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Republic of Croatia: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Croatia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with Republic of Croatia, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 4, 2008, with the officials of Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 4, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of May 9, 2008, updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 9, 2008 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the Republic of Croatia.

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

Financial System Stability Assessment
Selected Issues Paper

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

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REPUBLIC OF CROATIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the
2008 Consultation with the Republic of Croatia

Approved by Poul M. Thomsen and Anthony Boote

April 17, 2008

Discussions for the 2008 Article IV consultation took place in Zagreb from February 21 to March 4, 2008. The staff team comprised Messrs. Feldman (head), Jafarov, and Moore (all EUR), and Mmes. Ilyina (PDR) and Ötker-Robe (MCM). The mission met with Deputy Prime Minister and Minister of Economy Polančec; Finance Minister Šuker; Croatian National Bank (CNB) Governor Rohatinski; other senior officials; and representatives of social partners, think tanks, and the private sector.

Following parliamentary elections in November 2007, the largest party in the government, the center-right Croatian Democratic Union (HDZ), formed a coalition with two smaller parties and seven independents. The coalition holds a small parliamentary majority.

Croatia started accession negotiations with the European Union in 2005. The European Commission has indicated that accession negotiations could be completed in autumn 2009, stressing the importance of further progress with judicial and administrative reforms, fighting corruption, and shipyard restructuring.

Croatia has accepted the obligations of Article VIII (Appendix II) and subscribes to the Fund's Special Data Dissemination Standard. Data are broadly adequate for effective surveillance, though some improvements would be desirable (Appendix III).

The mission held a press conference on the concluding statement (published in Croatian and English). The authorities intend to publish this staff report.

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EXECUTIVE SUMMARY

Background and outlook. Although growth accelerated last year, Croatia has significant vulnerabilities: a large current account deficit and high external debt, alongside balance-sheet exposures to currency risk. Also, surging food and utility prices pushed inflation higher. But Croatia has so far felt limited effects from the global financial turbulence. The real exchange rate appears broadly in line with fundamentals.

Staff's baseline for this year is for growth to slow, but to remain around estimated potential (4–4½ percent); inflation to ease but stay higher than in recent years; and the current account deficit and external debt to remain modestly above their 2007 levels. Downside risks to the baseline predominate. Thus, Croatia is confronted with the important policy challenges of reducing vulnerabilities and ensuring that higher inflation does not become entrenched in expectations, while raising potential growth.

Policies. Staff and the authorities agreed on the benefits of a tightly managed *exchange rate* in light of balance-sheet exposures. But this policy requires strong support from financial, fiscal and structural policies to ensure adequate risk management in banks, restrain demand, and boost export growth and productivity. This, in turn, would lessen external vulnerabilities and raise economic growth on a sustainable basis, and is all the more important when external sustainability could be threatened by a further deterioration in the global environment and repricing of credit risks by foreign lenders. The CNB has introduced additional administrative and prudential measures to limit credit growth and macro-financial vulnerabilities; and nonbank supervision and regulation has continued to improve.

Staff recommends a somewhat more ambitious *fiscal adjustment* path than envisaged by the authorities: saving any revenue overperformance in 2008 and bringing the general government deficit to 1 percent of GDP or less in 2009, also aiming for balance by the end of the government's term. Expenditure reform and restraint are key, as is significant frontloading of fiscal adjustment, with a view to more quickly addressing external vulnerabilities and inflation.

Faster *structural reforms* would raise confidence in successfully concluding EU accession negotiations and thus in economic stability. Once again, the discussions underscored the urgency of improving the business environment and addressing corruption, which have deterred investors and dampened export performance. Reform of the heavily indebted shipyards is urgent.

I. BACKGROUND

1. **Growth accelerated in 2007, but external imbalances continued to increase.** On the back of strong domestic demand, real GDP growth reached 5.6 percent, albeit with some moderation in the second half of the year (Figure 1 and Table 1). Domestic demand pressures were also reflected in the current account deficit, which widened to 8.6 percent of GDP, with higher world energy prices contributing as well (Table 2). External debt reached nearly 88 percent of GDP at end-2007 (Figure 2).

2. **The exchange rate has been stable, but inflation picked up.** Because of financial euroization (Figure 3) and balance-sheet exposures,[1] the Croatian National Bank (CNB) has sought to maintain broad exchange rate stability, intervening periodically in the foreign exchange market (text chart). In 2007, although the volume of intervention declined, the kuna-euro exchange rate fluctuated within an increasingly narrow range.[2] Until very recently, the stable exchange rate helped keep inflation between 2 and 4 percent, aided by moderate wage growth and limited pass-through of rising world oil prices to retail energy prices (Figure 4). Nevertheless, surging food and utility prices pushed year-on-year headline inflation above 6 percent in early 2008, the highest rate since the early 1990s. Year-on-year core inflation reached 5.3 percent in January 2008.

3. **The headline fiscal deficit narrowed significantly in recent years, though a broader measure of fiscal policy shows an expansionary fiscal stance in 2007 as the economy boomed.** The government reduced the general government deficit from 6.1 percent of GDP in 2003 to 3 percent in 2006, and to an estimated 2.3 percent in 2007.[3] Taking into account off-budget and quasi-fiscal activities not included in the general government accounts,[4] a broader measure of the fiscal deficit was little changed in 2006 and 2007 (Table 3). But with growth particularly rapid in 2007, cyclical adjustment implies that the overall fiscal stance was expansionary in that year.

4. **External competitiveness appears adequate**. Despite some gradual real exchange rate appreciation, indicators of price and cost competitiveness vis-à-vis central European peer countries remain benign (Figure 5). Market share of goods exports has been steady. Tourism receipts—which account for almost 40 percent of exports of goods and nonfactor services—

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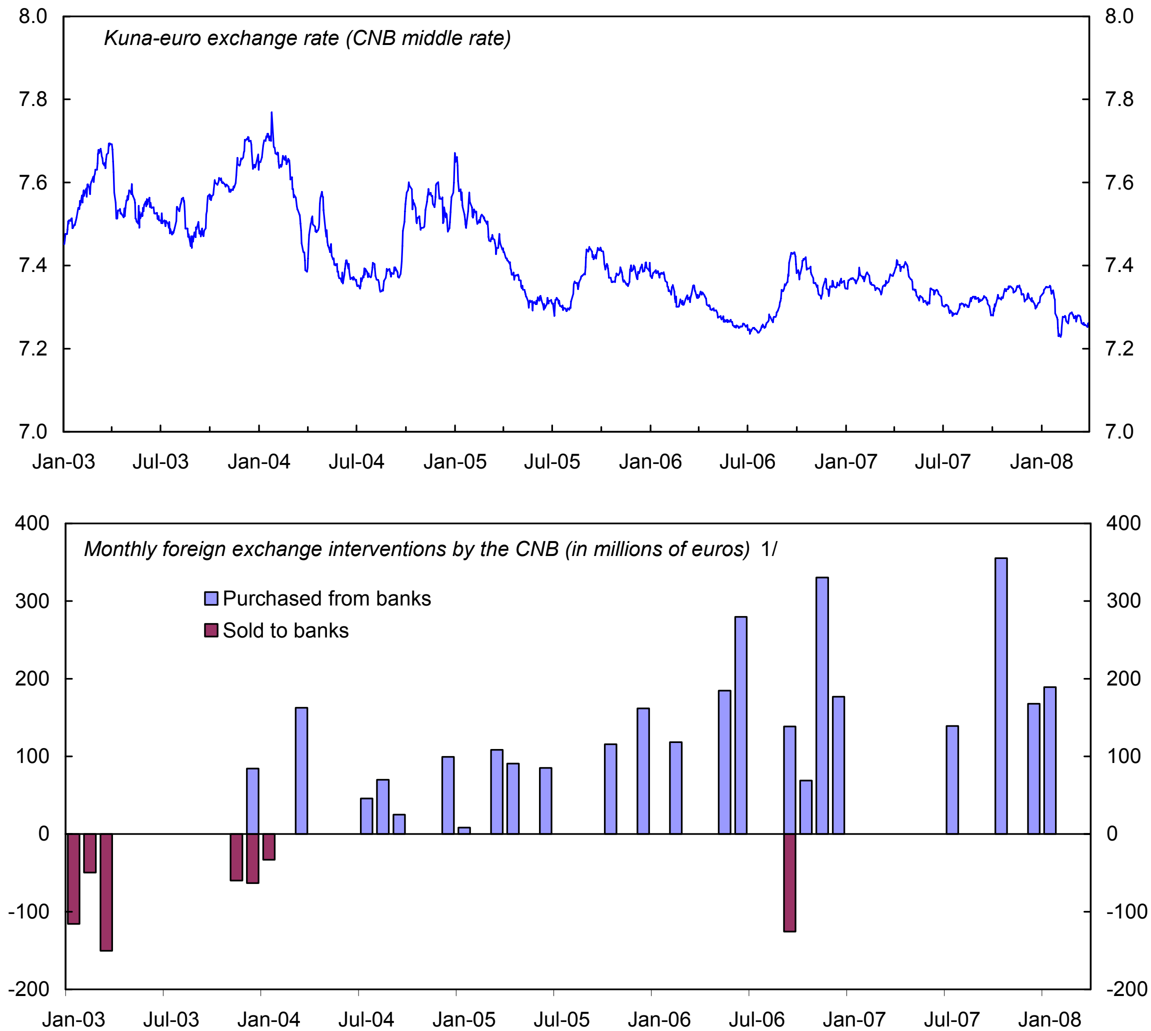
[1] Balance-sheet exposures were analyzed in IMF Country Report No. 07/82.

[2] In February 2008, the CNB announced that it would resist depreciation beyond 7.35 kuna per euro; it would be "concerned" by—but did not commit to resisting—appreciation beyond 7.25 kuna per euro.

[3] On a modified GFS basis, used in the 2004-06 stand-by arrangement.

[4] This includes "pensioners' debt" repayments of 1.2 percent of GDP. IMF Country Report No. 06/128 explains these payments and their treatment in the fiscal accounts.

Croatia: Nominal Exchange Rate and Foreign Exchange Intervention, 2003–08



Source: Croatian National Bank.

1/ Besides direct foreign exchange interventions, the exchange rate may have been influenced by other CNB actions, such as administrative measures (for example, the MRR; see Table 7) and regular (local-currency) reverse repo operations.

have been strong.[5] Staff estimates discussed in the policy issues section below indicate that the real exchange rate is broadly consistent with fundamentals.

5. **The financial sector is healthy, but risks associated with rapid credit growth have been a concern.** Bank credit to the nongovernment sector increased by 23 percent in 2006 (Table 4, Figure 3), taking the stock above 70 percent of GDP and—in contrast to most other countries in the region—above "equilibrium" levels estimated by several studies.[6] As

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[5] See IMF Country Report No. 07/81 for discussion of Croatia's tourism competitiveness indicators.

[6] See ECB Working Paper No. 687 (2006) and IMF Working Paper WP/07/236.

discussed in the accompanying Financial Sector Stability Assessment (FSSA), banks' capital adequacy and asset quality are at sufficiently comfortable levels to withstand a range of shocks (Tables 5 and 6). Though declining, profitability is still high. Nevertheless, significant external imbalances and rising asset prices (and volatility in the case of equities) accompanying credit growth expose banks to sudden shifts in market sentiment. Banks also face significant interest and exchange rate induced credit risks: the majority of their loans is at variable interest rates and linked to foreign currency; and adverse shocks would erode borrowers' debt-servicing capacity in circumstances of high corporate and household debt. The CNB has taken a range of measures, whose aims include curbing banks' borrowing from abroad and domestic credit expansion (Table 7); bank credit subsequently slowed.

6. **While Croatia had not been particularly hurt by the financial turbulence through 2007, cracks have appeared** (Figure 6). In particular, stock prices surged in 2006–07 (increasing by 60 percent annually), taking market capitalization to 130 percent of GDP; but prices slumped by almost 30 percent in the first 3 months of 2008.[7] A widening CDS spread suggests concerns with external vulnerabilities, though not to the same extent as for some other countries.

II. Macroeconomic Outlook and Risks

7. **The outlook for 2008 suggests macroeconomic imbalances will persist.**

- In staff's baseline (Table 8), which assumes the authorities achieve their targets for the general government deficit (discussed below), growth slows this year to within staff's estimate of potential (4–4½ percent).[8] This is in line with the moderation already under way since the second half of 2007, and mainly reflects slower consumption growth, with the bulk of the "pensioners' debt" now repaid and lower consumer confidence in the wake of stock market weakness, and the unwinding of last year's jump in government investment. Nevertheless, inflation, while projected to ease from its current rate, remains higher than in recent years. The current account deficit and external debt stay modestly above their levels in 2007. There was broad agreement on the macroeconomic setting, with only minor differences with the authorities' forecasts.

- Downside risks to the baseline predominate. Inflation could be worse than expected if there are second-round effects from higher food and utility prices—for example, if wage moderation were not maintained. A deeper slowdown in trading partners' growth—for example, if the financial and external risks flagged in the April 2008 WEO were to materialize—would widen the current account deficit and likely cause less favorable external

[7] Real estate price increases averaged 9–10 percent annually in recent years.

[8] See "Economic Growth in Croatia: Potential and Constraints," IMF Country Report No. 07/82, forthcoming in *Financial Theory and Practice*.

debt dynamics. While Croatia has so far felt little impact from the turmoil in global financial markets, the ongoing global repricing of credit risks could eventually push up external costs for Croatian borrowers and result in higher local bank lending rates. The potential for shocks in southeastern Europe represents an additional downside risk.

8. **From a medium-term perspective, the baseline envisages progress toward external stability.** The current account deficit steadily narrows in relation to GDP. The external-debt-to-GDP ratio falls during the government's term.

9. **Tensions from heavy capital inflows, if they were to persist, could strain the macroeconomic framework in an environment combining a number of underlying difficulties.** These include heavy state presence in the economy, lackluster growth in goods exports, and extensive euroization. Tensions could be particularly acute in the absence of continued structural reforms conducive to higher greenfield FDI and other capital flows that would add to productive capacity, especially in the tradables sector.[9]

10. **Two alternative scenarios—one assuming more vigorous structural reforms and the other a worse external environment—illustrate the potential benefits of greater ambition but the risks from policy inaction.** Table 9 illustrates a higher sustainable growth path assuming early resolution of problems in the shipyards and substantial reform of the business environment. Table 10 presents a scenario based on a more severely deteriorating external environment. The resulting weaker export performance, higher current account deficits, and lower-than-baseline FDI imply a continuing buildup of external debt over the projection period—and heightened vulnerabilities to shocks.[10] Slow structural reform implementation and a failure to attract more greenfield FDI would increase the risk of external instability.

III. Policy Issues

11. **In light of the outlook, the discussions focused on measures to jointly attain the goals of reducing vulnerabilities, ensuring that higher inflation does not become entrenched in expectations, and raising potential growth.** Specifically, the discussions centered on the benefits of a significant reduction in the size of government, including by a frontloaded expenditure-led contraction in the general government deficit. They also focused on the critical importance of maintaining and rigorously applying high prudential standards in the financial sector. Finally, the merits of accelerating structural reforms—also to bolster confidence in the prospects for acceding to the EU and thereby confidence in economic stability—were also discussed. To inform the discussions, staff prepared, and gave seminars on, two accompanying selected issues papers on assessing external stability and analyzing

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[9] See IMF Working Paper WP/07/244.

[10] A large depreciation could push external debt well over 120 percent of GDP (Appendix I).

the efficiency of government expenditure. Table 11 summarizes the authorities' responses to past Fund recommendations.

12. **With monetary policy constrained by the tightly managed exchange rate, there was broad agreement that maintaining stability required strong support from financial, fiscal, and structural policies.**

- Because a stable exchange rate tends to reduce perceptions of exchange rate risk and is therefore conducive to unhedged foreign-currency borrowing, strong prudential policies and bank supervision are needed to ensure adequate risk management.

- The tightly managed exchange rate also limits the ability of monetary policy to respond to domestic demand pressures, implying that support from fiscal policy is essential to help contain higher inflation and external imbalances. Fiscal policy could, however, face a trade-off between these objectives if growth were to slow substantially below potential. In such a case, consideration would need to be given to allowing automatic stabilizers to play, taking into account the extent of external imbalances at the time.

- Finally, a gradual narrowing of external imbalances and orderly real convergence with the EU can only be achieved through improvement in the competitiveness of Croatia's economy brought about by wage moderation and structural reforms. There was broad recognition that the impact on competitiveness of any attempt to weaken the exchange rate would likely be offset by higher inflation and adverse balance-sheet effects.

A. Monetary, Exchange Rate, and Financial Sector Policies

13. **The advantages of the CNB's policy of tightly managing the exchange rate were well recognized.** A stable exchange rate has been a key element of Croatia's successes, including by acting as a powerful anchor for inflationary expectations after Croatia's experience with hyperinflation. And given persistently high levels of financial euroization, maintaining broad exchange rate stability has mitigated significant balance sheet risks.

14. **Staff discussed its external stability assessment of Croatia.**[11] Reassuringly, staff calculations using the CGER methodologies, based on the baseline, imply that the real exchange rate is broadly in line with fundamentals (text table). However, all recognized that the risk of instability is accentuated by the high level of external debt-to-GDP ratio and the further widening of the current account deficit.

15. **In view of persistent external imbalances and rising demand, the CNB introduced additional credit measures in 2007.** These measures were taken against a

[11] Details are provided in the accompanying selected issues paper on assessing external stability, which also provides more specifics on staff's assessment of competitiveness and the exchange rate.

Assessing the Real Exchange Rate Using CGER Methodologies
(In percent of GDP, unless otherwise indicated)

	Macroeconomic balance approach		External sustainability approach	
	Norm _CA	Norm _NFA	CA balance stabilizing NFA at its: end-2007 level (-69 percent)	2003–07 average (-60 percent)
Current account norm 1/	-3.8	-4.2	-5.0	-4.3
Underlying current account balance 2/	-4.9	-4.9	-4.9	-4.9
Current account elasticity to REER 3/	-0.39	-0.39	-0.39	-0.39
Implied REER adjustment (in percent, "+" appreciation) 4/	**-2.8**	**-1.8**	**0.1**	**-1.6**

1/ Current account norm corresponds to a CA level that is consistent with a specific set of economic fundamentals; "Norm_CA" and "Norm_NFA" are computed using the panel regression estimates for two model specifications, with lagged current account balance and initial NFA position, respectively. The external sustainability approach assumes the medium/long-run real GDP growth rate of 4.8 percent and inflation rate of 3 percent (in euros). The benchmark NFA position is based on the latest official data, with the exception of the inward FDI position, which is estimated as cumulative FDI flows from 1998 onward. The rest of the data comes from the latest WEO (April, 2008). For more details on the CGER methodologies, see *Methodology for CGER Exchange Rate Assessments (2006).*

2/ Underlying current account balance assumes that both domestic and foreign output gaps are closed and is adjusted for the projected REER movement during 2008–13.

3/ Current account elasticity to REER is computed using the standard long-run real exchange rate elasticities for imports (0.92) and exports (-0.71), as well as the values of Croatia's exports and imports of goods and services (in percent of GDP) over the period of 2003–07.

4/ Given forecast standard errors, an estimated misalignment is considered significant if its magnitude exceeds +/- 10 percent.

background of concerns about a loosening fiscal stance: elections were coming up in the fall and known off-budget fiscal spending was slated to increase (notably because of "pensioners' debt" repayments of 1.2 percent of GDP). In addition, options to curtail rapidly growing credit were judged to be limited. In these circumstances, the CNB introduced credit controls in 2007, while recognizing their potentially negative side effects—including on credit to smaller enterprises and bank competition. The CNB has extended the controls to 2008. The controls have contributed to a significant slowdown in bank credit, as intended by the CNB; available data suggests that total credit growth to the private sector (from external sources and domestic banks and nonbanks) slowed modestly (Figure 3). Arguably, the effects of the controls were more significant from a counterfactual point of view, to the extent that credit growth would have been higher without the controls.

16. **The CNB has taken a number of prudential and supervisory measures to limit macro-financial vulnerabilities.** The prudential measures (listed in Table 7) have contributed to a fall in the share of foreign currency-linked loans since 2006. In addition, banks seem to be more aware of risks related to such lending, have reduced their foreign borrowing, and intensified efforts to attract deposits and capital. There are also recent signs

of a tightening of lending standards, including through increased lending rates and tighter conditions in granting loans.

