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INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
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Statement by the Hon. **MARKO SKREB**,
Governor of the Fund for the **REPUBLIC OF CROATIA**,
at the Joint Annual Discussion

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Mr. Chairman, honorable delegates, ladies and gentlemen,

One year after the wake up call for concerted action on the part of the international financial community aimed at containing the financial crisis and facing the challenges of globalization, one can observe with pleasure that steps to create positive changes in the international financial system have been taken and have gained.

Like most countries, Croatia has also been touched by effects of the financial crisis, and unfortunately, not only a financial but also a political one – that in Kosovo.

That happened in the moment when, after four years of fast growth of GDP of around 6 percent, accompanied by reconstruction and increase in the standard of living, the expansion of domestic demand exhausted its potentials. So we had to contend with an increasingly difficult external environment, while experiencing a slow-down in domestic demand. These conditions resulted in a sharp contraction of economic activity followed by disturbances in the banking system.

Despite these circumstances Croatia has been able to maintain **price stability** keeping inflation at 4 percent throughout 1999. The policy of the Croatian National Bank will continue to be uncompromising and steadfast adherence to the principle of low inflation.

An area of great concern to us has been our external current account deficit. However, although Croatia had a very high deficit in 1997 (12,6 percent of GDP) it has been steadily going down. In 1998 it was 7.8 percent of GDP, and it would have gone down to 6,5 percent of GDP had it not been for the Kosovo crises in 1999. We expect the deficit of current account to remain at around 7 to 7,5 percent of GDP this year, and to decrease at least one percentage point further in 2000, thereafter falling well below 5 percent in 2002-3, a level that we believe to be both sustainable and necessary at this point in the transition. Therefore, we have not only avoided the worst case scenario in the past few years, but we have also successfully brought the deficit down by 5 percentage points of GDP in only three years. Unfortunately, there are no quick fixes. The external current account deficit has many deeper, structural reasons, and stimulating depreciation of the kuna would surely exacerbate it.

It is our belief that our export performance cannot be buttressed by superficial measures such as the exchange rate changes; rather, exports` ability to compete has to be enhanced. That, in turn, can only be achieved by increasing FDI and by swift and full integration of Croatia into the various levels of regional integration. Let me develop the both points.

If we compare ourselves to other transitional economies, those of Hungary and Poland for example, we will see that Croatia has received only a fraction of their FDI: 2,5 billion US$. Both Hungary and Poland have received well in excess of 20 billion US$, although both countries have already gone through the phase of "privatization related FDI" which is still in front of Croatia. The export performance of the sectors that received the FDI improved markedly, yet the export performance of the sectors that did not remains bedeviled by the same worries as Croatian export sectors – loss of market share in the European Union, and generally loosing out in the battle for competitiveness.

Apart from that, CEFTA and then Association Agreement with the EU are considered to be the main prerequisites of the investors interest. The fact that we are still not in CEFTA makes our exports more expensive in that market form the outset. That remains the goal of the Croatian Government and the Croatian National Bank in particular. Only with significant increase in export sector efficiency can we improve our current account balance.

In terms of economic policies, the Government further encourages adjustment to continuously changing circumstances. As already emphasized by many distinguished colleagues, responsible policymakers cannot imagine withstanding the pressure from defense of the peg in the present world of a globalized economy and high capital mobility, without having sound economic and financial structures. This would be just one reason more for **enhancing structural reforms, continuing with sound fiscal policy and with consolidation of financial system.** These will continue to have a salient position in the agenda for the Croatian economy.

Allow me to brief you on what have we done from this point of view in order to prepare us for the future.

In terms of structural reforms, a lot of work has been done (privatization of telecommunications, the establishment of the related regulatory framework, the restructuring of some other public enterprises so as to prepare the basis for their further privatization etc.), but there are still some deep-seated problems to be resolved. From this point of view, significant steps have been taken to implement program of measures encompassing: amendments to legislation regarding bankruptcy and the execution of court decision (collaboration with the World Bank is underway); measures for enhancing the independence of the judicial system as to prevent abuses and crime in the economy and social system; measures to further encourage the honoring of contracts etc.

Successful implementation of these measures (along with the reform of the pension and healthcare system) is a keystone for maintenance of macroeconomic stability at this stage. In addition, fiscal consolidation is at the top of priority tasks. So far, **fiscal policy** has been carefully managed.

After the successful introduction of VAT, with enhanced collection efforts and despite the drop in revenues because of the economic slowdown, the central government overall balance has been kept within the limits of Maastricht criteria. But (one has to be honest) the existing level of public spending is unsustainable in the long run. Serious measures have been therefore endorsed. The healthcare and pension system reforms, supported by World Bank expertise and resources, are continuing - but, they take time. So as to be able to get through this transitional period, Government has vigorously started with measures to improve administration and financial management as well as to increase transparency (the introduction of single treasury account system is expected at the very beginning of 2000). Recommendations stated in the **Code of Good Practices in Transparency of Fiscal Policy** and the accompanying - revised - Manual, are a helpful reference from this point of view.

Monetary policy has been characterized by a high degree of consistency throughout past years, consistency of both goals and instruments. That will be the case, I assure you, in the future as well. No surprise will come from monetary policy, and we will maintain our conservative position, both in the goals (low inflation, stable exchange rate) and in the instruments.

With respect to fiscal policy, there is no news either. The central budget can borrow from the Croatian National Bank only to bridge its gaps between receivables and expenditures and up to a limit which is predetermined by the Law on Croatian National Bank. The central budget is currently indebted 1,3 billion kuna or less that 0,2 billion US$ to the central bank; and this will be returned by the end of this year. There will be no monetary relaxation in important matters such as financing of the budget.

