



Excessive Deficit Procedure and Macroeconomic Imbalances Procedure

Requirements for Croatia and current state of play

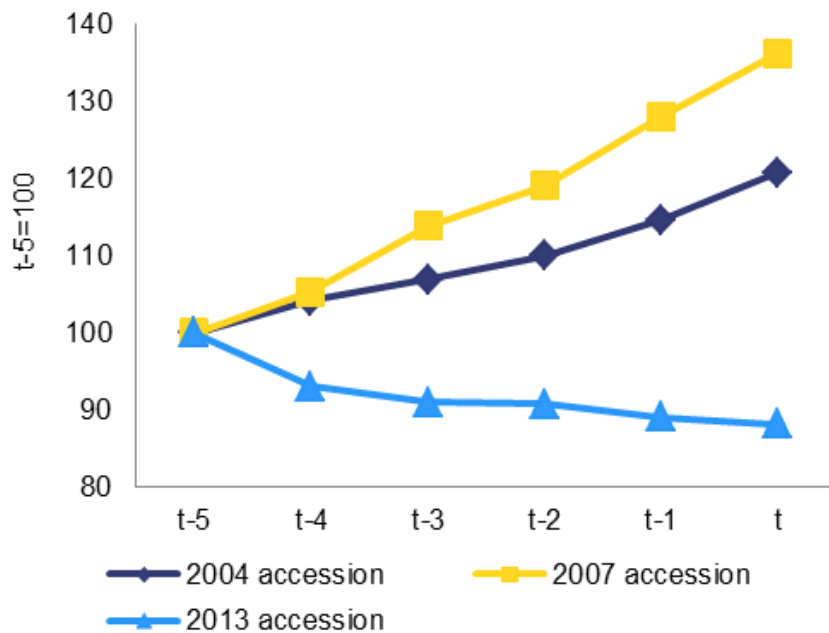
Servaas DEROOSE

Deputy Director-General
European Commission, DG Economic and Financial Affairs

Challenges of budget management in Croatia – Zagreb, 11 December 2014

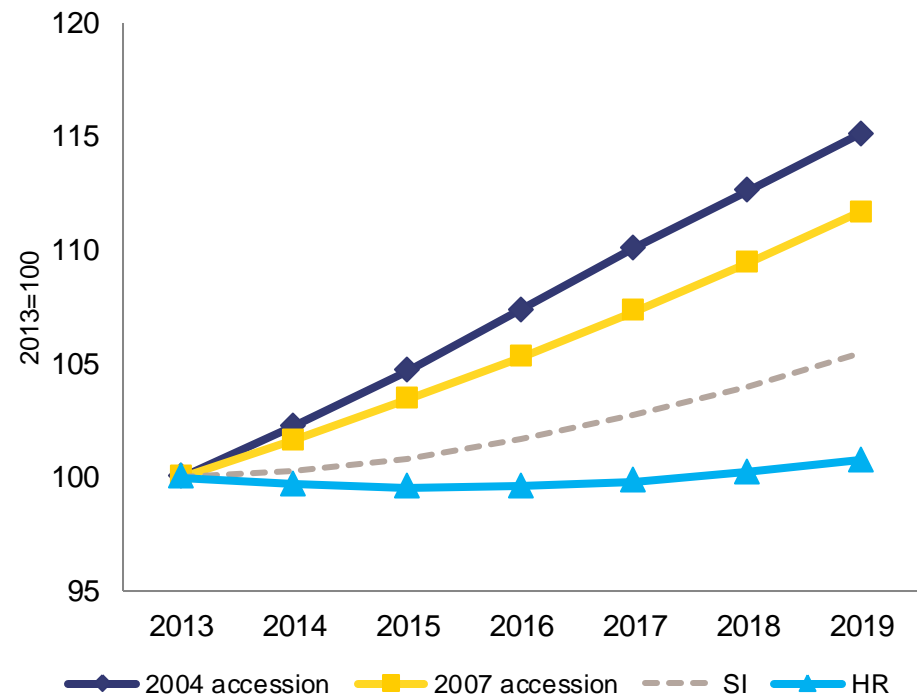
EU accession did not act as a growth trigger and medium-term growth prospects remain bleak

Real GDP dynamics in the run-up to EU accession



Source: Eurostat; Commission services; t - year of EU accession; 2004 (weighted av. for PL, CZ, SK, HU, SI, EE, LV, LT); 2007 (weighted av. for RO and BG); 2013 - HR

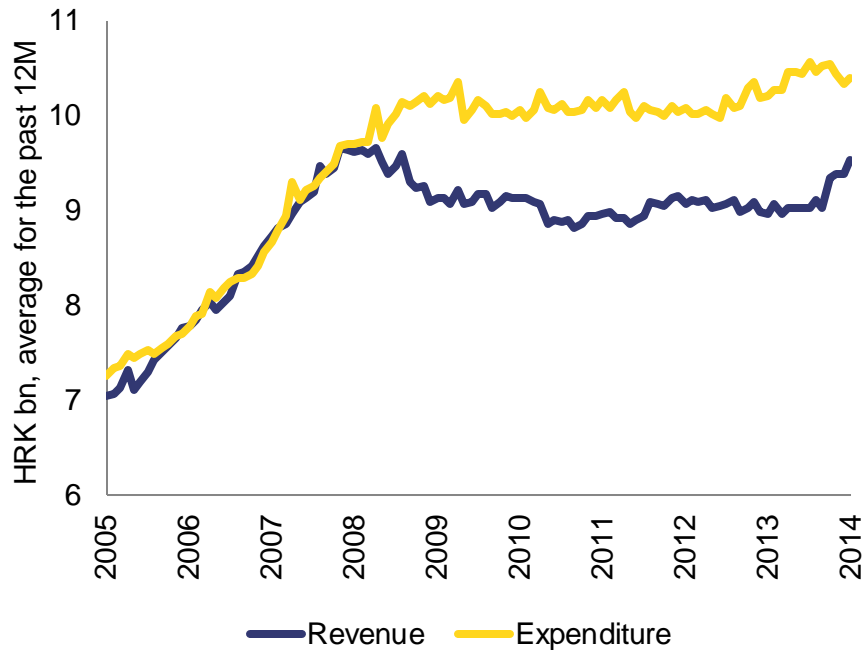
Potential output



Source: European Commission estimates (2014 Autumn Forecast)

