February 2003
IMF Country Report No. 03/27

Republic of Croatia: Request for Stand-By Arrangement—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia

In the context of the request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **December 11, 2002,** with the officials of the Republic of Croatia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 14, 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 statement of **February 3, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its February 3, 2002 discussion** of the staff report that completed the request.

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

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

Letter of Intent sent to the IMF by the authorities of the Republic of Croatia*
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.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Request for Stand-By Arrangement

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

(In consultation with other departments)

Approved by Carlo Cottarelli and Shigeo Kashiwagi

January 14, 2003

- The government intends to carry forward its program of fiscal consolidation and economic reforms, supported by a new stand-by arrangement, in the runup to general elections likely to be held in the second half of 2003.

- With stable prices and a manageable current account deficit, macroeconomic stability is threatened in the medium term by the large fiscal deficit and a rising public debt ratio. At the same time, a high public expenditure ratio and delayed structural reforms are a drag on growth. While falling short of the objectives of the ambitious adjustment scenario discussed with the authorities during the 2002 Article IV consultation, the present program aims at making progress toward fiscal sustainability and higher, sustained rates of economic growth.

- Under the program, GDP growth is expected to reach 4.2 percent, inflation to remain below 3½ percent, and the external current account deficit to remain close to 3 ½ percent of GDP. The programmed reduction of the fiscal deficit from an expected 6.2 percent of GDP in 2002 to 5.0 percent in 2003 is expected to stabilize the public debt ratio at around 57 ½ percent of GDP.

- Access under the requested arrangement would be SDR 105.88 million (29.0 percent of quota) over a 14-month period. As the Croatian National Bank (CNB) has repurchased all Fund credit outstanding, access is sufficiently front-loaded to allow upper credit tranche conditionality and quarterly phasing. The authorities do not plan to make any purchases under the arrangement.

- Stand-by discussions were held in two rounds during October/November and December 2002. Messrs. Flickenschild (head), Bonato, Konuki (all EU1), Dodzin (PDR), Mr. Norregaard (resident representative), and Ms. Stephens (administrative assistant) participated in one or both missions. Meetings were held with the Deputy Prime Ministers for economic and social affairs, the Ministers of Finance, the Economy, Defense, and Reconstruction and Public Works, the Governor of the CNB, the chairman of the parliamentary budget committee, heads of government agencies, and representatives of banks and economic research institutes. Mr. Courtney (World Bank) participated in some of the discussions.

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Main Websites for Croatian Data

Data in this report reflect statistical information received by December 23, 2002.
More recent data can be obtained from the following internet sources:
Croatian Bureau of Statistics....................http://www.dzs.hr
Croatian National Bank....................http://www.hnb.hr
Ministry of Finance....................http://www.mfin.hr
Ministry of Economy....................http://www.mingo.hr
Information on Croatian economics statistics can be found at the Fund's Special Data Dissemination Standard website...http://dsbb.imf.org/country.htm

I. Recent Economic Developments and Near-Term Outlook[1]

1. **Buoyant domestic demand continues to bolster economic activity.** After reaching 3.8 percent in 2001, real GDP growth accelerated to 4.1 percent in the first half of 2002, underpinned by strong household consumption and business and government investment.[2] High-frequency indicators show that activity continued to be strong in the third quarter, with year-on-year growth of 8.1 percent for industrial production and 15.9 percent for retail sales volume (Figure 1). Even if consumption and investment decelerated as expected in the last quarter, the staff projects growth of at least 4 percent in 2002 (text table). After the strong increase in consumer credit in 2002 (see paragraph 4), growing household indebtedness should moderate the growth of private consumption in 2003. However, real GDP growth is expected to accelerate further to 4.2 percent on the back of stronger external demand and continuing support from private and government investment.

Main Economic Indicators
(In percent, unless otherwise indicated)

	1999	2000	2001	2002 proj.	2003 prog.
Real GDP	-0.9	2.9	3.8	4.0	4.2
of which (growth contributions):					
Domestic demand	-2.6	-0.3	5.1	6.0	4.0
Consumption	-3.5	3.0	1.9	3.1	1.6
Gross fixed capital formation	-0.9	-0.9	2.1	2.9	2.4
Change in inventories	1.9	-2.4	1.1	0.0	0.0
Net foreign demand	1.8	3.2	-1.3	-2.0	0.2
Exports	0.3	5.1	4.4	2.8	2.3
Imports	1.4	-1.9	-5.7	-4.8	-2.2
Retail price inflation (period average)	4.1	6.2	4.9	2.4	3.0
Current account balance (as a percentage of GDP)	-7.0	-2.4	-3.8	-3.6	-3.6
General government balance (as a percentage of GDP)	-8.2	-6.5	-6.8	-6.2	-5.0

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

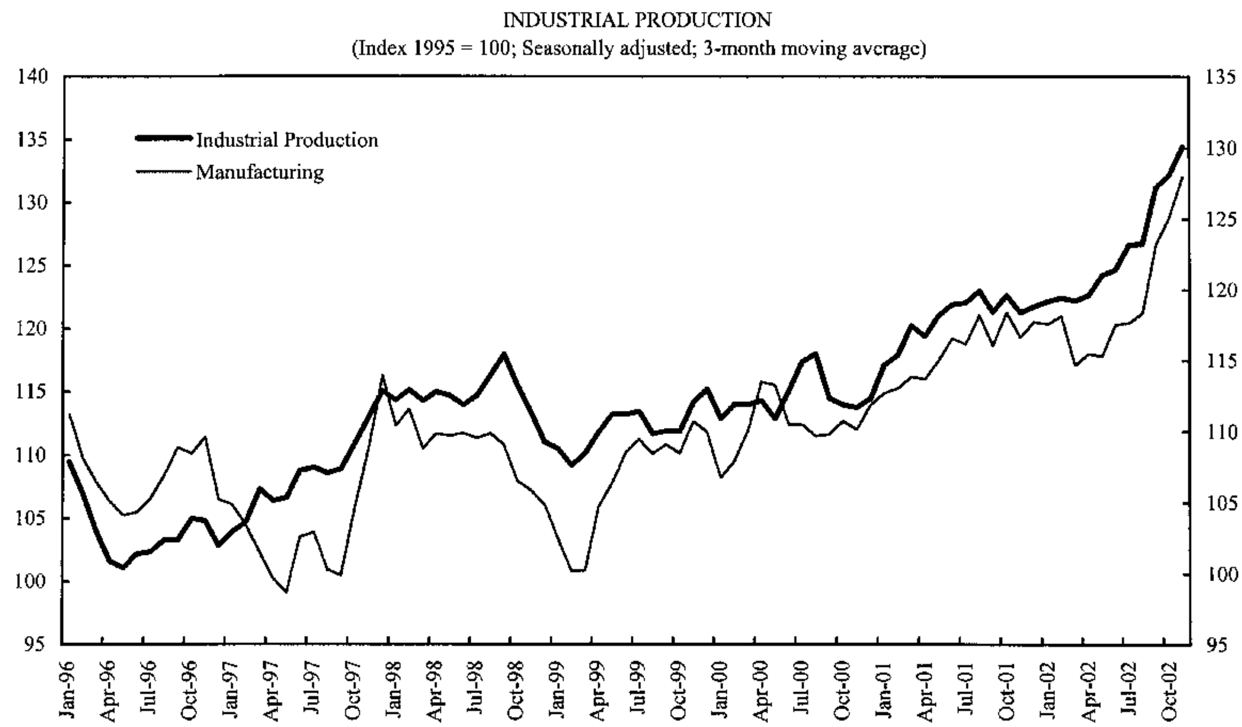
2. **Despite a disappointing merchandise trade performance, strong exports of services and private transfers have helped restrain the current account deficit.** While merchandise exports have been affected by a weak external environment and lack of structural change,[3] the tourist season was good, with an annual increase in real turnover estimated at around 5 percent. As a result, despite a strong increase in imports, the current account deficit is likely to narrow from 3.8 percent of GDP in 2001 to 3.6 percent of GDP in 2002. Exports of services (transportation and tourism) and income transfers from abroad have increased significantly in recent years thanks to improved economic and political

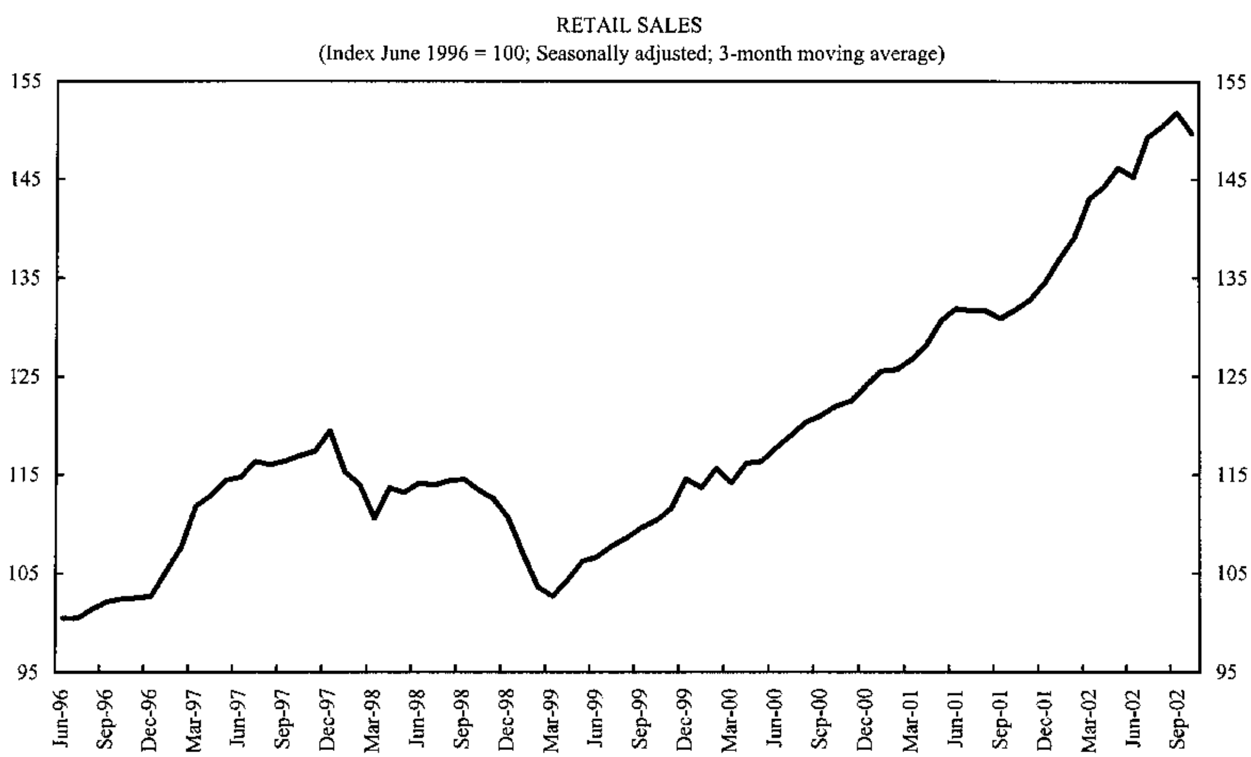
[1] See also Republic of Croatia—Staff Report for the 2002 Article IV Consultation, IMF Country Report No. 02/178, July 17, 2002.

[2] The statistical institute has recently revised downward GDP data for the last three years. The revision reduces average annual real GDP growth in the period 1999-2001 from 2.5 percent to 1.9 percent.

[3] For a discussion of the problems affecting Croatian exports, see S. Dodzin, "Selected Aspects of Export Performance, Competitiveness, and Trade Policy" in IMF Country Report No. 02/179, p.34.

Figure 1. Croatia: Real Sector Developments, 1996-2002



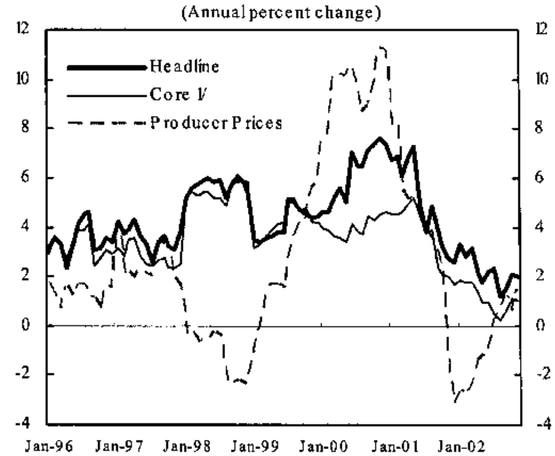


Source: Croatian Bureau of Statistics.

stability in the region. With the further upgrading of hotels and recreational infrastructure, these trends are likely to continue. Import growth is expected to slow in 2003 as machinery and equipment for highway construction have already been procured, car purchases decline, and imports to stock the new supermarkets wind down. If the recovery in Europe will materialize as expected, the current account deficit should remain broadly unchanged in 2003.

3. **Inflationary pressures remain subdued.** Despite a recent increase in electricity prices, retail price inflation remains low, with annual rates of 2 percent for headline inflation and 1 percent for core inflation in November (Figure 2). On average, headline inflation is likely to have fallen from 4.9 percent in 2001 to 2.4 percent in 2002. However, after two years of continuous declines facilitated by wage restraint, import tariff reductions, and increased competition in retail trade, the return of positive producer price inflation after mid-year suggests that retail price inflation may have reached a bottom and be about to rise to a slightly higher level, reflecting lower productivity growth in the nontradable sector in the context of broad exchange rate stability (Balassa-Samuelson effects).[4] Staff and authorities estimate this level to be around 3-3½ percent on average.

Figure 2. Croatia: Retail Price Inflation, 1996-2002
(Annual percent change)



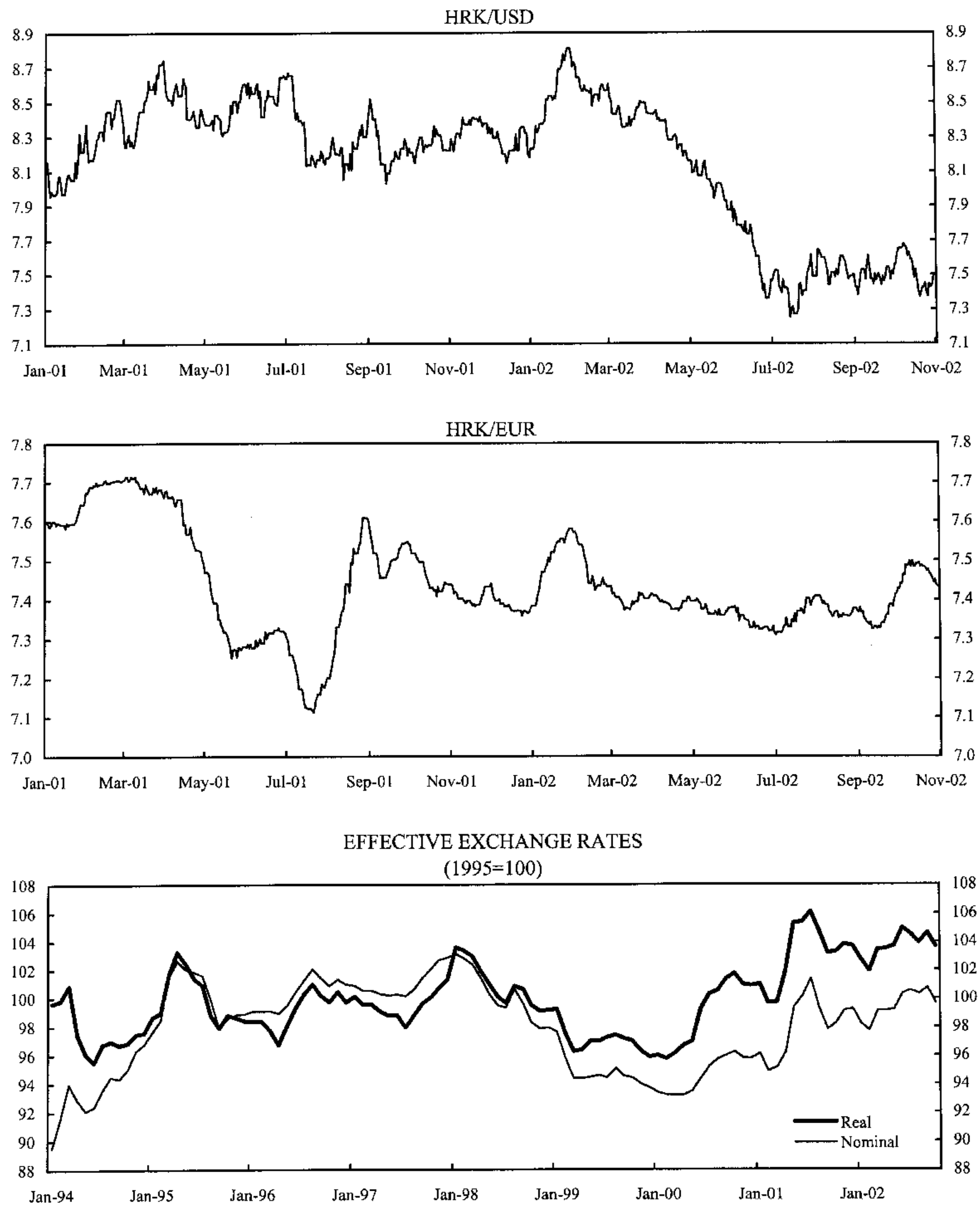
Sources: Croatian National Bureau of Statistics; and Croatian National Bank.
1/ Excludes energy and administrative prices.

4. **While monetary conditions are stabilizing, credit to the private sector continues to expand rapidly**. With the exception of a temporary weakenings in July (due to large external debt repayments) and October (for seasonal reasons), the currency has been broadly stable and the CNB has intervened mostly to stem its appreciation (Figure 3). The kuna has remained rather stable against the euro, while appreciating by 12 percent against the dollar, and competitiveness—as measured by the CPI-based real effective exchange rate—has deteriorated by less than one percent. The growth of broad money has slowed considerably, and its twelve month rate of increase is expected to decline sharply in coming months due to base-year effects.[5] Liquidity in the banking system remains high, and money market interest rates currently hover at around 1½ percent. The strong growth of bank credit to the private sector—credit to households increased by 36 percent year on year in September, as opposed to 22 percent for enterprises—has not yet shown any signs of abating (Figure 4). However,

[4] See IMF Country Report No. 02/178, p.17, fn. 8.

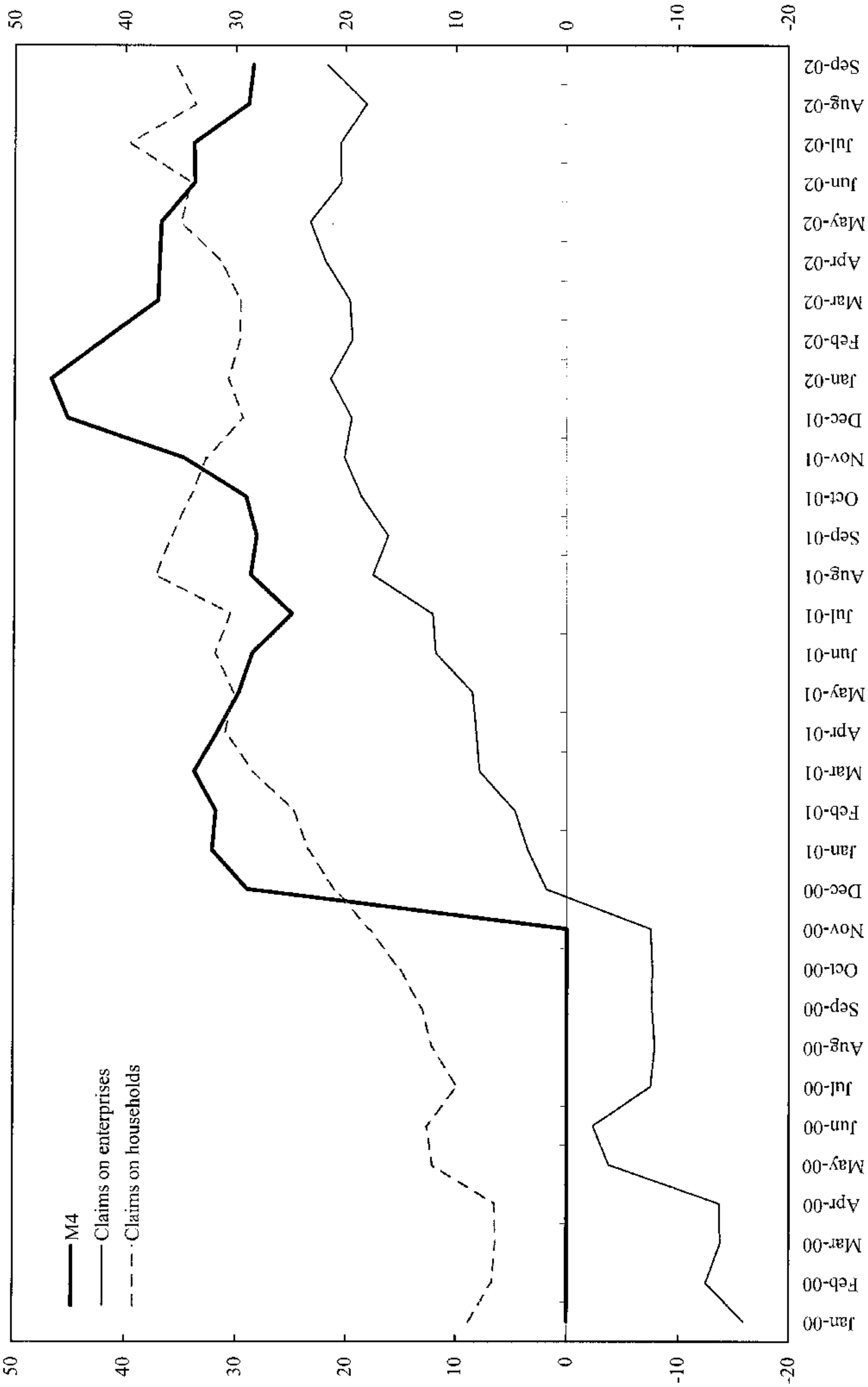
[5] These effects are due to the large inflow of foreign currency deposits associated with euro conversion in late 2001-early 2002. While most deposits have remained in the banking system, banks have substantially increased private sector credit by drawing down their deposits with foreign banks that had been accumulated during euro conversion.

Figure 3. Croatia: Exchange Rates Development, 1994-2002



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

Figure 4. Croatia: Money and Bank Credit, 2000-2002
(Annual percentage changes)



Source: Croatian National Bank.

there is no evidence yet that banks' loan portfolio has deteriorated as a consequence. Indeed, the share of nonperforming loans is declining and indicators of solvency and profitability continue to improve.[6]

5. **Further progress has been made on fiscal consolidation.** Notwithstanding stepped-up highway and housing construction, the general government deficit is expected to decline from 6.8 percent of GDP in 2001 to 6.2 percent of GDP in 2002. Expenditure overruns are projected on wages due to delays in defense sector layoffs and higher year-end bonuses and on goods and other services in the health sector. However, a better-than-expected revenue performance (from profit tax, personal income tax, and customs duties), savings on interest payments, and lower-than-planned capital spending—due to technical difficulties in implementing the ambitious original plan by the highway construction agency (HAC)—will more than offset these slippages. The deficit could be even lower if the fourth-quarter acceleration of highway construction falls short of expectations. Despite the reduction of the deficit, however, general government debt (including guarantees) is projected to rise from 55 percent of GDP at end-2001 to 57½ percent at end-2002, mainly due to the extension of government guarantees.

