

**Republic of Croatia: First Review of the Stand-By Arrangement—Staff Report; Staff Supplement; News Brief on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia**

In the context of the First Review of the Stand-By Arrangement with the Republic of Croatia, the following documents have been released and are included in this package:

- the staff report for the First Review of the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **August 9, 2001** with the officials of the Republic of Croatia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 13, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Staff Supplement of **October 31, 2001** updating information on recent economic developments.
- a News Brief summarizing the **views of the Executive Board as expressed during its November 5, 2001 discussion** of the staff report that completed the request.
- a Statement by the Executive Director for the Republic of Croatia.

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

Letter of Intent by the authorities of The Republic of Croatia\*

Memorandum of Economic and Financial Policies by the authorities of The Republic of Croatia\*

\*May also be included in Staff Report.

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

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**International Monetary Fund  
Washington, D.C.**

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

**First Review of the Stand-By Arrangement**

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

(In consultation with other departments)

Approved by C. Maxwell Watson and Shigeo Kashiwagi

September 13, 2001

- This report is based on discussions held in Zagreb during July 27-August 9. The mission met with Deputy Prime Minister Linić, Croatian National Bank (CNB) Governor Rohatinski, Ministers Crkvenac (Finance), Stavljenić-Rukavina (Health), and Vidović (Labor and Social Welfare), Deputy Ministers Brinar (Economy) and Kuštrak (Finance), and other government and private sector representatives.
- The team consisted of Messrs. Flickenschild (head), Bonato, Konuki, Maggi (all EU1), and Wieczorek (PDR), with Mrs. La Torre (EU1) as administrative assistant. Mr. Norregaard (resident representative) assisted the mission.
- The authorities' program for 2001 relies on fiscal adjustment, wage restraint, and structural reform in the context of a broadly stable exchange rate to achieve economic growth of 4 percent, reduce inflation from 7.4 percent to 4.5 percent on an end-year basis, and increase net international reserves of the CNB. This program is supported by a 14-month stand-by arrangement in the amount of SDR 200 million that was approved by the Board on March 19, 2001. Due to Croatia's comfortable balance of payments position and easy access to international capital markets, the authorities are treating the arrangement as precautionary.
- The second and final review mission, which will focus on the budget for 2002, is scheduled for October-November 2001, with Board discussion expected in December 2001.

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## EXECUTIVE SUMMARY

**Economic prospects:** The authorities' growth, inflation and international reserves objectives for 2001 are likely to be either met or exceeded. Notwithstanding delays in policy implementation and a less favorable than expected external environment, economic performance in the first half of 2001 was strong, and prospects are good for further economic growth, disinflation, and—more modest—international reserve gains in the second half. Improved access to foreign markets, the strengthened regional security situation, and domestic policy efforts have contributed to a substantial reduction in the external current account deficit, and confidence of financial markets has remained high, leading to a further narrowing of spreads despite bouts of emerging market turbulence.

**Program implementation and performance:** Program implementation experienced some delay, especially with regard to the authorities' intentions to cut wages and employment in the government sector and accelerate privatization. There also was slippage in reducing sick pay and containing the growth of child benefits. Nonetheless, performance under the program has been broadly satisfactory, especially with respect to observance of the quantitative performance criteria. The fiscal deficit ceilings for end-March and end-June were observed, albeit by a narrow margin at the latter date, and the international reserves floors and net domestic asset ceilings for the same test dates were observed with ample margins. The other quantitative performance criteria were also observed comfortably, except that the ceilings on domestic bank financing of the government, government arrears, and short-term external public debt were breached at end-June, in large part due to the shortfall of privatization revenue. Although the structural performance criterion on government sector wage cuts was not observed at end-March, the wage policy implemented since June ensures that the initially programmed reduction of the wage bill will be achieved in 2001. As the macroeconomic consequences of these breaches were limited, the staff recommends waivers for the nonobservance of the four criteria in the context of completing the present review.

**The program for the remainder of 2001:** The fiscal deficit target remains at 5.3 percent of GDP, requiring an additional adjustment of at least 0.8 percent of GDP in the remainder of the year to offset expenditure overruns. The fiscal adjustment proposed by the authorities exceeds this amount and falls mainly on the expenditure side. Most of the measures are permanent and aim at rationalizing the social transfer system by cutting benefits for privileged groups and reducing generous general benefits or improving their targeting. The remainder are discretionary cuts in subsidies, other transfers, and expenditure on goods, nonwage services, and capital investment. Parliamentary approval of the amendments to the social transfer system and of a revised budget for 2001 is a prior action for completion of the present review. The unchanged fiscal deficit is more than fully financed from abroad. With lower privatization receipts about offset by higher net foreign borrowing, the almost unchanged domestic financing surplus will be used almost entirely to reduce government arrears. Layoffs of excess labor, mainly in the ministries of interior and defense, are expected to lead to a net employment reduction in the government sector by some 10,000 by year-end. While the structural performance criterion on the size of these layoffs remains unchanged, the timeline for the structural benchmark on progress in privatizing the two energy companies was extended from end-September to end-December 2001. With money demand stronger than expected and a higher than targeted international reserve gain in the first half of the year, the monetary program has been revised to preserve most of the reserve gain, while giving some additional room for credit expansion to the private sector.

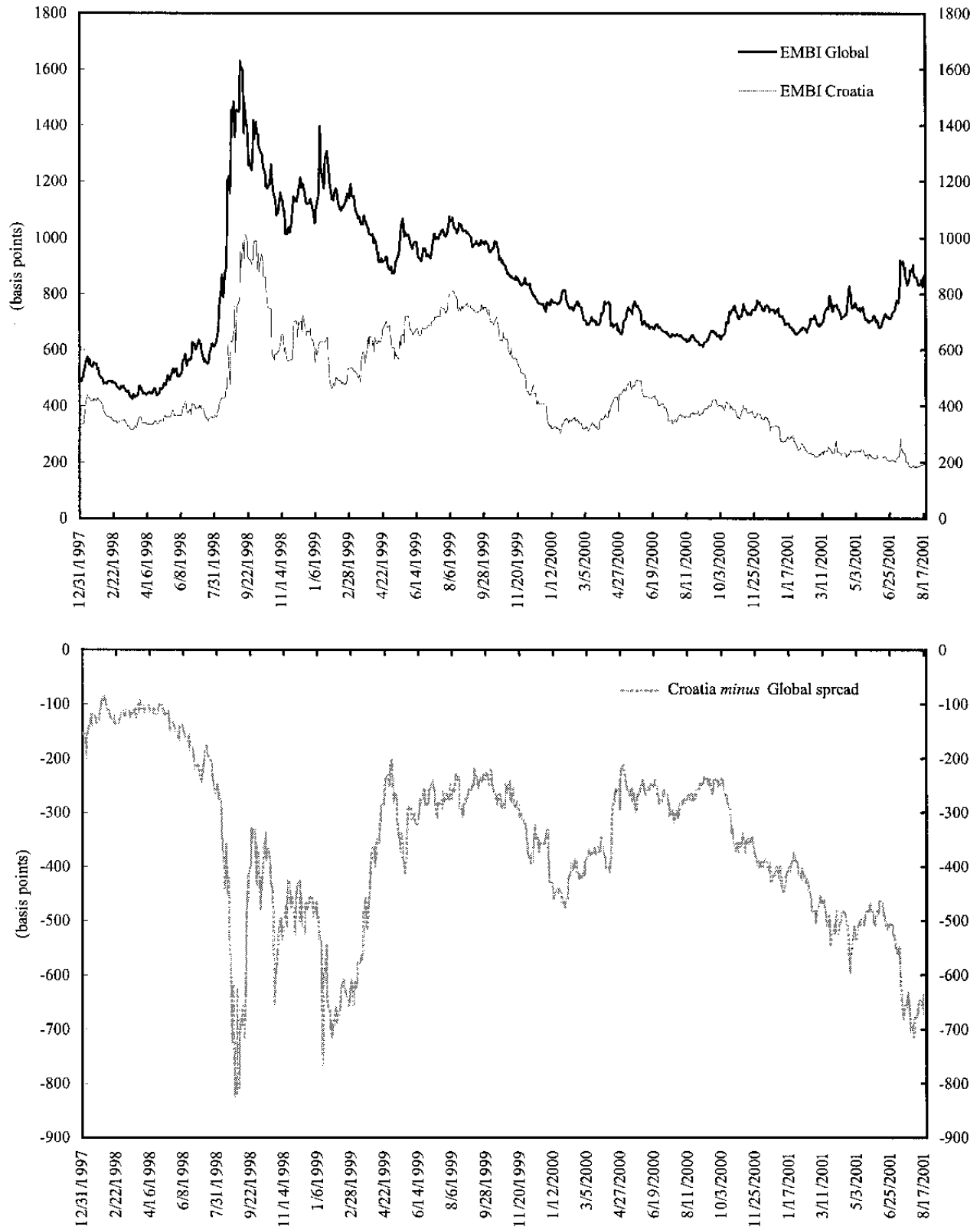
## I. RECENT DEVELOPMENTS AND OUTLOOK

1. **Political problems caused delays in the implementation of the government economic program.** Structural reforms were deferred and fiscal commitments could not be met on time. The ruling coalition did not manage to attract support for a measure reducing sick pay benefits and had to withdraw the proposal from parliament. Local elections in May held up important decisions on government wages and employment, privatization, and fiscal decentralization. Political tensions continued after the May elections and a small regional party left the fractious six-party coalition. In July, the government decision to extradite two Croatian generals to the international war crimes tribunal in The Hague triggered the resignation of four ministers from the second-largest coalition party and forced the government to call a confidence vote in parliament. The coalition won this vote by a large margin, improving the prospects for a renewed focus on economic issues. The government is now working on a fiscal package that will be submitted to parliament when it reconvenes on September 17.

2. **Notwithstanding the slow policy implementation, the confidence of financial markets remains high.** Croatia remained immune to the financial turmoil in other emerging market economies in early 2001 and more recently was only modestly affected by the renewed turbulence in these markets and the domestic political uncertainties. Notwithstanding increased volatility in emerging markets, spreads on Croatian bonds continued to narrow, as evidenced by the Croatia component of the EMBI Global index (Figure 1). A top-up of the March € 500 million eurobond issue by € 250 million in July was fully subscribed at a spread of 182 basis points, compared with 215 basis points for the original issue.

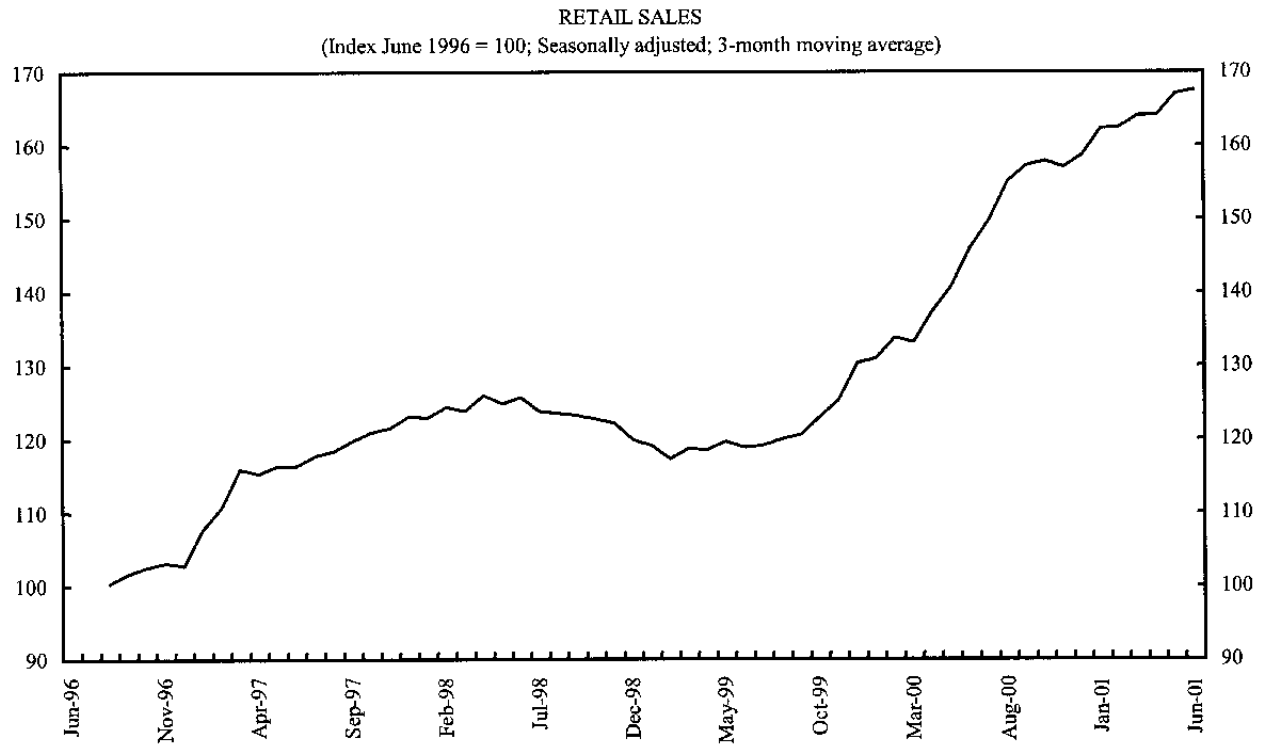
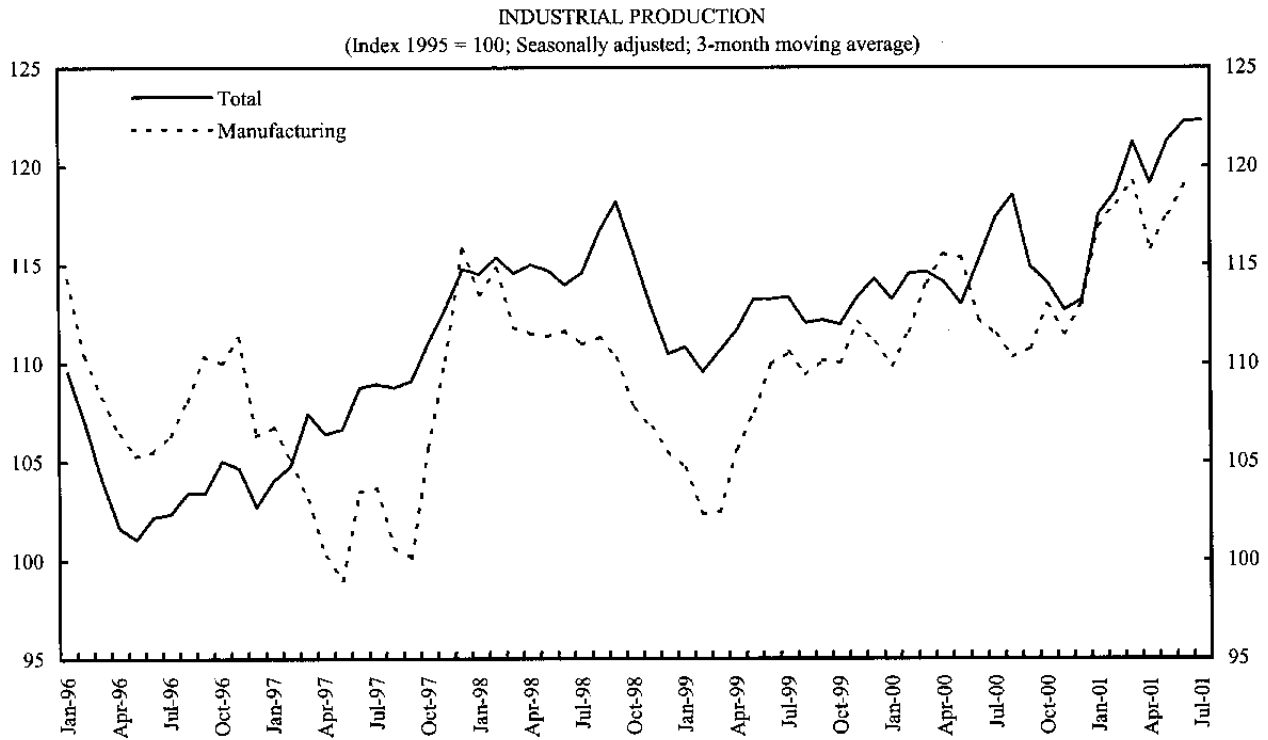
3. **Despite a weaker external environment, economic growth is likely to reach the program objective of 4 percent.** Real GDP increased by 4.2 percent year on year in the first quarter of 2001 and high-frequency indicators of economic activity show continuing strong growth in the following months. In the first seven months of 2001, industrial production expanded by 5.5 percent and retail sales by 11.7 percent year on year (Figure 2). Larger social transfers and lower income taxes are boosting private consumption, despite a small decline in real gross wages. Strong imports of capital and intermediate goods and a resumption of credit to private enterprises indicate that business investment is recovering after several years of contraction (Tables 1, 2 and 3). While demand in major trading partner countries is weaker than expected, exports are buoyant. Nonship merchandise exports increased by 10.3 percent year on year during January-June. Tourist nights increased by 21 percent year on year in January-June and all indications point to a strong third-quarter season, notwithstanding lingering tensions in neighboring countries and some exchange rate appreciation early in the season (Figure 3). Thus, real GDP growth seems set to reach 4 percent this year, but achievement of the authorities' objective of slightly higher growth rates in 2002 and 2003 hinges crucially on further fiscal consolidation and structural reform as well as the reacceleration of growth in major trading partner countries.

Figure 1. Croatia: Bond Spread, 1997-2001



Source: JP Morgan.

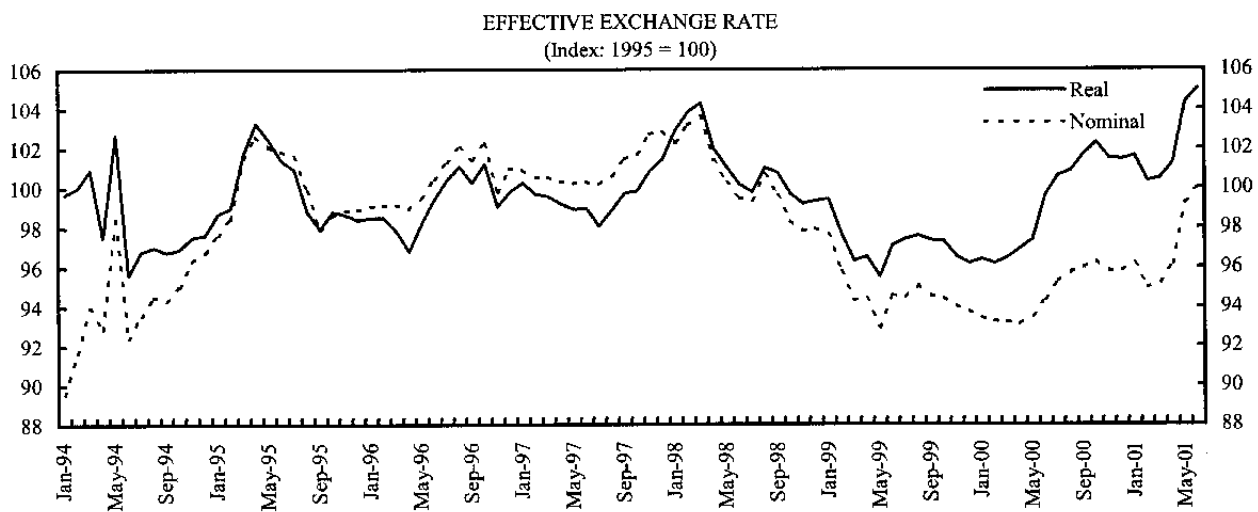
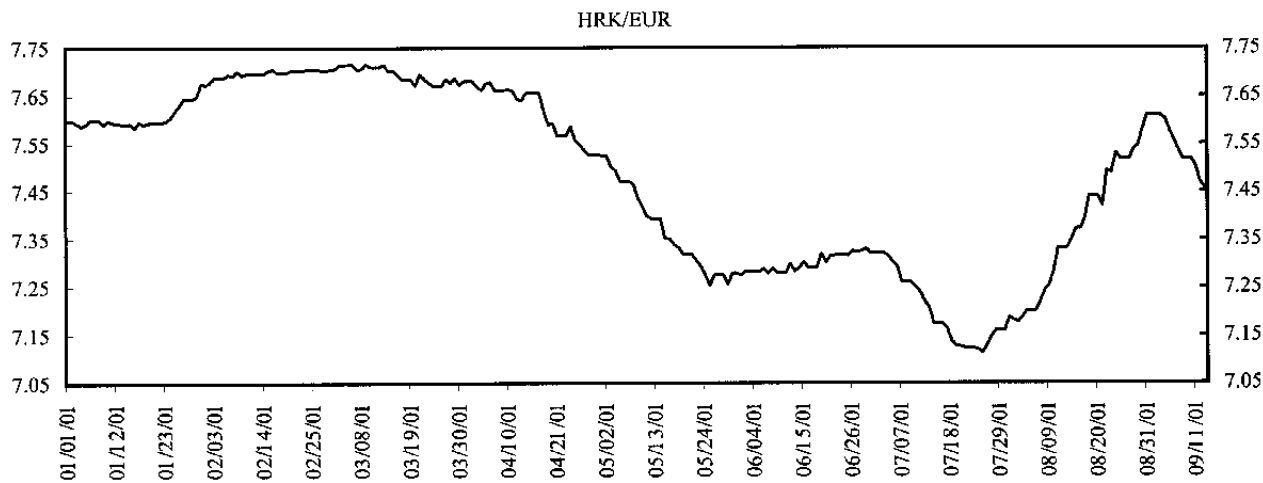
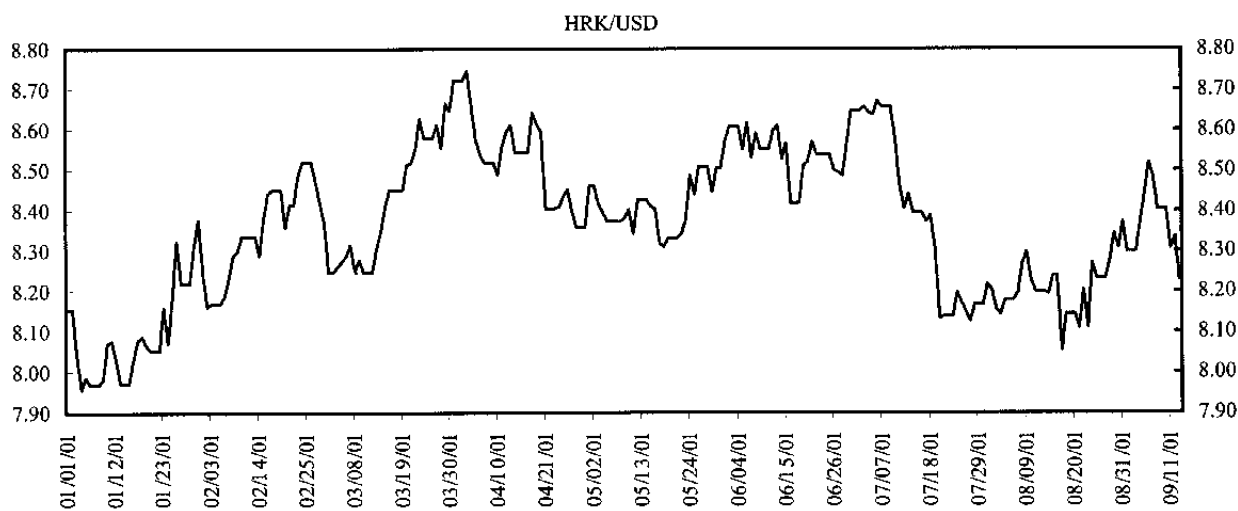
Figure 2. Croatia: Real Sector Developments, 1996-2001



Source: Croatian Bureau of Statistics.



Figure 3. Croatia: Exchange Rate Developments, 1994-2001



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

4. **After remaining unexpectedly high through May, inflationary pressures are receding.** High oil prices and increases in excise taxes in early 2001 caused headline inflation to accelerate to 7.2 percent year on year in May. However, with labor costs and producer prices decelerating and the one-off impact of last year's excise tax increases falling away, retail price inflation has more recently been declining. The absence of underlying inflationary pressures caused retail price inflation to fall to a two-year low of 3.8 percent in July (Figure 4), before jumping to 5.8 percent in August in response to increases in administered prices of electricity, telecommunications, and natural gas. The program target of 4.5 percent at year end is nonetheless expected to be achieved, as core inflation remains at 3.9 percent and the easing of monetary conditions seems to have reached an end (Figure 5). In these circumstances, inflation may ease further to 3.5–4 percent in 2002.

