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Republic of Croatia: First Review Under the Stand-By Arrangement and Requests for Waiver of Nonobservance and Applicability of Performance Criteria—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia

In the context of the first review under the Stand-By Arrangement and requests for waiver of nonobservance and applicability of performance criteria, the following documents have been released and are included in this package:

- the staff report for the first review under the Stand-By Arrangement and requests for waiver of nonobservance and applicability of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **May 23, 2003**, 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 9, 2003**. 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 supplement of **July 30, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its August 1, 2003 discussion** of the staff report that completed the review.

- a statement by the Executive Director for the Republic of Croatia.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Republic of Croatia*
Supplementary Memorandum of Economic and Financial Policies by the authorities of the Republic of Croatia*

*May also be included in Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

First Review Under the Stand-By Arrangement and Requests for Waiver of Nonobservance and Applicability of Performance Criteria

Prepared by the European I and the Policy Development and Review Departments

(In consultation with other departments)

Approved by Carlo Cottarelli and John Hicklin

July 8, 2003

- Messrs. Flickenschild (head), Eskesen, Konuki (all EU1), Čihák (MFD), and Dodzin (PDR), assisted by Mr. Norregaard (resident representative), visited Zagreb during May 12-23 to conduct the first review under the 14-month stand-by arrangement approved on February 3, 2003. Mr. Stučka (OED) attended the meetings. The mission worked closely with staff from the local World Bank office.

- The mission met with the Deputy Prime Minister for economic affairs, the Ministers of Finance and Tourism, the Governor of the Croatian National Bank (CNB), senior officials of these and other ministries and government agencies, and representatives of unions, employers, banks, and the academic community.

- The authorities are treating the arrangement, which amounts to SDR 105.88 million (29 percent of quota), as precautionary. The second review mission is scheduled for September 2003, with Board discussion expected in November 2003. The third and final review mission is scheduled for November 2003, with Board discussion expected in January 2004.

- Croatia submitted its application for EU membership in February. Elections are likely to be held in late 2003.

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Main Websites for Croatian Data

Data in this report reflect statistical information received by July 1, 2003.
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. RECENT ECONOMIC DEVELOPMENTS AND POLICY IMPLEMENTATION

1. **An unexpected burst in domestic demand propelled real GDP growth to 5.2 percent in 2002**, exceeding the staff's projection of 4 percent (Tables 1 and 2). Fueled by credit expansion, domestic demand accelerated during the second half of 2002, with concurrently rising imports putting pressure on the external current account. Despite a weaker external environment, economic activity remained strong in early 2003: real GDP growth was 4.9 percent in the first quarter, and year-on-year growth in industrial output was 5.8 percent during January-May 2003, while retail sales volume grew by 7.6 percent during January-April 2003 (Figure 1).

2. **Inflation has been lower than expected, with the twelve-month rate of retail price inflation falling from 2.3 percent at end-2002 to 0.9 percent in May 2003** (Figure 2). Core inflation in May was even lower at 0.3 percent. However, producer price inflation has been positive since the second quarter of last year, reaching 1.8 percent in May.

3. **Fueled by the credit boom, the external current account deficit widened sharply to 6.9 percent of GDP in 2002** (Table 3). Despite a good tourist season, the current account deterioration resulted from the surge of imports in the second half of the year and a stagnation of non-ship merchandise exports. Heavy private sector borrowing from abroad, in part to sustain the credit boom, and adverse exchange rate movements caused the external debt to GDP ratio to surge to 68.2 percent at end-2002. Foreign trade data indicate that the current account deficit remained large in the first half of 2003.[1]

4. **Despite a weaker balance of payments and bouts of political tension, Croatia has maintained favorable access to international capital markets**. Disputes over privatization, new labor legislation, the handling of war-crimes trials, and drought relief to farmers have weakened the coalition government. However, neither the political tensions nor the worsened current account deficit has adversely affected Croatia's standing in the financial markets. A € 500 million seven-year bond and a ¥ 25 billion six-year bond were placed at yields of 4.6 percent and 1.2 percent in February and June, respectively, and Croatia's EMBI stripped spread has been hovering around 100 basis points since May 2003 (Figure 3).

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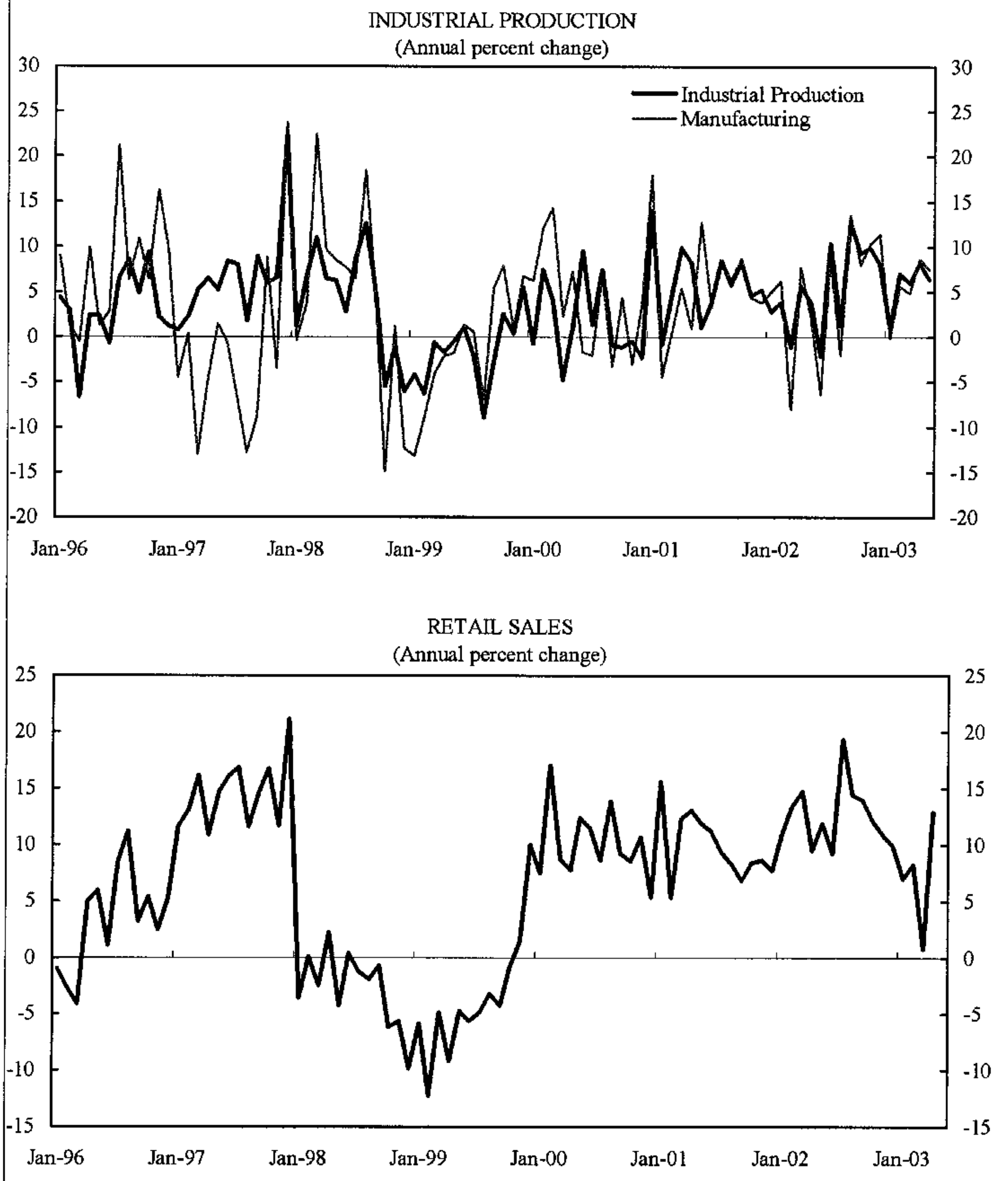
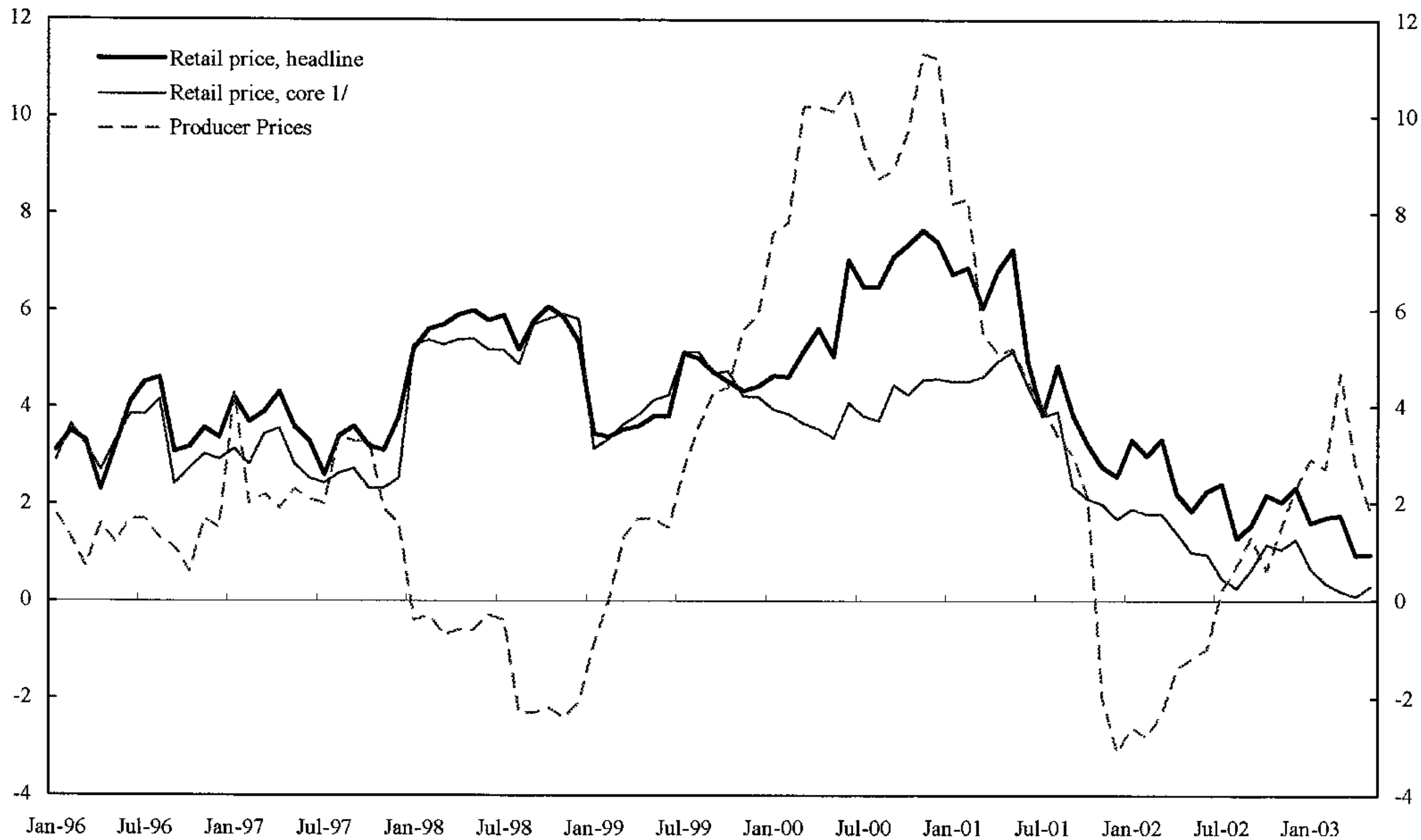
[1] Large negative net errors and omissions in Croatia's balance of payments statistics are believed to result mainly from unsurrendered export proceeds (mainly tourism) and unrecorded investments by residents abroad. Their increase in 2002 is likely to reflect economic agents' attempt to reconstitute their cash balances from export proceeds after the conversion of euro legacy currencies in late 2001-early 2002.

Figure 1. Croatia: Real Sector Developments, 1996-2003



Source: Croatian Bureau of Statistics.

Figure 2. Croatia: Retail and Producer Price Inflation, 1996-2003
(Annual percent change)



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

Figure 3. Croatia: Sovereign Bond Spread, 1997-2003
(In basis points)

Source: JP Morgan.
1/ Difference between the weighted average of each country's government bond yields, calculated after taking out the collaterized portion of bonds, and the weighted average of US government bond yields with the same maturity.

5. **The fiscal outcome was stronger than expected in 2002 and early 2003.** The general government deficit was 4.8 percent of GDP in 2002 (Table 4), compared with 6.2 percent projected in the staff report (IMF Country Report No. 03/27). Revenue was 0.4 percentage points of GDP higher than foreseen, mainly reflecting stronger economic growth. Total expenditure was 1 percentage point of GDP lower than foreseen, with all main expenditure categories performing better except for net lending and purchases of goods and non-wage services. Subsidies and transfers undershot expectations mainly due to underspending on the employment enhancement program and lower social transfers. Capital expenditure was lower because the highway construction agency and local governments faced difficulties in implementing their ambitious investment plans. The fiscal performance in the first quarter was better than programmed (Box 1). Buoyant economic activity boosted revenue and especially profit and personal income tax receipts (Table 6). Several factors contributed to lowering expenditure: (i) adverse weather conditions delayed highway construction; (ii) lower unemployment and continued difficulties with implementation of employment enhancement and other programs led to lower than projected subsidies and transfers; and (iii) the low interest rate environment, U.S. dollar weakness, and lower financing requirements resulted in savings on interest payments.

Box 1. Program Performance Through March 31, 2003

Program performance has been mixed. All end-March quantitative performance criteria were observed except for that on arrears of the central government (Table 5). This nonobservance is not likely to have had any significant macroeconomic effects, and the authorities have agreed to make up for the slippage by end-September 2003 (Supplementary Memorandum of Economic and Financial Policies (SMEFP), ¶ 13). As discussed in paragraph 9, all end-March structural conditions (one performance criterion and three benchmarks) were missed.

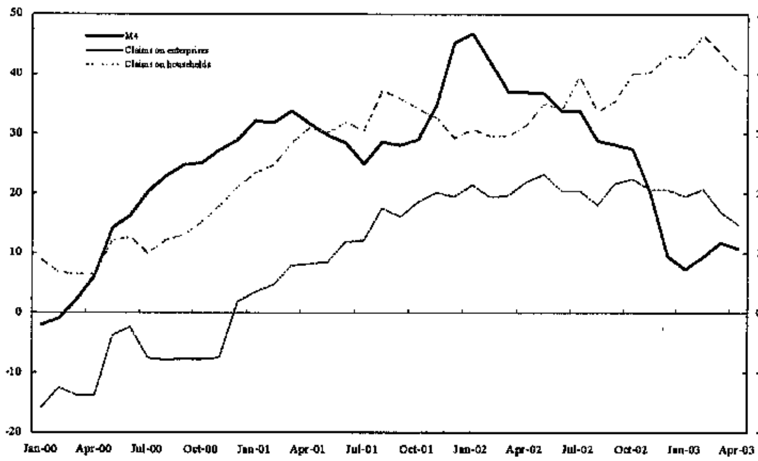
Staff expects that the end-June quantitative performance criteria, which will be controlling at the time of the first review, will be met.

6. **The CNB tightened monetary policy by administrative measures to cool off the economy.** Following years of anemic growth, credit to the private sector began to expand more rapidly in mid-2001 as banks began to see improved lending opportunities in the household and business sectors. After exhausting the room created by the euro conversion in mid-2001—early 2002, banks financed continued rapid credit expansion by borrowing from their parents abroad.[2] As a result, domestic liquidity remained high throughout 2002, and private sector credit expanded by more than 30 percent during 2002. In response, the CNB announced on January 15 that banks whose lending grew by more than 4 percent per quarter would be obliged to purchase CNB bills at penalty rates in an amount twice as high as the

[2] Some banks syndicated loans to their subsidiaries in Croatia to avoid breaching country exposure limits.

excess credit. It also increased the required foreign exchange coverage of banks' foreign exchange liabilities to discourage foreign borrowing. Although the end-March limit was exceeded somewhat, credit growth slowed to 7 ½ percent in the first five months in 2003 (Figure 4), with 1/2 percent due to valuation effects.[3]

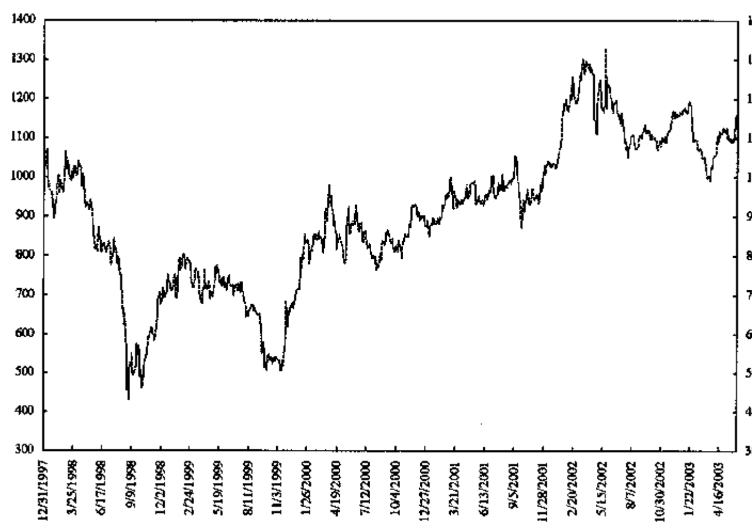
Figure 4. Croatia: Money and Private Sector Bank Credit, 2000-2003
(Annual percent change)



Source: Croatian National Bank.

7. **The brisk credit expansion has not boosted asset prices.** As of early June 2003, the stock price index was about 15 percent lower than at its peak in May 2002 (Figure 5). Although there are no good indicators on nationwide property prices, anecdotal evidence suggests that real estate prices in the Zagreb area have been flat for three years.

Figure 5. Croatia: Crobex (Stock Price Index), 1997-2003
(July 1, 1997=1000)



Source: Bloomberg.

8. **The kuna has been broadly stable in the first six months of 2003**. It depreciated by about 3 percent against the euro in the first quarter (Figure 6). Apart from the usual seasonal factors, the increased foreign exchange cover requirements and loan repayments by enterprises seem to have exacerbated the depreciation pressures. The CNB sold the equivalent of €315 million of foreign currency in the first

[3] After adjusting for attempts by banks to circumvent the limits, credit growth is estimated at 10 percent, compared with 12 percent in the comparable 2002 period.

Figure 6. Croatia: Exchange Rates Developments, 1995-2003

Sources: Croatian National Bank; and IMF Information Notice System.

quarter, but its international reserves rose to a new record as the government deposited the proceeds of its Eurobond with the CNB. Since early April, the kuna has largely reversed the depreciation.

9. **Progress with privatization and structural reforms has been slower than envisaged under the program.** The government postponed its decision on the bids received for the partial privatization of the oil company (INA), missing the end-March structural benchmark. The structural benchmark on preparing a privatization program for the postal bank (HPB) was also missed as the government changed its strategy following recommendations by an IFC mission against the prior acquisition of Croatia Banka for commercial reasons and because it would delay the privatization.[4] The state aid law was approved by parliament in March in accordance with the authorities' original plan. However, the parliamentary approval of the new budget law slipped into May, missing the end-March structural benchmark. The government did not prepare criteria for issuing government guarantees during the first quarter, missing the end-March structural performance criterion. By contrast, a regulation to include options in the calculation of banks' net foreign exchange position took effect on April 1, meeting structural benchmarks for end-June and end-September 2003. This regulation has raised some banks' long position above the statutory limit of 20 percent of capital.

