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Republic of Croatia: Second Review Under the Stand-By Arrangement, and Requests for Waiver of Performance Criteria and for Modification of a Performance Criterion—Staff Report; Staff Statement; News Brief on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia

In the context of the Second Review Under the Stand-By Arrangement, and Requests for Waiver of Performance Criteria and for Modification of a Performance Criterion, the following documents have been released and are included in this package:

- the staff report for the Second Review Under the Stand-By Arrangement, and Requests for Waiver of Performance Criteria and for Modification of a Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on **February 15, 2002,** 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 March 15, 2002**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **March 29, 2002** updating information on recent developments.

- a News Brief summarizing the **views of the Executive Board as expressed during its March 29, 2002 discussion** of the staff report that completed the review.

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

The document(s) listed below have been or will be separately released.

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

*May also be included in 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

Second Review Under the Stand-By Arrangement, and Requests for Waiver of Performance Criteria and for Modification of a Performance Criterion

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

(In consultation with other departments)

Approved by Carlo Cottarelli and Shigeo Kashiwagi

March 15, 2002

- This report is based on discussions held in Zagreb during November 22–December 5, 2001 and February 7–15, 2002. The staff met with Prime Minister Račan, First Deputy Prime Minister Granić, Deputy Prime Minister Linić, Ministers Crkvenac (Finance), Fižulić (Economy), and Mimica (European Integration), Croatian National Bank (CNB) Governor Rohatinski, and other government and private sector representatives.

- Messrs. Flickenschild (head), Bonato, and Konuki (all EU1) participated in both missions, and Messrs. Wieczorek (PDR), Lybek (MAE), and Mrs. Shelley (assistant–EU1) participated in the first mission. Mr. Norregaard (resident representative) assisted both missions. Mr. Faulend (OED) attended the second round of discussions.

- An SDR 200 million stand-by arrangement, treated as precautionary by the Croatian authorities, was approved on March 19, 2001. The Board completed the first review under the arrangement on November 5, 2001, granting waivers for the nonobservance of performance criteria, modifying a structural performance criterion, extending the program period by one quarter to end-March 2002, and rephasing the purchases under the arrangement.

- The 2002 Article IV consultation discussions are scheduled to be held in May 2002, together with discussions on a successor arrangement to the current one, which expires on May 18, 2002.

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Executive Summary

Economic developments and outlook: Macroeconomic performance in 2001 surpassed the program objectives: economic growth was higher, inflation lower, and the international reserves gain larger than originally programmed. Growth appears to have remained strong in the final quarter of 2001, and—with continued buoyant private domestic demand and gradually brightening prospects in Western Europe—growth of 3.5 percent seems achievable in 2002. Inflation declined rapidly in the second half of 2001, to 2.6 percent in December. With core inflation at 1.8 percent in February 2002 and producer prices falling, the inflation outlook remains benign.

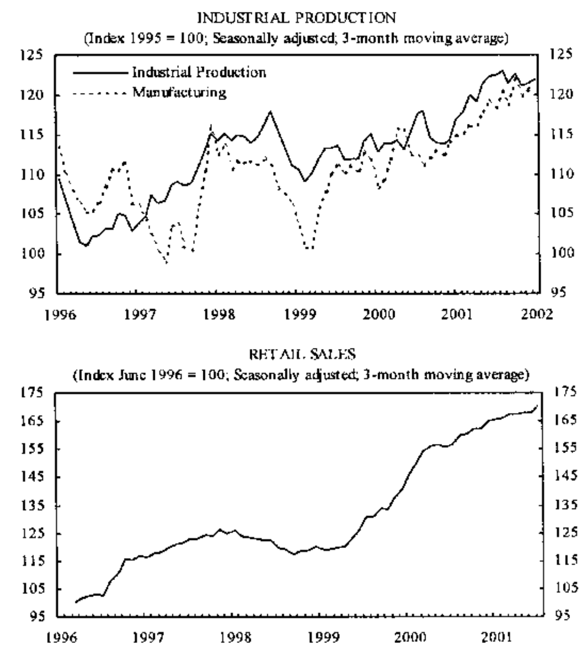
Program implementation and performance: Although there were continuing delays in structural reforms, the main performance criteria for end-2001—on the fiscal deficit, reduction of government employment, the CNB's international reserves, and the CNB's net domestic assets—were observed. However, a delay of privatization receipts led to nonobservance of the performance criteria on domestic bank credit to the government, government arrears, and the contracting and guaranteeing of external public debt. The staff supports waivers for the nonobservance of these performance criteria on the grounds that the nonobservance is likely to be largely temporary in the light of an unchanged privatization program, and that there is no evidence that it caused a crowding out of the private sector.

The 2002 fiscal program and policies and performance criteria for January–March 2002: Under the authorities' program, the deficit of the consolidated central government is to be reduced from 5.4 percent of GDP in 2001 to 4.25 percent of GDP in 2002. As the revenue ratio is projected to decline by 1.2 percent of GDP, largely due to losses associated with the introduction of the second pension pillar, the expenditure ratio needs to be reduced by 2.4 percent of GDP. Except for interest, all major expenditure categories are budgeted to decline in relation to GDP. Government employment reductions are expected to allow redressing pay inequities within a nominally constant wage bill, while last year's reform of the social transfer system will allow subsidies and transfers to decline despite new agricultural and employment subsidies. The proposed quantitative performance criteria for March 31, 2002 have been derived from this fiscal program and the CNB's monetary program, which envisages a private sector credit expansion of 10½ percent in 2002. Because of the delay in approving defense sector reform, the authorities request a relatively small modification of the structural performance criterion on government employment reduction for March 31, 2002. Parliamentary approval of the employment law and the privatization laws for the power (HEP) and oil (INA) companies and appointment of a privatization advisor for the postal bank (HPB) are prior actions.

I. Recent Developments and Outlook

1. **Economic growth remained strong in the second half of 2001** (LOI, ¶3). Supported by rising domestic demand and a good tourist season, real GDP increased by 4 percent year on year in the third quarter, bringing growth for the first three quarters to 4.3 percent. High-frequency indicators exhibited persisting strength in the fourth quarter (Figure 1), with industrial production growing at 6 percent and retail sales volume at 8.5 percent on an annual basis. Encouraged by good economic prospects and abundant credit, business investment strengthened further, while external demand seems to have been stronger than expected. It is therefore likely that real GDP growth exceeded the program target of 4 percent (see text table). With continued strong private domestic demand and gradually brightening prospects in Western Europe, the economic growth forecast of 3.5 percent for 2002, on which the authorities' program is based, appears achievable.

Figure 1. Croatia: Real Sector Developments, 1996-2002



Source: Croatian Bureau of Statistics.

Croatia: Macroeconomic Indicators, 2001-2003

	2001 Original Program	2001 Revised Program	2001 Actual	2002 Projections	2003 Projections
	(Percentage changes)				
Real GDP	4.0	4.0	4.2 1/	3.5	4.5
Retail prices (e.o.p.)	4.5	4.5	2.6	3.0	3.0
Broad money	15.3	23.2	45.2	9.8	12.6
Nongovernment credit	15.9	17.3	24.7	10.6	14.6
	(In percent of GDP)				
Consolidated central government balance	-5.3	-5.2	-5.4 1/ 2/	-4.2	-2.0
Central government debt (e.o.p) 3/	46.2	48.4	50.7 1/	50.4	49.3
Current account balance	-3.9	-3.6	-3.3 1/	-2.0	-2.4
External debt (e.o.p.)	50.4	50.1	48.6 1/	47.7	45.3
Reserve cover (months of imports of goods and services)	4.3	4.6	5.3 1/	5.8	6.2
Short-term debt (in percent of gross usable official reserves) 4/	75.7	66.9	47.0	42.3	41.8

Sources: Croatian authorities; Information Notice System; and Fund staff estimates and projections.

1/ Estimate.

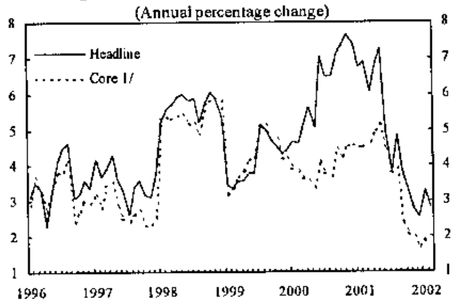
2/ Even though the fiscal deficit target has been met, and despite somewhat larger real GDP growth, the ratio to nominal GDP is larger than programmed due to a downward revision of the GDP deflator.

3/ Including arrears and publicly guaranteed debt.

4/ On a remaining maturity basis.

2. **The fall in inflation has been unexpectedly rapid.** After accelerating in August due to increases in administered prices, the twelve-month rate of retail price inflation declined to 2.6 percent in December, against a program target of 4.5 percent (Figure 2). While a methodological revision of the retail price index contributed 0.9 points to the decline, the fall in inflation is fundamentally due to the abatement of underlying inflationary pressures, as witnessed by the declining trend of core inflation and housing prices. The decline in core inflation reflects structural changes in the economy, including import duty reductions and increased retail price competition, in the context of broadly appropriate monetary policies. Notwithstanding excise tax and administrative price increases in January, inflation stood at 2.8 percent in February. With core inflation at 1.8 percent in February and producer prices falling, the inflation outlook remains benign.

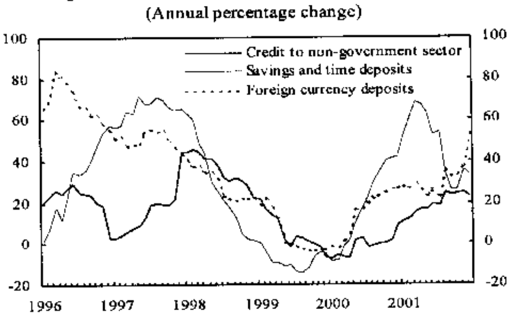
Figure 2 Croatia: Retail Price Inflation, 1996-2002
(Annual percentage change)



Sources: Croatian Bureau of Statistics; and Croatian National Bank.
1/ Excludes energy and administered prices.

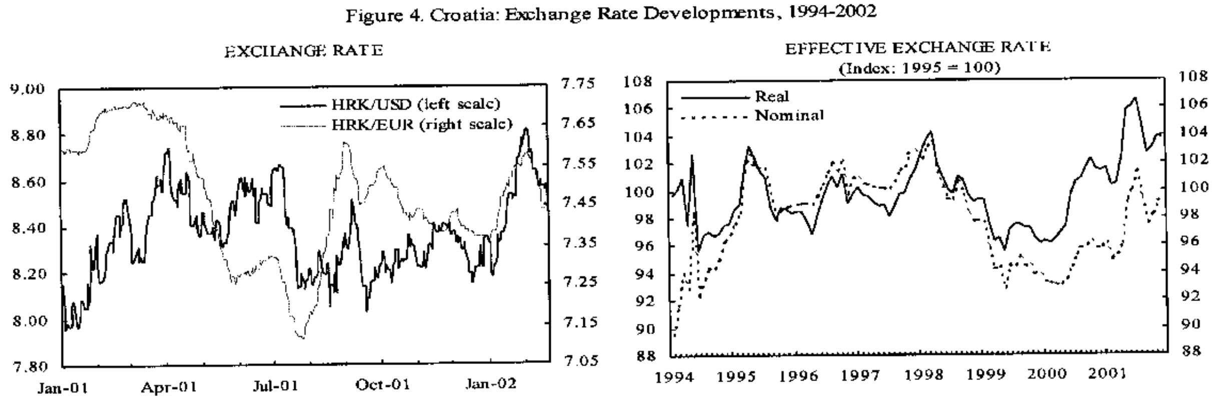
3. **The inflow of foreign currency connected to euro conversion was much larger than expected.** Large amounts of euro area currencies, previously held outside the banking system, were deposited in banks, causing foreign currency deposits to expand by 40 percent in the second half of 2001 (Figure 3). The additional foreign currency liquidity was mostly used by banks to improve their net foreign asset position, while a substantial amount had to be converted into local currency to satisfy reserve requirements. This created appreciation pressure on the kuna and the CNB intervened repeatedly to provide local currency to the market (Figure 4). Overall, there is no evidence that the increase in foreign currency liquidity has led to an acceleration of credit to the private sector. In fact, while the extension of foreign currency loans accelerated somewhat at year-end, overall credit growth slowed down due to a subdued kuna component.

Figure 3. Croatia: Monetary Developments, 1996-2001
(Annual percentage change)



Source: Croatian National Bank.

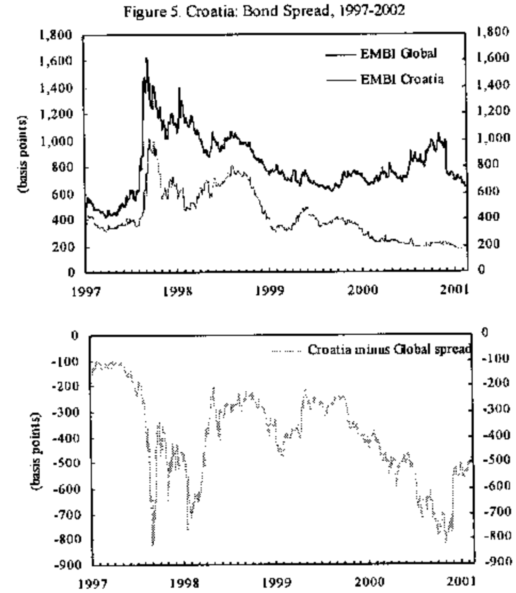
Figure 4. Croatia: Exchange Rate Developments, 1994-2002



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

4. **Despite delays in implementing reforms and increased political tensions, financial markets have remained supportive.** As described below, legislation to reduce government employment and make labor markets more flexible experienced further delays, as did measures to restructure and privatize banks and companies. In February, tensions in the five-party coalition resurfaced following the election of a new chairman of the second largest party, and a cabinet reshuffle was announced in early March. However, these difficulties did not reflect negatively on financial markets, where spreads on Croatian bonds continued their steady decline (Figure 5). A € 500 million 7-year eurobond was twice oversubscribed in January at a coupon of 6.25 percent and with a spread of 148 basis points over comparable Bunds at the time of issuance.

Figure 5. Croatia: Bond Spread, 1997-2002



Source: JP Morgan.

II. Program Implementation and Performance

5. **Most quantitative performance criteria were met at end-2001** (Table 5). The key criteria on net international reserves and net domestic assets of the CNB and on the deficit of the consolidated central government were observed, the latter with a very small margin. Also observed were the performance criteria on domestic bank credit to selected public enterprises, short-term external public debt outstanding, and the contracting and guaranteeing of nonconcessional public debt with an original maturity of more than one but less than 5 years. Although detailed results of the operations of the ten large public enterprises in 2001 were not available at the time of the discussions (see, however, ¶13), it appears that the bank borrowing ceiling, which had been established to limit the scope for quasi-fiscal operations and protect the private sector's access to domestic bank credit, was observed with a large margin because of improved profitability, scaled back investment plans, and increased nonbank borrowing by the enterprises as a group.

6. **A shortfall of privatization receipts of 0.9 percent of GDP led to nonobservance of the performance criteria on government arrears, domestic bank financing of the government, and contracting or guaranteeing of new nonconcessional external public debt with an original maturity of more than one year.** The authorities are requesting waivers for the nonobservance on the grounds that it is temporary because their privatization program has only been delayed, in part by adverse market conditions and in part by

contractual and legislative hurdles (LoI, ¶2).[1] In the staff's view, the higher-than-programmed public debt ratio resulting from the nonobservance has so far not had any adverse macroeconomic effects. Moreover, the debt ratio may decline in 2002 more rapidly than projected because the authorities are committed to use any privatization receipts above the conservatively budgeted amount for debt reduction (¶ 8).

7. **Experience with observing structural conditionality was mixed.** The end-2001 structural performance criterion on the reduction of government employment was met, mainly due to layoffs in the Ministries of Interior and Defense. However, parliamentary approval of privatization laws for the power (HEP) and oil (INA) companies, which was a structural benchmark for end-2001, is now expected in mid-March 2002. Experience with implementing other structural measures not covered by Fund conditionality is summarized in Paragraph 12 and Appendix IV.

A. Fiscal Policy

8. **The authorities resorted to discretionary expenditure cuts to respect their fiscal deficit limit in spite of slippages in wage spending.** Contrary to program assumptions, the government paid Christmas, child, and long-service bonuses in December as part of an agreement with unions on a new social partnership. As a result, the decline in the nominal wage bill was only 3.8 percent in 2001, compared with 4.8 percent expected at the time of the first review. Although revenue slightly exceeded projections (reflecting buoyant customs duties and nontax revenue) and interest payments were lower (due to falling foreign benchmark rates), the authorities had to restrain spending on goods, nonwage services, and capital to observe the fiscal ceiling.

