June 2009
IMF Country Report No. 09/185

Republic of Croatia: 2009 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of 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 2009 Article IV consultation with the Republic of Croatia the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 7, 2009, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 21, 2009. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 2, 2009, discussion of the staff report that concluded the Article IV consultation.

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation
with the Republic of Croatia

Approved by Poul M. Thomsen and Michele Shannon

May 21, 2009

Discussions. Zagreb, March 26 to April 7, 2009. The mission met with Prime Minister Sanader; 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. A press conference was held at the end of the mission.

Team: Messrs. Arvanitis (head), Atoyan, Jafarov (all EUR), Prokopenko (MCM), and Rother (SPR). Mr. Galac (OED) also joined the discussions.

Consultation focus: The discussions focused on the impact of the global economic and financial turmoil on Croatia, and on policies needed to maintain financial and external stability and pave the way for sustained recovery.

Policy advice. The staff report advocates: (i) a cautionary monetary policy stance until external pressures abate to support the authorities' exchange rate strategy in this period of heightened uncertainty; (ii) spending restraint to achieve the budget target and alleviate pressures on domestic credit markets; (iii) careful monitoring of the banks' credit portfolio, including through diagnostic reviews of banks, and preemptive measures to strengthen the banking system; (iv) continuing and further enhancing cooperation with foreign parent banks and their supervisors to ensure adequate external financing; (v) upgrading the framework for resolution of impaired assets; and (vi) advancing structural reforms to raise potential growth and reduce external imbalances.

The authorities' position: The authorities broadly shared the staff's diagnosis and noted that financial stability was their key priority. There was broad agreement on the monetary framework and policy requirements, and the authorities noted steps taken to strengthen banking oversight and high frequency monitoring of banks. They also stressed their effort to contain the fiscal deficit in 2008 and in 2009, including through spending cuts. Structural reforms remain an important policy objective.

Exchange rate: *De jure* managed float with no predetermined path; *de facto* other managed float under the Fund's classification. Croatia has accepted the obligations under Article VIII, Sections 2, 3, and 4, and maintains an exchange rate free of restrictions on payments and transfers for current international transactions.

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I. CONTEXT

1. **Strong capital flows and rapid credit growth in recent years helped Croatia reach high levels of prosperity, but also increased vulnerabilities**. Annual GDP growth accelerated to 4–5 percent, per capita incomes advanced further toward the EU average, and unemployment declined to the lowest levels since Croatia's independence (Table 1). But domestic and external imbalances also widened considerably. Rapid credit growth led to a significant debt build-up; prevalent foreign currency borrowing aggravated balance sheet vulnerabilities; and booming domestic demand led to surging trade deficits, moderated only partially by strong tourism earnings.

2. **Policies aimed to lessen the imbalances, but limitations soon became evident**. A stable exchange rate helped keep inflation and inflation expectations low (notwithstanding a temporary blip in early 2008 due to the spike in food and energy prices) but was also conducive to unhedged foreign currency borrowing. The authorities aimed for a balanced budget by 2010–11, but the fiscal stance lacked sufficient force to ease demand pressures. Banking supervision and regulation were strengthened in 2007–08, but proved to be only partially effective in restraining the strong credit demand. The need for structural reforms was well acknowledged, but their implementation was slow (Box 1 discusses the authorities' reaction to past Fund advice).

3. **Croatia is now in the midst of a sharp adjustment, with external factors aggravating existing imbalances**. Markedly lower private capital inflows and tight domestic credit conditions force domestic demand to contract while plummeting external demand exacerbates pressures on the tradable sector. Economic activity is decelerating fast, with manufacturing production, construction, and exports declining sharply (Figure 1).

4. **Risks to financial stability have increased**. External vulnerabilities remain substantial, with a large stock of external debt and sizable external financing needs in 2009 and 2010; concerns are mounting about the private sector's ability to meet its obligations; and the financial sector is highly vulnerable to deteriorating cross border funding conditions and worsening credit portfolios.

5. **Thus far, a robust policy response has helped Croatia navigate the crisis relatively well**. In the face of a fluid situation, a proactive and forceful monetary policy has succeeded in maintaining the orderly functioning of markets and averting destabilizing pressures on the kuna. A revised budget adopted in April provided a more realistic framework for 2009. However, downside risks are significant in the period ahead as the declining economy and financing constraints start to feed on each other.

6. Against this background, this year's Article IV consultation focused on ways to deal with the current challenges and help the economy to emerge more resilient from the crisis.

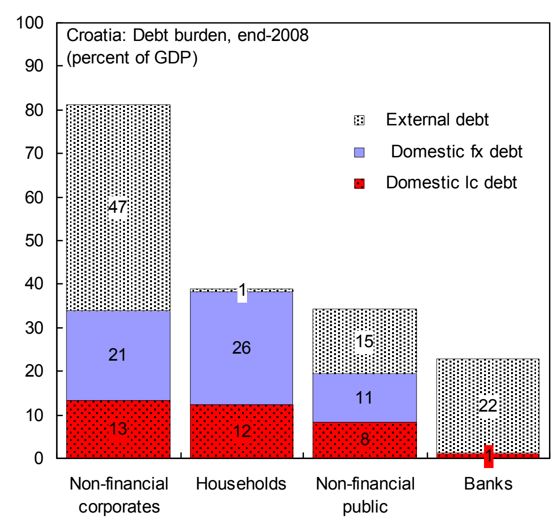
Box 1. Croatia's Reaction to Past IMF Advice

Croatia and the IMF have an excellent working relationship and a constructive policy dialogue. The authorities maintained a tightly managed exchange rate regime, in light of balance sheet exposures, and recognized the constraints this imposes on fiscal and structural policies to ensure adequate demand restraint and boost export growth and productivity. In this context, the headline general government budget balance was reduced in 2007–08, although budget revenue overperformance was partially spent, instead of saved as staff recommended. On financial sector policies, there was broad agreement on the need to strengthen prudential regulations to ensure adequate risk management in banks, but differences emerged on the nature of some administrative lending controls that staff advised against. The recommendations of the recent FSAP Update have been broadly implemented (Appendix I). On structural reforms, progress has been slow and Croatia still lags behind most other peer countries on business environment indicators. This said, the recently enacted health care reforms help relieve pressures and bring the system closer to sustainability.

At the time of the 2008 Article IV Consultations (concluded on May 16, 2008), Executive Directors welcomed strong economic growth in recent years, accompanied by improvements in policies. They noted in particular, the reduction in the general government deficit and continued strengthening of financial supervision. Concerns focused mainly on rising external imbalances, pointing out to the need for continued policy efforts to mitigate resulting imbalances and create an environment conducive to sustained high growth.

II. Balance Sheet Vulnerabilities and Strains

7. ***Heavy overall indebtedness.*** The debt burden swelled during a period of easy access to domestic and foreign financing. Push and pull factors played a role. A prolonged period of economic expansion and prospects of EU accession reduced Croatia's risk premium, pulling in large capital inflows, while the increased prospects of income convergence and easy access to domestic and foreign financing fueled domestic demand for credit. At the same time, cyclical conditions in mature markets combined with technological innovations in the financial industry pushed overwhelming capital flows to emerging Europe, including to Croatia. Notwithstanding CNB's efforts to curb credit growth and external borrowing through prudential and administrative measures, the corporate and household sectors accumulated quickly a heavy debt burden.[1]



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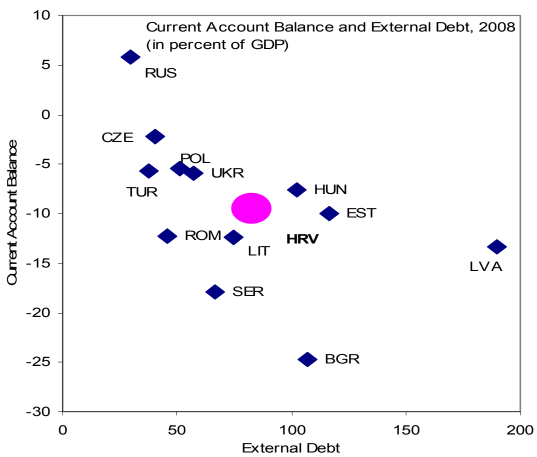
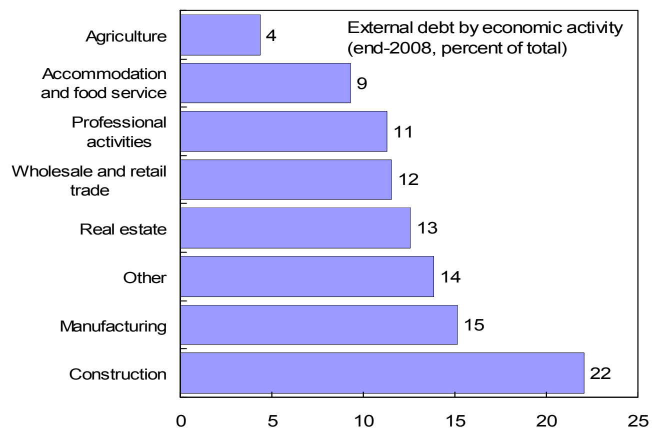
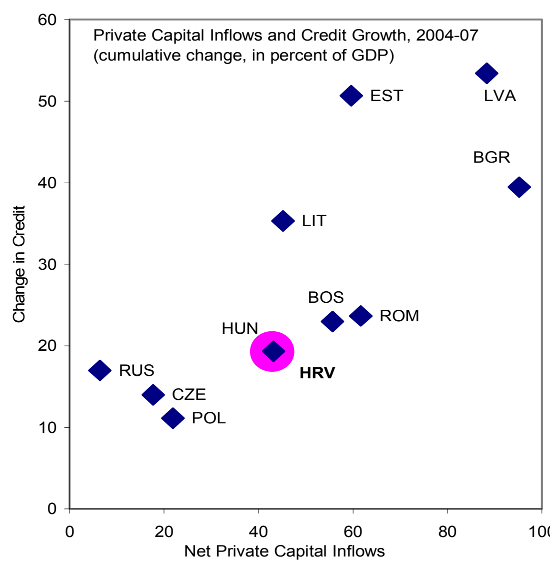
[1] Household debt as a share of GDP is one of the highest among CEE countries.

8. ***Large current account deficits and external debt***. While a part of financial inflows was in the form of FDI, external borrowing increased rapidly. To some extent, this was an inadvertent side effect of measures to rein in domestic credit growth, as corporates switched increasingly to external borrowing. Much of the external flows went into consumption and nontradables (construction, real estate, and wholesale and retail trade), feeding into higher imports and a widening current account deficit. At 83 percent of GDP (200 percent of exports), total external debt is relatively large. More importantly, external liabilities maturing in 2009 amount to €13 billion (some 29 percent GDP) giving rise to liquidity risks in the current adverse financial environment.



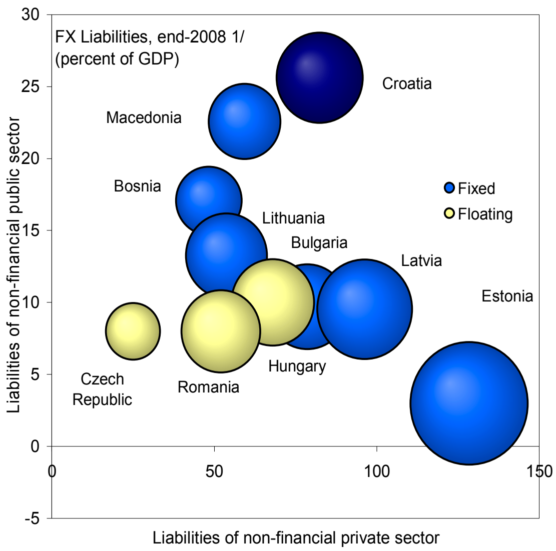


9. ***Rapid credit growth, although more contained than in peer countries.*** Banks, mostly foreign owned, were instrumental in intermediating capital inflows. With easy access to external funding and ample capital injections from parent banks—to avoid regulatory costs on foreign borrowing—bank credit as a share of GDP increased steadily from 53 percent in 2002 to 77 percent in 2008. About half of the loans were distributed to the household sector. While bank loans to the corporate sector are sufficiently diversified, the share of manufacturing or export-enhancing sectors is relatively small.



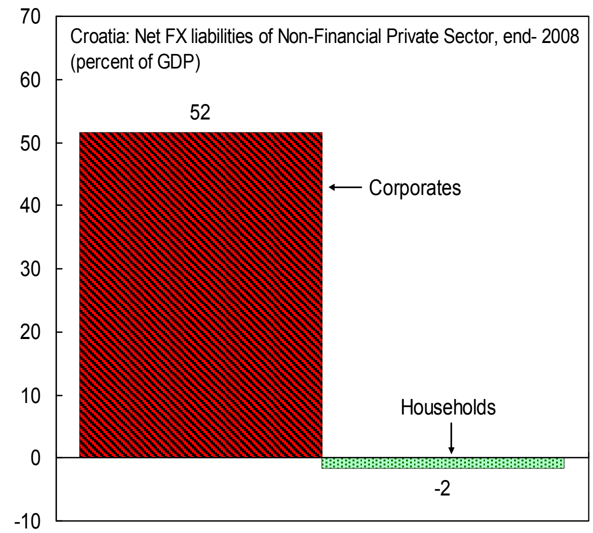
10. ***Significant balance sheet exposures to exchange rate risk***. Lower interest rates on foreign borrowing and foreign currency denominated loans became increasingly attractive for private sector borrowers, even if the private sector had no financial or natural hedges. About three quarters of corporate debt and 90 percent of household debt are external and foreign currency-denominated. Only a small fraction of bank loans (about 5 percent of household and 9 percent of corporate loans) are hedged. To some extent, high euroization of financial assets mitigates these foreign currency exposures. In particular, large foreign currency deposits by

households reduce currency mismatches at the aggregate level, although there could still be mismatches at the individual level between borrowers and depositors. Net foreign currency liabilities of the nonfinancial corporates remain large at around 50 percent of GDP.



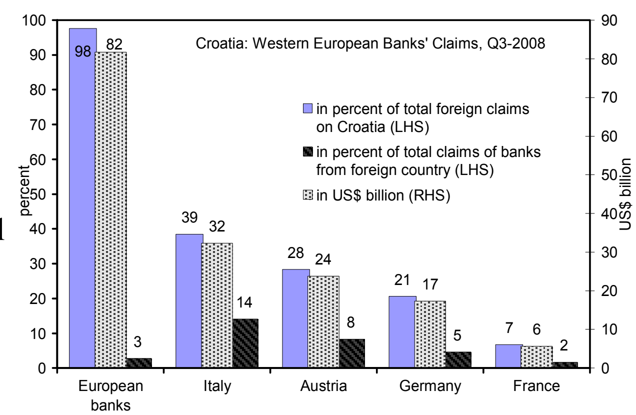
1/ Size of the ball represents net liabilities of non-financial private sector, ranging from 20 percent of GDP for Czech Republic to 93 percent of GDP for Estonia.

Source: CNB, WEO, IFS, and staff estimates.



11. ***Banks are well capitalized but vulnerable***. At end-2008, the aggregate capital adequacy ratio of the banking sector was 14.5 percent (vs. the regulatory minimum of 10 percent). This reflected the long-lasting preference of foreign parent banks to inject capital in their Croatian subsidiaries rather than to extend loans, which until recently were subject to high marginal reserve and foreign currency liquidity requirements. The level of nonperforming loans is relatively low (about 5 percent of total loans), with the nonperforming loans net of provisions standing at around 12 percent of the capital. These good indicators notwithstanding, banks are vulnerable to funding and credit risks.

- ***Funding risk***. While the loan-to-deposit ratio of Croatian banks of 113 percent compares favorably to that of other countries in the region, banks also became increasingly dependent on foreign funding. About one quarter of all bank liabilities is due to nonresidents (mainly to parent banks, concentrated in Italy, Austria, and Germany).[2] This has increased their vulnerability to external developments and contagion risks, both



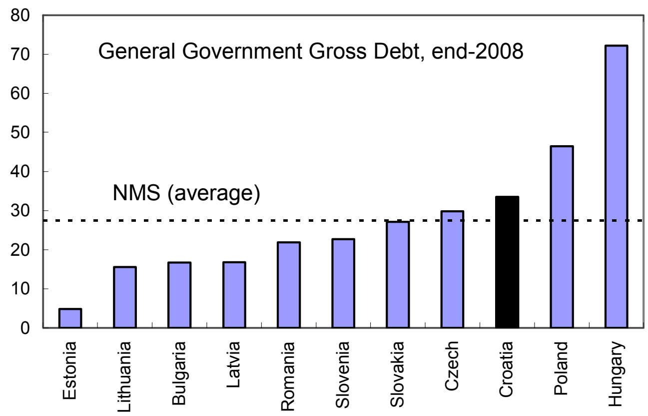
Source: BIS databases and IMF staff estimates.

[2] As of end-2008, about 70 percent of the EUR 10 billion external bank debt was owed to parents.

directly through their foreign funding needs and indirectly through conditions in their parent banks.

- ***Credit risk***. Although bank balance sheet mismatches in foreign currencies or interest rate are small, the large currency and interest rate exposures of the private sector could translate into credit risk for banks. The results of the most recent stress tests conducted by the CNB reaffirm banks' vulnerability to credit risk, particularly risks induced by an exchange rate depreciation.

12. ***The public sector balance sheet is relatively robust, although less so than elsewhere in the region.*** At around 34 percent of GDP, the government's total debt is moderate. About two thirds of this debt is in foreign currency. Including liabilities of HBOR, a state owned development bank, and state guarantees raises the total public debt to 43 percent of GDP.



Source: Croatian authorities; IMF, World Economic Outlook database; and Fund staff estimations.

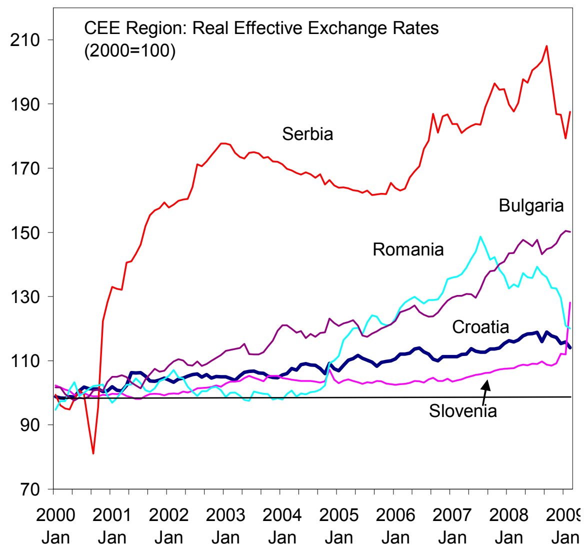
III. Competitiveness Concerns

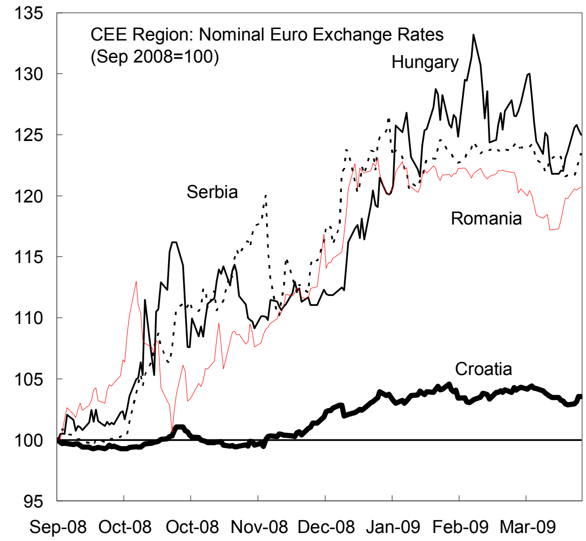
13. **A long period of nominal exchange rate stability accompanied by large trade deficits raise concerns about the adequacy of Croatia's competitiveness.** These are amplified by the recent strong depreciation of several competitor country currencies.

14. **The evidence on external competitiveness is mixed**. On the one hand, the real exchange rate has appreciated only moderately over the past decade compared to other CEE countries. Moreover, standard IMF analysis suggests that the real exchange rate is not significantly misaligned (Box 2).[3] However, the export sector has benefited little from the strong capital inflows (including FDI) experienced in recent years, and has been stifled by long-standing structural issues, an unfriendly business environment, and relatively high unit labor costs (Figure 2). Unlike in neighboring countries, the share of Croatia's small and narrow export sector in GDP remained flat over the past decade, and Croatia's share in world and EU imports has stagnated (Figure 3). As a result, growing imports responding to a consumption and inward-oriented investment boom, gave rise to large trade and current account deficits. Although the current environment is forcing a significant current account

[3] For a more detailed discussion of longer-term trends in competitiveness, see Republic of Croatia—Staff Report for the 2008 Article IV Consultation (IMF Country Report 08/158, May 08); and Republic of Croatia—Selected Issues, (IMF Country Report 08/159, May 2008).

adjustment (trade data for the first two months of 2009 suggest exports falling by 15 percent y-o-y and imports declining by a staggering 28 percent), a key challenge ahead is to improve tradable sector performance so that it can take up the slack from the nontradable economy.





