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Republic of Croatia: 2004 Article IV Consultation and Request for Stand-By Arrangement—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with the Republic of Croatia and request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation and request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on May 25, 2004, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 16, 2004. 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 Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its August 4, 2004 discussion of the staff report that concluded the Article IV consultation and the request, respectively.

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

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

Letter of Intent sent to the IMF by the authorities of the Republic of Croatia*
Memorandum of Economic and Financial Policies of the authorities of the Republic of Croatia*
Report on the Observance of Standards and Codes—Update
Selected Issues Paper and Statistical Appendix
Technical Memorandum of Understanding*
*May also be included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Staff Report for the 2004 Article IV Consultation and Request for Stand-By Arrangement

Prepared by the European Department
(in consultation with other departments)

Approved by Carlo Cottarelli and Anthony Boote

July 16, 2004

- A team comprising Messrs. Demekas (head), Eskesen, Konuki, Vamvakidis (all EUR), Čihák (MFD), Dodzin (PDR), and Norregaard (Resident Representative) conducted the discussions on the 2004 Article IV consultation and the request for a Stand-By Arrangement (SBA) in Zagreb during April 13–21 and May 18–25, 2004. Discussions on the SBA were concluded in Washington during June 9–12. The team met Prime Minister Mr. Sanader; Deputy Prime Ministers Mr. Hebrang and Ms. Kosor; Finance Minister Mr. Šuker; Sea, Tourism, Transport and Development Minister Mr. Kalmeta; the Governor of the Croatian National Bank (CNB) Mr. Rohatinski; senior government officials; and representatives of parties, unions, banks, and the private sector. Mr. Stučka (OED) and World Bank staff attended some of these meetings.

- In last November's elections, the Social Democrats were ousted and the Croatian Democratic Union (HDZ) came to power, heading a minority government with support by six other parties, including the Pensioners' Party and representatives of ethnic minorities.

- The previous precautionary SBA, approved on February 3, 2003, expired on April 2, 2004, after going off track in late 2003. The authorities have requested a successor SBA, which they also intend to treat as precautionary. Access under the proposed arrangement would be SDR 97 million (26.6 percent of quota) over a 20-month period. Policies under the SBA are presented in the attached Memorandum of Economic and Financial Policies (MEFP).

- Croatia applied for EU membership in February 2003. In its opinion on Croatia's application in April 2004, the European Commission noted that Croatia can be regarded as a market economy. On June 18, 2004, the Council of the European Union granted candidate status to Croatia. Accession negotiations are to start in early 2005.

- The mission held a joint press conference with the Prime Minister at the end of the second mission and engaged in other outreach activities. The authorities intend to publish this report and the MEFP.

- Croatia has accepted the obligations of Article VIII (Appendix I) and subscribes to the Special Data Dissemination Standard (Appendix III). A full safeguards assessment of the CNB is currently under way.

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Executive Summary

Background: Since the mid-1990s, Croatia has recorded satisfactory growth and low inflation. However, a persistent savings-investment gap over the same period has led to high current account deficits and a build-up of foreign debt, trends that accelerated in 2001–02 with a credit-fueled domestic demand boom. Private sector activity started moderating in 2003 but there was a sharp reversal of fiscal policy in the runup to the November elections, and the deficit jumped to 6.3 percent of GDP, derailing the last Stand-By Arrangement (SBA). Although the current account improved last year due to large tourism receipts, external debt continued to rise reflecting strong capital inflows.

Macroeconomic strategy and outlook: The new government this year has resumed the fiscal consolidation effort, aiming at a substantial fiscal and quasi-fiscal adjustment in 2004-05 in order to reduce the savings-investment imbalance and stabilize the external debt-to-GDP ratio. The slowdown in private sector activity, notwithstanding significant uncertainties and data deficiencies, should facilitate this task. In support of their policies, the authorities have requested a new SBA, which they intend to treat as precautionary.

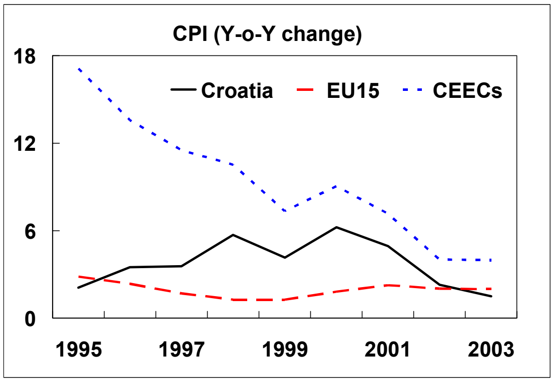
Fiscal policy: The government targets a fiscal deficit of 4.5 percent of GDP in 2004 and 3.7 percent in 2005, and has taken steps to eliminate off-budget fiscal transactions, contain quasi-fiscal deficits, and improve transparency and public debt and expenditure management. Staff welcomes the ambitious adjustment but expresses concerns about its composition: the adjustment in 2004 relies to some extent on one-off revenues, effectively postponing part of the adjustment effort to 2005; and not enough is being done to reduce current spending, where Croatia compares unfavorably with similar countries. The authorities explain the reliance on one-off measures in 2004 partly by the amount of inherited spending obligations from last year, as well as by the fact that a number of measures introduced this year will take time to bear fruit. Staff supports the authorities' plans to reduce the deficit further over the medium term while simultaneously reducing the high tax burden. To reconcile these objectives, staff recommends a comprehensive medium-term expenditure policy framework, as well as reforms to contain the wage bill, streamline social transfers, and reduce subsidies.

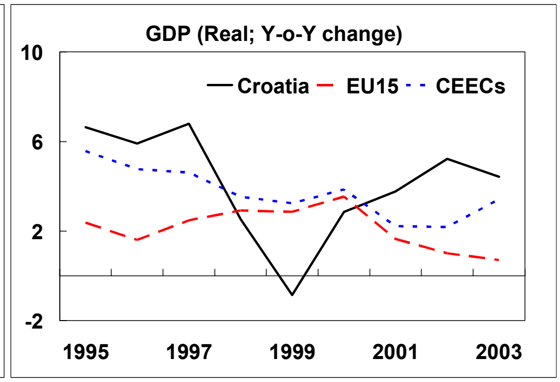
Monetary policy: The authorities argue that high degree of trade and capital account integration, advanced currency substitution, and weak interest rate transmission—tested in a staff Selected Issues paper—underscore the importance of exchange rate stability and limit the scope for monetary policy. Staff points out the attendant risks but acknowledges that the CNB's pragmatic approach to monetary policy has worked well. Monetary policy will focus on limiting net domestic asset growth and preparing the ground for open market operations.

Structural policies and financial sector issues: The banking system is generally sound and banking supervision has improved over recent years. The authorities are committed to closing gaps in financial sector supervision, preserving the sustainability of the pension system, and restoring momentum to other structural reforms.

I. Background and Recent Developments

1. **Since the mid-1990s, Croatia has established a record of satisfactory growth and low inflation**. Real GDP growth has averaged 4½ percent with inflation in the low single digits. These numbers compare well with the EU-15 and Central and Eastern European countries (CEECs).





2. **Structural reform has progressed and the private sector is vibrant, but Croatia still lags somewhat behind the CEECs**. The economy is open to trade and capital flows; privatization is advanced, albeit uneven; the private sector accounts for 60 percent of the economy, including virtually the entire banking system; and foreign direct investment (FDI) has been strong. But partly due to the war in the early 1990s, Croatia lags the CEECs in terms of overall progress: the state still maintains a significant role in the economy in the form of high government spending (50 percent of GDP), sizeable direct state aid (about 3½ percent of GDP, compared to less than 2 percent in CEECs), and onerous regulation (one of the factors behind a weak business environment, according to the World Bank). Stringent labor market regulation may explain why, despite a good growth performance, unemployment remains relatively high (14¼ percent in 2003) (see accompanying Selected Issues paper for details on labor market performance).

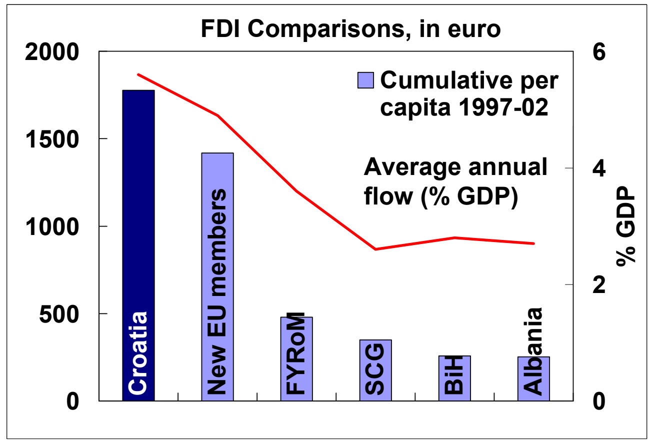
EBRD Overall Transition Indicators, 1998-2002
(Index from 1(lowest) to 4)

	1998	1999	2000	2001	2002
Bulgaria	2.7	2.9	3.0	3.0	3.1
Croatia	**3.0**	**3.0**	**3.1**	**3.1**	**3.2**
Czech Republic	3.4	3.4	3.5	3.5	3.5
Hungary	3.7	3.7	3.7	3.7	3.7
Poland	3.5	3.5	3.5	3.6	3.6
Slovak Republic	3.1	3.2	3.3	3.3	3.3
Slovenia	3.2	3.2	3.3	3.3	3.3

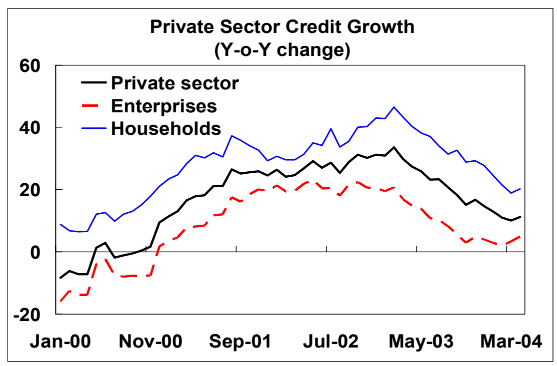
Source: EBRD.

3. **Domestic investment has outstripped savings since the mid-1990s, resulting in persistent current account deficits and a gradual buildup of foreign debt**. Liberalization and privatization stimulated extensive restructuring and high investment. Public infrastructure investment, particularly in roads, has averaged an extraordinary 6½ percent of GDP in recent years. This was accompanied by a rise in imports—especially capital goods—to 45 percent of GDP by the end of the 1990s. Tourism has become

increasingly important as a source of foreign exchange. Nonetheless, current account deficits have persisted since the mid-1990s (Figure 1) and errors & omissions have been consistently large and negative. Although Croatia has been able to attract high FDI relative to other CEECs, there has also been a gradual buildup of both public and private foreign debt, facilitated by Croatia's investment grade rating and low world interest rates and spreads (Figure 2).



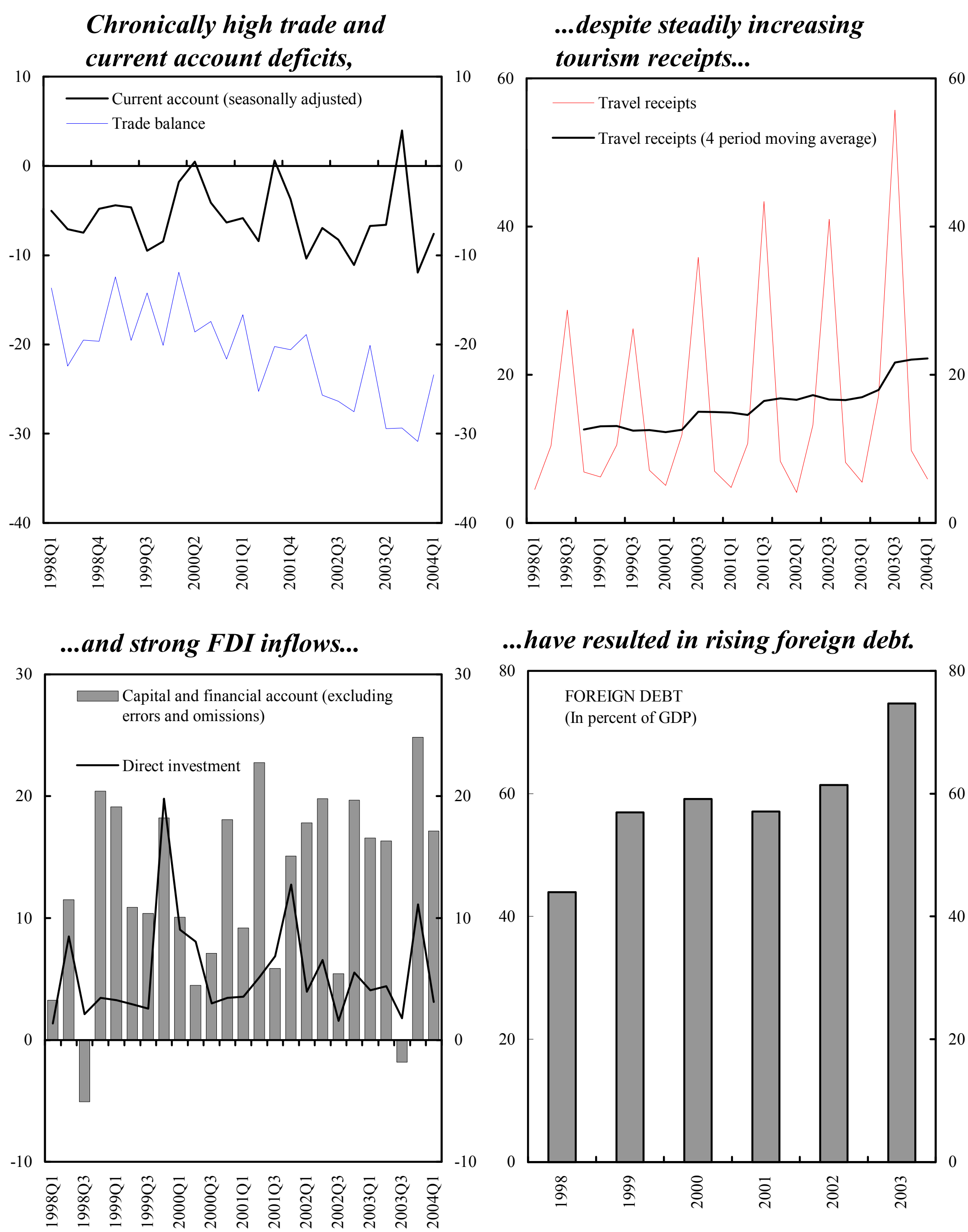
4. **These trends accelerated since the turn of the decade, fueled by a credit boom in 2001–02**. Following the 1998–99 banking crisis, the remaining state-owned banks were sold to foreigners, who now own 90 percent of the system. The state controls only two small commercial banks accounting for 3 percent of assets. The 2002 FSSA (IMF Country Report No. 02/180) concluded that the banking system was generally sound and well-supervised. But increased competition among banks and easy access to credit from their parent banks abroad turned a jump in bank liquidity—triggered by large-scale repayments of government arrears in 2000 and a sudden inflow of deposits due to euro conversion in 2001—into a sustained lending boom during 2001–02.



5. **Macroeconomic policies did not manage to contain the credit-financed surge in domestic demand and the external position deteriorated sharply in 2001–02**. The fiscal consolidation underway was not sufficient to offset the growth in private consumption and investment. Monetary policy was constrained by the CNB's preference for nominal exchange rate stability and a very open capital account. As a result, the current account deficit rose sharply to 8.4 percent of GDP in 2002 (Table 1).

6. **Private sector activity started moderating in the second half of 2003**. The momentum of domestic demand from 2002 was largely carried forward in 2003 and real GDP growth still averaged 4.3 percent. But Q4 national accounts and monthly indicators suggest that private consumption and investment have started slowing down—trends that have continued in early 2004 (Figure 3). Several factors may explain this slowdown: a natural unwinding of the boom in 2002 and early 2003, debt-carrying capacity constraints, and the bank credit ceilings imposed by the CNB last year (see below), which may have had a dampening impact on household consumption. But lack of data precludes a full assessment of these trends.

Figure 1. Croatia: External Developments, 1998-2003
(Quarterly flows in percent of GDP, annualized)

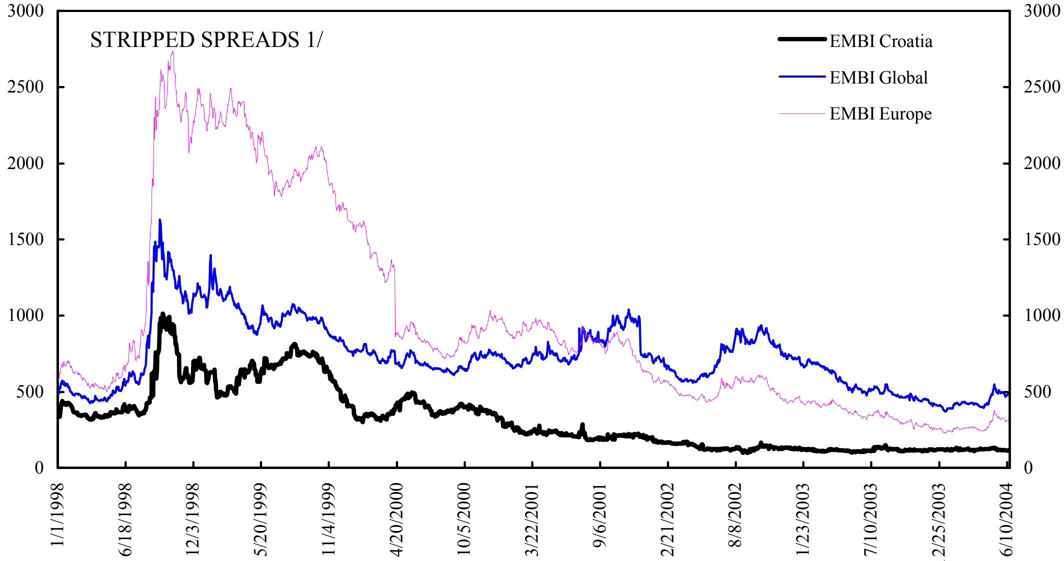


Source: CNB.

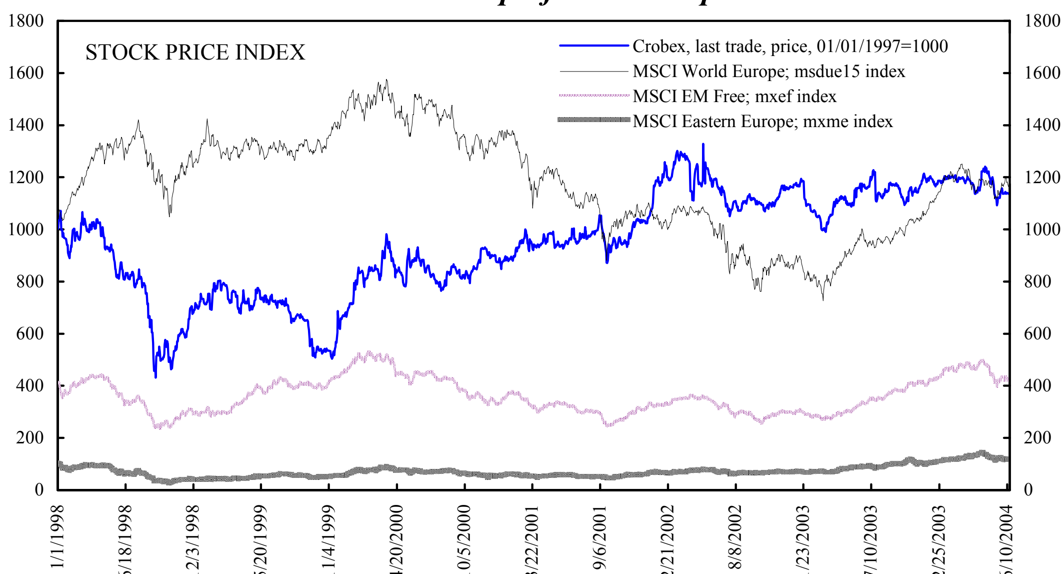
Figure 2. Croatia: Capital Market Conditions, 1998-2004

(In basis points)

Spreads have steadily declined...



...and the stock market has outperformed competitors.

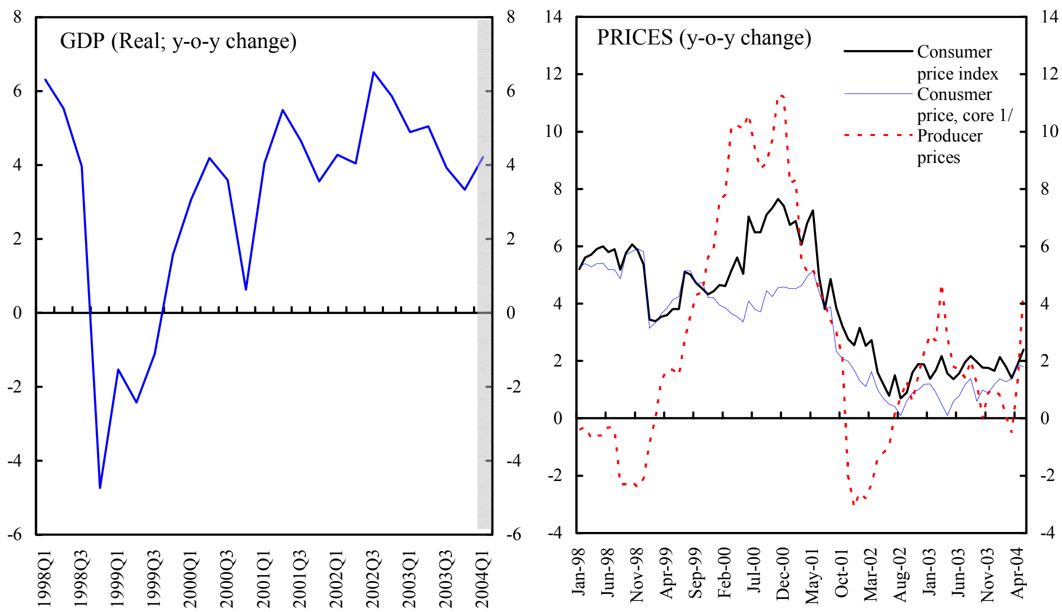


Sources: JP Morgan; and Bloomberg.

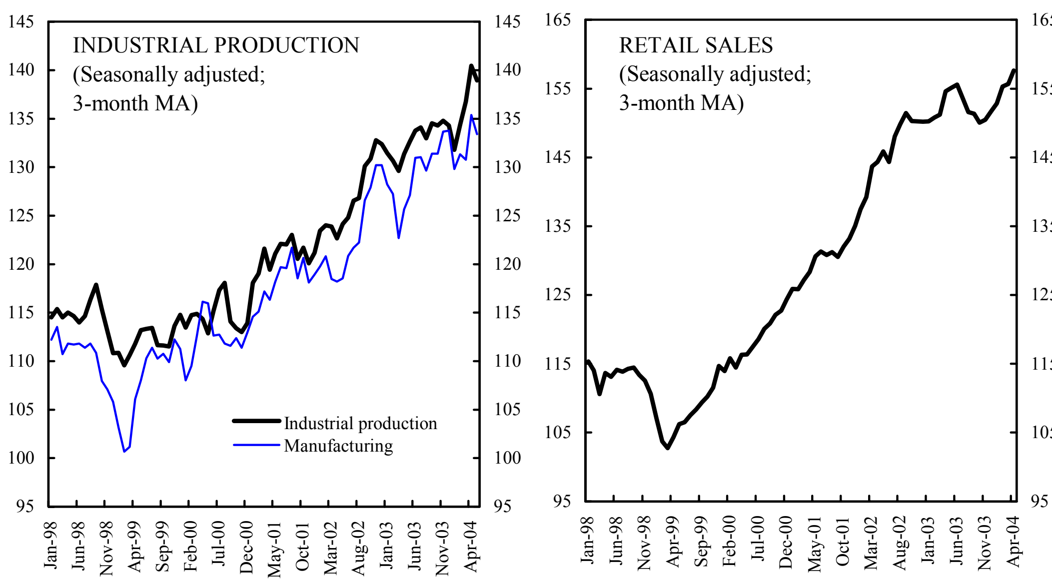
1/ Difference between the weighted average of each country's government bond yields, calculated after taking out the collaterized portion of bonds and the weighted average of US government bond yields with the same maturity.

