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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/10-1

10:00 a.m., February 8, 2019

1. Republic of Croatia—2018 Article IV Consultation

Documents: SM/19/21 and Correction 1; and Correction 2; and Supplement 1; and Supplement 1, Correction 1; SM/19/22; and Correction 1

Staff: Seshadri, EUR; Sun, SPR

Length: 36 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	T. Sitima-wina (AE), Temporary
	T. Nguema-Affane (AF), Temporary
	J. Di Tata (AG)
	G. Johnston (AP)
	Z.Mohammed (BR), Temporary
	P. Sun (CC)
	M. Mulas (CE), Temporary
	A. McKiernan (CO)
	C. Just (EC)
	A. Castets (FF)
S. Meyer (GR)	
	P. Dhillon (IN), Temporary
	L. Cerami (IT), Temporary
	H. Mori (JA), Temporary
	K. Badsi (MD), Temporary
	M. Choueiri (MI), Temporary
	R. Doornbosch (NE)
	I. Skrivere (NO), Temporary
	S. Potapov (RU), Temporary
	F. Rawah (SA), Temporary
	K.Tan (ST)
	P. Trabinski (SZ)
	D. Ronicle (UK)
	A. Grohovsky (US), Temporary

G. Bauche, Acting Secretary
P. Cirillo, Summing Up Officer
M. Gislen, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Communications Department: G. Vilkas. European Central Bank: K. Nikolaou. European Department: J. Decressin, O. Harrison, T. Lybek, C. Mulas Granados, S. Seshadri, K. Sakr, S. Vtyurina. Legal Department: N. Rendak. Strategy, Policy, and Review Department: Y. Sun. World Bank Group: D. De Rosa, A. Kucey.

Alternate Executive Director: P. Rozan (FF). Senior Advisors to Executive Directors: P. Braeuer (GR), Y. Danenov (SZ), E. Rojas Ulo (AG), C. Williams (CO). Advisors to Executive Directors: P. Braeuer (GR), J. Hanson (NE), Z. Huang (CC), M. Josic (NE), T. Manchev (NE), M. Mehmedi (EC), P. Mooney (CO).

1. REPUBLIC OF CROATIA—2018 ARTICLE IV CONSULTATION

Mr. Doornbosch and Mr. Josic submitted the following statement:

On behalf of the Croatian authorities, we thank Mr. Seshadri and his team for the set of candid reports and for the fruitful policy discussions during the Article IV mission. The authorities broadly agree with staff's appraisal and appreciate their useful policy recommendations.

Recent Economic Development and Outlook

Economic growth continued to be robust, inflation benign, and unemployment reached historical low levels. Real GDP growth was 2.8 percent y-o-y in the third quarter of 2018 and high frequency indicators point to a similar expansion in the last quarter. At the same time, fiscal consolidation continued, supporting the goal to reach the Stability and Growth Pact (SGP) threshold of 60 percent of GDP in the medium-term. The CNB continued to pursue an expansionary monetary policy, maintaining very high levels of liquidity in the domestic financial market, while further building international reserves and keeping the exchange rate stable. The level of NPLs continued to decrease.

In the medium term, growth is expected to moderate to its potential level. However, the authorities are strongly committed to address key bottlenecks and increase the level of public and private investment, which would offset the anticipated slowdown and increase potential output.

Fiscal Policy and Debt Management

During the last three years, the authorities have used the window of opportunity arising from a favorable cyclical position, which, combined with expenditure control and an adequate debt management strategy, resulted in a budget surplus of 0.9 percentage points of GDP in 2017, after a deficit of 5.1 percent of GDP in 2014.

Since the last consultations, the authorities have continued with fiscal consolidation and remained strongly committed to prudent fiscal policy in the medium-term. Based on the latest available data, a budget surplus of 0.2 percentage points will be recorded in 2018, including a one-off and unexpected payment of almost 0.7 percent of GDP for called guarantees on the Uljanik shipyard. Despite these challenging factors, the public debt-to-GDP ratio further decreased to 74.5 percent in the third quarter of 2018, putting Croatia in the top five EU economies with the largest decline in public debt in the last three years (total of 9.2 percentage points of GDP).

It is also worth noting that public debt has increased by almost 20 percent of GDP in the last 16 years because of the pension reform introduced in 2002 with the assistance of the World bank. The reform strongly reduced future contingent liabilities by introducing a capital-based second pillar in the pension system.

The authorities share staff's view that the level of public debt, despite positive developments, is still high and vulnerable to several risks. Therefore, they stay committed to continue with fiscal consolidation and increase their efforts to further improve the sustainability of public finance, which is crucial to supporting the authorities' goal to enter the ERM-II during 2020. At the same time, the ongoing fiscal consolidation is in line with the SGP provisions, because the public debt-to-GDP ratio is decreasing at more than sufficient pace toward the reference value of 60 percent (over the previous three years at an average rate of three times more than the requested 1/20th per year). In order to support the overall goal, the authorities have adopted a new Fiscal Responsibility Law in December 2018, which clearly defines fiscal rules in line with SGP rules, while the Fiscal Policy Commission has been depoliticized and given financial autonomy which will allow for a better and independent control of the entire budget process.

On the real estate tax, the authorities believe that further work is needed to establish an adequate valuation and administration system before a real estate tax could be introduced. They support staff's recommendation to introduce this revenue measure but consider that it must be a multi annual project if large execution problems are to be avoided. In the broader context where almost 90 percent of the population owns real estate (for most of them it is their only property) and where a valuation system is not properly established, the authorities believe that further steps are needed to develop a fair system and remain committed to continue with the preparatory work. As a first step, the authorities started a project of data collection for real estate valuation.

Monetary Policy and Financial Stability

The monetary policy of the CNB remained expansionary and continued to support the economic recovery while working towards maintaining a stable kuna/euro exchange rate. Throughout 2018, the CNB has further supported the kuna liquidity of the banking system, which was predominantly spurred by the purchase of foreign exchange from banks, alleviating appreciation pressures on the domestic currency. This also contributed to a further build-up in gross international reserves, which reached EUR 17.4 billion at the end of 2018, enough to cover eight months of imports of goods and services. The highly accommodative policy stance continued to improve the financing conditions of both the households and corporate sector, bringing interest rates to historical low levels and further supporting credit recovery. The monetary authorities stand ready to react to tight external conditions, should these materialize. However, on the issue of harnessing inflation expectations, the monetary authorities would like to highlight that they have always been successful in using the anchor of a stable exchange rate to achieve the goal of price stability; that inflation developments in Croatia are largely determined by energy and food prices and, that the survey points to well-anchored inflation expectations.

The authorities share staff's assessment that the banking system is very liquid, well-capitalized, and adequately profitable. Against this background, the ratio of NPLs to total loans continued to decrease and stood at 10.3 percent at the end of the third quarter of 2018. At the same time, more than 60 percent of NPLs has been adequately provisioned, while close to half of the NPLs was concentrated in one sector, namely construction. However, the authorities share staff's view that the level is still higher than desirable, particularly when compared to international standards. In this vein, the CNB remains committed to strong and prudent supervision, to being vigilant about deploying macroprudential measures for new loans, as well as to being supportive of banks' sales of NPLs. At the same time, the CNB will continue with education and delivery of tools and publications that promote financial literacy and raise awareness of currency and interest rates risks.

With respect to the increased general cash loan for households, this increase is assessed to be in line with the increase in personal consumption (evidenced by the Bank Lending survey) and with the households' increased optimism (evidenced by the Consumer Confidence Survey) and does not differ from the situation in the rest of Central and Eastern Europe. However, the authorities share staff's concerns about the potential risk to financial stability. They remain vigilant and stand ready to implement new macroprudential tools if needed. In the context of house prices, their increase was so far limited to certain geographical areas (the coast and the capital) and mostly in line with macroeconomic fundamentals. However, the authorities expressed their commitment to act timely and implement macroprudential policy instruments that could affect borrowers (households), pledged assets (collateral) and/or lenders (banks).

On the process of euro adoption, the authorities reiterated their commitment to enter the single currency union considering the high credit and deposit euroization and the dominance of foreign-owned banks in the domestic banking system. At the same time, they are economically and financially firmly integrated in the euro area (business cycle largely mimics developments in the euro area)[1]. In this context, they have already initiated discussions with relevant European counterparts and are ready to enter the ERM-II during 2020.

Structural Reforms and Competitiveness

The authorities appreciate and recognize the bottlenecks identified by staff and share their views on the need to implement a wide range of structural reforms to create a more dynamic state and further decrease the income gap with euro area countries. In this context, the authorities have updated the National Reform Program in April 2018 which is now fully in line with the EU2020 strategy of achieving smart, sustainable and inclusive growth. The authorities also recognize that the implementation of structural reforms will be crucial during the euro adoption process, and therefore reiterate their strong commitment.

Changes in the Civil Servants' Employment Act and the adoption of the Single Wage Act are underway. This will harmonize salaries across different layers of the administration and enable promotions based on performance, which will, in combination with attrition, contain the wage bill growth. In addition, the authorities have already initiated the process of streamlining the network of 54 public agencies and institutions, and result in savings in staffing and operational costs, while improving the overall efficiency of the provided services.

The Action Plan for Administrative Relief of the Economy resulted in savings to employers in 2018 and 2019 of about HRK 1.3 billion. These measures will not only make businesses more cost efficient, but also simplify their operations with the state administration, which is usually identified as an impediment to doing business. In addition, 24 professions, like pharmacists and physicists, will be fully liberalized during 2019. Lastly, tax reform applied on January 1, 2019 will decrease the overall cost of gross salaries for employers, while increasing net salaries for highly educated and skilled people.

[1] More information about the authorities' Strategy for the Adoption of the Euro in the Republic of Croatia can be found here.

Measures to improve the financial sustainability of the health sector have also been applied. Significant progress has been made with the functional integration of the hospitals and with a central procurement system, where almost one third of all joint public procurement will be done centrally by Summer 2019, resulting in substantial savings. In addition, amendments to the Pharmaceutical Act, that will enable the authorities to define the highest possible price and make it public, is estimated to save around HRK 300 million per year. Lastly, contribution to health insurance increased by 1.5 percentage points, which will help the system to stop accumulating new arrears.

The authorities believe that the pension reform, introduced on January 1, 2019, strikes the right balance between creating a long-term sustainable system and addressing the issue of aging. It addresses demographic challenges by increasing the legal age for retirement and penalizing early retirement, while enabling retirees to stay active in the labor market, thus contributing to a higher labor participation rate, which is in line with previous staff's recommendations.

On the state-owned enterprises, the authorities share staff's view that improving their efficiency would contribute to public financial and public investment management, as well as to increase overall productivity. In this regard, the authorities have introduced at the beginning of 2018 the Corporate Governance Code fully in line with OECD standards, which established internal auditing in all public companies and enabled the authorities to have a detailed insight in their liabilities and plans. Parallel to this, the authorities have pushed forward the process of divesting non-strategic state assets, particularly real estates and shares in touristic companies, which is line with staff's recommendations. Challenges remain with the companies in which Croatia's share is lower than 20 percent.

The authorities share staff's view that EU funds can play a significant role in boosting investment and productivity levels in the medium term. At the same time, they recognized that the current level of utilization is lower than the EU average, mostly due to capacity constraints. This was partly addressed by employing close to 1,000 people directly working on EU projects, as well as outsourcing part of the work to the private sector. At the moment, 58 percent of the total allocation from the 2014-2020 financial perspective has been decided (EUR 7.3 billion), and the authorities remain committed and confident that considering the N+3 rule, the entire allocation will be utilized.

Lastly, on the social benefits, the authorities share staff's view that a one-stop shop would provide better targeting but prefer a gradual approach to this reform. So far, the authorities have collected data from local entities, and the work of consultants on the IT solution that would be efficient and enable data exchange between various levels of the administration should conclude during the first quarter of 2019. After receiving the analysis and recommendations, the authorities will pursue further steps.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Croatian economy continues to grow strongly, with a projected fourth year of positive growth in 2018 following a six-year recession. Fiscal and external buffers have improved, and the authorities have made commendable progress in bringing down both public and external debt levels. Reaching the first fiscal surplus i=n 2017 since independence was a significant milestone in the fiscal consolidation effort. However, further fiscal and structural reform efforts will be needed to make the economy more dynamic and resilient, particularly in the context of ERM II entry which is targeted for 2020.

