

**DOCUMENT OF THE EUROPEAN BANK  
FOR RECONSTRUCTION AND DEVELOPMENT**

**STRATEGY FOR CROATIA**

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## EXECUTIVE SUMMARY

Croatia is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

The Croatian economy declined by a cumulative 12 per cent between 2009 and 2014, the second largest contraction in the European Union (EU) after Greece. While the economy has expanded since, buoyed by increased tourism, stronger external demand and lower oil prices, achieving sustainable growth will require addressing key structural deficiencies that constrain Croatia's productivity and overall competitiveness. To this end, reforms are needed in a range of areas, such as in reducing the role and increasing the efficiency of the public sector, restructuring and enhancing performance of SOEs, improving the business environment, policy transparency and predictability, as well as enhancing administrative and judicial procedures and strengthening anti-corruption efforts.

Croatia's access to EU funding and programmes establishes an important anchor for advancing the much-needed reforms, but the institutional capacity to absorb EU funds needs to be enhanced. The authorities have expressed support for continued EBRD engagement in the upcoming years, as the Bank's comparative advantages and track record in supporting private sector-led growth, promoting reform and fostering institutional capacity building have become even more relevant, given the pressing need to tackle structural impediments to long-term growth within a limited fiscal space.

The Bank's engagement in Croatia in the new strategy period stands to gain significantly from acceleration in the pace of the reform process, with the reverse also true. Accordingly, the Bank will aim to enhance the impact by (1) focusing on areas where commitment to the reforms is suitably evident and effective government counterparties are identified, and (2) aligning its priorities, wherever possible, with those set forth in the EU-Croatia "Partnership Agreement" and the EU country-specific recommendations, as well as leveraging available EU funds for Croatia. The Bank will also closely co-ordinate with other IFIs, including the EIB and World Bank Group.

The Bank will emphasise continued engagement with the private sector and targeted investment in the public sector to support private sector participation and promote operational and economic/financial efficiency of public companies. The Bank will apply the Green Economy Transition (GET) approach across all relevant sectors and respective sector-specific activities, as applicable, and will seek to promote inclusive growth with respect to youth, regions and gender.

The Bank will thus focus on the following strategic priorities, for the most part in continuity with the previous strategy:

- **Support private sector competitiveness through fostering innovation, operational and resource efficiency, as well as improvement of the business climate and economic inclusion.** The prolonged recession highlighted structural vulnerabilities and institutional deficiencies hampering competitiveness of the corporate sector, in particular micro, small and medium enterprises (MSMEs), which often lack the right skills mix and modern technologies to compete in the wider EU market. The Bank will continue supporting larger domestic corporates and small and medium enterprises (SMEs) seeking to adopt modern operational and management practices, and foreign

direct investments (FDIs) that produce technology transfers and serve to integrate local economy into global value chains. The main thrust of the Bank's policy dialogue in this area will be fostering an institutional environment that is conducive to innovation and sustainability. Through its investments, the Bank will seek to promote improvements in corporate governance, standards and operating practices. The Bank will seek to invest in projects which promote youth inclusion, as well as improved vocational and technical training, with a particular focus on less developed regions.

- **Deepening financial markets to broaden access to finance with focus on capital markets developments.** Given constrained access by the Croatian MSMEs to finance, the Bank will continue to provide long term funding directly to local companies and through partner financial institutions (banks as well as leasing and factoring companies) and, whenever possible, blend the financing with capacity building. The Bank will continue providing SME advisory through the Advice for Small Businesses programme. The Bank will help achieve a better diversification of financing sources by developing the non-bank segment of the financial sector; providing support to policy makers in improving the institutional, legal and regulatory environment, and financial market infrastructure to enable development of capital market activity and the expansion of new investment products in the market. In line with the objectives of the European Commission's Capital Markets Union (CMU) initiative, the Bank will put emphasis on the development of local capital markets in order for the Croatian financial sector to be better integrated into global financial markets and equity investing.
- **Promote commercialisation of public companies, including the improvement of corporate governance, and support the privatisation of some state-owned companies.** Improving the corporate governance, operational performance and financial results of public enterprises and public utilities in the municipal infrastructure and energy sectors would contribute to productivity growth, fiscal consolidation and debt sustainability. The Bank will work with the state and local authorities to accelerate the reform of public companies through promotion of commercialisation and increased private sector participation, including through PPP and ESCO models, enhancement of corporate governance, as well as implementation of financial and operational improvement programmes which, among other objectives, will focus on energy and resource efficiency in line with the GET. Subject to political commitment, and leveraging its extensive track record in preparing companies for privatisations through funding and dedicated technical assistance, the Bank may consider selective involvement in privatisation of potentially viable SOEs.

## 1 OVERVIEW OF THE BANK'S ACTIVITIES

### 1.1 The Bank's current portfolio

Private sector ratio: 73.9 per cent\*, as of 30 April 2017

| Sector Group                                 | Sector Team                      | Portfolio no of operations | Portfolio (€m) | % Portfolio | Op Assets  | % Op Assets |
|--|----------------------------------|----------------------------|----------------|-------------|------------|-------------|
| <b>Energy</b>                                | Natural Resources                | 1                          | 39             | 4%          | 39         | 4%          |
|  | Power and Energy                 | 2                          | 5              | 0%          | 4          | 0%          |
|  |                                  | <b>3</b>                   | <b>44</b>      | <b>4%</b>   | <b>43</b>  | <b>5%</b>   |
| <b>Financial Institutions</b>                | Depository Credit (banks)        | 16                         | 126            | 11%         | 77         | 8%          |
|  | Insurance, Pension, Mutual Funds | 0                          | 0              | 0%          | 0          | 0%          |
|  | Leasing Finance                  | 3                          | 62             | 6%          | 54         | 6%          |
|  | Non-depository Credit (non-bank) | 7                          | 78             | 7%          | 78         | 8%          |
|  |                                  | <b>26</b>                  | <b>267</b>     | <b>24%</b>  | <b>209</b> | <b>22%</b>  |
| <b>Industry, Commerce &amp; Agribusiness</b> | Agribusiness                     | 9                          | 75             | 7%          | 68         | 7%          |
|  | Equity Funds                     | 15                         | 38             | 3%          | 19         | 2%          |
|  | ICT                              | 4                          | 8              | 1%          | 8          | 1%          |
|  | Manufacturing & Services         | 8                          | 72             | 7%          | 65         | 7%          |
|  | Property and Tourism             | 7                          | 57             | 5%          | 50         | 5%          |
|  |                                  | <b>42</b>                  | <b>250</b>     | <b>23%</b>  | <b>211</b> | <b>22%</b>  |
| <b>Infrastructure</b>                        | Municipal & Env Inf              | 11                         | 94             | 9%          | 75         | 8%          |
|  | Transport                        | 12                         | 446            | 41%         | 408        | 43%         |
|  |                                  | <b>23</b>                  | <b>540</b>     | <b>49%</b>  | <b>483</b> | <b>51%</b>  |
| <b>Summary</b>                               |                                  | <b>94</b>                  | <b>1,100</b>   | <b>100%</b> | <b>946</b> | <b>100%</b> |

\*5-year rolling ratio

Source: EBRD Business Performance Navigator

### 1.2 Implementation of the previous strategic directions

The Bank is currently operating in Croatia on the basis of a Country Strategy approved in June 2013. The implementation of the Country Strategy took place against the backdrop of a struggling economy (which remained in recession for much of the strategy period), low private and public sector investment activity and stalled reforms despite the significantly increased amount of available EU funds and EIB financing after Croatia's accession to the EU. Notwithstanding, the Bank's engagement in Croatia to date has yielded good results establishing a robust basis for deeper and more strategic cooperation in the future. In particular, the Bank has accelerated its investment programme and invested €807 million since 2014 with Annual Business Investment (ABI) ranging between €198 million and €311 million over the course of the strategy period, maintaining its focus on the private sector to try to support the economic recovery from the prolonged recession in the country.

The strategic priorities of the existing Country Strategy are 1) mitigating the impact of the crisis and restoring sustainable growth; 2) leveraging the benefits of accession to the European Union (EU) to advance transition; and 3) restructuring and commercialising public sector enterprises. The priorities are in accord with the government's development plans, including the Government's Economic Programme. The following sections present key

highlights of the EBRD performance in Croatia as well as major lessons for the new strategy period.

### **Theme 1: Mitigating the impact of the crisis and restoring sustainable growth**

This strategic priority has been the main driver of the Bank's engagement in Croatia over the strategy period, as it substantially increased its investment in the country to counter the deleveraging by the European banks and overall low capital inflows.

By **providing long term funding to local corporates** across various sectors (such as €73 million syndicated loan to food processing and pharmaceutical company Podravka, €20 million multi-currency loan to pharmaceutical company Jadran Galenski Laboratorij, €10 million to food producer Atlantic Trade), the Bank supported their expansion into the regional and European markets, assisting them in the acquisition of foreign companies, as well as in expanding their business and production capacities. Long-term funding also enabled large corporates to stabilise their balance sheets for future growth.

In parallel, the Bank **supported youth and regional inclusion** through its investments in Atlantic Grupa and Marina Dalmacija by creating stronger progression routes from education into employment through work placements and high quality trainings in partnership with the Zadar Maritime School and Zadar University. In 2014, the Bank became a signatory to the Croatian Youth Initiative for the Private Sector. The Bank, together with the Food and Agriculture Organization of the United Nations (FAO) and the Ministry of Agriculture, assisted in obtaining Geographical Indication for two traditional food products (mandarins from the Neretva Valley and salami from Baranja region) to help improve local producers' competitiveness and increase their export potential within the EU market.

The Bank also worked to enhance the **role of equity financing** in the economy. As an anchor investor, the Bank contributed to launching several regional equity funds targeting Croatia among other countries, also signalling the attractiveness of the region to the private equity industry. A regional fund in the Bank's portfolio with a specific focus on investing in clean energy projects (Crescent Clean Energy) made an investment in Zelengrad, Croatia's second largest wind farm, with a production set to avoid the emission of 24,000 tons of CO<sub>2</sub> and generate more than 10 per cent of the country's wind power capacity.

The Bank **contributed to fostering local capital markets development**. It supported the establishment of the SEE Link to create a unified cross-border trading platform and harmonise the exchange procedures of the Bulgarian Stock Exchange – Sofia (BSE), the Macedonian Stock Exchange (MSE) and the Zagreb Stock Exchange (ZSE). At the end of January 2016, Belgrade and Ljubljana stock exchanges also became active members. The SEE Link became fully operational in March 2016 and accounts for a total market capitalisation of \$38.5 billion and 500 securities. Furthermore, ZSE's acquisition of the Ljubljana Stock Exchange (LJSE) was backed by the Bank's equity investment in ZSE in January, representing another step towards consolidating the regional capital markets. Leading regional blue-chips are included in equity index SEE Link. The Bank's work to enhance capital markets earned the Bank the ZSE Award in 2014 and in 2016.

As a large number of Croatian borrowers servicing the local industry have limited receivables in euro, the Bank has also supported the **development of the kuna** denominated debt instruments to help municipalities and corporates including SMEs, with local currency

revenues to reduce their exchange rate exposure. This work will continue in the next strategy period.

The Bank's efforts have also been significant in **supporting SMEs' access to finance, entrepreneurship and competitiveness** (the Bank supported 2, 351 SMEs during the last strategy period) and it contributed to mitigating the impact of the crisis on the investment climate, both through policy dialogue (strengthening, among others, the capacity of the national SME agency HAMAG BICRO) and the provision of a variety of financing instruments. In particular, the Bank's policy dialogue with the Croatian Financial Services Supervisory Agency (HANFA) and the Ministry of Finance led to the introduction of the new law on factoring. On the back of these positive regulatory changes, in addition to €75 million of SME credit lines via local commercial banks, the Bank provided €135 million of financing to support leasing and factoring activities via 4 partner financial institutions.

The Bank's ASB programme, focusing on advisory services to SME clients to enhance their competitiveness<sup>1</sup>, contributed to improving clients' productivity by 39 per cent, increasing turnover by 46 per cent and the number of employees by 39 per cent, on average in 2014 and 2016. Since 2013, 88 SMEs were advised through ASB. The Bank's Women in Business programme (WiB) was also launched in the current strategy period, initially by way of two credit lines with local commercial banks for a total of €15 million, supplemented by strong advisory support. Under the WiB, the Bank provided advisory assistance, trainings and mentoring to 254 women entrepreneurs since 2013.

## **Theme 2: Leveraging the benefits of accession to the European Union (EU) to advance transition**

The Bank's activities under this theme were constrained by the delay of the finalisation of the EU operational programmes. However, albeit limited, there have been some positive results.

The €4 million loan to Poreč's municipal company under the EU-EBRD Cohesion Funds Co-financing Water&Wastewater Framework was **co-financed with EU Structural and Investment Funds (ESIF)**, the first such project in water and wastewater in the country. The objective was to improve wastewater collection and treatment services in the City of Poreč and surrounding municipalities, including the extension and reconstruction of the wastewater network.

**Leveraging EU grants** under the Western Balkan Sustainable Energy Financing Facility II (WeBSEFF II), the Bank supports a regional approach to sustainable use and conservation of energy as part of its Green Energy Transition approach. Of the €92 million financed under WeBSEFF II, €45 million were provided to three commercial banks in Croatia (€10 million to Erste&Steiermärkische Bank, €15 million to Privredna banka Zagreb and €20 million Zagrebacka banka) for on-lending to private companies and municipal borrowers for investments in energy efficiency (EE) and renewable energy. As at end of Q1 2016, the Participating Financial Institutions (PFIs) placed €25.6 million towards 80 sub-loans.

EBRD investments in energy efficiency represented 26 per cent of the Bank's business volume for 2013-2015 with benefits for private companies' competitiveness as well as for the

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<sup>1</sup>SBS projects evaluated in 2014-2016.



environment. Projects signed in Croatia from 2013 to December 2016 resulted in Greenhouse Gas (GHG) estimated emissions reduction of 145 ktCO<sub>2</sub> per year, while total energy savings from 2013 to 2016 are estimated at 1,623,059 GJ/y.

In line with **EU objectives**, the Bank provided €10 million financing for the rehabilitation of the district heating network, construction of new heat generation facilities and the implementation of the first municipal integrated energy management system in Rijeka, with the total population benefitting from improved district heating estimated at 45,213 households.

On the back of these investments, the Bank has provided technical and regulatory advice to:

- Develop the ESCO market, draft the template for the street lighting contract and support the preparation of five tenders - two of which are under implementation;
- Design and implement the Energy Efficiency Obligation (EEO) scheme to ensure full compliance with the requirements under the **EU Energy Efficiency Directive (EED)**;
- Review Croatia's regulations for the inspection of heating and air-conditioning systems to ensure full compliance with the requirements under the **EU Energy Performance Buildings Directive (EPBD)**.

### **Theme 3: Restructuring and commercialising public sector enterprises**

Another priority for the Bank throughout the strategy period has been to assist with the **restructuring and commercialisation of selected public sector enterprises** in the municipal and environmental infrastructure and in the transport sector.

In this respect, the Bank signed four wastewater management investment projects (€46.5 million) and started supporting the financial and operational performance improvement of four water utilities (Rijeka, Sisak, Zagreb and Poreč). The total population benefitting from improved access to wastewater services is estimated at than one million people or around 25 per cent of the total population of the country. The Bank has been pursuing its advocacy of reforms to regionally consolidate the fragmented water/wastewater utilities, with pilot 'consolidation' cases already having started in Rijeka (where the fixed monthly component of the tariff is already equalised and work is on-going to eliminate cross subsidies) and Poreč.

In the transport sector, which represents 39 per cent of the Bank's portfolio, the Bank provided a €250 million sovereign loan for the restructuring of the Croatian Motorway company (HAC), to demonstrate the successful restructuring of SOEs and establish a clear toll review mechanism. The commercialisation of the roads sector started in late through the separation of the tolling and maintenance subsidiaries (operated by HAC and ARZ and supported by the Bank's technical assistance).

The Bank also combined €40 million in debt funding and technical assistance to support advancing the railways reform agenda, fund capital expenditure and assist in the adoption by HŽ Infrastruktura d.o.o. (Croatian railways infrastructure management company) of labour restructuring and energy efficiency action plans. Key achievements include the preparation of audited financial statements in accordance with the IFRS and of the 5 year rolling business plan, approval of the EE Action Plan, the development of the new track access charges methodology and the introduction of the new Management contract between the Company and the Republic of Croatia.



### 1.3 Key lessons

The active engagement by the Government, as well as the World Bank's involvement, enabled the Bank to provide extensive support to HAC, a clear demonstration of a strong impact the Bank can deliver with demonstrable political support and reform commitment by the authorities, and in co-operation with other key actors.

Notwithstanding the successes, the Bank encountered some implementation challenges.

**The Bank has been less successful than it had anticipated in helping Croatia leverage its EU accession.** Whereas Croatia's EU membership was meant to become a catalyst for reforms and investments and thus a driving force for the Bank's scale of engagement in the current strategy period, protracted finalisation of the EU 2014-20 programmes (Operational Programme Competitiveness and Cohesion approved in December 2014 and Rural Development Programme approved in May 2015) decelerated the Bank's implementation on the ground accordingly.

- A strengthened focus on client absorption capacity and a better selectivity of engagement areas will drive the new strategy for Croatia. If requested by authorities, the Bank is available to help support the public administration's implementation capacity to implement projects and help Croatia prepare and manage projects in order to increase its currently low absorption of ESIF funds available during the period 2014-2020.

**Difficult macroeconomic environment, as well as the rising level of non-performing loans (NPLs)** has increased the vulnerabilities of the corporate sector, deterring investment.

- The Bank together with the World Bank (the latter as lead IFI), prepared a report on the impediments to NPL resolution in Croatia under the Vienna 2 Initiative and, if requested by the authorities, could provide detailed policy advice based on its experience in Hungary (where it has been the lead IFI) and Serbia.
- Long-term funding is needed for large corporates to create stable balance sheet platform for future growth whereby the Bank's role as the lead arranger in the syndication or participant in the large NPL related transactions will be of utmost importance.
- Support to international investors has proved critical for the transfer of knowledge, skills and technology to ease the integration into global value chains.

