

**Statement by J. de Beaufort Wijnholds, Executive Director  
for Republic of Croatia  
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Staff has written a very candid but fair report on Croatia's economy. The focus on vulnerabilities and ample use of cross country analyses will constitute an important input for the still to be formed government. Indeed, it would be highly desirable if the degree of frankness, indispensable for this Board to focus on the most pressing issues, were copied in the staff reports for all other countries, including larger ones. The authorities' intention to publish the staff report is testimony to Croatia's increasing transparency and its continuing dialogue with the international community, including the private sector, as to the optimal policies to be followed. On behalf of the authorities I wish to thank staff for their continuous analytical support and their role as a sounding board and economic policy sparring partner.

In many respects Croatia's economy can look confidently ahead into the new year. Monetary and exchange rate policy is in the hands of a highly competent central bank, which has managed to keep inflation below 5.5 percent since 1994. As the staff report notes this is an exceptional performance among transition economies, and has contributed importantly to the prolonged period of exchange rate stability. In addition, monetary policy has been supported by prudent fiscal policy, with the consolidated central government balance not exceeding -1.3 percent GDP since 1994, well below, for instance, the average of the European Union in that period.

Confidence with respect to Croatia's outlook is also shared by foreign investors. The privatization of Hrvatska Telekom and sale of a 35 percent stake to Deutsche Telekom (equivalent to roughly 4.2 percent GDP) was highly successful; bond spreads are coming down as evinced by the December Samurai bond issue of Yen 25 billion (roughly \$ 250 million, or 1.2 percent GDP), with a coupon of 4 percent and a maturity of 5 years to which Standard & Poor's assigned its triple-'B'-minus investment grade rating; and following the electoral outcome spreads on Series B bonds have tightened further from 390 basis points to 360 basis points. This confidence is – and I am quoting the rating report of Standard & Poor's - driven by “the government's recent initiatives to step up structural reform through accelerated large-scale privatization and liquidation of failing banks (..), a relatively manageable, although increasing, government debt burden (..) and prudent monetary management”.

What may also have enhanced confidence in Croatia is the sharp decline in the current account deficit. This has come down from – 11.6 percent GDP in 1997 to roughly – 6.5 percent GDP this year. The scenario for next year is that it will further decline to – 5 percent GDP. Although this is still sizeable, I would note that staff projects this deficit to be entirely covered by foreign direct investment in 2000. In addition, Croatia has almost no short term debt. The staff report notes that the short-term debt to reserves ratio is projected at 88 percent in 1999. As staff notes, however, this ratio is on a 'residual maturity basis' and the short-term debt consists primarily of medium and long term debt falling due. Indeed, on an

'original maturity basis' (i.e. ignoring the medium and long term debt falling due), short term debt would amount to only 10.6 percent of gross reserves and 14.3 percent of gross official usable reserves.

Like many other transition economies, Croatia faces important structural challenges. Interestingly, there is near consensus among both the government and the opposition parties as to what the structural problems are and the need to resolve them.

First, while macro-economic management has been sound, there is a realization that this performance is increasingly burdened by the rising transfers to the pension and health funds, where there has been a growing asymmetry between the expenditures and revenues of these funds. Importantly, however, Croatia is in the midst of fundamental pension reform which will shift the PAYG system to a more fully funded one.

Second, the legacy of pre-independence central planning has been a weak banking sector. Here, however, the central bank has acted decisively intervening in no less than 14 banks (8 of these have now been declared bankrupt, for 3 the bankruptcy request is pending and 3 have been put under special administration) and putting an additional 11 under enhanced supervision. This comprehensive reform has been greatly aided by the new banking law passed by parliament in December 1998, which has removed important impediments for CNB to exercise its supervisory responsibilities. Thanks to these changes, I believe it is fair to say that the banking sector has moved from the emergency room to the recovery room. This will be further aided by the continued foreign interest in Croatia's banking sector bringing capital, expertise and competition. Three small banks were taken over by foreign banks since October, in addition to the sale of 66 percent of PBZ— the second largest bank in Croatia - to an Italian bank.

The third main challenge, and perhaps the most difficult one, remains enterprise and corporate restructuring. This will be essential to boosting Croatia's exports and further bringing down the still sizeable current account deficit. As the selected issues paper points out, however, Croatia's sluggish exports may have been due not so much to lack of their competitiveness but to their relative lack of market access to their main trading partners, most notably the EU and the CEEC countries (what could have been added is that Croatia suffered significantly from the Kosovo crisis, which severely dented tourism receipts). In contrast, Croatia's own trade regime is already more open, with an overall rating of 2 on the 10-point Fund index of trade restrictiveness (below the average of 2.7 for CEEC's and 4 for the EU). It is hoped that Croatia's accession to the WTO (which is beyond the authorities control) will soon allow it to negotiate new trade arrangements with the EU and CEFTA. Accession to the WTO would also make Croatia's tariffs one of the lowest among the CEEC's.

Finally, I want to inform the Board on the proposed decision to approve an exchange restriction falling under the jurisdiction of Article VIII. This has come as a complete surprise to the authorities. Not once in any of the IMF staff reports or staff missions since 1991 (including the most recent one) have the authorities been advised, either in written form or

otherwise, that the “Law on the Transformation of Household Foreign Exchange Deposits into Public Debt of the Republic of Croatia”, could in any way constitute an exchange restriction. Foreign exchange arising from household foreign exchange savings deposits were not available to Croatian banks after the breakup of the former SFRY since these funds remained in the former National Bank of Yugoslavia. To prevent a bank run the Croatian government took over the claims of the former central bank and transformed them into time-deposits. Data for June 30, 1999 indicate that the amount of frozen foreign exchange deposits has gone down considerably (approximately 87 percent of ‘frozen deposits’ claims have been settled, i.e. these deposits amounted to \$ 3,293 million on December 31, 1991 and the balance on June 30, 1999 was \$ 421 million). It is extremely difficult, if not impossible, to determine if, among the outstanding frozen deposits, income is included that was generated from current account transactions. Indeed, the staff report notes that this ‘may’ be the case. In addition, foreign exchange regulations currently in force do not contain any provision which imposes restrictions on the transfer of interest. For this reason, the authorities have asked staff and management to reconsider its finding that Croatia maintains an exchange restriction.