The authorities are rightly taking advantage of the strong macroeconomic environment to engage in fiscal consolidation and bring down high public debt levels. With growth projected to moderate over the next several years, we would urge some caution against staff's recommendation for a faster fiscal adjustment beyond the current baseline, which already projects fiscal surpluses and falling debt levels. However, we agree with staff that the authorities could greatly improve expenditure composition by shifting toward much-needed public investment and away from current spending, particularly on wages and poorly-targeted social programs. This shift could help improve the medium-term growth outlook and therefore provide additional time for the authorities to continue their fiscal adjustment in a growth-friendly way. Additionally, could staff elaborate on whether the authorities were receptive to TA on public investment management, as briefly mentioned on page 13? We also strongly encourage passage of the Budget Act, which is important for recognizing contingent liabilities within the budget context and spending limits.

In addition to improving the spending composition, Croatia needs to improve on structural issues related to the labor market and business environment to catch up with regional peers. We welcome Messrs. Doornbosch and Josic's buff statement laying out a structural reform agenda to boost competitiveness. Improvement on these issues is necessary to support flexibility and dynamism in the economy given the authorities' commitment to adopting the euro in the coming years. While staff briefly reference the coming shift in the exchange rate regime and the need to improve flexibility in the context of the policy discussions, we would have welcomed additional analysis on Croatia's progress on these structural issues as they relate to the ERM II timeline. Given the consequential nature of this exchange rate regime decision, whether a lack of progress on these reforms in the next few years would warrant the authorities' shifting their timeline later to ensure that the economy is sufficiently dynamic and resilient would seem to warrant more attention.

Mr. Meyer submitted the following statement:

We thank staff for their informative report and selected issues papers in the context of the Croatia's Article IV consultation. We also thank Mr. Doornbosch and Mr. Josic for their informative buff statement.

The economic expansion in Croatia has continued, which helped the authorities to unwind further and significantly the existing structural imbalances. Importantly, fiscal balances have improved considerably, public debt is on a downward path, and non-performing loans (NPLs) have also been reduced. At the same time high levels of public, private and external debt in a context of low potential growth remain key sources of vulnerabilities for Croatia. In this regard, emigration, population aging, and insufficient investment levels are particularly pressing issues. We welcome the authorities recent reform efforts, including the first budget surpluses since independence, and encourage them to continue implementing structural reforms with particular attention paid to reducing labor market segmentation and increasing the public sector's efficiency. The continuation of such structural reforms will be particularly important given ERM II and euro adoption goals. Going forward, close attention should be paid to the causes of low labor force participation and high emigration, and to institutional quality including SOE governance.

Macroeconomic Developments

Croatia's overall macroeconomic developments have been favorable and, while the outlook remains strong, it is subject to downside risks. Although growth has peaked in 2017, it remained well above its potential rate in 2018, driven by strong private consumption, tourism and exports. While the pace of the economy may have been slower than in many peer EU countries, it is important to note that it was accompanied by a significant reduction of fiscal imbalances and of external debt. Investment growth has been sluggish, especially in view of the significant catching-up needs of the country. The unemployment rate also declined quickly, dropping to single digits by end 2018, with some evidence for emerging labor shortages that are set to support further wage growth, whereas inflation remains relatively low. Overall the outlook remains benign, underpinned by the strong dynamics of domestic consumption; although both external and domestic risks point to the downside.

Fiscal Policies

We commend the authorities for their significant consolidation efforts that have put public debt on a steady declining path. According to staff's estimate, the improvement in the structural balance was close to 4 percentage points of GDP in the last four years. This puts public finances in an improved position and affords increasingly focusing on the quality of fiscal measures. However, we note that public debt still stood at around 75 percent of GDP in 2018 and will require further progress to reach the 60 percent SGP threshold. Against this background, we support staff's recommendation to further constrain current spending as a share of GDP but would place more emphasis on better targeting social spending, to tackle poverty, and reducing the overall public wage bill through efficiency gains. With regards to the latter we are doubtful whether, given shortages of skilled labor, encouraging transition from public to private sector employment is consistent with improving the administrative capacity of the public sector. Moreover, Croatia has improved its fiscal framework, aligning it with the EU fiscal rules, which is an important and welcome step to ensure long-term sustainability. However, there is room for further improvement, especially in health-care spending which is the main source of sustainability concerns. Finally, the budget composition should further support growth. In particular, public investment should be raised, especially via a better absorption of EU funds.

Financial Market Policies

We welcome the efforts of the Croatian National Bank to encourage banks to swiftly reduce their legacy NPL stock, taking advantage of the favorable market environment. In the last decade, Croatian banks have faced considerable headwinds: the financial crisis, the prolonged recession of the Croatian economy (from 2009 to 2014), and the 2017 crisis of Agrokor, the largest private company in Croatia. While we agree with staff that the banking sector is well-capitalised, liquid and increasingly profitable, we also note the remaining vulnerabilities in the Croatian economy, particularly high corporate indebtedness. Although, as staff also reports, there has been important progress in reducing the stock of impaired assets, we would also note the observed slowdown in the sale of non-performing loans throughout 2018, mainly due to higher share of less-impaired assets remaining on banks' balance sheets. . Therefore, removing remaining structural impediments to NPL resolution (for example by speeding up insolvency procedures), further strengthening NPL supervision and appropriately incentivizing further NPL reduction by Croatian banks, remains paramount. We fully agree with staff that maintaining prudent banking supervision and macroprudential policies is of utmost importance in preparation for membership in the Banking Union and would hence encourage the authorities to establish a legal basis for borrower-based measures, similarly to efforts in other EU member states.

Structural Policies

Further structural reforms are needed in the run up to euro adoption to ensure a flexible and competitive economy. Although the Croatian authorities have been successful in managing a tight exchange rate regime in past decades, increasing the growth potential and strengthening the structural resilience of the economy appears warranted to continue delivering income convergence. We see labor market weaknesses and the need to strengthen institutional capacity to attract more investments as the main challenges policymakers face. This is why we would have liked to find more analysis in the report about the drivers of labor market segmentation, emigration, low participation and high structural unemployment that is also geographically dispersed. We also wonder if the tourism sector carries too much of the burden in generating growth and how complete the transformation of previous era sectors (such as shipyards) is. Staff note that potential GDP can be considered low in a regional comparison which makes us wonder about the impediments to investment and the ways to improve public services. Overall, we believe that to ensure real convergence and a smooth participation in ERM II – and eventually in the euro area, it is crucial that the country undertakes additional reforms that increase its growth potential and strengthen its structural resilience, including fiscal soundness and institutional quality, in a lasting manner. Hence, we strongly encourage the Croatian authorities to use the current favorable macroeconomic environment to fully implement the remaining reforms.

Mr. Di Tata and Mr. Rojas Ulo submitted the following statement:

We would like to thank staff for the informative report and Mr. Doornbosch and Mr. Josic for their insightful buff statement.

Croatia's economic expansion has continued, supported by strong private consumption and tourism, but progress on structural reforms remains slow. Real GDP growth has started to moderate in 2018. At the same time, unemployment has declined while wage growth has increased after several years, suggesting that the output gap may be closing. The process of fiscal consolidation has continued, albeit at a slower pace, with strong revenues and expenditure control. Although still elevated, public debt is on a downward path and the country has come closer to achieving investment grade status. Under the assumption of continued slow implementation of structural reforms, staff expects economic growth to stabilize at around 2 percent a year over the medium term. Downside risks to the outlook have risen because of possible changes in regional or global conditions and/or materialization of further contingent liabilities. Against this backdrop, fostering growth and reducing vulnerabilities require further efforts to build fiscal space, increase public and private investment, and revive the momentum for structural reforms.

We concur with staff on the need to moderately strengthen the envisaged medium-term fiscal effort. As noted in the report, steadily raising the fiscal surplus to 1 percent of GDP by 2023 (compared with 0.4 percent in the baseline scenario) would help build fiscal space and achieve a faster reduction of the public debt to bring it below the Stability and Growth Pact threshold of 60 percent of GDP by 2023. The proposed fiscal strategy would also allow for a higher level of public investment by strengthening revenue and reducing current spending. To achieve these results, staff recommended, among other measures, establishing a well-designed real estate tax. The authorities are of the view, however, that further substantial work is required to establish an adequate valuation and administration system before a real estate tax could be introduced. Could staff elaborate on this issue as well as on whether the Fund or other agencies could provide technical assistance in this area? Could it also comment on other possible options to strengthen revenues and on the measures being implemented by the authorities to contain the growth of the wage bill?

We welcome the efforts made by the authorities in other areas with important fiscal and structural implications. Specifically, we take positive note of the pension reform introduced early this year, which seeks to strike a balance between establishing a long-term sustainable system and addressing the issue of ageing; the efforts under way to improve the efficiency of the state-owned enterprises and divest non-strategic state assets; and the plans to establish a one-stop shop for social benefits. We also welcome the new Fiscal Responsibility Law introduced in December 2018, as well as the ongoing steps to increase the utilization of EU funds to boost investment and productivity levels. We note, however, that there is still room to improve the pension system by eliminating group-specific pension provisions and strengthening the second pillar of the system. Could staff comment on the prospects for receiving technical assistance on public investment management and for better targeting social programs in consultation with the World Bank?

As noted by staff, the exchange rate anchor has served Croatia well, helping to ensure financial and price stability. So far, the accommodative policy stance has supported the economic recovery while seeking to keep a stable exchange rate. The external position remains broadly in line with fundamentals and international reserves are at a comfortable level. Looking ahead, we note that the authorities stand ready to react to tightened external conditions, if necessary. Preparations for ERM II and Banking Union membership will play an important role in the authorities' agenda.

The staff report indicates that the banking sector, on average, remains well-capitalized and liquid, and that profitability has improved since 2017. In addition, there has been remarkable progress in reducing the ratio of NPLs to total loans, although the latter is still high at 10.3 percent. Going forward, we encourage the authorities to continue to closely monitor vulnerabilities in some areas, including the growth of cash loans and developments in the real estate market, which may require the adoption of additional macroprudential measures. It is also important to address the issues behind the relatively high financial intermediation costs of Croatian banks and enhance the efficiency of bankruptcy procedures to facilitate further private sector deleveraging.

On the structural front, significant efforts are necessary to enhance institutional quality and improve the business environment to foster private activity. In this regard, we encourage the authorities to streamline regulations and accelerate the implementation of the 2016-18 National Reform Program, which seeks to reduce fragmentation and enhance efficiency in the provision of services by simplifying the very high number of subnational governments and public agencies. Efforts should also continue to simplify judicial processes, including by revising insolvency procedures, modernizing the cadaster and land registry, speeding up digitalization and, more generally, improving the organization and management of judicial bodies. It is also important to better balance flexibility and job security in the labor market; enhance training, in part with continued support from EU funds; and facilitate civil servants' exchanges with the private sector. Better child-care facilities are likely to encourage increased female participation in the labor force. We welcome the Action Plan for Administrative Relief of the Economy, which is reducing costs for businesses and simplifying their operations with the public administration.

With these comments, we wish the Croatian authorities every success in their future endeavors.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for their clear reports and broadly support their assessment and policy recommendations. We also thank Mr. Doornbosch and Mr. Josic for their helpful buff statement and welcome the Croatian authorities’ commitment to a comprehensive reform program to address structural weaknesses and prepare the economy for the envisaged adoption of the euro. We associate ourselves with Mr. Meyer’s statement and provide the following comments for emphasis.

Croatia has enjoyed favorable economic conditions, underpinned by strong private consumption and exports, rising employment and stable inflation. However, risks to the outlook are tilted to the downside, with the slowdown of major trading partners and a further tightening of financial conditions weighing on the ability to support economic growth and continue with fiscal consolidation, in a context of still high domestic and external debt. We concur with staff that reducing debt, boosting public and private investments, and strengthening financial stability will be key to sustaining economic growth and income convergence to the euro area average.

To cement the commendable progress in fiscal consolidation, driven by strong economic performance, the authorities should focus on broadening the revenue base and improving the quality of spending. On the revenue side, staff recommend the adoption of a property tax, while acknowledging it would require extensive preparatory work, as also confirmed by the buff. We agree with the authorities that an adequate valuation and administration system should first be established to ensure fairness. What alternative revenue options, with similar budgetary impact, but lesser technical and political challenges, have been discussed with the authorities? On the spending side, we share staff’s assessment on the need for better targeting social benefits in consultation with the World Bank and improving the absorption capacity of EU funds, and we would support Fund’s TA on public investment management. We also join staff in calling for further progress in addressing contingent liabilities from the health sector and state-owned enterprises.

The authorities have taken some important steps to improve the business climate, such as the reduction of para-fiscal fees. However, more could be done for streamlining regulations, increasing the efficiency of the public administration and the judiciary, and providing high-quality education and training. Regarding the public sector, staff identify the high level of fragmentation in comparison with regional peers and other highly decentralized EU countries as a potential cause for inefficiency; however, we stress the importance of a well-designed consolidation of the public sector to exploit synergies across administrations and achieve the expected efficiency gains.

