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Republic of Croatia: Staff Report for 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of the Republic of Croatia on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with the Republic of Croatia, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of the Republic of Croatia; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the 1999 Consultation with the Republic of Croatia

Approved by Jacques Artus and Ishan Kapur

December 17, 1999

- The 1999 Article IV consultation discussions—including an assessment of the effectiveness of past Fund technical assistance and of possible future needs in this area—were held in Zagreb during September 27–October 8, 1999 by a staff team consisting of Hans Flickenschild, Rachel van Elkan, Riccardo Maggi (all EU1), Joël Toujas-Bernaté (PDR), and Jane Tito (assistant, TGS). Gary O'Callaghan (resident representative) assisted the mission and Arend Kapteijn (OED) participated in the discussions. Meetings were held with the Ministers of Finance; Health; and Labor and Social Welfare; the Governor of the Croatian National Bank (CNB); the chairman of the parliamentary budget committee; and representatives of other ministries, agencies, public enterprises, financial sector institutions, employers, trade unions, academia and the opposition parties.

- In concluding the 1998 Article IV consultation with Croatia, the Fund's Executive Directors commended the authorities for the success of their exchange rate based stabilization program, but highlighted the risks inherent in the country's external imbalance and its weak banking sector. Directors therefore urged more decisive action on a number of fronts—including macroeconomic adjustment and acceleration of public enterprise and banking sector reform—to ensure the sustainability of Croatia's external position and to promote macroeconomic stability and durable growth.

- Elections for the lower house of parliament are scheduled for January 3, 2000. Opinion polls indicate the possibility of a change in government. In addition, presidential elections must be held within sixty days of President Tudjman's death on December 10.

Contents

I. THE GENERAL SETTING AND MAIN THEMES

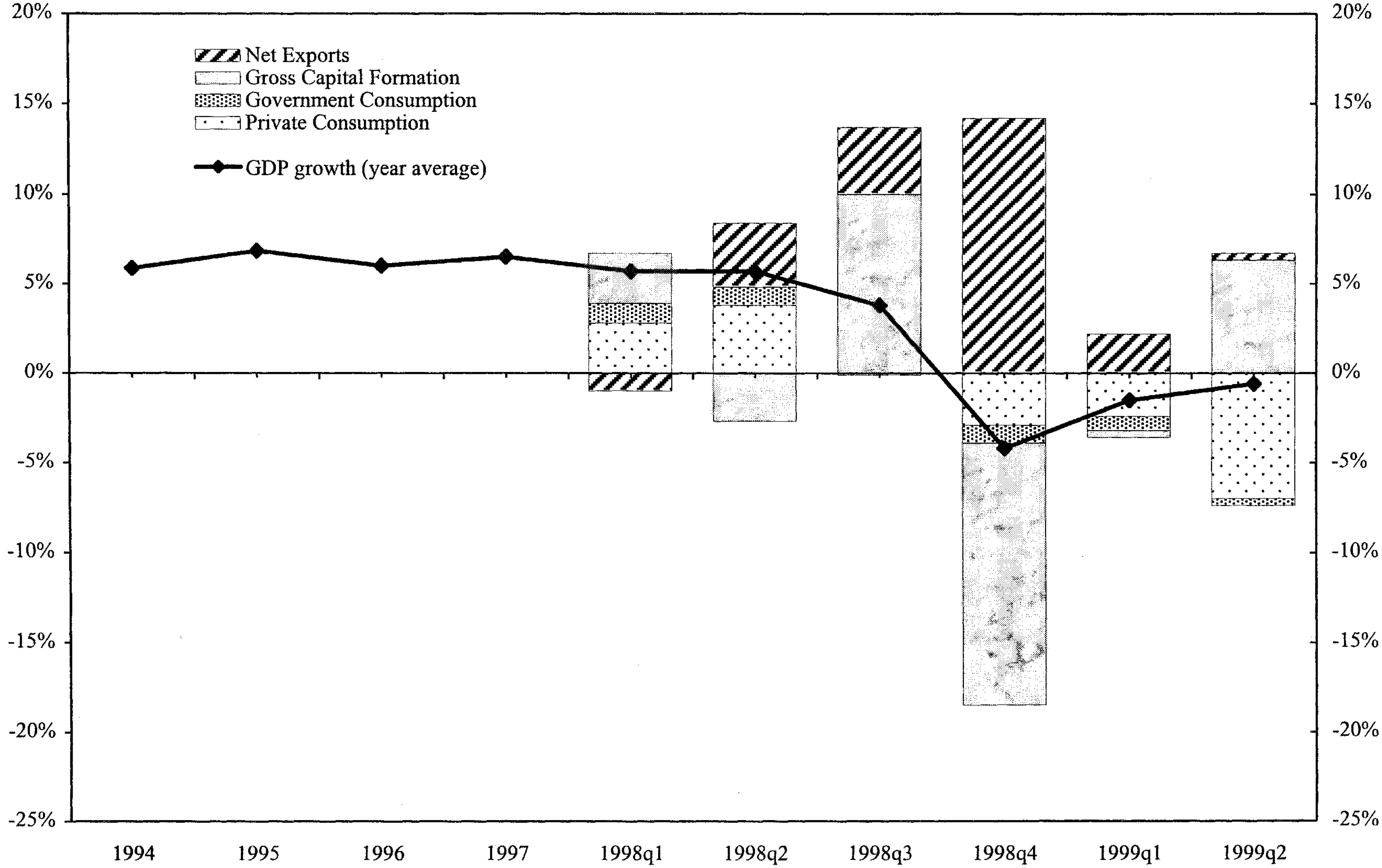
1. Until recently, Croatia's economic performance was the envy of many countries in transition: a successful stabilization effort in late 1993 was followed by virtual price stability and real GDP growth of 6 percent a year during 1994–97 (Figure 1). However, the mostly domestic demand driven expansion was accompanied by burgeoning imports, while exports stagnated as wage increases outpaced productivity gains induced by labor shedding (Figures 2 and 3). As a result, the external current account deficit widened to unsustainable levels and employment declined. Reluctant to rein in mounting fiscal spending pressures, the Croatian authorities relied mainly on tax increases and a combination of monetary tightening and exchange rate depreciation (Figures 4 and 5) to redress the external balance. Their success in reducing the current account deficit in 1998 and early 1999 was, however, accompanied by a sharp slowdown in economic activity and banking problems, which exacerbated fiscal pressures and contributed to the rapid accumulation of domestic payment arrears.

2. Notwithstanding three consecutive quarters of negative growth and a concurrent real effective depreciation, the current account adjustment was still incomplete at the time of the mission, and the banking system remained fragile despite more determined supervisory action to address the problems of troubled banks. The fiscal position was precarious, with tax collections running below the downward revised budget projections, delays in government spending, and pressures to lower taxes and raise expenditure in the pre-election period. On the bright side, higher than budgeted proceeds from the privatization of the telecommunications company, realized toward the end of the mission, provided welcome balance of payments and fiscal relief.

3. In this situation, and mindful of Executive Directors' recommendation to urge fundamental policy reforms, the mission adopted a two-pronged approach in the discussions. First, as fundamental policy adjustments could not be expected before the election, it assessed with the authorities the immediate policy requirements to steer the economy through the difficult period until a new government can be formed in early 2000. Second, it discussed with the authorities the economic strategy that the new government should pursue in 2000 and beyond. The mission also met with the major opposition parties to discuss with them the policy challenges facing the new government. All agreed that fiscal adjustment was needed to reduce the current account deficit, and after weighing the pros and cons of alternative exchange rate regimes, there was near-unanimity that continued exchange rate stability was essential. This view was also shared by representatives of the labor unions and employers. The mission therefore prepared a scenario that would reduce the current account deficit further toward 5 percent of GDP in 2000. The mission stressed that the implied improvement in the domestic saving-investment balance would require strong fiscal adjustment and a strengthening of competitiveness through wage restraint and reform-induced productivity gains.

Figure 1. Croatia: GDP Growth and Contributions to Growth, 1994-99 1/

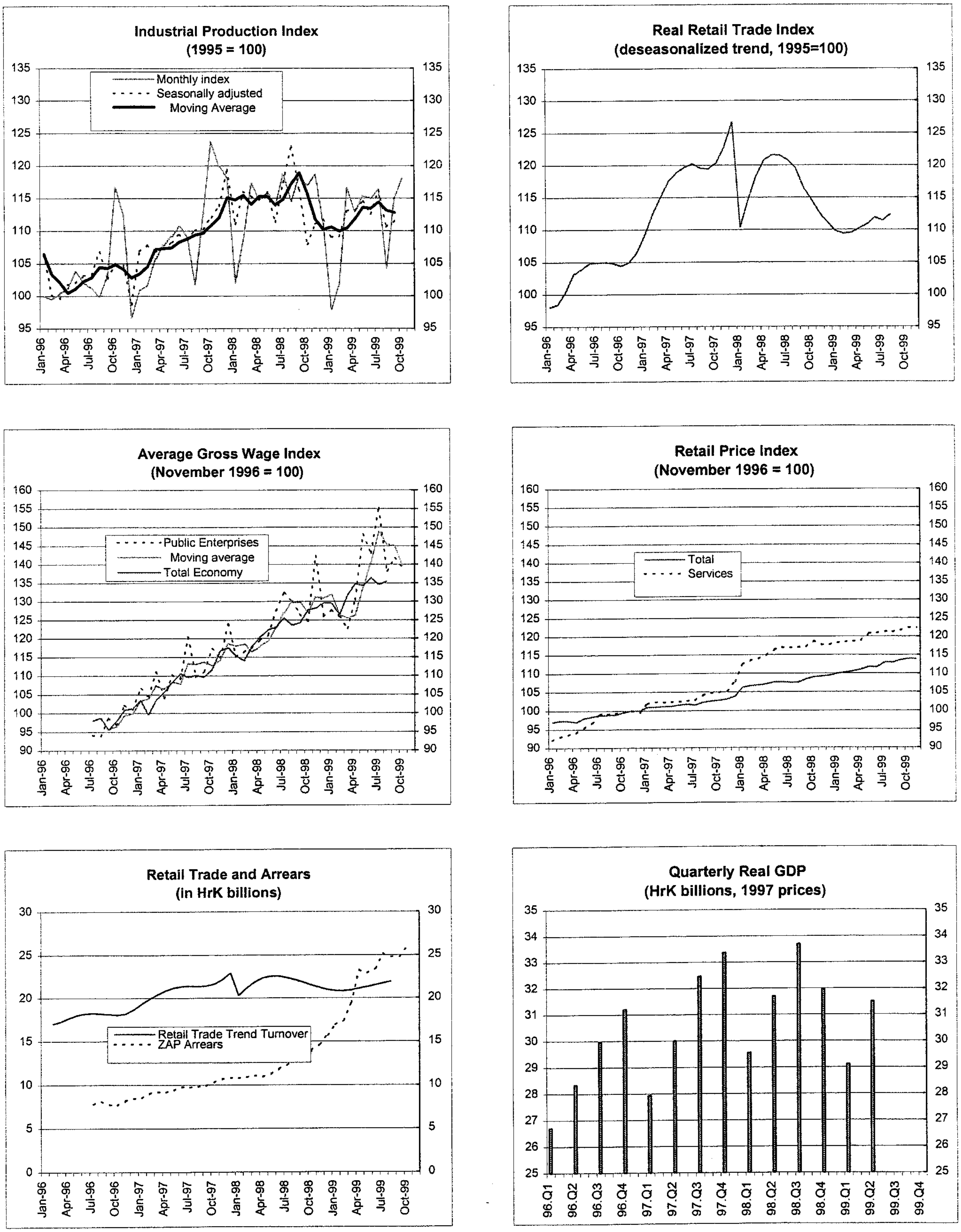
(In percent; year on year)



Sources: Central Bureau of Statistics and IMF staff estimates.

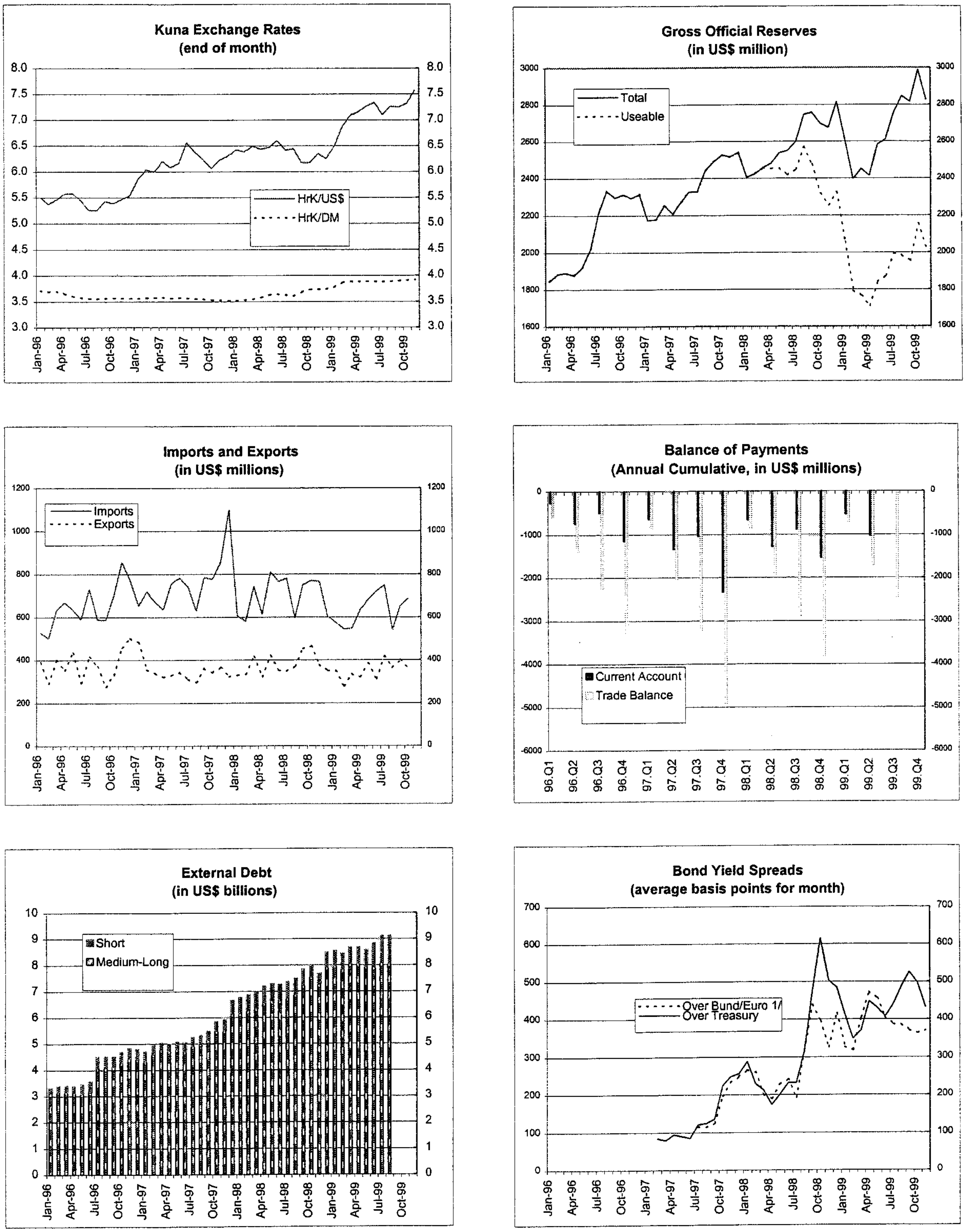
1/ Breakdown of GDP growth by expenditure available only from 1998.

Figure 2. Croatia: Real Sector Developments, 1996-99



Sources: Central Bureau of Statistics, ZAP and ORESE.

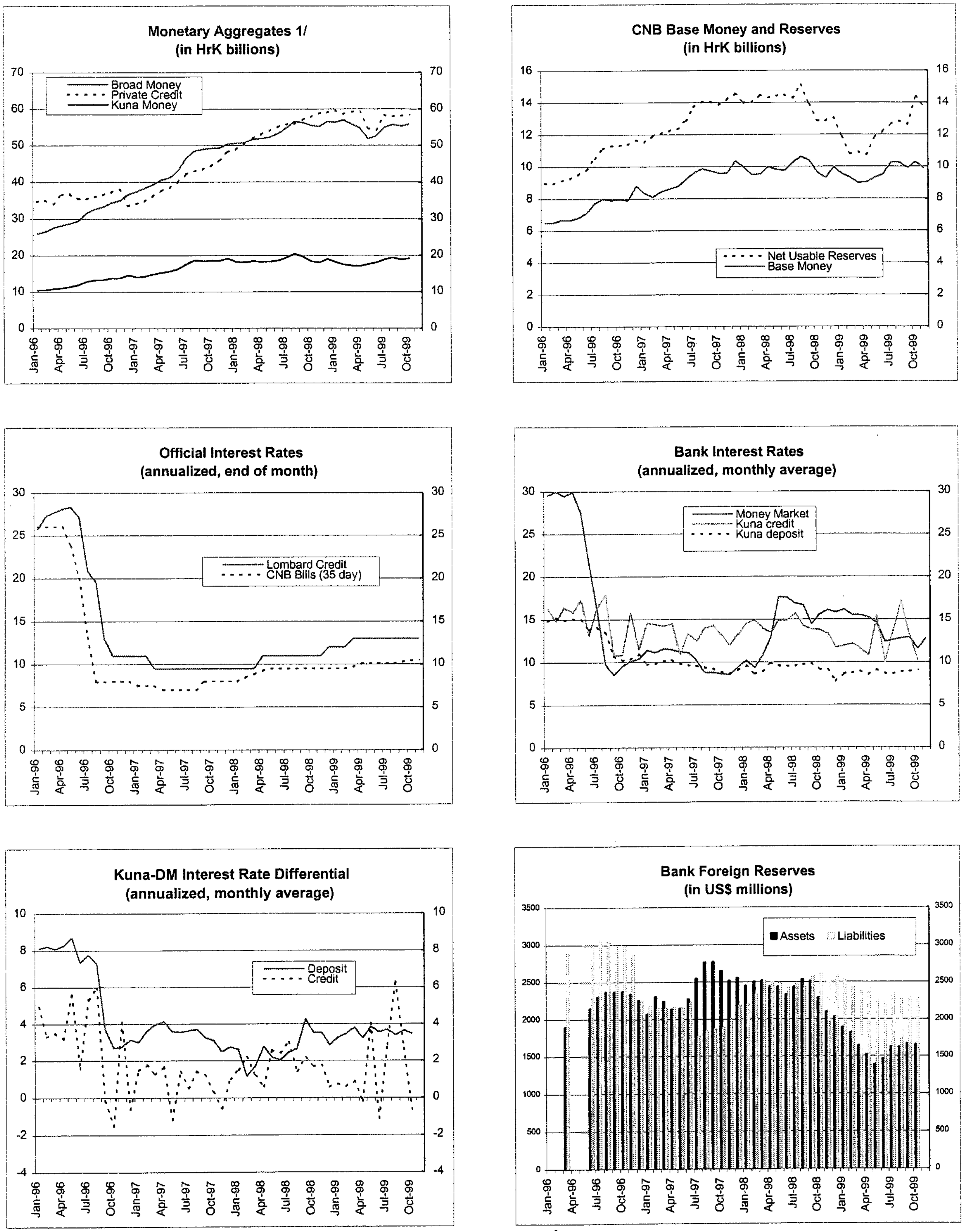
Figure 3. Croatia: Balance of Payments Developments, 1996-99.



Sources: Croatian National Bank and Bloomberg.

1/ For Bund/Euro, benchmark bond changed in March 1999, implying an increase of 50 bp.

