



REPUBLIC OF CROATIA
MINISTRY OF FINANCE



CROATIAN NATIONAL BANK

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President of the Eurogroup

Zagreb, 9 July 2020

Dear Mr Centeno,

Following up on our letter dated 4 July 2019, stating the firm intention of the Government of the Republic of Croatia and the Croatian National Bank to accede to the Exchange Rate Mechanism II (ERM II) and ultimately introduce the euro, and having regard to the statement by the Eurogroup of 8 July 2019, welcoming the intention of the Croatian authorities to put in place the necessary elements for the successful participation in ERM II, we hereby request to initiate the ERM II Procedure with the intention to join ERM II.

Allow us to recall the following achievements of the Republic of Croatia in preparing its economy for successful participation in ERM II:

- (1) The Republic of Croatia has been successful in maintaining price and financial sector stability for more than 25 years now, by pursuing a monetary policy based on stabilizing the exchange rate of the Croatian kuna against the euro. The Croatian National Bank operates a managed floating exchange rate regime with no predefined levels or fluctuation bands. Currency stability has been supported by other economic policies, in particular by macro-prudential policy. Such a policy mix is conducive to growth and macroeconomic stability.
- (2) Since 2015, the Republic of Croatia has brought its public finances onto a more sustainable path. Following the correction of the excessive deficit in 2016, in 2019 the general government balance recorded a surplus for the third consecutive year. Because of this and a strong nominal GDP growth, general government debt has declined by 11 percentage points between 2015 and 2019, to 73.2% of GDP. The European Commission 2020 spring forecast projects the general government balance to deteriorate sharply in 2020 on the back of the economic contraction caused by the COVID-19 pandemic, as automatic stabilizers and temporary support measures on both the revenue and expenditure side of the budget play their role. In the same vein, the debt ratio is also set to increase sharply in 2020. According to the forecast, the debt ratio should start declining strongly again in 2021, as the economy rebounds and fiscal temporary measures expire.

- (3) The Republic of Croatia has also achieved a substantial reduction of its external imbalances. It has been reporting sizable current account surpluses in recent years, largely due to strong export growth following EU accession. Against this background, the net international investment position improved considerably, by 44 percentage points of GDP between 2010 and 2019, when it stood at 51 percent of GDP. The current account surplus is expected to narrow in 2020 under the impact of the pandemic crisis, but modestly, since the crisis is affecting both imports and exports. In the labour market, the unemployment rate fell from above 17 percent in 2014 to below 7 percent in 2019, which is in line with the EU average. The Government's wage and liquidity support measures will partly mitigate the adverse impact of the COVID-19 crisis on the labour market. With the expected economic rebound in 2021, both the current account balance and unemployment are expected to improve quickly.
- (4) The Croatian banking system is highly liquid, profitable and well capitalized, with the total capital ratio standing at 23.4 percent in March 2020. Non-performing loans have been reduced significantly between 2015 and the first quarter of 2020, and are adequately covered by provisions. The soundness of the banking system has recently been confirmed by the comprehensive assessment conducted by the European Central Bank, which found that none of the banks that had been included in the assessment faced capital shortfalls even under the adverse scenario. The Croatian National Bank maintains a vigilant supervisory approach. It has been actively implementing recommendations by the European Central Bank and the European Banking Authority, in particular when it comes to bank capitalisation and risk management practices.
- (5) In the context of the European Semester, the Commission and the Council monitor, assess and issue recommendations to the Republic of Croatia, taking into account the need to tackle structural weaknesses and reduce macroeconomic imbalances. In the Croatia Country Report 2020, the Commission acknowledges the progress that Croatia made in a number of areas since it started participating in the Semester in 2014. Going forward, the Government of the Republic of Croatia will build on the progress achieved and continue to address the Council country-specific recommendations.
- (6) Following our firm intention to join ERM II, the Republic of Croatia fully implemented the set of prior commitments in six policy areas – as put forward in the Action Plan of the Republic of Croatia for joining ERM II and the Banking Union that was annexed to our letter of 4 July 2019.
- In its letter of 8 June 2020, the Republic of Croatia notified the ERM II parties of the progress made, i.e. the full implementation of the prior commitments under titles 2-6, and requested a formal assessment of the implementation of these policy commitments. Subsequently, the European Commission and the European Central Bank confirmed, each within its own area of competence, that these prior commitments had been fully implemented.

