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Minutes of Executive Board Meeting 08/40-3

2:30 p.m., May 9, 2008

3. Republic of Croatia—2008 Article IV Consultation

Documents: BUFF/08/54; SM/08/111 and Correction 1 and Supplement 1; SM/08/115; SM/08/119 and Correction 1

Staff: Feldman, EUR; Otker-Robe, MCM; Boote, PDR

Length: 38 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE), Temporary
	M. Alle (AF), Temporary
	J. Maciel (AG), Temporary
	S. Na (AU), Temporary
	J. Prader (BE)
	R. Santana (BR), Temporary
	J. He (CC)
	E. Valle (CE), Temporary
	S. Ladd (CO), Temporary
	A. Lahreche (FF), Temporary
	F. Haupt (GR), Temporary
	S. Krishnan (IN), Temporary
	F. Spadafora (IT), Temporary
	N. Imamura (JA), Temporary
	S. Maherzi (MD), Temporary
	A. El-Ganainy (MI), Temporary
A. Bakker (NE)	Y. Yakusha (NE)
	D. Abazorius (NO), Temporary
	L. Palei (RU), Temporary
	S. Alnefaee (SA), Temporary
	S. Mathema (ST), Temporary
	S. Antic (SZ), Temporary
	D. Heath (UA)
	H. Robinson (UK), Temporary

L. Hubloue, Acting Secretary
J. Young, Assistant

Also Present
IBRD: S. Juma, J. Pollner. ECB: F. Ramon-Ballester. European Department: R. Feldman, E. Jafarov. Legal Department: M. Milford. Monetary and Capital Markets: I. Otker-Robe, V. Vassili Prokopenko. Policy Development and Review Department: A. Boote, A. Ilyina. Secretary's Department: A. Blazejewski, P. Cirillo. Senior Advisors to Executive Directors: I. Ábel (BE). Advisors to Executive Directors: S. Cerovic (NE), T. Galac (NE), R. Lin (CC), H. Sabtu (ST), M. Tomic (NE), P. Wood (UA).

3. REPUBLIC OF CROATIA—2008 ARTICLE IV CONSULTATION

Mr. Bakker and Mr. Galac submitted the following statement:

The authorities value their continuing cooperation with the Fund, as their economic policies are being increasingly shaped by the ongoing efforts to speed up Croatia's accession to the European Union. They thus greatly appreciate that the 2008 Article IV consultation focused on those topics important to the Croatian economy that are in the domain of the Fund's core competencies—fighting rising inflation and persistent external vulnerabilities, and strengthening the financial sector. The authorities welcome the thorough staff analysis and mostly agree with the staff's recommendations.

In 2008, the reelected government took office for a new four-year term that is expected to see Croatia becoming a full member of NATO in 2009 and in the same year finishing negotiations with the EU. While the invitation to join NATO, extended to Croatia in April 2008, provides a security blanket in a still relatively unstable area, the ongoing EU negotiations continue to act as an important anchor for macroeconomic stability. In such a stable environment, the key objective of the authorities is to speed up progress in structural reforms, supporting key growth sectors of the economy and restructuring lagging ones.

Economic Performance and Outlook

Croatia has experienced seven years of uninterrupted real output growth of around 5 percent per year, with consumer price inflation subdued below 3.5 percent per year. Real GDP rose by 5.6 percent in 2007, as both private and government final consumption accelerated, spurred by the political cycle and a large pay-out of so called "pensioners debt". With a lag, solid growth and price stability resulted in an increase of the average number of employed persons over 3 percent in both 2006 and 2007, after a sluggish growth over the past five years; the unemployment rate reached its lowest level of 9.5 percent in 2007. Recently, consumer price inflation picked up, peaking at 6.2 percent in January 2008, as the economy could no longer buffer rising energy and food prices. Years of above-potential growth, increasingly financed by foreign borrowing, have pushed up the current account balance to 8.6 percent and external debt to 88 percent of GDP in 2007, the latter being higher than in most comparator countries.

