

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

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

- the staff report for the second review under the Stand-By Arrangement and request for waiver of nonobservance of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **September 17, 2003**, with the officials of Croatia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 29, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **November 10, 2003** updating information on recent developments.
- a Press Release summarizing the views of the Executive Board as expressed during its **November 12, 2003** discussion of the staff report that completed the review.
- a statement by the Executive Director for Croatia.

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

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

*May also be included in the Staff Report

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

**Second Review Under the Stand-By Arrangement and Request for Waiver of
Nonobservance of Performance Criteria**

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

(In consultation with other departments)

Approved by Carlo Cottarelli and Anthony Boote

October 29, 2003

- A mission comprising Messrs. Flickenschild (head), Eskesen, Konuki (all EU1), Dodzin (PDR), and Norregaard (resident representative) conducted the second review under the 14-month stand-by arrangement in the amount of SDR 105.88 million (29 percent of quota)—treated as precautionary by the authorities—in Zagreb during September 4–17, 2003. The mission worked closely with staff from the local World Bank office.
- The mission met with the President, the Prime Minister, the Deputy Prime Minister for economic affairs, the Ministers of Finance, Health, and Defense, the Governor of the Croatian National Bank (CNB), senior officials of other ministries and government agencies, and representatives of unions, banks, and the academic community. Mr. Stučka (OED) and World Bank staff attended some of these meetings.
- The Board completed the first review on August 1, 2003, adding an early second review to ensure that the external current account adjustment is on target.
- The third and final review mission is planned for December 4–17 2003, after the parliamentary election scheduled for November 23.

	Contents	Page
I.	Recent Economic Development and Policy Implementation	4
II.	The Program for the Remainder of 2003	12
	A. Monetary and Exchange Rate Policy and Financial Sector Supervision	13
	B. Fiscal Policy	14
	C. Structural Reforms	16
III.	Outlook and Authorities' Strategy for 2004	17
IV.	Staff Appraisal.....	19
Text Box		
1.	Program Performance Through September 30, 2003	11
Text Figures		
1.	Money Market Interest Rate	8
2.	Stock of CNB Bills in Kuna.....	12
Figures		
1.	Real Sector Developments, 1996–2003.....	5
2.	Retail and Producer Price Inflation, 1996–2003	6
3.	Sovereign Bond Spread, 1997–2003	7
4.	Money and Private Sector Bank Credit, 2002–2003	9
5.	Exchange Rates Developments, 1998–2003.....	10
6.	Indicators of Competitiveness, 1995–2003.....	15
Tables		
1.	Key Macroeconomic Indicators, 2000–2004.....	21
2.	GDP by Expenditure Category, 2000–2004	22
3.	Performance Under the Stand-By Arrangement During the First Nine Months of 2003	23
4.	Balance of Payments, 2001–2004	24
5.	Current Account, Foreign Direct Investment, and Reinvested Earnings, 2001–2004	25
6.	External Debt by Domestic Sectors.....	26
7.	Monetary Accounts, 2001–2004	27
8.	Financial Soundness Indicators of the Banking System.....	28
9.	Debt Stock of Consolidated General Government	29
10.	Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis, 2001–2004.....	30

11.	Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis.....	31
12.	Saving-Investment Balances, 2000–2004.....	32
13.	Conditionality Under the Stand-By Arrangement During the Fourth Quarter of 2003	33
14.	Schedule of Purchases Under the Stand-By Arrangement	34
15.	Projected Payments to the Fund as of September 30, 2003 Under Obligated Repurchase Schedule.....	35
16.	Indicators of Capacity to Repay the Fund, 2003–2010	36
17.	Indicators of External and Financial Vulnerability, 1998–2003	37
18.	External Financing Requirements, 2001–2007.....	38

Appendices

1.	Fund Relations.....	39
2.	World Bank Relations.....	43
3.	Statistical Issues	49
4.	Transactions Related to the Transfer of a Patent Licensing Agreement by a Large Croatian Company—Nature and Treatment in the Balance of Payments.....	55
5.	Sustainability Analysis	56

Appendix Tables

19.	Core Statistical Indicators.....	54
20.	Public Debt Sustainability Framework, 1997–2007.....	57
21.	External Debt Sustainability Framework, 1997–2007	58

Attachment I

1.	Letter of Intent.....	59
----	-----------------------	----

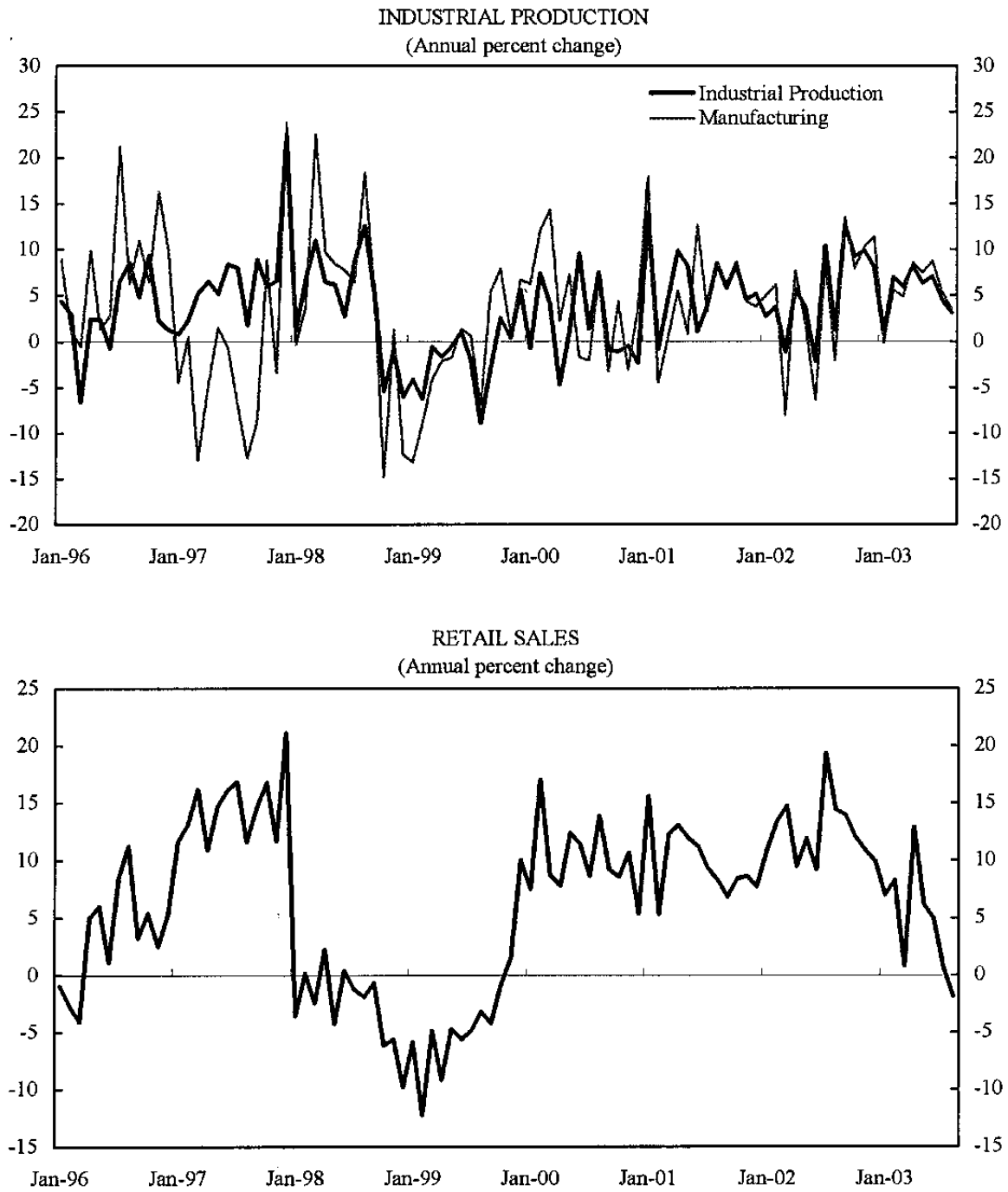
I. RECENT ECONOMIC DEVELOPMENTS AND POLICY IMPLEMENTATION

1. **Despite a weaker external environment, domestic economic activity has remained strong amid easing inflation.** Underpinned by strong investment, year-on-year real GDP growth was 5 percent in the first half of 2003. In the first eight months, industrial production and retail sales volume grew by 5.5 percent and 5 percent, respectively, in relation to the corresponding 2002 period (Figure 1). The twelve-month retail price inflation rate fell from 2.3 percent at end-2002 to 1.6 percent in September, with core inflation at 0.9 percent (Figure 2). As a result of the more favorable output and inflation trends, staff has revised its 2003 projections for real GDP growth and average retail price inflation from 4.2 percent and 3 percent, respectively, to 4.7 percent and 1¾ percent (Tables 1 and 2).
2. **The external current account remains weak, although recent data suggest some improvement.** The current account deficit in the first half of 2003 exceeded the projection under the first review by 0.8 percent of projected annual GDP. Although tourist receipts beat expectations, the current account failed to improve as expected due to brisk import growth and a large increase in investment income outflows. However, reinvested investment income was 0.7 percent of GDP higher than projected at the first review, thus financing most of the current account deterioration.¹ Preliminary third-quarter data indicate record tourism receipts and slowing merchandise imports, thus suggesting that current account adjustment is underway. The program now assumes that the current account deficit will decline to 5.9 percent of GDP, compared with 5.5 percent of GDP under the first review. Despite the weak balance of payments, Croatia's EMBI stripped spread declined from 150 basis points in early August to 115 basis points in late September (Figure 3).
3. **The CNB has tightened monetary policy in response to the widening external current account deficit.** In addition to the administrative credit ceilings introduced in January 2003 (IMF Country Report No. 03/252),² the CNB raised the local currency component of reserve requirements on banks' foreign currency liabilities by 10 percentage points to 35 percent in early September 2003 to absorb kuna liquidity. In response, money market interest rates rose from some 4½ percent to 9 percent in mid-September, before easing to 7–8 percent. The administrative credit restraints have slowed credit growth to an

¹ The current account data for 2003 exclude US\$328 million of immediately reinvested profits of foreign investors resulting from the revaluation of a patent licensing agreement by a large company in 2002 (see Appendix IV explaining the nature of the transaction and its treatment in the balance of payments statistics).

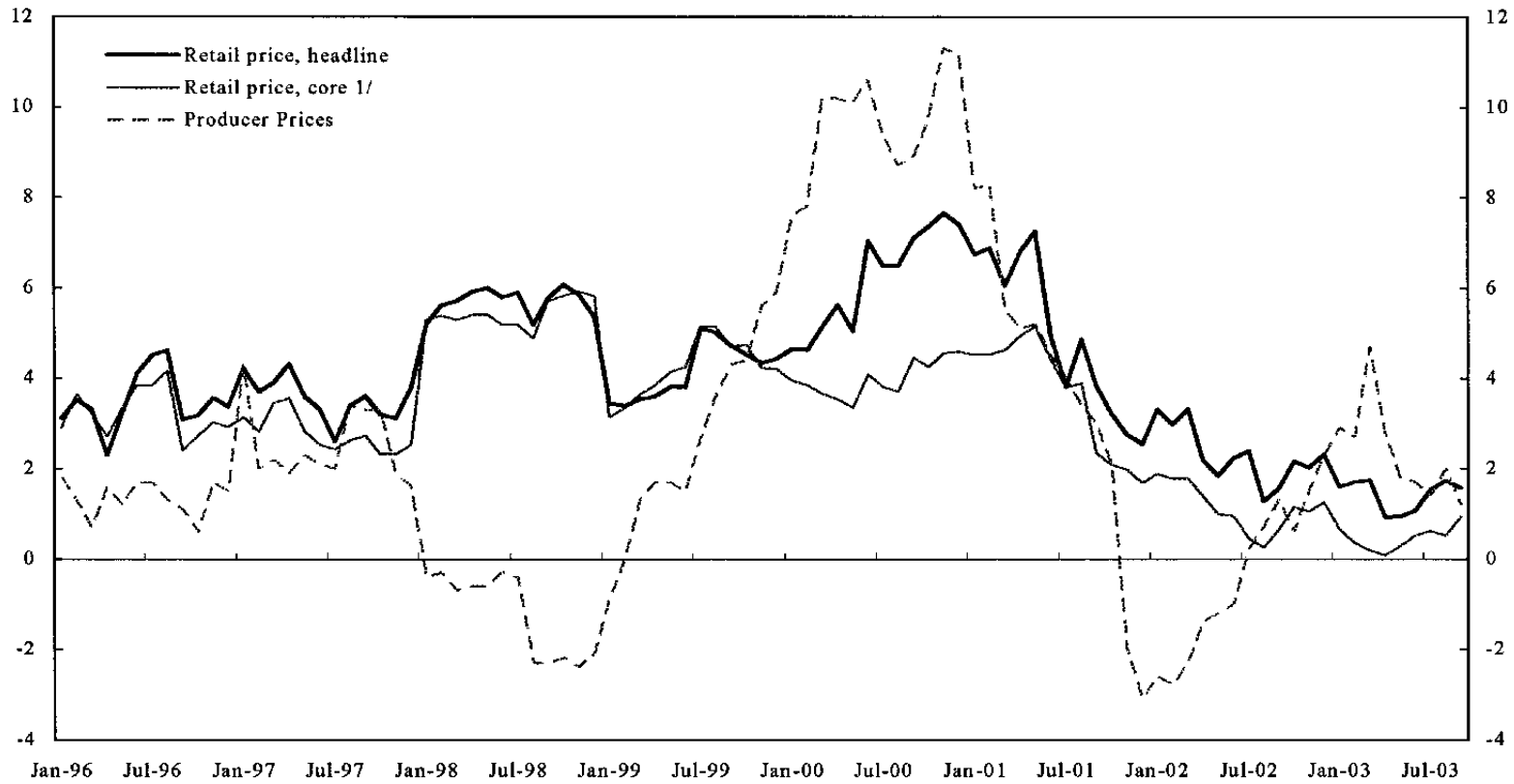
² Banks with credit growth of over 4 percent per quarter were required to acquire CNB bills at penalty interest rates for twice the amount of the excess. At the same time, banks were required to raise their short-term foreign exchange liquidity requirements to at least 35 percent of their foreign exchange liabilities by end-March 2004.

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



Source: Croatian Bureau of Statistics.

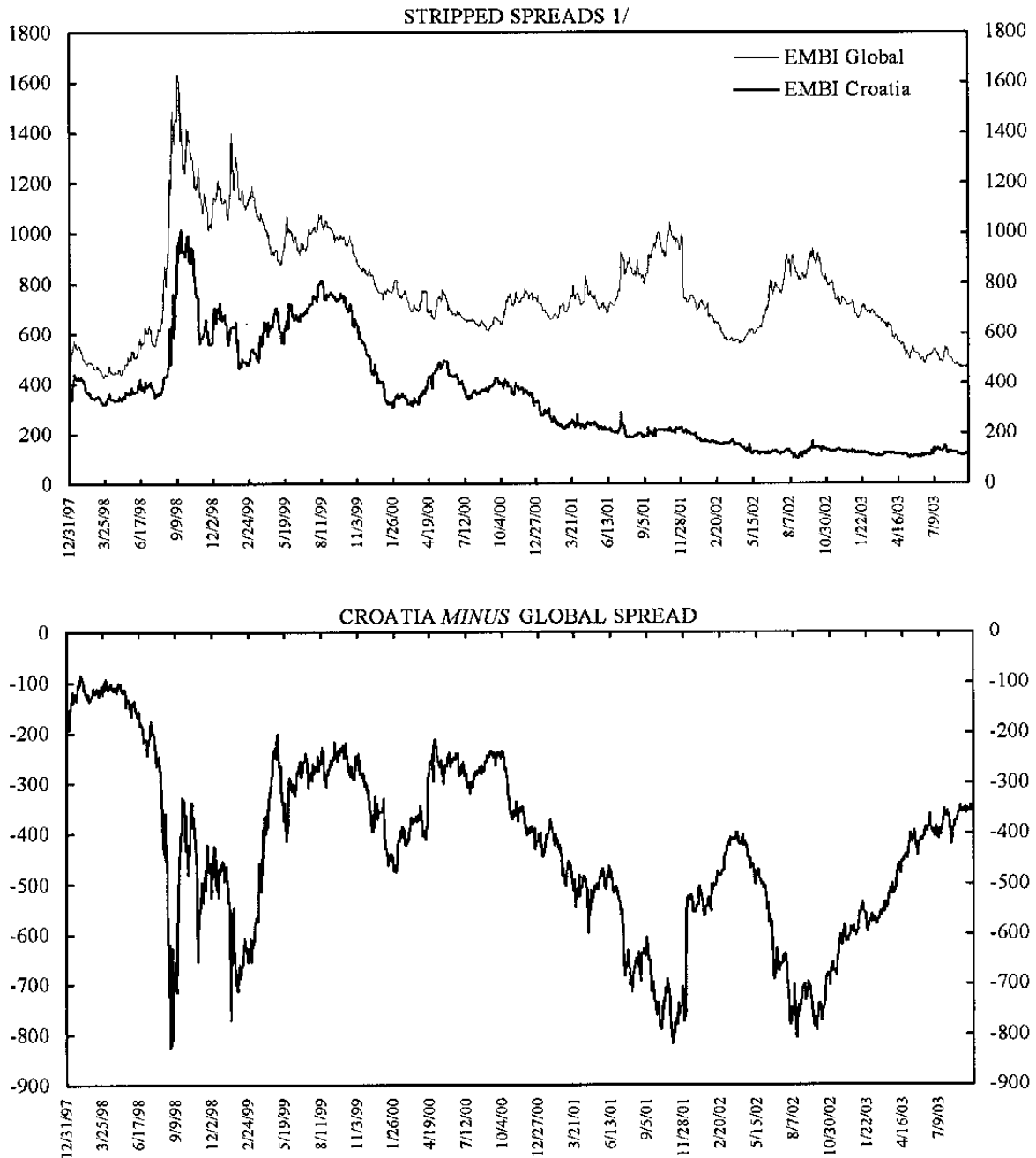
Figure 2. Croatia: Retail and Producer Price Inflation, 1996–2003
(Annual Percent Change)



Sources: Croatian Bureau of Statistics; and Croatian National Bank.

1/ Excludes energy and administered prices.

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

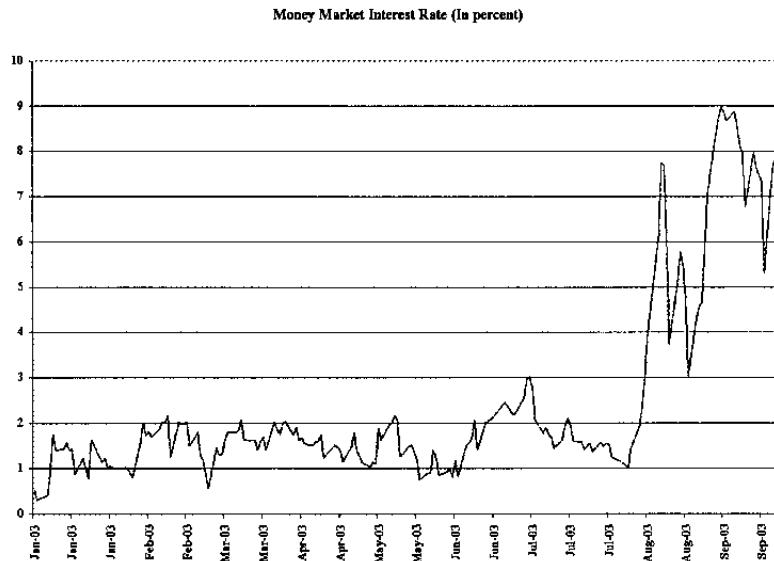


Source: JP Morgan.

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

estimated 12¾ percent during the first eight months of 2003 (after adjusting for exchange rate movements and attempts by banks to circumvent the limits through securitization and asset swaps), compared with 20½ percent in the comparable 2002 period.

The twelve-month growth of corporate credit slowed considerably from 20½ percent at end-2002 to 8¼ percent in August 2003, while the growth of household credit moderated from 43 percent to 31½ percent in the same period (Figure 4). The kuna has been rather stable against the euro since early April 2003 without CNB intervention (Figure 5).

