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INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

Selected Issues

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Approved by the European Department

April 24, 2008

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PREFACE

This document contains two selected issues papers. With one paper assessing external stability in Croatia and the other taking a cross-country perspective on analyzing inefficiencies in Croatian public spending, the papers are integral to the analysis for the 2008 Article IV consultation. In addition, the latter paper also served as input into a technical assistance mission on short-term expenditure rationalization, which the Fund's Fiscal Affairs Department undertook in collaboration with the World Bank in January–February 2008.

The first paper focuses on external stability, an important issue in view of Croatia's external imbalances and the requirements of the IMF's 2007 Decision on Bilateral Surveillance. The paper concludes that the real exchange rate is broadly in line with economic fundamentals, and that external debt dynamics are sustainable over the medium-term, as long as macroeconomic policies remain strong. However, there are risks to external stability, largely related to financial account vulnerabilities that arise from the possibility of increases in the cost of foreign borrowing and/or a significant slowdown in capital inflows. This underscores the importance of policies to reduce Croatia's external imbalances, not only through strong macroeconomic policies, but also through structural reforms. It also underscores the importance of the authorities having contingency measures at the ready.

The second paper finds evidence of significant inefficiencies in Croatia's social spending. This implies there is room to reduce government spending without unduly sacrificing the quality of social services. The paper discusses a number of reform measures to reduce inefficiencies in public spending and generate budgetary savings, with a view to reducing the size of the general government deficit.

I. Assessing Croatia's External Stability[1]

A. Introduction

1. **The deteriorating global economy and ongoing re-pricing of credit risks warrant a closer look at countries with high current account deficits and large external financing requirements**.[2] In view of the magnitude of Croatia's external imbalances, as well as the requirements of the IMF's 2007 Decision on Bilateral Surveillance,[3] external stability is a key focus of this Article IV consultation.

2. **External stability is defined as "a balance of payments position that does not, and is not likely to, give rise to disruptive adjustments in exchange rates."[4]** This requires that: (i) the *underlying current account* (i.e., the current account stripped of temporary factors, such as cyclical fluctuations, temporary shocks, and adjustment lags) is broadly in equilibrium—a situation in which the country's net external asset position is evolving consistently with the economy's structure and fundamentals; and (ii) the *capital and financial account* does not create risks of abrupt shifts in capital flows.

3. **This Chapter asks three main questions**:

- What are the key drivers of Croatia's current account dynamics?
- Is Croatia's current account position sustainable?
- Do financial account and external debt positions pose any risks to external stability?

4. **The main conclusion is that external stability risks relate largely to financial account vulnerabilities rather than exchange rate misalignment.** There is no compelling evidence that the widening current account deficit reflects competitiveness problems stemming from real exchange appreciation; rather the lackluster merchandise export performance seems to be largely due to structural factors. Under the baseline medium-term scenario, which assumes a limited impact of global slowdown on Croatia and a continuation of strong macroeconomic policies, the *underlying current account balance* is broadly in line

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[1] Prepared by Anna Ilyina.

[2] See, e.g., "Emerging Europe's Current Account Deficits: Mind the Gap!" by FitchRatings, January 31, 2008.

[3] In particular, the 2007 Decision on Bilateral Surveillance clarifies that the objective of the IMF's surveillance is to foster stability of the international monetary system by encouraging national policies that do not disrupt or compromise the members' own "external stability."

[4] *Decision on Bilateral Surveillance,* http://www.imf.org/external/np/pp/2007/eng/062107.htm