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

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

- the staff report for the First Review Under the Stand-By Arrangement and Requests for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases, prepared by a staff team of the IMF, following discussions that ended on June 6, 2005, 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 August 9, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of September 6, 2005 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its September 14, 2005 discussion of the staff report that completed the review and requests.

- 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*
Annex*
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.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

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

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

Approved by Reza Moghadam and Anthony Boote

August 9, 2005

The 20-month, SDR 97 million (26.6 percent of quota) Stand-By Arrangement, which the authorities treat as precautionary, was approved on August 4, 2004. At that meeting, the Executive Board also concluded the 2004 Article IV consultation with Croatia.

Discussions on the first review of the SBA took place during two missions in late 2004 (October 27–November 8 and December 2–13) and, after a delay of a few months requested by the authorities (resulting in a postponement of the Board meeting initially planned for March), during May 24–June 6, 2005. The missions comprised Messrs. Demekas (head), Eskesen, Konuki, Moore (EUR), Hilaire (PDR), and Ms. Mitra (MFD) and were assisted by Mr. Vamvakidis, Resident Representative in Zagreb. Staff met Prime Minister Sanader; Deputy Prime Ministers Hebrang and Polančec; Finance Minister Šuker; Sea, Tourism, Transport and Development Minister Kalmeta; Health Minister Ljubičić; Agriculture Minister Čobanković; Economy Minister Vukelić; Croatian National Bank (CNB) Governor Rohatinski; other senior officials; members of parliamentary committees; and representatives of political parties, trade unions, and the private sector. Mr. Stučka (OED) attended some of the meetings.

The missions had frequent contact with the media and engaged in other outreach activities. The authorities intend to publish this report and the attached letter to the Managing Director.

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

The EU's Stabilization and Association Agreement with Croatia entered into force on February 1, 2005. Croatia has been recognized as a candidate country but the EU has delayed the start of accession negotiations pending Croatia's full cooperation with the International Criminal Tribunal for the former Yugoslavia (Hague Tribunal).

The February 2005 on-site Safeguards Assessment concluded that the requirements of the safeguards policy are met. CNB financial statements comply with international standards and controls are comprehensive and detailed.

Contents Page

I. Recent Developments and Program Performance in 2004

1. **Real GDP growth averaged 3.8 percent in 2004, consistent with program projections, though it slackened somewhat in early 2005** (Table 1). The renewed fiscal adjustment effort under the program was reflected in a slowdown in public consumption and investment in the second half of 2004, largely compensated by continued steady growth of private consumption and investment. Data for the first few months of 2005 point to a modest weakening of activity, reflecting in part the lagged effects on the economy of higher oil prices. First quarter national accounts show real GDP growth slowing to a year-on-year rate of 1.8 percent, but these data are affected by the early Easter this year, which reduced working time in Q1 by 1½ percent compared to last year, thus exaggerating the measured slowdown. Other indicators—including industrial production, retail sales, and credit—also weakened in Q1 but rebounded in Q2 (Figure 1). The 12-month CPI inflation rate was 2.7 percent at end-2004. Despite higher oil prices and a temporary hike in early 2005 in the wake of winter storms, inflation has remained below 3 percent since May.

2. **The balance of payments improved beyond program expectations in 2004** (Figure 2). The merchandise trade deficit fell to 24 percent of GDP, an improvement of some 3 percentage points from 2003, on the back of strong exports. Recorded tourism receipts (almost 20 percent of GDP) were also slightly up from 2003 (Table 2).[1] The current account deficit declined to 4.5 percent of GDP, a full percentage point below program projections, although half of this overperformance reflected a one-off receipt of reinvested earnings from foreign subsidiaries of a large Croatian pharmaceutical company. External debt at end-2004 stood at 82 percent of GDP, the same as at end-May 2004 (the benchmark used in the program)[2] while at 38 percent of GDP, net debt was slightly lower than its end-May 2004 level. The good current account performance continued in early 2005, although external debt edged upwards as a result of strong capital inflows to domestic banks, reaching 83 percent of GDP at end-May.

3. **Policy implementation in 2004 was broadly in line with the program**. All end-September and end-December performance criteria (PCs) were met, some by sizeable margins, with the exception of the end-December target for the general government deficit

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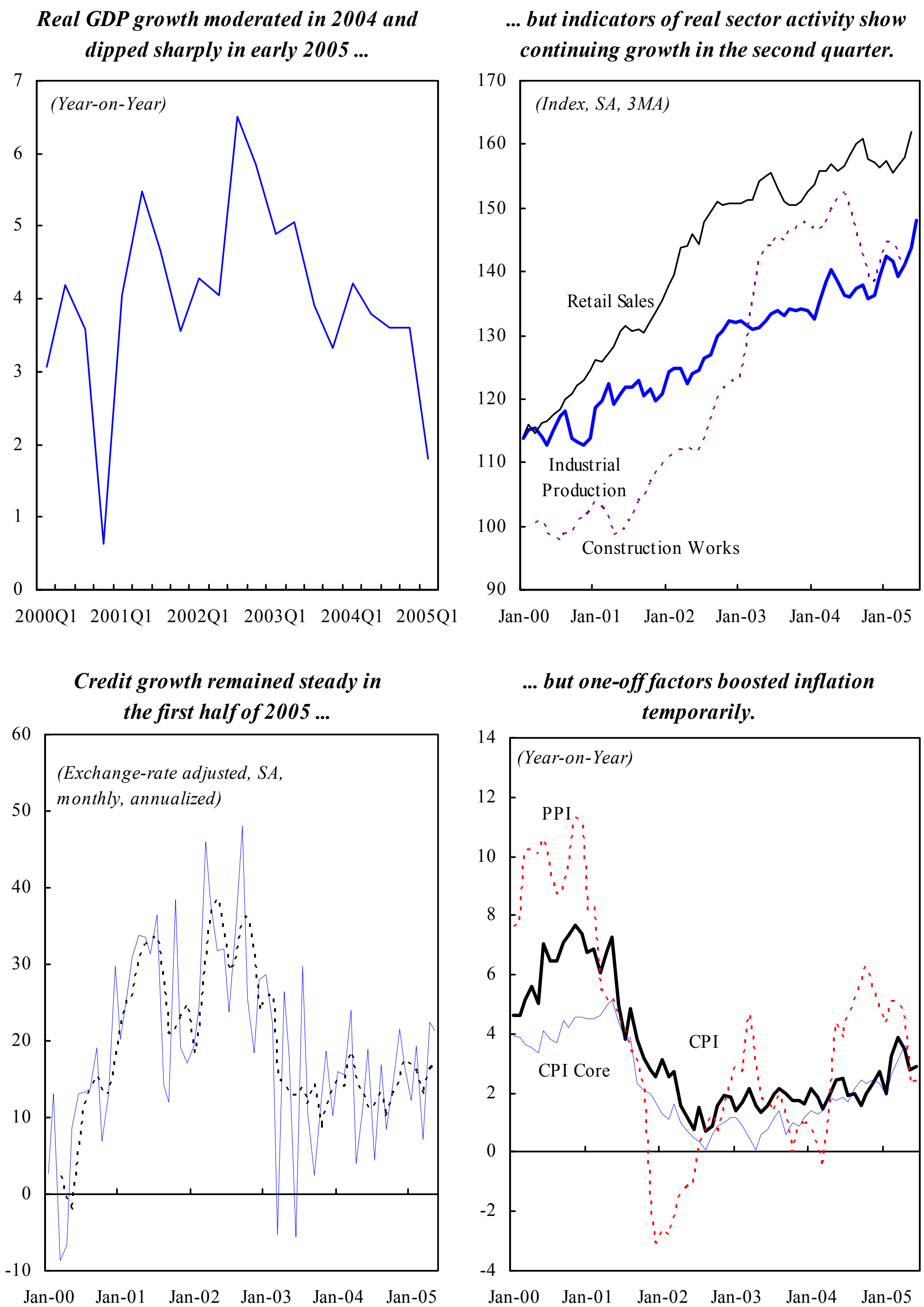
[1] Data on arrivals and overnight stays indicate that tourism performed better than suggested by current account data, which are subject to measurement errors. This is corroborated by the decline in (negative) errors & omissions by almost ½ percentage point of GDP in 2004.

[2] Last October, the CNB started compiling external debt data according to the requirements of IMF/WB/OECD/ EUROSTAT: *External Debt Statistics - Guide for Compilers and Users, 2003*. The inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals caused an upward adjustment in the external debt series of the order of 3 percentage points of GDP compared to the data reported in IMF Country Report No. 04/253.

Figure 1. Croatia: GDP and Selected High-Frequency Indicators, 2000-05

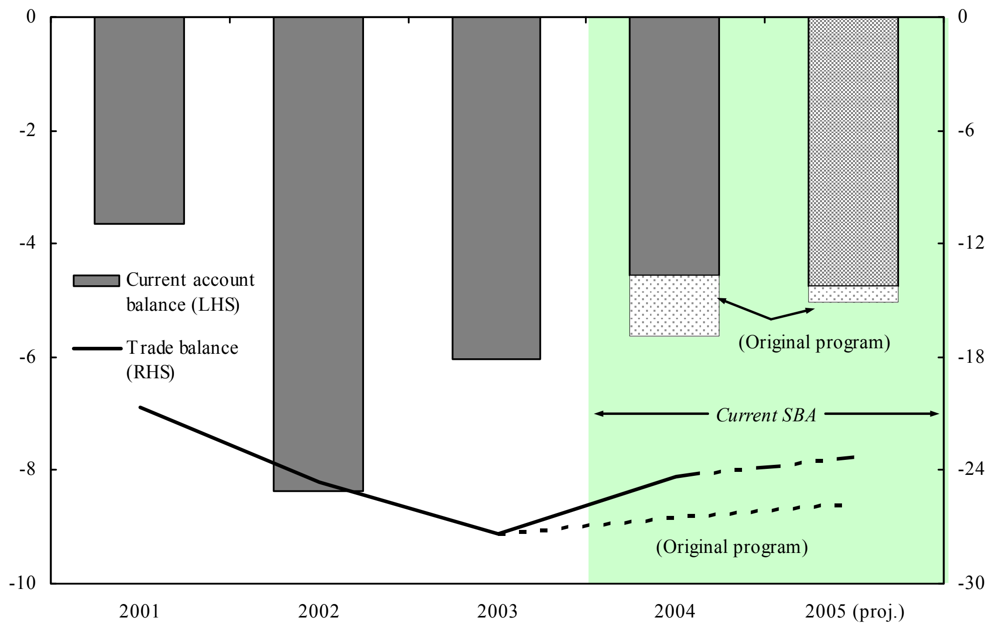


Source: Croatian authorities, and Fund staff calculations.

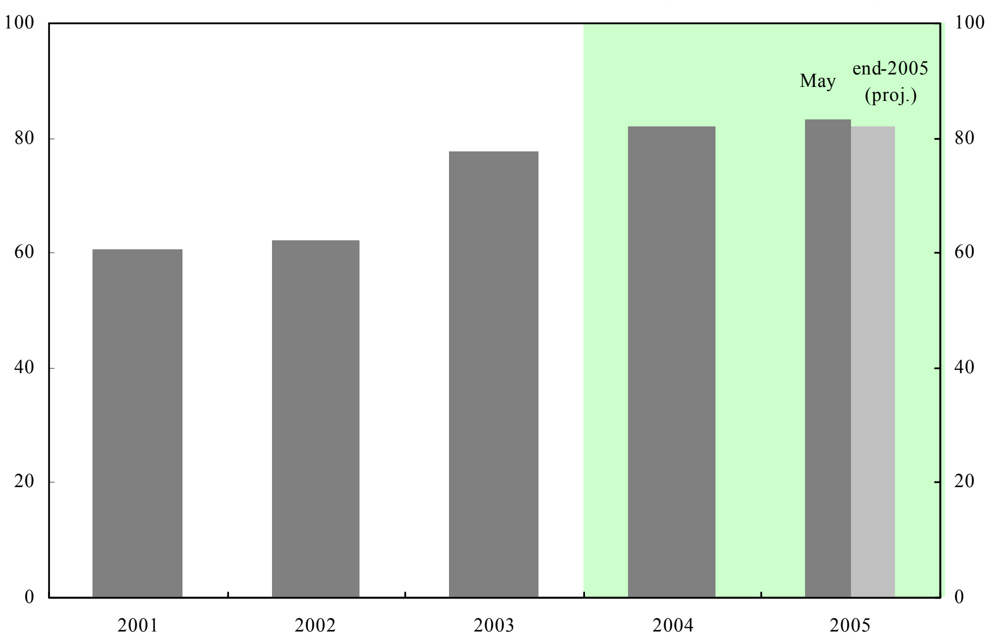
Figure 2. Croatia: External Developments, 2001-05

(In percent of GDP)

The balance of payments improved by more than programmed last year ...



... and external debt is still likely to stabilize this year.



Source: Croatian authorities, and Fund staff estimates.

and the end-September and end-December targets for the reduction of general government arrears (Table 3). One structural PC and three benchmarks were also met, although completion of a fourth benchmark was delayed.

- The general government deficit was reduced to 4.9 percent of GDP in 2004 from 6.3 percent in 2003, but fell short of the 4.5 percent target (Table 4). About 0.2 of a percentage point reflected a shortfall in some extraordinary one-off revenues anticipated in 2004, mainly dividends from the telecom company, while the rest was due to a slippage in tax collection; total expenditure was on target. Excluding one–off items, the fiscal slippage vis-à-vis the program was thus ¼ percent of GDP. Outside the general government, the balances (net of budget transfers) of the Croatian Development Bank (HBOR), whose operations are largely quasi-fiscal, and of public enterprises were reduced further than programmed.

- The targets on the reduction of general government arrears were missed by HRK 101 million at end-September and HRK 684 million at end-December as the overall stock increased instead of declining as programmed. This reflected an increase in health sector arrears, while other government arrears fell. At HRK 1.4 billion (0.7 percent of GDP), the total outstanding stock of government arrears remains relatively low.

4. **The buildup of arrears was symptomatic of more fundamental problems in the finances of the health sector**. Health sector arrears jumped in 2004, especially in the first half, though the authorities explained that this reflected the proper recording of overdue liabilities that had accumulated mainly in 2003. Measurement issues aside, the sector is faced with both overconsumption and inadequate cost control, evidenced by a relatively high public spending on health by regional standards. Though the government took measures to improve cost control in 2004 and early 2005 (Section II.C), health sector arrears have continued edging up.

Public spending on health, 2001
(In percent of GDP)

Croatia	**7.3**	Romania	4.7
EU average	**6.8**	Lithuania	4.3
Slovak Republic	7.0	Hungary	4.1
Czech Republic	6.6	Bulgaria	3.3
Slovenia	5.6	Latvia	3.2
Estonia	4.9		

Source: Staff estimates.

5. **For the first time, the authorities have set their macroeconomic program in the context of a medium-term framework**. Fiscal consolidation is the cornerstone, as monetary policy remains largely focused on maintaining the stability of the exchange rate vis-à-vis the euro (Section II.B). In preparation for EU accession, the government approved in December 2004 a medium-term Pre-Accession Economic Program (PEP) (Box 1). The PEP—Croatia's first—laid out a coherent macroeconomic framework and ambitious fiscal targets, also incorporated in a three-year rolling budget for 2005–07. These targets provided a appropriate medium-term perspective for the macroeconomic program supported by the SBA, meeting the key structural conditionality under the arrangement. The PEP was well received by the European Commission, who noted that the envisaged fiscal adjustment was "appropriate and encouraging", albeit lacking detail on specific policies.

Box 1. Croatia's Pre-Accession Economic Program

The PEP (http://www.mfin.hr/download.php?id=508) set as its main macroeconomic goal a reduction in external vulnerability and public debt, driven by a decline in the general government deficit to under 3 percent of GDP by 2007. The fiscal consolidation is to be achieved by expenditure rationalization focusing on the public administration, health system, subsidies, and social benefits, while the tax burden is to be gradually reduced. This would be supported by efforts to strengthen fiscal transparency and budget management. Moreover, privatization coupled with microeconomic reforms would aid fiscal consolidation and boost Croatia's growth potential. The macroeconomic framework underlying the government's plan—on which the staff was invited to comment—is very similar to the staff's medium-term projections underlying the program.

Authorities' Pre-Accession Economic Program 1/

(In percent of GDP unless otherwise stated)

	2004	2005	2006	2007
Real GDP (percentage change)	3.8	4.4	4.5	4.6
General government revenue	46.6	46.6	46.5	46.1
General government expenditure	51.6	50.4	49.6	49.0
Fiscal balance	-4.9	-3.7	-3.2	-2.9
Current account balance	-4.5	-5.1	-4.4	-3.8

Sources: Ministry of Finance and Fund staff estimates.

1/ 2004 is actual outcome and projected ratios are expressed in terms of the GDP projected by staff.