17. **The CNB has worked to improve communications with banks in Croatia and cooperation with the supervisory authorities of their parent banks abroad.** The recent update of the IMF-World Bank Financial Sector Assessment Program (FSAP) viewed these actions as crucial (Table 12). Interactions with banks (e.g., through workshops and consultations) have contributed to a better understanding of CNB measures, improved their acceptability, and raised risk awareness, thus helping better align the incentives of the financial institutions with those of the CNB. With foreign banks owning more than 90 percent of the banking system, the CNB was actively seeking to upgrade home-host supervisory coordination.

18. **Preparations for Basel II—to become effective in January 2009—appear on track.** According to the FSSA, while the framework for risk-focused supervision is still evolving, the current supervisory techniques and risk management processes do not appear to pose risks for successful implementation of Basel II. In addition, consultations between the CNB and banks have been useful in enhancing preparations for Basel II.

19. **Supervision and regulation of the nonbank financial sector has continued to improve.** The inclusion of previously unregulated leasing companies under the oversight of the nonbank supervisor, HANFA, has helped in closing a channel for circumvention of the credit measures on banks. Coordination efforts have also been stepped up between the CNB and HANFA on information sharing, the intention to jointly inspect banking groups, and the plans to map cross-sector risk exposures and ownership linkages between banks and nonbanks.

20. **The authorities nevertheless recognize the need for vigilance, including by stepping up contingency planning efforts.** It was therefore recognized that further prudential measures may need to be considered to contain any emerging risks, especially from abroad, including contagion risks from global financial turbulence via mature-market European banks (as illustrated by the worst-case stress tests in the FSSA). The CNB also plans to produce a forward-looking financial stability report, expanding the stress testing analyses to a variety of possible shocks, and has initiated formal communications with foreign supervisory authorities concerning contingency planning for possible external shocks. The authorities are also working to clarify the roles of different agencies in bank resolution and deposit insurance.

B. Fiscal Policy

21. **The government envisages a further narrowing of the general government deficit.** Its current plans target a deficit of ½ percent of GDP (on a modified GFS basis) by 2010. The path to this target represents a considerable tightening compared with the plans during the previous Article IV consultation (Table 11).

22. **Staff recognized that the targeted adjustment was significant, but recommended maintaining momentum by aiming for balance by 2011 (the end of the government's term) while significantly frontloading adjustment**. More frontloaded adjustment would have a more immediate impact in dealing with the current challenges of bringing down inflation (and inflation expectations) and reducing external imbalances. More frontloading would also raise the likelihood of meeting the targets for the general government balance, as politics will make reforms increasingly difficult in the latter part of the government's term. Reducing the government's size would also raise the private sector's share of economic activity, thereby enhancing overall productivity and the rate of potential growth.

23. **The discussions focused on achieving an expenditure-led reduction in the fiscal deficit.** Some progress on reform is in train, including discussions on containing health care spending and designing an approach to compiling a database on various social assistance benefits paid. However, the authorities and staff agreed that more needs to be done to develop specific measures. Staff noted the potential for significant budgetary savings with reforms in other areas, including the civil service, education, and state aid (subsidies). Given the significant room for improvement in the efficiency of public spending, a substantial expenditure reduction can be achieved without unduly compromising the delivery of public services.[12]

24. **The discussions also noted some favorable aspects of the 2008 budget.**

- The budget targets a general government deficit of 2.3 percent of GDP, equal to the 2007 preliminary outturn, but lower than the original target of 2.8 percent for the 2007 budget. Taking into account the formation of a coalition government and the associated spending pressures, staff recognized the accomplishment this would represent.

- The government intends to limit government wage increases to 6 percent. Because the government is a very large employer, there was agreement that this could send a helpful signal to keep other wage increases moderate. Revenues are also estimated conservatively, leaving potential room for further deficit reduction.

- A broad measure of the fiscal deficit that takes into account off-budget and quasi-fiscal activities (outside the general government accounts) shows that the overall fiscal stance will considerably tighten in 2008, though this mainly reflects the one-off effects of repaying the bulk of pensioners' debt in the preceding year rather than specific new policy measures.

25. **Reflecting the benefits of frontloading, but with the budget already approved, staff recommended that the authorities take any opportunity available to further**

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[12] This was a key message of the accompanying selected issues paper on the efficiency of government spending. The paper was accepted for presentation in April 2008 at a Zagreb conference (*Welfare Performance and Design*) sponsored by the Croatian Institute of Public Finance.

reduce the 2008 fiscal deficit. This would provide some insurance against downside risks requiring fiscal action. Staff urged the authorities to save any revenue overperformance, while keeping to or below budgeted expenditures, taking advantage of any buffers.

26. **Frontloading also implies that 2009 is the time to undertake the lion's share of fiscal adjustment.** Thus, staff recommended a fiscal deficit in 2009 no larger and preferably smaller than 1 percent of GDP. This is smaller than the authorities' target of a deficit of 1.4 percent of GDP. Any expansion in the deficits of off-budget entities should be offset by general government adjustment. In addition, there was widespread recognition of the benefits of starting preparatory work soon because of the need to take underlying measures in several spending areas. Staff also emphasized that avoiding a ratcheting up of spending when revenues overperform would facilitate adjustment in later years.

27. **Ways to enhance fiscal flexibility and thereby improve the readiness of fiscal policy to respond to unanticipated shocks were an additional point of emphasis.** In this regard, staff recommended a gradual increase in the general contingency reserve and having contingent spending measures at the ready. Staff—working with the authorities—has identified a menu of options for expenditure reduction that would be more than sufficient to achieve the recommended fiscal adjustment. The authorities noted that with about three-quarters of spending already pre-determined (notably on wages, social protection, and health care), budget flexibility was constrained.

C. Structural Issues

28. **Discussions with representatives of the public and private sector continued to underscore the urgency of improving the business environment and addressing corruption.** This includes improvements in the efficiency and transparency of all levels of public administration. There was broad recognition that enhancing Croatia's attractiveness as a destination for "greenfield" foreign direct investment is key to sustainably increasing the growth of total factor productivity (estimated by staff at only 1.3 percent)[13] and thereby Croatia's overall growth potential. In this context, judicial reform was seen as essential, both to underpin the rule of law needed for a better business environment, and as part of the EU accession process. Indeed, while the World Bank's *2008 Doing Business* survey ranks Croatia as the second-top reformer last year in terms of improvements in country scores, Croatia still lags behind most other peer countries on business environment indicators (Figure 7), possibly explaining its comparatively lackluster goods export performance (Figure 5).

29. **The authorities indicated their intention to move forward with privatization.** The government, in previous years, launched IPOs for the oil and telecom companies. While the

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[13] See IMF Country Report No. 07/82.

broader privatization process slowed last year, new management for the privatization fund was recently appointed. The authorities also announced plans to start the sale of two shipyards at end-2008. In addition, the authorities are considering setting up "closed-end" investment funds, consisting of shares in the remaining state-owned enterprises. These fund shares would be sold by public offering, with a view to accelerating privatization.

IV. Staff Appraisal

30. **Croatia has experienced recent successes.** Strong economic growth has generated increasing employment. Policies have improved in recent years: the general government deficit has been significantly reduced and financial supervision has been strengthened. A broadly stable exchange rate has helped anchor inflation expectations and, along with wage moderation, delivered, until recently, low inflation.

31. **But worrying macroeconomic imbalances are present.** Inflation is up and the current account deficit and external debt have continued to increase. Moreover, the outlook for this year suggests that imbalances will persist: inflation, while falling, remains higher than in recent years, and the current account and external debt are modestly above last year's levels.

32. **In these circumstances, there are a number of key goals for policy.** These include reducing external and financial vulnerabilities. In light of Croatia's past experience with hyperinflation, it is also important to ensure that higher inflation does not become entrenched in expectations, not least by avoiding second-round effects from higher food and utility prices. Accelerating structural reforms would support orderly convergence with the EU and lessen external imbalances.

33. **While the monetary policy framework continues to be appropriate for Croatia, support from other policies is essential.** In light of the high degree of euroization, sensitivities to balance-sheet mismatches, adequate external competitiveness, and the strong anchor provided historically, maintaining a stable exchange rate is a sensible policy. But this policy puts considerable onus on fiscal policy to manage demand and address macroeconomic imbalances. Since a stable exchange rate is conducive to unhedged foreign-currency borrowing, strong prudential policies and financial sector supervision are needed to ensure adequate risk management. Wage moderation and faster and deeper structural reforms are the only ways to strengthen competitiveness, helping also to both raise potential growth and narrow the current account deficit.

34. **The authorities' medium-term target for the general government deficit moves fiscal policy in the right direction.** Achieving their target of a ½ percent of GDP deficit by 2010 would represent a significant adjustment. Aiming for fiscal balance by 2011 would maintain momentum and signal the authorities' intention to continue with fiscal consolidation.

35. **Frontloading adjustment would be well advised.** Bringing down inflation and reducing external imbalances are immediate concerns, and greater frontloading would provide more immediate help from fiscal policy. Because politics will increasingly make reforms difficult, especially in the latter part of the government's term, frontloading also raises the likelihood of meeting the recommended 2011 target. Thus, with the 2008 budget already passed, saving any revenue overperformance while keeping at or below budgeted expenditure would be beneficial. The benefits of frontloading also suggest aiming for a more ambitious target than the authorities' 1.4 percent of GDP in 2009. Aiming for 1 percent of GDP or less would have considerable merit. Finally, stronger-than-recommended fiscal adjustment may be needed if external imbalances or inflation were to turn out worse than expected. Thus, the authorities would be well advised to identify contingency measures without delay.

36. **There is ample room to lower the government deficit by spending reform.** This is important because large fiscal adjustments are more successful, durable, and friendly to growth when they rely on reducing current expenditure. Moreover, inefficiencies in public spending suggest that expenditure cuts can be achieved without unduly compromising the delivery of public services. Key areas for reform, some already under active discussion, are health care, education, social security, social assistance and social benefits, subsidies, and civil service employment. But specificity is needed soon to ensure timely adjustment. Near-term wage moderation is also crucial, in light of the importance of avoiding secondary price effects. In addition to keeping government wage growth moderate, state-owned enterprises must follow suit, an intention the government could usefully reiterate. Policies should also seek to ensure the sustainability of the pension system, including by avoiding further backtracking on earlier reforms.

37. **The financial sector is healthy and much progress has been made in strengthening its supervision.** The CNB's increases in required capital cushions and risk weights to limit macro-financial vulnerabilities, improved communications, and efforts to strengthen home-host supervisory coordination are welcome improvements. The continued strengthening in supervision of the nonbank sector is also encouraging. To support Basel II preparations, further dialog between the CNB and banks, through consultative papers on Pillars 2 and 3, would be helpful.

38. **Other challenges lie ahead.** While the impact on Croatia has been limited, continued turbulence in global markets underscores the need to be vigilant in maintaining high prudential standards and closely monitoring banks' risk management and lending practices. Plans to produce a forward-looking financial stability report are welcome. And timely responses from foreign authorities on formal communications concerning contingency planning for possible external shocks would be helpful. That said, stress tests suggest that higher buffers may be needed in certain worst-case, but plausible scenarios. Further prudential measures may also need to be considered to contain any emerging but unforeseen risks. Although the CNB's rationale for introducing credit and other administrative measures

is understandable, they are not sustainable. As also highlighted in the FSSA, they have negative side effects. Thus, transitioning away from administrative measures is another important task ahead, but one that requires careful planning to maintain stability.

39. **Faster structural reforms will be needed for Croatia to realize its goals of sustainably raising living standards and successfully concluding EU accession negotiations.** Absent reforms, Croatia will have difficulty substantially boosting export growth, thereby lessening external vulnerabilities, and raising economic growth on a sustainable basis. Reform of the heavily indebted shipyards is urgent for advancing accession negotiations and containing the substantial drain on the public resources. Difficult decisions to rationalize capacity and employment are inevitable. More generally, privatization needs to be completed, with strategic investors playing an important role to ensure appropriate restructuring and corporate governance. Notwithstanding recent efforts, improving the business environment requires improvements in several areas, including reducing the administrative burden, legal uncertainties, and corruption. This is critical to enhance Croatia's attractiveness as a destination for greenfield foreign direct investment, rightly recognized in the authorities' *Strategic Plan for the Economic Development of Croatia* as key to sustainably increasing total factor productivity and potential growth.

40. It is expected that the next Article IV consultation with Croatia will be on the 12-month cycle.

Table 1. Croatia: Key Macroeconomic Indicators, 2003–08

	2003	2004	2005	2006	2007 Prel.	2008 Proj.
			(Percentage change)			
Output, unemployment, and prices						
Real GDP	5.3	4.3	4.3	4.8	5.6	4.3
Unemployment (labor force survey, in percent)	14.3	13.8	12.7	11.1	9.5	9.0
CPI inflation (average)	1.8	2.0	3.3	3.2	2.9	5.5
			(In percent of GDP)			
Saving and investment						
Domestic investment	31.1	30.6	31.0	32.8	32.7	32.1
Of which: fixed capital formation	28.6	28.1	28.1	29.8	30.0	29.4
Domestic saving	25.0	25.6	24.7	24.9	24.2	23.1
Government	1.8	2.5	2.7	3.3	4.6	3.8
Nongovernment	23.2	23.1	22.0	21.6	19.5	19.2
Government sector 1/						
General government revenue	45.1	44.9	44.5	44.8	46.3	45.2
General government expenditure	51.3	49.7	48.5	47.7	48.6	47.6
General government balance	-6.1	-4.8	-4.0	-3.0	-2.3	-2.3
General government financing requirement 2/	-6.1	-4.8	-4.0	-3.9	-3.5	-2.6
HBOR balance (net of budget transfers)	-0.7	-0.4	-0.1	-0.2	-0.7	-0.8
Cyclically adjusted primary balance, broader coverage 3/	-5.0	-3.2	-1.9	-1.9	-2.5	-1.7
General government debt	40.9	43.3	43.8	41.0	37.9	37.0
			(End of period; change in percent)			
Money and credit						
Bank credit to the nongovernment sector	14.6	14.0	17.4	23.1	15.0	…
Broad money	11.0	8.6	10.5	18.0	18.3	…
			(Period average; in percent)			
Interest rates 4/						
Average kuna deposit rate (unindexed)	1.5	1.9	1.7	1.7	2.3	…
Average kuna credit rate (unindexed)	11.6	11.7	11.2	9.9	9.3	…
Average credit rate, foreign currency-indexed loans	8.0	7.4	6.7	6.3	6.3	…
			(In millions of euros)			
Balance of payments						
Current account balance	-1,600	-1,434	-1,976	-2,692	-3,206	-3,672
(In percent of GDP)	-6.1	-5.0	-6.3	-7.9	-8.6	-9.0
Capital and financial account	3,664	2,527	3,840	4,996	4,865	5,197
Overall balance	1,235	43	822	1,412	721	709
			(End of period; in millions of euros)			
Debt and reserves						
Gross official reserves	6,554	6,436	7,438	8,725	9,307	10,016
In months of following year's imports of goods and NFS	4.9	4.4	4.5	4.8	4.7	4.8
External debt service to exports ratio (in percent)	22.8	24.4	27.2	37.5	37.7	31.2
Total external debt (in percent of GDP)	75.8	80.0	82.4	85.5	87.8	87.9
Net external debt 5/	33.2	37.7	43.1	44.3	46.1	46.1

Sources: Croatian authorities, and Fund staff estimates.

1/ Modified-accrual GFS methodology.
2/ Includes “pensioners’ debt” repayments, equivalent to 1.0 percent of GDP in 2006, 1.2 percent in 2007, and 0.3 percent in 2008.
3/ Includes off-budget and quasi-fiscal activities (outside the general government accounts), in particular repayments of “pensioners’ debt” and the balance of HBOR (net of budget transfers).
4/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.
5/ Net of official reserves and commercial bank foreign assets.

Table 2a. Croatia: Balance of Payments, 2003–13

(In millions of euros, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
Current account	-1,600	-1,434	-1,976	-2,692	-3,206	-3,672	-3,801	-3,776	-3,804	-3,761	-3,818
Merchandise trade balance	-6,971	-6,724	-7,518	-8,344	-9,434	-9,970	-10,483	-10,955	-11,536	-12,119	-12,748
Exports f.o.b.	5,575	6,607	7,220	8,464	9,193	10,250	11,031	12,052	13,166	14,417	15,776
Imports f.o.b.	-12,546	-13,331	-14,738	-16,808	-18,626	-20,220	-21,514	-23,007	-24,702	-26,536	-28,524
Services and income	4,127	4,099	4,358	4,546	5,183	5,235	5,601	6,060	6,572	7,157	7,684
Transportation	252	299	376	425	450	519	567	636	709	794	886
Travel	4,977	4,822	5,395	5,709	6,034	6,550	7,129	7,749	8,445	9,107	9,799
Other services	-296	-353	-453	-423	-164	-435	-552	-553	-561	-563	-565
Compensation of employees	184	234	260	373	494	437	473	515	562	609	659
Interest and investment income	-990	-904	-1,219	-1,538	-1,632	-1,835	-2,016	-2,287	-2,583	-2,789	-3,094
Current transfers	1,245	1,192	1,184	1,106	1,045	1,063	1,081	1,119	1,160	1,202	1,246
Capital and financial account	3,664	2,527	3,840	4,996	4,865	5,197	5,039	5,419	5,888	6,212	6,465
Capital account 1/	102	31	54	-134	34	130	130	130	130	130	130
Financial account 1/	3,562	2,495	3,786	5,130	4,830	5,067	4,909	5,289	5,758	6,082	6,335
Direct investment	1,368	671	1,276	2,561	3,419	2,132	2,205	2,499	2,776	3,051	3,373
Portfolio investment	868	287	-1,178	-547	-35	741	30	28	396	67	42
Medium- and long-term loans	2,322	2,141	1,697	2,717	2,692	2,548	2,612	2,716	2,343	2,715	2,671
Assets	-84	41	-110	-132	3	0	0	0	0	0	0
Liabilities	2,406	2,100	1,806	2,849	2,689	2,548	2,612	2,716	2,343	2,715	2,671
Disbursements	4,628	4,288	4,513	7,578	7,673	7,221	7,544	8,084	9,250	10,150	10,100
Amortization	-2,222	-2,188	-2,706	-4,729	-4,984	-4,673	-4,932	-5,368	-6,907	-7,435	-7,429
Currency and deposits	-1,083	57	1,516	229	-1,681	-549	-140	-154	0	0	0
Short-term capital flows (net)	483	-421	592	189	168	-41	0	0	0	0	0
Trade credits	-395	-243	-120	-22	266	235	202	200	244	248	250
Net errors and omissions 2/	-828	-1,050	-1,043	-891	-938	-816	-879	-950	-1,026	-1,107	-1,195
Overall balance	1,235	43	822	1,412	721	709	359	693	1,059	1,344	1,452
Financing	-1,235	-43	-822	-1,412	-721	-709	-359	-693	-1,059	-1,344	-1,452
Gross reserves (-= increase)	-1,235	-43	-822	-1,412	-722	-709	-359	-693	-1,059	-1,344	-1,452
IMF (net purchases)	0	0	0	0	0	0	0	0	0	0	0
Exceptional financing	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:											
Current account (in percent of GDP)	-6.1	-5.0	-6.3	-7.9	-8.6	-9.0	-8.7	-7.9	-7.4	-6.8	-6.4
Gross official reserves	6,554	6,436	7,438	8,725	9,307	10,016	10,375	11,068	12,127	13,471	14,923
in months of following year's imports of goods and NFS	4.9	4.4	4.5	4.8	4.7	4.8	4.6	4.6	4.7	4.8	4.8
Net foreign assets of the CNB	6,188	6,434	7,436	8,723	9,305	10,014	10,373	11,066	12,124	13,469	14,921
in months of following year's imports of goods and NFS	4.6	4.4	4.5	4.8	4.7	4.8	4.6	4.6	4.7	4.8	4.8
Outstanding debt	19,884	22,933	25,748	29,274	32,929	35,864	38,567	41,357	44,340	47,370	50,333
External debt to GDP ratio	75.8	79.9	82.3	85.5	87.8	87.9	87.8	87.0	86.5	85.6	84.2
External debt in percent of exports of goods and NFS	151.3	161.0	168.6	172.2	179.5	177.0	176.2	173.3	170.3	167.1	163.2
Short-term debt by residual maturity (in percent of GIR)	66.2	92.0	119.8	113.9	103.9	108.4	103.6	116.7	102.1	92.0	83.1
External debt service	-2,990	-3,482	-4,155	-6,370	-6,919	-6,328	-7,701	-7,697	-10,091	-9,619	-9,800
GDP (millions of euros)	26,232	28,681	31,263	34,220	37,496	40,816	43,931	47,513	51,287	55,362	59,760
GDP (millions of kuna)	198,422	214,983	231,349	250,590	275,078	299,435	322,286	348,564	376,254	406,143	438,407

Sources: Croatian National Bank; and Fund staff estimates.

