

**FOR  
AGENDA**

SM/08/119  
Correction 1

May 8, 2008

To: Members of the Executive Board  
From: The Secretary  
Subject: **Republic of Croatia—Selected Issues**

The attached corrections to SM/08/119 (4/25/08) have been provided by the staff.

**Typographical Errors**

**Page 25, Figure I.10:** Panel titles have been amended to reflect correct footnote numbering and footnotes have been renumbered accordingly.

Questions may be referred to Mr. Feldman (ext. 36317) and Mr. Jafarov (ext. 36369) in EUR, and Ms. Ilyina, PDR (ext. 35351).

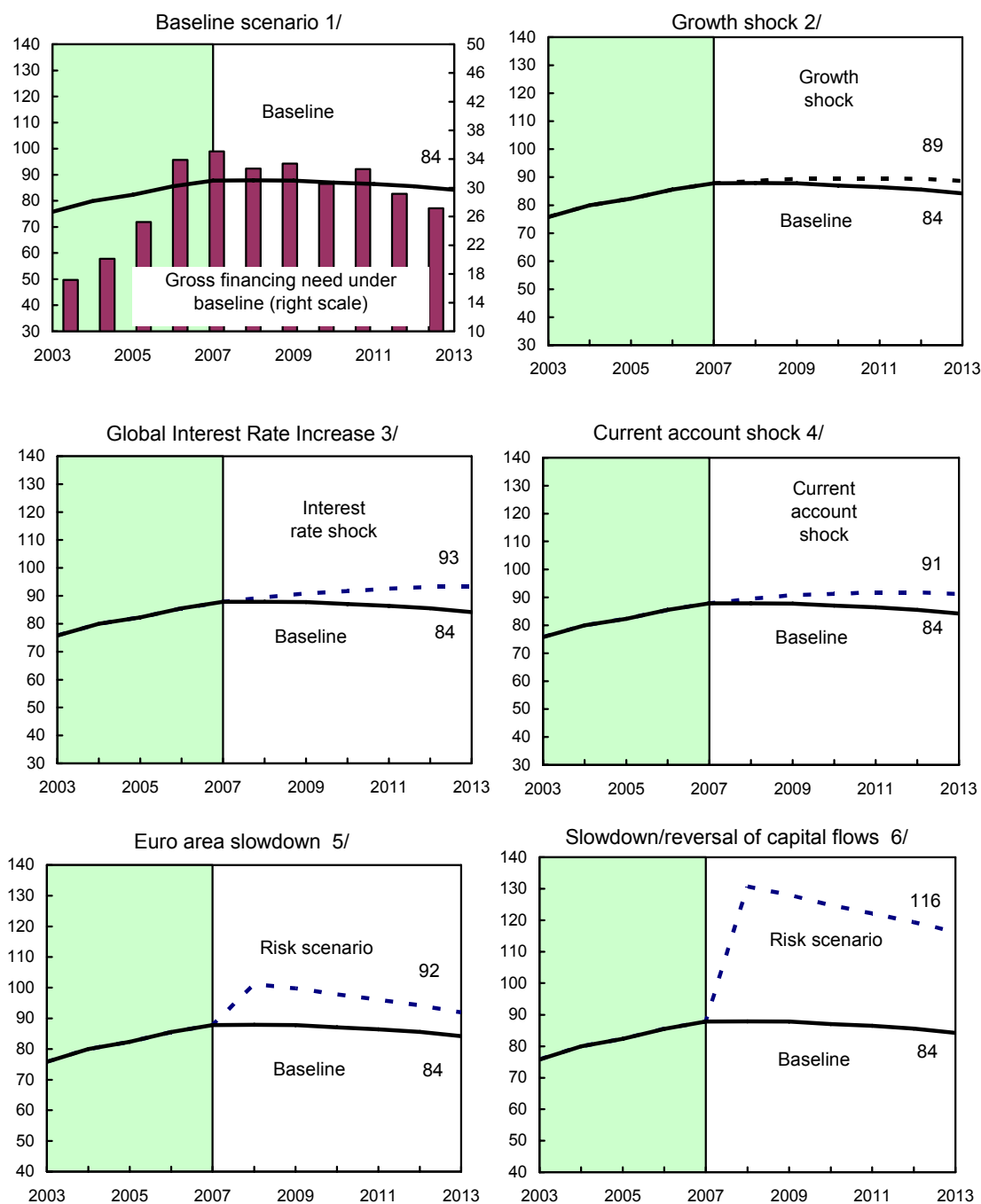
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Figure I.10. External Debt (in percent of GDP): Baseline and Downside Risk Scenarios



Sources: IMF, Croatian authorities, and staff estimates.