The progress achieved in the **banking system consolidation** (the banking industry still prevails in Croatian financial system) is an example. Work has still not been completed but much has been done. After a generally successful restructuring of some major - at the time - state owned banks, addressing problems inherited from the former socialist system, in 1998 we were suddenly faced by severe disturbances in the banking industry, especially in some of the newly established banks. At the end of 1998 the first problems in the banking sector started to surface and became apparent. Much before that the central bank, aware of the irregularities in some of the banks, had started to initiate the procedure to have a new Banking Law adopted. Under the old law, the maneuvering space for the central bank was very limited, and powers to deal with the problematic banks hardly existed.

The new Law was adopted in December 1998, after a relatively quick parliamentary procedure. Immediately after that, the central bank exercised the powers granted to it by the new Law by installing temporary administrators in the banks that were suspected to be in a serious trouble.

The causes of the banking crises are well known. After 2 years of very rapid economic growth and credit expansion, during which the credits to domestic sectors grew

44 percent in 1997 and 22 percent in 1998, there was a general slowdown of the economy. The credit supply diminished, and some big private companies went bankrupt, dragging down the banks that were connected to them. Needles to say, the bankrupt banks had high amount of connected lending, and their asset portfolio was not healthy, so they were vulnerable to the collapse of their connected enterprises.
The effect was confined only to a handful of banks, connected further among themselves. There was very little systemic damage beyond this particular group of the banks.

Public perception is very important, because although we continually maintained that the troubles were confined to a smaller group of banks and that the rest of the banking sector is healthy, and in better shape than a few years ago, it was important that public choices prove this to be the case. Today we have a group of big and medium sized banks that are doing very well, we have some banks with the substantial foreign participation, we have rehabilitated big banks that are going to be privatized in the course of the next two years and we have an important number of the foreign branches and one subsidiary. The situation is certainly much better than it was before.

This year, it became more than evident that the general recommendations of international financial community had to be applied quickly and become reality of Croatian banking system. The adoption of **internationally accepted standards** and their internal development and dissemination, enhancement of **transparency**, closer monitoring of banking system soundness through effective supervision (supported by an adequate legislative framework), in relation with macroeconomic policy as well, have to be our priority. Besides, a number of rules have been set and/or are going to be established in the near future as to enhance market discipline, owner control and supervisory effectiveness. Precious advice in this respect has been received from the World Bank and IMF staff through technical assistance missions. Needless to say, in the design and implementation of the above mentioned measures, provisions of the **Basle Core Principles for Effective Banking Supervision** and other internationally accepted standards have been duly respected. By increasing transparency in this way, we have tried to facilitate foreign entry in order to increase the competition.

As everything is mutually related, one change so as to achieve an aim, leads to another. The recently experienced turbulence in our economy taught us that close communication with all market participants (domestic or foreign) is a prerequisite for having an effective macroeconomic policy transmission mechanism. **Transparency** in one area by itself does not suffice. The IMF initiative in terms of the **Code of Good Practices on Transparency in Monetary and Financial Policy** and its further elaboration through the Manual will be of utmost help. Once again, tasks at the micro level (e.g. country level, regardless the size of the country) are identical to global prerequisites. Our adherence to SDDS is already well established, as is our **openness to IMF policies** and advice. Croatia, that is, made public its Letter of Intent five years ago. Therefore it is needless to say that we support the release of the **Article IV Staff Report**.

A **larger integration of the Croatian economy into the world economy,** remains one of the main goals in the future, although the growth of foreign trade and foreign direct investment has been evidenced in the last year (1998). As the process of negotiation is approaching its end, it is expected that Croatia becomes full member of the World Trade Organization at the end of this year. We truly hope, that this is going to open the doors for Croatia in other international and regional organizations and associations.

In a small, open economy at the advanced stage of transition as the Croatian economy is, we cannot allow ourselves not to be up to date with (above all) recent discussions, opinions, and experiences related to capital account liberalization. It is beyond any doubt that c**apital account liberalization** is necessary as a part of financial integration. But so as to use all the benefits from liberalization, it should be carefully managed and adjusted to the strength of financial system of the country concerned (especially, in transition countries). If financial disturbances are to be avoided, this fact must be taken into account by all international institutions that try to monitor or regulate capital account liberalization. In this respect, the IMF study on the use and effectiveness of specific capital controls is going to be of invaluable help to us.

Consequently, we support all the efforts of the international financial institutions in searching for mechanisms for the prevention and resolution of crises by **securing private sector involvement**. It is essential to limit moral hazards, strengthen market discipline, and ensure orderly adjustment processes, while maintaining international financial flow. The only thing I would like to stress in this regard is that, independently of the approach taken, the equality of treatment should be ensured.

Further, we believe that IMF readiness to place more emphasis on social issues in developing programs will be broadly welcomed. This will undoubtedly increase public support for the IMF programs, and make implementation of them easier, especially in recipient countries.

Throughout the year we have reached out continuously (more or less successfully) for help from the IMF and the World Bank - our friends and critics alike - to obtain appropriate solutions in banking, financial, and social sector, as well as to mitigate the effects of regional spillovers associated with the Kosovo crisis.

And now allow me to express our thanks to the management and the entire staff of the IMF and the World Bank for their valuable assistance and unselfishly shared expertise and knowledge.

Thank you very much for your kind attention.