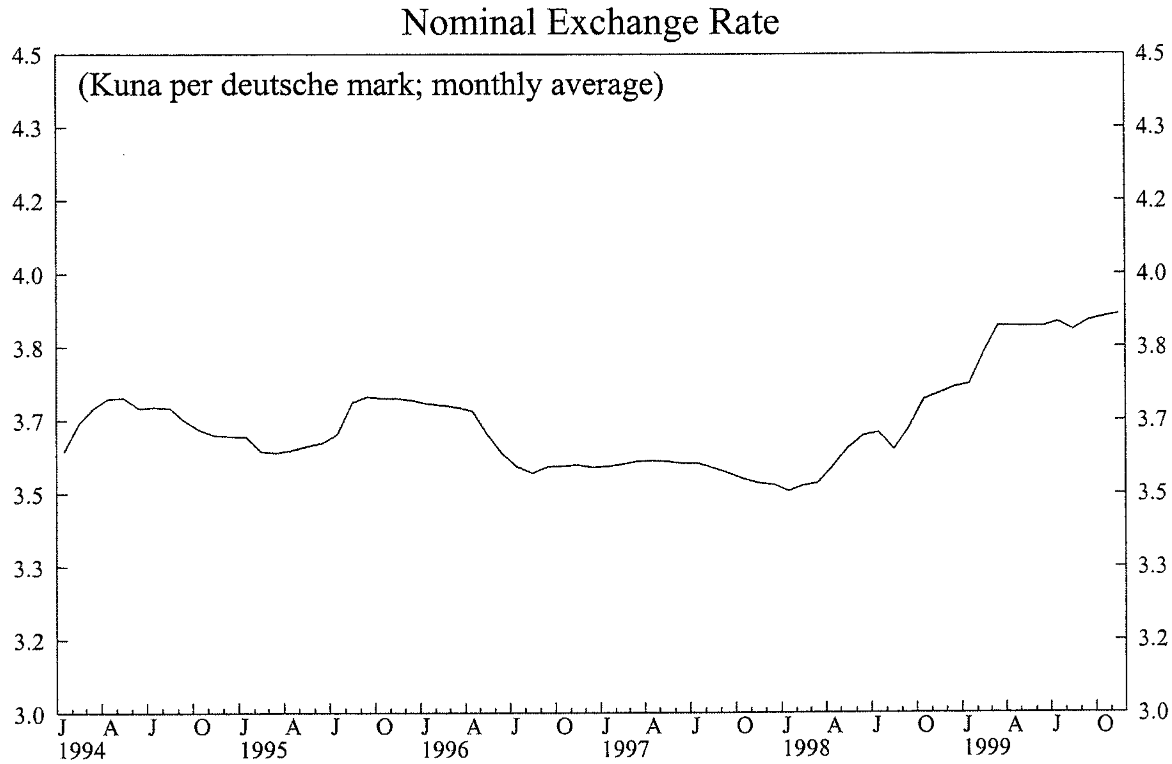
Figure 4. Croatia: Monetary Developments, 1996-99

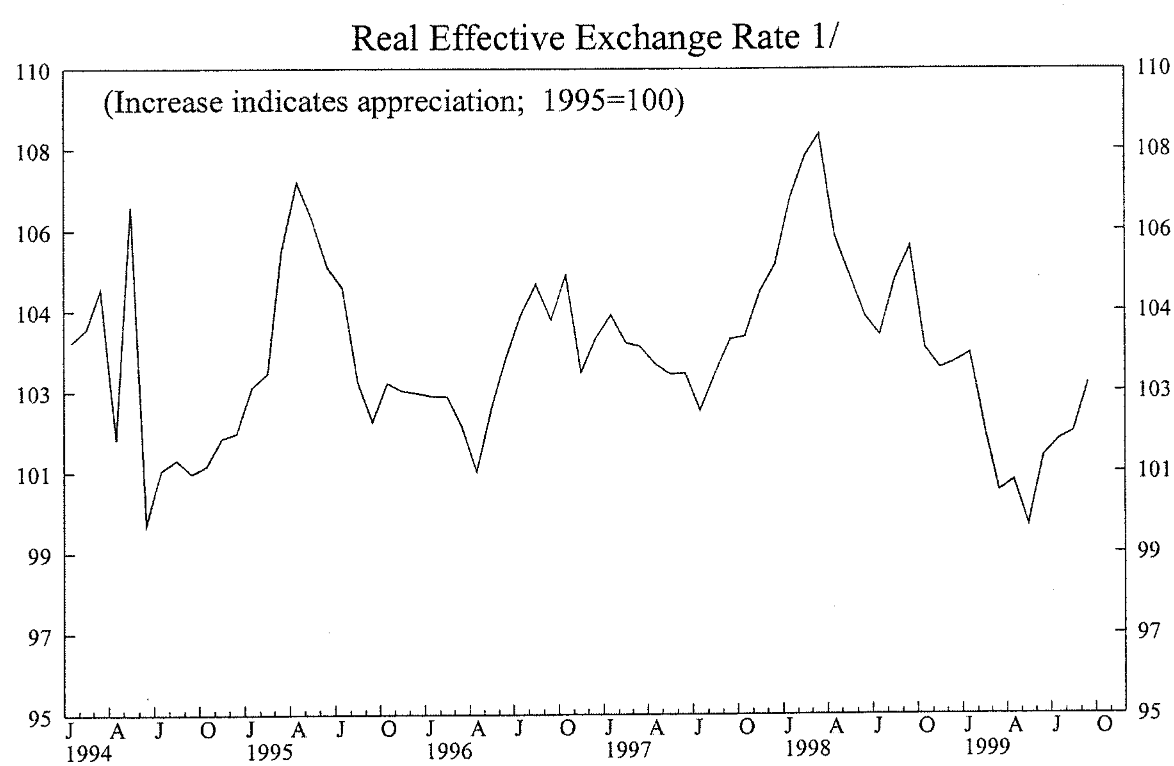


Source: Croatian National Bank.

1/ The apparent decline in some series in May 1999 reflects the removal of certain banks from the total. Also, in July 1999, the apparent increase in some series is due to classification changes.

Figure 5. Croatia: Exchange Rate Developments, 1994-99





Source: National Bank of Croatia and Information Notice System.

1/ CPI based.

II. Economic Background: Recent Developments and Near-Term Prospects

4. **Faced with the need to cope with a persistent excess of domestic absorption over production and a weakening of capital flows, the authorities relied mainly on a combination of monetary tightening, gradual exchange rate depreciation, and balance of payments borrowing**. Fiscal policy contributed little to adjusting the saving-investment imbalance as even a large tax increase in 1998 was mostly used to finance the steady rise of public spending. The underlying stance of fiscal policy is, however, obscured by the presentation of budget data on a cash basis and by a number of large one-off transactions in recent years (Box 1). The discussion of recent developments in this section follows the Croatian budget presentation, with appropriate references to arrears financing and large one-off transactions such as privatization receipts and bank resolution costs.

A. Recent Developments

5. **The successful implementation of the stabilization program in late 1993 ushered in a period of vigorous economic growth and high price stability**. Although fiscal policy remained restrained, with the consolidated central government accounts in approximate balance, the resurgence of private domestic demand caused the external current account to shift from a substantial surplus in 1994 to large deficits in 1995–96 (Table 1). These deficits were, however, financed largely by nondebt creating capital inflows as residents repatriated their foreign savings.

6. **Signs of overheating emerged in 1997, prompting a macroeconomic policy tightening**. The improved security situation, strong income growth, rapid expansion of consumer credit, and the pending introduction of a value-added tax all contributed to a surge in private domestic demand—particularly consumption—that caused the current account deficit to double to 11½ percent of GDP. In contrast to previous years, its financing shifted from nondebt creating flows to external borrowing, and the external debt ratio jumped from 23 percent of GDP at end-1996 to 32 percent of GDP at end-1997. The authorities reacted by tightening monetary policy late in the year and again in early 1998, including by introducing reserve requirements on banks' foreign liabilities[1], raising interest rates, and allowing the exchange rate to appreciate. As a result, private sector credit growth was halved to—a still high—22 percent in 1998. On the fiscal side, the introduction of the VAT in January 1998 shifted the consolidated central government from a cash deficit of 1¼ percent of GDP in 1997 to a cash surplus of 1¾ percent of GDP (annual basis) in the first half of 1998.

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[1]Croatia maintains a relatively liberal capital control regime. Capital inflows in the form of loans, FDI or portfolio investment, as well as repatriation of capital and transfers abroad of profits, are not restricted. On the other hand, while FDI abroad by residents is allowed, outward portfolio investment is restricted. See Appendix I of the accompanying Selected Issues paper for information on regulations governing capital account transactions.

Box 1. The Underlying Stance of Fiscal Policy

The Croatian presentation of the budget, together with a number of one-off factors, obscures underlying fiscal trends during 1997–2000. In order to reveal these underlying trends, the following corrections were made to the Croatian budgetary data:

(i) privatization receipts (which peaked at 4.3 percent of GDP in 1999) are deducted from revenues;

(ii) temporary expenditures—associated with bank resolution, the diversion of part of pension contributions from the current PAYG to a new fully funded system, and court-mandated retroactive indexation of pensions, which together increased from 0.8 percent of GDP in 1998 to a projected 3.8 percent of GDP in 2000—are removed from expenditures;[1] and

(iii) expenditures financed by non-cash methods, including arrears, are added to cash expenditure.[2]

With these corrections, it is apparent that the underlying position of the consolidated central government deteriorated by 1¾ percent of GDP during 1997–99, coming entirely from an expansion in underlying expenditure since non-privatization revenues remained around 42½ percent of GDP. This expansion is most evident between 1997 and 1998, when consolidated revenue (excluding privatization) increased by nearly 3 percentage points of GDP, while the balance improved by only ¼ percentage point of GDP. In contrast, the 2 percentage point deterioration in the underlying balance projected for 1999 is attributable to a revenue fall of 2¾ percentage points of GDP, while underlying expenditure is projected to contract by about ½ percentage point of GDP. Excluding temporary factors, the staff scenario for 2000 envisages a 3¼ percentage point improvement in the primary fiscal balance, stemming mainly from compression of underlying expenditures.

	1997	1998	1999		2000
			Revised Budget	Staff Proj.	Staff Scenario
	(In percent of GDP)				
Consolidated central government (cash balance)	-1.3	0.6	-1.0	-0.7	-1.2
Privatization receipts (-)	0.6	1.7	4.2	4.3	3.7
Bank resolution expenses (+)	0.0	0.4	0.8	0.8	1.8
Transitory cost of second pillar of pension system (+)	0.0	0.0	0.0	0.0	0.9
Court-mandated temporary pension payments (+)	0.0	0.4	1.2	1.2	1.1
Net change in expenditure arrears (-)	0.6	2.1	-2.0	1.4	0.0
Underlying balance of the consolidated central government	-2.5	-2.2	-1.2	-4.3	-1.1
Memorandum items:					
Consolidated central government revenue (excl. privatization)	42.5	45.4	44.8	42.9	42.6
Consolidated central government expenditure	45.0	47.6	46.0	47.2	43.7
Underlying primary balance of the consolidated central government	-1.1	-0.8	0.4	-2.7	0.6

[1] An additional temporary expenditure item is post-war reconstruction spending. Owing to inadequate information, no downward adjustment of expenditure has been made for this item.
[2] The stock of expenditure arrears is projected by the staff to amount to more than 6 percent of GDP at end-1999.

7. **While macroeconomic policy tightening helped reduce the current account deficit to 7 percent of GDP in 1998, it also contributed to the recession which began in the fourth quarter of 1998.** The freezing of deposits in insolvent banks in the second half of 1998, the diversion of liquidity to purchase foreign currency for speculative purposes, and inadequate restructuring of privatized firms led to a rapid buildup in domestic arrears of public and private enterprises, which rose to 10½ percent of GDP at end-1998 and 16½ percent of GDP in mid-1999. Mounting structural problems reinforced the impact of the restrictive macroeconomic policy stance, and real GDP fell by 4¼ percent (year on year) in the last quarter of 1998 and by 1 percent in the first half of 1999. The contraction in GDP was associated with a sharp drop in domestic absorption and imports. This, together with modest growth in tourism earnings and the completion of several export projects with long gestation periods, reduced the external current account deficit further to 6¼ percent of GDP in the year ended in June 1999. The deficit was financed in part by new borrowing, with external debt rising to 38½ percent of GDP by mid-1999, while interest rate spreads remained high (Figure 6).

8. **Monetary tightening, the weak economy, and a drying-up of repatriated foreign savings exposed the underlying insolvency of a group of rapidly growing private banks.** The CNB intervened in 17 distressed banks—accounting for 17 percent of banking sector assets—during 1998 and the first half of 1999.[2] Bankruptcy proceedings were initiated against eleven banks, three politically sensitive banks were to be merged, and the CNB appointed temporary administrators in the remaining three banks. Deposits in the banks undergoing bankruptcy (corresponding to 7 percent of broad money or 2¾ percent of GDP) were frozen. About 80 percent of these deposits were covered by deposit insurance.[3] With accumulated premiums insufficient to cover the liability to depositors, the payout obligation was assumed by the budget.[4] Payments began in July 1999 but have proceeded slowly.[5]

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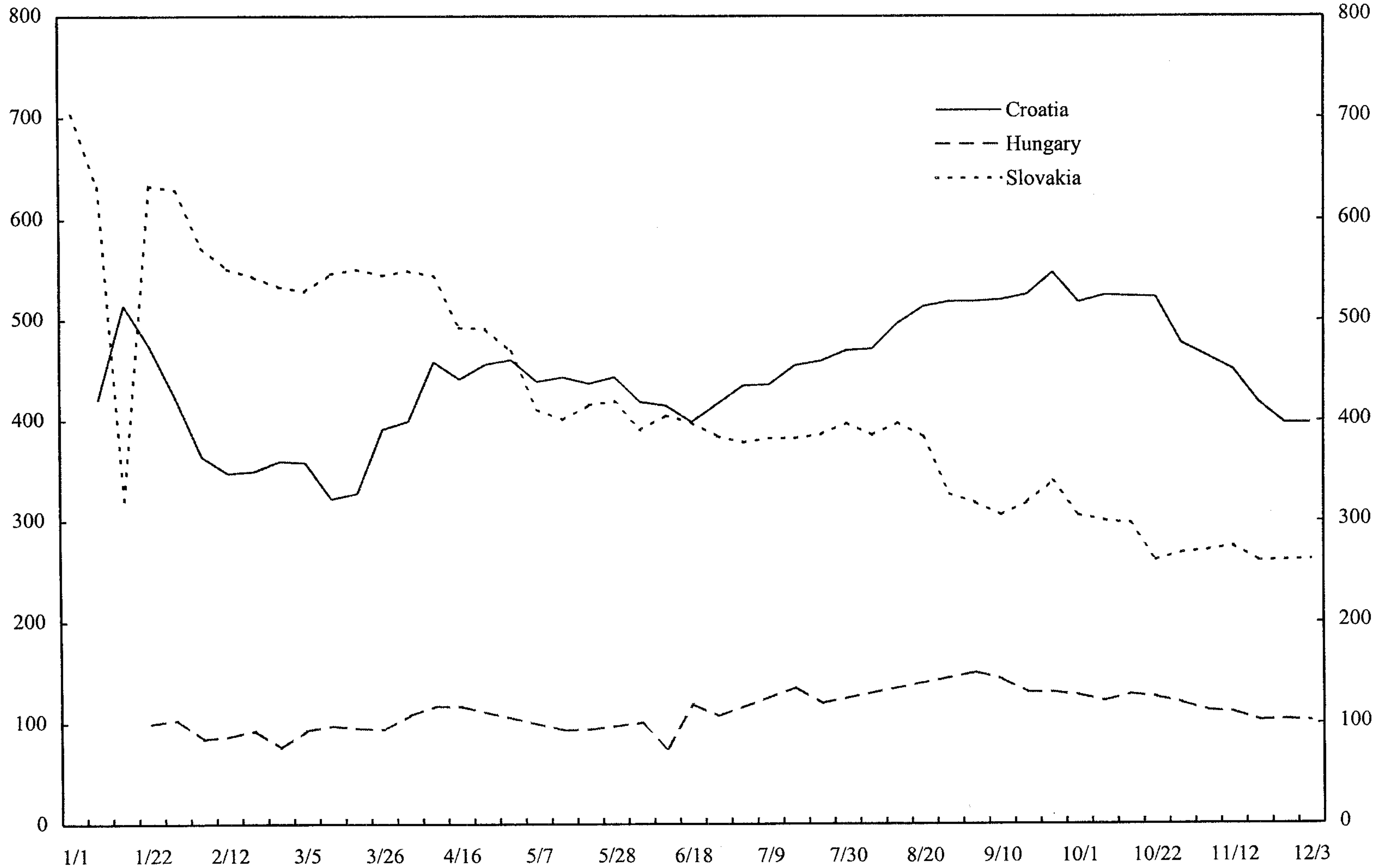
[2] A new Banking Law, which took effect in December 1998, greatly enhanced the CNB's ability to intervene in problem banks and speeded up procedures regarding their resolution.

[3] Just prior to the failure of one medium-sized bank, deposit insurance coverage was expanded, adding considerably to the fiscal cost of bank resolution.

[4] The fiscal cost of dealing with the problems of the 17 banks in which the CNB took action is estimated at Hrk 5.3 billion (3¾ percent of GDP), comprising primarily the payout of insured deposits and the repayment of CNB liquidity loans .

[5] The payout scheme adopted allows all account holders with deposits of up to Hrk 80,000—about 97,000 persons—to be fully paid out this year, while the remaining 21,000 account holders with deposits up to the insured limit (Hrk 100,000) will receive payment only in 2000.

Figure 6. Interest Rate Spreads in Selected Central European Countries, 1999 1/
(In basis points, weekly average)



Source: Bloomberg.

1/ Against U.S. Treasury benchmarks.

9. **A relaxation of fiscal policy and intensifying problems in the banking sector led to exchange market pressures in late 1998 and early 1999**. Increased public spending for social services and benefits (which almost doubled during 1995–99 and now accounts for more than 28 percent of GDP), reconstruction of war-damaged housing and infrastructure, an ambitious road-building program, and civil service wages more than offset the unexpectedly large VAT revenues, reducing the cash surplus to ¾ percent of GDP for 1998 as a whole. Including new payment arrears, the consolidated balance shifted to a deficit of 1½ percent of GDP.[6] Spending pressures intensified in early 1999 and, combined with a drop in revenue collections well in excess of declines in the corresponding bases, led to a further relaxation of the fiscal stance (Figure 7). As difficulties in the banking sector and budget shortfalls increased, the CNB stepped up its lending, with credit to distressed banks and government (net) rising from -1 percent of base money at end-1998 to 24 percent of base money at end-March 1999 (Figure 8).[7] This monetary accommodation was mostly undertaken at the expense of other bank liquidity, but easing of the fiscal stance and concerns about the soundness of the banking sector caused the kuna to depreciate by 9½ percent against the deutsche mark/euro, and by 6¼ percent in nominal effective terms, between August 1998 and March 1999, despite heavy foreign exchange sales (see Figure 5).

10. **Notwithstanding a modest improvement in competitiveness in the wake of kuna depreciation and continued labor shedding, export performance remained poor.** Reductions in employment contributed to an increase in productivity during 1998 and the first half of 1999.[8] This, together with the depreciation of the kuna, more than offset a 10 percent increase in industrial gross wages, generating a seasonally adjusted 3½ percent depreciation in the unit-labor-cost based real bilateral exchange rate vis-à-vis Germany during 1998 and the first quarter of 1999. Over the same period, the CPI-based real effective exchange rate depreciated by 5 percent, as retail price inflation moderated following the introduction of the VAT and the pass-through of the depreciation to domestic prices remained moderate. The good inflation performance through mid-1999 also reflected the weak cyclical position of the domestic economy.[9] Nonetheless, exports failed to respond as Croatia does not benefit from

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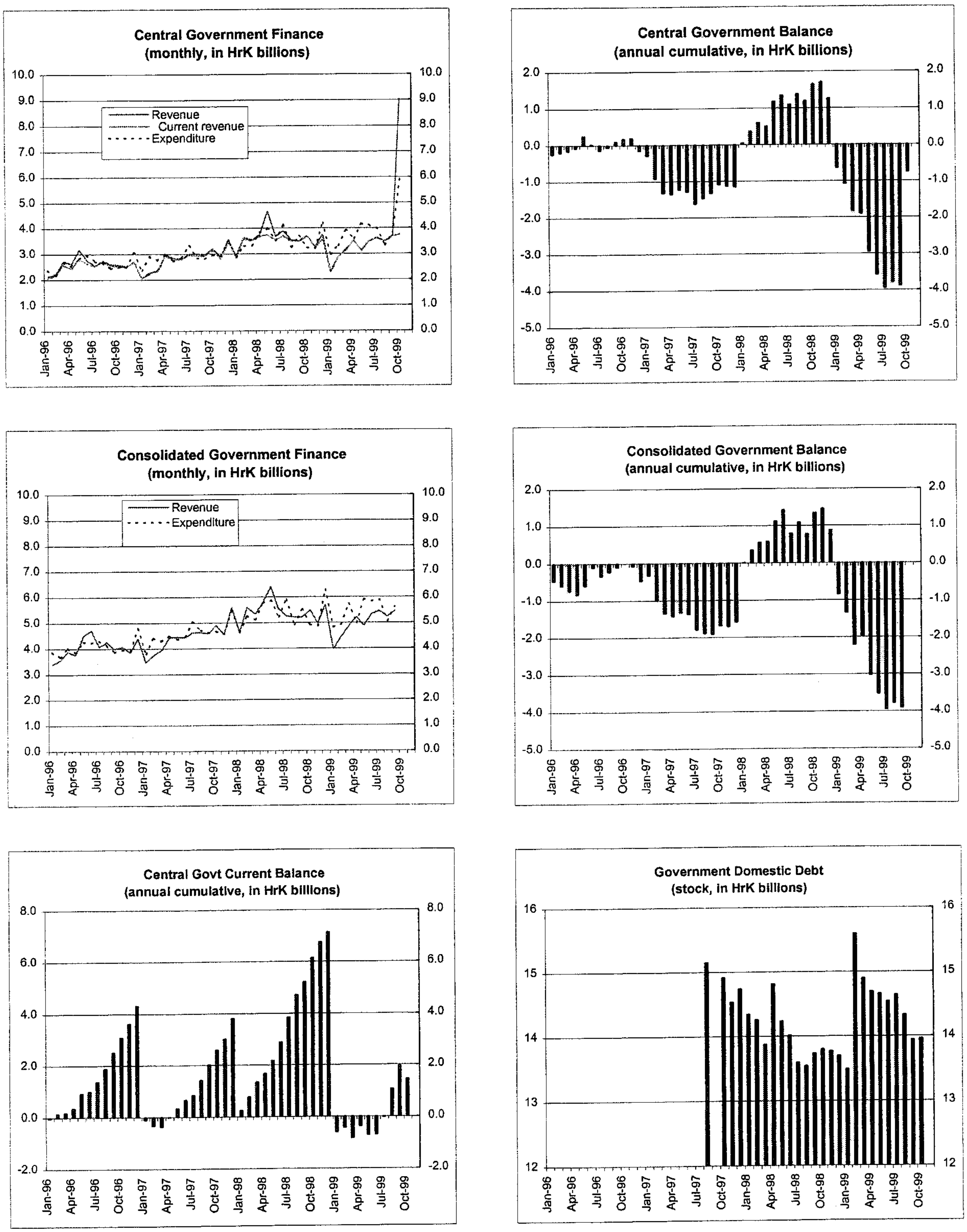
[6] The central government and the health fund incurred arrears of Hrk 2.3 billion and Hrk 540 million (1¾ percent and ½ percent of GDP), respectively. The 1999 central government budget includes provisions in current spending for full repayment of these arrears. Repayment of health fund arrears, expected in 1999, is treated as a financing item.