The authorities recognize the potential risks associated with Croatia's external imbalances, especially in light of the dimming global growth outlook and persistent strains in commodity and financial markets. Both fiscal and monetary policies for 2008 and beyond have been adapted accordingly, as underlying growth projections have been reduced to 4.5 percent and inflation projections raised to 5.5 percent, close to current WEO projections. These conservative projections will support the authorities' efforts to further reduce the government deficit and to curb the growth of domestic credit, in the medium term. Against this background, the authorities now expect external debt and the current account balance to stabilize close to their end-2007 levels in the baseline, supported by a further reduction in the growth rates of broad money and bank credit to the private sector.

Monetary Policy and External Sector

Faced with hyperinflation in the early 1990s and financial euroization thereafter (one of the highest levels in Europe), monetary policy has aimed at maintaining broad nominal exchange rate stability, that has served the economy well, as it has brought down inflation and inflation expectations, and curbed balance sheet risks. While closely monitoring growing inflationary pressures, the Croatian National Bank (CNB) has focused on mitigating external vulnerabilities for some time now. In particular, to combat high credit growth, mostly financed from abroad, that adds to the rising current account deficit, the CNB has resorted to a battery of direct monetary and prudential measures (Table 4 in the FSSA Report), while at the same time strengthening its communication to the financial community and the general public.

The measures produced considerable results during 2007, as the government reined its finances, bankers focused on profits rather than on market shares, and external financing conditions tightened. Specifically, total credit growth slowed noticeably, especially to the household sector,. Moreover, the measures significantly reduced the proportion of foreign currency denominated loans in total loans, supported by a significant rise in the proportion of domestic currency in total deposits. The measures provided the right incentives for most banks to raise additional capital and have prevented a more severe widening of the current account deficit. The authorities are aware of possible negative side-effects of these measures (well indicated in the FSSA report). Nevertheless, given the limited options for monetary policy, and given that vulnerabilities have not yet been sufficiently reduced, the authorities contend that it is premature to phase these measures out in the short term.

The authorities agree with staff's assessment that Croatia's growing current account deficit is mostly driven by structural deficiencies, while there is no compelling evidence of real exchange rate misalignment. Therefore, the monetary authorities closely monitor macro-prudential indicators for any signs of emerging pressures which might warrant a tightening of prudential standards. As recognized by staff, the authorities are addressing immediate risks to Croatia's external liquidity position, stemming from the worsening global outlook. As a precautionary measure, the central bank is currently assessing how to increase the flexibility of its liquidity management instruments for the banking sector and improve its existing crisis management framework. Nevertheless, the authorities expect that external stability indicators will follow closely the baseline scenario under the DSA. This expectation is based on the continued success of measures to slow down credit growth to the private sector, on the positive effects of accelerated structural reforms on government finances, and on the expected increase of non-debt creating inflows from Croatia's major investing partners, as they by and large come from neighboring countries, and thus have longer-term investment horizons.

Fiscal Policy and Structural Reforms

The authorities have successfully pursued fiscal consolidation over the past several years. The overall general government deficit has declined from 6.2 percent of GDP in 2003, to 2.3 percent by 2007. Pension reform, wage moderation, and investment cuts all have contributed. Revenue collection overperformed in 2007, which was quite remarkable given the political cycle. However, the authorities are aware that the total public financing requirement decreased at a slower pace. Therefore, they are committed to further medium-term fiscal consolidation. To this end, the authorities have secured a 2008 budget, that aims at a significant reduction in the total public financing requirement, due to lower extra-budgetary payments of "pensioners debt." Moreover, the medium-term framework envisages significant further reductions in the general government deficit for 2009 and 2010.

Against this background, the authorities concur with the results of the staff's debt-sustainability analysis that shows further declining levels of the public debt-to-GDP ratio under the baseline scenario, while the bound tests show that the current level of the public debt-to-GDP ratio is robust to a number of reasonable shocks.

