	5,538	5,916	5,275
Reserve money (CNB definition) 5/	49,743	56,142	54,694	55,858	55,882	56,249	57,570	62,981	59,603	62,380	60,822	61,549
Year-on-year percent changes												
Monetary survey												
Net domestic assets	10.2	-2.8	-4.1	-0.4	-3.3	6.0	4.6	7.1	11.6	9.9	13.1	9.1
Domestic credit (CNB definition) 1/	15.8	-1.7	-1.8	4.2	4.4	9.0	5.5	8.1	8.8	9.7	-1.7	-6.8
Claims on government, net 2/	45.0	7.6	0.2	9.4	-35.6	17.2	3.0	10.9	62.2	49.5	42.0	45.4
Claims on other domestic sectors 3/	10.6	-0.6	-0.5	3.0	5.2	6.8	5.9	6.5	6.6	5.4	11.2	6.5
Broad money	4.3	-0.9	1.6	2.8	3.8	4.4	3.3	3.5	3.7	3.5	6.1	6.9
Quasi money	7.5	3.6	1.4	2.4	1.4	4.4	3.4	2.8	5.0	2.4	7.9	7.8
Balance sheet of the Croatian National Bank												
Base money	-12.7	5.9	3.7	1.2	5.1	-0.2	5.0	12.3	6.7	11.3	12.4	10.5
Reserve money (CNB definition) 5/	-4.2	12.9	3.7	1.4	5.9	0.2	5.3	12.8	6.7	10.9	11.2	10.2
Memorandum items:												
Nominal GDP (yearly total)	343,412	328,672	327,383	325,502	326,243	326,980	327,964	330,020	332,660	333,955	333,858	333,666
Narrow money multiplier	0.96	0.77	0.80	0.82	0.85	0.80	0.79	0.78	0.79	0.78	0.71	0.77
Broad money multiplier	3.89	3.64	3.73	3.71	3.84	3.81	3.67	3.42	3.73	3.55	3.53	3.59
Broad money (percent of GDP)	65.5	67.9	67.8	69.0	71.3	71.2	69.9	70.4	72.5	72.2	70.5	71.9
Foreign currency (percent of broad money)	52.1	60.7	61.8	60.8	61.8	63.4	62.1	60.5	61.1	60.2	61.1	60.3
Credit to other domestic sectors: stock (percent of GDP)	67.2	69.9	70.8	72.5	73.2	75.0	74.9	76.1	76.5	77.4	77.2	75.3
Credit to other domestic sectors: 12-month flow (percent of GDP)	6.5	-0.4	-0.3	2.1	3.6	4.7	4.2	4.6	4.8	4.0	3.6	0.0

Sources: Croatian National Bank; and IMF staff estimates.

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

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

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

4/ From 2007, includes obligatory CNB bills.

5/ Excludes statutory reserves in foreign currency.

Table 3. Croatia: Consolidated General Government Finances, 2008–17

(Percent of GDP; ESA 95 presentation)

	2008	2009	2010	2011	2012		2013	2014	2015	2016	2017
					Budget	Proj.			Proj.		
Revenue	39.2	39.0	37.8	36.8	37.4	37.5	37.7	37.6	37.6	37.4	37.4
Taxes	23.2	22.4	21.9	21.0	22.0	21.8	21.9	21.9	21.9	21.8	21.8
Taxes on income, profits, and capital gains	6.2	6.0	4.8	5.0	5.0	5.2	5.1	5.0	5.0	4.9	5.0
Payable by individuals	3.1	3.2	2.8	2.8	2.7	2.9	2.8	2.7	2.6	2.5	2.5
Payable by corporations and other enterprises	3.1	2.9	2.0	2.2	2.3	2.3	2.3	2.3	2.4	2.4	2.5
Taxes on property	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.4	0.4	0.4	0.4
Taxes on goods and services	16.0	15.1	15.7	15.2	16.1	15.8	16.1	16.1	16.1	16.1	16.1
Of which:											
VAT	12.0	11.3	11.5	11.3	12.1	12.0	12.2	12.2	12.2	12.2	12.2
Excises	3.5	3.3	3.7	3.4	3.4	3.3	3.4	3.4	3.4	3.4	3.4
Taxes on international trade and transactions	0.6	0.5	0.5	0.5	0.5	0.5	0.4	0.2	0.2	0.2	0.2
Other taxes 1/	0.1	0.4	0.7	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	11.9	12.2	11.8	11.6	11.0	11.3	11.1	10.9	10.7	10.5	10.5
Grants	0.1	0.2	0.2	0.3	0.5	0.5	0.8	1.1	1.4	1.4	1.4
Of which: from EU							0.8	1.1	1.4	1.4	1.4
Other revenue	4.0	4.2	3.9	4.0	3.9	3.9	3.9	3.7	3.7	3.7	3.7
Expenditure	40.5	43.1	42.9	42.0	41.4	41.5	41.0	41.3	41.0	41.0	40.9
Expenses	38.4	41.2	41.4	40.5	39.7	40.1	39.6	39.8	39.5	39.4	39.4
Compensation of employees	9.8	10.7	10.7	10.7	10.3	10.6	10.0	10.0	10.0	10.0	10.0
Use of goods and services	4.8	4.6	4.7	4.6	4.6	4.5	4.3	4.3	4.3	4.3	4.3
Interest	1.5	1.7	2.0	2.3	2.4	2.4	2.9	3.0	3.1	3.2	3.2
Subsidies	2.4	2.5	2.4	2.3	2.0	1.8	2.1	2.0	2.0	2.0	2.0
Grants	0.7	0.7	0.6	0.5	0.6	0.6	1.0	1.6	1.6	1.6	1.6
Of which: from EU							0.5	1.1	1.1	1.1	1.1
Social benefits	15.5	17.3	17.6	17.1	16.8	17.1	16.7	16.4	16.1	15.9	15.9
Other expense	3.8	3.7	3.3	3.1	2.9	2.9	2.5	2.5	2.4	2.4	2.4
Repayment of called guarantees	0.1	0.6	0.3	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Repayment of "pensioners' debt"	0.3	0.2	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0
Net acquisition of nonfinancial assets	2.1	1.9	1.5	1.5	1.7	1.3	1.4	1.5	1.5	1.5	1.6
Acquisition	2.6	2.2	1.7	1.8	2.0	1.6	1.6	1.7	1.8	1.8	1.8
Disposal	0.4	0.2	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Gross operating balance	0.8	-2.2	-3.6	-3.7	-2.3	-2.6	-1.9	-2.3	-1.9	-2.0	-2.0
Overall balance	-1.3	-4.2	-5.1	-5.2	-4.0	-4.0	-3.3	-3.7	-3.4	-3.6	-3.6
Financing Requirement	-1.3	-4.2	-5.1	-5.2	-4.0	-4.0	-3.3	-3.7	-3.4	-3.6	-3.6
Financing	1.3	4.2	5.1	5.2	4.0	4.0	3.3	3.7	3.4	3.6	3.6
Net acquisition of financial assets	0.8	2.0	0.8	0.0	-0.1	0.5	0.2	0.2	0.2	0.2	0.2
Domestic	0.8	2.0	0.8	0.0	-0.1	0.5	0.2	0.2	0.2	0.2	0.2
Privatization	0.1	0.0	0.0	0.1	0.6	0.4	0.6	0.6	0.6	0.5	0.5
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	2.2	6.2	5.9	5.2	3.9	4.5	3.5	3.9	3.6	3.8	3.7
Domestic	2.5	4.0	4.5	2.6	0.8	1.4	0.0	1.8	3.5	1.8	2.0
Foreign	-0.3	2.2	1.3	2.6	3.1	3.1	3.5	2.1	0.2	1.9	1.8
Memorandum items:											
Primary balance	0.2	-2.4	-3.0	-2.9	-1.6	-1.5	-0.4	-0.7	-0.3	-0.4	-0.3
Cyclically adjusted balance	-3.0	-2.9	-3.8	-4.5	-3.2	-3.2	-2.8	-3.3	-3.2	-3.4	-3.6
HBOR balance (net of budget transfers) 2/	-0.1	-0.6	-0.1	0.1	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
HAC balance 2/	-0.9	-0.8	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Broader measure of fiscal balance 3/	-2.3	-5.5	-5.3	-5.2	-4.9	-4.9	-4.2	-4.6	-4.3	-4.5	-4.5
General government debt	29.3	35.8	42.2	46.7	53.6	53.8	55.4	56.9	57.8	58.7	59.2
General government guarantees	13.0	15.5	18.2	17.9	15.2	15.2	15.2	15.2	15.2	15.2	15.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ For 2009-2010, includes revenue from the "solidarity tax."
2/ The balances of HBOR and HAC for 2013-17 are assumed to remain at their 2012 levels.
3/ Includes the balances of HBOR and HAC (net of budget transfers).

