

**EXECUTIVE
BOARD
MEETING**

SM/21/146

Correction 1

August 26, 2021

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Republic of Croatia—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/146 (7/29/21) have been provided by the staff:

Evident Ambiguity

Page 1

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 4, 6, 7 (Figure 3), 10, 19, 25, 26, 27, 29, 32, 55 (Annex Figure IX.1, bottom left chart, Note 2), 59

Typographical Errors

Pages 7 (Figure 2) and 55 (Annex Figure IX.1, bottom left chart, Note 1)

Questions:

Mr. Lybek, EUR (ext. 38656)
Ms. Bunda, EUR (ext. 38562)
Mr. Seshadri, EUR (ext. 36793)
Ms. Li, EUR (ext. 35808)



REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

July 27, 2021

KEY ISSUES

Context: As other emerging economies reliant on tourism (about 25 percent ~~of GDP and employment~~ total contribution of tourism-related industries in GDP and employment), Croatia has been hit hard by the pandemic and two devastating earthquakes, leading the economy to contract by 8.0 percent in 2020. Vaccinations have been rolled out to about 38 percent of the population (end-June 2021). Staff projects growth to bounce back to 5.4 percent in 2021, driven by a rebound in the services sector and investment, aided by fiscal and monetary policies, and bolstered by large EU grants over the medium-term.

Policies:

- **Rebuild resilient and sustainable tourism:** Near term, policies should focus on still-affected businesses and workers. Policies that foster the green and digital transition of existing public tourism infrastructure, the development of tourism beyond established destinations will help reduce scarring and rebuild sustainable tourism.
- **Balance short term support with medium-term discipline:** Once the recovery is on a firm footing, fiscal deficits and the public debt need to resume their pre-pandemic downward trajectory. Successful absorption of substantial forthcoming EU funds accompanied by full implementation of reforms promised under the latest National Recovery and Resilience Plan (NRRP), as well as by strengthening public investment management, are essential to facilitate higher growth, and to lower debt.
- **Anchor stability through exchange rate, monetary, and financial policies:** The **highly** expansionary monetary stance, within the exchange rate anchor and ample global liquidity, has been appropriate for the pandemic. Supervisory vigilance should be continued. Efforts to facilitate more efficient debt restructuring should be furthered.

CONTEXT

1. **Croatia (HRV) has been hit hard by the pandemic and two severe earthquakes in 2020.** The 8.0 percent real GDP decline in 2020 reflects lower domestic and external demand—particularly, a drop of some 60 percent in tourism receipts (year-on-year). Ample support of fiscal and monetary policy, coupled with appropriate relaxation of supervisory requirements, helped to contain the effects of the pandemic. Some 40 percent of the population was vaccinated with at least one shot as of July 2021.
2. **ERM II membership commenced on July 10, 2020.** It is a critical step toward the authorities' aspiration to adopt the euro.¹ The Croatian National Bank (CNB) and the European Central Bank (ECB) also established close cooperation on banking supervision effective October 2020.²
3. **Next Gen EU Funds, if effectively utilized, represent a unique opportunity.** Totalling some 11 percent of GDP over the next six years, these funds are substantial, since they will double the amount that Croatia has been receiving through regular EU Multiannual Financial Framework funds. They would allow for higher investment in green infrastructure, education and skills of the workforce, and technological advancements that substantially improve medium-term growth, whilst reducing fiscal risks and narrowing the per capita income gap with respect to the EU average (Box 2).

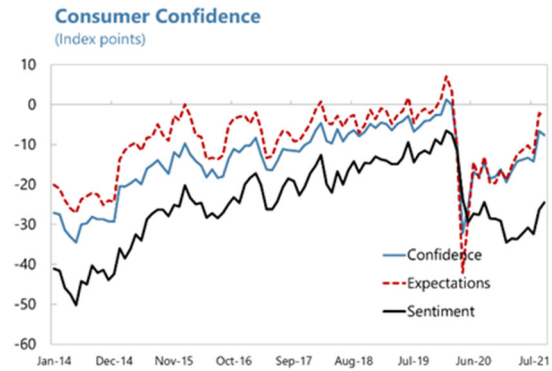
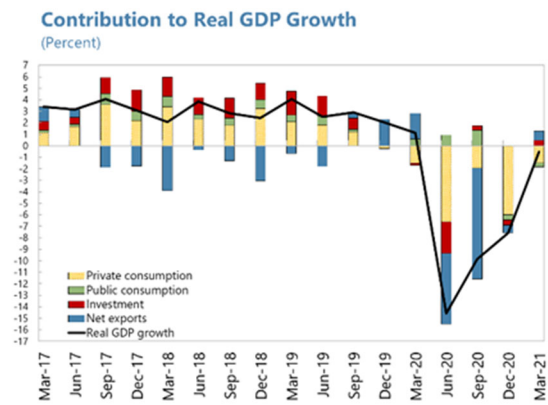
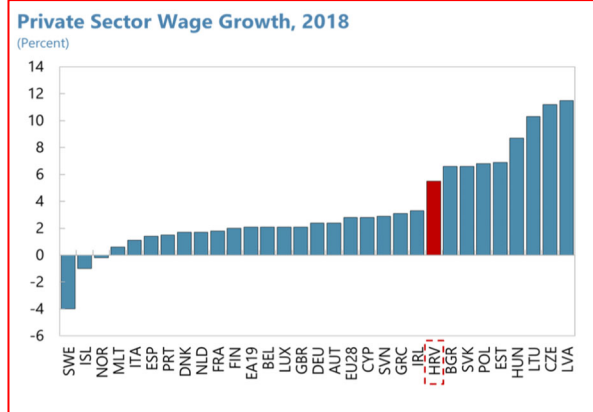
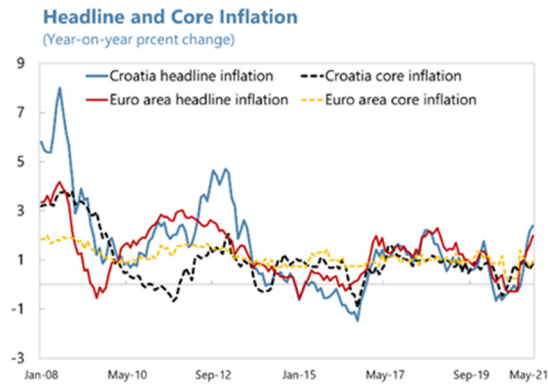
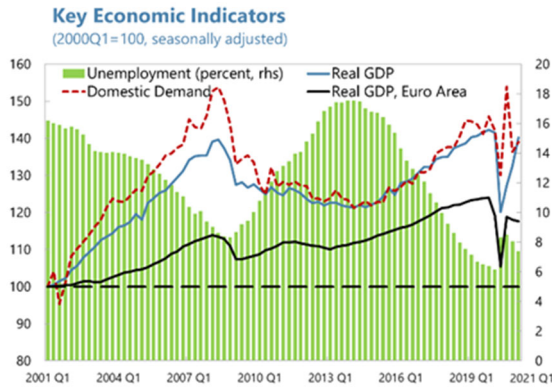
RECENT DEVELOPMENTS