II. THE PROGRAM FOR THE REMAINDER OF 2003

10. **The prospects for achieving the original program's principal objective of stabilizing the public debt ratio remain favorable, but the recent credit boom and the related sharp increase in the external current account deficit have created new challenges.** As described below, staff believes that, with unchanged policies, the general government deficit in 2003 is now likely to be 4.6 percent of GDP, rather than 5 percent under the original program. Moreover, a downward revision of debt statistics[5] and a more conservative approach to extending guarantees will facilitate debt ratio stabilization. However, the large external deficit, concurrently with lower than anticipated direct foreign investment, has led to a sharp increase in gross external debt and raises issues of vulnerability

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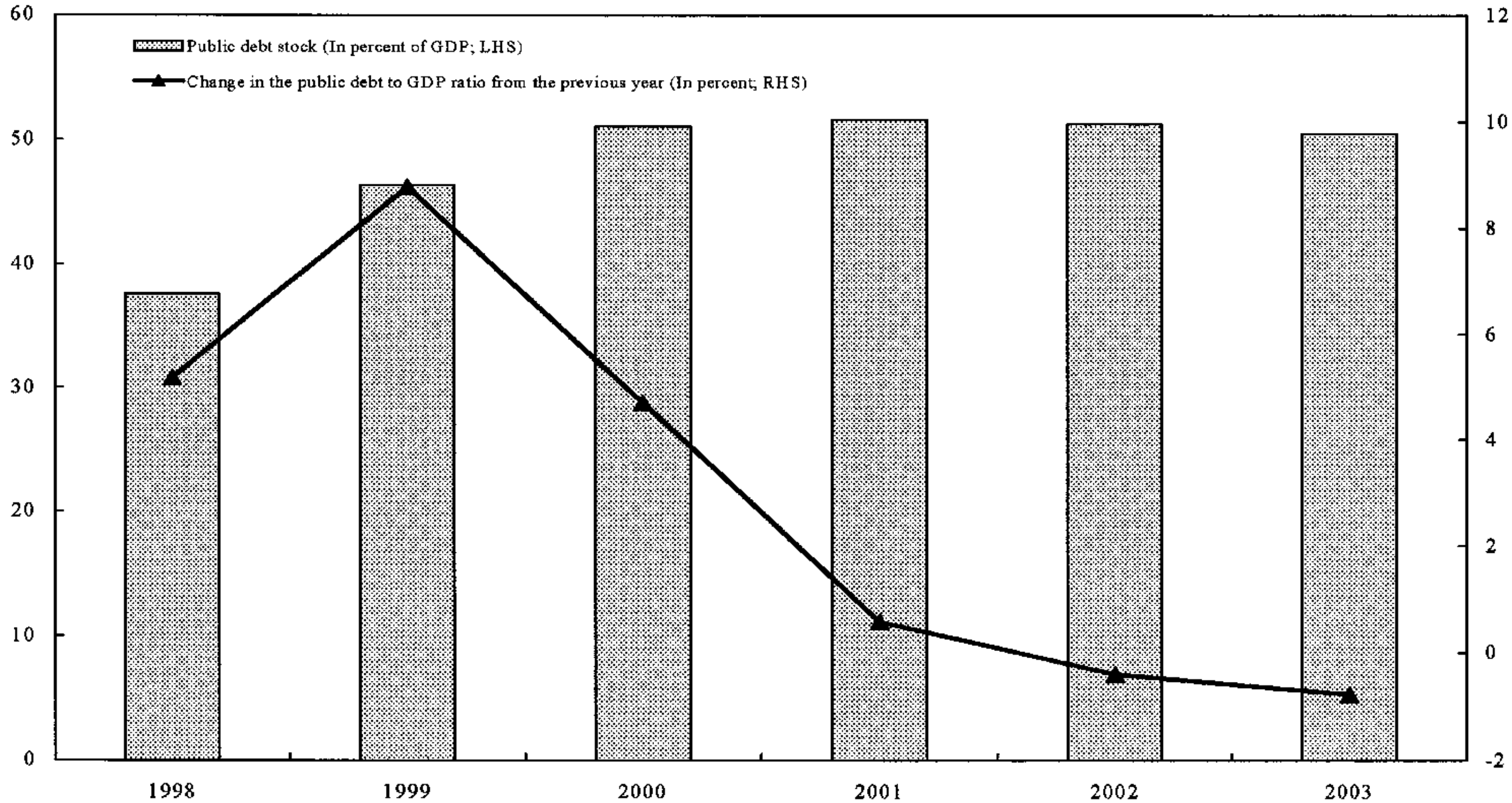
[4] The implementation of this structural benchmark is monitored in consultation with the IFC (MEFP, ¶ 23).

[5] The elimination of double counting of some direct and guaranteed debt, together with lower net borrowing to finance the lower fiscal deficit, lowered the public debt to GDP ratio to 51.6 percent of GDP at end-2002 (Figure 7).

Figure 7. Croatia: Public Debt Stock, 1998-2003



Sources: Ministry of Finance; and Fund staff estimates.

(Box 2). These risks are exacerbated by the large foreign exchange exposure of nonbank businesses and households in the context of a heavily managed exchange rate.[6]

11. **Driven by monetary tightening, the revised program therefore needs to steer the economy toward a lower external deficit.** The authorities consider that a current account deficit of 3½-4 percent of GDP would be appropriate in the medium term (Box 2). They view a reduction of the deficit by 1½ percentage points to 5.5 percent of GDP in 2003 as an intermediate step toward this goal. In their view, action on the monetary front is preferable to other instruments for three reasons. First, the exchange rate does not appear misaligned from the viewpoint of Croatia's competitiveness and a depreciation would have severe balance sheet effects. Second, tightening fiscal policy would not address the root of the problem, which has been a sharp deterioration in the private saving-investment balance (Table 7), caused by the credit boom. Third, a few months ahead of parliamentary elections, fiscal tightening would prove difficult to implement and involve implementation delays. Staff accepted this position but pointed out that further fiscal adjustment would be needed beyond the program period to reduce the still large deficit and the economy's vulnerability, particularly if the saving-investment balance of the private sector does not improve rapidly.

Box 2. External Vulnerability

The larger current account deficit and higher external debt have increased external vulnerability. Standard sustainability analysis shows much greater sensitivity of the external debt ratio to some of the shocks applied to the baseline projection than reported in the last staff report. The new baseline continues to exhibit a declining trend for the external debt ratio, thanks to a current account deficit that declines to 3½ percent of GDP by 2007 and the assumption that, as an EU accession candidate, Croatia will attract sufficient FDI and other nondebt creating flows to finance a deficit of this size (Appendix V). As a result of the worsened starting position, however, standard shocks to the baseline trigger larger (but still temporary) jumps in the external debt ratio. In particular, the ratio jumps to 104½ percent of GDP in the case of a one-time 30 percent depreciation (compared to 87 percent in the last staff report), which could lead to severe balance sheet effects, before resuming its decline.

A. Near-Term Outlook and Risks

12. **Economic growth in 2003 is expected to remain in line with the original program objective.** An increased share of capital goods imports in early 2003 suggests that fixed

[6] The balance sheet of the nonbank sector is not available and its vulnerabilities must be inferred from bank balance sheets. However, the financial agency (FINA) has recently begun collecting financial statements of incorporated businesses.

capital formation is likely to keep its momentum. However, private consumption growth is expected to moderate in response to tighter monetary conditions and growing household indebtedness. A cutback in public consumption and a government sector wage freeze will also cool down domestic demand. However, an acceleration of merchandise exports in the early months, prospects of a strong tourist season, and an expected deceleration of imports are likely to improve the current account balance in the second half of the year. As a result, staff expects real GDP growth to moderate to 4.2 percent in 2003, which is consistent with the original program objective.

13. **Inflation is expected to be lower than originally assumed.** After falling to very low levels, retail price inflation is likely to edge up, reflecting lower productivity growth in the nontradable sector in the context of broad exchange rate stability. Staff and authorities expect retail prices to rise by some 2 ¼ percent this year.

14. **Although higher than under the original program, the external current account deficit is expected to decline to 5.5 percent of GDP in 2003,** contributing to the stabilization of the external debt ratio. The current account adjustment, concentrated in the second half of the year, is expected to result from more moderate import growth, an acceleration of merchandise exports, and higher tourism exports as Croatia is likely to benefit as a tourist destination in the prevailing international environment.

15. **The principal risk to this outlook relates to the CNB's ability to rein in credit expansion.** The current account deficit may not come down as expected, and external vulnerability would remain high, if the gradual tightening of monetary conditions described in paragraph 19 did not succeed in curtailing credit growth or if banks manage to circumvent the administrative limits on credit. Banks have used securitization and asset swaps to elude the credit limits. The CNB has closed these loopholes and is prepared to raise minimum reserve requirements, as indicated in ¶ 14 of the SMEFP, supplemented by stepped-up supervisory efforts to ensure prudent lending decisions. An additional review mission has been scheduled for September 2003 to focus on progress in current account adjustment.

B. Fiscal Policy

16. **With unchanged policies, staff expects that the general government deficit will be 4.6 percent of GDP in 2003 and the public debt to GDP ratio could decline to 50½ percent at end-2003.** With overall expenditure projected to remain largely unchanged relative to the original program (SMEFP, ¶ 12), the fiscal improvement is driven almost entirely by an upward revision of projected revenue based on higher than expected growth in 2002 and buoyant tax collections in early 2003. As long as the government adheres to the planned zero net issuance of guarantees and implements its privatization program, it could realize the program objective of public debt ratio stabilization with a comfortable margin.

Consolidated General Government Finances
(In percent of GDP)

	1999	2000	2001	2002		2003	
				Staff Report	Actual	Staff Report	Revised Prog.
Revenue and grants	48.4	46.2	44.7	45.4	45.2	45.0	44.9
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0	50.0	49.5
General government deficit	-8.2	-6.5	-6.8	-6.2	-4.8	-5.0	-4.6

Sources: Ministry of Finance and staff projections.

17. **The authorities are determined to resist pressures for tax cuts and expenditure increases in the run-up to elections.** Achieving the revised deficit target still hinges on defense sector employment reduction by some 10,000 and containment of current transfers. While actual layoffs trailed the plan in the first quarter, the authorities are confident to catch up with the plan. The government will consult with the Fund on appropriate measures to safeguard the fiscal deficit target if the cumulative wage bill continues to exceed the indicative limits (Table 8). In addition, current transfers might increase if the finances of hospitals deteriorate more than currently envisaged, in which case the government is determined to cut back expenditure on goods and services and capital spending.

18. **In response to the downward revision of the fiscal deficit, the government will scale down net foreign borrowing.** Relying on domestic financing will support the tightening of monetary policy, reduce exchange rate appreciation pressure, and help develop domestic capital markets. Privatization receipts have been revised up to a still conservative 1.7 percent of GDP, with the majority expected to come from the partial sale of INA. An asymmetric adjuster calls for offsetting expenditure cuts if privatization receipts fall short of the projected level. Staff suggested that the Samurai bond be canceled considering the reduced financing needs. The authorities rejected the idea, arguing that domestic financing prospects could be adversely affected by the upcoming elections, but agreed to deposit the bond proceeds abroad as a contingency reserve (SMEFP, ¶ 13). Although domestic financing has also been revised down due to the lower deficit and higher privatization receipts, it will still reach 1.5 percent of GDP, compared with 0.2 percent in 2002.

C. Monetary and Exchange Rate Policy and Financial Sector Supervision

19. **Authorities and staff agreed that the credit boom raised both macroeconomic and macroprudential issues.** A slowdown of credit expansion was needed to reverse the current account deterioration. Although the administrative measures appear to have been moderately effective, staff stressed that these measures would distort competition and encourage balance sheet manipulation and that they should not be a substitute for market-oriented monetary policy actions or close financial sector supervision. The CNB was skeptical about the effect of higher interest rates in the highly euroized economy and feared that higher interest rates would attract further capital inflows. It had nonetheless accepted a gradual increase in the CNB bill rate from 2 percent to 2.5 percent at a time when interest

rates abroad had fallen. The CNB was adamant to maintain the administrative measures until the end of 2003 to preserve its credibility and reputation for immunity to outside pressure to repeal them; from 2004, supplementary provisioning requirements for rapidly growing banks would replace the administrative credit restraints. Instead of directly raising interest rates, the CNB stands ready to increase the minimum reserve requirements if the current account fails to improve (SMEFP ¶ 14). If needed, it might restrict capital inflows based on the recently adopted foreign exchange law.[7] Staff advised that any such measures should be consistent with Article VIII.

20. **The CNB intends to complement credit restraint with stepped-up supervisory measures to ensure that the banking system remains sound.** The financial soundness indicators on banks' capital adequacy, profitability, and liquidity do not signal a deterioration, but nonperforming loans increased slightly in the first quarter of 2003 after three years of decline (Table 9). Private sector representatives indicated that corporate leverage has increased, portending a possible deterioration of asset quality. Staff found that insurance companies have taken on a substantial part of the credit risk associated with banks' retail portfolios.[8] This is a source of concern, given the limited risk management and supervision capacity in the insurance sector. To address this potential risk, the CNB intends to strengthen cooperation with domestic nonbank supervisory agencies.

21. **The exchange rate remains adequate according to standard competitiveness indicators.** Croatia's unit labor costs and real effective exchange rate have increased somewhat in recent months, but not by more than those of its main competitors and trading partners (Figure 8). Staff suggested to allow greater short-term fluctuations than in the past, pointing out that the CNB's low tolerance of exchange rate movements could encourage the buildup of unhedged foreign exchange positions. Considering exchange rate stability a major achievement of its policy, the CNB resisted this suggestion, preferring instead to use its supervisory powers to warn economic agents about the risks of unhedged foreign exchange exposure (SMEFP, ¶ 15). Supervisors needed to ascertain that these risks are priced properly, given that 78 percent of bank loans are denominated in or linked to foreign exchange and that a significant share of those loans is extended to borrowers with kuna denominated sources of income and often limited access to hedging instruments. In this

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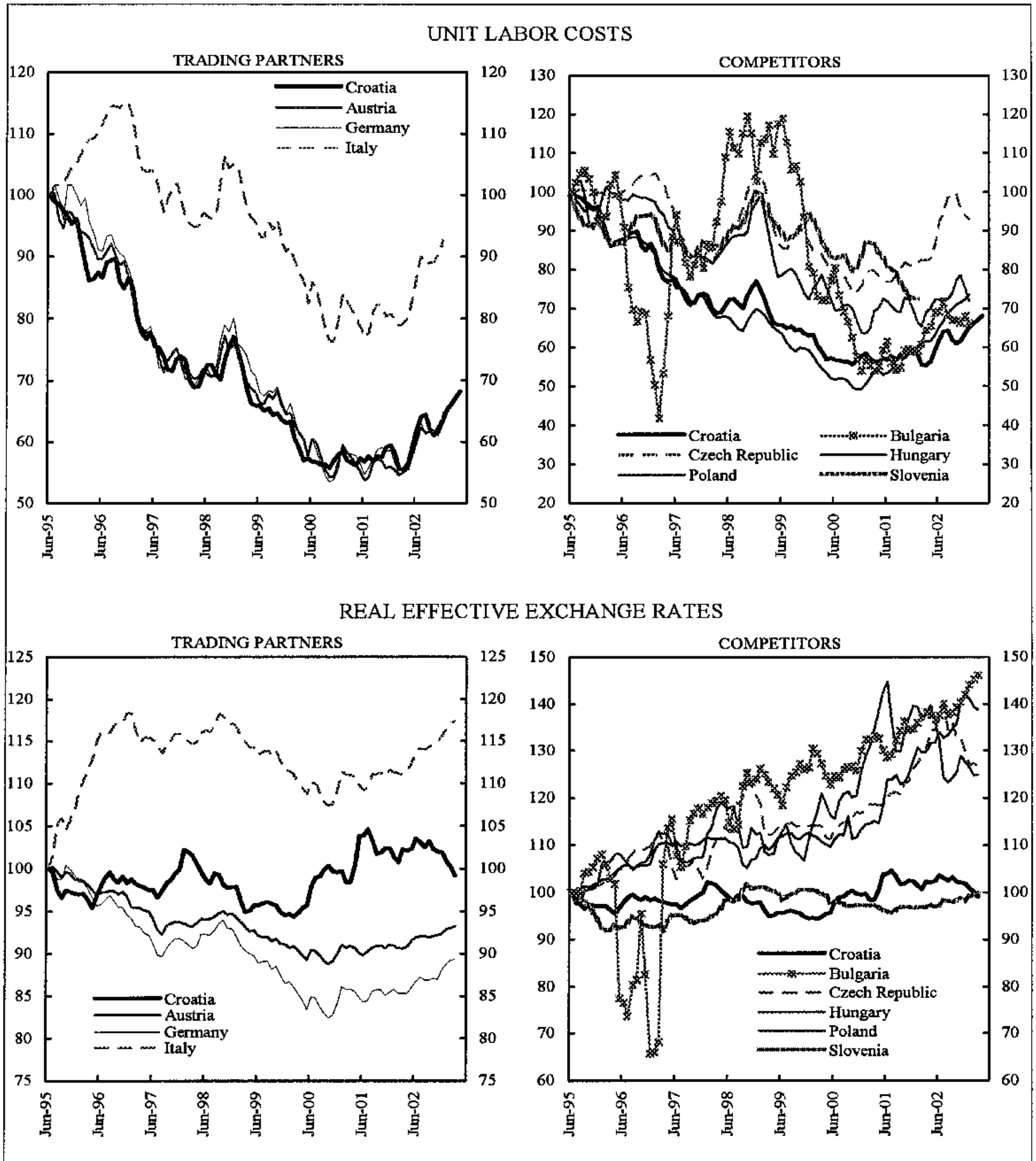
[7] The new law, whose substantive features are summarized in Appendix IV, allows the CNB to implement short-term "safety measures," including restrictions on credit and securities transactions between residents and nonresidents.

[8] Although no precise data are available, staff estimates that the risk transfer might be as high as one quarter of private sector credit.

Figure 8. Croatia: Indicators of Competitiveness, 1995-2003
(June 1995=100)



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

context, staff welcomed that the CNB intends to start asking banks to inquire and report on their largest customers' foreign exchange exposure (SMEFP, ¶ 15). To comply with the new regulation to include foreign exchange options in banks' net open positions, some banks will convert their loans with asymmetric foreign exchange indexation clauses to kuna. This would reinforce the trend toward greater use of kuna in deposit and credit operations since the beginning of 2003 and reduce the vulnerability of the economy to sudden exchange rate movements.

22. **The revised monetary program for 2003 is expected to contribute to a slowdown of credit expansion to the private sector and support current account adjustment.** In light of the growth and inflation outlook for 2003, broad money and base money growth remain unchanged from the original program at around 14 percent (Table 10). The phased increase in the required short-term foreign exchange cover of banks' foreign exchange liabilities will increase their demand for foreign exchange. In line with its exchange rate objective, the CNB is likely to provide some of this foreign exchange to the market. Both this measure and the revised current account projection for 2003 suggest that the floor on international reserves of the CNB in the original program would be too ambitious. As a result, the annual target for the accumulation of net usable international reserves, measured at program exchange rates, has been relaxed by US$290 million to US$200 million (Table 9). The targets for the net domestic assets of the CNB have been modified accordingly. Under the revised monetary program and the government's modified financing plan, credit expansion to the nongovernment sector is expected to decelerate from 31.3 percent in 2002 to 18.2 percent in 2003. This will buttress the current account adjustment and keep the reserve cover at over 5 months of imports, as in the original program. If base money growth turns out stronger than projected, the CNB will consult with the Fund to determine whether the inflation outlook is consistent with the limits on net domestic assets.

D. Structural Reforms

23. **To make up for the slippages in the first quarter, the government will accelerate the fiscal sector reforms.** Parliament adopted a new budget law satisfying the criteria spelled out in ¶ 16 of the MEFP in May so that the 2004 budget will be prepared in accordance with its provisions. The government will prepare a complete register of active government guarantees before the Board meeting (prior action), including a record of all new and expired or amortized guarantees during the first half of 2003, and report on the stock of guarantees outstanding at end-September and end-December 2003 (structural benchmarks). It will adopt stricter criteria for issuing guarantees in accordance with ¶ 16 of the MEFP before the Board meeting (prior action) to ensure that the recent guarantee to a private shipyard remains an exception. These actions will facilitate public debt management, on which technical assistance has been requested under the EU CARDS program, but staff remains concerned about the quality and timeliness of public debt statistics. FAD has identified a fiscal advisor for the Ministry of Finance, who will start work in September 2003, to strengthen the operations of the debt management, macroeconomic analysis, and treasury departments. The advisor's top priority will be the timely production of reliable fiscal data. A fiscal ROSC in October 2003 will help identify further improvements in the medium term.

24. **In the financial sector, the authorities will further strengthen the regulatory framework.** The CNB is preparing detailed guidelines, to be issued by end-2003, for application of the by-laws to the new banking law (SMEFP, ¶ 19). At the same time, the CNB will seek to establish formal arrangements with foreign supervisory agencies, and strengthen cooperation arrangements with domestic nonbank supervisors. These are important, given the high foreign ownership of Croatian banks and widespread credit risk transfers between banks and other financial institutions. Following the 2001-02 FSAP missions and recent technical assistance from MFD, the CNB is also working toward strengthening its capacity to assess risks to financial soundness of individual banks and the banking sector as a whole.

