



# Project Information Document (PID)

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Concept Stage | Date Prepared/Updated: 07-Mar-2020 | Report No: PIDC27965



**BASIC INFORMATION**

**A. Basic Project Data**

Country Croatia	Project ID P172024	Parent Project ID (if any)	Project Name Financial Access for Supporting Territorial Economic Regeneration of Croatia (P172024)
Region EUROPE AND CENTRAL ASIA	Estimated Appraisal Date Jun 01, 2020	Estimated Board Date Sep 08, 2020	Practice Area (Lead) Finance, Competitiveness and Innovation
Financing Instrument Investment Project Financing	Borrower(s) Croatian Bank for Reconstruction and Development (HBOR)	Implementing Agency Croatian Bank for Reconstruction and Development (HBOR)	

**Proposed Development Objective(s)**

The Project Development Objective is to: (i) support investment activity in the lagging regions, and (ii) strengthen institutional capacity of HBOR.

**PROJECT FINANCING DATA (US\$, Millions)**

**SUMMARY**

<b>Total Project Cost</b>	150.00
<b>Total Financing</b>	150.00
<b>of which IBRD/IDA</b>	150.00
<b>Financing Gap</b>	0.00

**DETAILS**

**World Bank Group Financing**

International Bank for Reconstruction and Development (IBRD)	150.00
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Environmental and Social Risk Classification

Concept Review Decision



Substantial

Track II-The review did authorize the preparation to continue

Other Decision (as needed)

N.A.

## B. Introduction and Context

### Country Context

- Economic recovery started in 2015, driven by increase in consumption and exports of goods and services.** Over the last five years, economic growth averaged just slightly below 3 percent, largely driven by robust domestic demand. This was the result of strong private consumption on the account of growth in employment and wages coupled with continuing low inflation and tax reduction. Exports performed strongly since 2015, supported by tourism revenues and a recovery of merchandise exports, as Croatian firms integrated in European value chains and increased their market shares after EU accession.
- Low level of investment hampers Croatia's medium-term growth prospect.** Croatia invested around 20 percent of its GDP during 2015-18, consistent with EU average level but substantially lower than the fast-growing EU-peers such as Estonia, Czech Republic or Hungary. Private investment level is low in Croatia due to low replacement of depreciated fixed capital and the limited scale of new investment (new production). Public investment remains subdued partly due to slow absorption of EU funds. As the cyclical recovery matures, Croatia will need more investment to boost productivity and sustain the economic recovery.
- Croatia's lengthy recession disrupted convergence towards EU living standards.** Over the period of 2008 to 2018, the ratio of Croatia's GDP per capita to the EU average has been surpassed by Hungary, Latvia, Lithuania, Romania and Poland. The income aggregates are masking regional disparities in Croatia. According to the Act on Regional Development<sup>1</sup>, 12 out of 21 counties<sup>2</sup> are currently classified as lagging regions based on a development index<sup>3</sup>. In 2016 (latest available data<sup>4</sup>), GDP per capita ranged between 107 percent of the EU average in Zagreb to a mere 34 percent in Virovitica-Podravina county in eastern Croatia. In absolute terms, GDP per capita in the lagging regions, averaging EUR 7,788 in 2016, is 40 percent below the average of EUR 13,098 in the non-lagging counties. As a result, the lagging regions account for 36 percent of the national population but just a quarter of domestic output. The impact of EU funds, and of the EU policies behind those funds, on improving the regions' competitiveness is still limited.
- Lack of investment is a key deterrent for economic development in the lagging regions.** In the private sector, there is a dearth of investment to improve the productivity of existing firms and to create new businesses in the lagging regions. The low level of private investment contributes to a stagnant private sector that reduces economic opportunities for local population - firms in the lagging regions are less productive, less profitable and also export less than firms in the non-lagging counties<sup>5</sup>, and the lagging regions have significantly smaller number of firms per unit of population

<sup>1</sup> Official Gazette (147/14, 123/17, 118/18).