5. **A temporary surge in car imports and the revival of capital goods imports are resulting in a moderate worsening of the external current account in 2001.** A weak merchandise trade performance in the first half of 2001, though partly reflecting the growing demand from manufacturing, was mostly caused by one-off factors. The announcement that car import privileges for war veterans would be eliminated at end-May spurred a one-time surge of such imports equivalent to about 1 percent of GDP. Also, merchandise exports were depressed in the first quarter by the absence of ship exports, which are inherently irregular. The weakness in the merchandise trade balance was offset by strong travel receipts and private transfers (Figure 6). As a result, and with the assistance of strong capital inflows, gross official reserves of the central bank reached US\$3.8 billion at end-June, or some US\$300 million above the level programmed at current exchange rates. Based on the continuation of the recent trend of merchandise trade and a strong tourist season, the current account deficit is expected to increase from 2.1 percent of GDP in 2000 to 3.5 percent of GDP in 2001, before declining to about 2 percent of GDP in 2002 (Table 4).<sup>1</sup>

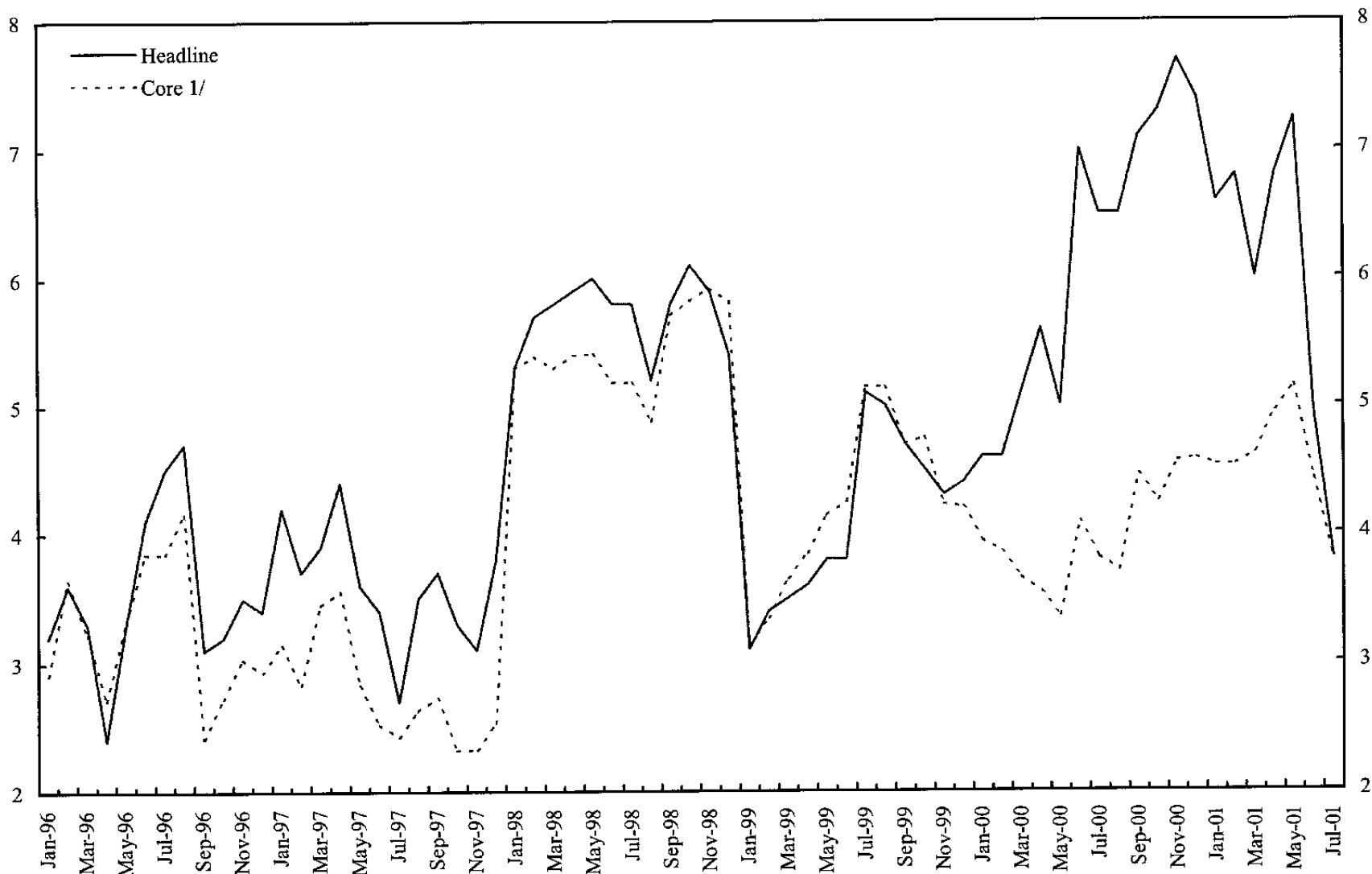
## II. PROGRAM IMPLEMENTATION AND PERFORMANCE

6. **In line with the favorable macroeconomic trends, performance under the program has been broadly satisfactory, especially with respect to observance of the quantitative performance criteria.** All such criteria for end-March were observed except for the subceiling on domestic bank financing, which was breached because of smaller than programmed external financing and faster than programmed arrears reduction (Table 5). The pivotal fiscal deficit ceiling for end-June was observed by a narrow margin. Four other quantitative performance criteria for end-June were observed with ample margins (public enterprises borrowing, nonconcessional debt contracting, net usable international reserves of the CNB, and net domestic assets of the CNB). However, three quantitative performance

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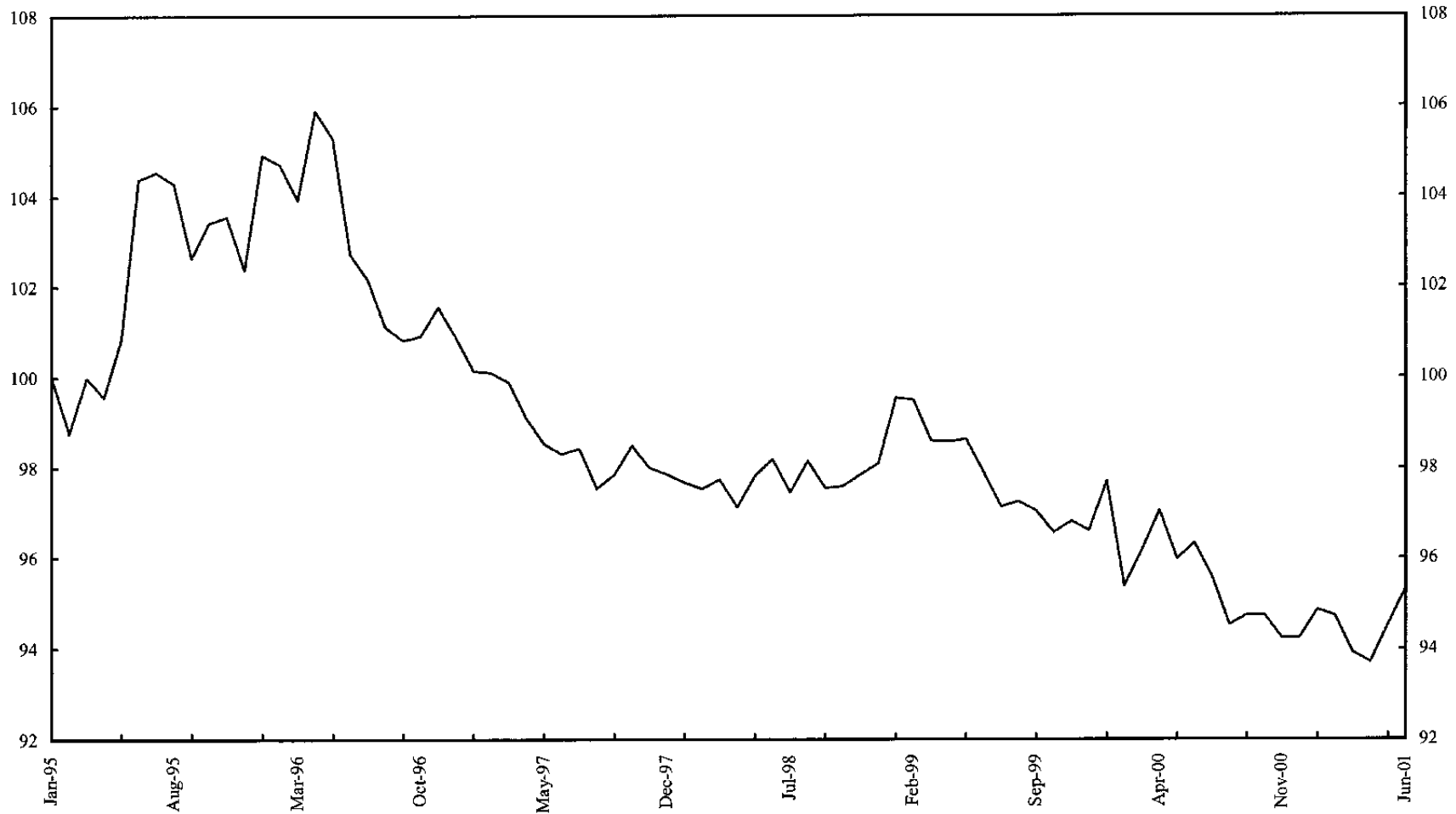
<sup>1</sup> On the basis of preliminary data through end-September, a current account deficit 4.6 percent of GDP had been expected at the time the program for 2001 was agreed. The much better outcome is explained by a methodological revision of private transfers data as well as stronger tourism exports and lower merchandise imports in the last quarter of 2000.

Figure 4. Croatia: Retail Price Inflation, 1996-2001  
 (Annual percentage change)



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

Figure 5. Croatia - Monetary Conditions Index<sup>1</sup>, 1995-2001  
 (January 1995 = 100)

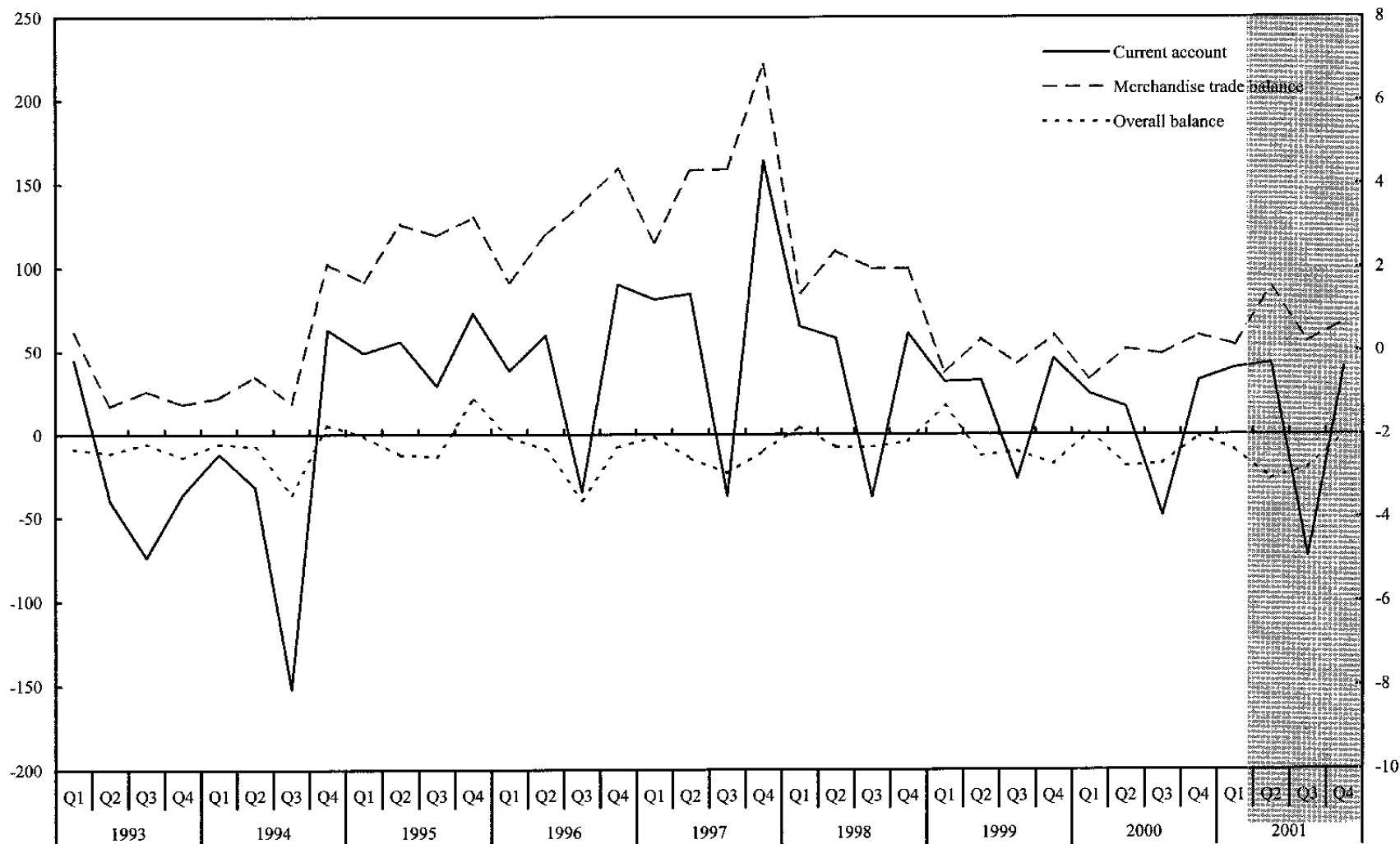


Sources: Croatian National Bank; Croatian Bureau of Statistics; and IMF, Information Notice System.

1/ The index is the weighted average of the real interest rate and the real effective exchange rate, where the weights are intended to represent the relative impact of interest rate and exchange rate on aggregate demand. In this case, the ratio between the weights is assumed to be 2-to-1, that is, a 1 percentage point change in the interest rate has approximately the same impact on aggregate demand as a 2 percent change in the exchange rate.

Figure 6. Croatia: External Balance, 1993-2001

(In millions of U.S. dollars; percent of annual GDP)



Sources: Croatian National Bank; and IMF staff projections.

Note: Data from the second quarter of 2001 are projections.

criteria were breached, in large part due to a shortfall of privatization revenue: (i) the subceiling on domestic bank financing of the consolidated central government; (ii) the ceiling on arrears of the consolidated central government; and (iii) the ceiling on public and publicly guaranteed external short-term debt.

7. **The implementation of structural measures has been less satisfactory.** The end-March structural performance criterion on government sector wage policy was not observed and progress in privatizing the telecommunications company (HT) has been slower than envisaged under the program, which caused the government to slow the programmed pace of reduction of arrears and to breach the domestic bank borrowing limit. It also necessitated the rollover of a US\$400 million bridge loan (of which US\$360 million is owed to foreign creditors), thus breaching the June ceiling on short-term external public debt.

8. **The macroeconomic consequences of these breaches were limited, as they seem to have had no effect on the financing available for the private sector.** Driven by stronger than programmed money demand and an accommodating monetary policy, domestic credit grew faster than programmed (by HrK 2.7 billion), mainly on account of a less rapid reduction of net government borrowing (by HrK 2.1 billion). The remainder of the additional credit expansion went to the nongovernment sector, thus offsetting about two thirds of the liquidity effects of the less rapid reduction of government arrears. As large public enterprises needed considerably less domestic bank credit than allowed under the program, private sector credit (inclusive of the effects of government arrears repayment) grew somewhat faster than programmed. Thus, there is no evidence that the additional government borrowing has crowded out private investment (Tables 6 and 7).

#### A. Fiscal Policy

9. **The end-June performance criterion on the deficit of the consolidated central government was met by a small margin.** Late implementation of the new wage policy in the government sector and slippages in social transfers caused a small expenditure overrun, offset by a better than projected revenue performance, especially in VAT and customs duties.

10. **Due to political pressures and protracted negotiations with unions, the new wage policy for government workers, originally planned for adoption in March, was agreed only after the May local elections.** As a consequence, the end-March structural performance criterion on wage policy was breached and the indicative target on the central government wage bill for the second quarter was not observed. New wage coefficients began to be applied in June to most ministries, but—contrary to program assumptions—workers in the ministries of education, science and technology, and—on a temporary basis—defense were excluded. At the same time, however, the new coefficients were extended to the extrabudgetary funds (particularly health care workers) and a new basic wage was established so as to ensure the originally programmed 9 percent reduction of the wage bill of the consolidated central government for 2001.

11. **Social transfers exceeded their budgetary allocation by a significant margin.** Lacking parliamentary approval, the authorities could not reduce sick pay benefits as

assumed in the program, and child benefit payments were considerably higher than expected due to the extension of the entitlement to previously excluded categories. A first budget amendment, approved by parliament in late June, made the technical adjustments required as of midyear to bring pension fund operations on the central budget and devolve certain revenues and expenditure to local governments, but it failed to come to grips with the rising expenditure pressures.

12. **Delays caused a substantial shortfall in privatization receipts, which was fully offset by additional foreign and domestic borrowing.** The second phase of the privatization of HT, originally scheduled for the second quarter, was deferred to the second half of 2001, opening a gap in government financing needs relative to program assumptions equal to 3.3 percent of GDP (HrK 5.8 billion). Although temporarily pushing up the public debt ratio, this shortfall was fully compensated by higher net foreign borrowing and by increased domestic financing. Besides the lower than programmed reductions of arrears and net bank credit mentioned in paragraph 8, the increased domestic financing included the placement of a small amount of Treasury bills with domestic nonbanks.

#### **B. Monetary and Exchange Rate Policy**

13. **As mandated by the new central bank law, monetary policy is now primarily focused on price stability.** Given the very open nature of the economy, however, the CNB also strives to maintain the exchange rate stable, inter alia by smoothing seasonal fluctuations, and relies more heavily on open market operations and policy interest rate adjustments to achieve its price stability objective. The decline of inflation in the context of falling interest rates and ample liquidity indicates that the CNB has so far been successful in discharging its mandate.

14. **Monetary policy succeeded in achieving the quantitative performance criteria on international reserves and net domestic assets through end-June.** In the face of strong capital repatriation by domestic banks, the target on net usable international reserves of the CNB was met comfortably. The target on net domestic assets of the CNB was also observed with a large margin thanks to a substantial increase in government deposits and the reduced need for liquidity loans to banks.

15. **Monetary expansion has been faster than expected, but declining trend inflation, exchange rate appreciation, and reserve gains indicate that the real demand for money has been stronger than expected.** The seasonal fall of base money in the first quarter was muted, and base money growth in April-May was substantially higher than expected (Table 7). Progress in the remonetization of the economy, favored by exchange rate appreciation and banking system stability, was reflected in a stronger than programmed increase in bank deposits, both in kuna and in foreign currency. The CNB supported easier conditions by lowering its Lombard rate from 12 percent to 9.5 percent in March.

16. **Faced with unseasonally early pressures on the currency, the CNB intervened repeatedly to smooth the appreciation.** These pressures resulted from domestic banks unwinding their long foreign exchange positions to both meet domestic demand for credit

and profit from the expected seasonal appreciation of the kuna. This prompted the CNB to buy the equivalent of about US\$182 million of foreign currency in April-May, largely sterilized through subsequent sales of CNB bills. Moreover, the CNB decided to accompany a reduction of the reserve requirement rate from 23.5 percent to 22 percent in June-July with an extension of its base to include foreign borrowing by the banks, thereby increasing banks' demand for foreign exchange to meet the reserve requirement. Despite these measures, appreciation pressures re-emerged in July and the CNB intervened once more in the exchange market, buying the equivalent of US\$122 million (Figure 7). Since then, however, the pressure has reversed and the CNB had to sell the equivalent of US\$375 million in August as banks and large companies were building long positions ahead of the seasonal weakening of the currency. While—in a break with their past behavior—the banks seem to have been exploiting the seasonal fluctuation of the exchange rate, at least part of the recent foreign exchange purchases by companies appear to represent a structural shift in response to the permission, given earlier this year, for companies to open foreign exchange accounts with domestic banks.

### C. Public Enterprise Reform and Privatization

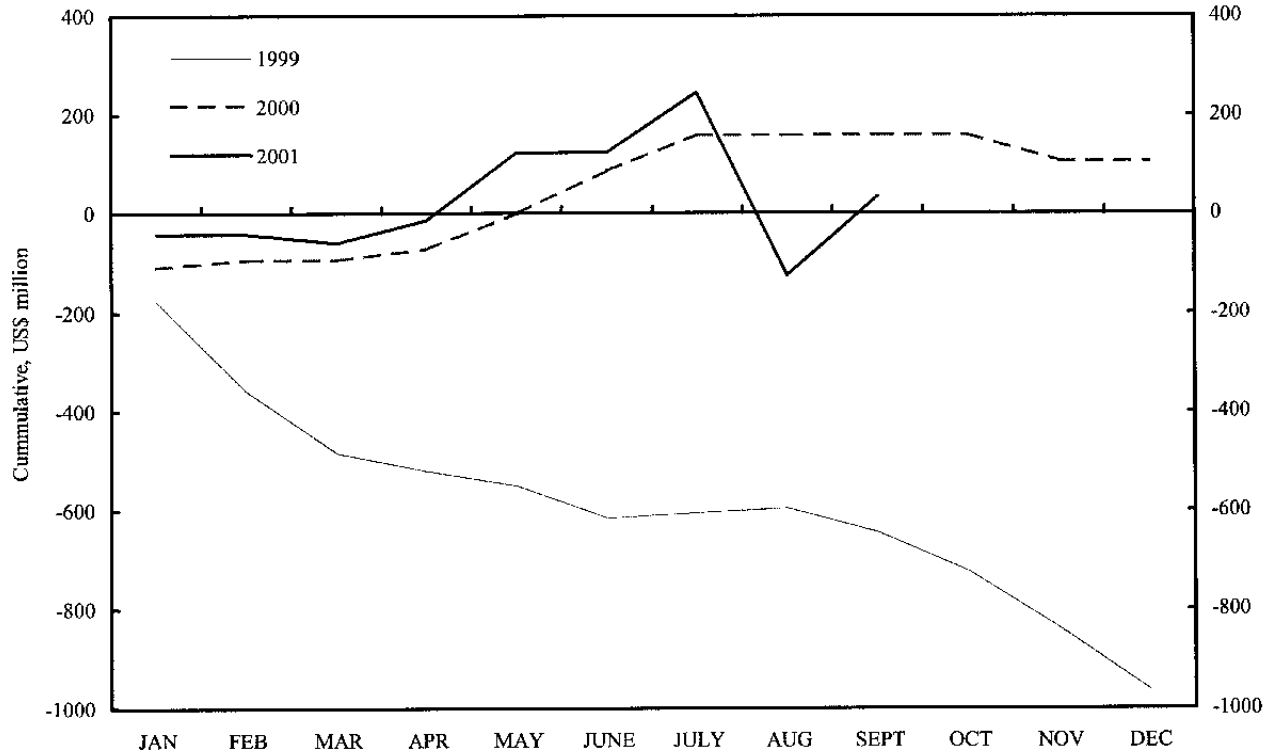
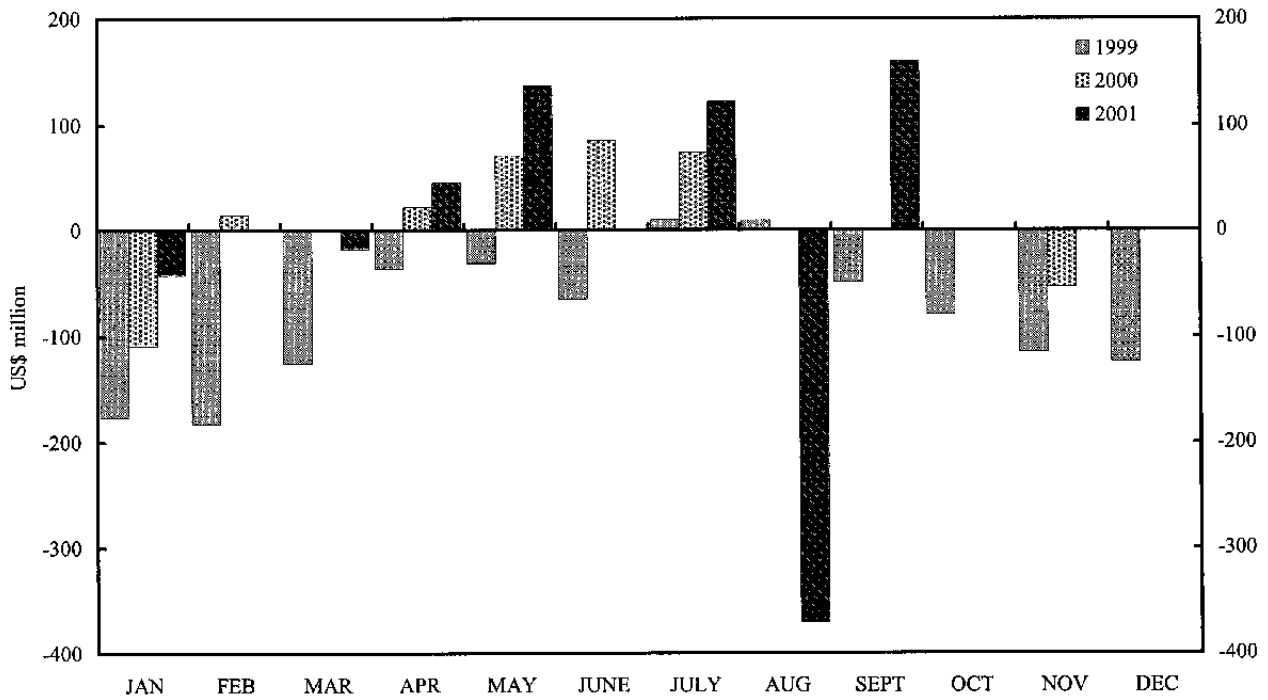
17. **The structural benchmark on completing all the steps necessary for the privatization of at least 20 percent of HT by end-June has not been met.** The second phase of the privatization of HT encountered impediments. Citing low telecom prices as a reason, the authorities delayed the public sale of a 20 percent stake in HT, but re-opened negotiations with Deutsche Telekom to raise its ownership share from 35 percent to 51 percent. These negotiations were successfully concluded in early July.

