March 2006
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Republic of Croatia: Second Review Under the Stand-By Arrangement and Requests for Extension and Augmentation of the Arrangement, Rephasing of Purchases, and Waiver of Nonobservance of Performance Criterion—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia

In the context of the second review under the Stand-By Arrangement and requests for an extension and augmentation of the arrangement, rephasing of purchases, and a waiver of nonobservance of a performance criterion, the following documents have been released and are included in this package:

- the staff report for the Second Review Under the Stand-By Arrangement and Requests for Extension and Augmentation of the Arrangement, Rephasing of Purchases, and Waiver of Nonobservance of Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on December 16, 2005, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 8, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Press Release summarizing the views of the Executive Board as expressed during its March 29, 2006 discussion of the staff report that completed the review and requests.

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

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

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

*Also included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Second Review Under the Stand-By Arrangement and Requests for Extension and Augmentation of the Arrangement, Rephasing of Purchases, and Waiver of Nonobservance of Performance Criterion

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

Approved by Poul Thomsen and Anthony Boote

March 8, 2006

The 20-month, SDR 97 million (26.6 percent of quota) Stand-By Arrangement, which the authorities treat as precautionary, was approved on August 4, 2004 (when the Executive Board also concluded the 2004 Article IV consultation). The first review was concluded on September 14, 2005.

Discussions on the second review took place during two missions in late 2005 (October 31–November 7 and December 8–16), comprising Messrs. Demekas (head), Gueorguiev, Moore (EUR), Hilaire (PDR), and Ms. Mitra (MFD) and assisted by Mr. Vamvakidis, Resident Representative. Staff met Prime Minister Sanader; Deputy Prime Ministers Polančec and Kosor; Finance Minister Šuker; Health Minister Ljubičić; Economy Minister Vukelic; Croatian National Bank (CNB) Governor Rohatinski; other senior officials; members of parliamentary committees; and representatives of political parties, trade unions, and the private sector. Mr. Christofides (OED) attended some of the meetings.

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

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

On October 3, 2005, Croatia started accession negotiations with the EU. The European Commission assessed in the context of the 2005 Progress Report that Croatia can be regarded as a functioning market economy that should be able to cope with the competitive pressures within the Union in the medium term provided it continues its reforms (economic criteria for membership). The arrest abroad in December of the last Croat fleeing indictment by the International Criminal Tribunal for the former Yugoslavia underscored Croatia's full cooperation with the Tribunal, which satisfied a major outstanding element of the political criteria for membership.

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I. Program Performance and Developments in 2004–05

1. **Breaking with the track record of previous years, policy implementation under this SBA has yielded sizeable fiscal consolidation and advances in structural reforms, despite some snags**. In pursuing the program objective of reducing external vulnerability, the authorities implemented policies whose benefits will continue to be reaped well into the future. Although preoccupation with presidential and local elections led to some policy drift in early 2005, an upward revision of the original 2005 budget deficit target, and a delay in completing the first review, the program has been brought decisively back on track.

- The government delivered a ***fiscal and quasi-fiscal adjustment*** of 2¾ percent of GDP over 2004–05 by cutting spending. The general government deficit was reduced from 6.3 percent in 2003 to 4.2 percent of GDP in 2005 notwithstanding a notable revenue drop through slower wage bill growth, lower transfers and public investment, and structural reforms. Outside the general government, the balance of the Croatian Development Bank (HBOR), whose operations are largely quasi-fiscal, was reduced by another 0.6 percent of GDP. Fiscal policy has been set for the first time in a medium-term framework with the introduction of rolling 3-year budgets in 2005—a key element of the program's structural conditionality. Fiscal management and transparency have been improved through bringing all state aid to the railways on budget; including in the single treasury account the largest extrabudgetary funds; and lowering contingent liabilities and public enterprise deficits.

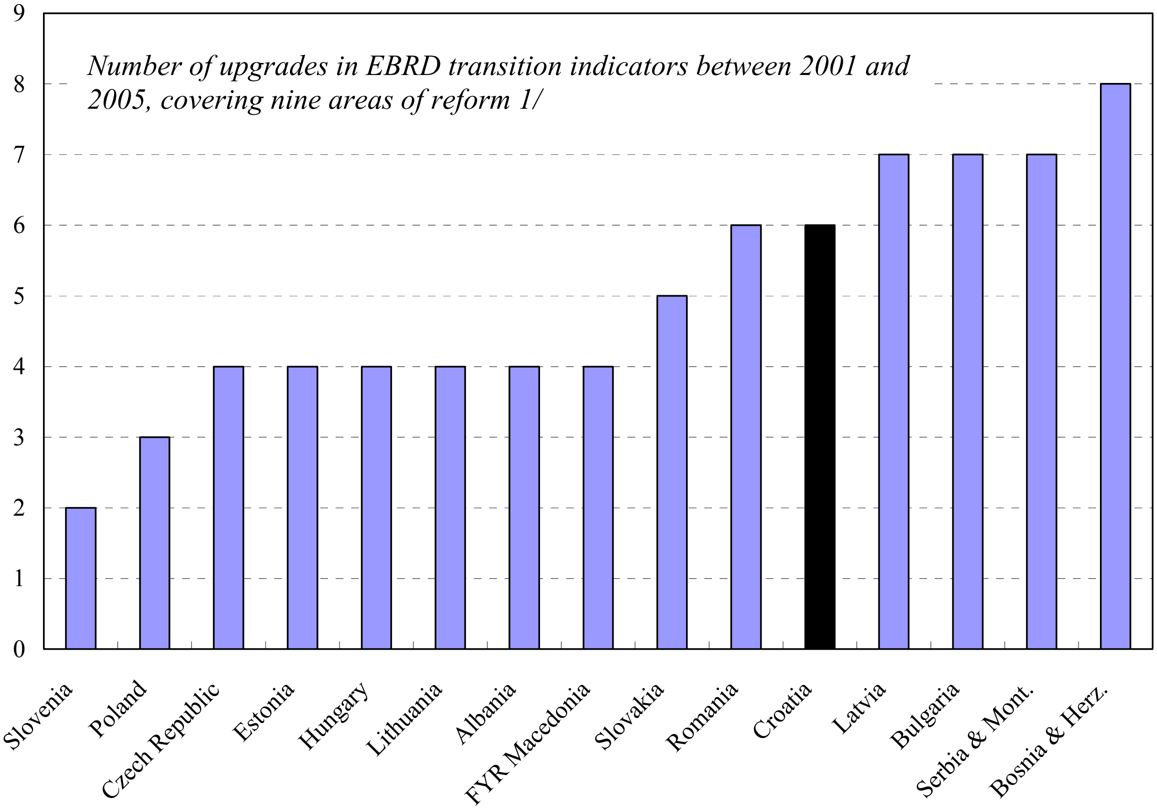
- ***Structural reforms*** have advanced, often beyond what was envisaged in the original program. Although Croatia still lags other Central European countries (Figure 1), recent efforts have begun to address long-standing rigidities and are strengthening the sustainability of the adjustment. The government revised the pension indexation formula to reflect both wage and price developments; introduced an administrative fee for medical services; started implementing a medium-term subsidy reduction plan; and brought the Law on State Aid in line with the EU's *acquis communautaire*. With assistance from the World Bank, it started restructuring the railways so as to improve cost recovery and reduce subsidies. Privatization, however, has been delayed by a number of lawsuits against the Privatization Fund, unresolved property issues in many companies and, in some cases, strong opposition from vested interests.

- All end-December 2005 ***performance criteria*** (PCs) were met,[1] with the exception of the target on the reduction of general government arrears, for which the authorities request a waiver. This breach was due to continued accumulation of arrears in the health sector (government arrears in all other areas have been all but eliminated),

[1] All end-September PCs were also met except for the targets for arrears and for government external borrowing. The latter was due to the earlier-than-expected contracting of the World Bank's PAL1 loan; the end-December target for government external borrowing was met.

Figure 1. EBRD Transition Indicators

Croatia's transition indicators have improved markedly over the past four years...



...but Croatia still lags behind Central Europe and the Baltics, especially as regards the private sector share of GDP.

Croatia and Selected Countries: Average EBRD Transition Indicator Scores, 2005	Private sector share of GDP EBRD mid-year estimate (%)	Enterprise reform & governance	Markets & trade	Financial institutions	Infrastructure reform
Central Europe and Baltics	76	4-	4-	4-	3
Croatia	**60**	**3+**	**3+**	**3+**	**3**
Southeastern Europe	66	3	3+	2+	2+

Sources: EBRD Transition Reports, 2001 and 2005; IMF staff calculations of (unweighted) regional and category averages. Indicators range from 1 (no reform) to 4+ (standards of an industrialized market economy).

1/ The nine areas are large-scale privatization; small-scale privatization; governance & enterprise restructuring; price liberalization; trade & foreign exchange system; competition policy; banking reform & interest rate liberalization; securities markets & non-bank financial institutions; and infrastructure reform.

which is characterized by generous and insufficiently targeted benefits, drug stockpiling, and inadequate cost control. Although at HRK 1.6 billion (0.7 percent of GDP) the stock of health arrears is low and the associated expenditures are captured in the general government deficit, this situation undermines financial discipline and keeps public spending on health high by regional standards. A credible plan has now been drawn up to address these problems over the medium term. Three structural benchmarks were also met, while completion of two other benchmarks has so far been delayed (Tables 1 & 2).

Public spending on health, 2003
(In percent of GDP)

Croatia	**7.1**	Bulgaria	4.5
EU-15 average	**7.1**	Poland 1/	4.3
Czech Republic	6.8	Estonia	4.2
Hungary 1/	5.5	Lithuania	3.9
Slovakia	5.2	Romania	3.8

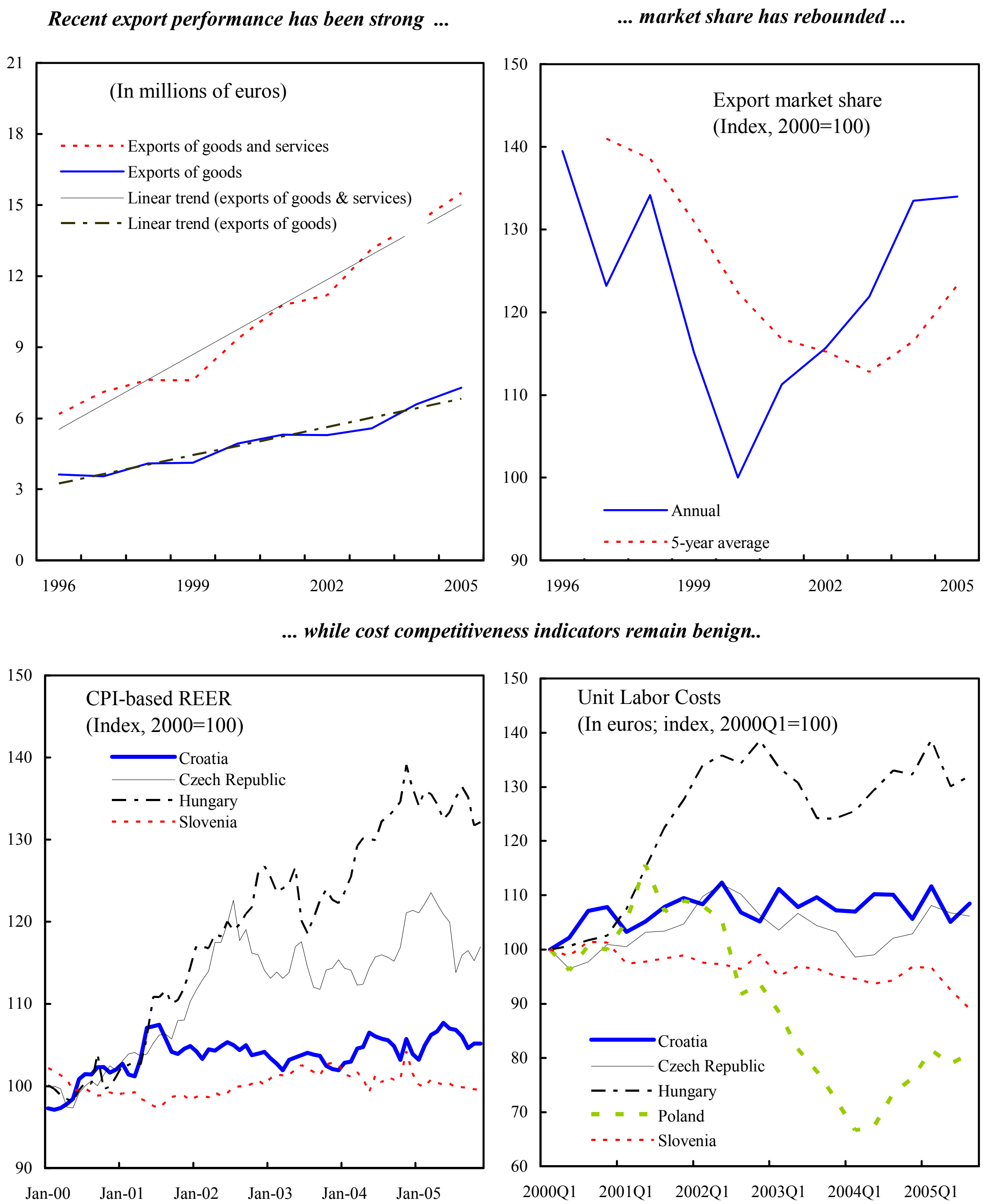
1/ 2002.
Source: OECD, Eurostat, and staff estimates.

2. **Powered by enduring private investment, productivity growth, and strong competitiveness, the economy shrugged off the withdrawal of fiscal stimulus and continued to grow at a healthy clip, while inflation remained tame**. Rising private capital formation offset the impact of declining public investment and productivity growth averaged around 3 percent per annum during the program period, continuing the trend since the start of the decade. Exports performed better than expected and price and cost competitiveness indicators remain strong (Figure 2). As a result, real GDP growth remained around 4 percent and unemployment declined during 2004-05 (Table 3). The latest high-frequency indicators suggest that activity strengthened in the second half of 2005 fueled partly by a pickup in credit growth, offsetting the modest slowdown in the first quarter and foretelling continuing solid expansion (Figure 3). After peaking at 4.1 percent in October, the 12-month CPI inflation rate fell to 3.9 percent in January 2006. Core inflation (excluding energy and administered prices) was 3 percent at end-2005.

3. **External imbalances—adjusted for statistical revisions—have improved**. The current account deficit in 2005 is estimated at 6 percent of GDP (Table 4), only somewhat lower than in 2003, and indeed higher than the 2005 program projection. The picture, however, is clouded by a major change in CNB's statistical methodology for estimating tourism revenue resulting in a downward revision in previously published data by ¾ of a percentage point of GDP starting in 2004, with a counterpart in an equivalent drop in negative errors & omissions. Adjusted for this break in the series, the current account deficit has improved by about 1 percentage point of GDP between 2003 and 2005, despite higher-than-expected oil prices and nonoil imports in 2005. Alternative measures suggest that the improvement in the underlying external flow imbalance may in fact have been higher.[2]

[2] Given the correspondence between estimated tourism receipts and errors & omissions—flagged already in IMF Report Nos. 04/253 & 05/349—the sum of the current account deficit and errors & omissions may be used as an alternative measure for gauging the *change*, if not the level, of the external flow imbalance. This measure improved by 2½ percentage points of GDP between 2003 and 2005 (Figure 4). This measure, however, may overestimate the underlying external adjustment, as errors & omissions are also sensitive to capital inflows.

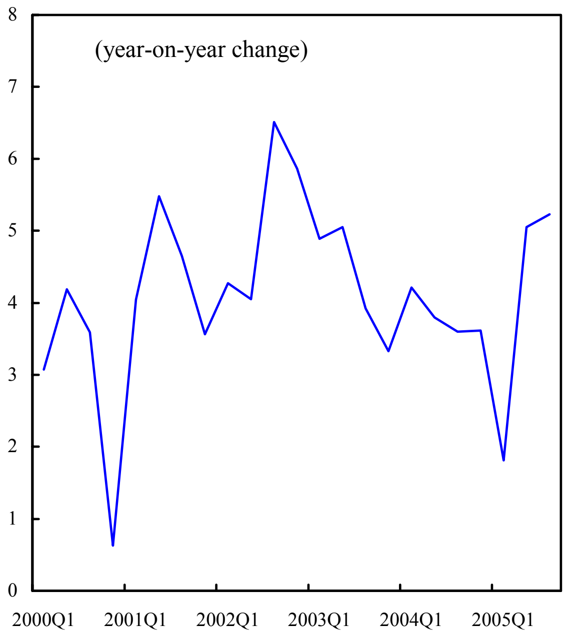
Figure 2. Croatia and Selected European Countries: Competitiveness Indicators, 2000-05



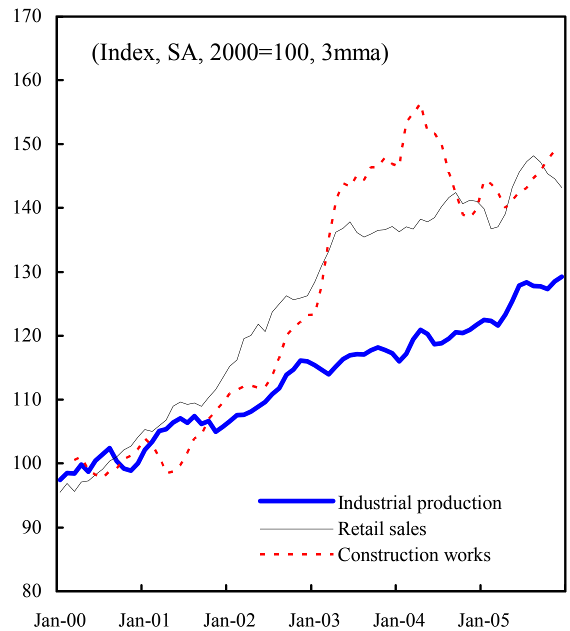
Sources: Croatian authorities, IMF's Direction of Trade database, and Fund staff calculations.

Figure 3. Croatia: GDP and Selected High-Frequency Indicators, 2000-06

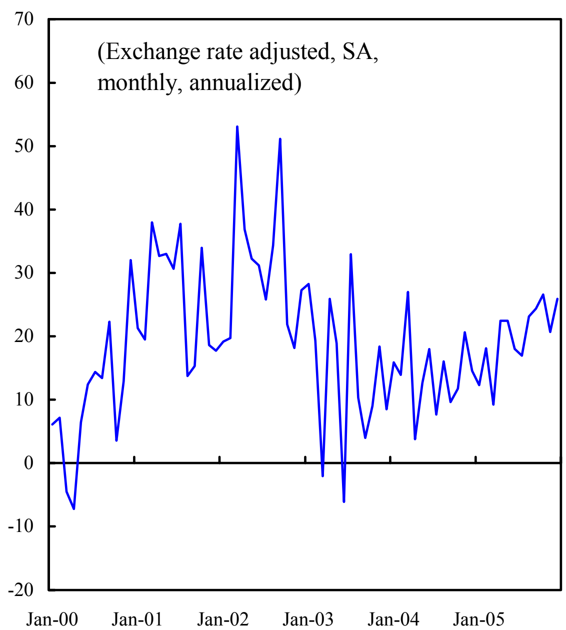
Real GDP growth dipped in 2005 Q1, but rebounded in Q2 and Q3 ...