1/ In 2003, excludes debit entry of € 289 million in the item “investment income” in the current account, and an offsetting credit entry in the item “FDI-reinvested earnings” of the capital account, related to the “distribution” and “reinvestment” of paper income from the revaluation of a patent by a Croatian company (see IMF Country Report No. 03/358, Appendix IV).

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

Table 2b. Croatia: Balance of Payments, 2003–13
(In percent of GDP)

	2003	2004	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
Current account	-6.1	-5.0	-6.3	-7.9	-8.6	-9.0	-8.7	-7.9	-7.4	-6.8	-6.4
Merchandise trade balance	-26.6	-23.4	-24.0	-24.4	-25.2	-24.4	-23.9	-23.1	-22.5	-21.9	-21.3
Exports f.o.b.	21.3	23.0	23.1	24.7	24.5	25.1	25.1	25.4	25.7	26.0	26.4
Imports f.o.b.	-47.8	-46.5	-47.1	-49.1	-49.7	-49.5	-49.0	-48.4	-48.2	-47.9	-47.7
Services and income	15.7	14.3	13.9	13.3	13.8	12.8	12.7	12.8	12.8	12.9	12.9
Transportation	1.0	1.0	1.2	1.2	1.2	1.3	1.3	1.3	1.4	1.4	1.5
Travel	19.0	16.8	17.3	16.7	16.1	16.0	16.2	16.3	16.5	16.4	16.4
Other services	-1.1	-1.2	-1.4	-1.2	-0.4	-1.1	-1.3	-1.2	-1.1	-1.0	-0.9
Compensation of employees	0.7	0.8	0.8	1.1	1.3	1.1	1.1	1.1	1.1	1.1	1.1
Interest and investment income	-3.8	-3.2	-3.9	-4.5	-4.4	-4.5	-4.6	-4.8	-5.0	-5.0	-5.2
Current transfers	4.7	4.2	3.8	3.2	2.8	2.6	2.5	2.4	2.3	2.2	2.1
Credit	5.9	5.5	5.2	4.8	4.2	4.0	3.8	3.6	3.5	3.4	3.2
Debit	-1.1	-1.4	-1.4	-1.6	-1.4	-1.4	-1.3	-1.3	-1.2	-1.2	-1.2
Capital and financial account	14.0	8.8	12.3	14.6	13.0	12.7	11.5	11.4	11.5	11.2	10.8
Capital account 1/	0.4	0.1	0.2	-0.4	0.1	0.3	0.3	0.3	0.3	0.2	0.2
Financial account	13.6	8.7	12.1	15.0	12.9	12.4	11.2	11.1	11.2	11.0	10.6
Direct investment 1/	5.2	2.3	4.1	7.5	9.1	5.2	5.0	5.3	5.4	5.5	5.6
Portfolio investment	3.3	1.0	-3.8	-1.6	-0.1	1.8	0.1	0.1	0.8	0.1	0.1
Medium- and long-term loans	8.9	7.5	5.4	7.9	7.2	6.2	5.9	5.7	4.6	4.9	4.5
Assets	-0.3	0.1	-0.4	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	9.2	7.3	5.8	8.3	7.2	6.2	5.9	5.7	4.6	4.9	4.5
Disbursements	17.6	15.0	14.4	22.1	20.5	17.7	17.2	17.0	18.0	18.3	16.9
Amortization	-8.5	-7.6	-8.7	-13.8	-13.3	-11.4	-11.2	-11.3	-13.5	-13.4	-12.4
Currency and deposits	-4.1	0.2	4.9	0.7	-4.5	-1.3	-0.3	-0.3	0.0	0.0	0.0
Short-term capital flows (net)	1.8	-1.5	1.9	0.6	0.4	-0.1	0.0	0.0	0.0	0.0	0.0
Trade credits	-1.5	-0.8	-0.4	-0.1	0.7	0.6	0.5	0.4	0.5	0.4	0.4
Net errors and omissions 2/	-3.2	-3.7	-3.3	-2.6	-2.5	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Overall balance	4.7	0.2	2.6	4.1	1.9	1.7	0.8	1.5	2.1	2.4	2.4
Financing	-4.7	-0.2	-2.6	-4.1	-1.9	-1.7	-0.8	-1.5	-2.1	-2.4	-2.4
Gross reserves (-= increase)	-4.7	-0.2	-2.6	-4.1	-1.9	-1.7	-0.8	-1.5	-2.1	-2.4	-2.4
IMF (net purchases)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Gross external debt	75.8	79.9	82.3	85.5	87.8	87.9	87.8	87.0	86.5	85.6	84.2
Net external debt	33.2	37.7	43.1	44.3	46.1	46.1	46.1	45.3	44.7	43.8	42.5

Sources: Croatian National Bank; and Fund staff estimates.

1/ In 2003, excludes debit entry of 1.1 percent of GDP in the item “investment income” in the current account, and an offsetting credit entry in the item “FDI-reinvested earnings” of the capital account, related to the “distribution” and “reinvestment” of paper income from the revaluation of a patent by a Croatian company (see IMF Country Report No. 03/358, Appendix IV).

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

Table 3. Croatia: Consolidated General Government Finances, 2003–13 1/

(In percent of GDP; modified-accrual based on GFS 1986 unless otherwise indicated)

	2003	2004 2/	2005 2/	2006	2007			2008	2009	2010	2011	2012	2013
					Budget	Revised budget	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue	45.1	44.9	44.5	44.8	44.8	46.0	46.3	45.2	45.1	44.9	44.7	44.2	43.8
Taxes	27.2	26.2	26.2	26.6	26.4	26.6	26.9	26.9	26.8	27.0	27.0	26.7	26.6
Taxes on income, profits, and capital gains	5.8	5.6	5.8	6.4	6.2	6.6	6.9	6.9	6.9	6.8	6.8	6.5	6.2
Payable by individuals	3.6	3.6	3.4	3.5	3.4	3.6	3.6	3.6	3.7	3.7	3.7	3.5	3.3
Payable by corporations and other enterprises	2.2	2.0	2.4	2.9	2.9	3.1	3.3	3.3	3.2	3.1	3.1	3.0	2.9
Taxes on goods and services	20.0	19.3	19.2	19.1	19.1	18.9	18.9	18.8	18.8	19.1	19.1	19.1	19.2
VAT	14.2	13.9	13.9	13.9	14.0	13.9	13.9	13.9	14.0	14.3	14.3	14.2	14.3
Excises	5.3	4.9	4.7	4.6	4.5	4.4	4.4	4.3	4.3	4.3	4.3	4.3	4.4
Taxes on international trade and transactions	0.9	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social security contributions	13.8	13.7	13.5	13.5	13.6	13.5	13.6	13.6	13.6	13.3	13.3	13.1	12.9
Other revenue and grants	4.1	5.0	4.8	4.6	4.8	5.8	5.8	4.8	4.7	4.6	4.4	4.4	4.3
Total expenditure 3/	51.3	49.7	48.5	47.7	47.6	48.6	48.6	47.6	46.4	45.4	44.7	43.7	43.1
Expense (current)	45.2	44.3	43.7	43.2	43.1	43.1	43.4	43.1	42.5	41.7	41.0	40.1	39.5
Compensation of employees	12.4	11.9	11.5	11.3	11.2	11.3	11.4	11.2	11.1	10.9	10.7	10.5	10.3
Use of goods and services	4.8	4.7	4.9	5.5	5.4	5.3	5.5	5.7	5.6	5.5	5.5	5.5	5.5
Interest	2.0	2.1	2.2	2.2	2.1	2.0	2.0	2.1	2.0	2.0	1.9	1.8	1.7
Subsidies	3.2	2.7	2.6	2.6	2.5	2.5	2.7	2.7	2.6	2.3	2.0	1.8	1.5
Grants	0.0	0.5	0.6	0.6	0.8	0.8	0.8	0.9	0.6	0.6	0.9	0.9	0.9
Social benefits	19.2	19.1	18.4	17.9	17.6	17.9	17.7	17.3	17.3	17.3	16.9	16.7	16.9
Other expense	3.6	3.4	3.5	3.2	3.5	3.2	3.4	3.2	3.2	3.1	3.1	2.9	2.7
Acquisition of nonfinancial assets (investment) 4/	5.7	4.9	4.3	4.1	3.9	5.0	4.8	4.1	3.5	3.3	3.3	3.3	3.3
Net lending	0.3	0.5	0.4	0.4	0.5	0.5	0.3	0.3	0.4	0.4	0.3	0.3	0.2
Overall balance	-6.1	-4.8	-4.0	-3.0	-2.8	-2.6	-2.3	-2.3	-1.4	-0.5	0.0	0.4	0.6
Repayment of “pensioners’ debt”	…	…	…	1.0	1.1	1.1	1.2	0.3	0.3	0.2	0.2	0.2	0.0
Financing requirement	-6.1	-4.8	-4.0	-3.9	-3.9	-3.7	-3.5	-2.6	-1.6	-0.7	-0.2	0.2	0.6
Financing	6.1	4.8	4.0	3.9	3.9	3.7	3.5	2.6	1.6	0.7	0.2	-0.2	-0.6
Privatization and disposal of fixed assets	2.1	0.6	0.6	2.6	2.2	2.2	2.3	1.2	0.6	0.4	0.3	0.3	0.1
External financing	2.5	1.8	-1.9	-1.4	-0.8	0.0	0.0	2.0	0.0	-0.1	-0.5	-0.6	-0.6
Disbursements	3.8	4.1	0.7	1.1	1.0	1.7	1.7	3.4	2.5	1.7	1.4	0.1	0.0
Amortization	-1.2	-2.3	-2.6	-2.5	-1.7	-1.7	-1.7	-1.4	-2.4	-1.8	-1.9	-0.7	-0.6
Domestic financing	1.5	2.4	5.3	2.7	2.4	1.5	1.1	-0.5	0.9	0.4	0.4	0.1	-0.1
Memorandum items:													
Primary balance	-4.1	-2.7	-1.8	-0.8	-0.7	-0.6	-0.2	-0.3	0.7	1.5	1.9	2.2	2.3
HBOR balance (net of budget transfers)	-0.7	-0.4	-0.1	-0.2	-0.6	-0.4	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Broader measure of fiscal balance 5/	-6.8	-5.2	-4.1	-4.1	...	...	-4.2	-3.5	-2.5	-1.5	-1.1	-0.6	-0.2
Cyclically adjusted primary balance, broader definition 5/	-5.0	-3.2	-1.9	-1.9	-2.6	-2.4	-2.5	-1.7	-0.6	0.3	0.8	1.2	1.5
General government debt	40.9	43.3	43.8	41.0	...	39.1	37.9	37.0	35.9	34.0	32.0	29.7	27.3
General government guarantees and arrears	11.5	9.6	6.2	6.3	...	...	6.7	6.9	7.0	7.1	7.1	7.1	7.1

Sources: Ministry of Finance; and Fund staff estimates.

1/ Baseline projections are based on the authorities’ achieving their targets for the general government balance in 2008–10 and staff’s recommendation for 2011.

2/ Deficit presented for 2004 includes in “other revenue” HRK 197 million secured in December 2004 from an auction of a GSM licence, but not received in cash until February 2005; this amount is not included in 2005 revenues.

3/ Excluding “pensioners’ debt” repayments; including accumulation of arrears in “use of goods and services.”

4/ The increase in investment in 2007 is mainly due to one-off spending on roads.

5/ Includes repayments of “pensioners’ debt” and the balance of HBOR (net of budget transfers).

Table 4. Croatia: Monetary Accounts, 2004–08

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

	2004	2005	2006	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Feb	2004	2005	2006	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Feb
Monetary Survey									(Change in percent)							
Net Foreign Assets	31,743	23,304	27,614	29,124	31,860	44,982	49,447	44,034	-3.1	-26.6	18.5	124.4	127.7	76.0	79.1	57.7
(In millions of euros)	*4,138*	*3,160*	*3,760*	*3,945*	*4,362*	*6,177*	*6,750*	*6,051*	-3.4	-23.6	19.0	122.6	126.2	78.4	79.5	59.2
Croatian National Bank	49,355	54,844	64,069	70,264	66,956	64,029	68,161	70,409	4.3	11.1	16.8	18.6	5.6	6.7	6.4	0.2
(In millions of euros)	*6,434*	*7,436*	*8,723*	*9,518*	*9,168*	*8,793*	*9,305*	*9,675*	4.0	15.6	17.3	17.7	4.9	8.1	6.7	1.2
Deposit money banks	-17,613	-31,540	-36,455	-41,140	-35,096	-19,047	-18,714	-26,376	21.1	79.1	15.6	-11.0	-29.0	-44.8	-48.7	-37.7
(In millions of euros)	*-2,296*	*-4,276*	*-4,963*	*-5,573*	*-4,806*	*-2,616*	*-2,555*	*-3,624*	20.7	86.3	16.1	-11.7	-29.5	-44.0	-48.5	-37.1
Net Domestic Assets	108,205	131,343	154,844	155,898	162,586	152,726	166,376	165,569	12.6	21.4	17.9	10.9	9.0	1.0	7.4	7.0
Domestic credit (CNB definition) 1/	141,278	168,428	200,329	209,243	215,740	221,614	226,076	226,519	11.8	19.2	18.9	17.2	14.5	14.5	12.9	12.0
Claims on government, net 2/	13,165	18,811	16,510	17,150	15,462	18,155	14,118	13,333	-3.8	42.9	-12.2	-20.3	-33.1	-11.2	-14.5	-13.0
Claims on other domestic sectors 3/	125,521	147,401	181,488	189,680	197,545	200,266	208,688	209,895	14.0	17.4	23.1	22.4	21.2	17.4	15.0	13.7
Other items (net)	-33,073	-37,084	-45,485	-53,345	-53,154	-68,888	-59,701	-60,950	9.3	12.1	22.7	40.4	35.3	62.4	31.3	28.2
Broad Money	139,948	154,647	182,459	185,021	194,446	197,707	215,822	209,603	8.6	10.5	18.0	20.5	19.2	11.9	18.3	14.7
Narrow Money	34,562	38,817	48,521	46,753	51,561	49,909	57,878	51,225	2.0	12.3	25.0	22.4	22.1	13.3	19.3	12.8
Currency outside banks	10,956	12,164	14,609	14,382	16,080	15,612	16,007	15,239	3.6	11.0	20.1	18.9	14.8	8.9	9.6	9.1
Demand deposits	23,606	26,653	33,912	32,371	35,481	34,297	41,871	35,986	1.2	12.9	27.2	24.1	25.7	15.4	23.5	14.4
Quasi Money	105,386	115,830	133,938	138,268	142,885	147,798	157,944	158,378	10.9	9.9	15.6	19.8	18.2	11.4	17.9	15.4
Kuna-denominated	23,643	29,069	45,681	47,569	50,844	48,110	54,854	54,528	24.6	23.0	57.1	44.3	27.6	1.2	20.1	14.3
Foreign currency-denominated	81,743	86,761	88,257	90,700	92,042	99,688	103,090	103,850	7.5	6.1	1.7	10.0	13.6	17.0	16.8	15.9
Balance Sheet of the Croatian National Bank									(Contribution to change in base money)							
Net Foreign Assets	49,355	54,844	64,069	70,264	66,956	64,029	68,161	70,409	5.5	12.3	17.1	20.0	5.7	7.0	6.5	0.3
Of which: Banks' reserves in foreign currency	10,765	13,496	16,577	21,616	18,711	14,547	14,257	15,614	10.9	6.1	5.7	7.8	-1.8	-0.5	-3.7	-8.9
Net International Reserves	38,555	41,334	47,479	48,616	48,219	49,446	53,830	54,754	10.2	6.2	11.4	12.2	7.5	7.4	10.1	9.1
Net Domestic Assets	-4,654	-901	-1,105	-3,015	231	1,503	-1,951	-5,660	1.2	8.4	-0.4	1.9	3.5	7.5	-1.3	-1.9
Of which: Claims on government (net)	-260	-331	-187	-175	-288	-249	-198	-177	3.5	-0.2	0.3	0.0	-0.1	0.0	0.0	0.4
Claims on banks	409	4,216	3,911	2,640	5,670	7,091	4,178	538	-1.5	8.5	-0.6	3.8	5.7	8.0	0.4	-1.0
Of which: open market operations	394	4,201	3,897	2,625	5,283	6,200	2,815	519	…	8.5	-0.6	3.8	5.1	6.5	-1.7	-1.0
Claims on other domestic sectors	83	73	64	64	64	68	68	68	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	-4,886	-4,859	-4,893	-5,543	-5,216	-5,407	-5,999	-6,088	-0.7	0.1	-0.1	-1.8	-2.1	-0.5	-1.8	-1.3
									(Change in percent)							
Base Money	44,702	53,943	62,965	67,249	67,187	65,531	66,210	64,749	19.9	20.7	16.7	22.0	9.3	14.4	5.2	-1.6
Currency	10,956	12,164	14,609	14,382	16,080	15,612	16,007	15,239	3.6	11.0	20.1	18.9	14.8	8.9	9.6	9.1
Deposits	33,746	41,779	48,355	52,867	51,107	49,920	50,202	49,510	26.3	23.8	15.7	22.8	7.7	16.3	3.8	-4.5
Of which: Settlement accounts	6,408	8,411	8,536	7,652	7,723	8,130	7,554	8,321	14.1	31.3	1.5	33.3	24.1	28.7	-11.5	23.0
Statutory reserves in kuna 4/	14,674	17,605	20,478	21,212	21,601	22,256	24,267	22,660	16.4	20.0	16.3	22.2	16.2	14.4	18.5	7.1
Statutory reserves in foreign currency	10,765	13,496	16,577	21,616	18,711	14,547	14,257	15,614	61.0	25.4	22.8	24.9	-5.5	-1.9	-14.0	-27.3
Reserve Money (CNB definition) 5/	33,924	40,391	46,331	45,565	48,416	50,941	51,924	49,095	10.9	19.1	14.7	20.6	16.3	20.2	12.1	10.9
Memorandum items:																
Nominal GDP (yearly total)	214,983	231,349	250,590	256,430	262,992	269,387	275,078									
Narrow money multiplier	0.77	0.72	0.77	0.70	0.77	0.76	0.87									
Broad money multiplier	3.13	2.87	2.90	2.75	2.89	3.02	3.26									
Broad money (in percent of GDP)	65.1	66.8	72.8	72.2	73.9	73.4	78.5									
Foreign currency in percent of broad money	58.4	56.1	48.4	49.0	47.3	50.4	47.8									
Credit to other domestic sectors: stock (in percent of GDP)	58.4	63.7	72.4	74.0	75.1	74.3	75.9									
Credit to other domestic sectors: 12-month flow (in percent of GDP)	7.2	9.5	13.6	13.5	13.1	11.0	9.9									

Sources: Croatian National Bank; and Fund staff estimates.

1/ Comprises net claims on central government, gross claims on local government, and claims on other domestic sectors.

2/ Comprises claims on central government and funds, and local government and funds, net of their deposits in the banking system. Central government funds include the Croatian Bank for Reconstruction and Development (HBOR).

3/ Comprises claims on households, enterprises, other banking institutions (housing savings banks, savings and loan cooperatives, and investment funds), and other financial institutions.

4/ From 2007, includes obligatory CNB bills.

5/ Excludes statutory reserves in foreign currency.

