October 2006
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Republic of Croatia: Third Review Under the Stand-By Arrangement—Staff Report; and Press Release on the Executive Board Consideration

In the context of the third review under the Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the Third Review Under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on June 2, 2006, with the officials of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 15, 2006. 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 Press Release on the Executive Board's consideration of the third review under the Stand-By Arrangement.

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

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

*Also included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Third Review Under the Stand-By Arrangement

Prepared by European Department
(in consultation with other departments)

Approved by Poul Thomsen and Anthony Boote

September 15, 2006

The 20-month, SDR 97 million (26.6 percent of quota) Stand-By Arrangement, which the authorities treat as precautionary, was approved on August 4, 2004 (when the Executive Board also concluded the 2004 Article IV consultation). On March 29, 2006, the Board completed the second review, augmented the SBA by SDR 2 million, and extended it by seven months through November 15, 2006.

Discussions on the third review took place during May 23–June 2. The mission comprised Messrs. Demekas (head), Gueorguiev, Moore (EUR), and Hilaire (PDR) and was assisted by Mr. Vamvakidis, Resident Representative. Staff met Prime Minister Sanader; Deputy Prime Minister Polančec; Finance Minister Šuker; Health Minister Ljubičić; Economy Minister Vukelić; Croatian National Bank (CNB) Governor Rohatinski; other senior officials; and representatives of political parties and the private sector. Mr. Christofides (OED) attended some of the meetings.

The authorities intend to publish this report and attached letter to the Managing Director.

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

On October 3, 2005, Croatia started accession negotiations with the EU. The European Commission assessed in its 2005 Progress Report that Croatia can be regarded as a functioning market economy that should be able to cope with the competitive pressures within the Union in the medium term provided it continues its reforms (economic criteria for membership).

On July 7, parliament reappointed Mr. Rohatinski as Governor of the Croatian National Bank for a second 6-year term.

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I. BACKGROUND

A. Performance Under the Program

1. **The Stand-By Arrangement (SBA), approved in 2004 to support policies aimed at mitigating external vulnerabilities, has entered its final months**. Policies under the SBA have sought to reduce Croatia's savings-investment imbalance and stabilize the external debt-to-GDP ratio. Given the focus of monetary policy on exchange rate stability, the main plank of the authorities' strategy has been a substantial fiscal and quasi-fiscal adjustment, accompanied by measures to safeguard financial sector stability and accelerate structural reform. The structural agenda of the original program, which had been focused on fiscal transparency, expenditure and debt management, and privatization was substantially expanded at the first review in September 2005 in the areas of tax administration, civil service reform, state aid and subsidies, pensions, and health. In March 2006, at the time of the second review, the SBA was augmented and extended through November 2006, and a third and final review was added, *inter alia* to examine the possible macroeconomic impact of the planned "pensioners' debt" repayments (IMF Country Report No. 06/128).

2. **Policy implementation under the program has generally been good, although there have been delays in the execution of the structural agenda**. The government reduced the fiscal and quasi-fiscal balance (general government plus quasi-fiscal operations of the Croatian Development Bank—HBOR) to 4.2 percent of GDP in 2005, consistent with the program, an adjustment of 2.6 percentage points from 2003; an additional one percentage point of GDP of adjustment is planned this year. All end-June 2006 performance criteria (PCs) were met (Annex Table 1).[1] Structural reforms have also moved ahead broadly as planned, with the important exceptions of enterprise reform and privatization, where progress has been slower than expected (Annex Table 2). Three structural benchmarks were observed in the areas of banking supervision, health reform, and on preparing a plan for the privatization of the state-owned insurance company CO (which will be merged with the state-owned bank HPB and subsequently privatized). Two other end-June 2006 benchmarks, however, were not met: the government is continuing work on a national plan for shipyard restructuring in consultation with the European Commission, as well as on the third phase of privatization of the telecommunications company (HT) and the second phase of privatization

[1] The end-March PC on the general government deficit was missed: although revenue exceeded program targets by HRK 694 million (triggering the revenue adjustor) and central government spending was kept under control, local governments overspent targets by HRK 290 million. Also, the end-March target on the deficit of HBOR was exceeded because the HBOR Supervisory Board adjusted its annual lending target in line with the program only in mid-March. In both cases, the authorities took corrective measures in the second quarter and brought the program back on track.

of the oil company (INA). The authorities are taking steps to ensure completion of these transactions by end-2006.

3. **The current account has improved broadly as planned during the program period, albeit unevenly**. After correcting for statistical revisions (discussed in IMF Country Report No. 06/128), the current account improved by 1½ percentage points of GDP in 2004 but widened last year to 6.3 percent of GDP (Tables 1 & 2). The widening in 2005 was entirely due to the impact of oil prices, as the non-energy current account deficit continued shrinking on the back of stronger-than-programmed exports. During 2004-05, the improvement in the non-energy current account balance was 1¾ percentage points.

4. **External debt has continued to edge upwards reflecting private sector portfolio decisions, but there is evidence that net external debt may have started to decline**. Gross debt reached 82.5 percent of GDP at end-2005,[2] 2.2 percentage points above end-2004; by comparison, this ratio had risen by 5 percentage points in 2004 and 14 percentage points in 2003 (Figure 1). Gross debt increased further to 84.4 percent by end-June, mainly reflecting higher borrowing by foreign-owned banks. These hikes reflected private portfolio decisions: private foreign borrowing during 2004–05 was 7 percentage points of GDP above program projections, reflecting both banks and—increasingly—enterprises borrowing directly from abroad; in contrast, the government reduced its foreign indebtedness by shifting budget financing to domestic sources. At 46.4 percent of GDP at end-June, measured net external debt—defined as gross debt minus official reserves and commercial bank foreign assets—is much lower, but has also risen. Measured net debt, however, does not capture nonbank private sector foreign assets. Flow-of-funds analysis suggests that these have increased substantially and the true net external debt ratio may have declined in 2005 (Box 1). Reflecting higher-than-expected capital inflows, gross official reserves reached € 8.7 billion (5 months of imports GNFS) at end-June, exceeding program projections by over € 1¼ billion.

[2] IMF Country Report No. 06/128 reported this figure as 84.7 percent. The difference is due to a March 2006 revision of national accounts by the Statistical Office that resulted in an upward revision to historical GDP estimates by about 3 percent.

Box 1. Private Sector Borrowing, Asset Accumulation, and Net Debt

A flow-of-funds analysis points to excess foreign borrowing by the private sector in 2005. The flow-of-funds framework shows how the saving-investment balances of the main sectors are financed through acquisition of assets and liabilities across sectors and with the rest of the world, using data from the national accounts, government, balance of payments, and monetary statistics. In the case of Croatia, while government financing roughly matched the government's S-I balance, private sector borrowing exceeded its financing need by almost 7 percentage points of GDP.

Aside from statistical discrepancies, the counterpart of this borrowing is likely to reflect unrecorded accumulation of foreign assets by the private sector. Private sector assets fall in three categories: claims against the government, against domestic banks, and against nonresidents. The change in private sector claims against the government and domestic banks (which are reliably recorded) is already captured in the table below; therefore, the residual (excess financing) likely reflects the change in claims against nonresidents, which are not recorded in the balance of payments and debt statistics.

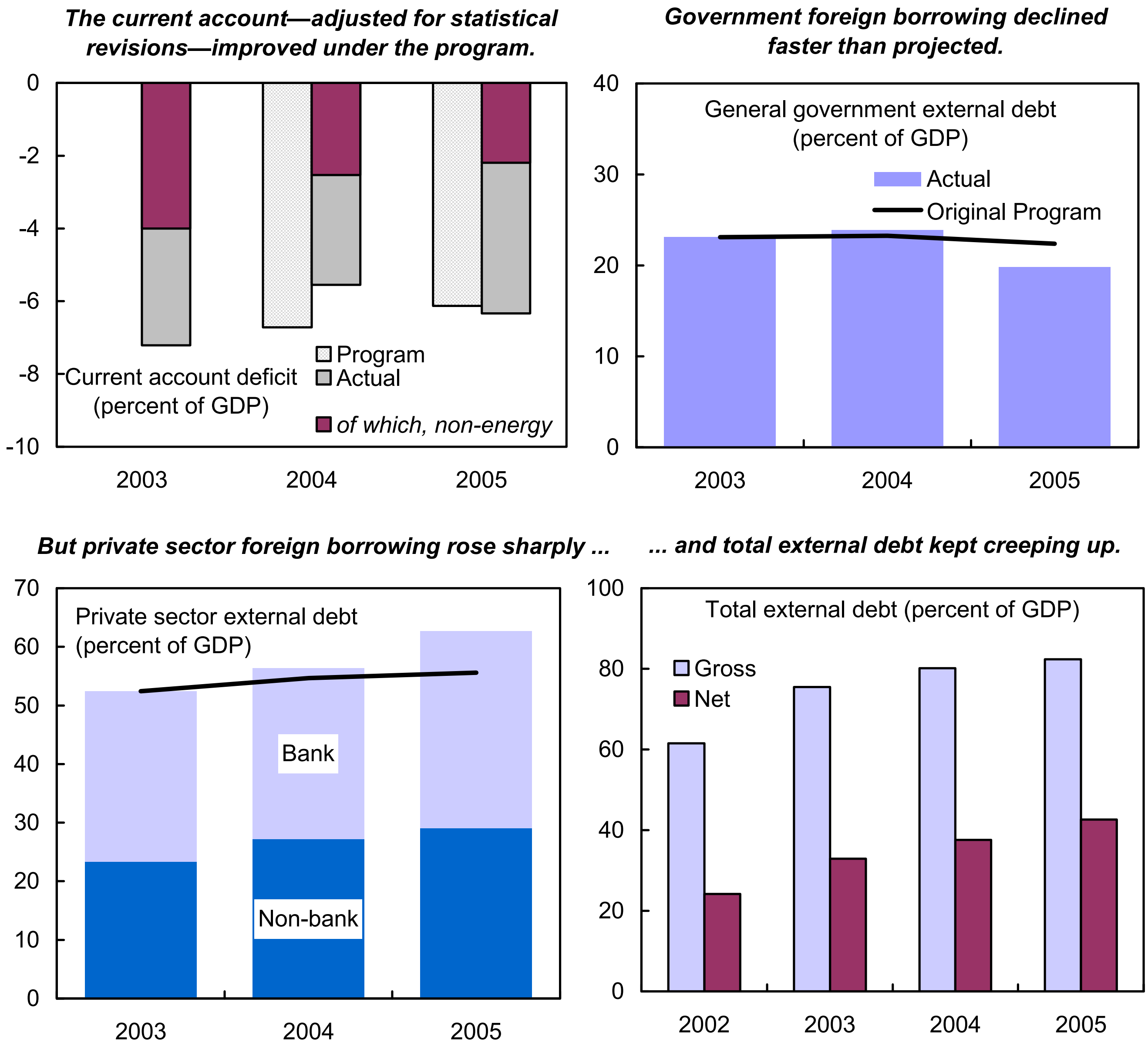
This residual is higher than the increase in total measured net debt, which amounted to 5.4 percentage points of GDP in 2005. Although BOP data weaknesses (IMF Country Report No. 04/253) mean that the conclusions of this analysis should be treated with caution, this finding strongly suggests that true net debt may have actually declined.

Croatia: Flow of Funds, 2005
(In percent of GDP)

	Domestic economy A(=B+C+D)	General government B	Private sector C	Banking system D	Rest of the world E
Saving-investment balances	**-8.0**	**-3.3**	**-4.8**	**0.0**	**8.0** 1/
Foreign financing					
Nonmonetary					
Direct investment	3.8		3.8		-3.8
Net foreign borrowing	5.5	-1.9	7.4		-5.5
Monetary					
Change in net foreign liabilities	3.7			3.7	-3.7
Domestic financing					
Monetary					
Domestic credit		3.2	8.8	-12.0	
Broad money			-6.4	6.4	
Nonbank		2.3	-2.3		
Total financing	**13.0**	**3.6**	**11.3**	**-1.9**	**-13.0**
Excess financing ("asset accumulation")	**5.0**	**0.3**	**6.6**	**-1.9**	**-5.0**

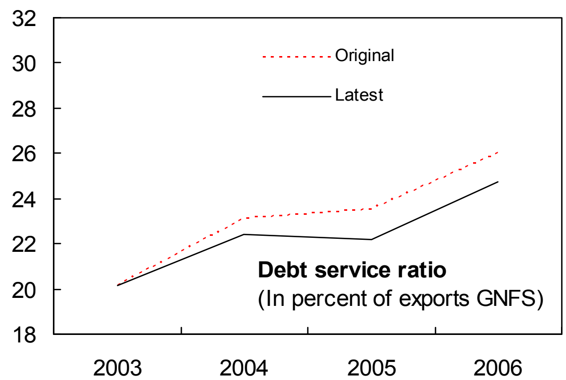
Sources: Croatian National Bank, Central Statistics Bureau, and Fund staff estimates.
1/ Differs from the current account deficit because of the discrepancy between BOP and national accounts sources for exports and imports.

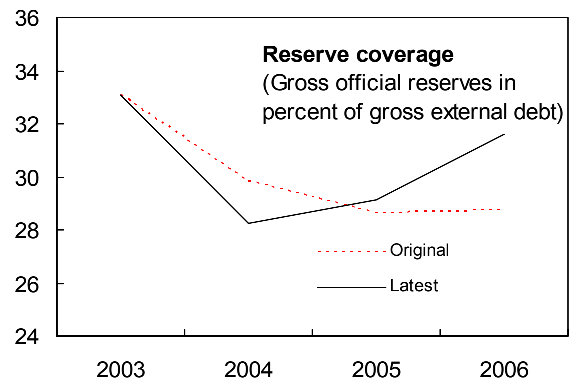
Figure 1. Croatia: Current Account and External Debt, 2003–05



Sources: Croatian National Bank and Fund staff calculations.

5. **The economy's debt-carrying capacity and market access have improved**. Market confidence has been strong and bond spreads remain at historically low levels, despite recent volatility in emerging markets (Figure 2). Despite the higher debt stock, stronger exports and higher reserves have kept the debt-service ratio below, and reserve coverage above, original program projections. Official reserves remain well above short-term foreign debt (Table 3).





B. Developments in 2006

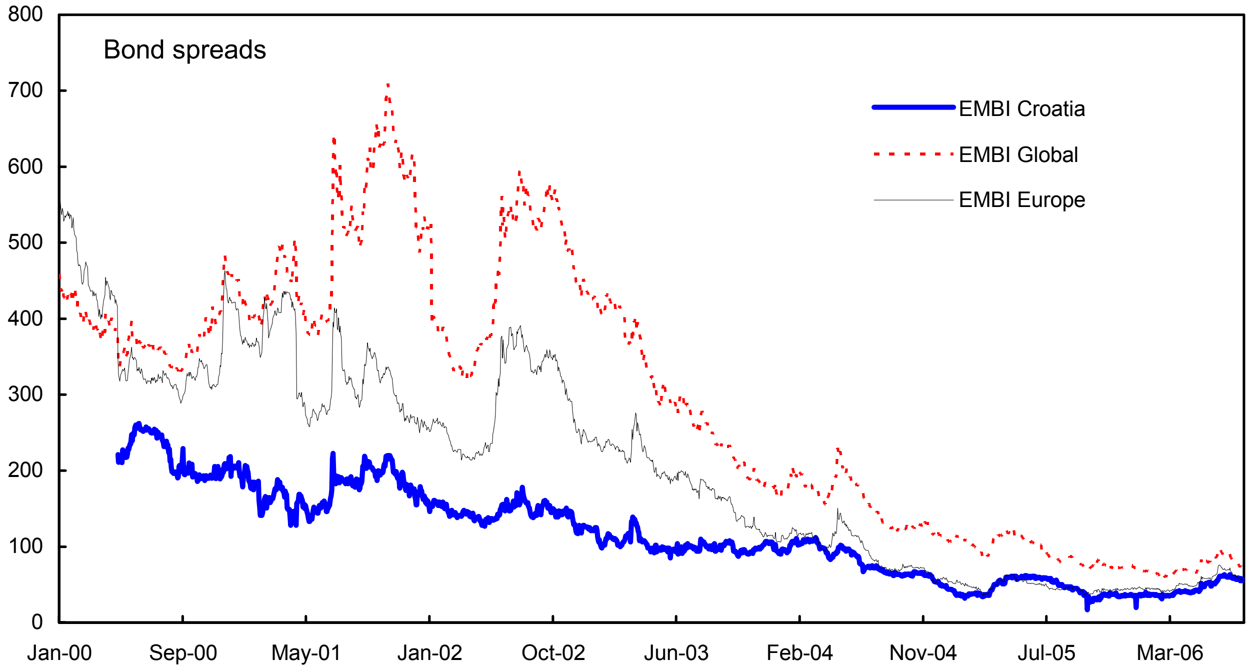
6. **Economic growth has picked up, powered by private investment, while inflation remains moderate**. The pace of activity started strengthening toward the end of last year. Real GDP growth averaged 4.3 percent in 2005 as a whole, up from 3.8 percent in 2004. Exports performed better than expected and competitiveness indicators remain benign (Figure 3). This year, private investment has gained further momentum, more than offsetting the impact of declining public investment; a surge in investment in 2006 Q1 boosted real GDP growth to 6 percent year-on-year. The 12-month CPI inflation rate was 3.4 percent at end-July 2006, with core inflation (excluding energy and administered prices) at 2½ percent.