The planned improvements in Croatia's fiscal position assume rapid and considerable positive effects of planned structural reforms. Some of these reforms are among the most difficult of the Croatian economic landscape ever, but they are prerequisites for the last stage of Croatia's convergence into the EU. Among the top priorities for the 2008-09 period are finalization of the already well advanced pension reform as well as completion of the privatization process, particularly the disposal of large government stakes in railways and shipbuilding. In anticipation of this privatization these sectors will be restructured, with a view of permanently reducing subsidies in line with EU standards. The government has already announced plans to privatize two viable shipyards. The government announced in March 2008 that it would establish a new investment fund for other companies, to which the entire portfolio of the Croatian Privatization Fund (HFP) would be transferred. The privatization process will be effectively completed after shares in this investment fund have been successfully offered to the general public.

Other far-reaching reforms concern the health sector, education and social security, for reasons well elaborated in the selected issues papers.

Financial sector

As noted in the FSSA Report, Croatia's financial system has made a huge leap forward since the 2002 FSAP. In this period, the assets of the financial sector doubled; non-banking financial intermediaries have entered the scene; the securities markets developed from a miniscule base; and financial conglomerates emerged. At the same time, the CNB has put in place an effective bank supervision framework, whereas the supervision of the non-banking financial sector has significantly improved under the unified non-banking supervisor (HANFA). Memorandums of understanding have been signed between the two supervisors, as well as with relevant foreign supervisory authorities. While there is a need to further develop the financial system, staff rightly concludes that the financial sector remains broadly healthy, and that the authorities have been proactive in addressing the remaining challenges.

Regarding staff recommendations for further strengthening the financial system, the authorities are actively addressing areas that can be dealt with immediately. In the banking sector, the CNB is improving its surveillance and communication strategy, and preparing a forward-looking financial stability report to be published in the second half of 2008. The central bank is modifying its liquidity management framework, to address potential effects of cross-border illiquidity spillovers, as well as to improve

the functioning of the money market. The authorities are working on clarifying the roles of various agencies involved in the banking resolution process, and the central bank initiated formal contacts with relevant foreign bank supervisors in order to strengthen contingency planning.

In the longer run, further development of the financial sector will require full harmonization of financial legislation with EU standards, especially in the area of investor protection and enforcement of contracts. Completion of other reforms, including the transition to Basel II, and improvements in land ownership records, will significantly contribute to increased efficiency of financial intermediation. The authorities are also examining the benefits of inclusion of information on non-bank creditors and on legal person debtors in the national credit registry. Finally, strengthening the capacity and the powers of HANFA will improve the efficiency of non-banking sector supervision.

Mr. Sadun and Mr. Spadafora submitted the following statement:

We thank staff for the excellent set of papers and Mr. Bakker and Mr. Galac for their informative buff statement.

In a context of sustained growth, Croatia faces heightened vulnerabilities stemming from a large current account deficit, high external debt and balance-sheet exposure to currency risk arising from rapid credit growth and a high degree of euroization in the financial system.

The main risk factors include an increase in foreign interest rates and, above all, a slowdown or reversal in capital inflows that may lead to significant downward pressures on the kuna.

Given the current policy framework, with monetary policy focused to tightly managing the kuna-euro exchange rate, we agree with staff that support from fiscal, financial and structural policies is essential to ensure economic and financial stability.

Following the progress achieved in fiscal consolidation since 2003, in cyclically-adjusted terms the fiscal stance turned expansionary in 2007, as the deficit increased from 1.9 to 2.5 percent of GDP. This added to domestic demand pressures and contributed to widen the current account deficit to 8.6 percent of GDP, in a context of rising inflation risks.

Both headline and core inflation rates indeed spiked at the beginning of 2008, to 6.2 and 5.3 percent respectively. We note that the two measures of inflation are very close to each other and also show similar dynamics, despite substantial increases in food prices since the second half of 2007 (on the contrary, the rise in world oil prices has had a limited pass-through to domestic energy prices). Staff comments, particularly on the implications for inflation expectations and the risk of second-round effects, are welcome.