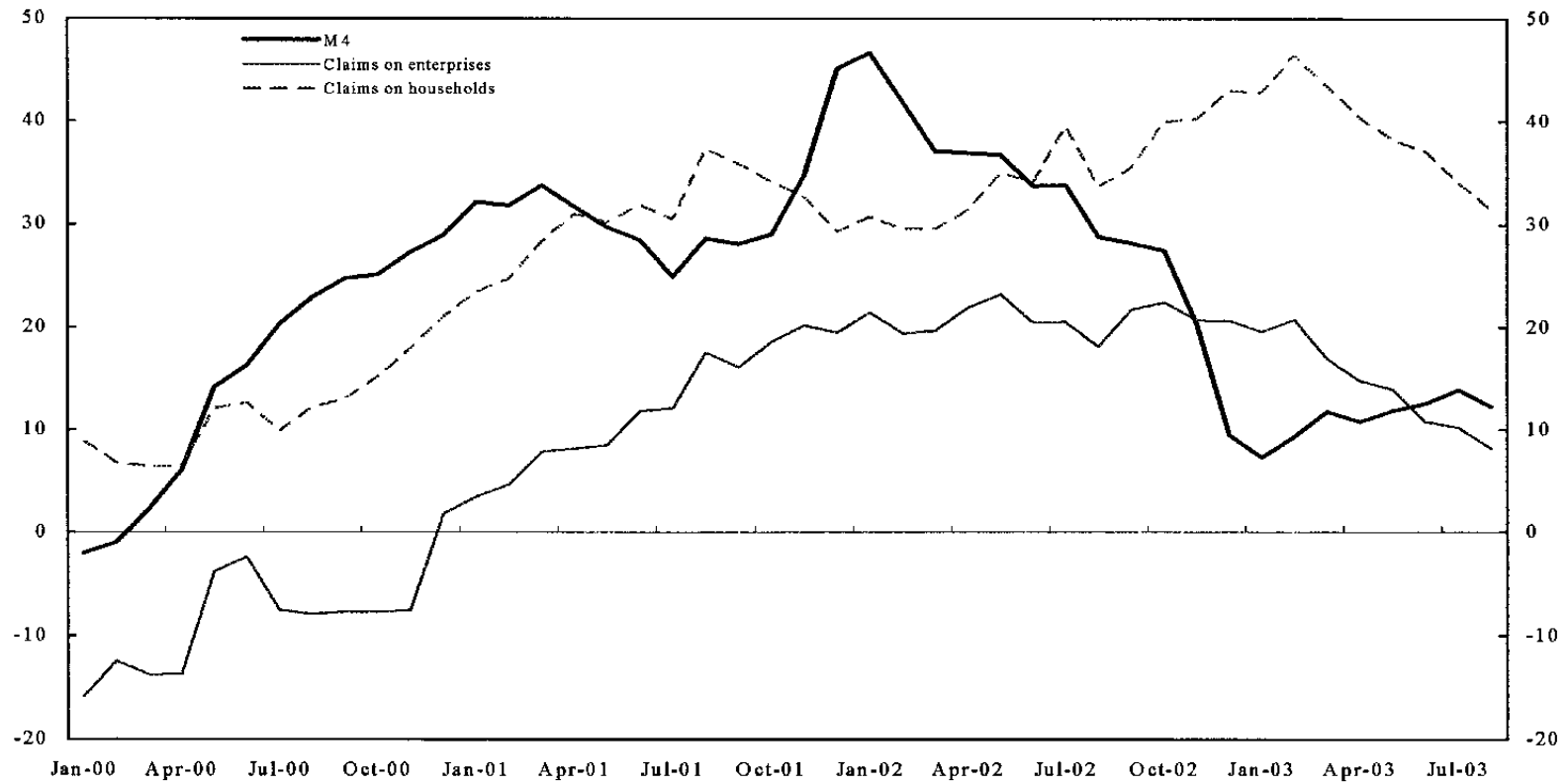


4. **Fiscal performance has improved and prospects are good that the general government deficit target of 4.6 percent of GDP in 2003 can be achieved.** After a temporary dip of revenue collections in the second quarter, preliminary data for central government revenue collections in the third quarter show a strong catchup for practically all categories. The revenue shortfall in the second quarter was largely attributable to three factors: (i) an overestimation of the effect of broadening the base for social security contributions; (ii) a greater-than-expected loss of customs duties due to implementation of trade agreements³; and (iii) a drop in nontax revenue. Total expenditure during the first half of the year was in line with program projections. The wage bill exceeded the programmed level mostly due to slower layoffs and higher severance payouts in the defense sector.⁴ This

³ Croatia has been implementing tariff reductions according to its trade agreements with the WTO, EU, CEFTA, and bilateral partners. These agreements cover more than thirty countries.

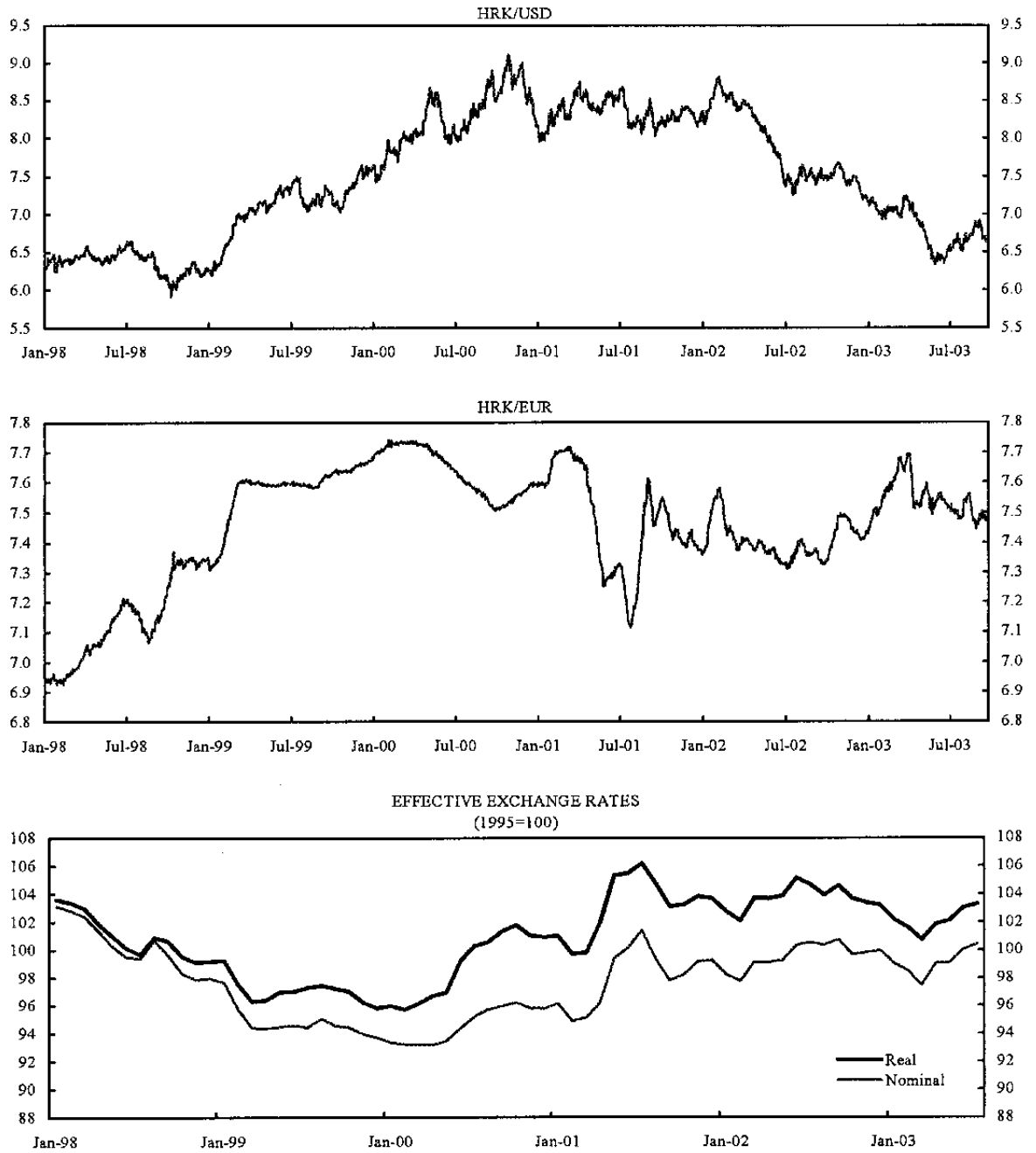
⁴ By June 2003, employment in the military sector had been reduced by around 5,500 persons, some 3,000 less than planned. By year-end, employment is expected to be reduced by another 3,000 persons. As a result, employment will have been reduced by around 2,000 less than originally planned. However, an additional 3,000 people are expected to be made reservists at 60 percent of previous pay.

Figure 4. Croatia: Money and Private Sector Bank Credit, 2002–2003
(Annual percent changes)



Source: Croatian National Bank.

Figure 5. Croatia: Exchange Rates Developments, 1998–2003



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

was offset by (i) lower spending on goods and nonwage services; (ii) savings on interest payments resulting from low interest rates and U.S. dollar weakness; and (iii) fewer subsidies due to a drought-related drop in agricultural production. Recent data suggest that spending remains on track, although highway construction is larger than expected.

Box 1. Program Performance Through September 30, 2003

All end-June quantitative performance criteria were observed (Table 3). All but three of the end-September quantitative performance criteria, which are relevant for the completion of the second review, are also expected to have been observed; data on the observance of end-September performance criteria will be submitted separately before the Board meeting. In addition, the government largely made up for slippages in structural conditionality during the first quarter, as discussed in paragraph 5.

The performance criterion on the cumulative deficit of the consolidated central government is expected to have been missed because of insufficient adjustment in response to the temporary delay in the programmed receipt from the partial privatization of the oil company (INA). The government expects to receive this payment in October 2003 and the criterion would have been met if the receipts had come in by end-September 2003.

The performance criterion on net usable international reserves of the CNB was missed by US\$46 million (less than 1 percent of gross reserves). The CNB argues that market intervention to buy foreign exchange would have undercut its attempts at monetary tightening and that the reserve levels of the CNB and the banks are comfortable.

The performance criterion on the net domestic assets of the CNB was missed by Hrk 46 million ($\frac{1}{4}$ of 0.1 percent of GDP). The CNB asks for a waiver because of the small size of the excess.

5. **Government and parliament have made up for the slippages in structural reforms during the first half.** In early July, the government adopted criteria for issuing guarantees, in accordance with paragraph 16 of the Memorandum of Economic and Financial Policies (MEFP). In mid-July, the Ministry of Finance prepared a register of active government guarantees, including a record of all new, expired, and amortized guarantees during the first half of 2003, but the register is still work in progress and more work is needed before full coverage can be confirmed. In late July, the government reached a final decision on the partial privatization of the oil company (INA), accepting a bid by the Hungarian oil company MOL of US\$505 million, which exceeded the programmed receipts by 40 percent. However, the proceeds from the sale were not received until October 2003. Parliament adopted new bankruptcy, company, competition, and labor laws in July and 24 more laws aimed at harmonizing domestic legislation with EU standards in September-October 2003.

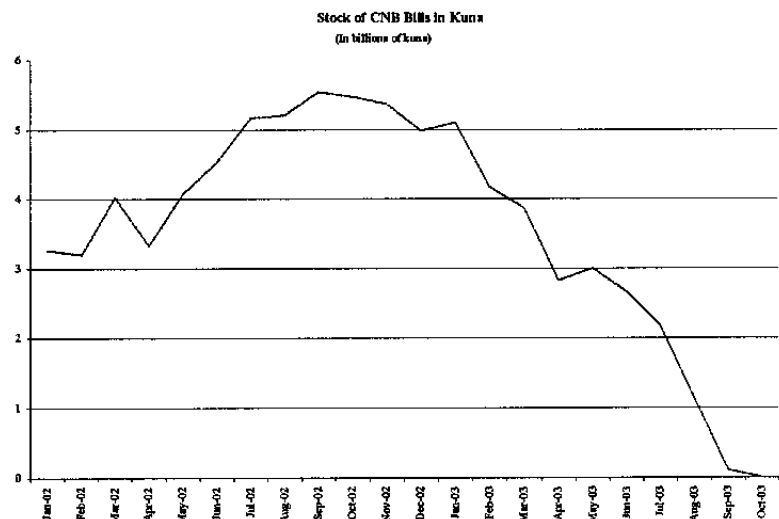
II. THE PROGRAM FOR THE REMAINDER OF 2003

6. **The discussions during the review focused on whether the macroeconomic policy stance was adequate to achieve the external current account target.** As data for the first half of 2003 suggested that this was not the case, the authorities had decided to tighten reserve requirements. They preferred this course of action for two reasons. First, the exchange rate did not appear misaligned and the widening of the current account deficit seemed to be related primarily to the ongoing credit boom. Second, so close to the election and the end of the program year, fiscal policy could not be tightened swiftly, although the authorities recognized that it was over the longer period an effective policy instrument to bring about the required current account adjustment. The CNB also stated that no further tightening was necessary to reduce the current account deficit from 7.2 percent of GDP in 2002 to 5.9 percent of GDP in 2003 (Tables 4 and 5).⁵ The CNB also saw no need to reinforce its monetary tightening by imposing additional deposit requirements on banks' foreign liabilities or, in general, broader forms of capital inflow restrictions.

7. **Staff expressed concern about the increased external vulnerability and urged the authorities to take further action if the current account did not improve as expected.** The sharp increase in external debt has increased vulnerability to exogenous shocks

(Table 6). The authorities view a reduction of the current account deficit by 1¼ percentage points to 5.9 percent of GDP as an intermediate step toward their medium-term goal to bring down the deficit to 3½ percent of GDP, which would ensure external sustainability (Appendix V). Staff cautioned that the slowdown of credit growth might not improve the current account balance as expected, as imports may be in part

sustained by direct borrowing abroad, suppliers credits, and leasing operations (the latter have increased substantially following the imposition of administrative credit ceilings). Staff also pointed out that the higher foreign exchange cover requirements for banks' external liabilities had encouraged foreign borrowing. Moreover, the tightening of reserve



⁵ As noted, the 2003 deficit is ½ percentage point higher than envisaged in the first program review. However, the increase reflects higher reinvested profits and does not raise the external borrowing requirement.

requirements on banks' foreign liabilities risked being undermined by base money expansion caused by the authorities' passive acceptance of a sharp reduction of outstanding CNB and Treasury bills. Staff encouraged the authorities to contain base money expansion by selling such bills at higher interest rates and, given the vulnerability of the financial system to the exchange rate, resort to price-based capital inflow restrictions, if needed.

8. **However, staff did not insist on further policy tightening as it appeared that recent data bear out the authorities' current account projections.** As noted in paragraph 2, preliminary data suggest that the current account did indeed improve strongly in the third quarter and that the authorities' deficit target of 5.9 percent of GDP is achievable. Nonetheless, the authorities have agreed to take additional measures if the current account fails to improve as expected (LOI, ¶ 6 and ¶ 10). Moreover, the final review mission, scheduled for early December, will focus on progress in current account adjustment and the policy stance in the post-election period.

A. Monetary and Exchange Rate Policy and Financial Sector Supervision

9. **The revised monetary program for 2003 assumes a credit slowdown and aims at supporting current account adjustment.** Following the slowdown since April 2003, staff now expects that private sector credit growth will decelerate to 16¼ percent in 2003, compared with 18¼ percent projected during the first review (Table 7 and LOI, ¶ 13). In light of the broadly offsetting changes in the real growth and inflation outlook for 2003, and despite higher interest rates, broad money growth in 2003 remains virtually unchanged at around 14 percent.⁶ Base money growth has been revised upward to incorporate the impact of the increased kuna component of reserve requirements on banks' foreign liabilities, which is estimated at around Hrk 2.3 billion. Because credit growth is revised down while broad money growth is kept unchanged, the quantitative targets on net international reserves and net domestic assets at the end of the year would likely be achieved with some margins. But the CNB stands ready to intervene in the foreign exchange market to ensure that the end-year performance criterion on net usable international reserves is observed.

10. **The CNB intends to complement its monetary tightening with stepped-up supervisory efforts to ensure that the banking system remains sound (LOI, ¶ 14).** Midyear financial soundness indicators show a renewed decline of nonperforming loans, continued strong capitalization and profitability, and a decline in banks' net open foreign exchange position (Table 8). While the decline in nonperforming loans was largely due to the writing-off of existing nonperforming loans, the recent decline of the ratio of loan loss provisions to nonperforming loans reflects a decreasing share of heavily impaired loans in total nonperforming loans. Since October 2003, banks should benefit in their lending

⁶ As noted, the interest rate increase resulted from the increased demand for base money in the wake of tightened reserve requirements.

decisions from a debtors blacklist compiled by the bankers' association.⁷ Data from the insurance supervisor indicate that credit risks of one sixth of household credits were transferred to insurance companies as of June 2003, indicating the need for closer insurance company supervision. The CNB is fine-tuning its early warning system and stress tests of banks' balance sheets on the basis of recommendations by a recent MFD technical assistance mission.

11. **Standard competitiveness indicators suggest that the exchange rate remains adequate.** Croatia's U.S. dollar unit labor costs have increased somewhat in recent months, but not by more than those of its main competitors and trading partners (Figure 6). Staff suggested to allow greater short-term fluctuations than in the past, pointing out that the CNB's low tolerance of exchange rate movements could result in high foreign exchange exposure for unhedged borrowers. The CNB reaffirmed its intention to keep the exchange rate of the kuna broadly stable against the euro. However, it continues to be ready to allow some exchange rate variability to discourage one-way bets and has not intervened in the foreign exchange market since March 2003. It has recently asked banks to report on their ten largest customers' foreign exchange exposure (prior action, LOI, ¶ 14). It is also compiling aggregate corporate income statements and balance sheets to assess the credit risk resulting from exchange rate fluctuations. The new regulation to include foreign exchange options in banks' net open positions has reinforced the trend toward greater use of kuna in deposit and credit operations (Table 8). The CNB expects these supervisory efforts to reduce the vulnerability of the economy to sudden exchange rate movements.

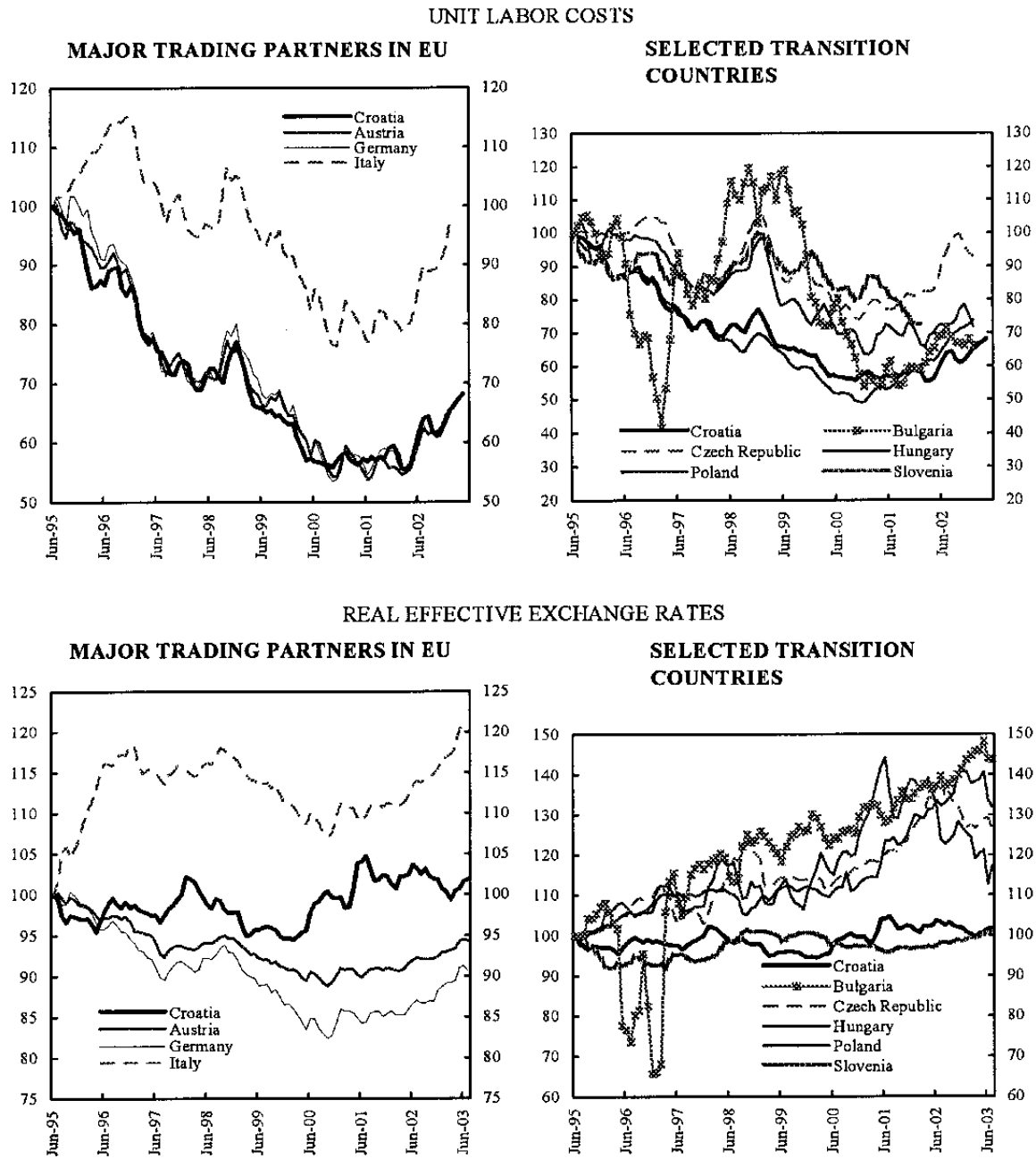
B. Fiscal Policy

12. **The program's principal objective of stabilizing the general government debt ratio remains achievable.** With higher privatization receipts, the public debt ratio would even edge down somewhat in 2003 if the general government fiscal deficit target of 4.6 percent of GDP is achieved and guaranteed debt were in line with the program (Table 9).

- As to the first condition, staff expects overall revenue and expenditure to be in line with program projections, thus allowing the deficit target to be met (Table 10). On the revenue side, an upward revision of profit and indirect taxes—reflecting the higher than anticipated economic activity—and nontax revenue—primarily road toll collections boosted by buoyant tourism and new highways—is likely to offset a shortfall in social security contributions and customs duties. On the expenditure side, a deficit-neutral budget amendment has increased the wage bill by around 0.6 percent of GDP. This mainly reflects court-mandated payments to unlawfully laid-off military personnel in the early 1990s and slower employment reduction and higher severance pay in the defense sector. However, the wage bill overrun is expected to be fully offset by lower spending on goods and nonwage services, lower interest payments

⁷ This temporary measure will be replaced by a credit registry during 2004.

Figure 6. Croatia: Indicators of Competitiveness, 1995–2003
(June 1995=100)



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

due to low interest rates and a weak U.S. dollar, and lower subsidies and current transfers reflecting low agricultural production and a drop in unemployment (Table 11).

- As to the second condition, a net increase in guaranteed debt of 0.8 percent of GDP in the first three quarters, unless it is reversed in the fourth quarter, makes debt ratio reduction difficult to achieve. However, debt ratio stabilization still remains feasible in 2003.