Figure 3. Croatia: Real Economic Conditions, 1998-2004

Growth started moderating in the 2nd half of 2003...



...and high-frequency indicators corroborate a slowdown in consumption since late last year.



Source: Croatian Bureau of Statistics; and CNB.

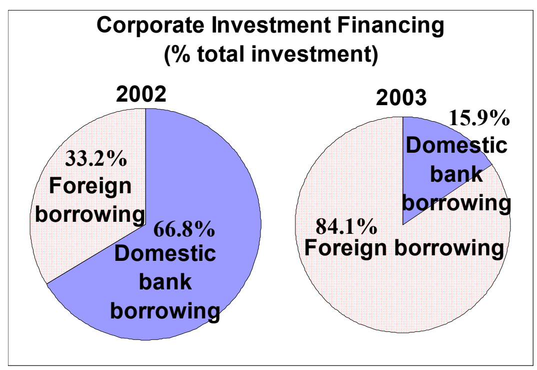
1/ Excludes energy and administered prices.

7. **However, there was a sharp reversal of fiscal policy as spending discipline evaporated in the runup to the November 2003 elections**.

- Worrying signs were already evident in the fall, when the annual spending plan of the Highway Construction Agency (HAC) was raised by 0.2 percent of GDP (partly offset by higher expected toll revenues). In the event, despite assurances to the contrary,[1] even the revised HAC spending plan was exceeded by 0.4 percent of GDP, other capital and current spending was also above budget, and the general government deficit as defined under the program for the year as a whole exceeded the target under the last SBA (4.5 percent of GDP) by almost one percentage point, derailing the program (Table 2).

- In addition, two large off-budget fiscal operations had taken place even before the last quarter. First, the state-owned and controlled Croatian Development Bank (HBOR) provided loans for housing reconstruction, whose servicing was the responsibility of the Ministry of Construction. And second, the chronically loss-making Croatian Railways (HŽ), which was already receiving sizeable budget transfers, was directed to borrow additional funds under government guarantee for financing both operating and capital expenses, with the liabilities subsequently taken over by the budget. Including these two operations in the general government accounts implies a fiscal deficit of 6.3 percent of GDP in 2003 (Table 3 and Figure 4).

8. **The CNB resorted to direct credit controls in 2003 in a largely unsuccessful attempt to control aggregate demand**. Faced with booming credit and a mounting external imbalance, the CNB introduced credit ceilings and additional liquidity requirements in early 2003 (described in IMF Country Report No. 03/252). Bank credit decelerated (Table 4), possibly affecting spending by households that do not have easy access to foreign borrowing. Corporates, however, were able to switch borrowing from domestic to foreign banks and use leasing and other forms of financing.

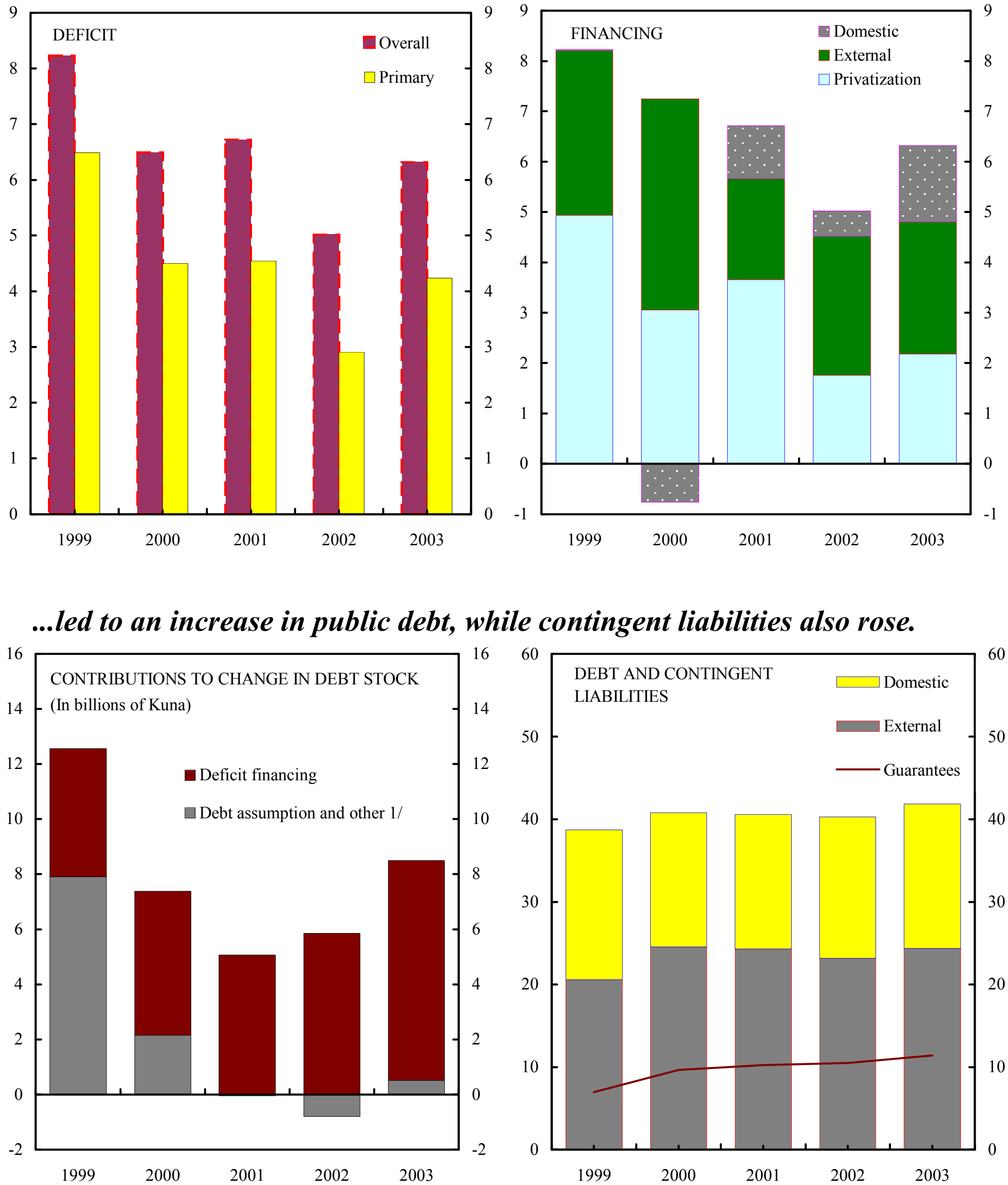


9. **Despite the fiscal relaxation, the current account improved in 2003 due to bumper tourism receipts, but external debt continued to rise**. Although import growth continued strong and the trade balance deteriorated, the current account deficit declined to

[1] The previous government had assured the Fund, including in a letter to Management on December 16, that higher HAC outlays would be offset by lower-than-budgeted central government spending, so that the end-year performance criterion on the general government deficit under the SBA would be observed.

Figure 4. Croatia: General Government Finances, 1999-2003
(In percent of GDP)

A higher deficit in 2003, largely financed through foreign borrowing...



Sources: Ministry of Finance; and Fund staff estimates.

1/ Other includes foreign exchange and other valuation effects.

6.1 percent of GDP last year as tourism receipts surged by over 6 percentage points of GDP (Table 5).[2] Negative errors & omissions were an additional 4.2 percent of GDP. Partly reflecting a buildup of official reserves to a record 5 months of imports, external debt jumped to 74½ percent of GDP at end-2003.

10. **Developments in early 2004 confirm the moderate pace of private activity**. Although the credit ceilings were abolished, credit growth has not bounced back, suggesting that the deceleration in 2003 was demand-driven: annualized seasonally-adjusted credit growth for the first five months of 2004 was 14½ percent, virtually the same as last year. Private foreign borrowing in the first quarter was also subdued. Preliminary Q1 national accounts show a slight strengthening in domestic demand but also a pickup in net exports. However, the seasonally-adjusted current account deficit in Q1 was still large and, partly due to seasonally high financing needs, external debt rose to 77 percent of GDP at end-May.

11. **The financial sector remains sound despite the rapid credit expansion since 2001**. Financial soundness indicators signal a further improvement in the health of the banking system since the previous FSAP (Table 6). Profitability has remained strong, asset quality continued to improve (allowing a decline in the ratio of provisions to nonperforming loans), and the banking system has generally been liquid. However, banks are still vulnerable to credit risk due to currency mismatch between assets and liabilities in some of their clients.

II. Report on the Article IV Consultation Discussions

12. **Discussions started from the recognition of macroeconomic vulnerabilities and focused on policies to reduce these in the short and the medium term**. Neither the fiscal slippage in 2003 nor recent developments in emerging bond markets have affected Croatia's spreads. The authorities pointed out that the EU's recent decision to extend candidate status to Croatia provided additional reassurance about long-term prospects, a perception confirmed by market participants and rating agencies (indeed S&P changed the outlook for Croatia's BBB- rating to positive). But all agreed that the extent of the external imbalance was a source of concern: Croatia's external debt-to-GDP ratio was more than twice the average of emerging markets and substantially higher than in the CEECs; in addition, the recent trends were unsustainable. Staff noted that net external debt (excluding official reserves and commercial bank foreign assets), which may be a better measure of external sustainability, had also risen—albeit at a more moderate pace than gross debt—reaching 36 percent of GDP at end-May. In these conditions, a sharp rise in interest rates or other external shocks (e.g., affecting tourism) might lead to financing difficulties and force an abrupt current account adjustment. The fiscal deficit in 2003 had also reached a level that was unsustainable: with a primary deficit of 4¼ percent of GDP, the government debt-

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[2] This increase may reflect to some extent a change in the survey methodology last year.

to-GDP ratio was bound to rise rapidly over time. To reverse these trends required both immediate macroeconomic policy action and sustained structural reform.

A. The Overall Economic Strategy

13. **The authorities' overarching macroeconomic goal was to narrow the domestic savings-investment gap so as to reverse the trend of the external debt-to-GDP ratio over the medium term**. On the assumption that non debt-creating capital flows would gradually decline over the medium term as privatization is completed, staff projections (Table 7) indicated that a current account deficit of 5–5½ percent of GDP in 2004–05, gradually declining to about 4 percent in the medium term, would first stabilize and then start reducing the external debt burden. The authorities broadly agreed, although they felt that non privatization-related FDI was likely to get a boost from the prospects of EU accession.

14. **Fiscal consolidation was the centerpiece of the authorities' strategy to achieve this goal**. With competitiveness at a broadly comfortable level (Box 1), reducing the domestic savings-investment gap required reining in aggregate demand. Authorities and staff agreed that fiscal policy was the instrument of choice for two reasons: *first*, especially after the slippage in 2003, the fiscal deficit was a major cause of the excess aggregate demand pressures and public debt was at an unsustainable path; and *second*, Croatia's choice of exchange rate stability as the guiding principle of monetary policy, aside from other implications, meant that the burden for managing aggregate demand fell on fiscal policy.

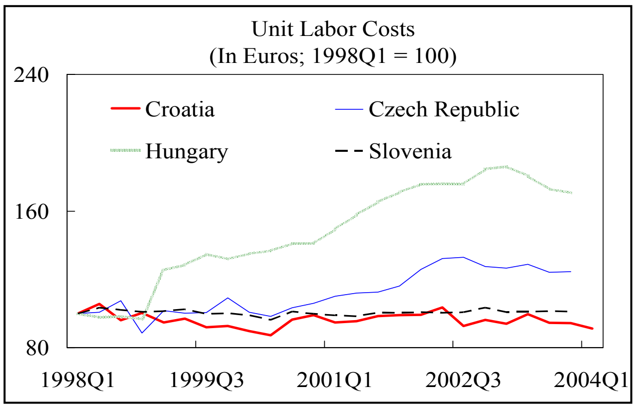
15. **The authorities also saw the need for fiscal consolidation in a broader context**. Restoring discipline and transparency in public finances after 2003 was important not only from a macroeconomic point of view but also for the accountability and credibility, domestically and abroad, of the state. For this reason, the consolidation effort would not only focus on reducing the government deficit but encompass quasi-fiscal operations, debt management, and the wider public sector. The government also saw consolidation in 2004-05 as the foundation for future measures to reduce the high tax burden in Croatia.

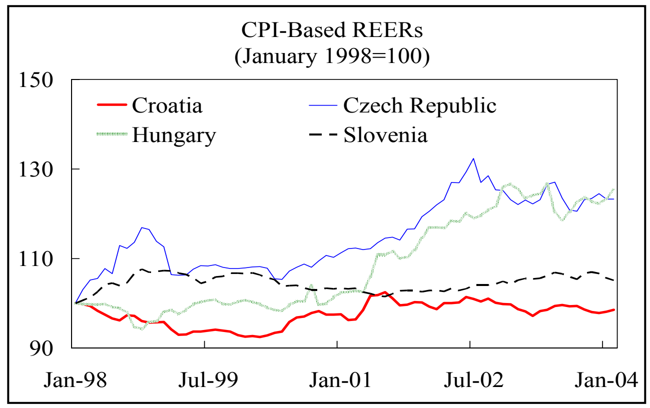
16. **An alternative strategy, relying on substantially greater exchange rate flexibility and monetary tightening, was discussed with the authorities, but its benefits were uncertain**. Although it would reduce some of the risks associated with exchange rate stability, its merits in terms of greater leeway for monetary policy were dubious (section D). In addition, focusing the action to contain aggregate demand on monetary tightening would likely result in a marked appreciation, with adverse implications on competitiveness and the external balance, and potentially destabilize expectations.

Box 1. Recent Competitiveness Trends

A study on Croatia's competitiveness during the last Article IV consultation concluded that Croatian export performance had been mixed: while goods exports lagged compared to other CEECs, exports of services, in particular transportation and tourism, had grown vigorously. The real effective exchange rate (REER) and unit labor cost (ULC) indicators did not suggest any problems. Authorities and staff agreed that these trends reflected Croatia's comparative advantage in tourism.

These trends have continued. In 2000–2003, the growth of merchandise exports was among the lowest in CEECs. However, growth of services exports (mainly tourism) was among the highest, and overall Croatia's share of exports of goods and services increased. The share of Croatian tourism sector has increased among European countries with major tourist destinations and a study by the World Trade and Tourism Council rated Croatia's tourism sector highly across a number of indicators. REER and ULC continue to suggest a comfortable position. For more details, see Appendix V.





17. **Over the medium term, economic and structural policies would also be driven by the exigencies of EU accession**. EU accession as early as possible was the authorities' ultimate objective. The authorities were aware that this had manifold implications for fiscal policy: the deficit had to converge to EU norms, state aid reduced, the public administration modernized, and room made for new accession-related expenditures. At the same time, harmonization with the *acquis communautaire* would require an acceleration of structural reforms over a broad front.

18. **The authorities have requested a new SBA in support of their policies for 2004–05**. In view of the imminent start of EU membership negotiations, the new government asked for Fund support of their policies for 2004–05 in the form of a new SBA, which they intend to treat as precautionary. Policies under the proposed SBA are detailed in the attached MEFP and program issues are discussed in section III.

B. Macroeconomic Outlook

19. **The private consumption slowdown and renewed fiscal adjustment would moderate growth and lead to an improvement in the external position in 2004–05**. The authorities and staff expected private consumption growth to decelerate in 2004 and start recovering moderately in 2005, partly underpinned by fiscal consolidation. Private investment growth was also expected to moderate somewhat but still make a positive contribution to GDP growth during these two years. Data on bank credit and import growth through May corroborate these projections. Exports were projected to rise in line with external demand. On this basis, real GDP growth would decline to 3¾ percent in 2004 and recover only modestly to about 4 percent in 2005 and the current account deficit remain in the 5–5½ percent of GDP range in both years. Assuming a modest increase in non privatization-related FDI and continued large negative errors & omissions,[3] staff expected the external debt-to-GDP ratio to remain at about 77 percent in 2004–05. Inflation was expected to accelerate reflecting higher oil prices but remain below 3 percent in 2004–05.

20. **This short-term outlook was subject to considerable uncertainties, underscoring the need for a more aggressive approach to demand management**. Staff cautioned that tourism receipts may not remain at the unprecedented level of 2003 and that the causes behind the slowdown in private sector activity were not fully understood, raising the possibility of a rapid resumption in private domestic and foreign borrowing later this year. The authorities were confident that recent tourism trends would be sustained, pointing out encouraging first quarter data and information on advance bookings for the summer, but agreed that major uncertainties surrounded the outlook for private consumption and investment. Indeed the CNB projected somewhat higher private capital inflows in 2004 resulting, all other things being equal, in an external debt ratio of about 79 percent of GDP by year-end. The staff argued that, if anything, these risks underscored the need for more conservative fiscal targets in 2004–05.

21. **The immediate need to reduce external vulnerability notwithstanding, staff's medium-term projections highlighted the importance of policies with a longer-term payoff**. The staff's baseline medium-term scenario indicated that, even if the external debt ratio was put on a declining path, Croatia would continue to rely on sizeable external savings. Foreign debt would still be over 70 percent of GDP by end-2009 and sensitivity analysis showed that it could be substantially higher (though not above 90 percent of GDP) in most plausible alternative scenarios (Appendix IV). The authorities agreed with the staff that structural reforms, in particular measures to supplement and sustain fiscal consolidation, were also a critically important part of their economic policies for 2004–05.

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[3] Although it is unusual to forecast errors & omissions, staff considers them unrecorded outflows that are unlikely to disappear in the short run.

C. Fiscal Policy

Fiscal policy in 2004–05

22. **The key objectives of the government's fiscal policy for 2004 were to resume fiscal consolidation and restore transparency**. The 2004 budget (MEFP ¶10–11), including a supplementary budget approved by parliament on July 15, aimed at a general government deficit of 4.5 percent of GDP. This was to be achieved through an increase in revenues and, to a lesser extent, a reduction in investment. The former reflected one-off revenues (dividend payments and larger-than-expected receipts from the concession of a GSM license totaling almost 1 percentage point of GDP) and a hike in excise rates on cars and tobacco as of July 15. The government was also taking a number of permanent measures which, however, would have an impact only starting next year, notably the re-establishment of the Financial Police; limits to borrowing by local governments; and measures to control health sector spending, where significant slippages had occurred in 2003 (MEFP ¶11). To improve transparency and contain quasi-fiscal deficits, the government intended to reflect all financing of HŽ and loans for housing reconstruction on-budget, as well as curtail all other HBOR activities. Indeed by end-July, HBOR's Supervisory Board would reduce its lending plan for 2004 by HRK 200 million, bringing its target deficit (net of budget transfers) to ½ percent of GDP.

23. **In 2005, the emphasis would shift to expenditure measures to reach a deficit of 3.7 percent of GDP** (MEFP ¶13). Current spending would be reduced by 1 percentage point of GDP reflecting a lower wage bill as a result of ongoing reductions in personnel (mainly in the defense sector) and cost savings in the administration of public services. The health sector measures of 2004 were also expected to generate gains and capital spending to be scaled back further in the context of the new four-year plans of the Highway and Road Agencies. On the revenue side, the full-year effect of the excise tax hikes this year, and the impact of the Financial Police on collections were expected to offset about half of the loss of this year's one-off measures. Finally, HBOR operations would be curtailed further.

Croatia: Fiscal and Quasi-Fiscal Operations 2003-2005
(In percent of GDP, GFS2001 basis)

	2003	2004 Prog.	2005 Prog.
General Government			
Revenues	46.4	47.4	46.5
o/w one-off	...	1.0	...
Expenditures	52.7	51.9	50.3
Current and net lending	46.8	46.5	45.5
o/w one-off	...	0.4	...
Investments	5.9	5.4	4.8
Balance	-6.3	-4.5	-3.7
Quasi-fiscal			
HBOR balance (net of budget transfers)	-0.7	-0.5	-0.5
Total fiscal and quasi-fiscal balance	-7.0	-5.0	-4.2

Sources: Ministry of Finance; and staff estimates.

24. **Staff welcomed the ambitious deficit targets for 2004–05 but questioned the composition of the planned adjustment**. The total fiscal and quasi-fiscal adjustment implied by the government's plans during 2004–05 amounted to 2¾ percentage points of GDP. This seemed to be consistent with the objective of reducing the domestic savings-

investment gap by just over 1 percent of GDP, even assuming some offsetting decline in private savings. Moreover, this adjustment would bring the primary deficit closer to a level that, even in the absence of privatization receipts, would stabilize the government debt ratio (indeed taking into account planned privatization receipts, the debt ratio would decline during 2004–05). Staff supported the planned scaling back of capital spending: due to the reconstruction of long-neglected infrastructure, government investment in recent years had exceeded by far that in comparator countries and, with major projects now nearing completion, there was significant room for savings. But staff noted that the adjustment in current spending—where Croatia also ranked high relative to comparator countries (Table 8)—during these two years was relatively unambitious. Moreover, the reliance in one-off measures in 2004 weakened the macroeconomic impact in 2004 and effectively shifted part of the adjustment to next year.

Capital Spending, 2000-2003
(In percent of GDP)

	2000	2001	2002	2003 1/
Croatia	**4.9**	**5.3**	**5.9**	**7.3**
Czech Republic	5.4	5.2	5.6	5.7
Slovenia	4.0	4.2	3.9	4.1
Bulgaria	4.2	4.0	3.2	3.5
Latvia	3.7	3.5	3.8	3.5
Lithuania	1.9	1.9	3.1	3.5
Romania	3.0	3.1	3.2	3.5
Slovak Republic	5.5	5.4	6.1	3.4
Estonia	3.0	3.0	3.6	3.1
Poland	2.7	2.6	2.7	2.8
Hungary	3.3	3.6	3.1	2.7

Sources: Authorities and staff estimates.
1/ Preliminary.

25. **The authorities explained that the underlying adjustment in current expenditure was larger than it appeared, and saw the one-off revenue measures in 2004 as a necessary expedient**. The 2004 budget was burdened by one-off obligations inherited from last year, notably hospital arrears and contracts for housing reconstruction amounting to 0.4 percent of GDP (MEFP ¶9). Moreover, measures that would generate permanent savings in current transfers (e.g., health spending) and improve the operations of loss-making public enterprises that burdened the budget (notably HŽ) were launched this year but would take time. These factors justified the recourse to one-off revenue measures in 2004, which the authorities saw as a transitional year. They nonetheless stressed their commitment to the deficit target, and outlined concrete contingency measures to be taken by November 1 should it come under threat (MEFP ¶12).

26. **Budget financing would gradually shift to domestic sources**. Both sides agreed that, despite higher borrowing costs, shifting to domestic financing would help reduce the government's exposure to exchange rate risk, boost the development of the domestic capital market, and might help absorb excess liquidity in the private sector in the short run. Therefore, staff welcomed the plan to meet at least one-third of the government's borrowing requirement from domestic sources this year and raise this proportion in 2005 (MEFP ¶15).

27. **In addition to reining on fiscal and quasi-fiscal deficits, the authorities intended to control contingent liabilities**. Staff and authorities agreed that debt guarantees allowed the recipient enterprises to lower their costs without, at the same time, allowing the government to exercise sufficient control on how these implicit subsidies were spent. The government thus planned to keep the nominal stock of outstanding guarantees from increasing during 2004–05 (MEFP ¶16).

Fiscal policy in the medium term

28. **Although the government was still formulating its medium-term fiscal plans at the time of the discussions, the broad themes were already clear**.

