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Macroeconomic Imbalances - Croatia 2014

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Croatia is experiencing *excessive macroeconomic imbalances, which require specific monitoring and strong policy action*. In particular, policy action is required in view of the vulnerabilities arising from sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt, all within a context of low growth and poor adjustment capacity. The Commission will put in motion a specific monitoring of policy implementation, and will regularly report to the Council.

More specifically, after an expansionary phase, in which imbalances accumulated, Croatia is now experiencing a prolonged bust, in which a range of external and internal risks have come to the fore. External rebalancing is beset by important risks pending the reduction of Croatia's foreign liabilities to safer levels and is conditioned on improved competitiveness and broadening exports beyond tourism to support growth. The deleveraging of non-financial corporates is still at an early stage and non-performing loan developments in this segment need monitoring. State-owned enterprises, which in some sectors still play a dominant role and which are often un-restructured, are overall highly indebted and weakly profitable. Croatia has the lowest activity and employment rates in the EU, which is partly related to underlying institutions and policy settings. Better labour market functioning will be crucial to support the growth and adjustment needed in view of external and internal vulnerabilities. On nearly a range of standard indicators, Croatia's business environment ranks significantly below the average for central and eastern European Member States. These factors combine to lower potential growth, which hinders private sector balance sheet repair and increases the required fiscal consolidation effort. There is a need for significant additional fiscal consolidation efforts to curtail the deficit and prevent debt from rising unsustainably. Croatia is in EDP and needs to take effective action to address the excessive deficit by 30 April 2014. On current trends, in the absence of additional measures, Croatia risks missing its targets by a large margin in 2014.

Excerpt of country-specific findings on Croatia, COM(2014) 150 final, 5.3.2014

Executive Summary and Conclusions	7
1. Introduction	11
2. Macroeconomic Developments	13
3. Imbalances and Risks	19
3.1. EXTERNAL SECTOR ANALYSIS AND COMPETITIVENESS ISSUES	19
3.1.1. External sector trends	19
3.1.2. External Competitiveness	22
3.2. INDEBTEDNESS AND DELEVERAGING DYNAMICS	34
3.2.1. Private sector indebtedness	35
3.2.2. Public indebtedness	41
3.3. MONETARY AND FINANCIAL SECTOR ISSUES	48
3.3.1. Macro-prudential policy in Croatia in the run-up to the crisis	49
3.3.2. Monetary and exchange rate issues	50
3.3.3. The situation of the banking sector	52
4. Policy Challenges	61
References	63

LIST OF TABLES

2.1. Key economic, financial and social indicators - Croatia	18
3.1. Structure of the Croatian banking system	53
3.2. Capital and loan loss provisions analysis	57

LIST OF GRAPHS

2.1. GDP dynamics and contributions	13
2.2. CPI inflation	14
2.3. Selected labour market indicators	14
2.4. 5-year CDS USD	16
2.5. Current account and components	16
2.6. Gross external debt	17
3.1. Current account composition	19
3.2. Exports and Imports	19

3.3.	Current account financing	20
3.4.	Net IIP	20
3.5.	Current account adjustment in selected Member States	20
3.6.	Decomposition of rate of change of NIIP	21
3.7.	Gross IIP - liability-side breakdown % of total	21
3.8.	Gross external debt per sector	21
3.9.	Export market share decomposition	22
3.10.	Volume of exports of goods and services	22
3.11.	Trade openness	23
3.12.	Value of exports of travel services	23
3.13.	Compensation and productivity	26
3.14.	Nominal ULC	26
3.15.	Adjusted wage share	27
3.16.	ULC-deflated REER	27
3.17.	REER deflated for nominal wage costs in manufacturing	27
3.18.	Doing business 2014, country ranking	30
3.19.	Economic freedom 2014 index, country ranking	31
3.20.	Global competitiveness 2013-14 index, country ranking	31
3.21.	FDI inflows	32
3.22.	FDI inflows per sectors, % of total	32
3.23.	Sectoral structure of inward FDI stock	33
3.24.	Debt by sector, non-consolidated	34
3.25.	Private sector debt	35
3.26.	Decomposition changes in debt-to-GDP ratio, households	36
3.27.	Decomposition changes in debt-to-GDP ratio, NFC	36
3.28.	NFC leverage indicators	36
3.29.	Household leverage - Croatia and CEE10	40
3.30.	NFC leverage - Croatia and CEE10	40
3.31.	Credit institutions' claims	41
3.32.	Consolidated central government	44
3.33.	General government balance	44
3.34.	Structural government balance	44
3.35.	General government debt	44
3.36.	Contingent state liabilities	45
3.37.	T-bills auctions, average yields	46
3.38.	Kuna exchange rate	51
3.39.	Croatia - Real and nominal effective exchange rates (42 countries; monthly data)	51
3.40.	NPLs and coverage ratio, Q3 2013	53
3.41.	Key financial indicators	53
3.42.	Corporate debt evolution	54
3.43.	Banking and leasing assets	54
3.44.	Loans and deposits	55

3.45. Property price index	60
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LIST OF BOXES

3.1. Croatia's declining goods exports	25
3.2. Employment protection legislation as impediment to competitiveness	30
3.3. Financial Performance of Firms, including SOEs	38
3.4. Pre-bankruptcy settlement legislation	43
3.5. Public debt sustainability analysis	47
3.6. Banks' exposure to the general government and SOEs	58

EXECUTIVE SUMMARY AND CONCLUSIONS

EXECUTIVE SUMMARY

In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful to investigate the nature of and potential risks related to Croatia's external position, trade performance and competitiveness, as well as internal developments. To this end this In-Depth Review (IDR) provides an economic analysis of the country's macroeconomic and structural situation in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP), with a view to understanding whether imbalances exist. Croatia joined the EU on 1 July 2013 and this is its first IDR. The main observations and findings of this analysis are:

- **After an expansionary phase up to 2009, in which imbalances accumulated, Croatia is now experiencing a deep and prolonged downturn, in which a range of external and internal risks have come to the fore.** Delayed restructuring of the manufacturing sector and an inability to establish sizeable, competitive export industries beyond tourism limited Croatia's participation in regional trade integration during the boom years as a result of which it has remained one of the least open of the smaller EU member states with low relative income levels. A widening current account deficit was largely funded by the foreign parents of Croatian banks and by Foreign Direct Investment (FDI) into inward-oriented sectors of the Croatian economy. As the global financial crisis unfolded, capital inflows suddenly stopped in 2009. The impact on Croatia was severe: domestic demand rapidly contracted and the ensuing recession led to soaring unemployment. The country entered a long-drawn recession from which it has not yet recovered. Despite the reversal in the current account, vulnerabilities such as high external liabilities, uncompetitive exports, a corporate debt overhang and growing public sector indebtedness persist. Structural weaknesses have contributed to these imbalances, including a poor business environment and a malfunctioning labour market. State-owned enterprises still play a dominant role and are often highly indebted and weakly profitable. These factors also combine to lower potential growth, which hinders private sector balance sheet repair and increases the required fiscal consolidation effort.
- **External rebalancing is beset by important risks pending the reduction of Croatia's high foreign liabilities.** Domestic economic weakness reduces the affordability of foreign liabilities and limits the appeal of Croatia to lenders and existing investors in inward-oriented industries. The recession therefore increases Croatia's vulnerability to capital flow reversals. For 2014 public and private sector external re-financing needs are in excess of 20% of GDP. The high share of FDI in overall liabilities does reduce volatility to an extent, although it comprises a substantial portion of intra-company loans. Dramatically lowered import volumes have closed the current account, but the small surpluses forecast for 2014 and 2015 will not suffice to bring the negative net international investment position to a safer level.
- **Croatia's low competitiveness had been eroding export market shares even before the crisis.** Croatia has been and remains a comparatively expensive production location. After 2004, Croatia's export market shares started falling from their already low level. These losses have accelerated since the crisis, indicating the persistence of a substantial competitiveness gap. Export market share losses have been concentrated in goods exports, where labour cost levels stand out in regional comparison, whereas overall labour costs have grown moderately since 2009 in comparison with competitors. High costs combine with a wide range of non-cost-competitiveness deficiencies. One-off factors, including the restructuring of the shipbuilding and chemicals industries, have interacted with low overall competitiveness to generate a decline in goods exports in 2013.
- **Weaknesses in the labour market and in the wider business environment have amplified the impact of the crisis and prevent adjustment towards stronger, more sustainable growth and employment.** The employment rate in Croatia was consistently low throughout the past decade and, from 2010, has been the lowest out of the (now) EU28 countries. The protracted recession has pushed

the unemployment rate above 17% in 2013, a twofold increase since 2008, with young people and low-skilled workers particularly affected. Beyond cyclical developments, these dismal labour market outcomes are also partly related to aspects of underlying institutions and policy settings. The social protection system provides multiple avenues for early withdrawal from and discourages participation in the labour market. Obstacles in the business environment include a high regulatory burden, inefficiencies in the administration of construction permits and property registration, prolonged litigation and bankruptcy procedures, weak protection of investments, and high policy uncertainty.

- **The non-financial private sector, and in particular non-financial corporations, entered the crisis highly leveraged as a result of rapid credit growth in the preceding years.** Countercyclical monetary policy loosening and buffers in the financial system initially absorbed some of the shock. This deferred the onset of contractionary credit retrenchment and balance sheet repair in the non-financial corporate sector. But the high level of euroisation has limited the central bank's room for manoeuvre. Deleveraging pressures began to grow as of 2011 but refinancing by banks and foreign parent companies has on the whole remained available and the reduction in corporate sector indebtedness is proceeding at a rather slow pace. Many state-owned enterprises, in particular, appear to have comparatively high debt levels, especially in view of their overall weak profitability. Household balance sheets are also under pressure, notably as a result of labour market developments, but the sector's lower level of indebtedness limits vulnerabilities.
- **The largely foreign-owned banking system has shown resilience.** Previous macro-prudential measures helped to ensure that banks built significant capital and liquidity buffers, and both of these proved useful during the crisis. Still, the weak economy has started to interact with the banking sector, and non-performing loans (NPLs) to corporate borrowers have risen to high levels. Despite some recent signs of stabilisation, these developments will need to be closely monitored. The persistent weakness in the economy has also led to a reduced demand for credit from the private sector, and banks have compensated by increasing lending to public entities. A continuation of these trends would be problematic, however, in light of the high level of indebtedness of several SOEs.
- **Loose fiscal policies in the downturn have exerted sustained pressure on the general government deficit and debt.** The general government deficit averaged 6% of GDP in 2009-2013. Deficit trends and sizeable negative stock-flow adjustments have caused a sharp deterioration of Croatia's general government debt ratio, which had been comparable to those of regional peers before the crisis but has risen sharply to reach 64.9% of GDP at the end of 2013. Commission projections and sensitivity analysis indicate the need for significant additional consolidation efforts to curtail the deficit and prevent debt from rising unsustainably. The high foreign currency share and the relatively short average maturity of the debt, together with contingent fiscal liabilities arising in troubled state-owned enterprises, add to sovereign financing vulnerabilities.

The IDR also discusses the policy challenges stemming from these imbalances and what could be possible avenues for the way forward. A number of elements could be considered:

- **Greater sustainability of Croatia's external position is conditioned on improved cost and non-cost competitiveness and broadening exports beyond tourism.** This would be instrumental to attract substantial, high quality FDI and regenerate Croatia's industrial fabric to support rebalancing and lay the foundations for sustainable growth and the creation of jobs. These objectives can be further supported by efficient leverage of European Structural and Cohesion funds. In view of the high external liabilities, and the extent of foreign-currency denominated obligations of the financial, non-financial and public sectors, the maintenance of strong, stability-oriented macroeconomic policies is a strategic imperative.

- **The low activity and employment rates and the scale of the labour market adjustment arising from the decline of Croatia's manufacturing industries represent a major policy challenge.** A comprehensive response could involve carefully reconsidering, and, where necessary, adjusting a number of institutions and policies affecting labour market functioning. Building on reforms recently undertaken, there could be further scope to reduce inactivity traps, to make employment protection less onerous for businesses and to enhance the effectiveness and reach of Active Labour Market Policies. In view of the multiple and wide-ranging business environment challenges that hinder adjustment and constitute a barrier to investment and exports, there is scope for concerted improvements.
- **In view of private sector over-indebtedness, it would be important to ensure the necessary conditions for a smooth continuation of the deleveraging process, including through proper functioning of insolvency and debt-restructuring regimes.** Correctly functioning financial intermediation is also important, notably to ensure that credit is correctly allocated within the economy as deleveraging continues. It may be useful to monitor the increase in bank lending to SOEs.
- **Close monitoring and supervision of systemic banks will continue to be important, in cooperation with home country supervisors.** In this respect, the ongoing ECB comprehensive assessment exercise will include the four largest Croatian banks, through their respective parents. There is scope to consider complementing this with additional supervisory diagnostic steps from a Croatian perspective.
- **There is a pressing need for high-quality, structural fiscal consolidation measures.** Compliance with the targets contained in the excessive deficit procedure opened on 28 January, 2014 and thereafter with the requirements of the SGP would ensure that Croatia's debt is on the sustainable path. A number of supporting policies can be considered, including tax shifting towards less mobile factors, substantial reductions in subsidies to firms, and improved targeting of and administration of social benefits. Credible fiscal policy supported by fiscal institutions and rules, at all levels of government, will support sustained deficit and debt reductions.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its third Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

The AMR suggested the need to look more closely at whether Croatia is exhibiting macroeconomic imbalances of an external and internal nature, in the context of a contracting economy. On the external side, the AMR highlighted the high negative net international investment position and poor export performance, reflecting unfavourable product specialisation and geographic orientation. On the internal side, the AMR highlighted high private sector debt, increasing non-performing loans, deleveraging pressures, rising public debt and contingent fiscal liabilities, and weaknesses in the business environment, domestic competition and labour market. To this end this IDR provides an analysis of the Croatian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 first provides an overview the general macroeconomic developments, Section 3 looks more in detail into the main imbalances and risks. Section 4 discusses policy considerations.

2. MACROECONOMIC DEVELOPMENTS

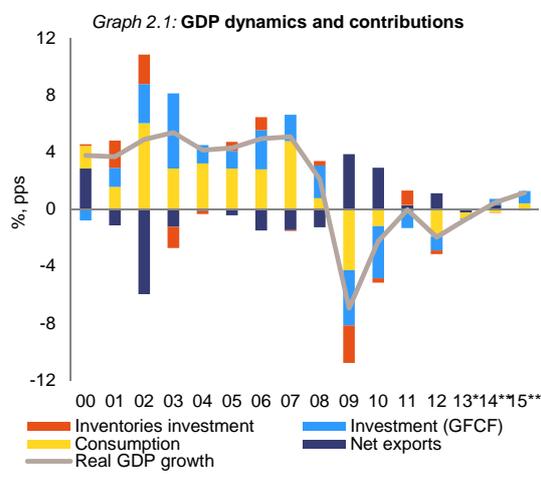
Real economy and price developments

Croatia has been mired in recession since 2009.

Five years of contraction have reduced Croatia's real GDP by nearly 12% and only a muted recovery is forecast for the coming two years. The 2008 global financial crisis brought to the surface deep-rooted structural problems, including uncompetitive export industries, a significant private debt overhang, a weak labour market and poor governance of public finances. These factors, which are accentuated by the unsupportive external environment, make economic adjustment slower and more costly and have thereby lengthened and deepened the recession. The obstacles to stronger, more sustainable growth are still firmly in place.

The decline in real GDP since 2008 is attributable to a sharp contraction in domestic demand, chiefly investment (Graph 2.1).

From a peak of 28% of GDP in 2008, investments have plummeted to 19%, a real decline entailing a particularly steep contraction of construction activity. Household consumption was hit by the rapidly deteriorating labour market, in combination with declining disposable income, worsening consumer sentiment and tighter bank lending conditions. Net trade made a positive contribution to GDP for most of the period as depressed household and corporate demand caused imports to contract more than exports. Low and declining labour utilisation (the lowest activity rate in the EU) and major disinvestment have dragged potential growth into negative territory.



Recent GDP developments underline the weakness of the economy.

Real GDP declined by 0.9% year-on-year in the first three quarters of 2013 following a 2% contraction a year earlier. Falling exports turned the contribution of net exports to growth negative amid continued subdued external demand, the on-going restructuring of the once important shipbuilding sector and trade diversion following the exit from the Central European Free Trade Agreement (CEFTA) area. Domestic demand continued to contract in 2013, but there were signs of a subdued rebound, possibly supported by positive impacts on household consumption and investment activity from EU entry.

Medium-term prospects are slightly more favourable.

A gradually improving external environment and access to significant European Structural and Cohesion Funds have the potential to lift economic activity.⁽¹⁾ The magnitude of this impulse will depend on the ability of the authorities to effectively address some of the long-standing structural bottlenecks to growth. According to the Commission Winter 2014 forecast (WF2014), real GDP growth of 0.5% in 2014 is set to be followed by a slight acceleration to 1.2% in 2015. The main risk to the country's short-term growth profile stems from the need for significant fiscal adjustment to avoid unsustainable debt trajectories and restore credibility.

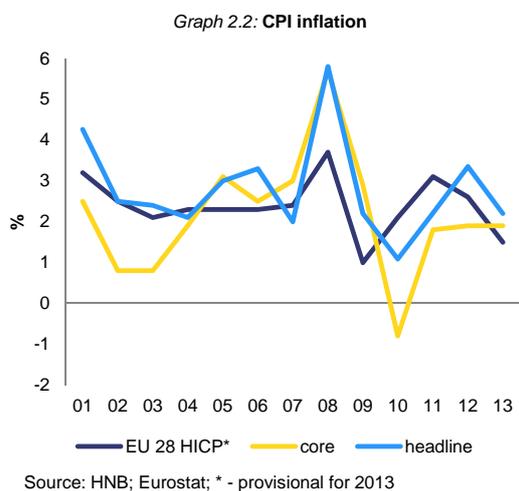
CPI inflation moderated significantly in the course of 2013.

This reflected weak demand that more than offset increases of indirect taxes and regulated prices. The average annual inflation slowed down to 2.2% in 2013 from 3.4% a year earlier, and is set to further decline in 2014, according to the WF2014 (Graph 2.2) in the absence of demand-side pressures despite new indirect tax increases.⁽²⁾ Core inflation has

⁽¹⁾ Economic modelling suggests structural and cohesion funds can yield sizeable, permanent GDP increases in new member states, although the impact hinges on the quality of implementation. Based on the 2007-2013 programme, Varga and In 't Veld (2009) estimate the impact to be in excess of 3 pp of GDP

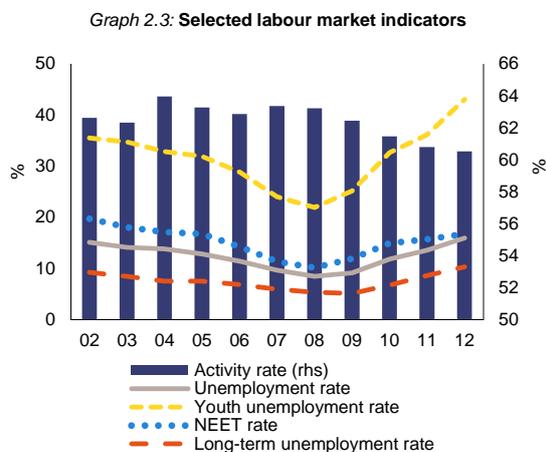
⁽²⁾ As of 2014, the increase of the intermediate VAT tax rate and of the excises on fuel and cigarettes are expected to add 0.3 pp to the annual CPI figure, according to the estimates of the central bank (assuming a 70% pass-through effect from the VAT increase)

stabilised at around 2% in the last few years, but has also started easing from the second half of 2013.



Labour market developments

Protracted recession has hit the labour market, pushing the unemployment rate above 17% in 2013, a twofold increase since 2008 (Graph 2.3). Hiring in the already large public sector and the slow process of restructuring of troubled state-owned companies averted an even steeper rise in joblessness. Cyclical developments have compounded long-existing structural deficiencies that are reflected in one of the lowest employment rates in the now EU 28 throughout the past decade. These structural elements include legislation that dampens job creation by raising implicit labour costs. The social protection system may also lead to inactivity traps and discourage labour market participation. At the same time, the high levels and long spells of long-term unemployment reduce the employability of the labour force even in times of rising activity, signalling skills gaps, hiring barriers or a combination of both. These impediments, if not addressed, risk impairing the transmission of future economic growth into job creation, keeping jobless rates elevated for longer and so accentuating labour market hysteresis.



The economic crisis has particularly affected young people and low-skilled workers. Youth unemployment (in the age group 19-24) has soared to around 50% in 2013, taking it to a scale that can have potentially lasting impacts on social cohesion. Structural features of the labour market lead to high fragmentation and significant hiring constraints, which disproportionately affect new entrants to the labour market. The increased use of fixed term contracts risks exacerbating labour market segmentation, particularly for young people. The unemployment rate among the low-skilled is also high, while the activity ratio in this segment remains low and on a declining trend, which is suggestive of skills mismatches. Budgets for youth employment promotion have been increased and some relevant measures have been implemented.

Rising unemployment is mirrored in worsening social indicators. The share of people at risk of poverty increased by 4 pp in four years, peaking at 21.3% in 2011. This is in contrast with the relative stability of this indicator in the EU, including Member States in Central and Eastern Europe, over the same period. Apart from the stronger worsening of the labour market situation in Croatia compared to the EU average, this divergence appears to be also the result of insufficient fiscal room for social policies to cushion the effect of the crisis. The social implications of job losses are also reflected in the high, and rising, share of people living in families with low work intensity (16.1% in 2012 versus 10.3% in the EU). Structural labour

market challenges and the low participation rate thus affect both economic and social outcomes.

Public finances

The pro-cyclical fiscal policies of the boom years have been followed by relatively loose policies in the downturn, exerting sustained pressure on the general government deficit.