7. **Despite the pickup in lending and external liabilities, monetary growth remains only slightly above program expectations**. While reserves are higher than envisaged under the program (5.2 months of next year's imports of GNFS at end-June), growth in broad money picked up in June (14.4 percent year-on-year) and is now slightly above the envisaged range for 2006 of 10–13 percent. The kuna has been subject to moderate appreciation pressures, though CNB interventions have limited the actual appreciation to 1 percent against the euro in the year to August.

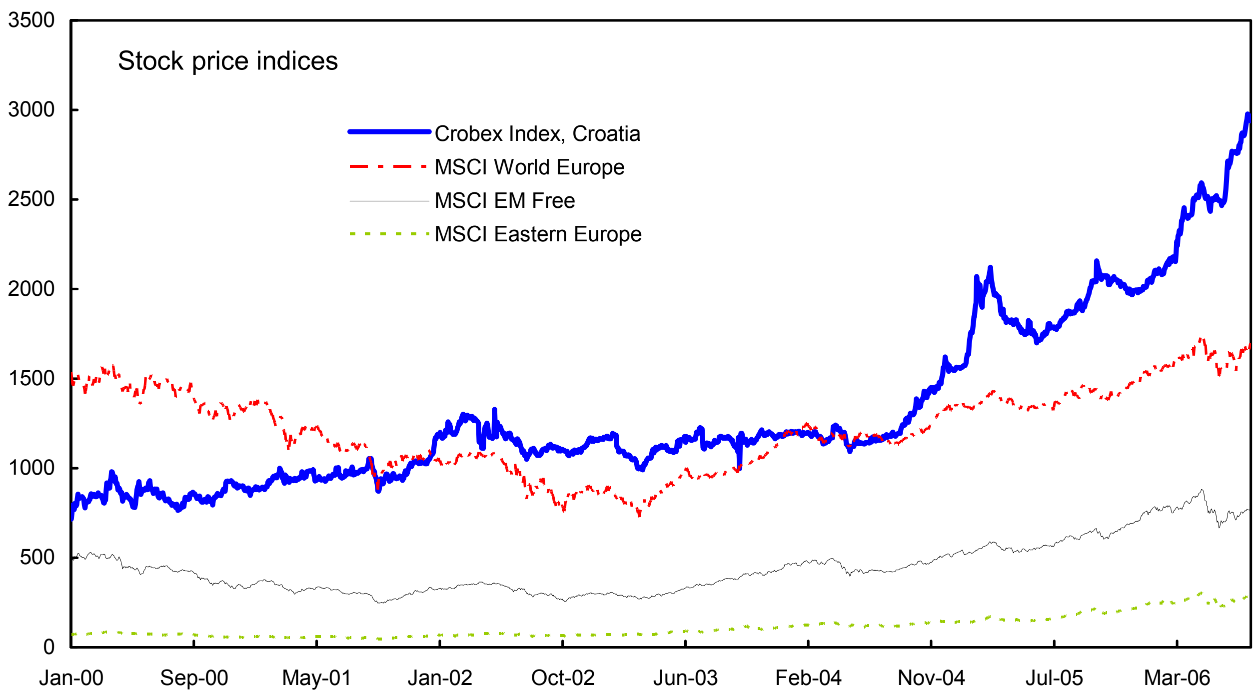
8. **The financial sector remains liquid and well capitalized, though foreign exchange-linked credit risk is a concern**. Financial soundness indicators show adequate capitalization and improving asset quality (Table 4), despite the pick-up in credit to households since mid-2005. Most households seem exposed to some currency risk: 80 percent of long-term bank loans to households are linked to foreign currency, with a high proportion of new credits in Swiss francs; and while households' foreign-currency deposits

Figure 2. Croatia: Capital Market Conditions, 2000–06
(In basis points)

Market access is strong with bond spreads remaining near historically low levels ...

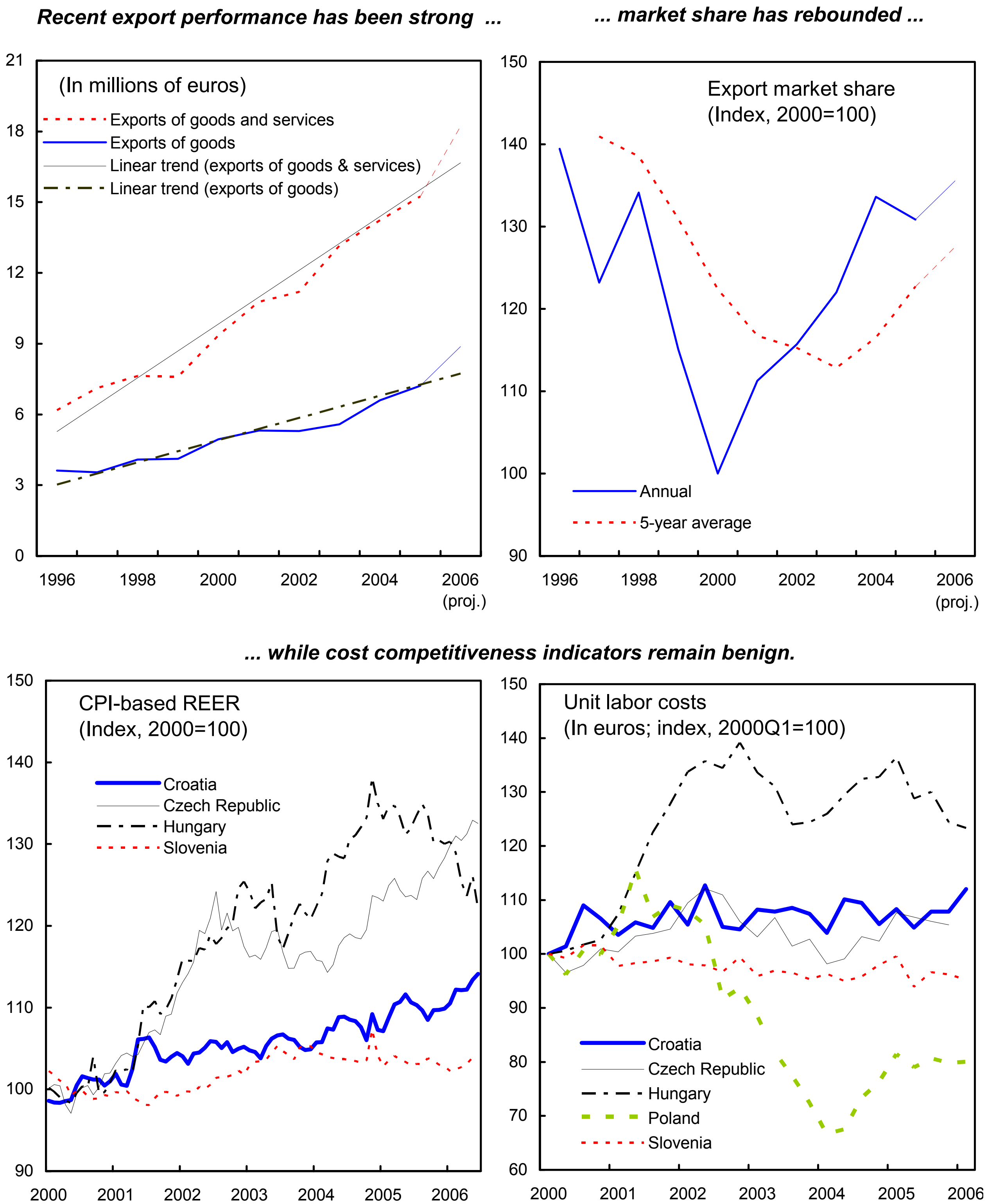


...while the stock market remains robust, unaffected by recent volatility in emerging markets.



Sources: Croatian authorities; and JP Morgan/Bloomberg.

Figure 3. Croatia and Selected European Countries: Competitiveness Indicators, 2000–06



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

are sizeable in the aggregate, borrowers and savers may overlap only partly. Both households and enterprises are vulnerable to interest rate risk, as more than 80 percent of bank loans have variable rates. Under the program, the CNB has been taking steps to make banks internalize these risks and, more broadly, to slow down the pace of foreign borrowing by banks.

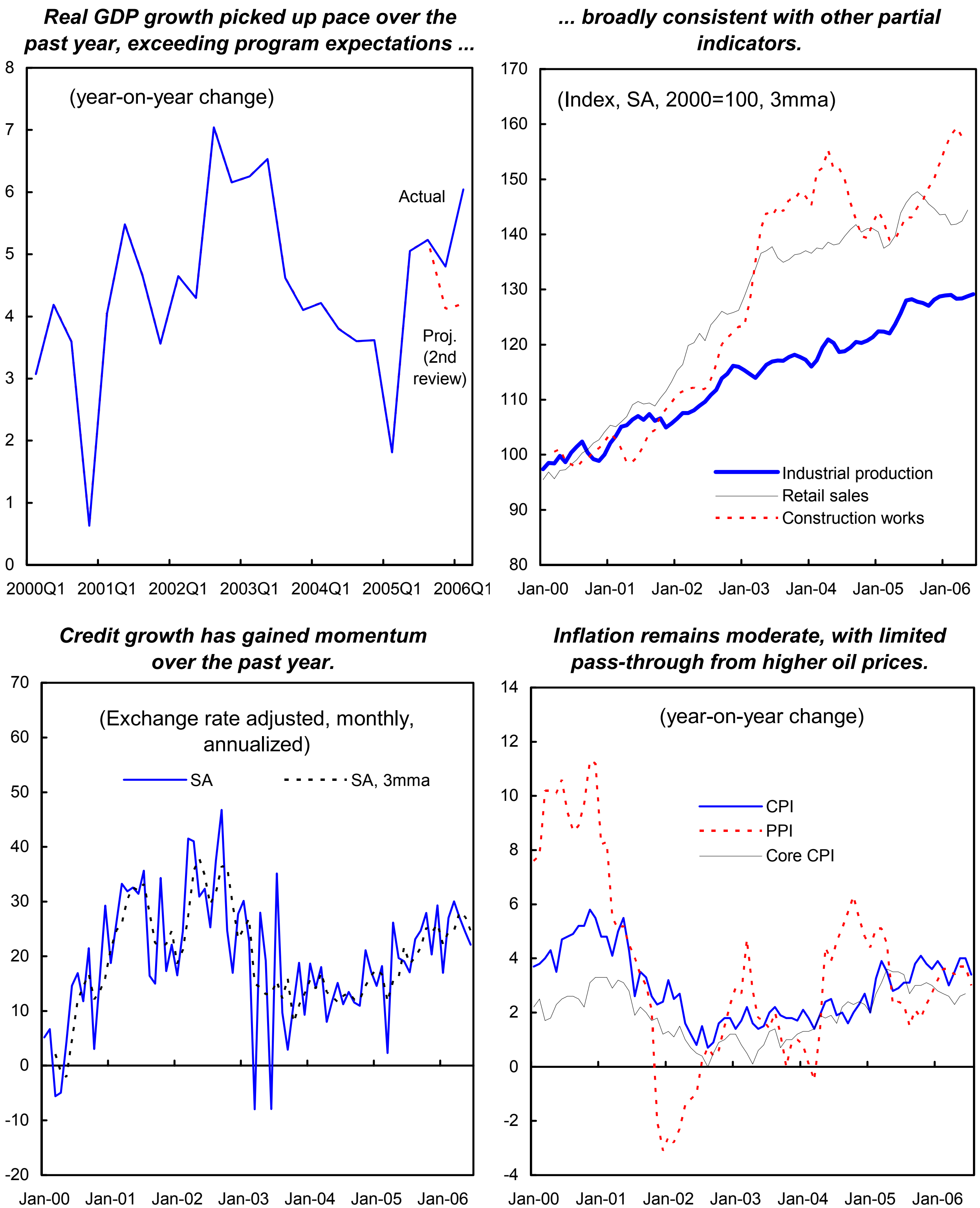
II. Economic Outlook

9. **High-frequency indicators show signs of accelerating demand**. Although retail sales and industrial production data show that activity moderated in Q2 (Figure 4), several other indicators suggest strong demand: government revenues rose by 12 percent year-on-year in January–June, well above the budget target; non-energy imports are growing solidly; and credit growth accelerated to 23½ percent in the year to June, not out of line with regional standards, but its highest pace since 2003. Housing credit has been especially strong over the past year, with credit to enterprises also picking up in recent months. In the nonbank sector, credit by leasing companies and credit card companies is expanding rapidly. On this basis, real GDP growth is projected to reach 4½–4¾ percent in 2006, slightly faster than last year. Given the broadly stable exchange rate, weak pass-through so far of oil prices to inflation, and continuing wage moderation, on the other hand, staff projects CPI inflation at 3¼ percent by end-2006 (3½ percent annual average).

10. **On present trends, the current account deficit in 2006 will deteriorate somewhat**. The combination of incipient demand pressures and higher oil prices will push it to 6¾–7 percent of GDP this year. The start of pensioners' debt repayments in the second half of the year will add to the pressures, although its incremental impact on aggregate demand would be minor (Box 2). Unless the private sector asset accumulation is arrested, the stabilization of the gross external debt-to-GDP ratio may again prove elusive this year.

11. **Croatia's medium-term outlook, on the other hand, remains solid, with significant upside potential**. Staff's medium-term baseline (Table 5)—which will be re-examined in more depth at the forthcoming 2006 Article IV consultation in the fall—incorporates the authorities' updated medium-term budget for 2007–09, a small further increase in private savings, and the estimated impact from "pensioners' debt" repayments. Growth is projected to stay at around 4½ percent and inflation around 3 percent. The combined effects of recent infrastructure improvements, FDI potential (WP/05/110), and ongoing structural reforms in the context of harmonization with the EU could accelerate total

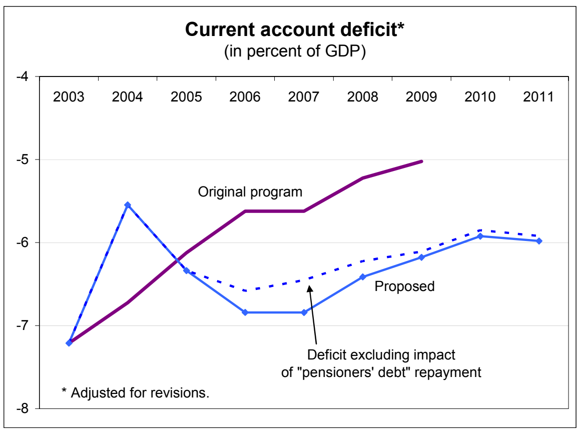
Figure 4. Croatia: GDP and Selected High-Frequency Indicators, 2000–06

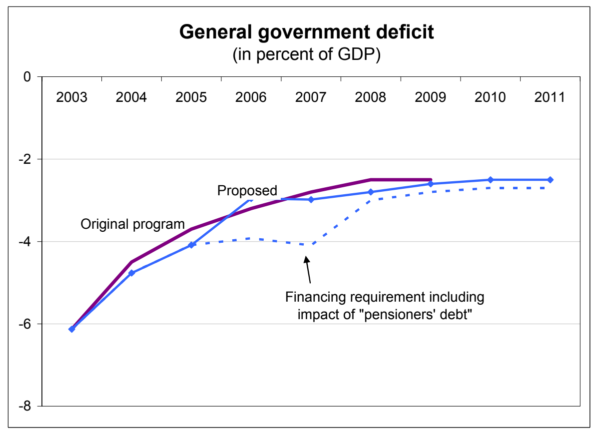


Sources: Croatian authorities; and Fund staff calculations.