Staff assess the banking sector overall as sound. Nonetheless, the level of non-performing loans (NPL) remains high, especially with respect to the non-financial corporate sector, and requires close vigilance as well as measures to improve corporate governance and bankruptcy procedures. To strengthen financial stability and prepare for joining the banking union, we also encourage the authorities to focus on macroprudential measures to prevent excessive household borrowing.

Mr. Mozhin and Mr. Potapov submitted the following statement:

We thank staff for a set of well written reports and Mr. Doornbosch and Mr. Josic for their helpful buff statement. We note that the authorities broadly agree with staff on the evaluation of current developments and long-term challenges, as well as policy recommendations. We would limit our comments to the following points.

Croatia’s economy continues to expand, with the expected growth rate at around 2.7 percent in 2018-19. The baseline scenario shows a gradual slowdown of real GDP growth to about 2 percent in 2023. Such a projection is based on the assumptions of slow implementation of structural reforms, low productivity growth, population aging, and continuing emigration. Although investment growth has been subdued recently, it is expected to accelerate, supported by higher EU funds absorption. Could staff elaborate on the most efficient ways, including economic sectors, to invest these funds to boost productivity in the economy? Could staff also provide comparisons of GDP per capita growth as well as GDP per working person growth between Croatia and its peer countries?

The growth outlook is subject to both domestic and external risks. We would appreciate staff’s additional elaboration on how the slowdown in the large economies in the European Union could impact the external position and growth prospects in Croatia.

Fiscal consolidation is proceeding well, reflecting over-performance on the revenue side and lower public investment. The fiscal balance turned from a deficit of 5.3 percent of GDP in 2014 to a surplus of 0.9 percent of GDP in 2017. Staff also expect a fiscal surplus of 0.4 percent of GDP in 2018. The authorities' plans to streamline some taxes in 2019 could help partly offset the consequences of declining population and high net emigration. Staff argue that there is additional room for broadening revenue base, improving targeting of social benefits, and strengthening public investment management. At the same time, long-term challenges to fiscal sustainability require addressing spending obligations stemming from the health and pension systems. We agree with the authorities that the introduction of the real estate tax requires putting in place adequate safeguards and improving data collection to mitigate implementation risks. Could staff elaborate on any best practices in this area in Croatia's peer countries?

The recent fiscal performance has enabled a relatively fast reduction of public debt. According to staff's DSA, public debt is expected to decline from 85 percent of GDP in 2015 to 74 percent of GDP in 2018. It will continue to gradually decline over the medium term, reaching around 61 percent of GDP in 2024. It is rightly emphasized that this projection is vulnerable to various types of shocks, including lower growth prospects and the materialization of contingent liabilities. Against this background, the recent activation of state guarantees for the shipyard Uljanik and the health sector arrears are worrisome developments. Could staff provide greater details on fiscal risks in Croatia and their potential implications for public debt?

The authorities are planning to enter the ERM II in 2020. The plans to adopt the euro raise the importance of accelerating reforms to benefit from joining the currency union while enhancing the economy's ability to respond to adverse shocks. In this context, we expect a deeper analysis of possible implications from the euro adoption in future Article IV reports. We agree with Mr. Doornbosch and Mr. Josic that an already high level of economic and financial integration into the euro area together with high credit and deposit euroization present upside risks to this process. At the same time, do staff believe that the overall conditions for the euro adoption are in place and the economy's fundamentals provide sufficient safeguards for mitigating potential risks and costs from Croatia's transition to the euro?

We welcome the authorities' plans to accelerate structural reforms aimed at improving the business environment and the quality of public administration. The heavy administrative burden and Croatia's relatively low ranking in the 2019 Doing Business Database point to the scope for more ambitious structural reforms. Their proper implementation will be critical for boosting growth, reducing unemployment, and ensuring convergence to EU income levels. We welcome the authorities' efforts to address labor market shortages, tackle governance issues in the SOEs, and improve social spending.

Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-focused set of reports and Mr. Doornbosch and Mr. Josic for their helpful buff statement. We are in broad agreement with staff's conclusions and policy recommendations and would limit our remarks to a few issues.

We welcome the continued robust economic growth, benign inflation, rising employment, and improving fiscal and external buffers, but challenges remain. These include high unemployment despite a notable decline, still-high public debt-to-GDP ratio, and relatively low public and private investment. In this context, the authorities should take advantage of the current favorable economic conditions to accelerate structural reforms to enhance growth potential while reducing vulnerabilities.

It is encouraging that fiscal consolidation has continued, but the DSA underlines that debt projections remain vulnerable, including to the materialization of contingent liabilities such as state guarantees. Indeed, even in 2018, we note that the activation of state guarantees issued for Uljanik shipyard erased some of the overall fiscal surplus and additional payments are expected in 2019. In this regard, while footnote 8 provides some information, we would welcome staff elaboration on the circumstances leading to the materialization of contingent liabilities and the steps taken by the authorities to address the financial difficulties of this shipyard. Looking ahead, we encourage the authorities to build on the recent success with fiscal consolidation to achieve a moderately faster public debt reduction as well as reorient expenditures towards public investment. On fiscal governance, we commend the authorities for the adoption of a new Fiscal Responsibility Law in line with staff's recommendations.

Monetary policy has appropriately remained accommodative within the limits of the exchange rate anchor, which has served Croatia well in delivering financial and price stability. While the banking sector remains on average well capitalized and liquid and progress has been made in reducing NPLs, vigilance is needed due to the still-high NPL ratio. We welcome the Central Bank's strong supervisory and macroprudential policies to help safeguard financial stability and the willingness to consider additional macroprudential measures, if needed. On the process of euro adoption, we take note in the buff statement that the authorities have already initiated discussions with relevant European counterparts and are ready to enter the ERM-II during 2020. In this regard, we look forward to comprehensive coverage in the next staff report.

Finally, we welcome the emphasis on the structural agenda in the staff report and encourage the authorities to make further progress. In this context, priorities include enhancing business environment and labor force participation, improving efficiency of SOEs, and reforming the judicial system.

With these remarks, we wish the authorities further success.

Mr. Ostros and Ms. Skrivere submitted the following statement:

We thank staff for the report and Mr. Doornbosch and Mr. Josic for their informative BUFF statement. We broadly share staff's appraisal and agree that the current favorable macroeconomic environment should be used to improve Croatia's fiscal position and renew reform efforts to further strengthen the economy's resilience. We associate ourselves with the statement by Mr. Meyer, and we offer the following additional remarks on fiscal policy and structural adjustment.

We commend the authorities for their significant consolidation efforts; however, as debt levels remain high, we agree with staff that the pace of debt reduction could be accelerated. The Croatian authorities have achieved notable progress in improving their fiscal position in recent years. Nevertheless, as public debt remains high at around 75 percent of GDP and there are potential contingent liabilities stemming from the health and pension systems, we share staff's recommendation of a moderately faster fiscal adjustment. We also note the importance of the quality of the adjustment and encourage the authorities to improve the targeting of social spending and contain the public wage bill growth. This could provide room for increasing efficient public investment that could contribute to Croatia's medium-term growth prospects. We also encourage the authorities to strengthen their administrative capacity and improve the absorption of EU funds.

Given the structural bottlenecks and domestic and external vulnerabilities, we encourage the authorities to advance their structural reform implementation efforts. While notable progress has been made, we share staff's views on the need to further improve the business environment, address the low labor market participation rate, tackle the remaining issues in the judicial system, and consider reducing the very high number of subnational governments to simplify public administration and make it less fragmented. These reforms are important not only because of the prospects of joining the euro area, but more importantly to strengthen productivity, economic growth, and living standards in the country. The current economic expansion provides a useful window of opportunity to achieve meaningful progress with the authorities' reform agenda.

Mr. Tan and Mr. Pham submitted the following statement:

We thank staff for the insightful set of reports and Messrs. Doornbosch and Josic for their informative buff statement. Macroeconomic developments in Croatia have been positive, with continuing growth and strong fiscal performance. Coupled with the Croatian National Bank (CNB)'s accommodative policy and favorable global conditions, the authorities' sound budget management have helped to reduce public indebtedness and strengthen external buffers. Notwithstanding these commendable efforts, vulnerabilities stemming from the relatively low public and private investment, emigration and population aging, as well as structural impediments to investment and growth threaten to weigh on medium-term growth prospects. Against this background, we underscore staff's call to implement policy measures and expedite structural reforms that will put the Croatian economy firmly on a more diversified, open and competitive growth model. We agree with the broad thrust of the staff appraisal and offer the following comments for emphasis.

We support staff's emphasis on growth-friendly fiscal consolidation to further reduce public debt and enhance growth prospects. As stated in the buff, Croatia's recent budget performance has been commendable with a budget surplus in 2018. This reflects the authorities' concerted efforts to contain expenditure, particularly current spending, and mobilize domestic revenue. We also welcome the authorities' adoption of a new Fiscal Responsibility Law, which clearly defines fiscal rules in line with the Stability and Growth Pact. That said, we share staff's view to strengthen the budget position in light of a still high public debt, with particular focus on a more growth-friendly composition of public expenditure, and a gradual shift to more stable revenue collection from a broader tax base. While we appreciate the basis for broadening and stabilizing the tax base by introducing a real estate tax, staff's comments are welcome on the authorities' view that it should be done gradually and properly in the absence of an effective valuation and administration system.

An accommodative monetary policy stance remains broadly appropriate as long as risks to inflation and financial stability remain low. We agree with the authorities that the CNB should maintain an accommodative monetary stance to continue supporting the economic recovery and stand ready to respond to potentially tighter external conditions. We note that the Croatian banking system is very liquid, well capitalized and profitable. At the same time, the still high corporate indebtedness and non-performing loans ratio, albeit decreasing, remain a material concern. In this regard, we agree with staff and would encourage the authorities to continue to exercise strong regulation and close supervision to maintain financial sector stability, particularly in preparation for ERM II and Banking Union membership.

Structural reforms should be accelerated to increase the dynamism and resilience of the economy. As rightly pointed out by staff, the current positive economic conditions provide an opportunity for Croatia to make progress on policies that will help fundamentally transform its economy. To this end, we support renewed efforts toward putting in place key aspects of the National Reform Program, which covers a wide range of structural reforms and fully in line with the EU2020 strategy as stated in the buff statement. Considering still low labor force participation rate and relatively high unemployment, we support the authorities' view of benefits of active labor market policies to secure better employment prospects for young and women, as well as enhance labor market flexibility. Given structural challenges to growth, most notably demographic as highlighted in the report, we echo staff's view that reforms to improve the business and institutional environment, enable higher private investment and create more jobs are imperative for raising and fulfilling the country's growth potential.

Mr. Just and Mr. Mehmedi submitted the following statement:

We thank staff for the comprehensive reports, including the assessment of financial imbalances through the balance sheet approach, and Messrs. Doornbosch and Josic for the in-depth and informative buff statement. While Croatia's growth remains robust and near-term macroeconomic prospects remain favorable, growth has started to gradually moderate and structural rigidities are becoming more pronounced. Concurrently, vulnerabilities stemming from the elevated public debt, high unemployment rate, aging, emigration, and structural impediments to investment and growth weigh on the medium-term growth prospects. Against this backdrop, we encourage the authorities to continue with the growth-friendly fiscal consolidation and reduce fiscal risks, while accelerating the implementation of structural reforms and addressing challenges relating to the institutional framework, including regulatory quality. This is critical to achieve a smooth participation in the ERM II, as well as ensure higher growth and faster income and institutional convergence with the European Union. We broadly agree with the thrust of the staff appraisal and associate ourselves with the statement by Mr. Meyer.

A gradual, growth-friendly fiscal consolidation is essential to achieve the authorities' debt reduction target and build fiscal buffers. We commend the authorities for achieving a significant fiscal consolidation over the last few years, although we note that part of last year's fiscal surplus was due to the under-execution of capital investment. In view of Croatia's high public debt level and gross financing needs, as well the authorities' intention to enter the ERM II in 2020, continuing with a growth-friendly fiscal consolidation is essential to reach the Stability and Growth Pact threshold of 60 percent of GDP over the medium term. In this vein, we see significant scope for improving the structure of the budget through containing current expenditure, including by better targeting social spending and transfers, as well as rationalizing the elevated public sector wage bill through implementing the public administration reform. At the same time, we encourage the authorities to enhance the efficiency of public investment spending and improve the capacity to absorb EU funds, which would ultimately help narrow the investment gaps in Croatia. Staff's comments on whether the authorities are considering requesting a Public Investment Management Assessment are welcome. We take note of the 2019 tax reform and staff's suggestions on broadening the revenue base, including by introducing a real estate tax. Staff's further elaboration on their suggestion to introduce a wealth tax is welcome.