13. **Although staff expects the fiscal deficit target to be met, additional spending restraint could prove necessary.** While revenue collections have caught up with the projections during the third quarter, it might still be necessary to contain spending to offset any revenue shortfalls in the fourth quarter or spending overruns on highway construction. The authorities agreed to implement additional expenditure cuts if needed to meet the deficit target in 2003 and to refrain from promising tax cuts or increasing expenditure in the runup to the election. The expenditure cuts would be targeted at discretionary spending such as nonwage services and capital investment

14. **With higher privatization receipts and increased external borrowing, the financing of the deficit in 2003 has changed significantly.** The higher receipts from the sale of 25 percent plus one share of INA will increase privatization receipts to around 2.1 percent of GDP, around 0.4 percentage points higher than projected in the first review. The authorities will use the excess proceeds to reduce borrowing in accordance with an asymmetric adjuster in the program. Nonetheless, net foreign borrowing will also be higher than projected in the first review as the proceeds from the second-quarter Samurai bond issue were drawn down to bridge the delay in the privatization of INA. To prevent an even greater reduction of access to the domestic financial market, the government has decided to keep the proceeds from the disbursement of the second tranche of the World Bank's SAL in a foreign currency account with the CNB until the first quarter of 2004 (prior action; LOI, ¶ 5). As nonbank domestic financing will stay unchanged, the government will provide funds to the banking system equivalent to 1.2 percent of GDP in 2003, compared with a 0.2 percent of GDP net borrowing requirement expected in the first review. The staff observed that by substituting external for domestic financing, the Ministry of Finance had failed to support the CNB's monetary tightening, but the authorities argued that the higher cost of domestic borrowing would have interfered with their deficit reduction objective.

C. Structural Reforms

15. **The government will take further steps to strengthen fiscal sector reforms (LOI, ¶ 9).** It will report data on outstanding government guarantees on September 30, 2003 and December 31, 2003, based on the newly created register of government guarantees (structural benchmark). A Fund-provided resident fiscal advisor started work in September 2003 and will focus initially on improving the production of timely and reliable fiscal data, including guarantees. The fiscal ROSC mission has been postponed to early 2004 to combine it with a Country Financial Accountability Assessment by the World Bank. The government is

looking forward to the fiscal ROSC and remains committed to undertake the other reforms mentioned in paragraph 18 of the MEFP.

16. **Although it took a significant step with the sale of 25 percent plus one share in INA, the government has postponed the remainder of its privatization program until after the election.** Except for a few tenders currently in the pipeline, it has stopped all privatizations through the privatization fund (HFP) pending the adoption of a new privatization law. The new law, which passed its first reading before parliament adjourned for the election, envisages speedier privatization and greater stress on employee shareholding. The government has also postponed the sale of the 7 percent of the telecom (HT) company to its employees until 2004 due to union resistance. In addition to pursuing an agreement with the Catholic church on the transfer of 25 percent of the insurance company's (CO) capital (LOI, ¶ 16), it is contemplating selling another 20 percent of CO's shares on the stock exchange in 2004. Privatization of the distribution network of the electricity company (HEP) is not likely to take place until 2005.

17. **In the financial sector, the authorities will further strengthen the regulatory framework** (LOI, ¶ 14). The CNB has issued the bylaws and guidelines for the new foreign exchange law and all guidelines for the application of the bylaws to the new banking law. Parliament recently asked the Ministry of Finance to establish a council of domestic financial supervisors, including the CNB, to improve cooperation among supervisors. Such cooperation has become particularly important with the transfer of credit risk from banks to insurance companies. The CNB is intensifying cooperation with foreign bank supervisors on account of both the high foreign ownership of Croatian banks and Croatian banks' ownership of foreign subsidiaries. It will restructure its banking supervision department by end-2003 and strengthen its capacity by adding staff and continued professional training.

18. **The government has modified its strategy on the privatization of the postal bank (HPB).** The IFC will conduct due diligence in October-November 2003 on the basis of a revised mandate letter recently sent by the government (prior action), aiming at obtaining IFC Board approval to subscribe to 19 percent of HPB' capital by end-2003 (modified structural benchmark).

III. OUTLOOK AND AUTHORITIES' STRATEGY FOR 2004

19. **With continued prudent macroeconomic policies, staff expects the brisk economic growth to be broadly maintained in 2004.** Investment is likely to remain strong due to strengthened confidence after the election, the possible initiation of a four-year railroad infrastructure project, and a projected economic recovery in the EU (Tables 2 and 11). While merchandise exports should benefit from the EU recovery, the growth of tourism exports and merchandise imports is expected to moderate, with the net foreign contribution to growth turning neutral after three years of being a drag on growth. As a result, the growth rate should remain at around 4½ percent and the current account deficit is likely to decline to

about 5¼ percent in 2004. Administered price increases and continued strength in economic growth could push up average inflation to some 3½ percent in 2004.

20. **The provisional budget for 2004 aims at a general government deficit of 3.8 percent of GDP and the accompanying medium-term fiscal plan envisages a further decline of the deficit to 2 percent of GDP by 2007.** The revenue burden will drop by 0.3 percent of GDP in 2004 driven by new income and profit tax exemptions⁸ and further erosion in customs duties due to continued implementation of trade liberalization agreements (Table 10). To reach their deficit target, the authorities intend to reduce the expenditure burden by 1.1 percent of GDP. Freezing the nominal wage bill at its 2003 level would generate savings of 0.8 percent of GDP (LOI, ¶ 6) while still allowing net wage increases of 4–5 percent due to layoffs and new income tax exemptions. Additional savings of 0.3 percent of GDP would result from a nominal freeze of highway construction expenditure and containment of other capital expenditure. However, staff pointed out that additional adjustments of 1.2 percent of GDP would be necessary on an annual basis if the new government decided to go ahead with a four-year railroad infrastructure investment program. Staff and authorities agreed that increasing the gasoline excise tax could generate 0.3 percent of GDP in additional revenue and that cuts in spending on transfers (0.5 percent of GDP), goods and services (0.2 percent of GDP), subsidies (0.1 percent of GDP), and central government investment (0.1 percent of GDP) could generate the remaining savings. If the nominal wage bill freeze proves unfeasible, staff suggested scaling back the highway and railroad infrastructure plans and cutting other, nonpriority spending categories further as needed. The final review mission will discuss the provisional budget and its financing plan as well as the medium-term fiscal consolidation plan in greater detail.

21. **The CNB intends to begin pursuing a more orthodox monetary policy in 2004.** Aware that credit ceilings distort bank competition in the banking system and may eventually be circumvented, the CNB intends to eliminate them at the beginning of 2004. It is contemplating strengthening its money market tools by introducing a deposit facility for bank liquidity to create an interest rate corridor with the existing Lombard lending facility and guiding market interest rates within this corridor through active open market operations (LOI, ¶ 11). It has requested early MFD technical assistance to help prepare for this policy framework change. As the new provisioning requirements for rapidly expanding banks will not have the same restraining effect on credit expansion as the administrative credit ceilings, and pending the introduction of the new monetary policy framework, the CNB will use its existing instruments to keep monetary conditions tight after the elimination of the credit ceilings.

⁸ On orthopedic equipment and medical treatment, housing related expenses, and charitable donations as well as R&D and education expenses.

IV. STAFF APPRAISAL

22. **With the recent sharp increases in the current account deficit and external debt, reducing external vulnerability has become the top macroeconomic priority.** Although there are clear indications that the targeted current account adjustment is indeed underway, attainment of the revised deficit target is far from assured. In view of these downside risks, the authorities should not hesitate to take additional measures if needed. More generally, they should tighten both fiscal and monetary policy in 2004 to restore a sustainable current account position.

23. **The CNB's performance in reversing the external deterioration has been mixed.** The administrative credit restrictions have succeeded in slowing bank credit expansion and the recent tightening of reserve requirements has raised the demand for base money and interest rates. However, the higher foreign exchange liquidity requirements against banks' foreign liabilities have encouraged capital inflows, and the supply of base money has been boosted by the CNB's reluctance to offer higher interest rates on its bills. The CNB should therefore tighten monetary conditions at the first sign that current account adjustment is not on track and consider higher deposit requirements on additional bank borrowing from abroad or other price-based capital restrictions, if necessary.

24. **Cooperation between the Ministry of Finance and the CNB needs to be strengthened.** The increased reliance on foreign financing of the general government deficit has been unhelpful in supporting tighter domestic monetary conditions. The Ministry of Finance should buttress the CNB's efforts by accepting higher interest rates on its Treasury bills and other domestic borrowing. Cooperation on borrowing plans and data reconciliation should be improved.

25. **The CNB's willingness to consider switching to a more orthodox monetary policy framework is welcome.** The elimination of the distortionary credit restrictions creates a vacuum in early 2004 that cannot be filled by the new provisioning requirements for rapidly expanding banks. Thus, the CNB should step in resolutely with its existing policy instruments to prevent a renewed surge in credit and move expeditiously with Fund technical assistance to prepare for the introduction of active open market operations within an appropriate interest rate corridor.

26. **Efforts to strengthen financial supervision are right on target and should be pursued with determination.** The CNB is to be commended for its initiatives to strengthen banking supervision. As some of the risks have been transferred to less closely supervised nonbank financial institutions, it is important to strengthen nonbank supervision as well. In this context, the new council of domestic supervisors should begin work as soon as possible to improve cooperation among domestic supervisors. As the administrative credit restrictions have encouraged the rapid expansion of unsupervised leasing companies owned by banks abroad, the CNB should closely cooperate with foreign bank supervisors.

27. **Fiscal policy seems on target to stabilize the public debt ratio.** Higher privatization receipts have facilitated achieving this objective. With the recovery of revenue collections, prospects are good that the general government deficit target will be met. But the authorities need to resist electoral pressures to lower revenue or raise expenditure and remain prepared to cut spending to offset unexpected slippages. Debt ratio stabilization also requires that the new guidelines to extend government guarantees be applied more restrictively than in the past to prevent an increase in guarantees outstanding.

28. **The government should consider further fiscal tightening in 2004 if the current account deficit does not decline as expected.** While the plans to reduce the fiscal deficit further in 2004 and beyond are welcome, their implementation requires firm decisions on expenditure cuts, especially if the new government decides to go ahead with new railroad infrastructure investment or if the nominal wage bill cannot be contained to its 2003 level. However, the government may have to reduce the deficit further if monetary policy fails to reduce external vulnerability.

29. **After a brief electoral hiatus, the government needs to press ahead with structural reforms.** While much has been achieved, a heavy agenda of structural reforms remains, including restructuring and privatization of public enterprises and remaining state banks, to boost competitiveness and economic growth as Croatia pursues its application for EU membership.

30. **The staff supports the authorities' request of waivers for nonobservance** of the end-September performance criteria on the deficit of the consolidated central government and the net usable international reserves and the net domestic assets of the CNB—the first because the deviation was caused by the delay in privatization proceeds which have now been received; the second because the margin of nonobservance is small in relation to the CNB's international reserve holdings and because the CNB is committed to intervene if necessary to ensure that the relevant end-year performance criterion is observed; and the third because the margin of nonobservance was indeed very small. On the basis of the authorities' program for the remainder of 2003, **the staff proposes completion of the second review under the stand-by arrangement.**

Table 1. Croatia: Key Macroeconomic Indicators, 2000–2004

	2000	2001	2002	2003			2004
				Program EBS/03/3	Program EBS/03/99	Revised Program	2004 Proj.
(Percentage change)							
Output, unemployment, and prices							
Real GDP	2.9	3.8	5.2	4.2	4.2	4.7	4.5
Unemployment (survey based, in percent)	16.1	15.8	14.8	...	...	...	...
RPI inflation (average)	6.2	4.9	2.2	3.0	2.3	1.7	3.5
(In percent of GDP)							
Saving and investment							
Gross national saving	19.3	19.9	21.6	23.0	22.4	22.1	23.9
Gross domestic investment	21.8	23.7	28.7	26.6	27.8	28.0	29.1
General government operations							
Revenue and grants	46.2	44.7	45.2	45.0	44.9	44.9	44.9
Expenditure and net lending	52.7	51.5	50.0	50.0	49.5	49.5	48.7
Overall balance	-6.5	-6.8	-4.8	-5.0	-4.6	-4.6	-3.8
Privatization receipts 1/	3.1	3.7	1.8	1.2	1.7	2.1	0.6
Foreign borrowing	4.2	2.0	2.8	1.5	1.3	2.4	2.1
Domestic borrowing (including arrears)	-0.8	1.1	0.2	2.2	1.5	0.1	1.0
(End of period; change in percent)							
Money and credit							
Credit to the nongovernment sector	9.4	24.5	31.3	13.7	18.2	16.2	12.6
Broad money	28.9	45.2	9.5	14.4	14.2	13.9	10.7
Base money	13.6	51.9	29.3	15.6	14.3	23.9	11.2
(End of period; in percent)							
Interest rates							
Average deposit rate	3.4	2.8	1.8	...	...	...	...
Average credit rate	10.5	9.5	12.5 4/	...	...	...	...
(In millions of U.S. dollars)							
Balance of payments							
Current account balance	-459	-725	-1,606	-893	-1,502	-1,680	-1,596
(In percent of GDP)	-2.5	-3.7	-7.2	-3.6	-5.5	-5.9	-5.2
Capital and financial account	1,950	2,614	3,482	1,465	1,992	2,522	2,071
Overall balance	611	1,344	827	572	599	771	475
(End of period; in millions of U.S. dollars)							
Debt and reserves							
Gross official reserves	3,525	4,704	5,886	6,278	6,639	7,079	7,553
In months of following year's imports of goods and NFS	3.9	4.4	4.4	5.6	5.2	5.0	5.0
Gross usable international reserves 2/	2,629	3,653	4,729	5,038	5,259	5,597	6,072
In months of following year's imports of goods and NFS	2.9	3.4	3.5	4.5	4.1	3.9	4.0
As a percentage of short-term debt 3/	116	156	209	260	203	202	204
External debt service to exports ratio (in percent)	23.5	24.9	27.5	17.4	20.5	20.2	21.2
Public debt (in percent of GDP)	51.1	51.6	51.6	57.2	50.5	51.5	50.7
Of which: External	31.9	31.4	31.7	32.4	29.3	31.5	31.3
Total external debt (in percent of GDP)	59.7	58.0	68.5	59.0	67.3	68.4	67.8

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 liabilities to residents (banks, government).

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

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

Table 2. Croatia: GDP by Expenditure Category, 2000–2004

	2000	2001	2002	2003	2004
				Prog.	Proj.
(Percentage changes)					
Real GDP	2.9	3.8	5.2	4.7	4.5
Domestic demand	-0.3	4.9	9.2	5.3	4.0
Consumption	3.6	2.3	4.7	3.7	1.9
Private 1/	4.2	4.6	6.6	4.7	2.8
Government	2.0	-3.5	-0.5	0.7	-0.9
Gross fixed capital formation	-3.8	9.7	10.1	11.7	11.4
Private 1/	10.0	8.1	8.7	12.4	9.1
Government	-32.9	15.0	14.5	9.5	18.5
Exports	12.0	9.5	3.0	14.5	5.7
Imports	3.7	11.1	11.0	13.7	4.6
(Percentage contributions)					
Real GDP	2.9	3.8	5.2	4.7	4.5
Domestic demand	-0.3	5.1	9.9	5.9	4.5
Consumption	3.0	1.9	3.9	3.0	1.5
Private 1/	2.5	2.7	4.0	2.9	1.7
Government	0.5	-0.8	-0.1	0.2	-0.2
Gross fixed capital formation	-0.9	2.1	2.3	2.8	2.9
Private 1/	1.6	1.4	1.5	2.3	1.8
Government	-2.5	0.7	0.8	0.6	1.2
Change in inventories 2/	-2.4	1.1	3.6	0.0	0.0
Net foreign demand	3.2	-1.4	-4.6	-1.1	0.0
Exports	5.1	4.4	1.4	6.9	2.9
Imports	-1.9	-5.7	-6.1	-8.0	-2.9
(Percentage change in implicit deflators)					
GDP	4.7	2.9	2.9	2.7	3.5
Consumption	4.7	3.3	1.6	2.5	3.5
Private	5.5	4.3	1.7	2.0	3.5
Government	2.8	1.0	1.4	3.8	3.4
Gross fixed capital formation	4.8	2.1	6.5	3.7	3.4
Exports	10.9	2.5	0.2	-1.5	1.7
Imports	10.1	2.3	-0.2	-4.6	1.1
Nominal GDP	152,519	162,909	176,429	189,827	205,313

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

1/ Includes public enterprises.

2/ Includes statistical discrepancy.

Table 3. Croatia: Performance Under the Stand-By Arrangement During the First Nine Months of 2003

		End of			
		March	June	September	
(In millions of kuna, unless indicated otherwise)					
Quantitative performance criteria					
1-a	Cumulative Deficit of the Consolidated Central Government 1/	Program Actual Margin (+)	4,053 3,153 900	6,398 2/ 5,941 457	7,244
1-b	Cumulative Deficit of the Consolidated General Government 1/	Program Actual Margin (+)	4,325 2/ 2,960 1,365	6,615 5,719 896	6,938 2/
2	Reduction of Arrears of the Consolidated Central Government 3/	Program Actual Margin (+)	150 119 -31	300 303 3	450
3	Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 1/ 4/				
					>1 year
		Program Actual Margin (+)	704 513 191	970 757 213	652
					<5 years
		Program Actual Margin (+)	100 0 100	100 25 75	100
4	Cumulative Increases in Short-term External Debt by the General Government, CNB, and HBOR 1/ 4/	Program Actual Margin (+)	120 0 120	0 0 0	0
5	Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 3/ 4/	Program Actual Margin (+)	-120 53 173	-184 111 295	46 5/ 0 -46
6	Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 1/	Program Actual Margin (+)	331 -569 900	2,167 1,264 903	4,885 6/ 4,931 -46
Indicative limits					
1	Consolidated Central Government Wage Bill 1/	Program Actual Margin (+)	4,603 4,660 -57	9,075 9,463 -388	13,600
2	Cumulative Changes in Net Credit of the Banking System to the Consolidated General Governments 1/	Program Actual Margin (+)	-170 -1,733 1,563	-4 -1,131 1,127	-745
3	Cumulative Increases in Net Credit of the Banking System to Selected Public Enterprises 1/	Program Actual Margin (+)	463 -337 800	278 -772 1,050	-550 417 -967
Structural performance criterion					
1	Government to prepare criteria for issuing guarantees by end-March 2003.	Not observed. Done on July 15, 2003.			
Structural benchmarks					
1	Parliament to approve by end-March 2003 a new budget law satisfying the conditions specified in paragraph 16 of the MEFP.	Not observed. Approved by parliament on May 29, 2003.			
2	CNB to issue by end-June 2003 and implement by end-September 2003 a regulation to include options in the calculation of banks' net foreign exchange position.	The regulation took effect on April 1, 2003.			
3	Government to make a decision by end-March 2003 on the bids received for the privatization of INA.	Not observed. A final decision was made in July 2003.			
4	Government to prepare by end-March 2003 a privatization program for HPB that satisfies the conditions specified in paragraph 23 of the MEFP (to be monitored in consultation with the IFC).	Not observed. The government formally invited the IFC to subscribe to 19 percent of HPB's capital with appropriate veto powers on June 10, 2003.			
5	Report data on government guarantees outstanding on September 30, 2003.	Pending.			

Source: Data provided by the Croatian authorities.

1/ Ceiling.

2/ Indicative limits (not a performance criterion).

3/ Floor.

4/ In millions of U.S. dollars.

5/ Adjusted for the shortfall of the INA privatization receipts and funds disbursed by the U.S. Treasury after lifting the freeze on the assets of the National Bank of the former Socialist Federal Republic of Yugoslavia (Table 4, Attachment I of IMF Country Report 03/252).

6/ Adjusted for the shortfall of the INA privatization receipts (Table 4, Attachment I of IMF Country Report No. 03/252).