- As regards the implementation of the prior commitment under title 1 – to further strengthen banking supervision by entering into close cooperation with the European Central Bank – the European Central Bank assessed the relevant Croatian legislation, ensuring that the Croatian National Bank would be obliged to adopt all measures requested by the ECB in relation to Croatian credit institutions, and conducted a comprehensive assessment of five Croatian banks. The positive assessment by the European Central Bank, also based on the results of the comprehensive assessment published on 5 June 2020, confirmed that the conditions for entering into close cooperation had been fulfilled. On this basis, the European Central Bank adopted a decision to enter into close cooperation with the Croatian National Bank.

(7) In the past few months, constructive discussions were held with the European Central Bank, the Commission, the euro area Member States and Denmark on the necessary elements for joining ERM II.


In light of all of the above considerations, we hereby submit our application to join ERM II, i.e. to include the Croatian kuna in ERM II, and restate our firm intention to introduce the euro once the convergence criteria in accordance with Article 140 of the Treaty on the Functioning of the European Union will have been fulfilled. To this purpose, we confirm our readiness to establish close cooperation with the European Central Bank and firmly commit to implement a number of policy measures in reform areas of high relevance for achieving a high degree of sustainable economic convergence and successful participation in the third stage of the Economic and Monetary Union, in particular:

- 1) to strengthen the anti-money laundering framework following the transposition of the 5th Anti-Money Laundering Directive (AML5 Directive);
- 2) to reduce the administrative and financial burden for the economy through further simplification of administrative procedures and reduction of parafiscal and non-tax charges;
- 3) to improve corporate governance of state-owned enterprises (SOEs) through revising and aligning regulation and practices in accordance with the OECD Guidelines on Corporate Governance of SOEs;
- 4) to strengthen the national insolvency framework in line with Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.


The Republic of Croatia also remains dedicated to pursuing sustainable economic and structural policies that further enhance the competitiveness and resilience of the Croatian economy, including its financial system, as well as to achieving an environment that is conducive to sustainable economic convergence.

We propose to include the Croatian kuna in ERM II with a central rate equal to the ECB reference rate of the Croatian kuna against the euro as recorded during the daily concertation procedure among the central banks in Europe on Friday, 10 July 2020. The Croatian kuna will be subject to the standard ERM II fluctuations margins of ± 15 percent. We stand ready to discuss further on this basis with the euro area Member States, Denmark, the European Central Bank and the European Commission, including on the main features of the arrangement with regard to the participation of the Croatian kuna in ERM II.

Sincerely yours,



Zdravko Marić
Deputy Prime Minister and Minister of Finance
Republic of Croatia





Boris Vujčić
Governor
Croatian National Bank



cc:

President of the European Central Bank

President of the Economic and Financial Committee and the Eurogroup Working Group

Attachment

The Republic of Croatia's Action Plan for participation in Exchange Rate Mechanism II (ERM II) ("Post-entry commitments")

**THE REPUBLIC OF CROATIA'S ACTION PLAN
FOR PARTICIPATION IN EXCHANGE RATE MECHANISM II (ERM II)
("POST-ENTRY COMMITMENTS")**