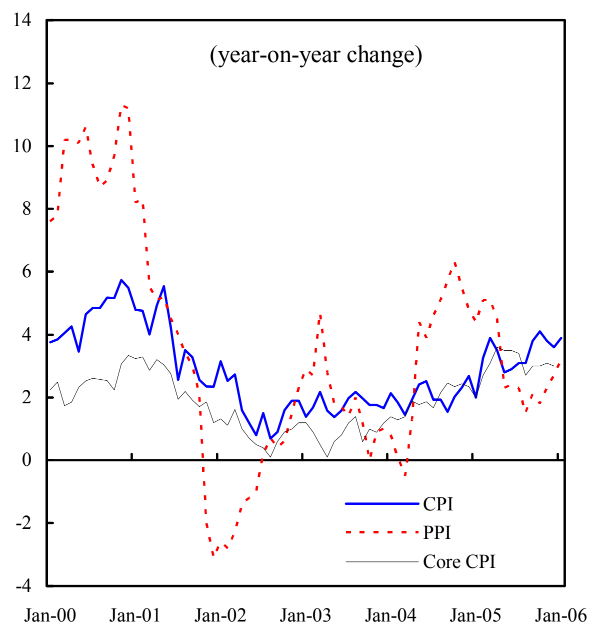
...consistent with indicators of real sector activity.



Credit growth picked up in the second half of 2005.



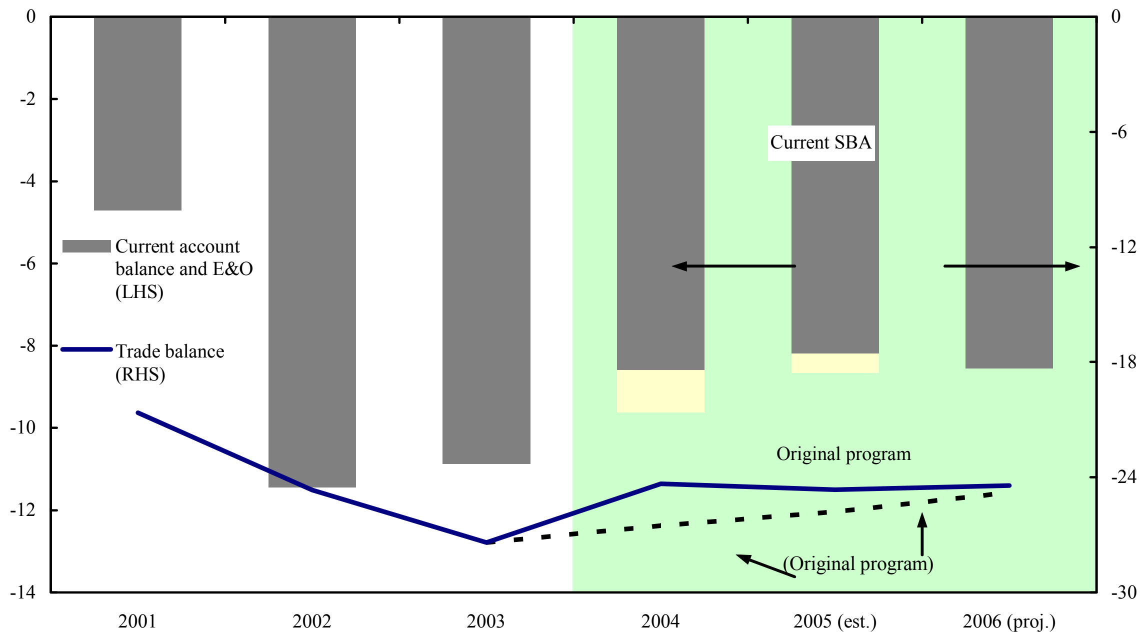
Inflation remains moderate despite higher oil prices.



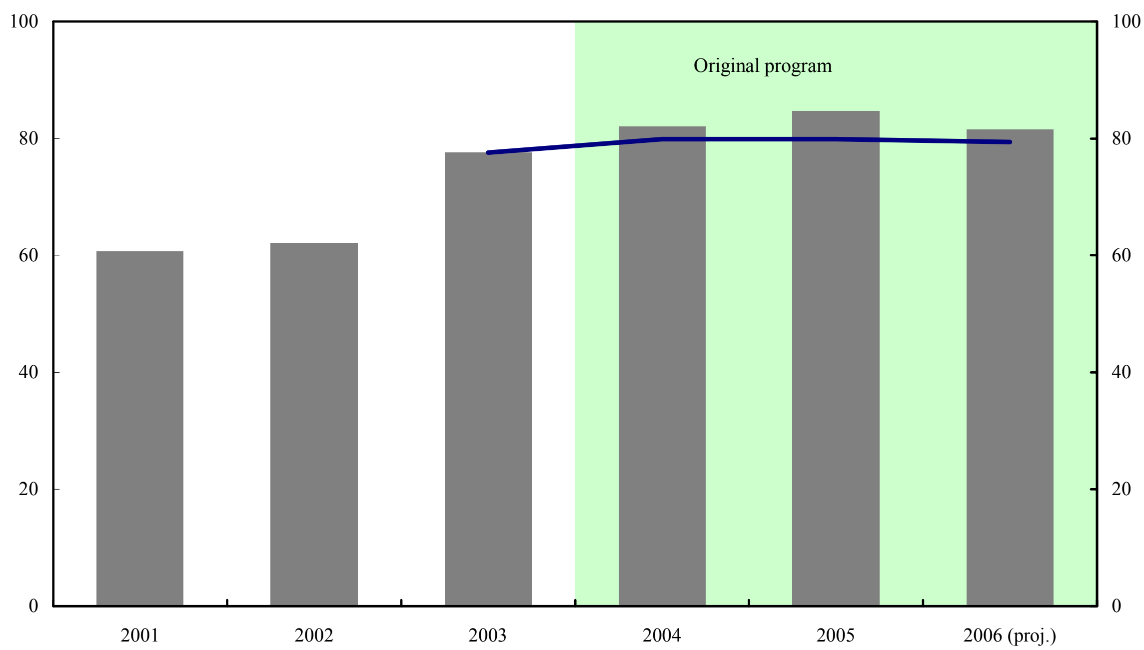
Sources: Croatian authorities; and IMF staff calculations.

Figure 4. Croatia: External Developments, 2001-06
(In percent of GDP)

The external imbalance improved by more than programmed in 2004-2005 ...



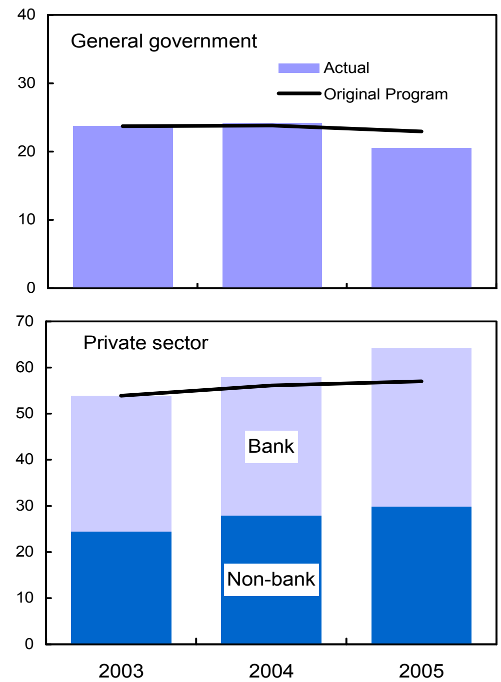
... though the expected stabilization of external debt in 2005 has been delayed.



Sources: Croatian authorities, and Fund staff estimates.

4. **Despite this, the gross external debt ratio did not stabilize, although its rise has slowed considerably**. Gross external debt—the program proxy for measuring external vulnerability—stood at 84.7 percent of GDP at end-2005, 2¼ percentage points above its level at end-2004. By comparison, the gross external debt-to-GDP ratio rose by 5 percentage points in 2004 and 16 percentage points in 2003. At 43.8 percent of GDP net external debt is much lower, but rose by more than gross debt during 2005 as banks reduced foreign assets to fund domestic activities. Partly reflecting higher capital inflows, gross reserves reached € 7.4 billion (4.7 months of imports GNFS) at end-2005, exceeding program projections by almost € 1 billion.

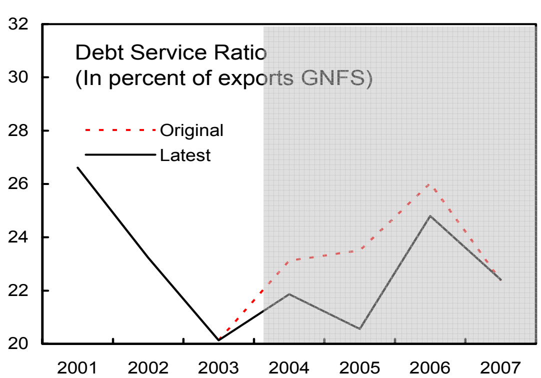
External indebtedness, 2003-05
(In percent of GDP)



Source: Croatian National Bank.

5. **Given the improvement in the external flow imbalance, the higher-than-expected level of external debt reflected private portfolio decisions**. External private borrowing during 2004–05 was over 7 percentage points of GDP higher than anticipated in the program, with foreign-owned banks fighting for market share and enterprises increasingly borrowing directly from abroad. In contrast, the government reduced its foreign indebtedness by shifting budget financing to domestic sources. The higher external borrowing essentially reflects asset accumulation and other portfolio decisions by private agents, over which macroeconomic policies have only a limited impact in an environment of free capital movements, extensive financial euroization, and sustained inflows.

6. **Meanwhile, the economy's debt-carrying capacity and market access have improved relative to program projections**. Market confidence has been strong and bond spreads remain near historic lows (Figure 5); stronger exports and higher reserves have kept the debt service ratio below and the reserve coverage well above original program projections; and official reserves still exceed total short-term foreign debt (Table 5).



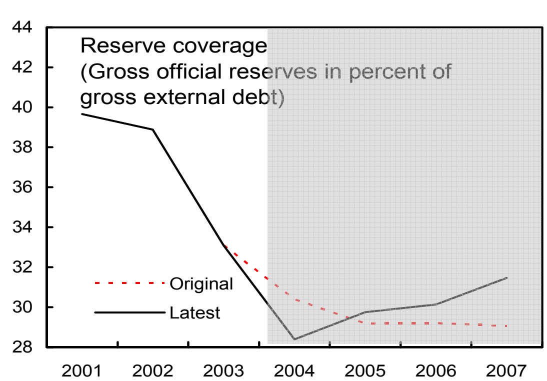
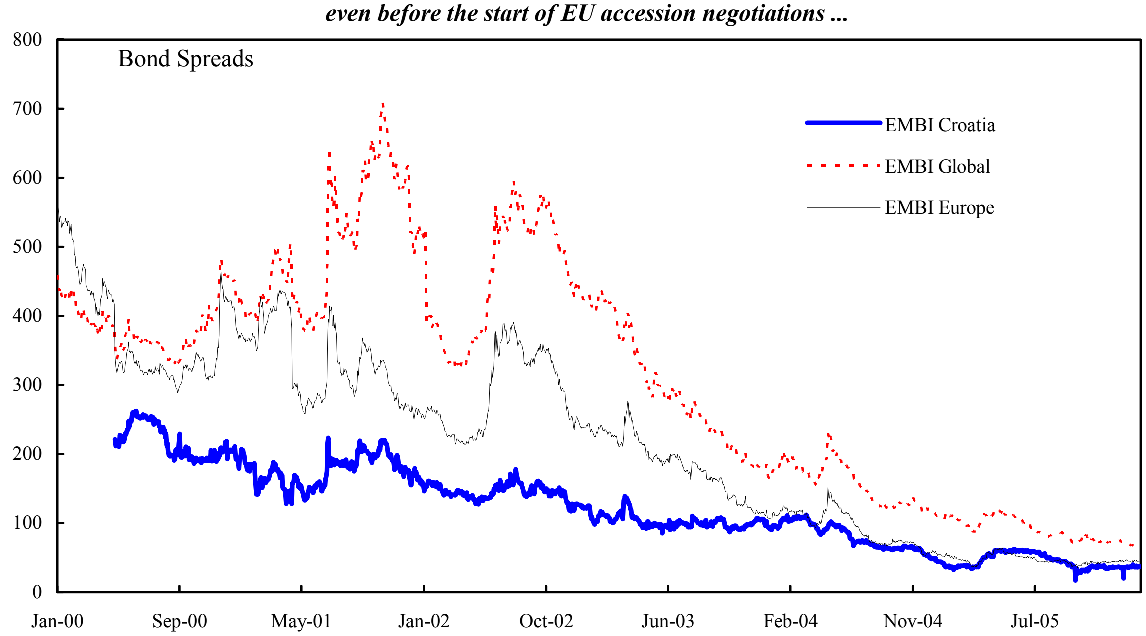
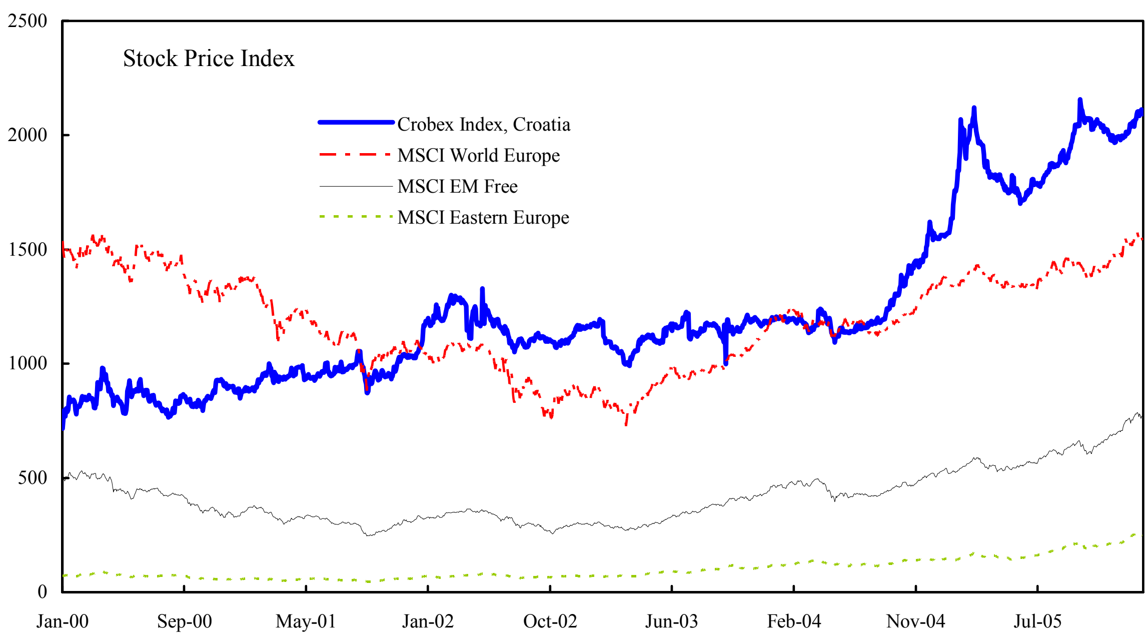


Figure 5. Croatia: Capital Market Conditions, 2000-06
(In basis points)

Market access is strong and bond spreads were at historically low levels even before the start of EU accession negotiations ...



...while the stock market remains robust.



Sources: Croatian authorities; and JP Morgan/Bloomberg.

7. **The financial sector remains sound, though foreign exchange-linked credit risk is a concern**. Financial soundness indicators show the banking system remains strong (Table 6). Credit to households picked up pace in the second half of 2005, peaking at 23 percent year-on-year in October before easing to 20 percent by end-year. Although their debt burden is not excessive,[3] most households are probably exposed to some currency risk: 80 percent of long-term bank loans to households are linked to foreign currency; and while households' foreign currency deposits are sizeable, there is no information on their other foreign currency assets and income. Both households and corporates are also vulnerable to interest rate risk as more than 80 percent of bank loans have variable rates. A single nonbank financial supervisor began operations in January 2006, filling gaps in supervisory coverage.

II. The Program for 2006

8. **The economic outlook for 2006 is favorable**. Staff now projects growth to hover above 4 percent, inflation to return to 3 percent by year-end, and the current account deficit to decline to just under 6 percent of GDP. Aggregate demand is projected to grow at a similar pace to 2005: although "pensioners' debt" repayments (see below) will start contributing to consumption from mid-year, this will be offset by further fiscal consolidation and by the impact on credit of CNB measures to strengthen bank risk management. Also, consistent with the latest WEO, prospects for tourism and exports are projected to improve.

9. **However, the underlying momentum of private sector activity creates its own risks**. If capital inflows and credit growth accelerate and translate into higher consumption, the external (flow and stock) imbalances might deteriorate. Given the large financing requirement that is likely to persist in the coming years, Croatia will stay vulnerable to external market or interest rate shocks. And whether these vulnerabilities will remain manageable ultimately depends on the extent to which inward capital flows—both FDI and borrowing by Croatian enterprises—contribute to higher potential growth.

10. **The start last October of hitherto delayed EU negotiations has strengthened the government and may improve further the business climate**. With its major immediate objective achieved and elections due in late 2007, the government can now shift its focus to economic issues and tackle controversial issues like health reform and privatizing large loss-making companies. Although the start of negotiations had been discounted (Croatian bond spreads, already very low, barely budged), the fact that membership is now in sight may engender greater confidence domestically. While this would make economic adjustment easier, it might also aggravate the risk of accelerating credit and consumption growth.

11. **The macroeconomic program for 2006 aims at securing the improvement in the external accounts achieved during 2004–05 and supporting the reforms underway in**

[3] Bank claims on households were 35 percent of GDP at end-2005, below the euro-area average (55 percent) but above the maximum among new EU members (17 percent).

the context of EU accession. The authorities' program is outlined in the attached letter to the Managing Director (paragraph references are to the Annex of the attached letter). Consistent with the authorities' economic strategy since 2004, the program is based on continued fiscal consolidation and a strengthened structural agenda. Fiscal policy in 2006 targets an underlying adjustment of about 1 percent of GDP that would bring fiscal and quasi-fiscal deficits to 3½ percent this year, down from 7 percent of GDP at the beginning of the program, while monetary policy will remain largely focused on maintaining the stability of the exchange rate vis-à-vis the euro. Moreover, to meet the objective of preparing for EU membership and compensate for the policy slippage in early 2005, the government has strengthened the structural component of the program already since the first review. This program is consistent with the authorities' medium-term macroeconomic vision as detailed in the latest Pre-Accession Economic Program (PEP)—Croatia's second—approved in December 2005 (Box 1). It is also consistent with the objective of stabilizing external debt: given the manageable current account outlook and the expectation of sizeable privatization receipts this year, and on the basis of the government's medium-term targets in the PEP, staff's debt sustainability analysis suggests that the external debt ratio would start to decline in 2006 (Appendix I).

Box 1. Croatia's Pre-Accession Economic Program

As in 2004, the December 2005 update of the PEP sets as its main macroeconomic goal a reduction in external vulnerability and public debt, driven by a decline in the general government deficit to under 3 percent of GDP by 2008 (program definition; under 2 percent on GFS2001 basis). The targeted fiscal consolidation is based on health sector reform, subsidy cuts, and savings in public administration and social benefits, while the tax burden is to be gradually reduced. In cooperation with the World Bank, the government has prepared a medium-term subsidy reduction plan and created an inter-ministerial working group to study improved targeting of social benefits. The PEP provides for the first time detailed estimates of the costs of the 1990s war on the budget (reconstruction, refugee resettlement, etc.), which peaked to 2.5 percentage points of GDP in 2004 and are to decline to below 2 percentage points by 2008. Efforts to strengthen fiscal transparency and budget management will continue, as will the reduction in the government's external indebtedness. Moreover, enterprise restructuring and privatization would boost Croatia's growth potential.