**Privatisation of eligible SOEs has been hindered by the pace and direction of structural reforms.**

- The Bank will continue its proactive engagement and initiatives related to the restructuring, commercialisation and privatisation of selected SOEs which was confirmed by the National Reform Plan approved at the end of April 2016. The Bank will also seek to join forces with other IFIs and the EU to promote corporate reform and private sector participation where applicable.

## 2 OPERATIONAL ENVIRONMENT

### 2.1 Political context

Centre-right HDZ, which has been in power since the November 2015 elections, won the plurality of the votes in early general elections that took place on 11 September 2016, although short of the outright majority. The post-electoral negotiations led to the renewal of the governing coalition, dominated by its representatives, and the third-placed pro-reform party, MOST. The coalition led by Prime Minister Andrej Plenkovic, who assumed the HDZ leadership in July 2016, includes also political parties representing ethnic minorities.

The new coalition government, formally endorsed by the parliament on 19 October 2016, enjoyed a comfortable majority in the parliament conducive to consistent policies. On the face of it, the programme of the new authorities provides for continuity as regards the National Reform Programmes adopted in April 2016 and 2017 with their focus on achieving simultaneously the objectives of reducing budget deficit, generating growth and creating new jobs, eliminating red tape and improving business environment, and tax reform. The 2017 programme also stresses the need for demographic revival, reform of education, and strengthening of the social justice and solidarity. In the area of foreign policy, the government's priorities include preparations for the country's first ever EU presidency in 2020.

The departure of MOST in April 2017 has weakened the governing coalition, although the government has so far managed to mobilise support from independent and minority MPs necessary to maintain a majority in the parliament.

See Annex 1 for a detailed political assessment in the context of Article 1.

### 2.2 Macroeconomic context

**The Croatian economy declined by a cumulative 12.6 per cent between 2009 and 2014, the second largest contraction in the EU after Greece.** The recession also took its toll on the labour market. Unemployment was 16.2 per cent in 2015 (the 3rd highest in the EU after Greece, Spain and Cyprus) and youth unemployment (although declining) stood even higher at 28.8 per cent in 2016, significantly above the pre-crisis rates of 8.6 and 23.8 per cent (2008). Also, employment levels are lower in rural areas (44.7 per cent) compared to cities (89.3 per cent) reflecting regional disparities in terms of economic performance.

**The economy returned to growth in 2015 after six years of recession.** GDP grew by 1.6 per cent in 2015, driven by export growth on the back of a strong tourist season, pick-up in EU demand and increases in both private and public consumption. Growth in exports and low oil prices contributed to the high current account surplus. The recovery accelerated in 2016 with 2.9 per cent year-on-year GDP growth driven by strong exports and domestic demand. Croatia would need persistently high growth rates to reduce unemployment. The (average annual) inflation was still negative in 2016 at -1.1 per cent, but recovery of domestic demand and waning effects of the gas price cut will support the inflation in 2017. Mid-term growth prospects depend strongly on further efforts to improve the business environment and accelerate the absorption of EU funds.

**The stability of the banking sector has been maintained despite the drawn-out recession.** On average, banks are liquid, well-capitalized, cost-efficient and overall have been profitable until 2015, when one-off effects from the conversion of Swiss franc-denominated mortgage loans into euro resulted in a loss for the overall sector. The economy is still highly euroised despite regulatory efforts including increasing costs in transacting in foreign currency and keeping an interest differential in favour of local currency savings. Borrowers have started to switch to local currency, but the process is still slow.

**Despite the banks' good liquidity and adequate capital base, lending has been on decline, as the recession affected demand, risk appetite and the quality of bank assets.** Despite significant decline through market sales, NPLs remain high at close to 13.8 per cent as of December 2016, with a particularly high share in the corporate sector at 28.3 per cent. There are preliminary indications that the high NPL ratio has started to decline, as the inflow of new NPLs has fallen, while the process of banks' balance sheet clean-up has continued. Tax treatment of write offs has been an obstacle, but a new tax legislation from end 2016 includes one-off measures, applicable only during 2017, addressing these concerns and thus facilitate resolving the debt-overhang of many corporations. NPL resolution still requires a coordinated approach by different authorities, including improvement of the legal and regulatory environment for NPL sales and transfers, bankruptcy and restructuring, as well as availability of new capital.

**Croatia introduced a law on the conversion of Swiss franc mortgage loans to euros.** Following the abandonment by the Swiss central bank of the currency cap against the euro in 2015, the subsequent appreciation of the Swiss franc increased debt repayments for approximately 55,800 households in Croatia holding Swiss franc-denominated mortgages. Recent legislative changes in the Consumer Credit Act and the Credit Institutions Act, adopted in September 2015, stipulate the conversion of Swiss franc-denominated mortgage loans to the euro using historical exchange rates and interest rates that were effective when the loans were extended. Despite negative one-off effects of the conversion, banks' capital adequacy ratios and the country's foreign exchange reserves remain ample.

**Private debt has stabilised, but external liabilities and euroisation remain high.** The current account registered a record surplus (4.8 percent of GDP) in 2015, partly explained by losses of foreign-owned banks related to the Swiss franc loan conversion. At 2.6 per cent of GDP in 2016 the current account surplus was still higher than before 2015. In the medium-term, export growth is projected to remain strong, but may decelerate as benefits from EU accession level off. Imports are also projected to gradually increase, as consumption and investment continue to recover.

**Fiscal challenges need to be tackled as government debt increased rapidly and medium-term sustainability risks are high.** The country has been under the EU Excessive Deficit Procedure (EDP) since January 2014. The weakening fiscal position has resulted in the downgrade of the sovereign debt rating below investment grade. Public debt (which surpassed 85 per cent of GDP in 2015) and banks' assets invested in the government sector increased from 15.6 per cent to 33.1 per cent over 2008-2015. However, fiscal metrics have improved since 2015, with fiscal deficit contracting significantly (from 5.4 per cent of GDP in 2014 to 3.4 per cent in 2015 and 0.8 in 2016) and public debt starting to fall in 2016. Although Croatia might soon exit the EDP, fiscal discipline needs to be sustained and underpinned by more structural measures. Remaining risks to fiscal sustainability include continuing pressure for wage increases in the public sector, litigation risks associated with the

conversion of Swiss franc-denominated loans, subsidies to SOEs and high gross financing needs (above 20 per cent of GDP) which make the country sensitive to interest rate changes.

**Both public and private investment experienced a sharp decline during the crisis** from around 28 per cent of GDP in 2008 to below 20 per cent in 2016, while public investment dropped from around 6 per cent in 2002-2008 to below 3.0 per cent in 2015 (one of the lowest among peers). This large investment gap constrains longer-term growth. Private investment started to recover in 2015, but bottlenecks persist mostly in the shape of administrative barriers to business activity, complex and often changing regulation, and weaknesses in public administration. EU's structural and investment funds are set to contribute substantially to public investment assuming absorption capacity increases.

**The balance of risks continues to be tilted to the downside.** There are substantial downside risks, including a slowdown in exports and tourism revenues due to potentially weaker EU demand and mitigation of security risks in competing tourist destinations and the tightening of global monetary conditions, which could lead to higher public financing costs. Long-term growth will remain weak in the absence of further reforms in the business environment, resolving high level of (corporate) NPLs as well as reducing household and corporate leverage. Upside risks include the acceleration of reforms, further supporting growth and competitiveness, as well as reducing vulnerabilities. However, this positive scenario is dependent on achieving political stability with a strong reform momentum.

### 2.3 Structural reform context

**Ambitious structural reforms in the areas of investment climate, corporate governance and the economy's competitiveness are essential** to enhance Croatia's growth potential and for the private sector to develop in a sustainable manner. Weak growth performance can be mostly attributed to the pre-crisis investment boom in the non-tradable sector creating significant, non-productive overcapacities and also leading to high corporate NPLs after the crisis. Reforms are to be focused on a wide range of areas from restoring the fiscal balance through making the public sector smaller and more efficient, reducing the para-fiscal<sup>2</sup> and administrative burden, improving policy transparency and predictability as well as administrative and judicial procedures (most notably in dealing with construction permits), strengthening anti-corruption efforts, restructuring SOEs to make them more efficient, resolving NPLs especially in the corporate sector as well as developing financial markets, by providing long term (local currency) funding.

**Croatia needs to unlock growth potential and create space for the private sector focusing on fiscal sustainability and reducing the large public sector footprint.** Modernised public enterprises with improved corporate governance as well as operational and financial efficiencies along with a reduction in the logistics costs in infrastructure (e.g. transport, energy and ICT) are needed to accomplish the country's goals of fiscal responsibility and public sector service delivery. With Croatia under EU Excessive Deficit Procedure, the government has committed to target spending cuts and implement structural reforms. Interest payments on public debt of 3.6 per cent of GDP in 2015 displace more

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<sup>2</sup> Para-fiscal charges are levies that are typically collected by public institutions based on regulations passed specifically for this purpose. For example, Croatia collects para-fiscal charges for inspections, environmental protection, licensing, etc., amounting to 2.6 per cent of GDP. Besides direct costs, there is a significant documentation, reporting and other administrative burden associated with para-fiscal charges.

productive uses of public expenditures while bank financing of the public debt may crowd out lending to the private sector. Furthermore, operational efficiency of public utilities needs to be further optimised in order to improve service quality, meet environmental standards and reduce costs as their role is critical to the overall competitiveness of the country as providers of inputs (energy, water, etc.) for the private sector and insofar they facilitate trade and provide logistics support for the economy as a whole.

**Raising exports and strengthening integration in Global Value Chains (GVC) is another opportunity** as foreign trade's (goods and services) share in GDP (approx. 50 per cent vs. above 80 per cent in CEE countries) and Croatian companies' integration into global value chains are lower compared to CEE peers. The difference is even more pronounced for exports of goods (below 25 per cent for Croatia in 2015 vs. 74 per cent in Hungary). Despite recent improvements after Croatia adopted the EU trade framework and policies from 2013 as the proportion of all European standards adopted as national standards approached 93 per cent, some barriers to trade still remain<sup>3</sup>.

**Labour productivity needs to rise to improve the country's competitiveness.** The ratio of labour costs to operating revenue is significantly higher than in the CEE region (37.1 per cent vs CEE average of 25.9 per cent). In addition, the private sector suffers from low labour productivity coupled with lack of the right skill mix and advance technologies. The 2013 and 2014 labour market reforms have significantly reduced the gap with other EU economies in terms of employment protection legislation, with a positive impact on employment growth but also leading to a significant increase in the use of temporary contracts. Over recent years, wages have moderated and unit labour costs sharply decreased, but inefficient wage determination in the public sector still hampers government's control over the public wage bill and may hinder wage responsiveness.

**The share of the grey economy, at around 25 per cent of GDP, is higher in Croatia than the EU average** (18.3 in 2013) and is closer to that of Bulgaria, Romania and Turkey<sup>4</sup>. The relevance of the grey economy is highest in the real estate, construction, fishing and tourism sectors, creating unfair competition to legally operating enterprises as shown by business surveys.

**Restructuring of SOEs is advancing slowly.** Overall, SOEs play an important role in the Croatian economy. The value of Croatian SOEs' assets is high by regional standards at almost 80 per cent of country's GDP, much of it due to the expensive public roads. In addition, SOEs employ 73,000 workers or 5 per cent of the total workforce. Although the value of SOE's assets is much higher than in CEE countries, SOEs' revenues stand only at 15 per cent of GDP. State-owned enterprises (SOEs) in Croatia generate less profit or more losses than CEE peers in the same sector. This relatively weak performance weighs on public finances as subsidies to SOEs amount to 2 per cent of GDP, significantly above EU average. SOEs record, on average, lower productivity than their CEE peers, measured by revenue per

<sup>3</sup> Croatia implements 47 trade liberalizing (less than the EU average above 70) and 140 protectionist measures (Source: GlobalTradeAlert).

<sup>4</sup> See Schneider, F., & Kearney, A. T. (2013). The Shadow Economy in Europe, 2013. Johannes Kepler Universität, Linz.  
<http://www.atkearney.fr/documents/10192/1743816/The+Shadow+Economy+in+Europe+2013.pdf>



worker, while their leverage is higher. Improvements in the economic efficiency and corporate governance of SOEs will generate stronger financial results and thus contribute to fiscal sustainability through reduced state transfers to selected public utilities, as would private sector participation in the provision of public services (e.g. in the form of concessions, PPPs, ESCO, etc.), which is currently low. Through competitive bidding processes, the stakes in the leading insurance company Croatia Osiguranje, Rijeka port and electrical company Koncar were sold to private investors. Binding bids were also called for the national carrier Croatia Airlines, but sale of Railways Cargo, chemical and banking assets have been unsuccessful to date.

**The National Reform Programme (2017) includes wide-ranging reforms plans, many of which will require political consensus.** The reforms are divided into three main areas focusing on (i) strengthening the competitiveness of the economy, (ii) raising employability and connecting education with the labour market, and (iii) sustainability of public finances. The NRP's agenda is encouraging but it will require a stable political platform as well as decisive implementation of concrete measures in order to achieve its objectives. It will be crucial that the political support is maintained through the implementation process.

## 2.4 Access to finance

### *Private sources of capital*

**Access to finance is the top business environment obstacle identified by Croatian firms** in the Business Environment and Enterprise Performance Survey (BEEPS) V survey. Of the firms surveyed, 29 per cent applied for a loan or a line of credit and almost 30 per cent of them reported that their application was rejected; nearly double the Central Europe and the Baltic States (CEB) average. Of those that did not apply for a loan, 17.3 per cent stated that the reason were high interest rates. Of the firms surveyed, 53.7 per cent had a credit line or a loan, which is above the CEB average of 40.5 per cent and indicates lack of equity in the market. However, more than half of the firms (57.2 per cent) that needed a loan were credit-constrained – they were either discouraged from applying for a loan or rejected when they applied. Croatian firms relied more on bank financing than CEB firms on average: around 18.6 per cent of fixed assets and 9.8 per cent of working capital were financed by bank loans, and the median collateral (as a percentage of loan value) was 173 per cent, well above the CEB median of 153 per cent. SMEs in particular are credit-constrained as Croatia was one of the countries where the extent to which SMEs are credit-constrained has increased the most since the crisis. Enterprise surveys suggest 60 per cent of SMEs who need a loan have difficulty getting one, compared with 15 per cent in the mid-2000s and there is a need to improve access to finance via financial intermediaries. The financing gap, in particular, is a major obstacle in enabling the transition of SMEs from micro to small and medium-sized businesses with different but no greater challenges for women-led businesses.

**The Croatian banking sector is largely foreign-owned and well capitalised.** Over 90 per cent of Croatian banks are foreign owned (around 40 per cent of the sector's assets are owned by Italian banks while Austrian owned banks are the second largest owners). The capital adequacy ratio of the sector is among the highest in Europe, at 20.1 per cent at the end of March 2016, providing strong shock absorbing capacity despite high NPLs. Banks remain dependent on their parent banks for medium and longer term funding.

**Public and private equity funding markets are underdeveloped** and constrained by factors such as small market size, limited local institutional investor appetite, limited new capital market issuances and low free float of listed companies. ZSE lacks IPOs but increase in corporate listings is expected. During the last twelve months, ZSE already saw two new listings, namely Tankerska Next Generation and Granolio. Additional listings are expected in the mid-term partly stemming from the planned privatization of SOEs. IPO privatisations of SOEs also have a positive spill-over effect on private sector companies as experienced in other countries (e.g. Poland) and in Croatia during the IPOs of INA and Hrvatski Telekom (HT) in 2007.

**The corporate bond market remains underutilised as a financing option.** As of Q2 2016 there were 16 corporate bonds listed on the Zagreb Stock Exchange (ZSE). Corporate bonds listed on ZSE are issued in both HRK and EUR, with maturities up to 5 years (with the exception of 7 securities with extended maturities as a result of pre-bankruptcy procedures). The total amount outstanding as of Q2 2016 amounted to HRK 1,831 million (€130 million equivalent). Listed corporate bonds include a mix of financial institutions and non-financial corporates. There is a reasonably well developed local institutional investor base but the market remains largely buy-and-hold with secondary market turnover for 2015 being negligible. Croatian companies are more indebted than CEE peers and this reduces their access to debt finance without raising equity.

**Although local currency financing has gained momentum recently, there is still room for further increase in the volume of kuna loans, especially for longer maturities, for borrowers and financial institutions.** Wider availability of (long term) local currency funding could reduce risks arising from high euroisation and currency mismatches, in part controlled by the managed exchange rate. Borrowers have started to switch to local currency funding, but such trend can only be sustained in the long run if it is supported by a persistent increase in kuna deposits and other (also long-term) instruments. Croatia has not opted out to adopt the euro but it has to comply with all criteria to be able to do so. Until then, Croatia will continue to have its own currency.

#### *Multilateral and bilateral development bank finance and the EU<sup>5</sup>*

A number of multilateral development banks (MDBs) and bilateral financial institutions are active in Croatia, with varying investment levels and priorities.

#### **EU**

The European Commission adopted a "Partnership Agreement" with Croatia setting down the strategy for the optimal use of European Structural and Investment Funds throughout the country in October 2014. The Operational Programme "Competitiveness and Cohesion" for the period 2014-2020 was approved in December 2014 while the Rural Development Programme was approved in May 2015 on the basis of which the utilisation of the allocated funds could commence. For the 2014-2020 period, Croatia was allocated €8.61 billion in total Cohesion Policy funding, including €4.3 billion for ERDF, €1.5 billion for ESF and €2.6 billion for the Cohesion Fund (CF). These funds will support the priorities set out in the Partnership Agreement and aimed to boost the competitiveness, develop an environmentally

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<sup>5</sup> This section focuses on large scale financing, whereas other donor and TC activities are captured in Annex 6.



friendly and a resource-efficient economy, support active employment measures and fight against social exclusion.

The **EIB** has significantly increased its operations since Croatian EU accession, mainly working through the Croatian Bank for Reconstruction and Development (“HBOR”) by providing credit lines covering, among other sectors, municipal and environmental infrastructure, focusing on EU Structural and Cohesion grant co-financing in several corporate sectors as well directly with financial intermediaries. In 2013-2015, EIB increased its activities and policy dialogue in Croatia. Among others, it provided HBOR with some €900 million and committed €170 million financing to local commercial banks, mostly for SMEs, which are still underfunded. EIB also granted a €300 million loan to the Croatian government to co-finance EU projects.

