

Republic of Croatia: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 5, 2002**, with the officials of the Republic of Croatia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 17, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **August 5, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 5, 2002 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Croatia.

The document(s) listed below have been or will be separately released.

Selected Issues and Statistical Appendix
Financial System Stability Assessment

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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REPUBLIC OF CROATIA

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation
with the Republic of Croatia

Approved by Carlo Cottarelli and Shigeo Kashiwagi

July 17, 2002

The 2002 Article IV discussions were held in Zagreb during May 23-June 5, 2002. The mission comprised Messrs. Flickenschild (head), Bonato, Konuki (all EU1), Dodzin (PDR), and Lybek (MAE), with Ms. Craig (EU1) as administrative assistant. Mr. Norregaard (resident representative) assisted the mission. Messrs. Wajid (MAE) and Martinez (World Bank) joined the mission to discuss the draft FSAP report with the authorities. Mr. Faulend (OED) attended the meetings. The mission worked closely with World Bank staff.

The mission met with President Mesić; Prime Minister Račan; Minister of Finance Crkvenac; Croatian National Bank (CNB) Governor Rohatinski; Minister of Economy Vojković; Minister of Labor and Social Welfare Vidović; Minister of Health Vlahušić; Minister for European Integration Mimica; senior officials from these institutions and other government agencies; the leadership of parliament; and representatives of unions, employers, banks, and the academic community. The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

Croatia has accepted the obligations of Article VIII and is on a 12-month consultation cycle (Appendix II). It has subscribed to the Fund's Special Data Dissemination Standard (Appendix IV).

One of the principal objectives of the government is to advance membership in the European Union (EU). A Stabilization and Association Agreement was signed in October 2001 and is expected to be ratified by EU member countries by 2003. Due to disagreements within the five-party coalition, the government resigned in early July and a minority four-party coalition government is expected to be appointed soon, with no significant change in policies. General elections must be held by January 2004.

Contents		Page
I.	Background	4
II.	Responsiveness to Board Recommendations and Implementation of Stand-By Arrangement-Supported Program	11
III.	Policy Discussions	11
	A. Fiscal Policy	12
	B. Monetary and Exchange Rate Policy	15
	C. Structural and Trade Policies	17
	D. Financial System	18
	E. Statistical Issues	20
	F. Frozen Bank Deposits	20
IV.	Staff Appraisal	21
Text Boxes		
1.	Conclusions of the Financial System Assessment Program (FSAP) Mission	19
2.	Frozen Bank Deposits	20
Text Tables		
1.	Real GDP Growth, 1993-2002	4
2.	Consumer Price Inflation, 1993-2002	6
3.	Consolidated General Government Operations, 1999-2002	12
4.	Macroeconomic Scenario, 2002-2006	14
Figures		
1.	Real Gross Domestic Product, 1997-2002	4
2.	Real Sector Developments, 1996-2002	5
3.	Retail Price Inflation, 1996-2002	6
4.	Effective Exchange Rate, 1994-2002	6
5.	General Government Balance, Debt Stock, Expenditure and Net Lending, 1997-2001	8
6.	Exchange Rate Developments, 2001-2002	9
7.	Monetary Conditions Index, 1997-2002	10
Tables		
1.	GDP by Expenditure Category, 1999-2003	23
2.	Saving-Investment Balances, 1999-2003	24
3.	Balance of Payments, 1998-2003	25
4.	Central Government Fiscal Operations (SBA definition)	26
5.	Consolidated General Government Fiscal Operations	27
6.	Monetary Accounts, 1999-2003	28

7. Implementation of Performance Criteria, March 2002	29
8. Selected Indicators of External Vulnerability, 1998-2002.....	30
9. Selected Indicators of Financial Sector Vulnerability, 1996-2002	31

Appendices

1. Main Economic Indicators, 1995-2003.....	32
2. Relations with the Fund.....	33
3. IMF-World Bank Relations	38
4. Statistical Issues	47

Main Websites for Croatian Data

Data in this report reflect statistical information received by June 28, 2002. More recent data can be obtained from the following internet sources:

Croatian Bureau of Statistics.....<http://www.dzs.hr>

Croatian National Bank.....<http://www.hnb.hr>

Ministry of Finance.....<http://www.mfin.hr>

Ministry of Economy.....<http://www.mingo.hr>

Information on Croatian economic statistics
can be found at the Fund's Special

Data Dissemination Standard website<http://dsbb.imf.org/country.htm>

I. BACKGROUND

1. **Croatia experienced solid growth in the last two years, but unemployment remains high.** Following a brief recession in 1999, growth averaged 3.9 percent in 2000-01, outpacing both the euro area and EU accession candidates. Initially triggered by a resumption of tourist inflows after the cessation of hostilities in Kosovo, growth has increasingly been supported by private consumption and business investment, fueled by higher disposable income, lower interest rates, and improved confidence (Table 1). In spite of sizable job creation by small and medium sized enterprises, unemployment has not substantially fallen, reflecting ongoing restructuring and a growing labor force. After reaching 16.1 percent in 2000, the unemployment rate declined only slightly to 15.8 percent in 2001. Although high relative to the EU, unemployment is in line with other CEECs.

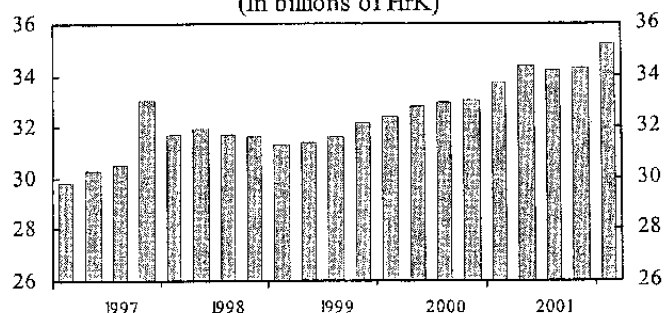
Real GDP Growth, 1993-2002
(percentage rate of change, annual averages)

	1993-95	1996-99	2000-01
Croatia	3.1	2.9	3.9
Euro area	2.0	1.9	2.6
EU accession candidates	2.9	2.3	2.6
World	3.4	2.9	3.6

Sources: WEO and Croatian Bureau of Statistics.

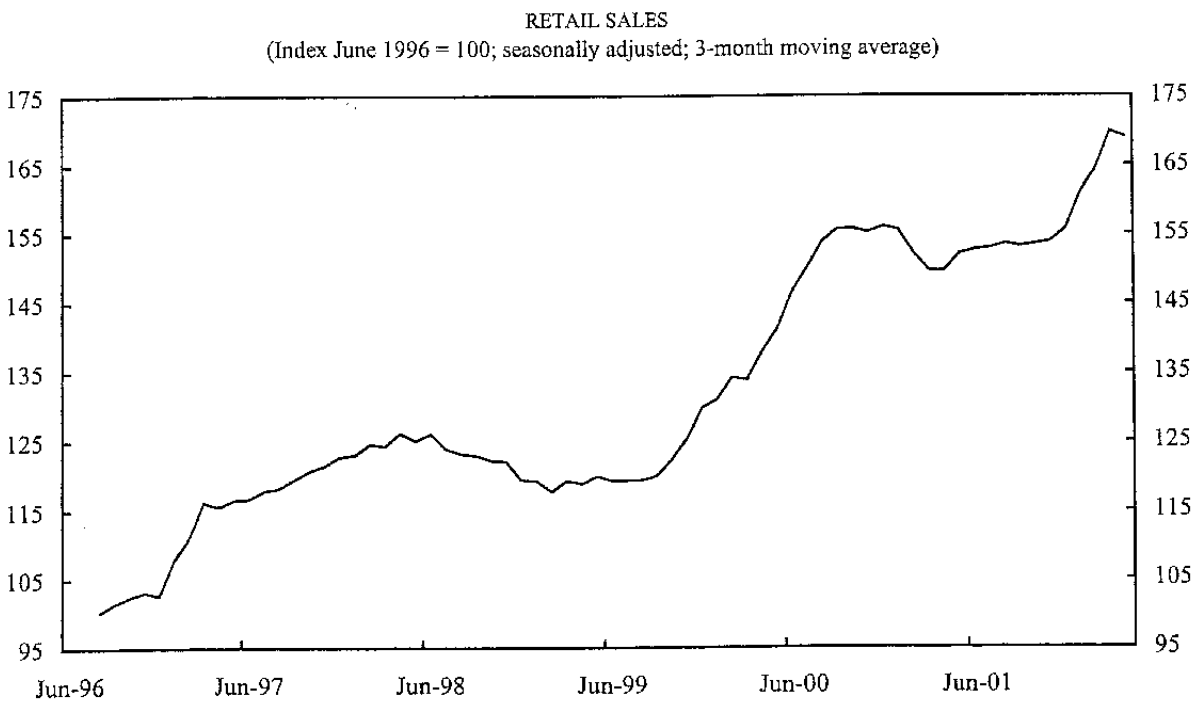
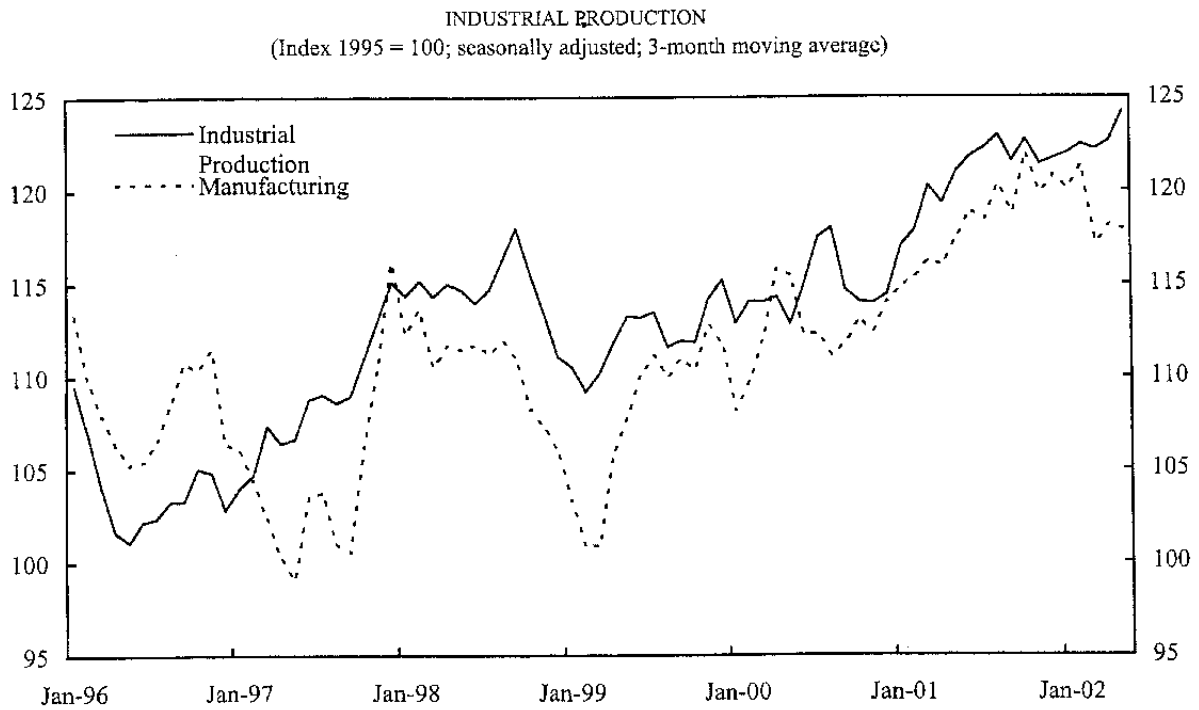
2. **The short-run growth outlook is favorable, but marred by uncertainty.** After a temporary deceleration at the end of 2001 in the wake of the slowdown in Europe, GDP grew by 4.6 percent year on year in the first quarter of 2002 amid signs of strengthening industrial production and retail sales (Figures 1 and 2). With recovery of net exports still lagging, economic activity is sustained by strong domestic demand. In spite of reduced government transfers and wage moderation, private consumption grew at an annual rate of 6 percent in the first quarter. In the same period, bolstered by brisk credit expansion and large public projects, investment growth reached 9.4 percent year on year. Even though private consumption is likely to decelerate in the second half of the year after a rapid increase in household indebtedness, growth should reach 3.5 percent in 2002, supported by an expected recovery in Europe and a good tourist season.

Figure 1. Croatia: Quarterly Real Gross Domestic Product, 1997-2002
(In billions of HrK)



Source: Croatian Bureau of Statistics.

Figure 2. Croatia: Real Sector Developments, 1996-2002



Source: Croatian Bureau of Statistics.

3. Exchange rate stability and structural changes have helped reduce inflation to below the euro area level.

Besides the success of monetary policy in maintaining a stable exchange rate, inflationary pressures are eased by trade liberalization, wage moderation, productivity increases, and enhanced competition in the retail sector. In May 2002, headline inflation fell to

1.8 percent—below the 2.0 percent registered in the euro area—despite sizable adjustments in administered prices. Also in May, core inflation was 1 percent and producer price inflation was a negative 1.2 percent (Figure 3). However, reflecting pending increases in household electricity and natural gas prices, inflation is expected to accelerate in the second half of 2002 to reach 3.5 percent on average.

4. Despite the revival of private investment and the initiation of large public infrastructure projects, the external current account deficit is small thanks to an increase in private saving (Table 2).

After rising to 3.1 percent of GDP in 2001, the current account deficit is expected to ease slightly to 2.8 percent of GDP in 2002 (Table 3). This projected improvement reflects several factors. Advance bookings suggest a strong tourist season while the opening of large retail stores is expected to continue reducing cross-border shopping. More generally, improvements in services and income are expected to offset a worsening

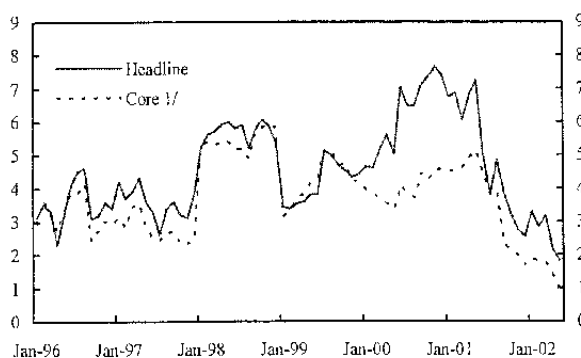
Consumer Price Inflation, 1993-2002
(In percent; annual averages)

	1993-95	1996-99	2000-01
Croatia	219.4	4.2	5.6
Euro area	3.2	1.6	2.5
Average of other CEECs 1/	36.6	25.0	11.5

Sources: WEO and Croatian Bureau of Statistics.

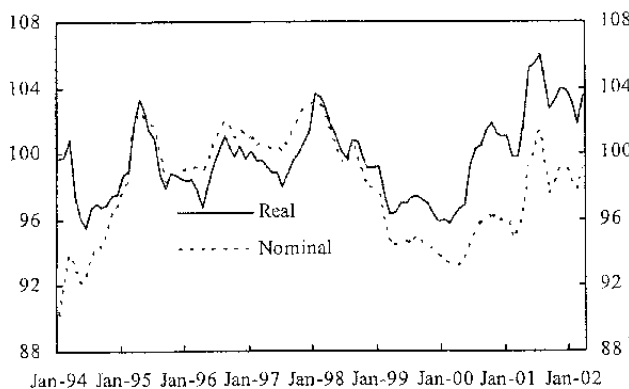
1/ Includes Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia.

Figure 3. Croatia: Retail Price Inflation, 1996-2002
(Annual percentage change)



Sources: Croatian Bureau of Statistics; and Croatian National Bank.
1/ Excludes energy and administered prices.