II. The Authorities' Strategy and Program for 2003

6. **The aim of the new program is to make progress toward long-term fiscal sustainability and strengthen the prospects for sustained high rates of growth.** The authorities realize that further progress will be needed after 2003 to achieve these goals.[7] But they view their program as a continuation of their medium-term efforts at fiscal consolidation and structural reform in a difficult pre-electoral period. In view of the strong external position, the authorities do not need the support of the Fund's financial resources, but they are convinced that the discipline of a Fund-supported program and the increased financial market confidence that would accompany it would help them achieve their objectives. Therefore, the proposed access is low and the authorities plan to treat the arrangement as precautionary.

7. **The program seeks a further acceleration of economic growth to some 4¼ percent.** Notwithstanding some fiscal withdrawal, the slight acceleration of growth would result from an improvement in external conditions, confidence effects, and the cumulative impact of structural reforms. The principal contribution would come from net exports and private domestic demand. Most of the impulse provided by the highway construction program will occur in the first half of 2003 (Tables 1-2).

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[6] Not too much should be made of these trends, however, as nonperforming loans are generally a lagging indicator of credit problems. A risk remains due to lending in, or indexed to, foreign exchange to unhedged borrowers.

[7] For a discussion of a more ambitious adjustment scenario, see IMF Country Report No. 02/178, pp. 13-14.

8. **Inflation is targeted to remain below 3½ percent.** In the absence of severe external shocks or large increases in administered prices, the CNB is confident that inflation will remain below 3.5 percent. A lower objective would not be achievable with exchange rate stability in the presence of significant Balassa-Samuelson effects.[8] With goods prices virtually stable and producer prices falling until mid-2002, retail price inflation is mainly attributable to higher services prices, which have been rising at an annual rate of 5-10 percent. The program assumes an average retail price inflation of 3 percent (3.3 percent as measured by the GDP deflator) to accommodate price increases in sectors with less rapid productivity increases. In line with its primary policy objective of price stability, the CNB stands ready to tighten monetary policy if the inflation objective is threatened.

9. **The CNB intends to keep the reserve cover at over 5 months of imports.** Assuming a recovery in Western Europe and a stable security situation in South-Eastern Europe, the current account deficit should remain close to 3½ percent of GDP. Structural measures to attract greenfield investment, privatization, and continued trade integration should ensure direct investment inflows that, as in recent years, exceed the projected current account deficit and allow both a decline in the external debt ratio and the reserve gain necessary to attain the programmed reserve cover ratio (Table 4).

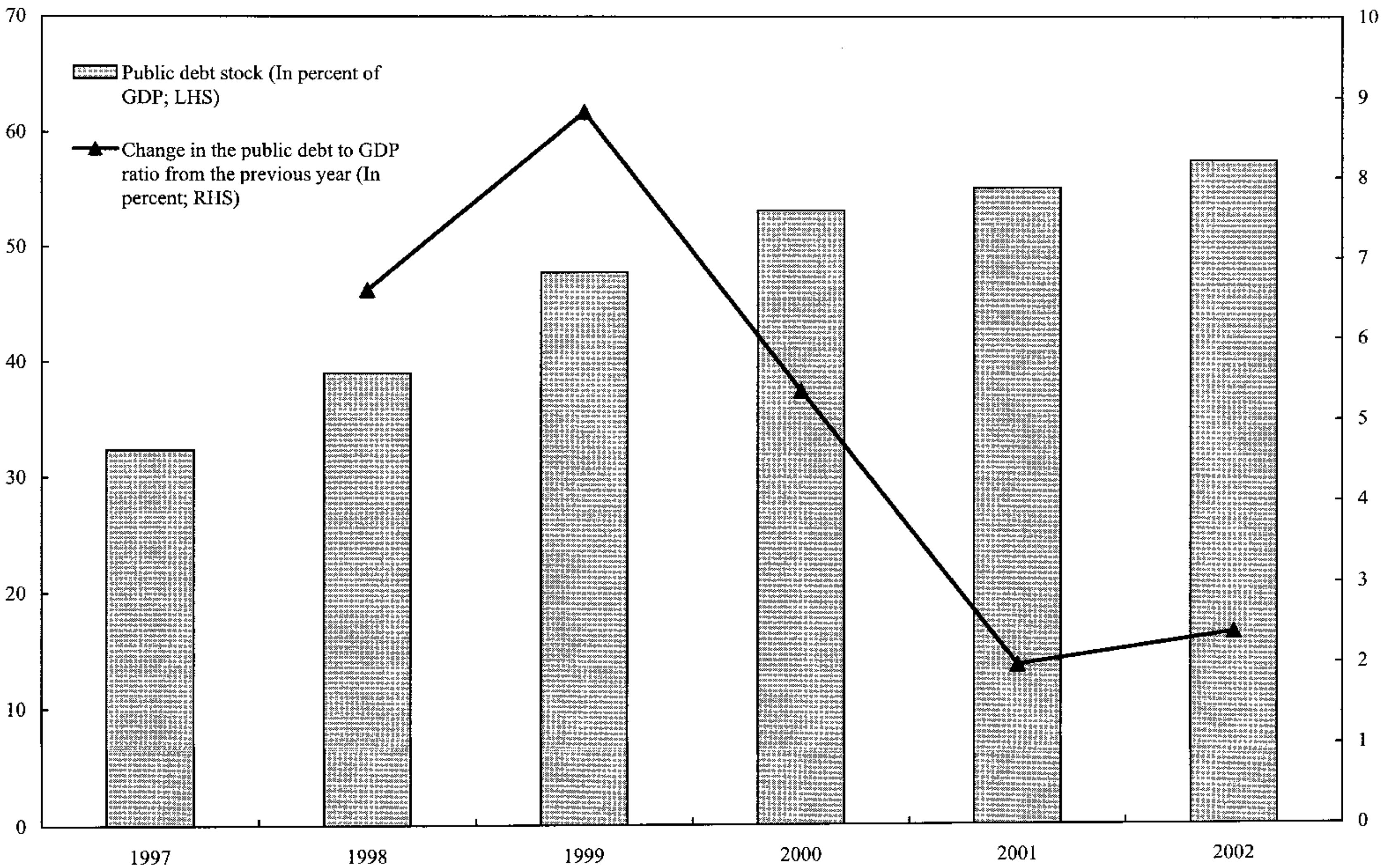
A. Fiscal Policy

10. **The principal aim of the 2003 fiscal program is to stabilize the general government debt ratio.**[9] After uninterrupted increases since independence in 1991 and a jump of 25 percentage points during 1997-2002 (Figure 5), debt ratio stabilization would represent a major achievement. To this end, the recently adopted 2003 budget envisages a further reduction of the general government deficit from an expected 6.2 percent of GDP in 2002 to 5 percent of GDP in 2003. With a conservatively estimated amount of privatization receipts and no further increase in government guarantees, a deficit of this size would stabilize the debt ratio at its estimated end-2002 level of 57½ of GDP. Given the impact on the 2003 budget of exceptional factors—notably the highway construction program, which

[8] The CNB is reluctant to accept exchange rate appreciation to achieve still lower inflation rates as this would likely be perceived as posing risks to competitiveness and might trigger political pressure on its monetary policy.

[9] The debt stock monitored under the program includes arrears and guarantees extended to entities outside the general government. In contrast to the previous stand-by arrangement, the proposed one would monitor performance under a broader general government consolidation, including additionally the highway (HAC) and road (HC) construction and maintenance agencies, the privatization fund (HFP), the bank rehabilitation and deposit insurance agency (DAB), and the 53 largest local governments. At the central government level, only the development bank (HBOR) will remain outside the consolidation, but its financial operations will be monitored separately (MEFP, Annex III). Although there are 566 local governments in Croatia, the 53 largest ones account for about 80 percent of local government expenditure.

Figure 5. Croatia: Public Debt Stock, 1997-2002



Sources: Ministry of Finance; and staff estimates.

accounts for a net deficit of 1.9 percent of GDP—and the revenue loss from introducing the second pension pillar, which is expected to reach 1.3 percent of GDP, a fiscal deficit of 5 percent of GDP is an ambitious target (text table).

Fiscal Adjustment Program
(In percent of GDP)

	1999	2000	2001	2002 Proj.	2003 Prog.
Revenue and grants	48.4	46.2	44.7	45.4	45.0
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0
Consolidated general government balance	-8.2	-6.5	-6.8	-6.2	-5.0
Adjusted for 2nd pillar introduction cost	-8.2	-6.5	-6.8	-5.1	-3.7
Consolidated general government primary balance	-6.5	-4.5	-4.6	-3.9	-2.5
General government debt stock	47.8	53.2	55.1	57.5	57.2
Privatization receipts	4.9	3.1	3.7	2.0	1.2
Memorandum items:					
Balance under old stand-by definition	-7.4	-5.7	-5.7	-4.3	-3.1
Balance excluding highway projects and cost of 2nd pension pillar	-8.2	-6.5	-6.5	-3.6	-1.8

Sources: Ministry of Finance and staff estimates.

11. **As the revenue ratio is budgeted to decline, the deficit reduction would be achieved by an even larger reduction of the expenditure ratio.**

- The revenue ratio is expected to decline from 45.4 percent of GDP in 2002 to 45 percent of GDP in 2003 (Tables 5-6). Revenue losses would come from the full-year effect of introducing the second pension pillar in 2002, an increase in the standard personal income tax deduction, an exemption from the real estate transaction tax for first-time home buyers, a small reduction of social security contributions, and ongoing import tariff reductions under international agreements. These losses would outweigh expected gains coming from the extension of the base of social security contribution collections to virtually all types of labor income, the reduction of personal income tax deductions for residents of designated special areas, the introduction of an additional car insurance tax, and the full-year effect of supplementary health insurance introduced in mid-2002 (MEFP, paragraph 8).

- The expenditure ratio is expected to decline from 51.5 percent of GDP in 2002 to 50 percent of GDP in 2003. Restraint on spending for wages (-0.6 percentage points of GDP with respect to 2002), goods and non-wage services (-0.9 percentage points of GDP), and subsidies and other current transfers (-0.4 percentage points of GDP) would more than account for the expected expenditure ratio reduction and make room for increases in capital spending and interest payments (MEFP, paragraph 9).

12. **To achieve its fiscal adjustment objectives, the program relies heavily on a tight wage policy in the government sector.** The main elements of the measures to restrain wage payments in the government sector are described in paragraph 9 of the MEFP. The budget limits the increase in the nominal wage bill of the general government to only 1 percent in 2003. Although still significantly higher than in most other central and eastern European countries, the wage bill to GDP ratio would decline from 11.1 percent in 2002 to 10.5 percent in 2003. This result is to be achieved through a general wage freeze and the implementation of the recently adopted defense sector reform legislation, which envisages a reduction of employment by 12,000 in the first nine months of 2003.[10] Increases with respect to 2002 are limited to ad hoc adjustments for primary and secondary schoolteachers (0.1 percent of GDP) and a vacation bonus (0.1 percent of GDP).[11] Nominal reductions of some other bonuses and allowances for central government workers would also help contain the total wage bill. The authorities will consult with the Fund on appropriate measures to safeguard their fiscal deficit target if the cumulative quarterly wage bill of the central government exceeds the indicative limits specified in Annex III of the MEFP.

13. **Deficit financing relies less on privatization and foreign borrowing and more on domestic financing than in the past.** Privatization is budgeted conservatively to yield only 1.2 percent of GDP (MEFP, paragraph 10), with more than two thirds expected from the oil (INA) and telecommunication (HT) companies. To buttress the debt ratio reduction objective, an asymmetric adjustor calls for offsetting expenditure cuts in the case of underperformance, and debt reduction in the case of overperformance, with respect to the privatization target. In contrast to the past and the government's original borrowing plans for 2003, net borrowing, equivalent to 3.8 percent of GDP, will rely mainly on the domestic capital market. The authorities agreed to the staff's proposal as this change would ease the appreciation pressure on the exchange rate and provide financial assets to private pension funds collecting second-pillar contributions. This borrowing is to be carefully coordinated with the CNB, whose monetary program envisages bank financing for the government of 1.3 percent of GDP. The remaining gross foreign borrowing requirement is less than half its estimated 2002 level, given the absence of bullet bond repayments in 2003. In addition, a brief delay in privatization receipts will require the contracting of a short-term bridge loan of 0.5 percent of GDP. The Ministry of Finance will arrange all foreign borrowing by the general government.

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[10] Severance payments, the cost of retraining programs, and wage costs for those re-employed as reservists have been incorporated in the 2003 budget.

[11] In addition, net wages of all government workers are estimated to increase by 2-3 percent as a result of the higher standard income tax deduction and lower employee contributions for social security.

B. Monetary and Exchange Rate Policy

14. **The monetary program for 2003 aims at maintaining inflation at less than 3½ percent on average.** Even though the new CNB law clearly identifies price stability as its main policy objective, the CNB considers that conditions are not appropriate for formal inflation targeting and intends to continue to pursue its mandate by maintaining the exchange rate of the kuna broadly stable vis-à-vis the euro.[12] In the CNB's view, balance of payments trends and competitiveness indicators suggest that the present level of the exchange rate is broadly appropriate.[13] If anything, market forces are pushing the exchange rate toward appreciation, and the CNB indicated that it will not resist prolonged appreciation pressures if its inflation objective is jeopardized or if its target for purchases of foreign exchange were to be exceeded. Responding to the staff's concern about one-way bets and unhedged foreign exchange exposure, the CNB is committed to allow some exchange rate variability under the program.

15. **Fiscal adjustment, reduced government reliance on foreign borrowing, and the new foreign exchange law will greatly facilitate the conduct of monetary policy under the program.** Large foreign currency inflows due to government external borrowing have contributed to appreciation pressure and monetary instability in the past. The government's contribution to these inflows will be substantially reduced under the program, leaving room for the issuance of government debt in the domestic financial market, some of which will be denominated in kuna. In addition, the CNB stands ready to use the room for a more active monetary policy that will result from the power to introduce temporary exchange controls on short-term capital inflows under the new foreign exchange law.

16. **The growth of monetary and credit aggregates is expected to decelerate under the program.** The twelve-month rate of broad money growth is forecast to rise slightly to 14½ percent at end-2003. This rate of increase is not out of line with monetary expansion before the recent surge associated with euro conversion (Table 7). Taking into account Croatia's relatively high per capita income, the rate of monetization is not excessive and the projected monetary growth should be absorbed without inflationary or balance of payments pressures. Should credit growth fail to slow down, the CNB will consider the introduction of higher provisioning requirements on banks with rapidly expanding loan portfolios. The CNB

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[12] The authorities' position is based on the following arguments: the retail price index is still fraught with methodological problems; there is a dearth of leading high-frequency economic indicators; the exchange rate is easier to monitor; broad exchange rate stability is important in the highly euroized and foreign exchange indexed small open economy; continuing financial sector reform makes the transmission process particularly uncertain; and the fiscal imbalances are still large. The staff broadly concurs with this position (see L. Bonato, "Practical Issues in Adopting Inflation Targeting in Croatia" in IMF Country Report No. 02/179, p.23).

[13] Again, the staff is in broad concurrence with this view. See S. Dodzin, op. cit.

does not see any room to ease reserve requirements in 2003, and it stands ready to resist further reductions of market interest rates. If base money growth turns out stronger than programmed, the CNB will consult with the Fund to determine whether the inflation outlook is consistent with the limits on net domestic assets (MEFP, paragraph 15).

C. Structural Reforms

17. **Because of their importance for sustainable high growth, structural reforms will be crucial elements of the program.** The government intends to implement major reforms in many areas in 2003.

- In the **fiscal** area, the authorities fully recognize the need to improve fiscal transparency and strengthen debt management. Although four new central spending units were created under the 2003 budget,[14] all of them have been included in the 2003 budget, together with the funds for employment and growth and for regional development. The authorities view these funds and agencies as necessary to implement their government program and international commitments (e.g., under the EU Stabilization and Association Agreement). Their transparent incorporation into the state budget should ensure the timely compilation of fiscal information. No new funds or agencies will be created during 2003 (MEFP, paragraph 17). With a view to ensuring the stabilization of the general government debt ratio and slowing the expansion of bank credit, the Ministry of Finance will issue new guarantees only to the extent that existing guarantees are amortized or expire (MEFP, paragraph 12). By end-March 2003, criteria for issuing guarantees—in particular, subjecting them to the 60 percent of GDP limit for general government debt—will be adopted (structural performance criterion; MEFP, paragraph 16). To improve the capacity of the Ministry of Finance to conduct debt management and report comprehensive and reliable statistics for the general government in a timely manner, the ministry will hire appropriately qualified staff, reorganize its operation, and request technical assistance during 2003 (MEFP, paragraph 18). The ministry, the CNB, and the Croatian Bureau of Statistics (CBS) will form a task force to reconcile statistics on general government operations.

- In the **financial** sector, the authorities are further strengthening the legislative framework. A new foreign exchange law is expected to be approved by parliament in January 2003. Seven bylaws to implement the new banking law will be issued by end-2002. New regulations on the calculation of the net open foreign exchange position of banks for prudential purposes will be issued by end-June 2003 and implemented by end-September 2003 (structural benchmarks; MEFP, paragraph 20).

[14] The environmental protection fund, the agency for small and medium-sized enterprises, the agency for investment and export promotion, and the state aid agency.

- The government is determined to accelerate **privatization and restructuring** of the oil (INA) and power (HEP) companies (MEFP, paragraph 22) and of the companies owned by the privatization fund, the deposit insurance agency, and the pension fund (MEFP, paragraph 21). These measures would enhance the medium-term growth potential of the economy. The postal bank (HPB) will acquire Croatia Banka, which could not be privatized, and then be privatized. The adoption of a privatization plan for HPB to end the government's majority ownership has been made a structural benchmark (MEFP, paragraph 23).

- **To enhance the functioning of markets and stimulate employment growth**, the government is preparing new company, competition, bankruptcy, and labor laws for parliamentary adoption by early 2003 (MEFP, paragraph 24). Judicial reform will support these same objectives (MEFP, paragraph 25).

- **Trade liberalization** will continue. An agreement to join CEFTA will take effect on March 1, 2003. A free trade agreement with Yugoslavia is expected to be signed soon. Other free trade agreements are being negotiated with Estonia, Latvia, and Moldova (MEFP, paragraph 26). Although more than 80 percent of foreign trade is now conducted under free trade agreements, Croatia's exports to the EU continue to be hampered by the non-application of the Pan European Rules of Cumulation of Origin.

D. Risks to the Program and External Financing

18. **The risks to the program relate mainly to the external environment and slippages in program implementation.**

- Tourism receipts are very sensitive to regional stability and various other factors outside the control of the authorities (weather, environmental and terrorism scares, economic conditions in countries of origin). Some of these (fear or air travel, environmental pollution or bad weather in competing tourist destinations) might actually boost tourism inflows. However, a one-percent drop in tourism receipts would increase the current account deficit by 0.2 percent of GDP. More than 50 percent of Croatia's merchandise exports are to the EU. A one-percent drop in growth in advanced partner countries in Europe would raise the current account deficit by 0.6 percent of GDP. Although it produces small amounts of hydrocarbons and exports refined oil products to neighboring countries, Croatia is a net importer of crude petroleum. A US$1 increase in the price of oil would raise the current account deficit by 0.1 percent of GDP. As growth and oil price assumptions of the winter WEO were used for the program, the likelihood that some of these risks will materialize has grown.

- The main risks to the fiscal deficit target attach to wage policy and the strict implementation of the employment reduction planned in the defense sector, which are politically difficult. However, the government is prepared to implement corrective measures, in consultation with the Fund, if the central government wage bill exceeds its cumulative quarterly limits.

- Risks of overheating and asset bubbles are small. There still is substantial unemployment (15.2 percent, based on survey data) and prices of financial assets and real estate have not increased much despite capital inflows and monetary ease.

19. **Standard sustainability analysis shows that most isolated shocks do not destabilize the general government and external debt ratios (Appendix V).** Some risks attach to the baselines, which assume a continuation of high growth and low interest rates. However, the government debt ratio resumes its decline even after a combined shock. By contrast, the external debt ratio is more vulnerable to isolated shocks (and, of course, their combination): it exhibits sustained increases in response to shocks to the Croatian U.S. dollar GDP deflator or the current account. Its vulnerability to shortfalls in privatization receipts is small: the debt ratio would be 2.4 percentage points higher in 2005 if none of the receipts projected for 2003-05 were forthcoming, and no further privatizations are projected after 2005.

20. **Croatia is likely to meet its external financing requirements in 2003 and beyond.** Partly due to the absence of bullet loan repayments, the gross financing requirement (including the programmed accumulation of international reserves) is expected to decline by almost 30 percent in 2003, before gradually increasing again during 2004-07 (Table 8). In light of the most recent vulnerability indicators, prospective market access would not seem to be a problem in meeting the reduced financing requirements of both the government and private sectors in 2003 (Table 9). The government intends to meet most of its external borrowing needs early in 2003 by issuing a eurobond of € 500 million, while borrowing the balance around midyear in the Japanese market. The short-term bridge loan mentioned in paragraph 13 above is expected to be repaid in the second quarter with proceeds from the privatization of INA. As indicated in paragraph 10 of the MEFP, the government intends to cut expenditure if privatization receipts were to fall short of the budgeted amount.

III. Design of the Proposed Stand-By Arrangement

A. Modalities of the Arrangement

21. **The arrangement is proposed to be for the 14 months ending in early April 2004, allowing purchases related to performance under a one-year program period for calendar year 2003.** Test dates are set at the end of each quarter. Under the arrangement, the requested amount of SDR 105.88 million (29 percent of quota) will be made available in five purchases. Due to the early repurchase of the entire amount of Fund credit outstanding, immediate access of more than 25 percent of quota will be necessary to allow upper credit tranche conditionality and quarterly phasing. The first purchase, equivalent to SDR 91.276 million (a little more than 25 percent of quota) will be available on approval. The other purchases, all of equal amount (1 percent of quota), will be available after each of the four quarterly test dates according to the schedule provided in Table 10. In view of the comfortable reserve level, easy access to capital markets, and the positive external outlook,

the authorities intend to treat the arrangement as precautionary and do not plan to make any purchases.

B. Program Monitoring

22. **The authorities have proposed the implementation of prior actions for staff to support the recommendation of Board approval of the stand-by arrangement** (MEFP, Annex II). As of January 14, 2003, substantial progress had been made toward the timely completion of the proposed prior actions (Table 11). All prior actions are expected to be completed prior to Board consideration of the authorities' request.