Table 5. Croatia: Financial Soundness Indicators, 2001–07
(Banks, in percent, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007 Q3
Core Set							
Regulatory capital to risk-weighted assets	18.5	17.4	16.5	16.0	15.2	13.6	16.1
Regulatory Tier I capital to risk-weighted assets	16.9	15.2	14.1	13.7	13.5	12.5	15.7
Nonperforming loans net of loan-loss provisions to capital	21.0	19.6	22.6	19.0	16.7	12.4	10.8
Nonperforming loans to total gross loans 1/	13.8	10.2	8.9	7.5	6.2	5.2	4.9
Sectoral distribution of loans to total loans							
Nonfinancial corporations	47.9	45.0	41.0	39.5	38.5	40.0	37.6
Households	42.5	44.5	47.8	49.9	49.7	49.4	49.4
Other sectors	9.6	10.5	11.2	10.6	11.7	10.7	13.0
Return on assets	0.9	1.6	1.6	1.7	1.6	1.5	1.6
Return on equity	6.6	13.7	14.1	16.1	15.1	13.0	11.8
Net interest income to gross income	59.0	56.3	58.9	56.6	57.9	58.3	57.2
Noninterest expenses to gross income	84.4	72.9	72.7	68.0	66.7	67.8	65.9
Liquid assets to total assets 2/	26.8	17.6	18.7	16.1	11.5	12.6	11.1
Liquid assets to short-term liabilities 2/	90.3	57.8	66.8	62.0	42.1	47.0	43.9
Net open position in foreign exchange to capital	...	...	24.7	18.2	7.4	2.6	2.7
Encouraged Set							
Deposit Takers 3/							
Capital to assets	9.2	9.5	8.9	8.6	9.0	10.3	12.0
Large exposures to capital	224.8	151.3	128.4	161.4	122.6	83.7	60.3
Geographical distribution of loans to total loans							
Residents	99.5	99.5	99.6	99.8	99.7	99.5	99.4
Nonresidents	0.5	0.5	0.4	0.2	0.3	0.5	0.6
Gross asset position in derivatives to capital	...	...	...	0.8	0.6	0.9	1.1
Gross liability position in derivatives to capital	...	...	...	1.2	1.0	0.7	0.8
Noninterest income to total income	41.0	43.7	41.1	43.4	42.1	41.7	42.8
Personnel expenses to noninterest expenses	30.5	33.9	32.5	32.7	34.1	33.8	25.2
Spread between domestic lending and deposit rates	6.3	11.0	10.1	9.9	9.5	8.2	7.1
Spread between foreign exchange lending and deposit rates	6.2	5.5	5.0	4.2	3.8	3.3	3.2
Noninterbank loans to noninterbank deposits	63.6	80.9	87.0	92.2	101.1	107.9	112.4
Foreign currency-denominated loans to total loans 4/	78.4	75.8	70.9	76.7	78.5	69.6	60.8
Foreign currency-denominated liabilities to total liabilities 4/	79.1	76.0	76.1	78.1	78.8	77.9	73.8
Net open position in equities to capital	...	...	...	0.3	0.2	0.1	0.1
Other Financial Corporations (OFCs)							
OFCs' assets to total financial system assets	12.5	15.0	16.6	18.6	21.3	23.7	26.3
OFCs' assets to GDP	12.3	16.1	19.5	23.9	29.9	37.0	41.0
Nonfinancial Corporations 5/							
Total debt to equity	45.8	44.5	40.9	45.9	49.3	57.0	...
Return on equity	1.1	3.6	1.8	2.7	4.4	5.1	...
Net foreign exchange exposure to equity	7.3	8.9	10.0	10.9	12.4	13.2	...
Households							
Household debt to GDP	19.0	24.7	28.9	31.8	35.5	40.3	40.3
Household debt service and principal payments to income	3.7	4.6	6.1	6.0	6.1	6.0	...
Real Estate Markets							
Residential real estate loans to total loans	13.9	13.0	15.0	16.8	17.9	19.5	19.8
Other Indicators							
Loan-loss provisions to nonperforming loans	71.4	68.0	60.6	62.3	60.0	61.5	58.9
Change in credit to GDP ratio	8.3	13.5	8.3	6.9	11.3	14.0	10.8
Net interest income to average total assets	3.6	3.3	3.4	3.0	2.9	2.7	2.7
Noninterest expenses to average total assets	5.1	4.2	4.1	3.6	3.3	3.2	3.1
Loans to assets	44.4	53.0	53.9	54.7	58.5	61.6	63.4
Liquid assets to total deposits	38.0	24.6	26.6	23.8	17.4	18.9	17.5
Net claims on government to total assets	18.6	16.8	13.6	9.9	11.6	5.5	5.4
Foreign currency deposits to total deposits	77.4	74.4	73.1	74.2	73.1	64.6	61.3

Source: Croatian National Bank.

1/ Assets include gross loans, interbank loans, investment portfolio of banks, total interest income, total off-balance sheet claims.

2/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper, and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans received. The sharp decline in liquidity in 2005 coincided with the start of reverse repo operations by the CNB that gave banks market-based access to liquidity when needed.

3/ Commercial banks only. End-year FSIs, based on audited annual financial statements, can differ slightly from quarterly data.

4/ Includes kuna-denominated instruments linked to foreign currencies.

5/ Based on unconsolidated audited financial statements following IAS; not in line with the IMF FSI Compilation Guide.

Table 6. Croatia: Indicators of External and Financial Vulnerability, 2003–08
(In percent, unless otherwise indicated)

	2003	2004	2005	2006	2007 Prel.	Latest Value	Latest Date
External indicators							
Real effective exchange rate (using consumer prices) 1/, 2000=100	105.4	107.6	109.7	111.8	112.9	115.6	Dec-07
Exports of goods and services (volumes, percentage change, yoy) 2/	11.4	5.7	4.6	6.9	5.7	2.1	Q4 -07
Imports of goods and services (volumes, percentage change, yoy) 2/	12.1	4.6	3.5	7.3	5.8	6.0	Q4 -07
Current account deficit (millions of euros) 3/	-1,600	-1,434	-1,976	-2,692	-3,206	-3,206	Q4 -07
Current account deficit in percent of GDP 3/	-6.1	-5.0	-6.3	-7.9	-8.6	-8.6	Q4 -07
Capital and financial account in percent of GDP 3/	14.0	8.8	12.3	14.6	13.0	13.0	Q4 -07
Gross official reserves (millions of euros)	6,554	6,436	7,438	8,725	9,307	9,677	Feb-08
Gross official reserves in percent of broad money (M4)	38.9	35.3	35.5	35.1	31.6	33.6	Feb-08
Gross official reserves in percent of reserve money	163.9	145.5	135.8	138.3	131.3	143.4	Feb-08
Gross official reserves in months of current year's imports of goods and NFS	5.2	4.8	5.1	5.3	5.2	5.3	Feb-08
Gross usable international reserves in percent of domestic FX deposits	50.6	47.2	47.7	53.8	52.3	52.8	Feb-08
CNB net international reserves (NIR; millions of euros)	4,546	5,026	5,604	6,464	7,348	7,524	Feb-08
CNB NIR in months of current year's import of goods and NFS	3.6	3.7	3.8	4.0	4.1	4.2	Feb-08
Short-term debt (by residual maturity, in percent of NIR)	95.4	117.8	158.5	148.6	127.7	127.7	Q4 -07
Short-term debt and current account deficit net of FDI (in percent of NIR)	111.5	130.7	160.2	146.0	148.8	148.8	Q4 -07
Total external debt, percent of GDP	75.8	80.0	82.4	85.5	87.8	87.8	Dec-07
External debt service to export ratio 3/	22.8	24.4	27.2	37.5	37.7	37.7	Q4 -07
Financial indicators							
General government debt in percent of GDP	40.9	43.3	43.8	41.0	37.9	37.9	Dec-07
Domestic in percent of GDP	17.8	19.9	24.2	24.4	23.6	23.6	Dec-07
Foreign in percent of GDP	23.1	23.4	19.6	16.6	14.3	14.3	Dec-07
Broad money (M4, percentage change, yoy)	11.0	8.6	10.5	18.0	18.3	14.7	Feb-08
Claims on other domestic sectors (change, yoy)	14.6	14.0	17.4	23.1	15.0	13.7	Feb-08
Short-term interest rate (in percent, e.o.p.)	6.2	4.8	3.0	2.8	6.0	5.2	Feb-08
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,185	1,565	1,998	3,211	5,239	3,797	4/2/08
Zagreb Stock Exchange, capitalization (stocks, percent of GDP)	25	40	50	80	128	113	4/2/08
Bond yield spreads (EMBI Global, e.o.p.)	96	42	36	40	94	125	4/2/08
Debt ratings: Moody's:							
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Apr-08
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	Apr-08
Foreign debt ratings							
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	Apr-08
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	Apr-08
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	Apr-08
Standard and Poor's: Foreign currency LT	BBB-	BBB	BBB	BBB	BBB	BBB	Apr-08
Banking system:							
Regulatory capital to risk-weighted assets	16.5	16.0	15.2	13.6	...	16.1	Q3 -07
Nonperforming loans to total loans	8.9	7.5	6.2	5.2	...	4.9	Q3 -07
Loan-loss provisions to non-performing loans	60.6	62.3	60.0	61.5	...	58.9	Q3 -07
Net open foreign exchange position to capital	24.7	18.2	7.4	2.6	...	2.7	Q3 -07
Foreign currency deposits to total deposits 4/	73.1	74.2	73.1	64.6	...	61.3	Q3 -07
Foreign currency loans to total loans 4/	70.9	76.7	78.5	69.6	...	60.8	Q3 -07

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

1/ An increase in the index reflects an appreciation; annual averages through 2007.
2/ National accounts concept.
3/ Sum of four quarters to the latest observation.
4/ Including foreign currency-linked deposits and loans.

Table 7. The CNB's Measures 1/

Prudential and supervisory

- Higher reserve requirements for general banking risks for banks with asset growth above specific thresholds;
- Introduction of capital charges for market risks;
- Increased risk weights on unhedged foreign-currency loans;
- Issuance of guidelines for banks for managing risks related to FX and household loans;
- Intensified cross-border supervisory coordination;
- Intoduction of link between minimum required capital and loan growth.

Administrative

- Marginal reserve requirement (MRR) on banks' new foreign borrowing: introduced in mid-2004 at a rate of 24 percent, subsequently increased in steps to 55 percent; loopholes in the base closed. A 55 percent special reserve requirement also applies to banks' bond issuance (to close a loophole in the MRR).
- Reintroduction of credit controls, effective at the start of 2007; previously used in 2003.

  In 2007, banks were required to purchase low-yielding CNB bills for 50 percent of the amount by which their credit growth exceeded the CNB ceiling, which is consistent with 12 percent credit growth for the full year.

  The CNB modified the current controls several times to close loopholes, and, in December 2007, confirmed the retention of the controls in 2008. In 2008, 1 percent monthly sublimits apply and other conditions were tightened: the purchase requirement for excess credit growth was increased to 75 percent; and the CNB bill yield was cut to 0.25 percent.
- Foreign-currency liquid asset requirement, also known as the "32 percent rule."

  The CNB broadened its base in late 2006 to include indexed instruments.
- Banks are also subject to a high general reserve requirement (17 percent).

Source: adapted from the accompanying FSSA Update.

1/ Outside the CNB's remit, other relevant measures in 2006–07 include the launch of the credit registry; and the Leasing Act, which prohibits non-leasing credits by leasing companies.

Table 8. Croatia: Staff Medium-Term Baseline Scenario, 2003–13

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector					(Percentage changes)						
Real GDP 1/	5.3	4.3	4.3	4.8	5.6	4.3	4.0	4.8	4.8	4.8	4.8
Consumption, total	3.7	3.5	2.8	3.1	5.5	4.5	3.9	4.0	4.4	4.2	4.3
Of which: private	4.6	4.8	3.4	3.5	6.2	4.7	4.3	4.5	4.5	4.5	4.5
Gross fixed capital formation, total	24.7	5.0	4.9	10.9	6.5	1.9	1.8	4.3	4.5	4.5	4.5
Of which: private	24.0	8.1	8.0	14.4	3.5	4.4	4.2	5.0	4.5	4.5	4.5
General government finances 2/					(In percent of GDP)						
Revenue	45.1	44.9	44.5	44.8	46.3	45.2	45.1	44.9	44.7	44.2	43.8
Expenditure 3/	51.3	49.7	48.5	47.7	48.6	47.6	46.4	45.4	44.7	43.7	43.1
Balance 3/	-6.1	-4.8	-4.0	-3.0	-2.3	-2.3	-1.4	-0.5	0.0	0.4	0.6
Privatization receipts 4/	2.1	0.6	0.6	1.6	1.1	0.8	0.4	0.2	0.1	0.1	0.1
Domestic financing	1.5	2.4	5.3	3.7	2.3	-0.2	1.2	0.6	0.6	0.3	-0.1
Foreign financing	2.5	1.8	-1.9	-1.4	0.0	2.0	0.0	-0.1	-0.5	-0.6	-0.6
Debt	40.9	43.3	43.8	41.0	37.9	37.0	35.9	34.0	32.0	29.7	27.3
Balance of payments					(In percent of GDP)						
Current account balance	-6.1	-5.0	-6.3	-7.9	-8.6	-9.0	-8.7	-7.9	-7.4	-6.8	-6.4
Exports f.o.b.	21.3	23.0	23.1	24.7	24.5	25.1	25.1	25.4	25.7	26.0	26.4
Imports f.o.b.	-47.8	-46.5	-47.1	-49.1	-49.7	-49.5	-49.0	-48.4	-48.2	-47.9	-47.7
Merchandise trade balance	-26.6	-23.4	-24.0	-24.4	-25.2	-24.4	-23.9	-23.1	-22.5	-21.9	-21.3
Services and income, net	15.7	14.3	13.9	13.3	13.8	12.8	12.7	12.8	12.8	12.9	12.9
Of which: travel receipts (credits)	21.2	19.2	19.2	18.4	18.0	18.0	18.1	18.2	18.4	18.4	18.3
Capital and financial account	14.0	8.8	12.3	14.6	13.0	12.7	11.5	11.4	11.5	11.2	10.8
Of which: FDI	5.2	2.3	4.1	7.5	9.1	5.2	5.0	5.3	5.4	5.5	5.6
Gross external debt	75.8	80.0	82.4	85.5	87.8	87.9	87.8	87.0	86.5	85.6	84.2
Net external debt	33.2	37.7	43.1	44.3	46.1	46.1	46.1	45.3	44.7	43.8	42.5
Nominal GDP (in millions of kuna)	198,422	214,983	231,349	250,590	275,078	299,435	322,286	348,564	376,254	406,143	438,407
Nominal GDP (in millions of euros)	26,232	28,681	31,263	34,220	37,496	40,816	43,931	47,513	51,287	55,362	59,760

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

1/ Assumes an increase in total factor productivity and potential growth as EU accession approaches.
2/ Modified accrual basis based on GFS 1986 methodology.
3/ Excludes repayments of “pensioners’ debt.”
4/ Excludes privatization receipts used to repay “pensioners’ debt.”

Table 9. Croatia: Staff Medium-Term Alternative (Reform) Scenario, 2003–13 1/

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector					(Percentage changes)						
Real GDP 1/	5.3	4.3	4.3	4.8	5.6	4.3	4.8	6.3	6.5	7.0	7.0
Consumption, total	3.7	3.5	2.8	3.1	5.5	4.5	4.4	5.2	5.8	5.9	6.2
Of which: private	4.6	4.8	3.4	3.5	6.2	4.7	4.9	6.0	6.3	6.5	6.7
Gross fixed capital formation, total	24.7	5.0	4.9	10.9	6.5	1.9	2.5	5.4	6.9	7.8	7.8
Of which: private	24.0	8.1	8.0	14.4	3.5	4.4	5.0	6.3	7.0	8.0	8.0
General government finances 2/					(In percent of GDP)						
Revenue	45.1	44.9	44.5	44.8	46.3	45.2	45.2	45.2	45.1	44.6	44.3
Expenditure 3/	51.3	49.7	48.5	47.7	48.6	47.6	46.4	45.4	44.8	43.7	42.8
Balance 3/	-6.1	-4.8	-4.0	-3.0	-2.3	-2.3	-1.2	-0.2	0.3	0.9	1.4
Privatization receipts 4/	2.1	0.6	0.6	1.6	1.1	0.8	0.4	0.2	0.1	0.1	0.1
Domestic financing	1.5	2.4	5.3	3.7	2.3	-0.2	1.0	0.3	0.2	-0.2	-0.9
Foreign financing	2.5	1.8	-1.9	-1.4	0.0	2.0	0.0	-0.1	-0.5	-0.6	-0.5
Debt	40.9	43.3	43.8	41.0	37.9	37.0	35.4	32.8	30.0	26.7	23.3
Balance of payments					(In percent of GDP)						
Current account balance	-6.1	-4.9	-6.2	-7.9	-8.6	-9.0	-8.9	-8.4	-7.5	-6.9	-6.4
Exports f.o.b.	21.3	23.0	23.1	24.7	24.5	25.1	25.1	25.4	26.0	26.5	26.8
Imports f.o.b.	-47.8	-46.5	-47.1	-49.1	-49.7	-49.5	-48.9	-48.3	-48.1	-48.0	-48.0
Merchandise trade balance	-26.6	-23.4	-24.0	-24.4	-25.2	-24.4	-23.8	-22.9	-22.2	-21.5	-21.1
Services and income, net	15.7	14.3	13.9	13.3	13.8	12.8	12.5	12.2	12.6	12.6	12.8
Of which: travel receipts (credits)	21.2	19.2	19.2	18.4	18.5	18.0	18.3	18.4	18.8	18.9	19.1
Capital and financial account	14.0	8.8	12.3	14.6	13.0	12.7	12.6	12.7	11.7	11.6	11.2
Of which: FDI	5.2	2.3	4.1	7.5	9.1	5.2	5.3	5.9	6.1	6.5	6.7
Gross external debt	75.8	80.0	82.4	85.5	87.8	87.9	87.9	86.8	84.5	81.6	78.4
Net external debt	33.2	37.7	43.1	44.3	46.1	46.1	46.1	45.1	42.7	39.8	36.6
Nominal GDP (in millions of kuna)	198,422	214,983	231,349	250,590	275,078	299,435	324,843	356,190	390,723	430,616	474,582
Nominal GDP (in millions of euros)	26,232	28,681	31,263	34,220	37,496	40,816	44,280	48,553	53,260	58,698	64,691

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

1/ Assumes substantial reform of the business environment that resolves land ownership uncertainties, reduces corruption and the regulatory burden, and transparently completes privatization. This results in higher greenfield FDI inflows and faster growth in total factor productivity (about double the baseline pace) from 2009. Increased competitiveness is reflected in both higher goods exports and in higher tourism investment and receipts.

2/ Modified accrual basis based on GFS 1986 methodology.

3/ Excludes repayments of “pensioners’ debt.”

4/ Excludes privatization receipts used to repay “pensioners’ debt.”

Table 10. Croatia: Staff Medium-Term Alternative (Worse External Environment) Scenario, 2003–13 1/

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector					(Percentage changes)						
Real GDP 1/	5.3	4.3	4.3	4.8	5.6	4.0	3.5	4.3	4.3	4.3	4.3
Consumption, total	3.7	3.5	2.8	3.1	5.7	4.3	3.8	3.8	4.2	4.0	4.1
Of which: private	4.6	4.8	3.4	3.5	6.2	4.6	4.2	4.3	4.3	4.3	4.3
Gross fixed capital formation, total	24.7	5.0	4.9	10.9	6.5	1.8	1.7	4.1	4.3	4.3	4.3
Of which: private	24.0	8.1	8.0	14.4	3.5	4.2	4.1	4.8	4.3	4.3	4.3
General government finances 2/					(In percent of GDP)						
Revenue	45.1	44.9	44.5	44.8	46.3	45.2	45.1	45.1	44.9	44.5	44.2
Expenditure 3/	51.3	49.7	48.5	47.7	48.6	47.6	46.7	45.9	45.4	44.7	44.3
Balance 3/	-6.1	-4.8	-4.0	-3.0	-2.3	-2.4	-1.5	-0.8	-0.4	-0.1	0.0
Privatization receipts 4/	2.1	0.6	0.6	1.6	1.1	0.8	0.3	0.2	0.1	0.1	0.1
Domestic financing	1.5	2.4	5.3	3.7	2.3	0.0	1.4	0.9	1.1	0.9	0.6
Foreign financing	2.5	1.8	-1.9	-1.4	0.0	2.0	0.0	-0.1	-0.5	-0.6	-0.6
Debt	40.9	43.3	43.8	41.0	37.9	37.3	36.5	35.0	33.5	31.8	30.1
Balance of payments					(In percent of GDP)						
Current account balance	-6.1	-5.0	-6.3	-7.9	-8.6	-9.2	-9.1	-8.8	-8.5	-8.1	-7.8
Exports f.o.b.	21.3	23.0	23.1	24.7	24.5	25.0	24.9	25.0	25.3	25.6	26.0
Imports f.o.b.	-47.8	-46.5	-47.1	-49.1	-49.7	-49.6	-49.1	-48.6	-48.4	-48.2	-48.0
Merchandise trade balance	-26.6	-23.4	-24.0	-24.4	-25.2	-24.6	-24.3	-23.5	-23.1	-22.5	-22.0
Services and income, net	15.7	14.3	13.9	13.3	13.8	12.8	12.6	12.4	12.2	12.1	12.1
Of which: travel receipts (credits)	21.2	19.2	19.2	18.4	18.5	17.8	18.0	18.0	18.1	18.1	18.1
Capital and financial account	14.0	8.8	12.3	14.6	13.0	12.7	11.0	11.3	11.5	11.5	11.5
Of which: FDI	5.2	2.3	4.1	7.5	9.1	4.7	4.3	4.4	4.4	4.4	4.4
Gross external debt	75.8	80.0	82.4	85.5	87.8	88.5	88.9	89.3	89.9	90.6	91.1
Net external debt	33.2	37.7	43.1	44.3	46.1	46.8	47.2	47.5	48.2	48.8	49.4
Nominal GDP (in millions of kuna)	198,422	214,983	231,349	250,590	275,078	298,683	320,041	344,485	370,076	397,569	427,105
Nominal GDP (in millions of euros)	26,232	28,681	31,263	34,220	37,496	40,714	43,625	46,957	50,445	54,193	58,219

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

1/ Assumes a less favorable external environment (lower-than-baseline import demand for Croatia's goods and services and higher external borrowing costs). This results in real GDP growth and new FDI inflows modestly lower than in the baseline, wider-than-baseline current account deficits, and a continuing increase in the external debt-to-GDP ratio through the projection period.