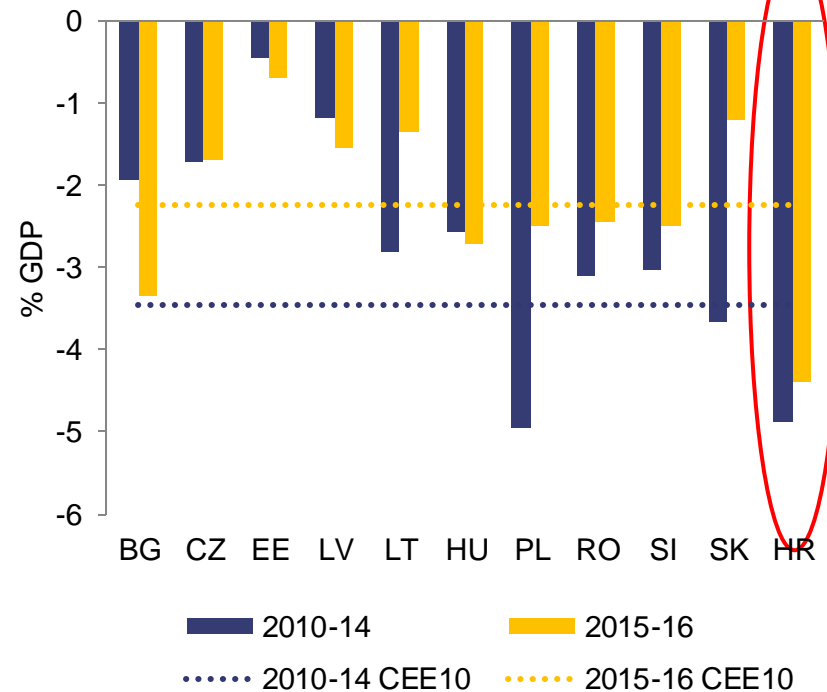
Protracted recession has contributed to further deterioration of Croatia's public finances

Consolidated central government revenue and expenditure, Croatia



Source: Ministry of Finance of Croatia. Commission services calculations.

General government structural balance



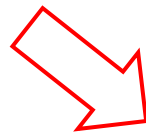
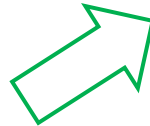
Source: European Commission 2014 Autumn Forecast; AMECO.

How the Stability and Growth Pact works

Treaty-based limits
(in % of GDP)

3% General government budget deficit

60% Gross government debt, or diminishing by at least 1/20 p.a.