4. **The effects of the 2020 contraction were widespread.** They were manifested by large drops in personal consumption (-6.2 percent, yoy) and private investment (-9.5 percent, yoy). Job preservation measures prevented a significant rise in unemployment (averaging 9 percent in 2020, compared with 7.8 percent in 2019) and supported household incomes. Net exports contracted by 8.1 percent in 2020 following the unprecedented sudden stop of international tourism (exports and imports plummeted by 25 percent and 14 percent, respectively).
5. **Output rebounded-grew strongly in 2021:Q1.** Exceeding expectations (5.8 percent qoq and -0.9 percent yoy, SA), growth was driven by merchandise exports and investment. High-frequency second quarter data (car and retail sales, fiscalized receipts) indicate consumption is rapidly catching up. Industries like construction, manufacturing, and ICT have already reached or exceeded pre-pandemic levels. Tourism and others dependent on it (e.g., food and transport) are understandably the key laggards, where there is the most potential for scarring.

¹ A [Eurobarometer survey conducted in May 2021](#) found that 61 percent of Croatians were in favor and 37 percent against euro adoption.

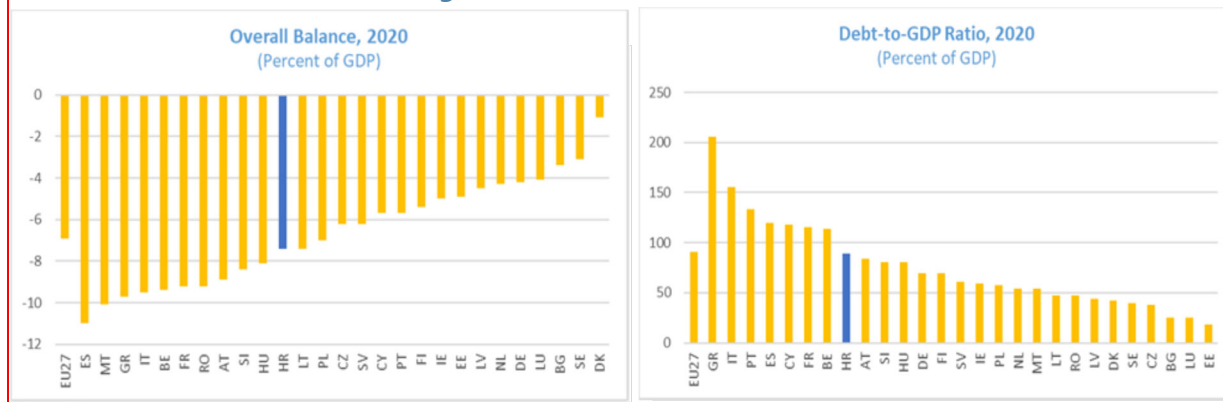
² The CNB joined the Single Supervisory Mechanism (SSM). The ECB thereby supervises eight significant banks, while the CNB supervises the rest on behalf of the ECB. The CNB continues to formulate and implement macroprudential policy in collaboration with the ECB. Croatia also participates in the Single Resolution Mechanism (SRM).

Figure 1. Selected Real Sector Indicators



Sources: Croatian National Bank, Croatian Bureau of Statistics/Haver Analytics; Eurostat; and IMF staff calculations.