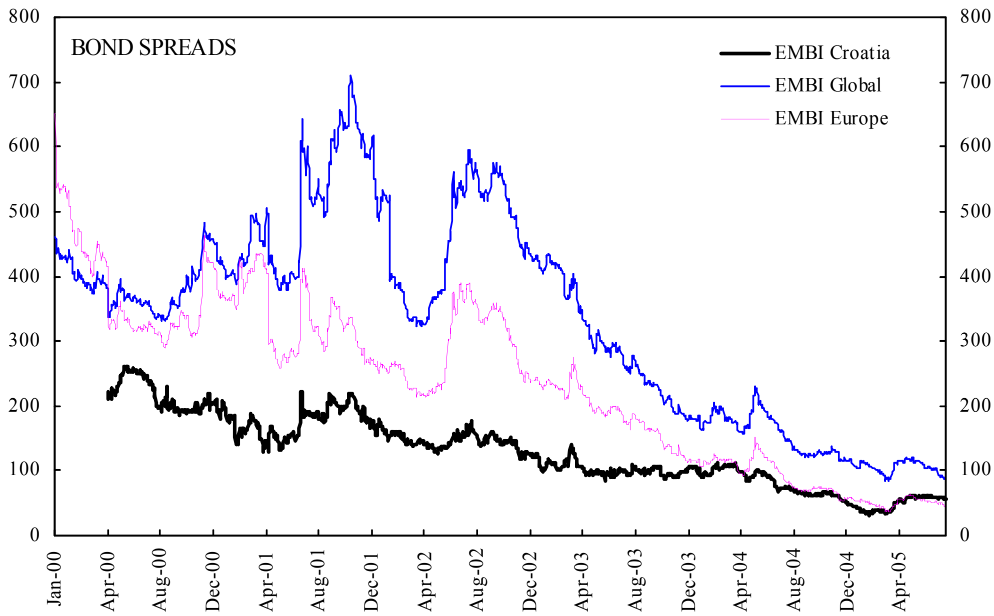
6. **The financial sector remains sound and market confidence strong**. Financial soundness indicators show a continuation of the overall strengthening of the banking system (Table 5), although foreign exchange-related credit risk remains high. International capital market developments have been generally favorable: bond spreads remain historically low (Figure 3) and Croatia has retained good access. In late 2004 S&P upgraded Croatia's sovereign foreign currency rating to BBB (Table 6), citing the track record of reforms in recent years and the ongoing stabilization of external debt. In July 2005, however, Fitch downgraded its outlook for Croatia from "positive" to "stable" due to the delay in EU accession negotiations and fiscal policy drift in the first half of the year.

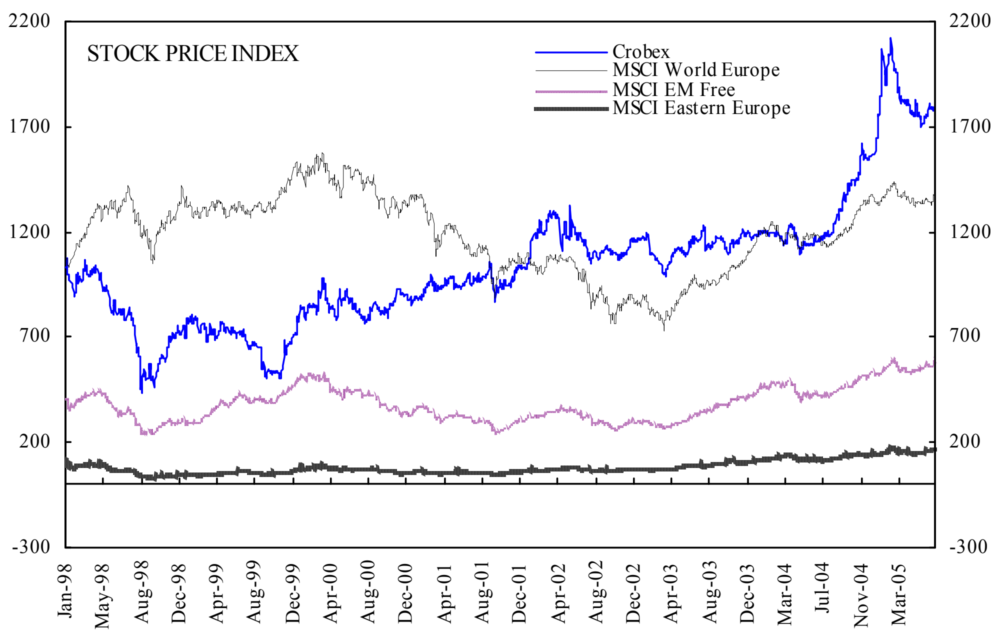
II. The Program for 2005

7. **The short-term outlook has worsened somewhat vis-à-vis the original program projections and policy implementation faltered in early 2005**. The original program envisaged a slight pickup in growth in 2005 to over 4 percent, but staff now expects growth to average around 3½ percent. This revised projection takes into account both the weak first quarter and the projected impact of the latest WEO oil price baseline (Box 2). Political constraints also complicated program implementation: presidential elections in January and local elections in May weakened the government's focus on economic policies in early 2005.

Figure 3. Croatia: Capital Market Conditions, 1998-2005
(In basis points)

Investor confidence remains at historically high levels.





Sources: JP Morgan; and Bloomberg.

As a result, fiscal policy slipped in the first few months of the year and completion of the first review was delayed.

Box 2. The Impact of Higher Oil Prices in 2005

The latest WEO oil price forecast for 2005 is 36 percent higher than that incorporated in the original program projections. Staff has estimated the likely first-round impact *ceteris paribus* on trade, growth, and prices compared to the original program baseline.

The value of net oil imports could be higher by 0.8 percent of GDP compared to program projections. These estimates are an upper limit, since they do not take into account potential feedback effects on domestic demand. They are in line with CNB projections and private sector simulations based on the Oxford Economic Forecasting Model.

Output growth would be dampened. In the short run, the impact on aggregate demand, and thus growth, would be equivalent to the 0.8 percent of GDP estimated above. Supply-side estimates, measuring the impact over a longer period of time, are lower: using a production function estimated for Croatia with capital, labor, and oil as inputs, and assuming that oil prices affect output with a six-month lag, staff estimates that growth in 2005 would be lower by 0.4 percentage points compared to the original program.

Oil Prices and the Croatian Economy

	2005
Volume (in millions of barrels)	
Oil exports	15.8
Oil imports	40.0
Net oil exports	-24.2
Average oil price (US$)	
Original program projections	37.3
WEO (June 6, 2005) - baseline	50.7
Change in value of net oil exports (percent of GDP)	-0.8
Impact on real GDP growht (in percent points)	-0.4
Impact on CPI inflation (in percent points)	1.7

Sources: CNB, WEO, and Fund staff estimates.

The consumer price impact could reach up to 1.7 percentage points. The total weight of oil products, heating, and transportation costs in the consumer price index is about 5 percent. This implies a level of prices in 2005 higher by 1.7 percent than program projections. Because this assumes full pass-through of world oil to domestic prices, they are likely to overestimate the actual impact in 2005.

8. **Policies have since been brought back on track, with a less ambitious fiscal target for 2005 as a whole but a significantly strengthened structural agenda**. Lower-than-expected growth and delays in policy implementation led the government to revise upwards the original 2005 fiscal deficit target. Therefore, to preserve the thrust of its medium-term strategy in the PEP, the government strengthened the structural component of its program this year, taking a number of measures (Section II.C). The authorities' program for 2005 is outlined in the attached letter to the Managing Director (Attachment I). Given the stronger-than-expected current account outlook, with rising exports compensating for the impact of higher oil prices on imports, this strategy remains consistent with the original program's ultimate macroeconomic objective: stabilizing and, over the medium term, reducing the external debt-to-GDP ratio. On the basis of the revised targets for 2005 and the medium-term plans in the PEP, staff's debt sustainability analysis suggests that the external debt ratio would be held at approximately its end-2004 level by end-2005 and start falling thereafter (Appendix I).

A. Fiscal Policy

9. **The original 2005 budget targeted a general government deficit of 3.7 percent of GDP**. The budget, discussed with staff during the first round of the review discussions and approved by parliament in November 2004, was burdened by reform and one-off costs of about ¾ percent of GDP, partly related to Croatia's program of harmonization with the EU (Annex ¶8).[3] To offset these, the budget cut other spending, primarily in the wage bill and pensions (the latter through a change in the base of pension indexation from wages to a price-wage composite planned for February 2005). On the revenue side, the budget was based on optimistic growth assumptions, and featured several revenue-neutral reforms to income taxes to remove distortions and improve compliance (Annex ¶8).

10. **But weak implementation in early 2005 and the changing economic circumstances made this budget target unattainable**. It quickly became clear that the pace of activity in 2005 would fall short of budget assumptions. Tax collections in late 2004 turned out below expectations, further eroding the tax base this year. Expenditures in the first quarter ran well above budget. And the change in the pension indexation formula—a key measure underlying the budget—did not take place as scheduled. Authorities and staff agreed that, in the absence of new measures, the deficit in 2005 could reach some 5 percent of GDP. The second round of review discussions thus focused on bringing fiscal policy back on track.

11. **In July 2005, parliament approved a supplementary budget with a revised general government deficit target of 4.2 percent of GDP**. The supplementary budget features updated revenue projections, adjustments in certain expenditure items that had been underbudgeted, and additional expenditure cuts totaling some HRK 1.5 billion (¾ percent of GDP) on goods and services, subsidies and grants, and investment (Annex ¶10). Consistent with the original program, budget financing would continue to shift to domestic sources in 2005, supplemented by privatization receipts. The authorities argued that the revised deficit target was justifiable from a macroeconomic point of view in light of the better-than-expected balance of payments and slower-than-projected growth. Staff agreed that the revised target was still consistent with the objective of stabilizing external debt, although its achievement was now perhaps more precarious. Staff also noted that about ¼ percentage point of GDP of revenue envisaged in the supplementary budget was an extraordinary dividend payment from a large partly state-owned company (unrelated to the one-off revenues planned but not received in 2004). The authorities argued that the one-off outlays burdening this year's budget, as well as the extent of slippage in the first half, made recourse to some one-off revenues necessary for the remainder of the year. Indeed the revised target preserved most of the adjustment envisaged in the original program: excluding one-off items in both revenues and expenditures, the underlying fiscal and quasi-fiscal adjustment

[3] Paragraph numbers refer to the Annex to the attached letter to the Managing Director (Attachment I), which supplements the original Memorandum of Economic Policies.

Fiscal and Quasi-Fiscal Operations, 2003-05
(In percent of GDP)

	2003	2004		2005		
		Prog. 1/	Actual	Prog. 1/	Original budget	Prog. revised
General government						
Revenues	46.4	47.1	46.6 2/	46.3	46.9	46.3
of which: one-off	...	1.0	0.8 2/	...	...	0.3
Expenditures	52.7	51.6	51.6	50.0	50.6	50.5
Current and net lending	46.8	46.1	46.5	45.2	45.5	45.6
of which: one-off	...	0.4	0.3	...	0.3	0.3
Investments	5.9	5.4	5.1	4.8	5.1	4.9
Balance	-6.3	-4.5	-4.9	-3.7	-3.7	-4.2
Quasi-fiscal						
HBOR balance (net of budget transfers)	-0.7	-0.5	-0.4	-0.5	-0.4	-0.4
Total fiscal and quasi-fiscal balance	-7.0	-5.0	-5.4	-4.2	-4.1	-4.6
Underlying balance (excluding one-off items)	-7.0	-5.6	-5.9	-4.2	-3.8	-4.6

Sources: Ministry of Finance; and staff estimates.
1/ GDP shares are calculated using most recent GDP estimates.
2/ Includes 0.1 percent of GDP in revenues accrued in 2004 but encashed in February 2005 (Table 4, footnote 1).

during 2004–05 would be 2.4 percentage points of GDP, compared to the 2¾ points envisaged in the program.

12. **At the same time, the government took a number of important structural measures that would take effect starting later this year and in 2006**. To address the problems in tax collection that emerged in 2004, the government, drawing on Fund technical assistance recommendations, took a number of measures to strengthen tax administration (Annex ¶11). Other structural measures taken in July include a new Civil Service law, prepared in consultation with the World Bank; introducing co-payments for health services, as the first step toward comprehensive health reform; curbing housing subsidies; promulgating the (delayed) change in the base of pension indexation from wages to a wage-price composite effective January 1, 2006; and introducing a reduced 10 percent VAT rate for all tourist accommodation, thus eliminating the zero VAT rate hitherto applying to foreign tour operators (Annex ¶12). The government also intended later this year to amend the State Aid law, finalize a medium-term subsidy reduction plan, and reduce employment subsidies. Staff welcomed these measures—many of which go beyond the original program commitments—because they provided reassurance that the government's medium-term targets were still achievable despite the slippage this year. Staff, however, questioned the introduction of a reduced VAT rate for tourist accommodation, which might complicate administration and trigger pressures to shift additional products off the standard rate. The authorities explained that it was not feasible to impose the standard 22 percent rate on foreign tour operators, a key export activity; argued that domestic and foreign operators should face a level playing field; and were confident that this measure would result in higher revenue in the long run.

13. **Efforts to strengthen financial discipline in the broader public sector remain an important component of the program**. Besides curtailing HBOR's operations further this year, the government intended to control closely contingent liabilities and public enterprise deficits and continue the restructuring of Croatian Railways (Annex ¶14). Staff questioned the need for issuing the additional government debt guarantees of HRK 2.9 billion (1.4 percent of GDP) planned for this year. The authorities explained that much of this was to facilitate the restructuring of the state-owned shipyards and pointed out that even with this increase, the stock of outstanding contingent liabilities would fall by about 1½ percent of GDP over 2004–05, consistent with the program.

B. Monetary and Financial Sector Policies

14. **Monetary policy would continue to play a supporting role in 2005**. The CNB is focused on exchange rate stability, while allowing for small, mainly seasonal, fluctuations. This policy has served Croatia well and remains appropriate.[4] Accordingly, the CNB can support macroeconomic management by avoiding an unwarranted liquidity injection that might trigger credit expansion. The CNB's monetary program envisaged broad money growth of 9–10 percent (Annex ¶15 and Table 7), based on projected gross official reserves of €6.7 billion at end-2005 that would maintain reserve coverage at 4.4 months of next year's imports. Base money growth and the corresponding net domestic assets targets under the program would be higher, however, reflecting changes to the reserve requirements (see below). The authorities and staff agreed that these targets were consistent with the macroeconomic objectives of the program for 2005.

15. **The successful launch of open market operations (OMOs) this year should help the development of the domestic money market**. After a slow start, banks have shown increasing interest in OMOs. The development of OMOs will facilitate the domestic financing of the government, as well as allow the CNB to pursue its long-term goal of a gradual reduction in the reserve requirement without jeopardizing liquidity management in the system.

16. **In addition, the CNB took a number of measures intended to discourage external borrowing**. Concerned at the pace of capital inflows to banks (especially foreign-owned subsidiaries with easy access to credit lines from parent banks), the CNB took a series of measures over the past year (Box 3). Staff saw the CNB's measures as prudent steps, since monetary instruments could be adjusted more quickly than fiscal policy—which was the key to longer-term external sustainability. But staff and the CNB agreed that these measures had severe limitations: they burdened the regulatory environment but their effectiveness would be limited as long as foreign borrowing remained profitable for banks. Moreover, they tended to divert borrowing to nonbank channels—indeed, lending by leasing companies has jumped by

[4] IMF Country Report No. 04/253 discusses in detail Croatia's choice of exchange rate stability as the anchor for monetary policy.

over 50 percent over the past two years (albeit from a very low base)—and increasingly induce clients to borrow abroad directly.

Box 3. Monetary Policy Measures to Curb Foreign Borrowing

Responding to rising external bank liabilities, the CNB introduced in August 2004 a marginal reserve requirement (MRR) on new bank borrowing from abroad, involving an unremunerated foreign currency deposit at the CNB related to the increase in banks' foreign liabilities from a base period (June 2004). The MRR was originally set at 24 percent, and has since been raised to 30 percent (February 2005) and 40 percent (May 2005). In addition, the CNB raised the kuna share[1] of the reserve requirement on foreign currency liabilities from 42 percent to 50 percent.

Under the program, the CNB has also taken measures supporting the government's efforts to switch from foreign to domestic financing. In October 2004, the CNB reduced the reserve requirement rate from 19 to 18 percent, releasing HRK 1.8 billion in bank liquidity to allow the government to refinance a maturing Samurai bond domestically. In February 2005, the CNB reduced the minimum coverage requirement of foreign exchange claims by foreign exchange liabilities from 35 to 32 percent, releasing HRK 4 billion for the domestic refinancing of a €500 million eurobond without crowding out other domestic borrowers.

[1] The general reserve requirement—as distinct from the MRR—applies to all bank liabilities. Reserves on kuna sources of funds are payable in kuna; reserves on foreign-currency sources are payable in a mix of kuna and foreign currency.

17. **The authorities made further steps toward strengthening financial supervision**. Given the high proportion of banking system activity denominated in or linked to euros, the authorities have continued to give priority to foreign exchange-induced credit risk. They plan several measures to strengthen the legal and supervisory framework of the financial sector. Legislation is forthcoming to establish a single nonbank financial supervisor from 2006, filling gaps in supervisory coverage, notably over leasing. Laws on Insurance, Accounting and Auditing, and Investment Funds are also pending. Finally, the CNB has made progress in finalizing Memoranda of Understanding with foreign supervisors (Annex ¶17).