Reform efforts to address structural weaknesses, mainly on the expenditure side, have remained timid. The debt level was increased by a further 4% of GDP in 2009-2011 by the assumption of obligations of state-owned companies, mostly related to activation of government credit guarantees that impact public finances negatively via the interest expenditure channel. These trends have contributed to more than double the nominal debt since the end of 2008, reaching 64.9% of GDP at the end of 2013.

After some consolidation measures in 2012, fiscal policy was loosened again in 2013.

The government twice revised its cash-based deficit target in 2013, the second time in November by 2 percentage points of GDP. Manifestly overoptimistic macroeconomic projections underlying the budget combined with unexpected revenue shortages (in VAT collection⁽³⁾ and corporate income tax collection)⁽⁴⁾ as well as settlements of debt arrears in the healthcare sector⁽⁵⁾ drove a substantial wedge between budget and outturns. The 2014 budget adopted in December 2013 does not reverse the public-finance trajectory. A revision is pending in the first quarter of the year to take into account the required fiscal adjustment in line with the recommendations issued by the Council in the context of the excessive deficit procedure on 28 January 2014.

Significant fiscal consolidation measures are required to safeguard the sustainability and

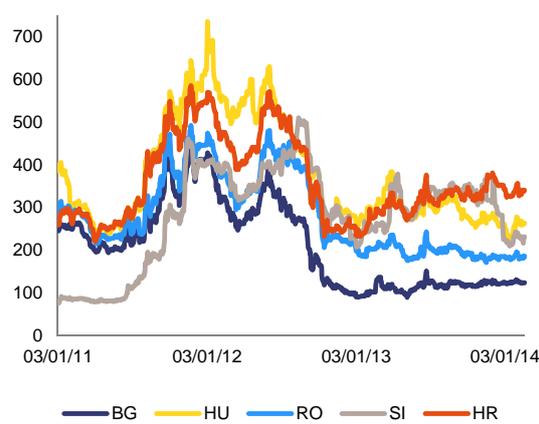
⁽³⁾ The change in the methodology for VAT collection after the EU accession (at the point of sale, rather than on import has resulted in a one-off revenue loss estimated at HRK 1.6bn (0.5% of GDP)

⁽⁴⁾ Corporate income tax revenues declined by HRK 1.4bn (or 0.4% of GDP) year-on-year in January-November, as some companies tried to benefit from the tax break introduced by the government.

⁽⁵⁾ This expenditure increases the deficit on a cash basis by 1 percentage point of GDP, but on an accrual basis it is expected to be deficit neutral as these arrears have been already recorded in deficit of previous years under the ESA95 methodology.

stability of Croatia's public debt. According to the Commission's latest forecast, on current trends, in the absence of additional measures, Croatia would not be able to curb the upward public debt dynamics (see Box 3.5 in Section 3.2.) on debt sustainability analysis). High domestic bank liquidity, supported by the central bank's policies, is currently central to the uninterrupted financing of the rising needs of the state although the authorities have continued to tap international financial markets. Croatia placed two bonds on the US market in 2013, albeit at high, and rising, costs (Graph 2.4).⁽⁶⁾ Apart from the steep growth in the public debt, contingent liabilities stemming from state guarantees for loans to public companies are also a cause of concern in view of their still elevated levels and the track record of activation in recent years.

Graph 2.4: 5-year CDS USD



Source: Bloomberg

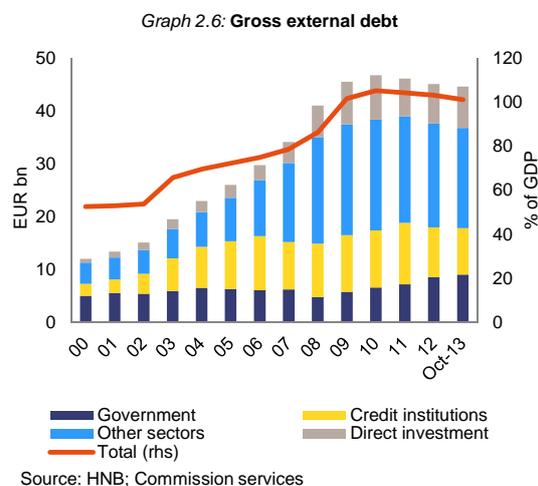
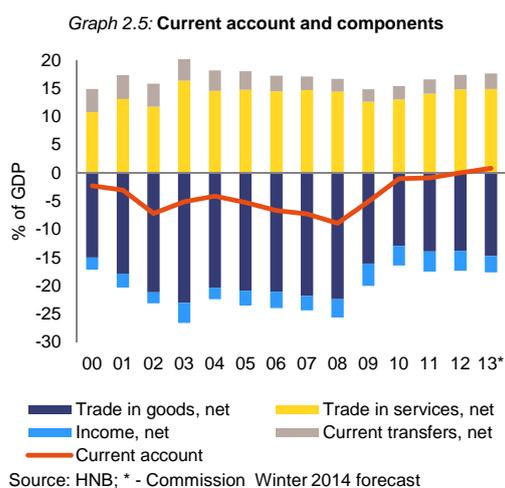
External sector

The crisis has induced an abrupt swing from a current account deficit of close to 9% of GDP in 2008 to a surplus of around 1% of GDP in 2013

(Graph 2.5). Depressed household and investment demand caused imports to fall further than exports. The underlying merchandise export performance remained constrained by the unfavourable external environment, the low competitiveness of domestic

⁽⁶⁾ Croatia was downgraded to 'speculative' rating by the major three credit rating agencies in less than a year. It is now rated two notches below investment rating by S&P at BB, and one notch, BB+ and Ba1, by respectively Fitch and Moody's. In February 2014, Fitch has changed its outlook on the rating to 'negative' from 'stable', citing weak growth prospects and deteriorating fiscal position.

goods and the restructuring of key export sectors (notably shipbuilding). After a sharp decline in 2009, exports of services, especially tourism, have recovered well, benefiting from positive global trends as well as diversion of tourist flows arising from political instability in North Africa and the Middle East.



On the financing side, net FDI declined sharply from 8.9% of GDP in 2008 to around 2.4% in 2012. The investment potential in the banking and real estate sectors has been largely exhausted and other sectors have not established investor-appeal, despite the accession to the EU, so a further decline was recorded in 2013. Worsening macroeconomic prospects, the poor business climate, restrictive labour legislation, and the high degree of policy uncertainty also deter investors.

Significant government borrowing counteracted bank and corporate deleveraging to maintain the country's gross external debt above 100% of GDP (Graph 2.6). High external financing needs make the country vulnerable to external shocks and exchange rate risks. The latter seems to be mitigated by the central bank's focus on maintaining a stable exchange rate against the euro and a stable international reserve stock, covering more than 8 months of (albeit cyclically low) imports at the end of 2013.

Financial sector

Problems in the real economy are denting banking sector performance. Depressed economic activity has translated into weak credit demand resulting in contracting credit to both households and corporates since mid-2012. Supply factors also played a role in the credit contraction, as lenders focused on limiting risks and cleaning rapidly deteriorating balance sheets, which may hinder investment in the real sector. The share of non-performing loans (NPLs) to the private sector stood at 15.6% at the end of 2013 chiefly due to NPLs in excess of 28% in the corporate segment. Households have also fallen behind in their debt-servicing, although at a more gradual pace. Households are particularly affected by unemployment trends and adverse exchange rate effects related to Swiss franc-denominated loans. Interest rates on such loans are subject to a cap from 2014. While these developments are intended to make repayments more affordable, they dent bank profitability and may distort incentives. Capital buffers nevertheless remain sufficient and the sector maintains an adequate level of liquidity. The central bank has macro-prudential policies in place to mitigate the build-up of new risks. The dominant foreign ownership of banks reduces potential contingent liabilities for the sovereign. Feedback loops with the real and fiscal sectors could, however, intensify, due to the banks' increasing holdings of government securities and lending to state-owned enterprises.

Table 2.1:

Key economic, financial and social indicators - Croatia	2007	2008	2009	2010	2011	2012	Forecast		
							2013	2014	2015
Real GDP (yoy)	5.1	2.1	-6.9	-2.3	0.0	-2.0	-0.7	0.5	1.2
Private consumption (yoy)	6.5	1.4	-7.5	-1.3	0.2	-2.9	-0.7	-0.5	0.5
Public consumption (yoy)	5.0	-0.2	0.4	-2.1	-0.6	-0.8	0.0	0.3	0.5
Gross fixed capital formation (yoy)	7.1	8.7	-14.2	-15.0	-6.4	-4.6	-0.3	2.0	4.0
Exports of goods and services (yoy)	3.7	1.7	-16.2	4.8	2.0	0.4	-1.3	2.5	3.0
Imports of goods and services (yoy)	6.1	4.0	-21.4	-2.8	1.3	-2.1	-0.7	1.7	3.2
Output gap	4.9	5.1	-2.2	-3.4	-1.9	-2.4	-2.2	-1.5	-0.9
Contribution to GDP growth:									
Domestic demand (yoy)	6.6	3.1	-8.2	-5.0	-1.3	-2.9	-0.5	0.2	1.2
Inventories (yoy)	-0.1	0.3	-2.6	-0.3	1.0	-0.3	0.0	0.0	0.0
Net exports (yoy)	-1.5	-1.3	3.9	2.9	0.3	1.1	-0.3	0.3	0.0
Current account balance BoP (% of GDP)	-7.2	-9.0	-5.2	-1.3	-0.9	-0.1	0.8	1.3	0.9
Trade balance (% of GDP), BoP	-7.0	-8.0	-3.4	0.0	0.1	0.9	0.5	1.1	1.2
Terms of trade of goods and services (yoy)	1.1	1.1	1.3	0.4	0.7	0.0	0.7	1.0	0.5
Net international investment position (% of GDP)	-92.8	-75.3	-87.8	-96.3	-92.0	-89.4	.	.	.
Net external debt (% of GDP)	37.1	47.3	58.3	62.4	61.9	59.8	.	.	.
Gross external debt (% of GDP)	77.1	86.3	100.6	105.5	104.5	102.4	.	.	.
Private credit flow (consolidated, % of GDP)	17.8	17.6	5.3	8.2	-0.1	-2.1	.	.	.
Private sector debt, consolidated (% of GDP)	103.8	117.3	128.0	137.0	134.2	132.0	.	.	.
Deflated house price index (yoy)	8.8	-2.0	-6.7	-9.5	-6.1	-2.4	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	24.1	-9.7	5.0	4.7	2.0	0.9	.	.	.
Employment, persons (yoy)	3.5	1.1	-1.8	-5.1	-2.3	-3.9	-2.5	-0.2	0.5
Unemployment rate	9.6	8.4	9.1	11.8	13.5	15.9	17.6	17.6	17.2
Long-term unemployment rate (% of active population)	5.9	5.3	5.1	6.7	8.6	10.3	.	.	.
Youth unemployment rate (% of active population in the same age group)	24.0	21.9	25.1	32.6	36.1	43.0	49.9	.	.
Activity rate (15-64 years)	63.4	63.2	62.4	61.4	60.8	60.5	.	.	.
Young people not in employment, education or training (% of total population)	11.3	10.1	11.9	14.9	15.7	16.7	.	.	.
People at-risk poverty or social exclusion (% total population)	.	.	.	30.7	32.3	32.3	.	.	.
At-risk poverty rate (% of total population)	18.0	17.3	17.9	20.5	21.3	20.5	.	.	.
Severe material deprivation rate (% of total population)	.	.	.	14.3	14.8	15.4	.	.	.
Persons living in households with very low work intensity (% of total population)	.	.	.	13.7	15.4	16.2	.	.	.
GDP deflator (yoy)	4.1	5.7	2.9	0.8	2.0	2.0	1.9	1.4	1.8
Harmonised index of consumer prices (yoy)	2.7	5.8	2.2	1.1	2.2	3.4	2.3	1.3	1.5
Nominal compensation per employee (yoy)	5.7	6.9	1.0	1.9	3.0	3.2	2.2	1.0	1.8
Labour Productivity (real, person employed, yoy)	1.5	1.0	-5.2	3.0	2.4	2.0	.	.	.
Unit labour costs (whole economy, yoy)	4.1	5.8	6.6	-1.1	0.7	1.2	0.4	0.3	1.1
Real unit labour costs (yoy)	0.0	0.1	3.6	-1.9	-1.3	-0.8	-1.4	-1.1	-0.6
REER (ULC, yoy)	2.8	4.1	1.6	-2.1	-1.7	-3.4	0.0	-0.4	-0.1
REER (HICP, yoy)	0.4	3.9	1.5	-3.4	-2.7	-2.5	1.3	0.5	-0.6
General government balance (% of GDP)	.	.	-5.3	-6.4	-7.8	-5.0	-6.0	-5.4	-4.8
Structural budget balance (% of GDP)	.	.	-4.4	-5.0	-7.0	-4.0	-4.7	-5.7	-5.0
General government gross debt (% of GDP)	.	.	36.6	44.9	51.6	55.5	64.9	67.4	68.7

Source: Eurostat, ECB, AMECO

3. IMBALANCES AND RISKS

3.1. EXTERNAL SECTOR ANALYSIS AND COMPETITIVENESS ISSUES

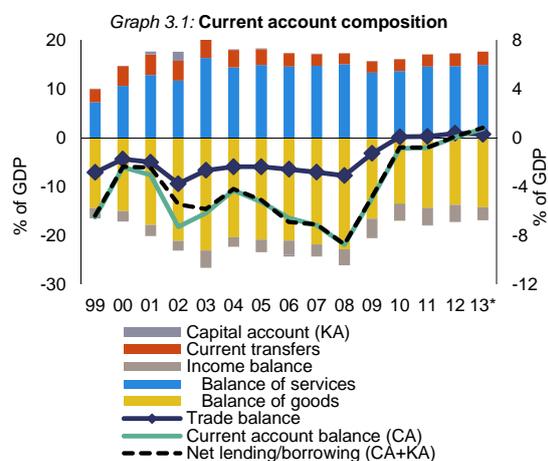
Strong capital inflows up to the 2008 global financial crisis were to a large extent directed to and channelled through Croatia's banking sector. As in regional peer economies, these inflows were the driving force of Croatia's growth. However, the sizeable foreign direct investment (FDI) inflows largely by-passed the tradable sector. In fuelling domestic demand, capital inflows widened the current account deficit, contributing to the build-up of internal and external debt and price pressures. By 2008, Croatia had accrued gross external debt in excess of 100% of GDP but had invested only a small part in productive domestic assets and economic transformation. Consequently, the domestic economy is now in a period of forced balance sheet repair which weighs on growth (see Section 3.2.).

Subsection 3.1.1. presents the dynamics and the financing of the current account and the net international investment position (NIIP) and discusses external vulnerabilities. Subsection 3.1.2. explores the underlying export performance, which is very weak for merchandise, and examines the distinct roles of cost-competitiveness, the labour market, the business environment and FDI.

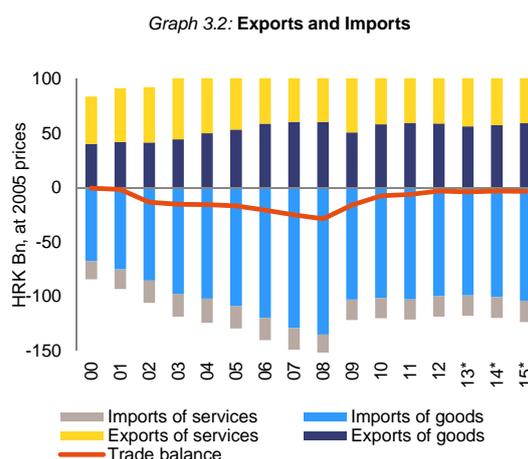
3.1.1. External sector trends

The expansionary phase

The converging Croatian economy ran sizeable current account deficits from 2000 to 2008. Consumption and investment exceeded domestic production and savings, resulting in an average current account deficit of 5.5% of GDP over the period. Surging investment pushed the deficit close to 9% of GDP in 2008 (see Graph 3.1). The negative trade balance, reflecting a strong deficit in goods trade, accounted for the bulk of the deficit. This was partially compensated by the surplus from trade in services arising from the large tourist sector (see Graph 3.2).

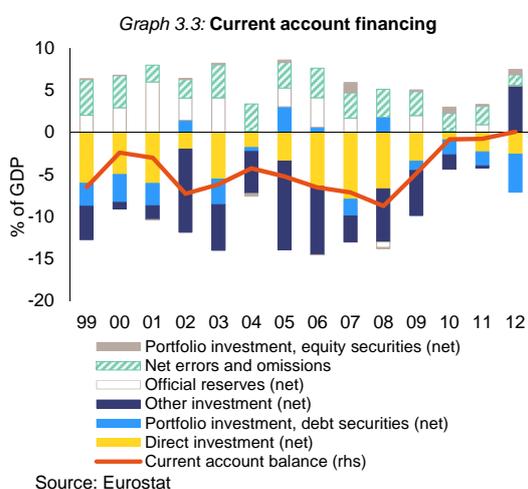


Source: Eurostat; Commission services; * estimate



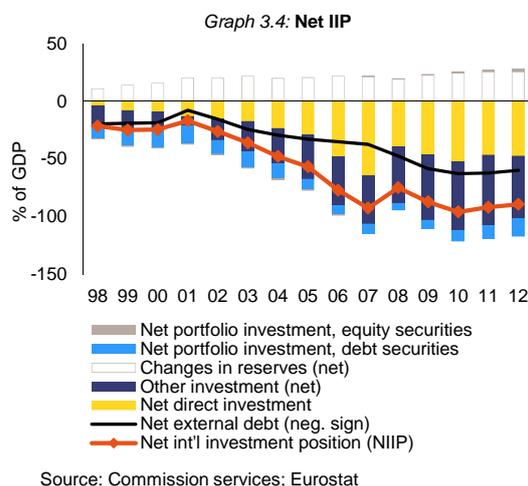
Source: Eurostat; Commission services; * - forecast

Large deficits were mainly financed by robust FDI inflows. Annual average net FDI amounted to nearly 5% of GDP in the period 2000-2008, covering approximately 90% of the current account deficit. Privatisations and follow-up investments by parent companies were key determinants of FDI (see Graph 3.3). Other investments, principally long-term loans to corporates and foreign banks' deposits, were of a broadly equal magnitude to the FDI flows in the years preceding the crisis.



The economy's stock of foreign liabilities grew more than five-fold between 2000 and 2007.

Private capital inflows, together with negative valuation effects due to rapidly growing asset prices, contributed to a surge in the NIIP from 17% of GDP at the end of 2001 to 93% at the end of 2007 (Graph 3.4).⁽⁷⁾ These financing flows, while increasing gross external debt, also enabled significant accumulation of international reserves.

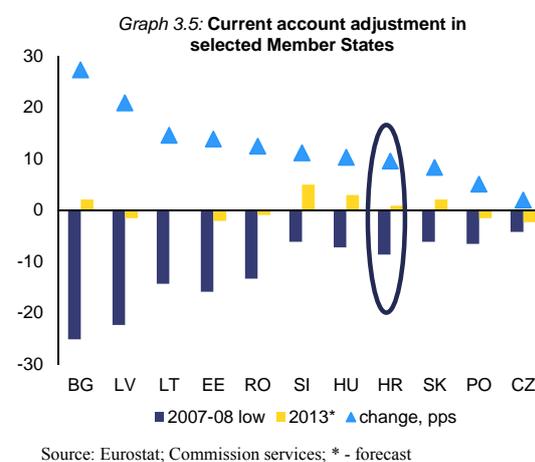


The prolonged downturn

From a deficit of 8.8% of GDP in 2008, the current account swung into a small surplus in 2013. Falling domestic demand through the long

⁽⁷⁾ The discontinuity in 2008 arises due to a one-off positive re-valuation of the FDI stock

recession has caused an abrupt fall in imports. The drop in imports of capital goods was particularly pronounced, mirroring very weak investment activity amid corporate balance sheet repair (see also Section 3.2.). Goods exports fell in absolute terms over the period, but exports of services rebounded due to tourism, which benefited from diversion of tourist flows from North Africa and the Middle East. Despite the severity of the downturn in Croatia, the current account swing has been of an average magnitude for the region (Graph 3.5).



The downturn transformed the external financing of the economy. Annual average net FDI flows plummeted to 2% of GDP in the 2010-13 period, from around 6% of GDP between 1999 and 2008. An even stronger contraction was recorded in long-term borrowing reflecting ongoing deleveraging by banks and corporates (see also Section 3.2.)⁽⁸⁾ A change in the financing patterns of businesses, from foreign to domestic sources, was also evident. At the same time, portfolio investments increased as a result of foreign borrowing by the state.

The headline current account is expected to remain in surplus in the near future. Investment is set to remain subdued and household demand will be under pressure from negative labour market developments. At the same time, the gradually improving external outlook and potential efficiency gains as a result of the industrial

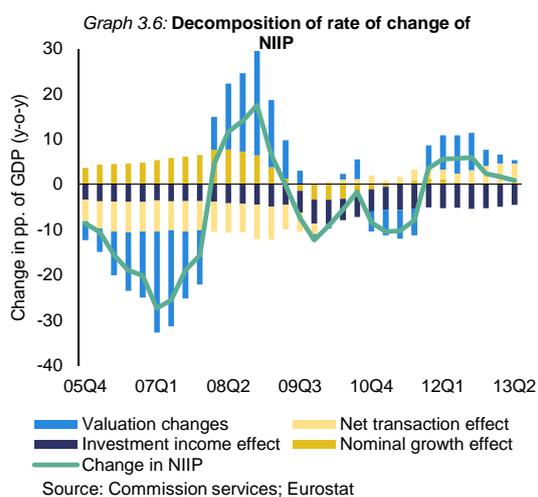
⁽⁸⁾ In 2012 alone, "other investments" recorded net outflows of some 5.5% of GDP that arose from both debt repayments by companies and withdrawal of deposits by banks.

restructuring taking place in the last few years in legacy industries such as shipbuilding and chemicals may stem the decline in exports.