Figure 2. Fiscal Sector Indicators



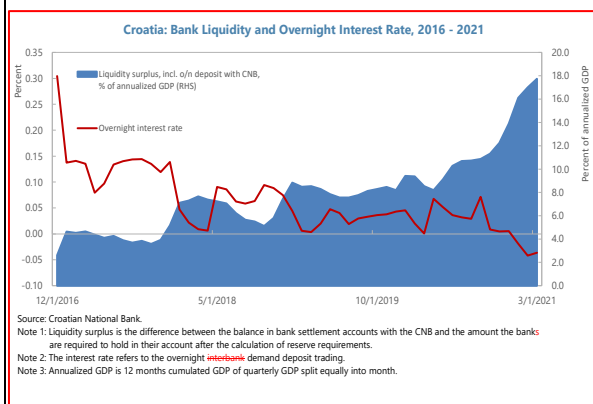
Sources: Eurostat; and IMF staff calculations

11. The banking system retained comfortable buffers. At end-2020, the capital adequacy ratio (CAR) was around 25 percent. (The two banks with lowest CAR, had ratios above 14.0 percent.) This was helped by changes in prudential regulation (mainly, prohibited dividend distribution and lower risk-weights on FX denominated claims on sovereign debt) and increased lending to the government. All banks remained very liquid with comfortable liquidity coverage ratios well over the regulatory minimum. Bank profitability more than halved in 2020, but only 4 of the 23 credit institutions reported losses. The stability of the NPL ratio in 2020 (around 7 percent, FSI definition), was mainly due to the flexible interpretation of IFRS 9 (as part of Covid-19 measures aligned with EBA guidance) and NPL sales. The reactivation of the credit registry in mid-2020, after a General Data Protection Regulation (GDPR) induced pause, helped banks' risk management.⁵

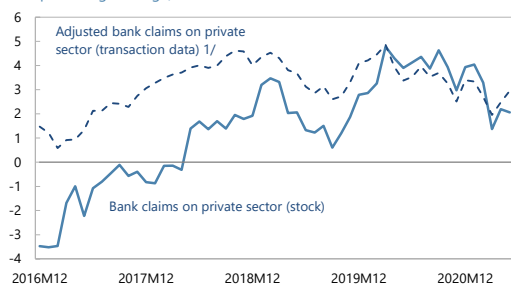
Figure 3. Monetary Stance and Bank Lending to the Private Sector, 2016–2021

The monetary stance has been highly expansionary while maintaining exchange rate stability.

Bank lending to the private sector, particularly households, remained firm during the pandemic.

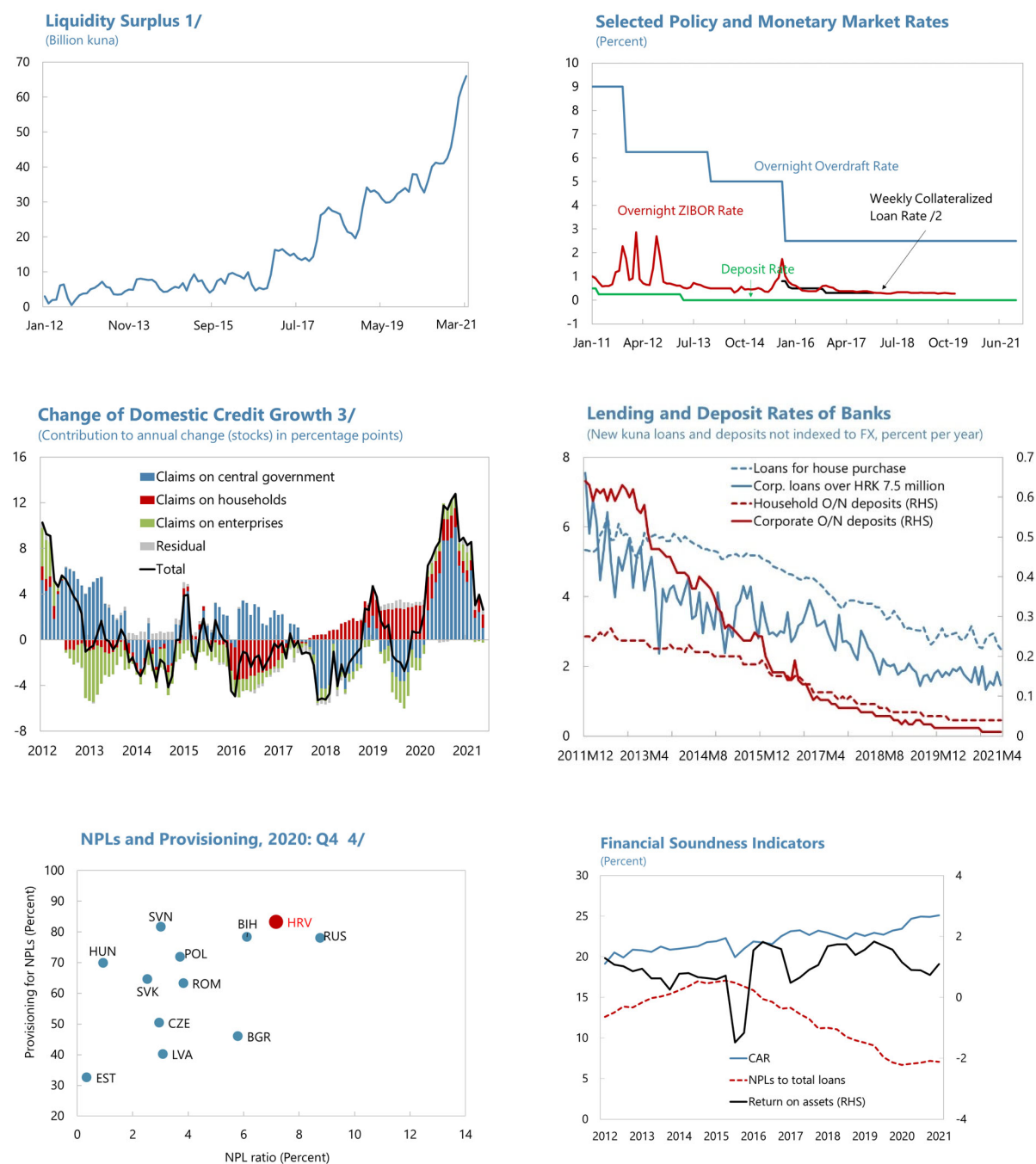


Bank Claims on Private Sector, 2016 - 2021 (Annual percentage change)



⁵ After May 2018, banks suspended the exchange of information in the Croatian Registry of Credit Obligations (HROK), due to concerns of some banks about the legal implication of the transposition of the GDPR. In August 2019, banks began to exchange information about defaulting clients. In June 2020, following amendments of Credit Institutions Act, more detailed information was again shared in the new Basic Register System (OSR), which is also owned and operated by the Croatian Banking Association. Thus far, leasing companies only share information about legal persons, but not about natural person due to concerns about the legal implications of GDPR.

