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INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

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Statement by the Hon. **BORIS VUJČIĆ,**
Governor of the Fund for the **REPUBLIC OF CROATIA,**
at the Joint Annual Discussion

Statement by the Hon. Boris Vujčić,
Governor of the Fund for the Republic of Croatia,
at the Joint Annual Discussion

Mr. Chairman, honorable delegates, ladies and gentlemen,

It is my honor to address the 2008 Annual Meetings of the Boards of Governors of the World Bank and the Fund here in Washington D.C. This year stands out as a year in which the Fund undertook important governance and finance reforms, broadly supported by its membership. But, it also stands out as a year in which the landscape of financial markets is being changed, triggered by financial crises in the US market, and a year in which inflation came back. With no doubt, the latter two developments represent a test for the international financial system and add to the Fund's challenging task of promoting the stability of the international monetary system.

Allow me first to outline the major economic developments related to Croatia. Thereafter, I will touch on Croatia’s relations with the Fund and the Bank, and finally, I intend to discuss a couple of policy issues relevant for the Bank/Fund business.

Croatia, like other emerging European economies, was faced with increasing inflation rates during the last 12-month period, mainly due to increases in food and energy prices, but also due to demand pressures, given strong private consumption growth, especially in the last year. More than half of the July inflation rate (8.4 percent; annualized) can be attributed to increases coming from food prices, while an additional quarter comes from oil and electricity prices. However, we expect the inflation to ease by the year-end, and to come down towards 5 percent. In achieving this, the central bank will continue to rely on exchange rate stability that anchors inflationary expectations, as well as on polices that, on the one hand, restrain excess liquidity in the banking system, and on the other hand contain banks' credit activity within reasonable limits (i.e. on policies that help contain demand pressures and safeguard stability of the financial system). The role of the government also continues to have a paramount importance in curbing inflationary expectations by suppressing any wage demands (within their jurisdiction) that would go beyond productivity gains, which serves as an important signal. It thus helps prevent potential second-round effects (through the wage spiral) on inflation. No doubt, besides the prudent policies on the domestic front, future inflationary path will continue to depend primarily on global developments in food and oil prices. In this respect, we very much welcome the analysis on commodity prices and inflation provided in the coming World Economic Outlook, which gives no reassurance that the price hikes of food, metals and oil that we have been observing in the recent past are firmly behind us.

Ongoing distress in global financial and capital markets, particularly in the US, is not hurting Croatia's banking system, which accounts for three-quarters of the total financial system assets in Croatia, and represents the most important source of funding for the economy. Neither can we see any immediate risks that could arise in the foreseeable future (affecting the stability of our banks). This is so because Croatian banks have not been directly exposed, nor have their parent banks had any significant exposures to the developments in the US. And thanks to the central bank's measures (both monetary and prudential ones) that have helped build solid cushioning elements into the system over the recent past. On the one hand, these measures have restrained excessive credit growth and foreign debt build-up, while on the other hand, they have ensured a build-up of liquidity reserves in the banking system that can help the system in withstanding even the serious international financial market disturbances we are currently witnessing. We observe, though, some indirect effects of the distress on our banks: lending standards tightening and slightly increasing interest rates. But so far, these factors have not been affecting banks' activity in a way that would require the central bank's reaction. Also, we observe the impact of the distress on the Croatian capital market, but this has a very limited effect on broader economic activity, given the negligible role of the capital market in real economy financing, and even helps in both cooling private consumption and reducing banks' foreign borrowing, as money has started to move back from investment funds and shares into bank deposits.

Against this background, the Croatian economy is in a cooling mode this year; after the last year's very strong growth performance (5.6 percent) primarily fuelled by buoyant private consumption. The economy is expected to grow by roughly 4 percent this year, mainly due to decelerating private consumption and weaker net exports' performance. The budget deficit for 2008 is projected at 1.3 percent of GDP (ESA 95 methodology). The fiscal impact together with the fact that the pensioners' debt repayment scheme has entered into the second stage this year (with lower annual installments paid out to pensioners) will, however, have a far less expansionary effect on the economy this year than in 2007. Nonetheless, current account deficit is expected to deteriorate to -9.7 percent of GDP in 2008, (from -8.6 percent of GDP last year), primarily as a consequence of this year's oil price hikes. External debt, on the other hand, is likely to improve by 1.7 percentage points of GDP, to 86.9 percent of GDP in 2008. An important contribution to an expected relative decline in external debt will come from banks, since banks have been scaling back their foreign liabilities as a reaction to the central bank's measures.

