**Republic of Croatia: Staff Concluding Statement of the 2017 Article IV Mission**

October 27, 2017

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| A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](http://www.imf.org/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.   The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF’s Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision. |

*The economic recovery continues into the third year, helped by improved macroeconomic policies. However, real incomes are still well below the EU average and their catch up has suffered a major setback during the recession period. Supporting faster income convergence to average EU income levels will require growth-friendly fiscal and productivity-enhancing structural reforms. In this regard, it is critical to further reform and modernize the public sector, notably health care, education and training, as well as the legal process.*

**Recent Developments and Outlook**

1. IMF Staff projects real GDP to grow by 3.1 percent in 2017 and 2.8 percent in 2018. Growth is mostly driven by private consumption and tourism. Investment is lagging but envisaged to increase in the near term, as absorption of EU structural and investment funds improve and private sector deleveraging gradually comes to an end. Inflation is projected to slowly pick-up but will remain low in line with regional trends. The current account surplus—projected at 3.7 percent of GDP in 2017—is expected to steadily decline as export and tourism growth moderates. Despite the recovery, GDP per capita and employment have not yet reached pre-global-financial-crisis levels. Unless critical structural reforms are implemented, growth is projected to decelerate over the medium term towards its potential rate of around 2 percent, which is below the growth of peers.
2. There are upside risks to the projections, but the balance of risks is tilted to the downside. Private consumption, tourism, and favorable trading partner conditions may continue to surprise on the upside. The impact of the Agrokor crisis has thus far been contained, but its restructuring is ongoing and there could still be downside risks. Other downside risks include further delays in structural and fiscal reforms. External and public debt and financing needs are projected to continue to decline. However, they will remain substantial, keeping the economy vulnerable to global interest rate increases.

**Fiscal Policy**

1. Consecutive sizable fiscal consolidation has allowed Croatia to exit the EU’s Excessive Deficit Procedure in June 2017. The better-than-expected budget deficit was due to strong cyclical revenues, ongoing tax administration reforms, expenditure restraint, and lower interest payments. On the spending side, expense for interest payment was lower than planned. Other expenditures were well contained while public wages were increased as budgeted. IMF staff projects the 2017 general government deficit at about 0.9 percent of GDP. While this projected outcome is similar to last year’s deficit, the cyclically-adjusted balance would deteriorate by about 0.5 percent of potential GDP, pointing to a procyclical fiscal stance. To contain this procyclical fiscal stance, it is key to seize any opportunity to rationalize expenditure in the remainder of the year.
2. A successful implementation of the 2018 budget would result in a broadly similar overall fiscal deficit (0.8 percent of GDP). IMF staff projects that gradual consolidation as outlined in the authorities’ Convergence Program would eventually turn the deficit into a slight surplus and reduce public debt to close to 65 percent of GDP by 2022.
3. Given the relatively strong outlook for growth in the short run, it would be advisable to aim at a faster reduction in the still sizable public debt over the near term due to downside risks. This would help build fiscal space that can be used in case of downturns. Staff, therefore, recommends implementing additional measures over the medium term, which would reduce the public debt to below 60 percent of GDP by 2022. This would help reduce vulnerabilities and the financing costs of the government. The additional consolidation should be accompanied by improving the structure of both revenue and expenditure to support growth and job creation.
4. A modern more equitable property tax could allow for a reduction of less growth-friendly taxes. A modern well-designed real estate tax that is based on objective criteria would be more equitable and would yield more revenue than the existing communal fees. This additional revenue could compensate for a further reduction in the income tax burden, the parafiscal fees, or even VAT. It is important that any tax rate reduction be revenue-neutral.
5. On the expenditure side, the authorities are encouraged to build on, and implement, the measures contained in the Convergence and National Reform Programs. In particular, containing the already high wage bill requires implementation of a civil service reform that would gradually reduce the large size of the public workforce and reward performance, and would thus help improve public service delivery. To achieve the sustainability of the healthcare sector, it is necessary to stop accumulating new arrears, while legacy arrears are reduced. Furthermore, contributions for supplementary insurance should be raised and the collection improved by removing exemptions. In addition, the efficiency of the sector should be enhanced by reducing the large number of specialized centers and by centralizing procurement. Consideration should also be given to moving the health insurance fund back under the Treasury to better contain arrears. The pension system is also on a non-sustainable path and key reforms are critical to address its chronic imbalances. In particular, it would be important to bring forward the planned phased-in increases of the retirement age and reduce the generous early retirement incentives. Furthermore, social benefits need to be better-targeted and rationalized with a view to reducing the disincentives to work while protecting the vulnerable groups.