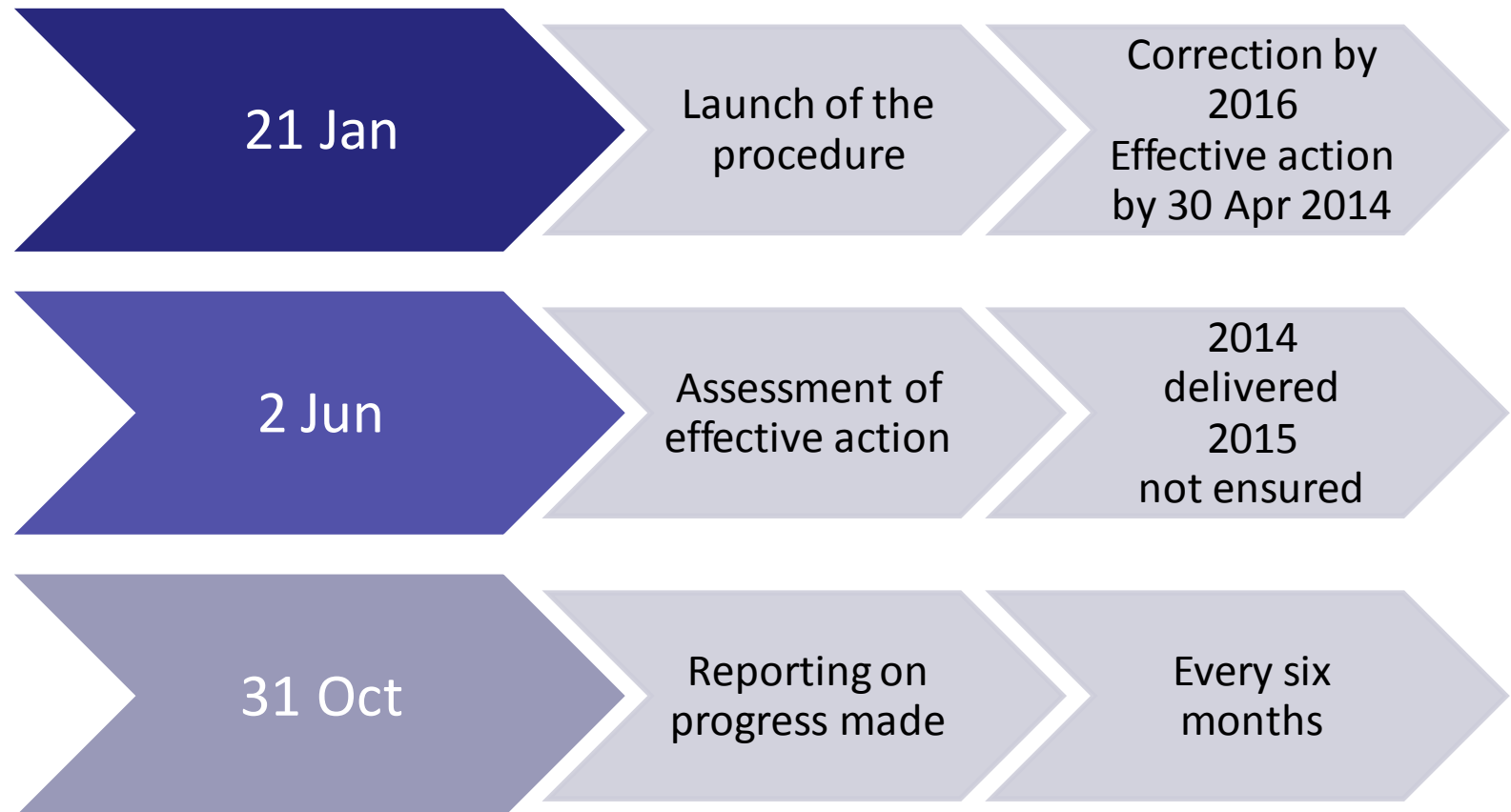
Preventive arm

<p>Medium-term objective Country-spec. reference value in structural terms</p>	<p>Expenditure benchmark To prevent net spending from rising faster than potential GDP</p>	<p>Balanced-budget rule Structural deficit <0.5% of GDP</p>	<p>Flexibility</p> <ul style="list-style-type: none"> • Negative growth • Major structural reforms
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Corrective arm: Excessive Deficit Procedure (EDP)

<p>Deadline of up to 6 months to comply with time-bound recommendation</p>	<p>No effective action</p>	<p>Stepping up, possibly sanctions (0.2% of GDP), ESI fund suspension</p>
	<p>Events outside govt. control</p>	<p>Deadline extension, revised recommendation</p>
	<p>Effective action</p>	<p>Putting the procedure on hold</p>

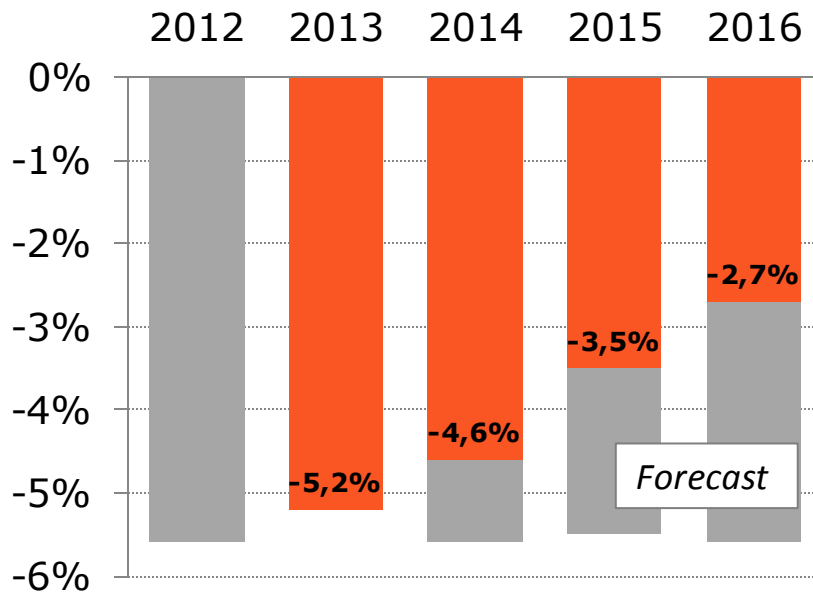
What have been the main milestones for Croatia under the EDP so far?



What is expected of Croatia?

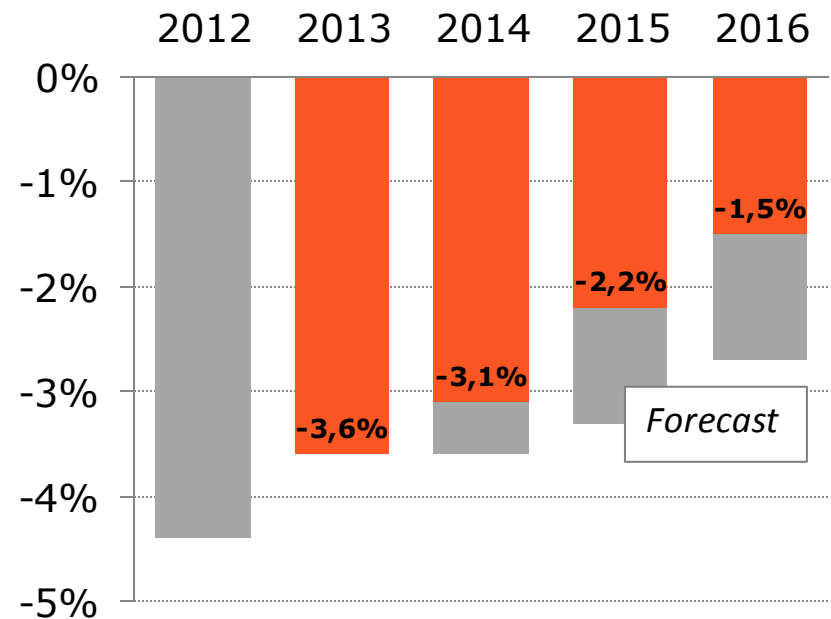
Headline deficit (% GDP)

EDP & EC 2014 Autumn Forecast



Structural balance (% GDP)

EDP & EC 2014 Autumn Forecast



Consolidation measures of 2.3% of GDP in 2014, 1 % of GDP in 2015 and 2016

Where does Croatia stand in 2014 and 2015?

EDP Recommendation and Commission 2014 Autumn Forecast (% GDP)

	2014			2015		
	EDP	Forecast		EDP	Forecast	
Headline budget deficit	4.6%	5.6%	✗	3.5%	5.5%	✗
Corrected change in structural balance	0.5%	0.0%	✗	0.9%	0.3 %	✗
Bottom-up assessment	2.3%	2.4%	✓	1.0%	0.7%	✗



Need to complement the 2015 budget with a detailed specification of concrete measures underpinning the fiscal targets

Main discretionary measures underpinning the Commission assessment

2014

- Increase in health contributions
- Increase in the lower VAT rate
- Increase in fuel taxes
- Increase in pension contributions

- Drop in investment
- Savings in intermediate consumption
- Reduction in subsidies
- Decrease in the wage bill
- Savings in health care