<sup>2</sup> The 12 counties are: County of Krapina-Zagorje, County of Koprivnica-Križevci, County of Šibenik-Knin, County of Osijek-Baranja, County of Karlovac, County of Požega-Slavonia, County of Slavonski Brod-Posavina, County of Bjelovar-Bilogora County of Lika-Senj, County of Vukovar-Sirmium, County of Sisak-Moslavina and County of Virovitica-Podravina. In addition to counties (regional self-government units), the development index is calculated on the municipality level (local self-government units) as well – out of 556 municipalities in Croatia 304 are classified as lagging.

<sup>3</sup> The development index is composed of the following indicators: unemployment rate, income per capita, income of local/regional budget per capita, population change, rate of education, ageing index.

<sup>4</sup> The 2017 data will be available by end-February 2020.

<sup>5</sup> See Diagnostics on Growth and Jobs in Slavonija, Baranja, and Srijem Project Report (pages 256-259).



compared with the non-lagging regions.<sup>6</sup> In the public sector, insufficient investment in social infrastructure further reduces the attractiveness of the lagging regions to workers and firms.

#### Sectoral and Institutional Context

5. **Difficulty in obtaining appropriate financing is a major bottleneck for boosting private sector investment in the lagging regions.** Most lagging regions in Croatia are faced with the same obstacles of the country, but in the lagging regions these issues have greater influence on overall economic and social outcomes. Access to finance is ranked by firms as the third largest constraint to firm growth in the lagging regions (after high taxes and qualification of workforces) - 33 percent of the surveyed firms in the lagging regions report lack of credit as a major problem the firm faced in growth, much higher compared with 23 percent for non-lagging regions.<sup>7</sup> The inability to get external finance severely constrain the firms' ability to invest and grow, which in turn reduces economic opportunities for the local population.

6. **Access to finance is more difficult for small and medium enterprises (SMEs) who are key sources of investment and engines for economic development.** SMEs employ for 73 percent of labor force, generates 60 percent of firm revenue and 55 percent of exports in Croatia.<sup>8</sup> More than 40 percent of surveyed SMEs in Croatia do not use a loan, and more than 50 percent of these firms suggest the reason they do not use a loan is that they were not able to get one.<sup>9</sup> According to a latest survey<sup>10</sup>, SMEs in the lagging regions are less likely to obtain formal sources of financing than their counterparts in more developed regions, and the SMEs who obtain financing report greater dissatisfaction about the amount, type and maturity of external financing they receive (Figure B). The lack of access to finance for SMEs constrains investment and reduces business dynamics and economic opportunities for local population in the lagging regions.

7. **Lack of financing to local government units/municipalities reduces public sector investment.** In addition to administrative capacity to obtain financing, the local government units in the lagging regions face financial capacity constraints. They face difficulties in receiving enough long-term funding, which hampers the ability of local government units to invest in social infrastructure in the lagging region. This may be a result of banking sector credit limits, imposed by parent banks, towards the local government as well as the more developmental and social nature of investments.

8. **Difficulty in obtaining finance contributes to low absorption of EU funds and further reduces investment in the lagging regions.** EU membership allows Croatia to benefit from sizeable EU funds for investment purposes. The allocation of funds under the European Structural and Investment Funds (ESIF) to Croatia amounts to €10.7 billion over the period of 2014-2020, or around a fifth of Croatia's GDP in 2019. As of end of 2019, just around 30 percent of the allocated ESIF funds were paid out to final beneficiaries in Croatia, well below the EU average of 39 percent. This reflects various challenges currently affecting the absorption of funds. In addition to institutional capacity for co-financing remains an issue. Under EU rules, investment projects need to be pre-financed (as EU-funded projects are reimbursed) and co-financed from own resources.<sup>11</sup> The inability of public and private sector entities in the lagging regions to secure pre-financing and co-financing from external sources reduces their ability to obtain EU funds for their investment projects, thus multiplying its adverse impact on regional development.

9. **Access to finance challenges have greater adverse impact on the entities in the lagging regions.** The lagging regions have a lower corporate sector lending to output ratio compared to the more developed parts of Croatia.<sup>12</sup> Given

<sup>6</sup> In the city of Zagreb, there are around 50 firms per 1,000 population, whereas the lagging regions typical have only around 10 to 20 firms per 1,000 population. Number of firms is proxied by the number of legal entities and natural persons.

