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March 2006
IMF Country Report No. 06/128

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

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

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

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

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

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

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

*Also included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

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

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

Approved by Poul Thomsen and Anthony Boote

March 8, 2006

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

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

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

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

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

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I. Program Performance and Developments in 2004–05

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

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

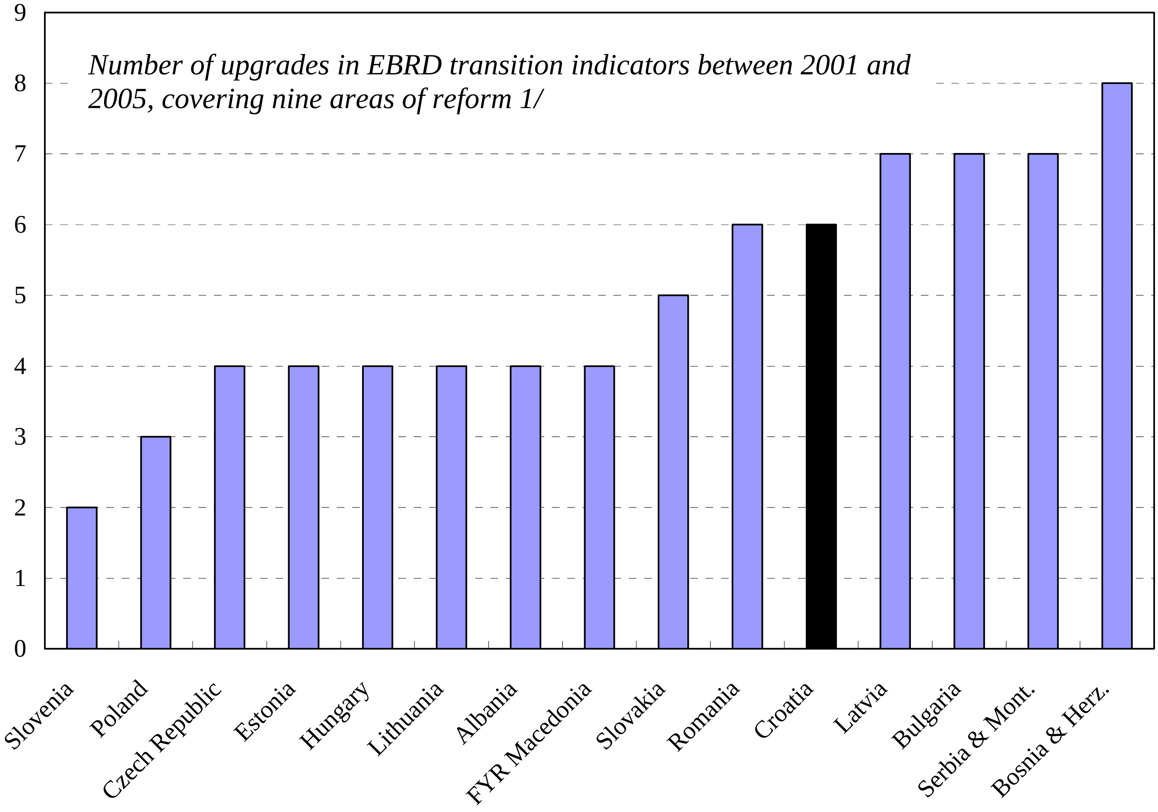
- ***Structural reforms*** have advanced, often beyond what was envisaged in the original program. Although Croatia still lags other Central European countries (Figure 1), recent efforts have begun to address long-standing rigidities and are strengthening the sustainability of the adjustment. The government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