23. **The monitoring of the program will be based on the following quantitative performance criteria** (MEFP, Annexes III-VIII): (i) a quarterly limit on the cumulative change of the deficit of the consolidated central or general government, respectively;[15] (ii) a quarterly limit on the cumulative change of the stock of central government arrears;[16] (iii) a quarterly limit on the cumulative change in the contracting or guaranteeing by the public sector of non-concessional external debt with an original maturity of over one year, with a sublimit on such debt with an original maturity of more than one and less than five years; (iv) a quarterly limit on the cumulative net change of the stock of short-term external public and publicly guaranteed debt; (v) a quarterly limit on the cumulative change in the net usable international reserves of the CNB; and (vi) a quarterly limit on the cumulative change in the net domestic assets of the CNB.[17] **Continuous performance criteria cover** : (i) the non-accumulation of new external payments arrears by the Republic of Croatia; and (ii) the imposition or intensification of restrictions on the making of payments and transfers for current international transactions, the introduction or modification of multiple currency practices, the conclusion of bilateral payments agreements that are inconsistent with Article VIII, and the imposition or intensification of import restrictions for balance of payments reasons.

24. **Structural conditionality will be limited to one performance criterion and five benchmarks.**

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[15] The central government deficit will be the performance criterion for the first and third quarters and the general government deficit in the second and fourth quarters. An asymmetric adjustor regarding privatization receipts will be used to prevent an increase in the public debt ratio (MEFP, Annex III).

[16] Local government arrears will be monitored quarterly by the Ministry of Finance (MEFP, paragraph 11).

[17] To give the CNB some flexibility in meeting the targets in (v) and (vi), these limits are defined as averages of a period starting 10 business days before, and ending 10 business days after, the quarterly test dates.

- The performance criterion relates to the preparation of new guidelines for issuing government guarantees that subject such guarantees to the 60 percent of GDP limit on the general government debt ratio by end-March 2003, a measure that has become more urgent after their recent rapid increase and that is needed to ensure stabilizing the debt ratio.

With regard to structural benchmarks,

- The preparation of a privatization plan by end-March 2003 for the new bank resulting from the acquisition of Croatia Banka by HPB is crucial to avoid the repetition of quasi-fiscal operations and to signal the government's determination to get out of commercial banking.

- Although a three-year fiscal framework was prepared along with the 2003 budget and the staff is assisting the authorities to improve fiscal reporting on a general government basis, adoption of legislation by end-March 2003 that enshrines these requirements is considered important for fiscal transparency and accountability.

- Given the experience with a recent run on the third largest bank[18] and the importance of a stable banking system in the highly euroized economy, issuance and implementation of a regulation requiring the inclusion of options in the calculation of banks' net open foreign exchange position are made structural benchmarks for end-June and end-September 2003, respectively.

- Adoption of a decision on the partial privatization of INA by end-March 2003 is important for the program's debt ratio stabilization objective.

25. **Two reviews are scheduled under the arrangement,** before the second and fourth purchases. Both reviews would focus on progress in implementing structural reforms and wage and employment policy in the government sector. During the first review, the quantitative performance criteria for the second half of 2003 would also be established.

C. Capacity to Repay the Fund and Safeguards Assessment

26. **Should a need emerge to draw on the resources made available under the arrangement, the staff is confident that Croatia can meet its financial obligations to the Fund.** Under the proposed purchase schedule, Fund credit outstanding would peak at SDR 105.88 million (2.6 percent of gross usable international reserves), while debt service to the

[18] Following disclosure of foreign exchange trading losses by Riječka Banka in March 2002, the bank suffered large deposit withdrawals. Thanks to the skillful handling of the episode (prompt liquidity support and immediate reprivatization of the bank), the deposit outflow, which had spread to two other banks, stopped and began to reverse itself in May 2002. For details, see SM/02/230.

Fund would not exceed 0.5 percent of exports of goods and nonfactor services during the entire repayment period (Tables 12 and 13).

27. **A full safeguards assessment of the CNB has been completed.** The conclusions indicate that the safeguards in place at the CNB appear generally adequate, but certain weaknesses were identified in the internal audit and control areas. The safeguards assessment recommended the following principal measures: (i) strengthening of the internal audit function by enhancing the skills of the Internal Audit Department staff, (ii) extending coverage of internal audit to higher-risk areas of the CNB's operations, and (iii) establishing control procedures for the reconciliatoin of data reported to the Fund. The authorities have committed to the implementation of these and other recommendations, which will be monitored by staff in the context of program reviews.

IV. Staff Appraisal

28. **The authorities are to be commended for adopting a program in a pre-electoral period that remains faithful to their fiscal consolidation and structural reform strategy.** Much has been achieved in the first three years of the government's term in office. The general government deficit and expenditure ratios have been lowered and progress has been made in restructuring and privatizing the economy, especially in the banking sector. However, the public debt ratio has continued to climb, the labor market remains inflexible, and several large public enterprises are a drag on the economy. Against this backdrop, the authorities' program promises further substantial progress, although this will have to be followed by further adjustment and reform efforts in future years.

29. **With debt ratio stabilization as the lynchpin of the macroeconomic program, the authorities should not spare any effort to reduce the fiscal deficit to the proposed level, realize their privatization objective, and limit the extension of guarantees.** A fiscal adjustment of 1.2 percentage points of GDP despite a declining revenue ratio and an ambitious investment program represents a substantial effort. It requires, in particular, the firm implementation of the adopted wage policy and of the plans to reduce employment in the defense sector. The budget has no room for accommodating slippages in these areas without necessitating major cutbacks in investment spending. The government should strictly adhere to its privatization plans and use excess privatization receipts for debt reduction. At the same time, the planned new criteria for extending guarantees should be applied restrictively in 2003 so as to prevent any further increase in guarantees outstanding and contribute to the slowdown in credit expansion.

30. **The shift from external to domestic borrowing to finance the fiscal deficit is welcome.** The domestic market remains very liquid and interest rates are low. The government should strive to borrow in domestic currency to lower its vulnerability to exchange rate fluctuations. Doing so without the customary indexation clauses should have become easier after several years of experience with, and in light of continued favorable prospects for, low inflation and exchange rate stability. Government borrowing in the domestic market must be closely coordinated with the CNB. It will facilitate the CNB's task

by reducing currency appreciation pressure and promote the development of the domestic capital market.

31. **The CNB's monetary program aims at an orderly deceleration of monetary and credit aggregates.** After the extraordinary growth triggered by the euro conversion, monetary aggregates are already slowing down. However, bank credit is still expanding at a speed that, if sustained, is not compatible with the program's inflation and external current account targets and raises concerns about the prudential implications of such an expansion. Although aggregate financial indicators give no reason for alarm, the CNB appropriately relies on its supervisory powers to ensure that banks' lending decisions remain sound and it should not hesitate to make good on its intentions to raise provisioning requirements if credit expansion does not slow down as expected. Banks should be cautioned about risks stemming from lending in, or indexed to, foreign exchange to unhedged borrowers.

32. **The CNB's exchange rate policy remains broadly appropriate.** External current account and real effective exchange rate trends do not suggest that the level of the exchange rate has ceased to be adequate. Improvements in competitiveness should therefore be sought through structural reforms, wage restraint, and improved market access. The maintenance of a broadly stable exchange rate has served the economy well, but the CNB is right to warn economic agents against unhedged foreign exchange exposure. It should also allow greater exchange rate variability so as to discourage one-way bets.

33. **While helpful in the program context, the structural reform measures will mainly serve to improve the medium-term prospects of the economy.** Measures to produce timely, high-quality fiscal data are an urgent priority to monitor the present program and enhance fiscal transparency. A fiscal ROSC should point the way for further improvements in the medium term. The new foreign exchange law should facilitate the conduct of a more active interest rate policy, while the implementation of the bylaws to the banking law and the inclusion of options in banks' net open foreign exchange position should further improve bank efficiency and financial soundness as well as strengthen banking supervision. The government should press ahead with its privatization and restructuring plans and withdraw from commercial banking and most other productive activities. Finally, new company, competition, bankruptcy and labor laws as well as judicial reform should exert strong positive effects on growth and employment in the medium term.

34. **In the given circumstances, the authorities' program for 2003 constitutes a major step toward long-term fiscal sustainability and higher economic growth that deserves the support of the Fund.** The authorities recognize that more needs to be done in the future to boost the population's standard of living and put Croatia on a firm path of real convergence with the EU. The present program does not only prevent any backsliding in the difficult pre-electoral period, it also makes substantial progress in laying the foundations for pursuing this ambitious longer-term agenda. For this reason, the staff supports the authorities' request for a stand-by arrangement.

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

	1999	2000	2001	Projections 2002	Program 2003
			(Percentage change)		
Output and prices					
Real GDP	-0.9	2.9	3.8	4.0	4.2
CPI inflation (average)	4.1	6.2	4.9	2.4	3.0
CPI inflation (end of period)	4.4	7.4	2.6	3.5	2.1
			(In percent of GDP)		
Savings and investment					
Gross national savings	18.6	19.4	19.8	21.5	23.0
Gross domestic investment	25.7	21.8	23.6	25.1	26.6
General government operations					
Revenue and grants	48.4	46.2	44.7	45.4	45.0
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0
Overall balance	-8.2	-6.5	-6.8	-6.2	-5.0
Privatization receipts 1/	4.9	3.1	3.7	2.0	1.2
Foreign borrowing	3.3	4.2	2.0	3.8	1.5
Domestic borrowing (including arrears)	0.0	-0.8	1.1	0.4	2.2
			(End of period; change in percent)		
Money and credit					
Credit to the nongovernment sector	...	9.4	24.5	29.8	13.7
Broad money	...	28.9	45.2	11.7	14.4
Base money	...	13.6	51.9	23.1	15.6
			(End of period; in percent)		
Interest rates					
Average deposit rate	4.3	3.4	2.8	1.7 4/	...
Average credit rate	13.5	10.5	9.5	13.0 4/	...
			(In millions of U.S. dollars)		
Balance of payments					
Current account balance	-1,398	-439	-740	-800	-893
(In percent of GDP)	-7.0	-2.4	-3.8	-3.6	-3.6
Capital and financial account	2,786	1,814	2,503	3,166	1,465
Overall balance	410	611	1,344	1,109	572
			(End of period; in millions of U.S. dollars)		
Debt and reserves					
Gross official reserves	3,025	3,525	4,704	5,706	6,278
In months of following year's imports of goods and NFS	3.8	3.9	4.7	5.3	5.6
Gross usable international reserves 2/	2,249	2,629	3,653	4,547	5,038
In months of following year's imports of goods and NFS	2.8	2.9	3.7	4.3	4.5
As a percentage of short-term debt 3/	125	123	171	307	260
External debt service to exports ratio (in percent)	21.0	23.5	23.1	25.3	17.4
Public debt (in percent of GDP)	47.8	53.2	55.1	57.5	57.2
Of which: External	29.1	33.7	33.0	33.3	32.4
Total external debt (in percent of GDP)	49.6	59.7	57.5	61.7	59.0

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 proj.	2003 prog.
	(Percentage changes)			
Real GDP	2.9	3.8	4.0	4.2
Domestic demand	-0.3	4.8	5.6	3.7
Consumption	3.6	2.3	3.8	2.0
Private 1/	4.2	4.6	4.7	4.0
Government	2.0	-3.5	1.3	-3.8
Gross fixed capital formation	-3.8	9.7	12.3	9.6
Private 1/	10.0	8.1	8.0	11.1
Government	-32.9	15.0	26.2	5.3
Exports	12.0	9.5	5.8	4.7
Imports	3.7	11.0	8.7	3.7
	(Percentage contributions)			
Real GDP	2.9	3.8	4.0	4.2
Domestic demand	-0.3	5.1	6.0	4.0
Consumption	3.0	1.9	3.1	1.6
Private 1/	2.5	2.7	2.8	2.4
Government	0.5	-0.9	0.3	-0.8
Gross fixed capital formation	-0.9	2.1	2.9	2.4
Private 1/	1.6	1.4	1.4	2.0
Government	-2.5	0.7	1.4	0.4
Change in inventories 2/	-2.4	1.1	0.0	0.0
Net foreign demand	3.2	-1.3	-2.0	0.2
Exports	5.1	4.4	2.8	2.3
Imports	-1.9	-5.7	-4.8	-2.2
	(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	1.5	3.2
Gross fixed capital formation	4.8	2.1	6.0	4.7
Exports	10.9	2.5	-2.7	0.6
Imports	10.1	2.3	-4.3	1.0
Nominal GDP	152,519	162,909	174,433	187,760

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

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

Table 3. Croatia: Saving-Investment Balances, 1999-2007

	1999	2000	2001	2002 proj.	2003 prog.	2004 proj.	2005 proj.	2006 proj.	2007 proj.
				(In millions of kuna)					
External saving	9,942	3,632	6,177	6,314	6,842	6,805	8,299	8,056	7,341
Domestic saving-investment gap	-9,942	-3,632	-6,177	-6,314	-6,842	-6,805	-8,299	-8,056	-7,341
Saving	26,395	29,641	32,316	37,529	43,147	49,283	54,382	59,769	64,679
Investment	36,337	33,274	38,494	43,843	49,989	56,089	62,681	67,826	72,019
Consolidated general government (accrual basis)	-10,056	-8,645	-9,889	-9,936	-8,101	-5,692	-5,487	-5,414	-5,863
Saving 1/	607	-1,143	-1,082	1,757 5/	4,691 5/	8,068	9,795	11,515	12,447
Investment 2/	10,663	7,502	8,807	11,693	12,792	13,760	15,282	16,929	18,310
Non-government sector 3/	114	5,013	3,712	3,622	1,259	-1,113	-2,812	-2,642	-1,478
Saving	25,788	30,784	33,398	35,772 5/	38,456 5/	41,215	44,587	48,254	52,232
Investment 4/	25,674	25,772	29,687	32,150	37,197	42,329	47,399	50,897	53,709
				(In percent of GDP)					
External saving	7.0	2.4	3.8	3.6	3.6	3.4	3.8	3.4	2.9
Domestic saving-investment gap	-7.0	-2.4	-3.8	-3.6	-3.6	-3.4	-3.8	-3.4	-2.9
Saving	18.6	19.4	19.8	21.5	23.0	24.3	24.8	25.2	25.2
Investment	25.7	21.8	23.6	25.1	26.6	27.6	28.5	28.6	28.0
Consolidated general government (accrual basis)	-7.1	-5.7	-6.1	-5.7	-4.3	-2.8	-2.5	-2.3	-2.3
Saving 1/	0.4	-0.7	-0.7	1.0 5/	2.5 5/	4.0	4.5	4.8	4.8
Investment 2/	7.5	4.9	5.4	6.7	6.8	6.8	7.0	7.1	7.1
Non-government sector 3/	0.1	3.3	2.3	2.1	0.7	-0.5	-1.3	-1.1	-0.6
Saving	18.2	20.2	20.5	20.5 5/	20.5 5/	20.3	20.3	20.3	20.3
Investment 4/	18.1	16.9	18.2	18.4	19.8	20.8	21.6	21.4	20.9
Memorandum items									
GDP at current prices (millions of kuna)	141,579	152,519	162,909	174,433	187,760	203,076	219,642	237,560	256,939
Gross national disposable income at current prices (millions of kuna)	143,540	156,633	166,490	179,066	191,895	207,940	224,472	242,408	261,716
Consolidated general government	36,206	36,211	35,323	39,200	41,893	47,532	52,335	57,520	61,704
Non-government sector	107,334	120,422	131,167	139,866	150,002	160,408	172,137	184,888	200,012

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

1/ Current revenues minus current expenditures (excluding current transfers and interest payments).
2/ Excludes net lending.
3/ Includes public enterprises.
4/ Includes change in inventories.
5/ The introduction of the second pillar of the pension system is expected to reduce government saving (and correspondingly increase non-government saving) by 1 percent of GDP in 2002 and 1.3 percent of GDP in 2003.

Table 4. Croatia: Balance of Payments, 1998–2003

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

	1998	1999	2000	2001	2002	2003				2003
						q1	q2	q3	q4	Prog
Current account	-1,453	-1,398	-439	-740	-800	-964	-933	1,352	-348	-893
Merchandise trade balance	-4,071	-3,299	-3,204	-4,101	-4,757	-1,128	-1,560	-1,290	-970	-4,948
Exports f.o.b.	4,581	4,395	4,567	4,759	4,989	1,162	1,320	1,510	1,529	5,522
Ships	397	273	374	283	469	162	113	173	127	575
Non-Ship exports	4,183	4,121	4,193	4,476	4,520	1,000	1,208	1,337	1,402	4,946
Imports f.o.b.	-8,652	-7,693	-7,771	-8,860	-9,746	-2,290	-2,880	-2,800	-2,499	-10,469
Services and income	1,913	1,268	1,882	2,396	2,912	-95	347	2,352	340	2,944
Transportation	229	84	179	169	186	57	52	63	47	218
Travel	2,133	1,742	2,190	2,729	3,194	98	475	2,404	334	3,311
Other services	-286	-201	-101	25	-10	4	-9	-10	1	-14
Compensation of employees	70	60	70	125	146	35	36	39	42	152
Interest income	-234	-417	-456	-662	-603	-290	-207	-143	-83	-723
Current transfers	706	632	883	966	1,045	259	281	289	282	1,111
Capital and Financial account	1,629	2,786	1,814	2,503	3,166	884	864	-851	568	1,465
Capital account	19	25	21	133	24	6	8	8	5	26
Financial account	1,610	2,761	1,793	2,370	3,142	878	856	-859	563	1,439
Direct investment	835	1,413	1,077	1,368	1,083	95	185	109	241	629
Portfolio investment	15	573	722	716	344	407	163	-85	60	546
Medium- and long-term loans	1,018	526	438	120	568	9.06	66	-119	-56	-99
Assets	0	-14	2	-7	-1					0
Liabilities	1,018	540	435	127	569	9.1	66.2	-118.9	-55.7	-99
Disbursements	1,735	1,645	1,717	1,485	1,916	208	428	193	204	1,034
Amortization	-717	-1,104	-1,281	-1,358	-1,347	-199	-362	-312	-260	-1,133
Currency and deposits 2/	192	233	-1,053	466	1,295	186	186	-286	336	423
Short term capital flows (net) 1/	36	-4	231	-418	-120	98	-139	-3	0	-44
Trade Credits 2/	-486	19	378	119	-28	83	395	-476	-18	-16
Net errors and omissions	-16	-978	-764	-420	-1257	0	0	0	0	0
Overall balance	160	410	611	1,344	1,109	-80	-69	501	220	572
Financing	-160	-410	-611	-1,344	-1,109	80	69	-501	-220	-572
Gross reserves (-= increase)	-152	-378	-582	-1,313	-1,001	80	69	-501	-220	-572
IMF (net purchases)	-9	-31	-29	-31	-108	0	0	0	0	0
Memorandum Items										
Current account (in percent of GDP)	-6.7	-7.0	-2.4	-3.8	-3.6	-16.9	-15.2	20.5	-5.7	-3.6
Gross official reserves	2,816	3,025	3,525	4,704	5,706	5,625	5,557	6,058	6,278	6,278
in months of following year's imports of goods and NFS	3.5	3.8	3.9	4.7	5.3	5.1	5.0	5.5	5.6	5.6
Net international reserves	2,581	2,807	3,325	4,535	5,570	5,490	5,421	5,922	6,142	6,142
in months of following year's imports of goods and NFS	3.2	3.5	3.7	4.6	5.2	4.9	4.9	5.4	5.4	5.4
Gross usable international reserves 3/	2,320	2,249	2,629	3,653	4,547	4,463	4,364	4,823	5,037	5,038
in months of following year's imports of goods and NFS 3/	2.8	2.8	2.9	3.7	4.3	4.0	3.9	4.4	4.5	4.5
Net usable international reserves	2,085	2,031	2,430	3,484	4,412	4,327	4,228	4,687	4,902	4,902
in months of following year's imports of goods and NFS	2.6	2.5	2.7	3.5	4.1	3.9	3.8	4.2	4.3	4.3
Outstanding debt 4/	9,586	9,872	11,002	11,216	13,639	14,422	15,094	14,126	14,448	14,448
of which:short-term debt 1/ 4/	490	357	520	149	163	344	600	121	103	103
of which:currency and deposits of foreign residents	615	538	433	634	1,257	1,444	1,630	1,344	1,681	1,681
Next Year amortizaton	1,151	1,441	1,611	1,992	1,320					1,830
Short term debt by residual maturity	1,641	1,798	2,131	2,140	1,482					1,933
External debt to GDP ratio	44.3	49.6	59.7	57.5	61.7					59.0
Short-term debt by residual maturiry in percent of gross international usable reserve	70.7	79.9	81.0	58.6	32.6					38.4
Short-term debt and current account deficit net of FDI in percent of gross international usable reserves 3/ 4/ 5/	70.1	51.6	57.1	50.8	38.4					36.0
External debt service	-1,158	-1,703	-2,035	-2,222	-2,660	-551	-484	-560	-388	-1,983
External debt service to exports ratio	13.6	21.0	23.5	23.1	25.3	29.9	20.0	12.0	15.6	17.4
GDP (millions of U.S. dollars)	21,628	19,906	18,427	19,503	22,105	5,695	6,127	6,606	6,082	24,508
GDP (millions of Kuna)	137,604	141,579	152,519	162,909	174,433	43,463	46,684	50,279	47,335	187,760
Exchange rates										
Kuna per Euro (pa)	7.13	7.59	7.65	7.48	7.43	7.46	7.46	7.46	7.63	7.50
Kuna per US dollar (pa)	6.36	7.11	8.28	8.35	7.89	7.63	7.62	7.61	7.78	7.66
Kuna per Euro (eop)						7.46	7.46	7.54	7.63	7.63

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 5: 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 Proj.	2003 Prog.
Revenue and grants	48.4	46.2	44.7	45.4	45.0
Current revenue	48.3	46.1	44.7	45.4	45.0
Tax revenue	44.1	42.1	41.2	41.4	41.1
Personal Income tax	5.3	4.9	4.0	4.0	3.8
Social Security contributions	13.8	13.3	13.2	12.6	12.8
Profits tax	2.4	1.6	1.7	2.1	2.1
Real Estate Transactions tax	0.5	0.5	0.4	0.4	0.3
Taxes on goods and services	18.7	19.1	19.2	19.8	19.7
Value-added tax	14.0	14.0	14.0	13.8	13.8
Excises	4.4	4.8	5.0	5.6	5.4
Other	0.4	0.2	0.2	0.4	0.5
Customs duties	3.0	2.5	2.3	2.2	2.2
Other	0.3	0.3	0.4	0.3	0.3
Non-tax revenue (incl. own revenues)	4.2	4.0	3.5	4.0	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	51.5	50.0
Expenditure	55.5	51.9	50.8	51.0	49.3
Current expenditure	48.0	47.0	45.4	44.3	42.5
Expenditure on goods and services	25.1	24.5	22.3	21.5	19.8
Wages excl. employer's contributions	12.8	12.9	11.7	11.1	10.5
Other purchases of goods and services	12.3	11.6	10.6	10.3	9.4
Interest payments	1.7	2.0	2.2	2.3	2.5
Subsidies and other current transfers	21.1	20.5	20.8	20.6	20.2
Subsidies	2.9	2.9	2.7	2.8	3.0
Current transfers	18.2	17.6	18.1	17.8	17.2
Capital expenditure	7.5	4.9	5.4	6.7	6.8
Lending minus repayments	1.1	0.8	0.8	0.5	0.7
Consolidated general government balance	-8.2	-6.5	-6.8	-6.2	-5.0
Financing	8.2	6.5	6.8	6.2	5.0
Privatization revenues 2/	4.9	3.1	3.7	2.0	1.2
Foreign borrowing	3.3	4.2	2.0	3.8	1.5
Disbursements	4.2	6.9	4.9	6.8	3.6
Amortization	-0.9	-2.8	-2.8	-3.0	-2.1
Domestic borrowing	0.0	-0.8	1.1	0.4	2.2
From other non-banking sector	0.9	-3.8	0.4	0.7	0.9
Net change in arrears	0.8	-3.7	-0.9	-0.5	-0.3
From banking sector	-0.8	3.0	0.7	-0.3	1.3
Memorandum items:					
Estimated Debt Stock (as percent of GDP)	47.8	53.2	55.1	57.5	57.2
Nominal GDP	141,579	152,519	162,909	174,433	187,760

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/ In 2003, includes 0.5 percent of GDP in bridge loan.