[7] Of this, two thirds (1 percent of GDP) corresponded to liquidity support for distressed banks.

[8] The registered unemployment rate continued to rise, reaching more than 19 percent in July 1999 from nearly 17 percent a year earlier.

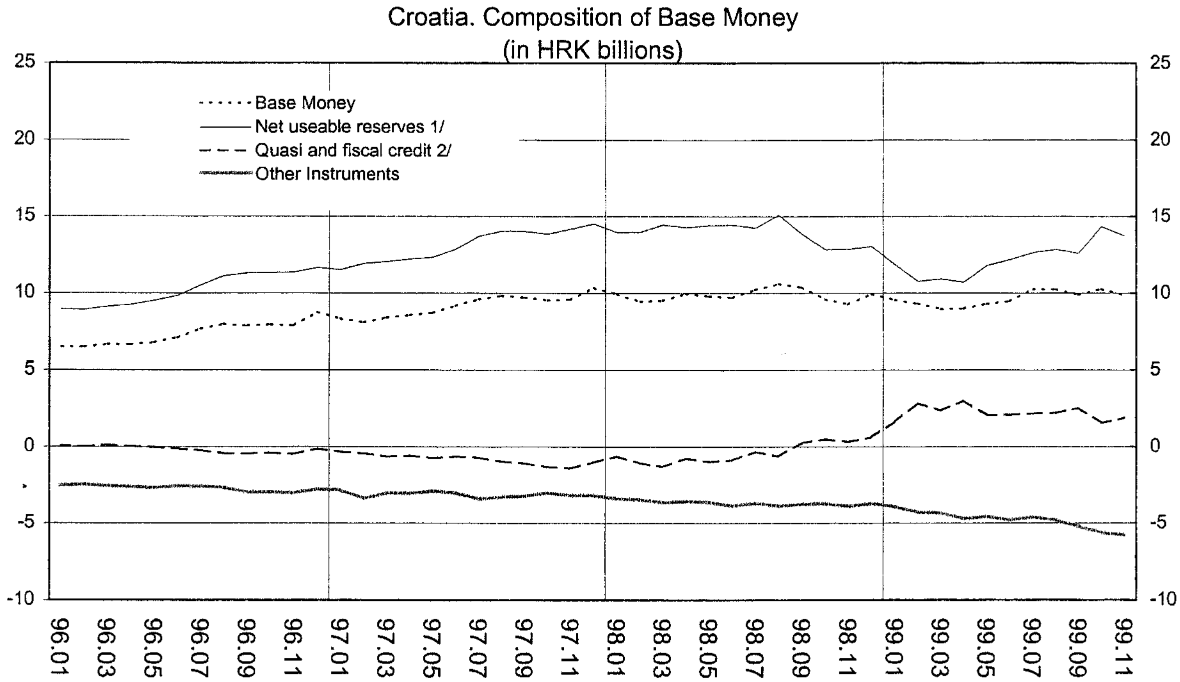
[9] Increases in excise taxes and administered prices for petroleum products caused 12-month inflation to jump from 3¾ percent in June to more than 5 percent in July 1999.

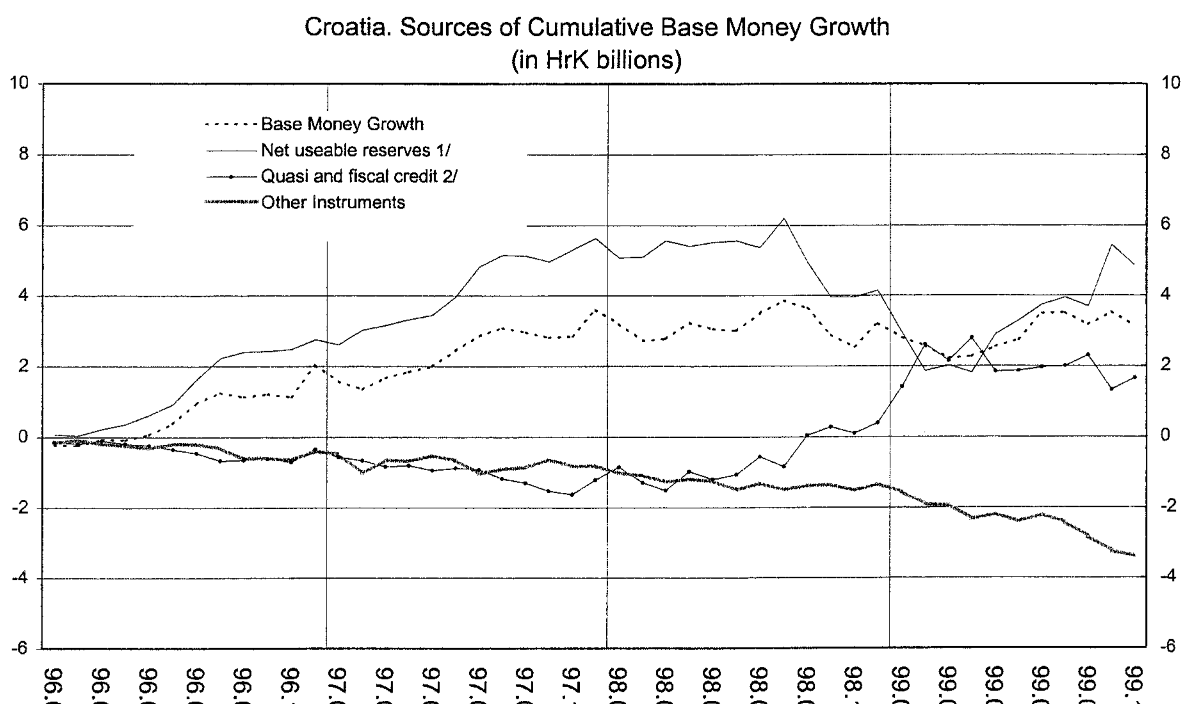
Figure 7. Croatia: Fiscal Accounts, Cash Basis 1996-99



Source: Ministry of Finance.

Figure 8. Croatia: Base Money Trends, 1996-99





Source: Croatian National Bank.

1/ Foreign reserves minus foreign liabilities and bank foreign exchange deposits and bills.

2/ Net credit to government plus credits to banks.

preferential trade agreements and its product variety and quality have been slow to adapt to the demands of new foreign markets. Also, growth in the traditional markets for Croatian exports (Italy, Germany, and Austria) slowed down during this period.[10]

11. **A loss of confidence weakened base money demand, leading to an outflow of international reserves and a resurgence of currency substitution**. Base money contracted by nearly 6 percent in the year to March 1999 as the CNB's net usable reserves fell from 152 percent of base money to 122 percent. Nonetheless, thanks to an increase in foreign currency liabilities to domestic banks, the CNB's net international reserves position was nearly unchanged in U.S. dollar terms in the 12 months to March 1999.[11] The loss of confidence in the kuna was reflected in a lower local currency share of broad money (31 percent at end-March 1999, compared with 38 percent at end-1997).

12. **Concerns about depleting reserves, insufficient external financing, and depreciation of the currency led to a renewed tightening of macroeconomic policies from March 1999**. The CNB tightened policy by raising reserve requirements and official interest rates, sharply restricting credit expansion—especially to the budget—and announcing that it would vigorously defend the kuna. The exchange rate stabilized immediately, without further intervention. In addition, the budget was tightened in June 1999 to target a consolidated central government deficit of 1 percent of GDP for 1999, following a deficit of over 5 percent of GDP on an annual basis in the first half of the year. The main features of the mid-year budget correction were a downward revision of tax revenues, a 10 percent reduction in discretionary current spending, a 25 percent cut in most capital spending and larger receipts from privatization to finance deposit payouts (equal to ¾ percent of GDP). However, the revised budget retained a cumulative 17½ percent increase in civil service wages, and allowed for the payout of only about a third of insured deposits in 1999. The revised budget also included larger transfers to the extrabudgetary funds (EBFs) to compensate for their revenue shortfalls, but this did not affect the balance of the consolidated government. Excluding privatization receipts, the cost of bank restructuring, additional transfers to the EBFs, and repayment of arrears, the revised budget implied an underlying fiscal adjustment of 2 percentage points of GDP in the second half of 1999.

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[10] In addition, Croatian exports to the Russian Federation dropped sharply in the first half of 1999 compared with the same period last year, contributing to about one third to the 9 percent decrease in the U.S. dollar value of exports.

[11] Between March 1998 and March 1999, foreign exchange liabilities to domestic banks increased by US$690 million, due to net purchases by banks of US$210 million in CNB foreign exchange bills and US$480 million in reserve requirements against short-term foreign currency deposits of households. The latter requirement was phased in during September 1998–May 1999.

B. Near-Term Prospects

13. **The recession that began in late 1998 is likely to extend through at least the end of this year**. As a result mainly of weak private consumption, tight budget execution in the second half of the year, and depressed demand in trading partner countries and other external factors, the mission expects real GDP to contract by some 2 percent in 1999. Nine-month data for industrial production, retail sales, and tourist stays as well as rising unemployment support this view. The attendant reduction of the external current account deficit—to almost 6½ percent of GDP—is, however, being slowed by the poor export performance: despite real effective depreciation, merchandise exports are falling in volume terms, while tourism receipts were dented—albeit less than feared—by the effect of the Kosovo crisis. Substantial real wage gains in the public sector (including state-owned enterprises) contrast with wage arrears and lower employment elsewhere in the economy. The risks to this forecast are mainly on the downside: prevailing uncertainty may delay the recovery of consumption, and sharp production cutbacks may follow the large accumulation of inventories in the three recessionary quarters ended in June 1999.

14. **The macroeconomic outlook for 2000 is brighter**. With elections out of the way and faster growth abroad, a domestic recovery, propelled by exports (especially tourism), private consumption, and investment, could see growth return to 2½–3 percent. Tourism is expected to rebound from the setback occasioned by the Kosovo crisis, and private spending should no longer be held back by balance sheet adjustments to the recent nominal exchange rate depreciation. Notwithstanding its negative direct contribution to growth, the indirect effects of fiscal consolidation through durable expenditure reduction would be likely to boost private demand, while import growth would be restrained by the real effective depreciation during 1999 and the low import content of tourism exports. The mission prepared a scenario for the authorities (Tables 2–4) under which the CNB would maintain its stable exchange rate policy, underpinned by fiscal adjustment, wage restraint, structural reforms, and privatization. Under such a scenario, inflation would remain moderate and the external current account deficit could be reduced further toward 5 percent of GDP, allowing external debt to stabilize. If balance of payments (and budget) financing through privatization and foreign borrowing were to remain limited to a little over US$1 billion in 2000, net international reserves would decline to US$2.3 billion by mid-year, before recovering to US$2.7 billion by year-end (3¼ months of imports and 165 percent of short-term debt).[12] Even if the domestic policy requirements were met, this scenario has downside risks: the unexpected presidential elections could delay the economic recovery, delays in the resolution of the remaining problems in the banking sector could undermine confidence, balance sheet adjustments to recent nominal depreciation may take longer than expected, the external recovery could be less vigorous, WTO accession could be further delayed, and there still remains the threat of UN imposed sanctions for noncooperation with the Hague War Crimes Tribunal.

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[12] Net usable international reserves would be about US$0.9 billion lower, when taking into account CNB foreign currency liabilities to domestic banks.

III. The Policy Discussions

A. Immediate Policy Requirements

15. **With the successful telecom privatization, the authorities were confident to have regained control over the external and fiscal situation**. The gradual depreciation of the kuna, which had resumed toward the end of the tourist season, came to a halt with the disbursement of the privatization receipts in early October, and the Ministry of Finance used the proceeds immediately to effect pent-up payments (Box 2). The CNB mopped up most of the resulting liquidity expansion, mainly through the placement of kuna-denominated bills, and gross official reserves remained near the record level attained when the Ministry of Finance surrendered a large portion of its privatization receipts. The fiscal authorities justified the speed with which they spent the full amount received by their desire to pre-empt fiscal slippage due to additional spending not foreseen in the revised budget. For similar reasons, they had persuaded the parliamentary leadership to expedite approval of the VAT reduction for four items (bread, milk, books, and medical supplies) to zero. The ensuing revenue loss of HrK 500 million (0.3–0.4 percent of GDP) a year would be fully offset at the consolidated central government level by lower VAT payments by the health fund and higher excise taxes on cigarettes, cars, and luxury items. The speedy action had forestalled a much larger revenue erosion from demands to broaden the range of zero-rated items and lower the VAT rate across the board. The mission nonetheless expressed regret at the precedent that the exemptions from the general VAT rate had created.

Box 2. Telecom Privatization

After rejecting a joint bid of US$611 million from Telia of Sweden and Telenor of Norway for 35 percent of Croatia Telecom (HT), the government accepted in a second round a US$850 million bid from Deutsche Telekom for the same share of HT. Ninety-five percent of the purchase price was paid immediately; the remaining 5 percent are expected to be paid in early 2000. Of the amount received by the Ministry of Finance after repayment of US$375 million of bridge financing and payment of commissions and fees for the privatization advisor, US$315 million was surrendered to the CNB. The Ministry of Finance used the local counterpart of this amount and the unsurrendered balance to make the following payments: promissory notes and arrears, transfers to the deposit insurance agency and the health fund, and repayment of a portion of its CNB advances. The CNB sterilized most of the liquidity expansion through the sale of foreign exchange and kuna-denominated bills.

The HT privatization is expected to be completed in 2000 with the sale/transfer of 7 percent of equity each to HT employees and war veterans, the transfer of 30 percent to the pension fund, and an IPO of 21 percent.

16. **In the mission's view, however, further expenditure cuts were needed so as not to exceed the deficit in the revised budget**. Even after higher-than-budgeted privatization receipts, the mission forecast a revenue shortfall of 1.2 percent of GDP, mainly due to sluggish tax collection stemming from lower economic activity and weaker compliance. While broadly agreeing with the mission's revenue projections, the authorities considered that tax compliance was likely to improve following the use of privatization receipts to pay government obligations. Given a lack of financing and to the extent that the revenue shortfalls did materialize, the authorities were, however, prepared to pare back expenditure on goods and services and on investment. They felt, however, unable to renege on their commitment to raise government wages by 12 percent in December. The mission expressed its disappointment about the government's inability to avoid the wage increases (a 5 percent wage increase had already been granted in August) in the prevailing recessionary environment, noting that these increases would raise wage pressures elsewhere in the economy while adding about 1½ percent of GDP of additional expenditure to the 2000 budget.

17. **The authorities considered the fiscal situation in early 2000 manageable**. Revenue would be bolstered in the first quarter by the privatization of three rehabilitated banks and the largest insurance company as well as by the balance of the telecom privatization (see Box 2). At the same time, monthly overall spending would be constrained to one-twelfth of 1999 expenditure under a provisional financing arrangement for the first quarter of the year. The additional revenue from privatization and the tight expenditure constraint would allow meeting the seasonal surge of debt service obligations to the Paris and London Clubs without recourse to exceptional foreign financing. Although accepting that a temporary financing arrangement was a second-best solution, the authorities felt that the government was not prepared to seek parliamentary approval of a tough 2000 budget prior to the election.[13]

B. Policies for the New Government

18. **As the approach of the election precluded the adoption of major adjustment measures, the mission discussed with the authorities the policy challenges of the post-election period**. To prepare for these discussions, the mission sought the views of a broad spectrum of Croatian civil society. A far-reaching coincidence of views emerged as to key objectives and broad policy requirements. All shared the desire to maintain price stability and return to the growth rates experienced during 1994–97, but growth had to be more export oriented and labor absorbing so as to strengthen the external current account and reduce unemployment. Broad agreement also prevailed as to the need to shift the policy mix toward tighter fiscal and looser monetary policy, to reduce the size of the government sector, to restrain wage growth, and to push ahead with privatization and structural reforms.

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[13] After the mission, the authorities secured some US$325 million in additional foreign financing from a bond issue and a bank loan. The mission therefore expects that the fiscal situation will be manageable through early 2000 if spending is held to the limit specified under the provisional financing arrangement.

Exchange rate policy

19. **Following a thorough discussion of the issues, the authorities considered the current level of the exchange rate broadly appropriate.**[14] They rejected nominal depreciation as both unnecessary and dangerous. For one, the slide of the kuna over the preceding 12 months had already led to a real effective depreciation of 3¼ percent; exports were likely to respond in the period ahead, reinforced by the recovery abroad. More importantly, however, while the recent gradual nominal depreciation had not been accompanied by significant inflationary pressures or financial distress, further adjustment of the exchange rate entailed substantial risks. The threshold beyond which depreciation is passed on to prices and wages was likely to be exceeded (and this threshold might itself decline as the economic recovery was taking hold), thus thwarting any further real depreciation while threatening to erode the margin obtained so far. Moreover, further depreciation would have an adverse effect on consumption due to foreign exchange hoarding and rising debt servicing costs. And finally, there were likely to be severe balance sheet problems for individual banks, enterprises, and households. Although the banking system as a whole had eliminated its net short position in foreign exchange and the larger banks now all had net long positions, substantial credit risk remained from banks' lending to unhedged borrowers in the business and household sectors. Economic agents were still adjusting to the recent cumulative depreciation of the kuna, as evidenced, for instance, by the weakness in consumption despite real wage increases, and any further nominal exchange rate depreciation could stifle the expected recovery. The mission was prepared to support the authorities' position on the understanding that a more determined effort was made to redress the fiscal situation and put in place the policies necessary to shore up competitiveness through wage restraint and other measures to strengthen corporate governance. In the mission's view, a relative fall in domestic unit labor costs could be achieved by a social agreement on wage restraint and efficiency gains from corporate restructuring, privatization, and more effective use of public ownership rights (see paragraph 28).

20. **The authorities restated their commitment to maintaining exchange rate stability by means of a managed float**. While a credible peg, especially a currency board arrangement, would offer a stable framework for long-term business decisions and a rapid convergence of interest rates toward those in the anchor country, the authorities preferred the flexibility of the current arrangement, which discouraged speculative capital flows while allowing the CNB to

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[14] In this, they were supported by all outsiders met by the mission with the exception of the representative of one small political party and some representatives of the academic community. The CNB representatives insisted, and the fiscal authorities concurred, that exchange rate policy is, by law and in actual practice, the exclusive domain of the CNB. The mission nonetheless suggested that the CNB listen to the arguments put forward by the new government on this question and cooperate with the new government in this area. Should the CNB wish to continue with a stable exchange rate, it should try to persuade the new government regarding the desirability of such a policy and obtain its agreement on the necessary supporting policies.

iron out erratic exchange rate movements and to smooth the pronounced seasonality of the Croatian foreign exchange market.[15] As demonstrated over the past twelve months, the present arrangement also allowed a gradual adjustment of the level of the exchange rate in response to sustained exchange market pressures. The mission urged the authorities to keep an open mind on their choice of exchange rate regime until the new government's policies are known. Without the requisite fiscal adjustment, wage restraint, and structural reforms, commitment to a stable exchange rate would prevent the decline in real interest rates needed to stimulate output, employment, and current account adjustment. The failure of past governments to implement the appropriate supporting policies—most glaringly illustrated by the 1999 wage increases in the government sector—counseled caution in precommitting to exchange rate stability by giving the government the benefit of the doubt. This said, the mission agreed that interest rates would decline toward international levels under a managed float of the type preferred by the monetary authorities as soon as the markets became convinced that the government will deliver on the policies needed to support a stable exchange rate.