Source: Fund staff calculations.

Box 2. Assessing Croatia's Real Exchange Rate

Quantitative estimates of misalignment suggest that Croatia's real exchange rate is close to its equilibrium, with most calculations indicating a modest overvaluation in the 2–3 percent range. These point estimates, however, need to be interpreted with caution given large uncertainty regarding structural changes and the pattern of capital flows in the years ahead.

Macroeconomic balance approach. The current account 'norm' was estimated based on the CGER panel regression coefficients (Croatia is included in the sample used in the panel regression). The underlying current account balance assumes that output gaps in Croatia and trading partners close over the medium-term, and is adjusted for the projected REER movement. Croatia's 'normal' deficit is about one percent of GDP below the underlying current account balance, implying an overvaluation of the exchange rate of 2.5 percent. Alternative measures for the norm that rely on Croatia's NFA position rather than its lagged current account balance as key fundamental do not change the picture qualitatively.

Table 1: Real Exchange Rate Assessment using CGER methodologies

Table 1: Macroeconomic Balance Approach

	Norm _CA	Norm_NFA1	Norm_NFA2
Current account norm (in percent of GDP) 1/	-2.7	-2.8	-2.5
Underlying current account balance (in percent of GDP) 2/	-3.5	-3.5	-3.5
Current account elasticity to REER 3/	-0.33	-0.33	-0.33
Implied REER adjustment (in percent, "+" appreciation)	**-2.5**	**-2.0**	**-2.8**

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.

2/ Underlying current account balance assumes that both domestic and foreign output gaps are closed and is adjusted for the projected REER movement during 2009-2014.

3/ CA elasticity to the RER is computed using the standard long-run exchange rate elasticities for imports (0.92) and exports (- 0.71), as well as exports and imports of goods and services (in percent of GDP) over 2000-08.

External sustainability approach. The extent of exchange rate misalignment was assessed by (i) computing the difference between the underlying current account and the current account that would stabilize the NFA position of the country at some benchmark level; and (ii) translating this difference into an exchange rate adjustment consistent with bringing the CA balance to its NFA-stabilizing level. Acknowledging the difficulties involved in determining an adequate NFA target with precision, the table above shows equilibrium current account balances for a variety of plausible levels conditional on the economy's growth performance. The analysis suggests that even in the case of a very conservative NFA target of -34 percent of GDP, which is less than half of Croatia's current NFA level, the degree of exchange rate overvaluation would remain below 5 percent.

Table 2: Benchmark NFA stabilizing CA balance (in percent of GDP)

	Real GDP growth assumptions				Implied REER change (baseline) 1/
	5.0	Baseline 4.0	3.0	2.0	
NFA benchmarks					
-74 percent of GDP (Q3, 2008)	-5.2	-4.6	-4.0	-3.4	**3.3**
-65 percent of GDP (2004-08 average)	-4.8	-4.2	-3.7	-3.1	**2.1**
-34 percent of GDP (EM average)	-2.5	-2.2	-1.9	-1.6	**-3.8**

1/ In percent, "+" implies appreciation.

IV. Macro-Financial Challenges

15. The combination of adverse feedback loops between vulnerabilities, primarily in private balance sheets, deteriorating financial conditions and a weakening economy, give rise to a number of policy challenges in the period ahead.

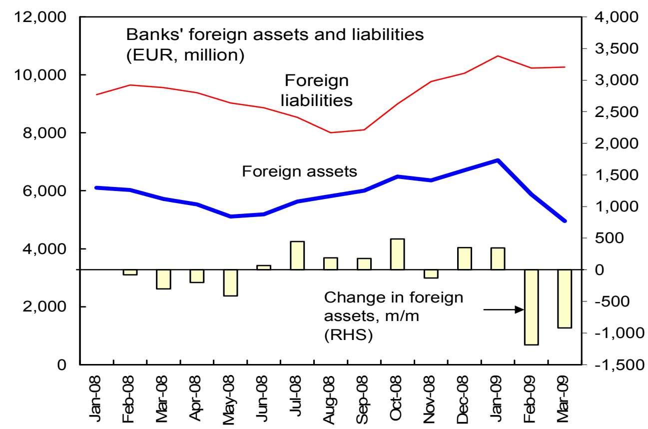
A. External Funding and Financial Stability

16. **While the impact of the global financial turbulence on Croatia was relatively limited in the first part of 2008, financial pressures intensified quickly in the second half of the year.**

- Financial asset prices became very volatile after October 2008, sovereign spreads shot up, and the Zagreb stock market plunged (Figure 4).

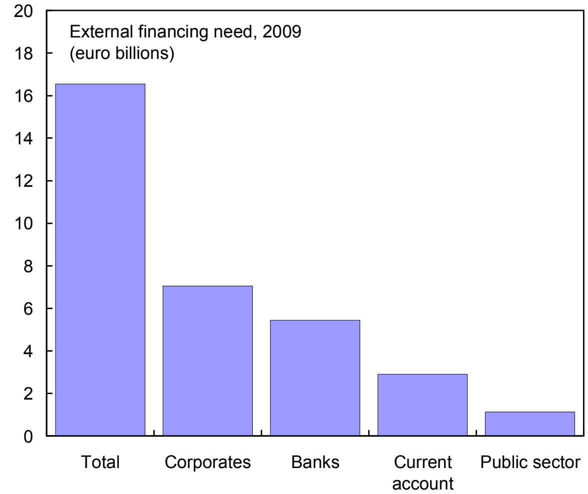
- External financing conditions tightened and the strong inflow of private external debt came to an abrupt halt in late 2008.

- Financial market jitters, including uncertainties about the financial health of parent banks, escalated to a mini bank run in October. Domestic banks responded to these pressures by increasing their foreign financing and, since January, by drawing down their foreign assets, facilitated by regulatory changes.



17. **In the fragile post-October environment, monetary policy was geared to support financial stability and maintain a broadly stable kuna**. The CNB addressed emerging liquidity shortages through active use of regulatory requirements and repo auctions, while it maintained policy rates (the repo auction rate) broadly stable at 6 percent (Box 3 for a list of measures). This together with intermittent intervention that resulted in a reserve loss of €0.9bn between September 2008 and March 2009 succeeded in stabilizing markets, strengthening confidence, and limiting the depreciation of the kuna against the euro (Figure 5). More recently, and particularly in late March and April, market sentiment started to show signs of improvement, spreads declined from their recent highs, and the exchange rate appreciated somewhat since March 2009.

18. **Notwithstanding this welcome improvement, Croatia's external financing needs are large and represent a key risk.** Banks and the corporate sector need to meet significant repayment obligations. Thus far, banks and most large firms have been able to roll over maturing debt, albeit at a higher price than in the pre-crisis environment. This indicates continued willingness of foreign parent institutions to maintain their exposure to Croatia. But small and medium-sized companies have found it increasingly difficult to raise new financing. For them, HBOR has started to offer a variety of working capital and other facilities.



Source: CNB, IMF staff estimates.

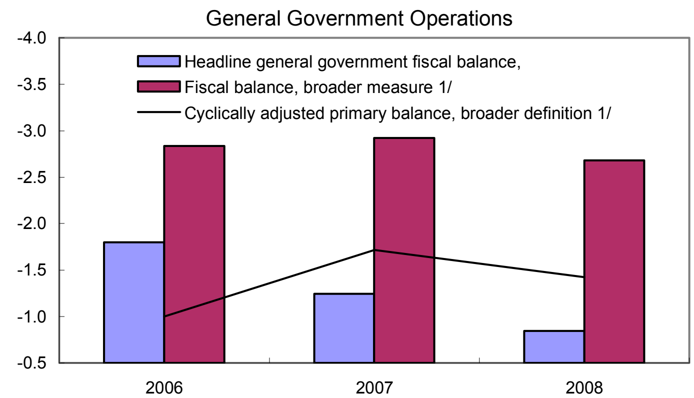
Box 3. Financial Measures in Response to the Crisis

- The amount of guaranteed bank deposit was increased from HRK 100,000 (€14,000) to HRK 400,000 (€56,000) in October 2008, after banks experienced a spate of household deposit withdrawals. In addition, the parliament authorized the government to increase the limit further if necessary. Together with adequate support from the CNB and parent banks, this measure helped stop and reverse deposit withdrawals.
- The marginal reserve requirement on banks' foreign borrowing was eliminated in October 2008. This facilitated attraction of new funds from parent banks abroad.
- The general reserve requirement was reduced from 17 percent to 14 percent in December 2008, and the foreign currency liquidity ratio was lowered in three steps from 32 percent in May 2008 to 20 percent, releasing liquidity in the system. In February, the CNB increased the limit on banks' open foreign exchange position from 20 percent to 30 percent. The resulting increase in bank liquidity helped stabilize the foreign exchange market and improve domestic credit conditions, and facilitated a €750 million syndicated loan of six domestic banks to the government.
- The CNB has tightly managed kuna liquidity through its weekly reverse repo transactions. In December 2008, the CNB increased the kuna share of allocation of reserve requirements on FX deposits from 50 percent to 75 percent to boost demand for kuna. These measures helped reduce selling pressure on the kuna, at the expense of increased volatility of interest rates on the interbank money market.
- In November 2008, the CNB simplified rules for bank access to the emergency liquidity assistance. This provided a signaling effect on the capacity of the CNB to act quickly, even though this facility has not been used so far.
- The government stepped up efforts to secure funds for the state development bank, HBOR, from international institutions to support exporters and SMEs.
- The authorities impressed upon banks the importance of keeping their profits in Croatia.

B. Public Finances Under Pressure

19. **Revenues have been weakening rapidly and budget financing has turned increasingly difficult (Table 2).**

- While revenue was buoyant for most of 2008, this situation turned around in late-2008. Tax revenue, particularly VAT and excises, started to underperform reflecting collapsing trade volumes and softening economic activity. For 2008 as a whole, revenues fell short of the budget target by more than 1 percentage points of GDP.



Source: Croatian authorities; and Fund staff estimations.
1/ Includes quasi-fiscal operations of HBOR and HAC, state-owned development bank and road company, as well as the so-called repayment of pensioners' debt.

- In response, the authorities reduced cash spending in late 2008, mainly on goods and services. But payment discipline also started to suffer, and the stock of arrears increased to about ½ percent of GDP at end-2008.[4] Overall, the general government budget deficit declined to 0.9 percent of GDP, compared with the budget target of 1.1 percent of GDP.

- Revenue underperformance continued in 2009. Budgetary pressures and lack of access to foreign financing forced the government to increase its domestic borrowing, increasingly in foreign currency.

- The authorities initially adopted a general government deficit target of 0.9 percent of GDP for 2009, but the worsening economic outlook made the budget approved in late December 2008 increasingly untenable. A revised budget was approved in April (see discussion in ¶38).

C. Credit Constraints and Solvency Concerns

20. **Domestic credit growth has held up, but headline numbers mask a significant shift in the structure of credit.** Since December 2008, government borrowing has increased significantly, offsetting a steady retrenchment of lending to households (Table 3). Corporate borrowing has remained high, as corporates have increasingly shifted toward domestic sources of financing. In the absence of new foreign funding, bank competition for deposits

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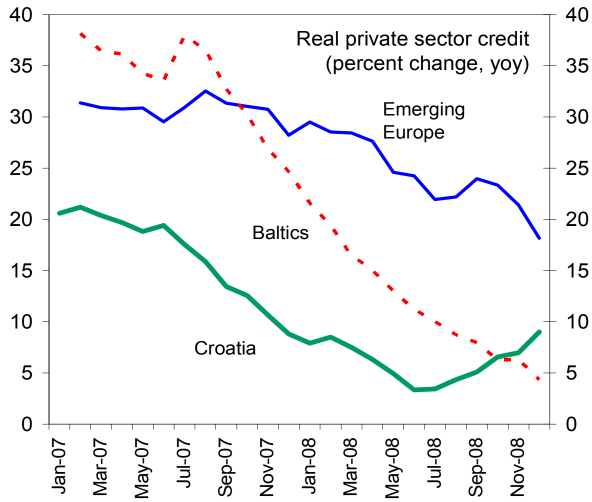
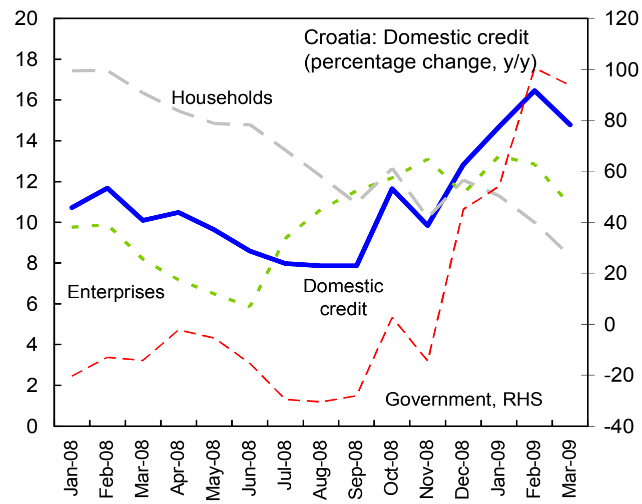
[4] Most of the arrears relate to overdue payments for goods and services.

has increased. In March–April, interest rates on new deposits doubled to 6.5–7 percent from 3.7 percent in September 2008.

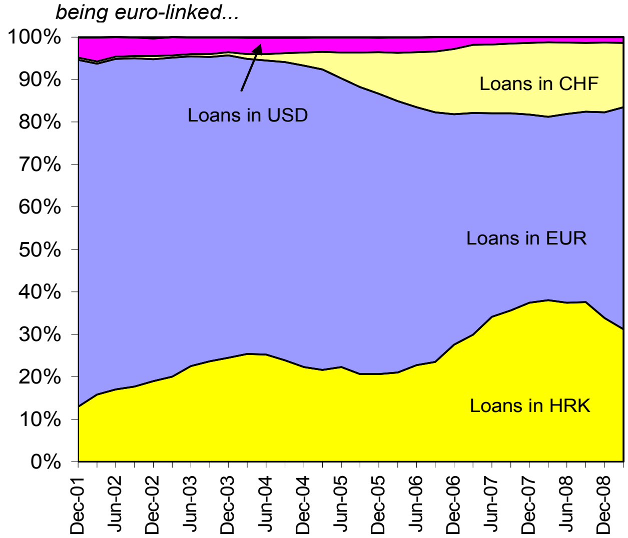




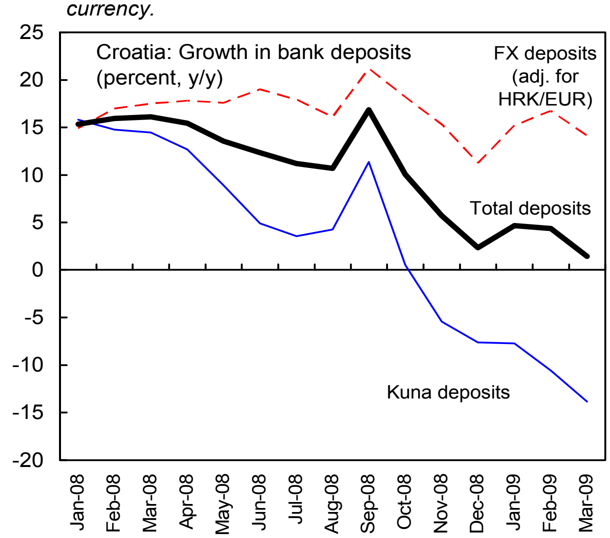
21. **Lending conditions are likely to become tighter.** With increased public sector demand for credit, tightening lending standards, and higher risk aversion, credit constraints are likely to emerge. Corporates (households) are likely to experience pressures on both sides of their balance sheet as sales (income) come under pressures while the cost of funding has increased. The deepening recession and tightening of funding conditions will likely cause nonperforming loans to increase.

22. **The intensification of financial euroization is a reflection of higher risk perceptions**. Foreign currency deposit now accounts for over 60 percent of all deposits, and almost all new lending in 2009 is linked to foreign currencies (Figure 6).

Financial euroization is intensifying, with all new credit being euro-linked...



...and bank deposits increasingly shifting towards foreign currency.



V. Outlook

23. **With the global environment and domestic conditions unsettled, projections are subject to an unusual high degree of uncertainty.** Real GDP growth has been marked down to -3.5 percent for 2009 on the back of declining consumption and investment. As prospects for a recovery in Europe and normalization of financial markets are fragile, growth is expected to remain subdued in 2010 (0.3 percent), weighed down further by weak domestic demand conditions (Table 4). Inflation is projected remain low in the coming years (under 3 percent), in view of downward pressures on prices from the output gap.

24. **The current account deficit is projected to shrink considerably, but would still leave significant external financing needs, exceeding €16 billion in 2009 and €13 billion in 2010 (Tables 5–7)**.

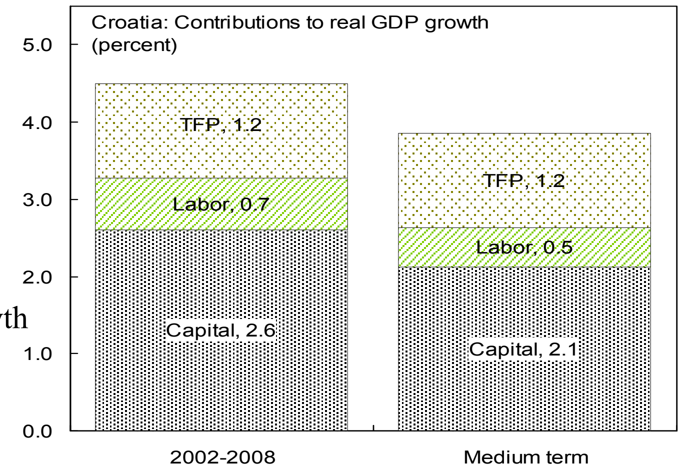
- Private capital inflows are projected to cover most of the external financing needs. These would decline sharply but remain positive, with (i) sizable FDI inflows reflecting mainly retained earnings of foreign banks and corporates; (ii) a moderate drawdown of bank foreign assets; and (iii) rollover of about 90 percent of maturing debt, reflecting recent experience and strong commitments from parent firms to maintain exposure to local subsidiaries and corporate clients. The public sector is assumed to place a eurobond and increase its access to financing from the World Bank, the European Investment Bank, and other multilaterals. External financing conditions would normalize in 2010. Under these assumptions, central bank reserves would fall by about €1.6 billion in 2009 and €0.6 billion in 2010.

- Potential deviations from this path are possible, both on the upside but particularly on the downside if the ongoing global financial turmoil were to persist or deepen. An alternative scenario highlights the sensitivity of the outlook to changes in the behavior of Croatia's foreign creditors. Assuming that banks could only rollover 85 percent and non-FDI corporates only 60 percent of their long-term debt (and 95 percent and 80 percent of their respective short-term debt) in the remainder of the year (with assumptions for the current account and FDI unchanged), the loss of central bank reserves would increase to €2.5 billion in 2009, reducing the reserve cover of short-term debt (by residual maturity) to about 60 percent.

25. **The authorities broadly agreed with the risk assessment in the staff's analysis**. Ministry of Finance officials considered that a softer growth downturn of about 2 percent could still be possible, based on expectations of stronger recovery in the second half of the year. CNB officials, however, were more pessimistic, concerned with downside risks, and expect a GDP contraction of 4 percent. Private sector forecasts ranged between -2 and -5 percent while the consensus forecast centered at -3 percent. The authorities considered the staff's financing assumptions under the baseline and particularly under the alterative scenario to be overly pessimistic.

26. **Over the medium-term, growth is expected to resume, but is unlikely to recover to the pre-crisis trend.** With capital inflows and capital accumulation below their recent boom levels potential output is likely to stay below the pre-crisis levels even with a favorable contribution from total factor productivity. To achieve historical growth rates of 4–5 percent over the medium-term, the competitiveness of the economy needs to improve considerably.

Lower capital accumulation will need to be compensated by higher TFP



Source: CROSTAT, IMF staff estimates.

VI. Policy Discussions

27. Given the risks in the current juncture, discussions centered on policies to increase the resilience of the economy to the ongoing turmoil and reduce vulnerabilities.

