

**FOR  
INFORMATION**

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August 26, 2021

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Republic of Croatia—Statement by the European Central Bank Representative**

Board Action: Executive Directors' **information**

Additional Information: For the Executive Board discussion on the Republic of Croatia to be held on Monday, August 30, 2021.



August 26, 2021

**Statement by Rasmus Rueffer (ECB representative) and Sander Tordo  
on Croatia - 2021 Article IV Consultation  
(Preliminary)**

**IMF Executive Board Meeting**

August 30, 2021

We thank Mr. Hilbers and Mr. Milutinovic for their informative Buff statement and Staff for their report. We associate ourselves with the Statement of Mr. Pösö and would like to highlight the following issues:

**We largely agree with Staff's assessment of the macroeconomic situation and outlook for Croatia, although incoming data for the second and third quarter points to a potentially stronger than projected recovery.** In particular, positive incoming data for the second and third quarter of 2021 on tourism arrivals, consumption, industrial production, construction and the labour market point to a stronger than expected recovery in economic activity in 2021.

**Our views on risks to the growth path of Croatia are broadly aligned with those of Staff.** Tourist turnover in the summer season is crucial: adverse shifts in the pandemic are thus considered a major source of risk to the short-term growth prospects of Croatia. Over the medium-term, we agree with Staff that the main upside risk to growth is a stronger than expected impact of higher public investment, although low administrative capacity constitutes a risk in this respect as it may limit a swift absorption of EU investment funds. We also see downside risks stemming from a possible surge in firms' bankruptcies (as policy measures are gradually phased-out) and the related financial disruptions (including an increase in NPLs), which could weigh on banks' intermediation capacity as well as employment and GDP growth in the medium term.

**With respect to fiscal policies, we broadly agree with the Staff assessment of the economic impact of the COVID-19 crisis and the policy response.** The fiscal support has indeed contributed to attenuate the impact of the pandemic on output. At the same time, the large fiscal deficits contributed to raising the already elevated (but declining prior to the pandemic) government debt-to-GDP ratio by 15.9 percentage points to 88.7% in 2020. In light of Croatia's intention to adopt the euro in 2023, deficit and debt-to GDP ratios need to be on a safely decreasing path in the medium-term, including on account of higher GDP growth. We note that according to the Staff projections, the safety margin towards the 3% of GDP deficit reference value in 2022 is slim (i.e. 2.9% of GDP) and that Staff considers that Croatia is not subject to the Excessive Deficit Procedure (EDP) "given its track record and the fact that both the public deficit and debt are projected to decline" (p. 18). In that context, it may be useful to recall that the European Commission considered in its spring package from 2 June that at this juncture a decision on whether to place Member States under the EDP should not be taken, reflecting, inter alia, the high uncertainty and the agreed fiscal policy response to the COVID-19 crisis.

**Looking ahead, we share the Staff view that fiscal policies in Croatia should support the incipient recovery (especially in the tourism sector).** Priority should be given to green investment and digitalization, as envisaged in the Croatian Recovery and Resilience Plan (RRP). To capitalize on the relatively high amount of grants to be received under this program, we fully agree with Staff that it is important to strengthen the absorption capacity and the public investment management practices.

**On risks to financial stability, we broadly concur with the Staff assessment on the outlook** The Croatian banking sector entered the COVID-19 crisis with strong capital and liquidity buffers and a high degree of resilience, as also reflected in the results of the ECB Comprehensive Assessment for the five largest Croatian banks that were published in June 2020.<sup>1</sup> This enabled Croatian banks to weather the pandemic-related economic disruptions without compromising their intermediation capacity, as reflected in lending developments, with total credit growing at 3.9% in 2020 (compared to 4.2% in 2019). Following the major economic recession of 2020, first signs of asset quality deterioration in the banking sector are starting to become visible in the share of IFRS stage 2 loans, as mentioned by Staff in their report. Credit risk developments call for close monitoring from a financial stability perspective in the short term to ensure timely credit risk recognition and use of available capital buffers to absorb losses as needed. Furthermore, residential real estate prices continued to grow, but at a slower pace than before the pandemic.

**We share Staff's view that the macroprudential measures in Croatia are adequate and sufficient to address current risks.** As regards capital-based measures, we concur with the assessment of subdued cyclical risks that support maintaining the countercyclical capital buffer at 0% in the context of remaining uncertainty regarding the further pandemic evolution, the economic recovery path and credit supply developments while public support measures are gradually phased out. We agree with Staff that real-estate related risks in Croatia require close monitoring from a macroprudential policy perspective. The ECB welcomed the establishment of a legal basis for borrower-based measures in Croatia prior to the start of ERM 2 and SSM close cooperation, as it provides the Croatian National Bank (HNB) with additional macroprudential instruments to address the potential build-up of imbalances in real-estate related lending during the recovery.

**Turning to structural issues, we agree with Staff that renewed momentum for reforms is needed to increase Croatia's resilience to future adverse shocks and realize a sustainable increase in potential growth.** Reforms should eliminate several impediments to higher potential growth related, in particular, to the business and institutional environment, the judiciary system, the large public sector (including state-owned enterprises) as well as the public sector administration. Moreover, long-standing issues in the labour market, including a very low participation rate and high structural unemployment, should be addressed by reforms. In this respect, implementing reforms using the RRP is a unique

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<sup>1</sup> <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200605~ca8b62e58f.en.html>

opportunity to address Croatia's low growth potential and boost employment without weighing on public debt.