2015

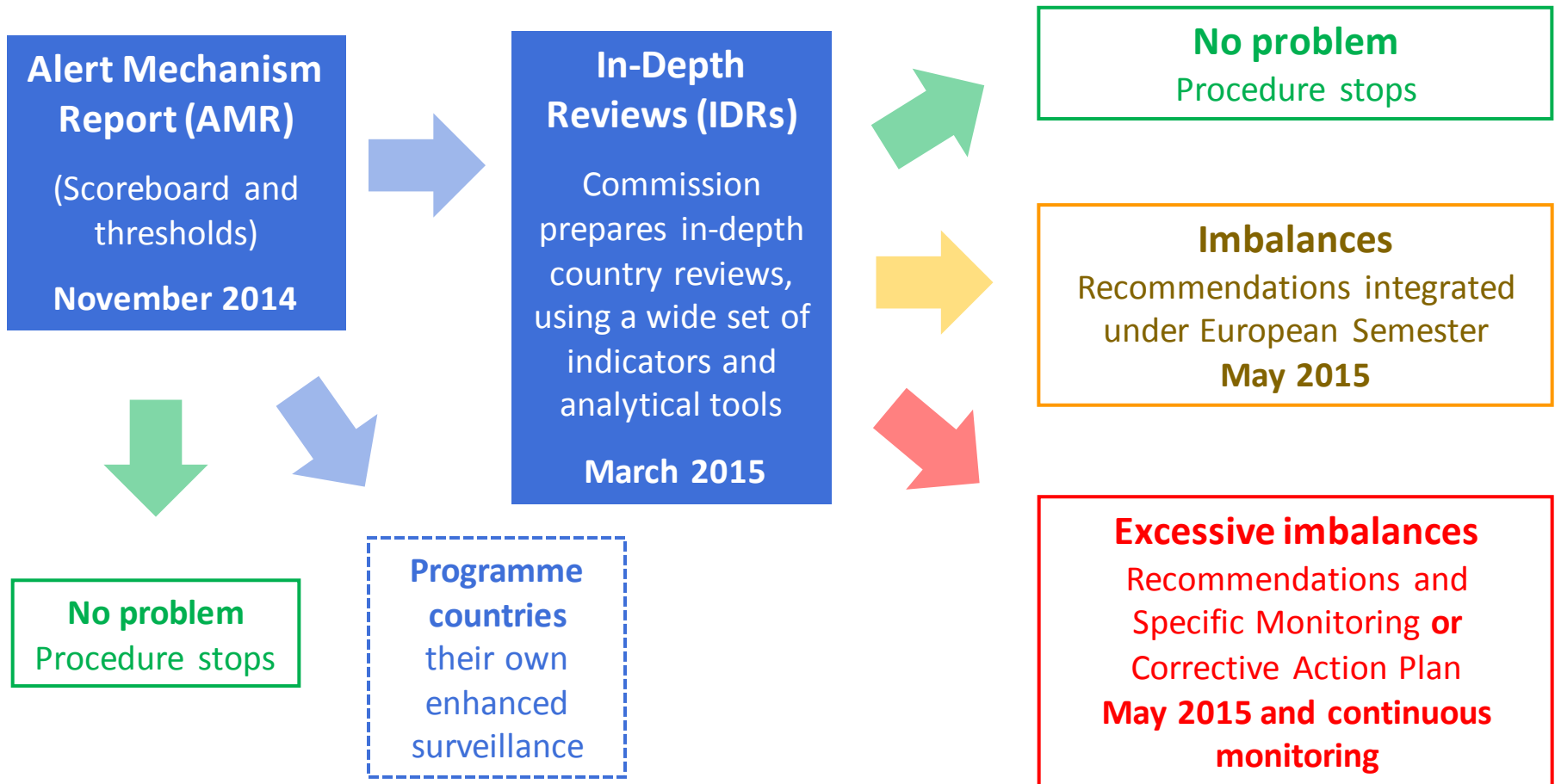
- Most of the 2014 measures impact fiscal effort in 2015 positively (adopted in the middle of the year)

- No further measures were known at the cut-off date of the forecast

- Deficit-increasing PIT reform
- New deposit interest tax
- Broadening of the lottery tax
- Qualitative expenditure cuts

2015
Budget

Macroeconomic Imbalances Procedure



The scope of the AMR's scoreboard

EXTERNAL IMBALANCES

- **External positions:** current accounts, net international investment positions
- **Competitiveness developments :** real effective exchange rates, unit labour costs
- **Export performance:** export market shares

INTERNAL IMBALANCES

- **Private sector indebtedness:** credit, debt
- **Public sector indebtedness**
- **Assets markets:** housing
- **Financial sector developments:** financial sector liabilities
- **Unemployment**