Key Macroeconomic Indicators in the Pre-Accession Economic Program[1]
(in percent of GDP unless otherwise stated)

	2005	2006	2007	2008
Real GDP (percentage change)	3.9	4.0	4.1	4.3
General Government Revenue	46.0	45.9	44.7	44.1
General Government Expenditure	50.2	49.2	47.8	46.9
Fiscal Balance (SBA definition) 2/	-4.2	-3.3	-3.1	-2.8
Fiscal Balance (GFS 2001)	-3.1	-2.4	-2.2	-1.9
Current Account Balance	-5.8	-5.3	-4.5	-3.8

Sources: Ministry of Finance and staff estimates

1/ Ratios to GDP are expressed in terms of the GDP projected by staff. Fiscal balance is on a GFS 1986 basis.

2/ The program definition includes policy-related net lending, arrears, and disposal of fixed assets in the deficit.

12. **In support of their program for 2006, the authorities request a 7-month extension of the current arrangement**. They see Fund support as important in the early phase of the process of harmonization with EU norms, while key structural reforms are being launched. The extension would provide the opportunity to bring to completion key measures initiated under the current SBA and secure its main external objective. The modalities of the proposed extension are presented in Section III.

A. Fiscal Policy

13. **The 2006 budget targets a deficit of 3.3 percent of GDP (excluding "pensioners' debt" repayments),[4] based on realistic revenue projections and expenditure restraint** (Table 7). While the government initially envisaged a deficit of 3.5 percent of GDP in the 2006-08 three-year budget approved last summer, it eventually decided on a tighter target to address risks arising from the still-uncertain impact of "pensioners' debt" repayments on aggregate demand in late 2006 (¶10). On the revenue side, higher EU grants and nontax

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

	2003	2004		2005		2006
		Prog. 1/	Actual	Prog. (1st rev.)	Actual	Prog. 1/
General government						
Revenues	46.4	47.1	46.6 2/	46.1	46.2	45.9
of which: one-off	...	1.0	0.8 2/	0.3	0.3	0.1
Expenditures	52.7	51.6	51.6	50.3	50.3	49.2
Current and net lending	46.8	46.1	46.5	45.4	45.8	44.8
of which: one-off	...	0.4	0.3	0.3	0.3	...
Investments	5.9	5.4	5.1	4.9	4.5	4.3
Balance	-6.3	-4.5	-4.9	-4.2	-4.2	-3.3
Quasi-fiscal						
HBOR balance (net of budget transfers)	-0.7	-0.5	-0.4	-0.4	-0.1	-0.2
Total fiscal and quasi-fiscal balance	-7.0	-5.0	-5.4	-4.6	-4.3	-3.5
Underlying balance (excluding one-off items)	-7.0	-5.6	-5.9	-4.6	-4.3	-3.6

Sources: Ministry of Finance and staff estimates.
1/ GDP shares are calculated using most recent GDP estimates.
2/ Includes 0.1 percent of GDP in revenues accrued in 2004 but encashed in February 2005 (see Table 6).

[4] The statistical treatment of these repayments is ambiguous. The government will not include them in spending because they represent settlement of a long-standing liability, akin to a debt restructuring, that does not affect the government's balance sheet. This argument is valid but, as this liability has so far not been included in official government debt statistics, staff will report their impact on the public finances as in Table 7.

revenue would only partly offset the loss of one-off dividend receipts in 2005.[5] The only tax policy change is the broadly revenue-neutral introduction of a reduced 10 percent VAT rate for all tourist lodging, thus eliminating the zero VAT rate hitherto applying to foreign tour operators. The targeted budget consolidation relies on current and capital expenditure savings arising mainly from the amended pension indexation formula, health reform, and modest wage growth in the budgetary sector, while EU harmonization-related expenses will grow; and is consistent with stabilizing the government debt-to-GDP ratio this year. Budget financing would be limited to domestic sources, supplemented by large privatization receipts. Continued control over HBOR's operations, which lie outside the general government, will result in a reduction in the fiscal and quasi-fiscal deficit to 3½ percent of GDP, down from 7 percent at the start of the SBA.

14. **Achievement of this target depends on timely and full implementation of certain macro-critical reforms during 2006**. In particular, the budget is predicated on the assumption that a minimum set of measures yielding ¼ percent of GDP is implemented by mid-year as part of the ongoing health reform (see below). The government recognizes that these expected savings, while permanent and potentially sizeable over time, will depend on the shape of the final package when approved by parliament, as well as on changes in behavior of economic agents that are hard to predict now. It is thus committed to re-assessing the fiscal outlook once the details of the health reform are finalized and, if necessary, taking steps to safeguard the general government target for 2006 (¶11). Moreover, the successful restructuring of the railway company and of state-owned shipyards will be critical for the reduction of state aid.

15. **Efforts to rein in the broader public sector operations continue as well.** Besides maintaining strict control over HBOR's lending, the government intends to continue limiting contingent liabilities and public enterprise deficits and persist with the restructuring of Croatian Railways (¶15 and ¶24). Staff expressed concern about the stream of government debt guarantees issued to the shipyards (0.7 percent of GDP in 2005); without a restructuring plan to reduce losses and provide a perspective for viability over the medium term, these guarantees were likely to be turned into actual state liability. The authorities explained that the delay of the restructuring plan—initially aimed for end-2005 and still under preparation—was caused by the need to reach internal consensus and incorporate suggestions by the European Commission, while shipyards needed state guarantees *inter alia* to meet their numerous orders. They expected the restructuring plan to be in place by mid-year (¶23).

16. **Settlement of the "pensioners' debt", while welcome, will likely add to domestic demand pressures from the second half of 2006 and may have implications for fiscal policy**. This has been a long-standing state liability that the current government vowed to resolve—a commitment reflected in the original Memorandum of Economic and Financial

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[5] Revenues in 2006 include a small amount (US$51 million, 0.1 percent of GDP) of repossession of Croatia's share of frozen deposits of former Yugoslavia.

Policies. The basic elements of the settlement scheme give eligible pensioners the option of a cash payment at a 50 percent discount during 2006–07 or full repayment during 2008–13 (Box 2). The first option—likely to be chosen by the majority—is advantageous for the budget in net present value terms, but would imply transfers that, under preliminary staff assumptions, could amount to as much as 1 percentage point of GDP in 2006 and 2007. Regardless of their statistical treatment in the budget, staff expressed concern about their possible impact on aggregate demand and imports at a time when external vulnerability remains high. The authorities pointed out that these payments will be one-off and a large proportion of them was likely to be saved—a plausible assumption from a consumption-smoothing point of view. Nonetheless, they were taking steps to offset this risk: *first*, they had decided on a tighter deficit target than previously envisaged; *second*, in the event of revenue overperformance due to faster-than-forecast demand growth, they intended to let automatic stabilizers work (¶10); and *third*, they were prepared to take additional action, if needed, in the context of a mid-year supplementary budget. Staff welcomed these plans. Given the high discount rate implied by the decision of a majority of eligible pensioners to accept a large cut in the nominal value of their claim, however, staff cautioned that the propensity to consume out of such windfall payments would likely be higher than the authorities expected. The macroeconomic impact of these transfers and the appropriate policy response will feature prominently in the discussions on the third review.

Box 2. Repaying the "Pensioners' Debt"

The "pensioners' debt" arose from a 1998 Constitutional Court ruling that the state was liable for unpaid pension indexation entitlements during 1993–98. Although during that period pensions were legally indexed to nominal wages, governments capped indexation payments at lower levels. The Court ruled that the pensioners remained entitled to nominal wage indexation through June 1998, when the law was changed. The liability resulting from the gap between entitlements and actual payments became known as "pensioners' debt". Including accrued interest, this liability amounts to HRK 13.8 billion (5¾ percent of 2006 GDP).

In July 2005, parliament approved a scheme to repay this debt. Each eligible pensioner will be offered a choice between cash payments of half the amount over 2006–07 (in four equal installments) or full repayment over 2008–2013. The government plans to finance these payments through privatization receipts and has created a special fund that will receive state shares in companies under privatization (or proceeds from their sale) and manage the repayment of "pensioners' debt". Some 426,000 eligible pensioners were asked to make the choice between the two repayment options by February, and the first two installments under the cash option are to be paid in June and December 2006. Although the size of these repayments is still uncertain, preliminary estimates suggest that approximately 70–75 percent of eligible pensioners would choose the cash option. Under this assumption, the repayments could amount to HRK 2–2.5 billion (about 1 percentage point of GDP) in 2006 and 2007.

17. **The Ministry of Finance continues to upgrade the management of public expenditure and debt**. The development of the single treasury account received a major boost with the inclusion of the accounts of the Highway and the Road Construction Funds on January 1, 2006. Staff and the authorities agreed that the remaining accounts of the Deposit Insurance Agency and the Privatization Fund will be incorporated when pending legal disputes are settled and amendments to the legal framework of the Deposit Insurance Agency

finalized (¶16). In the area of debt management, the Ministry of Finance will fully implement the permanent software solution supported by the EU CARDS program and introduce an electronic system for Treasury bills auctions in the first half or 2006.

B. Monetary and Financial Sector Policies

18. **Monetary policy will continue to support price stability in 2006**. The CNB uses the exchange rate as a *de facto* nominal anchor, while allowing for limited, mostly seasonal fluctuations. This strategy, discussed in detail in IMF Country Report No. 04/253, has served Croatia well although, at the same time, it limits the scope for monetary policy and contributes to unhedged private sector borrowing in foreign currency. The CNB's monetary program for this year aims at maintaining a reserve cover of about 4½ months of next year's imports GNFS and is consistent with broad money growth of 10–13 percent (¶17 and Table 8). Base money growth and the corresponding net domestic assets targets under the program would be lower, however, reflecting changes to the reserve requirements (¶18). The net credit flow to the nongovernment sector is projected to decline from 9 to 7¼ percent of GDP, corresponding to a slowdown in the growth rate from 17 to 12–13 percent.

19. **Since the first review, the authorities have taken a number of measures to discourage external borrowing, address foreign currency-related credit risk (Box 3), and strengthen supervision**. The CNB saw the surge in bank foreign borrowing (mostly by foreign-owned subsidiaries from their parent banks) as both directly and indirectly threatening the objective of stabilizing external debt, the latter by fueling domestic credit and thus widening the current account deficit. In response, it raised the cost of banks' foreign funds while simultaneously reducing the general reserve requirement from very high levels, in order to facilitate the government's efforts to shift budget financing to domestic sources. Furthermore, the CNB was concerned that banks—especially foreign subsidiaries—were not internalizing sufficiently the risks of foreign currency-linked lending to unhedged borrowers, and launched measures to strengthen risk management in banks. Staff welcomed these measures on both macroeconomic and prudential grounds. Indeed, staff estimates suggest that the 55 percent marginal reserve requirement would make foreign borrowing barely

Box 3. CNB Measures to Curb Foreign Borrowing and Address Credit Risk

In view of the rapidly rising bank foreign liabilities, the CNB raised the marginal reserve requirement (MRR) on new bank borrowing from abroad (¶18). The MRR (40 percent at end-2005) requires an unremunerated foreign currency deposit at the CNB related to the increase in banks' foreign liabilities from June 2004. Effective January 2006, the MRR was augmented by a second-tier requirement, set at 55 percent and applicable to the increase in banks' foreign liabilities relative to November 2005. The new MRR will apply to a broader base as well, which includes corporate borrowing from abroad guaranteed by Croatian banks and banks' borrowing from domestic leasing companies.

The CNB adopted several measures—to be fully effective by mid-2006— that aim to mitigate credit risks related to foreign currency and foreign currency-indexed loans and, in the process, moderate credit growth to the private sector (¶19). The thrust of these measures is to raise banks' awareness of such risks; introduce a common framework for reporting and dealing with them; and, reflecting the higher risk exposure associated with such loans to unhedged borrowers, raise their risk weight. The CNB will also initiate a public campaign to inform borrowers of the risks of unhedged foreign currency and floating interest rate loans.

profitable at the margin (at current interest rates) and induce banks to moderate their credit expansion once the effect of the lower general reserve requirement wears out. As such, these measures would make recourse to direct controls on capital inflows—which the CNB continues to see as a last-resort option (¶17)—less likely. But staff and the CNB agreed that these measures also tended to divert borrowing to nonbank channels and induce corporate clients to borrow abroad directly. In this context, staff welcomed the creation of a unified nonbank financial regulator—a key commitment under the program—at the start of this year.

C. Structural Policies

20. **The authorities' structural agenda was expanded considerably at the time of the first review**. The original program focused mostly on the areas of fiscal management—where the government has made significant progress; and privatization—where there have been delays. During last year, farther-reaching reforms were initiated in the areas of health, pensions, state aid, and subsidies. Among the remaining challenges, health reform is critical, as it will have a considerable impact on public finances over the medium term; the restructuring of shipbuilding, steel, and railways is a prerequisite for achieving the government's medium-term subsidy reduction plan; and the privatization agenda still awaits completion.

21. **The health reform aims at improving the financial situation in the sector and rationalizing public spending on health**. In 2005, spurred by the continuing accumulation of arrears in the sector, the government launched a reform that went well beyond the limited measures included in the original program. As a first step, the government introduced administrative fees for doctors' visits and prescription drugs in October 2005. The second stage, to be effective in mid-2006, will widen the scope of patients subject to co-payments for non-generic drugs, shift the supplementary insurance scheme for drugs to the private sector, and strengthen financial discipline and accountability in health care providers (¶21). These measures are macro-critical because they are expected to address the problem of arrears and generate sizeable savings in public health spending over time. Staff welcomed this strategy, but noted that the fiscal impact of the measures planned for this year is uncertain. It thus supported the government's intention to remain vigilant and take additional measures, if needed, to safeguard its macroeconomic targets this year. Moreover, the World Bank believes that additional action will be necessary over the medium term to address fundamental problems in the health sector, and is discussing these with the authorities in the context of the PAL.

22. **After harmonizing the legal framework for state aid with EU norms and adopting a medium-term subsidy reduction plan in 2005, the government has started to address the most complicated sectors**. First, implementation of the World Bank-supported restructuring plan in the ***railways*** continues with the separation of infrastructure and business operations, improving the working ratio, and initiating privatization of subsidiaries (¶24). And second, the government in consultation with the European Commission is preparing a restructuring plan for ***shipyards*** (¶23). The plan, to be implemented by mid-year, will focus on reducing the level of state aid to EU levels and ensuring its compatibility with EU rules.

The largest companies in the sector will be prepared for privatization, with the first sale launched already in 2006. Similar plans for privatization are underway in the ***steel sector***.

23. **Despite difficulties and delays, the government is persevering with its privatization efforts**. It has initiated the process for several large transactions: it has retained an advisor for the sale of a 15 percent stake in the oil company INA (already partly privatized), which it intends to complete, together with the sale of the remaining state holdings stake in the telecommunications company, by mid-2006; and three metallurgical companies, the Uljanik shipyard, and the insurance company (CO) are to follow later in the year. Regarding other companies, the government's revised plan is to clear the remaining Privatization Fund portfolio (excluding shipyards) by end-2007, with one-third of the companies in which the government holds a majority stake to be sold or closed by mid-2006 (¶22). To deliver on these plans, the authorities now believe that an amendment of the Privatization Act to allow new privatization models (employee buyouts and stock option purchases, public-private partnerships, etc.) is necessary. Staff supported the government's agenda but expressed reservations regarding significant employee ownership: this might not bring new capital or know-how to the firm, while it could repel potential strategic investors. The government, however, gave examples of successful buyouts in neighboring countries and noted that employee ownership has long been a Croatian tradition.

III. Modalities of the Proposed Program Extension and Risks

24. **As noted above, the authorities have requested an extension of the arrangement through November 15, 2006**. The extended SBA will set quantitative performance criteria (PCs) for end-March and end-June, and incorporate an additional (third) review in summer 2006. The third review will focus on assessing the macroeconomic outlook for the second half of the year in view of the impact of "pensioners' debt" repayments on aggregate demand and the balance of payments and the details of the health reform and, if necessary, adjust fiscal policy; it would also set PCs for end-September. The proposed quantitative and structural conditionality is summarized in Tables 1 and 2 of the Attachment. The extension would increase access by SDR 2 million, equal to the average access under the original SBA, prorated for 7 months (excluding the first purchase, which incorporated Croatia's reserve tranche). The authorities intend to continue treating the arrangement as precautionary. Tables 9–12 show the amended schedule of purchases, external financing requirements, and indicators of Croatia's capacity to repay.

25. **The extended program is not without macroeconomic and implementation risks**. A possible surge in aggregate demand later in the year, financed by credit and fueled further by "pensioners' debt" repayments, could jeopardize the external objective of the program. So could further accumulation of external liabilities by residents for portfolio adjustment purposes or a shortfall in privatization receipts. The government is now strong, following the opening of the EU accession talks; but its commitment to fiscal discipline and structural reforms will be tested, especially as the 2007 elections approach. Uncertainties remain regarding the impact of the health reform. And large state-owned loss-makers, in particular shipyards, whose restructuring plan is still debated, represent a risk for fiscal discipline.

IV. Staff Appraisal

26. **Since the start of the program external vulnerabilities have been reduced, while growth and inflation performance have remained good**. Export performance and reserve accumulation have been stronger than originally anticipated and, as a result of the fiscal consolidation, the external flow imbalance has improved during 2004–2005. Over the program period, growth has averaged 4 percent and inflation 2¾ percent and unemployment has declined.

27. **At the same time, the Croatian experience highlights the limitations of macroeconomic policies to address the external stock imbalance**, which continued edging up—albeit at a diminishing pace. Private sector portfolio allocation decisions, over which aggregate demand management policies have little impact in the short run, trumped program expectations. The CNB's recent interventions to curb bank borrowing from abroad are an effort to influence these decisions directly, at least for banks.

28. **These limitations notwithstanding, reducing external vulnerabilities further remains the focus of macroeconomic management in 2006**. The targeted fiscal consolidation will secure the progress made over 2004–05 in reducing the external flow imbalance. On present projections, it would also bring about the stabilization of the external debt-to-GDP ratio. The measures to improve bank risk management can also be expected to curb bank credit, which would have a moderating impact on aggregate demand. This policy mix is appropriate, in particular the emphasis on fiscal consolidation; monetary policy can only play a supporting role owing to its appropriate (for Croatia) focus on exchange rate stability.

29. **Staff believes the 2006 general government deficit target of 3.3 percent of GDP is appropriate given the current outlook**. It implies a total fiscal and quasi-fiscal adjustment of 3½ percentage points of GDP during the three years covered by the SBA. It also provides a solid basis for stabilizing Croatia's government debt-to-GDP ratio this year, achieving its medium-term fiscal objectives as outlined in the latest Pre-Accession Economic Program and, further down the road, meet the rigors of EU and ERM2 membership.

30. **Achieving this target depends crucially on the implementation of certain key structural reforms, which should start having a significant fiscal impact this year**. The health reform, in particular, should improve the public finances in 2006 and beyond. The measures identified during the review discussions and incorporated in the program may not exhaust the broader health reform agenda, which the government is discussing with the World Bank, but are nonetheless critical for the macroeconomic program in 2006. Given the complexity of the planned reform, the yield of these measures is subject to uncertainty; staff therefore welcomes the government's commitment to re-assess their likely impact later in the year and, if necessary, take appropriate fiscal action. Staff also welcomes the medium-term plan to reduce subsidies and state aid, as well as the initiated review of social benefits. The forthcoming plan to rationalize state aid in the shipyard industry and prepare the major companies for privatization should address this perennial source of losses.