2/ Modified accrual basis based on GFS 1986 methodology.

3/ Excludes repayments of “pensioners’ debt.”

4/ Excludes privatization receipts used to repay “pensioners’ debt.”

Table 11. Croatia: Past Fund Policy Recommendations and Implementation

Policy area	**Directors' recommendations (2006 Article IV consultation)**	**Implementation**
Fiscal policy	More ambitious fiscal consolidation than envisaged in the authorities' (2006) medium-term plans.	Significant tightening of medium-term fiscal targets in the July 2007 revision of the *Economic and Fiscal Policy Guidelines*.
	Resist spending pressures in the run-up to elections in late 2007, and ensure a fiscal deficit in 2007 no larger than the budget target.	With revenues overperforming in mid-2007, a supplementary budget provided for higher spending but a lower deficit. The general government deficit outcome (2.3 percent of GDP) was significantly below the original budget target (3.0 percent). Taking into account off-budget and quasi-fiscal activities, cyclical adjustment implies that the overall fiscal stance was expansionary in 2007.
Central bank policies	Support for the tightly managed exchange rate, but emphasized the importance of supporting policies (fiscal, structural, financial).	The CNB continues to tightly manage the exchange rate.
	Reservations about the reintroduction of credit controls, whose impact and side effects would need close monitoring, while sharing concerns about the prudential and macroeconomic risks of ongoing rapid credit growth.	The CNB closed loopholes in the credit controls in 2007 and maintained the controls in 2008.
	Consider tighter prudential measures that would raise credit quality and reduce vulnerabilities.	Other prudential and supervisory measures recently implemented, including a further increase in risk weights on unhedged foreign-currency loans, and the introduction of a link between minimum required capital and loan growth (see Table 7).
Structural policies	Significantly improve the business environment: reduce the administrative burden, legal uncertainties, and corruption.	Some progress (see para. 28), but Croatia still lags most peer countries on business environment indicators.
	Restructure the loss-making shipyards, reform the remaining public enterprises, and remove impediments to privatization.	Shipyard reform was delayed through 2007. In March 2008, the authorities announced plans to start the sale of two shipyards at end-2008.
		Mixed progress on privatization. A new head of the privatization fund was appointed in February 2008.

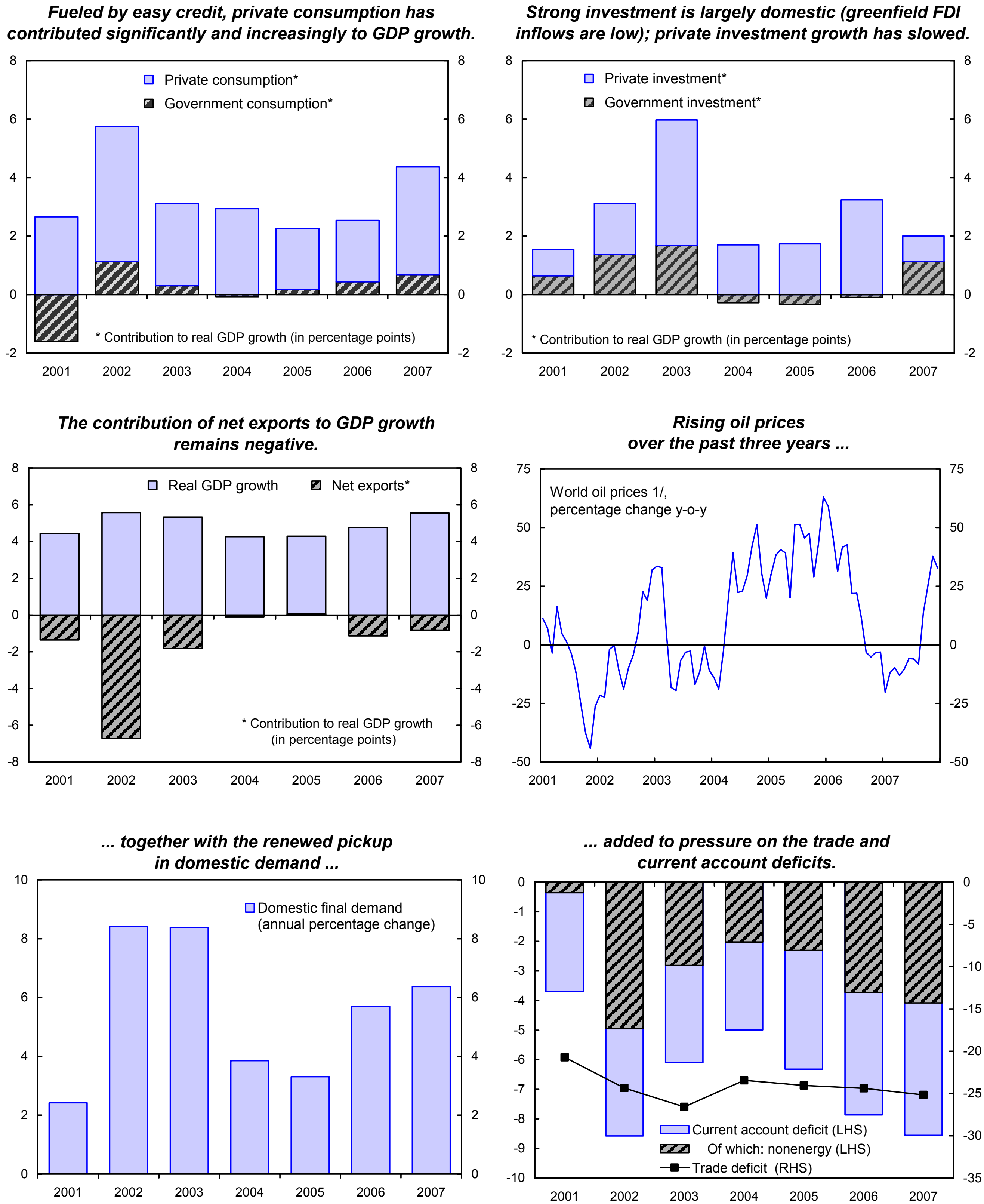
Table 12. Croatia: Key Recommendations of the FSAP Update

MEASURES	TIMING	PRIORITY	STATUS
Financial sector stability			
• Carefully plan the transition away from administrative measures, with the objective of eliminating negative side effects while maintaining financial stability*	ST	High	Pending; discussions ongoing
• Continue to monitor closely and frequently banks' risk management practices and lending standards and take appropriate measures to address emerging risks	ST	High	Ongoing
• Strengthen stress testing analyses and regularly use in monitoring risks and assessing financial stability*	ST	High/Med	Ongoing
• Reduce incentives that stimulate particular types of bank loans	MT	High	Pending
• Continue efforts to raise risk awareness of banks, borrowers, and stock market investors	MT	High	Ongoing
• Expand the coverage of the credit registry to include non-banking institutions	MT	High/Med	Pending
Contingency planning			
• Establish formal communications with monetary and supervisory authorities of the parent banks on issues of crisis management	ST	High	Initiated; waiting for response
• Adopt the law on deposit insurance consistent with the EU framework and design of an effective bank resolution mechanism, with clarity as to the legal framework and roles and responsibilities of all the parties involved in bank resolution and restructuring process*	MT	High/Med	Ongoing; discussions took place to clarify the roles
Liquidity and risk management			
• Broaden the range of eligible collateral for interbank securitized lending to help reduce segmentation in the interbank money market*	MT	High	Pending
• Develop hedging markets/instruments to facilitate management of interest and FX risks*	MT	High	Pending
Nonbank financial sector and cross-sector risks			
• Build comprehensive data and monitoring processes (investor composition, trading trends and composition, automated early warning system for suspicious trades, including through OMX), and map ownership structures of conglomerates, and clarify the roles for their supervision*	ST	High/Med	Initiated, efforts ongoing
• Improve regulatory capacity to monitor and enforce financial accounting standards and market disclosure	ST	Medium	Pending
• Increase pension funds' permissible investments in foreign securities	MT	Medium	Pending
• Pursue plans to increase the level of contribution and further privatize the pension fund system	MT	Medium	Pending
• Enhance supervisory capacity to migrate to Solvency II risk based standards for insurance companies	MT	Medium	Pending

Source: accompanying FSSA Update.

* Possible areas for technical cooperation.

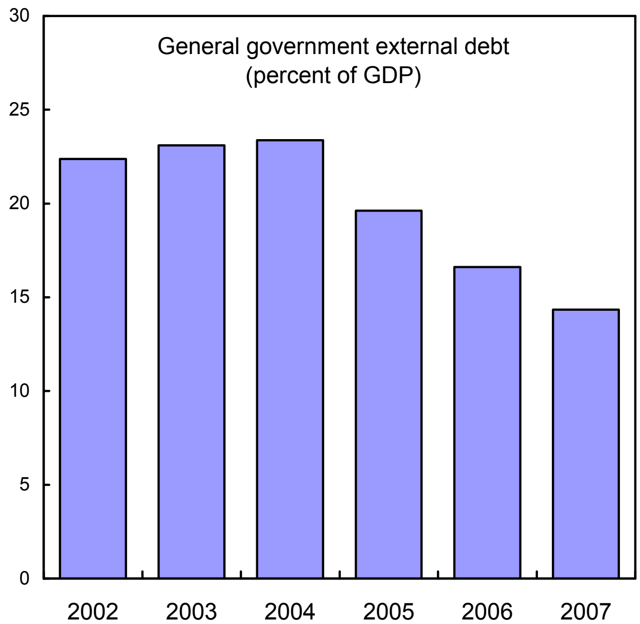
Figure 1. Croatia: Macroeconomic Developments, 2001–07
(In percent of GDP, unless specified otherwise)



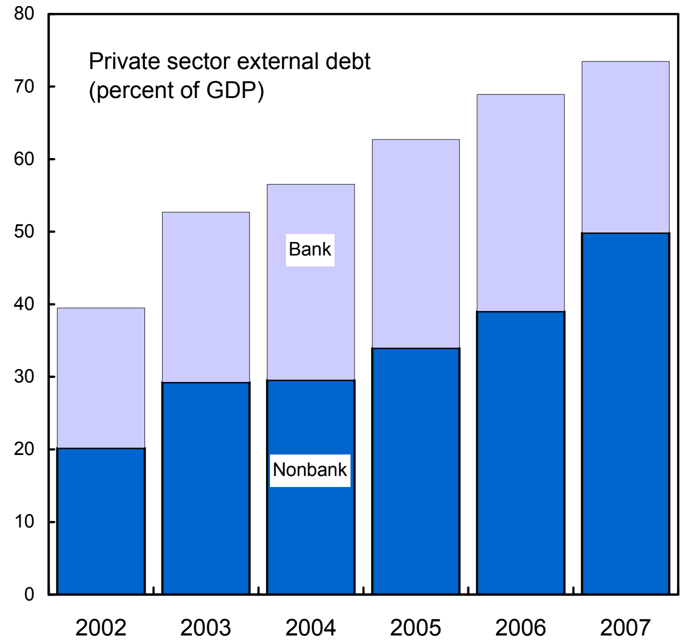
Sources: Croatian authorities; and Fund staff calculations.
1/ Based on oil prices in euros, converted from the simple average of three spot prices (Dated Brent, West Texas Intermediate, and the Dubai Fateh, US$ per barrel).

Figure 2. Croatia: External Debt, 2002–07

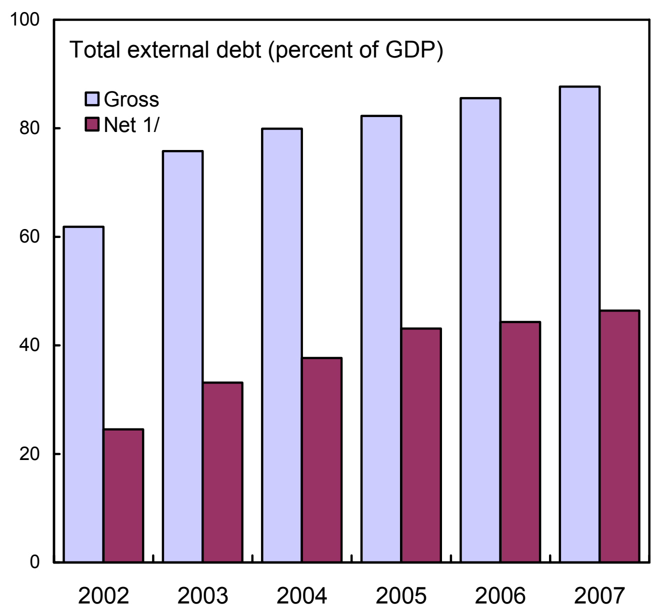
Government foreign borrowing declined ...



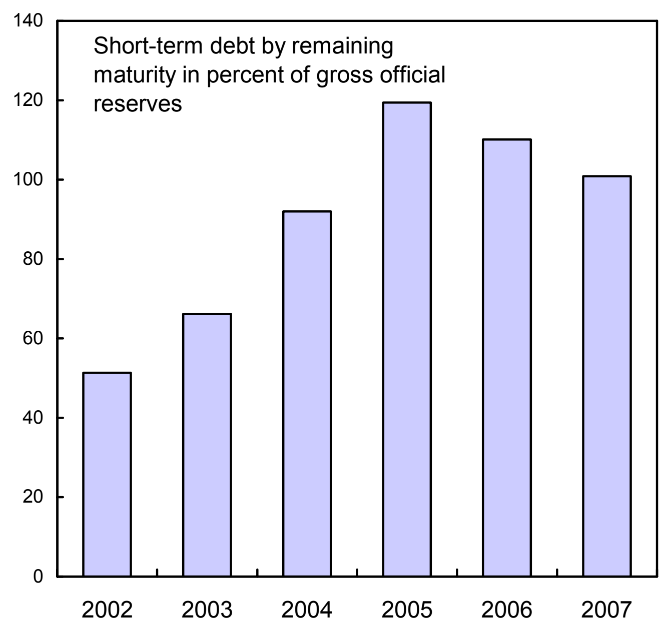
... but private sector foreign borrowing rose sharply.



Though the pace of accumulation has slowed, total external debt is high and still increasing.



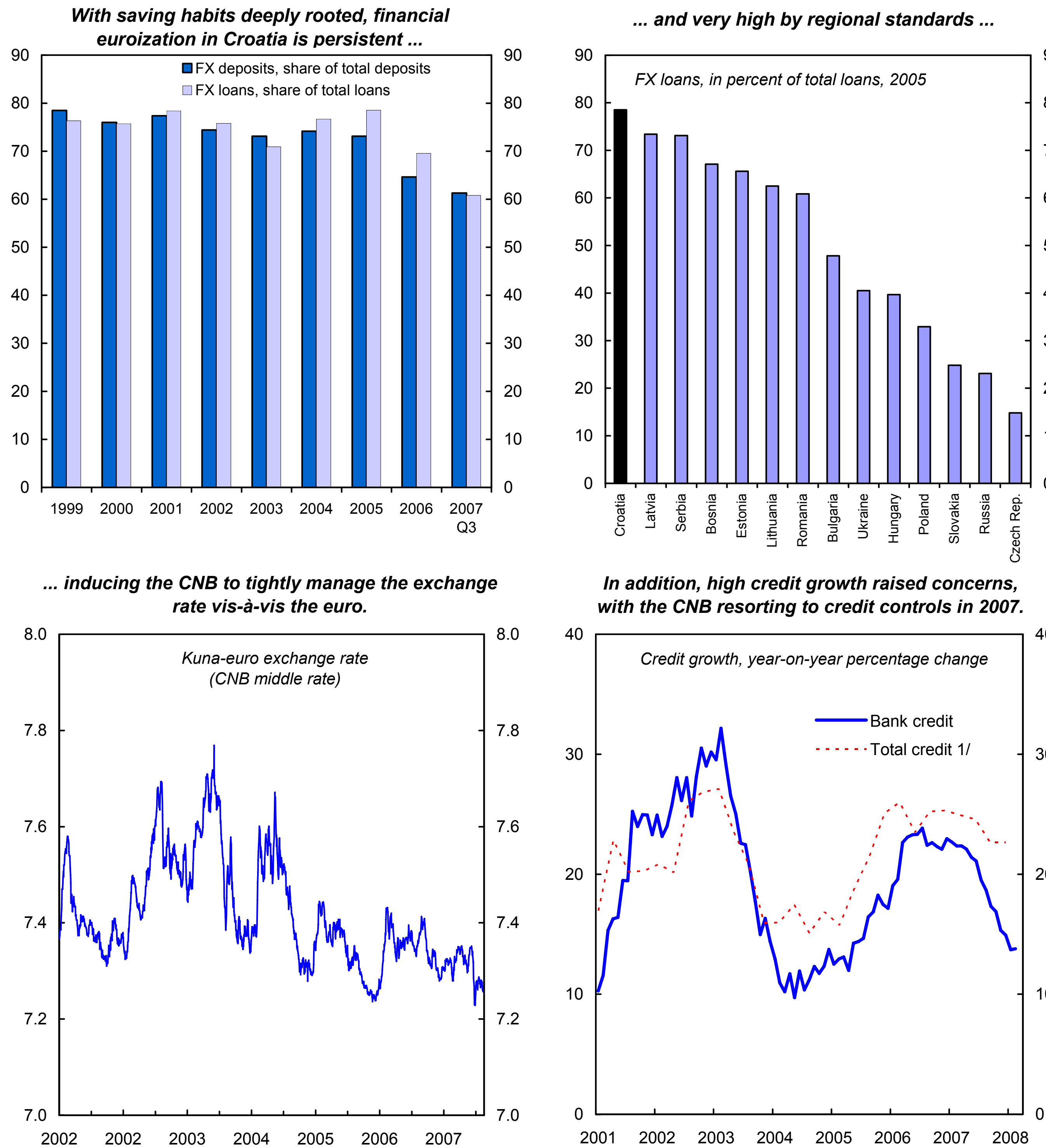
The proportion of short-term debt (an indicator of rollover risk) is high, boosted by local bank borrowing from foreign parents.



Sources: Croatian National Bank; and Fund staff calculations.

1/ Measured net debt equals gross debt less official reserves and commercial banks foreign assets. It may overestimate "true" net debt as there is evidence of unrecorded private sector foreign asset accumulation, described in Box 1 of IMF Country Report No. 06/346.