25. **The remaining exchange restriction has been eliminated and the CNB's financial safeguards provisions have been strengthened.** In June 2003, the Ministry of Finance announced that it will ensure prompt convertibility and transferability of any outstanding frozen foreign currency deposit balances in domestic banks that represent proceeds from payments and transfers for current international transactions. The CNB has also implemented all but one of measures proposed in the Fund's safeguards assessment (SMEFP, ¶ 20 and Appendix I, Section VII).

26. **The government intends to boost competitiveness and economic growth by implementing its public enterprise restructuring and privatization programs.** The aggregate financial result of the nine largest public enterprises improved by 1 percent of GDP during 2002, largely as a result improvements in efficiency. The government intends to seek further efficiency gains. A final and irrevocable decision on the privatization of 25 percent plus 1 share of INA is to be made in early July 2003 (prior action). The sale of 7 percent of the telecommunication company (HT) to its employees has been postponed until after the elections, while a 25 percent share in the insurance company (CO) will be offered to the Catholic church and other investors to settle restitution claims. The government will begin privatizing power generation and distribution of the electricity company (HEP) in 2004, although its transmission network (as well as the JANAF pipeline) will remain publicly owned. The recent change in the supervisory board of the privatization fund (HFP) has not significantly slowed the fund's privatization program. Priority is currently being given to privatizing tourism and agricultural enterprises from among its majority holdings (SMEFP, ¶ 21).

27. **To demonstrate their determination to withdraw from commercial banking, the authorities have sent the IFC a mandate letter inviting it to do the due diligence for taking a 19 percent equity participation with strong veto powers in HPB** (prior action). The subscription agreement with the IFC will be signed by end-September 2003 (structural benchmark) and a plan to privatize more than 50 percent of the bank will be prepared jointly with the IFC within 24 months of signing the subscription agreement. The authorities will prepare a plan to privatize Croatia Banka, accounting for 0.8 percent of banking system assets and currently administered by the bank rehabilitation and deposit insurance agency (DAB), by December 31, 2003 (structural benchmark). They will approach the IFC shortly to examine the possibility of auctioning off DAB's bad loan portfolio.

28. **The government attaches great importance to legislation to satisfy the conditions for the second tranche disbursement of the World Bank's SAL and promote EU accession.** A new bankruptcy law passed its first parliamentary reading in May 2003. It is expected that this law and new company, competition, and labor laws will be approved by end-July 2003 (SMEFP, ¶ 22). These laws would enhance the functioning of markets and stimulate employment growth.

III. Staff Appraisal

29. **With the sharp deterioration of the external position, reducing external vulnerability has become as urgent as stabilizing the public debt ratio.** The authorities have revamped their program for the remainder of 2003 to face up to the new challenge. While the prospects for stabilizing the public debt ratio have brightened, success in reducing external vulnerability is less certain and the authorities should not hesitate to strengthen their program further if the external position fails to improve as expected.

30. **Staff welcomes the government's firm commitment to resist pressure to loosen the fiscal stance in the run-up to general elections.** As the revenue projection for 2003 has been revised upward while total expenditure remains largely unchanged, the general government deficit promises to be lower than originally programmed, as appropriate in light of the increased external risks. The government needs to adhere strictly to the new criteria for issuing guarantees to ensure that the public debt ratio stabilizes in 2003. It deserves praise for its intention to use any excess privatization receipts for debt reduction. Beyond 2003, further fiscal adjustment will be critical as the fiscal deficit remains sizable, and to support the strengthening of the external account.

31. **To support the CNB's monetary tightening, the government should stick to its financing plan, which increasingly relies on domestic borrowing.** The government is therefore right to leave the proceeds of the recent external bond placement abroad until they are needed for external debt service payments in 2004. Increased reliance on domestic borrowing will lower the country's vulnerability to exchange rate fluctuations and promote the development of the domestic capital market.

32. **The CNB's monetary program is appropriate to help cool off the economy.** The administrative controls appear to be moderately effective in slowing the expansion of credit, but they distort competition and invite balance sheet manipulation. The CNB's decision to eliminate them at the end of 2003 and replace them with prudential measures is welcome. The CNB's reluctance to try to reinforce the administrative credit controls by more orthodox monetary measures is regrettable. The CNB should monitor credit and current account developments—as well as asset prices—closely with a view to tightening monetary conditions before the second review if warranted. The powers of the new foreign exchange law to restrict capital inflows if needed should give it confidence in this endeavor.

33. **The level of the exchange rate remains broadly appropriate, but greater fluctuations would be desirable to ward off speculative inflows.** Standard indicators suggest that the country's competitiveness is adequate. As indicated in the recent FSSA, the credit risk resulting from exchange rate fluctuations remains an important source of vulnerability, even though the potential impact on banks is partly mitigated by their high capitalization and foreign ownership. The CNB's stepped-up efforts to warn economic agents against unhedged foreign exchange exposure are therefore welcome, as are its efforts to strengthen its capacity to assess risks to the soundness of the banking system, and in particular those posed by the foreign exchange exposure of banks' clients. However, the CNB should also allow greater exchange rate variability so as to discourage one-way bets. The inclusion of foreign exchange options in banks' net open positions will reinforce the trend toward greater use of kuna in deposit and credit operations. Such developments would help reduce the vulnerability of the economy to sudden exchange rate movements.

34. **The authorities should press ahead with structural reforms.** Measures to produce timely, high-quality fiscal data and to improve public debt management should be given top priority. The resident fiscal advisor will have to be effectively used in this endeavor and the upcoming fiscal ROSC should point the way for further improvements over the medium term. The guidelines for the application of the bylaws to the new banking law should help further improve financial soundness and strengthen banking supervision. The government should firmly stick to its plan on public enterprise restructuring and privatization and seek timely parliamentary approval for the bankruptcy, competition, company, and labor laws to boost competitiveness and economic growth.

35. **The elimination of the remaining exchange restriction and the CNB's measures to strengthen its internal audit function and publish externally audited financial reports are welcome.** Croatia now maintains an exchange system that is free of restrictions on payments and transfers for current international transactions and its central bank's financial operations broadly satisfy the Fund's safeguards standards.

36. Corrective action for the nonobservance of the end-March structural performance criterion on issuing government guarantees will be taken by the authorities as a prior action. In view of this corrective action, staff supports the authorities' request for a waiver of the nonobservance of the March 31, 2003 structural performance criterion. Furthermore, as staff expects all end-June 2003 quantitative performance criteria to be met, staff supports the authorities' request for waivers of applicability of those end-June 2003 quantitative performance criteria for which data is unavailable at the time of the Board meeting. In light of the risks attached to the CNB's monetary strategy, staff welcomes the addition of an early review that will focus on progress with current account adjustment. On the basis of the authorities' program for the remainder of 2003, **staff proposes completion of the first review under the stand-by arrangement.**

Table 1. Croatia: Key Macroeconomic Indicators, 1999-2003

	1999	2000	2001	2002 Projections in EBS/03/3	2002 Preliminary Outcome	2003 Program in EBS/03/3	2003 Revised Program
				(Percentage change)			
Output, unemployment, and prices							
Real GDP	-0.9	2.9	3.8	4.0	5.2	4.2	4.2
Unemployment (survey based, in percent)	13.6	16.1	15.8	...	14.8	...	...
CPI inflation (average)	4.1	6.2	4.9	2.4	2.2	3.0	2.3
				(In percent of GDP)			
Saving and investment							
Gross national saving	18.6	19.3	19.9	21.5	21.8	23.0	22.4
Gross domestic investment	25.7	21.8	23.7	25.1	28.7	26.6	27.8
General government operations							
Revenue and grants	48.4	46.2	44.7	45.4	45.2	45.0	44.9
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0	50.0	49.5
Overall balance	-8.2	-6.5	-6.8	-6.2	-4.8	-5.0	-4.6
Privatization receipts 1/	4.9	3.1	3.7	2.0	1.8	1.2	1.7
Foreign borrowing	3.3	4.2	2.0	3.8	2.8	1.5	1.3
Domestic borrowing (including arrears)	0.0	-0.8	1.1	0.4	0.2	2.2	1.5
				(End of period; change in percent)			
Money and credit							
Credit to the nongovernment sector	...	9.4	24.5	29.8	31.3	13.7	18.2
Broad money	...	28.9	45.2	11.7	9.5	14.4	14.2
Base money	...	13.6	51.9	23.1	29.3	15.6	14.3
				(End of period; in percent)			
Interest rates							
Average deposit rate	4.3	3.4	2.8	1.7	1.8	...	...
Average credit rate	13.5	10.5	9.5	13.0 4/	12.5	...	...
				(In millions of U.S. dollars)			
Balance of payments							
Current account balance	-1,397	-459	-725	-800	-1,547	-893	-1,502
(In percent of GDP)	-7.0	-2.5	-3.7	-3.6	-6.9	-3.6	-5.5
Capital and financial account	2,359	1,950	2,661	3,166	3,539	1,465	1,992
Overall balance	410	611	1,344	1,109	827	572	599
				(End of period; in millions of U.S. dollars)			
Debt and reserves							
Gross official reserves	3,025	3,525	4,704	5,706	5,886	6,278	6,639
In months of following year's imports of goods and NFS	3.8	3.9	4.4	5.3	4.8	5.6	5.2
Gross usable international reserves 2/	2,249	2,629	3,653	4,547	4,729	5,038	5,259
In months of following year's imports of goods and NFS	2.8	2.9	3.4	4.3	3.9	4.5	4.1
As a percentage of short-term debt 3/	124	116	156	307	224	260	203
External debt service to exports ratio (in percent)	21.1	23.5	24.9	25.3	27.3	17.4	20.5
Public debt (in percent of GDP)	46.4	51.1	51.6	57.5	51.2	57.2	50.5
Of which: External	27.5	31.9	31.4	33.3	30.1	32.4	29.3
Total external debt (in percent of GDP)	44.3	59.7	58.0	61.7	68.2	59.0	67.3

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

1/ In 2000, includes 0.5 percent of GDP in back taxes.

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

3/ On a remaining maturity basis. Coverage is limited to short-term debt contracts registered with the CNB.

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

Table 2. Croatia: GDP by Expenditure Category, 2000-2003

	2000	2001	2002	2003
				prog.
	(Percentage changes)			
Real GDP	2.9	3.8	5.2	4.2
Domestic demand	-0.3	4.9	10.4	5.0
Consumption	3.6	2.3	4.7	3.2
Private 1/	4.2	4.6	6.6	4.4
Government	2.0	-3.5	-0.5	-0.2
Gross fixed capital formation	-3.8	9.7	10.1	12.0
Private 1/	10.0	8.1	8.7	12.8
Government	-32.9	15.0	14.5	9.3
Exports	12.0	9.5	3.5	6.0
Imports	3.7	11.1	13.8	7.0
	(Percentage contributions)			
Real GDP	2.9	3.8	5.2	4.2
Domestic demand	-0.3	5.1	11.1	5.6
Consumption	3.0	1.9	3.9	2.7
Private 1/	2.5	2.7	4.0	2.7
Government	0.5	-0.8	-0.1	0.0
Gross fixed capital formation	-0.9	2.1	2.3	2.9
Private 1/	1.6	1.4	1.5	2.3
Government	-2.5	0.7	0.8	0.6
Change in inventories 2/	-2.4	1.1	4.9	0.0
Net foreign demand	3.2	-1.4	-5.9	-1.3
Exports	5.1	4.4	1.7	2.9
Imports	-1.9	-5.7	-7.6	-4.2
	(Percentage change in implicit deflators)			
GDP	4.7	2.9	2.9	3.3
Consumption	4.7	3.3	1.6	3.1
Private	5.5	4.3	1.7	3.0
Government	2.8	1.0	1.4	3.2
Gross fixed capital formation	4.8	2.1	6.5	3.6
Exports	10.9	2.5	-0.4	-1.3
Imports	10.1	2.3	-2.7	-5.0
Nominal GDP	152,519	162,909	176,429	189,909

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

1/ Includes public enterprises.
2/ Includes statistical discrepancy.

Table 3. Croatia: Balance of Payments, 2001–2003

(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003				2003
			q1	q2	q3	q4	Prog
Current account	-725	-1,547	-940	-768	1,168	-963	-1,502
Merchandise trade balance	-4,101	-5,279	-1,355	-1,596	-1,562	-1,509	-6,022
Exports f.o.b.	4,759	4,995	1,464	1,448	1,503	1,446	5,861
Ships	283	352	124	150	172	100	546
Non-Ship exports	4,476	4,642	1,340	1,297	1,331	1,347	5,315
Imports f.o.b.	-8,860	-10,274	-2,819	-3,044	-3,065	-2,955	-11,883
Services and income	2,411	2,640	126	508	2,389	204	3,227
Transportation	167	141	35	24	36	20	114
Travel	2,729	3,030	253	728	2,485	344	3,810
Other services	32	-53	14	-31	-33	8	-42
Compensation of employees	125	155	37	38	41	44	162
Interest and investment income	-641	-633	-213	-251	-140	-212	-816
Current transfers	966	1093	288	320	342	342	1,292
Capital and Financial account	2,661	3,539	1,167	1,040	-1,011	796	1,992
Capital account	133	24	6	8	7	5	26
Financial account	2,528	3,515	1,161	1,032	-1,019	791	1,966
Direct investment	1,407	886	194	117	453	130	895
Portfolio investment	601	-216	746	214	-127	-88	744
Medium- and long-term loans	306	662	352	189	3	198	741
Assets	41	13					0
Liabilities	265	649	352	189	3	198	741
Disbursements	1,765	2,196	844	549	454	543	2,390
Amortization	-1,501	-1,547	-492	-361	-451	-345	-1,650
Currency and deposits 2/	506	1,712	-135	612	-598	457	335
Short term capital flows (net) 1/	-420	84	21	-199	-861	-24	-1,063
Trade Credits 2/	129	387	-16	100	111	119	314
Net errors and omissions	-592	-1166	110	0	0	0	110
Overall balance	1,344	827	337	272	157	-167	599
Financing	-1,344	-827	-337	-272	-157	167	-599
Gross reserves (— increase)	-1,313	-697	-337	-272	-157	167	-599
IMF (net purchases)	-31	-130	0	0	0	0	0
<u>Memorandum Items</u>							
Current account (in percent of GDP)	-3.7	-6.9	-15.2	-11.2	15.3	-14.2	-5.5
Current account (in percent of annual GDP)							
Exports (in percent of GDP)	24.4	22.3					21.4
Impots (in percent of annual GDP)	-45.4	-45.8					-43.3
Gross official reserves	4,704	5,886	6,208	6,649	6,806	6,639	6,639
in months of following year's imports of goods and NFS	4.4	4.8	4.9	5.3	5.4	5.2	5.2
Net international reserves	4,535	5,858	6,050	6,285	6,648	6,481	6,481
in months of following year's imports of goods and NFS	4.3	4.8	4.8	5.0	5.3	5.1	5.1
Gross usable international reserves 3/	3,653	4,729	4,956	5,353	5,413	5,259	5,259
in months of following year's imports of goods and NFS 3/	3.4	3.9	3.9	4.2	4.3	4.1	4.1
Net usable international reserves	3,484	4,701	4,798	4,989	5,256	5,101	5,101
in months of following year's imports of goods and NFS	3.3	3.8	3.8	3.9	4.2	4.0	4.0
Outstanding debt 4/	11,317	15,284					18,446
of which: short-term debt 1/ 4/	150	304	325	478	589	793	793
of which: currency and deposits of foreign residents	634	1,976	1,840	2,452	1,854	2,311	2,311
Next Year amortizaton	2,192	1,811					1,802
Short term debt by residual maturity	2,341	2,115					2,596
External debt to GDP ratio	58.0	68.2					67.3
Short-term debt by residual maturiry in percent of gross international usable reserve	64.1	44.7					49.4
	156.0	223.6					202.6
Short-term debt and current account deficit net of FDI in percent of							
gross international usable reserves 3/ 4/ 5/	82.2	57.6					58.0
External debt service	-2,396	-2,883	-832	-484	-711	-547	-2,574
External debt service to exports ratio	24.9	27.3	36.3	16.6	14.7	21.9	20.5
GDP (millions of U.S. dollars)	19,503	22,422	6,172	6,872	7,627	6,768	27,415
GDP (millions of Kuna)	162,909	176,429	43,575	46,895	52,095	47,344	189,909

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

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

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

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

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

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

Table 4: Croatia : Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis, 1999-2003 1/
(In percent of GDP)

	1999 Actual	2000 Actual	2001 Actual	2002 Prel.	2003 Prog.
Revenue and grants	48.4	46.2	44.7	45.2	44.9
Current revenue	48.3	46.1	44.7	45.2	44.9
Tax revenue	44.1	42.1	41.2	41.1	41.0
Personal Income tax	5.3	4.9	4.0	4.1	3.9
Social Security contributions	13.8	13.3	13.2	12.5	12.6
Profits tax	2.4	1.6	1.7	2.1	2.2
Real Estate Transactions tax	0.5	0.5	0.4	0.4	0.3
Taxes on goods and services	18.7	19.1	19.6	20.7	20.6
Value-added tax	14.0	14.0	14.3	14.7	14.8
Excises	4.4	4.8	5.1	5.6	5.5
Other	0.4	0.2	0.2	0.4	0.3
Customs duties	3.0	2.5	2.0	1.2	1.0
Other	0.3	0.3	0.4	0.3	0.3
Non-tax revenue (incl. own revenues)	4.2	4.0	3.5	4.1	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	56.6	52.7	51.5	50.0	49.5
Expenditure	55.5	51.9	50.8	49.3	48.8
Current expenditure	48.0	47.0	45.4	43.2	42.4
Expenditure on goods and services	25.1	24.5	22.3	20.8	19.9
Wages excl. employer's contributions	12.8	12.9	11.7	11.0	10.3
Other purchases of goods and services	12.3	11.6	10.6	9.9	9.6
Interest payments	1.7	2.0	2.2	2.1	2.4
Subsidies and other current transfers	21.1	20.5	20.8	20.3	20.1
Subsidies	2.9	2.9	2.7	2.5	3.0
Current transfers	18.2	17.6	18.1	17.8	17.1
Capital expenditure	7.5	4.9	5.4	6.1	6.4
Lending minus repayments	1.1	0.8	0.8	0.7	0.7
Consolidated general government balance	-8.2	-6.5	-6.8	-4.8	-4.6
Financing	8.2	6.5	6.8	4.8	4.6
Privatization revenues 2/	4.9	3.1	3.7	1.8	1.7
Foreign borrowing	3.3	4.2	2.0	2.8	1.3
Disbursements	4.2	6.9	4.9	5.3	2.9
Amortization	-0.9	-2.8	-2.8	-2.5	-1.5
Domestic borrowing	0.0	-0.8	1.1	0.2	1.5
From other non-banking sector	0.9	-3.8	0.4	1.2	1.3
Net change in T-bills	0.0	0.0	0.3	1.2	1.5
Net change in arrears	0.8	-3.7	-0.9	0.0	-0.3
Others	0.0	-0.1	0.9	-0.1	0.1
From banking sector	-0.8	3.0	0.7	-1.0	0.2
Memorandum items:					
Estimated Debt Stock (as percent of GDP) 3/	46.4	51.1	51.6	51.2	50.5
Nominal GDP	141,579	152,519	162,909	176,429	189,909

Sources: Ministry of Finance and staff estimates

1/ Includes the 53 largest local governments.

2/ In 2000, includes 0.5 percent of GDP in back taxes.

3/ Including the debt stock of remaining local governments would add around 0.4 percentage points to the debt ratio in 2002.