18. **Progress to prepare the power (HEP) and oil (INA) companies for privatization has also been slower than envisaged under the program.** Privatization advisors for both companies have been appointed and some decisions have been taken regarding the divestiture of noncore assets owned by these companies. Five laws on energy sector reform were approved by parliament in July. These laws will not come into effect until the beginning of 2002 except for the law on energy services, which took effect immediately.

19. **In accordance with their program undertakings and in contrast to the experience in recent years, the authorities managed to keep a tight rein on wages and employment in the public enterprises.** Gross labor costs in the ten large enterprises listed in Annex VI of the Supplementary Memorandum of Economic and Financial Policies (SMEFP) were 8 percent lower in January-June 2001 than in the corresponding 2000 period. However, reflecting reductions of employer social security contributions and income taxation, net wages were unchanged in nominal terms. Meanwhile, employment in the ten enterprises was 2 percent lower year on year in June 2001, with programs to reduce surplus staff under implementation in most of the enterprises.



Figure 7. Croatia: Croatian National Bank Net Foreign Exchange Intervention, 1999-2001



Source: Croatian National Bank.

### III. THE PROGRAM FOR THE REMAINDER OF 2001

#### A. Fiscal Policy

20. **The fiscal deficit target for 2001 will remain at 5.3 percent of GDP.** Although aggregate revenue projections for the second half of 2001 are unchanged from the original program (SMEFP, ¶10), expenditure overruns related to child benefits, delays in health sector reform, and the unanticipated additional recapitalization of the state-owned postal bank (HPB) would cause the budget deficit to reach 6.1 percent of GDP (Table 6). Hence, the attainment of the unchanged fiscal deficit target requires an adjustment in the remainder of 2001 of at least 0.8 percent of GDP relative to current trends.<sup>2</sup> On the other hand, the underlying trend of the external current account suggests that there is no need to reduce the deficit target to 4.8 percent of GDP, as envisaged by a program contingency (EBS/01/12, ¶15).

21. **The required fiscal adjustment is to be achieved by a combination of permanent and discretionary expenditure cuts,** which will produce savings equivalent to almost 1.0 percent of GDP during the second half of 2001, creating a safety cushion of almost 0.2 percent of GDP. Higher co-payments for drugs took effect in mid-August. The authorities will shortly submit to parliament legislative proposals to rationalize the social transfer system by either fully aligning or partially harmonizing benefits for privileged groups with those for the general population and better target or reduce existing generous benefits (SMEFP, ¶11). These measures are expected to produce a permanent reduction of social spending of almost 0.6 percent of GDP in 2001 and 1.4 percent of GDP in 2002. Discretionary cuts of spending on goods and nonwage services, subsidies, and capital investment, which took effect at the beginning of September, are expected to create additional savings of almost 0.4 percent of GDP in 2001. A revised budget for 2001 incorporating all these measures will be sent to parliament in September. Parliamentary approval of the proposed changes to the social transfer system and of the revised budget for 2001 is a prior action for completion of the review (SMEFP, Annex IX).

22. **To facilitate the maintenance of an unchanged nominal wage bill in 2002–03 while creating room for some wage increases, the authorities' program for 2001 calls for a net employment reduction in the government sector.** The authorities have determined that most of the excess employment in the government sector resides in the ministries of interior and defense. By midyear, employment was already reduced by some

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<sup>2</sup> At 3.9 percent of GDP, the required annual adjustment effort in 2001 is substantial as the deficit reduction from 5.7 to 5.3 percent of GDP has to contend with a reduction of the revenue ratio by 2.3 percent of GDP that results from tax reductions during 2000 and at the start of 2001 and with an increase in the expenditure ratio of 1.2 percent of GDP that results from court-mandated special pension payments.

750 in each of these ministries. In addition, another 3,600 staff in the Ministry of Interior were notified in August 2001 that they will be laid off in the fourth quarter of 2001, while some 5,000 employees will be dismissed in the Ministry of Defense in the same quarter following the parliamentary approval of a new defense law. Combined with smaller personnel reductions in other ministries, these measures are expected to realize a net reduction of some 10,000 government workers by end-2001, which is a structural performance criterion under the program. The authorities intend to use World Bank resources to retrain laid-off workers.

**23. Despite the downward revision of privatization receipts, the unchanged fiscal deficit will be financed without net domestic borrowing.** The authorities have revised their financing plan for 2001, taking into account the expected shortfall in privatization receipts, mostly due to the scaling back of HT privatization (SMEFP, ¶12). Privatization receipts were reduced from 5.2 percent of GDP to 4.0 percent of GDP. About two thirds of that amount is expected to be realized from the sale of 16 percent of HT shares to Deutsche Telekom (€ 500 million) and the disbursement of an amount retained in an escrow account from the sale of 35 percent of HT shares to Deutsche Telekom in 1999 (US\$46 million).<sup>3</sup> The authorities are pursuing several additional privatization projects that should ensure achievement of their overall privatization target in the second half of 2001, including bridge financing as a last resort. Net foreign borrowing was raised from 1 percent of GDP to 2.3 percent of GDP, reflecting the top-up of the March eurobond issue by € 250 million in July and expected EFSAL (DEM80 million) and SAL (US\$100 million) disbursements from the World Bank. Consequently, there would be a domestic financing surplus of 1.0 percent of GDP for 2001 as a whole, which will be used almost entirely to reduce arrears of the government and the health fund. The targeted reduction of arrears during 2001 has remained unchanged at HrK 1,500 million, with HrK 900 million to be achieved in the second half of the year (SMEFP, Annex IV.III).<sup>4</sup> The postponement of HT privatization and the backloading of the arrears reduction imply that the consolidated central government will shift from a net borrower in the first half of 2001 to a net provider of funds to the domestic economy in the second half of 2001.

**24. Both the fiscal deficit and the government expenditure ratio are planned to be reduced further in 2002–2003.** The authorities recognize that—in light of vanishing privatization receipts—a fiscal deficit of 5.3 percent of GDP is unsustainable and that government expenditure in relation to GDP is still much higher than in the EU and CEECs. The authorities' revised fiscal framework for 2002-03 envisages reducing the deficit to 4.25 percent of GDP in 2002 and 1.4 percent of GDP in 2003, with a drop of the expenditure

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<sup>3</sup> The program target on net bank borrowing will be adjusted automatically at end-September if the receipts from these transactions fall short of the expectation (SMEFP, Annex IV.II).

<sup>4</sup> The arrears definition has been tightened from “payments overdue by more than 90 days” to “all payments that have not been made within their original or modified terms.” As a result, the stock of arrears at end-June rose from HrK 372 million to HrK 1,377 million.

ratio to some 41 percent and 38 percent of GDP, respectively. The budgets for 2002 and 2003 will benefit from the full year effects of the new wage policy and permanent savings in social spending introduced in 2001. Staff reductions in the ministries of interior and defense in the second half of 2001 will also help achieve these targets. If expenditures can be cut according to the framework, there will be room to reduce the burden of taxes and social security contributions by 1.3 percent of GDP in 2002–03, in accordance with the authorities' electoral program.

## **B. Monetary and Exchange Rate Policy**

25. **The monetary program is consistent with the greater emphasis on price stability mandated by the new central bank law.** The inflation target remains at 4.5 percent at year end, down from 7.4 percent at the end of 2000, to be achieved despite larger than anticipated increases in administered prices and excise taxes. With money demand stronger than expected and a higher than targeted reserve gain in the first half of 2001, the monetary program has been revised, raising the annual target for the accumulation of net usable international reserves by US\$334 million compared with the original program and adjusting the CNB net domestic asset ceiling accordingly.<sup>5</sup> This would preserve most of the unexpected reserve gain in the first half of the year, while giving additional room for credit expansion. To allow for unforeseen foreign exchange intervention, the CNB's quarterly international reserves targets have been reduced by US\$100 million with respect to this baseline scenario, with a corresponding increase in the CNB's net domestic assets, and the performance criteria have been set on that basis (SMEFP, Annexes VII and VIII). Base money demand is projected to remain strong in the second half, despite a seasonal slowdown in the fourth quarter. Deviations from these projections would trigger a reaction from the CNB. If demand turns out to be weaker than expected, the CNB will tighten liquidity in order to prevent net usable international reserves from falling below their program target. If, instead, demand turns out to be stronger than projected, the CNB will consult with the Fund to determine if the inflation outlook warrants an unsterilized buildup of international reserves. The CNB will consider another reduction of reserve requirements only if liquidity conditions justify this.

26. **The program provides enough room to finance the continued expansion of the private sector.** Although businesses can rely on larger profits—and the larger ones, on access to foreign borrowing—to fund their investment, demand for domestic bank credit from the private sector is likely to remain strong. The program, assuming a further small decline in velocity, creates room for a further expansion of credit to the nongovernment sector in the second half of 2001 by 5¼ percent. This would bring annual credit expansion to 17¼ percent, compared with 16 percent under the original program. Moreover, repayment of government arrears will contribute to maintain good liquidity conditions. In order to prevent

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<sup>5</sup> Reserves have been boosted additionally by US\$123 million in June, representing Croatia's share in the reserve assets of the central bank of the former SFRY previously held at the BIS.

public enterprises from excessive borrowing, the program establishes quarterly net bank borrowing limits for 10 large public enterprises (SMEFP, Annex VI).

27. **Recent developments confirm the need for flexibility in the monetary program.** After intervening repeatedly between April and July to dampen an unseasonally early appreciation of the kuna, the CNB had to face an equally early reversal of these pressures (Figure 3). In addition to banks exploiting the anticipated seasonal depreciation of the exchange rate, the demand for foreign exchange was driven by large companies (including public ones), which were allowed to open foreign exchange accounts by the recently introduced amendments to the foreign exchange law. In order to prevent too rapid a depreciation, the CNB intervened in August with unusually large amounts (Figure 7), while reducing the ceiling on banks' foreign exchange exposure from 25 to 20 percent of risk-based capital with effect from September 1. In response, money market rates rose sharply and banks took recourse to CNB credit, while the currency appreciated. On September 5, the CNB raised the Lombard rate from 9.5 to 10.5 percent. It also boosted yields on CNB bills, lowered remuneration of reserve requirements, and required that part of reserve requirements on foreign currency liabilities would henceforth be fulfilled in domestic currency. The CNB has reaffirmed its readiness to tighten liquidity and raise interest rates further if needed to ensure observance of the international reserves floors for end-September and end-December 2001.

### C. Structural Measures Subject to Fund Conditionality

28. In addition to the prior action on social transfers (involving legislative changes) and a revised budget for 2001, **structural measures that are subject to Fund conditionality during the second half of 2001 are limited to the authorities' intention to reduce employment in the government sector (a performance criterion) and to make progress in privatizing HEP and INA (a benchmark).** A large number of other structural measures are part of the authorities' program for 2001, but are not covered by Fund conditionality (Box 1). Progress in their implementation and changes in their timelines are reviewed in Appendix IV. In essence, while much progress has been made in all areas and timelines have generally been respected in the financial sector, there has been widespread slippage outside the financial sector and the authorities have committed themselves to new deadlines for implementation.

29. **Based on the layoff plans mentioned in paragraph 22 above, the authorities are confident that they will observe the performance criterion on employment reduction in the government sector by end-2001.** With respect to progress in privatizing HEP and INA, the recently passed package of laws to reform the energy sector and the appointment of privatization advisors, both mentioned in paragraph 18 above, represent important preconditions for the two companies' privatization. Separate laws are now being drafted in the Ministry of Economy to establish a legal basis for privatization. It is expected that these laws will be approved by parliament by end-2001, instead of end-September 2001 as envisaged under the original program.

## **Box 1. Croatia—Structural Conditionality**

### **1. Coverage of Structural Conditionality in the Current Program**

Structural conditionality under the original program (13 measures subsumed into 4 prior actions; 2 structural performance criteria; and 2 structural benchmarks) is macroeconomically relevant (macro-critical in the case of the two PCs; both in the wage policy area) and within the Fund's areas of expertise except for the two structural benchmarks on privatization (EBS/01/12, Annex III). The prior actions (including individual measures) for approval of the stand-by arrangement were set in the areas of: (i) fiscal management (2); (ii) wage policy (9); (iii) banking (1); and (iv) import taxation (1). This frontloading of conditionality aimed at establishing the credibility of the program in the absence of a track record and creating an institutional basis for its implementation. The emphasis on wage policy reflected the authorities' strategy to reduce the fiscal deficit and improve competitiveness. The two structural benchmarks on privatization and restructuring of key utility companies were set to generate economy-wide efficiency gains and contribute to fiscal sustainability. The Fund staff monitors progress in wage policy and telecom privatization and relies on the Bank's expertise in assessing the progress in restructuring and privatization in the energy sector. The new prior action for the completion of the present review is macro-critical for the achievement of the fiscal deficit target.

### **2. Status of Structural Conditionality from Earlier Programs**

The previous program supported by the EFF approved in March 1997 included actions on (i) restructuring and privatizing large state-owned enterprises and banks; (ii) improving fiscal management; (iii) developing financial markets; and (iv) reducing trade distortions. The 1997 program stalled after the first review and the structural conditionality under the present program takes up some of its unfinished agenda (e.g., implementation of a single treasury account and privatization of telecom and energy sector companies). The bulk of measures in the financial sector were implemented (including with Fund TA) in the course of dealing with the aftermath of the 1998 banking crisis, and several auxiliary measures are to be implemented under the current arrangement but are not subject to formal conditionality (see ¶4 below). The 1997 trade policy agenda has been overtaken by Croatia's unilateral liberalization of trade in the wake of its WTO accession, and on a bilateral and regional basis through a series of free trade agreements concluded recently or to be concluded in the near future.

### **3. Structural Areas Covered by World Bank Lending and Conditionality**

Under the recently agreed SAL, to be approved by the Bank's Executive Board in October, the Bank will support structural reform measures aimed at: (i) improving coordination and management in economic policy making; (ii) enhancing fiscal discipline; (iii) strengthening market institutions and the competitiveness of the economy; (iv) enhancing flexibility in the labor market; and (v) strengthening social protection.

### **4. Other Relevant Structural Measures not Subject to Formal Fund Conditionality**

The current program also covers many other structural measures that are not subject to formal Fund conditionality including measures in (i) the fiscal sector, including healthcare and pension reforms; (ii) public enterprises; (iii) the monetary and financial sector; and (iv) the judicial system. They are assessed as not critical for the achievement of the macroeconomic targets (EBS/01/12, Annex I). Some of these measures are being covered by the Bank (e.g., measures in healthcare and pension reforms constitute prior actions under the SAL). Progress in implementing these measures is reviewed in Appendix IV.

#### IV. STAFF APPRAISAL

30. **The authorities' growth, inflation and international reserves objectives for 2001 are likely to be either met or exceeded.** Notwithstanding delays in policy implementation and a less favorable than expected external environment, economic performance in the first half of 2001 was strong, and prospects are good for further economic growth, disinflation, and—more modest—international reserve gains in the second half. The import-induced weakening of the external contribution to growth is compensated by a stronger expansion of private demand, as both consumption and investment are growing faster than anticipated. Improved access to foreign markets, the strengthened regional security situation, and domestic policy efforts have contributed to a substantial reduction in the current account deficit. Further fiscal adjustment and more decisive structural reforms are now required to ensure a lasting reduction in the country's external vulnerability.

31. **The authorities remain committed to their policy agenda, notwithstanding the delays experienced.** Reducing government wages and employment is a bold endeavor, and, despite the delay and tradeoffs accepted, the authorities are to be commended for having implemented without social disruptions a wage policy that achieves the wage bill reduction envisaged for this year at the level of the consolidated central government. The authorities must now complete the implementation of their employment reduction plan and ensure that employees temporarily excluded are also covered by the new wage system so as to strengthen the prospects for maintaining an unchanged nominal wage bill in the central government in 2002–03 while creating room for modest wage increases. The authorities' success in reducing wages and employment in the public enterprises are equally commendable, and their efforts should now focus on avoiding any backsliding. The authorities are encouraged to persevere with their efforts in other areas, such as public enterprise reform and privatization, where policy initiatives have stalled earlier this year.

32. **With the arrangement's pivotal quantitative performance criteria observed in the first half of 2001, the breaches of the three performance criteria on government bank financing, arrears, and short-term external debt appear of subordinate importance.** This is partly because all three breaches are related to the delay in the privatization of the telecommunications company, which has now been agreed, with the resulting receipts, required to meet the performance criteria, expected soon. As to the nonobservance of the structural performance criterion on wage policy, although a somewhat different policy was implemented almost one quarter later than originally programmed, the annual wage bill target for the consolidated central government will be achieved this year and the full-year effect of the measure is larger than originally envisaged. In light of these circumstances and the authorities' program for the second half of 2001, the staff supports the authorities' request for waivers for the nonobservance of these four performance criteria.

33. **The authorities' program for the second half of 2001 represents a bold effort to stem a looming fiscal deterioration and preserves most of the greater than programmed international reserve gain in the first half of the year.** Although the package of planned fiscal measures is sufficient to achieve the program's fiscal deficit target with a small margin, it needs to be implemented fully and without delay to guard against any slippage. By relying

mainly on durable expenditure reduction, the planned fiscal adjustment measures will facilitate the preparation of budgets for 2002 and 2003 that are in line with the authorities' medium-term fiscal adjustment strategy. The authorities now need to accelerate the privatization of banks and companies to ensure the level of receipts needed under their revised program for 2001 and to finance the budgets for 2002 and 2003.

34. **In light of the changed behavior of banks and large companies, the CNB must be prepared to tighten liquidity and raise interest rates as needed to meet its international reserves targets.** While some further depreciation of the exchange rate during the off-tourist season would be compatible with the CNB's inflation target and would not be unwelcome for competitive reasons, the CNB's reserve targets do not leave much room for further intervention to stem a larger depreciation. The recent liberalization of access to foreign exchange for legal entities should not be reversed, nor should there be any further tightening of limits on banks' foreign exchange exposure. As the recent buildup of speculative long positions has been facilitated by the large inflow of deposits into the banking system and the lowering of policy interest and reserve requirement rates, the CNB should use open market operations and other policy instruments to decrease the supply of kuna and the demand for foreign exchange. The recent measures by the CNB to raise interest rates are welcome in this context. At any rate, there appears to be no room at this juncture to reduce reserve requirements further.

35. **To strengthen external competitiveness and lay the foundations for sustainable growth and higher employment, the authorities need to accelerate structural reforms in the labor and product markets.** In the Fund's areas of primary interest, the potential of the single treasury system should be fully exploited following the recent internal reorganization of the Ministry of Finance, timely reporting of the operations of subnational governments should be implemented, the postal bank should be restructured or privatized, and the new banking law should be approved by parliament.

36. On the basis of the authorities' program for the remainder of 2001, the staff proposes completion of the first review under the stand-by arrangement. In line with the authorities' supplementary letter of intent, the staff expects the second and final review under the arrangement to be completed by December 31, 2001.



Table 1. Croatia: Main Economic Indicators, 1995-2001

	1995	1996	1997	1998	1999	2000	2001	
							Original Program	Revised Program
Real economy (percentage change)								
Real GDP	6.8	6.0	6.6	2.5	-0.4	3.7	4.0	4.0
Unemployment rate (average; percent of labor force) 1/	n.a	10.0	9.9	11.4	13.6	16.1	14.5	15.5
Retail prices (e.o.p.)	3.7	3.4	3.8	5.4	4.4	7.4	4.5	4.5
Gross national saving (percent of GDP)	9.9	16.1	18.2	17.2	19.4	21.9	22.0	23.4
Gross domestic investment (percent of GDP)	17.6	21.9	29.6	24.3	26.3	24.0	25.8	26.9
Public finance (percent of GDP)								
Consolidated central government (cash basis) 2/	-0.9	-0.4	-1.3	0.6	-2.0	-4.9	-0.8	-2.1
Consolidated central government (accrual basis)	...	...	-2.0	-3.0	-7.4	-5.7	-5.3	-5.2
Consolidated government debt (e.o.p) 3/	19.3	29.2	31.9	38.8	49.3	50.9	46.2	48.4
Money and credit (e.o.p.; percentage change)								
Broad money	40.4	49.1	37.6	13.0	-1.1	29.3	15.3	23.2
Credit to consolidated central government	-3.0	-3.4	-49.9	-2.7	59.9	12.0	0.0	-4.2
Other credit	18.9	3.1	44.1	22.4	-8.8	9.1	15.9	17.3
Interest rates (e.o.p.; percent)								
Average deposit rate	6.1	4.2	4.4	4.1	4.3	3.6	...	...
Average credit rate	22.3	18.5	14.1	16.1	13.5	10.5	...	...
Balance of payments (percent of GDP)								
Trade balance	-17.3	-18.2	-25.8	-19.2	-16.4	-16.8	-17.3	-19.7
Current account balance	-7.7	-5.5	-11.6	-7.1	-6.9	-2.1	-3.9	-3.6
External debt (e.o.p.)	20.8	23.2	31.9	40.3	44.5	53.1	50.4	50.0
Gross official reserves (US\$ million; e.o.p.)	1,895	2,314	2,539	2,816	3,025	3,525	3,663	4,090
Reserve cover (months of following year's imports of goods and services)	2.3	2.4	2.9	3.5	3.8	3.9	4.1	4.5
Short-term debt (in percent of gross usable official reserves) 4/	31.6	40.7	45.6	75.1	78.6	67.6	75.7	61.5
Fund position (July 31, 2001)								
Holdings of currency (percent of quota)								130.2
Holdings of SDRs (percent of allocation)								226.4
Quota (SDR million)								365.1
Exchange rate								
Exchange rate regime								Other managed floating
Kuna per US\$ (August 31, 2001)								8.3725
Nominal effective rate (1995=100; p.a.)	100.0	100.3	101.0	100.3	94.7	94.6	...	...
Real effective rate (1995=100; p.a.)	100.0	99.3	99.6	101.2	97.1	99.3	...	...

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

1/ Labor Force Survey (based on ILO standards).

2/ National presentation, with privatization receipts above the line.

3/ Including arrears and publicly guaranteed debt. Data for 1995 and 1996 exclude arrears.

4/ On a remaining maturity basis.

Table 2. Croatia: Medium-Term Framework, 1997-2003  
(In millions of kuna)

	1997	1998	1999	2000	2001 prog.	2002 proj.	2003 proj.
External saving	14,108	9,698	9,826	3,320	6,183	3,651	4,202
Domestic saving-investment gap	-14,108	-9,698	-9,826	-3,320	-6,183	-3,651	-4,202
Saving	22,519	23,733	27,687	34,510	40,585	46,981	53,497
Investment	36,628	33,431	37,513	37,830	46,768	50,632	57,699
Consolidated central government (accrual basis) 1/	-1,957	-3,093	-9,033	-7,759	-8,126	-6,719	-1,738
Saving 2/	3,734	4,905	-1,020	-2,490	-1,521	-1,210 4/	3,771 4/ 5/
Investment 1/	5,690	7,998	8,013	5,269	6,605	5,509	5,509
Non-government sector 3/	-12,152	-6,605	-794	4,439	1,943	3,068	-2,464
Saving	18,786	18,829	28,707	37,000	42,106	48,191 4/	49,726 4/ 5/
Investment	30,937	25,433	29,500	32,561	40,163	45,123	52,190
	(In percent of GDP)						
External saving	11.4	7.0	6.9	2.1	3.6	1.9	2.1
Domestic saving-investment gap	-11.4	-7.0	-6.9	-2.1	-3.6	-1.9	-2.1
Saving	18.2	17.2	19.4	21.9	23.4	24.9	26.1
Investment	29.6	24.3	26.3	24.0	26.9	26.9	28.2
Consolidated central government (accrual basis) 1/	-1.6	-2.2	-6.3	-4.9	-4.7	-3.6	-0.8
Saving 2/	3.0	3.6	-0.7	-1.6	-0.9	-0.6 4/	1.8 4/ 5/
Investment 1/	4.6	5.8	5.6	3.3	3.8	2.9	2.7
Non-government sector 3/	-9.8	-4.8	-0.6	2.8	1.1	1.6	-1.2
Saving	15.2	13.7	20.1	23.5	24.2	25.6 4/	24.3 4/ 5/
Investment	25.0	18.5	20.7	20.7	23.1	24.0	25.5
<u>Memorandum items</u>							
GDP at current prices (millions of kuna)	123,812	137,604	142,700	157,510	173,764	188,305	204,650
Gross national disposable income at current prices (millions of kuna)	129,027	141,052	144,712	162,038	178,252	192,217	208,823
Consolidated central government	29,868	37,250	30,508	30,602	28,650	29,434	33,963
Non-government sector	99,159	103,802	114,204	131,436	149,602	162,783	174,860

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

1/ Excludes net lending, includes change in inventories.