Figure 4. Croatia: Effective Exchange Rate, 1994-2002
(Index: 1995 = 100)



Source: IMF, Information Notice System.

merchandise trade balance, which reflects high investment activity. The competitiveness outlook remains positive. The CPI-based real effective exchange rate increased by less than 8 percent since January 2000 (Figure 4), but based on unit labor cost, competitiveness actually improved by more than 2 percent in the same period, and access to international markets is expected to expand further, reflecting the implementation of new free trade agreements.¹

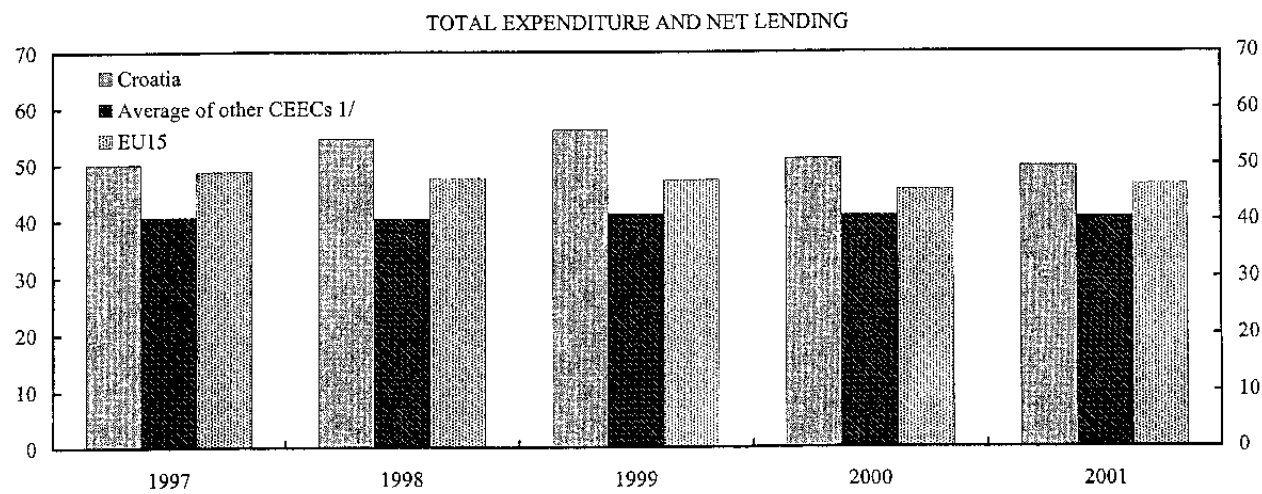
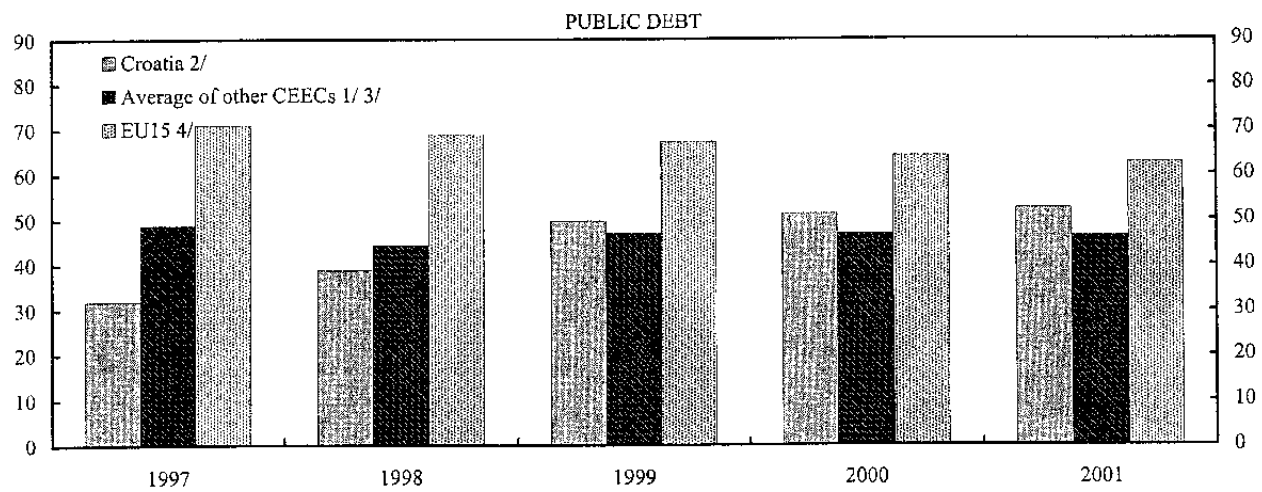
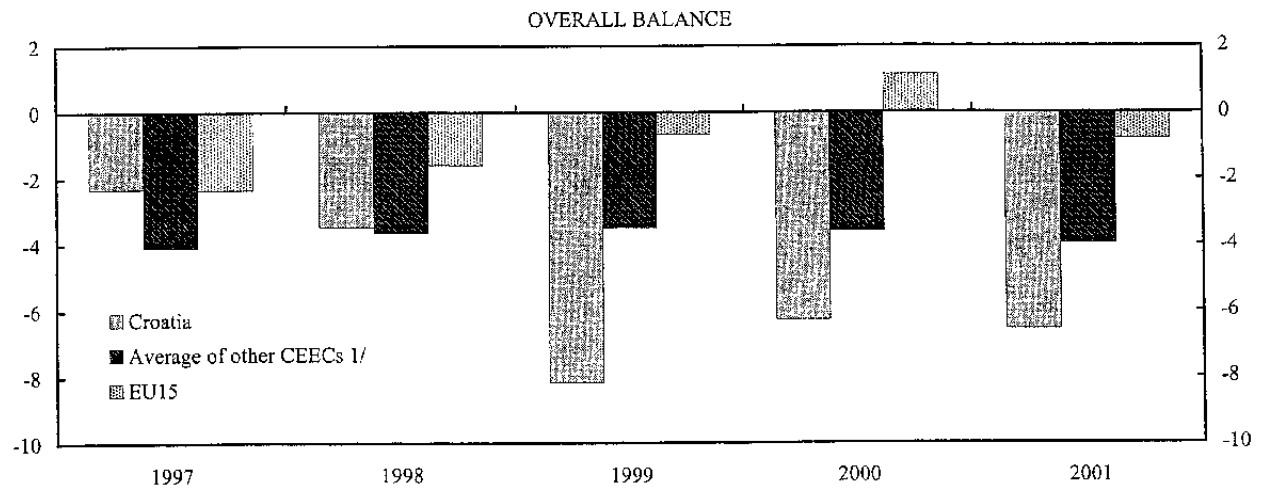
5. **While improving in 2000-01, the fiscal situation remains weak.** With the implementation of important reforms in public administration and social transfers, the fiscal deficit of the central government has been reduced from 7.4 percent of GDP in 1999 to 5.4 percent in 2001 (Table 4). In 2002, the authorities intend to lower the deficit to 4.25 percent of GDP. However, in light of some slippages in the first quarter (Section II), the attainment of this target is at risk. Moreover, expenditure outside the central government has been boosted by the launch of an ambitious highway construction project and the general government deficit is expected to remain unchanged at 6.6 percent of GDP in 2002 (Table 5, Figure 5). After rising by about 20 percentage points in 1997-2001, the public debt ratio is projected to approach 54 percent of GDP in 2002, and is bound to increase further without corrective action.

6. **Capital inflows are putting pressure on the exchange rate to appreciate.** Euro conversion, privatization receipts, and the placement abroad of government bonds more than financed the modest current account deficit, creating pressure on the kuna, which appreciated by some 13.5 percent against the dollar and by 3 percent against the euro between early February and early June (Figure 6). To stem these pressures, the Croatian National Bank (CNB)—traditionally keen to avoid large exchange rate swings—bought almost €600 million during February–June, and gross official reserves reached \$5,350 million (6 months of imports) in mid-June. In addition to the large accumulation of reserves, the external debt ratio declined in 2001 and is projected to decline further in 2002 (Table 3). Appreciation pressures are expected to peak during the tourist season. Seasonal fluctuations aside, the pressure from capital inflows is likely to persist in the medium term. While the remaining restrictions to short-term capital inflows will provide some protection, foreign direct investment inflows already amounted to 6.6 percent of GDP in 2001 and are expected to grow in the future, partly because of pending privatizations.

7. **In the context of low inflation and an appreciating exchange rate, monetary policy continues to be accommodating.** The CNB has been reluctant to fully sterilize its large foreign exchange purchases. The increase in kuna liquidity has reduced money market rates to below 2 percent, but lower inflation and an appreciating exchange rate have resulted

¹ See Selected Issues Paper.

Figure 5. Croatia: General Government Balance, Debt Stock, Expenditure and Net Lending, 1997-2001
(In percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

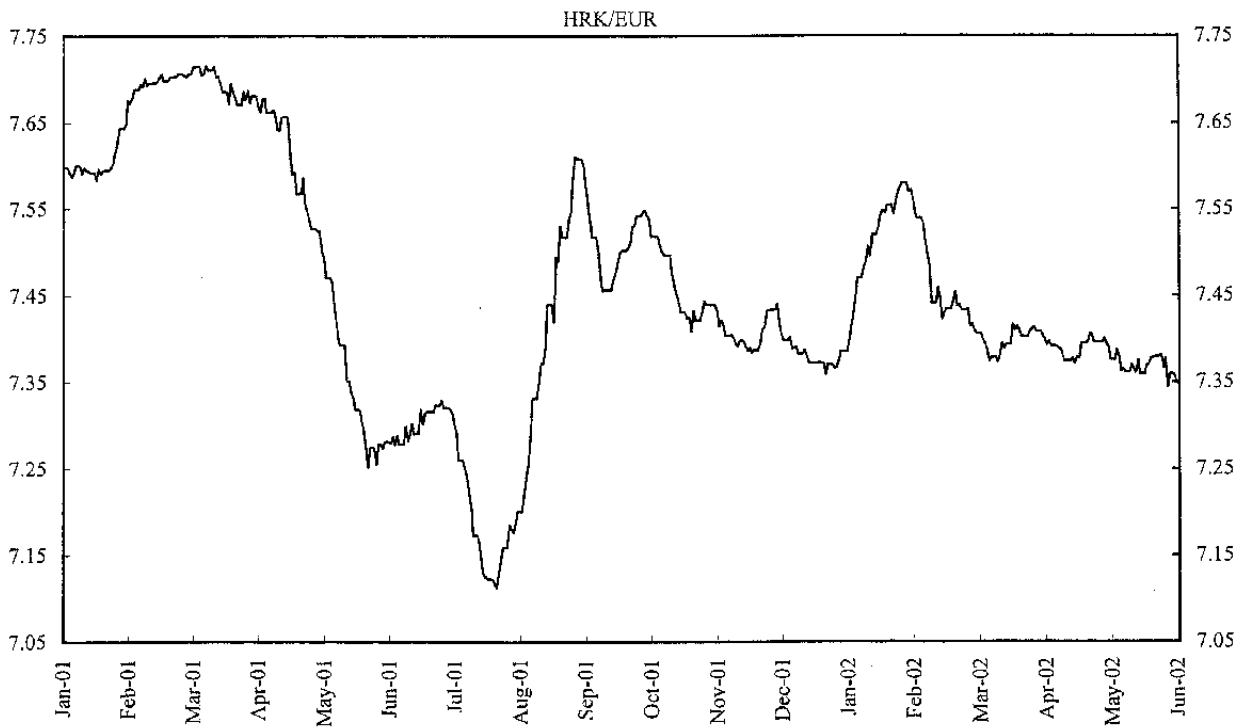
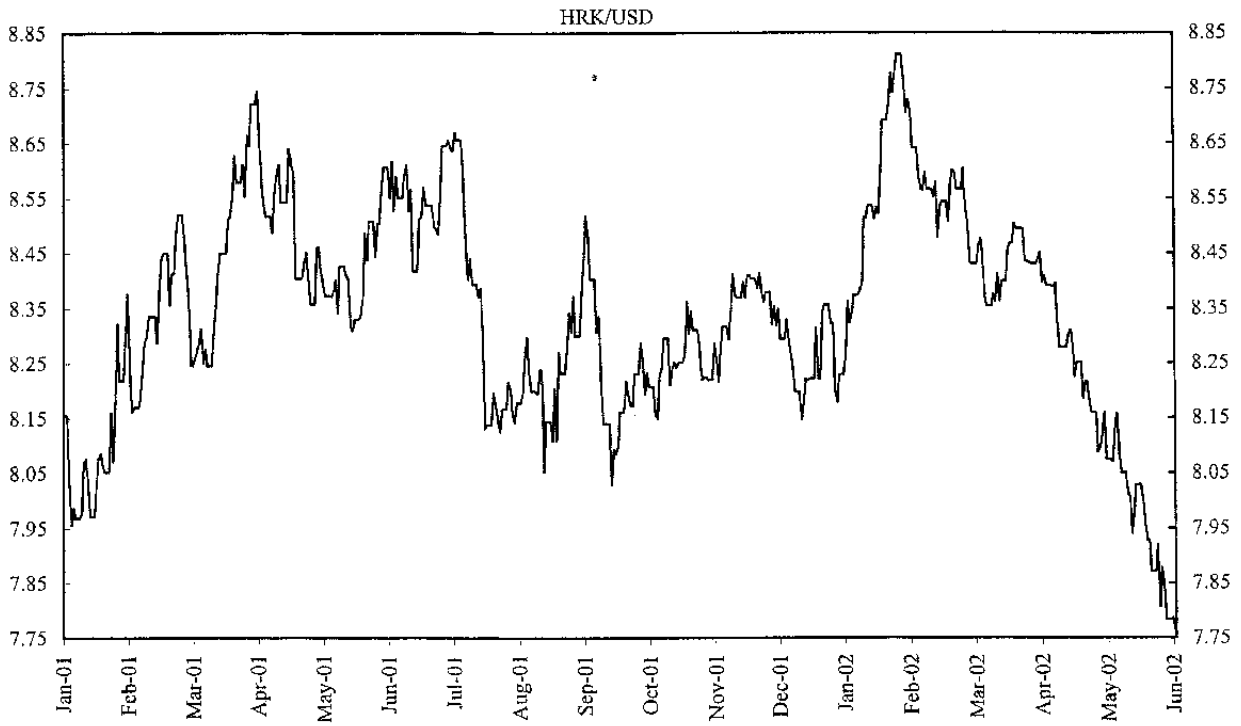
1/ Includes Albania, Bulgaria, Czech Rep., Hungary, Poland, Romania, Slovak Rep., and Slovenia.

2/ Inclusive of guarantees and arrears.

3/ Except for Czech Republic, direct debt only. The Czech debt stock includes guarantees.

4/ Direct debt only.

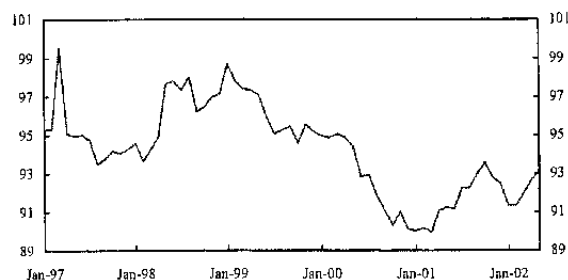
Figure 6. Croatia: Exchange Rate Developments, 2001-2002



Source: Croatian National Bank.

in some tightening of monetary conditions (Figure 7). The foreign currency liquidity resulting from euro conversion in late 2001, initially placed abroad by banks, has returned to the domestic market after most of the additional deposits remained in the banking system as a result of improved confidence. As a consequence, credit to both consumers and businesses continued to expand strongly, with an annual increase of about 25 percent in April, and broad money growth, which reached almost 47 percent year-on-year at the height of euro conversion in January, declined only gradually to about 38 percent in April.

Figure 7. Croatia: Monetary Conditions Index ^{1/}, 1997-2002
(January 1995 = 100)



Sources: Croatian National Bank; Croatian Bureau of Statistics; and IMF.
1/ The index is the weighted average of the real interest rate and the real effective exchange rate, where the weights are intended to represent the relative impact of interest rate and exchange rate on aggregate demand. In this case, the ratio between the weights is assumed to be 2-to-1, that is, a 1 percentage point change in the interest rate has approximately the same impact on aggregate demand as a 2 percent change in the exchange rate.

8. **Despite a run on the third largest bank, the banking system has remained stable.** In mid-March the disclosure of large foreign currency trading losses caused a run on Riječka Banka. The bank had lost almost US\$100 million during 1998-early 2002, and its capital adequacy ratio dropped to 6.2 percent. The authorities reacted promptly by providing liquidity support, taking over the majority stake of the bank for a symbolic price, and changing its management. The bank has been reprivatized and will be recapitalized by the new owner. The deposit outflow, which had spread to two other banks, stopped and began to reverse itself in May.

9. **Progress in structural reforms continues to be slow.** Structural reforms are a key element of the authorities' medium-term strategy to reduce unemployment and improve living standards. However, lack of consensus within the coalition government and social opposition have hampered the authorities' efforts. Even when parliament approved framework legislation, delays in the preparation of by-laws or weaknesses in the institutions responsible for the implementation often reduced the effectiveness of reforms. Nonetheless, progress has been made in rationalizing social transfers, introducing a second pillar of the pension system, reforming the public sector compensation system and the police and defense sectors, starting fiscal decentralization, and introducing a single treasury. In the financial sector, the legislative framework was strengthened and bank privatization was all but completed. However, reforms have lagged behind in other areas. Among large public enterprises, only the telecom company has been privatized. Reforms in the health, education, and judicial sectors have been repeatedly postponed. Long-overdue labor market reforms have been delayed by strong union opposition. Subsidies to agriculture, shipbuilding, and other sectors have remained high. As these reforms are being postponed, the medium-term prospects for growth and employment remain seriously impaired.

II. RESPONSIVENESS TO BOARD RECOMMENDATIONS AND IMPLEMENTATION OF STAND-BY ARRANGEMENT-SUPPORTED PROGRAM

10. **The authorities have generally been receptive to Fund policy advice, but implementation outside the financial sector has been hampered by unwieldy government decision-making procedures and strong popular opposition.** In concluding the last Article IV consultation with Croatia on March 19, 2001, Executive Directors welcomed the progress achieved in restoring control over public finances and the adoption of a comprehensive economic program for 2001-03. They urged rapid fiscal consolidation and an acceleration of structural reforms including privatization, which the program supported under the 18-month stand-by arrangement (SBA) that expired in May 2002 sought to promote.

11. **Although policy implementation was mixed, particularly in the structural area, performance under the SBA-supported program was broadly satisfactory.** In 2001 the key performance criteria on the fiscal deficit, government employment reduction, and the CNB's NIR and NDA were observed, and growth, inflation, and international reserve performance was better than programmed. However, four end-March 2002 performance criteria—fiscal deficit, bank credit to the government, bank credit to public enterprises, and government expenditure arrears—were not observed, reflecting overruns in wages and capital expenditure, lower-than-projected personal income tax revenue, and privatization shortfalls (Table 7). The nonobservances were relatively small, but not altogether trivial, with the deficit target being exceeded by almost $\frac{1}{4}$ of GDP. Throughout the arrangement period, slippages occurred with respect to structural performance criteria and benchmarks. In particular, a large shortfall of privatization receipts—which required waivers for the nonobservance of end-2001 performance criteria on government arrears, government bank borrowing, and public debt contracting—caused the public debt ratio to continue to rise rather than decline, as originally programmed.

12. **After the expiration of the SBA in May, the authorities had expressed interest in a successor arrangement, to be treated, like its predecessor, as precautionary.** However, discussions have not been completed due a delay in the preparation of fiscal data based on a broader general government consolidation (see below). It was agreed to resume discussions in October 2002.

III. POLICY DISCUSSIONS

13. **The discussions focused on fiscal sustainability, monetary policy stance, and progress in structural reforms.** The performance of the economy in the last two years has been good. The external current account deficit and inflation have remained low, and GDP growth rates have exceeded those of EU accession countries. While GDP is expected to decelerate on average in 2002, this is due to the weakening of external demand. With the latter expected to pick up soon, output is likely to accelerate again. Against this background,

the discussions focused on forward-looking issues that cast doubt on an otherwise favorable outlook.

- The fiscal deficit remains high and the public debt ratio has continued to rise. This has created uncertainty about medium-term growth and stability prospects.
- Strong capital inflows have lowered interest rates significantly and money and credit have accelerated sharply. While inflation remains low, prices typically react with a lag to a monetary expansion. Are these developments the harbinger of future excess demand pressures that would eventually weaken inflation and—possibly—external performance? In particular, should the CNB be more active in sterilizing the inflows? And should the exchange rate be allowed to appreciate faster?
- The delays in structural reforms have increased the risks that potential output growth will fall short of the increase in aggregate demand over the medium term. In this respect, the FSAP exercise allowed an assessment of financial system soundness, which is a requirement for sustained medium-term growth.