Box 2. Impact of the "Pensioners' Debt" Repayment

"Pensioners' debt" payments may boost the government's borrowing requirement, but their macroeconomic effect will be small and transient. IMF Country Report No. 06/128 provides the details of the scheme. The payments will reach 1 percent of GDP in 2006 and 1.1 percent of GDP in 2007. Assuming a 70 percent propensity to consume out of these one-off receipts, they would add about 0.5–0.7 percentage points of GDP to private consumption in each year. Under different hypotheses regarding the propensity to import, this could temporarily boost the current account deficit by 0.2–0.4 percentage points of GDP in 2006–07.





The impact on the current account appears insensitive to different assumptions on the marginal propensity to consume (MPC). The authorities suggest that much of these one-off payments could be saved, as pensioners may smooth consumption over time. Staff sees the majority choice for lower but upfront payments implying a high MPC. But the staff estimates are not very sensitive to the MPC assumption: a 10 percentage point increase in this parameter results in a current account deficit higher by only 0.04 percentage points of GDP.

Sensitivity to propensity to consume, percentage points of GDP

Marginal propensity to consume, percent	70	80	90	100
Impact on consumption, 2006	0.48	0.55	0.62	0.69
Impact on the current account deficit, 2006	0.25	0.29	0.32	0.36

The first repayment in June 2006 has been financed by a bridge loan. The repayments are meant to be financed by privatization receipts, mainly from the HT and INA sales, that would be transferred to the Pensioners' Compensation Fund (PCF). However, owing to the delay in the privatizations, a local bank—HPB, whose subsidiary is managing the assets of the PCF— provided bridge financing for the June repayment until the privatization receipts materialize later in the year. This bridge loan has only a transitory impact on the public finances.

factor productivity growth significantly from the baseline (Box 3). The debt sustainability analyses (Appendix I) also indicate that public debt will remain stable and external debt will be on a declining path under most reasonable assumptions.

Box 3. Growth Decomposition

A preliminary analysis of the sources of growth in Croatia shows that the main engine since the end of the war has been capital accumulation. In contrast, total factor productivity (TFP) growth still remains low, reflecting the late start of structural reforms. The staff medium-term baseline is based on historical trends. The impact of recent and prospective reforms, however, could easily raise TFP and, given projected labor force growth and investment levels, result in significantly higher GDP growth. This analysis will be extended during the forthcoming 2006 Article IV consultation.

GDP growth and contributions

	1996-2002	2003-2005	2006-2009
Real GDP Growth	3.9	4.5	4.6
Contributions:			
- capital	3.2	2.6	2.7
- labor	-0.5	0.5	0.5
- productivity	1.3	1.4	1.4

III. Policies for the Remainder of the Program

12. **Discussions on policies for the rest of 2006 focused on how to manage the incipient demand pressures while maintaining the reform momentum that will generate medium-term payoffs**. Staff and authorities agreed that external vulnerabilities remained high and the emerging demand pressures could, if left unchecked, undo much of the progress achieved under the program; and that to realize the economy's strong medium-term potential, structural reform efforts had to continue. That 2007 is an election year also argued for taking corrective action early, both on the macroeconomic and on the structural front. The authorities' strategy for 2006 was thus based on three components: *first*, fiscal action in order to mitigate domestic demand pressures; *second*, a further tightening of prudential regulations to safeguard financial stability in the face of accelerating credit growth; and, *third*, steps to restore the momentum of privatization.

A. Fiscal Policy

13. **Fiscal policy was on track for achieving the deficit target set at the second review**. The 2006 budget originally targeted a deficit of 3.2 percent of GDP, excluding

pensioners' debt repayments,[3] compared to 4.1 percent in 2005. This consolidation was based on current and capital expenditure savings arising mainly from public sector wage restraint, the 2005 amendment to the pension indexation formula, and the health reforms under preparation; the latter had an implementation target date of mid-2006 (IMF Country Report No. 06/128). During the first half, revenue collection was higher than planned, reflecting both cautious budgeting and stronger-than-expected growth. Progress in tax administration—anti-fraud measures in the administration of VAT and strengthening the risk-based selection of taxpayers for audit—has also helped. Although the government prepared the health reform on schedule (the draft laws were submitted to parliament in March, meeting a prior action for the second review), the parliamentary process, over which the government had little control, was more protracted than expected owing to the controversy surrounding this difficult reform. As a result, the draft laws were finally approved on July 13, and implementation of the reform postponed to September. The revenue overperformance, however, would be sufficient to cover the additional costs implied by this delay and still meet comfortably the original budget target.

14. **But in view of the incipient demand pressures, the government decided to aim at a more ambitious target this year, and passed a supplementary budget targeting a general government deficit of 3.0 percent of GDP** (Table 6 and Annex ¶8). In the supplementary budget, approved by parliament in July, revenue is higher by 0.5 percent of GDP compared to the original budget, mainly reflecting higher VAT and corporate income tax collections. Current expenditure is also higher by 0.5 percent of GDP, mainly to cover the costs of lower-than-budgeted savings from the health reform (0.2 percent of GDP), as well as higher spending by the local governments and small overruns in other areas. The savings come from a 0.2 percent of GDP cut in capital spending.

15. **Staff welcomed this modest tightening of the target, although savings in current expenditure would have been preferable**. The tightening would help contain demand pressures in the rest of this year. With this target for 2006, the cumulative fiscal and quasi-fiscal adjustment during the two-and-a-half years of the program would reach 3.6 percentage points of GDP. This additional effort would also place the government in a better position to achieve its 2007 deficit target (2.8 percent of GDP). But staff was concerned that the additional savings this year were in public investment: while poorly selected capital projects with low social rates of return should not be immune from cuts, there was clearly room for savings in current spending. The government pointed out that over the period of the program, current expenditure had been reduced by 1¾ percentage points of GDP, and argued that

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[3] Because of the ambiguity regarding the appropriate statistical treatment of these repayments, staff reports the government financing requirement both excluding and including these payments (see IMF Country Report No. 6/128 for details).

Fiscal and Quasi-Fiscal Operations, 2003–06
(In percent of GDP)

	2003	2004		2005		2006	
		Prog. 1/	Actual	Prog. 1/ (1st rev.)	Actual	Prog. 1/ (2nd rev.)	Suppl. budget
General government							
Revenue	45.1	45.8	45.4 2/	44.8	44.9	44.3	44.9
of which: one-off	...	1.0	0.8 2/	0.3	0.3	0.1	0.1
Expenditure	51.3	50.2	50.2	48.8	49.0	47.5	47.8
Current and net lending	45.5	44.9	45.3	44.1	44.6	43.3	43.8
of which: one-off	...	0.4	0.3	0.3	0.3	...	...
Investments	5.7	5.3	5.0	4.8	4.4	4.2	4.0
Balance	-6.1	-4.4	-4.8	-4.1	-4.1	-3.2	-3.0 3/
Quasi-fiscal							
HBOR balance (net of budget transfers)	-0.7	-0.5	-0.4	-0.4	-0.1	-0.2	-0.2
Total fiscal and quasi-fiscal balance	-6.8	-4.9	-5.2	-4.5	-4.2	-3.4	-3.2
Underlying balance (excluding one-off items)	-6.8	-5.4	-5.7	-4.5	-4.2	-3.5	-3.3

Sources: Ministry of Finance and staff estimates.
1/ GDP shares are calculated using the latest GDP estimates and projections.
2/ Includes 0.1 percent of GDP in revenues accrued in 2004 but encashed in February 2005 (see Table 6).
3/ Excludes the "pensioners' debt" repayments (see Table 6).

additional current spending cuts were difficult to identify and implement halfway through the fiscal year.

16. **The targets set at the second review on quasi-fiscal activities and public enterprise operations remain unchanged** (¶9). The government will continue to identify and account transparently for all forms of state aid; contain the deficit (net of government transfers) of HBOR to 0.2 percent of GDP; and limit the issuance of debt guarantees and the borrowing of the eight largest public enterprises in line with the understandings reached at the second review.

B. Monetary and Financial Sector Policies

17. **Monetary policy continues to aim at a broadly stable exchange rate**. The CNB is adhering to its strategy (discussed in detail in IMF Country Report No. 04/253) of using the exchange rate as a *de facto* nominal anchor, while allowing for limited, mostly seasonal fluctuations. In Croatia's highly euroized economy, this strategy has anchored expectations, built credibility, and delivered consistently low inflation over the years. In the remainder of the year, monetary policy will continue to avoid an unwarranted liquidity injection that could fuel credit expansion. Gross reserves at end-2006 are projected to remain around 5 months of next year's imports of GNFS. Growth in base money—which includes commercial banks' required foreign currency reserves—is expected to slow in line with the seasonal decline in banks' foreign borrowing in the latter part of the year (Table 7). Net domestic assets are accordingly projected to remain broadly unchanged during the second half of 2006.

18. **The CNB was actively taking measures to safeguard financial stability**. These included measures to strengthen supervision and address foreign currency-induced and other credit risks, as well as steps to discourage external borrowing by banks.

- The CNB has fully implemented the measures to strengthen bank supervision envisaged at the second review, including raising capital-adequacy risk weights on foreign currency loans to unhedged borrowers (¶12). Nevertheless, while viewing the banking system as basically sound, the CNB remained concerned by continued rapid growth of credit, especially foreign currency-linked loans. In the context of containing credit risk, the CNB strongly encouraged banks to introduce a credit registry. The registry, whose operation is now imminent, has 20 participating banks covering 98 percent of banking assets. The authorities are currently preparing the necessary legislation to allow nonbank participation in the credit registry by end-2006. The CNB was also taking additional steps to address credit risks and encourage banks to use the credit registry (¶13).

- Following the introduction in 2004 of a marginal reserve requirement (MRR) on commercial banks' new foreign borrowings, the CNB raised the MRR rate in steps, most recently to 55 percent in late 2005, and broadened its base (IMF Country Report No. 06/128). Although banks' foreign borrowing continued to rise in the first half of 2006, the CNB and staff agreed it was too soon to judge the effectiveness of the latest increase in the MRR. The CNB had thus decided to wait before changing again the level of the MRR, also in light of the tightening of monetary conditions now underway in the euro area, which would have an impact in Croatia. But in view of continuing strong credit growth, the CNB deferred plans for a reduction in the general reserve requirement, which remains at 17 percent.

19. **The authorities are also closing gaps in nonbank supervision, notably over leasing companies**. The unified nonbank regulator, HANFA, began operations in January 2006, and is already cooperating with the CNB on financial stability issues. On leasing companies, staff noted that existing legislation did not provide explicitly for regulatory authority by either the CNB or HANFA. Accordingly, the government has submitted to parliament a draft law on leasing, which regulates leasing company activities and clarifies HANFA's regulatory responsibility in this area (¶14).

C. Structural Policies

20. **The authorities are persevering with their expanded structural agenda, though progress in some key areas has been slower than envisaged**. As noted above, the structural reform agenda was expanded at the time of the first review in the areas of tax administration, civil service reform, state aid and subsidies, pensions, and health. Progress has been broadly on track, except in privatization and the restructuring of state-owned shipyards, which have been plagued by delays. In the case of privatization, these were partly due to different legal disputes, some of which are still ongoing (notably a dispute between

local governments and HT on the ownership of underground cables of HT, which has escalated costs and caused delays in the process of privatization). The restructuring of the shipbuilding and steel sectors is facing strong political resistance; but it is in any case required for Croatia to comply with its commitments under the SAA with the EU.

21. **The government is taking steps to restore momentum to the privatization process** (¶16). The second phase of the privatization of INA is now scheduled for October. In September, the government plans to approve a model for the privatization of 15 percent of the company through an initial public offering, with listings in Zagreb and in London; a further 7 percent of INA is being sold to employees. It also plans to approve in September the model for the third phase of the privatization of HT, with the goal of completing the transaction by end-2006. Staff welcomed these steps, as they provided reassurance that the INA and HT privatizations, which were expected to yield 4-5 percentage points of GDP, are on track. Beyond these large privatizations, the authorities have continued working on a revised privatization law to allow new privatization models, including employee buyouts and stock option purchases. Staff expressed reservations regarding significant employee ownership: this might not bring new capital or know-how to the firm, while it risked deterring potential strategic investors. The authorities felt that allowing some employee ownership was important in securing consensus for the privatization process. On the basis of the revised privatization law, expected to be promulgated shortly, the authorities intend to complete the sale of all remaining shares in the portfolio of the Privatization Fund by end-2007.

22. **Restructuring plans for the steel industry and the shipyards are under preparation** (¶17). Since state aid to these sectors has to conform to EU state aid rules, the preparation of both plans is closely coordinated with the European Commission. The government has in any event decided to proceed with the privatization of the two state-owned steel companies (Sisak and Split), for which tenders are to be issued in mid-September. On shipyards, the government appointed a consultant to finalize the restructuring plan in June, and is in the process of discussing the consultant's proposals with the Commission and with individual shipyards. The government expects to approve the final plan for shipyards by end-November.

IV. Program Modalities and Risks

23. **The authorities consider this program a success, a judgment the staff broadly shares**. Strong policy ownership has delivered a significant fiscal adjustment and spurred a number of key reforms, although there have been persistent delays in some structural policy areas. The authorities felt that, partly as a result of the progress made under this program, Croatia would not require a successor arrangement. They intended, however, to continue the close cooperation with the Fund in the context of surveillance.

24. **There are minimal risks for the program in the limited time remaining**. Most major policy actions under the program have already been implemented. Understandings were reached with staff on critical measures as prior actions for the third review, and these have largely been implemented. The proposed review will set quantitative PCs for end-September and one structural PC for end-October, on the initial public offering for INA.

25. **However, the economic outlook remains subject to risks**. In the short term, the main risks are that (i) private sector borrowing continues unabated, despite the measures taken to stem it; and (ii) the planned large privatization deals (HT and INA) are not completed this year. In both cases, gross external debt might edge up farther than projected in 2006. But this impact is likely to be temporary. Over the medium term, the main risk is a surge in aggregate demand fueled by capital inflows. Unless structural reforms are advanced enough to enable a commensurate supply side response, such a surge would lead to overheating. Although the sizeable fiscal consolidation of recent years has placed the government in a good position to manage this risk, and the 3-year budgets provide some anchor for future policies, the forthcoming elections may intensify spending pressures. And the experience of other countries in the runup to EU membership in the 1990s suggests that the risk of overheating could test the macroeconomic policy framework. The forthcoming Article IV consultation will provide an opportunity to re-assess this risk.

V. Staff Appraisal

26. **Policies under the program have mitigated vulnerabilities without harming growth performance**. Indeed, real GDP growth has been slightly faster than projected under the program, while inflation has been remained contained. The recent strength in private investment has boosted growth at the same time that fiscal and quasi-fiscal deficits have been scaled back. Private sector external borrowing has proven stronger than expected under the program, and now appears likely to push up the gross external debt-to-GDP ratio for another year. This was due to private sector portfolio decisions that, as noted at the second review, are largely beyond the control of aggregate demand management policies. But the macroeconomic adjustment under the program has doubtless contributed to the sharp slowdown in gross debt accumulation from the worrisome pace of recent years, and the evidence suggests that net external debt may have actually started to fall.

27. **The main success of the program has been a fundamental improvement of Croatia's public finances**. The fiscal and quasi-fiscal balance improved by 3½ percentage points of GDP during the 2½ years covered by the SBA, with an additional 0.2 percent targeted in the remainder of this year. Half of this adjustment has come from current expenditure savings. In addition, fiscal policy has been firmly placed in a medium-term context with the introduction of rolling three-year budgets, fiscal transparency and public expenditure and debt management have been improved, and important reforms have been initiated in pensions and health.

28. **But these gains will be fragile until structural reforms start boosting the economy's growth potential**. Until then, capital inflows—likely to be considerable in the period ahead—will continue to translate into excess demand, feed the external imbalances, and strain the macroeconomic policy framework.

29. **The modest mid-year tightening of the 2006 fiscal target underscores the government's commitment to the program objectives**. Staff considers this additional adjustment appropriate in light of the current macroeconomic conjuncture, although it would have been preferable if it were based on permanent current, rather than capital spending cuts. Also, the more ambitious the adjustment this year, the easier it would be for the government to stay on course for achieving its medium-term fiscal targets through the election pressures next year. Nevertheless, staff notes that these medium-term targets and, more broadly, fiscal policy should remain flexible to adjust as needed to the changing macroeconomic circumstances.