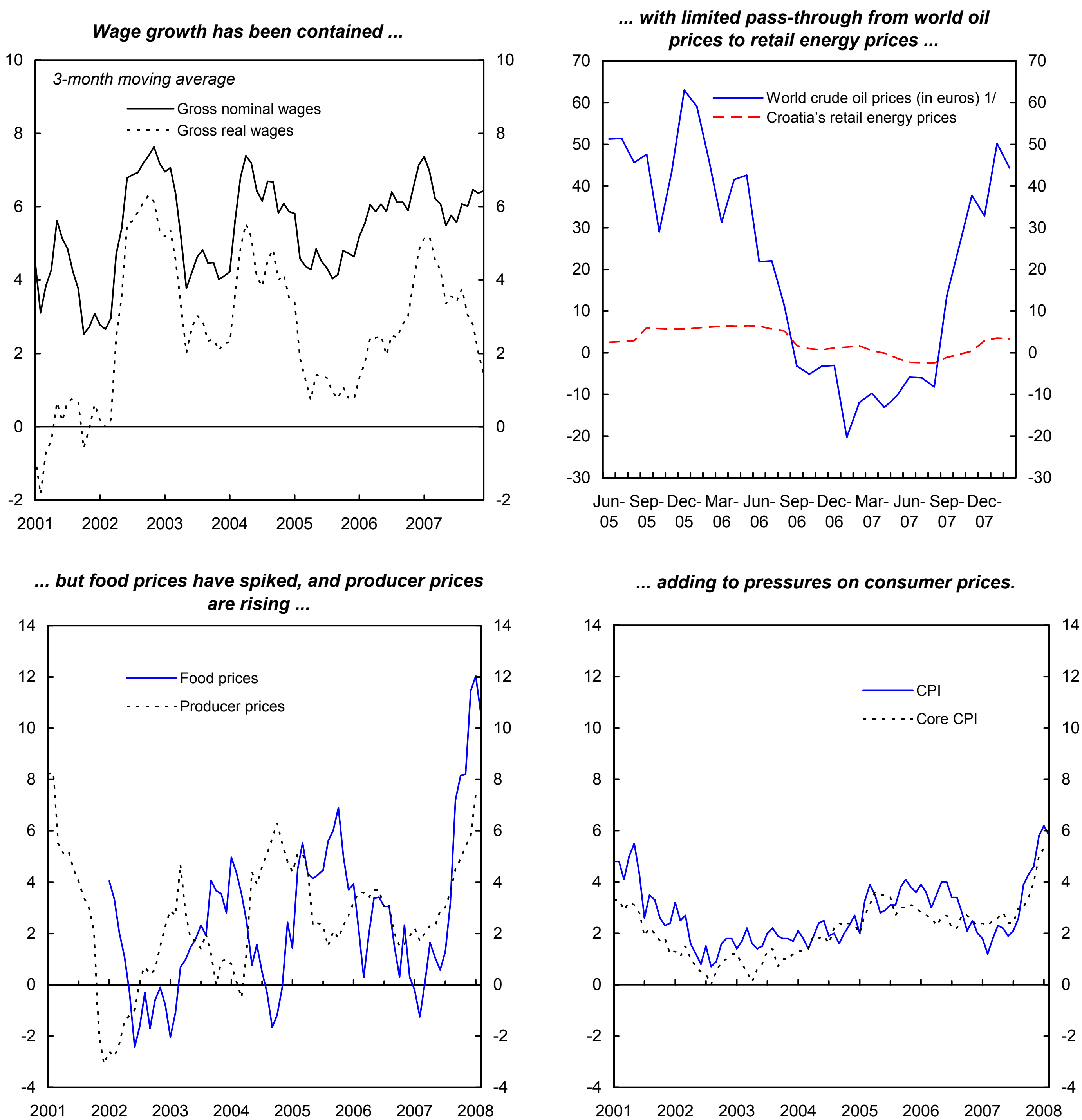
Figure 3. Croatia: Euroization and Credit Growth, 1999–2008



Sources: Croatian National Bank; the accompanying Financial Sector Stability Assessment Update; and Fund staff calculations.

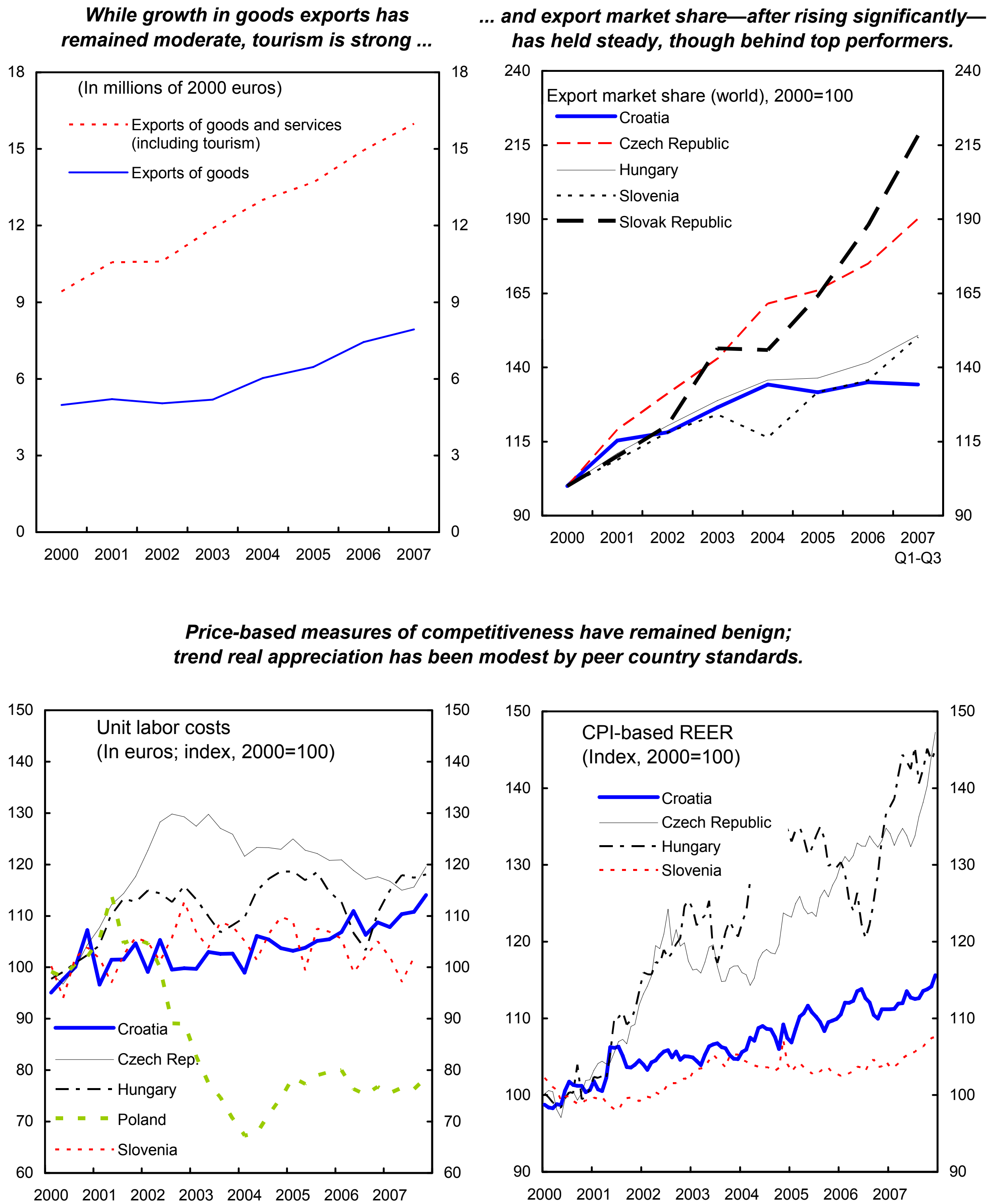
1/ Total credit to households and nonfinancial enterprises (excluding public enterprises), including domestic credit by banks and leasing companies, and direct borrowing from abroad.

Figure 4. Croatia: Inflation, 2001–08
(Year-on-year percentage changes)



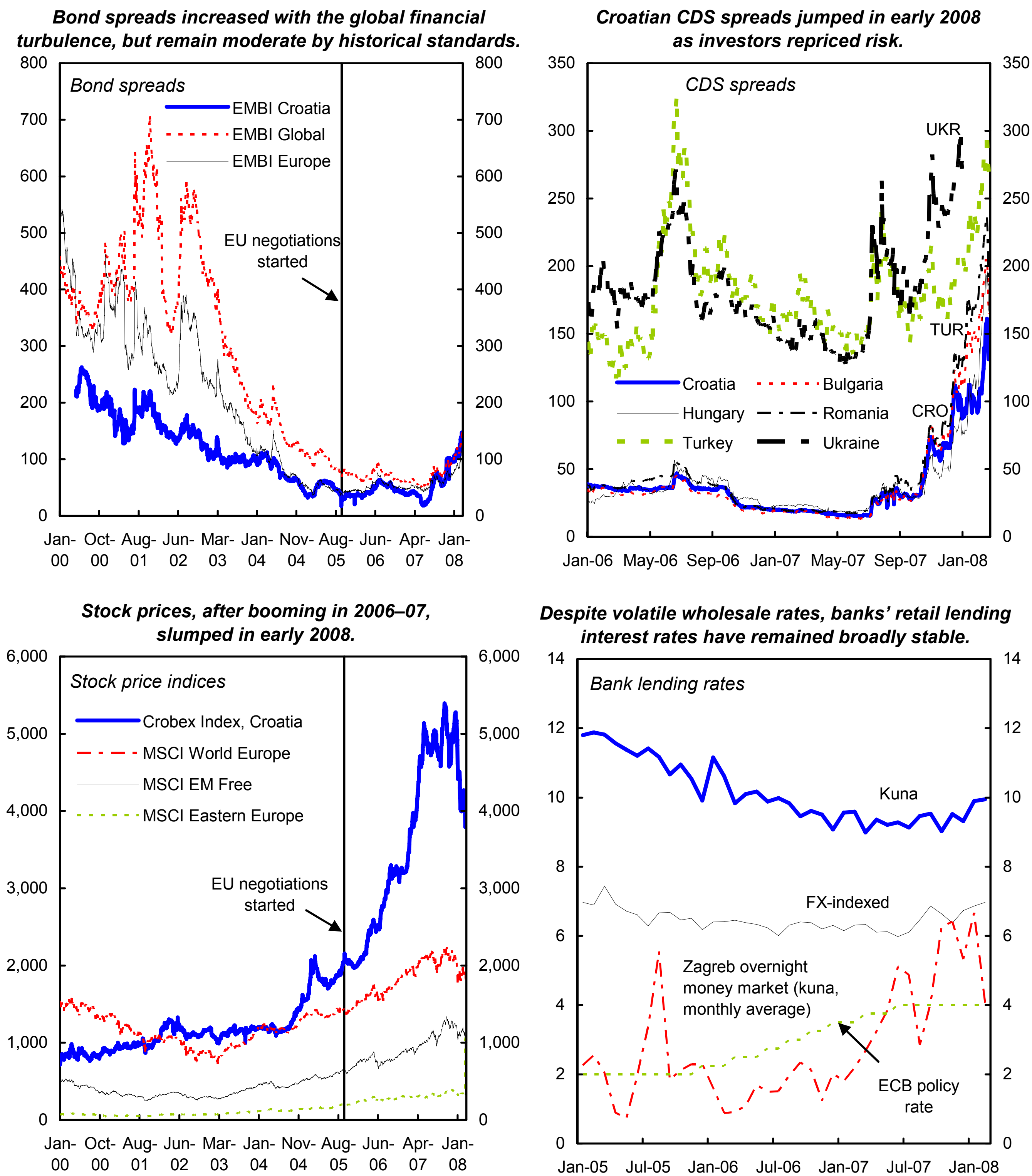
Sources: Croatian authorities; and Fund staff calculations.
1/ Based on oil prices in euros, converted from the simple average of three spot prices (Dated Brent, West Texas Intermediate, and the Dubai Fateh, US$ per barrel).

Figure 5. Croatia and Selected European Countries: Competitiveness Indicators, 2000–07



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

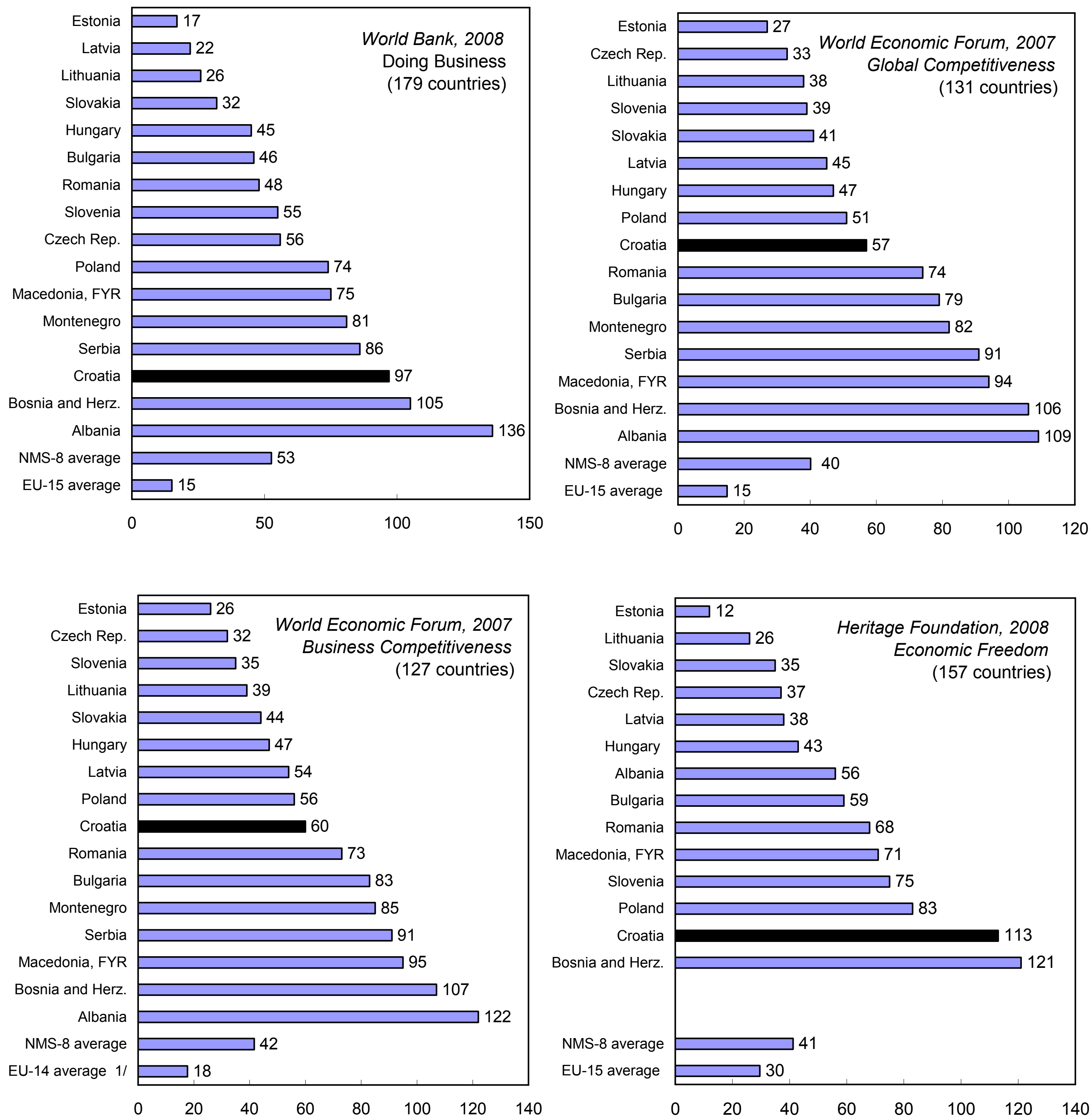
Figure 6. Croatia: Financial Market Conditions, 2000–08
(In basis points)



Sources: Croatian National Bank; Haver Analytics; and JP Morgan/Bloomberg.

Figure 7. Croatia and Selected European Countries: Business Environment, 2005–08

Despite recent improvements, Croatia still performs below the average of its peers in central and eastern Europe in various cross-country rankings of business environment indicators.



Sources: World Bank; World Economic Forum; Heritage Foundation.

1/ No ranking available for Luxembourg.

APPENDIX I. CROATIA: DEBT SUSTAINABILITY ANALYSIS

A. Fiscal Sustainability

1. Fiscal consolidation would keep public debt on its downward trend. Under the baseline scenario, public debt would fall from 38 percent of GDP in 2007 to 27 percent of GDP by 2013. Stress-testing suggests that most shocks leave public debt either declining or unchanged (Table 13, Figure 8). The one notable exception is the scenario keeping key variables at their historical averages, under which the debt ratio increases by 13 percentage points of GDP between 2007 and 2013. This is because the historical primary deficit does not yet fully account for the significant fiscal consolidation in 2004–06—with consolidation continuing in the medium term baseline—while the historical growth rate is unduly affected by a recession in 1999. Assuming no policy change beyond 2007, the debt ratio would stay roughly constant over the forecast horizon, as it also would in the case of a large and sustained drop in economic activity. The dynamics of the debt ratio would continue to be resilient under the assumptions behind scenarios including a policy-induced widening of the primary deficit, and also a combination of a policy-induced widening of the primary deficit, a slowdown in growth, and an interest rate hike. Under the two one-time shock scenarios, the debt ratio resumes a downward trend following the initial shock. The inclusion of the stock of state guarantees and arrears (about 10 percent of GDP) in the above analysis does not materially change the described responses to shocks.

B. External Sustainability

2. External debt rose by over 26 percentage points of GDP (in euro terms) between 2002 and 2007, on the back of strong private sector borrowing and notwithstanding efforts at fiscal consolidation, a shift by the public sector towards domestic financing, and measures by the central bank to discourage bank external borrowing. In the baseline projection—which incorporates a deterioration of the external current account balance relative to GDP in 2008 followed by a gradual improvement in subsequent years—the debt-to-GDP ratio continues to hover around 88 percent in 2008–09 and then gradually declines towards 84 percent by 2013 (Table 14). Alternative scenarios demonstrate the sensitivity of external debt to several factors, highlighting the need for vigilance in economic management to forestall unsustainable debt dynamics (Figure 9). In the scenario keeping key variables at their historical averages, the external debt ratio eases slightly. In scenarios with lower growth or a worsening current account, the debt-to-GDP ratio rises to around 90 percent. The small effect of the interest rate shock partly reflects the low historical standard deviation of interest rates (with one-half standard deviation equivalent to about 70 basis points); doubling the size of the interest rate shock would push the debt/GDP ratio to over 90 percent. A large real depreciation has significant adverse effects, with the debt-to-GDP ratio possibly averaging over 120 percent between 2009 and 2013.