A. Fiscal Policy

14. **The authorities noted that the current fiscal effort was sizable.** They reconfirmed their fiscal targets under the recent SBA-supported program, i.e., a reduction of the deficit of the *central government* from 5.4 percent to 4.25 percent of GDP in 2002. They also stressed that the fiscal adjustment effort was stronger than suggested by these figures because of a revenue loss of some 1.1 percent of GDP resulting from the introduction of the second, privately managed, pension pillar.

Croatia: Consolidated General Government Operations, 1999-2002
(In percent of GDP)

	1999	2000	2001 Prel.	2002 Proj.
Revenue and grants	48.0	44.8	43.1	43.1
Expenditure and net lending	56.2	51.0	49.7	49.7
Consolidated general government balance	-8.2	-6.3	-6.6	-6.6
Adjusted for 2nd pillar introduction cost	-8.2	-6.3	-6.6	-5.5
Consolidated general government primary balance	-6.4	-4.4	-4.5	-4.2
General government debt (e.o.p.)	49.7	51.2	52.4	53.9
Privatization receipts	4.9	2.5	3.6	2.0
<i>Memorandum item:</i>				
Central government balance (SBA definition)	-7.4	-5.7	-5.4	-4.3

15. **The staff welcomed these developments in the central budget, but noted that the fiscal position was much weaker if assessed at a broader level.** As large infrastructure spending was now taking place outside the central government, the *general government* deficit was still as high as 6.6 percent of GDP in 2002 (see text table).^{2 3} The primary balance was a negative 4.2 percent of GDP and well above the level that (under reasonable assumptions about growth and interest rates) would be needed to stabilize the public debt ratio in the absence of privatization receipts (1¼ percent of GDP).⁴ Thus, on current trends the debt dynamics were not sustainable.

16. **Staff argued that a more upfront fiscal adjustment was called for.** While it would be difficult to envisage a major correction to the authorities' fiscal plans in 2002,⁵ in the scenario depicted below the general government deficit would fall by some 2 percentage points of GDP in 2003 and by a cumulative 1½ percent of GDP over the following two years. Given the current strength of domestic demand, the expected recovery in external demand in the second half of 2002, the continuation of relaxed monetary conditions that a fiscal tightening would justify, and the confidence effects related to fiscal consolidation, this sizable fiscal tightening was not seen by the staff as inconsistent with strong GDP growth, as long as the latter was supported by structural supply-side reforms (see below).

² The general government includes local governments and two newly established agencies for highway (HAC) and road (HC) construction.

³ Staff acknowledged that it was uncertain to what extent some infrastructure spending outside the central government was relevant to the issue of sustainability. In particular, the highway-related expenditure may be regarded as self-financing (because it would be covered by future service fees). However, given uncertainties on the future level of the fees—which remained subject to political decisions—and the need for further infrastructure investment, it was prudent to take a conservative view of this issue.

⁴ The 1¼ percent primary deficit, which is consistent with debt stability, assumes a real GDP growth rate of 4 percent and an average interest rate 5 percent, which corresponds to the current actual average interest paid on Croatia's public debt. Given the faster speed of financial integration with the EU and the still large income differential, it is reasonable to assume that the interest rate in Croatia will remain below the nominal GDP growth rate, thus allowing the stabilization of the debt ratio without a primary surplus. For each percentage point of lower GDP growth, the primary balance needed to stabilize the debt ratio changes by 0.3 percent of GDP.

⁵ As noted, the attainment of the 2002 target of 4.25 percent of GDP is subject to some risk. However, at the moment staff believes that achieving such a target does not require immediate policy action, although it does require careful expenditure management.

Croatia: Macroeconomic Scenario, 2002-2006

	2002	2003	2004	2005	2006
Real GDP 1/	3.5	4.5	5.0	6.0	7.0
Retail prices (c.o.p.) 1/	3.5	4.0	4.0	4.0	4.0
General government balance (accrual basis) 2/	-6.5	-4.4	-3.3	-3.0	-2.9
Expenditure 2/	49.6	46.4	44.8	44.1	43.7
Revenue 2/	43.1	42.0	41.5	41.1	40.8
Primary general government balance 2/	-4.1	-2.0	-0.9	-0.6	-0.5
General government debt (e.o.p.) 2/	53.5	50.1	47.9	46.4	44.7
Broad money 1/	8.4	16.8	13.8	12.0	12.8
Credit to the private sector 1/	12.5	20.9	13.4	15.4	18.0
Current account balance 2/	-2.8	-3.4	-2.8	-2.8	-2.7
External debt (e.o.p.) 2/	49.3	46.9	44.9	43.8	43.2
Reserve cover 3/	5.4	5.9	6.3	6.1	5.8

Source: Staff projections.

1/ Annual percentage change.

2/ As a percentage of GDP.

3/ In months of imports of goods and services.

17. **The authorities accepted the mission's assessment and expressed determination to further reduce the deficit over the medium term.** While their fiscal plans for 2003 were not yet firm, the deficit was expected to fall significantly also next year. However, they held out little hope that the policies required to lower the deficit by as much as recommended by the staff could be implemented in an election year.

18. **Expenditure restraint would remain the principal instrument of deficit reduction in 2002-03.** Although government wages might be increased by one half of real GDP growth in 2003—easing the three-year wage freeze—the wage bill was expected to continue to decline in relation to GDP as a result of employment reductions, especially in the health and defense sectors. The pressure on pension finances had eased somewhat as a result of the 1998 first-pillar reform, with the dependency ratio improving for the first time in many years. Special court-mandated pension payments equivalent to 1 percent of GDP are scheduled to expire at the end of 2002, but the authorities doubted that they could be discontinued altogether in an election year. By contrast, substantial savings were resulting from the reform of social benefits in late 2001. Capital spending would remain high in 2002-03, reflecting the implementation of the highway construction program. The mission stressed the need to restrain the wage bill, whose ratio to GDP remained high, and expressed concern about recent decisions to raise subsidies for agriculture, shipbuilding, and other sectors. Moreover, the mission advised against the continuation of the special pension payments and suggested that further reform of the first pillar was necessary, including by raising the

retirement age, establishing actuarially neutral incentives for retirement, and lowering the frequency and the degree of indexation.

19. **Under the authorities' plans, revenue policy would aim at broadening tax and social contribution bases, while providing tax incentives for spending on education and mortgages.** Social security contributions were expected to be collected on all types of income from about mid-2002, but there was pressure to exempt certain groups. Thought was also being given to replacing standard income tax deductions in 2003 with itemized deductions that would encourage spending on education and housing. Staff advised against exemptions and pointed out that itemized deductions would complicate tax administration and make revenue projections more uncertain. Contrary to earlier intentions, the authorities no longer see room for reducing the value added tax. Moreover, they indicated that they would resist pressures for additional zero rating.

20. **To alleviate the appreciation pressure on the exchange rate, the government intends to borrow more in the highly liquid domestic market.** Staff supported this intention and agreed with the authorities that this would help develop the domestic capital market and provide financial assets to the new private pension funds. To the extent possible, government borrowing should be in kuna. However, staff warned that additional borrowing on the domestic market could crowd out the private sector unless government financing requirements were substantially reduced.

21. **The authorities agreed on the need to improve fiscal transparency.** The most important step in this direction would be the publication of comprehensive statistics for the general government. While difficulties still exist due to the lags and low frequency of reporting by local governments and central government agencies, the Ministry of Finance intends to strengthen its technical services to provide reliable and timely general government data. The authorities also agreed on the mission's recommendation that the new funds for regional development and for employment and growth should be fully on budget and integrated with the treasury system.

B. Monetary and Exchange Rate Policy

22. **Authorities and staff agreed that the monetary policy framework—centered on broad exchange rate stability—was adequate.** The CNB representatives explained that the room for an independent monetary policy was narrowly circumscribed by the high euroization, with roughly three quarters of bank deposits and almost half of bank domestic placements either in foreign currency or indexed to it. Moreover, the shallowness of financial markets hampered the development of a transmission mechanism based on interest rates. The current exchange rate policy had served Croatia well, as evidenced by low inflation and strong competitiveness. Under these circumstances, and with EU accession as the medium-term goal, the CNB considered maintaining a broadly stable exchange rate as the best option for the immediate future. However, the CNB was also examining possible alternatives while promoting reforms aimed at developing financial markets and strengthening the transmission

mechanism. Staff observed that, to increase the effectiveness of interest rates in the transmission of policy, further improvements were necessary in domestic liquidity management and forecasting.

23. **Discussions then focused on the appropriate amount of foreign exchange intervention.** The CNB reiterated that its foreign exchange intervention was intended to smooth volatility induced by seasonal factors—mainly related to tourism and front-loaded government foreign borrowing—or lack of liquidity in the market so as to avoid rapid and unnecessary changes in expectations. Though trying to keep the euro exchange rate within certain bands—which may vary from time to time and in any case were never publicly announced to prevent speculative attacks—the CNB did not aim to resist prolonged and sustained pressures justified by fundamental changes. In particular, the CNB noted that, while aiming at broad exchange rate stability in principle, it would accept exchange rate appreciation should price stability be seriously jeopardized. Staff pointed out that the tolerance of exchange rate movements shown by the authorities seemed to be quite low and that it created the conditions for a perpetuation of the high euroization of the economy, and resulting high exchange rate risk of nonhedged sectors.⁶ The authorities replied that vulnerability was tempered by their gradual approach to capital account liberalization.

24. **Regarding the management of exchange rate and monetary policy in 2002, staff questioned whether the amount of intervention in recent months, which had prevented a stronger exchange rate appreciation, and the limited sterilization of that intervention, was consistent with keeping inflation low.** The authorities, though accepting that there was considerable uncertainty about the monetary stimulus currently provided, explained that Croatia had already experienced periods of strong money growth and low inflation, reflecting increasing money demand, and that the process of monetization had still some way to go. Moreover, the acceleration of broad money due to euro conversion did not represent a real increase in monetization, but rather the emersion of money balances previously hidden.⁷ The authorities also explained that increases in interest rates due to sterilization would likely attract more capital inflows. Staff observed that credit expansion following the increase in euro-conversion-related deposits would, however, have an expansionary impact. Moreover, staff was of the view that, on account of the remaining capital account restrictions, there remained room for sterilizing capital inflows. The CNB remained skeptical about the

⁶ In a recent working paper, the staff provides evidence that, when compared with other countries with a similar exchange rate regime, Croatia exhibits lower volatility in the exchange rate and higher volatility in the monetary base and inflation. See Billmeier and Bonato, “Exchange Rate Pass-Through and Monetary Policy in Croatia”, IMF Working Paper, WP/02/109.

⁷ The authorities estimate the so-called euro conversion effect at about €2 billion, or 14 percent of broad money.

possibility, and the usefulness, of more sterilization at this stage, but concurred that there was no room for additional easing and that plans for further reductions of reserve requirements had to be postponed.

25. **In spite of some risks from the sizable growth of monetary aggregates, and assuming a sizable fiscal tightening in the period ahead, staff indicated that the 2003 outlook remained favorable.** As external demand recovers, growth is expected to accelerate to reach 4–4.5 percent in 2003, with the envisaged fiscal tightening moderating domestic demand pressure. In this scenario, which the authorities broadly shared, inflation was likely to average 3.5–4 percent, with the small rebound reflecting the acceleration of demand. In the context of continued exchange rate stability, this small rebound in inflation seemed consistent with Balassa-Samuelson effects.⁸ With only moderate changes in competitiveness, the external current account balance was likely to deteriorate slightly to 3.5 percent of GDP, more than financed by FDI inflows.

C. Structural and Trade Policies

26. **The authorities remained committed to structural reform.** They reaffirmed their intention to implement the recently legislated defense sector reform and continue reforming the pension and health care systems. Major reforms of the judicial and education systems would be launched later this year, aimed at better protecting property rights, faster resolution of labor disputes and bankruptcy cases, and a better qualified labor force. Staff commended these intentions, as weaknesses in the judicial system and lack of skilled workers were discouraging investment. Further administrative reform—to slim down the central government through more decentralization and fewer ministries assisted by well-focused implementing agencies—was also under consideration. To succeed in downsizing the general government without jeopardizing the quality of public services, authorities and staff agreed that the institutional capacity of local governments had to be improved.

27. **But political and social resistance to reform remains strong.** The authorities reported continued resistance to their privatization plans, including from unions. Also, unions objected to changes in the labor law that would make the labor market more flexible. In discussions with the social partners, agreement had been reached on 24 of 28 outstanding issues, but the last four of them—a reduction of severance pay, a shortening of advance notice periods for dismissals, the definition of small firms that would remain exempt from the provisions of the labor law, and a solidarity fund for workers in bankrupt firms—

⁸ These effects, which are significant in transition economies, are due to rapid productivity catching-up in the tradable sector. The resulting increase in wages causes inflationary pressures in the low-productivity nontradable sector. In Croatia, this is currently reflected in large differences in inflation—about ten percentage points since December 2001—between goods (mostly tradable) and services (mostly nontradable).

remained unresolved. The authorities hoped to reach agreement over the summer. Staff stressed that an acceleration of privatization and structural reforms was essential, and encouraged the authorities to continue with their efforts to persuade the social partners of the need for reforms.

28. **Progress was being made to remove obstacles to business activity.** The authorities reported on a successful project at the county level, where greenfield investment had been attracted through a business-friendly environment. In accordance with World Bank advice, some local authorities had cut red tape by creating a one-stop shop for obtaining licenses and permits and had offered land for industrial sites with access to all needed utilities. Staff recommended that other local authorities follow this example. The Ministry of Economy is also considering the creation of an investment promotion agency to attract foreign investment. More generally, staff stressed that high subsidies and arrears among public enterprises remain one of the main obstacles to a level playing field.

29. **Integration in the international trading system is almost complete.** Croatia maintains a liberal trade regime with a simple average tariff of 6.3 percent—one of the lowest among CEECs—and an overall trade restrictiveness rating index of 1 (most liberal) according to the TPD database. Croatia signed a Stabilization and Association Agreement (SAA) with the EU in October 2001 and is expected to be admitted soon to the Pan-European System of Cumulation of Origin. The latter, by granting duty-free import to Croatian products with inputs from other signatories to the agreement, would allow Croatia to benefit fully from its free trade agreements with the EU and other European countries. In the meantime, the authorities continue to implement their obligations under the SAA, with a view to completing 50 percent of the required measures by end-2002 and another 25 percent by end-2003. Croatia joined WTO in November 2001 and undertook steps to liberalize its trade regime and foster trade and regional cooperation. Croatia is expected to join CEFTA in 2003 and is currently negotiating free trade agreements with Latvia, Lithuania, Estonia, Albania, Romania, and Yugoslavia.

D. Financial System

30. **The financial system has strengthened and can now absorb moderate macroeconomic shocks.** The main risk to the banking system, however, remains macroeconomic instability resulting in increased credit risk and indirect exchange rate risk.⁹ While most banks have modest direct foreign exchange exposure, many of their borrowers do not have foreign currency income and have not hedged their exposure (see Box 1).

⁹ See the accompanying FSSA Report.

Box 1. Conclusions of the Financial System Assessment Program (FSAP) Mission

Compared to the last banking crisis in 1998/99, **the financial system is now more resilient**. The larger banks are now generally better capitalized and their risk management systems have been improved. But the economy remains highly euroized and susceptible to shifts in residents' sentiments toward the local currency, so that severe macroeconomic shocks can cause difficulties for banks by straining the debt servicing capacity of borrowers.

The **banking system**—total assets amounted to 84½ percent of GDP at end-2001—dominates the financial system, which also comprises insurance companies, investment funds, private pension funds, brokerage houses, and savings cooperatives. Banks remain on average **relatively well capitalized**, although the capital adequacy ratio has declined from 21.4 percent at end-2000 to 18.5 percent at end-2001. The banking system has generally remained profitable during 2001 (Table 9). With the privatization of Dubrovačka Bank in early 2002, almost 90 percent of banks' assets is majority foreign owned, compared with less than 7 percent at end-1998.

The CNB is continuing to strengthen **banking supervision** by moving toward a more risk-based approach. A new banking law, which will address many of the weaknesses identified by the FSAP mission, is expected to be adopted soon. Regulations will be amended to better address: (i) market risks, operational risk, country risk, and other risks; (ii) supervision of banking groups on a consolidated basis; (iii) co-operation with other supervisory authorities; and (iv) monitoring competition in banking services. The mission stressed the importance of incorporating options, including embedded options, in the calculation of banks' net open position in foreign exchange. The mission also encouraged the authorities to ensure that aggressively expanding banks have appropriate systems in place to monitor their risks.

The insurance industry does not pose any major systemic risk, but it suffers from distortions and weaknesses, which include poor corporate governance and internal controls, and lack of regular on-site inspections (the latter partly reflecting lack of resources of the insurance supervisor).

Capital markets remain underdeveloped with considerable weaknesses in their regulatory infrastructure, which are expected to be remedied by new legislation. In particular, there is a need to strengthen the powers of the Croatian Securities Commission, clarifying the procedures for inspections and surveillance in the securities business.

The potential for settlement risk is limited and significant reforms have been implemented to modernize the payment systems. The observance of the Core Principles for the two systemically important payment systems is high, although there are minor deficiencies, particularly regarding the location of backup facilities.

The mission stressed the **importance of close coordination among supervisors**. Banking groups are increasingly getting involved in securities trading, insurance activities, and management of pension funds. However, while there may be merit in merging the nonbank supervisory entities, it may be premature to establish one unified supervisory agency. The CNB has made significant strides toward improving banking supervision, its autonomy is ensured by law, and it is more likely that the CNB will have the resources necessary to conduct banking supervision than a newly established agency. Due to the predominant foreign ownership of the banking system, it is also important that the CNB coordinates with foreign banking supervisors.

The authorities have continued to strengthen the legal and regulatory framework for anti-money laundering (AML) and combating financing for terrorism (CFT). The legal framework has recently been amended to extend the time limit for blocking suspicious transactions without the order of an investigating judge from 6 to 72 hours. The mission suggested streamlining the reporting procedures to prevent that the anti-money laundering unit at the Ministry of Finance is overwhelmed by irrelevant transactions.

