Republic of Croatia: Staff Concluding Statement for the 2023 Article IV Consultation Mission

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Zagreb, Croatia: *The euro adoption marks a momentous achievement for Croatia and is a testament to diligent policymaking and concerted efforts. The economy has also been resilient in the face of the pandemic and Russia's war against Ukraine, in part reflecting the authorities' skillful macroeconomic and financial management. The authorities' steadfast implementation of the National Recovery and Resilience Plan (NRRP) is commendable. That said, Croatia still faces the challenge to further raise the living standards of its people in a sustainable manner. Growth is projected to moderate in 2023, following two years of strong performance. While inflation has peaked, it remains elevated and broad-based. Policies should focus on (i) continuing prudent fiscal, financial, and macroprudential policy stances to complement the ECB's monetary tightening and build adequate buffers, and (ii) advancing structural reforms and maintaining reform momentum to improve competitiveness and foster faster income convergence with richer eurozone countries, anchored by the NRRP.*

CONTEXT

The euro adoption is a testament to Croatia's considerable progress since joining the EU in 2013. It has largely removed exchange rate risks, improved sovereign ratings, and eased access to capital markets, and is expected to bolster foreign investment and trade. Being now part of the eurozone, Croatia must rely on fiscal, macroprudential, financial, and structural policies to address any idiosyncratic shocks and imbalances. Advancing structural reforms remains a priority to reap the full benefits of euro adoption and foster faster income convergence to richer eurozone countries.

The economy has shown resilience in the face of the pandemic and Russia's war against Ukraine, in part reflecting the authorities' skillful macroeconomic and financial management. Croatia posted another year of strong growth in 2022, despite the slowing momentum in the second half. Surging energy and food prices drove headline inflation to a multi-decade high towards year end. While inflation has peaked, it remains elevated and broad-based. The euro adoption has had a very limited impact on inflation. The fiscal balance improved considerably to a small surplus, and public debt fell to 68½ percent of GDP in 2022, below pre-pandemic levels. External imbalances remain contained. Absorption of EU funds continues to improve.

OUTLOOK AND RISKS

Growth is expected to moderate to 2.2 percent in 2023. Weak external demand, tightening financial conditions, and high global uncertainty would weigh on growth, partially offset by a decline in global commodity prices, resilient tourism, and a buoyant labor market. Growth is projected to recover to its potential (about 3 percent) over the medium-term, supported by investment and reforms under the National Recovery and Resilience Plan (NRRP). As energy prices fall from their previous peaks and supply bottlenecks ease, headline inflation will recede, averaging 7½ percent in 2023 and gradually falling towards the ECB's target of 2 percent in late 2025. Core inflation is likely to be stickier.

The outlook remains subject to significant uncertainty and risks to growth are broadly balanced. An intensification of the war in Ukraine, a renewed surge of commodity prices and inflation, a sharper global or regional recession, and tighter-than-expected financial conditions are major downside risks to growth. On the upside, the euro adoption and entry into the Schengen area could provide a stronger boost to tourism, trade, and investment. Risks to inflation are tilted to the upside. Positive inflation risks from stronger passthrough of nominal wage growth are partially offset by downside risks from weaker-than-expected domestic demand.

FISCAL POLICY

The near-term fiscal policy needs to complement monetary tightening and avoid adding to aggregate demand. The labor market is tight, core inflation remains elevated, and the euro adoption has mitigated the impact of the ECB’s tightening. Therefore, an expansionary fiscal stance risks fueling domestic demand and inflation and hurting Croatia’s competitiveness. Based on the government’s latest budget plan and assuming no additional fiscal support, we project a deficit of 0.8 percent of GDP in 2023, which translates to an estimated positive fiscal impulse of ½ percent of GDP after taking into account the projected growth slowdown.

To achieve a tighter fiscal position and given declining energy prices, the support measures need to be better targeted, temporary, and transparent. Albeit timely, the government’s responses to the cost-of-living challenge have been largely untargeted. We recommend reversing energy prices caps and tax cuts, which are broad-based, costly and disrupt price signals. Instead, temporary targeted cash transfers, vouchers, and discounts to the most vulnerable are preferable. The design of support measures can be improved by speedily completing the household registry and social security reform. Higher-than-budgeted revenue should be saved.

Over the medium-term, maintaining a growth-friendly fiscal consolidation is paramount for Croatia to deal with future shocks, safeguard sustainability of public finances, and

strengthen competitiveness. We recommend improving tax policy, reducing spending rigidity, and enhancing spending efficiency.

- Given Croatia's high budget spending rigidity and the need to further reduce public debt, any tax reforms should preserve revenue resources while improving the tax system structure to reduce distortions and support fairness and growth. In this context, reforming the current tax regime favoring residential real estate investments would help dampen demand, activate idle residences, and encourage labor participation. We see merit in introducing a value-based property tax and improving personal income tax (PIT) equity, particularly through removing the excessively favorable taxation on short-term rental income. The implementation and administration of a modern property tax requires the existence of comprehensive and accurate registers of ownership and up-to-date recording of property values. Careful preparation, sequencing, and public communication of reform measures are crucial. In the short term, the communal fees and the tax on vacation homes can be transformed into an elementary value-based property tax, with special arrangements in place to protect the most vulnerable and households only with primary residences.