9. **Shortfalls in privatization receipts and foreign loan disbursements in the final quarter of 2001 required additional domestic borrowing.** Already substantially scaled down by the time of the first review, privatization receipts slipped further. Due to delays, the privatization of Croatia Banka, Dubrovačka Banka, and the insurance company (CO) and the sale of residual shares in previously privatized banks and companies are now expected in 2002.[2] The delays in privatization and extension of government guarantees kept the public debt ratio close to its end-2000 peak of 50.9 percent of GDP at end-2001, compared with an originally programmed decline to some 46 percent. External borrowing, which had been raised substantially to make up for the looming privatization shortfall at the time of the first

[1] The small margin leading to the nonobservance of the arrears ceiling, which could have been avoided by closer expenditure management and larger margins of nonobservance of the two other performance criteria, will be made up in the first quarter of 2002 by a faster reduction of arrears.

[2] The privatization of Dubrovačka Banka and the sale of residual shares in Splitska Banka were completed and the proceeds are now expected to be received by end-March 2002.

review, also turned out lower as the World Bank's SAL disbursement slipped into early 2002.[3] In response, the government borrowed more domestically. In addition to the already mentioned higher-than-programmed recourse to bank borrowing and arrears, the authorities also increased their borrowing from nonbanks, mainly by issuing a medium-term euro denominated bond in November.

B. Monetary and Exchange Rate Policy

10. **Despite faster-than-expected monetary expansion, the end-year inflation target was achieved comfortably.** In the absence of inflationary pressures and with the kuna under appreciation pressure, the CNB allowed monetary conditions to ease. In December, the reserve requirement ratio was reduced from 22 percent to 19 percent and the Lombard rate from 10.5 percent to 10 percent, while the part of required reserves on foreign currency liabilities to be held in kuna was raised from 20 percent to 25 percent. Even after adjusting for these changes in line with program provisions (SLOI, ¶9 and Attachment), the increase in reserve money was higher than programmed (Table 5). In the ensuing consultation in accordance with ¶18 of the SMEFP, the mission agreed with the CNB that this increase was mostly due to required reserve holdings against the unexpectedly large increase in foreign currency deposits connected with the euro conversion and thus did not call for sterilization. However, the mission urged the CNB to (i) advise the banks to remain cautious in extending credit on the basis of what appears to be a mostly permanent gain of liquidity and (ii) tighten liquidity if price stability appeared to be jeopardized.

11. **In contrast with the turbulence experienced in August, when the kuna became subject to strong depreciation pressures** (see Figure 4)**, the exchange rate remained relatively stable in late 2001 and early 2002.** As banks were unloading excess foreign exchange holdings from the tourist season and euro conversion inflows, the CNB intervened repeatedly in the latter part of 2001 and early 2002 to avoid an appreciation of the exchange rate. The staff supported this action, but noted that the exchange rate should be kept sufficiently flexible and that monetary policy should be used to pursue price stability.

C. Structural Policies

12. **Despite some delays, there was progress with structural reform.** The delayed reduction of the level and duration of sick pay took effect on January 1, 2002, as did the basic healthcare package and supplementary health insurance, the latter subject to adoption of by-laws that were still under preparation in early February. Adoption of the new employment and labor laws experienced further delay, with the former now expected in March 2002 and the latter by mid-2002. The payment system and financial agencies laws were approved by parliament in December 2001, and a new banking law was sent to parliament. The

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[3] All conditions for the disbursement of the first tranche were met before year-end except for the parliamentary approval of the SAL agreement.

privatization fund (HFP) privatized 582 companies, including 327 by public auction, keeping residual shares in about 30 percent of them to settle nationalization claims. Privatization advisors for the pipeline company (JANAF) have initiated work to be completed by end-2002. And the government has sent the privatization laws for HEP and INA to parliament (see below).

13. **Financial discipline in public enterprises was strengthened in 2001.** The gross wage bill of the 10 large enterprises listed in Annex VI of the SMEFP declined by 3 percent in nominal terms. Nonetheless, reflecting lower employer contributions to social security and income tax reductions, as well as a small employment reduction, it appears that real net wages for the 10 enterprises as a group remained roughly constant in 2001. A year-on-year comparison of fourth-quarter data indicates, however, that wage increases were granted in the enterprises in the latter part of 2001.

III. The 2002 Budget

14. **As envisaged in the original stand-by request, the deficit of the consolidated central government is to be reduced to 4.25 percent of GDP in 2002** (see text table). This would result in a small decline in the public debt ratio from 50.7 percent of GDP at end-2001 to 50.4 percent at end-2002, assuming no increase in guaranteed debt. The deficit reduction assumes a revenue loss from the introduction of the second pension pillar of 1.2 percent of GDP. Consequently, at the consolidated central government level, the fiscal adjustment amounts to almost 2½ percent of GDP in 2002.[4]

[4] The adjustment would, however, be smaller for a broader fiscal definition. The staff has been working on a general government consolidation, which would be used to monitor a successor arrangement. Preliminary data indicate that under such a consolidation—which would include local governments, the recently introduced highway construction (HAC) and road construction (HC) agencies, the privatization fund (HFP), and the bank rehabilitation and deposit insurance agency (DAB)—the deficit would remain unchanged at 7.2 percent of GDP. After correcting for the introduction of the second pension pillar, the adjustment would be 1.2 percent of GDP in 2002. The expected deterioration of the performance of the so far unconsolidated portion of the general government in 2002 is more than explained by the accelerated implementation of foreign-financed highway projects by HAC.

Croatia: Consolidated Central Government Operations, 1999-2002
(In percent of GDP)

	1999 Actual	2000 Actual	2001 Prel.	2002 Prog.
Revenue and grants	42.8	39.9	38.4	37.2
Expenditure and net lending	50.2	45.5	43.8	41.4
Court mandated pension payments	1.2	1.4	2.3	2.2
Other	49.0	44.1	41.5	39.2
Consolidated central government balance	-7.4	-5.7	-5.4	-4.2
Adjusted for second pillar introduction cost	-7.4	-5.7	-5.4	-3.0
Memorandum items				
Central government debt stock 1/	49.3	50.9	50.7	50.4
General government balance	...	...	-7.2	-7.2
Adjusted for second pillar introduction cost	...	...	-7.2	-6.0

Sources: Ministry of Finance and Fund staff estimates.

1/ Includes publicly guaranteed debt and arrears. The general government debt is likely to be higher because some local governments can borrow without central government guarantee.

15. **As the revenue ratio is budgeted to continue to decline, the deficit reduction is once more expected to be achieved by an even larger reduction of the expenditure ratio** (LOI, ¶6 and 7). The revenue ratio is expected to decline from 38.4 percent of GDP in 2001 to 37.2 percent of GDP in 2002 as revenue losses from the introduction of the second pension pillar, lower import duties due to WTO accession and free trade agreements, and the full-year effect of decentralization outweigh revenue gains from higher excise taxes on cars and beer, a new car insurance tax, measures to boost social security collections, and the inclusion of spending units' own revenue in the budget. With the exception of interest payments, all major expenditure categories are expected to decline in relation to GDP, lowering the expenditure ratio from 43.8 percent of GDP in 2001 to 41.4 percent of GDP in 2002. The authorities expect layoffs, especially in defense, to create room to address wage inequities within a declining wage bill ratio. New subsidies for job creation and economic development partly offset the savings, estimated at almost 1.4 percent of GDP, from the reform of the system of social transfers adopted before the completion of the first program review.

16. **Unlike 2000-01, budget financing relies much less on privatization receipts and more on domestic nonbank financing.** Privatization is budgeted conservatively to yield only one half of the disappointing 2001 outcome (LoI, ¶8). By contrast, net foreign borrowing is likely to be almost double its 2001 amount, largely reflecting the postponement

of the SAL disbursement to early 2002. Domestic nonbank borrowing is expected to increase strongly in response to the new private pension funds' placement needs, leaving enough room for the elimination (by mid-year) of remaining arrears and a large reduction of indebtedness to banks. The latter is expected to provide the resources to permit a credit expansion to the nongovernment sector of 10½ percent under the CNB's monetary program for 2002.

17. **While taking a number of steps to increase transparency,[5] the 2002 budget creates two new on-budget funds that risk undermining the progress made** (LoI, ¶5). The funds are allowed to spend up to 2 percent of GDP, the bulk of it to be financed with privatization receipts. The authorities view the funds as necessary to highlight their commitment to growth, employment, and regional development and to rally support for privatization. Should privatization receipts fall short of the budgeted amount, the authorities intend to keep the funds' expenditure below the budget figures. However, the funds will be allowed to prefinance spending for up to 20 percent of budgeted privatization receipts, with a 10 percent limit during the first quarter of 2002 (LoI, ¶7). Hence, any privatization shortfalls beyond these limits will result in lower government expenditure and a lower fiscal deficit. Should, however, privatization receipts exceed the conservatively budgeted amount (i.e., 1.5 percent of GDP), the excess receipts will be used for debt reduction. The funds' operations will be reviewed in mid-2002. The first phase of the decentralization process initiated in mid-2001 was completed at the start of 2002 with the transfer to local bodies of responsibility for operational and maintenance costs of the homes for the elderly and the disabled. However, following Fund technical assistance advice, the second and third phases of the decentralization plan have been postponed pending improvement of local implementation capacity.

IV. The Program for January–March 2002

18. **The quantitative performance criteria proposed for March 31, 2002 were derived from the government's 2002 budget and the CNB's monetary program for 2002** (LoI, Attachment I). The ceiling on the deficit of the consolidated central government is to be raised/lowered by the amount by which the second pillar collections of pension contributions by the private pension funds during the first quarter of 2002 exceed/fall short of the estimated amount of HrK 412 million (LoI, ¶9). The subceiling on net banking system credit to the consolidated central government will be raised by up to HrK 250 million to accommodate some prefinancing of privatization receipts earmarked for spending by the two new budgetary funds (LoI, ¶9). Performance criteria for March 31, 2002 are also proposed for the stock of arrears of the consolidated central government, the increase in net credit of the banking system to selected public enterprises, the increase in the CNB's net usable

[5] The 2002 budget is presented on a modified accrual basis, with privatization receipts as a financing item, and includes all five former extrabudgetary funds and own revenue and corresponding expenditure of spending units.

international reserves, the increase in the CNB's net domestic assets, the stock of short-term external public and publicly guaranteed debt, and the contracting or guaranteeing of nonconcessional external debt with an original maturity of more than one year, with a subceiling on such debt with a maturity of less than 5 years. As in 2001, the CNB will consult with the Fund if base money exceeds its projection to determine whether the inflation outlook warrants an unsterilized buildup of international reserves (LoI, ¶11).

19. **Structural conditionality is limited to actions of macroeconomic relevance, mainly to ensure observance of the fiscal deficit target for 2002 and its financing.** There are three prior actions: parliamentary approval of the privatization laws for HEP and INA, initially envisaged for end-September 2001 (LoI, ¶15); appointment of a privatization advisor for the postal bank (HPB; LoI, ¶16); and parliamentary approval of the employment law (LoI, ¶18). Because of its importance for realizing the budgeted amount of privatization receipts, the adoption of a privatization plan for at least 25 percent of INA is a structural benchmark for March 31, 2002 (LoI, ¶15; text table). Finally, a further reduction of government employment is a structural performance criterion (LoI, ¶18; see paragraph 20).

Croatia: Structural Benchmarks under the Stand-By Arrangement

	Expected Completion Date as of		
	Original Program	First Review	Second Review
1. Adoption of privatization laws for HEP and INA	September 30, 2001	December 31, 2001	March 20, 2002 1/
2. Complete preparation of IPO of HT	May 31, 2001	... 2/	... 2/
3. Government approval of a privatization program for INA	...	...	March 31, 2002

1/ Prior Action.

2/ No longer a structural benchmark. The authorities want to complete the IPO once telecom market valuations have improved.

20. **The proposed structural conditionality deviates in two respects from what was envisaged at the time of the first review.** *First,* the authorities have been slow in preparing HPB for privatization. However, preliminary results for 2001, confirmed by the bank's auditor and the CNB on-site examiner, indicate that HPB's financial performance has improved considerably under new management and with the sale of its nonperforming assets to the privatization fund, and that the bank is adequately capitalized. Following a small profit in 2001, its business plan calls for another profit in 2002. Against this background, the authorities propose to appoint a privatization advisor before the Board meeting and to sell at least 75 percent of the bank (to remove the government's veto power over management decisions) on the basis of a plan to be developed by May 15, 2002 (LoI, ¶16). *Second,* it is not expected that the authorities meet the end-March structural performance criterion on employment reduction set at the time of the first review under the arrangement. Measures envisaged by the authorities to reduce central government employment have been delayed, and parliamentary approval of a set of defense sector reform laws is now expected to occur around mid-March 2002. However, as the defense sector reform aims at a net reduction of the armed forces from 41,000 to 25,000, the authorities expect to reach the originally targeted

net reduction of government employment by 10,000 by May 2002, followed by further reductions in the following months. They therefore request to modify the structural performance criterion for March 31, 2002 to reflect a lower cumulative employment reduction target of approximately 8,700 (instead of 10,000) since the end of 2000 (LoI, ¶18, and Attachment II).

21. The authorities undertake not to accumulate external payments arrears nor to introduce new or intensify existing payment restrictions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments purposes during the remaining program period.

V. Status of Safeguards Assessment

22. Preliminary work on the Stage One safeguards assessment of the CNB was conducted in mid-2001. However, while in the process of completing the assessment, the staff learned that the CNB had engaged an international auditor to conduct the first private external audit of the bank, and restate prior-year financial statements in accordance with International Accounting Standards. As a result, the staff decided to delay the assessment pending the completion of this audit.

VI. Staff Appraisal

23. **Croatia's macroeconomic performance has been good, and the near-term outlook is favorable, despite remaining fiscal and structural policy challenges.** Economic growth was higher, inflation lower, and the international reserves gain larger than originally programmed for 2001. Notwithstanding the still unfavorable external environment and delays in structural reforms, these positive trends are expected to continue in the near term, with growth supported by domestic demand and an improving current account balance, inflation subsiding on an average annual basis, and further international reserve gains. For growth with price stability to continue, however, further progress is needed with fiscal consolidation and structural reform.

24. **Despite the nonobservance of three quantitative performance criteria for December 31, 2001, overall performance under the program has been good.** The key performance criteria on the fiscal deficit, government employment reduction, international reserves, and net domestic assets have been observed, along with those on credit to selected public enterprises, short-term external public debt, and contracting and guaranteeing of nonconcessional public debt with a maturity of more than one but less than 5 years. The three instances of nonobservance are related to a shortfall of privatization receipts, although the small margin of nonobservance of the arrears ceiling could have been avoided by more careful expenditure management. While prospective market conditions suggest that not all of the privatization shortfall is temporary, the higher-than-programmed public debt ratio has so far not had any adverse macroeconomic effects. In the expectation that the authorities will monitor arrears more closely and use excess privatization receipts to reduce government

debt, the staff supports the authorities' request for waivers for the nonobservance of the three performance criteria.

25. **The authorities' fiscal program for 2002 is an important further step to reduce the government expenditure ratio and the fiscal deficit,** especially in view of the revenue loss associated with the introduction of the second pension pillar. The authorities now need to implement their program forcefully, resisting pressures to exceed the budgeted wage bill and grant additional subsidies. Progress has been made in improving fiscal transparency, but the creation of two new budgetary funds is a step backward. Their operation should be closely monitored and spending tied closely to the realization of privatization receipts. In the future, the government should pursue its employment, growth, and regional development targets without sacrificing fiscal transparency. A broader general government consolidation has become an urgent priority in light of increased government spending outside the traditional central government consolidation, especially by the highway construction agency. Further fiscal adjustment should be based on such a broader consolidation.

26. **In view of the still high government sector wage bill, the authorities' plans to continue reducing government employment are welcome.** The staff expects that the structural performance criterion on government employment reduction for March 31, 2002 will not be observed. However, the expected deviation is relatively small and temporary as the targeted employment reduction will likely be achieved in May 2002, and substantially larger additional employment reductions are expected from the defense sector reform currently underway. The staff therefore supports the authorities' request for a modification of the March 31, 2002 performance criterion on government employment reduction. The effects of these employment reductions on unemployment are expected to be minor, as many of the redundant personnel will be eligible for early retirement or put into the reserve at reduced pay, and as private sector employment opportunities should improve with the adoption of the employment and labor laws.