2/ Current revenues minus current expenditures (excluding current transfers and interest payments).

3/ Includes lower levels of government and public enterprises.

4/ Government saving is reduced and non-government saving is increased by 1.3-1.4 percent of GDP due to the introduction of the second pillar of the pension system.

5/ Government saving is increased and non-government saving is reduced by 1 percent of GDP due to cessation of payments under the Small Law.

Table 3. Croatia: GDP Measures and Projections, 1998-2003

	1998	1999	2000	2001	2002	2003
				prog.	proj.	proj.
(Percentage changes)						
Real GDP	2.5	-0.4	3.7	4.0	4.2	4.5
Domestic demand	-1.5	-1.9	1.4	5.4	2.4	4.9
Consumption	2.7	-4.5	2.9	2.8	1.5	2.9
Private 1/	-0.2	-2.7	4.1	7.5	2.5	5.0
Government	11.5	-9.6	-0.9	-11.9	-2.3	-5.3
Gross investment	2.5	-1.1	-3.5	15.9	5.7	11.4
Private 1/	-5.0	-0.2	7.2	15.6	10.4	13.5
Government	34.7	-3.8	-37.0	17.4	-19.4	-3.8
Exports	3.9	0.8	9.9	9.5	4.1	4.8
Imports	-4.6	-2.6	3.9	11.7	0.6	5.5
(Percentage contributions)						
Real GDP	2.5	-0.4	3.7	4.0	4.2	4.5
Domestic demand	-1.7	-2.1	1.5	5.8	2.6	5.2
Consumption	2.3	-3.9	2.4	2.3	1.2	2.3
Private 1/	-0.1	-1.7	2.5	4.6	1.6	3.1
Government	2.4	-2.2	-0.2	-2.4	-0.4	-0.8
Gross fixed capital formation	0.6	-0.3	-0.8	3.6	1.4	2.9
Private 1/	-1.0	0.0	1.3	2.9	2.2	3.0
Government	1.6	-0.2	-2.2	0.6	-0.8	-0.1
Change in inventories 2/	-4.6	2.1	0.0	0.0	0.0	0.0
Net foreign demand	4.2	1.7	2.2	-1.8	1.6	-0.7
Exports	1.6	0.3	4.2	4.3	1.9	2.3
Imports	2.6	1.4	-2.0	-6.0	-0.3	-2.9

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

1/ Includes local government.

2/ Includes statistical discrepancy.

Table 4. Croatia: Balance of Payments, 1998-2003 1/  
(In millions of U.S. dollars, unless otherwise indicated)

	1998	1999	2000	2001				2001	2002	2003
				q1	q2	q3	q4			
Current account	-1,531	-1,390	-399	-596	-642	1,112	-604	-731	-413	-471
Merchandise trade balance	-4,147	-3,299	-3,204	-806	-1,329	-838	-1,015	-3,988	-3,735	-3,923
Exports f.o.b.	4,604	4,395	4,567	1,111	1,147	1,342	1,309	4,909	5,222	5,558
Imports f.o.b.	-8,752	-7,693	-7,771	-1,918	-2,476	-2,179	-2,324	-8,897	-8,956	-9,481
Services and income	1,911	1,276	1,947	-5	446	1,714	186	2,341	2,457	2,573
Transportation	228	84	179	45	48	63	54	211	245	262
Travel	2,133	1,742	2,190	81	498	1,790	197	2,566	2,632	2,714
Other services	-286	-201	-111	6	14	-32	-31	-43	4	9
Compensation of employees	70	60	69	29	17	19	8	72	70	70
Interest income	-234	-410	-380	-167	-131	-126	-42	-465	-493	-482
Current transfers	706	632	858	215	241	236	225	917	865	879
Capital and Financial account	1,629	2,544	1,294	418	1,051	-805	605	1,269	821	1,045
Capital account	19	25	21	3	126	5	6	140	18	18
Financial account	1,610	2,519	1,273	415	924	-809	599	1,129	803	1,027
Direct investment	835	1,445	898	59	102	584	384	1,129	786	772
Portfolio investment	15	574	733	574	0	138	0	712	-121	139
Medium- and long-term loans	1,018	348	55	-4	0	-35	147	108	128	116
Assets	0	-75	-5	-3	0	0	0	-3	0	0
Liabilities	1,018	423	60	-1	0	-35	147	111	128	116
Disbursements	1,735	1,657	1,210	160	268	201	344	973	1,144	1,140
Amortization scheduled	-717	-1,234	-1,150	-160	-269	-236	-197	-862	-1,017	-1,024
Currency and deposits 2/	192	76	-1,058	112	360	-699	0	-227	0	0
Short term capital flows (net) 3/	36	60	268	3	94	-360	144	-119	0	0
Trade Credits 4/	-486	16	378	-329	369	-437	-77	-474	11	0
Net errors and omissions	62	-744	-284	318	0	0	0	318	0	0
Overall balance	160	410	611	140	408	307	1	856	409	575
Financing	-160	-410	-611	-140	-408	-307	-1	-856	-409	-575
Gross reserves (= increase)	-152	-378	-582	-140	-395	-304	13	-826	-375	-541
IMF (net purchases)	-9	-31	-29	0	-14	-3	-14	-30	-33	-33
<u>Memorandum Items</u>										
Current account (in percent of GDP)	-7.1	-6.9	-2.1	-2.9	-3.2	5.5	-3.0	-3.6	-1.9	-2.1
Gross official reserves	2,816	3,025.1	3,525	3,514	3,799	4,102	4,090	4,090	4,465	5,006
in months of following year's imports of goods and NFS	3.5	3.8	3.9	3.9	4.3	4.6	4.5	4.5	4.7	4.9
Net international reserves	2,581	2,807	3,325	3,314	3,612	3,919	3,920	3,920	4,329	4,903
in months of following year's imports of goods and NFS	3.2	3.5	3.7	3.7	4.1	4.4	4.3	4.3	4.5	4.8
Gross usable international reserves 5/	2,320	2,249	2,629	2,688	2,947	3,146	3,184	3,184	3,559	4,100
in months of following year's imports of goods and NFS 5/	2.8	2.8	2.9	3.0	3.3	3.5	3.5	3.5	3.7	4.0
Net usable international reserves	2,085	2,031	2,430	2,488	2,761	2,963	3,014	3,014	3,423	3,997
in months of following year's imports of goods and NFS	2.6	2.5	2.7	2.8	3.1	3.3	3.3	3.3	3.6	3.9
Outstanding debt 6/	8,708	8,937	10,101	10,138	10,115	9,854	10,132	10,132	10,105	10,327
of which: short-term debt 3/ 7/	468	473	676	713	625	265	409	409	409	409
External debt to GDP ratio 6/	40.3	44.5	53.1	52.8	51.7	49.6	50.0	50.0	47.5	45.1
Short-term debt in percent of gross international usable reserves 3/ 7/ 8/	75.1	78.6	67.6					61.5	44.8	47.3
Short-term debt and current account deficit net of FDI in percent of gross international usable reserves 3/ 7/ 8/	72.8	56.5	52.4					49.7	36.3	40.0
External debt service	-1,055	-1,691	-1,674	-413	-378	-408	-309	-1,508	-1,928	-1,574
External debt service to exports ratio	12.3	20.8	19.3	24.3	17.7	11.2	15.5	15.9	19.3	14.9
GDP (millions of U.S. dollars)	21,628	20,063	19,030	4,665	5,117	5,452	5,021	20,276	21,277	22,906
GDP (millions of Kuna)	137,604	142,700	157,510	38,666	43,455	47,090	44,553	173,764	188,305	204,650
<u>Exchange rates</u>										
Kuna per Euro (pa)	7.08	7.58	7.64	7.66	7.43					
Kuna per US dollar (pa)	6.36	7.11	8.28	8.29	8.49					

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

1/ Based upon CNB balance of payments revisions of June 2001. Actual data: CNB reserves, external debt, currency and deposits, and merchandise trade through end-June, all other items through end-March.

2/ A significant proportion of the currency and deposit flows in 1998 and 1999 are the repatriation of foreign currency reposit requirements held at the CNB.

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

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

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

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

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

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

Table 5. Croatia: Implementation of Quantitative Performance Criteria, January-June 2001  
(In millions of kuna, unless indicated otherwise)

		End of				
		March	June			
1	Cumulative Deficit of the Consolidated Central Government 1/	program	3,500	3,850		
		actual	3,219	3,824		
		margin (+)	281	26		
2	Cumulative Increases in the Net Credit of the Banking System to the Consolidated Central Government 1/	program	-1,550	-2,300		
		actual	-756	-240		
		margin (+)	-794	-2,060		
3	Arrears of the Consolidated Central Government 1/	program	0	-1,500		
		actual	-457	-599		
		margin (+)	457	-901		
4	Cumulative Increases in the Net Credit of the Banking System to Selected Public Enterprises 1/	program	600	600		
		actual	251	-43		
		margin (+)	349	643		
5	Public and Publicly Guaranteed External Debt	program	500	100		
		a) Stock of Short-Term Debt 1/2/	<1 year	actual	394	366
			margin (+)	106	-266	
			program	1,250	1,300	
		>1 year	actual	921	990	
			margin (+)	329	310	
			program	250	250	
		b) Cumulative Increases in Nonconcessional Debt 1/ 2/	<5 years	actual	192	205
			margin (+)	58	45	
			program	-125	-11	
6	Cumulative Increases in the Net Usable International Reserves of the Croatian National Bank 2/ 3/ 4/	actual	151	496		
		margin (+)	276	507		
		program	197	1,086		
7	Cumulative Increases in the Net Domestic Assets of the Croatian National Bank 1/ 5/	actual	-1,680	-3,459		
		margin (+)	1,877	4,545		
		program				
<b>Memorandum item:</b>						
Central Government Wage Bill		program	3,715	3,523		
		actual	3,709	3,753		
		margin (+)	6	-230		

1/ Ceiling.

2/ In millions of U.S. dollars.

3/ Floor.

4/ The program floor for June and beyond has been raised by \$122 million due to the distribution in June of the former SFRY's assets held at the BIS and reduced in the June quarter only by \$121 million due to the delayed privatization of HT (see Annex VII of MEFP).

5/ The program ceiling has been raised by HRK1,049 million in the June quarter only due to the delayed privatization of HT (see Annex VIII of the MEFP).

Table 6. Croatia - Consolidated Central Government Fiscal Operations by Economic Category on an Accrual Basis, 1997-2003  
(In millions of kuna)

	1997	1998	1999	2000	2001				2001	2001	2001	2001	2002	2003
	Actual	Actual	Actual	Actual	Original Program	Revised Budget	Staff Projec.	Revised Program	Q1 Actual	Q2 Actual	Q3 Program	Q4 Program	MOF Proposal	MOF Proposal
Revenue and grants	52,623	62,813	61,122	62,801	64,783	65,236	65,355	65,355	14,353	16,744	17,065	17,193	66,876	71,162
Current revenue	52,623	62,813	61,122	62,801	64,782	65,234	65,354	65,354	14,353	16,744	17,064	17,192	66,875	71,161
Tax revenue	49,880	59,902	58,044	59,739	62,066	62,201	62,582	62,582	13,801	15,839	16,383	16,559	63,223	67,366
Personal Income tax	4,102	4,915	4,571	4,095	3,220	3,784	3,650	3,650	888	804	947	1,011	3,569	3,912
Social Security contributions	18,105	19,575	19,727	20,549	21,652	22,288	21,575	21,575	5,090	5,399	5,478	5,608	22,098	23,498
Profits tax	1,785	2,461	2,366	1,674	1,581	1,681	1,781	1,781	293	814	327	346	1,601	1,623
Real Estate Transactions tax	243	271	247	259	264	264	264	264	68	66	56	74	283	304
Taxes on goods and services	20,538	28,097	26,379	28,902	31,671	30,632	31,550	31,550	6,661	7,583	8,725	8,581	32,562	34,842
Sales tax	15,133	1,972	388	153	75	75	75	75	35	46	-3	-3	25	0
Value-added taxes	0	20,228	19,830	21,425	22,719	22,416	23,286	23,286	4,982	5,632	6,294	6,378	24,007	25,832
Excises	5,405	5,897	6,161	7,323	8,877	8,141	8,188	8,188	1,644	1,905	2,434	2,206	8,530	9,011
Custom duties	4,640	4,128	4,288	3,795	3,005	3,025	3,237	3,237	667	1,077	713	780	3,107	3,184
Other tax revenue	467	456	467	465	672	525	525	525	134	96	138	158	3	3
Non-tax revenue	2,743	2,911	3,078	3,063	2,716	3,034	2,772	2,772	552	905	681	633	3,652	3,795
Capital revenue	0	0	1	0	1	1	1	1	0	0	0	0	1	1
Grants	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Expenditure and net lending	55,149	66,973	71,614	71,735	73,839	74,458	75,881	74,309	17,536	17,590	19,933	19,250	74,426	73,731
Expenditure	54,538	65,894	70,115	70,559	73,009	73,628	75,051	73,479	17,450	17,425	19,643	18,961	73,596	72,901
Current expenditure	48,847	57,896	62,102	65,291	67,429	67,556	68,372	66,876	16,519	16,529	17,250	16,577	68,086	67,391
Expenditure on goods and services	26,134	32,345	31,528	33,091	30,576	30,208	30,658	30,171	7,087	7,901	7,406	7,777	30,644	30,192
Wages and employer contributions	12,744	15,037	16,686	18,143	16,517	16,574	16,504	16,504	4,425	4,432	3,913	3,734	16,546	16,546
Other purchases of goods and services	13,390	17,309	14,842	14,948	14,059	13,634	14,153	13,666	2,662	3,469	3,493	4,043	14,099	13,646
Interest payments	2,008	2,132	2,334	2,879	3,595	3,645	3,645	3,645	1,433	389	1,266	556	3,537	3,883
Subsidies and other current transfers	20,706	23,419	28,240	29,321	33,258	33,703	34,069	33,060	7,999	8,239	8,578	8,245	33,905	33,317
Capital expenditure	5,690	7,998	8,013	5,268	5,580	6,073	6,679	6,604	931	896	2,394	2,384	5,509	5,509
Lending minus repayments	611	1,079	1,499	1,176	830	830	830	830	86	165	289	289	830	830
Consolidated central government balance (as percent of GDP)	-2,526 -2.0	-4,159 -3.0	-10,491 -7.4	-8,934 -5.7	-9,056 -5.3	-9,223 -5.4	-10,526 -6.1	-8,955 -5.2	-3,183 -1.8	-846 -0.5	-2,868 -1.7	-2,058 -1.2	-7,550 -4.2	-2,569 -1.3
Financing	2,526	4,159	10,491	8,934	9,056	9,223	10,526	8,955	3,219	605	2,971	2,160	7,550	2,569
Privatization revenues	723	2,297	6,420	3,158	8,894	6,872	6,872	6,872	56	96	4,631	2,088	5,620	3,720
"Tax bonds" revenues	0	0	0	750	0	0	0	0	0	0	0	0	0	0
Foreign borrowing	3,112	87	4,632	6,396	1,770	3,949	4,070	4,070	4,116	-73	-1,485	1,512	901	2,647
Central budget, disbursements	4,204	2,319	5,906	10,599	7,936	10,104	9,864	9,864	5,627	56	2,411	1,771	6,089	5,805
Central budget, amortization	-1,218	-2,328	-1,291	-4,142	-6,166	-6,155	-5,794	-5,794	-1,498	-105	-3,914	-277	-5,188	-3,158
Central budget, net change in deposits	0	0	0	0	0	0	0	0	0	0	0	0	0	0
EBFs, net borrowing	126	96	17	-61	0	0	0	0	-14	-24	19	19	0	0
Domestic borrowing	-1,308	1,775	-561	-1,370	-1,608	-1,598	-416	-1,987	-953	582	-175	-1,441	1,029	-3,798
From other general government	0	0	0	0	-29	0	-29	-29	0	0	-20	-9	55	47
From other non-banking sector	103	2,833	1,123	-5,792	-1,581	-1,671	-1,369	-1,401	-197	66	-471	-799	1,605	1,167
Net change in arrears	0	2,638	1,164	-5,698	-1,500	-1,500	-1,499	-1,499	-457	-142	-450	-450	-750	-568
From banking sector	-1,411	-1,058	-1,684	4,423	2	73	983	-557	-756	516	316	-633	-631	-5,012

Sources: Ministry of Finance (MoF) and staff estimates

Table 7. Croatia : Monetary Accounts, 1999-2003

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

	1999	2000	2001				2002	2003	1999 6/ Percent change	2000 Percent change	2001 Percent change	2002 Percent change	2003 Percent change
			q1	q2	q3 prog.	q4 prog.							
<b>Monetary Survey 1/</b>													
Net Foreign Assets	16,695	29,276	31,374	30,565	39,199	40,225	43,579	47,385	31.3	75.4	37.4	8.3	8.7
Net Domestic Assets	40,004	44,045	46,388	49,143	48,761	50,101	60,801	66,544	-10.4	10.1	13.7	21.4	9.4
of which: domestic credit	65,939	72,290	75,791	78,921	79,390	82,043	95,048	105,822	-1.5	9.6	13.5	15.9	11.3
to government, net	11,403	12,766	12,011	12,527	12,843	12,210	11,579	6,567	59.9	12.0	-4.4	-5.2	-43.3
to other domestic sectors	54,536	59,523	63,780	66,394	66,547	69,832	83,469	99,255	-8.8	9.1	17.3	19.5	18.9
Broad Money	56,699	73,321	77,762	79,708	87,960	90,326	104,380	113,929	-1.1	29.3	23.2	15.6	9.1
Narrow Money	13,859	18,030	17,395	18,969	20,272	20,989	25,447	29,236	2.4	30.1	16.4	21.2	14.9
Currency outside banks	5,959	6,637	6,412	7,212	7,645	7,974	8,906	9,940	4.2	11.4	20.2	11.7	11.6
Demand deposits	7,900	11,394	10,983	11,756	12,626	13,015	16,540	19,296	1.1	44.2	14.2	27.1	16.7
Quasi Money	42,840	55,291	60,367	60,739	67,689	69,337	78,933	84,693	-2.2	29.1	25.4	13.8	7.3
denominated in kuna	5,874	8,390	9,660	9,689	10,962	11,213	13,968	15,112	0.6	42.8	33.7	24.6	8.2
denominated in foreign currency	36,966	46,902	50,706	51,050	56,727	58,124	64,965	69,581	-2.6	26.9	23.9	11.8	7.1
<b>Balance Sheet of National Bank</b>													
Net Usable International Reserves 2/ in US dollars	15,529	19,814	21,702	23,875	25,593	26,742	30,294	35,717	19.2	27.6	35.0	39.6	49.6
Net Foreign Assets	21,800	27,117	29,316	31,495	33,801	35,028	39,149	44,859	35.2	24.4	29.2	33.5	42.4
less: Banks' foreign currency reserves	4,636	5,491	5,676	6,511	7,210	7,388	8,258	8,844	177.9	18.4	34.6	45.5	35.8
CNB bills in foreign currency	1,635	1,813	1,937	1,110	998	898	598	298	15.8	10.9	-50.5	-69.2	-73.2
Net Domestic Assets 3/ of which: claims on government (net)	-5,219	-8,096	-10,356	-11,321	-11,988	-12,656	-13,216	-16,096	69.8	55.1	56.3	4.4	21.8
claims on banks	1,139	330	23	226	200	200	200	200	8.1	-71.0	-39.4	0.0	0.0
claims on other domestic sectors	277	290	275	270	250	250	250	250	27,843.9	4.6	-13.6	0.0	0.0
other items (net)	-4,293	-4,847	-5,471	-5,691	-6,135	-6,335	-7,399	-7,512	55.4	12.9	30.7	16.8	1.5
less: CNB bills in kuna	1,252	2,395	2,581	3,158	3,247	3,517	2,402	3,564	50.8	91.2	46.9	-31.7	48.4
blocked deposits 4/	381	315	261	295	290	290	290	290	219.4	-17.2	-7.9	0.0	0.0
Reserve Money	10,310	11,717	11,346	12,553	13,605	14,087	17,078	19,621	3.6	13.6	20.2	21.2	14.9
Currency	6,341	7,169	6,786	7,752	8,054	8,424	9,356	10,390	6.2	13.1	17.5	11.1	11.0
Deposits	3,969	4,548	4,560	4,801	5,551	5,663	7,722	9,231	-0.4	14.6	24.5	36.4	19.5
<b>Memorandum items:</b>													
Kuna/dollar exchange rate (eop)	7.65	8.16	8.72	8.65	...	...	...	...					
Narrow money multiplier	1.34	1.54	1.53	1.51	1.49	1.49	1.49	1.49					
Velocity of Kuna broad money	7.23	5.96	5.95	5.77	5.43	5.40	4.78	4.61					
Broad money/GDP ratio	0.40	0.47	0.48	0.48	0.52	0.52	0.60	0.61					
Foreign currency as a perc. of broad money	65.2	64.0	65.2	64.0	64.5	64.3	62.2	61.1					
Net Usable Int. Reserves at the program exchange rate 5/		2,327	2,479	2,823	3,002	3,055							
NDA of the National Bank at the program exchange rate 5/		-8,455	-10,136	-11,914	-12,416	-12,390							

Sources: Croatian National Bank and staff projections

1/ Data from Q2 1999 onwards exclude the assets and liabilities of the banks declared bankrupt in April 1999. Changes in the statistical reporting system introduced a break in the data in July 1999.

2/ See the definition in Annex VII of the MEFP.

3/ See the definition in Annex VIII of the MEFP.

4/ Blocked and restricted deposits, excluding required reserves in foreign currency.

5/ The kuna/dollar program exchange rate is equal to 8.6675.

6/ Growth rates for 1999 are affected by changes in the statistical reporting system and by the bankruptcy of various banks in the course of the year. The latter caused a drop in broad money of nearly 5 billion Kuna and a fall in domestic credit of roughly 5.4 billion. After adjusting for all these factors, estimates of the 1999 growth rate are 9.4 percent for broad money and -0.8 percent for credit to other domestic sectors.

Table 8. Croatia: External Financing Requirements and Sources, 1998-2003  
(In millions of U.S. dollars)

	1998	1999	2000	IMF Staff Projection		
				2001	2002	2003
<b>1. Gross financing requirements</b>	<b>3,051.3</b>	<b>3,450.6</b>	<b>2,739.9</b>	<b>3,185.8</b>	<b>2,838.0</b>	<b>2,699.2</b>
External current account deficit (exc. official transfers inflows)	1,608.2	1,466.6	488.6	814.4	472.7	530.6
Debt amortization	1,157.5	1,743.1	1,722.8	1,776.3	1,956.7	1,594.0
Medium and long term debt	716.6	1,274.7	1,296.1	1,100.8	1,547.5	1,184.8
Public sector	260.2	107.8	396.6	395.8	691.1	374.8
Multilateral 1/	...	65.5	82.0	82.2	72.8	72.8
Bonds and notes	...	40.5	146.2	239.2	530.7	161.2
Other	...	1.9	168.4	74.4	87.5	140.7
Commercial banks	154.7	643.3	482.3	175.4	305.3	356.7
Corporate private sector	301.8	523.6	417.3	529.7	551.1	453.2
Short-term debt 2/	440.9	468.4	426.7	675.5	409.2	409.2
Repayment of arrears	-	-	-	-	-	-
Gross reserves accumulation	276.6	209.5	499.7	564.7	375.3	541.2
IMF repurchases and repayments	8.9	31.4	28.7	30.4	33.3	33.4
<b>2. Available financing</b>	<b>3,165.1</b>	<b>3,890.2</b>	<b>2,996.1</b>	<b>3,661.3</b>	<b>3,126.0</b>	<b>3,049.2</b>
Foreign direct investment (net)	834.7	1,444.3	897.7	1,128.7	786.0	771.9
Debt financing from private creditors	2,218.1	2,698.9	2,764.9	2,333.0	1,962.9	1,849.2
Medium- and long-term financing	1,749.7	2,272.2	2,089.4	1,923.8	1,553.7	1,440.0
To public sector	263.0	911.9	1,066.6	1,309.7	697.3	650.0
<i>of which: balance of payments financing 3/</i>	15.0	614.8	879.2	951.3	409.3	300.0
To commercial banks	517.0	589.4	309.6	103.6	325.3	256.7
To corporate private sector	969.7	770.9	713.2	510.4	531.1	533.2
Short-term financing	468.4	426.7	675.5	409.2	409.2	409.2
<i>of which: balance of payments financing 3/</i>	0.0	75.7	400.0	0.0	0.0	0.0
Official creditors 4/	325.6	373.4	277.1	442.3	348.0	410.0
Multilateral 1/	325.6	373.4	277.1	442.3	348.0	410.0
<i>of which: balance of payments financing 3/</i>	-	-	-	100.0	100.0	0.0
Bilateral	-	-	-	-	-	-
To public sector	-	-	-	-	-	-
<i>of which: balance of payments financing 3/</i>	-	-	-	-	-	-
To private sector	-	-	-	-	-	-
IMF	-	-	-	-	-	-
Accumulation of arrears (exceptional)	-	-	-	-	-	-
Financing gap	-	-	-	-	-	-
Other flows 5/	-113.8	-439.6	-256.2	-475.5	-288.0	-350.0
<b>Memorandum item:</b>						
Total balance of payments financing	<b>15.0</b>	<b>690.5</b>	<b>1,279.2</b>	<b>1,051.3</b>	<b>509.3</b>	<b>300.0</b>

1/ Excluding the IMF.