Table 4. Croatia: Balance of Payments, 2008–17

(Millions of euros, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Est.	Proj.					
Current account	-4,258	-2,293	-472	-437	-591	-528	-976	-1,328	-1,781	-2,450
Merchandise trade balance	-10,855	-7,416	-5,991	-6,360	-6,329	-6,461	-6,986	-7,739	-8,588	-9,484
Exports f.o.b.	9,753	7,675	9,064	9,781	10,043	10,612	11,191	11,905	12,793	13,741
Imports f.o.b.	-20,608	-15,090	-15,054	-16,142	-16,373	-17,073	-18,177	-19,643	-21,381	-23,225
Services and income	5,527	4,087	4,431	4,769	4,505	4,617	4,914	5,279	5,639	5,829
Transportation	625	483	512	481	500	535	559	585	621	659
Travel	6,694	5,656	5,601	5,968	6,005	6,183	6,490	6,822	7,186	7,563
Other services	-245	-253	-126	-78	-131	-201	-230	-179	-219	-261
Compensation of employees	564	587	621	657	475	492	516	492	521	551
Interest and investment income	-2,112	-2,385	-2,177	-2,258	-2,344	-2,392	-2,421	-2,442	-2,470	-2,683
Current transfers	1,070	1,036	1,088	1,154	1,234	1,317	1,097	1,131	1,167	1,205
Capital and financial account	5,444	4,362	1,656	1,877	1,654	1,373	1,807	2,125	2,547	3,196
Capital account 1/	15	43	35	-8	35	35	256	256	256	256
Financial account 1/	5,430	4,319	1,621	1,885	1,619	1,338	1,551	1,869	2,291	2,940
Direct investment	3,248	1,527	408	1,043	949	955	1,216	1,314	1,420	1,859
Portfolio investment	-810	421	477	646	1,437	289	228	132	-187	-264
Medium- and long-term loans	2,900	663	-315	-514	-944	-91	288	477	1,045	1,260
Assets	-64	-8	-29	-57	0	0	0	0	0	0
Liabilities	2,965	671	-285	-457	-944	-91	288	477	1,045	1,260
Disbursements	7,640	5,929	5,555	4,391	5,977	5,792	5,251	5,306	6,068	6,732
Amortization	-4,676	-5,258	-5,840	-4,847	-6,920	-5,883	-4,963	-4,829	-5,023	-5,471
Currency and deposits	-512	1,743	550	1,322	151	100	-356	-240	-186	-128
Short-term capital flows (net)	696	-31	256	1	83	87	117	123	129	135
Trade credits	-95	-5	244	-613	-58	-2	58	63	70	77
Other liabilities (long-term)	1	2	1	1	0	0	0	0	0	0
Net errors and omissions 1/	-1,517	-1,173	-1,100	-1,039	-1,039	-958	-933	-905	-874	-836
Overall balance	-330	896	84	401	24	-113	-102	-109	-108	-91
Financing	330	-896	-84	-401	-24	113	102	109	108	91
Gross reserves (-= increase)	330	-896	-84	-401	-24	113	102	109	108	91
IMF (net purchases)	0	0	0	0	0	0	0	0	0	0
Exceptional financing	0	0	0	0	0	0	0	0	0	0
Memorandum items:										
Current account (percent of GDP)	-9.0	-5.1	-1.1	-1.0	-1.3	-1.1	-2.0	-2.6	-3.3	-4.3
Export goods volume growth (excluding ships)	0.6	-14.2	9.6	1.3	0.7	3.2	2.6	3.6	4.7	4.6
Import goods volume growth	-2.7	2.2	-16.2	-6.2	-2.8	1.6	3.0	4.0	3.8	4.3
Gross official reserves	9,060	10,390	10,660	11,187	11,211	11,098	10,996	10,887	10,779	10,688
Months of next year's imports of goods and nonfactor services	6.1	7.0	6.8	7.0	6.7	6.2	5.8	5.2	4.8	4.7
Outstanding debt 2/	40,316	45,244	46,483	45,734	45,712	46,153	47,083	48,528	50,317	52,347
External debt to GDP ratio 2/	84.8	101.1	103.6	101.9	101.6	98.8	96.5	94.6	93.4	92.0
External debt in percent of exports of goods and nonfactor services 2/	203.2	277.3	262.4	243.7	238.4	229.7	222.6	216.6	210.4	205.1
Short-term debt by remaining maturity (percent of GIR)	142.7	106.5	113.1	125.0	114.6	112.1	116.1	119.0	126.9	129.3
External debt service	-6,823	-8,248	-7,249	-7,471	-9,058	-7,876	-7,222	-7,436	-7,555	-8,202
GDP (millions of euros)	47,537	44,770	44,864	44,896	45,006	46,693	48,815	51,285	53,880	56,884
GDP (millions of kuna)	343,412	328,672	326,980	333,955	334,770	347,319	363,105	381,478	400,781	423,124

Sources: Croatian National Bank; and IMF staff estimates.

1/ Errors and omissions are explicitly projected to reflect persistent unrecorded capital outflows.
2/ Since end-2008, external debt is reported based on the new reporting system (INOK).

Table 5. Croatia: External Financing Requirement, 2008–13

(Millions of euros, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013
				Est.	Proj.	
Financing requirements	-12,541	-15,799	-10,855	-12,589	-13,746	-12,495
Current account deficit	-4,258	-2,293	-472	-437	-591	-528
Amortization of medium and long-term debt	-5,412	-7,645	-6,357	-7,420	-8,441	-7,401
Public	-776	-1,350	-405	-1,443	-667	-614
Private	-4636	-6296	-5952	-5977	-7774	-6786
Banks 1/	-914	-2,182	-1,361	-1,883	-1,386	-2,029
Nonbanks 2/	-3,722	-4,114	-4,591	-4,094	-6,388	-4,757
Repayment of short-term debt (including deposits and trade credit)	-2,871	-5,862	-4,026	-4,732	-4,714	-4,566
Public	32	-33	0	-1	0	0
Private	-2,903	-5,829	-4,026	-4,731	-4,714	-4,566
Banks	-2,357	-3,791	-3,091	-3,003	-3,006	-2,824
Nonbanks	-546	-2,037	-935	-1,728	-1,708	-1,742
Financing sources	12,541	15,800	10,855	12,589	13,746	12,495
Capital transfers	15	43	35	-8	35	35
FDI, net	3,248	1,527	408	1,043	949	955
Disbursements on bonds and MLT loans	8,028	10,808	6,724	6,935	8,665	7,755
Public	581	2,382	1,225	1,860	2,363	1,422
Private	7,446	8,426	5,498	5,076	6,301	6,333
Banks	594	3,481	1,038	2,251	1,142	1,811
Nonbanks	6,852	4,945	4,461	2,824	5,159	4,522
Short-term financing	4,514	5,304	4,414	5,173	4,499	4,653
Public	0	0	0	0	0	0
Private	4,514	5,304	4,414	5,173	4,499	4,653
Banks 1/	3,654	3,076	3,202	3,514	2,757	2,824
Nonbanks 2/	860	2,228	1,212	1,659	1,742	1,829
Other flows	-3,594	-986	-641	-153	-379	-1,016
Gross international reserves (- = increase)	330	-896	-84	-401	-24	113
Financing gap	0	0	0	0	0	0
Memorandum items						
Current account deficit (percent of GDP)	-9.0	-5.1	-1.1	-1.0	-1.3	-1.1
Gross official reserves	9,060	10,390	10,660	11,187	11,211	11,098
Months of imports	6.1	7.0	6.8	7.0	6.7	6.2
Percent of short-term debt by remaining maturity	70	94	88	80	87	89
GDP	47,537	44,770	44,864	44,896	45,006	46,693

Sources: Croatian National Bank; and IMF staff projections.