C. Structural Policies

18. **The government has reinforced its structural reform agenda**. Progress is continuing on the agenda of the original program in the areas of fiscal management and privatization. Farther-reaching reforms have been set in motion in the areas of health, state aid and subsidies, public administration, and pensions (Box 4), several of which have been added to the program in the context of this review (Table 8).

19. **The measures in the area of health are aimed at addressing the financial situation in the sector and, over the medium term, rationalizing and reducing public spending on health**. Building on the cost control measures in 2004 and early 2005, the government launched a comprehensive reform to address the fundamental problems in the sector (Box 4 and Annex ¶19). Staff welcomed these plans: although their impact was hard to quantify, as it would depend largely on the consumers' response, they were likely to make a significant contribution toward addressing the pervasive problem of arrears and, over time,

Box 4. Strengthening the Program's Structural Agenda

In 2004 and early 2005, the government introduced a number of measures to improve cost control in the **health sector**, in part anticipated in the original Memorandum on Economic and Financial Policies. These included new patient identification cards, international benchmarking of drug prices, competitive bidding for costly medical supplies used by hospitals, unified procurement of drugs, and promotion of generic drugs. Moreover, in the summer of 2005, the government launched a major health reform in two stages (Annex ¶19) that goes well beyond the original program. As a first step, parliament approved in July administrative fees (co-payments) for medical services effective from October 2005. The authorities expect this to reduce public health spending annually by about HRK 500-600 million (¼ percent of GDP). The second stage of the reform, to be completed by year-end, will restructure the health insurance system, shifting the supplementary insurance scheme to the private sector.

The government has taken a number of measures to reduce **state aid and subsidies** beyond what was envisaged in the original program (Annex ¶12 and ¶21):

- an amendment to the law on building societies approved in July reduced the housing subsidy from 25 to 15 percent of housing savings;
- eligibility criteria for employment subsidies are to be tightened in August, targeting these to hires who have been unemployed for at least 6 months, rather than at least 30 days;
- the law on State Aid is to be amended by end-September, harmonizing procedures for disbursing state aid with EU requirements and strengthening the role of the Agency for Market Competition;
- a medium-term subsidy reduction plan, prepared in cooperation with the World Bank, is to be approved by end-September; and
- restructuring plans for state-owned shipyards and steel companies are to be finalized in cooperation with the European Commission by year-end.

Also going beyond the original program, parliament approved in July a new **civil service law** (Annex ¶12) that promotes efficiency and transparency by introducing a new job classification; clearly delineating political and administrative appointments; and strengthening the link of wages and promotion to performance.

Finally, instead of linking pensions to real wages as—against staff's reservations (IMF Country Report No. 04/253)—the government had envisaged in the original Memorandum on Economic and Financial Policies, parliament in July revised **the base of pension indexation** for both old-age and veterans' pensions, replacing nominal wages by a composite of prices and wages with equal weights ("Swiss formula") starting in 2006.

reducing the overconsumption of medical services and drugs. Staff and the authorities agreed that, given the scope of this reform, the widest possible political consensus should be sought to ensure its success.

20. **Other reforms are ongoing to continue improving fiscal transparency and debt management** (Annex ¶18). *First*, the Ministry of Finance and the CNB are finalizing an agreement on the procedures for the ongoing reconciliation of the registries of government debt guarantees. *Second*, to make the single treasury account fully operational, the authorities will eliminate the bank accounts of the Highway and Road Funds (HAC and HC) by end-December 2005, as envisaged in the original program. However, the authorities argued that they needed more time to eliminate the bank accounts of the Deposit Insurance and Bank Rehabilitation Agency (DAB) and the Privatization Fund (HFP), which they now plan to complete by end-June 2006. And *third*, on the basis of the recent fiscal ROSC findings, the government is making further improvements in debt management, data reporting, and internal audit.

21. **Despite legal delays, the authorities are persevering with the privatization process** (Annex ¶21). Although the original program envisaged completing by mid-2005 the sales of remaining government holdings in the Privatization Fund (HFP) and HFP's subsequent closure, this process has been delayed by a number of lawsuits against HFP. In these circumstances, the authorities' revised plan is to privatize one-third of all companies in which the government is the majority shareholder, and half of all companies in which the government retains minority stakes, by mid-2006. These plans are also supported by the World Bank's Programmatic Adjustment Loan, currently pending approval by the World Bank Board. In addition, the government is planning the sale of a 15 percent stake in the state oil company INA; the remaining stake in the telecommunications company HT; the Uljanik shipyard; and is preparing a plan for the sale of the insurance company CO.

22. **The recent decision to settle "pensioners' debt" provides closure to a long-standing problem but will add to domestic demand pressures starting in the second half of next year**. This state liability, arising from a 1998 Constitutional Court decision and currently estimated by the authorities at 7 percentage points of GDP, has been a long-standing burden that successive governments failed to address. On taking office, the current government vowed to resolve it—a commitment reflected in the original Memorandum of Economic and Financial Policies. It recently announced the basic elements of a scheme that gives eligible pensioners the option of a cash payment at a 50 percent discount during 2006–07 or full repayment during 2008–13 (Box 5). Although the first option—likely to be chosen by the majority of eligible pensioners—is advantageous for the budget in net present value terms, staff has expressed its concerns about the macroeconomic impact of transfers equivalent to 1-1½ percentage points of GDP in 2006 and 2007. Depending on the modalities of its financing, this scheme might also have implications for government cash flow and debt sustainability. Once the details of the government's scheme are finalized, this topic is expected to feature prominently in the discussions on the second program review.

Box 5. Repaying the "Pensioners' Debt"

The "pensioners' debt" arose from a 1998 Constitutional Court ruling that the state was liable for unpaid pension indexation entitlements during 1993-98. Although during that period pensions were legally indexed to nominal wages (the law was changed in July 1998), governments through various means capped indexation payments. The Court ruled that these practices did not override pensioners' entitlement to nominal wage indexation through June 1998. The liability resulting from the gap between entitlements and actual payments, which successive governments failed to address, became known as "pensioners' debt". The authorities now estimate that this liability, including accrued interest, amounts to HRK 13.8 billion (7 percent of 2005 GDP).

In July 2005, parliament approved a scheme to repay this debt. Each eligible pensioner will be offered a choice between cash payments of half the amount over 2006-07 or full repayment over 2008-2013. The government plans to finance these payments entirely through privatization receipts, and has created a special fund that will receive state shares in companies under privatization or other state assets and manage the repayment of "pensioners' debt". Details of the operation are to be finalized in the coming months.

III. Staff Appraisal

23. **The authorities' program has started bearing fruit**. The resumption of the fiscal consolidation effort contributed significantly to the improvement in the external accounts. Croatia's gross external debt—a major source of external vulnerability—increased by 15 percentage points of GDP in 2003, but the increase in 2004 was limited to about 4 percentage points. With further fiscal consolidation in 2005, the objective of broadly stabilizing the external debt-to-GDP ratio by end-2005 remains within reach. S&P's upgrade of Croatia's sovereign rating in late 2004 was indicative of improved market perceptions.

24. **For the first time, the authorities have set macroeconomic policies for 2004–05 in the context of a broader medium-term framework, whose targets are appropriate**. Croatia's first PEP features an ambitious and coherent set of targets for achieving and maintaining macroeconomic stability. It not only encompasses the core objective of this program—reducing external vulnerability—but more broadly aims at strengthening Croatia's capacity to respond to cyclical shocks and preparing the economy for EU membership.

25. **Although the easing of the pace of adjustment vis-à-vis the original program is regrettable, staff supports the revised 2005 fiscal deficit target of 4.2 percent of GDP**. Delays in policy implementation in early 2005 weakened the fiscal adjustment envisaged in the original program for this year. As a result, conclusion of this review has been delayed. The recently-approved supplementary budget brought fiscal policy back on track. It implies a total fiscal and quasi-fiscal adjustment (excluding one-off items) of 2.4 percentage points of GDP during the two years covered by the SBA, compared to the 2¾ percentage points originally envisaged. The difference appears small and, in view of the improvement in the balance of payments, unlikely to jeopardize the ultimate objective of the program. The revised deficit target this year relies on ¼ percent of GDP in one-off revenues that do not contribute to medium-term adjustment. Nevertheless, given its mid-year timing, the supplementary budget probably delivers the maximum adjustment feasible in the remainder of 2005 and leaves the PEP medium-term targets still within reach.

26. **The enhanced structural agenda, which should start having a significant fiscal impact next year, compensates for the slower-than-envisaged fiscal adjustment this year**. The major reform of the health sector addresses directly a hitherto chronic fiscal concern. Staff also welcomes the concrete steps to start rationalizing the extensive web of subsidies and state aid programs, as well as the politically difficult change in the pension indexation formula. Although the latter could not be implemented in time to deliver the savings envisaged in the original budget for this year, it is essential for the long-run sustainability of the public pension system.

27. **Difficult policy issues remain to be resolved at the time of the second review**. Discussions on the second review this fall will focus on the 2006 budget. This would not only need to advance the medium-term consolidation but also tackle the macroeconomic consequences from the resolution of "pensioners' debt", which could be considerable. Several fundamental reforms are still to be elaborated, including the restructuring of the steel and shipyard industries. And the second stage of the health reform is still unfinished. This is

a demanding agenda. But on the basis of the track record thus far under the program, staff believes that completing the first review affords the best prospects for sustaining the reform momentum into 2006.

28. **The CNB should remain vigilant in its monetary policy and banking supervision**. The CNB has been successfully striking a difficult balance between maintaining exchange rate stability while responding promptly to increases in bank external borrowing and addressing the attendant prudential risks. Staff welcomes the introduction of open market operations, supports the CNB's measures to curb external borrowing, and expects that these would have an increasing, albeit limited, impact in the rest of this year. In this context, it will be crucial for the CNB to continue enhancing its monitoring of the rest of the financial system and co-operate closely with the new nonbank supervisor scheduled to begin operations next year.

29. **The staff supports the authorities' requests for completion of the first review under the SBA, rephasing of the undrawn amount under the Arrangement, and waivers for nonobservance of end-December 2004 performance criteria** (PC). In staff's view, the small size of the fiscal slippage (excluding one-off measures) in 2004 and the corrective measures taken this year justify the waiver for the nonobservance of the PC on the general government deficit; and the determined policy action now evident in the health area justifies the waiver for the nonobservance of the PC on general government arrears. Because of the delay in completing the first review, the second review is now scheduled for February 2006. Access under the arrangement remains appropriate and the authorities' capacity to repay unimpaired.

Table 1. Croatia: Key Macroeconomic Indicators, 2001-06

	2001	2002	2003	2004	2005 Prog.	2006 Proj.
			(Percentage change)			
Output, unemployment, and prices						
Real GDP	4.4	5.2	4.3	3.8	3.4	3.9
Unemployment (survey-based, in percent)	15.8	14.8	14.3	13.8	...	...
CPI inflation (average)	4.9	2.2	1.8	2.1	3.0	2.5
			(In percent of GDP)			
Savings and investment 1/						
Domestic investment	...	34.3	32.8	33.3	33.8	34.4
of which: fixed capital formation	...	24.6	27.5	27.6	27.5	28.0
Domestic saving	...	26.0	26.7	28.7	29.1	28.9
Government	...	1.4	1.5	2.8	3.3	4.1
Nongovernment	...	24.6	25.2	25.9	25.8	24.9
General government and HBOR operations 2/						
General government revenues	44.0	46.3	46.4	46.6	46.3	46.5
General government expenses and net lending	50.7	51.4	52.7	51.6	50.5	49.6
Overall general government balance	-6.7	-5.0	-6.3	-4.9	-4.2	-3.2
Overall HBOR balance (net of budget transfers)	-0.4	-0.2	-0.7	-0.4	-0.4	-0.4
Fiscal and quasi-fiscal balance	-7.1	-5.2	-7.0	-5.4	-4.6	-3.6
General government debt	40.1	39.8	41.5	44.2	44.6	44.3
			(End of period; change in percent)			
Money and credit						
Credit to the nongovernment sector	24.5	31.3	14.7	12.8	11.8	…
Broad money	45.2	9.5	11.0	8.6	9.5	…
Base money	36.0	26.4	23.8	19.9	16.2	…
			(End of period; in percent)			
Interest rates						
Average deposit rate	2.8	1.6	1.7	1.8	1.7 5/	…
Average credit rate	9.5	10.9	11.5	11.4	11.4 5/	…
			(In millions of euros)			
Balance of payments						
Current account balance 3/	-812	-2,027	-1,538	-1,256	-1,402	-1,281
(In percent of GDP)	-3.7	-8.4	-6.0	-4.5	-4.8	-4.1
Capital and financial account	2,606	3,635	4,015	2,433	2,372	2,161
Overall balance	1,562	862	1,239	58	269	261
			(End of period; in millions of euros)			
Debt and reserves						
Gross official reserves	5,338	5,854	6,554	6,436	6,706	6,968
In months of following year's imports of goods and NFS	4.6	4.6	4.8	4.5	4.4	4.4
External debt service to exports ratio (in percent)	26.6	23.2	20.0	21.6	19.9	20.1
Total external debt (in percent of GDP)	60.7	62.1	77.6	82.0	82.0	81.6
Net external debt 4/	16.5	24.4	33.8	38.2	35.7	…

Sources: Croatian authorities, 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. Revenues in 2004 include HRK 197 million in GSM license fee received in February 2005, but pertaining to auction held in December 2004. Figures for 2006 are based on the December 2004 Pre-Accession Economic Programme (PEP). A revised PEP with new medium-term targets is under preparation and will be the focus of the second review.

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 percentage points of GDP.

4/ Net of official reserves and commercial bank assets.

5/ As of May 2005.

Table 2. Croatia: Balance of Payments, 2001–05
(In millions of euros, unless otherwise indicated)

	2001	2002 1/	2003	2004	2005 Proj.
Current account	-812	-2,027	-1,538	-1,256	-1,402
Merchandise trade balance	-4,578	-5,973	-6,994	-6,721	-6,863
Exports f.o.b.	5,314	5,292	5,579	6,599	7,141
Ships	316	373	397	439	437
Non-Ship exports	4,998	4,919	5,181	6,160	6,704
Imports f.o.b.	-9,892	-11,265	-12,573	-13,320	-14,004
Services and income	2,668	2,793	4,212	4,273	4,278
Transportation	187	173	252	245	263
Travel	3,046	3,205	5,045	4,998	5,084
Other services	43	-27	-297	-352	-402
Compensation of employees	143	168	184	234	240
Interest and investment income	-751	-725	-972	-852	-906
Current transfers	1,098	1,153	1,244	1,192	1,182
Credit	1,332	1,454	1,540	1,585	1,600
Debit	-234	-301	-296	-393	-418
Capital and Financial account	2,606	3,635	4,015	2,433	2,372
Capital account 2/	149	25	74	23	27
Financial account	2,457	3,610	3,941	2,410	2,345
Direct investment 2/ 3/	1,321	1,156	1,501	732	848
of which: privatization receipts	817	339	464	27	0
Portfolio investment	671	-464	853	501	-101
Medium- and long-term loans	191	835	2,363	1,698	951
Assets	46	-55	-24	12	0
Liabilities	145	890	2,386	1,686	951
Disbursements	1,999	2,630	4,281	3,645	2,824
Amortization	-1,853	-1,741	-1,894	-1,958	-1,873
Currency and deposits	525	1,761	-847	8	778
Short term capital flows (net)	-384	-88	458	-233	0
Trade Credits	134	410	-386	-296	-131
Net errors and omissions 4/	-232	-746	-1,239	-1,120	-700
Overall balance	1,562	862	1,239	58	269
Financing	-1,562	-862	-1,239	-58	-269
Gross reserves (-= increase)	-1,528	-725	-1,239	-58	-269
IMF (net purchases)	-34	-137	0	0	0
Exceptional financing	0	0	0	0	0
Memorandum Items					
Current account (in percent of GDP)	-3.7	-8.4	-6.0	-4.5	-4.8
Gross official reserves	5,338	5,854	6,554	6,436	6,706
in months of following year's imports of goods and NFS	4.6	4.6	4.8	4.5	4.4
Net international reserves	5,146	5,827	6,188	6,434	6,704
in months of following year's imports of goods and NFS	4.5	4.6	4.6	4.5	4.4
External debt 5/	13,458	15,055	19,811	22,675	24,172
External debt to GDP ratio 5/	60.7	62.1	77.6	82.0	82.0
External debt as a percentage of exports goods and NFS	125.0	134.5	149.9	157.4	156.7
Short-term debt by residual maturity in percent of gross official reserve	45.1	44.5	62.7	85.5	81.1
External debt service	-2,865	-2,601	-2,649	-3,113	-3,073
GDP (millions of euros)	22,177	24,220	25,526	27,627	29,489
GDP (millions of kuna)	165,639	179,390	193,067	207,082	220,869

Sources: Croatian National Bank, and Fund staff estimates.

1/ There is a 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 the 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 foreign subsidiary (see IMF Country Report No. 03/358, Appendix IV).

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

5/ In 2005, the central bank revised the methodology for estimating external debt. The inclusion of hybrid and subordinated instruments, repos, late interest and interest accruals has caused an upward revision of the historical series going back to 2001 by about 2 to 3 percentage points of GDP.