Against this background, we welcome the tightened fiscal stance envisaged by the 2008 budget, which targets a significant reduction of the cyclically-adjusted deficit to 1.7 percent of GDP. Staff's call on the authorities to pursue a more ambitious (and frontloaded) fiscal adjustment, by saving any revenue overperformance in 2008 and more aggressively cutting expenditures in 2009, is consistent with the need to address inflation risks and external vulnerabilities in a timely manner. Furthermore, as evidenced in the SIPs, widespread inefficiencies in Croatia's social spending (which accounts for more than half of total government spending) point to a large potential for reducing government expenditure without undeservedly affecting the coverage of public services.

The Financial System

According to the FSAP update, the financial system is reasonably sound, although it faces heightened vulnerabilities arising from the exposure to interest- and exchange rate-induced credit risk, as most loans are at variable interest rates and denominated in or indexed to foreign currencies.

As the external debt-to-GDP ratio reached about 90 percent at end-2007,[1] stress tests performed by staff suggest that the baseline external debt dynamics may not be sustainable under certain "extreme but plausible" risk scenarios.

In this regard, we agree with staff on the importance to enhance the banks' capital buffer as a safeguard against such scenarios and welcome the further increase by CNB of the risk weights on unhedged foreign-currency loans (over 60 percent of the total), which also addresses the potential for some complacency toward exchange rate risk that often comes as a by-product of several years of exchange rate stability. It is however reassuring that bank balance sheets' exposure to foreign currency mismatch is limited.

[1] The first SIP refers to a "safe" level of external debt at around 35 percent of GDP, although the usual notes of caution apply to the meaningfulness of such a "threshold" level, particularly for transition economies.

We also appreciate the progress made since the 2002 FSAP to improve the overall regulatory and supervisory framework, including the establishment of a single regulator (HANFA) for the non-bank financial sector given its increased systemic importance. In fact, leasing companies operating in this sector now represent the second largest group of intermediaries, making up 11 percent of total assets.

We concur with staff on the necessity for the authorities to carefully plan a phasing out of the several administrative measures adopted over the last few years to curb credit growth. As correctly pointed out by staff, such measures carry well-known negative side effects, not least by providing financial intermediaries with incentives to circumvent those same measures that, in turn, often call for a second round of administrative controls (Box 1 of the FSAP update). In fact, in the case of Croatia, the increase of loans directly extended by the previously-unregulated leasing companies can be partly traced back to the administrative credit controls put in place by CNB to contain the rapid growth in bank credit.

Another example is the Special Reserve Requirement applied to banks' liabilities arising from the issue of securities. This requirement seems to be at odds with the need to develop the shallow and segmented interbank money market; it may also be contradictory to the goal of containing recourse to foreign funding, which is being pursued by other measures.

With these remarks, we wish the authorities well in their future endeavors.

Mr. He and Ms. Lin submitted the following statement:

We thank staff for their well-focused papers and Messrs. Bakker and Galac for their helpful statement. These documents point to a complex economic situation, demanding a challenging mix of macroeconomic policies. Since we agree with the thrust of staff's appraisal, we will confine our comments to the following.

In its efforts toward EU accession, Croatia's exchange rate system has helped rein in inflationary pressure and mitigate balance-sheet exposure. We do not see particular usefulness of difficult debate over the label of the regime. The label does not change or affect the regime. We are heartened to note that the current exchange rate level is in line with medium-term fundamentals, eliminating a possible source of external instability. Rapid credit expansion over recent years has contributed to booming asset prices and a significant

external imbalance. In this regard, we are encouraged that bank credit to the private sector has slowed as a result of the authorities' strong supervisory and prudential measures to enhance the resilience of the banking sector and limit macrofinancial vulnerabilities. Despite the undesirable consequences of direct monetary measures, we sympathize with the authorities' desire to maintain credit controls in the absence of other efficient monetary tools.

The large current account deficit is the principal source of vulnerability due to the lackluster export performance—explained by Croatia's intensified integration in the goods and financial markets and structural weaknesses. From this perspective, it is imperative that the authorities carry out productivity-enhancing structural reforms through improving the business environment and reducing administrative and regulatory burdens. Progress in these areas will also help achieve the convergence criteria for EU accession and attract "greenfield" FDI, viable external financing for the current account deficit.