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POLICY AREA	1. ANTI-MONEY LAUNDERING
DESCRIPTION OF THE POLICY AREA	<p>Strengthening the anti-money laundering framework following the transposition of the 5th Anti-Money Laundering Directive (AML5-Directive).</p> <p>The Croatian authorities commit to take further steps with the purpose of strengthening the anti-money laundering and terrorist financing framework following up on the already fully transposed Directive (EU) 2018/843, by taking measures that will mitigate identified risks and threats of money laundering and terrorist financing. The Croatian supervisory authorities (Croatian National Bank, Financial Inspectorate, Croatian Financial Services Supervisory Agency, Tax Administration) will continue to closely cooperate in the supervision and monitoring of obliged entities, as well as in the exchange of information with the Anti-Money Laundering Office (Croatian Financial Intelligence Unit).</p>
MEASURES	<p>1.1 Raising the level of awareness among all responsible parties for the implementation of measures through regular education (competence of all supervisory authorities).</p> <p>Supervisory bodies and the Anti-Money Laundering Office will provide regular appropriate education for staff of all reporting entities, including both anti-money laundering compliance officers and management of credit institutions. The education initiatives will focus on raising awareness of the risk-based approach in conducting customer due diligence measures and on the obligation to report suspicious activities. Updated information on developments in the area of money laundering will be regularly communicated by the Supervisory authorities and Anti-Money Laundering Office to reporting entities.</p> <p>1.2 Continued cooperation between the Anti-Money Laundering Office and the supervisory authorities, based on updated signed memoranda of understanding and through regular meetings.</p> <p>An institutional framework for cooperation in the field of supervision and monitoring of reporting entities already exists in Croatia. Within this framework, supervisory bodies will continue participating in the <i>Inter-institutional Working Subgroup for Supervision</i>. This subgroup was formed in 2011 within the <i>Inter-institutional Working Group on Prevention of Money Laundering and Financing of Terrorism</i>. A review of existing memoranda of understanding between supervisory bodies and the Anti-Money Laundering Office will be undertaken. Alongside domestic cooperation, supervisory bodies will continue international cooperation and exchange of good practice in combating money laundering and financing of terrorism.</p> <p>1.3 Implementation of the new Action Plan to reduce the risk of money laundering and financing of terrorism based on the updated National risk assessment.</p> <p>In 2017 the Croatian Government adopted the first <i>Action plan to reduce the risk of money laundering and financing of terrorism</i>. Following the implementation of measures from this action plan, a project of updating the national risk assessment was initiated in 2018 within the mandate</p>

	<p>of the <i>Inter-Institutional Working Group on Prevention of Money Laundering and Financing of Terrorism</i>, and with the participation of the academic community and representatives from the private sector (reporting entities). On 25th of June 2020, the Croatian Government adopted National risk assessment on money laundering and terrorist financing with Action plan for mitigating the identified risks, which contains measures that the competent authorities are obliged to implement by the end of 2021.</p>
<p>DELIVERABLES</p>	<p>1.1</p> <ul style="list-style-type: none"> a) Setting up a framework for continuous education of reporting entities staff (deadline: December 2020). b) Holding the Annual Conference on the Prevention of Money Laundering and Financing of Terrorism, (Croatian National Bank, Financial Inspectorate, Tax Administration, Croatian Financial Services Supervisory Agency in cooperation with the Office for the Prevention of Money Laundering). <p>1.2 Update of the cooperation agreement by the end of 2020, continuous cooperation and holding of working meetings within the Inter-institutional Working Group for Supervision.</p> <p>1.3 Implementation of the new Action Plan to reduce the risk of money laundering and financing of terrorism (deadline: December 2021).</p>

POLICY AREA	2. BUSINESS ENVIRONMENT
DESCRIPTION OF THE POLICY AREA	Enabling a less costly and administratively simpler business environment for the private sector through further reduction of the administrative burden and decreases in parafiscal and non-tax charges.
MEASURES	<p>2.1 Simplification and digitalisation of administrative procedures as specified in the Action Plan for Administrative Burden Reduction 2020, adopted by the Government on 30 April 2020.</p> <p>2.2 Reduction of fiscal burden for the economy through further reduction of parafiscal charges. Measures aimed at such reduction have been identified through independent analysis, and in close cooperation with private sector representative organisations. Furthermore, administrative fees that are paid into the central state budget will be decreased or abolished, and the fees charged for taking specific sector exams will be decreased.</p>
DELIVERABLES	<p>2.1 Implementation of the Action Plan for Administrative Burden Reduction by March 2022 (10 sets of administrative procedures with a projected reduction in the administrative burden estimated to amount to HRK 686 million).</p> <p>2.2 Implementation of the Action Plan for Reduction of Non-tax and Parafiscal Charges (33 measures to reduce parafiscal and non-tax charges which include abolishment/decrease of selected administrative fees, and 17 measures to reduce fees for sector-specific exams). All measures are planned to be implemented by September 2021.</p>