Table 3. Croatia: Performance under the Stand-By Arrangement, 2004-05

				End of	
				September 2004	December 2004
				(In millions of kuna, unless indicated otherwise)	
Quantitative performance criteria					
1	Cumulative deficit of the consolidated general government 1/		Program	10,383 4/	9,250
			Actual	9,091	10,446
			Margin (+)	1,292	-1,196
2	Cumulative change of the stock or arrears of the consolidated general government 1/		Program	-100	-300
			Actual	1	384
			Margin (+)	-101	-684
3	Cumulative deficit of HBOR 1/		Program	823	1,093
			Actual	692	904
			Margin (+)	131	189
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 1/ 2/		Program	1,336	1,566
			Actual	1,160	1,161
			Margin (+)	176	405
			Program	0	0
		<1 years	Actual	0	0
			Margin (+)	0	0
5	Cumulative issuance of guarantees extended by the general government 1/		Program	1,724 5/	1,773 5/
			Actual	953	1,170
			Margin (+)	771	603
6	Cumulative change in the Net International Reserves of the Croatian National Bank 2/ 3/		Program	12	-138
			Actual	269	384
			Margin (+)	257	522
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 1/		Program	7,068 4/	6,945
			Actual	4,739	4,549
			Margin (+)	2,329	2,396
Indicative limits					
1	Cumulative increase in the total debt of selected public enterprises 1/		Program	90	0
			Actual	-97	-76
			Margin (+)	187	76
Structural performance criterion					
1	Government to prepare three-year budgets starting with 2005-07 by end-September 2004.		Observed. Done on September 29, 2004.		
Structural benchmarks					
1	Government to restructure the Debt Management department of the Ministry of Finance by end-September 2004.		Done in early October 2004.		
2	Government to appoint a Working Group by end-September 2004 to prepare the reform to unify the supervision of nonbank financial intermediaries.		Done in early October 2004.		
3	Government to formulate a medium-term business plan on HŽ by end-December 2004 to reduce its reliance on subsidies and improve cost recovery.		Done in February 2005.		
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.		Substantial progress but not completed.		
5	Government to eliminate bank accounts of DAB by end-June 2005, HFP by end-September 2005, and HAC and HC by end-December 2005.		Delayed for DAB and HFP (Annex, ¶ 18); Pending for HAC and HC (Table 8).		
6	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.		Pending (Table 8).		

Source: Data provided by the Croatian authorities.

1/ Ceiling.
2/ In millions of Euros.
3/ Floor.
4/ Adjusted for the delay of receipts of dividend payments by the telephone company (HT) originally expected by September 30, 2004.
5/ Adjusted for the amount of repayments of guaranteed debt by the government in excess of the amount incorporated in ceiling.

Table 4. Croatia: Consolidated General Government Finances, 2002-05
(In percent of GDP; GFS 2001 basis)

	2002	2003	2004		2005	
			Prog.	Actual 1/	Original Budget	Suppl. Budget
REVENUE	46.3	46.4	47.1	46.6	46.9	46.3
Taxes	28.2	27.9	27.5	27.2	28.0	27.3
Taxes on income, profits, and capital gains	6.1	6.0	5.7	5.9	6.0	6.2
Payable by individuals	4.0	3.7	3.5	3.7	3.8	3.7
Payable by corporations and other enterprise	2.1	2.2	2.2	2.1	2.3	2.5
Taxes on property	0.3	0.3	0.3	0.4	0.4	0.4
Taxes on goods and services	20.4	20.5	20.5	20.1	20.7	19.9
o/w VAT	14.5	14.6	14.6	14.4	14.8	14.4
Excises	5.5	5.4	5.4	5.1	5.4	5.0
Taxes on international trade and transactions	1.1	0.9	0.8	0.8	0.7	0.7
Other taxes	0.3	0.2	0.3	0.2	0.2	0.2
Social security contributions	14.0	14.2	14.4	14.2	14.6	14.3
Other revenue and grants	4.0	4.2	5.1	5.1	4.2	4.7
TOTAL EXPENDITURES	51.4	52.7	51.6	51.6	50.6	50.5
Expense (current)	46.4	46.5	45.7	46.0	45.2	45.2
Compensation of employees	12.4	12.7	12.1	12.3	11.9	12.1
Use of goods and services	5.5	4.9	4.8	4.9	4.9	4.7
Interest	2.1	2.1	2.1	2.2	2.2	2.2
Subsidies	2.8	3.3	2.8	2.8	2.8	2.7
Grants	0.1	0.0	0.3	0.5	0.5	0.4
Social benefits	20.1	19.8	19.8	19.8	19.0	19.2
Other expense	3.4	3.7	3.6	3.5	3.9	3.8
Acquisition of non-financial assets (investment)	4.4	5.9	5.4	5.1	5.1	4.9
Net lending	0.6	0.3	0.5	0.5	0.3	0.4
OVERALL BALANCE	-5.0	-6.3	-4.5	-4.9	-3.7	-4.2
FINANCING	5.0	6.3	4.5	4.9	3.7	4.2
Capital revenues	1.8	2.2	1.2	0.6	2.6	2.4
External financing	2.8	2.6	1.7	1.9	0.3	-1.4
Disbursements	5.2	3.9	3.9	4.2	3.3	1.5
Amortization	-2.5	-1.3	-2.2	-2.3	-3.0	-2.9
Domestic financing	0.5	1.5	1.5	2.5	0.9	3.3
Memorandum items:						
Primary budget balance	-2.9	-4.2	-2.4	-2.8	-1.5	-2.0
General government debt	39.8	41.5	41.7	44.2	43.9	44.6
General government guarantees and arrears	10.9	11.8	11.3	9.9	10.3	10.3

Source: Ministry of Finance and staff estimates.

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

Table 5. Croatia: Financial Soundness Indicators, 1999-2005
(Banks, in percent, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	Q1 2005
Regulatory capital to risk-weighted assets	20.6	21.3	18.5	17.2	15.7	14.1	15.4
Capital to assets	11.9	11.9	9.3	9.5	9.0	8.5	9.3
Nonperforming loans to total gross loans	10.3	9.5	7.3	5.9	5.1	4.5	4.5
Loan-loss provisions to nonperforming loans	78.7	79.9	71.8	68.1	60.8	60.3	60.6
After-tax return on average assets	0.7	1.3	0.7	1.3	1.4	1.4	1.4
After-tax return on average equity	4.8	10.4	6.5	13.7	15.6	16.6	15.8
Loans to deposits	70.8	64.6	59.2	67.0	66.2	66.9	68.6
Net open foreign exchange position to capital 1/	...	32.5	7.9	10.7	13.3	12.5	4.6
Foreign currency deposits to total deposits 2/	90.0	91.3	91.2	89.4	87.1	86.8	86.9
Foreign currency loans to total loans 2/	85.7	85.6	84.9	80.0	74.4	75.8	77.0

Source: Croatian National Bank, Financial Stability Department.

1/ From 2003Q1, net open positions include foreign currency options.
2/ Foreign currency deposits (loans) include those denominated in kuna and linked to foreign exchange.

Table 6. Croatia: Indicators of External and Financial Vulnerability, 2001-05
(In percent, unless otherwise indicated)

	2001	2002	2003	2004	2005 Latest	2005 Date
External indicators						
Real effective exchange rate (using consumer prices) 1/, 1995=100	103.4	103.4	102.0	103.7	106.6	Apr-05
Exports of goods and services (percentage change in euros, yoy) 2/	15.2	4.0	18.1	9.0	0.9	Q1 -05
Imports of goods and services (percentage change in euros, yoy) 2/	16.2	14.5	10.1	6.7	4.3	Q1 -05
Current account deficit (cumulative, millions of euros) 3/	-812	-2,027	-1,538	-1,256	-1,310	Q1 -05
Current account deficit (yoy) in percent of GDP 3/	-3.7	-8.4	-6.0	-4.5	-4.4	Q1 -05
Capital and financial account (yoy) in percent of GDP 3/	11.8	15.0	15.7	8.8	3.5	Q1 -05
Gross official reserves (millions of euros)	5,338	5,854	6,554	6,436	6,991	May-05
Gross official reserves in percent of broad money (M4)	37.1	36.2	38.9	35.3	36.3	May-05
Gross official reserves in percent of reserve money	220.8	182.6	163.9	145.5	154.7	May-05
Gross official reserves in months of current year's imports of goods and NFS	5.3	5.1	5.2	4.8	4.8	May-05
Gross usable international reserves in percent of domestic foreign currency deposits	42.7	46.9	50.6	47.2	48.0	May-05
Net international reserves (millions of euros)	5,146	5,827	6,188	6,434	6,988	May-05
Net international reserves in months of current year's import of goods and NFS	5.1	5.1	4.9	4.8	4.8	May-05
Short-term debt in percent of gross usable reserves 4/ 5/	58.1	44.6	84.4	109.4	111.9	Mar-05
Short-term debt and current account deficit net of FDI in percent of gross usable reserves	79.1	45.2	69.7	120.5	116.6	Mar-05
Total external debt, percent of GDP 6/	60.6	62.1	77.6	82.0	83.2	May-05
External debt service to export ratio	26.6	23.2	20.0	21.6	55.7	Q1 -05
Financial indicators						
General government debt in percent of GDP	40.1	39.8	41.5	44.2	43.9	Mar-05
Domestic in percent of GDP	15.8	16.7	17.1	19.8	23.7	Mar-05
Foreign in percent of GDP	24.3	23.2	24.3	24.4	20.1	Mar-05
Broad money (M4, percentage change, yoy)	45.2	9.5	11.0	8.6	10.3	May-05
Claims on other domestic sectors (change, yoy)	24.6	31.3	14.7	12.8	13.3	May-05
Short-term interest rate (in percent, e.o.p.)	2.3	1.7	6.2	4.8	2.6	May-05
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,035	1,173	1,185	1,565	1,791	Jul-05
Zagreb Stock Exchange, capitalization, percent of GDP	16	22	31	42	43	Jul-05
Bond yield spreads (EMBI Global, e.o.p.)	155	125	96	42	57	Jul-05
Debt ratings: Moody's:						
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Jul-05
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Baa1	Jul-05
Foreign debt ratings						
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	Jul-05
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	Jul-05
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	Jul-05
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB	BBB	Jul-05
Banking system:						
Regulatory capital to risk-weighted assets	18.5	17.2	15.7	14.1	15.4	Mar-05
Nonperforming loans to total loans	7.3	5.9	5.1	4.5	4.5	Mar-05
Loan-loss provisions to non-performing loans	71.8	68.1	60.8	60.3	60.6	Mar-05
Net open foreign exchange position to capital 7/	7.9	10.7	13.3	12.5	4.6	Mar-05
Foreign currency deposits to total deposits 8/	91.2	89.4	87.1	86.8	86.9	Mar-05
Foreign currency loans to total loans 8/	84.9	80.0	74.4	75.8	77.0	Mar-05

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; annual averages through 2004.

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/ As to 2004, the results for the first three quarters.

4/ Coverage limited to short-term debt on a remaining maturity basis registered with the CNB.

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

6/ Includes estimates of external obligations due to bond repurchase agreements (repos transaction).

7/ From 2003, net open position includes foreign currency options.

8/ Include foreign currency-linked deposits and loans.

Table 7. Croatia: Monetary Accounts, 2002-05
(End-period; in millions of kuna unless otherwise stated)

	2002	2003	2004	2005 Q1	2005 Q2 Proj.	2005 Q3 Proj.	2005 Q4 Proj.	2002	2003	2004	2005 Proj.
Monetary Survey								(Change in percent)			
Net Foreign Assets	32,817	32,771	31,743	22,172	22,079	25,055	22,479	-32.6	-0.1	-3.1	-29.2
Net Domestic Assets	83,324	96,122	108,205	115,803	121,773	128,382	130,802	45.1	15.4	12.6	20.9
of which: domestic credit	110,089	123,781	138,686	146,747	151,695	156,989	159,464	27.6	12.4	12.0	15.0
to government, net	16,740	16,735	17,902	25,008	26,238	26,457	24,388	10.5	0.0	7.0	36.2
to other domestic sectors 1/	93,349	107,046	120,784	121,739	125,458	130,532	135,076	31.3	14.7	12.8	11.8
Broad Money	116,142	128,893	139,948	137,975	143,852	153,437	153,281	9.5	11.0	8.6	9.5
Narrow Money	30,870	33,889	34,562	34,547	38,081	38,520	37,563	30.2	9.8	2.0	8.7
Currency outside banks	9,681	10,573	10,956	11,062	12,270	12,145	12,148	13.8	9.2	3.6	10.9
Demand deposits	21,189	23,316	23,606	23,486	25,811	26,375	25,415	39.4	10.0	1.2	7.7
Quasi Money	85,272	95,004	105,386	103,427	105,771	114,917	115,718	3.5	11.4	10.9	9.8
denominated in kuna	13,217	18,969	23,643	23,450	26,710	28,381	27,870	25.5	43.5	24.6	17.9
denominated in foreign currency	72,055	76,035	81,743	79,977	79,061	86,536	87,848	0.3	5.5	7.5	7.5
Balance Sheet of the National Bank											
								(Contribution to base money change)			
Net International Reserves	41,863	47,321	49,355	49,848	51,349	53,016	51,284	17.4	18.1	5.5	4.3
less: Banks' foreign currency reserves	7,042	6,687	10,765	12,290	12,601	13,358	14,065	5.6	-1.2	10.9	7.4
CNB bills in foreign currency	1,226	4,920	0	0	0	0	0	-7.1	12.3	-13.2	0.0
Net Usable International Reserves	33,595	35,714	38,591	37,558	38,748	39,658	37,220	18.9	7.0	7.7	-3.1
								(Contribution to base money change)			
Net Domestic Assets	-11,744	-10,035	-4,654	-4,475	-1,310	-1,417	639	9.0	5.7	14.4	11.8
of which: claims on government (net)	-768	-1,550	-260	-589	-458	-679	-632	4.1	-2.6	3.5	-0.8
claims on banks	18	972	409	15	2,043	2,157	4,074	0.0	3.2	-1.5	8.2
of which, open market operations	*0*	*0*	*0*	*0*	*2,028*	*2,142*	*4,059*				
claims on other domestic sectors	111	94	83	78	83	83	83	-0.5	-0.1	0.0	0.0
other items (net)	-4,892	-4,631	-4,886	-3,979	-2,979	-2,979	-2,886	4.7	0.9	-0.7	4.5
less: CNB bills in kuna	4,986	0	0	0	0	0	0				
CNB bills in foreign currency	1,226	4,920	0	0	0	0	0				
								(Change in percent)			
Base Money	30,119	37,285	44,702	45,373	50,039	51,599	51,924	26.4	23.8	19.9	16.2
Currency	9,681	10,573	10,956	11,062	12,270	12,145	12,148	13.8	9.2	3.6	10.9
Deposits	20,438	26,712	33,746	34,311	37,769	39,454	39,776	33.4	30.7	26.3	17.9
of which: settlement accounts	3,923	5,616	6,408	5,582	6,910	7,155	7,233	60.1	43.1	14.1	12.9
statutory reserve in kuna	8,186	12,604	14,674	14,762	16,150	16,854	16,391	30.1	54.0	16.4	11.7
statutory reserve in foreign currency	7,042	6,687	10,765	12,290	12,601	13,358	14,065	23.4	-5.0	61.0	30.7
of which: general reserve requirement	7,042	6,687	10,295	10,538	9,072	9,553	9,722	23.4	-5.0	54.0	-5.6
marginal reserve requirement	0	0	470	1,752	3,529	3,806	4,343				
Reserve Money (CNB definition)	23,028	30,586	33,924	33,071	37,425	38,228	37,847	29.3	32.8	10.9	11.6
Memorandum items:											
Nominal GDP (yearly total)	179,390	193,067	207,082				220,869				
Narrow money multiplier	1.02	0.91	0.77				0.72				
Broad money multiplier	3.86	3.46	3.13				2.95				
Broad money to GDP ratio	0.65	0.67	0.68				0.69				
Foreign currency in percent of broad money	62.0	59.0	58.4				57.3				

Sources: Croatian National Bank; and Fund staff projections.