Table 5. Croatia: Performance Under the Stand-By Arrangement as of March 31, 2003

Quantitative performance criteria			(In millions of kuna, unless indicated otherwise)	
1-a	Cumulative Deficit of the Consolidated Central Government 1/		Program	4,053
			Actual	3,153
			margin (+)	900
1-b	Cumulative Deficit of the Consolidated General Government 1/		Program	4,325 2/
			Actual	2,960
			margin (+)	1,365
2	Reduction of Arrears of the Consolidated Central Government 1/		Program	150
			Actual	119
			margin (+)	-31
3	Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 1/3/		Program	704
		>1 year	Actual	510
			margin (+)	194
			Program	100
		<5 years	Actual	0
			margin (+)	100
4	Cumulative Increases in Short-term External Debt Contracted by the General Government, CNB, and HBOR 1/ 3/		Program	120
			Actual	0
			margin (+)	120
5	Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 3/ 4/		Program	-120
			Actual	53
			margin (+)	173
6	Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 1/		Program	331
			Actual	-569
			margin (+)	900
Indicative limits				
1	Consolidated Central Government Wage Bill 1/		Program	4,603
			Actual	4,660
			margin (+)	-57
2	Cumulative Changes in the Net Credit of the Banking System to the Consolidated General Governments 1/		Program	-170
			Actual	-1,733
			margin (+)	1,563
3	Cumulative Increase in the Net Credit of the Banking System to Selected Public Enterprises 1/		Program	463
			Actual	-337
			margin (+)	800
Structural performance criterion				
1	Government to prepare criteria for issuing guarantees by end-March 2003.		Not observed	
Structural benchmarks				
1	Parliament to approve by end-March 2003 a new budget law satisfying the conditions specified in paragraph 16 of the MEFP.		Not observed. Approved by parliament on May 29, 2003.	
2	CNB to issue by end-June 2003 and implement by end-September 2003 a regulation to include options in the calculation of banks' net foreign exchange position.		The regulation regarding this took effect on Aril 1, 2003.	
3	Government to make a decision by end-March 2003 on the bids received for the privatization of INA		Not observed. A final decision will be made by mid-July 2003.	
4	Government to prepare by end-March 2003 a privatization program for HPB that satisfies the conditions specified in paragraph 23 of the MEFP (to be monitored in consultation with the IFC).		Not observed. The government formally invited the IFC to subscribe to 19 percent of HPB's capital with appropriate veto powers on June 10, 2003.	

1 Ceiling.
2 Indicative limits (not a performance criterion).
3 In millions of US dollars.
4 Floor.

Table 6: Croatia - Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis
(In millions of kuna)

	2003 Prog.	2003 Q1 Prog.	2003 Q2 Prog.	2003 Q3 Prog.	2003 Q4 Prog.
Revenue and grants	85,245	18,627	21,845	22,033	22,739
Current revenue	85,245	18,627	21,845	22,033	22,739
Tax revenue	77,769	16,974	19,820	20,180	20,794
Personal Income tax	7,381	1,690	1,795	1,808	2,088
Social Security contributions	23,958	5,511	5,961	6,120	6,367
Profits tax	4,147	672	1,729	871	874
Real Estate Transactions tax	625	125	157	156	187
Taxes on goods and services	39,158	8,276	9,582	10,615	10,684
Value-added taxes	28,119	5,986	6,838	7,397	7,898
Excises	10,407	2,155	2,563	3,070	2,618
Other	632	134	181	148	169
Customs duties	1,943	387	515	522	518
Other	558	314	81	88	76
Non-tax revenue	7,476	1,653	2,025	1,853	1,945
Capital revenue	0	0	0	0	0
Grants	0	0	0	0	0
Expenditure and net lending	93,937	21,587	23,904	23,952	24,493
Expenditure	92,649	21,428	23,580	23,552	24,089
Current expenditure	80,578	19,291	19,791	20,037	21,459
Expenditure on goods and services	37,836	8,550	9,550	9,515	10,221
Wages excl. employer's contributions	19,610	5,043	4,906	4,850	4,810
Other purchases of goods and services	18,226	3,506	4,643	4,665	5,411
Interest payments	4,502	1,680	822	901	1,098
Subsidies and other current transfers	38,241	9,061	9,419	9,620	10,140
Subsidies	5,720	1,452	1,476	1,363	1,429
Current transfers	32,521	7,609	7,943	8,258	8,711
Capital expenditure	12,071	2,137	3,788	3,515	2,630
Lending minus repayments	1,287	159	324	400	404
Consolidated general government balance	-8,692	-2,960	-2,059	-1,918	-1,754
(as percent of GDP)	-4.6	-1.6	-1.1	-1.0	-0.9
Financing	8,692	2,960	2,059	1,918	1,754
Privatization revenues	3,251	174	159	2,572	346
Foreign borrowing	2,561	3,114	-483	116	-185
disbursements 1/	5,498	3,845	348	946	359
amortization 1/	-2,937	-731	-832	-830	-544
Domestic borrowing	2,880	-327	2,383	-769	1,593
From other non-banking sector	2,424	1,406	758	-132	392
Bonds, T-bills, and other	2,974	1,525	923	33	493
Net change in arrears	-550	-119	-166	-165	-100
From banking sector	455	-1,733	1,625	-637	1,201

Sources: Ministry of Finance and staff estimates

Table 7. Croatia: Saving-Investment Balances, 1999-2003

	1999	2000	2001	2002	2003 prog.
	(In millions of kuna)				
External saving	9,938	3,802	6,056	12,170	10,406
Domestic saving-investment gap	-9,938	-3,802	-6,056	-12,170	-10,406
Saving	26,399	29,472	32,488	38,510	42,448
Investment	36,337	33,274	38,545	50,681	52,854
Consolidated general government (accrual basis)	-10,056	-8,645	-9,889	-7,195	-7,404
Saving 1/	607	-1,143	-1,082	3,543 5/	4,666 5/
Investment 2/	10,663	7,502	8,807	10,738	12,071
Non-government sector 3/	118	4,843	3,833	-4,975	-3,001
Saving	25,792	30,615	33,570	34,968 5/	37,782 5/
Investment 4/	25,674	25,772	29,738	39,943	40,783
	(In percent of GDP)				
External saving	7.0	2.5	3.7	6.9	5.5
Domestic saving-investment gap	-7.0	-2.5	-3.7	-6.9	-5.5
Saving	18.6	19.3	19.9	21.8	22.4
Investment	25.7	21.8	23.7	28.7	27.8
Consolidated general government (accrual basis)	-7.1	-5.7	-6.1	-4.1	-3.9
Saving 1/	0.4	-0.7	-0.7	2.0 5/	2.5 5/
Investment 2/	7.5	4.9	5.4	6.1	6.4
Non-government sector 3/	0.1	3.2	2.4	-2.8	-1.6
Saving	18.2	20.1	20.6	19.8 5/	19.9 5/
Investment 4/	18.1	16.9	18.3	22.6	21.5
Memorandum items					
GDP at current prices (millions of kuna)	141,579	152,519	162,909	176,429	189,909
Gross national disposable income at current prices (millions of kuna)	143,544	156,463	166,661	181,032	193,396
Consolidated general government	36,206	36,211	35,323	40,269	42,502
Non-government sector	107,338	120,252	131,338	140,763	150,894

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

1 Current revenues minus current expenditures.

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-g saving) by 1 percent of GDP in 2002 and 1.3 percent of GDP in 2003.

Table 8. Croatia: Proposed Conditionality Under the Stand-By Arrangement During the Second Half of 2003 1/

1. Prior actions

1. Prepare a complete register of active government guarantees, including a record of all new and expired or amortized guarantees during the first half of the year, by July 15, 2003.

2. Send a mandate letter to the IFC by June 15, 2003, requesting the latter to conduct due diligence of HPB with a view to subscribing to 19 percent of its capital with appropriate veto powers.

3. Reach a final, irrevocable decision by July 15, 2003 on the privatization of 25 percent plus one share of INA.

4. Adopt criteria for issuing government guarantees in accordance with the requirements outlined in paragraph 16 of the MEFP by July 15, 2003.

2. Quantitative performance criteria		September 30	December 31
		(In millions of kuna, otherwise specified)	
1-a. Cumulative Deficit of the Consolidated Central Government 2/		7,244	9,274 3/
1-b. Cumulative Deficit of the Consolidated General Government 2/		6,938 3/	8,692
2. Cumulative Reduction of Arrears of the Consolidated Central Government 2/		450	550
3. Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 2/ 4/ 5/	>1 year	652	968
	<5 years	100	100
4. Cumulative Increases in Short-term External Debt Disbursed by the General Government, CNB, and HBOR 2/ 4/		–	--
5. Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 4/ 6/		353	200
6. Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 2/		-141	2,121
3. Indicative limits			
1. Consolidated Central Government Wage Bill 2/		13,600	18,005
2. Cumulative Changes in Net Credit of the Banking System to the Consolidated General Governments 2/		-745	455
3. Cumulative Increases in Net Credit of the Banking System to Selected Public Enterprises 2/		-550	-415

4. Structural benchmarks

1. On the basis of the database created under prior action No.1, report data on government guarantees outstanding on September 30, 2003 and December 31, 2003.
2. Sign a subscription agreement with the IFC committing the latter to acquire 19 percent of HPB's capital with appropriate veto powers (by September 30, 2003).
3. Prepare a plan to privatize Croatia Banka (by December 31, 2003).

1 The continuous performance clauses remain as in the MEFP, paragraph 26 and Annex II.
2 Ceiling.
3 Indicative limits (not a performance criterion).
4 In millions of US dollars.
5 Cumulative increases from June 30, 2003.
6 Floor.

Table 9. Croatia: Financial Soundness Indicators of the Banking System
(In percent)

	1998	1999	2000	2001	2002	Q1 2003
Regulatory capital to risk-weighted assets	12.7	20.6	21.4	18.5	17.6	18.7
Nonperforming loans to total gross loans	9.3	10.3	9.5	7.2	5.8	6.3
Loan-loss provisions to nonperforming loans	84.4	78.7	79.8	75.7	68.1	63.4
After-tax return on average assets	-2.8	0.8	1.2	1.3	1.3	1.7
Loans to deposits	109.4	110.5	89.6	81.8	90.3	94.5
Net open position in foreign exchange to capital [1]	17.6	43.3	30.0	6.6	13.6	27.7
Foreign currency deposits to total deposits [2]	...	90.0	91.3	91.2	89.4	88.5
Foreign currency loans to total loans [2]	...	85.7	85.6	84.9	80.0	77.8

Source: Croatian National Bank

[1] The 2003 figure is for end-April. Since April 1, 2003, the CNB started including foreign currency options in the net open positions (the respective number without options would be 10.8 percent).

[2] Foreign currency deposits (loans) include those denominated in and linked to foreign exchange.

Table 10. Croatia - Monetary Accounts, 2000-2003

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

	2000	2001	2002	2003 q1	2003 q2 prog.	2003 q3 prog.	2003 q4 prog.	2000	2001	2002	2003 prog.
Monetary Survey								(In percent change)			
Net Foreign Assets	29,017	48,661	32,817	32,838	28,445	36,401	33,625	74.2	67.7	-32.6	2.5
Net Domestic Assets	44,044	57,410	83,324	85,953	94,120	94,080	98,967	10.1	30.3	45.1	18.8
of which: domestic credit	71,323	86,257	110,089	114,696	120,013	122,340	128,464	9.2	20.9	27.6	16.7
to government, net 1/	14,248	15,146	16,740	15,963	17,588	16,951	18,151	8.2	6.3	10.5	8.4
to other domestic sectors	57,075	71,111	93,349	98,733	102,425	105,390	110,312	9.5	24.6	31.3	18.2
Broad Money	73,061	106,071	116,142	118,791	122,564	130,482	132,591	28.9	45.2	9.5	14.2
Narrow Money	18,030	23,704	30,870	29,512	32,111	33,655	35,168	30.1	31.5	30.2	13.9
Currency outside banks	6,637	8,507	9,681	9,526	10,115	10,265	10,551	11.4	28.2	13.8	9.0
Demand deposits	11,394	15,196	21,189	19,986	21,996	23,390	24,618	44.2	33.4	39.4	16.2
Quasi Money	55,031	82,368	85,272	89,279	90,454	96,827	97,423	28.6	49.7	3.5	14.2
denominated in kuna	8,129	10,531	13,217	15,210	16,052	16,378	16,712	39.3	29.5	25.5	26.4
denominated in foreign currency	46,902	71,837	72,055	74,069	74,402	80,449	80,711	26.9	53.2	0.3	12.0
Balance Sheet of the National Bank											
Net International Reserves	27,117	37,711	41,863	43,345	42,906	45,952	45,334	26.3	39.1	11.0	8.3
in US dollars	3,325	4,535	5,858	6,050	6,285	6,648	6,481	18.5	36.4	29.2	10.6
less: Banks' foreign currency reserves	5,491	5,705	7,042	7,563	7,597	8,214	8,241	18.4	3.9	23.4	17.0
CNB bills in foreign currency	1,813	2,913	1,226	1,408	1,408	1,408	1,408	10.9	60.7	-57.9	14.8
Net Usable International Reserves	19,813	29,093	33,595	34,375	33,902	36,331	35,686	30.4	46.8	15.5	6.2
in US dollars	2,430	3,484	4,701	4,798	4,989	5,256	5,101	19.6	43.4	34.9	8.5
Net Domestic Assets	-8,096	-11,290	-10,567	-12,491	-9,867	-11,140	-9,362	-65.8	-39.4	6.4	11.4
of which: claims on government (net)	-1,157	-1,752	-768	-2,857	-2,857	-1,857	-768	-210.2	-51.4	56.2	0.0
claims on banks	330	18	18	14	14	14	18	-71.0	-94.4	-3.4	0.0
claims on other domestic sectors	290	229	111	111	111	111	111	4.6	-20.8	-51.8	0.0
other items (net)	-4,849	-6,001	-4,892	-5,861	-5,002	-6,565	-6,840	-12.9	-23.8	18.5	-39.8
less: CNB bills in kuna	2,395	3,459	4,986	3,871	2,106	2,816	1,857	91.2	44.4	44.2	-62.8
blocked deposits 2/	315	325	49	27	27	27	27	-17.2	3.3	-84.9	-45.6
Reserve Money	11,717	17,803	23,028	21,884	24,035	25,191	26,324	13.6	51.9	29.3	14.3
Currency	6,637	8,507	9,681	9,526	10,115	10,265	10,551	11.4	28.2	13.8	9.0
Deposits	5,081	9,296	13,347	12,357	13,920	14,926	15,773	16.8	83.0	43.6	18.2
Memorandum items:											
Nominal GDP (yearly total)	152,519	162,909	176,429	179,548	183,031	186,784	189,909				
Kuna/dollar exchange rate (eop)	8.16	8.32	7.15	7.16	6.83	6.91	6.99				
Narrow money multiplier	1.54	1.33	1.34	1.35	1.34	1.34	1.34				
Velocity of Kuna broad money	5.83	4.76	4.00	4.25	3.94	3.80	3.66				
Broad money/GDP ratio	0.48	0.65	0.66	0.66	0.67	0.70	0.70				
Foreign currency as a perc. of broad money	64.2	67.7	62.0	62.4	60.7	61.7	60.9				
NUIR in kuna at program exchange rates 3/			34,062	34,465	34,062	34,062	34,062				
NDA of the National Bank at program exchange rates 3/			-34,062	-11,981	-10,027	-8,871	-7,738				

Source: Croatian National Bank and staff projections

1/ Discrepancy between the bank financing in the fiscal table and the change in the banking sector's credit to the government in 2003Q1 is due to the secondary market transaction of government bonds by banks.

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

3/ The kuna/dollar program quarterly exchange rates (period average) are 7.63 (March), 7.62 (June), 7.61 (September), and 7.78 (December).

Table 11. Croatia: Schedule of Purchases Under the Stand-By Arrangement

Date	Amount of Purchase[1] In millions of SDRs	In percent of quota	Conditions
February 3, 2003	91.276	25.0	Board approval of stand-by arrangement.
August 1, 2003	3.651	1.0	Observance of end-June 2003 performance criteria and completion of first review.[2]
August 15, 2003	3.651	1.0	Observance of end-June 2003 performance criteria.
November 15, 2003	3.651	1.0	Observance of end-September 2003 performance criteria and completion of the second review.
February 15, 2004	3.651	1.0	Observance of end-December 2003 performance criteria.
Total 14-month SBA	**105.880**	**29.0**	

[1] Assuming maximum approved access. The authorities plan to treat the arrangement as precautionary and do not intend to make any purchases.

[2] A waiver of applicability has been requested for those performance criteria for which data will not yet be available at the time of the Executive Board discussion.

Table 12. Croatia: Projected Payments to the Fund as of April 30, 2003 Under Obligated Repurchase Schedule
(in millions of SDRs)

	2003 May -Dec	2004	2005	2006	2007	2008	2009	2010	2011	2012	Beyond	Total
Obligations from existing drawings												
Principal												
GRA Repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Charges and Interest 1/												
SDR Net Charges	0.6	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.5	8.3
Total obligations	0.6	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.5	8.3
(percent of quota)	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	2.3
Obligations from prospective drawings												
Principal												
GRA Repurchases	0.0	0.0	0.0	23.7	52.5	29.2	0.5	0.0	0.0	0.0	0.0	105.9
Charges and Interest 1/												
Periodic Charges	1.4	2.5	2.5	2.4	1.6	0.4	0.0	0.0	0.0	0.0	0.0	10.7
Total obligations	1.4	2.5	2.5	26.1	54.1	29.6	0.5	0.0	0.0	0.0	0.0	116.6
(percent of quota)	0.4	0.7	0.7	7.1	14.8	8.1	0.1	0.0	0.0	0.0	0.0	31.9
Cumulative (existing and prospective)												
Principal												
GRA Repurchases	0.0	0.0	0.0	23.7	52.5	29.2	0.5	0.0	0.0	0.0	0.0	105.9
Charges and Interest 1/	2.0	3.3	3.3	3.2	2.4	1.2	0.8	0.8	0.8	0.8	0.5	19.0
Periodic Charges	1.4	2.5	2.5	2.4	1.6	0.4	0.0	0.0	0.0	0.0	0.0	10.7
SDR Net Charges	0.6	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.5	8.3
Total obligations	2.0	3.3	3.3	26.9	54.9	30.4	1.3	0.8	0.8	0.8	0.5	124.9
(percent of quota)	0.5	0.9	0.9	7.4	15.0	8.3	0.4	0.2	0.2	0.2	0.1	34.2

Source: IMF Treasurer's Department

1/ The GRA basic rate of charge 2.24 percent is computed by applying a factor of 1.3200 to the SDR interest rate of 1.75 percent. It is then increased by 0.01 percent for burden sharing and furthermore by 0.08 percent for the SCA for a total rate of 2.33 percent.

Table 13. Croatia: Indicators of Capacity to Repay the Fund, 2003–2010
(Under Obligation)

	2003 May-Dec	2004	2005	2006	2007	2008	2009	2010
Fund repurchases and charges 1/								
In millions of SDRs	2.0	3.3	3.3	26.9	54.9	30.4	1.3	0.8
In millions of US dollars	2.8	4.5	4.5	37.1	75.7	41.9	1.8	1.1
In percent of exports of goods and NFS	0.0	0.0	0.0	0.3	0.5	0.3	0.0	0.0
In percent of debt service	0.1	0.2	0.1	1.1	2.1	1.0	0.0	0.0
In percent of quota	0.5	0.9	0.9	7.4	15.0	8.3	0.4	0.2
In percent of gross official reserves	0.0	0.1	0.1	0.5	0.9	0.5	0.0	0.0
Fund credit outstanding (e.o.p.) 1/								
In millions of SDRs	102.2	105.9	82.2	29.7	0.5	0.0	0.0	0.0
In millions of US dollars	140.9	145.8	113.2	40.9	0.6	0.0	0.0	0.0
In percent of quota	28.0	29.0	22.5	8.1	0.1	0.0	0.0	0.0
In percent of GDP	0.5	0.5	0.4	0.1	0.0	0.0	0.0	0.0
In percent of gross official reserves	2.1	2.1	1.6	0.5	0.0	0.0	0.0	0.0
Memorandum items								
Exports of goods and NFS (millions of US dollars)	12,529	13,017	13,717	14,608	15,637	16,733	17,909	19,170
Debt service (millions of US dollars) 1/	-2,576	-2,662	-3,284	-3,528	-3,660	-4,277	-4,907	-6,399
Quota (millions of SDRs)	365	365	365	365	365	365	365	365
Quota (millions of US dollars)	503	503	503	504	504	504	504	504
Gross official reserves (millions of US dollars) 1/	6,668	7,033	7,256	7,566	8,040	8,337	8,186	7,473
GDP (millions of US dollars)	27,415	29,707	31,938	34,368	37,015	32,757	35,606	38,704

Source: Croatian National Bank; WEO; and staff estimates

1/ Including the hypothetical purchases under the proposed precautionary stand-by arrangement, not shown in balance of payments projections (Table []).