31. **The legislative framework is being strengthened further.** A new banking law consistent with EU directives is expected to be adopted soon. The CNB is already drafting new regulations to better address market and operational risk as well as supervision of banking groups on a consolidated basis. A new foreign exchange law is being drafted that would give the CNB sufficient power to temporarily restrict capital flows. The latter would be liberalized gradually under appropriate macroeconomic conditions in the context of a sound and well supervised banking system.

E. Statistical Issues

32. **Despite continuing improvements, deficiencies in statistics remain a concern.** Among other things (Appendix IV), the quarterly national account data exhibit significant discrepancies with the revised annual data, which are released with a long lag. Moreover, the mission pointed to the need to remove the fictitiously unemployed from the official unemployment register and to produce survey based monthly unemployment data with a short publication lag.

F. Frozen Bank Deposits

33. **The frozen foreign currency deposit balances in domestic banks, which give rise to an exchange restriction, were reduced by almost 70 percent in the 16 months to April 2002 and stood at below 2 percent of their original value, or 0.3 percent of GDP (Box 2).** As banks have used their discretion and reduced the deposits more rapidly than required, the authorities are confident that all frozen balances will be released by the banks by the 2005 terminal date at the latest.

Box 2. Frozen Bank Deposits

In December 1991 the Government of Croatia modified the terms of certain foreign currency deposits, effective retroactively to April 27, 1991, and transformed them into 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, 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 ½ percent of GDP per annum. Moreover, interest payments on these deposits have been made twice annually, and in a timely fashion. However, because the remaining frozen balances may include proceeds 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, Section 2 (a) of the Fund's Article of Agreement.

IV. STAFF APPRAISAL

34. **The Croatian authorities have achieved much in the past 2½ years.** Economic growth has been restored and inflation has been reduced to a low level in the context of a broadly stable exchange rate. The external position has been considerably strengthened, with a low current account deficit, large international reserves, and easy access to international capital markets.
35. **Despite these achievements, the fiscal deficit is still high, the public debt ratio has continued to climb, and some key reforms needed to accelerate real convergence objectives have been delayed.** A more determined fiscal effort—reducing the primary deficit to about 1¼ of GDP—and accelerated implementation of structural reforms are required to stabilize the debt ratio and boost employment and growth.
36. **In view of the high expenditure ratio, fiscal consolidation should be achieved mainly through expenditure cuts.** There is a need to cut wages, subsidies, and transfers as a share of GDP. The reduction should be higher than needed to achieve the deficit target so as to allow room for spending necessitated by EU and NATO membership and growth promoting expenditure on education and infrastructure. At the same time, transfers should be better targeted to benefit lower income groups.
37. **There is ample room to cut the wage bill, subsidies, and transfers.** The wage bill ratio, which is still high by international standards, should be reduced mainly through employment reductions, while the planned review of all subsidy programs should ensure that they remain temporary. An appropriately funded social safety net and well-designed active labor market policies would mitigate the social impact of these measures. Further reform of the first pension pillar is necessary and special temporary payments should be allowed to cease as originally envisaged. To reduce health spending and improve the quality of health services, efficiency in their delivery should be raised and their more rational use should be encouraged.
38. **The Ministry of Finance should put urgent attention to compiling reliable and timely general government data.** The new funds for regional development and for employment and growth should be fully on the 2003 budget and integrated into the treasury system. Any new funds and agencies, if truly needed, should be included transparently in the general government consolidation.
39. **The monetary framework remains appropriate.** The high degree of euroization and the weak and uncertain interest rate transmission mechanism make a compelling case for continued focus on the exchange rate as a key to low inflation. The current level of the exchange rate is adequate, as shown by the good external current account position and international comparisons of competitiveness. The latter needs to be maintained by removing remaining barriers to foreign trade and by structural policies and wage moderation. However, the CNB should gradually increase its focus on inflation, even at the cost of greater exchange

rate flexibility. This effort should be accompanied by measures to develop financial markets and promote effective communication with the public.

40. **Monetary policy should stand ready to react to any emerging inflationary pressures.** As a result of euro conversion and unsterilized capital inflows, money and credit aggregates have accelerated in recent months and interest rates have fallen. Even though this development partly reflects increased confidence in the currency and the banking system and inflationary pressures remain muted, excess liquidity and low interest rates might fuel future inflationary pressures. Should this risk materialize, and insufficient support come from fiscal contraction, the CNB should tighten the monetary stance, if needed through increased sterilization.

41. **Structural reforms should receive new impulse.** Reforms aimed at improving efficiency and promoting a business-friendly environment are needed to boost growth. The vitality shown by the private sector, where all employment growth in the last two years has been concentrated, should be encouraged by reducing the still large role of the government in the economy. Privatization needs to be accelerated and extended to the assets of local governments. Further reform of the public administration is necessary, with more delegation of responsibility and initiative to local governments accompanied by enhancements of their institutional capacity. The prompt approval of the new labor law would ensure a faster growth of employment.

42. **Despite considerable strengthening of the financial system, some vulnerabilities remain.** While the direct exchange rate exposure of banks is limited, indirect credit risk remains a concern. Unhedged positions in the corporate and household sectors may be encouraged by the perceived absence of exchange rate risk. More variation in the exchange rate would help dispel that perception. At the same time, the CNB should continue promoting the development of financial markets while cautiously proceeding with the liberalization of capital movements to allow the development of markets for hedging instruments. As banks continue to switch from foreign placements into domestic ones and their loan portfolio continues to grow, the CNB needs to direct increased supervisory attention to the soundness of banks' lending decisions and insist on appropriate provisioning.

43. **Economic statistics should be further improved.** Despite the progress made, deficiencies remain in important areas such as national accounts, prices, and labor statistics.

44. In view of the further progress in paying out the frozen foreign currency deposits, even ahead of the established timetable for their phased elimination, it is proposed to grant temporary approval for the **exchange restriction** that arises in connection with the freeze on these deposits held by nonresidents.

45. It is recommended that the next Article IV consultation with Croatia be held on the standard twelve-month cycle.

Table 1. Croatia: GDP by Expenditure Category, 1999-2003

	1999	2000	2001	2002 Proj.	2003 Proj.
(Percentage changes)					
Real GDP	-0.4	3.7	4.1	3.5	4.0
Domestic demand	-1.8	1.3	4.5	4.5	4.0
Consumption	-4.7	2.6	2.1	2.4	2.3
Private 1/	-2.7	4.1	4.6	4.5	2.7
Government	-8.2	-1.1	-4.4	-3.4	0.9
Gross fixed capital formation	-1.1	-3.5	9.7	12.2	9.8
Private 1/	1.5	10.3	6.5	4.3	11.2
Government	-6.1	-32.4	20.6	36.0	6.6
Exports	0.5	10.3	9.5	4.1	6.4
Imports	-2.9	3.9	9.6	5.9	6.1
(Percentage contributions)					
Real GDP	-0.4	3.7	4.1	3.5	4.0
Domestic demand	-2.0	1.4	4.8	4.8	4.3
Consumption	-4.1	2.1	1.7	2.0	1.8
Private 1/	-1.6	2.4	2.7	2.7	1.6
Government	-2.1	-0.3	-1.0	-0.7	0.2
Gross fixed capital formation	-0.3	-0.8	2.2	2.9	2.5
Private 1/	0.2	1.7	1.1	0.8	2.0
Government	-0.5	-2.5	1.0	2.1	0.5
Change in inventories 2/	2.3	0.1	0.9	0.0	0.0
Net foreign demand	1.7	2.3	-0.7	-1.3	-0.3
Exports	0.2	4.3	4.2	1.9	3.0
Imports	1.5	-2.0	-4.9	-3.2	-3.4

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

1/ Includes public enterprises.

2/ Includes statistical discrepancy.

Table 2. Croatia: Saving-Investment Balances, 1999-2003

	1999	2000	2001	2002 proj.	2003 proj.
(In millions of kuna)					
External saving	9,889	3,582	5,205	5,128	6,904
Domestic saving-investment gap	-9,889	-3,582	-5,205	-5,128	-6,904
Saving	27,568	34,295	38,060	44,189	49,045
Investment	37,457	37,876	43,265	49,317	55,949
Consolidated general government (accrual basis)	-10,056	-8,645	-10,128	-11,011	-10,180
Saving 1/	607	-1,143	-898	1,990 ^{5/}	4,169 ^{5/}
Investment 2/	10,663	7,502	9,230	13,001	14,349
Non-government sector 3/	167	5,063	4,923	5,883	3,276
Saving	26,961	35,438	38,958	42,199 ^{5/}	44,876 ^{5/}
Investment 4/	26,794	30,374	34,035	36,316	41,600
(In percent of GDP)					
External saving	6.9	2.3	3.1	2.8	3.5
Domestic saving-investment gap	-6.9	-2.3	-3.1	-2.8	-3.5
Saving	19.3	21.8	22.5	24.4	25.2
Investment	26.2	24.0	25.6	27.2	28.7
Consolidated general government (accrual basis)	-7.0	-5.5	-6.0	-6.1	-5.2
Saving 1/	0.4	-0.7	-0.5	1.1 ^{5/}	2.1 ^{5/}
Investment 2/	7.5	4.8	5.5	7.2	7.4
Non-government sector 3/	0.1	3.2	2.9	3.2	1.7
Saving	18.9	22.5	23.1	23.3 ^{5/}	23.0 ^{5/}
Investment 4/	18.8	19.3	20.1	20.0	21.3
<u>Memorandum items</u>					
GDP at current prices (millions of kuna)	142,700	157,510	168,973	181,151	194,991
Gross national disposable income at current prices (millions of kuna)	144,712	161,674	172,625	186,192	199,356
Consolidated general government	36,206	36,211	35,373	37,918	41,674
Non-government sector	108,506	125,463	137,252	148,274	157,682

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

1/ Current revenues minus current expenditures (excluding current transfers and interest payments).

2/ Excludes net lending.

3/ Includes public enterprises.

4/ Includes change in inventories.

5/ The introduction of the second pillar of the pension system is expected to reduce government saving (and correspondingly increase non-government saving) by 1.1 percent of GDP in 2002 and 1.2 percent of GDP in 2003.

Table 3. Croatia: Balance of Payments, 1998–2003 1/
(In millions of U.S. dollars, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003
Current account	-1,531	-1,390	-433	-623	-618	-830
Merchandise trade balance	-4,147	-3,299	-3,204	-4,012	-4,304	-4,590
Exports f.o.b.	4,604	4,395	4,567	4,752	4,966	5,378
Ships	397	273	374	283	377	402
Non-Ship exports	4,207	4,121	4,193	4,469	4,589	4,976
Imports f.o.b.	-8,752	-7,693	-7,771	-8,764	-9,270	-9,968
Services and income	1,911	1,276	1,888	2,423	2,695	2,758
Transportation	228	84	179	169	202	222
Travel	2,133	1,742	2,190	2,729	2,831	2,957
Other services	-286	-201	-101	54	46	56
Compensation of employees	70	60	70	125	124	125
Interest income	-234	-410	-450	-653	-507	-602
Current transfers	706	632	883	966	990	1,001
Capital and Financial account	1,629	2,553	1,538	2,324	1,710	1,531
Capital account	19	25	21	133	18	18
Financial account	1,610	2,528	1,517	2,191	1,691	1,513
Direct investment	835	1,445	1,086	1,325	970	973
Portfolio investment	15	574	722	716	88	229
Medium- and long-term loans	1,018	348	175	37	291	161
Assets	0	-75	8	-6	-1	0
Liabilities	1,018	423	168	43	291	161
Disbursements	1,735	1,657	1,413	1,091	1,666	1,357
Amortization scheduled	-717	-1,234	-1,245	-1,048	-1,376	-1,196
On current outstanding					-1,376	-1,196
Currency and deposits 2/	192	85	-1,053	466	539	0
Short term capital flows (net) 2/ 3/	36	60	214	-412	-97	-3
Trade Credits 4/	-486	16	372	59	-98	153
Net errors and omissions	62	-752	-494	-357	-316	0
Overall balance	160	410	611	1,344	775	701
Financing	-160	-410	-611	-1,344	-775	-701
Gross reserves (= increase)	-152	-378	-582	-1,313	-741	-668
IMF (net purchases)	-9	-31	-29	-31	-34	-34
Exceptional financing	0	0	0	0	0	0
Memorandum Items						
Current account (in percent of GDP)	-7.1	-6.9	-2.3	-3.1	-2.8	-3.5
Gross official reserves	2,816	3,025	3,525	4,704	5,445	6,113
in months of following year's imports of goods and NFS	3.5	3.8	4.0	5.0	5.4	5.7
Net international reserves	2,581	2,807	3,325	4,535	5,310	6,011
in months of following year's imports of goods and NFS	3.2	3.5	3.7	4.9	5.3	5.7
Gross usable international reserves 5/	2,320	2,249	2,629	3,653	4,394	5,062
in months of following year's imports of goods and NFS 5/	2.8	2.8	3.0	3.9	4.4	4.8
Net usable international reserves	2,085	2,031	2,430	3,484	4,259	4,960
in months of following year's imports of goods and NFS	2.6	2.5	2.7	3.7	4.2	4.7
Outstanding debt 6/	8,708	8,937	10,101	10,493	10,757	11,111
of which: short-term debt 3/ 7/	468	473	676	298	201	197
External debt to GDP ratio 6/	40.3	44.5	53.1	51.9	49.3	47.4
Short-term debt in percent of gross international usable reserves 3/ 7/ 8/	75.1	83.5	75.2	60.4	63.1	33.3
Short-term debt and current account deficit net of FDI in percent of gross international usable reserves 3/ 7/ 8/	72.8	54.4	48.5	50.8	32.2	25.1
External debt service	-1,158	-1,821	-1,986	-1,885	-2,452	-2,020
External debt service to exports ratio	13.5	22.4	22.9	19.6	24.5	18.9
GDP (millions of U.S. dollars)	21,628	20,063	19,030	20,229	21,835	23,441
GDP (millions of Kuna)	137,604	142,700	157,510	168,973	181,151	194,991
Exchange rates						
Kuna per Euro (pa)	7.13	7.59	7.65	7.48	...	...
Kuna per US dollar (ps)	6.36	7.11	8.28	8.35	...	...

Sources: Croatian National Bank, World Economic Outlook, and staff estimates

1/ Based upon CNB balance of payments revisions of February 2002 and preliminary data for end-December, 2001.

2/ Projections for Q1 2002 include the assumed change in resident deposits reflecting the introduction of the Euro.

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

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

7/ Coverage is limited to short term debt contracts registered with the CNB.

8/ Short-term debt is presented on a remaining maturity basis.

Table 4: Croatia: Central Government Fiscal Operations (SBA definition)
by Economic Category on an Accrual Basis, 1999-2003
(In percent of GDP)

	1999	2000	2001	2002	2003
	Actual	Actual	Prel.	Prog.	Prog.
Revenue and grants	42.8	39.9	38.7	37.3	36.6
Current revenue	42.8	39.9	38.7	37.3	36.6
Tax revenue	40.7	37.9	36.9	35.3	34.6
Personal Income tax	3.2	2.6	2.0	1.8	1.7
Social Security contributions	13.8	13.0	12.9	12.3	12.3
Profits tax	1.7	1.1	1.2	1.3	1.3
Real Estate Transactions tax	0.2	0.2	0.2	0.1	0.1
Taxes on goods and services	18.5	18.3	18.1	17.5	17.0
Value-added taxes	13.9	13.6	13.5	13.3	13.2
Excises	4.3	4.6	4.5	4.0	3.8
Other	0.3	0.1	0.1	0.2	0.0
Customs duties	3.0	2.4	2.3	2.1	2.0
Other	0.3	0.3	0.3	0.2	0.2
Non-tax revenue	2.2	1.9	1.9	2.0	2.0
Capital revenue	0.0	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	50.2	45.5	44.2	41.6	39.9
Expenditure	49.1	44.8	43.7	41.2	39.5
Current expenditure	43.5	41.5	40.4	38.2	36.4
Expenditure on goods and services	22.1	21.0	18.3	16.5	16.0
Wages excl. employer's contributions	11.7	11.5	10.3	9.7	9.2
Other purchases of goods and services	10.4	9.5	7.9	6.8	6.8
Interest payments	1.6	1.8	1.9	2.1	2.2
Subsidies and other current transfers	19.8	18.6	20.2	19.5	18.3
Capital expenditure	5.6	3.3	3.3	3.0	3.0
Lending minus repayments	1.1	0.7	0.5	0.4	0.4
Central government balance	-7.4	-5.7	-5.4	-4.3	-3.3
Financing	7.4	5.7	5.4	4.3	3.3
Privatization revenues	4.5	2.0	3.1	1.3	1.0
"Tax bonds" revenues	0.0	0.5	0.0	0.0	0.0
Foreign borrowing	3.2	4.1	1.6	2.2	0.0
Domestic borrowing	-0.4	-0.9	0.7	0.7	2.3
From other non-banking sector	0.8	-3.7	0.3	0.8	1.1
Net change in arrears	0.8	-3.6	-0.9	-0.3	0.0
From banking sector	-1.2	2.8	0.5	-0.1	1.2
Memorandum items:					
Estimated Debt Stock (as percent of GDP)	49.3	50.9	51.6	51.5	50.1

Sources: Ministry of Finance and staff estimates

Table 5: Croatia: Consolidated General Government Fiscal Operations
by Economic Category on an Accrual Basis, 1999-2003
(In percent of GDP)