2/ Original maturity of less than 1 year. Stock at the end of the previous period.

3/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.

4/ Includes both loans and grants.

5/ Includes all other net financial flows, and errors and omissions.



Table 9. Croatia: Selected Indicators of External Vulnerability,<sup>1/</sup> 1998-2001  
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2001	2001	
						Mar	Jun
<b>Economic indicators</b>							
RPI inflation, yearly change (c.o.p.)	5.4	4.4	7.4	6.0	4.9	3.8	July
Real GDP growth rate, yoy	2.5	-0.4	3.5	4.2	...		
Central government debt in percent of GDP 2/	26.2	32.7	38.1	46.4	...	44.3	May
domestic central government debt in percent of GDP 2/	10.9	11.7	13.6	15.5	...	15.1	May
foreign central government debt in percent of GDP 2/	15.3	21.0	24.5	30.9	...	29.2	May
Broad money (M4, percentage change, yoy)	13.0	-1.1	29.3	34.1	28.4		
Claims on other domestic sectors 3/ (change, yoy)	22.4	-8.8	9.1	14.8	18.8	17.2	May
35-day CNB-bill yield, monthly average, percent	9.5	10.5	6.7	6.6	...	6.3	May
35-day CNB-bill real yield 4/, percent	4.1	6.1	-0.8	0.6	...	-0.9	May
<b>External indicators</b>							
Real effective exchange rate (using retail prices) 5/, 1995=100	100.3	97.1	99.3	100.5	...	104.3	May
Export of goods and service (percentage change in US\$, yoy) 6/	4.3	-5.3	6.6	5.6	...		
Import of goods and service (percentage change in US\$, yoy) 6	-6.5	-8.0	-2.0	12.5	...		
Current account balance (US\$ million, yoy)	-1,531	-1,390	-399	-592	...		
Current account balance (yoy) in percent of GDP 2/	-7.1	-6.9	-2.1	-3.1	...		
Capital and financial account (yoy) in percent of GDP 2/	7.5	12.7	2.7	2.2	...		
Gross official reserves (US\$ million)	2,816	3,025	3,525	3,514	3,799	4,176	July
Gross official reserves in percent of broad money (M4)	31	41	39	39	41		
Gross official reserves in percent of reserve money	177	224	245	270	262		
Gross official reserves in months of imports of goods and NFS	3.2	3.7	4.4	4.3	4.4		
Net international reserves (US\$ million)	2,581	2,807	3,325	3,314	3,612		
Net international reserves in months of import of goods and NFS	2.9	3.4	4.2	4.0	4.2		
Short-term debt in percent of gross usable reserves 7/ 8/ 9/ 10/	75.1	78.6	67.6	...	...		
Short-term debt and current account deficit net of FDI in percent of gross usable reserves 10/	72.8	56.5	52.4	...	...		
Total external debt, percent of GDP 11/	40.3	44.5	53.1	52.8	51.7		
External debt service to export ratio	12.3	20.8	24.0	24.3	17.7		
<b>Financial market indicators</b>							
Stock market CROBEX index (1000 at July 1, 1997), c.o.p.	712	715	890	935	983	1,008	July
Zagreb Stock Exchange, capitalization, percent of GDP	13.3	13.5	14.1	15.9	16.8		
Bond yield spreads 2/2002 (U.S. treasury notes, e.o.p.)	...	347.9	237.6	107.7	143.3	169.5	July
Bond yield spreads 3/2006 (German bonds, e.o.p.)	...	360.8	235.1	198.4	143.4	174.7	July
<b>International ratings</b>							
Debt ratings: Moody's:							
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	August
Government bonds, domestic currency	...	Baa1	Baa1	Baa1	Baa1	Baa1	August
Fitch: Local currency LT	A-	BBB	BBB	BBB	BBB+	BBB+	August
Fitch: Foreign currency LT	BBB-	BB+	BB+	BB+	BBB-	BBB-	August
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	August
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	August
<b>Memorandum items:</b>							
Nominal GDP (US\$ millions) 12/	21,628	20,064	19,030	19,183	19,555		
Nominal exchange rate (HrK/US\$, e.o.p.)	6.25	7.65	8.16	8.72	8.65	8.37	August

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

1/ Italics indicate preliminary figures or program data.

2/ Quarterly figures may be affected by the quarterly annualized GDP.

3/ Claims on domestic sector excluding central government and government funds.

4/ The 35-day CNB bill yield minus the annual percentage change in the retail prices.

5/ An increase in the index reflects a depreciation: end-year figures indicated annual average

6/ In January 2000, a new methodology, in line with European standards, for processing data on imports and exports was adopted. The new presentation uses the date when the declaration was cleared rather than the date when the declaration was received.

7/ Data for short-term commercial bank credits derived from the CNB Foreign Exchange Department.

8/ Coverage limited to short-term debt contracts registered with the CNB.

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

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

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

12/ Using the average exchange rate for the period.

**CROATIA—RELATIONS WITH THE FUND**  
(As of July 31, 2001)

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

<b>II. General Resources Account:</b>	<u>SDR million</u>	<u>% Quota</u>
Quota	365.10	100.0
Fund holdings of currency	475.47	130.2
Reserve position in Fund	0.16	0.0

<b>III. SDR Department:</b>	<u>SDR million</u>	<u>% Allocation</u>
Net cumulative allocation	44.21	100.0
Holdings	100.10	226.4

<b>IV. Outstanding Purchases and Loans:</b>	<u>SDR million</u>	<u>% Quota</u>
Extended arrangements	28.78	7.9
Systemic Transformation Facility	81.75	22.4

**V. Financial Arrangements:**

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

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

	<u>Overdue</u>	<u>Forthcoming</u>				
	<u>5/31/2001</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Principal	--	13.3	26.6	26.6	26.6	10.2
Charges/Interest	--	<u>2.4</u>	<u>3.8</u>	<u>2.7</u>	<u>1.5</u>	<u>0.5</u>
Total	--	15.7	30.4	29.3	28.1	10.7

**VII. Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the Croatian National Bank (CNB) is subject to a full Stage One safeguards assessment with respect to the Stand-By arrangement, which was approved on March 19, 2001, and is scheduled to expire on May 18, 2002.

The Stage One safeguards assessment of the CNB is underway.

### VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with occasional participation of the Croatian National Bank. The authorities' exchange rate policy regarding the Croatian kuna is accordingly classified as "managed floating with no pre-announced path for the exchange rate". The Croatian National Bank transacts only in euros, U.S. dollars, and SDRs. On August 31, 2001, the official exchange rate was kuna 8.3725 per U.S. dollar (middle rate).

### IX. Article IV Consultation and Recent Use of Fund Resources

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

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

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

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

### X. FSAP Participation:

Croatia agreed to participate in the FSAP. The first FSAP mission took place in April 2001 and the second mission took place in September 2001.

**XI. Technical Assistance 1992–2001**

<b>Department</b>	<b>Timing</b>	<b>Purpose</b>
FAD	November 1992	Tax Policy and Administration
	May 1993	VAT and Tax Administration
	November 1993	Public Expenditure Management
	March 1994	Treasury Establishment
	August 1994	Budget Preparation Mission
	November 1994	Follow up Mission on Treasury Establishment
	March 1995	Treasury Management Seminar
	August 1995	Treasury implementation
	Nov.–Dec.1995	Treasury implementation
	June-July 1997	Impact of VAT
	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
STA	December 1992	Multi-topic mission
	October 1993	Monetary Statistics
	November 1993	Government Finance Statistics
	April 1994	Money and Banking Statistics
	July 1994	National Accounts
	November 1994	Balance of Payments
	January 1995	Money and Banking Statistics (together with EU1 mission)
	February 1996	BOP mission
	September 1996	National Accounts
	January 1998	Balance of Payments
	January 1998	Data Dissemination Standard
	February 1998	Quarterly National Accounts
	September 1998	Quarterly National Accounts
	November 1998	Quarterly National Accounts
	January 1999	Quarterly National Accounts
	February 1999	Balance of Payments
	June 1999	Quarterly National Accounts
	July 1999	Producer Price Indices
	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
October 2000	Quarterly National Accounts	
April 2001	Monetary Statistics	
MAE	December 1992	Bank Supervision
	October 1993	Monetary Instruments; Exchange Market
	January 1994	Monetary Operations and Banking

	May 1994	Supervision; Exchange Market Payments System, Monetary Operations, Foreign Exchange, Banking Supervision, and Accounting
	Aug. 1994–Aug. 1995	Monetary Operations (9 expert visits)
	October 1994	Monetary Operations Review
	December 1994	Payments system
	Jan.–Feb. 1995	Monetary Operations, Organization and Management, and Foreign Reserve Management
	Feb.–Dec. 1995	Payments System (4 expert visits)
	Aug. 1995–Apr. 1996	Monetary Operations (5 expert visits)
	September 1995	Foreign Exchange Management
	November 1995	Foreign Exchange, Public Debt, Monetary Policy
	September 1996	Interbank and Government Securities Markets, Internal Audit, Foreign Reserve Management
	October 1996	Foreign Exchange Management
	November 1996	Payments System
	March 1997	Foreign Exchange Management (expert visit)
	April 1997	Banking Law Issues (staff visit with LEG)
	April 1997–Feb. 1998	Accounting (6 expert visits)
	July 1997	Banking Sector Strategy (staff visit)
	September 1997	Banking Sector Strategy and Banking Law Issues
	Sept.–Nov. 1997	Information Technology (2 expert visits)
	Mar. 1998–Mar. 1999	Accounting (resident advisor)
	Apr. 1998–Aug. 1999	Banking Supervision (resident advisor)
	April–June 1998	Foreign Exchange Management (2 expert visits)
	May 1998	Banking Law Issues (2 staff visits)
	August 1998	Banking Soundness and Banking Law Issues
	November 1998	Banking Supervision (with WB mission)
	March–Dec. 1999	Banking Supervision (resident advisor)
	April 1999	Foreign Exchange Operations and Reserves (two expert visits)
	November 1999	Accounting
	May-June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March-April 2001	Central Bank Accounting
INS	1993–97	Fiscal Policy Management (7 participants)
	1993–99	Monetary and Banking Statistics (6)
	1994	Basic Economics (1)
	1994	Tax Policy Administration (1)
	1994–95	Public Expenditure Policy and Management (2)
	1994–96	Government Finance Statistics (5)
	1994–96	External Sector Policies (3)
	1994–97	Comprehensive Course in Applied Market

	Economics (7)
1994–98	Central Bank Accounting (5)
1994–99	Foreign Exchange Policies and Operations (5)
1995	Public Finance (1)
1995	Tax Policy in Transition Economies (1)
1995	Value Added Tax (1)
1995–97	Financial Market Instruments (2)
1995–97	Financial Programming Policy (2)
1995–98	Banking Supervision (2)
1995–98	Techniques of Financial Analysis and Programming (4)
1995–99	Balance of Payments (3)
1995–99	Macroeconomic Analysis and Policy (9)
1995–99	Public Expenditure and Treasury Management (7)
1996	Financial Transactions for Lawyers (1)
1996–97	Tax Administration and Reform (2)
1997	Payment System (1)
1997	Banking Soundness and Monetary Policy in World of Global(1)
1997–98	Monetary Operations (2)
1998	Current Legal Issues Affecting Central Banks (1)
1998	Monetary and Exchange Operations (1)
1998	Specialized Course on Exchange Rate Policies (1)
1998	Trade and Exchange Rate Policies (1)
1999	A Decade of Transition: Achievements and Challenges (1)
1999	Management and Operational Issues for Central Bank Accountant (1)

## **XII. Resident Representative**

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

### **CROATIA: RELATIONS WITH THE WORLD BANK**

1. Croatia succeeded to the membership of the Socialist Federal Republic of Yugoslavia (SFRY) in the World Bank in 1993. Croatia is current on its debt service payments in accordance with an agreement on debt apportionment reached with the Bank whereby Croatia assumed debt service responsibility for Bank loans benefiting borrowers on its territory.
2. Currently, there are twelve Bank supported projects (11 investment projects and 1 adjustment operation) totaling US\$594.1 million under implementation in Croatia: The Highway Sector Project (US\$80 million) became effective in July 1997 and a Farmer Support Service Project (US\$17 million) in July 1996. An Emergency Transport and Mine - Clearing Project (US\$102 million) became effective in March 1997, a Coastal Forest Reconstruction and Protection Project (US\$42 million) in July 1997, and an Enterprise and Financial Sector Adjustment Loan (EFSAL) (US\$95 million) in November of the same year. Furthermore, an Investment Recovery Project (US\$30 million) became effective in March 1998 and the Eastern Slavonia Reconstruction Project (US\$40.6 million) in January 1999. The Municipal Environmental Infrastructure Project (US\$36.3 million) was approved in June 1998, the Railway Modernization and Restructuring Project (US\$ 101 million) in January 1999, a Technical Assistance Loan II (US\$7.3 million) in April 1999, a Health System Project (US\$29 million) in October 1999 and the Trade and Transport Facilitation in South-East Europe (US\$13.9 million) in May 2001. A Commercial Courts and Bankruptcy Management Learning Instrument Loan (US\$5 million) has been approved in June but is not yet effective.
3. Investment projects under preparation include: a Pension Reform Implementation project, a GEF activity, a District Heating project, a Land Registry/Cadastre project, a Municipal Water Pollution Control project, and a Rijeka Port/Road Betterment project. Furthermore, projects on Social Protection and Health Sector Reform are under consideration.
4. The essential preconditions for economic growth are fiscal consolidation and supportive macro policies and deeper structural reforms, including those to reduce the level of public expenditures and the size of the state, pension and health sector reforms, safeguarding confidence in the banking system, enhancing enterprise efficiency, strengthening market institutions and competitiveness in the economy to attract FDI, and mitigation of the social cost of reforms and poverty through restructuring social spending programs. Progress is being made in these areas. A Public Expenditure and Institution Review (PEIR) has been completed, and a US\$202 million Structural Adjustment Loan (SAL) has been successfully negotiated in June 2001 and is expected to be submitted for Board approval next October. The PEIR and SAL were key elements of the Bank's assistance strategy in the 1999 CAS. Because of Croatia's greatly improved prospects for European integration, the Bank is ready to provide not only lending but also non-lending assistance in support of the country's accelerated accession process with the EU.

5. After consultations with the Government and stakeholders in country, the World Bank has prepared Progress Report on the 1999 CAS, which is now scheduled for Board discussion in September 2001.

6. IFC has approved nine investments in Croatia to date: (1) the acquisition of a US\$2.6 million equity stake in a Croatian bank; (2) a US\$13.3 million loan investment in a cement company; (3) a US\$4 million loan to a small regional bank based in Split, for the financing of small and medium-sized enterprises; (4) a US\$6.2 million equity investment and a US\$14.1 million loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility; (5) a US\$5.0 million equity investment in a venture capital fund; (6) a US\$15 million loan to a regional bank for a credit line for on-lending to small and medium-sized enterprises; (7) a US\$3 million equity investment in a pension management company to be founded under Croatia's landmark pension reform law; (8) a US\$6 million loan and US\$6.1 million equity investment to modernize a ship repairing facility in Rijeka, and (9) US\$6 million loan and US\$10 million equity in the leading pharmaceutical complex in Croatia. IFC is seeking to expand its activities in Croatia, focusing on financial market development, restructuring industry, tourism, infrastructure privatization, restructuring on the oil sector and private sector involvement in health care.



## **CROATIA: STATISTICAL ISSUES**

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

### **A. National Accounts**

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

### **B. Prices**

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

### **C. Wages and Employment**

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

cover a significant part of the working population, including persons employed in trade and crafts, contract workers, farmers, and military and police workers.

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

#### **D. Fiscal Data**

6. A large amount of data on government finance statistics is produced on a monthly basis with lags of between three and twelve weeks, and is available in the Monthly Statistical Review of the Ministry of Finance or provided directly to the Fund. Revenue data on a GFS basis are reliable and available on request on a next-day basis for most major categories for both the budget and the extrabudgetary funds. In 2000, the inclusion of outstanding receivables cancelled against arrears in off-setting operations diminished the transparency of the central budget accounts. Expenditure data on a cash basis are available according to GFS methodology (economic and functional classification) for the budget and the extrabudgetary funds. These data, however, record the release of expenditure authorizations by the Ministry of Finance, rather than the actual expenditure of funds. Data on financing by non-cash methods and budget users "own revenues" are not published, but the authorities have provided information to the staff more readily than in the past. The data on central government financing in the Ministry of Finance reports, the monetary survey and the balance of payments are not reconciled. The reliability of fiscal statistics is expected to improve considerably under a comprehensive treasury system scheduled to operate from the beginning of 2001.

7. Data on the stock of government debt suffer from certain deficiencies although a new Croatian National Bank database represents a major improvement. The detailed data on domestic public bonds published in the Monthly Statistical Review of the Ministry of Finance are now compounded by a central government debt table in the Croatian National Bank Bulletin, which also reports stocks of central government guaranteed debt. However, data on publicly guaranteed debt, expenditure arrears –formally recorded for the first time at the end of 1999–, promissory notes and receivable issues linked to banks privatization are not included.

8. Data on the operations of local governments and consolidated general government are available only on an annual basis and with a considerable lag.

### **E. Monetary Data**

9. Data on the monetary survey and the balance sheet of the Croatian National Bank (CNB) and deposit money banks are published monthly with an approximate six week lag. Key data such as currency in circulation, reserve deposits, and international reserves of the CNB are available on request with a one-day lag. A new statistical reporting system which enables banks to report in a single set of forms their balance sheets, reserve requirements, interest rates, etc., was introduced on July 1, 1999, together with a new chart of accounts. No attempt is made by the CNB or the Ministry of Finance to reconcile the data on net bank credit to government with government financing statistics.

### **F. Banking Statistics**

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

### **G. Balance of Payments Data**

11. Balance of payments data are compiled on a quarterly basis according to the fifth edition of the IMF's Balance of Payments Manual, and published by the CNB making use of information from commercial banks, the CNB, and the Ministry of Finance, among other entities. The data are generally available with a lag of two to three months and are subject to substantial revisions in subsequent releases; however, trade data are available with a lag of four to six weeks and data on international reserves are available the next day by request. In January 1998 a major revision of balance of payments statistics took place which led to the evaluation of imports on an f.o.b. basis and the inclusion of goods imported into free trade zones. The new surveys introduced in 1999 on transportation, travel, government services, and labor income have only been partially successful. The quality of data, particularly on travel, transfers, and currency and deposits is still questionable. Improvements are also needed in the compilation of data on communication, insurance, and construction services. During 1999 and 2000, the CNB has increased the coverage of direct investment by identifying additional enterprises. The coverage and quality of portfolio investment data are reasonably complete and accurate.

12. The coverage of external debt data improved in 1999 with the publication of information on external debt by debtor. A large part of Croatia's external debt was contracted prior to the dissolution of the former SFRY and Croatia's share was agreed with Paris and London Club creditors in 1995 and 1998, respectively. This information has further improved in 2000 with the introduction of the new CNB database. Foreign debt statistics are available on request on the same day, but certain breakdowns (e.g., external public and publicly

guaranteed debt by creditors), loans received by the resident household sector, and credits received with a maturity of less than 90 days are not covered in the standard reports. Also, there is still a problem of identifying payments arrears; however, the authorities are in the process of updating their database for earlier years in order to identify genuine arrears, if any, and record them in the balance of payments.

**Table 10. Croatia: Core Statistical Indicators  
As of August 31, 2001**

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/Imports	Current Account Balance	Central Government Balance	GDP	External Debt/Debt Service
<b>Date of Latest Observation</b>	August 31, 2001	August 31, 2001	August 31, 2001	August 31, 2001	July 31, 2000	August 31, 2000	Jul-2001	Jul-2001	Q1 2001	Jun-2001	Q1 2001	June 30, 2001
<b>Date Received</b>	August 31, 2001	August 31, 2001	August 31, 2001	August 31, 2001	August 23, 2001	August 31, 2001	August 30, 2001	August 30, 2001	June 4, 2001	Jul-2001	August 30, 2000	July 24, 2001
<b>Frequency of Data</b>	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
<b>Frequency of Reporting</b>	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly
<b>Source of Update</b>	CNB Website	CNB Website	CNB Website	CNB Website	CNB Website	CNB Website	CBS Website	CBS Website	CNB Website	Ministry of Finance	CBS Website	CNB Website
<b>Mode of Reporting</b>	On-line	On-line	E-mail	E-mail	E-mail	E-mail	On-line	On-line	E-Mail	E-Mail	On-line	E-Mail
<b>Confidentiality</b>	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
<b>Frequency of Publication</b>	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

**CROATIA: IMPLEMENTATION OF STRUCTURAL MEASURES NOT SUBJECT TO FUND  
CONDITIONALITY**

**A. Fiscal Sector**

1. Significant slippage occurred in the health sector. Strong opposition prevented the government from implementing the planned reduction of sick-pay benefits in the first quarter (item 4a in the attached table), which will now be included in the draft law on health services to be approved by year-end. The same law will redefine the criteria for the provision of basic health services (item 4e). Co-payments were raised in August, but their increase was limited to drugs (item 4b). Together with a revision of the drug list, an additional co-payment rate of 10 percent has been added to the existing rates of 25 percent and 50 percent, increasing from 62 to 145 the number of drugs for which co-payments are required. Performance-based reimbursements for basic medical services (item 4f) will be introduced on January 1, 2002 as part of a new system of payments for hospital services. The treasury single account (item 1 and 2) has been successfully introduced, even though the closure of accounts of spending unit is proceeding slowly. The monitoring system for government guarantees and lease contracts (item 3) is still being developed and has become part of World Bank SAL conditionality.

**B. Public Enterprises**

2. Progress in this area has been very slow. The second phase of the privatization of the telecommunications company (HT), which had constituted a structural benchmark under the program, was delayed because of unfavorable market conditions and the IPO is now expected to take place by year-end (item 2). The definition of a regulatory framework for the energy sector, which is a prerequisite for the privatization of the electricity company (HEP) and the petroleum company (INA), was delayed (item 6), with cascading effects on the restructuring process (items 7 and 8) and the privatization of these companies (item 10). The government has also encountered difficulties in implementing its resolution to privatize or liquidate the enterprises listed in the law on rehabilitation of public enterprises (item 11).

**C. Monetary and Financial Sector**

3. Some minor slippages occurred also in the reform agenda for the monetary and financial sector. The most relevant one is the delay in submitting to parliament the draft of the new banking law due to an extensive consultation process (item 3a). The implementation of other items on the agenda, like the review of current banking regulations and practices (item 6a) and the adoption of consolidated supervision for financial conglomerates (item 6d), will also be delayed as they are included in the new draft law. A new securities law is also being prepared (item 6b) and approval is now expected by year-end. Some resource constraints are hampering efforts to improve insurance supervision (items 6e and 6f).

**D. Judicial System**

4. Measures to strengthen the capacity of commercial courts to settle bankruptcy procedures are now being funded by a World Bank loan (LIL) and are therefore under its conditionality, with deadline for implementation by end-September 2001.

Table 11. Croatia: Structural Measures

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



**Table 11. Croatia: Structural Measures (continued)**

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

Table 11. Croatia: Structural Measures (continued)

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

1/ Institution primarily responsible for providing technical assistance and general advice for implementing the structural measure(s) concerned. Except where explicitly footnoted, the structural measures listed in this matrix do not represent program conditionality.

2/ Copayments have been introduced for drugs only.

3/ Structural benchmark.