We welcome the recently enhanced fiscal policy framework, but note that more progress is needed in reducing contingent liabilities. We commend the authorities on the adoption of a new Fiscal Responsibility Law and the introduction of three new fiscal rules governing structural balance, budget expenditure, and public debt. In this context, we underscore the importance of implementing public financial management reforms pertaining to the prevention and accumulation of arrears, with a focus on the health sector, and reducing contingent liabilities stemming from state-owned enterprises (SOEs) through employing a comprehensive SOE reform. The introduction of the Corporate Governance Code, as noted in Messrs. Doornbosch and Josic's buff statement, is a step in the right direction, but further progress is needed in divesting non-strategic state assets.

The monetary policy stance remains broadly appropriate. We concur that the Croatian National Bank (CNB) should maintain an accommodative monetary stance, while preserving the exchange rate and financial stability in the context of a high level of euroization. Given that the CNB is expected to initiate the preliminary procedures and discussions for ERM II entry this year, we regret that the Staff Report does not include a more in-depth analysis on the Euro adoption considerations, which should have built on the discussion from the 2017 Article IV Consultation while drawing on Fund's rich cross-country knowledge, in particular from Slovenia, the Slovak Republic, as well as the Baltic republics. We underscore that ensuring a smooth ERM II membership and eventual euro adoption process will entail the implementation of a multi-pronged strategy focused on creating fiscal space, further reducing the high public debt, and advancing structural reforms to accelerate convergence and facilitate internal adjustment in case of external shocks. Considering that Croatia's business cycle synchronization with the euro area is much lower than within the euro area, we would welcome staff's comments on the timing, as well as the pros and cons of the euro adoption decision.

Financial sector policies should be geared towards further enhancing supervision, and reducing risks pertaining to non-performing loans (NPLs) and the large balance sheet exposure to interest rate and currency risks. We commend staff for the highly valuable balance sheet approach which examines the balance sheets and cross-sectoral exposures of the public, banking, and private sectors, while drawing lessons from the Agrokor crisis. While the banking sector remains liquid and well-capitalized, the high NPL ratio and cross-sectoral balance sheet exposure drag private credit growth. In this context, policy efforts should aim at reducing vulnerabilities stemming from unhedged borrowers, banks and corporate balance sheet FX mismatches, and households' interest rate exposures. This, in turn, will require further strengthening the regulatory and supervisory frameworks, and considering additional macroprudential tools, which would bode well with the authorities' preparation for the membership in the banking union. Staff's comments on the scope for utilizing Fintech to reduce the high cost of financial intermediation in Croatia are welcome.

The expeditious implementation of the structural reform agenda is vital to increase potential growth, address headwinds stemming from aging and emigration. In this context, the focus should be on enhancing the business environment and boosting productivity by reducing parafiscal charges, strengthening the rule of law, and protecting property rights. Tackling the high structural unemployment rate and tapering off emigration will require increasing the flexibility of the labor market, improving education outcomes, reducing the skills mismatch, and expanding vocational training to create sustainable job opportunities at home. At the same time, raising the low labor force participation rate, including through increasing the provision of child care facilities, remains essential.

Ms. Levonian, Ms. McKiernan and Mr. Williams submitted the following statement:

We thank staff for their comprehensive set of papers and Messrs. Doornbosch and Josic for their insightful buff statement. The Croatian economy continues to show strong resolve with steady growth and benign inflation supported by solid fiscal performance. This has enabled the authorities to reduce indebtedness and strengthen external viability. We encourage the authorities to seize the opportunity presented by the favorable economic climate to advance the reform agenda and stimulate faster and more inclusive growth. We broadly agree with staff’s assessments and recommendations and offer the following remarks for emphasis.

We commend the authorities’ impressive fiscal turnaround while urging continued prudence. Robust revenue growth and prudent expenditure control over the last 4 years have reversed a general government deficit of over 5 percent of GDP to a surplus. It is imperative that Croatia sustain this strong performance to durably reduce debt, solidify its external position, and reinforce fiscal resilience. That said, the quality of fiscal adjustment remains key. In this regard, we see scope for reorienting the budget in a growth-enhancing manner, away from recurrent - including the relatively high wage bill - toward public investment and well-targeted social spending. Additionally, the introduction of a new fiscal responsibility law is a welcome enhancement to the fiscal architecture. The broad parameters of the law appear reasonably robust to buoy policy credibility, improve fiscal risk management, and lock in macro-fiscal gains.

The financial system continues to improve but vulnerabilities need to be closely monitored. We welcome news of a return to profitability in the banking sector following the Agrokor crisis, and we acknowledge the substantial efforts made to reduce NPLs. However, we urge the authorities to remain vigilant in enforcing prudential requirements, including through continued efforts to further reduce NPLs and high corporate indebtedness. At the same time, they should carefully monitor rising household debt and stand ready to introduce additional macroprudential measures, if warranted, to contain financial stability risks.

Accelerating structural reforms will help invigorate private sector involvement in the economy and uplift potential growth. The authorities have taken noteworthy steps to untangle structural rigidities. We note that they remain committed to further bold reforms but face political constraints. In this regard, we encourage them to develop a time-bound strategically-sequenced reform plan with immediate focus on impactful and achievable measures. These should include further reducing parafiscal fees, better leveraging IT, and accelerating activities to improve implementation capacity within the public sector, including for capital expenditure; all actions that could generate quick wins. Can staff comment on whether technical assistance on public investment management is in the pipeline? Deeper reforms to rationalize the SOE sector, simplify legislative and judicial processes, and to boost labor force participation over the medium term will help enlarge the private sector's footprint in the economy, bolster economic resilience, and enable Croatia to benefit from a smooth integration into the eurozone.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the excellent reports and Mr. Doornbosch and Mr. Josic for their informative buff statement.

Growth in Croatia has remained solid with tourism, trade partner linkages and consumption being strong drivers. Wages are growing, poverty is declining, employment is rising, inflation remains benign and public debt is decreasing. However, downside risks externally from global economic and financial conditions and domestically, from low labor utilization and investments and the slow pace of structural reforms could undermine Croatia's growth opportunities. Against this backdrop, we positively note that the authorities are strongly committed to addressing key bottlenecks and increasing the level of public and private investment. Overall, we broadly agree with the thrust of the staff report and would like to make the following points for emphasis.

Fiscal Policy and Debt Management

We commend the strong fiscal performance and buoyant revenues and align ourselves with staff views on broadening the revenue base and quality of spending. Continued fiscal consolidation and debt reduction will be paramount for higher growth and to leverage the commendable advancements in reducing debt and achieving a budget surplus. Staff has mentioned that social benefits could be reduced by one percent of GDP and suggested related reforms for health and pension. We feel it is fundamental to examine the consequences of these measures on the vulnerable groups before a relatively parsimonious path for social benefits is adopted. Beyond the fiscal cost of Croatia’s social benefits being one percent of GDP higher than peers, we would like to hear more of the staffs’ views on how this reduction would play out, including on the sequencing and targeting of benefits. Staff comments are welcome.

Monetary Policy and Financial Stability

The CNB’s continued pursuit of an expansionary monetary policy has maintained high levels of liquidity, built international reserves and kept the exchange rate stable. Notably, bank credit has been recovering in 2017 and NPLs have been declining despite the Agrokor impact. It is reassuring that the monetary authorities stand ready to react to the emerging external conditions and remain vigilant with prudent supervision and use of macroprudential measures. In preparation of the ERM II and Banking Union membership agenda, it would be important to increase the resilience of the economy to reap the full benefits of joining the currency union.

Structural Reforms and Competitiveness

By stepping up its reform agenda, Croatia could experience prolonged economic growth and improved social conditions. We welcome the efforts of the authorities mentioned by Mr. Doornbosch and Mr. Josic on several aspects, including the wage bill growth, the action plan for administrative relief, health sector interface and pension reforms. On improving the business environment and boosting private sector productivity and competitiveness, we look forward to continued progress, including on administrative measures, further reforming of the justice and regulatory framework, raising the quality of human and physical capital, and modernizing of public services. SOEs play an important role in the Croatian economy and we note that the authorities are engaged with the World bank on the operational restructuring of the highway companies. Some details are mentioned in Annex I and we would be interested in knowing if additional restructuring exercises and privatizations are in the pipeline for SOEs?

Mr. Sun and Mr. Huang submitted the following statement:

We thank staff for the set of papers and Mr. Doornbosch and Mr. Josic for their helpful buff statement. The Croatian economy is projected to expand for the fourth consecutive year on the back of the authorities' skillful macroeconomic management. As the cyclical recovery matures and expansion moderates, further reform is essential to address the structural bottlenecks and uplift the mid-term growth prospect. Continued fiscal consolidation and sound financial sector policy are also needed to address remaining vulnerabilities and further build buffers. We agree with the thrust of staff's appraisal and would limit our comments to the following.

The recent fiscal consolidation is commendable and is bearing fruit. The public debt-to-GDP ratio has declined steadily since its peak in 2014. We note that 40 percent of Croatian public debt is denominated in foreign currencies, mostly in euro. As Croatia is targeting entry into the European Exchange Rate Mechanism (ERM) II and eventually the euro area, these parts of foreign currency-denominated debt would automatically become domestic currency-denominated debt after the entry. Could staff comment on how the entry into the euro area would impact Croatia's public debt dynamic and how the authorities should adjust its financing and debt management strategy accordingly?

Public investment, on infrastructure in particular, is critical to boost growth potential in the medium term. We note with concern that public investment in Croatia is persistently subdued. As a country at the crossroads of Central and Southeast Europe and with a relative long coastline, Croatia could play an important role in boosting regional connectivity and gains the benefits. We see merit in staff's suggestion for enhancing the capacity to absorb EU funds and welcome the authorities' commitment to better utilize the EU funds. The authorities are also encouraged to consider utilizing additional resources including private sector funds to fill the infrastructure investment gap.

We commend the authorities' efforts for maintaining a stable exchange rate to the euro and for strengthening the banking system. Recent accommodative monetary policy has helped support the real economy, but more could be done to build-up reserves to better absorb external shocks. Staff expressed concerns about the potential risks from the cash loans and real estate market to financial stability. The authorities should stand ready to introduce macroprudential policies when needed. The dominance of foreign-owned banks in the banking system deserves more attention, given that financial sector may be exposed to cross-border contagion risks where risk management capacity is to be further enhanced. Meanwhile, we encourage the authorities to step up efforts to develop domestic financial institutions. Could staff elaborate more on the potential spill-over effects from the Italian Banks given their significant share in the Croatian banking sector?

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its informative report and selected issues paper and Mr. Doornbosch and Mr. Josic for their informative buff statement. We generally share the staff's appraisal, particularly on the diagnostic and on the need to progress on the structural agenda. We associate ourselves with the comments made by Mr. Meyer on his statement and we stress the following comments for emphasis.

Economic growth in Croatia continues to be robust and unemployment has been reduced remarkably. Growth remained solid in 2018 and the poverty rate has continued trending downward as the labor market improved and real net wages and disposable income increased. The economic recovery, coupled with negative migration flows, led to a further decline in unemployment. Real per capita income has returned to the 2008 pre-crisis levels; however, it is still the second lowest in the EU. As a result, the world's three leading rating agencies have revised upward either their ratings or their outlook on Croatia in 2018. We commend authorities for their achievements and encourage them to use the good times to accelerate the pace of structural reforms and to enhance investment, including by taking full advantage of EU funds, to foster Croatia's growth opportunities and medium-term convergence process.

We welcome the Croatian authorities' commitment to enter the single currency union. We welcome that authorities have already initiated discussion with relevant European counterparts to enter the ERM-II during 2020. We believe that Croatia could reap significant and permanent benefits from the adoption of the euro: a more transparent and competitive market, lower travel costs, more cross-border trade and international trade and better access to capital. The benefits of introducing the euro in Croatia could be relatively higher due to a high credit and deposit euroization, the dominance of foreign-owned bank in the domestic system and the high economic integration with the euro area. However, the benefits of the euro are not unconditional and depend on the Member State's capacity to operate smoothly inside the Economic and Monetary Union, based on sound policies. Therefore, it is crucial that Croatia undertakes additional reforms to increase its growth potential and strengthen its structural resilience.

Croatia's banking sector has notably improved, but the pace of reduction of NPLs has abated. We commend the authorities for these improvements while we encourage them to continue addressing the high level of NPLs, particularly when compared to international standards. Could staff comment on the observed slowdown in the sale of NPLs and its potential impact on the NPL reduction outlook? Could staff elaborate if further measures are needed to ensure NPL reduction?