A. Preserving Market Stability and Anchoring Expectations

28. **Exchange rate and financial stability remain at the center of the authorities' policies.** They view these two as interlinked and inseparable objectives. While some limited exchange rate flexibility has been allowed in recent months, the authorities are determined to avoid a sharp exchange rate depreciation that could lead to large balance sheet effects undermining financial stability and cause a sharp adjustment in inflation expectations. They are aware that the large current account deficits in recent years would need to be reduced to more sustainable levels. But they noted that fiscal consolidation to contain domestic absorption and structural reforms to improve export competitiveness and support shifting resources from the nontradable to the tradable sector can help deliver this adjustment.

29. **Staff acknowledged the difficult trade-offs involved in deciding on the exchange rate policy.** On the one hand, the existing policy has provided a valuable nominal anchor, there is little evidence of a significant exchange rate misalignment, and a sharp depreciation could have large balance sheet effects. On the other hand, rising labor costs in combination with exchange rate depreciation in some neighboring countries risk eroding competitiveness, hampering growth potential, and widening imbalances in the future. Staff emphasized that the authorities' exchange rate strategy would require securing adequate external financing and strong macroeconomic policies to bolster market confidence. In addition, crisis management should not detract from the urgent need to make swift progress with structural reforms.

30. **In the near term, a cautious monetary policy would be required until balance of payment pressures abate**. The CNB's active liquidity management through repo auctions and Lombard loans and relaxation of reserve and liquidity requirements have helped alleviate tensions. But staff noted that the recent practice of setting the repo rate and rationing the amount auctioned has led to a nontransparent system and increased interbank market rate volatility. Staff and the authorities agreed that overall liquidity conditions in the banking system would need to remain tight, constrained by the need to reduce pressures on the kuna. Bolstering market confidence is key, including to help prevent further financial euroization. The latter increases currency risks, undermines the effectiveness of monetary policy, and limits policy options down the road. Staff viewed the recent increase in the kuna share of allocation of reserves requirements on FX deposits and lowering of the foreign currency liquidity ratio as steps in the right direction, providing stronger disincentives to further euroization.

31. **Tight liquidity conditions, increasing risk premia, and a more cautionary attitude by banks would likely constrain credit growth**. So far, credit growth has been strong, but could slow down considerably in the period ahead. While the CNB reduced reserve requirements to ease banks' lending constraints, the ability of monetary policy to respond to domestic credit conditions should be carefully weighed against exchange rate pressures. In this context, fiscal policy would need to be supportive of monetary policy objectives and the public sector's borrowing needs should be contained to avoid crowding out private sector lending.

B. Preparing the Banking Sector for a Difficult Period Ahead

32. **Aided by tight prudential requirements, banks entered the crisis with relatively strong profitability and capital positions**. Strong prudential ratios, including high liquidity requirements and risk weighting for foreign currency lending, have generated a cushion for banks (Figure 7, Table 8).

33. **Although the banking sector has been resilient, it remains vulnerable to liquidity risks**. The CNB has intensified its monitoring of liquidity and credit risks and is prepared to intervene, if necessary, in case of adverse liquidity shocks. Reserve requirements provide partial liquidity cover of banks' liabilities and therefore some protection in the event of liquidity pressures. To expand policy space, the authorities have also simplified and enhanced access of banks to the CNB's emergency liquidity assistance window.

34. **The authorities recognize the crucial importance of securing high roll-over rates on maturing external liabilities to reduce banks' liquidity risk**. To this end, they maintain close cooperation with foreign parent banks and their home supervisors. Through the first quarter of 2009, the roll-over rates on liabilities to parent banks have been around 100 percent. But in the current unsettled environment, the prospects of smooth refinancing can not be assured, including because of regional spillovers, and, therefore, continued vigilance would be required.

35. **The weak macroeconomic outlook requires preventive measures to strengthen the banking sector**. The economy is in unchartered waters, with a dramatic downturn at a time when corporate and household leverage are at historic high levels. Banks credit portfolios are likely to weaken in the period ahead. The authorities have strengthened their stress testing capabilities and have updated these tests recently.[5] However, the underlying assumptions still remain optimistic relative to the economic outlook. It would be important that the authorities undertake a diagnostic review of the financial condition of all individual Croatian banks, based on stress tests to identify banks which need to enhance their capital buffers. These should be required to present a viable program to increase their capital. To avoid a negative impact on credit growth, the capital increase should be achieved by further injections by shareholders. In this regard, staff welcomed the intention of the largest banks to restrict dividend payments.

36. **The authorities have taken steps to improve preparedness to manage a potential crisis**. The CNB should continue to monitor closely bank risk management policies and lending standards, in order to be able to promptly address any emerging risks. At the same time, the framework for resolution of troubled assets should be upgraded. The authorities should proceed with the planned adoption of the new foreclosure law which would help speed up the resolution of bankruptcies. An efficient foreclosure framework, including through the introduction of private bailiffs, which is envisaged under this new law, would complement the voluntary restructuring of problem loans through refinancing and lengthening of maturities, as contemplated by banks as a first line of defense against the anticipated increase in distressed assets

37. **The planned formalization of the interagency coordination on crisis preparedness and management should be advanced**. While many elements of Croatia's contingency framework to deal with banks in distress are consistent with international best practices, there is no formalized mechanism for interagency coordination on crisis preparedness and management.[6] A memorandum of understanding between various agencies dealing with financial stability issues (Ministry of Finance, CNB, HANFA, and deposit insurance fund) is currently under preparations, and is expected to be adopted shortly. As other countries' experience shows, having an *ex ante* formalized mechanism for communication among authorities should facilitate effective action.

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[5] The most recent stress tests conducted by the CNB based on the end-September 2008 data show that banking sector resilience to macroeconomic shocks is strong. In a scenario of 2 percent decline in GDP and a 10 percent depreciation of the exchange rate, the nonperforming loan ratio would increase by 120 percent from its low base, but the capital adequacy ratio would fall by only 2.2 percentage points (see details in the CNB's Financial Stability Report, No 2, 2009).

[6] Recent amendments to the laws on credit institutions and deposit insurance addressed a number of weaknesses. For example, the legal protection of the CNB was strengthened and the timeline for payments of insured deposits was shortened.

C. Fiscal Discipline Remains Key

38. **The revised budget adopted in April is targeting a general government budget deficit of 1.6 percent of GDP**. Compared with the original budget, revenues are projected to decline by 2.9 percentage points of GDP, mainly on account of lower VAT and social security contributions. Spending is set to decline by 2.2 percentage points of GDP, through a wide range of spending cuts, including a freeze of salaries of civil servants and state employees.[7]

Central Government: Differences between the Original and the Revised 2009 Budget Plans.
(In millions of kunas)

Revenue shortfall	8,033
Expendture savings	5,413
Current	4,798
Compensation of employees	1,389
of which: salaries	1,029
Use of goods and services	883
Subsidies	318
Grants	520
Social benefits	709
Other	972
Capital	615
Difference	-2,620

Sources: Croatian authorities; and Fund staff estimates.

39. **Staff agreed that the deficit target, which implies a cyclical tightening of 1 percent of GDP in 2009, was broadly appropriate**. Croatia's vulnerable external position, tight domestic financing conditions, and the need to preserve space for crisis-related contingencies leave little room for a more accommodative stance.

40. **However, a more negative macro outlook than assumed in the budget would result in a higher deficit**. Staff considered that the deficit could exceed 2.0 percent of GDP, and the discussions focused on risks to budget execution. In particular, the budget is optimistic in the VAT collection projections and the recent sharp decline in VAT revenues shows their sensitivity to the economic cycle. Social security contributions may also be lower than envisaged in the budget, reflecting the rapidly weakening economy. Broader tax collection efforts could also weaken in the downturn. On the other hand, pressure for more government spending is very strong. Staff urged the authorities to rein in spending commitments to achieve the budget deficit objective and avoid the re-emergence of public sector arrears, which can have damaging ripple effects throughout the economy, undermining payment discipline. In this context, staff welcomed the recent health sector reforms to improve cost recovery, including through income-tested increase in co-payments and premia, aimed at reducing the stock of overdue payments.

41. **To prevent a higher deficit, a strategy should be developed to**: (i) contain a possible decline in taxpayers' compliance, including by public enterprises, focusing on highest revenue risks and improving tax administration; and (ii) develop contingency measures that could be adopted quickly with a supplementary budget. Spending restraint should be the lynchpin of any adjustment since the expenditure-to-GDP ratio in Croatia is among the highest in the region, while the tax burden is among the heaviest, discouraging

[7] The 6 percent annual wage increase granted in 2006 as part of a three-year agreement with the labor unions was suspended until GDP growth exceeds 2 percent for two consecutive quarters.

employment and labor force participation. Possible measures include curtailing subsidies; improving cost recovery for social services; containing the growth of privileged pensions; better targeting social benefits while protecting the most vulnerable; and scaling back the public investment program. The authorities noted recent improvements in tax collection and the increase in the assessment base for social welfare in line with previous staff advice. They argued that the introduction of tax identification numbers (TIN) and the ongoing upgrading of information technology at the tax administration office would further support tax efforts and help better target social benefits.

42. **The budget deficit should be financed without putting undue stress on the banking system.** Staff estimates the gross financing requirement at about 11 percent of GDP, to which the borrowing requirement of public enterprises for quasi-fiscal operations would add another 2 percent of GDP. Of this, short-term treasury bills account for about 5 percent of GDP, which are rolled over as they mature. The February syndicated loan and a planned eurobond placement in May would cover about 3½ percent of GDP, leaving a residual borrowing need for the general government of about 2½ percent of GDP. To avoid crowding out private sector credit, the authorities should advance their efforts to increase absorption of EU and World Bank funds.

43. **The authorities agreed that a supplementary budget might be needed, but stated that it was too early to have another revision to the budget**. They explained that they would pursue further expenditure cuts even without a supplementary budget to avoid a significant deviation from the budget balance, pointing to the experience in late 2008, when spending cuts more than offset the underperformance of revenues and reduced the budget deficit below the 2008 budget plan target.

44. **For 2010, there was agreement that the fiscal policy stance needs to be supportive of the overall policy framework and bolster the structural fiscal position**. The authorities have not yet announced their specific intentions for 2010 given large uncertainties ahead. Staff's baseline projections suggest that a (headline) deficit of 2½ percent of GDP could be reached by a modest structural improvement. However, staff noted that structural reforms would be needed to put public debt back on a declining path and roll back the weight of the public sector in Croatia's economy. Given the large share of entitlements in the budget, civil service reform and rationalization of the structure of government operations is urgently needed. In addition, the restructuring of loss-making SOEs should be advanced to reduce subsidies on a permanent basis. Finally, while the pension system needs to be reformed, staff urged the authorities to refrain from changing the second pillar of the pension system. This could have a devastating effect on already battered capital markets and erode investor confidence. Instead, staff recommended reforming the pay-as-you-go Pillar I of the pension system to ensure its sustainability in line with recommendation of the 2008 IMF report on expenditure rationalization.

D. Advancing Structural Reforms

45. **Staff and the authorities agreed about the need to accelerate structural reforms.** In an environment of reduced capital inflows, productivity needs to improve to achieve growth rates in excess of 4 percent over the medium term as envisaged by the authorities. There was agreement that the emphasis needs to be given to judicial and administrative reforms and anti-corruption measures (key areas for strengthening the business environment), as well as restructuring and privatization of loss-making SOEs, and improving flexibility in labor markets (Figure 8). On the latter, staff recommended reforms to address incentive structures both on the (labor) supply and demand side, including measures to reduce significant labor supply disincentives (e.g., incentives for early retirement and very generous benefits for parts of the labor force); and measures to boost labor demand by reducing rigidities in the formal labor market, which are large by regional standards.[8] On SOEs, staff welcomed the authorities' intention to restructure and privatize the shipyards in 2009 and urged the authorities to accelerate the restructuring and final privatization of the subsidiaries of the railroad company and state assets held in the Privatization Fund.[9]

VII. Staff Appraisal

46. **Croatia's recent solid growth performance has been disrupted by the worst global crisis in sixty years.** Confronted with strong headwinds from the regional downturn and the still unsettled financial markets, domestic demand and trade flows are declining rapidly and labor markets have begun to soften. Growth is expected to decline by about 3.5 percent in 2009, and to remain sluggish in 2010.

47. **In this fragile juncture, economic and financial stability hinges crucially on the maintenance of strong policies.** Private sector indebtedness swelled during a period of ample liquidity, with a large part of the financing supporting consumption and nontradable sectors. Now, vulnerable private sector balance sheets and significant external financing needs pose risks and constrain policy flexibility. The authorities have the difficult task of facilitating an orderly private sector adjustment to more sustainable levels of current account deficit and debt, while cushioning the impact of the crisis. They are determined to keep the kuna broadly stable. In this period of heightened uncertainty, the current exchange regime provides a useful anchor. But it is also constraining other policies and limits policy space to cushion the downturn. Most importantly, it needs to be supported with adequate external financing, continuing efforts to limit the financing needs of the public sector, and a faster pace in implementing structural reforms to help the recovery and lessen future external imbalances.

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[8] While some progress has been made in increasing labor market flexibility, Croatia has unusually low participation and employment rates, as well as high rates of youth and long-term unemployment.

[9] As of April 2009, the fund's portfolio comprised 850 companies, in 87 of which the state is a majority owner.

48. **Monetary policy has been supportive of external and financial stability**. The policy stance has been tight, while the CNB's liquidity management operations through repo auctions and loans and changes in the reserve and liquidity requirements have helped alleviate liquidity pressures. Cautionary policy should continue until external pressures abate.

49. **The authorities have rightly focused on ensuring adequate external financing.** High debt rollovers are needed to protect bank and corporate balance sheets and thus support financial stability and a stable exchange rate. The CNB should continue to monitor banks' debt exposures and maintain already close cooperation with home supervisors of foreign parent banks. Going forward, rollover risks may become more pronounced particularly in the corporate sector, including public enterprises. In this regard, it would be important to track developments closely, using the CNB's monitoring system to obtain relevant information on banks and their most important corporate clients.

50. **The financial sector needs vigilant supervision, larger capital buffers, and measures to strengthen the contingency framework to deal with banks in distress**. Although bank solvency ratios remain satisfactory, the economic downturn will weaken bank credit quality and increase vulnerabilities. Staff encourages the authorities to undertake a diagnostic review of the financial conditions of all banks, and those with potential recapitalization needs should be asked to raise their capital buffers. The authorities should also proceed with upgrading the framework for resolution of troubled assets and the adoption of the new foreclosure law to speed up resolution of corporate and household bankruptcies. Many elements of the contingency framework are consistent with international best practice. However, the authorities should proceed quickly to adopt a memorandum of understanding on crisis preparedness and management coordination between various agencies dealing with financial stability issues to facilitate an effective response if needed.

51. **A strong fiscal policy is key to weathering the crisis.** The revised budget deficit target is appropriate under current circumstances. A cyclical tightening was necessary in view of tight external conditions and the risk of government financing crowding out lending to the private sector. Were the creditworthiness of the government to come into question, risk premia would increase, financing conditions would worsen, and pressures on the currency would intensify. To achieve the current fiscal target and avoid the re-emergence of public sector arrears, the authorities will need to rein in spending commitments, including through a supplementary budget; and develop a strategy to contain a possible decline in taxpayers' compliance. The financial situation of public enterprises should be carefully monitored to reduce risks from contingent liabilities.

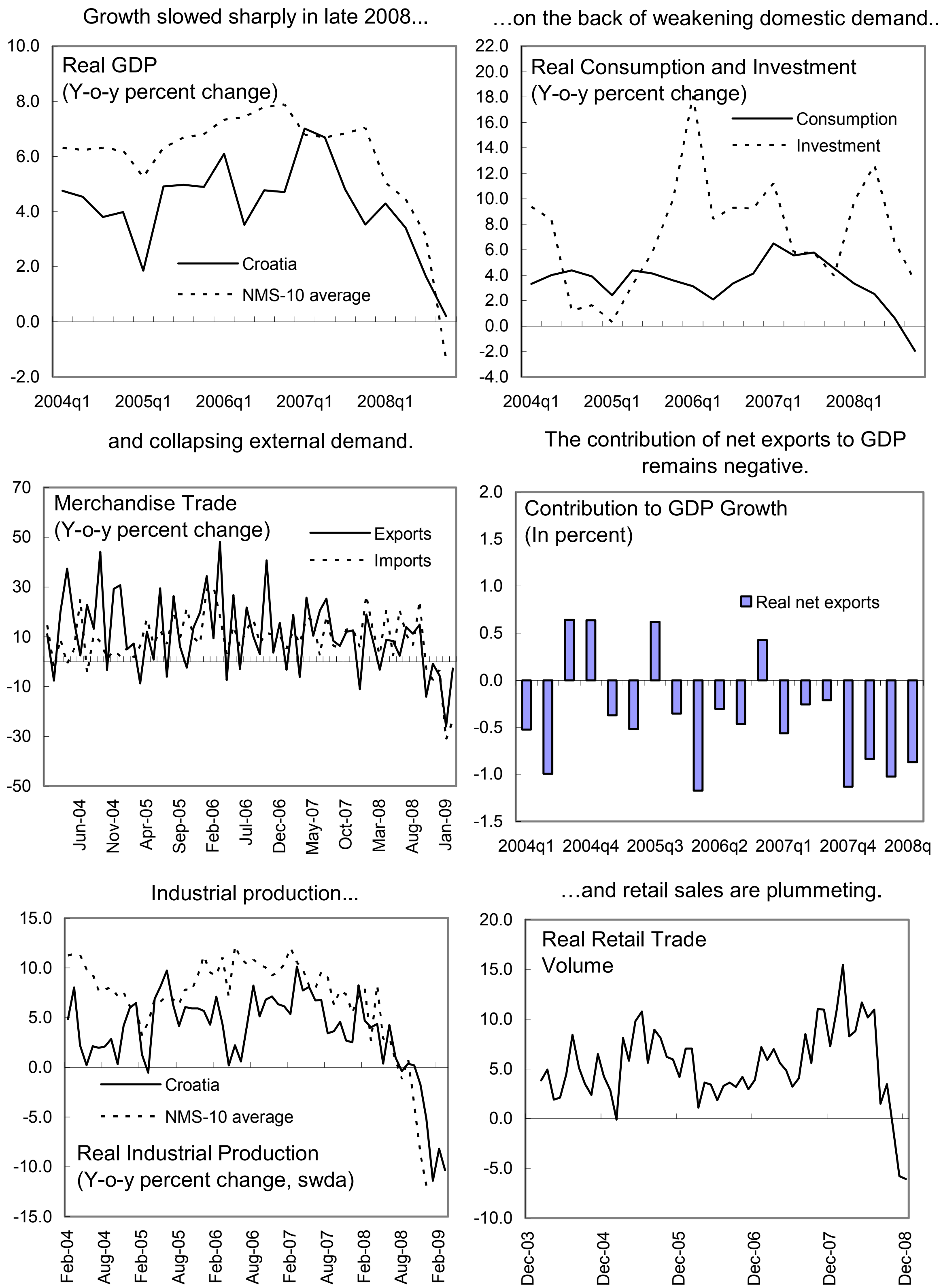
52. **A credible fiscal position is needed to ensure medium-term sustainability and maintain market confidence.** Reducing budget rigidities and rationalizing public spending while improving the quality of public services will go a long way toward durably scaling back the weight of the government in the economy. There is room in 2009 for starting with a civil service reform, and rationalization of the structure of government operations. Other desirable measures include improving cost recovery for social services, advancing the restructuring of loss making SOE to reduce subsidies, streamlining social spending by

making use of the recently adopted tax identification numbers, and reforming the first pillar of the pension system to help ensure its sustainability.

53. **Crisis management should not detract from the need to tackle long standing structural shortcomings.** The economy needs to emerge from the current juncture more resilient and dynamic. To help raise potential growth and narrow the current account deficits, faster and deeper reforms are needed to reorient the economy towards the tradable sector. This involves notably raising labor productivity and improving the business environment. The privatization of loss making SOEs also needs to be completed swiftly. In this regard, the restructuring and privatization of the shipyards in 2009 would send a strong signal to investors, support ongoing EU accession negotiations, and help contain the significant drain on the public resources.