30. **The battery of measures to tighten prudential requirements and close supervisory gaps is welcome; it will reduce credit-related risks and bolster financial stability**. While the CNB can do little to target and control overall credit growth, it can influence its quality. The ongoing measures should help mitigate the extent to which bank and borrower behavior result in risky lending decisions. The new credit registry, in particular, will provide critical support to the CNB's efforts, and staff supports the steps to encourage banks to make regular use of it. The establishment of HANFA this year as an independent nonbank regulator was an important step towards improving supervision of the wider financial system, and staff welcomes its increasingly close cooperation with the CNB. Staff also looks forward to the adoption of the leasing law, which will close a significant gap in supervisory coverage.

31. **Progress is being made in structural reforms, although delays in state enterprise restructuring and privatization are regrettable**. Health reform, in particular, was a major step forward: shifting health insurance to the private sector and increasing copayments for drugs are necessary for achieving savings beginning this year, and will be helpful in addressing the ongoing arrears problem. Staff looks forward to future reforms in the sector, which the authorities are discussing with the World Bank. On privatization, progress during the program has been disappointing. However, the recent government steps with respect to the privatization of INA and HT provide some reassurance that these major transactions will be completed this year. Finally, despite the delays in finalizing the restructuring plans for the steel and shipyard sectors, the process is now underway. In recent months, the pressure coming from Croatia's obligations under the SAA and the ongoing EU membership negotiations has started providing significant momentum in this area.

32. **Staff supports the authorities' request for completion of the third and final review under the SBA**. Access under the arrangement remains appropriate and the authorities' capacity to repay the Fund is unimpaired.

Table 1. Croatia: Key Macroeconomic Indicators, 2003–06

	2003	2004	2005	2006	
				Prog. 1/	Proj.
Output, unemployment, and prices					
Real GDP	5.3	3.8	4.3	4.1	4.6
Unemployment (survey-based, in percent)	14.3	13.8	12.7	...	...
CPI inflation (average)	1.8	2.1	3.3	3.2	3.5
Savings and investment 2/					
Domestic investment	30.5	31.2	31.4	...	32.5
Of which: fixed capital formation	28.6	28.6	28.6	...	29.6
Domestic saving	24.4	26.0	25.0	...	25.6
Government	1.8	2.8	3.1	...	3.6
Nongovernment	22.6	23.2	22.0	...	22.0
General government and HBOR operations 3/					
General government revenues	45.1	45.4	44.9	44.3	44.9
General government expenses and net lending	51.3	50.2	49.0	47.5	47.8
Overall general government balance	-6.1	-4.8	-4.1	-3.2	-3.0
Overall general government financing requirement 4/	-6.1	-4.8	-4.1	-4.1	-3.9
Overall HBOR balance (net of budget transfers)	-0.6	-0.4	-0.1	-0.2	-0.2
Fiscal and quasi-fiscal balance	-6.8	-5.2	-4.2	-3.4	-3.2
General government debt	40.9	43.7	44.3	41.9	41.8
Money and credit					
Credit to the nongovernment sector	14.7	12.8	16.7	12.4	20.9
Broad money	11.0	8.6	10.5	13.0	13.5
Base money 5/	23.8	19.9	20.7	4.1	18.2
Interest rates					
Average kuna deposit rate (unindexed)	1.7	1.8	1.6	…	…
Average kuna credit rate (unindexed)	11.5	11.4	9.9	…	…
Balance of payments					
Current account balance	-1,596	-1,455	-1,961	-1,907	-2,317
(In percent of GDP)	-6.1	-5.1	-6.3	-5.7	-6.8
Capital and financial account	4,015	2,532	3,700	3,410	4,863
Overall balance	1,239	58	823	648	1,448
Debt and reserves					
Gross official reserves	6,554	6,436	7,438	8,086	8,886
In months of following year's imports of goods and NFS	4.8	4.4	4.7	4.6	5.0
External debt service to exports ratio (in percent)	20.1	22.4	22.2	24.8	24.8
Total external debt (in percent of GDP)	75.5	80.2	82.5	78.2	83.1
Net external debt 6/	32.9	37.5	42.9	39.2	44.4

Sources: Croatian authorities, and Fund staff estimates.

1/ Ratios to GDP are recalculated using the latest GDP estimates and projections. Historical GDP data were revised in March 2006, resulting in an upward revision of about 3 percentage points.

2/ Domestic savings and investment statistics and staff projections are hampered by the large errors term in the national accounts estimates.

3/ Revenues in 2004 include HRK 197 million in GSM license fees from an auction held in December 2004 but received in February 2005.

4/ Including estimated 1 percent of GDP for "pensioners' debt" repayment under the cash option.

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

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

Table 2. Croatia: Balance of Payments, 2003–06
(In millions of euros, unless otherwise indicated)

	2003	2004	2005	2006 Proj.
Current account	-1,596	-1,455	-1,961	-2,317
Merchandise trade balance	-6,994	-6,724	-7,455	-8,389
Exports f.o.b.	5,579	6,600	7,221	8,241
Ships	397	439	319	588
Non-ship exports	5,181	6,161	6,901	7,653
Imports f.o.b.	-12,573	-13,324	-14,676	-16,630
Services and income	4,154	4,075	4,322	4,885
Transportation	252	245	375	404
Travel	4,986	4,814	5,368	5,874
Other services	-297	-352	-453	-593
Compensation of employees	184	234	259	282
Interest and investment income	-972	-866	-1,227	-1,082
Current transfers	1,244	1,194	1,172	1,186
Credit	1,540	1,586	1,619	1,651
Debit	-296	-392	-447	-465
Capital and financial account	4,015	2,532	3,700	4,863
Capital account 1/	74	23	51	10
Financial account	3,941	2,509	3,649	4,853
Direct investment 1/ 2/	1,501	764	1,149	2,257
of which: privatization receipts	464	27	0	1,000
Portfolio investment	853	511	-1,036	-555
Medium- and long-term loans	2,363	1,957	1,624	1,652
Assets	-24	41	-97	0
Liabilities	2,386	1,916	1,721	1,652
Disbursements	4,281	3,933	3,748	4,460
Amortization	-1,894	-2,017	-2,026	-2,808
Currency and deposits	-847	-26	1,594	800
Short-term capital flows (net)	458	-415	543	627
Trade credits	-386	-281	-226	71
Net errors and omissions 3/	-1,181	-1,020	-916	-1,098
Overall balance	1,239	58	823	1,448
Financing	-1,239	-58	-823	-1,448
Gross reserves (-= increase)	-1,239	-58	-823	-1,448
IMF (net purchases)	0	0	0	0
Exceptional financing	0	0	0	0
Memorandum items:				
Current account (in percent of GDP)	-6.1	-5.1	-6.3	-6.8
Gross official reserves (GIR)	6,554	6,436	7,438	8,886
in months of following year's imports of goods and NFS	4.8	4.4	4.6	5.0
Net foreign assets of the CNB	6,188	6,434	7,436	8,884
in months of following year's imports of goods and NFS	4.6	4.4	4.6	5.0
Outstanding debt 4/	19,811	22,781	25,541	28,136
External debt to GDP ratio 4/	75.5	80.2	82.5	83.1
External debt as a percentage of exports of goods and NFS	150.6	160.1	167.6	166.4
Short-term debt by residual maturity (in percent of GIR)	63.6	81.4	85.1	79.0
Net external debt to GDP ratio	32.9	37.5	42.9	44.4
External debt service	-2,649	-3,187	-3,380	-4,185
GDP (millions of euros)	26,234	28,393	30,946	33,865
GDP (millions of kuna)	198,422	212,826	229,031	247,924

Sources: Croatian National Bank; and Fund staff estimates.

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

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

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

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

Table 3. Croatia: Indicators of External and Financial Vulnerability, 2003–06
(In percent, unless otherwise indicated)

	2003	2004	2005	2006 Latest	2006 Date
External indicators					
Real effective exchange rate (using consumer prices) 1/, 2000=100	105.4	107.6	109.7	114.1	Jun-06
Exports of goods and services (volumes, percentage change, yoy) 2/	11.4	5.4	4.6	14.0	Q1 -06
Imports of goods and services (volumes, percentage change, yoy) 2/	12.1	3.5	3.5	16.1	Q1 -06
Current account deficit (millions of euros)	-1,596	-1,455	-1,961	-1,992	Q1 -06
Current account deficit in percent of GDP	-6.1	-5.1	-6.3	-6.3	Q1 -06
Capital and financial account in percent of GDP	15.3	8.9	12.0	7.0	Q1 -06
Gross official reserves (millions of euros)	6,554	6,436	7,438	8,744	Jun-06
Gross official reserves in percent of broad money (M4)	38.9	35.3	35.5	38.9	Jun-06
Gross official reserves in percent of reserve money	163.9	145.5	135.8	152.4	Jun-06
Gross official reserves in months of current year's imports of goods and NFS	5.2	4.8	5.1	5.2	Jun-06
Gross usable international reserves (GUIR) in percent of domestic FX deposits	50.6	47.2	47.7	53.9	Jun-06
CNB net foreign assets (millions of euros)	6,188	6,434	7,436	8,740	Jun-06
CNB net foreign assets in months of current year's import of goods and NFS	4.9	4.8	5.1	5.2	Jun-06
Short-term debt in percent of GUIR 3/ 4/	84.4	111.0	114.5	...	...
Short-term debt and current account deficit net of FDI in percent of GUIR	98.6	119.3	103.9	...	...
Total external debt, percent of GDP 5/	75.5	80.2	82.4	84.4	Jun-06
External debt service to export ratio	20.1	22.4	22.2	...	...
Financial indicators					
General government debt in percent of GDP	40.9	43.7	44.3	41.3	Jun-06
Domestic in percent of GDP	17.8	20.1	24.5	24.7	Jun-06
Foreign in percent of GDP	23.1	23.6	19.8	16.6	Jun-06
Broad money (M4, percentage change, yoy)	11.0	8.6	10.5	14.4	Jun-06
Claims on other domestic sectors (change, yoy)	14.7	12.8	16.7	23.5	Jun-06
Short-term interest rate (in percent, e.o.p.)	6.2	4.8	3.2	2.5	Jun-06
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,185	1,565	1,998	2,872	Jul-06
Zagreb Stock Exchange, capitalization, percent of GDP	25	41	50	62	Jun-06
Bond yield spreads (EMBI Global, e.o.p.)	96	42	36	61	Jun-06
Debt ratings: Moody's:					
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Jul-06
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Jul-06
Foreign debt ratings					
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	Jul-06
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	Jul-06
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	Jul-06
Standard and Poor's: Foreign currency LT	BBB-	BBB	BBB	BBB	Jul-06
Banking system:					
Regulatory capital to risk-weighted assets	15.7	14.1	13.9	15.0	Q1 -06
Nonperforming loans to total loans	5.1	4.5	4.0	3.9	Q1 -06
Loan-loss provisions to non-performing loans	60.8	60.3	58.0	58.2	Q1 -06
Net open foreign exchange position to capital 6/	13.3	12.5	8.4	4.6	Q1 -06
Foreign currency deposits to total deposits 7/	87.1	86.8	84.3	84.8	Q1 -06
Foreign currency loans to total loans 7/	74.4	75.8	77.5	77.2	Q1 -06

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

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

Table 4. Croatia: Financial Soundness Indicators, 2003–06

(Banks, in percent, unless otherwise indicated)

	2003	2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006
Regulatory capital to risk-weighted assets	15.7	14.1	15.4	15.2	14.9	13.9	15.0
Capital to assets	9.0	8.5	9.3	9.3	9.0	8.7	9.5
Nonperforming loans to total gross loans	5.1	4.5	4.5	4.3	4.1	4.0	3.9
Loan-loss provisions to nonperforming loans	60.8	60.3	60.6	60.1	60.1	58.0	58.2
After-tax return on average assets	1.4	1.4	1.4	1.3	1.4	1.4	1.3
After-tax return on average equity	15.6	16.6	15.8	14.2	16.5	16.0	14.8
Foreign-currency-indexed loans to deposits 1/	66.2	66.9	68.6	70.3	72.7	71.4	72.8
Total loans to total deposits	96.0	99.5	104.8	108.9	106.6	108.8	114.8
Net open foreign exchange position to capital 2/	13.3	12.5	4.6	2.6	7.0	8.4	4.6
Foreign-currency deposits to total deposits 3/	87.1	86.8	86.9	85.1	84.9	84.3	84.8
Foreign-currency loans to total loans 3/	74.4	75.8	77.0	76.4	77.7	77.5	77.2

Source: Croatian National Bank.

1/ Denominator includes foreign-currency and foreign-currency-indexed deposits and loans received.
2/ Net open positions include foreign currency options.
3/ Foreign currency deposits (loans) include those denominated in kuna and linked to foreign exchange.

Table 5. Croatia: Staff Medium-Term Scenario, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Basic assumptions, national accounts & prices									
Real GDP	5.3	3.8	4.3	4.6	4.7	4.5	4.5	4.5	4.5
Consumption, total	3.7	2.7	2.8	4.3	4.7	4.1	4.2	4.2	4.2
Of which: private	4.6	3.9	3.4	4.4	5.1	4.6	4.5	4.5	4.5
Gross fixed capital formation, total	24.7	4.4	4.8	8.6	3.9	4.5	4.0	4.0	4.0
Of which: private	24.0	7.7	7.9	11.4	4.5	4.7	4.0	4.0	4.0
GDP deflator	3.9	3.3	3.2	3.5	3.1	3.0	3.0	3.0	3.0
Consumer prices (e.o.p.)	1.7	2.7	3.6	3.3	2.8	2.7	2.8	2.8	2.8
General government finances									
Revenue	45.1	45.4	44.9	44.9	44.0	43.5	42.9	42.9	42.8
Expenditure 1/	51.3	50.2	49.0	47.8	46.8	46.1	45.2	45.2	45.1
Balance 1/	-6.1	-4.8	-4.1	-3.0	-2.8	-2.6	-2.4	-2.3	-2.3
Privatization receipts	2.1	0.6	0.6	3.5	1.5	0.4	0.3	0.3	0.2
Domestic financing	1.5	2.4	5.4	1.7	1.8	1.4	1.8	1.6	1.6
Foreign financing	2.5	1.8	-1.9	-1.2	0.6	1.0	0.4	0.6	0.7
Debt	40.9	43.7	44.3	42.2	41.9	41.8	41.5	41.1	40.9
Balance of payments									
Current account balance	-6.1	-5.1	-6.3	-6.8	-6.8	-6.4	-6.2	-5.9	-6.0
Exports f.o.b.	21.3	23.2	23.3	24.3	24.4	24.1	24.2	24.1	24.2
Imports f.o.b.	-47.9	-46.9	-47.4	-49.1	-49.4	-48.7	-47.9	-47.8	-47.7
Merchandise trade balance	-26.7	-23.7	-24.1	-24.8	-25.0	-24.5	-23.8	-23.6	-23.5
Services, net	15.8	14.4	14.0	14.4	14.8	14.8	14.3	14.5	14.4
Of which: travel receipts	21.3	19.4	19.3	19.2	19.1	19.0	18.9	18.8	18.8
Current transfers	4.7	4.2	3.8	3.5	3.4	3.3	3.3	3.2	3.2
Capital and financial account	15.3	8.9	12.0	14.4	10.1	9.6	8.3	8.4	7.8
FDI	5.7	2.7	3.7	6.7	4.8	4.7	5.2	5.1	5.1
Portfolio investment	3.3	1.8	-3.3	-1.6	-0.4	0.6	-0.6	0.8	-0.3
Medium-term borrowing, net	9.0	6.9	5.2	4.9	4.3	2.9	1.8	0.4	1.0
Short-term and other	-2.7	-2.5	6.3	4.5	1.3	1.4	1.8	2.0	2.0
Net errors and omissions (E&O)	-4.5	-3.6	-3.0	-3.2	-2.6	-2.6	-2.0	-2.0	-2.0
Gross official reserves (in months of imports)	4.8	4.4	4.6	5.0	4.9	4.7	4.4	4.4	4.4
Gross external debt	75.5	80.2	82.5	83.1	82.4	81.2	78.3	75.8	72.8
Net external debt	32.9	37.5	42.9	44.4	43.7	42.5	39.6	37.1	34.1
Memorandum item:									
Current account balance plus net E&O	-10.6	-8.7	-9.3	-10.1	-9.4	-9.0	-8.2	-7.9	-8.0
Nominal GDP (in millions of kuna)	198,422	212,826	229,031	247,924	267,823	288,403	310,423	334,124	359,634
Nominal GDP (in millions of euros)	26,234	28,393	30,946	33,864	36,437	39,237	42,233	45,457	48,928

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

1/ Excludes repayments of “pensioners’ debt.”