Croatia needs to greatly diversify its economy and reduce its dependency on tourism. To this end, Croatia needs to improve its institutional quality and business environment, as stated in the Staff Report. We believe that Croatia needs to boost private sector productivity and competitiveness, reform its justice and regulatory framework, raise the quality of human and physical capital, and modernize its public services. This would strengthen its growth potential and enhance further reductions in poverty.

Mr. Raghani, Mr. Sylla and Mr. Nguema-Affane submitted the following statement:

We thank staff for a set of interesting papers and Mr. Doornbusch and Mr. Josic for their insightful buff statement.

Croatia's macroeconomic performance remained solid in 2018 supported by vibrant domestic demand, notably robust private consumption and strong net exports. As a result, we note upward pressures on inflation and wages while unemployment is declining. This growth performance, coupled with significant fiscal consolidation, has helped maintain an overall fiscal surplus and bring down public debt as percentage of GDP.

Nevertheless, medium-term growth prospects are constrained by significant impediments while significant downside risks to the outlook remain, which call for policy actions to enhance resilience. Low investment, high administrative for doing business, and adverse demographic dynamics—stemming notably from emigration and population ageing—are important structural factors that hold back more favorable growth prospects. Downside risks include notably a further materialization of contingent liabilities, protectionism, slowdown in main trading partners in the Eurozone, and tightening global financial conditions, Against this backdrop, we share the view that policies going forward should be geared towards tackling the debt overhang, raising public investment through space provided by current expenditure cuts, promote labor force participation among the youth and women, accelerating implementation of structural reforms aimed at addressing structural rigidities and increasing resilience to shocks.

On the fiscal front, additional adjustment is needed to further increase fiscal buffers and bring public debt down to the Stability and Growth Pact (SGP) threshold. We welcome the agreement between the authorities and staff on a more growth-friendly fiscal adjustment path going forward, underpinned by measures to increase domestic revenue mobilization and improve the quality of spending. On fiscal reforms, we note the authorities' diverging approach to containing the wage bill growth and their reluctance to introduce a real estate tax at this moment. Staff comments on the impact of the authorities' position on the recommended adjustment pace will be appreciated. In addition to the necessary trimming of current spending, we stress the need to strengthen SOEs performance to reduce fiscal risks. Likewise, health and pension system reforms as well as efforts to enhance fiscal governance should be stepped up to limit contingent liabilities. On capital expenditures, strengthening the EU funds absorption should be a top priority reform in order to increase the low public investment execution rate.

We encourage the authorities to pursue the current monetary policy stance and exchange rate management which are in line with the objective of joining the ERM II by 2020. The accommodative monetary policy remains appropriate given the benign inflation outlook in a context of ample liquidity. Reserve accumulation should continue as long as conditions allow it.

Regarding the financial sector, we note that the banking sector remains broadly sound, commend the authorities for their continued efforts in strengthening banking supervision, and encourage them to pay due attention to preserving financial stability through adequate macroprudential measures. The reduced intercompany lending for foreign-owned banks is particularly noteworthy, as it has lessened potential contagion risks from parent companies. Nonetheless, greater vigilance and eventually additional macroprudential measures are needed to preserve financial stability against risks from rising real estate prices and rapidly growing cash loans to households. We encourage the authorities to press ahead with the strengthening of the business insolvency and bankruptcy frameworks, which will be critical to speed up corporate deleveraging. We note from the Selected Issues paper that contagion risks from cross sectoral balance sheet exposures remain high. Staff comments on the priority actions needed to reduce those risks will be appreciated.

We encourage the authorities to implement the necessary reforms to mitigate the risks hanging over the medium-term growth. In this sense, reforms aimed at improving the business environment and addressing labor market shortcomings—including those aimed at promoting training and incentivizing work among women and the youth–should be accelerated. We note the authorities’ plan to carry out an extensive review of administrative measures, which could help improve the business climate. Could staff elaborate on the scope of this review? We find appropriate the focus of the reform program on improving the effectiveness of the public sector, notably the civil service, the judicial framework, and the education, health, pension and social protection systems. We commend the authorities for the actions already taken in these areas, which should be sustained. Finally, we would appreciate staff’s elaboration on its stated need to revive a few aspects of the 2016-2018 National Reform Program (NRP).

Mr. Trabinski and Mr. Danenov submitted the following statement:

We thank staff for a valuable set of papers and Mr. Doornbosch and Mr. Josic for their insightful buff statement. We welcome the continuous growth of the Croatian economy driven by strong private consumption, exports and tourism. While fiscal performance has improved, both public and private debt remain elevated requiring ongoing effort aimed at keeping them on a downward trajectory. We share staff’s view on the medium-term growth perspective. Deterioration of growth outlook for euro area and trade tensions poses major downside risks to the economy.

We commend the authorities’ commitment to reduce public debt. However, we agree with staff’s opinion that additional shifts in the budget composition are needed to spur the potential growth. We concur with the staff’s view that that the fiscal buffers should be expanded by cutting excessive current expenditure and redesigning tax system towards a more growth-friendly and fairer one. In this regard, we welcome the changes in the Civil Servant’s Employment Act and the implementation of the Single Wage Act, as described by Mr. Doornbosch and Mr. Josic in their buff statement. It is specifically important given the size and territorial fragmentation of Croatia’s public administration. While the authorities’ commitment to fiscal consolidation deserves merit, it should not proceed at the expense of the capital spending cuts. In this regard better utilization of EU Funds would help to boost investment and productivity.

We support staff’s recommendations regarding policy measures aimed at increasing labor participation rate. Activity and employment rates of both men and women are one of the lowest in the EU and structural unemployment is high. Moreover, demographic factors and migration patterns will continue to have negative impact on Croatia’s workforce. Therefore, effective active labor market policy (ALMP) measures should be a key priority of authorities.

We concur with the staff's assessment that the overall condition of the Croatian banking sector is balanced, yet we encourage the authorities to address existing pockets of vulnerabilities. We note that cash loans are issued quickly and only at a slightly higher interest rates compared to collateralized loans even if such loans usually carry higher risk than collateralized loans. Could staff elaborate on whether the lending standards are too loose and what potential measures could help to reduce risk steaming from cash loans?

Still high indebtedness of NFCs remains important source of risk to the stability of the Croatian banking sector. High debt service of NFCs could expose the financial sector to liquidity and FX risks if global financial conditions would deteriorate, ultimately putting a renewed upward pressure on NPLs. Therefore, we see scope for considering pre-emptive macroprudential measures to increase banks' resilience to existing risks. Finally, the observed pace of NPL reduction is commendable, yet the NPL ratios remain high. As the efficiency of resolving insolvency and recovery ratios is low, we would like to ask how the authorities envisage further NPL reduction while kick-starting NFC lending?

We note the authorities' commitment to join the ERM II. In this regard, we recall the recent approval of the ERM II action plan by the Bulgarian authorities, which was met by some European authorities with a suggestion to opt-in to the banking union in advance of being admitted to the ERM II. Does staff envisage similar conditions for Croatia?

Mr. de Villeroché, Mr. Castets and Mr. Rozan submitted the following statement:

We would like to thank staff for their comprehensive report and selected issues paper, as well as Mr Doornbosch and Mr Josic for their helpful buff statement. Over the past few years, the country has managed to achieve stronger growth and demonstrated good fiscal performances, which has allowed Croatia to finally close the gap with pre-crisis output and employment levels. Current favorable macroeconomic conditions offer a favorable environment for addressing the structural rigidities the country faces, recreating buffers and allowing for stronger medium-term growth, in order to trigger faster income convergence with the EU average. We associate ourselves with Mr Meyer's statement and wish to offer the following comments.

First, we agree with the emphasis placed on structural reforms in the staff report, since reaping the benefits of stronger EU convergence requires continuing their implementation. We note that significant progress has been made on the implementation of past IMF recommendations (as illustrated by the useful annex). Enhancing the business environment should continue to be a priority, notably by focusing on the efficiency of state owned enterprises. We also encourage the authorities to make further efforts regarding the efficiency of court and out-of-court dispute resolutions. An important issue concerns labor market functioning, given high (albeit declining) unemployment, and the low participation rate; better vocational training, and increased child care access would be particularly useful.

Second, on fiscal management, we welcome the authorities' positive track record. Going forward, continuing to rebuild policy buffers through a growth-friendly and gradual consolidation will help to withstand downside risks should they materialize. We concur with staff assessment that additional measures could be taken on the revenue and expenditure side. In this regard, protecting investment and social spending is particularly important to make sure that the current good economic performances translate into an inclusive. In this regard, we note that public investment remains under-executed and that the absorption rate of EU funds is one of the lowest in the region. As regards, the consequence of aging on public finances, it appears that the EU Commission in the 2018 Aging report are not fully consistent with staff's assessment, the latter being more alarming in this regard. Staff's comments would be appreciated. Finally, we would welcome further explanation regarding the situation that led to the activation of the state's guarantee on Uljanik shipyard, and remediation measures going forward.

Third, we note that monetary and financial sector policies are deemed appropriate overall, with an adequate monetary stance and a liquid and well capitalized banking system. The macroprudential policies appear to have been efficient to limit the risks arising from the important household's indebtedness. We thank staff for the selected issues paper on reducing financial imbalances, which points at ways to support further deleveraging of corporate balance sheets, and welcome the authorities' commitment to amend the bankruptcy legislation.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their Report and Issues Papers and Mr. Doornbosch and Mr. Josic for their buff Statement. We associate ourselves with the statement by Mr. Meyer and would like to further highlight a few issues.

We agree with Staff that the economic expansion in Croatia has continued, although risks for the short- to medium-term outlook are tilted to the downside. Macroeconomic developments have been favourable, with growth driven largely by strong private consumption, tourism and exports, while supported by slightly pro-cyclical fiscal policy. However, investment growth has been sluggish, especially in view of the significant catching-up needs of the country. At the same time, macroeconomic imbalances have been further and significantly unwound recently, largely supported by favourable cyclical developments, but still remain substantial. Croatia's key vulnerabilities remain the high levels of public, private and external indebtedness (largely denominated in foreign currency) in a context of low potential growth. This, in turn, constrains the adjustment capacity of the economy and increases its vulnerability to external risks such as a tightening of global financial conditions and/or changes in investors' sentiment.

The government's ERM II membership and, subsequently, euro adoption goals create a particular need to support the capacity of the economy to cope with shocks and further reduce macroeconomic imbalances. Actions in multiple policy areas should be combined, bearing in mind that monetary policy, albeit currently appropriately accommodative, is limited by the tightly managed exchange rate regime and the high level of euroisation. Therefore, it is essential to accelerate structural reforms and to create fiscal space to maximize the benefits of joining the euro area.

We concur with Staff that fiscal policy should be geared towards growth-friendly fiscal consolidation. Croatia has improved its fiscal framework, aligning it with the EU fiscal rules, which is an important step to ensure long-term sustainability. However, there is room for further improvement. Fiscal consolidation efforts are needed to further reduce the debt level and build fiscal space, taking advantage of the current economic upturn. Moreover, the budget composition should further support growth. In particular, public investment should be raised, especially via a better absorption of EU funds. At the same time, the reduction of administrative fragmentation could contribute to enhance the efficiency of public sector expenditure. Moreover, contingent liabilities from state-owned enterprises (SOEs) and large trade credits, especially in the hospital sector, could further drive up the debt-to-GDP ratio. This calls for further reforms in this sector, including with respect to governance.

The Croatian banking system had to cope with a number of headwinds over the last decade and some legacy vulnerabilities remain that need to be addressed. Croatian banks were affected by the financial crisis, the prolonged recession of the Croatian economy (from 2009 to 2014), and the 2017 crisis of Agrokor. The efforts of the Croatian National Bank, including in the pre-crisis period, have provided support to the banking system during this difficult period and in recent years the Croatian banking system has remained profitable, well-capitalised and liquid. Nevertheless, the still high NPL ratio, in particular in the NFC loan segment, reflects legacy issues from the crises, as well as remaining structural risks, which warrant close scrutiny and monitoring. Therefore, we welcome the efforts of the Croatian National Bank to encourage banks to swiftly reduce their legacy NPL stock, taking advantage of the favourable market environment. Against this background, removing remaining structural impediments to NPL resolution (for example by speeding up insolvency procedures), further strengthening NPL supervision and appropriately incentivizing further NPL reduction by Croatian banks, remains paramount. At the same time, Croatian banks are also structurally exposed to considerable currency and interest rate related credit risks in the private household and NFC loan segments, due to the high degree of euroisation in the respective loan books.