Figure 7. Banking Sector Developments



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

1/ Liquidity surplus is the difference between the balance in bank settlement accounts with the CNB and the amount that banks are required to hold in their accounts after the calculation of reserve requirement.

2/ Reverse repo re-introduced in 2015, mainly due to mandated retroactive conversion of Swiss franc-indexed household loans into euros.

3/ Change in stock of domestic credit from monetary survey.

4/ According to FSI data. Impairment in percent of NPLs (national definition) is around 64 percent.

and practices in accordance with the OECD guidelines and [recommendations](#)); Improving the national insolvency framework (enhance the qualification requirements for liquidators and adopt a framework for a comprehensive insolvency database). Moreover, early warnings are expected to be introduced with the transposition of the 2019 EU Directive on [Preventive Restructuring Frameworks](#).

31. The highly expansionary monetary policy, within the exchange rate anchor and ample global liquidity, is appropriate. The ~~output gap is still large-economic recovery has only begun~~, and there are no large or persistent imbalances. However, as the recovery gains traction, continued vigilance on risks is warranted. If rapid domestic credit growth fuels imbalances and persistently higher inflation than in the euro area, the CNB may need to reduce excess liquidity in the banking system, while maintaining exchange rate stability. Conversely, should significant negative shocks reemerge, causing dysfunctionality in financial markets, tailored temporary measures, like those used during the pandemic, may be needed. Should potential imbalances prove persistent, the overall policy mix, including structural reforms, may need to be adjusted to facilitate real sector adjustment.

Banking System

32. Continued supervisory vigilance is warranted. The reported credit quality is expected to deteriorate, with the expiration of the moratoria and the accompanying flexible loan classification, as indicated by the recent increase of stage II loans (particularly to NFCs). Provisions, however, remain high. New tax rules, effective in 2021, will facilitate bank write-offs of NPLs. While a commendable step, the effectiveness remains to be seen, as some banks may prefer the proven practice of NPL sales. The CNB's stress testing exercise (based on end-2020 data), shows that banks have sizable loss-absorption capacity. In a severe adverse scenario with negative real GDP growth during the 2021–23 period, the conservative SREP capital requirements were encroached by eleven banks, accounting for about 4.8 percent of total assets, while eight banks encroached the pillar I capital requirement (8 percent).²⁰

33. Housing loans remained strong during the pandemic. In 2020, about 10 percent of the households negotiated a debt-service moratorium. Most had expired by March 2021. Uncollateralized general-purpose cash loans declined. The increasing NPL ratio for these loans may be an opportunity to revisit some of the credit scoring models. Conversely, housing loans have continued to grow, underpinned by low interest rates, favorable taxation,²¹ and the support scheme for first time buyers.²²

²⁰ This extreme scenario assumes negative real GDP growth during 2021–23 (respectively, -1.2; -4.0; and -1.4 percent), a depreciation of the currency (almost 7 percent), and a decline in real estate prices (see chapter seven in the CNB's [May 2021 Financial Stability Report](#)).

²¹ There is a real estate transaction tax. However, a well-calibrated modern property tax could be less distortive if it would better account for the quality of the residence and whether is intended as an investment property for rentals. Also, for broader reasons of diversifying revenues, as well as reducing distorting incentives favoring real estate, a modern real estate tax would be desirable, but it is not seen as politically feasible.

²² The current housing support scheme for young families were introduced in 2017 and since adjusted. In 2020, it was doubled and there were two rounds in contrast to only one in previous years. It may have reduced the rationing element that previously [tended to boost prices during the months it was available](#). In 2021, there will only be one round, but the period is extended. Data suggest that the average loan-to-collateral-value (LTC) and debt-service-to-income (DSTI) were slightly higher for subsidized housing loans.

