CONCLUDING STATEMENT

Croatia: Staff Concluding Statement of the 2024 Article IV Consultation Mission

FOR IMMEDIATE RELEASE

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

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

Zagreb, Croatia: *Following an exceptionally strong post-pandemic recovery during 2021-22 and with tighter monetary policy, Croatia's growth moderated to 3.1 percent in 2023, still among the highest in the euro area (EA). The robust growth performance reflects buoyant domestic demand as the strong labor market and the authorities' policies have supported household income and EU funds have boosted investment. Inflation has receded significantly since early 2023 but remains above the EA average with sticky and elevated services inflation. Croatia's near-term economic outlook is favorable, yet subdued productivity and labor shortages pose challenges to its medium-term growth prospects. With a renewed 4-year mandate and leveraging the commendable steadfast implementation of the National Recovery and Resilience Plan (NRRP), the government is well positioned to advance deep-seated reforms to further lift Croatia's standards of living. Policies should focus on (i) preserving fiscal prudence and pursuing decisive reforms to build buffers for future shocks and meet long-term spending needs; (ii) staying vigilant in safeguarding financial stability; and (iii) advancing structural reforms to ease supply-side constraints, boost potential growth, and accelerate the green transition.*

Outlook and Risks

1. **The economy is expected to remain robust with gradual disinflation.** We project real growth at 3.4 percent in 2024 and 2.9 percent in 2025, supported by buoyant domestic demand even as tourism growth is expected to recede from its strong performance in recent years. The output gap is estimated to narrow but remains positive during 2024-26. Disinflation is expected to continue albeit gradually, with inflation averaging about 4.2 percent in 2024 and approaching the European Central Bank's target of 2 percent only in late 2025. Services inflation would be sticky reflecting strong wage increases and tourism demand. Over the medium term, we project growth to approach its potential of 2½ percent, as productivity-enhancing investment under the NRRP mitigates the drag from demographic headwinds.

2. **Risks to the outlook are broadly balanced.** Intensifying regional conflicts, commodity price volatility, and a global or regional recession could pose downside risks to growth. Domestically, continued wage growth exceeding productivity could undermine competitiveness and potential growth as well as prolonging elevated inflation. Faster

implementation of reforms could raise actual and potential growth. Supply shocks could pose upside and downside risks to inflation.

Fiscal Policies

3. **The authorities should reduce the fiscal stimulus in 2024.** We project a sizable increase in the overall deficit from 0.7 percent of GDP in 2023 to 2½ percent of GDP in 2024, driven by generous increases in social payments and compensation of public employees. This implies a further fiscal loosening relative to the already expansionary stance in 2023. The expansionary and procyclical fiscal stance could fuel domestic demand and risks hampering the disinflation and undermining competitiveness. We call for promptly reversing the broad-based cost-of-living measures (notably tax cuts and price controls), which would yield about ⅓ percent of GDP in savings while restoring price signals. Any remaining support measures should be temporary and target the most vulnerable, while revenue over-performance should be saved. Moreover, where feasible, raising revenue and/or cutting discretionary non-priority current spending should be explored to reduce the stimulus.

4. **We support the Ministry of Finance's plan to meaningfully reduce the overall deficit starting from 2025 and return to a structural primary balance by 2027.** Recurrent fiscal expansion during a period of robust economic growth could damage Croatia's hard-won fiscal credibility. Fiscal prudence and decisive reforms are also warranted to create fiscal space for long-term spending needs and build buffers for future shocks. Croatia faces large investment needs, including for the green and digital transitions, and increasing fiscal costs from an aging population. Currently, a large share of public investment is financed by the EU. It is important to generate and reserve fiscal space for future investment as the importance of the EU funding recedes and to ensure that debt accumulation is used to finance high-return public investment. Moreover, Croatia needs buffers for a more uncertain and shock-prone world. The planned reduction of the headline deficit by about ⅔ percent of GDP in 2025 is also achievable. Under this fiscal consolidation path, we project public debt to further decline to 55 percent of GDP in 2029 and assess Croatia's sovereign stress risk to be low.

5. **Addressing Croatia's large investment and social needs calls for broadening the tax base, reducing spending rigidity, and increasing spending efficiency.**

- **Tax policy.** Property and income taxation favoring residential real estate investment and short-term rental and limited environmental taxation reduce the tax base and create distortions. We reiterate our recommendation to introduce a modern value-based property tax and remove the excessively favorable taxation on short-term rental income. Removing explicit and implicit subsidies on fossil fuels would raise revenues (estimated around 2 percent of GDP annually) while promoting the green transition.

- **Public wage bill.** The recent wage reform could enhance the fairness and competitiveness of the public remuneration system. Further reforms are needed to reduce the size of public wage bill in the coming years. There is scope to rationalize the public workforce based on a functional review of the public sector and to develop the internal market to improve mobility. An attrition rule needs to be more strictly enforced except for essential functions.

- **Pension and healthcare systems.** Measures to address pension costs could include (i) increasing the statutory retirement age and/or increasing minimum contribution years and indexing the retirement age to life-expectancy; and (ii) strengthening the second pillar pension by expanding its coverage and building trust while improving the adequacy of the PAYG system. On healthcare, co-payments designed to directly reduce fiscal costs could be introduced while seeking to broaden healthcare access, which may save costs by providing less expensive primary care or reduce reliance on old-age homes.