Fiscal policy

21. **The authorities favor a reduction of the size of government that is large enough to balance the fiscal accounts and lower nonwage labor costs.** As the recent increase in government expenditure mainly resulted from social security and welfare spending (which is estimated to have increased by 7 percentage points of GDP during 1994–99), they realized that a major contribution had to come from pension and health care reform. While outside observers often criticized the high levels of spending on defense and internal security, substantial cuts (of 6¼ percentage points of GDP on a cash basis, reducing the level of such expenditure to 5¾ percent of GDP)[16] had already been realized during 1995–99. High privatization receipts in 2000 would allow the adjustment to be spread out somewhat, but the authorities agreed that one-off revenue should not be relied on to finance recurrent spending. Also, some expenditures would wind down over time, such as court-mandated payments of back pensions and the post-war reconstruction effort. Moreover, after the recent increases, a government sector wage pause should provide some fiscal relief in 2000. Finally, the adjustment would be facilitated by the expected economic recovery that should bolster current revenue and reduce spending on unemployment benefits. Meanwhile, the introduction of the mandatory second pillar of the pension system in mid-2000 would cost the public pension

[15] The authorities welcomed the recent volatility in the exchange rate as a way to increase perceived exchange rate risk, thereby increasing the attractiveness to the private sector of kuna-denominated bank loans.

[16] The mission prepared a functional classification of government expenditure, which is included in Section I of the accompanying Selected Issues paper.

system almost 1 percent of GDP in 2000. A budget based on these considerations would need to be prepared after the election.[17]

22. **Reducing the imbalances of the pension and health funds is a key priority for the authorities**. Demographic trends, legislated and court-mandated increases in entitlements, and the assumption of beneficiaries from newly re-integrated regions without offsetting increases in contributions had contributed to the imbalances as had lax financial control and inefficiencies resulting from excessive hiring, wages, and healthcare capacity. The authorities explained that the latter type of problems needed to be addressed by stricter oversight and control by the branch ministries. More fundamental reforms were under preparation, with the help of the World Bank, to strengthen the link between contributions and benefits in both funds. Independently of the introduction of a fully funded mandatory second pillar in 2000, the pension finances were already being strengthened by reform of the first, pay-as-you-go pillar that began to be phased in at the start of this year.[18] Similarly, the Health Ministry announced in October 1999 a plan to limit publicly provided healthcare to a standard package while providing voluntary insurance for additional benefits. The plan, which would need to be adopted during the next legislative period, would allow a reduction in labor cost through lower contribution rates. The mission welcomed these initiatives and made a few additional proposals for strengthening both funds.[19] In view of their persistently poor financial performance and their increasingly redistributive nature and heavy dependence on the budget, the mission also suggested bringing both funds under the purview of the budget pending completion of the reforms and subjecting their operations to the direct oversight and control of their respective branch ministries.

[17] The mission's scenario for 2000 envisages a 3¼ percent of GDP adjustment in the underlying fiscal balance (see Box 1).

[18] These reforms include extending the period for calculating the pensionable base from the 10 years with the highest income to lifetime earnings, changing the basis for indexation from wages to wages and prices (with equal weights), raising the statutory retirement age from 60 to 65 for men and from 55 to 60 for women, and tightening access to disability pensions. As the reform began to bite, the number of pensioners jumped by more than 10 percent in 1999, raising the dependency ratio to 0.96.

[19] Apart from stepping up collection efforts with stricter sanctions than in the past for failure to do so, the proposals included stretching out the payout period for the balance of the court-mandated back pensions, recertification of all pensioners, shifting the indexation of veterans' pensions from wages to wages and prices (as is the case for other pensions) as well as tightening access to sick pay and reducing its maximum amount, introducing reference prices for hospital supplies, reducing reimbursements to patients for travel expenses, increasing copayments (by reducing pervasive exemptions and raising rates), raising prescription charges, and lowering replacement rates for maternity and pregnancy complication benefits.

23. **The mission prepared and discussed with the authorities a fiscal scenario for 2000** (Box 3 and Table 2). Without committing themselves to the scenario, the authorities considered a budget along the lines suggested feasible. The mission suggested that design and implementation of the new government's budget would be greatly facilitated by a number of measures to improve fiscal transparency and accountability. Among them, the long-delayed public expenditure review, to be conducted by the World Bank, would provide a transparent basis for expenditure decisions. Fund technical assistance could help improve the classification and presentation of fiscal data.[20] And a single treasury account should be established in the Ministry of Finance, in line with recommendations made by Fund technical assistance several years ago (see paragraph 31 below). In addition, the authorities should avoid the accumulation of arrears and allow promissory notes to be issued only by the Ministry of Finance. Amounts outstanding should be included, fully and transparently, in public debt statistics, as should government guarantees, about the recent increase of which the mission expressed its concern.[21]

Box 3. A Fiscal Scenario for 2000

A fiscal scenario for 2000 that supports a reduction in the external current account deficit to 5 percent of GDP was developed, based on the assumption of 3 percent real GDP growth, 5 percent inflation, and an average exchange rate unchanged from its current (more depreciated) level. Under these assumptions, the consolidated central government deficit is projected to decline to ¼ percent of GDP (excluding the cost of introducing the fully funded second pillar of the pension system), compared with a cash deficit of 0.7 percent of GDP in 1999 and a deficit of 2.1 percent of GDP including the estimated net increase in expenditure arrears.

The scenario envisages tight budget execution in 2000, with no further increase in expenditure arrears. Revenues are projected to be boosted by a recovery in consumption and further large privatizations, and no further deterioration in tax and contribution compliance is anticipated. Owing to additional payouts of insured deposits and the full-year effect of the large government sector wage increases granted in late 1999, other spending categories need to be trimmed, including capital projects without earmarked foreign financing and transfers to Bosnia and Herzegovina. In the extrabudgetary funds, health spending is contained through copayments and improved expenditure oversight, while additional savings in the pension fund are obtained from the reform of the first pillar. Introduction of the second pillar of the pension scheme in mid-2000 would cost the budget 0.9 percent of GDP in the form of diverted contributions.

[20] The current presentation of the budget shows expenditures that benefit specific target groups under various categories, making it difficult to assess where room exists for expenditure restraint. The mission therefore recommended using a zero-based approach in developing the 2000 budget.

[21] Government guarantees of external borrowing rose from Hrk 6.3 billion to Hrk 9.8 billion in the first eight months of 1999. In addition, domestic guarantees increased by Hrk 1.2 billion during the same period.

Monetary and incomes policy and structural reform

24. **To keep the exchange rate stable against the euro, the CNB was prepared to adjust monetary policy flexibly to seasonal fluctuations and unforeseen shocks.** With the expected improvement in economic conditions, the CNB projected money demand to strengthen and interest rates to decline. The mission suggested equalizing reserve requirements on local and foreign currency deposits and lowering them as permitted by the exchange rate objective. At the same time, the CNB should raise the remuneration on reserve requirements against local currency deposits in an effort to reduce the spread between deposit and lending rates. The authorities generally agreed with these recommendations but noted that the rate of remuneration could not be raised before 2000 because the CNB's profitability had been squeezed in 1999 as a result of provisions that had to be made against collateral acquired from a bankrupt commercial bank. Finally, the authorities were examining the legality of alternative proposals to differentiate deposit insurance premia according to the riskiness of the insured institutions. The measure, which might deny insurance to the riskiest institutions, was expected to lower interest rates and spreads and to contribute to the recent trend toward concentration in the banking system.

25. **With the resolution of problem banks well under way, the authorities saw evidence of a gradual recovery of the banking system.**[22] The CNB had used the powers of the new banking law, in effect since late 1998, to initiate bankruptcy procedures in eleven banks (see tabulation) and place temporary administrators in three other ones. While the insured deposits in the bankrupt banks would continue to be paid out during 2000, least-cost solutions for the other troubled banks were being developed, including for three larger and politically sensitive banks. At end-September, one of these had entered the rehabilitation process while a solution was urgently sought for the remaining two. Another group of eleven solvent but distressed banks had been subjected to an enhanced supervision regime which had staved off bankruptcy in spite of the adverse macroeconomic conditions. These conditions affected the remaining banks as well, forcing them to make larger provisions (in part, required by the new banking law) and to adopt a more prudent lending policy. These institutions, which accounted for more than 80 percent of bank assets, were considered sound, even if mergers and acquisitions were expected to reduce their still excessive number.[23] The banks' resilience to the recent weakening of the kuna was taken as an indication that the direct and indirect vulnerability of the banking system to moderate exchange rate fluctuations was limited. Interest rate vulnerability was also considered small since there was no large maturity mismatch between assets and liabilities and banks were generally reluctant to provide long-term loans at fixed interest rates. This said, the authorities realized that the banking system was still weak and needed to be strengthened by further reducing operating expenses and

[22] Recent developments in the financial sector are reviewed in greater detail in Section II of the accompanying Selected Issues paper.

[23] Since the mission three small domestic banks have been acquired by foreign banks.

developing noninterest sources of income (Table 6). Notwithstanding the unfavorable macroeconomic environment, there were signs that the system was on the mend: following several years of decline, the capital adequacy ratio had risen to 13½ percent in mid-1999, and unaudited reports of the two largest banks indicated rising profits in the first half of 1999. Moreover, foreign interest in the privatization of the three rehabilitated banks was strong.

Croatia: Banking Sector Statistics, 1999
(HrK billion, unless otherwise stated; end of period)

Type of Bank	Number June 1999	Assets (percent of total) June 1999	Insured deposits October 1999	Outstanding CNB liquidity loans June 1999
Under temporary administration	3	0.9	0.345	0.037
Sensitive	3	7.4	1.723	0.774
Pending bankruptcy request	3	0.1	0.057	0.005
Distressed (under enhanced CNB supervision)	11	7.4	1.741	0.353
Foreign owned	10	8.9	...	0
Zagrebacka Banka (largest bank, privately owned)	1	25.8	...	0
Rehabilitated and under privatization	3	33.4	...	0
Memorandum items:				
Bankrupt banks	8	6.7 1/	3.172 2/	0.319
Banking sector total	54	100.0	24.026	1.627

Sources: Croatian National Bank; and IMF staff estimates.

1/ As of end-1998
2/ On opening of bankruptcy proceedings.

26. **In terms of its legal framework, the authorities considered supervisory reform all but complete**. All regulations to implement the new banking law had been adopted, except for the one on on-site inspections. An institutional development plan had also been prepared to beef up the CNB's bank supervision department so as to better enforce the new regulations. In this respect, progress was still needed with regard to enforcement of banks' exposure limits to foreign exchange risk and large borrowers and the strengthening of commercial courts' implementation capacity. More time was required to hire and train the staff needed to carry out the CNB's new supervisory tasks. A new unified system for both prudential and analytical data reporting had been introduced in mid-1999 and was functioning satisfactorily except for temporary delays in obtaining data on nonperforming loans. Moreover, reclassification of certain loans and the recording of financial assets at face (rather than market) value continued

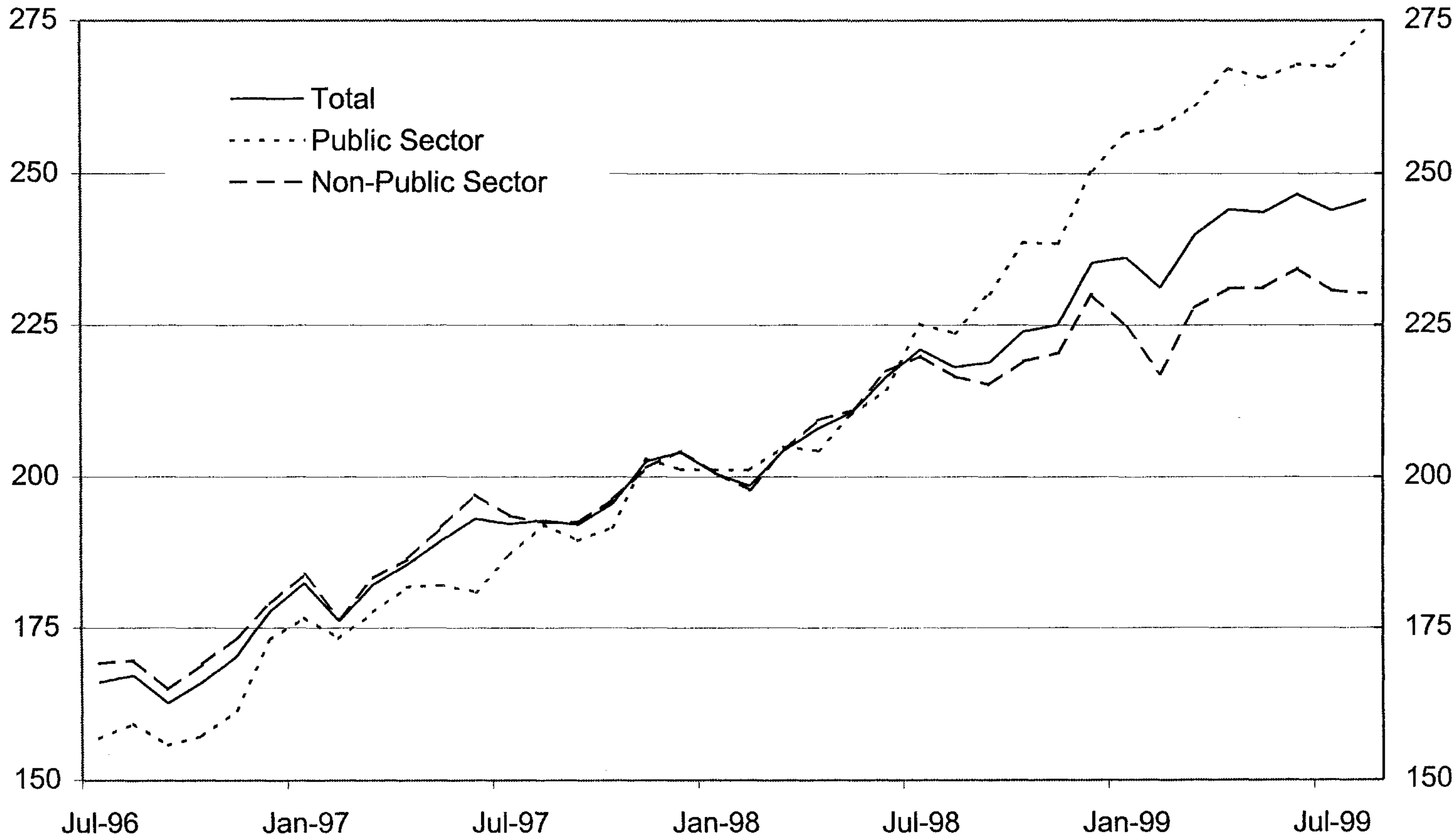
to entail underprovisioning of bad assets and an overstatement of capital adequacy ratios.[24] Meanwhile, the reform of the payment system was progressing: a real-time gross settlements system had been successfully introduced in April 1999 and a clearing house was expected to become fully operational in early 2000.

27. **The authorities expected wage moderation in 2000, an impression that was reinforced by the representatives of labor unions with whom the mission met**. Initial discussions between employers, unions, and the government in the Economic and Social Council had revealed a growing realization of the link between wages and employment and a readiness on the part of unions to accept wage increases below productivity increases for a period of time. The authorities hoped to enshrine such a rule in a new tripartite social agreement, which would act as a guide to enterprise-level wage negotiations throughout the economy. While the government would not directly interfere in such negotiations, it had established guidelines for state-owned enterprises that restricted wage increases to what could be paid out of increased profits. In the government sector, initial indications suggested that the unions would not demand real wage increases in 2000. The mission agreed that under current conditions wage pressures were unlikely to emerge from the private sector but it suggested a tougher approach in public sector wage negotiations. The large increases in government and state enterprise wages in recent years (Figure 9) justified a temporary wage freeze in the government and perhaps also in the state-owned enterprises to build additional momentum for their privatization. Management of enterprises violating the freeze should be dismissed.

28. **A more efficient economy was expected to emerge as a result of privatization, direct foreign investment, and WTO accession**. The authorities expected that the three rehabilitated banks and the largest insurance company could be privatized by early 2000, followed by an IPO of 21 percent of Croatia Telecom in late 2000. The plans for other state enterprises were still in flux: the petroleum company (INA) was in merger talks with a foreign partner, but might be privatized as an alternative, whereas the power company (HEP) had been slow to restructure itself by unbundling generation, transmission, and distribution facilities. As past privatization, by favoring insiders, had failed to improve efficiency and corporate governance, the mission encouraged the authorities to use the leverage provided by tax and social contribution arrears in many of these enterprises to raise cash by forcing them to sell controlling stakes to outsiders. Alternatively, the government could restore control over these enterprises through debt-equity swaps, before reprivatizing them immediately to strategic investors. The mission urged the authorities to accelerate privatization of remaining state enterprises, including in the tourism sector. In this connection, it asked the authorities to reconsider plans to consolidate all state-owned tourist facilities under the aegis of the Ministry of Tourism as such a move was likely to be costly to the budget and detrimental to the quality of the industry's product. The mission also encouraged the authorities to consolidate the shares held by several government agencies in the privatization agency. This and the consolidation of

[24] See Appendix III, paragraph 11.

Figure 9. Croatia: Average Net Wage Index, 1996-99
(1994 = 100)



Source: Croatian National Bank.

Note: The lead of public sector wages is likely to have grown further in the second half of 1999, as wage increases of 5 percent and 12 percent were given to government workers in September and December 1999, respectively.

shares privatized through the voucher scheme across different privatization investment funds was likely to strengthen corporate governance. To attract direct foreign investment, the authorities were considering tax incentives. The mission advised against this, suggesting that foreign investors be offered instead a time-bound protection against business tax increases. Finally, with all other negotiations completed, the authorities still hoped to overcome the impasse created by a US-EU disagreement over the permissible import content of audio-visual products in time for WTO membership before year-end. They also hoped to make progress toward a closer trading relationship with the EU and CEFTA in 2000.

29. Based on its recommendations for structural reform in the enterprise and government sectors, the mission prepared a **medium-term scenario** that delivers an acceleration in real growth and a decline in the saving-investment shortfall (Box 4). This would ensure that Croatia is soundly on the road to external viability and begins catching up to Western European income levels.

C. Other Issues

30. Notwithstanding recent improvements in the coverage and accuracy of **economic and financial data**, major deficiencies remain which could impact the reliability of macroeconomic analysis (Appendix III). In particular, lack of comprehensive data on arrears of the central government (including the extrabudgetary funds) means that the mission's estimates of fiscal balances on an accrual basis and of domestic saving-investment balances are subject to an unknown, but possibly large, margin of error.

31. The discussions included a **technical consultation** with the authorities to assess the effectiveness of past technical assistance provided by the Fund and possible future needs in this area (Appendix IV). Technical assistance from FAD, MAE, and STA was generally considered of high quality and tailored to the needs specified. A preference was, however, expressed for greater continuity in the expert assignments and for Fund experts rather than external consultants in order to minimize the possibility of receiving conflicting advice. Also, the working relationship between experts and local counterparts had not always been satisfactory, a fact that may be attributable to reluctance of some counterparts to accept change. One technical assistance department also mentioned that on occasion the local counterparts had expected the expert to do the day-to-day work. These problems aside, the mission considers that technical assistance had generally been well received and successfully implemented, with the notable exception of recommendations to set up a single treasury account. The authorities identified the following priorities for technical assistance: implementation of a single treasury account, banking supervision, foreign reserves management, monetary policy instruments, balance of payments statistics (quarterly international investment position), and central bank accounting. They also saw a need for follow-up technical assistance in national accounts statistics. Except for banking supervision and implementation of a single treasury account, the amount of assistance needed would seem to be modest.

Box 4. Medium-Term Scenario

A medium-term scenario that achieves external sustainability is underpinned by a reinvigoration of structural reform in the enterprise sector and a downsizing of the role of government in the economy. Continued privatization of key firms and state-owned banks to strategic investors would provide needed external financing and improve the allocation of physical and financial resources. Accession to the WTO and participation in regional trade arrangements helps attract greenfield investment, thereby replenishing and upgrading Croatia's capital stock and expanding its growth potential. This, together with export-promoting policies similar to those in neighboring countries, will help establish Croatia as a platform for exporting to the EU as well as other transition countries. In order to develop the country's strong tourism potential, which is a major source of foreign exchange earnings, blocks of shares in tourism enterprises held by the state or acquired by banks through debt-equity swaps would be sold to strategic investors who will provide much needed capital and management skills. Investment in new tourism facilities would also be sought in order to increase sectoral capacity.