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

Table 6. Croatia: Medium-Term Baseline Scenario, 2008–17 1/

(Percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
							Proj.			
Real sector (percent change)										
Real GDP	2.1	-6.9	-1.4	0.0	-1.5	0.7	1.5	2.0	2.0	2.5
Domestic demand	3.1	-10.2	-3.7	-0.3	-2.5	0.6	1.6	2.0	1.9	2.6
Consumption, total	0.9	-5.6	-1.0	0.0	-2.2	-1.2	1.0	1.5	1.5	1.8
Of which: private	1.3	-7.6	-0.9	0.2	-2.0	0.6	1.5	2.0	2.0	2.2
Gross fixed capital formation, total	8.7	-14.2	-15.0	-7.2	-3.5	5.0	4.9	4.9	4.9	5.0
Of which: private	15.6	-14.1	-14.6	-7.9	-2.9	4.8	4.9	4.8	5.2	5.2
CPI inflation (average)	6.1	2.4	1.0	2.3	3.0	3.0	3.0	3.0	3.0	3.0
Saving and investment										
Domestic investment	33.4	27.6	24.3	23.3	23.0	24.2	24.6	25.3	26.2	27.2
Of which: fixed capital formation	27.4	24.5	20.6	18.8	18.2	18.9	19.6	20.1	20.7	21.2
Domestic saving	24.5	22.4	23.2	22.4	21.7	23.0	22.6	22.7	22.9	22.9
Government	3.2	0.2	-1.5	-1.8	-1.0	-0.4	-0.7	-0.4	-0.2	-0.3
Nongovernment	21.2	22.3	24.7	24.2	22.8	23.5	23.4	23.1	23.1	23.2
General government finances 2/										
Revenue	39.2	39.0	37.8	36.8	37.5	37.7	37.6	37.6	37.4	37.4
Expenditure	40.5	43.1	42.9	42.0	41.5	41.0	41.3	41.0	41.0	40.9
Balance	-1.3	-4.2	-5.1	-5.2	-4.0	-3.3	-3.7	-3.4	-3.6	-3.6
Government debt	29.3	35.8	42.2	46.7	53.8	55.4	56.9	57.8	58.7	59.2
Balance of payments										
Current account balance	-9.0	-5.1	-1.1	-1.0	-1.3	-1.1	-2.0	-2.6	-3.3	-4.3
Exports of goods, f.o.b.	20.5	17.1	20.2	21.8	22.3	22.7	22.9	23.2	23.7	24.2
Imports of goods, f.o.b.	-43.4	-33.7	-33.6	-36.0	-36.4	-36.6	-37.2	-38.3	-39.7	-40.8
Capital and financial account	11.5	9.7	3.7	4.2	3.7	2.9	3.7	4.1	4.7	5.6
Of which: FDI, net	6.8	3.4	0.9	2.3	2.1	2.0	2.5	2.6	2.6	3.3
Gross official reserves	19.1	23.2	23.8	24.9	24.9	23.8	22.5	21.2	20.0	18.8
Gross external debt	84.8	101.1	103.6	101.9	101.6	98.8	96.5	94.6	93.4	92.0
Net external debt	51.4	62.7	65.6	65.3	65.0	62.3	59.9	58.0	56.8	55.4
Memorandum items:										
Nominal GDP (millions of kuna)	343,412	328,672	326,980	333,955	334,770	347,319	363,105	381,478	400,781	423,124
Nominal GDP (millions of euros)	47,537	44,770	44,864	44,896	45,006	46,693	48,815	51,285	53,880	56,884

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

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

2/ ESA 95 presentation.

Table 7. Croatia: Indicators of External and Financial Vulnerabilit, 2008–12

	2008	2009	2010	2011	2012	Latest observation
External indicators						
Current account deficit (millions of euros)	-4,258	-2,293	-472	-437	-591	2012Q2
Percent of GDP	-9.0	-5.1	-1.1	-1.0	-1.3	2012Q1
Capital and financial account (percent of GDP)	11.5	9.7	3.7	4.2	3.7	2012Q2
FDI, net (percent of GDP)	6.8	3.4	0.9	2.3	2.1	2012Q2
Export goods volume growth (excluding ships, percent)	0.6	-14.2	9.6	1.3	0.7	2012Q2
Import goods volume growth (percent)	-2.7	2.2	-16.2	-6.2	-2.8	2012Q2
Real effective exchange rate (CPI-based, 2005=100)	107.5	108.7	105.9	103.7	100.7	2012M8
Gross official reserves (millions of euros)	9,060	10,390	10,660	11,187	11,211	2012Q2
Percent of broad money	29.7	34.0	33.8	35.0	33.3	2012Q2
Percent of reserve money	134.3	135.0	140.0	135.1	142.6	2012M7
Months of following year's imports of goods and nonfactor services	6.1	7.0	6.8	7.0	6.7	2012Q2
Percent of domestic FX deposits	57.0	56.0	53.4	58.1	56.5	2012M7
Net international reserves (millions of euros)	7,967	9,378	9,644	10,374	10,476	2012Q2
Months of current year's imports of goods and nonfactor services	4.0	6.3	6.5	6.6	6.6	2012Q2
Total external debt (percent of GDP)	84.8	101.1	103.6	101.9	101.6	2012Q2
Short-term debt (by remaining maturity, percent of NIR)	162.3	118.0	125.0	134.8	122.6	2012Q2
Short-term debt and current account deficit net of FDI (percent of NIR)	171.9	118.7	118.7	131.4	118.5	2012Q2
External debt service to export ratio	53.3	85.3	68.7	77.1	83.1	2012Q2
Financial indicators						
General government debt (percent of GDP)	29.3	35.8	42.2	46.7	53.8	2012Q2
Broad money (year-on-year percent change)	4.3	-0.9	4.4	3.5	3.9	2012M7
Claims on private sector (year-on-year percent change)	11.8	-0.7	6.1	5.5	-2.7	2012M7
3-month interbank rate (period average)	7.2	8.9	2.2	2.9	3.3	10/5/2012
Stock market CROBEX index (1000 at July 1, 1997, e.o.p.)	1,722	2,004	2,111	1,740	1,711	9/28/2012
Zagreb Stock Exchange, capitalization (stocks, percent of GDP)	51.6	52.2	59.2	61.9	53.8	10/5/2012
Bond yield spreads (EMBI Global, e.o.p.)	...	195	298	602	322	10/5/2012
Long-term foreign currency sovereign debt ratings						
Domestic currency (Fitch)	BBB+	BBB	BBB	BBB	BBB	21-May-09
Foreign currency (Fitch)	BBB-	BBB-	BBB-	BBB-	BBB-	28-Jun-01
Domestic currency (Moody's)	Baa2	Baa3	Baa3	Baa3	Baa3	17-Apr-09
Foreign currency (Moody's)	Baa3	Baa3	Baa3	Baa3	Baa3	27-Jan-97
Domestic currency (Standard and Poor's)	BBB+	BBB	BBB-	BBB-	BBB-	21-Dec-10
Foreign currency (Standard and Poor's)	BBB	BBB	BBB-	BBB-	BBB-	21-Dec-10

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

Table 8. Croatia: Financial Soundness Indicators, 2008–12

(Percent, unless otherwise indicated)