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

Table 8. Croatia: Prior Actions, Performance Criteria, and Structural Benchmarks for 2005

Prior actions for the First Review	
1. Parliament to approve supplementary budget consistent with a general government deficit of 4.2 percent of GDP in 2005.	Annex, Para. 10
2. Government to approve and submit to Parliament amendments to the subsidy to building societies.	Annex, Para. 12
3. Parliament to approve new Civil Service Law.	Annex, Para. 12
4. Government to tighten eligibility criteria for employment subsidies.	Annex, Para. 12
5. Ministry of Finance and the CNB to finalize the agreement on the procedures for the ongoing reconciliation of the registries of government debt guarantees.	Annex, Para. 18
6. Government to appoint the Advisor for sale of state shares in INA.	Annex, Para. 21
Quantitative performance criteria	
1. Quarterly limits on the cumulative deficits of the consolidated general government.	
2. Quarterly limits on the cumulative changes of the stock of general government arrears.	
3. Quarterly limits on the cumulative deficits of HBOR.	
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.	
5. Quarterly limits on the cumulative issuance of guarantees extended by the general government.	
6. Quarterly floors under the cumulative changes of the net international reserves of the CNB.	
7. Quarterly limits on the cumulative changes of the net domestic assets of the CNB.	
Indicative Limits	
1. Quarterly limits on the cumulative increase in the total debt stock of selected public enterprises.	
Structural benchmarks	
1. Government to incorporate the accounts of HAC and HC into the single treasury account by end-2005.	MEFP, Para. 22 and Annex, Para. 18
2. Parliament to approve amendments to the Law on State Aid by end-September 2005.	Annex, Para. 12
3. Government to submit to Parliament for approval the draft law on the reform of supplementary health insurance by end-November 2005.	Annex, Para. 19
4. Government to submit to Parliament for approval the law creating unified supervision of non-bank financial institutions by end-November 2005.	Annex, Para. 17
5. Government to formulate a plan on privatization of CO and complete the third phase of privatization of HT by end-December 2005.	MEFP, Para. 25
Performance clauses 1/	
1. No new external payments arrears.	MEFP, Para. 27
2. No new, or intensification of existing, restrictions of the making of payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments reasons.	MEFP, Para. 27

1/ To be monitored on a continuous basis.

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

Date	Amount of Purchase 1/ In millions of SDRs	Amount of Purchase 1/ 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.
September 14, 2005	0.818	0.22	Observance of end-December 2004 performance criteria and completion of first review.
October 31, 2005	0.818	0.22	Observance of end-September 2005 performance criteria.
February 15, 2006	2.456	0.67	Observance of end-December 2005 performance criteria and completion of second review.
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 Financing Requirements, 2003–2010

(In millions of euros)

			Projections				
	2003	2004	2005	2006	2007	2008	2009
Gross Financing Requirements	4,813	3,791	4,146	4,155	3,988	4,435	5,489
Current account	1,538	1,256	1,402	1,281	1,118	985	1,008
Amortization on bonds and medium and long term loans	2,037	2,478	2,475	2,612	2,689	2,978	4,503
Public sector	339	814	836	887	817	982	1,703
Banks	714	457	707	1,000	557	855	1,395
Other sectors	984	1,206	932	726	1,316	1,141	1,405
Gross reserves accumulation	1,239	58	269	261	181	472	-22
IMF repurchases and repayments	0	0	0	0	0	0	0
Available Financing	4,813	3,791	4,146	4,155	3,988	4,435	5,489
Direct investment (net)	1,501	732	848	1,039	1,103	1,025	1,104
Disbursements on bonds and medium and long term loans	4,937	4,485	3,324	3,597	3,357	3,803	4,711
Public sector 1/ 2/	1,370	1,544	474	947	957	1,003	1,611
Banks	1,655	995	900	1,000	600	800	1,000
Other sectors	1,912	1,946	1,950	1,650	1,800	2,000	2,100
Short term financing (net) 3/	72	-529	-131	16	22	23	23
Other flows (net) 4/	-1,697	-896	105	-497	-493	-417	-349

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: 2005–2010
(Under obligation)

	2005	2006	2007	2008	2009	2010
Fund repurchases and charges 1/						
In millions of SDRs	1.5	4.7	4.7	16.4	52.0	38.8
In millions of Euros	1.7	5.5	5.5	19.2	60.9	45.5
In percent of exports of goods and NFS	0.0	0.0	0.0	0.1	0.3	0.2
In percent of debt service	0.1	0.2	0.2	0.5	1.2	1.0
In percent of quota	0.4	1.3	1.3	4.5	14.3	10.6
In percent of gross official reserves	0.0	0.1	0.1	0.2	0.8	0.6
Fund credit outstanding (e.o.p.) 1/						
In millions of SDRs	94.5	97.0	97.0	85.3	37.1	0.3
In millions of Euros	108.6	113.8	113.8	99.9	43.4	0.4
In percent of quota	25.9	26.6	26.6	23.4	10.2	0.1
In percent of GDP	0.4	0.4	0.3	0.3	0.1	0.0
In percent of gross official reserves	1.6	1.6	1.6	1.3	0.6	0.0
Memorandum items:						
Exports of goods and NFS (millions of Euros)	15,426	16,402	17,217	18,104	19,062	19,865
Debt service (millions of Euros) 1/	-3,074	-3,301	-3,343	-3,534	-5,159	-4,573
Quota (millions of SDRs)	365	365	365	365	365	365
Quota (millions of Euros)	419	428	428	428	427	427
Gross official reserves (millions of Euros) 1/	6,815	7,081	7,262	7,720	7,641	8,094

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

1/ Including the hypothetical purchases under the precautionary stand-by arrangement, not shown in balance of payments projections.

Table 12. Croatia: Projected Payments to the Fund as of May 31, 2005 Under the Obligations Repurchase Schedule
(In millions of SDRs)

	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
SDR net charges	0.6	1.1	1.1	1.1	1.1	1.1
Total obligations	0.6	1.1	1.1	1.1	1.1	1.1
(percent of quota)	0.2	0.3	0.3	0.3	0.3	0.3
Obligations from prospective drawings						
Principal						
GRA repurchases	0.0	0.0	0.0	11.7	48.2	36.8
Charges and interest 1/						
GRA charges and interest	0.9	3.6	3.6	3.6	2.7	0.9
Total obligations	0.9	3.6	3.6	15.3	50.9	37.7
(percent of quota)	0.3	1.0	1.0	4.2	13.9	10.3
Cumulative (existing and prospective)						
Principal						
GRA repurchases	0.0	0.0	0.0	11.7	48.2	36.8
Charges and interest 1/	1.5	4.7	4.7	4.7	3.8	2.0
Total obligations	1.5	4.7	4.7	16.4	52.0	38.8
(percent of quota)	0.4	1.3	1.3	4.5	14.2	10.6

Source: IMF Finance Department.
1/ Assumes the GRA rate of charge of 3.57 percent plus 12 basis points for burden sharing.

Zagreb, 7 August, 2005

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

Dear Mr. de Rato:

The government remains fully committed to limiting external vulnerability and preparing Croatia for EU accession through the implementation of its economic program for 2004–05, which is being supported by the 20-month Stand-By Arrangement (SBA) approved by the Fund in August 2004.

We are requesting completion of the first review under the program. All quantitative performance criteria for end-December 2004 have been observed, save for the targets on the reduction of general government arrears and on the general government deficit, for which we are requesting waivers. The deep-seated structural problems in the health sector have so far constrained our ability to reduce arrears. Following our initial measures last year, we are introducing new reforms to address these problems more forcefully. A delay and shortfall in expected one-off revenues and lower than-anticipated indirect tax collections were the main reasons for the breach of the end-December performance criterion on the general government deficit. Absent the lower-than-expected one-off revenues in 2004, the breach would have been contained to around ¼ percent of GDP. Structural policies were in line with the program and all structural benchmarks were observed, except for the benchmark on reconciliation of government debt guarantee registers, although significant progress has been made in this area.

We are continuing to implement policies that will achieve the program's objectives and are proposing to establish quantitative performance criteria for end-September and end-December 2005, as well as rephase the scheduled purchases under the Arrangement from four purchases to two purchases. The budget for 2005 initially targeted a deficit of 3.7 percent of GDP. However, owing to the weak revenue base last year, slower than expected economic growth in 2005, a delayed change in the pension indexation formula, and some unplanned spending commitments during the first half of the year, it has proved impossible to reach this target. We have thus revised the deficit target to 4.2 percent of GDP in the context of a supplementary budget approved on July 13. While the deficit is somewhat higher than originally planned, we are satisfied that it remains consistent with our external debt objective and macroeconomic stability. Moreover, in order to assure continued fiscal consolidation over the medium term we are taking additional steps to strengthen tax collection and generate permanent fiscal savings. These policies, as well as other components of the strengthened structural agenda, are explained in the attached Annex to our original

Memorandum on Economic and Financial Policies of July 13, 2004 and Technical Memorandum of Understanding (TMU).

The discussion with staff on the second program review planned for October-November 2005 will focus on the 2006 budget, including the macroeconomic effects of settlement of outstanding debt of the government to pensioners.

We believe the policies set forth in the Annex are adequate to achieve the objectives of our program, and we will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the Annex, in accordance with the Fund's policies on such consultations. The government will continue to treat the Stand-By Arrangement as precautionary.

Sincerely yours,

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

Attachments:
Annex
Technical Memorandum of Understanding

1. As stated in the Memorandum on Economic and Financial Policies (MEFP) attached to our letter dated July 13, 2004 to the Managing Director of the International Monetary Fund, limiting external vulnerability and preparing for EU accession as rapidly as possible continue to be Croatia's paramount goals over the medium term. Our economic strategy, outlined in Croatia's first Pre-Accession Economic Program, which we submitted to the European Commission in December 2004, is consistent with the policy program for 2004–05 supported by the Stand-By Arrangement. This Annex reviews program implementation in 2004, developments in the first half of 2005, and the detailed targets under the policies for the second half of the year.

2. The main pillar of our program included in the MEFP for 2004–05 is an ambitious fiscal adjustment to limit external vulnerability and arrest the increase of Croatia's external debt-to-GDP ratio. At the same time, our program aims at enhancing transparency and financial management in the government and the broader public sector and accelerating key structural reforms. Given its focus on exchange rate stability, monetary policy plays a supporting role.

3. The planned adjustment in 2004–05 would set public finances on a course that meets EU requirements in the medium term, in particular by bringing the general government deficit to under 3 percent of GDP by 2007, while the structural components of our program would support fiscal consolidation and boost Croatia's growth potential.

I. Program Implementation in 2004

4. Our policies during 2004 were firmly oriented toward these objectives and consistent with the targets detailed in our MEFP. Despite the fact that the 2004 budget was passed only in March, we achieved a major reduction in the general government deficit from 6.3 percent of GDP in 2003 to 4.9 percent in 2004. All quantitative performance criteria for end-September and end-December 2004 were met, with two exceptions (Table 1):

- The end-December performance criterion on the deficit of the general government was exceeded by HRK 1.2 billion mainly due to a delay in the receipt of the proceeds from the last auction of GSM/UMTS licenses, a shortfall in the profit transfer from Croatian Telecom (HT), and lower-than-expected indirect taxes. The shortfall does not affect the cumulative fiscal adjustment targeted under our program for 2004-05 and, given the one-off nature of some of these revenues, it had only a negligible impact on aggregate demand.

- The end-September performance criterion on the reduction of general government arrears was missed by HRK 101 million and the end-December performance criterion by HRK 684 million. This reflected long-standing structural weaknesses in the health sector, notably inadequate cost control and overconsumption. A number of measures we introduced in June 2004 helped lower the growth in health sector arrears, but their impact during the second half of 2004 was not sufficient to ensure observance of the overall target on arrears reduction. Additional measures, specifically targeted toward controlling health costs, were implemented in early 2005 (¶19).

All other quantitative performance criteria for 2004 were met, some by wide margins. Moreover, structural policies were in line with our program and all structural benchmarks for 2004 were observed, except for the benchmark on the reconciliation of the debt guarantee register between the Ministry of Finance and the CNB, which was delayed.

5. Program implementation in 2004 has started to yield results. Balance of payments data for 2004 show that Croatia's external position has strengthened as projected under the program despite higher oil prices. Indeed the current account deficit for the year fell to 4.5 percent of GDP, around 1 percentage point better than expected, due to buoyant merchandise exports, as well as a large repatriation of income from a Croatian pharmaceutical company's foreign subsidiaries. Gross external debt at end-December was 82 percent of GDP and equal to its end-May level, the benchmark used in our program, and has subsequently fallen to reach 81 percent of GDP in April.[5]

II. Macroeconomic Policies in 2005

6. Although we expect economic activity in Croatia to continue at a satisfactory pace in 2005, we now project real GDP growth to average 3½ percent, lower than our previous forecast from end-2004 due in part to an upward revision of oil price assumptions and the slowdown evidenced in the first quarter. Inflation will be higher than in 2004 but will remain at around 3 percent, underpinned by our policy of exchange rate stability. We expect the current account deficit to remain at or below 5 percent of GDP. Given the projected level of non debt-creating flows, the stabilization of the foreign debt-to-GDP ratio by end-2005—a key macroeconomic objective of our program for 2004–05—remains within reach.

7. These projections, however, are fraught with risk, especially as regards the impact of oil prices on our major trading partners and our own economy. Although at this stage we expect this impact to be temporary, it has already resulted in slower growth, putting pressure on our budget for 2005, as well as on the private sector, which will have to adjust to higher costs. If oil prices do not decline as projected during 2005, or the external environment deteriorates for some other reason, the impact may be more significant and could necessitate a re-assessment of our external objectives and policies.

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[5] The CNB has started to compile Croatia's external debt data according to the requirements of IMF/WB/OECD/EUROSTAT: *External Debt Statistics - Guide for Compiler and Users, 2003*, with the intention of disseminating the new SDDS external debt template in the first quarter of 2005. Accordingly, the inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals has caused a upward adjustment in the external debt series by 2–3 percentage points of GDP compared to previously released data.

A. Fiscal policy

8. Our 2005 budget, approved last November, set a target for the general government deficit of 3.7 percent of GDP. On the revenue side, we implemented a number of reforms in direct taxes to rationalize the system and remove distortions, notably (i) raising the tax-free threshold for personal income; (ii) lowering the global cap for income tax deductions; (iii) abolishing taxation of distributed profits; and (iv) removing the lump-sum depreciation allowance. These reforms are estimated to be revenue-neutral. The start of operations of the Financial Police in September 2005, is expected to be a major step toward reducing tax evasion, supplemented by the measures included in the government's program against the grey economy, notably establishing a register of concessions and strengthening controls for unregistered employment. On the expenditure side, the budget was burdened by significant structural reform costs. First, reform of the judiciary and institution-building in the areas of environmental protection, waste management, and coastal protection are urgent priorities for harmonization with the *acquis communautaire,* and entail outlays of about HRK 500 million (0.2 percent of GDP). Second, to take full advantage of the EU's Common Agricultural Policy after accession, the budget provides additional resources of HRK 200 million (0.1 percent of GDP) to expand and modernize agriculture in 2005. And third, the budget includes one-off outlays of HRK 1.2 billion (0.6 percent of GDP) resulting from the extension of the application deadlines for resettlement and compensation of war refugees, a necessary step to overcome the enduring legacy of the last war. To meet the 2005 general government deficit target while making room for these priorities, the budget envisages strict spending restraint in other areas, notably the wage bill.

9. However, the combination of lower-than-expected tax revenue collection in 2004; slower growth this year; a delay in the change of the base for indexation of pensions from wages to a price-wage composite, originally planned for February; and a faster-than-planned pace of expenditure growth during the first quarter necessitated a re-assessment of our fiscal policy target for 2005. Left unchecked, these factors would have resulted in a deficit of around 5 percent of GDP, compared to our budget target of 3.7 percent. When the magnitude of the problem became clear during the first half of the year, we decided to act to maintain the integrity of our economic program and medium-term targets. Our strategy has three prongs: (i) a supplementary budget to ensure a general government deficit consistent with the external objectives of the program; (ii) measures to improve tax administration and tax collection; and (iii) an acceleration of structural reforms that will generate permanent savings over time.

10. The government has decided in the context of a supplementary budget approved by the Sabor on July 12, 2005 to take additional fiscal measures aimed at a deficit of 4.2 percent of GDP this year. Given the better-than-expected performance of the balance of payments, this upward revision of the deficit target compared to the original budget is justifiable from a macroeconomic point of view and preserves an increase in the current government surplus relative to 2004. The supplementary budget incorporates an updated revenue projection in line with our latest growth estimates, as well as corrections in certain expenditure items that had not been budgeted properly. To achieve the new deficit target, the supplementary budget also incorporates a number of additional savings measures that focus almost exclusively on

the expenditure side, notably HRK 544 million on goods & services, HRK 418 million on subsidies and grants, and HRK 673 million on investment and capital transfers.

11. Faced with the problems in tax collection, we sought urgent technical assistance from the IMF's Fiscal Affairs Department in the spring of this year. Drawing on the technical assistance mission's recommendations, we have formulated and started implementing an action plan, including in particular the following measures:

- We established a Large Taxpayers' Office for Zagreb, Rijeka, Split, and Osijek.
- The Sabor approved an extension of the time for processing VAT refund claims from the current 15 days to 30 days, in order to harmonize our practice with EU norms and allow sufficient time to our Tax Administration to assess compliance risk.
- We plan to redeploy resources within the tax administration toward VAT audits by end-2005.
- We will develop by end-2005 a VAT refund verification program based on ranking refund claimants according to compliance risk.

12. Finally, in parallel with these measures aimed at containing the deficit in 2005, in recent weeks we also started implementing a number of key structural steps that will yield savings and set fiscal policy on a more sound footing over the medium term. In particular,

- The Sabor approved amendments that reduce the existing subsidy to building societies to encourage home purchases by individuals.
- The Sabor approved a new Civil Service law professionalizing and strengthening the efficiency of the public administration.
- The Sabor amended the VAT law to eliminate the zero rate for foreign tour operators effective January 1, 2006, replacing it with a uniform rate of 10 percent for all tourist accommodation.
- The Sabor promulgated the delayed revision of the indexation formula for pensions from wages to a wage-price composite as of next year.
- The government will tighten the rules and eligibility criteria of the current employment subsidy program to target it better to the long-term unemployed by end-August, 2005.
- We will amend the existing law on State Aid to harmonize procedures for disbursing state aid with EU requirements and strengthen the role of the Agency for Market Competition in order to minimize market distortions by end-September, 2005.