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

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

Figure 1. EBRD Transition Indicators

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



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

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

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

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

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

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

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

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

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

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

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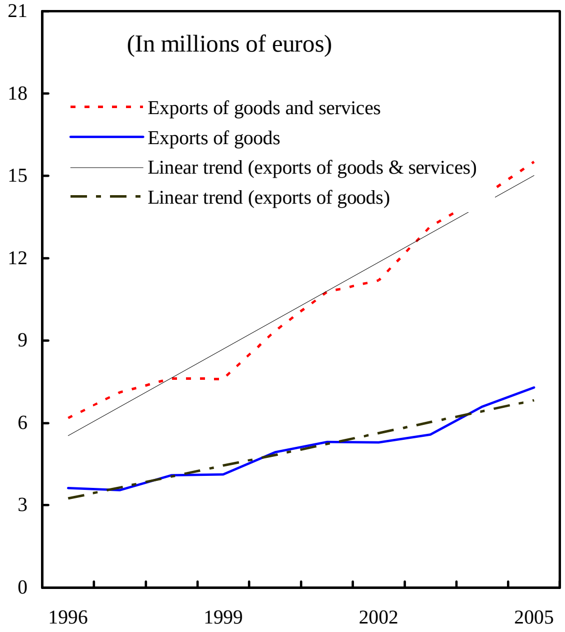
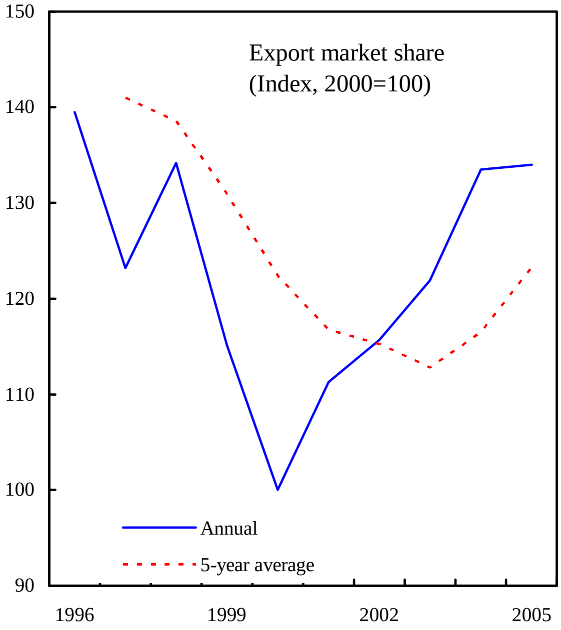
[2] Given the correspondence between estimated tourism receipts and errors & omissions—flagged already in IMF Report Nos. 04/253 & 05/349—the sum of the current account deficit and errors & omissions may be used as an alternative measure for gauging the *change*, if not the level, of the external flow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

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

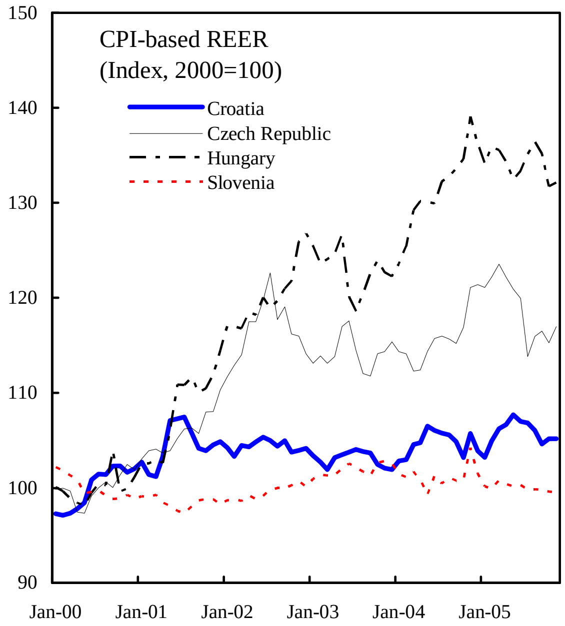
Recent export performance has been strong ...