We concur with Staff that a firm commitment and focus on implementing further structural reforms is needed in Croatia, especially in view of the country’s intention to enter ERM II. The perspective of euro adoption has acted as a catalyst for the implementation of a number of structural reforms, but further progress still needs to be made. These reforms closely track the Commission’s Country Specific Recommendations, the implementation of which had been lagging significantly until only a year ago. Yet, to ensure real convergence and a smooth participation in ERM II, it is crucial to ensure that the country undertakes additional reforms that increase its growth potential and strengthen its structural resilience, including fiscal soundness and institutional quality, in a lasting manner. In particular, we agree that addressing deficiencies in the business and institutional environment, together with removing the structural weaknesses in the labour market, are key priorities to lift the low growth potential. Moreover, we consider institutional quality particularly important for ensuring financial stability during the envisaged path towards euro adoption. Hence, we strongly encourage the Croatian authorities to use the current favourable macroeconomic environment to fully implement the remaining needed reforms.

The Acting Chair (Mr. Zhang) made the following statement:

In the gray statements, Directors recognized the authorities’ commendable efforts toward fiscal consolidation, particularly the remarkable achievement of the first fiscal surplus in 2017, which is the first surplus since the country became independent almost 20 years ago. Directors also encouraged the authorities to build on the success and take advantage of the favorable external environment, and macroeconomic environment, to press ahead with further fiscal reforms and to implement wide-ranging structural reforms to boost the private sector. This is important given the preparations required for the European Exchange Rate Mechanism II (ERM II) entry by 2020, and the joining of the EU banking union and the eventual adoption of the euro. All of these are a way down the road.

Mr. Meyer made the following statement:

The economic expansion in Croatia has continued, and overall macroeconomic developments have been favorable. The outlook remains benign, underpinned by the strong dynamics of domestic consumption, although both external and domestic risks point to the downside. We commend the authorities for their significant consolidation efforts that have resulted in the first budget surplus since independence and have put public debt on a steady declining path. While maintaining this declining path toward the 60 percent of GDP threshold is important, the current positive economic and fiscal environment should allow the authorities to focus increasingly on the quality of their measures. In this regard, we support the staff's recommendation to further constrain current spending, but would place more emphasis on better targeting social spending and reducing the overall public wage bill through efficiency gains.

We welcome the important progress that was made in reducing nonperforming loans (NPLs) and welcome the efforts of the authorities to encourage banks to further reduce their NPL stock. However, we also note the observed slowdown in the sale of NPLs throughout 2018, so it remains paramount to remove remaining structural impediments to NPL resolution, further strengthen NPL supervision, and appropriately incentivize further NPL reduction.

Finally, further structural reforms are needed in the run-up to euro adoption to ensure a flexible and competitive economy. To ensure real convergence and a smooth participation in ERM II and eventually to the euro area, increasing growth potential and strengthening the structural resilience of the economy will be crucial. We fully agree with the staff that maintaining prudent banking supervision and macroprudential policies is of utmost importance in preparation for membership in the banking union. With this, I wish the authorities all the best.

Ms. Mulas made the following statement:

We thank Mr. Doornbosch and Mr. Josic for their informative buff statement. We have issued a gray statement, and we associate ourselves with the comments made by Mr. Meyer. We would like to emphasize the following points.

On fiscal policy, we would like to commend the authorities not only for placing the debt ratio on a downward path but also for improving its profile, as noted in the Debt Sustainability Analysis (DSA). We encourage the authorities to continue with a growth-friendly fiscal consolidation, including by protecting and better targeting social spending to enhance growth and make it more inclusive.

We also thank the staff for its responses to our questions. We have read all of them carefully, and the response on the conditions for the euro adoption to be interesting. As the staff notes, Croatia has a high degree of trade and financial integration. Taking this into account, we believe that Croatia could reap significant and permanent benefits from the adoption of the euro. To this end, it is crucial that Croatia undertakes additional reforms to increase its growth potential and strengthen its structural resilience.

Another issue that the staff highlighted in that response is that Croatia is much less diversified and dependent on tourism, an issue that we also raised in our gray statement. Does the staff see merit in analyzing this issue further in the next Article IV consultation?

Finally, we commend the staff for linking some of its policy recommendations to a specific technical assistance (TA) proposal. This chair advocates for greater integration of surveillance and capacity development, and we consider this report to be a positive example in this regard.

Mr. Tan made the following statement:

Like Mr. Meyer, I also commend the authorities for the efforts in putting in place a strong fiscal regime to reduce public debt and strengthen macroeconomic stability. We have supported the economic recovery that has taken place in Croatia over the last few years and bolstered the country's resilience to domestic and external shocks. Clearly the job is not done yet, but the positive rebound from the post-crisis recession suggests that the authorities must be doing something right. This will set the stage in the later consultation for a more nuanced discussion of policy implications with a stronger, longerterm focus on structural reforms, on safeguarding the progress made, and seeing Croatia take the next steps forward in securing sustained medium-term growth.

In a way, the key issue at hand, which is more forward-looking in nature, is a good problem to have for the authorities, but it is not an easy one. It is a more aspirational one than some others that we have seen. To the staff's credit, they have made comprehensive recommendations, with various Directors contributing to the policy discussed through their gray statements.

Such a focus on continuing macro policy with a growth-friendly emphasis and reinvigorating implementation efforts that are geared toward addressing the structural challenges and bottlenecks is a constructive one. With that in mind, I would like to focus on two questions for the staff's comment, both relating to the underlying political economy constraints that have come up consistently in the report, such as on the introduction of a real estate tax, on having more ambitious pension reforms, and on reducing national fragmentation and instituting public service reforms.

First, as we join other Directors in encouraging the authorities to pursue the necessary reforms expediently. I would appreciate the staff's take on the feasibility of timely implementation while recognizing the particular constraints in Croatia. I ask the staff to discuss the implementation challenges that often stem from such domestic political economy constraints, as well as the likely policy repercussions and the potential cost of any delays that may materialize in the near-term.

Second, besides having an informed sense of the political economy of reform to achieve real impact, the overall policy agenda should be pursued with careful prioritization given that many of the critical reforms are not just politically challenging to implement but also complex and wide ranging in nature.

To conclude, my question is with respect to the timing and sequencing of these reforms. It would be helpful to hear from the staff how we can support the authorities in navigating the competing priorities to secure the best and most realistic chance of successful reform implementation. I wish the authorities further success.

Mr. Trabinski made the following statement:

The Croatian economy has experienced strong economic growth, and the authorities' sustained efforts in improving fiscal performance and implementing structural reforms are commendable. Nevertheless, existing risks, mostly related to potential slower growth among European partners, and existing vulnerabilities stemming from the elevated public debt warrant the authorities' close attention.

We thank the staff for providing answers to our questions and would like to offer the following points for emphasis. First, we agree with the staff's advice on the need to further improve the medium-term growth prospects. While public investment remains under-executed, we see scope for increasing the efficiency and size of public investment, including by more effective absorption of EU funds. In this regard, we encourage the authorities to consider conducting a Public Investment Management Assessment (PIMA) while continuing their fiscal adjustment in a growth-friendly manner.

Second, given the high-level of regional fragmentation in Croatia, we would like to encourage the authorities to continue with implementation of the national reform program. This initiative could create additional fiscal savings while being supportive of the business environment. In the future, we would appreciate if the staff report contained more detailed elaboration of the progress made in implementing the national reform program. However, any additional comments from the staff on this topic today would be also welcome.

Finally, we wish the authorities success in their future endeavors, especially within the context of future integration with the euro area.

Mr. Just made the following statement:

We thank the staff for the answers to our technical questions. We have issued a gray statement and would like to emphasize the following points. We also associate ourselves with Mr. Meyer's intervention.

The macroeconomic performance of Croatia was much weaker than that of other Central and Eastern European countries. However, following the painful period since 2008, several indicators suggest that the Croatian economy was able to adjust under the managed exchange rate regime. This could bode well for eventual euro adoption.

We commend the authorities for having made important strides in improving the health of Croatia's public finances. The first fiscal surplus since independence is a significant achievement, and it bears witness to the authorities' commitment to ensuring the sustainability of public finances and to putting debt on a firm downward trajectory. However, there is further progress needed, as mentioned by the staff, and we fully share that assessment.

We also see more traction in the implementation of the past recommendations on the structural reform agenda, but transition legacies continue to pose substantial challenges, and structural rigidities are apparent. Debt levels are high. Administrative procedures in the business environment and regulatory quality have to improve, and governance overall is not yet conducive to enabling more private sector-led growth. At the same time, labor market rigidities and emigration weigh on medium-term growth prospects. There is a need for a well-sequenced, multipronged strategy to tackle all these constraints to growth and investment while preparing for eventual euro adoption and achieving a higher institutional convergence with the EU. We would have appreciated if the staff had provided more in-depth analysis on the challenges the authorities have to tackle to prepare for euro adoption, and one could draw on the Fund's rich cross-country knowledge from Croatia's peers.

Otherwise, we agree with the sensible observation by Ms. Pollard and Mr. Mozhin that if Croatia does not make the necessary progress related to ERM II, this may warrant a modification of the authorities' timeline. But this is only the sense of the economists, and the authorities in Croatia have already decided on the date for the euro entry. We trust the authorities' commitment to make the necessary reforms.

The staff representative from the European Department (Mr. Seshadri), in response to questions and comments from Executive Directors, made the following statement:[2]

We fielded about 30-odd questions in writing, and there were a few that came up in the Board. I will take them in turn.

First, there was a question from Ms. Mulas about the merits of analyzing the lack of diversification. Yes, there are merits to analyzing that further. As we highlighted in our written answers, the biggest risks in terms of euro adoption come from the fact that there are risks of asymmetric shocks, and the risks of asymmetric shocks are higher in a less diversified economy. We have done some work on that in the past, but as the euro adoption timeline

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

comes closer, we do intend to analyze this and other structural issues in more depth.

We also agree about the positive engagement on TA. Croatia has not historically taken much TA from the Fund, but we are trying to work with them on PIMA and a few other issues, including public expenditure reform.

There was a question from Mr. Tan about the political economy of reforms, from the real estate tax to pension reform to the public sector wage bill. It is a bit difficult to disentangle where the economic difficulties begin and the political economy difficulties end. There is an element of both in all of these, so if I were to take them in turn, the real estate tax does have certain organizational things that need to be done, as we noted in the report, that it will take a long time to have a land registry and evaluation done properly. But there are also political economy dimensions to it. For example, for all the pensioners who have real estate but do not have much cash flow, we have to find adequate vents in a real estate tax policy but also consider communication. Communication becomes important because this is a case where when one introduces a new tax, there will naturally be some resistance in any population.

With regard to pension reform, the report highlights that there are certain groups for which there are group-specific provisions. That is where the political economy dimension comes in. This relates to Croatia's history, and I do not know that there is any international support that could be lent to that. But in practical terms what needs to be done, as the World Bank has highlighted, is to delineate pension benefits from benefits to veterans, benefits for unemployment, extended unemployment, so that we can make the system more transparent. That is probably the right approach to take.

With respect to public sector wages, the authorities have first taken the approach that attrition combined by a merit-based pay system will lower the wage bill system. That is a pragmatic approach that makes sense. At this point, it seems that they want to see the results of this before reducing the actual head count of public employment. To some extent that is a fair point, but after they see whether these attrition numbers start taking effect, they may have to consider more difficult reforms.

Mr. Trabinski asked some questions about whether the fragmentation process should be addressed more in the next report. We wrote about that in the 2016-17 reports. We wrote a selected issues paper on the topic, but these are issues that are tied up with an EU charter on local government representation to some extent, which the authorities are considering. We have to give them time to do their internal deliberations on that, see what views they come up with on that subject, and then further polish our recommendations.

I would also like to note that there are some corrections to the fiscal table, the text table on page 11, that the staff are discussing.

Mr. Doornbosch made the following concluding remarks:

As Mr. Just noted, following six years of recession after the global financial crisis, Croatia has recovered and returned to solid growth and has recorded its first budget surplus, as was noted by the Acting Chair and many Directors. The Croatian authorities sincerely appreciate this recognition.

Various macroeconomic policies, like ensuring a stable exchange rate, inflation, sound public finances, and well-capitalized and liquid financial sectors have shown a very good track record over recent years though structural weaknesses remain. The authorities strongly believe that the staff rightly emphasizes the need to strengthen the dynamism and the resilience of the economy, and they also believe that the key to unlock higher growth is public sector reform, as the staff rightly noted.

I would just like to make three comments, two on the issues of fiscal consolidation and the euro adoption, and one on another issue that is very important for the authorities, and that is emigration.