- **Deficit reduction** would remain the overarching objective. After the major adjustment in 2004–05, the general government deficit would be reduced by approximately ½ percentage point of GDP per year until it was below the Maastricht ceiling of 3 percent.

- **Lowering the tax burden** was a key element of the government's agenda. Initial plans to reduce the standard VAT rate from 22 to 20 percent in 2005 proved too costly, given the magnitude of the required adjustment, and were abandoned. The government was still planning to reduce some direct tax rates and broaden the tax base in 2005 (MEFP ¶14) in a revenue-neutral way, but intended to prepare a bolder tax reform in the medium term.

- The process of **harmonization with EU legislation** would necessitate significant adjustments in spending priorities.

29. **Staff supported these priorities, stressing, however, that fiscal policy should remain flexible and responsive to macroeconomic objectives**. The planned reduction in the general government deficit was appropriate: government debt would stabilize in 2004-05 partly due to the planned privatization receipts; continued effort was thus necessary to ensure sustainability. While welcoming the decision on VAT, staff supported the authorities' medium-term plans for tax reform: Croatia's tax burden was high compared to other CEECs (Table 8), sapping the private sector's growth potential and encouraging tax evasion. Tax reform should focus on lowering the tax burden on capital and labor and simplifying the system. But staff cautioned against too rigid an approach: as the main macroeconomic policy instrument, fiscal policy should remain oriented first and foremost to reducing external vulnerability and maintaining macroeconomic equilibrium.

30. **Against this background, the authorities and staff agreed that a medium-term expenditure framework was critical** to reconcile the objectives of deficit reduction, tax reform, and expenditure reallocation. Such a framework would illustrate tradeoffs and allow rational planning of tax and expenditure reforms so as to reduce the size of the government in a sustainable way. In the staff's view, expenditure reforms should focus on further rationalizing public administration and the health sector, streamlining the welfare system, and reducing direct and indirect subsidies. A medium-term fiscal framework would also be required once EU accession negotiations start. As a first step, the government intended to prepare rolling three-year budgets starting with the 2005 budget (MEFP ¶23) and requested the staff's assistance in this task.

D. Monetary Policy

31. **Croatia's choice of a stable exchange rate was dictated by the openness of the economy and advanced currency substitution**. In addition to the usual reasons justifying "fear of floating" (an import-to-GDP ratio of over 50 percent, high trade and capital market integration with the euro area, limited hedging opportunities for kuna holders), the authorities pointed out two related factors at play: memories of hyperinflation in the former Yugoslavia and advanced currency substitution (75 percent of bank loans and almost 90 percent of banks deposits were in foreign currency—largely euro—or foreign currency-linked instruments). Under these circumstances, the authorities saw stability in the kuna/euro rate as the predominant monetary policy objective, although they have eschewed a formal commitment to a certain level.

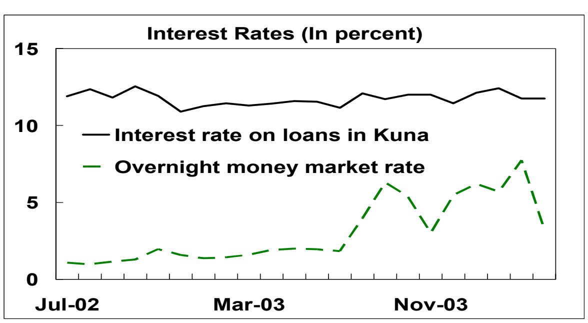
32. **Staff saw merits in the CNB's policy framework despite the risks**. *First*, it has performed well over time, ensuring low inflation and anchoring expectations while supporting policies have maintained competitiveness. *Second*, the CNB was operating this framework pragmatically, allowing short-term exchange rate fluctuations (±4½ percent around the average since 1999). *Third*, the liberalization of most short-term capital controls in 2001 meant that short-term capital flows would increasingly limit the impact of the CNB on money market rates: indeed there was some evidence that the sensitivity of short-term flows to interest rates had increased since 2001 (Selected Issues paper). And *fourth*, even if there were a link between monetary policy stance and money market rates, the transmission of money market rates to bank lending rates was at best weak (Box 2 and Selected Issues

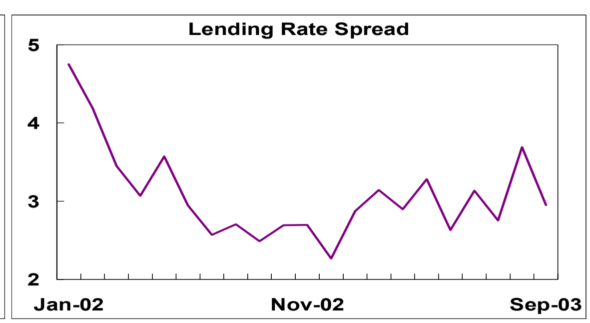
Box 2. The Evidence on Interest Rate Transmission

- Although money market interest rates increased during 2003 in response to several hikes in the kuna portion of required reserves (from 25 to 42 percent), the effective lending rate of domestic banks remained unaffected (left chart); so did the spread between this and foreign interest rates (right chart).

- This impression is confirmed by Granger tests that do not indicate a link between (lagged) policy rates and the effective lending rate. This may, of course, reflect the absence of effective policy instruments rather than fundamentals. In 2003, in particular, it may also be due to credit rationing in response to the ceilings.

- VAR models suggest that changes in policy rates do get transmitted to lending rates but with long lags (6–9 months, compared to the typical 1–3 months). However, most of the data used for the VAR cover the period before the liberalization of capital flows in 2001, when such transmission was to be expected.





paper). Altogether, this suggested that one cannot rely much on monetary policy for aggregate demand management. Still, staff pointed out that this policy framework encouraged unhedged borrowing, perpetuated currency mismatches, and placed the burden for demand management almost entirely on fiscal policy.

33. **Both sides nonetheless agreed that monetary policy could still help reduce external vulnerability**. In the context of its 2004 monetary program (MEFP ¶19), the CNB planned to modernize its toolkit and, in close cooperation with the Ministry of Finance, start open market operations (OMOs) with government paper. Although these were unlikely to be very effective in altering monetary conditions, they could enhance liquidity management and facilitate the shift in government financing toward domestic sources. To avoid an unwarranted liquidity injection that might spur credit expansion, the CNB aimed at maintaining its net domestic assets at their end-March level (except for purchases of government paper required to kickstart OMOs toward the end of the year). And to signal its commitment to the external objectives of its program, the CNB introduced on July 1 a marginal reserve requirement on foreign borrowing (MEFP ¶20).

34. **The CNB reiterated that capital controls remained a last-resort policy option**. In case unexpected capital inflows threatened macroeconomic stability, the CNB was prepared to introduce price-based capital controls. Staff felt that the circumstances under which the benefits of capital controls could outweigh the costs in an economy like Croatia were limited. The CNB concurred, seeing these measures as a last-resort stop-gap until other policies adjust or inflows abate.

E. Structural and Financial Sector Policies

Public sector reforms

35. **Enhancing fiscal transparency and improving expenditure and debt management were key elements of the government's agenda for 2004–05**. In addition to incorporating HŽ financing and housing reconstruction loans into the budget and limiting HBOR's quasi-fiscal activities and the issuance of contingent public liabilities, as described above, the government requested a fiscal ROSC and technical assistance on improving debt management. The two missions had delivered their preliminary recommendations and, at the time of the discussions, the authorities were formulating their action plans (MEFP ¶22). Key objectives were the introduction of commitments-based reporting and the establishment by end-2005 of a single treasury account, including the two largest spending agencies (for highway and road construction).

36. **Authorities and staff explored means to ensure financial discipline and continued restructuring in public enterprises**. Although their aggregate financial condition had been steadily improving in recent years, there were important pockets of weakness, as the case of HŽ demonstrated. The government had a case-by-case approach: it had discontinued the practice of hidden subsidies to HŽ and, in cooperation with the World Bank, was preparing a business plan for the company, which should be completed by year-end; and it had started restructuring efforts for Croatian Forests and the shipping company

Jadrolinija. Staff supported this approach, but felt that the aggregate borrowing of the largest public enterprises should also be closely monitored—a suggestion the government accepted (MEFP ¶17).

37. **The authorities reiterated their commitment to the sustainability of the pension system**. The government in March revised the indexation formula to link pensions to real wages (pensions were previously indexed to the average of prices and wages), and was studying ways to honor a 1998 Constitutional Court decision on "pensioners' debt".[4] Staff expressed concern: although the new indexation formula did not threaten sustainability (the share of pension spending to GDP was projected to decline), linking nominal pensions to real wages might increase the volatility of pensioners' benefits; and the size of "pensioners' debt" was unclear and, depending on the means used to repay it, could prove costly. The government explained that these steps had been taken under the terms of an agreement with the Pensioners' Party, on whose parliamentary support it relied, and reiterated its commitment to safeguarding the core of the 1998 pension reform and ensuring the viability of the system—a commitment repeated to the staff by the Pensioners' Party. The government stood ready to make any adjustments to the system that may be necessary in this regard. Furthermore, it emphasized that payments against "pensioners' debt" would not be in cash or bonds but take the form of state equity, and agreed to consult with the Fund and the World Bank before finalizing the scheme (MEFP ¶24).

Financial sector issues

38. **Against reassuring indicators of banking sector soundness, discussions focused on measures to close gaps in supervision and improve monitoring of foreign exchange risk**. Banking supervision had been improved in recent years in line with key FSAP recommendations, but some gaps remained. Staff noted the recent rapid expansion of unregulated and unsupervised leasing companies (whose assets had reached 6 percent of bank assets at end-2003), as well as the significant risk transfer from banks to insurance companies (which was now roughly equal to the latter's capital plus provisions). To cover these gaps, the authorities planned to unify supervision of nonbank financial institutions (MEFP ¶26). Staff noted that, while such unification would be useful, efforts to cover some of these gaps should not wait for the merger of supervisory agencies. Staff also recommended improved supervisory cooperation between bank and nonbank supervision and between domestic and foreign supervisory agencies. Finally, although the banking system was covered against direct foreign exchange risk, it was exposed indirectly through unhedged customers, in particular households and retail business, who accounted for about 60 percent of bank loans. Therefore, the CNB and staff agreed that the closer monitoring of customers' foreign exchange risk during on-site bank inspections was appropriate.

[4] The decision had validated claims of discriminatory treatment by pensioners in earlier periods.

39. **Staff has prepared factual updates of three financial sector ROSCs**. These report on progress in banking supervision, the payments system, and securities regulation since the 2002 FSAP and are circulated separately.

Other structural issues

40. **The government intended to restore momentum in privatization** notably through the sale by mid-2005 of all remaining government holdings in the portfolio of the Privatization Fund, which would then be closed; the second phase of privatization of the oil company (INA); further sales of shares in the telecommunications company, which was already majority private; and plans to start privatizing the insurance company (MEFP ¶25).

41. **A World Bank Programmatic Adjustment Loan (PAL) under preparation would provide a framework for other microeconomic reforms**. The PAL, expected to be finalized by early next year, would focus *inter alia* on judicial and public administration reforms (Appendix II). Staff also recommended measures to improve the business environment and—following the amendments to the labor law earlier this year—to relax further employment protection legislation.

42. **Croatia's trade policy was guided by its obligations to the WTO and the need for harmonization with EU rules**. As of May 2004, Croatia had signed trade liberalization agreements with more than thirty countries. A major step toward regional trade integration was accomplished when the agreement with Serbia and Montenegro became operational. Tariffs were progressively lowered (industrial MFN tariffs would average less than 4 percent by end-2005, although some individual tariffs were much higher), and the authorities were planning to start discussions on a new agreement on trade in textiles with the EU once the current one expires in January 2005.

43. **The quality of statistical data remained mixed**. Despite recent progress, significant weaknesses persisted. In particular, the large discrepancy between the demand components and total GDP and the sizeable negative errors & omissions in the balance of payments hampered the analysis of domestic and external savings. The authorities were considering technical assistance from the Fund to improve balance of payments statistics.

III. Design of the Proposed Arrangement

44. **The experience with the last SBA was mixed**. Policies were broadly in line with the program most of last year and two reviews were completed (in August and November). There was also progress in a number of structural areas, notably bank supervision and privatization. But lack of ownership by the previous government meant that the program did not provide an effective anchor for macroeconomic policies in the runup to the elections: tensions with the CNB increased as the burden fell on monetary policy, most end-December performance criteria were not met—some by wide margins—and the third review was not completed. The program also did not do enough to control quasi-fiscal deficits. The improvement in the current account was largely the result of a positive external shock and was not sufficient to avert a further increase in foreign indebtedness.

45. **These lessons have been reflected in the proposed program**. The authorities saw the new SBA as a useful framework for their macroeconomic policies for 2004–05, when negotiations with the EU are supposed to start. The experience with fiscal policy in 2003 was reflected in several key features of their policy program for 2004–05 (the emphasis on budgetary transparency, steps to curtail lending by HBOR, measures to introduce a single treasury account and improve debt management, and the move toward a medium-term fiscal framework), as well as in the design of the proposed SBA (in addition to the general government deficit, performance criteria are proposed on the net lending of HBOR and issuance of government debt guarantees, an indicative ceiling on net borrowing by public enterprises, a structural performance criterion on the introduction of 3-year rolling budgets starting in 2005, and structural benchmarks focusing on public finance reforms).[5] Staff believed that ownership of this program by the government would be strong, especially given the phase of the electoral cycle.

46. **Access under the proposed SBA is low and the authorities intend to treat it as precautionary**. The proposed 20-month SBA would end in April 2006. The requested amount under the arrangement, equivalent to SDR 97 million (26.6 percent of quota), would be made available in seven purchases (Table 9).[6] A somewhat lower level of access compared to the last SBA was seen as a symbolic step toward graduating from UFR. A new safeguards assessment of the CNB is under way.

47. **Should purchases nonetheless be made, staff is confident that Croatia can meet its financial obligations to the Fund**. Under the proposed purchase schedule, Fund credit outstanding would peak at 1.8 percent of gross official reserves in 2005, while debt service to the Fund would not exceed 1 percent of exports of goods & nonfactor services during the repayment period (Tables 10–12).

48. **The program is subject to both macroeconomic and policy-related risks**. An abrupt deterioration in external conditions—such as a sharp downturn in tourism or sudden shifts in private capital inflows—or an acceleration of bank credit would require reassessing the program targets. However, the quality of statistical data and uncertainties underlying recent trends weaken the ability of both authorities and staff to monitor and respond effectively to rapid changes in the macroeconomic environment. HDZ's minority government appears to be strong and its popularity was boosted by the positive EU decision. Its commitment to fiscal discipline has been underscored by its willingness to take politically difficult measures (most notably stopping hidden subsidies and postponing the VAT rate cut) but may still be tested by domestic political pressures. Weak control over decentralized spending agencies until the single treasury account is fully operational also

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[5] Details of program design are presented in MEFP Table 2.

[6] In keeping with normal practice, Croatia would be allowed to withdraw its first credit tranche upon approval.

creates risks. Despite the measures under the program, state-owned enterprises still represent a potential threat to fiscal discipline.

IV. Staff Appraisal

49. **Despite the disruptions in the first half of the 1990s, Croatia's economic and policy record is good**. Economic growth has been strong, with inflation in the low single digits. Structural reform has advanced, though still lagging CEECs. Strong FDI, increasing tourist arrivals, easy access to capital at low spreads and, not least, the recent decision by the European Council to declare it a candidate country attest to the international confidence and popularity Croatia enjoys.

50. **But this good performance was accompanied by a gradual worsening of Croatia's external position, which accelerated since the turn of the decade**. The growing gap between domestic savings and investment, spurred further by a credit boom and sizeable capital inflows since 2001, has pushed the current account deficit and external debt to high levels. Although private sector activity has recently moderated and the current account balance improved, external debt rose further. As a result, Croatia has become more vulnerable to external shocks.

51. **The authorities have recognized the extent of the external imbalance and adopted a strategy that relies on fiscal consolidation to redress it**. Despite its risks, the choice of exchange rate stability has worked well for Croatia and continues to be appropriate, as long as supporting policies are in place. The level of exchange rate is broadly appropriate from the view point of competitiveness. The renewed emphasis on fiscal consolidation is thus welcome, as monetary policy can only play a supporting role. But however ambitious they may appear today, fiscal and monetary targets can only be judged in reference to the goal of macroeconomic stability. If future external developments jeopardize this goal, policies should be adjusted accordingly.

52. **The fiscal targets for 2004–05 are ambitious but the composition of the planned adjustment is not optimal**. A total fiscal and quasi-fiscal adjustment of 2¾ percentage points of GDP is substantial although, helped by the projected cooling of private sector activity, just the minimum required to stabilize the external debt-to-GDP ratio at about its current level by end-2005. Significant uncertainties remain regarding private capital inflows, underscoring the need to keep policies—especially fiscal policy—flexible. But not enough is done to reduce the share of current spending, especially entitlements, where Croatia compares unfavorably with countries at a similar level of development. Greater effort in this area would have allowed a more ambitious deficit reduction and/or a larger reduction in the tax burden during 2004–05. Moreover, relying partly on one-off revenue measures in 2004, though understandable given the inherited burden from 2003 and the magnitude of the planned adjustment this year, shifts part of the adjustment effort to the future.

53. **Expenditure reform will be the main challenge in the medium term**. The government is to be commended for postponing the reduction of VAT rates planned

for 2005; this has brought the ambitious targets for 2004–05 within reach. But even if this adjustment succeeds in stabilizing public debt and reducing external vulnerability, the task of expenditure reform will still need to be tackled. The government's goals of reducing the tax burden and the size of the government, as well as reallocating spending priorities in order to meet EU-related needs, cannot be achieved without far-reaching reforms of government spending. These should focus on the wage bill, welfare system, and subsidies. The government's commitment to start preparing three-year rolling budgets in 2005 is an important first step.

54. **Measures to enhance transparency, control quasi-fiscal activities, and improve expenditure and debt management are crucial parts of the government's program**. Against the experience in 2003, the measures to include all financing of HŽ into the budget, introduce gradually a single treasury account, control the issuance of government debt guarantees, and monitor the financial performance of public enterprises are critical for the success of the government's program.

55. **Monetary policy has a secondary but nonetheless important role to play in the effort to reduce the external imbalance**. The CNB alone cannot manage aggregate demand effectively. But managing bank liquidity will still be important in Croatia's bank-dominated financial sector. The CNB should continue to allow short-term exchange rate fluctuations as in the past and stand ready to take additional measures to safeguard its international reserves target, if needed. The plans to introduce open market operations and the commitment to cooperate closely with the Ministry of Finance are welcome.

56. **Structural reform efforts should be revitalized**. The authorities recognize the need for structural reforms but implementation has been patchy in the past. Completing the sale of Privatization Fund holdings by mid-2005 and privatizing or continuing the privatization of utilities and the insurance company will require sustained effort. Restructuring of public enterprises, most urgently HŽ, should also be given high priority. The labor market needs to become more flexible to improve its stagnant performance. These reforms will also help maintain competitiveness in the context of a stable exchange rate.

57. **The financial sector is in good health and supervision has been improved, but gaps remain**. The CNB's increased focus on the foreign exchange exposure of banks' customers during on-site visits is welcome. The authorities should also close gaps in nonbank financial supervision, improve cooperation between bank and nonbank and domestic and foreign supervisors, considering the significant risk transfers from banks to other financial institutions and the high degree of financial integration with the rest of the world.

58. **The authorities need to improve economic statistics further.** Despite the progress made, important deficiencies remain in national accounts and balance of payments statistics. These make monitoring and implementation of the government's program more difficult and need to be addressed urgently.

59. **Staff supports the authorities' request for the new precautionary SBA**. The authorities have shown political commitment to their ambitious deficit targets for 2004–05. The proposed program will control the quasi-fiscal operations and help improve expenditure and debt management. Under these conditions, although both macroeconomic uncertainties and implementation risks remain, the proposed program will help Croatia at the beginning of its EU membership negotiations, underpin market confidence, and reduce the risk of a crisis.

60. **It is proposed that Croatia remain on a 24-month consultation cycle as long as the new SBA remains on track**.

Table 1. Croatia: Key Macroeconomic Indicators, 2001-05

	2001	2002	2003 Est.	2004 Prog.	2005 Prog.
	(Percentage change)				
Output, unemployment, and prices					
Real GDP	4.4	5.2	4.3	3.7	4.1
Unemployment (survey-based, in percent)	15.8	14.8	14.3	...	...
CPI inflation (average)	4.9	2.2	1.8	2.5	2.9
	(In percent of GDP)				
Savings and investment 1/					
Domestic investment	...	34.4	32.8	33.3	32.9
o/w Fixed capital formation	...	24.6	27.5	28.2	28.6
Domestic Savings	...	26.0	26.7	27.7	27.9
Government	...	1.4	1.5	3.1	3.2
Non-government	...	24.6	25.2	24.5	24.7
General government and HBOR operations 2/					
General government revenues	44.0	46.3	46.4	47.4	46.5
General government expenses and net lending	50.7	51.4	52.7	51.9	50.3
Overall general government balance	-6.7	-5.0	-6.3	-4.5	-3.7
Overall HBOR balance (net of budget transfers)	-0.4	-0.2	-0.7	-0.5	-0.5
Fiscal and quasi-fiscal balance	-7.1	-5.2	-7.0	-5.0	-4.2
General government debt	40.1	39.8	41.5	41.7	40.6
	(End of period; change in percent)				
Money and credit					
Credit to the nongovernment sector	24.5	31.3	14.7	14.3	...
Broad money	45.2	9.5	11.0	9.4	...
Base money	36.0	26.4	23.8	17.9	...
	(End of period; in percent)				
Interest rates					
Average deposit rate	2.8	1.6	1.7	1.7 5/	...
Average credit rate	9.5	10.9	12.0	11.8 5/	...
	(In millions of euros)				
Balance of payments					
Current account balance 3/	-810	-2,031	-1,566	-1,531	-1,459
(In percent of GDP)	-3.7	-8.4	-6.1	-5.6	-5.0
Capital and financial account	2,957	3,733	3,866	2,337	2,777
Overall balance	1,500	874	1,231	-319	175
	(End of period; in millions of euros)				
Debt and reserves					
Gross official reserves	5,338	5,854	6,554	6,198	6,374
In months of following year's imports of goods and NFS	4.6	4.6	4.9	4.4	4.4
External debt service to exports ratio (in percent)	24.9	22.2	19.6	23.1	23.5
Total external debt (in percent of GDP)	57.1	61.4	74.5	76.8	76.8
Net external debt 4/	21.6	25.6	31.6	36.0	36.9

Sources: Croatian National Bank, and Fund staff estimates.

1/ Domestic savings and investment statistics and staff projections are hampered by the large errors term in the national accounts estimates, particularly before 2002.

2/ Prior to 2002 on GFS 1986 basis and from 2002 on GFS 2001 basis, with net lending and government-guaranteed loans to the railway company included in expenses and all privatization in financing.

3/ Break in the series in 2002 due to a change in methodology of estimating the costs of insurance and freight, which led to an upward revision of the current account deficit by 1.3 percent of GDP.

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

5/ As of April 2004.