	1999 Actual	2000 Actual	2001 Prel.	2002 Prog.	2003 Prog.
Revenue and grants	48.0	44.8	43.1	43.0	42.2
Current revenue	47.9	44.7	43.1	43.0	42.2
Tax revenue	43.7	40.8	39.7	39.2	38.4
Personal Income tax	5.3	4.8	3.8	3.7	3.7
Social Security contributions	13.6	12.8	12.7	12.1	12.1
Profits tax	2.3	1.5	1.7	1.7	1.7
Real Estate Transactions tax	0.5	0.5	0.4	0.3	0.3
Taxes on goods and services	18.6	18.5	18.5	19.0	18.4
Value-added taxes	13.9	13.6	13.5	13.3	13.2
Excises	4.3	4.6	4.9	5.4	5.1
Other	0.4	0.2	0.2	0.3	0.1
Customs duties	3.0	2.4	2.3	2.1	2.0
Other	0.3	0.3	0.4	0.2	0.2
Non-tax revenue	4.2	3.9	3.3	3.8	3.9
Capital revenue	0.0	0.0	0.0	0.0	0.0
Grants	0.1	0.1	0.0	0.0	0.0
Expenditure and net lending	56.2	51.0	49.7	49.6	47.9
Expenditure	55.1	50.2	49.1	49.1	47.4
Current expenditure	47.6	45.5	43.6	41.9	40.1
Expenditure on goods and services	24.9	23.7	21.5	19.8	19.2
Wages excl. employer's contributions	12.7	12.5	11.3	10.6	10.0
Other purchases of goods and services	12.2	11.2	10.2	9.2	9.2
Interest payments	1.7	1.9	2.1	2.4	2.5
Subsidies and other current transfers	20.9	19.8	20.1	19.7	18.4
Capital expenditure	7.5	4.8	5.5	7.2	7.4
Lending minus repayments	1.1	0.8	0.6	0.5	0.5
Consolidated general government balance	-8.2	-6.3	-6.6	-6.6	-5.7
Financing	8.2	6.3	6.6	6.6	5.7
Privatization revenues	4.9	2.5	3.6	2.0	1.0
"Tax bonds" revenues	0.0	0.5	0.0	0.0	0.0
Foreign borrowing	3.2	4.1	2.0	4.1	1.9
o/w Central government	3.2	4.1	1.6	2.2	0.0
HAC	0.0	0.0	0.3	1.9	2.0
Domestic borrowing	0.0	-0.7	1.0	0.5	2.7
From other non-banking sector	1.0	-3.5	0.4	0.9	1.5
Net change in arrears	0.8	-3.6	-0.9	-0.3	0.0
From banking sector	-1.0	2.8	0.7	-0.4	1.2
Memorandum items:					
Estimated Debt Stock (as percent of GDP)	49.7	51.2	52.4	53.8	54.5

Sources: Ministry of Finance and staff estimates

Table 6. Croatia: Monetary Accounts, 1999-2003
(End-period; in millions of kuna unless otherwise stated)

	1999	2000	2001	2002	2003	2000	2001	2002	2003
				Proj.	Proj.				
Monetary Survey						(Percent change)			
Net Foreign Assets	16,656	29,017	48,661	51,647	58,530	74.2	67.7	6.1	13.3
Net Domestic Assets	40,004	44,044	57,410	63,057	72,904	10.1	30.3	9.8	15.6
of which: domestic credit	65,939	72,289	87,638	94,756	108,130	9.6	21.2	8.1	14.1
to government, net	13,170	17,590	18,767	17,984	20,279	33.6	6.7	-4.2	12.8
to other domestic sectors	52,769	54,699	68,871	76,772	87,851	3.7	25.9	11.5	14.4
Broad Money	56,659	73,061	106,071	114,704	131,434	28.9	45.2	8.1	14.6
Narrow Money	13,859	18,030	23,704	27,447	33,049	30.1	31.5	15.8	20.4
Currency outside banks	5,959	6,637	8,507	9,277	10,224	11.4	28.2	9.0	10.2
Demand deposits	7,900	11,394	15,196	18,170	22,825	44.2	33.4	19.6	25.6
Quasi Money	42,800	55,031	82,368	87,257	98,385	28.6	49.7	5.9	12.8
denominated in kuna	5,834	8,129	10,531	12,079	15,514	39.3	29.5	14.7	28.4
denominated in foreign currency	36,966	46,902	71,837	75,178	82,871	26.9	53.2	4.7	10.2
Balance Sheet of National Bank									
Net Usable International Reserves	15,529	19,814	29,111	35,333	41,259	27.6	46.9	21.4	16.8
in US dollars	2,031	2,430	3,484	4,259	4,960	19.6	43.4	22.2	16.5
Net Foreign Assets	21,800	27,117	37,729	44,458	49,943	24.4	39.1	17.8	12.3
less: Banks' foreign currency reserves	4,636	5,491	5,705	7,250	7,009	18.4	3.9	27.1	-3.3
CNB bills in foreign currency	1,635	1,813	2,913	1,876	1,676	10.9	60.7	-35.6	-10.7
Net Domestic Assets	-5,219	-8,096	-11,307	-13,096	-17,652	55.1	39.7	15.8	34.8
of which: claims on government (net)	-373	-1,157	-1,752	-1,752	-1,752	210.2	51.4	0.0	0.0
claims on banks	1,139	330	18	34	34	-71.0	-94.4	81.7	0.0
claims on other domestic sectors	277	290	229	128	128	4.6	-20.8	-44.1	0.0
other items (net)	-4,293	-4,849	-6,001	-6,166	-6,966	12.9	23.8	2.7	13.0
less: CNB bills in kuna	1,252	2,395	3,459	4,724	9,045	91.2	44.4	36.6	91.5
blocked deposits 1/	381	315	325	110	110	-17.2	3.3	-66.2	0.0
Reserve Money	10,310	11,717	17,803	22,237	23,607	13.6	51.9	24.9	6.2
Currency	6,341	7,169	9,046	10,145	11,092	13.1	26.2	12.1	9.3
Deposits	3,969	4,548	8,757	12,092	12,515	14.6	92.5	38.1	3.5
<u>Memorandum items:</u>									
Nominal GDP (yearly total)	142,700	157,511	168,973	181,151	194,991				
Kuna/dollar exchange rate (eop)	7.65	8.16	8.36	...	...		
Narrow money multiplier	1.34	1.54	1.33	1.23	1.40				
Velocity of Kuna broad money	7.25	6.02	4.94	4.68	4.02				
Broad money/GDP ratio	0.40	0.46	0.63	0.63	0.67				
Foreign currency as a perc. of broad money	65.2	64.2	67.7	65.5	63.1				

Sources: Croatian National Bank and staff projections

1/ Blocked and restricted deposits, excluding required reserves in foreign currency.

Table 7. Croatia: Implementation of Performance Criteria, March 2002 1/
(In millions of kuna, unless indicated otherwise)

			Mar
Quantitative Performance Criteria			
1	Cumulative Deficit of the Consolidated Central Government 2/ 3/	program	2,448 *
		actual	2,840
		margin (+)	-392
2	Cumulative Increases in the Net Credit of the Banking System to the Consolidated Central Government 2/	program	-221
		actual	539
		margin (+)	-760
3	Arrears repayment of the Consolidated Central Government 4/	program	-267
		actual	-14
		margin (+)	-253
4	Cumulative Increases in the Net Credit of the Banking System to Selected Public Enterprises 2/	program	150
		actual	819
		margin (+)	-669
5	Public and Publicly Guaranteed External Debt		
	a) Stock of Short-Term Debt 2/ 5/	<=1 year	
		program	0
		actual	0
		margin (+)	0
		>1 year	
		program	865
		actual	437
		margin (+)	428
	b) Cumulative Increases in Nonconcessional Debt 2/ 5/		
		<5 years	
		program	55
		actual	0
		margin (+)	55
6	Cumulative Increases in the Net Usable International Reserves of the Croatian National Bank 4/ 5/	program	-200
		actual	154
		margin (+)	354
7	Cumulative Increases in the Net Domestic Assets of the Croatian National Bank 2/	program	1,562
		actual	609
		margin (+)	953
Structural Performance Criterion 6/			
1	Employment in government sector	program	168,804
		actual	168,314
		margin (-)	490
<i>Memorandum Item</i>			
	Cumulative Increases in Reserve Money	program	-171
		actual	1,945
		margin (-)	-2,116

Sources: Croatian authorities and IMF staff.

1/ Revised program (EBS/02/47), cumulative changes from January 1, 2002. "*" indicates that an adjustor was applied.

2/ Ceiling.

3/ This limit was lowered by Hrk 120 mn. to take into account the shortfall in second-pillar collections by the private pension funds.

4/ Floor.

5/ In millions of US dollars.

6/ Besides the performance criterion on government employment reduction, the structural benchmark on the government approval of a privatization program for INA was observed, and the authorities have followed up on prior actions. After the appointment of a privatization advisor for the postal bank (HIPB), which was a prior action for the completion of the second review (EBS/02/47), the government has received the report from the advisor in June and is currently evaluating the different options proposed for the privatization of 25 percent of the bank.

Table 8. Croatia: Selected Indicators of External Vulnerability, 1/ 1998-2002
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2002	
						Mar	Latest Figure	Date
Economic indicators							
RPI inflation, yearly change (e.o.p.)	5.4	4.4	7.4	2.6	3.2	1.8	May-02
Real GDP growth rate, yoy	2.5	-0.4	3.7	4.1	...	4.6	Mar-02
General government debt in percent of GDP	38.8	49.7	51.2	52.4	...	52.4	Dec-01
domestic general government debt and guaranteed debt in percent of GDP	16.5	20.8	18.8	20.4	...	20.4	Dec-01
foreign general government debt and guaranteed debt in percent of GDP	22.3	28.9	32.4	32.1	...	32.1	Dec-01
Broad money (M4, percentage change, yoy)	13.0	-1.2	28.9	45.2	37.1	37.6	Apr-02
Claims on other domestic sectors (change, yoy) 2/	22.4	-6.5	3.7	25.9	23.2	24.8	Apr-02
35-day CNB-bill yield, monthly average, percent	9.5	10.5	6.7	3.4	3.4	3.0	May-02
35-day CNB-bill real yield, percent 3/	3.9	5.8	-0.7	0.8	0.2	1.2	Jun-02
External indicators							
Real effective exchange rate (using retail prices), 1995=100 4/	105.3	100.9	101.1	103.8	103.4	103.4	Mar-02
Export of goods and services (percentage change in US\$, yoy) 5/	4.3	-5.3	6.7	10.8	-3.6	-3.6	Mar-02
Import of goods and services A42 (percentage change in US\$, yoy) 5/	-6.5	-8.0	-2.0	11.0	4.1	4.1	Mar-02
Current account balance (US\$ million, yoy)	1,531	1,390	433	623	795	795	Mar-02
Current account balance (yoy) in percent of GDP 6/	7.1	6.9	2.3	3.1	3.6	3.6	Mar-02
Capital and financial account (yoy) in percent of GDP 6/	7.5	12.7	8.1	11.5	25.6	25.6	Mar-02
Gross official reserves (US\$ million)	2,816	3,025	3,525	4,704	4,886	5,350	14-Jun-02
Gross official reserves in percent of broad money (M4)	31	41	39	37	39	38	Apr-02
Gross official reserves in percent of reserve money	177	224	245	221	210	198	Apr-02
Gross official reserves in months of imports of goods and NFS	3.2	3.7	4.4	5.3	5.5	6.0	14-Jun-02
Net international reserves (US\$ million)	2,581	2,807	3,325	4,528	4,720	4,997	May-02
Net international reserves in months of import of goods and NFS	2.9	3.4	4.2	5.1	5.3	5.3	Mar-02
Short-term debt in percent of gross usable reserves 7/ 8/ 9/ 10/	75.1	83.5	75.2	60.4	44.1	44.1	Mar-02
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 10/	72.8	54.4	48.5	22.8	40.3	40.3	Mar-02
Total external debt, percent of GDP 11/	40.3	44.5	53.1	51.8	51.3	51.3	Mar-02
External debt service to export ratio	13.5	22.4	22.9	19.6	53.6	53.6	Mar-02
Financial market indicators							
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	712	715	890	1,035	1,280	1,226	May-02
Zagreb Stock Exchange, capitalization, percent of GDP	13	13	14	15	18	18	May-02
US bond yield spread (EMBI Croatia, e.o.p.)	...	407	330	187	170	123	May-02
International ratings							
Debt ratings: Moody's:							
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	May-02
Government bonds, domestic currency	...	Baa1	Baa1	Baa1	Baa1	Baa1	May-02
Foreign debt ratings							
Fitch: Local currency LT	A-	BBB	BBB	BBB+	BBB+	BBB+	May-02
Fitch: Foreign currency LT	BBB-	BB+	BB+	BBB-	BBB-	BBB-	May-02
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	May-02
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	May-02
Memorandum items:							
Nominal GDP (US\$ millions) 12/	21,628	20,063	19,030	20,229	20,565		
Nominal exchange rate (HrK/US\$, e.o.p.)	6.25	7.65	8.16	8.36	8.49	7.36	Jun-02

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

1/ Italics indicate preliminary figures or program data.

2/ Claims on domestic sector excluding general government.

3/ 35-day CNB bill yield deflated by the annual percentage change in the retail prices.

4/ An increase in the index reflects an appreciation: end-year figures indicate annual average.

5/ In January 2000, a new methodology, in line with European standards, for processing data on imports and exports was adopted. The new presentation uses the date when the declaration was cleared rather than the date when the declaration was received.

6/ Quarterly figures may be affected by the quarterly annualized GDP.

7/ Data for short-term commercial bank credits derived from the CNB Foreign Exchange Department.

8/ Coverage limited to short-term debt contracts registered with the CNB.

9/ Short-term debt is presented on a remaining maturity basis.

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

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

12/ Using the average exchange rate for the period, annualized for quarters. Data for March 2002 are staff projections.

Table 9. Croatia: Selected Indicators of Financial Sector Vulnerability,^{1/} 1995-2002
(percent at end of period, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000 Dec	2001 Mar	2001 Jun	2001 Sep	2001 Dec	2002 Mar
Solvency indicators											
Risk-weighted capital adequacy ratio ^{2/}	18.2	17.7	16.4	12.7	20.6	21.4	<i>19.0</i>	<i>18.8</i>	<i>19.2</i>	<i>18.5</i>	<i>17.1</i>
Leverage ratio, tier I capital in percent of total liabilities	...	13.4	12.0	9.6	11.3	11.6	...	<i>10.7</i>	<i>10.1</i>	<i>9.0</i>	<i>8.9</i>
Liquidity indicators											
Loan to deposit ratio ^{3/}	129.6	92.6	98.0	107.0	102.5	85.0	85.5	87.6	83.2	71.7	76.9
Banks' reserves in percent of deposits ^{4/}	16.0	13.7	11.1	8.2	8.6	7.7	7.0	7.3	7.6	9.5	10.9
cash in vaults ^{4/}	0.6	0.5	0.5	0.5	0.8	0.8	0.5	0.7	0.5	0.6	0.9
reserves held with the CNB ^{4/}	15.4	13.2	10.6	7.7	7.9	6.9	6.4	6.6	7.1	9.0	10.0
of which required reserves ^{4/}	10.6	10.4	8.7	6.8	7.4	6.2	4.8	4.9	6.0	6.5	7.3
CNB bills on a voluntary basis, percent of deposits	1.0	2.4	1.6	4.3	5.7	6.4	5.8	5.8	6.3	5.4	5.8
Primary liquidity ratio ^{5/}	0.63	2.63	2.92	1.65	1.30	3.32	3.22	2.44	1.16	3.23	3.44
Money market interest rate, weighted daily averages	27.2	10.4	9.4	15.8	12.7	4.5	3.6	2.8	5.4	2.7	2.4
Credit risk indicators											
Total assets, change, yoy	14.7	7.7	26.4	9.4	-0.1	17.9	19.4	20.0	20.0	29.7	26.1
Loans and advances to the domestic private sector, change, yoy	23.5	9.0	48.8	23.9	-6.4	8.9	15.9	20.2	24.6	24.3	23.3
Nonperforming assets, percent of total assets ^{6/}	7.6	9.2	7.2	11.4	11.8	10.6	10.2	9.7	8.5	7.2	6.9
Nonperforming loans, percent of total classified loans ^{6/}	...	...	...	...	...	17.6	17.1	15.9	14.7	13.6	12.9
Specific provisions in percent of total assets ^{7/}	7.9	8.4	6.7	8.1	9.1	8.6	...	8.0	7.2	6.2	5.5
Foreign exchange risk indicators											
Net open position in foreign exchange ^{8/}	...	...	...	...	34	31	19	6	6	6	16
Net foreign assets in percent of total assets	-9.3	0.1	2.8	-3.7	-5.2	1.7	1.6	-1.0	-0.3	7.7	2.2
Profitability indicators											
Reported return before tax, percent of assets	0.3	0.8	1.5	-2.9	0.9	1.7	1.7	<i>1.9</i>	<i>1.8</i>	<i>1.4</i>	2.2
Spread between lending and deposit rates, kuna ^{9/}	16.2	14.3	9.7	12.0	9.3	7.1	5.4	6.7	6.4	6.8	11.7
in kuna indexed to foreign exchange ^{9/}	6.9	9.5	6.8	5.6	5.9	5.2	4.2	4.5	4.8	4.7	6.4
in foreign exchange ^{9/}	12.6	14.4	8.8	3.0	2.5	4.2	3.5	3.8	3.6	3.3	3.6
Market's assessment of banks											
Deposits with banks, change, yoy	42.8	52.5	40.6	13.6	-2.3	31.2	34.7	29.0	29.1	47.5	37.0
Foreign currency deposits with banks, change, yoy	60.5	54.7	43.4	21.4	-2.6	26.9	28.4	25.7	32.5	53.2	39.9
Intermediation indicators											
Assets in percent of GDP ^{10/}	63.7	62.5	68.9	67.8	65.3	69.8	74.5	68.4	68.7	84.4	87.3
Loans and advances to other domestic sectors in percent of GDP ^{10/}	27.8	27.6	35.9	40.0	36.1	35.6	39.1	36.9	36.7	41.3	44.8
Broad money (M4) in percent of GDP ^{10/}	25.0	34.0	41.0	41.7	39.7	46.4	50.1	46.7	48.5	62.8	63.9

Source: Croatian National Bank, and IMF staff estimates.

1/ Covers deposit money banks. Figures in italics are preliminary.

2/ The significant increase from 1998 to 1999 should be seen in context with the fact that a relatively large number of banks reported negative capital in 1998. Furthermore, regulation was amended affecting the capital adequacy ratio. The information for 2001 only covers commercial banks.

3/ Loans and advances to domestic sector excluding claims on central government and its funds, in percent of demand, savings, time, and foreign currency deposits, excluding central government and its funds.

4/ Deposits here include demand, savings, time, and foreign currency deposits, but excluding central government and its funds.

5/ The primary liquidity ratio is the percentage of monthly day-to-day free reserves averages on monthly day-to-day averages of deposits which constitute the reserve base.

6/ Nonperforming assets include loans classified in categories C-E in percent of total assets, which here refers to total assets of deposit money banks as published in Table D1 in CNB's Monthly Bulletin. At end-2001, nonperforming loans amounted to 7.8 percent of classified assets.