27. **Monetary policy needs to tread carefully in the wake of recent foreign exchange inflows and in the face of the accelerated implementation of foreign-financed highway projects.** Most of the deposit increase in connection with the euro conversion seems to be permanent, testifying to the improved confidence in the domestic banking system. The CNB should remind banks to remain cautious in extending credit. There will be appreciation pressure as banks convert foreign assets to finance domestic lending and as the highway construction agency sells external loan proceeds to pay for mainly domestic project costs. In these circumstances, the CNB will need to consider sterilized intervention to avoid the emergence of inflationary pressures. At any rate, there is no room for monetary policy easing.

28. **There is an urgent need to press ahead with structural reforms and, in particular, privatization.** The government's efforts at privatizing large public enterprises have been unconvincing and need to be stepped up decisively to improve economic efficiency and prevent a further rise in the public debt ratio.

29. **The improved financial position of HPB has bought time and raised prospects for its privatization.** Once the privatization advisor has made its recommendations, the government should move expeditiously to sell a large enough share of the bank to remove its own veto power over management decisions.

30. A safeguards assessment of the CNB is delayed pending the receipt of a recently completed first-time private external audit of the CNB. Preliminary work on the assessment revealed minor weaknesses in the safeguards of the bank, which have already been communicated to the CNB. As a result of the delay in receiving the first-time audit report, it is not expected that the assessment will be completed by the time of the Executive Board's consideration of the second program review, as required under the safeguards policy. Nevertheless, the staff proposes to complete the review, given the limited risks of misuse and misreporting identified during the preliminary work on safeguards. The staff expects that the full assessment will be completed shortly after the receipt of the results of the first-time audit.

31. On the basis of the authorities' program for 2002 and the proposed policies and performance criteria for the period up to March 31, 2002, the staff recommends completion of the second and final review under the stand-by arrangement.

Table 1. Croatia: Main Economic Indicators, 1995-2003

	1995	1996	1997	1998	1999	2000	2001 Original Program	2001 Estimates	2002 Projections	2003 Projections
Real economy (percentage change)										
Real GDP	6.8	6.0	6.6	2.5	-0.4	3.7	4.0	4.2	3.5	4.5
Unemployment rate (average; percent of labor force) 1/	n.a	10.0	9.9	11.4	13.6	16.1	14.5	15.0	14.0	13.0
Retail prices (e.o.p.)	3.7	3.4	3.8	5.4	4.4	7.4	4.5	2.6 2/	3.0	3.0
Gross domestic saving (percent of GDP)	9.9	16.1	18.2	17.2	19.4	21.7	22.0	23.6	25.7	27.0
Gross domestic investment (percent of GDP)	17.6	21.9	29.8	24.3	26.3	24.0	25.8	26.8	27.7	29.4
Public finance (percent of GDP)										
Consolidated central government (cash basis) 3/	-0.9	-0.4	-1.3	0.6	-2.0	-7.3	-0.8	-3.1	-3.0	-1.9
Consolidated central government (accrual basis)	...	...	-2.0	-3.0	-7.4	-5.7	-5.3	-5.4	-4.2	-2.0
Consolidated central government debt (e.o.p) 4/	19.3	29.2	31.9	38.8	51.1	50.9	46.2	50.7	50.4	48.5
Money and credit (e.o.p.; percentage change)										
Broad money	40.4	49.1	37.6	13.0	-1.2	28.9	15.3	45.2 2/	9.8	12.6
Credit to consolidated central government	-3.0	-3.4	-49.9	-2.7	59.9	12.0	0.0	5.1 2/	-30.5	-16.3
Other credit	18.9	3.1	44.1	22.4	-8.8	9.1	15.9	24.7 2/	10.7	14.6
Interest rates (e.o.p.; percent)										
Average deposit rate	6.1	4.2	4.4	4.1	4.3	3.4	...	2.8	...	...
Average credit rate	22.3	18.5	14.1	16.1	13.5	10.5	...	9.5	...	...
Balance of payments (percent of GDP)										
Trade balance	-17.3	-18.2	-25.8	-19.2	-16.4	-16.8	-17.3	-19.7	-17.9	-17.7
Current account balance	-7.7	-5.5	-11.6	-7.1	-6.9	-2.3	-3.9	-3.3	-2.0	-2.4
External debt (e.o.p.)	20.8	23.2	31.9	40.3	44.5	53.1	50.4	48.6	47.7	45.3
Gross official reserves (US$ million; e.o.p.)	1,895	2,314	2,539	2,816	3,025	3,525	3,663	4,697	5,187	5,933
Reserve cover (months of imports of goods and services)	2.4	2.8	2.7	3.2	3.7	4.4	4.3	5.3	5.8	6.2
Short-term debt (in percent of gross usable official reserves) 5/	31.6	40.7	45.6	75.1	83.5	75.2	75.7	47.0	42.3	41.8
Exchange rate										
Exchange rate regime	Other managed floating									
Kuna per US$ (February 28, 2002)	8.6007									
Nominal effective rate (1995=100; p.a.)	100.0	100.4	102.1	100.3	94.8	94.6	...	98.1	...	...
Real effective rate (1995=100; p.a.)	100.0	99.7	100.6	101.0	97.1	98.9	...	103.1	...	...

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

1/ Labor Force Survey (based on ILO standards).
2/ Actual.
3/ National presentation, with privatization receipts above the line.
4/ Including arrears and publicly guaranteed debt.
5/ On a remaining maturity basis.

Table 2. Croatia: Saving-Investment Balances, 1997-2003

(In millions of kuna)

	1997	1998	1999	2000	2001 prog.	2002 proj.	2003 proj.
External saving	14,316	9,738	9,889	3,582	5,549	3,554	4,620
Domestic saving-investment gap	-14,316	-9,738	-9,889	-3,582	-5,549	-3,554	-4,620
Saving	22,519	23,733	27,687	34,146	40,225	46,668	52,839
Investment	36,835	33,472	37,576	37,727	45,773	50,222	57,459
Consolidated central government (accrual basis)	-1,957	-3,093	-9,033	-7,759	-8,377	-6,952	-3,140
Saving 1/	3,734	4,905	-1,020	-2,490	-2,741	-1,515 5/	2,417 5/ 6/
Investment 2/	5,690	7,998	8,013	5,269	5,636	5,437	5,557
Non-government sector 3/	-12,359	-6,645	-857	4,177	2,828	3,398	-1,480
Saving	18,786	18,829	28,707	36,636	42,966	48,183 5/	50,422 5/ 6/
Investment 4/	31,145	25,474	29,564	32,458	40,137	44,785	51,902
	(In percent of GDP)						
External saving	11.6	7.1	6.9	2.3	3.3	2.0	2.4
Domestic saving-investment gap	-11.6	-7.1	-6.9	-2.3	-3.3	-2.0	-2.4
Saving	18.2	17.2	19.4	21.7	23.6	25.7	27.0
Investment	29.8	24.3	26.3	24.0	26.8	27.6	29.4
Consolidated central government (accrual basis)	-1.6	-2.2	-6.3	-4.9	-4.9	-3.8	-1.6
Saving 1/	3.0	3.6	-0.7	-1.6	-1.6	-0.8 5/	1.2 5/ 6/
Investment 2/	4.6	5.8	5.6	3.3	3.3	3.0	2.8
Non-government sector 3/	-10.0	-4.8	-0.6	2.7	1.7	1.9	-0.8
Saving	15.2	13.7	20.1	23.3	25.2	26.5 5/	25.8 5/ 6/
Investment 4/	25.2	18.5	20.7	20.6	23.5	24.7	26.5
Memorandum items							
GDP at current prices (millions of kuna)	123,812	137,604	142,700	157,510	170,497	181,672	195,543
Gross national disposable income at current prices (millions of kuna)	129,027	141,052	144,712	161,674	174,023	185,019	198,854
Consolidated central government	29,868	37,250	30,508	30,602	28,145	28,187	32,047
Non-government sector	99,159	103,802	114,204	131,072	145,878	156,832	166,807

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

1/ Current revenues minus current expenditures (excluding current transfers and interest payments).
2/ Excludes net lending.
3/ Includes lower levels of government and public enterprises.
4/ Includes change in inventories.
5/ Due to the introduction of the second pillar of the pension system, government saving is reduced (and non-government saving correspondingly increased) by 1.2 percent of GDP in 2002 and 1.3 percent of GDP in 2003.
6/ Government saving is increased and non-government saving is reduced by 0.9 percent of GDP due to cessation of payments under the Small Law.

Table 3. Croatia: GDP by Expenditure Category, 1998-2003

	1998	1999	2000	2001 est.	2002 proj.	2003 proj.
(Percentage changes)						
Real GDP	2.5	-0.4	3.7	4.2	3.5	4.5
Domestic demand	-1.6	-1.8	1.3	5.0	2.0	4.7
Consumption	2.7	-4.5	2.9	1.1	0.5	2.6
Private 1/	-0.2	-2.7	4.1	4.4	2.5	4.0
Government	11.5	-9.6	-0.9	-9.0	-6.6	-3.0
Gross fixed capital formation	2.5	-1.1	-3.5	11.0	7.2	12.1
Private 1/	-5.0	-0.2	7.2	12.3	9.6	14.0
Government	34.7	-3.8	-37.0	3.6	-6.3	-0.8
Exports	4.4	0.5	10.3	8.5	4.3	5.6
Imports	-4.5	-2.9	3.9	9.6	1.2	5.8
(Percentage contributions)						
Real GDP	2.5	-0.4	3.7	4.2	3.5	4.5
Domestic demand	-1.9	-2.0	1.4	5.4	2.1	5.0
Consumption	2.3	-3.9	2.4	0.9	0.4	2.0
Private 1/	-0.1	-1.7	2.5	2.7	1.6	2.5
Government	2.4	-2.2	-0.2	-1.8	-1.2	-0.5
Gross fixed capital formation	0.6	-0.3	-0.8	2.4	1.7	3.0
Private 1/	-1.0	0.0	1.3	2.3	1.9	3.0
Government	1.6	-0.2	-2.2	0.1	-0.2	0.0
Change in inventories 2/	-4.8	2.1	-0.1	2.0	0.0	0.0
Net foreign demand	4.4	1.7	2.3	-1.1	1.3	-0.5
Exports	1.8	0.2	4.3	3.8	2.0	2.6
Imports	2.6	1.5	-2.0	-5.0	-0.6	-3.1

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

1/ Includes local government.
2/ Includes statistical discrepancy.

Table 4. Croatia: Balance of Payments, 2000–03 1/

(In millions of U.S. dollars, unless otherwise indicated)

	2000	2001				2001	2002				2002	2003
		q1	q2	q3	q4		q1	q2	q3	q4		
Current account	-433	-611	-840	1,222	-435	-664	-594	-474	1,223	-583	-428	-555
Merchandise trade balance	-3,204	-808	-1,284	-975	-948	-4,016	-776	-1,092	-964	-1,086	-3,918	-4,152
Exports f.o.b.	4,567	1,111	1,164	1,220	1,254	4,750	1,152	1,196	1,295	1,323	4,966	5,287
Imports f.o.b.	-7,771	-1,920	-2,448	-2,195	-2,203	-8,766	-1,928	-2,288	-2,259	-2,408	-8,884	-9,439
Services and income	1,888	-25	190	1,959	279	2,403	-31	379	1,957	272	2,577	2,684
Transportation	179	45	38	50	15	148	63	59	70	26	218	233
Travel	2,190	81	392	1,979	260	2,713	100	462	1,945	261	2,768	2,858
Other services	-101	6	22	14	26	69	13	30	22	36	100	108
Compensation of employees	70	29	30	32	31	121	17	17	20	16	70	70
Interest income	-450	-187	-292	-116	-53	-648	-224	-189	-100	-67	-579	-584
Current transfers	883	223	254	238	234	949	213	239	229	231	913	913
Capital and Financial account	1,538	316	1,140	9	44	1,509	394	638	-681	601	952	1,335
Capital account	21	3	119	-113	6	16	5	5	5	5	18	18
Financial account	1,517	313	1,020	122	38	1,493	390	633	-685	597	934	1,317
Direct investment	1,086	74	370	165	588	1,197	164	358	120	448	1,090	954
Portfolio investment	722	576	27	175	-62	716	52	145	-75	0	122	39
Medium- and long-term loans	175	-14	22	33	-5	36	203	36	38	155	431	195
Assets	8	-2	3	-9	1	-7	0	0	0	0	0	0
Liabilities	168	-12	19	41	-5	43	203	36	38	155	431	195
Disbursements	1,413	196	227	383	285	1,091	363	303	261	402	1,329	1,485
Amortization scheduled	-1,245	-208	-208	-341	-291	-1,048	-160	-267	-223	-247	-898	-1,290
Currency and deposits 2/	-1,053	47	353	-584	484	300	-103	101	-601	-116	-719	0
Short term capital flows (net) 2/ 3/	214	-59	-26	-9	-319	-412	173	-56	-128	70	58	0
Trade Credits 4/	372	-310	274	342	-649	-344	-100	51	-39	40	-48	129
Net errors and omissions	-494	435	101	-814	777	499	0	0	0	0	0	0
Overall balance	611	140	401	417	386	1,344	-200	164	542	18	524	780
Financing	-611	-140	-401	-417	-386	-1,344	200	-164	-542	-18	-524	-780
Gross reserves (-= increase)	-582	-140	-387	-414	-372	-1,313	203	-150	-539	-4	-490	-746
IMF (net purchases)	-29	0	-14	-3	-14	-31	-3	-14	-3	-14	-34	-34
Exceptional financing	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum Items												
Current account (in percent of GDP)	-2.3	-3.0	-4.1	6.0	-2.1	-3.3	-2.7	-2.2	5.6	-2.7	-2.0	-2.4
Gross official reserves	3,525	3,514	3,799	4,416	4,697	4,697	4,494	4,644	5,183	5,187	5,187	5,933
in months of following year's imports of goods and NFS	4.0	4.0	4.3	5.0	5.2	5.2	4.8	4.9	5.4	5.4	5.4	5.9
Net international reserves	3,325	3,314	3,612	4,233	4,528	4,528	4,328	4,492	5,034	5,052	5,052	5,831
in months of following year's imports of goods and NFS	3.8	3.7	4.1	4.8	5.0	5.0	4.6	4.7	5.3	5.3	5.3	5.8
Net usable international reserves	2,430	2,488	2,761	3,045	3,476	3,476	3,276	3,440	3,982	4,000	4,000	4,780
in months of following year's imports of goods and NFS	2.7	2.8	3.2	3.5	3.9	3.9	3.5	3.6	4.2	4.2	4.2	4.7
Outstanding debt 6/	10,101	10,138	10,115	10,282	9,929	9,929	10,181	10,348	10,308	10,449	10,449	10,649
of which: short-term debt 3/ 7/	676	713	625	615	298	298	298	298	298	298	298	298
External debt to GDP ratio 6/	53.1	52.8	52.0	51.9	48.6	48.6	49.1	48.7	47.7	47.7	47.7	45.3
Short-term debt in percent of gross international usable reserves 3/ 7/ 8/	75.2					47.0					42.3	41.8
Short-term debt and current account deficit net of FDI in percent of gross international usable reserves 3/ 7/ 8/	54.9					28.9					32.7	35.0
External debt service	-1,986	-595	-333	-564	-407	-1,900	-821	-430	-441	-359	-2,051	-2,106
External debt service to exports ratio	22.9	35.0	16.1	15.0	20.4	19.9	45.8	19.5	11.5	17.1	20.6	20.1
GDP (millions of U.S. dollars)	19,030	4,665	5,023	5,454	5,269	20,412	4,984	5,533	5,839	5,543	21,898	23,508
GDP (millions of Kuna)	157,510	38,666	42,652	45,509	43,670	170,497	41,419	45,952	48,421	45,880	181,672	195,543
Exchange rates												
Kuna per Euro (pa)	7.65	7.65	7.41	7.43	7.42	7.48	...	...	...	...	...	...
Kuna per US dollar (pa)	8.28	8.29	8.49	8.34	8.29	8.35	...	...	...	...	...	...

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

1/ Based upon CNB balance of payments revisions of February 2002 and preliminary data for end-December 2001.

2/ Projections for Q1 2002 include the assumed change in resident deposits reflecting the introduction of the Euro.

3/ Data for short term commercial bank credits derived from the CNB foreign exchange department.

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

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

7/ Coverage is limited to short term debt contracts registered with the CNB.