Table 6. Croatia: Consolidated General Government Finances, 2003–06

(In percent of GDP)

	2003	2004 1/	2005 1/		2006	
			Prog.	Act.	Budget	Suppl. Budget
Revenue	45.1	45.4	44.8	44.9	44.3	44.9
Taxes	27.2	26.5	26.5	26.4	25.9	26.4
Taxes on income, profits, and capital gains	5.8	5.7	6.0	5.8	5.8	6.0
Payable by individuals	3.6	3.6	3.6	3.4	3.5	3.4
Payable by corporations and other enterprises	2.2	2.1	2.4	2.4	2.3	2.6
Taxes on property	0.3	0.3	0.3	0.3	0.3	0.3
Taxes on goods and services	20.0	19.5	19.3	19.4	18.9	19.2
Of which: VAT	14.2	14.0	13.8	14.1	13.7	14.0
Excises	5.3	5.0	4.9	4.8	4.7	4.7
Taxes on international trade and transactions	0.9	0.7	0.7	0.7	0.6	0.6
Other taxes	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	13.8	13.9	13.7	13.7	13.6	13.5
Other revenue and grants	4.1	5.0	4.5	4.8	4.9	4.9
Total expenditure 2/	51.3	50.2	48.8	49.0	47.5	47.8
Expense (current)	45.2	44.8	43.7	44.2	43.0	43.5
Compensation of employees	12.4	12.0	11.6	11.6	11.2	11.3
Use of goods and services	4.8	4.8	4.7	4.9	5.2	5.3
Interest	2.0	2.1	2.2	2.2	2.2	2.2
Subsidies	3.2	2.7	2.6	2.6	2.4	2.5
Grants	0.0	0.5	0.4	0.6	0.5	0.6
Social benefits	19.2	19.3	18.5	18.5	17.9	18.1
Other expense	3.6	3.4	3.6	3.6	3.5	3.4
Acquisition of non-financial assets (investment)	5.7	5.0	4.8	4.4	4.2	4.0
Net lending	0.3	0.5	0.4	0.4	0.3	0.3
Overall balance	-6.1	-4.8	-4.1	-4.1	-3.2	-3.0
Repayment of “pensioners’ debt” 3/	...	...	...	...	1.0	1.0
Financing requirement	-6.1	-4.8	-4.1	-4.1	-4.1	-3.9
Financing	6.1	4.8	4.1	4.1	4.1	3.9
Privatization and disposal of fixed assets	2.1	0.6	1.4	0.6	3.5	3.5
External financing	2.5	1.8	-0.4	-1.9	-1.2	-1.2
Disbursements	3.8	4.1	2.4	0.7	1.4	1.3
Amortization	-1.2	-2.3	-2.8	-2.6	-2.6	-2.5
Domestic financing	1.5	2.4	3.1	5.4	1.9	1.7
Memorandum items:						
Primary budget balance	-4.1	-2.7	-2.0	-1.8	-0.9	-0.8
General government debt	40.9	43.7	43.6	44.3	41.9	42.2
General government guarantees and arrears	11.5	9.7	10.2	9.4	9.5	9.2

Sources: Ministry of Finance and Fund staff estimates.

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

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

3/ Discount option payments in 2006-07 (chosen by 74 percent of eligible pensioners); face-value option payments begin after the final discount option payment.

Table 7. Croatia: Monetary Accounts, 2003–06

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

	2003	2004	2005	2006 Q1	2006 Q2	2006 Q3 Proj.	2006 Q4 Proj.	2003	2004	2005	2006 Proj.
Monetary Survey								(Change in percent)			
Net Foreign Assets	32,771	31,743	23,304	12,977	13,994	12,218	16,094	-0.1	-3.1	-26.6	-30.9
Net Domestic Assets	96,122	108,205	131,343	140,596	149,113	159,848	159,435	15.4	12.6	21.4	21.4
Of which: Domestic credit	123,781	138,686	166,212	176,501	186,080	196,980	197,570	12.4	12.0	19.8	18.9
To government, net	16,735	17,902	25,304	27,898	29,882	31,227	27,252	0.0	7.0	41.3	7.7
To other domestic sectors 1/	107,046	120,784	140,909	148,603	156,198	165,752	170,319	14.7	12.8	16.7	20.9
Broad Money	128,893	139,948	154,647	153,574	163,107	172,067	175,528	11.0	8.6	10.5	13.5
Narrow Money	33,889	34,562	38,817	38,186	42,226	41,818	44,272	9.8	2.0	12.3	14.1
Currency outside banks	10,573	10,956	12,164	12,091	14,003	14,944	13,873	9.2	3.6	11.0	14.1
Demand deposits	23,316	23,606	26,653	26,095	28,223	26,874	30,399	10.0	1.2	12.9	14.1
Quasi Money	95,004	105,386	115,830	115,387	120,880	130,249	131,256	11.4	10.9	9.9	13.3
Kuna-denominated	18,969	23,643	29,069	32,961	39,861	37,537	38,826	43.5	24.6	23.0	33.6
Foreign currency-denominated	76,035	81,743	86,761	82,427	81,019	92,712	92,430	5.5	7.5	6.1	6.5
Balance Sheet of the Croatian National Bank								(Contribution to change in base money)			
Net Foreign Assets	47,321	49,355	54,844	59,222	63,427	64,855	65,473	18.1	5.5	12.3	19.4
Less: Banks' foreign currency reserves	6,687	10,765	13,496	17,306	19,809	20,555	20,724	-1.2	10.9	6.1	53.6
CNB bills in foreign currency	4,920	0	0	0	0	0	0	12.3	-13.2	0.0	...
Net International Reserves	35,714	38,591	41,348	41,916	43,619	44,300	44,749	7.0	7.7	6.2	8.2
Net Domestic Assets	-10,035	-4,654	-901	-4,087	-1,951	-1,486	-1,727	5.7	14.4	8.4	-1.5
Of which: Claims on government (net)	-1,550	-260	-331	-163	-250	-159	-159	-2.6	3.5	-0.2	0.3
Claims on banks	972	409	4,216	564	2,155	3,000	3,000	3.2	-1.5	8.5	-2.3
Of which: open market operations	0	394	4,201	550	2,141	3,000	3,000	...	...	...	-2.2
Claims on other domestic sectors	94	83	73	73	73	92	92	-0.1	0.0	0.0	0.0
Other items (net)	-4,631	-4,886	-4,859	-4,562	-3,930	-4,419	-4,660	0.9	-0.7	0.1	0.4
Less: CNB bills in foreign currency	4,920	0	0	0	0	0	0				
								(Change in percent)			
Base Money	37,285	44,702	53,943	55,134	61,477	63,370	63,746	23.8	19.9	20.7	18.2
Currency	10,573	10,956	12,164	12,091	14,003	14,944	13,873	9.2	3.6	11.0	14.1
Deposits	26,712	33,746	41,779	43,043	47,474	48,426	49,873	30.7	26.3	23.8	19.4
Of which: Settlement accounts	5,616	6,408	8,411	5,740	6,223	6,000	6,200	43.1	14.1	31.3	-26.3
Statutory reserve in kuna	12,604	14,674	17,605	17,355	18,596	19,392	20,666	54.0	16.4	20.0	17.4
Statutory reserve in foreign currency	6,687	10,765	13,496	17,306	19,809	20,555	20,724	-5.0	61.0	25.4	53.6
Of which: General reserve requirement	6,687	10,293	9,266	9,006	9,122	9,945	9,947	-5.0	53.9	-10.0	7.3
Marginal reserve requirement	0	472	4,230	8,300	10,686	10,610	10,777	...	...	...	154.8
Reserve Money (CNB definition) 2/	30,586	33,924	40,391	37,768	41,645	42,802	43,010	32.8	10.9	19.1	6.5
Memorandum items:											
Nominal GDP (yearly total)	198,422	212,826	229,031				247,924				
Narrow money multiplier	0.91	0.77	0.72				0.69				
Broad money multiplier	3.46	3.13	2.87				2.75				
Broad money to GDP ratio	0.65	0.66	0.68				0.71				
Foreign currency in percent of broad money	59.0	58.4	56.1				52.7				

Sources: Croatian National Bank; and Fund staff projections.

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

2/ Excludes statutory reserve in foreign currency.

Table 8. Croatia: Schedule of Purchases Under the 27-Month Stand-By Arrangement

Date	Amount of Purchase 1/ In millions of SDRs	Amount of Purchase 1/ In percent of quota	Conditions
August 4, 2004	92.09	25.22	Board approval of stand-by arrangement.
October 30, 2004	0.818	0.22	Observance of end-September 2004 performance criteria.
September 14, 2005	0.818	0.22	Observance of end-December 2004 performance criteria and completion of first review.
October 31, 2005	0.818	0.22	Observance of end-September 2005 performance criteria.
February 15, 2006	2.456	0.67	Observance of end-December 2005 performance criteria and completion of second review.
April 30, 2006	0.66	0.18	Observance of end-March 2006 performance criteria.
August 15, 2006	0.66	0.18	Observance of end-June 2006 performance criteria and completion of third review.
October 31, 2006	0.68	0.19	Observance of end-September 2006 performance criteria.
Total 27-month SBA	**99.0**	**27.1**	

Source: Fund staff.

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

Table 9. Croatia: Indicators of Capacity to Repay the Fund: 2006–11

(Under the obligations repurchase schedule)

	2006	2007	2008	2009	2010	2011
Fund repurchases and charges 1/						
In millions of SDRs	1.4	6.9	6.9	6.9	55.2	52.6
In millions of euros	1.6	8.0	8.0	8.0	64.3	61.3
In percent of exports of goods and NFS	0.0	0.0	0.0	0.0	0.3	0.3
In percent of debt service	0.0	0.2	0.2	0.1	0.9	0.8
In percent of quota	0.4	1.9	1.9	1.9	15.1	14.4
In percent of gross official reserves	0.0	0.1	0.1	0.1	0.7	0.6
Fund credit outstanding (e.o.p.) 1/						
In millions of SDRs	99.0	99.0	99.0	99.0	49.5	0.0
In millions of euros	115.3	115.1	114.9	114.8	57.1	0.0
In percent of quota	27.1	27.1	27.1	27.1	13.6	0.0
In percent of GDP	0.3	0.3	0.3	0.3	0.1	0.0
In percent of gross official reserves	1.3	1.2	1.2	1.2	0.6	0.0
Memorandum items:						
Exports of goods and NFS (millions of euros)	16,905	18,216	19,494	20,986	22,503	24,250
Debt service (millions of euros) 1/	-4,187	-4,234	-4,967	-6,563	-6,780	-7,561
Quota (millions of SDRs)	365	365	365	365	365	365
Quota (millions of euros)	425	424	424	423	421	420
Gross official reserves (millions of euros) 1/	9,002	9,242	9,467	9,504	9,665	9,504

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

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

Table 10. Croatia: Projected Payments to the Fund as of August 21, 2006
Under the Obligations Repurchase Schedule
(In millions of SDRs)

	2006	2007	2008	2009	2010	2011
Obligations from existing drawings						
Principal						
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0
SDR net charges	0.4	1.7	1.7	1.7	1.7	1.7
Total obligations	0.4	1.7	1.7	1.7	1.7	1.7
(percent of quota)	0.1	0.5	0.5	0.5	0.5	0.5
Obligations from prospective drawings						
Principal						
GRA repurchases	0.0	0.0	0.0	0.0	49.5	49.5
Charges and interest 1/						
GRA charges and interest	0.9	5.2	5.2	5.2	4.0	1.4
Total obligations	0.9	5.2	5.2	5.2	53.5	50.9
(percent of quota)	0.3	1.4	1.4	1.4	14.7	13.9
Cumulative (existing and prospective)						
Principal						
GRA repurchases	0.0	0.0	0.0	0.0	49.5	49.5
Charges and interest 1/	1.4	6.9	6.9	6.9	5.7	3.1
Total obligations	1.4	6.9	6.9	6.9	55.2	52.6
(percent of quota)	0.4	1.9	1.9	1.9	15.1	14.4

Source: IMF Finance Department.

1/ Assumes the GRA rate of charge of 4.97 percent plus 26 basis points for burden sharing.

Table 11. Croatia: External Financing Requirements, 2003–11

(In millions of euros)

				Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011
Gross Financing Requirements	4,872	4,050	5,404	7,127	6,091	6,739	7,952	8,623	9,349
Current account	1,596	1,455	1,961	2,317	2,494	2,517	2,609	2,692	2,926
Amortization on bonds and medium and long-term loans	2,037	2,537	2,620	3,363	3,357	3,998	5,305	5,712	6,526
Public sector	339	815	836	1,042	920	1,046	1,488	1,517	2,379
Banks	714	460	852	1,026	794	1,162	1,800	1,891	1,734
Other sectors	984	1,262	932	1,295	1,642	1,790	2,017	2,304	2,413
Gross reserves accumulation	1,239	58	823	1,448	241	224	37	219	-104
IMF repurchases and repayments	0	0	0	0	0	0	0	0	0
Available Financing	4,872	4,050	5,404	7,127	6,091	6,739	7,952	8,623	9,349
Direct investment (net)	1,501	764	1,149	2,257	1,753	1,852	2,184	2,340	2,507
Disbursements on bonds and medium and long-term loans	4,937	4,787	3,748	4,460	4,806	5,357	5,831	6,149	6,603
Public sector 1/ 2/	1,370	1,564	472	660	1,001	1,253	1,093	1,418	1,727
Banks	1,655	1,173	1,130	1,450	1,300	1,435	1,998	2,033	2,133
Other sectors	1,912	2,050	2,146	2,350	2,505	2,669	2,740	2,698	2,743
Short-term financing (net) 3/	72	-695	317	698	429	500	676	792	837
Other flows (net) 4/	-1,639	-805	190	-288	-897	-970	-740	-658	-598

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

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

APPENDIX I. CROATIA: DEBT SUSTAINABILITY ANALYSIS

I. Fiscal Sustainability

1. Under the baseline scenario, public debt peaked at 44 percent of GDP in 2005 and from 2006 stabilizes around 41 percent of GDP, driven primarily by continued fiscal consolidation and assisted by expected sizable privatization receipts in 2006 and 2007 (excluding the amounts earmarked for the "pensioners' debt" repayments). Stress-testing suggests that a severe economic slowdown accompanied by a revenue drop could halt fiscal consolidation and keep the debt ratio on a modestly upward trend (Table 12, Figure 5). With key variables at their historical averages (scenario A1), the debt ratio increases by 18 percentage points of GDP between 2005 and 2011. This is because the historical primary deficit does not fully account for the recent significant fiscal consolidation—a trend projected to continue in the medium term—while the historical growth rate is unduly affected by a recession in 1999. Assuming no policy change from 2005 (scenario A2), the debt ratio would increase modestly over the forecast horizon, similar to the effect of a policy-induced widening of the primary deficit (scenario B3), or a combined slowdown in growth with the concomitant rise in the primary deficit plus an interest rate hike (scenario B4). Similarly, a large and sustained drop in economic activity (scenario B2) would raise debt by 3–4 percentage points, assuming that the primary balance widens proportionately to the fall in revenue. Under the two one-time shocks (scenarios B5 and B6), the debt ratio resumes a downward trend following the initial shock. The inclusion of the stock of state guarantees and arrears (about 10 percent of GDP) in the above analysis would not materially change the described responses to shocks.