7/ In addition to specific provisions, banks are required to make general provisions of, at minimum, 1 percent of their assets in category A. Total assets here refer to assets of deposit money banks as published in Table D1 in the CNB's bulletin.

8/ The net open position in foreign exchange was reduced from 30 percent of capital to 25 percent effective December 1, 2000, and to 20 percent effective September 1, 2001, at which time certain exemptions were also abolished.

9/ Weighted averages of monthly interest rates. A change of the maturity structure may thus affect the spread.

10/ Nominal GDP annualized by multiplying quarterly GDP by four.

Croatia: Main Economic Indicators, 1995-2003

	1995	1996	1997	1998	1999	2000	2001	2002 Proj.	2003 Proj.
Real economy (percentage change)									
Real GDP	6.8	6.0	6.6	2.5	-0.4	3.7	4.1	3.5	4.0
Unemployment rate (average; percent of labor force) 1/	n.a.	10.0	9.9	11.4	13.6	16.1	15.8	14.5	13.0
Retail prices (e.o.p.)	3.7	3.4	3.8	5.4	4.4	7.4	2.6	3.0	3.5
Gross national saving (percent of GDP)	9.9	16.1	16.0	17.0	19.3	21.8	22.5	24.4	25.2
Gross domestic investment (percent of GDP)	17.6	21.6	27.6	24.0	26.2	24.0	25.6	27.2	28.7
Public finance (percent of GDP)									
General government balance (accrual basis)	...	...	...	...	-8.2	-6.3	-6.6	-6.6	-5.7
General government debt (e.o.p.) 2/	19.3	29.2	31.9	38.8	49.7	51.2	52.4	53.8	54.5
Money and credit (e.o.p.; percentage change)									
Broad money	40.4	49.1	37.6	13.0	-1.2	28.9	45.2	8.1	14.6
Credit to consolidated general government	...	...	...	...	...	33.6	6.7	-4.2	12.8
Other credit	...	...	...	...	...	3.7	25.9	11.5	14.4
Interest rates (e.o.p.; percent)									
Average deposit rate	6.1	4.2	4.4	4.1	4.3	3.4	2.8	2.0 ^{4/}	...
Average credit rate	22.3	18.5	14.1	16.1	13.5	10.5	9.5	13.8 ^{4/}	...
Balance of payments (percent of GDP)									
Trade balance	-17.3	-18.2	-25.8	-19.2	-16.4	-16.8	-19.8	-19.7	-19.6
Current account balance	-7.7	-5.5	-11.6	-7.1	-6.9	-2.3	-3.1	-2.8	-3.5
External debt (e.o.p.)	20.8	23.2	31.9	40.3	44.5	53.1	51.9	49.3	47.4
Gross official reserves (US\$ million; e.o.p.)	1,895	2,314	2,539	2,816	3,025	3,525	4,704	5,445	6,113
Reserve cover (months of imports of goods and services)	2.4	2.8	2.7	3.2	3.7	4.4	5.3	5.8	6.1
Short-term debt (in percent of gross usable official reserves) 3/	31.6	40.7	45.6	75.1	83.5	75.2	60.4	63.1	33.3
Exchange rate									
Exchange rate regime								Other managed floating	
Kuna per US\$ (June 30, 2002)								7.3597	
Nominal effective rate (1995=100; p.a.)	100.0	100.4	101.1	100.3	94.8	94.6	98.1	99.1 ^{5/}	...
Real effective rate (1995=100; p.a.)	100.0	99.2	99.5	101.0	97.1	98.9	103.1	103.6 ^{5/}	...

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

1/ Labor Force Survey (based on ILO standards).

2/ Including arrears and publicly guaranteed debt.

3/ On a remaining maturity basis.

4/ March. A change in methodology has introduced a break in the series as of January 2002.

5/ April.

CROATIA—RELATIONS WITH THE FUND
(As of May 31, 2002)

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

II. General Resources Account:	<u>SDR million</u>	<u>% Quota</u>
Quota	365.10	100.00
Fund holdings of currency	448.88	122.95
Reserve position in Fund	0.16	0.04

III. SDR Department:	<u>SDR million</u>	<u>% Allocation</u>
Net cumulative allocation	44.21	100.00
Holdings	71.22	161.12

IV. Outstanding Purchases and Loans:	<u>SDR million</u>	<u>% Quota</u>
Extended arrangements	23.98	6.57
Systemic Transformation Facility	59.95	16.42

V. Financial Arrangements:

<u>Approval Type</u>	<u>Expiration Date</u>	<u>Amount Approved Date</u>	<u>Amount Drawn (SDR million)</u>	<u>(SDR million)</u>
Stand-by	3/19/2001	5/18/2002	200.00	0.00
EFF	3/12/1997	3/11/2000	353.16	28.78
Stand-by	10/14/1994	4/13/1996	65.40	13.08

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

Overdue		<u>Forthcoming</u>				
	<u>2/28/2002</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Principal	--	13.30	26.60	26.60	10.20	4.80
Charges/Interest	--	<u>1.30</u>	<u>1.90</u>	<u>1.10</u>	<u>0.40</u>	<u>0.20</u>
Total	--	14.60	28.50	27.70	10.60	5.00

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, Croatian National Bank (CNB) was subject to a full safeguards assessment with respect to the Stand-By Arrangement, which was approved on March 19, 2001 and expired on May 18, 2002. The safeguards assessment of the CNB has been completed and the report was sent to the CNB authorities for their comments on April 23, 2002. The safeguards assessment will be finalized as soon as the response from the authorities is received, which should take place prior to the upcoming UFR mission, currently scheduled for October 2002. The

safeguards assessment report makes several recommendations, implementation of which would become a part of the program discussions.

VIII. 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 "managed floating with no pre-announced path for the exchange rate". The Croatian National Bank transacts only in euros, U.S. dollars, and SDRs. On June 30, 2002, the official exchange rate was kuna 7.3597 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions except for a residual balance of foreign currency deposits frozen in 1991 that may include proceeds from current international transactions.

X. 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 March 19, 2001 (EBS/01/27 and SM/01/80, both published). Executive Directors welcomed the progress achieved by the new government in restoring control over the public finances and its adoption of a comprehensive economic program for 2001-2003.

On March 19, 2001 Directors approved a 14-month **stand-by arrangement** for an amount equivalent to SDR 200 million (55 percent of quota). Directors agreed that this program, with its focus on the fiscal deficit and tax reductions, wage discipline, and structural reforms in the context of a stable exchange rate, offered the best prospects for achieving sustainable economic growth and external viability, while increasing employment and the population's standard of living in the medium term.

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 programs for the second and third arrangement years did not take place and the arrangement expired without further purchases on March 11, 2000.

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.

XI. FSAP Participation:

Croatia agreed to participate in the FSAP. The first FSAP mission took place in April 2001 and the second mission took place in September 2001. The FSAP report is expected to be issued soon, and an FSSA has been prepared for the 2002 Article IV consultation.

XII. Technical Assistance 1992–2002:

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
	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification
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
	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Quarterly National Accounts
	April 2001	Monetary Statistics
	March 2002	Accounting and Budgetary Classification
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)
	November 1999	Accounting

	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March-April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
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)

XIII. Resident Representative:

Mr. Norregaard took up his post in Zagreb on January 15, 2001.

CROATIA: IMF-WORLD BANK RELATIONS

I. PARTNERSHIP IN CROATIA'S DEVELOPMENT STRATEGY

1. The Croatian authorities are determined to maintain macroeconomic stability and attain rapid and sustainable economic growth. To this end, the Government has embarked on reforms to address several key economic challenges, including: (i) reducing macroeconomic imbalances to ensure stability while introducing complementary reforms to address underlying structural causes of fiscal imbalances; (ii) increasing the flexibility of the economy; and (iii) creating a business-friendly environment that is conducive to attracting investment.

2. The IMF has taken the lead in assisting Croatia in maintaining macroeconomic stability. An 18 month stand-by arrangement expired on May 18, 2002. Structural measures in the program were closely coordinated with the World Bank and structural conditionality was limited to areas with significant macroeconomic, typically fiscal, implications. The Government has expressed interest in a successor arrangement to buttress macroeconomic stability in the run up to parliamentary elections that must be held by January 2004.

3. The World Bank has taken the lead in policy dialogue on structural and institutional reforms in a number of sectors. This reform agenda includes measures to: (i) reduce the level of public expenditures and the size of the state; (ii) restructure pension and health sectors; (iii) enhance labor market flexibility; (iv) strengthen market institutions and the competitiveness of the economy; and (v) mitigate the social cost of reforms and poverty through restructuring of social welfare programs. Progress is being made in all of these areas. A US\$202 million Structural Adjustment Loan (SAL) was approved by the World Bank Board in December 2001. A Public Expenditure and Institutional Review (PEIR) was completed in March 2002. The PEIR and SAL were key elements of the Bank's assistance strategy in the 1999 Country Assistance Strategy (CAS). Finally, a Country Economic Memorandum (CEM) is currently being drafted by the Bank following a request by the Government of Croatia to assist in its efforts to join the European Union (EU) down the road.

IMF-World Bank Collaboration in Specific Areas

4. The IMF and World Bank staff maintain a close collaborative relationship in supporting the Government's structural reforms. In the financial sector, the Bank and the Fund share responsibility and are coordinating their policy advice to the Croatian authorities. A joint FSAP has been conducted. In preparation for the possibility of a new SBA, Bank and Fund staff have tentatively agreed on a detailed matrix stipulating areas where each institution will take the lead in supporting key structural measures including several areas of joint responsibility including fiscal transparency and budgetary procedures, public debt management, and reform of the payments system.

5. In most areas of structural reform the Bank has taken the lead, though these areas would be a critical part of the broader economic program which could be supported by a successor SBA.

- *Public expenditure management and control*

6. Key challenges include: (i) ensuring that recently initiated efforts to create a transparent budget decision making process by consolidating government accounts become broadened to cover all fiscal operations including all off-budget funds and road agencies, as well as local government units; (ii) improving the usefulness, quality, and timeliness of information upon which budget decisions are made; (iii) enhancing financial decision-making by the introduction of an explicit multi-year budgetary framework into the Budget Law, and (iv) strengthening fiscal discipline by increasing penalties for overspending units and introducing transparent criteria for issuing treasury guarantees.

7. The Bank has taken the lead in dialogue on these reforms in the context of the SAL. Implementation on some of these issues has been slower than anticipated. For instance, while the 2002 budget was adopted with a new chart of accounts which includes four extra-budgetary funds and the fiscal activities of the Croatian Bank for Reconstruction and Development, and while it follows modified commitment-based accounting consistent with the methodology of GFS 2001, one extra-budgetary fund and several agencies (Road Agency, Highway Agency, Croatian Privatization Fund and Bank Rehabilitation Agency) were not included in the budget, nor presented as a part of the consolidated budget. In addition, two new funds have been created (the Employment and Development Fund and the Regional Development Fund) and an increasing amount of fiscal spending has been undertaken by the Road and Highway agencies, outside the budgetary framework. Also, an Environment Protection Fund and an Agency for SME Development will start functioning in 2003, with the legislation for their establishment adopted early in 2002. Regarding other issues, the 2002 budget did not adopt penalties for overspending budget units nor set criteria nor a ceiling for government guarantees, as envisaged in the SAL. However, the Government is now drafting a new organic budget law which should address all of the issues raised in paragraph 6. IMF staff insistence in initial discussions on a potential successor SBA that such a program must use broader general government data in its quarterly performance criteria has dovetailed in a timely fashion with Bank advice to the authorities.

8. Direct subsidies in Croatia, at some 2.7 percent of GDP in 2001, are in line with other transition countries. But this figure excluded hidden subsidies (custom waivers, social security contribution waivers, tax waivers, credit lines with subsidized interest rates, and debt-equity swaps at nominal value) given to shipyards, agro-conglomerates and other state-owned companies. Together, direct and indirect subsidies have been used to postpone the resolution of non-viable enterprises.

9. However, substantial progress has been made. Under the SAL program the Government has eliminated all indirect subsidies and is drafting a Law on State Aid which will set the types of allowed subsidies in accordance with the WTO guidelines, as well as establish a body to monitor all state aid. Also, at the end of 2001, the Government drafted a subsidies reduction action plan for 2002-2005. In addition, the Government is committed to compile a registry of farmers to facilitate the provision of income support subsidies. This operation will be supported by the Bank through the Farmer Support Services Project. While the latter seems to be on track, direct subsidies in the 2002 budget were not reduced as envisaged in the subsidies reduction action plan. In the context of SAL supervision, the Bank is urging the Government to ensure that subsidies in the 2002 out-turn and the 2003 budget are in line with the action plan.

- *Pension and health reform*

10. The Government's pension reform aims to reduce the reliance of the pension system on budgetary transfers, while addressing the overall, longer-term problems of coverage, affordability, equity, and adequacy. At the same time, pensions have played an important role in rural poverty alleviation and as a social safety net for the elderly. Although Croatia initiated the design of a comprehensive overhaul of its pension system in the late 1990s, implementation was slow. The reforms included 1998 amendments to the first pillar law which helped control expenditures, protect the minimum pension, and gradually increase the retirement age. These steps were followed in 1999 by legislation providing the framework for mandatory and voluntary funded pensions, managed by private pension funds.

11. The Bank has taken the lead role in supporting pension reform measures under the Pension System Investment Project, as well as the SAL. A multi-pillar pension system was established in January 2002. Implementation has been fully satisfactory. However, further reform challenges remain, including revision of the Pension Insurance Act aimed at strengthening short-term sustainability of the first pension pillar by: (i) increasing actuarial decrement for the early retirement; (ii) reducing the minimum pension accrual rate; (iii) basing pension accruals solely on paid contributions; and (iv) introducing annual pension indexation. In addition, completion of the legal framework for establishment of pension insurance companies, licensing of voluntary pension funds and development of voluntary pension schemes, as well as improving the Law on Mandatory and Voluntary Pension Funds will create the basis for safe development of the second and third pillars.

12. Croatia spends about 9 percent of its GDP on health, which is well above the levels of CEECs, which average 6-7 percent of GDP. These high levels of health spending are not sustainable. Beleaguered by systemic, sustained and substantial financial deficits in recent years, the health sector has required sizable infusions of funds to stay afloat and maintain the flow of inputs necessary to keep the provision of health services at levels expected by the population. The Ministry of Health has developed and received Parliamentary approval for a Health Sector Reform Strategy in 2001, which is intended to

be the basis for overhauling relevant legislation, and reorienting health system practices. In addition, cost-saving measures such as hard budget caps for hospitals and reference pricing for drugs have been introduced by the Ministry of Health in an effort to contain the upward cost spiral.

13. The Bank is supporting a comprehensive program of sector reforms through the Health Reform Project and a program of economic and sector work. A number of structural reform measures, including use of alternative care settings, different primary care models, and improved hospital management practices, are being piloted in Koprivnica with World Bank support. The SAL-supported agenda in the sector includes: reduction of duration of sick leave; revision of co-payment schedules for drugs and selected services; reduction in exemptions from co-payments; and adoption of a methodology for prioritizing health service delivery and input purchases. In addition, a centralized regular monthly reporting system of health institutions through the Treasury will be established and will separate costs of basic from the additional health package. Finally, a draft Law on Obligatory Contributions Payment was submitted to Parliament in June. The law will complement the aforementioned measures by: raising the minimum contribution base; unifying, simplifying and broadening the contribution bases; establishing a contribution cap; and improving enforcement responsibilities.

- *Enhancing labor market flexibility*

14. As part of the program of reforms supported by the SAL, the new Law on Employment Mediation and Entitlements During Unemployment was adopted by Parliament in March 2002. The law permits the operation of private employment services, and raises the length of employment necessary to qualify for open-ended unemployment benefit by five years, to 35 and 30 years of service for men and women, respectively. This increase will be implemented gradually over five years, by raising the necessary employment record by 6 months every half year.

15. The Government is pursuing discussions within a tripartite working group to introduce changes to the Labor Law. The proposed changes are consistent with those agreed under the SAL. They aim at improving labor market flexibility through reducing the dismissal costs in order to foster hiring and job creation. The most important proposed changes include: (a) relaxing restrictions on the use of fixed-term contracts from 2 to 5 years, (b) easing the pre-conditions for valid dismissals, (c) exempting small firms (employing up to 20 employees) from regulations governing dismissals, (d) shortening the advance notice period from 6 to maximum 3 months, (e) reducing the amount of severance pay from half to one-third of the monthly pay and defining the maximum to 6 pays, and (f) relaxing the definition of mass lay-offs.

16. Strong trade union opposition has delayed agreement within the tripartite working group on the draft Labor Law. While the legislation was originally envisaged for adoption by Parliament in mid-2002, the Government has recently announced that the draft law will not be submitted to Parliament before October 2002. Polls indicate that

there has been little public support for the proposed changes and employers have not taken an active role in the tripartite discussions.

- *Strengthening market institutions and the competitiveness of the economy*

17. Croatia's performance in terms of enterprise restructuring, privatization, new business environment, attraction of FDI, and overall creation of an enabling environment for development of an internationally competitive private sector do not compare favorably to CEECs which are EU accession candidates. One important aspect of this lack of progress was reflected in the relative lack of hardening of budget constraints on incumbent enterprises. In the context of reforms supported by the SAL, the Government recognized such actions as vital to help reduce the distortions engendered by non-payments, barter and subsidies—especially in public enterprises. Hardening budget constraints helps to induce restructuring, free resources bottled up in nonviable firms that can be reallocated to more productive uses, and create economic space for new entry. In this regard, the Croatian authorities acknowledged that there is a critical role to be played by accelerating reform of the key public enterprises in terms of eliminating arrears, making payments and requiring sales in cash and on time, and increasing financial transparency to help lead the way for further enterprise restructuring economy-wide.

18. The elimination of arrears and barter of public enterprises is being monitored by the Bank as part of the SAL. Despite a significant decrease in arrears by the end of 2001, overdue receivables and liabilities have not yet been eliminated. The Government is redoubling its efforts on this front and the Bank will continue to monitor the situation closely.

19. In addition to hardening budget constraints on public enterprises, the government plans to undertake a comprehensive privatization program which includes divesting Government stakes in the banks (Croatia banka, Privredna banka, and Croatian Postal Bank), the Croatia insurance company, the telecommunications company, the portfolio held by the Croatian Privatization Fund (tourism, shipyards, agribusiness) and energy companies (INA, HEP, and JANAF).