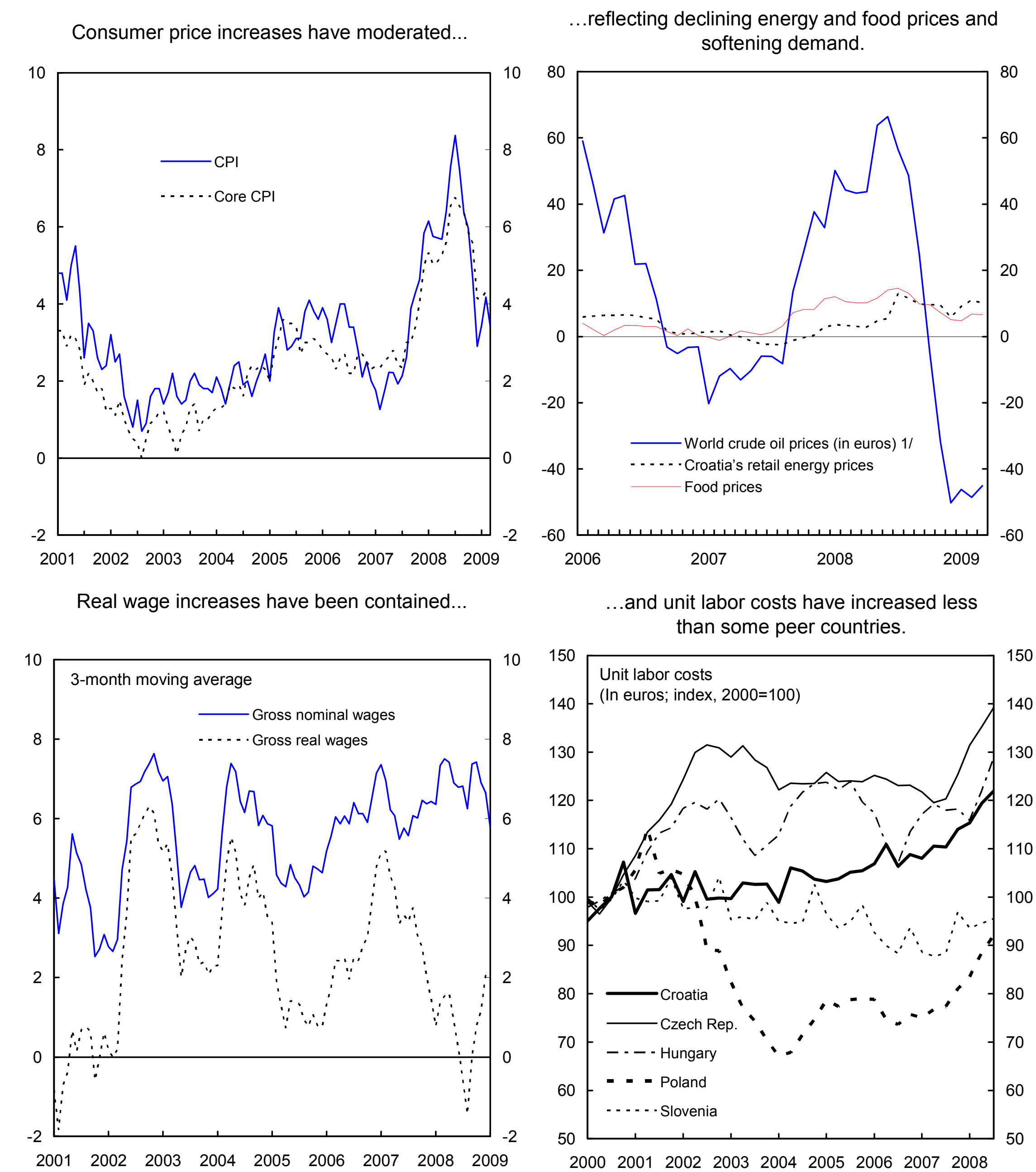
54. It is proposed to hold the next Article IV Consultation on a 12-month cycle.

Figure 1. Croatia: Macroeconomic Developments, 2004–08



Source: Haver; and Fund staff estimations.

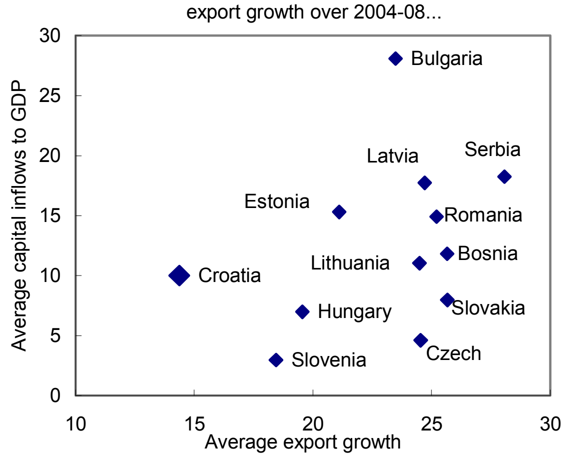
Figure 2. Croatia: Inflation and Wage Developments, 2001–09
(Year-on-year percentage changes)



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 3. Croatia: External Sector Developments, 2000-08

In Croatia, capital inflows were not associated with strong export growth over 2004-08...



...and FDI, often a key source of knowledge transfer, went into inward-looking sectors.

Inward FDI flows, receiving sectors (avg. sectoral shares over 2004-2008 period)	
Financial intermediation	44
Real estate	8
Refined pretroleum	8
Wholesale trade	6
Retail trade	5
Oil & gas extraction	5
Hotels & restaurants	3
Other	21
Total	100

Source: Croatian National Bank.

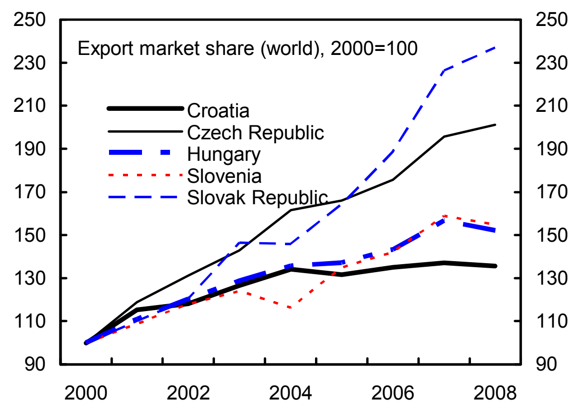
Competitiveness indicators flag structural issues relative to Croatia's peers.

--Croatia ranks 106th out of 181 countries in the World Bank's 2009 Doing Business Report.

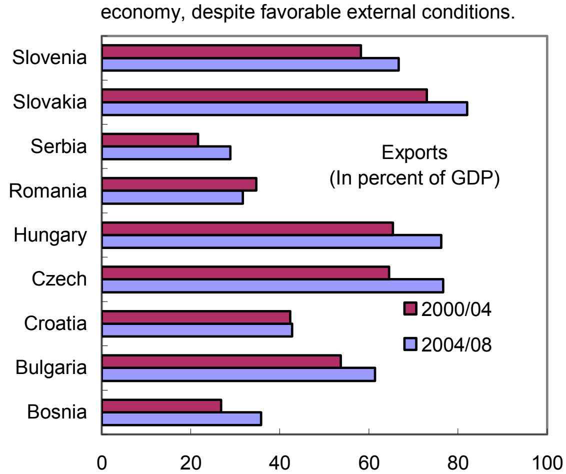
--In the region, it scores lower than Bulgaria (45th), Romania (47th), Macedonia (71st), Czech Republic (75th), Poland (76th), Belarus (85th), Albania (86th), Montenegro (90th), and Serbia (94th).

--Key problem areas are employing workers, obtaining construction permits, and protecting investors.

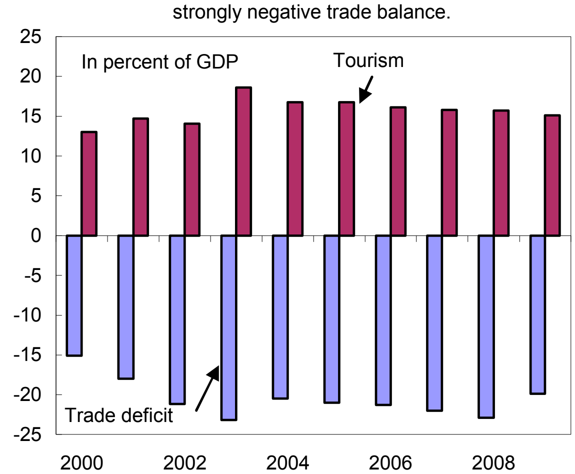
Export market share has held steady...



…and the export sector did not increase its weight in the economy, despite favorable external conditions.

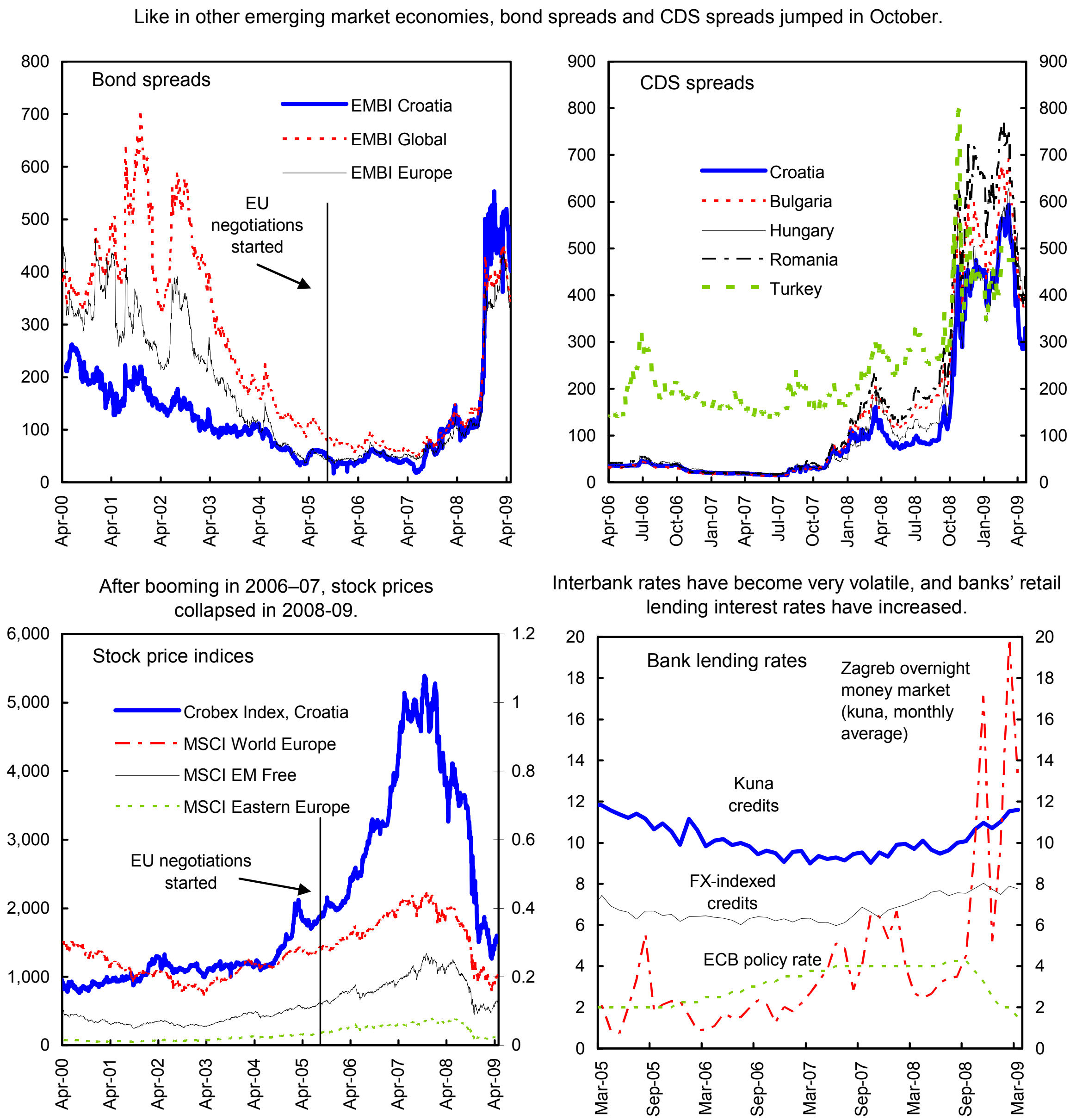


Strong tourism receipt have been key to mitigate a strongly negative trade balance.



Sources: Croatian National Bank; World Bank Doing Business; and IMF staff calculations.

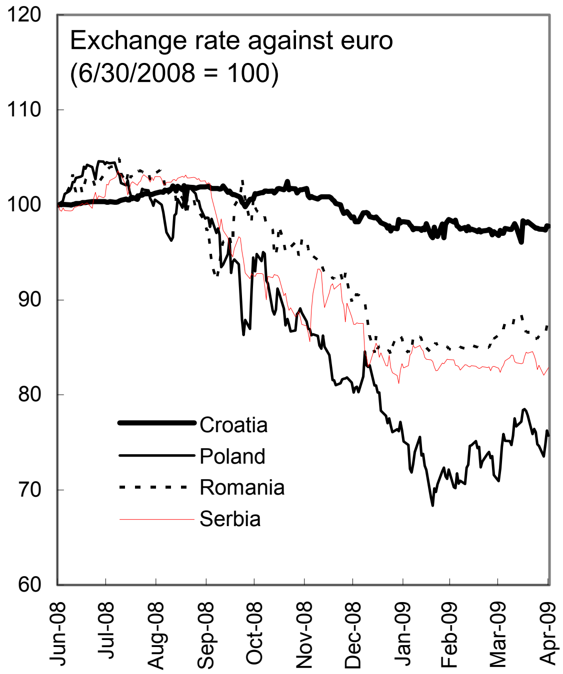
Figure 4. Croatia: Financial Market Conditions, 2000–09
(In basis points)



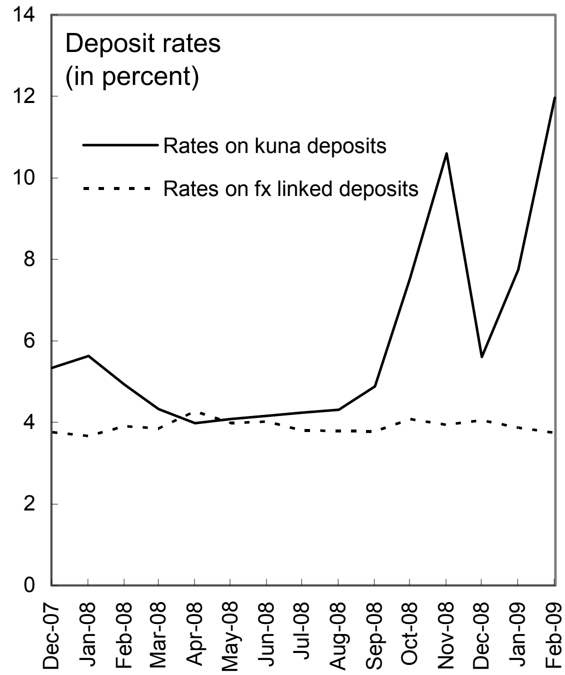
Sources: Croatian National Bank; Haver Analytics; and JP Morgan/Bloomberg.

Figure 5. Croatia: Foreign Exchange Market, 2007-09

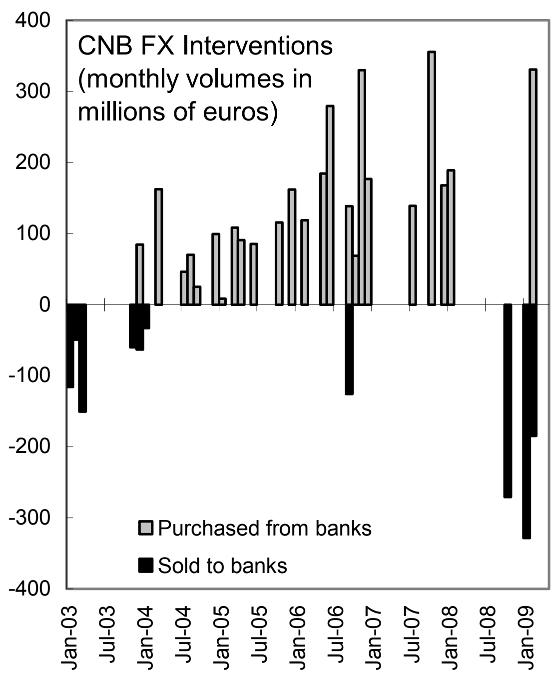
Notwithstanding pressure, the exchange rate has been relatively stable.



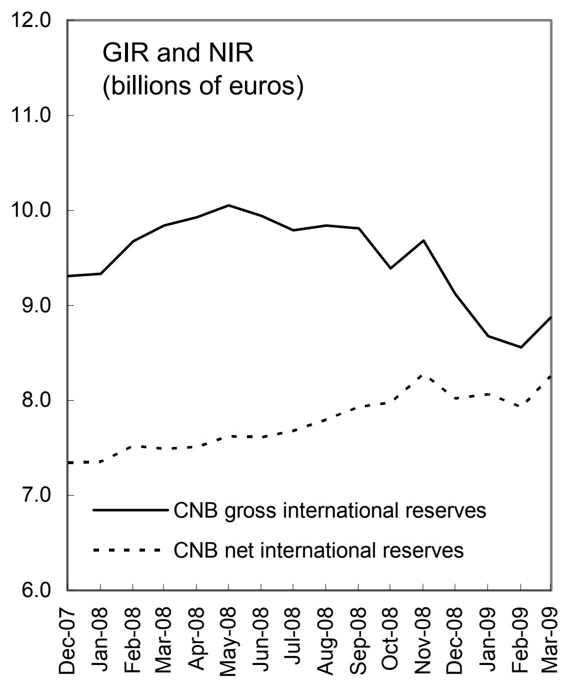
The spread between kuna and foreign currency deposits has widened.



The CNB intervened directly to prop up the value of the kuna...

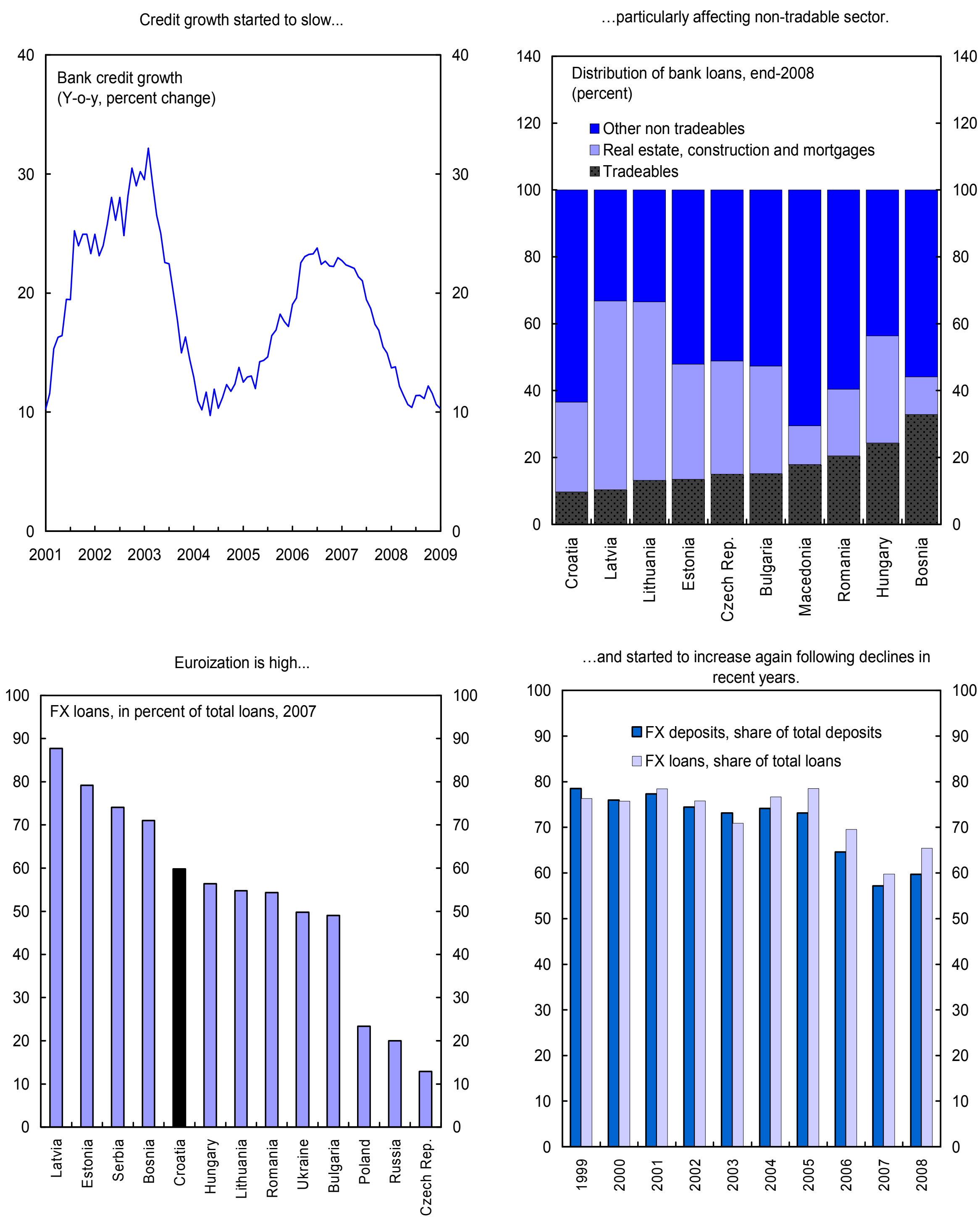


… and reserves declined.