- **Public investment management (PIM).** Progress has been made in implementing some recommendations of the IMF's 2021 Public Investment Management Assessment. Further efforts are needed to move towards a more centralized framework for appraisal, processing, and monitoring of all public investments and duly implement the recently drafted PIM manual and action plan.

6. **The authorities should stay the course to strengthen corporate governance and fiscal risks management of state-owned enterprises (SOEs).** Croatia is undertaking significant reforms to its SOE ownership, governance, monitoring, and oversight practices. A new single law on SOEs to strengthen corporate governance is also expected to be adopted by end-2024. Regular assessment, reporting, and disclosure of fiscal risks of SOEs need to be introduced.

7. **Croatia needs to strengthen its medium-term fiscal framework in order to prepare and successfully implement the structural fiscal plan required by the new EU fiscal rules.** In this context, the authorities should consider preparing and publishing a Fiscal Risk Statement, covering all aspects of risks to the budget. There is also scope to improve the role of the Fiscal Policy Commission in promoting sustainable public finances. Such a Commission should continue to build its capacity to assess the robustness of macroeconomic and fiscal forecasts. It can also play a useful role in assessing fiscal risks such as contingent liabilities, as well as long-term fiscal sustainability including the analysis of aging and climate costs.

Financial Sector Policies

8. **Continued vigilance and close monitoring are warranted to safeguard financial stability.** The financial sector has weathered well the monetary tightening. Systemic risks have remained broadly unchanged and appear manageable. Despite the improved balance sheets of households and corporates, higher financing costs coupled with a more normal economic growth could still pose challenges to the repayment capacity of some. Supervisors should continue to ensure that banks maintain adequate capital buffers and diligently monitor credit risks. They also need to continue scrutiny of the buoyant albeit stabilizing real estate market for signs of overheating and risk buildup. Furthermore, despite the financial sector's limited direct exposure to commercial real estate, more efforts are needed to investigate indirect exposures and manage potential spillovers and inter-linkages. Finally, given the significant intercompany loans, we recommend relevant agencies to gather more granular information and step up the monitoring of associated vulnerabilities.

9. **The authorities should continue to assess the need for introducing explicit borrower-based macroprudential limits and stand ready to do so as warranted.** Given the maturing expansionary phase for both the credit and housing cycles, the tight stance of capital-based macroprudential measure is appropriate. The authorities are invited to continue reassessing the adequate level of counter-cyclical capital buffer and consider the merits of a positive neutral framework, which is irrespective of the credit gap estimates and could facilitate communication. Despite signs of market cooling, the residential real estate sector may face renewed pressures, given favorable taxation, growth of disposable incomes, and high bank liquidity. Should strong market momentum begin to resume, the authorities should stand ready to introduce explicit borrower-based measures (BBMs) to preempt future financial stability risks. To alleviate inequality or other social concerns, first-time house buyers could be subject to different BBM thresholds, coupled with targeted measures to improve housing affordability and bearing in mind that BBMs should be used predominantly to contain systemic risks. The welcome expiration of housing loan subsidies and the decline of foreign demand have eased structural obstacles for implementing effective BBMs.

STRUCTURAL POLICIES

10. Boosting Croatia's growth prospects calls for addressing labor shortages and revitalizing productivity. The multidimensional nature of labor shortages requires coordinated policies to foster higher labor participation, reduce skills mismatch, facilitate labor mobility, and integrate foreign workers. Targeted interventions should aim at strengthening vocational education and training to ease school-work transition, expanding opportunities for and improving the quality of adult learning to facilitate re-skilling and up-skilling, and improving domestic labor mobility. Boosting productivity requires comprehensive reforms to encourage innovation, strengthen business dynamism, and facilitate access to financing. Policies need to facilitate firm entry and exit by removing regulatory barriers in services and improving business insolvency procedures. Furthermore, boosting public financing for research and development, developing capital markets with the creation of a capital markets union for Europe, and encouraging equity financing can broaden financing options for innovative investment. Strengthening the quality of institutions will also improve the business environment and incentivize private investment. Croatia should keep the momentum in strengthening the effectiveness of its AML/CFT regime to exit the Financial Action Task Force's grey list.

11. Policies to address housing affordability need to tackle the underlying supply gap in housing rather than helping demand. Boosting supply calls for making better use of the sizable existing vacant stock and modernizing and streamlining regulations. Importantly, reducing or removing the favorable tax treatment of residential real estate investment and short-term rental would help reduce speculative demand and activate idle housing. Policy action is also warranted to accelerate the modernization of the legal cadaster, develop the currently thin longer-term rental market, and invest in infrastructure and green social housing for low-income households. Demand-side measures such as subsidies to home buyers, even if well targeted, tend to be effective only in the short term, as they at least partially contribute to higher house prices or rental costs over the medium term.

12. Croatia needs to accelerate the green transition. The recent National Energy and Climate Plan (NECP) presents a good starting point and should be integrated with other strategic documents and subject to public consultation. Reaching the EU's climate change mitigation goals requires economy-wide carbon pricing, reinforced by sectoral policies (notably feebates for power, transport, and building heating) and targeted support to vulnerable households.

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