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Republic of Croatia: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Croatia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 8, 2006, 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 January 19, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of February 14, 2007 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 16, 2007 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Croatia.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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

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REPUBLIC OF CROATIA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the
2006 Consultation with the Republic of Croatia

Approved by Poul Thomsen and Anthony Boote

January 19, 2007

Discussions for the 2006 Article IV consultation took place in Zagreb from October 26 to November 8, 2006. The staff team comprised Messrs. Feldman (head), Gueorguiev, and Moore (all EUR), and Mmes. Ilyina (PDR) and Mitra (MCM), assisted by Mr. Vamvakidis (Resident Representative). The mission met with Prime Minister Sanader; Deputy Prime Minister Polančec; Finance Minister Šuker; Health Minister Ljubičić; Economy Minister Vukelić; Croatian National Bank (CNB) Governor Rohatinski; other senior officials; and representatives of political parties, social partners, think tanks, and the private sector.

The current minority government of the Croatian Democratic Union (HDZ), supported by six other parties, was formed in early 2004. The next parliamentary elections are due in late 2007.

In October 2005, Croatia started accession negotiations with the European Union (EU). The first, "screening" phase of the accession process was completed in October 2006. The European Commission has assessed Croatia as a functioning market economy that should be able to cope with the competitive pressures within the Union in the medium term provided it continues its reforms.

Croatia has accepted the obligations of Article VIII (Appendix I) and subscribes to the Fund's Special Data Dissemination Standard. Data are broadly adequate for effective surveillance, though some improvements would be desirable (Appendix II).

The mission participated in a joint press conference with the Prime Minister and held a separate press conference on the published concluding statement. The authorities intend to publish this staff report.

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Executive Summary

Background. Croatia has experienced solid growth and low inflation in recent years. Policies in 2004–06, supported by a Stand-By Arrangement, sought to mitigate vulnerabilities through significant fiscal adjustment and a series of prudential measures by the CNB. Notwithstanding that the financial sector is healthy and much progress has been made in improving supervision, rapid credit growth and the possibly widespread exposure of households to currency risk remain vulnerabilities. Compounding these vulnerabilities, the current account deficit widened to about an estimated 8 percent of GDP in 2006, and the external debt ratio to 84 percent.

Besides the outlook, the consultation focused on the interrelated issues of raising economic growth and addressing vulnerabilities. Without further fiscal consolidation and faster and deeper structural reforms, Croatia cannot expect to significantly raise potential growth and accelerate income convergence to western European levels. Total factor productivity growth has been low. And export growth has been significantly below the average for Croatia's peer countries, which have been more successful in attracting greenfield FDI.

- **Outlook**. Staff projects medium-term growth around potential, now estimated just below 4½ percent, with strong private consumption and investment supporting a temporarily higher pace in 2006-07. The current account deficit is projected to remain large at about 8 percent of GDP in 2007, with gross external debt staying well above 80 percent of GDP.

- **Fiscal policy.** To enhance growth and lessen vulnerabilities, staff urged a reduction in the size of government and further, expenditure-led, fiscal consolidation. The authorities agreed with staff's recommendation to lower the fiscal deficit to 1½ percent of GDP by 2009. Staff are concerned, however, about potentially serious risks to fiscal policy implementation in 2007: although the 2007 deficit target of 2.8 percent of GDP is achievable, spending is too high and further spending pressures must be resisted.

- **Monetary policy.** Staff and the authorities agreed the tightly managed float remained appropriate in light of the successful track record on inflation and the high level of euroization. Given this, addressing vulnerabilities and strengthening competitiveness mostly depends on fiscal and structural policies. Careful monitoring of rapid credit growth is required: if credit growth does not slow, tighter prudential measures—which would be preferable to credit controls—would need to be considered.

- **Structural reform.** The business environment and associated bureaucratic obstacles are a significant constraint on economic growth. Staff stressed the importance of improving the business climate and attracting strategic investors. Accelerating the public enterprise reform agenda, which has been plagued by delays, has also become increasingly urgent. While the authorities have had the same reform agenda for some time, implementation has been slow and represents a key uncertainty going forward.

I. BACKGROUND

1. **In recent years, Croatia has experienced solid growth and low inflation, but an already large current account deficit has started to widen again** (Figures 1 and 2; Tables 1 and 2). GDP growth averaged around 4¾ percent in 2001–06. Contributions to growth from private consumption and investment have accelerated in recent years, and have been associated with rapidly expanding domestic credit and imports. The contribution of net exports to growth recently turned negative, with domestic demand pressures and higher international energy prices causing the current account deficit to widen in 2005–06. Meanwhile, headline inflation has been contained to 2–4 percent (with core inflation even lower) by a combination of a broadly stable exchange rate, moderate wage growth, and limited pass-through from international to domestic energy prices. The unemployment rate remains high, despite recent declines that reflected both employment growth and declining labor-market participation (Figure 3).

2. **Although external competitiveness appears adequate, export performance has lacked the dynamism of top performers**. Exchange rate-based indicators of external competitiveness do not appear particularly worrisome. The growth of goods exports has in fact improved over the past couple of years and market share is well above its level at the start of this decade, while receipts from tourism have expanded robustly and overall growth has not been thwarted by external competitiveness problems (Figure 4, Box 1). Still, exports to the euro area[1] remain below potential and export growth significantly below the average in Croatia's peer countries, which have been more successful in attracting greenfield foreign direct investment (Figures 5 and 6). Survey measures of competitiveness underscore structural weaknesses in the business environment, as discussed below.

3. **Policies in 2004–06, supported by a precautionary Stand-By Arrangement (SBA), sought to mitigate external vulnerabilities by lowering Croatia's current account deficit and stabilizing the external debt-to-GDP ratio**. Given the focus of monetary policy on exchange rate stability, the authorities largely relied on fiscal (and quasi-fiscal) adjustment, accompanied by CNB measures to safeguard financial sector stability and discourage external debt accumulation by banks. Box 2 highlights Croatia's response to past Fund policy recommendations.

4. **The government substantially reduced the fiscal deficit during 2004–06**. The deficit reduction—from 6.1 percent of GDP in 2003 to an estimated 2.8 percent in 2006—reflected continued pension reform, wage moderation, and investment cuts, with automatic revenue stabilizers playing only a moderate role (Table 3). In addition, the state-owned Development Bank (HBOR) scaled back its (quasi-fiscal) activity.

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[1] These exports account for about 80 percent of the total.

Box 1. How Competitive is Croatia's Tourism Sector?

The tourism sector in Croatia is one of the most important in the economy. Receipts from tourism account for nearly 20 percent of GDP. Likely reflecting the beauty of the Croatian coast, the sector has grown exceptionally strongly since 1999 (when tourism was affected by regional instability): annual foreign tourist arrivals have nearly doubled, as has Croatia's market share in the Mediterranean/Black Sea region (Figure 7).

Tourism competitiveness indicators appear favorable. The indicators below assess competitiveness according to both price and quality of services (latest data are 2004). Croatia scores at or above average along all dimensions. The closest regional comparator in terms of price competitiveness is Turkey, though Croatia scores better in terms of quality of environment, technology, and human resources. Land ownership issues, however, have been a major disincentive to investment in the coastal areas where tourism has greatest potential.

2004 Country Rankings
(Most competitive is number 1; least competitive is number 212)

	Tunisia	Egypt	Turkey	Croatia	Romania	Bulgaria	Cyprus	Greece	Spain	France	Italy
Price Competitiveness	**15**	**24**	**28**	**29**	33	50	66	*93*	*95*	*99*	*103*
Human Tourism	33	29	37	n/a	62	**13**	n/a	n/a	36	*54*	*52*
Infrastructure	n/a	61	67	n/a	88	34	**11**	76	65	41	44
Environment	**21**	55	110	**43**	**38**	45	107	75	**5**	52	**30**
Technology	*119*	*127*	75	**46**	84	**71**	**41**	**35**	**39**	**29**	**24**
Human Resources	*114*	*136*	99	**50**	61	**43**	55	**25**	**13**	**17**	**37**
Openness	64	108	**45**	83	**32**	**24**	**4**	69	74	82	98
Social	106	110	75	71	**32**	61	57	**33**	**31**	**19**	**40**

Bold denotes above-average performance, and *italics* below-average performance.
The methodology underlying the above indices is available at www.wttc.org; see also Country Report No. 04/365.

Source: *The Competitiveness Monitor*, World Travel and Tourism Council.

5. **While bank restructuring and privatization have strengthened the financial sector, strong credit expansion and foreign exchange-induced credit risk have raised concerns that prompted a prudential policy response by the CNB**. Large foreign banks own over 90 percent of the system, which is well developed by regional standards (Figure 8). Financial soundness indicators show adequate capitalization and asset quality (Table 4). But intense competition among banks and easy access to credit from foreign parents has contributed to a vigorous credit expansion that gained momentum over 2005–06 (Table 5). The pace of the ongoing credit expansion increases the potential for asset quality to deteriorate in the event of a downturn.[2] Most households seem exposed to currency risk:

[2] An accompanying selected issues paper examines the sensitivity of bank provisioning to macroeconomic conditions and rapid credit growth. In a similar vein to a CNB study, it suggests that banks increase their loan-loss reserves to provide a buffer against potential loan losses in the event of a downturn, to avoid a potentially significant hit on capital.

Box 2. Croatia: Past Fund Policy Recommendations and Implementation

Policy implementation has been in the context of the recent SBA (Appendix III), which expired in November 2006 and effectively covered the entire period since the previous Article IV consultation in August 2004.

Fiscal Policy: In line with Fund recommendations, the government implemented considerable fiscal and quasi-fiscal adjustment in the context of a new medium-term fiscal framework.

Financial Sector: The CNB has used the marginal reserve requirement to counter banks' foreign borrowing, and eschewed direct bank credit ceilings, whose abolition Directors welcomed at the previous consultation. The authorities have implemented most recommendations from the 2002 FSAP and are addressing the remainder.

Structural reforms: Implementation on reinvigorating structural reform efforts and accelerating privatization has been mixed: restructuring of state-owned enterprises and key privatizations have been delayed, though the recent sale of shares in the oil company (INA) was a major step forward; but the authorities have made more progress in other areas than envisaged in 2004, notably in pensions and health.

75 percent of long-term bank loans to households are linked to foreign currencies (mainly euro, though recent loans have been largely Swiss-franc); and, even though households' foreign-currency deposits are sizeable in the aggregate, borrowers and savers may only partly overlap. Concerned about safeguarding financial stability, the CNB responded with a series of measures to slow the bank-related portion of capital inflows: a progressive increase in its marginal reserve requirement (MRR) on banks' foreign borrowing, broadening its base, and issuing various prudential measures and guidelines (discussed in ¶21 and 22 of the policy section).

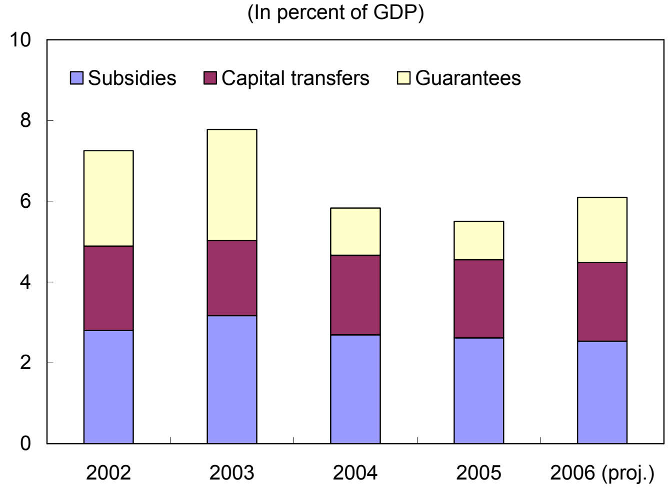
6. **Despite countervailing policy efforts, external vulnerabilities remain significant**. The increase in the external debt-to-GDP ratio has been arrested, Croatia's market access is strong, and, in the context of strong capital inflows and a tightly managed float, reserves have increased (Figures 9 and 10; Table 6). However, gross external debt (above 80 percent of GDP at end-2006) and the current account deficit (estimated at 8 percent of GDP in 2006) remain high, in circumstances in which privatization receipts are expected to drop sharply after 2007 and sizable new FDI is not assured.[3] Large external financing needs—to finance the current account deficit and roll over maturing debt—imply vulnerability to shocks and contagion. Indeed, the CNB has publicly warned of the risk of debt-service and rollover

[3] Staff estimates that a current account deficit of around 7¼ percent of GDP would, with FDI of about 4½ percent of GDP, stabilize external debt (Appendix IV).

difficulties should the still-positive investor sentiment toward emerging markets sour.[4] High debt also reduces the flexibility—already limited by euroization—of monetary and exchange rate policy, putting considerable responsibility on fiscal policy for demand management.

7. **The large role of the state, slow progress in key structural reforms, and less-than-satisfactory conditions for doing business have constrained economic performance**. The state's presence in many aspects of economic activity remains significant and is reflected in one of the biggest governments in the region (Figure 11), high state aid (text chart), and a large public sector share of output (about 40 percent of GDP, high relative to Croatia's peers; Figure 12). While recent progress in some transition indicators has been significant, privatization and reform of state-owned enterprises has lagged (¶26) because of legal disputes, resistance of vested interests, onerous investment and employment conditions, and a legal framework favoring insiders—a bias that the pending draft privatization law could worsen. In addition, survey evidence—corroborated consistently by the mission's discussions with public and private sector representatives—shows that the conditions for doing business are hampered by the heavy administrative burden and difficulties enforcing property rights (Figure 13; text table), with many problems at the local level.

Croatia: Forms of State Aid, 2002–06
(In percent of GDP)



Sources: Ministry of Finance; and Fund staff estimates.

Ease of Doing Business	2006 rank	2005 rank	Change in rank
Overall	**124**	**134**	**10**
Starting a business	100	112	12
Dealing with licenses	170	171	1
Employing workers	130	131	1
Registering property	109	109	0
Getting credit	117	117	0
Protecting investors	156	156	0
Paying taxes	58	72	14
Trading across borders	92	140	48
Enforcing contracts	28	28	0
Closing a business	80	76	-4

Source: The World Bank's *Doing Business* website.

[4] Another accompanying selected issues paper, using the balance sheet approach, analyzes how the vulnerabilities of main economic sectors to foreign exchange, interest rate, and liquidity (debt rollover) shocks have increased between 2000 and 2005 as external debt rose by over 20 percentage points of GDP.

II. Macroeconomic Outlook and Risks

8. **Growth is projected to remain around its medium-term potential, but with strong private consumption and investment supporting a temporarily higher pace in 2006–07**.

- The staff scenario (Table 7) projects an acceleration in private consumption in 2006–07, partly reflecting the large but one-time "pensioners' debt" payments (1 percent of GDP in each of 2006 and 2007, described in Country Report No. 06/346). Investment growth—after the rapid pace in preceding years—is projected to moderate from 2007, though investment remains high as a share of GDP. Projected exports rise slowly as a share of GDP, broadly in line with the growth in trading-partner demand. On this basis, staff projects real GDP growth lifting to 4.6 percent in 2006 and 4.7 percent in 2007, returning to 4½ percent afterwards—with inflation around 3 percent. But the commodity price outlook and the strength of domestic demand imply a wider current account deficit in 2006 and 2007, about 8 percent of GDP in each year. For the medium term, taking into account the constraints to growth posed by the business environment, staff estimates potential growth for Croatia just below 4½ percent (Box 3).

- The authorities have a similar view of the growth outlook for 2007, but somewhat higher growth approaching 5 percent for the medium term, reflecting a more optimistic investment and export outlook. They agreed that the 2006 current account deficit would remain high (data for the four quarters to 2006Q3 already showed a deficit of 8.1 percent of GDP) and may even widen a bit next year. Further ahead, the authorities' *Strategic Development Framework* envisages a pickup in real GDP growth to over 7 percent annually by 2010–13—assuming sharply higher FDI and full implementation of reforms to improve the business environment.

- Upside risks to both short-term growth and the current account deficit arise from a potentially stronger-than-expected stimulus from rapid credit growth to private consumption and investment. Downside risks to growth—which could, however, widen the current account deficit—include the potential for a renewed increase in oil prices, lower-than-expected trading partner growth, and/or a deterioration in investor sentiment toward emerging markets.

9. **The main risk from a medium-term perspective is that strong capital inflows might fuel consumption and real estate speculation rather than augment the economy's productive capacity.** This would clearly aggravate external vulnerabilities. In an environment combining a number of underlying difficulties—including heavy state presence in the economy, a still-high public sector deficit (including the pensioners' debt repayments), lackluster goods exports, and extensive euroization—heavy capital inflows could seriously strain the macroeconomic framework. This risk would be heightened by the absence of

Box 3. Total Factor Productivity and Potential Growth

Recent economic growth has relied on capital accumulation, with only a limited contribution from growth in total factor productivity (TFP) and less from employment. The growth decomposition below applies a Cobb-Douglas production function based on Hodrick-Prescott-filtered labor supply (which has reflected the declining activity rate) and productivity. The modest growth in TFP is a concern, and reflects the unfinished structural reform agenda.

These estimates imply potential growth of just below 4½ percent in the medium term. An accompanying selected issues paper provides details of these estimates[1]—and corroborates them using other methodologies. Recommended structural reforms could boost TFP and result in significantly higher GDP growth.

	1996–2001	2002–05	2006–09
Real GDP growth (percent)	3.6	4.7	4.4
Contributions:			
Capital	3.2	2.7	2.7
Labor	-1.0	0.9	0.5
Productivity	1.5	1.1	1.1

[1] As described in the selected issues paper, alternative capital stock data from the statistical office—which are very preliminary and subject to change—imply lower capital accumulation (1.5 percent in 1996–2001 and 2.2 percent in 2002–05), correspondingly higher TFP (to 3.2 percent in 1996-2001 but only 1.6 percent in 2002-05), and slightly lower potential growth of 4.3 percent.

structural reforms that help channel capital flows to productivity-enhancing uses and raise exports.

III. Policy Issues

10. **The consultation focused on issues related to raising potential growth and addressing vulnerabilities, which are core objectives of the authorities' economic strategy**. Their medium-term fiscal framework envisages further fiscal consolidation, with the aim of reducing external vulnerability and public debt.[5] In addition, their broad-ranging

[5] Outlined in the *Economic and Fiscal Policy Guidelines* (EFPG; mid-year) and the *Pre-Accession Economic Program* (PEP; end-year).

Strategic Development Framework stresses the importance of completing the "unfinished transition" and the benefits of providing market incentives to encourage all value-adding activity, rather than picking particular sectors for development. For its part, staff prepared four accompanying selected issues papers on the interwoven topics of raising economic growth and reducing vulnerabilities.

A. Fiscal Policy

11. **The core fiscal policy issues were reducing the size of the government, undertaking further fiscal consolidation, and enhancing the flexibility of fiscal policy**. Progress on these interrelated fronts is important for several reasons: first, the opportunity to boost economic growth by reducing the burden of the large state; second, the need to address a large current account deficit and ensure a sustainable debt path; and third, with monetary policy constrained, the benefits of enhancing fiscal flexibility to cope with shocks.

12. **The authorities have been planning further medium-term fiscal consolidation—albeit on a moderate scale.** The July 2006 EFPG and December 2006 PEP target a fiscal deficit of 2.8 percent of GDP in 2007, gradually declining to 2.4 percent of GDP by 2009 (text table). The planned adjustment is based on ongoing structural reforms (in the areas of pensions, health, and subsidy reduction) and on a continuation of the expenditure restraint practiced since 2004.

13. **Staff strongly recommended more ambitious medium-term fiscal targets**. Indeed, several advantages from targeting fiscal deficits of 2 percent of GDP in 2008 and 1½ percent in 2009—as recommended by staff—were noted. The lower fiscal deficits would help counter current account-related vulnerabilities, lock in a sustainable path for public debt (Appendix IV shows the standard sustainability analysis), and, with monetary policy constrained, provide needed insurance against negative surprises. With the authorities aspiring to join the EU as soon as possible and enter ERM-2 fairly quickly, a strong fiscal adjustment would also add to the credibility of these aspirations and to the goal of early euro adoption, while helping to create room for an increase in expenditure to absorb

Croatia's Medium-Term Fiscal Framework
(In percent of GDP unless otherwise stated)

	2006	2007	2008	2009
2005 PEP 1/				
General government revenue	44.4	43.1	42.3	...
General government expenditure	47.6	46.0	45.0	...
Fiscal balance	-3.2	-3.0	-2.7	...
2006 Supplementary Budget and July 2006 EFPG				
General government revenue	44.9	44.2	43.6	42.7
General government expenditure	47.9	47.0	46.2	45.1
Fiscal balance	-3.0	-2.8	-2.6	-2.4
2006 PEP and 2007 Budget				
General government revenue	45.0	44.9	44.3	43.8
General government expenditure	47.8	47.7	46.9	46.2
Fiscal balance	-2.8	-2.8	-2.6	-2.4

Sources: Croatian Ministry of Finance; and Fund staff estimates.

1/ For comparability with later projections, ratios to GDP are adjusted to reflect revisions to historical GDP data and staff GDP projections.

structural funds and pay Croatia's contribution to the EU budget once in the EU. The authorities were receptive to these arguments, and the Prime Minister publicly spoke in favor of the more ambitious deficit target of 1½ percent of GDP in 2009, though underlying policies would need to be elaborated.[6] The authorities also noted that higher public spending because of EU-related expenditures makes fiscal adjustment all the more challenging, requiring more adjustment elsewhere for a given deficit target.

14. **Staff also emphasized that successful implementation of the medium-term fiscal framework beyond 2007 would require structural measures to reduce expenditures permanently**. With Croatia's expenditure-to-GDP ratio well above peers (Figure 11), there is scope for significant savings, which would enable both tax cuts (including cuts in contributions) to boost growth and lower fiscal deficits.

- The authorities envisage public sector reforms, but underlying specifics are yet to be worked out. Staff noted that the wage bill is very large by regional standards and emphasized the importance, in undertaking civil service reform, of allowing more flexibility and sharper performance-based differentiation of individual wages, while keeping the overall compensation cost on a steeper-than-envisaged declining path by reducing the high public sector employment (the authorities assume increases in employment). Additional medium-term savings could come from implementing the existing medium-term subsidy-reduction plan, especially in the railways; and from the forthcoming shipyard restructuring. However, staff would encourage the authorities to be even more ambitious than planned on subsidy cuts, including in agriculture.

- Since the more ambitious deficit targets recommended by staff would imply a sharper reduction in the expenditure-to-GDP ratio than envisaged in the medium-term fiscal framework, staff also urged the authorities to widen the reform agenda beyond existing plans, in particular in social benefit spending.[7] The authorities noted that high benefit spending, especially for veterans, was necessary owing to the legacy of the 1990s wars. Staff acknowledged this legacy, but argued that this made better benefit targeting all the more important. High priority, in staff's view, should be to target welfare, family, and health benefits taking into account the income (and assets) of recipients, and consolidating the numerous welfare benefits (which could also help address disincentives to labor-market participation, which, as shown in Figure 3, has declined significantly).

[6] The 2006 PEP also sees deeper fiscal consolidation as a realistic option, based on better revenue collection, stricter expenditure control, and further progress in expenditure-reducing structural reforms.

[7] Adapting the Fund's Global Fiscal Model to Croatia, a selected issues paper shows that more ambitious expenditure reforms would provide room for significant tax cuts, in turn stimulating investment, employment, growth, and consumption.

15. **The 2007 budget targets a general government deficit of 2.8 percent of GDP**. Thus, the overall balance would be little changed from 2006 and would worsen on a structural basis, according to staff estimates. The authorities felt that adhering to this target was appropriate considering the fiscal adjustment already implemented over the past three years and the expenditure demands they faced in the politically charged pre-election environment. In addition, financing options—for both the budget and the current account—would seem to afford some flexibility in the timing of fiscal adjustment, notwithstanding the deterioration in the current account.

16. **While staff recognized that achieving the 2007 deficit target would be an accomplishment in the politically charged atmosphere before elections, it expressed concerns about potentially serious risks to fiscal policy implementation in 2007.**

- Spending pressures were mounting. Ahead of the mission, the government approved increases in child and maternity benefits and free school textbooks, adding 0.3 percent of GDP to expenditure. During the mission, demands to boost wages, and the pensions of post-1999 retirees—either through a reversal of pension reform parameters, or through "off-budget" accounting schemes—were evident and represented sizeable fiscal risks.[8]

- In addition, fiscal and quasi-fiscal activities, not showing up in the headline deficit, were planned that would add to aggregate demand pressures at a time of a widening current account deficit. These included the scheduled "pensioners' debt payments (1.1 percent of GDP), HBOR's plans, after the recent consolidations, to raise its deficit from an expected 0.2 percent of GDP in 2006 to 0.6 percent in 2007, and potentially large borrowing by shipyards using government guarantees (up to 1.6 percent of GDP).