II. External Sustainability

2. External debt rose quickly in recent years in Croatia—by over 20 percentage points of GDP (in euro terms) between 2002 and 2005. The buildup was facilitated by good access to international capital markets. But efforts at fiscal consolidation, a shift by the public sector towards domestic financing, and measures by the central bank to discourage bank external borrowing contributed to a marked slowdown of the growth to the debt to GDP ratio by 2005.[4] In the baseline projection, which incorporates a fairly flat external current account balance relative to GDP with some improvement in the outer years and continued restraint by the public sector towards foreign borrowing, the debt to GDP ratio declines gradually to about 73 percent by 2011 (Table 13). Alternative scenarios

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[4] An upward revision of the GDP series has resulted in a small decline in the debt to GDP ratios compared to previously reported data. For example, at end-2005 the ratio is now estimated at 82.5 percent of GDP, in comparison with 84.7 percent in IMF Country Report No.. 06/128.

demonstrate the sensitivity of external debt to several factors, highlighting the need for vigilance in economic management to forestall an unsustainable situation (Figure 6). In the scenario involving key variables being kept at their historical averages,[5] the external debt ratio rises slightly. Scenarios with higher interest rates, lower growth or a worsening of the current account indicate a slower decline in the debt to GDP ratio relative to the baseline, especially for the latter shock. The small effect of the interest rate shock partly reflects the low historical standard deviation of interest rates. A large real depreciation scenario is adverse effects, with the debt to GDP ratio possibly averaging over 100 percent between 2006 and 2011.

[5] The key variables are growth in real GDP and the GDP deflator, nominal interest rates, and the non-interest current account and non-debt flows in percent of GDP.

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

(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 10/
1 **Baseline: Public sector debt 1/**	40.9	43.7	44.3	**42.2**	**41.9**	**41.8**	**41.5**	**41.1**	**40.9**	**-0.3**
Of which: foreign-currency denominated	32.7	37.1	36.2	32.2	30.4	29.2	27.5	26.2	25.1	
2 Change in public sector debt	0.9	2.8	0.6	-2.1	-0.3	-0.1	-0.3	-0.3	-0.2	
3 Identified debt-creating flows (4+7+12)	1.4	1.2	0.9	-2.4	-0.3	-0.1	-0.3	-0.3	-0.2	
4 Primary deficit	4.1	2.7	1.8	0.8	0.5	0.3	0.1	0.1	0.1	
5 Revenue and grants	45.1	45.4	44.9	44.9	44.0	43.5	42.9	42.9	42.8	
6 Primary (noninterest) expenditure	49.2	48.0	46.7	45.6	44.5	43.8	43.0	42.9	42.9	
7 Automatic debt dynamics 2/	-0.6	-2.1	-0.9	-1.2	-0.9	-0.7	-0.7	-0.7	-0.7	
8 Contribution from interest rate/growth differential 3/	-1.4	-0.6	-0.9	-1.2	-0.9	-0.7	-0.7	-0.7	-0.7	
9 *Of which:* contribution from real interest rate	0.5	0.8	0.9	0.7	1.0	1.0	1.1	1.0	1.0	
10 *Of which:* contribution from real GDP growth	-2.0	-1.4	-1.7	-1.9	-1.8	-1.8	-1.7	-1.7	-1.7	
11 Contribution from exchange rate depreciation 4/	0.8	-1.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0	
12 Other identified debt-creating flows	-2.1	0.7	-0.1	-2.0	0.1	0.3	0.3	0.3	0.4	
13 Privatization receipts (negative)	-2.1	-0.6	-0.6	-2.5	-0.4	-0.2	-0.2	-0.1	0.0	
14 Recognition of implicit or contingent liabilities	0.0	1.2	0.5	0.5	0.5	0.5	0.4	0.4	0.4	
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-0.5	1.6	-0.3	0.3	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	90.7	96.3	98.6	94.1	95.3	96.1	96.7	95.9	95.7	
Gross financing need 6/	12.3	15.1	14.3	13.0	11.8	11.0	11.4	12.5	11.9	
In billions of U.S. dollars	3.2	4.3	4.4	4.4	4.3	4.3	4.8	5.7	5.8	
A1. Scenario with key variables at their historical averages 7/				**45.8**	**49.1**	**52.5**	**55.9**	**59.2**	**62.6**	**-0.5**
A2. Scenario with no policy change (constant primary balance) in 2006-2011				**43.0**	**44.1**	**45.5**	**46.8**	**48.2**	**49.6**	**-0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	5.3	3.8	4.3	4.6	4.7	4.5	4.5	4.5	4.5	
Average nominal interest rate on public debt (in percent) 8/	5.6	5.6	5.5	5.4	5.8	5.8	5.8	5.8	5.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	2.3	2.3	1.9	2.6	2.8	2.8	2.8	2.8	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.7	4.8	-1.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.9	3.3	3.2	3.5	3.1	3.0	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.4	1.3	1.4	2.1	2.1	2.9	2.5	4.4	4.3	
Primary deficit	4.1	2.7	1.8	0.8	0.5	0.3	0.1	0.1	0.1	
B. Bound Tests										
B1. Real interest rate is at historical average plus one-half standard deviation				**42.3**	**42.1**	**42.1**	**41.9**	**41.6**	**41.5**	**-0.2**
B2. Real GDP growth is at historical average minus one-half standard deviation in 2006 and 2007				**43.1**	**44.2**	**45.0**	**45.5**	**46.0**	**46.7**	**-0.4**
B3. Primary balance is at historical average minus one-half standard deviation				**43.0**	**43.5**	**44.1**	**44.5**	**44.9**	**45.4**	**-0.4**
B4. Combination of B1-B3 using 1/4 standard deviation shocks				**42.9**	**43.2**	**43.7**	**44.1**	**44.4**	**44.8**	**-0.1**
B5. One time 30 percent real depreciation in 2006 9/				**60.0**	**59.4**	**58.9**	**58.3**	**57.7**	**57.2**	**-0.6**
B6. 10 percent of GDP increase in other debt-creating flows in 2006				**52.2**	**51.7**	**51.4**	**50.9**	**50.4**	**50.1**	**-0.5**

1/ Gross direct debt of the general government.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as αε(1+r).

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

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

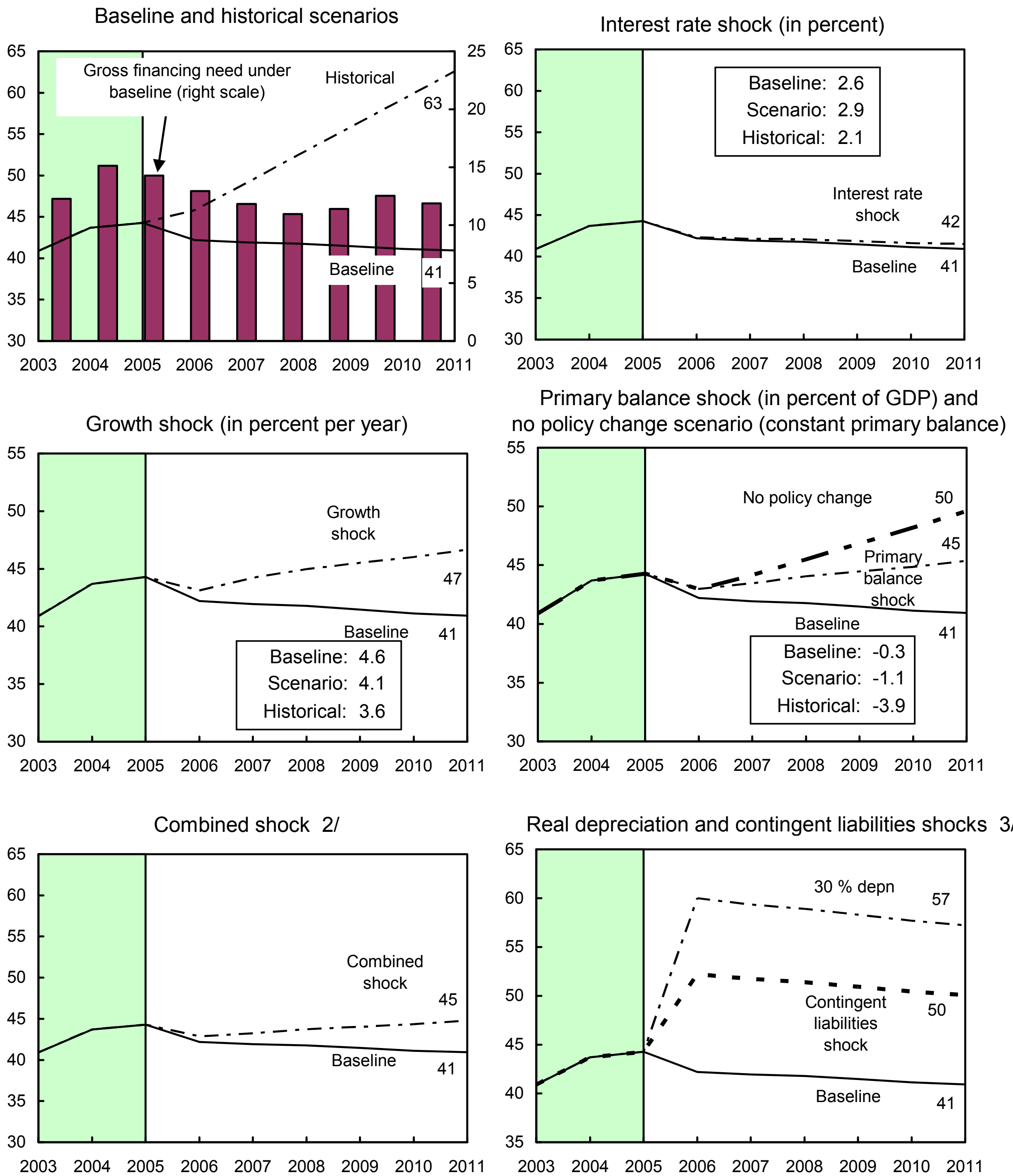
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

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

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

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



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

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

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 13. Croatia: External Debt Sustainability Framework, 2003–11

(In percent of GDP, unless otherwise indicated)

		Actual			Projections							
		2003	2004	2005	2006	2007	2008	2009	2010	2011	For debt stabilization	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	75.5	80.2	82.5	**83.1**	**82.4**	**81.2**	**78.3**	**75.8**	**72.8**		**-7.9**
2	Change in external debt	14.0	4.7	2.3	0.6	-0.7	-1.1	-2.9	-2.5	-3.0	0.0	
3	Identified external debt-creating flows (4+8+9)	-3.8	-3.3	-4.0	-3.3	-1.6	-1.7	-2.4	-2.5	-2.3	0.0	
4	Current account deficit, excluding interest payments	3.8	2.8	3.9	4.4	4.5	4.0	3.2	3.4	3.5	7.9	
5	Deficit in balance of goods and services	7.8	7.1	7.0	8.0	8.0	7.5	6.6	6.6	6.6		
6	Exports	50.2	50.1	49.2	49.9	50.0	49.7	49.7	49.5	49.6		
7	Imports	58.0	57.2	56.2	57.9	58.0	57.2	56.3	56.1	56.1		
8	Net non-debt creating capital inflows (negative)	-5.7	-2.7	-3.7	-6.7	-4.8	-4.7	-5.2	-5.1	-5.1	-5.1	
9	Automatic debt dynamics 1/	-1.8	-3.5	-4.2	-1.1	-1.3	-1.0	-0.4	-0.8	-0.6	-2.7	
10	Contribution from nominal interest rate	2.3	2.3	2.5	2.4	2.4	2.4	3.0	2.5	2.5	2.4	
11	Contribution from real GDP growth	-3.1	-2.6	-3.2	-3.5	-3.7	-3.4	-3.4	-3.3	-3.2	-3.0	
12	Contribution from price and exchange rate changes 2/	-1.1	-3.1	-3.5	...	...	...	...	...	...	-2.1	
13	Residual, incl. change in gross foreign assets (2-3) 3/	17.8	8.0	6.3	3.9	0.9	0.6	-0.5	0.0	-0.7	0.0	
	External debt-to-exports ratio (in percent)	150.6	160.1	167.6	166.4	164.8	163.5	157.6	153.1	146.9		
	Gross external financing need (in billions of US dollars) 4/	4.2	5.6	7.2	8.6	9.5	10.6	12.5	13.5	15.3		
	in percent of GDP	16.0	19.8	23.3	25.5	26.1	27.0	29.6	29.8	31.2		
	Scenario with key variables at their historical averages 5/				**83.1**	**83.1**	**82.9**	**81.6**	**80.7**	**79.1**		**-6.9**
											For debt stabilization	
	Key Macroeconomic Assumptions Underlying Baseline											
	Real GDP growth (in percent)	5.3	3.8	4.3	4.6	4.7	4.5	4.5	4.5	4.5	4.5	
	GDP deflator in US dollars (change in percent)	1.8	4.3	4.5	4.6	2.7	3.0	3.0	3.0	3.0	3.0	
	Nominal external interest rate (in percent)	4.1	3.3	3.3	3.2	3.1	3.2	3.9	3.5	3.6	3.6	
	Growth of exports (US dollar terms, in percent)	17.5	8.1	7.1	10.9	7.8	7.0	7.7	7.2	7.8		
	Growth of imports (US dollar terms, in percent)	10.1	6.8	7.1	12.7	7.8	6.1	6.1	7.2	7.6		
	Current account balance, excluding interest payments	-3.8	-2.8	-3.9	-4.4	-4.5	-4.0	-3.2	-3.4	-3.5		
	Net non-debt creating capital inflows	5.7	2.7	3.7	6.7	4.8	4.7	5.2	5.1	5.1		
	Bound Tests											
	B1. Nominal interest rate is at historical average plus one standard deviation				**83.1**	**82.8**	**82.1**	**79.6**	**77.5**	**74.9**		**-7.5**
	B2. Real GDP growth is at historical average minus one standard deviations				**83.1**	**83.4**	**83.2**	**81.1**	**79.3**	**76.9**		**-7.4**
	B3. Non-interest current account is at historical average minus one standard deviations				**83.1**	**83.9**	**84.2**	**82.8**	**81.6**	**79.9**		**-8.1**
	B4. Combination of B1-B3 using 1/2 standard deviation shocks				**83.1**	**83.9**	**84.2**	**82.6**	**81.3**	**79.5**		**-7.6**
	B5. One time 30 percent real depreciation in 2006				**83.1**	**120.3**	**116.8**	**111.0**	**105.8**	**99.9**		**-11.4**

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

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

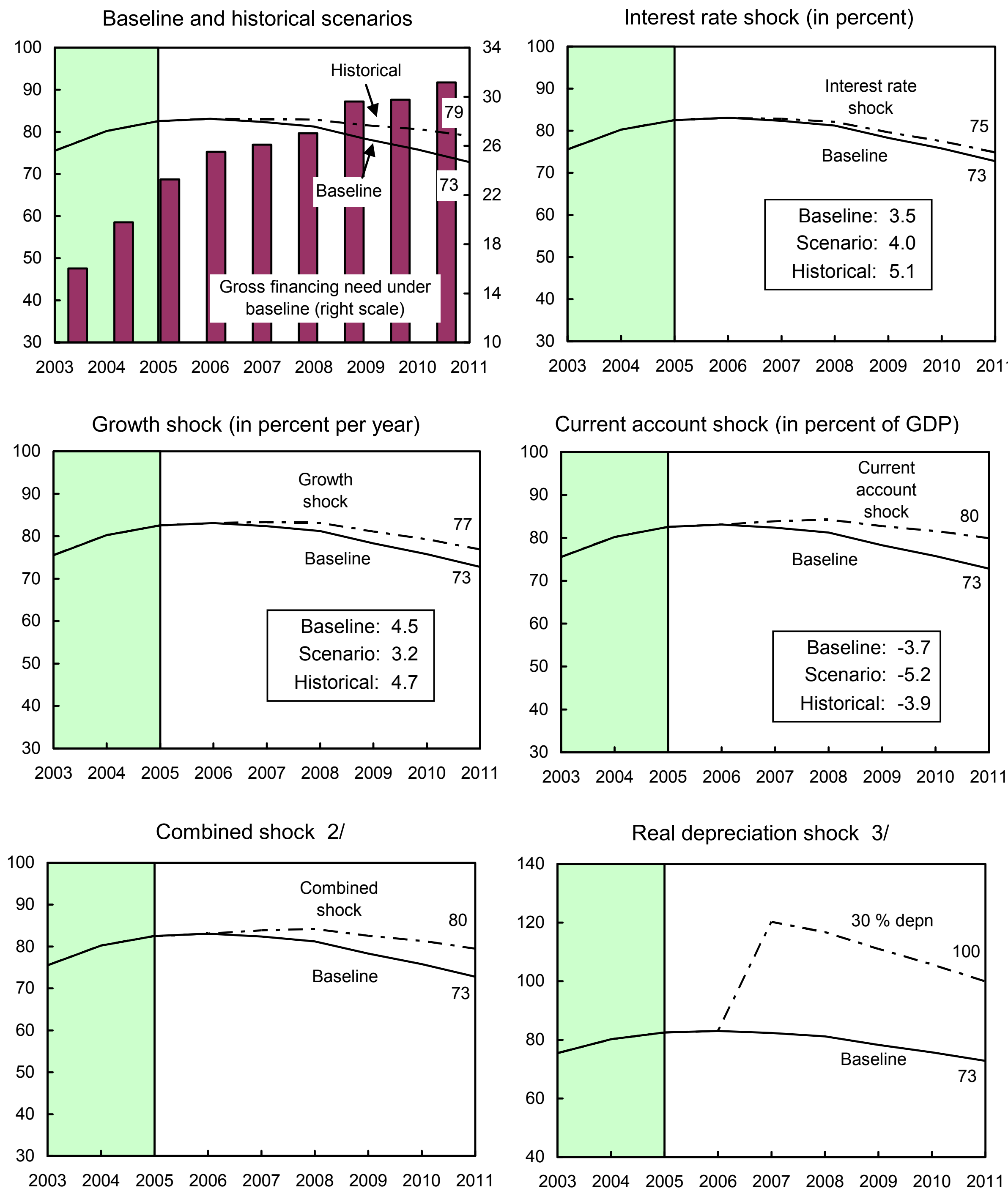
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Figure 6. Croatia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



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

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

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

3/ One-time real depreciation of 30 percent occurs in 2006.