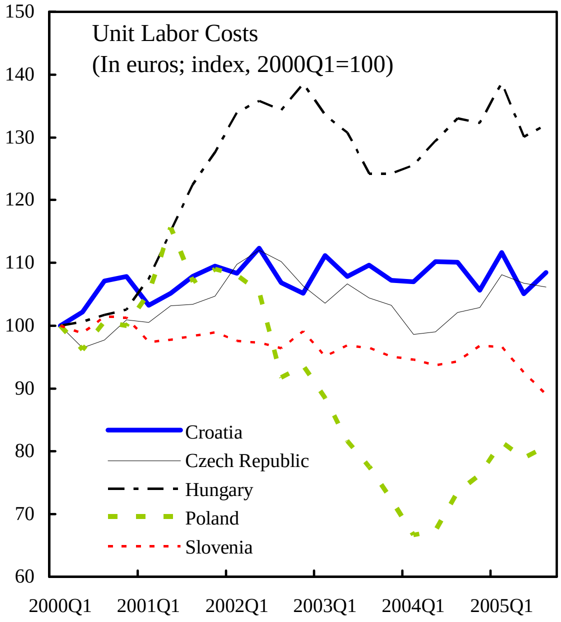


... market share has rebounded ...



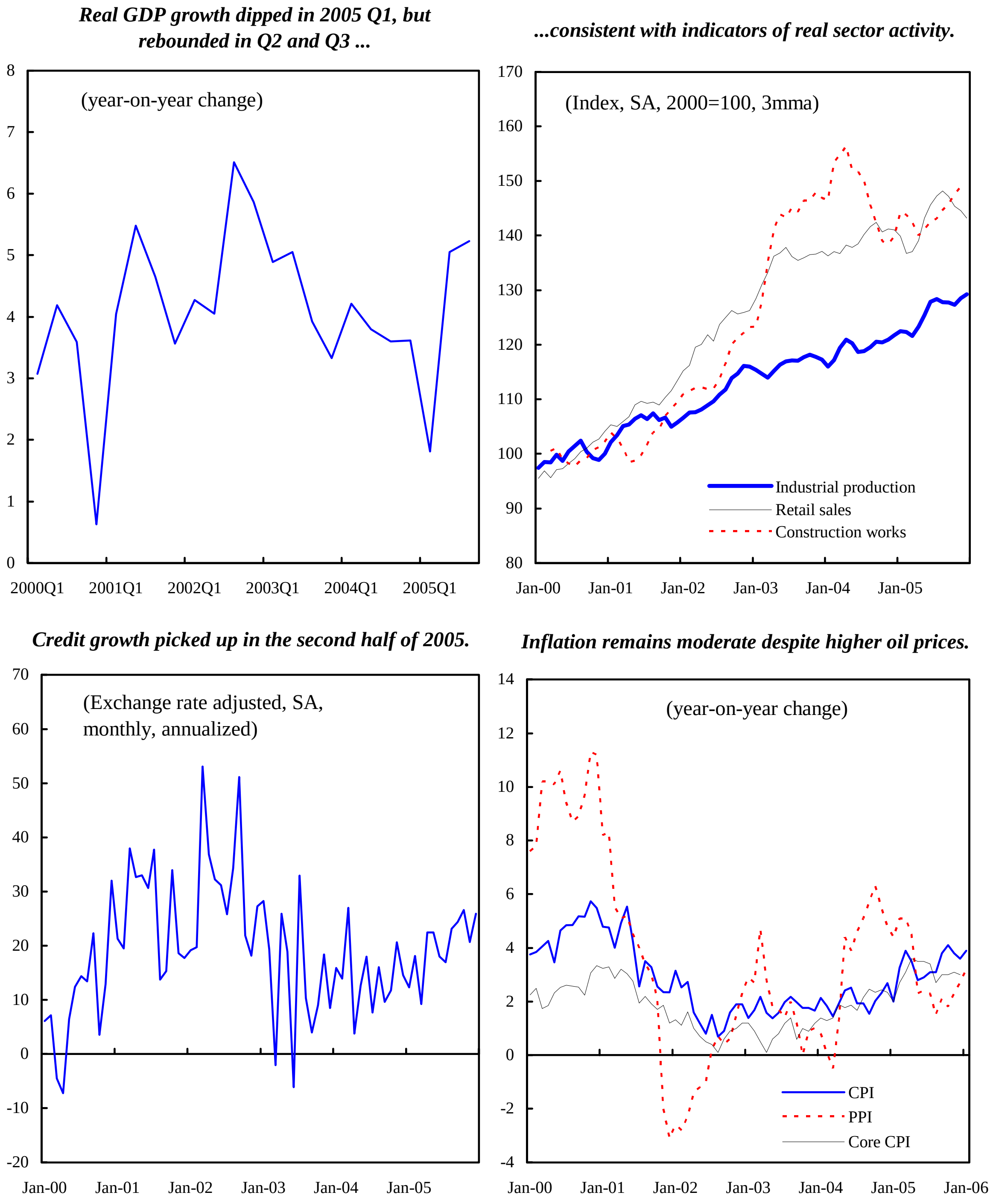
... while cost competitiveness indicators remain benign..