Table 4. Croatia: Balance of Payments, 2001–2004
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003				2003 Proj.	2004 Proj.
			q1	q2	q3	q4		
Current account	-725	-1,606	-997	-942	1,257	-998	-1,680	-1,596
Merchandise trade	-4,101	-5,279	-1,347	-2,002	-1,970	-1,705	-7,023	-7,245
Exports f.o.b.	4,759	4,995	1,491	1,535	1,604	1,661	6,291	6,765
Ships	283	352	124	71	127	176	499	472
Non-ship exports	4,476	4,642	1,366	1,464	1,478	1,485	5,792	6,293
Imports f.o.b.	-8,860	-10,274	-2,837	-3,537	-3,574	-3,366	-13,314	-14,010
Services and income	2,411	2,597	21	688	2,855	315	3,879	4,103
Transportation	167	141	48	64	98	79	289	289
Travel	2,729	3,030	263	1,210	2,859	399	4,730	5,049
Other services	32	-56	-68	-113	11	-65	-235	-216
Current transfers	966	1,076	328	372	371	393	1,464	1,546
Credit	1,175	1,359	393	449	434	432	1,708	1,616
Debit	-209	-282	-65	-77	-63	-39	-244	-70
Capital and Financial account	2,614	3,482	1,255	1,219	-1,343	1,390	2,522	2,071
Capital account 2/	133	24	6	62	7	7	83	83
Financial account	2,481	3,458	1,249	1,157	-1,350	1,383	2,438	1,987
Direct investment 1/ 2/	1,407	886	302	335	74	610	1,320	1,114
Portfolio investment	601	-260	812	244	-76	89	1,069	180
Medium- and long-term loans	306	662	384	97	-25	504	766	1,363
Assets	41	-46	20	24	0	0	44	0
Liabilities	265	708	364	-121	-25	504	722	1,363
Disbursements 3/	1,765	2,265	849	421	477	887	2,635	3,075
Amortization	-1,501	-1,557	-485	-542	-503	-383	-1,913	-1,712
Currency and deposits	459	1,699	52	206	-319	-33	-94	-261
Short-term capital flows (net)	-420	84	21	-12	-1,103	84	-1,010	-548
Trade credits 4/	129	387	-322	481	99	130	388	139
Net errors and omissions	-545	-1050	-84	13	0	0	-70	0
Overall balance	1,344	827	174	291	-85	392	771	475
Financing	-1,344	-827	-174	-291	85	-392	-771	-475
Gross reserves (= increase)	-1,313	-697	-174	-291	85	-392	-771	-475
IMF (net purchases)	-31	-130	0	0	0	0	0	0
Memorandum Items								
Current account (in percent of GDP)	-3.7	-7.2					-5.9	-5.2
Gross official reserves	4,704	5,886	6,208	6,772	6,687	7,078	7,078	7,553
in months of following year's imports of goods and NFS	4.4	4.4	4.4	4.8	4.8	5.0	5.0	5.1
Net international reserves	4,535	5,858	6,050	6,640	6,519	6,911	6,911	7,386
in months of following year's imports of goods and NFS	4.3	4.3	4.3	4.7	4.6	4.9	4.9	5.0
Gross usable international reserves 5/	3,653	4,729	4,956	5,264	5,209	5,597	5,597	6,072
in months of following year's imports of goods and NFS 5/	3.4	3.5	3.5	3.7	3.7	3.9	3.9	4.1
Net usable international reserves	3,484	4,701	4,798	5,132	5,042	5,430	5,430	5,904
External debt	11,317	15,355	16,996	18,560			19,357	20,662
External debt to GDP ratio	58.0	68.5	70.9	72.5			68.4	67.8
External debt as a percentage of exports goods and NFS	117.5	145.6					138.9	138.5
Short-term debt by residual maturity in percent of gross international usable reserves	64.4	47.9	47.3	45.3			49.6	45.4
External debt service	-2,396	-2,896	-830	-650	-755	-577	-2,811	-3,156
External debt service to exports of goods and NFS ratio	24.9	27.5	36.0	19.0	14.0	20.5	20.2	21.2
GDP (millions of U.S. dollars)	19,503	22,422	6,160	7,032	7,939	7,224	28,287	30,476
GDP (millions of kuna)	162,909	176,429	43,492	46,781	52,133	47,422	189,827	205,313

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

1/ In 2003 excludes debit entry of US\$327.8 million in the item "investment income" in the current account, and offsetting credit entry in the item "FDI-reinvested earnings" of the financial account related to the "distribution" and "reinvestment" of paper income from the revaluation of a patent by a Croatian company (see Appendix IV).

2/ In 2002 excludes a debit entry of US\$419.4 million in the item "direct investment abroad" and an offsetting credit entry in the item "capital transfers" related to the revaluation and transfer of a patent by a Croatian company in exchange for capital in its foreign subsidiary (see Appendix IV).

3/ In Q4 2003 includes disbursement of SAL in the amount of US\$100 million, which is put in an account with the CNB until the beginning of 2004 (and offsetting debit entry in short-term assets).

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

5/ Gross reserves are adjusted downward by foreign currency liabilities to residents (banks, government) and by distributed claims on the central bank of former SFRY.

Table 5. Croatia: Current Account, Foreign Direct Investment and Reinvested Earnings, 2001-2004

	2001	2002				2003				2003	2004	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Proj.	Proj.	
		Prel.		Proj.		Proj.		Proj.				
(In millions of U.S. dollars)												
Current account	-725	-876	-777	1,003	-955	-1,606	-997	-942	1,257	-998	-1,680	-1,596
Merchandise trade balance	-4,101	-1,012	-1,381	-1,411	-1,475	-5,279	-1,347	-2,002	-1,970	-1,705	-7,023	-7,245
Exports f.o.b.	4,759	1,051	1,250	1,319	1,374	4,995	1,491	1,535	1,604	1,661	6,291	6,765
Imports f.o.b.	-8,860	-2,063	-2,632	-2,730	-2,849	-10,274	-2,837	-3,537	-3,574	-3,366	-13,314	-14,010
Services	2,927	114	561	2,177	264	3,115	242	1,161	2,967	413	4,783	5,121
Transportation	167	30	23	49	39	141	48	64	98	79	289	289
Travel	2,729	95	552	2,096	287	3,030	263	1,210	2,859	399	4,730	5,049
Credit	3,335	237	757	2,350	468	3,811	390	1,357	3,147	604	5,498	5,875
Debit	-606	-142	-205	-254	-180	-781	-127	-148	-288	-205	-768	-826
Other services	32	-12	-14	32	-62	-56	-68	-113	11	-65	-235	-216
Income	-516	-218	-219	-60	-21	-518	-221	-473	-111	-98	-904	-1,018
Direct Investment Income	-291	-74	-202	-40	-23	-339	-62	-460	-46	-26	-595	-625
Credit	20	1	3	7	9	20	11	2	8	11	31	32
Debit	-311	-75	-205	-47	-33	-359	-73	-462	-54	-37	-626	-657
of which: reinvested in Croatia	-153	-52	-108	0	-10	-170	-56	-300	0	-10	-366	-370
Interest income	-350	-178	-54	-60	-41	-334	-206	-54	-111	-122	-493	-586
Compensation of employees	125	35	36	40	44	155	47	41	46	50	184	193
Current Transfers	966	240	263	297	277	1,076	328	372	371	393	1,464	1,546
FDI	1,407	224	362	20	280	886	302	335	74	610	1,320	1,114
Abroad	-155	-8	-31	-36	-19	-95	-23	-3	-57	-20	-104	-109
In Croatia	1,561	232	393	57	299	981	325	338	131	630	1,424	1,223
of which: reinvestment in Croatia	153	52	108	0	10	170	56	300	0	10	366	370
Capital transfers	133	6	8	7	3	24	6	62	7	7	83	83
Current account less reinvested earnings	-572	-824	-669	1,003	-945	-1,436	-941	-642	1,257	-988	-1,314	-1,226
Current account +FDI+capital transfers	815	-647	-407	1,030	-672	-696	-689	-545	1,339	-381	-276	-398
(In millions of euros)												
Current account	-804	-1,013	-824	1,035	-950	-1,752	-929	-829	1,107	-884	-1,535	-1,429
Merchandise trade balance	-4,594	-1,170	-1,464	-1,457	-1,467	-5,558	-1,255	-1,762	-1,735	-1,510	-6,261	-6,486
Exports f.o.b.	5,317	1,215	1,325	1,362	1,366	5,269	1,389	1,351	1,413	1,470	5,623	6,056
Imports f.o.b.	-9,911	-2,385	-2,790	-2,819	-2,834	-10,827	-2,643	-3,114	-3,147	-2,980	-11,885	-12,542
Services	3,290	131	594	2,247	263	3,236	226	1,022	2,613	366	4,227	4,585
Transportation	186	35	24	51	38	149	44	57	86	70	257	259
Travel	3,067	110	585	2,164	286	3,144	245	1,065	2,517	354	4,181	4,520
Credit	3,744	274	802	2,426	465	3,967	363	1,195	2,771	535	4,864	5,259
Debit	-677	-164	-217	-262	-179	-823	-118	-130	-254	-181	-684	-740
Other services	36	-14	-15	33	-61	-57	-63	-99	9	-58	-211	-194
Income	-579	-252	-232	-62	-20	-567	-206	-416	-98	-87	-908	-912
Direct Investment Income 1/	-330	-86	-214	-41	-23	-364	-58	-405	-41	-23	-527	-559
Credit	23	1	4	7	9	20	10	2	7	9	28	29
Debit	-353	-86	-217	-48	-32	-385	-68	-407	-48	-33	-555	-588
of which: reinvested in Croatia	-175	-61	-114	0	-10	-184	-32	-264	0	-9	-325	-331
Interest income	-388	-206	-57	-62	-41	-366	-192	-48	-98	-108	-445	-525
Compensation of employees	139	40	39	41	44	163	44	36	40	44	164	173
Current Transfers	1,080	277	279	306	275	1,138	306	327	327	348	1,308	1,384
FDI 1/2	-174	259	383	21	279	942	281	294	65	540	1,181	998
Abroad	-174	-10	-33	-37	-19	-99	-22	-3	-50	-18	-92	-97
In Croatia	0	268	416	58	298	1,041	303	297	115	558	1,273	1,095
of which: reinvestment in Croatia	175	61	114	0	10	184	52	264	0	9	325	331
Capital transfers 2/	152	6	8	8	3	26	6	55	7	6	74	75
Current account less reinvested earnings	-628	-953	-709	1,035	-940	-1,567	-877	-565	1,107	-875	-1,209	-1,097
Current account +FDI+capital transfers	-826	-748	-432	1,064	-668	-784	-642	-480	1,179	-337	-280	-356

Source: CNB, and Fund staff estimates.

1/ In 2003 excludes debit entry of US\$327.8 million in the item "investment income" in the current account, and offsetting credit entry in the item "FDI-reinvested earnings" of the financial account related to the "distribution" and "reinvestment" of paper income from the revaluation of a patent by a Croatian company (see Appendix IV).
 2/ In 2002 excludes a debit entry of US\$419.4 million in the item "direct investment abroad" and an offsetting credit entry in the item "capital transfers" related to the revaluation and transfer of a patent by a Croatian company in exchange for capital in its foreign subsidiary (see Appendix IV).

Table 6. Croatia: External Debt by Domestic Sectors

	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Mar-03	Jun-03	Jul-03	Dec-03 Proj.	Dec-04 Proj.
(in millions of US dollars)											
General Government and HBOR 2/	2,906	3,412	3,975	4,828	5,133	6,361	6,895	7,371	7,367	7,562	8,345
Croatian National Bank	232	233	197	159	122	0	0	0	0	0	0
o/w: IMF	232	233	197	159	122	0	0	0	0	0	0
Banks	2,216	2,492	2,185	2,086	2,299	4,009	4,473	5,002	5,410	5,243	5,196
Other Sectors	2,099	3,546	3,621	3,981	3,763	4,985	5,628	6,186	6,431	6,553	7,121
Total	7,452	9,683	9,978	11,055	11,317	15,355	16,996	18,560	19,208	19,357	20,662
(In percent of GDP)											
General Government and HBOR 2/	14.5	15.8	20.0	26.2	26.3	28.4	24.4	26.1	26.0	26.7	27.4
Croatian National Bank	1.2	1.1	1.0	0.9	0.6	0.0	0.0	0.0	0.0	0.0	0.0
o/w: IMF	1.2	1.1	1.0	0.9	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Banks	11.0	11.5	11.0	11.3	11.8	17.9	15.8	17.7	19.1	18.5	17.0
Other Sectors	10.4	16.4	18.2	21.6	19.3	22.2	19.9	21.9	22.7	23.2	23.4
Total	37.1	44.8	50.1	60.0	58.0	68.5	60.1	65.6	67.9	68.4	67.8
Memorandum item:											
GDP (in millions of US dollars)	20,109	21,628	19,906	18,427	19,503	22,422	23,964	25,598	27,072	28,287	30,476

Source: CNB, and Fund staff estimates.

1/For 2003 - relative to 2003 annual projected GDP.

2/ In Q4 2003 includes disbursement of SAL in the amount of US\$100 million, which is put in an account with the CNB until the beginning of 2004.

Table 7. Croatia: Monetary Accounts, 2001–2004

	2001	2002	2003				2004	2001	2002	2003	2004
			Q1	Q2	Q3	Q4					
					Proj.	Proj.	Proj.			Proj.	Proj.
Monetary Survey	(In millions of kuna, unless indicated otherwise)							(Change in percent)			
Net Foreign Assets	48,661	32,817	32,838	30,298	32,112	34,758	40,393	67.7	-32.6	5.9	16.2
Net Domestic Assets	57,410	83,324	85,953	89,724	98,207	97,569	106,136	30.3	45.1	17.1	8.8
of which: domestic credit	86,257	110,089	114,682	116,816	122,296	124,363	137,818	20.9	27.6	13.0	10.8
to government, net 1/	15,146	16,740	15,949	16,675	17,979	15,882	15,632	6.3	10.5	-5.1	-1.6
to other domestic sectors 2/	71,111	93,349	98,733	100,141	104,318	108,481	122,185	24.6	31.3	16.2	12.6
Broad Money	106,071	116,142	118,791	120,022	130,319	132,327	146,530	45.2	9.5	13.9	10.7
Narrow Money	23,704	30,870	29,512	32,828	35,146	35,952	40,257	31.5	30.2	16.5	12.0
Currency outside banks	8,507	9,681	9,526	10,637	11,388	11,361	12,951	28.2	13.8	17.4	14.0
Demand deposits	15,196	21,189	19,986	22,191	23,758	24,591	27,306	33.4	39.4	16.1	11.0
Quasi Money	82,368	85,272	89,279	87,193	95,173	96,375	106,272	49.7	3.5	13.0	10.3
denominated in kuna	10,531	13,217	15,210	16,089	19,963	20,254	25,995	29.5	25.5	53.2	28.3
denominated in foreign currency	71,837	72,055	74,069	71,104	75,210	76,121	80,277	53.2	0.3	5.6	5.5
Balance Sheet of the National Bank											
Net International Reserves	37,711	41,863	43,345	43,653	42,803	45,368	49,511	39.1	11.0	8.4	9.1
in U.S. dollars	4,535	5,858	6,050	6,640	6,520	6,911	7,386	36.4	29.2	18.0	6.9
less: Banks' foreign currency reserves	5,705	7,042	7,563	7,983	6,173	6,199	6,461	3.9	23.4	-12.0	4.2
CNB bills in foreign currency	2,913	1,226	1,408	1,570	3,165	3,165	3,165	60.7	-57.9	158.1	0.0
Net Usable International Reserves	29,093	33,595	34,375	34,100	33,464	36,004	39,886	46.8	15.5	7.2	10.8
in U.S. dollars	3,484	4,701	4,798	5,132	5,042	5,430	5,904	43.4	34.9	15.5	8.7
Net Domestic Assets	-11,290	-10,567	-12,491	-9,835	-5,962	-7,482	-8,173	-39.4	6.4	29.2	9.2
of which: claims on government (net)	-1,752	-768	-2,857	-2,554	-1,554	-768	-768	-51.4	56.2	0.0	0.0
claims on banks	18	18	14	14	14	18	18	-94.4	-3.4	0.0	0.0
claims on other domestic sectors	229	111	111	102	102	111	111	-20.8	-51.8	0.0	0.0
other items (net)	-6,001	-4,892	-5,861	-4,722	-2,068	-3,095	-4,295	-23.8	18.5	36.7	38.8
less: CNB bills in kuna	3,459	4,986	3,871	2,660	2,440	3,732	3,605	44.4	44.2	-25.1	-3.4
blocked deposits 3/	325	49	27	15	15	15	15	3.3	-84.9	-68.4	0.0
Reserve Money	17,803	23,028	21,884	24,265	27,502	28,522	31,713	51.9	29.3	23.9	11.2
Currency	8,507	9,681	9,526	10,637	11,388	11,361	12,951	28.2	13.8	17.4	14.0
Deposits	9,296	13,347	12,357	13,627	16,114	17,161	18,762	83.0	43.6	28.6	9.3
Memorandum items:											
Nominal GDP (yearly total)	162,909	176,429	179,465	182,834	186,625	189,827	205,313				
Kuna/dollar exchange rate (eop)	8.32	7.15	7.16	6.57	6.57	6.56	6.76				
Narrow money multiplier	1.33	1.34	1.35	1.35	1.28	1.26	1.27				
Velocity of Kuna broad money	4.76	4.00	4.24	3.88	3.44	3.38	3.10				
Broad money/GDP ratio	0.65	0.66	0.66	0.66	0.70	0.70	0.71				
Foreign currency as a percent of broad money	67.7	62.0	62.4	59.2	57.7	57.5	54.8				
NUR in kuna at program exchange rates 4/		34,062	34,465	34,895	34,412	37,220					
NDA of the National Bank at program exchange rates 4/		-11,412	-11,981	-10,630	-6,910	-8,698					

Source: Croatian National Bank and staff projections.

1/ Discrepancy between the bank financing in the fiscal table and the change in the banking sector's credit to the government in 2003Q1 and Q2 is due to the secondary market transaction of government bonds by banks.

2/ Includes net credit to HBOR.

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

4/ 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: Financial Soundness Indicators of the Banking System
(In percent)

	1998	1999	2000	2001	2002	2003	
						Q1	Q2
Regulatory capital to risk weighted assets	12.7	20.6	21.3	18.5	16.6	16.9	16.9
Nonperforming loans to total gross loans	9.3	10.3	9.5	7.2	5.8	5.9	5.4
Loan-loss provisions to nonperforming loans	84.4	78.7	79.8	75.7	68.1	64.5	64.2
After-tax return on average assets	-2.8	0.8	1.2	1.3	1.3	1.7	1.7
Loans to deposits	109.4	110.5	89.6	81.7	90.3	94.5	96.7
Net open position in foreign exchange to capital 1/	...	...	32.5	7.9	10.7	28.9	20.8
Foreign currency deposits to total deposits 2/	...	90.0	91.3	91.2	89.4	88.5	88.0
Foreign currency loans to total loans 2/	...	85.7	85.6	84.9	80.0	77.8	75.8

Source: Croatian National Bank.

1/ From 2003Q1 on, net open position includes foreign currency options.

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

Table 9. Croatia: Debt Stock of Consolidated General Government

	1997	1998	1999	2000	2001	2002	2003 June	2003 Proj.	2004 Proj.
(In millions of kuna)									
Direct Debt Stock	33,052	35,389	46,781	59,864	66,349	71,455	78,373	78,672	85,143
Domestic	15,538	15,159	17,634	22,462	26,128	29,892	33,476	33,170	35,262
External	17,514	20,230	29,147	37,402	40,221	41,564	44,897	45,503	49,880
Guarantees Stock	1,844	8,477	9,849	14,720	16,943	18,778	18,884	18,778	18,778
Arrears Stock	5,192	7,830	8,994	3,296	838	780	437	230	230
Total Debt Stock	40,088	51,695	65,624	77,880	84,131	91,013	97,694	97,680	104,150
(In percent of GDP)									
Direct Debt Stock	26.7	25.7	33.0	39.3	40.7	40.5	41.3	41.4	41.5
Domestic	12.5	11.0	12.5	14.7	16.0	16.9	17.6	17.5	17.2
External	14.1	14.7	20.6	24.5	24.7	23.6	23.7	24.0	24.3
Guarantees Stock	1.5	6.2	7.0	9.7	10.4	10.6	9.9	9.9	9.1
Arrears Stock	4.2	5.7	6.4	2.2	0.5	0.4	0.2	0.1	0.1
Total Debt Stock	32.4	37.6	46.4	51.1	51.6	51.6	51.5	51.5	50.7

Source: Croatian Central Bank, Ministry of Finance, and staff estimates.

Note: Guarantees stock data prior to 2002 was provided by Croatian National Bank and from 2002 by the Ministry of Finance with smaller differences in total stock and larger differences in distribution between domestic and external guarantees. Local government debt stock prior to 2002 was provided by Croatian National Bank and from 2002 by the Ministry of Finance, which records a generally higher level of local government debt.

Table 10. Croatia: Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis, 2001–2004
(In percent of GDP)

	2001 Actual	2002 Actual	2003 Proj.	2004 Proj.
Revenue and grants	44.7	45.2	44.9	44.9
Current revenue	44.7	45.2	44.9	44.9
Tax revenue	41.2	41.1	40.9	41.0
Personal income tax	4.0	4.1	3.9	3.7
Social security contributions	13.2	12.5	12.5	12.5
Profits tax	1.7	2.1	2.3	2.4
Real estate transactions tax	0.4	0.4	0.3	0.3
Taxes on goods and services	19.6	20.7	20.8	21.0
Value-added tax	14.3	14.7	14.8	14.8
Excises	5.1	5.6	5.6	5.9
Other	0.2	0.4	0.3	0.3
Customs duties	2.0	1.2	0.9	0.8
Other	0.4	0.3	0.2	0.2
Non-tax revenue (incl. own revenue)	3.5	4.1	4.0	4.0
Capital revenue	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0
Expenditure and net lending	51.5	50.0	49.5	48.7
Expenditure	50.8	49.3	48.9	48.1
Current expenditure	45.4	43.2	42.5	40.9
Expenditure on goods and services	22.3	20.8	20.2	19.2
Wages excl. employer's contributions	11.7	11.0	10.9	10.1
Other purchases of goods and services	10.6	9.9	9.3	9.1
Interest payments	2.2	2.1	2.2	2.2
Subsidies and other current transfers	20.8	20.3	20.0	19.4
Subsidies	2.7	2.5	2.8	2.7
Current transfers	18.1	17.8	17.2	16.7
Capital expenditure	5.4	6.1	6.4	7.2
Lending minus repayments	0.8	0.7	0.6	0.6
Consolidated general government balance	-6.8	-4.8	-4.6	-3.8
Financing	6.8	4.8	4.6	3.8
Privatization revenues	3.7	1.8	2.1	0.6
Foreign borrowing	2.0	2.8	2.4	2.1
Disbursements	4.9	5.3	3.8	4.6
Amortization	-2.8	-2.5	-1.4	-2.5
Domestic borrowing	1.1	0.2	0.1	1.0
From banking sector	0.7	-1.0	-1.2	-0.1
From non-banking sector	0.4	1.2	1.3	1.1
Bonds, T-bills, and others	0.3	1.2	1.6	1.1
Net change in arrears	-0.9	0.0	-0.3	0.0
Memorandum items (in percent of GDP):				
Primary general government balance	-4.6	-2.7	-2.3	-1.6
Estimated debt stock 2/	51.6	51.6	51.5	50.7

Sources: Ministry of Finance and staff estimates.

1/ Includes the 53 largest local governments.