On the fiscal consolidation, the Croatian authorities are well on the way and fully committed to achieve and implement their strategy to bring public debt firmly below 60 percent of GDP in the medium-term, around 2023. Important elements of this strategy are a comprehensive assessment of expenditures, particularly current expenditure; containing the wage bill growth, as was mentioned this morning; and careful public debt management. They consider that restoring the investment grade credit rating should help further decrease debt-servicing costs. In addition to this, the authorities see important room for improvement in better managing state assets, including state-owned enterprises. The sales of real estate and shares of companies in the tourist sector over the last six months have been on schedule, while the process of restructuring several large companies has been initiated. This also refers to the Uljanik shipyard, where the process is on track to find private partners that are expected to become new large shareholders, and that will be announced soon.

On emigration, the authorities consider emigration to be a significant problem for the labor market, as well as for the sustainability of the pension system. Outward migration started with EU membership and fits within a broader trend seen in many Eastern European countries, and to revert this negative trend, a comprehensive set of measures has been taken—increasing net salaries by limiting the tax wedge, raising the minimum wage, increasing the child allowance for high school and university students, introducing real-estate supported programs for young families, and providing financial incentives to companies for internships. In addition, almost 1.2 percent of GDP of other active labor market policies have been taken.

Finally, on the euro adoption, my authorities strongly believe that euro adoption would bring more benefits compared to the cost implied by this process, taking into account that Croatia has historically been a mainly euro-based and before that a deutsche mark-based economy. At the same time, they do realize that the transition needs to be carefully managed to guarantee support from the people and to alleviate a wide range of concerns. To initiate the application process, the authorities plan to send a letter of intent to join ERM II to the European Commission and the European Central Bank, accompanied by several prior commitments in policy areas which are of high relevance for a smooth transition to ERM II, likely by the end of this year.

With these remarks, the Croatian authorities greatly appreciate the continued dialogue with the Board and with the staff, and would like to thank Mr. Seshadri and his team for their cooperation and the excellent report. They would also like to thank the previous mission chief and Ms. Vtyurina, the outgoing economist, for their dedicated work and helpful recommendations over the last years.

The Acting Chair (Mr. Zhang) noted that the Republic of Croatia is Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Croatia’s continued economic recovery, which has helped further reduce indebtedness and build external buffers. Directors commended the attainment of the first fiscal surplus in 2017 since independence. They encouraged the authorities to seize the opportunity presented by favorable macroeconomic conditions to advance the reform agenda by stimulating more inclusive growth, persevering with fiscal consolidation and debt reduction, and fully implementing structural reforms.

Directors welcomed the authorities' commitment to fiscal discipline, and stressed the importance of pursuing growth-friendly fiscal consolidation, while improving the structure of revenues and the quality of expenditure. To this end, they encouraged the authorities to broaden the tax base and take measures to reduce the informal economy. To improve growth prospects, they urged the authorities to shift the balance of expenditures toward public investment. Directors welcomed the passage of the Fiscal Responsibility Law, and encouraged the authorities to enact the Budget Act which would integrate the analysis of contingent liabilities as part of the budget process and facilitate medium-term planning. They considered that, as circumstances permit, further fiscal consolidation would be desirable to rebuild fiscal space. Directors called for more ambitious restructuring of public administration including by reducing high public employment outlays and reducing the fragmentation in sub-national levels of government. While welcoming the passage of pension reform, as well as recent measures to improve the efficiency of the healthcare system, they underscored that the elimination of the healthcare system's arrears as well as ensuring long-term sustainability of the pension system would require further reforms.

Directors considered that monetary policy has been appropriately accommodative within the limits of the exchange rate anchor. With preliminary discussions regarding ERM II about to commence, they underscored the need to complete wide-ranging reforms to harness the maximum benefits from envisaged euro adoption, as well as the need to retain strong buffers to withstand any negative asymmetric shocks.

Directors commended the Croatian National Bank for its conservative prudential policies, and encouraged the authorities to consider additional measures to prevent excessive household borrowing if needed. They welcomed efforts to continue to reduce the stock of non-performing loans, and stressed the need to closely monitor corporate indebtedness. Directors encouraged continued improvements in bankruptcy legislation, and advised a comprehensive review to ensure that the insolvency framework aligns fully with international best practice.

Directors highlighted the need to improve the business environment by further reducing administrative and tax burdens, and welcomed recent initiatives to reduce parafiscal fees. They advised rationalizing the state-owned enterprise sector, divesting under-utilized state assets, and improving the efficiency of legislative and judicial processes. Directors underscored the importance of pursuing a balanced approach to increasing labor market flexibility that guards against the creation of a dual labor market which would further encourage the emigration of the young, to the detriment of medium-term growth prospects.

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

APPROVAL: April 21, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***We would appreciate staff's additional elaboration on how the slowdown in the large economies in the European Union could impact the external position and growth prospects in Croatia.***

- Italy and Germany are two of the largest trading partners, and a few Croatian exports to Europe also find their way through Central European supply chains. Although Croatia is a services-based economy, industry contributes 14 percent to output, and industrial production in Croatia contracted 1 percent in 2018. More broadly, a slowdown in the large economies in the European Union could shrink the current account by widening the goods trade deficit and reducing tourism exports. On the other hand, the primary income deficit is mostly offset by personal remittances and EU funds flows which are both relatively stable sources of secondary income. Sustained external deleveraging since the GFC has led to stronger external balance sheets and lower external debt refinancing needs which imply less elevated vulnerabilities to tighter external conditions. Gross international reserves moderately exceed the ARA metric and provide a buffer with which the authorities can respond to adverse external shocks. Growth could be affected by the reduction in private consumption if tourism receipts weaken, however, weaker growth in the EU will keep interest rates low allowing for further investment and credit growth.

2. ***We note from the Selected Issues paper that contagion risks from cross sectoral balance sheet exposures remain high. Staff comments on the priority actions needed to reduce those risks will be appreciated.***

- Public debt is above 70 percent, and the corporate sector's debt is concentrated in a few segments and remains high relative to the sectors' financial assets, which may indicate potential solvency risks. To reduce contagion risks from cross sectoral exposures, priority should be given to pursuing a more ambitious fiscal consolidation and facilitate further corporate deleveraging though specific policy options and strategies. In particular, the bankruptcy procedures need to be made even more efficient, e.g., by facilitating out-of-court settlements, and providing more flexibility to deal with corporate bankruptcy. Efforts should continue to ease and simplify the process of writing off debt, and encourage banks to carry out loan restructuring, while respecting owners' rights and minimize moral hazard and potential fiscal costs.

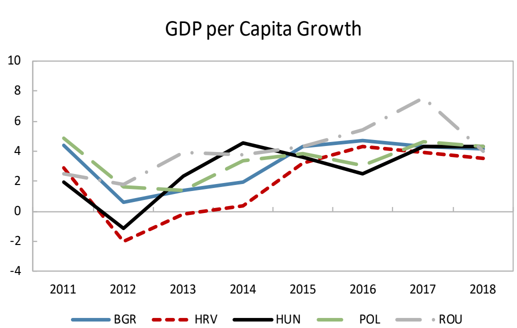
3. ***Could staff provide greater details on fiscal risks in Croatia and their potential implications for public debt?***

- Fiscal risks stem from arrears in the health sector, and the remaining structural deficit in the pension system. In both cases, structural spending is higher than structural revenues. The size of health care arrears is about 2 percent of GDP and the size of the pension deficit is about 4 percent of GDP. Annually, there are transfers from the State budget to finance those deficits, what slows down the path of debt reduction. Authorities are starting to tackle the underlying sources of structural deficit in both systems, for example by introducing new sources of permanent revenues (e.g., increasing the health contribution rate) and containing the growth of spending (e.g., postponing the retirement age).

4. ***The consequence of aging on public finances, it appears that the EU Commission in the 2018 Aging report are not fully consistent with staff's assessment, the latter being more alarming in this regard. Staff's comments would be appreciated.***

- Staff considers that pension spending could be a source of fiscal risk based on the current structural deficit of the pension system. According to the World Bank (WB), this structural deficit (before the 2018 reform) was about 4 percent of GDP. Given that the authorities acknowledge that the recent reform will not imply substantial savings, the potential fiscal risk remains sizable. Per the European Commission (EC) aging report 2018, it seems that assumptions for Croatia imply a growing fertility rate, growing female labor force participation, and a reverse of outward migration trends. Under these premises, the EC sees less of a fiscal risk embedded in pension projections than the WB. At the same time, the EC recognizes that the age dependency ratio for Croatia is clearly worsening and now predicts that Croatia will be among the group of 7 EU countries that will have a ratio above 80 percent (5 persons in working age population for 4 aged more than 65) by 2070.

5. ***Could staff also provide comparisons of GDP per capita growth as well as GDP per working person growth between Croatia and its peer countries?***



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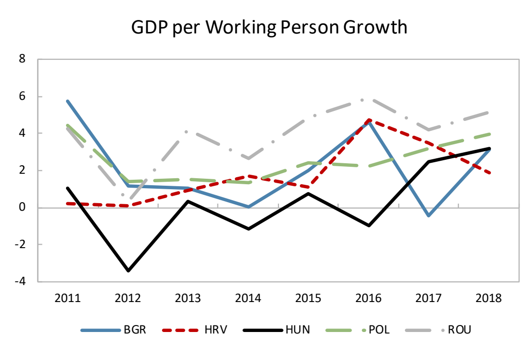

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Fiscal Policy

6. ***On fiscal reforms, we note the authorities' diverging approach to containing the wage bill growth and their reluctance to introduce a real estate tax at this moment. Staff comments on the impact of the authorities' position on the recommended adjustment pace will be appreciated. Could it also comment on other possible options to strengthen revenues and on the measures being implemented by the authorities to contain the growth of the wage bill?***

- Staff's recommended fiscal path involves a faster fiscal adjustment than authorities' path. The purpose is to reduce debt faster and build stronger fiscal buffers before the next deceleration. Alternatives to the real estate tax could be wealth or environmental taxes (see below).

- In relation to the wage bill, the authorities are already implementing attrition, so that only 50 percent of retirees every year are replaced with new entrants. Additionally, the government is reviewing the pay scale, to facilitate merit increases and reward productivity. No other plans currently are being considered to reduce the amount of public employment.

7. ***Could the staff elaborate on this issue as well as on whether the Fund or other agencies could provide technical assistance in this area? Could the staff elaborate on any best practices in this area in Croatia's peer countries? While we appreciate the basis for broadening and stabilizing the tax base by introducing a real estate tax, staff's comments are welcome on the authorities' view that it should be done gradually and properly in the absence of an effective valuation and administration system. What alternative revenue options, with similar budgetary impact, but lesser technical and political challenges, have been discussed with the authorities? Staff's further elaboration on their suggestion to introduce a wealth tax is welcome.***

- The tax policy division in FAD offers technical assistance in tax reform and, if requested, could recommend additional tax efforts to both raise revenues and make tax systems less distortionary.

- Alternatives to the real estate tax could be a wealth tax (which some European countries have implemented as a supplement to the income tax). Also, environmental taxes could help additional revenues, reduce externalities and spur innovation.

- In case the authorities decide to go ahead with the real estate tax, the experience of other European countries could be useful. If residential property is taxed as capital investment, tax neutrality should be achieved by levying a capital tax on the (net) return on all forms of investments. Alternatively, the tax can target the consumption service of the house, thereby approximating the VAT and be levied on the rental value. Currently there is a utility tax that is paid on real estate.

- While the introduction of the real estate tax could be challenging, Croatia has the administrative capacity to deploy an effective system, which could be administered effectively. Since it will require introducing changes with respect to land registry (see below), putting in place new information systems, and strengthening the coordination at all levels of government, this process should be done gradually.

8. ***Could staff provide greater details on fiscal risks in Croatia and their potential implications for public debt? We would welcome further explanation regarding the situation that led to the activation of the state's guarantee on Uljanik shipyard, and remediation measures going forward. In this regard, while footnote 8 provides some information, we would welcome staff elaboration on the circumstances leading to the materialization of contingent liabilities and the steps taken by the authorities to address the financial difficulties of this shipyard.***

- In the period from 2010 to September 2018, government guarantees in the amount of 7.5 billion kuna were in place to help with obtaining financing for new vessels and liquidity provision. At the end of 2018, active guarantees remained in the amount of to 4.3 billion kuna. Delays in production led to the cancellation of contracts for the construction of several ships which required the activation of these remaining state guarantees. The State paid out about 3.2 billion kuna in principal, interests and fees. Currently a strategic partner is being sought.