Vulnerabilities

The closing of the current account has not improved Croatia's external liability position.

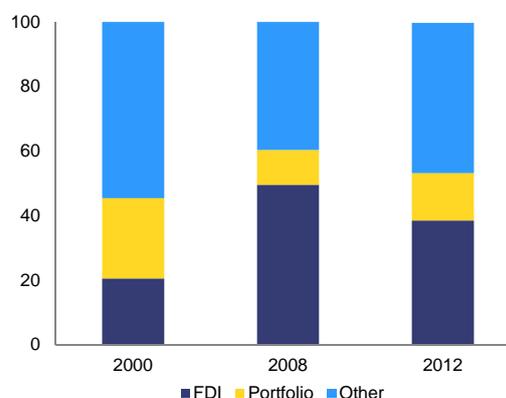
The NIIP is gently reducing from around 90% of GDP as the result of valuation changes and two opposing trends in transactions: a gradual reduction in the stock of corporate and banking sector liabilities and an increase in portfolio borrowing, in particular by the state (Graph 3.6). This relative stability belies significant refinancing pressures for banks and corporates and mounting refinancing risks for the state. Absent strong nominal GDP growth, which would accelerate private balance sheet repair, curtail sovereign borrowing needs and ease the external debt burden, current trends in transactions and valuations are not going to substantially reduce the NIIP.



The high stock of FDI mitigates Croatia's exposure to sudden reversals in financial flows.

Direct investments accounted for 50% of foreign liabilities at the end of 2008 (see Graph 3.7). The share of direct investments held by non-residents has since slightly receded due to valuation effects. On the asset side, international reserves have been on an upward trend continuing through the recession period when private capital inflows abated. Sizeable assets accumulated in the non-banking financial sector, in particular in pension funds, are set to play an increasing role in NIIP developments.

Graph 3.7: Gross IIP - liability-side breakdown
% of total

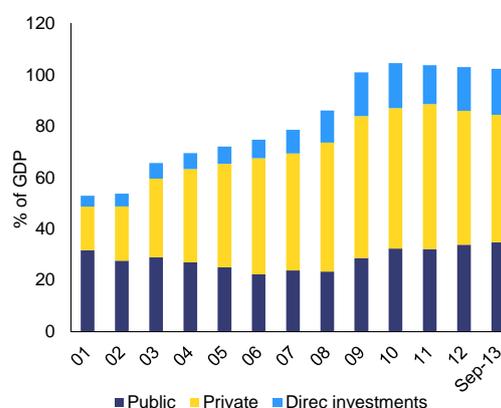


Source: Commission services; HNB

However, the high level of gross external debt requires close monitoring.

Reduced external exposure of financial institutions and public companies has brought gross external debt slightly below the 2011 peak level of 105% of GDP (see Graph 3.8).⁽⁹⁾ These trends would have brought about a steeper decline, were it not for rising foreign borrowing by the sovereign and increasing cross-border, inter-company lending. Since the start of the crisis, the share of public external debt rose by 7 percentage points to reach 34% of total external debt at the end of October 2013. A commensurate drop was recorded in the share of private foreign debt (excluding inter-company lending) in line with the gradual deleveraging.

Graph 3.8: Gross external debt per sector



Source: Commission services; HNB

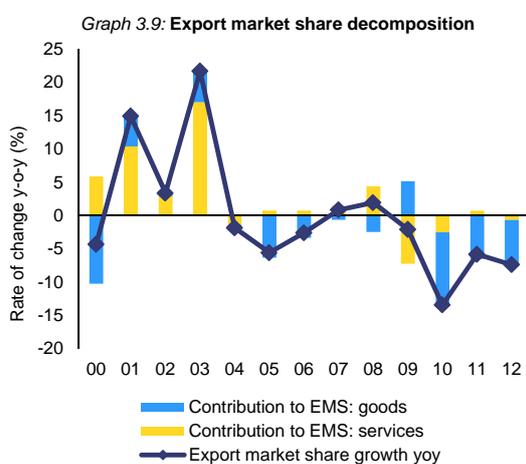
⁽⁹⁾ A shift in financing from foreign to domestic sources is the underlying factor for the fall in the stock of gross external debt of public companies.

High external repayment needs remain an important vulnerability. Projected gross external debt repayments for 2014 exceed 20% of GDP, predominantly falling on the private sector. Intercompany loans and financing from parent banks, i.e. two types of debt that are usually more easily re-financeable, account for a considerable portion of due debt for corporates and banks (close to 12% of GDP). Nevertheless, a worsening in external financing conditions such as the emergence of liquidity constraints or a rise in borrowing costs, for instance through changes in risk premia, could affect refinancing possibilities. As for the sovereign, 2014 foreign debt re-financing needs have been covered to some extent, although at high borrowing costs, thus contributing to a steep increase of the interest payment bill and a deterioration of the fiscal position.

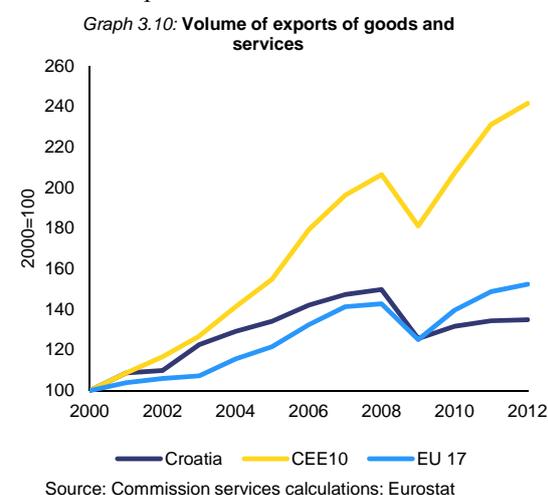
3.1.2. External Competitiveness

Export performance

The sudden halt of private capital inflows with the 2008 global financial crisis brought to the surface Croatia's weak competitiveness. High investment (and borrowing) rates before the crisis, including significant FDI, did not result in strong export performance. Croatia has been losing export market shares since 2004 and there has been a particular intensification in these losses since 2008 (see Graph 3.9, note the large relative increases in the first years start from a very low base). Greater sustainability of Croatia's external position is conditioned on improved competitiveness and ability to export.



Croatia's export performance lags significantly behind that of its peers. All new Member States from Central and Eastern Europe (CEE10) register higher export growth and latterly even the more mature euro area economy is outstripping Croatia (Graph 3.10).⁽¹⁰⁾ The divergence in trade performance becomes particularly visible in the post-2008 period. While exports of the CEE10 (with the exception of Slovenia) managed to recover strongly from the one-off slump in 2009, Croatia's volume of exports was 10% below its 2008 peak level in 2012.



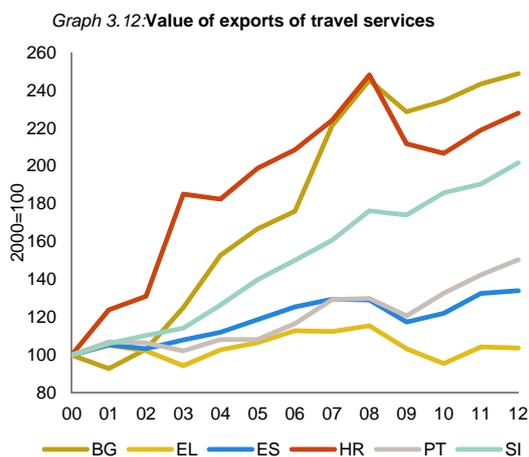
Weak goods exports are central to Croatia's poor overall export performance. This is evident from Graph 3.10 above and examined in greater detail in Box 3.1. In the last 13 years, goods exports have remained stable at 22% of GDP. This is in marked contrast with the expansion recorded in CEE10 (from 46% of GDP in 2000 to 62% of GDP in 2012). Goods account for around half of Croatia's exports, with sizeable shares for machinery, electrical, chemical and mineral products.

One-off factors explain some of the more recent declines. As described in Box 3.1, specific industries as well as some export markets account for the bulk of the most recent declines. The shipbuilding sector, Croatia's once leading export industry, is currently in restructuring. The exit

⁽¹⁰⁾ These include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

from the CEFTA area implies reduced access to some regional markets, in particular Bosnia and Herzegovina, Croatia's second largest export market and one in which Croatian producers enjoyed competitive advantages.⁽¹¹⁾ **The tourism sector has shown some resilience but this has not sufficed to stem the decline in overall exports.** Tourism already accounts for a third of Croatia's exports (and two thirds of services exports).⁽¹²⁾ Services exports, led by tourism, fared better than goods exports over the past 13 years period (see Graph 3.12), but also underperformed when compared with new Member States, especially during the post-boom cycle.

succeeded in maintaining external sustainability after early success in the tourism market.



Source: Eurostat; Commission services calculations

Growth in tourism will become challenging to maintain in the longer term. Substantial development beyond summer tourism could only be pursued with significant investment. The absence of seasonal complementarities with other industries causes significant volatility in the labour market. To lengthen the season and attract higher-spending tourists, the sector's competitiveness would also need to be improved across several dimensions (see Heatmap), a process that realistically can only be achieved with sustained effort over long periods. Regional peers with similar natural endowments have not always

⁽¹¹⁾ Holzner, M. (2013), "Impact of Croatian EU Accession on Regional Trade Patterns", wiiw Policy Note No. 10, June 2013

⁽¹²⁾ Germany is the top market and has remained strong, with tourists from Germany accounting for almost a quarter of overnight stays.

Heatmap: Tourism Ratings Across Five Dimensions of Competitiveness

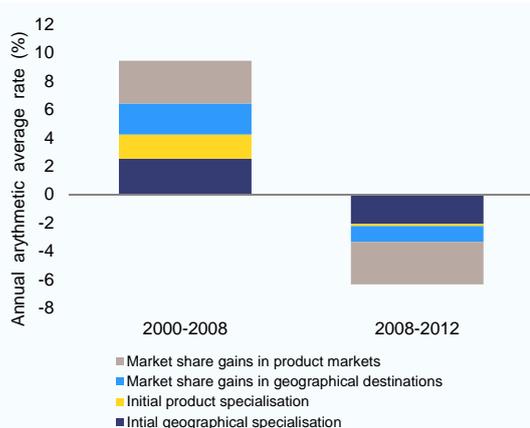
	HR	EL	IT	CY	MT	PT	ES
Business environment	4.43	4.65	4.76	4.89	5.06	4.78	5.3
Travel & tourism regulatory framework	4.99	5.02	4.9	5.35	5.47	5.42	5.48
Human, cultural and natural resources	4.37	4.58	5.05	4.27	4.22	4.84	5.36
Policy, rules and regulations	4.24	4.22	4.21	4.33	4.57	4.72	4.52
Price competitiveness	4.01	3.59	3.4	4.21	4.32	4.04	4.11

Source: WEF Travel and Tourism Competitiveness Report 2013

Box 3.1: Croatia's declining goods exports

This box examines the trends in market shares by sectoral and geographic destination of goods exports. Croatia was able to capitalise on its initial specialisation and increase its market shares in the period 2000-2008 as a result of high growth in 2001 and 2003. This situation was reversed in 2008-2010, when initial geographic specialisation and losses in specific sector market shares dragged down export performance (see Graph 1). ⁽¹⁾ Indicatively, two thirds of the decline can be attributed to losses in competitiveness.

Graph 1: Geographical and sectoral decomposition of goods export market shares



Source: COMTRADE data (HS 1992 commodity classification); Commission services calculations

i. Proximity to and therefore reliance on the depressed Italian, Bosnian and Slovenian markets were a significant drag on exports in 2008-2012 (see Graph 2a). This was compounded by market share losses in Italy and Bosnia. There were no dynamic markets among Croatia's top-10 export destinations.

ii. Heavy reliance on depressed sectors including machinery, metals and vessels undermined overall export performance in 2008-2012 (see Graph 2b). This was coupled with loss of competitiveness in moderately more dynamic sectors such as foodstuffs and minerals. The drag from these trends far exceeded the isolated gains in the chemicals and agriculture sectors.

For 2013, the available data point to an absolute decline in nominal goods exports of the order of 6%. ⁽²⁾ Two thirds of this decline is attributable to 'other transport equipment' (mainly ships) – a sector that has registered a cumulative drop of around 80% over two years. The other major weaknesses appear in sugar, metal ores, petrol, fertilisers, telecommunications equipment, electrical machinery, apparel and – carried forward from 2012 – plastics. Strong growth was only registered in the export of electric current, which may be weather-related. The concentration of weak performance in a few sectors suggests specific supply-side dislocations are playing an important role, compounding the overall competitiveness deficit.

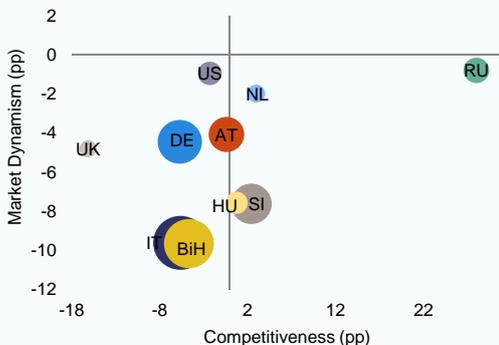
⁽¹⁾ This exposition attributes the change in export market shares to dynamism (growth or decline) of geographic and product markets and residuals that reflect market share gains (or losses) in those geographic or product markets. For methodology, see ch. 3, QREA 2/2012.

⁽²⁾ According to Eurostat data to October 2013 for intra and extra EU goods exports in Euros. The data needed to calculate market shares are not yet available for 2013.

(Continued on the next page)

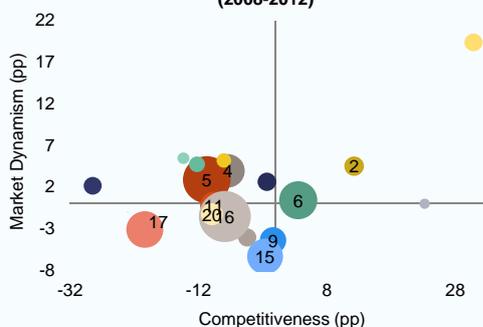
Box (continued)

Graph 2a: Dynamism and competitiveness of top-10 goods export destinations(2008-2012)



Source: COMTRADE; Commission services; Bubble size varies directly with destinations's share in Croatia's goods exports

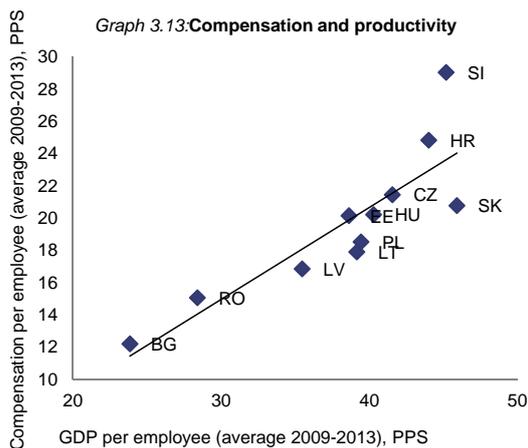
Graph 2b: Dynamism and competitiveness of top-10 goods export destinations (2008-2012)



Source: COMTRADE; Commission services; Bubble size varies directly with sectors's share in Croatia's goods exports; Key: 2=agriculture; 4=foodstuff & tobacco; 5=mineral products; 6=chemical products; 9=wood&cork; 11=textiles; 15=metals; 16=machinery & electrical; 17=vehicles; 20=miscellaneous

Underlying competitiveness position

Croatia has been, and remains, a comparatively expensive production location. Croatian labour costs already exceeded those of most regional competitors in 2000. Along with Slovenia, Croatia has sustained relative labour cost levels that more than proportionately reflected higher labour productivity (Graph 3.13).

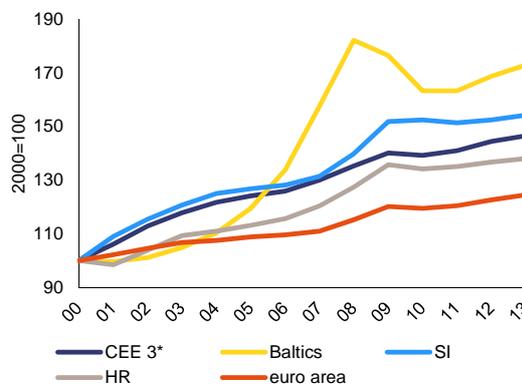


Source: Commission services (AMECO)

Nominal unit labour costs (ULC) have evolved moderately, albeit from a high starting point. Since 2000, wage and productivity developments have yielded ULC growth slightly higher than in the euro area, but lower than in the faster-growing

competitors in Central and Eastern Europe (Graph 3.14).⁽¹³⁾

Graph 3.14: Nominal ULC

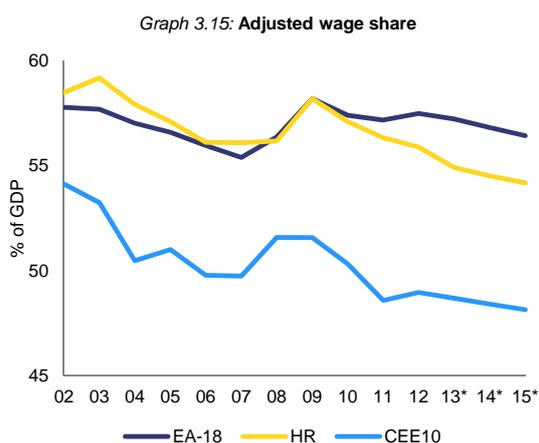


Source: Commission services calculations; Eurostat; * - SK, CZ, HU

Overall, Croatia's uncompetitive positioning has remained largely unimproved. Nominal ULC and productivity developments have resulted in a declining wage share in both Croatia and the

⁽¹³⁾ Croatia may however have achieved less quality improvement in its exports to compensate cost increases. Benkovskis and Woerz (2012) find that loss in price/cost competitiveness in 1999-2011 for the CEE10 was more than offset by gains in non-price competitiveness, in particular due to improvements in quality (physical and intangible). Unlike in the CEE10, quality gains does not seem to have played a significant role for Croatia's manufacturer exports in 2000-2007, as found out by Stojcic et al (2012).

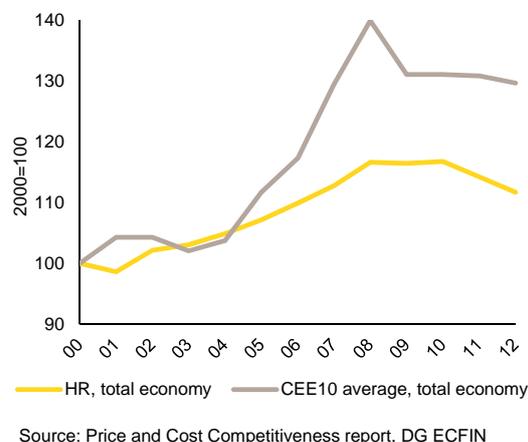
CEE10 (see Graph 3.15). The wage share in Croatia remains rather close to that of the euro area overall, whereas its industrial structure differs markedly and its level of human capital and human capital utilisation is lower.



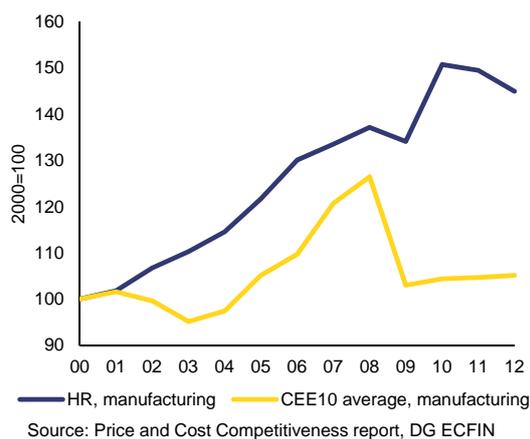
The damage to cost-competitiveness seems to have been most pronounced in the manufacturing sector (Graph 3.17). There was a steep worsening of the real effective exchange rate (REER) based on ULC dynamics in manufacturing. This contrasts sharply with the usual pattern of declining manufacturing ULC observed in competing economies, where productivity gains play a role, and in fast-adjusting economies. Relatively high labour cost and low productivity levels may account for some of the poor goods export performance detailed above and in Box 3.1.

There are signs that cost adjustment is beginning to take place. Over time, these reductions may facilitate the reorientation of the economy towards external demand. However, export market share losses have been gathering pace even since the turnaround in cost-competitiveness trends. This may reflect the degree of remaining cost misalignment and may also indicate impacts from additional, non-cost-competitiveness factors.

Graph 3.16: ULC-deflated REER



Graph 3.17: REER deflated for nominal wage costs in manufacturing



The role of the labour market

Croatia has recorded the lowest employment rates in the EU since 2010. Even during the expansionary phase of the cycle, the employment rate (for age 15-64) never exceeded 58% and was always one of the four lowest among the (now) EU28; by 2012 the employment rate had fallen to 52.4%. Unemployment rates dipped into single digits only briefly during the boom years. Lack of competitiveness constrained hiring in export-oriented industries, typically an engine of job creation in the region. Unsurprisingly, the large employment gap widened further during the recession. In addition to the social consequences, low employment impinges on fiscal sustainability and, through potential output, on overall external sustainability.

The large public sector has exerted upward pressure in economy-wide wage levels. There were significant increases in the wages of public sector employees between 2007 and 2009. Compensation in the sector was additionally raised by significant increases in bonuses and other payments, which were partly reversed in mid-2009, when the authorities scrapped a 6% increase in wages in the public administration that had been introduced at the beginning of the year. This was followed in 2013 by a 3% cut in the public wage bill. In the business economy, labour costs have followed the economic cycle somewhat more closely, declining from 35% of the EU average in 2008 to reach 30% in 2012. ⁽¹⁴⁾

Significant jobs losses have been recorded in sectors exposed to actual or potential competition from abroad. Whereas job destruction was largely the consequence of the downsizing of some non-tradable sectors to more sustainable levels (e.g. construction), sharp job losses were also recorded in manufacturing. This indicates clear weaknesses in sectors that are or could potentially be in competition with abroad and adds to the challenges of fostering a more competitive economy.