The **World Bank** aims to provide to Croatia its expertise especially in the area of public finance and public administration, helping define and deliver good health, social protection and education systems with the available money. Looking at the areas of interest of the EBRD, the World Bank is mainly engaged in the transport sector, focusing on the railways modernisation programme. It provided financing to three state-owned railway companies, HZ Infrastructure, HZ Passenger Transport and HZ Cargo to finance immediate capex needs related to traffic safety as well as working capital and labour restructuring and continued its advisory assistance to help with of the financial restructuring and to secure the long-term sustainability of the railways sector in Croatia. Highways are the other World Bank’s main activity. In particular, it is focusing on the debt side, as the latter is very short term and expensive, by trying to design a financial scheme to approach the lenders, and extend the maturity of the debt, but with guarantees from the World Bank.

## 2.5 Business environment and legal context

### *Business environment*

**Croatia’s competitiveness and business environment rankings remain low relative to EU peers.** Croatia ranks 43<sup>th</sup> (out of 190 economies) in the World Bank's Doing Business 2017 report (down from 39<sup>th</sup> in 2016). The country is scoring the lowest in dealing with construction permits (128<sup>th</sup>), with low ratings in starting a business, access to credit and electricity, registering property and resolving insolvency. Despite improvements in the macroeconomic environment, Croatia’s competitiveness also remains low according to the Global Competitiveness Index published by the World Economic Forum, as it ranks 74<sup>th</sup> among 138 countries (moving up 3 places from last year’s 77<sup>th</sup> out of 140 countries). The main obstacles are weak innovation capacity, labour and goods market inefficiencies, underdeveloped financial markets and weak institutions. Key reform measures envisioned by the government in the NRP 2017 include:

- **Reduction** of administrative costs and **para-fiscal charges**;
- Improvement of cadaster and land registry systems;
- More responsible management and improved monitoring of companies in the state portfolio;
- Improving the system of early, pre-primary, primary and secondary education;
- Shortening the length of court proceedings and reducing the number of unresolved cases.

The Government's objective was to reduce administrative business costs by a minimum of 20 per cent by the end of 2016 in the field of starting companies and craft businesses, occupational health and safety, health and sanitation, energy efficiency in construction, and real estate brokerage. The country has made concerted efforts in improving governance and fighting corruption. Judicial reform and anti-corruption programmes have resulted in increased prosecution of corruption cases, although challenges remain.

#### *Legal context*

Prior to its EU accession in 2013, Croatia had significantly advanced its commercial legislation in an effort to align its legislative framework with the EU standards. Post-accession legislative reform has continued but despite the greatly compliant framework, some key challenges remain to be addressed.

The 2015 EBRD assessment on the corporate governance legislation and practices of companies in the EBRD region revealed that the corporate governance framework and practices in Croatia are relatively sound. There is a robust framework on the functioning of the judiciary, and the issue of corruption is constantly being addressed. However, the civil courts still suffer from a large case backlog despite the recent endeavours to curb it. Alternative dispute resolution methods are in place but they appear to be underutilised.

In the area of access to finance, provisions on taking non-possessory pledge over movable assets and rights are currently part of the Croatian Enforcement Act, while the Property Law contains the relevant provisions on possessory pledge. This fragmentation has resulted in increased and arguably unnecessary transaction costs. Therefore, a revamp of the secured transactions framework where possessory and non-possessory pledge provisions are combined into the property law would be recommended. EBRD provided technical assistance to the Croatian authorities in drafting the new Law on Factoring which was introduced in 2014.

The legal framework on electronic communication/telecom seems to be fully aligned with the EU sector legal and regulatory framework and no notable shortcoming has been identified in this respect. Similarly, the concessions legislation is compliant with the EU concession procurement rules, although there is still some room for improvement in public private partnership (PPP) and concessions framework. For example, the legislation could include the explicit possibility to resort to international arbitration, which is an important element for PPP bankability. The public procurement legislation has regained stability after frequent amendments and reforms which it underwent in an effort to have an EU compliant framework. The implementation of proper contract management procedures after the contract is signed and introducing more precise provisions on the cancellation of the procurement process would provide for a higher efficiency and accountability in this sector.

In 2015, Croatia introduced a new Bankruptcy Law in order to address the numerous shortcomings contained in the previous law. The shift in managing pre bankruptcy procedures from the Croatian Financial Agency (FINA) to the commercial courts was a welcome addition.

Finally, the country has also made substantial progress in aligning the energy framework with EU standards but further efforts should be undertaken with respect to market opening and energy price deregulation.

See Annex 4 for a more detailed assessment of the legal environment in specific areas relevant to the Bank's investment strategy.

## 2.6 Social context

Croatia ranks 47<sup>th</sup> out of 188 countries, placing it in the category of countries with '**very high human development**' on the UNDP 2015 Human Development Index (HDI). Life expectancy at birth in Croatia is 77.9 years, lower than EU average, with a gender gap of 6.3 years in favour of the female population. The population in Croatia is expected to fall by 16.2 per cent to 3.6 million within the next four decades, mainly due to low fertility rates forecast by the United Nations to remain around 1.5-1.6 between 2015 and 2050. Educational attainment in Croatia is lower than that of comparable economies with the average years of schooling at 11 years (OECD 11.9, Czech Republic 12.3, Slovakia 12.2, Poland 11.8 and Hungary 11.6) and, according to PISA 2015, 32 per cent (23 per cent in OECD) of 15 year old students do not have the basic life skills in mathematics, a figure which was 29 per cent in 2006, the first PISA wave Croatia participated in. Public expenditure on education is low at 4.2 per cent of GDP compared to an average of 5.3 per cent in the EU.

The prolonged deterioration of economic conditions in Croatia between 2009 and 2014 has been accompanied by a dramatic **increase in the relative poverty rate** which was just above 10 per cent during the pre-crisis period and now stands close to 20 per cent. The World Bank notes that the profile of the poor has changed during the recession: initially poverty affected primarily those with limited labour market experience and low-skilled workers; the lengthy recession, however, is affecting better educated young people in urban areas who have come under threat of falling into poverty. Inactivity and unemployment, especially youth unemployment, have contributed to the recent increase in relative poverty. Structural challenges within Croatia's education and employment systems contributed to this high level of youth unemployment.

Despite strong education participation, graduates of both vocational education and training (VET) and tertiary education programmes lack practical skill sets required particularly by private sector employers. This is largely due to outdated VET and higher education curricula that do not meet the skills, knowledge and competences required by the labour market. The EC's country specific recommendations on Croatia in 2014 and 2016 persistently pointed to these structural weaknesses that negatively affect the transition from school-to-work. Key recommendations focus on the necessity to implement measures to improve the labour market relevance and quality of education outcomes. Progress is on the way with the adoption of the NRP which includes better alignment of education system with the needs of the labour market.

Significant legal reforms took place in the period 2008-2014, intended to align Croatia's **labour and employment legislation** with EU acquis and to reduce perceived rigidities in the Croatian labour market. However, in its Annual Review of Labour Relations and Social Dialogue, Friedrich Ebert Stiftung (2014) notes that trade unions and employers have expressed concern that the speed of recent legislative reforms has left little time for substantial discussion or analysis of draft laws by social partners. Key changes for increased flexibility included (i) eased restrictions on fixed term contracts; (ii) eased restrictions on temporary agency workers; (iii) simplified redundancy procedures; (iv) extended scope for rescheduling working hours; (iv) introduction of a new minimum wage; and (v) new limitations on collective bargaining agreements. The EU's 2015 Country Report, in

discussing the application of the 2014 Labour Act, suggests an increase in the use of flexible working arrangements and temporary agency work, as well as some of the other provisions introduced in 2014 to increase flexibility on the labour market.

In 2014, women's employment rate in Croatia was 50 per cent. Women are more likely to be unemployed than men (18.3 per cent for women compared to 16.5 per cent for men). Youth unemployment is high for both men and women. In 2014, the gender pay gap in Croatia was 10.4 per cent, slightly lower than the EU average of 16.1 per cent. The gender gap in access to finance is smaller (15.8 per cent) than in other EBRD Countries of Operations. In 2014, 87 per cent of women and 90 per cent of men had a bank account. According to the 2013-2015 BEEPS, out of 360 firms surveyed in Croatia, 32 per cent had women among the owners and 25 percent of firms have at least 50 percent women ownership. The same source shows that only 19 per cent of firms had women in top management positions. Finally, certain groups of women in Croatia are more vulnerable to social and economic exclusion. Roma women in particular experience discrimination on ethnic and gender grounds which makes their participation in social and economic life more difficult, as evidenced by a very low employment rate of 7 per cent in 2011.

Finally, regional inequalities in access to clean/safe water intended for human consumption, heating and quality health persist while inter-region dispersion of GDP per capita and GDP per employee in Croatia have increased during the recession period. Research highlights that the economic downturn had a disproportionately negative impact on the economically weaker counties<sup>6</sup> where job numbers dropped in even higher numbers compared to central regions. Regional inequality and poverty is especially severe in the war-affected areas of Eastern Slavonia, which are still recovering economically from the effects of the war in the 1990s.

## 2.7 Resource efficiency and climate change context

**Energy intensity of Croatia's economy is above the EU average.** While the transposition of EU-compliant regulations supports action in the area, the underlying binding targets also require the country to step up its action to transition into a green economy.

Croatia is a party to the UN Framework Convention on Climate Change, the UNFCCC, the Kyoto Protocol and has ratified the Paris Accords, a new climate agreement on global greenhouse gas emission reductions. In March 2015, the European Union and its member states submitted to UNFCCC Secretariat a jointly planned National Contributing Contribution (INDC), which is committed to reducing greenhouse gas emissions by at least 40 per cent by 2030 compared to 1990 levels. The national climate change mitigation policy will be implemented in accordance with the Low Carbon Development Strategy of the Republic of Croatia by 2030 and is being developed together with the Action Plan, whose adoption is planned in 2018. At local level, 74 cities/towns in Croatia are signatories of the Covenant of Mayors, which commits them to 20 per cent GHG emissions reduction by 2020, and a number of them have also developed or are developing adaptation strategies. Croatia has been participating in the third phase of the EU ETS since 2013. Sizeable energy users across a

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<sup>6</sup> Counties which faced the greatest reduction in relative development were identified as Virovitica-Podravina, Brod-Posavina, Pozega-Slavonia, Vukovar-Sirmium, Bjelovar-Bilogora, Sisak-Moslavina. The agricultural sector is more represented in these counties and the majority of them still face post-war consequences. Therefore it is claimed that these counties appear to be more vulnerable to the crisis.

number of sectors in Croatia are therefore subject to emission caps and are required to improve energy efficiency and reduce carbon emissions.

Croatia is subject to the Industrial Emissions Directive or IED (Directive 2010/75/EU), the main EU instrument regulating pollutant emissions from industrial installations and promotes the implementation of Best Available Techniques (BAT) in industrial operations to ensure compliance with environmental standards. The IED has been transposed in the Croatian legislation, but further efforts need to be made to improve compliance and performance by companies. The EU Directive on Energy End-use Efficiency and energy Services (2006/32/EC) has also been transposed into the national laws and a National Energy Efficiency Action Plan (NEEAP) for 2008-2016 sets a final energy saving target of 22.76 PJ by 2020. The government created a state-owned Environmental Protection and Energy Efficiency Fund (EPEEF) to help fund energy efficiency investments, focussing primarily on public and residential sectors, however with little support provided to private/SME sector.

The building sector is a significant energy consumer in Croatia. The residential sector alone consumes around one third of the total national energy consumption (Eurostat, 2014), thus considered to have the largest energy saving potential. The government has developed national energy renovation programs for public, single family and multi-apartment buildings for 2014-2020. As part of these programmes EPEEF blends national funds with allocations from EU Structural and Cohesion Funds to provide incentives for energy efficiency in the buildings sector. A separate program is established for energy saving in commercial non-residential buildings for 2014-2020. There remain significant market barriers, such as related to the lack of effective regulations and practices for collective residential buildings management and maintenance and insufficient proliferation of the ESCO approach. Investment subsidies made available under governmental programs do not leverage private sector financing instruments, and the implementation of viable energy efficiency measures is postponed in the absence of investment grants or lack of co-financing from project beneficiaries. Weak utilisation of consumption-based billing system, low public awareness in energy efficiency, highly perceived technical and financial risks in energy efficiency investments, and lack of capacity of local financiers to finance energy efficiency investments remain as bottlenecks.

The National Action Plan for Renewable Energy Sources (RES) sets specific targets to increase Croatia's RES share in total energy supply – 39 per cent of RES electricity generation, 10 per cent of RES in transportation and 20 per cent of RES in heating and cooling. Despite the relatively attractive feed-in tariffs introduced nationwide, the long administrative process associated with the deployment of RES projects remains as an obstacle. A new Renewable Energy and High Efficiency Cogeneration Act, adopted in 2015 and entered into force in January 2016, established a new concept of a premium model instead of the feed-in tariff system. The Act foresees the quota for incentivising electricity generation from renewable energy and cogeneration for the period 2016-2020, including the capacity in the existing power purchasing agreements. It also provides competitive procedures for the use of state property for renewable energy installations, as well as going through tendering procedures to obtain building rights or land lease agreements. The increase in the share of renewable energy will put pressure on the existing grid system and its operator, and smart grids will be an important tool in the development of a more efficient and flexible energy system. Further strengthening and expansion of the grid, with the creation of cross-border links with neighbouring countries combined with smart grid tools (especially in the south of the country) will further attract additional private investments in RES and stimulate additional cross-border trading of green energy.



In Croatia, there is a significant number of outdated Combined Heat and Power (CHP) plants, built during the 1970s and 1980s, mostly with obsolete technology and with different fuel sources, and all those plants are highly inefficient and in need of imminent modernisation. There is an immediate need to introduce BATs in the area of gas fired CHP plants (combined cycle cogeneration gas turbine) that will replace the outdated units, satisfying the highest energy efficiency / resource efficiency and environmental standards to comply with the EU's Industrial Emission Directive and BAT requirements.

**Croatia is vulnerable to a range of projected climate change impacts, that will require significant improvements in water resources management and conservation.** The share of total renewable water originating from outside Croatia is around 64 per cent (2013, FAO), which is significantly higher than the neighbouring countries. Croatia's Fifth National Communication to the UNFCCC (2010) states that over the coming decades mean temperature increases are expected across the country with reduction in annual precipitation. Improvement in wastewater treatment and reducing water losses by more than half the current level is part of Croatia's national target. The Water Act ("Official Gazette" no. 153/09, 63/11, 130/11, 56/13 and 14/14) and Water Management Financing Act ("Official Gazette" no. 153/09, 90/11, 56/13 and 154/14) are central legislations and provisions have been built around improving water quality and access, as well as polluter pays principle for wastewater and cost recovery for water under affordability constraints. Water supply loss records around 40-50 per cent, and only 3 per cent of all wastewater gets the highest level of wastewater treatment, requiring more investments in treatment facilities and sewage networks<sup>7</sup>.

The government plans to connect 60 per cent of the population to a treated wastewater network by 2020, but this is estimated to cost around €3.4 billion without sufficient monitoring in progress. Demand-side programmes are also lacking, such as introducing technologies to reduce water losses and consumption in agricultural and industrial sectors.

**Croatia has in place a relatively strong regulatory framework for waste management.** The overarching national waste policy is defined by the Act on Waste Management (2013), which includes international benchmark provisions and built around a waste hierarchy and the polluter pays principle. It also defines clear responsibilities, management and enforcement plans with penalties and aims and/or targets. A set of by-laws that focus on the typical important waste streams transposes the EU acquis into the Croatian law, and further ordinances for industrial hazardous waste streams are in place. However, there have been severe delays in the implementation of National Waste Management Plan (updated in 2007), reflecting the fragmentation in responsibilities and weak institutional coordination and inadequate budget allocation. Croatia remains one of the worst performing EU countries in reducing the share of biodegradable waste being landfilled, mainly due to slow progress in the restructuring process of the landfilling system that previously shut down illegal dumping sites and small landfills with modern regional Waste Management Centres (WMCs). In 2014, only 16.5 per cent of municipal waste recorded being recycled, far below the EU-28 average of 44 per cent and EU common recycling target of 65 per cent by 2030. In January 2017 the Government adopted the waste management plan for the period 2017-2022 which is an important prerequisite for the use of the Operational Programme Competitiveness and Cohesion funds and set basis for Croatia to keep pace with the circular economy.

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<sup>7</sup> Source: Croatia authorities "Around 80% of the wastewater is treated, out of which 46% with primary treatment, 51% with secondary treatment and only 3% with tertiary wastewater treatment".

The situation could benefit from greater private sector participation in the WMCs. Further elimination of illegal dumping and uncontrolled landfills will also increase the landfilling fees that would incentivise waste reduction/recycling and resource efficiency especially in the industrial sector. The issue of management of sludge from municipal and industrial waste water treatment is also becoming acute and the government is planning to launch a zero waste-to-landfill programme in 2016-2022.

### 3 STRATEGIC ORIENTATIONS

#### 3.1 Strategic Directions

In the wake of the global financial crisis, Croatia experienced a six-year long severe economic recession, due to the combined impact of the financial crisis (leading to falling internal demand on one hand and tightening of credit on the other) and the postponement of internal economic reforms, which laid bare the remaining transition challenges across most sectors of the economy.

Croatia's access to EU funding and programmes provides an important anchor for advancing the much-needed reforms, but the institutional capacity to absorb EU funds needs to be enhanced. The authorities have expressed support for continued EBRD engagement in the upcoming years, as the Bank's comparative advantages and track record in supporting private sector-led growth, promoting reform and fostering institutional capacity building have become even more relevant, given the pressing need to tackle structural impediments to long-term growth within a limited fiscal space.

The Bank's ability to make the most of its engagement in the new strategy period will be a function of the government's readiness to accelerate the reform process. Accordingly, the Bank will aim to enhance the impact by (1) focusing on areas where commitment to the reforms is suitably evident and effective government counterparties are identified, and (2) aligning its strategic priorities, wherever possible, in the areas of competence complementary with those set forth in the NRP 2017, the EU-Croatia "Partnership Agreement" and the EU Country-Specific Recommendations, as well as leveraging available EU funds for Croatia. The Bank will also closely co-ordinate with other IFIs, including the EIB and World Bank Group.