Source: Bloomberg; and CNB.

Figure 6. Croatia: Credit Developments, 2001–08

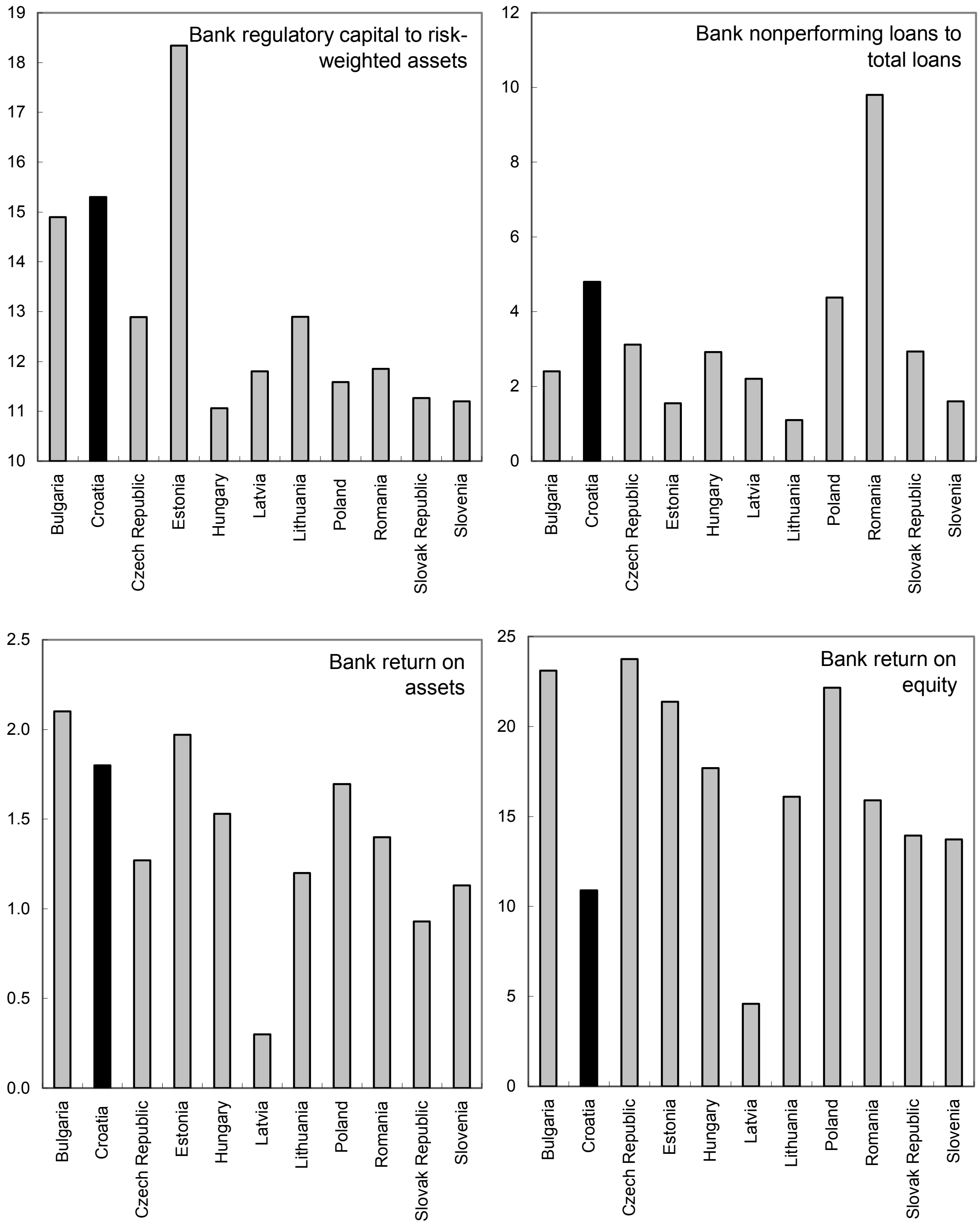


Sources: Croatian National Bank; the accompanying Financial Sector Stability Assessment Update; and Fund staff calculations.

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 7. Croatia: Banking Performance, 2008 1/

Backward looking performance indicators suggest that the banking system is generally healthy.

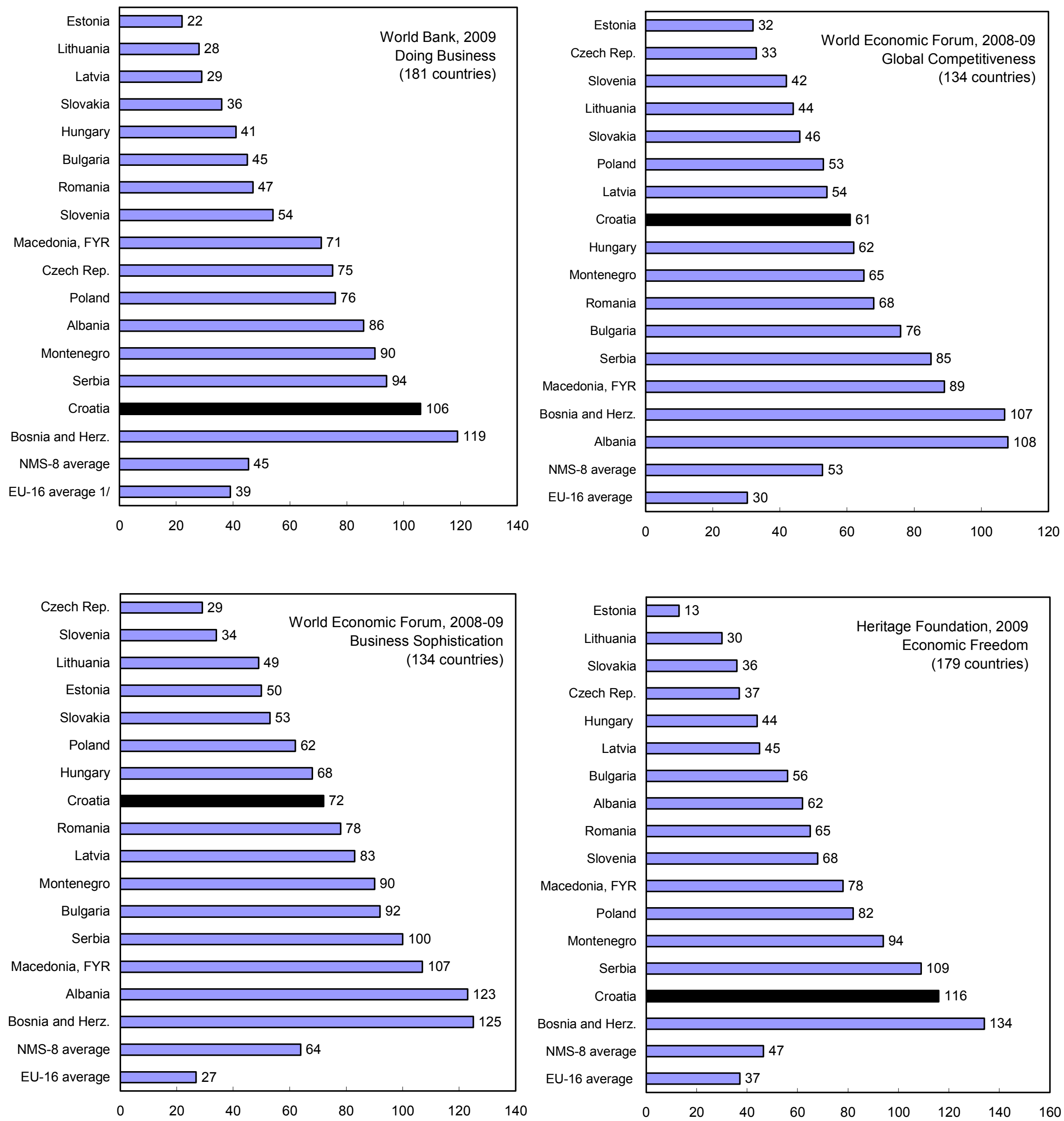


Source: GFSR.

1/ Latest data available in 2008.

Figure 8. Regional Comparison: Business Environment, 2008–09

Croatia 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 Cyprus and Malta.

Table 1. Croatia: Key Macroeconomic Indicators, 2004–10 1/

	2004	2005	2006	2007	2008 Prel.	2009 Proj.	2010 Proj.
				(Percent change)			
Output, unemployment, and prices							
Real GDP	4.2	4.2	4.7	5.5	2.4	-3.5	0.3
Unemployment (labor force survey, in percent)	13.8	12.7	11.1	9.6	8.4	11.0	11.3
CPI inflation (average)	2.0	3.3	3.2	2.9	6.1	2.5	2.8
				(In percent of GDP)			
Saving and investment							
Domestic investment	27.7	28.0	29.8	30.5	32.4	30.1	28.3
Of which: fixed capital formation	24.6	24.6	26.1	26.2	27.6	24.0	23.4
Domestic saving	23.4	22.5	22.9	22.9	23.0	23.3	24.0
Government	2.2	2.3	2.9	3.8	2.9	1.4	1.6
Nongovernment	21.1	20.2	20.0	19.2	20.0	22.0	22.3
Government sector 2/							
General government revenue 2/	39.7	39.2	39.6	40.7	39.8	39.5	39.6
General government expenditure 2/	43.1	42.1	41.4	42.0	40.7	41.7	42.0
General government balance 2/	-3.4	-2.8	-1.8	-1.2	-0.9	-2.1	-2.4
General government balance (broad definition) 2/ 3/	-3.4	-2.8	-2.6	-2.3	-1.1	-2.4	-2.6
HBOR balance (net of budget transfers)	-0.4	-0.1	-0.2	-0.6	-0.7	-1.0	-1.0
Cyclically adjusted primary balance 2/	-1.6	-0.9	0.0	0.0	0.4	1.1	1.3
General government debt	37.9	38.4	35.9	33.2	33.5	36.7	38.5
				(End of period; change in percent)			
Money and credit							
Bank credit to the nongovernment sector	14.0	17.4	23.1	15.0	10.6	...	...
Broad money	8.6	10.5	18.0	18.3	4.3	...	...
				(Period average; in percent)			
Interest rates 4/							
Average kuna deposit rate (unindexed)	1.9	1.7	1.7	2.3	2.8	…	…
Average kuna credit rate (unindexed)	11.7	11.2	9.9	9.3	10.1	…	…
Average credit rate, foreign currency-indexed loans	7.4	6.7	6.3	6.3	7.5	…	…
				(In millions of euros)			
Balance of payments							
Current account balance	-1,434	-1,976	-2,715	-3,237	-4,454	-2,909	-1,843
(In percent of GDP)	-4.4	-5.5	-6.9	-7.6	-9.4	-6.5	-4.1
Capital and financial account	2,603	3,924	5,083	4,861	5,304	2,247	2,195
Overall balance	43	822	1,412	722	-330	-1,612	-648
				(End of period; in millions of euros)			
Debt and reserves							
Gross official reserves	6,436	7,438	8,725	9,307	9,121	7,509	6,860
In percent of short-term debt (by residual maturity)	108	85	88	109	69	68	55
In months of following year's imports of goods and NFS	4.4	4.5	4.9	4.7	5.3	4.3	3.7
Net international reserves	5,026	5,604	6,464	7,349	8,020	6,413	5,765
External debt service to exports ratio (in percent)	24.4	27.2	37.5	37.8	34.3	50.5	38.1
Total external debt (in percent of GDP)	70.0	72.1	74.9	77.6	83.0	85.4	85.3
Net external debt 5/	33.0	37.7	38.8	41.1	46.4	48.8	48.7

Sources: Croatian authorities, and Fund staff estimates.

1/ National account data for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). Revised nominal GDP figure for 2008 is about 14 percent higher than the previous estimate.

2/ ESA 95 presentation. Operations of HAC, a state-oned road company, were excluded from the coverage of the general government in 2008.

3/ Includes “pensioners’ debt” repayments.

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 2. Croatia: Consolidated General Government Finances, 2004–10 1/
(In millions of kuna; ESA 95 presentation)

	2004	2005	2006	2007	2008 Prel.	2009 Original budget	2009 Revised budget	2009 IMF staff projections	2010 Proj.
Revenue	97,405	103,712	113,503	128,020	136,143	144,519	134,635	133,087	136,714
Taxes	56,396	60,500	66,768	73,392	76,313	80,344	74,442	73,487	76,047
Taxes on income, profits, and capital gains	12,135	13,397	15,972	18,762	21,132	21,328	20,796	20,638	21,099
Payable by individuals	7,735	7,825	8,813	9,938	10,567	10,943	10,557	10,398	10,606
Payable by corporations and other enterprises	4,400	5,572	7,159	8,825	10,565	10,385	10,240	10,240	10,493
Taxes on property	732	764	962	1,155	1,180	1,242	1,239	1,066	1,211
Taxes on goods and services	41,582	44,393	47,894	51,491	52,083	55,810	50,436	49,914	51,782
VAT	29,865	32,243	34,932	37,748	41,308	44,438	40,442	39,398	41,187
Excises	10,619	10,917	11,565	12,169	8,949	9,416	8,686	8,686	8,723
Taxes on international trade and transactions	1,591	1,563	1,588	1,641	1,901	1,946	1,953	1,852	1,938
Other taxes	355	384	351	342	18	18	18	18	18
Social security contributions	29,478	31,301	33,877	37,203	40,703	43,033	40,771	40,178	41,162
Other revenue and grants	10,668	11,048	11,572	16,120	17,911	19,927	18,214	18,214	18,271
Grants	14	28	197	446	1,024	1,141	1,035	1,035	771
Other revenues	10,654	11,020	11,375	15,674	16,887	18,785	17,179	17,179	17,501
Capital revenue	863	863	1,286	1,304	1,215	1,216	1,208	1,208	1,233
Total expenditure	105,815	111,185	118,655	131,934	139,132	147,334	140,062	140,312	144,973
Current expenditures	95,279	101,137	108,293	119,614	129,891	137,535	131,037	131,287	134,873
Compensation of employees	25,518	26,677	28,212	31,112	24,998	26,997	25,495	25,495	26,770
Use of goods and services	10,144	11,311	13,700	15,825	17,321	18,260	16,563	16,563	16,969
Interest	4,535	5,105	5,478	5,554	5,639	5,876	5,869	6,119	6,617
Subsidies	5,736	5,999	6,562	7,504	8,028	8,076	7,782	7,782	7,472
Grants	975	1,392	1,428	1,702	2,348	2,124	1,254	1,254	2,281
Social benefits	41,034	42,468	44,824	48,731	60,774	65,283	64,573	64,573	65,929
Other expense	7,338	8,183	8,088	9,186	10,783	10,919	9,501	9,501	8,834
Capital expenditure	10,537	10,049	10,362	12,319	9,241	9,799	9,025	9,025	10,100
Overall balance/Net lending 2/	-8,410	-7,473	-5,152	-3,913	-2,989	-2,815	-5,427	-7,225	-8,259
Repayment of “pensioners’ debt”	…	…	2,398	3,345	942	816	816	816	816
Financing requirement	-8,410	-7,473	-7,549	-7,258	-3,930	-3,631	-6,243	-8,041	-9,075
Financing	8,410	7,473	7,549	7,258	3,930	3,631	6,243	8,041	9,075
Privatization and disposal of fixed assets	1,211	1,384	4,114	3,042	913	513	0	0	379
External financing	3,870	-4,397	-3,483	62	-943	-179	-2,331	-2,331	-1,183
Disbursements	8,706	1,600	2,724	4,734	2,578	7,028	7,028	7,028	6,005
Amortization	-4,836	-5,997	-6,207	-4,672	-3,521	-7,207	-9,359	-9,359	-7,188
Domestic financing	3,330	10,487	6,918	4,155	3,960	3,298	8,573	10,371	9,879
Memorandum item:									
Primary balance	-3,875	-2,368	326	1,641	2,650	3,061	443	-1,105	-1,642

Sources: Ministry of Finance; and Fund staff estimates.

1/ Operations of HAC, a road fund, was excluded from the coverage of the general government in 2008.
2/ Excluding “pensioners’ debt” repayments; including accumulation of arrears in “use of goods and services.”

Table 2. Croatia: Consolidated General Government Finances, 2004–10 (concl.) 1/

(In percent of GDP; ESA 95 presentation)

	2004	2005	2006	2007	2008 Prel.	2009 Original Budget	2009 Revised Budget	2009 IMF staff proj.	2010 Proj.
Revenue	39.7	39.2	39.6	40.7	39.8	42.9	40.0	39.5	39.6
Taxes	23.0	22.9	23.3	23.4	22.3	23.9	22.1	21.8	22.0
Taxes on income, profits, and capital gains	4.9	5.1	5.6	6.0	6.2	6.3	6.2	6.1	6.1
Payable by individuals	3.2	3.0	3.1	3.2	3.1	3.3	3.1	3.1	3.1
Payable by corporations and other enterprises	1.8	2.1	2.5	2.8	3.1	3.1	3.0	3.0	3.0
Taxes on goods and services	16.9	16.8	16.7	16.4	15.2	16.6	15.0	14.8	15.0
VAT	12.2	12.2	12.2	12.0	12.1	13.2	12.0	11.7	11.9
Excises	4.3	4.1	4.0	3.9	2.6	2.8	2.6	2.6	2.5
Taxes on international trade and transactions	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.6
Other taxes	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Social security contributions	12.0	11.8	11.8	11.8	11.9	12.8	12.1	11.9	11.9
Other revenue and grants	4.3	4.2	4.0	5.1	5.2	5.9	5.4	5.4	5.3
Capital revenue	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total expenditure	43.1	42.1	41.4	42.0	40.7	43.8	41.6	41.7	42.0
Current expenditures	38.8	38.3	37.8	38.1	38.0	40.9	38.9	39.0	39.1
Compensation of employees	10.4	10.1	9.9	9.9	7.3	8.0	7.6	7.6	7.8
Use of goods and services	4.1	4.3	4.8	5.0	5.1	5.4	4.9	4.9	4.9
Interest	1.8	1.9	1.9	1.8	1.6	1.7	1.7	1.8	1.9
Subsidies	2.3	2.3	2.3	2.4	2.3	2.4	2.3	2.3	2.2
Grants	0.4	0.5	0.5	0.5	0.7	0.6	0.4	0.4	0.7
Social benefits	16.7	16.1	15.7	15.5	17.8	19.4	19.2	19.2	19.1
Other expense	3.0	3.1	2.8	2.9	3.2	3.2	2.8	2.8	2.6
Capital expenditure	4.3	3.8	3.6	3.9	2.7	2.9	2.7	2.7	2.9
Overall balance 2/	-3.4	-2.8	-1.8	-1.2	-0.9	-0.8	-1.6	-2.1	-2.4
Repayment of “pensioners’ debt”	…	…	0.8	1.1	0.3	0.2	0.2	0.2	0.2
Financing	3.4	2.8	2.6	2.3	1.1	1.1	1.9	2.4	2.6
Privatization and disposal of fixed assets	0.5	0.5	2.3	1.1	0.5	0.2	0.0	0.0	0.1
External financing	1.6	-1.7	-1.2	-0.1	-0.3	-0.1	-0.7	-0.7	-0.3
Disbursements	3.5	0.6	1.0	-0.1	0.8	2.1	2.1	2.1	1.7
Amortization	-2.0	-2.3	-2.2	0.0	-1.0	-2.1	-2.8	-2.8	-2.1
Domestic financing	1.4	4.0	1.6	1.3	0.9	1.0	2.5	3.1	2.9
Memorandum items:									
Primary balance	-1.6	-0.9	0.1	0.5	0.8	0.9	0.1	-0.3	-0.5
Cyclically adjusted primary balance	-1.6	-0.9	0.0	0.0	0.4	0.7	1.5	1.1	1.3
HBOR balance (net of budget transfers)	-0.4	-0.1	-0.2	-0.6	-0.7	-1.0	-1.0	-1.0	-1.0
HAC 1/					-0.9	-0.9	-0.9	-0.9	-0.9
Broader measure of fiscal balance 3/	-3.8	-2.9	-2.8	-2.9	-2.7	-3.0	-3.8	-4.3	-4.5
General government debt	37.9	38.4	35.9	33.2	33.5	36.7	36.7	36.7	38.5
General government guarantees and arrears	8.4	5.4	5.5	4.7	6.0	6.0	6.8	6.8	7.2

Sources: Ministry of Finance; and Fund staff estimates.