Table 6: Croatia - Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis, 2003

(Hrk million)

	2003 Prog.	2003 Q1 Prog.	2003 Q2 Prog.	2003 Q3 Prog.	2003 Q4 Prog.
Revenue and grants	84,474	18,323	21,775	22,034	22,343
Current revenue	84,473	18,323	21,775	22,033	22,342
Tax revenue	77,215	16,798	19,823	20,322	20,273
Personal Income tax	7,056	1,576	1,765	1,781	1,934
Social Security contributions	24,093	5,585	5,994	6,154	6,360
Profits tax	3,917	503	1,678	893	844
Real Estate Transactions tax	649	110	174	173	191
Taxes on goods and services	36,929	8,016	8,972	10,112	9,829
Value-added taxes	25,848	5,628	6,263	6,829	7,128
Excises	10,226	2,204	2,462	3,079	2,481
Other	856	183	248	204	220
Customs duties	4,068	886	1,113	1,081	988
Other	502	122	125	127	127
Non-tax revenue	7,258	1,525	1,952	1,712	2,070
Capital revenue	0	0	0	0	0
Grants	1	0	0	0	0
Expenditure and net lending	93,862	22,648	24,064	23,590	23,559
Expenditure	92,575	22,486	23,739	23,187	23,163
Current expenditure	79,784	19,788	19,560	19,926	20,510
Expenditure on goods and services	37,202	8,421	9,285	9,307	10,189
Wages excl. employer's contributions	19,643	5,023	4,892	4,864	4,864
Other purchases of goods and services	17,559	3,398	4,393	4,442	5,325
Interest payments	4,642	1,919	842	925	956
Subsidies and other current transfers	37,940	9,448	9,433	9,694	9,365
Subsidies	5,628	1,463	1,463	1,351	1,351
Current transfers	32,312	7,985	7,970	8,343	8,014
Capital expenditure	12,792	2,698	4,179	3,262	2,653
Lending minus repayments	1,286	162	325	403	397
Consolidated general government balance	-9,388	-4,325	-2,290	-1,556	-1,217
(as percent of GDP)	-5.0	-2.3	-1.2	-0.8	-0.6
Financing	9,388	4,325	2,290	1,556	1,217
Privatization revenues	2,332	88	1,759	81	404
"Tax bonds" revenues	0	0	0	0	0
Foreign borrowing	2,860	4,050	-30	-727	-432
disbursements 1/	6,736	4,866	1,688	94	89
amortization 1/	-3,876	-816	-1,718	-821	-522
Domestic borrowing	4,195	188	561	2,202	1,245
From other non-banking sector	1,704	358	395	432	519
Net change in arrears	-550	-150	-150	-150	-100
From banking sector	2,492	-170	166	1,770	726
Memorandum items:					
Estimated Debt Stock (as percent of GDP)	57.2				
Nominal GDP	187,760	187,760	187,760	187,760	187,760

Sources: Ministry of Finance and staff estimates.

1/ In 2003, includes 0.5 percent of GDP in bridge loan.

Table 7. Croatia - Monetary Accounts, 2000-2003

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

	2000	2001	2002	2003				2000	2001	2002	2003
				q1	q2	q3	q4				
			proj.	prog.	prog.	prog.	prog.			proj.	prog.
Monetary Survey								(In percent change)			
Net Foreign Assets	29,017	48,661	39,174	37,707	35,563	42,606	42,289	74.2	67.7	-19.5	8.0
Net Domestic Assets	44,044	57,410	79,315	82,145	88,748	88,837	93,260	10.1	30.3	38.2	17.6
of which: domestic credit	71,323	86,257	106,822	110,235	117,422	118,666	121,931	9.2	20.9	23.8	14.1
to government, net	14,268	15,242	14,657	14,487	14,653	16,423	17,149	8.3	6.8	-3.8	17.0
to other domestic sectors	57,054	71,014	92,164	95,748	102,768	102,243	104,782	9.4	24.5	29.8	13.7
Broad Money	73,061	106,071	118,489	119,852	124,311	131,443	135,549	28.9	45.2	11.7	14.4
Narrow Money	18,030	23,704	30,634	29,822	31,704	33,513	35,426	30.1	31.5	29.2	15.6
Currency outside banks	6,637	8,507	10,267	9,662	10,145	10,724	11,395	11.4	28.2	20.7	11.0
Demand deposits	11,394	15,196	20,367	20,160	21,559	22,789	24,031	44.2	33.4	34.0	18.0
Quasi Money	55,031	82,368	87,855	90,030	92,608	97,930	100,123	28.6	49.7	6.7	14.0
denominated in kuna	8,129	10,531	13,418	13,731	13,998	14,984	15,631	39.3	29.5	27.4	16.5
denominated in foreign currency	46,902	71,837	74,437	76,299	78,610	82,946	84,492	26.9	53.2	3.6	13.5
Balance Sheet of the National Bank											
Net International Reserves	27,117	37,711	41,775	41,865	41,284	45,582	47,804	26.3	39.1	10.8	14.4
in US dollars	3,325	4,535	5,570	5,490	5,421	5,922	6,142	18.5	36.4	22.8	10.3
less: Banks' foreign currency reserves	5,491	5,705	7,159	7,338	7,560	7,977	8,126	18.4	3.9	25.5	13.5
CNB bills in foreign currency	1,813	2,913	1,527	1,527	1,527	1,527	1,527	10.9	60.7	-47.6	0.0
Net Usable International Reserves	19,813	29,093	33,089	33,000	32,197	36,077	38,151	30.4	46.8	13.7	15.3
in US dollars	2,430	3,484	4,412	4,327	4,228	4,687	4,902	19.6	43.4	26.6	11.1
Net Domestic Assets	-8,096	-11,290	-11,182	-11,674	-9,525	-12,111	-12,817	65.8	39.4	-1.0	14.6
of which: claims on government (net)	-1,157	-1,752	-800	-800	-800	-800	-800	210.2	51.4	-54.3	0.0
claims on banks	330	18	17	17	17	17	17	-71.0	-94.4	-6.4	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	-5,704	-5,800	-5,941	-6,618	-7,057	12.9	23.8	-4.9	23.7
less: CNB bills in kuna	2,395	3,459	4,782	5,179	2,889	4,798	5,065	91.2	44.4	38.3	5.9
blocked deposits 1/	315	325	23	23	23	23	23	-17.2	3.3	-92.9	0.0
Reserve Money	11,717	17,803	21,907	21,326	22,672	23,966	25,334	13.6	51.9	23.1	15.6
Currency	6,637	8,507	10,267	9,662	10,145	10,724	11,395	11.4	28.2	20.7	11.0
Deposits	5,081	9,296	11,640	11,664	12,527	13,242	13,939	16.8	83.0	25.2	19.8
<u>Memorandum items</u>:											
Nominal GDP (yearly total)	152,519	162,909	174,433	177,440	180,712	184,323	187,760				
Kuna/dollar exchange rate (eop)	8.16	8.32	7.50	7.63	7.62	7.70	7.78				
Narrow money multiplier	1.54	1.33	1.40	1.40	1.40	1.40	1.40				
Velocity of Kuna broad money	5.83	4.76	3.96	4.31	4.11	3.87	3.68				
Broad money/GDP ratio	0.48	0.65	0.68	0.68	0.69	0.71	0.72				
Foreign currency as a perc. of broad money	64.2	67.7	62.8	63.7	63.2	63.1	62.3				
NUIR in kuna at program exchange rates 2/			33,089	32,445	31,687	35,183	36,852				
NDA of the National Bank at program exchange rates 2/			-11,182	-11,118	-9,015	-11,217	-11,518				

Source: Croatian National Bank and staff projections.

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

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

Table 8. Croatia: External Financing Requirements, 2001–2007

(In millions of U.S. dollars)

		Projections					
	2001	2002	2003	2004	2005	2006	2007
Gross Financing Requirements	3,694	3,900	2,785	2,893	3,109	3,459	3,604
Current account	740	800	893	897	1,130	1,145	1,098
Medium and long term debt amortization	1,611	1,992	1,320	1,830	1,825	2,195	2,072
Public sector	399	757	441	800	915	1,048	922
Portfolio	253	554	187	554	735	800	603
Medium and long term loans	146	203	254	246	181	247	318
Banks	603	453	271	335	388	334	343
Other sectors	609	782	607	695	521	814	807
Gross reserves accumulation	1,313	1,001	572	166	154	119	433
IMF repurchases and repayments	31	108	0	0	0	0	0
Available Financing	3,694	3,900	2,785	2,893	3,109	3,459	3,604
Direct investment (net)	1,368	1,083	629	1,016	1,117	1,166	1,207
Medium and long term debt disbursements	2,460	2,936	1,766	1,853	1,948	2,239	2,348
Public sector 1/	1,142	1,697	1,008	850	850	950	950
Portfolio	975	850	712	400	400	500	500
Medium and long term loans 2/	167	847	295	450	450	450	450
Banks	730	593	271	355	398	339	348
Other sectors	588	646	487	648	700	950	1,050
Short term financing (net) 3/	-299	-148	-60	-2	18	28	23
Other flows (net) 4/	166	29	449	26	26	26	26

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

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.

Table 9. Croatia: Indicators of External and Financial Vulnerability, 1998-2002

(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002 Latest Figure	Date
External Indicators						
Real effective exchange rate (using retail prices) 1/, 1995=100	105.3	100.9	101.1	103.8	104.0	Aug-02
Export of goods and service (percentage change in US$, yoy) 2/	6.5	-5.0	6.7	11.2	15.1	Jun-02
Import of goods and service (percentage change in US$, yoy) 2/	-7.4	-7.1	-2.0	12.5	11.6	Jun-02
Current account deficit (US$ million, yoy)	-1,453	-1,398	-439	-740	-703	Jun-02
Current account deficit (yoy) in percent of GDP 3/	-6.7	-7.0	-2.4	-3.8	-3.2	Jun-02
Capital and financial account (yoy) in percent of GDP 3/	7.5	14.0	9.8	12.8	7.1	Jun-02
Gross official reserves (US$ million)	2,816	3,025	3,525	4,704	5,712	Nov-02
Gross official reserves in percent of broad money (M4)	31	41	39	37	38	Oct-02
Gross official reserves in percent of reserve money	177	224	245	221	215	Oct-02
Gross official reserves in months of imports of goods and NFS	3.2	3.7	4.4	5.2	5.8	Oct-02
Net international reserves (US$ million)	2,581	2,807	3,325	4,535	5,476	Oct-02
Net international reserves in months of import of goods and NFS	2.9	3.4	4.2	5.0	5.5	Oct-02
Short-term debt in percent of gross usable reserves 4/ 5/ 6/ 7/	70.7	79.9	81.0	56.8	35.8	Sep-02
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 8/	70.1	51.6	57.1	49.1	44.8	Sep-02
Total external debt, percent of GDP 9/	44.3	49.6	59.7	57.5	62.8	Sep-02
External debt service to export ratio	13.6	21.0	23.5	23.1	15.6	Sep-02
Financial indicators						
General government debt in percent of GDP 3/	39.0	47.8	53.2	55.1	55.1	Sep-02
domestic general government debt and guaranteed debt in percent of GDP 3/	16.7	18.7	19.5	22.1	22.7	Sep-02
foreign general government debt and guaranteed debt in percent of GDP 3/	22.3	29.1	33.7	33.0	32.4	Sep-02
Broad money (M4, percentage change, yoy)	13.0	-1.2	28.9	45.2	27.4	Oct-02
Claims on other domestic sectors (change, yoy)	22.4	-6.5	3.1	25.6	28.8	Oct-02
35-day CNB-bill yield, monthly average, percent	9.5	10.5	6.7	3.4	2.0	Oct-02
35-day CNB-bill real yield, percent /10	3.9	5.8	-0.7	0.8	-0.1	Oct-02
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	712	715	890	1,035	1,120	Nov-02
Zagreb Stock Exchange, capitalization, percent of GDP	13	13	15	16	15	Oct-02
Bond yield spreads (EMBI Global, e.o.p.)	...	407	330	187	135	Nov-02
Debt ratings: Moody's:						
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Nov-02
Government bonds, domestic currency	...	Baa1	Baa1	Baa1	Baa1	Nov-02
Foreign debt ratings (Fitch IBCA						
Fitch: Local currency LT	A-	BBB	BBB	BBB+	BBB+	Nov-02
Fitch: Foreign currency LT	BBB-	BB+	BB+	BBB-	BBB-	Nov-02
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	Nov-02
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	Nov-02

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

Table 10. Croatia: Schedule of Purchases Under the Proposed Stand-By Arrangement

Date	Amount of Purchase 1/ In millions of SDRs	In percent of quota	Conditions
February 4, 2003	91.276	25.0	Board approval of stand-by arrangement.
May 15, 2003	3.651	1.0	Observance of end-March 2003 performance criteria and completion of first review.
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 proposed access. The authorities plan to treat the arrangement as precautionary and do not intend to make any purchases.

Table 11. Croatia: Status of Prior Actions as of January 14, 2003

Policy Measures	Status	Legal Mechanism
1. Parliament to approve a central government budget and the Ministry of Finance to provide consolidated budget data for the 53 largest local governments consistent with the fiscal program.	Partly done	The central government budget was approved on December 6. Budgets for the local governments have been approved and consolidated data are expected soon.
2. Parliament to approve a package of measures producing not less than the net revenue effect indicated in paragraph 8 of the MEFP.	Done	All measures were approved in December and entered into effect on January 1.
3. Government to issue a decree that limits the issuance of new guarantees to the extent by which old guarantees are amortized or expiring and that reserves the right to issue guarantees to the Ministry of Finance.	In progress	The decree has been drafted and is expected to be approved by the government on January 23.
4. Government to submit to parliament a new budget law that satisfies the conditions specified in paragraph 16 of the MEFP.	Pending	The law has been drafted and is expected to be approved by the government and sent to parliament on January 16.
5. Government to maintain January 22, 2003 as the deadline for receiving binding offers for 25 percent plus one share in INA.	On target	The deadline has been maintained and binding offers are expected by January 22.
6. Government to submit to parliament a labor law that satisfies the conditions specified in paragraph 24 of the MEFP (to be monitored in consultation with the World Bank).	Pending	The law has been drafted and is expected to be approved by the government and sent to parliament on January 23.

Source: Croatian Authorities.

Table 12. Croatia: Projected Payments to the Fund as of November 30, 2002 Under Obligations Repurchase Schedule

(In millions of SDRs)

	2002 Nov-Dec	2003	2004	2005	2006	2007	2008	2009	2010	Beyond	Total
Obligations from existing drawings											
Principal											
GRA Repurchases	70.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	70.6
Charges and Interest 1/											
Periodic Charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR Net Charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations	70.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	70.6
(percent of quota)	19.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	19.3
Obligations from prospective drawings											
Principal											
GRA Repurchases	0.0	0.0	0.0	35.6	52.5	17.3	0.5	0.0	0.0	0.0	105.9
Charges and Interest 1/											
Periodic Charges	0.0	2.6	3.1	2.8	1.5	0.2	0.0	0.0	0.0	0.0	10.2
Total obligations	0.0	2.6	3.1	38.4	54.0	17.5	0.5	0.0	0.0	0.0	116.1
(percent of quota)	0.0	0.7	0.8	10.5	14.8	4.8	0.1	0.0	0.0	0.0	31.8
Cumulative (existing and prospective)											
Principal											
GRA Repurchases	70.6	0.0	0.0	35.6	52.5	17.3	0.5	0.0	0.0	0.0	176.5
Charges and Interest 1/											
Periodic Charges	0.0	2.6	3.1	2.8	1.5	0.2	0.0	0.0	0.0	0.0	10.2
SDR Net Charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations	70.6	2.6	3.1	38.4	54.0	17.5	0.5	0.0	0.0	0.0	186.7
(percent of quota)	19.3	0.7	0.8	10.5	14.8	4.8	0.1	0.0	0.0	0.0	51.1

Source: IMF Treasurer's Department.

1/ The GRA basic rate of charge 2.85 percent is computed by applying a factor of 1.2800 to the SDR interest rate 2.23 percent. It is then increased by 0.02 percent for burden shari and furthermore by 0.08 percent for the SCA for a total rate of 2.95 percent.

Table 13. Croatia: Indicators of Capacity to Repay the Fund, 2002–2010

(Under Obligations Schedule)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Dec				Projections 1/				
Fund repurchases and charges 2/									
In millions of SDRs	70.6	2.6	3.1	38.4	54.0	17.5	0.5	0.0	0.0
In millions of US dollars	93.5	3.4	4.1	51.1	72.0	23.3	0.7	0.0	0.0
In percent of exports of goods and NFS	0.9	0.0	0.0	0.4	0.5	0.2	0.0	0.0	0.0
In percent of debt service	3.5	0.2	0.2	1.9	2.2	0.7	0.0	0.0	0.0
In percent of quota	19.3	0.7	0.8	10.5	14.8	4.8	0.1	0.0	0.0
In percent of gross official reserves	1.6	0.1	0.1	0.9	1.5	0.6	0.0	0.0	0.0
Fund credit outstanding (e.o.p.) 2/									
In millions of SDRs	0.0	105.9	105.9	70.3	17.8	0.5	0.0	0.0	0.0
In millions of US dollars	0.0	140.2	140.6	93.6	23.7	0.7	0.0	0.0	0.0
In percent of quota	0.0	29.0	29.0	19.3	4.9	0.1	0.0	0.0	0.0
In percent of GDP	0.0	0.6	0.5	0.3	0.1	0.0	0.0	0.0	0.0
In percent of gross official reserves	0.0	2.2	2.3	1.6	0.5	0.0	0.0	0.0	0.0
Memorandum items									
Exports of goods and NFS (millions of US dollars)	10,499	11,397	12,027	12,498	13,272	14,162	15,108	16,094	17,121
Debt service (millions of US dollars) 2/	-2,662	-1,990	-2,525	-2,683	-3,333	-3,457	-3,453	-4,024	-5,174
Quota (millions of SDRs)	365	365	365	365	365	365	365	365	365
Quota (millions of US dollars)	483	483	485	486	487	487	487	487	487
Gross official reserves (millions of US dollars) 2/	5,799	6,308	6,248	5,887	4,878	3,926	3,335	2,504	1,052
GDP (millions of US dollars)	22,105	24,508	26,446	28,498	30,714	33,269	32,548	35,380	38,458
US dollars per SDR 3/	1.323	1.324	1.328	1.331	1.333	1.333	1.333	1.333	1.333

Source: Croatian National Bank; WEO; and staff estimates.

1/ As of August 31, 2002

2/ Including the hypothetical purchases under the proposed precautionary stand-by arrangement, not shown in balance of payments projections (Table 4).

3/ For the projection period: WEO assumptions of August 2002

CROATIA—FUND RELATIONS
(As of November 30, 2002)

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	435.58	119.30
Reserve position in Fund	0.16	0.04

III. SDR Department:

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	57.10	129.17

IV. Outstanding Purchases and Loans:

	SDR million	% Quota
Extended arrangements	21.59	5.91
Systemic Transformation Facility	49.05	13.43

V. Financial Arrangements:

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

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

		Forthcoming[1]				
		2002	2003	2004	2005	2006
Principal	--	--	26.60	26.60	10.25	4.80
Charges/Interest	--	--	1.64	0.94	0.33	0.15
Total	--	--	28.23	27.54	10.58	4.94

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 requested arrangement. 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 recommends corrective actions to address them.

VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with occasional participation of the Croatian National Bank. The authorities' exchange rate policy regarding the Croatian kuna is accordingly classified as "managed floating with no pre-announced path for the exchange rate". The Croatian National Bank transacts only in euros, U.S. dollars, and SDRs. On November 30, 2002, the official exchange rate was kuna 7.4828 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions except for a residual balance of foreign currency deposits frozen in 1991 that may include proceeds from current international transactions. This restriction was given temporary approval at EBM/02/84.

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 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 requested stand-by arrangement, Croatia will be 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).

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** in an amount equivalent to SDR 353.16 million (135 percent of quota) was approved on March 12, 1997, and a first purchase of SDR 28.78 million was made at that time. The first review was completed on a lapse-of-time basis on October 10, 1997, but the authorities decided not to draw on the resources then made available. Discussions on programs for the second and third arrangement years did not take place and the arrangement expired without further purchases on March 11, 2000.

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

XI. FSAP Participation:

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 will be forwarded to the authorities shortly.