4/ Of the five laws approved by parliament in July, the one on regulation of energy services is already in force. The other four laws will become effective on January 1, 2002.

Zagreb, Croatia  
August 29, 2001

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

Dear Mr. Köhler:

1. We are happy to report that the macroeconomic objectives of our economic program for 2001, which is supported by the International Monetary Fund through a 14-month stand-by arrangement in an amount of SDR 200 million, are likely to be either fully met or substantially exceeded. More specifically, we are confident to achieve this year economic growth of 4 percent and reduce retail price inflation to 4.5 percent on an end-year basis, while exceeding the targeted gain of net international reserves by a large margin.
2. Although we have experienced delays in the implementation of some important measures of our program, much has been achieved and the recent parliamentary vote of confidence in the government has re-energized us to bring the implementation of our program back on track. The attached Supplementary Memorandum of Economic and Financial Policies for 2001 (the Memorandum) (i) reports on program implementation to date and on the measures we will implement in the remainder of this year in pursuit of our program objectives, and (ii) proposes the quantitative performance criteria for September 30 and December 31, 2001. In particular, the measures described in the Memorandum will allow us to keep the deficit of the consolidated central government at 5.3 percent of GDP, in accordance with the original program. The attached Memorandum supplements the Memorandum of Economic and Financial Policies that is attached to our January 31, 2001 letter to the Managing Director of the International Monetary Fund and continues to represent our policy undertakings in all respects not specifically addressed in the attached Memorandum.
3. On the basis of our performance under the arrangement so far and the policies described in the Memorandum, we request (i) waivers for the nonobservance of the performance criteria on wage policy implementation, on domestic bank borrowing and arrears of the consolidated central government, and on short-term public debt and (ii) the completion of the first review under the arrangement. In order to allow sufficient time for the preparation of relevant documents for the Fund's Executive Board, we also propose postponing the second and final review from November 30 to December 31, 2001.

4. We believe that the policies described in the attached Memorandum are adequate to achieve the objectives of our economic program, but we stand ready to take any further measures to keep our program on track. We will remain in close consultation with the Fund in accordance with the Fund's policies on such consultations. The second program review will provide one such opportunity to assess progress with program implementation and reach understandings on any measures that may be needed to achieve the program's objectives.

5. We would like to reaffirm our intention not to make the purchases that will become available under the arrangement with the completion of the present review and after completion of the second review and observance of the performance criteria for September 30 and December 31, 2001.

Sincerely yours,

/s/  
Slavko Linić  
Deputy Prime Minister

/s/  
Mato Crkvenac  
Minister of Finance

/s/  
Željko Rohatinski  
Governor  
Croatian National Bank

Attachment: Supplementary Memorandum of Economic and Financial Policies

## SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. We remain committed to the objectives of the economic program for 2001–03 as outlined in the Memorandum of Economic and Financial Policies attached to our letter of January 31, 2001 to the Managing Director of the International Monetary Fund. In pursuit of these objectives, we have reviewed its implementation during the first half of 2001 and adopted the policies described in Section III to achieve our program objectives in the second half of the year.

### I. RECENT ECONOMIC DEVELOPMENTS AND NEAR-TERM OUTLOOK

2. Notwithstanding the slowdown in major trading partners, the Croatian economy is growing strongly. After an expansion of 3.7 percent in 2000, the economic recovery continues and our growth objective of 4 percent for this year is likely to be achieved despite weaker external demand (Annex I). Real GDP grew by 4.2 percent year on year in the first quarter and high-frequency indicators of economic activity (retail sales, industrial production, and tourist nights) indicate that growth remained robust in the second quarter. Indications are that the third-quarter tourist season is very strong despite lingering regional tensions and some exchange rate appreciation. While private consumption remains buoyant due to larger social transfers and lower income taxes, strong imports of machinery, equipment and intermediate goods and a revival of credit to private enterprises indicate that the expected pickup of business investment is underway.

3. We also expect to achieve our inflation objective for 2001. After remaining high during the first five months of the year as a result of rising oil prices, seasonally accelerating food prices, and an increase in excise taxes, the twelve-month rate of retail price inflation fell to below 4 percent during the following two months and is expected to be no more than 4.5 percent by year end. Subdued producer price inflation and a stable core rate of retail price inflation support this expectation, notwithstanding increases in the administered prices of electricity and natural gas.

4. Our original program's international reserves target is certain to be exceeded and we have tightened our monetary program as outlined in Section III below. Despite a temporary weakening in the first half, mainly due to a surge of car imports, and the expected continued underlying growth of imports, the external current account deficit is projected to be around 3½ percent in 2001. Strong tourism receipts and the recovery of manufacturing exports support this forecast. Improved access to foreign markets, the political normalization in the region, and continued fiscal consolidation suggest that the large current account deficits of the past are unlikely to recur. This year's deficit will be more than financed by privatization receipts and government bond placements in the international capital markets. We were pleased to note that Croatia has so far remained immune to the recent turmoil in emerging market economies and that the spreads on our international bonds continued to narrow during most of this period, while the exchange rate of the kuna continued to firm, prompting the Croatian National Bank (CNB) to intervene in the foreign exchange market.

## II. PROGRAM IMPLEMENTATION AND PERFORMANCE

5. Notwithstanding the delayed implementation of certain important policy measures, we are broadly satisfied with the performance under our program. All quantitative performance criteria for end-June 2001 were observed, except for the ceilings on bank borrowing and arrears of the consolidated central government and on short-term external public debt (Annex II). All three breaches were related to the delayed privatization of the telecommunication company (HT). Despite the delayed implementation of the new wage policy in the government sector, which caused the end-March structural performance criterion to be breached, we managed to observe the end-June performance criterion on the deficit of the consolidated central government by a narrow margin. By contrast, the performance criteria on net usable international reserves and net domestic assets of the CNB (and the limits on external public debt contracting and public enterprise borrowing) were observed with comfortable margins.

6. Our principal fiscal policy achievement in the first half of 2001 was the adoption of a new wage policy for government workers after the May local elections. New wage coefficients were established across most ministries and a new basic wage was set at such a level as to ensure the originally programmed 9 percent reduction of the wage bill of the consolidated central government. The late implementation of the new wage policy and the exclusion therefrom of workers in the ministries of education, science and technology, and—on a temporary basis—defense means that the wage bill in the budgetary sphere will be exceeded by some 0.2 percent of GDP in 2001, but the extension of the policy to the extrabudgetary funds (and particularly health care workers) will entail offsetting wage bill savings in the rest of the central government. . Contrary to program assumptions, however, we have not been able yet to reduce sick pay benefits, and child benefit payments are substantially exceeding their budgetary allocation.

7. Supported by exchange rate appreciation and banking system stability, the remonetization of the economy progressed faster than expected and base money demand was stronger than programmed. As banks repatriated a large part of their substantial foreign holdings to extend credit to the domestic economy, the CNB supported the easing of domestic lending rates by lowering its Lombard rate from 12 percent to 9.5 percent in March. Thereafter, with tourism inflows adding to the exchange market pressures, the CNB intervened repeatedly in the foreign exchange market, largely sterilizing its interventions through subsequent sales of CNB bills. In addition, the CNB reduced the reserve requirement rate from 23.5 percent to 22 percent and extended its base to include foreign currency loans. This measure, which was phased in during June-July, served to increase the supply of kuna while increasing the demand for foreign exchange.

8. As noted, we experienced delays with the second phase of privatizing HT. In the face of depressed international stock market valuations, we decided to postpone the initial public offering of at least 20 percent of the company's shares, but instead reached agreement with Deutsche Telekom in July on the sale of 16 percent of the company's capital, raising Deutsche Telekom's stake in HT to 51 percent. Privatization advisors have been appointed

for the power (HEP) and oil (INA) companies and five laws on energy sector reform were approved by parliament in July, with the law on energy services regulation taking effect immediately.<sup>1</sup> Other important reforms introduced so far include the introduction of a single treasury system for all government ministries in January 2001 and its extension to the pension fund at midyear, the amendment of the foreign exchange law, a new central bank law, and a new law on local and district self-government. Drafts of a new banking law and a health reform law have also been prepared.

### **III. POLICIES FOR THE REMAINDER OF 2001**

#### **A. Fiscal Policy and Government Sector Reform**

9. We remain committed to the reduction of the deficit of the consolidated central government to 5.3 percent of GDP as the centerpiece of our economic program for 2001. Although at 5.7 percent of GDP the deficit in 2000 turned out to be lower than expected, this represents an adjustment effort of 3.9 percent of GDP as tax reductions during 2000 and at the start of 2001 are lowering this year's revenue ratio by 2.3 percent of GDP and court-mandated special pension payments are adding 1.2 percent of GDP to the expenditure ratio. The central government budget was amended at midyear to bring pension fund operations on the budget and to replace expenditure devolved to the local governments by transfers of the taxes earmarked for this purpose. The revised budget also reduced privatization receipts from 5.2 percent of GDP to 4.0 percent of GDP, with an attendant increase in foreign borrowing. When making these changes, we realized, however, that slippages on the expenditure side, mainly related to much higher than budgeted child benefits, the postponement of health sector reform, and unforeseen additional recapitalization of the state-owned postal bank (HPB), required additional fiscal measures to prevent the deficit from exceeding 5.3 percent of GDP.

10. With a shortfall in excise tax collections being offset by higher value added taxes, total revenue is projected to remain fully in line with our original program.<sup>2</sup> As we are committed to reducing the burden of taxes and social contributions in future years, we have, with the exceptions noted in footnote 2, ruled out revenue increases to achieve our deficit

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<sup>1</sup> We expect a one-quarter delay in the parliamentary approval of the two privatization laws for HEP and INA, respectively. Both laws are currently being prepared in the Ministry of Economy and will be submitted to parliament by end-September. Parliamentary approval is now expected by end-December 2001, compared with the end-September 2001 structural benchmark under our original program.

<sup>2</sup> For program purposes, the revised revenue projection has been reduced by the equivalent of 0.1 percent of GDP to account for the failure of the central government to transfer to the new highway construction agency (Croatian Highways) the full amount of revenue envisaged in the original program.

target in 2001. Instead, almost the entire adjustment will be achieved through expenditure reductions.

### Planned Fiscal Savings

The planned fiscal savings, which fall predominantly on the expenditure side, will mostly be achieved by permanent measures that require parliamentary approval and, in the case of means testing of child benefits, the issuing of a government decree. Most of these permanent measures aim at rationalizing the social transfer system by either fully aligning or partially harmonizing benefits for privileged groups (e.g., war veterans, members of parliament, or scientists) with existing benefits for the general population. In addition to these permanent measures, we have identified specific one-off measures to reduce certain subsidies and transfers and expenditure on goods, nonwage services, and capital investment to below budgetary allocations. Taken together, these measures are estimated to produce savings equivalent to almost 1 percent of GDP in 2001. These estimates still exclude further savings expected from rationalizing expenditure in the education sector (e.g., by closing schools and kindergartens with very low attendance) and introducing a single registry for all recipients of social transfers.

	2001	2002
	(in millions of HRK)	
<b>Permanent measures</b>	<b>1,001</b>	<b>2,706</b>
<i>In percent of GDP</i>	<i>0.58</i>	<i>1.44</i>
Benefit rationalization	233	933
Reduction in general benefits	768	1,773
<b>Discretionary measures</b>	<b>655</b>	<b>n.a.</b>
<i>In percent of GDP</i>	<i>0.38</i>	<i>n.a.</i>
Subsidies and transfers	367	n.a.
Goods and nonwage services	212	n.a.
Capital spending	76	n.a.
<b>Total</b>	<b>1,656</b>	<b>2,706</b>
<i>In percent of GDP</i>	<i>0.95</i>	<i>1.44</i>

11. Based on an estimated adjustment need of 0.8 percent of GDP, we have decided on the following expenditure cuts (Box). As part of our preparation of the budgets for 2002 and 2003 and of a comprehensive attempt to rationalize our ill-coordinated system of social transfers, we are preparing amendments to eleven laws that will reduce spending on special pensions, child benefits, disability and home care allowances, maternity leave, and sick pay



by about 1.4 percent of GDP annually on a permanent basis.<sup>3</sup> The effect of these measures, which are expected to be adopted by parliament in September, during the remainder of this year will be almost 0.6 percent of GDP. New labor and defense laws will also be sent to parliament in September, and we expect additional savings, especially from layoffs of military service staff, during 2002–03. Additional expenditure savings of almost 0.4 percent will be achieved during the remainder of 2001 through discretionary cuts of spending on goods and nonwage services, subsidies, and capital investment that are being implemented with immediate effect. We are confident that these measures, which should produce somewhat more than the adjustment required, will limit the fiscal deficit to 5.3 percent of GDP; but we will in any case take any additional measures needed to avoid exceeding this limit in 2001. Performance criteria for end-September and end-December have been established to this effect (Annex IV). A revised budget incorporating all these measures will be sent to parliament in September. Approval of the eleven law amendments and of the revised budget will be a prior action for the completion of the first review (Annexes III and IX).

12. As noted, our revised financing plan for 2001 envisages privatization receipts equivalent to 4.0 percent of GDP. More than one half of that amount is expected to be realized in September from the recent agreement to sell 16 percent of HT's shares to Deutsche Telekom. The remainder will be ensured by the privatization of Croatia Banka and Dubrovačka Banka, for which final bids are expected in October, and by a combination of options that include the privatization of the insurance company, the public sale and sale to employees of additional shares of HT, and the sale of residual government share holdings in previously privatized banks and companies.<sup>4</sup> Net foreign borrowing will rise to 2.3 percent of GDP with the recent augmentation of the € 500 million euro bond by € 250 million and expected EFSAL (DM 80 million) and SAL (US\$100 million) disbursements from the World Bank. The residual domestic financing surplus of 1.0 percent of GDP will be used almost entirely for arrears reduction. In the remainder of the year, the government will retire a portion of outstanding Treasury bills and replace them with medium-term euro-denominated domestic bonds. Performance criteria for net bank borrowing and arrears of the consolidated central government have been established (Annex IV). Similarly, performance criteria have been established in the form of ceilings on short-term external public debt and the contracting and guaranteeing of nonconcessional external public debt with a maturity of more than one year (Annex V).

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<sup>3</sup> Some of the savings, such as those arising from the lowering of the income tax threshold for pensions and the increase in copayments for medicines and medical services, will accrue on the revenue side.

<sup>4</sup> In the unlikely event of shortfalls, we will seek external bridge financing of future privatization receipts.

13. We have begun to decentralize primary and secondary education, primary health care, and retirement homes, initially limiting the local governments' financial responsibility to the maintenance of physical infrastructure and spending on materials. The resources earmarked for the local governments to defray these expenses are being transferred from the central government budget. Advice from a Fund technical assistance mission in September will be used in the further implementation of our decentralization plans. Under recently approved legislation, the local authorities have been empowered as from January 1, 2002 to raise their own resources to supplement the budgetary transfers. With the growing fiscal responsibilities of the local authorities, we realize the importance of timely information on their fiscal operations. We will therefore develop by the end of this year a plan to accomplish timely reporting in a GFS format within the shortest possible delay. We will also ask the privatization fund (HFP), the highway construction agency (HA), and the development bank (HBOR) to report their operations quarterly in a GFS format.

14. To facilitate the maintenance of an unchanged nominal wage bill in 2002–03 while creating room for some wage increases, it is important to eliminate excess government sector employment. The largest pockets of excess employment reside in the Ministries of Interior and Defense, and staffing levels were reduced by some 750–775 in each of them by midyear. Another 3,600 employees will be laid off in the Ministry of Interior starting in August 2001, whereas 5,000 people are expected to be laid off in the fourth quarter of 2001 following parliamentary approval of the new defense law. Together with small net reductions in other ministries, we expect to achieve an aggregate net employment reduction in the central government of some 10,000 by end-2001. We reconfirm this target as a performance criterion under the arrangement for end-December 2001. Once severance payments have been exhausted, there will be room for wage increases next year. World Bank resources will be used to retrain laid-off workers.

15. To fully exploit the potential of the new treasury system, we have reorganized the Ministry of Finance to improve reporting to the treasurer. All central budget expenditure (including since July pension spending and routine items of all budget users) is now authorized and certified by the treasury and separate ministerial accounts are being closed. With the closure of these accounts, which is expected by end-2001, and the inclusion of own income of all budget users in the central budget from January 1, 2002, all payments will be effected by the treasury and arrears data will be automatically compiled. With the introduction of health care reform on January 1, 2002, health spending will also be channeled through the treasury.

16. The startup of operations of the central registry of affiliates (REGOS) and the regulatory authority for private pension funds (HAGENA) will allow us to proceed with the introduction of the mandatory second pension pillar on January 1, 2002. To this effect, we have established a project implementation unit in the Ministry of Labor that is supported with World Bank funds. We currently estimate the fiscal transition cost of introducing the second pillar at 1.3–2.0 percent of GDP in 2002, depending on how many of the 40–50 year age bracket will choose to participate in the second pillar. The voluntary third pillar is expected to be available before end-September 2001.

## **B. Monetary Policy and Financial Sector Reform**

17. The new central bank law enshrines price stability as the CNB's primary objective. Accordingly, monetary and exchange rate policy will be used primarily to reduce the twelve-month rate of retail price inflation to 4.5 percent at the end of 2001, assuming no further increases in administered prices beyond those currently envisaged. This inflation objective as well as economic growth of 4 percent, a further small decline in velocity, and a more ambitious international reserves target underlie the revised monetary program for 2001, which leaves room for an expansion of credit to the nongovernment sector of 5¼ percent in the second half of 2001, or 17¼ percent for 2001 as a whole. These resources, an improved margin for self-financing, government arrears repayment, and foreign market borrowing by larger companies should provide ample financing to sustain the recovery of output and investment in the second half of 2001. To ensure that the envisaged room for credit expansion to the nongovernment sector is not pre-empted by public enterprise borrowing, we have established quarterly limits on net bank borrowing by 10 large public enterprises. These limits will be a performance criterion under the arrangement (Annex VI).

18. Within the constraints imposed by its revised monetary program, the CNB intends to rely on intervention rather than interest rate policy to address the customary weakening of base money demand after the tourist season. To the extent allowed by liquidity conditions, the CNB will consider a further moderate reduction in reserve requirements this year, in line with its desire gradually to lower reserve requirement ratios to internationally practiced levels. In light of the large overperformance in the first half of 2001, the CNB has raised its annual target for the increase in net usable international reserves and adjusted accordingly the quarterly floors for net usable international reserves, which constitute performance criteria under the arrangement, for the remainder of this year (Annex VII). Concurrently, it has adjusted the net domestic asset ceilings, which are performance criteria under the arrangement and will guide the CNB in the implementation of its monetary policy in the remainder of 2001 (Annex VIII). Should base money demand be weaker than assumed in the CNB's program, the CNB will tighten liquidity and thereby reduce net domestic assets sufficiently to ensure that its revised international reserve targets are observed. If, however, base money demand turns out to be stronger than assumed, the CNB will consult with the Fund to determine if the inflation outlook warrants an unsterilized buildup of international reserves.

19. With the privatization of Croatia Banka and Dubrovačka Banka, almost 88 percent of banking assets will be controlled by foreign owners. With the exception noted in paragraph 20, we consider the banking system fully recovered from the 1998–99 crisis and have strengthened banking supervision to prevent a recurrence. One small bank and two savings institutions were closed during 2001 and their insured deposits have been paid out promptly with deposit insurance funds. We are now considering to limit the existing insurance cover of up to HrK 100,000 per deposit to time and savings deposits, but an eventual increase of the insurance limit to the EU norm remains our longer term objective.

20. The financial situation of the state-owned postal bank (HPB) needs early resolution. The bank, which accounts for 2.1 percent of bank assets and has insured deposits, mostly from small depositors, equivalent to 0.6 percent of GDP, has received budgetary support equivalent to 0.5 percent of GDP in 2001 to restore compliance with the statutory capital adequacy ratio. With the breathing room provided, the government is now examining its options, including the bank's privatization, and will adopt a firm decision on the bank's future by end-2001, as envisaged in the original program.

21. A new securities law will be submitted to parliament by end-September 2001, with approval expected by year-end.

#### **IV. THE PROGRAM FOR 2002–03**

22. Our broad objectives for 2002–03 remain unchanged: a modest acceleration of growth in the context of moderating inflation and a small external current account deficit. The principal precondition for their achievement is continued fiscal consolidation. In this respect, we reconfirm our commitment to reducing both the fiscal deficit and the government expenditure ratio. More specifically, we are in the process of preparing budgets for 2002 and 2003 that aim at reducing the deficit of the consolidated central government to 4.25 percent of GDP in 2002 and further to 1.4 percent of GDP in 2003, with a decline in the expenditure ratios to some 41 percent and 38 percent, respectively, of GDP. We expect to mobilize sufficient resources from the privatization of HEP, INA and the oil pipeline (JANAF) to allow the reduction of the public debt-to-GDP ratio from 48.6 percent in mid-2001 to 42.7 percent by end-2003. The budget for 2002 will be discussed with the Fund during the second review under the present arrangement.

## Croatia: Main Economic Indicators, 1995-2001

	1995	1996	1997	1998	1999	2000	2001	
							Original Program	Revised Program
Real economy (percentage change)								
Real GDP	6.8	6.0	6.6	2.5	-0.4	3.7	4.0	4.0
Unemployment rate (average; percent of labor force) 1/	n.a	10.0	9.9	11.4	13.6	16.1	14.5	15.5
Retail prices (e.o.p.)	3.7	3.4	3.8	5.4	4.4	7.4	4.5	4.5
Gross national saving (percent of GDP)	9.9	16.1	18.2	17.2	19.4	21.9	22.0	23.4
Gross domestic investment (percent of GDP)	17.6	21.9	29.6	24.3	26.3	24.0	25.8	26.9
Public finance (percent of GDP)								
Consolidated central government (cash basis) 2/	-0.9	-0.4	-1.3	0.6	-2.0	-4.9	-0.8	-2.1
Consolidated central government (accrual basis)	...	...	-2.0	-3.0	-7.4	-5.7	-5.3	-5.2
Consolidated government debt (e.o.p.) 3/	19.3	29.2	31.9	38.8	51.1	50.9	46.2	48.4
Money and credit (e.o.p.; percentage change)								
Broad money	40.4	49.1	37.6	13.0	-1.1	29.3	15.3	23.2
Credit to consolidated central government	-3.0	-3.4	-49.9	-2.7	59.9	12.0	0.0	-4.2
Other credit	18.9	3.1	44.1	22.4	-8.8	9.1	15.9	17.3
Interest rates (e.o.p.; percent)								
Average deposit rate	6.1	4.2	4.4	4.1	4.3	3.6	...	...
Average credit rate	22.3	18.5	14.1	16.1	13.5	10.5	...	...
Balance of payments (percent of GDP)								
Trade balance	-17.3	-18.2	-25.8	-19.2	-16.4	-16.8	-17.3	-19.7
Current account balance	-7.7	-5.5	-11.6	-7.1	-6.9	-2.1	-3.9	-3.6
External debt (e.o.p.)	20.8	23.2	31.9	40.3	44.5	53.1	50.4	50.1
Gross official reserves (US\$ million; e.o.p.)	1,895	2,314	2,539	2,816	3,025	3,525	3,663	4,090
Reserve cover (months of imports of goods and services)	2.4	2.8	2.7	3.2	3.7	4.4	4.3	4.6
Short-term debt (in percent of gross usable official reserves) 4/	31.6	40.7	45.6	75.1	78.6	67.6	75.7	66.9
Fund position (June 30, 2001)								
Holdings of currency (percent of quota)								130.2
Holdings of SDRs (percent of allocation)								226.4
Quota (SDR million)								365.1
Exchange rate								
Exchange rate regime								Other managed floating
Kuna per US\$ (July 31, 2001)								8.21719
Nominal effective rate (1995=100; p.a.)	100.0	100.3	101.0	100.3	94.7	94.6	...	...
Real effective rate (1995=100; p.a.)	100.0	99.3	99.6	101.2	97.1	99.3	...	...

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

1/ Labor Force Survey (based on ILO standards).

2/ National presentation, with privatization receipts above the line.

3/ Including arrears and publicly guaranteed debt.

4/ On a remaining maturity basis.