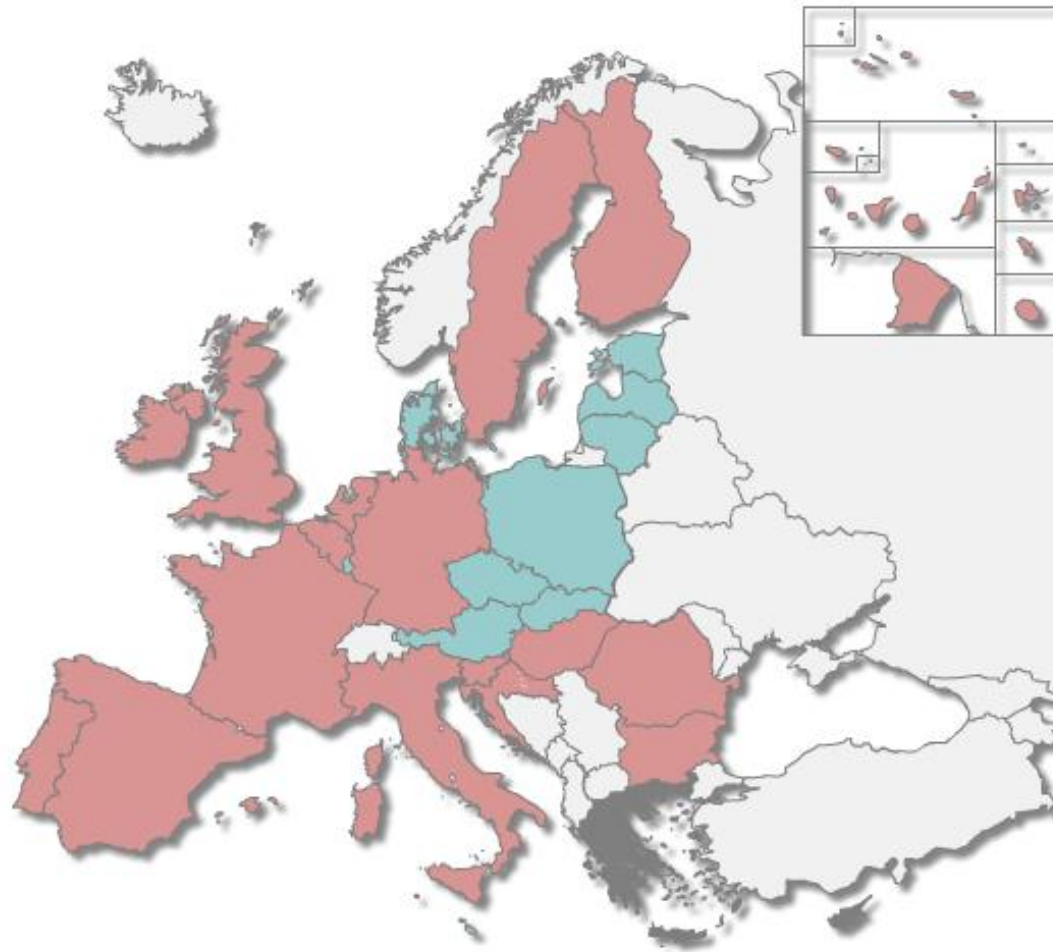
+ auxiliary indicators and auxiliary social indicators (no thresholds)

Croatia's performance in 2015 AMR's scoreboard

Indicator		Threshold	2012	2013	
External	Current Account Balance (% GDP)	3Y average	-4%/6%	-0.8	-0.1
	Net Internat. Investment Position (% GDP)		-35%	-89.9	-88.7
	Change in Real Effective Exchange Rate (%)	3 years	±5% & ±11%	-8.3	-4
	Change in Export Market shares (%)	5 years	-6%	-22.8	-20.9
	Change in Nominal ULC (%)	3 years	9% & 12%	-1.6	0.9
Internal	Change in Deflated House Prices (%)	y-o-y	6%	-2.2	-18.1
	Private Sector Credit Flow (% GDP)	consolid.	14%	-3.3	-0.2
	Private Sector Debt (% GDP)	consolid.	133%	123.4	121.4
	General Government Sector Debt (% GDP)		60%	64.4	75.7
	Unemployment Rate (%)	3Y average	10%	14.1	15.8
	Change in Total Financial Sector Liab. (%)	% y-o-y	16.5%	0.8	3.4

Source: European Commission

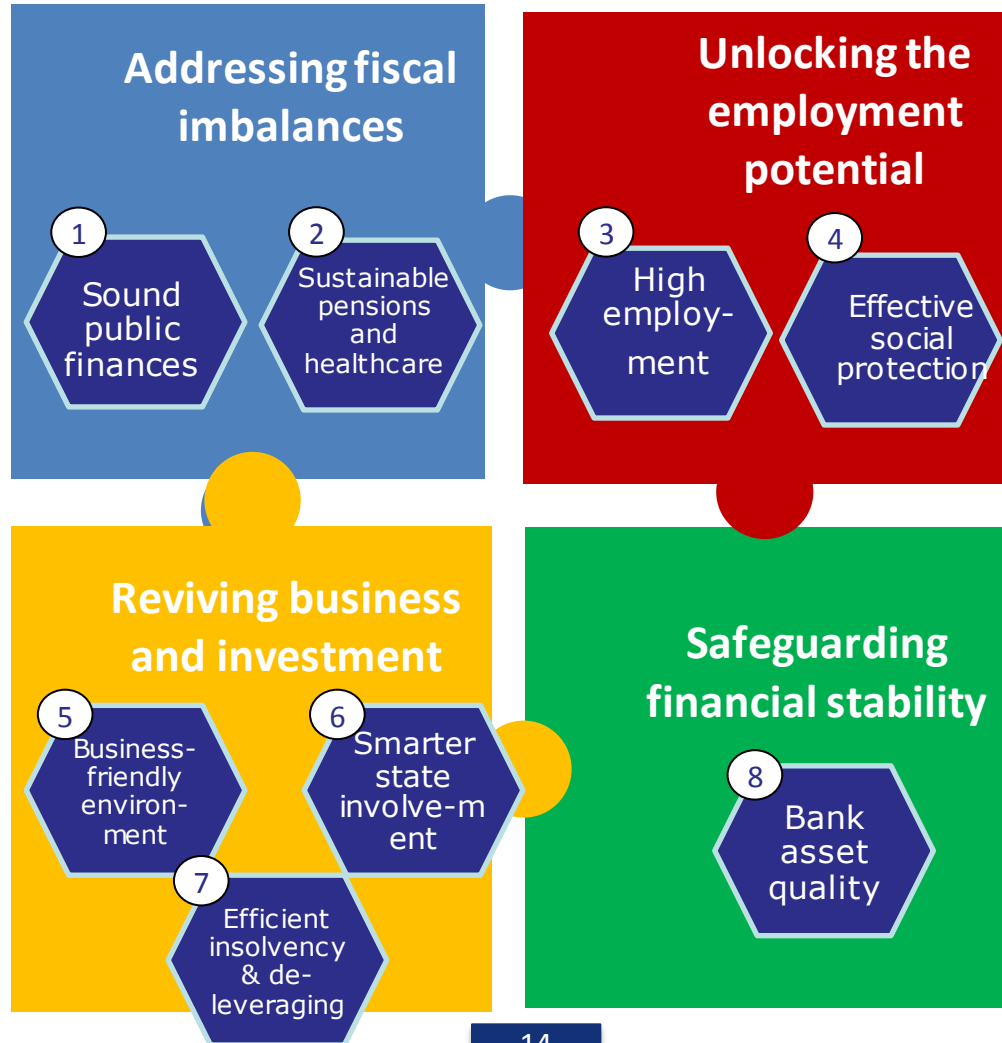
16 Member States will be analysed in-depth