The Bank will emphasise continued engagement with the private sector and targeted investment in the public sector to support private sector participation and promote operational and economic/financial efficiency of public utilities.

As per above, the Bank will focus on the following strategic priorities, for the most part in continuity with the previous strategy:

- **Support private sector competitiveness through fostering innovation, operational and resource efficiency, as well as improvement of the business climate and economic inclusion.** The prolonged recession highlighted structural vulnerabilities and institutional deficiencies hampering competitiveness of Croatia's corporate sector, in particular MSMEs, which often lack the right skills mix and modern technologies to compete in the wider EU market. The Bank will continue supporting domestic larger corporates and SMEs seeking to adopt modern operational and management practices, and FDIs that produce technology transfers and serve to



integrate local economy into global value chains. The main thrust of the Bank's policy dialogue in this area will be fostering an institutional environment conducive to innovation and viability. Through its investments, the Bank will seek to promote improvements in corporate governance, standards and operating practices. The Bank will seek to invest in projects which promote youth inclusion as well as improved vocational and technical training, with a particular focus on less developed regions.

- **Deepening financial markets to broaden access to finance with focus on capital markets developments.** Given constrained access by the Croatian MSMEs to finance, the Bank will continue to provide long term funding directly to local companies and through partner financial institutions (banks as well as leasing and factoring companies) and, whenever possible, to blend the financing with capacity building. The Bank will continue providing advisory through the Advice for Small Businesses programme. The Bank will help achieve a better diversification of financing sources by developing the non-bank segment of the financial sector; providing support to policy makers in improving the institutional, legal and regulatory environment and financial market infrastructure to enable development of capital market activity and the expansion of new investment products in the market. In line with the objectives of the EC's Capital Markets Union initiative, the Bank will put emphasis on the development of local capital markets, in order for the Croatian financial sector to be better integrated into global financial markets and equity investing.
- **Promote commercialisation of public companies, including improvement of corporate governance, and support the privatisation of some state-owned companies.** Improving the corporate governance, operational performance and financial results of public enterprises and public utilities in the municipal infrastructure and energy sectors would contribute to productivity growth, fiscal consolidation and debt sustainability. The Bank will work with the state and local authorities to accelerate the reform of public companies through promotion of commercialisation and increased private sector participation, including through PPP and ESCO models, enhancement of corporate governance, as well as implementation of financial and operational improvement programmes which, among other objectives, will focus on energy and resource efficiency in line with the GET. Subject to political commitment, and leveraging its extensive track record in preparing companies for privatisations through funding and dedicated technical assistance, the Bank may consider selective involvement in privatisation of potentially viable SOEs.

The Bank will aim to apply the Green Economy Transition approach across all relevant sectors and respective sector-specific activities, as applicable, and will seek to promote inclusive growth with respect to youth, regions and gender.

### 3.2 Key challenges and Bank activities

*Priority 1: Support private sector competitiveness through fostering innovation, resource efficiency as well as improvement of the business climate and economic inclusion.*

#### Transition Challenges

- Croatia's **labour productivity**, measured as value added per worker is, in general, **well below the EU average** (€24 thousand vs. €54 thousand). To achieve private sector-led growth (Croatia's private sector share of GDP remains at 70 per cent, a level lower than its EU peers) and faster convergence with EU, actions are needed to further liberalise the labour market and accelerate enterprise restructuring. A growth model based on productivity, human capital, innovation, and transit-related services (to maximize the country's geo-economic potential a European transport hub) would support sustainable convergence of the Croatian economy. Some sectors (agriculture, financial services, and ICT) are already competitive vis-a-vis EU peers given higher than average productivity levels.<sup>8</sup> This relative productivity advantage, however, may not capture weaknesses in the broader business environment. SMEs require particular attention as skills and productivity gaps are even higher than for larger companies, in particular access to finance for new, smaller firms facing much larger competition now that Croatia is a part of an open EU market.
- International surveys suggest that Croatia has a **weaker business environment** than peer EU countries of Central and South-Eastern Europe and even two Western Balkans countries (Montenegro and FYR Macedonia), as highlighted in the World Bank's Doing Business and the World Economic Forum's Global Competitiveness Index indicators. A business environment action plan should include measures for removing all kinds of barriers and burdens imposed on the economy, including measures aimed at improving the ease of doing business (Doing Business), reducing regulatory restrictiveness of the market/economy (OECD Product Market Regulation), as well as reforming the EU services market and regulated professions. In recent years, Croatia's progress on improving the business environment for the private sector has been partial. Croatia has achieved substantial progress on improving efficiency, reducing the court case backlog, and increasing the accountability and transparency of the judicial system. It has also continued to speed up land and property registration and reduce backlogs. The country needs to significantly reduce para-fiscal charges, remove excessive barriers for service providers as well as identify and implement steps to improve the efficiency and quality of commercial courts.
- Croatia has to step up **innovation** to further enhance its competitiveness leading to faster and more sustainable economic growth. The country has limited venture capital available, despite the relatively good quality of scientific research institutions and progress in the economy. In 2014, Croatia had the fourth lowest R&D intensity level in the EU as its spending on R&D as a proportion of GDP is still very low at 0.79 per cent (Eurostat), compared to a European average of 2.07 per cent - with a high proportion of public funds (0.41 per cent), and only 0.38 per cent of the GDP from the business sector. According to the European Commission, Croatia is a moderate

<sup>8</sup> Value added per 1 EUR of wage cost is 4.4 for Croatia vs. 3.8 for EU-28 in agriculture, 2.7 vs 2.0 in financial services, 2.2 vs. 1.9 in information and communication technologies.

innovator and is performing below the EU average in most innovation dimensions. Croatia's capacity for frontier innovation is weak compared to other EU countries and cooperation between innovative firms and public research organizations, where 60 per cent of public R&D investments goes, is limited to 24 per cent in Croatia as compared to 38 per cent in Slovenia (World Bank). According to the Global Innovation Index 2015, Croatia scores 41.7 out of 100, ranking 41<sup>st</sup> out of 141 countries, below the EU average. Key challenges include increasing public and private investments in research and development and directing public and private investments to areas where Croatia has the greatest opportunities for achieving economic growth on the basis of the Smart Specialisation Strategy (S3), as well as enhancing linkages within the local innovation system including collaboration between industry and universities to promote cutting edge innovation. Croatia has at its disposal over €700 million for direct co-funding of research and development activities in the public and private sectors within the EU financial perspective 2014-2020.

- Croatia's economy is **more energy and carbon-intensive** than the EU average. Croatia needs to make further efforts to comply with the EU environmental and climate change/energy acquis. With EU membership, Croatia became a party to the 2020 Climate and Energy Package and set binding national savings targets for the reduction of GHG, an increase in consumption from renewable energy resources, an improvement in energy efficiency, as well as compliance with EU environmental standards. While progress is being made, Croatia needs to put more effort into scaling up its "green" programmes and investments to improve competitiveness of private businesses and economy as a whole, reduce negative environmental footprint, improve welfare of population (both through higher quality utility services as well as improved comfort of public and residential buildings), alleviate energy security concerns and improve access to reliable and affordable energy imports. Given that similar activities were included in the Operational Programme Competitiveness and Cohesion under priority axes 4 Promoting Energy Efficiency and Renewable Energy Sources, 5 Climate Change and Risk Management, 6 Environmental Protection and Sustainability of Resources and 7 Connectivity and Mobility thus ensuring a significant part of project costs to be financed from the European Fund for Regional Development. Therefore, the importance of coordinated efforts of national bodies in charge of management and control of ESI Funds and the EBRD is emphasized, in order to achieve synergy in accomplishing mutual goals.
- **Tourism as a leading sector that could bring much more value to Croatia.** At present, the tourism sector in Croatia produces much less value added per employee than the EU average (about one third) or France (about one fifth) despite tourism being a key sector in Croatia, with total contribution of tourism at 23.2 per cent of GDP in 2015 (vs. 18.5 per cent for Greece<sup>9</sup>).
- There is a **substantial skills mismatch** between the requirements of the labour market and the output of Croatia's education system, specifically at vocational and tertiary levels and companies still struggle to attract and retain well qualified staff at entry level. Partly due to some government efforts, youth unemployment has fallen from a high of 49.8 percent (2013) to 43.6 per cent in 2015.

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<sup>9</sup> World Travel and Tourism Council, <http://www.wttc.org/datagateway/>.

- Croatia still has to step up its efforts to **improve corporate governance**, in particular reinforce the pre-insolvency and insolvency frameworks for businesses in order to facilitate debt restructuring and put in place a personal insolvency procedure. Looking at the sub-components of the WEF Global Competitiveness Index related to corporate governance, Croatia is 93<sup>rd</sup> in terms of firm accountability and 98<sup>th</sup> in terms of management practices which point to the prevailing of outdated corporate structures and require improvements in terms of corporate restructuring and succession planning. This will serve as a prerequisite for a transparent and efficient process of restructuring enterprises and preventing insolvency and the removal of insolvent enterprises from the market.
- **FDIs have been mostly concentrated in non-tradable sectors**, including the banking sector, wholesale and retail, real estate and tourism related construction. An improved business environment could stimulate FDI into tradable sectors and also raise overall FDI levels. The country has to leverage its role of gateway between Central Europe, the Western Balkans and the Mediterranean region in terms of energy, transports and capital markets infrastructure connectivity agenda.

### Operational Response

- The Bank will seek to provide long term debt and equity funding (including through Direct Financing Facility, Enterprise Expansion Fund – ENEF and ENIF), as well as working capital financing, to corporates in the processing and service industry, targeting innovative products and/or processes, knowledge economy, technology transfers and efficiency gains, while also seeking to improve corporate governance and operational and management practices. Funding will be also provided through partner banks (via on-lending and risk-sharing) and institutional quality private equity funds.
- Recognising the importance of export-driven growth for the overall private sector competitiveness, the Bank will put special emphasis on supporting Croatian exporters and on helping local companies in their cross-border activities, thus promoting development of regional operational linkages and value chains. Conversely, the Bank will seek opportunities to support quality inbound FDI. The Bank will seek to further contribute to the integration of the Croatian businesses in the region by improving connectivity, including through investments in logistics, as well as in strengthening relevant transport links to Western Balkans and beyond, helping leverage Croatia's advantage of lying along three pan-European transport corridors between the EU and Southeast Europe.
- The Bank will selectively engage with corporates that have a sound business model and strong growth potential, but may require financial and/or operational restructuring. Where possible, the Bank will mobilise other co-financiers including commercial banks, private equity and investment and pension funds to provide substantial value-additive support to local enterprises for the benefits of successful restructuring.
- Given the prominence of the tourism and agribusiness sectors in Croatia, the Bank will focus on providing equity and debt financing to companies operating in these sectors, supporting in parallel supplementary industries along the value chain, improving competitiveness, energy and resource efficiency, environmental compliance, as well as youth inclusion, particularly through work based learning and improved skills standards, and reaching out to underserved groups and regions.

- The Bank will provide financing targeted at renewable energy, energy and resource efficiency and reduction of the environmental footprint, directly and through financial intermediaries. It will aim to stimulate investment in resource-efficiency, climate resilience and environmental technologies and best practices; to improve management processes and operational practices in industry across all sectors. The Bank will continue to expand the Croatia Residential Sustainable Energy Financing Facility (CroRSEFF).
- The Bank will also aim to emphasise projects that contribute to economic inclusion and access to finance of underserved customer segments (youth in particular) as well as improved vocational and technical training reflecting employer needs, particularly through work based learning and improved skills standards.

#### Policy Dialogue

- **Corporate governance.** The EBRD will closely coordinate with other IFIs on policy advisory activities to improve corporate governance and the investment climate, building on its expertise in specific areas, including improving administrative and judicial procedures. The activities will be based on detailed needs assessment, agreed with the authorities.
- **Economic inclusion.** The Bank will engage with the private sector companies and academic institutions in a dialogue to tackle unemployment amongst youth, through the promotion of vocational training, enhanced work based learning and the facilitation of school-to-work progression routes in association with its investment projects. This will include structured dialogue between educational authorities and the private sector to enhance training provision and skills standards in line with employer requirements.
- **Energy and resource efficiency.** The Bank will work with the national branches of the Green Building Council to improve standards of energy efficiency and energy sustainability both through coordinating the policy dialogue activities as well as on the structuring of specific projects, where applicable.

**Priority 1: Support private sector competitiveness through fostering innovation, resource efficiency, as well as improvement of the business climate and economic inclusion.**

|  | CHALLENGES   | OBJECTIVES  | ACTIVITIES  | TRACKING INDICATORS   |
|--|--|---|---|---|
| 1.1  | Competitiveness is hampered by limited innovation and lack of modern technologies, difficult business environment and red tape | <b>Strengthen competitiveness through increasing operational efficiencies, innovation and inclusion</b> | <ul style="list-style-type: none"> <li>Direct long-term investment &amp; working capital financing to companies, including via the Direct Finance Framework (DFF) and Enterprise Expansion Fund (ENEF).</li> <li>Support large and medium enterprises through direct and indirect (i.e. equity funds) equity and debt instruments, as well as on-lending through banks, including risk sharing, for capex, operational and financial restructuring, innovation and technology transfers (ENIF and VCIP).</li> <li>Support the competitiveness of selected corporates through improvements in corporate governance practices, equal opportunities, and economic inclusion, with a focus on processing industries, property and tourism.</li> </ul> | <ul style="list-style-type: none"> <li>No. of companies invested in by client Funds (<i>Baseline – 0</i>)</li> <li>No. of companies that improve operational performance or efficiency measures supported directly or indirectly by the Bank (turnover) (<i>Baseline – 0</i>)</li> </ul>    |
| 1.2  | Croatia still lags behind in terms of resource efficiency and resource productivity.   | <b>Improve resource (including energy) efficiency</b>   | <ul style="list-style-type: none"> <li>Financing projects directly or under dedicated frameworks, including CroRSEFF and WebSEFF II, to enhance energy &amp; resource efficiency as well as policy dialogue alongside the World Green Building Council to improve standards of energy sustainability to comply with the Bank's Green Economy Transition across all sectors where applicable, but especially in the manufacturing, infrastructure, property and tourism sector and agribusiness.</li> </ul>  | <ul style="list-style-type: none"> <li>CO2 emissions reduction associated with the Bank's operation in tCO2e/yr (<i>Baseline – 0</i>)</li> <li>Number/volume of outstanding loans for energy/resource efficiency of partner banks (e.g. CroRSEFF, WebSeff) (<i>Baseline – 0</i>)</li> </ul> |
| 1.3  | Trading across borders and investments across the region needs to be encouraged  | <b>Increased cross-border trade and investments flows</b>   | <ul style="list-style-type: none"> <li>Support local FDI in the development of regional financial and operational linkages and value chains improving corporates' access to the export markets.</li> <li>Support trade finance activities.</li> <li>Support new investments linked to improving regional interconnectivity and co-operation energy, transports and capital markets.</li> <li>Support logistic companies in Croatia in order to boost transport in ports, highways and railways.</li> </ul>  | <ul style="list-style-type: none"> <li>Increase in sales of local (export oriented) companies supported by the Bank (<i>Baseline – N/A</i>)</li> <li>Net increase in the throughput of infrastructure (annual tonnage) (<i>Baseline – 0</i>)</li> </ul>                                     |
| <b>Impact indicator:</b> World Bank Doing Business 2017 rank 43 <sup>rd</sup> /190; Global Innovation Index 38.3/128 (AT Kearney/INSEAD) |  |   |   |   |



***Priority 2: Deepening financial markets to broaden access to finance with focus on capital markets developments.***

Transition Challenges

- **Limited access to (long-term) finance, especially for SMEs, constrain firms' investment capacity.** Encouraging credit activity supported by risk-sharing products and limited credit insurance would incentivise banks to introduce new products for SMEs and positively affect the quality of their new loan portfolio. Improving the availability of funding for SMEs is one of the key objectives of the authorities in the field of SME development in order to establish new financial instruments which meet the business needs of entrepreneurs at all stages of their development, such as soft loans, micro-loans, guarantees, and entrepreneurial venture capital. Croatia has access to EU funds within the 2014-2020 perspective intended to encourage the development of a number of financial instruments in order to further stimulate economic activity and help create and maintain jobs. The government's envisaged establishment of new measures to support SME, some of which are being implemented through Operational Programme Competitiveness and Cohesion 2014-2020, Thematic Objective 3, in cooperation with the relevant financial institutions aims to further expand the options for financing SMEs through equity and debt investments with the government's ultimate objective to encourage substantial additional investments in SMEs by the end of 2020 based on new financial instruments. Furthermore, the large and rising public debt, increasingly financed by the banking sector, is crowding out the private sector from bank financing.
- **Capital markets activity is limited**, with turnover on the ZSE representing less than 2 per cent of GDP. Despite the existence of a relatively strong institutional investor base (banks and pension funds) MSMEs lack access to capital markets. Croatia's financial sector is overwhelmingly dominated by banks. The banking sector assets make up more than 110 per cent of GDP, pension funds have assets under management of around 21 per cent, insurance companies 11 per cent, investment funds below 5 per cent of GDP in 2014. Euro area banks make up more than 80 per cent of bank assets, making them systemically important. The majority of SMEs lack access to capital markets and do not figure among the listed companies on the stock exchange nor as the issuers of debt securities.
- **Corporate bond issuance is to a large extent limited to a handful of corporate issuers.** Most bonds are issued in euros and covered bonds are non-existent. Introduction of new long term instruments would help banks lengthen their funding base, thus improving their maturity matching and potentially supporting lending growth as well as foster the development of capital markets.
- **High corporate NPL levels** (still at close to 26 per cent level) and leverage<sup>10</sup> **contribute to the slow recovery in economic growth** as banks have grown risk-averse despite high liquidity, while companies that have defaulted on their loans or are highly indebted, have effectively lost access to credit. The resolution of non-performing loans is important to improve productivity and long-term growth in Croatia. NPL resolution would require a holistic approach by the government,

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<sup>10</sup> The debt of overleveraged companies, with long term debt/3-year average EBITDA>10 (excluding motorways and railways), is high at almost EUR 8bn (20% of GDP) according to Orbis data.



involving all key stakeholders and focusing on all factors that impede resolution including among others tax regulations, efficiency of pre-insolvency and insolvency frameworks and different factors affecting the transferability of NPLs. The newly announced tax reform addresses the tax incentive for the banks' related to the NPLs write offs, albeit within pre-defined timeframe.