31. **The main issue for the third review would be to gauge and, if necessary, tackle the macroeconomic consequences from the repayment of "pensioners' debt" in the second half of the year**. The case for policy adjustment beyond what is already planned is open: although the impact of these repayments on consumption and the current account could be considerable, it will be temporary. Whether or not additional measures are necessary will thus depend on the overall outlook for the balance of payments. The third review will re-assess more broadly the outlook for the rest of the year, taking into account any new macroeconomic or implementation risks that may have arisen. In the meantime, staff believes that extending the arrangement will help maintain the reform momentum.

32. **Staff supports the CNB's plans for tightening credit conditions and enhancing banking supervision**. The CNB has been successfully maintaining exchange rate stability and responding promptly to rising bank external borrowing. Staff supports the measures to curb external borrowing and address the concomitant prudential risks, and expects that these would have a notable impact this year. It will be important for the CNB to cooperate closely with the new nonbank supervisor that began operations in January this year in monitoring the rest of the financial system.

33. **Staff supports the authorities' requests for completion of the second review under the SBA, a waiver for nonobservance of an end-December 2005 PC, and extension and augmentation of the arrangement until November 15, 2006**. In staff's view, the policy action now under way in the health sector justifies the waiver for the nonobservance of the PC on general government arrears. The extension would provide continued Fund support during a crucial period for Croatia's EU negotiations and help secure the main objective of the SBA. Access under the arrangement, as augmented, remains appropriate and the authorities' capacity to repay the Fund is unimpaired.

Table 1. Croatia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2004–05

				End of		End of	
				September 2004	December 2004	September 2005	December 2005
				(In millions of kuna, unless indicated otherwise)			
Quantitative performance criteria							
1	Cumulative deficit of the consolidated general government 1/		Program	10,383 4/	9,250	7,941	9,165
			Actual	9,091	10,446	7,474	9,108
			Margin (+)	1,292	-1,196	467	57
2	Cumulative change of the stock of arrears of the consolidated general government 1/		Program	-100	-300	-50	-100
			Actual	1	384	333	456
			Margin (+)	-101	-684	-383	-556
3	Cumulative deficit of HBOR 1/		Program	823	1,093	659	866
			Actual	692	904	-9	281
			Margin (+)	131	189	668	585
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 1/ 2/		Program	1,336	1,566	400	725
			Actual	1,160	1,161	518 6/	670
			Margin (+)	176	405	-118	55
			Program	0	0	0	0
		<1 years	Actual	0	0	0	0
			Margin (+)	0	0	0	0
5	Cumulative issuance of guarantees extended by the general government 1/		Program	1,724 5/	1,773 5/	2,820	2,931
			Actual	953	1,170	70	295
			Margin (+)	771	603	2,750	2,636
6	Cumulative change in the Net International Reserves of the Croatian National Bank 2/ 3/		Program	12	-138	300	150
			Actual	269	384	523	896
			Margin (+)	257	522	223	746
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 1/		Program	7,068 4/	6,945	3,537	6,876 7/
			Actual	4,739	4,549	1,993	2,828
			Margin (+)	2,329	2,396	1,544	4,048
Indicative limits							
1	Cumulative increase in the total debt of selected public enterprises 1/		Program	90	0	200	305
			Actual	-97	-76	-635	-377
			Margin (+)	187	76	835	682

Source: Data provided by the Croatian authorities.

1/ Ceiling.
2/ In millions of euros.
3/ Floor.
4/ Adjusted for the delay of receipts of dividend payments by the telephone company (HT) originally expected by September 30, 2004.
5/ Adjusted for the amount of repayments of guaranteed debt by the government in excess of the amount incorporated in ceiling.
6/ Includes € 150 million from the first PAL loan from the World Bank that was originally scheduled to be contracted in the fourth quarter of 2005.
7/ Adjusted upward by HRK 1,461 million because of the delay in privatization receipts expected from the sale of government shares in INA and HT.

Table 2. Croatia: Structural Conditionality under the Stand-By Arrangement, 2004-05

Original Program	
Structural performance criterion	
1. Government to prepare three-year budgets starting with 2005-07 by end-September 2004.	Done on September 29, 2004.
Structural benchmarks	
1. Government to restructure the Debt Management department of the Ministry of Finance by end-September 2004.	Done in early October 2004.
2. Government to appoint a Working Group by end-September 2004 to prepare the reform to unify the supervision of nonbank financial intermediaries.	Done in early October 2004.
3. Government to formulate a medium-term business plan on HŽ by end-December 2004 to reduce its reliance on subsidies and improve cost recovery.	Done in February 2005.
4. Government to complete the register of government debt guarantees, including guarantees by local governments, and reconcile data with the CNB by end-December 2004.	Substantial progress but not completed until first review (see below).
5. Government to eliminate bank accounts of DAB by end-June 2005, HFP by end-September 2005, and HAC and HC by end-December 2005.	Delayed for DAB and HFP; done by end-2005 for HAC and HC.
6. Government to formulate a plan on privatization of CO by end-June 2005 and complete the third phase of privatization of HT by end-December 2005.	Pending (see below).
First Review	
Prior actions	
1. Parliament to approve supplementary budget consistent with a general government deficit of 4.2 percent of GDP in 2005.	Done in July 2005.
2. Government to approve and submit to Parliament amendments to the subsidy to building societies.	Done in July 2005.
3. Parliament to approve new Civil Service Law.	Done in July 2005.
4. Government to tighten eligibility criteria for employment subsidies.	Done in July 2005.
5. Ministry of Finance and the CNB to finalize the agreement on the procedures for the ongoing reconciliation of the registries of government debt guarantees.	Done in August 2005.
6. Government to appoint the Advisor for sale of state shares in INA.	Done in September 2005.
Structural benchmarks	
1. Government to incorporate the accounts of HAC and HC into the single treasury account by end-2005.	Done.
2. Parliament to approve amendments to the Law on State Aid by end-September 2005.	Done in mid-November 2005.
3. Government to submit to Parliament for approval the draft law on the reform of supplementary health insurance by end-November 2005.	Delayed to 2006.
4. Government to submit to Parliament for approval the law creating unified supervision of non-bank financial institutions by end-November 2005.	Done in mid-October 2005.
5. Government to formulate a plan on privatization of CO and complete the third phase of privatization of HT by end-December 2005.	Delayed to 2006.

Table 3. Croatia: Key Macroeconomic Indicators, 2002-06

	2002	2003	2004	2005 Estimate	2006 Proposed Program
Output, unemployment, and prices					
Real GDP	5.2	4.3	3.8	4.1	4.1
Unemployment (survey-based, in percent)	14.8	14.3	13.8	13.5	...
CPI inflation (average)	2.2	1.8	2.1	3.3	3.2
Savings and investment 1/					
Domestic investment	...	29.6	29.9	29.9	29.6
of which: fixed capital formation	...	27.5	27.6	26.9	27.1
Domestic saving	...	23.3	24.7	23.8	23.7
Government	...	1.5	2.9	3.2	3.4
Nongovernment	...	21.9	21.8	20.6	20.3
General government and HBOR operations 2/					
General government revenues	46.3	46.4	46.6	46.2	45.9
General government expenses and net lending	51.4	52.7	51.6	50.3	49.2
Overall general government balance	-5.0	-6.3	-4.9	-4.2	-3.3
Overall general government balance (including "pensioners' debt") 3/	-5.0	-6.3	-4.9	-4.2	-4.3
Overall HBOR balance (net of budget transfers)	-0.2	-0.7	-0.4	-0.1	-0.2
Fiscal and quasi-fiscal balance	-5.2	-7.0	-5.4	-4.3	-3.6
General government debt	40.4	42.0	44.8	45.5	43.8
Money and credit					
Credit to the nongovernment sector	31.3	14.7	12.8	16.7	12.4
Broad money	9.5	11.0	8.6	10.5	13.0
Base money	26.4	23.8	19.9	20.7	4.1
Interest rates					
Average kuna deposit rate (unindexed)	1.6	1.7	1.8	1.6	…
Average kuna credit rate (unindexed)	10.9	11.5	11.4	9.9	…
Balance of payments					
Current account balance 4/	-2,027	-1,596	-1,442	-1,815	-1,907
(In percent of GDP)	-8.4	-6.3	-5.2	-6.0	-5.9
Capital and financial account	3,635	4,015	2,431	3,308	3,410
Overall balance	862	1,239	58	842	648
Debt and reserves					
Gross official reserves	5,854	6,554	6,436	7,438	8,086
In months of following year's imports of goods and NFS	4.6	4.8	4.4	4.7	4.6
External debt service to exports ratio (in percent)	23.2	20.1	21.9	20.5	24.8
Total external debt (in percent of GDP)	62.1	77.6	82.4	84.7	81.5
Net external debt 5/	24.4	33.8	38.6	43.8	40.8

Sources: Croatian authorities, and Fund staff estimates.

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

2/ Revenues in 2004 include HRK 197 million in GSM license fees received in February 2005, but pertaining to an auction held in December 2004.

3/ Including assumed 1 percent of GDP for "pensioners' debt" repayment under the cash option. The actual level of repayments will be determined only in spring 2006.

4/ Breaks in the series in 2003, due to a change in the methodology of estimating tourism revenue that raised travel receipts by 1.5 percent of GDP; and in 2004, due to another change in estimating tourism revenue that reduced travel receipts by 0.7 percent of GDP.

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

Table 4. Croatia: Balance of Payments, 2002–2006
(In millions of euros, unless otherwise indicated)

	2002	2003	2004	2005 Proj.	2006 Proj.
Current account	-2,027	-1,596	-1,442	-1,815	-1,907
Merchandise trade balance	-5,973	-6,994	-6,724	-7,444	-8,004
Exports f.o.b.	5,292	5,579	6,600	7,297	8,038
Ships	373	397	439	459	505
Non-ship exports	4,919	5,181	6,161	6,838	7,534
Imports f.o.b.	-11,265	-12,573	-13,324	-14,741	-16,042
Services and income	2,793	4,154	4,088	4,418	4,837
Transportation	173	252	245	375	454
Travel	3,205	4,986	4,814	5,313	5,685
Other services	-27	-297	-352	-322	-398
Compensation of employees	168	184	234	267	287
Interest and investment income	-725	-972	-853	-1,216	-1,191
Current transfers	1,153	1,244	1,194	1,212	1,260
Credit	1,454	1,540	1,586	1,649	1,717
Debit	-301	-296	-392	-437	-456
Capital and financial account	3,635	4,015	2,431	3,308	3,410
Capital account 1/	25	74	23	27	50
Financial account	3,610	3,941	2,408	3,281	3,360
Direct investment 1/ 2/	1,156	1,501	750	1,395	2,500
of which: privatization receipts	339	464	27	0	1,000
Portfolio investment	-464	853	511	-1,204	-555
Medium- and long-term loans	835	2,363	1,698	1,795	897
Assets	-55	-24	12	0	0
Liabilities	890	2,386	1,686	1,795	897
Disbursements	2,630	4,281	3,645	3,723	3,705
Amortization	-1,741	-1,894	-1,958	-1,928	-2,808
Currency and deposits	1,761	-847	-26	1,097	0
Short-term capital flows (net)	-88	458	-231	350	447
Trade credits	410	-386	-294	-152	71
Net errors and omissions 3/	-746	-1,181	-932	-651	-855
Overall balance	862	1,239	58	842	648
Financing	-862	-1,239	-58	-842	-648
Gross reserves (-= increase)	-725	-1,239	-58	-842	-648
IMF (net purchases)	-137	0	0	0	0
Exceptional financing	0	0	0	0	0
Memorandum items:					
Current account (in percent of GDP)	-8.4	-6.3	-5.2	-6.0	-5.9
Gross official reserves	5,854	6,554	6,436	7,438	8,086
in months of following year's imports of goods and NFS	4.6	4.8	4.4	4.7	4.6
Net foreign assets of the CNB	5,827	6,188	6,434	7,436	8,084
in months of following year's imports of goods and NFS	4.6	4.6	4.4	4.7	4.6
Outstanding debt 4/	15,055	19,811	22,781	25,508	26,368
External debt-to-GDP ratio 4/	62.1	77.6	82.4	84.7	81.5
of which: external public debt	24.4	25.9	26.2	24.0	21.4
External debt as a percentage of exports of goods and NFS	134.5	150.6	160.1	164.5	156.2
Short-term debt by residual maturity in percent of gross official reserves	44.5	62.7	80.3	84.5	83.8
Net external debt-to-GDP ratio	24.4	33.8	38.6	43.8	40.8
External debt service	-2,601	-2,649	-3,111	-3,188	-4,181
GDP (millions of euros)	24,220	25,526	27,627	30,111	32,367
GDP (millions of kuna)	179,390	193,067	207,082	222,852	239,546

Sources: Croatian National Bank, and Fund staff estimates.

1/ In 2003, it excludes debit entry of US$ 327.8 in the item "investment income"in the current account, and an offsetting credit entry in the item "FDI-reinvested earnings" of the capital account related to the "distribution" and "reinvestment" of paper income from the revaluation of a patent by the Croatian company (see IMF Country Report No. 03/358, Appendix IV).
2/ In 2002, it excludes a debit entry of US$ 419.4 million in the item "direct investment abroad" and an offsetting credit entry in the item "capital transfers" related to the revaluation and transfer of a patent by a Croatian company in exchange for the capital in a foreign subsidiary (see IMF Country Report No. 03/358, Appendix IV).
3/ Errors and omissions are explicitly projected to reflect persistent unrecorded capital outflows.
4/ In 2005, the central bank revised the methodology for estimating external debt. The inclusion of hybrid and subordinated instruments, repos, late interest and interest accruals has caused an upward revision of the historical series.

Table 5. Croatia: Indicators of External and Financial Vulnerability, 2001-05
(In percent, unless otherwise indicated)

	2001	2002	2003	2004	2005	
					Latest	Date
External indicators						
Real effective exchange rate (using consumer prices) 1/, 2000=100	104.5	104.4	103.0	104.7	105.2	Nov-05
Exports of goods and services (percentage change in euros, yoy) 2/	15.1	4.0	17.5	8.1	8.3	Q3 -05
Imports of goods and services (percentage change in euros, yoy) 2/	16.2	14.5	10.1	6.8	3.5	Q3 -05
Current account deficit (cumulative, millions of euros) 3/	-812	-2,027	-1,596	-1,442	-1,474	Q3 -05
Current account deficit in percent of GDP 3/	-3.7	-8.4	-6.3	-5.2	-5.8	Q3 -05
Capital and financial account in percent of GDP 3/	11.8	15.0	15.7	8.8	10.9	Q3 -05
Gross official reserves (millions of euros)	5,338	5,854	6,554	6,436	7,438	Dec-05
Gross official reserves in percent of broad money (M4)	37.1	36.2	38.9	35.3	35.5	Dec-05
Gross official reserves in percent of reserve money	220.8	182.6	163.9	145.5	135.8	Dec-05
Gross official reserves in months of current year's imports of goods and NFS	5.3	5.1	5.2	4.8	5.1	Dec-05
Gross usable international reserves in percent of domestic foreign currency deposits	42.7	46.9	50.6	47.2	47.7	Dec-05
CNB net foreign assets (millions of euros)	5,146	5,827	6,188	6,434	7,436	Dec-05
CNB net foreign assets in months of current year's import of goods and NFS	5.1	5.1	4.9	4.8	5.1	Dec-05
Short-term debt in percent of gross usable reserves 4/ 5/	58.1	44.6	84.4	111.0	114.5	Dec-05
Short-term debt and current account deficit net of FDI in percent of gross usable reserves	79.1	46.2	98.6	119.3	103.9	Dec-05
Total external debt, percent of GDP 6/	60.6	62.1	77.6	82.4	84.7	Dec-05
External debt service to export ratio	26.6	23.2	20.1	21.9	20.6	Q3 -05
Financial indicators						
General government debt in percent of GDP	40.6	40.4	42.0	44.8	45.5	Dec-05
Domestic in percent of GDP	15.8	17.8	18.3	20.6	25.1	Dec-05
Foreign in percent of GDP	24.8	22.6	23.7	24.2	20.4	Dec-05
Broad money (M4, percentage change, yoy)	45.2	9.5	11.0	8.6	10.5	Dec-05
Claims on other domestic sectors (change, yoy)	24.6	31.3	14.7	12.8	16.7	Dec-05
Short-term interest rate (in percent, e.o.p.)	2.3	1.7	6.2	4.8	3.2	Dec-05
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,035	1,173	1,185	1,565	1,998	Dec-05
Zagreb Stock Exchange, capitalization, percent of GDP	16	22	31	42	52	Dec-05
Bond yield spreads (EMBI Global, e.o.p.)	155	125	96	42	36	Dec-05
Debt ratings: Moody's:						
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Dec-05
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Baa1	Dec-05
Foreign debt ratings						
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	Dec-05
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	Dec-05
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	Dec-05
Standard and Poor's: Foreign currency LT	BBB-	BBB-	BBB-	BBB	BBB	Dec-05
Banking system:						
Regulatory capital to risk-weighted assets	18.5	17.2	15.7	14.1	14.9	Q3 -05
Nonperforming loans to total loans	7.3	5.9	5.1	4.5	4.1	Q3 -05
Loan-loss provisions to non-performing loans	71.8	68.1	60.8	60.3	60.1	Q3 -05
Net open foreign exchange position to capital 7/	7.9	10.7	13.3	12.5	7.0	Q3 -05
Foreign currency deposits to total deposits 8/	91.2	89.4	87.1	86.8	84.9	Q3 -05
Foreign currency loans to total loans 8/	84.9	80.0	74.4	75.8	77.7	Q3 -05

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

1/ An increase in the index reflects an appreciation; annual averages through 2004.
2/ In January 2000, a new methodology, in line with European standards, for processing data on imports and exports was adopted. The new presentation uses the date when the declaration was cleared rather than the date when the declaration was received.
3/ For 2005, the sum of the four quarters to 2005 Q2.
4/ Coverage limited to short-term debt on a remaining maturity basis registered with the CNB.
5/ Gross reserves adjusted downward by foreign currency redeposit requirements held at the CNB, and by the amount of outstanding foreign currency CNB bills.
6/ Includes estimates of external obligations due to bond repurchase agreements (repos transaction).
7/ From 2003, net open position includes foreign currency options.
8/ Including foreign currency-linked deposits and loans.

Table 6. Croatia: Financial Soundness Indicators, 2002-05
(Banks, in percent, unless otherwise indicated)

	2002	2003	2004	Q1 2005	Q2 2005	Q3 2005
Regulatory capital to risk-weighted assets	17.2	15.7	14.1	15.4	15.2	14.9
Capital to assets	9.5	9.0	8.5	9.3	9.3	9.0
Nonperforming loans to total gross loans	5.9	5.1	4.5	4.5	4.3	4.1
Loan-loss provisions to nonperforming loans	68.1	60.8	60.3	60.6	60.1	60.1
After-tax return on average assets	1.3	1.4	1.4	1.4	1.3	1.4
After-tax return on average equity	13.7	15.6	16.6	15.8	14.2	16.5
Foreign-currency-indexed loans to deposits 1/	67.0	66.2	66.9	68.6	70.3	72.7
Total loans to total deposits	90.3	96.0	99.5	104.8	108.9	106.6
Net open foreign exchange position to capital 2/	10.7	13.3	12.5	4.6	2.6	7.0
Foreign-currency deposits to total deposits 3/	89.4	87.1	86.8	86.9	85.1	84.9
Foreign-currency loans to total loans 3/	80.0	74.4	75.8	77.0	76.4	77.7

Source: Croatian National Bank.