1/ Operations of HAC, a road fund, was excluded from the coverage of the general government in 2008.

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

3/ Includes repayments of “pensioners’ debt” and the balances of HBOR and HAC (net of budget transfers).

Table 3. Croatia: Monetary Accounts, 2007–09

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

	2007	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1
Monetary Survey						
Net Foreign Assets	49,447	43,547	45,360	54,773	41,739	26,544
(In millions of euros)	*6,750*	*6,001*	*6,260*	*7,706*	*5,699*	*3,559*
Croatian National Bank	68,161	71,405	72,022	69,705	66,789	66,128
(In millions of euros)	*9,305*	*9,840*	*9,939*	*9,807*	*9,119*	*8,868*
Deposit money banks	-18,714	-27,858	-26,662	-14,932	-25,049	-39,584
(In millions of euros)	*-2,555*	*-3,839*	*-3,679*	*-2,101*	*-3,420*	*-5,308*
Net Domestic Assets	166,376	168,073	170,687	172,079	183,279	192,083
Domestic credit (CNB definition) 1/	226,076	231,040	234,626	239,395	232,777	232,480
Claims on government, net 2/	14,118	14,716	13,079	13,054	20,475	28,504
Claims on other domestic sectors 3/	208,688	212,998	218,206	222,544	230,905	232,862
Other items (net)	-59,701	-62,967	-63,939	-67,316	-49,498	-40,397
Broad Money	215,822	211,620	216,047	226,852	225,018	218,627
Narrow Money	57,878	52,807	54,400	53,677	55,222	46,637
Currency outside banks	16,007	15,337	16,909	16,556	17,051	15,826
Demand deposits	41,871	37,471	37,492	37,121	38,171	30,810
Quasi Money	157,944	158,813	161,646	173,175	169,796	171,990
Kuna-denominated	54,854	54,052	52,968	55,238	52,601	49,125
Foreign currency-denominated	103,090	104,761	108,678	117,938	117,195	122,865
Balance Sheet of the Croatian National Bank						
Net Foreign Assets	68,161	71,405	72,022	69,705	66,789	66,128
Of which: Banks' reserves in foreign currency	14,257	17,001	16,829	13,314	8,008	4,582
Net International Reserves	53,830	54,362	55,172	56,385	58,745	61,539
Net Domestic Assets	-1,951	-4,371	-3,957	-6,561	-8,982	-8,775
Of which: Claims on government (net)	-198	-308	-596	-441	-205	-383
Claims on banks	4,178	1,538	1,667	14	14	1,397
Of which: open market operations	2,815	1,524	1,652	0	0	1,359
Claims on other domestic sectors	68	68	65	65	64	64
Other items (net)	-5,999	-5,669	-5,094	-6,199	-8,855	-9,853
Base Money	66,210	67,034	68,064	63,144	57,807	57,352
Currency	16,007	15,337	16,909	16,556	17,051	15,826
Deposits	50,202	51,698	51,156	46,587	40,756	41,526
Of which: Settlement accounts	7,554	8,914	7,509	6,559	9,520	9,308
Statutory reserves in kuna 4/	24,267	22,624	22,981	23,092	19,223	24,080
Statutory reserves in foreign currency	14,257	17,001	16,829	13,314	8,008	4,582
Reserve Money (CNB definition) 5/	51,924	49,978	51,174	49,771	49,743	52,718
Memorandum items:						
Narrow money multiplier	0.87	0.79	0.80	0.85	0.96	0.81
Broad money multiplier	3.26	3.16	3.17	3.59	3.89	3.81
Broad money (in percent of GDP)	68.7	65.7	65.5	67.1	65.8	64.1
Foreign currency in percent of broad money	47.8	49.5	50.3	52.0	52.1	56.2
Credit to other domestic sectors: stock (in percent of GDP)	66.4	66.2	66.1	65.9	67.5	68.3
Credit to other domestic sectors: 12-month flow (in percent of GDP)	8.7	7.2	6.3	6.6	6.5	5.8

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 4. Croatia: Medium-Term Baseline Scenario, 2004–14 1/

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
					Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector					(Percent change)						
Real GDP 2/	4.2	4.2	4.7	5.5	2.4	-3.5	0.3	2.5	4.0	4.0	4.0
Consumption, total	3.9	3.6	3.2	5.6	1.1	-4.0	0.2	2.4	3.1	3.8	3.8
Of which: private	4.3	4.4	3.5	6.2	0.8	-4.5	0.0	2.4	3.0	3.9	3.9
Gross fixed capital formation, total	5.0	4.9	10.9	6.5	8.2	-15.1	-0.7	3.5	6.2	6.6	6.7
Of which: private	8.8	7.3	13.7	6.7	12.7	-15.7	-1.9	4.0	6.5	7.0	7.0
CPI inflation (average)	2.0	3.3	3.2	2.9	6.1	2.5	2.8	2.8	2.8	3.0	3.0
Saving and investment					(In percent of GDP)						
Domestic investment	27.7	28.0	29.8	30.5	32.4	30.1	28.3	28.2	29.1	29.1	29.1
Of which: fixed capital formation	24.6	24.6	26.1	26.2	27.6	24.0	23.4	23.6	24.2	24.8	25.5
Domestic saving	23.4	22.5	22.9	22.9	23.0	23.3	24.0	23.7	24.0	24.0	24.5
Government	2.2	2.3	2.9	3.8	2.9	1.4	1.6	2.5	3.2	4.0	4.4
Nongovernment	21.1	20.2	20.0	19.2	20.0	22.0	22.3	21.2	20.8	20.0	20.1
General government finances 3/											
Revenue	39.7	39.2	39.6	40.7	39.8	39.5	39.6	39.9	39.7	39.8	39.6
Expenditure 4/	43.1	42.1	41.4	42.0	40.6	41.7	42.0	41.4	40.6	39.8	39.1
Balance 4/	-3.4	-2.8	-1.8	-1.2	-0.8	-2.1	-2.4	-1.5	-0.9	0.0	0.5
Government debt	37.9	38.4	35.9	33.2	33.5	36.7	38.5	38.5	37.2	35.1	32.7
Balance of payments											
Current account balance	-4.4	-5.5	-6.9	-7.6	-9.4	-6.5	-4.1	-4.4	-4.9	-5.0	-4.5
Exports f.o.b.	20.2	20.2	21.6	21.5	20.6	19.6	20.5	20.7	20.7	20.8	21.1
Imports f.o.b.	-40.7	-41.3	-43.0	-43.5	-43.5	-39.5	-39.9	-40.2	-40.0	-40.0	-40.0
Capital and financial account	7.9	11.0	13.0	11.3	11.2	5.0	4.9	7.9	9.3	9.4	9.5
Of which: FDI	2.0	3.6	6.5	8.1	5.9	4.0	4.3	5.4	6.0	6.2	6.5
Gross external debt	70.0	72.1	74.9	77.6	83.0	85.4	85.3	83.4	81.1	78.9	76.5
Net external debt	33.0	37.7	38.8	41.1	46.4	48.8	48.7	46.9	44.6	42.3	40.0
Memorandum items:											
Nominal GDP (in millions of kuna)	245,550	264,367	286,341	314,223	342,158	336,649	344,910	363,254	389,118	416,823	446,501
Nominal GDP (in millions of euros)	32,759	35,725	39,102	42,833	47,370	44,767	45,086	47,484	50,865	54,487	58,366

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

1/ National account statistics for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). On average, revised nominal GDP figures are 15.6 percent higher than the previous estimates.

2/ Assumes an increase in total factor productivity and potential growth as EU accession approaches.

3/ ESA 95 presentation.

4/ Excludes repayments of “pensioners’ debt.”

Table 5. Croatia: Balance of Payments, 2007–14
(In millions of euros, unless otherwise indicated)

	2007	2008 Prel.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.
Current account	-3,237	-4,454	-2,909	-1,843	-2,084	-2,505	-2,710	-2,617
Merchandise trade balance	-9,434	-10,866	-8,919	-8,721	-9,251	-9,837	-10,444	-11,080
Exports f.o.b.	9,193	9,743	8,773	9,253	9,814	10,529	11,344	12,295
Imports f.o.b.	-18,626	-20,610	-17,692	-17,974	-19,065	-20,367	-21,788	-23,375
Services and income	5,154	5,372	4,941	5,728	5,917	5,973	6,256	6,857
Transportation	488	509	487	537	570	614	667	731
Travel	6,035	6,687	6,035	6,411	6,868	7,243	7,686	8,197
Other services	-257	-234	-282	-235	-250	-260	-266	-267
Compensation of employees	494	564	475	502	536	569	606	649
Interest and investment income	-1,606	-2,154	-1,774	-1,487	-1,808	-2,194	-2,437	-2,454
Current transfers	1,043	1,040	1,068	1,149	1,250	1,360	1,478	1,606
Capital and financial account	4,861	5,304	2,247	2,195	3,760	4,729	5,140	5,521
Capital account	35	32	35	35	35	35	35	36
Financial account	4,827	5,272	2,212	2,160	3,725	4,694	5,105	5,485
Direct investment	3,483	2,811	1,793	1,934	2,565	3,030	3,395	3,805
Portfolio investment	-3	-555	-28	0	261	163	114	114
Medium- and long-term loans	2,718	2,900	-938	226	870	1,446	1,464	1,460
Assets	3	-64	0	0	0	0	0	0
Liabilities	2,715	2,965	-938	226	870	1,446	1,464	1,460
Disbursements	7,700	7,640	5,545	5,299	6,816	7,568	7,162	7,112
Amortization	-4,985	-4,676	-6,483	-5,073	-5,947	-6,122	-5,697	-5,652
Other flows 1/	-1,374	114	1,384	0	29	55	131	106
Net errors and omissions 2/	-903	-1,180	-950	-1,000	-1,050	-1,100	-1,150	-1,200
Overall balance	722	-330	-1,612	-648	626	1,124	1,280	1,704
Financing	-722	330	1,612	648	-626	-1,124	-1,280	-1,704
Gross reserves (-= increase)	-722	330	1,612	648	-626	-1,124	-1,280	-1,704
Memorandum items:								
Current account (in percent of GDP)	-7.6	-9.4	-6.5	-4.1	-4.4	-4.9	-5.0	-4.5
Export volume growth (excl. ships)	7.6	0.1	-5.1	2.5	4.1	5.8	6.4	6.8
Import volume growth	9.3	4.0	-9.3	-2.5	3.8	5.2	5.5	5.6
Gross official reserves	9,307	9,121	7,509	6,860	7,487	8,611	9,891	11,595
in months of following year's imports of goods and NFS	4.7	5.3	4.3	3.7	3.8	4.1	4.1	4.1
Outstanding debt	33,253	39,300	38,221	38,446	39,607	41,270	42,980	44,660
External debt to GDP ratio 3/	78	83	85	85	83	81	79	77
External debt in percent of exports of goods and NFS	182	198	213	203	197	192	187	180
Short-term debt by residual maturity (in percent of GIR)	91	144	146	182	155	130	113	96
External debt service	-6,909	-6,801	-9,061	-7,206	-8,729	-7,802	-7,522	-7,875
GDP (millions of euros)	42,833	47,370	44,767	45,086	47,484	50,865	54,487	58,366
GDP (millions of kuna)	314,223	342,158	336,649	344,910	363,254	389,118	416,823	446,501

Sources: Croatian National Bank; and Fund staff estimates.

1/ Short-term debt flows, trade credit, and currency and deposits.
2/ Errors and omissions are explicitly projected to reflect persistent unrecorded capital outflows.
3/ Including inter-company loans.

Table 6. Croatia: External Financing Requirement, 2007-10
(In millions of euros; unless otherwise indicated)

	2007	2008	2009	2010
Financing requirements	-13,688	-13,131	-16,552	-13,578
Current account deficit	-3,237	-4,454	-2,909	-1,843
Amortization on MLT debt (exist.+new)	-5,698	-5,412	-8,296	-6,498
Public	-940	-776	-1,101	-743
Private	-4758	-4636	-7,195	-5,755
Banks 2/	-1,879	-914	-1,654	-1,599
Non-banks 3/	-2,879	-3,722	-5,541	-4,155
Repayment of short-term debt	-4,753	-3,265	-5,347	-5,237
Public	0	-1	-38	-36
Private	-4,753	-3,264	-5,309	-5,201
Banks	-2,885	-2,361	-3,793	-3,791
Non-banks	-1,869	-903	-1,515	-1,410
Financing sources	13,688	13,131	16,552	13,578
Capital transfers	35	32	35	35
FDI, net	3,483	2,811	1,793	1,934
Disbursements on bonds and MLT loans	8,673	8,170	7,293	6,724
Public	824	633	1,150	1,014
Private	7,848	7,538	6,143	5,709
Banks	1,249	636	1,545	1,581
Non-banks	6,599	6,901	4,598	4,128
Short-term financing	4,871	4,848	5,269	5,237
Public	0	33	36	36
Private	4,871	4,815	5,233	5,201
Banks 1/	2,244	3,634	3,791	3,791
Non-banks 2/	2,627	1,181	1,442	1,410
Other flows	-2,652	-3,061	550	-1,000
Gross International Reserves (- = increase)	-722	330	1,612	648
Financing gap	0	0	0	0
Memorandum items				
Current account deficit (in % of GDP)	-7.6	-9.4	-6.5	-4.1
Gross official reserves (EUR bn)	9,307	9,121	7,509	6,860
in months of imports	4.7	5.3	4.3	3.7
in percent of ST debt by residual maturity	109	69	68	55
GDP (EUR bn)	42,833	47,370	44,767	45,086

Sources: Croatian National Bank; and Fund staff estimates.

1/ Includes longer-term currency and deposits.
2/ Includes longer-term trade credits.

Table 7. Croatia: Indicators of External and Financial Vulnerability, 2004–09
(In percent, unless otherwise indicated)

	2004	2005	2006	2007	Latest	
					Value	Date
External indicators						
Real effective exchange rate (using consumer prices) 1/, 2000=100	107.6	109.7	112.0	113.0	114.7	Mar-09
Exports of goods and services (volumes, percentage change, yoy) 2/	5.4	3.7	6.5	4.3	1.7	Q4 -08
Imports of goods and services (volumes, percentage change, yoy) 2/	4.7	3.9	7.4	6.5	3.6	Q4 -08
Current account deficit (millions of euros) 3/	-1,434	-1,976	-2,715	-3,237	-4,454	Q4 -08
Current account deficit in percent of GDP 3/	-4.4	-5.5	-6.9	-7.6	-9.4	Q4 -08
Capital and financial account in percent of GDP 3/	7.9	11.0	13.0	11.3	11.2	Q4 -08
Gross official reserves (millions of euros)	6,436	7,438	8,725	9,307	8,869.5	Mar-09
Gross official reserves in percent of broad money (M4)	35.3	35.5	35.1	31.6	30.3	Mar-09
Gross official reserves in percent of reserve money	145.5	135.8	138.3	131.3	125.5	Mar-09
Gross official reserves in months of current year's imports of goods and NFS	4.8	5.1	5.3	5.2	4.9	Mar-09
Gross usable international reserves in percent of domestic FX deposits	47.2	47.7	53.8	52.3	50.1	Mar-09
CNB net international reserves (NIR; millions of euros)	5,026	5,604	6,464	7,349	8020.4	Dec-08
CNB NIR in months of current year's imports of goods and NFS	3.7	3.8	4.0	4.1	4.1	Dec-08
Short-term debt (by residual maturity, in percent of NIR)	118.1	155.9	153.8	115.8	164.7	Dec-08
Short-term debt and current account deficit net of FDI (in percent of NIR)	132.0	158.7	150.0	138.2	178.7	Dec-08
Total external debt, percent of GDP	70.0	72.1	74.9	77.6	83.0	Q4 -08
External debt service to export ratio 3/	24.4	27.2	37.5	37.8	34.3	Q4 -08
Financial indicators						
General government debt in percent of GDP	37.9	38.4	35.9	33.2	33.5	Dec-08
Domestic in percent of GDP	17.4	21.2	21.3	20.6	21.6	Dec-08
Foreign in percent of GDP	20.5	17.2	14.5	12.6	11.9	Dec-08
Broad money (M4, percentage change, yoy)	8.6	10.5	18.0	18.3	3.3	Mar-09
Claims on other domestic sectors (change, yoy)	14.0	17.4	23.1	15.0	9.3	Mar-09
Short-term interest rate (in percent, e.o.p.)	4.8	3.0	2.8	6.0	17.9	Feb-09
Stock market CROBEX index (1000 at July 1, 1997), e.o.p.	1,565	1,998	3,211	5,239	1,594	4/30/09
Zagreb Stock Exchange, capitalization (stocks, percent of GDP)	35	44	70	125	50	Apr 2009
Bond yield spreads (EMBI Global, e.o.p.)	42	36	40	94	408	4/29/09
Debt ratings: Moody's:						
Government bonds, foreign currency	Baa3	Baa3	Baa3	Baa3	Baa3	Apr-09
Government bonds, domestic currency	Baa1	Baa1	Baa1	Baa1	Baa3	Apr-09
Foreign debt ratings						
Fitch: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB+	Mar-09
Fitch: Foreign currency LT	BBB-	BBB-	BBB-	BBB-	BBB-	Mar-09
Standard and Poor's: Local currency LT	BBB+	BBB+	BBB+	BBB+	BBB	Mar-09
Standard and Poor's: Foreign currency LT	BBB	BBB	BBB	BBB	BBB	Mar-09
Banking system:						
Regulatory capital to risk-weighted assets	16.0	15.2	14.4	16.9	14.5	Q4 -08
Nonperforming loans to total loans	7.5	6.2	5.2	4.8	4.8	Q4 -08
Loan-loss provisions to non-performing loans	62.3	60.0	56.8	54.4	49.6	Q4 -08
Net open foreign exchange position to capital	18.2	7.4	2.6	4.3	1.5	Q4 -08
Foreign currency deposits to total deposits 4/	74.2	73.1	64.6	57.2	59.7	Q4 -08
Foreign currency loans to total loans 4/	76.7	78.5	69.6	59.8	65.4	Q4 -08

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 8. Croatia: Financial Soundness Indicators, 2002–08
(Banks, in percent, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008
Core Set							
Regulatory capital to risk-weighted assets	17.4	16.5	16.0	15.2	14.4	16.9	14.5
Regulatory Tier I capital to risk-weighted assets	15.2	14.1	13.7	13.5	13.3	16.6	14.2
Nonperforming loans net of loan-loss provisions to capital	19.6	22.6	19.0	16.7	14.0	11.3	12.3
Nonperforming loans to total gross loans 1/	10.2	8.9	7.5	6.2	5.2	4.8	4.8
Sectoral distribution of loans to total loans							
Nonfinancial corporations	45.0	41.0	39.5	38.5	40.0	38.5	38.2
Households	44.5	47.8	49.9	49.7	49.4	50.7	49.7
Other sectors	10.5	11.2	10.6	11.7	10.7	10.8	12.1
Return on assets	1.6	1.6	1.7	1.6	1.5	1.6	1.6
Return on equity	13.7	14.1	16.1	15.1	12.7	10.9	10.1
Net interest income to gross income	56.3	58.9	56.6	57.9	60.7	60.5	59.9
Noninterest expenses to gross income	72.9	72.7	68.0	66.7	70.7	68.9	65.0
Liquid assets to total assets 2/	17.6	18.7	16.1	11.5	12.6	12.7	11.6
Liquid assets to short-term liabilities 2/	57.8	66.8	62.0	42.1	47.0	49.3	51.6
Net open position in foreign exchange to capital	...	24.7	18.2	7.4	2.6	4.3	1.5
Encouraged Set							
Deposit Takers 3/							
Capital to assets	9.5	8.9	8.6	9.0	10.3	12.5	13.5
Large exposures to capital	151.3	128.4	161.4	122.6	77.0	58.4	48.5
Geographical distribution of loans to total loans							
Residents	99.5	99.6	99.8	99.7	99.5	99.3	99.2
Nonresidents	0.5	0.4	0.2	0.3	0.5	0.7	0.8
Gross asset position in derivatives to capital	...	...	0.8	0.6	0.9	0.6	0.2
Gross liability position in derivatives to capital	...	...	1.2	1.0	0.7	0.9	3.2
Noninterest income to total income	43.7	41.1	43.4	42.1	43.4	44.5	40.1
Personnel expenses to noninterest expenses	33.9	32.5	32.7	34.1	33.8	34.4	36.1
Spread between domestic lending and deposit rates	11.0	10.1	9.9	9.5	8.2	7.0	7.2
Spread between foreign exchange lending and deposit rates	5.5	5.0	4.2	3.8	3.3	3.2	3.8
Noninterbank loans to noninterbank deposits	80.9	87.0	92.2	101.1	107.6	105.6	113.9
Foreign currency-denominated loans to total loans 4/	75.8	70.9	76.7	78.5	69.6	59.8	65.4
Foreign currency-denominated liabilities to total liabilities 4/	76.0	76.1	78.1	78.8	78.0	73.6	75.7
Net open position in equities to capital	...	...	0.3	0.2	0.1	0.2	0.0
Other Financial Corporations (OFCs)							
OFCs' assets to total financial system assets	15.0	16.6	18.6	21.3	23.6	26.0	21.8
OFCs' assets to GDP	14.0	17.1	20.8	26.1	32.3	38.6	30.1
Nonfinancial Corporations 5/							
Total debt to equity	44.5	40.9	45.9	49.3	43.4	50.6	…
Return on equity	3.6	1.8	2.7	4.4	5.2	5.8	…
Net foreign exchange exposure to equity	8.9	10.0	10.9	12.4	11.1	9.6	…
Households							
Bank loans to households to GDP	19.7	23.2	25.5	28.6	32.4	34.9	35.8
Household debt service (interest) payments to income 6/	4.6	6.1	6.0	6.1	5.2	5.5	6.1
Real Estate Markets							
Residential real estate prices (annual percentage increase)	...	...	...	...	17.5	9.0	5.8
Residential real estate loans to total loans	13.0	15.0	16.8	17.9	19.5	20.7	21.1

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.