	2008	2009	2010	2011				2012	
				Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Core set									
Regulatory capital to risk-weighted assets	15.1	16.4	18.8	19.1	18.9	19.3	19.2	19.9	20.2
Regulatory Tier I capital to risk-weighted assets	14.9	15.8	17.5	17.8	17.5	17.7	17.5	18.2	18.5
Nonperforming loans net of loan-loss provisions to capital	12.8	22.0	34.5	34.9	36.3	37.2	37.8	38.7	39.7
Nonperforming loans to total gross loans 1/	4.9	7.7	11.1	11.3	11.8	12.1	12.3	12.6	13.2
Sectoral distribution of loans to total loans									
Nonfinancial corporations	37.5	36.8	37.5	37.2	37.5	38.0	38.5	38.4	36.4
Households	50.3	47.2	46.0	44.5	44.8	44.9	44.3	43.5	44.2
Other sectors	11.4	15.4	15.7	17.5	16.7	16.3	16.6	17.3	18.6
Nonresidents	0.8	0.6	0.7	0.7	0.9	0.9	0.6	0.7	0.8
Return on assets	1.7	1.2	1.2	1.3	1.3	1.3	1.2	1.3	1.1
Return on equity	12.8	8.8	8.3	9.2	9.2	9.2	8.8	9.3	7.8
Net interest income to gross income	62.1	56.7	64.3	67.1	67.3	67.0	66.1	65.6	63.8
Noninterest expenses to gross income	61.0	56.6	55.7	53.9	54.5	54.4	55.1	55.0	56.2
Liquid assets to total assets 2/	37.0	35.8	33.7	29.6	30.5	32.7	31.7	29.6	29.7
Liquid assets to short-term liabilities 2/	54.6	53.5	50.6	44.7	46.0	49.3	48.2	45.9	46.4
Net open position in foreign exchange to capital	3.6	5.4	5.2	2.6	3.9	...	...	...	...
Encouraged set									
Deposit takers 3/									
Capital to assets	13.3	13.8	13.8	14.1	13.9	13.8	13.6	13.8	13.8
Large exposures to capital	46.7	44.8	39.0	38.9	40.5	44.7	50.5	44.3	43.1
Geographical distribution of loans to total loans									
Residents	99.2	99.4	99.3	99.3	99.1	99.1	99.4	99.3	99.2
Nonresidents	0.8	0.6	0.7	0.7	0.9	0.9	0.6	0.7	0.8
Gross asset position in derivatives to capital	0.2	0.4	0.3	0.6	0.4	1.6	1.2	1.3	1.8
Gross liability position in derivatives to capital	3.1	0.8	2.7	1.4	2.8	2.4	2.5	2.5	2.7
Trading income to total income	7.1	15.5	8.0	6.2	5.9	6.2	6.8	8.9	9.7
Personnel expenses to noninterest expenses	40.0	39.8	40.6	42.7	42.2	41.0	40.6	43.4	42.3
Spread between domestic lending and deposit rates	3.8	4.0	4.5	4.4	4.2	4.2	4.1	3.9	3.8
Noninterbank loans to noninterbank deposits	81.0	78.1	80.0	77.3	76.4	78.7	77.5	75.1	76.1
Foreign currency-denominated loans to total loans 4/	65.5	72.3	74.3	74.5	75.0	74.4	75.1	74.6	73.6
Foreign currency-denominated liabilities to total liabilities 4/	76.1	79.0	77.0	78.2	77.9	77.4	77.2	79.1	78.9
Net open position in equities to capital	4.8	4.8	4.9	4.4	7.0	6.9	6.9	6.7	6.6
Other financial corporations (OFCs)									
OFCs' assets to total financial system assets	21.9	23.1	23.3	23.5	23.8	...	24.4	...	...
OFCs' assets to GDP	30.7	34.7	36.3	36.8	37.4	...	38.3	...	...
Nonfinancial corporations 5/									
Total debt to equity	58.3	...	...	...	...	...	...	...	...
Return on equity	3.9	...	...	...	...	...	...	...	...
Net foreign exchange exposure to equity	10.4	...	...	...	...	...	...	...	...
Households									
Bank loans to households to GDP	40.1	40.1	39.5	38.8	40.0	39.9	...	39.3	0.0
Household debt service (interest) payments to income	...	...	...	...	...	...	...	...	...
Real estate markets									
Residential real estate prices (annual percentage increase)	4.7	-3.1	-9.4	...	-5.1	...	-1.0	...	...
Residential real estate loans to total loans	21.9	21.5	22.2	21.3	21.9	22.0	21.8	21.4	21.8
Other indicators									
Loan-loss provisions to nonperforming loans	48.7	42.5	38.8	39.3	39.7	40.3	41.3	41.5	42.1
Change in credit to GDP ratio	9.0	1.7	6.1	6.5	...	...	...	...	...
Net interest income to average total assets	2.8	2.6	2.9	2.9	...	...	...	...	...
Noninterest expenses to average total assets	3.0	3.5	3.4	3.5	...	...	...	...	...
Loans to assets	66.6	66.7	68.3	69.9	...	...	...	...	...
Liquid assets to total deposits	17.4	17.3	16.7	15.3	...	...	...	...	...
Net claims on government to total assets	5.6	7.2	7.9	10.3	...	...	...	...	...
Foreign currency deposits to total deposits	59.7	67.7	69.1	68.6	...	...	...	...	...

Source: Croatian National Bank.

1/ Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims.
2/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper, and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans received. The sharp decline in liquidity in 2005 coincided with the start of reverse repo operations by the CNB that gave banks market-based access to liquidity when needed.
3/ Commercial banks only. End-year FSIs, based on audited annual financial statements, can differ slightly from quarterly data.
4/ Includes kuna-denominated instruments linked to foreign currencies.
5/ Based on unconsolidated audited financial statements following IAS; not in line with the IMF FSI Compilation Guide.

Table 9. Croatia: Public Sector Debt Sustainability Framework, 2007–17

(Percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Baseline: public sector debt 1/	32.9	29.3	35.8	42.2	46.7	53.8	55.4	56.9	57.8	58.7	59.2
Of which: foreign-currency denominated	26.1	23.9	27.4	31.4	34.7	38.5	40.6	41.9	42.0	42.9	43.4
Change in public sector debt	-2.6	-3.5	6.5	6.4	4.5	7.1	1.6	1.5	0.9	1.0	0.5
Identified debt-creating flows (4+7+12)	-4.4	0.0	5.0	8.0	6.4	6.5	0.8	0.8	0.2	0.3	0.0
Primary deficit	0.4	-0.2	2.4	3.0	2.9	1.5	0.4	0.7	0.3	0.4	0.3
Revenue and grants	39.8	39.2	39.0	37.8	36.8	37.5	37.7	37.6	37.6	37.4	37.4
Primary (noninterest) expenditure	40.2	39.1	41.4	40.9	39.7	39.0	38.1	38.3	37.9	37.8	37.7
Automatic debt dynamics 2/	-3.9	0.3	2.0	4.7	3.2	2.3	0.9	0.5	0.3	0.3	0.0
Contribution from interest rate/growth differential 3/	-1.3	-0.9	3.0	2.2	1.4	2.3	0.9	0.5	0.3	0.3	0.0
Of which: contribution from real interest rate	0.4	-0.3	0.9	1.7	1.4	1.6	1.3	1.3	1.4	1.4	1.4
Of which: contribution from real GDP growth	-1.6	-0.6	2.1	0.5	0.0	0.7	-0.4	-0.8	-1.1	-1.1	-1.4
Contribution from exchange rate depreciation 4/	-2.7	1.3	-1.0	2.5	1.8	…	…	…	…	…	…
Other identified debt-creating flows	-0.9	-0.1	0.5	0.3	0.4	2.6	-0.4	-0.4	-0.4	-0.4	-0.3
Privatization receipts (negative)	-1.0	-0.3	-0.2	0.0	-0.1	-0.4	-0.6	-0.6	-0.6	-0.5	-0.5
Recognition of implicit or contingent liabilities	0.1	0.1	0.6	0.3	0.4	0.3	0.2	0.2	0.2	0.2	0.2
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	2.7	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3) 5/	1.9	-3.6	1.5	-1.7	-1.9	0.6	0.7	0.7	0.7	0.7	0.5
Public sector debt-to-revenue ratio 1/	82.5	74.7	91.9	111.6	126.8	143.6	146.9	151.5	153.7	157.1	158.5
Gross financing need 6/	10.0	8.1	12.2	16.6	15.5	14.8	16.5	17.3	17.4	15.5	15.4
Millions of U.S. dollars	4323.1	3839.1	5466.3	7441.1	6968.5	6667.2	7698.1	8445.6	8936.2	8377.0	8780.5
Scenario with key variables at their historical averages 7/						53.8	55.8	57.7	59.6	61.6	63.4
Scenario with no policy change (constant primary balance) in 2011–16						53.8	54.8	57.1	59.1	61.3	62.9
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (percent)	5.1	2.1	-6.9	-1.4	0.0	-1.5	0.7	1.5	2.0	2.0	2.5
Average nominal interest rate on public debt (percent) 8/	5.4	4.8	5.6	5.7	5.5	5.3	5.4	5.5	5.6	5.6	5.6
Average real interest rate (nominal rate minus change in GDP deflator, percent	1.3	-0.9	2.7	4.7	3.3	3.5	2.4	2.5	2.6	2.6	2.6
Nominal appreciation (increase in U.S. dollar value of local currency, percent)	10.8	-4.8	3.9	-7.9	-5.2	…	…	…	…	…	…
Inflation rate (GDP deflator, percent)	4.1	5.7	2.9	0.9	2.1	1.8	3.0	3.0	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, percent)	7.5	-0.7	-1.4	-2.7	-2.7	-3.4	-1.6	2.0	1.0	1.6	2.4
Primary deficit	0.4	-0.2	2.4	3.0	2.9	1.5	0.4	0.7	0.3	0.4	0.3