- Against this background, and before the budget was prepared, staff recommended adhering to the expenditure-to-GDP ratio envisaged in the July 2006 EFPG. This would avoid a ratcheting up of spending that could be difficult to unwind in later years, and, according to staff estimates, result in a fiscal deficit well below the targeted 2.8 percent of GDP owing to expected revenue overperformance.

- In the event, the budget includes revenues and expenditures as shares of GDP that are 0.7 percentage point higher than the July 2006 EFPG plan for 2007. This reflects, in part, the inclusion in the central government accounts of small budget users previously outside the government (a welcome result of the single treasury account) and higher EU grants (with

[8] To address the unsustainability of the pay-as-you-go pension system, a 1999 reform reduced the generosity of the benefit formula. For this, and other reasons, post-1999 retirees have lower pensions than the pre-1999 retirees. One option under consideration would pay the post-1999 retirees "off-budget" (using the current accounting methodology), via a transfer of shares to an extrabudgetary fund. The accrual-based GFS 2001 or ESA 95 methodologies would treat either the share transfer or the fund payments as on-budget general government expenditure.

expenditure counterparts) than in the earlier plan. However, the budget also includes higher spending on subsidies to farmers, goods and services, and investment. The revenue estimates are realistic in staff's view, but would leave little room for overperformance.

- Spending pressures have since persisted, which would raise the deficit above 2.8 percent of GDP if not offset by cuts elsewhere. The authorities agreed with the public sector trade unions to a 6 percent wage increase (instead of the 5 percent assumed in the budget) and to paying bonuses to teachers in addition to the granted wage increase, straining the budget wage bill. Moreover, the national airline will receive additional unbudgeted subsidies.

17. **The discussions explored ways to enhance fiscal flexibility**. In the health sector, the authorities plan to shift financing gradually to a per-diagnosis basis in hospitals to remove perverse incentives to keep patients in hospitals, and to strengthen control over sick leave spending. Staff supported these plans, which would lessen rigidities in a large area of non-discretionary expenditure, and encouraged the authorities to start preparing the next stage of the health reform. Staff also recommended raising gradually the general contingency to about 1 percent of central government expenditure (from about 0.3 percent in the past), and that the authorities prepare contingent fiscal policy measures in case the deficit needs to be reduced at short notice.

18. **The authorities recognized the need for transparency and safeguards to avoid problems from contingent liabilities**. The Ministry of Finance (MoF) was determined to keep to a minimum the amount of guarantees extended to the shipyards ahead of adoption of a restructuring plan for the troubled sector, as most such guarantees will likely be called. To prevent other unexpected government expenditure, staff urged the MoF to scrutinize carefully any proposals for public-private partnerships (PPPs) to ensure adequate risk sharing is in place. Although the MoF was confident that sufficient controls were in place to avoid additional government expenditures on account of existing PPPs, it requested FAD technical assistance as an additional precaution, and in light of plans for new PPPs.

B. Monetary Policy and the Financial Sector

19. **The CNB continues to target broad stability in the kuna-euro exchange rate as the predominant operating objective of monetary policy, although it has avoided a formal commitment to a particular level or band**. The CNB has operated pragmatically, allowing moderate exchange rate fluctuations to accommodate seasonal market pressures. The authorities and staff agreed that the emphasis on exchange rate stability has clear advantages in light of extensive euroization—about 80 percent of bank loans and time deposits are foreign-currency denominated or indexed—as well as an import-to-GDP ratio of over 50 percent, and strong trade links with the euro area. Crucially, the tightly managed float has delivered consistently low inflation, fulfilling the CNB's primary objective.

20. **Staff supported the present monetary framework, while stressing the implications for other policies**. The limited exchange rate flexibility was conducive to unhedged borrowing in foreign currencies with potentially negative implications for financial stability, requiring more vigilance in bank supervision and tighter bank regulations than otherwise to address the attendant risks. The constraints on monetary policy also put considerable onus on fiscal policy, and underscore the importance of structural reforms. Indeed, given the high level of euroization, the adverse impact of a weaker exchange rate on balance sheets would likely offset any short-term gain in competitiveness. Thus, strengthening competitiveness would require wage moderation and faster and deeper structural reforms. These points were not new to CNB officials and in line with their thinking.

21. **The CNB remained concerned about high credit growth, having responded with a series of prudential measures over the past year**. The measures include: first, raising the MRR to 55 percent effective early 2006, and closing MRR loopholes to prevent banks borrowing abroad via local nonbank intermediaries; second, increasing risk weights on unhedged foreign-currency denominated and indexed loans; third, introducing quarterly reporting requirements for such loans; fourth, issuing new guidelines to banks on managing household and currency-induced credit risk, including a 75 percent loan-to-value ratio for mortgage loans and—when the new credit bureau begins operations shortly—higher risk weights for loans not checked against the credit bureau; and finally, phased in over October 2006–March 2007, a broadening of the base of the foreign-exchange liquidity requirement to cover instruments indexed or denominated in foreign currency. The MRR measure in particular has targeted the build-up in banks' external debt that has funded much of the credit expansion.

22. **While clearer information on banks' lending plans for 2007 is pending, emerging evidence suggests the CNB's measures may have started to have an impact**. During the mission's discussions, banks appeared to be changing behavior by scaling back foreign borrowing plans, instead financing their activities through retained earnings and intensifying efforts to attract domestic deposits. Staff therefore recommended the CNB adopt a wait-and-see approach, but consider further prudential measures (e.g., tightening loan eligibility requirements) if rapid credit growth went unabated. As in the past, staff argued against credit controls, which would likely be ineffective and push credit outside domestic banks. In late 2006, banks' foreign borrowing increased again, but reportedly to comply with the broadening of the foreign-exchange liquidity requirement. The ongoing adjustment to the broadened requirement complicates a near-term assessment of whether the CNB measures are having their desired effect.

23. **Major progress has been made in improving nonbank financial sector supervision**. The unified nonbank supervisor (HANFA) began operations in January 2006 and was cooperating increasingly closely with the CNB, concluding a memorandum of understanding in September 2006. The new leasing act, which parliament approved in

December 2006, clarifies HANFA's oversight of leasing companies and prevents these companies from extending new non-leasing credits. The authorities saw the legislation closing gaps both in supervisory coverage and in the CNB's reserve requirements. Other legislation is planned to gradually raise the limits on foreign investment and broaden the scope of equity investment by pension funds; the tight existing limits have channeled strong institutional demand for equity assets into a still-thin local capital market, contributing to the recent sharp increase in local stock prices.

24. **The authorities have implemented most recommendations of the original 2002 FSAP, and are addressing remaining concerns** (Table 8). Nevertheless, in light of the potential rise in financial sector vulnerabilities, they saw merits to an FSAP update. It could take place later in 2007, complementing an upcoming European Commission/World Bank joint review of the financial sector.

C. Structural Issues

25. **A broad range of public and private sector representatives viewed the business environment and bureaucratic obstacles as the main constraint on economic growth**.[9] The main impediments to doing business were the administrative burden, notably at the local level; high, numerous, and nontransparent local fees; and property-related legal uncertainties, specifically land ownership issues and enforcement of property rights. Important steps have already been taken at the central government level to simplify procedures, for example the "one-stop shop" to establish a business; "entrepreneurial zones" with good infrastructure and land free of ownership uncertainty; and the initiation of a "regulatory guillotine" to eliminate unnecessary regulations. The government was also trying to estimate the total tax burden on companies, including the numerous (and nontransparent) local government fees, with a view to eliminating uncertainty in this area. Various sources saw complex local government regulations as conductive to corruption. Central government authorities had little power to intervene at the local level but noted the importance of the fight against corruption both in its own right and as part of the EU accession process. Despite recent efforts to clear a judicial backlog, bankruptcy and contract enforcement procedures remain very slow. Survey evidence also suggests that, despite some relaxation in 2003, strict employment protection legislation remains a disincentive to new job creation.

26. **The authorities voiced their determination to move forward with their long-standing reform agenda for remaining state-owned enterprises**. The privatization process and plans to restructure loss-making sectors—notably shipyards and steel—have been plagued by delays.

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[9] Staff reaches the same conclusion in the selected issues paper on potential growth.

- The two largest transactions envisaged in the 2004 program were the sale of shares in INA (the national oil company) and HT (the telecom company) by end-2005. In the event, the government launched an initial public offering for INA shares in late 2006; and approved the model for an initial public offering for HT, now planned for 2007.

- Privatization of smaller companies in the portfolio of the Croatian Privatization Fund (HFP) also fell behind schedule—the 2004 program envisaged the sale of all of HFP's holdings by end-June 2005—partly because a series of ownership disputes. Complicated tender procedures have also slowed transactions. On the basis of a new privatization law (see below), the authorities now intend to complete the sale of most remaining shares in the HFP portfolio—excluding shipyards—by end-2007.

- Some officials saw the shipyards as the greatest near-term fiscal risk, because large losses in the sector might need to be covered by the state via government guarantees. A national restructuring plan to make the sector commercially viable—originally envisaged for end-2005—has yet to be finalized. But the need to comply with EU state aid rules has made its finalization increasingly urgent. The shipyards faced difficulties in the summer of 2006 when banks refused to lend to them even with government guarantees, because of concerns that the guarantees would contravene the State Aid Law (harmonized with EU state aid rules) without the restructuring plan in place. The government arranged a six-month reprieve with a "one-time, last-time" rescue package consistent with EU rules and now intends to finalize the long-awaited restructuring plan before the rescue package expires in March 2007.

- The authorities expected to complete the privatizations of the two large steel companies by end-2006. Turning to remaining state-owned financial institutions, the authorities' previous intention was to privatize the insurance company (CO) following a merger with the Postal Bank (HPB). However, it now appears these institutions will share capital but remain distinct legal entities, complicating the privatization plans.

27. **Staff expressed strong reservations on aspects of the draft privatization law still under discussion with social partners**. The draft law contains some welcome provisions to simplify privatization procedures without loss of transparency. However, it would also allow new privatization models including employee-management buyouts under an employee stock ownership program (ESOP). The government considered the ESOP essential for securing consensus for privatization and proposed an ESOP stake of up to 25 percent in enterprises being privatized, at a large discount.[10] Social partners have argued for even higher ESOP stakes. Staff was concerned that an ESOP component as large as proposed would risk deterring potential strategic investors and entrench insider control of enterprises, thereby worsening corporate governance problems and limiting the possibility for new investment.

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[10] Subsequently, this has been restricted to profitable enterprises.

IV. Staff Appraisal

28. **Croatia's macroeconomic performance has been broadly favorable and policies have improved in recent years**. Growth has been solid and inflation contained. The authorities, since 2004, have put the fiscal deficit on a downward path, improved transparency and budgeting processes, including by bringing a medium-term perspective to fiscal policy, curtailed quasi-fiscal activities, and brought the pension and health care systems closer to sustainability. Financial supervision both for banks and nonbanks has been strengthened. Looking ahead, progress in the EU accession process has boosted investment prospects and, absent negative shocks and policy slippages, growth over the medium term should remain solid with inflation in check.

29. **Still, to boost potential growth and to continue addressing Croatia's still-significant vulnerabilities, the reform process must be stepped up.** If Croatia fails to carry out further and significant fiscal consolidation and faster and deeper structural reforms, it cannot expect to significantly increase overall productivity and potential growth, reduce vulnerabilities associated with the high levels of the current account deficit and external debt, and speed up income convergence to western European levels.

30. **This means ongoing fiscal consolidation that is more ambitious than in the authorities' medium-term plans.** Achieving the more ambitious fiscal targets recommended by staff—in particular an expenditure-led reduction in the fiscal deficit to 2 percent of GDP in 2008 and 1½ percent of GDP by 2009—is important to address a large current account deficit, ensure a sustainable debt path, and boost economic growth by reducing the burden of the large government. Even then, fiscal consolidation would need to continue, with a view to positioning Croatia to make the most of the opportunities provided by EU accession and minimizing vulnerabilities in the run-up to euro adoption.

31. **While there have been indications of support from the authorities for more ambitious fiscal targets, resisting spending pressures now is key.** Though a smaller deficit target would have been preferable, the immediate task is to avoid additional unbudgeted spending and ensure that the 2007 fiscal deficit is no larger than the authorities' target of 2.8 percent of GDP. In this context, "off-budget" proposals to address spending demands would be counterproductive, even if the headline deficit is now unaffected, by adding to aggregate demand at a time when it is important to reduce the current account deficit, and by diminishing fiscal transparency. These proposals could also widen the budget deficit on an ESA 95 basis, which Croatia plans to adopt soon. Demands to reverse the parametric pension benefit reform, if met, would have especially damaging long-term consequences. Accommodating other spending pressures could also have serious medium-term implications on the fiscal accounts and vulnerability, and on the credibility of Croatia's strategy of joining the EU as soon as possible and adopting the euro at the earliest opportunity.

32. **To be successful, the medium-term adjustment effort must focus on permanently reducing expenditure.** It is therefore important to get an early start to the technical preparations for public expenditure reforms. Even if actions are unlikely before the 2007 elections, these preparations should begin before then. Key areas of focus are civil service reform, better targeting of welfare, family, and health benefits, greater subsidy cuts, and further progress in implementing health reform. In addition, HBOR's activities need to be consistent with fiscal policy goals, preferably by consolidating its activities within the general government. The planned expansion of its lending and external borrowing would go against government efforts to reduce public spending and foreign debt.

33. **The monetary policy framework remains suitable for Croatia, but needs support from other policies**. In particular, tightly managing the exchange rate is appropriate given the high degree of euroization, the openness of the economy, and external competitiveness that is adequate. But the constraints on monetary policy mean there are no quick fixes to maintain and improve Croatia's competitiveness. This underscores the importance of structural reforms to strengthen competitiveness so Croatia can catch up with the top performers in central and eastern Europe in terms of export growth. At the same time, fiscal policy must address macroeconomic imbalances.

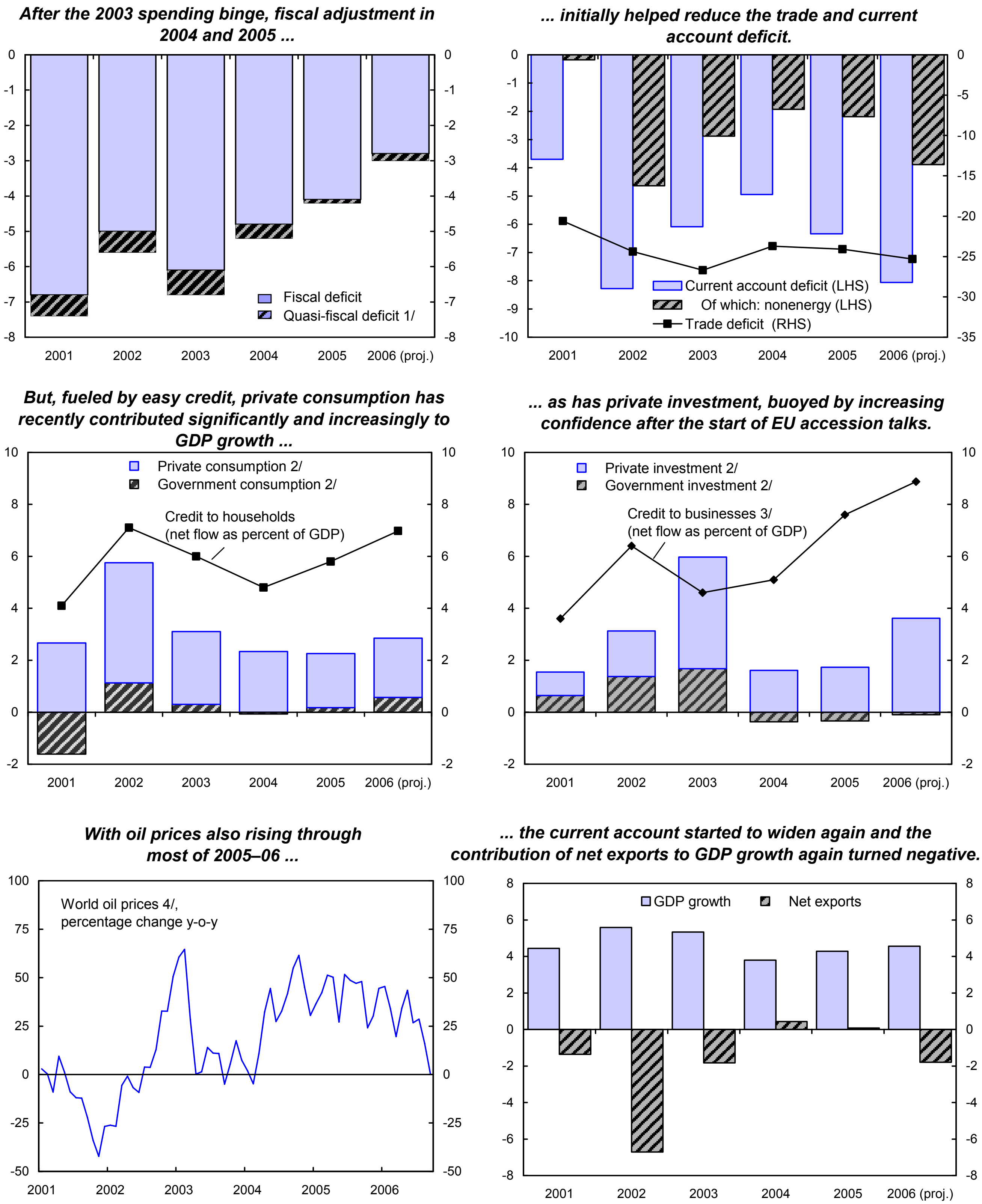
34. **The authorities recognize the structural measures needed to boost potential growth, but strong and timely actions are required on several fronts and difficult decisions therefore lie ahead.** Perhaps the most difficult are for shipyards, for which restructuring is necessary and overdue, likely involving cuts in capacity and employment. More broadly, attracting strategic investors across different sectors of the economy is essential, and privatization of remaining state-owned enterprises will be most successful with new investment and know-how from outside investors with sufficient ownership stakes to ensure good corporate governance and restructuring. Thus, the authorities should avoid privatization tenders with overly restrictive employment and investment conditions that risk deterring such investors. Until the privatization process can be accelerated, unrestructured loss-making state-owned enterprises will continue to demand public resources that could be used elsewhere more productively.

35. **The importance of significantly improving the business climate cannot be emphasized enough.** Indeed, the authorities' strategy for growth rightly stresses the importance of a business-friendly environment that safeguards market competition and promotes private sector investment, letting entrepreneurs rather than government assess which projects are most likely to be profitable. Notwithstanding recent progress, this, however, still requires improvements in several areas, including reducing the administrative burden, legal uncertainties, and corruption, which should help attract a much-needed increase in greenfield FDI in coming years, as a critical ingredient for boosting exports and growth while lessening vulnerabilities.

36. **Although the financial sector is healthy and much progress has been made in improving its supervision, vulnerabilities remain**. The CNB has been playing a critical role in address vulnerabilities through its efforts to strengthen prudential regulation and supervision. In addition, the banking system remains profitable and well capitalized. The establishment and development of the independent nonbank supervisor HANFA over the past year is also welcome, as is its increasingly close cooperation with the CNB and other legislative changes to ensure comprehensive and seamless supervision of the financial sector. However, the recent decline in the nonperforming loans ratio may reflect rapid credit growth more than any significant improvement in asset quality. Moreover, the pace of credit growth remains a concern, especially since the ratios of household debt and bank assets to GDP are already high by regional standards. Careful monitoring is therefore required and, if credit growth goes unabated, tighter prudential measures would be need to be considered and would be preferable to distortionary administrative measures that could be readily circumvented. In light of the potential for vulnerabilities to arise more generally, the authorities are encouraged to formally request an FSAP update.

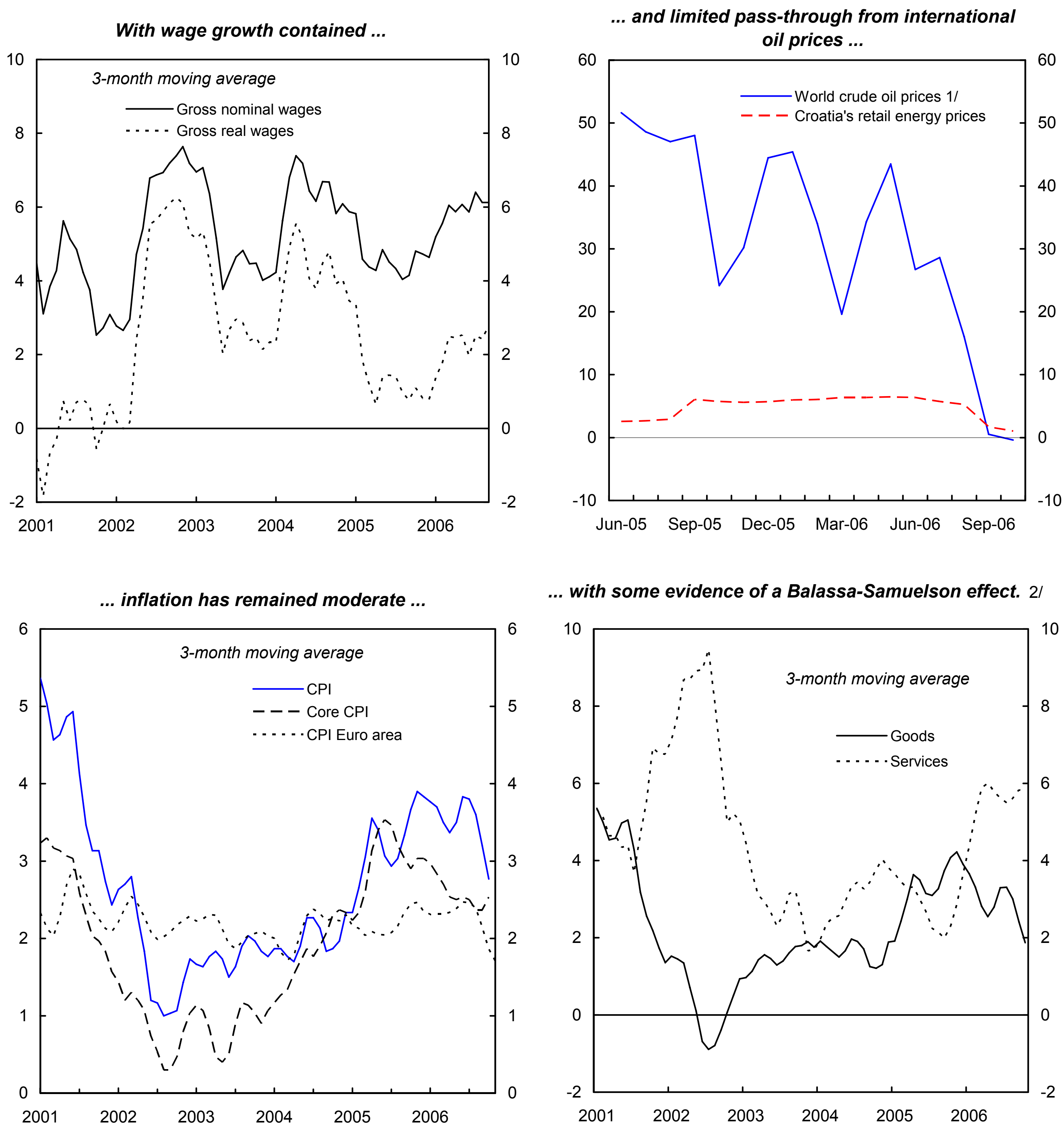
37. It is expected that the next Article IV consultation with Croatia will be on the 12-month cycle.

Figure 1. Croatia: Macroeconomic Developments, 2001–06
(In percent of GDP, unless specified otherwise)



Sources: Croatian authorities; and Fund staff calculations.
1/ The quasi-fiscal deficit is defined as the deficit of the state Development Bank (HBOR), engaged primarily in subsidized lending.
2/ Contribution to GDP growth, in percentage points.
3/ Domestic bank loans and direct external borrowing.
4/ A simple average of three spot prices: Dated Brent, West Texas Intermediate, and the Dubai Fateh, US$ per barrel.