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

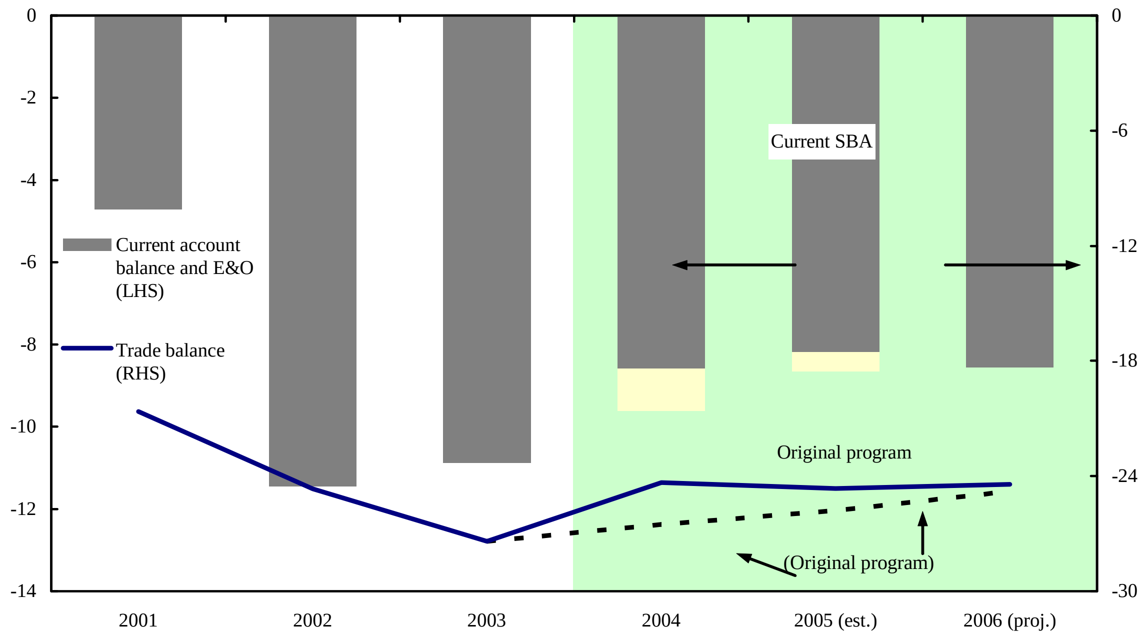
Figure 3. Croatia: GDP and Selected High-Frequency Indicators, 2000-06