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

Table 11. Croatia: Consolidated General Government Fiscal Operations by Economic Category on an Accrual Basis
(In millions of kuna)

	2003 Proj.	2003 Q1 Actual	2003 Q2 Actual	2003 Q3 Proj.	2003 Q4 Proj.
Revenue and grants	85,274	18,627	21,094	22,434	23,119
Current revenue	85,274	18,627	21,094	22,434	23,119
Tax revenue	77,682	16,974	19,392	20,451	20,864
Personal income tax	7,387	1,690	1,753	1,829	2,115
Social security contributions	23,725	5,511	5,820	6,060	6,334
Profits tax	4,370	672	1,832	943	924
Real estate transactions tax	624	125	152	156	192
Taxes on goods and services	39,451	8,276	9,593	10,863	10,719
Value-added taxes	28,158	5,986	6,910	7,496	7,766
Excises	10,667	2,155	2,511	3,221	2,780
Other	626	134	172	146	173
Customs duties	1,766	387	406	499	474
Other	358	314	-163	101	107
Non-tax revenue (incl. own revenue)	7,592	1,653	1,702	1,982	2,255
Capital revenue	0	0	0	0	0
Grants	0	0	0	0	0
Expenditure and net lending	93,940	21,587	23,853	23,618	24,882
Expenditure	92,777	21,428	23,546	23,226	24,578
Current expenditure	80,701	19,291	19,692	20,128	21,590
Expenditure on goods and services	38,404	8,550	9,684	9,788	10,383
Wages excl. employer's contributions	20,683	5,043	5,239	5,173	5,228
Other purchases of goods and services	17,721	3,506	4,445	4,615	5,155
Interest payments	4,255	1,680	723	867	985
Subsidies and other current transfers	38,042	9,061	9,284	9,474	10,222
Subsidies	5,367	1,452	1,291	1,328	1,296
Current transfers	32,675	7,609	7,993	8,146	8,927
Capital expenditure	12,077	2,137	3,854	3,098	2,988
Lending minus repayments	1,162	159	307	392	304
Consolidated general government balance (as percent of GDP)	-8,666 -4.6	-2,960 -1.6	-2,759 -1.5	-1,185 -0.6	-1,763 -0.9
Financing	8,666	2,960	2,759	1,185	1,763
Privatization revenues	3,892	174	168	129	3,421
Foreign borrowing	4,576	3,239	1,386	-134	84
disbursements 1/ amortization	7,141 -2,566	3,971 -731	1,974 -587	609 -743	588 -504
Domestic borrowing	198	-453	1,204	1,190	-1,743
From banking sector	-2,219	-1,872	445	1,303	-2,097
From non-banking sector	2,417	1,419	759	-114	354
Bonds, T-bills, and others	2,967	1,538	943	33	454
Net change in arrears	-550	-119	-184	-147	-100

Sources: Ministry of Finance and staff estimates.

1/ Excludes disbursement of second tranche of World Bank's SAL of US\$100 million in the fourth quarter, which is held in an account with the CNB until early 2004.

Table 12. Croatia: Saving-Investment Balances, 2000–2004

	2000	2001	2002	2003 prog.	2004 proj.
(In millions of kuna)					
External saving	3,802	6,056	12,635	11,274	10,750
Domestic saving-investment gap	-3,802	-6,056	-12,635	-11,274	-10,750
Saving	29,472	32,488	38,067	41,933	48,988
Investment	33,274	38,545	50,702	53,207	59,739
Consolidated general government	-8,645	-9,889	-7,195	-7,503	-6,514
Saving 1/	-1,143	-1,082	3,543 ^{5/}	4,573 ^{5/}	8,367 ^{5/}
Investment 2/	7,502	8,807	10,738	12,077	14,882
Non-government sector 3/	4,843	3,833	-5,440	-3,770	-4,236
Saving	30,615	33,570	34,524 ^{5/}	37,360 ^{5/}	40,621 ^{5/}
Investment 4/	25,772	29,738	39,964	41,130	44,857
(In percent of GDP)					
External saving	2.5	3.7	7.2	5.9	5.2
Domestic saving-investment gap	-2.5	-3.7	-7.2	-5.9	-5.2
Saving	19.3	19.9	21.6	22.1	23.9
Investment	21.8	23.7	28.7	28.0	29.1
Consolidated general government	-5.7	-6.1	-4.1	-4.0	-3.2
Saving 1/	-0.7	-0.7	2.0 ^{5/}	2.4 ^{5/}	4.1 ^{5/}
Investment 2/	4.9	5.4	6.1	6.4	7.2
Non-government sector 3/	3.2	2.4	-3.1	-2.0	-2.1
Saving	20.1	20.6	19.6 ^{5/}	19.7 ^{5/}	19.8 ^{5/}
Investment 4/	16.9	18.3	22.7	21.7	21.8
Memorandum items					
GDP at current prices (millions of kuna)	152,519	162,909	176,429	189,827	205,313
Gross national disposable income at current prices (millions of kuna)	156,463	166,661	180,570	192,102	207,224
Consolidated general government	36,211	35,323	40,269	42,977	47,754
Non-government sector	120,252	131,338	140,300	149,125	159,470

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

1/ Current revenue minus current expenditure.

2/ Excludes net lending.

3/ Includes public enterprises.

4/ Includes change in inventories.

5/ The introduction of the second pillar of the pension system has reduced government saving (and correspondingly increased non-government saving) by 1 percent of GDP in 2002 and 1.3 percent of GDP thereafter.

Table 13. Croatia: Conditionality Under the Stand-By Arrangement During the Fourth Quarter of 2003 1/

1. Prior actions		
1. Government to receive the proceeds of the partial privatization of INA (LOI, para. 5).		
2. CNB to ask banks to report on their ten largest customers' foreign exchange exposure (LOI, para. 14).		
3. Government to place the proceeds from the second-tranche SAL disbursement in a foreign currency account with the CNB until early 2004 (LOI, para. 5).		
4. Government to send a revised mandate letter to the IFC requesting the latter to conduct due diligence of HPB with a view to subscribing to 19 percent of HPB's capital (LOI, para. 16).		
2. Quantitative performance criteria 2/		December 31, 2003
		(In millions of kuna, unless otherwise specified)
1-a. Cumulative Deficit of the Consolidated Central Government 3/		9,274 4/
1-b. Cumulative Deficit of the Consolidated General Government 3/		8,692
2. Cumulative Reduction of Arrears of the Consolidated Central Government 5/		550
3. Cumulative Increases in the Contracting and Guaranteeing of Nonconcessional External Debt by the General Government, CNB, and HBOR 3/ 6/ 7/	>1 year	968
	<5 years	100
4. Cumulative Increases in Short-term External Debt Disbursed by the General Government, CNB, and HBOR 3/ 6/		--
5. Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 5/ 6/		398 8/
6. Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 3/		3,342 9/
3. Indicative limits		
1. Consolidated Central Government Wage Bill 2/		18,005
2. Cumulative Changes in Net Credit of the Banking System to the Consolidated General Governments 2/		455
3. Cumulative Increases in Net Credit of the Banking System to Selected Public Enterprises 2/		-415
4. Structural benchmarks		
1. Report data on government guarantess outstanding on December 31, 2003.		
2. Obtain IFC Board approval to subscribe to 19 percent of HPB's capital by December 31, 2003.		
<hr/>		
1/ The continuous performance clauses remain as in the MEFP, paragraph 26 and Annex II.		
2/ As agreed during the first program review (Table 3, Attachment I of IMF Country Report 03/252).		
3/ Ceiling.		
4/ Indicative limit (not a performance criterion).		
5/ Floor.		
6/ In millions of U.S. dollars.		
7/ Cumulative increases from June 30, 2003.		
8/ Adjusted for the excess of the INA privatization receipts and for funds disbursed by the U.S. Treasury after lifting the freeze on the assets of the National Bank of the former Socialist Federal Republic of Yugoslavia (Table 4, Attachment I of IMF Country Report 03/252).		
9/ Adjusted for the excess of the INA privatization receipts (Table 4, Attachment I of IMF Country Report 03/252).		

Table 14. Croatia: Schedule of Purchases Under the Stand-By Arrangement

Date	Amount of Purchase ^{1/}		Conditions
	In millions of SDRs	In percent of quota	
November 12, 2003 ^{2/}	102.229	28.0	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 and completion of the third review.
Total 14-month SBA	105.880	29.0	

^{1/} Assuming maximum approved access. The authorities plan to treat the arrangement as precautionary and do not intend to make any purchases.

^{2/} Includes access that had been approved earlier in the program, but not drawn.

Table 15. Croatia: Projected Payments to the Fund as of September 30, 2003 Under Obligated Repurchase Schedule
(In millions of SDRs)

	2003 Oct-Dec	2004	2005	2006	2007	2008	2009	2010	2011	2012	Beyond	Total
Obligations from existing drawings												
Principal												
GRA Repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Charges and Interest 1/												
Periodic Charges	0.0	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	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	-6.3	0.0
Total obligations	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	-6.3	0.0
(percent of quota)	0.0	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	-1.7	0.0
Obligations from prospective drawings												
Principal												
GRA Repurchases	0.0	0.0	0.0	0.0	52.5	52.9	0.5	0.0	0.0	0.0	0.0	105.9
Charges and Interest 1/												
Periodic Charges	0.5	2.2	2.2	2.2	1.8	0.7	0.0	0.0	0.0	0.0	0.0	9.7
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	0.0
Total obligations	0.5	2.2	2.2	2.2	54.3	53.7	0.5	0.0	0.0	0.0	0.0	115.6
(percent of quota)	0.1	0.6	0.6	0.6	14.9	14.7	0.1	0.0	0.0	0.0	0.0	31.7
Cumulative (existing and prospective)												
Principal												
GRA Repurchases	0.0	0.0	0.0	0.0	52.5	52.9	0.5	0.0	0.0	0.0	0.0	105.9
Charges and Interest 1/												
Periodic Charges	0.7	2.8	2.9	2.9	2.5	1.4	0.7	0.7	0.7	0.7	-6.3	9.8
SDR Net Charges	0.5	2.2	2.2	2.2	1.8	0.7	0.0	0.0	0.0	0.0	0.0	9.7
SDR Net Charges	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	-6.3	0.0
Total obligations	0.7	2.8	2.9	2.9	55.0	54.4	1.1	0.7	0.7	0.7	-6.3	115.6
(percent of quota)	0.2	0.8	0.8	0.8	15.1	14.9	0.3	0.2	0.2	0.2	-1.7	31.7

Source: IMF Finance Department

1/ The GRA basic rate of charge of 2.11 percent is computed by applying a factor of 1.3200 to the SDR interest rate of 1.54 percent. It is then increased by 0.01 percent for burden sharing and furthermore by 0.07 percent for the SCA for a total rate of 2.11 percent.

Table 16. Croatia: Indicators of Capacity to Repay the Fund, 2003–2010
(Under obligated repurchase schedule)

	2003	2004	2005	2006	2007	2008	2009	2010
	Oct-Dec							
Fund repurchases and charges 1/								
In millions of SDRs	0.7	2.8	2.9	2.9	55.0	54.4	1.1	0.7
In millions of US dollars	0.9	4.0	4.0	4.0	75.9	75.0	1.6	0.9
In percent of exports of goods and NFS	0.0	0.0	0.0	0.0	0.4	0.4	0.0	0.0
In percent of debt service	0.0	0.1	0.1	0.1	2.0	1.7	0.0	0.0
In percent of quota	0.2	0.8	0.8	0.8	15.1	14.9	0.3	0.2
In percent of gross official reserves	0.0	0.1	0.0	0.0	0.8	0.8	0.0	0.0
Fund credit outstanding (e.o.p.) 1/								
In millions of SDRs	102.2	105.9	105.9	105.9	53.4	0.5	0.0	0.0
In millions of US dollars	142.0	147.0	146.5	146.4	73.7	0.6	0.0	0.0
In percent of quota	28.0	29.0	29.0	29.0	14.6	0.1	0.0	0.0
In percent of GDP	0.5	0.5	0.4	0.4	0.2	0.0	0.0	0.0
In percent of gross official reserves	2.0	1.9	1.8	1.7	0.8	0.0	0.0	0.0
Memorandum items								
Exports of goods and NFS (millions of US dollars)	13,937	14,917	15,591	16,534	17,553	18,661	19,841	21,096
Debt service (millions of US dollars) 1/	-2,812	-3,160	-3,021	-3,590	-3,880	-4,366	-4,930	-5,915
Quota (millions of SDRs)	365	365	365	365	365	365	365	365
Quota (millions of US dollars)	507	507	505	505	504	504	504	504
Gross official reserves (millions of US dollars) 1/	7,220	7,558	8,309	8,868	9,461	9,799	9,342	8,467
GDP (millions of US dollars)	28,287	30,476	32,783	35,160	37,750	41,224	44,487	48,210

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

1/ Including the hypothetical purchases under the proposed precautionary stand-by arrangement, not shown in balance of payments projections (see Table 14).

Table 17. Croatia: Indicators of External and Financial Vulnerability, 1998–2003
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	Date
						Latest Figure	
External indicators							
Real effective exchange rate (using retail prices) 1/, 1995=100	101.0	97.0	98.9	103.2	103.7	103.3	Jul-03
Export of goods and services (percentage change in U.S.\$, yoy) 2/	6.5	-5.0	6.7	11.2	9.5	41.5	Jun-03
Import of goods and services (percentage change in U.S.\$, yoy) 2/	-7.4	-7.1	-2.0	12.6	17.6	31.6	Jun-03
Current account deficit (U.S.\$ million, yoy)	-1,453	-1,397	-459	-725	-1,606	-942	Jun-03
Current account deficit (yoy) in percent of GDP 3/	-6.7	-7.0	-2.5	-3.7	-7.2	-3.3	Jun-03
Capital and financial account (yoy) in percent of GDP 3/	7.5	11.9	10.6	13.6	15.5	4.3	Jun-03
Gross official reserves (U.S.\$ million)	2,816	3,025	3,525	4,704	5,886	6,624	Aug-03
Gross official reserves in percent of broad money (M4)	31	41	39	37	36	36	Aug-03
Gross official reserves in percent of reserve money	177	224	245	221	183	175	Aug-03
Gross official reserves in months of imports of goods and NFS	3.2	3.7	4.4	5.2	5.6	5.1	Aug-03
Net international reserves (U.S.\$ million)	2,581	2,807	3,325	4,535	5,858	6,457	Aug-03
Net international reserves in months of import of goods and NFS	2.9	3.5	3.7	4.3	5.5	5.0	Aug-03
Short-term debt in percent of gross usable reserves 4/ 5/ 6/ 7/	70.9	80.7	86.4	64.1	47.9	45.3	Jun-03
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 8/	69.9	52.9	60.5	82.2	55.5	57.2	Jun-03
Total external debt, percent of GDP 9/	44.3	49.6	60.0	58.0	68.5	72.5	Jun-03
External debt service to export ratio 10/	13.6	21.1	23.8	24.9	27.5	23.5	Jun-03
Financial indicators							
General government debt (including arrears and guarantees) in percent of GDP 3/	37.6	46.4	51.1	51.6	51.6	51.5	Jun-03
domestic debt in percent of GDP 3/	16.7	18.8	19.1	20.2	19.9	20.2	Jun-03
foreign debt in percent of GDP 3/	20.9	27.5	31.9	31.4	31.7	31.3	Jun-03
Broad money (M4, percentage change, yoy)	13.0	-1.2	28.9	45.2	9.5	12.3	Aug-03
Claims on other domestic sectors (change, yoy)	22.4	-6.5	9.5	24.6	31.3	20.8	Aug-03
35-day CNB-bill yield, monthly average, percent	9.5	10.5	6.7	3.4	2.4	2.5	Aug-03
35-day CNB-bill real yield, percent 11/	3.9	5.8	-0.7	0.8	0.2	0.8	Aug-03
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	712	715	890	1,035	1,173	1,093	Sep-03
Zagreb Stock Exchange, capitalization, percent of GDP	13	13	15	16	22	28	Sep-03
Bond yield spreads (EMBI Global, e.o.p.)	...	407	330	187	132	115	Sep-03
Debt ratings: Moody's:							
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Sep-03
Government bonds, domestic currency	...	Baa1	Baa1	Baa1	Baa1	Baa1	Sep-03
Foreign debt ratings							
Fitch: Local currency LT	A-	BBB	BBB	BBB+	BBB+	BBB+	Sep-03
Fitch: Foreign currency LT	BBB-	BB+	BB+	BBB-	BBB-	BBB-	Sep-03
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	Sep-03
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	Sep-03

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

1/ An increase in the index reflects a depreciation; end-year figures indicated annual average.

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

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

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

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

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

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

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

9/ Using the average exchange rate for the period, annualized for quarters.

10/ Annualized for quarters.

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

Table 18. Croatia: External Financing Requirements, 2001–2007
(In millions of U.S. dollars)

	2001	2002	2003Q1	2003Q2 Prel.	2003Q3 Proj.	2003Q4 Proj.	2003 Proj.	2004 Proj. 2005	Proj.	2006 Proj.	2007 Proj.
Gross Financing Requirements	3,823	4,634	1,737	1,775	-759	1,784	4,537	4,405	4,470	4,656	4,788
Current account	725	1,606	997	942	-1,257	998	1,680	1,596	1,542	1,447	1,328
Medium and long term debt amortization	1,754	2,201	566	542	583	394	2,085	2,334	2,173	2,649	2,815
Public sector	408	711	133	68	146	84	431	951	855	1,124	1,125
Portfolio -debt	253	554	81	0	81	0	161	586	732	791	562
Medium and long term loans	155	157	53	68	65	84	270	365	123	333	562
Banks	617	545	200	242	136	28	606	404	627	450	517
Portfolio-debt	0	0	0	0	0	0	0	0	0	0	0
Medium and long term loans	617	545	200	242	136	28	606	404	627	450	517
Other sectors	729	945	232	232	301	283	1,048	979	691	1,075	1,174
Portfolio -debt		91	0	0	0	11	11	35	0	42	207
Medium and long term loans	729	854	232	232	301	271	1,036	943	691	1,034	967
Gross reserves accumulation	1,313	697	174	291	-85	392	771	475	755	560	645
IMF repurchases and repayments	31	130	0	0	0	0	0	0	0	0	0
Available Financing	3,823	4,634	1,737	1,775	-759	1,784	4,537	4,405	4,470	4,656	4,788
Direct investment (net)	1,407	886	302	335	74	610	1,320	1,114	1,166	1,513	1,606
Medium and long term debt disbursements	2,748	3,320	1,593	645	482	987	3,707	3,877	3,284	3,027	3,070
Public sector 1/	1,308	757	576	279	126	362	1,344	1,806	1,584	1,377	1,220
Portfolio	983	209	542	212	0	0	754	552	500	500	500
Medium and long term loans 2/	325	547	34	67	126	362	590	1,255	1,084	877	720
Banks	750	611	451	48	50	50	598	501	600	600	800
Other sectors	690	1,953	566	318	307	574	1,765	1,570	1,100	1,050	1,050
Portfolio	0	846	202	12	5	100	319	250	100	150	150
Medium and long term loans	690	1,107	364	306	302	474	1,446	1,320	1,000	900	900
Short term financing (net) 3/	-384	471	-301	469	-1,004	214	-622	-409	-63	33	29
Other flows (net) 4/	51	-43	144	326	-312	-26	132	-177	83	83	83

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

1/ Includes General Government and HBOR.

2/ Excluding the IMF. In Q4 2003 includes disbursement of SAL in the amount of US\$100 million, which is put in an account with the CNB until the beginning of 2004.

3/ Short term loans and trade credits with original maturity less than one year.

4/ Includes all other flows and errors and omissions.

CROATIA—FUND RELATIONS
(As of October 1, 2003)

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

II. General Resources Account:	<u>SDR million</u>	<u>% Quota</u>
Quota	365.10	100.00
Fund holdings of currency	364.94	99.96
Reserve position in Fund	0.16	0.04

III. SDR Department:	<u>SDR million</u>	<u>% Allocation</u>
Net cumulative allocation	44.21	100.00
Holdings	0.52	0.46

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

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

VI. Projected Obligations to Fund (SDR million; based on present holdings of SDRs)^{1/}:

	<u>Forthcoming</u>				
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.17	0.68	0.68	0.68	0.68
Total	0.17	0.68	0.68	0.68	0.68

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

VII. Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Croatian National Bank (CNB) is subject to an assessment with respect to the present arrangement (see Section X). A full safeguards assessment of the CNB was completed on January 3, 2003. The assessment concluded that safeguards in place at the CNB appear generally adequate. However, certain weaknesses were identified in the internal audit and control systems, and the safeguards assessment recommended corrective actions to

address them, as reported in paragraph 27 of IMF Country Report No. 03/27. These recommendations have been implemented by the CNB except for the one aiming at the periodic reconciliation of monetary data reported to the Fund for monitoring program performance with the CNB's audited financial and accounting records. This proposed remedy was rated of "low" importance in the safeguards assessment report.

VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with occasional participation of the CNB. 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 CNB transacts only in euros, U.S. dollars, and SDRs. On October 1, 2003, the official exchange rate was kuna 6.4826 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

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

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

On August 1, 2003 Directors completed the first review under the 14-month **stand-by arrangement** for an amount equivalent to SDR 105.88 million (29 percent of quota), which was approved on February 3, 2003. The authorities intend to treat the arrangement as precautionary. Directors commended the generally satisfactory observance of quantitative performance criteria in the first half of 2003, but regretted the slow implementation of structural measures. They expressed their confidence that the stabilization of the public debt ratio, which was the principal objective of the program, was now within reach. However, they were concerned about the sharp deterioration of the external position.

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

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

XI. FSAP Participation:

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

XII. Technical Assistance 2000–2003: ^{2/}

Department	Timing	Purpose
FAD	April 2000 May 2000 September 2001 March 2002	Implementation of Single Treasury Account Tax Policy Fiscal Decentralization Accounting and Budgetary Classification (with STA)
STA	March 2000 September 2000 October 2000 April 2001 March 2002 October 2002	Quarterly National Accounts Balance of Payments Quarterly National Accounts Monetary Statistics Accounting and Budgetary Classification (with FAD) Government Finance Statistics
MFD	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and

March-April 2001	Money and Securities Markets
December 2001	Central Bank Accounting
April 2003	Monetary Policy Instruments
	Stress Testing and Foreign Exchange Reserve Management
February 2004	Monetary Policy Instruments (forthcoming)

2/ Technical assistance during 1992-1999 is listed in Appendix I of IMF Country Report No. 03/27.