<sup>7</sup> Firm-level productivity survey (2019) conducted by the World Bank.

<sup>8</sup> Small and Medium Enterprises Report Croatia, SME and Entrepreneurship Policy Centre, 2018.

<sup>9</sup> A list of reasons that are non-mutually exclusive were cited, rejection of loan application, too long and/or too complex granting procedures, too high interest and/or fees, unacceptable collateral requirements and inadequate creditworthiness. From Croatia National Bank, Macroeconomic Developments and Outlook, May 2018.

<sup>10</sup> Firm-level productivity survey (2019) conducted by the World Bank.

<sup>11</sup> Depending on the type of projects, co-financing can be range between 15 percent to 50 percent.

<sup>12</sup> Based on data on the five counties of Slavonia. Data for other counties in the lagging regions will be obtained from the central bank during project



the relatively weaker economic development and prospects of the lagging regions and pronounced information asymmetry especially among smaller businesses, banks are more hesitant to lend to entities in the lagging regions, contributing to the more severe market failures and difficulty in access to finance in the lagging regions.

10. **Public support is warranted to reconcile the urgent need for investment in the lagging regions.** To address the areas where the private sector is not willing or able to operate, the role of the state is crucial in addressing market failures, building capacity, and crowding in EU and private sector financing to support investment activities in the lagging regions. This is especially affecting newer, innovative and fast-growing companies and SMEs.

### **HBOR's Role in Supporting the Development of Croatia and the Lagging Regions**

11. **Croatian Bank for Reconstruction and Development (HBOR) plays the role of development financier in Croatia.** HBOR plays a critical public policy role in implementing the government's vision, including regional development policy. In 2019, HBOR's total assets amounted to €3.6 billion, which is equivalent to 7 percent of the Croatian banking sector assets (comparable to the sixth largest bank). HBOR's role in facilitating EU funds absorption has been crucial, especially for SMEs and local government. Its credit activity grew by 9 percent in 2018 largely as a result of co-financing EU funds-supported projects. The Government guarantees all HBOR's obligations unconditionally, irrevocably, and on first demand, without issuing a separate guarantee instrument, as stipulated by the HBOR Act.

12. **HBOR provides extensive support to private and public investment in the lagging regions.** Over the last three years, HBOR committed on average around €200 million annually, or around a third of its credit activities, to the lagging regions. Counties in the lagging regions typically receive HBOR lending amounting to 1 to 3 percent of county output, compared with less than 0.3 percent in the city of Zagreb. Most funding is used for investment activities – over the past four years, 80 percent of approved HBOR funds are for investment purposes. In terms of private and public sector split, over 80 percent of the lending goes to private sector firms, of which around two thirds were committed for SME lending and one third to larger firms. For the lending towards public sector (specifically local government units), HBOR's financing aims to crowd in EU funding and is mainly used as pre-financing and co-financing of local economic infrastructure projects.

13. **In January 2020, HBOR adopted its first-ever medium-term Strategy since its establishment in 1992.** The Strategy was developed with technical assistance funded by European Commission's Structural Reform Support Service. The Strategy features the following five key pillars to support HBOR's new mission to "proactively support development of Croatia". The five key pillars of HBOR Strategy are (i) Encourage equity & quasi-equity investment; (ii) Promote balanced social, regional, urban and rural development; (iii) Promote Croatian economy internationalization and globalization; (iv) Promote competitiveness, emphasizing research, development and innovation, digital transformation and Industry 4.0; and (v) Promote climate co-benefits and energy-efficient projects. Each of the five pillars under the HBOR Strategy will be supported by detailed Operational Plans.

14. **To support the delivery under identified Strategy pillars, HBOR identified three necessary groups of enablers (Strategy Enablers) underpinned by operational and organizational improvements.** The enabler of the HBOR Strategy are: (i) proactive utilization of EU funds, national financing sources and International Financial Institutions' sources of funding; (ii) cooperation with financial intermediaries, relevant ministries and miscellaneous entities in the economy and society; and (iii) flexible and sustainable organization with proactive business approach. Operational and organizational improvements are envisaged to support implementation of HBOR Strategy. The key improvements relate to organizational changes, enhancement in risk management, and upgrade of operational processes and products. These reforms echo well with the need to strengthen the operational framework and the role HBOR needs to play if Croatia is to catch up with the more successful and competitive regions of the EU.