Table 1. Croatia: Selected Economic Indicators, 2016–26

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
	Proj.										
Output, unemployment, and prices (Percent change, annual average, unless otherwise indicated)											
Real GDP growth	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
Contributions:											
Domestic demand	3.2	4.2	4.6	2.7	-2.3	3.9	6.5	4.9	3.1	1.7	1.7
Net exports	0.3	-0.7	-1.9	0.2	-5.8	1.5	-0.7	-0.9	0.2	1.5	1.4
Unemployment	15.0	12.4	9.9	7.8	9.0	8.5	8.0	7.7	7.2	7.0	6.8
CPI inflation (avg.)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
Saving and investment (percent of GDP)											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Government	3.5	4.4	5.0	5.7	-1.1	1.4	2.6	3.5	4.3	4.9	5.1
Nongovernment	19.7	21.1	20.2	20.0	26.3	24.4	23.4	23.2	23.4	22.3	21.7
Government sector (ESA 2010 definition)											
General government revenue	46.5	46.0	46.2	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
General government expenditure	47.4	45.2	46.0	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
General government balance	-1.0	0.8	0.2	0.4	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Structural balance 1/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4
General government debt 2/	80.8	77.5	74.2	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Balance of payments (percent of GDP)											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Debt and reserves											
Gross official reserves (billions of euros)	13.5	15.7	17.4	18.6	18.9	22.3	24.0	25.4	26.1	26.4	26.6
IMF metric (percent) 3/	88.5	102.0	112.4	103.4	125.6	138.9	143.2	147.2	146.9	145.7	144.4
In months of imports in goods and services (based on next year level)	7.5	7.8	7.9	7.9	9.3	9.7	8.8	8.6	8.3	8.0	7.6
Total external debt (percent of GDP)	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
Money and credit (End of period, change in percent)											
Broad money (M4)	4.7	2.1	5.5	2.9	9.3	7.0	5.0	4.5	4.0	4.0	4.0
Claims on other domestic sectors 4/	-3.4	-0.8	1.8	2.6	3.3	...	...	...	...	...	...
Interest rates											
Average 12-month T-bill interest rate (in kuna)	1.0	0.4	0.1	0.1	0.1	...	...	...	...	...	...
Kuna credit rate (unindexed, outstanding amount)	6.5	6.0	5.7	5.2	4.8	...	...	...	...	...	...
Exchange rate											
Kuna per euro	7.6	7.5	7.4	7.4	7.5	...	...	...	...	...	...
Real effective exchange rate (percent, "+" = appreciation)	0.3	0.7	1.9	-1.4	...	...	...	...	...	...	...
Memorandum items:											
Nominal GDP (billions of euros)	46.6	49.3	52.0	54.3	49.3	52.4	56.2	59.8	63.0	66.0	69.1

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.

1/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015. The 2020 overall budget balance (-7.4 percent of GDP) minus the cyclical component (-1.7 percent of GDP) results in a cyclically adjusted budget balance of -5.7 percent of GDP. Includes the one-offs related to the COVID-19 package of -3.8 percent of GDP. For 2021, the overall budget balance (-4.1 percent of GDP) minus the cyclical component (-0.9 percent of GDP) results in a cyclically adjusted budget balance of -3.2 percent of GDP. Includes the one-offs related to the COVID-19 package of -2.5 percent of GDP.

2/ Gross debt as defined by the EU under the Maastricht Treaty.

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

4/ Comprises claims on households and non-financial corporations.

Table 2. Croatia: Medium-Term Baseline Scenario, 2016–2026

(Percent of GDP, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Est.	proj.					
Real GDP (percent change)	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
CPI inflation (average)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
CPI inflation (end-of-period)	0.2	1.2	0.8	1.4	-0.7	2.7	2.1	2.0	2.0	2.0	2.0
Real sector (percent change)											
Domestic demand	3.2	4.2	4.6	2.9	-2.5	3.6	6.1	4.6	2.9	1.6	1.6
Consumption, total	2.5	2.9	3.1	3.5	-3.8	3.7	5.0	3.7	2.7	2.3	2.0
Gross fixed capital formation, total	6.5	5.1	6.5	7.1	-2.9	7.7	16.4	8.4	0.5	0.2	0.2
Saving and investment											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Balance of payments											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Exports of goods, f.o.b.	22.5	23.8	23.5	23.7	24.7	24.2	23.9	23.8	24.4	24.4	24.2
Imports of goods, f.o.b.	38.8	40.9	42.1	43.0	42.2	44.8	49.3	50.1	50.3	50.8	50.8
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
<i>Of which</i> : FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Gross official reserves	29.0	31.9	33.5	34.2	38.4	42.5	42.6	42.5	41.5	40.1	38.5
Gross external debt	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
General government finances											
Revenue	46.5	46.1	46.3	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
Expenditure	47.5	45.3	46.1	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
Balance	-0.9	0.8	0.2	0.3	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Government debt	80.8	77.6	74.3	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Memorandum items:											
Nominal GDP (billions of kuna)	351.2	367.5	385.4	402.3	371.5	394.4	423.5	450.1	474.5	496.8	520.7
Output gap	0.0	0.0	-0.5	0.4	-3.8	-2.0	-0.8	-0.3	-0.2	-0.1	0.0
Potential GDP growth	2.4	3.2	3.2	2.3	-4.0	3.5	4.5	3.5	3.2	3.0	3.0

Sources: Central Bureau of Statistics; Croatian National Bank; Ministry of Finance; and IMF staff estimates.