Table 2. Croatia: Performance Under the Stand-By Arrangement During 2003

				End of			
				March	June	September	December
				(In millions of kuna, unless indicated otherwise)			
Quantitative performance criteria							
1-a	Cumulative Deficit of the Consolidated Central Government 1/		Program	4,053	6,398 2/	4,889 3/	9,274
			Actual	3,104	6,024	7,214	10,213
			Margin (+)	949	374	-2,325	-939
1-b	Cumulative Deficit of the Consolidated General Government 1/		Program	4,325 2/	6,615	4,620 2/ 3/	8,692
			Actual	2,911	5,801	6,818	10,481
			Margin (+)	1,414	814	-2,198	-1,789
2	Reduction of Arrears of the Consolidated Central Government 4/		Program	150	300	450	550
			Actual	119	303	415	35
			Margin (+)	-31	3	-35	-515
3	Cumulative Increases in Nonconcessional External Debt Contracted by the General Government, CNB, and HBOR 1/5/		Program	704	970	652	968
		>1 year	Actual	513	757	193	782
			Margin (+)	191	213	459	186
			Program	100	100	100	100
		<5 years	Actual	0	25	0	200
			Margin (+)	100	75	100	-100
4	Cumulative Increases in Short-term External Debt by the General Government, CNB, and HBOR 1/ 5/		Program	120	0	0	0
			Actual	0	0	0	0
			Margin (+)	120	0	0	0
5	Cumulative Changes in the Net Usable International Reserves of the Croatian National Bank 4/ 5/		Program	-120	-184	46	398 6/
			Actual	53	111	0	224
			Margin (+)	173	295	-46	-174
6	Cumulative Changes in the Net Domestic Assets of the Croatian National Bank 1/		Program	331	2,167	4,885	4,999 7/
			Actual	-569	1,264	4,931	5,410
			Margin (+)	900	903	-46	-411
Indicative limits							
1	Consolidated Central Government Wage Bill 1/		Program	4,603	9,075	13,600	18,005
			Actual	4,660	9,463	14,230	19,300
			Margin (+)	-57	-388	-630	-1,295
2	Cumulative Changes in Net Credit of the Banking System to the Consolidated General Governments 1/		Program	-170	-4	-745	455
			Actual	-1,733	-1,131	28	-747
			Margin (+)	1,563	1,127	-773	1,202
3	Cumulative Increases in Net Credit of the Banking System to Selected Public Enterprises 1/		Program	463	278	-550	-415
			Actual	-337	-772	417	1,789
			Margin (+)	800	1,050	-967	-2,204
Structural performance criterion							
1	Government to prepare criteria for issuing guarantees by end-March 2003.		Not observed. Done on July 15, 2003.				
Structural benchmarks							
1	Parliament to approve by end-March 2003 a new budget law satisfying the conditions specified in paragraph 16 of the MEFP.		Not observed. The new budget law was approved on May 29, 2003.				
2	CNB to issue by end-June 2003 and implement by end-September 2003 a regulation to include options in the calculation of banks' net foreign exchange position.		The regulation took effect on Aril 1, 2003.				
3	Government to make a decision by end-March 2003 on the bids received for the privatization of INA		Not observed. The final decision was made in July 2003.				
4	Government to prepare by end-March 2003 a privatization program for HPB that satisfies the conditions specified in paragraph 23 of the MEFP (to be monitored in consultation with the IFC).		Not observed. The government formally invited the IFC to subscribe to 19 percent of HPB's capital with appropriate veto powers on June 10, 2003.				
5	Report data on government guarantees outstanding on September 30, 2003.		The data were received on October 14, 2003.				
7	Report data on government guarantees outstanding on December 31, 2003.		The data were received on February 26, 2004.				
8	IFC Board approval to subscribe to 19 percent of HPB's capital by December 31, 2003.		Not observed. IFC decided in favor of acquisition loan instead.				

Source: Data provided by the Croatian authorities.

1/ Ceiling.
2/ Indicative limits (not a performance criterion).
3/ Reduced for end-September by shortfall of privatization receipts caused by delay in receipts of INA privatization proceeds (Attachment I, Annex III, of IMF Country Report No. 03/27 and Attachment I, Annex III, of IMF Country Report No 03/252) by Hrk 2.4 billion and Hrk 2.3 billion for central and general government, respectively.
4/ Floor.
5/ In millions of U.S. dollars.
6/ Adjusted for the shortfall of the INA privatization receipts and funds disbursed by the U.S. Treasury after lifting the freeze on the assets of the National Bank of the former Socialist Federal Republic of Yugoslavia (Table 4, Attachment I of IMF Country Report No 03/252).
7/ Adjusted for the shortfall of the INA privatization receipts (Table 4, Attachment I of IMF Country Report No 03/252).

Table 3. Croatia: Consolidated General Government Finances, 2002-05 1/
(In percent of GDP)

	2002	2003 Prelim.	2004 Prog.	2005 Prog.
REVENUE	46.3	46.4	47.4	46.5
Taxes	28.2	27.9	27.7	28.1
Taxes on income, profits, and capital gains	6.1	6.0	5.7	5.7
Payable by individuals	4.0	3.7	3.5	3.5
Payable by corporations and other enterprises	2.1	2.2	2.2	2.2
Taxes on property	0.3	0.3	0.3	0.3
Taxes on goods and services	20.4	20.5	20.6	21.1
o/w VAT	14.5	14.6	14.7	14.9
Excises	5.5	5.4	5.4	5.8
Taxes on international trade and transactions	1.1	0.9	0.8	0.7
Other taxes	0.3	0.2	0.3	0.3
Social security contributions	14.0	14.2	14.5	14.5
Other revenue and grants	4.0	4.2	5.2	4.0
EXPENSE	46.4	46.5	46.0	45.0
Compensation of employees	12.4	12.7	12.4	11.8
Use of goods and services	5.5	4.9	4.8	4.7
Interest	2.1	2.1	2.2	2.2
Subsidies	2.8	3.3	2.9	3.1
Grants	0.1	0.0	0.3	0.3
Social benefits	20.1	19.8	19.9	19.5
Other expense	3.4	3.7	3.6	3.5
Acquisition of non-financial assets (investment)	4.4	5.9	5.4	4.8
Net lending	0.6	0.3	0.5	0.4
OVERALL BALANCE	-5.0	-6.3	-4.5	-3.7
FINANCING	5.0	6.3	4.5	3.7
Privatization revenues	1.8	2.2	1.2	2.0
External financing	2.8	2.6	1.7	0.8
Disbursements	5.2	3.9	3.9	3.6
Amortization	-2.5	-1.3	-2.2	-2.8
Domestic financing	0.5	1.5	1.5	0.9
Memorandum items:				
Primary budget balance	-2.9	-4.2	-2.3	-1.5
General government debt	39.8	41.5	41.7	40.6
General government guarantees and arrears	10.9	11.7	11.3	10.9

Source: Ministry of Finance and staff estimates.

1/ On a GFS 2001 basis. There may be differences from historical data, which were on a GFS 1986 basis.

Table 4. Croatia. Monetary Accounts, 2001-04
(End-period; in millions of kuna unless otherwise stated)

	2001	2002	2003	2004 prog.	2001	2002	2003	2004 prog.
Monetary Survey					(Change in percent)			
Net Foreign Assets	48,661	32,817	32,771	28,457	67.7	-32.6	-0.1	-13.2
Net Domestic Assets	57,410	83,324	96,122	112,549	30.3	45.1	15.4	17.1
of which: domestic credit	86,257	110,089	123,781	139,475	20.9	27.6	12.4	12.7
to government, net	15,146	16,740	16,735	17,094	6.3	10.5	0.0	2.1
to other domestic sectors	71,111	93,349	107,046	122,381	24.6	31.3	14.7	14.3
Broad Money	106,071	116,142	128,893	141,005	45.2	9.5	11.0	9.4
Narrow Money	23,704	30,870	33,889	36,621	31.5	30.2	9.8	8.1
Currency outside banks	8,507	9,681	10,573	11,383	28.2	13.8	9.2	7.7
Demand deposits	15,196	21,189	23,316	25,239	33.4	39.4	10.0	8.2
Quasi Money	82,368	85,272	95,004	104,384	49.7	3.5	11.4	9.9
denominated in kuna	10,531	13,217	18,969	24,581	29.5	25.5	43.5	29.6
denominated in foreign currency	71,837	72,055	76,035	79,803	53.2	0.3	5.5	5.0
Balance Sheet of the National Bank								
Net International Reserves	37,711	41,863	47,321	47,157	39.1	11.0	13.0	-0.3
o/w Banks' foreign currency reserves	5,705	7,042	6,687	10,791	3.9	23.4	-5.0	61.4
CNB bills in foreign currency	2,913	1,226	4,920	0	60.7	-57.9	301.2	-100.0
Net Domestic Assets	-13,878	-11,744	-10,035	-3,190	-44.7	15.4	14.6	68.2
o/w claims on government (net)	-1,752	-768	-1,550	1,242	-51.4	56.2	101.9	-180.2
claims on banks	18	18	972	24	-94.4	-3.4	5339.4	-97.6
claims on other domestic sectors	229	111	94	90	-20.8	-51.8	-15.4	-3.9
other items (net)	-6,001	-4,892	-4,631	-4,546	-23.8	18.5	5.3	1.8
Base Money	23,834	30,119	37,285	43,967	36.0	26.4	23.8	17.9
Currency	8,507	9,681	10,573	11,383	28.2	13.8	9.2	7.7
Deposits	15,326	20,438	26,712	32,584	40.8	33.4	30.7	22.0
o/w statutory reserve in kuna	6,291	8,186	12,604	15,146	54.2	30.1	54.0	20.2
o/w statutory reserve in f/c	5,705	7,042	6,687	10,791	3.9	23.4	-5.0	61.4
Reserve Money (CNB definition)	17,803	23,028	30,586	33,164	51.9	29.3	32.8	8.4
Memorandum items:								
Narrow money multiplier	0.99	1.02	0.91	0.83				
Broad money multiplier	4.45	3.86	3.46	3.21				
Broad money to GDP ratio	0.64	0.65	0.67	0.69				
Foreign currency as a perc. of broad money	67.7	62.0	59.0	56.6				

Sources: Croatian National Bank; and Fund staff projections.

Table 5. Croatia: Balance of Payments, 2001–05
(In millions of euros, unless otherwise indicated)

	2001	2002 1/	2003 Est.	2004 Proj.	2005 Proj.
Current account	-810	-2,031	-1,566	-1,531	-1,459
Merchandise trade balance	-4,579	-5,974	-7,006	-7,196	-7,466
Exports f.o.b.	5,313	5,292	5,559	6,060	6,426
Ships	316	373	397	443	307
Non-Ship exports	4,997	4,919	5,161	5,617	6,119
Imports f.o.b.	-9,892	-11,265	-12,564	-13,255	-13,892
Services and income	2,691	2,805	4,206	4,356	4,603
Transportation	186	173	252	265	287
Travel	3,046	3,205	5,045	5,119	5,479
Other services	36	-41	-307	-268	-228
Compensation of employees	139	164	179	191	208
Interest and investment income	-717	-695	-962	-952	-1,143
Current transfers	1,078	1,138	1,233	1,309	1,404
Credit	1,311	1,436	1,528	1,588	1,690
Debit	-233	-299	-295	-279	-286
Capital and Financial account	2,957	3,733	3,866	2,337	2,777
Capital account 2/	148	25	74	80	80
Financial account	2,808	3,707	3,792	2,257	2,697
Direct investment 2/ 3/	1,568	1,069	1,369	936	1,425
of which: privatization receipts	817	339	500	0	100
Portfolio investment	671	-243	893	-87	-127
Medium- and long-term loans	341	696	2,239	1,113	369
Assets	46	-53	-26	1	0
Liabilities	295	749	2,265	1,112	369
Disbursements	1,971	2,395	4,100	3,143	2,378
Amortization	-1,676	-1,646	-1,835	-2,030	-2,009
Currency and deposits	524	1,761	-847	322	848
Short term capital flows (net)	-440	21	513	-126	3
Trade Credits	144	404	-375	100	180
Net errors and omissions 4/	-646	-828	-1,069	-1,126	-1,144
Overall balance	1,500	874	1,231	-319	175
Financing	-1,500	-874	-1,231	319	-175
Gross reserves (-= increase)	-1,466	-737	-1,231	319	-175
IMF (net purchases)	-34	-137	0	0	0
Memorandum Items					
Current account (in percent of GDP)	-3.7	-8.4	-6.1	-5.6	-5.0
Gross official reserves	5,338	5,854	6,554	6,198	6,374
in months of following year's imports of goods and NFS	4.6	4.6	4.9	4.4	4.4
Net international reserves	5,146	5,827	6,188	6,196	6,374
in months of following year's imports of goods and NFS	4.5	4.6	4.6	4.4	4.4
Outstanding debt	12,841	15,338	18,805	20,769	22,244
External debt to GDP ratio	57.1	61.4	74.5	76.8	76.8
External debt as a percentage of exports goods and NFS	119.4	137.2	142.7	148.8	149.8
Short-term debt by residual maturiry in percent of gross official reserve	35.3	36.8	44.9	50.8	61.1
External debt service	-2,677	-2,481	-2,583	-3,226	-3,488
GDP (millions of Euros)	22,177	24,220	25,482	27,131	28,950
GDP (millions of Kuna)	165,639	179,390	193,067	205,747	220,635

1/ Break in the series in 2002 due to a change in methodology of estimating the costs of insurance and freight, which led to an upward revision of the current account deficit by 1.3 percent of GDP

2/ In 2003, it 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).

3/ In 2002, it excludes a debit entry of US$419.4 million in the item "direct investment abroad" and an offsetting credit entry in the item "capital transfers" related to the revaluation and transfer of a patent by a Croatian company in exchange for the capital in a foreign subsidiary (see IMF Country Report No. 03/358, Appendix IV).

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

Table 6. Croatia: Indicators of External and Financial Vulnerability, 2001-04
(In percent, unless otherwise indicated)

	2001	2002	2003	2004 Latest Figure	2004 Date
External indicators					
Real effective exchange rate (using retail prices) 1/, 1995=100	103.8	103.3	101.3	103.8	Mar-04
Export of goods and services (percentage change in euros, yoy) 2/	14.7	3.9	17.9	...	Dec-03
Import of goods and services (percentage change in euros, yoy) 2/	16.1	14.5	10.0	...	Dec-03
Current account deficit (cumulative, millions of euros)	-810	-2,031	-1,566	...	Dec-03
Current account deficit (yoy) in percent of GDP	-3.7	-8.4	-6.1	...	Dec-03
Capital and financial account (yoy) in percent of GDP	13.3	15.4	15.2	...	Dec-03
Gross official reserves (millions of euros)	5,338	5,854	6,554	6,393	May-04
Gross official reserves in percent of broad money (M4)	37.1	36.2	38.9	38.0	Apr-04
Gross official reserves in percent of reserve money	220.8	182.6	163.9	157.3	Apr-04
Gross official reserves in months of current year's imports of goods and NFS	5.3	5.1	5.3	...	Dec-03
Gross usable international reserves in percent of domestic foreign currency deposits	41.1	37.5	35.1	...	Dec-03
Net international reserves (millions of euros)	5,146	5,827	6,188	6,390	May-04
Net international reserves in months of current year's import of goods and NFS	5.1	5.1	4.9	...	Dec-03
Short-term debt in percent of gross usable reserves 3/ 4/	43.6	41.5	51.7	...	Dec-03
Short-term debt and current account deficit net of FDI in percent of gross usable reserves	71.8	54.4	61.2	...	Dec-03
Total external debt, percent of GDP	57.1	61.4	74.5	76.4	May-04
External debt service to export ratio	24.9	22.2	19.6	...	Dec-03
Financial indicators					
General government debt in percent of GDP	40.1	39.8	41.5	39.5	Mar-04
Domestic in percent of GDP	15.8	16.7	17.1	17.0	Mar-04
Foreign in percent of GDP	24.3	23.2	24.3	22.5	Mar-04
Broad money (M4, percentage change, yoy)	45.2	9.5	11.0	8.5	Apr-04
Claims on other domestic sectors (change, yoy)	24.6	31.3	14.7	11.2	Apr-04
Short-term interest rate (in percent, e.o.p.)	3.6	1.7	6.1	1.6	May-04
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,035	1,173	1,185	1,136	May-04
Zagreb Stock Exchange, capitalization, percent of GDP	16	22	31	33	May-04
Bond yield spreads (EMBI Global, e.o.p.)	187	132	122	116	Jun-04
Debt ratings: Moody's:					
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Mar-04
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Mar-04
Foreign debt ratings					
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	Mar-04
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	Mar-04
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	Mar-04
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	Mar-04
Banking system:					
Regulatory capital to risk-weighted assets	18.5	16.6	15.7	...	Dec-03
Nonperforming loans to total loans	7.2	5.8	5.1	...	Dec-03
Loan-loss provisions to non-performing loans	75.7	68.1	60.8	...	Dec-03
Net open foreign exchange position to capital 5/	7.9	10.7	13.3	...	Dec-03
Foreign currency deposits to total deposits 6/	91.2	89.4	87.1	...	Dec-03
Foreign currency loans to total loans 6/	84.9	80.0	74.4	...	Dec-03

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

1/ An increase in the index reflects a depreciation: end-year figures indicated annual average.
2/ In January 2000, a new methodology, in line with European standards, for processing data on imports and exports was adopted. The new presentation uses the date when the declaration was cleared rather than the date when the declaration was received.
3/ Coverage limited to short-term debt on a remaining maturity basis registered with the CNB.
4/ Gross reserves adjusted downward by foreign currency redeposit requirements held at the CNB, and by the amount of outstanding foreign currency CNB bills.
5/ From 2003, net open position includes foreign currency options.
6/ Include foreign currency-linked deposits and loans.

Table 7. Croatia: Staff Medium-Term Scenario, 2002-09

	2002	2003	2004	2005	2006	2007	2008	2009
Basic assumptions, national accounts & prices				(Percent change)				
Real GDP	5.2	4.3	3.7	4.1	4.5	4.5	4.5	4.5
Total consumption	...	3.2	2.9	3.3	3.5	3.7	3.8	3.9
Of which : private	7.5	4.1	3.3	4.5	4.3	4.5	4.5	4.5
Total investment	12.0	16.8	5.8	5.4	4.7	4.7	4.5	4.5
o/w private GFCF	...	11.5	8.6	8.7	5.4	5.3	5.1	5.1
Employment	4.0	1.1	0.6	0.9	1.1	1.1	1.1	1.1
Average wage	3.8	2.5	2.1	2.0	2.0	2.0	2.0	2.0
GDP deflator	2.9	3.2	2.7	3.0	3.0	3.0	3.0	3.0
General government finances				(GFS 2001, in percent of GDP)				
Revenues	46.3	46.4	47.4	46.5	46.1	45.2	44.3	43.4
Of which : tax	28.2	27.9	27.7	28.1	27.8	27.1	26.4	25.7
social contributions	14.0	14.2	14.5	14.5	14.3	14.1	13.9	13.7
Expenditures	51.4	52.7	51.9	50.3	49.3	48.0	46.9	46.0
Of which: Acquisition of non-financial assets	4.4	5.9	5.4	4.8	4.7	4.5	4.4	4.3
Balance	-5.0	-6.3	-4.5	-3.7	-3.2	-2.8	-2.5	-2.5
Privatization receipts	1.8	2.2	1.2	2.0	1.2	1.2	0.9	0.9
Domestic financing	0.5	1.5	1.5	0.9	1.4	1.0	1.1	1.1
Foreign financing	2.8	2.6	1.7	0.8	0.6	0.5	0.5	0.5
Debt	39.8	41.5	41.7	40.6	39.7	38.5	37.4	36.4
Debt incl. contingent liabilities and arrears	50.7	53.2	52.9	51.5	50.2	48.5	46.8	45.2
Balance of payments				(In percent of GDP)				
Current account	-8.4	-6.1	-5.6	-5.0	-4.5	-4.5	-4.1	-3.9
Exports	21.8	21.8	22.3	22.2	21.9	21.8	21.6	21.2
Imports 1/	-46.5	-49.3	-48.9	-48.0	-46.7	-46.0	-44.7	-43.3
Trade balance	-24.7	-27.5	-26.5	-25.8	-24.8	-24.2	-23.1	-22.1
Services, net	13.8	19.6	18.9	19.1	19.0	18.6	18.2	18.0
Of which : travel receipts	16.6	22.1	21.2	21.3	20.8	20.6	20.1	19.8
Current transfers	4.7	4.8	4.8	4.9	4.7	4.5	4.4	4.2
Capital and financial account	15.4	15.2	8.6	9.6	9.9	9.6	9.1	8.9
FDI	4.4	5.4	3.4	4.9	5.0	5.0	4.4	4.2
Portfolio investment	-1.0	3.5	-0.3	-0.4	-0.7	-0.3	0.9	-0.7
Medium-term borrowing, net	2.9	8.8	4.1	1.3	5.7	4.7	3.6	5.1
Short-term and other	9.1	-2.5	1.4	3.8	-0.2	0.3	0.2	0.2
Errors & omissions	-3.4	-4.2	-4.1	-4.0	-4.0	-3.8	-3.7	-3.7
Gross official reserves (in months of imports)	4.6	4.9	4.4	4.4	4.4	4.4	4.5	4.5
Foreign debt	61.4	74.5	76.8	76.8	76.3	75.6	74.1	72.7

Sources: Fund staff estimates.

1/ A break in the series occurs starting 2002 due to the change in methodology to estimate costs of insurance and freight.

Table 8. Selected Transition Economies: General Government Revenues and Expenditures as a Share of GDP, 1998-2003 1/

	Total Revenue	Nontax Revenue	Tax Revenue	Total Expenditure	Current Expenditure	Wages and Salaries	Good and Services	Subsidies and Transfers	Capital Expenditure
Croatia	**46.4**	**4.0**	**42.4**	**52.5**	**45.3**	**11.8**	**11.3**	**20.1**	**6.5**
Hungary	43.4	4.6	38.8	47.6	43.0	11.3	7.1	19.9	4.5
Czech Republic	38.9	2.6	36.3	43.9	38.6	3.5	5.2	28.9	5.4
Poland	38.5	4.4	34.1	42.9	40.0	11.1	6.3	19.7	2.9
Slovak Republic	38.8	5.2	33.5	42.8	37.9	8.3	5.2	19.8	4.9
Slovenia	41.0	2.5	38.3	42.7	38.6	9.5	8.0	18.9	4.2
Latvia	35.0	5.4	29.6	37.3	33.6	7.0	6.6	17.2	3.7
Estonia	36.2	3.8	32.3	37.0	33.5	7.6	14.4	11.3	3.5
Macedonia, FYR	33.7	2.1	31.5	36.2	33.7	7.9	4.7	19.4	2.6
Bulgaria	37.0	7.9	29.1	34.1	30.2	4.5	7.0	15.5	4.0
Romania	30.3	1.9	28.5	34.0	30.5	5.0	7.5	14.4	3.2
Lithuania	30.3	2.0	28.4	33.2	30.6	9.6	9.3	11.7	2.6
Euro area	47.3	5.1	42.2	49.2	45.2	10.6	...	27.8	4.0

Sources: European Commission; and IMF country desk data.

1/ 2003 data are preliminary.

