IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of Croatia

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On June 2, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.[1]

Background

The global crisis brought an end to Croatia's multi-year economic expansion. After reaching 5.5 percent in 2007, GDP growth decelerated to 2.4 percent in 2008 and the downdraft intensified further in the first months of 2009. Domestic demand and exports started to contract on the back of sharply diminished capital inflows and deepening recession in the EU and other regional trading partners. For the year as a whole, staff projects real GDP to decline by 3½ percent. Weighed down by weak domestic and external conditions, GDP is expected to grow only slightly in 2010.

The crisis exposed underlying vulnerabilities in Croatia's economy. As elsewhere in the region, the high growth rates relied on an unsustainable credit boom, facilitated by easy access to domestic and foreign financing, notwithstanding prudential and other credit measures taken by the authorities to curb credit growth. External debt reached high levels, with banks and corporates increasingly dependent on foreign funding. At the same time, domestic debt also swelled rapidly, predominantly in foreign currencies and mostly by unhedged borrowers.

Croatia is now in the midst of a sharp adjustment. A robust policy response has helped Croatia navigate the crisis relatively well, but downside risks remain significant. While the external imbalances are receding from the previous high levels, the adverse economic and financial conditions feed on each other, amplifying the downturn, reducing access to much needed external financing to cover sizable external liabilities maturing in 2009–10, and eroding the private sector's debt servicing capacity. While banks have comfortable cushions from relatively strong profitability and capital positions, the vulnerability of the domestic financial sector to external funding and credit risks has increased.

In response, the Central Bank of Croatia (CNB) has taken a number of measures to maintain the orderly functioning of markets, avert destabilizing pressures on the kuna, and help address the fallout of the crisis on the financial system. In particular, the CNB addressed liquidity shortages through active use of regulatory requirements, repo auctions, and intermittent foreign currency intervention. It maintained close cooperation with foreign banks to secure adequate external funding and reduce banks' liquidity risk. And it strengthened the oversight and monitoring of the banking system and upgraded stress test exercises. While these measures succeeded in stabilizing markets and preparing the banking system for the challenges ahead, heightened uncertainty has fueled deposit and loan euroization.

Fiscal policy has been under pressure. Revenues, especially VAT and excises, started to underperform in late 2008, reflecting sharply lower trade volumes and declining economic activity. In response, the government reduced cash spending on goods and services, limiting the 2008 general government deficit to 0.9 percent of GDP. Based on a wide range of spending cuts, including a freeze of salaries, the revised budget for 2009 aims for a deficit of 1.6 percent of GDP, entailing a cyclical tightening. However, the fiscal deficit is likely to widen to above 2 percent in 2009 due to a further deterioration of macroeconomic conditions. The government's domestic borrowing has recently risen sharply, with the government increasingly competing for resources with the private sector in the current tight credit environment.

Structural reforms remain an important policy objective and key to help the economy emerge from the current crisis more resilient and dynamic. However, recent progress has been slow, and Croatia still lags other central and eastern European countries on business environment indicators.

Executive Board Assessment

Executive Directors noted that, along with other countries in the region, Croatia has been severely affected by the global economic downturn and the continuing strains in financial markets. Real GDP is expected to contract this year—for the first time since 1999. Sharply lower capital inflows have triggered a correction in the external imbalances built up in recent years, but they also amplify pressures on the private sector in view of its relatively large debt overhang and sizable external financing needs.

Directors commended the authorities for the timely and well-targeted policy response, which has helped to maintain market confidence and mitigate the initial impact of the crisis. Monetary policy, including through liquidity operations and changes in reserve and liquidity requirements, has helped to alleviate liquidity pressures on banks and supported a broadly stable exchange rate. Directors took note of the staff's assessment that the real effective exchange rate is broadly in line with fundamentals, and considered that, in the current uncertain juncture, the authorities' exchange rate policy has helped anchor macroeconomic stability, particularly in the presence of large balance-sheet exposures to currency risk. At the same time, the exchange rate strategy limits policy options to cushion the downturn, and a cautionary monetary policy will need to be continued until external pressures abate. Moreover, this exchange rate policy also requires adequate external financing and support from prudent fiscal and financial sector policies, as well as faster implementation of structural reforms to bolster competitiveness. Attention to competitiveness issues was seen as important especially in view of recent strong depreciations of several competitor country currencies.

Directors supported the authorities' efforts to secure adequate external financing. They underlined the need for continued monitoring of banks' liquidity positions and close cooperation between domestic banks and their foreign parent banks, as well as between home and host supervisors. Directors welcomed the rollover arrangements in the banking sector, but cautioned that rollover risks in the corporate sector are particularly pronounced, underlining the importance of tracking developments closely.