**Croatia: Implementation of Quantitative Performance Criteria, January-June 2001**

(In millions of kuna, unless indicated otherwise)

		End of				
		March	June			
1	Cumulative Deficit of the Consolidated Central Government 1/	program	3,500	3,850		
		actual	3,219	3,824		
		margin (-)	281	26		
2	Cumulative Increases in the Net Credit of the Banking System to the Consolidated Central Government 1/	program	-1,550	-2,300		
		actual	-756	-240		
		margin (+)	-794	-2,060		
3	Arrears of the Consolidated Central Government 1/	program	0	-1,500		
		actual	-457	-599		
		margin (+)	457	-901		
4	Cumulative Increases in the Net Credit of the Banking System to Selected Public Enterprises 1/	program	600	600		
		actual	251	-43		
		margin (+)	349	643		
5	Public and Publicly Guaranteed External Debt	program	500	100		
		a) Stock of Short-Term Debt 1/2/	<1 year	actual	394	366
			margin (+)	106	-266	
			program	1,250	1,300	
		>1 year	actual	921	990	
			margin (+)	329	310	
			b) Cumulative Increases in Nonconcessional Debt 1/ 2/	program	250	250
		<5 years		actual	192	205
		margin (+)		58	45	
		6	Cumulative Increases in the Net Usable International Reserves of the Croatian National Bank 2/ 3/ 4/	program	-125	-11
actual	151			496		
margin (+)	276			507		
7	Cumulative Increases in the Net Domestic Assets of the Croatian National Bank 1/ 5/	program	197	1,086		
		actual	-1,680	-3,459		
		margin (+)	1,877	4,545		
<b>Memorandum item:</b>						
Central Government Wage Bill	program	3,715	3,523			
	actual	3,709	3,753			
	margin (+)	6	-230			

1/ Ceiling.

2/ In millions of U.S. dollars.

3/ Floor.

4/ The program floor for June and beyond has been raised by \$122 million due to the distribution in June of the former SFRY's assets held at the BIS and reduced in the June quarter only by \$121 million due to the delayed privatization of HT (see Annex VII of MEFP).

5/ The program ceiling has been raised by HRK1,049 million in the June quarter only due to the delayed privatization of HT (see Annex VIII of MEFP).

## Croatia: Monitoring the Implementation of the Program, July-December 2001

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### Prior action

- |  |                              |
|--|------------------------------|
| 1. Parliamentary approval of eleven law amendments securing fiscal savings of at least 0.4 percent of GDP in 2001 and at least 1.0 percent of GDP on an annual basis and of a revised budget for 2001 securing a deficit of the consolidated central government of no more than 5.3 percent of GDP in 2001 in accordance with the program definition | SMEFP, Para. 11 and Annex IX |
|--|------------------------------|

### Quantitative performance criteria

- |  |            |
|--|------------|
| 1. Consolidated central government   | Annex IV   |
| a) Quarterly limits on the cumulative deficit of the consolidated central government   |            |
| b) Quarterly limits on the cumulative increase in the net credit of the banking system to the consolidated central government  |            |
| c) Quarterly limits on arrears of the consolidated central government, with a sublimit on arrears that are overdue by more than 90 days  |            |
| 2. Public and publicly guaranteed debt   | Annex V    |
| a) Quarterly ceilings on the contracting and guaranteeing of nonconcessional external debt, with an original maturity of more than 1 year, with a subceiling on such debt with an original maturity of less than 5 years |            |
| b) Quarterly ceilings on the stock of short-term external debt   |            |
| 3. Quarterly limits on net bank borrowing by 10 large public enterprises   | Annex VI   |
| 4. Quarterly floors under the net usable international reserves of the CNB   | Annex VII  |
| 5. Quarterly limits on the cumulative change of the net domestic assets of the CNB   | Annex VIII |

### Structural performance criterion

- |  |                 |
|--|-----------------|
| 1. Reduce employment in the budgetary sphere by 10,000 | SMEFP, Para. 14 |
|--|-----------------|

### Performance clauses

- |  |                   |
|--|-------------------|
| 1. No new external payments arrears  | MEFP, Para. 35 1/ |
| 2. No new, or intensification of existing, payments restrictions, multiple currency practices, and import restrictions | MEFP, Para. 35 1/ |

### Structural benchmark

- |   |                   |
|---|-------------------|
| 1. Make progress in restructuring and privatizing HEP and INA | MEFP, Para. 34 1/ |
|---|-------------------|
-

### I. Limits on the Cumulative Deficit of the Consolidated Central Government

	Ceilings
	(In millions of kuna)
Cumulative Deficit as of June 30, 2001:	3,824
Cumulative Changes from June 30, 2001:	
September 30, 2001	3,098
December 31, 2001	5,385

The above listed ceilings on the cumulative deficit of the consolidated central government cover: (i) central government operations, that is, the central government budget (the Office of the President, the parliament, the government, the constitutional court, all ministries, other independent state administration and judicial bodies); (ii) existing central extrabudgetary funds (health, pension, employment, child benefit, and water management funds); and (iii) the proposed Fund of Assets for Investment Promotion and Fund for the Creation of New Jobs and Re-training. The government will not establish new extrabudgetary funds during the program period, but any such funds would be covered by the ceilings.

The ceilings do not include the net borrowing of the Croatian Bank for Reconstruction and Development (HBOR), the Deposit Insurance and Bank Rehabilitation Agency (DAB), and the Croatian Privatization Fund (HFP). Their net borrowings during the first half of 2001 were HrK 259 million for HBOR, HrK 56 million for DAB, and HrK 42 million for HFP. HBOR's net borrowing in the second half of 2001—defined as the change in gross liabilities minus the change in total loans—is projected to be a negative HrK 1.2 billion and will be monitored under the program. There will be no new borrowing by DAB or HFP in the second half of 2001. At any rate, their borrowing, which will also be monitored under the program, would be excluded from the ceilings.

For purposes of the program, the deficit will be defined on a cash-adjusted basis (i.e., on a cash basis adjusted by the net change in arrears). The cost for recapitalizing banks or the payment of insured deposits will be considered as "above the line." The following will be considered as "below the line": privatization receipts, payment of arrears, payment of promissory notes issued by the Ministry of Finance and the Health Fund, bonds issued including those for financing the recapitalization of banks or paying out insured deposits, redemption of government bonds tendered by the CNB in connection with bank resolution, and any release of foreign-held blocked foreign assets of the former SFRY to the government.

The limit on the deficit of the consolidated central government will be adjusted downward to offset the net effect of any reduction in interest payments attributable to rescheduling of existing government debt.



All currency conversions will be done using December 30, 2000 exchange rates (in HrK per unit of foreign currency) as follows:

Euro:	7.598334	Swiss franc:	4.989712
Japanese yen (100):	7.103902	U.S. dollar:	8.155344
Pound sterling:	12.176817		

The quarterly limits will be monitored from below the line on the basis of data provided monthly by the Ministry of Finance and the CNB within 30 days. For purposes of monitoring compliance with the ceilings, the cumulative difference since July 1, 2001 between road tolls collected by the budget and one fourth of excise taxes on fuel collected by Croatian Highways (HA) will be added to these data. Both data series will be provided by the Ministry of Finance within 30 days of the end of such calendar quarter. Net borrowing by HBOR and new borrowing by DAB and HFP will be reported quarterly by the CNB within 30 days.

## II. Limits on the Cumulative Increases in the Net Credit of the Banking System to the Consolidated Central Government

	Ceilings
	(In millions of kuna)
Stock as of June 30, 2001 1/	12,527
Cumulative changes from June 30, 2001:	
September 30, 2001	443
December 31, 2001	-63

1/ This stock of claims consists mainly of the counterpart to frozen foreign exchange deposits and "big bonds," which are restructuring bonds issued in 1991 and 1992, and held by banks in lieu of claims on enterprises; the total stock of claims as of June 30, 2001 also includes the bonds issued to finance the payout of insured deposits in failed banks.

The quarterly limits are cumulative. The consolidated central government is as defined in Section I above.

For program purposes, net credit of the banking system to the consolidated central government is defined as all claims of the banking system on the consolidated central government less all deposits of the consolidated central government with the banking system.

The ceiling for September 30, 2001 will be lowered by the equivalent of US\$360 million, if the envisaged repayment of this amount to settle the prefinancing by foreign banks of the sale of 16 percent of shares in the telecommunications company (HT) is delayed beyond the third quarter. The ceiling for September 30, 2001 will also be adjusted upward by the equivalent of the amount by which the sum of privatization receipts from the sale of 16 percent of HT shares in July 2001 (€ 500 million or US\$466 million at the applicable program exchange rates) and the disbursements of the amounts retained in an escrow account from the sale of 35 percent of HT shares in 1999 (US\$46 million) will fall short of the expected US\$512 million.

Data on banking system claims on and liabilities to the consolidated central government are taken from the balance sheets of the banks and the CNB, and will be provided monthly to the Fund by the CNB within 30 days. For purposes of monitoring compliance with the ceilings, the cumulative difference since July 1, 2001 between road tolls collected by the budget and one fourth of excise taxes on fuel collected by Croatian Highways (HA) will be added to these data. Both data series will be provided by the Ministry of Finance within 30 days of the end of each calendar quarter.

### III. Limits on the Arrears of the Consolidated Central Government

	Ceilings	
	(In millions of kuna)	
	All arrears	> 90 days overdue
Stock as of June 30, 2001	1,377	372
Cumulative changes from June 30, 2001:		
September 30, 2001	-450	-372
December 31, 2001	-900	-372

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 extrabudgetary funds. The stock of arrears will be provided monthly to the Fund by the Ministry of Finance within 30 days.

**Ceilings on the Stock of Short-Term External Public and  
Publicly Guaranteed Debt and on Contracting or Guaranteeing  
of Nonconcessional External Debt by the Public Sector**

	Ceilings		
	(In millions of U.S. dollars)		
	Ceilings ≤1 year	Ceilings >1 year	Subceilings <5 years
Stock as of June 30, 2001	366	6,209	320
Cumulative changes from June 30, 2001:			
September 30, 2001	-300	410	45
December 31, 2001	-300	535	45

For program purposes, the term debt has the meaning set forth in point No. 9 of the IMF Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 (Executive Board Decision No. 12274-(00/85)). However, for the time being lease contracts will not be covered by the ceilings. A reporting system for lease contracts is currently being set up by the Ministry of Finance. Once functional, leases will be included in the debt contracting ceilings.

The short-term debt limits do not apply to normal import-related credits.

The ceilings on medium- and long-term debt apply to the contracting or guaranteeing of new nonconcessional external debt with an original maturity of more than one year, and, within this limit, with an original maturity of more than one year and less than 5 years. 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 CIRR for loans with maturities of 15 years and more.

The public sector comprises the consolidated central government as defined in Annex IV.I, the CNB, DAB, HBOR, HFP, the 10 large public enterprises listed in Annex VI, and the lower levels of government. Excluded from the limits are performance guarantees on the construction of ships (for no more than the value of advance payments), and changes in indebtedness resulting from refinancing and rescheduling, including the capitalization of interest in arrears.

The above limits also do not apply to guarantees by the central government for suppliers' credits related to imports for constructing ships during the period until delivery of the ships takes place. In case of orders for multiple ships, the import related credits could take the form of revolving external credit lines. To monitor such guarantees, data on the guarantees extended for ship building, including performance guarantees or bonds, and the payments and deliveries for ships built with these guarantees will be supplied on a quarterly basis.

Debt falling within the limits shall be valued in U.S. dollars at the exchange rates prevailing at the time when the debt is contracted.

Information on the contracting and guaranteeing of new external debt and on the stock of short-term external debt outstanding falling both inside and outside the limits will be reported monthly to the Fund within 30 days by the CNB.

The September 30, 2001 ceiling on the stock of short-term external public debt will be adjusted upwards by US\$360 million if the transfer of the receipts from the sale of 16 percent of HT shares to the Croatian government accounts is delayed beyond end-September. In accordance with footnote 3 of paragraph 12, the December 31, 2001 ceiling on the stock of short-term external public debt will be raised by the amount of any bridge financing of future privatization receipts.

**Limits on the Cumulative Increases in the Net Credit of the  
Banking System to Selected Public Enterprises**

	Ceilings
	(In millions of kuna)
Stock as of June 30, 2001	655
Cumulative changes from June 30, 2001	
September 30, 2001	300
December 31, 2001	350

These aggregate limits cover the 10 enterprises listed below. Net credit is defined as the sum of all short-term and long-term bank claims in local and foreign currency on these enterprises by banks resident in Croatia plus the amount of credit guaranteed by Croatian banks from domestic nonbank and foreign sources, less the sum of these enterprises' total deposits in local and foreign currency with such banks. Credit guaranteed by the government or resulting from the calling of performance guarantees will be excluded from the ceilings to the extent that it is not already reflected in the balance sheets of the banks.

The 10 enterprises are as follows:

1. Hrvatska Elektroprivreda, Zagreb (Croatian Electricity Company)
2. INA Industrija Nafta, Zagreb (Oil Company)
3. Hrvatske Željeznice, Zagreb (Croatian Railroads)
4. Hrvatske Šume, Zagreb (Croatian Forests)
5. Hrvatske Telekomunikacije, Zagreb (Croatian Telecommunications)
6. Hrvatska Pošta, Zagreb (Croatian Post)
7. Hrvatska Radiotelevizija, Zagreb (Croatian Radio and Television Company)
8. Jadrolinija, Rijeka (Adriatic Shipping Line)
9. Croatia Osiguranje, Zagreb (Croatian Insurance Company)
10. Croatia Airlines, Zagreb

Enterprises on the above list that are privatized 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 credit outstanding to those enterprises at the end of the month preceding privatization. Whenever changes in accounting practices or the set of enterprises reporting to the CNB result in changes in the data series, the Fund will be notified and provided one quarter of data calculated with both the old and new definitions and an offsetting adjustment will be made to the limits. The limits will be adjusted downward by the amount of any bank or enterprise rehabilitation that writes off or removes these assets and liabilities from the banking system or any debt-equity swaps that convert bank debt into equity in the enterprises. Information regarding such debt-equity swaps will be provided by the Ministry of Economy if and when they occur.

The above maximum changes will be cumulative and will be monitored on the basis of December 30, 2000 exchange rates (as listed in Annex IV.I) from data collected monthly by the Ministry of Finance (ORESE) and supplied to the Fund within 30 days.

**Targets for Cumulative Increases in the Net Usable  
International Reserves of the Croatian National Bank**

	Floors
	(In millions of U.S. dollars)
Stock as of June 30, 2001	2,823
Cumulative changes from June 30, 2001:	
September 30, 2001 1/	79
December 31, 2001 1/	132

1/ Reduced by US\$100 million with respect to the baseline projection to allow for unforeseen foreign exchange interventions.

For purposes of the program, net usable international reserves of the Croatian National Bank (CNB) are defined as the U.S. dollar value of gross foreign assets minus reserve assets held against foreign currency deposits by domestic banks and against CNB foreign exchange bills minus gross foreign liabilities minus off-balance sheet foreign currency obligations.

For purposes of the program, gross foreign assets shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the CNB (the accounting values of exchange rates and SDRs are specifically defined below for program purposes). Any return to the CNB of blocked foreign assets that are not part of CNB foreign assets as of June 30, 2001 will be added to the reserve floor. Reserves that are pledged, frozen, or used as collateral shall be excluded from the gross foreign assets. In particular, any reserve assets pledged to secure government debt will be excluded from the reserves definition.

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

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 amounted to US\$0 million on June 30, 2001. For program purposes, only the off-balance sheet obligations will be deducted from the CNB's net international reserves position. These liabilities amounted to US\$0 million on June 30, 2001.

The floor on net usable international reserves for September 30, 2001 will be adjusted upward by US\$400 million, if the envisaged repayment of this amount to settle the

prefinancing of the sale of shares in the telecommunications company (HT) is delayed beyond the third quarter. This floor will be adjusted downward for the amount by which the sum of privatization receipts from the sale of 16 percent of HT shares in July 2001 (€ 500 million or US\$438 million at the applicable program exchange rates) and the disbursements of the amount retained in an escrow account from the sale of 35 percent of HT shares in 1999 (US\$46 million) will fall short of the expected US\$484 million as of September 30, 2001.

For program purposes, the accounting exchange rates are equal to the mid-points of the exchange rates obtaining on December 14, 2000. For the five most important currencies and the SDR, these exchange rates were (in kuna per unit of foreign currency):

Euro:	7.591856	Swiss franc:	5.051135
Japanese yen:	7.708251 (100 yen)	U.S. dollar:	8.667492
Pound sterling:	12.538160	SDR:	11.175344

The limits will be monitored from data on the accounts of the CNB supplied monthly to the Fund by the CNB within 15 days.



**Limits on the Cumulative Increases in the Net Domestic  
Assets of the Croatian National Bank**

	Ceilings
	(In millions of kuna)
Stock as of June 30, 2001	-11,914
Cumulative changes from June 30, 2001:	
September 30, 2001 1/	365
December 31, 2001 1/	391

1/ Raised by the equivalent of US\$100 million with respect to the baseline projection to allow for unforeseen foreign exchange interventions.

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

The limit for September 30, 2001 will be lowered by the equivalent of US\$400 million, if the envisaged repayment of this amount to settle the prefinancing of the sale of shares in the telecommunications company (HT) is delayed beyond the third quarter. This limit will be adjusted upward by the equivalent of the amount by which the sum of privatization receipts from the sale of 16 percent of HT shares in July 2001 (€ 500 million or US\$438 million at the applicable program exchange rates) and the disbursements of the amount retained in an escrow account from the sale of 35 percent of HT shares in 1999 (US\$46 million) will fall short of the expected US\$484 million as of September 30, 2001.

The CNB's policies in response to the intentions expressed in the final two sentences of paragraph 18 will be assessed in relation to the base money projections of HrK 13,605 million for September 30, 2001 and HrK 14,087 million for December 31, 2001. The limits and base money projections will be monitored from data on the accounts of the CNB supplied monthly to the Fund by the CNB within 15 days.

**Prior Action for Completion of the First Review of the  
Stand-by Arrangement**

As noted in paragraph 11 and in Annex III, amendments of eleven laws securing fiscal savings of at least 0.4 percent of GDP in 2001 and at least 1.0 percent of GDP on an annual basis and of a revised budget for 2001 securing a deficit of the consolidated central government of no more than 5.3 percent of GDP in 2001 in accordance with the program definition is a prior action for concluding the first review under the stand-by arrangement. The eleven laws to be amended are the following:

1. Law on Croatian defenders rights
2. Law on social welfare
3. Law on protection of military and civil invalids of war
4. Law on rights of ex-political prisoners
5. Law on pension insurance
6. Law on health insurance
7. Law on health protection
8. Law on child benefit
9. Law on maternity leave for self-employed and unemployed mothers
10. Law on personal income tax
11. Law on unified base for payments of obligatory social security contributions

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

**First Review Under the Stand-By Arrangement—Supplementary Information and Request for Modification of Performance Criteria and Rephrasing of Purchases**

Prepared by the European I and Policy Development and Review Departments

Approved by Carlo Cottarelli and Shigeo Kashiwagi

October 31, 2001

1. This supplement reports on economic developments since the staff report (EBS/01/163) was issued and proposes certain modifications to the economic program and stand-by arrangement (including the modification of a structural performance criterion and the addition of an adjustor to a quantitative performance criterion) that have been requested by the Croatian authorities in the attached supplementary letter of intent. An update on the status of the staff's safeguards assessment, a supplementary staff appraisal and a revised proposed decision are also included.

**I. RECENT ECONOMIC DEVELOPMENTS**

2. **Data released since issuance of EBS/01/163 indicate that the authorities remain on track to achieving their economic objectives in 2001.**

- Year-on-year growth of **real GDP** was 4.7 percent in the second quarter, after a 4.2 percent increase in the first quarter. The faster than expected acceleration of growth reflected mainly private consumption and investment. Except for a—possibly temporary—dip of industrial output in September, high-frequency indicators show no sign of a slowdown in the following months. Industrial output expanded at an annual rate of 5.9 percent in the nine months to September, while retail sales in January-August were 10.2 percent higher than in the corresponding 2000 period. The third-quarter tourist season fulfilled expectations, with U.S. dollar revenue increasing by 12 percent over 2000. In sum, the authorities' real GDP growth target of 4 percent is likely to be achieved.
- After accelerating to 5.8 percent in August due to a hike in administered prices, the twelve-month rate of **retail price increases** fell to 4.7 percent in September. Underlying inflationary pressures remain muted, with core and producer price inflation rates below 3 percent. After a recent decision to postpone the increase in the still regulated retail prices of electricity, the program target of 4.5 percent at year-end seems achievable.

- Second-quarter **balance of payments** data showed a larger than programmed current account deficit, mainly as a result of profit taking by foreign-owned companies, most of which was immediately reinvested. However, current account indicators for the third quarter are positive. The merchandise trade balance improved, reflecting seasonally strong exports and a marked decline in imports following the repeal of car import privileges for war veterans. Services benefited from the strong tourist season and private transfers kept growing strongly. Thus, the revised program objective of limiting the current account deficit to 3.5 percent of GDP in 2001 remains realistic.

3. **The September 11 terrorist attacks on the United States have not yet had any palpable effect on the economy and their future impact is still uncertain.** While the terms of trade effect of lower oil prices will be expansionary, the dwindling growth prospects of major trading partners will have a dampening effect on exports, and consumer and business confidence may already have weakened. The impact of recent events on tourism is unclear: while global tourism is likely to suffer, Croatia's share may well expand because of its proximity to, and overland access from, its major markets. Spreads of Croatian international bonds have remained fairly stable at a little more than 200 basis points, as Croatia benefited from the regional safe-haven status and from the fact that the bulk of its bonds are reportedly held by dedicated investors. The exchange rate volatility in August seems to have been a largely domestic phenomenon (see EBS/01/163, paragraph 16) and the exchange rate has appreciated recently, in spite of a large foreign exchange purchase by the CNB.

## II. PROGRAM IMPLEMENTATION AND PERFORMANCE IN THE THIRD QUARTER

4. **Program implementation in the second half of 2001 has been hampered by the incomplete coverage of the government sector wage policy and the delay in legislating reforms of social transfers.** As the wage policy adopted in June excluded the workers of the ministries of education, science and technology, and—on a temporary basis—defense, wages in the budgetary sphere have begun to exceed budget allocations. Moreover, the extension of the new wage policy to the extrabudgetary funds (mainly health workers) is not producing the expected full offset of overruns in the budgetary sphere, and child benefits continue to exceed budgetary allocations.<sup>1</sup> However, preliminary expenditure and revenue data suggest that the third-quarter fiscal deficit target was met, mainly thanks to a tight rein on capital spending that included the postponement of the further recapitalization of the state-owned postal bank (HPB). Despite apparently meeting the deficit target, however, government arrears were not reduced as programmed in the third quarter (Table 1), partly reflecting the

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<sup>1</sup> As a result of the recent slippages in wage policy implementation, it is now estimated that the nominal wage bill of the consolidated central government will be reduced by only 4.8 percent this year, compared with an intended reduction of 9 percent under the original program. The authorities have, however, stated their intention to reduce the 2002 wage bill to the originally programmed level for 2002.

delay in the receipt of the proceeds from the privatization of the telecommunications company (HT).

5. **By contrast the end-September international reserves and net domestic asset targets of the CNB were met with comfortable margins.** The CNB had to tighten policy substantially to bring about these results. As banks and companies took advantage of easy liquidity conditions in August and of the amended foreign exchange law to buy foreign exchange in anticipation of the usual seasonal depreciation of the currency at the end of the tourist season, the CNB engaged in massive unsterilized foreign exchange sales (almost 8½ percent of gross official reserves), raised the Lombard rate by 1 percentage point to 10.5 percent, required that a portion of compulsory reserves against foreign currency deposits be held in domestic currency, and lowered banks' foreign exchange exposure limits. In response, money market rates rose from 1 percent to 9.5 percent, the exchange rate depreciation was reversed, and the CNB was able to replenish its reserves.

### III. THE AUTHORITIES' POLICIES FOR THE REMAINDER OF THE PROGRAM

6. **In the attached supplementary letter of intent (SLOI), the authorities explain the policy measures they have adopted to ensure that the original program targets will be achieved.** Parliamentary approval of the package of 11 laws to rationalize the social transfer system took longer than expected and was completed only on October 19 with the approval of the laws on child allowances, health insurance, and veterans benefits. Because of the delay, a number of changes (including means-testing of some benefits) will not take effect until early 2002, thus reducing the budgetary savings that can be realized this year. The estimated full-year effect of social benefit reform will, however, slightly exceed the savings expected from the original package, and a revised 2001 budget was also approved by parliament on October 19 with sufficient discretionary expenditure cuts to ensure that the 2001 fiscal deficit limit of 5.3 percent of GDP will be respected (SLOI, ¶¶2-4).

7. **The authorities also request certain modifications to the performance criteria.**<sup>2</sup> First, they propose completing the net reduction of employment in the budgetary sphere by 10,000 positions by end-March 2002 instead of end-December 2001, with an intermediate target for end-December 2001 (SLOI, ¶8); the targets for these dates will be established as performance criteria. The draft of a new defense law, which will make these layoffs feasible, has been sent to parliament and is expected to be approved later this year. Second, the authorities propose adding an adjustor to the performance criterion on net domestic assets (NDA) of the CNB to offset the increase in NDA that results from recent and planned increases in the proportion of reserve requirements on foreign currency liabilities that must be held in local currency (SLOI, ¶9). These changes increase the monetary base without

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<sup>2</sup> Given the delay in completing the first review, performance criteria will not be set for end-September 2001. Instead, the targets for this test date set out in the authorities' MEFP will be indicative.

having an expansionary monetary effect. The proposed adjustor (see the Attachment to the SLOI) would also apply in the event of changes in the reserve requirement ratio and changes in the definition of the reservable base.