Table 14. Croatia: Indicators of External and Financial Vulnerability, 1998-2003

(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003 Latest Figure	Date
External indicators							
Real effective exchange rate (using retail prices) 1/, 1995=100	105.3	100.9	101.1	103.8	103.7	100.6	Mar-03
Export of goods and service (percentage change in US$, yoy) 2/	6.5	-5.0	6.7	11.2	9.5	18.8	Mar-03
Import of goods and service (percentage change in US$, yoy) 2/	-7.4	-7.1	-2.0	12.6	17.6	15.4	Mar-03
Current account deficit (US$ million, yoy)	-1,453	-1,397	-459	-725	-1,547	-940	Mar-03
Current account deficit (yoy) in percent of GDP 3/	-6.7	-7.0	-2.5	-3.7	-6.9	-3.4	Mar-03
Capital and financial account (yoy) in percent of GDP 3/	7.5	11.9	10.6	13.6	15.8	4.3	Mar-03
Gross official reserves (US$ million)	2,816	3,025	3,525	4,704	5,886	6,927	May-03
Gross official reserves in percent of broad money (M4)	31	41	39	37	36	38	Apr-03
Gross official reserves in percent of reserve money	177	224	245	221	183	193	Apr-03
Gross official reserves in months of imports of goods and NFS	3.2	3.7	4.4	5.2	5.6	6.1	May-03
Net international reserves (US$ million)	2,581	2,807	3,325	4,535	5,858	6,373	May-03
Net international reserves in months of import of goods and NFS	2.9	3.5	3.7	4.3	5.5	5.6	May-03
Short-term debt in percent of gross usable reserves 4/ 5/ 6/ 7/	70.9	80.7	86.4	64.1	44.7	44.7	Dec-02
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 8/	69.9	52.9	60.5	82.2	57.6	57.6	Dec-02
Total external debt, percent of GDP 9/	44.3	49.6	60.0	58.0	68.2	67.5	Mar-03
External debt service to export ratio 10/	13.6	21.1	23.8	24.9	27.3	25.1	Mar-03
Financial indicators							
General government debt (including arrears and guarantees) in percent of GDP 3/	37.6	46.4	51.1	51.6	51.2	50.9	Mar-03
domestic debt in percent of GDP 3/	16.7	18.8	19.1	20.2	21.2	20.7	Mar-03
foreign debt in percent of GDP 3/	20.9	27.5	31.9	31.4	30.1	30.2	Mar-03
Broad money (M4, percentage change, yoy)	13.0	-1.2	28.9	45.2	9.5	10.8	Apr-03
Claims on other domestic sectors (change, yoy)	22.4	-6.5	9.5	24.6	31.3	23.3	Apr-03
35-day CNB-bill yield, monthly average, percent	9.5	10.5	6.7	3.4	2.4	2.3	May-03
35-day CNB-bill real yield, percent /11	3.9	5.8	-0.7	0.8	0.2	1.4	May-03
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	712	715	890	1,035	1,173	1,159	Jun-03
Zagreb Stock Exchange, capitalization, percent of GDP	13	13	15	16	22	22	Jun-03
Bond yield spreads (EMBI Global, e.o.p.)	...	407	330	187	132	106	May-03
Debt ratings: Moody's:							
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	May-03
Government bonds, domestic currency	...	Baa1	Baa1	Baa1	Baa1	Baa1	May-03
Foreign debt ratings (Fitch IBCA							
Fitch: Local currency LT	A-	BBB	BBB	BBB+	BBB+	BBB+	May-03
Fitch: Foreign currency LT	BBB-	BB+	BB+	BBB-	BBB-	BBB-	May-03
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	May-03
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	May-03

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

1/ An increase in the index reflects a depreciation: end-year figures indicated annual average.
2/ 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.
3/ Quarterly figures may be affected by the quarterly annualized GDP.
4/ Data for short-term commercial bank credits derived from the CNB Foreign Exchange Department.
5/ Coverage limited to short-term debt contracts registered with the CNB.
6/ Short-term debt is presented on a remaining maturity basis.
7/ Gross reserves adjusted downward by foreign currency redeposit requirements held at the CNB, and by the amount of outstanding foreign currency CNB bills.
8/ Does not include debt that was excluded from the London Club agreement.
9/ Using the average exchange rate for the period, annualized for quarters.
10/ Annualized for quarters
11/ The 35-day CNB bill yield deflated by the annual percentage change in the retail prices.

Table 15. Croatia: External Financing Requirements, 2001–2007
(In millions of U.S. dollars)

			IMF Staff Projection				
	2001	2002	2003	2004	2005	2006	2007
Gross Financing Requirements	3,823	4,565	3,912	3,758	4,259	4,321	4,457
Current account	725	1,547	1,502	1,569	1,615	1,398	1,281
Medium and long term debt amortization	1,754	2,192	1,811	1,802	2,414	2,589	2,674
Public sector	408	711	475	545	918	1,036	903
Portfolio	253	554	161	534	795	845	622
Medium and long term loans	155	157	314	11	123	190	281
Banks	617	545	406	379	742	440	544
Portfolio	0	0	0	0	0	0	0
Medium and long term loans	617	545	406	379	742	440	544
Other sectors	729	936	930	878	755	1,113	1,228
Portfolio		91	0	33	3	11	159
Medium and long term loans	729	844	930	845	751	1,102	1,068
Gross reserves accumulation	1,313	697	599	386	231	334	502
IMF repurchases and repayments	31	130	0	0	0	0	0
Available Financing	3,823	4,565	3,912	3,758	4,259	4,321	4,457
Direct investment (net)	1,407	886	895	1,174	1,207	1,339	1,433
Medium and long term debt disbursements	2,748	3,259	3,501	2,548	3,002	2,950	2,950
Public sector 1/	1,308	1,397	1,228	850	950	950	950
Portfolio	983	850	757	400	500	500	500
Medium and long term loans 2/	325	547	472	450	450	450	450
Banks	750	611	686	450	752	700	600
Other sectors	690	1,252	1,587	1,248	1,300	1,300	1,400
Portfolio	0	214	354	48	100	300	400
Medium and long term loans	690	1,038	1,233	1,200	1,200	1,000	1,000
Short term financing (net) 3/	-291	471	-749	10	24	6	48
Other flows (net) 4/	-42	-51	265	26	26	26	26

Source: Croatian Central Bank, WEO, and Fund staff estimates.

1/ Includes General Government and HBOR.
2/ Excluding the IMF.
3/ Short term loans and trade credits with original maturity less than one year.
4/ Includes all other flows and errors and omissions.

CROATIA—FUND RELATIONS
(As of April 30, 2003)

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

II. **General Resources Account:**

	SDR million	% Quota
Quota	365.10	100.00
Fund holdings of currency	364.94	99.96
Reserve position in Fund	0.16	0.04

III. **SDR Department:**

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	0.52	1.17

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	2/03/2003	4/02/2004	105.88	0.00
Stand-by	3/19/2001	5/18/2002	200.00	0.00
EFF	3/12/1997	3/11/2000	353.16	28.78

VI. **Projected Obligations to Fund** (SDR million; based on present holdings of SDRs)[1/]:

		Forthcoming				
		2003	2004	2005	2006	2007
Principal	--	0.00	0.00	0.00	0.00	0.00
Charges/Interest	--	0.58	0.77	0.77	0.77	0.77
Total	--	0.58	0.77	0.77	0.77	0.77

1/ On December 27, 2002 Croatia made an early repurchase in respect of the entire amount of Fund credit outstanding.

VII. **Safeguards Assessment:**

Under the Fund's safeguards assessment policy, the Croatian National Bank (CNB) is subject to an assessment with respect to the present arrangement (see Section X). A full safeguards assessment of the CNB was completed on January 3, 2003. The assessment concluded that safeguards in place at the CNB appear generally adequate. However, certain weaknesses were identified in the internal audit and control systems, and the safeguards assessment recommended corrective actions to address them, as reported in paragraph 27 of IMF Country Report No. 03/27. These recommendations have been implemented by the CNB except for the one aiming at the periodic reconciliation of monetary data reported to the Fund for monitoring program performance with the CNB's audited financial and accounting records. This proposed remedy was rated of "low" importance in the safeguards assessment report.

VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as its 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 July 1, 2003, the official exchange rate was kuna 6.4999 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.

X. Article IV Consultation and Recent Use of Fund Resources:

The last **Article IV consultation** with Croatia was concluded on August 5, 2002 (IMF Country Reports Nos. 02/178, 02/179 and 02/180). Executive Directors commended Croatia's strong economic performance but expressed concern about the still high fiscal deficit, the rising public debt ratio, and delays in structural reforms. With the approval of the stand-by arrangement on February 3, 2003, Croatia was automatically placed on the 24-month consultation cycle, subject to the provisions of the decision on consultation cycles (Decision No. 12794-(02/76), adopted July 15, 2002).

On February 3, 2003 Directors approved a 14-month **stand-by arrangement** for an amount equivalent to SDR 105.88 million (29 percent of quota). The authorities intend to treat the arrangement as precautionary. Directors commended the program's primary objective of stabilizing the steadily rising public debt ratio through fiscal consolidation. They expressed strong support for the program's wide-ranging agenda of structural reforms, and stressed the importance of its timely implementation.

A 14-month **stand-by arrangement** for an amount equivalent to SDR 200 million (55 percent of quota) expired on May 18, 2002. Performance under the program was mixed. While its macroeconomic objectives were generally exceeded and most quantitative performance criteria were observed, slippages occurred with respect to structural performance criteria and benchmarks. No purchases were made under the arrangement, which was treated as precautionary by the authorities.

A three-year **extended arrangement** for 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.

XI. FSAP Participation:

An FSAP was concluded with the completion of the 2002 Article IV consultation on August 5, 2002 on the basis of missions that took place in April 2001 and September 2001. The FSSA was published (IMF Country Report No. 02/180) and the final FSAP report incorporating the AML/CFT assessment has been forwarded to the authorities.

XII. Technical Assistance 2000–2003 [2/]:

Department	Timing	Purpose
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification (with STA)
STA	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 (with FAD)
	October 2002	Government Finance Statistics

MFD	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
	April 2003	Stress Testing and Foreign Exchange Reserve Management

2/ Technical assistance during 1992-1999 is listed in Appendix I of IMF Country Report No. 03/3.

XIII. Resident Representative:

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

Croatia: 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. A 14 month stand-by arrangement expired on May 18, 2002. In February 2003 the IMF approved a successor 14-month SDR 105.8 million (US$146 million) stand-by arrangement to buttress macroeconomic stability in the run up to parliamentary elections that must be held by April 2004. Structural measures in both programs were closely coordinated with the World Bank and structural conditionality was limited to areas with significant macroeconomic, typically fiscal, implications.

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; (v) mitigate the social cost of reforms and poverty through restructuring of social welfare programs and (vi) begin the process of judicial reform. 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 and the first tranche was disbursed in February 2002. Based on the Government Cabinet Decision of March 27, 2003 stipulating a detailed plan of implementation for remaining SAL-supported measures, the World Bank approved an extension of the SAL closing date to July 31, 2003.

4. 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). A Country Economic Memorandum (CEM) focusing on European Integration issues has been drafted and discussed with the Government in March 2003. Publication of the CEM is expect in July 2003.

5. The findings of the CEM will underpin the design of a new CAS with a tentative Board date in April 2004. A high case scenario is likely to be centered on a potential successor adjustment loan, a Programmatic Adjustment Loan (PAL). Preliminary work is underway in designing this potential loan which is likely to have 3 components: (i) governance (public administration reform, legal and judiciary reform, decentralization, and public expenditure management); (ii) investment climate (preparation of energy sector

for EU integration, continued reduction of barriers to entry of new firms, continued tightening of financial discipline of State enterprises); (iii) building human capital and strengthening social protection (education, health and social protection reforms). The earliest Board date for the PAL would be April 2004, together with the new CAS.

IMF-World Bank Collaboration in Specific Areas

6. 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 current SBA, Bank and Fund staff agreed on areas where each institution would 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.

7. In most areas of structural reform the Bank has taken the lead, though these areas are a critical part of the broader economic program supported by the current SBA.

- ***Public expenditure management and control***

8. 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.

9. The Bank has taken the lead in dialogue on these reforms in the context of the SAL. Implementation on these issues has been slower than anticipated. It started with the adoption of the 2002 Budget with a new chart of accounts, which consolidated some of the extrabudgetary funds and followed modified commitment-based accounting consistent with the methodology of GFS 2001. The 2003 Budget broadened this coverage to include all extrabudgetary funds and is consolidated with off-budget agencies. Also, the Parliament adopted a new organic budget law, which addresses all of the issues raised in paragraph 7 in May 2003.

10. Subsidies' statistics was rather vague prior to 2002. Direct subsidies in Croatia, as shown in the fiscal accounts, were 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. However, substantial progress has been made under the SAL program and Stabilization and

Association Agreement with the EU. Namely, the Government has eliminated all indirect subsidies. Furthermore, in early 2003, Parliament passed a Law on State Aid which set the types of allowed subsidies in accordance with the WTO guidelines, as well as established a body for monitoring all state aid (Agency for Protection of Market Competition has been assigned this task). Also, at the end of 2001, the Government drafted a subsidies reduction action plan for 2002–2005 which has been applied in the outturn of 2002 Budget as well as in the 2003 Budget. In addition, the Government has compiled a registry of farmers to facilitate the provision of income support subsidies. The latter is supported by the Bank through the Farmer Support Services Project.

- ***Pension and health reform***

11. The implementation of the Government's pension reform has been quite successful. The 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. The reforms began in the late 1990s and 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.

12. 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. Further reforms were needed, including revision of the Pension Insurance Act, to strengthen short-term sustainability of the first pension pillar. Parliament passed the amendments of the Pension Insurance Act in December 2002 which increased actuarial decrement for the early retirement and reduced minimum pension accrual rate. In addition, 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 have created the basis for safe development of the second and third pillars.

13. 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 developed and received Parliamentary approval for a Health Sector Reform Strategy in 2001, which is 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.

14. 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 the 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. All of these measures were completed by August 2002. 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 Law on Obligatory Contributions Payment passed the Parliament in December 2002. The law complement the aforementioned measures by: raising the minimum contribution base; unifying, simplifying and broadening the contribution bases to non-wage income (excluding capital income); establishing a contribution cap; and improving enforcement responsibilities. However, in the second reading in Parliament exemptions had been extended to authorship contracts, artists, students and pupils' income which lessened the originally envisaged base broadening.

- ***Enhancing labor market flexibility***

15. 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 six months every half year. Thanks to the new Employment Law there are presently eight newly established private employment agencies and six additional ones applied for permission to operate. These agencies service mainly the market for professional workers. Moreover, a Temporary Work Agency (ADECCO) started its operation in mid-February this year, contributing to labor market flexibility by meeting the demand for short-term labor and at the same time providing temporary employment opportunities.

16. In order to improve the quality of labor market information the Croatian Employment Service started to classify the newly registered unemployed as (a) “unemployed who do not meet job search or job availability tests”, and (b) “job seekers”, i.e., persons who are actively looking for a job and are available for work and thus meet the ILO definition of unemployment. This has already narrowed the discrepancy between unemployment data coming from the administrative records and unemployment data coming from the Labor Force Survey (which used the ILO definition of unemployment). As a result, administrative data on unemployment better reflects actual labor market conditions and therefore will become more suitable for policy purposes.

17. The Government is pursuing further discussions within a tripartite working group to introduce final changes to the Labor Law. Draft amendments to the Labor Law were

approved by Parliament in the first reading in March 2003. 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.

18. However, strong trade union opposition has delayed agreement within the tripartite working group on the draft Labor Law. 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. The Government, however, endorsed a draft law in June 2003 and will seek enactment of the law no later than July 31, 2003.

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

19. 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 the 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 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 2002, 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.

20. 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 (Croatian Postal Bank merged with Croatia banka), the Croatia insurance company, the telecommunications company, the portfolio held by the Croatian Privatization Fund (tourism, shipyards, agribusiness) and energy companies (INA and HEP). 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 assets have been privatized. The Government recently divested 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 has fallen off track. 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 is likely to be privatized in the third quarter of 2003. Delays in the restructuring of HEP have led to delays in privatization.

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; inadequate trust by businesses in the bankruptcy process; and lack of confidence by the population in the efficiency of the overall judiciary system. The Bank is now providing technical assistance to the Government (in cooperation with USAID and EU) in this area through the Court and Bankruptcy Administration Project in addition to monitoring reforms in the context of the SAL. Drafted provisions to improve the legal and institutional framework for Croatia's bankruptcy regime, including certification of receivers (trustees), have recently passed the first reading in the Parliament, while its enactment is planned by end-June, 2003.

22. 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. These amendments took the important step of requiring all companies to prepare IAS financial statements. The Audit Law requires that audits 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 is significant lack of compliance with IAS and ISA and there is no enforcement or monitoring of compliance. 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.

23. 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. The Government is implementing an Action Plan that aims to improve Croatia's investment policy regime (both FDI and domestic investment) by bringing the fiscal, regulatory and legal policy framework in line with best international practice. The Action Plan is monitored on a quarterly basis by the Government and the Bank as a component of the SAL. Thus far, the majority of components of the Action Plan which required legislative changes have been adopted by Parliament, while only two are pending approval: abolishing location permits (adoption of the Law on Spatial Planning is planned by July 2003) and shortening the visa and work permits process time (adoption of the Law on Foreigners) is also planned by July 2003.

- ***Strengthening Social Protection***

24. 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.

25. 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. The Government has adopted a National Strategy for Combating Poverty which was sent to the Parliament for discussion. 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 by using the 2001 national census data to adjust the survey sample. Consultant teams working with MOLSW (within the context of the Bank-financed Social Protection Project) are in the processing of finalizing recommendations in the area of cash benefits and social services. The final recommendations on reforms in these areas are due at the end of June 2003. A Social Welfare Reform Strategy is to be developed shortly thereafter based on the consultant's recommendations.

World Bank Group Strategy and Lending Operations

26. 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.

27. 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.

28. Currently, there are eleven Bank active projects (10 investment loans and 1 adjustment operation) totaling US$530.1 million under implementation in Croatia: the Coastal Forest Reconstruction and Protection Project (US$42 million) became effective in July 1997, and 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) and the Railway Modernization and Restructuring Project (US$101 million) became effective in June 1999; Technical Assistance II (US$7.3 million) in August 1999 and the Health System Project (US$29 million) in March 2000. 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$202 million) became effective in February 2002. Two new loans became effective in February 2003; these are Pension System Investment Project (US$ 27.3 million) and the Real Property Registration and Cadastre (US$ 25.7 million). The GEF financed US$5 million grant for the Karst Ecosystem Conservation Project was signed on June 19, 2002.

29. Investment projects currently under preparation include: the Rijeka Gateway Project (negotiated in May 2003 at US$155 million), the Coastal Cities Pollution Control Project (approximately US$100 million), the District Heating Project (approximately US$30 million), the Social Protection Project (approximately US$36 million), the Social and Economic Recovery Project (approximately US$40 million), and Energy Efficiency Project (approximately US$5 million); the Science and Technology Project (approximately US$34.5 million) is also under consideration.

30. As of May 2003, the IFC had 11 projects to 7 different entities in its portfolio for a total of US$186.8 million (US$153.2 million for its own account). The projects are: (1) a US$2.5 million equity participation in TS Bank; (2) a US$6.0 million equity investment

and a US$39.2 million loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility; (3) a US$5.0 million equity investment in a venture capital fund; (4) a US$43.5 million loan to a regional bank for a credit line for on-lending to small and medium-sized enterprises; (5) a US$15 million loan and US$6.1 million equity investment to modernize a ship repairing facility in Rijeka; (6) a US$37.5 million loan and US$10 million equity investment in the leading pharmaceutical complex in Croatia; (7) a US$18 million loans and US$4 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.

31. 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. Funck (ext. 30874).

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 meeting the recommendations of the IMF Monetary and Financial Statistics Manual. In other areas, major deficiencies impact adversely the reliability and timeliness of macroeconomic analysis. In most cases, remedial action has been taken to improve data 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 (CNB) 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 requirements. 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 show 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 January 2004. 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 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 central budget and the extrabudgetary funds. Expenditure data on a cash basis are available according to GFS methodology (economic and functional classification) for the central 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 CNB. Following the recommendations of the October 2002 GFS mission, a task force, comprising staff from MOF, CNB, and CBS was formed to reconcile central government financing data produced by these institutions. Although the task force has not met since its inception, irregular meetings were held between the staffs of the MOF and CNB to try to reconcile fiscal and monetary data.

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 augmented 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 a quarterly basis and with a considerable lag. The Ministry of Finance regularly reports monthly data for publication in *IFS* and annual data for publication in the *GFS Yearbook*.

E. Monetary Data

9. Data on the monetary survey (including separate records for deposit money banks) and the balance sheet of the CNB are published monthly with four and two week lags, respectively, meeting the SDDS requirement. 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.

10. 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. However, data from the CNB on net credit to government continue to be inconsistent with the Ministry of Finance's data on the financing of government from the CNB. It should be noted that the Croatian Bank for Reconstruction and Development (HBOR) is included in the data on government in monetary statistics, but not in the fiscal data compiled by the Ministry of Finance. In line with the guidelines of the *Monetary and Financial Statistics Manual*, the 2001 mission recommended to treat the HBOR for monetary statistics purposes as an *other financial intermediary* within the other financial corporations subsector, rather than classifying it as part of the government sector.