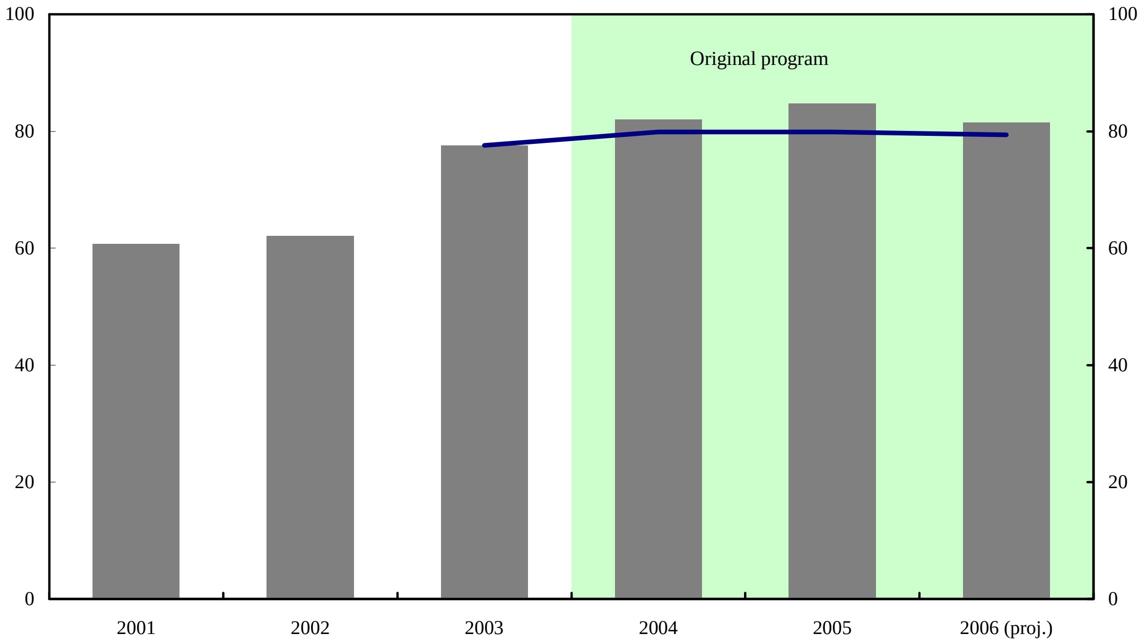
Sources: Croatian authorities; and IMF staff calculations.

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

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



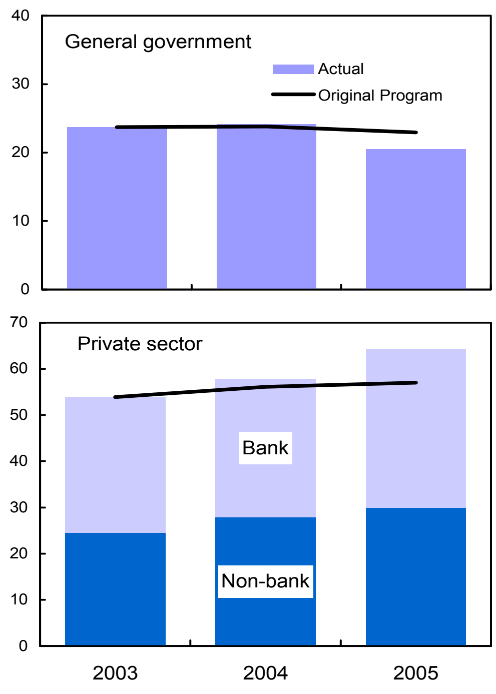
... though the expected stabilization of external debt in 2005 has been delayed.



Sources: Croatian authorities, and Fund staff estimates.

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

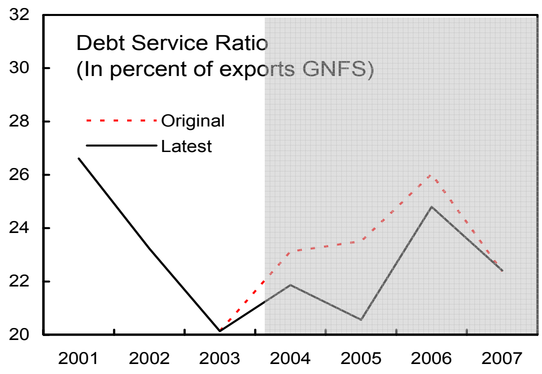
External indebtedness, 2003-05
(In percent of GDP)



Source: Croatian National Bank.