8. **As part of the cutback on capital spending, the government has decided to postpone the recapitalization of HPB.** Instead, a shareholders meeting will decide in December on the future of the bank. The government as the majority shareholder is committed to a least-cost solution, which would imply its immediate privatization (SLOI, ¶5). The budgetary cost will be absorbed by the 2002 budget which will shortly be submitted to parliament. A decision on the future of HPB will be prior action for the completion of the second review under the stand-by arrangement.

9. **Although the bulk of privatization receipts for this year was realized with the sale of a controlling share in HT to Deutsche Telekom in late October, the revised budget has trimmed further total expected privatization receipts.** The shortfall, estimated at HrK 1,167 million (or US\$141 million), is expected to be covered mainly by additional foreign borrowing, of which more than half will come from the prefinancing of the privatization of the insurance company.

10. **Because of the delay in completing the first review, the authorities propose the extension of the program period by one quarter to end-March 2002** (SLOI, ¶10). Quantitative performance criteria for end-March 2002 would be set as part of the second review. As the targets for end-September will remain indicative because of the delay in completing the first review, there is a need to rephase the purchase under the arrangement that would have become available in November 2001. At the same time, there is a need to schedule a new purchase for May 2002 on the basis of performance at end-March 2002.

#### IV. STATUS OF THE STAFF'S SAFEGUARDS ASSESSMENT

11. **In the process of conducting the Stage One safeguards assessment of the CNB, the staff has learned of significant developments in the CNB's auditing and accounting frameworks.** In particular, the CNB engaged for the first time a prominent private accounting firm to assist it in restating its 2000 financial statements in accordance with International Accounting Standards.

12. **These developments represent significant improvements in safeguards at the CNB.** As a result, the staff has thought it appropriate to delay completion of the Stage One safeguards assessment of the CNB until the bank restates its 2000 financial statements, which is expected to be completed by November 2001. The Stage One assessment is therefore expected to be finalized prior to the second review of the stand-by arrangement.

13. **This delay notwithstanding, the staff observed possible weaknesses in the bank's internal auditing function and in its internal control system.** These observations, while preliminary, have been brought to the attention of the authorities, and would need to be confirmed during the finalization of the Stage One assessment.

## V. STAFF APPRAISAL

14. **The increased reliance on discretionary measures to achieve the 2001 fiscal deficit target and the delays in reducing overstaffing in the budgetary sphere are disappointing.** Nonetheless, the authorities are to be commended for a courageous reform of the social transfer system, whose full-year budgetary savings promise to exceed slightly the originally planned amount. Together with the intended reduction of the 2002 wage bill of the consolidated central government to the nominal level originally targeted for 2001, this measure facilitates accommodating the cost of resolving the state-owned postal bank in a 2002 budget without jeopardizing the government's deficit reduction objective.

15. **In order to achieve the net employment reduction target and extend the new wage system to the defense sector, the authorities need to ensure urgent parliamentary approval of the new defense law.** The timely achievement of a lower level of government employment is necessary to create room for modest nominal wage increases under a reduced wage bill.

16. **The staff supports the authorities' proposals for the modification of the arrangement, including the changes to the performance criterion on net employment reduction, the introduction of an adjustor to the performance criterion on the net domestic assets of the CNB, and the extension of the program period to end-March 2002.** An adjustor is therefore proposed to be added to the calculation of the limits on the cumulative increases in the net domestic assets of the CNB (SMEFP, Annex VIII), and the purchases available under the arrangement are proposed to be rephased as suggested in Table 2. Quantitative performance criteria for end-March 2002 will be established in the context of the second program review. As all data on performance are normally provided within 30 days of the test date, there is no need to extend the arrangement period.

17. On the basis of the policy adjustments outlined in the authorities' supplementary letter of intent and the proposed modifications of the arrangement, the staff supports the completion of the first review under the stand-by arrangement. In line with the authorities' supplementary letter of intent, the staff expects the second review of the arrangement to be completed by end-February 2002.

Table 1 - Croatia: Implementation of Quantitative Performance Criteria, 2001  
(In millions of kuna, unless indicated otherwise)

			End of					
			Mar	Jun	Sep 1/	Dec 1/		
1	Cumulative Deficit of the Consolidated Central Government 2/	program	3,500	3,850	3,098	5,385		
		actual	3,179	3,820	2,491	...		
		margin (+)	321	30	607	...		
2	Cumulative Increases in the Net Credit of the Banking System to the Consolidated Central Government 2/	program	-1,550	-2,300	1,683 *	-63		
		actual	-756	-240	969	...		
		margin (+)	-794	-2,060	714	...		
3	Arrears of the Consolidated Central Government 2/	program	0	-1,500	-450	-900		
		actual	-457	-599	392	...		
		margin (+)	457	-901	-842	...		
4	Cumulative Increases in the Net Credit of the Banking System to Selected Public Enterprises 2/	program	600	600	300	350		
		actual	251	-43	...	...		
		margin (+)	349	643	...	...		
5	Public and Publicly Guaranteed External Debt							
		a) Stock of Short-Term Debt 2/ 3/	<=1 year	program	500	100	426 *	66
			actual	394	366	366	...	
	>1 year	program	1,250	1,300	410	435		
		actual	921	990	297	...		
		margin (+)	329	310	113	...		
	b) Cumulative Increases in Nonconcessional Debt 2/ 3/	<5 years	program	250	250	45	45	
		actual	192	205	0	...		
		margin (+)	58	45	45	...		
6	Cumulative Increases in the Net Usable International Reserves of the Croatian National Bank 3/ 4/ 5/	program	-125	-11	-5 *	132		
		actual	151	496	128	...		
		margin (+)	276	507	133	...		
7	Cumulative Increases in the Net Domestic Assets of the Croatian National Bank 2/ 6/	program	197	1,086	1,093 *	391		
		actual	-1,680	-3,459	-34	...		
		margin (+)	1,877	4,545	1,127	...		
<u>Memorandum Item</u>								
	Central Government Wage Bill	program	3,715	3,523	...	...		
		actual	3,709	3,753	...	...		
		margin (+)	6	-230	...	...		

1/ Revised program (SMEFP 8/29/01, EBS/01/63), cumulative changes from June 30, 2001. End-September targets are indicative; "\*" denotes the use of adjustors (SMEFP 8/29/01, Annexes IV, V, VII, and VIII).

2/ Ceiling.

3/ In millions of US dollars.

4/ Floor.

5/ The program floor for June and beyond has been raised by \$122 million due to the distribution in June of former SFRY's assets held at the BIS and reduced in the June quarter only by \$121 million due to the delayed privatization of HT (see Annex VII of MEFP).

6/ The program ceiling has been raised by HRK1,049 million in the June quarter only due to the delayed privatization of HT (see Annex VIII of MEFP).



Table 2. Croatia: Proposed Modified Schedule of Purchases Under the Stand-by Arrangement

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

1/ Assuming maximum proposed access. The authorities treat the arrangement as precautionary.

2/ Purchase to be made available upon completion of the first review scheduled for November 5, 2001.

3/ Re-phased purchase originally scheduled for November 2001.

4/ Re-phased purchase originally scheduled for February 2002.

Zagreb, October 31, 2001

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

Dear Mr. Köhler,

1. With reference to our letter to you of August 29, 2001, we are pleased to inform you that we have identified—and are in the process of implementing—budgetary measures which will ensure that the deficit target for 2001 of 5.3 percent of GDP for the consolidated central government will be achieved. Furthermore, the most recent economic developments in Croatia clearly demonstrate that we are on track to meet our 2001 objectives for real GDP growth of 4 percent and end-year retail price inflation of 4.5 percent, assuming no further increases in administered prices beyond those envisaged at the beginning of August 2001. We also expect to exceed the targeted gain in net international reserves of the Croatian National Bank (CNB) in 2001. The present letter describes the measures we have taken to ensure observance of our 2001 fiscal deficit limit, requests the modification of certain performance criteria and an extension of the program period, and proposes a postponement of the second program review.

2. In the Supplementary Memorandum of Economic and Financial Policies (SMEFP) that was attached to our August letter, we mentioned the adoption of a package of 11 laws to rationalize social transfers as a precondition for meeting the 5.3 percent of GDP deficit target (Annex IX). We are happy to report that the last three of these laws were passed by parliament on October 19, 2001, along with a revised budget for 2001. However, owing mainly to the prolonged debate in parliament, the implementation of many of these measures has been delayed. The total reduction in social expenditures in 2001 would therefore be HrK 660 million smaller than expected when the SMEFP was prepared. A major reason for this smaller reduction is the delay in approving the tightening of the means-testing criteria used to determine child allowances and some other social benefits, which will now be applied only as of 2002.

3. Furthermore, the reduction of the consolidated central government wage bill in 2001 is now projected to be HrK 766 million less than expected in August, mainly as a result of delays in staff layoffs and the full implementation of the new wage policy adopted in June 2001. In particular, higher wage coefficients have since August been agreed in the education and health sectors. Nevertheless, the overall trend for the wage bill of the consolidated central government is positive in the sense that the nominal wage bill in 2001 will be reduced by HrK 873 million (or 4.8 percent) compared to the wage bill in 2000. In

addition, we intend to reduce the government wage bill to the originally targeted level for 2001 as part of the 2002 budget—a task that will be facilitated by the full-year effect of the new wage policy, its pending extension to the defense sector, and early layoffs of surplus labor in the government.

4. To offset the expenditure overruns that result from lower than initially programmed reductions in wages and social transfers and from a small (HrK 110 million) downward revision in expected revenue collections, we have increased the discretionary cuts in other expenditure items for 2001 by HrK 1,576 million with respect to the intentions expressed in the SMEFP. As shown in the table, the revised budget's cuts of subsidies and transfers are lower, while those for spending on goods and nonwage services and on capital investment are substantially higher than originally planned. As a result of these cuts, the projected 2001 deficit of the consolidated central government is now HrK 8,914 million, compared with HrK 8,955 million in the SMEFP.

#### Planned Fiscal Savings

	2001		2002	
	SMEFP	Revised budget	SMEFP	Revised projection
	(In millions of HrK)			
Permanent measures	917 1/	257	2,706	2,850
<i>In percent of GDP</i>	<i>0.53</i>	<i>0.15</i>	<i>1.46</i>	<i>1.54</i>
Benefit rationalization	210	-	933	842
Reduction in general benefits	707	257	1,773	2,008
Discretionary measures	655	2,231	n.a.	n.a.
<i>In percent of GDP</i>	<i>0.38</i>	<i>1.29</i>	<i>n.a.</i>	<i>n.a.</i>
Subsidies and transfers	367	28	n.a.	n.a.
Goods and nonwage services	212	573	n.a.	n.a.
Capital spending	76	1,631	n.a.	n.a.
Total	1,572	2,488	2,706	2,850
<i>In percent of GDP</i>	<i>0.91</i>	<i>1.39</i>	<i>1.44</i>	<i>1.54</i>

1/ The revenue from permanent measures was estimated at HrK 1,001 million in the SMEFP, but the fiscal program was based on a more conservative estimate of HrK 917 million.

5. The state-owned postal bank (HPB) needs an early and final resolution. Accordingly, we have called a shareholders meeting on December 22, 2001 to which the government as the majority shareholder will recommend the least-cost solution to HPB's operational problems. On current indications, immediate privatization would seem to be the least-cost

solution. A firm decision on HPB's future will be taken before completion of the second program review. Any budgetary costs associated with the resolution of HPB will be accommodated within the deficit target of the consolidated central government of 4¼ percent of GDP in 2002.

6. The SMEFP reports on our performance under the arrangement through end-June. While final data on the majority of the quantitative performance targets for end-September will be available only after the end of October, it is clear already that the targets for the net domestic assets and the net usable international reserves of the CNB have been met. We have also made considerable progress regarding most of the structural reform measures and we have made a full report to the World Bank concerning implementation of the prior actions for the new SAL.

7. While we remain strongly committed to the full implementation of all the policy measures described in the original MEFP as amended by the SMEFP, it has become necessary to modify two of the end-2001 targets. We would, therefore, like to propose the following adjustments.

8. First, as a result of the above-mentioned delays in layoffs of central government workers, we request that the structural performance criterion on reducing staff by a total of 10,000 during 2001 (SMEFP, ¶14) be modified as follows. By end-December 2001, the net reduction of central government employment since the end of 2000 would be 6,385, including 5,000 people laid off but still receiving severance pay. The original target of reducing employment by 10,000 would be reached at end-March 2002. Accordingly, the projected development in central government staff would be as follows:

#### **Number of Central Government Staff**

(1) Number of staff at end-December 2000	177,514
(2) Actual layoffs during 2001 (i.e., staff no longer on payroll)	1,385
(3) Staff laid off but still receiving severance pay at end-December 2001	5,000
(4) Number of staff by end-December 2001 (1-2-3)	171,129
(5) Additional staff laid off with severance pay	3,615
(6) Number of staff by end-March 2002 (4-5)	167,514

9. Second, as a result of changes implemented by the CNB in September and October 2001 concerning the reserve requirements of commercial banks, it is now obvious that we will not be able to observe the original end-December target on the increase in net domestic assets of the CNB (SMEFP, Annex VIII). In September, banks were required to hold 10 percent of their required reserves on foreign exchange deposits in local currency, and in October this proportion was raised to 20 percent. In December, the CNB will consider increasing the portion of required reserves on foreign exchange deposits to be held in local currency further to 25 percent. The effects of these changes have increased or will increase the monetary base by HrK 1,614 million in September, HrK 1,711 million in October, approximately HrK 150 million in November, and by an additional amount in December

which is yet unknown. As these changes do not entail any monetary expansion, we request that, commencing with the test date for end-December 2001, an automatic adjustor be applied to the performance criterion on net domestic assets of the CNB and that Annex VIII of the SMEFP be amended as suggested in the Attachment to this letter. We understand that the adjustor would also be applied to reduce the net domestic asset ceiling if we proceed with tentative plans to reduce the reserve requirement ratio from 22 percent to 19 percent in December.

10. Because of the delays experienced in completing the first program review, we propose to extend the program period by one quarter to the end of March 2002 and delay completion of the second review further to the end of February 2002. Quantitative performance criteria for end-March 2002 will be set as part of the second review.

11. While we have experienced unfortunate delays in policy implementation in a number of areas, much has been achieved in a relatively short time. Furthermore, and despite the delays, with the reforms of the health and social transfer system and of the public wage structure firmly in place, we expect to see the full and positive impact on next year's budget, which will be discussed by parliament in November with expected approval by the end of December 2001.

12. Against that background, we are confident that we can achieve a deficit target of 4¼ percent of GDP for the consolidated central government in 2002, with a further significant deficit reduction in 2003. In this context, we would like to confirm our interest in a successor program to the present stand-by arrangement covering the period 2002–03.

Sincerely yours,

/s/  
Slavko Linić  
Deputy Prime Minister

/s/  
Mato Crkvenac  
Minister of Finance

/s/  
Željko Rohatinski  
Governor  
Croatian National Bank

Attachment: Adjustor for the CNB's NDA Ceiling

### Adjustor for CNB's NDA Ceiling

The following adjustor is proposed to be added to Annex VIII of the SMEFP.

“The ceilings shall be adjusted for changes in the required reserves in domestic currency, as follows.

$$\Delta NDA = \Delta r (B_0^D + \theta_0 B_0^F) + r_1 (\Delta B^D + \theta_1 \Delta B^F + \Delta \theta B_0^F)$$

where  $\Delta NDA$  = adjustment to the ceiling on net domestic assets of the CNB;

$B^D, B^F$  = domestic and foreign currency liabilities subject to reserve requirements;

$B_0^D, B_0^F$  = the originally programmed test-date levels of  $B^D$  and  $B^F$ ;

$r$  = reserve requirement ratio;

$\theta$  = the portion of liabilities in foreign currency subject to reserve requirements in domestic currency;

$r_0, \theta_0$  = the originally programmed test-date levels of  $r$  and  $\theta$ ,

$\Delta B^D, \Delta B^F$  = unprogrammed administrative changes to  $B^D, B^F$  affecting the definition and/or coverage of  $B^D, B^F$  compared with their originally programmed test-date levels;

$\Delta r, \Delta \theta$  = unprogrammed changes to  $r$  and  $\theta$ , so that

$r_1$  =  $r_0 + \Delta r$ ; and

$\theta_1$  =  $\theta_0 + \Delta \theta$ .

The adjustor applies only to the changes on account of administrative decisions that were not foreseen in the monetary program agreed in the SMEFP.”

**NEWS  BRIEF**

**FOR IMMEDIATE RELEASE**

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News Brief No. 01/110  
FOR IMMEDIATE RELEASE  
November 5, 2001

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

**IMF Completes First Review of Stand-by Arrangement with Croatia**

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Croatia's performance under the 14-month stand-by arrangement. The arrangement for SDR 200 million (about US\$254 million), which was approved on March 19, 2001, is being treated by the authorities as precautionary.

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

"The Croatian authorities are likely to either meet or exceed the original growth, inflation and international reserves objectives under their program for 2001. The weakening of the external contribution to growth is compensated by a stronger expansion of private domestic demand, as both consumption and investment are growing faster than anticipated. The authorities' reform program, improved access to foreign markets, and the strengthened regional security situation have contributed to this strengthening of macroeconomic performance.

"Durable expenditure reductions are critical to achieving and maintaining fiscal sustainability. The authorities are in the process of reducing public wages and employment from unsustainable levels. Although there have been some delays and tradeoffs have had to be accepted in discussions with social partners, the authorities are to be commended for having implemented a bold and significant reduction in the wage bill of the consolidated central government. Recently adopted reforms to rationalize and reduce social transfers will also make an important contribution to fiscal strengthening.

“The authorities have reaffirmed their commitment to reduce this year’s fiscal deficit. To this end, they have revised the budget by cutting spending on goods and nonwage services, subsidies, and investment. Adverse market conditions and delays in privatization have, however, forced changes in their financing plan which will slow the decline in the government debt ratio this year.

“The Croatian National Bank will continue to pursue price stability as its primary objective. While a broadly stable exchange rate remains important for achieving this objective, the CNB is committed to maintain strict control of domestic liquidity to support the disinflation process. Efforts will continue to develop the domestic financial market, and improve the effectiveness and widen the range of monetary policy instruments.

“Structural reforms will continue, including the restructuring and privatization of public enterprises and remaining state-owned banks. These reforms will contribute to improved efficiency and growth, as well as to strengthening the fiscal position,” Ms. Krueger said.



**Statement by J. de Beaufort Wijnholds, Executive Director for the Republic of Croatia  
November 5, 2001**

***Introduction***

The Croatian authorities would like to thank staff for a very thorough and fair assessment of the Croatian economic performance under the Stand-By Arrangement. Also, the authorities are grateful to staff for their efforts in helping them steer through the economic reform course, as well as for their important advisory role. I can confirm that the authorities intend to continue publishing all the SBA documentation and to continue to use this SBA as precautionary.

I am also pleased to confirm that the prior action for completion of the present review has been satisfied, since all eleven laws (aimed at rationalizing the social transfer system) together with a revised budget for 2001, containing discretionary cuts in other expenditure items, were approved by Parliament in mid-October.

***General Outlook***

Croatia's economic performance, thus far in 2001, has been strong and at this point it is almost certain that the authorities' growth, inflation and international reserves objectives for 2001 will be either met or exceeded. This is quite satisfactory having in mind the less favorable external environment and some unfortunate delays in policy implementation. It should be noted that delays in the implementation of the economic program primarily have a political background, although the complexity of the structural reforms agenda should also not be underestimated. Fortunately, the impact of somewhat slower policy implementation has been rather limited in the first half of the year. This is best seen through observance of the quantitative performance criteria at end-March and end-June. The most important PC – the fiscal deficit – was observed on both test dates, although the decision on government wages (a structural performance criterion) was implemented with a delay. Most of the other important PCs were also observed. I would also like to highlight the significant over performance of international reserves, which were some US\$300 mln. above the program floor at end-June.

The Croatian authorities are fully aware of the risks associated with slower policy implementation, in particular with regard to this year's fiscal deficit target (5.3 percent of GDP). However, the authorities remain fully committed to this deficit target and, in order to counteract fiscal slippages, they have taken a bold set of measures, which should ensure meeting the 2001 fiscal deficit target. These measures were recently approved by Parliament.

***Fiscal Policy***

Public finances in Croatia are undergoing fundamental changes, and reducing the fiscal deficit is only part of a broader effort to put the public finances on a sustainable footing in the medium-term. Reducing the level of the consolidated central government expenditures, as well as easing tax pressures are two objectives within this overall strategy.

This fiscal year is only the second year in a four-year path to fiscal sustainability. Already in 2000, the authorities made a large step in reducing the deficit, expenditure and the tax burden. These trends are to be continued this year, as well as next year, although at a somewhat slower pace. The final result should be seen in 2003, when the deficit is projected to account for only 1.3 percent of GDP, with expenditure standing at 36 percent of GDP. It is obvious that the magnitude of the fiscal adjustment over these four years is impressive, with the share of fiscal expenditures for instance projected to cumulatively decline by roughly 14 percentage points of GDP.

There is no doubt that achieving such large fiscal expenditure cuts in a short period of time is politically difficult, as not all measures are equally popular. It is unfortunate that some delays in approving and implementing fiscal measures (eleven laws) occurred this year in Croatia. Due to the delay, the fiscal effect of these measures will be negligible this year, but they will start to yield significant positive effects in coming years. However, to offset expenditure overruns this year, and in order to meet this year's annual deficit target, the authorities have taken a number of discretionary measures. Most of them are related to capital expenditure cuts, but significant cuts are also made within current expenditures.

### ***Monetary and Exchange Rate Policy***

Monetary performance under the program has been successful. The Croatian National Bank (CNB) has proven its skills in conducting monetary policy and keeping inflation low, notwithstanding the sometimes unfavorable environment. It should be noted that CNB has succeeded to maintain low single digit inflation for almost 8 years, despite the fact that only recently it was given a full mandate (by the new central bank law) to focus on price stability. In 2000, inflation had picked up to 7.4 percent, primarily due to increases in energy prices and excises. This year inflation is expected to come down to 4.5 percent. This achievement is especially noteworthy in light of further increases in administered prices and excises. The monetary authorities will continue to monitor closely inflation developments, and in doing so they will keep an eye on exchange rate movements. As regards the quantitative PCs set under the program, both criteria (on international reserves and on net domestic assets) were comfortably met. End-September targets were also observed.

Recently, the monetary authorities initiated changes in reserve requirements for commercial banks. Since these changes were previously unforeseen, and since it is now obvious that the monetary authorities will not be able to meet the end-December target for the increase in net domestic assets, the monetary authorities request an adjuster to be applied to take into account the previously unforeseen changes in reserve requirements.

### ***Structural Reforms***

Progress on the structural front has been somewhat less satisfactory. Although the decision on wages in the government sector was implemented with a slight delay (with some minor modifications), this year's wage bill will be almost 5 percent smaller in nominal terms in comparison to last year's. In addition, in an effort to reduce employment in the public

sector (another structural PC), so far almost 1,400 government employees have been laid off, and it is expected that some 5,000 more will be laid off by the end of the year. This falls somewhat short (by 3,600) of the original target of reducing employment in the government sector by 10,000 employees (over 5 percent of the total government workforce). The authorities, however, remain firmly committed to this target, but since laying off these additional 3,600 workers (mainly in the Ministry of Defense) requires Parliamentary approval of the new defense law, the authorities are requesting a 3-month extension of the deadline for this PC.

As regards privatization, the second phase of HT (Croatian Telecom) privatization did not materialize, as initially envisaged, due to unfavorable market conditions. However, the authorities re-opened the negotiations with Deutsche Telecom (DT), and in early July they were successfully concluded. As a result, an additional 16 percent of shares were sold to DT, raising its share to 51 percent. The authorities also expect to conclude the privatization of two banks, later this year. It is worth noting that at the end of 1998 only 7 percent of total banking assets were in majority foreign ownership, while in early 2001 this percentage already stood at 84 percent. After privatizing these additional two banks, the percentage of total banking assets that is majority foreign owned will be even higher – close to 90 percent. These developments demonstrate a strong track record in opening up the financial sector and the authorities' decisiveness in the banking system's privatization.

### *Conclusion*

The Croatian authorities wish to reiterate their firm commitment to structural reforms and to the overall program objectives, especially to containing the fiscal deficit within program targets. They are aware that progress on the structural front has been somewhat less satisfactory, but there is no doubt that the authorities are moving in the right direction. The recent approval of eleven laws and other tough fiscal measures underscores the authorities' determination to keep the program on track. In this regard, the authorities' efforts should be appropriately recognized. Finally, the recent signing of the Stabilization and Association Agreement (SAA) between Croatia and the EU should positively affect a further harmonization of economic policy in Croatia, in line with best EU practices.