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preparation.



15. **Improving institutional capacity of HBOR, as envisaged by the Strategy and associated operational plans, will enable HBOR to more effectively support the development of Croatian economy, with increased focus on the lagging regions.** One of the key pillars of the HBOR Strategy is the promotion of balanced regional development, demonstrating the commitment of the institution to supporting the lagging regions. The envisaged more proactive utilization of EU funds and cooperation with other financial intermediaries in the HBOR Strategy will help mobilize more public and private financing to boost investment and spur economic growth in the lagging regions.

#### Relationship to CPF

16. **The proposed project is consistent with the Country Partnership Framework (CPF) objective to create opportunities in less developed regions.** The current CPF (2019-2024) states that one of the most salient development challenges faced by Croatia is regional disparities, which is directly addressed by this project. The proposed project falls under CPF's Focus Area 1 - Enhancing Public Sector Performance and Institutions. The project was proposed as part of the short-term lending program in the CPF (2019-2024) and as a key Bank's engagement focused on improving access to finance and mobilize private and EU funds to support investment activities in the least developed parts of the country.

17. **The proposed project is also designed to strengthen HBOR's institutional capacity through support of implementation of the HBOR Strategy.** Supporting the implementation of HBOR Strategy is aligned with the emphasis of the CPF (2019-2024) in strengthening the capacity of public institutions in Croatia. In order to effectively incentivize HBOR to carry out its institutional reform agenda, the disbursement of loan proceeds will be conditional on achievement of key milestones and activities envisaged in the implementation of HBOR Strategy.

18. **The proposed project will complement planned and existing interventions financed by the World Bank in Croatia.** First, besides access to finance, poor business environment and justice services remain key constraints for the development of Croatia. The Croatia Justice for Business Program, financed by the World Bank, aims to improve business regulatory procedures and justice services for businesses, and will complement the project's effort in boosting investment in the lagging regions. Second, the identification and evaluation of investment activities to be financed by the project as well as the potential innovative financial products to be developed and financed by the project will benefit from key outputs and ongoing policy dialogue with regional development authorities based on the recent Reimbursable Advisory Services (RAS) conducted by the World Bank for the Croatian government. Key RAS outputs for reference includes reports on "Growth and Jobs in Slavonia, Baranja and Srijem" and "Financial Instruments and Business Support: Enabling Fit-for-Purpose Funding Opportunities in Croatia".

19. **The proposed project complements other Government reform efforts and WB engagements in the country and in the lagging regions specifically to tackle constraints to firm growth.** For example, the most recent tax reform, with many measures being implemented as of January 2020, will further improve country tax system. In addition, World Bank engagement through the Growth and Jobs in Slavonia, Baranja and Srijem RAS as well as Government's own priority to align education with labor market needs (as part of the National Development Strategy) aim to tackle the issue of labor supply and quality of workforce.

### C. Proposed Development Objective(s)

The Project Development Objective is to: (i) support investment activity in the lagging regions, and (ii) strengthen institutional capacity of HBOR.

#### Key Results (From PCN)

The following PDO results indicators are currently being considered:

- (i) total investment supported (directly and crowded-in) in the lagging regions;



- (ii) share of overall HBOR lending (on a portfolio basis) allocated to the lagging regions<sup>13</sup>; and
- (iii) new operational model implemented by HBOR.

The PDO indicators will be underpinned by a series of performance- based conditions (PBCs) based on key institutional building capacity activities envisaged under the HBOR Strategy and HBOR's increase of lending towards lagging regions.