The institutions underpinning labour market performance exhibit a number of shortcomings. The social protection system favours and provides multiple avenues for early withdrawal from the labour market and discourages labour market participation in the low-wage sector by putting a high floor under the reservation wages of certain categories of beneficiaries. Unemployment benefit replacement rates for are low, especially after 3 months, and duration is not very long. However, transitions into work, even into low-paid work, may still be disincentivised as a result of the immediate discontinuation of social assistance above low earned-income thresholds. ⁽¹⁵⁾ Adjustment difficulties, skills gaps and mismatches in the labour market stand out as major bottlenecks. Current employment protection

legislation, although not very stringent in EU comparison ⁽¹⁶⁾, may nevertheless hinder job creation, given Croatia's current stage of development and mounting adjustment needs (see Box 3.2.) although this may be addressed by on-going reform efforts. Furthermore, the de jure flexibility of employment legislation can be undermined by legal uncertainty and court delays. Finally, low recorded employment may also reflect a sizeable grey economy ⁽¹⁷⁾, which is also a feature of neighbouring countries and of economies dominated by seasonal work.

The role of the business environment and product markets

Croatia's business environment is marked by multiple shortcomings that may dent its cost and non-cost competitiveness as well as the performance of the domestically-oriented economy. Among these, a high regulatory burden, inefficiencies in the administration of construction permits and property registration, poor justice system functioning, prolonged litigation and bankruptcy procedures ⁽¹⁸⁾, weak protection of investments, high policy uncertainty ⁽¹⁹⁾, weak corporate governance, insufficient know-how in marketing local produce stand out as significant bottlenecks. ⁽²⁰⁾ Several surveys place the country amongst the worst EU performers in terms of business climate and competitiveness (see Graphs 3.18-3.20). While structural features such as these tend to exhibit significant persistence, they may interact with investment, particularly FDI, to explain worsening export performance.

⁽¹⁶⁾ Legislation in the EU as a whole is generally stricter than in other OECD countries.

⁽¹⁷⁾ See Schneider (2013)

⁽¹⁸⁾ Public administration as a whole scores relatively poorly according to the Worldwide Governance Indicators produced by the World Bank.

⁽¹⁹⁾ Policy uncertainty reflects numerous legislative amendments that are sometimes of a reverse nature. For example the VAT for the tourist sector was reduced from 25% to 10% as of 2013, but was then increased to 13% as of 2014. On a related note, a pre-bankruptcy settlement legislation adopted in October 2012 underwent several changes in less than a year and a new amendments is likely

⁽²⁰⁾ This list is not exhaustive. For instance, while paying taxes does not register as a problem overall, there are specific issues affecting SMEs and the existence of around 550 parafiscal levies (cut from around 600 in 2013) represents a significant burden for businesses (the scrapping of 50 of these is estimated to have reduced administrative burden by 0.1% of GDP).

⁽¹⁴⁾ Eurostat data

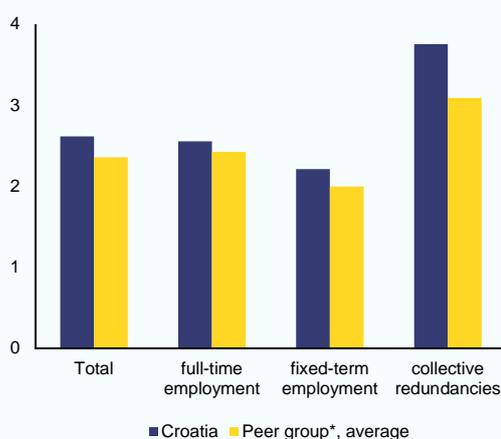
⁽¹⁵⁾ In addition, the attribution of the different social benefits is scattered among different services with little or no communication between them – including also local government, which can provide benefits on their own – and between the social welfare and the employment services. This makes it harder to coordinate benefits such as to promote labour supply.

Box 3.2: Employment protection legislation as impediment to competitiveness

Tight labour regulations can reduce the pace of adjustment of employment to economic activity, i.e., the dynamics of job creation and job destruction with too restrictive labour legislation are likely to lead to reduced labour market flows. This can have macroeconomic consequences particularly at a time of rapid structural change. The effect on employment levels over the longer run may be more ambiguous. ⁽¹⁾ Rigid employment rules, such as restrictive hiring and redundancy practices raise implicit labour costs. Rigid employment protection legislation also contributes to labour-market segmentation.

Tight employment protection legislation has been identified as a constraint for labour market adjustment in Croatia (WB 2011) and labour market rigidity has been highlighted as an important non-price barrier for Croatia's competitiveness (see IMF 2012 and WB 2011). According to National Bank of Croatia's estimates, Croatia's employment protection legislation (EPL) index as designed by the OECD stood at 2.61 in mid-2013, above the average reading for a group of peer economies (see Graph 1). Labour market outcomes are consistent with segmentation, notably Croatia's high youth unemployment, which rapidly deteriorated during the crisis, as well as its high shares of long-term unemployment and long spells of unemployment. The share of unemployment spells lasting in excess a year was 65% in 2012, the second highest reading in the EU after Slovakia. The considerable underutilization of human capital in turn degrades employability and productivity, particularly for vulnerable groups.

Graph 1: Employment protection legislation index

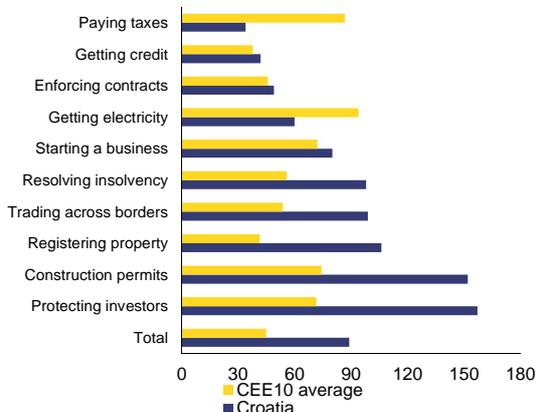


Source: CNB bulletin 194 ; * - SI, PO, EE, CZ, SK and HU

In order to improve labour-market flexibility, the authorities launched a two-stage reform in 2013. The first set of amendments to the labour legislation, which took effect in the middle of that year, focused on regulation of fixed-term contracts and procedures for dismissals. The government adopted a second legislative proposal in January 2014. If enacted, it will provide for reduction of dismissal costs by shortening and simplifying procedures and increase working-time flexibility. In addition, more flexible forms of employment such as part-time contracts would be introduced. Based on current information, these changes would result in an improvement in Croatia's EPL index, bringing the country largely on par with its peers.

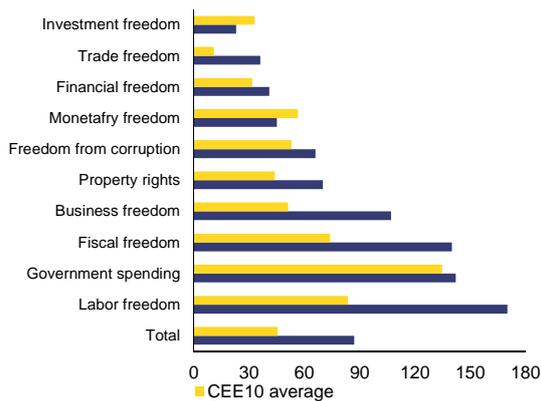
⁽¹⁾ See European Commission (2012), "Labour Market Developments in Europe", European Economy 5/2012 for a review of macroeconomic implications of EPL.

Graph 3.18: Doing business 2014, country ranking



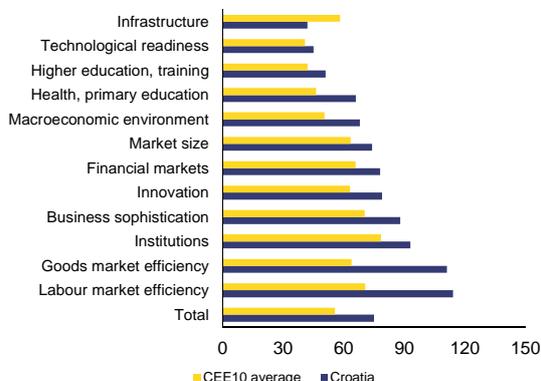
Source: World Bank

Graph 3.19: Economic freedom 2014 index, country ranking



Sources: Heritage foundation

Graph 3.20: Global competitiveness 2013-14 index, country ranking



Source: World Economic Forum

Several of the areas in which Croatia underperforms the CEE10 are directly relevant to potential investors searching for a production location. This can be illustrated taking five of the Doing Business indicators where Croatia scores poorly. The ease of trading across borders is important for potential exporters; Croatia's poor score is particularly attributable to the cost of procedures required in order to ship goods (amounting to USD 1,335 to ship a notional container which compares to USD 1,070 on average in the OECD). Registering property and obtaining construction permits are important for potential greenfield investors; Croatia's poor scores on these indicators largely stem from lengthy procedures, with registration taking 102 days for a notional warehouse project (versus 24 days on average in the OECD) and permits taking 317 days (141 days in the OECD). Finally, investors (including local investors) need to be well protected by the law and here Croatia's poor score is largely attributable to directors' limited disclosure requirements and obstacles to shareholders seeking redress. Barriers to FDI are also generally barriers to local entrepreneurship, investment, business start-ups and job creation.

The civil justice system is accumulating backlogs. The length of judicial proceedings in litigious civil and commercial cases remained among the highest in the EU, although it was slightly shortened from 462 days in 2010 to 457 day in 2012 (Disposition Time, CEPEJ data). Despite the fact that the courts in 2012 resolved 16% more litigious civil and commercial cases compared to 2010, the rising number of incoming cases and the reduced clearance rate of 95% contributed to the rise in backlog. Until the end of 2012, the number of litigious civil and commercial pending cases rose by 15% compared to 2010, and remained among the highest in the EU (measured per capita). Legislative amendments upgrading the role of the financial agency FINA appear to have improved the effectiveness of enforcement on monetary assets, although the effectiveness as regards other types of assets remains a challenge (e.g. immovable property where the recovery rate appears to be low). The length of proceedings in land registry cases was reduced from 50 days in 2010 to 42 days in 2012 (Disposition Time, CEPEJ data). Compared to 2010, the falling number of incoming land registry cases and the Clearance Rate of 101% resulted in a reduction of the number

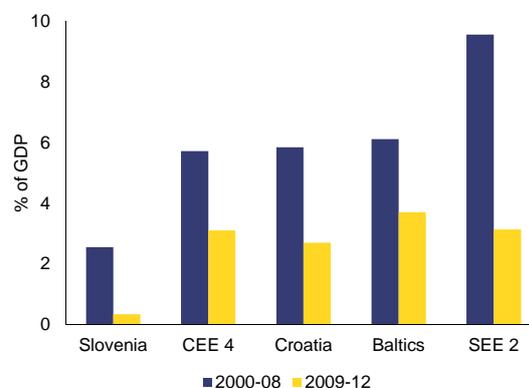
of pending cases by 20% by the end of 2012. Preliminary data indicate that the number of incoming insolvency cases in 2012 rose significantly, compared to 2010. Legal certainty and effective processing is important for investment and adjustment. This is the case not just for commercial cases, including insolvency, but also labour cases, where court delays and/or legal uncertainty can theoretically result in stronger job protection *de facto* than *de jure*. These results are consistent with Croatia's poor score on the resolving insolvency indicator of the World Bank's Doing Business Survey 2014, which finds procedures take 3.1 years to conclude (versus 1.7 years on average in the OECD) and that the recovery rate is around 30% (vs. 70% in the OECD).

Structural product market weaknesses have also been present. The transport, utilities and postal services were shielded from competitive pressures during the cyclical upturn. This protection came at the price of weaker efficiency and raised costs for the economy. Increasing competition, in particular in electricity distribution, is likely to lower producer costs in the economy over the medium term.

The role of FDI

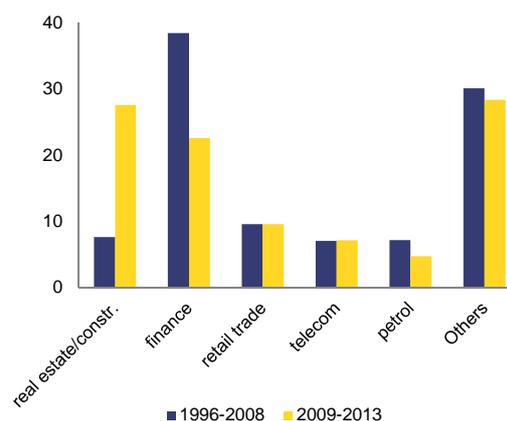
Croatia has missed out on the FDI flows that have transformed the export sectors of more successful peer economies. As detailed in Subsection 3.1.1., sizeable capital inflows comprising a high share of FDI led to the accumulation of a significant FDI stock in the 2000-2008 period. These inflows were comparable in magnitude to those of regional peers (Graph 3.21). However, the bulk of FDI was directed to the non-tradable sector, with financial intermediation and real estate activities and construction taking the lead. Countries such as the Czech Republic, Romania and Slovakia were able to attract a greater share of inward FDI into manufacturing (see Graph 3.22). Inward-looking investments in telecommunication and retail trade also featured prominently. Export-oriented sectors, on the other hand, attracted a small share of the huge investment flows in the period, resulting in a markedly different sectoral FDI structure compared to some of the CEE10 by 2012 (Graph 3.23).

Graph 3.21: FDI inflows



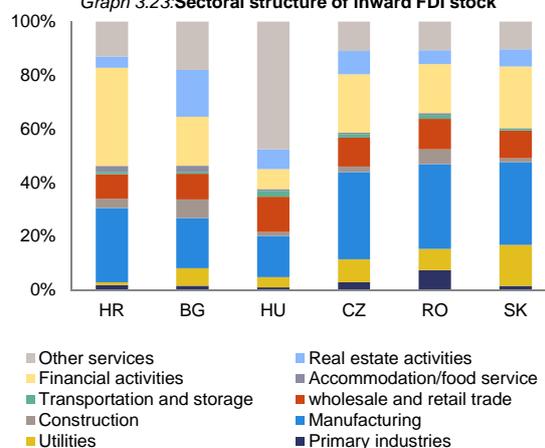
Source: Eurostat; Commission services; CEE4 (CZ, HU, PL, SK); SEE 2 (BG, RO)

Graph 3.22: FDI inflows per sectors, % of total



Source: Commission services; HNB

Graph 3.23: Sectoral structure of inward FDI stock



Source: Eurostat

Low FDI in export-oriented sectors reflects the full range of cost and non-cost-competitiveness shortcomings of the Croatian economy. In the labour-intensive export-oriented sectors, wage levels, taxation issues, labour regulatory issues and skills gaps are also likely to have deterred potential investors in the region. As a result of low FDI into export industries, Croatia missed opportunities to integrate into global supply chains and did not benefit from positive technological, governance and financial externalities associated with export-oriented FDI that ultimately lead to competitiveness gains and support economic growth. ⁽²¹⁾

FDI flows have dried up with the economic crisis and the remaining trickle still does not reach export-oriented sectors. Overall FDI went down sharply. This is partly a result of weak investment activity in Croatia's traditional EU investor base. ⁽²²⁾ Competition between locations seeking to attract FDI has also intensified in the current low investment conjuncture. In this respect Croatia's worsened economic prospects and slow progress with the structural reform agenda are major drawbacks. The real estate and construction sectors have continued to receive FDI as on-going projects were completed and foreign retail chains continued to expand on the Croatian market.

Conclusion

Substantial liabilities coupled with major adjustment challenges leave Croatia with external vulnerabilities. This section has detailed the accumulation of the net international investment position and gross external debt. While the current account has now closed, the adjustment process is set to be lengthy. A range of elements in the labour market, in the business environment and

in FDI trends have inhibited the growth and export performance that might speed the adjustment.

The Croatian manufacturing sector is in urgent need of renewal and FDI is the principal means by which this could be achieved. This section has highlighted the sharp deterioration in Croatia's goods exports performance, largely due to the near-collapse of certain industries. The manufacturing sector failed to capitalise on plentiful FDI in the boom years. The economic crisis and the withdrawal of subsidies have exposed these industries as uncompetitive in cost and non-cost terms. The sustainability and stability of Croatia's external position will depend on the regeneration of a manufacturing sector and other potentially-exporting sectors to complement tourism revenues. Until this is achieved, Croatia with its high foreign liability stock will remain vulnerable to currency movements and shifts in investor sentiment. An FDI facilitated structural shift into tradable sectors and economic integration into the EU would represent a break with the past borrow-to-consume model and set the foundations for more sustainable growth.

3.2. INDEBTEDNESS AND DELEVERAGING DYNAMICS

Rapid credit expansion, strong domestic activity and investor optimism were mutually reinforcing in the period to the 2008 crisis. On the supply side, credit growth was funded by sizeable foreign capital flows, driven by high global liquidity and strong investor appetite for emerging markets rather than by country-specific factors. These flows were partly channelled through the largely foreign-owned banking sector. Strong economic expansion went hand in hand with a steep accumulation of debt by the private sector, although from a relatively low level (Graph 3.24). ⁽²³⁾ Both households and non-financial corporations more than doubled their debt levels as a share of GDP in the period 2001-2008. The significant tax bias towards debt-financed investment also skewed firms' financing choices,

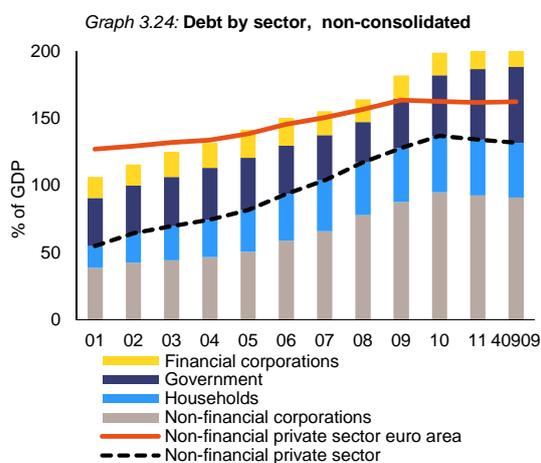
⁽²¹⁾ FDI in inward-facing industries can also contribute to economy-wide productivity and indirectly support competitiveness but this does not seem to have been the case in Croatia. Notably, FDI in the financial sector appears to have led to banks focusing on real estate, construction and consumer lending. By the same token, FDI in export-oriented sectors does not guarantee successful outcomes. The largest FDI transaction in the manufacturing sector in recent years concerned the purchase of a stake in the refinery operator which is now loss-making and subject to legal disputes.

⁽²²⁾ Outward FDI flows from the EU declined sharply after the global financial crisis and in 2012 recorded the lowest level since 2004.

⁽²³⁾ The private sector in this analysis consists of non-financial corporations and household and non-profit institutions serving households. Private sector debt includes securities other than shares (excluding financial derivatives) and loans.

contributing to corporate indebtedness.⁽²⁴⁾ The state was able to reduce its outstanding liabilities gradually over the period due to favourable economic trends. At the same time, however, the state accumulated significant contingent liabilities as it granted generous government guarantees to state-owned enterprises (SOEs), notably those involved in highway construction, railway infrastructure and shipbuilding.

As a result, Croatia had a relatively highly leveraged private sector at the time the crisis started, even though public indebtedness stood well below the EU average. With the onset of the crisis, the sudden halt in financial inflows, coupled with a rapid contraction in external and domestic demand, exposed existing vulnerabilities in the real sector. Prevailing debt stocks also hindered a smooth adjustment in the financial system in response to the deterioration in the external environment.



A counter-cyclical policy loosening by the monetary authorities allowed buffers in the financial system to absorb the shock and accommodate the adjustment of the Croatian economy in the initial phase of the crisis. The conduct and effectiveness of these policies is

⁽²⁴⁾ This bias has also constrained the deleveraging process during the subsequent recession. Debt-financed investments benefit from a negative effective marginal tax rate which is among the highest in the EU (-18% vs. -5% on average for the EU), according to Commission services calculations. The high debt bias of corporate taxation reflects generous depreciation allowances and treatment of financial costs.

described in detail in Section 3.3. Non-financial corporations (NFC) used the breathing space afforded by these policies as an opportunity to refinance existing liabilities, including external liabilities. This prevented a stronger reduction of the debt level, but did not stop a steep decline in new investment. Even so, negative feedback loops from deleveraging pressures, economic recession and the weak fiscal position of the sovereign continue to weigh on the economy. The following subsections look at the drivers of indebtedness and the dynamics of deleveraging in the private sector (Subsection 3.2.2.) and public sector (Subsection 3.2.3.) in greater detail. Subsection 3.2.4. concludes with a discussion of outstanding policy challenges related to indebtedness and deleveraging.