- We will finalize the medium-term subsidy reduction plan in cooperation with the World Bank by end-September.

- We launched a major reform that will shore up the finances of the health system, address the root of the persistent payments arrears in the health system, and lead gradually to a reduction of the cost of health care in Croatia (for details, see ¶19).

We believe that these measures are sufficient to secure our revised general government deficit target for this year and set the basis for a substantial further consolidation in 2006, which will be the main focus of the second review under the Stand-By Arrangement.

13. In line with our program, budget financing will continue shifting to domestic sources; indeed we expect to avoid recourse to net foreign financing for the general government this year. In addition, we expect significant increases in privatization receipts based on our privatization program (¶21).

14. We will continue our efforts to strengthen financial discipline and transparency in the broader public sector. In this context, we will continue to identify and account transparently for all forms of state aid, including transfers, debt assumptions, guarantees, and recapitalizations; contain the deficit (net of government transfers) of the Croatian Development Bank (HBOR) at HRK 900 million by reducing its net lending plan by HRK 200 million compared to 2004; limit the issuance of government debt guarantees so as to maintain the nominal stock of outstanding government contingent liabilities well below its end-2003 level; continue implementing our restructuring plan for Croatian Railways; and aim at reducing the borrowing requirement of the group of major public enterprises monitored under the program.

B. Monetary and Financial Sector Policies

15. The CNB continues to support the external objectives of our program by pursuing its policy of broad exchange rate stability against the euro, maintaining adequate international reserves, and preventing an inappropriate domestic liquidity expansion. The CNB's monetary program for 2005 is consistent with broad money growth during the year at about 9-10 percent. Gross official reserves at end-2005 are projected at about € 6.7 billion, maintaining reserve coverage at about 4.4 months of following year's imports of goods and non-factor services. Consistent with these targets, the growth in Net Domestic Assets of the CNB during 2005 will be contained to about HRK 5.4 billion. Should massive private capital inflows threaten to jeopardize macroeconomic stability, the CNB will consider, in consultation with the IMF, introducing price-based controls on capital inflows. In case of delays in the government's privatization plans for reasons beyond our control, NDA growth would increase. To allow for this, the end-December NDA target would be adjusted by up to HRK 1,461 million, with the exact amount determined by the realized shortfall in privatization revenues. This would, however, not affect the overall monetary targets.

16. In 2005 the CNB has taken steps to strengthen its operational framework and introduced additional measures to support the program objectives. The CNB started open

market operations (OMOs) with Treasury bills in April 2005. OMOs are expected to facilitate the shift towards domestic financing of the government and help develop the domestic financial market. Delivery-versus-payment in real time has been implemented and started operations on July 1, 2005. In preparation for this, we made the necessary amendments in the by-laws of the Central Depository and the CNB in March 2005. In addition, in order to reduce external borrowing and withdraw excess liquidity from the banking system, the CNB raised the marginal reserve requirement on new external borrowing in February 2005 from 24 to 30 percent, and subsequently to 40 percent in May 2005. Also in May, the CNB increased the foreign exchange reserve requirement calculation base allocated in kuna from 42 to 50 percent, and reduced the remuneration rates on both the kuna and foreign exchange components of the reserve requirement. The CNB stands ready to take additional measures if necessary to help maintain the external debt to GDP ratio within acceptable limits.

17. During 2005, we plan to strengthen the legal framework in the financial sector and harmonize it with that in the EU by promulgating the laws on Insurance, Accounting & Auditing, Investment Funds, and the Supervision of Non-Bank Financial Institutions by end-November. The CNB will step up its efforts to improve monitoring of borrowers' exposure to foreign exchange risk and strengthen supervision further, including by requiring banks to collect information on their borrowers' foreign currency exposure as part of their credit risk evaluation, and issuing a guideline for banks to report their exposures to foreign-exchange induced credit risk to CNB. In addition, the CNB is working with the banks to increase their awareness of foreign-currency-related credit risks by requiring them to develop their own internal policies on debtor classification. The unified non-bank supervisory agency is expected to begin operations by January 2006. The CNB also continues to improve cooperation with financial supervisors abroad: it has signed memoranda of understanding (MoU) with supervisors in Austria and Bosnia & Herzegovina, is finalizing an MoU with Italy, and is working on one with Hungary.

C. Structural Reforms

18. We will continue improving transparency and efficiency in public expenditure and debt management during 2005, as outlined in our MEFP. We will take all steps necessary for making the single treasury account fully operational for line Ministries, notably by finalizing a plan for the harmonization of their accounting and IT systems with the treasury by end-2005. As planned, we will also incorporate the accounts of HAC and HC into the single treasury account by end-2005. However, due to delays in privatization, the accounts of DAB and HFP will be incorporated by mid-2006. We will also ensure that the orderly financing of activities currently outside the treasury, notably road and highway investment, will continue after the introduction of the single treasury account. We will start implementing the recommendations of the 2004 Review on Observance of fiscal Standards & Codes. In particular, during 2005 we will (i) enter all loans on the guarantee register at the Ministry of Finance into the FTI STAR system and verify all data in the system against contracts by end-August; (ii) start publishing on a quarterly basis each debt guarantee granted and the amount of gross exposure in the Official Gazette by end-August; (iii) adopt a permanent software solution for debt management consistent with the decision of the IT expert and with support

by EU CARDS by end-August; (iv) introduce an electronic system for treasury bill auctions by end-2005; and (v) establish internal audit units in all budget users in the central government by year-end.

19. Improving the financial situation of the health sector is a major priority in 2005. This requires both immediate action and more fundamental medium-term reforms. In mid-2004, we already implemented a number of measures to improve cost control and enhance accountability. These measures have helped curb the growth of arrears and will continue contributing toward improved financial results for the Health Fund and hospitals in the future. In addition, to control the cost of drugs, we have introduced benchmarking of drug prices, in line with other European countries; unified public procurement of drugs and other supplies for hospitals as of January 1, 2005; and re-negotiated long-term procurement contracts with major suppliers. To address the structural problems in the sector, we have prepared a far-reaching reform aimed at shifting the supplementary insurance scheme to the private sector and introducing co-payments for medical services and drugs provided under the basic insurance scheme, which will remain in state hands. To minimize the impact of this reform on vulnerable groups, these co-payments will be modest and minors and senior citizens will be exempt. Because such a fundamental reform requires the broadest possible political consensus, we have started extensive consultations with the social partners and political parties. We started this process by introducing co-payments and reducing some benefits in July. The remaining reforms will be incorporated into a draft law to be approved by the Sabor by end-2005.

20. Our government is committed to the long-term sustainability of the pension system. In this context, we have revised the base for indexation of pensions from wages to a wage-price composite effective in 2006. In addition, we have started addressing the issue of the outstanding "pensioners' debt" arising from a 1998 Constitutional Court decision. Consistent with our plans outlined in the MEFP, we created a special fund that will receive shares and other state-owned equity to finance the repayment of this liability, which we estimate at HRK 13.8 billion (including accrued interest). We intend to provide eligible pensioners two options: a cash repayment during 2006–07 at a 50 percent discount, or repayment of the full amount over eight years, after a two-year grace period. The details of this scheme are currently being finalized. We will ensure this scheme is consistent with our country's long-term ability to afford such payments, as well as with short-term macroeconomic objectives, and will continue to consult with the IMF and the World Bank staff.

21. We intend to complete the sale of government holdings in companies held by the Privatization Fund (HFP) as soon as possible. However, due to the delays caused by a number of lawsuits against HFP, the original target to privatize all companies in its portfolio is no longer feasible. Consistent with our undertakings under the World Bank PAL, we intend to privatize one-third of all companies in which the government holds a majority stake, including the Uljanik shipyard, and sell the government shares in half of the companies in which the government holds a minority stake by mid-2006. As regards the steel and shipyard companies, in particular, we plan to finalize their restructuring plans in cooperation with the EU and international financial institutions by year-end, which will allow us to begin the process of modernizing the sectors and reducing their burden on the budget over the

medium term. We also plan to sell at least 15 percent of the oil company (INA) and complete the third phase of the privatization of the telecommunications company (HT) by end-December 2005. Pending the resolution of outstanding lawsuits by former shareholders of Croatia Banka, we have decided to merge the last two small state-owned banks by year-end with a view to their eventual privatization. Due to unresolved issues with certain former owners, the preparation of a privatization plan for the state-owned Croatian Insurance company (CO) has been delayed, and we now intend to complete it by year-end.

Table 1. Croatia: Performance under the Stand-By Arrangement during 2004

				End of September	End of December
				(In millions of kuna, unless indicated otherwise)	
Quantitative performance criteria					
1	Cumulative deficit of the consolidated general government 1/		Program	10,383 4/	9,250
			Actual	9,091	10,446
			Margin (+)	1,292	-1,196
2	Cumulative change of the stock or arrears of the consolidated general government 1/		Program	-100	-300
			Actual	1	384
			Margin (+)	-101	-684
3	Cumulative deficit of HBOR 1/		Program	823	1,093
			Actual	692	904
			Margin (+)	131	189
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 1/ 2/		Program	1,336	1,566
			Actual	1,160	1,161
			Margin (+)	176	405
			Program	0	0
		<1 years	Actual	0	0
			Margin (+)	0	0
5	Cumulative issuance of guarantees extended by the general government 1/		Program	1,724 5/	1,773 5/
			Actual	953	1,170
			Margin (+)	771	603
6	Cumulative change in the Net International Reserves of the Croatian National Bank 2/ 3/		Program	12	-138
			Actual	269	384
			Margin (+)	257	522
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 1/		Program	7,068 4/	6,945
			Actual	4,739	4,549
			Margin (+)	2,329	2,396
Indicative limits					
1	Cumulative increase in the total debt of selected public enterprises 1/		Program	90	0
			Actual	-97	-76
			Margin (+)	187	76
Structural performance criterion					
1	Government to prepare three-year budgets starting with 2005-07 by end-September 2004.		Observed. Done on September 29, 2004.		
Structural benchmarks					
1	Government to restructure the Debt Management department of the Ministry of Finance by end-September 2004.		Done in early October 2004.		
2	Government to appoint a Working Group by end-September 2004 to prepare the reform to unify the supervision of nonbank financial intermediaries.		Done in early October 2004.		
3	Government to formulate a medium-term business plan on HŽ by end-December 2004 to reduce its reliance on subsidies and improve cost recovery.		Done in February 2005.		
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.		Substantial progress but not completed.		

Source: Data provided by the Croatian authorities.

1/ Ceiling.
2/ In millions of Euros.
3/ Floor.
4/ Adjusted for the delay of receipts of dividend payments by the telephone company (HT) originally expected by September 30, 2004.
5/ Adjusted for the amount of repayments of guaranteed debt by the government in excess of the amount incorporated in ceiling.

Table 2. Croatia: Prior Actions, Performance Criteria, and Structural Benchmarks for 2005

Prior actions for the First Review	
1. Parliament to approve supplementary budget consistent with a general government deficit of 4.2 percent of GDP in 2005.	Annex, Para. 10
2. Government to approve and submit to Parliament amendments to the subsidy to building societies.	Annex, Para. 12
3. Parliament to approve new Civil Service Law.	Annex, Para. 12
4. Government to tighten eligibility criteria for employment subsidies.	Annex, Para. 12
5. Ministry of Finance and the CNB to finalize the agreement on the procedures for the ongoing reconciliation of the registries of government debt guarantees.	Annex, Para. 18
6. Government to appoint the Advisor for sale of state shares in INA.	Annex, Para. 21
Quantitative performance criteria	
1. Quarterly limits on the cumulative deficits of the consolidated general government.	
2. Quarterly limits on the cumulative changes of the stock of general government arrears.	
3. Quarterly limits on the cumulative deficits of HBOR.	
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.	
5. Quarterly limits on the cumulative issuance of guarantees extended by the general government.	
6. Quarterly floors under the cumulative changes of the net international reserves of the CNB.	
7. Quarterly limits on the cumulative changes of the net domestic assets of the CNB.	
Indicative Limits	
1. Quarterly limits on the cumulative increase in the total debt stock of selected public enterprises.	
Structural benchmarks	
1. Government to incorporate the accounts of HAC and HC into the single treasury account by end-2005.	MEFP, Para. 22 and Annex, Para. 18
2. Parliament to approve amendments to the Law on State Aid by end-September 2005.	Annex, Para. 12
3. Government to submit to Parliament for approval the draft law on the reform of supplementary health insurance by end-November 2005.	Annex, Para. 19
4. Government to submit to Parliament for approval the law creating unified supervision of non-bank financial institutions by end-November 2005.	Annex, Para. 17
5. Government to formulate a plan on privatization of CO and complete the third phase of privatization of HT by end-December 2005.	MEFP, Para. 25
Performance clauses 1/	
1. No new external payments arrears.	MEFP, Para. 27
2. No new, or intensification of existing, restrictions of the making of payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments reasons.	MEFP, Para. 27

1/ To be monitored on a continuous basis.

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, 2004:	
September 30, 2005	7,941
December 31, 2005	9,165

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. 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. For purposes of the program, the receipt in February 2005 of HRK 197 million from the auction of GSM/UMTS licenses held in December 2004 is included in the cash revenue for 2005, although this amount is reported as part of the 2004 fiscal outcome.

3. 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 2005 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.

4. The Ministry of Finance will report the reconciliation between the change in the general government debt stock and the deficit of the general government during each quarter

within 45 days from the end of the quarter, in the form of the table attached to this Technical Memorandum of Understanding.

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

	Ceilings
	(In millions of kuna)
Cumulative changes from December 31, 2004:	
September 30, 2005	-50
December 31, 2005	-100

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 Deficit of HBOR

	Cumulative Limits
	(In millions of kuna)
Cumulative changes from December 31, 2004	
September 30, 2005	659
December 31, 2005	866

6. The above ceilings on the cumulative deficit of HBOR incorporate an adjustment for all general government transfers to HBOR and 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.

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 2005. 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, 2004:		
September 30, 2005	400	0
December 31, 2005	725	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). Debt includes commitments contracted or guaranteed for which value has not been received. The limits on short-term debt do not apply to normal import-related credits and nonresident deposits in state-owned banks (HPB, HBOR).

9. 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.

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

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

Euro	7.307220
U.S. dollar	5.837370
Japanese yen (100)	5.411954
Pound sterling	10.648820
Swiss franc	4.728980
SDR	8.609829

12. 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)
Cumulative issuance from December 31, 2004:	
September 30, 2005	2,820
December 31, 2005	2,931

13. 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. The above ceilings are set on the assumption of repayments of HRK 1,031 million of guaranteed loans by the government for the year as a whole and will be adjusted upward by the amount of cumulative company repayments of the underlying loans during 2005.

14. 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 2005 with September 30 and December 31 as test dates.

VI. INDICATIVE LIMITS ON THE CUMULATIVE INCREASES IN THE TOTAL DEBT STOCK OF SELECTED PUBLIC ENTERPRISES

	Indicative limits
	(In millions of kuna)
Cumulative changes from December 31, 2004:	
September 30, 2005	200
December 31, 2005	305

15. 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. Hrvatska Pošta, 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 include all net borrowing from non-government sectors, including 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 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, 2004	6,434
Cumulative changes from December 31, 2004:	
September 30, 2005	300
December 31, 2005	150

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, 2004 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, 2004. 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, 2004.

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. The December 31, 2005 floor above will be adjusted downward by an amount up to € 150 million in case the PAL disbursement by the World Bank is not received by December 31, 2005.

25. 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.

26. 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)
Cumulative changes from December 31, 2004:	
September 30, 2005	3,537
December 31, 2005	5,415

27. 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 ¶19-21), both expressed in local currency at current exchange rates. 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.

28. If the 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 the 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.

30. The December 31, 2005 ceiling above will be adjusted upward by an amount up to HRK 1,096 million in case the PAL disbursement by the World Bank is not received by December 31, 2005.

31. In case of a shortfall in the privatization receipts received by December 31, 2005 from the sale of government shares in INA and HT, compared with expected receipts of HRK 2,000 million in the fourth quarter of 2005, then the above December 31, 2005 ceiling will be adjusted upward by an amount equivalent to the shortfall up to a maximum of HRK 1,461 million.

Table 1. Croatia: Reconciliation of General Government Deficit Financing and Change in Debt

Financing flows:			
Cumulative general government deficit			
	Financed by:		
		Capital revenues	
		Net borrowing 1/	
			Disbursements
			Repayments
		Other financing flows	
			Deposit drawdowns
			Change in arrears
			Other (residual)
Change in the Debt stock:			
Nominal change in debt stock from XX to YY 2/			
	Explained by:		
		Net borrowing 1/	
		Debt assumptions by government without repayments	
		Debt repayments assumed by government	
		Valuation effects	
		Other	

1/ Excluding repayment by government of assumed/guaranteed debt and loan-financing of these repayments.

2/ Does not include changes in the stock of guarantees and arrears.