XIII. Resident Representative:

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

CROATIA: WORLD BANK RELATIONS

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 since 2000 embarked on reforms to address several key economic challenges, including: (i) reducing macroeconomic imbalances to ensure stability while introducing complementary reforms to address underlying structural causes of fiscal imbalances; (ii) increasing the flexibility of the economy; and (iii) creating a business-friendly environment that is conducive to attracting investment.

2. The IMF has taken the lead in assisting Croatia in maintaining macroeconomic stability. A 14-month stand-by arrangement expired on May 18, 2002, while in February 2003 the IMF approved a successor 14-month SDR 105.8 million (US\$146 million) stand-by arrangement to buttress macroeconomic stability in the run up to parliamentary elections that will be held in November 2003. The IMF and World Bank staffs maintain a close collaborative relationship in supporting the Government's structural reforms. Thus, structural measures in both programs were closely coordinated with the World Bank and were limited to areas with significant macroeconomic, typically fiscal, implications.

3. The World Bank has taken the lead in policy dialogue on structural and institutional reforms in a number of sectors. This reform agenda includes measures to: (i) reduce the level of public expenditures and the size of the state; (ii) restructure the pension and health sectors; (iii) enhance labor market flexibility; (iv) strengthen market institutions and the competitiveness of the economy; (v) mitigate the social cost of reforms and poverty through restructuring of social welfare programs; and (vi) begin the process of judicial reform. Progress is being made in all of these areas. A US\$202 million Structural Adjustment Loan (SAL) was approved by the World Bank Board in December 2001 and the first tranche was disbursed in February 2002. Based on the Government Cabinet Decision on March 27, 2003 stipulating a detailed plan of implementation for remaining SAL-supported measures, the World Bank approved an extension of the SAL closing date to July 31, 2003. Since the Parliament rescheduled amendments of the Spatial Planning Law to abolish location permits for the autumn regular session, the SAL closing date was subsequently extended to October 31, 2003. Although funds will be available in October, the Government plans to disburse the SAL second tranche only in January 2004.

4. A Public Expenditure and Institutional Review (PEIR) was completed in March 2002. The PEIR and SAL were key elements of the Bank's assistance strategy in the 1999 Country Assistance Strategy (CAS). A Country Economic Memorandum (CEM) focusing on European Integration issues has been published in July 2003, followed by disseminations of the main findings and policy recommendations to the Government and broader public in Zagreb as well as to the European Commission in Brussels in mid-September.

5. The findings of the CEM will underpin the design of a new CAS with a tentative Board date in April 2004. A high-case scenario is likely to be centered on a potential successor adjustment loan, a Programmatic Adjustment Loan (PAL). Preliminary work is underway in designing this potential loan, which will have 3 components: (i) governance (public administration reform, legal and judiciary reform, decentralization, and public expenditure management); (ii) investment climate (preparation of energy sector for EU integration, restructuring/privatization of agro-combinates, tourist companies and shipyards, continued reduction of barriers to entry of new firms, continued tightening of financial discipline of state enterprises); (iii) building human capital and strengthening social protection (education, health and social protection reforms). The earliest Board date for the PAL would be April 2004, together with the new CAS.

The IMF/WB Collaboration in Specific Areas

- ***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 general government fiscal operations; (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. The Bank has taken the lead in dialogue on these reforms in the context of the SAL. The 2002 Budget was based on the new chart of accounts, which consolidated some of the extrabudgetary funds and followed modified commitment-based accounting consistent with the methodology of GFS 2001. The 2003 Budget broadened this coverage to include all extrabudgetary funds and is consolidated with off-budget agencies. The Parliament adopted a new organic budget law, which addresses all of the issues raised in the paragraph above, in May 2003.

7. Subsidies' statistics and the methods of subsidization were rather vague prior to 2002. Substantial progress has been made under the SAL program and Stabilization and Association Agreement with the EU. The Government has eliminated all indirect subsidies; Parliament passed an EU-adjusted Law on State Aid as well as established a body for monitoring all state aid. At the end of 2001, the Government drafted a subsidies reduction action plan for 2002–2005 that has been applied in the outturn of the 2002 Budget as well as in the 2003 Budget. In addition, the Government has compiled a registry of farmers to facilitate the provision of income support subsidies. The latter is supported by the Bank through the Farmer Support Services Project.

- ***Pension and health reform***

8. The Bank has taken the lead role in supporting pension reform measures under the Pension System Investment Project and the SAL. A multi-pillar pension system was

established in January 2002. Implementation has been fully satisfactory. Further reforms included revision of the Pension Insurance Act in December 2002 that further strengthened fiscal sustainability of the first pillar and enhanced the equity aspect. In addition, the legal framework for establishment of pension insurance companies, licensing of voluntary pension funds and development of voluntary pension schemes, as well as improving the Law on Mandatory and Voluntary Pension Funds have created the basis for the safe development of the second and third pillars.

9. Croatia spends about 9 percent of its GDP on health, a level that is not sustainable. A number of structural reform measures, including use of alternative care settings, different primary care models, and improved hospital management practices, are being piloted in Koprivnica with the World Bank Health Reform Project. The SAL-supported agenda was completed in August 2002 (this 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). A Law on Obligatory Contributions Payment passed the Parliament in December 2002 that complements the aforementioned measures by: raising the minimum contribution base and broadening the contribution base to non-wage income (excluding capital income); establishing a contribution cap; and improving enforcement responsibilities.

- *Enhancing labor market flexibility*

10. 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 benefits. Thanks to these changes there are presently eight newly established private employment agencies and six additional ones applied for permission to operate. Furthermore, in order to improve the quality of labor market information the Croatian Employment Service started to classify the newly registered unemployed according to the ILO definition of unemployment. As a result, administrative data on unemployment better reflect actual labor market conditions and therefore will become more suitable for policy purposes.

11. The new Labor Law was enacted by Parliament in July 2003. The changes aiming to improve labor market flexibility are consistent with those agreed under the SAL. The most important changes include: (a) relaxing restrictions on the use of fixed-term contracts from 2 to 3 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.

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

12. 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 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 this regard, the elimination of arrears and barter of public enterprises is being monitored by the Bank as part of the SAL. Despite a significant decrease in arrears by the end of June 2003, overdue receivables and liabilities have not yet been eliminated.

13. 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. Progress in privatizing the two remaining state-owned banks and the Croatia insurance company has been slow. The Bank has also played the lead role in assisting the Government in power sector restructuring, and strengthening the regulatory and legislative framework. Progress is being slower than originally envisaged; these reforms will likely be continued under the successor adjustment operation (PAL).

14. Within the context of the SAL, amendments to the bankruptcy law were adopted in July 2003 that improved the legal and institutional framework for Croatia's bankruptcy regime, including certification of receivers (trustees). Reforms are still needed to address: outdated court and case management; inexperience of commercial judges, trustees and receivers in the modern bankruptcy regime; inadequate trust by businesses in the bankruptcy process; and lack of confidence by the population in the efficiency of the overall judiciary system. The Bank is now providing technical assistance to the Government (in cooperation with USAID and EU) in this area through the Court and Bankruptcy Administration Project.

15. The emergence and development of SMEs in Croatia has been stifled by, among other problems: difficulties and complexities in business licensing and registration (identified by the FIAS study on Administrative Barriers to Investments), other barriers for investment (ineffective land register and cadastre, long delays in granting visas and work permits), and the lack of a well-coordinated and articulated pro-SME policy in the country. The Government designed an Action Plan, in accordance with the SAL, that aimed to improve Croatia's investment policy regime by bringing the fiscal, regulatory and legal policy framework in line with best international practice. At the moment, only one legislative change is pending approval: abolishing location permits (adoption of the Law on Spatial Planning is planned by mid-October 2003).

- ***Strengthening Social Protection***

16. Despite relatively high levels of social spending, the social protection system fails to provide adequate protection to the most vulnerable members of society. While the system suffers from a multiplicity of benefits, a few programs that are well targeted do not receive

sufficient funding. As a result, the overall objective of poverty alleviation is inefficiently addressed. Under the reform program supported by the SAL the Government adopted a National Strategy for Combating Poverty that lays out a coordinated strategy across the range of Government agencies to reduce poverty; in October 2001 the Government took steps in rationalizing social benefits (in particular of war veterans and privileged pensioners, as well as child benefit receivers); also, the official statistics improved the availability of reliable and nationally representative household survey data by using the 2001 national census data to adjust the survey sample. Consultant teams working with the Government (within the context of the Bank-financed Social Protection Project) have finalized a Social Welfare Reform Strategy. The Strategy is pending adoption of the Government and Parliament.

World Bank Group Strategy and Lending Operations

17. 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 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.

18. Currently, there are eleven Bank active projects (10 investment loans and 1 adjustment operation) totaling US\$644.6 million in Croatia: the Reconstruction Project for Eastern Slavonia, Baranja and Western Srijem (US\$40.6 million) became effective in January 1999; the Municipal Environmental Infrastructure Project (US\$36.3 million) and the Railway Modernization and Restructuring Project (US\$101 million) became effective in June 1999; Technical Assistance II (US\$7.3 million) in August 1999 and the Health System Project (US\$29 million) in March 2000. The Trade and Transport Facilitation in Southeast Europe (US\$13.9 million) became effective in May 2001; the Court and Bankruptcy Administration Project (US\$5 million) became effective in January 2002, and the SAL (US\$202 million) became effective in February 2002. Two new loans became effective in February 2003: the Pension System Investment Project (US\$ 27.3 million) and the Real Property Registration and Cadastre (US\$ 25.7 million), while the Rijeka Gateway Project (US\$ 156.5 million) was signed in July 2003. A GEF-financed US\$5 million grant for the Karst Ecosystem Conservation Project was signed on June 19, 2002.

19. Investment projects currently under preparation include: the Coastal Cities Pollution Control Project (approximately US\$100 million), the District Heating Project (approximately US\$30 million), the Social Protection Project (approximately US\$36 million), the Social and Economic Recovery Project (approximately US\$40 million), the Energy Efficiency Project (approximately US\$5 million); and the Science and Technology Project (approximately US\$42 million). A GEF-financed US\$7 million grant for the Energy Efficiency Project is under preparation.

20. As of September 2003, the IFC had 11 projects to 7 different entities in its portfolio for a total of US\$186.8 million (US\$153.2 million for its own account). The IFC is currently pre-appraising 19 percent of pure existing equity financing of Croatian postal bank (HPB).

Questions may be referred to the following Bank staff: Mr. Broadman (ext. 31312), Mr. Courtney (385 1 235 7215), Ms. Madzarevic-Sujster (385 1 235 7260), and Mr. Funck (ext. 30874).

CROATIA: STATISTICAL ISSUES

1. The economic database in Croatia is of mixed, though improving, quality. Data on monetary aggregates have the least problems and are close to meeting the recommendations of the IMF Monetary and Financial Statistics Manual. In other areas, major deficiencies impact adversely the reliability and timeliness of macroeconomic analysis. In most cases, remedial action has been taken to improve data coverage and reliability. But, in some instances, progress has been impeded by insufficient budgetary support and lack of cooperation between government agencies. The recent creation of a joint committee between the Ministry of Finance and the Croatian National Bank (CNB) should promote collaboration in the statistical area to advance the reconciliation of government finance and monetary data. Croatia has subscribed to the SDDS and its metadata are posted on the DSB (http://dsbb.imf.org).

A. National Accounts

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

B. Prices

3. The CBS produces monthly indices of retail and producer prices, and a monthly cost of living index based on the consumption basket of a typical low-income, non-farm household. Data are collected around the 20th day of each month, and the indices are released on the last working day of the month. However, price statistics are calculated using outdated weights on the basis of a small sample of observations. No import or export price deflators are produced, thereby hindering analysis of external sector developments. A new consumer price index will be released in April 2004. The main characteristics of the new index will be: a) its weighting structure, based on the household survey (rather than on the retail survey, as

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

C. Wages and Employment

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

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

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 budgetary funds. Expenditure data on a cash basis are available according to GFS methodology (economic and functional classification) for the central budget and the budgetary funds. A new chart of accounts has been used to develop the budget for part of general government entities since 2002. From 2002 budget users’ “own revenues,” excluding universities, have been brought into the 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 methodologies and definitions of government by the Ministry of Finance and the CNB. Following the recommendations of the October 2002 GFS mission, a task force, comprising staff from MOF, CNB, and CBS was formed to reconcile central government financing data produced by these institutions. However, the task force has not met yet and only irregular meetings were held between the staffs of the MOF and CNB to try to reconcile fiscal and monetary data.

7. Data on the stock of government debt suffer from certain deficiencies although a new CNB database represents a major improvement. The detailed data on domestic public bonds published in the Monthly Statistical Review of the Ministry of Finance are now augmented by a central government debt table in the CNB Monthly Bulletin, which also reports stocks of central government guaranteed debt. The Ministry of Finance prepared a database with government guarantees in July 2003, which will be used to monitor developments in the stock and flows of guarantees. However, the Ministry of Finance have temporarily ceased to publish the Monthly Statistical Review and it has not been published since April 2003. In addition, data on expenditure arrears—formally recorded for the first time at the end of 1999—promissory notes and receivable issues linked to banks privatization are not included.

8. Data on the operations of local governments and consolidated general government are available only on a quarterly basis and with a considerable lag. The Ministry of Finance regularly reports monthly data for publication in the *IFS* and annual data for publication in the *GFS Yearbook*.

E. Monetary Data

9. Data on the monetary survey (including separate records for deposit money banks) and the balance sheet of the CNB are published monthly with four and two week lags, respectively, meeting the SDDS requirement. Key data such as currency in circulation, reserve deposits, and international reserves of the CNB are available on request with a one-day lag. A statistical reporting system which enables banks to report in a single set of forms their balance sheets and income statements was introduced on July 1, 1999, together with a new chart of accounts. In January 2004, the CNB plans to introduce new statistical report forms and a new chart of account for banks, reflecting the recommendations of the July 2001 monetary and financial statistics mission on accrued interests and the IAS 39 requirements.

10. Following the recommendations of the monetary and financial statistics mission that visited Croatia in 2001, attempts have been made by the CNB and the Ministry of Finance to reconcile the monetary statistics and the government finance statistics. However, data from the CNB on net credit to government continue to be inconsistent with the Ministry of Finance's data on the financing of government from the CNB. It should be noted that the Croatian Bank for Reconstruction and Development (HBOR) is included in the data on government in monetary statistics, but not in the fiscal data compiled by the Ministry of Finance. In line with the guidelines of the *Monetary and Financial Statistics Manual*, the 2001 mission recommended that the HBOR be treated as an *other financial intermediary* within the other financial corporations subsector for monetary statistics purposes; the CNB is considering this.

11. As a subscriber to the SDDS, Croatia regularly disseminates the information on its international reserves and foreign currency liquidity in a template according to the IMF methodology. The data are disseminated monthly on the IMF and CNB external websites. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies. In March 2002, the CNB started to collect

financial information (balance sheets and investment structure) from investment and pension funds; the data are not yet published, but used for internal purposes. However, the CNB's *Monthly Bulletin* (no. 83) informed the public on the *other financial corporations'* development in the financial system and presented selected aggregate data (e.g., net assets of investment and pension funds). According to the CNB, the inclusion of other financial corporations in monetary statistics depends on the harmonization process of the Croatian monetary statistics with the statistical reporting requirements of the European Central Bank.

F. Banking Statistics

12. Banks' lending and deposit rates are published monthly in the CNB Monthly Bulletin. In January 2002, rates on interbank loans and loans of banks to the central government, which carried lower rates, were excluded. Thus, the average rate has increased, reflecting mainly rates on overdrafts for households and enterprises. In addition, prior to January 2002, saving banks' rates on loans and deposits were not included. These changes have introduced a break in the time series for banks' lending and deposit rates.

G. Balance of Payments Data

14. Balance of payments data are compiled on a quarterly basis according to the fifth edition of the IMF's *Balance of Payments Manual*, and published by the CNB making use of information from commercial banks, the CNB, and the Ministry of Finance, among other entities. The data are generally available with a lag of two months and are subject to substantial revisions in subsequent releases; however, trade data are available with a lag of one month and data on international reserves are available the next day on request. In January 1998, a major revision of balance of payments statistics took place which led to the evaluation of imports on an f.o.b. basis and the inclusion of goods imported into free trade zones. New surveys on transportation, travel, government services, and labor income were introduced in 1999. The methodology on travel surveys was modified in 2002. While the survey of transportation delivers very accurate estimates, the other three surveys still need improvements. Also, since 1999, valuation changes have been excluded from the asset side of currency and deposits in the banking sector. In mid-2001, new surveys on communication and insurance services were introduced. During 1999 and 2000, the CNB increased the coverage of the direct investment survey by identifying additional enterprises. The coverage and quality of portfolio investment data are reasonably complete and accurate.

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

process of updating their database for earlier years in order to identify genuine arrears, if any, and record them in the balance of payments.

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

Table 19. Croatia: Core Statistical Indicators
(As of October 1, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Retail Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/ Debt Service
Date of Latest Observation	Oct 1, 2003	Sep 2003	Aug 2003	Aug 2003	Aug 2003	Aug 2003	Aug 2003	Aug 2003	Q2 2003	Jul 2003	Q2 2003	Jul 2003
Date Received	Oct 1, 2003	Sep 26, 2003	Sep 20, 2003	Sep 20, 2003	Sep 20, 2003	Sep 8, 2003	Sep 8, 2003	Sep 30, 2003	Sep 4, 2003	Sep 2, 2003	Sep 26, 2003	Aug 28, 2003
Frequency of Data	Daily	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Weekly	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	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

CROATIA: TRANSACTIONS RELATED TO THE TRANSFER OF A PATENT LICENSING AGREEMENT BY A LARGE CROATIAN COMPANY—NATURE AND TREATMENT IN THE BALANCE OF PAYMENTS

In 2002, a large, internationally diversified Croatian company revalued and transferred a patent licensing agreement to a foreign subsidiary.

In the second quarter of 2002, the Croatian company revalued the licensing agreement (exclusive royalty rights for the sale of a commercial product) from 0 to US\$419.4 million (CNB estimate). The Croatian company then transferred the licensing agreement to its foreign subsidiary in exchange for an additional capital in the subsidiary of US\$419.4 million. The licensing agreement was used by the subsidiary as collateral for a loan to make an acquisition in a third country. The purpose of the transaction was to take advantage of the better international credit rating of the country of the subsidiary to obtain better loan terms. The transaction had a zero net value and did not affect the consolidated balance sheet of the Croatian company. According to the fifth edition of the IMF's *Balance of Payments Manual*, the transaction is recorded as a debit entry of US\$419.4 million in the item "direct investment abroad" (reflecting the transfer of royalty rights) and an offsetting credit entry in the item "capital transfers" (reflecting the acquisition of additional capital in the subsidiary).

In the second quarter of 2003, the Croatian company declared the revaluation of the licensing agreement as an extraordinary income in 2002 which was completely reinvested in the company without any dividend distribution to the shareholders. As about two thirds of the Croatian company's shares are held by foreign shareholders, this transaction was recorded in the balance of payments as a debit entry of US\$327.8 million in the current account, reflecting the distribution of earnings to foreign shareholders, and an offsetting credit entry in the same amount in the item "direct investment in Croatia" in the capital and financial account, reflecting the full reinvestment of these earnings in Croatia.

Because these transactions did not have any real economic effect, recording them in the balance of payments would reduce the informative value of the balance of payments presentation; the balance of payments would show an artificially low value of FDI in 2002 and an artificial deterioration of the current account in 2003. Therefore, these transactions have been taken out of the balance of payments presentation in the staff report.

CROATIA: SUSTAINABILITY ANALYSIS

1. Fiscal and external debt sustainability assessments were conducted over the medium term applying standardized sensitivity tests to the staff's baseline projections.

A. Fiscal Sustainability

2. The staff's baseline scenario predicts a decline in the public debt to GDP ratio from 51.6 in 2002 to 45.6 in 2007, and the different sensitivity tests suggest medium-term debt sustainability is not seriously at risk (Table 20) if the authorities pursue a course of fiscal consolidation and exchange rate stability is maintained. When the historical average values of the real interest rate, real GDP growth, and the primary balance are used throughout the projection period (scenario 1), the public debt ratio reaches 57.3 percent by 2007, around 12 percentage points above the baseline level. This is mainly explained by smaller primary deficits and higher real GDP growth assumed in the baseline scenario compared with their historical values. Among the isolated shocks during the first two years of the projection horizon (scenarios 2–4), the shock to the primary balance has the largest impact on the end-period debt ratio, while the shocks to real GDP and the interest rate lead to a less significant deterioration in the debt dynamics, although still quite substantial in the former case. In all three cases, the debt ratio resumes its decline once the impact of the shocks fades. The same is true for the combination of these shocks (scenario 5). A one-time 30 percent real depreciation in 2003 (scenario 6) increases the debt ratio by around 20 percentage points from the 2002 level, although the debt stock begins to decline once the depreciation shock wears off. The same holds true for a one-time 10 percentage point increase in the public debt ratio (scenario 7). An adverse shock to revenue (scenario 8) leads only to a minor worsening of the debt dynamics due to the high historical revenue ratios.