11. 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 are disseminated monthly on the IMF and CNB external websites. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies.

F. Banking Statistics

12. Banks' lending and deposit rates are published monthly in the CNB Monthly Bulletin. Beginning January 2002, a change in sampling has introduced a break in the time series for commercial banks' lending rates.

G. Balance of Payments Data

14. 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 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 on 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. Methodology on travel surveys was modified in 2002. 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.During 1999 and 2000, the CNB increased the coverage of the direct investment survey by identifying additional enterprises. The coverage and quality of portfolio investment data are reasonably complete and accurate.

15. 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.

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

Table 16. Croatia: Core Statistical Indicators
(As of June 9, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Retail Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/ Debt Service
Date of Latest Observation	Jun. 9, 2003	May 2003	Apr 2003	Apr 2003	Apr 2003	May 2003	May 2003	Apr 2003	Q4 2002	Mar 2003	Q4 2002	Dec 2002
Date Received	Jun 9, 2003	Jun 5, 2003	May 13, 2003	May 13, 2003	May 30, 2003	Jun 5, 2003	Jun 5, 2003	Jun 2, 2003	Mar 14, 2003	Apr 30, 2003	Mar 28, 2003	Mar 28, 2003
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	CNB	CNB	CNB	CNB	CNB	CBS	CBS	CNB	Ministry of Finance	CBS	CNB
Mode of Reporting	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

CROATIA: NEW FOREIGN EXCHANGE LAW

On May 29, 2003, parliament passed a new foreign exchange law. Reflecting the authorities' aim to protect the domestic market from speculative capital inflows, the law maintains more controls on capital inflows than outflows. The law incorporates comments by Fund staff, and is generally compatible with the obligations under Article VIII of the Fund's Articles of Agreement. The law also brings the Croatian foreign exchange legislation closer to EU standards, reflecting Croatia's obligations under the Stabilization and Association Agreement (SAA). The law gives the CNB and the Ministry of Finance 90 days (from its effectiveness date) to issue the required bylaws.

The new law enables Croatian residents to purchase abroad securities issued by OECD member countries, international financial institutions, and private issuers satisfying minimum conditions determined by the CNB (an "A" long-term international rating, according to a draft bylaw). Previous regulations allowed only financial institutions to invest in securities abroad. Under the new law, the Ministry of Finance may prescribe the conditions for the issuance, listing and sale of foreign securities in the capital markets in Croatia. Nonresidents wishing to issue, list, or sell securities in Croatia must fulfill minimum conditions determined by the Ministry of Finance (a "BBB-" long-term international rating, according to a draft bylaw). Nonresidents are prohibited from purchasing CNB bills and treasury bills; they can purchase and dispose of other short-term securities only subject to the CNB's regulations (the draft bylaw prohibits nonresidents from secondary trading ahead of the maturity date). In addition to restrictions that may be imposed on non-resident investments in securities on the money market, the CNB may also prescribe the opening and management of non-resident custody and cash accounts for payments and collections concerning the sale of securities in the capital markets in Croatia. An obligation may be imposed on non-residents regarding securities purchased in the capital market, not to alienate or pledge the acquired securities with residents, within a period of one year from the registration of title. The law stipulates that all these limitations will cease to be valid four years after coming into effect of the SAA.

Foreign direct investment remains unrestricted under the new law. The law retains restrictions on nonresidents' investments in real estate; however, nonresidents can invest in resident companies (as in the previous law), which can own real estate.

The new law generally liberalizes outflows of capital. Croatian residents are now free to transfer funds abroad to purchase real estate. The maximum amounts of cash that can be carried abroad are regulated by the CNB; the draft bylaw envisages an increase in the allowed amounts. The law leaves it to the CNB to prescribe conditions for opening residents' accounts abroad. The CNB plans to retain the existing requirement for residents to obtain a license for opening such accounts. There is no obligation for the CNB under the SAA to liberalize this area fully at this stage.

The law allows the CNB to implement short-term "safety measures" if capital movements cause or threaten to cause "serious difficulties in the implementation of monetary or foreign exchange policies." The measures can be prescribed for a maximum period of six months, unless an extension is approved by the parliament. The safety measures can comprise restrictions on: (i) the use by residents of funds in their accounts abroad or in their foreign exchange accounts in Croatia; (ii) the use by banks of foreign exchange derived from exchange transactions of banks and authorized exchange offices; (iii) credit transactions between residents and non-residents; (iv) payments and collection based on liabilities and claims in foreign transactions; (v) the transfer of securities, foreign cash, and gold into and from Croatia; (vi) securities and gold transactions between residents and non-residents; and (vii) the issuance of guarantees or warranties, offers of pledges, or other collateral for the accounts of non-residents.

CROATIA: SUSTAINABILITY ANALYSIS

1. Fiscal and external debt sustainability assessments were conducted over the medium term. To ensure the robustness of the staff's projections, the standardized sensitivity tests were applied to the staff's baseline projections.

A. Fiscal Sustainability

2. The staff's baseline scenario predicts a decline in the public debt to GDP ratio from 51.2 in 2002 to 48.2 in 2007. Various sensitivity tests suggest that medium-term debt sustainability is not seriously at risk (Table 17), if the authorities pursue fiscal consolidation and exchange rate stability is maintained. When the historical average values of the real interest rate, real GDP growth, and the primary balance are used throughout the projection period (scenario 1), the public debt ratio reaches 57.1 percent by 2007, almost 9 percentage points above the baseline level. This is mainly explained by the fact that the baseline assumes much smaller primary deficits than their historical average. Among the isolated shocks during the first two years of the projection horizon (scenarios 2–4), the shock to the primary balance has the largest impact on the end-period debt ratio, while the shocks to real interest rate and real GDP lead to a less significant deterioration in the debt dynamics, although still quite substantial in the latter case. In all three cases, the debt ratio resumes its decline once the impact of the shocks fades. The same is true for the combination of these shocks (scenario 5). A one-time 30 percent real depreciation in 2003 (scenario 6) increases the debt ratio by around 19 percentage points from the 2002 level, although the debt stock begins to decline once the depreciation shock wears off. The same holds true for a one-time 10 percentage point of GDP increase in the public debt ratio (scenario 7). An adverse shock to revenues (scenario 8) leads only to a minor worsening of the debt dynamics.

B. External Sustainability

3. Under the baseline scenario, the external debt to GDP ratio falls from 68.2 percent in 2002 to about 55½ percent in 2007 (Table 18). This decline is achieved mainly through a significant reduction of external borrowing by the general government due to a decline in the fiscal deficit and a switch to more domestic borrowing. Under the stress testing scenario 1 (interest rate, Croatian U.S. dollar GDP deflator growth, non-interest current account, and non-debt creating flows as a percentage of GDP are all at their historical average), the debt to GDP ratio rises to 105 percent by 2007, mainly due to lower GDP growth and a significantly larger current account deficit. Croatia appears to withstand relatively well isolated shocks to interest rates and GDP growth rates (scenarios 2 and 3). The isolated shocks to the U.S. dollar GDP deflator and the current account (scenarios 4 and 5) and a combination of shocks to various macroeconomic and external variables (scenario 6) lead to more adverse results. In particular, the debt to GDP ratio surges to about 120 percent in 2004 in the case of the combined shock, although it starts declining once the shock fades away. A one-time 30 percent depreciation leads to a large increase in the debt to GDP ratio in 2003 (to 104½ percent), but the debt ratio starts declining once the impact of this shock disappears.

Table 17. Croatia: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 Public sector debt 1/	32.4	37.6	46.4	51.1	51.6	51.2	50.5	49.6	49.2	48.9	48.2
o/w foreign-currency denominated	20.0	25.9	33.2	37.7	37.5	36.4	34.6	31.7	29.8	28.1	26.6
2 Change in public sector debt	...	5.2	8.8	4.7	0.6	-0.4	-0.8	-0.9	-0.3	-0.3	-0.8
3 Identified debt-creating flows (4+7+12)	0.0	-1.7	8.8	2.8	0.8	-3.6	-2.8	-0.7	0.2	0.1	-0.4
4 Primary deficit	0.7	1.9	6.5	4.5	4.6	2.7	2.2	2.1	1.6	1.2	0.7
5 Revenue and grants	47.7	51.1	48.4	46.2	44.7	45.2	44.9	43.9	43.6	43.2	43.0
6 Primary (noninterest) expenditure	48.4	53.0	54.9	50.7	49.3	47.9	47.1	46.0	45.2	44.3	43.6
7 Automatic debt dynamics 2/	0.3	-1.6	7.3	1.3	-0.1	-4.5	-3.3	-1.3	-0.9	-1.1	-1.1
8 Contribution from interest rate/growth differential 3/	-4.0	-1.4	1.1	-0.9	-0.6	-1.2	-0.9	-1.0	-1.0	-1.1	-1.1
9 Of which contribution from real interest rate	-0.8	-0.7	0.8	0.3	1.2	1.3	1.1	1.1	1.0	1.0	1.0
10 Of which contribution from real GDP growth	-3.2	-0.7	0.3	-1.2	-1.8	-2.5	-2.0	-2.1	-2.1	-2.0	-2.0
11 Contribution from exchange rate depreciation 4/	4.3	-0.2	6.2	2.2	0.5	-3.3	-2.3	-0.3	0.2	0.0	0.0
12 Other identified debt-creating flows	-1.0	-2.0	-4.9	-3.1	-3.7	-1.8	-1.7	-1.5	-0.5	0.0	0.0
13 Privatization receipts (negative)	-1.0	-2.0	-4.9	-3.1	-3.7	-1.8	-1.7	-1.5	-0.5	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	...	6.9	-0.1	1.9	-0.2	3.2	2.0	-0.2	-0.6	-0.4	-0.3
Public sector debt in percent of revenues 1/	67.8	73.5	95.8	110.5	115.5	113.4	112.5	112.8	113.0	113.3	112.0
Gross financing 5/	3.6	7.4	13.1	12.2	12.4	10.4	10.2	9.9	9.1	8.7	8.3
in millions of U.S. dollars	715.0	1609.0	2599.0	2242.2	2421.3	2323.0	2779.3	2937.6	2902.0	2991.2	3073.7
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	6.8	2.5	-0.9	2.9	3.8	5.2	4.2	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 6/	6.3	6.3	5.9	5.6	5.7	5.8	5.7	6.0	5.9	5.8	5.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	-2.1	2.1	0.9	2.7	2.9	2.4	2.5	2.4	2.3	2.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.1	0.9	-18.3	-6.2	-1.3	10.1	7.2	0.9	-0.6	0.0	0.0
Inflation rate (GDP deflator, in percent)	7.4	8.4	3.8	4.7	3.0	2.9	3.3	3.5	3.5	3.5	3.5
Growth of real primary spending (deflated by GDP deflator, in percent)	...	12.3	2.6	-4.9	0.9	2.1	2.6	2.1	2.6	2.5	2.9
II. Stress Tests											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						51.2	51.6	51.9	53.2	55.2	57.1
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						51.2	51.5	51.5	51.1	50.8	50.0
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						51.2	53.8	56.6	56.3	56.1	55.2
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						51.2	56.6	61.7	61.2	60.6	59.6
5. Combination of 2-4 using one standard deviation shocks						51.2	56.1	61.2	56.9	52.9	48.4
6. One time 30 percent real depreciation in 2003 7/						51.2	70.0	68.6	67.9	67.2	66.0
7. 10 percent of GDP increase in other debt-creating flows in 2003						51.2	60.5	59.3	58.8	58.3	57.3
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						51.2	52.6	52.7	52.3	52.0	51.1
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						113.4	122.8	123.2	120.1	120.4	118.9

Historical Statistics for Key Variables (past 5 years)	Historical Average	Standard Deviation
Primary deficit	3.6	2.3
Real GDP growth (in percent)	3.0	2.7
Nominal interest rate (in percent) 6/	5.9	0.3
Real interest rate (in percent)	0.5	2.1
Inflation rate (GDP deflator, in percent)	5.5	2.3
Revenue to GDP ratio	47.6	2.4

1/ General government's gross debt, including arrears and public guarantees extended to entities outside the general government.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the denominator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 18. Croatia: Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual 1997	1998	1999	2000	2001	Projections 2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 **External debt**	31.9	44.3	49.6	60.0	58.0	68.2	67.3	64.6	62.0	58.7	55.4
2 Change in external debt	8.7	12.4	5.3	10.4	-2.0	10.1	-0.9	-2.7	-2.6	-3.3	-3.3
3 Identified external debt-creating flows (4+8+11)	9.6	0.2	3.5	0.6	-7.6	-5.0	-10.6	-4.2	-3.6	-4.5	-4.9
4 Current account deficit, excluding interest payments	10.6	4.2	4.0	-1.5	-1.0	2.8	1.4	1.2	1.1	0.3	-0.1
5 Deficit in balance of goods and services	16.7	9.2	8.4	5.1	6.0	9.6	7.8	7.7	7.4	6.2	5.5
6 Exports	39.9	39.5	40.8	47.0	49.4	47.0	45.7	43.8	42.9	42.5	42.2
7 Imports	56.6	48.7	49.2	52.1	55.4	56.7	53.5	51.5	50.3	48.7	47.8
8 Net non-debt creating capital inflows (negative)	-2.6	-4.3	-7.4	-5.9	-8.0	-4.4	-3.6	-4.3	-4.1	-4.2	-4.2
9 Net foreign direct investment, equity	2.6	4.3	7.4	5.9	8.0	4.4	3.6	4.3	4.1	4.2	4.2
10 Net portfolio investment,equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Automatic debt dynamics 1/	1.6	0.3	6.8	8.0	1.4	-3.4	-8.4	-1.1	-0.6	-0.6	-0.6
12 Contribution from nominal interest rate	1.8	2.5	3.0	4.0	4.7	4.1	4.1	4.1	3.9	3.8	3.6
13 Contribution from real GDP growth	-1.5	-0.7	0.4	-1.5	-2.1	-2.6	-2.4	-2.8	-2.7	-2.6	-2.5
14 Contribution from price and exchange rate changes 2/	1.2	-1.5	3.4	5.5	-1.2	-4.9	-10.0	-2.4	-1.8	-1.8	-1.7
14 Residual, incl. change in gross foreign assets (2-3)	-0.8	12.2	1.8	9.8	5.6	15.2	9.7	1.6	1.0	1.2	1.6
External debt-to-exports ratio (in percent)	80.0	112.2	121.6	127.6	117.5	144.9	147.2	147.5	144.4	138.1	131.1
Gross external financing need (in billions of US dollars) 3/	3.3	2.4	2.8	2.2	2.7	4.0	3.2	3.6	4.0	3.4	3.0
in percent of GDP	16.6	11.1	14.0	11.7	13.9	17.7	11.8	12.2	12.4	9.9	8.1
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	6.6	2.5	-0.9	2.9	3.8	5.2	4.2	4.5	4.5	4.5	4.5
Exchange rate appreciation (US dollar value of local currency, change in perc	-11.7	-3.2	-10.5	-14.1	-0.9	6.2	13.6	0.2	-0.6	-0.5	-0.4
GDP deflator in US dollars (change in percent)	-5.0	4.9	-7.2	-10.0	2.0	9.3	17.3	3.7	2.9	3.0	3.1
Nominal external interest rate (in percent)	8.1	8.5	6.2	7.5	8.3	8.1	7.3	6.6	6.5	6.6	6.6
Growth of exports (US dollar terms, in percent)	0.6	6.5	-5.0	6.7	11.2	9.5	18.8	3.9	5.4	6.5	7.0
Growth of imports (US dollar terms, in percent)	15.2	-7.4	-7.1	-2.0	12.6	17.6	15.4	4.3	5.0	4.2	5.6
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average ir						68.2	80.9	86.4	91.9	98.0	105.0
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						68.2	68.6	67.8	65.1	61.8	58.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						68.2	71.3	73.6	70.9	67.5	64.1
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						68.2	90.6	108.0	105.0	101.3	97.5
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						68.2	79.0	88.1	85.3	81.7	78.2
6. Combination of 2-5 using one standard deviation shocks						68.2	95.7	119.8	116.7	112.9	109.0
7. One time 30 percent nominal depreciation in 2003						68.2	104.5	101.3	98.3	94.7	91.0

Historical Statistics for Key Variables (past 5 years)	Historical Average	Standard Deviation
Current account deficit, excluding interest payments	3.3	4.9
Net non-debt creating capital inflows	5.6	2.2
Nominal interest rate (in percent)	7.7	0.9
Real GDP growth (in percent)	3.0	2.7
GDP deflator in US dollars (change in percent)	-3.1	6.3

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Zagreb, Croatia
July 4, 2003

Dear Mr. Köhler:

1. We have reviewed with the Fund staff the implementation of our economic program for 2003 that is supported by a 14-month stand-by arrangement in an amount of SDR 105.88 million (29 percent of quota). This review has shown that our program remains largely on track and that its main objective—the stabilization of the general government debt ratio—is likely to be met with the continued implementation of prudent economic and financial policies. Nevertheless, we have found it necessary to make certain policy adjustments to begin to reverse an unexpected deterioration in the external current account in late 2002 and early 2003.

2. The attached Supplementary Memorandum of Economic and Financial Policies (SMEFP) for 2003 (i) reports on program implementation to date and on the measures we intend to implement in the remainder of this year in pursuit of our program objectives and (ii) proposes the quantitative performance criteria and structural benchmarks for September 30, 2003 and December 31, 2003. The SMEFP supplements the Memorandum of Economic and Financial Policies (MEFP) that is attached to our letter to you of December 27, 2002 and that continues to represent our policy undertakings in all respects not specifically addressed in the SMEFP.

3. On the basis of our performance under the program so far and the policies described in the SMEFP, we request (i) completion of the first review under the stand-by arrangement, (ii) a waiver of the nonobservance of the March 31, 2003 structural performance criterion on the adoption of criteria for issuing government guarantees, and (iii) waivers of applicability in respect of the June 30, 2003 quantitative performance criteria for which data will not be available by the time of the Executive Board meeting scheduled for August 1, 2003. We are confident that all end-June quantitative performance criteria will be met.

4. We believe that the policies described in the attached SMEFP are adequate to achieve the objectives of our economic program, but we stand ready to take any further measures to keep our program on track. We will remain in close consultation with the Fund in accordance with the Fund's policies on such consultations. The second program review, scheduled for mid-November 2003, will provide one such opportunity to assess progress with program implementation and reach understandings on any measures that may be needed to achieve the program's objectives. In addition, there will be a third review of program implementation, scheduled to take place in mid-February 2004.

5. We would like to reaffirm our intention not to make the purchases that will become available under the arrangement with the completion of the present review and after completion of the second and third reviews and observance of the performance criteria for September 30 and December 31, 2003.

Sincerely yours,

/s/	/s/	/s/
Slavko Linić	Mato Crkvenac	Željko Rohatinski
Deputy Prime Minister	Minister of Finance	Governor
		Croatian National Bank

Attachment: Supplementary Memorandum of Economic and Financial Policies

Supplementary Memorandum of Economic and Financial Policies

1. The main objectives of our economic program for 2003, as described in the Memorandum of Economic and Financial Policies attached to our letter of December 27, 2002 to the Managing Director of the International Monetary Fund, remain unchanged. There is mounting evidence that our strategy of seeking higher employment and standards of living through fiscal consolidation, price stability, and structural reforms is bearing fruit: per capita income is expected to exceed US$ 6,000 in 2003 compared with US$ 4,371 in 1999, while employment is likely to show growth of some 5 percent over the same period.

I. Recent Economic Developments and Near-Term Outlook

2. The prospects for achieving our economic growth objective of 4.2 percent for 2003 remain good (Table 1). A surge of domestic demand in the second half of 2002 boosted real GDP growth to 5.2 percent in 2002. Investment (both public and private) and private consumption experienced high growth while public consumption was reduced again in accordance with our medium-term fiscal consolidation program. Reflecting the burgeoning domestic demand, the foreign contribution to GDP growth became strongly negative as imports surged while export growth remained subdued (despite a good tourist season) in the face of near stagnation in our principal export markets. The growth of industrial output by 5.6 percent during January-April 2003, an acceleration of exports in the early months, and an increased share of capital goods imports all give us confidence that real GDP growth will reach 4.2 percent this year. While private consumption is expected to slow down and public consumption will once more contract, both private and public fixed capital formation are likely to maintain their momentum. Higher exports and an expected deceleration of import growth will sharply reduce the drag from net foreign demand.