While keeping a close eye on inflationary developments in the recent past, the Croatian authorities have remained strongly focused on external imbalances. In this respect, further fiscal consolidation that should help narrow the domestic savings-investment gap continues to be an objective of the policy stance. Government plans to achieve a balanced budget by 2010. On the monetary and financial fronts, the central bank has been taking new measures and vigilantly improving the existing ones for quite some time now, with a view to protecting the soundness of the banking system and supporting the overriding goal of external debt stabilization. As a result, banks' credit growth decelerated to reasonable levels over the last two years (but at no expense for productive investments), the banking system continues to be well-capitalized and sound, and it is well-positioned to withstand potential macroeconomic shocks of a reasonable magnitude.

Turning to my second point – Croatia's relations with the Fund and the Bank – I first want to stress that Croatia continues to have open and fruitful discussions with both the Fund staff (within the framework of Article IV Consultations) and the Bank staff. The Bank has been supporting Croatia in its efforts to intensify structural and institutional reforms that should make Croatia better prepared for the EU membership through Programmatic Adjustment Loans. In addition, Croatia has benefited from the Bank's investment lending focused primarily on improving social welfare, enhancing economic competitiveness, protecting the environment, improving trade and transport infrastructure, and advancing Croatia's knowledge-based economy.

Croatia has also been actively and intensively participating in a number of the Fund/Bank initiatives aimed at strengthening the architecture of the international financial system. Let me note in this context that in late 2007, the Fund/Bank staff conducted an Update of the Financial Sector Assessment Program for Croatia, which at the outset confirmed the soundness and resilience of the banking system. Also, apart from the ROSCs included in the FSAP, Croatia participated in two ROSCs in the recent past: the ROSC on Corporate Governance and ROSC on Accounting and Auditing. Moreover, in close cooperation with the authorities, the Bank staff is currently performing a Diagnostic Review of Consumer Protection and Financial Literacy. Besides, I wish to thank both the Fund and the Bank for providing us with expertise and technical assistance in specific areas, which is very much appreciated.

Finally, let me touch on a couple of policy issues relevant for the Fund/Bank business. First, regarding the Fund's governance reform package, Croatia supported enhanced voice and participation of low-income countries in the Fund by adopting the relevant Amendment to the Articles of Agreement of the Fund, as well as the second ad hoc quota increase for underrepresented countries based on a new formula this year. Let me note that the new formula has brought much-needed transparency into the quota calculation process, and it also strikes right balance between the size of countries and their openness. However, it failed to deliver simplicity. In this regard, any further work on the quota formula should restrain from including new variables, especially those for which data availability and reliability is questionable. Second, Croatia gave its support to the Fund's efforts to develop a more sustainable income-expenditure framework by accepting the Amendment to the Articles of Agreement of the Fund aimed at expanding the Fund's investment authority. With more degrees of freedom to invest, the Fund has obtained an opportunity to put its own finances on a sustainable path over the medium-term. However, this opportunity requires more responsibility on the part of the Fund, especially in times of financial distress. Third, concerning the Bank, we believe that increasing voice and participation of DTCs, is important for further enhancing the legitimacy, credibility, and effectiveness of the World Bank. We welcome the measures already taken by the Bank to increase country ownership and project communication, and we encourage the Bank to increase its efforts in this respect. Finally, we are pleased to see that the trend of improved development outcomes from Bank lending continued over the last three years, and that more and more projects are now better meeting their development objectives. Therefore, we see the ARDE as a tool for providing a good analysis of the state of the Bank's program portfolio.

Mr. Chairman, dear guests, allow me in conclusion to thank our hosts for their hospitality and excellent organization of these meetings. Let me also express my appreciation to both Mr. Strauss-Kahn and Mr. Zoellick for their dedicated services to our institutions. I wish the Fund and the Bank success in their future undertakings.