#### D. Concept Description

20. **The proposed financing instrument is a €150mn single component IPF with PBCs, with HBOR acting as the borrower and the implementing agency for the proposed project.**

21. **The IPF with PBCs structure aims to incentive HBOR to implement its Strategy and undertake institutional capacity building activities to better respond to the financing needs in lagging regions.** Under the IPF with PBCs structure, financing will be disbursed in tranches conditional on the achievement of PBCs, which are based on key milestones and institutional building capacity activities envisaged under the HBOR Strategy. The IPF with PBCs structure thus provides World Bank's endorsement for the HBOR Strategy and incentivize HBOR to implement the Strategy and associated operational plans. By strengthening institutional capacity, HBOR will be better positioned to support further investment activity in the lagging regions.

22. **The achievement of the PBCs would signify significant progress in implementing the HBOR Strategy.** The PBCs are closely linked to the organizational and operational improvements underpinning the three key enablers identified in the HBOR Strategy. The first PBC area on "Strategy and Reorganization" is aligned with the planned strategic and organizational changes to create a "flexible and sustainable organization with proactive business approach (Strategy Enabler #3)". The second, third and fourth PBC areas, on "Risk Management", "Operational Processes Upgrade", and "Introduction or Modernization of Products", are associated with capacity building of HBOR to achieve "proactive utilization of EU funds, national financing sources and international financial institutions' sources of funding (Strategy Enabler #1)" and to improve "cooperation with financial intermediaries, relevant ministries and miscellaneous entities in the economy and society (Strategy Enabler #2)".

23. **Conditional on the achievements of PBCs, the proceeds will be disbursed for on-lending to final borrowers/beneficiaries for specific sub-projects in the lagging regions.** Most of the loan will be earmarked for financing of private sector firms in the lagging regions, given their critical role in generating economic opportunities for local population. Final beneficiaries will be private sector firms in the lagging regions or firms that, supported by the project proceeds, invest in the lagging regions.<sup>14</sup> Private sector business entities are defined as companies, crafts businesses, sole traders, family farms and cooperatives with more than 50 percent private ownership or private control. In particular, the project will also seek to support women-owned or women-managed firms. During project preparation, the team will discuss the possibility to use the loan proceeds, albeit a small share of the loan not exceeding 20 percent of the total amount, to support firm investment and growth through innovative financial solutions, including for example HBOR private equity investments in firms via fund of funds structures. Public sector entities (local government units) in the lagging regions could also be financed - to a limit - to support public investment and utilization of EU funds in the lagging regions. Most of these public investments are expected to be co-financed with EU funds and will need to be screened (prior reviewed) by the Bank.

24. **The loan will be primarily used to finance investment activities in the lagging regions.** Sub-loans will be made for the financing of raw materials, spare parts, plant and equipment, and works, both for investment as well as working

<sup>13</sup> The target values will take into account the loan contribution.

<sup>14</sup> The team will be further discussing this possibility during the next mission, once HBOR team sends more details to WB on this product, currently under development in cooperation with the European Investment Fund.



capital purposes. Given the tenor of the World Bank loan and HBOR’s portfolio structure of more than 80 percent of HBOR loans used for investment purposes, however, the project funds are likely going to be mostly used for investment activities. Minimum maturity requirement on sub-loans and any other potential restrictions on working capital financing will be further discussed with HBOR during project preparation. The flexibility to use the loan to finance working capital is based on the identified needs of the firms in the lagging regions - fast-growth businesses in the ICT sector and agri-food industry, as well as successful export-oriented firms.

**25. HBOR will retain the flexibility to use the most suitable financing model to address market failures and mobilize finance for development.** As a development bank, HBOR is committed to use the funds in the most effective way to mobilize finance for development. HBOR will maintain the flexibility to support target beneficiaries using all types of financing models including both retail and wholesale lending. direct lending, indirect lending, risk-sharing, and co-financing. Since commercial banks remain reluctant to lend to the lagging regions, it seems likely that most of funds will be intermediated directly financing either through risk-sharing or co-financing. The cost of lending from HBOR to eligible final beneficiaries will include, at a minimum, the cost of funding plus an on-lending margin reflecting administrative costs (in the case of wholesale lending) or a credit risk margin associated with the particular sub-borrower (in the case of retail lending). All financing models will be detailed in the Operational Manual.

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

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**Implementing Agencies**





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**APPROVAL**

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