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

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



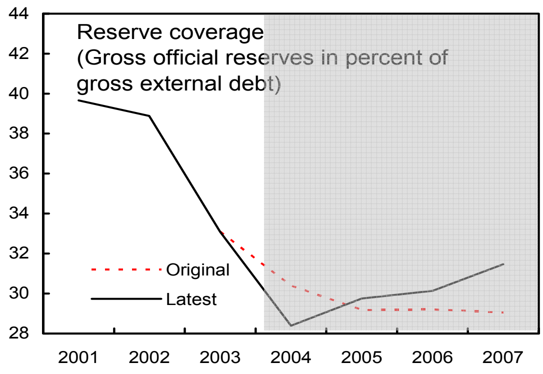
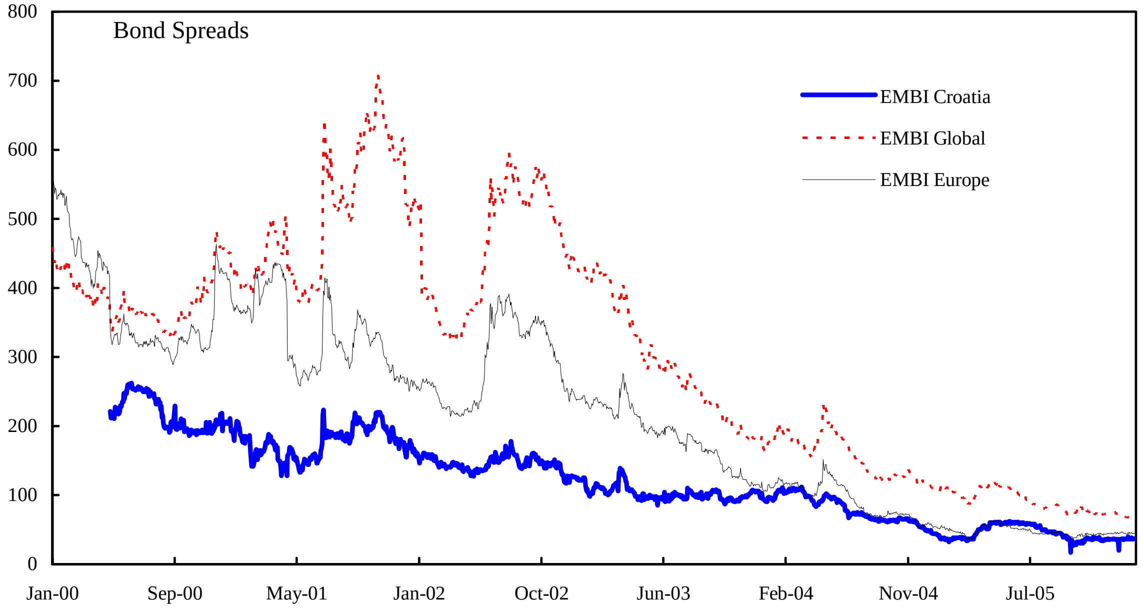
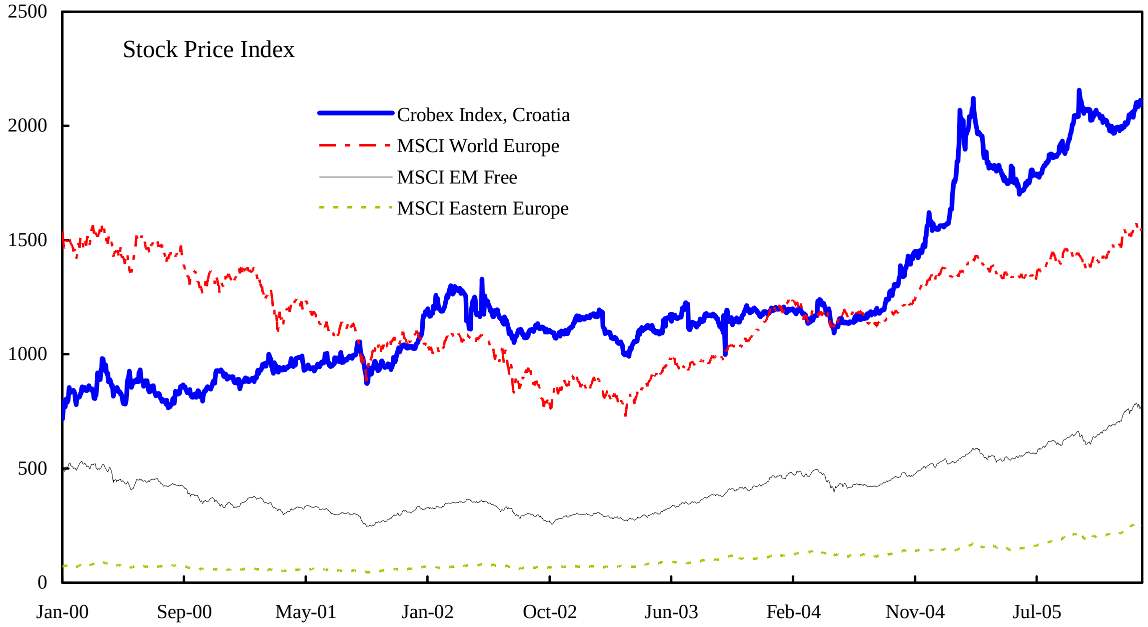