- **High corporate debt weighs on private investment.** Equity financing is all the more important to diversify corporate funding away from bank debt. However, despite the relatively strong institutional investor base (private pension funds and insurance companies) and a large stock market capitalisation (39 per cent of GDP vs. 31 per cent for Poland or 10.5 per cent in Hungary in 2013), equity market liquidity is very low by the region's standards. The turnover ratio was 2.3 per cent, steadily declining over the years, vs. 10.7 per cent in Poland and 5.1 per cent in Hungary in 2013.
- **Local currency financing to MSMEs is still low, although recent developments show an increase in kuna lending to the corporate sector.** Croatia is one of the most euroised economies in the EBRD region, with around 70 per cent of all loans denominated in a foreign currency and availability of local currency financing is limited. The corporate sector's net foreign exposure (predominantly in foreign currency) of €8.5 billion (19.4 per cent of GDP) in December 2015, also including potentially unhedged or partially hedged companies, poses a risk to the economy, notwithstanding the historically low currency volatility. Availability of local currency funding for unhedged borrowers (mainly SMEs and households) is important for reducing high currency mismatches.

#### Operational Response

- The Bank will work alongside local commercial banks, leasing and factoring institutions (including on a risk-sharing basis) to increase SMEs' access to finance through SMEs-tailored credit lines. Through ASB, the Bank will continue to develop a sustainable MSME support infrastructure through capacity building and development of local consultants.
- The Bank will explore how to best increase SMEs' access to finance, potentially through leveraging EU funds. In particular, the Bank might get involved at a later stage in the areas of SMEs competitiveness, agriculture, resource efficiency, including energy efficiency as well as water and wastewater improvements, through investments with ESIF funds alongside the national development bank HBOR, HAMAG BICRO and commercial banks, as well as EU facilities like the Connecting Europe Facility (CEF), COSME, Horizon 2020 and the Investment plan for Europe.
- The Bank will also explore the possibility of leveraging EU funding to enhance support for housing associations and small housing management companies but also investments by SMEs in the construction and manufacturing sectors which are contracted for the 'green renovations'; as well as to deploy resource efficiency credit lines in the industrial, corporate and SME sectors also under CroRSEFF.
- The Bank will seek valid opportunities to act as a key investor in bond issuances by corporates, banks and listed investment vehicles, large international syndications, as well as in corporate equity including IPOs. In cases when the Bank is considering direct equity investments in companies, it will seek to enhance corporate governance through development of Corporate Governance Action Plans and embed exit routes that may include listing or sales via stock exchange. The Bank will also continue to

seek opportunities to support institutional quality private equity funds active in the Central and South East Europe region.

- The Bank will seek appropriate opportunities to invest in financial instruments not yet available in Croatia, such as covered bonds and asset-backed securities as well as deploy the financial instruments under the Bank's SME Local Currency Programme.
- The Bank will continue contributing, through policy dialogue and investment, to the development of the capital markets infrastructure in Croatia (exchange, clearing platform, custodial service providers, deposit insurance agencies) and support its potential role as a regional financial hub.
- The Bank will try to assist commercial banks in managing their NPLs through investment in specialised servicing, workout and/or restructuring platforms, in the divestment of portfolios of NPLs or by providing finance alongside strategic investors for single, large NPLs which require comprehensive restructuring, as well as through investment in specialised turn-around equity funds.
- As part of the overall effort to facilitate access to finance and enhance the stability of the financial system, the Bank will explore the scope for providing advisory services and financial support to the newly established Resolution Fund managed by the State Agency for Deposit Insurance and Bank Resolution ("DAB") and in line with the EU's Banks' Recovery and Resolution Directive ("BRRD").
- The Bank will help increase liquidity of the local currency capital market by supporting the issuance of Kuna-denominated corporate bonds and participating in public equity offerings with strong demonstration effects.

#### Policy Dialogue

- The Bank will continue its advisory support to the Ministry of Finance to help with creating the legal framework for Covered Bonds Law in close coordination with relevant institutions including the Croatian National Bank, Ministry of Justice and HANFA.
- The Bank will continue to offer its expertise for the preparation of a new Capital Markets Law aligning the local legislation to the EU Directive MIFID II, working with the Ministry of Finance, HANFA and Zagreb Stock Exchange.
- The Bank will also continue its assistance to establish the regional Central Clearing Counterparty ("CCP") as a European Market Infrastructure Regulation ("EMIR") - compliant CCP with the possibility of covering the Croatian and Slovenian capital markets and to increase global attractiveness of these local markets.
- The Bank will provide advice to help establish a specialised "SME Growth Markets" trading platform to ease SMEs access to the Zagreb Stock Exchange in line with MIFID II.
- The Bank will provide technical assistance to the State Agency for Deposit Insurance and Bank Resolution in strengthening its institutional capacity with regards to its new role as Resolution Authority in line with the BRRD.
- If requested by the authorities, the Bank will help facilitate the resolution of NPLs in line with Vienna 2 Initiative recommendations and could provide detailed policy advice. The Bank has already engagements in other countries such as Hungary (where it was the lead IFI) and Serbia and it has been closely involved in a first

assessment in Croatia with the World Bank leading the work to date. In addition, the Bank is planning to engage in the bilateral discussions as well as to arrange a round table discussion on out of court restructuring with the Ministry of Justice, the Banking Association, key bank representatives, the IMF and the World Bank.

- Building on its enhanced profile developed in the corporate and the private equity sector, as a result of its growing equity portfolio as a direct investor and a limited partner, the Bank will promote corporate and institutional awareness of the benefits of equity financing and improved corporate governance practices.

**Priority 2: Deepening financial markets to broaden access to finance with focus on capital markets developments.**

|   | CHALLENGES  | OBJECTIVES  | ACTIVITIES   | TRACKING INDICATORS  |
|---|---|---|--|--|
| 2.1   | SMEs' constraints to access to finance have increased since the crisis  | <b>Improved access to long term funding</b>   | <ul style="list-style-type: none"> <li>SMEs- tailored credit lines (including, via banks, leasing and factoring institutions).</li> <li>Advice for Small Businesses on improving operational and management standards.</li> <li>Development of tailored financing programmes leveraging EU structural funds focusing on resource efficiency, SMEs competitiveness in agriculture and water and wastewater improvements, if requested by the authorities.</li> </ul>  | <ul style="list-style-type: none"> <li>Total number/volume of outstanding MSME loans of PFIs to identified target areas/instruments (such as women entrepreneurs, factoring) as relevant (<i>Baseline – established at projects approval</i>)</li> <li>Number of clients supported through Advice for Small Businesses with increased turnover/productivity (<i>Baseline – 0</i>)</li> </ul> |
| 2.2   | Capital markets activity is limited, and local corporates lack access to capital markets and local currency financing | <b>Strengthen the financial sector by achieving better diversification and integration into global financial markets, develop capital markets and, if possible, increase availability of local currency financing</b> | <ul style="list-style-type: none"> <li>Support diversification of financial sources through capital markets by participation in international syndicated loans, private equity funds, issuance of corporate bonds and IPOs.</li> <li>Policy advice on introducing the Law on Covered Bonds.</li> <li>Support development of capital markets infrastructure (SEE Link platform) to add new members.</li> <li>Development of financial infrastructure in line with EU CMU initiative including development of SME Growth Markets and participation in the Working Group on new Capital Market Law.</li> <li>Introduction of the SME Local Currency Lending Programme.</li> </ul> | <ul style="list-style-type: none"> <li>Demonstrable improvement of institutional and legal environment for local capital markets (e.g. law on covered bonds, capital market law and SEE link). (Qualitative account – <i>Baseline N/A</i>)</li> <li>No./volume of capital market transactions (e.g. bonds, equities traded) (<i>Baseline – 0</i>)</li> </ul>                                 |
| 2.3   | Bank lending has slowed down, as banks are burdened with NPLs   | <b>Facilitate the resolution of NPLs</b>  | <ul style="list-style-type: none"> <li>Identification of impediments to NPL resolution through policy dialogue (jointly with the World Bank) and participation in the policy dialogue and engagement on out of court restructuring.</li> <li>Support in developing regulation/legislation &amp; investment activities if suitable structures and investors are identified.</li> </ul>  | <ul style="list-style-type: none"> <li>Introduction of measures (e.g. impediments identification, regulation and legislation) to NPLs resolutions in the banking sector (<i>Baseline – N/A</i>)</li> </ul>   |
| <b>Impact indicator:</b> WDI Market Capitalisation to GDP (%) 36.2 (2011) |   |   |  |  |

***Theme 3: Promote commercialisation of public companies, including the improvement of corporate governance, and support the privatisation of some state-owned companies:***

Transition Challenges

- **State owned enterprises** continue to play a large role in the Croatian economy, with some of them often suffering from poor performance, and weak corporate governance, while state subsidies to SOEs are significantly higher than the EU average. Operational efficiency of public companies is well below most of its EU peers' standards and needs to be enhanced to improve service quality, meet environmental standards and reduce costs. In particular, the ratio of labour costs to operating revenue at 37.1 per cent is significantly higher than in the CEE-4 countries at 25.9 per cent for SOEs in 2014, suggesting plenty of room for efficiency enhancement that can also help reduce budgetary pressures. To improve operational and financial performance, selected public companies would benefit from a higher share of private sector participation in municipal and transport companies as well as tariff adjustments to better reflect costs.
- **State involvement in the economy remains extensive, in particular in transport and energy infrastructure.** The lack of private sector involvement in these areas to date has also held back Croatia's potential as a logistics hub, energy and trading integration with the region. Weaknesses in governance, including the lack of appropriate performance monitoring, continue to result in significantly lower profitability of relative to comparable private corporations, with negative impacts on public finance. Key effects to be achieved within the framework of this transition challenge include the reduction of fiscal risk to the state budget, greater contribution of public companies to the development of Croatia and public debt reduction through the activation of state property. In the past year, steps to open up SOEs to private ownership advanced slowly but reduction of state ownership over flats, office spaces and land is expected to advance, as well as the activation of unused state property. Therefore, some important privatisation opportunities might require the Bank's support in the years ahead and financial and operational restructuring in SOEs may be necessary before listing their shares on the stock exchange to help improve their corporate governance, notably by fostering reporting and internal control mechanisms.
- **Lessons from global best practices should be used to improve tendering capacity to develop viable PPP projects** in a variety of sectors, including municipal and transport, as some of the existing projects have faced problems during the implementation phase.
- **Waste and water management remain a challenge** in Croatia. The efficiency of the water supply and waste water management is low and system losses are high. Consolidate and upgrade the current solid waste management system into larger county-level system as significant inefficiencies exist in the delivery of solid waste which is significantly lagging behind the schedule agreed with EU, mainly due to low investment project preparation capacity. Significant investments are required for ensuring compliance with the relevant EU directives to reduce the amount of disposed waste, increase municipal waste recycling, landfill compliance, ensuring the quality of drinking water, and connection to public sewerage systems and water utility systems. Performance against recycling targets is weak, with only 15.5 percent of municipal waste being recycled vs an EU average of 41.3 per cent according to the

Eurostat. Croatia also lags behind in terms of resource productivity (economic value of €1.09/kg of raw material vs. EU average of €1.95/kg, according to the Eurostat).

- **Infrastructure gaps still remain in the transport sector with some of the main railway corridors not being fully restored from war damages.**
  - The **railway sector** can become a greater engine of growth and its railway companies more efficient and competitive in the EU. Given Croatia's vital transit position in Europe, one of the main competitive advantages and opportunities for the country is that its railway network is deeply embedded in Europe's major transport corridors (e.g. the East-West Pan-European Rail corridor X, corridor Vb connecting Rijeka with Zagreb and the Hungarian border, and corridor Vc connecting Ploce and running South-North across Bosnia and Herzegovina). However, the system faces severe operational and financial challenges, such as the poor quality of the tracks limits the speeds for freight and passenger trains and therefore limits the operational capacity and performance of any rolling stock used by operating companies. As a result, with a similar density of railway network, the country has substantially lower traffic intensity than its EU peers, reaching less than half the traffic intensity of the EU-28 average.
  - **Road sector** companies require material financial and operational restructuring, alongside the much needed improvements of the corporate governance in order to achieve greater long-term sustainability and to reduce the need for the budgetary transfers.
- **Energy:** The energy infrastructure will need to be further developed in terms of adherence to EU environmental standards and security of supply.

#### Operational response

- The Bank will aim to support greater involvement of the private sector in infrastructure financing and management, including PPPs, through debt and equity financing in the transport sector (such as port terminal operators or logistics/intermodal operators), as well as for selected projects (such as healthcare and transport infrastructure), with further application of GET including in the energy sector and bankable ESCO projects.
  - The Bank will seek to support urban regeneration investments that may also include providing assistance in the preparation of the master plan study on feasibility and commercial viability to attract private investors.
  - Under the Croatian EU Cohesion Fund Water Co-Financing Framework ("C2CF"), the Bank will seek opportunities to co-finance investments in service quality improvement and efficiency gains in large water and wastewater utilities, providing technical assistance with financial and operational improvement programmes (FOPIP) that serve to promote commercialisation, benchmarking and international procurement certification.
  - The Bank will aim to support energy efficiency measures, such as energy-efficient street lighting and sustainable urban transport solutions within the Sustainable Urban Mobility Planning ("SUMP"), as well as "green solutions" within its projects with public companies, in compliance with environmental sustainability targets moving transports away from individual means of transportation towards cleaner public transports as a viable alternative to cars (e.g. parking strategies).



- The Bank will be targeting state-owned companies to improve their resource efficiency and environmental standards, in line with GET approach. The Bank will seek to provide financing to public utilities to support higher efficiency and environmental performance improvements in line with EU BAT requirements. In the energy sector in particular, the financing will target projects (mainly CHP) that will result in significant increase of the electricity production and a much higher fuel efficiency and consistent decrease of CO2 emissions.
- Privatisation of SOEs. Subject to political commitment, the Bank may support the Government's privatisation programme, possibly in the transport and energy sectors. The Bank may also consider providing support when viable and convincing SOE commercialisation models have been agreed as alternatives to privatisation.
- The Bank will support transport, logistics and energy infrastructure enhancing Croatia's integration with regional markets, including gas and power interconnections. Where possible, the Bank will aim to support greater involvement of the private sector in infrastructure financing and management, including well-structured PPPs, through debt and equity financing in the transport sector (such as port terminal operators or logistics/ intermodal operators), as well as for selected municipal projects (such as healthcare facilities and public parking), with further application of GET. In the public sector, the Bank will support the ESCO approach.
- In the transport sector, the Bank will continue working with the Ministry of Transport and in cooperation with the World Bank to assist in the improvement of the corporate governance, financial and operational restructuring of the Croatian Motorways Company, fully owned by the Croatian government and if requested may considered extending its support to other companies in the road sector (such as Croatian Roads) which may require support for the operational and financial restructuring.

#### Policy Dialogue

- There is scope for the EBRD and the EU's Structural Reform Support Service to develop a programme focusing on monitoring the financial performance of SOEs and training nominee directors on corporate governance and legislation governing SOEs.
- If requested by the authorities, the Bank may provide its advice, in co-ordination with relevant other IFIs, to enhance the PPP legislative framework as well as implementation practice, including the review of the current PPP Framework Law and support for the development of the implementation and monitoring capacity.
- In the water and waste water sector, as a part of the Bank's C2CF, the Bank will seek to support the authorities, Ministry of Environment and Energy and the Hrvatske vode (the "Croatian Water Agency" or the "CWA") in the regionalisation and consolidation of the water and waste water companies to increase their absorption capacity under the Operational Programme "Competitiveness and Cohesion". Furthermore, introducing a sector wide performance benchmarking platform for the water sector may also benefit from some policy dialogue contribution.
- In addition, if required, the Bank may offer its support to the Ministry of Environment and Energy in designing financial instruments in the area of the energy efficiency as well as assistance in the investment project preparation in regional solid waste management as well as to co-financing such investments with EU funds.



Thus, the Bank's ability to engage in activities under this strategic theme will be contingent on the government's reform commitment.

**Priority 3: Promote commercialisation of public companies, including the improvement of corporate governance, and support the privatisation of some state-owned companies**

|   | CHALLENGES  | OBJECTIVES  | ACTIVITIES   | TRACKING INDICATORS   |
|---|---|---|--|---|
| 3.1   | Sub-optimal infrastructure in municipal, transport and energy sectors coupled with weak operational performance   | <b>Improved corporate governance, operational and financial performance of public enterprises</b> | <ul style="list-style-type: none"> <li>Support commercialisation and corporatisation of public enterprises in municipal owned utilities, energy and transport sectors through new investments, financial and operational improvement programmes (such as balance sheet restructuring and improvements in governance through introduction of Corporate Governance Action Plans and Public Service Agreements) and support privatisation of selected public companies.</li> <li>Support investments with higher efficiency and environmental performance improvements in line with EU BAT requirements.</li> <li>Water &amp; waste water sector under EU-EBRD Cohesion Funds Co-financing Water &amp; Wastewater Framework (including the regional consolidation of water/waste water companies, where applicable).</li> </ul> | <ul style="list-style-type: none"> <li>Improvements in financial and operational performance of client public utility (<i>Qualitative account - Baseline N/A</i>)</li> <li>Number of people benefitting from better infrastructure services (water and waste water) (<i>Baseline – established at project approval</i>)</li> <li>Water saved (m3/y), supported by the Bank (<i>baseline 0</i>)</li> </ul> |
| 3.2   | Private sector participation in public sector investments has to be increased to strengthen sustainability of large investments without reliance on sovereign guarantee | <b>Greater involvement of the private sector in infrastructure financing and management</b>       | <ul style="list-style-type: none"> <li>Support outsourcing certain services to private sector when commercially justifiable.</li> <li>Assistance with the development and implementation of PPPs in public sectors (such as parking infrastructure, street lighting and transport).</li> </ul>   | <ul style="list-style-type: none"> <li>Targeted infrastructure services transferred to private sector through PPP/concession structures (<i>Baseline – N/A</i>)</li> <li>Legal/regulatory/institutional reforms facilitating private sector participation in infrastructure and municipal utilities successfully adopted and/or implemented (<i>Qualitative account – Baseline N/A</i>)</li> </ul>        |
| <b>Impact indicator:</b> 2016-2017 Global Competitiveness Index 74 <sup>th</sup> /138 |   |   |  |   |

### 3.3 Managing Risks to Country Strategy implementation

The proposed Strategy for Croatia is ambitious, yet realistic given the Bank's past experience in the country, the alignment of the Bank's strategic priorities with Croatia's National Reform Programme and the EU Country Report Croatia 2016 as well as the fact that the Bank's unique model of transition through a combination of investment, advisory services and policy dialogue has become even more relevant in Croatia as the six-year economic recession has brought into starker relief structural weaknesses that have yet to be fully addressed. EBRD's ability to deliver on its strategy will be influenced by a number of factors outside the Bank's control. Where feasible, the Bank will work to address and mitigate these risks through proactive and sustained engagement with its clients, IFI partners and the government.