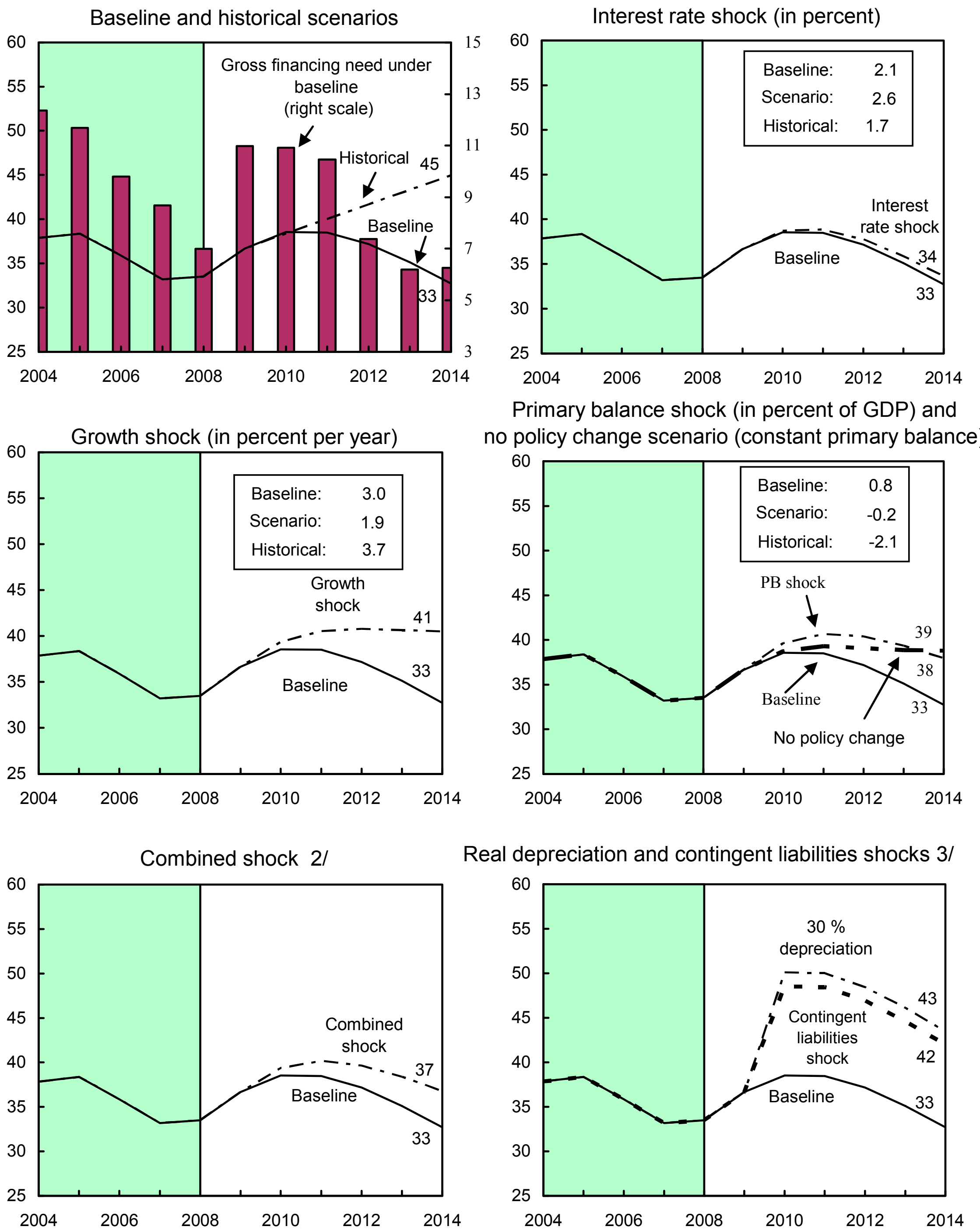
6/ 2008 data corresponds to the third quarter.

Table 9. Croatia: Public Sector Debt Sustainability Framework, 2004-14
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	37.9	38.4	35.9	33.2	33.5	36.7	38.5	38.5	37.2	35.1	32.7	-0.3
o/w foreign-currency denominated	32.2	31.4	28.9	26.4	24.0	23.7	22.8	20.4	20.1	19.9	18.6	
Change in public sector debt	2.1	0.5	-2.5	-2.7	0.3	3.2	1.9	-0.1	-1.3	-2.1	-2.4	
Identified debt-creating flows (4+7+12)	1.4	-1.2	-2.2	-2.5	-1.5	3.2	1.9	-0.1	-1.3	-2.1	-2.4	
Primary deficit	1.6	0.9	-0.1	-0.5	-0.8	0.3	0.5	-0.3	-0.8	-1.6	-2.1	
Revenue and grants	39.7	39.2	39.6	40.7	39.8	39.5	39.6	39.9	39.7	39.8	39.6	
Primary (noninterest) expenditure	41.2	40.1	39.5	40.2	39.0	39.9	40.1	39.6	39.0	38.2	37.6	
Automatic debt dynamics 2/	-0.8	-2.0	-1.2	-1.5	-1.1	2.4	1.0	-0.1	-0.9	-0.9	-0.8	
Contribution from interest rate/growth differential 3/	-0.9	-0.8	-1.0	-1.4	-1.1	2.4	1.0	-0.1	-0.9	-0.9	-0.8	
Of which contribution from real interest rate	0.6	0.7	0.6	0.4	-0.3	1.2	1.1	0.8	0.5	0.5	0.6	
Of which contribution from real GDP growth	-1.4	-1.5	-1.7	-1.8	-0.7	1.2	-0.1	-0.9	-1.4	-1.4	-1.3	
Contribution from exchange rate depreciation 4/	0.1	-1.2	-0.1	-0.1	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	0.6	-0.1	-1.0	-0.5	0.3	0.5	0.4	0.4	0.4	0.4	0.4	
Privatization receipts (negative)	-0.5	-0.5	-1.4	-1.0	-0.3	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	
Recognition of implicit or contingent liabilities	1.1	0.4	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	
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	
Residual, including asset changes (2-3) 5/	0.7	1.7	-0.3	-0.2	1.8	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	95.5	97.8	90.5	81.5	84.2	92.8	97.2	96.4	93.5	88.2	82.6	
Gross financing need 6/	12.4	11.7	9.8	8.7	7.0	11.0	10.9	10.5	7.4	6.2	6.3	
in billions of U.S. dollars	4048.4	4174.0	3832.1	3718.2	3312.1	4915.9	4925.4	4970.0	3750.8	3368.7	3650.3	
Scenario with key variables at their historical averages 7/						36.7	38.4	40.0	41.7	43.3	45.0	-0.5
Scenario with no policy change (constant primary balance) in 2009-2014						36.7	38.7	39.3	39.1	38.9	38.8	-0.4
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.2	4.2	4.7	5.5	2.4	-3.5	0.3	2.5	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	5.6	5.5	5.4	5.4	5.4	5.3	5.4	5.0	4.6	4.6	4.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.8	2.2	2.0	1.4	-1.0	3.3	3.2	2.2	1.6	1.6	1.8	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.3	4.0	0.4	0.3	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.8	3.3	3.4	4.0	6.4	2.0	2.2	2.7	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.1	1.4	3.2	7.3	-0.7	-1.4	0.9	1.3	2.3	2.0	2.2	
Primary deficit	1.6	0.9	-0.1	-0.5	-0.8	0.3	0.5	-0.3	-0.8	-1.6	-2.1	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ 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 9. Croatia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



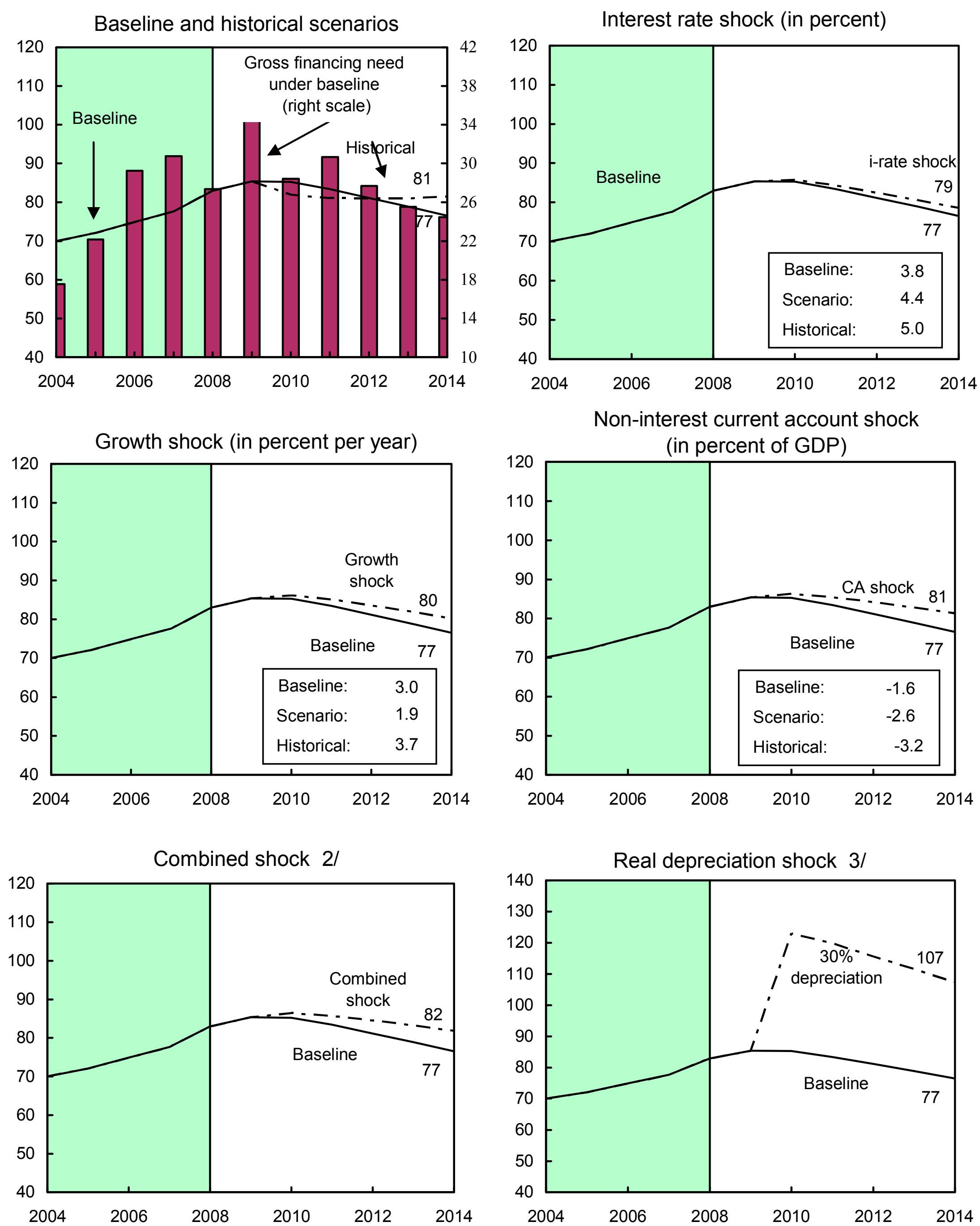
Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 10. Croatia: External Debt Sustainability Framework, 2004-14
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Debt-stabilizing non-interest current account 6/
Baseline: External debt	70.0	72.1	74.9	77.6	83.0	85.4	85.3	83.4	81.1	78.9	76.5	-9.1
Change in external debt	3.8	2.1	2.8	2.8	5.3	2.4	-0.1	-1.9	-2.3	-2.3	-2.4	
Identified external debt-creating flows (4+8+9)	-3.2	-3.9	-5.9	-7.1	-4.0	5.6	-0.4	-3.0	-4.1	-4.3	-5.0	
Current account deficit, excluding interest payments	2.0	3.1	4.3	4.3	6.1	3.8	0.7	1.2	2.0	2.0	1.9	
Deficit in balance of goods and services	6.0	6.2	6.8	7.4	8.2	6.0	4.5	4.3	4.4	4.3	4.1	
Exports	43.5	42.8	43.5	42.7	41.9	40.1	42.0	42.4	42.2	42.2	42.5	
Imports	49.4	48.9	50.2	50.1	50.1	46.0	46.4	46.8	46.6	46.6	46.6	
Net non-debt creating capital inflows (negative)	-2.0	-3.6	-6.6	-8.1	-5.9	-4.0	-4.3	-5.4	-6.0	-6.2	-6.5	
Automatic debt dynamics 1/	-3.2	-3.4	-3.6	-3.3	-4.2	5.8	3.1	1.2	-0.2	-0.1	-0.4	
Contribution from nominal interest rate	2.4	2.4	2.7	3.2	3.3	2.7	3.3	3.2	2.9	3.0	2.5	
Contribution from real GDP growth	-2.6	-2.7	-3.1	-3.7	-1.7	3.1	-0.2	-2.0	-3.1	-3.0	-2.9	
Contribution from price and exchange rate changes 2/	-3.0	-3.1	-3.1	-2.8	-5.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	7.0	5.9	8.7	9.9	9.3	-3.2	0.3	1.2	1.9	2.0	2.6	
External debt-to-exports ratio (in percent)	161.0	168.6	172.3	181.8	198.1	213.1	203.1	196.7	192.2	186.7	180.1	
Gross external financing need (in billions of Euros) 4/	5.7	7.9	11.4	13.2	13.0	16.1	12.8	14.6	14.1	13.9	14.3	
in percent of GDP	17.5	22.1	29.3	30.8	27.4	36.0	28.4	30.7	27.7	25.5	24.5	
Scenario with key variables at their historical averages 5/						85.4	81.9	81.1	81.0	81.0	81.5	-7.2
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.2	4.2	4.7	5.5	2.4	-3.5	0.3	2.5	4.0	4.0	4.0	
GDP deflator in Euro (change in percent)	4.7	4.7	4.5	3.9	8.0	-2.0	0.5	2.7	3.0	3.0	3.0	
Nominal external interest rate (in percent)	3.9	3.7	4.0	4.7	4.7	3.0	3.9	4.0	3.8	3.9	3.5	
Growth of exports (Euro terms, in percent)	8.4	7.2	11.3	7.6	8.5	-9.6	5.5	6.4	6.7	7.2	7.8	
Growth of imports (Euro terms, in percent)	6.7	7.9	12.4	9.4	10.5	-13.2	1.6	6.0	6.8	7.0	7.3	
Current account balance, excluding interest payments	-2.0	-3.1	-4.3	-4.3	-6.1	-3.8	-0.7	-1.2	-2.0	-2.0	-1.9	
Net non-debt creating capital inflows	2.0	3.6	6.6	8.1	5.9	4.0	4.3	5.4	6.0	6.2	6.5	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth ra
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (bas
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. Excludes LT trade credit and movements in LT currency and deposits.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 10. Croatia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Appendix I. Main Recommendations of the 2007 FSAP Update

Measures	Status
Financial sector stability	
Carefully plan the transition from administrative measures, with the objective of eliminating negative side effects while maintaining financial stability	Ongoing. Several requirements (marginal reserve requirement, special reserve requirement) were eliminated, reserve requirement was reduced.
Continue to monitor closely and frequently banks' risk management practices and lending standards and take appropriate measures to address emerging risks	Ongoing. A lending survey is periodically produced by the CNB.
Strengthen stress testing analyses and regularly use in monitoring risks and assessing financial stability	Stress tests are used in monitoring risks.
Reduce fiscal and other incentives to the extent they stimulate particular types of bank loans	No action. This has become a less pressing issue in the current environment of credit slowdown.
Continue efforts to raise risk awareness of banks, borrowers, and stock market investors	Ongoing.
Expand the coverage of the credit registry to include non-banking institutions	Done.
Contingency planning	
Establish formal communications with monetary and supervisory authorities of the parent banks on issues of crisis management	There is no formal communication mechanism, but periodic discussions take place.
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	Amendments to the deposit insurance law were passed in October 2008, and a new deposit insurance law is planned for adoption later in 2009.
Liquidity and risk management	
Broaden the range of eligible collateral for central bank lending to help reduce segmentation in the interbank money market	No action. The authorities are of the view that this could lead to pressures on the FX market.
Develop hedging markets/instruments to facilitate management of interest and FX risks	Ongoing.
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), and map ownership structures of conglomerates, and clarify the roles for their supervision	Work is under way.
Improve regulatory capacity to monitor and enforce financial accounting standards and market disclosure	Ongoing.
Increase pension funds' permissible investments in foreign securities	No action.
Pursue plans to increase the level of contribution and further privatize the pension fund system	No action.
Enhance supervisory capacity to migrate to Solvency II risk based standards for insurance companies	Resources of the nonbank supervisory agency were expanded.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Staff Report for the 2009 Article IV Consultation—Informational Annex

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

May 21, 2009

Contents | Page

Annex I. Croatia: Fund Relations

(as of April 30, 2009)

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	0.04	0.09

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

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	8/04/2004	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				
	2009	2010	2011	2012	2013
Principal					
Charges/Interest	0.15	0.19	0.19	0.19	0.19
Total	0.15	0.19	0.19	0.19	0.19

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 demand in the interbank market, with tight management by the CNB. Croatia's *de facto* exchange rate arrangement is classified as "other managed arrangement" from January 1, 2009. The CNB transacts only in euros, U.S. dollars, and SDRs. On May 19, 2009 the official exchange rate was kuna 7.379325 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 May 9, 2008 (IMF Country Reports Nos. 08/158 and 08/159 available at: http://www.imf.org/external/country/hrv/index.htm). Croatia is on the 12-month consultation cycle.

[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.

X. **FSAP:**

An FSAP Update mission took place in October–November 2007. The FSSA Update was published (IMF Country Report No. 160 available http://www.imf.org/external/country/hrv/index.htm).

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 2000–09:**[2]

Department	**Timing**	**Purpose**
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Accounting and Budgetary Classification (with STA)
	September 2003–March 2004	A Resident Advisor on Fiscal Reporting
	May 2004	Fiscal ROSC
	April 2005	Review of Indirect Tax Performance and Tax Administration
	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 (FAD)
	October 2002	Government Finance Statistics
	September 2006	Monetary and Financial Statistics

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

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–continuing	Macroeconomic Modeling and Forecasting

XII. **Resident Representative:** The post closed in June 2007.

Annex II. 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 (2000) 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 thirteenth and the twenty-first day of each month. The indices are released around the fifteenth 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 eighth 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. The authorities have started presenting budget plans based on the ESA 95 framework, but government finance statistics produced on a monthly basis on the GFSM framework (GFS) have been available in the *Monthly Statistical Review* of the Ministry of Finance (MoF). Data normally come with a lag of 30 days, but recently the lag has been much longer: the latest observation is from November 2008. While preliminary data were provided to the mission, the publication of final data would reduce uncertainties around the fiscal policy stance. Revenue data are reliable, and 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.

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 usually with a lag of 30 days. Recently, the lag has been much longer, and no data have been available for the period after the second quarter of 2008. Again, while preliminary data were provided to the mission, the publication of final data would reduce uncertainties around the fiscal policy stance. Local government data are partial as they include the operations of the 53 largest municipalities. Annual cash data through 2007 for the general government and its subsectors are published in the *2008 GFS Yearbook*. Up-to-date monthly data for the budgetary central government were reported for publication in the *IFS* until November 2008. All data for the *GFS Yearbook* and *IFS* have been 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 2008:Q4.