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

Table 5. Croatia: Implementation of Performance Criteria, September-December 2001 [1/]

(In millions of kuna, unless indicated otherwise)

				Sep	Dec
	Quantitative Performance Criteria				
1	Cumulative Deficit of the Consolidated Central Government 2/		program	3,098	5,385
			actual	2,644	5,378
			margin (+)	454	7
2	Cumulative Increases in the Net Credit of the Banking System to the Consolidated Central Government 2/		program	1,683 *	-63
			actual	969	1,052
			margin (+)	714	**-1,115**
3	Arrears of the Consolidated Central Government 2/		program	-450	-900
			actual	392	-871
			margin (+)	**-842**	**-29**
4	Cumulative Increases in the Net Credit of the Banking System to Selected Public Enterprises 2/		program	300	350
			actual	-387	-670
			margin (+)	687	1,020
5	Public and Publicly Guaranteed External Debt				
	a) Stock of Short-Term Debt 2/ 3/	<=1 year	program	426 *	66
			actual	366	0
			margin (+)	60	66
	b) Cumulative Increases in Nonconcessional Debt 2/ 3/	>1 year	program	410	535
			actual	298	738
			margin (+)	112	**-203**
		<5 years	program	45	45
			actual	0	44
			margin (+)	45	1
6	Cumulative Increases in the Net Usable International Reserves of the Croatian National Bank 3/ 4/		program	-5 *	132
			actual	132	637
			margin (+)	137	505
7	Cumulative Increases in the Net Domestic Assets of the Croatian National Bank 2/		program	1,093 *	3,465 **
			actual	-70	-272
			margin (+)	1,163	3,737
	Structural Performance Criterion				
1	Employment in government sector		program	n.a.	171,129
			actual		169,812
			margin (+)		1,317
	Memorandum Item				
	Cumulative Increases in Reserve Money		program	1,051	4,607 **
			actual	1,073	5,250
			margin (+)	**-22**	**-643**

1/ September targets are indicative. Revised program (SMEFP 8/29/01, EBS/01/63), cumulative changes from June 30, 2001. "*" denotes the use of adjustors (SMEFP 8/29/01, Annexes IV,V, VII, and VIII); "**" denotes the use of an adjustor for changes in reserve requirements (supplementary LOI 10/31/01).

2/ Ceiling.

3/ In millions of US dollars.

4/ Floor.

Table 6: Croatia - Consolidated Central Government Fiscal Operations by Economic Category on an Accrual Basis, 1999-2003

(In millions of kuna)

	1999	2000	2001						2002					2003
	Actual	Actual	Revised Program	Prel.	Q1 Actual	Q2 Actual	Q3 Actual	Q4 Prel.	Prog.	Q1 Prog.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Proj.
Revenue and grants	61,122	62,801	65,355	65,473	14,354	16,747	16,710	17,663	67,520	14,881	16,499	17,594	18,547	70,736
Current revenue	61,122	62,801	65,354	65,473	14,354	16,747	16,709	17,662	67,519	14,881	16,499	17,593	18,546	70,735
Tax revenue	58,044	59,739	62,582	62,272	13,802	15,842	15,911	16,717	63,551	14,210	15,497	16,417	17,426	66,520
Personal Income tax	4,571	4,095	3,650	3,404	888	804	808	904	3,532	961	766	845	959	3,687
Social Security contributions	19,727	20,549	21,575	21,779	5,090	5,402	5,482	5,805	22,055	5,040	5,247	5,849	5,919	23,382
Profits tax	2,366	1,674	1,781	1,987	293	814	386	494	2,082	421	709	429	523	2,219
Real Estate Transactions tax	247	259	264	282	68	66	66	82	300	68	72	69	91	303
Taxes on goods and services	26,379	28,902	31,550	30,517	6,661	7,583	8,057	8,215	31,599	6,834	7,686	8,226	8,852	33,141
Value-added taxes	19,830	21,425	23,286	22,731	4,982	5,632	5,811	6,307	23,990	5,247	5,856	6,081	6,805	25,698
Excises	6,161	7,323	8,188	7,634	1,644	1,905	2,215	1,871	7,218	1,494	1,728	2,050	1,947	7,443
Other	388	153	75	151	35	46	32	37	391	92	103	96	100	0
Customs duties	4,288	3,795	3,237	3,820	667	1,077	1,001	1,075	3,469	754	895	881	938	3,286
Other	467	465	525	483	134	96	111	143	514	132	122	117	144	501
Non-tax revenue	3,078	3,063	2,772	3,201	552	905	798	946	3,969	670	1,002	1,177	1,120	4,215
Capital revenue	1	0	1	0	0	0	0	0	1	0	0	0	0	1
Grants	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Expenditure and net lending	71,614	71,735	74,309	74,665	17,678	17,341	19,248	20,397	75,218	17,449	17,598	19,069	21,102	74,643
Expenditure	70,115	70,559	73,479	73,849	17,592	17,176	19,070	20,011	74,472	17,226	17,476	18,876	20,895	73,875
Current expenditure	62,102	65,291	66,876	68,214	16,524	16,542	17,093	18,055	69,036	16,539	16,236	17,489	18,772	68,319
Expenditure on goods and services	31,528	33,091	30,171	30,886	7,087	7,901	7,564	8,334	29,702	6,804	7,166	7,463	8,269	29,630
Wages excl. employer's contributions	16,686	18,143	16,504	17,457	4,425	4,432	4,201	4,399	17,417	4,324	4,334	4,352	4,407	16,981
Other purchases of goods and services	14,842	14,948	13,666	13,429	2,662	3,469	3,364	3,935	12,285	2,480	2,832	3,111	3,862	12,648
Interest payments	2,334	2,879	3,645	3,223	1,433	389	958	443	3,933	1,485	486	1,128	834	4,487
Subsidies and other current transfers	28,240	29,321	33,060	34,105	8,003	8,252	8,571	9,279	35,400	8,249	8,584	8,898	9,669	34,202
Capital expenditure	8,013	5,268	6,604	5,635	1,069	634	1,977	1,956	5,437	687	1,240	1,387	2,123	5,557
Lending minus repayments	1,499	1,176	830	815	86	165	178	386	746	223	123	193	207	768
Consolidated central government balance	-10,491	-8,934	-8,955	-9,191	-3,325	-593	-2,538	-2,735	-7,698	-2,568	-1,099	-1,475	-2,555	-3,907
(as percent of GDP)	-7.4	-5.7	-5.2	-5.4	-1.9	-0.3	-1.5	-1.6	-4.2	-1.4	-0.6	-0.8	-1.4	-2.0
Financing 1/	10,491	8,934	8,955	9,191	3,325	594	2,538	2,735	7,698	2,568	1,099	1,475	2,555	3,907
Privatization revenues	6,420	3,158	6,872	5,305	56	96	157	4,996	2,730	673	692	673	691	281
"Tax bonds" revenues	0	750	0	0	0	0	0	0	0	0	0	0	0	0
Foreign borrowing	4,632	6,396	4,070	2,622	4,222	-85	1,161	-2,675	5,306	1,802	2,471	-406	1,438	2,791
Central budget, disbursements	5,906	10,599	9,864	8,179	5,734	76	1,919	450	10,070	5,176	2,537	597	1,760	5,907
Central budget, amortization	-1,291	-4,142	-5,794	-5,479	-1,499	-137	-747	-3,095	-4,727	-3,364	-57	-993	-313	-3,117
Central budget, net change in deposits	0	0	0	0	0	0	0	0	0	0	0	0	0	0
EBFs, net borrowing	17	-61	0	-78	-14	-24	-11	-30	-37	-10	-9	-9	-8	0
Domestic borrowing	-561	-1,370	-1,987	1,263	-953	582	1,220	414	-338	92	-2,064	1,207	426	836
From other general government	0	0	-29	0	0	0	0	0	0	0	0	0	0	47
From other non-banking sector	1,123	-5,792	-1,401	450	-197	66	251	330	3,729	314	465	705	2,245	2,301
Net change in arrears	1,164	-5,698	-1,499	-1,470	-457	-142	392	-1,263	-506	-267	-239	0	0	0
From banking sector	-1,684	4,423	-557	813	-756	516	969	84	-4,067	-221	-2,529	503	-1,819	-1,511
Nominal GDP	142,700	157,510	173,764	170,497					181,672					195,543

Sources: Ministry of Finance and staff estimates

1/ Measured at actual exchange rate.

Table 7: Croatia - Consolidated Central Government Fiscal Operations by Economic Category on an Accrual Basis, 1999-2003

(In percent of GDP)

	1999	2000	2001						2002					2003
	Actual	Actual	Revised Program	Prel.	Q1 Actual	Q2 Actual	Q3 Actual	Q4 Prel.	Prog.	Q1 Prog.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Proj.
Revenue and grants	42.8	39.9	37.6	38.4	8.4	9.8	9.8	10.4	37.2	8.2	9.1	9.7	10.2	36.2
Current revenue	42.8	39.9	37.6	38.4	8.4	9.8	9.8	10.4	37.2	8.2	9.1	9.7	10.2	36.2
Tax revenue	40.7	37.9	36.0	36.5	8.1	9.3	9.3	9.8	35.0	7.8	8.5	9.0	9.6	34.0
Personal Income tax	3.2	2.6	2.1	2.0	0.5	0.5	0.5	0.5	1.9	0.5	0.4	0.5	0.5	1.9
Social Security contributions	13.8	13.0	12.4	12.8	3.0	3.2	3.2	3.4	12.1	2.8	2.9	3.2	3.3	12.0
Profits tax	1.7	1.1	1.0	1.2	0.2	0.5	0.2	0.3	1.1	0.2	0.4	0.2	0.3	1.1
Real Estate Transactions tax	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.1	0.2
Taxes on goods and services	18.5	18.3	18.2	17.9	3.9	4.4	4.7	4.8	17.4	3.8	4.2	4.5	4.9	16.9
Value-added taxes	13.9	13.6	13.4	13.3	2.9	3.3	3.4	3.7	13.2	2.9	3.2	3.3	3.7	13.1
Excises	4.3	4.6	4.7	4.5	1.0	1.1	1.3	1.1	4.0	0.8	1.0	1.1	1.1	3.8
Other	0.3	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.2	0.1	0.1	0.1	0.1	0.0
Customs duties	3.0	2.4	1.9	2.2	0.4	0.6	0.6	0.6	1.9	0.4	0.5	0.5	0.5	1.7
Other	0.3	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.3	0.1	0.1	0.1	0.1	0.3
Non-tax revenue	2.2	1.9	1.6	1.9	0.3	0.5	0.5	0.6	2.2	0.4	0.6	0.6	0.6	2.2
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	50.2	45.5	42.8	43.8	10.4	10.2	11.3	12.0	41.4	9.6	9.7	10.5	11.6	38.2
Expenditure	49.1	44.8	42.3	43.3	10.3	10.1	11.2	11.7	41.0	9.5	9.6	10.4	11.5	37.8
Current expenditure	43.5	41.5	38.5	40.0	9.7	9.7	10.0	10.6	38.0	9.1	8.9	9.6	10.3	34.9
Expenditure on goods and services	22.1	21.0	17.4	18.1	4.2	4.6	4.4	4.9	16.3	3.7	3.9	4.1	4.6	15.2
Wages excl. employer's contributions	11.7	11.5	9.5	10.2	2.6	2.6	2.5	2.6	9.6	2.4	2.4	2.4	2.4	8.7
Other purchases of goods and services	10.4	9.5	7.9	7.9	1.6	2.0	2.0	2.3	6.8	1.4	1.6	1.7	2.1	6.5
Interest payments	1.6	1.8	2.1	1.9	0.8	0.2	0.6	0.3	2.2	0.8	0.3	0.6	0.5	2.3
Subsidies and other current transfers	19.8	18.6	19.0	20.0	4.7	4.8	5.0	5.4	19.5	4.5	4.7	4.9	5.3	17.5
Capital expenditure	5.6	3.3	3.8	3.3	0.6	0.4	1.2	1.1	3.0	0.4	0.7	0.8	1.2	2.8
Lending minus repayments	1.1	0.7	0.5	0.5	0.1	0.1	0.1	0.2	0.4	0.1	0.1	0.1	0.1	0.4
Consolidated central government balance	-7.4	-5.7	-5.2	-5.4	-1.9	-0.3	-1.5	-1.6	-4.2	-1.4	-0.6	-0.8	-1.4	-2.0
Financing 1/	7.4	5.7	5.2	5.4	1.9	0.3	1.5	1.6	4.2	1.4	0.6	0.8	1.4	2.0
Privatization revenues	4.5	2.0	4.0	3.1	0.0	0.1	0.1	2.9	1.5	0.4	0.4	0.4	0.4	0.1
"Tax bonds" revenues	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign borrowing	3.2	4.1	2.3	1.5	2.5	0.0	0.7	-1.6	2.9	1.0	1.4	-0.2	0.8	1.4
Central budget, disbursements	4.1	6.7	5.7	4.8	3.4	0.0	1.1	0.3	5.5	2.8	1.4	0.3	1.0	3.0
Central budget, amortization	-0.9	-2.6	-3.3	-3.2	-0.9	-0.1	-0.4	-1.8	-2.6	-1.9	0.0	-0.5	-0.2	-1.6
Central budget, net change in deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBFs, net borrowing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic borrowing	-0.4	-0.9	-1.1	0.7	-0.6	0.3	0.7	0.2	-0.2	0.1	-1.1	0.7	0.2	0.4
From other general government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
From other non-banking sector	0.8	-3.7	-0.8	0.3	-0.1	0.0	0.1	0.2	2.1	0.2	0.3	0.4	1.2	1.2
Net change in arrears	0.8	-3.6	-0.9	-0.9	-0.3	-0.1	0.2	-0.7	-0.3	-0.1	-0.1	0.0	0.0	0.0
From banking sector	-1.2	2.8	-0.3	0.5	-0.4	0.3	0.6	0.0	-2.2	-0.1	-1.4	0.3	-1.0	-0.8

Sources: Ministry of Finance and staff estimates

1/ Measured at actual exchange rate.