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

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

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

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

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

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

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

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

Table 10. Croatia: External Debt Sustainability Framework, 2007–17

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing noninterest current account 6/
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Baseline: external debt	76.7	84.8	101.1	103.6	101.9	101.6	98.8	96.5	94.6	93.4	92.0	-5.5
Change in external debt	1.8	8.2	16.2	2.6	-1.7	-0.3	-2.7	-2.4	-1.8	-1.2	-1.4	
Identified external debt-creating flows (4+8+9)	-7.7	-4.4	6.9	-0.4	-1.5	0.7	-1.7	-1.9	-1.8	-1.2	-1.2	
Current account deficit, excluding interest payments	4.3	5.6	1.9	-1.7	-2.2	-2.3	-2.3	-0.9	-0.2	0.5	1.6	
Deficit in balance of goods and services	7.2	8.0	3.4	0.0	0.0	-0.1	-0.1	0.3	1.0	1.9	2.7	
Exports	42.1	41.7	36.4	39.5	41.8	42.6	43.0	43.3	43.7	44.4	44.9	
Imports	49.3	49.7	39.9	39.5	41.8	42.5	42.9	43.7	44.7	46.2	47.5	
Net non-debt creating capital inflows (negative)	-8.6	-6.7	-3.4	-1.3	-2.4	-2.1	-2.1	-2.5	-2.6	-2.7	-3.3	
Automatic debt dynamics 1/	-3.3	-3.4	8.5	2.5	3.1	5.1	2.7	1.5	1.0	1.0	0.5	
Contribution from nominal interest rate	3.0	3.3	3.2	2.8	3.2	3.6	3.4	2.9	2.8	2.8	2.7	
Contribution from real GDP growth	-3.5	-1.5	6.3	1.4	0.0	1.6	-0.7	-1.4	-1.8	-1.8	-2.2	
Contribution from price and exchange rate changes 2/	-2.8	-5.2	-1.0	-1.6	-0.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.5	12.6	9.3	3.0	-0.3	-1.0	-1.1	-0.4	0.0	-0.1	-0.2	
External debt-to-exports ratio (percent)	182.0	203.2	277.3	262.4	243.7	238.4	229.7	222.6	216.6	210.4	205.1	
Gross external financing need (billions of U.S. dollars) 4/	13.0	12.6	15.5	11.4	12.4	15.1	13.5	13.4	14.1	14.8	16.1	
Percent of GDP	30.0	26.4	34.7	25.4	27.7	33.5	28.9	27.5	27.5	27.4	28.4	
Scenario with key variables at their historical averages 5/						101.6	99.8	98.5	97.6	96.6	95.5	-6.1
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	5.1	2.1	-6.9	-1.4	0.0	-1.5	0.7	1.5	2.0	2.0	2.5	
GDP deflator in U.S. dollars (percent change)	3.9	7.3	1.2	1.6	0.1	1.8	3.0	3.0	3.0	3.0	3.0	
Nominal external interest rate (percent)	4.4	4.7	3.6	2.7	3.1	3.5	3.5	3.1	3.1	3.1	3.1	
Growth of exports (U.S. dollar terms, percent)	7.7	8.6	-17.8	8.6	5.9	2.2	4.8	5.3	6.0	6.7	6.7	
Growth of imports (U.S. dollar terms, percent)	9.3	10.5	-24.5	-0.7	5.9	2.0	4.7	6.4	7.5	8.7	8.5	
Current account balance, excluding interest payments	-4.3	-5.6	-1.9	1.7	2.2	2.3	2.3	0.9	0.2	-0.5	-1.6	
Net nondebt creating capital inflows	8.6	6.7	3.4	1.3	2.4	2.1	2.1	2.5	2.6	2.7	3.3	

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

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

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

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

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

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

Annex I. Croatia Risk Assessment Matrix[1]

(Scale—high, medium, or low)

Source of Risks	Relative Likelihood[2]	Impact if Realized
1. Strong intensification of the euro area crisis	**Medium** Heightened financial stress could adversely alter the outlook for the euro area.	**High** Lower export and tourism revenue plus dearth or reversal of capital inflows would induce a sharp recession, exchange rate pressures, higher and more difficult to finance fiscal deficit, and rising NPLs.
2. Slowdown of world growth	**Medium** Slowing demand from EU and the rest of the world.	
3. Acute deleveraging by euro area parent banks	**Medium** Higher than expected capital needs of euro area parent banks could lead to a reduction or closure of external credit lines of Croatian subsidiaries.	**High** Deleveraging could lead to a credit crunch, with negative effects on activity.
4. Sharp increase in oil prices	**Low** Geo-political risks could lead to a sharp increase in oil prices.	**Medium** Higher energy prices could depress demand and raise inflation.
5. No progress on structural reforms	**Medium** Implementation of measures to boost potential growth could be delayed.	**Medium** Potential growth would remain low in the medium term and investors' confidence could fall, adversely affecting cost of and access to external financing.
6. Stalled fiscal consolidation	**Low** Social resistance and lower than expected growth could slow fiscal consolidation.	**Medium** Debt sustainability would be endangered with negative effects on cost of and access to external financing.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline.

[2] In case the baseline does not materialize.

Annex II. Authorities' Response to Past IMF Policy Recommendations

IMF 2011 Article IV Recommendations	Authorities' Response
Fiscal policy Keep fiscal deficit at its 2010 level in percent of GDP. Implement further expenditure cuts in public employment, public wages and social expenditures to reach the FRL targets.	**Broadly consistent** A large deterioration of the fiscal deficit was avoided, with the 2011 fiscal deficit widening only by 0.1 percent of GDP compared to 2010. Significant consolidation measures were included in the 2012 budget with expenditures cuts in wages, subsidies and health spending, with partial success so far.
Monetary policy Gradually strengthen foreign currency buffers.	**Broadly consistent** Despite foreign exchange sales, foreign reserves have continued their pace of gradual increase.
Structural reforms Implement comprehensive structural reforms to boost growth potential.	**Marginally consistent** Limited reforms have been launched to foster labor market flexibility, improve business climate, and reduce the size of the public sector.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 23, 2012

Prepared By: European Department in Consultation with Other Departments

CONTENTS

ANNEX I. FUND RELATIONS

(As of August 31, 2012)

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

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

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	347.34	100.00
Holdings	303.15	87.28

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

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

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.01	0.04	0.04	0.04	0.04
Total	0.01	0.04	0.04	0.04	0.04

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

VII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with tight management by the CNB. Croatia's *de jure* exchange rate is a managed float without a predetermined path. Croatia's *de facto* exchange rate arrangement is classified as "crawl like arrangement" from April 30, 2011. The CNB transacts only in euros, U.S. dollars, and SDRs. On October 10, 2012 the official exchange rate was kuna 7,473547 per euro (middle rate).

VIII. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions, except for restrictions that Croatia maintains solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51).

IX. Article IV Consultation:

The previous **Article IV consultation** with Croatia was concluded on June 8, 2011 (IMF Country Report No. 11/159 available at: http://www.imf.org/external/country/hrv/index.htm). Croatia is on the 12-month consultation cycle.

X. FSAP:

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

The original FSAP was concluded with the completion of the 2002 Article IV consultation on August 5, 2002 on the basis of missions that took place in April 2001 and September 2001. The FSSA was published (IMF Country Report No. 02/180).

XI. Technical Assistance 2000–11:[12]

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

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

	October 2000	Real Sector Statistics
	April 2001	Monetary and Banking Statistics
	November 2001	Regional Visit on Reserves Data Template
	October 2002, June 2004	Government Finance Statistics
	September 2006	Monetary and Financial Statistics
	December 2007	LTE: Government Finance Statistics
MCM	May–June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March–April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
	April 2003	Stress Testing and Foreign Exchange Reserve Management
	February 2004	Monetary Policy Instruments
	January 2007–continuing	Macro-Financial Modeling and Forecasting
	May 2007	Macro-Financial Modeling and Forecasting
	June 2007	Modeling and Forecasting
	September 2007	Modeling and Forecasting
	October 2007	FSAP Update
	November 2007	Modeling and Forecasting
	March 2008	Modeling and Forecasting
	August 2008	Macro-Financial Modeling and Forecasting
	February 2009	Macro-Financial Modeling and Forecasting
	July 2009	Modeling
	May 2010	Monetary Policy and Modeling
	March 2011	Modeling
LEG	April 2010	AML/ CFT
	August 2010	AML/ CFT
	February 2011	AML/ CFT
	May 2011	AML/ CFT
	October 2011	AML/ CFT
	January 2012	AML/ CFT

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

ANNEX II. STATISTICAL ISSUES

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

A. National Accounts

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

B. Price

3. The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from a 2005 Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups but in all cases between the thirteenth and the twenty-first day of each month. The indices are released around the fifteenth day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country. A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology, but is not released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the CNB. The CBS also releases a monthly producer price index (PPI), usually on the eighth day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year.