1/ Shaded areas represent actual data. Figures in the boxes represent projections for the respective variables in the baseline and scenario being presented. All standard deviations are computed using historical data for the past ten years.

2/ A permanent half of a standard deviation reduction in real GDP growth rate.

3/ Increase of euro interest rates by 200 bps (**Macro 3** scenario in the FSSA report).

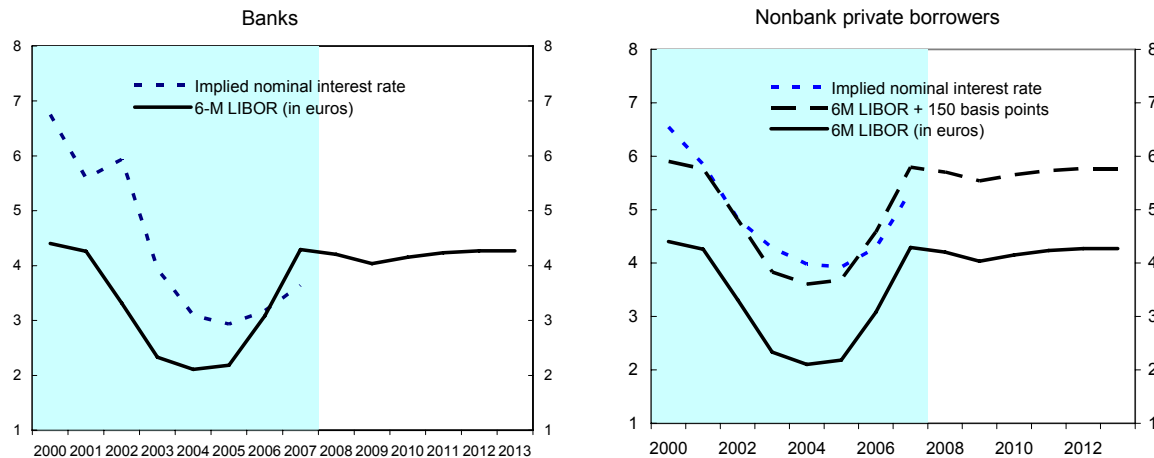
4/ A widening of current account deficit by one standard deviation in 2008, with the size of the shock decaying at the rate of 10 percent annually thereafter.

5/ One-time depreciation of the kuna by 10 percent, decrease of euro interest rates by 50 bp (**Macro 1** scenario in the FSSA report).

6/ One-time real depreciation of the kuna by 30 percent (**Macro 2** scenario in the FSSA report).

in credit market conditions may cause an upward revision of credit risk premia across a broad spectrum of borrowers, both banks and nonfinancial firms, while the Eurozone rates may not come down for some time due to inflation concerns.

Figure I.11. Croatia: Average Nominal Foreign Interest Rates by Domestic Sector



Sources: Croatian National Bank; World Economic Outlook and Fund staff estimates.

1/ The average nominal borrowing rates are imputed from the total interest payments in the current period and the stock of external debt at the end-of-previous period; shaded areas represent actual data.

29. **Based on a number of standard indicators, Croatia’s external liquidity position does not seem overly strong.** While the *external liquidity ratio* is estimated to have recently improved to over 120 percent at end-2007, the *reserve cover* remained below 80 percent and the *external debt service ratio* increased to around 38 percent in 2007 (Figure I.12).<sup>25</sup> Each of these indicators provides some information regarding the ability of a country to withstand the balance of payments pressures associated with significant slowdown or reversal of capital flows. While there are well known rules of thumb to determine the “comfortable” level of foreign exchange reserves (e.g., the Guidotti rule that says that reserves should fully cover total external debt by remaining maturity), the meaningful thresholds for the external liquidity indicators can only be determined within a framework that takes into account the relevant country circumstances that either provide additional buffers (e.g., in Croatia, short-term external debt includes a high proportion of bank borrowing from foreign parents, akin to “quasi-equity”) or could make the impact of negative shocks more damaging.<sup>26</sup> Moreover,

<sup>25</sup> The *external liquidity ratio* is defined as liquid external assets (net official reserves plus banks’ gross external assets) divided by liquid external liabilities (short-term external debt on the remaining maturity basis). The *reserve cover* is the ratio of official reserve to the sum of current account deficit and short-term external debt by remaining maturity. The *external debt service ratio* is the ratio of debt service to current external receipts.

<sup>26</sup> For example, an adjusted external liquidity ratio (which adds foreign currency deposits in domestic banks to external liabilities) is sometimes used to gauge the adequate level of external liquidity in the context of high financial dollarization/euroization (see, e.g., FitchRatings (March 2007)). This is because the adjusted external liquidity indicator also takes into account the amount of foreign exchange that banks would need to raise in an

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