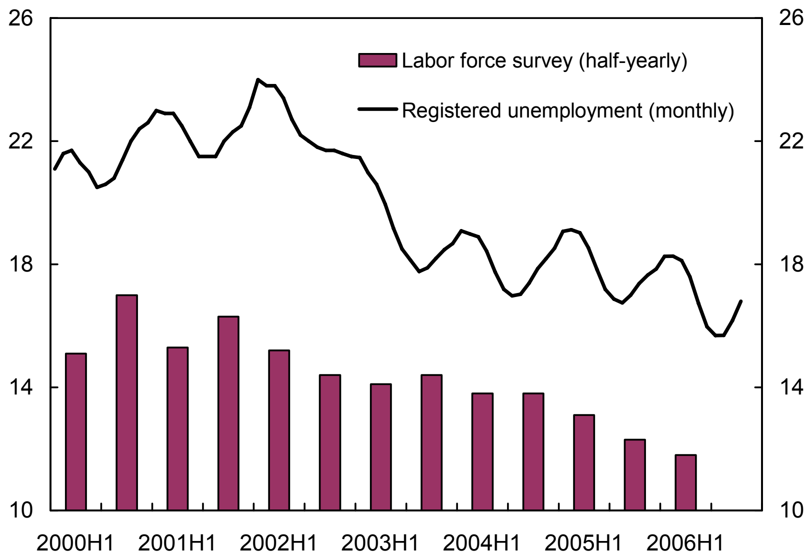
Figure 2. Croatia: Determinants of Inflation, 2001–06
(Percentage change, year-on-year)



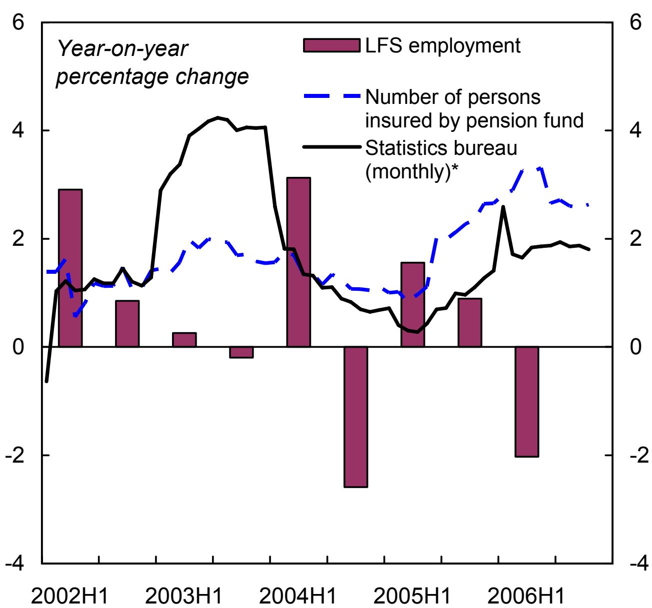
Sources: Croatian authorities; and Fund staff calculations.
1/ A simple average of three spot prices: Dated Brent, West Texas Intermediate, and the Dubai Fateh, US$ per barrel.
2/ Egert, B. (2005), in "Balassa-Samuelson Meets South Eastern Europe, the CIS and Turkey: A Close Encounter of the Third Kind?," *The European Journal of Comparative Economics*, estimates the Balassa-Samuelson effect on inflation in Croatia at 0.6–0.8 percent a year.

Figure 3. Croatia: Labor Market Indicators, 1998–2006
(In percent)

The unemployment rate has declined in recent years.

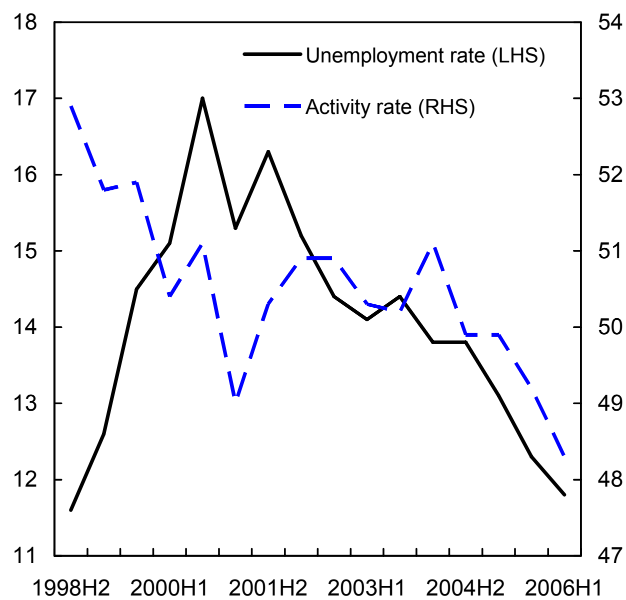


Employment has been growing steadily (the labor force survey in 2006H1 is an outlier) ...



* Data for current year are break-adjusted.

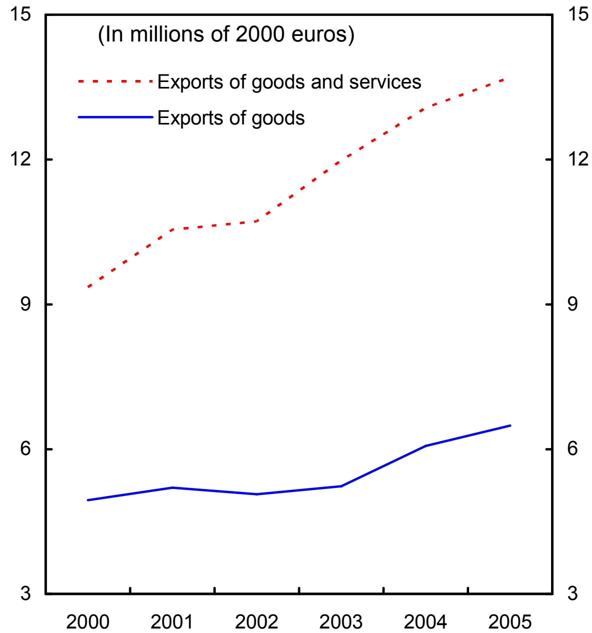
... but the trend decline in the activity rate (labor force in percent of working-age population) is worrisome.



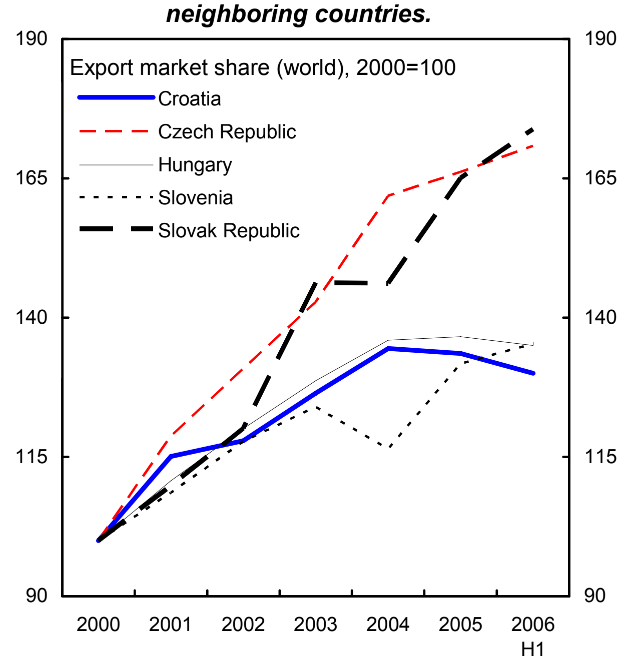
Sources: Central Bureau of Statistics, HZZO (Croatian Pension Insurance Fund), and Fund staff estimates.

Figure 4. Croatia and Selected European Countries: Competitiveness Indicators, 2000–06

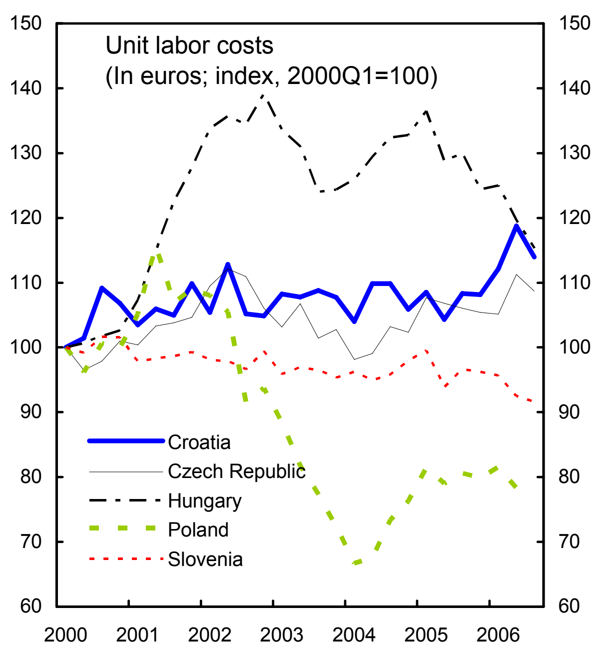
While tourism has helped, exports of goods have been sluggish.

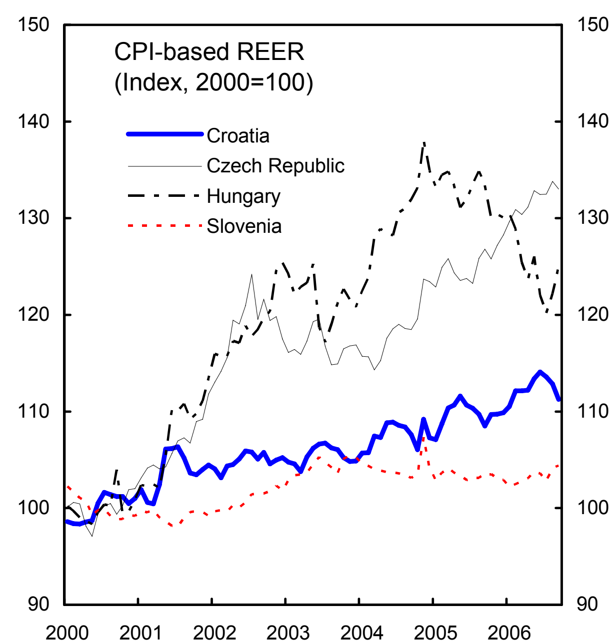


Market share in world exports has rebounded, albeit more slowly than in some neighboring countries.



Gradual real exchange rate appreciation partly reflects a Balassa-Samuelson effect of 0.6–0.8 percent a year. Cost and exchange rate-based competitiveness indicators vis-à-vis Croatia's closest competitors appear adequate, with unit labor cost (ULC) essentially flat in 2000–05. Still, in 2006 market share continued to ease modestly, while ULC picked up, and real appreciation pressures firmed somewhat.

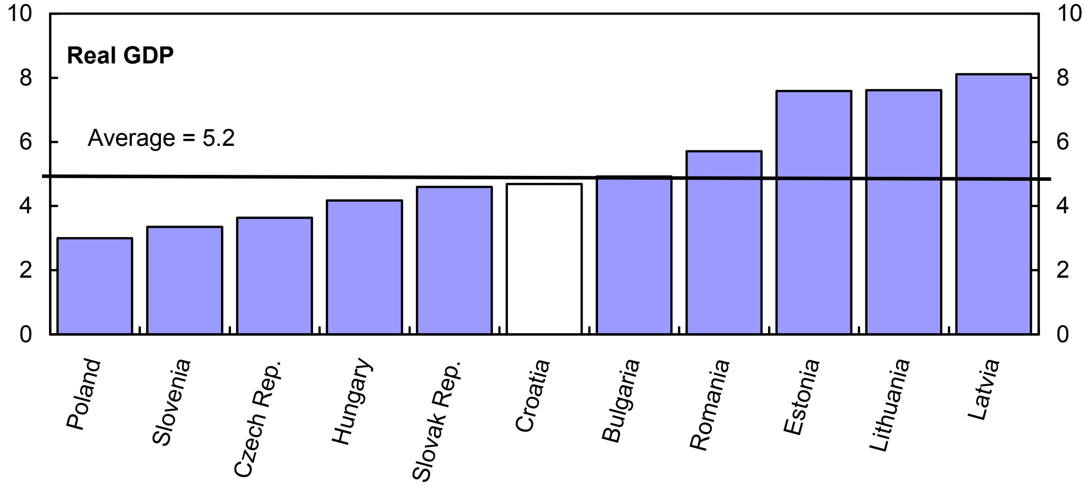




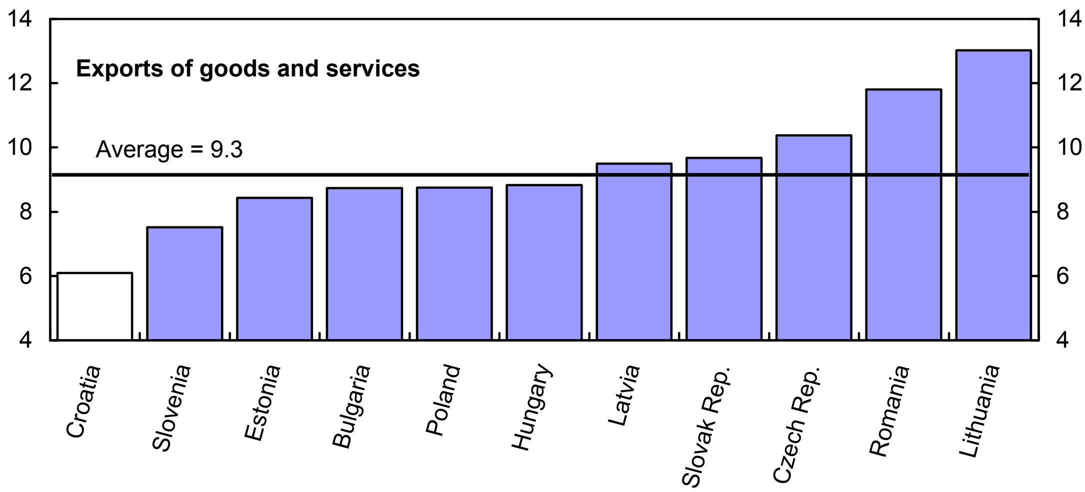
Sources: Croatian authorities; IMF's Direction of Trade database; INS; and Fund staff calculations.

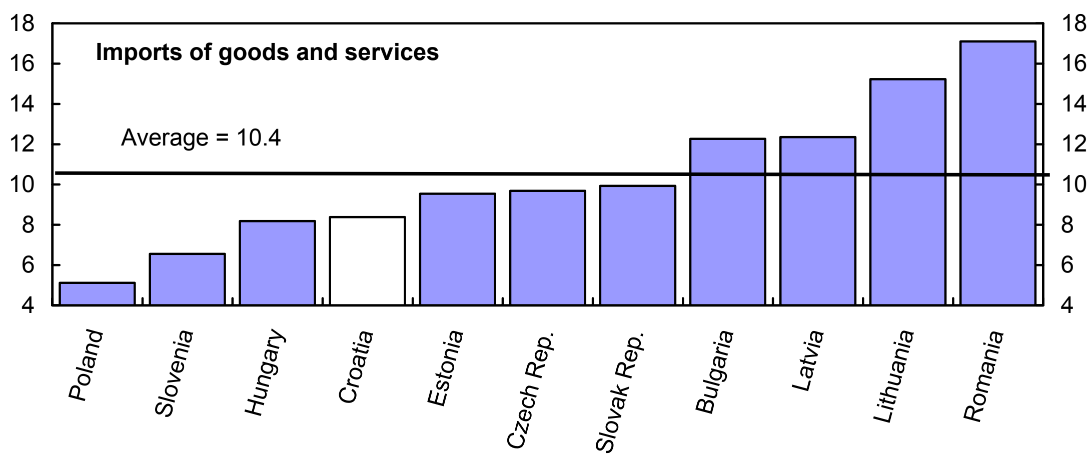
Figure 5. Growth and Trade: Croatia and Central and Eastern Europe
Geometric real growth rates, 2001–05

GDP growth has been slightly below the CEE average and well below that of the leaders ...



... and foreign trade expanded slowly by regional standards, with an ECB gravity model suggesting that Croatia's trade with the euro area may be well below potential. 1/



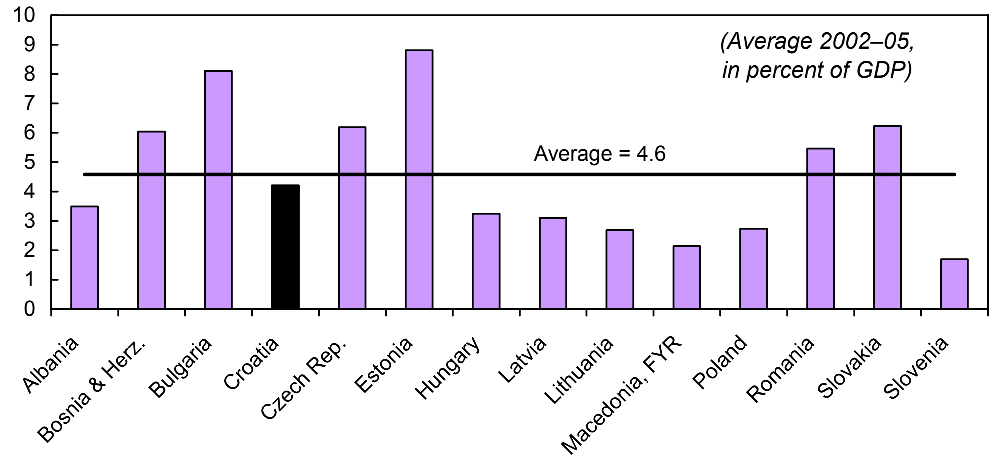


Source: IMF World Economic Outlook database.

1/ Bussière, M., J. Fidrmuc, and B. Schnatz, "Trade Integration of Central and Eastern European Countries: Lessons from a Gravity Model," ECB Working Paper 545, November 2005.

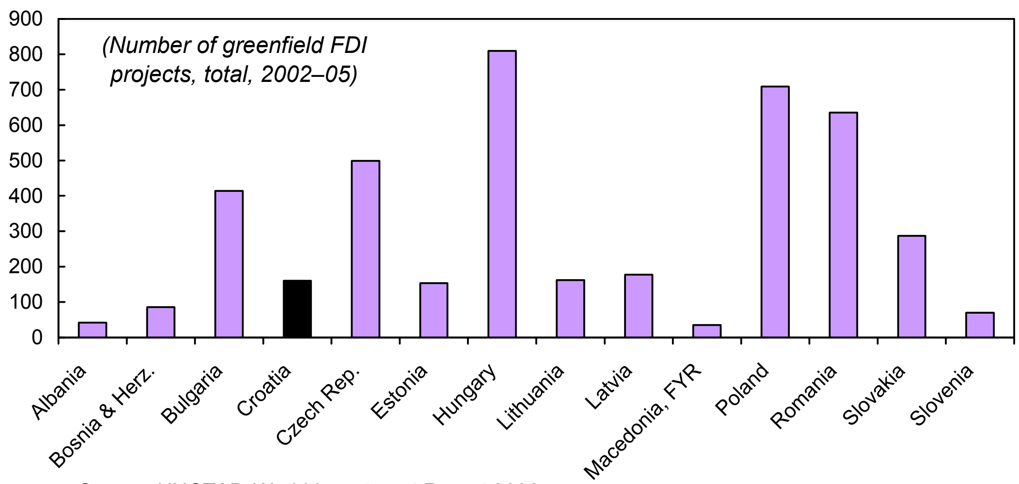
Figure 6. Croatia and Selected European Countries: Foreign Direct Investment, 2002–05

Net foreign direct investment (FDI) into Croatia has approached the regional average, but with a high share from privatizations and/or in the financial sector.



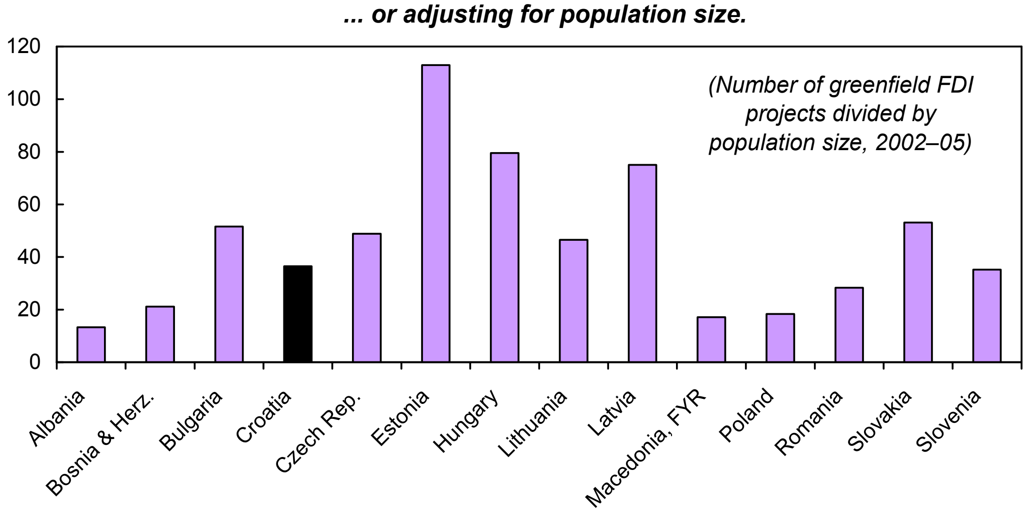
Source: IMF World Economic Outlook database.

Available data indicate that Croatia has lagged in attracting greenfield FDI, whether looking at the total number of new projects ... 1/



Source: UNCTAD *World Investment Report 2006.*
1/ These data should be interpreted cautiously in the absence of comparable data on the size of projects.

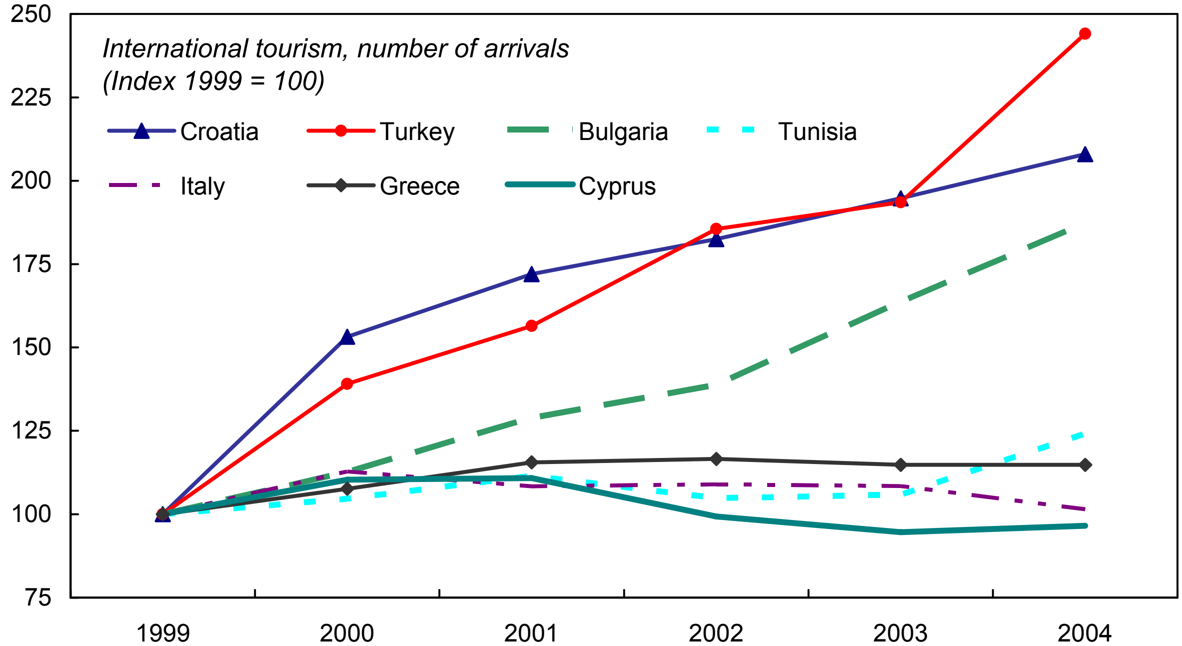
... or adjusting for population size.



Sources: UNCTAD; and Fund staff estimates.