20. The financial sector is in the final stages of privatization and restructuring. The Bank has provided assistance to the Government through the EFSAL, TAL I, and TAL II in addition to the FSAP. More than 90 percent of the banking sector has been privatized. While the Government is in the final stages of divesting its remaining minority stake in Privredna banka, progress in privatizing the two remaining State-owned banks has been slow. Privatization of the Croatia insurance company is on track for privatization by end 2002. The Bank has also played the lead role in assisting the Government in power sector restructuring, and strengthening the regulatory and legislative framework through the EFSAL and through the TAL II loan. Progress, while slower than originally envisaged, is being made in all of these areas. INA and JANAF are likely to be privatized by end 2002 and preparation for the privatization of HEP is on track for 2003.

21. Although a modern bankruptcy law was adopted in 1996 and amendments were passed in 2000, the bankruptcy system in Croatia does not function in a satisfactory manner. The reason for this is largely due to an inadequate institutional capacity of the commercial court system to handle bankruptcies expeditiously and efficiently and the inability to enforce collateral contracts. Reforms are needed to address: outdated court and case management; inexperience of commercial judges, trustees and receivers in the modern bankruptcy regime; lack of knowledge by creditors of their rights; inadequate trust by businesses in the bankruptcy process; and lack of confidence by the population in the efficiency of the overall judiciary system.

22. The Bank is now providing technical assistance to the Government (in cooperation with USAID) in this area through the Court and Bankruptcy Administration Project in addition to monitoring reforms in the context of the SAL. The Government is drafting provisions to improve the legal and institutional framework for Croatia's bankruptcy regime, including a law on certification of receivers (trustees) and amendments to the law on bankruptcy and the law on court registry.

23. An accounting and auditing ROSC report, prepared by the Bank in 2002, is based on an assisted self-assessment of accounting and auditing standards and practices in Croatia conducted under the management of a National Steering Committee consisting of representatives from government and the private sector. The self-assessment exercise specifically focused on the strengths and weaknesses of the institutional arrangements needed for the observance of International Accounting Standards (IAS) and International Standards of Auditing (ISA). The Accounting Act was amended in 1992 in order to adopt a more investor oriented approach. The Act took the important step of requiring all companies to prepare IAS financial statements. The Audit Law requires that the audit should be carried out by a certified auditor licensed under authority granted by the Ministry of Finance and in accordance with ISA. Therefore, Croatia does not suffer from a "standards gap". However, there are significant variations in the level of compliance with IAS and ISA and there is no enforcement or monitoring of compliance.

24. The National Steering Committee has approved a Country Action Plan consistent with the issues raised in the ROSC report. The Plan includes greater conformity between Croatian law and EU Directives, better monitoring of compliance with IAS and ISA, strengthened regulation and supervision of the audit profession, more efficient and effective requirements for the filing, and enhanced public access to corporate financial information.

25. Conditions in Croatia for new business entrants, including a dynamic SME sector, are not hospitable. Like other transition countries, Croatia inherited from the previous system a preponderance of large enterprises and a business culture which emphasized economies of scale, mass production, vertical integration and self-sufficiency (in-house production instead of subcontracting/outsourcing). SMEs offer the promise to generate competition, expand employment, increase exports and introduce new technologies. The emergence and development of SMEs has been stifled by, among other problems:

difficulties and complexities in business licensing and registration (identified by the FIAS study on Administrative Barriers to Investments), other barriers for investment (ineffective land register and cadastre, long delays in granting visas and work permits), and the lack of a well-coordinated and articulated pro-SME policy in the country.

26. The Government is committed to implementing an Action Plan that improves Croatia's FDI and domestic investment policy regime by bringing the fiscal, regulatory and legal policy framework in line with best international practice. The Action Plan will be monitored on a quarterly basis by the Government and the Bank as a component of the SAL. In addition, in order to facilitate financing of the smallest businesses, a legal and regulatory framework to facilitate provision of micro credit by non-governmental organizations will be established under the SAL-supported program.

- *Strengthening Social Protection*

27. Croatia has a wide-ranging system of social transfers targeted at groups that are needy. However, despite relatively high levels of spending, the system fails to provide adequate protection to the most vulnerable members of society. Substantial resources are allocated to programs which are not explicitly targeted to the poor. The few programs that are well targeted do not receive sufficient funding. Apart from the Poverty Assessment carried out by the Bank in 1999, there is little information on the targeting efficiency of social assistance programs. The system suffers from a multiplicity of benefits, which adds substantially to administrative costs and overall system complexity. As a result, the overall objective of poverty alleviation is inefficiently addressed.

28. The reform program of the SAL contains four key objectives: (i) ensuring a more coordinated approach to benefits, and changes in benefits policy; (ii) re-allocating resources towards programs that are well-targeted; (iii) ensuring more community-based social service delivery on grounds of both cost and quality; and (iv) improving the information base on which to monitor poverty reduction and the impact of policy changes.

29. The Government has prepared a draft national strategy for combating poverty which will be sent to the Parliament later in 2002. The document lays out a coordinated strategy across the range of Government agencies to reduce poverty. In October 2001 the Government took steps in rationalizing benefits by harmonizing with the rest of the population the tax allowances of war veterans and invalids as well as privileged pensioners. At the same time the Parliament adopted a new child benefit law which enhanced the targeting effectiveness of child allowances. The Government has already taken steps to improve the availability of reliable and nationally representative household survey data through expanding the household budget survey to cover the entire country. The recently collected national census data (carried out in April 2001) will be used to update sample design and create a reliable basis for policy-relevant data analysis.

World Bank Group Strategy and Lending Operations

30. The Bank's Board discussed the CAS for Croatia in June 1999 and a CAS progress report in September 2001. The progress report determined that policy reform in Croatia, while slower than anticipated in the CAS, was sufficient to place Croatia in a "base case" lending scenario. The base case triggers included adoption of fiscally sound budgets in 2000 and 2001, full pay-out under the deposit insurance scheme, privatization of three banks, bankruptcy proceedings against six insolvent banks, initiating the privatization of the largest state-owned insurance company, adoption of a telecommunications regulatory framework and invitation to strategic investors in the telecommunications company (HT), initiating restructuring/privatization of oil and gas, and maintaining satisfactory performance of 90 percent of the Bank portfolio.

31. The overall objectives of the CAS are: (i) supporting a sustainable fiscal policy while enhancing effectiveness of public expenditure; (ii) maintaining financial stability and continued financial sector reforms; (iii) reducing the size of the State; and (iv) improving governance.

32. Currently, there are eleven Bank supported projects (10 investment loans and 1 adjustment operation) totaling US\$524.1 million under implementation in Croatia: the Farmer Support Services Project (US\$17 million) became effective in July 1996, the Coastal Forest Reconstruction and Protection Project (US\$42 million) became effective in July 1997, and the Investment Recovery Project (US\$30 million) became effective in March 1998. The Reconstruction Project for Eastern Slavonia, Baranja and Western Srijem (US\$40.6 million) became effective 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, Technical Assistance II (US\$7.3 million) in April 1999 and the Health System Project (US\$29 million) in October 1999. The Trade and Transport Facilitation in Southeast Europe (US\$13.9 million) became effective in May 2001. The Court and Bankruptcy Administration Project (US\$5 million) became effective in January 2002, and the SAL (US\$202 million) became effective in February 2002, with a first-tranche disbursement of US\$102 million in the same month. A GEF financed US\$5 million grant for the Karst Ecosystem Conservation Project was signed on June 19, 2002.

33. Investment projects currently under preparation include: the Pension System Investment Project (US\$27.3 million), the Registration and Cadastre Project (US\$24.2 million), the District Heating Project (approximately US\$30 million), the Coastal Cities Pollution Control Project (approximately US\$100 million), the Rijeka Gateway Project (approximately US\$150 million), and the Social Protection Project (approximately US\$36 million). A Social and Economic Recovery Project is also under consideration.

34. As of May 2002, the IFC had 7 projects in its portfolio for a total of US\$114.9 million (US\$82.3 million for its own account) and had approved pending

commitments for three other projects for a total of US\$28.7 million. The projects are: (1) a US\$2.5 million equity participation in TS Bank; (2) a US\$2.2 million loan to a small regional bank based in Split, for the financing of small and medium-sized enterprises; (3) a US\$6.0 million equity investment and a US\$15.4 million loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility; (4) a US\$5.0 million equity investment in a venture capital fund; (5) a US\$12.2 million loan to a regional bank for a credit line for on-lending to small and medium-sized enterprises; (6) a US\$15 million loan and US\$6.1 million equity investment to modernize a ship repairing facility in Rijeka; (7) a US\$37.5 million loan and US\$10 million equity investment in the leading pharmaceutical complex in Croatia; (8) a US\$3 million equity investment in a pension management company; (9) a US\$5 million loan and US\$1.2 million equity investment in a Croatian leasing company; and (10) a US\$16 million loan and US\$3.5 million equity investment in Croatia Banka as a pre-privatization facility. The IFC is seeking to expand its activities in Croatia, focusing on financial market development, manufacturing, agribusiness, tourism, and infrastructure privatization.

Questions may be referred to the following Bank staff: Mr. Broadman (ext. 31312), Mr. Courtney (385 1 235 7215) and Ms. Madzarevic-Sujster (385 1 235 7260), Mr. Peters (ext. 33556).

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, excessive delays in data release, and subsequent revisions 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 and lack of cooperation between government agencies. The recent creation of a joint committee between the Ministry of Finance and the Croatian National Bank should promote collaboration in the statistical area to advance the reconciliation of government finance and monetary data. Croatia has subscribed to the SDDS and its metadata are posted on the DSBB (<http://dsbb.imf.org>).

A. National Accounts

2. National accounts (NA) data systems have undergone substantial improvement in the last few years, enabling publication of a broader, and more comprehensive, set of NA data. The Central Bureau of Statistics (CBS) compiles and publishes annual constant and current price data according to the production, income, and expenditure approaches. On June 30, 1999, the CBS began publishing quarterly GDP data by expenditure and main industry groupings at current and constant (1997) prices, thus meeting the SDDS target date. 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; inadequate 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). A particular problem is connected with the late publication of annual data, which generally present large differences with quarterly data. After the abolition of the payments agency (ZAP) in late 2001, enterprise financial statistics are collected by the finance agency (FINA). Further improvements are currently being implemented and a new project for the production of regional GDP statistics has been recently started.

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 are collected around the 20th day of each month, and the indices are released on the last working day of the month. However, 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. A new consumer price index will be released in April 2003. The main characteristics of the new index will be:

a) its weighting structure, based on the household survey (rather than on the retail survey, as in the old retail price index), to be revised every five years; b) the use of the geometric mean (as opposed to the arithmetic mean in the old RPI) to aggregate elementary series; c) the application of “implicit” quality adjustment. At the same time, the harmonized CPI will be calculated in line with Eurostat methodology, but will not be released for the time being to avoid confusion. A core inflation index will also be calculated based on a methodology developed by the CNB.

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 for the first time in 1996 on 7,200 households. The sample has been subsequently expanded and the survey is now being conducted on a regular basis with semi-annual results, released only after a delay of about five months. The difference between the survey-based unemployment rate and that based on registered unemployed is generally of about six percentage points.

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 are reliable and available on request on a next-day basis for most major categories for both the budget and the extrabudgetary funds. Expenditure data on a cash basis are available according to GFS methodology (economic and functional classification) for the budget and the extrabudgetary funds. A new chart of accounts was used to develop the 2002 budget for part of general government entities. Budget users “own revenues”, excluding universities, have been brought into the 2002 budget. The data on central government financing in the Ministry of Finance reports, the monetary survey and the balance of payments are not reconciled. Substantial discrepancies exist partly due to different definitions of government by the Ministry of Finance and the central bank.

7. Data on the stock of government debt suffer from certain deficiencies although a new CNB database represents a major improvement. The detailed data on domestic public bonds published in the Monthly Statistical Review of the Ministry of Finance are now compounded by a central government debt table in the CNB Monthly Bulletin, which also reports stocks of

central government guaranteed debt. However, data on expenditure arrears —formally recorded for the first time at the end of 1999—, promissory notes and receivable issues linked to banks privatization are not included.

8. Data on the operations of local governments and consolidated general government are available only on an annual basis and with a considerable lag.

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. Following the recommendations of the Monetary and Financial Statistics mission that visited Croatia in 2001, attempts have been made by the CNB and the Ministry of Finance to reconcile the monetary statistics and the government finance statistics data. However, data from the CNB on net credit to government continue to be inconsistent with the data on the financing of government from the Ministry of Finance. As a subscriber to the SDDS, Croatia regularly disseminates the information on its international reserves and foreign currency liquidity in a template according to the IMF methodology. The data is disseminated monthly on the IMF and CNB external websites. The source of data is the CNB balance sheet. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies.

F. Banking Statistics

10. Banks' lending and deposit rates are published monthly in the CNB Monthly Bulletin. 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. A change in sampling has introduced a break in the interest rate series since January 2002.

G. Balance of Payments Data

11. 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 and are subject to substantial revisions in subsequent releases; 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. In January 1998 a major revision of balance of payments statistics took place which led to the evaluation of imports on an f.o.b. basis and the inclusion of goods imported into free trade zones. The new surveys on transportation, travel, government services, and labor income were introduced in 1999. While the survey of transportation delivers very accurate estimates, the other three surveys still need improvements. Also since 1999 valuation changes have been excluded from the asset side of currency and deposits in the banking sector (a major improvement). In mid-2001 new surveys on communication and insurance services were introduced and a survey of construction services is being prepared. During 1999 and 2000, the CNB has increased the coverage of direct investment by identifying additional enterprises. The coverage and quality of portfolio investment data are reasonably complete and accurate.

12. 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. This information has further improved in 2000 with the introduction of the new CNB database. Foreign debt statistics are available on request on the same day, but certain breakdowns (e.g., external public and publicly guaranteed debt by creditors), loans received by the resident household sector, and credits received with a maturity of less than 90 days are not covered in the standard reports. Also, there is still a problem of identifying payments arrears; however, the authorities are in the process of updating their database for earlier years in order to identify genuine arrears, if any, and record them in the balance of payments.

13. Annual data on the international investment position are disseminated on the CNB website with a six-month delay.

Croatia: Core Statistical Indicators
(as of May 31, 2002)

	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	May 31, 2002	May 31, 2002	May 31, 2002	May 31, 2002	Apr. 30, 2002	May 31, 2002	Apr. 2002	Mar. 2002	Q4 2001	Mar. 2002	Q4 2001	Apr. 30, 2002
Date Received	May 31, 2002	May 31, 2002	May 31, 2002	May 31, 2002	May 31, 2002	May 31, 2002	May. 8, 2002	May 31, 2002	May 31, 2001	May 2002	Mar. 29, 2002	May 31, 2002
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Source of Update	CNB Website	CNB Website	CNB	CNB	CNB	CNB	CBS Website	CBS Website	CNB	Ministry of Finance	CBS Website	CNB
Mode of Reporting	On-line	On-line	E-mail	E-mail	E-mail	E-mail	On-line	On-line	E-mail	E-Mail	On-line	E-Mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

Statement by the IMF Staff Representative
August 5, 2002

This statement provides information that has become available since the issuance of the staff report for the Article IV consultation with Croatia (SM/02/230). This information does not change the thrust of the staff appraisal in that report.

1. As anticipated, a new four-party coalition government, under the continued leadership of Prime Minister Račan, received majority parliamentary support on July 30. Except for the Ministry of Economy, there were no personnel changes in the economic area, and the new government's program remains broadly unchanged, with focus on reducing unemployment, increasing competitiveness and exports, curbing public debt, accelerating structural reforms, and improving the efficiency of public administration and the judiciary.
2. The twelve-month rate of retail price inflation increased from 1.8 percent in May to 2.2 percent in June. However, the core rate of inflation remained at 1.0 percent and producer prices were 1.0 percent below their June 2001 level. During July, the exchange rate of the kuna depreciated slightly against the euro without foreign exchange intervention.
3. The twelve-month rate of broad money expansion continued to decelerate from (a recently downward revised) 37 percent in April to 34 percent in June. However, the year-on-year rate of credit expansion remained at 25½ percent in June, with a small slowdown in consumer credit offset by an acceleration in business lending.
4. Croatia's EMBI stripped spread has remained at around 120–130 basis points since early May, despite the sharp rise in spreads for the EMBI global composite. Although down by almost 20 percent from its May 20 peak, the Croatian stock market index (CROBEX) still was up by about 11 percent year on year on July 31.
5. The caretaker cabinet shortlisted five foreign bidders for due diligence procedures ahead of the sale of 25 percent of the oil company (INA) later this year. It also decided to sell the remaining 25 percent share in Privredna Banka, the second largest bank, to its foreign majority shareholder.
6. In early July, parliament approved the new banking law, with only minor changes from the version discussed with the mission, together with new laws on securities, savings banks, and seizure of joint stock companies. Also in July, the caretaker Minister of Economy submitted to parliament draft laws on consumer protection, investment promotion, and real estate trading.
7. Revised data indicate that the June 2001 fiscal deficit ceiling under the recently expired stand-by arrangement was exceeded by HrK 136 million (less than 0.1 percent of GDP). The reason for the excess was a HrK 166 million upward revision of domestic bank financing. This revision reflects the net effect of previously unreported net sales of government bonds in domestic banks' portfolios to foreigners (HrK 413 million) and the

exclusion of a €32.5 million (HrK 247 million) bank loan to the highway construction agency (HAC), which remained outside the fiscal consolidation under the stand-by arrangement. Performance under the fiscal ceilings for the remainder of 2001 remained unaffected by this revision, and no purchases were made under the precautionary stand-by arrangement, which expired on May 18, 2002.

**Statement by J. de Beaufort Wijnholds, Executive Director for the Republic of Croatia
August 5, 2002**

As usual, staff has painted a candid and fair picture of the Croatian economy. I thank staff for its continuous advisory role, which is much appreciated by the Croatian authorities.