The 2014 In-Depth Review highlighted five major risks and imbalances for Croatia

- 1** Competitiveness
Reflected in eroding export market shares
- 2** Adjustment capacity
Weaknesses in the labour market and the business environment have amplified the impact of the crisis
- 3** De-leveraging
Private sector entered the crisis highly indebted
External financing risks
- 4** Financial stability
Banking system has shown resilience
Still, non-performing loans very high
- 5** Public finances
Pro-cyclical fiscal policies have fuelled deficit and debt

2014 country-specific recommendations for Croatia



Specific MIP monitoring in Croatia reveals highly uneven progress since June

QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

- Progress on fiscal structural reforms piecemeal, facing implementation risks
- Only limited steps to align budgetary projections to ESA standards
- Expenditure review preparation in motion but no implementation timeframe
- Recurrent property tax being prepared but timing unclear
- Measures to improve pension sustainability yet to be outlined
- Limited ambition of measures to improve cost-effectiveness of health care

LABOUR MARKET & EFFECTIVENESS OF SOCIAL PROTECTION

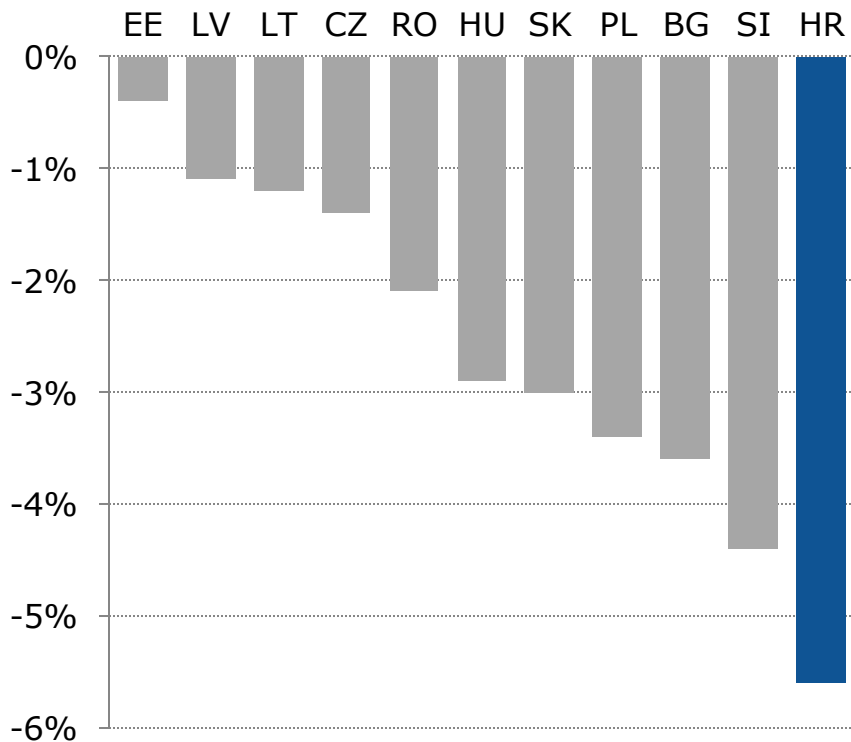
- Progress in improving the functioning of labour markets, labour law reform
- Further measures to tackle obstacles to job creation still to be defined
- Plan for social benefit consolidation needs full political endorsement

PROMOTING GROWTH & COMPETITIVENESS

- Business climate likely to benefit from planned enhancements of early rescue framework and reform of regional state administration
- Progress on removing para-fiscal levies slower than expected
- SOE governance improvements limited, restructuring behind plans
- Public administration and anti-corruption reforms risk being delayed

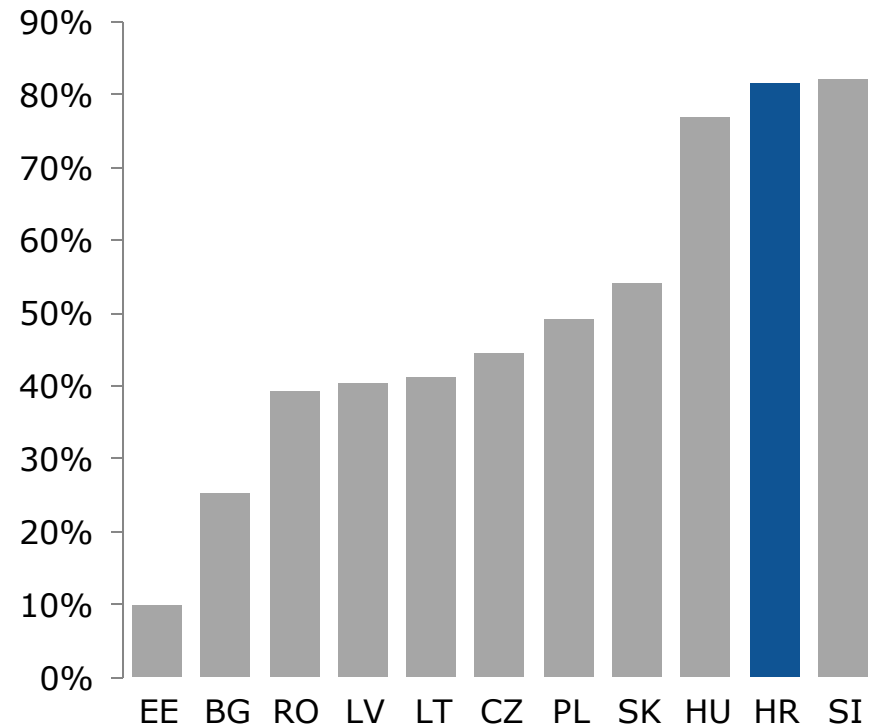
Government deficit is projected to remain high and government debt has risen quickly

General government balance, 2014 (% GDP)



Source: European Commission

General government debt, 2014 (% GDP)