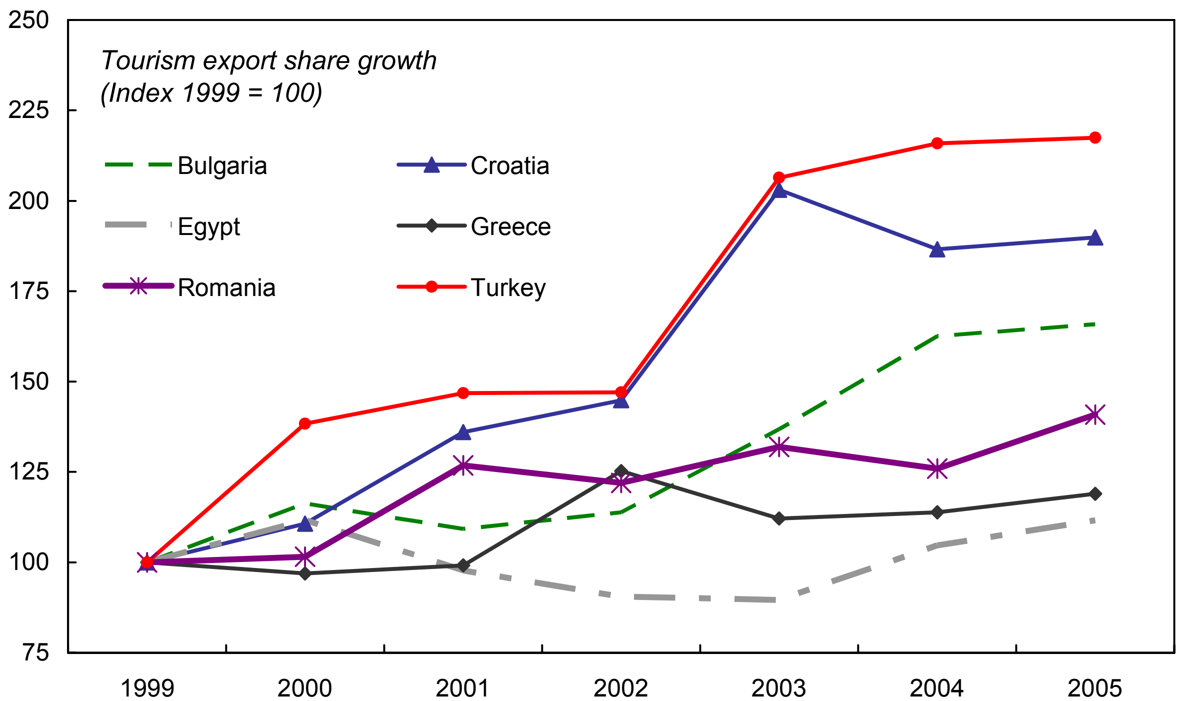
Figure 7. Croatia and Selected Regional Countries: Tourism, 1999–2005

Croatia's tourism sector has grown strongly since 1999: annual foreign tourist arrivals have nearly doubled ...



Source: World Bank.

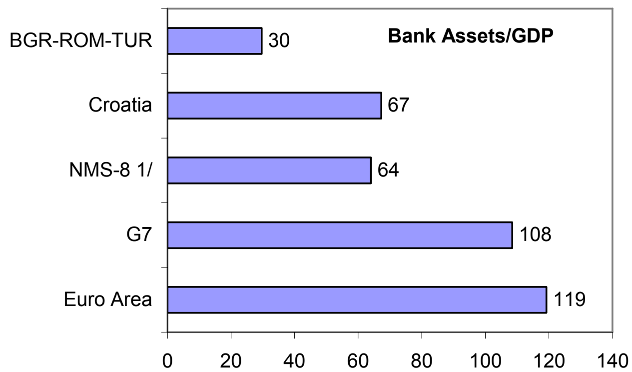
... as has Croatia's market share in the Mediterranean/Black Sea region.

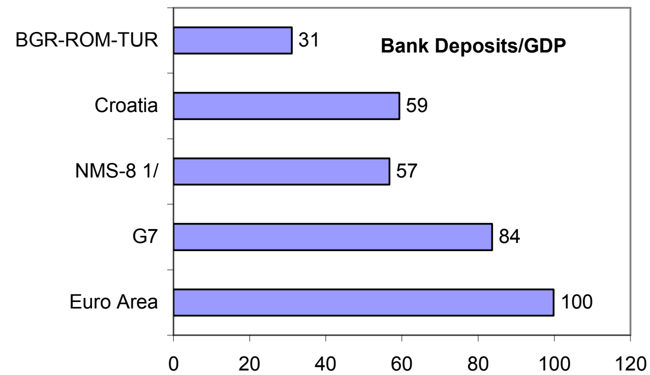


Source: IMF Balance of Payments Statistics database.

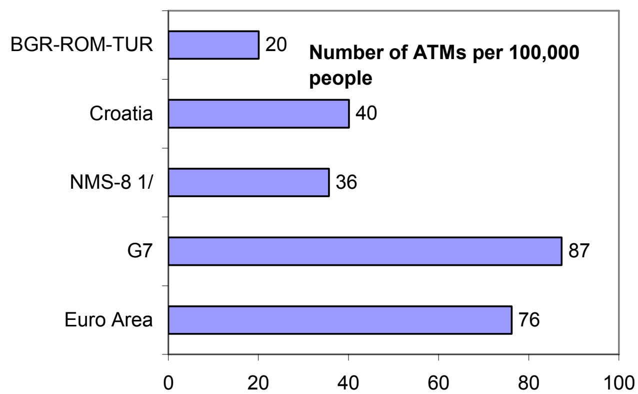
Figure 8. Croatia: Banking System Developments and Credit Dynamics, 2001–06

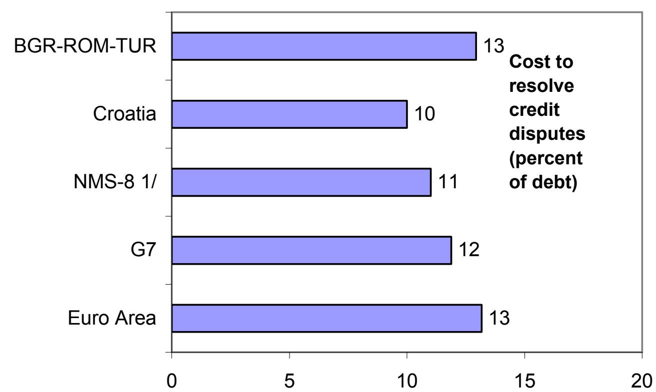
Privatization has contributed to rapid development of the banking system.



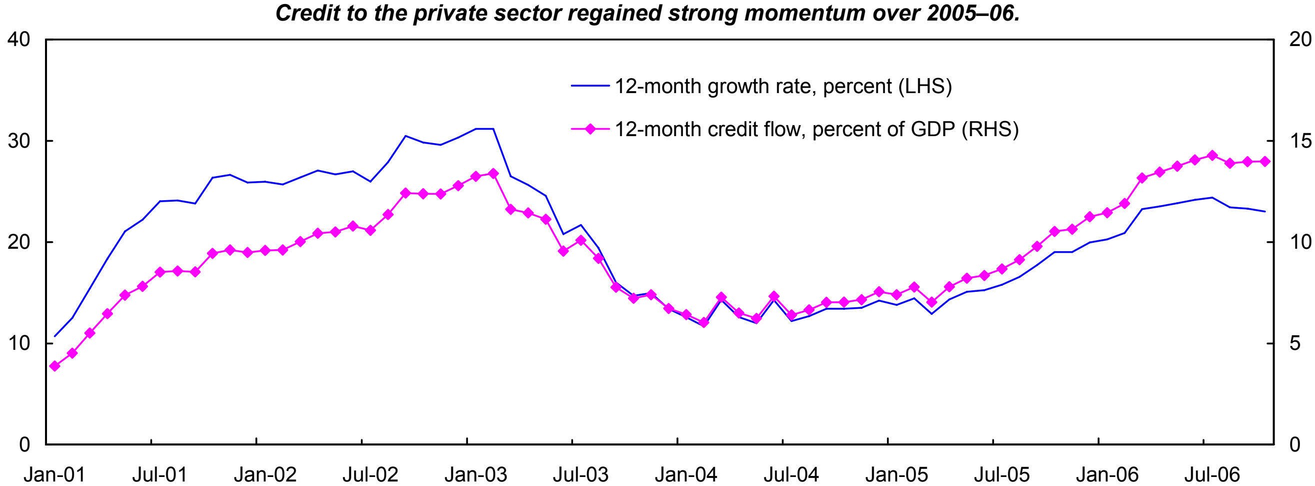


(Cross-country comparisons refer to 2004.)



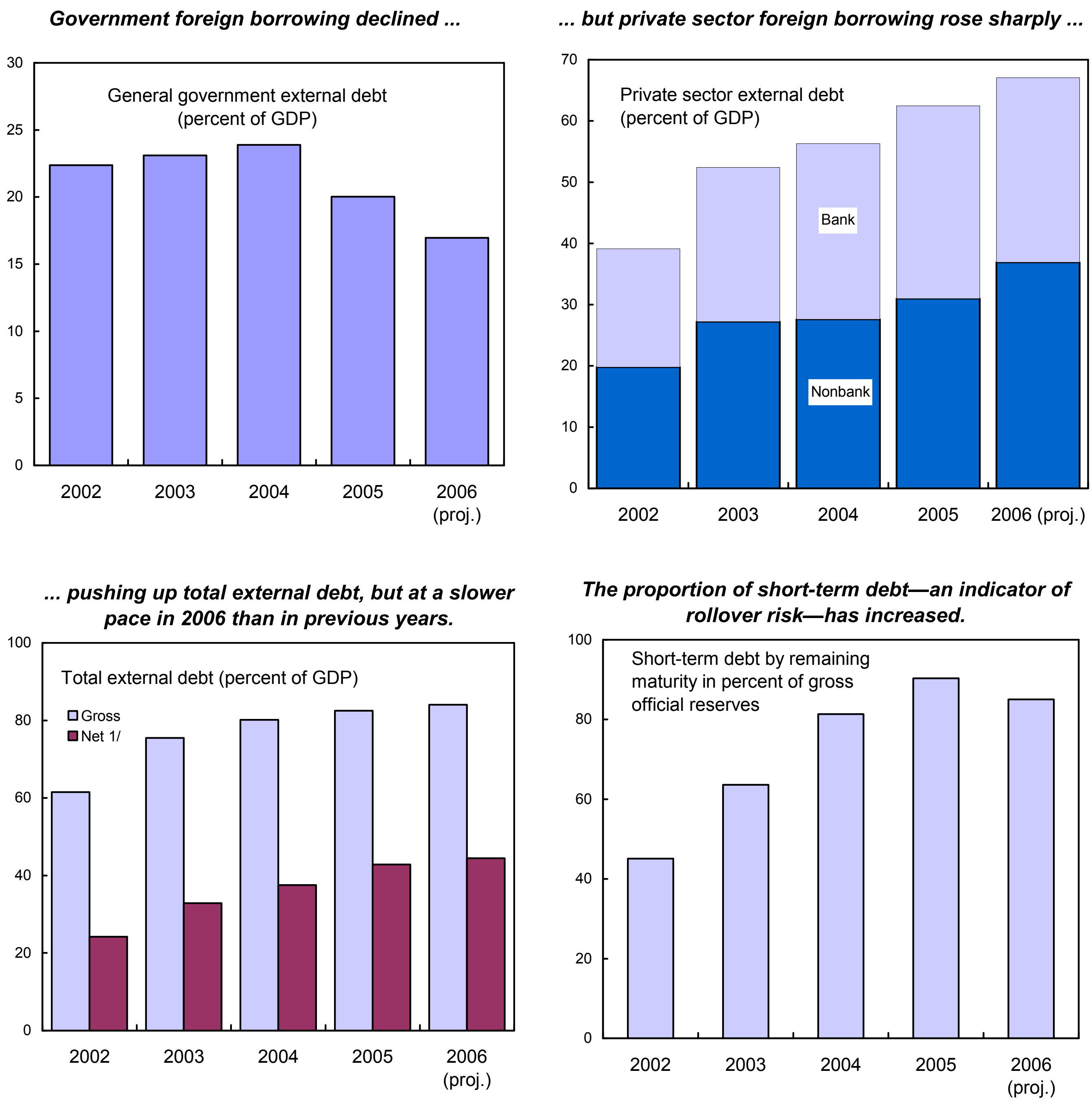


Credit to the private sector regained strong momentum over 2005–06.



Sources: Croatian authorities; and Fund staff calculations.
1/ The new member states of the EU: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia.

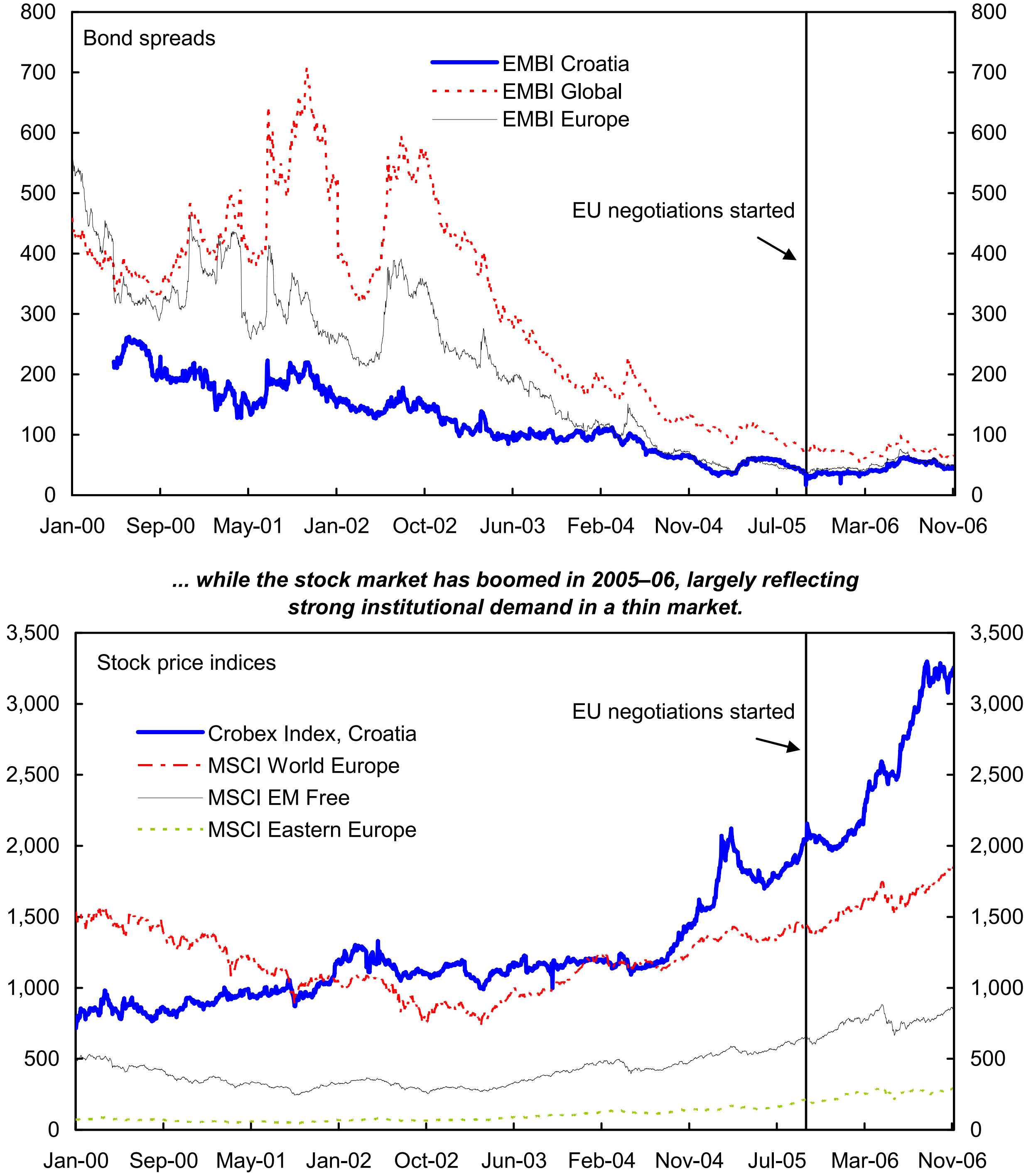
Figure 9. Croatia: External Debt, 2002–06



Sources: Croatian National Bank and Fund staff calculations.
1/ Measured net debt equals gross debt less official reserves and commercial banks foreign assets. It may overestimate “true” net debt as there is evidence of unrecorded private sector foreign asset accumulation, described in Box 1 of IMF Country Report No. 06/346.

Figure 10. Croatia: Capital Market Conditions, 2000–06
(In basis points)

Market access is strong with bond spreads at historically low levels even before the start of EU accession negotiations ...

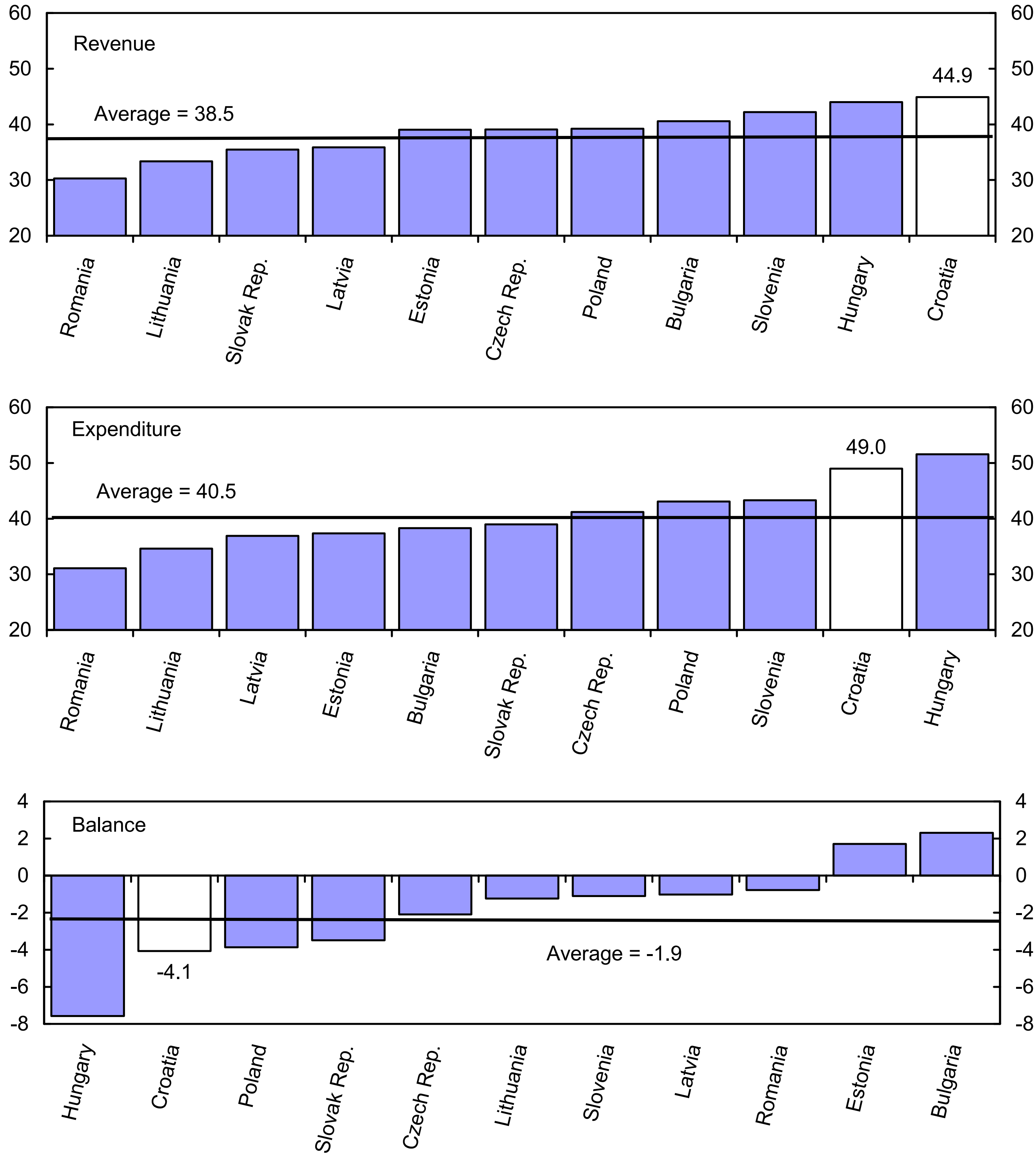


... while the stock market has boomed in 2005–06, largely reflecting strong institutional demand in a thin market.

Sources: Croatian authorities; and JP Morgan/Bloomberg.

Figure 11. General Government Accounts, 2005
(In percent of GDP)

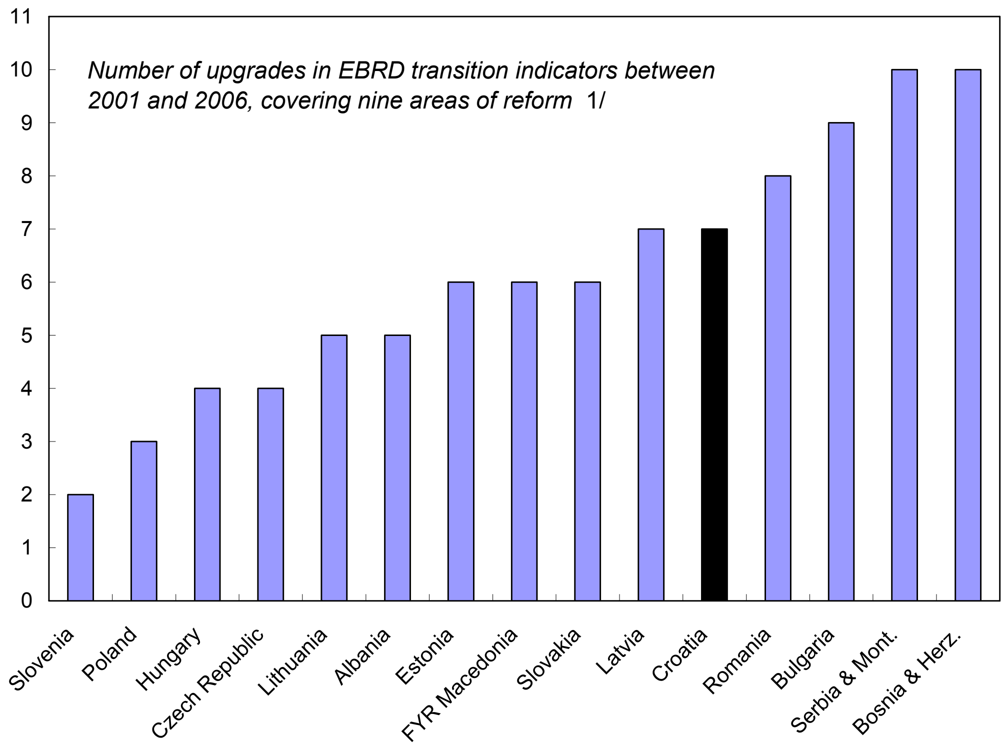
The government in Croatia is large relative to its regional peers.



Source: IMF *World Economic Outlook* database.

Figure 12. EBRD Transition Indicators

While Croatia's transition indicators have improved over the past five years ...