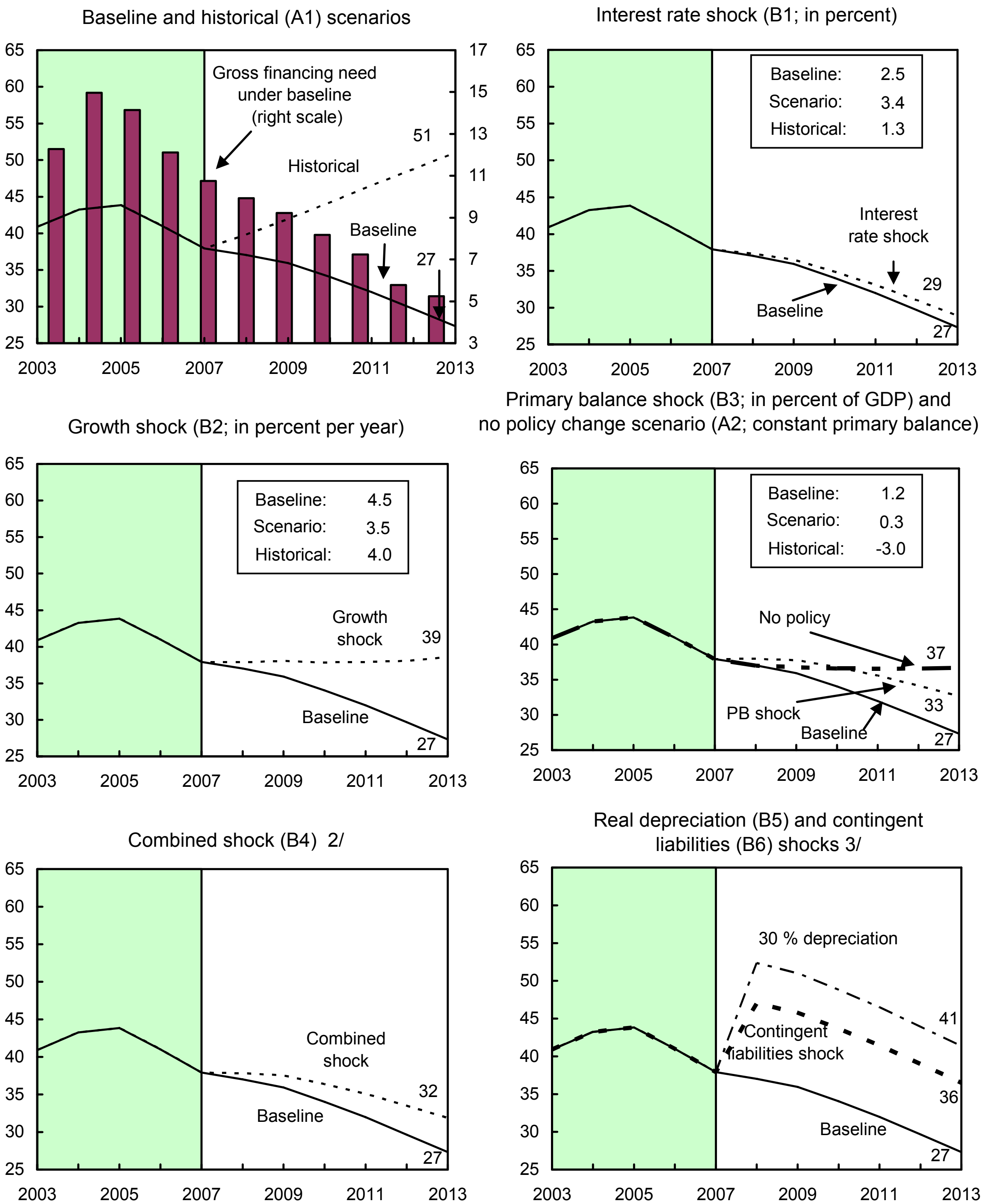
Table 13. Croatia: Public Sector Debt Sustainability Framework, 2003–13

(In percent of GDP, unless otherwise indicated)

	Actual				Preliminary	Projections						Debt-stabilizing primary balance 9/
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	
1 **Baseline: Public sector debt 1/**	40.9	43.3	43.8	41.0	**37.9**	**37.0**	**35.9**	**34.0**	**32.0**	**29.7**	**27.3**	**0.0**
o/w foreign-currency denominated	32.7	36.8	35.9	33.1	30.2	29.7	27.6	25.4	23.0	20.7	18.6	
2 Change in public sector debt	0.9	2.4	0.6	-2.8	-3.1	-0.9	-1.1	-1.9	-2.1	-2.3	-2.3	
3 Identified debt-creating flows (4+7+12)	1.4	2.4	-0.5	-1.7	-2.0	-0.9	-1.1	-1.9	-2.1	-2.3	-2.3	
4 Primary deficit	4.1	2.7	1.8	0.8	0.2	0.3	-0.7	-1.5	-1.9	-2.2	-2.3	
5 Revenue and grants	45.1	44.9	44.5	44.8	46.3	45.2	45.1	44.9	44.7	44.2	43.8	
6 Primary (noninterest) expenditure	49.2	47.6	46.3	45.6	46.5	45.5	44.4	43.4	42.8	42.0	41.4	
7 Automatic debt dynamics 2/	-0.6	-0.9	-2.2	-1.3	-1.6	-1.0	-0.6	-0.7	-0.6	-0.6	-0.5	
8 Contribution from interest rate/growth differential 3/	-1.4	-1.0	-0.9	-1.2	-1.6	-1.0	-0.6	-0.7	-0.6	-0.6	-0.5	
9 Of which contribution from real interest rate	0.5	0.6	0.9	0.7	0.5	0.5	0.8	0.8	0.9	0.9	0.8	
10 Of which contribution from real GDP growth	-2.0	-1.6	-1.7	-1.9	-2.1	-1.5	-1.4	-1.6	-1.5	-1.4	-1.3	
11 Contribution from exchange rate depreciation 4/	0.8	0.1	-1.4	-0.1	...	...	...	...	...	...	...	
12 Other identified debt-creating flows	-2.1	0.7	-0.1	-1.1	-0.6	-0.1	0.2	0.3	0.4	0.4	0.5	
13 Privatization receipts (negative)	-2.1	-0.6	-0.6	-1.6	-1.1	-0.8	-0.4	-0.2	-0.1	-0.1	-0.1	
14 Recognition of implicit or contingent liabilities	0.0	1.2	0.5	0.5	0.5	0.7	0.5	0.5	0.5	0.5	0.5	
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	
16 Residual, including asset changes (2-3) 5/	-0.5	0.0	1.1	-1.2	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	90.7	96.3	98.6	91.5	81.9	81.8	79.7	75.7	71.6	67.2	62.4	
Gross financing need 6/	12.3	15.0	14.1	12.1	10.8	9.9	9.2	8.2	7.2	5.8	5.2	
in billions of euros	3.2	4.3	4.4	4.1	4.0	4.1	4.0	3.9	3.7	3.2	3.1	
Scenario with key variables at their historical averages 7/					**37.9**	**39.8**	**42.0**	**44.2**	**46.5**	**48.8**	**51.0**	**-0.9**
Scenario with no policy change (constant primary balance) in 2008–13					**37.9**	**37.0**	**36.8**	**36.6**	**36.6**	**36.6**	**36.7**	**-0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.3	4.3	4.3	4.8	5.6	4.3	4.0	4.8	4.8	4.8	4.8	
Average nominal interest rate on public debt (in percent) 8/	5.6	5.6	5.5	5.4	5.4	5.9	5.9	5.9	6.0	6.0	6.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	1.7	2.3	2.0	1.4	1.5	2.4	2.7	3.0	3.0	3.1	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.7	-0.3	4.0	0.4	...	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.9	3.9	3.2	3.4	4.0	4.4	3.5	3.2	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.4	0.7	1.5	3.2	7.8	2.0	1.4	2.5	3.3	2.7	3.5	
Primary deficit	4.1	2.7	1.8	0.8	0.2	0.3	-0.7	-1.5	-1.9	-2.2	-2.3	

1/ Gross direct 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 e = nominal exchange rate depreciation (measured by increase in local currency value of the euro).
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/ 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 8. Croatia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: Croatian authorities; and Fund staff estimates.

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

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

Table 14. Croatia: External Debt Sustainability Framework, 2003–13
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	75.8	80.0	82.4	85.5	87.8	**87.9**	**87.8**	**87.0**	**86.5**	**85.6**	**84.2**	**-8.4**
2	Change in external debt	13.9	4.2	2.4	3.2	2.3	0.0	-0.1	-0.7	-0.6	-0.9	-1.3	
3	Identified external debt-creating flows (4+8+9)	-3.3	-3.8	-4.4	-3.2	-4.9	0.3	0.4	-1.2	-1.9	-2.6	-3.1	
4	Current account deficit, excluding interest payments	3.6	2.3	3.6	4.8	4.8	5.6	5.1	4.5	3.8	3.3	2.9	
5	Deficit in balance of goods and services	7.8	6.8	7.0	7.7	9.0	8.2	7.6	6.6	5.7	5.0	4.4	
6	Exports	50.1	49.7	48.9	49.7	48.9	49.6	49.8	50.2	50.8	51.2	51.6	
7	Imports	57.9	56.5	55.9	57.4	58.0	57.8	57.4	56.8	56.5	56.2	56.0	
8	Net non-debt creating capital inflows (negative)	-5.2	-2.3	-4.1	-7.5	-9.1	-5.2	-5.0	-5.3	-5.4	-5.5	-5.6	
9	Automatic debt dynamics 1/	-1.6	-3.8	-3.9	-0.6	-0.6	-0.1	0.3	-0.4	-0.2	-0.3	-0.3	
10	Contribution from nominal interest rate	2.5	2.7	2.7	3.0	3.7	3.3	3.5	3.5	3.7	3.5	3.5	
11	Contribution from real GDP growth	-3.1	-3.0	-3.2	-3.6	-4.3	-3.4	-3.3	-3.9	-3.9	-3.8	-3.8	
12	Contribution from price and exchange rate changes 2/	-1.1	-3.5	-3.5	...	...	...	...	...	...	...	...	
13	Residual, including change in gross foreign assets (2-3) 3/	17.2	8.0	6.8	6.4	7.2	-0.3	-0.5	0.5	1.3	1.7	1.7	
	External debt-to-exports ratio (in percent)	151.3	161.0	168.6	172.2	179.5	177.0	176.2	173.3	170.3	167.1	163.2	
	Gross external financing need (in billions of euros) 4/	4.5	5.8	7.9	11.6	13.1	13.3	14.7	14.5	16.7	16.1	16.2	
	in percent of GDP	17.2	20.1	25.2	33.9	35.1	32.7	33.4	30.6	32.6	29.1	27.1	
	Scenario with key variables at their historical averages 5/						**87.5**	**86.2**	**85.6**	**85.6**	**85.9**	**86.1**	**-8.5**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	5.3	4.3	4.3	4.8	5.6	4.3	4.0	4.8	4.8	4.8	4.8	
	GDP deflator in euros (change in percent)	1.8	4.9	4.5	4.5	3.8	4.4	3.5	3.2	3.0	3.0	3.0	
	Nominal external interest rate (in percent)	4.4	3.9	3.7	4.0	4.8	4.1	4.3	4.3	4.5	4.4	4.5	
	Growth of exports (euro terms, in percent)	18.1	8.4	7.2	11.3	7.9	10.4	8.0	9.0	9.1	8.9	8.8	
	Growth of imports (euro terms, in percent)	10.0	6.7	7.9	12.4	10.7	8.6	6.9	7.0	7.4	7.4	7.5	
	Current account balance, excluding interest payments	-3.6	-2.3	-3.6	-4.8	-4.8	-5.6	-5.1	-4.5	-3.8	-3.3	-2.9	
	Net non-debt creating capital inflows	5.2	2.3	4.1	7.5	9.1	5.2	5.0	5.3	5.4	5.5	5.6	

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 euro terms, g = real GDP growth rate, ε = nominal appreciation (increase in euro 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).

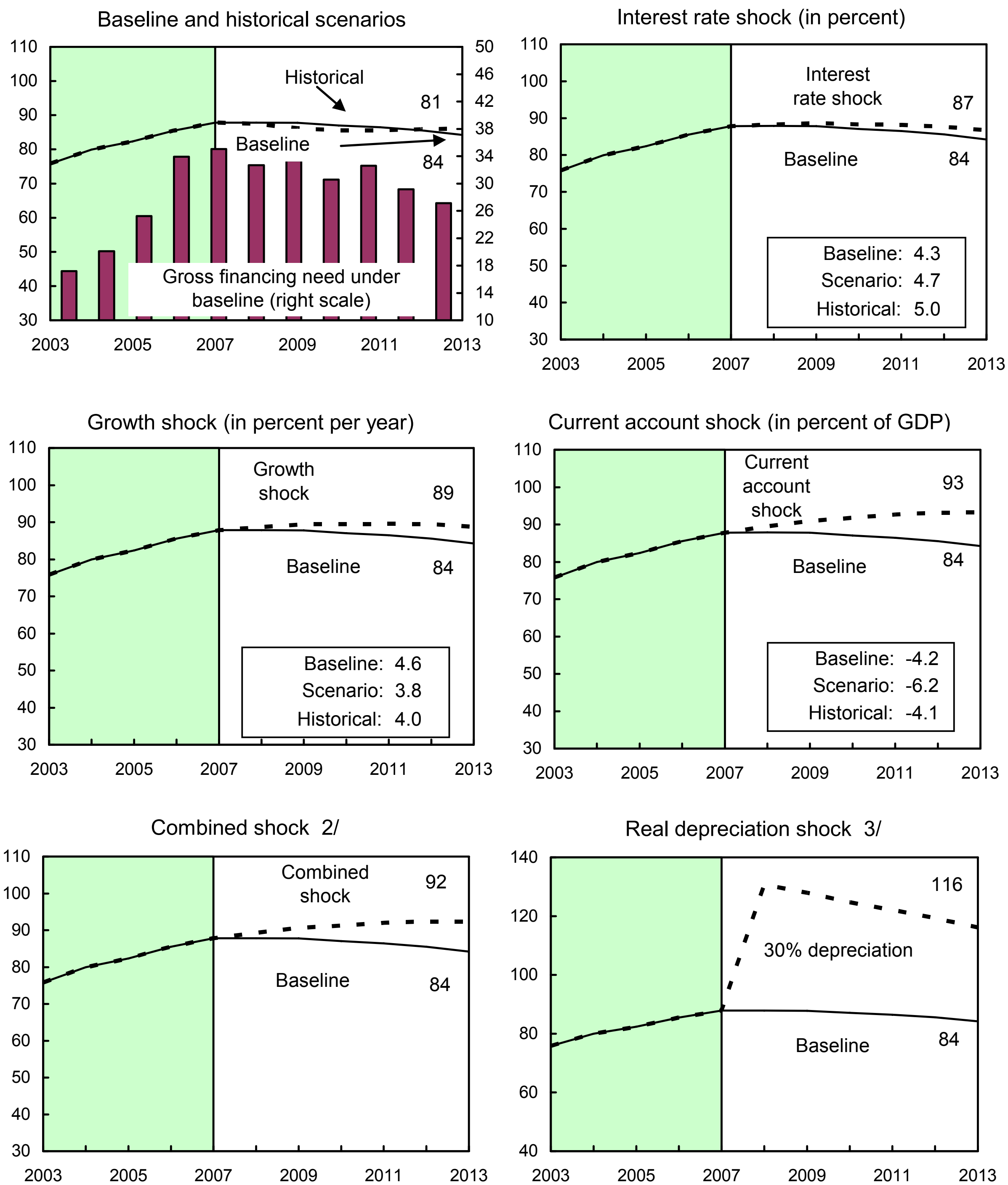
3/ For projection, line includes the impact of price and exchange rate changes.

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; euro 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, euro deflator growth, and net non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 9. Croatia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: Croatian authorities; and Fund staff estimates.

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

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

3/ One-time real depreciation of 30 percent.

APPENDIX II. CROATIA: FUND RELATIONS
(as of February 29, 2008)

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	100.0
Holdings	0.05	0.11

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

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

VI. Projected Obligations to Fund (SDR million; based on present holdings of SDRs):[1]

	Forthcoming				
	2008	2009	2010	2011	2012
Principal					
Charges/Interest	1.01	1.35	1.35	1.35	1.35
Total	1.01	1.35	1.35	1.35	1.35

VII. 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

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

demand in the interbank market, with tight management by the CNB. Staff has proposed to reclassify Croatia's *de facto* exchange rate arrangement from "managed floating with no pre-announced path for the exchange rate" to "conventional pegged arrangement" as from September 1, 2006. The authorities' response is pending. The CNB transacts only in euros, U.S. dollars, and SDRs. On April 3, 2008, the official exchange rate was kuna 7.270397 per euro (middle rate).

VIII. Exchange Restrictions:

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions, except for restrictions that Croatia maintains solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144(52/51).

IX. Article IV Consultation:

The previous **Article IV consultation** with Croatia was concluded on February 16, 2007 (IMF Country Reports Nos. 07/81 and 07/82, available at: http://www.imf.org/external/country/hrv/index.htm). Croatia is on the 12-month consultation cycle.

X. FSAP:

An FSAP Update mission took place in October–November 2007. An FSSA Update accompanies this report.

The original 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).

XI. Technical Assistance 2000–08:[2]

Department	**Timing**	**Purpose**
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization

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

	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
	February–March 2007	Revenue Administration (with World Bank)
	April 2007	Public-Private Partnerships
	January–February 2008	Short-Term Expenditure Rationalization
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
	September 2006	Monetary and Financial Statistics
MCM	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
	April 2003	Stress Testing and Foreign Exchange Reserve Management
	February 2004	Monetary Policy Instruments
	January 2007	Macroeconomic Modeling and Forecasting

XII. Resident Representative:

The post closed in June 2007.

Appendix III. Croatia: Statistical Issues

1. Data provision is broadly adequate for effective surveillance, though some improvements would be desirable. While remedial action has been taken to improve data coverage and reliability in most cases, progress in some instances has been impeded by insufficient resources and issues regarding coordination among government agencies. Croatia subscribes to the Special Data Dissemination Standard.

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) problems of coordination between the CBS and the Croatian National Bank (CNB) in reconciling tourism receipts estimates; (ii) incomplete coverage of unincorporated businesses and the self-employed (farmers, traders, and craftsmen); (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 an accrual basis; (ii) inadequate price deflators; and (iii) late publication of annual data, which show large differences with quarterly data.

B. Prices

3. The CBS produces a monthly consumer price index, with expenditure weights (updated every five years) derived from a 2005 Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups but in all cases between the 13th and the 21st day of each month. The indices are released around the 15th day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country. A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology, but is not released for the time being to avoid confusion. A core CPI is also calculated based on a methodology developed by the CNB. The CBS also releases a monthly producer price index (PPI), usually on the 8th day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year.

C. Wages and Employment

4. The CBS produces data on average net and gross earnings per person and employment by sector. Earning 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 the military and police.

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 was subsequently expanded and the survey is now being conducted on a regular basis. The CBS released semi-annual results from 1998, and began releasing quarterly results in 2007 with a lag 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 (GFS), produced on a monthly basis with a lag of 30 days, are available in the *Monthly Statistical Review* of the Ministry of Finance (MoF) or provided directly to the Fund. Revenue data 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 MoF reports are not reconciled with those in the CNB's monetary survey and balance of payments data, with substantial discrepancies owing partly to different methodologies and definitions of government. 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; after a slow start, meetings are now being held more regularly.

7. The detailed data on domestic public bonds published in the *Monthly Statistical Review* 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 that 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 available only on a quarterly basis and with a lag of 30 days. Local government data are partial as they include the operations of the 53 largest municipalities. Annual cash data through 2006 for the general government and its subsectors are published in the *2007 GFS Yearbook*. Up-to-date monthly data for the budgetary central government are reported for publication in the *IFS*. All data for the *GFS Yearbook* and *IFS* are reported in the *GFSM 2001* framework.

E. Monetary Data

9. Compilation of monetary statistics published by the CNB is consistent with the recommendations of the IMF's 2000 *Monetary and Financial Statistics Manual* (*MFSM*). 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. 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 collecting financial information (balance sheets and investment structure) from investment and pension funds; the data are not yet published, but used for internal purposes. 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. In November 2006, the CNB reported monetary data in the format of Standardized Report Forms for December 2001 to the present. These data accord with the concepts and definitions in *MFSM* and were published, along with the corresponding metadata, in *IFS* and the *IFS Supplement on Monetary and Financial Statistics*.

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*. 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. Net errors and omissions have ranged from 2½ to 3¾ percent of GDP since 2003, and are negative. The coverage and quality of portfolio investment data are reasonably complete and accurate.

11. A large part of external debt was contracted prior to the dissolution of the former Socialist Federal Republic of Yugoslavia 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. Quarterly data on the international investment position are available on the CNB website up to Q3 2007.

Croatia: Table of Common Indicators Required for Surveillance
(as of April 2, 2008)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	4/2/08	4/2/08	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	3/21/08	3/28/08	W and M	W and M	W and M
Reserve/Base Money	Feb 2008	3/31/08	M	M	M
Broad Money	Feb 2008	3/31/08	M	M	M
Central Bank Balance Sheet	Feb 2008	3/31/08	M	M	M
Consolidated Balance Sheet of the Banking System	Feb 2008	3/31/08	M	M	M
Interest Rates[2]	Feb 2008	3/31/08	M	M	M
Consumer Price Index	Feb 2008	3/14/08	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3 2007	1/16/08	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Nov 2007	3/4/08	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec 2007	3/14/08	M	M	M
External Current Account Balance	Q4 2007	3/31/08	Q	Q	Q
Exports and Imports of Goods and Services	Q4 2007	3/28/07	Q	Q	Q
GDP/GNP	Q4 2007	3/28/08	Q	Q	Q
Gross External Debt	Dec 2007	3/4/08	M	M	M

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

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

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

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

[5] Including currency and maturity composition.