Risks to the Strategy implementation include:

- **Political.** Overall success on Strategy delivery is dependent on the government in place during the strategy period sustaining its reform momentum and continuing to build implementation capacity. Policy design and implementation of the demanding objectives of the Strategy requiring comprehensive reform involve a high level of coordination.
- **Long-term growth may remain low.** Croatia returned to growth in 2015 following six years of economic contraction, but present long term growth forecasts remain modest and insufficient to generate sustained economic convergence and employment. Further, weak growth and high unemployment may weaken political support for key reforms.
- **Sovereign borrowing capacity is limited.** The continued need to support selected state-owned companies is likely to bring increased exposure to the sovereign, either directly or indirectly through guarantees or implicit support. Although declining, government debt (at above 85 per cent of GDP) is already very high, in comparison to peer countries, leaving very limited borrowing capacity.
- **The Government's commitment to NPL resolution will be needed to achieve significant results.** The bulk of NPLs are backed by real estate collateral, which, given the depressed state of the real estate market combined with the inability or unwillingness of some banks to absorb losses, prevents a speedy and successful resolution. NPL resolution requires a holistic approach by the Government, involving all key stakeholders.
- **Croatia's corporate sector largely comprises SMEs which have been badly affected by the years of GDP decline.** This has resulted in minimal sales growth, uncomfortably high leverage and challenged liquidity in a large number of the local companies. A return to sustained growth can be expected to ease the pressure and there is a role for the Bank to enhance the creditworthiness of its counterparties by encouraging the proceeds of productive investments to be at least partially directed into reducing leverage to more normal levels. SMEs cannot develop further if they lack access to finance (including equity finance) and support to improve operation/governance.

### 3.4 Environmental and Social Implications of Bank Proposed Activities

Prior to its EU accession in 2013, Croatia had already completed its transposition of EU environmental *acquis* in the national law. This sets out a sound framework for structuring EBRD-financed projects to comply with its Environmental and Social Policy ("ESP") and Performance Requirements ("PRs"). However, the implementation of some of the EU Directives, specifically those relating to waste, water, nature protection and environmental impact assessment, by Croatian competent authorities has not been fully successful. Therefore, the Bank needs to remain diligent in ensuring that the Bank's PRs and EU environmental standards are met until the Croatian authorities are building their capacity to

implement and enforce the EU Directives as a Member State and all Croatian legislation is brought into compliance with the environmental acquis.

Implementation of EU Directives is expected to continue to pose challenges, especially to the development of new large-scale infrastructure. Specifically, Croatia has designated 36.58 per cent of its coastal area and 4,986 km<sup>2</sup> of maritime areas as protected areas under the Natura 2000 ecological network. It will be important to ensure that both the EU Habitat Directive requirements and EBRD policy requirements relating to the protection of biodiversity are met and that any potential direct, indirect and cumulative impact of the Bank's prospective projects on the environment and biodiversity is appropriately assessed and mitigated when considering financing infrastructure projects that could adversely impact existing or proposed protected areas, specifically Natura 2000 sites. EBRD will continue to pay specific attention to ensuring that due process is followed in undertaking Environmental and Social Impact Assessments of projects both in line with EU EIA Directive and EBRD specific requirements to ensure that a participatory public disclosure and consultation is an integral part of development of such projects.

Proactive stakeholder engagement processes remain an important instrument in mitigating social impacts and ensuring that the ESP and those PRs relating to social sustainability are met, especially where the projects could have adverse and disproportionate impacts on minority groups, people at risk of social exclusion or otherwise vulnerable people. When EBRD considers projects that involve privatisation of infrastructure companies (transport, municipal and energy sectors) and may require labour restructuring and rationalisation programmes, it will aim to ensure that redundancies are carried out in a transparent, consultative and non-discriminatory way, according to both EBRD policy requirements and EU legislation.

A further liberalisation of the labour market and acceleration of enterprise restructuring may present a challenge for adequately implementing PR2, notably those requirements related to retrenchment, wages, benefits and conditions of work, as well as those covering non-employee workers. Enhancing operational efficiency of public utilities and reducing costs will need to be undertaken in line with retrenchment best practice and with the close involvement of EBRD. Clients will need to be committed to the consultation, planning and mitigation process essential for a sound implementation of any restructuring programme affecting a large number of workers, especially in the current context of high unemployment and increasing poverty rates.

Financing projects in the municipal environmental infrastructure sector will continue to offer the Bank significant opportunities to achieve tangible environmental and social benefits and public health improvements. EU funding is expected to mitigate constraints arising from affordability and ensure that investment programmes will be adequate to bring water, wastewater and solid waste management facilities into compliance with the Bank's PRs and EU standards.

Health and safety remains an important consideration in all EBRD projects. In transport infrastructure and urban transport projects the Bank will continue to promote road safety initiatives and require road safety assessments. EBRD will work with clients in all sectors to mitigate the health and safety risks through good project design and best practices in safety management.

### **3.5 EBRD co-operations with the EU and MDBs**

EBRD complementarity with the EU and other IFI and donors active in Croatia stems from its (1) engagement with the private sector especially in capital markets/local currency financing and (2) targeted investment in the public sector to promote private sector participation/PPPs and support operational and economic/financial efficiency. The EBRD will work closely and actively coordinate its efforts with the EU, the EIB, CEB and the World Bank to complement and enhance the leverage of its investment financing and policy dialogue.

- **The Bank will seek to deepen its engagement with the EU** to assist the country to increase its competitiveness and improve the quality and efficiency of public services. This will involve grant financing for project preparation and implementation as well as institution building and investments in municipal, transport and energy infrastructure, energy efficiency, SME financing and development. The relatively low utilisation of the EU structural funds to-date indicates that Croatia needs additional support to strengthen its absorption capacity. The Bank will therefore work closely with the authorities and the EU in selected areas with significant reform and financing needs, such as SME development including the energy efficiency and the municipal sector. Structural funds can be blended with those of the Bank to accelerate financial and operational improvements in the municipal sector through implementation of the Croatian EU Cohesion Fund Water Co-Financing Framework C2CF.
- **The Bank will co-finance infrastructure projects with the EIB**, in particular concerning:
  - Implementing the co-financed Vc Corridor project with HAC, the Croatian motorways company;
  - Through the 13 projects Western Balkans Investment Framework (“WBIF”), on-going or under preparation in Croatia, mainly in the energy sector. Among these, EBRD is taking the lead on and assisting in providing consultancy services under the WBIF for the preparation of several projects with natural gas transmission system operator Plinacro, and projects with Croatian Transmission System Operator HOPS and Program Sava, a 100 per cent subsidiary of HEP, the national power utility. Preparatory work for the LNG terminal investment has been completed and the Bank, together with the EIB being the lead arranger under the Juncker Plan for Europe, may consider financing the new LNG terminal.
- **The Bank will collaborate with the World Bank** mainly in the area of policy dialogue and advisory on NPLs resolution as well as on the reform of the Croatian Motorways and Railways Sector.
  - In the financial sector, the World Bank and the EBRD have jointly taken the lead on policy dialogue to tackle the multi-faceted NPL-problem under the umbrella of the Vienna Initiative. The World Bank is providing advice on a set of recommended actions for the country to improve its Doing in Business ranking. The World Bank and the EBRD have provided joint support by providing advice on amendments to the new bankruptcy law which was approved by the Parliament in 2015.
  - The World Bank has proposed to assist in the balance sheet restructuring of the whole motorway sector in Croatia with the Bank’s involvement with HAC being complementary to the World Bank's ongoing work and focusing on both operational and financial restructuring and corporate governance improvements.
  - In municipal infrastructure, the World Bank continues its Adriatic programme coordinated, funded and implemented through the Croatian Water Agency. This programme mainly targets smaller municipal water and wastewater upgrades. The Bank would be additional in the area of regionalisation of water

and wastewater utilities, as well as solid waste, assisting with their financial and operational improvement and procurement capacity.

- **The Bank will seek to collaborate with the IFC** on co-financing private sector projects as well as coordinating the joint support for the development of the PPP projects to attract private sector investors to enhance the commercialisation of the projects and alleviate the need for the sovereign funding.



## ANNEX 1 – POLITICAL ASSESSMENT IN THE CONTEXT OF ARTICLE 1

Croatia is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

The constitutional and legislative framework for a pluralistic parliamentary democracy is in place. The separation of powers and checks and balances in the political system, guarantees for fundamental rights and protection of minorities, and for a meaningful role of civil society are largely in line with international and European standards. Elections are conducted in a manner deemed by the OSCE to be free and in line with international standards. Croatia has been a member of the European Union since 2013.

### **Free Elections and Representative Government**

#### *Free, fair and competitive elections*

The existing legal framework provides a sound basis for the conduct of democratic elections in accordance with international standards, as assessed by the OSCE's Office for Democratic Institutions and Human Rights (OSCE/ODIHR). It has benefited from a series of reforms, including amendments to the legislation, adopted in February 2015 in accordance with OSCE/ODIHR recommendations, in respect of candidate registration, women's representation, media coverage and election observation. The OSCE/ODIHR has recommended further consolidating and harmonising various electoral laws into a single comprehensive electoral code that would regulate all types of elections. Among other possible areas for improvement remains the revision of the current constituencies' sizes, which were last delimited in 1999, in order to ensure full equality of the vote.<sup>11</sup> The conduct of the last general elections observed by the OSCE/ODIHR Election Assessment Mission (November 2015) was assessed by it positively, stressing good organisation.

Under the Constitution, the parliament is a unicameral body directly elected every four years on the basis of universal and equal suffrage through secret ballot. The latest (early) general elections, which were held 11 September 2016, took place in a calm and peaceful environment, characterised by the respect for the freedom of expression. The new parliament was constituted on 14 October 2016.

#### *Separation of powers and effective checks and balances*

The constitutional and legislative framework for a parliamentary democracy – underpinned by the separation of powers and checks and balances in the political system, independent legislature and well established procedures of legislative oversight in prescribed domains of decision-making – is in place in Croatia and largely in line with international standards. The scope of powers of the legislature to hold the government to account is largely in line with international standards.

#### *Effective power to govern of elected officials*

Croatia has established institutional, legal, and financial arrangements for elected officials to exercise effective power to govern, which are not constrained by any non-democratic veto powers or other undue influences.

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<sup>11</sup> OSCE/ODIHR, Croatia, Parliamentary Elections 8 November 2015, Election Assessment Mission, Final Report, 19 February 2016.

## Civil Society, Media and Participation

### *Scale and independence of civil society*

There is a satisfactory legal framework for civil society organisations. A new Law on Associations, which is aimed at increasing the transparency of the civil society sector, including as regards the use of public funds, came into force in October 2014. The Law on Financial Operations and Accountancy of Non-Profit Organisations, adopted in January 2015, increases the opportunities for CSOs to generate income by enabling associations to engage in economic activities without registering in court Register.

There are more than 50,000 registered civil society organisations in Croatia. CSOs are concentrated in large cities and their activities are largely limited to urban areas, however civic engagement is expanding in smaller cities and rural areas as well. There is a sophisticated and diverse network of institutions responsible for cooperation between the government and CSOs, including the Council for Civil Society Development - an advisory body to the government tasked with developing the cooperation between the government and CSOs in the implementation of the National Strategy for Creating an Enabling Environment for Civil Society Development. CSO representatives can attend open sessions of the parliament and get involved in the work of parliamentary committees. CSO representatives were actively involved in developing the 2014-2016 Action Plan for the implementation of the Open Government Partnership - among the first in the region. The Action Plan, which calls for the development of mechanisms to allow the public to shape and monitor the implementation of public policy, recognises CSOs as partners in anti-corruption programmes and provides for CSO involvement in the development of a new anti-corruption strategy.

The right to form trade unions is enshrined in the law and respected in practice. The Economic and Social Council plays an active role in the social dialogue. The Council's activity is based on a tripartite cooperation among the government, trade unions and employers' associations for tackling economic and social problems.

### *Independence and pluralism of media operating without censorship*

The Constitution provides guarantees for media freedom as well as the right to information. Pluralism in the media, which operate without censorship, has increased overall in recent years. Croatia has a diverse media environment, which includes more than ten national TV stations, 20 local TV channels, 145 radio stations and 10 daily newspapers, offering citizens a wide range of political views. Television remains the predominant source of information. The Croatian public broadcaster, Hrvatska Radiotelevizija (HRT), operates four nationwide TV channels and three national radio stations. Privately owned national stations have been gaining audience in the last few years. The Croatian Journalists' Association ensures the code of ethics and reviews complaints from media employees.

The internet penetration rate is growing rapidly, with 74 per cent of Croatians having web access in 2016 compared to 38 per cent in 2006.<sup>12</sup> Social media is playing an increasingly important role with around 1.8 million Croatian Facebook users in 2016.<sup>13</sup>

### *Multiple channels of civic and political participation*

<sup>12</sup> Internet Live Stats: <http://www.internetlivestats.com/internet-users/croatia/>

<sup>13</sup> Internet World Stats: <http://www.internetworldstats.com/>

Multiple channels of civic and political participation are in place. The system of public consultations is largely in place, although the rules are not always enforced. The Croatian parliament is one of few in the region that has an institutionalised system of external members of the parliamentary committees from among CSOs, independent experts, and academia.

### *Freedom to form political parties and existence of organised opposition*

The freedom to form political parties is both guaranteed by the Constitution and implemented in practice, as highlighted by the existence of a significant opposition able to campaign freely and oppose government initiatives. More than 20 political parties are represented in the current parliament. The main opposition political party currently holds more than 25 per cent of seats in the national parliament, its representatives chair a number of parliamentary committees, and they are also in majority in several municipalities.

## **Rule of Law and Access to Justice**

### *Supremacy of the law*

Necessary legislative and institutional safeguards for the supremacy of the law are in place. The right to a free and fair trial is envisaged in the legislation and citizens are free from arbitrary arrest or detention. The legal system has been harmonised with the EU laws.

### *Independence of the judiciary*

The independence of the judiciary is guaranteed by the Constitution and key safeguards are in place to ensure its impartiality. Under a new system that came into effect in 2013, all judicial candidates must complete the State School for Judicial Officials. Although recent judicial reform has increased the overall efficiency of the judiciary, the case backlog in courts remains significant.

### *Government and citizens equally subject to the law*

The Constitution guarantees the equality of all citizens before the law and it is generally upheld in practice. Any person, who claims that their constitutional or legal rights and freedoms have been infringed by bodies or legal persons vested with public authority, may lodge a complaint with the Ombudsman, who ensures and protects the citizens' rights. Croatia has a special Ombudsperson for Children, an Ombudsperson for Gender Equality and an Ombudsperson for Persons with Disabilities.

### *Effective policies and institutions to prevent corruption*

The latest (2016) Transparency International Corruption Perceptions Index (CPI)<sup>14</sup> ranked Croatia 55<sup>th</sup> among 176 countries. Croatia ranks among the top ten EBRD recipient countries.

The institutional and legal framework for fighting corruption is in place and Croatia has made significant efforts to improve in this area, as recognised by the EU a few months before the country's accession to the Union in 2013. The Council of Europe's Group of States Against Corruption (GRECO) has also noted the achievements made by Croatia in the fight against corruption, with a compliance rate of about 95 per cent in the First, Second and Third

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<sup>14</sup> Transparency International, Corruption Perceptions Index (CPI), 2016.

Evaluation Rounds.<sup>15</sup> Eleven new recommendations regarding the fight against corruption among members of the parliament, judges and prosecutors have been included in the fourth evaluation report by GRECO.<sup>16</sup> The Compliance report on the 4<sup>th</sup> round concluded that three measures have been implemented satisfactorily, four partially and four have not been implemented.<sup>17</sup> Furthermore, GRECO has recognised that virtually all recommendations have been included as specific outputs to the current national Anti-Corruption Strategy (2015-2020).<sup>18</sup> Croatia has an impressive record of investigating and prosecuting high-level corruption. At the same time, the frequent corruption scandals demonstrate that the problem persists.

## **Civil and Political Rights**

*Freedom of speech, information, religion, conscience, movement, association, assembly and private property*

Overall civil and political rights continue to be respected in Croatia.

The Constitution guarantees the basic freedoms and rights of citizens recognised in international law, while international treaties which have been concluded and ratified in accordance with the Constitution are a component of the domestic legal order and have a primacy over domestic law. Freedom of speech, information, religion and conscience, movement, association and assembly, and private property are fully guaranteed. The Constitution and relevant laws prohibit discrimination on grounds of sex, race, language, religion, national or social origin, property or social status. Croatia is a signatory to all major international human rights instruments.

The latest assessment of the track record of Croatia in the area of human rights in the framework of the United Nations Universal Periodic Review (UPR) was adopted in 2015. Among the top recommendations are those related to rights of the children (28 per cent of recommendations) and women's rights (22 per cent). Croatia accepted 95 per cent of a total of 179 recommendations made through the review process.<sup>19</sup>

*Political inclusiveness for women, ethnic and other minorities*

In February 2015, the parliament adopted amendments to the Law on the Election of Representatives of the Parliament, introducing a mandatory gender quota for candidate lists. However, following the Constitutional Court's repeal of the provision, there was a substantial decrease of the number of women entering the parliament as MPs. The parliament elected in 2016 had 13 per cent female MPs; this percentage has increased after some women MPs were sworn in to replace the lawmakers who opted for other posts. Croatia elected its first female president in January 2015.