Turning to fiscal policy, the authorities' efforts with fiscal consolidation have been commendable over the past five years, along with their ambitious plan to cut the fiscal deficit to 0.5 percent of GDP by 2010. These efforts have led to the declining public debt, another source of vulnerability. We note staff's suggestion for a more ambitious and front-loaded implementation strategy. However, given the unfavorable external environment and downside risks to the growth outlook, there is a need for fine-tuning the timing and pace of consolidation so as to avoid excessive impact on growth. Staff's elaboration on this issue is welcome. In view of the low efficiency in the provision of health care, education, and social protection, we welcome the envisaged over-arching reform in these areas, but caution that these reforms should be well-designed so as to avoid any unintended consequences for vulnerable groups.

With growing foreign presence in Croatia's banking system and heavy reliance on foreign funding, Croatian banks are exposed to external shocks including liquidity and contagion risks and also subject to interest rate and exchange rate adjustments. Specifically, the uncertainty surrounding parent banks' losses arising from the sub-prime mortgage market will pose liquidity and contagion risks through the financing channel and call for contingency planning. In addition to enhanced communication with the supervisory authorities of foreign banks, it is encouraging that the authorities have initiated efforts to set up a burden-sharing system in cross-border banking failure resolution.

With these comments, we wish the authorities every success in their policy endeavors.

Mr. Larsen and Ms. Robinson submitted the following statement:

We thank staff for this report which presents a fair and balanced assessment of the challenges faced by Croatia. Croatia has achieved numerous successes in recent years, including seven consecutive years of real output growth of around 5 percent per annum. As Mr. Bakker and Mr. Galac state in their informative buff statement, EU negotiations continue to act as an important anchor for macroeconomic stability, and we are pleased to note that the authorities' key objective is to accelerate progress in structural reforms, supporting key growth sectors of the economy and restructuring lagging ones. Nevertheless, macroeconomic imbalances are present and efforts will be required to reduce external and financial vulnerabilities, particularly in the context of a less certain external environment.

Monetary policy is constrained by the tightly managed exchange rate, which places more strain on other policies, particularly fiscal policy, for managing domestic demand pressures. Sustained policy and communication efforts will need to be made to avoid entrenching higher inflation expectations following the projected hike in inflation.

We agree that fiscal consolidation could play an important role in bolstering the economy and welcome the efforts made by the authorities to-date in this regard. However, we endorse staff's assessment that continued fiscal consolidation is needed, particularly in light of the limited monetary policy tools available for containing inflation. In exercising expenditure restraint it will be important to ensure that expenditure cuts do not adversely affect potential future productivity gains.

We agree with the recommendations made by staff regarding structural reforms, in particular the reform of the ship yards, and the need to improve the business environment to make it more efficient and conducive to investment. Implementation of some structural reforms may also have positive impact on the employment rate and would go some way to addressing Croatia's competitiveness within Europe.

Mr. Raczko and Mr. Antic submitted the following statement:

We thank staff for the well written papers on Croatia, which set out the scope of discussion. Staff's comprehensive papers, together with Mr. Bakker and Mr. Galac's buff statement, present a positive outlook of Croatia's economy. The documents prepared for today's Board meeting also provide an interesting picture of the challenges ahead.

Although Croatia's macroeconomic performance has been strong, gauging by economic growth, unemployment and inflation rates, the external imbalances continue to widen. The high growth rate was driven by strong domestic demand, fueled partially by strong credit growth. Unemployment has been cut by a third in the last five years, while inflation rate was low until the recent surge. However, the widening of the current account deficit and the level of external debt are signs that point to rising vulnerabilities.

Due to persistent and growing external imbalances, we concur with staff that downside risks are significant. Slower growth, more in line with potential, may not reduce external imbalances because higher international food prices combined with prolonged slowdown in world economy could put additional pressure on the country's current account deficit. Staff also see problems with strong capital inflows that complicate the conduct of monetary policy. However, the recent downward adjustment on the stock market suggests that investors might not be as active as before.