Figure 5. Croatia: Capital Market Conditions, 2000-06
(In basis points)

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



...while the stock market remains robust.



Sources: Croatian authorities; and JP Morgan/Bloomberg.

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

II. THE PROGRAM FOR 2006

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

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

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

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

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

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

Box 1. Croatia's Pre-Accession Economic Program

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

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

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

Sources: Ministry of Finance and staff estimates

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

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

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

A. Fiscal Policy

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

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

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

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

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

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

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

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

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

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

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

Box 2. Repaying the "Pensioners' Debt"

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

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

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

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

B. Monetary and Financial Sector Policies

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

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

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

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

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

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

C. Structural Policies

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

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

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

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

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

III. Modalities of the Proposed Program Extension and Risks

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

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

IV. Staff Appraisal

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

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

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

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

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

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

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

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

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

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

Source: Data provided by the Croatian authorities.

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

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

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

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

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

Sources: Croatian authorities, and Fund staff estimates.

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

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

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

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

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

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

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

Sources: Croatian National Bank, and Fund staff estimates.

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

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

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

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

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

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

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

Source: Croatian National Bank.

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

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

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

Source: Ministry of Finance and staff estimates.

1/ Deficit presented for 2004 includes in other revenues HRK 197 million secured in December 2004 at auction of a GSM license, but not received in cash until February 2005. In turn, this amount is not included in 2005 revenues.
2/ Excluding “pensioners’ debt” repayments and including accumulation of arrears in "Use of goods and services".
3/ Based on preliminary data showing that 75 percent of eligible pensioners will choose the cash repayment option at a 50 percent discount during 2006-07.

Table 8. Croatia: Monetary Accounts, 2003-06

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

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

Sources: Croatian National Bank; and Fund staff projections.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Zagreb, March 3, 2006

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

Dear Mr. de Rato:

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

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

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

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

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

Sincerely yours,

/s/

Ivan Šuker
Minister of Finance
Ministry of Finance

/s/

Željko Rohatinski
Governor
Croatian National Bank

Attachments:
Annex
Technical Memorandum of Understanding