CROATIA: SUSTAINABILITY ANALYSIS

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

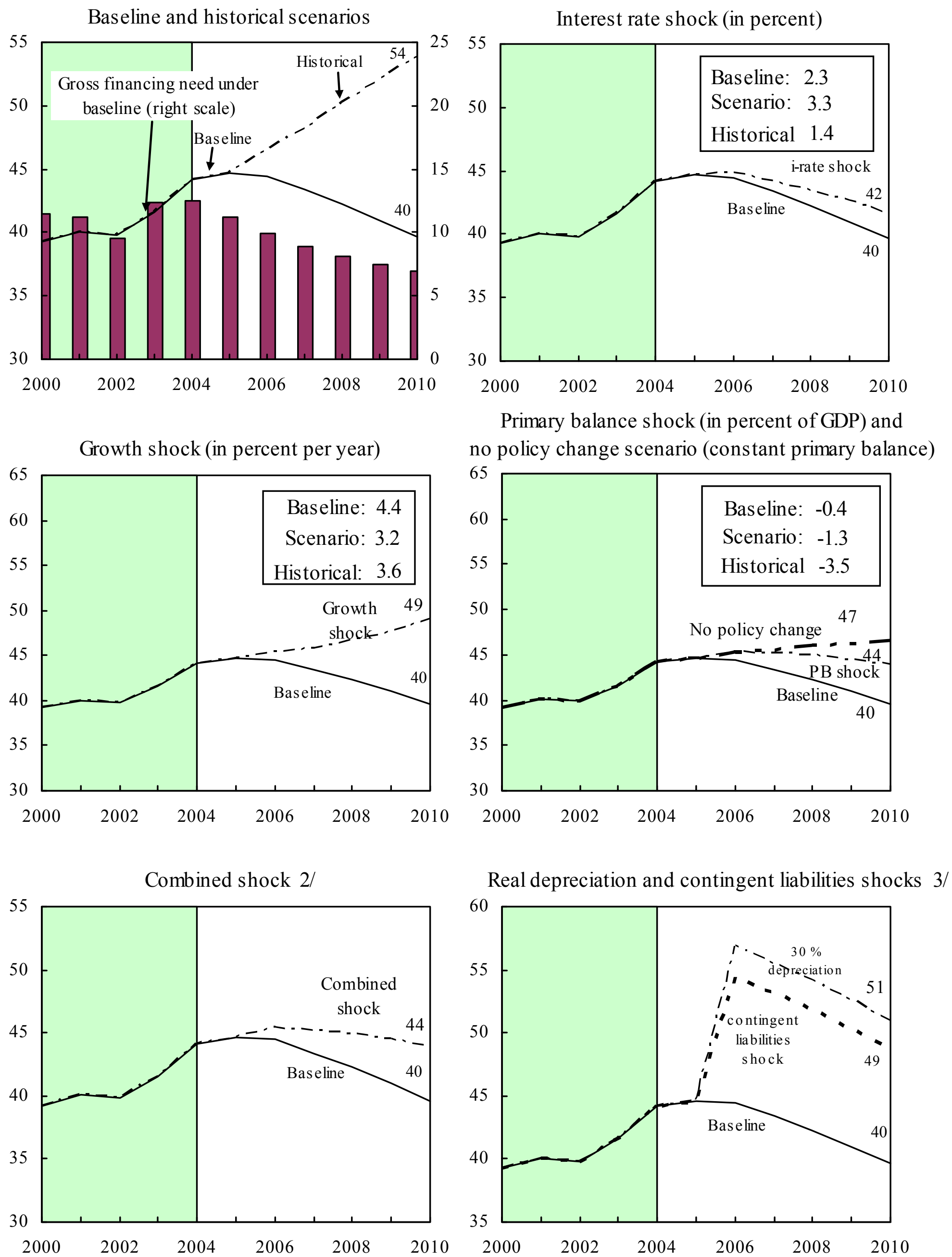
I. Fiscal Sustainability

2. Stress-testing of debt dynamics under different scenarios suggests that a severe economic slowdown accompanied by a proportional drop in revenues and/or privatization receipts could put the debt ratio on an upward trend (Table 13, Figure 4). According to staff's central scenario, the debt ratio peaks at around 44½ percent of GDP in 2005 and subsequently falls to around 39 percent of GDP by 2010, driven primarily by continued fiscal consolidation and assuming privatization receipts of around ¾–1 percent of GDP annually from 2006. If key variables are kept at their historical averages (scenario A1) the debt ratio increases by around 9¼ percent of GDP by 2010. This is mainly because the historical primary deficit is significantly above the projected deficit in the central scenario. Assuming no policy change (scenario A2), the debt ratio increases slightly over the entire forecast horizon. Turning to the bound 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 large and sustained drop in economic activity (scenario B2), which gives rise to a significant worsening of debt dynamics assuming that revenues fall in line with GDP.

II. External Sustainability

3. External debt has risen quickly in recent years in Croatia—by over 20 percent of GDP (in euro terms) between 2000 and 2003. Efforts at fiscal consolidation and an improved balance of payments performance have contributed to slowing this growth rate in 2004, and the ratio at end-2004 was 82 percent of GDP. In the staff's baseline projection, which incorporates a steadily improving external current account performance, the debt to GDP ratio would decline gradually to about 70 percent by 2010 (Table 14). Alternative scenarios demonstrate the sensitivity of external debt to several factors, highlighting the need for vigilance in economic management to forestall an unsustainable situation (Figure 5). In the scenarios involving higher interest rates, slower growth, or a worse current account than envisaged—whether individually or combined—the external debt ratio still declines from its 2004 level, but at slower rates than in the baseline. A large real depreciation could have much more adverse effects, with the debt to GDP ratio possibly jumping to over 100 percent.

Figure 4. Croatia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



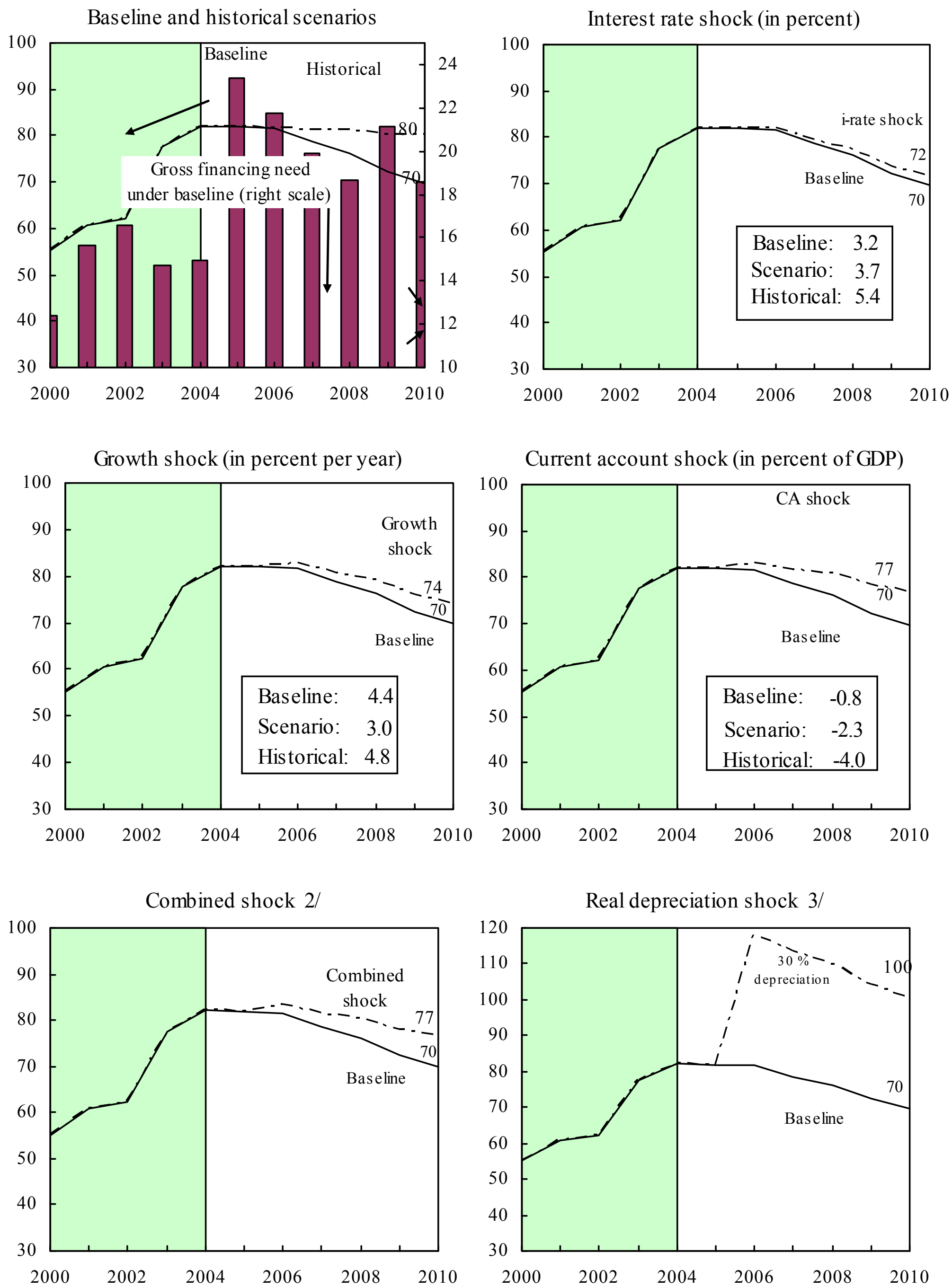
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 13. Croatia: Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing primary balance 10/**
1 **Public sector debt 1/**	39.3	40.1	39.8	41.5	44.2			**44.6**	**44.5**	**43.4**	**42.3**	**41.0**	**39.6**	**-1.7**
o/w foreign-currency denominated	28.2	28.2	27.3	28.5	25.8			25.2	24.7	24.1	23.5	22.9	22.7	
2 Change in public sector debt	6.2	0.8	-0.2	1.7	2.6			0.5	-0.2	-1.1	-1.1	-1.3	-1.4	
3 Identified debt-creating flows (4+7+12)	1.3	-0.9	0.5	1.9	2.0			-0.5	-0.6	-1.5	-1.5	-1.6	-1.7	
4 Primary deficit	4.5	4.5	2.9	4.2	2.9			1.9	1.0	0.5	0.3	0.2	0.1	
5 Revenue and grants	46.2	44.0	46.3	46.4	46.5			46.4	46.1	45.3	44.5	43.7	43.3	
6 Primary (noninterest) expenditure	50.7	48.5	49.2	50.6	49.4			48.3	47.1	45.9	44.8	43.9	43.3	
7 Automatic debt dynamics 2/	-0.6	-1.8	-0.7	-0.2	-0.3			-0.5	-0.5	-0.9	-1.0	-1.0	-0.9	
8 Contribution from interest rate/growth differential 3/	-0.4	-1.0	-1.0	-0.7	-0.6			-0.5	-0.5	-0.9	-1.0	-1.0	-0.9	
9 Of which contribution from real interest rate	0.5	0.6	1.0	0.8	0.9			0.9	1.1	0.9	0.8	0.7	0.8	
10 Of which contribution from real GDP growth	-0.9	-1.6	-1.9	-1.6	-1.5			-1.4	-1.6	-1.9	-1.8	-1.8	-1.7	
11 Contribution from exchange rate depreciation 4/	-0.3	-0.9	0.3	0.6	0.3			0.0	0.0	0.0	0.0	0.0	0.0	
12 Other identified debt-creating flows	-2.6	-3.7	-1.8	-2.2	-0.6			-1.9	-1.1	-1.1	-0.8	-0.8	-0.8	
13 Privatization receipts (negative)	-2.6	-3.7	-1.8	-2.2	-0.6			-1.9	-1.1	-1.1	-0.8	-0.8	-0.8	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3)	4.9	1.7	-0.7	-0.2	0.7			1.0	0.4	0.4	0.4	0.3	0.3	
Public sector debt-to-revenue ratio 1/	84.9	91.1	86.0	89.6	95.0			96.3	96.4	95.7	95.0	93.8	91.5	
Gross financing need 5/	11.4	11.3	9.6	12.4	12.5			11.2	9.9	8.9	8.1	7.5	6.9	
in billions of U.S. dollars	2286.8	2496.6	2322.0	3165.6	3378.1			3223.9	3043.1	2945.4	2893.8	2879.6	2872.6	
Key Macroeconomic and Fiscal Assumptions						7-Year Historical Average	7-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	2.9	4.4	5.2	4.3	3.8	3.6	2.3	3.5	3.9	4.5	4.5	4.5	4.5	4.4
Average nominal interest rate on public debt (in percent) 6/	6.5	6.0	5.7	5.6	5.7	6.1	0.6	5.4	5.5	5.4	5.2	5.0	5.2	5.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.8	2.0	2.8	2.4	2.4	1.4	2.0	2.4	2.8	2.4	2.2	2.0	2.2	2.3
Nominal appreciation (increase in euro value of local currency, in percent)	1.1	3.1	-1.0	-2.1	-1.1	-1.4	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	4.7	4.1	2.9	3.2	3.3	4.7	2.0	3.1	2.7	3.0	3.0	3.0	3.0	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.9	-0.1	6.8	7.1	1.4	2.1	4.5	1.1	1.4	1.7	2.1	2.4	3.1	2.2
Primary deficit	4.5	4.5	2.9	4.2	2.9	3.5	1.8	1.9	1.0	0.5	0.3	0.2	0.1	0.4
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 7/								**44.6**	**46.5**	**48.2**	**50.2**	**52.1**	**53.9**	**-2.1**
A2. No policy change (constant primary balance) in 2006-10								**44.6**	**45.4**	**45.6**	**46.0**	**46.3**	**46.6**	**-1.9**
B. Bound Tests														
B1. Real interest rate is at baseline plus one standard deviations								**44.6**	**44.9**	**44.2**	**43.5**	**42.6**	**41.6**	**-1.4**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007								**44.6**	**45.5**	**45.8**	**46.6**	**47.7**	**49.0**	**-1.5**
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007								**44.6**	**45.4**	**45.2**	**44.9**	**44.5**	**43.9**	**-1.8**
B4. Combination of B1-B3 using one standard deviation shocks								**44.6**	**45.4**	**45.1**	**44.9**	**44.4**	**43.9**	**-1.4**
B5. One time 30 percent real depreciation in 2006 9/								**44.6**	**56.8**	**55.5**	**54.1**	**52.6**	**50.9**	**-2.0**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**44.6**	**54.5**	**53.2**	**51.8**	**50.3**	**48.7**	**-1.9**

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/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 5. Croatia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Table 14. Croatia: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	55.1	60.7	62.2	77.6	82.1	**82.0**	**81.6**	**78.7**	**76.1**	**72.3**	**69.8**	**-5.9**
2 Change in external debt	2.2	5.6	1.5	15.4	4.5	-0.1	-0.3	-3.0	-2.5	-3.8	-2.5	
3 Identified external debt-creating flows (4+8+9)	-6.7	-7.8	-1.5	-3.0	-4.0	-0.8	-2.2	-3.4	-3.4	-3.4	-3.5	
4 Current account deficit, excluding interest payments	-0.6	0.5	5.7	3.6	2.2	2.7	1.7	1.1	0.6	0.1	0.4	
5 Deficit in balance of goods and services	5.2	5.9	10.8	7.8	6.6	6.5	5.5	4.8	4.2	3.7	3.9	
6 Exports	46.8	48.6	46.2	51.8	52.1	52.3	53.0	52.0	50.8	49.7	48.1	
7 Imports	52.0	54.4	57.0	59.6	58.8	58.8	58.5	56.8	55.0	53.4	51.9	
8 Net non-debt creating capital inflows (negative)	-5.9	-6.0	-4.8	-5.9	-2.6	-2.9	-3.4	-3.3	-2.9	-2.9	-2.9	
9 Automatic debt dynamics 1/	-0.3	-2.3	-2.5	-0.8	-3.6	-0.7	-0.6	-1.1	-1.1	-0.7	-0.9	
10 Contribution from nominal interest rate	3.1	3.1	2.6	2.4	2.3	2.0	2.4	2.3	2.2	2.5	2.1	
11 Contribution from real GDP growth	-1.4	-2.2	-2.9	-2.5	-2.7	-2.7	-3.0	-3.4	-3.3	-3.2	-3.0	
12 Contribution from price and exchange rate changes 2/	-2.0	-3.3	-2.2	-0.7	-3.2	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	9.0	13.4	3.0	18.5	8.5	0.7	1.9	0.4	0.9	-0.4	0.9	
External debt-to-exports ratio (in percent)	117.7	125.0	134.5	149.9	157.4	156.7	153.9	151.3	149.9	145.6	145.2	
Gross external financing need (in billions of US dollars) 4/	2.5	3.5	4.0	3.8	4.1	6.9	6.7	6.6	6.7	8.1	7.7	
in percent of GDP	12.4	15.6	16.5	14.7	14.9	23.4	21.7	19.9	18.7	21.1	18.5	
Scenario with key variables at their historical averages 5/						**82.0**	**81.7**	**81.1**	**81.3**	**80.1**	**80.2**	**-6.8**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.9	4.4	5.2	4.3	3.8	3.5	3.9	4.5	4.5	4.5	4.5	
GDP deflator in US dollars (change in percent)	4.0	6.3	3.8	1.1	4.3	3.1	1.0	2.5	3.0	3.0	3.1	
Nominal external interest rate (in percent)	6.4	6.3	4.8	4.1	3.2	2.6	3.1	3.0	3.0	3.5	3.1	
Growth of exports (US dollar terms, in percent)	22.9	15.1	4.0	18.1	9.0	7.1	6.3	5.0	5.2	5.3	4.2	
Growth of imports (US dollar terms, in percent)	13.1	16.2	14.5	10.1	6.7	6.8	4.3	3.9	4.3	4.5	4.8	
Current account balance, excluding interest payments	0.6	-0.5	-5.7	-3.6	-2.2	-2.7	-1.7	-1.1	-0.6	-0.1	-0.4	
Net non-debt creating capital inflows	5.9	6.0	4.8	5.9	2.6	2.9	3.4	3.3	2.9	2.9	2.9	

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

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP defl

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

CROATIA: FINANCIAL POSITION IN THE FUND
(as of June 30, 2005)

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	0.03	0.06

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Amount Expiration Date	Amount Approved (SDR million)	Drawn (SDR million)
Stand-By	8/04/2004	4/03/2006	97.00	0.00
Stand-By	2/03/2003	4/02/2004	105.88	0.00
Stand-By	3/19/2001	5/18/2002	200.00	0.00
EFF	3/12/1997	3/11/2000	353.16	28.78

VI. Projected Obligations to Fund (SDR million; based on present holdings of SDRs):[6]

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/Interest	0.56	1.13	1.13	1.13	1.13
Total	0.56	1.13	1.13	1.13	1.13

VII. Safeguards Assessment:

An updated safeguards assessment of the CNB for the existing Stand-By Arrangement was finalized in February 2005.