These policies are expected to gradually increase economic growth to 5 percent per annum—enabling GDP to recover to its 1990 level by 2004—and to lower the current account deficit to 3½ percent of GDP, while boosting reserves and reducing the external debt ratio (Figure 10 and Table 5). This is possible in the absence of further systematic nominal depreciation of the kuna provided that wages are kept in line with productivity improvements and fiscal spending is scaled back in order to avoid upward pressure on the prices of nontradables.

Much of the near-term improvement in the saving-investment balance is expected to derive from the fiscal sector. This reflects the unwinding of several one-off factors (completion of the payout of insured deposits and the termination of the court-mandated retroactive indexation of pensions) and the downsizing of government activities. Existing reforms to the first pillar of the pension system (including a gradual increase in retirement age and a lengthening of the wage history used to calculate individual pension benefits), measures to increase cost savings in the health system (including increased copayments and reductions in sick pay, maternity, and pregnancy complication benefits), and curtailment of state-financed large infrastructure projects are expected to reduce the size of government by 7½ percent of GDP between 1999 and 2004.[1] These savings will be sufficient to compensate for a falling-off of privatization revenues during the projection period, while still allowing for a gradual decline in the tax burden on labor in the context of a declining overall fiscal deficit.

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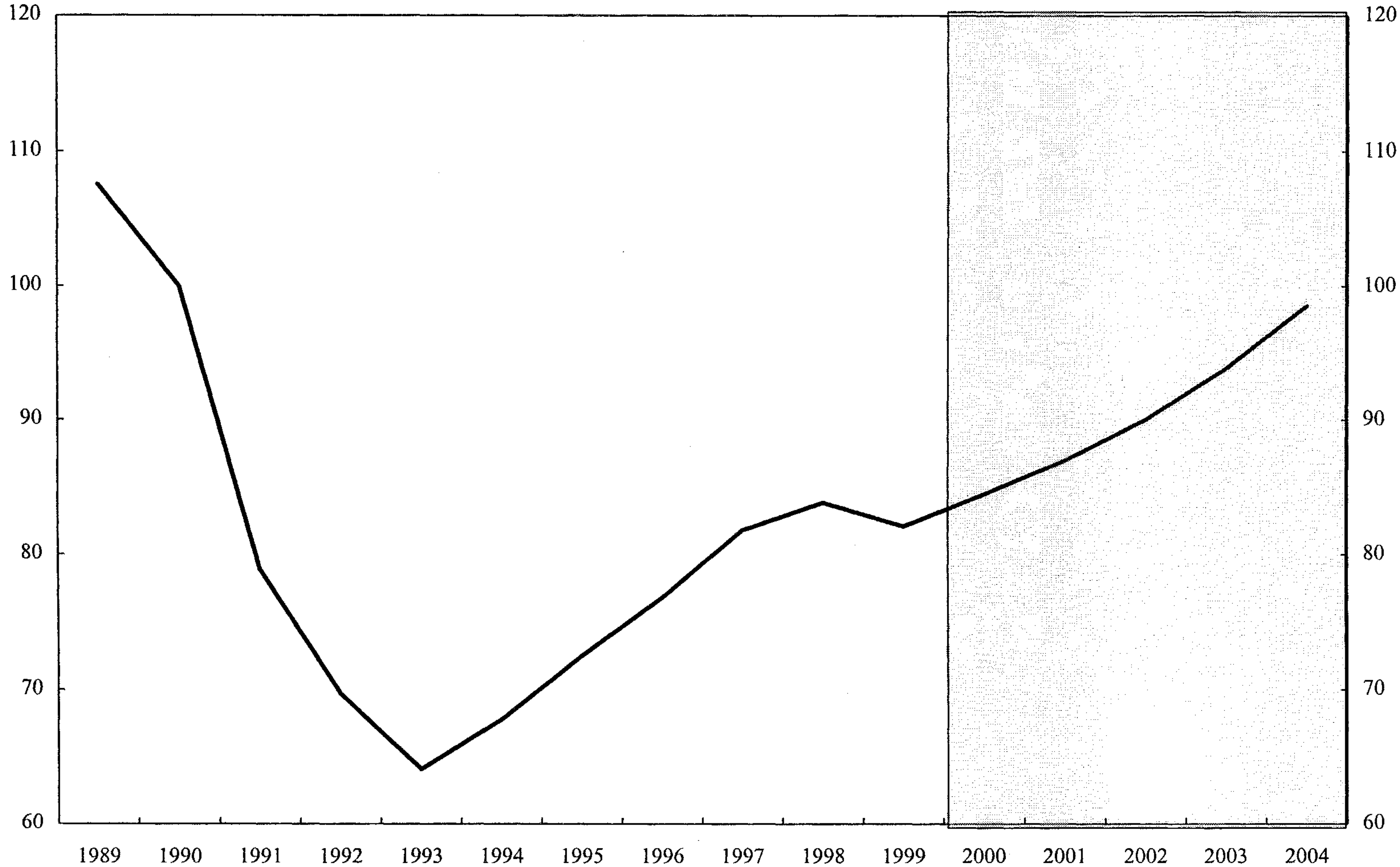
[1] The projections exclude the fiscal cost of the fully-funded second pillar of the pension system, scheduled to begin in mid-2000, and the government's plan to introduce a multi-pillar health care system.

Figure 10. Croatia: GDP at Constant 1990 Prices, 1989-2004



Source: Central Bureau of Statistics, and IMF staff projections.

32. The missions' interlocutors were confident about Croatia's **Y2K preparedness**. The major state enterprises (HEP, HT, INA, and HP-postal services) had successfully tested their systems. The CNB considers its systems Y2K compliant[25] and did not expect any significant problems in the banking system (particularly in the larger banks) or the payments agency (ZAP). Nonetheless, in coordination with plans in the euro area, the CNB intended to declare a bank holiday for the period around January 1, 2000. It had no plans, however, to create a special liquidity window. In early December, however, the CNB announced a temporary easing of access to its Lombard facility from mid-December to mid-January.

33. In 1992 the Government of Croatia modified the terms of certain foreign currency deposits, effective retroactively to April 27, 1991, and transformed them into time deposits to be repaid in 20 semi-annual installments starting June 30, 1995. These measures were taken in order to protect Croatian banks from collapse after the foreign exchange counterpart to these deposits had been blocked by the National Bank of the former SFRY. Since then, the stock of such frozen deposits has fallen considerably (and now stands at less than 20 percent of its original value), partly due to the fact that banks have been permitted to reduce the deposits more rapidly at their own discretion, but mainly due to budgetary repayments which still amount to about ¾ percent of GDP per annum. Moreover, interest payments on these deposits have been made twice annually, and in a timely fashion. However, because the frozen balances may include revenues from current international transactions that were generated prior to the 1991 freeze, the measure gives rise to an **exchange restriction** subject to approval under Article VIII, 2(a) of the Fund's Articles of Agreement. This restriction was not identified on the occasion of Croatia's acceptance of the obligations of Article VIII in 1995, but further investigation, initially conducted by staff in the context of other successor states to the former SFRY, has led to this finding.

IV. Staff Appraisal

34. **After a successful stabilization and four years of impressive economic growth, the Croatian economy is now in recession.** While a slowdown in external demand contributed to the recession, its principal causes were a necessary macroeconomic policy tightening to rein in an unsustainable level of domestic demand and an insufficiently flexible domestic economy. The policy tightening laid bare structural weaknesses and led to an accumulation of arrears and a banking crisis.

35. **With a still large external current account deficit and an only slowly recovering banking system, the authorities must tread carefully in managing the economy.** Their task is, however, likely to be facilitated by the revival of external demand, the recent small real effective depreciation of the currency, and the surge of confidence that usually greets a government at the start of its term.

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[25] The antiquated external debt database was expected to be replaced by a Y2K compliant system before year-end.

36. **Reducing the external current account deficit and stabilizing external indebtedness are key for a return to sustained economic growth.** The main tools in restoring a sustainable balance between domestic absorption and income are demand management and measures to improve competitiveness. The authorities will need to articulate a judicious combination of these two adjustment tools, bearing in mind that the rate of growth achieved during the adjustment process depends importantly on the success of the policies adopted in stimulating supply.

37. **The widely shared preference for continued exchange rate stability is understandable:** this policy has served Croatia well in the past, and a significant depreciation would jeopardize price stability, weaken unhedged balance sheets, and raise the cost of servicing foreign exchange denominated debt. But those who support exchange rate stability must accept the complementary policies required to make this course viable: a tight fiscal policy, wage restraint, and greater economic efficiency through privatization and structural reform. Only then will markets—wary of past policy shortcomings in these areas—allow interest rates to be reduced.

38. Regardless of the exchange rate policy chosen, **government expenditures must be cut vigorously, not only to balance the budget, but also to allow reductions in nonwage labor costs.** Although this objective is widely shared, the new government must translate it into concrete measures. The need for a government sector wage freeze is obvious after the large increases in 1999. But cuts must also be made in areas such as defense and police, war veterans, reconstruction, highway construction, and subsidies which involve difficult political choices. These can be facilitated by international benchmarking and undertaking a public expenditure review. With the scope for privatization receipts diminishing after 2000, the government should not postpone the required cuts to later years. Also, to maximize the scope for cutting nonwage labor costs, the government should guard against the erosion of other sources of taxation such as the VAT.

39. Given the large size of budget transfers, **it is impossible to restore fiscal balance without redressing the finances of the pension and health funds.** World Bank assisted reforms—ongoing in the case of pensions, planned in the case of the health care system—need to be supplemented by immediate measures to improve the collection of contributions and the efficiency of operations. Given the large increase in spending on social welfare in recent years and the need to cut nonwage labor costs, a better balance between contributions and benefits must probably be found by curtailing entitlements.

40. **Fiscal transparency and accountability must be improved.** Required steps include a better classification and presentation of fiscal data, including on arrears, promissory notes, and government guarantees; establishment of a single treasury account; strengthened oversight by branch ministries over the extrabudgetary funds and, perhaps, inclusion of their operations into the budget until they are properly reformed; and reserving the right to issue promissory notes to the Ministry of Finance.

41. To the extent permitted by its exchange rate objective, **the CNB should strive to lower its reserve requirements** and raise the rate of remuneration on the requirements for

local currency deposits in order to ease the burden on the banking system and facilitate the reversal of currency substitution.

42. **The authorities are to be commended for decisive action to clean up the banking system.** The CNB has made good use of its new powers to intervene and request the liquidation of banks. The payout of insured deposits in bankrupt banks must be completed soon and least-cost solutions must be adopted without delay for a few troubled banks, so as not to jeopardize their solvency. Further mergers and acquisitions should be encouraged to consolidate the banking system and make it more competitive. To avert a recurrence of banking problems, the CNB should strengthen its supervisory capacity and more strictly enforce prudential regulations. The court system also needs to be strengthened to expedite the resolution of bankrupted banks.

43. **Wage restraint will be a particularly important element of any future strategy**. The government should take advantage of the widely shared perception that past wage increases were excessive to negotiate a medium-term social pact with employers and unions that would establish general guidelines for wage negotiations. Agreement to keep real wage increases below productivity increases for several years would be particularly helpful in boosting competitiveness and employment.

44. **Privatization needs to be accelerated,** especially in some of the state enterprises, **and proper regulatory systems need to be adopted.** Progress in integrating Croatia in the global and regional trading arrangements is also essential to attract foreign investors.

45. Croatia has generally made good use of **Fund technical assistance.** Implementation of a single treasury account, banking supervision, foreign reserves management, monetary policy instruments, balance of payments statistics, and central bank accounting are priority areas for further technical assistance.

46. Notwithstanding ongoing efforts, **data deficiencies** hamper economic analysis. The authorities are encouraged to redouble their efforts in this area, in particular by providing fiscal arrears data and improving timeliness and quality of data needed to assess banking system soundness.

47. In view of the established timetable for their gradual elimination and the freedom of banks to accelerate payouts further, the staff proposes to grant temporary approval for the **exchange restriction** that arises in connection with the temporary freeze of certain foreign exchange denominated bank deposits held by nonresidents.

48. The authorities have requested to participate in the pilot program for the voluntary release of Article IV staff reports. It is recommended that the next **Article IV consultation** with Croatia be held on the standard 12-month cycle.

Table 1. Croatia: Basic Economic Indicators, 1994-2000

	1994	1995	1996	1997	1998	1999 Staff Proj.	2000 Staff Proj.
Real economy							
Real GDP (percentage change)	5.9	6.8	6.0	6.5	2.5	-2.1	2.9
Unemployment rate (average; percentage of labor force) 1/	14.5	14.5	16.4	17.5	17.2	20.1 4/	...
Nominal gross wages (percentage change; period average)	...	34.0	12.3	13.1	12.6	10.4 5/	...
Retail prices (percentage change; end of period)	-3.0	3.7	3.4	3.8	5.4	5.0	3.5
Gross national saving (percent of GDP)	23.1	9.9	16.3	16.6	16.1	18.3	19.7
Gross domestic investment (percent of GDP)	17.4	17.6	22.1	28.2	23.2	24.8	24.7
Public finance (percent of GDP)							
Central budget (cash basis)	0.6	-0.7	-0.1	-0.9	0.9	-0.1	-0.2
Excluding privatization	0.2	-1.3	-1.2	-1.3	-0.4	-4.3	-3.7
Consolidated central government (cash basis) 2/	1.6	-0.9	-0.4	-1.3	0.6	-0.7	-1.1 7/
Excluding privatization	1.2	-1.7	-1.6	-2.5	-1.0	-4.9	-4.9
Money and credit (end of period; percentage change)							
Broad money	74.5	40.2	49.3	38.4	13.0	-3.7	15.5
Credit to consolidated central government	-18.1	-3.0	-3.5	-49.9	-2.7	19.7	38.0
Other credit	36.3	18.6	3.1	44.4	22.4	-2.8	5.8
Average credit interest rate (end of period; percent)	15.4	22.3	18.5	14.1	16.1	14.0 6/	...
Balance of payments							
Trade balance (percent of GDP)	-8.0	-17.4	-18.6	-26.0	-19.1	-17.6	-17.5
Current account balance (percent of GDP)	5.7	-7.7	-5.8	-11.6	-7.1	-6.5	-5.0
Total external debt (percent of GDP; end of period)	22.5	20.8	23.2	31.9	37.1	39.0	36.5
Official reserves (US$ million; end of period)	1,405	1,895	2,314	2,539	2,816	2,783	2,890
Reserve cover (months of imports of goods and services)	2.5	2.4	2.8	2.7	3.2	3.4	3.4
Short-term debt in percent of gross usable reserves 3/	35.2	31.6	40.7	45.6	51.4	88.1	85.0
Exchange rate							
Nominal effective rate (1995=100; end of period)	96.8	99.1	101.0	102.8	98.0	99.8 6/	...
Real effective rate (1995=100; end of period)	97.6	98.6	99.8	101.6	100.0	102.7 6/	...
Geographic, social, and demographic indicators							
Per capita GDP (at market exchange rates)					$4,663		
Land area (km^2)					56,538		
Population					4,501,000		
Population density (people per km^2)					79.6		
Population growth (in percent)					-1.5		
Life expectancy at birth (years)				72			
Male				68			
Female				77			
Infant mortality rate (per 1,000 live births)				8.2			
Crude death rate (per 1,000 people)					12.0		

Sources: Croatian authorities; Information Notice System; and IMF staff estimates.

1/ Registered average unemployment rate. According to the Labor Force Survey (based on ILO standards), the unemployment rate was 10.0 percent in November 1996 and 12.6 percent in the first half of 1999.

2/ Including extrabudgetary funds.

3/ On a remaining maturity basis; limited to debt contracts registered with the CNB.

4/ In October 1999.

5/ In January-August 1999.

6/ In September 1999.

7/ Includes the cost of introducing the second pillar of the pension system in mid-2000, estimated at 0.9 percent of GDP.

Table 2. Croatia: Central Budget Fiscal Operations, 1994-2000

(In millions of kuna)

	1994 Actual	1995 Actual	1996 Actual	1997 Actual	1998 Actual	1999 Revised Budget	1999 Staff Proj.	2000 Staff Proj. 1/
Revenue and grants	23,143	27,981	31,367	33,846	43,809	47,909	46,228	48,292
Revenue	23,143	27,881	31,367	33,846	43,809	47,909	46,228	48,292
Current revenue	22,789	27,287	30,244	33,385	42,019	42,117	40,318	42,890
Tax revenue	22,377	26,505	28,530	31,338	39,900	40,023	38,470	40,445
Personal Income tax	3,212	3,498	4,217	4,102	4,915	4,604	4,465	4,769
Profits tax	592	1,009	1,271	1,785	2,461	2,769	2,492	2,689
Real Estate Transactions tax	118	142	172	243	271	260	235	247
Taxes on goods and services	14,921	17,763	18,895	20,538	28,097	27,742	26,497	28,120
VAT and sales tax	13,107	12,802	13,504	15,133	22,200	21,168	19,968	20,975
Excises	1,814	4,960	5,391	5,405	5,897	6,574	6,529	7,145
Taxes on international trade	3,487	3,922	3,942	4,640	4,128	4,115	4,300	4,621
Other tax revenue	49	172	33	30	28	533	480	...
Non-tax revenue	411	782	1,714	2,047	2,120	2,094	1,848	2,444
Capital revenue	354	594	1,123	461	1,789	5,792	5,910	5,402
Grants	0	100	0	0	0	0	0	0
Expenditure and net lending	22,599	28,696	31,502	35,006	42,552	49,334	46,430	48,577
Expenditure	22,283	28,476	30,973	34,395	41,390	48,223	45,505	47,408
Current expenditure	20,361	25,495	25,930	29,580	34,883	38,180	37,350	39,444
Expenditure on goods and services	16,614	20,735	19,623	20,263	22,649	22,510	21,830	22,785
Wages and employer contributions	7,885	10,110	10,332	11,040	13,030	14,590	14,590	16,378
Other goods and services	8,729	10,625	9,292	9,223	9,618	7,920	7,240	6,407
Interest payments	1,003	1,392	1,218	1,737	1,951	2,214	2,214	2,537
Domestic	895	911	950	775	917	986	986	...
External	107	481	268	962	1,034	1,228	1,228	...
Subsidies and other current transfers	2,744	3,369	5,089	7,579	10,283	13,455	13,305	14,121
Subsidies	1,763	1,810	2,077	2,307	3,275	2,929	2,829	2,863
Current transfers	982	1,559	3,012	5,272	7,008	10,527	10,477	11,258
Capital expenditure	1,922	2,980	5,043	4,815	6,507	10,044	8,156	7,964
Lending minus repayments	316	221	529	611	1,162	1,111	925	1,169
Central budget overall balance, unconsolidated	544	-715	-134	-1,160	1,257	-1,426	-203	-285
(as percent of GDP)	0.6	-0.7	-0.1	-0.9	0.9	-1.0	-0.1	-0.2
Excluding privatization receipts	190	-1,309	-1,257	-1,621	-533	-7,217	-6,113	-5,687
(as percent of GDP)	0.2	-1.3	-1.2	-1.3	-0.4	-5.1	-4.3	-3.7
Extrabudgetary funds balance, unconsolidated	695	-158	-405	-467	-387	-146	-829	-1,478
Transactions eliminated from financ in consolid process					12	96	96	0
Consolidated central government balance 2/	1,413	-883	-477	-1,587	882	-1,476	-936	-1,763
(as percent of GDP)	1.6	-0.9	-0.4	-1.3	0.6	-1.0	-0.7	-1.2
Excluding privatization receipts	1,059	-1,639	-1,742	-3,109	-1,416	-7,267	-6,996	-7,465
(as percent of GDP)	1.2	-1.7	-1.6	-2.5	-1.0	-5.1	-4.9	-4.9
Memorandum items:								
Consolidated central government financing need	...	2,295	2,281	3,305	1,078	3,822	3,534	4,563
External financing, net	...	714	907	3,099	87	3,766	1,611	648
Expenditure for defense, and public order and safet	10.8	12.2	9.3	7.9	7.2	5.8	...	...

Sources: Ministry of Finance and IMF staff estimates.

1/ Assumes a civil service wage freeze, no further bank failures, and the introduction of the second pillar of the pension scheme in mid year, estimated to cost 0.9 percent of GDP.

2/ Includes the central government and the extrabudgetary funds.