3.2.1. Private sector indebtedness

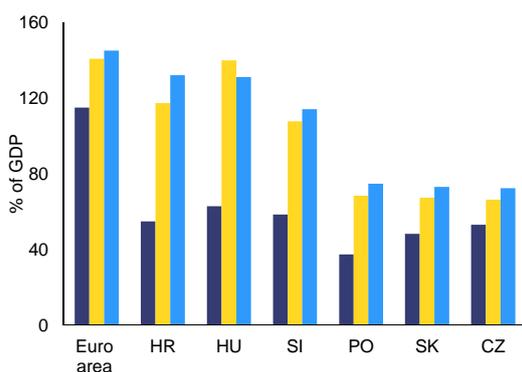
Strong consumer and business optimism, abundant international capital flows and risk-appetite in the financial sector allowed a quick accumulation of debt by the private sector in the run-up to the global financial crisis. The Croatian economy was not alone in witnessing a significant increase in financial liabilities (Graph 3.25), but its debt did accumulate rather fast in comparison, even taking into account the relatively limited initial levels of external indebtedness. Growth in household debt outpaced that of corporate debt, partly reflecting a lower base, but also loose lending policies on the part of banks. A widespread practice to extend credits linked to the Swiss franc to unhedged borrowers generated an exchange-rate risk for households and a corresponding credit risk for banks (see also Section 3.3.).⁽²⁵⁾ Rising residential prices also contributed to the increase in household indebtedness, as housing loans were leveraged against increasing collateral values. Thus, the household debt-to-GDP ratio peaked at 42% by the end of 2010. As for corporates, a gradual rise in indebtedness culminated with a steep increase at the peak of the business cycle, and the debt-to-

⁽²⁵⁾ Swiss franc-indexed loans accounted for over a third of total credit growth in 2005-2007. They were mainly extended to households, in particular for house purchases, while the corporate sector's exposure was limited. Even though these loans were largely suspended as of mid-2008, their share remained relatively high at 10% of the total outstanding credit at the end of 2013 from the 17.5% peak in early 2008.

GDP ratio surged nearly 30 pp from 2007 to reach 95% in 2010, supported by strong borrowing by both private and public companies.

The onset of the crisis did not bring about immediate deleveraging pressures. On the contrary, debt accumulation, in particular by companies, initially continued (see Box 3.3 for a sectoral analysis of corporate leverage). This was mostly due to refinancing provided by foreign parents (reflected in a growing stock of cross-border intra-company loans), but also accommodative monetary policies that ensured sufficient domestic liquidity. With the nominal debt level increasing, the prolonged economic contraction resulted in a further rise in the private sector debt-to-GDP ratio. Thus, it surged by 20 pp in only two years, peaking at 137% of GDP by the end of 2010, leaving the private sector amongst the most indebted in comparison to regional peers (Graph 3.25). The increase was almost entirely accounted for by the corporate sector, while households managed to keep their liability level relatively stable despite some pressures arising from the increase in the kuna-denominated household debt as a result of the steep appreciation of the Swiss franc in 2010. This affected loans (mainly housing and car-purchase credits) linked to the Swiss currency, putting a strain on the household debt-service burden.

Graph 3.25: Private sector debt



Source: Eurostat ■ 2001 ■ 2008 ■ 2012

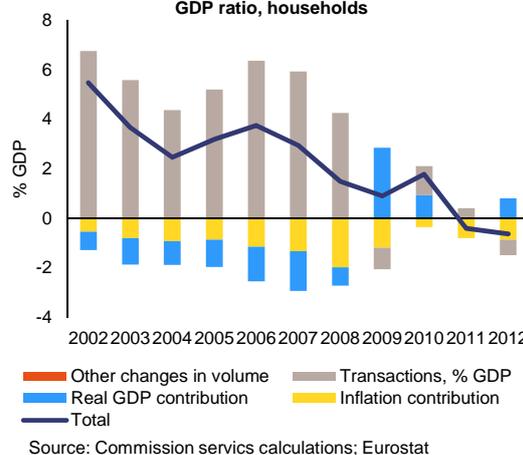
In view of the continuing weakening of economic activity, rising unemployment, and the high debt levels, deleveraging pressures built up as of 2011. This led to some modest

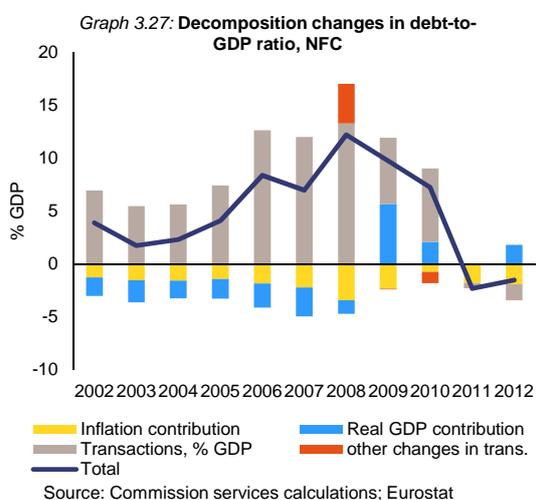
decrease in private sector leverage as net credit flows to the domestic economy turned negative in 2011. Thus the total private sector debt-to-GDP ratio fell by 5 pp since the peak at the end of 2010. Nearly four-fifths of this decrease was accounted for by companies, although the figures overestimate the actual adjustment due to the transfer of loans to shipyards to the government accounts in 2012.

Negative credit flows have driven deleveraging.

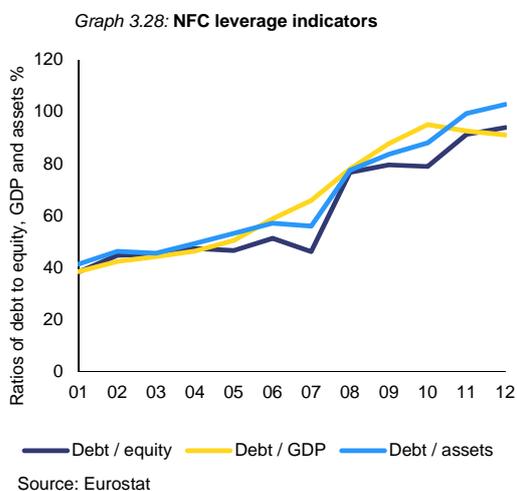
Having averaged around +15% of GDP in the period 2002-2008, net credit flows to the private sector turned negative in 2011 as strong contraction in corporate credit exceeded the remaining flow of credit into the household sector. Credit to the private sector fell more steeply in 2012-13. Inflation helped to curtail the private sector debt-to-GDP ratio through the denominator (Graph 3.26 and Graph 3.27). Valuation changes in the form of debt write-offs also played a role in the corporate sector, although their contribution was limited.

Graph 3.26: Decomposition changes in debt-to-GDP ratio, households





The reduction in corporate sector indebtedness continues at a slow pace. Debt refinancing, reflecting ongoing support from parent companies, but also the tendency of banks to renew debts even to risky creditors (bankruptcy proceedings and collection of debts are complex and costly), could explain the relatively subdued pace of deleveraging in the corporate sector. On-going and elevated borrowing by publicly-controlled companies also acted to moderate the overall pace of adjustment in the corporate debt-to-GDP ratio, as did the weak economic performance through falling nominal output (other than in 2011). However, when measured against total assets (or equity), the corporate debt ratio kept rising throughout the period, thus implying growing financial risks (Graph 3.28).



The household sector also faces deleveraging pressures. These stem from the rapidly deteriorating labour market and falling disposable income. Negative wealth effects as a result of declining residential and equity prices may also play a role.⁽²⁶⁾ As a result, there has been a steep drop in the stock of some types of consumer credit (notably car loans and credit card lending). At the same time, the stock of outstanding housing loans, which account for approximately half of the total household debt, remained relatively stable, thus preventing an even sharper rebalancing of the households' liability position. This was, however, largely due to the aforementioned negative foreign exchange rate effects associated with the appreciation of the Swiss franc (see also Section 3.3).⁽²⁷⁾ Vulnerabilities nevertheless remain limited due to the still relatively low level of household debt compared to the EU average.

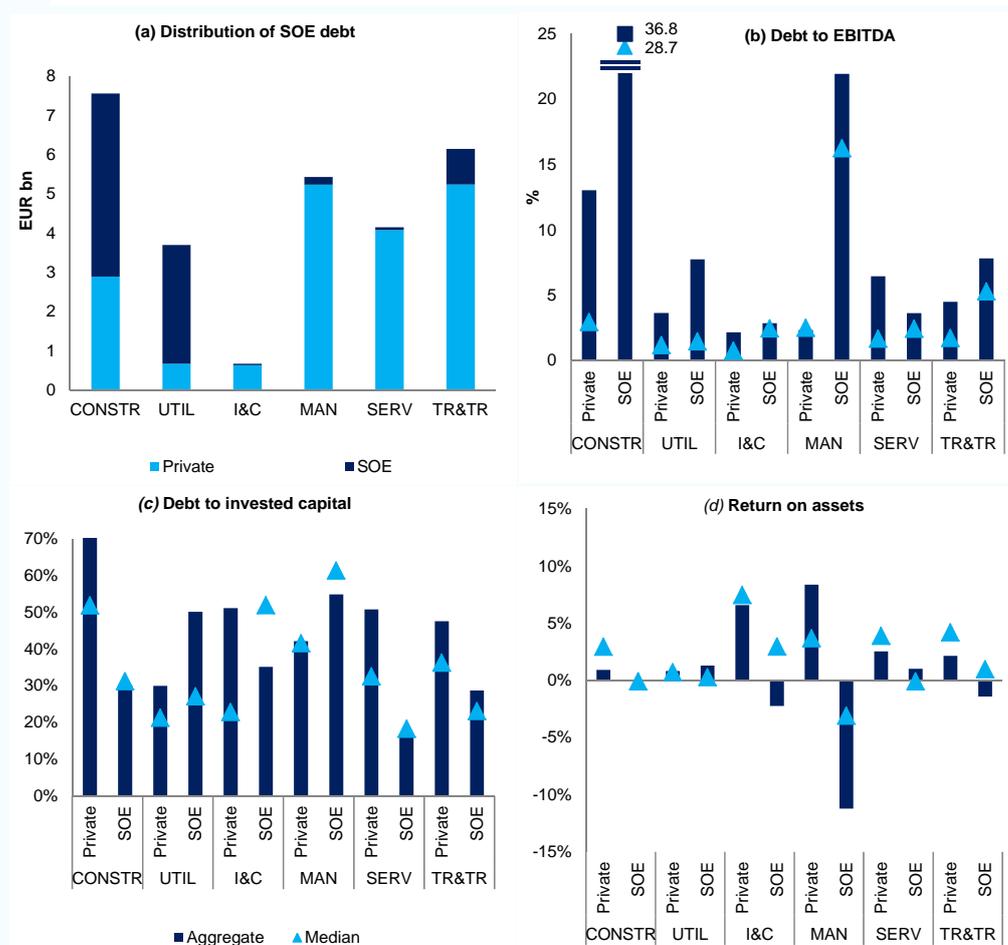
⁽²⁶⁾ In 2013, housing prices were down by 30% from their peak in early 2008. The main index of the Zagreb Stock Exchange, Crobex, lost approximately 65% of its value over the same period.

⁽²⁷⁾ Swiss franc-indexed housing loans reached approximately 40% in 2008 and their share in the housing loan stock remained stable for a long time because of the appreciation of the Swiss currency.

Box 3.3: Financial Performance of Firms, including SOEs

High corporate debt levels, as described in this chapter, are concentrated in a few unprofitable sectors and in firms in public ownership. ⁽¹⁾ Graph 1a shows the gross amounts of debt in question, by sector, to help interpret the magnitude of the issues raised by the ratios presented below.

Graph 1: Indicators of financial strength



From graph 1b, one can determine the sectors characterised by high debt relative to earnings available for debt servicing, the standard debt to earnings before income tax, depreciation and amortisation (EBITDA) ratio. ⁽²⁾ The construction and real estate and the 'other services' categories exhibit high indebtedness overall and SOEs are more indebted than non-SOEs within all categories except 'other services'. ⁽³⁾ Nearly a sixth of

⁽¹⁾ The analysis is based on 2012 financial data for 8,545 Croatian companies obtained from the Bureau Van Dijk Orbis database, of which 104 are (non-exhaustively) identified as State-owned enterprises (majority ownership by the central Government or local authorities). Privately-owned majority-controlled subsidiaries are included in the analysis due to identified data gaps at consolidated group level, which can lead to a small amount of double-counting (a check was also performed with data on a consolidated basis, which yields 3,913 firms, and the two approaches were found to yield broadly similar results).

⁽²⁾ The debt/EBITDA ratio is used as a measure of solvency, where the denominator is a commonly used proxy of cash generating capacity (pre-tax).

⁽³⁾ The high SOE reading for the construction sector stems from the three highway companies.

(Continued on the next page)

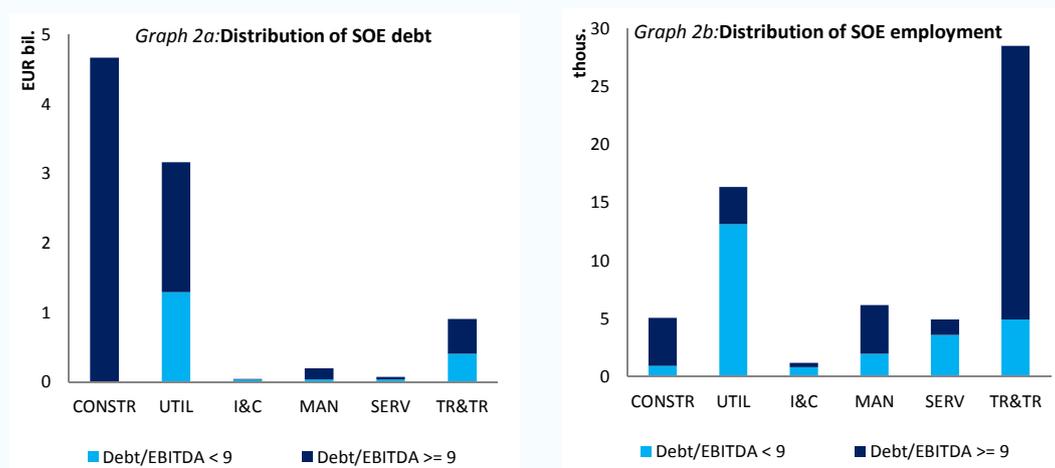
Box (continued)

the firms analysed recorded negative EBITDA in 2012. The degree and extent of financial weakness is consistent with the high and rising non-performing loan ratios of banks discussed in sub-section 3.3.

Graph 1c shows the degree of reliance on debt within private firms' and SOEs' overall funding, confirming the high indebtedness of construction and 'other services'. ⁽⁴⁾ The upper tail of the firm distribution (not graphed) is marked by very high leverage in most sectors and in particular for SOEs. Current indebtedness problems are therefore not merely a result of depressed earnings, but also reflect somewhat debt-heavy capital structures. Within the private sector, the information and communications, manufacturing and trade and transport segments also appear to be somewhat highly leveraged. Debt restructuring may be needed in some cases to make these financial structures more efficient (see Box 3.4. for discussion of pre-insolvency procedures).

Graph 1c illustrates the low aggregate profitability of firms in several sectors, as proxied by return on assets. SOEs are less profitable than private firms on aggregate within each sector. Within information and communication, manufacturing, trade and transport, SOEs are, on aggregate, destroying value. ⁽⁵⁾ Returns at the 50th and 75th percentiles show some private firms thriving, but not SOEs.

These results help to contextualise the strategies of banks now focusing on SOE-lending (see Box 3.6. in sub-section 3.3.), and provide circumstantial evidence that there are creditworthy private-sector firms that could be disadvantaged by these trends.



Graphs 2a and 2b show the policy relevance of high debt levels in SOEs. Taking a conservative debt multiple of nine times EBITDA as a cut-off ⁽⁶⁾, the debt of over-indebted SOEs analysed here amounted to over seven billion euros at year-end 2012. These SOEs also employed 37,000 people. These figures provide a first-order quantification of the contingent fiscal liabilities arising from state ownership discussed in sub-section 3.2.

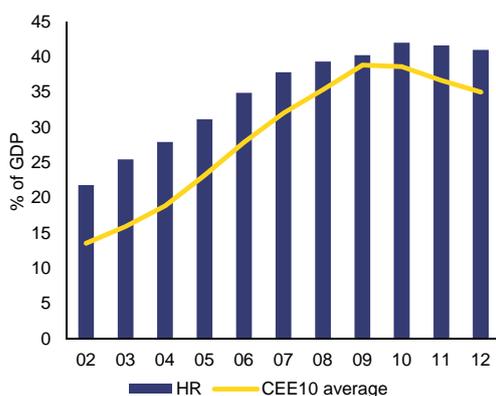
⁽⁴⁾ The share of debt in total capital employed (debt plus equity), reflecting a firm's financial leverage, is more revealing about funding choices (high amount of debt taken in the pre-crisis period) and abstracts from denominator effects (i.e. adverse shock to earnings during the crisis).

⁽⁵⁾ The causality between public ownership and poor performance, if any, may run in both directions. However, SOE losses can generally be sustained longer.

⁽⁶⁾ Even at 5x EBITDA a firm without demonstrable growth prospects might be considered over-indebted, but a higher threshold of 9x is used here to duly take into account low EBITDA in the 2012 recessionary context.

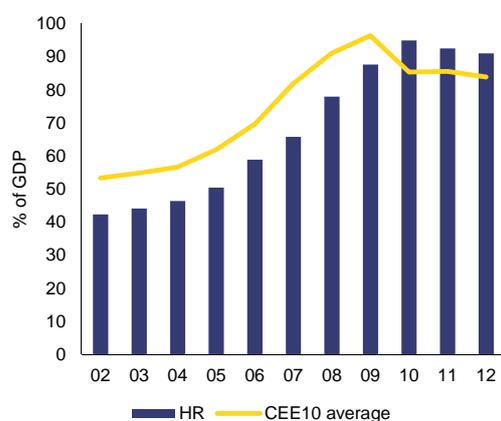
Cross-country comparison reveals that Croatia's private sector is more indebted than those of other countries in the region. Indeed, while during the boom years, households and firms in Croatia built up debt at comparable speed to the CEE10, the downturn in Croatia came later and the pace of deleveraging was slower (Graph 3.29 and Graph 3.30). As a result, by the end of 2012 Croatia's firms and households were more indebted than their peers in the CEE10 – by 6 pp points and 7.1 pp of GDP for households and corporations, respectively. This could impact negatively on Croatia's economic growth prospects and competitiveness going forward.

Graph 3.29: Household leverage - Croatia and CEE10



Source: Eurostat

Graph 3.30: NFC leverage - Croatia and CEE10



Source: Eurostat

Supply constraints have contributed to the gradual deleveraging of the economy as parent financing for the foreign-owned banking sector

was reduced. This process was particularly prominent in 2012, reflecting a shift in funding from cross-border operations to domestic financing. The sharp drop in banks' foreign liabilities (almost one-fourth in the period from the peak at end-2011 to August 2013) highlights the scale of reduction of external funding for the financial sector which was partly cushioned by offsetting counter-cyclical measures on the part of the monetary authorities. The pace of bank deleveraging largely abated in 2013, while increased domestic savings also compensated for the shortage in foreign funding. The latter, moreover, contributes to mitigating the impact of possible capital outflows, e.g. due to further potential downscaling of financing by foreign banks in view of tighter capital regulations and their on-going balance sheet adjustment.

The National Bank of Croatia (HNB) has been active in ensuring sufficient liquidity in the system to support credit flows.⁽²⁸⁾ However, these efforts have been so far insufficient to compensate for reduced corporate credit demand due to the recession. Furthermore, lenders grew more cautious to counter the worsening of their balance sheets, as reflected by a steep increase in the share of NPLs.⁽²⁹⁾ As a result of negative feedback loops from rapidly deteriorating public debt dynamics (see Subsection 3.3.3.), the domestic banks are becoming more closely linked with the sovereign: since 2008, the larger part of the growing government financing needs has been raised from the domestic market. This could potentially put banks at risk and reduce credit availability for the private sector in case rising public debt is not put back to a sustainable path.⁽³⁰⁾ However, risks of a severe credit crunch appear to be mitigated by the still strong, well-capitalised and liquid foreign-owned banking system, a functional capital market, and the

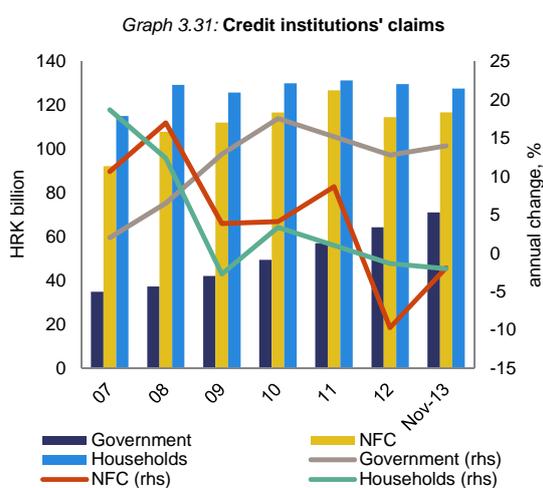
⁽²⁸⁾ In an attempt to increase liquidity and spur corporate lending, the National Bank of Croatia reduced commercial bank's capital-reserve and foreign-currency liquidity requirements at the beginning of 2009. More recently, the central bank decided to cut further its mandatory reserve requirements to 12% from 13.5%, effective December 2013.

⁽²⁹⁾ The share of private sector NPLs in the total loan book stood at close to 16% at the end of 2013, rising from less than 5% at the end of 2008.

⁽³⁰⁾ Adverse fiscal trends do create a substantial sovereign spread which is adding to the funding costs of the banking sector. In 2013, credit default swaps started to diverge increasingly from those of comparable EU countries.

commitment of foreign parent banks under the Vienna Initiative to maintain historic liquidity levels in the region.

Supply factors could lead to further deleveraging of the private sector as banks focus on lending to the government and SOEs. Indeed, a certain credit substitution of private sector loans with credits to the government appears to have taken place since the end of 2011. In particular, while the credit to the government has increased by HRK 14 billion since 2011, the stock of credit institutions' claims on the non-financial private sector has contracted by a similar amount (see Graph 3.31). However, the fall in private sector credit seems to be largely linked to declining demand by both households and corporations as a result of ongoing correction of their balance sheets and very weak economic activity. It was also seriously affected by one-off factors such as corporate credit takeover by the state.