1/ Denominator includes foreign-currency and foreign-currency-indexed deposits and loans received.
2/ From 2003, net open positions include foreign currency options.
3/ Foreign currency deposits (loans) include those denominated in kuna and linked to foreign exchange.

Table 7. Croatia: Consolidated General Government Finances, 2002-06
(In percent of GDP)

	2002	2003	2004 1/	2005 1/		2006
				Prog.	Act.	Budget
REVENUE	46.3	46.4	46.6	46.1	46.2	45.9
Taxes	28.2	27.9	27.2	27.3	27.1	26.8
Taxes on income, profits, and capital gains	6.1	6.0	5.9	6.2	6.0	6.0
Payable by individuals	4.0	3.7	3.7	3.7	3.5	3.6
Payable by corporations and other enterprises	2.1	2.2	2.1	2.5	2.5	2.3
Taxes on property	0.3	0.3	0.4	0.3	0.3	0.3
Taxes on goods and services	20.4	20.5	20.1	19.8	19.9	19.6
of which, VAT	14.5	14.6	14.4	14.2	14.5	14.2
Excises	5.5	5.4	5.1	5.0	4.9	4.9
Taxes on international trade and transactions	1.1	0.9	0.8	0.7	0.7	0.6
Other taxes	0.3	0.2	0.2	0.2	0.2	0.3
Social security contributions	14.0	14.2	14.2	14.1	14.0	14.0
Other revenue and grants	4.0	4.2	5.1	4.6	5.0	5.1
TOTAL EXPENDITURES 2/	51.4	52.7	51.6	50.3	50.3	49.2
Expense (current)	46.4	46.5	46.0	45.0	45.4	44.4
Compensation of employees	12.4	12.7	12.3	12.0	12.0	11.6
Use of goods and services	5.5	4.9	4.9	4.8	5.1	5.4
Interest	2.1	2.1	2.2	2.2	2.3	2.3
Subsidies	2.8	3.3	2.8	2.7	2.7	2.5
Grants	0.1	0.0	0.5	0.4	0.6	0.5
Social benefits	20.1	19.8	19.8	19.1	19.1	18.5
Other expense	3.4	3.7	3.5	3.7	3.7	3.6
Acquisition of non-financial assets (investment)	4.4	5.9	5.1	4.9	4.5	4.3
Net lending	0.6	0.3	0.5	0.4	0.4	0.4
OVERALL BALANCE	-5.0	-6.3	-4.9	-4.2	-4.2	-3.3
Repayment of "pensioners' debt" (cash option) 3/	...	...	...	...	...	1.0
FINANCING REQUIREMENT	-5.0	-6.3	-4.9	-4.2	-4.2	-4.3
FINANCING	5.0	6.3	4.9	4.2	4.2	4.3
Capital revenues	1.8	2.2	0.6	1.4	0.5	3.6
External financing	2.8	2.6	1.9	-0.4	-2.0	-1.3
Disbursements	5.2	3.9	4.2	2.5	0.7	1.4
Amortization	-2.5	-1.3	-2.3	-2.9	-2.7	-2.7
Domestic financing	0.5	1.5	2.5	3.2	5.7	2.0
Memorandum items:						
Primary budget balance	-2.9	-4.2	-2.8	-2.0	-1.9	-1.0
General government debt	40.4	42.0	44.8	44.8	45.5	43.8
General government guarantees and arrears	10.9	11.8	9.9	10.5	9.6	9.8

Source: Ministry of Finance and staff estimates.

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

2/ Excluding "pensioners' debt" repayments and including accumulation of arrears in "Use of goods and services".

3/ Based on preliminary data showing that 75 percent of eligible pensioners will choose the cash repayment option at a 50 percent discount during 2006-07.

Table 8. Croatia: Monetary Accounts, 2003-06

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

	2003	2004	2005 Act.	2006 Q1 Proj.	2006 Q2 Proj.	2006 Q3 Proj.	2006 Q4 Proj.	2003	2004	2005 Prog.	2005 Act.	2006 Proj.
Monetary Survey								(Change in percent)				
Net Foreign Assets	32,771	31,743	23,304	22,545	24,358	30,749	29,308	-0.1	-3.1	-29.2	-26.6	25.8
Net Domestic Assets	96,122	108,205	131,343	134,140	137,109	139,838	145,406	15.4	12.6	20.9	21.4	10.7
of which: domestic credit	123,781	138,686	166,212	171,017	174,148	178,554	187,567	12.4	12.0	15.0	19.8	12.8
to government, net	16,735	17,902	25,303	31,404	30,281	26,916	29,251	0.0	7.0	36.2	41.3	15.6
to other domestic sectors 1/	107,046	120,784	140,909	139,612	143,868	151,638	158,317	14.7	12.8	11.8	16.7	12.4
Broad Money	128,893	139,948	154,647	156,686	161,467	170,588	174,715	11.0	8.6	9.5	10.5	13.0
Narrow Money	33,889	34,562	38,817	37,898	40,995	42,073	42,662	9.8	2.0	8.7	12.3	9.9
Currency outside banks	10,573	10,956	12,164	12,134	13,572	13,870	14,078	9.2	3.6	10.9	11.0	15.7
Demand deposits	23,316	23,606	26,653	25,763	27,423	28,203	28,584	10.0	1.2	7.7	12.9	7.2
Quasi Money	95,004	105,386	115,830	118,788	120,472	128,515	132,052	11.4	10.9	9.8	9.9	14.0
denominated in kuna	18,969	23,643	29,069	31,340	33,313	34,294	36,312	43.5	24.6	17.9	23.0	24.9
denominated in foreign currency	76,035	81,743	86,761	87,448	87,159	94,221	95,740	5.5	7.5	7.5	6.1	10.3
Balance Sheet of the Croatian National Bank												
								(Contribution to base money change)				
Net Foreign Assets	47,321	49,355	54,844	53,463	54,493	58,869	60,226	18.1	5.5	4.3	12.3	9.8
less: Banks' foreign currency reserves	6,687	10,765	13,496	13,651	13,219	13,668	14,133	-1.2	10.9	7.4	6.1	4.7
CNB bills in foreign currency	4,920	0	0	0	0	0	0	12.3	-13.2	0.0	0.0	...
Net International Reserves	35,714	38,591	41,348	39,811	41,274	45,202	46,093	7.0	7.7	-3.1	6.2	11.5
								(Contribution to base money change)				
Net Domestic Assets	-10,035	-4,654	-901	-3,252	-2,509	-5,460	-4,080	5.7	14.4	11.8	8.4	-5.9
of which: claims on government (net)	-1,550	-260	-331	-800	-1,020	-3,240	-1,178	-2.6	3.5	-0.8	-0.2	-1.6
claims on banks	972	409	4,216	2,500	2,500	2,000	3,000	3.2	-1.5	8.2	8.5	-2.3
of which, open market operations	0	394	4,201	2,500	2,500	2,000	3,000	...	...	...	...	-2.2
claims on other domestic sectors	94	83	73	92	92	92	92	-0.1	0.0	0.0	0.0	0.0
other items (net)	-4,631	-4,886	-4,859	-5,044	-4,081	-4,312	-5,994	0.9	-0.7	4.5	0.1	-2.1
less: CNB bills (in foreign currency)	4,920	0	0	0	0	0	0					
								(Change in percent)				
Base Money	37,285	44,702	53,943	50,210	51,984	53,409	56,146	23.8	19.9	16.2	20.7	4.1
Currency	10,573	10,956	12,164	12,134	13,572	13,870	14,078	9.2	3.6	10.9	11.0	15.7
Deposits	26,712	33,746	41,779	38,076	38,412	39,539	42,068	30.7	26.3	17.9	23.8	0.7
of which: settlement accounts	5,616	6,408	8,411	5,600	5,100	4,500	6,000	43.1	14.1	12.9	31.3	-28.7
statutory reserve in kuna	12,604	14,674	17,605	16,986	18,010	19,070	19,618	54.0	16.4	11.7	20.0	11.4
statutory reserve in foreign currency	6,687	10,765	13,496	13,651	13,219	13,668	14,133	-5.0	61.0	30.7	25.4	4.7
of which: general reserve requirement	6,687	10,295	9,471	8,847	8,619	9,068	9,328	-5.0	54.0	-5.6	-8.0	-1.5
marginal reserve requirement	0	470	4,025	4,805	4,600	4,600	4,805			...	...	19.4
Memorandum items:												
Nominal GDP (yearly total)	193,067	207,082	222,852				239,546					
Narrow money multiplier	0.91	0.77	0.72				0.76					
Broad money multiplier	3.46	3.13	2.87				3.11					
Broad money to GDP ratio	0.67	0.68	0.69				0.73					
Foreign currency in percent of broad money	59.0	58.4	56.1				54.8					

Sources: Croatian National Bank; and Fund staff projections.

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

Table 9. Croatia: Schedule of Purchases Under the Proposed 27-Month Stand-By Arrangement

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

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

Table 10. Croatia: Indicators of Capacity to Repay the Fund, 2006–11
(Under the obligations repurchase schedule)

	2006	2007	2008	2009	2010	2011
Fund repurchases and charges 1/						
In millions of SDRs	4.8	5.5	5.6	41.8	52.8	14.4
In millions of euros	5.8	6.7	6.7	50.4	63.6	17.3
In percent of exports of goods and NFS	0.0	0.0	0.0	0.2	0.3	0.1
In percent of debt service	0.1	0.2	0.1	0.8	1.1	0.3
In percent of quota	1.3	1.5	1.5	11.5	14.5	3.9
In percent of gross official reserves	0.1	0.1	0.1	0.5	0.6	0.1
Fund credit outstanding (e.o.p.) 1/						
In millions of SDRs	99.0	99.0	99.0	62.4	12.9	0.0
In millions of euros	119.7	119.4	119.2	74.9	15.4	0.0
In percent of quota	27.1	27.1	27.1	17.1	3.5	0.0
In percent of GDP	0.4	0.3	0.3	0.2	0.0	0.0
In percent of gross official reserves	1.5	1.4	1.3	0.8	0.1	0.0
Memorandum items:						
Exports of goods and NFS (millions of euros)	16,881	18,780	20,064	21,566	23,035	24,654
Debt service (millions of euros) 1/	-4,187	-4,174	-4,706	-6,069	-6,030	-6,728
Quota (millions of SDRs)	365	365	365	365	365	365
Quota (millions of euros)	441	441	439	439	438	438
Gross official reserves (millions of euros) 1/	8,206	8,598	9,039	9,557	10,806	11,849

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

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

Table 11. Croatia: Projected Payments to the Fund as of December 31, 2005 Under the Obligations Repurchase Schedule
(In millions of SDRs)

	2006	2007	2008	2009	2010	2011
Obligations from existing drawings						
Principal						
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0
SDR net charges	1.3	1.3	1.3	1.3	1.3	1.3
Total obligations	1.3	1.3	1.3	1.3	1.3	1.3
(percent of quota)	0.4	0.4	0.4	0.4	0.4	0.4
Obligations from prospective drawings						
Principal						
GRA repurchases	0.0	0.0	0.0	36.6	49.5	12.9
Charges and interest 1/						
GRA charges and interest	3.4	4.2	4.2	3.9	1.9	0.2
Total obligations	3.4	4.2	4.2	40.5	51.4	13.1
(percent of quota)	0.9	1.2	1.2	11.1	14.1	3.6
Cumulative (existing and prospective)						
Principal						
GRA repurchases	0.0	0.0	0.0	36.6	49.5	12.9
Charges and interest 1/	4.8	5.5	5.6	5.2	3.3	1.5
Total obligations	4.8	5.5	5.6	41.8	52.8	14.4
(percent of quota)	1.3	1.5	1.5	11.5	14.5	3.9

Source: IMF Finance Department.
1/ Assumes the GRA rate of charge of 4.11 percent plus 14 basis points for burden sharing.

Table 12. Croatia: External Financing Requirements, 2003–11
(In millions of euros)

			Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011
Gross Financing Requirements	4,872	3,978	5,209	5,917	5,754	6,250	7,570	8,614	9,296
Current account	1,596	1,442	1,815	1,907	2,027	1,975	2,062	2,159	2,321
Amortization on bonds and medium and long term loans	2,037	2,478	2,552	3,363	3,335	3,834	4,946	5,147	5,917
Public sector	339	814	836	1,042	963	1,088	1,527	1,554	2,414
Banks	714	457	784	1,026	763	1,080	1,643	1,625	1,476
Other sectors	984	1,206	932	1,295	1,610	1,666	1,776	1,968	2,027
Gross reserves accumulation	1,239	58	842	648	392	441	562	1,308	1,059
IMF repurchases and repayments	0	0	0	0	0	0	0	0	0
Available Financing	4,872	3,978	5,209	5,917	5,754	6,250	7,570	8,614	9,296
Direct investment (net)	1,501	750	1,395	2,500	2,014	1,887	2,020	2,163	2,316
Disbursements on bonds and medium and long term loans	4,937	4,498	3,723	3,705	3,783	4,341	5,417	6,133	6,540
Public sector 1/ 2/	1,370	1,558	768	654	983	1,241	1,079	1,402	1,709
Banks	1,655	995	1,005	1,250	1,000	1,000	1,898	2,033	2,133
Other sectors	1,912	1,946	1,950	1,801	1,800	2,100	2,440	2,698	2,698
Short-term financing (net) 3/	72	-525	198	518	429	460	608	692	737
Other flows (net) 4/	-1,639	-746	-107	-805	-473	-437	-475	-374	-297

Sources: Croatian Central Bank, WEO, and Fund staff estimates.

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

Zagreb, March 3, 2006

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

Dear Mr. de Rato:

We remain fully committed to maintaining macroeconomic stability, limiting external vulnerability, and preparing Croatia for EU accession. Consistent with these objectives, we have been implementing our economic program for 2004–05, supported by the 20-month Stand-By Arrangement approved by the Fund in August 2004, for which the first review was completed in September 2005.

We are requesting completion of the second review under the program. All quantitative performance criteria for end-December 2005 have been observed, excluding the target on the reduction of general government arrears, for which we are requesting a waiver. While the total stock of general government arrears is small, our ability to reduce it further has so far been constrained by the deep-seated structural problems in the health sector, which we took first steps to reform in 2004 and 2005. In 2006, we are pressing ahead with farther-reaching reforms to the health sector, including an overhaul of the health insurance system, which will also help normalize the finances of the system and lead to a permanent reduction of arrears. The structural benchmarks set at the first review have also been observed, save for the submission to parliament of the supplementary health insurance law, which will now form part of the broader health system reform; and the formulation of a plan to privatize the Croatian Insurance company (CO), as well as the third phase of privatization of the telecommunications company (HT), which have been delayed.

Our macroeconomic policies in 2006 will continue to be guided by the same objectives as our program for 2004–05, notably to arrest the growth of Croatia's external debt-to-GDP, which is the biggest source of external vulnerability in the short run. This goal, narrowly missed in 2005, will require continued fiscal consolidation efforts and cautious monetary management. To support these policies and help secure the main goal of our program, we are requesting an extension of the Stand-By Arrangement through November 15, 2006. The attached Annex describes in detail our policies for this year and proposes performance criteria and indicative targets for end-March, end-June, and end-September 2006. The extension would also include a third review of the Arrangement by September 2006, to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve our objectives, particularly in view of the possible macroeconomic implications of the repayment of pensioners' debt obligations, which are to start in the second half of the year. Program implementation will also be monitored through structural performance benchmarks on the promulgation of health reform laws; approval of a restructuring plan for shipyards; progress in the sale of state holdings in CO, HT, and the oil distributor INA; and prudential measures to discourage bank foreign currency lending to unhedged customers.

We are also requesting additional access of SDR 2 million during the extension period of the program. We intend to continue treating the SBA as precautionary.

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

Sincerely yours,

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

Attachments:
Annex
Technical Memorandum of Understanding

1. This Annex reviews program implementation in 2005 and describes our macroeconomic policies and targets for 2006. It reaffirms the goals of our program for 2004–05 that has been supported by the Stand-By Arrangement: preserving macroeconomic stability and limiting external vulnerability, notably by stopping the increase in Croatia's external debt-to-GDP ratio. These goals are also consistent with our updated Pre-Accession Economic Program, which we submitted to the European Commission in December 2005.

2. Our macroeconomic policy strategy for 2006 is based on continuing the fiscal adjustment we have implemented over the past two years. In addition to helping mitigate external vulnerability, this will prepare Croatia to meet the EU fiscal deficit and debt requirements in the medium term. We plan further improvements in transparency and financial management in the government and the broader public sector, and the implementation of key structural reforms, including accelerated privatization, that will contribute both to permanent improvements in the fiscal position, and to Croatia's competitiveness ahead of EU accession. A crucial support to these policies is the continuity of the current monetary policy framework, which will stay focused on exchange rate stability.

3. The envisaged extension of the Stand-By Arrangement through November 15, 2006 would support these policies and help secure the gains made during 2004–05.

I. Program Implementation in 2004–05

4. Our policies during 2005 were consistent with the targets detailed in the Annex to our Letter of August 7, 2005. In particular, in 2005 we achieved the general government deficit target of 4.2 percent of GDP envisaged in our mid-year supplementary budget (3.3 percent of GDP on GFS 2001 basis). Thus, since 2003, we have reduced the fiscal and quasi-fiscal deficit by nearly 2½ percentage points of GDP.

5. With one exception, all program quantitative targets for end-December 2005 were met. The end-December target on the reduction of general government arrears was missed by HRK 556 million: this reflected continuing accumulation of arrears in the health sector, which remains subject to long-standing structural weaknesses. We are introducing major reforms to address these weaknesses (paragraph 21 below).

6. Under our program, we have made substantial progress across a broad range of structural reforms during 2004–05. We have set fiscal policy into a medium-term framework in the form of rolling three-year budgets. We have improved significantly fiscal management and transparency by eliminating hidden subsidies to Croatian Railways, controlling quasi-fiscal operations and contingent liabilities, expanding the single treasury account, initiating civil service reform, increasing data disclosure, reconciling the register of government debt guarantees between the Ministry of Finance and the CNB, transferring the treasury bill registry to the Central Depository Agency, establishing internal audit units in all budget users in the central government, and improving debt management. In line with the recommendation of recent IMF technical assistance, we are taking measures to improve tax administration. We have enhanced financial stability by strengthening bank and nonbank supervision, rationalizing monetary

policy instruments, starting open market operations, and upgrading the CNB's macro-prudential and financial stability analysis. And we have promoted economic efficiency and competitiveness by advancing privatization—despite the delays, strengthening the Croatian Competition Agency, starting the publication of regular state aid reports and amending the state aid law. Looking forward, we are also taking concrete steps to satisfy two of the structural benchmarks under the program whose implementation has been delayed, namely in the areas of health reform and privatization.

7. These efforts over 2004–05 have started to pay dividends. Despite the impact of higher oil prices, Croatia's external position has improved substantially. However, higher private capital inflows, in part reflecting confidence in our policies and in Croatia's EU accession prospects, meant that the objective to stabilize the external debt-to-GDP ratio was just missed in 2005. Gross external debt reached 84.7 percent of GDP at end-2005, up 2¼ percentage points from end-2004; this compares with an external debt accumulation averaging nearly 6 percent of GDP annually over the previous five years. In the latter part of last year, these capital inflows were also reflected in accelerating growth in bank credit to the private sector, which necessitated additional monetary and prudential measures.