Table 3. Croatia: Monetary Accounts, 1994-2000

(End-period; in millions of kuna unless otherwise stated)

	1994	1995	1996	1997	1998	1999 Q1 Actual	1999 Q2 Actual	1999 Q3 Actual	1999 Q4 Projection	2000 Q1 Projection	2000 Q2 Projection	2000 Q3 Projection	2000 Q4 Projection	Growth rate (percentage) 1998	Growth rate (percentage) 1999 2/	Growth rate (percentage) 2000
Monetary survey 1/																
Broad money	17,680	24,623	36,701	50,742	57,340	56,635	53,355	55,317	55,608	56,487	59,117	62,330	63,629	13.0	-3.0	14.4
Narrow money	6,643	8,235	11,369	13,731	13,531	11,982	13,269	13,561	13,916	13,613	14,454	15,219	15,754	-1.5	2.8	13.2
Currency outside banks	2,657	3,362	4,361	5,308	5,719	5,030	5,608	5,533	5,706	5,581	5,897	6,194	6,381	7.7	-0.2	11.8
Demand deposits	3,985	4,870	7,007	8,424	7,809	6,950	7,659	8,025	8,206	8,027	8,552	9,020	9,369	-7.3	5.1	14.2
Quasi money	11,037	16,388	25,332	36,877	43,809	44,653	40,086	41,757	41,691	42,874	44,663	47,110	47,875	18.8	-4.8	14.8
Denominated in kuna	2,046	2,158	3,387	5,599	5,684	5,353	4,977	5,253	5,254	5,246	5,659	5,812	6,118	1.5	-7.6	16.4
Denominated in foreign currency	8,783	14,099	21,817	31,278	37,971	39,165	34,970	35,862	35,927	37,627	39,004	41,298	41,757	21.4	-5.4	16.2
Net domestic assets	16,540	21,576	24,960	33,829	44,627	46,018	41,309	40,954	41,197	44,095	46,678	46,170	46,583	31.9	-7.7	13.1
Of which: Domestic credit	43,281	47,977	48,465	56,195	66,923	69,126	64,191	66,604	66,668	70,248	73,004	72,678	73,273	19.1	-0.4	9.9
To government, net	15,619	15,157	14,634	7,331	7,131	9,065	9,219	8,545	8,535	11,325	11,336	13,792	11,775	-2.7	19.7	38.0
To other domestic sectors	27,662	32,819	33,831	48,863	59,792	60,061	54,971	58,060	58,133	58,924	61,668	58,886	61,498	22.4	-2.8	5.8
Net foreign assets	1,140	3,047	11,741	16,913	12,713	10,617	12,046	14,363	14,411	12,392	12,439	16,159	17,046	-24.8	13.3	18.3
Balance sheet of National Bank																
Net foreign assets	7,192	8,900	11,658	14,534	16,127	15,787	17,608	18,841	18,730	17,098	16,605	19,027	19,724	11.0	16.1	5.3
(in millions of U.S .dollars)	1,278	1,674	2,105	2,306	2,581	2,227	2,399	2,599	2,583	2,358	2,290	2,624	2,721	11.9	0.1	5.3
Base money	4,714	6,744	8,770	10,346	9,954	8,966	9,494	9,907	10,059	9,840	10,448	11,001	11,388	-3.8	1.1	13.2
Currency outside banks	2,657	3,362	4,361	5,308	5,719	5,030	5,608	5,533	5,706	5,581	5,897	6,194	6,381	7.7	-0.2	11.8
Reserve liabilities to banks	2,057	3,379	4,409	5,039	4,232	3,934	3,883	4,371	4,348	4,254	4,546	4,802	5,002	-16.0	2.8	15.0
Other reserve liabilities	56	215	243	101	1,791	3,525	4,279	4,839	4,675	4,806	4,969	5,240	5,294	1671.2	161.0	13.2
Nonbank deposits	16	3	0	0	4	2	3	2	5	5	5	5	5	5792.4	33.7	0.0
Blocked deposits 3/	40	212	243	101	1,788	3,523	4,276	4,837	4,670	4,801	4,964	5,235	5,289	1668.6	161.3	13.2
Net domestic assets	-2,422	-1,941	-2,645	-4,087	-4,382	-3,295	-3,836	-4,095	-3,995	-2,452	-1,189	-2,786	-3,042	7.2	-8.8	-23.9
CNB claims on government (gross)	251	390	219	0	0	1,270	1,374	1,378	0	1,300	1,300	1,300	0	...	...	0.0
CNB claims on banks	224	220	214	34	1,054	1,638	1,309	1,610	3,235	3,427	4,641	2,993	3,988	3042.6	207.0	23.3
Memorandum items:																
Nominal GDP	87,441	98,382	107,981	123,813	138,392	142,005	142,005	142,005	142,005	152,956	152,956	152,956	152,956	11.8	2.6	7.7
Narrow money multiplier	1.4	1.2	1.3	1.3	1.4	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	2.4	1.8	0.0
Velocity of Kuna broad money	10.1	9.5	7.3	6.4	7.2	8.0	7.7	7.5	7.4	7.6	7.3	7.1	7.0	12.4	2.8	-5.6
Foreign currency deposits																
In millions of DM	2,418	3,805	6,125	8,893	10,168	10,083	9,004	9,190	9,212	9,407	9,751	10,325	10,439	14.3	-9.4	13.3
As a percentage of GDP	10.0	14.3	20.2	25.3	27.4	27.6	24.6	25.3	25.3	24.6	25.5	27.0	27.3	8.6	-7.8	7.9
Net usable reserve/Base money (in percent)	152.6	132.0	132.9	140.5	131.1	121.8	128.4	127.2	128.1	113.0	100.2	114.7	116.4			
Change in net domestic credit to the government									-10	2,790	11	2,456	-2,017			
Change in net domestic banks credit to the government									1,368	1,490	11	2,456	-717			

Sources: Croatian National Bank; and IMF staff projections

1/ Data from Q2 1999 onwards exclude the assets and liabilities of the banks declared bankrupt in April 1999. Changes in the statistical reporting system introduced a break in the data in July 1999.

2/ Growth rates for 1999 are affected by changes in the statistical reporting system and by the bankruptcy of various banks in the course of the year. The latter caused a drop in broad money of nearly 4.8 billion kuna and a fall in domestic credit of roughly 5.8 billion kuna. After adjusting for all these factors, estimates of the 1999 growth rate are +7.8 for broad money and +3.4 for credit to other domestic sectors

3/ Rapid growth in these deposits during 1998 and the first half of 1999 reflects the shifting to the CNB of the redeposit requirement on short-term foreign currency deposits.

Table 4. Croatia: Balance of Payments, 1994-2000 1/
(In millions of U.S. dollars, unless otherwise indicated)

	1994	1995	1996	1997	1998	1999 Staff Proj.	2000 Staff Proj.
Current account	826	-1451	-1148	-2,343	-1,543	-1,306	-1,050
Merchandise trade balance	-1,172	-3,268	-3,690	-5,224	-4,161	-3,538	-3,691
Exports f.o.b.	4,260	4,633	4,546	4,210	4,613	4,344	4,581
Imports f.o.b.	-5,432	-7,901	-8,236	-9,435	-8,773	-7,881	-8,272
Services and income	1,469	1,013	1,510	2,010	1,910	1,590	1,881
Transportation	321	314	310	283	228	167	293
Travel	1,405	924	1,504	2,000	2,133	1,949	2,154
Other services	-93	-197	-234	-251	-286	-230	-266
Compensation of employees	35	39	39	56	70	65	74
Interest income	-200	-67	-109	-76	-235	-361	-375
Current transfers	529	804	1,032	872	708	642	760
Capital and financial account	38	1,132	2,472	3,120	1,647	1,699	1,187
Capital account	0	0	16	21	19	5	0
Financial account	38	1,132	2,456	3,099	1,628	1,693	1,187
Direct investment	106	96	509	302	775	1,204	1,140
Portfolio investment	9	5	27	665	25	296	174
Medium- and long-term loans	-145	-142	454	1,205	1,058	-130	-312
Disbursements	184	315	844	1,792	1,775	682	936
Amortization scheduled	-329	-457	-391	-587	-717	-812	-1,248
Currency and deposits 2/	58	704	840	443	218	-237	0
Short term capital flows (net) 3/	10	470	199	248	36	58	0
Trade credits 4/	0	0	426	236	-484	502	185
Net errors and omissions	-540	406	-422	-590	181	-404	0
Overall balance	324	87	903	188	285	-11	137
Financing	-324	-87	-903	-188	-285	11	-137
Gross reserves (-= increase)	-789	-490	-419	-225	-277	42	-107
IMF (net purchases)	106	98	-4	37	-9	-31	-30
Exceptional financing	360	306	-479	0	0	0	0
Memorandum items:							
Current account (in percent of GDP)	5.7	-7.7	-5.8	-11.6	-7.1	-6.5	-5.0
Current account (in percent of adjusted GDP) 5/	4.5	-6.2	-4.6	-9.3	-5.7	-5.2	-4.0
Gross reserves (millions of U.S. dollars)	1,405	1,895	2,314	2,539	2,816	2,773	2,880
Reserves in months of imports of goods and NFS	2.5	2.4	2.8	2.7	3.2	3.4	3.4
Net international reserves (millions of U.S. dollars)	1,286	1,674	2,105	2,306	2,581	2,574	2,711
In months of imports of goods and NFS	2.3	2.2	2.5	2.4	2.9	3.1	3.2
Gross usable reserves (millions of U.S. dollars) 6/	1,405	1,895	2,314	2,539	2,320	1,922	1,931
Gross usable reserves in months of imports of goods and NFS 6/	2.5	2.4	2.8	2.7	2.6	2.3	2.3
Net usable international reserves (millions of U.S. dollars)	1,286	1,674	2,105	2,306	2,085	1,723	1,762
In months of imports of goods and NFS	2.3	2.2	2.5	2.4	2.3	2.1	2.1
Outstanding debt (millions of U.S. dollars) 7/	3,282	3,921	4,611	6,420	8,062	7,845	7,706
*Of which: S*hort-term debt 3/ 8/	37	208	355	441	366	320	320
Debt to GDP ratio 7/	22.5	20.8	23.2	31.9	37.1	39.0	36.5
Short-term debt in percent of gross usable reserves 3/ 8/ 9/	35.2	31.6	40.7	45.6	51.4	88.1	85.0
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 3/ 8/ 9/	131.7	65.3	128.9	75.9	55.8	83.4	93.1
Debt service	-642	-698	-713	-848	-1110	-1240	-1783
Debt service to exports ratio	9.0	9.9	9.1	10.3	12.9	15.2	20.3
GDP (millions of U.S. dollars)	14,583	18,811	19,871	20,109	21,752	20,108	21,097
GDP (millions of kuna)	87,441	98,382	107,981	123,813	138,392	142,005	152,956
Exchange rates							
Kuna per U.S. dollar (period average)	6.00	5.23	5.43	6.16	6.4	7.1	7.3

Sources: Croatian National Bank; World Economic Outlook; and IMF staff estimates.

1/ Based upon CNB balance of payments revisions of summer 1999.

2/ A significant proportion of the currency and deposit flows in 1998 and 1999 are the repatriation of foreign currency redeposit requirements held at the CNB.

3/ Data for short term commercial bank credits derived from the CNB foreign exchange department.

4/ Coverage only includes import trade credits with maturities less than three months.

5/ Includes an upward adjustment of 25 percent to GDP for the informal sector. While the exact size of the needed adjustment is not known, some such upward adjustment is clearly warranted and estimates by the Ministry of Finance and the Institute of Public Finance in Zagreb suggest that an adjustment on the order of 25 percent would be reasonable.

6/ Gross reserves adjusted downward by foreign currency redeposit requirements held at the CNB, and by the amount of outstanding foreign currency CNB bills.

7/ Does not include debt that was excluded from the London Club agreement.

8/ Coverage is limited to debt contracts registered with the CNB.

9/ Debt is presented on a remaining maturity basis.

Table 5. Croatia: Medium-Term Scenario, 1997-2004

	1997 Actual	1998 Actual	1999 Proj.	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
				(In percent of GDP)				
External saving 1/	11.7	7.1	6.5	5.0	4.5	4.0	3.8	3.6
Domestic saving-investment gap	-11.7	-7.1	-6.5	-5.0	-4.5	-4.0	-3.8	-3.6
Saving	16.5	16.1	18.3	19.8	20.5	21.3	22.4	23.5
Investment	28.2	23.2	24.8	24.7	25.0	25.3	26.2	27.1
Consolidated central government (accrual basis) 2/ 3/	-2.5	-3.1	-6.3	-4.0	-1.9	-1.6	-1.3	-1.1
Saving 4/	3.4	3.9	0.1 7/	1.6	2.0	2.2	2.4	2.5
Investment 5/	5.9	7.0	6.5	5.6	3.9	3.8	3.7	3.6
Non-government sector (accrual basis)	-9.1	-4.0	-0.2	-1.0	-2.6	-2.4	-2.5	-2.5
Saving	13.1	12.1	18.2	18.1	18.5	19.1	20.0	21.0
Investment	22.3	16.1	18.4	19.1	21.1	21.5	22.5	23.5
Memorandum items:								
Real GDP growth (in percent)	6.5	2.5	-2.1	2.9	3.0	3.5	4.3	5.0
Trade balance	-26.0	-19.1	-17.6	-17.5	-17.1	-16.9	-16.7	-16.3
Net exports of goods and nonfactor services	-15.9	-9.6	-8.2	-7.2	-6.0	-5.5	-4.8	-4.1
Foreign direct investment (including privatization)	1.5	3.6	6.0	5.4	3.9	3.5	3.1	3.1
External debt	31.9	37.1	39.0	36.5	35.2	33.9	33.8	33.1
Debt service to exports ratio	10.3	12.9	15.2	20.3	19.3	20.1	15.9	15.7
Net usable international reserves (millions of U.S. dollars) 6/	2,306	2,085	1,723	1,762	1,865	2,043	2,564	3,096
In months of imports of goods and NFS	2.4	2.3	2.1	2.1	2.1	2.2	2.6	2.9
Short-term debt (remaining maturity basis) in percent of gross usable reserves	45.6	51.4	88.1	85.0	94.1	74.0	64.5	49.2
Current account deficit and short-term debt net of FDI in percent of gross usable reserves	75.9	55.8	83.4	91.7	100.3	82.1	70.4	54.5
Public sector debt	26.5	24.5	29.7	29.2	27.6	26.3	25.3	23.9
External	14.7	14.6	19.9	18.4	17.8	16.7	16.6	15.7
Domestic	11.7	9.9	9.8	10.8	9.7	9.6	8.7	8.2
Balance of the consolidated central government (including privatization)	-1.9	-1.4	-2.1	-0.3	0.0	-0.4	-0.8	-0.6

Sources: Croatian National Bank, Ministry of Finance; Central Statistics Bureau; and IMF staff estimates.

1/ Net imports of goods and nonfactor services. A positive sign indicates a deficit.
2/ Balance of the consolidated central government excluding privatization receipts, on an accrual basis. Excludes the cost of introducing the second pillar of the pension system.
3/ Assumes a net increase in expenditure arrears equivalent to 1.4 percent of GDP in 1999.
4/ Current balance.
5/ Includes capital transfers and net lending. In 1997, includes 0.6 percent of GDP in reconstruction expenditure financed with enterprise shares held by the Croatian Privatization Fund.
6/ Net official reserves minus foreign exchange liabilities to domestic banks. Equivalent to the net foreign exchange position of the CNB.
7/ The sharp decline in the current fiscal balance in 1999 reflects primarily a fall in tax compliance and an increase in pension payments due to constitutional court-mandated retroactive indexation of pensions and a large increase in the number of early retirees ahead of pension reform.

Table 6. Croatia: Selected Commercial Bank Financial Indicators, 1994-98

(In percent at year-end unless otherwise indicated)

	1994	1995	1996	1997	1998
Solvency indicators					
Risk-weighted capital adequacy ratio	...	18.2	17.7	16.4	12.7
Problem assets/total assets (Categories B-E)	...	14.0	11.0	11.1	15.8
Specific provisions for identified losses (HrK billion)	3.1	5.5	4.3	4.4	9.5
Specific provisions/total assets	5.2	7.9	5.8	4.6	9.2
Efficiency indicators					
Assets/employee (HrK million)	3.1	3.6	3.1	4.0	4.3
Operating expenses/assets	6.6	6.7	7.5	3.7	...
Operating expenses/ordinary income	66.9	70.7	68.8	45.0	...
Interest expenses/assets	3.4	3.2	3.6	3.4	4.1
Profitability indicators					
Return on assets	0.2	0.3	0.8	1.4	-2.6
Return on equity	2.4	3.8	9.5	11.4	-28.7
Interest income/assets	5.8	5.8	7.0	6.6	8.3
Liquidity indicators					
Short-term assets/short-term liabilities	77.2	81.8	75.2	89.9	79.1
Loans/deposits	96.1	99.1	90.2	104.4	109.6

Sources: Croatian National Bank; and IMF staff estimates.

CROATIA—RELATIONS WITH THE FUND
(As of November 30, 1999)

I. Membership Status: Joined 12/14/92; Article VIII.

II. General Resources Account:	SDR million	% Quota
Quota	365.10	100.0
Fund holdings of currency	508.19	139.2
Reserve position in Fund	0.14	0.0

III. SDR Department:	SDR million	% Allocation
Net cumulative allocation	44.21	100.0
Holdings	138.07	312.3

IV. Outstanding Purchases and Loans:	SDR million	% Quota
Extended arrangements	28.78	7.9
Systemic Transformation Facility	114.45	31.3

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
EFF	3/12/97	3/11/00	353.16	28.78
Stand-by	10/14/94	4/13/96	65.40	13.08

VI. Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	11/30/99	1999	2000	2001	2002	2003
Principal	--	--	21.8	24.2	26.6	26.6
Charges/Interest	--	--	6.1	5.1	4.0	2.8
Total	--	--	27.9	29.3	30.6	29.4

VII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with occasional participation of the Croatian National Bank. The authorities' exchange rate policy regarding the Croatian kuna is accordingly classified as "other managed floating." The Croatian National Bank transacts only in euros, U.S. dollars, and SDRs. On December 17, 1999, the official exchange rate was kuna 7.555 per U.S. dollar.

VIII. Article IV Consultation and Recent Use of Fund Resources

Croatia is on a 12-month consultation cycle. The last **Article IV consultation** with Croatia was concluded on July 10, 1998 (SM/98/149, 6/19/98; and SM/98/158, 6/26/98). Executive Directors commended the authorities for the success thus far of their exchange rate-based stabilization program and welcomed efforts to advance structural reform. However, many Directors stressed the need to take decisive and early corrective action in the face of the unsustainably large current account deficit in 1997 and emerging difficulties in the banking sector.

A three-year **extended arrangement** in an amount equivalent to SDR 353.16 million (135 percent of quota) was approved on March 12, 1997, and a first purchase of SDR 28.78 million was made at that time. The first review was completed on a lapse-of-time basis on October 10, 1997, but the authorities decided not to draw on the resources then made available. Discussions on the second and third reviews did not take place and further performance criteria were not set. The arrangement has remained inoperative since then.

Discussions in May 1999 failed to reach agreement on a **stand-by-arrangement** to help finance a prospective balance of payments gap in the wake of the Kosovo crisis. The principal areas of disagreement were wage policy—where the staff was asking the authorities to rescind previously agreed government sector wage increases—and privatization policy—where the staff urged the sale of a larger share of state enterprises in order to finance the fiscal cost of resolving a banking crisis.