... Croatia still lags behind Central Europe and the Baltics, especially as regards the private sector share of GDP, and generally has room to improve.[2]

Croatia and Selected Countries: Average EBRD Transition Indicator Scores, 2006	Private sector share of GDP EBRD mid-year estimate (%)	Enterprise reform & governance	Markets & trade	Financial institutions	Infrastructure reform
Central Europe and Baltics	76	4-	4	4-	3
Croatia	**60**	**3+**	**3+**	**3+**	**3**
Southeastern Europe	66	3	3+	2+	2+

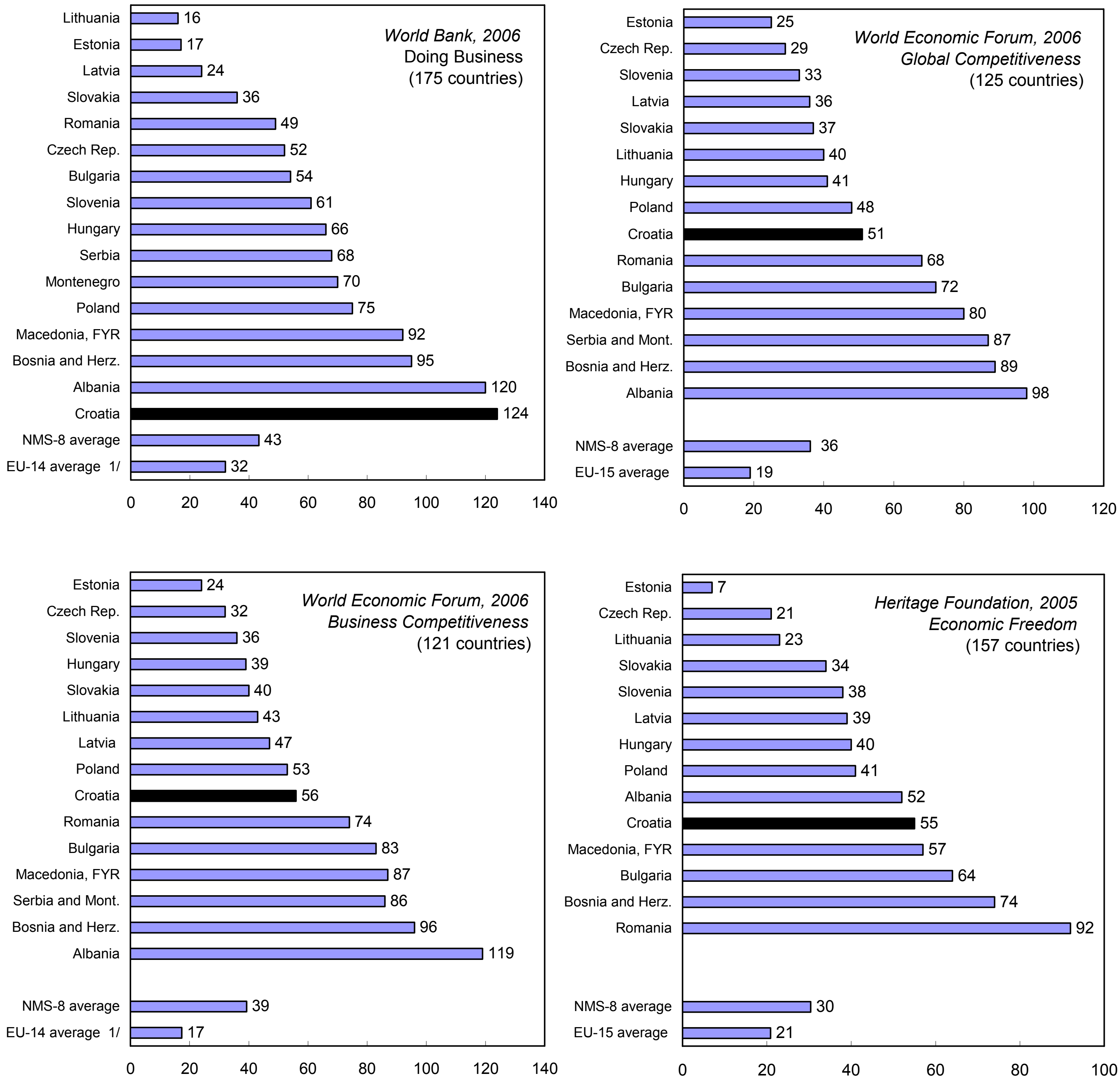
Sources: EBRD Transition Reports, 2001 and 2006; IMF staff calculations of (unweighted) regional and category averages.

1/ The nine areas are large-scale privatization; small-scale privatization; governance & enterprise restructuring; price liberalization; trade & foreign exchange system; competition policy; banking reform & interest rate liberalization; securities markets & non-bank financial institutions; and infrastructure reform.

2/ Doyle et al. (2002) suggest that countries in Central Europe that did better on various transition indicators related to structural reforms tended to have higher TFP growth (in Doyle, P., G Jiang, and L. Kuijs, *Real Convergence to EU Income Levels: Central Europe from 1990 to the Long Term*, published in *Into the EU: Policy Frameworks In Central Europe*, IMF, 2002).

Figure 13. Croatia and Selected European Countries: Business Environment, 2005–06

Croatia consistently performs below the average of its peers in central and eastern Europe in various cross-country rankings of business environment indicators.



Sources: World Bank; World Economic Forum; Heritage Foundation.

1/ No ranking available for Luxembourg.

Table 1. Croatia: Key Macroeconomic Indicators, 2003–07

	2003	2004	2005	2006 Proj.	2007 Proj.
			(Percentage change)		
Output, unemployment, and prices					
Real GDP	5.3	3.8	4.3	4.6	4.7
Unemployment (survey-based, in percent)	14.3	13.8	12.7	...	...
CPI inflation (average)	1.8	2.1	3.3	3.3	2.7
			(In percent of GDP)		
Savings and investment					
Domestic investment	30.5	31.2	31.4	33.3	33.5
Of which: fixed capital formation	28.6	28.6	28.6	30.6	30.9
Domestic saving	24.4	26.2	24.9	25.2	25.2
Government	1.8	2.8	3.1	3.6	3.7
Nongovernment	22.6	23.4	21.9	21.6	21.4
General government and HBOR operations 1/					
General government revenue	45.1	45.4	44.9	45.0	44.9
General government expense and net lending	51.3	50.2	49.0	47.8	47.6
Overall general government balance	-6.1	-4.8	-4.1	-2.8	-2.8
Overall general government financing requirement 2/	-6.1	-4.8	-4.1	-3.8	-3.9
Overall HBOR balance (net of budget transfers)	-0.6	-0.4	-0.1	-0.2	-0.6
Fiscal and quasi-fiscal balance	-6.8	-5.2	-4.2	-3.0	-3.4
General government debt	40.9	43.7	44.3	42.5	41.9
			(End of period; change in percent)		
Money and credit					
Credit to the nongovernment sector	14.7	12.8	16.7	21.1	…
Broad money	11.0	8.6	10.5	15.3	…
Base money 3/	23.8	19.9	20.7	18.1	…
			(End of period; in percent)		
Interest rates					
Average kuna deposit rate (unindexed)	1.7	1.8	1.6	…	…
Average kuna credit rate (unindexed)	11.5	11.4	9.9	…	…
			(In millions of euros)		
Balance of payments					
Current account balance	-1,596	-1,404	-1,994	-2,762	-3,031
(In percent of GDP)	-6.1	-4.9	-6.4	-8.1	-8.3
Capital and financial account	4,015	2,385	3,943	5,578	4,605
Overall balance	1,239	-118	1,002	1,458	374
			(End of period; in millions of euros)		
Debt and reserves					
Gross official reserves	6,554	6,436	7,438	8,896	9,270
In months of following year's imports of goods and NFS	4.9	4.4	4.5	5.0	4.9
External debt service to exports ratio (in percent)	20.1	21.7	24.2	26.4	26.0
Total external debt (in percent of GDP)	75.5	80.2	82.5	84.0	84.9
Net external debt 4/	32.9	37.5	42.9	44.4	45.3

Sources: Croatian authorities, and Fund staff estimates.

1/ Revenue in 2004 includes HRK 197 million in GSM license fees from an auction held in December 2004 but received in February 2005. For 2007, refers to the budget.

2/ Includes estimated 1 percent of GDP for “pensioners’ debt” repayment under the cash option in 2006 and 2007.

3/ Includes commercial banks’ statutory reserves in foreign currency (general and marginal reserve requirements).

4/ Net of official reserves and commercial bank foreign assets.

Table 2. Croatia: Balance of Payments, 2003–12
(In millions of euros, unless otherwise indicated)

	2003	2004	2005	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.
Current account	-1,596	-1,404	-1,994	-2,762	-3,031	-3,056	-3,251	-3,172	-3,373	-3,394
Merchandise trade balance	-6,994	-6,728	-7,522	-8,661	-9,314	-9,877	-10,413	-10,990	-11,671	-12,301
Exports f.o.b.	5,579	6,603	7,217	8,145	8,810	9,670	10,503	11,360	12,287	13,372
Imports f.o.b.	-12,573	-13,331	-14,738	-16,806	-18,124	-19,547	-20,916	-22,350	-23,957	-25,673
Services and income	4,154	4,132	4,343	4,700	5,025	5,498	5,770	6,387	6,804	7,346
Transportation	252	299	376	424	460	517	572	628	687	761
Travel	4,986	4,822	5,395	5,913	6,365	6,893	7,427	8,011	8,609	9,209
Other services	-297	-353	-453	-627	-672	-700	-725	-755	-792	-818
Compensation of employees	184	234	260	281	247	269	291	314	338	364
Interest and investment income	-972	-871	-1,234	-1,291	-1,375	-1,482	-1,794	-1,812	-2,038	-2,169
Current transfers	1,244	1,192	1,184	1,198	1,258	1,324	1,392	1,431	1,494	1,560
Capital and financial account	4,015	2,385	3,943	5,578	4,605	4,135	4,446	4,391	4,546	4,733
Capital account 1/	74	23	51	-150	20	50	105	110	120	121
Financial account	3,941	2,359	3,889	5,728	4,585	4,085	4,341	4,281	4,426	4,612
Direct investment 1/ 2/	1,501	708	1,229	2,362	2,133	1,759	1,893	2,038	2,193	2,361
of which: privatization receipts	464	27	0	750	400	0	0	0	0	0
Portfolio investment	853	245	-1,077	133	33	191	27	45	9	104
Medium- and long-term loans	2,363	2,100	1,493	1,736	2,222	1,795	1,996	1,804	1,824	1,748
Assets	-24	41	-108	-76	0	0	0	0	0	0
Liabilities	2,386	2,059	1,601	1,812	2,222	1,795	1996	1804	1824	1748
Disbursements	4,281	3,919	3,875	4,701	5,662	6,120	7,272	7,515	9,118	8,650
Amortization	-1,894	-1,860	-2,274	-2,889	-3,441	-4,324	-5,276	-5,712	-7,294	-6,902
Currency and deposits	-847	-32	1,601	571	0	0	0	0	0	0
Short-term capital flows (net)	458	-420	765	736	81	150	150	150	150	150
Trade credits	-386	-243	-122	190	117	190	276	245	249	250
Net errors and omissions 2/	-1,181	-1,099	-946	-1,358	-1,201	-900	-864	-909	-978	-1,053
Overall balance	1,239	-118	1,002	1,458	374	179	331	311	195	286
Financing	-1,239	118	-1,002	-1,458	-374	-179	-331	-311	-195	-286
Gross reserves (-= increase)	-1,239	118	-1,002	-1,458	-374	-179	-331	-311	-195	-286
IMF (net purchases)	0	0	0	0	0	0	0	0	0	0
Exceptional financing	0	0	0	0	0	0	0	0	0	0
Memorandum items:										
Current account (in percent of GDP)	-6.1	-4.9	-6.4	-8.1	-8.3	-7.8	-7.7	-7.0	-6.9	-6.4
Gross official reserves	6,554	6,436	7,438	8,896	9,270	9,449	9,780	10,091	10,286	10,572
in months of following year's imports of goods and NFS	4.9	4.4	4.5	5.0	4.9	4.6	4.5	4.5	4.5	4.5
Net foreign assets of the CNB	6,188	6,434	7,436	8,894	9,268	9,447	9,778	10,088	10,283	10,569
in months of following year's imports of goods and NFS	4.6	4.4	4.5	5.0	4.8	4.6	4.5	4.5	4.5	4.5
Outstanding debt 3/	19,811	22,781	25,541	28,472	30,924	33,251	35,699	37,943	40,175	42,426
External debt to GDP ratio 3/	75.5	80.2	82.5	84.0	84.9	84.8	84.6	83.5	82.1	80.6
External debt as a percentage of exports of goods and NFS	150.6	160.0	167.3	169.8	170.8	168.2	166.8	164.1	161.0	157.2
Short-term debt by residual maturity (in percent of GIR)	61.2	85.2	91.8	88.7	96.1	120.3	120.2	120.5	122.1	122.5
Net external debt to GDP ratio	32.9	37.5	42.9	44.4	45.3	45.2	45.0	43.9	42.5	41.0
External debt service	-2,649	-3,085	-3,688	-4,422	-4,711	-5,676	-8,178	-8,048	-10,368	-9,047
GDP (millions of euros)	26,234	28,393	30,946	33,896	36,423	39,222	42,216	45,439	48,909	52,643
GDP (millions of kuna)	198,422	212,826	229,031	247,835	267,707	288,279	310,289	333,979	359,479	386,925

Sources: Croatian National Bank; and Fund staff estimates.

1/ In 2003, excludes debit entry of US$327.8 in the item “investment income” in the current account, and an offsetting credit entry in the item “FDI-reinvested earnings” of the capital account related to the “distribution” and “reinvestment” of paper income from the revaluation of a patent by a Croatian company (see IMF Country Report No. 03/358, Appendix IV).

2/ Errors and omissions are explicitly projected to reflect persistent unrecorded capital outflows.

3/ In 2005, the central bank revised the methodology for estimating external debt. The inclusion of hybrid and subordinated instruments, repos, late interest and interest accruals has caused an upward revision of the historical series.

Table 3. Croatia: Consolidated General Government Finances, 2003–09

(In percent of GDP; modified-accrual based on GFS 1986 unless otherwise indicated)

	2003	2004 1/	2005 1/	2006			2007	2008 2/	2009 2/
				Budget	Suppl. Budget	Proj.	Budget	Proj.	Proj.
Revenue	45.1	45.4	44.9	44.3	44.9	45.0	44.9	44.3	43.8
Taxes	27.2	26.5	26.4	25.9	26.4	26.7	26.4	26.1	25.7
Taxes on income, profits, and capital gains	5.8	5.7	5.8	5.8	6.0	6.2	6.3	6.1	6.1
Payable by individuals	3.6	3.6	3.4	3.5	3.4	3.5	3.4	3.4	3.4
Payable by corporations and other enterprises	2.2	2.1	2.4	2.3	2.6	2.7	2.9	2.7	2.7
Taxes on goods and services	20.0	19.5	19.4	18.9	19.3	19.3	19.1	19.0	18.7
VAT	14.2	14.0	14.1	13.7	14.1	14.2	14.0	14.0	13.8
Excises	5.3	5.0	4.8	4.7	4.7	4.6	4.5	4.4	4.3
Taxes on international trade and transactions	0.9	0.7	0.7	0.6	0.6	0.6	0.6	0.5	0.4
Social security contributions	13.8	13.9	13.7	13.6	13.5	13.6	13.6	13.5	13.5
Other revenue and grants	4.1	5.0	4.8	4.9	4.9	4.6	4.8	4.6	4.6
Total expenditure 2/	51.3	50.2	49.0	47.5	47.8	47.8	47.6	46.9	46.2
Expense (current)	45.2	44.8	44.2	43.0	43.5	43.5	43.2	42.5	41.9
Compensation of employees	12.4	12.0	11.6	11.2	11.3	11.4	11.2	11.1	11.0
Use of goods and services	4.8	4.8	4.9	5.2	5.3	5.3	5.4	5.4	5.4
Interest	2.0	2.1	2.2	2.2	2.2	2.2	2.1	2.1	2.1
Subsidies	3.2	2.7	2.6	2.4	2.5	2.5	2.5	2.4	2.3
Grants	0.0	0.5	0.6	0.5	0.6	0.5	0.8	0.7	0.7
Social benefits	19.2	19.3	18.5	17.9	18.1	18.2	17.7	17.3	17.0
Other expense	3.6	3.4	3.6	3.5	3.4	3.4	3.5	3.4	3.4
Acquisition of nonfinancial assets (investment)	5.7	5.0	4.4	4.2	4.0	4.0	4.0	3.9	3.8
Net lending	0.3	0.5	0.4	0.3	0.3	0.3	0.5	0.4	0.4
Overall balance	-6.1	-4.8	-4.1	-3.2	-3.0	-2.8	-2.8	-2.6	-2.4
Repayment of “pensioners’ debt” 3/	...	...	...	1.0	1.0	1.0	1.1	0.2	0.2
Financing requirement	-6.1	-4.8	-4.1	-4.1	-3.9	-3.8	-3.9	-2.8	-2.6
Financing	6.1	4.8	4.1	4.1	3.9	3.8	3.9	2.8	2.6
Privatization and disposal of fixed assets	2.1	0.6	0.6	3.5	3.5	2.6	1.8	0.7	0.6
External financing	2.5	1.8	-1.9	-1.2	-1.2	-1.4	-0.8	-0.5	-1.7
Disbursements	3.8	4.1	0.7	1.4	1.3	1.1	1.0	0.9	0.8
Amortization	-1.2	-2.3	-2.6	-2.6	-2.5	-2.5	-1.7	-1.4	-2.5
Domestic financing	1.5	2.4	5.4	1.9	1.7	2.5	2.8	2.6	3.7
Memorandum items:									
Primary budget balance	-4.1	-2.7	-1.8	-0.9	-0.8	-0.6	-0.7	-0.5	-0.3
Cyclically adjusted primary balance	-4.5	-2.8	-1.9	-1.1	-0.9	-0.7	-0.9	-0.8	-0.6
Automatic revenue stabilizers	0.4	0.1	0.0	0.1	0.1	0.1	0.2	0.3	0.3
HBOR balance (net of budget transfers)	-0.7	-0.4	-0.1	-0.2	-0.2	-0.2	-0.6	...	...
General government debt	40.9	43.7	44.3	42.4	42.5	42.5	41.9	41.8	41.4
General government guarantees and arrears	31.1	30.8	25.8	9.5	9.4	9.4	10.5	10.5	10.4

Sources: Ministry of Finance; and Fund staff estimates.

1/ Deficit presented for 2004 includes in “other revenue” HRK 197 million secured in December 2004 at auction of a GSM licence, but not received in cash until February 2005. In turn, this amount is not included in 2005 revenues.

2/ Based on the authorities’ *2006 Pre-Accession Economic Programme* (PEP), November 2006; in percent of Fund staff GDP projections.

3/ Excluding “pensioners’ debt” repayments and including accumulation of arrears in “Use of goods and services.”

4/ Discount option payments in 2006–07 (chosen by 74 percent of eligible pensioners), face-value option payments afterwards.

Table 4. Croatia: Financial Soundness Indicators, 2001–06

(Banks, in percent, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006 Q2
Core Set						
Regulatory capital to risk-weighted assets	18.5	17.4	16.5	16.0	15.2	13.2
Regulatory Tier I capital to risk-weighted assets	16.9	15.2	14.1	13.7	13.5	11.9
Nonperforming loans net of loan-loss provisions to capital	22.6	20.7	24.1	22.5	19.9	18.9
Nonperforming assets to total gross assets 1/	7.3	5.9	5.2	4.6	4.0	3.5
Sectoral distribution of loans to total loans						
Nonfinancial corporations	47.9	45.0	41.0	39.5	38.5	38.2
Households	42.5	44.5	47.8	49.9	49.7	47.8
Other sectors	9.6	10.5	11.2	10.6	11.7	14.1
Return on assets	0.9	1.6	1.6	1.7	1.6	1.8
Return on equity	6.6	13.7	14.1	16.1	15.1	15.7
Net interest income to gross income	59.0	56.3	58.9	56.6	57.9	57.4
Noninterest expenses to gross income	84.4	72.9	72.7	68.0	66.7	64.6
Liquid assets to total assets 2/	26.8	17.6	18.7	16.1	11.5	9.6
Liquid assets to short-term liabilities 2/	90.3	57.8	66.8	62.0	42.1	37.2
Net open position in foreign exchange to capital	...	...	24.7	18.2	7.4	2.3
Encouraged Set						
Deposit Takers 3/						
Capital to assets	9.2	9.5	8.9	8.6	9.0	9.4
Large exposures to capital	224.8	151.3	128.4	161.4	122.6	89.4
Geographical distribution of loans to total loans						
Residents	99.5	99.5	99.6	99.8	99.7	99.5
Nonresidents	0.5	0.5	0.4	0.2	0.3	0.5
Gross asset position in derivatives to capital	...	...	...	0.8	0.6	0.7
Gross liability position in derivatives to capital	...	...	...	1.2	1.0	0.8
Noninterest income to total income	41.0	43.7	41.1	43.4	42.1	42.6
Personnel expenses to noninterest expenses	30.5	33.9	32.5	32.7	34.1	35.1
Spread between domestic lending and deposit rates	6.3	11.0	10.1	9.9	9.5	6.3
Spread between foreign exchange lending and deposit rates	6.2	5.5	5.0	4.2	3.8	3.5
Noninterbank loans to noninterbank deposits	62.8	74.4	76.1	80.6	89.1	96.1
Foreign currency-denominated loans to total loans 4/	78.4	75.8	70.9	76.7	78.5	76.9
Foreign currency-denominated liabilities to total liabilities 4/	79.1	76.0	76.1	78.1	78.8	79.3
Net open position in equities to capital	...	...	...	0.3	0.2	0.2
Other Financial Corporations (OFCs)						
OFCs' assets to total financial system assets	12.5	15.0	16.7	18.6	21.8	24.4
OFCs' assets to GDP	12.3	16.1	19.7	24.2	31.1	36.8
Nonfinancial Corporations 5/						
Total debt to equity	45.8	44.5	40.9	45.9	49.3	...
Return on equity	1.1	3.6	1.8	2.7	4.4	...
Net foreign exchange exposure to equity	7.3	8.9	10.0	10.9	12.4	...
Households						
Household debt to GDP	19.0	24.7	28.9	32.1	35.9	38.0
Household debt service and principal payments to income	3.7	4.6	6.1	6.0	6.1	...
Real Estate Markets						
Residential real estate loans to total loans	13.9	13.0	15.0	16.8	17.9	18.1

Source: Croatian National Bank.

1/ Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims.

2/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper, and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans received. The sharp decline in liquidity in 2005 coincides with the start of reverse repo operations by the CNB that gave banks market-based access to liquidity when needed.

3/ Commercial banks only. End-year FSIs, based on audited annual financial statements, can differ slightly from quarterly data.

4/ Includes kuna-denominated instruments linked to foreign currencies.

5/ Based on unconsolidated audited financial statements following IAS; not in line with the IMF FSI Compilation Guide.