- A simplified and transparent public sector remuneration system that rewards merit and productivity would help enhance public services and make the sector more efficient. It is important to finalize the public administration wage reform this year and to streamline the public service .

- Worsening healthcare and pension costs due to an aging population call for renewed efforts to lengthen the working life and decisively address persistent healthcare arrears. Efficiency gains could come from better use of centralized drug procurement, merging service provisions in underpopulated areas, and strengthening management of hospitals.

- A sound public investment management (PIM) system will help maximize the benefits of substantial EU funds and crowd-in private investment. A strong central coordination function in the Ministry of Finance (MoF) is needed to ensure that sound practices in line with international standards are consistently followed by line ministries. It should also implement a robust project appraisal framework. Climate change adaptation and mitigation should be embedded in reforms to strengthen PIM.

- Improving the monitoring and corporate governance of state-owned enterprises (SOEs) will reduce potential fiscal risks and maximize their contribution to growth. We welcome the process of preparing a new single law on SOEs for adoption in early 2024. IMF staff stands ready to provide technical assistance to help the MoF strengthen its capacity in financial oversight of SOEs.

FINANCIAL SECTOR POLICIES

At present, systemic financial risks appear manageable but continued vigilance and close monitoring are warranted given varying buffers in the system and ongoing challenges. The banking system remains profitable, well capitalized, and extremely liquid. While household and corporate vulnerabilities have moderated since the pandemic, a deeper-than-anticipated economic slowdown amid rising interest rates could pose new challenges to them and increase credit risks. Moreover, housing affordability appears to be a challenge as house prices have increased rapidly in recent years, although wages have also increased.

Explicit borrower-based measures could be considered to contain potential future financial stability risks of housing market pressures, taking into consideration measures already in place, as well as other risk mitigating factors. The recent increase in the counter-cyclical capital buffer was merited partly by housing price developments. There are indications that growth of residential prices and transactions may have temporarily paused after a period of rapid increases. However, as disposable incomes recover from the current slowdown, inflation still errs on the upside, taxation remains favorable for residential investments, and the very liquid banks look for lending opportunities, housing is poised for new pressures. As such, explicit borrower-based limits could be considered to preempt future financial stability risks.

A comprehensive review of housing support measures should be considered to identify the most pressing bottlenecks that affect housing affordability. Specifically,

- A review of subsidized house ownership should include the expiring subsidy scheme, current taxation, and supply bottlenecks. Strengthening supply is the most effective way to ensure affordable housing. As noted above, the current favorable taxation on real estate investments needs to be reformed to boost effective housing supply.
- Careful consideration of various well-intended proposals for additional rental support is needed. More government investment in subsidized apartments has a tendency to create rationing unless the eligible tenants are clearly defined and limited. Stricter rental procedures can limit the supply and instead amplify the pressure. More broad-based government rental support could result in support to less needy groups and further push up rental demand and prices. A well-calibrated balance is thus needed.

STRUCTURAL POLICIES

Croatia needs to raise productivity, which still lags behind its EU peers. Raising productivity will require a more ambitious and comprehensive set of reforms, along with the EU funds, to address inefficiencies and constraints that contribute to insufficient research and development (R&D) investment and technology adoption and an inefficient allocation of resources. Additionally, institutional quality needs to improve, both concerning the public and private sector. Accelerating Croatia's digital transition will also help raise productivity.

The authorities have taken steps to make the best of an aging and declining population, and the currently tight labor market offers an opportunity to carry out further reforms. The regulation of permanent work contracts can be streamlined. Croatia can also introduce more employment incentive schemes targeting vulnerable groups. Higher investment in childcare facilities and part-time contracts can further increase female labor force participation and well-designed subsidies can be used to incentivize workers' mobility. Managed well, inflows of foreign labor from non-EU countries can alleviate labor shortages.

The uncertainty in energy supply in Europe presents an opportunity to accelerate the green transition. It is important for Croatia, which is highly exposed to climate change and natural disasters, to implement the 2020 National Adaptation Strategy. Furthermore, despite the recent expansion of renewables, fossil fuels continue to dominate Croatia's energy consumption mix. Energy efficiency improvements remain a priority. Croatia would benefit from developing a comprehensive climate strategy, beyond the NRRP and fully aligned with its energy strategy, to ensure adherence to the more ambitious EU-wide mitigation targets. Particularly, an economy-wide carbon pricing accompanied by sectoral policies (notably feebates for power, transport, and building heating) and targeted support to the vulnerable could help promote cost-effective emission reductions.

The mission would like to thank the Croatian authorities and other stakeholders for their excellent cooperation and candid and open discussions. We are especially grateful to the Croatian National Bank and Ministry of Finance for assistance with meetings and logistical arrangements.