Appendix II. Croatia: Fund Relations
(as of July 31, 2006)

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

II. General Resources Account:

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

III. SDR Department:

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	0.52	1.18

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

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

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest	0.83	1.68	1.68	1.68	1.68
Total	0.83	1.68	1.68	1.68	1.68

VII. Safeguards Assessment:

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

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

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

VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with the participation of the CNB. The authorities' exchange rate policy regarding the Croatian kuna is accordingly classified as "managed floating with no pre-announced path for the exchange rate". The CNB transacts only in euros, U.S. dollars, and SDRs. On July 31, 2006, the official exchange rate was kuna 5.719107 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

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

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

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

On August 4, 2004, Executive Directors approved a new 20-month **Stand-By Arrangement** for an amount equivalent to SDR 97.00 million (26.6 percent of quota). The authorities treat the arrangement as precautionary. The policy program underlying the arrangement aims at containing the current account deficit and stabilizing external debt, mainly through fiscal adjustment. Directors completed the first and second reviews under this Arrangement on September 14, 2005 and March 29, 2006, respectively. In completing the second review, Directors also augmented the arrangement by SDR 2 million and extended it until November 15, 2006.

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

XI. FSAP:

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

XII. Technical Assistance 2000–05:[7]

Department	Timing	Purpose
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification (with STA)
	September 2003-March 2004	A Resident Advisor on Fiscal Reporting
	May 2004	Fiscal ROSC
	April 2005	Review of Indirect Tax Performance and Tax Administration
STA	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Quarterly National Accounts
	April 2001	Monetary Statistics
	March 2002	Accounting and Budgetary Classification (with FAD)
	October 2002	Government Finance Statistics
MFD	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets

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

March-April 2001	Central Bank Accounting
December 2001	Monetary Policy Instruments
April 2003	Stress Testing and Foreign Exchange Reserve Management
February 2004	Monetary Policy Instruments

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

XIII. Resident Representative:

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

APPENDIX III. CROATIA: STATISTICAL ISSUES

1. The statistical base is broadly adequate to conduct effective surveillance, despite shortcomings in certain areas. Economic and financial statistics are of mixed, although improving, quality. Data on monetary aggregates are close to meeting the recommendations of the IMF's *Monetary and Financial Statistics Manual*, but there are major deficiencies in other areas. In most cases, remedial action has been taken to improve data coverage and reliability, but in some instances progress has been impeded by insufficient resources and inadequate cooperation among government agencies. Croatia subscribed to the Special Data Dissemination Standard (SDDS) in May 1996 and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB).

A. National Accounts

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

B. Prices

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

C. Wages and Employment

4. Croatia produces data on average net and gross earnings per person in paid employment by sector, and employment by sector. Earnings data include bonuses, sick pay, and meal allowances, and are based on monthly surveys covering 70 percent of workers in permanent employment in each industrial category. They do not cover a significant part of the working population, including persons employed in trade and crafts, contract workers, farmers, and military and police workers.

5. The number of registered unemployed overstates the actual level of unemployment. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample has been subsequently expanded and the survey is now being conducted on a regular basis with semi-annual results released after a delay of about four months. The difference between the survey-based unemployment rate and that based on the registered unemployed has recently been reduced.

D. Government Finance Statistics

6. Government finance statistics, produced on a monthly basis with a lag of 30 days, are available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data on a GFS basis are reliable and available on request on a next-day basis for most major categories for both the central budget and the budgetary funds. Expenditure data on a cash basis are available according to GFS classifications (economic and functional) for the central budget and the budgetary funds. The data on central government financing in the Ministry of Finance (MOF) reports, the monetary survey, and the balance of payments are not reconciled and substantial discrepancies exist partly due to different methodologies and definitions of government used by the Ministry of Finance and the CNB. Following the recommendations of the October 2002 GFS mission, a task force, comprising staff from the MOF, CNB, and CBS was formed to reconcile central government financing data produced by these institutions; however, only irregular meetings have so far been held.

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

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

E. Monetary Data

9. Data on the monetary survey, including separate records for deposit money banks and the balance sheet of the CNB, are published monthly with four- and two-week lags, respectively. Key data, such as currency in circulation, reserve deposits, and international reserves of the CNB are available on request with a one-day lag. In January 2004, the CNB introduced new statistical report forms and a new chart of account for banks, reflecting the recommendations of the July 2001 monetary and financial statistics mission on accrued interest and the international accounting standards' 39 requirements. The CNB is planning to extend its statistical framework to balance sheet information of investment funds and insurance companies. In March 2002, the CNB started to collect financial information (balance sheets and investment structure) from investment and pension funds; the data are not yet published, but used for internal purposes. However, the CNB's *Bulletin* (no. 83) informed the public on the other financial corporations' development in the financial system and presented selected aggregate data (e.g., net assets of investment and pension funds). According to the CNB, the inclusion of other financial corporations in monetary statistics depends on the harmonization process of the monetary statistics with the statistical reporting requirements of the European Central Bank.

F. External Sector Statistics

10. Quarterly balance of payments data are compiled broadly in accordance with the fifth edition of the IMF's *Balance of Payments Manual (BPM5)* and published by the CNB. Data are generally available with a lag of two months and are subject to substantial revisions in subsequent releases; trade data are available with a lag of one month and data on international reserves are available the next day on request. Travel survey methodologies were modified in 2002, 2004, and again in 2005 while the method for estimating the cost of insurance and freight was modified in early 2004. The most recent modification of tourism revenue contributed to an upward revision of the current account deficit for 2004 equivalent to 0.7 percent of GDP. Negative net errors and omissions have ranged from 2 to 4½ percent of GDP since 2002, casting doubt on the accuracy of current account estimates. The coverage and quality of portfolio investment data are reasonably complete and accurate.

11. A large part of Croatia's external debt was contracted prior to the dissolution of the former SFRY and Croatia's share was agreed with Paris and London Club creditors in 1995 and 1998, respectively. The CNB compiles external debt data according to the requirements of *External Debt Statistics – Guide for Compilers and Users, 2003*, and began disseminating external debt data in the second quarter of 2003. The inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals and arrears has caused an upward adjustment in the external debt series compared to previously released data.

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

Croatia: Table of Common Indicators Required for Surveillance
(as of August 29, 2006)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	8/29/06	8/29/06	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	8/18/06	8/25/06	W	W	W
Reserve/Base Money	June 2006	7/31/06	M	M	M
Broad Money	June 2006	7/31/06	M	M	M
Central Bank Balance Sheet	June 2006	7/31/06	M	M	M
Consolidated Balance Sheet of the Banking System	June 2006	7/31/06	M	M	M
Interest Rates[2]	June 2006	7/31/06	M	M	M
Consumer Price Index	July 2006	8/17/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 2006	8/25/06	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	June 2006	7/31/06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2006	8/25/06	M	M	M
External Current Account Balance	Q1 2006	6/30/06	Q	Q	Q
Exports and Imports of Goods and Services	Q1 2006	6/30/06	Q	Q	Q
GDP/GNP	Q1 2006	6/30/06	Q	Q	Q
Gross External Debt	June 2006	8/17/06	M	M	M

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

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

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

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

[5] Including currency and maturity composition.

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

APPENDIX IV. CROATIA: WORLD BANK RELATIONS

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

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

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

4. The Bank Board approved the first out of three PALs in September 2005. PAL 1 amounts to EUR 150 million. The PAL has three major components: (i) strengthening governance through public administration reform and strengthening of public expenditure management; (ii) improving the investment climate through judicial reform, privatization, continued reduction of barriers to entry of new firms, and continued reduction of state subsidies; and (iii) strengthening financial sustainability of sectoral spending through health reform, social benefits streamlining, railways restructuring, and improvement of the fiscal and social sustainability of the pension system. The pre-appraisal mission for PAL 2 was conducted in November and December 2005, but the appraisal mission has been delayed pending further discussions on actions in the areas of health, privatization, and public administration.

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

Zagreb, September 14, 2006

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

Dear Mr. de Rato:

We remain committed to maintaining macroeconomic stability, limiting external vulnerability, and preparing Croatia for EU accession. Consistent with these objectives, we have been implementing our economic program for 2006, supported by the Stand-By Arrangement approved by the Fund in August 2004 and extended in March 2006.

We are requesting completion of the third and final review under the program. All quantitative performance criteria for end-June 2006 have been observed. The structural benchmarks set at the second review on health reform, banking supervision, and the plan for the privatization of the Croatian Insurance company have also been observed. On two other structural benchmarks, progress has been slower than we had envisaged, but we still intend to observe them by year-end: regarding the third phase of privatization of the telecommunications company (HT) and the second phase of privatization of the oil company (INA), we are taking steps to ensure completion of these transactions by end-2006; and we are continuing work on the national plan for shipyard restructuring in consultation with the European Commission.

The attached Annex to our original Memorandum of Economic & Financial Policies describes in detail our policies for the remainder of the program period and proposes quantitative performance criteria for end-September 2006 and one structural performance criterion for end-October 2006. We intend to continue treating the Arrangement as precautionary.

We believe the policies set forth in the attached Annex are adequate to achieve the objectives of our program, and we will take any further measures that may become necessary for this purpose. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the Annex, in accordance with the Fund's policies on such consultations.

Sincerely yours,

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

Attachments:
Annex
Technical Memorandum of Understanding

ANNEX

1. This Annex reviews program implementation in the first half of 2006 and describes our macroeconomic policies and targets for the remainder of the program period. It reaffirms the goals of our program that has been supported by the Stand-By Arrangement since 2004: preserving macroeconomic stability and limiting external vulnerability. These goals are consistent with our updated Pre-Accession Economic Program, which we submitted to the European Commission in December 2005, as well as the Strategic Plan for the Economic Development of Croatia, which we will adopt in November, 2006.

2. The economic environment in which we are pursuing these goals has deteriorated significantly during the last two years, as world oil prices and interest rates increased. Moreover, private sector borrowing, over which macroeconomic policies only have a limited impact, has continued unabated. As a result, although our export performance has been strong, the current account deficit has deteriorated, and external debt has continued to rise, albeit at a slowing pace. We nevertheless remain committed to our strategy, which is based on exchange rate stability, continued fiscal consolidation, strengthened financial sector supervision, and structural reform; and have adjusted our policies for the rest of this year in response to the changed economic environment. This strategy will achieve our macroeconomic goals and enhance Croatia's competitiveness ahead of EU accession.

I. Program Implementation in the First Half of 2006

3. Our macroeconomic policies during the first half of 2006 were consistent with the targets detailed in the Annex dated March 3, 2006, to our original Memorandum on Economic & Financial Policies. Most importantly, by maintaining tight expenditure control, we reduced the general government deficit in the first half of this year to HRK 4.2 billion, or 1.7 percent of annual GDP, compared to 3.6 percent of annual GDP in the first half of 2005. The Croatian National Bank (CNB) has maintained control over net domestic asset expansion, while gross international reserves continued to increase and at end-June stood at € 8.7 million. We have met all program quantitative targets for end-June.

4. We have also persevered with our structural reform agenda, though the progress here has been slower than expected. A new financial supervision agency for nonbank financial institutions (HANFA) started operations in January. The CNB took a number of measures to enhance the soundness of the banking system and discourage foreign borrowing by banks. Croatian Railways has continued implementing its restructuring plan agreed with the World Bank. And on July 13, the Sabor approved a major health reform that sets the basis for establishing the financial soundness and improving the quality of services provided by our public health system. But there have been delays in finalizing the restructuring plans for the steel and shipyard sectors; as well as in privatization, including of the remaining state shares in the telecommunications company (HT) and oil company (INA). These delays in privatization necessitated a bridge financing operation for the fund in charge of repaying "pensioners' debt" by a domestic bank. The first of these partial payments, which are supposed to be financed by privatization receipts, in an amount of HRK 1.2 billion, was

made in accordance to the law on June 28, 2006. The second payment is to take place at the end of the year, when we expect to have received a substantial share, if not the entirety, of the proceeds from the planned large privatizations.

5. These policies have helped to contain Croatia's external imbalance in the face of strong headwinds. But higher energy prices and, to a lesser extent, rapid credit growth (23 percent in the year to May) meant that the current account deteriorated, rising in the first quarter of this year to € 2.1 billion. Strong private sector borrowing and the delays in privatization also meant that external debt has continued to rise in the first part of the year, reaching 83.8 percent of GDP at end-May, up from 82.5 percent of GDP at the end of 2005.

II. Macroeconomic Outlook and Policies in the Remainder of 2006

6. We expect economic activity in Croatia to continue at a satisfactory pace in 2006. We project real GDP growth, which was very strong in the first quarter, to average around 4½ percent in 2006, broadly the same pace as in 2005, and inflation to average around 3½–3¾ percent, underpinned by our policy of exchange rate stability. But high oil prices could push the current account deficit to 6¾–7 percent of GDP for the year as a whole.

7. This outlook is subject to risks. The most important risk is the possibility of a further deterioration in the external environment, including even higher oil prices and/or weaker economic growth in trading partners, which would have important repercussions for Croatia's very open economy. Another risk is the possibility that the credit growth accelerates further and, together with the moderate impact on consumption of "pensioners' debt" repayments in the second half of the year, would lead to continued strong demand growth; while this would boost GDP growth beyond our current projections, it would also weaken the external position.

A. Fiscal Policy

8. Our 2006 budget set a target for the general government deficit of HRK 7.9 billion, equivalent to 3.2 percent of GDP following recent revisions to national accounts data. However, the heightened risks to the macroeconomic outlook—in particular, the risk of an even wider external current account deficit on account of higher oil prices and/or an acceleration in credit and domestic demand—place increased responsibility on fiscal policy. To lean against domestic demand pressures, we have adjusted our fiscal policy in 2006. On July 11, the Sabor approved a supplementary budget aiming at a more ambitious general government deficit of HRK 7.3 billion (3 percent of GDP). To achieve this, we will save part of the revenue overperformance in the consolidated central government (HRK 546 million out of a projected HRK 1074 million for the year as a whole) and reallocate expenditure to accommodate small deviations from the budget targets in some categories of spending during the first half (especially health, where the impact of the reform will only be felt in the latter part of the year, and local government spending). We have incorporated the new budget targets for 2006 in our medium-term fiscal plan, approved by the government in August 2006.

9. We will continue to identify and account transparently for all forms of state aid, including transfers, debt assumptions, guarantees, and recapitalizations. Also, as we outlined in the Annex of March 3, 2006, we will contain the 2006 deficit (net of government transfers) of the Croatian Development Bank (HBOR) at HRK 500 million; limit the issuance of government debt guarantees to HRK 3.2 billion for the year as whole; and keep the borrowing of the eight largest public enterprises to HRK 230 million. Finally, as of July 1, all forms of state aid to shipyards will be classified as budgetary expenditure until the restructuring plan currently under preparation is finalized and approved by the government.

B. Monetary and Financial Sector Policies

10. The CNB continues to support the external objectives of our program by pursuing its policy of broad exchange rate stability against the euro, maintaining adequate international reserves, and preventing an inappropriate domestic liquidity expansion. Gross official reserves at end-2006 are projected at about € 8.8 billion, assuming that government's privatization plans for the rest of the year are realized as planned. This would maintain reserve coverage at about 5 months of following year's imports of goods and non-factor services. This projection is consistent with broad money growth during the year at about 12–13 percent.