3. Retail price inflation is likely to remain well below the 3 percent program objective in 2003. After declining to 2.2 percent in 2002, its twelve-month rate of increase fell to 0.9 percent in April 2003. At the same time, the core rate of retail price inflation reached 0.1 percent. We do, however, expect a slight increase in inflation during the remainder of 2003. Producer price inflation has been rising for almost one year and stood at 2.8 percent in April 2003, suggesting that retail price inflation has reached bottom and is about to edge up, reflecting comparatively lower productivity growth in the nontradable sector in the context of broad exchange rate stability. As a result, we expect retail prices to increase by some 2 1/4 percent in 2003.

4. We hope to reduce the external current account deficit to 5.5 percent of GDP in 2003. The sudden widening of the external imbalance to 6.9 percent of GDP in 2002 must be addressed forcefully. It has contributed to a sharp increase in the external debt ratio and raises issues of external sustainability. While we cannot return to our original program target (a deficit of 3.6 percent of GDP) during the remainder of the year, we have taken measures, described in section III below, aimed at reducing it to 5.5 percent of GDP in 2003. Privatization receipts and direct foreign investment are expected to finance most of this deficit in 2003 while allowing to maintain the reserve cover ratios of imports and external

debt service at slightly above 5 months and more than 200 percent, respectively, without increasing the external debt ratio. In the medium term, however, we believe that the external current account deficit needs to be reduced further to 3 1/2-4 percent of GDP.

II. Program Implementation and Performance

5. Except for delays of some structural reforms, we are broadly satisfied with the implementation of our economic program. Our fiscal program is being implemented without major difficulties. The higher than anticipated level of economic activity is boosting tax receipts. At the same time, the budget is executed as planned except that highway construction was delayed in early 2003 because of severe winter weather. A € 500 million seven-year bond was placed at a record low 4.6 percent yield and its current spread is hovering at around 100 basis points, which reflects the improved standing of Croatia in international markets.

6. Contrary to earlier expectations, the Croatian National Bank (CNB) had to tighten monetary policy in early 2003 in an attempt to slow an excessive expansion of credit. As banks increasingly borrowed abroad to sustain annual rates of credit expansion of some 30 percent, the CNB announced in mid-January that banks whose lending grows by more that 4 percent per quarter would be obliged to buy CNB bills at penalty interest rates in an amount twice as high as the excess credit. At the same time, the CNB increased the minimum foreign exchange cover requirement of banks' foreign exchange liabilities to raise banks' liquidity in foreign exchange and discourage foreign borrowing. As a result, credit growth slowed to 5.8 percent during the first quarter, with almost half of the expansion reflecting the valuation effect from the weakening of the kuna. Despite the depreciation (since then largely reversed) and foreign exchange sales of €315 million, the CNB's international reserves increased to new record levels as the government deposited the proceeds of its euro bond issue with the CNB.

7. Structural reforms proved more difficult to implement than initially thought. The delays experienced included the privatization of the oil company (INA), which required further discussions with the successful bidders; the preparation of a privatization plan for the postal bank (HPB); and the adoption of new labor, competition, company, bankruptcy, budget, and foreign exchange laws. However, in accordance with our program, parliament did approve the state aid law in March; the government did issue a decree on limiting new state guarantees to the expiration or amortization of old ones in January; and the CNB adopted a regulation to include options in the calculation of banks' net foreign exchange position from April 1, 2003, thus meeting structural benchmarks for end-June 2003 and end-September 2003 ahead of time.

8. Most of Fund conditionality for the end-March 2003 test date was met. All quantitative performance criteria for that date were observed except for that on arrears reduction by the central government (Table 2). As noted in section III below, we intend to make up for the slippage by end-September 2003. Moreover, two of the three indicative limits for the end-March test date were met. The one on the central government wage bill

was missed by a small margin. By contrast, most structural conditions have not been met. The structural performance criterion on preparing criteria for issuing government guarantees was not met, and all three structural benchmarks (on privatization of INA, a privatization plan for HPB, and the adoption of a new budget law) were missed. As noted in section III below, we intend to implement these measures during the remainder of 2003.

III. Policies for the Remainder of 2003

9. The recent deterioration of the current account and the attendant rise in the external debt ratio pose new policy challenges. While progress with fiscal consolidation has been faster than anticipated, the surge of private domestic demand, supported by the strong expansion of credit, must be slowed down to help reduce the external imbalance. Also, such an expansion, if not bridled, may over time have a negative impact on the stability of the banking system. While an eventual recovery in our principal export markets and continued structural reforms are bound to strengthen our export performance in the medium term, the CNB will further tighten its monetary policy to bring about an early slowdown of imports.

A. Fiscal Policy

10. The stabilization of the general government debt ratio remains our principal fiscal policy objective in 2003. The elimination of double counting of some direct and guaranteed debt from our data base has led to a downward revision of the ratio by several percentage points. We will monitor the stock of outstanding guarantees during the remainder of the program period (structural benchmark) and restrain the extension of new guarantees appropriately to ensure that the debt ratio does not increase in 2003.

11. A very significant contribution to the stabilization of the debt ratio will come from a more rapid than originally programmed reduction of the general government deficit. The higher than expected growth in 2002 and buoyant tax collections in early 2003 have led us to raise our revenue projection for 2003 by 0.9 percent. At the same time, total expenditure is projected to remain virtually unchanged from its budgeted level. As a result, we now expect the general government deficit to be reduced to 4.6 percent of GDP instead of 5 percent of GDP under the original program (Table 3). As bids received indicate higher receipts from the privatization of INA, the net borrowing requirement has been reduced even more.

12. The government is determined to resist any pressures for tax relief or expenditure increases. There will be no supplementary budget this year, although we expect some revision in the composition of actual spending. As the table below shows, the largest projected increase is in expenditure for goods and nonwage services, which were budgeted at unrealistically low levels. The upward revision of subsidies and other transfers is more than

Croatia: Consolidated General Government Expenditure, 2002-03

	2002	2003		2003	
		original (o)	revised (r)	2003(r)/2002	2003(r)/2003(o)
		(In million of HrK)		(In percent)	
Expenditure and net lending	88,131	93,862	93,937	6.6	0.1
Expenditure	86,940	92,575	92,649	6.6	0.1
Current expenditure	76,224	79,784	80,578	5.7	1.0
Wages (excl. social security contrib.)	19,339	19,643	19,610	1.4	-0.2
Goods and nonwage services	17,391	17,559	18,226	4.8	3.8
Interest	3,709	4,642	4,502	21.4	-3.0
Subsidies and other transfers	35,785	37,940	38,241[1]	6.9	0.8
Capital expenditure	10,716	12,792	12,071	12.6	-5.6
Lending minus repayments	1,191	1,286	1,287	8.1	0.1

Includes HrK 3 million of wages of a steel mill paid with a loan from INA.

explained by likely transfers to clear arrears of public hospitals outside the general government consolidation. Lower interest payments result from lower interest rates, favorable exchange rate movements, and a lower debt stock. Capital expenditure has been reduced on the assumption that the delays in highway construction experienced due to adverse weather conditions in early 2003 is not likely to be fully compensated for in the remainder of the year as some capacity constraints impede the attainment of the original expenditure target.

13. Our revised deficit financing plan for 2003 relies on more domestic borrowing than in 2002 in an effort to support the CNB's monetary tightening. Privatization receipts have been raised to a still conservative 1.7 percent of GDP. We reaffirm our intention to (i) use higher receipts to reduce our net debt; and (ii) reduce the fiscal deficit by the amount of any shortfalls. A large amount of foreign borrowing has already been obtained through the euro bond issue, and we expect to receive the second tranche of the World Bank's SAL in the third quarter. Despite sharply lower gross foreign borrowing than in 2002, net foreign borrowing will still amount to 1.3 percent of GDP because of the absence of bullet bond repayments in 2003. As a precautionary measure, we have decided to issue a Yen 25 billion Samurai bond in June 2003, but its proceeds will remain abroad so that this operation will have no effect on net foreign borrowing[1]. Net domestic borrowing, mostly from the pension funds, will amount to 1.5 percent of GDP, compared with 0.2 percent of GDP in 2002. Despite a slow start, arrears reduction will amount to 0.3 percent of GDP in 2003 and the slippage recorded in the first quarter will be made up by the end of the third quarter.

[1] Like excess privatization receipts, we may, if not needed for liquidity purposes, use some of these proceeds to prepay burdensome external debt. We also plan to contract two bank loans this year to finance capital expenditure by the highway construction agency (HAC) in 2004.

B. Monetary and Exchange Rate Policy

14. The measure introduced in early 2003 to slow down credit expansion is temporary. The CNB intends to replace it by prudential and more priced-based measures at the end of 2003. In the meantime, the CNB will not hesitate to enhance the effects of the current measure by tightening banking sector liquidity through an increase in minimum reserve requirements if warranted by developments in domestic inflation, credit growth and the external current account balance. To this end, the second review under the program will focus on any monetary and other measures that may be needed to keep external developments in line with program targets.

15. The recent sharp deterioration of the external current account balance was not caused by a sudden drop of competitiveness, which remains adequate according to the standard indicators. The CNB realizes the usefulness of short-term exchange rate variability to discourage the buildup of unhedged foreign exchange positions and intends to continue with this policy. It will also increase its efforts to use its supervisory powers to warn banks, and through them their clients, about the risks of unhedged foreign exchange exposure and to ask them to inquire and report on their largest customers' foreign exchange exposure. In this connection, the new requirement to include foreign exchange options in banks' net open positions has raised some banks' long position above the regulatory limit of 20 percent of capital. The trend toward greater use of the kuna in deposit and credit operations that is evident since the start of the year is likely to be reinforced as banks convert their loans with asymmetric foreign exchange indexation clauses to comply with the new regulation.Banks exceeding the 20 percent limit have been given deadlines to comply with the new regulation. At any rate, the CNB has agreed on phased compliance schedules with the banks with excessive net foreign positions.

16. The CNB's monetary program for 2003 has only been slightly modified. With unchanged growth prospects and a slightly more favorable inflation outlook, broad money growth is expected to remain at some 14 percent. Assuming a phased compliance of banks with the new foreign exchange liquidity requirements against their foreign exchange liabilities, the CNB's net purchases of foreign exchange are estimated at US$ 412 million[2]. The associated buildup of net international reserves and the general government's net bank borrowing of 0.2 percent of GDP would leave 9 percent of GDP of credit to the nongovernment sector. This would represent a slowdown of credit expansion to the nongovernment sector from 31.3 percent in 2002 to 18.2 percent in 2003, contributing to the adjustment of the external current account while leaving the CNB's gross international reserves at 5 months of imports of goods and nonfactor services.

[2] The underlying target for the accumulation of net usable international reserves would be adjusted by the amount by which the privatization receipts from the partial sale of INA deviate from the assumed US$ 362 million (Table 4).

C. Structural Reforms

Fiscal sector reforms

17. A new budget law satisfying the criteria spelled out in paragraph 16 of the MEFP has been adopted by parliament and the 2004 budget will be prepared in accordance with its provisions. The government will by July 15, 2003 adopt new criteria for issuing guarantees, in line with the requirements in paragraph 16 of the MEFP (prior action), thus ensuring that the recent extension of a guarantee to the private Viktor Lenac shipyard remains an exception. Moreover, the Ministry of Finance, which has the exclusive right to issue guarantees on behalf of the Republic of Croatia, will compile a complete register of active guarantees by July 15, 2003, including a record of all new and expired or amortized guarantees in the first half of the year (prior action). This register will be kept up to date so as to facilitate monitoring the evolution of government debt under the program.

18. We welcome the Fund's acceptance of our request to place a resident fiscal advisor in the Ministry of Finance to strengthen the operations of the debt management, macroeconomic analysis, and treasury departments and offer the advisor our full cooperation, including through any necessary organizational and staffing changes. We look particularly forward to a rapid improvement of the flow of high-quality, timely general government data (including debt stock statistics) at an appropriate frequency under both the GFS 1986 and GFS 2001 methodologies. On the basis of the output generated, we will resume publication of the Ministry's monthly bulletin. We also look forward to the conduct of a fiscal ROSC in October 2003 and remain committed to the other reform undertakings of paragraph 18 of the MEFP.

Financial sector reforms

19. We have issued a set of bylaws to implement the new banking law (as per paragraph 20 of the MEFP). We are currently preparing detailed guidelines to be issued by end-2003 in support of the application of the by-laws. We are confident that the by-laws and the guidelines will help to strengthen the banking sector regulatory framework. In particular, starting on January 1, 2004, (i) banks will be required to include charges for market risk in the reported capital adequacy ratios; and (ii) banks with rapidly expanding loan portfolios will have to create additional provisions for general risks. The CNB is working also on establishing cooperation and information-sharing arrangements with relevant foreign supervisory agencies, and on strengthening cooperation arrangements with domestic supervisory agencies. The CNB is also working towards strengthening its capacity to assess risks to financial soundness of individual banks as well as the banking sector as a whole. Finally, a new deposit insurance law is being drafted by a task force comprising the Ministry of Finance, the CNB, the bank rehabilitation and deposit insurance agency (DAB), and the bankers' association.

20. The Ministry of Finance eliminated the only remaining exchange restriction subject to Article VIII of the Fund's Articles of Agreement in June 2003. In response to the Fund's safeguards assessment, the CNB has added staff to its internal audit department and intensified training of the department's staff. An audit plan with expanded coverage of higher risk areas of the CNB's operations has been approved by the Governor. Finally, the CNB's financial report for 2002, with the auditor's opinion, was sent to parliament in May 2003 and posted on the CNB's web site in June 2003.

Public enterprise reforms and privatization

21. The government remains committed to public enterprise restructuring and privatization to boost competitiveness and the growth potential of the economy. Employment in the nine largest public enterprises was reduced by 3 percent during 2002 and their aggregate financial result improved from a net loss of 0.3 percent of GDP in 2001 to a net profit of 0.7 percent of GDP in 2002. Efforts to improve efficiency are continuing. As to privatization, we expect to reach a final decision on the sale of 25 percent plus one share of INA to a foreign strategic investor by July 15, 2003 (prior action). The sale of 7 percent of the already majority privatized telecommunication company (HT) to its employees has been postponed until after the elections. A 25 percent share in the insurance company (CO) will be offered to the Catholic church and other investors to settle restitution claims. The unbundling and restructuring of the electricity company (HEP) is continuing and we expect to begin privatizing power generation and distribution in 2004. The company's transmission network (as well as the JANAF pipeline) will remain publicly owned. We have sent the IFC a mandate letter on June 10, 2003 inviting it to do the due diligence for taking a 19 percent equity participation with strong veto powers in the postal bank (HPB) (prior action). We expect to sign the subscription agreement with IFC by end-September 2003 (structural benchmark). Together, we will prepare a plan to privatize more than 50 percent of the bank within 24 months of signing the subscription agreement. We will prepare a plan to privatize Croatia Banka, currently administered by DAB, by December 31, 2003 (structural benchmark). Finally, we will approach the IFC shortly to examine the possibility of auctioning off DAB's bad loan portfolio. The recent change in the supervisory board of the privatization fund (HFP) has not significantly slowed the fund's privatization program, as outlined in paragraph 21 of the MEFP. Priority is currently being given to privatizing tourism and agricultural enterprises from among the majority holdings in the HFP's portfolio. In a change from past practice, the HFP attempts to improve the balance sheet of these enterprises by writing off, capitalizing or extending the maturity of state creditor claims prior to privatization. In the meantime, the sale of HFP's minority participations continues apace on the Zagreb and Varaždin stock exchanges.

Product and labor market developments

22. Legislation to align Croatian law with that of the EU and to satisfy the conditions of the second tranche disbursement of the World Bank's SAL are high on the parliament's agenda. We therefore expect new bankruptcy, company, competition, and labor laws to be approved by end-July 2003.

23. With the entry into force of the free trade agreement with Albania on June 1, 2003, there remain only a few unresolved trade agenda items. We have ratified new free trade agreements with Serbia-Montenegro and Turkey, but the former one has not entered into effect pending resolution of the Montenegrin side's objections to some of its agricultural provisions, and we are still waiting for Turkey's ratification. Negotiations on a free trade agreement with Moldova have yet to resume. Lastly, we have so far been unsuccessful in persuading the EU to apply the Pan-European Diagonal Cumulation of Rules of Origin to Croatian exports. We are working to resolve these issues soon.

Table 1. Croatia: Key Macroeconomic Indicators, 1999-2003

	1999	2000	2001	Projections in EBS/03/3 2002	Preliminary Outcome 2002	Program in EBS/03/3 2003	Program 2003
				(Percentage change)			
Output and prices							
Real GDP	-0.9	2.9	3.8	4.0	5.2	4.2	4.2
CPI inflation (average)	4.1	6.2	4.9	2.4	2.2	3.0	2.3
				(In percent of GDP)			
Savings and investment							
Gross national savings	18.6	19.3	19.9	21.5	21.8	23.0	22.4
Gross domestic investment	25.7	21.8	23.7	25.1	28.7	26.6	27.8
General government operations							
Revenue and grants	48.4	46.2	44.7	45.4	45.2	45.0	44.9
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0	50.0	49.5
Overall balance	-8.2	-6.5	-6.8	-6.2	-4.8	-5.0	-4.6
Privatization receipts 1/	4.9	3.1	3.7	2.0	1.8	1.2	1.7
Foreign borrowing	3.3	4.2	2.0	3.8	2.8	1.5	1.3
Domestic borrowing (including arrears)	0.0	-0.8	1.1	0.4	0.2	2.2	1.5
				(End of period; change in percent)			
Money and credit							
Credit to the nongovernment sector	...	9.4	24.5	29.8	31.3	13.7	18.2
Broad money	...	28.9	45.2	11.7	9.5	14.4	14.2
Base money	...	13.6	51.9	23.1	29.3	15.6	14.3
				(End of period; in percent)			
Interest rates							
Average deposit rate	4.3	3.4	2.8	1.7 4/	1.8	...	...
Average credit rate	13.5	10.5	9.5	13.0 4/	12.5	...	...
				(In millions of U.S. dollars)			
Balance of payments							
Current account balance	-1,397	-459	-725	-800	-1,547	-893	-1,499
(In percent of GDP)	-7.0	-2.5	-3.7	-3.6	-6.9	-3.6	-5.5
Capital and financial account	2,359	1,950	2,661	3,166	3,539	1,465	2,205
Overall balance	410	611	1,344	1,109	827	572	815
				(End of period; in millions of U.S. dollars)			
Debt and reserves							
Gross official reserves	3,025	3,525	4,704	5,706	5,886	6,278	6,639
In months of following year's imports of goods and NFS	3.8	3.9	4.4	5.3	4.8	5.6	5.2
Gross usable international reserves 2/	2,249	2,629	3,653	4,547	4,729	5,038	5,259
In months of following year's imports of goods and NFS	2.8	2.9	3.4	4.3	3.9	4.5	4.1
As a percentage of short-term debt 3/	124	116	156	307	224	260	203
External debt service to exports ratio (in percent)	21.1	23.5	24.9	25.3	27.3	17.4	20.5
Public debt (in percent of GDP)	46.4	51.1	51.6	57.5	51.2	57.2	50.5
Of which: External	27.5	31.9	31.4	33.3	30.1	32.4	29.3
Total external debt (in percent of GDP)	44.3	59.7	58.0	61.7	68.2	59.0	67.9

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

1/ In 2000, includes 0.5 percent of GDP in back taxes.

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

3/ On a remaining maturity basis. Coverage is limited to short-term debt contracts registered with the CNB.