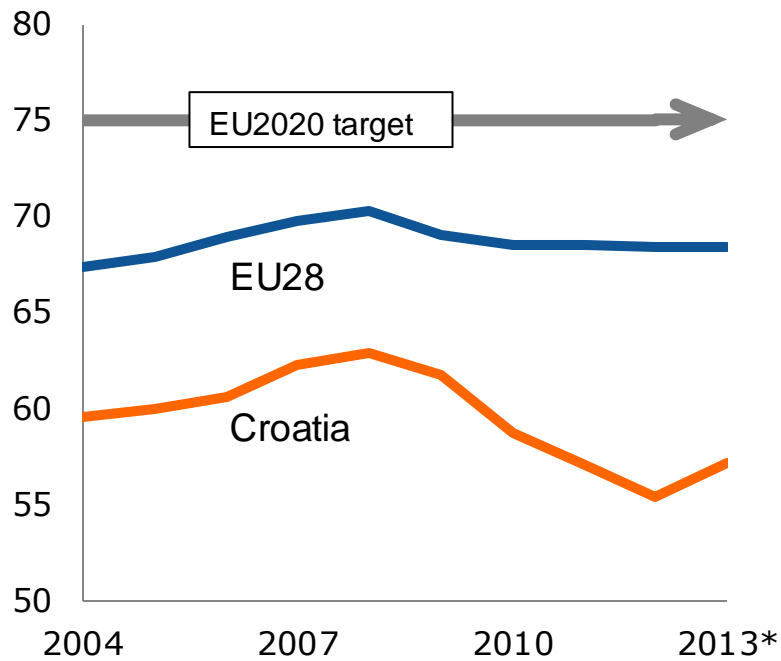
Source: European Commission

What main measures should be taken to address fiscal imbalances?

- » **Get quality of fiscal projections up to EU standards**
- » **Reinforce expenditure control**
- » **Review expenditure**
- » **Strengthen budgetary planning & fiscal rules**
- » **Optimise revenue & tax administration**
- » **Reform recurrent property taxation**
- » **Address weaknesses in pensions & healthcare**

Diverging labour market trends but major opportunities to mobilise employment exist

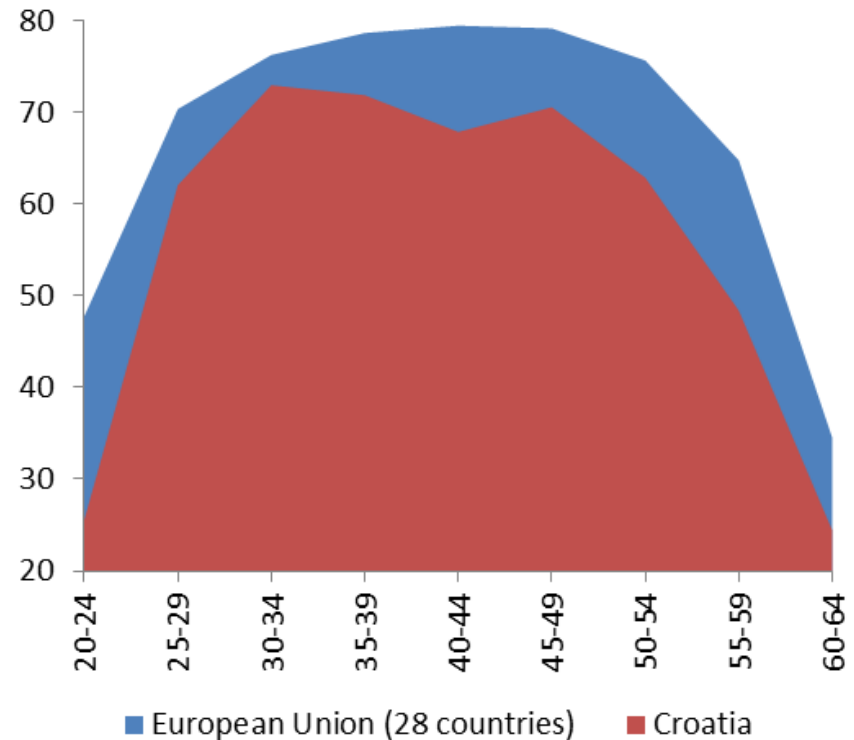
Employment rate 20-64 (%)



* 2013 Croatia: break in the series

Source: European Commission

Employment rate in 2013 by age bracket (%)



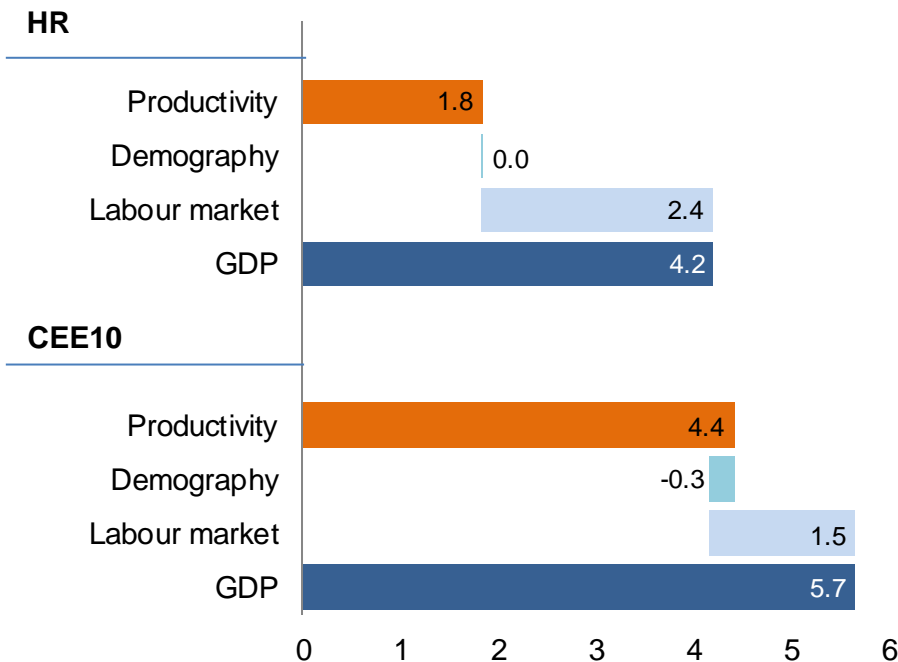
Source: European Commission

What main measures should be taken to unlock employment potential?