Table 3. Croatia: Statement of Operations of General Government, 2016–2026

(Percent of GDP, ESA 2010)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
								Proj.			
Revenue	46.5	46.1	46.3	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
Taxes	25.8	25.7	26.3	26.8	25.8	26.0	26.3	26.2	26.0	25.9	25.8
Income tax	5.9	5.7	5.9	5.9	5.6	5.4	5.4	5.3	5.1	5.0	4.9
VAT	12.9	13.1	13.4	13.7	12.8	13.2	13.4	13.4	13.4	13.4	13.4
Excise	4.4	4.5	4.6	4.5	4.6	4.7	4.7	4.7	4.7	4.7	4.7
Import duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.6	2.4	2.5	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Social contributions	11.9	11.9	11.9	11.8	12.1	11.8	12.3	12.8	12.8	12.8	12.8
Other revenue	4.4	4.2	3.6	4.2	6.0	9.2	9.7	9.1	7.5	6.0	5.4
Grants 1/	3.3	3.2	2.7	3.3	5.1	8.4	8.8	8.2	6.7	5.2	4.6
Property income	1.0	1.0	0.8	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
of which interest receivable:	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Sales of goods and services	4.5	4.2	4.4	4.5	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Expenditure	47.5	45.3	46.1	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
Expense	44.1	42.5	42.4	42.5	49.7	48.2	45.7	44.4	43.5	42.6	42.4
Compensation of employees	11.4	11.4	11.7	11.9	13.6	13.6	13.1	12.8	12.6	12.4	12.3
Use of goods and services	8.2	8.0	8.1	8.4	8.7	8.8	8.6	8.5	8.5	8.5	8.5
Interest, payable	3.1	2.6	2.3	2.2	2.0	1.7	1.6	1.3	1.0	0.9	0.9
Subsidies	1.3	1.5	1.6	1.5	3.8	3.2	1.9	1.9	1.9	1.9	1.9
Current grants 2/	2.3	2.1	1.5	1.3	2.1	2.2	2.2	2.2	2.1	1.4	1.4
Social benefits	16.0	15.6	15.4	15.5	17.4	16.8	16.3	15.9	15.5	15.5	15.5
Other expenses	1.8	1.3	1.8	1.9	2.0	1.9	1.9	1.9	1.9	1.9	1.9
Net acquisition of nonfinancial assets	3.4	2.8	3.6	4.4	5.8	7.1	9.6	9.7	8.1	6.8	6.2
Overall Balance	-0.9	0.8	0.2	0.3	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Memorandum item:											
General government gross debt 3/	80.8	77.6	74.3	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
General government net debt 4/	68.7	65.6	62.4	...	...	...	...	...	...	...	...
Structural balance 5/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4

Sources: Eurostat; and IMF staff estimates.

1/ Mostly EU structural and investment funds.

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

3/ Gross debt as defined by the EU under the Maastricht Treaty.

4/ Net debt is calculated as gross debt minus deposits, loans and debt securities as reported by Eurostat.

5/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises, one-off investment retrenchment in 2015, payment of guarantees of Ulianik shipyards in 2018/19; and Covid-19 fiscal package in 2020.

6/ Components of expenditures and revenues may not add to the total due to rounding.

Table 5. Croatia: Financial Soundness Indicators, 2014–2021:Q1

(Percent, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020				2021
							Q1	Q2	Q3	Q4	
Regulatory capital to risk-weighted assets	21.8	21.0	22.5	23.2	22.9	23.2	23.4	24.7	25.0	24.9	25.1
Regulatory Tier I capital to risk-weighted assets	20.6	19.2	20.9	21.8	21.8	22.4	22.7	24.0	24.3	24.3	24.6
Nonperforming loans net of loan-loss provisions to capital	41.1	34.2	19.4	14.2	12.9	5.6	4.9	4.9	4.4	5.4	5.4
Nonperforming loans to total gross loans 1/	16.7	16.3	13.6	11.2	9.7	7.0	6.7	6.8	7.0	7.2	7.1
Nonperforming loans to total gross loans 2/	...	...	12.2	8.8	7.6	5.5	5.3	5.5	5.5	5.4	5.3
Total loan-loss provision to nonperforming loans 1/	51.0	61.9	70.1	70.1	70.3	81.8	84.1	84.6	86.2	83.3	83.0
Return on assets	0.6	-1.2	1.6	1.1	1.4	1.6	1.2	0.9	0.9	0.7	1.1
Return on equity	4.6	-8.7	11.8	7.4	9.6	11.3	8.5	6.6	6.5	5.4	8.1
Interest margin to gross income	58.1	62.1	57.7	60.1	56.6	52.5	61.6	63.0	61.8	61.2	59.6
Noninterest expenses to gross income	57.3	61.9	53.4	56.5	54.3	51.8	59.6	58.4	58.8	59.2	55.8
Liquid assets to total assets 3/	27.3	27.7	29.6	33.0	34.4	34.4	33.6	33.3	34.1	36.2	36.7
Liquid assets to short-term liabilities 3/	42.7	41.9	42.6	47.3	47.1	46.7	45.5	44.6	45.6	48.1	48.5
Net open position in foreign exchange to capital	2.9	12.5	3.8	3.3	5.1	5.0	5.6	5.7	6.2	6.2	-4.3
Residential real estate prices, end of period (annual increase)	-1.4	-2.1	0.8	7.6	4.7	10.0	9.1	8.3	6.9	6.4	4.6

Source: Croatian National Bank and the IMF's *Financial Soundness Indicators (FSI)*.

Note: The classifications used in the table are consistent with the IMF's FSIs Database. However, figures in *italics* are most current figures provided by the CNB or the Croatian Bureau of Statistics.

1/ Total loan-loss provisions in percent of gross loans as defined by the FSIs.

2/ Total loan-loss provisions in percent of gross loans as defined by the ECB.

3/ 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.

Annex II. Public Debt Sustainability Analysis¹

The public debt ratio has increased sharply in 2020 due to Covid-19 crisis, reversing the downward trend started in mid-2010s. Under the baseline scenario, debt is expected to be around 87.6 percent of GDP at end-2021. It will continue to gradually decline over the medium term and reach 73.3 percent of GDP in 2026, slightly above its 2019 level. These projections remain sensitive to growth prospects and the materialization of contingent liabilities, such as the payment of healthcare arrears. On the other hand, there could be some gains if more state assets were divested (as planned in the NRRP), with the proceeds being used for public debt reduction.