II. Macroeconomic Outlook and Policies in 2006

8. We expect economic activity in Croatia to continue at a satisfactory pace in 2006. We project real GDP growth to reach around 4 percent in 2006, broadly the same pace as in 2005; average inflation to remain around 3¼–3½ percent in 2006, underpinned by our policy of exchange rate stability; and the current account deficit to remain at or below 6 percent of GDP.

9. However, these projections—especially for the current account deficit—are subject to several risks. The most important risk is the possibility of a deterioration in the external environment, which would have important repercussions for Croatia's very open economy. Another risk is the possibility that the recent acceleration in credit growth continues and intensifies, affecting aggregate demand and the external position. Finally, the phased repayment of pensioners' debt, which will start in June 2006 (paragraph 13), may also have implications for consumption and imports. If the macroeconomic environment worsens substantially, we are prepared to adjust our policies and targets in order to safeguard the objectives of our program.

A. Fiscal Policy

10. Our 2006 budget, which parliament approved on November 29, 2005, set a target for the general government deficit of 3.3 percent of GDP (2.4 percent on GFS 2001 basis). We project revenues as a share of GDP to stay broadly unchanged from 2005. In the event of revenue overperformance as a result of a surge in aggregate demand, we intend to keep budgetary expenditures to the level provided in the budget. Tax receipts will benefit from the measures we took last year to strengthen tax administration, in conjunction with technical assistance from the IMF. The loss of some one-off dividend payments included in the 2005 budget will be offset by higher nontax revenue and grants from the EU. The reduction in the deficit will come mainly from lower expenditures, both current and capital.

11. The expenditure savings envisaged for 2006 will arise in part from measures already implemented, like the revision in the pension indexation formula in mid-2005, the changes to the employment and housing subsidy schemes, and the introduction of an administrative fee for some health services. At the same time, however, the need for harmonization of our domestic legislation and institutions with the EU generate new spending requirements. To accommodate these while, at the same time, ensuring the achievement of our overall deficit target, the implementation of the following policies and reforms is critical for the 2006 budget:

- keeping average public sector wage growth to no more than 3 percent in 2006 while limiting average employment growth to no more than 1 percent, to accommodate new hires urgently needed in connection with EU harmonization;

- continuing the implementation of the restructuring plan for Croatian Railways that we approved last year in cooperation with the World Bank, with a view to reducing total budgetary support to the company to HRK 2.86 billion in 2006 (paragraph 24);

- implementing a restructuring plan for the loss-making state-owned shipyards that will rationalize their operations, provide a credible perspective for their subsequent privatization and—more important from a budgetary point of view—allow us to keep subsidies to shipyards at the HRK 400 million level provided in the 2006 budget (paragraph 23). Failure to start implementation of this restructuring plan by June 30 will imply that, in accordance with our commitments in the Stabilization and Association Agreement with the EU and the process of harmonization of state aid practices with EU rules, all state aid to shipyards after that date will be classified as budgetary expenditure.

- launching a comprehensive health reform in the second half of the year, described in paragraph 21, that will enable us to keep budgetary outlays on health to the HRK 14.9 billion provided in the budget, as well as set the basis for a reduction in health sector arrears. This reform, which we are currently finalizing, will not only affect key parameters of the current system but also change the incentives for providers and consumers of health care, introduce greater accountability, and engender changes in behavior. Therefore, the resulting budgetary savings, while sizeable over the medium term, are hard to forecast precisely at this point. As the reform takes its final shape, we will carefully estimate its impact and take additional measures if needed to ensure that our 2006 budget targets are met.

12. Beyond these measures that will yield tangible savings already in 2006, we are also advancing reforms that will generate significant but, in some cases, harder to quantify savings over the medium term. *First*, we have started the reform of state aid with the approval by parliament of the amendments to the law on State Aid in November 2005. These amendments bring procedures for disbursing state aid into line with EU requirements and strengthen the role of the Agency for Market Competition in minimizing market distortions. *Second*, with the assistance of the World Bank, we have adopted a medium-term subsidy reduction plan, under which subsidies to enterprises will be reduced to 2.14 percent of GDP by 2007. *Third*, a working group headed by the Ministry of Health and Social Welfare is preparing a blueprint for reforms to the social benefit system, aimed at better targeting assistance towards the most vulnerable citizens and harmonizing the system with the standards applied in EU countries.

13. Last year, we initiated the resolution of a long-standing debt to current pensioners, in compliance with a 1998 decision of the Constitutional Court. This debt, including accumulated interest, amounts to HRK 13.8 billion (5¾ percent of projected 2006 GDP). To resolve once and for all this outstanding issue and honor the state's obligation while, at the same time, minimizing the fiscal impact, we have offered eligible pensioners a choice: full repayment over 2008–2013; or accelerated repayment at a 50 percent discount in four half-yearly installments over 2006–07, with the first payment in June 2006. Pensioners are expected to make this choice during the first quarter of the year, and surveys suggest that most will choose the second option. We have created a special fund, to which we will transfer state assets that will be used to finance these payments. Since these are repayments of debt incurred during the 1990s, they will not be treated as budgetary expenditure. Nevertheless, we recognize the potential impact of these payments on consumption and imports. Once the size of these repayments is known, we will take additional measures if it appears that their impact could jeopardize the achievement of our main external objective under the program.

14. In line with our program, budget financing will continue shifting to domestic sources. As in 2005, we expect to avoid recourse to net foreign financing for the general government in 2006. In addition, we expect significant increases in privatization receipts in 2006 (paragraph 22).

15. We will continue strengthening financial discipline and transparency in the broader public sector. In this context, we will continue to identify and account transparently for all forms of state aid, including transfers, debt assumptions, guarantees, and recapitalizations; contain the deficit (net of government transfers) of the Croatian Development Bank (HBOR) at HRK 500 million by reducing its net lending plan accordingly; limit the issuance of government debt guarantees so as to maintain the nominal stock of outstanding government contingent liabilities well below its end-2003 level; and aim at reducing the borrowing requirement of the group of major public enterprises monitored under the program.

16. We are continuing to upgrade the management of public expenditure and debt. Significant progress was made toward the development of the single treasury account with the incorporation into it from the beginning of this year of the accounts of HAC and HC. As regards the accounts of DAB and HFP, the experience with the recent litigation and its impact on the financial operations of HFP, as well as the pending disputes regarding old bank rehabilitations involving DAB, militate against their premature incorporation into the single treasury account. We thus intend to bring these two agencies into the single treasury account once these disputes are settled and the pending amendments to the legal framework of DAB are finalized. The Ministry of Finance and the Croatian National Bank (CNB) have agreed on procedures for reconciling information on government guarantees. The two institutions will continue to monitor and reconcile guarantees as they are issued, and seek to ensure that the guarantee register includes information on guarantees issued by local governments. In the area of public debt management, we will implement fully the permanent software solution supported by EU CARDS by end-March and introduce an electronic system for treasury bill auctions by end-May.

B. Monetary and Financial Sector Policies

17. The CNB continues to support the external objectives of our program by pursuing its policy of broad exchange rate stability against the euro, maintaining adequate international reserves, and preventing an inappropriate domestic liquidity expansion. Gross official reserves at end-2006 are projected at about € 8 billion, maintaining reserve coverage at about 4½ months of following year's imports of goods and non-factor services; and the growth in net domestic assets of the CNB during 2006 will be contained to about HRK 1.5 billion. These targets are consistent with broad money growth during the year at about 13 percent and growth in credit to the private sector of 12-13 percent. Should massive private capital inflows threaten to jeopardize macroeconomic stability, the CNB will consider, in consultation with the IMF, introducing price-based controls on capital inflows.

18. The CNB is taking further measures to contribute towards arresting the growth of external debt. Effective January 2006, the CNB increased the marginal reserve requirement on commercial banks' new foreign borrowings after November 2005 from 40 to 55 percent. The higher marginal reserve requirement will apply to a broader base than previously, by including foreign lending based on guarantees issued by commercial banks in Croatia, and banks' borrowings from leasing companies. Effective March 2006, a similar marginal reserve requirement will apply to issuance of bonds by commercial banks, to close a potential loophole. At the same time, the CNB is supporting the government's efforts to finance the general government deficit without recourse to new foreign borrowing. Accordingly, the CNB reduced the general reserve requirement from 18 to 17 percent effective January 2006.

19. The CNB is also continuing to strengthen banking supervision, implementing several measures that will both help banks mitigate foreign-currency-related credit risks and contribute to more moderate growth in credit to the private sector:

- Preparing minimum standards for the proper management of these risks, which it will circulate to banks by end-February 2006.
- Requiring banks to prepare policies and techniques for managing their foreign-currency-related credit risks, for submission to the CNB by March 15, 2006, and implementation during April–May 2006.
- Introducing stricter reporting requirements on banks' unhedged loans effective from the second quarter of 2006.
- Increasing capital adequacy risk weights by 25 basis points on foreign currency or foreign currency-indexed loans to unhedged borrowers in the nongovernment sector effective from the second quarter of 2006.
- Undertaking a public campaign to inform borrowers of the risks of floating interest rate and unhedged foreign currency and foreign currency-indexed loans starting this year.
- Intensifying cooperation with foreign supervisors by concluding discussions on the pending Memoranda of Understanding (MoU) with Italy and Hungary.

20. In addition to the above measures, we are taking additional steps to improve financial sector supervision. On November 17, 2005, parliament approved legislation creating a single non-bank supervisor, the Croatian Agency for Supervision of Financial Services, to take over the responsibilities of the existing securities, pension fund, and insurance supervisory agencies. The Agency began operations in January 2006.

C. Structural Reforms

21. We are continuing our fundamental reforms to the health sector in 2006, building on initial measures in 2004 and 2005. We are preparing a package of several laws to address important aspects of the reform. These measures are part of a broader health reform that will be implemented over the medium term. Specifically:

- To help curb demand and ensure a more equitable sharing of healthcare costs, we will require co-payments for drugs that are not included in the main list and limit this main list of drugs (that are exempt from co-payments) only to the lowest-priced among clinically-equivalent drugs.

- Supplementary health insurance for drugs, currently provided by the state below cost, will be separated from the main health insurance fund (HZZO) and shifted to the private sector. Supplementary health insurance for all other health services will continue to be provided by HZZO but will also be open to the private sector;

- We will set targets for fund allocation to primary care providers and reward those who spend less by allowing them to keep part of the savings for their professional needs, while reducing the salary of those who spend in excess of their allocation.

- We will improve the transparency of the HZZO's revenue and expenditure by clearly identifying the sources of each outlay (health contributions or budgetary transfers).

- To strengthen accountability and incentives for sound financial management of hospitals, we will clarify the responsibilities for maintaining state and county hospitals between the central and local governments.

The government will approve and submit this package of laws to parliament by March 15, with a view to implementing it from July 1. In addition to its far-reaching implications for public services and the public finances, this reform will also stem the accumulation of new arrears in the health sector starting in the second half of 2006. However, its mid-year implementation implies that a further accumulation of arrears (about HRK 300 million) is possible during the first half.

22. We remain committed to our privatization program. Several major privatizations envisaged in 2005 are now nearing completion. In September 2005, we selected Merrill Lynch and Raiffeisen Bank as advisers in the second phase of privatization of 15 percent of the national oil company, INA; the sale will take place in the first half of 2006, as will the sale of the government's remaining holding in the telecom company HT. We expect to complete by end-2007 the sale of government holdings in companies (excluding shipyards) held by the Privatization Fund (HFP). By end-June 2006, and consistent with our undertakings under the World Bank PAL, we intend to complete the privatization or

liquidation of one-third of all companies in which the government holds a majority stake, and sell the government shares in half of the companies in which the government holds a minority stake. We are preparing to issue tenders for the Sisak and Split steel companies and the TLM aluminum company, in the first half of 2006, and for the Uljanik shipyard before year-end. Because of delays in settling open compensation claims, the preparation of a plan to privatize the Croatian Insurance company (CO) was delayed; we now intend to finalize this plan by end-June, with a view to starting the privatization of the company in the second half of this year. We plan to merge and subsequently privatize the two remaining state-owned banks, Croatia Banka and HPB, though this plan is on hold pending the court resolution of a lawsuit against Croatia Banka by former small shareholders.

23. State aid to the shipyard and steel sectors imposes high costs on the budget and is inconsistent with EU law. We are preparing a restructuring plan for shipyards in consultation with the European Commission aimed at curbing the industry's losses, reducing subsidies to EU levels, and ensuring that remaining government interventions comply with the *acquis communautaire*. The restructuring plan, which will be submitted to the government by end-April and approved by end-June, will set out a process for the shipyards' privatizations, which will be transparent and conducted by means of public tenders with defined terms of reference. We will also start phasing out state aid to the steel sector during 2006.

24. We will continue implementing our restructuring plan for Croatian Railways (HŽ) consistent with our undertakings under the World Bank PAL. In 2006, we will take further steps toward further separation of railway infrastructure and business operations, privatization of three subsidiaries of HŽ, and layoffs consistent with bringing the company's working ratio (total operating costs over total operating revenue) to 190 in 2006, down from 220 in 2005.

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

			End of		
			March 2006	June 2006	September 2006
			(In millions of kuna, unless indicated otherwise)		
Quantitative performance criteria (cumulative from January 1, 2006) 1/					
1	Cumulative deficit of the consolidated general government 2/		4,216	6,635	6,488
2	Cumulative change of the stock of arrears of the consolidated general government 2/		150	300	300
3	Cumulative deficit of HBOR 2/		-65	-124	-18
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 2/ 3/	Total	362	427	597
		<1 years	0	0	0
5	Cumulative issuance of guarantees extended by the general government 2/		1,705	2,610	2,814
6	Cumulative change in the Net International Reserves of the Croatian National Bank 3/ 4/		-345	-65	-400
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 2/		1,340	1,470	-1,140
Indicative limits					
1	Cumulative increase in the total debt of selected public enterprises 2/		-28	-97	169

1/ Performance criteria for end-March and end-June 2006; indicative targets for end-September 2006.
2/ Ceiling.
3/ In millions of euros.
4/ Floor. Net of commercial banks' required reserves in foreign currencies.

Table 2. Croatia: Prior Actions, Performance Criteria, and Structural Benchmarks for 2006

Prior actions for the Second Review	
1. Government to approve and submit to Parliament a package of draft laws on health reform that require co-payments for drugs not included in the main list, discontinue HZZO's provision of supplementary insurance for drugs, and open supplementary insurance for other health services to the private sector.	Annex, Para. 21
2. Supervisory board of HBOR to approve a revised lending plan, reducing net lending to HRK 1.36 billion in 2006, consistent with a deficit of HRK 500 million.	Annex, Para. 15
Quantitative performance criteria	
1. Quarterly limits on the cumulative deficits of the consolidated general government.	
2. Quarterly limits on the cumulative changes of the stock of general government arrears.	
3. Quarterly limits on the cumulative deficits of HBOR.	
4. Quarterly limits on the cumulative amount of the contracting of nonconcessional external debt by the general government and HBOR with sublimits on contracting of such debt with a maturity of up to 1 year.	
5. Quarterly limits on the cumulative issuance of guarantees extended by the general government.	
6. Quarterly floors under the cumulative changes of the net international reserves of the CNB.	
7. Quarterly limits on the cumulative changes of the net domestic assets of the CNB.	
Indicative limits	
1. Quarterly limits on the cumulative increase in the total debt stock of selected public enterprises.	
Structural benchmarks	
1. Parliament to approve, by end-June 2006, a package of draft laws on health reform that require co-payments for drugs not included in the main list, discontinue HZZO's provision of supplementary insurance for drugs, and open supplementary insurance for other health services to the private sector.	Annex, Para. 21
2. Government to approve, by end-June 2006, a plan for restructuring the shipyard industry.	Annex, Para. 23
3. Government to formulate a plan on privatization of CO by end-June 2006.	Annex, Para. 22
4. Government to complete the third phase of privatization of HT, and the second phase of privatization of INA, by end-June 2006.	Annex, Para. 22
5. CNB to increase risk weights by 25 basis points on credits to nongovernment clients exposed to foreign-currency-related credit risk, effective end-June 2006.	Annex, Para. 19
Performance clauses 1/	
1. No new external payments arrears.	MEFP, Para. 27
2. No new, or intensification of existing, restrictions of the making of payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments reasons.	MEFP, Para. 27

1/ To be monitored on a continuous basis.

TECHNICAL MEMORANDUM OF UNDERSTANDING

I. LIMITS ON THE CUMULATIVE DEFICITS OF THE CONSOLIDATED GENERAL GOVERNMENT

	Ceilings
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	4,216
June 30, 2006 (performance criterion)	6,635
September 30, 2006 (indicative target)	6,488

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

2. Paragraph 10 of the Annex provides that additional revenue in excess of the budget projections will be saved. To that effect, the above cumulative ceilings on the deficit will be adjusted downwards by the amount of excess revenue at the consolidated central government level (covering (i)-(iii) above) over the amount of HRK 21,344 million for March 31, HRK 45,674 million for June 30, and HRK 71,665 million for September 30. This adjustor will exclude revenues arising from new taxes or changes in existing tax rates.

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

4. Fiscal performance will be monitored monthly at the consolidated central government level covering (i)-(iii) defined above and tested quarterly at the consolidated general government level covering (i)-(iv) defined above with the test dates for 2006 being March 31, June 30, and September 30. The Ministry of Finance will provide data for consolidated central government on a monthly basis within 30 days from the end of the month and data for local governments every 3 months within 30 days from the end of the month.

5. The Ministry of Finance will report the reconciliation between the change in the general government debt stock and the deficit of the general government during each quarter within 45 days from the end of the quarter, in the form of the following table, which is a part of this Technical Memorandum of Understanding.

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

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

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

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

	Ceilings
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	150
June 30, 2006 (performance criterion)	300
September 30, 2006 (indicative target)	300

6. Arrears include (i) all payments overdue according to their original or modified terms; and (ii) any promissory notes issued by the Ministry of Finance and the central budgetary funds. Arrears comprise both domestic and external payments arrears and are not netted out by government cash holdings in banks. The stock of arrears will be provided monthly to the Fund by the Ministry of Finance within 30 days. Arrears monitored under the SBA are limited to arrears extended by the general government to all entities outside the general government. In case the general government assumes responsibility for arrears extended by entities outside the general government (e.g., hospitals), such arrears will be treated as expenditures of the general government at the time they are taken over by the government. For the purposes of this performance criterion, the stock of arrears will not be affected by the repayment of the HRK 809 million loan from Zagrebacka banka (i.e., should the loan repayment result in reduction of reported arrears, the reported stock will be adjusted upward correspondingly).

III. Limits on the Deficit of HBOR

	Cumulative Limits
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	-65
June 30, 2006 (performance criterion)	-124
September 30, 2006 (indicative target)	-18

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

8. Fiscal performance by HBOR will be monitored on a monthly basis and tested on a quarterly basis with March 31, June 30, and September 30 being the test dates for 2006. HBOR will provide data on a monthly basis within 30 days of the end of the month.

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

	Ceilings	
	(In millions of euros)	
	Ceilings	Subceilings ≤1 year
Cumulative changes from December 31, 2005:		
March 31, 2006 (performance criterion)	362	0
June 30, 2006 (performance criterion)	427	0
September 30, 2006 (indicative target)	597	0

9. For program purposes, the term "debt" is understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future points in time; these payments will discharge the principal and/or interest liabilities under the contract. (For details of definition of debt, refer to "Guidelines on Performance Criteria with respect to External Debt in Fund Arrangements" (IMF Executive Board Decision No. 12278—[00/86], August 25, 2000). Debt includes commitments contracted or guaranteed for which value has not been received. The limits on short-term debt do not apply to normal import-related credits and nonresident deposits in state-owned banks (HPB, HBOR).