9. ***Could the staff comment on the prospects for receiving technical assistance on public investment management and for better targeting social programs in consultation with the World Bank? Could the staff elaborate on whether the authorities were receptive to TA on public investment management, as briefly mentioned on page 13? Staff's comments on whether the authorities are considering requesting a Public Investment Management Assessment are welcome. Can staff comment on whether technical assistance on public investment management is in the pipeline?***

- In the context of the FY 2020 TA allocations, the authorities and staff are discussing a few possible areas for the provision of technical assistance, including PIMA and the wage bill. The authorities are in the process of internal consultations among the various ministries.

10. ***Could staff comment on how the entry into the euro area would impact Croatia's public debt dynamic and how the authorities should adjust its financing and debt management strategy accordingly?***

- Entering the euro area is not likely to impact significantly Croatia's public debt dynamics. Financing costs are likely to decline as risks, such as an exchange rate risk, will be eliminated. A large share of public debt had been in euro already, albeit declining recently. The debt management strategy by the authorities is already based on the assumption of a pegged exchange rate, which will eventually transition to the adoption of the single currency.

11. ***Beyond the fiscal cost of Croatia's social benefits being one percent of GDP higher than peers, we would like to hear more of the staffs' views on how this reduction would play out, including on the sequencing and targeting of benefits. Could the staff comment? Could the staff comment on the prospects for receiving technical assistance on public investment management and for better targeting social programs in consultation with the World Bank?***

- The largest share of social benefits is pensions. Any attempt to achieve savings in this category should continue along the lines of the recently approved pension reform. Controlling the growth of social benefits will also require careful calibration of veterans' pensions and associated benefits. As stated in footnote 13, the World Bank estimates that only 10 percent of Croatia's social programs are well-targeted, and many need to be replaced with alternatives that are (1) more consolidated across areas of extended unemployment and veterans' benefits; and (2) better income and means-tested to protect the vulnerable. There is also scope to streamline the provision of benefits across state vs. local levels and that is why the staff recommended the introduction of the electronic one-stop-system as a starting point of identifying where the benefits overlap and are not well targeted.

- The World Bank (WB) has been supporting the development of Croatia's social protection system for more than two decades. The WB has promoted and called for the consolidation of benefits and the use of means-tested or income-tested social benefits and to develop a modern system that offers to beneficiary families and needy individuals a better chance to reintegrate in society. In 2014, the WB approved a EUR 70mn loan under a Social Protection System Modernization Project to support a set of planned reforms to strengthen the country's social protection system and make it more cost-effective. The reforms that were envisaged included: (a) the consolidation of major social welfare and unemployment benefits under a one-stop shop network; (b) harmonization of disability certification; (c) development of the system to prevent, detect and correct error and fraud; (d) de-institutionalization of vulnerable children and adults; and (e) development of better activation measures for those at risk to becoming long-term unemployed. The Government of Croatia that came into power in 2016 decided to refocus the social one-stop-shop (with centralized front and back offices) to data exchange while maintaining decentralized administration structure. The WB have hence agreed to close the project prematurely and cancelled the undisbursed amount of the loan. Yet, the WB remains involved in this sector through policy work (for example under the work under the National Development Strategy 2020 RAS) and through continued contact in the field.

- The IMF can provide technical assistance on public expenditure rationalization (PER), and in that context offer advice on social assistance programs in Croatia, as it has done for other countries that requested PER. Outside of this context, and if the technical assistance request has a specific purpose of improving the targeting of social programs, the World Bank is better placed to provide that assistance.

ERM II and Euro Adoption

12. ***Does staff believe that the overall conditions for the euro adoption are in place and the economy's fundamentals provide sufficient safeguards for mitigating potential risks and costs from Croatia's transition to the euro? Considering that Croatia's business cycle synchronization with the euro area is much lower than within the euro area, we would welcome staff's comments on the timing, as well as the pros and cons of the euro adoption decision.***

- At the time of the last Board meeting on Croatia, the staff's deliberations with the authorities presented in the 2017 Article IV report were based on cross-country analyses conducted by European Department staff on the costs and benefits of euro adoption (summarized in Annex IX of the 2017 staff report, which summarizes key policy considerations). As an EU member, Croatia is committed to adopting the euro. The relevant European institutions will also make their determinations on this subject, and indeed the adoption process (adoption is envisaged in 2022-2025 period) could usefully serve as an anchor for the reforms that are to be completed. Preliminary discussions regarding ERM II are already taking shape. De facto, ERM II does not entail a material change given the peg which has been in place since 1994 causing the kuna to closely track the euro, and also given the high degree of euroization--over half the financial placements of loans and securities is in euro (this would be higher if Treasury securities were excluded), and over 80 percent of total savings and time deposits are in foreign currency.

- We can take a step back and go to more fundamental criteria that are laid out by the optimal currency area literature. There are usually five criteria that very frequently give varying signals, and Croatia is no exception:

(1) **A high degree of trade and financial integration**, which Croatia meets quite well in absolute terms and relative to many Central and Eastern European peers;

(2) **Synchronicity of business cycles and the impact of shocks**. The literature describes a few methods to study synchronicity of business cycles, and as mentioned, these do not provide unequivocally similar measures of synchronicity. In the interests of brevity, a quick summary would be that whether measured through GDP correlations—the simplest measure—or through more sophisticated means such as phase correlations and amplitude coherence, the CNB's studies point to an overall level of business cycle coherence that is comparable to other Central and Eastern European countries. The most recent ebb due to Croatia's slowness to emerge from recession points, as the staff report mentions to reform inertia. When it comes to shocks, the strongest reason for caution is an economy that has structurally different features, is much less diversified, dependent on tourism, and relatively less technologically intensive in terms of its manufactured goods. These differences in economic features raise risks of asymmetric shocks in the future.

(3) **Price and wage flexibility:** This criterion is not very strongly met, but this is also the case for many other economies including many in the euro area itself.

(4) **Labor Mobility:** Since 2015, Croatia's labor mobility within the euro area has been high as most euro area member states removed transitory restrictions on the free movement of Croatian workers. This is however a double-edged sword as migration of the young is also associated with labor shortages, and also challenges the pension and healthcare systems.

(5) **Fiscal and political integration**: This depends more on the broader frameworks set in the Euro area, but Croatia's participation in the European Semester, the passage of the fiscal responsibility law, the envisaged passage of the budget act, and the downward trajectory of public debt are all encouraging.

- All put together, the biggest areas in need of attention are the risk of asymmetric shocks, as well as the rigidities that have caused Croatia's incomes to lag. Regarding asymmetric shocks, the most important insurance is the rebuilding of fiscal space, which the staff report emphasizes through its recommendations for a growth friendly fiscal consolidation to take place prior to euro adoption. The Staff Report also places greater emphasis than in the past on structural issues so that the rigidities may be addressed to deliver greater income convergence and prepare the economy better to harness the full benefits of deeper integration with Europe.

13. ***We recall the recent approval of the ERM II action plan by the Bulgarian authorities, which was met by some European authorities with a suggestion to opt-***

in to the banking union in advance of being admitted to the ERM II. Does staff envisage similar conditions for Croatia?

- The Croatian authorities will later in 2019 submit the formal request for ERM II membership, whereupon the detailed conditions will be agreed by the pertinent parties. Currently, we are not aware of deliberations to opt-in the Banking Union in advance of being admitted to ERM II. It is also our understanding that the authorities retain the view that the Banking Union accession can take place closer to the actual time of euro adoption.

Financial Sector

14. ***Could staff elaborate more on the potential spill-over effects from the Italian Banks given their significant share in the Croatian banking sector?***

- The two largest Croatian banks are subsidiaries of Italian banks. They are liquid, profitable and well capitalized. They are a small part of their respective parents' balance sheets but contribute a relatively higher share of their profits compared to their weights. These subsidiaries are also more likely to be classified as part of the "core" business relative to some other subsidiaries of these banks and are less likely to be leaned upon by the parents unless conditions are very extreme. As noted in the Staff Report, Croatian bank subsidiaries have moved from having net foreign liabilities to assets since mid-2016. These attributes make them more (albeit not fully) protected from spillover effects.

15. ***Could staff elaborate on whether the lending standards are too loose and what potential measures could help to reduce risk steaming from cash loans?***

- The CNB is monitoring the situation closely (see the CNB's "*Macroprudential Diagnostics no:7"*). Its surveys acknowledge that some banks do apply more relaxed standards when approving general purpose loans than when approving housing loans. The CNB noted that the accompanying risks could be mitigated by stricter creditworthiness assessment criteria, an increase in the pillar 2 capital requirement, or introduction of maturity limits.

16. ***We would like to ask how the authorities envisage further NPL reduction and while kick-starting NFC lending?***

- It is staff's understanding that the authorities intend to review the insolvency framework as part of the transposition the EU business insolvency directive. Banks are now required to develop a credible action plan to reduce their NPLs, which may include NPL sales, write-offs, etc. In staff's view, the most helpful steps to revive

NFC lending would be through improving the business climate. Continued accommodative monetary policy and low interest rates are also likely to help. Through the State Development bank HBOR, there are programs particularly for Small and Medium Enterprises (SMEs) and other companies to help support sustainable NFC lending.

17. ***Could staff comment on the observed slowdown in the sale of NPLs and its potential impact on the NPL reduction outlook? Could staff elaborate if further measures are needed to ensure NPL reduction?***

- The sales of NPLs the first three quarters of 2018 amounted to about 51 percent of the total sales in 2017. However, a substantial part of such sales often takes place in the last quarter as banks tend to prepare their balance sheets for year-end. For instance, tax incentives to facilitate writing off fully provisioned loans (in 2017, which was "one-off" in nature) were not entirely successful as banks seem to prefer NPL sales as the primary vehicle for reductions. Clarification of tax treatment of NPL write-offs (possibly extending the 2017 "one-off" initiative further) may help further NPL reductions.

18. ***Staff's comments on the scope for utilizing Fintech to reduce the high cost of financial intermediation in Croatia are welcome.***

- It is staff's understanding that there is some scope for further use of fintech. Some Croatian banks are reportedly already using credit scoring derived from "Big Data" models. More importantly, further digitalization and use of internet banking, which typically correlates with fewer branches, could reduce operating costs of banks in the medium term.

Structural Issues

19. ***We would appreciate staff's elaboration on its stated need to revive a few aspects of the 2016-2018 National Reform Program (NRP).***

- Staff suggested to revive the intention to reduce regional fragmentation as stated in *para 21*. Staff also encouraged the authorities to be more ambitious in tackling the excessive provision of untargeted social benefits in certain areas. Bolder steps were also called for in divesting inefficient and non-profitable SOEs.

20. ***We note the authorities' plan to carry out an extensive review of administrative measures, which could help improve the business climate. Could staff elaborate on the scope of this review?***

- As the SR mentions, a unification of inspection services took place easing inspection time for businesses, and efforts are ongoing to relieve the economy from excessive administrative costs and non-tax payments. The NPR includes such actions as further services market liberalization and development of Point of Single Contact for business, the establishment of the e-Business system, improving the competency of public servants, designing and setting up an IT system for monitoring and supervision of administrative procedures and its introduction into all public bodies. There are also plans to upgrade the IT Systems in courts and improve the cadastre and land registry system (see below).

21. ***Could the staff elaborate on the most efficient ways, including economic sectors, to invest these funds to boost productivity in the economy? Could staff also provide comparisons of GDP per capita growth as well as GDP per working person growth between Croatia and its peer countries?***

- Croatia will use the allocated EU funds for the contribution to major EU initiatives. The EU funds will also be used to support structural reforms, i.e. to achieve the objectives defined by the NRP. Areas in which Croatia puts a special emphasis on are: (i) improving the use of digital technology, (ii) creating jobs and growth through research and innovation, (iii) improving the mobility of youth for the purpose of learning and training, employment, volunteering and youth exchanges, (iv) increasing the skill level of general population, (v) shifting towards a resource-efficient economy with low carbon emissions in order to achieve sustainable development.

22. ***Some details are mentioned in Annex I and we would be interested in knowing if additional restructuring exercises and privatizations are in the pipeline for SOEs?***

- As a part of the NRP, there are plans in motion to reevaluate strategic assets and reduce the state portfolio of companies, apartments, business premises and land. While no concrete plans are disclosed, there is a process of identification and preparation for privatization of non-strategic companies and sale of non-strategic companies with the purpose of selling minority interests, and companies in which there is no influence on the management and no economic benefit from profit or dividends. Another example of activating unused property is disposing of former army barracks through sales, leases, construction rights, etc., upon settling related property and legal documentation. For the divestiture experience to be efficient, a transformation of the existing State Property Register from an administrative into a management system is also necessary and is currently ongoing. Efforts are ongoing to find strategic partners for companies like Uljanik; for Croatia Airlines the search will start soon.