B. External Sustainability

3. Under the staff's baseline scenario, the external debt to GDP ratio falls from 68½ percent in 2002 to about 59½ percent in 2007 (Table 21). This decline is achieved mainly through a reduction of external borrowing by the government and an increase in non-debt creating financing (FDI). Under 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 external debt ratio rises to 114½ percent by 2007, mainly due to lower GDP growth and a significantly higher current account deficit. Croatia appears to withstand relatively well isolated shocks to interest rates and GDP growth rates (scenarios 2 and 3). The isolated shocks to the U.S. dollar GDP deflator and the current account (scenarios 4 and 5) and a combination of shocks to various macroeconomic and external variables (scenario 6) lead to more adverse results. The external debt ratio increases to about 105¾ percent in the case of an isolated shock to the GDP deflator and to about 84¼ percent in the case of an isolated shock to the current account, while it surges to more than 116½ percent in the case of the combined shock. A one-time 30 percent depreciation leads to a large increase in the external debt ratio to about 108½ percent in 2003, but the ratio starts to decline gradually once the impact of this shock fades away.

Table 20. 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/ o/w foreign-currency denominated	32.4	37.6	46.4	51.1	51.6	51.6	51.5	50.7	49.3	47.6	45.6
	20.0	25.9	33.2	37.7	37.5	36.5	35.6	34.3	33.1	31.6	30.2
2 Change in public sector debt	...	5.2	8.8	4.7	0.6	-0.1	-0.1	-0.7	-1.4	-1.7	-2.1
3 Identified debt-creating flows (4+7+12)	0.0	-1.7	8.8	2.8	0.8	-3.6	-5.2	2.1	-0.8	-1.3	-1.7
4 Primary deficit	0.7	1.9	6.5	4.5	4.6	2.7	2.3	1.6	0.8	0.3	-0.2
5 Revenue and grants	47.7	51.1	48.4	46.2	44.7	45.2	44.9	44.9	44.5	44.1	43.9
6 Primary (noninterest) expenditure	48.4	53.0	54.9	50.7	49.3	47.9	47.2	46.5	45.3	44.4	43.7
7 Automatic debt dynamics 2/	0.3	-1.6	7.3	1.3	0.1	-4.5	-5.4	1.2	-1.0	-1.2	-1.0
8 Contribution from interest rate/growth differential 3/	-4.0	-1.4	1.1	-0.9	-0.6	1.2	1.1	-0.7	-1.2	-1.2	-1.0
9 Of which contribution from real interest rate	-0.8	-0.7	0.8	0.3	1.2	1.3	1.2	1.4	0.9	0.9	0.9
10 Of which contribution from real GDP growth	-3.2	-0.7	0.3	-1.2	-1.8	-2.5	-2.3	-2.2	-2.1	-2.1	-2.0
11 Contribution from exchange rate depreciation 4/	4.3	-0.2	6.2	2.2	0.5	-3.3	-4.4	2.0	0.2	0.0	0.0
12 Other identified debt-creating flows	-1.0	-2.0	-4.9	-3.1	-3.7	-1.8	-2.1	-0.6	-0.5	-0.5	-0.5
13 Privatization receipts (negative)	-1.0	-2.0	-4.9	-3.1	-3.7	-1.8	-2.1	-0.6	-0.5	-0.5	-0.5
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	...	6.9	-0.1	1.9	-0.2	3.5	5.0	-2.9	-0.6	-0.4	-0.4
Public sector debt in percent of revenues 1/	67.8	73.5	95.8	110.5	115.5	114.1	114.5	112.9	110.9	108.0	103.8
Gross financing 5/ in millions of U.S. dollars	3.6	7.4	13.1	12.2	12.4	10.4	10.2	9.4	8.2	7.8	7.3
	715.0	1609.0	2599.0	2242.2	2421.3	2323.0	2876.9	2782.8	2633.1	2682.1	2690.9
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	6.8	2.5	-0.9	2.9	3.8	5.2	4.7	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 6/	6.3	6.3	5.9	5.6	5.7	5.8	5.4	5.6	5.6	5.6	5.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	2.1	2.1	0.9	2.7	2.9	2.6	3.1	2.1	2.1	2.3
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-12.1	0.9	-18.3	-6.2	-1.3	10.1	14.3	-5.4	-0.6	0.0	0.0
Inflation rate (GDP deflator, in percent)	7.4	8.4	3.8	4.7	3.0	2.9	2.7	2.5	3.5	3.5	3.5
Growth of real primary spending (deflated by GDP deflator, in percent)	...	12.3	2.6	-4.9	0.9	2.1	3.4	2.8	1.7	2.6	2.8
II. Stress Tests											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						51.6	52.5	53.3	54.6	56.0	57.3
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						51.6	52.3	52.4	51.0	49.2	47.1
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						51.6	54.9	58.4	56.9	55.0	52.7
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						51.6	57.4	63.6	61.9	59.9	57.6
5. Combination of 2-4 using one standard deviation shocks						51.6	57.0	62.9	56.8	50.5	44.0
6. One time 30 percent real depreciation in 2003 7/						51.6	72.8	72.6	70.8	68.6	66.1
7. 10 percent of GDP increase in other debt-creating flows in 2003						51.6	61.5	61.0	59.4	57.4	55.1
8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						51.6	53.6	55.5	54.0	52.2	50.0
8a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						114.1	125.2	129.6	120.2	117.1	112.8
Historical Statistics for Key Variables (past 5 years)											
			Historical Average			Standard Deviation					
Primary deficit			3.6			2.3					
Real GDP growth (in percent)			3.0			2.7					
Nominal interest rate (in percent) 6/			5.9			0.3					
Real interest rate (in percent)			0.5			2.1					
Inflation rate (GDP deflator, in percent)			5.5			2.3					
Revenue to GDP ratio			47.6			2.4					

1/ General government's gross debt, including arrears and public guarantees extended to entities outside the general government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha e(1+r)] / (1+g+\pi+g\pi)$ 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 denominated debt; and e = nominal exchange rate depreciation.

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 $\alpha e(1+r)$.

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 21. Croatia: External Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	1997	1998	Actual 1999	2000	2001	2002	2003	2004	Projections		
									2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	31.9	44.3	49.6	60.0	58.0	68.5	68.4	67.8	66.2	62.9	59.3
2 Change in external debt	8.7	12.4	5.3	10.4	-2.0	10.5	-0.1	-0.6	-1.6	-3.3	-3.6
3 Identified external debt-creating flows (4+8+11)	9.6	0.2	3.5	0.6	-7.6	-4.8	-13.3	-3.7	-4.0	-5.0	-5.4
4 Current account deficit, excluding interest payments	10.6	4.2	4.0	-1.5	-1.0	3.0	1.2	0.4	0.0	-0.6	-1.1
5 Deficit in balance of goods and services	16.7	9.2	8.4	5.1	6.0	9.7	7.9	7.0	6.5	5.7	5.0
6 Exports	39.9	39.5	40.8	47.0	49.4	47.0	49.3	48.9	47.6	47.0	46.5
7 Imports	56.6	48.7	49.2	52.1	55.4	56.7	57.2	55.9	54.1	52.7	51.5
8 Net non-debt creating capital inflows (negative)	-2.6	-4.3	-7.4	-5.9	-8.0	-4.4	-5.0	-4.0	-3.9	-4.6	-4.6
9 Net foreign direct investment, equity	2.6	4.3	7.4	5.9	8.0	4.4	5.0	4.0	3.9	4.6	4.6
10 Net portfolio investment, equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Automatic debt dynamics 1/	1.6	0.3	6.8	8.0	1.4	-3.4	-9.4	-0.1	-0.1	0.3	0.3
12 Denominator: 1+g+p+gp	1.0	1.1	0.9	0.9	1.1	1.1	1.3	1.1	1.1	1.1	1.1
12 Contribution from nominal interest rate	1.8	2.5	3.0	4.0	4.7	4.1	4.8	4.9	4.7	4.7	4.6
13 Contribution from real GDP growth	-1.5	-0.7	0.4	-1.5	-2.1	-2.6	-2.6	-2.9	-2.8	-2.8	-2.6
14 Contribution from price and exchange rate changes 2/	1.2	-1.5	3.4	5.5	-1.2	-4.9	-11.6	-2.1	-1.9	-1.7	-1.7
14 Residual, incl. change in gross foreign assets (2-3)	-0.8	12.2	1.8	9.8	5.6	15.2	13.2	3.1	2.4	1.7	1.8
External debt-to-exports ratio (in percent)	80.0	112.2	121.6	127.6	117.5	145.6	138.9	138.5	139.2	133.8	127.6
Gross external financing need (in billions of US dollars) 3/ in percent of GDP	3.3	2.4	2.8	2.2	2.7	4.0	3.7	3.9	3.8	3.5	3.2
	16.6	11.1	14.0	11.7	13.9	18.0	13.1	12.7	11.7	10.0	8.4
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	6.6	2.5	-0.9	2.9	3.8	5.2	4.7	4.5	4.5	4.5	4.5
Exchange rate appreciation (US dollar value of local currency, change in perc)	-11.7	-3.2	-10.5	-14.1	-0.9	6.2	17.3	-0.4	-0.5	-0.8	-0.7
GDP deflator in US dollars (change in percent)	-5.0	4.9	-7.2	-10.0	2.0	9.3	20.5	3.1	2.9	2.6	2.7
Nominal external interest rate (in percent)	8.1	8.5	6.2	7.5	8.3	8.2	8.8	7.6	7.4	7.7	7.9
Growth of exports (US dollar terms, in percent)	0.6	6.5	-5.0	6.7	11.2	9.5	32.2	7.0	4.5	6.0	6.2
Growth of imports (US dollar terms, in percent)	15.2	-7.4	-7.1	-2.0	12.6	17.6	27.3	5.3	4.1	4.5	4.8
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	68.5	84.8	92.2	99.5	106.7	114.5					
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004	68.5	68.9	69.5	67.9	64.6	61.0					
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	68.5	72.7	77.2	75.6	72.3	68.8					
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004	68.5	93.7	113.8	112.2	109.1	105.7					
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004	68.5	80.4	92.5	90.9	87.7	84.2					
6. Combination of 2-5 using one standard deviation shocks	68.5	98.2	124.6	123.0	119.9	116.6					
7. One time 30 percent nominal depreciation in 2003	68.5	108.3	107.6	106.0	102.8	99.5					
Historical Statistics for Key Variables (past 5 years)											
			Historical Average								Standard Deviation
Current account deficit, excluding interest payments			3.3								4.9
Net non-debt creating capital inflows			5.6								2.2
Nominal interest rate (in percent)			7.7								0.9
Real GDP growth (in percent)			3.0								2.7
GDP deflator in US dollars (change in percent)			-3.1								6.3

1/ Derived as $[r - g - \rho(1+g) + \alpha(1+r)]/(1+g+p+gp)$ times previous period debt stock, with r = nominal effective interest rate on external debt; p = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, α = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \alpha(1+r)]/(1+g+p+gp)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\epsilon > 0$) 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
October 27, 2003

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

Dear Mr. Köhler:

1. In accordance with paragraph 4 of our July 4, 2003 letter to you, we have conducted the second review of our economic program for 2003 that is supported by a 14-month stand-by arrangement in an amount of SDR 105.88 million (29 percent of quota). The review confirms that we remain on track to achieve our program's principal objective, the stabilization of the general government debt ratio after many years of uninterrupted increases. To shore up that objective, we have obtained parliamentary approval for an amendment of our budget in a way that safeguards the deficit target for 2003, which was tightened during the first review under the stand-by arrangement ("the first review"). The present review also indicates that the external adjustment is in line with the target set during the first review. Although the external current account deficit is now projected at 5.9 percent of GDP in 2003, the increase results entirely from higher profit remittances that were reinvested in Croatia. Nonetheless, we have tightened monetary policy further and taken measures to strengthen banking supervision to support the external adjustment. These and some other measures and the economic outlook for 2003-04 are described below.

The Economic Situation and Outlook

2. Despite the unexpectedly weak economic environment in Western Europe, domestic economic activity has remained strong amid easing inflation, and the near-term prospects for growth and inflation are favorable. Strong real GDP growth in the first quarter, continued strength of industrial production and retail sales in the second quarter, and indications of an exceptionally good tourism season in the third quarter have prompted us to raise our growth forecast for 2003 from 4.2 percent to 4.7 percent. We expect this higher growth rate to be broadly maintained in 2004 as moderating private consumption growth is likely to be balanced by higher growth of public investment with the initiation of a four-year railroad infrastructure project. Private investment is expected to remain strong due to strengthened confidence after the November election and the projected economic recovery in the EU. The contribution of net foreign demand is expected to be neutral—after three years of being a drag on growth—due to higher export demand in the EU and slower import growth.

3. The external current account deficit has not yet improved, but we are confident that the measures described below are adequate to reduce it sufficiently in the second half of 2003 to reach 5.9 percent of GDP for the year as a whole, as compared to 5.5 percent of GDP at the time of the first review. The larger current account deficit will, however, require no additional foreign borrowing, as the deterioration is more than explained by higher profit remittances, most of which have been reinvested in Croatia. As a result, the external debt ratio is expected to remain unchanged on a year-end basis at a little more than 68 percent of GDP in 2003. Under current policy intentions, the current account deficit is projected to decline to 5.2 percent of GDP in 2004 and the external debt ratio would remain at around 68 percent of GDP.

Fiscal Policy

4. We are on course to reduce the general government deficit to 4.6 percent of GDP in 2003. After a disappointing second quarter, revenue collections have picked up and we are confident to reach our revenue target for 2003. Higher profit, excise, and non-tax revenues are expected to be offset by shortfalls in social security contributions and customs duties. Contrary to earlier intentions, we decided to seek parliamentary approval for a deficit-neutral budget amendment. As a result of this amendment, the wage bill has been increased by 0.6 percent of GDP relative to the first review, mainly to reflect court-mandated payments to unlawfully laid-off military staff in the early 1990s and overruns related to the current defense sector reform. As regards the latter, we already reduced military employment by more than 5,500 by end-August through voluntary separation, including early retirement and layoffs. By year-end we expect to reduce defense sector employment by another 3,000 to 30,260, including 3,000 reservists at 60 percent of previous pay. The size of the armed forces will be reduced further over the medium term. A reform of the military pay system (after a seven-year wage freeze), higher severance pay, and small increases in the education sector have added to the wage cost overrun, which was fully offset by lower spending on investment, interest, subsidies and transfers, and goods and services. The government is prepared to implement additional expenditure cuts if needed to achieve our deficit target.

5. The financing of the deficit has changed substantially. The partial privatization of the oil company (INA), although delayed to the beginning of the fourth quarter, has yielded higher receipts than anticipated (prior action), thus reducing the net borrowing requirement and boosting the prospects of stabilizing the public debt ratio. Net foreign borrowing is expected to be a little more than 1 percent of GDP higher than envisaged at the first review, reflecting higher disbursements and exchange rate related savings on amortization payments. In particular, contrary to earlier intentions, we have drawn down the proceeds of the Samurai bond to bridge the delay of the INA privatization receipts. In partial compensation, we have placed the proceeds of the second-tranche SAL disbursement from the World Bank in a foreign currency account with the CNB until they are needed for external debt service

payments in early 2004 (prior action).¹ Reflecting these developments, the domestic net borrowing requirement has been reduced sharply. As nonbank financing (including arrears reduction) remains unchanged, the government is expected to be a net provider of funds to the banking system to the tune of 1.2 percent of GDP for 2003 as whole.

6. In accordance with the new budget law, the government has prepared a provisional budget for 2004 and medium-term fiscal projections that envisage lowering the government deficit to 2 percent of GDP by 2007. However, this budget will not be submitted to parliament before the election.² The budget aims at reducing the general government deficit to 3.8 percent of GDP in 2004. Revenue is projected to decline modestly to 44.6 percent of GDP, largely reflecting new personal income tax deductions and the continued erosion of import duty collections due to the implementation of WTO and bilateral and regional trade liberalization agreements. There would be no other changes in the revenue system. To reduce the deficit as intended, the expenditure ratio would need to be compressed by 1.1 percent of GDP. The nominal wage bill would remain at its 2003 level, for a budgetary saving of 0.8 percent of GDP. Employment reduction (including that achieved during 2003) and the new income tax deductions would nonetheless allow net real wage increases of about 4 percent. An additional saving of 0.3 percent of GDP would result from keeping highway construction expenditure constant in nominal terms and from cuts in capital spending financed by the state budget. We realize that the 2004 budget will need to be tightened further if the external current account does not adjust as envisaged.

7. If the new government decided to proceed with the implementation of a four-year railroad infrastructure investment program, the 2004 fiscal deficit objective would require additional resources of 1.2 percent of GDP on an annual basis. Our projections assume that 0.3 percent of GDP would be generated by a small increase in the gasoline excise tax. Cuts of spending on transfers (0.5 percent of GDP), goods and services (0.2 percent of GDP), subsidies, and central government investment (0.1 percent of GDP each) would generate the remaining resources.

8. As privatization receipts are likely to be much lower than in 2003 (see paragraph 16 below), the net borrowing requirement would be higher than in 2003 but it would still allow a small reduction of the public debt ratio in the absence of a net increase in government guarantees. Notwithstanding large domestic amortization, the government will rely on domestic borrowing to the extent possible.

¹ To avoid any impact of this transaction on the net usable international reserves (NUIR) target for December 31, 2003, we propose to adjust Annex VI of the MEFP by deducting reserve assets held by the CNB against government deposits from the NUIR definition.

² A temporary budget authorization for the first quarter of 2004 was approved by parliament together with the 2003 budget amendment. The government has also issued financing guidelines for 2004 to central government agencies and local governments.

9. The postponement of the fiscal ROSC mission to early 2004 in an attempt to combine it with the World Bank's Country Financial Accountability Assessment allows the Ministry of Finance additional time to prepare for it. The new SAP software system has proved helpful in executing the 2003 budget and preparing the 2004 budget, but it has yet to be applied to debt management and arrears monitoring. The Fund-provided fiscal advisor is expected to assist in this endeavor as well as in the compilation of timely and reliable fiscal data (including on guarantees), which will allow the Ministry to resume regular publication of its monthly bulletin.

Monetary and Exchange Rate Policy

10. In response to weak current account data, the CNB has recently reinforced the measures it took in January 2003 to restrain credit expansion and external borrowing by raising the domestic component of the 19 percent reserve requirement on banks' foreign liabilities from 25 percent to 35 percent. This measure has reduced bank liquidity and put upward pressure on interest rates, with money market rates rising to some 10 percent. The CNB believes that no further measures are needed for the remainder of the year but stands ready to take further measures if developments indicate that credit growth, imports, and the current account deficit do not decline as expected.

11. In 2004 the CNB intends to adopt a major change of its monetary policy regime. The temporary credit limits introduced in early 2003 will be eliminated at the start of 2004. As new supplementary provisioning requirements for rapidly expanding banks that enter into effect at the same time will not provide an equally restraining effect on credit expansion, the CNB will use its existing instruments to ensure that monetary conditions remain appropriately tight. At the same time, the CNB will consider changing its monetary policy framework by introducing a deposit facility for bank liquidity, thus creating an interest rate corridor with the existing Lombard lending facility, and to begin open market operations to guide interest rates within this corridor. To help prepare for this regime change, the CNB has asked for early Fund technical assistance.

12. The CNB would like to reaffirm its exchange rate policy. It considers the level of the exchange rate broadly appropriate. Accordingly, it intends to continue to maintain the exchange rate of the kuna broadly stable against the euro, allowing short-term fluctuations as in the past. It will mainly rely on its regulatory and supervisory powers to discourage the buildup of unhedged foreign exchange positions. In line with this policy, the CNB has not intervened in the foreign exchange market since March 2003.

13. The twelve-month rate of credit expansion has fallen from 31.3 percent at end-2002 to 20.8 percent in August 2003 and is expected to decline to 16.2 percent by year-end. While the annual rate of credit growth to the corporate sector was more than halved to 9.2 percent by August, household credit growth remained high at 31.3 percent. Apart from this slowdown and the reduced financing need of the central government, the CNB's monetary program for 2003 is broadly unchanged, thus resulting in a stronger net foreign asset position

of the banking system. The tentative program for 2004 envisages a further slowdown of broad money and private credit growth to 10 ¾ percent and 12 ½ percent, respectively.

14. The CNB continues to strengthen its regulatory and supervisory functions.³ The by-laws and guidelines for the recently approved foreign exchange law and all guidelines for the application of the by-laws adopted under the new banking law have been issued. By-laws on foreign bank branches and bank liquidity requirements have not been issued, the former because there is no present and foreseeable need for them and the latter because the CNB prefers instead to draw banks' attention to international best practice, as posted on the BIS and CNB websites. To improve cooperation among supervisors, parliament has asked the Ministry of Finance to establish a council of domestic supervisors, in which the CNB will participate. In the meantime, the CNB has obtained data from the insurance supervisor indicating that credit risk amounting to one sixth of retail credit (or 4 ¼ percent of GDP) had been transferred in mid-2003 from banks to insurance companies. The first memoranda of understandings on cross-border cooperation with foreign bank supervisors are expected to be signed in the next few months. In the meantime, the CNB is already cooperating informally with foreign bank supervisors. The CNB is compiling aggregate corporate balance sheets from data provided by the financial agency (FINA) and has asked banks (as a prior action) to report on their ten largest customers' foreign exchange exposure. It is also further developing its early warning system and stress tests of banks' balance sheets on the basis of recent Fund technical assistance. The banking supervision department will be restructured by end-2003 and strengthened by adding staff and continued professional training.

EU Accession and Structural Policies

15. EU membership remains our top political priority. The government has therefore sent its responses to the European Commission questionnaire and parliament has adopted the remaining 20 laws required to harmonize Croatian legislation with EU standards before adjourning. In the economic domain, it is now important to fully implement the new legislation. Thus, the new labor law, which will fully enter into effect on January 1, 2004, has lowered Croatia's employment protection legislation index, compiled in accordance with the OECD methodology, by 23 percent.