Croatian Constitution recognises the existence of 22 ethnic minorities. The latter are guaranteed eight seats in the 151-strong parliament, including three seats reserved for ethnic Serbs. There is a special legislation in place designed to protect the interests of ethnic minority communities, Constitutional Act on the Rights of National Minorities (CARNM). Despite constitutional protection for all minorities and the efforts by the authorities in this

<sup>15</sup> GRECO, Fourth Evaluation Round, Evaluation Report on Croatia, 25 June 2014

<sup>16</sup> GRECO, Fourth Evaluation Round, Evaluation Report on Croatia, 25 June 2014.

<sup>17</sup> GRECO, Fourth Evaluation Round, Compliance Report Croatia, 21 October 2016.

<sup>18</sup> GRECO, Fourth Evaluation Round, Compliance Report Croatia, 21 October 2016.

<sup>19</sup> United Nations, Universal Periodic Review (UPR), Croatia, and UPR Info Statistics [http://www.upr-info.org/database/statistics/index\\_sur.php?fk\\_sur=41&cycle=2](http://www.upr-info.org/database/statistics/index_sur.php?fk_sur=41&cycle=2)

direction, there are reports about continuing discrimination, mostly against ethnic Serbs and Roma.

The parliament adopted in 2014 a law approving same-sex partnerships. Social discrimination remains an issue for LGBT persons.

*Freedom from harassment, intimidation and torture*

Constitutional guarantees against harassment, intimidation, and torture are in place and are largely upheld in practice. A delegation of the Council of Europe's European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT) last visited Croatia in 2017. The report has not yet been published.

## ANNEX 2 – SELECTED ECONOMIC INDICATORS

|  | 2009  | 2010  | 2011  | 2012  | 2013  | 2014  | 2015  |
|--|---|-------|-------|-------|-------|-------|-------|
| <b>Output and expenditure</b>                              |   |       |       |       |       |       |       |
|  | <i>(Percentage change in real terms)</i>            |       |       |       |       |       |       |
| GDP  | -7.4  | -1.7  | -0.3  | -2.2  | -1.1  | -0.5  | 1.6   |
| Private consumption  | -7.4  | -1.5  | 0.3   | -3.0  | -1.9  | -1.6  | 1.2   |
| Public consumption   | 2.1   | -1.6  | -0.3  | -1.0  | 0.3   | -0.8  | -0.3  |
| Gross fixed capital formation                              | -14.4   | -15.2 | -2.7  | -3.3  | 1.4   | -2.8  | 1.6   |
| Exports of goods and services                              | -14.1   | 6.2   | 2.2   | -0.1  | 3.1   | 7.6   | 10    |
| Imports of goods and services                              | -20.4   | -2.5  | 2.5   | -3.0  | 3.1   | 4.5   | 9.4   |
| <b>Labour Market</b>                                       |   |       |       |       |       |       |       |
|  | <i>(Percentage change)</i>                          |       |       |       |       |       |       |
| Gross average monthly earnings in economy (annual average) | 2.2   | -0.4  | 1.5   | 1.0   | 0.8   | 0.2   | 1.3   |
| Real LCU wage growth                                       | -0.2  | -1.4  | -0.8  | -2.4  | -1.4  | 0.4   | 1.8   |
|  | <i>(In per cent of labour force)</i>                |       |       |       |       |       |       |
| Unemployment rate  | 9.2   | 11.6  | 13.7  | 15.9  | 17.3  | 17.3  | 16.3  |
| <b>Prices</b>  |   |       |       |       |       |       |       |
|  | <i>(Percentage change)</i>                          |       |       |       |       |       |       |
| Consumer prices (annual average)                           | 2.4   | 1.1   | 2.3   | 3.4   | 2.2   | -0.2  | -0.5  |
| Consumer prices (end-year)                                 | 1.9   | 1.8   | 2.1   | 4.7   | 0.3   | -0.5  | -0.6  |
| <b>Fiscal Indicators</b>                                   |   |       |       |       |       |       |       |
|  | <i>(in per cent of GDP)</i>                         |       |       |       |       |       |       |
| General government balance                                 | -6.0  | -6.2  | -7.8  | -5.3  | -5.3  | -5.4  | -3.4  |
| General government revenues                                | 41.6  | 41.3  | 41.0  | 41.8  | 42.6  | 43.1  | 45.2  |
| General government expenditure                             | 47.6  | 47.5  | 48.8  | 47.1  | 48.0  | 48.5  | 48.6  |
| General government debt                                    | 49.0  | 58.3  | 65.2  | 70.7  | 82.2  | 86.6  | 86.7  |
| <b>Monetary and financial sectors</b>                      |   |       |       |       |       |       |       |
| Broad money (M2, percentage change, end-year)              | n/a   | n/a   | 1.6   | 2.1   | 2.9   | 1.0   | 5.0   |
| Credit to the private sector (per cent of GDP, end-year)   | n/a   | 73.5  | 75.8  | 71.5  | 71.0  | 70.0  | 66.7  |
|  | <i>(In per cent of total loans)</i>                 |       |       |       |       |       |       |
| Non-performing loans ratio                                 | 7.8   | 11.2  | 12.4  | 13.9  | 15.7  | 17.1  | 16.7  |
| <b>Interest and exchange rates</b>                         |   |       |       |       |       |       |       |
|  | <i>(In per cent per annum)</i>                      |       |       |       |       |       |       |
| Policy rate *  | 9.0   | 9.0   | 7.0   | 7.0   | 7.0   | 7.0   | 3.0   |
| Deposit rate**   | n/a   | n/a   | 3.8   | 3.4   | 2.9   | 2.4   | 2.2   |
| Lending rate***  | n/a   | n/a   | 7.5   | 6.5   | 5.6   | 5.5   | 5.1   |
|  | <i>(HRK per EUR)</i>                                |       |       |       |       |       |       |
| Exchange rate (end-year)                                   | 7.3   | 7.4   | 7.5   | 7.5   | 7.6   | 7.7   | 7.6   |
| Exchange rate (annual average)                             | 7.3   | 7.3   | 7.4   | 7.5   | 7.6   | 7.6   | 7.6   |
| <b>External sector</b>                                     |   |       |       |       |       |       |       |
|  | <i>(In per cent of GDP)</i>                         |       |       |       |       |       |       |
| Current account  | -5.1  | -1.1  | -0.7  | 0.0   | 1.0   | 2.1   | 4.8   |
| Balance of goods and services                              | -3.7  | -0.3  | -0.4  | 0.5   | 0.5   | 2.0   | 2.5   |
| Trade balance of goods                                     | -16.5   | -13.2 | -14.3 | -14.3 | -15.1 | -15.1 | -15.9 |
| Merchandise exports  | 14.6  | 17.9  | 19.5  | 19.7  | 20.5  | 22.0  | 23.2  |
| Merchandise imports  | 31.2  | 31.1  | 33.8  | 34.1  | 35.6  | 37.1  | 39.1  |
| Trade balance of services                                  | 12.8  | 12.8  | 13.9  | 14.8  | 15.6  | 17.1  | 18.4  |
| Foreign direct investment, net                             | 2.9   | 1.8   | 2.5   | 2.8   | 1.9   | 1.6   | 0.6   |
| Gross international reserves                               | 23.0  | 23.7  | 25.0  | 25.6  | 29.7  | 29.5  | 31.2  |
| External debt stock  | 101.1   | 104.2 | 103.7 | 103.0 | 105.3 | 107.9 | 103.4 |
| Public external debt                                       | 29.2  | 32.8  | 32.6  | 34.5  | 38.2  | 41.4  | 44.5  |
| Private external debt                                      | 71.9  | 71.4  | 71.1  | 68.5  | 67.0  | 66.6  | 58.9  |
|  | <i>(In months of imports of goods and services)</i> |       |       |       |       |       |       |
| Gross international reserves                               | 7.2   | 7.5   | 7.3   | 7.4   | 8.3   | 8.1   | 8.1   |
| <b>Memorandum items</b>                                    |   |       |       |       |       |       |       |
|  | <i>(Denominations as indicated)</i>                 |       |       |       |       |       |       |
| Population (end-year, million)                             | 4.4   | 4.4   | 4.3   | 4.3   | 4.3   | 4.2   | 4.2   |
| GDP (in billions of EUR)                                   | 45.1  | 45.0  | 44.7  | 43.9  | 43.5  | 43.0  | 43.9  |
| GDP per capita (in EUR)                                    | 10500   | 10500 | 10400 | 10300 | 10200 | 10200 | 10400 |
| Share of manufacturing in GVA (in per cent)                | 14.4  | 14.2  | 14.4  | 14.5  | 14.1  | 14.5  | 14.7  |
| Share of agriculture in GVA (in per cent)                  | 5.0   | 4.9   | 4.7   | 4.5   | 4.4   | 4.3   | 4.3   |
| Share of tourism in GDP (in per cent)****                  | 22.5  | 20.4  | 21.7  | 20.4  | 21.7  | 22.2  | 23.2  |
| External debt (in billions of EUR)                         | 45.6  | 46.9  | 46.4  | 45.3  | 45.8  | 46.4  | 45.4  |

\* Discount rate,

\*\* Household term deposit rates (local currency), new businesses.

\*\*\* Corporate lending rate (local currency), new businesses.

\*\*\*\*World Travel and Tourism Council data,

Source: National Authorities and CEIC, except where noted separately.



## ANNEX 3 – ASSESSMENT OF TRANSITION CHALLENGES

| Market structure                  | Market institutions | Key challenges  |
|-----------------------------------|---------------------|---|
| <b>CORPORATES</b>                 |                     |   |
| <b>Agribusiness</b>               |                     |   |
| Small                             | Medium              | <ul style="list-style-type: none"> <li>increasing access to finance</li> <li>encouraging land consolidation in order to increase productivity</li> <li>supporting investments in technology, energy efficiency, and corporate restructuring to increase agribusiness sector competitiveness</li> </ul>  |
| <b>Manufacturing and Services</b> |                     |   |
| Small                             | Small               | <ul style="list-style-type: none"> <li>supporting investments in innovation, new technology, energy and resource efficiency and corporate restructuring</li> <li>accelerating restructuring either through privatisation or liquidation of companies that remain state-owned and reduce overall state involvement in the sector</li> <li>promoting labour market reforms and measures aimed at tackling main obstacles to doing business</li> </ul>   |
| <b>Real estate</b>                |                     |   |
| Medium                            | Small               | <ul style="list-style-type: none"> <li>further increasing focus on energy efficiency and sustainability</li> <li>further streamlining the bureaucracy related to real estate (such as the process of obtaining construction permits and registering a property)</li> <li>further increasing the involvement of the private sector and the associated value added services</li> <li>further increasing the supply of modern commercial property outside major cities and of higher quality tourism infrastructure</li> </ul> |
| <b>ICT</b>                        |                     |   |
| Small                             | Small               | <ul style="list-style-type: none"> <li>further developing the electronic communications telecommunications infrastructure (broadband internet)</li> <li>increasing competition in the fixed line segment</li> </ul>   |
| <b>ENERGY</b>                     |                     |   |
| <b>Natural Resources</b>          |                     |   |
| Small                             | Small               | <ul style="list-style-type: none"> <li>supporting further privatisation in the oil and gas import and supply</li> <li>enhancing competition in the retail oil products sector</li> <li>ensuring transparent and non-discriminatory third party access to import and transport infrastructures in the natural gas sector, and integrating the national gas market with the regional/EU market</li> <li>further liberalising the prices for gas to all customers</li> </ul>   |
| <b>Power</b>                      |                     |   |
| Large                             | Medium              | <ul style="list-style-type: none"> <li>increasing private sector participation on both wholesale and retail energy markets</li> <li>promoting an independent regulator with sole responsibility for tariff setting</li> <li>introducing cost reflective tariffs for end consumers</li> </ul>  |

| Market structure              | Market institutions | Key challenges  |
|-------------------------------|---------------------|---|
| <b>INFRASTRUCTURE</b>         |                     |   |
| <b>Water and wastewater</b>   |                     |   |
| Medium                        | Small               | <ul style="list-style-type: none"> <li>• decrease tariff differential between households and industries</li> <li>• contractual improvements to allow for economically viable regionalised water operations in line with the Long-term programme for construction of water utilities infrastructure</li> <li>• introduction of private sector participation to increase competitive pressures and raise quality (e.g. for sludge management if required by Authorities)</li> </ul>   |
| <b>Urban Transport</b>        |                     |   |
| Medium                        | Small               | <ul style="list-style-type: none"> <li>• increase in the transparency and predictability through better defined service contracts that include indexation of adjustments of service payments based on multi-year contractual agreements</li> <li>• increasing competitive pressures from sound private sector participation</li> <li>• introduction of e-ticketing systems to improve transparency in ticket collections, obtain better information about transport patterns and enhanced coordination among public transport service</li> </ul>  |
| <b>Roads</b>                  |                     |   |
| Small                         | Medium              | <ul style="list-style-type: none"> <li>• successful implementation of road PPP projects and any other forms of private sector participation (e.g. toll operations by management contracts)</li> <li>• improvements in procurement procedures</li> <li>• further commercialisation and restructuring of road companies through improvements in the financial and operational sustainability including the enhancement of the corporate governance</li> <li>• improvements in the contents of the contracts with constructors and operators (e.g. introduction of performance benchmarks)</li> </ul>                                  |
| <b>Railways</b>               |                     |   |
| Medium                        | Medium              | <ul style="list-style-type: none"> <li>• improvements in financial mechanisms including the allocation and well-functioning access charge mechanism</li> <li>• further enhancement of competition in the market</li> <li>• further commercialisation and restructuring of incumbent railway companies</li> </ul>  |
| <b>FINANCIAL INSTITUTIONS</b> |                     |   |
| <b>Banking sector</b>         |                     |   |
| Small                         | Small/<br>Medium    | <ul style="list-style-type: none"> <li>• developing local currency funding for unhedged borrowers (mainly SMEs and households) and diversification of the investors' base to reduce high currency mismatches</li> <li>• addressing legal issues in enforcement of creditor rights and regulatory gaps for certain financial products</li> <li>• continuing product innovation in areas such as SME finance and energy efficiency</li> <li>• building up capacity and mitigating systemic risk strengthening the institutional capacity of DAB with regards to its new role as Resolution Authority in line with the BRRD</li> </ul> |

| Market structure  | Market institutions | Key challenges  |
|---|---------------------|---|
|   |                     | <ul style="list-style-type: none"> <li>• broadening the availability of mortgages</li> </ul>  |
| <b>Insurance and other financial services</b>   |                     |   |
| Small   | Small               | <ul style="list-style-type: none"> <li>• introducing innovative non-bank financial instruments</li> <li>• establishing regulatory framework for factoring and for electronic signatures to enable electronic invoicing and factoring</li> <li>• creating registration system for warehouse receipts;</li> <li>• facilitate resolution of NPLs through support of NPL asset management companies and debt servicing platforms</li> </ul>   |
| <b>Private equity</b>   |                     |   |
| Medium  | Medium              | <ul style="list-style-type: none"> <li>• ensuring that government-backed funds do not distort the market as it develops</li> <li>• increasing participation by local institutional investors</li> </ul>   |
| <b>Capital markets</b>  |                     |   |
| Medium  | Small               | <ul style="list-style-type: none"> <li>• broaden the listed market with additional corporate issues, especially bond and structured financial instruments, and examine any barriers or costs associated with on-exchange transactions</li> <li>• deepen the capacity of the capital market to provide financing, possibly through linkages and/or cross-listing with other regional exchanges</li> <li>• develop covered bonds</li> <li>• develop the institutional framework for securitisation</li> </ul>           |
| <b>SME development</b>  |                     |   |
| Bank financing: Medium<br>Non-bank Financing: Medium<br>Legal Framework: Medium<br>Business Standards and Skills: Small<br>Business Environment: Medium |                     | <ul style="list-style-type: none"> <li>• developing tailored products such as specialised sector products and supply chain finance</li> <li>• expanding training programmes and technical assistance available to SMEs, including in areas of capacity building and financial management</li> <li>• improving the enforcement of creditors' rights and security rights over moveable assets</li> <li>• improving the ease of doing business for SMEs, e.g., by promoting the development of one-stop-shops</li> </ul> |
| <b>SUSTAINABLE RESOURCE INITIATIVE</b>  |                     |   |
| <b>Water efficiency</b>   |                     |   |
| Small   | Medium              | <ul style="list-style-type: none"> <li>• Improving coordination and funding of water and wastewater infrastructure investments</li> <li>• Increasing tariffs (abstraction and wastewater) towards full cost-recovery, and transposing existing additional charges into volumetric surcharges</li> </ul>   |
| <b>Materials efficiency</b>   |                     |   |
| Medium  | Medium              | <ul style="list-style-type: none"> <li>• Pushing construction of regional Waste Management Centres</li> <li>• Increasing budget for waste management in face of large infrastructure investments</li> <li>• Improving coordination with institutions across all environmental topics</li> <li>• Closing illegal and uncontrolled dumping sites</li> </ul>   |

| Market structure          | Market institutions | Key challenges  |
|---------------------------|---------------------|---|
| <b>Sustainable energy</b> |                     |   |
| Small                     | Medium              | <ul style="list-style-type: none"> <li>• Introducing cost reflective tariffs for end consumers</li> <li>• Streamlining the administrative processes for sustainable energy projects</li> <li>• Developing climate change related institutional project delivery capacity</li> <li>• Further increasing competition in the electricity sector</li> </ul> |

## ECONOMIC INCLUSION<sup>[1]</sup> GAP RATINGS

| ECONOMIC INCLUSION               |               |   |
|----------------------------------|---------------|---|
| Inclusion gap dimension          | Inclusion gap | Key challenges  |
| <b>Regions</b>                   |               |   |
| Institutions                     | Medium        | <ul style="list-style-type: none"> <li>▪ Strengthening social dialogue at the regional level in order to enhance participatory policy making processes</li> <li>▪ Improving the financial capacities of municipalities and towns in rural areas in order to reduce regional imbalances and support local governments to increase the quality of services provided</li> <li>▪ Establishing national standards for public services in order to ensure a quality assurance mechanism for services provided at the local level</li> </ul> |
| Access to Services and Education | Medium        | <ul style="list-style-type: none"> <li>▪ Improving regional access to social infrastructure (such as local healthcare and education) in order to decrease regional inequalities in access to services</li> </ul>  |
| <b>Youth</b>                     |               |   |
| Labour Market Structure          | Medium        | <ul style="list-style-type: none"> <li>▪ Reducing the costs of hiring and firing in order to encourage job creation and hiring</li> <li>▪ Rendering working hours more flexible so that firms can adjust labour input to seasonal fluctuations in product demand by rescheduling work hours</li> <li>▪ Addressing wage rigidities to promote adjustment of wages rather than employment to the fall in demand for labour</li> </ul>   |
| Youth Employment                 | Large         | <ul style="list-style-type: none"> <li>▪ Establishing work based learning opportunities (i.e. internships, apprenticeships, trainee programmes) through collaboration between the private sector and education providers</li> </ul>   |
| Quality of Education             | Medium        | <ul style="list-style-type: none"> <li>▪ Improving the quality and relevance of education to respond better to labour market needs</li> </ul>   |
| Skills Mismatch                  | Medium        | <ul style="list-style-type: none"> <li>▪ Supporting initiatives to enhance private sector participation in the setting of national skills standards that reflect labour market needs, particularly at vocational level</li> </ul>   |

|                             |        |  |
|-----------------------------|--------|--|
| Financial Inclusion         | Medium | <ul style="list-style-type: none"> <li>Improving access to finance for young people and the availability of financial and business advisory services targeted at young entrepreneurs</li> </ul>  |
| <b>Gender</b>               |        |  |
| Education and Training      | Medium | <ul style="list-style-type: none"> <li>Improving partnerships between the private sector clients and technical universities to enhance opportunities for women in STEM professions (science technology, engineering and mathematics) and thereby incentivise female enrolment</li> </ul>   |
| Labour Policy and Practices | Medium | <ul style="list-style-type: none"> <li>Improving policies and practices in relation to equal pay and differential retirement age to reduce gender pay gap and inequality in promotion and training opportunities</li> </ul>  |
| Employment and business     | Medium | <ul style="list-style-type: none"> <li>Improving client HR policies with regards to increasing female employment in sectors and types of positions with low female work force participation, including technical positions, as well as progression routes into management roles</li> </ul> |

<sup>1</sup> The EBRD Economic Inclusion gaps rate the institutions, markets and education systems across all EBRD's countries of operation in terms of their capacity to extend economic opportunity to individuals regardless of their gender, age or place of birth. These gaps measure *differences* in opportunities – between 15 to 24-year-olds and older workers, and between women and men – rather than opportunity *levels*. Gaps are reported in this Country Strategy where there exists an Inclusion Gap above Small. These gaps are consistent with the EBRD 2016 Inclusion Gap update.