Table 8. Croatia - Monetary Accounts, 2000-2003

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

	2000	2001				2002				2003	2000	2001	2002	2003
		q1	q2	q3	q4	q1 prog.	q2 proj.	q3 proj.	q4 proj.	proj.				
Monetary Survey											(Percent change)			
Net Foreign Assets	29,017	31,118	30,362	34,431	48,604	47,627	47,828	57,380	58,556	66,080	74.2	67.5	20.5	12.9
Net Domestic Assets	44,044	46,387	49,328	53,913	57,468	60,381	60,157	56,906	57,914	65,026	10.1	30.5	0.8	12.3
of which: domestic credit	72,289	75,817	78,690	84,337	87,638	91,414	92,028	89,617	91,467	101,949	9.6	21.2	4.4	11.5
to government, net	12,766	12,010	12,527	13,496	13,412	13,185	10,656	11,158	9,339	7,828	12.0	5.1	-30.4	-16.2
to other domestic sectors	59,523	63,807	66,164	70,841	74,225	78,229	81,372	78,458	82,128	94,120	9.1	24.7	10.6	14.6
Broad Money	73,061	77,505	79,690	88,344	106,071	108,007	107,985	114,286	116,470	131,106	28.9	45.2	9.8	12.6
Narrow Money	18,030	17,395	19,065	20,285	23,704	23,451	23,897	24,291	24,591	30,084	30.1	31.5	3.7	22.3
Currency outside banks	6,637	6,412	7,266	7,475	8,507	8,372	8,531	8,672	8,779	10,379	11.4	28.2	3.2	18.2
Demand deposits	11,394	10,983	11,799	12,810	15,196	15,079	15,366	15,619	15,812	19,705	44.2	33.4	4.1	24.6
Quasi Money	55,031	60,109	60,625	68,059	82,368	84,557	84,088	89,994	91,879	101,022	28.6	49.7	11.5	10.0
denominated in kuna	8,129	9,403	9,415	9,397	10,531	11,970	12,340	13,264	14,189	18,894	39.3	29.5	34.7	33.2
denominated in foreign currency	46,902	50,706	51,210	58,662	71,837	72,587	71,748	76,730	77,690	82,128	26.9	53.2	8.1	5.7
Balance Sheet of National Bank														
Net Usable International Reserves 1/	19,814	21,702	23,875	25,067	29,049	27,226	28,573	33,026	33,112	39,761	27.6	46.6	14.0	20.1
in US dollars	2,430	2,488	2,761	3,045	3,476	3,276	3,440	3,982	4,000	4,780	19.6	43.1	15.1	19.5
Net Foreign Assets	27,117	29,316	31,495	34,864	37,659	36,628	37,855	42,679	42,796	49,621	24.4	38.9	13.6	15.9
less: Banks' foreign currency reserves	5,491	5,676	6,511	6,719	5,697	6,139	6,068	6,489	6,571	6,946	18.4	3.8	15.3	5.7
CNB bills in foreign currency	1,813	1,937	1,110	3,078	2,913	3,263	3,213	3,163	3,113	2,913	10.9	60.7	6.9	-6.4
Net Domestic Assets 2/	-8,096	-10,356	-11,321	-11,439	-11,246	-9,594	-10,605	-14,762	-14,623	-18,273	55.1	38.9	30.0	25.0
of which: claims on government (net)	-1,157	-2,341	-2,672	-1,853	-1,752	-1,752	-1,752	-1,752	-1,752	-1,752	210.2	51.4	0.0	0.0
claims on banks	330	23	226	18	19	19	19	19	19	19	-71.0	-94.4	0.0	0.0
claims on other domestic sectors	290	275	270	264	229	229	229	229	229	229	4.6	-20.8	0.0	0.0
other items (net)	-4,849	-5,472	-5,693	-5,973	-5,952	-6,152	-6,352	-6,552	-6,752	-7,552	12.9	22.8	13.4	11.8
less: CNB bills in kuna	2,395	2,581	3,158	3,453	3,459	944	1,872	5,444	5,057	7,775	91.2	44.4	46.2	53.8
blocked deposits 3/	315	261	295	443	325	325	325	325	325	325	-17.2	3.3	0.0	0.0
Reserve Money	11,717	11,346	12,553	13,627	17,803	17,632	17,968	18,264	18,489	21,488	13.6	51.9	3.9	16.2
Currency	7,169	6,786	7,752	7,911	9,046	8,911	9,070	9,211	9,318	10,918	13.1	26.2	3.0	17.2
Deposits	4,548	4,560	4,801	5,716	8,757	8,721	8,898	9,053	9,172	10,571	14.6	92.5	4.7	15.3
Memorandum items:														
Kuna/dollar exchange rate (eop)	8.16	8.72	8.65	8.23	8.36	...	...	...	...	...				
Narrow money multiplier	1.54	1.53	1.52	1.49	1.33	1.33	1.33	1.33	1.33	1.40				
Velocity of Kuna broad money	6.02	6.01	5.77	5.63	4.98	4.89	4.87	4.78	4.77	3.99				
Broad money/GDP ratio	0.46	0.48	0.48	0.53	0.62	0.62	0.61	0.64	0.64	0.67				
Foreign currency as a perc. of broad money	64.2	65.4	64.3	66.4	67.7	67.2	66.4	67.1	66.7	62.6				
Net Usable Int. Reserves at the program exchange rate 4/	2,327	2,479	2,823	2,955	3,460	3,260								
NDA of the National Bank at the program exchange rate 4/	-8,455	-10,136	-11,914	-11,984	-12,186	-10,624								
Nominal GDP (yearly total)	157,511				170,497				181,672	195,543				

Source: Croatian National Bank and staff projections

1/ See the definition in Annex VII of the MEFP.
2/ See the definition in Annex VIII of the MEFP.
3/ Blocked and restricted deposits, excluding required reserves in foreign currency.
4/ The kuna/dollar program exchange rate is equal to 8.6675.

Table 9. Croatia: External Financing Requirements, 1999–2004
(In billions of U.S. dollars)

				IMF Staff Projection		
	1999	2000	2001	2002	2003	2004
1. Gross financing requirements	**3,450.6**	**2,910.6**	**3,966.2**	**2,579.2**	**2,987.4**	**2,953.6**
External current account deficit (exc. official transfers inflows)	1,466.6	550.8	786.9	488.4	605.4	654.5
Debt amortization	1,743.1	1,831.3	1,976.7	1,566.8	1,602.3	1,892.9
Medium and long term debt	1,274.7	1,404.6	1,301.2	1,416.2	1,451.7	1,742.2
Public sector	107.8	411.4	403.0	659.9	396.4	879.4
Multilateral 1/	65.5	82.0	82.2			
Bonds and notes	40.5	159.7	252.9	518.1	161.2	576.3
Other	1.9	169.7	67.9	69.0	162.4	230.4
Commercial banks	643.3	500.3	255.9	238.4	550.2	287.7
Corporate private sector	523.6	493.0	642.3	517.9	505.1	575.1
Short-term debt 2/	468.4	426.7	675.5	150.6	150.7	150.7
Repayment of arrears	-	-	-	-	-	-
Gross reserves accumulation	209.5	499.7	1,171.8	490.4	746.0	372.6
IMF repurchases and repayments	31.4					
2. Available financing	**3,890.2**	**3,254.8**	**4,168.5**	**3,093.5**	**3,417.3**	**3,558.4**
Foreign direct investment (net)	1,444.3	1,086.1	1,191.1	1,089.5	954.3	927.8
Debt financing from private creditors	2,698.9	2,970.1	2,216.8	2,120.4	1,835.8	1,943.2
Medium- and long-term financing	2,272.2	2,294.6	2,066.1	1,969.8	1,685.2	1,792.6
To public sector	911.9	1,117.1	1,141.5	1,213.1	629.9	854.8
of which: balance of payments financing 3/	614.8	882.0	974.8	640.4	200.0	250.0
To commercial banks	589.4	347.9	336.6	258.4	450.2	307.7
To corporate private sector	770.9	829.6	588.0	498.2	605.1	630.1
Short-term financing	426.7	675.5	150.6	150.7	150.7	150.7
of which: balance of payments financing 3/	75.7	400.0	0.0	0.0	0.0	0.0
Official creditors 4/	373.4	353.1	289.3	632.7	479.9	664.8
Multilateral 1/	373.4	353.1	289.3	632.7	479.9	664.8
of which: balance of payments financing 3/	-	-	0.0	201.5	0.0	0.0
Bilateral	-	-	-	-	-	-
To public sector						
of which: balance of payments financing 3/	-	-	-	-	-	-
To private sector	-	-	-	-	-	-
IMF	-	-	-	-	-	-
Accumulation of arrears (exceptional)	-	-	-	-	-	-
Financing gap	-	-	-	-	-	-
Other flows 5/	-439.6	-344.3	-202.3	-514.3	-429.9	-604.8
Memorandum item:						
Total balance of payments financing	**690.5**	**1,282.0**	**974.8**	**841.9**	**200.0**	**250.0**

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

1/ Excluding the IMF.
2/ Original maturity of less than 1 year. Stock at the end of the previous period.
3/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.
4/ Includes both loans and grants.
5/ Includes all other net financial flows, and errors and omissions.

Table 10. Croatia: Selected Indicators of External Vulnerability,[1/] 1998-2002
(In percent, unless otherwise indicated)

	1998	1999	2000	2001 Mar	2001 Jun	2001 Sep	2001 Dec	2002 Latest figure	2002 Date
Economic indicators									
RPI inflation, yearly change (e.o.p.)	5.4	4.4	7.4	6.0	4.9	3.8	2.6	2.8	Feb-02
Real GDP growth rate, yoy	2.5	-0.4	3.7	4.2	4.7	4.0	*4.2*	*4.2*	Dec-01
Central government debt in percent of GDP 2/	38.8	47.6	50.9	52.0	51.1	52.9	50.7	50.7	Dec-01
domestic central government debt and guaranteed debt in percent of GDP 2/	16.5	18.7	18.5	17.9	18.0	19.8	19.7	19.7	Dec-01
foreign central government debt and guaranteed debt in percent of GDP 2/	22.3	28.9	32.4	34.1	33.1	33.0	30.9	30.9	Dec-01
Broad money (M4, percentage change, yoy)	13.0	-1.2	28.9	33.8	28.5	28.1	45.2	46.7	Jan-02
Claims on other domestic sectors 3/ (change, yoy)	22.4	-6.6	8.9	15.4	19.3	23.4	22.9	24.7	Jan-02
35-day CNB-bill yield, monthly average, percent	9.5	10.5	6.7	6.6	5.5	5.0	3.4	3.4	Feb-02
35-day CNB-bill real yield 4/, percent	3.9	5.8	-0.7	0.5	0.5	1.1	0.8	0.6	Feb-02
External indicators									
Real effective exchange rate (using retail prices) 5/, 1995=100	101.0	97.1	98.9	100.1	104.2	104.5	103.6	103.8	Dec-01
Export of goods and service (percentage change in US$, yoy) 6/	4.3	-5.3	6.7	5.4	2.6	17.4	10.0	10.0	Dec-01
Import of goods and service (percentage change in US$, yoy) 6	-6.5	-8.0	-2.0	12.7	20.9	7.4	10.6	10.6	Dec-01
Current account balance (US$ million, yoy)	-1,531	-1,390	-433	-611	-840	1,222	-664	-664	Dec-01
Current account balance (yoy) in percent of GDP 2/	-7.1	-6.9	-2.3	-3.0	-4.1	6.0	-3.3	-3.3	Dec-01
Capital and financial account (yoy) in percent of GDP 2/	7.4	12.7	8.1	6.8	22.7	0.2	7.4	7.4	Dec-01
Gross official reserves (US$ million)	2,816	3,025	3,525	3,514	3,799	4,416	4,677	4,741	Feb-02
Gross official reserves in percent of broad money (M4)	31	41	39	40	41	41	37	38	Feb-02
Gross official reserves in percent of reserve money	177	224	245	270	262	267	220	215	Feb-02
Gross official reserves in months of imports of goods and NFS	3.5	3.8	4.0	4.0	4.3	5.0	5.2	5.2	Feb-02
Net international reserves (US$ million)	2,581	2,807	3,325	3,314	3,612	4,233	4,528	4,502	Feb-02
Net international reserves in months of import of goods and NFS	3.2	3.5	3.8	3.7	4.1	4.8	5.0	5.0	Feb-02
Short-term debt in percent of gross usable reserves 7/ 8/ 9/ 10/	75.1	83.5	75.2	...	...	...	47.0	47.0	Dec-01
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 10/	72.8	54.4	54.9	...	...	...	28.9	28.9	Dec-01
Total external debt, percent of GDP 11/	40.3	44.5	53.1	52.8	52.0	*51.9*	*48.6*	*48.6*	Dec-01
External debt service to export ratio	13.5	22.8	22.9	35.0	16.1	*15.0*	*19.9*	*19.9*	Dec-01
Financial market indicators									
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	712	715	890	935	983	937	1,035	1,035	Dec-01
Zagreb Stock Exchange, capitalization, percent of GDP	13	13	14	16	17	*13*	*15*	*15*	Dec-01
Bond yield spreads 2/2002 (U.S. treasury notes, e.o.p.)	...	407.0	330.0	236.0	210.0	187.0	187.0	159.0	Feb-02
International ratings									
Debt ratings: Moody's:									
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	02/27/02
Government bonds, domestic currency	...	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	02/27/02
Fitch: Local currency LT	A-	BBB	BBB	BBB	BBB+	BBB+	BBB+	BBB+	02/27/02
Fitch: Foreign currency LT	BBB-	BB+	BB+	BB+	BBB-	BBB-	BBB-	BBB-	02/27/02
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	02/27/02
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	02/27/02
Memorandum items:									
Nominal GDP (US$ millions) 12/	21,628	20,064	19,030	*17,732*	*19,732*	*22,116*	*20,412*	*20,412*	Dec-01
Nominal exchange rate (HrK/US$, e.o.p.)	6.25	7.65	8.16	8.72	8.65	8.23	8.36	8.60	Feb-02

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

1/ Italics indicate preliminary figures or program data.
2/ Quarterly figures may be affected by the quarterly annualized GDP.
3/ Claims on domestic sector excluding central government and government funds.
4/ The 35-day CNB bill yield deflated by the annual percentage change in the retail prices.
5/ An increase in the index reflects a depreciation: end-year figures indicated annual average.
6/ 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.
7/ Data for short-term commercial bank credits derived from the CNB Foreign Exchange Department.
8/ Coverage limited to short-term debt contracts registered with the CNB.
9/ Short-term debt is presented on a remaining maturity basis.
10/ Gross reserves adjusted downward by foreign currency redeposit requirements held at the CNB, and by the amount of outstanding foreign currency CNB bills.
11/ Does not include debt that was excluded from the London Club agreement.
12/ Using the average exchange rate for the period.

Table 11. Croatia: Proposed Schedule of Purchases Under the Stand-by Arrangement

Date	Amount of Purchase 1/ In millions of SDRs	In percent of quota	Conditions
March 19, 2001	40.0	10.956	Board approval of stand-by arrangement.
May 15, 2001	40.0	10.956	Observance of end-March 2001 performance criteria.
August 15, 2001 2/	40.0	10.956	Observance of end-June 2001 performance criteria and completion of first review.
February 28, 2002 3/	40.0	10.956	Observance of end-December 2001 performance criteria and completion of second review.
May 1, 2002 4/	40.0	10.956	Observance of end-March 2002 performance criteria.
Total 14-month SBA	**200.0**	**54.78**	

1/ Assuming maximum proposed access. The authorities treat the arrangement as precautionary.
2/ Purchase made available upon completion of the first review on November 5, 2001.
3/ Re-phased purchase originally scheduled for November 2001.
4/ Re-phased purchase originally scheduled for February 2002.

CROATIA—RELATIONS WITH THE FUND
(As of January 31, 2002)

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	462.17	126.59
Reserve position in Fund	0.16	0.04

III. SDR Department:

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	85.49	193.39

IV. Outstanding Purchases and Loans:

	SDR million	% Quota
Extended arrangements	26.38	7.23
Systemic Transformation Facility	70.85	19.41

V. Financial Arrangements:

Approval Type	Expiration Date	Amount Approved Date	Amount Drawn (SDR million)	(SDR million)
Stand-by	3/19/2001	5/18/2002	200.00	0.00
EFF	3/12/1997	3/11/2000	353.16	28.78
Stand-by	10/14/1994	4/13/1996	65.40	13.08

VI. Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	1/31/2002	2002	2003	2004	2005	2006
Principal	--	26.60	26.60	26.60	10.20	4.80
Charges/Interest	--	2.50	1.70	1.00	0.40	0.20
Total	--	29.10	28.30	27.60	10.60	5.00

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, Croatian National Bank (CNB) is subject to a full Stage One safeguards assessment with respect to the stand-by arrangement approved on March 19, 2001, which is scheduled to expire on May 18, 2002. The assessment was delayed pending a first-time private audit of the CNB. Although the audit was completed in late 2001, the staff has not received the resulting reports and has thus not been able to complete the assessment.

VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with occasional participation of the Croatian National Bank. 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 Croatian National Bank transacts only in euros, U.S. dollars, and SDRs. On August 31, 2001, the official exchange rate was kuna 8.3725 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

Croatia maintains an exchange restriction on payments and transfers for current international transactions in connection with frozen foreign currency deposits. This restriction was approved by the Fund until March 31, 2002 (Decision No. 12448 (01/28) adopted on March 19, 2001), and a short-term extension of this approval through end-August 2002 has been requested separately on a lapse-of-time from the Executive Board.

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

Croatia is on a 12-month consultation cycle. The last **Article IV consultation** with Croatia was concluded on March 19, 2001 (EBS/01/27 and SM/01/80, both published). Executive Directors welcomed the progress achieved by the new government in restoring control over the public finances and its adoption of a comprehensive economic program for 2001-2003.

On March 19, 2001 Directors approved a 14-month **stand-by arrangement** for an amount equivalent to SDR 200 million (55 percent of quota). Directors agreed that this program, with its focus on the fiscal deficit and tax reductions, wage discipline, and structural reforms in the context of a stable exchange rate, offered the best prospects for achieving sustainable economic growth and external viability, while increasing employment and the population's standard of living in the medium term.

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

Discussions in May 1999 failed to reach agreement on a **stand-by arrangement** to help finance a prospective balance of payments gap in the wake of the Kosovo crisis. The principal areas of disagreement were wage policy—where the staff was asking the authorities to rescind previously agreed government sector wage increases—and privatization policy—where the staff urged the sale of a larger share of state enterprises in order to finance the fiscal cost of resolving a banking crisis.

XI. FSAP Participation:

Croatia agreed to participate in the FSAP. The first FSAP mission took place in April 2001 and the second mission took place in September 2001. The FSAP report is expected to be issued soon, and the FSSA will be prepared for the 2002 Article IV consultation.