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

Table 2. Croatia: Performance Under the Stand-By Arrangement as of March 31, 2003

Quantitative performance criteria		(In millions of kuna, unless indicated otherwise)	
1-a Cumulative Deficit of the Consolidated Central Government 1/		Program	4,053
		Actual	3,153
		margin (+)	900
1-b Cumulative Deficit of the Consolidated General Government 1/		Program	4,325 2/
		Actual	2,960
		margin (+)	1,365
2 Reduction of Arrears of the Consolidated Central Government 1/		Program	150
		Actual	119
		margin (+)	-31
3 Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 1/3/		Program	704
	>1 year	Actual	510
		margin (+)	194
		Program	100
	<5 years	Actual	0
		margin (+)	100
4 Cumulative Increases in Short-term External Debt Contracted by the General Government, CNB, and HBOR 1/ 3/		Program	120
		Actual	0
		margin (+)	120
5 Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 3/ 4/		Program	-120
		Actual	53
		margin (+)	173
6 Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 1/		Program	331
		Actual	-569
		margin (+)	900
Indicative limits			
1 Consolidated Central Government Wage Bill 1/		Program	4,603
		Actual	4,660
		margin (+)	-57
2 Cumulative Changes in the Net Credit of the Banking System to the Consolidated General Governments 1/		Program	-170
		Actual	-1,733
		margin (+)	1,563
3 Cumulative Increase in the Net Credit of the Banking System to Selected Public Enterprises 1/		Program	463
		Actual	-337
		margin (+)	800
Structural performance criterion			
1 Government to prepare criteria for issuing guarantees by end-March 2003.		Not observed	
Structural benchmarks			
1 Parliament to approve by end-March 2003 a new budget law satisfying the conditions specified in paragraph 16 of the MEFP.		Not observed. Approved by parliament on May 29, 2003.	
2 CNB to issue by end-June 2003 and implement by end-September 2003 a regulation to include options in the calculation of banks' net foreign exchange position.		The regulation regarding this took effect on Aril 1, 2003.	
3 Government to make a decision by end-March 2003 on the bids received for the privatization of INA		Not observed. A final decision will be made by mid-July 2003.	
4 Government to prepare by end-March 2003 a privatization program for HPB that satisfies the conditions specified in paragraph 23 of the MEFP (to be monitored in consultation with the IFC).		Not observed. The government formally invited the IFC to subscribe to 19 percent of HPB's capital with appropriate veto powers on June 10, 2003.	

1/ Ceiling.
2/ Indicative limits (not a performance criterion).
3/ In millions of US dollars.
4/ Floor.

Table 3. Croatia: Proposed Conditionality Under the Stand-By Arrangement During the Second Half of 2003 1/

1. Prior actions

1. Prepare a complete register of active government guarantees, including a record of all new and expired or amortized guarantees during the first half of the year, by July 15, 2003.

2. Send a mandate letter to the IFC by June 15, 2003, requesting the latter to conduct due diligence of HPB with a view to subscribing to 19 percent of its capital with appropriate veto powers.

3. Reach a final, irrevocable decision by July 15, 2003 on the privatization of 25 percent plus one share of INA.

4. Adopt criteria for issuing government guarantees in accordance with the requirements outlined in paragraph 16 of the MEFP by July 15, 2003.

2. Quantitative performance criteria		September 30	December 31
		(In millions of kuna, otherwise specified)	
1-a. Cumulative Deficit of the Consolidated Central Government 2/		7,244	9,274 3/
1-b. Cumulative Deficit of the Consolidated General Government 2/		6,938 3/	8,692
2. Cumulative Reduction of Arrears of the Consolidated Central Government 2/		450	550
3. Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 2/ 4/ 5/	>1 year	652	968
	<5 years	100	100
4. Cumulative Increases in Short-term External Debt Disbursed by the General Government, CNB, and HBOR 2/ 4/		--	--
5. Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 4/ 6/		353	200
6. Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 2/		-141	2,121
3. Indicative limits			
1. Consolidated Central Government Wage Bill 2/		13,600	18,005
2. Cumulative Changes in Net Credit of the Banking System to the Consolidated General Governments 2/		-745	455
3. Cumulative Increases in Net Credit of the Banking System to Selected Public Enterprises 2/		-550	-415

4. Structural benchmarks

1. On the basis of the database created under prior action No.1, report data on government guarantees outstanding on September 30, 2003 and December 31, 2003.
2. Sign a subscription agreement with the IFC committing the latter to acquire 19 percent of HPB's capital with appropriate veto powers (by September 30, 2003).
3. Prepare a plan to privatize Croatia Banka (by December 31, 2003).

1/ The continuous performance clauses remain as in the MEFP, paragraph 26 and Annex II.

2/ Ceiling.

3/ Indicative limits (not a performance criterion).

4/ In millions of US dollars.

5/ Cumulative increases from June 30, 2003.

Table 4. Croatia: Amendments to Annexes III, IV, VI, and VII of the MEFP

Annex III

1. The projections for the cumulative privatization receipts are changed as follows. For the general government, HrK 2,905 million during January-September 2003 and HrK 3,251 million during January-December 2003. For the central government, HrK 2,623 million during January-September 2003 and HrK 2,859 million during January-December 2003.

2. The revised deficit projection of HBOR in 2003 is HrK 1,869 million.

3. It is clarified that all fiscal reporting should be on a modified accrual (commitment) -- rather than cash -- basis.

4. It is further clarified that all fiscal data should be reported by the Ministry of Finance.

5. The indicative cumulative limits on the wage bill of the central government are HrK 13,599 million for January-September 2003 and HrK 18,005 million for January-December 2003.

Annex IV

1. The debt contracting ceilings exclude municipal support agreements between local governments and the EBRD.

Annex VI

1. In accordance with the stipulation of paragraph 2 of Annex VI to the MEFP, the reserve floors will be raised by the amount of Funds disbursed by the U.S. Treasury after lifting the freeze on the assets of the National Bank of the former Socialist Federal Republic of Yugoslavia (approximately US$ 55 million).

2. The reserve floors will be raised/lowered by the amount by which the privatization receipts from the partial sale of INA exceed/fall short of US$ 362 million.

Annex VII

1. The net domestic asset ceiling will be lowered/raised by the kuna amount by which the privatization receipts from the partial sale of INA exceed/fall short of the kuna equivalent of US$ 362 million.

2. The stock of base money is projected to be HrK 25,191 million on September 30, 2003 and HrK 26,324 million on December 31, 2003.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

First Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria Supplementary Information

Prepared by the European I and the Policy Development and Review Departments

(In consultation with the Legal Department)

Approved by Michael Deppler and Anthony Boote

July 30, 2003

1. This supplement provides information on macroeconomic trends and policy measures that has become available since July 1, 2003 and on program performance as of the June 30, 2003 test date, as far as available, and the implementation of prior actions. It also proposes a decision granting waivers of nonobservance and applicability of performance criteria and completing the first review under the stand-by arrangement. The new information does not change the thrust of the staff appraisal.

I. Recent Developments

2. Macroeconomic data indicate continued strong output growth, low inflationary pressure, and a slowdown in credit expansion. However, there is no evidence yet that the external current account began to improve in the first half of 2003.

- Industrial output was up 7.1 percent year on year in June, raising output growth in the first half of 2003 to 6 percent over the corresponding 2002 period. By contrast, the twelve-month growth of retail sales volume slowed to 6.5 percent in May, reducing the year-on-year growth rate to 7.3 percent in the first five months of 2003.
- The twelve-month rate of retail price inflation edged up to 1.1 percent in June, with core inflation at 0.5 percent and producer price inflation at 1.7 percent.
- The kuna's exchange rate against the euro has remained stable without central bank intervention.
- On a month-to-month basis, credit to the nongovernment sector contracted in June. On a twelve-month basis, the rate of credit expansion slowed from 31.3 percent at end-2002 to 23.3 percent in mid-2003.
- Data for May indicate that the cumulative merchandise trade deficit in the first five months amounted to US$2.9 billion, compared with US$1.8 billion in the

corresponding 2002 period. In US$ terms, exports rose by 28.5 percent and imports by 45.1 percent with respect to 2002.

3. Policy actions and legislative measures have been in line with the revised program for 2003.

- The government decided to provide drought relief equivalent to 0.2 percent of GDP by reallocating unused budgetary resources of the Ministry of Agriculture and cutting the allocations for other ministries.
- Parliament adopted new bankruptcy, company, competition, and labor laws before its summer recess. The labor law is substantively identical with the draft law submitted by the government in January 2003 as a prior action for Board approval of the present stand-by arrangement (MEFP, ¶ 24) and will enter into effect on January 1, 2004.
- With the new laws, all but one of the remaining conditions for the release of the second tranche of the World Bank's SAL have been fulfilled. The remaining condition—parliamentary approval of a new spatial planning law—is expected to be met after parliament resumes its work in September. Accordingly, the World Bank has extended the SAL until October 31, 2003.

II. Program Performance and Prior Actions

4. The end-June performance criteria on the net usable international reserves and the net domestic assets of the Croatian National Bank (CNB) were observed with substantial margins (Table 1). The end-June performance criterion on the reduction of central government arrears was also observed.

5. All four prior actions listed in Table 8 of the staff report have been implemented. In particular, the government accepted a US$505 million bid by the Hungarian oil company MOL for 25 percent plus one share in the INA oil company. In line with Table 4 of the SMEFP, the end-September and end-December 2003 floors for the net usable international reserves of the CNB will be raised by US$143 million and the corresponding net domestic asset ceilings of the CNB will be lowered by an equivalent amount to adjust for the higher-than-programmed privatization receipts. In accordance with paragraph 13 of the SMEFP, the government will use the excess privatization receipts to reduce its net debt.

6. As anticipated in ¶ 36 of the staff report, as one of the prior actions the government issued a decree that establishes stricter criteria for the extension of government guarantees. This action fully meets the requirements listed in ¶ 16 of the MEFP for the structural performance criterion established for end-March 2003. The staff therefore supports the authorities' request for the waiver of nonobservance of this performance criterion.

Table 1. Croatia: Performance Under the Stand-By Arrangement as of June 30, 2003

			End of	
			March	June
Quantitative performance criteria		(In millions of kuna, unless indicated otherwise)		
1-a Cumulative Deficit of the Consolidated Central Government 1/		Program	4,053	6,398 2/
		Actual	3,153	
		margin (+)	900	
1-b Cumulative Deficit of the Consolidated General Government 1/		Program	4,325 2/	6,615
		Actual	2,960	
		margin (+)	1,365	
2 Reduction of Arrears of the Consolidated Central Government 1/		Program	150	300
		Actual	119	303
		margin (+)	-31	3
3 Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 1/3/	>1 year	Program	704	970
		Actual	510	
		margin (+)	194	
	<5 years	Program	100	100
		Actual	0	
		margin (+)	100	
4 Cumulative Increases in Short-term External Debt Contracted by the General Government, CNB, and HBOR 1/ 3/		Program	120	0
		Actual	0	
		margin (+)	120	
5 Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 3/ 4/		Program	-120	-184
		Actual	53	111
		margin (+)	173	295
6 Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 1/		Program	331	2,167
		Actual	-569	1,264
		margin (+)	900	903
Indicative limits				
1 Consolidated Central Government Wage Bill 1/		Program	4,603	9,075
		Actual	4,660	
		margin (+)	-57	
2 Cumulative Changes in the Net Credit of the Banking System to the Consolidated General Governments 1/		Program	-170	-4
		Actual	-1,733	
		margin (+)	1,563	
3 Cumulative Increase in the Net Credit of the Banking System to Selected Public Enterprises 1/		Program	463	278
		Actual	-337	
		margin (+)	800	

1/ Ceiling.
2/ Indicative limits (not a performance criterion).
3/ In millions of US dollars.
4/ Floor.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 03/136
FOR IMMEDIATE RELEASE
August 1, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review of Croatia's Stand-by Arrangement

The Executive Board of the International Monetary Fund (IMF) completed today the first review of Croatia's 14-month, SDR 105.88 million (about US$147 million) Stand-by Arrangement. In completing the review, the Executive Board granted a waiver of the nonobservance of the structural performance criterion on adoption of guidelines for issuing government guarantees. The Croatian authorities continue to treat the Stand-By Arrangement as precautionary and do not intend to draw the available financing under it (see Press Release No. 03/13).

Following the Executive Board's discussion of Croatia's economic performance, Agustin Carstens, Deputy Managing Director and Acting Chairman, stated:

"Croatia has made important strides in restoring robust economic growth and achieving price stability while continuing to strengthen its net international reserves position. These achievements owe much to a multi-year effort at fiscal consolidation and—albeit more limited—progress with structural reform. As a result of the fiscal adjustment, stabilization of the public debt ratio is within reach. A new challenge has, however, arisen as a result of an excessively rapid expansion of private sector credit, which has fueled import growth. The attendant sharp deterioration of the external current account was financed by foreign borrowing, which has pushed up the external debt ratio. An early reduction of the external imbalance has thus become an urgent policy priority for the Croatian authorities.

"The government's commitment to resist pressures to loosen the fiscal stance in the runup to general elections is welcome. With improved revenue prospects, the general government deficit is expected to decline to 4.6 percent of GDP in 2003. Further fiscal adjustment will, however, be required beyond 2003 as the fiscal and external current account deficits remain sizable. Higher than expected privatization receipts and a strict application of the new criteria for extending government guarantees should help stabilize or even reduce the public debt ratio. To the extent possible, the government is encouraged to meet its borrowing requirements in the domestic capital market, to promote its development, stem appreciation pressures, and absorb liquidity.

"The monetary authorities have had some success in slowing down credit expansion through administrative restraints. However, as these measures distort competition and encourage balance sheet manipulation, the authorities' decision to replace them with prudential measures at the start of 2004 is welcome. In the meantime, the authorities will carefully monitor external current account developments and where appropriate reinforce these measures by more traditional monetary tightening.

"The level of the exchange rate remains broadly appropriate. Although banks are well capitalized and largely foreign owned, the central bank's stepped-up efforts to warn economic agents about unhedged foreign exchange exposure and strengthen its capacity to assess risks to the soundness of the banking system are welcome.

"The pace of reforms has accelerated considerably with the recent parliamentary approval of new bankruptcy, budget, company, competition, foreign exchange, and labor laws. The government should now focus on public enterprise restructuring and privatization as well as remaining measures to promote Croatia's EU membership bid," Mr. Carstens stated.

Statement by Jeroen Kremers, Executive Director for the Republic of Croatia
August 1, 2003

Overview

1. This year, an election year, the Croatian authorities commenced with the second precautionary SBA. This arrangement helps them in signaling their determination to continue with the reforms embarked on since 2000. The EU accession efforts further bolster these fiscal, structural and political reforms. The authorities are on track with the program; the economy is growing at a strong pace, resilient to unfavorable external conditions; and the financial markets have rewarded this performance by decreasing the country's risk premium. The Croatian authorities thank staff for the support and policy advice during the last years, helping the country to manage transitional maladies.

2. The authorities – aided by advice from the staff – have managed to change the economy for the better. The public administration has been reformed, improving efficiency and reducing the wage bill; a pension reform has been carried out (introducing a second and third pillar) as well as a health reform; labor market flexibility has been increased by modifying the labor law; and market functioning has been improved by adopting new bankruptcy, company and competition laws. Also, the banking system has been restructured; it is now 90 percent foreign owned. At the same time, the central bank's degree of independence has been augmented, in line with EU legislation. Although the economy has been transformed significantly in the last years, many difficult tasks and challenges lie ahead.

3. The future tasks and challenges are foremost embodied in achieving sustainable nominal and real convergence in accordance with the Maastricht framework as well as concluding the process of harmonizing domestic with EU laws. Also, a further reduction in the budget deficit is targeted while aiming for a lower tax burden. Furthermore, the authorities will strengthen the capacity of public administration as a necessary step towards EU accession. Beside the advances in the fiscal area, additional strengthening of the overall institutional framework is foreseen as well as reforming the judiciary system. Finally, the authorities are committed to maintaining the momentum of structural reforms by privatizing the remaining two state-owned banks, the hotel industry, agricultural conglomerates and the energy utility.

4. A current challenge the authorities are facing is the deterioration of the balance of payments. The widening external current account deficit and increasing external debt, owing to steady robust domestic credit growth, led to a tightening of monetary policy. A "corset" on bank lending and banks' foreign borrowing brought about this tightening. These measures are seen as short-term, precautionary as well as prudent to take off some "heat" from the economy. The rise in the external deficit and external debt has not concerned the financial markets. In fact, in July 2003, Fitch revised Croatia's sovereign credit rating outlook to positive from stable.

5. The SBA quantitative criteria for the first quarter have been broadly met. The authorities regret missing the performance criterion target regarding the development of criteria for the issuance of government guarantees and therefore request a waiver. This

condition has been executed by now. In the interim, some data have become available, indicating that the fiscal and monetary program is on track. For the remaining performance criteria for the second quarter, the authorities request a waiver of applicability.

6. The prospects for keeping the public debt ratio stable have brightened further. In 2002, the general government debt has stabilized at a level of just over 40 percent, and total debt (including guarantees) at about 51 percent of GDP. In addition, Croatia has recently privatized 25 percent of INA, the state-owned oil company, receiving US$ 143 million more than projected. In accordance with the SBA, the authorities will use this amount for debt repayment.

Monetary policy

7. Inflation remains low. In June, the annual inflation rate was 1.1 percent. The exchange rate remains stable and the already high foreign reserves increased further, above 5.5 months of goods and services imports.

8. A recent challenge for monetary policy has been to slow down expanding domestic bank lending financed through foreign debt rather than domestic deposits. The monetary authorities used two measures. The first measure constrains bank lending to the private sector to 16 percent annually. Growth rates above 4 percent quarterly are penalized by an obligatory purchase of CNB bills at a penalty interest rate. The second measure discourages excessive foreign borrowing by stipulating that liquid foreign assets must be held for not less than 35 percent of foreign liabilities. Both measures attempt to decelerate bank lending to the private sector.

9. These measures are set for a limited time and correspond to the particular characteristics of the domestic money market, one of which is a weak interest rate transmission mechanism. Therefore, a more orthodox measure was not deemed a viable option for the authorities at this stage.

10. The measures taken by the monetary authorities had an effect. During the first half of 2003, lending growth was down to about 8 percent from 15 percent during the same period in 2002. In the first quarter, further signs of the economy's cooling off are reflected in retail sales' growing by only 7.3 percent compared to 12.0 percent in 2002.

11. The effects of the monetary measures taken will continue to be closely monitored. If these measures prove not to be sufficiently effective, the authorities stand ready to introduce further measures. In his recent speech to the parliament, the Governor announced that monetary policy could entail an increase in the minimum reserve requirement and capital restrictions in accordance with the new foreign exchange law. Any such measures will be in accordance with the IMF Article VIII.

External sector

12. The external current account deficit widened by 3.4 percentage points to 7.1 percent in 2002. Although it could be considered as substantial, this deficit is not different from

many EU accession countries. High economic activity boosted imports and external debt. However, in the first quarter of this year, because of monetary measures the external deficit shrank (in domestic currency terms). In addition, the structure of imports shifted toward capital goods, which should drive faster growth in 2004.

13. The increase in external debt has not shaken the markets' confidence in the economy's health. The debt stems largely from the banking system borrowing from banks' parent companies abroad. Moreover, direct borrowing is well structured, at medium and long maturities. Thus, as staff correctly points out, the country's EMBI-stripped spread has been decreasing in the last three years to around 100 basis points. And, as already mentioned, the financial markets are viewing Croatia more positively.

Fiscal policy

14. Since 2000, the general government deficit (on accrual basis) declined by 3.7 percentage points of GDP, to a targeted 4.6 percent in 2003. This was achieved despite supply side policies embodied in motorway construction and maintenance worth 1.6 percent of GDP in 2002. The motorways are important for tourism growth and for leveling out imbalances in regional development. At the same time, government expenditure arrears have been almost fully repaid.

15. In 2002, public debt stood at 40.1 percent of GDP. Together with the total stock of guarantees, general government debt amounted to 50.8 percent of GDP. This places Croatia amid the average EU accession performers. The data has been revised in close cooperation with Fund staff to account for some double counting in issued guarantees. The authorities realized the deficiencies in this area. A fiscal advisor, as part of a technical assistance project carried out by the Fund, and fiscal ROSC will serve to improve debt management and data quality further.

16. Debt management further supports monetary tightening. More precisely, the government increased the share of domestic borrowing. Apart from issuing domestic non-indexed bonds (0.5 percent of GDP), the authorities deposited receipts from the recent samurai bond issuance abroad for future debt repayment.

Structural reforms

17. The authorities have undertaken several difficult reforms. Recently, the parliament has passed new laws – the company, the competition, the bankruptcy and the labor laws. The laws have been drafted in cooperation with the World Bank. Implementing these laws will improve market functioning. In addition, the labor law should enhance labor market flexibility and further boost the continuous trend in declining unemployment.

18. In addition to implementing new laws, the authorities have made further progress in privatizing state-owned companies. Despite a strong public debate, the authorities privatized 25 percent of the state oil company INA. The privatization receipts exceeded the anticipated amount by approximately 0.5 percent of GDP and will be used for reducing public debt. Furthermore, negotiations are under way between the authorities and IFC to privatize HPB

(the postal bank). By end-2003 privatization plans regarding Croatia Banka, another small state-owned bank, are to be submitted. In addition, some companies in the tourism and agricultural industry have been privatized.

Conclusion

My authorities look forward to continued fruitful cooperation with the Fund. In this respect, the Executive Board's support for the conclusion of the first review under the precautionary SBA will be welcome. It constitutes a further step in supporting Croatia's determination to carry on with reforms and to improve further its market position.