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

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

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

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

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

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

	Ceilings
	To all entities outside the consolidated general government (In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	1,705
June 30, 2006 (performance criterion)	2,610
September 30, 2006 (indicative target)	2,814

14. Cumulative issuance of debt guarantees listed above will be measured at the exchange rates listed in Section IV. The above limits cover debt guarantees issued by the general government to entities outside the general government as well as guarantees extended for HBOR's lending to entities outside the general government. The limits do not cover guarantees extended to HBOR's borrowing from entities outside the general government. The above ceilings are set on the assumption of repayments of HRK 1,347 million of guaranteed loans by the government for the year as a whole and will be adjusted upward by the amount of cumulative company repayments of the underlying loans during 2006.

15. Guarantee issuance will be monitored on a monthly basis. The Ministry of Finance will provide, within 30 days from the end of the month, data on gross issuance of guarantees and repayments of guaranteed loans by both the original borrowers and by the government. Performance will be tested on a quarterly basis and in 2006 with March 31, June 30, and September 30 as test dates. In addition, for the purpose of public debt statistics, the Ministry of Finance will provide the same set of data on gross issuance and repayments, calculated at spot exchange rates, within 30 days following each test date.

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

	Indicative limits
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006	-28
June 30, 2006	-97
September 30, 2006	169

16. The above listed indicative aggregate limits cover the following 8 enterprises:

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

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

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

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

VII. Floors under the Cumulative Changes in the Net International Reserves of the Croatian National Bank

	Floors
	(In millions of euro)
Stock as of December 31, 2005	5,560
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	-345
June 30, 2006 (performance criterion)	-65
September 30, 2006 (indicative target)	400

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

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

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

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

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

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

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

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

	Ceilings
	(In millions of kuna)
Stock as of December 31, 2005	-1,822
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	1,340
June 30, 2006 (performance criterion)	1,470
September 30, 2006 (indicative target)	-1,140

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

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

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

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

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

CROATIA: DEBT SUSTAINABILITY ANALYSIS

I. Fiscal Sustainability

1. Under the baseline scenario, public debt peaks at 45½ percent of GDP in 2005 and then gradually tapers off to 41 percent of GDP by 2011, driven primarily by continued fiscal consolidation and sizable privatization receipts in 2006 and 2007. The "pensioners' debt" repayments do not affect the debt dynamics because they are assumed to be fully financed by privatization receipts. Stress-testing of debt dynamics suggests, however, that a severe economic slowdown accompanied by a revenue drop could halt fiscal consolidation and put the debt ratio on an upward trend (Table 13, Figure 6). If key variables are kept at their historical averages (scenario A1) the debt ratio increases by 16½ percentage points of GDP by 2011. This is because the historical primary deficit does not fully account for the recent significant fiscal consolidation—a trend projected to continue in the medium term—while the historical growth rate is unduly affected by a recession in 1999. Assuming no policy change from 2005 (scenario A2), the debt ratio would increase modestly over the forecast horizon, similar to the effect of a policy-induced widening of the primary deficit (scenario B3), or a combined slowdown in growth with the concomitant rise in the primary deficit plus an interest rate hike (scenario B4). However, a large and sustained drop in economic activity (scenario B2) would raise debt by 6 percentage points, assuming that the primary balance widens proportionately to the fall in revenue. Under the two one-time shocks (scenarios B5 and B6), the debt ratio resumes a downward trend following the initial shock.

II. External Sustainability

2. External debt has risen quickly in recent years in Croatia—by over 25 percent of GDP (in euro terms) between 2000 and 2004. Efforts at fiscal consolidation, a shift by the public sector towards domestic financing, and measures by the central bank to discourage bank external borrowing have resulted in a marked slowdown of the growth in the debt to GDP ratio in 2005. In the staff's baseline projection, which incorporates a steadily improving external current account performance, the debt to GDP ratio would decline gradually to about 70 percent by 2011 (Table 14). Alternative scenarios demonstrate the sensitivity of external debt to several factors, highlighting the need for vigilance in economic management to forestall an unsustainable situation (Figure 7). In the scenario involving key variables being kept at their historical averages,[6] the external debt ratio rises slightly. Scenarios with higher interest rates, lower growth or a worsening of the current account indicate a slower decline in the debt to GDP ratio relative to the baseline, especially for the latter shock. A large real depreciation has particularly adverse effects, with the debt to GDP ratio possibly averaging over 90 percent between 2006 and 2011.

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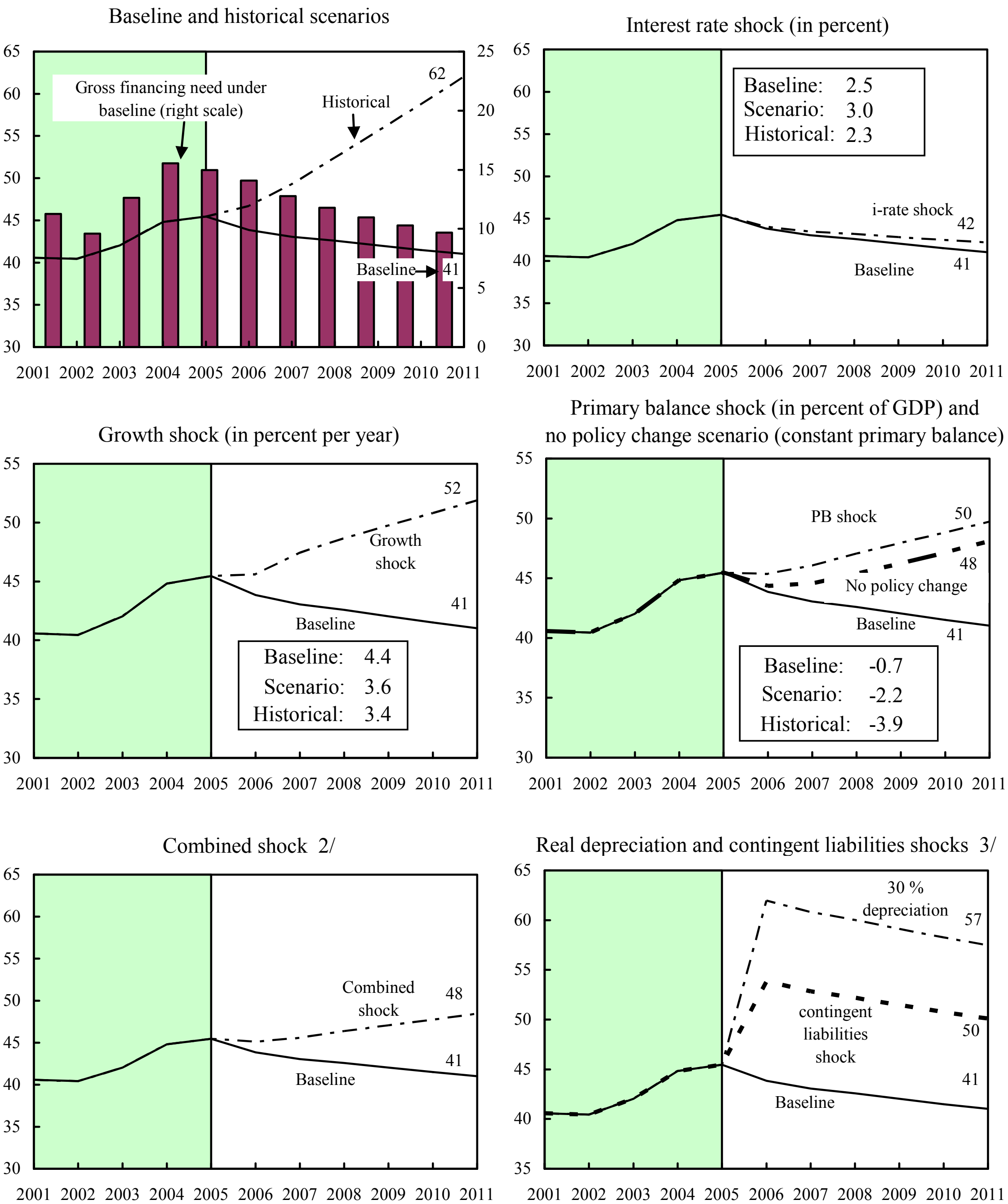
[6] The key variables are growth in real GDP and the GDP deflator, nominal interest rates, and the non-interest current account and non-debt flows in percent of GDP.

Table 13. Croatia: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

		Actual						Projections						
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 10/
1	**Baseline: Public sector debt 1/**	39.7	40.6	40.4	42.0	44.8	45.5	**43.8**	**43.1**	**42.6**	**42.0**	**41.5**	**41.0**	**-0.2**
	o/w foreign-currency denominated	28.2	28.2	28.3	29.4	32.5	36.8	34.6	33.1	31.9	30.7	29.5	28.3	
2	Change in public sector debt	6.3	0.9	-0.1	1.6	2.8	0.6	-1.6	-0.8	-0.5	-0.5	-0.5	-0.5	
3	Identified debt-creating flows (4+7+12)	1.3	-0.9	0.4	1.9	1.2	1.0	-0.8	-0.2	0.1	0.0	0.0	0.1	
4	Primary deficit	4.5	4.5	2.9	4.2	2.8	1.9	1.4	0.9	0.6	0.4	0.4	0.3	
5	Revenue and grants	46.2	44.0	46.3	46.4	46.6	46.2	45.9	44.9	44.3	43.9	43.6	43.3	
6	Primary (noninterest) expenditure	50.7	48.5	49.2	50.6	49.4	48.0	47.2	45.7	44.9	44.4	44.0	43.7	
7	Automatic debt dynamics 2/	-0.7	-1.8	-0.7	-0.2	-1.0	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8	-0.8	
8	Contribution from interest rate/growth differential 3/	-0.4	-1.0	-1.0	-0.8	-0.7	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8	-0.8	
9	Of which contribution from real interest rate	0.5	0.7	1.0	0.8	0.8	0.8	0.9	1.0	0.9	1.0	1.0	0.9	
10	Of which contribution from real GDP growth	-0.9	-1.6	-2.0	-1.6	-1.5	-1.7	-1.8	-1.8	-1.8	-1.8	-1.8	-1.7	
11	Contribution from exchange rate depreciation 4/	-0.3	-0.9	0.3	0.6	-0.4	...	...	...	...	...	...	...	
12	Other identified debt-creating flows	-2.6	-3.7	-1.8	-2.2	-0.6	0.0	-1.3	-0.2	0.4	0.4	0.5	0.6	
13	Privatization receipts (negative)	-2.6	-3.7	-1.8	-2.2	-0.6	-0.5	-1.9	-0.8	-0.2	-0.2	-0.1	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.5	0.6	0.6	0.6	0.6	0.6	0.6	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	5.0	1.8	-0.6	-0.3	1.6	-0.4	-0.8	-0.6	-0.6	-0.6	-0.6	-0.6	
	Public sector debt-to-revenue ratio 1/	85.9	92.3	87.3	90.7	96.1	98.5	95.6	95.9	96.2	95.7	95.1	94.7	
	Gross financing need 6/	11.4	11.3	9.6	12.6	15.5	15.0	14.1	12.8	11.8	11.0	10.3	9.7	
	in billions of U.S. dollars	2.3	2.5	2.3	3.2	4.3	4.5	4.6	4.5	4.4	4.4	4.5	4.5	
	A1. Scenario with key variables at their historical averages 7/							**46.7**	**49.3**	**52.4**	**55.6**	**58.8**	**62.0**	**-0.1**
	A2. Scenario with no policy change (constant primary balance) in 2006-2011							**44.4**	**44.6**	**45.4**	**46.2**	**47.1**	**48.1**	**-0.4**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
	Real GDP growth (in percent)	2.9	4.4	5.2	4.3	3.8	4.1	4.1	4.5	4.5	4.5	4.5	4.5	
	Average nominal interest rate on public debt (in percent) 8/	6.4	6.0	5.6	5.6	5.6	5.5	5.5	5.5	5.5	5.6	5.6	5.5	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.7	2.0	2.7	2.3	2.3	2.1	2.2	2.5	2.5	2.6	2.6	2.5	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	1.1	3.1	-1.0	-2.1	1.2	...	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	4.7	4.0	2.9	3.2	3.3	3.4	3.2	3.0	3.0	3.0	3.0	3.0	
	Growth of real primary spending (deflated by GDP deflator, in percent)	-4.9	-0.1	6.8	7.1	1.3	1.3	2.4	1.2	2.5	3.3	3.6	3.7	
	Primary deficit	4.5	4.5	2.9	4.2	2.8	1.9	1.4	0.9	0.6	0.4	0.4	0.3	
	B. Bound Tests													
	B1. Real interest rate is at historical average plus one standard deviation							**44.1**	**43.5**	**43.2**	**42.8**	**42.5**	**42.2**	**-0.1**
	B2. Real GDP growth is at historical average minus one standard deviation in 2006 and 2007							**45.6**	**47.4**	**48.7**	**49.8**	**50.8**	**51.9**	**-0.4**
	B3. Primary balance is at historical average minus one standard deviation							**45.4**	**46.1**	**47.1**	**48.0**	**48.8**	**49.7**	**-0.4**
	B4. Combination of B1-B3 using 1/2 standard deviation shocks							**45.1**	**45.6**	**46.4**	**47.1**	**47.7**	**48.5**	**0.2**
	B5. One time 30 percent real depreciation in 2006 9/							**62.0**	**60.8**	**60.0**	**59.1**	**58.3**	**57.5**	**-0.6**
	B6. 10 percent of GDP increase in other debt-creating flows in 2006							**53.8**	**52.9**	**52.2**	**51.5**	**50.7**	**50.1**	**-0.4**

1/ Gross debt of the general government.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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



Sources: Croatian authorities; and staff estimates.

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

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

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

Table 14. Croatia: External Debt Sustainability Framework, 2000-2011
(In percent of GDP, unless otherwise indicated)

		Actual					Projections							
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011		Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	55.1	60.7	62.2	77.6	82.4	**84.7**	**81.5**	**78.2**	**75.2**	**72.6**	**71.6**	**70.0**		**-7.9**
2	Change in external debt	2.2	5.6	1.5	15.4	4.8	2.3	-3.2	-3.3	-3.0	-2.7	-1.0	-1.6	0.0	
3	Identified external debt-creating flows (4+8+9)	-6.7	-7.8	-1.5	-2.8	-3.4	-1.7	-5.1	-3.4	-3.0	-3.0	-3.0	-3.0	0.0	
4	Current account deficit, excluding interest payments	-0.6	0.5	5.7	3.9	2.9	3.9	3.4	3.4	3.0	2.5	2.8	2.7	7.9	
5	Deficit in balance of goods and services	5.2	5.9	10.8	8.0	7.3	6.9	7.0	7.0	6.5	6.0	6.2	6.0		
6	Exports	46.8	48.6	46.2	51.5	51.5	51.5	52.2	53.9	53.5	53.4	53.0	52.7		
7	Imports	52.0	54.4	57.0	59.6	58.8	58.4	59.1	60.9	60.0	59.4	59.2	58.8		
8	Net non-debt creating capital inflows (negative)	-5.9	-6.0	-4.8	-5.9	-2.7	-4.6	-7.7	-5.8	-5.0	-5.0	-5.0	-5.0	-5.0	
9	Automatic debt dynamics 1/	-0.3	-2.3	-2.5	-0.8	-3.6	-1.0	-0.7	-1.0	-1.0	-0.5	-0.8	-0.7	-2.9	
10	Contribution from nominal interest rate	3.1	3.1	2.6	2.4	2.3	2.1	2.5	2.4	2.3	2.7	2.2	2.3	2.2	
11	Contribution from real GDP growth	-1.4	-2.2	-2.9	-2.5	-2.7	-3.1	-3.3	-3.4	-3.3	-3.1	-3.0	-3.0	-3.0	
12	Contribution from price and exchange rate changes 2/	-2.0	-3.3	-2.2	-0.7	-3.2	...	...	...	...	...	...	...	-2.1	
13	Residual, incl. change in gross foreign assets (2-3) 3/	9.0	13.4	3.0	18.3	8.2	4.0	1.9	0.1	0.1	0.4	2.1	1.4	0.0	
	External debt-to-exports ratio (in percent)	117.7	125.0	134.5	150.6	160.1	164.5	156.2	145.1	140.6	135.8	135.1	132.8		
	Gross external financing need (in billions of US dollars) 4/	2.8	3.9	4.4	4.2	5.5	7.0	8.2	8.8	9.7	11.3	12.1	13.6		
	in percent of GDP	13.9	17.6	18.3	16.5	20.1	23.2	25.3	25.3	25.8	28.1	27.9	29.1		
	Scenario with key variables at their historical averages 5/						**84.7**	**86.3**	**85.8**	**85.1**	**84.7**	**85.8**	**86.1**		**-7.0**
	Key Macroeconomic Assumptions Underlying Baseline													For debt stabilization	
	Real GDP growth (in percent)	2.9	4.4	5.2	4.3	3.8	4.1	4.1	4.5	4.5	4.5	4.5	4.5	4.5	
	GDP deflator in US dollars (change in percent)	4.0	6.3	3.8	1.1	4.3	4.7	3.2	3.0	3.0	3.0	3.0	3.0	3.0	
	Nominal external interest rate (in percent)	6.4	6.3	4.8	4.1	3.2	2.8	3.2	3.2	3.2	3.8	3.3	3.4	3.3	
	Growth of exports (US dollar terms, in percent)	22.9	15.1	4.0	17.5	8.1	9.0	8.9	11.2	6.8	7.5	6.8	7.0		
	Growth of imports (US dollar terms, in percent)	13.1	16.2	14.5	10.1	6.8	8.2	8.9	10.8	6.1	6.6	7.3	6.8		
	Current account balance, excluding interest payments	0.6	-0.5	-5.7	-3.9	-2.9	-3.9	-3.4	-3.4	-3.0	-2.5	-2.8	-2.7		
	Net non-debt creating capital inflows	5.9	6.0	4.8	5.9	2.7	4.6	7.7	5.8	5.0	5.0	5.0	5.0		

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

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

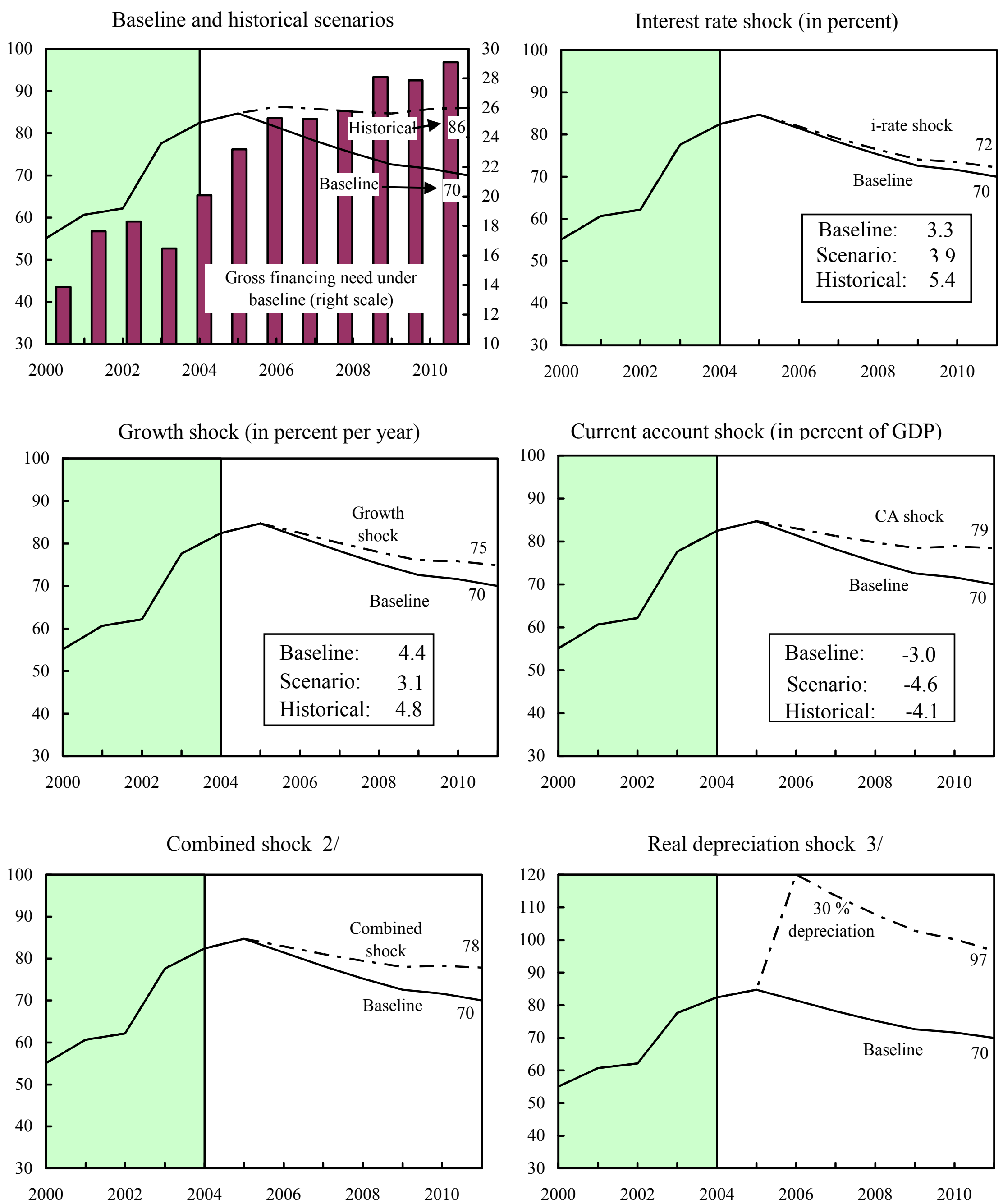
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Figure 7. Croatia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: Croatian authorities; and staff estimates.