Table 9. Croatia: Schedule of Purchases Under the Proposed Stand-By Arrangement

Date	Amount of Purchase 1/ In millions of SDRs	In percent of quota	Conditions
August 4, 2004	92.09	25.22	Board approval of Stand-By Arrangement.
October 30, 2004	0.818	0.22	Observance of end-September 2004 performance criteria.
March 15, 2005	0.818	0.22	Observance of end-December 2004 performance criteria and completion of first review.
April 30, 2005	0.818	0.22	Observance of end-March 2005 performance criteria.
July 31, 2005	0.818	0.22	Observance of end-June 2005 performance criteria.
December 15, 2005	0.818	0.22	Observance of end-September 2005 performance criteria and completion of second review.
January 31, 2006	0.82	0.22	Observance of end-December 2005 performance criteria.
Total 20-month SBA	**97.0**	**26.6**	

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

Table 10. Croatia: External Financial Requirements, 2003–09
(In millions of euros)

	2003	2004	2005	2006	2007	2008	2009
Gross Financing Requirements	4,774	3,765	4,271	5,051	4,661	5,224	6,120
Current account	1,566	1,531	1,459	1,395	1,500	1,479	1,558
Amortization on bonds and medium and long term loan	1,978	2,554	2,637	3,199	2,720	3,274	4,057
Public sector	285	590	1,103	1,608	2,559	3,559	4,351
Portfolio -debt	143	506	627	691	511	468	1,017
Medium and long term loans	201	290	218	310	462	567	662
Banks	699	463	872	1,016	452	769	844
Portfolio-debt	0	0	0	0	0	0	0
Medium and long term loans	699	463	872	1,016	452	769	844
Other sectors	935	1,294	919	1,183	1,294	1,469	1,533
Portfolio -debt	0	17	0	0	128	27	47
Medium and long term loans	935	1,277	919	1,183	1,166	1,443	1,486
Gross reserves accumulation	1,231	-319	175	457	441	471	505
IMF repurchases and repayments	0	0	0	0	0	0	0
Available Financing	4,774	3,765	4,271	5,051	4,661	5,224	6,120
Direct investment (net)	1,369	936	1,425	1,569	1,654	1,581	1,669
Disbursements on bonds and medium and long term loa	4,767	3,943	2,878	4,783	4,176	4,894	5,826
Public sector 1/ 2/	1,373	1,374	1,193	1,238	1,226	1,296	1,949
Banks	1,612	691	554	1,100	568	786	853
Other sectors	1,782	1,878	1,131	2,445	2,383	2,813	3,024
Short term financing (net) 3/	139	-26	183	-123	31	23	17
Other flows (net) 4/	-1,500	-1,087	-216	-1,179	-1,201	-1,275	-1,392

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

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

Table 11. Croatia: Indicators of Capacity to Repay the Fund, 2004–2010

	2004	2005	2006	2007	2008	2009	2010
Fund repurchases and charges 1/							
In millions of SDRs	1.5	3.6	3.6	15.1	49.5	37.8	2.2
In millions of Euros	1.8	4.3	4.4	18.2	59.4	45.3	2.7
In percent of exports of goods and NFS	0.0	0.0	0.0	0.1	0.3	0.2	0.0
In percent of debt service	0.1	0.1	0.1	0.5	1.3	0.8	0.0
In percent of quota	0.4	1.0	1.0	4.1	13.6	10.4	0.6
In percent of gross official reserves	0.0	0.1	0.1	0.2	0.8	0.5	0.0
Fund credit outstanding (e.o.p.) 1/							
In millions of SDRs	92.9	96.2	97.0	85.5	38.4	1.5	0.1
In millions of Euros	111.4	115.5	116.5	102.6	46.1	1.8	0.1
In percent of quota	25.4	26.3	26.6	23.4	10.5	0.4	0.0
In percent of GDP	0.4	0.4	0.4	0.3	0.1	0.0	0.0
In percent of gross official reserves	1.8	1.8	1.7	1.4	0.6	0.0	0.0
Memorandum items:							
Exports of goods and NFS (millions of Euros)	13,955	14,854	15,747	16,769	17,921	19,172	20,401
Debt service (millions of Euros) 1/	-3,227	-3,492	-4,097	-3,751	-4,448	-5,493	-5,788
Quota (millions of SDRs)	365	365	365	365	365	365	365
Quota (millions of Euros)	438	438	439	438	438	437	437
Gross official reserves (millions of Euros) 1/	6,310	6,489	6,947	7,374	7,789	8,250	8,886

Sources: Croatian National Bank; WEO, and Fund staff estimates.

1/ Including the hypothetical purchases under the proposed precautionary Stand-By Arrangement, not shown in the balance of payments projections.

Table 12. Croatia: Projected Payments to the Fund as of June 15, 2004 Under Obligated Repurchase Schedule
(In millions of SDRs)

	2004	2005	2006	2007	2008	2009	2010
Obligations from existing drawings							
Principal							
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR net charges	0.4	0.8	0.8	0.8	0.8	0.8	0.8
Total obligations	0.4	0.8	0.8	0.8	0.8	0.8	0.8
(percent of quota)	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Obligations from prospective drawings							
Principal							
GRA repurchases	0.0	0.0	0.0	11.5	47.1	36.9	1.4
Charges and interest 1/							
GRA charges	1.1	2.8	2.8	2.8	1.7	0.1	0.0
Total obligations	1.1	2.8	2.8	14.3	48.7	37.0	1.4
(percent of quota)	0.3	0.8	0.8	3.9	13.3	10.1	0.4
Cumulative (existing and prospective)							
Principal							
GRA repurchases	0.0	0.0	0.0	11.5	47.1	36.9	1.4
Charges and interest 1/	1.5	3.6	3.6	3.6	2.5	0.9	0.8
Total obligations	1.5	3.6	3.6	15.1	49.5	37.8	2.2
(percent of quota)	0.4	1.0	1.0	4.1	13.6	10.3	0.6

Source: IMF Finance Department.
1/ Assumes the GRA rate of charge of 2.82 percent.

CROATIA: FUND RELATIONS
(As of May 31, 2004)

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

II. **General Resources Account:**

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

III. **SDR Department:**

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	0.29	0.65

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

V. **Financial Arrangements:**

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

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.38	0.76	0.76	0.76	0.76
Total	0.38	0.76	0.76	0.76	0.76

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

VII. **Safeguards Assessment:**

A new safeguards assessment of the CNB for a new SBA is under way.

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 participation of the CNB. The authorities' exchange rate policy regarding the Croatian kuna is accordingly classified as "managed floating with no pre-announced path for the exchange rate". The CNB transacts only in euros, U.S. dollars, and SDRs. On June 15, 2004, the official exchange rate was kuna 6.1595 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

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

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

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

On April 2, 2004, the 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. Because of the slippages in fiscal policy in late 2003 caused mainly by a pre-election spending surge, most end-December performance criteria were not met, and the new government decided to let the SBA expire without completing the third and final review, and start discussions on a new precautionary SBA.

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

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) and the final FSAP report incorporating the AML/CFT assessment has been forwarded to the authorities.

XII. Technical Assistance 2000–2004:

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
STA	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Quarterly National Accounts
	April 2001	Monetary Statistics
	March 2002	Accounting and Budgetary Classification (with FAD)
	October 2002	Government Finance Statistics
MFD	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March-April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
	April 2003	Stress Testing and Foreign Exchange Reserve Management
	February 2004	Monetary Policy Instruments

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

XIII. Resident Representative:

Mr. Vamvakidis took up his post in Zagreb on June 17, 2004.

CROATIA: WORLD BANK RELATIONS

1. The World Bank is taking the lead in assisting Croatia on structural and institutional reforms in a number of sectors. These activities have been broadly aimed at: (i) reducing the level of public expenditures and strengthen public expenditure and debt management; (ii) restructuring the pension and health sectors; (iii) enhancing labor market flexibility; (iv) strengthening market institutions and the competitiveness of the economy; (v) mitigating the social cost of reforms and poverty through restructuring of social welfare programs; and (vi) beginning the process of judicial reform. In support of this strategy, a US$202 million Structural Adjustment Loan (SAL) was approved by the World Bank Board in December 2001 and the first tranche was disbursed in February 2002. The second tranche was disbursed on October 24, 2003.

2. A Country Economic Memorandum (CEM) focusing on European Integration issues were published in July 2003. The findings of the CEM will underpin the design of a new CAS with a tentative Board date in April 2004. A high-case scenario is likely to be centered on a potential successor adjustment loan, a Programmatic Adjustment Loan (PAL). Preparatory work is underway in designing this PAL, which will have three components: (i) governance (public administration reform, legal and judiciary reform, local governance and public expenditure management); (ii) investment climate (preparation of energy sector for EU integration, restructuring/privatization of agro-combinates, tourist companies and shipyards, continued reduction of barriers to entry of new firms, continued tightening of financial discipline of state enterprises); (iii) building human capital and strengthening social protection (education, health and social protection reforms). The identification mission for a potential PAL was conducted in May-June 2004.

3. Currently, there are eleven Bank active projects totaling US$447.6 million in Croatia: the Reconstruction Project for Eastern Slavonia, Baranja and Western Srijem (US$40.6 million, effective January 1999); the Municipal Environmental Infrastructure Project (US$36.3 million, June 1999); the Railway Modernization and Restructuring Project (US$101 million, June 1999); Technical Assistance II (US$7.3 million, August 1999); Health System Project (US$29 million, March 2000); the Trade and Transport Facilitation in Southeast Europe (US$13.9 million, May 2001); the Court and Bankruptcy Administration Project (US$5 million, January 2002); the Pension System Investment Project (US$27.3 million, February 2003); the Real Property Registration and Cadastre (US$25.7 million, February 2003); the Rijeka Gateway Project (US$156.5 million, October 2003); the Energy Efficiency project (US$5 million, signed in November 2003); and a GEF-financed US$7 million grant for the Energy Efficiency Project (also signed in November 2003).

4. Investment projects under preparation include: the Coastal Cities Pollution Control (approximately US$100 million), District Heating (approximately US$30 million), Social Protection (approximately US$36 million), Social and Economic Recovery (approximately US$24 million), and Science and Technology (approximately US$42 million).

5. As of September 2003, the IFC had 11 projects to 7 different entities in its portfolio for a total of US$186.8 million (US$153.2 million for its own account).

CROATIA: STATISTICAL ISSUES

1. Croatia's economic and financial statistics are of mixed, though improving, quality. Data on monetary aggregates are close to meeting the recommendations of the IMF's *Monetary and Financial Statistics Manual*. In other areas, however, there are major deficiencies. In most cases, remedial action has been taken to improve data coverage and reliability. But in some instances, progress has been impeded by insufficient resources and lack of cooperation between government agencies. The recent creation of a joint committee between the Ministry of Finance and the Croatian National Bank (CNB) should promote collaboration in the statistical area to advance the reconciliation of government finance and monetary data. Croatia has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB) (http://dsbb.imf.org/Applications/web/dsbbhome/).

A. National Accounts

2. The national accounts (NA) have undergone substantial improvements in the last few years. The Central Bureau of Statistics (CBS) compiles and publishes annual constant and current price data according to the production, income, and expenditure approaches. On June 30, 1999, the CBS began publishing quarterly GDP data by expenditure and main industry groupings at current and constant (1997) prices, thus meeting the SDDS requirements. Nonetheless, shortcomings remain. A substantial statistical discrepancy exists between expenditure-based and value-added-based GDP data. This problem comes from: (i) insufficient coordination between the CBS and CNB to reconcile their 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 accruals basis; (ii) inadequate price deflators; and (iii) the late publication of annual data, which generally show large differences with quarterly data. After the abolition of the payments agency (ZAP) in late 2001, enterprise financial statistics are collected by the finance agency (FINA). Further improvements are currently being implemented and a new project for the production of regional GDP statistics has been recently started.

B. Prices

3. The CBS produces monthly indices of consumer and producer prices. Data are collected around the 20th day of each month, and the indices are released by the10th of the following month. Since January 2004, a new consumer price index (CPI) replaced the retail price index (RPI). At the same time, the harmonized CPI will be calculated in line with Eurostat methodology, but will not be released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the CNB.

C. Wages and Employment

4. Croatia produces data on average net and gross earnings per person in paid employment by sector, 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 has been 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. Fiscal Data

6. Government finance statistics are produced on a monthly basis with lags of between three and twelve weeks, and are available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data on a GFS basis are reliable and available on request on a next-day basis for most major categories for both the central budget and the budgetary funds. Expenditure data on a cash basis are available according to GFS methodology (economic and functional classification) for the central budget and the budgetary funds. A new chart of accounts has been used to develop the budget for part of general government entities since 2002. The data on central government financing in the Ministry of Finance reports, the monetary survey, and the balance of payments are not reconciled. Substantial discrepancies exist partly due to different methodologies and definitions of government by the Ministry of Finance and the CNB. Following the recommendations of the October 2002 GFS mission, a task force, comprising staff from MOF, CNB, and CBS was formed to reconcile central government financing data produced by these institutions. However, only irregular meetings have so far been held.

7. Data on the stock of government debt suffer from certain deficiencies, although a new CNB database represents a major improvement. The detailed data on domestic public bonds published in the Monthly Statistical Review of the Ministry of Finance are now augmented by a central government debt table in the CNB Monthly Bulletin, which also reports stocks of central government guaranteed debt. The Ministry of Finance prepared a database with government guarantees in July 2003, which has been used to monitor developments in the stock and flows of guarantees. In addition, data on expenditure arrears—formally recorded, for the first time at the end of 1999—promissory notes and receivable issues linked to banks privatization are not included. The latest Monthly Statistical Review is for April 2004.

8. Data on the operations of local governments and consolidated general government are available only on a quarterly basis and with a lag of about one month. The Ministry of

Finance regularly reports monthly data for publication in the *IFS* and annual data for publication in the *GFS Yearbook.*

E. Monetary Data

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

10. Following the recommendations of the July 2001 mission, attempts have been made by the CNB and the Ministry of Finance to reconcile the monetary statistics and the government finance statistics. However, data from the CNB on net credit to government continue to be inconsistent with the Ministry of Finance's data on the financing of government from the CNB.

11. As a subscriber to the SDDS, Croatia regularly disseminates the information on its international reserves and foreign currency liquidity in a template according to the IMF methodology. The data are disseminated monthly on the IMF and CNB external websites. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies. In March 2002, the CNB started to collect financial information (balance sheets and investment structure) from investment and pension funds; the data are not yet published, but used for internal purposes. However, the CNB's *Bulletin* (no. 83) informed the public on the other financial corporations' development in the financial system and presented selected aggregate data (e.g., net assets of investment and pension funds). According to the CNB, the inclusion of other financial corporations in monetary statistics depends on the harmonization process of the Croatian monetary statistics with the statistical reporting requirements of the European Central Bank.

F. Banking Statistics

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

G. Balance of Payments Data

13. Balance of payments data are compiled on a quarterly basis according to the fifth edition of the IMF's *Balance of Payments Manual* and published by the CNB making use of information from commercial banks, the CNB, and the Ministry of Finance, among other entities. The data are generally available with a lag of two months and are subject to substantial revisions in subsequent releases; however, trade data are available with a lag of one month and data on international reserves are available the next day on request. In January 1998, a major revision of balance of payments statistics took place which led to the evaluation of imports on an f.o.b. basis and the inclusion of goods imported into free trade zones. New surveys on transportation, travel, government services, and labor income were introduced in 1999. The methodology on travel surveys was modified in 2002. The CNB changed the methodology to estimate the cost of insurance and freight in early 2004. While the survey of transportation delivers very accurate estimates, the other three surveys still need improvements. In particular, the size of negative net errors and omissions has been around 3–4 percent of GDP since 1999. This casts doubts about the accuracy of current account estimates of the CNB. Also, since 1999, valuation changes have been excluded from the asset side of currency and deposits in the banking sector. In mid-2001, new surveys on communication and insurance services were introduced. During 1999 and 2000, the CNB increased the coverage of the direct investment survey by identifying additional enterprises. The coverage and quality of portfolio investment data are reasonably complete and accurate.

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

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

Table 13. Croatia: Core Statistical Indicators
(As of July 1, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/ Debt Service
Date of Latest Observation	Jul 1, 2004	Jun 2004	May 2004	May 2004	May 2004	May 2004	May 2004	May 2004	Q1 2004	Mar 2004	Q1 2004	Apr 2004
Date Received	Jul 1, 2004	Jun 25, 2004	Jun 15, 2004	Jun 15, 2004	Jun 27, 2004	Jun 8, 2004	Jun 15, 2004	Jul 1, 2004	May 19, 2004	May 19, 2004	Jun 30, 2004	Jun 18, 2004
Frequency of Data	Daily	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Source of Update	CNB	CNB	CNB	CNB	CNB	CNB	CBS	CBS	CNB	Ministry of Finance	CBS	CNB
Mode of Reporting	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	E-mail	On-line	On-line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

CROATIA: SUSTAINABILITY ANALYSIS

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

H. Fiscal Sustainability

2. Stress testing of debt dynamics under different scenarios suggests that fiscal sustainability is not seriously at risk, although a severe economic slowdown accompanied by a proportional drop in revenues could put the debt ratio temporarily on an upward trend. According to staff's central scenario, the debt ratio stabilizes slightly below 42 percent of GDP in 2004 and subsequently falls to 36½ percent of GDP by 2009 driven primarily by continued fiscal consolidation and supported by privatizations. If key variables are kept at their historical averages (scenario A1) the debt ratio increases by around 5 percent of GDP by 2009. This is mainly because the historical primary deficit is significantly above the projected deficit in the central scenario. Turning to the boundary tests (scenarios B1-B6), the debt ratio in all cases resumes a downward trend following the initial shock. The only exception is the case of a significant drop in economic activity (scenario B2), which gives rise to a significant worsening of debt dynamics assuming that revenues fall in line with GDP.

I. External Sustainability

3. Under the staff's central scenario, the external debt to GDP ratio falls from about 76¾ percent (in euro terms) in 2004 to 72¾ percent in 2009 (Table 15)[7]. Three alternative scenarios (A1-A3) are considered. Under the first scenario, the main parameters (interest rate, Croatian terms of trade, non-interest current account, and non-debt creating flows as a percentage of GDP) are at the historical average. Under the second scenario, Croatian GDP growth in 2005 is -1 percent due mainly to a drop in exports of goods and tourism receipts. The third scenario assumes GDP growth and current account balance based on the consensus forecast of the three largest banks in Croatia. As Table 15 demonstrates, under alternative scenarios, the debt to GDP ratio does not exceed 81 percent of GDP. The boundary shocks yield more adverse results. Croatia withstands relatively well the shocks to interest rates, real GDP growth, terms of trade shock and non-interest current account (tests B1- B4). The combination of various shocks (B5), as well as a 30 percent depreciation of the Kuna against the U.S. dollar (B6) result in the debt to GDP ratio of more than 100 percent.

[7]This appendix calculates debt to GDP ratio as euro value of debt to euro value of GDP. When the ratio calculated as Kuna value of external debt to Kuna GDP the results are very similar with the debt falling from 76.8 percent to 72.7 percent of GDP by 2009 (Table 15).

Table 14. Croatia: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual		Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	
					I. Baseline Projections				**Debt-stabilizing primary balance 11/**
Public sector debt 1/	39.8	41.5	41.7	40.6	39.7	38.5	37.4	36.4	**-1.6**
o/w foreign-currency denominated	27.3	28.5	25.9	25.1	23.4	22.9	22.3	21.8	
Change in public sector debt	-0.2	1.2	0.2	-1.1	-0.9	-1.2	-1.1	-1.0	
Identified debt-creating flows (4+7+12)	0.5	1.8	0.7	-1.1	-0.6	-1.0	-1.1	-1.2	
Primary deficit	2.9	4.2	2.3	1.5	1.4	0.9	0.6	0.5	
Revenue and grants	46.3	46.4	47.4	46.5	43.2	42.8	42.0	41.2	
Primary (noninterest) expenditure	49.2	50.6	49.7	48.1	44.7	43.7	42.6	41.7	
Automatic debt dynamics 2/	-0.7	-0.2	-0.4	-0.6	-0.8	-0.7	-0.7	-0.8	
Contribution from interest rate/growth differential 3/	-1.0	-0.8	-0.4	-0.6	-0.8	-0.7	-0.7	-0.8	
Of which contribution from real interest rate	1.0	0.8	1.1	1.0	0.9	0.9	0.9	0.8	
Of which contribution from real GDP growth	-1.9	-1.6	-1.5	-1.6	-1.7	-1.7	-1.6	-1.6	
Contribution from exchange rate depreciation 4/	0.3	0.6	0.3	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	-1.8	-2.2	-1.2	-2.0	-1.2	-1.2	-0.9	-0.9	
Privatization receipts (negative)	-1.8	-2.2	-1.2	-2.0	-1.2	-1.2	-0.9	-0.9	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-0.7	-0.6	-0.5	0.0	-0.3	-0.2	0.0	0.2	
Public sector debt-to-revenue ratio 1/	86.9	89.5	88.0	87.3	91.9	89.9	89.1	88.3	
Key Macroeconomic and Fiscal Assumptions									Projected Average
Real GDP growth (in percent)	5.2	4.3	3.7	4.1	4.5	4.5	4.5	4.5	4.3
Average nominal interest rate on public debt (in percent) 7/	5.6	5.6	5.5	5.7	5.4	5.7	5.7	5.5	5.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.7	2.3	2.8	2.7	2.4	2.7	2.7	2.5	2.6
Nominal appreciation (increase in Euro value of local currency, in percent)	-1.0	-2.1	-1.1	0.0	0.0	0.0	0.0	0.0	-0.2
Inflation rate (GDP deflator, in percent)	2.9	3.2	2.7	3.0	3.0	3.0	3.0	3.0	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	6.8	7.1	2.0	0.7	-2.9	2.2	1.8	2.3	1.0
Primary deficit	2.9	4.2	2.3	1.5	1.4	0.9	0.6	0.5	1.2
					II. Stress Tests for Public Debt Ratio				**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios									
A1. Key variables are at their historical averages in 2005-09 8/			41.7	42.3	43.4	44.6	46.2	47.9	**-2.1**
A2. No policy change (constant primary balance) in 2005-09			41.7	41.4	41.5	41.6	42.3	43.0	**-1.8**
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard devia			41.7	40.6	39.8	38.5	37.4	36.4	**-1.6**
A4. Selected variables are consistent with market forecast in 2005-09			41.7	40.6	39.7	38.5	37.4	36.4	**-1.6**
B. Bound Tests									
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006			41.7	41.7	42.0	40.7	39.6	38.6	**-1.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006			41.7	45.4	52.1	55.6	59.0	62.4	**-2.3**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006			41.7	46.6	51.6	50.2	48.9	47.7	**-1.9**
B4. Combination of 2-4 using one standard deviation shocks			41.7	46.0	51.0	49.4	48.1	46.8	**-1.9**
B5. One time 30 percent real depreciation in 2005 10/			41.7	53.2	52.1	50.7	49.4	48.1	**-1.9**
B6. 10 percent of GDP increase in other debt-creating flows in 2005			41.7	50.6	49.6	48.1	46.9	45.6	**-1.8**

1/ General government gross debt
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 Euro).
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/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ The implied change in other key variables under this scenario is discussed in the text.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 15. Croatia: External Debt Sustainability Framework, 1999-2008
(In percent of GDP, unless otherwise indicated)

		2001	2002	2003	2004	2005	2006	2007	2008	2009
					Projections					
					I. Baseline Projections					
1	**External debt**	57.9	63.3	73.8	76.6	76.8	76.1	75.6	74.1	**72.7**
2	Change in external debt	2.8	5.4	10.5	2.8	0.3	-0.7	-0.5	-1.5	-1.4
3	Identified external debt-creating flows	-8.9	-0.9	-2.5	-2.2	-4.7	-6.0	-5.5	-5.6	-5.5
4	Current account deficit, excluding interest payments	0.6	5.8	3.8	3.2	2.1	1.6	1.5	1.0	0.4
5	Deficit in balance of goods and services	5.9	10.9	7.9	7.7	6.7	5.9	5.6	4.9	4.1
6	Exports	48.5	46.2	51.7	51.4	51.3	50.5	50.2	49.4	48.6
7	Imports	54.4	57.0	59.6	59.1	58.0	56.4	55.8	54.3	52.7
8	Net non-debt creating capital inflows (negative)	-7.1	-4.4	-5.4	-3.4	-4.9	-5.0	-5.0	-4.4	-4.2
9	Automatic debt dynamics 1/	-2.4	-2.3	-0.9	-1.9	-1.9	-2.6	-2.0	-2.3	-1.7
10	Contribution from nominal interest rate	3.1	2.5	2.4	2.5	2.9	2.9	3.0	3.1	3.6
11	Contribution from real GDP growth	-2.2	-2.8	-2.6	-2.6	-3.0	-3.2	-3.2	-3.2	-3.1
12	Contribution from price and exchange rate changes 2/	-3.3	-2.1	-0.7	-1.8	-1.8	-2.3	-1.8	-2.2	-2.2
13	Residual, incl. change in gross foreign assets	11.7	6.3	12.9	4.9	5.0	5.3	5.0	4.1	4.1
	External debt-to-exports ratio (in percent)	119.4	137.2	142.7	148.8	149.8	150.6	150.4	149.9	149.5
	Gross external financing need (in billions of US dollars) 3/	3.3	3.9	3.7	4.5	4.6	5.3	4.8	5.4	6.2
	in percent of GDP	14.8	16.2	14.6	16.5	15.9	17.0	14.4	14.8	15.8
	Key Macroeconomic Assumptions									
	Real GDP growth (in percent)	4.4	5.2	4.3	3.7	4.1	4.5	4.5	4.5	4.5
	Exchange rate appreciation (US dollar value of local currency, change in percent)	2.2	0.8	-2.1	-0.3	-0.5	0.0	-0.5	0.0	0.0
	GDP deflator in US dollars (change in percent)	6.3	3.8	1.1	2.5	2.5	3.0	2.5	3.0	3.0
	Nominal external interest rate (in percent)	6.2	4.8	3.9	3.6	4.1	4.0	4.3	4.4	5.2
	Growth of exports (US dollar terms, in percent)	14.7	3.9	17.9	5.9	6.4	6.0	6.5	6.9	7.0
	Growth of imports (US dollar terms, in percent)	16.1	14.5	10.0	5.5	4.7	4.7	6.0	5.7	5.5
	Current account balance, excluding interest payments	-0.6	-5.8	-3.8	-3.2	-2.1	-1.6	-1.5	-1.0	-0.4
	Net non-debt creating capital inflows	7.1	4.4	5.4	3.4	4.9	5.0	5.0	4.4	4.2
					II. Stress Tests for External Debt Ratio					
	A. Alternative Scenarios									
	A1. Key variables are at their historical averages in 2004-08 4/				76.6	77.9	79.4	80.4	80.5	80.6
	A2. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation 5/				76.6	80.2	79.7	79.2	78.2	77.7
	A3. Selected variables are consistent with market forecast in 2004-08				76.6	77.1	76.9	77.0	76.1	75.4
	B. Bound Tests									
	B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005				76.6	79.9	82.3	81.6	80.0	78.5
	B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005				76.6	85.0	93.3	92.3	90.3	88.5
	B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005				76.6	85.2	94.1	93.0	91.0	89.2
	B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005				76.6	87.3	97.1	96.0	93.9	92.1
	B5. Combination of 2-5 using one standard deviation shocks				76.6	91.8	108.7	107.5	105.3	103.3
	B6. One time 30 percent nominal depreciation in 2005				76.6	108.3	106.6	105.3	102.8	100.7
	Memorandum item:									
	Kuna value of external debt to GDP 7/	57.1	61.4	74.5	76.8	76.8	76.3	75.6	74.1	72.7

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

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ 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.