C. Wages and Employment

4. The CBS produces data on average net and gross earnings per person and employment by sector. Earning data include bonuses, sick pay, and meal allowances, and are based on monthly surveys covering 70 percent of workers in permanent employment in each industrial category. They do not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, farmers, and the military and police.

5. The number of registered unemployed overstates the actual level of unemployment. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample was subsequently expanded and the survey is now being conducted on a regular basis. The CBS released semi-annual results from 1998, and began releasing quarterly results in 2007 with a lag of about four months.

D. Government Finance Statistics

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

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

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

E. Monetary Data

9. Compilation of monetary statistics published by the CNB is consistent with the recommendations of the IMF's 2000 *Monetary and Financial Statistics Manual* (*MFSM*). Data on the monetary survey, including separate records for deposit money banks and the balance sheet of the CNB, are published monthly with four- and two-week lags, respectively. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies. In March 2002, the CNB started collecting financial information (balance sheets and investment structure) from investment and pension funds; the data are not yet published, but used for internal purposes. According to the CNB, the inclusion of other financial corporations in monetary statistics depends on the harmonization process of the monetary statistics with the statistical reporting requirements of the European Central Bank. In November 2006, the CNB reported monetary data in the format of Standardized Report Forms for December 2001 to the present. These data accord with the concepts and definitions in *MFSM* and were published, along with the corresponding metadata, in *IFS* and the *IFS Supplement on Monetary and Financial Statistics*.

F. External Sector Statistics

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

11. A large part of external debt was contracted prior to the dissolution of the former Socialist Federal Republic of Yugoslavia and Croatia's share was agreed with Paris and London Club creditors in 1995 and 1998, respectively. The CNB compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2003*, and began disseminating external debt data in the second quarter of 2003. The inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals and arrears has caused an upward adjustment in the external debt series compared to previously released data. Quarterly data on the international investment position are available on the CNB website up to 2012:Q2.

Croatia: Table of Common Indicators Required for Surveillance

(as of October 9, 2012)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	10/08/12	10/08/12	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	August 2012	9/28/12	M	M	M
Reserve/Base Money	August 2012	9/28/12	M	M	M
Broad Money	August 2012	9/28/12	M	M	M
Central Bank Balance Sheet	August 2012	9/28/12	M	M	M
Consolidated Balance Sheet of the Banking System	August 2012	9/28/12	M	M	M
Interest Rates 2/	August 2012	10/02/12	M	M	M
Consumer Price Index	August 2012	10/02/12	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2012:Q2	9/18/12	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	July 2012	9/18/12	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	June 2012	9/18/12	M	M	M
External Current Account Balance	2012:Q2	9/28/12	Q	Q	Q
Exports and Imports of Goods and Services	2012:Q2	9/28/12	Q	Q	Q
GDP/GNP	2012:Q2	9/28/12	Q	Q	Q
Gross External Debt	June 2012	9/19/12	M	M	M
International Investment Position	2012:Q2	9/28/12	Q	Q	Q

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

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

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

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

5/ Including currency and maturity composition.

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

ANNEX III. WORLD BANK RELATIONS

1. The World Bank's Board endorsed the Country Partnership Strategy (CPS) for Croatia for FY09–12 in September 2008, just before the full onset of the global financial crisis. In 2012, it was extended for a year to coincide with the Croatia's pre-accession period. The goal of the CPS is to support the completion of Croatia's EU accession process, the rapid convergence of its income level with that of current EU member states in a fiscally, socially and environmentally sustainable fashion. This overarching goal is in line with the Government's priorities expressed in various government programs. In pursuing this goal, the Bank Group program aims at contributing in the following four areas:

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

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

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

4. In FY10, the Bank's Board has approved three loans amounting to US$475 million, to help mitigate the impact of the global economic crisis and provide funding for the private sector, through a credit line of about EUR100 million for exporters, and through a Fiscal, Social and Financial Sector Development Policy Loan of EUR200 million. In addition, an investment operation for judicial sector of US$36.3 million has been approved. In FY11, the Bank's Board approved two loans amounting to USD242 million: (i) an Economic Recovery Development Policy Loan of EUR150 million to support the authorities in implementing Economic Recovery Program from April 2010 aiming to address the vulnerabilities and competitiveness issues of the economy; and (ii) investment loan EU Natura 2000 Integration of US$28.8 million to support adjustment to EU Species and Habitats Directives. In FY12, the Bank's Board has approved Integrated Land Administration project amounting to US$23.8 million. Projects under preparation for FY13 are the Second Science and Technology (STP II), Export Finance Intermediation Loan Additional Financing and the Second Economic Recovery DPL. Currently, the World Bank finances 13 operations in a wide range of sectors with a net commitment of about US$1 billion. IFC's portfolio amounts to about US$273 million, and MIGA guarantees gross exposure amounts to US$330 million in the financial sector.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/123
FOR IMMEDIATE RELEASE
November 13, 2012

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

IMF Executive Board Concludes the 2012 Article IV Consultation with the Republic of Croatia

On November 7, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.[1]

Background

Sustained recovery from the economic crisis in 2009 remains elusive. Growth stagnated in 2011 after two years of contraction. With unfavorable external conditions and subdued domestic demand, GDP is expected to contract further by 1½ percent in 2012, only modestly picking up by ¾ percent in 2013. Further on, barriers to investment and employment growth, if not forcefully addressed, will keep potential growth modest.

Despite a significant narrowing of the current account deficit, external vulnerabilities remain high, with gross external debt above 100 percent and an external financing requirement of about 30 percent of GDP. Competitiveness is hampered by substantial non-price weaknesses, which have severely limited export growth performance.

To address these weaknesses and restart growth, the authorities adopted a comprehensive structural reform program in August 2012. The program aims to improve the business climate and competition and foster labor force participation by reducing administrative barriers to investment, speeding up restructuring and privatization of

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

state-owned enterprises, and reforming pensions and health care systems. While some measures have already been taken, many important reforms remain to be developed in terms of specific policies and desired effects.

To restore fiscal sustainability, the authorities have launched a significant consolidation in 2012, aimed at reducing the deficit from 5.2 percent of GDP in 2011 to 4 percent of GDP in 2012 under staff's macroeconomic projections. The adjustment has focused on better targeting of subsidies, restraints on expenditures of goods and services, and improved tax collection. Reforms in public sector workers' remuneration and further rationalization of health expenditures have also been initiated, with results expected from 2013 on.

Within their framework centered on a broadly stable exchange rate, the Croatian National Bank has allowed in recent years increased two-way exchange rate flexibility, which has facilitated macroeconomic adjustment and limited speculation. Despite official credit support schemes, credit growth slowed down markedly in 2012 reflecting weak demand. The largely foreign-owned banking system remains well capitalized, although growing non-performing loans have started eroding profitability.

Executive Board Assessment

Executive Directors noted that Croatia is experiencing a prolonged recession reflecting subdued domestic demand, lackluster competitiveness, and a difficult external environment. Short-term growth prospects remain weak and downside risks prevail, while structural impediments hamper medium-term growth. Directors underscored the importance of advancing with policies and structural reforms to boost growth and reduce vulnerabilities.

Directors welcomed the authorities' commitment to fiscal consolidation and the expenditure retrenchment that has taken place in 2012. While they recognized that fiscal consolidation is particularly challenging at the current juncture, they underscored its necessity to restore debt sustainability, satisfy the requirements of the Fiscal Responsibility Law, and retain market access. Directors therefore saw a need to continue a gradual but steady expenditure-based consolidation in 2013 and well into the medium term, while protecting capital spending. Directors also encouraged the authorities to persevere with their efforts to rebalance the tax structure away from labor in a revenue-neutral way.