11. The CNB will continue to contribute towards arresting the growth in external debt. In late 2005, the CNB raised the marginal reserve requirement (MRR) on commercial banks' new foreign borrowings to 55 percent and, more recently, it broadened the base of the MRR. We plan to maintain the MRR at its current level, which commercial banks should take into account as they plan their financing operations for the remainder of 2006 and 2007. Also, the CNB is supporting the government's efforts to finance the general government deficit without recourse to new foreign borrowing. Accordingly, the CNB reduced the general reserve requirement from 18 to 17 percent effective January 2006; and provided a temporary exemption from the liquidity requirements for the bridge loan extended to the government by domestic banks to finance the repayment of a € 400 million eurobond maturing in March, until the planned privatization proceeds are received later in the year. In view of the pickup in credit growth to the private sector in early 2006, the CNB does not plan further reductions in the reserve requirement pending clear and sustained evidence of a slowdown in credit growth. If credit growth continues at a level that could jeopardize macroeconomic stability, the CNB will take additional appropriate action. And as before, should massive private capital inflows threaten the objectives of our program, the CNB stands ready to introduce, in consultation with the IMF, price-based controls on capital inflows.

12. The CNB has made progress in early 2006 in strengthening banking supervision, along the lines envisaged under our program, by:

- circulating to banks in February minimum standards for the proper management of foreign currency-related credit risks;

- requiring banks to prepare their own policies and techniques for managing their foreign currency-related credit risks, which they submitted to the CNB by end-April;

- introducing stricter reporting requirements on banks' unhedged foreign loans, beginning with reports for June 30; and

- increasing capital adequacy risk weights by 25 basis points on foreign currency and foreign currency-indexed loans to unhedged private borrowers effective from the second quarter of this year.

13. Although our banking system is sound and well-capitalized, we remain concerned by the rapid growth in total credit and, in particular, in foreign currency and foreign currency-linked credit to unhedged borrowers. The operation of the credit registry, which will start in October, will make a major contribution toward mitigating the associated credit risks. We intend to expand the registry to cover leasing, credit card debt, and other liabilities of households by the end of this year, and a working group to prepare the necessary law is already in operation. To strengthen the banks' risk management and encourage them to use the credit registry, the CNB:

- reduced in June the limit on the overall annual rate of growth of credit above which banks are required to hold additional reserves for "general bank risks" from 20 to 15 percent (regardless of the level of their capital adequacy ratio), and more than doubling the level of these reserves; the new requirement will apply to the financial reports for 2006;

- will issue guidelines by end-September on the minimum standards for proper management of credit risk in light of the information provided by the credit registry;

- will require banks to prepare their own policies on the basis of these standards and submit them to the CNB for review by November; and

- will amend prudential regulations by December to penalize banks that do not take the credit registry into account in their loan decisions by increasing the risk weight of such loans to 300 percent.

14. We are also taking steps to enhance the soundness and stability of the broader financial system. We will close a major gap in financial supervision this year with the adoption of the Law on Leasing, which will regulate leasing activities and establish HANFA's authority in this area. The CNB and HANFA will co-operate closely to ensure seamless supervisory coverage of the financial system.

C. Structural Reforms

15. Following adoption by the Sabor of a package of laws on health reform, we are now in the process of completing the two lists of drugs that will be the backbone of the new system. We expect this work, in cooperation with the World Bank and other international experts, to be finished in September.

16. Although our privatization agenda has proceeded more slowly than expected, the process has continued moving forward and we intend to accelerate it in the second half of the

year. The two large transactions previously scheduled for end-June 2006—the second phase of the privatization of the national oil company, INA, and the third phase of the privatization of the telecom company, HT—are now scheduled for completion in the second half of the year.

- For INA, an initial public offering (IPO) of 15 percent of the company will take place by end-October 2006. We will resolve the remaining issues through government decisions, including the approval of the privatization model for the IPO.

- For HT, the government appointed in July the financial advisor, and is seeking a consultant to help resolve the pipeline ownership dispute between HT and local governments that has been partly responsible for the delays. The government will approve the model of privatization by September 15 and we expect the sale to be completed by year-end.

17. Reform of the shipyards and metals sectors remains a priority. In the steel sector, following elaboration of a national restructuring plan in accordance with Croatia's Stabilization and Association Agreement with the EU, we have started the process of privatization and will issue tenders for the Sisak and Split steel companies by mid-September. We also issued a tender for the TLM aluminum company in September 2006. Regarding shipyards, the government in June appointed HVB Global Shipping to act as a consultant on the shipyard restructuring plan. Work is now underway, in coordination with the European Commission, and we expect the plan to be finalized and approved by the government by end-November.

18. We have finalized the principles for the privatization of the state-owned insurance company, Croatia Osiguranje (CO), and have announced plans for the merger of CO with the state-owned bank HPB. After the merger, we intend to reduce the share of government holdings in the new company to under 50 percent by a share capital increase open to the private sector. We have already appointed the financial advisor to prepare this operation, which we intend to complete by year-end. As regards Croatia Banka, we intend to privatize it when the legal dispute with the former owners is resolved. Despite delays, we still intend to sell all state shares in companies in the portfolio of the Croatian Privatization Fund (HFP) by end-2007.

19. Finally, we are preparing a new law on privatization in consultation with the World Bank, which we expect to submit to the Sabor for approval in October.

Table 1. Croatia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2006

				End of		
				March 2006	June 2006	September 2006
				(In millions of kuna, unless indicated otherwise)		
Quantitative performance criteria (cumulative from December 31, 2005)						
1	Cumulative deficit of the consolidated general government 1/		Program	3,522 4/	5,115 6/	5,734
			Actual	3,887	4,160	...
			Margin (+)	-365	955	...
2	Cumulative change of the stock of arrears of the consolidated general government 2/		Program	150	300	300
			Actual	114	267	...
			Margin (+)	36	33	...
3	Cumulative deficit of HBOR 1/		Program	-65	-124	286
			Actual	204	-149	...
			Margin (+)	-269	25	...
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 1/ 2/	Total	Program	362	427	597
			Actual	0	26	...
			Margin (+)	362	402	...
		<1 years	Program	0	0	0
			Actual	0	0	...
			Margin (+)	0	0	...
5	Cumulative issuance of guarantees extended by the general government 1/		Program	1,960 5/	2,981 5/	2,814
			Actual	940	1,743	...
			Margin (+)	1,020	1,238	...
6	Cumulative change in the Net International Reserves of the Croatian National Bank 2/ 3/		Program	-345	-65	400
			Actual	186	579	...
			Margin (+)	531	644	...
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 1/		Program	1,340	1,470	681
			Actual	-2,773	-1,537	...
			Margin (+)	4,113	3,007	...
Indicative limits						
1	Cumulative increase in the total debt of selected public enterprises 1/		Program	-28	-97	169
			Actual	-173	-446	...
			Margin (+)	145	349	...

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

Table 2. Croatia: Structural Conditionality under the Stand-By Arrangement, 2006

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

ATTACHMENT

TECHNICAL MEMORANDUM OF UNDERSTANDING

I. Limits on the Cumulative Deficits of the Consolidated General Government

	Ceiling
	(In millions of kuna)
Cumulative change from December 31, 2005:	
September 30, 2006 (performance criterion)	5,734

1. The above ceiling on the cumulative deficit of the consolidated general government are on a GFS2001 basis (including net lending). The consolidated general government includes: (i) central government operations, that is, the central government budget (the Office of the President, the parliament, the government, the constitutional court, all ministries, other independent state administration and judicial bodies); (ii) existing central budgetary funds (health, pension, employment, and water management) and agencies (the agencies for state aid, for investment and export promotion, and for small and medium-sized enterprises); (iii) the highway (HAC) and road (HC) construction and maintenance agencies, the privatization fund (HFP), the bank rehabilitation and deposit insurance agency (DAB), and the Environment Protection Fund; and (iv) the 53 largest local governments (20 counties, Zagreb, and 32 other cities). The above ceilings exclude all transactions related to the 1998 decision U-I-283/1997 by the Constitutional Court in relation to pensioners' debt repayments. The government does not intend to establish new budgetary or extrabudgetary funds or agencies during the program period, but any new funds or agencies would be covered by the ceilings. In accordance with paragraph 11 of the Annex, if a restructuring plan for the state-owned shipyards is not approved by the government by June 30, 2006, all state aid to shipyards after that date shall be included in budgetary spending of the central government.

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

3. Fiscal performance will be monitored monthly at the consolidated central government level covering (i)-(iii) defined above and tested quarterly at the consolidated general government level covering (i)-(iv) defined above with the remaining test date for 2006 being September 30. The Ministry of Finance will provide data for consolidated central government on a monthly basis within 30 days from the end of the month and data for local governments every 3 months within 30 days from the end of the month.

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

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

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

1/ Excluding repayment by government of assumed/guaranteed debt and loan-financing of these repayments.
2/ Does not include changes in the stock of guarantees and arrears.

within 45 days from the end of the quarter, in the form of the following table, which is a part of this Technical Memorandum of Understanding.

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

	Ceiling
	(In millions of kuna)
Cumulative change from December 31, 2005:	
September 30, 2006 (performance criterion)	300

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

government at the time they are taken over by the government. For the purposes of this performance criterion, the stock of arrears will not be affected by the repayment of the HRK 809 million loan from Zagrebacka banka (i.e., should the loan repayment result in reduction of reported arrears, the reported stock will be adjusted upward correspondingly).

III. Limits on the Deficit of HBOR

	Cumulative Limit
	(In millions of kuna)
Cumulative change from December 31, 2005:	
September 30, 2006 (performance criterion)	286

6. The above ceiling on the cumulative deficit of HBOR incorporates an adjustment for all general government transfers to HBOR (projected at HRK 595 million for 2006) and is on a GFS1986 basis with revenues comprising interest receipts, fees, and other lending-related revenues, and expenses comprising wages, use of goods and services, interest payments, net lending, and capital spending.

7. Fiscal performance by HBOR will be monitored on a monthly basis and tested on a quarterly basis with September 30 being the remaining test date for 2006. HBOR will provide data on a monthly basis within 30 days of the end of the month.

IV. Ceilings on the Contracting of Nonconcessional External Debt by the General Government and HBOR

	Ceilings	
	(In millions of euros)	
	Ceiling	Subceiling ≤1 year
Cumulative change from December 31, 2005:		
September 30, 2006 (performance criterion)	597	0

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

August 25, 2000). Debt includes commitments contracted or guaranteed for which value has not been received. The limits on short-term debt do not apply to normal import-related credits and nonresident deposits in state-owned banks (HPB, HBOR).

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

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

11. Debt falling within the limits shall be valued in euro at the following exchange rates of December 31, 2005 (in kuna per unit of foreign currency) at each test date:

Euro	7.375626
U.S. dollar	6.233626
Japanese yen (100)	5.308115
Pound sterling	10.753209
Swiss franc	4.744388
SDR	8.912040

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

V. Limits on the Cumulative Issuance of Debt Guarantees Extended by the General Government

	Ceiling
	To all entities outside the consolidated general government (In millions of kuna)
Cumulative change from December 31, 2005:	
September 30, 2006 (performance criterion)	2,814

13. Cumulative issuance of debt guarantees listed above will be measured at the exchange rates listed in Section IV. The above limits cover debt guarantees issued by the general government to entities outside the general government as well as guarantees extended for HBOR's lending to entities outside the general government. The limits do not cover guarantees extended to HBOR's borrowing from entities outside the general government. The above ceiling is set on the assumption of repayments of HRK 1,347 million of guaranteed loans by the

government for the year as a whole and will be adjusted upward by the amount of cumulative company repayments of the underlying loans during 2006.

14. Guarantee issuance will be monitored on a monthly basis. The Ministry of Finance will provide, within 30 days from the end of the month, data on gross issuance of guarantees and repayments of guaranteed loans by both the original borrowers and by the government. Performance will be tested on a quarterly basis and in 2006 with September 30 as the remaining test date. In addition, for the purpose of public debt statistics, the Ministry of Finance will provide the same set of data on gross issuance and repayments, calculated at spot exchange rates, within 30 days following each test date.

VI. Indicative Limits on the Cumulative Increases in the Total Debt Stock of Selected Public Enterprises

	Indicative limit
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
September 30, 2006	169

15. The above listed indicative aggregate limit covers the following 8 enterprises:

1. Hrvatska Elektropriveda, Zagreb (Croatian Electricity Company)
2. Hrvatske Željeznice, Zagreb (Croatian Railroads)
3. Hrvatske Šume, Zagreb (Croatian Forests)
4. Hrvatska Pošta, Zagreb (Croatian Post)
5. HRT, Zagreb (Radio and Television Company)
6. Jadrolinija, Rijeka (Shipping Line)
7. Croatia Osiguranje, Zagreb (Insurance Company)
8. Croatia Airlines, Zagreb

16. These cumulative flows include all net borrowing from non-government sectors, including HBOR.

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

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

VII. FLOORS UNDER THE CUMULATIVE CHANGES IN THE NET INTERNATIONAL RESERVES OF THE CROATIAN NATIONAL BANK

	Floor
	(In millions of euro)
Stock as of December 31, 2005	5,560
Cumulative change from December 31, 2005:	
September 30, 2006 (performance criterion)	400

19. For purposes of the program, net international reserves of the Croatian National Bank (CNB) are defined as the euro value of reserve assets minus reserve liabilities.

20. For purposes of the program, reserve assets shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the CNB. Any return to the CNB of blocked foreign assets that are not part of CNB reserve assets as of December 31, 2005 will be added to the reserve floor. Reserves that are pledged, frozen or used as collateral shall be excluded from the reserve assets. In particular, any reserve assets pledged to secure government debt will be excluded from the reserves definition.

21. For purposes of the program, reserve liabilities shall be defined as all foreign exchange liabilities of the CNB to residents and foreign exchange and kuna-denominated liabilities of the CNB to non-residents—excluding deposits into the special accounts for external debt servicing—with an original maturity of up to and including one year, as well as liabilities arising from IMF purchases and bridge loans from the BIS, irrespective of their maturity. For purposes of the program, reserve liabilities shall also include arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies, and future and contingent commitments to sell foreign exchange arising from transactions in derivative assets (futures, forwards, swaps, and options). Central government foreign exchange deposits at the CNB are excluded from reserve liabilities.

22. The net forward position of the CNB is defined as the difference between the face value of foreign currency-denominated CNB off-balance sheet claims on nonresidents (forwards, swaps, options, and futures market contracts) and foreign currency obligations to both residents and nonresidents. This position was zero on December 31, 2005. For program purposes, only the off-balance sheet obligations will be deducted from the CNB's net international reserves position. These liabilities amounted to zero on December 31, 2005.

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

24. For purposes of the program, the end-of-quarter net international reserves of the CNB are calculated as the arithmetic average of 11 observations centered on the last business day of each period. This applies also to the end-2005 stock of net international reserves of the CNB.

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

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

	Ceiling
	(In millions of kuna)
Stock as of December 31, 2005	-1,822
Cumulative change from December 31, 2005:	
September 30, 2006 (performance criterion)	681

26. The net domestic assets of the Croatian National Bank (CNB) are defined as base money minus the net foreign assets of the CNB, both expressed in local currency at program exchange rates (see Section IV).

27. Base money is defined as currency outside banks, vault cash of banks, giro and required reserve deposits of banks in domestic currency, deposit money, required reserve deposits of banks in foreign currency, restricted deposits, and escrow deposits held at the CNB.

28. Net foreign assets of the CNB are defined as reserve assets plus those foreign assets of the CNB that are excluded from reserve assets under the definition in Section VII, minus foreign liabilities of the CNB.

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

30. For the purposes of the program, the net domestic assets of the CNB and the base money at the end of each period will be calculated as the arithmetic average of 11 observations centered on the last business day of the period. This applies also to the end-2005 stock of net domestic assets of the CNB.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) has completed on a lapse of time basis[8] the third review under a Stand-By Arrangement for the Republic of Croatia, which was initially approved on August 4, 2004 (See Press Release No. 04/170) and extended to November 15, 2006 (see Press Release No. 06/66). At the second review, access under the arrangement was augmented, bringing it to an amount equivalent to SDR 99 million (about US$146.3 million). The authorities are treating the arrangement as precautionary.

[8] The Executive Board takes decisions under its lapse of time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.