- » **Review wage setting framework**
- » **Strengthen active labour market policies**
- » **Address undeclared work**
- » **Review tax/benefit system to make work pay**

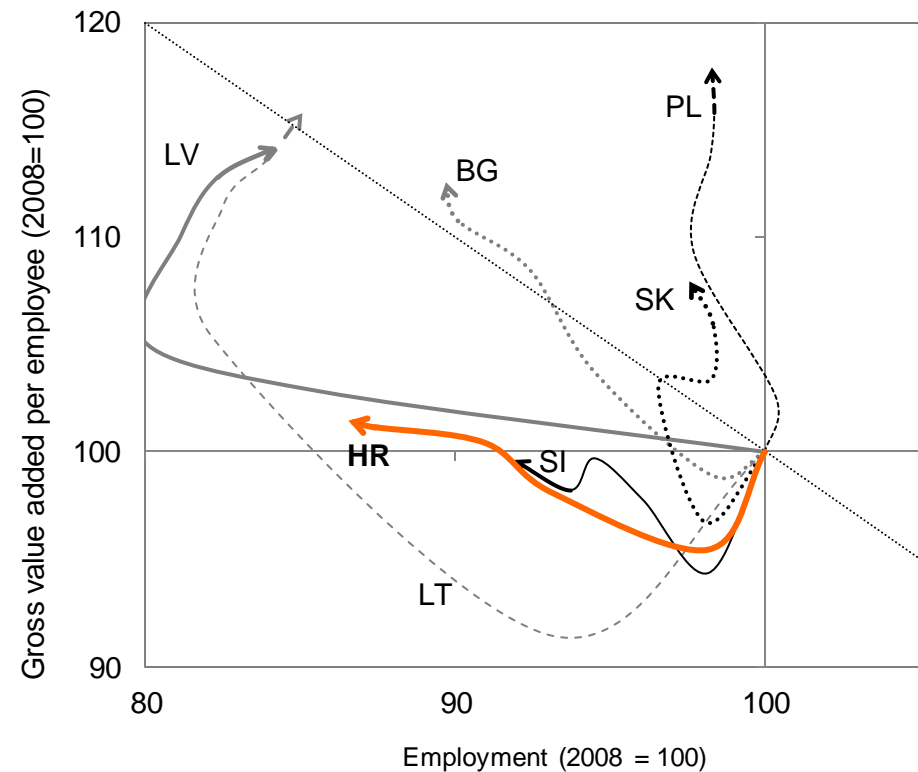
Productivity growth was low before the crisis and is not picking up strongly despite large job losses

Growth accounting, 2002-2008 (%)



Source: European Commission

GDP growth decomposition, 2008-13 (%)



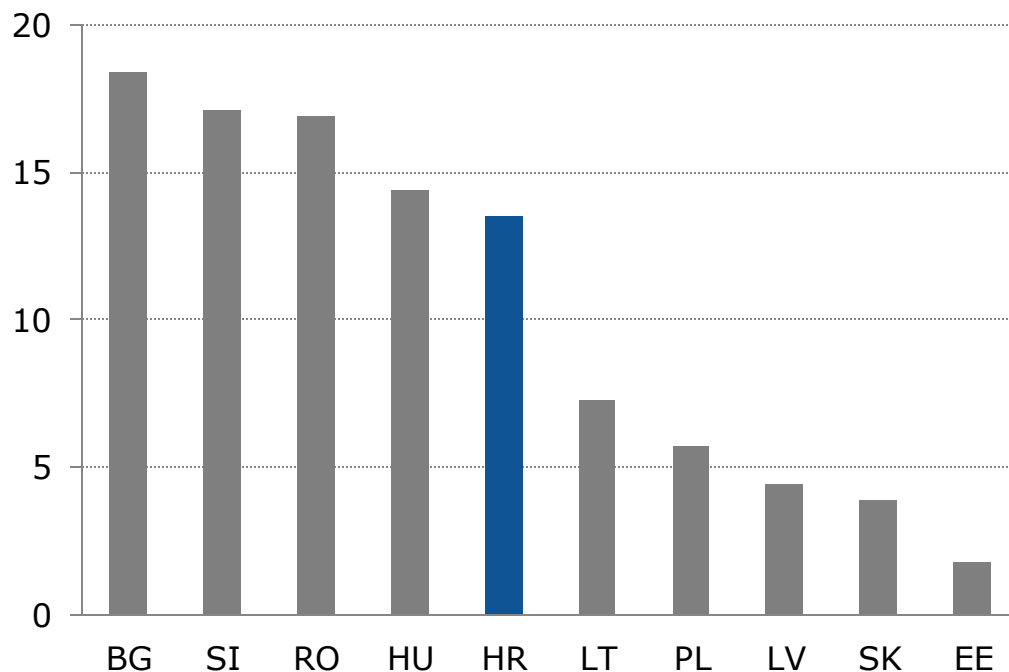
Source: European Commission

What main measures should be taken to revive business activity and investment?

- » **Lower administrative burdens**
- » **Make the best use of EU funds**
- » **Improve governance of state-owned enterprises**
- » **Zero in on corruption and public procurement**
- » **Get pre-insolvency & insolvency procedures right**
- » **Strengthen efficiency of courts**

While the banking sector remains well capitalised the long recession justifies supervisory vigilance

Non-performing loans (% total)
June 2014



- » The central bank is now undertaking a tailor-made portfolio screening exercise
- » Focus is on important portfolios not covered by the ECB and on mid-size and smaller banks

Recent and next steps for the EU and Croatia

November 2014

- European Semester resumed with the AGS
- The AMR identified countries for in-depth review
- EDP implementation was assessed, following the Autumn Forecast

Spring 2015

- 2nd Monitoring Report reviews progress of reforms in Croatia
- Commission publishes In-Depth Reviews
- Member States present their National Reform Programmes and Stability/Convergence Programmes
- Commission proposes Country-Specific Recommendations