Source: Commission services calculations based on HNB

The government has undertaken measures to strengthen pre-bankruptcy procedures (see Box 3.4) These steps could facilitate the deleveraging process in the economy, in particular in the corporate sector. At the same time, regulatory uncertainty, including on taxation and on the possible development of a system of energy certificates for certain residential sales, could lead to lower household credit demand and depressed activity. The household sector does appear to have maintained payment discipline and to be in a more favourable position to withstand deleveraging pressures in the medium term, also given its lower

initial leverage. Nevertheless, a possible upturn in consumer credit will largely depend on a turnaround of the negative trends in the labour market and household income. Negative risks thus attach to a prolonged recession depressing household spending power.

3.2.2. Public indebtedness

The ongoing deleveraging pressures in the private sector arise at a time of significant fiscal challenges for the country. To the extent that deleveraging trends in the private sector are reflected in weak investment and household consumption, this in turn depresses revenues and accentuates the consolidation challenge for public finances, re-enforcing potential negative feedbacks to the real economy.

Loose fiscal policy during the cyclical upturn limited the room for Croatia to respond in a counter-cyclical manner once the crisis started.

The prolonged recession has caused sustained tax revenue losses that have only partially been offset by numerous indirect tax increases, mostly VAT and excises (Graph 3.32). Decisive reforms of the public administration, healthcare and pension systems could have alleviated pressures arising from the expenditure side of the budget, but were delayed. Sizeable subsidy payments and recurrent capital injections into loss-making state-owned enterprises contributed substantially to overall expenditure pressures. Moreover, the fiscal position further deteriorated because of the increase in the budgetary interest burden following activation of state guarantees on loans extended to state-owned enterprises (mostly in the now privatised shipbuilding sector).⁽³¹⁾

Croatia's general government deficit averaged 6.1% of GDP in the period 2009-2013. This figure, which reflects the negative impact on public finances from the recession, is not significantly different from the government deficits recorded in a number of CEE10 countries

⁽³¹⁾ The stock of government guarantees to public companies, mainly concerning loss-making entities in the transport sector and the shipbuilding industry, nearly trebled in the period 2007-2011 to above 14% of GDP. As a result of a recent restructuring of the shipbuilding industry, in line with the requirements for accession to the EU, the state had to assume their debts worth HRK 6.6 billion (2% of GDP) and ensure servicing of the credits that currently weighs on the expenditure side of the budget.

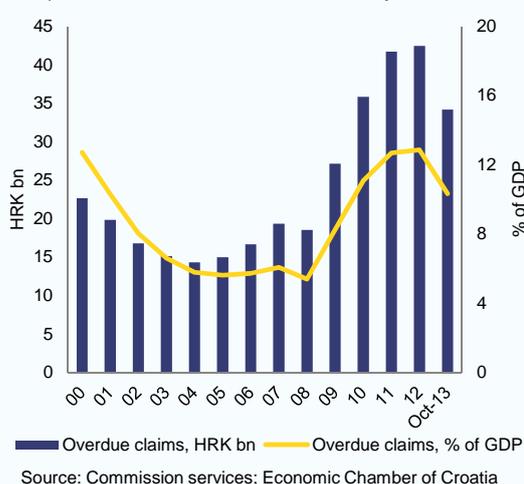
Box 3.4: Pre-bankruptcy settlement legislation

The Financial Operations and Pre-Bankruptcy Settlement Act entered into force on 1 October 2012 with the objective to provide a solution for the rapidly mounting indebtedness in the crisis-stricken economy by finding an alternative to the complex, expensive and lengthy bankruptcy procedures in the country. The procedure aims at facilitating financial restructuring of ailing companies but also gives the possibility for settlement for individual debtors such as sole proprietors and craftsmen. Apart from providing a viable solution for the debtors, it is also considered beneficial for creditors in view of simplified procedures for liability collection and higher return rates compared to the ones under the standard bankruptcy procedure.

The results during the first year of the implementation of the measure have been encouraging although some loopholes in the legislation have become visible from its start. The pre-bankruptcy settlement not only put a break on liability accumulation, but managed to reduce the total stock of overdue payments by nearly HRK 10 billion in the period to HRK 34 billion at the end of October (see Graph 1). The number of insolvent companies (including sole proprietors and craftsmen) went down by 20% and some 15,000 job places had been retained, according to the calculations of the authorities.

Despite these positive developments, a number of shortcomings remain. The role of the state is not sufficiently well defined as it participates as both a creditor and an administrator in the out-of-court settlement process. The procedure could create moral hazard incentives by either making unviable companies seek postponement of the standard bankruptcy procedure (in an attempt to avoid the exercise of the right of foreclosure by creditors) or by encouraging healthy companies to pursue debt haircuts. The latter possibility could be suggested by the amount of company claims for restructuring – nearly HRK 53bn, or 16% of GDP, in slightly more than a year. Issues with efficient implementation of the legislation arise from the still weak institutional capacity of the country, but also various loopholes in the legal definitions that necessitated four legislative changes in a year.

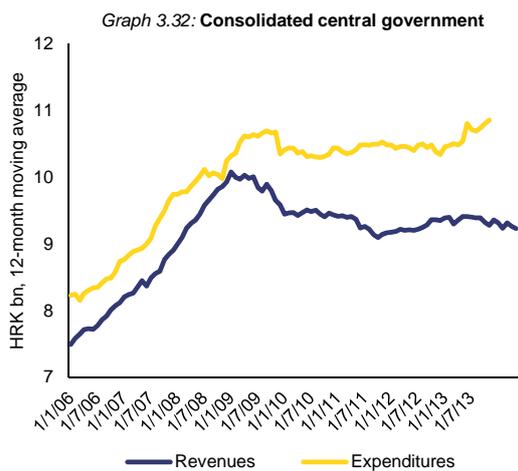
Graph 1: Overdue liabilities of insolvent companies



(Graph 3.33), but gives rise to greater concerns due to the relatively higher debt level and Croatia's lower near-term growth prospects. The Commission Winter 2014 forecast shows an

improvement in Croatia's budget deficit in 2014-15 mainly as a result of the one-off effect of transferring a part of the assets from the second pillar private pension system to the first – state – pillar. Under the ESA95 accounting rules, which will be replaced in September 2014 by ESA2010, the headline general government deficit would improve to 5.4% and 4.7% of GDP in 2014 and

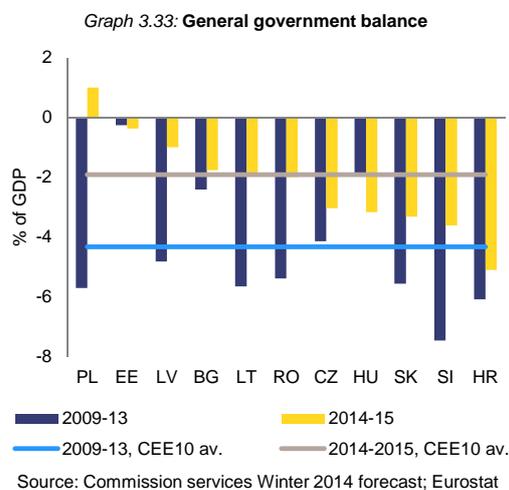
2015, respectively. Abstracting from this, there would be a marked deviation in the medium-term fiscal trends of Croatia. Croatia's structural budget deficit is projected at 5.3% of GDP on average in the period 2014-2015 compared with only 2.2% for the CEE10 (see Graph 3.34).



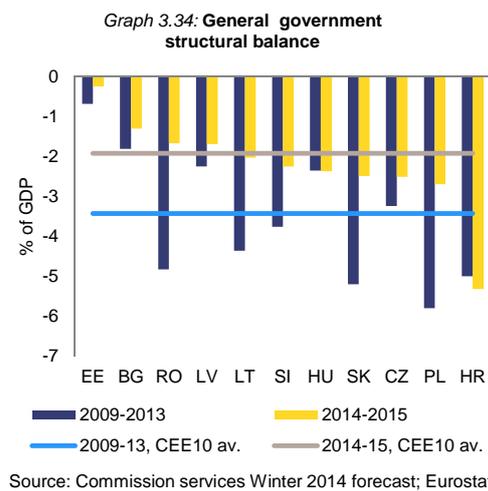
Source: Ministry of Finance; Commission services calculations

Persistent primary budget deficits, rapidly growing interest expenditures and negative stock-flow adjustments have resulted in a sharp deterioration of Croatia's general government debt since the crisis. These developments, combined with nominal GDP remaining below its 2008 peak for a long period, boosted the government debt-to-GDP ratio by nearly 30 pp in four years to estimated 64.9% of GDP at the end of 2013 (Graph 3.35).⁽³²⁾ Although this ratio still remains well below the EU average, it is among the highest among the CEE Member States and remains subject to numerous sustainability risks.

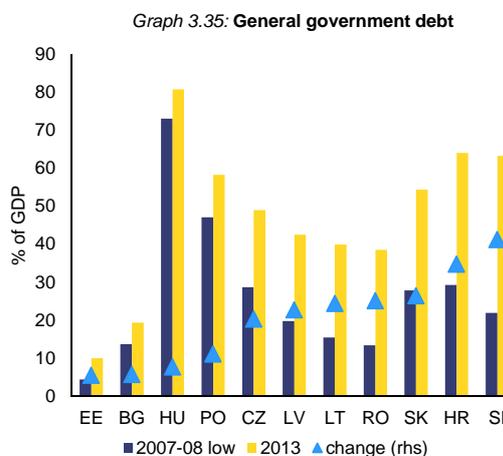
⁽³²⁾ See European Commission (2014)



Source: Commission services Winter 2014 forecast; Eurostat



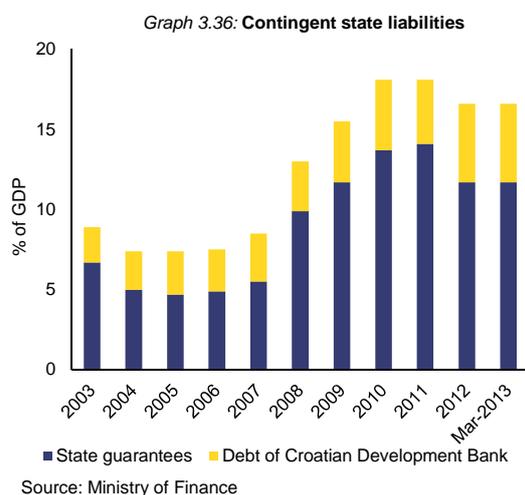
Source: Commission services Winter 2014 forecast; Eurostat



Source: Commission services calculations; Eurostat

The relatively short maturity structure of public debt also has implications for sustainability and debt management. It exposes the country to vulnerabilities stemming from a possible worsening of financing conditions on global markets that would further increase the already high borrowing costs. The sovereign financing needs, consisting of debt (including short-term debt) refinancing and the net lending/borrowing by the state, will continue to grow, reaching close to 20% of GDP in 2014. While rollovers, including of instruments denominated in foreign currency, are concentrated in the first few months of the year, the government is already largely pre-funded for 2014.

Weak state-owned companies continue to cloud the prospects for public finances. Their liabilities have occasionally migrated into the government's balance sheet and thus served as an important factor for the growing deficit and debt figures in recent years. In the absence of more ambitious restructuring efforts in the railway and road infrastructure companies, the main recipients of state guarantees, the risk of additional debt pile-up for the state remain significant.



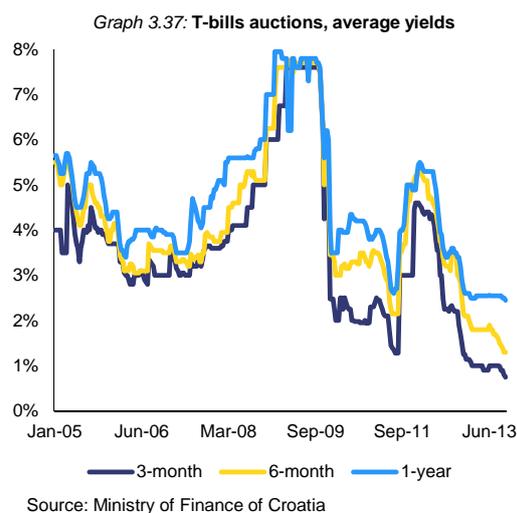
A high foreign exchange share of the public debt exposes Croatia to potential currency shifts.⁽³³⁾ A number of empirical studies highlight unfavourable exchange rate shocks as a source of risk for Croatia's debt sustainability.⁽³⁴⁾ These

⁽³³⁾ Approximately 75% of Croatia's government debt was in foreign currency at the end of 2013.

⁽³⁴⁾ See Sopek (2011) and National Bank of Croatia (2013).

risks should be viewed against the good track record of the central bank of ensuring stability of the local currency against the euro, a policy made necessary by the high euroisation of the economy. International reserves, coupled with considerable forex proceeds from the tourist sector, further contributes to the stability of the local currency.

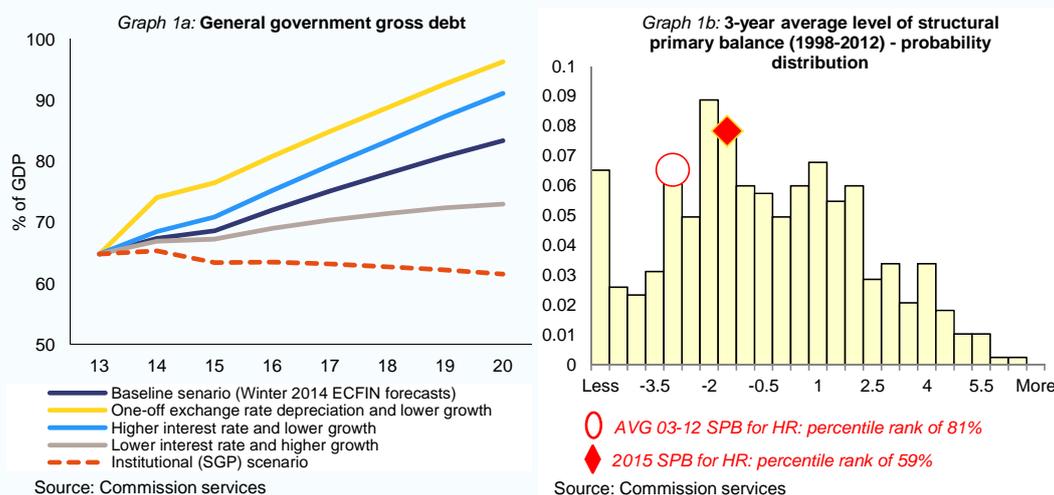
Several factors mitigate public finance risks. Croatia benefits from a relatively deep financial market that for the time being has been able to meet the financing needs of the state at a relatively low price. This refers to both short-term financing needs (covered mostly by commercial banks) and long-term ones (institutional investors, namely pension funds). High liquidity in the banking system, supported by expansionary central bank policies, coinciding with a period of weak credit demand from the real sector, have made lenders focus on financing the state, thus bringing domestic borrowing costs for the sovereign to record low levels in 2013 (Graph 3.37). Furthermore, despite rating downgrades, the country successfully tapped international markets in November 2013. However, it should be noted that growing external debt service costs are exerting significant pressures on the budget, narrowing the possibility for growth-enhancing spending in a situation of weak revenue proceeds and insufficient expenditure-side reforms.



Box 3.5: Public debt sustainability analysis

This box provides an assessment of the sustainability of Croatia's public debt using the Debt Sustainability Monitor (DSM) model developed by the Commission's services. The debt simulations⁽¹⁾, which take as point of departure the Commission Winter 2014 forecast, are based on a no-policy change assumption, which means that no fiscal consolidation measures are considered in addition to the ones included in the forecast.⁽²⁾

Under the baseline scenario, Croatia's public debt is projected to further increase and reach 83% of GDP at the end of 2020 (Graph 1a). The debt-to-GDP ratio exceeds 90% at the end of 2020 in two negative-shock scenarios incorporated in the model. When stressing for the exchange rate dynamics, assuming a 10% permanent depreciation of the local currency against the euro⁽³⁾, and a lower-than-expected GDP growth⁽⁴⁾, public debt is estimated to reach 96% of GDP. This reflects mostly the high share of foreign currency-denominated debt, which was above 70% of the total at the end of 2013. A largely similar negative debt trajectory is recorded when testing for unfavourable GDP dynamics and sensitivity on interest rates, to reflect possible heightened tensions on financial markets that could lead to an increase of financing costs.⁽⁵⁾



A positive-shock scenario has been also simulated to reflect possible improvements in the economic context, partly stemming from the potential favourable impact for the economy from the absorption of EU funds. These positive effects would be translated in both higher growth and lower interest rates on new and rolled-over debt. In this case, GDP growth is revised upwards relatively to the baseline scenario, while interest rates on new and rolled-over debt are lowered.⁽⁶⁾ Under this scenario, general government debt would still

- (1) In the model, the short- and long-term interest rates have been adjusted to be consistent with forecast implicit interest rates, the latest Eurostat data on the shares of short- and long-term public debt, and Bloomberg data on maturing debt.
- (2) This means that the structural primary deficit projection of 1.1% of GDP for 2015 is kept constant at that level thereafter. The long-term budgetary projections for GDP growth and changes in age-related public expenditures, namely for pensions and health care, are those calculated by the Croatian Central Bureau for Statistics and reported in Croatia's 2012 pre-accession economic programme.
- (3) Such an assumption seems on the conservative side in historical perspective.
- (4) Compared to the baseline, GDP growth is assumed to be lower by -1.5 pp in 2014 and 2015 and -1 pp afterwards.
- (5) This model assumes a permanent increase of by 50 bp in short- and long-term interest rates on new and rolled-over debt from 2014, accompanied by a decrease of GDP compared to the baseline (-1.5 pp in 2014 and 2015, -1 pp afterwards)
- (6) Growth is assumed to be high than the baseline by 0.5 pp in 2014, 1 pp in 2015, and 1 pp afterwards, while interest are lower by 1 pp from 2014 onwards. This would translate in an average real GDP growth of about 2.7% over the period 2014-2020 (1.7 pp higher than in the baseline) and an implicit interest rate of 5.6% in 2020 (0.7 pp lower).

(Continued on the next page)

Box (continued)

continue rising (given the primary deficit forecasted for 2015), reaching about 72% of GDP at the end of 2020, although the pace of its increase would slow down considerably.

This reveals that a debt reduction path can be achieved only by having further fiscal consolidation. Moreover, historical outcomes for the Croatian structural primary balance did not appear to be sufficiently ambitious, ranking only in the 81th percentile compared with EU countries (see Graph 1b above).⁽⁷⁾ This low rank largely reflects the past low debt ratio in Croatia, allowing for a relatively lax structural primary balance. Furthermore, reaching and sustaining a structural primary deficit of -1.1% of GDP would not appear to be too demanding in relation to past outturns, as it corresponds only to the 59th percentile of the distribution, suggesting that there is some margin for taking additional consolidation measures.

Therefore, a fifth scenario has been considered, an 'institutional' one, where adjustments to the structural primary balance are set in compliance with the fiscal effort recommended under the EDP (an improvement in the structural primary balance of 1.8 pp, 0.9 pp and 0.3 pp of GDP between 2014 and 2016, respectively) until the excessive deficit is corrected. Thereafter, additional structural (de)consolidation effort is implemented until the medium-term objective (MTO) is reached and maintained.⁽⁸⁾ A feedback effect of the fiscal consolidation on GDP growth has been applied in proportion to the difference between the forecasted fiscal effort (change in the structural balance) and the assumed fiscal effort. Graph 1a shows that adhering to these fiscal rules would be sufficient to stabilise the debt to GDP ratio at about 62% of GDP by 2020.⁽⁹⁾

In conclusion, the debt sustainability analysis shows that the debt-to-GDP ratio can be stabilised only if substantial fiscal adjustment is achieved and maintained - meaning correction of the excessive deficit by 2016 and thereafter benchmarking fiscal adjustment towards the MTO. This would entail an improvement from a structural deficit of 5.6% of GDP in 2014 to the MTO of -1.5% of GDP in 2017.

⁽⁷⁾ The rank is an indication as to where the country specific fiscal effort observed or projected lies in the overall distribution of fiscal efforts made by all EU countries over the years 1998 to 2012.

⁽⁸⁾ An indicative MTO of -1.5% of GDP has been calculated for Croatia.

⁽⁹⁾ A 1 p.p.-of-GDP consolidation effort impacts negatively on baseline GDP growth by 0.5 pp in the same year. In the IMF October 2010 World Economic Outlook (Chapter 3) it is found that a fiscal consolidation of 1% of GDP typically reduces GDP growth by 0.5% within 2 years. This result is based on fiscal actions to reduce the deficit in 15 advanced economies (Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Portugal, Spain, Sweden, UK, US) over 1980-2009.

The state's asset management activities also affect the debt and fiscal risks. The banks were successfully privatised before the crisis, which brought revenues and increased the stability of the sector (see Section 3.3.). The privatisation process has continued at a slow pace, but there has been limited investor appetite for the state's remaining assets since the crisis and the government did not achieve its targeted sell-off revenues in 2013. If the planned sale of the biggest insurer and the possible concession to run the highways were transacted, this would lead to a significant rise in proceeds in 2014 and thus have a positive impact on the public debt dynamics. The restructuring of troubled state-owned companies could also have an indirect positive impact by reducing contingent liabilities and possible future government expenditures (in the forms of subsidies or re-capitalisation costs). The weight of contingent

liabilities has already declined with the restructuring of the shipbuilding sector and could further diminish if re-organisation in the railway sector is stepped up.

3.3. MONETARY AND FINANCIAL SECTOR ISSUES

Croatia is experiencing the after effects of a period of rapid credit growth, driven by internal and external financial institutions. While the authorities used macro-prudential measures to limit lending from domestically-supervised banks, indebtedness still grew very rapidly due to both external borrowing (directly from the foreign parent banks of Croatian subsidiaries) and borrowing from non-bank financial intermediaries. With the deterioration in the financial position of the

corporate sector, banks' non-performing loans (NPLs) to corporate borrowers have reached high levels. Still, the conservative approach adopted by the Croatian National Bank (HNB) to macro-prudential regulation, notably in relation to capital levels, has meant that banks have built up a degree of resilience that has proven to be useful given the challenges they now face from the weak economy.