5/ The implied change in other key variables under this scenario is discussed in the text.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

7/ Consistent with the design of a standard template, the debt to GDP ratio is calculated as euro value of debt to euro value of GDP. When the ratio is calculated as Kuna value of external debt to Kuna GDP the results are very similar.

CROATIA: RECENT TRENDS IN COMPETITIVENESS INDICATORS AND COMPETITIVENESS OF THE CROATIAN TOURISM SECTOR

1. A study on Croatian competitiveness conducted for the 2002 Article IV consultation concluded that Croatian export performance in recent years had been mixed. While exports of goods lagged compared to most Central and Eastern European countries (CEECs), exports of services, in particular in transportation and tourism, had grown vigorously[8]. The real effective exchange rate (REER) and unit labor cost (ULC) indicators of external competitiveness did not show deterioration of Croatia's external competitiveness. The study concluded that the relatively high growth of exports of services compared to other CEECs suggested that Croatia may have a comparative advantage in services exports because of nature and location (e.g., transport and tourism). But the growth of merchandise exports was too low compared to other CEEC countries and the industrial wage level was relatively high.

2. The updated competitiveness indicators suggest that the above trends have continued. In 2000–03, the overall growth of exports of goods and non-factor services was 40½ percent—well below the average of about 60 percent in the CEECs, and growth of merchandise exports—only 12½ percent—among the lowest (Table 16). At the same time, growth of exports of services (mainly tourism) was close to 70 percent—among the highest in the group. Similar to the conclusions of the 2002 study, industrial wages continued to be relatively high, but the gap with the competitors has narrowed (Table 17), and REER and ULC indicators (Box 1) do not show deterioration of external competitiveness.

Competitiveness of the Croatian Tourism Sector

3. The Croatian tourism sector is one of the most important in the Croatian economy. Surpluses in tourism services partially offset a persistently large merchandise trade deficit.

4. How competitive is the Croatian tourism sector compared with those in other countries with popular tourist destinations, in particular those with access to the Mediterranean and the Black Sea? The competitiveness of the tourism sector is much more difficult to gauge than that of manufacturing industry, both because each tourist destination differs from others and because the quality of tourist services depends on a variety of factors—among them infrastructure, environment, openness of trade, culture of the country, and overall social development. The World Travel and Tourism Council—an international forum of the tourism industry—calculates several competitiveness indices reflecting these factors for more than 200 countries (Box 1).

5. Table 18 presents these indices for Croatia and some other countries with popular tourist destinations. It demonstrates that Croatia compares favorably with other European

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[8] See Croatia: *Selected Aspects of Export Performance, Competitiveness and Trade Policy* in the Selected Issues paper IMF Country Report No. 02/179.

countries with the access to the Mediterranean and the Black Sea in the price of tourism services and the quality of environment, on par in human resource quality, but lags in technology and openness compared to the more advanced EU countries. Overall, the indicators show Croatia's tourism sector to be competitive with good prospects, which is consistent with the growth in tourist receipts in recent years. The prospects can be further improved by advancing the technological sophistication of tourist facilities and further increasing openness. The government of Croatia has worked with the World Travel and Tourism Council to design a strategy for tourism that sets out an action plan for the development of the sector, and this strategy is now in the implementation phase.

Box 1. World Travel and Tourism Council: Indicators of Competitiveness

The World Travel and Tourism Council (WTTC) is a forum of tourism industry professionals comprising the presidents, chairs, and CEOs of 100 of the world's important tourism companies. The WTTC calculates a broad range of indicators of competitiveness indices for over 200 countries.

The **Price Competitiveness index** is a weighted average of hotel price index, the purchasing power parity index, adjusted consumer price index, and taxes on goods and services.

The **Infrastructure index** measures the competitiveness of infrastructure and is calculated using information on road quality, access to improved sanitation facilities, access to improved drinking water, and the railways.

The **Environment index** is calculated using population density, carbon emissions, and the degree of government's ratification of environmental treaties.

The **Openness index** takes into account tourism openness using data including visa requirements, the extent to which a country is open to international tourism, trade openness, and taxes on international trade.

The **Social Development index** measures a country's development in social issues using data on population access to daily newspapers, personal computers, television sets, and criminality.

The **Human Resource index** measures the quality of human resources in each country. It is calculated using data regarding life expectancy, literacy rates, education, employment, population, training, skills, and gender equality indicators.

Source: World Tourism Council (http://www.wttc.org/).

Table 16. Central and Eastern European Countries: Export Performance Indicators, 2000-03

(In percent unless otherwise indicated)

	Growth of exports of goods and non-factor services (2000-2003) 1/	Growth of exports of goods (2000-2003) 1/	Growth of exports of non-factor services (2000-2003) 1/	Growth of exports of goods to EU (2000-2003) 1/	Share of exports of goods and nonfactor services in GDP			Share of exports of nonfactor services in GDP			Share of exports of goods to the EU in total exports of goods		Change in market share of goods exports to the EU	Change in real exchange rate (INS, 1994-98, + = appreciation)	Cumulative FDI in percent of cumulative GDP (1994-98)
					2000	2003	Change	2000	2003	Change	2000	2003			
BULGARIA	30.6	30.6	30.5	57.7	17.3	16.3	-5.7	17.3	16.3	-5.7	51.0	52.3	3.8	37.7%	2.3%
CROATIA 2/	**40.5**	**12.4**	**71.9**	**47.9**	**47.0**	**65.2**	**38.6**	**22.2**	**37.7**	69.5	**45.2**	**59.5**	10.4	**3.1%**	**2.2%**
CZECH REPUBLIC	57.0	67.4	13.2	70.8	69.8	66.0	-5.5	13.3	9.1	-31.9	68.5	69.8	9.8	20.3%	3.3%
ESTONIA	41.1	37.7	48.4	33.7	93.7	81.0	-13.5	29.2	26.5	-9.0	79.0	76.7	19.5	45.7%	5.1%
HUNGARY	50.5	51.7	44.2	27.8	75.2	62.4	-16.9	12.3	10.0	-19.2	72.5	61.1	-10.5	1.3%	5.0%
LATVIA	43.3	54.1	25.1	92.1	45.6	49.6	8.7	16.9	16.0	-5.2	58.6	73.0	42.2	16.6%	6.3%
LITHUANIA	80.8	88.7	50.6	80.7	45.7	50.6	10.8	9.5	8.7	-7.7	45.0	43.1	5.2	35.8%	3.3%
POLAND	55.9	69.9	7.5	48.3	27.8	34.4	23.9	6.2	5.3	-14.5	61.7	53.8	-1.5	27.4%	1.9%
ROMANIA	90.9	69.8	…	77.6	28.3	37.0	30.5	0.3	4.5	…	64.0	66.9	6.6	34.0%	2.6%
SLOVAK REPUBLIC	77.9	83.9	46.0	81.6	69.8	77.2	10.6	11.1	10.1	-9.3	59.1	58.3	23.7	5.2%	0.9%
SLOVENIA	46.9	46.8	47.5	35.5	56.4	57.3	1.6	10.0	10.2	2.0	63.3	58.5	3.9	8.3%	1.2%
AVERAGE	**55.9**	**55.7**	**38.5**	**59.4**	**52.4**	**54.3**	**7.6**	**13.5**	**14.0**	**-3.1**	**60.7**	**61.2**	**10.3**	**21.4%**	**3.1%**
(standard deviation)	(19.2)	(23.1)	(19.4)	(22.3)	(23.2)	(19.3)	(17.9)	(7.8)	(10.0)	(27.1)	(10.7)	(9.8)	(14.1)	(15.7)	(1.7)
MEDIAN	**50.5**	**54.1**	**45.1**	**57.7**	**47.0**	**57.3**	**8.7**	**12.3**	**10.1**	**-8.4**	**61.7**	**59.5**	**6.6**	**20.3%**	**2.6%**

Sources: WEO; Direction of Trade Statistics (DOTS), and Fund staff estimates.

1/ Exports are expressed in Euros

Table 17. Monthly Industrial Wages in Selected CEECs, 1997-2003
(In euros)

	1997	1998	1999	2000	2001	2002	2003
BULGARIA	122	157	180	216	235	258	271
CROATIA	545	579	544	495	534	578	619
CZECH REPUBLIC	300	326	347	382	434	513	530
ESTONIA	257	293	303	289	315	368	483
HUNGARY	321	326	334	323	364	455	572
LATVIA	228	239	251	249	253	273	305
LITHUANIA	213	258	273	269	274	311	376
POLAND	329	357	426	433	489	506	547
ROMANIA	128	161	134	134	151	164	186
SLOVENIA	745	795	793	724	736	817	1021
SLOVAK REPUBLIC	274	284	259	247	256	298	391
AVERAGE	315	343	349	342	367	413	482
(standard deviation)	(183)	(188)	(185)	(163)	(169)	(185)	(225)
MEDIAN	274	293	303	289	315	368	483

Source: Country authorities, and Fund staff estimates.

Table 18. Croatia and Selected Countries: Indices of Competitiveness in Tourism Sector 1/

		Price	Human Tourism	Infrastructure	Environment	Technology	Human Resources	Openness	Social
Bulgaria	Index Value	44	64	68	48	69	73	66	66
	Ranking	81	41	18	94	69	40	66	61
Croatia	Index Value	41	n/a	n/a	62	75	68	68	68
	Ranking	88	n/a	n/a	34	64	51	57	55
Czech republic	Index Value	51	90	n/a	69	86	71	77	72
	Ranking	65	20	n/a	12	52	47	19	43
Turkey	Index Value	60	31	59	46	70	45	64	59
	Ranking	46	73	41	101	67	93	77	79
Italy	Index Value	20	50	n/a	64	100	84	70	78
	Ranking	111	52	n/a	27	26	19	48	32
Spain	Index Value	23	68	n/a	74	94	94	71	77
	Ranking	107	32	n/a	2	40	12	40	33
Greece	Ranking	36	64	n/a	54	99	79	70	73
		93	37	n/a	69	31	29	49	42
Thailand	Index Value	67	46	57	43	70	59	67	54
	Ranking	36	56	48	113	68	70	60	91
Mexico	Index Value	50	19	52	48	66	59	68	60
	Ranking	66	89	60	92	71	70	54	77

Source: The World Travel & Tourism Council (WTTC).

1 / On 0-100 scale, with 100 representing the highest score.

Zagreb, 13 July, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

We have prepared an economic policy program for 2004 and 2005 to limit external vulnerability arising from the high current account deficit and the heavy external debt burden, and prepare Croatia for EU accession. To achieve these objectives, our program relies on fiscal adjustment to stabilize the external debt-to-GDP ratio at approximately its present level, and structural reforms to reduce the role of the state in the economy and promote private sector activity. In support of our program and to signal our commitment to strong macroeconomic policies, we herewith request a Stand-By Arrangement in an amount of SDR 97 million (26.7 percent of quota) for a 20-month period starting from Board approval.

The implementation of our program, which is described in the attached Memorandum on Economic and Financial Policies (MEFP) and Technical Memorandum of Understanding (TMU), will be monitored through quantitative performance criteria, indicative targets, and structural benchmarks. Our fiscal program will be monitored by performance criteria on the general government and HBOR deficits, the change in the stock of general government arrears, the contracting of new nonconcessional external debt of the general government and HBOR, and the cumulative issuance of debt guarantees by the general government. To ensure that the operations of public enterprises will not jeopardize fiscal consolidation and to increase transparency, the deficits of selected public enterprises, net of budget transfers, will also be monitored on the basis of indicative targets. The implementation of the CNB's monetary program will be monitored through performance criteria on the net international reserves and net domestic assets of the CNB.

The MEFP proposes performance criteria and indicative targets for end-September and end December 2004. There will be two reviews during the period of the requested arrangement, before the third and sixth purchases, respectively, to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives. The first review will focus in particular on the 2005 budget. Program implementation will also be monitored through a structural performance criterion on the preparation of 3-year rolling budgets starting in 2005 and structural benchmarks.

We believe that the policies and measures set forth in the MEFP and the TMU are sufficient to attain the objectives of our economic program. However, we stand ready to take any further measures that may be needed toward this end. We will consult periodically with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in implementing our economic program, and in advance of any revisions to the policies covered by the MEFP. We will provide the Fund with such information as it requests on policy implementation and achievement of program objectives.

In view of Croatia's comfortable international reserves position and easy access to international capital markets, we intend to treat the arrangement as precautionary. Therefore, we do not intend to make the purchases under the requested arrangement that will become available upon its approval and after observance of its performance criteria and completion of its reviews.

Sincerely yours,

/s/	/s/
Ivan Šuker	Željko Rohatinski
Minister of Finance	Governor
Ministry of Finance	Croatian National Bank

Attachments: Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding

MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES

1. **Croatia is a functioning market economy with a well-established track record of satisfactory growth and low inflation**. Real GDP growth has averaged 4½ percent with inflation in the low single digits since the mid-1990s, the economy is open to the rest of the world, foreign investment is strong, and structural reform has advanced over a wide front. This performance compares favorably to that in other countries in the region and has provided the basis for the recent positive *avis* by the European Commission, which recommended opening negotiations for EU membership with our country.

2. **But certain structural problems have long been left unaddressed and our government is starting with a heavy burden from the past.** This burden is reflected in two features of our economy. *First*, the public sector is large and inefficient: the share of public spending to GDP is higher than in other countries at a similar level of development; public agencies and enterprises are not subject to strict financial discipline; state aid in various forms is higher than in the rest of Central and Eastern Europe—indeed above the average in the EU; and the fiscal deficit last year was very high. And *second*, public and private external debt has reached high levels, exposing Croatia to significant risks.

3. **Addressing the underlying causes and alleviating this burden is critical for the health of our economy and for an early and successful entry into the EU, which is our primary strategic objective.** The government and the Croatian National Bank (CNB), with the support of the International Monetary Fund (IMF), have thus cooperated in the design of an economic policy program with two main goals:

- **in the short term**, restoring order in Croatia's public finances and limiting the vulnerability arising from the high current account and external debt burden; and

- **in the medium term**, modernizing and reducing the role of the state, promoting private sector activity, and preparing Croatia to compete within the EU.

These goals are complementary: the long-term competitiveness and growth of our economy and, in particular, the accession to the EU require a stable macroeconomic environment and a low fiscal deficit. This Memorandum presents the policies that we believe will achieve these goals and is an integral part of our government's broader economic and social program. Although it focuses on the period immediately ahead, it also incorporates policies that have a longer time horizon and will require consistent implementation in the coming years.

4. **Our program will be monitored by quarterly performance criteria, indicative targets, and structural benchmarks** specified and defined in the attached Technical Memorandum of Understanding.

V. MACROECONOMIC POLICIES FOR 2004–05

5. **The immediate objective of macroeconomic policies for 2004–05 is to reduce external vulnerability**. Croatia is a small open economy operating in an uncertain international

environment. Heavy foreign borrowing by both the public and the private sectors in the last decade has resulted in a very high foreign debt to GDP ratio (77 percent of GDP at end-May 2004 in euro terms). Although foreign borrowing is likely to continue as our economy invests in the future, the size of the current account deficit and foreign debt makes Croatia vulnerable to external shocks and shifts in market sentiment: for example, tourism receipts may fluctuate substantially in reaction to international events, while foreign borrowing by domestic banks and enterprises can be very volatile. Our immediate objective therefore is to contain the external current account imbalance and reduce sharply the reliance on foreign borrowing.

6. **Fiscal policy is the main instrument to achieve this objective**. The external imbalance can only be addressed by a lasting reduction in the domestic saving-investment gap. Given its focus on exchange rate stability, monetary policy can only play a supporting role; the burden for narrowing the saving-investment gap falls on fiscal policy. The fiscal effort will encompass not only the central government but also extra-budgetary funds and agencies, the broader public sector, and the Croatian Development Bank (HBOR).

7. **Our fiscal targets for 2004 and 2005 are also guided by the need to restore credibility and set fiscal policy on a course that meets EU requirements in the medium term**. A sizable fiscal adjustment is needed in order to reverse the excesses of last year, when spending slippages by the previous government in the last quarter of the year resulted in a widening of the general government deficit to 6.3 percent of GDP (including hidden subsidies to Croatian Railways—see ¶9), missing the 2003 budget target by a wide margin and taking the previous Stand-By Arrangement with the IMF off track. At the same time, we intend to continue critical infrastructure projects and provide budgetary room for the costs associated with the process of harmonization with the EU.

8. **Achieving the main short-term objective of our program will be facilitated by the return of the pace of economic growth to a more sustainable level**. The unwinding of the credit boom and the restoration of fiscal discipline are expected to maintain real GDP growth to 3½–3¾ percent and keep the current account deficit around 5–5½ percent of GDP in 2004–05. Inflation will remain at the range of 2–3 percent per year. Given this economic outlook, we expect the policies for 2004–05 outlined in this Memorandum will result in stabilizing the external debt-to-GDP ratio at around its end-May 2004 level. If developments during the program period indicate a significant deviation from our macroeconomic objectives, in particular a sizeable increase in the external debt-to-GDP ratio net of official and commercial bank reserves, we will adjust macroeconomic policies, in particular fiscal policy, to achieve our targets.

A. Fiscal Policy

9. **The first task of our government this year was to deal with the lack of transparent accounting and accumulated fiscal obligations inherited from 2003**. *First*, the deficits reported in 2002 and 2003 had been artificially suppressed because the previous government had forced the loss-making Croatian Railways (HŽ) to finance part of its spending by government-guaranteed short-term loans, which were planned to be taken over and serviced by the budget this year. We have discontinued this practice and our budget now includes all

transfers required by HŽ to finance both capital and current spending. And *second*, expenditures in 2004 are burdened by a number of one-off obligations inherited from last year, including hospital arrears, wage arrears, and contracts for housing reconstruction that amount to about HRK 800 million (0.4 percent of GDP), as well as the impact of substantial wage increases awarded to civil servants by the previous government one month before the last November elections.

10. **Against this background, the main objective of fiscal policy in 2004 is to restore transparency and order in our public finances and begin the process of medium-term consolidation**. We aim at a general government deficit of HRK 9.3 billion (4½ percent of GDP) on a GFS 2001 basis including net lending, an adjustment of 1.8 percent of GDP from 2003. This target was set in the 2004 budget, prepared by our government and approved in March, and is supported by a set of additional measures in a supplementary budget that we have submitted to parliament for approval by July 15.

11. **To achieve this major adjustment, we rely on a combination of expenditure and revenue measures, as well as some one-off revenues**. An adjustment of this magnitude could not be achieved by permanent measures alone, especially given the inherited obligations from 2003 and the fact that a quarter of the year had elapsed before the budget could be approved. Our budget and supplementary budget include a number of permanent measures:

- No increase in real terms in the wage bill, to be achieved despite the higher wage payments through the ongoing rationalization of the defense sector;

- Savings of about HRK 700 million as spending on highway and road construction return to more reasonable levels;

- A reduction in the statutory limit to local government borrowing from 3 percent to 2 percent of last year's annual revenue.

- Measures to improve spending control in the health sector and prevent the re-emergence of significant payments arrears by hospitals, notably introducing expenditure planning and reporting by hospitals on a monthly basis, limiting the number of prescriptions per doctor refunded by the Health Institute, introducing a tender system for the procurement of the most expensive drugs, and benchmarking domestic drug prices to the average of the 5 lowest-cost EU members;

- Additional revenue of HRK 200 million from higher excises on cars and tobacco that will take effect on July 15;

- The re-introduction of the Financial Police, which will improve tax compliance and lead to better collections (although most of this impact will be felt starting in 2005).

Moreover, we expect HRK 2.1 billion from additional dividend payments from a number of public enterprises and higher-than-planned receipts from the concession of the third GSM license. Finally, we will reduce the annual lending plan of HBOR, which is essentially an arm of government policy, by HRK 200 million by a decision of its Supervisory Board by July 23.

12. **We are firmly committed to achieving this deficit target in 2004 and stand ready to take additional measures if necessary**. To safeguard our target, we plan to use any receipts from privatization or succession agreements beyond what is currently budgeted to reduce foreign debt rather than finance spending. If our measures in the health area do not achieve the intended objectives, we will increase co-payments for medical services and drugs, reduce the number of exemptions from co-payments, and introduce changes to the supplementary health insurance scheme to reduce outlays by November 1.

13. **The 2005 budget will aim at a general government deficit of 3.7 percent of GDP, with continued effort to limit HBOR's net lending**. To achieve this objective, we intend to contain the general government wage bill growth to no more than the rate of inflation; lower further investment on roads and highways in the context of the new four-year plans of the Highway and Road Agencies (HAC and HC); contain health system spending further on the basis of the measures taken in 2004; and reduce administrative costs of the Health, Pension, and Employment Funds. At the same time, we will have to start meeting the costs associated with harmonization with the *acquis communautaire* in the context of EU membership negotiations, which we expect to begin soon, as well as provide additional resources to the priority sectors of education and the judiciary. All told, we intend to lower general government current spending-to-GDP ratio by about 1 percentage point and total spending and net lending by 1¾ percentage point. These measures, together with the full-year effect of the higher excises on cars and tobacco and the impact of the Financial Police on collection, will offset at least half of the loss of this year's one-off revenues. We also plan to reduce HBOR's lending plans by an additional HRK 200 million compared to 2004.