XII. Technical Assistance 1992–2002:

Department	**Timing**	**Purpose**
FAD	November 1992	Tax Policy and Administration
	May 1993	VAT and Tax Administration
	November 1993	Public Expenditure Management
	March 1994	Treasury Establishment
	August 1994	Budget Preparation Mission
	November 1994	Follow up Mission on Treasury Establishment
	March 1995	Treasury Management Seminar
	August 1995	Treasury Implementation
	Nov.–Dec.1995	Treasury Implementation
	June-July 1997	Impact of VAT
	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification (with STA)

STA	December 1992	Multi-topic mission
	October 1993	Monetary Statistics
	November 1993	Government Finance Statistics
	April 1994	Money and Banking Statistics
	July 1994	National Accounts
	November 1994	Balance of Payments
	January 1995	Money and Banking Statistics (together with EU1 mission)
	February 1996	BOP mission
	September 1996	National Accounts
	January 1998	Balance of Payments
	January 1998	Data Dissemination Standard
	February 1998	Quarterly National Accounts
	September 1998	Quarterly National Accounts
	November 1998	Quarterly National Accounts
	January 1999	Quarterly National Accounts
	February 1999	Balance of Payments
	June 1999	Quarterly National Accounts
	July 1999	Producer Price Indices
	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Quarterly National Accounts
	April 2001	Monetary Statistics
	March 2002	Accounting and Budgetary Classification (with FAD)
	October 2002	Government Finance Statistics
MAE	December 1992	Bank Supervision
	October 1993	Monetary Instruments; Exchange Market
	January 1994	Monetary Operations and Banking Supervision; Exchange Market
	May 1994	Payments System, Monetary Operations, Foreign Exchange, Banking Supervision, and Accounting
	Aug. 1994–Aug. 1995	Monetary Operations (9 expert visits)
	October 1994	Monetary Operations Review
	December 1994	Payments system
	Jan.–Feb. 1995	Monetary Operations, Organization and Management, and Foreign Reserve Management
	Feb.–Dec. 1995	Payments System (4 expert visits)
	Aug. 1995–Apr. 1996	Monetary Operations (5 expert visits)
	September 1995	Foreign Exchange Management
	November 1995	Foreign Exchange, Public Debt, Monetary Policy
	September 1996	Interbank and Government Securities Markets,

		Internal Audit, Foreign Reserve Management
	October 1996	Foreign Exchange Management
	November 1996	Payments System
	March 1997	Foreign Exchange Management (expert visit)
	April 1997	Banking Law Issues (staff visit with LEG)
	April 1997–Feb. 1998	Accounting (6 expert visits)
	July 1997	Banking Sector Strategy (staff visit)
	September 1997	Banking Sector Strategy and Banking Law Issues
	Sept.–Nov. 1997	Information Technology (2 expert visits)
	Mar. 1998–Mar. 1999	Accounting (resident advisor)
	Apr. 1998–Aug. 1999	Banking Supervision (resident advisor)
	April–June 1998	Foreign Exchange Management (2 expert visits)
	May 1998	Banking Law Issues (2 staff visits)
	August 1998	Banking Soundness and Banking Law Issues
	November 1998	Banking Supervision (with WB mission)
	March–Dec. 1999	Banking Supervision (resident advisor)
	April 1999	Foreign Exchange Operations and Reserves (two expert visits)
	November 1999	Accounting
	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March-April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
INS	1993–97	Fiscal Policy Management (7 participants)
	1993–99	Monetary and Banking Statistics (6)
	1994	Basic Economics (1)
	1994	Tax Policy Administration (1)
	1994–95	Public Expenditure Policy and Management (2)
	1994–96	Government Finance Statistics (5)
	1994–96	External Sector Policies (3)
	1994–97	Comprehensive Course in Applied Market Economics (7)
	1994–98	Central Bank Accounting (5)
	1994–99	Foreign Exchange Policies and Operations (5)
	1995	Public Finance (1)
	1995	Tax Policy in Transition Economies (1)
	1995	Value Added Tax (1)
	1995–97	Financial Market Instruments (2)
	1995–97	Financial Programming Policy (2)
	1995–98	Banking Supervision (2)
	1995–98	Techniques of Financial Analysis and Programming (4)
	1995–99	Balance of Payments (3)

1995–99	Macroeconomic Analysis and Policy (9)
1995–99	Public Expenditure and Treasury Management (7)
1996	Financial Transactions for Lawyers (1)
1996–97	Tax Administration and Reform (2)
1997	Payment System (1)
1997	Banking Soundness and Monetary Policy in World of Global(1)
1997–98	Monetary Operations (2)
1998	Current Legal Issues Affecting Central Banks (1)
1998	Monetary and Exchange Operations (1)
1998	Specialized Course on Exchange Rate Policies (1)
1998	Trade and Exchange Rate Policies (1)
1999	A Decade of Transition: Achievements and Challenges (1)
1999	Management and Operational Issues for Central Bank Accountant (1)

XIII. Resident Representative:

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

Croatia: IMF-World Bank Relations

I. Partnership in Croatia's Development Strategy

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

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

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

IMF-World Bank Collaboration in Specific Areas

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

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

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

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

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

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

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

- ***Pension and health reform***

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

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

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

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

13. The Bank is supporting a comprehensive program of sector reforms through the Health Reform Project and a program of economic and sector work. A number of structural reform measures, including use of alternative care settings, different primary care models, and improved hospital management practices, are being piloted in Koprivnica with World Bank support. The SAL-supported agenda in the sector includes: reduction of duration of sick leave; revision of co-payment schedules for drugs and selected services; reduction in exemptions from co-payments; and adoption of a methodology for prioritizing health service delivery and input purchases. 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 draft Law on Obligatory Contributions Payment was submitted to Parliament in June 2002. The law will complement the aforementioned measures by: raising the minimum contribution base; unifying, simplifying and broadening the contribution bases; establishing a contribution cap; and improving enforcement responsibilities. However, in the second reading in Parliament exemptions have been extended which will lesson the originally envisaged base broadening.

- ***Enhancing labor market flexibility***

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

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

16. Strong trade union opposition has delayed agreement within the tripartite working group on the draft Labor Law. While the legislation was originally envisaged for adoption by Parliament in mid-2002, the Government has recently announced that the draft law will not be submitted to Parliament in January 2003. Polls indicate that there has been little public support for the proposed changes and employers have not taken an active role in the tripartite discussions.

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

17. Croatia's performance in terms of enterprise restructuring, privatization, new business environment, attraction of FDI, and overall creation of an enabling environment for development of an internationally competitive private sector do not compare favorably to 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 Croatian authorities acknowledged that there is a critical role to be played by accelerating reform of the key public enterprises in terms of eliminating arrears, making payments and requiring sales in cash and on time, and increasing financial transparency to help lead the way for further enterprise restructuring economy-wide.

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

19. In addition to hardening budget constraints on public enterprises, the government plans to undertake a comprehensive privatization program which includes divesting Government stakes in the banks (Croatian Postal Bank which is envisaged to be 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, HEP, and JANAF).

20. The financial sector is in the final stages of privatization and restructuring. The Bank has provided assistance to the Government through the EFSAL, TAL I, and TAL II in addition to the FSAP. More than 90 percent of the banking sector 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 Government will pursue a different method of privatization in 2003. 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 first 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.

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

23. An accounting and auditing ROSC report, prepared by the Bank in 2002, is based on an assisted self-assessment of accounting and auditing standards and practices in Croatia conducted under the management of a National Steering Committee consisting of representatives from government and the private sector. The self-assessment exercise specifically focused on the strengths and weaknesses of the institutional arrangements needed for the observance of International Accounting Standards (IAS) and International Standards of Auditing (ISA). The Accounting Act was amended in 1992. 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.

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

25. Conditions in Croatia for new business entrants, including a dynamic SME sector, are not hospitable. Like other transition countries, Croatia inherited from the previous system a preponderance of large enterprises and a business culture which emphasized

economies of scale, mass production, vertical integration and self-sufficiency (in-house production instead of subcontracting/outsourcing). SMEs offer the promise to generate competition, expand employment, increase exports and introduce new technologies. The emergence and development of SMEs has been stifled by, among other problems: difficulties and complexities in business licensing and registration (identified by the FIAS study on Administrative Barriers to Investments), other barriers for investment (ineffective land register and cadastre, long delays in granting visas and work permits), and the lack of a well-coordinated and articulated pro-SME policy in the country.

26. The Government is implementing an Action Plan that aims to improveeCroatia'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, several components of the Action Plan which require legislative changes have been adopted by Parliament, while several others are pending approval. The pending changes include: ensuring electronic access to every public notary office; shortening the approval period for construction license; abolishing location permits; shortening the visa and work permits process time; reducing administrative fees; streamlining registration procedures; and reducing registration costs.

- ***Strengthening Social Protection***

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

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

29. The Government has prepared a draft national strategy for combating poverty which has been 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 through expanding the household budget survey to cover the entire country. The recently collected national census data (carried out in April 2001) will be used to update sample design and create a reliable basis for policy-relevant data analysis.

World Bank Group Strategy and Lending Operations

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

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

32. Currently, there are eleven Bank supported projects (10 investment loans and 1 adjustment operation) totaling US$524.1 million under implementation in Croatia: the Farmer Support Services Project (US$17 million) became effective in July 1996, the Coastal Forest Reconstruction and Protection Project (US$42 million) became effective in July 1997, and the Investment Recovery Project (US$30 million) became effective in March 1998. The Reconstruction Project for Eastern Slavonia, Baranja and Western Srijem (US$40.6 million) became effective in January 1999. The Municipal Environmental Infrastructure Project (US$36.3 million) was approved in June 1998, the Railway Modernization and Restructuring Project (US$101 million) in January 1999, Technical Assistance II (US$7.3 million) in April 1999 and the Health System Project (US$29 million) in October 1999. The Trade and Transport Facilitation in Southeast Europe (US$13.9 million) became effective in May 2001. The Court and Bankruptcy Administration Project (US$5 million) became effective in January 2002, and the SAL (US$202 million) became effective in February 2002, with a first-tranche disbursement of US$102 million in the same month. A GEF financed US$5 million grant for the Karst Ecosystem Conservation Project was signed on June 19, 2002.

33. Two investment projects (the Pension System Investment Project [US$27.3 million] and the Registration and Cadastre Project [Euro26 million]) were approved by the Board in August and signed in September 2002. Both are expected to be effective by end-2002.

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

35. As of May 2002, the IFC had 7 projects in its portfolio for a total of US$114.9 million (US$82.3 million for its own account) and had approved pending commitments for three other projects for a total of US$28.7 million. The projects are: (1) a US$2.5 million equity participation in TS Bank; (2) a US$2.2 million loan to a small regional bank based in Split, for the financing of small and medium-sized enterprises; (3) a US$6.0 million equity investment and a US$15.4 million loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility; (4) a US$5.0 million equity investment in a venture capital fund; (5) a US$12.2 million loan to a regional bank for a credit line for on-lending to small and medium-sized enterprises; (6) a US$15 million loan and US$6.1 million equity investment to modernize a ship repairing facility in Rijeka; (7) a US$37.5 million loan and US$10 million equity investment in the leading pharmaceutical complex in Croatia; (8) a US$3 million equity investment in a pension management company; (9) a US$5 million loan and US$1.2 million equity investment in a Croatian leasing company; and (10) a US$16 million loan and US$3.5 million equity investment in Croatia Banka as a pre-privatization facility. The IFC is seeking to expand its activities in Croatia, focusing on financial market development, manufacturing, agribusiness, tourism, and infrastructure privatization.

Questions may be referred to the following Bank staff: Mr. Broadman (ext. 31312), Mr. Courtney (385 1 235 7215) and Ms. Madzarevic-Sujster (385 1 235 7260), Mr. 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 should promote collaboration in the statistical area to advance the reconciliation of government finance and monetary data. Croatia has subscribed to the SDDS and its metadata are posted on the DSBB (http://dsbb.imf.org).

A. National Accounts

2. National accounts (NA) data systems have undergone substantial improvement in the last few years, enabling publication of a broader, and more comprehensive, set of NA data. The Central Bureau of Statistics (CBS) compiles and publishes annual constant and current price data according to the production, income, and expenditure approaches. On June 30, 1999, the CBS began publishing quarterly GDP data by expenditure and main industry groupings at current and constant (1997) prices, thus meeting the SDDS target date. Nonetheless, shortcomings remain which limit the coverage and hinder the reliability of the estimates. These include: a lack of quarterly source data for the seasonally volatile agricultural sector; incomplete coverage of the informal sector; inadequate conversion of government finance statistics from a cash to an accrual basis; insufficient access to preliminary or unpublished source data; inadequate source data for measuring changes in inventories; inadequate price deflators; and incomplete coverage of unincorporated businesses and the self employed (farmers, trade and crafts). A particular problem is connected with the late publication of annual data, which generally present large differences with quarterly data. After the abolition of the payments agency (ZAP) in late 2001, enterprise financial statistics are collected by the finance agency (FINA). Further improvements are currently being implemented and a new project for the production of regional GDP statistics has been recently started.

B. Prices

3. The CBS produces monthly indices of retail and producer prices, and a monthly cost of living index based on the consumption basket of a typical low-income, non-farm household. Data are collected around the 20th day of each month, and the indices are released on the last working day of the month. However, price statistics are calculated using outdated weights on the basis of a small sample of observations. No import or export price deflators are produced, thereby hindering analysis of external sector developments. A new consumer price index will be released in April 2003. The main characteristics of the new index will be:

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

C. Wages and Employment

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

5. The number of registered unemployed overstates the actual level of unemployment. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample has been subsequently expanded and the survey is now being conducted on a regular basis with semi-annual results, released only after a delay of about five months. The difference between the survey-based unemployment rate and that based on registered unemployed is generally of about six percentage points.

D. Fiscal Data

6. A large amount of data on government finance statistics is produced on a monthly basis with lags of between three and twelve weeks, and is available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data on a GFS basis are reliable and available on request on a next-day basis for most major categories for both the 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 central bank.

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

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

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

E. Monetary Data

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

F. Banking Statistics

10. Banks' lending and deposit rates are published monthly in the CNB Monthly Bulletin. Banks' annual financial statements tend to understate the riskiness of their assets by misclassifying loans to certain sectors and by booking "big bonds" (government bonds issued to clear outstanding enterprise debt) and other assets at face value even though some of these assets trade at a large discount. This produces a misleading picture of the quality of bank assets, leading to underprovisioning of bad assets and overstatement of capital adequacy ratios. A change in sampling has introduced a break in the interest rate series since January 2002.

G. Balance of Payments Data

11. Balance of payments data are compiled on a quarterly basis according to the fifth edition of the IMF's Balance of Payments Manual, and published by the CNB making use of information from commercial banks, the CNB, and the Ministry of Finance, among other

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

12. The coverage of external debt data improved in 1999 with the publication of information on external debt by debtor. A large part of Croatia's external debt was contracted prior to the dissolution of the former SFRY and Croatia's share was agreed with Paris and London Club creditors in 1995 and 1998, respectively. This information has further improved in 2000 with the introduction of the new CNB database. Foreign debt statistics are available on request on the same day, but certain breakdowns (e.g., external public and publicly guaranteed debt by creditors), loans received by the resident household sector, and credits received with a maturity of less than 90 days are not covered in the standard reports. Also, there is still a problem of identifying payments arrears; however, the authorities are in the process of updating their database for earlier years in order to identify genuine arrears, if any, and record them in the balance of payments.

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

Table 14. Croatia: Core Statistical Indicators
(As of December 26, 2002)

	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	Dec 4, 2002	Nov 2002	Oct 2002	Oct, 2002	Oct 2002	Oct 2002	Oct 2002	Aug 2002	Q2 2002	Sep 2002	Q2 2002	Sep 2002
Date Received	Dec 4, 2002	Dec 1, 2002	Nov 15, 2002	Nov 15, 2002	Nov 15, 2002	Nov 15, 2002	Nov 8, 2002	Oct 15, 2002	Aug 31, 2001	Nov 15, 2002	Sep 27, 2002	Nov 30, 2002
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Source of Update	CNB	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: 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.

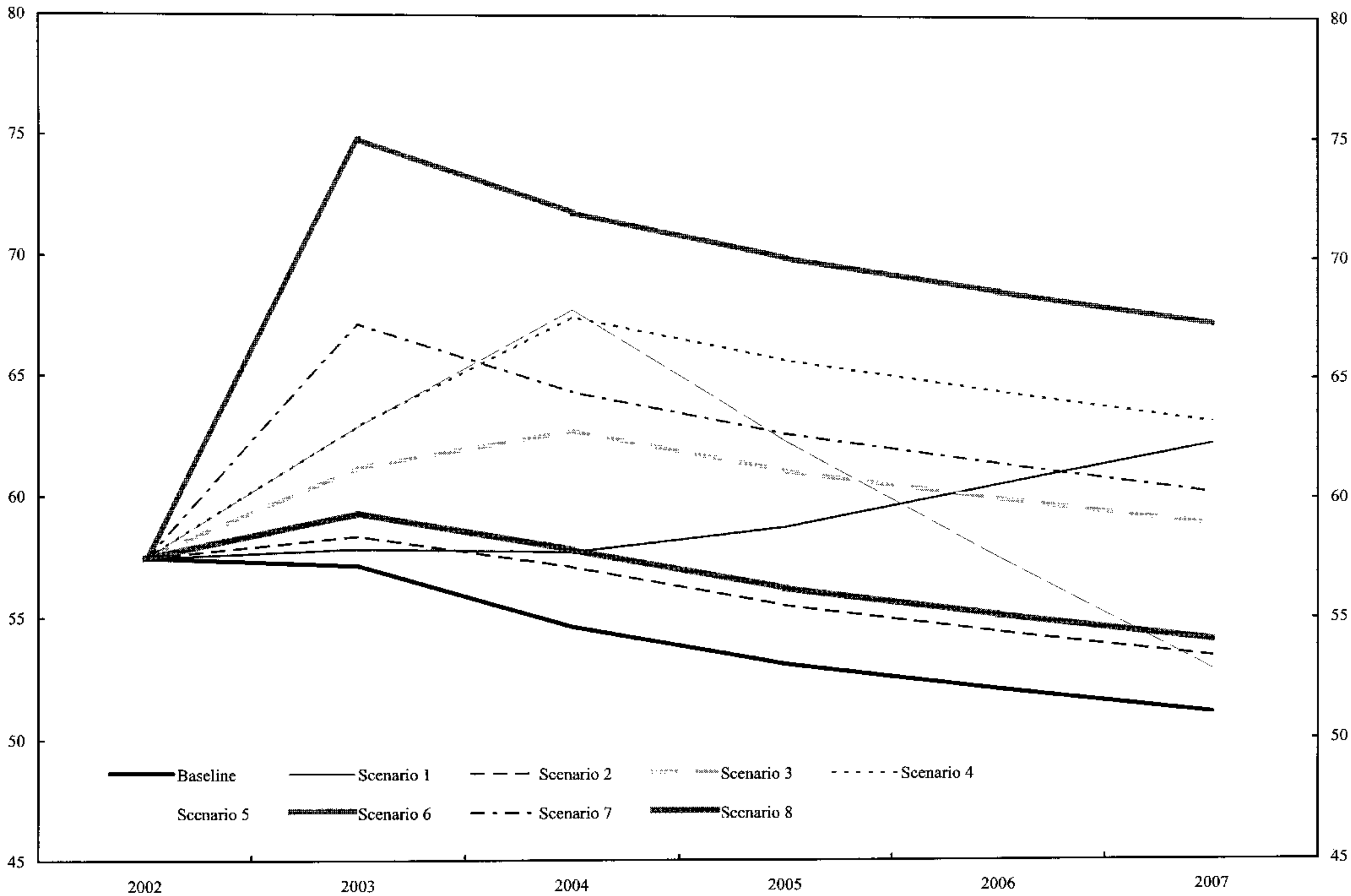
A. Fiscal Sustainability

2. The staff's baseline scenario predicts a decline in the public debt to GDP ratio of 6½ percentage points between 2002 and 2007. When the historical average values of real interest rate, real GDP growth, and primary balance are used throughout the projection period, the public debt ratio climbs to 62¼ percent by 2007, about 11 percentage points higher than in the baseline. This is mainly explained by the fact that the baseline assumes a much lower primary deficit with tight fiscal consolidation than its historical average. The isolated shocks to real interest rate, real GDP growth, and primary balance for the first two years were added to the baseline. The public debt ratio increases most seriously with the negative primary balance shock, while the real interest rate shock does not lead to a significant deterioration of the debt dynamics. In all three types of isolated shocks, the debt ratio would resume its decline once the impact of the shocks fades. The same is true for the combination of these shocks. A one-time 30 percent real depreciation in 2003 increases the debt ratio by 17¼ percentage points, due to the high foreign currency denominated share in public debt. Similarly to the cases of negative shocks to various macro variables, the debt stock starts declining once the depreciation shock disappears. The same is true for a one-time 10 percentage point of GDP increase in the public debt ratio. An isolated adverse shock to public revenue does not lead to a sizeable worsening of the debt dynamics.

B. External Sustainability

3. Under the baseline scenario, the external debt to GDP ratio falls by more than 15 percentage points from 61¾ percent in 2002 to 45⅓ percent in 2007. This decline is achieved mainly through a significant reduction of external borrowing by the general government due to a switch to more domestic borrowing and through the decline in the fiscal deficit. 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 about 86 percent by 2007, mainly due to a lower GDP growth rate and significantly higher levels of external borrowing necessary to finance the larger current account deficit. Croatia appears to withstand relatively well isolated stresses 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. The debt to GDP ratio increases to about 82—87 percent in the case of isolated shocks to the U.S. dollar GDP deflator and the current account, while it surges to more than 100 percent in the case of the combined shock. A one-time 30 percent depreciation leads to a large increase in the debt to GDP ratio in 2003 (to more than 87 percent), but the debt ratio starts declining once the impact of this shock fades away.

Figure 6. Croatia: Fiscal Debt Sustainability Analysis - Baseline and Stress Testing Scenarios, 2002-2007
(As percent of GDP) 1/



Sources: Croatian authorities; and Fund staff estimates.

1/ For a description of the scenarios, see Appendix V, Table 15.