Table 5. Croatia: Monetary Accounts, 2003–06

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

	2003	2004	2005	2006 Q1	2006 Q2	2006 Q3	2006 Q4 Proj.	2003	2004	2005	2006 Q4 Proj.
Monetary Survey								(Change in percent)			
Net Foreign Assets	32,771	31,743	23,304	12,977	13,994	25,557	23,906	-0.1	-3.1	-26.6	2.6
(In millions of euros)	*4,286*	*4,138*	*3,160*	*1,772*	*1,928*	*3,462*	*3,244*	*-2.8*	*-3.4*	*-23.6*	*2.7*
Of which: Croatian National Bank	47,321	49,355	54,844	59,222	63,427	60,034	65,547	13.0	4.3	11.1	19.5
(In millions of euros)	*6,188*	*6,434*	*7,436*	*8,086*	*8,740*	*8,133*	*8,894*	*10.0*	*4.0*	*15.6*	*19.6*
Deposit money banks	-14,549	-17,613	-31,540	-46,245	-49,434	-34,477	-41,641	60.8	21.1	79.1	32.0
(In millions of euros)	*-1,903*	*-2,296*	*-4,276*	*-6,315*	*-6,812*	*-4,671*	*-5,650*	*56.5*	*20.7*	*86.3*	*32.1*
Net Domestic Assets	96,122	108,205	131,343	140,596	149,113	151,195	154,412	15.4	12.6	21.4	17.6
Of which: Domestic credit	123,781	138,686	166,212	176,501	186,080	191,074	195,804	12.4	12.0	19.8	17.8
To government, net	16,735	17,902	25,304	27,898	29,882	28,201	25,227	0.0	7.0	41.3	-0.3
To other domestic sectors 1/	107,046	120,784	140,909	148,603	156,198	162,873	170,577	14.7	12.8	16.7	21.1
Broad Money	128,893	139,948	154,647	153,574	163,107	176,752	178,318	11.0	8.6	10.5	15.3
Narrow Money	33,889	34,562	38,817	38,186	42,226	44,047	44,227	9.8	2.0	12.3	13.9
Currency outside banks	10,573	10,956	12,164	12,091	14,003	14,331	14,359	9.2	3.6	11.0	18.0
Demand deposits	23,316	23,606	26,653	26,095	28,223	29,716	29,868	10.0	1.2	12.9	12.1
Quasi Money	95,004	105,386	115,830	115,387	120,880	132,705	134,091	11.4	10.9	9.9	15.8
Kuna-denominated	18,969	23,643	29,069	32,961	39,861	47,532	48,318	43.5	24.6	23.0	66.2
Foreign currency-denominated	76,035	81,743	86,761	82,427	81,019	85,173	85,773	5.5	7.5	6.1	-1.1
Balance Sheet of the Croatian National Bank								(Contribution to change in base money)			
Net Foreign Assets	47,321	49,355	54,844	59,222	63,427	60,034	65,547	18.1	5.5	12.3	19.8
Less: Banks' foreign currency reserves	6,687	10,765	13,496	17,306	19,809	14,833	18,575	-1.2	10.9	6.1	9.4
CNB bills in foreign currency	4,920	0	0	0	0	0	0	12.3	-13.2	0.0	...
Net International Reserves	35,714	38,591	41,348	41,916	43,619	45,201	46,972	7.0	7.7	6.2	10.4
Net Domestic Assets	-10,035	-4,654	-901	-4,087	-1,951	-2,776	-1,867	5.7	14.4	8.4	-1.8
Of which: Claims on government (net)	-1,550	-260	-331	-163	-250	-246	-244	-2.6	3.5	-0.2	0.2
Claims on banks	972	409	4,216	564	2,155	2,511	3,000	3.2	-1.5	8.5	-2.3
Of which: open market operations	0	394	4,201	550	2,141	2,497	3,000	...	...	...	...
Claims on other domestic sectors	94	83	73	73	73	73	92	-0.1	0.0	0.0	0.0
Other items (net)	-4,631	-4,886	-4,859	-4,562	-3,930	-5,115	-4,715	0.9	-0.7	0.1	0.3
Less: CNB bills in foreign currency	4,920	0	0	0	0	0	0				
								(Change in percent)			
Base Money	37,285	44,702	53,943	55,134	61,477	57,258	63,680	23.8	19.9	20.7	18.1
Currency	10,573	10,956	12,164	12,091	14,003	14,331	14,359	9.2	3.6	11.0	18.0
Deposits	26,712	33,746	41,779	43,043	47,474	42,928	49,320	30.7	26.3	23.8	18.1
Of which: Settlement accounts	5,616	6,408	8,411	5,740	6,223	6,315	8,426	43.1	14.1	31.3	0.2
Statutory reserve in kuna	12,604	14,674	17,605	17,355	18,596	19,458	19,698	54.0	16.4	20.0	11.9
Statutory reserve in foreign currency	6,687	10,765	13,496	17,306	19,809	14,833	18,575	-5.0	61.0	25.4	37.6
Of which: General reserve requirement	6,687	10,293	9,266	9,006	9,009	8,457	8,927	-5.0	53.9	-10.0	-3.7
Marginal reserve requirement	0	472	4,230	8,300	10,800	6,377	9,647	...	...	...	...
Reserve Money (CNB definition) 2/	30,586	33,924	40,391	37,768	41,645	42,368	45,093	32.8	10.9	19.1	11.6
Memorandum items:											
Nominal GDP (yearly total)	198,422	212,826	229,031				247,835				
Narrow money multiplier	0.91	0.77	0.72				0.69				
Broad money multiplier	3.46	3.13	2.87				2.80				
Broad money (in percent of GDP)	65.0	65.8	67.5				72.0				
Foreign currency in percent of broad money	59.0	58.4	56.1				48.1				
Credit to the private sector (in percent of GDP)	53.9	56.8	61.5				68.8				

Sources: Croatian National Bank; and Fund staff projections.

1/ Including net credit to the Croatian Development Bank (HBOR).

2/ Excludes statutory reserve in foreign currency.

Table 6. Croatia: Indicators of External and Financial Vulnerability, 2003–06

(In percent, unless otherwise indicated)

	2003	2004	2005	2006 Latest	2006 Date
External indicators					
Real effective exchange rate (using consumer prices) 1/, 2000=100	105.4	107.6	109.7	111.2	Sep-06
Exports of goods and services (volumes, percentage change, yoy) 2/	11.4	5.4	4.6	5.2	Q2 -06
Imports of goods and services (volumes, percentage change, yoy) 2/	12.1	3.5	3.5	4.2	Q2 -06
Current account deficit (millions of euros) 3/	-1,596	-1,404	-1,994	-2,686	Q3 -06
Current account deficit in percent of GDP 3/	-6.1	-4.9	-6.4	-8.1	Q3 -06
Capital and financial account in percent of GDP 3/	15.3	8.4	12.7	12.4	Q3 -06
Gross official reserves (millions of euros)	6,554	6,436	7,438	8,516	Oct-06
Gross official reserves in percent of broad money (M4)	38.9	35.3	35.5	34.8	Oct-06
Gross official reserves in percent of reserve money	163.9	145.5	135.8	144.6	Oct-06
Gross official reserves in months of current year's imports of goods and NFS	5.2	4.8	5.1	5.2	Oct-06
Gross usable international reserves (GUIR) in percent of domestic FX deposits	50.6	47.2	47.7	55.6	Oct-06
CNB net foreign assets (millions of euros)	6,188	6,434	7,436	8,515	Oct-06
CNB net foreign assets in months of current year's import of goods and NFS	4.9	4.8	5.1	5.2	Oct-06
Short-term debt in percent of GUIR 4/ 5/	85.3	104.2	119.8	123.3	Sep-06
Short-term debt and current account deficit net of FDI in percent of GUIR	99.4	120.3	132.7	139.0	Sep-06
Total external debt, percent of GDP 6/	75.5	80.2	82.5	81.5	Sep-06
External debt service to export ratio 3/	20.1	22.4	22.2	26.7	Sep-06
Financial indicators					
General government debt in percent of GDP	40.9	43.7	44.3	41.9	Sep-06
Domestic in percent of GDP	17.8	20.1	24.5	25.0	Sep-06
Foreign in percent of GDP	23.1	23.6	19.8	16.9	Sep-06
Broad money (M4, percentage change, yoy)	11.0	8.6	10.5	18.4	Oct-06
Claims on other domestic sectors (change, yoy)	14.7	12.8	16.7	21.9	Oct-06
Short-term interest rate (in percent, e.o.p.)	6.2	4.8	3.2	2.8	Oct-06
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,185	1,565	1,998	3,236	12/4/06
Zagreb Stock Exchange, capitalization, percent of GDP	25	41	50	83	12/4/06
Bond yield spreads (EMBI Global, e.o.p.)	96	42	36	44	12/4/06
Debt ratings: Moody's:					
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Dec-06
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Dec-06
Foreign debt ratings					
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	Dec-06
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	Dec-06
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	Dec-06
Standard and Poor's: Foreign currency LT	BBB-	BBB	BBB	BBB	Dec-06
Banking system:					
Regulatory capital to risk-weighted assets	15.7	14.1	13.9	13.2	Q2 -06
Nonperforming loans to total loans	5.1	4.5	4.0	3.6	Q2 -06
Loan-loss provisions to non-performing loans	60.8	60.3	58.0	55.5	Q2 -06
Net open foreign exchange position to capital 7/	13.3	12.5	8.4	2.4	Q2 -06
Foreign currency deposits to total deposits 8/	87.1	86.8	84.3	83.2	Q2 -06
Foreign currency loans to total loans 8/	74.4	75.8	77.5	75.8	Q2 -06

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

1/ An increase in the index reflects an appreciation; annual averages through 2005.
2/ National accounts concept.
3/ Sum of four quarters to the latest observation.
4/ Coverage limited to short-term debt on a remaining maturity basis registered with the CNB.
5/ Gross reserves adjusted downward by foreign-currency redeposit requirements held at the CNB, and by the amount of outstanding foreign-currency CNB bills.
6/ Includes estimates of external obligations due to bond repurchase agreements (repos transaction).
7/ Net open position includes foreign currency options.
8/ Including foreign currency-linked deposits and loans.

Table 7. Croatia: Staff Medium-Term Scenario, 2003–12

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
				Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector					(Percentage changes)					
Real GDP	5.3	3.8	4.3	4.6	4.7	4.5	4.5	4.5	4.5	4.5
Consumption, total	3.7	2.7	2.8	3.5	4.6	4.4	4.2	4.0	4.4	3.9
Of which: private	4.6	3.9	3.4	3.8	4.9	4.6	4.5	4.5	4.5	4.5
Gross fixed capital formation, total	24.7	4.4	4.8	12.2	5.3	4.5	4.0	4.0	4.0	4.0
Of which: private	24.0	7.7	7.9	16.0	6.0	5.0	4.3	4.3	4.0	4.3
GDP deflator	3.9	3.3	3.2	3.5	3.1	3.0	3.0	3.0	3.0	3.0
General government finances 1/					(In percent of GDP)					
Revenue	45.1	45.4	44.9	45.0	44.9	44.3	43.8	43.3	43.1	42.5
Expenditure 2/	51.3	50.2	49.0	47.8	47.6	46.9	46.2	45.2	44.8	43.5
Balance 2/	-6.1	-4.8	-4.1	-2.8	-2.8	-2.6	-2.4	-1.8	-1.6	-1.0
Privatization receipts	2.1	0.6	0.6	2.6	1.8	0.7	0.6	0.4	0.4	0.3
Domestic financing	1.5	2.4	5.4	2.5	2.8	2.6	3.7	1.0	0.7	0.2
Foreign financing	2.5	1.8	-1.9	-1.4	-0.8	-0.5	-1.7	0.6	0.7	0.6
Debt	40.9	43.7	44.3	42.5	41.9	41.8	41.4	40.6	39.6	38.2
Balance of payments					(In percent of GDP)					
Current account balance	-6.1	-4.9	-6.4	-8.1	-8.3	-7.8	-7.7	-7.0	-6.9	-6.4
Exports f.o.b.	21.3	23.3	23.3	24.0	24.2	24.7	24.9	25.0	25.1	25.4
Imports f.o.b.	-47.9	-47.0	-47.6	-49.6	-49.8	-49.8	-49.5	-49.2	-49.0	-48.8
Merchandise trade balance	-26.7	-23.7	-24.3	-25.6	-25.6	-25.2	-24.7	-24.2	-23.9	-23.4
Services, net	15.8	14.6	14.0	13.9	13.8	14.0	13.7	14.1	13.9	14.0
Of which: travel receipts	21.3	19.4	19.4	18.9	18.9	19.0	19.1	19.1	19.1	19.0
Current transfers	4.7	4.2	3.8	3.5	3.5	3.4	3.3	3.1	3.1	3.0
Capital and financial account	15.3	8.4	12.7	16.5	12.6	10.5	10.5	9.7	9.3	9.0
FDI	5.7	2.5	4.0	7.0	5.9	4.5	4.5	4.5	4.5	4.5
Portfolio investment	3.3	0.9	-3.5	0.4	0.1	0.5	0.1	0.1	0.0	0.2
Medium-term borrowing, net	9.0	7.4	4.8	5.1	6.1	4.6	4.7	4.0	3.7	3.3
Short-term and other	-2.7	-2.4	7.4	4.0	0.6	1.0	1.3	1.1	1.1	1.0
Net errors and omissions (E&O)	-4.5	-3.9	-3.1	-4.0	-3.3	-2.3	-2.0	-2.0	-2.0	-2.0
Gross official reserves (in months of imports)	4.9	4.4	4.5	5.0	4.9	4.6	4.5	4.5	4.5	4.5
Gross external debt	75.5	80.2	82.5	84.0	84.9	84.8	84.6	83.5	82.1	80.6
Net external debt	32.9	37.5	42.9	44.4	45.3	45.2	45.0	43.9	42.5	41.0
Nominal GDP (in millions of kuna)	198,422	212,826	229,031	247,835	267,707	288,279	310,289	333,979	359,479	386,925
Nominal GDP (in millions of euros)	26,234	28,393	30,946	33,896	36,423	39,222	42,216	45,439	48,909	52,643

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

1/ Modified accrual basis based on GFS 1986 methodology.

2/ Excludes repayments of “pensioners’ debt.”

Table 8. Croatia: FSAP Recommendations and Implementation

Recommendations	Implementation
General	
Explore the scope for exploiting synergy among nonbank supervisory bodies.	Unified nonbank supervisor, HANFA, established in 2006.
Make coordination more effective among the regulatory bodies.	MoU signed between CNB and HANFA in September 2006.
Pay greater attention to the monitoring of foreign exchange-induced credit risk.	Supervisory guidelines recently adopted; risk weights on unhedged foreign-exchange loans increased.
Improve forecast accuracy of the government's cash flows and make coordination between the MoF and the CNB more effective to enhance liquidity management of the CNB.	There is some but limited exchange of information between the CNB and the MoF on such forecasts.
Foster the development of a liquid and efficient interbank market.	Interbank market still illiquid. The CNB started open market operations for short-term liquidity smoothing purposes through weekly reverse repo operations. The bigger banks rely more on these reverse repos than the interbank market as the latter cannot meet the volume of their requirements.
Develop the domestic long-term government securities market, possibly in parallel with the introduction of the second pillar pension reform.	One long-term kuna bond was issued at end-2005.
Consider disclosing State Agency for Deposit Insurance and Bank Rehabilitation (DAB's) externally audited financial statements to the public.	Yet to be done.
Banking Supervision	
Conduct supervision on consolidated accounts.	Consolidated supervision introduced in mid-2003.
The calculation of the minimum capital adequacy ratio (CAR) should be based on not only credit risk, as is done currently and is above the Basel recommendation and set at 10 percent for all banks, but also on market and related risks.	Additional risks included in CAR calculation as of January 2004; banks growing by more than 20 percent per year to form additional general reserves.
Give supervisory staff explicit immunity from legal prosecution for performing duties in good faith.	Addressed in the new banking law.
In the future, as country risk gains prominence, give it appropriate attention.	CNB has assessed this risk to be negligible since Croatian banks are not very active abroad.
Improve supervisory cooperation: Due to the lack of legal backup, agreements with foreign supervisory agencies have not yet been established, and in practice, coordination with other domestic supervisors appears to take place only on an ad hoc basis.	MoUs with Bosnia & Herzegovina, Austria, Italy, and Hungary and with HANFA signed and published on the web.

Table 8 (continued). Croatia: FSAP Recommendations and Implementation

Recommendations	Implementation
Payments Systems	
Introduce a fully collateralized intra-day liquidity facility for Croatian Large Value System (HSVP), and suitable Delivery versus Payment (DVP) for securities in real time.	Full collateralization not implemented; a suitable form of DVP not resolved between the CNB and the securities depository (SDA).
Strengthen back-up facilities, including secondary site arrangements, of both the HSVP and the National Clearing System (NKS) .	Secondary site arrangements implemented for the NKS but not for the HSVP.
Improve governance of the NKS.	Implemented.
Improve CNB's organizational structure by clearly separating oversight responsibilities from operational ones.	Responsibilities separated.
Publish a broader range of statistics on the payment system.	Implemented.
Transparency of Monetary and Financial Policies	
Monetary policy	
Regularly publish CNB’s views on macroeconomic outlook.	Implemented.
Publish CNB's monetary policy framework.	Partially done; the CNB website releases summaries of discussions on monetary policy instruments.
Issue explanatory press releases in conjunction with monetary policy decisions.	Implemented.
Post schedule of Board meetings on the website.	Yet to be done.
Disclose internal operating procedures of the Internal Audit.	Yet to be done.
Financial policy	
Clearly state the main objective(s) of banking supervision in the Annual Report or a separate publication.	Yet to be done.
Publish the CNB's own assessment of banking sector performance and developments.	Implemented.
Provide aggregate information on emergency liquidity assistance, within confidentiality limits.	Yet to be done.
Publish the CNB's internal governance procedures and Internal Audit Department procedures.	This will be put in place after the manuals and procedures are updated for Basel II.
Payments system oversight	
CNB should collect and publish data on the payments system on a regular basis.	Implemented.
Accounting and Auditing	
Close the “compliance gap” between practices and legislation; substantial changes in the dissemination of audited financial statements of companies are needed.	According to the new Accounting Act, various financial sector supervisory authorities are authorized to have their own regulations to determine the form and contents of financial reports, thus minimizing the “compliance gap.”

APPENDIX I. CROATIA: FUND RELATIONS
(as of November 30, 2006)

I. Membership Status: Joined December 14, 1992; Article VIII.

II. General Resources Account:

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

III. SDR Department:

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	0.11	0.25

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	8/04/2004	11/15/2006	99.00	0.00
Stand-By	2/03/2003	4/02/2004	105.88	0.00
Stand-By	3/19/2001	5/18/2002	200.00	0.00
EFF	3/12/1997	3/11/2000	353.16	28.78

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal					
Charges/Interest	1.78	1.79	1.78	1.78	1.78
Total	1.78	1.79	1.78	1.78	1.78

VII. Safeguards Assessment:

An updated safeguards assessment of the CNB with respect to the recent augmentation of the Stand-By Arrangement was finalized in August 2006. The assessment determined that the CNB continues to maintain an effective system of internal controls and that nearly all areas of the safeguards framework meet the

[1] On December 27, 2002, Croatia made an early repurchase in respect of the entire amount of Fund credit outstanding. The charges shown below are net charges and assessments by the SDR Department.

policy's requirements, though the internal audit mechanism could be strengthened further.

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 the significant participation of the CNB. The authorities' exchange rate policy regarding the Croatian kuna is classified as "managed floating with no pre-announced path for the exchange rate" and the float has been tightly managed. The CNB transacts only in euros, U.S. dollars, and SDRs. On December 30, 2006, the official exchange rate was kuna 5.578401 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII, Section 2–4 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 previous **Article IV consultation** with Croatia was concluded on August 4, 2004 (IMF Country Reports Nos. 04/251, 04/252 and 04/253). Executive Directors commended Croatia's strong economic performance but expressed concern over the persistently wide current account deficit and external debt-to-GDP ratio, which had over time increased Croatia's external vulnerability significantly. With the approval of the Stand-By Arrangement on August 4, 2004, 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 4, 2004, Executive Directors approved a 20-month **Stand-By Arrangement** for an amount equivalent to SDR 97.00 million (26.6 percent of quota). The authorities treated the arrangement as precautionary. The policy program underlying the arrangement aimed at containing the current account deficit and stabilizing external debt, mainly through fiscal adjustment. Directors completed the first and second reviews under this Arrangement on September 14, 2005 and March 29, 2006, respectively. In completing the second review, Directors also augmented the arrangement by SDR 2 million and extended it until November 15, 2006. The third and final review was completed on a lapse-of-time basis on September 29, 2006.

On April 2, 2004, a previous 14-month **Stand-By Arrangement** for an amount equivalent to SDR 105.88 million (29 percent of quota) expired. The authorities treated the arrangement as precautionary. The first and second reviews were completed on August 2, 2003 and November 12, 2003, respectively. Directors commended the generally satisfactory observance of quantitative performance criteria in the first nine months of 2003. However, they were concerned about the deterioration of the external position. Because of the slippages in fiscal policy in late 2003 caused mainly by a pre-election spending spree, the new government decided to let the current SBA expire without completing the third and final review but started negotiations for a new precautionary SBA.

XI. FSAP:

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).

XII. Technical Assistance 2000–06:[2]

Department	Timing	Purpose
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification (with STA)
	September 2003–March 2004	A Resident Advisor on Fiscal Reporting
	May 2004	Fiscal ROSC
	April 2005	Review of Indirect Tax Performance and Tax Administration
STA	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Quarterly National Accounts
	April 2001	Monetary Statistics
	March 2002	Accounting and Budgetary Classification (with FAD)
	October 2002	Government Finance Statistics

[2] Technical assistance during 1992–99 is listed in Appendix I of IMF Country Report No. 03/27.

	September 2006	Monetary and Financial Statistics
MFD	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March-April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
	April 2003	Stress Testing and Foreign Exchange Reserve Management
	February 2004	Monetary Policy Instruments

XIII. Resident Representative:

Mr. Vamvakidis took up his post in Zagreb on June 17, 2004. The post will close in June 2007.

APPENDIX II. CROATIA: STATISTICAL ISSUES

1. Data provision is broadly adequate for effective surveillance, though some improvements would be desirable. While remedial action has been taken to improve data coverage and reliability in most cases, progress in some instances has been impeded by insufficient resources and issues regarding coordination among government agencies. Croatia subscribed to the Special Data Dissemination Standard (SDDS) in May 1996 and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB).

A. National Accounts

2. The national accounts have undergone substantial improvements in the last few years. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the 1995 ESA. Quarterly GDP estimates are disseminated at current prices and at constant (1997) prices for the main categories of expenditure and main industry groupings. Nonetheless, shortcomings remain. Significant discrepancies exist between expenditure-based and value-added-based GDP data, stemming from: (i) problems of coordination between the CBS and CNB in reconciling tourism receipts estimates; (ii) incomplete coverage of unincorporated businesses and the self employed (farmers, trade and crafts); (iii) inadequate data for measuring changes in inventories; (iv) incomplete coverage of the informal sector; and (v) a lack of quarterly data for the seasonally volatile agricultural sector. Other shortcomings include: (i) inadequate conversion of government finance statistics from a cash to an accrual basis; (ii) inadequate price deflators; and (iii) the late publication of annual data, which show large differences with quarterly data.

B. Prices

3. The CBS produces the monthly consumer price index, with expenditure weights (updated every five years) derived from a 2001 Household Budget Survey. In between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups but in all cases between the 13th and the 21st day of each month. The indices are released around the 15th day of the following month. The price collection is confined to nine Croatian towns, but the weights are based on a sample of households in the whole country. A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology, but is not released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the CNB. The CBS also releases a monthly producer price index (PPI), usually on the 8th day of the following month. The weights of the PPI are based on the 2000 Annual Report of Industry and are updated every five years; an update is due in 2007.

C. Wages and Employment

4. Croatia produces data on average net and gross earnings per person and employment by 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. They do 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 was subsequently expanded and the survey is now being conducted on a regular basis with semi-annual results released after a delay of about four months. The difference between the survey-based unemployment rate and that based on the registered unemployed has recently been reduced.

D. Government Finance Statistics

6. Government finance statistics (GFS), produced on a monthly basis with a lag of 30 days, are available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data 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 classifications (economic and functional) for the central budget and the budgetary funds. The data on central government financing in the Ministry of Finance (MoF) reports, the monetary survey, and the balance of payments are not reconciled, with substantial discrepancies partly due to different methodologies and definitions of government used by the Ministry of Finance and the CNB. Following the recommendations of the October 2002 GFS mission, a task force, comprising staff from the MoF, CNB, and CBS was formed to reconcile central government financing data produced by these institutions; after a slow start, meetings are now being held more regularly.

7. The detailed data on domestic public bonds published in the Monthly Statistical Review of the MoF are now augmented by a central government debt table in the CNB Monthly Bulletin, which also reports stocks of central government guaranteed debt. The MoF prepared a database with government guarantees in July 2003, which has been used to monitor developments in the stock and flows of guarantees.

8. Data on the operations of local governments and consolidated general government are only available on a quarterly basis and with a lag of 30 days. Local government data are partial as they include the operations of the 53 largest municipalities. Annual cash data for the central and local governments up to 2004 are published in the *2005 GFS Yearbook*. In the IFS only annual cash data to 2002 are published.

E. Monetary Data

9. Compilation of monetary statistics published by the CNB is consistent with the recommendations of the IMF's *Monetary and Financial Statistics Manual*, 2000 (*MFSM*) with only a few deviations. These deviations are (i) only central bank's foreign-currency denominated assets, liabilities, and central government deposits in kuna incorporate *interest accrued* in the outstanding amount of the underlying financial asset or liability, but otherwise accrued amounts are classified in *other* assets and liabilities; (ii) loss and other specific provisions are classified in capital accounts rather than in other liabilities; (iii) financial derivatives are included in other items net rather than classified by economic sector of counterparty; and (iv) operating banks' positions with the (non-operating) banks in bankruptcy are classified as positions with nonfinancial enterprises rather than as positions with other financial corporations. However, these deviations have been fully addressed in the compilation of Standardized Report Forms (SRFs) (see below).

10. 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. Key data, such as currency in circulation, reserve deposits, and international reserves of the CNB are available with a one-day lag. 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 collecting 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 *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 monetary statistics with the statistical reporting requirements of the European Central Bank. In November 2006, the CNB reported monetary data in the format of SRFs for December 2001 to the present. These data accord with the concepts and definitions in *MFSM*.