In order to assess the extent to which the financial sector can contribute to imbalances and risks, this section begins with a brief review of macro-prudential policy in the run-up to the crisis. It continues with an overview of monetary and exchange rate policy, before analysing the situation of the banking sector.

3.3.1. Macro-prudential policy in Croatia in the run-up to the crisis

Macro-prudential and monetary/exchange-rate policies have been closely interlinked in Croatia. The authorities sought to internalise the potential risks to financial stability associated with being an economy subject to volatile capital flows and exhibiting a high degree of euroisation. In an environment of rapid financial liberalisation and with insufficient support from fiscal policies, the HNB relied on macro-prudential measures to limit balance sheet risks for banks, slow down the pace of credit growth and increase the banking sector's resilience against the vulnerabilities of financial euroisation.

Managing balance sheet risk

Limits on banks' net open foreign exchange positions sought to avoid currency mismatches on banks' balance sheets. Raising or lowering the limit allowed the HNB to affect credit conditions. The limit was initially set at 20% of regulatory capital, but was raised to 30% during the crisis, mainly to allow banks to take on foreign currency loans or deposits without having to increase their assets.

The authorities sought to take into account indirect credit risk for banks stemming from currency mismatches on borrowers' balance sheets. From 2004, the HNB tightened capital requirements for lending in foreign currency through higher risk weights on loans denominated in or indexed to foreign currency. From mid-2006, an additional

25% risk weight add-on had to be applied for foreign currency loans to unhedged borrowers, and at the beginning of 2008, the add-on was raised to 50%. The measures had to be abolished at the beginning of 2010, as the implementation of Basel II no longer allowed for higher risk weights for foreign currency loans. The HNB responded by raising the required minimum capital ratio from 10% to 12%. Under Basel III, the HNB now explicitly accounts for currency-induced credit risk in its supervisory review process (pillar 2).

Measures to contain credit growth and increase reserve buffers

Measures were put in place to slow down the pace of credit growth. The first measure to be implemented was the 'credit growth reserve' (2003 to early-2004), which required banks to purchase low-yielding central bank bills in the event of a more than 4% expansion of credit in a given quarter. The measure was partly effective in containing lending growth, but it also produced evasion effects as lending activity was shifted to leasing companies or replaced by direct cross-border lending by parent banks. In addition, it may have distorted competition by discouraging smaller banks from expanding more rapidly and gaining market share.

Some of the negative side effects of macro-prudential measures were addressed. From mid-2004, the 'credit growth reserve' was replaced by a measure targeting banks' external funding sources. The so-called 'marginal reserve requirement' obliged banks to deposit between 24% (2004) and 55% (from late 2005) of their newly incurred foreign liabilities in non-interest bearing accounts with the central bank.⁽³⁵⁾ From early 2006, the marginal reserve requirement was complemented by a 'special reserve requirement' to be applied on banks' liabilities from newly issued securities. Both measures were removed following the onset of the crisis in October 2008 to allow parent banks to support their subsidiaries. Between 2007 and 2009, a revamped version of the credit growth reserve was put in place, this time covering a

⁽³⁵⁾ This increase in the regulatory cost of foreign borrowing encouraged parent banks to boost the capital ratios of their subsidiaries rather than extend loans, partly explaining the high capital ratios of Croatian subsidiaries.

broader set of assets and reducing the lending growth ceiling to 1% per month.

Reserve requirements on deposits were also used. These ranged from 17% to 19% in the pre-crisis period. From December 2008, the HNB cut reserve requirements in various steps to stimulate lending and assist government programmes for providing cheap loans to the corporate sector. In December 2013, the reserve requirement stood at 12%.

Liquidity management

As the HNB faced constraints in fulfilling its function of lender of last resort to the heavily euroised banking system, banks were required to build their own foreign exchange liquidity reserves. In 2003 a 'foreign currency liquidity requirement' was introduced, prescribing that banks hold 35% of their total foreign currency liabilities (including deposits) in liquid assets with a maturity of no more than three months. The rate was lowered in several steps in the course of the crisis to reach 17% in 2013.

Assessment and challenges

The macro-prudential policies ensured that banks built up capital and liquidity buffers, which were both useful during the crisis. In particular, the marginal and special reserve requirement and the higher risk weights applied to foreign currency-loans to unhedged borrowers helped to build significant loss-absorbing capacity, with capital adequacy ratios of about 20% for the largest banks. The banking sector was also well prepared to cope with the almost complete cessation of foreign inflows in late 2008/early 2009, thanks to high foreign currency liquidity buffers in the system.

As the experience of other countries demonstrates, even well-designed macro-prudential measures can give rise to substantial "leakages", and may not be fully effective in containing credit growth.⁽³⁶⁾ In the presence of credit growth limits, foreign-owned subsidiaries helped arrange cross-border borrowing from parent banks and set up leasing

⁽³⁶⁾ For example, Aiyar, Calomiris and Wieladek (2012) found that macro-prudential measures in the UK were not fully successful in constraining aggregate credit growth. While regulated banks reduced their lending in response to tighter capital requirements, this was partly offset by increased lending by unregulated banks.

companies to shift part of the lending activity off balance sheets. Banks also attempted to circumvent the foreign currency liquidity requirement by offering kuna deposits indexed to an exchange rate. While leasing companies were brought under the supervision of the non-bank regulatory agency HANFA and the foreign currency liquidity requirement was extended to cover currency-indexed deposits from 2006, the HNB's ability to reign in cross-border lending remained limited.

While the banking sector is largely shielded from direct exchange rate risk, it is still exposed to foreign-currency-linked credit risk. The practice of extending loans either denominated or indexed in foreign currency transferred the exchange rate risk to banks' clients, large parts of which were unhedged, even though export-oriented companies and about 10% of households have access to foreign income (remittances, tourism). In the dominant euro-denominated loan segment, the risk is limited by the authorities' commitment to a broadly stable HRK/EUR exchange rate. In the Swiss franc-denominated loan portfolio, however, credit risk started to materialise in the form of rising NPLs, following the appreciation of the Swiss franc against the kuna in autumn 2011. Meanwhile, NPLs for household loans remain well below those for corporate loans.

3.3.2. Monetary and exchange rate issues

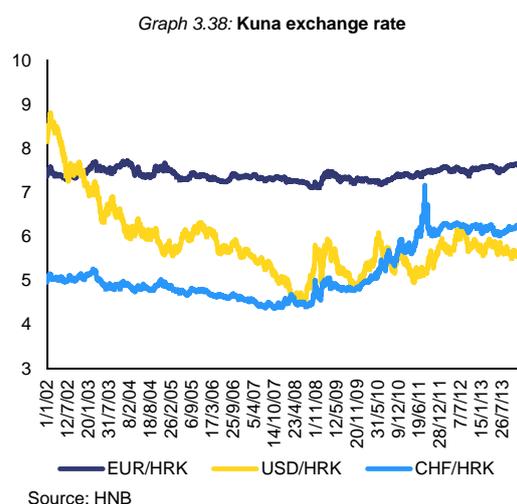
Maintaining a broadly stable exchange rate of the kuna against the euro has been a key element of Croatia's economic policy strategy.

The exchange rate as a nominal anchor is considered important for two main reasons. First, it serves as a key anchor for price stability given the country's high import-dependency. Second, it is important from a financial stability perspective due to the high foreign currency exposure of both the public and the private sector. The degree of financial euroisation in Croatia is among the highest in the world, which stems from a strong preference of the population for saving in foreign currency, combined with an obligation on banks to adjust the currency structure of assets and liabilities.⁽³⁷⁾ While the kuna is the currency used

⁽³⁷⁾ Tkalec and Verbic (2012) found that negative balance sheet effects following a depreciation of the kuna against the euro would outweigh any positive effects on

for payments, the vast majority of savings and loans are either denominated in or linked to foreign currency (71% of loans and 83% of deposits). Apart from the euro (61% of outstanding loans and almost all foreign currency deposits), the Swiss franc plays a role, though its importance has gradually decreased since the crisis (to about 10% of outstanding loans).

The exchange rate regime can be described as a tightly managed float. Over the past decade, the HRK/EUR exchange rate has remained broadly stable, with movements between 7.1 and 7.7 (Graph 3.38). The central bank does not defend a pre-determined target rate or band, but aims at countering excess volatility. It uses macro-prudential tools and occasionally intervenes on currency markets. Foreign exchange reserves stood at EUR 12.9 billion at year-end 2013, equivalent to around 29% of GDP and covering close to 90% of short-term external debt. Although the pace of reserve growth has slowed down following the outbreak of the financial crisis, Croatia continues to accumulate foreign currency reserves. However, this also reflects borrowing on external markets, notably by the government, which brings its own vulnerabilities.

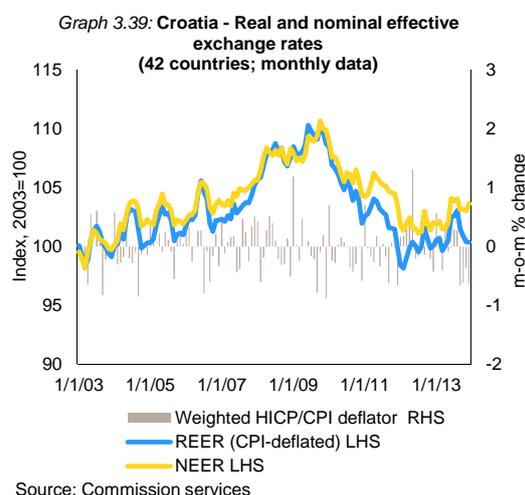


In nominal and real effective terms, the kuna remained broadly stable during 2013. While it appreciated by 1½% in nominal effective terms, it remained almost unchanged in real effective terms

competitiveness. The latter would arguably be limited by the narrow export base and large import content of exports.

(Graph 3.39). A slight nominal depreciation against the euro was counterbalanced by an appreciation against the US dollar, the Chinese yuan and the Russian ruble – the currencies of Croatia's most important non-euro area trading partners. In real-effective terms (CPI-deflated), the kuna has benefited from slightly lower inflation compared to trading partners since mid-2010, which resulted in a slightly lower real-effective exchange rate path as compared to the nominal-effective rate.

In contrast to many other countries in the region, Croatia experienced relatively low and broadly stable inflation during the past decade. While inflation has been very sensitive to commodity price shocks (food prices in 2007-8, energy prices in 2012), the responsiveness to the business cycle has been more muted, both during the boom period and during the crisis. Annual inflation was 2.8% on average during the past decade, the third lowest among the CEE and Baltic countries. Since the onset of the crisis in 2009, annual inflation has come down to 2.2% on average.



The low inflation environment allowed the HNB to maintain an accommodative monetary policy stance, with continued high liquidity provision to the banking sector. Between December 2008 and year-end 2013, it decreased reserve and liquidity requirements in various steps and implemented credit support schemes involving the Croatian development bank HBOR. However, with the exchange rate as the monetary policy anchor

and given the high level of euro-denominated debt, the central bank's room for manoeuvre remains limited. An improvement in macroeconomic fundamentals, in particular export competitiveness, would help to underpin exchange rate stability in the medium-term and increase leeway for monetary policy to support the recovery of the economy.

3.3.3. The situation of the banking sector

Croatia's banking system is characterised by a high degree of foreign ownership, minimal state presence, and capital levels among the highest in the region. The banking sector as a whole has total assets of EUR 54 billion, or about 130% of domestic GDP, which is on the high side for the CEE region.⁽³⁸⁾ There are around 30 banks in Croatia, with the five largest, representing 75% of the system, being subsidiaries of banks from Italy and Austria (see Table 1). State ownership is limited to two banks, representing only around 5% of total banking assets.⁽³⁹⁾ Foreign parent banks of Croatian subsidiaries generally have a strong presence in the region.⁽⁴⁰⁾ In line with the conservative macro-prudential approach taken by the HNB, the reported capital adequacy ratios of the largest foreign banks stand at above 20%, while liquidity coefficients remain well above the minimum required ratios. Mid-sized banks have a reported average capital adequacy ratio of 16.6%. Compared to large banks, mid-size banks are proportionally more exposed to corporates, and less exposed to the government and the retail sector.

The high degree of foreign ownership of banks in Croatia (Table 3.1) has generally been seen in a positive light. There is evidence that foreign banks can play a stabilising role during crises and can bring benefits such as increased efficiency, the transfer of knowledge (including knowledge of bank management and risk management) and the stability of lending relationships.⁽⁴¹⁾ Foreign ownership should also, in principle, help to limit linkages between the sovereign and the banks, notably in cases where additional capital may be required. However, market structure is highly concentrated, with the largest bank accounting for over a quarter of banking assets, and the two largest accounting for over 40%.

⁽⁴¹⁾ Foreign bank presence is associated with a lower probability of systemic banking crises, while foreign banks are also less likely to pull back from a host country in the face of problems (Demirgüç-Kunt, Levine and Min, 1998; Cull and Martinez Peria, 2010). Galac and Kraft (2000) found that foreign banks in Croatia had competitive advantages in terms of cheaper funding sources, lower loan interest rates and superior personnel, but the impact of foreign entry on competition and new product and service innovation was only modest.

⁽³⁸⁾ In the group of Central, Eastern and South-Eastern Europe (CESEE) countries, Croatia has the fourth largest banking sector when measured by the share of banking assets to GDP (after Cyprus, Malta and Slovenia).

⁽³⁹⁾ Hrvatska Postanska Banka d.d. is the eight-largest bank, with EUR 2.2 billion of assets (around 4% of the total), and is in the process of being sold. Croatia Banka d.d., with a EUR 0.2 billion balance sheet (less than 0.5% of total assets), was put under a restructuring programme in 2010, and received state aid amounting to about EUR 30 million. The current owner is the state agency responsible for managing the deposit guarantee scheme.

⁽⁴⁰⁾ In September 2013 the European Commission approved a restructuring plan for Hypo Group Alpe Adria (HGAA), which is 100% owned by the Republic of Austria and which is the parent bank of Hypo Alpe Adria d.d., Croatia's fifth-largest bank. Under the plan, the operative parts of the bank will be sold while the non-viable remainder is to be put into an orderly wind-down process.

Table 3.1:

Structure of the Croatian banking system

Bank name	Ownership	Organisation	Assets (bn EUR)	Assets (% of balance sheet)
Zagrebacka Banka d.d.	Unicredit, Allianz	subsidiary, Italy	13.65	25.7
Privredna Banka Zagreb d.d.	Intesa Holding Int., EBRD	subsidiary, Italy	9.04	17.0
Erste & Steiermarkische Banka	ESB Holding GMBH	subsidiary, Austria	7.69	14.5
Raiffeisenbank Austria d.d.	Raiffeisen Group, Raiffeisenbank	subsidiary, Austria	4.68	8.8
Hypo Alpe-Adria-Bank d.d.	Hypo Alpe-Adria-Bank International AG	subsidiary, Austria	4.55	8.6
Largest five			35.07	66.1
Societe Generale-Splitska Banka d.d.	Societe General	subsidiary, France	3.47	6.5
Hrvatska Postanska Banka d.d.	Republic of Croatia, Croatian Post, Croatian Pension Insurance Admin.		2.24	4.2
OTP Banka Hrvatska d.d.	OTP Bank NYRT	subsidiary, Hungary	1.75	3.3
Largest eight			42.5	80.1

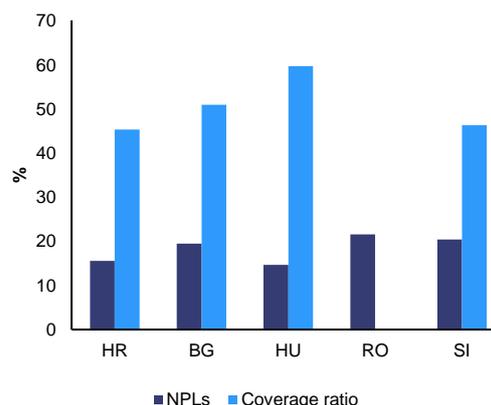
Source: HNB

One of the major challenges facing Croatian banks is the high level of NPLs to corporates, although their rate of increase has slowed recently. The protracted weak macroeconomic environment has had a significant effect on banks' asset quality. Overall NPLs reached 15.3% at end 2013, up from 14% one year earlier and 5% in 2008 (Graph 3.40 and 3.41).⁽⁴²⁾ This effect has been strongest in the corporate sector, with NPLs at 27.4% in the same period, up from 24% in the previous year. Corporate NPLs are highest in construction and real estate as well as the wholesale and retail trade sector. In terms of currency, NPL are higher for CHF-denominated loans, which rose from 35.8% in June 2011 to 52.9% in September 2013. In comparison to other countries that experienced a similar GDP contraction in recent years, NPLs are high. However, the year-on-year growth in corporate NPLs slowed to 12% in 2013, from 23% in 2012. While provision coverage ratios have been increasing recently, they are low in comparison to other countries and the past. Since NPLs are one of the main channels through which the state of the economy can impact banks' balance sheets, their future evolution needs to be closely monitored. It has to be noted that some corporate loans may

⁽⁴²⁾ The national classification of NPLs in Croatia is very similar to the standard, 90-days-past-due definition adopted by the EBA, and the same is true for the definition of forbearance. Nonetheless, two factors need to be considered with regard to the classification of risky loans. First, loans remain classified as performing as long as there are no payment irregularities, even when the loan guarantor is called upon. Second, public loans benefiting directly or indirectly from a state guarantee and representing a large share of the banks' balance sheets could tend to be reported as performing even when the underlying project is in disarray. Thus, there are potentially large contingent liabilities for the state.

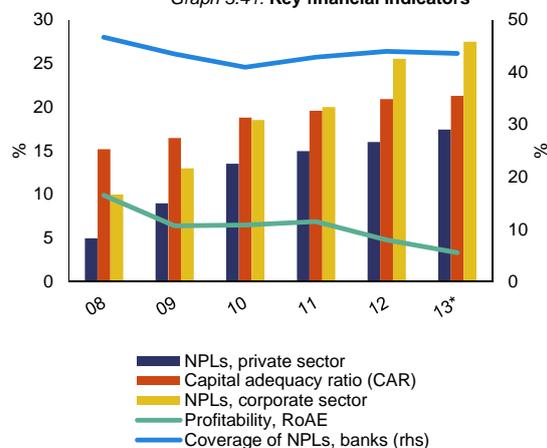
need to be restructured, which could result in higher provisions, but in some cases banks might be inclined to keep funding non-viable businesses rather than take additional losses.

Graph 3.40: NPLs and coverage ratio, Q3 2013



Source: HNB

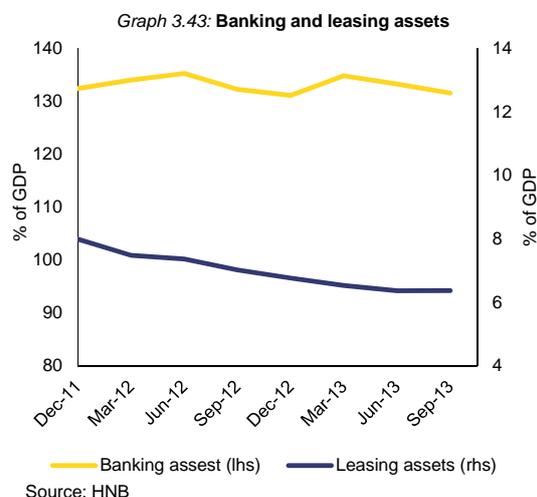
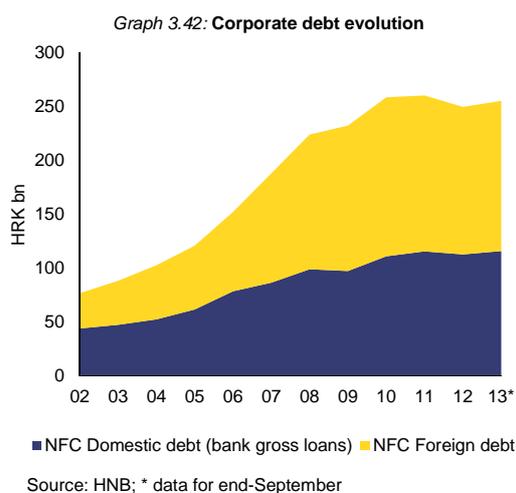
Graph 3.41: Key financial indicators



Source: HNB; * - data for end-September

Domestic banks were not the main drivers of the rise in corporate indebtedness. As noted

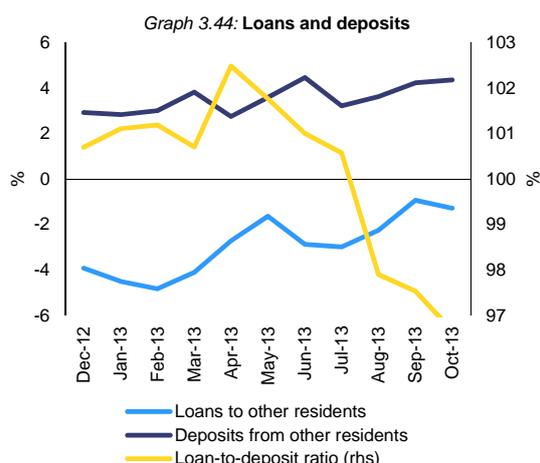
above, various macro-prudential measures limited the role of domestically-supervised banks in aggregate credit supply during the 2000s. Consequently, the rise in corporate indebtedness was mainly driven by increased external borrowing, with a prominent role played by foreign parent banks of Croatian subsidiaries (Graph 3.42). The credit risk for these loans remains with the parents. Similarly, lending to corporates was also channelled through non-bank financial intermediaries, notably leasing companies, again with the intention of circumventing the HNB's macro-prudential restrictions on banks. All large international bank groups present in Croatia have leasing subsidiaries generally funded through parent banks. When leasing companies became subject to stricter regulation, the sector underwent a substantial deleveraging (Graph 3.43).