Croatia: Table of Common Indicators Required for Surveillance
(as of May 20, 2009)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	5/19/09	5/19/09	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Mar 2009	4/15/09	M	M	M
Reserve/Base Money	Mar 2009	4/30/09	M	M	M
Broad Money	Mar 2009	4/30/09	M	M	M
Central Bank Balance Sheet	Mar 2009	4/30/09	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 2009	4/30/09	M	M	M
Interest Rates 2/	Mar 2009	4/30/09	M	M	M
Consumer Price Index	Mar 2009	4/30/09	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2008:Q2	9/16/08	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	Nov 2008	2/2/09	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	Dec 2008	3/26/09	M	M	M
External Current Account Balance	2008:Q4	3/31/09	Q	Q	Q
Exports and Imports of Goods and Services	Mar 2009	4/30/09	Q	Q	Q
GDP/GNP	2008:Q4	3/31/09	Q	Q	Q
Gross External Debt	Feb 2009	4/30/09	M	M	M
International Investment Position	2008:Q4	3/31/09	Q	Q	Q

1/ Reserve assets that are pledged of otherwise encumbered are specified separately. Data comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
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).

Annex III. Croatia: World Bank Relations

1. The World Bank's Board endorsed the Country Partnership Strategy (CPS) for Croatia for FY09–12 in September 2008, just before the full onset of the global financial crisis. The goal of the CPS is to support the completion of Croatia's EU accession process, the rapid convergence of its income level with that of current EU member states in a fiscally, socially and environmentally sustainable fashion. This overarching goal is in line with the Government's priorities expressed in various government programs. In pursuing this goal, the Bank Group program aims at contributing in the following four areas:

- sustaining macroeconomic stability;
- strengthening private sector-led growth and accelerating convergence with the EU;
- improving the quality and efficiency in the social sectors; and
- increasing the sustainability of long-term development.

2. The EU accession agenda remains a cross-cutting theme in the design and implementation of the Bank Group program. In the selection and design of operations, primary consideration is given to the assessment of proposed projects' support of Croatia's EU accession agenda. In the case of social sectors not covered under the EU *acquis*, consideration is also given to how projects complement the EU accession efforts. Project components that enhance Croatia's capacity to absorb EU funds, especially following the accession, have high priority.

3. The CPS envisages an indicative base-case lending envelope of about US$1.0–1.4 billion for investment operations over the four-year period. The CPS also includes an upside scenario, with possible development policy lending amounting to some US$1.4–1.8 billion. The lending program will be based on and complemented by analytical work, particularly in the areas of public expenditure reform, governance, investment climate, and climate change.

4. In FY09, the Bank's Board has already approved three loans exceeding US$240 million, for the continuation of the Rijeka gateway and coastal cities pollution control programs, and for the improvement of emergency medical services, as well as a GEF grant. At the request of the authorities, to help mitigate the impact of the global economic crisis and provide funding for the private sector, the Bank has agreed to prepare a credit line of about EUR100 million for exporters, through HBOR, the Croatian development bank, and commercial banks. Other projects under preparation focus on judicial reforms, disaster risk management and mitigation, port development, irrigation, and education. This program might be adjusted, if necessary, to help address the consequences of the global economic downturn.

5. Currently, the World Bank finances 18 operations 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$340 million, and MIGA guarantees exceed US$40 million.

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FOR IMMEDIATE RELEASE
June 15, 2009

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

IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of Croatia

On June 2, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Croatia.[1]

Background

The global crisis brought an end to Croatia's multi-year economic expansion. After reaching 5.5 percent in 2007, GDP growth decelerated to 2.4 percent in 2008 and the downdraft intensified further in the first months of 2009. Domestic demand and exports started to contract on the back of sharply diminished capital inflows and deepening recession in the EU and other regional trading partners. For the year as a whole, staff projects real GDP to decline by 3½ percent. Weighed down by weak domestic and external conditions, GDP is expected to grow only slightly in 2010.

The crisis exposed underlying vulnerabilities in Croatia's economy. As elsewhere in the region, the high growth rates relied on an unsustainable credit boom, facilitated by easy access to domestic and foreign financing, notwithstanding prudential and other credit measures taken by the authorities to curb credit growth. External debt reached high levels, with banks and corporates increasingly dependent on foreign funding. At the same time, domestic debt also swelled rapidly, predominantly in foreign currencies and mostly by unhedged borrowers.

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[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.

Croatia is now in the midst of a sharp adjustment. A robust policy response has helped Croatia navigate the crisis relatively well, but downside risks remain significant. While the external imbalances are receding from the previous high levels, the adverse economic and financial conditions feed on each other, amplifying the downturn, reducing access to much needed external financing to cover sizable external liabilities maturing in 2009–10, and eroding the private sector's debt servicing capacity. While banks have comfortable cushions from relatively strong profitability and capital positions, the vulnerability of the domestic financial sector to external funding and credit risks has increased.

In response, the Central Bank of Croatia (CNB) has taken a number of measures to maintain the orderly functioning of markets, avert destabilizing pressures on the kuna, and help address the fallout of the crisis on the financial system. In particular, the CNB addressed liquidity shortages through active use of regulatory requirements, repo auctions, and intermittent foreign currency intervention. It maintained close cooperation with foreign banks to secure adequate external funding and reduce banks' liquidity risk. And it strengthened the oversight and monitoring of the banking system and upgraded stress test exercises. While these measures succeeded in stabilizing markets and preparing the banking system for the challenges ahead, heightened uncertainty has fueled deposit and loan euroization.

Fiscal policy has been under pressure. Revenues, especially VAT and excises, started to underperform in late 2008, reflecting sharply lower trade volumes and declining economic activity. In response, the government reduced cash spending on goods and services, limiting the 2008 general government deficit to 0.9 percent of GDP. Based on a wide range of spending cuts, including a freeze of salaries, the revised budget for 2009 aims for a deficit of 1.6 percent of GDP, entailing a cyclical tightening. However, the fiscal deficit is likely to widen to above 2 percent in 2009 due to a further deterioration of macroeconomic conditions. The government's domestic borrowing has recently risen sharply, with the government increasingly competing for resources with the private sector in the current tight credit environment.

Structural reforms remain an important policy objective and key to help the economy emerge from the current crisis more resilient and dynamic. However, recent progress has been slow, and Croatia still lags other central and eastern European countries on business environment indicators.

Executive Board Assessment

Executive Directors noted that, along with other countries in the region, Croatia has been severely affected by the global economic downturn and the continuing strains in financial markets. Real GDP is expected to contract this year—for the first time since 1999. Sharply lower capital inflows have triggered a correction in the external imbalances built up in recent years, but they also amplify pressures on the private sector in view of its relatively large debt overhang and sizable external financing needs.

Directors commended the authorities for the timely and well-targeted policy response, which has helped to maintain market confidence and mitigate the initial impact of the crisis. Monetary policy, including through liquidity operations and changes in reserve and liquidity requirements, has helped to alleviate liquidity pressures on banks and supported a broadly stable exchange rate. Directors took note of the staff's assessment that the real effective exchange rate is broadly in line with fundamentals, and considered that, in the current uncertain juncture, the authorities' exchange rate policy has helped anchor macroeconomic stability, particularly in the presence of large balance-sheet exposures to currency risk. At the same time, the exchange rate strategy limits policy options to cushion the downturn, and a cautionary monetary policy will need to be continued until external pressures abate. Moreover, this exchange rate policy also requires adequate external financing and support from prudent fiscal and financial sector policies, as well as faster implementation of structural reforms to bolster competitiveness. Attention to competitiveness issues was seen as important especially in view of recent strong depreciations of several competitor country currencies.

Directors supported the authorities' efforts to secure adequate external financing. They underlined the need for continued monitoring of banks' liquidity positions and close cooperation between domestic banks and their foreign parent banks, as well as between home and host supervisors. Directors welcomed the rollover arrangements in the banking sector, but cautioned that rollover risks in the corporate sector are particularly pronounced, underlining the importance of tracking developments closely.

The banking sector remains resilient, with relatively strong profitability and capital positions, aided by prudent regulatory requirements. However, loan quality could suffer as the recession deepens and financing conditions tighten. Directors encouraged the authorities to undertake a diagnostic review of the financial conditions of all banks, and to require those with potential recapitalization needs to raise capital buffers. The framework for resolution of troubled assets could also be upgraded, including through a swift adoption of the new foreclosure law. While many elements of Croatia's contingency framework to deal with banks in distress are consistent with international best practice, Directors saw scope for improving interagency coordination on crisis preparedness and management.

Directors considered the cyclical tightening envisaged in the revised 2009 budget appropriate in light of the tight financing conditions. They welcomed the recent eurobond issue, which signals investor confidence in the authorities' policies and helps reduce the government's domestic financing needs. However, in view of the downside risks to revenue collection, spending commitments should be reined in, and a strategy should be developed to contain a possible decline in taxpayers' compliance and to avoid the re-emergence of public sector arrears. Looking forward, Directors stressed the importance of rationalizing public spending without unduly compromising the delivery of public services. They welcomed the authorities' actions to improve public financial management, and encouraged stepped up efforts to modernize the civil service, improve cost recovery for social services, reduce subsidies, and better target social spending.

Accelerating structural reforms is crucial to raise productivity growth, boost Croatia's growth potential, and facilitate real adjustment by reorienting resources towards the tradable sector. Directors stressed the importance of further improving the business environment, advancing labor market flexibility, and swiftly completing the restructuring and privatization of loss-making state-owned enterprises.

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 2009 Article IV Consultation with Croatia is also available.

Republic of Croatia: Selected Economic Indicators 1/

	2004	2005	2006	2007	2008 Prel.	2009 Proj.
Output, unemployment, and prices			(Percent change)			
Real GDP	4.2	4.2	4.7	5.5	2.4	-3.5
CPI inflation (average)	2.0	3.3	3.2	2.9	6.1	2.5
Saving and investment			(In percent of GDP)			
Domestic investment	27.7	28.0	29.8	30.5	32.4	30.1
Domestic saving	23.4	22.5	22.9	22.9	23.0	23.3
Government	2.2	2.3	2.9	3.8	2.9	1.4
Nongovernment	21.1	20.2	20.0	19.2	20.0	22.0
Government sector 2/						
General government revenue 2/	39.7	39.2	39.6	40.7	39.8	39.5
General government expenditure 2/	43.1	42.1	41.4	42.0	40.7	41.7
General government balance 2/	-3.4	-2.8	-1.8	-1.2	-0.9	-2.1
General government balance (broad definition) 2/ 3/	-3.4	-2.8	-2.6	-2.3	-1.1	-2.4
HBOR balance (net of budget transfers)	-0.4	-0.1	-0.2	-0.6	-0.7	-1.0
Cyclically adjusted primary balance 2/	-1.6	-0.9	0.0	0.0	0.4	1.1
General government debt	37.9	38.4	35.9	33.2	33.5	36.7
Money and credit			(End of period; change in percent)			
Bank credit to the nongovernment sector	14.0	17.4	23.1	15.0	10.6	…
Broad money	8.6	10.5	18.0	18.3	4.3	…
Balance of payments			(In millions of euros)			
	-	-	-	-	-	
Current account balance	1,434	1,976	2,715	3,237	4,454	-2,909
(In percent of GDP)	-4.4	-5.5	-6.9	-7.6	-9.4	-6.5
Capital and financial account	2,603	3,924	5,083	4,861	5,304	2,247
Overall balance	43	822	1,412	722	-330	-1,612
Debt and reserves						
Gross official reserves 4/	6,436	7,438	8,725	9,307	9,121	8,870
In percent of short-term debt (by residual maturity) 4/	108	85	88	109	69	81
In months of following year's imports of goods and NFS 4/	4.4	4.5	4.9	4.7	5.3	5.1
Net international reserves	5,026	5,604	6,464	7,349	8,020	8,252
External debt service to exports ratio (in percent)	24.4	27.2	37.5	37.8	34.3	50.5
Total external debt (in percent of GDP)	70.0	72.1	74.9	77.6	83.0	85.4
Net external debt 5/	33.0	37.7	38.8	41.1	46.4	48.8

Sources: Croatian authorities, and IMF staff estimates.

1/ National account data for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). Revised nominal GDP figure for 2008 is about 14 percent higher than the previous estimate.

2/ ESA 95 presentation. Operations of HAC, a state-oned road company, were excluded from the coverage of the general government in 2008.

3/ Includes “pensioners’ debt” repayments.

4/ Data for 2009 corresponds to end-March.

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

Statement by Age Bakker, Executive Director for the Republic of Croatia and Tomislav Galac, Advisor to the Executive Director June 2, 2009

Croatia's first priority for the past several years has been implementation of far-reaching administrative, social, and economic reforms aimed at benefiting optimally from the country's ongoing European integration. This process has been progressing well in the areas of trade and investment for a number of years, while political integration reached its first milestone with Croatia becoming a full member of NATO in April 2009. The authorities are working arduously to complete the remaining legislative reforms in the context of the ongoing EU accession negotiations by the end of this year, and prepare for their future practical implementation.

The Croatian authorities value their continuing cooperation with the International Monetary Fund. They had constructive and fruitful discussions with the team led by Mr. Arvanitis during the 2009 Article IV Consultations with the Republic of Croatia. The authorities welcome the thorough staff analysis and broadly agree with the staff assessment.

Economic performance and outlook

The global financial and economic crisis has begun to affect Croatia since the last quarter of 2008. A short-lived drop in bank deposits, a spike in market measures of sovereign credit risk, and sudden depreciation pressures occurred soon after the Lehman Brothers collapse, as a consequence of a negative shock to depositors' and investors' confidence. The extent and potential negative effects of these events were successfully curbed by an array of swift and decisive official measures, as also highlighted by staff.

The spillovers in the real sector were relatively limited in 2008, although the drop in private consumption in the fourth quarter did lower the average growth for the year to just 2.4 percent (compared to 5.5 percent in 2007). Also, the surge in global commodity prices earlier in the year pushed the average CPI inflation to 6.1 percent, its highest level in a decade. At the same time, the slow but persistent deterioration of Croatia's long-standing external imbalances continued, with the current account deficit increasing to 9.4 percent, and external debt reaching 82.9 percent of GDP by the end of the year. The fiscal policy response to these developments was timely and appropriate, as confirmed by staff, and the general government deficit accounted for 0.9 percent of GDP in 2008.

High frequency indicators point to a significant further deterioration of growth prospects for 2009, as investments and exports are being hit hard, in addition to the continued weakness in private consumption. Moreover, public consumption and investment will have to be curbed, as the current financing conditions leave little, if any, room for countercyclical policies. In the baseline, it can be expected that the GDP will drop between 3 and 4 percent in real terms, while the trend decline in unemployment will be reversed. At the same time, in the short run, inflation presents a secondary concern while the goods trade deficit should decline. These projections are still subject to an unusual degree of uncertainty, as they hinge upon external factors that will determine the important tourist revenues and the availability and cost of external financing in the period ahead, both critical for covering the balance of payments needs.

Fiscal policy

The authorities have successfully pursued fiscal consolidation over the last several years: the general government deficit has declined from 3.4 percent of GDP in 2004, to 0.9 percent by 2008, and the public debt-to-GDP ratio declined from 37.9 to 33.5 in this period. However, the authorities recognize that a more aggressive curbing of current expenditures is needed to achieve both the short-term goal of a balanced budget by 2011, and the medium-term aim of reducing the role of the government in the economy and solidifying the sustainability of public finances. Their commitment to these goals has been reaffirmed in April of 2009, when the revised budget involving wide-ranging spending cuts was adopted, aiming for a general government deficit of 1.6 percent of GDP in 2009.

The revised budget involves a sizable reduction of current expenditures, including a rollback of the recent increase in public employees' wages. At the same time, it provides for unchanged or modestly larger expenditures related to the most vulnerable social categories, and to corporate sectors particularly hard hit by the crisis. The authorities contend and staff agrees that the revised budget strikes the right balance between the limited fiscal space and the need to protect the vulnerable and support the hardest hit parts of the economy. Moreover, the authorities also committed to undertaking a combination of additional spending cuts, postponements, and budget revisions if the underlying fundamentals deteriorate further.

Looking forward, the planned medium-term fiscal consolidation will be further supported by a number of legislative and administrative measures implemented during the past year or being implemented now, to improve the public finance management framework. The new budget law was adopted, providing for a three-year, rolling budget framework, and implementation of sophisticated safeguards against fiscal risks. The personal (tax) identification number has been in use since January to assist in better targeting social benefits and combating corruption, tax evasion, and money laundering. A comprehensive social healthcare reform with the aim of partial cost-recovery has been successfully launched. And, the authorities have also committed to reviewing the effectiveness of the implemented pension system reforms after 2011 in providing a sound basis for the long-term financial sustainability of social pensions, an important goal advocated by staff.

Monetary policy

Monetary policy has been for years aimed at maintaining broad nominal exchange rate stability - a policy that has served the small, open, and highly euroized Croatian economy well. While holding a tight rein on consumer price inflation, since 2003 the Croatian National Bank (CNB) has also focused on proactively mitigating external vulnerabilities. In the absence of a well-functioning interest rate channel, the CNB has resorted to a number of direct, counter-cyclical monetary and prudential measures. Overall, the measures implemented produced considerable results in the period 2003-2008, with bank credit growth in Croatia markedly lower than in the peer countries. Moreover, the measures significantly reduced the degree of financial euroization and provided incentives for most banks to raise additional capital and liquidity buffers. As a consequence, the financial system entered the global financial crisis from a position of strength.

The CNB's response to the first wave of the global financial collapse has been to secure the bank liquidity while at the same time preserving the stability of the nominal exchange rate. The marginal reserve requirement on foreign borrowings has been abolished, the foreign currency liquid reserves requirement has been reduced, and the general reserve requirement has been lowered and modified, altogether significantly increasing the banks' foreign currency liquidity. At the same time domestic currency liquidity has been held appropriately tight through judicious use of the discount window and regular weekly repo operations with banks. By the end of April, as market confidence returned, both the nominal exchange rate and short-term interest rates related to the repo rate stabilized.

Looking forward, the CNB intends to continue with the policy of tightly managing the kuna/euro nominal exchange rate, to preserve confidence in the financial system, curb the systematic balance sheet risks, and prevent imported inflation and inflation expectations from creeping back. The central bank also stands ready to act swiftly in case of further deposit outflows or profit repatriations that would undermine the capital positions of systemically important banks. Provided that the recent stabilization of the exchange rate and interest rates persists, and that inflation remains on a downward path, the CNB will weigh its short-term focus on financial stabilization against the risk of a credit crunch, as suggested by staff. In this regard, the central bank will also seek support from the fiscal policy in avoiding the crowding out of the private sector from the domestic financial market by the government. In this regard, the government has already met the key benchmark on May 27th when it successfully placed its first Eurobond issue in over five years.

The authorities fully agree with staff that this choice of monetary policy presupposes a strong adjustment in the fiscal and private non-financial sectors in the short run, supported by a faster implementation of structural reforms to increase public confidence in the financial system in the short run and increase the competitiveness of the economy in the medium term. Likewise, the authorities welcome the staff's assessment that Croatia's long-standing external imbalances also reflect structural deficiencies, especially in the tradable sector, while there is no compelling evidence of real exchange rate misalignment.

Structural reforms

Significant progress has been achieved in reforms aimed at improving the overall business environment: 1) the administrative capacity and the role of the Competition Agency has been strengthened; 2) electronic registers of national regulations, non-tax government revenues, and recipients of social benefits and state aid have been or are being established; and 3) the company registration procedures have been further simplified. Most notably, further progress in reducing the backlog of court cases has been achieved, and a judicial reform strategy for the period 2008-2011 was adopted aimed at raising the overall quality and speed of judicial procedures. Related to this, a new anti-corruption strategy was adopted, and the number of high-profile cases investigated and prosecuted increased rapidly.

Regrettably, the global financial crisis has negatively impacted the pace of the privatization process of large loss-making SOEs in the railways and shipbuilding sectors. Nevertheless, the authorities are working diligently to meet their stated goal of exiting from the ownership structure of the remaining enterprises in these two sectors by the end of 2009. The government is also examining the modalities for privatization of the remaining companies still in the state portfolio.

Overall, in spite of the large number of complex and comprehensive structural reforms that have been implemented during the past year or are being implemented during 2009, their full impact on the economy will only be felt with a lag. Thus, the authorities would like to caution against reliance on synthetic indicators of the business environment for assessing the recent progress on structural reforms in Croatia.