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

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

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

CROATIA: FINANCIAL POSITION IN THE FUND
(as of January 31, 2006)

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

II. **General Resources Account:**

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

III. **SDR Department:**

	SDR million	% Allocation
Net cumulative allocation	44.21	100.00
Holdings	0.48	1.09

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

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

VI. **Projected Obligations to Fund** (SDR million; based on present holdings of SDRs):[7]

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest	1.41	1.44	1.45	1.44	1.44
Total	1.41	1.44	1.45	1.44	1.44

VII. **Safeguards Assessment:**

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

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

VIII. Exchange Rate Arrangement:

In December 1991, Croatia left the Yugoslav dinar area and adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with the participation of the CNB. The authorities' exchange rate policy regarding the Croatian kuna is accordingly classified as "managed floating with no pre-announced path for the exchange rate". The CNB transacts only in euros, U.S. dollars, and SDRs. On January 31, 2006, the official exchange rate was kuna 6.092667 per U.S. dollar (middle rate).

IX. Exchange Restrictions:

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

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

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

On August 4, 2004, Executive Directors approved a new 20-month **Stand-By Arrangement** for an amount equivalent to SDR 97.00 million (26.6 percent of quota). The authorities treat the arrangement as precautionary. The policy program underlying the arrangement aims at containing the current account deficit and stabilizing external debt, mainly through a fiscal adjustment over 2004–05. Directors completed the first review under this Arrangement on September 14, 2005.

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

XI. FSAP:

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

XII. Technical Assistance 2000–05:[8]

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

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

April 2003	Stress Testing and Foreign Exchange Reserve Management
February 2004	Monetary Policy Instruments

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

XIII. Resident Representative:

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

CROATIA: STATISTICAL ISSUES

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

A. National Accounts

2. The national accounts have undergone substantial improvements in the last few years. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the 1995 ESA. Quarterly GDP estimates are disseminated at current prices and at constant (1997) prices for the main categories of expenditure and main industry groupings. Nonetheless, shortcomings remain. Significant discrepancies exist between expenditure-based and value-added-based GDP data, stemming from: (i) insufficient coordination between the CBS and CNB to reconcile tourism receipts estimates; (ii) incomplete coverage of unincorporated businesses and the self employed (farmers, trade and crafts); (iii) inadequate data for measuring changes in inventories; (iv) incomplete coverage of the informal sector; and (v) a lack of quarterly data for the seasonally volatile agricultural sector. Other shortcomings include: (i) inadequate conversion of government finance statistics from a cash to accrual basis; (ii) inadequate price deflators; and (iii) the late publication of annual data, which generally show large differences with quarterly data. The summary methodology on national accounts on the IMF's DSBB was last updated in July 2003.

B. Prices

3. The CBS produces the monthly consumer price index, with expenditure weights (updated every five years) currently derived from a 2001 Household Budget Survey. Data are collected between the 13th and the 21st day of each month, and the indices are released around the 15th day of the following month. A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology, but is not released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the CNB. The CBS also releases a monthly producer price index (PPI), usually on the 8th day of the following month. The weights of the PPI are based on the 2000 Annual Report of Industry and are updated every five years.

C. Wages and Employment

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

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

D. Government Finance Statistics

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

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

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

E. Monetary Data

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

F. External Sector Statistics

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

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

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

Croatia: Table of Common Indicators Required for Surveillance
(as of February 21, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	2/21/06	2/21/06	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2/10/06	2/17/06	W	W	W
Reserve/Base Money	Dec 2005	1/31/06	M	M	M
Broad Money	Dec 2005	1/31/06	M	M	M
Central Bank Balance Sheet	Dec 2005	1/31/06	M	M	M
Consolidated Balance Sheet of the Banking System	Dec 2005	1/31/06	M	M	M
Interest Rates[2]	Dec 2005	1/31/06	M	M	M
Consumer Price Index	Jan 2006	2/15/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 2005	2/7/06	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Dec 2005	2/3/06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec 2005	2/14/06	M	M	M
External Current Account Balance	Q3 2005	12/29/05	Q	Q	Q
Exports and Imports of Goods and Services	Q3 2005	12/08/05	M	M	M
GDP/GNP	Q3 2005	12/29/05	Q	Q	Q
Gross External Debt	Dec 2005	2/7/06	M	M	M

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

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

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

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

[5] Including currency and maturity composition.

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

CROATIA: WORLD BANK RELATIONS

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

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

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

4. The Bank Board approved the first out of three PALs in September 2005. PAL 1 amounts to EUR 150 million. The PAL has three major components: (i) strengthening governance through public administration reform and strengthening of public expenditure management; (ii) improving the investment climate through judicial reform, privatization, continued reduction of barriers to entry of new firms, and continued reduction of state subsidies; and (iii) strengthening financial sustainability of sectoral spending through health reform, social benefits streamlining, railways restructuring, and improvement of the fiscal and social sustainability of the pension system. The pre-appraisal mission for PAL 2 was conducted in November and December 2005. The appraisal mission is currently planned for end-March 2006 with the Board date planned for end-September 2006.

5. The current amount of committed funds to Croatia stands at $1.69 billion for 33 IBRD and GEF projects. Currently, the Bank's active portfolio in Croatia is comprised of 13 IBRD and three GEF projects. Thus far in FY06 three IBRD investment loans have been approved: Science and Technology (EUR 31 million), PAL 1 (EUR 150 million), and the Education SWAp (EUR 67.8 million). An additional IBRD loan (Agricultural Acquis Cohesion, in the amount of EUR 25.5 million) has been submitted to the Bank's Board for approval in mid-February 2006.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/66
FOR IMMEDIATE RELEASE
March 29, 2006

International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) today completed the second review under an SDR 97 million (about US$139.9 million) Stand-By Arrangement for the Republic of Croatia, approved on August 4, 2004 for 20 months (see Press Release No. 04/170). The authorities are treating the arrangement as precautionary.

In completing the review, the Executive Board also granted an extension of the arrangement until November 15, 2006 as well as an augmentation of access to an amount equivalent to SDR 99 million (about US$142.7 million). The Executive Board also granted a waiver for the nonobservance of the end-December 2005 quantitative performance criterion pertaining to the stock of general government arrears.

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

"Croatia's economy has experienced steady growth, external vulnerabilities have been reduced, inflation remains low, and key structural reforms have moved forward. This good performance has been underpinned by an impressive combined fiscal adjustment attained mainly through expenditure reductions. At the same time, much larger than expected private borrowing caused the external debt-to-GDP ratio to increase slightly in 2005—although at a slower pace than in previous years—and the level of debt remains high.

"Continuing the fiscal consolidation efforts and the implementation of key structural reforms are prerequisites for making further progress in reducing vulnerabilities. In that light, the 2006 budget target, which implies a further combined fiscal effort on top of the adjustment achieved in 2004–05, is welcome. The authorities intend to limit budgetary expenditures to the level provided for in the budget, even if the revenue outturn is better than expected. This is appropriate to address risks to domestic demand, including the impulse to domestic demand from the government's payment of "pensioners' debt" starting in the second half of the year. Holding the line on public spending will also reinforce the credibility of the medium-term plans for expenditure reduction in the Pre-Accession Economic Program.

"Structural reforms have advanced, notably in the pensions and healthcare areas, although further reforms will be needed to enable Croatia to keep pace with other central European countries and pave the way for eventual EU accession. Timely implementation of the health sector reforms should start yielding budget savings from mid-2006, but further measures to encourage more efficient use of health care services may be necessary in the medium term. The authorities are encouraged to persevere with their privatization agenda and their plans to reduce subsidies and state aid. In this context, an important element will be the reform of the shipyard industry.

"The Croatian National Bank (CNB) continues to play its part in mitigating vulnerabilities by keeping inflation low, maintaining exchange rate stability, and addressing the prudential risks associated with higher bank foreign borrowing and rapid credit growth. The CNB has raised the marginal reserve requirement on new foreign borrowing by banks and introduced a series of measures to help them mitigate foreign-currency-related credit risk. The creation of a single nonbank financial regulator at the start of 2006 is a welcome step. The CNB and the nonbank regulator will need to work together closely in monitoring the financial system," Ms. Krueger said.

Statement by Yuri G. Yakusha, Alternate Executive Director for Republic of Croatia and Charalambos Christofides, Advisor to Executive Director
March 29, 2006

Introduction

The authorities continue to strongly emphasize maintaining the good macroeconomic performance of recent years and further invigorating structural reform. With steadfast commitment on the part of the political and economic leadership, and policies anchored by the Fund-supported precautionary stand-by arrangement (SBA) and the prospect of EU accession, further progress in these areas can be expected. A key uncertainty that prevailed last year regarding the possibility of Croatia's accession into the EU was favorably resolved last October. Already Croatia is undergoing a screening of its legislation by the European Commission, which is rapidly progressing. Looking ahead, EU accession will provide comfort to foreign investors, help further promote FDI, and contribute to lower than otherwise interest rate differentials, thereby enhancing confidence for investors and consumers alike.

Program performance and economic developments in 2004-05

The authorities are pleased to agree with the staff assessment that "policy implementation under this SBA has yielded sizeable fiscal consolidation and advances in structural reforms," both key program objectives. During the period 2004-05, the general government fiscal deficit was cut by 2.1 percent of GDP, more than accounted for by reductions on expenditure totaling 2.4 percent of GDP. By not relying on revenue increases, fiscal adjustment contributes to a reduction in the size of the public sector. The quasi-fiscal deficits of the Croatian Development Bank (HBOR), which are not included in the definition of general government, were reduced by 0.6 percent of GDP, yielding a total fiscal adjustment of 2.7 percent of GDP. All in all, while recognizing some past difficulties in the area of fiscal consolidation, the degree of fiscal adjustment over the more recent period represents a considerable achievement.

On structural and related reform, a number of measures deserve mention. A 3-year rolling medium term fiscal plan was put into operation and it formed the basis for Croatia's pre-accession program (as described in Box 1 of the Staff Report). In part to underpin its successful operation, the authorities altered the pension indexation formula to a weighted average of wages and prices, and put into effect a medium-term subsidy reduction plan. The necessary restructuring of the railways began with World Bank assistance. The law on State Aid was amended to conform with EU requirements.

In terms of economic outcomes, the program and related policies performed well. Growth remained good, rising to an estimated 4.1 percent in 2005 from 3.8 percent in 2004, while inflation was contained despite higher food and energy prices. Though from a high base, the labor-force survey-based unemployment has been trending downward, a notable achievement in light of strong productivity gains (GVA per employee in industry for 2005 is estimated to have risen by 7 percent) and stable unit labor costs.

Finally, in terms of program criteria, all quantitative PCs were met with the exception of the end-September target for government external borrowing—which was caused by an unexpectedly early disbursement of the World Bank PAL1 loan and which was done in December—and of the end-September and end-December target on reducing general government arrears. This was mostly due to health arrears and will be addressed through a comprehensive reform (discussed below). Missed PCs have either already been addressed or are being addressed (including through a prior action on the health care sector).

The program for 2006

The completion of the second review and the requested SBA extension, if approved by the Executive Board, have the potential to strengthen gains on the fiscal, monetary, and structural fronts.

The program forecasts are for continued solid growth at low inflation rates and a stabilization in the current account deficit and external debt. These developments are underpinned by significant monetary and fiscal actions. On the monetary side the Croatian National Bank (CNB) will maintain its focus on price stability, while keeping an eye on exchange rate developments. However, to help contain credit growth and limit foreign borrowing, the CNB already raised the cost of foreign funds by raising the unremunerated marginal reserve requirement on new borrowing from 40 to 55 percent, while simultaneously expanding the base to counter the leakage of funds through leasing companies and also to include bank-issued bonds, as described in Box 3 of the Staff Report. In light of the commercial banks balance sheet structure (about two-thirds of bank liabilities are in foreign currency, and approximately the same portion of their assets is indexed to foreign currency) the CNB is introducing or strengthening a number of prudential measures which are intended to safeguard the integrity of the banking and financial system more broadly against foreign exchange risk that could manifest as credit risk.

Fiscal policy envisages a significant further adjustment of 0.9 percent of GDP, which would bring the deficit down to 3.3 percent in 2006—most of the way to the 2.8 percent of GDP medium term (2008) target in the pre-accession program. This would be achieved as previously through expenditure restraint, and would allow for a further reduction in the revenue-to-GDP ratio (based on realistic projections and only neutral changes in tax measures). In addition to containing wage growth in the public sector, expenditure will be kept within target through the new pension formula (already enacted) but also significant reform in the health care sector. Together with limits on HBOR operations (a prior action that is already done), and privatization receipts, the fiscal measures would stabilize (in fact, reduce) the general government debt-to-GDP ratio in 2006, following a small increase during 2004-05.

Finally, the program envisages significant continued progress on structural reform. Other than health reform, the program includes progress on plans for shipbuilding, steel, and railways restructuring, as well as privatization. On privatization, the government is considering a plan to cancel part of the debt of 200 enterprises on a case-by-case basis and only in the context of their privatization to improve their balance sheets and make them more attractive privatization candidates. It will also exempt potential investors from a requirement to buy all outstanding shares. A consortium of advisors has been retained to help value the national oil company (INA) with a view to privatizing through a sale of shares 15 percent of this company, and a tender for an advisor to the sale of 49 percent of the telecom company has been launched. Additional ideas and a possible amendment to the Privatization Act are also being considered, all with a view to strengthening privatization (i.e., shortening the time needed for the privatization process, and making the procedures less complicated and more efficient).

Beyond what is included in the program, it is notable that the authorities are also attempting to enhance governance. A plan has already been presented to the Government covering six areas: judiciary, health care, government, economy, education, and politics.

External debt and vulnerability

Reducing vulnerability is one of the key objectives of an extended SBA and is a priority for the authorities. As the staff have noted, a rapid rise in domestic credit together with an uptick in imports could be a cause for concern, and might be contributing to the rise in the external debt ratio. The authorities agree with the program measures that help contain vulnerability, but feel that the appropriate starting point for the analysis is one that recognizes that the degree of vulnerability is already fairly well contained.

The rise in the domestic credit (between 15-20 percent for the corporate and household sector respectively) is relatively large. However, like many countries emerging from transition status, it is not unusual to see a period of rapid credit growth, since the stock of credit was initially sub-optimally small. The financial sector, for its part, is well capitalized and managed, with 90 percent foreign ownership. Nonetheless, the authorities do agree with the idea of taking measures (as in fact the CNB has already done), in order to ensure that the situation remains manageable also in the future.

The external balance, adjusted for statistical revisions, is found to have improved during 2003-05 despite the higher oil prices. A number of vulnerability indicators, especially reserves in months of imports and the reserves-to-short term debt ratio remain healthy. The key variable of course is the total external debt to GDP ratio which, at 84.7 percent of GDP in 2005, is somewhat higher than in 2004. Indeed, given the relatively open capital account, and the higher domestic borrowing rates, it has proved difficult to completely control this variable while loopholes (such as the use of leasing companies) have allowed households and corporate entities to continue to access cheaper foreign capital. The authorities believe that the recent measures taken by the CNB as they are implemented will help stem these inflows, while the lower fiscal deficit and the composition of its financing mean that the government will not itself be directly contributing significantly to the accumulation of higher external debt. In agreement with staff, no recourse to non-price or non-prudential measures is currently deemed necessary. However, the CNB has both the independence and the tools to take further measures as necessary.

The health care sector

As most everyone acknowledges, the health care sector is in need of reform. Not only for fiscal reasons (with large deficits and arrears), but also to improve efficiency in the delivery of services. For a number of reasons, including long term effects from the wars of the 1990s, but also because of the way in which the sector is organized, there are heavy demands on health services and an urgent need to rationalize their provision. The authorities have not shied away from implementing reform, and in fact have been working on reform plans for some time. What has been foremost on their mind, however, is the need to get reform right, as attempting to implement an incomplete or inefficient plan would have negative long term repercussions.

A strong plan has now been prepared and approved by the Council of Ministers, and it is being submitted to parliament (thus fulfilling the program prior action in this area). The plan includes a number of important elements that will help address the financial concerns while also changing the incentives for provision of services and enhancing accountability: co-payments for drugs; supplementary private sector health insurance; better transparency on revenue and expenditure of the health insurance fund; clarified responsibilities between different levels of health care provision; and a financial mechanism for drug rebates to reduce incentives for over-medication. The authorities are confident that this plan will contribute significantly in the problem areas earlier identified.

The pensioners' debt

Dealing with the problem of pensioners' debt, which the authorities inherited from the past, has become an urgent priority. It is not only a legal obligation but also a human obligation to pensioners, many of whom have been living on reduced incomes. Given the large sums involved, the authorities have devised a plan that balances the need to minimize the impact on the macro economy and on the government finances, while also providing options to retirees that are valuable depending on their individual circumstances. The pensioners were given the option of longer term payments, or shorter term payments at a discount relative to net present value. Thus, higher repayments could be accommodated over a longer period of time, reducing their macroeconomic impact, while pensioners with greater need for immediate funds could still choose that option.