The pandemic has undone the gains that Croatia had previously made. From 2016–19, public debt came down by 7.6 ~~8~~ percentage points, the budget moved from headline deficits to surplus, and the average growth rate was 3.1, compared with -0.4 for 2010–15. This trend of relative stability was abruptly interrupted in 2020, with the public debt to GDP ratio surging from 72.8 percent in 2019 to 88.7 percent in 2020. The increase was driven by the pandemic-induced economic contraction and the sizable fiscal measures to address the extraordinary emergency.

Definitions, Debt Profile and Vulnerabilities

- *Definitions and coverage:* Croatia's gross debt statistics cover the general government (central, local, social security funds and state-owned enterprises), and consists of liabilities in the following instruments: cash and deposits, debt securities and credits and loans.²
- *Debt profile and developments:* Central government debt accounts for 80 percent of general government gross debt. More than 96 percent of outstanding debt matures beyond one year (the average maturity of domestic bonds placed since 2019 has been about 10 years). Unlike the past, Croatia managed to borrow at longer maturity in sovereign bond markets, as the June 2020 11-year €2 billion Eurobond and the 12–20-year February 2021 €2 billion Eurobond have shown. About 43–71 percent of public debt is denominated in foreign currency (mainly euro-denominated). Euro denominated debt has ~~increased~~ ~~decreased~~ gradually during the last few years. Since its previous peak in 2014, public debt has declined more than 12 percentage points; and significant progress was made in the financial restructuring of the road sector which had contributed significantly to the build-up of debt in the past. Public debt reached an unprecedented 88.7 percent of GDP in 2020 and is estimated to decline to 87.6 percent of GDP in 2021. Gross financing needs almost doubled in 2020, as a result of the Covid-19 shock and subsequent policy support but are estimated to decline to 9.8 percent of GDP in 2021

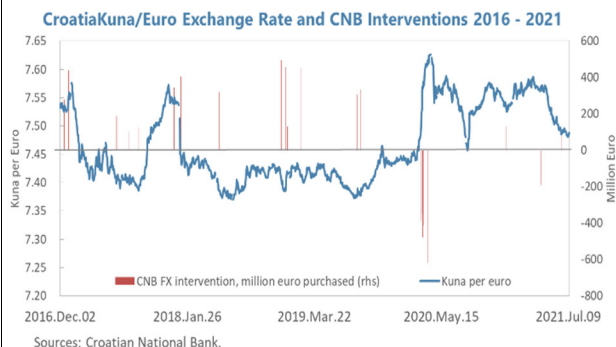
¹ Prepared by Irina Bunda

² All SOE's debt is included in the statistics as they are part of the General Government definition. Note that Uljanik shipyards are not within the general government perimeter, as they are technically private companies (although they received state guarantees to help finance their investments in the past). The cost on these guarantees became part of the general government debt when the guarantees were called, and the state had to honor them. Other possible materialization of associated contingent liabilities is conceived as a future risk. On the main contingent liability item, healthcare arrears, estimated at about HRK 4.7 billion: HRK 2.6 bn have been cleared via spending reallocation within the 2021 revised budget (the remaining is assumed to be cleared over the next years).

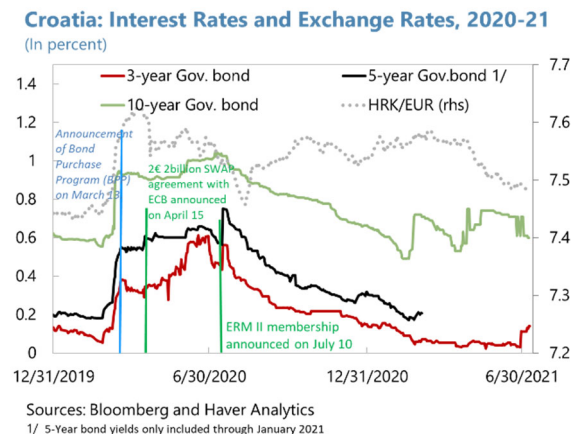
the EU framework against excessive budget deficits, ensured that the potential risk of fiscal dominance never materialized. Since end-June 2020, long bond yields have declined, the spreads vis-à-vis bunds and thus the slope of the Croatian yield curve declined.

Annex Figure IX.1. Croatia: Selected Monetary Policy Indicators of Croatia, 2016–2021

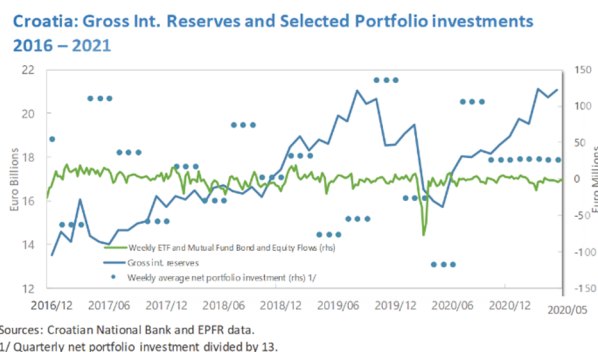
Exchange rate quickly stabilized after the Covid-19 shock.



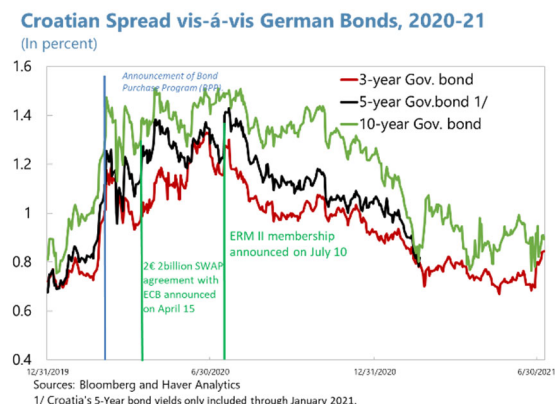
Croatian long bond yields increased at the beginning of the pandemic but have since declined.