NPLs in the household sector are well below those for corporates, but are also growing more rapidly. At the end of 2013 household sector NPLs stood at 10.6%. While household NPLs increased relatively rapidly between 2008 and 2010, their growth subsequently slowed. More recently, however, there has been acceleration in the growth of household NPLs, from 10% year-on-year in 2012 to 17% year-on-year in 2013, driven by a strong increase in NPLs for mortgage loans. Despite this, household NPLs remain well below the levels reported for the corporate sector. A key part of the explanation for the better performance of household loans seems to be that payment discipline by mortgage borrowers is relatively strong in Croatia compared to some other countries, while loan-to-value (LTV) ratios did not rise as much as elsewhere. However, the evolution of household NPLs differs with the currency of denomination. In June 2011, NPLs for household loans stood at 6.8% in both the euro- and CHF-denominated segments. By end-2013, NPLs for household loans rose to 13.3% for CHF-denominated loans, whereas in the euro-denominated portfolio the corresponding figure was 8.6%. While banks have transferred the exchange rate risk for these loans to the borrowers (many of whom are unhedged), the strong preference by borrowers for foreign-currency-linked loans does create indirect credit risk for banks. The existence of this risk helps to explain why the HNB adopted a conservative approach to bank capital levels in recent years.

Bank liquidity conditions have been improving.

With increased risk aversion by the private sector, deposit volumes have increased and deposit funding has become cheaper for banks. This along with more readily available domestic retail funding (deposits), has led to an improvement in the loan-to-deposit ratio (Graph 3.44) and has also enabled the large banks to pay back foreign liquidity sources (credit lines and interbank-loans) and reduce their reliance on parent funding. This has reduced the degree of funding vulnerability of Croatian subsidiaries. Conversely, medium-sized banks are historically more reliant on domestic sources of funding and less affected by potential foreign deleveraging. Loan-to-deposit ratios are lower than in other countries that experienced rapid credit growth in the recent past, and which should support a revival in credit growth once demand picks up.



Croatian banks remain profitable, but profitability has nevertheless come under pressure from several sources.

Rapid deleveraging in the corporate sector has meant that many loans are not being renewed, which reduces banks' ability to earn interest income. Both deteriorating asset quality and deleveraging are negatively affecting the business performance of the Croatian banks, while margins are also under pressure. Bank profits fell by 28% year-on-year in 2012 and by preliminary 70% year-on-year in 2013, but still remained positive and higher than in neighbouring countries throughout the crisis, due in part to the high flexibility in adjusting interest rates in the past, as well as to improvements in

operating efficiency more recently. In 2014 profits are expected to come under further pressure, given the stricter regulation on provisions for late-stage arrears (an increase by 10% a year independently of collateral valuations), the new minimum haircuts on property collateral valuation, and the reduction in lending volumes.

Croatian banks' interest margins have come under pressure.

This is mainly due to weak loan demand from households and NFCs, and a reorientation of lending towards less risky clients (the general government sector and SOEs) where the interest rate charged would typically be lower. Furthermore, interest income has also fallen as a result of increasing NPLs, and also as a result of the different regulations on the setting of interest rates. The combined impact of these factors is reflected in the lowest net interest margins since 2008 with annual net interest income falling to 2.5% of average assets from 2.9% in 2011. Although the interest margin is diminishing, there is little room for the banks to increase lending rates given the weak economy.

The various measures regulating the setting of interest rates could give rise to a number of adverse effects for the economy and for borrowers.

There are three different types of interest rate regimes that banks are obliged to apply. First, on retail loans denominated in Swiss Francs, a maximum interest rate of 3.23% was set, which is a lower rate than on other loans, despite the fact that no new CHF-denominated loans have been sold for the past five years. Second, a ceiling has been imposed on the maximum interest rate that can be charged to clients in arrears (11% for retail and 15% for corporates). In addition to negatively affecting banks' ability to earn interest income, an adverse side effect of this regulation is that it may not be profitable for banks to lend to less creditworthy borrowers, and there is a risk that some borrowers could be forced to look for credit from less well regulated lenders. Third, in setting interest rates to clients, banks are required to choose one among five benchmarks plus a margin. Most large banks have chosen Euribor, which is currently at historically low levels, with the consequence that interest rates for clients can likely only increase. Moreover, Euribor may not be a reliable indicator of Croatian banks' funding costs, given that they also have to internalise CDS spreads. Although this particular measure was

Table 3.2:

	Scenario 1:		Scenario 2:	
	current NPLs provisions lifted to 60%		NPLs lifted to 25% provisions lifted to 60%	
	in bn EUR	in %	in bn EUR	in %
Current Regulatory capital (net)	6.4	19.8	6.4	19.8
Total Risk weighted assets	32.4		32.4	
Current provisions (Coverage ratio)	2.3	43	3.8	43
Additional provisions required	0.9	17.0	1.5	17.0
Total provisions required	3.2	60	5.3	60
Total NPLs	5.4	15.3	8.8	25.0
Total loans	35.2		35.2	
New Regulatory capital (net)	5.5	16.9	4.9	15.1

Source: Commission services; HNB

taken with the aim of increasing transparency for customers about the lending rates that banks charge, it risks introducing market rigidities and reducing competition, thus potentially leading to counterproductive outcomes. Furthermore, it could limit banks' ability to supply credit to the real economy.

Weak loan growth to the private sector appears to mainly reflect reduced demand for credit, as the subdued macroeconomic environment has led households and NFCs to deleverage. Given that Croatia has experienced five consecutive years of recession, demand for credit has fallen sharply. Weaker credit demand stems mainly from small and medium-sized enterprises (SMEs) and in relation to long-term credit. Still, the HNB reports that SMEs continue to need access to credit for working capital purposes and to refinance existing debt, but that they are facing tighter credit standards.⁽⁴³⁾ According to the latest EIB CESEE lending survey, credit supply conditions for mortgages, large companies and long-term loans have tightened and are expected to continue doing so in the next months. Tighter credit standards are partly a consequence of banks' increased risk-aversion, which is not only due to the interest rate caps, discussed above, but also due to the need to keep risks and capital under control. The EIB survey found that, while credit demand remains

weak, it is expected to expand slightly, also due to the positive impact of debt restructuring actions.

Banks have responded to reduced private demand for credit by increasing the supply of loans to state entities, but this could give rise to problems further down the road. Total loans by monetary financial institutions to the Croatian economy peaked at EUR 46.9 billion in March 2012. Since then, loans to the general government sector and SOEs have increased, while loans to the rest of the economy have fallen (see Box 3.6.). Loans to the private sector have contracted by EUR 2.2 billion or almost 5% from their peak, which has been mainly driven by the strong reduction of loans to NFCs. By October 2013 bank credit to NFCs had declined by 12.6% from the peak in March, while credit to households had fallen by 4%. Weak loan demand from households likely reflects, among other things, worsening labour market conditions, notably the increase in the unemployment rate. In contrast, loans to the general government have been rising, reaching 11% y-o-y growth in the first ten months of 2013 (see Graph 4 in Box 3.1). Viewed from a pure banking/credit-risk perspective, an increase in loans to SOEs may not necessarily be problematic provided the enterprises are creditworthy. However, a continuation of these trends would be incompatible with a reduced role for the state in the economy. There may also be doubts about the longer-term viability of many SOEs. Furthermore, there are important contingent liabilities for the government associated with guarantees to SOEs.

⁽⁴³⁾ The tightening of credit conditions may partly reflect stricter Austrian supervisory guidance requiring subsidiaries to reduce their loan-to-deposit (LTD) ratios to below 120%.

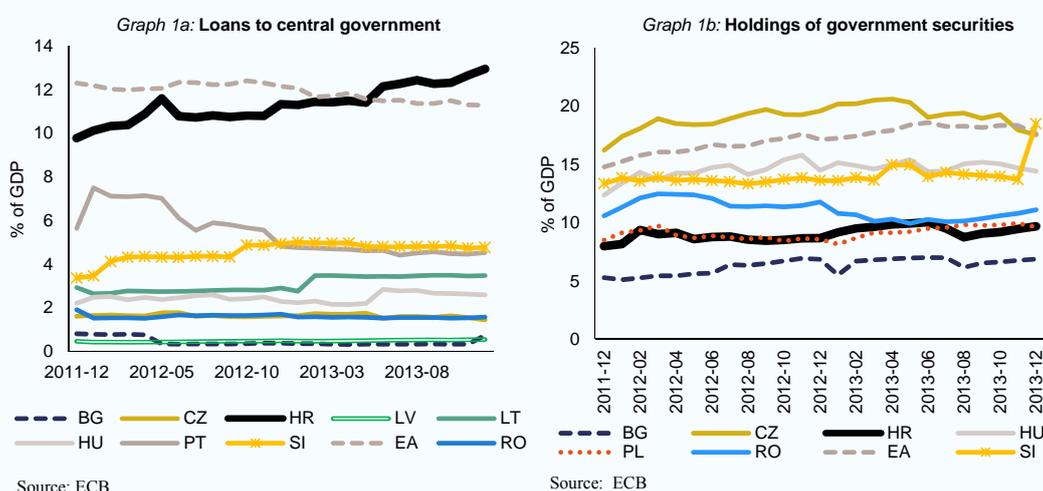
Finally, it will be important to ensure that there has not been a structural shift in banks' risk appetite to the detriment of newer, private companies.

Box 3.6: Banks' exposure to the general government and SOEs

The growth of loans to the central government has increased almost constantly since 2011 (from 9.8 to 12.3% of GDP). While these levels are high when compared to other CEE countries, they are not out of line with figures for the euro area (Graph 1a). Loans to the central government represent about 10% of banking assets (EUR 5.5bn) and are concentrated in the large private banks. The increase stems from the fall in demand for credit from the private sector and enables the banks to partially compensate for the reduced interest income, while also limiting credit risk.

While loans to the corporate sector contracted by 4% y-o-y in September 2013, this figure masks different trends between private corporates and state-owned enterprises (SOEs). Croatian SOEs represent 13% of corporate income but absorb 23% of corporate loans.⁽¹⁾ Whereas the volume of loans to private corporates had dropped by 9% in September 2013 on a y-o-y basis, bank credit to SOEs increased by 10%. Besides demand factors, banks may consider SOEs to represent a lower credit risk than other NFCs. State guarantees (whether explicit or implicit⁽²⁾) as well as their sector of activity often tightly linked to public services (e.g. utilities) may also be a factor behind the perceived lower credit risk of the sector. However, such a credit policy may lead to a misallocation of capital within the Croatian economy, and can hinder needed corporate sector restructuring, notably of SOEs with questionable viability. To the extent that it continues, there is also a risk that privately-owned firms, and especially newer, more innovative companies, may not be able to contribute strongly to Croatia's recovery, as they may be at a disadvantage in terms of access to credit compared to SOEs.

Holding of sovereign securities by Croatian banks represent 8% of bank assets and 9% of GDP. They were on a modestly increasing path up to the first quarter of 2013, but holdings have declined since then (Graph 1b). Holdings of government securities also are instrumental for banks to fulfil liquidity requirements as well as to be able to access central bank liquidity in case of need. The large majority of bonds (around 90%) are held by the largest banks, while small banks hold mostly Treasury bills.



The reallocation of banks' credit portfolios towards public sector entities (central government and public enterprises) discussed above has allowed banks to partially compensate for the downward pressure on their profitability as a result of weak credit demand from the private sector. Indeed, this development may be one

⁽¹⁾ The Government Asset Management Company, which manages the Croatian firms with direct government ownership, has more than 600 firms in its portfolio. Most likely there are many more firms with some minor share of public sector ownership or indirect state ownership.

⁽²⁾ Loans to public institutions benefit from a zero risk-weighting for capital purposes, but loans to SOEs with a commercial purpose do not.

(Continued on the next page)

Box (continued)

of the factors that has allowed Croatian banks to achieve higher profitability levels than banks in other countries in the region over recent years (with return on average assets rising to 1.3% and that on average equity to 6.8%). But these trends need to be monitored closely to ensure that credit is not being misallocated.

Balance sheet repair, together with other initiatives, should help strengthen the capacity of banks to support the economy.

Factors that are weighing on bank profitability, and thus constraining their ability to lend, include the high stock of NPLs coupled with inefficiencies in the court system that may hinder banks' ability to work through NPLs. Recent revisions to the pre-bankruptcy procedure should help with this. An additional positive factor is the various parent banks' initiatives to dispose of bad assets within their groups, which might help to release new resources for lending over the next year. The European Commission and EIB are also proposing an initiative to boost lending to SMEs, by providing funds from the two institutions, and to allow for risk sharing and/or guarantees for funding from the commercial banks. Such initiatives are potentially very useful, especially if the environment is characterised by heightened risk aversion, but care should be taken by banks to avoid compromising lending standards.

High capital levels should allow Croatian banks to accommodate any further needed increase in provision coverage ratios.

Despite increasing recently, provision levels are lower than in the past but higher capital levels provide an important buffer. The provision coverage ratio stood at 43% at end 2013, and including a general provision for performing loans, it was at 49%.⁽⁴⁴⁾ While the coverage ratio has increased rapidly during the last year (also due to the new supervisory regulation introduced in June 2013 on additional haircuts for the property collateral), it is still low compared to the past (it stood at 52% in 2007) and compared to the euro-area average of around 60%.

A simple sensitivity analysis appears to show that Croatian banks remain adequately capitalised for now. With a reported core capital adequacy ratio of 19.8% at end-September 2013, banks in Croatia are capitalised much above the

EU averages and above the Basel requirements.⁽⁴⁵⁾ A simple sensitivity analysis shows that with the provisioning coverage ratio at 60% and NPLs at 25%, capital adequacy would be reduced to 15%, which is still above the minimum requirement of 13% (Table 3.2). These buffers seem to be high enough to cover future potential losses. However, this conclusion is obviously preliminary, since it is not based on any in-depth analysis of individual banks' balance sheets.

The four largest Croatian subsidiaries will participate in the ECB Comprehensive Assessment exercise via their parent banks.

The Comprehensive Assessment exercise will be undertaken by the ECB and the relevant national competent authorities during 2014 in the context of the Single Supervisory Mechanism (SSM). It will consist of a supervisory review, an asset quality review and a stress test. It should, however, be recognised that the exercise might be less informative about the situation of Croatian banking sector, as selection of loan portfolios will be done on a banking group level, and thus may not fully reflect the circumstances of Croatian subsidiaries. In view of this, there is scope to consider whether additional supervisory diagnostic actions can be taken from a Croatian perspective to complement the Comprehensive Assessment and, thus, provide any needed additional information. The SSM will move the supervision of parent groups of the main Croatian banks to the ECB, and will represent an opportunity to strengthen cross-border supervision and cooperation between home and host supervisors, including also for non-SSM host supervisors, such as the HNB.

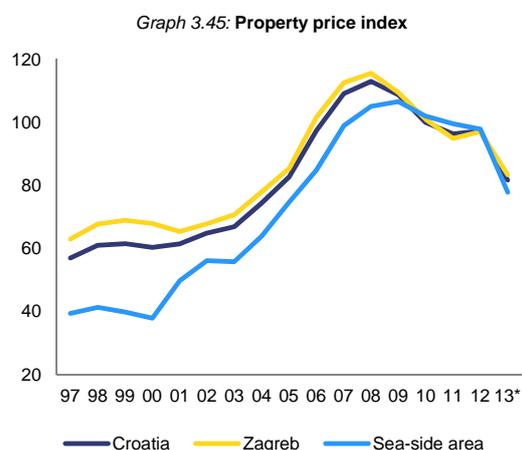
While banks' asset quality may be affected by any further falls in property prices, notably

⁽⁴⁴⁾ The HNB estimates that the new requirement on higher provisioning reduced banks' profits by 37%.

⁽⁴⁵⁾ Macro-prudential tools in place between 2004 and 2008 (high reserve requirements on banks' foreign liabilities, high foreign currency liquidity requirements) boosted banks' capital positions, as they induced foreign parent banks to provide a large part of financing in the form of equity.

through collateral valuation, there are factors which should help to mitigate this risk. House prices in Croatia nearly doubled in the five years leading up to 2008, and since then have declined by approximately 30% (Graph 3.45).⁽⁴⁶⁾ In parallel, deleveraging in the real estate sector started at the end of 2012. However, banks are to some extent protected against real-estate related risks, due to relatively low loan-to-value ratios and to guarantees. Nevertheless, aware of the risks that further falls in property prices could potentially have on banks' balance sheets, the HNB conservatively introduced additional haircuts on property collateral in June 2013 (see above).

whether it leads to a timely restructuring of firms (from both an operational and a debt perspective) and whether it enables the restructured firm to emerge as truly viable at the end of the process and therefore capable of accessing credit.



The efficiency of the legal system will affect the ability of banks to work through problem loans.

A well-functioning legal system can be helpful in speeding adjustment to, and recovery from, property price shocks. For example, impediments to banks' ability to realise the value of loan collateral would likely mean that such collateral would only re-enter the market with a significant lag. In relation to corporate loans, the Croatian authorities introduced a pre-bankruptcy framework in 2013, to speed-up the restructuring and repayment process of companies in distress and avoid the lengthy bankruptcy procedure as far as possible (see Box 3.4.). This new pre-bankruptcy procedure got off to an imperfect start, however, in part due to legal loopholes, and had to be revised. It remains to be seen whether it appropriately balances the rights of creditors and debtors,

⁽⁴⁶⁾ Source: Financial Stability Report, 2013.

4. POLICY CHALLENGES

POLICY CHALLENGES

After an expansionary phase, in which imbalances accumulated, Croatia is now experiencing a prolonged downturn, in which a range of external and internal risks have come to the fore. The current account reversal since 2009 has exposed high external liabilities, uncompetitive exports, a corporate debt overhang and public sector indebtedness as particular vulnerabilities. Structural deficiencies have contributed to these imbalances, including a poor business environment and a malfunctioning labour market. State-owned enterprises still play a dominant role in some sectors and they are often highly indebted and weakly profitable. These factors also combine to lower potential growth, which hinders private sector balance sheet repair and increases the required fiscal consolidation effort.

External sustainability and exports

Greater sustainability of Croatia's external position is conditioned on improved competitiveness and broadening exports beyond tourism to support growth. Although labour costs have grown moderately since 2009 in comparison with competitors, these trends will only bring labour costs down to competitive levels if sustained and would yield greater benefits if combined with non-cost-competitiveness improvements, including in the business environment. These are preconditions for Croatia to attract high-quality FDI, regenerate its industrial fabric, rebalance and lay the foundations for sustainable growth and the creation of jobs. The maintenance of strong, stability-oriented monetary and fiscal policies is a strategic imperative, in view of high external liabilities, and the extent of foreign-currency-denominated obligations of the financial, non-financial and public sectors.

Indebtedness and deleveraging

In view of private sector over-indebtedness, it is important to ensure the conditions for a smooth continuation of the deleveraging process, including through proper functioning of insolvency and debt-restructuring regimes. Correctly functioning financial intermediation would also be beneficial, notably to ensure that

credit is correctly allocated within the economy as deleveraging continues. The orientation of bank lending within the corporate segment could be monitored, especially in view of debt levels and doubts as to long-term viability of some publicly-owned entities. Removing some of the restrictions on banks' ability to set interest rates can also contribute to efficient financial intermediation. Close monitoring and supervision of systemic banks will continue to be important, in cooperation with home country supervisors. In this respect, the ongoing ECB comprehensive assessment exercise will include the four largest Croatian banks, through their respective parents. There is scope to consider complementing this with additional supervisory diagnostic steps from a Croatian perspective.

With reference to the risks to the current trajectory of public debt, there is a pressing need for high-quality, structural fiscal consolidation measures amounting to a clear and credible overall public finance consolidation strategy. Compliance with the targets contained in the EDP and thereafter with the requirements of the SGP would ensure that Croatia's debt is on the sustainable path. A number of supporting policies can be considered. Tax shifting towards less mobile factors could boost labour market participation and growth and yield second-round fiscal benefits. Further asset disposals and concession agreements could yield proceeds to pay-off debt and reduce fiscal risks from the potential socialisation of losses incurred by publicly-controlled enterprises. Substantial reductions in subsidies to firms, improved targeting of social benefits, a more effective social protection system, together with credible fiscal institutions and rules at all levels of government, could help support sustained deficit and debt reductions.

Growth, employment and the business environment

Croatia has been in recession for five consecutive years and only a muted recovery is in sight. Growth and employment are desirable as ends in themselves but would also ease private sector deleveraging, improve fiscal ratios, strengthen banks and make external liabilities more sustainable. Therefore, the structural reforms,

including of the labour market, became ever more important. This would be complemented by efforts to efficiently mobilise EU funds to boost potential growth in the wider economy.

The scale of the employment shortfall and of economic adjustment represents a major policy challenge. The employment rate has been the lowest in the EU since 2009, and stayed low throughout the economic cycle. Reforms currently under way in the labour market could be accompanied by flanking initiatives to boost legal certainty and increase the speed and efficiency with which employment cases are considered by the courts. A comprehensive response could also involve, where necessary, adjusting a number of institutions and policies affecting labour market functioning. Building on recent steps to improve targeting of social benefits, unemployment assistance and other benefits could be revisited to reduce inactivity traps. Closely monitoring and enhancing the effectiveness of Active Labour Market Policies, while increasing their coverage of vulnerable groups, would help to address unemployment and skills mismatches.

The authorities recognise the need for structural policies to promote orderly adjustment and rebalancing and boost competitiveness. Some steps have been taken in this direction. Recently adopted measures include, among others, changes in the investment promotion legislation that simplify procedures and introduce new incentives for investors, and streamlining of social contributions to encourage labour force participation. The authorities have also introduced amendments in the bankruptcy legislation aimed at significantly facilitating exit from the market and have simplified procedures for granting construction permits in an attempt to revive the sector.

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