IX. Technical Assistance 1992–99

Department	Timing	Purpose
FAD	November 1992	Tax Policy and Administration
	May 1993	VAT and Tax Administration
	November 1993	Public Expenditure Management
	March 1994	Treasury Establishment
	August 1994	Budget Preparation Mission
	November 1994	Follow up Mission on Treasury Establishment
	March 1995	Treasury Management Seminar
	August 1995	Treasury implementation
	Nov.–Dec. 1995	Treasury implementation
	June-July 1997	Impact of VAT
STA	December 1992	Multi-topic mission
	October 1993	Monetary Statistics
	November 1993	Government Finance Statistics
	April 1994	Money and Banking Statistics
	July 1994	National Accounts
	November 1994	Balance of Payments

	January 1995	Money and Banking Statistics (together with EU1 mission)
	February 1996	BOP mission
	September 1996	National Accounts
	January 1998	Balance of Payments
	January 1998	Data Dissemination Standard
	February 1998	Quarterly National Accounts
	September 1998	Quarterly National Accounts
	November 1998	Quarterly National Accounts
	January 1999	Quarterly National Accounts
	February 1999	Balance of Payments
	June 1999	Quarterly National Accounts
	July 1999	Producer Price Indices
MAE	December 1992	Bank Supervision
	October 1993	Monetary Instruments; Exchange Market
	January 1994	Monetary Operations and Banking Supervision; Exchange Market
	May 1994	Payments System, Monetary Operations, Foreign Exchange, Banking Supervision, and Accounting
	Aug. 1994–Aug. 1995	Monetary Operations (9 expert visits)
	October 1994	Monetary Operations Review
	December 1994	Payments system
	Jan.–Feb. 1995	Monetary Operations, Organization and Management, and Foreign Reserve Management
	Feb.–Dec. 1995	Payments System (4 expert visits)
	Aug. 1995–Apr. 1996	Monetary Operations (5 expert visits)
	September 1995	Foreign Exchange Management
	November 1995	Foreign Exchange, Public Debt, Monetary Policy
	September 1996	Interbank and Government Securities Markets, Internal Audit, Foreign Reserve Management
	October 1996	Foreign Exchange Management
	November 1996	Payments System
	March 1997	Foreign Exchange Management (expert visit)
	April 1997	Banking Law Issues (staff visit with LEG)
	April 1997–Feb. 1998	Accounting (6 expert visits)
	July 1997	Banking Sector Strategy (staff visit)
	September 1997	Banking Sector Strategy and Banking Law Issues
	Sept.-Nov. 1997	Information Technology (2 expert visits)
	Mar. 1998–Mar. 1999	Accounting (resident advisor)
	Apr. 1998–Aug. 1999	Banking Supervision (resident advisor)
	April–June 1998	Foreign Exchange Management (2 expert visits)
	May 1998	Banking Law Issues (2 staff visits)
	August 1998	Banking Soundness and Banking Law Issues
	November 1998	Banking Supervision (with WB mission)

	March–Dec. 1999	Banking Supervision (resident advisor)
	April 1999	Foreign Exchange Operations and Reserves (two expert visits)
INS	1993–97	Fiscal Policy Management (7 participants)
	1993–99	Monetary and Banking Statistics (6)
	1994	Basic Economics (1)
	1994	Tax Policy Administration (1)
	1994–95	Public Expenditure Policy and Management (2)
	1994–96	Government Finance Statistics (5)
	1994–96	External Sector Policies (3)
	1994–97	Comprehensive Course in Applied Market Economics (7)
	1994–98	Central Bank Accounting (5)
	1994–99	Foreign Exchange Policies and Operations (5)
	1995	Public Finance (1)
	1995	Tax Policy in Transition Economies (1)
	1995	Value Added Tax (1)
	1995–97	Financial Market Instruments (2)
	1995–97	Financial Programming Policy (2)
	1995–98	Banking Supervision (2)
	1995–98	Techniques of Financial Analysis and Programming (4)
	1995–99	Balance of Payments (3)
	1995–99	Macroeconomic Analysis and Policy (9)
	1995–99	Public Expenditure and Treasury Management (7)
	1996	Financial Transactions for Lawyers (1)
	1996–97	Tax Administration and Reform (2)
	1997	Payment System (1)
	1997	Banking Soundness and Monetary Policy in World of Global..(1)
	1997–98	Monetary Operations (2)
	1998	Current Legal Issues Affecting Central Banks (1)
	1998	Monetary and Exchange Operations (1)
	1998	Specialized Course on Exchange Rate Policies (1)
	1998	Trade and Exchange Rate Policies (1)
	1999	A Decade of Transition: Achievements and Challenges (1)
	1999	Management and Operational Issues for Central Bank Accountant (1)

X. Resident Representative

Mr. O'Callaghan took up his post in Zagreb on June 11, 1997

CROATIA: RELATIONS WITH THE WORLD BANK

1. Croatia succeeded to the membership of the Socialist Federal Republic of Yugoslavia (SFRY) in the World Bank in 1993. Croatia is current on its debt service payments in accordance with an agreement on debt apportionment reached with the Bank whereby Croatia assumed debt service responsibility for Bank loans benefiting borrowers on its territory.

2. There are currently fifteen Bank projects supported by loans totaling US$909.2 million under implementation in Croatia: The Istria Water Supply and Sewerage Project (US$28 million) was approved in 1990 when Croatia was still part of the SFRY. The Emergency Reconstruction Project became effective in August 1994 (US$128 million), the Health I Project (US$40 million) in August 1995 and the Highway Sector Project (US$80 million) in July of the same year. An Emergency Reconstruction Project (US$128 million) became effective in June 1994, a Farmer Support Service Project (US$17 million) and a Technical Assistance Support Loan I (US$5 million) in July 1996. An Emergency Transport and Mine - Cleaning Project (US$102 million) became effective in March 1997 and in addition, a Coastal Forest Reconstruction and Protection Project (US$42 million) in July 1997 and an Enterprise and Financial Sector Adjustment Loan (EFSAL) (US$95 million) in November 1997. Furthermore, an Investment Recovery Project (US$30 million) became effective in March 1998 and the Eastern Slavonia Reconstruction Project (US$40.6 million) in January 1999. The Municipal Environmental Infrastructure Project (US$36.3 million) was approved in June 1998, the Railway Modernization and Restructuring Project (US$ 101 million) in January 1999, a Technical Assistance Loan II (US$7.3 million) in April 1999 and the Health System Project (US$29 million) in October 1999.

3. Projects under preparation include: the Kastela Bay Cultural Heritage Project, a Trade and Transport Facilitation in Southeast Europe/SECI Project (regional project with participation of Croatia), a Bankruptcy Technical Assistance, a Registry/Cadastre Project and a GEF activity. Furthermore, projects on the Pension System, District Heating, the Gas Sector and Rijeka Port are under consideration. If requested by the authorities, the Bank would be ready to support structural reforms through adjustment lending, provided that satisfactory agreement can be reached on measures in key areas, including the reduction of the size of the public sector (including the pension and health sector reforms), banking/financial sector reforms and privatization, restructuring and privatization of utilities, and governance and judicial reforms to improve the enabling environment for private sector activity.

4. The World Bank staff is preparing a white paper to provide economic policy guidance to the incoming government. Its macroeconomic and exchange rate policy advice will be based on input from the Fund staff.

5. IFC has approved seven investments in Croatia to date: (1) the acquisition of a US$2.6 5illion equity stake in a Croatian bank; (2) a US$10.8 million loan investment in a cement company; (3) a US$4 million loan to a small regional bank based in Split, for the financing of small and medium-sized enterprises; (4) a US$6.2 million equity investment and a US$14.1 loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility; (5) a US$5.0 million equity investment in a venture capital fund; (6) a US$15 million loan to a regional bank

for a credit line for onlending to small and medium-sized enterprises; and (7) a US$3 million equity investment in a pension management company to be founded under Croatia's landmark pension reform law. The IFC is seeking to expand its activities in Croatia. It is targeting projects in the manufacturing and financial sectors, the support of small and medium-sized private enterprises, and the rehabilitation and modernization of the tourism sector.

CROATIA: STATISTICAL ISSUES

1. The economic database in Croatia is of mixed, though improving, quality. Data on monetary aggregates have the least problems and are close to Fund standards. In other areas, major deficiencies and excessive delays in data release could impact the reliability and timeliness of macroeconomic analysis. In most cases, however, remedial action has been taken to improve data quality, coverage and reliability, but in some instances progress has been impeded by insufficient budgetary support.

A. National Accounts

2. National accounts (NA) data systems have undergone substantial improvement since the last Article IV consultation, enabling publication of a broader, and more comprehensive, set of NA data. The Croatian Bureau of Statistics (CBS) compiles and publishes annual constant and current price data according to the production, income, and expenditure approaches. The CBS also published on June 30, 1999 quarterly GDP data by expenditure and main industry groupings at current and constant (1997) prices, thus meeting the SDDS target date. Seasonally adjusted quarterly constant price production side estimates are also available. Nonetheless, shortcomings remain which limit the coverage and hinder the reliability of the estimates. These include: a lack of quarterly source data for the seasonally volatile agricultural sector; incomplete coverage of the informal sector; only partial conversion of government finance statistics from a cash to an accrual basis; insufficient access to preliminary or unpublished source data; inadequate source data for measuring changes in inventories; inadequate price deflators; and incomplete coverage of unincorporated businesses and the self employed (farmers, trade and crafts).

B. Prices

3. The CBS produces monthly indices of retail and producer prices, and a monthly cost of living index based on the consumption basket of a typical low-income, non-farm household. Data is collected around the 20th day of each month, and the indices are released on the last working day of the month. However, the price statistics are calculated using outdated weights on the basis of a small sample of observations. No import or export price deflators are produced, thereby hindering analysis of external sector developments.

C. Wages and Employment

4. Croatia produces data on average net and gross earnings per person in paid employment by industrial sector, and employment by industrial sector. Earnings data include bonuses, sick pay, and meal allowances, and are based on monthly surveys covering 70 percent of workers in permanent employment in each industrial category. It does not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, farmers, and military and police workers.

5. The number of registered unemployed overstates the actual level of unemployment. A preliminary Labor Force Survey, which meets ILO standards, was conducted on 7,200 households in 1996. The sample was expanded to 10,450 households in 1997, and concluded that the unemployment rate was 9.9 percent against a registered unemployment rate of 16.5 percent. The CBS has carried out semi-annual Labor Force Surveys since June 1997.

D. Fiscal Data

6. A large amount of data on government finance statistics is produced on a monthly basis with lags of between three and twelve weeks, and is available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data on a GFS basis is reliable and available on a next-day basis by request for most major categories for both the budget and the extrabudgetary funds. Expenditure data on a cash basis is available according to GFS methodology (economic and functional classification) with extensive disaggregation for the budget and the extrabudgetary funds. Both revenue and expenditure data are published in an unconsolidated and consolidated format. Data on expenditures financed by non-cash methods—which is thought to be an important component of total expenditure of the budget and extrabudgatary funds during certain periods—is not published, and the authorities are reluctant to provide this data to the staff. The reliability of fiscal statistics would be improved under a comprehensive treasury system.

7. Data on the stock of government debt, particularly the foreign component, suffer from certain deficiencies. Detailed data on domestic public debt are published in the Monthly Statistical Review of the Ministry of Finance. However, comprehensive external debt and historical domestic debt data are not reported. Data on expenditure arrears is not available, while domestic debt data exclude promissory notes issued by the government.

8. Local government and consolidated general government data are published on a yearly basis in the Annual Reports of the Ministry of Finance. Croatia is a regular reporter of fiscal data for publication in the IMF's *Government Finance Statistics Yearbook* and *International Financial Statistics*.

E. Monetary Data

9. Data on the monetary survey and the balance sheet of the Croatian National Bank (CNB) and deposit money banks are published monthly with an approximate six-week lag. Key data such as currency in circulation, reserve deposits, and international reserves of the CNB are available on request with a one-day lag. A new statistical reporting system which enables banks to report in a single set of forms their balance sheets, reserve requirements, interest rates, etc, was introduced on July 1, 1999, together with a new chart of accounts for the central bank. In this connection, STA will undertake a review of Croatia's monetary data to ensure consistent classification of accounts between the new and old charts of accounts.

10. No attempt is made by the CNB or the Ministry of Finance to reconcile the data on net bank credit to government with government financing statistics.

F. Banking Statistics

11. Banks' lending and deposit rates are published monthly in the Monthly Bulletin of the CNB. Banks' annual financial statements tend to understate the riskiness of their assets by misclassifying loans to certain sectors and by booking "big bonds" (government bonds issued to clear outstanding enterprise debt) and other assets at face value even though some of these assets trade at a large discount. This produces a misleading picture of the quality of bank assets, leading to underprovisioning of bad assets and overstatement of capital adequacy ratios.

G. Balance of Payments Data

12. Balance of payments data are compiled on a quarterly basis according to the fifth edition of the IMF's Balance of Payments Manual, and published by the CNB making use of information from commercial banks, the CNB, and the Ministry of Finance, among other entities. The data are generally available with a lag of two to three months; however, trade data are available with a lag of four to six weeks and data on international reserves are available the next day by request. A major revision of balance of payments statistics took place in January 1998 which led to the valuing of imports on an f.o.b. basis and including in imports goods imported into free trade zones.

13. The coverage of external debt data improved in 1999 with the publication of information on external debt by debtor. A large part of Croatia's external debt was contracted prior to the dissolution of the former SFRY and Croatia's share was agreed with Paris and London Club creditors in 1995 and 1998, respectively.

H. Special Data Dissemination Standard

14. Croatia has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Fund's Data Standards Bulletin Board (DSBB). On the basis of the information provided by the authorities to the Fund and posted on the DSBB, Croatia is not in observance of the SDDS for the coverage and timeliness of the central and general government operations data and the coverage of the central government debt, interest rates, and share price index data. The Croatian authorities note, however, that daily calculations of long-term government bond yields cannot be performed due to the absence of market-traded long-term government debt and that a link at the web site of the CNB to the Zagreb Stock Exchange has been established which allows access to share price index data.

Table 7. Croatia: Core Statistical Indicators

As of December 9, 1999

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/Debt Service
Date of Latest Observation	December 9, 1999	November 31, 1999	November 31, 1999	November 30, 1999	October 31, 1999	December 8, 1999	November 1999	October 1999	June 1999	Sept. 1999	Q2 1999	August 1999
Date Received	December 9, 1999	December 7, 1999	December 9, 1999	December 9, 1999	December 9, 1999	December 9, 1999	December 8, 1999	November 30, 1999	Sept. 1999	Nov. 1999	Sept. 30	Nov. 1999
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Source of Update	CNB Website	Reuters	Croatian National Bank	Croatian National Bank	Croatian National Bank	Reuters	Reuters	Croatian Statistical Office	Croatian National Bank	Ministry of Finance	Croatian Statistical Office	Croatian National Bank
Mode of Reporting	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	Express Mail	On-line	On-line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

CROATIA: REVIEW OF FUND PROVIDED TECHNICAL ASSISTANCE

1. This appendix presents an assessment of the outcome of technical assistance (TA) provided to Croatia from the perspective of each of the TA-providing departments.

A. Statistics Department

Balance of payments statistics

2. Over the last two years, Croatia has received two technical assistance missions in balance of payments statistics; they took place in January 1998 and February 1999, respectively. The first mission set out to provide a more accurate measure of the current account balance and to review the results of the first phase of a work program that the Croatian National Bank (CNB) had initiated to improve the quality of balance of payments statistics in response to concerns raised by the 1997 Article IV consultation mission. The second mission was aimed at assessing and reviewing work undertaken in the second and final phase.

3. The first phase of the CNB's program sought to improve the compilation of the statistics by revising estimation methods based on existing data sources and making necessary classification and coverage adjustments. Additional sources of data were to be developed through new surveys.

4. The January 1998 mission significantly revised the current account results and thus sizably reduced the net errors and omissions item. It found that important improvements had been made in line with the first phase of the CNB program and assisted with this work. It reviewed new surveys (e.g., for direct and portfolio investment) that had been introduced and made recommendations for the second phase of the program.

5. The February 1999 mission found that all of the main requirements of the second phase had been implemented and major compilation advances achieved. These included the introduction of new surveys of transport enterprises, travel expenditures, and trade credit and expanded coverage of direct investment in enterprises. Reflecting the evolving and ongoing process of data improvement, it recommended some additional improvements in the statistics (e.g., the exclusion of valuation changes from official reserves data, and to make use of monetary survey data to improve figures on currency and deposits). As well, it recommended the implementation of several outstanding, albeit less important, recommendations of the January 1998 mission relating to embassy expenditures, labor income, and migrants' and other capital transfers.

6. The mission also took account of the increased policy interest in stock statistics and reviewed the compilation of international investment position (IIP) and external debt statistics. The authorities agreed to expand the coverage of stock data to include quarterly direct and portfolio investment data and to introduce a complete, quarterly IIP statement (including external debt data) by the end of 1999.

7. The findings of the missions indicate that the authorities have met the main objectives of technical assistance provided by STA. Against this background, it is no surprise that they have requested another mission in mid-2000 to review progress on the work underway, notably on the compilation of the quarterly IIP.

Real sector statistics

8. The Central Bureau of Statistics (CBS) began publication of quarterly national accounts at the end of June 1999, meeting the time frame for the SDDS. This was accomplished through a technical assistance project from STA that involved a sequence of six missions from July 1994 through June 1999. Several concerns are still outstanding from the June 1999 mission that may affect future estimates:

- Government payments arrears increased significantly in the latter part of 1998, widening the difference between government expenditures on a cash and an accrual basis and making the need for adjustments to cash basis data acute for the accuracy of the national accounts;

- Data from the Ministry of Finance that are needed by the CBS to convert government finance statistics from a cash to an accrual basis have not been forthcoming, much less timely; and

- The CBS must compile future quarterly national accounts data without the assistance of the Economic Institute of Zagreb (EIZ), which was responsible for most of the quarterly compilation work under a contractual arrangement with the CBS.

9. This last issue is significant because the CBS was unable to pay the EIZ for all contracted services, and consequently the final documentation of all sources, methods and assumptions for compilation has not been started.

10. A producer price statistics mission visited the CBS in July 1999 to provide assistance in updating and improving the producer price index (PPI). Although the CBS has a conscientious program underway to improve its price indices, the mission identified several deficiencies with the PPI including small sample sizes, out-of-date weights, the need for more detailed product specifications, improvements for the treatment of missing prices, and better procedures for introducing new weights into the index. Continued government support for this effort will be needed for its success.

11. There are no more resources for additional technical assistance missions to Croatia in the current Regional Allocation Plan.

Money and banking statistics

12. STA technical assistance to Croatia in monetary statistics was provided in December 1992 (multisector statistics mission headed by Mr. Pownall) and April 1994 (money and banking statistics mission by Mr. Merris). All the recommendations of these missions have

been implemented, which led to the introduction of an *IFS* page for Croatia in September 1995. To date, Croatia reports money and banking statistics for *IFS* publication on a regular and timely basis. There are no major data issues.

B. Fiscal Affairs Department

13. The volume of technical assistance provided by FAD to the Croatian authorities has been fairly modest in recent years, with a total of five missions since 1993, the latest carried out in June-July 1997. The 1997 mission, which in part built on a previous 1993 mission on the implementation of a VAT, assisted the authorities in estimating the economic effects of introducing a VAT to replace the existing sales taxes. The mission also offered advice concerning the rate structure and the tax threshold. The VAT introduced in January 1998 was broadly in line with the recommendations given, perhaps with one notable exception: the VAT threshold actually chosen was about 1/5 of what the mission had recommended, with the result that a large number of small traders were captured in the tax net. Presumably, this has put some pressure on the tax administration without having had any noticeable positive impact on the tax yield. The EU1 mission was asked to pursue this issue and probe whether the low threshold has, in fact, burdened the tax administration with minimal benefits in revenue terms.[1]

C. Monetary and Exchange Affairs Department

Past experience

Assessment

14. The operations of the Croatian National Bank (CNB) are very uneven. Its Research and Statistics Departments are outstanding and its formulation and implementation of monetary policy has been relatively successful. The development of banking supervision has been unnecessarily slow but has made significant progress. Dealing with banking sector problems has taken up considerable staff and management time, and has been characterized by an unwillingness to take early corrective actions, largely as a result of political considerations and pressures. However, during 1999, the CNB management has taken more determined steps in line with a banking sector strategy recommended by MAE. The CNB's accounting systems have made very good progress in 1998, while its internal audit unit remains weak. Information technology is strong but the steady improvement in its reserve management over the past few years has stalled recently.

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[1] The authorities informed the mission of their intention to consider raising the VAT threshold in 2000, but the lower than recommended threshold was viewed as less of a problem than issues of compliance (especially in agriculture) and the recent zero rating of selected items. The introduction of zero rating, which had been opposed by the Finance Ministry, was contrary to FAD advice.

15. Annual missions in the last three years have focused primarily on strengthening the banking sector, including the adoption of a new banking law drafted with IMF assistance. MAE has also offered advice in the areas of money and government securities markets development, and monetary policy instrument design.

16. A program to develop a new chart of accounts and modernize accounting systems got off to a poor start in 1997 with a series of short-term expert visits as a result of the failure of the expert and his counterpart to establish a mutually acceptable working relationship. The placement of a different, long-term accounting expert from March 1998 to March 1999 (with several follow-up short-term visits) completed the project very successfully.

17. The Department of Foreign Exchange Operations and Reserve Management has received a relatively large number of short-term expert visits (provided by staff of the Bank of Israel) over the last three years, also with generally good results. The experts have been good and well-received. Earlier progress has more recently stalled as a result of weakened management after the Executive Director of the Department was temporarily reassigned to oversee the administration of a failed bank.

18. The area of banking supervision has been particularly difficult. For several years, despite considerable technical assistance from USAID, the World Bank and the Fund, resistance to change toward modern systems of supervision from the Director of the Banking Supervision Department (since replaced) greatly slowed progress and discouraged foreign advisors. The occasional withdrawal of USAID advisors, in support of other (unrelated) U.S. foreign policy objectives, also undercut TA efforts in this area. One recent long-term MAE resident advisor and one short-term MAE resident advisor visiting for relative long periods have made positive contributions, which, however, fell short of expectations.

19. Payment system reform has progressed very slowly, but new RTGS and clearinghouse systems are now in place. However, banks still have not been permitted to provide domestic payment services and the domestic payment law remains to be enacted.