**Monetary and Banking Sector Policies**

1. Given the benign inflation outlook, the Croatian National Bank (CNB) has appropriately maintained low interest rates and continued to ensure ample liquidity. The CNB is encouraged to continue to adopt an accommodative monetary stance within the limits of the overriding objective of maintaining exchange rate and financial stability. It would also be important to take advantage of the strong balance of payments position to further bolster international reserves.
2. The banking system remains on average well capitalized, profitable, and liquid. The quality of the loan portfolio has generally improved and prudential limits on exposures have helped contain the impact of the Agrokor crisis. Based on transaction data, deleveraging has come to an end and bank lending is slowly picking up. The CNB’s effort to provide long-term kuna liquidity and increase awareness of foreign exchange and interest rate risks is welcome. Going forward, it is vital to continue to maintain conservative prudential policies and banking supervisory vigilance, including by considering revisiting macroprudential measures should the pace of real estate prices accelerate.
3. The authorities are launching a public debate about the pros and cons of euro adoption. Croatia’s monetary policy is closely linked to the Euro Area as the exchange rate moves closely with the euro and in view of the high degree of euroization. While euro adoption would eliminate the current limited monetary policy independence, it would allow full participation in the Euro Area. Exchange rate risk would be reduced to a large extent and transaction costs lowered. However, to maximize the benefits and minimize the risks of joining the currency union, it is essential to increase the dynamism and resilience of the economy by accelerating structural reforms. It is also necessary to rapidly reduce public debt in order to create the fiscal space that can be used to support growth in future downturns. This is particularly important to enable adequate policy response in case future shocks affect Croatia and the Euro Area in an asymmetric way.

**Structural Reforms**

1. The current upswing should be used to advance structural reforms. Implementation of these reforms has been slow, which constitutes the biggest obstacle to improving Croatia’s competitiveness and income levels. In order to boost investment (including FDI), potential growth, and employment creation, it is critical to reduce the administrative burden on doing business, increase the flexibility of the labor market, improve the efficiency of the public sector, and enhance property rights and the judicial process.
2. Croatia has a very complex and multilayered public administration. This leads to costly para fiscal fees, creates a cumbersome and confusing environment for businesses and citizens, and provides opportunities for corruption. Licensing costs and red tape can be substantially reduced by merging and streamlining the overlapping functions of the large number of government bodies. Increasing the use of electronic hubs and simplifying administrative processes and required documents would also improve the ease of doing business.
3. Croatia’s labor force participation remains low and unemployment is high, especially among the youth and particularly for women. Moreover, there are reports of emerging shortages of both skilled and unskilled workers. A first step would be to make the regulations on temporary employment and the hiring and retrenchment of employees less restrictive and costly. Streamlining and better targeting social benefits would increase incentives to accept jobs, while improving the provision of child care facilities and rules on part time work would help increase labor force participation. Furthermore, enhancing education and vocational training and implementing efficient active labor market policies would support new entry into the labor market, especially among the youth and veterans.
4. Divesting scattered and underutilized state assets would contribute to improving the use of resources in the economy. In addition, state-owned enterprises exist in almost all sectors and suffer from low efficiency. While some progress has been made in depoliticizing their management, further strengthening of their governance, procurement rules, and spending discipline would go a long way in improving their efficiency and contribution to growth. Too many of these enterprises are classified as strategic, which impedes their privatization.
5. It would also be important to enhance corporate governance in general. While bankruptcy legislation for large corporates has been improved in response to the Agrokor crisis, it would be useful to identify and address any remaining gaps that may be impacting corporate governance, accounting and auditing standards, and insolvency and creditor rights. In the meantime, with a view to limit the impact of the Agrokor challenges, it is important to continue to make progress on its resolution and to communicate such progress to the public in a timely and transparent fashion.
6. Progress has been made in improving the judicial process with the accession to the European Union. Further improvements, including digitalization of court procedures, streamlining procedures for small claims, and further facilitating out-of-court settlement would help expedite the legal process and reduce the cost to businesses and citizens. Furthermore, a modernization of land registry and the cadaster would go a long way in enhancing property rights and, thus, facilitate a better utilization of assets.

*An IMF mission led by Khaled Sakr visited Zagreb during October 17–27, 2017. The Mission met with Minister of Finance Marić, Minister of Demography, Families, Youth and Social Policies Murganić, Governor of the Croatian National Bank Vujčić, the Fiscal Policy Committee of the Parliament, and other officials and representatives of the business community, labor unions, and academia. The mission would like to thank the authorities and other interlocutors for the constructive dialogue and kind hospitality.*