The banking sector remains resilient, with relatively strong profitability and capital positions, aided by prudent regulatory requirements. However, loan quality could suffer as the recession deepens and financing conditions tighten. Directors encouraged the authorities to undertake a diagnostic review of the financial conditions of all banks, and to require those with potential recapitalization needs to raise capital buffers. The framework for resolution of troubled assets could also be upgraded, including through a swift adoption of the new foreclosure law. While many elements of Croatia's contingency framework to deal with banks in distress are consistent with international best practice, Directors saw scope for improving interagency coordination on crisis preparedness and management.

Directors considered the cyclical tightening envisaged in the revised 2009 budget appropriate in light of the tight financing conditions. They welcomed the recent eurobond issue, which signals investor confidence in the authorities' policies and helps reduce the government's domestic financing needs. However, in view of the downside risks to revenue collection, spending commitments should be reined in, and a strategy should be developed to contain a possible decline in taxpayers' compliance and to avoid the re-emergence of public sector arrears. Looking forward, Directors stressed the importance of rationalizing public spending without unduly compromising the delivery of public services. They welcomed the authorities' actions to improve public financial management, and encouraged stepped up efforts to modernize the civil service, improve cost recovery for social services, reduce subsidies, and better target social spending.

Accelerating structural reforms is crucial to raise productivity growth, boost Croatia's growth potential, and facilitate real adjustment by reorienting resources towards the tradable sector. Directors stressed the importance of further improving the business environment, advancing labor market flexibility, and swiftly completing the restructuring and privatization of loss-making state-owned enterprises.

Republic of Croatia: Selected Economic Indicators [1/]

	2004	2005	2006	2007	2008 Prel.	2009 Proj.
Output, unemployment, and prices	(Percent change)					
Real GDP	4.2	4.2	4.7	5.5	2.4	-3.5
CPI inflation (average)	2.0	3.3	3.2	2.9	6.1	2.5
Saving and investment	(In percent of GDP)					
Domestic investment	27.7	28.0	29.8	30.5	32.4	30.1
Domestic saving	23.4	22.5	22.9	22.9	23.0	23.3
Government	2.2	2.3	2.9	3.8	2.9	1.4
Nongovernment	21.1	20.2	20.0	19.2	20.0	22.0
Government sector [2/]						
General government revenue [2/]	39.7	39.2	39.6	40.7	39.8	39.5
General government expenditure [2/]	43.1	42.1	41.4	42.0	40.7	41.7
General government balance [2/]	-3.4	-2.8	-1.8	-1.2	-0.9	-2.1
General government balance (broad definition)[2/] [3/]	-3.4	-2.8	-2.6	-2.3	-1.1	-2.4
HBOR balance (net of budget transfers)	-0.4	-0.1	-0.2	-0.6	-0.7	-1.0
Cyclically adjusted primary balance [2/]	-1.6	-0.9	0.0	0.0	0.4	1.1
General government debt	37.9	38.4	35.9	33.2	33.5	36.7
Money and credit	(End of period; change in percent)					
Bank credit to the nongovernment sector	14.0	17.4	23.1	15.0	10.6	…

Broad money	8.6	10.5	18.0	18.3	4.3	…
Balance of payments	(In millions of euros)					
Current account balance	-1,434	-1,976	-2,715	-3,237	-4,454	-2,909
(In percent of GDP)	-4.4	-5.5	-6.9	-7.6	-9.4	-6.5
Capital and financial account	2,603	3,924	5,083	4,861	5,304	2,247
Overall balance	43	822	1,412	722	-330	-1,612
Debt and reserves						
Gross official reserves 4/	6,436	7,438	8,725	9,307	9,121	8,870
In percent of short-term debt (by residual maturity) 4/	108	85	88	109	69	81
In months of following year's imports of goods and NFS 4/	4.4	4.5	4.9	4.7	5.3	5.1
Net international reserves	5,026	5,604	6,464	7,349	8,020	8,252
External debt service to exports ratio (in percent)	24.4	27.2	37.5	37.8	34.3	50.5
Total external debt (in percent of GDP)	70.0	72.1	74.9	77.6	83.0	85.4
Net external debt 5/	33.0	37.7	38.8	41.1	46.4	48.8

Sources: Croatian authorities, and IMF staff estimates.

1/ National account data for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). Revised nominal GDP figure for 2008 is about 14 percent higher than the previous estimate.

2/ ESA 95 presentation. Operations of HAC, a state-oned road company, were excluded from the coverage of the general government in 2008.

3/ Includes "pensioners' debt" repayments.

4/ Data for 2009 corresponds to end-March.

5/ Net of official reserves and commercial bank foreign assets.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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