Analysis of results

20. Progress toward the goal of a well functioning modern central bank, while impressive in some areas, has been slow and disappointing in others due to weak management in some areas and the diversion of some strong managers to deal with emergencies (failed bank administration). At the highest level, the CNB has always been very cooperative and receptive to TA advice. However, providing TA to the CNB has often been difficult because of differences in views between experts and middle management over the appropriate role of advisors. CNB managers expect advisors to perform the needed work themselves, while some experts preferred to limit their participation to advice. The most successful projects, such as (ultimately) accounting, were those in which the adviser participated quite actively in the work of the department (though less so than might have been desired by the CNB).

Future needs

21. Croatia will need to continue the development of its banking supervision. The CNB has finally adopted a strategic plan for the development of supervision as part of conditions for a second disbursement under a World Bank EFSAL, which should, if adhered to, provide better focus in providing further training and development of systems such as the offsite report and early warning system.

22. Some additional advice and training will be needed in the reserve management area. MAE has already committed to assisting with the drafting of a new central bank law in the Spring of 2000 to modernize this legislation and bring it in line with the new banking law, approved in December 1998.

23. Three other areas of possible assistance deserve consideration. Croatia needs a new domestic payment law, and payment system reform will not be complete until banks are providing domestic payment services. The functioning of the money and securities markets might also be reviewed in light of recent payment system changes. The internal audit function needs strengthening.

Statement by the Staff Representative
January 7, 2000

The following information, which does not change the substance of the staff appraisal, has become available since the staff report was issued.

1. A center-left coalition of Social Democrats and Social Liberals has won a decisive victory over the long ruling Croatian Democratic Union in the January 3 elections for the lower house of parliament. Together with a four-party electoral group led by the Peasant Party, the two parties intend to form a coalition government that would command an almost two-thirds majority in the lower house. Meanwhile, presidential elections have been scheduled for January 24, with February 7 as a possible runoff election date.

2. According to preliminary data released this week, real GDP continued to contract in the third quarter of 1999, falling by 0.8 percent year on year. As this decline is less than projected by the consultation mission, GDP may have declined in 1999 as a whole by less than the 2.1 percent envisaged in the staff's macroeconomic scenario. During the first eleven months of 1999, industrial production dropped 2 percent relative to the same period in 1998.

3. In September, net wages were 11.4 percent higher than one year earlier. Retail price inflation continued to decline, to 4.3 percent year on year in November, while the exchange rate depreciated by 0.6 percent against the euro and 4.3 percent against the U.S. dollar during November-December.

4. As noted in footnote 13 of the staff report, in late 1999 the authorities secured some US$325 million in additional foreign financing relative to the assumptions underlying the staff projections. Mainly for this reason, gross reserves equaled US$3,020 million at year-end, compared with the projected US$2,773 million, and net usable reserves stood at US$2,027 million, or 150 percent of base money, compared with the projected US$1,723 million and 128 percent, respectively. Higher official reserves coincided with a stronger demand for base money, which rose by 3.9 percent December on December, compared with the projected 1.1 percent.

5. Reflecting both higher expenditures and lower current revenues than envisaged in the staff projection, the central government cash balance for October-November was some HrK 1 billion (0.7 percent of GDP) lower than expected. However, the additional foreign financing covered the increase in the deficit and permitted repayment in full of loans from the Croatian National Bank and lower recourse to domestic bank credit than projected.

6. The sale of a 66.3 percent share in state-owned Privredna Banka, the second largest bank, to Banca Commerciale Italiana last month, noted in footnote 30 of the selected issues paper, yielded € 301 million (1½ percent of GDP), which will be disbursed early this year. Meanwhile, bidding for the sale of Riječka Banka closed on December 22.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/4
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Croatia

On January 7, 2000, the Executive Board concluded the Article IV consultation with Croatia.[1]

Background

Until recently, Croatia's economic performance was the envy of many countries in transition: a successful stabilization effort in late 1993 was followed by virtual price stability and real GDP growth of 6 percent a year during 1994-97. However, the mostly domestic demand driven expansion was accompanied by burgeoning imports, while exports stagnated as wage increases outpaced productivity gains. As a result, the external current account deficit widened to 11 ½ percent of GDP in 1997 and external debt increased by 9 percentage points to 32 percent of GDP. A tightening of monetary policy late in the year and again in early 1998 resulted in a 4 ½ percentage point improvement in the current account in 1998. A revenue windfall stemming from the introduction of the VAT in January 1998 also contributed to the external improvement.

While macroeconomic policy tightening helped reduce the current account deficit, it also contributed to the recession which began in the fourth quarter of 1998. The freezing of deposits in insolvent banks in the second half of 1998, the diversion of liquidity to purchase foreign currency for speculative purposes, and inadequate restructuring of public and privatized firms led to a rapid accumulation of arrears, which rose to 10 ½ percent of GDP at end-1998 and to 16 ½ percent of GDP in mid-1999. These structural problems reinforced the impact of the restrictive macroeconomic policy stance, causing real GDP to fall by 4 ¼ percent (year on year) in the last quarter of 1998 and by 1 percent in the first half of 1999. This, together with modest growth in exports, reduced the

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

external current account deficit further in the first half of 1999, although external debt continued to rise, reaching 38 ½ percent of GDP by mid-1999.

Monetary tightening, the weak economy, and a drying-up of repatriated foreign savings exposed the underlying insolvency of a group of rapidly growing banks. The Croatian National Bank (CNB) intervened in 17 distressed banks—accounting for 17 percent of bank assets—during 1998 and the first half of 1999. Most of these banks are facing bankruptcy proceedings, while three banks are under CNB administration, and a solution avoiding bankruptcy is being sought for three politically sensitive banks. About 80 percent of deposits in the banks undergoing bankruptcy (about 5 ½ percent of broad money and 2 ¼ percent of GDP) are covered by deposit insurance, with the payouts to be funded by the budget.

A relaxation of fiscal policy and intensifying problems in the banking sector led to exchange market pressures in late 1998 and early 1999. Increased public spending for social services and benefits, reconstruction of war-damaged housing and infrastructure, an ambitious road-building program, large civil service wage increases, and new payment arrears more than offset the large VAT revenues and resulted in a deficit of 1 ½ percent of GDP on an accrual basis in 1998. The fiscal stance eased further in early 1999 as spending increased while revenues dropped against corresponding bases. The easing of fiscal policy and concerns about the soundness of the banking sector caused the kuna to depreciate by nearly 10 percent against the deutsche mark/euro between August 1998 and March 1999, despite heavy foreign exchange sales. Nonetheless, thanks to an increase in foreign currency liabilities to domestic banks, the CNB's net international reserve position was nearly unchanged in the year to March 1999.

Notwithstanding a modest improvement in competitiveness following the kuna depreciation and continued labor shedding, export performance remained poor. Depreciation coupled with structural reductions in employment more than offset a 10 percent increase in gross industrial wages, generating a 3 ½ percent depreciation in the unit labor cost based real exchange rate vis-a-vis Germany during 1998 and the first quarter of 1999. Nonetheless, exports failed to respond as Croatia is not a participant in preferential trade agreements and its product variety and quality have been slow to adapt to the demands of new foreign markets.

Concerns about the depletion of usable reserves, insufficient external financing, and depreciation of the currency led to a renewed tightening of macroeconomic policies in the second quarter of 1999. Following an increase in reserve requirements and official interest rates, and sharp restrictions on credit expansion—especially to the budget—the exchange rate stabilized. In addition, the budget was tightened in June to produce a consolidated central government deficit of 1 percent of GDP for 1999, following a deficit of over 5 percent of GDP on an annual basis in the first half of the year. The main features of the budget revision were a downward revision of tax revenues, a 10 percent reduction in discretionary current spending, a 25 percent cut in most capital spending, and larger receipts from privatization to finance deposit payouts. However, the revised budget retained a 17 ½ percent increase in civil service wages and allowed for the payout of only about a third of insured deposits in1999. Excluding one-off factors, the revised budget implied an underlying adjustment in expenditures of 2 percentage points of GDP in the second half of 1999.

The recession that began in late 1998 is likely to extend through at least the end of the year, and real GDP is expected to contract by 2 percent in 1999. The outlook for 2000 is, however, brighter and a recovery propelled by exports, private consumption and investment could see growth recover to 2 ½ –3 percent.

Executive Board Assessment

Executive Directors noted that following several years of favorable economic performance, the economy had recently fallen into recession. The new government faced daunting challenges—including an insufficiently flexible domestic economy and a still unsustainable external imbalance. However, Directors saw opportunities for a new start. There was some prospect for a resumption of positive economic growth, facilitated by the revival of external demand, the recent real effective depreciation of the currency, and a recovery of confidence in the wake of the parliamentary and presidential elections. But Directors stressed that to realize this growth and to make it durable, the new government would need to adopt policies that stabilized the external current account deficit at a more sustainable level.

On fiscal policy, Directors noted the need for a cut in expenditures sufficient to balance the budget and make room for a reduction of nonwage labor costs. The need for durable expenditure cuts was all the more urgent as privatization proceeds would dry up soon after the sale of a few large state enterprises and financial institutions. To this end, the authorities should undertake an early public expenditure review; hold the line on government wages, which had just been increased sharply in real terms; and guard against an erosion of VAT revenues.

Directors emphasized that the task of restoring fiscal balance could not be accomplished without redressing the finances of the pension and health care systems. Given the large increase in spending on social welfare in recent years and the need to reduce nonwage labor costs, they urged the authorities to implement a comprehensive pension reform and to adopt promptly a health care reform.

Directors called for greater fiscal transparency and accountability by improving the classification and presentation of fiscal data; establishing a single treasury account; and strengthening oversight by branch ministries of the extrabudgetary funds.

Directors noted that an adequate level of competitiveness was essential for strengthening the external current account and boosting growth and employment. While noting that the gradual depreciation of the past year appeared to have broadly improved competitiveness, Directors underscored the importance of wage restraint in sustaining the newly acquired level of competitiveness and in reactivating the economy and boosting employment.

As regards the exchange rate, Directors noted the continued preference for exchange rate stability. This had served Croatia well, and the authorities had skillfully managed a measured real effective depreciation that would facilitate an eventual economic recovery. They agreed that a sudden depreciation now, when economic agents were still adjusting to the gradual depreciation over the past 15 months, could jeopardize price stability and could undermine economic recovery by weakening unhedged balance sheets and raising the cost of servicing foreign-exchange denominated debt. But Directors stressed that tight fiscal policy, wage restraint, and greater economic efficiency through privatization and structural reform will be required to ensure that this strategy is viable. They recommended that, to the extent permitted by their exchange rate objective, the monetary authorities should strive to lower reserve requirements, and raise the remuneration on requirements for local currency deposits to ease their burden on the banking system and to facilitate the reversal of currency substitution.

Directors agreed that structural reform was another essential dimension in any successful strategy for renewed growth. They welcomed the recent acceleration of privatization efforts, and encouraged the authorities to press ahead with further sales of state enterprises and financial institutions.

Directors welcomed the steps taken to improve the soundness of the financial sector, and of the banking system in particular. They noted that strengthening confidence in the system will require that the payout of insured deposits in the failed banks be completed soon, and that quick solutions be found for a few troubled banks. Directors encouraged the CNB to further strengthen its supervisory capacity, enforce prudential regulations more strictly, and strengthen the overall regulatory system.

While Croatia's statistics are generally adequate for surveillance, Directors encouraged the authorities to redouble their efforts to improve economic data, in particular by providing fiscal arrears data, and improving timeliness and quality of data needed to assess banking system soundness.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 1999 Article IV consultation with Croatia is also available on the IMF's website (http://www.imf.org).

Croatia: Selected Economic Indicators

	1994	1995	1996	1997	1998	1999	1/	2000	1/
Real economy									
Real GDP (percentage change)	5.9	6.8	6.0	6.5	2.5	-2.1		2.9	
Unemployment rate (average; percentage of labor force) 2/	14.5	14.5	16.4	17.5	17.2	20.1	4/	...	
Nominal gross wages (percentage change; period average)	...	34.0	12.3	13.1	12.6	10.4	5/	...	
Retail prices (percentage change; end of period)	-3.0	3.7	3.4	3.8	5.4	5.0		3.5	
Gross national saving (percent of GDP)	23.1	9.9	16.3	16.6	16.1	18.3		19.7	
Gross domestic investment (percent of GDP)	17.4	17.6	22.1	28.2	23.2	24.8		24.7	
Public finance (percent of GDP)									
Central budget (cash basis)	0.6	-0.7	-0.1	-0.9	0.9	-0.1		-0.2	
Excluding privatization	0.2	-1.3	-1.2	-1.3	-0.4	-4.3		-3.7	
Consolidated central government (cash basis) 3/	1.6	-0.9	-0.4	-1.3	0.6	-0.7		-1.1	7/
Excluding privatization	1.2	-1.7	-1.6	-2.5	-1.0	-4.9		-4.9	
Money and credit (end of period; percentage change)									
Broad money	74.5	40.2	49.3	38.4	13.0	-3.7		15.5	
Credit to consolidated central government	-18.1	-3.0	-3.5	-49.9	-2.7	19.7		38.0	
Other credit	36.3	18.6	3.1	44.4	22.4	-2.8		5.8	
Average deposit money banks' credit rate (end of period; percent	15.4	22.3	18.5	14.1	16.1	14.0	6/	...	
Balance of payments									
Trade balance (percent of GDP)	-8.0	-17.4	-18.6	-26.1	-19.1	-17.6		-17.5	
Current account balance (percent of GDP)	5.7	-7.7	-5.8	-11.6	-7.1	-6.5		-5.0	
Total external debt (percent of GDP; end of period)	22.5	20.8	23.2	31.9	37.1	39.0		36.5	
Gross official reserves (US$ million; end of period)	1,405	1,895	2,314	2,539	2,816	2,783		2,890	
Reserve cover (months of imports of goods and services)	2.5	2.4	2.8	2.7	3.2	3.4		3.4	
Exchange rates									
Exchange rate regime			Other managed floating						
Present rate (December 17, 1999)			HrK 7.555 per US$1						
Nominal effective rate (1995=100; end of period)	96.8	99.1	101.0	102.8	98.0	99.8	6/	...	
Real effective rate (1995=100; end of period)	97.6	98.6	99.8	101.6	100.0	102.7	6/	...	

Sources: Croatian authorities; IMF Information Notice System; and IMF staff estimates.

1/ Staff macroeconomic scenario, unless otherwise indicated.

2/ Registered average unemployment rate. According to new Labor Force Survey (based on ILO standards), the unemployment rate was 10.0 percent in November 1996 and 12.6 percent in the first half of 1999.

3/ Including extrabudgetary funds.

4/ In October 1999.

5/ In January-August 1999.

6/ In September 1999.

7/ Includes the cost of introducing the second pillar of the pension system in mid-2000, estimated at 0.9 percent of GDP.

Statement by J. de Beaufort Wijnholds, Executive Director
for Republic of Croatia
January 7, 2000

Staff has written a very candid but fair report on Croatia's economy. The focus on vulnerabilities and ample use of cross country analyses will constitute an important input for the still to be formed government. Indeed, it would be highly desirable if the degree of frankness, indispensable for this Board to focus on the most pressing issues, were copied in the staff reports for all other countries, including larger ones. The authorities' intention to publish the staff report is testimony to Croatia's increasing transparency and its continuing dialogue with the international community, including the private sector, as to the optimal policies to be followed. On behalf of the authorities I wish to thank staff for their continuous analytical support and their role as a sounding board and economic policy sparring partner.

In many respects Croatia's economy can look confidently ahead into the new year. Monetary and exchange rate policy is in the hands of a highly competent central bank, which has managed to keep inflation below 5.5 percent since 1994. As the staff report notes this is an exceptional performance among transition economies, and has contributed importantly to the prolonged period of exchange rate stability. In addition, monetary policy has been supported by prudent fiscal policy, with the consolidated central government balance not exceeding –1.3 percent GDP since 1994, well below, for instance, the average of the European Union in that period.

Confidence with respect to Croatia's outlook is also shared by foreign investors. The privatization of Hvratska Telekom and sale of a 35 percent stake to Deutsche Telekom (equivalent to roughly 4.2 percent GDP) was highly successful; bond spreads are coming down as evinced by the December Samurai bond issue of Yen 25 billion (roughly $ 250 million, or 1.2 percent GDP), with a coupon of 4 percent and a maturity of 5 years to which Standard & Poor's assigned its triple-'B'-minus investment grade rating; and following the electoral outcome spreads on Series B bonds have tightened further from 390 basis points to 360 basis points. This confidence is – and I am quoting the rating report of Standard & Poor's - driven by "the government's recent initiatives to step up structural reform through accelerated large-scale privatization and liquidation of failing banks (..), a relatively manageable, although increasing, government debt burden (..) and prudent monetary management".

What may also have enhanced confidence in Croatia is the sharp decline in the current account deficit. This has come down from – 11.6 percent GDP in 1997 to roughly – 6.5 percent GDP this year. The scenario for next year is that it will further decline to – 5 percent GDP. Although this is still sizeable, I would note that staff projects this deficit to be entirely covered by foreign direct investment in 2000. In addition, Croatia has almost no short term debt. The staff report notes that the short-term debt to reserves ratio is projected at 88 percent in 1999. As staff notes, however, this ratio is on a 'residual maturity basis' and the short-term debt consists primarily of medium and long term debt falling due. Indeed, on an 'original maturity basis' (i.e. ignoring the medium and long term debt falling due), short term debt would amount to only 10.6 percent of gross reserves and 14.3 percent of gross official usable reserves.

Like many other transition economies, Croatia faces important structural challenges. Interestingly, there is near consensus among both the government and the opposition parties as to what the structural problems are and the need to resolve them.

First, while macro-economic management has been sound, there is a realization that this performance is increasingly burdened by the rising transfers to the pension and health funds, where there has been a growing asymmetry between the expenditures and revenues of these funds. Importantly, however, Croatia is in the midst of fundamental pension reform which will shift the PAYG system to a more fully funded one.

Second, the legacy of pre-independence central planning has been a weak banking sector. Here, however, the central bank has acted decisively intervening in no less than 14 banks (8 of these have now been declared bankrupt, for 3 the bankruptcy request is pending and 3 have been put under special administration) and putting an additional 11 under enhanced supervision. This comprehensive reform has been greatly aided by the new banking law passed by parliament in December 1998, which has removed important impediments for CNB to exercise its supervisory responsibilities. Thanks to these changes, I believe it is fair to say that the banking sector has moved from the emergency room to the recovery room. This will be further aided by the continued foreign interest in Croatia's banking sector bringing capital, expertise and competition. Three small banks were taken over by foreign banks since October, in addition to the sale of 66 percent of PBZ– the second largest bank in Croatia - to an Italian bank.

The third main challenge, and perhaps the most difficult one, remains enterprise and corporate restructuring. This will be essential to boosting Croatia's exports and further bringing down the still sizeable current account deficit. As the selected issues paper points out, however, Croatia's sluggish exports may have been due not so much to lack of their competitiveness but to their relative lack of market access to their main trading partners, most notably the EU and the CEEC countries (what could have been added is that Croatia suffered significantly from the Kosovo crisis, which severely dented tourism receipts). In contrast, Croatia's own trade regime is already more open, with an overall rating of 2 on the 10-point Fund index of trade restrictiveness (below the average of 2.7 for CEEC's and 4 for the EU). It is hoped that Croatia's accession to the WTO (which is beyond the authorities control) will soon allow it to negotiate new trade arrangements with the EU and CEFTA. Accession to the WTO would also make Croatia's tariffs one of the lowest among the CEEC's.

Finally, I want to inform the Board on the proposed decision to approve an exchange restriction falling under the jurisdiction of Article VIII. This has come as a complete surprise to the authorities. Not once in any of the IMF staff reports or staff missions since 1991 (including the most recent one) have the authorities been advised, either in written form or otherwise, that the "Law on the Transformation of Household Foreign Exchange Deposits into Public Debt of the Republic of Croatia", could in any way constitute an exchange restriction. Foreign exchange arising from household foreign exchange savings deposits were not available to Croatian banks after the breakup of the former SFRY since these funds remained in the former National Bank of Yugoslavia. To prevent a bank run the Croatian government took over the claims of the former central bank and transformed them into time-deposits. Data for June 30, 1999 indicate that the amount of frozen foreign exchange deposits has gone down considerably (approximately 87 percent of 'frozen deposits' claims have been settled, i.e. these deposits amounted to $ 3,293 million on December 31, 1991 and the balance on June 30, 1999 was $ 421 million). It is extremely difficult, if not impossible, to determine if, among the outstanding frozen deposits, income is included that was generated from current account transactions. Indeed, the staff report notes that this 'may' be the case. In addition, foreign exchange regulations currently in force do not contain any provision which imposes restrictions on the transfer of interest. For this reason, the authorities have asked staff and management to reconsider its finding that Croatia maintains an exchange restriction.