Table 15. Croatia: Public 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	39.0	47.8	53.2	55.1	**57.5**	**57.2**	**54.6**	**53.1**	**52.0**	**51.1**
o/w foreign-currency denominated	20.0	27.3	34.7	39.5	39.6	40.5	38.6	35.1	32.7	30.6	29.0
2 Change in public sector debt	.	6.6	8.8	5.4	2.0	2.3	-0.3	-2.5	-1.6	-1.0	-1.0
3 Identified debt-creating flows (4+7+12)	0.1	-1.7	9.3	2.9	0.9	-2.3	1.8	-2.3	-0.8	-0.5	-0.5
4 Primary deficit	0.7	1.9	6.5	4.5	4.6	3.9	2.5	1.1	0.8	0.6	0.6
5 Revenue and grants	47.7	51.1	48.4	46.2	44.7	45.4	45.0	43.9	43.5	43.1	42.9
6 Primary (noninterest) expenditure	48.4	53.0	54.9	50.7	49.3	49.2	47.5	45.0	44.3	43.7	43.5
7 Automatic debt dynamics 2/	0.4	-1.5	7.8	1.5	0.0	-4.2	0.5	-1.6	-1.0	-1.1	-1.1
8 Contribution from interest rate/growth differential 3/	-3.9	-1.4	1.2	-0.9	-0.5	-0.7	-0.9	-1.2	-1.1	-1.1	-1.1
9 Of which contribution from real interest rate	-0.7	-0.6	0.9	0.4	1.4	1.4	1.3	1.2	1.2	1.1	1.1
10 Of which contribution from real GDP growth	-3.2	-0.7	0.3	-1.3	-1.9	-2.1	-2.2	-2.4	-2.3	-2.2	-2.2
11 Contribution from exchange rate depreciation 4/	4.3	-0.2	6.5	2.3	0.5	-3.5	1.4	-0.4	0.1	0.0	0.0
12 Other identified debt-creating flows	-1.0	-2.0	-4.9	-3.1	-3.7	-2.0	-1.2	-1.7	-0.6	0.0	0.0
13 Privatization receipts (negative)	-1.0	-2.0	-4.9	-3.1	-3.7	-2.0	-1.2	-1.7	-0.6	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)	...	8.3	-0.5	2.4	1.1	4.7	-2.1	-0.3	-0.8	-0.5	-0.5
Public sector debt in percent of revenues 1/	67.8	76.2	98.8	115.0	123.3	126.7	127.0	124.5	122.0	120.7	119.0
Gross financing 5/	3.6	7.4	13.2	12.3	12.6	12.2	11.3	9.7	8.9	8.7	8.7
in millions of U.S. dollars	715.0	1609.0	2626.5	2267.2	2459.7	2688.3	2763.4	2565.9	2527.8	2664.8	2893.1
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	6.8	2.5	-0.9	2.9	3.8	4.0	4.2	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 6/	6.5	6.5	6.1	5.8	5.8	5.7	5.9	5.9	5.9	6.0	6.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.9	-1.9	2.3	1.1	2.9	2.9	2.6	2.4	2.5	2.4	2.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.1	0.9	-18.3	-6.2	-1.3	10.1	-3.6	1.2	-0.4	0.0	0.0
Inflation rate (GDP deflator, in percent)	7.4	8.4	3.8	4.7	3.0	2.9	3.4	3.5	3.4	3.5	3.5
Growth of real primary spending (deflated by GDP deflator, in percent)	...	12.3	2.6	-4.9	0.9	3.8	0.5	-1.1	3.0	3.1	4.0
II. Stress Tests											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						**57.5**	**57.9**	**57.7**	**58.8**	**60.5**	**62.3**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						**57.5**	**58.4**	**57.1**	**55.5**	**54.4**	**53.4**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**57.5**	**61.2**	**62.7**	**61.1**	**59.9**	**58.9**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						**57.5**	**62.9**	**67.5**	**65.7**	**64.4**	**63.2**
5. Combination of 2-4 using one standard deviation shocks						**57.5**	**62.9**	**67.8**	**62.3**	**57.5**	**52.9**
6. One time 30 percent real depreciation in 2003 7/						**57.5**	**74.8**	**71.8**	**70.0**	**68.6**	**67.3**
7. 10 percent of GDP increase in other debt-creating flows in 2003						**57.5**	**67.2**	**64.4**	**62.6**	**61.4**	**60.2**
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						**57.5**	**59.3**	**57.8**	**56.2**	**55.1**	**54.1**
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						**126.7**	**138.6**	**135.1**	**129.2**	**127.8**	**126.0**

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/	6.1	0.3
Real interest rate (in percent)	0.7	2.0
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 16. Croatia: External 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 **External debt**	31.9	44.3	49.6	59.7	57.5	**61.7**	**59.0**	**54.7**	**51.3**	**47.8**	**45.3**
2 Change in external debt	8.7	12.4	5.3	10.1	-2.2	4.2	-2.7	-4.2	-3.4	-3.5	-2.5
3 Identified external debt-creating flows (4+8+11)	9.6	0.2	3.5	0.5	-7.3	-8.7	-5.6	-5.4	-4.5	-4.4	-4.4
4 Current account deficit, excluding interest payments	10.6	4.2	4.1	-1.4	-0.9	-0.5	-0.6	-0.7	0.2	0.2	-0.1
5 Deficit in balance of goods and services	16.7	9.2	8.4	5.1	6.0	6.3	5.8	5.8	6.2	5.9	5.4
6 Exports	39.9	39.5	40.8	47.0	49.4	47.5	46.5	45.5	43.9	43.2	42.8
7 Imports	56.6	48.7	49.2	52.1	55.4	53.8	52.4	51.2	50.1	49.1	48.2
8 Net non-debt creating capital inflows (negative)	-2.6	-4.3	-7.3	-5.8	-7.8	-5.6	-3.2	-4.5	-4.5	-4.4	-4.2
9 Net foreign direct investment, equity	2.6	4.3	7.3	5.8	7.8	5.6	3.2	4.5	4.5	4.4	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	7.8	1.4	-2.7	-1.8	-0.3	-0.2	-0.1	-0.1
12 Contribution from nominal interest rate	1.8	2.5	3.0	3.8	4.7	4.1	4.2	4.1	3.8	3.5	3.4
13 Contribution from real GDP growth	-1.5	-0.7	0.4	-1.5	-2.1	-2.1	-2.3	-2.5	-2.3	-2.1	-2.0
14 Contribution from price and exchange rate changes 2/	1.2	-1.5	3.4	5.5	-1.2	-4.7	-3.7	-1.9	-1.7	-1.6	-1.5
14 Residual, incl. change in gross foreign assets (2-3)	-0.8	12.2	1.7	9.6	5.1	12.9	2.9	1.2	1.1	0.9	1.8
External debt-to-exports ratio (in percent)	80.0	112.2	121.6	127.0	116.5	129.9	126.8	120.3	116.9	110.6	105.8
Gross external financing need (in billions of US dollars) 3/	3.3	2.4	2.8	2.1	2.6	2.9	2.3	2.9	2.9	2.9	2.6
in percent of GDP	16.6	11.1	14.0	11.5	13.3	13.1	9.5	10.9	10.3	9.5	7.8
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	6.6	2.5	-0.9	2.9	3.8	4.0	4.2	4.5	4.5	4.5	4.5
Exchange rate appreciation (US dollar value of local currency, change in perce	-11.7	-3.2	-10.5	-14.1	-0.9	5.9	3.0	-0.2	-0.4	-0.4	-0.4
GDP deflator in US dollars (change in percent)	-5.0	4.9	-7.2	-10.0	2.0	8.9	6.4	3.3	3.1	3.1	3.1
Nominal external interest rate (in percent)	8.1	8.5	6.1	7.1	8.4	8.1	7.6	7.4	7.4	7.5	7.6
Growth of exports (US dollar terms, in percent)	8.4	6.5	-5.0	6.7	11.2	9.0	8.6	5.5	3.9	6.2	6.7
Growth of imports (US dollar terms, in percent)	25.4	-7.4	-7.1	-2.0	12.5	10.1	7.9	5.6	5.3	5.7	5.7
	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 in 2						**61.7**	**67.1**	**71.3**	**75.7**	**80.2**	**86.1**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						**61.7**	**60.1**	**57.1**	**53.6**	**50.2**	**47.6**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**61.7**	**63.0**	**63.1**	**59.7**	**56.2**	**53.6**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						**61.7**	**74.6**	**86.9**	**83.4**	**79.8**	**77.2**
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						**61.7**	**72.6**	**82.1**	**78.5**	**75.0**	**72.4**
6. Combination of 2-5 using one standard deviation shocks						**61.7**	**81.6**	**102.3**	**98.8**	**95.2**	**92.5**
7. One time 30 percent nominal depreciation in 2003						**61.7**	**87.2**	**82.8**	**79.3**	**75.7**	**73.1**

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	2.1
Nominal interest rate (in percent)	7.6	1.0
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.

Zagreb, Croatia
December 27, 2002

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

Dear Mr. Köhler:

1. The Croatian authorities have prepared an economic and financial program for 2003 that aims at maintaining macroeconomic stability and strengthening the foundations for high economic growth in the runup to parliamentary elections that must be held by March 2004. To achieve these objectives, the program relies on fiscal adjustment and structural reform (including further privatization) in the context of a broadly stable exchange rate. In support of our program, we herewith request a stand-by arrangement in an amount of SDR 105.88 million (29 percent of quota) to be made available over a 14-month period ending in March 2004.

2. The implementation of our program, which is described in the attached Memorandum of Economic and Financial Policies (MEFP), will be monitored through quantitative performance criteria and indicative targets in the fiscal, monetary, and external sectors. In this regard, the MEFP proposes performance criteria for end–March and end–June 2003 and indicative targets for the second half of 2003. Program implementation will also be monitored through one structural performance criterion and five structural benchmarks, all of which are listed in Annex II of the MEFP. The quantitative performance criteria are described in greater detail in Annexes III-VIII.

3. We believe that the policies and measures set forth in the MEFP are sufficient to attain the objectives of our economic program. However, we will take any further measures that may be needed toward this end. We will consult periodically with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in implementing the economic program described in the MEFP, and in advance of any revisions to the policies covered by the MEFP. We will provide the Fund with such information as it requests on policy implementation and achievement of program objectives. In any event, there will be two reviews during the period of the requested arrangement, scheduled to take place by May 15, 2003 and November 15, 2003, in order to (i) set the quantitative performance criteria for September 30 and December 31, 2003 (at the time of the first review) and (ii) assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

4. In view of Croatia's comfortable international reserves position and easy access to international capital markets, we have recently repurchased the entire amount of Fund credit outstanding and we do not intend to make the purchases under the requested arrangement that will become available upon its approval and after observance of its performance criteria and completion of its reviews.

Sincerely yours,

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

Attachment: Memorandum of Economic and Financial Policies

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. The government and the Croatian National Bank (CNB) have cooperated in the design and adoption of a fiscal and monetary program for 2003, with supporting structural measures, to maintain macroeconomic stability and promote higher rates of economic growth. Our program aims at reducing the fiscal deficit and the government expenditure ratio and at stabilizing the public debt ratio after many years of uninterrupted increases. However, we realize that further fiscal consolidation is required beyond the current program period to attain long-term fiscal sustainability. Our program for 2003 is described in Section II below.

I. THE EXPECTED ECONOMIC OUTCOME IN 2002

2. Despite a weak external environment, economic growth is likely to have accelerated to 4 percent in 2002 (Annex I). Private consumption, a good tourist season, and strongly rising investment, partly as a result of an ambitious highway construction program, have contributed to this favorable outcome. Inflation has abated further, aided by heightened competition in the retail sector, a broadly stable exchange rate, and the absence of wage pressures. We expect retail prices to rise by 2½ percent on average in 2002. Meanwhile, revised import data indicate that the external current account deficit is likely to decline from 3.8 percent of GDP in 2001 to 3.6 percent in 2002. Notwithstanding the higher than previously reported imports, gross official international reserves are likely to have risen to more than 5 months of imports of goods and nonfactor services by end–2002 as the CNB intervened repeatedly to stem currency appreciation pressures. Despite stepped-up public investment, the general government deficit is expected to be reduced from 6.8 percent of GDP in 2001 to 6.2 percent of GDP in 2002. Both the deficit and economic growth could, however, turn out to be somewhat smaller if the fourth-quarter acceleration in the execution of highway construction were to fall short of expectations.

II. THE ECONOMIC PROGRAM FOR 2003

3. Our program for 2003 consists of the general government budget, which is part of a three-year fiscal framework covering 2003–05, a monetary program, and a number of supporting structural measures that are described in Section II D below.

A. Objectives

4. In line with our overarching objective of increasing employment and raising the standard of living of the population, our program seeks a further acceleration of economic growth. Despite the dim prospects for the world economy and in particular for our principal export markets in Germany and Italy, we are projecting real GDP to grow by 4.2 percent in 2003. With the foreign contribution about neutral, virtually all of this growth is likely to come from domestic demand. Private consumption and investment are expected to contribute almost 4½ percentage points to growth, while the government sector's contribution to aggregate demand will be negative despite continued growth in public investment, reflecting strict control of public consumption.

5. In the absence of severe external price shocks (oil prices are now fully passed through to consumers) and with a broadly stable exchange rate, we envisage average retail price inflation to remain below 3½ percent in 2003. Keen competition and lower import tariffs should keep goods prices virtually constant, while services prices are likely to continue rising at an annual rate of 5-10 percent due to lower productivity growth and occasional adjustments of administered prices. This rather sanguine view is underpinned by recent core inflation rates of around 1 percent, producer price inflation that is barely positive, and the absence of significant wage pressures.

6. Our external sector objectives are to maintain the external current account deficit at close to 3½ percent of GDP and to keep the gross official international reserve cover of imports of goods and nonfactor services at above 5 months. The improved regional security situation and better access to foreign markets facilitate the pursuit of these objectives. With a broadly stable exchange rate, their achievement relies primarily on fiscal adjustment, wage restraint, and structural reforms. Under our program, inward direct foreign investment is expected to be large enough to ensure the targeted international reserves buildup while lowering the external debt ratio.

B. Fiscal Policy

7. The principal aim of the government's fiscal program for 2003 is the stabilization of the general government debt ratio after many years of uninterrupted increases. In line with this objective, the recently adopted 2003 budgets of the central and local governments reduce the general government deficit from an expected 6.2 percent of GDP in 2002 to 5 percent of GDP in 2003. Parliamentary approval of a central government budget and provision of consolidated budget data for the 53 largest local governments that are consistent with the 2003 general government deficit target are a prior action. With a modest amount of privatization receipts (see paragraph 10 below) and no net increase in guarantees (see paragraph 12 below), a deficit of this size is expected to be sufficient to stabilize the debt ratio at its estimated end–2002 level of 57.5 percent of GDP. Although the program represents an adjustment effort of 1.4 percent of GDP (including 0.2 percentage points due to the full-year cost of the introduction of the privately administered mandatory second pillar of the pension insurance system in 2002), the government realizes that additional fiscal consolidation is required in the future to compensate for the eventual disappearance of privatization receipts and to reduce the burden of government debt, whose servicing already requires 2.5 percent of GDP in interest payments (almost as much as the budget for primary and secondary education).

8. The 2003 budget's revenue projection incorporates the following changes to the tax and social contributions system:

- A combined revenue loss of 0.5 percent of GDP is estimated to result from an increase in the standard monthly personal income tax deduction from HrK 1,250 to HrK 1,500; a reduction of social security contribution rates from 37.67 percent to 37.20 percent; and an exemption from the 5 percent real estate transaction tax for first-time home buyers.

- A combined revenue gain of 0.6 percent of GDP is estimated to result from the reduction of the personal income tax deduction for residents of special areas (islands, war affected regions) to the level of the increased standard deduction; the extension of the base for social security contributions to labor compensation from other than regular employment of all groups except students or copyright protected income; and an additional car insurance tax.

The legislation for all these changes (and a few additional ones with only minor revenue effects) has been adopted by parliament and will take effect on January 1, 2003 (prior action). Apart from import tariff reductions under international agreements, the government will not introduce any other changes to the tax and social contributions system. Reflecting in part the full-year effect of the cost of introducing the second pension pillar in 2002, the general government's revenue to GDP ratio is projected to decline by 0.4 percent of GDP despite the expected small increase in net revenue collections resulting from the above-specified measures.

9. The small decline in the revenue ratio adds to the need for expenditure restraint to achieve the deficit reduction target. As the table below shows, restraint on expenditure

Croatia: Consolidated General Government Expenditure, 2002-03

	Proj. 2002	Prog. 2003	Change	Proj. 2002	Prog. 2003	Change
	(In millions of HrK)		(In percent)	(In percent of GDP)		
Expenditure and net lending	89,848	93,862	4.5	51.5	50.0	-1.5
Expenditure	89,048	92,575	4.0	51.0	49.3	-1.7
Current expenditure	77,355	79,784	3.1	44.3	42.5	-1.8
Wages (excl. social security contrib.)	19,439	19,643	1.0	11.1	10.5	-0.6
Goods and other services	18,004	17,559	-2.5	10.3	9.4	-0.9
Interest	4,000	4,642	16.1	2.3	2.5	0.2
Subsidies and other transfers	35,912	37,940	5.6	20.6	20.2	-0.4
Capital expenditure	11,693	12,792	9.4	6.7	6.8	0.1
Lending minus repayments	800	1,286	60.8	0.5	0.7	0.2

for wages, goods and services, and subsidies and other current transfers more than accounts for the 1.5 percentage point reduction in the expenditure ratio required to reduce the fiscal deficit to 5 percent of GDP in 2003, thus creating room for higher spending of interest, capital investment and net lending. Key to the success of the fiscal program is a firm wage and employment reduction policy that guarantees adherence to the budgeted wage bill. To this effect, the government has decided to keep the basic monthly wage unchanged at HrK 4,232.43 in 2003. Wage coefficients, which are multiplied with the basic wage to determine actual wages paid, will also remain unchanged except that some 0.1 percent of GDP has been allocated to raise the coefficients of primary and secondary schoolteachers. All central government workers will be entitled to a vacation bonus budgeted at 0.1 percent of GDP, but year-end bonuses will be granted only to the extent that sufficient room is created through net employment reduction. While funds have been provided to expand employment in the judicial and education systems and the Ministry of Finance, a substantial net employment reduction is expected to be achieved as a result of the implementation of the defense sector reform. Starting with some 5,000 layoffs in the first quarter of 2003, the government intends to reduce employment in the Ministry of Defense by some 12,000 in 2003. In accordance with this plan, severance payments, the cost of retraining programs, and wage costs for those re-employed as reservists have been included in the budget. The government will monitor closely the quarterly central government wage bills and will consult with the Fund to ensure achievement of its fiscal deficit target should their budgeted amount be exceeded. While direct subsidies to the railways and the shipyards have been increased, the increased share of all subsidies in terms of GDP is more than offset by lower pension and health related transfers, whose growth is slowed by the phased introduction of the 1999 first-pillar reform and various past and new health reform measures. In addition, savings of a little more than 0.1 percent of GDP result from the replacement of special court-mandated payments under the recently expired small pension law by a lower, permanent payment stream. In line with the government's strong commitment to development, capital expenditure (particularly for highways) continues to expand, raising its ratio to GDP to 6.8 percent. Notwithstanding its overall restraint, the 2003 budget includes 0.4 percent of GDP in expenditure for education and judicial reforms, research and development, and transfers to restructure state agricultural enterprises.

10. The financing plan of the 2003 budget relies less on privatization receipts and more on domestic borrowing than in the past. Privatization receipts of the general government are conservatively budgeted at 1.2 percent of GDP (see paragraph 22 below). Any receipts in excess of budgeted amounts will be used to reduce borrowing. However, any shortfalls in receipts will be offset by an equivalent reduction of government expenditure so as to ensure achievement of the debt ratio stabilization objective. To alleviate the appreciation pressure on the exchange rate, help develop the domestic capital market, and provide financial assets to the private pension funds collecting second-pillar contributions, the government intends to rely more than in the past on domestic borrowing. Under the CNB's monetary program (see paragraph 14 below), there is room for bank credit to the general government of 1.3 percent of GDP. The nonbank sector is expected to be provided with liquidity equivalent to 0.3 percent of GDP from the virtual elimination of remaining central government arrears and it is expected to absorb government paper equivalent to 1.2 percent of GDP, mostly to satisfy the statutory investment needs of the pension funds. Given foreign debt repayment obligations of only 1.6 percent of GDP (due to the absence of bullet bond repayments in 2003), the gross foreign borrowing requirement of the government of 3.1 percent of GDP is less than half of its 2002 level[1]. Apart from project disbursements and the second tranche of the World Bank's Structural Adjustment Loan (SAL), this borrowing will be arranged by the

[1] In addition, a short-term loan to bridge a brief delay in privatization receipts will add 0.5 percent of GDP to both disbursements and amortization.

Ministry of Finance, starting with a Euro bond issue of €500 million in the first quarter of 2003, to be followed by a Samurai bond in mid–2003.

11. Observance of the government's fiscal program will be monitored by performance criteria on the central and general government deficits and the change of the stock of central government arrears (Annex III) as well as on net changes in the stock of short-term external debt and on the contracting or guaranteeing of new nonconcessional external debt with a maturity of more than one year of the general government, CNB, and HBOR (including a subceiling on such debt in the 1-5 maturity range; Annex IV). To ensure adequate room for credit to the nongovernment sector, the general government's net borrowing from domestic banks will be monitored on the basis of indicative targets (Annex V). Finally, local government arrears, which amounted to 0.2 percent of GDP at end–September 2002, will be monitored quarterly by the Ministry of Finance. As a result of a larger share in personal income tax collections, the local governments are expected to achieve a small surplus in 2003, and their own privatization receipts would be sufficient to reduce or even eliminate existing arrears.

12. As agreed under the World Bank's SAL, the government is developing criteria for issuing government guarantees. To prevent the growth of indirect government debt, which is estimated to rise to 14.7 percent of GDP by end-2002, and achieve the programmed stabilization of the government debt ratio, the Ministry of Finance will issue new loan guarantees only to the extent that room is created by the amortization or expiration of existing ones. No other government body is authorized to enter into financial commitments on behalf of the Republic of Croatia. A government decree to this effect will be issued soon (prior action).

C. Monetary and Exchange Rate Policy

13. The programmed fiscal adjustment and reduced government reliance on external borrowing will greatly facilitate the conduct of monetary policy. As conditions are not yet appropriate for inflation targeting, the CNB intends to pursue its price stability mandate under the new central bank law by continuing to maintain the exchange rate of the kuna broadly stable against the euro. This said, the CNB is prepared to allow sufficient exchange rate variability from time to time to discourage one-way currency bets and it advises economic agents not to incur unhedged foreign exchange positions.

14. The CNB's monetary program for 2003 aims at maintaining inflation at below 3½ percent, an objective that is considered compatible with both its mandate and broad exchange rate stability. Economic growth and the preservation of confidence in the pre-electoral period are expected to attract sufficient resources to the banking system to allow the unsterilized purchase of US$350 million in international reserves and credit to the government of 1.3 percent of GDP, leaving 6.7 percent of GDP of credit for the nongovernment sector. The implied slowdown of credit expansion from an estimated 29.8 percent in 2002 to a programmed 13.7 percent in 2003 should be facilitated by increased margins for self-financing out of rising profits, the payment of almost all remaining central

government arrears, and easy access to foreign borrowing by export-oriented enterprises. Should, however, credit growth fail to slow down soon, the CNB will undertake adequate measures, including the introduction of higher provisioning requirements on banks with excessive credit growth. There are no indications yet of deteriorating loan portfolios, and the CNB has made banks aware of its concerns and is using its supervision to examine the quality of loan portfolios and enforce existing provisioning standards. In terms of monetary policy, the CNB does not see room for reducing reserve requirements, and it stands ready to resist any further reduction in market interest rates during the program period. The pending adoption of a new foreign exchange law (see paragraph 19 below) is expected to provide it greater latitude to make monetary policy more effective.

15. The implementation of the CNB's monetary program will be monitored through performance criteria on the net usable international reserves and net domestic assets of the CNB (Annexes VI and VII). Should base money demand be weaker than assumed in the CNB's program, the CNB will tighten credit sufficiently to ensure that its international reserves targets are observed. If, however, base money growth turns out to be stronger than assumed, the CNB will consult with the Fund to determine if the inflation outlook justifies easing the limits on net domestic assets. To ensure that the envisaged room for credit expansion to the nongovernmental sector is not pre-empted by public enterprise borrowing, we have established indicative limits on net domestic bank borrowing by nine large state enterprises (Annex VIII).

D. Structural Reforms

Fiscal sector reforms

16. The new budget law, which will be submitted to parliament in early January 2003 (prior action), requires the submission of an updated three–year budgetary framework with each annual budget, the presentation of all budget data on a consolidated general government basis, and the regular publication of these data. It also strengthens the enforcement of penalties for overspending budget units. This law is expected to be approved by end-March 2003 (structural benchmark). The government is now preparing criteria for issuing guarantees, to be completed by end-March 2003 (structural performance criterion). These are likely to set a minimum social rate of return, to be assessed by the Ministry of Finance, for activities to be covered by the guarantee; restrict the extension of guarantees to private sector companies without government participation; and subject guarantees to the 60 percent of GDP ceiling for the general government debt ratio proposed in the new budget law.