F. External Sector Statistics

11. Quarterly balance of payments data are compiled broadly in accordance with the fifth edition of the IMF's *Balance of Payments Manual (BPM5)* and published by the CNB. Data are generally available with a lag of two months and are subject to substantial revisions in subsequent releases; trade data are available with a lag of one month and data on international reserves are available the next day on request. Travel survey methodologies were modified in 2002, 2004, and again in 2005, while the method for estimating the cost of insurance and freight was modified in early 2004. The most recent modification of tourism revenue contributed to an upward revision of the current account deficit for 2004 equivalent to 0.7 percent of GDP. Net errors and omissions have ranged from 2½ to 4½ percent of GDP since 2003, and are negative. The coverage and quality of portfolio investment data are reasonably complete and accurate.

12. A large part of 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. The CNB compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2003*, and began disseminating external debt data in the second quarter of 2003. The inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals and arrears has caused an upward adjustment in the external debt series compared to previously released data. Quarterly data on the international investment position are available on the CNB website up to Q2 2006.

Croatia: Table of Common Indicators Required for Surveillance
(as of December 11, 2006)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	11/30/06	12/7/06	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/24/06	12/1/06	W and M	W and M	W andM
Reserve/Base Money	Oct 2006	11/30/06	M	M	M
Broad Money	Oct 2006	11/30/06	M	M	M
Central Bank Balance Sheet	Oct 2006	11/30/06	M	M	M
Consolidated Balance Sheet of the Banking System	Oct 2006	11/30/06	M	M	M
Interest Rates[2]	Oct 2006	12/07/06	M	M	M
Consumer Price Index	Oct 2006	11/15/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep 2006	11/24/06	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct 2006	12/11/06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Oct 2006	12/11/06	M	M	M
External Current Account Balance	Q3 2006	11/30/06	Q	Q	Q
Exports and Imports of Goods and Services	Q2 2006	9/11/06	Q	Q	Q
GDP/GNP	Q2 2006	10/4/06	Q	Q	Q
Gross External Debt	Oct 2006	12/07/06	M	M	M

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

APPENDIX III. CROATIA: PERFORMANCE UNDER THE 2004–06 STAND-BY ARRANGEMENT

The recent SBA, which expired in November 2006, effectively covered the entire period since the previous Article IV consultation in August 2004. The main goal of the program was to reduce external vulnerabilities by narrowing the domestic savings-investment gap and stabilizing the external debt-to-GDP ratio. The main policy to achieve this goal was fiscal consolidation; monetary policy continued to focus on maintaining exchange rate stability.

Macroeconomic policy implementation was good, while structural reforms moved ahead but with delays in key areas.

- The government implemented a ***fiscal and quasi-fiscal adjustment*** of 2.6 percentage points of GDP in 2004–05 in the context of a new ***medium-term fiscal framework***—a key reform (structural performance criterion). The government targeted an additional 1.2 percentage points of fiscal and quasi-fiscal adjustment in 2006. It also improved ***fiscal management and transparency*** by reducing contingent liabilities by 2 percentage points of GDP in 2004–05, bringing all state aid to the railways on budget, and including the largest extrabudgetary funds in the single treasury account.

- In the ***financial sector***, the CNB sought to deter banks' foreign borrowing by introducing a marginal reserve requirement (MRR), which has been successively increased and its base broadened. To address foreign-currency-related credit risk, the CNB raised the risk weight of loans in foreign currencies to unhedged borrowers. A new unified supervisory authority for nonbank financial institutions started operating in 2006.

- The ***structural reform*** agenda was broadened beyond that envisaged in the original program, notably in pensions and health. The restructuring of the railway company and the first stage of the health reform are underway. However, the restructuring and privatization plan for the state-owned shipyards (large loss-makers) was repeatedly delayed.

- ***Privatization*** was delayed by property disputes and resistance of vested interests. Two large deals outstanding from 2005—the sale of share packages in the telecom (HT) and the oil company (INA)—fell schedule because of ownership disputes over certain company assets (HT) and a late start (INA). In September 2006, the authorities approved the privatization models featuring initial public offerings (IPOs) for both deals. The IPO for INA was launched in November 2006. The timing of the HT transaction remains uncertain but the authorities now expect it to take place in 2007. After some delay, the authorities also issued tenders for two steel companies and one aluminum plant.

- Notwithstanding good macroeconomic policy performance, strong private borrowing for portfolio purposes lifted the ***external debt-to-GDP ratio*** above program projections. The original program sought to stabilize the debt-to-GDP ratio at 76¾ percent in 2004; debt is now projected to have reached 84 percent of GDP at end-2006. However, its pace of accumulation slowed sharply in 2005–06.

Tables 9 and 10 below summarize performance under the program in 2006. Country Report No. 06/128 and Country Report No. 05/349 describe earlier performance.

Table 9. Croatia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2006

				End of	
			March 2006	June 2006	September 2006
			(In millions of kuna, unless indicated otherwise)		
Quantitative performance criteria (cumulative from December 31, 2005)					
1 Cumulative deficit of the consolidated general government 1/		Program	3,522 4/	5,115 6/	5,734
		Actual	3,887	4,160	3,812
		Margin (+)	-365	955	1,922
2 Cumulative change of the stock of arrears of the consolidated general government 2/		Program	150	300	300
		Actual	114	267	301
		Margin (+)	36	33	-1
3 Cumulative deficit of HBOR 1/		Program	-65	-124	286
		Actual	204	-149	213
		Margin (+)	-269	25	73
4 Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 1/ 2/	Total	Program	362	427	597
		Actual	0	26	182
		Margin (+)	362	402	415
	<1 years	Program	0	0	0
		Actual	0	0	0
		Margin (+)	0	0	0
5 Cumulative issuance of guarantees extended by the general government 1/		Program	1,960 5/	2,981 5/	3,337 5/
		Actual	940	1,743	2,141
		Margin (+)	1,020	1,238	1,196
6 Cumulative change in the Net International Reserves of the CNB 2/ 3/		Program	-345	-65	400
		Actual	186	579	694
		Margin (+)	531	644	294
7 Cumulative change in the Net Domestic Assets of the CNB 1/		Program	1,340	1,470	681
		Actual	-2,773	-1,537	-2,034
		Margin (+)	4,113	3,007	2,715
Indicative limits					
1 Cumulative increase in the total debt of selected public enterprises 1/		Program	-28	-97	169
		Actual	-173	-446	-465
		Margin (+)	145	349	634

1/ Ceiling.
2/ In millions of euros.
3/ Floor. Net of commercial banks' required reserves in foreign currencies.
4/ Adjusted downwards by HRK 694 million in revenue overperformance at the consolidated central government level.
5/ Adjusted upwards for the amount of company repayments of guaranteed debt as provided in Section V of the TMU.
6/ Adjusted downwards by HRK 1,520 million in revenue overperformance at the consolidated central government level.

Table 10. Croatia: Structural Conditionality under the Stand-By Arrangement, 2006

Structural Benchmarks, Second Review	Status
1. Parliament to approve, by end-June 2006, a package of draft laws on health reform that require co-payments for drugs not included in the main list, discontinue HZZO's provision of supplementary insurance for drugs, and open supplementary insurance for other health services to the private sector.	Done in July. Prior action for the third review.
2. Government to approve, by end-June 2006, a plan for restructuring the shipyard industry.	Not observed. The government is continuing work on the plan in consultation with the European Commission.
3. Government to formulate a plan on privatization of CO (state insurance company) by end-June 2006.	Done.
4. Government to complete the third phase of privatization of HT, and the second phase of privatization of INA, by end-June 2006.	Not observed. Intermediate steps were prior actions for the third review. The INA IPO was launched in November 2006; the HT IPO is expected in the first half of 2007.
5. CNB to increase risk weights by 25 basis points on credits to nongovernment clients exposed to foreign-currency-related credit risk, effective end-June 2006.	Done.
Prior Actions for the Third Review	
1. Parliament to approve supplementary budget aiming at a general government deficit of at most HRK 7.5 billion (3 percent of GDP).	Done.
2. Government to approve an updated medium-term fiscal framework consistent with the revised budget targets for 2006.	Done.
3. Parliament to approve a package of draft laws on health reform that require co-payments for drugs not included in the main list, discontinue HZZO's provision of supplementary insurance for drugs, and open supplementary insurance for other health services to the private sector.	Done.
4. Government to approve the privatization model for the sale of a 15 percent share package in INA through an initial public offering (IPO).	Done.
5. Government to approve privatization model for the third phase of privatization of HT.	Done.
6. Government to issue tenders for the Sisak and Split steel companies.	Done.
7. Government to submit to Parliament draft Law on Leasing.	Done.
Structural Performance Criterion	
1. IPO for the INA share package to take place by end-October 2006.	The IPO was launched on November 13.

APPENDIX IV. CROATIA: DEBT SUSTAINABILITY ANALYSIS

I. Fiscal Sustainability

1. Under the baseline scenario, public debt would gradually decline toward 38 percent of GDP by 2012 from its peak at 44 percent in 2005, driven primarily by continued fiscal consolidation and assisted by expected sizable privatization receipts in 2006 and 2007 (excluding the amounts earmarked for the "pensioners' debt" repayments). Stress-testing suggests that most foreseeable shocks leave public debt either declining or unchanged (Table 11, Figure 14). The one notable exception is scenario A1 (keeping key variables at their historical averages), under which the debt ratio increases by 18 percentage points of GDP between 2005 and 2012. This is because the historical primary deficit does not yet fully account for the recent significant fiscal consolidation—a trend projected to continue in the medium term—while the historical growth rate is unduly affected by a recession in 1999. Assuming no policy change beyond 2006 (scenario A2), the debt ratio would stay roughly constant over the forecast horizon, as it also would in the case of a large and sustained drop in economic activity (scenario B2), a policy-induced widening of the primary deficit (scenario B3), or a combined slowdown in growth with the concomitant rise in the primary deficit plus an interest rate hike (scenario B4). Under the two one-time shocks (scenarios B5 and B6), the debt ratio resumes a downward trend following the initial shock. The inclusion of the stock of state guarantees and arrears (about 10 percent of GDP) in the above analysis would not materially change the described responses to shocks.

II. External Sustainability

2. External debt rose quickly in recent years in Croatia—by over 20 percentage points of GDP (in euro terms) between 2002 and 2005. The buildup was facilitated by good access to international capital markets. But efforts at fiscal consolidation, a shift by the public sector towards domestic financing, and measures by the central bank to discourage bank external borrowing contributed to much smaller increases in 2005–06. In the baseline projection—which incorporates a deterioration of external current account balance relative to GDP in 2006–07 followed by a gradual improvement in the outer years and continued restraint by the public sector towards foreign borrowing—the debt-to-GDP ratio continues to hover between 84 and 85 percent in 2006–09 and then gradually declines to about 80–81 percent by 2012 (Table 12). Alternative scenarios demonstrate the sensitivity of external debt to several factors, highlighting the need for vigilance in economic management to forestall an unsustainable situation (Figure 15). In the scenario keeping key variables at their historical averages, the external debt ratio rises slightly. In scenarios with lower growth or a worsening of the current account, the debt-to-GDP ratio rises to around 88–89 percent. The small effect of the interest rate shock partly reflects the low historical standard deviation of interest rates; doubling the size of the interest rate shock would push the debt/GDP ratio above 86 percent. A large real depreciation scenario has adverse effects, with the debt-to-GDP ratio possibly averaging over 115 percent between 2007 and 2012.

Table 11. Croatia: Public Sector Debt Sustainability Framework, 2003–12

(In percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2003	2004	2005	7-Year Historical Average	7-Year Standard Deviation	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance 10/
1 **Baseline: Public sector debt 1/**	40.9	43.7	44.3			**42.5**	**41.9**	**41.8**	**41.4**	**40.6**	**39.6**	**38.2**	**-0.4**
Of which: foreign-currency denominated	32.7	37.1	36.2			32.1	29.0	26.4	22.9	21.9	21.0	20.2	
2 Change in public sector debt	0.9	2.8	0.6			-1.8	-0.6	-0.2	-0.4	-0.8	-0.9	-1.5	
3 Identified debt-creating flows (4+7+12)	1.4	1.2	1.2			-1.6	-0.6	-0.2	-0.4	-0.8	-0.9	-1.5	
4 Primary deficit	4.1	2.7	1.8			0.6	0.7	0.5	0.3	-0.3	-0.5	-1.1	
5 Revenue and grants	45.1	45.4	44.9			45.0	44.9	44.3	43.8	43.3	43.1	42.5	
6 Primary (noninterest) expenditure	49.2	48.0	46.7			45.6	45.5	44.8	44.1	43.1	42.7	41.5	
7 Automatic debt dynamics 2/	-0.6	-2.1	-0.5			-1.2	-1.1	-0.9	-0.8	-0.8	-0.8	-0.8	
8 Contribution from interest rate/growth differential 3/	-1.4	-0.6	-0.9			-1.2	-1.1	-0.9	-0.8	-0.8	-0.8	-0.8	
9 *Of which:* contribution from real interest rate	0.5	0.8	0.9			0.7	0.8	0.9	0.9	0.9	0.9	0.9	
10 *Of which:* contribution from real GDP growth	-2.0	-1.4	-1.7			-1.9	-1.9	-1.8	-1.7	-1.7	-1.7	-1.7	
11 Contribution from exchange rate depreciation 4/	0.8	-1.5	0.4			0.0	0.0	0.0	0.0	0.0	0.0	0.0	
12 Other identified debt-creating flows	-2.1	0.7	-0.1			-1.1	-0.2	0.2	0.2	0.3	0.3	0.3	
13 Privatization receipts (negative)	-2.1	-0.6	-0.6			-1.7	-0.7	-0.5	-0.4	-0.3	-0.2	-0.2	
14 Recognition of implicit or contingent liabilities	0.0	1.2	0.5			0.5	0.5	0.7	0.5	0.5	0.5	0.5	
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	
16 Residual, including asset changes (2-3) 5/	-0.5	1.6	-0.7			-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	90.7	96.3	98.6			94.6	93.5	94.3	94.6	93.6	91.9	89.8	
Gross financing need 6/	12.3	15.1	14.3			12.2	11.9	11.1	10.9	12.0	11.2	10.2	
In billions of U.S. dollars	3.2	4.3	4.4			4.1	4.3	4.4	4.6	5.5	5.5	5.4	
A1. Scenario with key variables at their historical averages 7/							**45.5**	**49.0**	**52.3**	**55.6**	**59.0**	**62.4**	**-0.6**
A2. Scenario with no policy change (constant primary balance) in 2007–12							**41.9**	**41.9**	**41.8**	**41.9**	**42.1**	**42.2**	**-0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (in percent)	5.3	3.8	4.3	3.6	2.2	4.6	4.7	4.5	4.5	4.5	4.5	4.5	
Average nominal interest rate on public debt (in percent) 8/	5.6	5.6	5.5	5.9	0.6	5.4	5.3	5.4	5.4	5.5	5.5	5.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	2.3	2.3	2.1	0.5	1.9	2.2	2.4	2.4	2.5	2.5	2.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.7	4.8	-1.0	0.0	3.2	...	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.9	3.3	3.2	3.8	0.5	3.5	3.1	3.0	3.0	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.4	1.3	1.4	1.8	3.9	2.0	4.6	2.8	2.8	2.1	3.6	1.6	
Primary deficit	4.1	2.7	1.8	3.9	1.5	0.6	0.7	0.5	0.3	-0.3	-0.5	-1.1	
B. Bound Tests													
B1. Real interest rate is at historical average plus one-half standard deviation							**42.0**	**42.0**	**41.7**	**41.0**	**40.1**	**38.8**	**-0.3**
B2. Real GDP growth is at historical average minus one-half standard deviation in 2007 and 2008							**42.8**	**44.1**	**44.6**	**44.6**	**44.5**	**43.8**	**-0.5**
B3. Primary balance is at historical average minus one-half standard deviation							**42.7**	**43.3**	**43.6**	**43.6**	**43.3**	**42.6**	**-0.5**
B4. Combination of B1-B3 using 1/4 standard deviation shocks							**42.6**	**43.1**	**43.3**	**43.1**	**42.8**	**42.0**	**-0.2**
B5. One time 30 percent real depreciation in 2007 9/							**57.5**	**57.0**	**56.3**	**55.2**	**54.0**	**52.2**	**-0.6**
B6. 10 percent of GDP increase in other debt-creating flows in 2007							**51.9**	**51.6**	**51.0**	**50.0**	**48.9**	**47.2**	**-0.6**

1/ Gross direct debt of the general government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign currency-denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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 numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

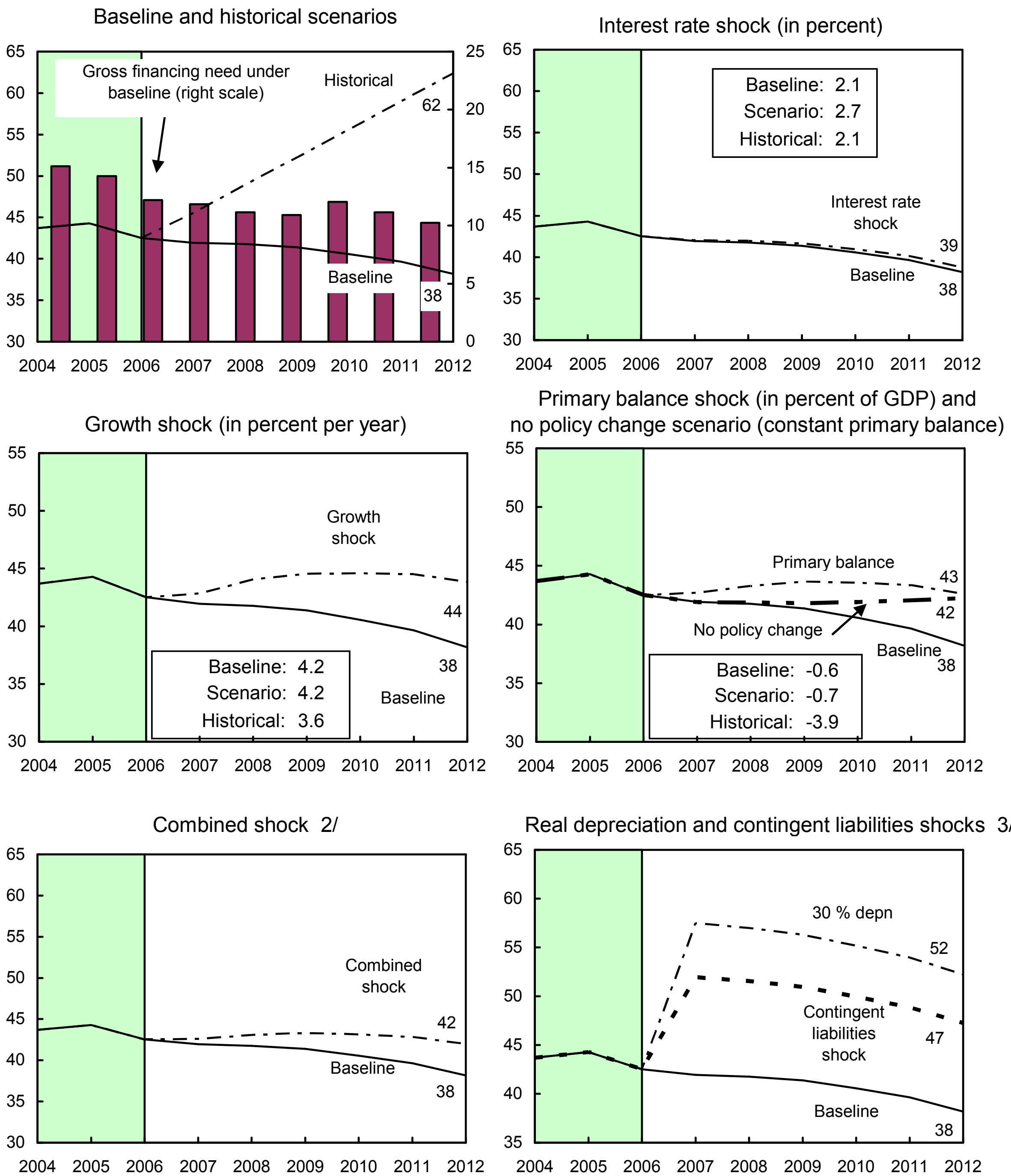
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 14. Croatia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Croatian authorities, and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Seven-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

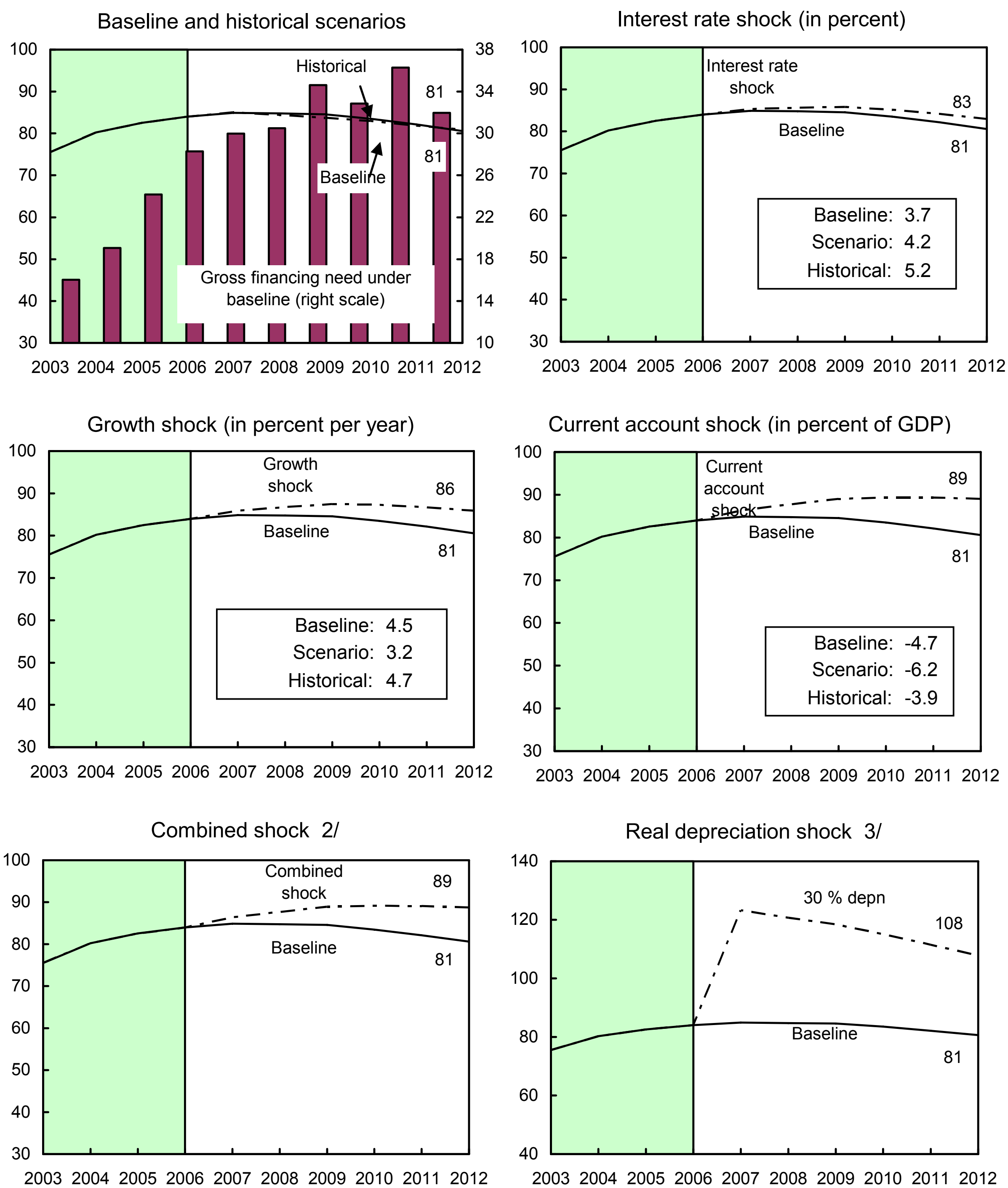
Table 12. Croatia: External Debt Sustainability Framework, 2003–12

(In percent of GDP, unless otherwise indicated)