Directors welcomed the recent adoption of the government's structural reform program, which makes a good start on the road to restore competitiveness and spur growth. Strengthening EU funds absorption capacity would allow Croatia to take full advantage of EU accession by supporting growth-enhancing investments. Directors encouraged the authorities to develop specific policies and prioritize measures, focused on raising labor force participation, enhancing labor market flexibility, reducing barriers to market entry, and fostering competition.

Directors welcomed the increased exchange rate flexibility of recent years, as it has improved the economy's resilience to shocks and aided macroeconomic adjustment. They generally agreed, however, that the broadly stable exchange rate framework has served Croatia well and that excessive exchange movements would be harmful given the high degree of euroization and the sizeable external debt. In order to build further an important buffer against external shocks, Directors recommended that the central bank continue to gradually accumulate international reserves.

Directors noted that the financial sector appears well-capitalized and resilient to shocks, but faces risks related to potential further deterioration of asset quality, indirect credit risk stemming from vulnerable borrowers, and sizeable dependence on parent banks for funding. They stressed the importance of maintaining high statutory capital buffers, ensuring adequate provisioning for non-performing loans, further strengthening financial supervision and regulation and cross-border supervisory cooperation, and closely monitoring liquidity and credit developments.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with the Republic of Croatia is also available.

Croatia: Selected Economic Indicators, 2007–13 1/

	2007	2008	2009	2010	2011	2012	2013
					Est.	Proj.	
Output, unemployment, and prices	(Percent change, unless otherwise indicated)						
Real GDP	5.1	2.1	-6.9	-1.4	0.0	-1.5	0.7
Contributions:							
Domestic demand	6.6	3.4	-11.2	-4.0	-0.3	-2.6	0.6
Net exports	-1.5	-1.3	4.2	2.6	0.3	1.1	0.1
Unemployment (labor force survey, percent)	9.4	8.3	9.1	12.2	13.7	14.2	13.8
CPI inflation (average)	2.9	6.1	2.4	1.0	2.3	3.0	3.0
Average monthly nominal wages	6.2	7.1	2.2	-0.4	1.5	...	...
Saving and investment	(Percent of GDP)						
Domestic investment	31.4	33.4	27.6	24.3	23.3	23.0	24.2
Of which: fixed capital formation	26.2	27.4	24.5	20.6	18.8	18.2	18.9
Domestic saving	24.2	24.5	22.4	23.2	22.4	21.7	23.0
Government	3.9	3.2	0.2	-1.5	-1.8	-1.0	-0.4
Nongovernment	20.3	21.2	22.3	24.7	24.2	22.8	23.5
Government sector 2/							
General government revenue	39.8	39.2	39.0	37.8	36.8	37.5	37.7
General government expenditure	41.9	40.5	43.1	42.9	42.0	41.5	41.0
General government balance	-2.1	-1.3	-4.2	-5.1	-5.2	-4.0	-3.3
General government balance (broad definition) 3/	-3.1	-2.3	-5.5	-5.3	-5.2	-4.9	-4.2
HBOR balance (net of budget transfers)	-0.5	-0.1	-0.6	-0.1	0.1	-0.8	-0.8
Cyclically adjusted balance	-3.5	-3.0	-2.9	-3.8	-4.5	-3.2	-2.8
General government debt	32.9	29.3	35.8	42.2	46.7	53.8	55.4
Money and credit 4/	(End of period, change in percent)						
Bank credit to the nongovernment sector	15.0	10.6	-0.6	6.8	5.4	-1.6	...
Broad money	18.3	4.3	-0.9	4.4	3.5	3.2	...
Interest rates 4/ 5/	(Period Average, percent)						
Average kuna deposit rate (unindexed)	2.3	2.8	3.2	1.8	1.7	1.9	...
Average kuna credit rate (unindexed)	9.3	10.1	11.6	10.4	9.7	9.5	...
Average credit rate, foreign currency-indexed loans	6.3	7.5	8.1	8.1	7.3	7.1	...
Balance of payments	(Millions of euros, unless otherwise indicated)						
Current account balance	-3,151	-4,258	-2,408	-582	-437	-591	-528
Percent of GDP	-7.3	-9.0	-5.1	-1.3	-1.0	-1.3	-1.1
Capital and financial account	5,159	5,444	4,418	1,804	1,877	1,654	1,373
FDI, net (percent of GDP)	7.9	6.8	3.4	1.3	2.3	2.1	2.0
Overall balance	722	-330	896	84	401	24	-113
Errors and Omissions (percent of GDP)	-3.0	-3.2	-2.6	-2.5	-2.3	-2.3	-2.1
Debt and reserves	(End of period, millions of euros, unless otherwise indicated)						
Gross official reserves	9,307	9,060	10,376	10,660	11,187	11,211	11,098
Percent of short-term debt (by residual maturity)	109	70	94	88	80	87	89
Months of following year's imports of goods and nonfactor services	4.7	6.1	7.0	6.8	7.0	6.7	6.2
Net international reserves	7,349	7,967	9,365	9,644	10,374	10,476	10,363
Reserves (Fixed, percent of RAM)	85.4	74.3	86.0	84.7	85.6	88.5	84.7
Reserves (Float, percent of RAM)	125.1	105.5	124.0	121.5	120.8	126.7	122.7
External debt service to exports ratio (percent)	58.4	53.3	85.3	68.7	77.1	83.1	72.0

Croatia: Selected Economic Indicators, 2007–13 1/ (continued)

	2007	2008	2009	2010	2011	2012	2013
					Est.	Proj.	
Total external debt (percent of GDP)	77.7	85.0	99.1	101.1	101.9	101.6	98.8
Net external debt (percent of GDP)	40.6	51.4	62.7	65.6	65.3	65.0	62.3
Exchange rate							
Kuna per euro, end of period 6/	7.3	7.4	7.3	7.4	7.5	7.4	...
Kuna per euro, period average 6/	7.3	7.2	7.3	7.3	7.4	7.5	...
Real effective rate (CPI, percent change) 4/	0.7	4.6	1.2	-2.6	-2.1	-2.8	...
Memorandum items:							
Nominal GDP (millions of euros)	43,380	47,537	44,770	44,864	44,896	45,006	46,693
Output gap (percent of potential)	3.4	4.3	-2.8	-3.0	-1.6	-2.3	-1.7
Per capita GDP (2011, WEO): $13,999			Percent of population below poverty line (2004): 11.1				
Quota (2010): SDR 365 million (563 million U.S. dollars)							

Sources: Croatian authorities; and IMF staff estimates.

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

2/ ESA 95 presentation.

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

4/ Latest data as of end July 2012

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

6/ Latest data as of end September 2012

Statement by Mr. Menno Snel and Ms. Ana Martinis on the Republic of Croatia
November 7, 2012

The Croatian authorities value the open and constructive discussions with staff during their mission to Croatia. They broadly share the staff's assessment and policy advice as presented in the Article IV report and welcome insightful supplementary papers which are rightly focused on two major issues for the Croatian economy – growth drivers and competitiveness.

Economic developments and outlook

Croatia's economy continues to face complex challenges as the euro area crisis weighs on the country's export performance and investors' confidence. After stagnation in 2011, this year GDP growth turned negative again as a result of a drop in both domestic and external demand. Foreign direct investment declined further and the private sector continued to deleverage amid lower capital inflows. In the face of subdued import demand, the current account deficit stabilized at around 1 percent of GDP. The external debt has stabilized too, albeit at a high level, thus remaining a key vulnerable point of the economy.

Inflation has picked up as of March this year, pushed by an increase in the basic VAT rate and a rise in locally regulated gas and electricity prices. As a result, the average annual consumer price inflation could increase to around 3.3 percent in 2012, but is expected to slow down in 2013, as weak personal consumption and adverse labor market conditions keep the inflation pressures contained.

Quarterly developments suggest that the recession may have reached its turning point, as GDP stabilized in the second quarter, mainly due to strong tourism performance. Looking ahead, growth is expected to resume modestly towards the end of the year, driven mainly by the start-up of the investment cycle of the public sector. Gradual recovery should continue through 2013 as exports and investment pick-up, supported also by the increase in confidence following Croatia's expected accession to the EU. Nevertheless, amid persistent high unemployment and continued fiscal consolidation, the recovery is likely to be sluggish. Against this background, the authorities broadly share staff's assessment of the outlook. They also agree that the risks to this outlook are clearly tilted to the downside, with the strong deterioration of the euro area crisis being the major source of risks that could affect Croatia through trade and financial channels.