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

APPENDIX IV. CROATIA: WORLD BANK RELATIONS

1. The World Bank is assisting Croatia in its structural and institutional reforms, within the context of the EU integration process. The Bank's Board discussed the second Country Assistance Strategy (CAS) for Croatia in December 2004. The CAS Progress Report (CAS PR), which was presented to the Board in May 2007, assessed the relevance of the CAS and adjusted the second half of the CAS program to take account of developments including (i) the EU's launch of membership negotiations with Croatia in October 2005 and Croatia's progress towards accession; (ii) progress toward achieving the CAS outcomes; and (iii) the status of implementation of Croatia's structural reform program supported by the Bank's Programmatic Adjustment Loans (PAL).

2. The proposed operations in the CAS PR aim to address areas cited in the EU Progress Report as needing significant effort—including judicial and public administration reform, anti-corruption, agriculture, environment—as well as to facilitate Croatia's absorption of EU IPA grant funds. The backbone of the World Bank assistance to Croatia remains a series of PALs, with investment 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. The Bank Board approved the PAL1 in September 2005 and the PAL2 in May 2007, each amounting to EUR 150 million. The PAL loans aim to support enhanced economic growth through: (i) improving the investment climate; (ii) strengthening governance; and (iii) reducing the size and improving the efficiency of the public sector. They also aim to support government reforms needed for the fulfillment of the EU accession criteria and successful EU integration.

3. Currently, the World Bank finances 17 operations in Croatia in a wide range of sectors with a combined loan amount of close to US$1.1 billion. IFC's portfolio amounts to about US$300 million and there are over US$40 million MIGA guarantees. The Bank's current program (the "base case"), set out in the 2007 CAS PR, envisages about US$160 million in new lending during the Bank's fiscal year ending June 30, 2008. The projects under preparation are: the Judicial Reform project, the Sustainable Health System project, and the Rijeka Gateway II project. The Bank will also seek a dialogue with the government on the future of the PAL program, including on the remaining actions that could trigger the release of the first and second tranches of the EUR 150 million PAL2.

4. The new Croatia Country Partnership Strategy (CPS) will cover July 2008 through June 2012 (the Bank's fiscal years 2009–12). The World Bank Group seeks to launch CPS discussions with the government in early 2008. The discussions between the government and the Bank on support for structural reforms and investments, as well as analytical work during the upcoming CPS period, will be aimed at strengthening (i) Croatia's efforts to accelerate its accession to the EU, taking account of the findings of the EC's latest Croatia Progress Report; and (ii) the fiscal and social sustainability of Croatia's public expenditures and policies.

Statement by the Staff Representative on Republic of Croatia
May 9, 2008

1. This statement reports on recent developments and adds to the information contained in the staff report for the 2008 Article IV consultation. It does not change the thrust of the staff appraisal.

2. Recent data releases are broadly consistent with the outlook in the staff report. Twelve-month CPI inflation fell to 5.7 percent in March. Year-on-year growth in domestic bank credit to the nongovernment sector eased to 12.3 percent at end-March. In line with EU requirements, the Croatian National Bank has changed the external debt reporting system. This resulted in an upward revision to Croatia's end-2007 external debt of 1.3 percent of GDP.

3. Staff's proposal to reclassify Croatia's de facto exchange rate arrangement from "managed floating with no preannounced path for the exchange rate" to "conventional pegged arrangement" (as from September 1, 2006) remains under consideration.

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IMF Executive Board Concludes 2008 Article IV Consultation with the Republic of Croatia

On May 9, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.[1]

Background

Growth accelerated in 2007, but external imbalances continued to increase. Real GDP growth reached 5.6 percent, on the back of strong domestic demand. The latter was also reflected in a widening current account deficit (8.6 percent of GDP), with higher world energy prices contributing as well. External debt reached nearly 88 percent of GDP at end-2007.

Inflation picked up. Because of financial euroization and balance-sheet exposures, the Croatian National Bank (CNB) has maintained the exchange rate in a tight range. Until very recently, this has helped keep inflation between 2 and 4 percent, aided by moderate wage growth. Nevertheless, surging food and utility prices pushed year-on-year headline inflation above 6 percent in early 2008, the highest rate since the early 1990s.

The general government deficit was brought down significantly in recent years, from 6.1 percent of GDP in 2003 to 3 percent in 2006, and to an estimated 2.3 percent in 2007. But with economic growth particularly rapid in 2007, and taking into account off-budget and quasi-fiscal

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the May 9, 2008 Executive Board discussion based on the staff report.

activities not included in the general government accounts, cyclical adjustment implies that the overall fiscal stance was expansionary in 2007.

External competitiveness appears adequate. Despite some gradual real exchange rate appreciation, indicators of price and cost competitiveness vis-à-vis central European peer countries remain benign. Market share of goods exports has been steady and tourism receipts strong. Staff estimates indicate that the real exchange rate is broadly consistent with fundamentals.

The financial sector is healthy, but risks associated with rapid credit growth have been a concern. Banks' capital adequacy and asset quality are at sufficiently comfortable levels to withstand a range of shocks. Though declining, profitability is still high. Nevertheless, significant external imbalances and rising asset prices—and volatility in the case of equities—accompanying credit growth could expose banks to sudden shifts in market sentiment. Banks also face significant interest and exchange rate induced credit risks. The CNB has taken a range of measures aimed at limiting vulnerabilities, including to curb banks' borrowing from abroad and domestic credit expansion.

Although Croatia was not particularly hurt by the global financial turbulence through 2007, stock prices slumped in the early months of 2008. Widening credit default swap spreads suggest concerns with external vulnerabilities, though not to the same extent as for some other countries.

Some progress was made on structural reforms, but Croatia still lags most central and eastern European countries on business environment indicators. In the heavily indebted shipyard sector, reforms were delayed through 2007; recently, the authorities announced plans to start the sale of two shipyards at end-2008. Progress on privatization was mixed: initial public offerings for the oil and telecom companies were successful but the broader privatization process slowed.

The discussions focused on measures aimed at reducing vulnerabilities, ensuring that higher inflation does not become entrenched in expectations, and raising potential growth.

Executive Board Assessment

Executive Directors welcomed Croatia's strong economic growth in recent years, which has generated an appreciable increase in employment. This strong performance has been accompanied by commendable improvements in policies, notably a reduction in the general government deficit since 2003 and a continued strengthening of financial supervision. At the same time, Directors noted that the current account deficit has continued to widen, external debt has remained high, and inflation has increased sharply. They emphasized the need for continued policy efforts to mitigate these imbalances and create an environment conducive to sustained high growth.

Directors stressed the importance of near-term wage moderation, both in the government sector as intended and the state-owned enterprises. Wage moderation will be key to avoiding second-round effects from food and utility price increases and preventing higher inflation from becoming entrenched in expectations, as well as underpinning external competitiveness.

Directors noted that the real exchange rate is broadly in line with fundamentals, and recognized the advantages of maintaining a stable exchange rate in circumstances of high financial euroization, sensitivities to balance-sheet mismatches, and the past success of this policy. At the same time, Directors emphasized the need for support from other policies, including continued fiscal adjustment to manage domestic demand and help address macroeconomic imbalances; accelerated structural reforms to lessen vulnerabilities while raising sustainable growth; and strong prudential policies and financial sector supervision.

Against this background, Directors welcomed the authorities' intention to continue to reduce the general government deficit. They noted that achieving the authorities' target of a deficit of ½ percent of GDP by 2010 would represent a significant adjustment, and encouraged them to maintain this momentum going forward by announcing a target of fiscal balance by 2011. Directors generally considered that frontloading fiscal adjustment—including by saving any revenue overperformance—would provide welcome immediate support in reducing macroeconomic imbalances and raising the likelihood of meeting the recommended targets. A fiscal deficit target of 1 percent of GDP or less in 2009 would have considerable merit.

Directors underlined the benefits of expenditure-led fiscal adjustment and saw room to reduce current expenditure without unduly compromising the delivery of public services. They also pointed to the importance of ensuring the sustainability of the pension system, including by avoiding further backtracking on earlier reforms. More broadly, Directors encouraged the authorities to identify contingency measures that could be readily put in place in case macroeconomic imbalances turned out worse than expected.

Directors noted that Croatia's financial sector remains healthy, while stressing that continued strains in global financial markets and balance-sheet vulnerabilities underscore the importance of vigilance in maintaining high prudential standards and closely monitoring banks' risk management and lending practices. Directors commended the authorities' measures to strengthen banking supervision, including through increases in required capital cushions, improved communications with market participants, and efforts to strengthen home-host supervisory coordination. They also welcomed the continued strengthening in supervision of the nonbank sector, and the authorities' plan to produce a forward-looking financial stability report.

While understanding the central bank's rationale for implementing credit and other administrative measures, Directors considered that, taking into account their side effects, a phasing out of the measures would be desirable, acknowledging that this would need to be done in a careful way. This would require support from tighter fiscal policy to reduce excess demand pressures and close supervision of banks.

Directors stressed the considerable benefits of faster structural reforms for reducing vulnerabilities, raising living standards, and successfully concluding EU accession negotiations. They encouraged the authorities to continue to improve the business environment by reducing administrative burdens, legal uncertainties, and corruption. Such actions would make Croatia a more attractive destination for the investments needed to sustainably increase productivity, exports, and potential growth. Directors also looked forward to swift action on reforming the heavily indebted shipyards and on completing the broader privatization process, with involvement of strategic investors.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with the Republic of Croatia is also available.

Republic of Croatia: Selected Economic Indicators

	2004	2005	2006	2007 Est.	2008 Proj.
Output, unemployment, and prices	(Percentage change)				
Real GDP	4.3	4.3	4.8	5.6	4.3
Unemployment (labor force survey, in percent)	13.8	12.7	11.1	9.5	9.0
CPI inflation (average)	2.0	3.3	3.2	2.9	5.5
Saving and investment	(In percent of GDP)				
Domestic investment	30.6	31.0	32.8	32.7	32.1
Of which: fixed capital formation	28.1	28.1	29.8	30.0	29.4
Domestic saving	25.6	24.7	24.9	24.2	23.1
Government	2.5	2.7	3.3	4.6	3.8
Nongovernment	23.1	22.0	21.6	19.5	19.2
Government sector 1/					
General government revenue	44.9	44.5	44.8	46.3	45.2
General government expenditure	49.7	48.5	47.7	48.6	47.6
General government balance	-4.8	-4.0	-3.0	-2.3	-2.3
General government financing requirement 2/	-4.8	-4.0	-3.9	-3.5	-2.6
HBOR balance (net of budget transfers)	-0.4	-0.1	-0.2	-0.7	-0.8
Cyclically adjusted primary balance, broader coverage 3/	-3.2	-1.9	-1.9	-2.5	-1.7
General government debt	43.3	43.8	41.0	37.9	37.0
Money and credit	(End of period; change in percent)				
Bank credit to the nongovernment sector	14.0	17.4	23.1	15.0	…
Broad money	8.6	10.5	18.0	18.3	…
Interest rates 4/	(Period average; in percent)				
Average kuna deposit rate (unindexed)	1.9	1.7	1.7	2.3	…
Average kuna credit rate (unindexed)	11.7	11.2	9.9	9.3	…
Average credit rate, foreign currency-indexed loans	7.4	6.7	6.3	6.3	…
Balance of payments	(In millions of euros)				
Current account balance	-1,434	-1,976	-2,692	-3,206	-3,672
(In percent of GDP)	-5.0	-6.3	-7.9	-8.6	-9.0
Capital and financial account	2,527	3,840	4,996	4,865	5,197
Overall balance	43	822	1,412	721	709

Republic of Croatia: Selected Economic Indicators (concluded)

	2004	2005	2006	2007 Est.	2008 Proj.
Debt and reserves	(End of period; in millions of euros)				
Gross official reserves	6,436	7,438	8,725	9,307	10,016
In months of following year's imports of goods and NFS	4.4	4.5	4.8	4.7	4.8
External debt service to exports ratio (in percent)	24.4	27.2	37.5	37.7	31.2
Total external debt (in percent of GDP)	80.0	82.4	85.5	87.8	87.9
Net external debt 5/	37.7	43.1	44.3	46.1	46.1

Sources: Croatian authorities; and Fund staff estimates.

1/ Modified-accrual GFS methodology.

2/ Includes “pensioners’ debt” repayments, equivalent to 1.0 percent of GDP in 2006, 1.2 percent in 2007, and 0.3 percent in 2008.

3/ Includes off-budget and quasi-fiscal activities (outside the general government accounts), in particular repayments of “pensioners’ debt” and the balance of HBOR (net of budget transfers).

4/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.

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

Statement by Age Bakker, Executive Director for Republic of Croatia and Tomislav Galac, Advisor to Executive Director May 9, 2008

The authorities value their continuing cooperation with the Fund, as their economic policies are being increasingly shaped by the ongoing efforts to speed up Croatia's accession to the European Union. They thus greatly appreciate that the 2008 Article IV Consultation focused on those topics important to the Croatian economy that are in the domain of the Fund's core competencies – fighting rising inflation and persistent external vulnerabilities, and strengthening the financial sector. The authorities welcome the thorough staff analysis and mostly agree with the staff's recommendations.

In 2008, the reelected government took office for a new four-year term that is expected to see Croatia becoming a full member of NATO in 2009 and in the same year finishing negotiations with the EU. While the invitation to join NATO, extended to Croatia in April 2008, provides a security blanket in a still relatively unstable area, the ongoing EU negotiations continue to act as an important anchor for macroeconomic stability. In such a stable environment, the key objective of the authorities is to speed up progress in structural reforms, supporting key growth sectors of the economy and restructuring lagging ones.

Economic performance and outlook

Croatia has experienced seven years of uninterrupted real output growth of around 5% per year, with consumer price inflation subdued below 3.5% per year. Real GDP rose by 5.6% in 2007, as both private and government final consumption accelerated, spurred by the political cycle and a large pay-out of so called "pensioners debt". With a lag, solid growth and price stability resulted in an increase of the average number of employed persons over 3% in both 2006 and 2007, after a sluggish growth over the past five years; the unemployment rate reached its lowest level of 9.5% in 2007. Recently, consumer price inflation picked up, peaking at 6.2% in January 2008, as the economy could no longer buffer rising energy and food prices. Years of above-potential growth, increasingly financed by foreign borrowing, have pushed up the current account balance to 8.6% and external debt to 88% of GDP in 2007, the latter being higher than in most comparator countries.

The authorities recognize the potential risks associated with Croatia's external imbalances, especially in light of the dimming global growth outlook and persistent strains in commodity and financial markets. Both fiscal and monetary policies for 2008 and beyond have been adapted accordingly, as underlying growth projections have been reduced to 4.5% and inflation projections raised to 5.5%, close to current WEO projections. These conservative projections will support the authorities' efforts to further reduce the government deficit and to curb the growth of domestic credit, in the medium term. Against this background, the authorities now expect external debt and the current account balance to stabilize close to their end-2007 levels in the baseline, supported by a further reduction in the growth rates of broad money and bank credit to the private sector.

Monetary policy and external sector

Faced with hyperinflation in the early 1990s and financial euroization thereafter (one of the highest levels in Europe), monetary policy has aimed at maintaining broad nominal exchange rate stability, that has served the economy well, as it has brought down inflation and inflation expectations, and curbed balance sheet risks. While closely monitoring growing inflationary pressures, the Croatian National Bank (CNB) has focused on mitigating external vulnerabilities for some time now. In particular, to combat high credit growth, mostly financed from abroad, that adds to the rising current account deficit, the CNB has resorted to a battery of direct monetary and prudential measures (Table 4 in the FSSA Report), while at the same time strengthening its communication to the financial community and the general public.

The measures produced considerable results during 2007, as the government reined its finances, bankers focused on profits rather than on market shares, and external financing conditions tightened. Specifically, total credit growth slowed noticeably, especially to the household sector,. Moreover, the measures significantly reduced the proportion of foreign currency denominated loans in total loans, supported by a significant rise in the proportion of domestic currency in total deposits. The measures provided the right incentives for most banks to raise additional capital and have prevented a more severe widening of the current account deficit. The authorities are aware of possible negative side-effects of these measures (well indicated in the FSSA report). Nevertheless, given the limited options for monetary policy, and given that vulnerabilities have not yet been sufficiently reduced, the authorities contend that it is premature to phase these measures out in the short term.

The authorities agree with staff's assessment that Croatia's growing current account deficit is mostly driven by structural deficiencies, while there is no compelling evidence of real exchange rate misalignment. Therefore, the monetary authorities closely monitor macro-prudential indicators for any signs of emerging pressures which might warrant a tightening of prudential standards. As recognized by staff, the authorities are addressing immediate risks to Croatia's external liquidity position, stemming from the worsening global outlook. As a precautionary measure, the central bank is currently assessing how to increase the flexibility of its liquidity management instruments for the banking sector and improve its existing crisis management framework. Nevertheless, the authorities expect that external stability indicators will follow closely the baseline scenario under the DSA. This expectation is based on the continued success of measures to slow down credit growth to the private sector, on the positive effects of accelerated structural reforms on government finances, and on the expected increase of non-debt creating inflows from Croatia's major investing partners, as they by and large come from neighboring countries, and thus have longer-term investment horizons.

Fiscal policy and structural reforms

The authorities have successfully pursued fiscal consolidation over the past several years. The overall general government deficit has declined from 6.2 percent of GDP in 2003, to 2.3 percent by 2007. Pension reform, wage moderation, and investment cuts all have contributed. Revenue collection overperformed in 2007, which was quite remarkable given the political cycle. However, the authorities are aware that the total public financing requirement decreased at a slower pace. Therefore, they are committed to further medium-term fiscal consolidation. To this end, the authorities have secured a 2008 budget, that aims at a significant reduction in the total public financing requirement, due to lower extra-budgetary payments of "pensioners debt". Moreover, the medium-term framework envisages significant further reductions in the general government deficit for 2009 and 2010.

Against this background, the authorities concur with the results of the staff's debt-sustainability analysis that shows further declining levels of the public debt-to-GDP ratio under the baseline scenario, while the bound tests show that the current level of the public debt-to-GDP ratio is robust to a number of reasonable shocks.

The planned improvements in Croatia's fiscal position assume rapid and considerable positive effects of planned structural reforms. Some of these reforms are among the most difficult of the Croatian economic landscape ever, but they are prerequisites for the last stage of Croatia's convergence into the EU. Among the top priorities for the 2008-09 period are finalization of the already well advanced pension reform as well as completion of the privatization process, particularly the disposal of large government stakes in railways and shipbuilding. In anticipation of this privatization these sectors will be restructured, with a view of permanently reducing subsidies in line with EU standards. The government has already announced plans to privatize two viable shipyards. The government announced in March 2008 that it would establish a new investment fund for other companies, to which the entire portfolio of the Croatian Privatization Fund (HFP) would be transferred. The privatization process will be effectively completed after shares in this investment fund have been successfully offered to the general public.

Other far-reaching reforms concern the health sector, education and social security, for reasons well elaborated in the Selected Issues papers.

Financial sector

As noted in the FSSA Report, Croatia's financial system has made a huge leap forward since the 2002 FSAP. In this period, the assets of the financial sector doubled; non-banking financial intermediaries have entered the scene; the securities markets developed from a miniscule base; and financial conglomerates emerged. At the same time, the CNB has put in place an effective bank supervision framework, whereas the supervision of the non-banking financial sector has significantly improved under the unified non-banking supervisor (HANFA). Memorandums of understanding have been signed between the two supervisors, as well as with relevant foreign supervisory authorities. While there is a need to further develop the financial system, staff rightly concludes that the financial sector remains broadly healthy, and that the authorities have been proactive in addressing the remaining challenges.

Regarding staff recommendations for further strengthening the financial system, the authorities are actively addressing areas that can be dealt with immediately. In the banking sector, the CNB is improving its surveillance and communication strategy, and preparing a forward-looking financial stability report to be published in the second half of 2008. The central bank is modifying its liquidity management framework, to address potential effects of cross-border illiquidity spillovers, as well as to improve the functioning of the money market. The authorities are working on clarifying the roles of various agencies involved in the banking resolution process, and the central bank initiated formal contacts with relevant foreign bank supervisors in order to strengthen contingency planning.

In the longer run, further development of the financial sector will require full harmonization of financial legislation with EU standards, especially in the area of investor protection and enforcement of contracts. Completion of other reforms, including the transition to Basel II, and improvements in land ownership records, will significantly contribute to increased efficiency of financial intermediation. The authorities are also examining the benefits of inclusion of information on non-bank creditors and on legal person debtors in the national credit registry. Finally, strengthening the capacity and the powers of HANFA will improve the efficiency of non-banking sector supervision.