14. **Next year, we also intend to start the medium-term process of tax reform**. Our government believes that the relatively high tax burden, particularly on capital and labor, acts as a break on Croatia's growth. Given the urgent need to restore order in our public finances, we have postponed the VAT rate reduction initially planned for 2005. But we are considering a number of changes with a view to reducing distortions, improving incentives, broadening the base, and supporting low-income earners, such as eliminating a number of personal income tax exemptions, reducing some tax rates, simplifying the taxation of reinvested profits, and reducing the number of goods subject to zero VAT rate. These or any other tax reforms in 2005 will be revenue-neutral so as not to jeopardize our overall deficit target.

15. **Budget financing will gradually shift to domestic sources**. This would reduce the government's exposure to exchange rate risk, boost the development of the domestic capital market, and may help absorb excess liquidity in the private sector. We aim at raising at least HRK 2 billion of domestic financing this year (about one-third of the general government's borrowing requirement), and raise this proportion in the coming years. Specifically, we will cancel the issuance of a new Samurai Bond planned for 2004 and postpone the syndicated foreign loan planned by HBOR in the fourth quarter. As regards 2005, we intend to shift the bulk of both central government and HAC and HC borrowing to domestic sources.

16. **We will limit the issuance of new government debt guarantees**. The outstanding stock of debt guarantees to entities outside the general government (including guarantees issued for HBOR loans) has grown to some HRK 19 billion (almost 10 percent of GDP). We will limit the issuance of new debt guarantees to a level of HRK 2.2 billion in 2004, with a view to keeping the stock of outstanding guarantees broadly constant at its present level during this year and gradually reducing it over the medium term.

17. **Finally, we intend to strengthen financial discipline and improve the performance of public enterprises.** The recent transactions by HŽ highlight the soft budget constraint under which public enterprises operate. We intend to cover all of HŽ's financing needs for operating and investment expenditures from the budget and finalize by end-December 2004 a medium-term business plan that will return the company on a sound financial footing. We are seeking the assistance of the World Bank in this area. We also intend to continue restructuring the state-owned shipyards, with a view to reducing their reliance on the budget and preparing them for privatization. Finally, we will continue the restructuring efforts in key public enterprises, notably Croatian Forests and the shipping company Jadrolinija, with a view to improving asset management, reducing personnel, and preparing these enterprises for privatization. To ensure that the public enterprise sector as a whole continues to improve its aggregate financial position, we will impose limits on the total borrowing of 8 large public enterprises for 2004 and 2005.

B. Monetary and Exchange Rate Policy

18. **The CNB has a secondary but nonetheless important role in reducing external vulnerability**. Given the openness of the economy, strong trade links with the euro area, large capital flows, and limited hedging opportunities for kuna holders, the CNB intends to pursue its price stability mandate by continuing to maintain the exchange rate of the kuna broadly stable against the euro. Coupled with the high degree of integration of Croatian banks and corporates with the international capital market, this limits the ability of the CNB to affect the level of economic activity, the current account deficit, and foreign debt.

19. **For the remainder of this year, the CNB will pursue its announced monetary policy targets**. CNB's monetary program for 2004 targets reserve and broad money growth at about 8–9 percent. Gross official reserves at end-2004 are projected at HRK 47 billion (equivalent to 4½ months of following year's imports of goods & nonfactor services or close to 200 percent of following year's maturing external debt), a level that we judge to be adequate for maintaining confidence in our policies. To achieve these targets and signal its commitment to the external objectives of the program, the CNB introduced as of July 1 a new marginal reserve requirement on borrowing from non-residents, to be kept with the CNB, and intends to maintain its Net Domestic Assets (NDA) below the level of HRK -3 billion for the remainder of the year. In the event of higher-than-expected capital inflows (aside from the usual seasonal fluctuations), the CNB will intervene in order to maintain broad exchange rate stability. Should liquidity in the system increase excessively or the balance of payments weaken significantly, the CNB will resume issuing CNB bills during the course of the year in order to meet the reserve targets under the program. In the event that massive private capital inflows threaten to

undermine macroeconomic stability, the CNB will consider, in consultation with the IMF, introducing price-based controls on capital movements.

20. **By the end of this year, the CNB, in cooperation with the Ministry of Finance, will establish technical prerequisites for the introduction of open market operations.** To facilitate the shift towards domestic financing of the government and develop the domestic financial market, we will work on establishing the necessary technical preconditions for the introduction of open market operations with government paper. In particular, the Ministry of Finance will complete the transfer of the Treasury bill registry to the Central Depository Agency by end-July 2004 and ensure that the registry is fully operational; and the CNB intends to begin open market operations by end-2004 and will implement delivery versus payment in real time by end-March 2005 at the latest. Both the CNB and the Ministry of Finance recognize the need for a close coordination on these issues.

C. Structural Reforms

21. **Structural reforms are a key part of our program in order both to supplement our macroeconomic policies and to prepare our economy for EU accession**. Most of these measures require consistent implementation over time and will only bear fruit in the medium and long term. But they are an important part of our vision for the Croatian economy because they will raise the long-term potential growth rate and prepare the country for competing within the EU. Moreover, some of these measures will facilitate the achievement of our short-term macroeconomic objectives. These reforms are thus a critical part of our program also for 2004–05, and most of them are incorporated in a three-year Programmatic Adjustment Loan (PAL) from the World Bank, expected to be agreed in early 2005.

Public finance reforms

22. **There is an urgent need to enhance transparency and efficiency in public expenditure and debt management**. The recent fiscal ROSC mission with the IMF and the World Bank-IMF technical assistance mission on public debt management have helped identify the major weaknesses in these areas. During the next 18 months, we intend to:

- make the single treasury account fully operational by eliminating bank accounts of the Deposit Insurance and Bank Rehabilitation Agency (DAB) by end-June 2005, the Privatization Fund (HFP) by end-September 2005 and the Highway and Road funds (HAC and HC) by end-December 2005, as well as introducing commitments-based reporting;

- prepare an action plan by end-October 2004 to implement the recommendations of the fiscal ROSC report currently under preparation;

- strengthen public debt management by appointing by end-June this year the Steering Committee that will oversee the implementation of improvement measures; restructuring the Debt Management department by end-September and strengthening staff and training by year-end; enhancing software support by end-August; and, following the recommendations of the IT expert and with support by the EU CARDS program, decide on a permanent software solution for debt management by end-2004;

- complete by end-2004 the register of government debt guarantees, including guarantees by local governments, and reconcile data with the CNB;

23. **We plan to set the annual budgets in the context of a medium-term fiscal policy framework**. A detailed, multi-year policy framework, with annual targets for the major expenditure programs and the policies to achieve these, would be the linchpin of our fiscal policy. It would inform public debate, illustrate policy tradeoffs, and allow making strategic choices rationally. It will also allow us to plan our medium-term tax and spending reforms with a view to achieving a substantial reduction in the share of government spending to GDP. Such a framework will also be necessary once negotiations with the EU start. As a first step, the government will prepare rolling three-year budgets starting with the preparation of the 2005 budget.

24. **The government is committed to ensuring the long-term sustainability of the pension system**. The recent change in the pension indexation formula, on which we will seek a formal interpretation by parliament by July 15, 2004, links pension increases to the change in average real wages in the economy. This will ensure that the share of pension spending to GDP continues to decline in the medium-term. We intend to honor the 1998 Constitutional Court decision on "pensioners' debt" to the extent it has not been covered by subsequent laws. To ensure a solution that is consistent with the country's ability to afford such payments, we have decided to use only state shares in enterprises or other types of equity. We plan to consult with the staff of the IMF and the World Bank before determining the details of this solution and moving to the implementation stage. More generally, we are strongly committed to reviewing all aspects of the pension system and continuing the reform process, in order to maintain its financial sustainability, stimulate private savings, and encourage financial market developments.

Privatization

25. **We will restore momentum in the privatization process**. Privatization will enhance the economic efficiency and growth potential over the medium term and help reduce foreign debt. The HFP aims at privatizing all companies in which the government holds a share of up to 25 percent by year-end and all remaining holdings in its portfolio by end-June 2005. Outside HFP's portfolio, we will resume efforts to restructure and privatize large state enterprises. In particular, the government will sell at least 15 percent of the oil company (INA) by end-2005 and will formulate the plan on privatization of the insurance company (CO) by end-June 2005 and complete the third phase of privatization of the telecommunication company (HT) by end-December 2005. Finally, the government will disengage from Croatia Banka by end-June 2005 and consider the options for privatization or a strategic partnership for HPB.

Other structural reforms

26. **Finally, the government will take steps to improve the business environment, financial sector supervision, and statistics**.

- In the context of the World Bank PAL, we will implement reforms in the judiciary (including improving and computerizing the operation of courts, training court personnel, improving the operation of the cadastre and eliminating backlogs in land registration) and in public administration (including reforming the salary scale and introducing performance-related pay).

- The government intends to unify the supervision of nonbank financial intermediaries. In this context, it will appoint a Working Group by September 2004 to prepare this ambitious reform, and draft new laws on insurance and on investment funds to be adopted by end-2005.

- The CNB will step up its efforts to supervise banks' credit risk resulting from their borrowers' exposure in foreign exchange.

- We will make additional efforts to improve balance of payments statistics, where serious deficiencies hamper the analysis of external developments. We intend to request technical assistance from the IMF to help address this urgent problem.

27. Under our program, we will not impose or intensify restrictions on the making of payments and transfers for current international transactions, introduce or modify multiple currency practices, conclude bilateral payments agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement, or impose or intensify import restrictions for balance of payments purposes, nor will we accumulate external payments arrears.

Table 1. Croatia: Key Macroeconomic Indicators, 2001-05

	2001	2002	2003 Est.	2004 Prog.	2005 Prog.
			(Percentage change)		
Output, unemployment, and prices					
Real GDP	4.4	5.2	4.3	3.7	4.1
Unemployment (survey based, in percent)	15.8	14.8	14.3	...	...
CPI inflation (average)	4.9	2.2	1.8	2.5	2.9
			(In percent of GDP)		
General government and HBOR operations 1/					
General government revenues	44.0	46.3	46.4	47.4	46.5
General government expenses and net lending	50.7	51.4	52.7	51.9	50.3
Overall general government balance	-6.7	-5.0	-6.3	-4.5	-3.7
Overall HBOR balance (net of budget transfers)	-0.4	-0.2	-0.7	-0.5	-0.5
Fiscal and quasi-fiscal balance	-7.1	-5.2	-7.0	-5.0	-4.2
General government debt	40.1	39.8	41.5	41.7	40.6
			(End of period; change in percent)		
Money and credit					
Credit to the nongovernment sector	24.5	31.3	14.7	14.3	...
Broad money	45.2	9.5	11.0	9.4	...
Base money	36.0	26.4	23.8	17.9	...
			(End of period; in percent)		
Interest rates					
Average deposit rate	2.8	1.6	1.7	1.7 4/	...
Average credit rate	9.5	10.9	12.0	11.8 4/	...
			(In percent of GDP)		
Balance of payments and external debt					
Current account balance 2/	-3.7	-8.4	-6.1	-5.6	-5.0
Total external debt (end of period)	57.1	61.4	74.5	76.8	76.8
Net external debt (end of period) 3/	21.6	25.6	31.6	36.0	36.9

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

1/ Prior to 2002 on GFS 1986 basis and from 2002 on GFS 2001 basis with net lending and government-guaranteed loans to the railway company included in expenses and all privatization in financing.

2/ Break in the series in 2002 due to a change in methodology of estimating the costs of insurance and freight, which led to an upward revision of the current account deficit by 1.3 percent of GDP.

3/ Net of gross official reserves and commercial bank assets.

4/ As of April 2004.

Table 2. Croatia: Monitoring the Implementation of the Program

Prior actions	
1. The supplementary 2004 budget to be adopted by parliament.	MEFP, Para. 10
2. The Supervisory Board of HBOR to reduce its annual lending plan for 2004 by HRK 200 million.	MEFP, Para. 11
Quantitative performance criteria	
1. Quarterly limits on the cumulative deficits of the consolidated general government.	TMU, Section I
2. Quarterly limits on the cumulative changes of the stock of general government arrears.	TMU, Section II
3. Quarterly limits on the cumulative deficits of HBOR.	TMU, Section III
4. Quarterly limits on the cumulative amount of the contracting of nonconcessional external debt by the general government and HBOR with sublimits on contracting of such debt with a maturity of up to 1 year.	TMU, Section IV
5. Quarterly limits on the cumulative issuance of guarantees extended by the general government.	TMU, Section V
6. Quarterly floors under the cumulative changes of the net international reserves of the CNB.	TMU, Section VII
7. Quarterly limits on the cumulative changes of the net domestic assets of the CNB.	TMU, Section VIII
Indicative Limits	
1. Quarterly limits on the cumulative increase in the total debt stock of selected public enterprises.	TMU, Section VI
Structural performance criterion	
1. Government to prepare rolling three-year budgets starting with 2005-07 by end-September 2004.	MEFP, Para. 23
Continuous Performance Criteria	
1. No new external payments arrears.	MEFP, Para. 27
2. No new, or intensification of existing, restrictions on the making of payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments reasons.	MEFP, Para. 27

Table 2. Croatia: Monitoring the Implementation of the Program (Concluded)

Structural benchmarks	
1. Government to formulate a medium-term business plan on HŽ by end-December 2004 to reduce its reliance on subsidies and improve cost recovery.	MEFP, Para. 17
2. Government to eliminate bank accounts of DAB by end-June 2005, HFP by end-September 2005, and HAC and HC by end-December 2005.	MEFP, Para. 22
3. Government to restructure the Debt Management department of the Ministry of Finance by end-September 2004.	MEFP, Para. 22
4. Government to complete the register of government debt guarantees, including guarantees by local governments, and reconcile data with the CNB by end-December 2004.	MEFP, Para. 22
5. Government to formulate a plan on privatization of CO by end-June 2005 and complete the third phase of privatization of HT by end-December 2005.	MEFP, Para. 25
6. Government to appoint a Working Group by end-September 2004 to prepare the reform to unify the supervision of nonbank financial intermediaries.	MEFP, Para. 26

TECHNICAL MEMORANDUM OF UNDERSTANDING

I. LIMITS ON THE CUMULATIVE DEFICITS OF THE CONSOLIDATED GENERAL GOVERNMENT

	Ceilings (In millions of kuna)
Cumulative changes from December 31, 2003:	
September 30, 2004	8,100
December 31, 2004	9,250

1. The above ceilings on the cumulative deficit of the consolidated general government are on a GFS2001 basis (including net lending) and cover: (i) central government operations, that is, the central government budget (the Office of the President, the parliament, the government, the constitutional court, all ministries, other independent state administration and judicial bodies); (ii) existing central budgetary funds (health, pension, employment, and water management) and agencies (the agencies for state aid, for investment and export promotion, and for small and medium-sized enterprises); (iii) the highway (HAC) and road (HC) construction and maintenance agencies, the privatization fund (HFP), the bank rehabilitation and deposit insurance agency (DAB), and the Environment Protection Fund; and (iv) the 53 largest local governments (20 counties, Zagreb, and 32 other cities). The government does not intend to establish new budgetary or extrabudgetary funds or agencies during the program period, but any new funds or agencies would be covered by the ceilings.

2. The September 30, 2004 ceiling above will be adjusted upward by HRK 2,283 million in case the dividend payment by the telephone company (HT) expected in 2004 is not received by September 30, 2004.

3. For purposes of the program, the deficits of the consolidated central and general governments will be defined on a modified accrual basis with cash data corrected for changes in outstanding stock of central and local government arrears and commitment based spending reported for HAC and HC.

4. Fiscal performance will be monitored monthly at the consolidated central government level covering (i)-(iii) defined above and tested quarterly at the consolidated general government level covering (i)-(iv) defined above with the test dates for 2004 being September 30 and December 31. The Ministry of Finance will provide data for consolidated central government on a monthly basis within 30 days from the end of the month and data for local governments every 3 months within 30 days from the end of the month.

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

	Ceilings (In millions of kuna)
Stock as of December 31, 2003	957
Cumulative changes from December 31, 2003:	
September 30, 2004	-100
December 31, 2004	-300

5. Arrears include (i) all payments overdue according to their original or modified terms; and (ii) any promissory notes issued by the Ministry of Finance and the central budgetary funds. Arrears comprise both domestic and external payments arrears and are not netted out by government cash holdings in banks. The stock of arrears will be provided monthly to the Fund by the Ministry of Finance within 30 days. Arrears monitored under the SBA are limited to arrears extended by the general government to all entities outside the general government. In case the general government assumes responsibility for arrears extended by entities outside the general government (e.g., hospitals), such arrears will be treated as expenditures of the general government at the time they are taken over by the government.

III. Limits on the Cumulative deficits of HBOR

	Cumulative Limits (In millions of kuna)
Cumulative changes from December 31, 2003	
September 30, 2004	823
December 31, 2004	1,093

6. The above ceilings on the cumulative deficit of HBOR are on a GFS1986 basis with revenues comprising interest receipts, fees, and other lending-related revenues, and expenses comprising wages, use of goods and services, interest payments, net lending, and capital spending. The ceilings are adjusted downward for central government transfers.

7. Fiscal performance by HBOR will be monitored on a monthly basis and tested on a quarterly basis with September 30 and December 31 being the test dates for 2004. HBOR will provide data on a monthly basis within 30 days of the end of the month.

IV. CEILINGS ON THE CONTRACTING OF NONCONCESSIONAL EXTERNAL DEBT BY THE GENERAL GOVERNMENT AND HBOR

	Ceilings (In millions of euros)	
	Ceilings	Subceilings ≤1 year
Cumulative changes from December 31, 2003:		
September 30, 2004	1,336	0
December 31, 2004	1,566	0

8. For program purposes, the term “debt” is understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services at some future points in time; these payments will discharge the principal and/or interest liabilities under the contract. (For details of definition of debt, refer to “Guidelines on Performance Criteria with respect to External Debt in Fund Arrangements” (IMF Executive Board Decision No. 12278—[00/86], August 25, 2000).

9. The limits on short-term debt do not apply to normal import-related credits and nonresident deposits in state-owned banks (HPB, HBOR).

10. Concessional loans are defined as those with a grant element of at least 35 percent, using currency-specific discount rates based on the six-month average commercial interest rates reported by the OECD (CIRRs) for loans with maturities of less than 15 years, and on the 10-year average CIRRs for loans with maturities of 15 years and more.

11. The ceilings will be raised by the amount by which the government retires existing debt before its scheduled maturity.

12. Debt falling within the limits shall be valued in euro at the following exchange rates (in euro per unit of foreign currency) at the end of the quarter in question:

Kuna	0.13
Japanese yen (100)	0.88
U.S. dollar	0.81
Pound sterling	1.50
Swiss franc	0.63
SDR	1.20

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

V. Limits on the Cumulative issuance of debt guarantees extended by the General Government

	Ceilings To all entities outside the consolidated general government (In millions of kuna)
Stock of outstanding guarantees as of December 31, 2003	17, 964
Cumulative issuance from December 31, 2003:	
September 30, 2004	2,000
December 31, 2004	2,200

14. Cumulative issuance of debt guarantees listed above will be measured at the exchange rates listed in Section IV. The above limits cover debt guarantees issued by the general government to entities outside the general government as well as guarantees extended for HBOR's lending to entities outside the general government. The limits do not cover guarantees extended to HBOR's borrowing from entities outside the general government. In case some of these loans are dropped from guarantee register because the government takes over the liability, the ceilings will be adjusted downward by the amount of amortization due to these loans from the time of debt assumption to the end of the year.

15. Guarantee issuance will be monitored on a monthly basis and the Ministry of Finance will provide data within 30 days from the end of the month. Performance will be tested on a quarterly basis and in 2004 with September 30 and December 31 as test dates.

VI. Indicative Limits on the Net Borrowing of Selected Public Enterprises

	Indicative limits (In millions of kuna)
Cumulative flows from December 31, 2003:	
September 30, 2004	90
December 31, 2004	0

The above listed indicative aggregate limits cover the following 8 enterprises:

1. Hrvatska Elektropriveda, Zagreb (Croatian Electricity Company)
2. Hrvatske Željeznice, Zagreb (Croatian Railroads)

3. Hrvatske Šume, Zagreb (Croatian Forests)
4. HP, Zagreb (Croatian Post)
5. HRT, Zagreb (Radio and Television Company)
6. Jadrolinija, Rijeka (Shipping Line)
7. Croatia Osiguranje, Zagreb (Insurance Company)
8. Croatia Airlines, Zagreb

16. These cumulative flows do not include transfers or net lending by the general government or amortization of debt of these enterprises taken over by the general government and included in the budget; they include borrowing by HBOR.

17. Enterprises on the above list in which the government's share falls below 50 percent in the course of the arrangement will be removed from the limits and the limits will be adjusted downward by the amount of the net borrowing of these enterprises by the end of the month preceding privatization. The limits will be adjusted by the amount of any government assumption of their debts.

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

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

	Floors (In millions of euro)
Stock as of December 31, 2003	6,188
Cumulative changes from December 31, 2003:	
September 30, 2004	12
December 31, 2004	-138

19. For purposes of the program, net international reserves of the Croatian National Bank (CNB) are defined as the euro value of gross foreign assets minus gross foreign liabilities minus off-balance sheet foreign currency obligations.

20. For purposes of the program, gross foreign assets shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the CNB. Any return to the CNB of blocked foreign assets that are not part of CNB foreign assets as of December 31, 2003 will be added to the reserve floor. Reserves that are pledged, frozen or used as collateral shall be excluded from the gross foreign assets. In particular, any reserve assets pledged to secure government debt will be excluded from the reserves definition.

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

22. The net forward position of the CNB is defined as the difference between the face value of foreign currency-denominated CNB off-balance sheet claims on nonresidents (forwards, swaps, options, and futures market contracts) and foreign currency obligations to both residents and nonresidents. This position was zero on December 31, 2003. For program purposes, only the off-balance sheet obligations will be deducted from the CNB's net international reserves position. These liabilities amounted to zero on December 31, 2003.

23. For the purpose of program monitoring, the stock of reserve assets and liabilities for each quarter in question will be valued in euro at the exchange rates specified in Section IV.

24. For purposes of the program, the end-of-quarter net international reserves of the CNB are calculated as the arithmetic average of 11 observations centered on the last business day of each quarter.

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

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

	Ceilings (In millions of kuna)
Stock as of December 31, 2003	-10,035
Cumulative changes from December 31, 2003:	
September 30, 2004	4,785
December 31, 2004	6,945

26. The net domestic assets of the Croatian National Bank (CNB) are defined as the difference between the base money and the net international reserves of the CNB (as defined for program purposes in Section VII), both expressed in local currency at program exchange rates (see Section IV). Base money is defined as currency outside banks, vault cash of banks, giro and required reserve deposit of banks in domestic currency, deposit money, required reserve deposit of banks in foreign currency, restricted deposits, and escrow deposits held at the CNB.

27. The September 30, 2004 ceiling above will be adjusted upward by HRK 2,283 million in case the dividend payment by the telephone company (HT) expected in 2004 is not received by September 30, 2004.

28. If reserve requirement ratio and/or the definition of liabilities subject to reserve requirements is changed during the program period, the CNB will consult with the Fund to modify the above limits appropriately.

29. For purposes of the program, the net domestic assets of the CNB and the base money at the end of each quarter will be calculated as the arithmetic average of 11 observations centered on the last business day of the quarter.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/90
FOR IMMEDIATE RELEASE
August 12, 2004

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

IMF Concludes 2004 Article IV Consultation with the Republic of Croatia

On August, 4, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.[1]

Background

Croatia has established a record of solid growth and low inflation since the mid-1990s: real GDP growth has averaged about 4.5 percent with inflation in the low single digits. This performance compares well with the EU-15 and other Central and Eastern European countries (CEECs). Structural reform has also advanced and the private sector is vibrant, although Croatia lags behind CEECs in terms of overall progress in this area, partly due to the war and disruptions in the early 1990s. This record has provided the basis for the recent decision by the Council of the European Union to grant candidate status to Croatia and start accession negotiations in early 2005.