XII. Technical Assistance 1992–2002:

Department	Timing	Purpose
FAD	November 1992	Tax Policy and Administration
	May 1993	VAT and Tax Administration
	November 1993	Public Expenditure Management
	March 1994	Treasury Establishment
	August 1994	Budget Preparation Mission
	November 1994	Follow up Mission on Treasury Establishment
	March 1995	Treasury Management Seminar
	August 1995	Treasury Implementation
	Nov.–Dec.1995	Treasury Implementation
	June-July 1997	Impact of VAT
	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification
STA	December 1992	Multi-topic mission
	October 1993	Monetary Statistics
	November 1993	Government Finance Statistics
	April 1994	Money and Banking Statistics
	July 1994	National Accounts
	November 1994	Balance of Payments
	January 1995	Money and Banking Statistics (together with EU1 mission)
	February 1996	BOP mission
	September 1996	National Accounts
	January 1998	Balance of Payments
	January 1998	Data Dissemination Standard
	February 1998	Quarterly National Accounts
	September 1998	Quarterly National Accounts
	November 1998	Quarterly National Accounts
	January 1999	Quarterly National Accounts
	February 1999	Balance of Payments
	June 1999	Quarterly National Accounts

	July 1999	Producer Price Indices
	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
MAE	December 1992	Bank Supervision
	October 1993	Monetary Instruments; Exchange Market
	January 1994	Monetary Operations and Banking Supervision; Exchange Market
	May 1994	Payments System, Monetary Operations, Foreign Exchange, Banking Supervision, and Accounting
	Aug. 1994–Aug. 1995	Monetary Operations (9 expert visits)
	October 1994	Monetary Operations Review
	December 1994	Payments system
	Jan.–Feb. 1995	Monetary Operations, Organization and Management, and Foreign Reserve Management
	Feb.–Dec. 1995	Payments System (4 expert visits)
	Aug. 1995–Apr. 1996	Monetary Operations (5 expert visits)
	September 1995	Foreign Exchange Management
	November 1995	Foreign Exchange, Public Debt, Monetary Policy
	September 1996	Interbank and Government Securities Markets, Internal Audit, Foreign Reserve Management
	October 1996	Foreign Exchange Management
	November 1996	Payments System
	March 1997	Foreign Exchange Management (expert visit)
	April 1997	Banking Law Issues (staff visit with LEG)
	April 1997–Feb. 1998	Accounting (6 expert visits)
	July 1997	Banking Sector Strategy (staff visit)
	September 1997	Banking Sector Strategy and Banking Law Issues
	Sept.–Nov. 1997	Information Technology (2 expert visits)
	Mar. 1998–Mar. 1999	Accounting (resident advisor)
	Apr. 1998–Aug. 1999	Banking Supervision (resident advisor)
	April–June 1998	Foreign Exchange Management (2 expert visits)
	May 1998	Banking Law Issues (2 staff visits)
	August 1998	Banking Soundness and Banking Law Issues
	November 1998	Banking Supervision (with WB mission)
	March–Dec. 1999	Banking Supervision (resident advisor)
	April 1999	Foreign Exchange Operations and Reserves (two expert visits)
	November 1999	Accounting
	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
INS	1993–97	Fiscal Policy Management (7 participants)
	1993–99	Monetary and Banking Statistics (6)
	1994	Basic Economics (1)
	1994	Tax Policy Administration (1)
	1994–95	Public Expenditure Policy and Management (2)
	1994–96	Government Finance Statistics (5)
	1994–96	External Sector Policies (3)
	1994–97	Comprehensive Course in Applied Market Economics (7)
	1994–98	Central Bank Accounting (5)
	1994–99	Foreign Exchange Policies and Operations (5)
	1995	Public Finance (1)
	1995	Tax Policy in Transition Economies (1)
	1995	Value Added Tax (1)
	1995–97	Financial Market Instruments (2)
	1995–97	Financial Programming Policy (2)
	1995–98	Banking Supervision (2)
	1995–98	Techniques of Financial Analysis and Programming (4)
	1995–99	Balance of Payments (3)
	1995–99	Macroeconomic Analysis and Policy (9)
	1995–99	Public Expenditure and Treasury Management (7)
	1996	Financial Transactions for Lawyers (1)
	1996–97	Tax Administration and Reform (2)
	1997	Payment System (1)
	1997	Banking Soundness and Monetary Policy in World of Global(1)
	1997–98	Monetary Operations (2)
	1998	Current Legal Issues Affecting Central Banks (1)
	1998	Monetary and Exchange Operations (1)
	1998	Specialized Course on Exchange Rate Policies (1)
	1998	Trade and Exchange Rate Policies (1)
	1999	A Decade of Transition: Achievements and Challenges (1)
	1999	Management and Operational Issues for Central Bank Accountant (1)

XIII. Resident Representative:

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

CROATIA: RELATIONS WITH THE WORLD BANK

1. Croatia succeeded to the membership of the Socialist Federal Republic of Yugoslavia (SFRY) in the World Bank in 1993. Croatia is currently on its debt service payments in accordance with an agreement on debt apportionment reached with the Bank whereby Croatia assumed debt service responsibility for Bank loans benefiting borrowers on its territory.

2. Currently, there are eleven Bank supported projects (10 investment loans and 1 adjustment operation) totaling US$524.1 million under implementation in Croatia: the Farmer Support Services Project (US$17 million) became effective in July 1996, the Coastal Forest Reconstruction and Protection Project (US$42 million) in July 1997, and the Investment Recovery Project (US$30 million) became effective in March 1998. The Reconstruction Project for Eastern Slavonia, Baranja and Western Srijem (US$40.6 million) became effective in January 1999. The Municipal Environmental Infrastructure Project (US$36.3 million) was approved in June 1998, the Railway Modernization and Restructuring Project (US$ 101 million) in January 1999, Technical Assistance II (US$7.3 million) in April 1999 and the Health System Project (US$29 million) in October 1999. The Trade and Transport Facilitation in Southeast Europe (US$13.9 million) became effective in May 2001. The Court and Bankruptcy Administration Project (US$5 million) became effective in January 2002, whereas the Structural Adjustment Loan (US$202 million) was made effective in February 2002, with a first-tranche disbursement of US$99.9 million.

3. Investment projects under preparation include the following operations: Pension System Investment Project, District Heating Project, Registration and Cadastre Project, Coastal Cities Pollution Control Project, Energy Efficiency Project, a US$150 million Rijeka Port and Roads Project as well as GEF financed US$5 million grant for Karst Ecosystem Conservation Project. Furthermore, projects on Social Protection and Health Sector Reform are under consideration.

4. The essential preconditions for economic growth are fiscal consolidation and supportive macro policies as well as deeper structural reforms. Structural reforms include those reforms intended to: (i) reduce the level of public expenditures and the size of the state; (ii) restructure pension and health sectors; (iii) safeguard confidence in the banking system; (iv) enhance enterprise efficiency; (v) strengthen market institutions and competitiveness in the economy to attract FDI; (vi) enhance labor market flexibility; and (vii) mitigate the social cost of reforms and poverty through restructuring of social welfare programs. Progress is being made in these areas. A Public Expenditure and Institutional Review (PEIR) has been completed, and a US$202 million Structural Adjustment Loan (SAL) was made effective and the first tranche released in February 2002. The PEIR and SAL were key elements of the Bank's assistance strategy in the 1999 CAS. Because of Croatia's greatly improved prospects for European integration, the Bank is ready to provide not only lending but also non-lending assistance in support of the country's accelerated accession process with the EU, through so-called EU/Country Economic Memorandum.

5. After consultations with the Government and stakeholders in the country, the World Bank has prepared Progress Report on the 1999 CAS, which was approved by the Board in September 2001.

6. IFC has approved nine investments in Croatia to date: (1) the equity participation of a US$2.6 million in a Croatian bank; (2) a US$3.2 million loan to a small regional bank based in Split, for the financing of small and medium-sized enterprises; (3) a US$6.0 million equity investment and a US$19.6 loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility; (4) a US$5.0 million equity investment in a venture capital fund; (5) a US$15 million loan to a regional bank for a credit line for on-lending to small and medium-sized enterprises; (6) a US$3 million equity investment in a pension management company to be founded under Croatia's landmark pension reform law; (7) a US$15 million loan and US$6.1 million equity investment to modernize a ship repairing facility in Rijeka, (8) a US$6 million loan and US$10 million equity in the leading pharmaceutical complex in Croatia, and (9) a US$5 million loan and US$1.2 million equity investment in a Croatian leasing company. IFC is seeking to expand its activities in Croatia, focusing on financial market development, restructuring industry, tourism, infrastructure privatization, restructuring on the oil sector and private sector involvement in health care.

Croatia: Statistical Issues

1. The economic database in Croatia is of mixed, though improving, quality. Data on monetary aggregates have the least problems and are close to Fund standards. In other areas, major deficiencies, excessive delays in data release, and subsequent revisions impact the reliability and timeliness of macroeconomic analysis. In most cases, however, remedial action has been taken to improve data quality, coverage and reliability, but in some instances progress has been impeded by insufficient budgetary support and lack of cooperation between government agencies. The recent creation of a joint committee between Ministry of Finance and Croatian National Bank should promote collaboration in the statistical area to advance the reconciliation of government finance and monetary data.

A. National Accounts

2. National accounts (NA) data systems have undergone substantial improvement in the last two years, enabling publication of a broader, and more comprehensive, set of NA data. The Central Bureau of Statistics (CBS) compiles and publishes annual constant and current price data according to the production, income, and expenditure approaches. On June 30, 1999, the CBS began publishing quarterly GDP data by expenditure and main industry groupings at current and constant (1997) prices, thus meeting the SDDS target date. Nonetheless, shortcomings remain which limit the coverage and hinder the reliability of the estimates. These include: a lack of quarterly source data for the seasonally volatile agricultural sector; incomplete coverage of the informal sector; inadequate conversion of government finance statistics from a cash to an accrual basis; insufficient access to preliminary or unpublished source data; inadequate source data for measuring changes in inventories; inadequate price deflators; and incomplete coverage of unincorporated businesses and the self employed (farmers, trade and crafts). The government is currently preparing plans to ensure the continued availability of enterprise financial statistics when ZAP, the payments system agency that currently collects them, will be phased out.

B. Prices

3. The CBS produces monthly indices of retail and producer prices, and a monthly cost of living index based on the consumption basket of a typical low-income, non-farm household. Data are collected around the 20th day of each month, and the indices are released on the last working day of the month. However, the price statistics are calculated using outdated weights on the basis of a small sample of observations. No import or export price deflators are produced, thereby hindering analysis of external sector developments.

C. Wages and Employment

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

working population, including persons employed in trade and crafts, contract workers, farmers, and military and police workers.

5. The number of registered unemployed overstates the actual level of unemployment. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample has been subsequently expanded and the survey is now being conducted on a regular basis with semi-annual results, released only after a delay of about ten months. The last available data, relating to the first half of 2000, showed the unemployment rate at 15.1 percent, against the level of 21.2 percent reported by administrative sources.

D. Fiscal Data

6. A large amount of data on government finance statistics is produced on a monthly basis with lags of between three and twelve weeks, and is available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data on a GFS basis are reliable and available on request on a next-day basis for most major categories for both the budget and the extrabudgetary funds. In 2000, the inclusion of outstanding receivables cancelled against arrears in off-setting operations diminished the transparency of the central budget accounts. Expenditure data on a cash basis are available according to GFS methodology (economic and functional classification) for the budget and the extrabudgetary funds. These data, however, record the release of expenditure authorizations by the Ministry of Finance, rather then the actual expenditure of funds. Data on financing by non-cash methods are not published, but the authorities have provided information to the staff more readily than in the past. Budget users "own revenues" have been brought into the 2002 budget. The data on central government financing in the Ministry of Finance reports, the monetary survey and the balance of payments are not reconciled.

7. Data on the stock of government debt suffer from certain deficiencies although a new Croatian National Bank 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 compounded by a central government debt table in the Croatian National Bank Bulletin, which also reports stocks of central government guaranteed debt. However, 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 an annual basis and with a considerable lag.

E. Monetary Data

9. Data on the monetary survey and the balance sheet of the Croatian National Bank (CNB) and deposit money banks are published monthly with an approximate six week lag. 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 new statistical reporting system which enables banks to report in a single set of forms their balance sheets, reserve requirements, interest rates, etc.,

was introduced on July 1, 1999, together with a new chart of accounts. No attempt is made by the CNB or the Ministry of Finance to reconcile data on net bank credit to government with government financing statistics. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies.

F. Banking Statistics

10. Banks' lending and deposit rates are published monthly in the CNB Monthly Bulletin. Banks' annual financial statements tend to understate the riskiness of their assets by misclassifying loans to certain sectors and by booking "big bonds" (government bonds issued to clear outstanding enterprise debt) and other assets at face value even though some of these assets trade at a large discount. This produces a misleading picture of the quality of bank assets, leading to underprovisioning of bad assets and overstatement of capital adequacy ratios.

G. Balance of Payments Data

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

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

Table 12. Croatia: Core Statistical Indicators
(as of February 28, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/ Debt Service
Date of Latest Observation	Feb. 28, 2002	Feb. 28, 2002	Feb. 28, 2002	Feb. 28, 2002	Jan. 31, 2002	Feb. 28, 2002	Jan. 2002	Dec. 2001	Q3 2001	Dec. 2001	Q3 2001	December 31, 2001
Date Received	Feb. 28, 2002	Feb. 28, 2002	Feb. 28, 2002	Feb. 28, 2002	Feb. 23, 2002	Feb. 28, 2002	Feb. 8, 2002	Feb. 12, 2002	Dec. 4, 2001	Jan 2002	Dec. 28, 2002	Jan. 24, 2002
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
Source of Update	CNB Website	CNB Website	CNB	CNB	CNB	CNB	CBS Website	CBS Website	CNB	Ministry of Finance	CBS Website	CNB
Mode of Reporting	On-line	On-line	E-mail	E-mail	E-mail	E-mail	On-line	On-line	E-mail	E-Mail	On-line	E-Mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

CROATIA: IMPLEMENTATION OF STRUCTURAL MEASURES NOT SUBJECT TO FUND CONDITIONALITY

A. Fiscal Sector

1. Some minor slippages occurred in the fiscal sector. The monitoring system for government guarantees and lease contracts (item 3) is still being developed. The registry of farmers receiving subsidies has not been implemented yet (item 7).

B. Public Enterprises

2. Progress in this area has been slow. The IPO of the telecommunications company (HT) was postponed because of unfavorable market conditions (item 2). The privatization of the insurance company (CO) and pipeline (JANAF) have also been delayed (items 3 and 4). The privatization laws for the electricity company (HEP) and the petroleum company (INA) will be adopted by parliament by March 20, 2002 (item 10a), as a prior action, paving the way for their restructuring and privatization (items 7, 8, and 10b). Although INA has divested its noncore assets, divesture of HEP and the railroad (HZ) will not be completed by end-March 2002 (item 9b). Privatization of five out of the 12 enterprises listed in the law on rehabilitation of public enterprises has been postponed due to poor market conditions (item 11).

C. Monetary and Financial Sector

3. Minor slippages occurred in the reform agenda for the monetary and financial sector. The most relevant ones are the delay in adopting a firm plan for the future of the postal bank (HPB, item 1b) and submitting the draft of the new banking law to parliament (item 3a), the latter due to an extensive consultation process. The adoption of consolidated supervision for financial conglomerates (item 6d) will be delayed as the relevant measures are included in the new draft banking law. Amendments to the securities law have been prepared (item 6b).