17. Four new funds and agencies have been created under the 2003 budget (the environmental protection fund, the agency for small and medium-sized enterprises, the agency for investment and export promotion, and the state aid agency). Like the fund for regional development and the fund for employment and growth, they have been included transparently in the state budget. The government does not intend to create any new funds or agencies during 2003.

18. The Ministry of Finance needs to strengthen its debt management, macroeconomic analysis, and treasury departments and improve cooperation with the CNB in the areas of policy coordination and data reconciliation. To this effect, the ministry intends to hire suitably qualified staff and reorganize its operations as appropriate during 2003. Technical assistance will be received shortly through the EU CARDS program and, perhaps, from the Fund to enhance debt management capacity, including the monitoring of arrears. Debt management will avail itself of the capabilities of the existing SAP treasury system. Better use of that system will also be made by the treasury for budget preparation and execution and the monitoring of arrears. Technical assistance has already been received, and may be required again, from the Fund to produce high-quality, timely general government data at an appropriate frequency under both the GFS 1986 and GFS 2001 methodologies. In line with the technical assistance recommendations, quarterly and annual general government (with local governments limited to the 53 largest units) data will be compiled from accounting data collected directly from general government units. Finally, a task force comprising staff from the Ministry of Finance, the Croatian Bureau of Statistics (CBS), and the CNB will be formed to reconcile fiscal statistics of the general government. The government will request that the Fund place a resident fiscal advisor in the Ministry of Finance to assist in these reforms. To assess its practices and procedures, the government has decided to request a fiscal ROSC to be prepared by the Fund.

Financial sector reforms

19. A new foreign exchange law is expected to be approved by parliament in late January 2003. It will be consistent with EU standards and with Article VIII of the Fund's articles of agreement and empower the CNB to introduce temporary restrictions on short-term capital inflows. It will also require that foreign securities eligible for outward portfolio investment by residents must satisfy minimum ratings from international rating agencies.

20. Seven bylaws (on classification of claims, calculation of capital-asset ratios, supervision methodology, auditing decision, consolidated supervision, management of liquidity risk, and operation of subsidiaries) to implement the new banking law have been prepared by the CNB and will be issued by end-2002 for application from January 1, 2004 at the latest. Options will be included in the calculation of net open foreign exchange positions for regulatory purposes; the pertinent CNB regulation will be issued by end–June 2003 (structural benchmark) and implemented by end–September 2003 (structural benchmark).

Public enterprise reform and privatization

21. The government remains committed to divesting virtually all public enterprises and to keep a minority share in only some of them. The privatization fund (HFP) expects to reduce its pooled portfolio of some 1,100 companies to about one half by end–2003. Sales of minority shares are being conducted against privatization vouchers at the Varaždin exchange and by auction at the Zagreb exchange, while majority shares are sold by public tender. Apart from retiring privatization vouchers, these sales are not expected to result in significant cash revenues for their owners (HFP, the deposit insurance agency—DAB, and the pension fund).

22. Outside HFP's portfolio, the government continues to pursue the restructuring and privatization of most large state enterprises. Binding offers for 25 percent plus one share of the oil and gas company (INA) are expected to be received by January 22, 2003, a deadline that will not be further extended (prior action). The government will decide on the bids received by end-March 2003 (structural benchmark), and the resulting privatization proceeds are expected in the second quarter of 2003. The electricity company (HEP) will complete its unbundling into separate power generation, transmission, and distribution companies during 2003, for possible privatization of power plants in 2004. Like other distribution infrastructure, the JANAF pipeline will not be privatized. After two failed attempts, the government has given up on selling a majority share in the insurance company (CO) by public tender. Instead, it plans to sell 30 percent of the company in 2003 on the Zagreb stock exchange. Finally, 7 percent of shares in the telecommunications company (HT) will be sold to its employees in the second quarter of 2003.

23. The government has decided to make the postal bank (HPB) acquire Croatia Banka, for which no buyer has been found. The financial performance of HPB has improved considerably after a capital increase, the sale of its nonperforming portfolio to HFP, and restructuring and cost cutting measures. The bank is now well capitalized and profitable. Nonetheless, the government does not believe that it should own a commercial bank and has therefore decided to privatize it in stages, first by selling 25 percent to the IFC in 2003 and then by selling at least another 26 percent to a strategic investor in 2004. The preparation of a privatization plan satisfying these requirements by end-March 2003 is a structural benchmark under the program, which will be monitored in consultation with the IFC.

Product and labor market reforms

24. To enhance the functioning of markets and encourage the growth of employment, the government is preparing new company, competition, and labor laws. The company law is expected to be submitted to parliament by end–2002 for approval by end-March 2003. The competition and labor laws are expected to receive parliamentary approval by end–February 2003. Government approval of a draft labor law that:

- reduces severance pay to no more than one third of a month's salary per year of service with a ceiling of six monthly salaries;
- shortens the advance period for dismissals to a maximum of three months for workers with at least 20 years of service;
- relaxes the definition of mass layoffs to the dismissal of no less than 20 workers within 90 days; and
- eases the preconditions for valid dismissals, especially in small firms;

is a prior action under our program. Finally, a new bankruptcy law aimed at accelerating bankruptcy procedures and allowing payouts to creditors before the completion of all procedures is expected to be approved by end-March 2003.

25. Aided by additional funding under the 2003 budget, judicial reform will proceed, e.g., by encouraging out-of-court procedures and using single judges instead of panels of judges to settle and adjudicate commercial disputes.

26. Our CEFTA membership takes effect on March 1, 2003. A free trade agreement with the Federal Republic of Yugoslavia was initialed in November 2002 and is expected to come into effect soon. Other free trade agreements are being negotiated with Estonia, Latvia, and Moldova. While CEFTA has agreed to apply the Pan European Rules of Cumulation of Origin immediately, the government is still negotiating with the EU on the application of this agreement to Croatia's exports. Under our program, we will not impose or intensify restrictions on the making of payments and transfers for current international transactions, introduce or modify multiple currency practices, conclude bilateral payments agreements that are inconsistent with Article VIII of the Fund's articles of agreement, or impose or intensify import restrictions for balance of payments purposes, nor will we accumulate external payments arrears (to be monitored on a continuous basis).

Croatia: Key Macroeconomic Indicators

	1999	2000	Projections 2001	Program 2002	2003
			(Percentage change)		
Output and prices					
Real GDP	-0.9	2.9	3.8	4.0	4.2
CPI inflation (average)	4.1	6.2	4.9	2.4	3.0
CPI inflation (end of period)	4.4	7.4	2.6	3.5	2.1
			(In percent of GDP)		
Savings and investment					
Gross national savings	18.6	19.4	19.8	21.5	23.0
Gross domestic investment	25.7	21.8	23.6	25.1	26.6
General government operations					
Revenue and grants	48.4	46.2	44.7	45.4	45.0
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0
Overall balance	-8.2	-6.5	-6.8	-6.2	-5.0
Privatization receipts 1/	4.9	3.1	3.7	2.0	1.2
Foreign borrowing	3.3	4.2	2.0	3.8	1.5
Domestic borrowing (including arrears)	0.0	-0.8	1.1	0.4	2.2
			(End of period; change in percent)		
Money and credit					
Credit to the nongovernment sector	...	9.4	24.5	29.8	13.7
Broad money	...	28.9	45.2	11.7	14.4
Base money	...	13.6	51.9	23.1	15.6
			(In millions of U.S. dollars)		
Balance of payments					
Current account balance	-1,398	-439	-740	-800	-893
(In percent of GDP)	-7.0	-2.4	-3.8	-3.6	-3.6
Capital and financial account	2,786	1,814	2,503	3,166	1,465
Overall balance	410	611	1,344	1,109	572
			(End of period; in millions of U.S. dollars)		
Debt and reserves					
Gross official reserves	3,025	3,525	4,704	5,706	6,278
In months of following year's imports of goods and NFS	3.8	3.9	4.7	5.3	5.6
Gross usable international reserves 2/	2,249	2,629	3,653	4,547	5,038
In months of following year's imports of goods and NFS	2.8	2.9	3.7	4.3	4.5
As a percentage of short-term debt 3/	125	123	171	307	260
External debt service to exports ratio (in percent)	21.0	23.5	23.1	25.3	17.4
Public debt (in percent of GDP)	47.8	53.2	55.1	57.5	57.2
Of which: External	29.1	33.7	33.0	33.3	32.4
Total external debt (in percent of GDP)	49.6	59.7	57.5	61.7	59.0

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.

Croatia: Monitoring the Implementation of the Program

Prior actions	
1. Parliament to approve a central government budget and the Ministry of Finance to provide consolidated budget data for the 53 largest local governments consistent with the fiscal program.	MEFP, Para. 7
2. Parliament to approve a package of measures producing not less than the net revenue effect indicated in paragraph 8 of the MEFP.	MEFP, Para. 8
3. Government to issue a decree that limits the issuance of new guarantees to the extent by which old guarantees are amortized or expiring and that reserves the right to issue guarantees to the Ministry of Finance.	MEFP, Para. 12
4. Government to submit to parliament a new budget law that satisfies the conditions specified in paragraph 16 of the MEFP.	MEFP, Para.16
5. Government to maintain January 22, 2003 as the deadline for receiving binding offers for 25 percent plus one share in INA.	MEFP, Para. 22
6. Government to submit to parliament a labor law that satisfies the conditions specified in paragraph 24 of the MEFP (to be monitored in consultation with the World Bank).	MEFP, Para. 24
Quantitative performance criteria	
1. Quarterly limits on the cumulative deficits of the consolidated central and general governments.	Annex III
2. Quarterly limits on the cumulative changes of the stock of central government arrears.	Annex III
3. Quarterly limits on the cumulative amount of nonconcessional external debt contracted or guaranteed by the general government, CNB, and HBOR with an original maturity in excess of one year, with sublimits on such debt with a maturity of up to 5 years.	Annex IV
4. Quarterly limits on the net changes of the stock of short-term external debt contracted or guaranteed by the general government, CNB, and HBOR.	Annex IV
5. Quarterly floors under the cumulative changes of the net usable international reserves of the CNB.	Annex VI
6. Quarterly limits on the cumulative changes of the net domestic assets of the CNB.	Annex VII
Structural performance criterion	
1. Government to prepare criteria for issuing guarantees by end-March 2003	MEFP, Para. 16
Performance clauses 1/	
1. No new external payments arrears.	MEFP, Para. 26
2. No new, or intensification of existing, restrictions of the making of payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments reasons.	MEFP, Para. 26

1/ To be monitored on a continuous basis.

Croatia: Monitoring the Implementation of the Program

Structural benchmarks	
1. Parliament to approve by end-March 2003 a new budget law satisfying the conditions specified in the prior action set out in point 4 above.	MEFP, Para. 16
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 open foreign exchange position.	MEFP, Para. 20
3. Government to make a decision by end-March 2003 on the bids received for the privatization of INA.	MEFP, Para. 22
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).	MEFP, Para. 23

I. Limits on the Cumulative Deficits of the Consolidated Central and General Governments

	Ceilings		Privatization receipts	
	Central	General	Central	General
	(In millions of kuna)			
Cumulative changes from December 31, 2002:				
March 31, 2003	-4,053	-4,325[1/]	38	88
June 30, 2003	-6,398[1/]	-6,615	1,718	1,847
September 30, 2003 [2/]	-7,934	-8,171[1/]	1,756	1,928
December 31, 2003 [2/]	-9,440[1/]	-9,388	2,023	2,332

[1/] Indicative limits (not a performance criterion).
[2/] Provisional (performance criteria and privatization targets to be specified at the time of the first review).

The above listed ceilings on the cumulative deficit of the consolidated central government cover: (i) central government operations, that is, the central government budget (the Office of the President, the parliament, the government, the constitutional court, all ministries, other independent state administration and judicial bodies); (ii) existing central budgetary funds (health, pension, employment, water management, employment and growth, regional development, and environmental protection funds) and agencies (the agencies for state aid, for investment and export promotion, and for small and medium-sized enterprises); and (iii) the highway (HAC) and road (HC) construction and maintenance agencies, the privatization fund (HFP), and the bank rehabilitation and deposit insurance agency (DAB). In addition to (i) – (iii), the consolidated general government comprises (iv) the 53 largest local governments (20 counties, Zagreb, and 32 other cities). The government will not establish new budgetary or extrabudgetary funds or agencies during the program period, but any such funds or agencies would be covered by the ceilings. The ceilings do not include the operations of the Croatian Bank for Reconstruction and Development (HBOR). HBOR's deficit in 2003 is projected to be HRK 1,803 million and will be monitored separately under the program.

The above listed ceilings will be reduced by the amount by which the cumulative quarterly privatization receipts of the consolidated central and general governments (as defined above) fall short of the amounts indicated.

The limits on the deficits of the consolidated central and general governments will be adjusted downward to offset the net effect of any reduction in interest payments attributable to rescheduling of existing government debt.

For purposes of the program, the deficits of the consolidated central and general governments will be defined on a modified accrual basis, i.e., all expenditure should be on a "payment due" basis. The cost for recapitalizing banks and public enterprises, and payouts of insured deposits will be considered as "above the line." The following will be considered as "below the line": privatization receipts, net change of arrears, inssuance and payment of promissory notes issued by the Ministry of Finance and the Health Fund, the collection of tax arrears, bonds issued for financing the recapitalization of banks and public enterprises or payouts of insured deposits, redemption of government bonds tendered by the CNB in connection with bank resolution, and any release of foreign-held blocked foreign assets of the former SFRY to the government. Purchases and sales of general government securities in the secondary market do not finance the general government deficit and must therefore be excluded from the data reported to the Fund. For bank financing, this includes secondary market transactions with domestic nonbanks and nonresidents. For domestic nonbanks, this includes such transactions with domestic banks and nonresidents.

For purposes of program monitoring, all financing flows in foreign currency will be converted at the following average exchange rates (in HrK per unit of foreign currency):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Euro	7.46	7.46	7.46	7.63
Japanese yen (100)	6.46	6.49	6.51	6.69
U.S. dollar	7.63	7.62	7.61	7.78
Pound sterling	11.70	11.67	11.62	11.85
Swiss franc	5.09	5.07	5.05	5.14
SDR	9.86	9.87	9.87	10.11

Fiscal performance will be monitored monthly at the consolidated central government level and tested quarterly at the consolidated central or general government level. As local governments still need to adjust to more frequent than semi-annual reporting, performance will be tested at the central government level at end-March and end-September 2003 and at the general government level at end-June and end-December 2003. The pertinent data will be provided in all cases in GFS 1986 classification within 30 days from the end of the month. The monthly monitoring will be based on the narrow consolidation of the central government (i.e., excluding HAC, HC, DAB, HFP, and HBOR) and separate monthly reports from HAC, HC, DAB, and HFP. Unlike the monthly monitoring, which relies on a variety of sources, the quarterly testing is based on accounting data (classified on the basis of the new chart of accounts) with direct links to GFS 2001, except for HAC, HC, DAB, and HFP, which must be converted to GFS 1986 separately.

Cumulative quarterly performance will be assessed from above the line and below the line, whichever is larger.

II. Limits on the Cumulative Changes of the Stock of Central Government Arrears

	Ceilings
	(In millions of kuna)
Stock as of December 31, 2002	600
Cumulative changes from December 31, 2002:	
March 31, 2003	-150
June 30, 2003	-300
September 30, 2003 [1/]	-450
December 31, 2003 [1/]	-550

[1/] Provisional (performance criteria to be specified at the time of the first review).

Arrears include (i) all payments overdue according to their original or modified terms; and (ii) any promissory notes issued by the Ministry of Finance and the central budgetary funds. Arrears comprise both domestic and external payments arrears. The stock of arrears will be provided monthly to the Fund by the Ministry of Finance within 30 days.

III. Indicative Limits on the Consolidated Central Government Wage Bill

	Cumulative Limits
	(In millions of kuna)
January – March 2003	4,603
January – June 2003	9,075
January – September 2003 [1/]	13,520
January – December 2003 [1/]	17,965

[1/] Provisional (indicative limits to be specified at the time of the first review).

The cumulative wage bills exclude employers' contributions to social security. These limits do not constitute performance criteria. If wage payments exceed these limits the government will consult with the Fund on the timely adoption of measures to ensure observance of the cumulative deficit limits specified in Section I above.

Ceilings on the Net Changes of the Stock of Short-Term External Public and Publicly Guaranteed Debt and on New Contracting or Guaranteeing of Nonconcessional External Debt by the Public Sector

	Ceilings		
	(In millions of U.S. dollars)		
	Ceilings ≤1 year	Ceilings >1 year	Subceilings <5 years
Stock as of December 31, 2002	0.0	6,933	267
Cumulative changes from December 31, 2002:			
March 31, 2003	120	704	100
June 30, 2003	0.0	970	100
September 30, 2003 [1/]	0.0	1,033	100
December 31, 2003 [1/]	0.0	1,185	100

[1/] Provisional (performance criteria to be specified at the time of the first review).

For program purposes, the term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), adopted August 24, 2000), which reads as follows: "(a) For the purposes of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future points in time; these payments will discharge the principal and/or interest liabilities under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt." However, for the time being lease contracts will not be covered by the ceilings. A reporting system for lease contracts is currently being set up by the Ministry of Finance. Once completed, leases will be included in the debt contracting ceilings.

The short-term debt limits refer to the cumulative net changes in public sector debt disbursed and outstanding with an original maturity of up to and including one year. These limits do not apply to normal import-related credits and nonresident deposits in state-owned banks (HPB, HBOR).

For medium- and long-term external debt, the performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt, but also to commitments contracted or guaranteed for which value has not been received.

The ceilings on medium- and long-term external debt apply to the contracting or guaranteeing of new noncessional external debt with an original maturity of more than one year, and, within this limit, with an original maturity of more than one year and less than 5 years. Concessional loans are defined as those with a grant element of at least 35 percent, using currency-specific discount rates based on the six-month average commercial interest rates reported by the OECD (CIRRs) for loans with maturities of less than 15 years, and on the 10-year average CIRRs for loans with maturities of 15 years and more.

The ceilings on medium- and long-term public debt (but not the subceilings) will be raised by the amount by which the government retires existing debt before its scheduled maturity.

The public sector comprises the consolidated general government as defined in Annex III Section I, the CNB, and HBOR. Excluded from the limits are HPB, the public enterprises, performance guarantees on the construction of ships (for no more than the value of advance payments), and changes in indebtedness resulting from refinancing and rescheduling, including the capitalization of interest in arrears.

The above limits also do not apply to guarantees by the general government for suppliers' credits related to imports for constructing ships during the period until delivery of the ships takes place. In case of orders for multiple ships, the import related credits could take the form of revolving external credit lines. To monitor such guarantees, data on the guarantees extended for ship building, including performance guarantees or bonds, and the payments and deliveries for ships built with these guarantees will be supplied on a quarterly basis.

Debt falling within the limits shall be valued in U.S. dollars at the average exchange rates indicated in Annex III.

Information on the contracting and guaranteeing of new debt falling both inside and outside the the limits will be reported monthly to the Fund within 30 days by the CNB.

Indicative Limits on the Cumulative Changes in the Net Credit of the Banking System to the Consolidated General Government

	Indicative Limits
	(In millions of kuna)
Stock as of December 31, 2002 [1/]	14,657
Cumulative changes from December 31, 2002:	
March 31, 2003	-170
June 30, 2003	-4
September 30, 2003 [2/]	1,766
December 31, 2003 [2/]	2,492

[1/] This stock of claims consists mainly of the counterpart to frozen foreign exchange deposits and "big bonds," which are restructuring bonds issued in 1991 and 1992, and held by banks in lieu of claims on enterprises; the total stock of claims as of December 31, 2002 also includes the bonds issued to finance the payout of insured deposits in failed banks.
[2/] Provisional (indicative limits to be specified at the time of the first review).

The quarterly limits are cumulative. The consolidated general government is as defined in Annex III, Section I.

For program purposes, net credit of the banking system to the consolidated general government is defined as all claims of the banking system on the consolidated general government (excluding HBOR) less all deposits of the consolidated general government (excluding HBOR) with the banking system.

Data on banking system claims on and liabilities to the consolidated general government are taken from the balance sheets of the banks and the CNB, and will be provided monthly to the Fund by the CNB within 30 days.

Foreign currency flows derived from stocks at December 31, 2002 and the most recent quarter tested shall be valued at the average exchange rates of the quarter in question, indicated in Annex III.

Floors under the Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank

	Floors
	(In millions of U.S. dollars)
Stock as of December 31, 2002	4,412
Cumulative changes from December 31, 2002:	
March 31, 2003	-120
June 30, 2003	-184
September 30, 2003 [1/]	275
December 31, 2003 [1/]	490

[1/] Provisional (performance criteria to be specified at the time of the first review).

For purposes of the program, net usable international reserves of the Croatian National Bank (CNB) are defined as the U.S. dollar value of gross foreign assets minus reserve assets held against foreign currency deposits by domestic banks and against CNB foreign exchange bills minus gross foreign liabilities minus off-balance sheet foreign currency obligations.

For purposes of the program, gross foreign assets shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the CNB. Any return to the CNB of blocked foreign assets that are not part of CNB foreign assets as of December 31, 2002 will be added to the reserve floor. Reserves that are pledged, frozen or used as collateral shall be excluded from the gross foreign assets. In particular, any reserve assets pledged to secure government debt will be excluded from the reserves definition.

For purposes of the program, reserve liabilities shall be defined as all liabilities of the CNB to non-residents—excluding deposits into the special accounts for external debt servicing—with an original maturity of up to and including one year, as well as liabilities arising from IMF purchases and bridge loans from the BIS, irrespective of their maturity. For purposes of the program, reserve liabilities shall also include guarantees provided by the CNB backed by reserves as collateral.

The net forward position of the CNB is defined as the difference between the face value of foreign currency-denominated CNB off-balance sheet claims on nonresidents (forwards, swaps, options, and futures market contracts) and foreign currency obligations to both residents and nonresidents. This position amounted to US$0 million on December 31, 2002. For program purposes, only the off-balance sheet obligations will be deducted from the CNB's net international reserves position. These liabilities amounted to US$0 million on December 31, 2002.

Cumulative flows in U.S. dollars will be measured by applying the average exchange rates of the most recent quarter, as indicated in Annex III, to the stock of reserves of December 31, 2002 and the end of the quarter in question.

For purposes of the program, the end-of-quarter net usable international reserves of the CNB (including their end-2002 stock) are calculated as the arithmetic average of 21 observations centered on the last business day of each quarter.

The limits will be monitored from data on the accounts of the CNB supplied monthly to the Fund by the CNB within 15 days of the last business day included in the observations.

Limits on the Cumulative Changes in the Net Domestic Assets of the Croatian National Bank

	Ceilings
	(In millions of kuna)
Stock as of December 31, 2002	-11,182
Cumulative changes from December 31, 2002:	
March 31, 2003	331
June 30, 2003	2,167
September 30, 2003 [1/]	-35
December 31, 2003 [1/]	-336

[1/] Provisional (performance to be specified at the time of the first review).