	Actual			Projections							
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	75.5	80.2	82.5	**84.0**	**84.9**	**84.8**	**84.6**	**83.5**	**82.1**	**80.6**	**-7.4**
2 Change in external debt	14.0	4.7	2.3	1.5	0.9	-0.1	-0.2	-1.1	-1.4	-1.6	
3 Identified external debt-creating flows (4+8+9)	-3.8	-3.3	-4.1	-2.3	-1.2	-0.2	-0.3	-1.0	-1.1	-1.5	
4 Current account deficit, excluding interest payments	3.8	2.5	3.8	5.9	5.9	5.1	4.3	4.1	4.0	3.7	
5 Deficit in balance of goods and services	7.8	6.9	7.1	8.7	8.7	8.1	7.4	6.8	6.5	6.0	
6 Exports	50.2	50.2	49.3	49.5	49.7	50.4	50.7	50.9	51.0	51.3	
7 Imports	58.0	57.1	56.5	58.2	58.4	58.5	58.1	57.7	57.5	57.3	
8 Net non-debt creating capital inflows (negative)	-5.7	-2.5	-4.0	-7.0	-5.9	-4.5	-4.5	-4.5	-4.5	-4.5	
9 Automatic debt dynamics 1/	-1.8	-3.3	-4.0	-1.2	-1.2	-0.9	-0.2	-0.6	-0.6	-0.7	
10 Contribution from nominal interest rate	2.3	2.5	2.6	2.2	2.5	2.7	3.4	2.9	2.9	2.8	
11 Contribution from real GDP growth	-3.1	-2.6	-3.2	-3.4	-3.7	-3.5	-3.5	-3.5	-3.5	-3.4	
12 Contribution from price and exchange rate changes 2/	-1.1	-3.1	-3.5	...	...	...	...	...	...	...	
13 Residual, including change in gross foreign assets (2-3) 3/	17.8	8.0	6.4	3.7	2.1	0.1	0.1	0.0	-0.3	-0.1	
External debt-to-exports ratio (in percent)	150.6	160.0	167.3	169.8	170.8	168.2	166.8	164.1	161.0	157.2	
Gross external financing need (in billions of euros) 4/	4.2	5.4	7.5	9.6	10.9	12.0	14.6	14.9	17.7	16.8	
in percent of GDP	16.0	19.1	24.2	28.3	30.0	30.5	34.6	32.9	36.3	32.0	
Scenario with key variables at their historical averages 5/				**84.0**	**85.0**	**84.4**	**83.7**	**82.9**	**81.9**	**80.9**	**-7.0**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	5.3	3.8	4.3	4.6	4.7	4.5	4.5	4.5	4.5	4.5	
GDP deflator in euros (change in percent)	1.8	4.3	4.5	4.7	2.6	3.0	3.0	3.0	3.0	3.0	
Nominal external interest rate (in percent)	4.1	3.6	3.6	2.9	3.2	3.4	4.3	3.7	3.8	3.6	
Growth of exports (euro terms, in percent)	17.5	8.2	7.2	9.8	8.0	9.2	8.3	8.0	7.9	8.2	
Growth of imports (euro terms, in percent)	10.1	6.5	7.9	12.9	7.8	7.8	7.0	6.9	7.2	7.2	
Current account balance, excluding interest payments	-3.8	-2.5	-3.8	-5.9	-5.9	-5.1	-4.3	-4.1	-4.0	-3.7	
Net non-debt creating capital inflows	5.7	2.5	4.0	7.0	5.9	4.5	4.5	4.5	4.5	4.5	
Bound Tests											
B1. Nominal interest rate is at historical average plus 1/2 standard deviation				**84.0**	**85.3**	**85.6**	**85.8**	**85.1**	**84.2**	**83.0**	**-7.1**
B2. Real GDP growth is at historical average minus 1/2 standard deviations				**84.0**	**85.9**	**86.8**	**87.5**	**87.3**	**86.7**	**85.9**	**-6.8**
B3. Non-interest current account is at historical average minus 1/2 standard deviations				**84.0**	**86.4**	**87.8**	**89.0**	**89.4**	**89.3**	**89.1**	**-7.7**
B4. Combination of B1-B3 using 1/4 standard deviation shocks				**84.0**	**86.4**	**87.7**	**88.9**	**89.2**	**89.1**	**88.7**	**-7.0**
B5. One time 30 percent real depreciation				**84.0**	**123.2**	**120.7**	**118.4**	**115.1**	**111.5**	**107.8**	**-10.7**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = 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 [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 15. Croatia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Croatian authorities, and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent.

APPENDIX V. CROATIA: WORLD BANK RELATIONS

1. The World Bank is assisting Croatia in its structural and institutional reforms, within the context of the EU integration process. The Bank's Board discussed the second Country Assistance Strategy (CAS) for Croatia on December 21, 2004. The main strategic objective of the Croatian government, supported by the CAS, is successful integration into the EU.

2. The proposed four-year base case lending volume is about US$1 billion, with an additional US$0.5 billion under the high case. The proposed four-year low-case lending volume is US$300 million. Three triggers will determine whether Croatia will enter and sustain the base case: (a) satisfactory macroeconomic framework and fiscal consolidation; (b) implementing policies and improving governance for more competitive business environment; and (c) improving targeting, sustainability, quality and efficiency of social services.

3. The backbone of World Bank assistance to Croatia (up to US$550 million or 37 percent) is a series of Programmatic Adjustment Loans (PALs). The other 63 percent is split between investment loans and sector wide approach (SWAp) type of loans supplementing the PALs. The investment loans address institutional capacity problems; work in concert with the PALs in mitigating the effects reforms may have on vulnerable groups; and assist Croatia in addressing significant environmental challenges of the accession process. SWAps will address sector reforms related to the process of EU integration for the infrastructure and energy sectors, and Croatia's competitiveness through the reform of the education and health sectors.

4. The Bank Board approved the first out of three PALs in September 2005. PAL 1 amounts to EUR 150 million. The PAL has three major components: (i) strengthening governance through public administration reform and strengthening of public expenditure management; (ii) improving the investment climate through judicial reform, privatization, continued reduction of barriers to entry of new firms, and continued reduction of state subsidies; and (iii) strengthening financial sustainability of sectoral spending through health reform, social benefits streamlining, railways restructuring, and improvement of the fiscal and social sustainability of the pension system. The pre-appraisal mission for PAL 2 was conducted in November and December 2005. The appraisal mission and negotiations are scheduled for January 2007, which could allow the proposed PAL 2 to be presented to the Board in March 2007.

5. The current amount of committed funds to Croatia stands at US$1.7 billion for 34 IBRD and GEF projects. Currently, the Bank's active portfolio in Croatia comprises 14 IBRD and three GEF projects. Thus far in FY06, four IBRD investment loans have been approved: Science and Technology (EUR 31 million), PAL 1 (EUR 150 million), Education SWAp (EUR 67.8 million), and Agricultural Acquis Cohesion (EUR 25.5 million).

Statement by the IMF Staff Representative
February 16, 2007

1. This statement reports on recent developments and adds to the information contained in the Staff Report for the 2006 Article IV Consultation. It does not change the thrust of the staff appraisal.

2. On data, real GDP increased by 4.7 percent (year-on-year) in the third quarter of 2006 and year-average inflation was 3.2 percent for 2006, both consistent with the macroeconomic projections presented in the Staff Report. In addition, December foreign trade data and November fiscal data were broadly in line with the projections. Bank credit to households and enterprises increased by 23 percent in the year to December 2006, while external debt reached 86 percent of GDP at end-2006, somewhat higher than projected in the Staff Report.

3. In response to developments in credit and external debt, the Croatian National Bank (CNB) implemented at the start of 2007 an administrative measure to slow credit growth by banks. Banks with credit growth exceeding a ceiling of 12 percent in 2007, calculated on a cumulative monthly basis, will be required to purchase low-yielding (0.75 percent on current policies), 360-day CNB bills in an amount equal to 50 percent of the credit extended above the ceiling. As discussed in the Staff Report, staff had expressed a preference for tighter prudential measures if rapid credit growth went unabated.

4. The government has introduced to parliament legislation to extend "pensioners' debt" repayments (described in IMF Country Report No. 06/128) to an additional 44,000 beneficiaries, who receive special and family pensions. The authorities estimate the amount necessary to cover the payments to these additional beneficiaries at around 0.5 percent of GDP, on top of planned pensioners' debt payments of 1.1 percent of GDP in 2007. The authorities treat pensioners' debt payments as outside the budget, pending a Eurostat decision. In any case, the planned additional payments would add to aggregate demand pressures in a situation of a high current account deficit and rising external debt.

5. The Staff Report noted (¶26) the government's intention to finalize by March 2007 its long-awaited restructuring plan for the shipyards, to comply with European Union state aid rules. On February 1, the government forwarded its draft plan to the European Commission. Staff has not seen details of the plan.

Statement by Yuriy G. Yakusha, Alternate Executive Director for Republic of Croatia and Charalambos Christofides, Advisor to Executive Director
February 16, 2007

Introduction

The authorities welcome the thorough staff analysis and mostly agree with the staff's recommendations. This is the first Article IV consultation to take place following the successful conclusion of the Stand-By Arrangement last November, and it provides a good opportunity to focus on economic issues from a longer-term and analytical perspective rather than from a program perspective. The authorities value their close cooperation with the Fund, and consider that the consultation process has worked well and has focused on topics of importance to the Croatian economy.

The authorities strongly emphasize maintaining the good macroeconomic performance of recent years and further invigorating structural reform. The prospect of EU accession continues to act as an important anchor, providing one impetus for further progress in these areas. The negotiations with the EU have been gaining momentum after the process of screening of Croatian legislation by the European Commission was finalized. A key objective is to keep macroeconomic stability and to maintain progress on per-capita incomes and hence promote convergence with the EU, by continuing to attract FDI and developing key growth sectors while restructuring lagging ones.

Economic performance and outlook

From a longer-term perspective, the Croatian economy continued to exhibit solid growth, averaging 4 ¾ percent over the past five years, propelled by private consumption and investment. Unemployment has continued to decline to levels not seen for many years, while inflation has remained well contained despite rising energy and commodity costs. Savings have been healthy, aided by improving government savings, which helped maintain a rising investment share in the economy. FDI has correspondingly also been strong.

The current account deficit has widened although, as the staff points out, competitiveness was adequate and wage growth moderate. Goods exports have grown, gaining rather than losing market share relative to that of a few years ago. Tourism has also been strong, with Croatia viewed as an attractive destination possessing great natural beauty. Imports have, however, also been rising, partly driven by higher energy prices and partly by rapid credit growth in response to the availability of cheap foreign loans.

Looking forward, prospects for growth remain good, with perhaps a temporary acceleration in domestic demand as the spending effect of the settlement of the "pensioners debt" works itself through. Over the medium term, potential growth is likely to continue to improve somewhat, reaching perhaps 5 percent, given continuing strong investment, but also assuming that restructuring takes place and that reform results in an improving business environment. Following EU accession, FDI could rise and the convergence process could accelerate even further, allowing for an additional pickup in potential growth.

Monetary policy and external vulnerability

The Croatian National Bank (CNB) continued to achieve low inflation, maintaining its strong track record in this regard during 2006. Core inflation declined from 3.0 percent in December, 2005 to 2.3 percent in December, 2006, while headline inflation, aided by declining oil and food prices, fell more strongly—dropping to 2.0 percent from 3.6 percent over the same period. The CNB kept its focus on mitigating vulnerabilities by maintaining exchange rate stability while standing ready to take steps to address the risks associated with bank foreign borrowing and rapid credit growth. This readiness was already expressed to the Board on a number of occasions, including in our Buff statement of March 23, 2006 and in the Annex to the government's Letter of Intent for the 3rd Review of the Stand-By Arrangement in October, 2006.

It should be said at the outset that external vulnerability remains manageable, with higher external debt on the one hand counterbalanced by higher gross official reserves, strong market access, and a healthy financial sector (which is in any event 90 percent foreign owned) on the other. However, the CNB remained concerned with the possible macroeconomic implications of persistently high and increasing credit growth and a rising current account deficit in an environment of already high—in relation to neighbors—external debt-to-GDP and credit ratios. Another consideration was that fiscal policy for 2007 is already set from the legislative point of view. Finally, the CNB observed that the set of measures (that is, all such measures falling within the CNB's competence, well-described in paragraph 21 of the Staff Report) taken in an attempt to arrest high credit growth and already implemented during 2006 were not sufficient enough to achieve the expected result.

Indeed, credit growth accelerated in the last month of 2006, reaching 22.9 percent in December 2006 (y/y), driven by increased foreign borrowing by commercial banks. During just the last quarter of 2006, banks increased their external debt by almost 11 percent (an additional €1.3 bn), with the bulk of it used to fuel new credits; according to CNB estimates, banks needed only some €150 million of additional borrowing to comply with the broadening of the foreign-exchange liquidity requirement mandated to occur by year-end. This in turn caused the total external debt-to-GDP ratio to increase to 86.1 percent at end-2006 from 82.5 percent at end-2005, and the current account deficit to deteriorate further to 8.1 percent of GDP in 2006.

In view of the above considerations, CNB responded with enacting a temporary credit control measure in December, 2006, described in the Staff Statement. The prudential measures already taken, while possibly still having a lagged effect, and while no doubt helping to maintain the quality of new credits, do not necessarily curb credit growth. Further, the CNB has no doubt that an important step to improving the external balance is to slow down credit growth. That being said, the CNB is fully aware of the partial effectiveness of the credit control measure, i.e., that it cannot entirely solve the underlying problem of increasing external imbalances, but it considers that the measure adds to the overall efforts, and that it serves as an important signaling function.

Fiscal policy

The authorities have implemented a successful policy of fiscal consolidation over the past few years, in agreement also with staff in the context of the successfully completed Stand-By Arrangement. The overall general government deficit has declined from 6.2 percent of GDP in 2003, to roughly 3 percent by 2006 as estimated on a preliminary basis. Even during 2006, a better-than-expected revenue performance was mostly absorbed into a better-than-programmed fiscal balance, with the expenditure side continuing to experience contraction as a ratio to GDP. A supplementary budget was implemented to help achieve this result. A series of measures contributed to this outturn, including pension reform, wage moderation, and investment cuts. The changes in the pension formula (already enacted), should continue to produce fiscal benefits through the medium term. The staff's calculations indicate only a moderate role for automatic stabilizers. In the context also of the Stand-By Arrangement, the deficits of the Development Bank were scaled down.

The authorities plan further medium-term fiscal consolidation, taking account of the impact of necessary structural reforms, projected growth, development requirements as expressed in the *Strategic Development Framework* , and Croatia's aspirations for EU accession and eventual ERM-2 entry.

The planned improvements do consider that there will be continuing success in structural reforms. These include not only the pension reform already mentioned, but also a plan to continue reducing subsidies gradually, and significant reforms in the health sector (these were described in more detail in our last Buff statement as they formed an important part of the Stand-By Arrangement). Finally, the staff's debt-sustainability analysis shows contained and further declining levels of the public debt-to-GDP ratio, while the bound tests generally show that the public debt ratio is robust to a number of possible shocks.

Structural reform and the financial sector

A number of reforms were already mentioned when considering the government's medium-term fiscal plan. Other notable areas include plans for shipbuilding, steel, and railways restructuring, as well as privatization. On privatization, the government is considering a plan to cancel part of the debt of 200 enterprises on a case-by-case basis and only in the context of their privatization to improve their balance sheets and make them more attractive privatization candidates. It will also exempt potential investors from a requirement to buy all outstanding shares. A block of 15 percent of shares in the national oil company (INA) has already been sold to private investors (both foreign and domestic). The sale was very successful, and the share price (the company was jointly listed with the London Stock Exchange) has shown a strong tendency to rise. A tender for an advisor to the sale of 49 percent of the telecom company has already been launched. Additional ideas and a possible amendment to the Privatization Act are also being considered, all with a view to strengthening privatization (i.e., shortening the time needed for the privatization process, and making the procedures less complicated and more efficient).

On the financial sector, the independent non-bank supervisor (HANFA) has been operating now for about one year. It has done a number of audits of transactions involving brokerages. The leasing law was approved by parliament in December, 2006, which is a welcome development. Finally, the authorities expect an updated FSAP exercise to be conducted in a coordinated manner with the European Commission's "Peer Review" exercise later in the year.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Executive Board Concludes 2006 Article IV Consultation with the Republic of Croatia

On February 16, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.[1]

Background

Croatia has experienced solid growth and low inflation in recent years, with GDP growth averaging around 4¾ percent in 2001–06 and headline inflation contained to 2–4 percent. But domestic demand pressures and higher international energy prices caused the current account deficit to widen in 2005–06.

Although external competitiveness appears adequate, export growth has been significantly below the average in Croatia's peer countries, which have been more successful in attracting greenfield foreign direct investment. Survey measures of competitiveness underscore structural weaknesses in the business environment.

Policies in 2004–06, supported by a precautionary Stand-By Arrangement, sought to mitigate external vulnerabilities by lowering Croatia's current account deficit and stabilizing the external debt-to-GDP ratio. The authorities largely relied on fiscal adjustment, accompanied by measures by the Croatian National Bank (CNB) to safeguard financial sector stability and discourage external debt accumulation by banks. Reform of pension indexation, wage

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

moderation, and investment cuts contributed to a reduction in the fiscal deficit from 6.1 percent of GDP in 2003 to an estimated 2.8 percent in 2006. However, despite these countervailing policy efforts, gross external debt and the current account deficit remain high.

While bank restructuring and privatization have strengthened the financial sector, strong credit expansion and foreign exchange-induced credit risk have raised concerns. Large foreign banks own over 90 percent of the system, which is well developed by regional standards. Financial soundness indicators show adequate capitalization and asset quality. But intense competition among banks and easy access to credit from foreign parents has contributed to a vigorous credit expansion that gained momentum over 2005–06. The pace of the ongoing credit expansion increases the potential for asset quality to deteriorate in the event of a downturn. Moreover, most households also seem exposed to currency risk: the bulk of long-term bank loans to households are linked to foreign currencies; and, even though households' foreign-currency deposits are sizeable in the aggregate, borrowers and savers may only partly overlap. Concerned about safeguarding financial stability, the CNB responded with a series of measures to slow the bank-related portion of capital inflows: a progressive increase in its marginal reserve requirement on banks' foreign borrowing, broadening its base, and issuing various prudential measures and guidelines.

The large role of the state, slow progress in key structural reforms, and less-than-satisfactory conditions for doing business have constrained economic performance. While recent progress in some transition indicators has been significant, privatization and reform of state-owned enterprises has lagged because of legal disputes, resistance of vested interests, onerous investment and employment conditions, and a legal framework favoring insiders—a bias that the pending draft privatization law could worsen. In addition, conditions for doing business are hampered by the heavy administrative burden and difficulties enforcing property rights, with many problems at the local level.

The consultation focused on the interrelated issues of how to raise economic growth in Croatia and addressing vulnerabilities.

Executive Board Assessment

Croatia's recent economic growth has been solid and inflation contained, and its progress with the EU accession process has boosted investment prospects. However, the high external debt-to-GDP ratio, the increase in short-term external debt, and the widening current account deficit are sources of concern. Directors welcomed the improvements in policies in recent years, but noted that continued efforts will be needed to address significant external vulnerabilities. They stressed the importance of faster and deeper structural reforms if Croatia is to boost potential growth. Progress in these areas should be high on the agenda of the next government.

To address external vulnerabilities and reduce the burden of the large government on economic growth, Directors recommended more ambitious fiscal consolidation than the authorities' medium-term plans currently envisage. In this connection, it will be essential to resist spending pressures in the run-up to elections in late 2007—including through off-budget proposals to address spending demands—and to ensure a fiscal deficit in 2007 no larger than the budget target. Measures are also needed to reduce public expenditure permanently, with a view to providing room for cutting taxes, including social security contributions, in order to boost growth while lowering the budget deficit. Action on the fiscal front will also help narrow the large current account deficit and ensure a sustainable debt path. With Croatia's expenditure-to-GDP ratio well above that of peers, Directors saw considerable scope for savings, and encouraged the next government to make significant progress in this area.

Directors agreed that the present monetary framework remains appropriate for Croatia. Given the high degree of euroization, the openness of the economy, and adequate external competitiveness, they supported the tightly managed exchange rate. At the same time, noting the constraints this places on monetary policy, Directors emphasized the importance of other supporting policies, including structural reforms, to strengthen competitiveness; fiscal consolidation, to redress macroeconomic imbalances; and strong financial sector supervision, to address possible balance-sheet currency and maturity mismatches.

Directors welcomed the progress achieved by the authorities in improving financial sector supervision and regulation. They commended the Croatian National Bank's efforts over the past few years to strengthen the prudential regulation of banks—which remain profitable and well capitalized—as well as the recent establishment and development of the independent nonbank supervisor. Directors shared the authorities' concerns about the prudential and macroeconomic risks of the ongoing rapid growth in bank credit. They commended the Croatian National Bank for standing ready to address risks associated with bank foreign borrowing and rapid credit growth. They nevertheless expressed reservations about the recent reintroduction of direct credit controls, whose impact, including undesirable side-effects, will need to be monitored closely. Directors encouraged the authorities to consider tighter prudential measures that would also raise credit quality and reduce vulnerabilities.

Directors called for significant improvements in the business environment. Reducing the administrative burden, legal uncertainties, and corruption will be critical in the coming years for attracting a much-needed increase in greenfield foreign direct investment required to boost exports and economic growth while lessening vulnerabilities. Noting the slow pace of recent structural reforms, Directors stressed the urgency of restructuring the loss-making shipyards, reforming the remaining public enterprises, and removing impediments to privatization.

Republic of Croatia: Selected Economic Indicators

	2003	2004	2005	2006 Proj.	2007 Proj.
Output, unemployment, and prices			(Percentage change)		
Real GDP	5.3	3.8	4.3	4.6	4.7
Unemployment (survey-based, in percent)	14.3	13.8	12.7	...	...
CPI inflation (average)	1.8	2.1	3.3	3.3	2.7
Savings and investment			(In percent of GDP)		
Domestic investment	30.5	31.2	31.4	33.3	33.5
Of which: fixed capital formation	28.6	28.6	28.6	30.6	30.9
Domestic saving	24.4	26.2	24.9	25.2	25.2
Government	1.8	2.8	3.1	3.6	3.7
Nongovernment	22.6	23.4	21.9	21.6	21.4
General government and HBOR operations 1/					
General government revenue	45.1	45.4	44.9	45.0	44.9
General government expense and net lending	51.3	50.2	49.0	47.8	47.6
Overall general government balance	-6.1	-4.8	-4.1	-2.8	-2.8
Overall general government financing requirement 2/	-6.1	-4.8	-4.1	-3.8	-3.9
Overall HBOR balance (net of budget transfers)	-0.6	-0.4	-0.1	-0.2	-0.6
Fiscal and quasi-fiscal balance	-6.8	-5.2	-4.2	-3.0	-3.4
General government debt	40.9	43.7	44.3	42.5	41.9
Money and credit			(End of period; change in percent)		
Credit to the nongovernment sector	14.7	12.8	16.7	21.1	…
Broad money	11.0	8.6	10.5	15.3	…
Base money 3/	23.8	19.9	20.7	18.1	…
Interest rates			(End of period; in percent)		
Average kuna deposit rate (unindexed)	1.7	1.8	1.6	…	…
Average kuna credit rate (unindexed)	11.5	11.4	9.9	…	…
Balance of payments			(In millions of euros)		
Current account balance	-1,596	-1,404	-1,994	-2,762	-3,031
(In percent of GDP)	-6.1	-4.9	-6.4	-8.1	-8.3
Capital and financial account	4,015	2,385	3,943	5,578	4,605
Overall balance	1,239	-118	1,002	1,458	374
Debt and reserves			(End of period; in millions of euros)		
Gross official reserves	6,554	6,436	7,438	8,896	9,270
In months of following year's imports of goods and NFS	4.9	4.4	4.5	5.0	4.9
External debt service to exports ratio (in percent)	20.1	21.7	24.2	26.4	26.0
Total external debt (in percent of GDP)	75.5	80.2	82.5	84.0	84.9
Net external debt 4/	32.9	37.5	42.9	44.4	45.3

Sources: Croatian authorities, and IMF staff estimates.
1/ Revenue in 2004 includes HRK 197 million in GSM license fees from an auction held in December 2004 but received in February 2005. For 2007, refers to the budget.
2/ Includes estimated 1 percent of GDP for “pensioners’ debt” repayment under the cash option in 2006 and 2007.
3/ Includes commercial banks’ statutory reserves in foreign currency (general and marginal reserve requirements).
4/ Net of official reserves and commercial bank foreign assets.