D. Judicial System

4. The World Bank Court and Bankruptcy Administration Project became effective in March 2002.

Table 13. Croatia: Structural Measures

Structural Measures	Lead Institution 1/	March 2001	June 2001	Sep. 2001	Dec. 2001	Mar. 2002	After Mar.02
Fiscal Sector							
1. Operationalize the treasury and the treasury single account.	IMF						
a) Startup of treasury operations.		*					
b) Channel all but routine central budget expenditures through the treasury single account.		*					
c) Channel all expenditures of the central budget and the extrabudgetary funds (except the health fund) through the treasury single account.			*				
d) Channel health fund expenditures through the treasury single account.						*	
2. Start applying the new treasury information system to monitor arrears and payments float.	IMF	*					
3. Develop and apply a monitoring system for government guarantees and lease contracts.	WB		* →	→	* →	→	*
4. Health care reform.	WB						
a) Reduce the level and duration of sick-pay benefits.		* →	→	→	*		
b) Increase/Introduce co-payments for drugs and selected health services and reduce the exemptions. 2/			* →	*			
c) Introduce budget caps on spending for outpatient polyclinics.		*					
d) Moratorium on new capital investments in health sector except for those foreign-financed projects already included in the budget.		*					
e) Introduce a basic package for public health provision.			* →	→	*		
f) Introduce performance-based reimbursements for the ten most frequent medical services.			* →	→	*		
5. Strengthen the first-pillar reform by improving efficiency and operations of the Pension Institute.	WB	*					
6. Ensure adequate budget resources for the introduction of the second pillar of the pension system in the 2002 budget.	WB				*		
7. Ministry of Agriculture to compile a list of farmers to facilitate the provision of income support subsidies.	WB			* →	→	→	*
8. Prepare the 2002 budget on the basis of recommendations of the Public Expenditure Review.	WB				*		
Public Enterprises							
1. Croatian Privatization Fund	WB						
a) Adopt action plan for divestiture of all shares.		*					
b) Divest all shares in 327 enterprises.					*		
c) Divest any assets that are returned to the Privatization Fund due to the nonpayment by the beneficiary (within one year in the case of each enterprise).							
2. Complete preparation for IPO of HT.	WB		* →	→	* →	→	*
3. Prepare privatization and conduct tender for the insurance company.	WB			* →	→	→	*
4. Prepare privatization and conduct tender for the privatization of JANAF.	WB				* →	→	*
5. Any subsidization of enterprises to be transparent in the budget and not to include tax concessions (throughout the entire period).	WB						

Table 13. Croatia: Structural Measures (continued)

Structural Measures	Lead Institution 1/	March 2001	June 2001	Sep. 2001	Dec. 2001	Mar. 2002	After Mar.02
Public Enterprises (continued)							
6. Regulatory framework for public utilities.	WB						
a) Submission of regulations to parliament. 3/		* →	*				
b) Enactment of regulations. 3/			* →	*			
7. Implement the decision to unbundle the National Power Company (HEP).	WB		* →	→	* →	→	*
8. Implement the decision to restructure the National Petroleum Company (INA).	WB		* →	→	* →	→	*
9. HEP, INA and National Railroad (HZ).	WB						
a) Decision on divestiture of noncore assets of public enterprises (HEP, INA, HZ).		* →	*				
b) Implementation of this decision.				* →	→	→	*
10. Privatization of HEP and INA.	WB						
a) Adoption of privatization laws for HEP and INA. 4/				* →	* →	*	
b) Privatization of both companies. 5/						* →	*
11. Implementation of the Government resolution to privatize/liquidate 12 enterprises listed in the Law on Rehabilitation of Selected State-Owned Enterprises.	WB		* →	→	→	* →	*
Monetary and Financial Sector							
1. Bank privatization.	WB						
a) Adopt a plan to improve efficiency of Hrvatska Poštanska Banka (including budget provision for recapitalization if needed).		* →	*				
b) Adopt a plan to rationalize Hrvatska Poštanska Banka, including the possibility of privatization. 6/					* →	→	*
c) Prepare for privatization and conduct privatization tender for:							
Dubrovačka Banka		* →	*				
Croatia Banka			* ←	*			
2. Obtain parliamentary approval for the draft National Bank Law to adopt price stability as the CNB's primary objective, give the CNB exclusive responsibility for monetary and exchange rate policy, ensure the personal independence of the CNB's board, prohibit the CNB from lending to the government, and formalize the procedures for consultation and information sharing between the CNB and the Ministry of Finance.	IMF	* →	*				
3. Banking A new law to provide for CNB's automatic, but graduated response to banks not in compliance with regulations, ensure prompt bank resolution based on the least-cost principle, and lengthen the transitional period for adjusting bank exposure (if needed). The new law will also clarify and strengthen the procedures pertaining to the insolvency of banks.	IMF						
a) Submit draft law to parliament.			* →	* →	*		
b) Obtain parliamentary approval.					* →	*	
4. Exchange restrictions	IMF						
a) Allow enterprises to hold foreign exchange deposits.		*					
b) Allow banks to lend to residents in foreign exchange.		*					

Table 13. Croatia: Structural Measures (continued)

Structural Measures	Lead Institution 1/	March 2001	June 2001	Sep. 2001	Dec. 2001	Mar. 2002	After Mar.02
Monetary and Financial Sector (continued)							
5. Money market	IMF						
a) Introduce monthly instead of weekly auctions of CNB bills.		*					
b) Develop repo market and establish master repo agreement.			*				
6. Bank and nonbank supervision.	WB/IMF						
a) Review current banking regulations and practices with a view to identify deficiencies vis-à-vis EU directives.			*				
b) Review securities law, regulations and practices with a view to identify deficiencies vis-à-vis pertinent EU directives.			*				
c) Adopt a plan to formalize cooperation among supervisory agencies.				*	▶ *		
d) Adopt consolidated supervision for financial conglomerates.			*	> *			▶ *
e) Increase the frequency of on-site supervision of insurance companies.			*	> *			
f) Agree on a timetable for the full compliance with the insurance law.			*	> *	▶ *		
7. Capital market	IMF/WB						
a) Avoid issuing T-bills and CNB bills with same maturities.		* <	*				
b) Consolidate all outstanding government bonds into one single type of bond with different maturities.						*	▶ *
8. Payments system	IMF/WB						
a) Implement the new clearing system (NKS).		*					
b) Abolish the CNB's intervention credit facility.		*					
c) Steering Committee on ZAP finalizes drafting amendments to law on domestic payment system.		*					
d) Obtain parliamentary approval of amendments of domestic payment system law with a view to reorganize ZAP.				*	▶ *		
e) Include the depository for CNB bills in the Central Depository Agency.					*		▶ *
f) Adopt delivery-versus-payment of securities transactions.					*		▶ *
Judicial System							
Begin to take measures to strengthen the capacity of the commercial courts to settle bankruptcy cases (measured by satisfactory progress under a new World Bank loan).	WB	*		> *		▶ *	

1/ Institution primarily responsible for providing technical assistance and general advice for implementing the structural measure(s) concerned. Except where explicitly footnoted, the structural measures listed in this matrix do not represent program conditionality.
2/ Co-payments have been introduced for drugs only.
3/ Of the five laws approved by parliament in July, the one on regulation of energy services entered into force immediately. The other four laws became effective on January 1, 2002.
4/ Parliamentary approval by March 20, 2002 of the privatization laws of HEP and INA is a prior action for the second review.
5/ Privatization program for INA to be developed by end-March 2002 is a new structural benchmark for the second review.
6/ The appointment of a privatization advisor is a prior action for the second review. The advisor shall prepare a plan by May 15, 2002 to sell a large enough share of the bank to remove the government's veto power on management decisions.

——▶ Revision as of the second review.
——> Revision as of the first review.

Zagreb, Croatia
March 11 , 2002

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

Dear Mr. Köhler:

1. This letter describes the economic policies the Croatian authorities intend to pursue during the remaining period of the stand-by arrangement approved by the Executive Board of the International Monetary Fund on March 19, 2001; proposes quantitative performance criteria and an additional structural benchmark for the end of the program period on March 31, 2002; and requests the modification of an existing structural performance criterion for March 31, 2002. The policy intentions expressed in (i) the Memorandum of Economic and Financial Policies attached to our letter of January 31, 2001, (ii) the Supplementary Memorandum of Economic and Financial Policies attached to our letter of August 29, 2001, and (iii) our letter of October 31, 2001 continue to represent our policy undertakings under the arrangement in all respects not specifically addressed in the present letter.

2. The performance criteria for December 31, 2001 have been observed except for that on government arrears, which was exceeded by a very small margin, and those on government borrowing from domestic banks and on contracting and guaranteeing public debt, which were missed by larger margins. All three breaches were the result of a shortfall in privatization receipts. To make up for the breach of the performance criterion on arrears, we have programmed a more rapid reduction of arrears in the first quarter of 2002. As we have not changed the scope of our privatization program, we expect the higher recourse to domestic bank financing also to be temporary. And, as noted in paragraph 8, we intend to use any excess of privatization receipts in 2002 to lower government indebtedness.

3. Macroeconomic developments in 2001 were better than programmed: economic growth was higher, inflation lower, and the international reserves gain larger than originally programmed. Notwithstanding the unfavorable external environment, we expect real GDP growth to slow only moderately in 2002 to 3.5 percent, while inflation is expected to subside further on an average annual basis to no more than 4 percent despite excise tax and administered price increases. Our fiscal and monetary programs for 2002 have been based on these assumptions.

4. The budget approved by parliament envisages a further reduction of the deficit of the consolidated central government from 5.4 percent of GDP in 2001 to 4.25 percent of GDP in 2002. At the same time, the expenditure to GDP ratio is expected to decline further from

43.3 percent in 2001 to 41.0 percent in 2002. The government debt to GDP ratio would decline from 50.7 percent at end-2001 to 50.4 percent at end-2002, assuming no further increase in guaranteed debt (disbursed and outstanding). We are thus continuing to implement our medium-term fiscal consolidation program that aims at reducing and eventually stabilizing the public debt ratio, while streamlining fiscal operations and reducing the size of government.

5. The 2002 budget seeks to enhance transparency by incorporating all five extrabudgetary funds[1] in the central budget, bringing spending units' own resources (estimated at 0.5 percent of GDP) and expenditure financed therefrom on budget, and presenting the budget on a modified accrual basis with privatization receipts treated as a financing item. At the same time, as a sign of the government's commitment to reduce unemployment and raise the standard of living throughout the country, we have created two funds for development and employment and for regional development. The funds, which remain on the budget and are authorized to spend up to 2 percent of GDP, will channel privatization receipts and supplementary budgetary resources to selected priority capital investment and active labor market projects in an attempt to rally support for privatization and address a perceived lack of development and labor market orientation of the government's policies. The funds will be managed without additional staffing and their activities will be subject to parliamentary oversight. We intend to review their operation in mid-2002. In line with Fund technical assistance recommendations, we have postponed the implementation of the second and third phases of our decentralization plan. However, the first phase of decentralization was completed at the start of 2002 with the transfer to local bodies of responsibility for operational and maintenance costs for the homes for the elderly and disabled.

6. The revenue to GDP ratio is expected to decline further from 38.4 percent to 37.2 percent of GDP, despite higher excises on cars and beer, a new car insurance tax, measures to boost social security collections, and the inclusion of ministries' own revenue in the budget. While the reduction of import duties and the full-year effect of decentralization do not entail substantial drops in revenue, the introduction of the second pension pillar on January 1, 2002 is expected to result in a revenue loss of 1.2 percent of GDP.

7. The deficit reduction is thus again more than fully attributable to a cut in the expenditure ratio. Among the major expenditure categories, only interest payments will increase faster than nominal GDP. All other expenditure categories (wages, goods and other services, subsidies and transfers, and investment and net lending) are expected to decline in relation to GDP by a combined total of 2.6 percentage points. With the basic wage unchanged in 2002, we expect to realize sufficient savings from layoffs, especially in the defense sector, to address some pay inequities and still remain within the budgetary

[1] The pension fund, the health fund, the unemployment fund, the child benefit fund, and the water management fund.

envelope. While social spending (including cash benefits and the provision of health services) is projected to be reduced by almost 1.4 percent of GDP as a result of the measures adopted in September–October 2001, the total amount of subsidies and current transfers declines by less than this amount because of new subsidies toward job creation and agricultural and industrial development. Spending for these purposes by the two new budgetary funds is to be financed mainly by privatization proceeds. We intend to limit the prefinancing of such spending to no more than 20 percent of budgeted privatization revenue (i.e., HrK 500 million or 0.25 percent of GDP). In the first quarter of 2002, such prefinancing will not exceed one half of this amount (Attachment I, footnote 3).

8. The deficit is expected to be more than financed by privatization receipts of 1.5 percent of GDP and net foreign borrowing of 2.9 percent of GDP, leaving a domestic financing surplus of 0.2 percent of GDP. As the private pension funds and other nonbanks are likely to absorb a substantial amount of government debt (2.3 percent of GDP), there would be a sufficiently large surplus to eliminate remaining government arrears (0.3 percent of GDP) and reduce indebtedness to domestic banks (by 2.2 percent of GDP). Although the government is still firming up its privatization plans, the budget counts on a much lower level of privatization receipts than in the past. Any excess in the realization of receipts during 2002 will be used to reduce government borrowing. About one quarter of the budgeted annual total is expected to be realized by end-March 2002, mainly from the privatization of Dubrovačka banka and the sale of the government's remaining stake in Splitska banka. Also, we have already obtained US$102 million under the recently approved World Bank SAL and borrowed €500 million in the international capital market.

9. The cumulative deficit of the consolidated central government for the first quarter of 2002 will be a performance criterion under the stand-by arrangement for March 31, 2002. It will be adjusted by the amount by which social contributions collected by the private pension funds deviate from the amount projected (Attachment I). Consistent with the first-quarter deficit's financing plan, performance criteria are also being proposed on net credit of the banking system and arrears of the consolidated central government for March 31, 2002. The programmed contraction of net bank financing will be reduced by up to HrK 500 million to reflect the amount of any prefinancing of expenditures by the two new budgetary funds (Attachment I). In addition, limits on short-term external public debt and the contracting and guaranteeing of nonconcessional external public debt with a maturity of more than one year (including a subceiling on such debt with a maturity of less than 5 years) are being proposed as performance criteria for end-March 2002 (Attachment I).

10. We will start immediately with work to broaden the coverage of the government sector. To this end, we will consolidate with the newly expanded budget in the course of 2002: the fiscal operations of the counties and larger cities; the recently established agencies for highway construction (HAC) and for road maintenance and construction (HC); the privatization fund (CFP); and the deposit insurance and bank rehabilitation agency

(DAB).[2] Fund technical assistance will be provided in March 2002 to help with the setting up of the reporting system and overcome difficulties experienced with the new chart of accounts. Since January 1, 2002, the transactions of all former extrabudgetary funds are being channeled through the treasury single account and all separate ministerial accounts were closed as of that date. While some 2,400 accounts of individual spending units cannot be closed immediately due to legal constraints, budgetary revenue and expenditure will no longer be channeled through these accounts. The upgrading of software for the single treasury system allows the daily reporting of arrears since the start of 2002.

11. In accordance with the new CNB law, monetary policy continues to aim at price stability. The CNB intends to pursue this objective during 2002 primarily by aiming at a broadly stable exchange rate. The external current account outlook gives no indication that the present level of the exchange rate is inappropriate. If base money exceeds its projection, the CNB will consult with the Fund to determine whether the inflation outlook warrants an unsterilized buildup of international reserves (Attachment I).

12. The monetary program adopted for 2002 aims at keeping gross official reserves at about five months of imports on average. It is based on the assumption that a substantial share of the inflows related to the euro conversion will remain in the banking system. Nonetheless, some outflows can be expected and, on an annual basis, the pace of remonetization is expected to slow down considerably in 2002. The government's financing surplus would leave sufficient room for noninflationary credit expansion to the nongovernment sector. With government arrears reduction, financing from the new private pension funds, continued good profitability, and an expected slowdown of credit to the household sector, this should allow for a further recovery of investment. To protect the private sector's access to domestic bank credit in the first quarter of 2002, a performance criterion is being proposed for the extension of bank credit to 10 large public enterprises as of March 31, 2002 (Attachment I). Performance criteria are also being proposed for the CNB's net usable international reserves and net domestic assets at end-March 2002 (Attachment I).

13. The CNB will exercise prudence in implementing its monetary program. The extent of deposit withdrawals after the euro conversion is uncertain, and unexpectedly large withdrawals—which would lead to a lower demand for required reserves in kuna— may need to be countered with prompt liquidity tightening. At any rate, the CNB does not intend to reduce reserve requirements during the remainder of the arrangement period. The CNB will improve short-term liquidity forecasting as a basis for its effective liquidity management. For this purpose, the Ministry of Finance will from April 1, 2002 provide information on its cash flow projections to the CNB on a regular basis.

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[2] The financial operations of the development bank (HBOR) will continue to be monitored outside this consolidation, but using the same GFS methodology.

14. A new draft banking law to strengthen the legal framework, including with respect to consolidated supervision and capital adequacy (currently, market risks are excluded), has been discussed by parliament in its first reading and is expected to be adopted by end-March 2002. As the last part of the major payment system reforms, a new law on national payment systems and a new law on financial agencies were adopted by parliament on December 14, 2001. From April 1, 2002, payment transactions can be handled by banks rather than exclusively by the domestic payment agency (FINA, formerly ZAP). The new law on financial agencies gives the management of FINA up to end-2002 to determine services to be privatized, including the national clearing system (NKS).