The net domestic assets of the Croatian National Bank (CNB) are defined as the difference between the base money and the net usable international reserves of the CNB (as defined for program purposes in Annex VI), both expressed in local currency at program exchange rates (see Annex III). Base money is defined as currency outside banks, vault cash of banks, giro and required reserve deposit of banks in domestic currency, and deposit money held at the CNB.

The above listed ceilings shall be adjusted for changes in the required reserves in domestic currency, as follows:

$$\Delta NDA = \Delta r(B_0^D + \theta_0 B_0^F) + r_1(\Delta B^D + \theta_1 \Delta B^F + \Delta\theta B_0^F)$$

where ΔNDA = adjustment to the ceiling on net domestic assets of the CNB;

B^D, B^F = domestic and foreign currency liabilities subject to reserve requirements;

B_0^D, B_0^F = the originally programmed test-date levels of B^D and B^F;

r = reserve requirement ratio;

θ = the portion of liabilities in foreign currency subject to reserve requirements in domestic currency;

r_0, θ_0 = the originally programmed test-date levels of r and θ;

ΔB^D , ΔB^F	=	unprogrammed administrative changes to B^D, B^F affecting the definition and/or coverage of B^D, B^F compared with their originally programmed test-date levels;
$\Delta r, \Delta \theta$	=	unprogrammed changes to r and θ, so that
r_1	=	$r_0 + \Delta r$; and
θ_1	=	$\theta_0 + \Delta \theta$.

The adjustor applies only to the changes on account of administrative decisions that were not foreseen in the monetary program.

If base money demand exceeds its projections, the CNB will consult with the Fund to determine whether these limits can be exceeded without jeopardizing the authorities' inflation target. The projected stocks of base money are as follows:

	Projection
	(In millions of kuna)
Stock as of December 31, 2002	21,907
March 31, 2003	21,326
June 30, 2003	22,672
September 30, 2003 [1/]	23,966
December 31, 2003 [1/]	25,334

[1/] Provisional (projections to be specified at the time of the first review).

For purposes of the program, the net domestic assets of the CNB and the monetary base at the end of each quarter (including their end-2002 stock) will be calculated as the arithmetic average of 21 observations centered on the last business day of the quarter.

The limits will be monitored from data on the accounts of the CNB supplied monthly to the Fund by the CNB within 15 days of the last business day included in the observations.

Indicative Limits on the Cumulative Increases in the Net Credit of the Banking System to Selected Public Enterprises

	Indicative limits
	(In millions of kuna)
Stock as of December 31, 2002	1,801
Cumulative changes from December 31, 2002:	
March 31, 2003	463
June 30, 2003	278
September 30, 2003 [1/]	-550
December 31, 2003 [1/]	-415

[1/] Provisional (indicative limits to be specified at the time of the first review).

The above listed indicative aggregate limits cover the 9 enterprises listed below. Net credit is defined as the sum of all short-term and long-term bank claims in local and foreign currency on these enterprises by banks resident in Croatia plus the amount of credit guaranteed by Croatian banks from domestic nonbank and foreign sources, less the sum of these enterprises' total deposits in local and foreign currency with such banks. Credit guaranteed by the government or resulting from the calling of performance guarantees will be excluded from the ceilings to the extent that it is not already reflected in the balance sheets of the banks.

The 9 enterprises are as follows:

1. Hrvatska Elektropriveda, Zagreb (Croatian Electricity Company)
2. INA Industrija Nafte, Zagreb (Oil Company)
3. Hrvatske Željeznice, Zagreb (Croatian Railroads)
4. Hrvatske Šume, Zagreb (Croatian Forests)
5. HP, Zagreb (Croatian Post)
6. HRT, Zagreb (Radio and Television Company)
7. Jadrolinija, Rijeka (Shipping Line)
8. Croatia Osiguranje, Zagreb (Insurance Company)
9. Croatia Airlines, Zagreb

Enterprises on the above list that are privatized with more than 50 percent in the course of the arrangement will be removed from the limits and the limits will be adjusted downward by the amount of the net credit outstanding to those enterprises at the end of the month preceding privatization. Whenever changes in accounting practices or the set of enterprises reporting to the CNB result in changes in the data series, the Fund will be notified and provided one quarter of data calculated with both the old and new definitions and an offsetting adjustment will be made to the limits. The limits will be adjusted by the amount of any bank or enterprise rehabilitation that writes off or removes these assets and liabilities from the banking system or any debt-equity swaps that convert bank debt into equity in the enterprises. Information regarding such debt-equity swaps will be provided by the Ministry of Economy if and when they occur.

The above indicative limits will be cumulative and will be monitored on the basis of the average quarterly exchange rates (as listed in Annex III) from data collected monthly by the Ministry of Finance (ORESE) and supplied to the Fund within 30 days.

Statement by the IMF Staff Representative on the Republic of Croatia
February 3, 2003

This statement provides information that has become available since the issuance of the staff report on "Republic of Croatia—Request for Stand-By Arrangement." The new information does not change the thrust of the staff appraisal in that report.

1. As noted in the staff report on "Republic of Croatia—Request for Stand-By Arrangement," five prior actions remained to be completed before Board consideration of Croatia's stand-by request. On January 15, the Ministry of Finance provided consolidated budget data for the 53 largest local governments consistent with the fiscal program stipulated in the Memorandum of Economic and Financial Policies (MEFP). On January 17, the government opened three binding offers for 25 percent plus one share in the oil company (INA). On January 23, the government submitted to parliament a new budget law that satisfies the conditions specified in paragraph 16 of the MEFP and a labor law that satisfies the conditions specified in paragraph 24 of the MEFP. On January 24, the government issued a decree that limits the issuance of new guarantees to the amount by which old guarantees are amortized or expiring and reserves the right to issue guarantees to the Ministry of Finance. All prior actions have thus been completed.

2. Economic indicators suggest unexpected strength of economic activity. Real GDP grew by 6.5 percent year on year in the third quarter of 2002, bringing annual growth during the first nine months of the year to 5 percent. Investment and private consumption were particularly buoyant while external demand was weaker than expected. Retail sales volume recorded annual growth of 10.9 percent in November and industrial production grew by 8.1 percent year on year in December, raising its annual growth rate to 5.4 percent. Real GDP growth is thus likely to have exceeded the staff's projection of 4 percent in 2002.

3. The twelve-month rate of retail price inflation increased from 2.0 percent in November to 2.3 percent in December, while the core rate of inflation increased from 1 percent to 1.2 percent. On average, headline inflation fell from 4.9 percent in 2001 to 2.2 percent in 2002, while core inflation declined from 3.6 percent to 1.1 percent. On January 7, the CNB sold €75 million of foreign exchange to stem the seasonal depreciation of the kuna, which has remained stable against the euro since then.

4. The twelve-month rate of broad money growth continued to decelerate from 28 percent in September to 20 percent in November. However, the strong growth of bank credit to the private sector continued: while year-on-year growth of business lending declined from 22 percent in September to 21 percent in November, consumer credit accelerated further from 36 percent in September to 40 percent in November. Also, bank lending is increasingly being financed by foreign borrowing. In this situation, the CNB announced measures on January 15 to curb credit growth. Banks whose placements grow by more than 4 percent by end-March, 8 percent by end-June, 12 percent by end-September, and 16 percent by end-December 2003 will be obliged to buy CNB bills bearing interest of 0.5 percent for twice the amount of their excess credit expansion.

5. Croatia's EMBI stripped spread has remained at around 120–130 basis points since early December, while spreads for the EMBI global composite stayed in the range of 650–700 basis points. Although down by 16 percent from its peak on May 20, 2002, the Croatian stock market index (CROBEX) was virtually unchanged from a year ago on January 27.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 03/13
FOR IMMEDIATE RELEASE
February 3, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves 14-month, US$146 Million Stand-By Credit for Croatia

The Executive Board of the International Monetary Fund (IMF) today approved the Republic of Croatia's request for a 14-month stand-by credit for SDR 105.9 million (about US$146 million) to support the country's economic and financial program through April 2004. The authorities intend to treat the arrangement as precautionary and are not planning to draw funds under the credit.

Following the Executive Board discussion, Anne Krueger, First Deputy Managing Director and Acting Chair, said:

"The Croatian authorities are to be commended for adopting an economic program for 2003 that aims at further fiscal consolidation and structural reform, with emphasis on stabilizing the public debt ratio, increasing labor market flexibility, and stepping up progress in privatization. The program begins to lay the foundation for fiscal sustainability and sustained high economic growth rates, but will need to be followed up in future years with continued fiscal adjustment and structural reform.

"To stabilize the public debt ratio after many years of uninterrupted increases, it is important for the authorities to reduce the fiscal deficit and prevent an increase in government debt guarantees. Privatization receipts, which are conservatively projected, are also expected to contribute to stabilizing the debt ratio. The planned fiscal deficit reduction depends crucially on the implementation of the adopted wage policy and on plans to reduce employment in the defense sector. Firm implementation of these policies would help avoid cutbacks in the investment program. The new criteria for extending government debt guarantees should be applied strictly in 2003 to prevent an increase in such obligations. The authorities' privatization plans will help ensure that net borrowing does not exceed the budgeted level.

"Fiscal consolidation and the budget's increased reliance on domestic borrowing should help stem exchange rate appreciation pressure and coincides well with the investment needs of the new private pension funds and the development needs of the domestic capital market. While exchange rate stability has served the economy well, the central bank should allow greater exchange rate flexibility to reduce incentives for unhedged foreign exchange exposure and one-way bets.

"Notwithstanding the expected slowdown in monetary expansion in the wake of last year's euro conversion, credit to the private sector continues to grow rapidly. The central bank needs to continue to supervise closely the banking system to ensure that banks' lending decisions remain sound.

"The structural measures to be adopted under the program are intended to increase competitiveness, employment, and growth in the medium term. Most important in this context are the measures to improve the functioning of factor and product markets by aligning them with best practices in the European Union," Ms. Krueger said.

ANNEX

Recent Economic Developments

Following two years of steady economic growth, buoyant domestic demand continues to bolster economic activity. After 3.8 percent in 2001, real GDP accelerated to 5.0 percent in the first nine months of 2002, underpinned by strong household consumption and business and government investment. Despite an expected deceleration in consumption and investment in the last quarter, staff projects growth to have exceeded 4 percent in 2002.

Strong exports of services and private transfers have helped restrain the current account deficit, despite a disappointing merchandise trade performance due to a weak external environment and lack of structural change. The tourist season was good enough to offset a strong increase in imports. As a result, the current account deficit is likely to narrow to 3.6 percent of GDP in 2002 from 3.8 percent in 2001.

Inflationary pressures remain subdued with headline inflation on average likely having fallen to 2.2 percent in 2002 from 4.9 percent in 2001. While monetary expansion is slowing, credit to the private sector continues to expand rapidly. The currency has been broadly stable and the Croatian National Bank (CNB) has intervened mostly to stop its appreciation. Liquidity in the banking system remains high, and money market interest rates currently hover around 1.5 percent.

Further progress has been made on fiscal consolidation and, notwithstanding stepped-up highway and housing construction, the general government deficit is expected to have declined to 6.2 percent of GDP in 2002 from 6.8 percent in 2001. Despite the reduction of the deficit, however, general government debt is projected to have risen to 57.5 percent of GDP at end-2002 from 55 percent at end-2001, mainly due to the extension of government guarantees.

Program Summary

The aim of the new program is to make progress toward long-term fiscal sustainability and strengthen the prospects for sustained high rates of growth. The authorities view their program as a continuation of their medium-term efforts at fiscal consolidation and structural reform in a difficult pre-electoral period. In view of the strong external position, the authorities do not need the support of the IMF's financial resources, but are convinced that the discipline of an IMF-supported program and the increased financial market confidence that would accompany it would help them achieve their objectives.

Notwithstanding some fiscal withdrawal, the program seeks economic growth of some 4.5 percent resulting from an improvement in external conditions, confidence effects, and the cumulative impact of structural reforms. The principal contribution would come from net exports and private domestic demand. Most of the impulse provided by the major highway construction program will occur in the first half of 2003.

Inflation is targeted to remain below 3.5 percent. In line with its primary policy objective of price stability, the CNB stands ready to tighten monetary policy if the inflation objective is threatened. It intends to keep the reserve cover at over 5 months of imports. The conduct of monetary policy under the program will be greatly facilitated by fiscal adjustment, reduced government reliance on foreign borrowing, and the new foreign exchange law.

The principal aim of the 2003 fiscal program is to stabilize the general government debt ratio. To this end, the 2003 budget envisages a further reduction of the general government deficit to 5 percent of GDP in 2003 from an expected 6.2 percent of GDP in 2002. With a conservatively estimated amount of privatization receipts and no further increase in government guarantees, a deficit of this size would stabilize the debt ratio at its estimated end-2002 level of 57.5 percent of GDP. Given the impact on the 2003 budget of exceptional factors—notably the highway construction program, which accounts for a net deficit of 1.9 percent of GDP—and the revenue loss from introducing the second pension pillar, which is expected to reach 1.3 percent of GDP, a fiscal deficit of 5 percent of GDP is an ambitious target. As the revenue ratio is budgeted to decline, the deficit reduction would be achieved by an even larger reduction of the expenditure ratio.

To achieve its fiscal adjustment objectives, the program relies heavily on a tight wage policy in the government sector. This is to be achieved through a general wage freeze and the implementation of the recently adopted defense sector reform legislation, which envisages a reduction of employment by 12,000 in the first nine months of 2003. Nominal reductions of some other bonuses and allowances for central government workers would also help contain the total wage bill. Under the program, deficit financing relies less on privatization and foreign borrowing and more on domestic financing than in the past. In contrast to the past and the government's original borrowing plans for 2003, net borrowing, equivalent to 3.8 percent of GDP, will rely mainly on the domestic capital market. This borrowing is to be carefully coordinated with the CNB, whose monetary program envisages bank financing for the government of 1.3 percent of GDP.

Structural reforms will be a crucial element of the program because of their importance for sustainable high growth. In the fiscal area, the authorities fully recognize the need to improve fiscal transparency and strengthen debt management. In the financial sector, they are further strengthening the legislative framework with a new foreign exchange law, bylaws to implement a new banking law, and a new regulation to calculate the net open foreign exchange position of banks for prudential purposes. Further, the government is determined to accelerate privatization and restructuring of the oil (INA) and power (HEP) companies and of the companies owned by the privatization fund, the deposit insurance agency, and the pension fund. It submitted to parliament a labor law aimed at making the labor market more flexible. Finally, it is preparing new company, competition, and bankruptcy laws, and will begin implementing judicial reform.

The Republic of Croatia joined the IMF on December 14, 1992, and its quota[1] is SDR 365.1 million (about US$503 million). Croatia has no outstanding use of IMF financing.

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.

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

	1999	2000	2001	Projections 2002	Program 2003
			(Percentage change)		
Output and prices					
Real GDP	-0.9	2.9	3.8	4.0	4.2
CPI inflation (average)	4.1	6.2	4.9	2.4	3.0
CPI inflation (end of period)	4.4	7.4	2.6	3.5	2.1
			(In percent of GDP)		
Savings and investment					
Gross national savings	18.6	19.4	19.8	21.5	23.0
Gross domestic investment	25.7	21.8	23.6	25.1	26.6
General government operations					
Revenue and grants	48.4	46.2	44.7	45.4	45.0
Expenditure and net lending	56.6	52.7	51.5	51.5	50.0
Overall balance	-8.2	-6.5	-6.8	-6.2	-5.0
Privatization receipts 1/	4.9	3.1	3.7	2.0	1.2
Foreign borrowing	3.3	4.2	2.0	3.8	1.5
Domestic borrowing (including arrears)	0.0	-0.8	1.1	0.4	2.2
			(End of period; change in percent)		
Money and credit					
Credit to the nongovernment sector	...	9.4	24.5	29.8	13.7
Broad money	...	28.9	45.2	11.7	14.4
Base money	...	13.6	51.9	23.1	15.6
			(End of period; in percent)		
Interest rates					
Average deposit rate	4.3	3.4	2.8	1.7 4/	...
Average credit rate	13.5	10.5	9.5	13.0 4/	...
			(In millions of U.S. dollars)		
Balance of payments					
Current account balance	-1,398	-439	-740	-800	-893
(In percent of GDP)	-7.0	-2.4	-3.8	-3.6	-3.6
Capital and financial account	2,786	1,814	2,503	3,166	1,465
Overall balance	410	611	1,344	1,109	572
			(End of period; in millions of U.S. dollars)		
Debt and reserves					
Gross official reserves	3,025	3,525	4,704	5,706	6,278
In months of following year's imports of goods and NFS			4.7	5.3	5.6
Gross usable international reserves 2/	2,249	2,629	3,653	4,547	5,038
In months of following year's imports of goods and NFS			3.7	4.3	4.5
As a percentage of short-term debt 3/	125	123	171	307	260
External debt service to exports ratio (in percent)	21.0	23.5	23.1	25.3	17.4
Public debt (in percent of GDP)	47.8	53.2	55.1	57.5	57.2
Of which: External	29.1	33.7	33.0	33.3	32.4
Total external debt (in percent of GDP)	49.6	59.7	57.5	61.7	59.0

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.

Statement by Jeroen Kremers, Executive Director for the Republic of Croatia February 3, 2003

Introduction

The Croatian authorities would like to thank staff for their fair assessment of the economic performance, and for their continuous efforts in helping them to steer through the complex economic reform course. After successful completion of the previous precautionary SBA in May last year, which was beneficial for the country in many ways, the authorities decided to request another precautionary SBA, with an aim to confirm their decisiveness regarding the reform process. This time, to demonstrate even more the precautionary nature of the program, the authorities repaid all their obligations towards the Fund ahead of schedule (in late December 2002), and they requested the lowest possible access (less then 30 percent of their quota) under the new arrangement.

General Outlook

Last year's economic growth could be as high as 5 percent (according to preliminary estimates), which is well above all previous projections. Let me recall that the authorities entered into the last year with a conservative growth projection of 3.5 percent, and then accepted a 4.0 percent projection after the first quarter data became available. However, the good tourist season, and very strong industrial production seem to have accelerated real growth even further, which is especially satisfactory in light of the less favorable external environment and the ongoing (considerable) fiscal consolidation. Good growth prospects are expected for this year too (above 4 percent for GDP), and the latest figures on the industrial production (which indicated an acceleration in the last quarter of 2002) are encouraging in this respect.

Turning back to last year's strong economic growth, it is noteworthy that this growth was mainly an outcome of the impressive performance of the private sector. For the first time since transition started, the aggregate net profit/loss balance of the Croatian enterprises turned to positive values last year. Furthermore, unemployment statistics improved, despite significant lay-offs in the public sector. Unemployment still remains high in Croatia, roughly 15 percent on an ILO basis, but it fell by a full percentage point last year.

Fiscal Policy

Perhaps the main accomplishment over the past few years was in the fiscal area. The fiscal adjustment has been considerable in every aspect (well-presented in the table on page 12 of the staff report) – the fiscal deficit has been lowered by some 2–3 percentage points of GDP, and the government expenditures by some 5 percentage points of GDP. At the same time, the tax burden has been lowered too, and almost all government arrears (which amounted to some 5 percent of GDP at end-1999) have been paid. However, despite strong consolidation efforts, the public debt continued to climb (although at a much slower pace than before). Hence, the authorities' strong aim under the proposed new arrangement is to reverse the debt dynamics, and to make further progress towards the medium-term soundness of the public finances.

Against this background, the authorities are committed to reduce the consolidated general government deficit to 5 percent of GDP in 2003. Although this figure still looks high, it represents a significant adjustment effort (1.4 percentage points of GDP), which comes in the pre-election period. It is also worth noting that the figure includes highway construction (an annual cost of approximately 2 percentage points of GDP), which has the characteristics of a self-financing investment project. In any case, the latter fact at least adds to the medium-term debt sustainability. In addition, let me underscore that beside the authorities' strong intention to reduce the deficit this year, they are fully committed to further fiscal consolidation. The track record they have established over the past three years speaks the best for their determination to put the public finances on a sound footing.

Monetary and Exchange Rate Policy

Monetary policy successfully continues to be focused on low inflation, while keeping an eye on exchange rate developments. Last year's inflation was 2.3 percent, with core inflation about 1 percent. It is noteworthy that this year – 2003 – is the 10th anniversary of the stabilization program (implemented in Fall 1993), during which Croatia has been experiencing very low inflation rates. On average, annual headline inflation has been roughly 3.3 percent, and core inflation has remained below 2.5 percent. With such a performance, Croatia is an excellent performer among CEE transition countries, and there is little need to stress how eager the central bank is to continue to perform well on the inflation front.

The role of exchange rate stability should not be underestimated in considering the outstanding inflation performance. This is especially true in light of Croatia's monetary history, which provides an explanation for the high level of euroization in the economy. Hence, the monetary authorities intend to continue to rely on foreign exchange interventions at their discretion, with an aim to preserve the price stability objective, but also to discourage any potential one-way bets on the foreign exchange market. To this end, such a policy is entirely consistent with the authorities' aspirations to join the EU and to introduce the euro as legal tender in a manner consistent with practices that are applicable to the economies embarking on an accession path, and consistent with the recommendations of the EU and the ECB.

Separately, with regard to strong growth of bank credit to the private sector, let me note that the monetary authorities have already adopted measures to discourage excessive commercial banks' lending. Given the fact that the recent growth in bank placements has been based on the growth in foreign liabilities rather than on domestic deposits, the adopted measures tend not only to preserve a quality of commercial banks loan portfolio, but also to reduce pressures on the balance of payments and the external debt.

Structural Reforms

Without any doubt, the structural agenda continues to be complex, given the wide-ranging nature of reforms. To provide some sense of its complexity, let me shortly outline some of the most important actions planned for this year. In the context of fiscal sector reforms, the authorities intend to adopt a new budget law and to strengthen their debt management. Then, to improve the functioning of markets and support employment, the authorities plan to adopt new company, competition, bankruptcy and labor laws. Furthermore, health sector reform, as well as judicial reform will proceed. Finally, regarding privatization, beside further divestiture programs in public enterprises (from the privatization fund's portfolio), the authorities plan to privatize 25 percent plus one share of the oil and gas company (INA), and also to start privatizing the only remaining bank in state hands. It is noteworthy that the last state-owned bank is relatively small in size (3–4 percent of total banking assets), and that it is well-capitalized. In addition, preparatory work for potential privatization of power plants (after 2003), within the electricity company, will also be completed in the course of the year.

All in all, despite the demanding structural agenda, and the fact that some reforms might not be politically popular, the authorities are determined to finish the job. That said, they are well aware that only successful implementation of these reforms could pave the way towards a full-fledged and stable market economy.

Conclusion

The Croatian authorities would like to underscore the very fruitful cooperation with staff. They consider the proposed arrangement as a help to address various challenges that are on the way ahead, particularly in the area of public finances and structural reform. At the same time, they are of the opinion that such a program is the best way to confirm their strong reform orientation.