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

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 30, 2005, the official exchange rate was kuna 6.062782 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 4, 2004 (IMF Country Reports Nos. 04/251, 04/252 and 04/253). Executive Directors commended Croatia's strong economic performance but expressed concern over the persistently wide current account deficit and external debt to GDP ratio, which had over time increased Croatia's external vulnerability significantly. With the approval of the Stand-By Arrangement on August 4, 2004, Croatia was automatically placed on the 24-month consultation cycle, subject to the provisions of the decision on consultation cycles (Decision No. 12794-(02/76), adopted July 15, 2002).

On August 4, 2004 Executive Directors approved a new 20-month **Stand-By Arrangement** for an amount equivalent to SDR 97.00 million (26.6 percent of quota). The authorities treat the arrangement as precautionary. The policy program underlying the arrangement aims at containing the current account deficit and stabilizing external debt mainly through a fiscal adjustment over 2004–05.

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. Directors commended the generally satisfactory observance of quantitative performance criteria in the first nine months of 2003. However, they were concerned about the deterioration of the external position. Because of the slippages in fiscal policy in late 2003 caused mainly by a pre-election spending spree, the new government decided to let the current SBA expire without completing the third and final review but would start negotiations for a new precautionary SBA.

XI. FSAP:

An FSAP was concluded with the completion of the 2002 Article IV consultation on August 5, 2002 on the basis of missions that took place in April 2001 and September 2001. The FSSA was published (IMF Country Report No. 02/180).

XII. Technical Assistance 2000–05:[7]

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

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

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: 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 prices. Data are collected between the 13th and the 21st day of each month, and the indices are released around the 15th day of the following month. Since January 2004, a new consumer price index (CPI) has replaced the retail price index (RPI). The weights are based on the 2001 Household Budget Survey and are updated every 5 years. A harmonized index of consumer prices (HICP) is calculated in line with Eurostat methodology, but is not released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the CNB. The CBS also releases a monthly producer price index (PPI), usually on the 8th day of the following month.

The weights of the PPI are based on the 2000 Annual Report of Industry and are updated every 5 years.

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 a lag of 30 days, 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 classifications (economic and functional) 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.

8. Data on the operations of local governments and consolidated general government are available only on a quarterly basis and with a lag of 30 days. 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. 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. New surveys on transportation, travel, government services, and labor income were introduced in 1999. The methodology on travel surveys was modified in 2002 and 2004. 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, casting doubts about the accuracy of current account estimates. 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. 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 The coverage of external debt data improved in 2000 with the introduction of a 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. The CNB has started to compile Croatia's external debt data according to the requirements of IMF/WB/OECD/ EUROSTAT: *External Debt Statistics - Guide for Compilers and Users, 2003*, and disseminated the new SDDS external debt template in the first quarter of 2005. The inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals and arrears has caused an upward adjustment in the external debt series compared to previously released data.

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

CROATIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(as of July 29, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	7/20/05	7/20/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	7/22/05	7/29/05	W	W	W
Reserve/Base Money	May 2005	7/7/05	M	M	M
Broad Money	May 2005	7/7/05	M	M	M
Central Bank Balance Sheet	May 2005	7/7/05	M	M	M
Consolidated Balance Sheet of the Banking System					
Interest Rates[2]	May 2005	7/7/05	M	M	M
Consumer Price Index	Jun 2005	7/14/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jun 2005	7/29/05	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Jun 2005	7/25/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	May 2005	7/28/05	M	M	M
External Current Account Balance	Q1 2005	6/30/05	Q	Q	Q
Exports and Imports of Goods and Services	May 2005	7/14/05	M	M	M
GDP/GNP	Q1 2005	6/30/05	Q	Q	Q
Gross External Debt	May 2005	7/7/05	M	M	M

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

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

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

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

[5] Including currency and maturity composition.

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

CROATIA: WORLD BANK RELATIONS

1. The World Bank is taking the lead in assisting Croatia on structural and institutional reforms. The second Country Assistance Strategy for the country was discussed by the Bank's Board on December 21, 2004. The main strategic objective of the Croatian government, supported by the CAS, is successful accession and integration into the EU.

2. The proposed four-year base case lending volume is about US$1 billion (US$250-275 million per year, compared to average annual lending levels in the past three years of US$155 million), with an additional US$0.5 billion under the high case. This significant increase is needed to support the acceleration of difficult structural reforms and major institution building efforts, which Croatia, as an EU candidate country, will need to achieve within a relatively short period. Three triggers will determine whether Croatia will enter the base case: (a) satisfactory macroeconomic framework and fiscal consolidation; (b) introducing policies and improving governance to advance competitiveness; and (c) improving targeting and sustainability of social services. The proposed four-year low-case lending volume is US$300 million.

3. The reform program around which CAS support has been developed comprises (i) improved macroeconomic sustainability; (ii) sustainable private sector-led growth; (iii) broad participation in growth; and (iv) sustainable natural resource management. The European Commission was consulted to ensure Bank support for EU requirements and maximization of Croatian utilization of EC grant funds.

4. The backbone of World Bank assistance to Croatia (up to US$550 million or 37 percent) is a series of Programmatic Adjustment Loans (PALs) focusing on improving the investment climate, fiscal consolidation, and strengthened governance. The other 63 percent is split between investment loans and sector wide approach (SWAp) loans supplementing the PALs. The investment loans would address institutional capacity problems, mitigate the effects reforms may have on vulnerable groups, and assist Croatia in addressing environmental challenges of accession. SWAps will address reforms related to EU integration for infrastructure and energy and aim to raise Croatia's competitiveness through the reform of education and health.

5. The first out of three PALs has been negotiated in June 2005 and is scheduled for the Board in September 2005. The PAL 1 amounts to EUR 120 million. It has three major components: (i) strengthening governance through public administration reform and strengthening of public expenditure management; (ii) improving investment climate through judicial reform, privatization (in particular of agro-combinates, tourist companies and shipyards), continued reduction of barriers to entry of new firms, and continued tightening of financial discipline of state enterprises and related reduction of state subsidies; (iii) health reform, social benefits streamlining, railways restructuring and improvement of fiscal and social sustainability of pension system.

6. Current amount of committed funds to Croatia stands at $1.35 billion for 34 projects. Currently, the Bank's portfolio in Croatia comprises 14 active projects and an additional four projects at advanced stage of preparation. On March 28, 2005, the World Bank Board approved the Social and Economic Recovery Loan in the amount of €35 million, the first loan approved under the new CAS. This was followed by the approval of Social Welfare Support Program, GEF Renewable Energy Resources and Science and Technology Loan in June and July 2005. Two more operations have been negotiated by the close of the fiscal year 2005—PAL and Education Sector Development Program, the first SWAp for Croatia.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

First Review Under the Stand-By Arrangement and Requests for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases—Supplementary Information

Prepared by the European Department
(in consultation with the Policy Development and Review and Legal Departments)

Approved by Reza Moghadam and Anthony Boote

September 6, 2005

1. This note supplements the staff report (issued August 10, 2005) with information on the implementation of prior actions for Board consideration of the first review under the Stand-By Arrangement. The new information does not affect the thrust of the staff appraisal in the main report.

Prior actions

2. The authorities have completed all but one of the six prior actions. At the time of issuance of the staff report, parliament had approved the supplementary budget consistent with a general government deficit of 4.2 percent of GDP (prior action), amendments to the subsidy to building societies (submission to parliament a prior action), and the new civil service law (prior action); and the government had abolished the employment subsidies scheme (tightening eligibility criteria a prior action). On September 1, the Ministry of Finance and the Croatian National Bank finalized the agreement on the procedures for the ongoing reconciliation of the registries of government debt guarantees (prior action).

3. However, the authorities have informed the staff of the risk that the remaining prior action—for the government to appoint the advisor for the sale of state shares in the oil company, INA (Industrija nafte d.d.)—might not be completed until after the Board discussion.

4. The process of appointing the advisor is under way. On May 24, the government announced its intention to sell a 15 percent stake in INA, the second stage in its privatization (see also Annex ¶21). On July 22, the government established a commission for the sale, headed by the deputy prime minister. On August 2, the commission issued the tender for the privatization advisor, with a view to appointing the advisor by end-August. The authorities have since been in an intensive dialogue with the six banking groups that applied for the advisory role, and may need more time to resolve all outstanding queries. They expect to

appoint the advisor shortly, but given their ongoing discussions this may not take place ahead of the Board discussion.

5. Staff believes that the authorities have demonstrated their commitment to completing the prior action on INA by announcing their privatization plans and issuing the tender for the advisor. Moreover, the program contains additional privatization-related conditionality, including an end-December 2005 structural benchmark on the privatizations of the insurance and telecom companies, which promotes further progress in this area. Staff therefore continues to support the authorities' requests for completion of the first review under the Stand-By Arrangement, rephasing of the undrawn amount under the Arrangement, and waivers for nonobservance of December 2004 performance criteria.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 05/208
FOR IMMEDIATE RELEASE
September 14, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review of Croatia's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) completed the first review under an SDR 97 million (about US$142.8 million) Stand-By Arrangement for the Republic of Croatia, approved on August 4, 2004 for 20 months (see Press Release No. 04/170). The authorities are treating the arrangement as precautionary.

In completing the review, the Executive Board also granted waivers for the nonobservance of the end-December 2004 quantitative performance criteria on the deficit of the consolidated general government and general government arrears.

Following the Executive Board's discussion of the Republic of Croatia, Ms. Anne O. Krueger, First Deputy Managing Director and Acting Chair, stated:

"Following the approval of the Stand-By Arrangement in August 2004, policy implementation was broadly in line with the program through end-2004, in a context of solid economic growth and low inflation. The resumption of fiscal consolidation efforts contributed significantly to the improvement in the external accounts last year, although the external debt-to-GDP ratio needs to be brought down. Policy implementation faltered in early 2005, but the Croatian authorities have taken appropriate corrective measures in recent months, including on the structural front.

"It will be essential for the authorities to adhere to the revised fiscal deficit target for 2005. Although the fiscal adjustment this year will now be less ambitious than originally planned, its achievement together with the accelerated structural agenda will leave Croatia's medium-term targets still within reach. Looking forward, the authorities now have the task of preparing a budget for 2006 that both builds on permanent structural measures and helps offset the macroeconomic impact of repayments of state liabilities to pensioners, which are expected to begin next year. While details of the pension repayments remain to be resolved, their impact could be considerable, and—excluding the measured costs of the repayments—could warrant a tighter fiscal policy stance in 2006 than currently envisaged.

"The authorities' structural agenda is demanding. The politically difficult change in the pension indexation formula was essential for the long-run sustainability of the public pension system; and the introduction of administrative fees in the health sector is an important first step in the effort to address directly a hitherto chronic fiscal concern. Looking forward, it is critical that the authorities follow through on the reforms now being prepared in the areas of health care, state aid and subsidies, and public administration. Other fundamental reforms remain to be elaborated, including the restructuring of the steel and shipyard industries.

"The Croatian National Bank (CNB) should remain vigilant in its monetary policy and banking supervision. The CNB has been successfully striking a difficult balance between maintaining exchange rate stability and responding promptly to increases in bank external borrowing, while addressing the attendant prudential risks. The CNB will need to continue enhancing its monitoring of the rest of the financial system and to co-operate closely with the new nonbank supervisor scheduled to begin operations next year," Ms. Krueger said.

Statement by Jeroen Kremers, Executive Director for Republic of Croatia and Tihomir Stučka, Advisor to Executive Director September 14, 2005

Introduction

The authorities published recently their medium-term economic plan that envisages a fiscal adjustment from a deficit level of 6.3 percent of GDP in 2003 to a deficit of 4.2 percent of GDP in 2005, and to 2.8 percent in 2008. The medium-term reforms are supported and catalyzed by the Fund program and by a series of PAL and SWAp programs by the World Bank as defined in the recently approved Country Assistance Strategy.

The EU and broader political context

The start of the accession negotiations with the EU has not yet materialized as quickly as anticipated at the time when the Fund program was agreed in August 2004, with negotiations being postponed since March 2005. An Action Plan has been agreed between the EU Council of Ministers and the Croatian authorities, and an EU Task Force has been set up to evaluate the implementation of this Plan. Significant progress has been achieved in implementing the Plan, which is envisaged to contribute to momentum in the approval of the start of the negotiation process with the EU. The authorities are aware that the pending negotiations with the EU, as well as presidential elections last January and local elections held in May 2005, have taken a temporary toll on reform implementation. They have, therefore, embarked on difficult, permanent saving measures as embodied in the supplementary budget passed in parliament in June.

Fiscal policy

According to this supplementary budget, the deficit in 2005 is set at 4.2 percent of GDP, exceeding the initially agreed target by 0.5 percent of GDP. Since external debt is expected to stabilize in 2005, this deficit is in line with macroeconomic stability and the overall Fund program goals. In addition, public debt sustainability appears robust to various shocks remaining considerably below the Maastricht level for the period up to 2010.

While fiscal adjustment in 2004 was aided by short- and long-term revenue measures, in 2005 restraint in current expenditures has taken place and permanent savings measures were introduced going beyond the initial agreements under the Fund program.

On the expenditure side, the major achievement in the structural area was the change of the pension indexation. In addition, the government reduced inefficient transfers to households in the form of subsidies to building societies, and tightened the eligibility criteria of the current employment program. Furthermore, the first phase of the health reform has been launched by introducing co-payments, reducing exemptions, and introducing cost-control measures, so as to improve incentives affecting the demand for health services and reduce costs on the supply side. Finally, a new Civil Service law has been passed, which has modernized the public administration in line with EU standards. Further by-laws expected under PAL2 will aim to decompress the public sector wage bill and reduce its size by 2008.

Further structural measures are in progress and their completion is expected by end-2005. These measures include the second phase of the health reform, and a medium-term subsidy reduction plan that goes hand in hand with amendments to the State Aid law harmonizing procedures with EU requirements. Finally, restructuring plans for the shipyards and the two steel companies are in an advanced phase, and are expected to be completed by end-2005.

On the revenue side, the government introduced a unified VAT rate of 10 percent for all tourism accommodation, thus eliminating distortions emanating from a differentiated tax rate for foreign- and domestically organized tourist groups.

Monetary policy

Monetary policy continues to focus on price stability through ensuring broad exchange rate stability against the euro. The authorities expect a slight pick-up in this year's inflation rate to 3 percent due to forces beyond their control such as oil price spikes combined with bad weather conditions causing higher food prices.

Considering the lion’s share of foreign owned subsidiaries in external debt, the central bank resorted to price-based measures already in mid-2004, raising the price on foreign capital. This has been achieved, among other things, through several increases of the marginal reserve requirement on new bank external borrowing.

In addition, the central bank successfully started to conduct open market operations (OMO) with Treasury bills in early 2005. With this step, not only has the central bank modernized its monetary arsenal, but it has also gained a valuable tool for managing liquidity in the money market. At the same time, the OMOs facilitated a shift toward domestic borrowing. In general, the central bank has supported this shift, in particular, with a reduction of the general reserve requirement by a percentage point (to 18 percent) in late 2004.

Significant progress has also been achieved in further improving banking supervision. A new Law on Insurance, Accounting and Auditing, and Investment Funds planned for November 2005 will close some supervisory gaps. The resulting unified non-bank supervisory institution is expected to start operating early 2006. Finally, cooperation with foreign supervisors has been strengthened through progress in finalizing MoUs with Austria, Italy, Hungary, and Bosnia and Herzegovina.