15. We realize that insufficient progress has been made to boost the efficiency of the economy and attract foreign capital. We therefore will re-energize our privatization drive in an effort to put government owned assets to more productive use. We will definitely privatize in 2002 Croatia banka and the insurance company (CO) and parts of the petroleum company (INA) and sell our remaining shares in Riječka banka and Privredna banka. The laws authorizing the privatization of INA and the power company (HEP) will be adopted by parliament by March 20, 2002 (prior action; Attachment II), thus completing a measure that was a structural benchmark for December 31, 2001 under the arrangement. A privatization program for INA will be developed by end-March 2002 as a new structural benchmark. Under this program, at least 25 percent of INA will be privatized in the second half of 2002 in accordance with a recent government decision. Because of depressed telecom prices, we have decided to postpone the IPO of the telecommunications company (HT). However, if market conditions improve, we will proceed with the IPO in 2002.

16. We will also privatize the postal bank (HPB). Under new management, and with the sale of its nonperforming portfolio to the privatization fund and a reduced fee for its use of post office (HP) facilities, its performance has improved. There has been a small (as yet unaudited) profit in 2001, and another small profit is envisaged for 2002. HPB's capital adequacy ratio is now very high, and the bank will not require budgetary support in the foreseeable future. Nonetheless, the bank needs a strategic investor for its long-term viability. We have therefore appointed a privatization advisor (prior action; Attachment II) to prepare a plan by May 15, 2002 to sell a large enough share of the bank to remove the government's veto power on management decisions. A shareholders meeting of HPB will decide by June 30, 2002 on how to privatize the bank in accordance with the privatization advisor's recommendations. In the meantime, we already have approached the IFC as a possible investor in HPB.

17. To attract foreign investment, we have adopted a series of measures proposed by the World Bank's FIAS to cut red tape and opened a one-stop shop to facilitate dissemination of information to potential investors and their applications for visas, permits and licenses. We expect parliament to approve a law on industrial parks by end-March 2002. We also expect to send to parliament by end-March 2002 a draft bankruptcy trustee services law aimed at improving the qualifications of certified bankruptcy trustees.

18. Financial discipline in the public enterprises has been strengthened. Labor cost and employment have been reduced in the 10 large enterprises subject to close monitoring (for their list, see Annex VI to the Supplementary Memorandum of Economic and Financial Policies). In addition, we have reduced government sector employment to below the agreed limit on December 31, 2001. However, because of the delayed approval of the defense sector reform laws, we will not reach our end-March 2002 employment reduction target (a structural performance criterion) until the end of May 2002. We therefore request a modification of this performance criterion (Attachment II). Additional employment reductions in the government sector will be effected during the remainder of 2002 on the basis of the new legislation aiming at restructuring and modernizing the defense sector, which we expect to be approved by parliament by March 15, 2002. We expect the absorption of unemployed labor to improve following implementation of the recently approved employment law (prior action; Attachment II) and of a new labor law, which is expected to be approved by parliament by June 30, 2002. Retraining and other active labor market measures under the 2002 budget, financed in part by World Bank lending, will support this effort.

19. On the basis of our performance to date and the policies described in this letter, we request the completion of the second review under the stand-by arrangement and waivers for the nonobservance of the three performance criteria indicated in paragraph 2. We believe that the policies described in this letter are adequate to achieve the objectives of our economic program, but we stand ready to take any further measures to keep our program on track. We will remain in close consultation with the Fund in accordance with the Fund's policies on such consultations. Discussions on an arrangement to succeed the present one will provide an opportunity to assess progress with program implementation and reach any understandings that may be needed to achieve the present program's objectives.

20. We would like to reaffirm our intention not to make the purchases that will become available under the arrangement with the completion of the second review and with observance of the performance criteria for March 31, 2002.

Sincerely yours,

/s/	/s/	/s/
Slavko Linić Deputy Prime Minister	Mato Crkvenac Minister of Finance	Željko Rohatinski Governor Croatian National Bank

Attachments

Croatia: Proposed Quantitative Performance Criteria for March 31, 2002 1/

		Cumulative Flows During January 1–March 31, 2002
		(In millions of Kuna)
1.	Limit on the Cumulative Deficit of the Consolidated Central Government (Annex IV.I)	2,568 2/
2.	Limit on the Cumulative Increase in the Net Credit of the Banking System to the Consolidated Central Government (Annex IV.II)	-221 3/
3.	Limit on the Arrears of the Consolidated Central Government (Annex IV.III.)	-267
4.	Limit on the Cumulative Increase in the Net Credit of the Banking System to Selected Public Enterprises (Annex VI)	150
5.	Limit on the Cumulative Increase in the Net Domestic Assets of the Croatian National Bank (Annex VIII)	1,562
		(In millions of US dollars)
6.	Ceiling on the Stock of Short-Term External Public and Publicly Guaranteed Debt and on Contracting or Guaranteeing of Nonconcessional External Debt by the Public Sector (Annex V)	
	a. Short-term debt outstanding	--
	b. Contracting of nonconcessional debt in excess of 1 year	865
	c. Of which: with a maturity of less than 5 years	55
7.	Target for the Cumulative Increase in Net Usable International Reserves of the Croatian National Bank (Annex VII)	-200
		(In millions of Kuna)
Memorandum item:		
	Base money	17,632

1/ Except as indicated in footnotes 2 and 3, the definitions of the performance criteria remain as in Annexes IV–VIII of the Supplementary Memorandum of Economic and Financial Policies attached to our letter of August 29, 2001 and the Attachment to our letter of October 31, 2001.

2/ This limit will be raised/lowered by the amount by which second-pillar collections by the private pension funds in the first quarter of 2002, as reported by REGOS, exceed/fall short of HrK 412 million.

3/ This limit will be raised by up to HrK 250 million to reflect the amount of prefinancing of privatization receipts earmarked for budget spending of the two new budgetary funds.

Croatia: Prior Actions, Structural Conditionality, and Performance Clauses
For the Remainder of the Program Period, January 1–March 31, 2002

Prior Actions

1. Parliamentary approval of the privatization laws for HEP and INA
2. Appointment of a privatization advisor for HPB
3. Parliamentary approval of the employment law

Performance criterion

1. Reduction of government employment to no more than 168,804 people by March 31, 2002[1]

Structural benchmark

1. Government approval of a privatization program for INA by March 31, 2002

Performance clauses

1. No new external payments arrears
2. No new, or intensification of existing, payments restrictions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and import restrictions for balance of payments purposes

[1] Modification of the limit of 167,514 employees approved by the Fund's Executive Board in completing the first program review on November 7, 2001. See SMEFP, paragraph 8.

Statement by the IMF Staff Representative
March 29, 2002

The following information, which does not change the substance of the staff appraisal, has become available since the staff report was issued.

1. As noted in EBS/02/47, three prior actions remained to be completed before the Board's consideration of the second review under the stand-by arrangement with Croatia. These actions have now been completed. On March 19, parliament approved the privatization laws for HEP and INA. On March 21, parliament approved the new employment law. On March 7, the government decided to appoint the consortium CA-IB, Zagreb and Deloitte & Touche, Budapest as its advisor for the privatization of HPB. On March 27, the Agency for Deposit Insurance and Bank Rehabilitation (DAB) signed a contract with the consortium to prepare proposals for the privatization of 25 percent plus two shares in 2002. According to information received by the staff on March 28, this contract will be modified as soon as possible to provide for the privatization of another 50 percent in the bank in 2003. On the basis of this information, the staff considers that the third prior action has been met, but it regrets that the five-day rule for the completion of prior actions has been breached.

2. Tensions in the government have been resolved following the March 15 agreement within the five-party coalition on the appointment of two new ministers (Economy and Transport). The agreement is based on a renewed commitment towards macroeconomic stability and structural reforms.

3. Economic activity remains strong. Real retail sales grew by 10.9 percent year on year in January and manufacturing production increased by 5.7 percent year on year in January–February. Retail price inflation in February was 2.8 percent year on year, after a temporary increase to 3.3 percent in January due to increases in road tolls and excise taxes on fuel. Core inflation remained roughly flat at 1.8 percent, while producer prices continued falling.

4. Large foreign currency inflows connected with euro conversion continued in January, and, according to preliminary data, in February. Most of the inflows have remained in the banking system, giving rise to a further net addition to bank deposits. Credit growth continues to be strong, both for households and businesses. Appreciation pressures on the kuna continued, and the CNB intervened again on March 15 selling domestic currency. The end-March target on international reserves seems easily attainable. So does the end-March target on the CNB's net domestic assets, despite the extension of emergency liquidity credit to Riječka Banka (see below).

5. On March 14, concerns about significant currency trading losses led to deposit withdrawals from Riječka Banka, the third largest bank. The CNB promptly assisted the bank with emergency liquidity and any systemic impact was averted. On March 20, the CNB board approved the acquisition of an up to 90 percent stake in the bank by the State Agency for Deposit Insurance and Bank Rehabilitation (DAB), after Bayerische Landesbank Girozentrale München (BLB) had agreed to surrender to DAB its 59.9 percent shareholding.

Since then, new management has been appointed and the government has announced its intention to resell the bank as soon as possible.

6. On March 21, the government approved a privatization program for INA, which is a structural benchmark for March 31, 2002 under the stand-by arrangement. As for structural measures not subject to Fund conditionality, on March 19 parliament approved the defense sector reform laws, which will enable a substantial reduction of government employment. On the other hand, parliamentary approval of the new banking law and of the law on industrial parks is now expected during the parliamentary session that starts in mid-April 2002, and the draft law on bankruptcy trustee services is still being discussed among experts in government procedure.

7. The draft report for the off-site safeguards assessment of the CNB is currently being reviewed by Departments. The assessment, which included a review of the 2000 financial statements that had been restated under international accounting standards and audited under international standards of auditing, did not find significant vulnerabilities. The draft report, however, makes a series of recommendations in the areas of internal and external audit systems of the CNB and its system of internal controls. The staff found the CNB very cooperative throughout the assessment process.

Statement by J. de Beaufort Wijnholds, Executive Director for the Republic of Croatia March 29, 2002

Introduction

This is the final review under the precautionary SBA, and after Board approval, Croatia will have successfully finalized the current arrangement. This should provide an important signal to the authorities and to the markets, indicating that the hard work of the past two years has produced the desired results. The Croatian authorities would like to express their gratitude to staff for both their fair assessment of the economic performance and for their continuous efforts in helping them to steer through the complex economic reform course.

I am pleased to confirm that all three prior actions for completion of the second review have been fully implemented, as well as that the authorities intend to continue publishing all the SBA documentation and to continue to treat this SBA as precautionary.

General Outlook

At the time of the first review it was already clear that the authorities' growth, inflation and international reserves objectives for 2001 were likely to be either met or exceeded. Croatia has indeed significantly overperformed in two areas--inflation and international reserves. As regards economic growth, it is very likely that some overperformance will also be ascertained. This is gratifying, bearing in mind the less favorable external environment and some unforeseen delays in policy implementation. These delays resulted from both domestic political instability and the complexity of the structural reform agenda. Fortunately, slower policy implementation did not significantly affect the economic performance under the SBA. Most of the quantitative PCs were observed at end 2001. Furthermore, the fiscal deficit target of the consolidated central government was met.

Fiscal Policy

Fiscal consolidation is not only the cornerstone of the Fund-supported program, but also the primary objective of the authorities' overall strategy. When the current government entered into the office in early 2000, the fiscal deficit stood at almost 7.5 percent of GDP, and accumulated government arrears (towards the rest of the economy) accounted for roughly 5 percent of GDP. In addition, the consolidated central government expenditures amounted to 50.2 percent of GDP. In the past two years, the authorities succeeded to reduce the fiscal deficit by more than 2 percentage points of GDP, while decreasing the share of the government expenditures in GDP to 43.8 percent. Moreover, during the same period, almost all arrears were repaid (the remaining 0.3 percent of GDP will be repaid by mid 2002).

Achieving large fiscal expenditure cuts in a short period of time has been difficult for the authorities in many ways. While it is unfortunate that some delays in approving and implementing fiscal measures occurred during the program, the authorities did nevertheless achieve their key target – reducing the fiscal deficit of the consolidated central government. This target was achieved even though the wage bill declined by less than envisaged. The authorities' efforts in reducing the wage bill should not be underestimated, however, since in real terms the wage bill was reduced by 6.5 percent, and in relation to GDP by more than 11 percent.

The authorities are now entering into the second half of their mandate with an ambition to continue and finalize their 'mission', which basically means putting the public finances on a sustainable footing in the medium-term. The aim for next year is to achieve a fiscal deficit of about 2 percent of GDP, with the fiscal expenditures falling below 40 percent of GDP.

Monetary and Exchange Rate Policy

Monetary performance under the program, measured by inflation and two quantitative PCs, has been very satisfactory, with inflation (2.6 percent) falling below the program target. Last year's inflationary performance was achieved despite increases in administered prices and excises.

The two quantitative PCs set under the program (international reserves and net domestic assets), were both met with ample margins. It is worth noting that international reserves have increased by $1.2 bln during 2001, reaching a level of $4.7 bln (or 5.2 months of imports). This increase was partly an outcome of the last year's good tourist season. However, the main reason for the increase was the one-off effect of the euro changeover, due to which large amounts of Deutsche Marks (previously held outside the banking system) were deposited in banks. According to the Croatian National Bank's estimates, almost 2 bln euro (about 25 percent of foreign currency deposits) was deposited in banks due to the changeover process, implying that Croatian citizens held on average 500 euro in cash. Although these numbers are surprisingly high at first glance, the CNB expected significant inflows of foreign currency on the basis of the previous research done in this area. On the same basis, the CNB expects most of this "fresh" money to stay within the banking system. Large inflows of foreign currency also affected interest rates, which declined significantly.

Structural Reforms

Performance on the structural front has been more uneven. The numerous delays in implementation of structural reforms were basically a reflection of their complexity and of political developments. Nevertheless, much has been done. The structural PC set under the program (on reducing employment in government sector) was observed at the end of December 2001, and the process of reducing the number of government employees is still ongoing. Moreover, the process will continue even after the number of government employees is reduced by 10,000 (5 percent of the government total workforce). However, due to delays in parliamentary approval of a set of defense sector reform laws, the authorities expect now that the cumulative employment reduction by end-March 2002 will account for some 8,700 employees. The initial target of 10,000 employees will be reached soon thereafter.

Progress in privatization was slower than expected, but the privatization strategy has not changed, nor has the authorities' decisiveness to proceed with the process. It is worth recalling that the authorities' strategy for privatizing the banking system, for instance, has not been to privatize for the sake of privatization revenues, but to find strategic investors and thereby ensuring more certainty in the future for particular banks. This strategy has helped to create a highly competitive and stable banking system. Presently, banks representing some 90 percent of total banking assets are majority foreign owned, while three years ago this was only 7 percent.

Conclusion

The Croatian authorities wish to underscore the very fruitful cooperation with the Fund staff during the program period, which has produced visible positive results. They are aware, however, that although significant steps towards a full-fledged market economy have been made, there is still much to be done. In this light, the authorities would like to stress their firm commitment to continue with structural reforms, especially to put public finances on a sustainable footing. They are also looking toward continuation of close cooperation with the Fund for the future.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

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International Monetary Fund
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Washington, D. C. 20431 USA

IMF Completes Second Review of Croatia Under Stand-By Credit

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Croatia's performance under the 14-month stand-by credit. The arrangement for SDR 200 million (about US$249 million), which was approved on March 19, 2001, is being treated by the Croatian authorities as precautionary (see Press Release No. 01/10).

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

"The Executive Board completed the second and final review under the Stand-By Arrangement with Croatia, welcoming the favorable macroeconomic developments in 2001 as well as the success of the authorities in the implementation of their policies.

"Prospects for 2002 are generally favorable, with continued steady growth in economic activity, relatively low inflation, and a further reduction in the deficit of the consolidated central government. As the introduction of the second pillar of pension reform will entail substantial revenue losses for the budget, the program relies on restraint of all primary expenditure categories. In implementing the budget, it will be important to resist pressures to increase wages or subsidies beyond budgeted levels.

"Although most of the recent deposit inflows in connection with the euro conversion seem to be permanent, supervisory activity should prevent a lowering of credit standards by banks and monetary policy should watch liquidity conditions carefully and act as necessary to preserve the objective of maintaining low inflation.

“Good progress has been made on structural reforms, including a retrenchment in employment in the government and defense sectors, and, through continuing privatization, the establishment of a competitive and stable banking system. Privatization is to be pursued more resolutely in 2002, and the authorities are committed to using any privatization receipts above the targeted amount to reduce government indebtedness,” Ms. Krueger said.