## ANNEX 4 – LEGAL TRANSITION

This annex offers critical analysis on selected legal topics relevant to the Bank's investment strategy in Croatia during the forthcoming period. It is based on the assessments of commercial laws conducted by EBRD Legal Transition Programme. For ease of reference, the analysis is presented along the main strategic orientations defined in this country strategy, in particular the actions proposed under 'Policy dialogue'.

***Priority: Support private sector competitiveness through fostering innovation, resource efficiency, as well as improvement of the business climate and economic inclusion.***

### *Energy Efficiency, Renewable Energy, Energy Infrastructure and Regulation*

The energy legal framework of Croatia underwent significant changes in recent years, particularly in the context of EU accession. The recent legislative changes were made in the context of Croatia accession to the EU, aiming at transposing requirements of the Third Energy Package into national legislation. However, further efforts are needed to ensure adequate implementation of measures introduced by the legal framework. Market opening, effective cross border energy interconnection, appropriate balance of state and private ownership of energy market players, energy tariff structure adaptation and energy price deregulation stand out among the priority reforms which are yet to be fully addressed.

Croatian electricity sector remains highly regulated, with its liberalisation still underway. Despite electricity market being formally open, the national market operator and the transmission and distribution companies are still indirectly under state ownership. In November 2015, the Croatian energy exchange was launched, in what was one of the latest steps towards market liberalisation.

The Renewable Energy Act, which came into force in January 2016, is believed to be a considerable step toward RES promotion in Croatia. The Energy Strategy for the Republic of Croatia sets out a target of 20 per cent renewable energy share of the final gross energy consumption by 2020 in line with the EU law. As of 2014, the share of renewable energy in gross final consumption was 27.9 per cent, which effectively means that Croatia has largely achieved its 2020 renewable energy sources (RES) target. However, RES share in transport is currently at 2.1 per cent, which is short from the projected 10 per cent RES share target.

Croatia has transposed the EU Directive on Energy Efficiency (2012/27/EU) into national law, and its National Energy Efficiency Action Plan sets a final energy saving target of 22.76 Petajoules (PJ) by 2020. Further progress should be made with respect to Energy Efficiency (EE) in the energy production, distribution and final consumption in terms of both implementation and institutional capacity. The establishment of the National Agency for Energy Efficiency and Renewable Energy would also set a good practice for specialised institutional capacity for the sector.

### *Contract Enforcement / Judicial Capacity*

The Constitution of the Republic of Croatia is based on the principle of separation of powers which calls for an autonomous and independent judiciary. All court hearings are open to the public and rulings are pronounced publicly in the name of the Republic of Croatia.

Recent legislative amendments introducing mandatory security clearance for first time judicial appointments are currently undergoing constitutional scrutiny, having raised concerns about a possible breach of independence of the judiciary. Judges are appointed by the National Judicial Council (NJC) for life and they are obliged to undergo professional training and continuously develop their professional skills as well as participate in educational

programmes organised by the Judicial Academy, the independent public institution responsible for providing initial and continuous training for the judiciary.

Although significant improvements took place in recent years, particularly in the context of EU accession, lengthy court proceedings, case backlogs and lack of consistent case law still affect the quality of the administration of justice. To address this issue in commercial courts, an initial exploration of business processes and case management has been undertaken that could improve the operation of the High Commercial Court and commercial courts. As a result of the reorganisation of the civil courts further to the recent judicial map reform, the judicial workload is expected to be evened out and the consistency of case law is expected to improve. Although the introduction of information and communication technologies (ICT) in courts has largely been successful, particularly as regards case management, the use of ICT in communication between court and parties / lawyers needs to be further promoted. Corruption still affects business in Croatia, although progress has been reported in addressing this issue.

Alternative dispute resolution (ADR) methods are in place but they appear to be underutilised. Both court and extra-judicial methods of mediation are envisaged and the Ministry of Justice has established and appointed the ADR Commission, tasked with monitoring the development of ADR and proposing measures for promoting it.

Croatia ranks 43<sup>th</sup> (out of 190 economies) in the World Bank's Doing Business 2017 report; the “Enforcing Contracts” indicator was ranked 7th. Under the recent Business Environment and Enterprise Performance Survey, the three major obstacles for conducting business in Croatia, as identified by firms, are: access to finance; the informal sector; and tax administration.

## ***Priority 2: Deepening financial markets to broaden access to finance with focus on capital markets developments***

### *Access to finance*

Provisions of taking non-possessory pledge over movable assets and rights are currently part of the Croatian Enforcement Act, as the Property Act provides for possessory pledge only. This has created some legal uncertainties and increased transaction costs.

In Croatia, a mortgage is created by execution of a written agreement between owners of a real-estate property whose signature needs to be certified and the mortgage creditor, and registration of the agreement into the land registry. The land registry is operated at the municipal courts throughout the country, in the specialised land registry divisions.

Financial and operative leasing is regulated by the Leasing Law. The law provides modern legislative framework for undertaking leasing transactions. Leasing companies are regulated, require license and are supervised by the Croatian Financial Markets Supervisory Agency (HANFA). As far as factoring is concerned, with EBRD technical assistance a new factoring law was introduced in 2014. The law provides both contract law framework for undertaking factoring transactions and sets regulatory environment for supervision of factoring services. EBRD technical assistance consisted primarily of drafting contract law provisions while HANFA was in charge for the regulatory part.

***Priority 3: Promote commercialisation of public companies, including the improvement of corporate governance, and support the privatisation of some state-owned companies:***

*Corporate governance*

The 2015 EBRD assessment on the corporate governance legislation and practices of companies in the EBRD region revealed that the corporate governance framework and practices in Croatia are relatively sound. Boards of the largest companies show a much higher degree of gender diversity compared to other EU countries in the EBRD region, however, the law does not set forth any qualification requirements for board members and only a few companies disclose that information. While the company law fails to assign all key functions to the board, the banking framework is clearer in this respect. Companies are required to publish their annual reports and they appear to comply well with this requirement. Companies listed on the regulated market are also required to publish their reports on a quarterly basis. Moreover, the law requires financial statements to be prepared in line with IFRS and made public and all ten largest listed companies appear to comply.

Related party transactions and conflict of interest appear to be well regulated for banks but less so for companies. Insider trading is regulated by law and seems to be well enforced in practice. Basic shareholders rights are granted by the law and a share register of issuers is maintained by an independent registry institution.

On the negative side, shareholders' agreements are not regulated by law, and it is not clear if they are enforceable against third parties. It is also unclear if a minimum shareholding is required to nominate supervisory board members. The legislator should consider assessing the independence and strategic role of the audit committee so to enhance its effectiveness. Furthermore, the Corporate Governance Code should be reviewed and updated and its monitoring further strengthened (especially with regard to the quality of explanations). Finally, it is worth noting that there is no comprehensive whistleblowing legislation in place.

*Concessions/PPP*

Generally, the Croatian legal framework in the area of PPP and concessions is in line with the EU policies and appears to be fair and comprehensive, incorporating many necessary rules and clear procedures. The EBRD Assessment of the PPP/Concessions Laws (2012), which was undertaken before the new PPP and Concessions Laws were adopted later that year, concluded that the PPP/Concessions legal framework in Croatia was in high compliance with best international standards and practice. Moreover, the subsequently introduced laws were also deemed to compliant with best international standards and practice.

Nevertheless, some important elements generally necessary for the financing of PPP projects appear to be missing. For example, although arbitration is provided for PPP dispute resolution, it would be useful to incorporate an explicit reference to the possibility of resorting to international arbitration. Furthermore, while the approval procedure for PPP projects has been simplified, burdensome requirements regarding documents preparation (including preparation of a Public Sector Comparator) could potentially be a barrier for first-time PPP projects in a particular sector. On the other hand, Concessions Law reportedly incorporates less stringent documentation-related and approval requirements. The line between concessions and PPP projects is drawn on a case-by-case basis.

## ANNEX 5 – GENDER PROFILE

### *Gender inequality and human development*

According to the UNDP 2015 Human Development Index (HDI)<sup>20</sup>, Croatia ranks 47 out of 188 countries, a very high human development ranking. Croatia ranks slightly better in terms of the UNDP Gender Inequality Index (GII) at 33 globally out of 149 countries.<sup>21</sup> The 2015 World Economic Forum Global Gender Gap Index<sup>22</sup> ranked Croatia 59<sup>th</sup> out of 145 countries. Croatia has a comprehensive legal framework supporting gender equality, including two Gender Equality Acts passed in 2003 and 2008. Any form of discrimination is prohibited by Article 23 of the Constitution.

### *Employment*

In 2014, women's employment rate in Croatia was 50 per cent. Women are more likely to be unemployed than men (18.3 per cent for women compared to 16.5 per cent for men). The last data available (2015), show that youth unemployment is high for both, men (41.9 per cent) and women (44.5 per cent). In 2014, the gender pay gap in Croatia was 10.4 per cent, slightly lower than the EU average of 16.1 per cent. The Croatian labour market presents a pattern of horizontal segregation along gender lines. While "wholesale & retail", "agriculture, forestry & fishery" and "manufacturing" are the sectors where more men and women work, others like "health & social work" and "education", are typically female. For example, 11.7 per cent of all employed women work in "health & social work" whereas only 2.3 per cent of men work in this sector. On the other hand, the second most popular sector for men is "construction" in which 13.9 per cent of all employed men work. The share of employed women who work in this sector is very low with only 1.1 per cent. Vertical segregation is also a problem with only 22 per cent of management positions being occupied by women in 2012.

### *Access to finance, entrepreneurship and decision-making*

The gender gap in access to finance is small. In 2014, 87 per cent of women in Croatia had a bank account, as did 90 per cent of men. According to the 2013-2015 Business Environment and Enterprise Performance Survey (BEEPS), out of 360 firms surveyed in Croatia, 32 per cent had women among the owners, the average for SEE being 27.6 per cent; and 19 per cent had women in positions of top management. Only 25 per cent of firms have at least 50 per cent women ownership. Although gender gap has been identified as small, certain specific challenges faced by women-led businesses have been identified and captured by the WiB programme launched in 2015.

<sup>20</sup> The HDI is comprised of the following three dimensions: health, education and decent standard of living.

<sup>21</sup> The GII captures the loss in human development, within a country, due to inequality between female and male achievements in the three GII dimensions: reproductive health (maternal mortality and adolescent birth rates), empowerment (share of parliamentary seats held by women and attainment in secondary and higher education by each gender) and economic activity (labour market participation of men and women).

<sup>22</sup> The Global Gender Gap Index examines the gap between men and women in four fundamental categories (sub-indexes): Economic Participation and Opportunity, Educational Attainment, Health and Survival and Political Empowerment.

*Women's Political Participation*

While there are no formal quotas in Croatia, Article 12 of the Gender Equality Act makes provisions for affirmative action to promote equal participation of women and men in bodies of legislative, executive and judicial power, including public services. The parliament elected in 2016 had 13 per cent female MPs. However, concerns have been raised about the low number of women in local legislative bodies, the Government and the civil service – including in senior and decision-making positions.

*Roma Women in Croatia*

The estimated number of Roma in Croatia is between 30,000 and 40,000 according to the European Parliament (2013). In Croatia, Roma women are highly vulnerable because of their socioeconomic conditions and social exclusion. While Roma experience multiple and intersectional discrimination on many grounds including ethnicity and language, Roma women face additional problems as a result of gender discrimination rooted in the traditional patriarchal family system. The majority of Roma women live in large families of 5 or more and have on average 4-5 children. Early marriage, followed by early motherhood is a common practice reported by the European Commission. All of this impacts Roma women's economic inclusion, as shown by an extremely low rate of employment (7 per cent) in 2011.

## ANNEX 6 – EBRD AND THE DONOR COMMUNITY

Donor funded technical cooperation (TC) in Croatia has allowed the Bank to undertake early diagnostic work, including the preparation of infrastructure investment opportunities, building capacities of prospective clients and sharing transition experience from policy makers and private sector stakeholders from EBRD Countries of Operations in Central and Eastern Europe. Further, TC funds have been provided to support the transfer of skills and the growth of local private MSMEs, including through local and international consultants under the Advice for Small Businesses programme.

Croatia has also benefited from co-investment grants in the last strategy period. Funds totalling €5.4 million for financial incentives were signed under the Western Balkans Sustainable Energy Financing Facility II from EU funds contributed to the Regional Energy Efficiency Programme for the Western Balkans.

The focus of donor grants is expected to remain on developing core infrastructure, enhancing energy security and increasing the competitiveness of SMEs. To sustain these needs, the EBRD will rely on a number of donor funds administered by the Bank, in addition to resources made available by its shareholders:

- **The European Union:** Croatia ceased to be eligible for funding from the Instrument for Pre-Accession when it acceded to the EU on 1 July 2013. This includes in the context of the regional WBIF which concentrates its efforts on the development of core infrastructure projects in the environment, social, transport and energy sectors. Whilst Croatia no longer qualifies as a direct recipient of WBIF resources, it remains an important coordination platform of regional priority investments amongst beneficiary governments of the Western Balkans.

The Bank continues to work closely with the national authorities and the EU's Structural Reform Support Service to identify areas where the EBRD could offer tailor-made technical assistance to foster effective implementation of structural reforms and build the institutional and administrative capacity. The potential area of cooperation may include enhancing of the monitoring activities of SOEs through provision of support to the State Assets Agency as well as providing tailored training for the nominee directors on corporate governance and legislation governing SOEs.

The EBRD is also exploring with the managing authorities in Croatia and the European Commission the possibility of leveraging EU grants with commercial financing and in the overall design of potential new financial programmes focused on energy efficiency, SME access to finance and agricultural sector. In particular, the Connecting Europe Facility may offer the possibility of grants in the power and energy sector, and Horizon 2020 could enable grants relevant to promoting access to finance for innovative SMEs.

- **Bilateral donors:** grant funds will be sought from bilateral donors who hold accounts administered by the EBRD, who have expressed interest in supporting activities in Croatia across all sectors.
- **EBRD Shareholder Special Fund (SSF)** endowed by the Bank's net income. The SSF is a complementary facility to donor resources and will provide TC and co-investment



grants in areas where there is shortage or lack of support, however the area remains a priority for the Bank to advance transition.

#### TC COMMITMENTS BY DONOR THROUGH EBRD, 2011-2016\*

| Donor                         | TC Commitments (€m) |
|-------------------------------|---------------------|
| EBRD Shareholder Special Fund | 6.62                |
| Austria                       | 1.29                |
| Taipei China                  | 0.75                |
| European Union                | 0.69                |
| Small Business Impact Fund    | 0.30                |
| France                        | 0.25                |
| Spain                         | 0.25                |
| Czech Republic                | 0.24                |
| <b>TOTAL</b>                  | <b>10.39</b>        |

#### TC COMMITMENTS BY COUNTRY STRATEGY THEME THROUGH EBRD, 2011-2016\*

| Country Strategy Themes                                   | TC Commitments (€m) |
|---|---------------------|
| Sustainable Infrastructure and Energy Security            | 3.70                |
| Green Economy Transition                                  | 3.10                |
| Entrepreneurship and SMEs                                 | 1.82                |
| Good Governance   | 0.58                |
| Strong Resilient and Effective Financial Sector Developed | 0.56                |
| Private Sector Competitiveness                            | 0.37                |
| Local Currency and Capital Markets                        | 0.26                |
| <b>TOTAL</b>  | <b>10.39</b>        |

Note: 2012-2015 data is based on TC Commitments as at the end of March 2016 (the latest available date before the data migration in a new Donor Funds System. 2016 data is based on 2016 earmarks at the project level).