General Outlook

Last year's macroeconomic performance was good, despite the less favorable external environment and some unforeseen delays in policy implementation. Croatia even overperformed in several key areas – economic growth was above 4 percent, inflation was below 3 percent, and international reserves increased by almost \$1.2 bln. It is worth mentioning that good economic growth was achieved in the wake of considerable fiscal consolidation, which indicates an impressive performance of the private sector. Let me only support this with the fact that for the first time since transition started, the last year's aggregate net profit/loss balance of the Croatian enterprises turned to positive values. On the structural front, performance was somewhat less satisfactory, as the complexity of the reform agenda and domestic political instability caused delays in implementation. Nonetheless, reasonable progress has been accomplished and the previous SBA successfully reached its end in Spring 2002.

The good macroeconomic performance was continued this year. The first quarter growth figure (4.6 percent) was a positive surprise, especially since analysts thought that the growth deceleration (which started in the last quarter of 2001) would continue in the first half of this year. Presently, analysts are revising their growth projections, and there is no doubt anymore that 3.5 percent growth will be achieved in 2002. The only question is whether 4 percent growth is within reach.

Fiscal Policy

Fiscal policy continues to represent the main vulnerability of a broader macroeconomic setup. However, much has been done over the last two years, and the sustainability of fiscal policy has improved considerably. This is also recognized by the markets, as is borne out by the falling spreads on government bonds, which declined (by some 280 bp since end-1999) to 120 bp at present.

The authorities realize, however, that there is still a long way to go. The task continues to be complex, as progress in fiscal consolidation also requires decisive and coordinated progress on the structural front. However, the authorities are committed to accomplish their mission of reaching a sustainable fiscal position. This year, they plan to reduce the fiscal deficit of the consolidated central government by an additional percentage point of GDP, while reducing revenues by almost 1.5 percentage points of GDP. This implies a 2.5 percentage point of GDP adjustment on the expenditure side, and the authorities are determined to achieve this objective despite a slight underperformance in the first quarter.

Staff efforts to compile statistics on the general government are much appreciated,

and this is the first time the table presenting these figures are presented to the Board. It is important to note that the fiscal deficit figures of the consolidated general government could be somewhat confusing, as they do not give the impression of ongoing fiscal consolidation. As staff points out in footnote 3, a large infrastructure spending is taking place outside the central government, which staff decided to integrate into the general government, since they wanted to be on the safe side. While appreciating this conservative approach, the authorities wish to highlight again that the highway, which is currently under construction, is a self-financing project completely under the jurisdiction of a state owned company (Croatian Motorways Ltd.). The company has its own revenues (coming from road tolls and sales of gasoline), which will be fully sufficient to repay loans and cover current maintenance costs.

Monetary and Exchange Rate Policy

Monetary policy continues to be focused on low inflation, while keeping an eye on exchange rate developments. In fact, exchange rate stability (against the euro) contributed to an outstanding inflation performance since late 1993. The experience of several periods of hyperinflation since the 70's through the early 90's, and banking system's instability, has taught citizens to adjust. The adjustment took place in form of Dmarkization (now euroization), which has not been reversed despite 8 years of monetary stability.

This also explains why monetary policy still relies significantly on foreign exchange interventions, and why an inflation targeting system would be a less adequate tool in the near future. Staff suggestions which go in the direction of less f/x intervention, more volatility in the exchange rate and strictly focusing on inflation, are well taken by the authorities. But in practice, the first best theoretical solutions do not always give the expected (first best) results. Besides the historical reasons, there is an additional peculiarity which strongly affects monetary policy – and that is the tourist season. Summer is always the part of the year with most appreciation pressures, while the winter shows the opposite. In absence of any intervention, the exchange rate would clearly exhibit much stronger seasonal peaks and downs. This would provide an even better opportunity for speculation. Hence, the authorities keep an eye on exchange rate movements, with an aim to discourage any kind of speculation. But in doing so, they also have a clear objective – to preserve price stability – which has been recently formalized in the central bank law. Finally, let me note that such a policy is entirely consistent with the authorities' aspirations to join the EU and introduce the euro as legal tender in a manner consistent with practices that are applicable to the economies embarking on an accession path and consistent with the recommendations of the EU and the ECB.

Financial system

The Croatian financial system, like monetary policy, is also heavily influenced by monetary history. Most of its liabilities are denominated in foreign currency. At the same time, a relatively small part of assets is in foreign currency. The banks have found a way out of this mismatch through loan indexation. However, solving the mismatch has not solved the indirect credit risk, which could occur if the currency depreciates significantly. The FSSA paper clearly points to this vulnerability, and in fact, there is no quick fix for this problem. Again, once Croatia joins the EU and adopts the euro, the problem will be solved.

It is interesting to note that the main finding of the FSAP mission – the financial system

is now more resilient – has been recently tested. In March 2002, after the announcement that Rijecka banka (3rd largest bank) lost \$100 mln in foreign currency trading losses, a run on the bank occurred. The authorities reacted decisively and immediately, they took a majority stake for 1 euro, changed the management of the bank, and soon thereafter sold the bank to another foreign bank. Through this action, the authorities earned some 50 mln euro, while saving the bank.

Structural Reforms

Paragraph 9 of the report clearly describes a number of structural reforms, which have been implemented up to now. Obviously, the implemented reforms are wide-ranging, which gives the impression of the overall complexity of the reform program. But the same paragraph also suggests a further agenda. Indeed, the authorities are now working on reforming the judiciary, and to undertake reforms in the health and education sectors. In addition, reform of the labor market is being extensively discussed with both employees and entrepreneurs. Regarding the slow progress in privatization, I note that the strategy has not changed, nor has the authorities' decisiveness to proceed with the process. The authorities' approach to privatizing the banking system, for instance, has not been to quickly generate privatization revenues, but to find strategic investors, thereby ensuring more certainty in the future for particular banks. This strategy has helped to create a highly competitive and stable banking system.

Exchange Restriction

Before concluding, let me draw attention to one rather unfortunate issue, which is related to the proposed decision to temporarily approve an exchange restriction falling under the jurisdiction of Article VIII. I would like to remind the Board that this issue was 'discovered' quite recently (in 1999), although the frozen foreign exchange deposits had a much longer history (they emerged in 1991), and although regulation addressing the underlying issue was devised with the expert help from both the Fund and the World Bank right from its inception. The authorities have been constantly arguing (since 1999) that there is nothing within these frozen deposits, which would give rise to an exchange restriction. In fact, the reasoning of the LEG staff that these deposits might include income, which was generated from current account transactions, has a very weak foundation. And it seems that the LEG staff has recognized over time that it is indeed hard to believe that in the wake of the former Yugoslavia's breakdown, citizens would leave their current foreign exchange proceeds in banks for even a very short period of time. In addition, even in the case that small amount of current income was frozen in households' foreign exchange accounts on April 17, 1991, these funds have been paid out by now. It might be useful to point out that the outstanding amount of frozen deposits accounted for \$3.30 bln (on April 27, 1991), \$0.36 bln (on December 31, 1999), and \$0.06 bln (on April 30, 2002).

This led LEG staff to state in early May 2002 (before the EU1 mission left for Zagreb), that if the two conditions are satisfied (equal treatment of residents and non-residents and accrued interest already repaid), LEG staff would rule that there is no reason any longer which would give rise to an exchange rate restriction. The authorities responded that it was clear that these two conditions had already been satisfied long before 1999, when LEG staff 'discovered' the case. Still, again the Board is asked to approve the exchange

restriction. In early July, LEG staff requested the authorities to issue legislation, stating that if there is still (in any case) some 'current' money in frozen deposits, the authorities would immediately repay this money. As a matter of principle, the authorities have decided not to issue this legislation. Not only do they feel that this issue has not been treated correctly, they also have strong reasons to believe that not all successor countries of the former Yugoslavia have been treated equally. Thus, the authorities request LEG staff to come with a paper which would show whether uniformity of treatment has been respected for all successor countries.

Conclusion

While the authorities have accomplished much over the last two years, there are still various challenges on the way ahead, particularly in the area of public finances and structural reform. The authorities are well aware of that, and they wish to reiterate their firm commitment to continue with the job they started two years ago. In the same vein, they are looking toward continuation of close and fruitful cooperation with the Fund for the future.



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August 8, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with the Republic of Croatia

On August 5, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.¹

Background

Croatia experienced solid growth in the last two years, with growth rates of around 4 percent, exceeding those of the euro area and of many other transition countries. The recovery, initially propelled by private consumption and exports, has more recently extended to investment, encouraged by easy access to credit and public infrastructure spending. After decelerating at the end of 2001 in the wake of the slowdown in Europe, growth resumed strongly in the first quarter of 2002 supported by domestic demand. While private consumption is likely to slow down after a rapid increase in household indebtedness, leading indicators confirm that the prospects for the tourist season are good while exports are likely to benefit from the expected recovery in Europe. In spite of sizable employment creation by small and medium-sized enterprises, unemployment remains at about 16 percent of the labor force, which is in line with other transition countries.

Inflation is low despite continuing upward adjustment of administered prices. Exchange rate stability, trade liberalization, wage moderation, productivity increases, and enhanced competition in retail trade, all contributed to ease inflationary pressures. Annual retail price inflation, after reaching 7.4 percent at the end of 2000, fell to 1.8 percent in May 2002.

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.

Indicators of core inflation and producer price inflation confirm that underlying inflationary pressures remain muted. However, inflation in sectors less exposed to competition, like services, remains substantially higher.

The external position is strong. After rising to 3.1 percent in 2001, the current account deficit is expected to decline to 2.8 percent in 2002, with strong tourism inflows and income transfers offsetting large imports of capital goods. Capital inflows related to euro conversion, privatization receipts and government borrowing have continued to strengthen international reserves and external vulnerability indicators have improved.

The fiscal position remains weak. Aided by reforms in public administration and social transfers, the fiscal deficit of the central government was reduced from 7.4 percent of GDP in 1999 to 5.4 percent in 2001. Nonetheless, expenditure outside the central budget increased substantially as a result of an ambitious highway construction program, and the general government deficit is expected to remain unchanged at 6.6 percent of GDP in 2002.

Under pressure from capital inflows, the exchange rate has slightly appreciated. The Croatian National Bank (CNB) intervened repeatedly to stem these pressures, further boosting international reserves. Encouraged by the favorable inflation outlook, the CNB only partially sterilized these inflows, trying to avoid the emergence of interest rate differentials that would attract further capital. The abundant liquidity has reduced interest rates to very low levels and credit to both consumers and businesses has grown briskly.

Despite a run on the third largest bank, the banking system has remained stable. The prompt reaction of the authorities, with the provision of liquidity support and the rapid reprivatization of the bank, helped contain the crisis. While important reforms in the financial sector have contributed to its further strengthening and vulnerability indicators have improved, the indirect exposure of the banking system to exchange rate risk remains a significant concern.

Progress in structural reforms has continued to be slow. Some progress has been made in pensions, public sector wages, social transfers, and fiscal administration. However, reforms have lagged behind in privatization, health, judiciary, education, labor market, and subsidies. These delays have postponed efficiency gains and undermined the economy's medium-term growth prospects.

Integration in the interantional trading system is all but complete. The trade regime has been liberalized, and Croatia has become a member of the WTO and has concluded free trade agreements, including a Stabilization and Association Agreement with the EU, covering 28 countries.

The outlook for 2002 is moderately positive. With a good tourist season and improving external conditions, GDP growth is likely to reach 3.5 percent in 2002. The risks appear evenly balanced. Even though the recovery in Europe may turn out to be slower than expected, there is a sizable prospect that private consumption will continue to be strong.

Executive Board Assessment

Executive Directors commended Croatia's recent strong economic performance, noting that growth has been restored to above the central and east European average, while inflation had been reduced to EU levels. The external position has strengthened considerably, with a low current account deficit, a high level of international reserves, and ready access to international capital markets. Croatia has also made good progress in trade liberalization and integration with the EU and other regional markets. However, Directors expressed concern about the still high fiscal deficit, the rising public debt ratio, and delays in the area of structural policies. They therefore urged the authorities to accelerate fiscal consolidation and structural reforms in order to stabilize the debt ratio and to boost employment and economic growth.

Directors agreed that, given Croatia's high tax burden and expenditure ratio, fiscal consolidation should rely primarily on expenditure reforms—which are also needed to make room for EU and NATO-related spending, as well as education and infrastructure programs. Directors stressed several priorities for expenditure reductions: the wage bill, mainly through employment cuts in defense, and through administrative reforms; subsidies—where Directors questioned the newly-decided increases for agriculture, shipbuilding and other sectors; and transfers, through further reform of the first pension pillar, the cessation of temporary special pension payments, and continuing health sector reform. The social impact of these measures should be mitigated by an appropriately funded social safety net and well designed active labor market policies.

Directors urged the authorities to improve fiscal transparency. They attached particular importance to the compilation of reliable and timely general government data, and the inclusion of the new funds for employment and growth and for regional development in the 2003 budget. Off-budget funds should be included transparently in the general government.

Directors supported the monetary framework, with its emphasis on broad exchange rate stability in the pursuit of low inflation. The favorable external current account position and competitiveness considerations suggest that the level of the exchange rate is broadly appropriate. Nevertheless, competitiveness should be further enhanced by removing remaining barriers to foreign trade, and by structural policies and wage moderation. In light of the high degree of euroization, and the weak and uncertain monetary policy transmission mechanism, Directors found the focus on the exchange rate by the CNB appropriate at this stage. While a few Directors considered such a policy suitable for Croatia going forward, most Directors suggested that the CNB gradually increase its focus on inflation, and accept the greater exchange rate flexibility that would likely result. Such a refocusing should be accompanied by measures to further develop financial markets and promote the public understanding of monetary policy.

Directors noted the rapid growth of the monetary aggregates due to euro conversion and unsterilized capital inflows, which occurred in a setting of growing confidence in the currency and the banking system. While inflation pressures are muted at present, and broad money growth has recently slowed, Directors urged the CNB to react promptly should signs of inflation emerge. They considered that the CNB should tighten its monetary stance—through increased

sterilization, if needed—if excess liquidity and low interest rates rekindle inflationary pressures, especially if fiscal consolidation were to provide insufficient support.

Directors noted with satisfaction the substantial strengthening of the financial system. Nonetheless, they observed that some vulnerabilities remain, especially from credit risk due to unhedged currency exposure. In their view, this exposure may be encouraged by public perceptions that exchange rate risk is absent—a concern that also supports the call for greater exchange rate flexibility. While promoting the development of the financial markets, the authorities should also cautiously liberalize capital movements to allow the development of markets for hedging instruments. In view of the rapid growth of bank credit, Directors recommended that the CNB direct increased supervisory attention to the soundness of banks' lending decisions and insist on appropriate provisioning. Directors agreed that while creating a single supervisory agency is premature at present, there is scope for more effective coordination among the regulatory bodies and possibly the unification of nonbank supervisory functions under one umbrella. Directors welcomed the strengthened legal and regulatory framework for combating money laundering and the financing of terrorism.

Directors urged the authorities to give a fresh impulse to structural reform, focusing on measures to improve efficiency and promote a business-friendly environment. The still large role in production of the government—including local authorities—should be reduced by privatization and elimination of subsidies. Public administration should be made more efficient by delegating responsibility and initiative to institutionally strengthened local governments. Directors also viewed greater flexibility of the labor market as necessary to reduce unemployment, which is high relative to EU levels.

Directors encouraged the authorities to improve national accounts, price, and labor statistics; shorten the lags in the publication of data; reduce the discrepancies between quarterly and annual national accounts data; and strengthen the reliability of unemployment statistics, in particular in the official unemployment register.

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.

Croatia: Main Economic Indicators, 1995-2003

	1995	1996	1997	1998	1999	2000	2001	2002 Proj.	2003 Proj.
Real economy (percentage change)									
Real GDP	6.8	6.0	6.6	2.5	-0.4	3.7	4.1	3.5	4.0
Unemployment rate (average; percent of labor force) 1/	n.a.	10.0	9.9	11.4	13.6	16.1	15.8	14.5	13.0
Retail prices (e.o.p.)	3.7	3.4	3.8	5.4	4.4	7.4	2.6	3.0	3.5
Gross national saving (percent of GDP)	9.9	16.1	16.0	17.0	19.3	21.8	22.5	24.4	25.2
Gross domestic investment (percent of GDP)	17.6	21.6	27.6	24.0	26.2	24.0	25.6	27.2	28.7
Public finance (percent of GDP)									
General government balance (accrual basis)	...	...	...	...	-82	-6.3	-6.6	-6.6	-5.7
General government debt (e.o.p.) 2/	19.3	29.2	31.9	38.8	49.7	51.2	52.4	53.8	54.5
Money and credit (e.o.p.;percentage change)									
Broad money	40.4	49.1	37.6	13.0	-1.2	28.9	45.2	8.1	14.6
Credit to consolidated general government	...	...	...	...	...	33.6	6.7	-4.2	12.8
Other credit	...	...	...	..	...	3.7	25.9	11.5	14.4
Interest rates (e.o.p.;percent)									
Average deposit rate	6.1	4.2	4.4	4.1	4.3	3.4	2.8	2.0 4/	...
Average credit rate	22.3	18.5	14.1	16.1	13.5	10.5	9.5	13.8 4/	....
Balance of payments (percent of GDP)									
Trade balance	-17.3	-18.2	-25.8	-19.2	-16.4	-16.8	-19.8	-19.7	-19.6
Current account balance	-7.7	-5.5	-11.6	-7.1	-6.9	-2.3	-3.1	-2.8	-3.5
External debt (e.o.p.)	20.8	23.2	31.9	40.3	44.5	53.1	51.9	49.3	47.4
Gross official reserves (US\$ million; e.o.p.)	1,895	2,314	2,539	2,816	3,025	3,525	4,704	5,445	6,113
Reserve cover (months of imports of goods and services)	2.4	2.8	2.7	3.2	3.7	4.4	5.3	5.8	6.1
Short-term debt (in percent of gross usable official reserves) 3/	31.6	40.7	45.6	75.1	83.5	75.2	60.4	63.1	33.3
Exchange rate									
Exchange rate regime									
Kuna per US\$(June 30, 2002)	100.0	100.4	101.1	100.3	94.8	94.6	98.1	99.1 5/	...
Nominal effective rate (1995=100;p.a.)	100.0	99.2	99.5	101.0	97.1	98.9	103.1	103.6 5/	...
Real effective rate (1995=100;p.a.)									

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

1/ Labor Force Survey (based on ILO standards).

2/ Including arrears and publicly guaranteed debt.

3/ On a remaining maturity basis.

4. March. A change in methodology has introduced a break in the series as of January 2002.

5/ April.