As for the medium-term prospects, the authorities are cognizant that the pre-crisis growth drivers, namely the private and government consumption supported by debt-creating inflows, have been exhausted, and that Croatia needs to develop a new growth model focused on exports and competitiveness. Thus, the authorities aim to implement a combination of structural reforms, restrictive fiscal policy and reasonably expansionary monetary policy to support redistribution of limited funding from consumption to investment, and use this investment to initiate sustainable economic growth aided by low inflation and exchange rate stability.

Fiscal policy

Since the last Article IV consultation, the authorities have initiated substantial fiscal consolidation. The new government, elected in December of 2011, adopted a new budget in February, envisaging significant changes both on the revenue and the expenditure side aimed at stabilizing public finances.

An increase in the basic VAT rate from 23 to 25 percent was introduced in March, and was followed by a reduction of the compulsory health insurance contributions from 15 to 13 percent. Despite negative economic trends, the budget execution has been kept broadly on track. Budgetary revenues exceeded forecasts, increasing by 3.6% in the first seven months of this year, mainly thanks to changes in tax legislation and improved tax and contribution collection. In particular, notwithstanding the cut in the rate of health insurance contributions, these revenues grew marginally as the government stipulated that employers may not pay out employee wages without first paying contributions to the government.

The budget expenditures have also been kept within with the planned framework. However, the expenditure structure has been somewhat less favorable than initially planned, with higher current spending broadly offset by underspending on capital investment. The current spending overrun was mainly a result of higher compensations for public employees and the provisional budget financing that was in effect in the first quarter of 2012. Notwithstanding the expenditure structure, the 2012 targeted deficit reduction of 1.2 percent of GDP is likely to be met.

The government initiated several important measures to reduce the public wage bill. Most temporary work contracts have been cancelled, overtime and other payments in addition to salary have been cut and the rationalization of state agencies is ongoing. The Parliament adopted the Law on Representation which allows the government to cancel collective agreements three months after their expiration. This legislation enabled the government to cancel Christmas bonus and reduce salaries for a part of the public sector already in this year.

Despite the achieved consolidation, public debt growth picked up considerably due to the assumption of liabilities of shipyards. Going forward, the authorities are fully aware of the need to continue the process of fiscal consolidation in order to put the public debt-to-GDP ratio on a downward trajectory. The authorities' commitment to fiscal consolidation has been recognized by the financial markets and rating agencies, as reflected in the narrowing of sovereign spreads and the recent revision of Croatia's outlook from negative to stable by Fitch Ratings.

For 2013 the government already announced several measures aimed at further fiscal consolidation, including the introduction of the value-based property tax, increase in excises and introduction of a cash registry. The authorities agree with staff's assessment of the need for additional measures to achieve an expenditure cut of 1 percent of GDP (corrected by the costs of ageing), as envisaged by the Fiscal Responsibility Law. To this end, the government will take staff's advice into account when designing the 2013 budget, which is currently being prepared. However, unlike staff, the authorities are of the view that the increase of the zero VAT rate to 5 percent as of next year is appropriate given the sensitivity of the socially most vulnerable population to the prices of products affected by this decision. As an offsetting measure, the authorities would prefer starting with the adjustment of excises to the EU levels as of January rather than July 2013.

Monetary policy and financial system

The monetary authorities continue to be firmly committed to the policy of maintaining exchange rate stability. This policy has served the country well, as it anchored inflation expectations and preserved confidence in the monetary and financial system in an environment of widespread euroisation and high foreign currency exposure of both private and public sectors. That said, the central bank allows for some intra-year volatility of the kuna in line with regular seasonal developments and in order to limit speculation, but only to the extent that it does not affect expectations of the broad stability of the currency. The authorities underscore that exchange rate depreciation would be detrimental for financial stability, external debt sustainability, and hence to overall macroeconomic stability, whereas its effects on export competitiveness are uncertain given the low export base and large import component in exports.

While maintaining exchange rate stability, the Croatian National Bank has also supported high domestic liquidity with the aim to spur the recovery of bank lending and stimulate domestic economic activity. In this regard, in May the central bank contributed to establishing a new credit scheme for supporting lending exporters by reducing the reserve requirement rate. Going forward, the CNB will continue to support the liquidity in the banking system in order to help improve domestic financing conditions. However, the expansionary orientation of monetary policy will be continued only to the extent that it does not jeopardize the exchange rate and, consequently, price and financial stability.

The specifics of the Croatian monetary environment, in particular the high euroization and external indebtedness, require having adequate reserve buffers. In view of this, the central bank has been steadily increasing international reserves over time, including during the past few years despite significantly lower capital inflows. It is worth noting that reserves stood at €9.1 billion (equivalent to 19 percent of GDP and 4.6 months of imports) at end-2008, while the current level of reserves amounts to €11.4 billion, equivalent to 25.7 percent of GDP and 7.2 months of imports. The CNB considers the level of reserves adequate, as they exceed by a large margin the amount of reserve money and cover more than 7 months of imports. Although reserves cover somewhat less than 100 percent of short-term debt (around 80 percent), one needs to be mindful of the share of the external debt related to intra-industry debt (i.e. debt of daughter companies), which accounts for more than 1/3 of the total. If at least a part of the intra-industry debt is considered stable, then the coverage of short-term debt surpasses the threshold of 100 percent. That said, the CNB policy will continue to be oriented to further gradual accumulation of reserves, depending on capital flows dynamics and in a manner which does not collide with the underlying exchange rate policy.

The Croatian banking system proved highly resilient throughout both the U.S. subprime crisis and the euro area crisis, mainly thanks to sound fundamentals and macroprudential measures implemented in the pre-crisis period. The banking system remains highly liquid, and with decent profitability at close to 8 percent, despite increasing provisioning needs against the growth of non-performing loans. The high capital adequacy of the banking sector (20.2 percent as of end-June) sufficiently ensures its resilience to potential shocks.

The deleveraging process in the euro area banks has so far affected the Croatian banking system only modestly, thanks to the solid profitability of domestic banks and the strict macroprudential policy which created substantial foreign liquidity reserves in banks. In addition, steady growth of domestic deposits has so far been sufficient to finance the subdued credit demand. Going forward, for the steady recovery of the economy it will be critical that banks bolster their credit activity. One has to be aware, however, of the risks to such a credit recovery posed by the introduction of (formal and informal) macroprudential measures by home countries targeting the overall exposure of their banks and their subsidiaries. Hence, we have to make sure in a cooperative manner that this risk does not materialize.

Structural reforms

Competitiveness remains a key challenge for boosting Croatia's growth. To this end, the recently adopted reduction in social security contributions has reduced the labor cost and shifted the tax burden from labor to consumption. In addition, the recent decision to exclude investors' reinvested profits from taxation and the cut of certain non-tax duties are seen as welcome signs of the government's intention to encourage foreign direct investment. Finally, in the coming months the Government will initiate the reform of the labor law, which will facilitate temporary and part-time work.

In August 2012 the Government adopted a new comprehensive structural reform program. The program includes measures for a wide range of areas, including reforms of subsidies distribution, restructuring of publicly owned enterprises, and reforms of the labor market, health care, social security and the pension system. Significant part of the envisaged reforms is also aimed at improving business climate, reduction of red tapes, and improving administrative capacities for the absorption of EU funds.

In the transport sector, the restructuring of the state-owned railway company is well under way. Cargo, passenger and infrastructure businesses of the company have been divided to separate entities and the government is currently negotiating privatization of the cargo business, while other parts are being prepared for EU funding. State-owned companies in the road transport are also going through a restructuring process, including significant cuts in the number of employees and monetization of the road business by offering concessions to private partners. The restructuring process of the shipyard industry has reached the final phase in an effort to meet EU demands that the shipyards must either be privatized or pay back the state funding they had received so as to comply with EU competition law.

The new government has announced a more flexible approach to privatization, including the sale of state-owned businesses that are not of strategic importance in the coming years. Privatization of a state-owned bank and insurance company are planned to be finalized in the first quarter of 2013. In addition, the government is preparing for privatization a number of state-owned companies in the tourism and agriculture sectors.

To conclude, the Croatian authorities are mindful of the challenges ahead, but firmly believe that the right policy mix, together with strengthened efforts to implement the envisaged reforms, will enhance the economy's competitiveness and growth potential.