This performance, however, was accompanied by a gradual worsening of the external position. Domestic investment has outpaced savings since the mid-1990s, resulting in persistent current account deficits. These trends accelerated after the turn of the decade due to a credit-financed surge in private domestic demand in 2001–02, and the current account deficit reached about 8.5 percent of GDP in 2002. As a result and despite Croatia's ability to attract high foreign direct

[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 and this PIN summarizes the views of the Executive Board.

investment (FDI) compared with other CEECs, private and public external debt gradually increased, facilitated by an investment grade rating and low world interest rates and spreads.

Although domestic demand pressures began to ease in the second half of 2003, fiscal discipline waned in the runup to the November elections. Both capital and current spending—particularly on highway construction, went significantly over budget, and there were sizeable off-budget fiscal operations, notably hidden subsidies to the Croatian Railways in the form of government-guaranteed loans. As a result, the fiscal deficit reached 6.3 percent of GDP in 2003 compared with the target of 4.5 percent, derailing the last Stand-By Arrangement. Monetary policy could only play a limited role due to the Croatian National Bank's (CNB) choice of exchange rate stability, the open capital account, and high degree of euroization. The CNB resorted to direct credit controls in January 2003. Although this may have dampened spending by households that do not have easy access to foreign borrowing, corporations were able to switch their borrowing from domestic to foreign borrowing and leasing.

Despite the fiscal relaxation and the largely unsuccessful effort of the CNB to control aggregate demand, bumper tourist receipts and the slowing of private consumption eased balance of payment pressures last year and the current account deficit declined to 6 percent of GDP. Due to continuing high capital inflows, however, external debt continued to increase, reaching about 74.5 percent of GDP in euro terms at end-2003. These trends have continued thus far in 2004: bank credit and import data confirm the moderate pace of aggregate demand and preliminary first quarter national accounts show a pickup in net exports. However, reflecting seasonally high financing needs, external debt rose further to 77 percent of GDP at end-May.

The new government, which has been in office since January, has resumed the fiscal consolidation effort, aiming at a general government deficit of 4.5 percent of GDP in 2004 and 3.7 percent in 2005, with a view to containing the external imbalance and keeping the external debt-to-GDP ratio broadly stable during these two years. The government also took steps to improve transparency in the fiscal accounts, rein in quasi-fiscal operations, and strengthen public expenditure and debt management. The CNB intends to continue playing a supporting role, managing closely domestic bank liquidity, and working with the Finance Ministry to introduce open market operations to facilitate the planned shift of government financing to domestic sources. To support their policies for 2004-05, the authorities have requested a new 20-month Stand-By Arrangement, which they intend to treat as precautionary.

Executive Board Assessment

Croatia's economic growth and inflation performance since the mid-1990s compares well with the CEECs, the economy is open, and structural reform is advanced—although Croatia still lags other CEECs in this area. This overall performance had contributed to the recent decision by the Council of the European Union to grant candidate status to Croatia and start accession negotiations in early 2005. While recognizing these achievements, Directors expressed concern over the persistently wide current account deficits and rising external debt-to-GDP ratio, which have over time increased significantly Croatia's external vulnerability.

Directors supported the authorities' overall strategy to deal with external vulnerability mainly through renewed fiscal consolidation. Most Directors agreed that the choice of a broadly stable exchange rate regime remained suitable for Croatia, provided that supporting policies are in place and the level of the exchange rate continues to promote competitiveness. Some suggested, however, that the appropriateness of the exchange rate regime should be reassessed as circumstances change.

Directors considered the envisaged fiscal adjustment for 2004–05 to be significant, but questioned its composition. A total fiscal and quasi-fiscal adjustment of 2¾ percentage points of GDP, while ambitious, was the minimum required to stabilize the external debt-to-GDP ratio around its current level by the end of 2005, in the context of the projected moderation of private domestic demand pressures. Directors commended the government's decision to postpone the reduction of VAT rates planned for 2005. However, they pointed to the need to further curtail current spending, which is high relative to other similar countries. They also regretted the reliance on one-off revenue measures in 2004, although they recognized that this was a response to the inherited burden from 2003 and the size of the planned adjustment. Directors cautioned that the authorities should be ready to take additional measures if the envisaged adjustment proves insufficient to reduce external vulnerability.

Directors welcomed the measures to enhance fiscal transparency and improve public expenditure and debt management. Weaknesses in these areas were major factors behind the sharp deterioration in the fiscal stance which derailed the previous Stand-By Arrangement. Directors underscored, in particular, the importance of controlling the issuance of government guarantees, introducing a single treasury account, and monitoring closely the financial performance of public enterprises.

Directors urged the authorities to articulate a medium-term expenditure plan. A detailed and comprehensive plan, underpinning far-reaching reforms of government spending, is a prerequisite for the successful implementation of the government's objectives of reducing Croatia's high tax burden, meeting the Maastricht deficit ceiling, and reallocating spending priorities in order to meet the EU-related needs. Directors recommended that these reforms should cover wages and the public administration, the welfare system, and subsidies.

Although monetary policy, in the context of the current exchange rate regime, was not an effective tool for managing aggregate demand, Directors felt it had an important supporting role to play by reining in the growth in bank liquidity and providing an enabling environment for fiscal consolidation. Directors welcomed the abolition of direct bank credit ceilings, which had done little to curb aggregate demand during 2003, as well as the CNB's plans to introduce, in cooperation with the Ministry of Finance, open market operations with government paper.

Directors noted the reassuring financial sector indicators, but recommended that the authorities remain vigilant to ensure that the system can withstand the risks associated with currency mismatches of borrowers and existing gaps in supervision. Directors encouraged the authorities to close gaps in nonbank financial supervision and improve cooperation between bank and nonbank, and domestic and foreign supervisors.

Directors encouraged the authorities to reinvigorate structural reform efforts. In particular, they urged them to accelerate privatization and give high priority to the restructuring of public enterprises, most urgently the railway company. They also stressed the need to improve the business environment with a view to preparing for competition within the EU.

Directors urged the authorities to improve the quality of economic statistics. Deficiencies in national account and balance of payments statistics, in particular, hampered surveillance and program monitoring.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Croatia: Key Macroeconomic Indicators, 2001–05

	2001	2002	2003 Est.	2004 Prog.	2005 Prog.
			(Percentage change)		
Output, unemployment, and prices					
Real GDP	4.4	5.2	4.3	3.7	4.1
Unemployment (survey based, in percent)	15.8	14.8	14.3	...	...
CPI inflation (average)	4.9	2.2	1.8	2.5	2.9
			(In percent of GDP)		
General government and HBOR operations 1/					
General government revenues	44.0	46.3	46.4	47.4	46.5
General government expenses and net lending	50.7	51.4	52.7	51.9	50.3
Overall general government balance	-6.7	-5.0	-6.3	-4.5	-3.7
Overall HBOR balance (net of budget transfers)	-0.4	-0.2	-0.7	-0.5	-0.5
Fiscal and quasi-fiscal balance	-7.1	-5.2	-7.0	-5.0	-4.2
General government debt	40.1	39.8	41.5	41.7	40.6
			(End of period; change in percent)		
Money and credit					
Credit to the nongovernment sector	24.5	31.3	14.7	14.3	...
Broad money	45.2	9.5	11.0	9.4	...
Base money	36.0	26.4	23.8	17.9	...
			(End of period; in percent)		
Interest rates					
Average deposit rate	2.8	1.6	1.7	1.7 2/	...
Average credit rate	9.5	10.9	12.0	11.8 2/	...
			(In percent of GDP)		
Balance of payments and external debt					
Current account balance 3/	-3.7	-8.4	-6.1	-5.6	-5.0
Total external debt (end of period)	57.1	61.4	74.5	76.8	76.8
Net external debt (end of period) 4/	21.6	25.6	31.6	36.0	36.9

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

1/ Prior to 2002 on GFS 1986 basis and from 2002 on GFS 2001 basis with net lending and government-guaranteed loans to the railway company included in expenses and all privatization in financing.
2/ As of April 2004.
3/ Break in the series in 2002 due to a change in methodology of estimating the costs of insurance and freight, which led To an upward revision of the current account deficit by 1.3 percent of GDP.
4/ Net of gross official reserves and commercial bank assets.

Press Release No. 04/170
FOR IMMEDIATE RELEASE
August 4, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves 20-Month Stand-By Arrangement for the Republic of Croatia

The Executive Board of the International Monetary Fund (IMF) has approved a 20-month Stand-By Arrangement in an amount equivalent to SDR 97 million (about US$141.3 million) for the Republic of Croatia to support the country's economic program. The Croatian authorities intend to treat the arrangement as precautionary and are not planning to draw funds under the credit.

The previous Stand-By Arrangement, which was also treated as precautionary, was approved on February 3, 2003 (see Press Release No. 03/13). It expired on April 2, 2004.

Following the Executive Board discussion of the Republic of Croatia on August 4, 2004, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"Croatia's economic growth and inflation performance since the mid-1990s compares well with the Central and Eastern European countries (CEECs), the economy is open, and structural reform is advanced. But this good performance has been accompanied by a worsening of Croatia's external current account deficit and rising external debt. These trends accelerated since the turn of the decade and have made Croatia vulnerable to external shocks. The authorities have recognized the extent of the external imbalance and should be commended for designing a set of policies to address it that emphasizes fiscal consolidation and supporting structural measures.

"The total fiscal and quasi-fiscal adjustment of 2¾ percentage points of GDP targeted for 2004-05 is ambitious. The government has shown its commitment by the decision to postpone the planned VAT rate reduction. But given the uncertainties surrounding the short-term outlook, the authorities should stand ready to adjust fiscal targets as needed to secure the macroeconomic objectives of the program.

"The measures to enhance transparency, control quasi-fiscal activities, and improve expenditure and debt management are welcome. To sustain the fiscal adjustment, the government will need to undertake significant expenditure reforms in the context of a medium-term expenditure plan. This would also enable it to achieve its goals of reducing the tax burden and adjusting spending priorities in order to meet EU accession-related needs. To achieve these goals, the government should focus on reducing the share of current spending, which is relatively high in Croatia.

"Exchange rate stability has worked well as the basis for monetary policy in Croatia. Although this choice constrains monetary policy, managing bank liquidity is still important in a bank-dominated financial sector. The Croatian National Bank (CNB) should continue to allow short-term exchange rate fluctuations and stand ready to take measures to safeguard its international reserves target. The plans to introduce open market operations and the commitment to close cooperation between the CNB and the Ministry of Finance are welcome.

"The financial sector seems to be in good health and supervision has been improved, but gaps remain. The CNB needs to increase the focus on the foreign exchange exposure of banks' customers. The authorities should also close gaps in nonbank financial supervision and improve cooperation between supervisors at home and abroad, considering the significant risk transfers from banks to other financial institutions and the high degree of financial integration with the rest of the world," Mr. Kato said

ANNEX

Recent Economic Developments

Since the mid-1990s, Croatia has recorded satisfactory GDP growth averaging 4.5 percent and inflation in the low single digits. These numbers compare well with the EU-15 and Central and Eastern European countries (CEECs).

However, a persistent gap between savings and investment since the mid-1990s has led to high current account deficits and a gradual build-up of foreign debt–trends that were fueled by a credit boom in 2001-02. Macroeconomic policies did not manage to contain the credit-financed surge in domestic demand and the external position deteriorated sharply during this period. The fiscal consolidation underway was not sufficient to offset the growth in private consumption and investment; and monetary policy was constrained by the Croatian National Bank's preference for nominal exchange rate stability and a very open capital account. As a result, the current account deficit rose sharply to 8.4 percent.

Private sector activity started moderating in the second half of 2003, but there was a sharp reversal of fiscal policy in the run-up to the November elections. As a result, the deficit jumped to 6.3 percent of GDP, derailing the last Stand-By Arrangement. Although the current account improved in 2003 due to large tourism receipts, external debt continued to rise reflecting strong capital inflows.

Program Summary

The government's program is designed, in the short term, to restore order in Croatia's public finances and limit the vulnerability arising from the high current account and external debt burden, and in the medium term, to modernize and reduce the role of the state, promote private sector activity, and prepare Croatia to compete within the EU.

Fiscal policy is the main instrument to achieve the objective of narrowing the gap between domestic savings and investment so as to reverse the trend of the external debt-to-GDP ratio over the medium term. On the assumption that non debt-creating capital flows would gradually decline over the medium term as privatization is completed, staff projects that a current account deficit of 5-5.5 percent of GDP in 2004-05 will gradually decline to about 4 percent in the medium term. This would first stabilize and then start reducing the external debt burden. The authorities also expect foreign direct investment unrelated to privatization, to get a boost from the prospects of EU accession.

In the short term, the government will aim at resuming fiscal consolidation and restoring transparency. The 2004 budget, including a supplementary budget approved by parliament in mid-July, targets a general government deficit of 4.5 percent to be achieved through an increase in revenues and, to a lesser extent, a reduction in investment. In 2005, the emphasis will shift to expenditure measures to reduce the deficit to 3.7 percent of GDP. Current spending will decrease by 1 percentage point of GDP, reflecting a lower wage bill as a result of ongoing reductions in personnel (mainly defense sector) and cost savings it the administration of public services. Budget financing will gradually shift to domestic sources, which will help reduce the government's exposure to exchange rate risk, boost the development of the domestic capital market, and help absorb excess liquidity in the private sector in the short run. In addition, the authorities intend to limit the issuance of new government debt guarantees, strengthen financial discipline, and improve the performance of public enterprise.

The government also sees the need for fiscal consolidation in a broader context. Restoring discipline and transparency in the public finances after 2003 is important not only from a macroeconomic point of view, but also for the accountability and credibility, domestically and abroad, of the state. For this reason, the consolidation effort would not only focus on reducing the government deficit, but also encompass quasi-fiscal operations, debt management, and the wider public sector. The government also sees consolidation in 2004-05 as the foundation for future measures to reduce the high tax burden in Croatia.

In regard to monetary policy, the CNB intends to pursue its price stability mandate by keeping the exchange rate of the kuna broadly stable agains the euro. It will pursue its 2004 targets for reserve and broad money growth at about 8-9 percent. To achieve these targets and signal its commitment to the external objectives of the program, the CNB introduced on July 1 a new marginal reserve requirement on foreign borrowing, and intends to maintain its Net Domestic Assets (NDA) below the level of negative HRK 3 billion for the remainder of the year. Further, the CNB plans to start open market operations (OMOs) with government paper to enhance liquidity management and facilitate the shift in government financing toward domestic sources.

On public sector reforms, the government is planning to take steps to enhance fiscal transparency and improve expenditure and debt management based on recent IMF and World Bank findings on major weaknesses in these areas. Further, the government plans to set annual budgets in the context of a medium-term fiscal policy framework, and ensure the long-term sustainability of the pension system. The authorities intend to restore momentum in the privatization process. The Privatization Fund (HFP) will aim at privatizing all companies in which the government holds a share of up to 25 percent by year-end and all remaining holdings in its portfolio by end-June 2005. Outside HFP's portfolio, the government will resume efforts to restructure and privatize large state enterprises. Finally, the government will take steps to improve the business environment, financial sector supervision, and statistics.

Croatia: Key Macroeconomic Indicators, 2001–05

	2001	2002	2003 Est.	2004 Prog.		2005 Prog.
Output, unemployment, and prices						
Real GDP	4.4	5.2	4.3	3.7		4.1
Unemployment (survey based, in percent)	15.8	14.8	14.3	...		...
CPI inflation (average)	4.9	2.2	1.8	2.5		2.9
General government and HBOR operations 1/						
General government revenues	44.0	46.3	46.4	47.4		46.5
General government expenses and net lending	50.7	51.4	52.7	51.9		50.3
Overall general government balance	-6.7	-5.0	-6.3	-4.5		-3.7
Overall HBOR balance (net of budget transfers)	-0.4	-0.2	-0.7	-0.5		-0.5
Fiscal and quasi-fiscal balance	-7.1	-5.2	-7.0	-5.0		-4.2
General government debt	40.1	39.8	41.5	41.7		40.6
Money and credit						
Credit to the nongovernment sector	24.5	31.3	14.7	14.3		...
Broad money	45.2	9.5	11.0	9.4		...
Base money	36.0	26.4	23.8	17.9		...
Interest rates						
Average deposit rate	2.8	1.6	1.7	1.7	4/	...
Average credit rate	9.5	10.9	12.0	11.8	4/	...
Balance of payments and external debt						
Current account balance 2/	-3.7	-8.4	-6.1	-5.6		-5.0
Total external debt (end of period)	57.1	61.4	74.5	76.8		76.8
Net external debt (end of period) 3/	21.6	25.6	31.6	36.0		36.9

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

1/ Prior to 2002 on GFS 1986 basis and from 2002 on GFS 2001 basis with net lending and government-guaranteed loans to the railway company included in expenses and all privatization in financing.

2/ Break in the series in 2002 due to a change in methodology of estimating the costs of insurance and freight, which led to an upward revision of the current account deficit by 1.3 percent of GDP.

3/ Net of gross official reserves and commercial bank assets.

4/ As of April 2004.

Statement by Jeroen Kremers, Executive Director for Republic of Croatia and Tihomir Stučka, Advisor to Executive Director
August 4, 2004

Introduction

Mid-2004, Croatia obtained candidacy status for EU membership, and accession negotiations will commence early 2005. Market analysts have already acknowledged this political and economic accomplishment; in July, S&P improved Croatia's outlook to positive from stable. The accession process will anchor future reforms and economic policies. These will be undertaken according to defined government plans, and it is foreseen that these plans are tackled within the framework of the requested precautionary Fund program and the World Bank Country Assistance Strategy to benefit from their effect in catalyzing good policies domestically, as well as to enhance external credibility and knowledge transfer. The authorities are aware of the remaining structural and economic weaknesses that need to be addressed fully. In particular, the fiscal slippages toward end-2003, when lack of monitoring and some excessive spending ended up in a higher-than-envisaged fiscal deficit. This has led partly to the increase in external debt and is addressed under the requested Fund program. *Hence, enhancing fiscal consolidation and transparency is at the core of the authorities' economic program to stabilize and subsequently reduce external debt, as demonstrated by the supplementary budget and the three-year rolling general government budget passed recently in parliament.*

EU accession

The country enjoys EU 'market economy status' and numerous issues related to the aquis communitaire have been resolved under the Stability and Association Agreement. **Therefore, entering the EU in 2007 appears feasible, albeit challenging**. Overall, the accession process will be conducive to advances in structural reforms in the legal, regulatory and judicial areas, to achieve harmonization with the EU and remove administrative obstacles. In the fiscal area, pre-accession funds are treated with caution. It is well understood that, while available pre-accession grants will ease the financing of expenditures, matching these funds is likely to lead to increased spending pressures to be compensated elsewhere.

Fiscal stance

The Fund program target is to stabilize and subsequently reduce overall external debt driven by the fiscal sector and private foreign-owned banks. Therefore, the primary goal is fiscal consolidation and public sector restructuring. In 2004, according to the supplementary budget, the **fiscal adjustment will amount to 1.8 percentage points of GDP**, with a deficit of 4.5 percent of GDP. By 2007, the deficit is to be reduced to 2.9 percent of GDP, notwithstanding the expenditure pressures related to EU accession.

Staff notices correctly that in the first year some short- and long-term revenue measures aid the fiscal adjustment, instead of additional restraint in current expenditures. There are several external aspects affecting adversely current expenditures, therefore rendering a different expenditure composition in 2004 difficult. *First*, to increase fiscal transparency, the Railway Company (HŽ) has been integrated into the budget, terminating the previous practice of financing parts of its current operations off-budget. *Second,* the authorities will need to provide the appropriate environment for the return of refugees, as agreed with the EU. *Third*, in the last quarter of 2003, the previous government raised the wage bill by 8 percent starting in 2004 without completing the downsizing of the administration. *Fourth*, hospital arrears accruing to previous years have had a significant impact on current expenditures. *Finally*, current spending is not as high as it may appear from the staff paper. The overall impression from the peer comparison in Table 8 (p. 35) is somewhat biased in that it incorporates countries which include the informal economy in their GDP. This is not the case for Croatia.

The authorities desire a Fund program with high ownership and high credibility, reflecting their own policies in Fund program conditionality. Hence, the 2004 budget is needed to stabilizing the fiscal stance, increasing transparency, and refocusing on domestic financing. In the next two years, this will be followed by deeper changes in the expenditures composition. In this regard, during the first six months of being in power, the government has undertaken several concrete measures. In the health sector, *30 new long-term savings* measures have been introduced mid-2004. The decision has been taken to *moderate capital spending.* More precisely, the new four-year motorway investment plan is set to be published end-2004 slowing down capital spending in the following years. Finally, *improvements in monetary and fiscal policy coordination* have taken root; the government has changed plans to issue samurai bonds, and instead issued bonds on the domestic market, albeit at higher interest costs. Institutional investors hold substantial amounts of the issued domestic debt, therefore having an impact on foreign indebtedness.

Structural measures

To gather public support for reforms, the government has adopted and is in the process of publishing plans for the period 2004 – 2007. These have four main pillars. The first pillar refers to the aforementioned *fiscal consolidation* and *enhanced transparency* including the Railway Company and other extra-budgetary institutions, most notably the Motorway Company and the Road Company, into the automated single treasury account by 2005. This will improve budget execution monitoring. The second pillar refers to *subsidy reductions* and *increased efficiency of the administration*. The authorities intend to decrease subsidies by 1.2 and the wage bill by 1.5 percentage points of GDP by 2007. The third pillar defines the reallocation *of budgetary means* to growth-enhancing sectors. This implies reallocating spending from the defense sector and capital expenditures for infrastructure to education and science. Furthermore, social and health spending will need to be significantly reduced and targeted more efficiently. Here, the second round of pension reforms and the health care reform will play a crucial role. Finally, the fourth pillar reflects *privatization* and *tax reform* plans. The plan is to restructure the public sector and reduce the overall tax burden, which is recognized as one of the elements impeding stronger greenfield investments.

Monetary policy

Financial intermediation has grown strongly in Croatia, and as a result, foreign-owned banks have a lion's share in mounting external debt. More precisely, US$ 720 million or 38 percent of the gross external debt increase in 2004 is associated with banks and their leasing companies. Despite this, credit growth in 2004 abated compared to 2003, portfolio quality has not deteriorated, and profitability remains high. In addition, since around 90 percent of the banking sector is foreign owned, it is widely accepted that risk management is advanced. In terms of banks' external indebtedness, loans from parent companies have long maturities. At the same time, non-resident deposits are unlikely to be prone to reversals, since parent banks are major regional players and, hence, walking away could involve exposure to reputational risk.

Nevertheless, the authorities are not proponents of the Lawson doctrine[1] - **in July, the CNB introduced a 24 percent unremunerated reserve requirement for new foreign borrowing**. Hence, from August onward, banks will have to deposit as reserves 24 percent of borrowing from abroad. This should assist the efforts of fiscal policy to stabilize overall external debt. The CNB has refrained more from intervening in the foreign exchange market compared to previous years, mostly to moderate appreciation pressures. Foreign exchange reserves are at comfortable levels of over 5 months of goods and services imports. Besides, in conducting monetary policy, the CNB continues to be geared toward building on an already strong track record of low and stable inflation. Finally, by end-2004, circumstances permitting, the CNB will introduce open market operations.

In sum, the authorities' intention is to lock in EU-membership expectations, reforms, and economic policies with Fund and World Bank program conditionality to pave the way to EU accession. Croatia has benefited in many respects from the close cooperation with the Fund over the years. Without this intense cooperation, obtaining the EU candidacy status would have been more difficult. In this regard, the authorities would like to thank management and staff for the ongoing open and fruitful discussions.

[1] The Lawson doctrine says that an increase in a current account deficit that results from a shift in private sector behavior should not be a matter of policy concern. On the other hand, the public budget balance is a matter of policy concern and the focus should be on this.