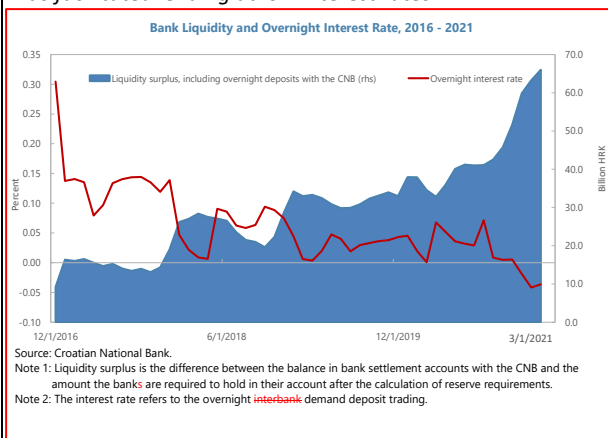
Minor capital outflows at the beginning of the pandemic soon reversed and reserves recuperated.



Long-term yields of Croatian government bonds have also declined compared to German bunds.



Record high levels of excess liquidity in the banking system has facilitated lending at low interest rates.



Secondary turnover in government securities reflect the CNB's bond purchase program.

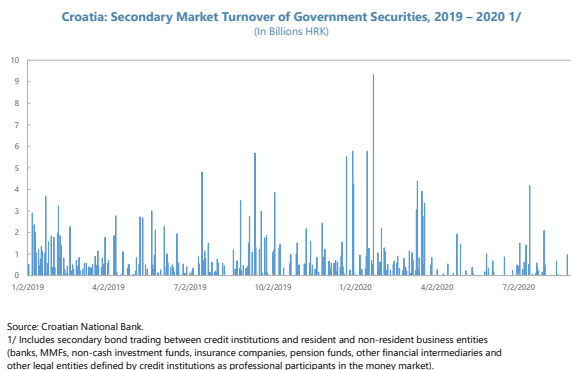


Table 1. Croatia: Selected Economic Indicators, 2016–26

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
	Proj.										
Output, unemployment, and prices											
(Percent change, annual average, unless otherwise indicated)											
Real GDP growth	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
Contributions:											
Domestic demand	3.2	4.2	4.6	2.7	-2.3	3.9	6.5	4.9	3.1	1.7	1.7
Net exports	0.3	-0.7	-1.9	0.2	-5.8	1.5	-0.7	-0.9	0.2	1.5	1.4
Unemployment	15.0	12.4	9.9	7.8	9.0	8.5	8.0	7.7	7.2	7.0	6.8
CPI inflation (avg.)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
Saving and investment (percent of GDP)											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Government	3.5	4.4	5.0	5.7	-1.1	1.4	2.6	3.5	4.3	4.9	5.1
Nongovernment	19.7	21.1	20.2	20.0	26.3	24.4	23.4	23.2	23.4	22.3	21.7
Government sector (ESA 2010 definition)											
General government revenue	46.5	46.0	46.2	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
General government expenditure	47.4	45.2	46.0	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
General government balance	-1.0	0.8	0.2	0.4	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Structural balance 1/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4
General government debt 2/	80.8	77.5	74.2	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Balance of payments (percent of GDP)											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Debt and reserves											
Gross official reserves (billions of euros)	13.5	15.7	17.4	18.6	18.9	22.3	24.0	25.4	26.1	26.4	26.6
IMF metric (percent) 3/	88.5	102.0	112.4	103.4	125.6	138.9	143.2	147.2	146.9	145.7	144.4
In months of imports in goods and services (based on next year level)	7.5	7.8	7.9	7.9	9.3	9.7	8.8	8.6	8.3	8.0	7.6
Total external debt (percent of GDP)	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
Money and credit											
(End of period, change in percent)											
Broad money (M4)	4.7	2.1	5.5	2.9	9.3	7.0	5.0	4.5	4.0	4.0	4.0
Claims on other domestic sectors 4/	-3.4	-0.8	1.8	2.6	3.3	...	...	...	...	...	...
Interest rates											
Average 12-month T-bill interest rate (in kuna)	1.0	0.4	0.1	0.1	0.1	...	...	...	...	...	...
Kuna credit rate (unindexed, outstanding amount)	6.5	6.0	5.7	5.2	4.8	...	...	...	...	...	...
Exchange rate											
Kuna per euro	7.6	7.5	7.4	7.4	7.5	...	...	...	...	...	...
Real effective exchange rate (percent, "-" = appreciation)	0.3	0.7	1.9	-1.4	...	...	...	...	...	...	...
Memorandum items:											
Nominal GDP (billions of euros)	46.6	49.3	52.0	54.3	49.3	52.4	56.2	59.8	63.0	66.0	69.1

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.

1/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015. The 2020 overall budget balance (-7.4 percent of GDP) minus the cyclical component (-1.7 percent of GDP) results in a cyclically adjusted budget balance of -5.7 percent of GDP. Includes the one-offs related to the COVID-19 package of -3.8 percent of GDP. For 2021, the overall budget balance (-4.1 percent of GDP) minus the cyclical component (-0.9 percent of GDP) results in a cyclically adjusted budget balance of -3.2 percent of GDP. Includes the one-offs related to the COVID-19 package of -2.5 percent of GDP.

2/ Gross debt as defined by the EU under the Maastricht Treaty.

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

4/ Comprises claims on households and non-financial corporations.