16. With the successful sale of 25 percent plus one share of INA, the government has all but completed its privatization program. To accelerate the privatization of the postal bank (HPB), the government has sent a revised mandate letter to the IFC (prior action), with a view to obtaining IFC Board approval to subscribe to 19 percent of the bank's capital by end-2003 (modified structural benchmark). The IFC has already sent a mission to initiate the due diligence process, which is expected to be completed in October-November 2003. In view of

³ Banks' lending decisions should benefit as of October 2003 from a debtors' blacklist compiled under the auspices of the bankers' association. This temporary measure will be replaced by a credit registry in the course of 2004.

union resistance the government has postponed the sale of 7 percent of the telecommunication company's (HT) capital to 2004. This is likely to be the only major privatization receipt for the budget in 2004. The government still hopes to reach agreement with the Catholic church on the transfer of 25 percent of the insurance company's (CO) capital in restitution for post-Second World War expropriations. Another 20 percent of CO's capital could then be sold on the stock exchange in 2004. Finally, the government intends to privatize only the distribution part of the electricity company (HEP). Such privatization is not likely to happen before 2005. All privatizations through the privatization fund (HFP), except for a few tenders currently in the pipeline, have been stopped pending the adoption of a new privatization law by the next parliament.

* * *

17. The assessments, projections and policies described in this letter supersede those set forth in the Memorandum of Economic and Financial Policies that is attached to our letter to you of December 27, 2002 and in the Supplementary Memorandum of Economic and Financial Policies that is attached to our letter to you of July 4, 2003, both of which continue to represent our policy intentions in all respects not specifically addressed in the present letter.

18. On the basis of the performance under our program to date and the policies in this letter, we request (i) completion of the second review under the stand-by arrangement and (ii) a waiver of the nonobservance of the September 30, 2003 performance criteria on the cumulative deficit of the consolidated central government, on the net usable international reserves of the CNB, and the net domestic assets of the CNB. The former performance criterion was missed because of the delay in the privatization receipts from the partial sale of INA. This payment has now been received and we believe that the performance criterion has otherwise been met. The latter performance criterion was missed by a relatively small amount as exchange market conditions were not conducive to intervention. We are confident that all other end-September performance criteria have been observed and that a waiver of applicability of performance criteria will not be needed at the time of the Board discussion.

19. We believe that the policies described in this letter are adequate to achieve the objectives of our economic program, but we stand ready to take any further measures to keep our program on track. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in this letter, in accordance with the Fund's policies on such consultations. The third program review, scheduled for completion in mid-February, 2004, will provide one such opportunity.

20. It remains our intention not to make the purchases that will become available under the arrangement with the completion of the present review and after completion of the third review and observance of the performance criteria for December 31, 2003.

Sincerely yours,

/s/

Slavko Linić
Deputy Prime Minister

/s/

Mato Crkvenac
Minister of Finance

/s/

Željko Rohatinski
Governor
Croatian National Bank

Attachment: Prior Actions and Revised Structural Benchmark

Table 1. Prior Actions and Revised Structural Benchmark

A. Prior Actions

1. Government to receive the proceeds of the partial privatization of INA.
2. CNB to ask banks to report on their ten largest customers' foreign exchange exposure.
3. Government to place the proceeds from the second-tranche SAL disbursement in a foreign currency account with the CNB until early 2004.
4. Government to send a revised mandate letter to the IFC requesting the latter to do due diligence of HPB with a view to subscribing to 19 percent of HPB's capital.

B. Revised structural benchmark

1. Obtain IFC Board approval to subscribe to 19 percent of HPB's capital by December 31, 2003.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

**Second Review Under the Stand-By Arrangement and Request for
Waiver of Nonobservance of Performance Criteria—
Supplementary Information**

Prepared by the European and the Policy Development and
Review Departments

(In consultation with the Legal Department)

Approved by Michael Deppler and Anthony Boote

November 10, 2003

1. This supplement provides additional information on economic trends and program performance that has become available since the issuance of the staff report. It also proposes a waiver of the nonobservance of the end-September performance criterion on central government arrears reduction on the basis of a letter received from the authorities (attached). The new information does not change the basic thrust of the staff appraisal in the staff report.

I. RECENT DEVELOPMENTS

2. The twelve-month rate of retail price inflation eased from 1.6 percent in September to 1.5 percent October, with core inflation rising from 0.9 percent to 1 percent.
3. The twelve-month growth of industrial production slowed from 3.1 percent in August to 2.9 percent in September, reducing the year-on-year growth rate in the first nine months from 5.5 percent to 5.2 percent.
4. The exchange rate of the kuna has remained stable against the euro without intervention by the Croatian National Bank (CNB) in the foreign exchange market. The proceeds of the partial privatization of the oil company (INA) have been repatriated (US\$505 million) and US\$200 million of these proceeds have been sold by the government to the CNB. Direct sales to the CNB of another US\$200 million are planned in December, and the balance is expected to be used for foreign exchange payment obligations of the government.
5. Credit expansion to the nongovernment sector slowed to an estimated 12¼ percent during the first nine months of 2003 (after adjusting for exchange rate movements and

attempts by banks to circumvent the credit ceilings through securitization and asset swaps) from 24 percent in the corresponding 2002 period.

6. Money market interest rates declined from 5.9 percent in the second week of October to 3 percent in the fourth week of October. While the reasons for this decline are still unclear, it may be related to the seasonal decline in currency circulation after the main tourist season and to the openness of the capital account. On November 3, the CNB announced a further increase in the local currency component of the reserve requirements on banks' foreign currency liabilities from 35 percent to 42 percent, to be phased in during November-December. The measure is intended to offset the expansionary effect from the government's spending of the converted privatization proceeds and may be accompanied by a renewed increase in money market interest rates.

7. Fiscal performance during the first nine months of 2003 was somewhat better than expected. Central government revenue was in line with projections, while central government expenditure was 0.4 percent of GDP lower than projected, mainly due to reduced spending on nonwage services and investment. The local governments also performed better than expected. However, despite the expected pickup in excise tax and toll revenue, accelerated execution of highway projects led to a larger than projected deficit of the highway construction agency (HAC). Overall, the general government deficit was 0.3 percent of GDP smaller than projected.

8. The general government debt ratio, which includes the stock of outstanding guarantees and arrears, rose to 52.3 percent of GDP at end-September from 51.6 percent at end-2002. The increase was driven by deficit financing and, in particular, the net issuance of government guarantees. With the INA privatization receipts and strict limitation of new guarantees, the government's objective to reduce the debt ratio to its end-2002 level by end-2003 remains achievable.

9. The cumulative merchandise trade deficit in the first nine months of 2003 amounted to US\$5.2 (€ 4.7) billion, which is in line with staff's projection, compared with US\$3.8 (€ 4.1) billion in the corresponding 2002 period. In US\$ (€) terms, exports rose by 24 (3.5) percent and imports by 30.6 (8.9) percent with respect to the corresponding 2002 period. Together with (still preliminary) record tourist receipts, staff now expects the external current account deficit to remain below the revised program target of 5.9 percent of GDP.

10. Reflecting continued net borrowing by the business and banking sectors, the external debt ratio rose from 68.5 percent of GDP at end-2002 to 70.1 percent of GDP at end-September. As a result, staff now expects the external debt ratio to remain above 70 percent of GDP at year end.

II. PROGRAM PERFORMANCE

11. All prior actions for holding the Board discussion on November 12 have been completed (Table 1). The proceeds from the partial privatization of INA were deposited in the CNB's account with a foreign commercial bank on November 10. Although this is less than five business days before the scheduled Board meeting, staff has confirmed that the deposit actually has been made.

12. The end-September performance criteria on the contracting and guaranteeing of nonconcessional medium- and long-term external public debt and on the short-term external debt outstanding have been observed.

13. As expected, the end-September performance criterion on the cumulative deficit of the central government was exceeded, but only because of the delay in the INA privatization receipts.

14. The end-September performance criterion on the reduction of central government arrears was missed by a small margin. The authorities attribute this nonobservance to the lack of liquidity resulting from the delay of the privatization receipts and request a waiver of nonobservance. Staff supports this request given the small size of the deviation (less than 0.02 percent of GDP) and in the expectation that the end-December arrears reduction objective will be achieved after the recent receipt of the privatization proceeds.

This overrun underscores the need for the authorities to strengthen program implementation and of the importance of the authorities' commitment—referred to in paragraph 30 of the staff appraisal—to take the necessary action to ensure observance of the end-December performance criteria.

15. The government has reported data on the end-September stock of its outstanding guarantees (structural benchmark), indicating a net increase in such guarantees of 0.8 percent of GDP during the first three quarters of 2003.

16. An IFC mission visited Zagreb during November 3-11 to conduct due diligence aimed at obtaining its Board's approval to a 19 percent capital subscription to the postal bank (HPB) by end-2003, which is a structural benchmark under the program.

Attachment

Table 1. Croatia: Performance Under the Stand-By Arrangement During the First Nine Months of 2003

		End of			
		March	June	September	
Prior Actions					
1	Government to receive the proceeds of the partial privatization of INA.	Done on November 10, 2003.			
2	CNB to ask banks to report on their ten largest customers' foreign exchange exposure.	Done on October 23, 2003.			
3	Government to place the proceeds from the second-tranche SAL disbursement in a foreign currency account with the CNB until early 2004.	Done on October 24, 2003.			
4	Government to send a revised letter to the IFC requesting the latter to conduct due diligence of HPB with a view to subscribing to 19 percent of HPB's capital.	Done on October 2, 2003.			
(In millions of kuna, unless indicated otherwise)					
Quantitative performance criteria					
1-a	Cumulative Deficit of the Consolidated Central Government 1/	Program	4,053	6,398 2/	4,885 3/
		Actual	3,153	5,941	6,823
		Margin (+)	900	457	-1,934
1-b	Cumulative Deficit of the Consolidated General Government 1/	Program	4,325 2/	6,615	4,620 2/ 3/
		Actual	2,960	5,719	6,427
		Margin (+)	1,365	896	-1,807
2	Reduction of Arrears of the Consolidated Central Government 4/	Program	150	300	450
		Actual	119	303	415
		Margin (+)	-31	3	-35
3	Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 1/5/	Program	704	970	652
	>1 year	Actual	513	757	193
		Margin (+)	191	213	459
	<5 years	Program	100	100	100
		Actual	0	25	0
		Margin (+)	100	75	100
4	Cumulative Increases in Short-term External Debt by the General Government, CNB, and HBOR 1/ 5/	Program	120	0	0
		Actual	0	0	0
		Margin (+)	120	0	0
5	Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 4/ 5/	Program	-120	-184	46 6/
		Actual	53	111	0
		Margin (+)	173	295	-46
6	Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 1/	Program	331	2,167	4,885 7/
		Actual	-569	1,264	4,931
		Margin (+)	900	903	-46
Indicative limits					
1	Consolidated Central Government Wage Bill 1/	Program	4,603	9,075	13,600
		Actual	4,660	9,463	14,230
		Margin (+)	-57	-388	-630
2	Cumulative Changes in Net Credit of the Banking System to the Consolidated General Governments 1/	Program	-170	-4	-745
		Actual	-1,733	-1,131	28
		Margin (+)	1,563	1,127	-773
3	Cumulative Increases in Net Credit of the Banking System to Selected Public Enterprises 1/	Program	463	278	-550
		Actual	-337	-772	417
		Margin (+)	800	1,050	-967
Structural performance criterion					
1	Government to prepare criteria for issuing guarantees by end-March 2003.	Not observed. Done on July 15, 2003.			
Structural benchmarks					
1	Parliament to approve by end-March 2003 a new budget law satisfying the conditions specified in paragraph 16 of the MEFP.	Not observed. Approved by parliament on May 29, 2003.			
2	CNB to issue by end-June 2003 and implement by end-September 2003 a regulation to include options in the calculation of banks' net foreign exchange position.	The regulation took effect on April 1, 2003.			
3	Government to make a decision by end-March 2003 on the bids received for the privatization of INA.	Not observed. A final decision was made in July 2003.			
4	Government to prepare by end-March 2003 a privatization program for HPB that satisfies the conditions specified in paragraph 23 of the MEFP (to be monitored in consultation with the IFC).	Not observed. The government formally invited the IFC to subscribe to 19 percent of HPB's capital with appropriate veto powers on June 10, 2003.			
5	Report data on government guarantees outstanding on September 30, 2003.	The data were received on October 14, 2003			

Source: Data provided by the Croatian authorities.

1. Ceiling.

2. Indicative limits (not a performance criterion).

3. Reduced by HRK 2,355 million for the central government and by HRK 2,318 million for the general government, respectively, to account for the shortfall of privatization receipts caused by delay in receipts of INA privatization proceeds (Attachment I, Annex III, of IMF Country Report No. 03/252 and Attachment I, Annex III, of IMF Country Report 03/252).

4. Floor.

5. In millions of U.S. dollars.

6. Adjusted for the shortfall of the INA privatization receipts and funds disbursed by the U.S. Treasury after lifting the freeze on the assets of the National Bank of the former Socialist Federal Republic of Yugoslavia (Table 4, Attachment I of IMF Country Report No. 03/2).

7. Adjusted for the shortfall of the INA privatization receipts (Table 4, Attachment I of IMF Country Report No. 03/252).

**Statement by Yuriy G. Yakusha, Alternate Executive Director
for the Republic of Croatia
and Tihomir Stucka, Advisor to Executive Director
November 12, 2003**

The authorities thank staff for a clear and fair analysis of economic developments in the country. Furthermore, the authorities fully appreciate the Fund's assistance in creating an adequate policy framework, which will help the country join the second wave of EU accession countries. Croatia strives for receiving the EU accession candidacy status by next spring, and starting negotiations with the EU. Looking ahead, this is one of the most important issues facing the authorities. The country has no Fund credits outstanding.

Despite a somewhat weaker performance in the region, Croatian economic growth remained strong with inflation under firm control. Near-term prospects are also favorable, assisted by an extremely good tourist season, while the medium-term outlook is secured by accelerated structural reforms.

Admittedly, Croatia's performance under the second review has not been exemplary. However, the authorities have a track record of meeting almost all criteria by large margins, so this occurrence has been exceptional and technical, mostly owing to the delay of the INA oil company privatization receipts (1.8 percent of GDP).

Structural reforms

The public administration reform, which started in 2001, will be accelerated in the forthcoming period. This year, significant progress has been made in reducing military personnel, as part of the NATO Membership Action Plan (MAP). Although severance payments have had a one-off impact on the wage bill, the overall budget deficit target has been preserved. The authorities will also need to start setting up institutions necessary to administer EU funds. Furthermore, adjustments of state aid to enterprises, especially in the area of transport and tourism will be necessary.

In terms of privatization, 25 percent of the national oil company INA was sold to the Hungarian oil company MOL, and the Croatian Privatization Fund (HFP) has privatized some enterprises from the transportation and tourism sector, as well as the food industry. Furthermore, the IFC will take part in the privatization of the two remaining, small public banks (accounting for less than 4 percent of total banking assets). Also, privatization of large enterprises and utilities could be more pronounced in the medium-term perspective. In addition to privatizing large enterprises, the electricity market has been liberalized. In the first stage, the 15 largest enterprises will be able to choose their electricity provider, while in the subsequent stages the same will apply for the remaining companies and households. Croatia is in need of stronger institutions, similar to its more advanced CEE peers. The country is in the process of modernizing the legal system, and improvements in the judicial system are important. In this area, the World Bank assists in modernizing commercial courts and increasing competence of judges and bankruptcy trustees. In this regard, the second SAL

tranche has been released as a result of several laws being adopted regulating market competition, strengthening market institutions, and enhancing the flexibility of the labor market. This tranche will remain with the CNB to be at budget disposal next year.

Fiscal policy

For 2003, the targeted general government deficit amounts to 4.6 percent of GDP and this objective will be met¹. Nevertheless, it is still a rather high deficit. At the same time, it should be acknowledged that this deficit has been on a continuously downward trend since 2001, and its current size compares favorably with many accession countries, particularly when one considers that a significant highway development program has almost been completed. In addition, the pension reform has been launched in 2002, which was a rather costly undertaking.

In this context, it should also be noted that eleven days after the Board meeting parliamentary elections will be held in Croatia. For several months, the polls have indicated it to be a very tight race. Our Croatian authorities have performed well under the program, and resisted election-related overspending. Looking ahead, the authorities aim for a 3.8 percent deficit in 2004, and reducing it further to 2.6 percent in 2005, and to 2 percent by 2007.

The authorities realize that in the future special attention will have to be paid to further reducing expenditures, and improving the quality of spending cuts, bearing in mind the cyclical nature of certain budget components. More precisely, recent years have been marked by a robust growth performance and decreasing unemployment, bringing about strong tax revenues and less pronounced automatic stabilizers on the spending side. Furthermore, reducing expenditures should have a positive influence on the external current account deficit.

A flourishing economy and increased government discipline have also contributed to the stabilization of the general government debt ratio. Since the issue of debt sustainability cannot be related to a single threshold indicator, it should be pointed out that the debt stock includes part of the debt burden of former Yugoslavia, as well as the authorities' financing requirements for settling the inherited stock of arrears amounting to over 6 percent of GDP. Here it should be mentioned that the authorities regret missing the performance criterion target on arrears by a small margin, reflecting the imperfections of the treasury system, but also liquidity considerations in the light of the privatization receipts delay.

The balance of payments

¹ The technical nature of the waiver for the missed performance criterion on the cumulative general government deficit is accurately described in the staff report (Box 1), and can be attributed to the temporary delay of programmed receipts. Hence, it is technical in nature. Furthermore, the authorities stand ready to implement expenditure cuts if needed to adhere to the deficit target.

Strong tourism revenues have marked this year so far contributing to a moderating external account deficit. Based on preliminary data, by end-2003 the current account deficit is expected to decline to 5.9 percent of GDP from 7.1 percent in 2002, with some upside risks.

With a view of further accelerating commodity trade, the authorities very much welcomed the recent signing of contracts with leading European companies as this will diversify the trade, and boost employment in some economically challenged regions. Needless to say, the increase in greenfield investments will improve the sustainability of the current account deficit.

Monetary policy

A few days ago, the Croatian National Bank (CNB) announced that it would further tighten monetary policy by increasing the kuna portion of reserve requirements on foreign exchange denominated liabilities from 35 percent to 42 percent. This will help sterilize parts of the privatization related inflows. This measure marks a transition period during which the monetary authorities intend to develop open market operations facilities using more extensively the interest rate channel. Early next year, a Fund TA mission will help with the preparations for establishing the new monetary toolkit, which would be implemented later in the year, conditions permitting. In the interim period, domestic currency CNB bills for sterilization purposes have already been discontinued for all practical purposes as a step toward modernizing the monetary policy instruments.

The exchange rate has remained stable without any CNB interventions in the foreign exchange market since March 2003. In this context, the authorities regret having missed the target floor on net usable international reserves by less than 1 percent of gross reserves. Purchasing foreign exchange at times when pursuing restrictive monetary policy in their opinion could be interpreted as sending inconsistent signals to the market. Furthermore, the NUIR target was projected assuming that the INA privatization receipts would have been paid at a somewhat earlier date.

Looking ahead, after the elections the scene will be set for further improvements in coordination between monetary and fiscal policy. Moreover, the new monetary instruments and credible fiscal policy should align economic policy instruments more closely with those in existence in the EU member countries, and bring Croatia closer to its medium term goal, namely entering the EU by end-2007.



Press Release No. 03/191
FOR IMMEDIATE RELEASE
November 12, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review and Grants Waivers Under Stand-By Arrangement with the Republic of Croatia

The Executive Board of the International Monetary Fund (IMF) today completed the second review of the Republic of Croatia's economic performance under the 14-month Stand-By Arrangement.

In completing the review, the Executive Board granted the Republic of Croatia's request for waivers for the non-observance of four quantitative performance criteria relating to the consolidated central government budget, central government arrears, and net usable international reserves and net domestic assets of the Croatian National Bank.

The Stand-By Arrangement amounting to SDR 105.9 million (about US\$151 million) was approved on February 3, 2003 (see [Press Release No. 03/13](#)). The Croatian authorities continue to treat the Stand-By Arrangement as precautionary and do not intend to draw the available financing.

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

“Croatia continues to enjoy robust economic growth, price stability, and rising international reserves. Since the first stand-by review, real GDP growth has been higher and retail price inflation lower than expected. However, in light of the still-wide external current account deficit, the authorities must pursue prudent macroeconomic policies, in addition to further structural reforms, to sustain this good economic performance. To this end, the authorities need to continue efforts at fiscal consolidation and maintaining a tight monetary policy, within an appropriately reformed monetary control framework.

“The government is on a path to achieve its general government deficit target in 2003. It has so far resisted pressures during the election campaign to raise spending. Going forward, the government needs to continue expenditure restraint and maintain its revenue effort to reduce the deficit further in the medium term. Progress in achieving external sustainability will be a key factor in deciding the needed size of the fiscal adjustment in 2004.

“To support the central bank's monetary policy, the government is encouraged to meet more of

its financing requirements in the domestic market. Apart from a lower deficit and higher privatization receipts, stabilizing the public debt ratio (broadly defined to include direct debt and guarantees) requires a stricter implementation of the guidelines on extending government guarantees.

“The current account deficit has begun to decline due to an excellent tourist season and the credit slowdown reflecting the central bank’s administrative measures and tightened reserve requirements. In the period ahead, the central bank is committed to monitoring current account developments carefully and take additional measures if the deficit does not come down as expected. The central bank remains committed to preventing a renewed acceleration of credit expansion. It intends to eliminate the administrative credit ceilings at the start of 2004 and is willing to consider replacing them with a more orthodox monetary policy framework in the course of 2004 by developing traditional open market operations. The authorities have made commendable progress in strengthening financial supervision, though they need to ensure effective implementation and reinforcement of reforms in this area.

“The partial privatization of the state-owned oil company represents a welcome step toward inducing greater efficiency in the productive sector. Following the adoption of a vast array of reform legislation in bankruptcy and other fields, the authorities need to focus their attention on implementing these reforms, and on the restructuring and privatization of public enterprises in order to sustain high rates of economic growth and further advance the prospects of Croatia’s EU accession,” Ms. Krueger said.