POLICY AREA	3. PUBLIC SECTOR GOVERNANCE
DESCRIPTION OF THE POLICY AREA	Improved governance of state-owned enterprises.
MEASURES	<p>3.1 Improving corporate governance in state-owned enterprises (SOEs) by revising and aligning regulation and practices in accordance with the OECD Guidelines on Corporate Governance of SOEs.</p> <p>The goal of this measure is to conduct a <i>Review of Corporate Governance of Croatian SOEs</i>, a gap analysis of the existing corporate governance regulation and practices in SOEs with respect to best practices. Furthermore, recommendations for the revision of the corporate governance regulatory framework identified in the analysis will be implemented.</p> <p>Implementing these recommendations and adapting the regulatory framework to best international practices will create the preconditions for a more active role of ownership bodies in setting financial and operational goals of SOEs, and improved coordination between competent national authorities.</p> <p>In addition to the implementation of appropriate recommendations, the Government will work on strengthening institutional capacity in the relevant parts of the Croatian state administration through trainings. Strengthening of human resources is one of the specific objectives in the Strategy of State Property Management for the Period 2019-2025, which was adopted by the Croatian Parliament on 2 October 2019.</p>
DELIVERABLES	3.1 Conducting and publishing a Review of Corporate Governance of Croatian SOEs. Formal decisions/acts of the Government on implementing the relevant recommendations. Deadline: March 2022.

POLICY AREA	4. JUDICIARY
DESCRIPTION OF THE POLICY AREA	<p>Strengthening the national insolvency framework in line with Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 (amending Directive (EU) 2017/1132 on Restructuring and Insolvency) on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.</p> <p>Further to the implementation of reforms of the insolvency framework in 2015, the transposition obligations derived from the Directive on Restructuring and Insolvency will be made part of a broader exercise of improving the current legal framework for insolvency practitioners and data collection.</p>
MEASURES	<p>4.1 Insolvency Practitioners</p> <p>Implementing a modern and uniform legal and regulatory framework, aligned with best practice in other Member States, for the Insolvency Practitioners (IP) profession in Croatia will have a strong positive impact on the efficiency, length and costs of insolvency proceedings.</p> <p>4.2 Data Collection</p> <p>This measure entails a review of the procedures to collect data in the field of restructuring, insolvency and discharge of debt and the implementation of the necessary changes to comply with the Directive on Restructuring and Insolvency and fulfil its optional data collection provisions. The creation of a centralised system to collect data in the field of restructuring, insolvency and discharge of debt, as well as more exhaustive and detailed information will allow closer monitoring of the efficiency and effectiveness of the insolvency framework. These changes will have a positive impact in the functioning of the insolvency legal framework.</p>
DELIVERABLES	<p>4.1 Address, with legislative and operational actions, the findings of the DG REFORM supported project „Supporting the Framework for Insolvency and Restructuring Practitioners in Croatia“. Actions, based on the recommendations provided, will cover areas of: i) licensing and entrance exam, ii) qualifications and training, iii) appointment system, iv) regulation and supervision of the profession, v) work standards and ethics, and vi) remuneration.</p> <p>4.2 Establishment of the efficient and centralized system of data collection in the field of restructuring, insolvency and discharge of debt. The Government will adopt actions needed for the establishment of the efficient and centralised system of data collection and publication in the field of restructuring, insolvency and discharge of debt.</p> <p>The collection and aggregation of data will include an additional set of data (“may” clause in the Directive) on:</p> <ul style="list-style-type: none"> a) The average cost of each type of procedure; b) The average recovery rates for secured and unsecured creditors and, where applicable, other types of creditors, separately; c) The number of entrepreneurs who, after having undergone a procedure leading to a discharge of debt incurred by insolvent

- entrepreneurs, launch a new business;
- d) The number of job losses linked to restructuring and insolvency procedures.

Deadline for the measures 4.1 and 4.2 is March 2022.