On the fiscal side tightening is the appropriate answer to rising imbalances. Government decision to further tighten medium term fiscal targets is a very encouraging signal. We support the position of staff that frontloading of fiscal measures and concentration on expenditure cuts are needed to meet the current challenges.

Although the authorities do not have a precise plan to contain expenditures, health care and civil service should be the main objectives of the reform. Significant cuts are also possible on different forms of subsidies that are at the level of 3.5 percent of GDP in 2007. Similar levels of subsidies have been present in the last five years, which implies that this area did not go through reforms.

Tight management of the exchange rate, as the principal operating objective of monetary policy, has served the country well. In a highly euroised country that had periods of very high inflation in the past, the relatively stable exchange rate has been used as the anchor curbing inflation expectations.

Staff's assessment of the exchange rate—that it is broadly in line with fundamentals—is also a sign of the effectiveness and capacity of the Croatian National Bank (CNB) to manage the exchange rate properly.

The loosening of the fiscal stance due to elections created inflationary pressure that was addressed by administrative credit controls introduced in 2007. Those measures have some effects on slower credit growth. The positive results urged the CNB to extend credit controls in 2008. Staff's comments on the experience and effectiveness of administrative credit controls, particularly those that lasted relatively long, will be appreciated.

We are puzzled by the size and even more by the persistence of the errors and omissions item in the balance of payments. Staff's explanation that this item reflects capital outflows that were not recorded seems plausible. However, it is not clear why staff project errors and omissions of this size until 2013? Can staff elaborate more on the nature of this item?

Mr. Silva-Ruete and Mr. Maciel submitted the following statement:

We thank the staff for a comprehensive and well-written set of documents, and Mr. Bakker and Mr. Galac for their insightful buff statement. We commend the authorities for Croatia's significant economic growth in recent years, while maintaining a tamed inflation. We are pleased that the authorities' implementation of IMF advice from past Article IV consultations and FSSA reports has led to reliable economic policies and successful outcomes that undoubtedly have contributed to Croatia's prospects of becoming a NATO and EU member in 2009.

Despite last year's strong GDP growth, inflation rose to 5.7 percent in March, after peaking at 6.2 percent in January 2008, while external imbalances continued to increase. As a consequence of domestic demand growth, the current account deficit widened to 8.6 percent of GDP and the external debt reached 88 percent of GDP at the end of 2007. Although these indicators are not very different from other countries in the region, they should be carefully addressed by the Croatian authorities in order to attain a successful convergence towards EU accession. In this regard, we concur with the staff's appraisal and broadly endorse their recommendations.

As mentioned by Messrs. Bakker and Galac, the authorities have already taken the necessary actions to adapt 2008 fiscal and monetary policies to achieve moderate growth and lower inflation. These targets mainly reflect the projections of a slower consumption growth and a drop in government

expenditure. On the exchange rate regime, we are pleased to see that the Central Bank of Croatia (CNB) has succeeded in maintaining a stable value of the Kuna against the Euro, which until recently contributed to keeping a low inflation. We support the CNB's exchange rate policy and we are pleased with the staff's appraisal that the real exchange rate is in line with fundamentals.

We commend the authorities' efforts to pursue fiscal consolidation over recent years, bringing down the deficit to 2.3 percent by 2007. However, we concur with the staff's assessment to maintain momentum and reach a fiscal balance by 2011. This implies a frontloaded adjustment, not only further reducing the 2008 deficit, but also with the aim to achieve a fiscal deficit no larger than 1 percent of GDP in 2009. As the staff rightly notes, additional savings could be sought in government expenditures, although we do not agree in compromising any reduction of public services, especially to the poorer segment of the population. The government's intention to limit government wage increases to 6 percent is a step in the right direction.

Given the limited room for monetary measures, the use of financial, fiscal and structural policies are imperative to maintain stability and reduce vulnerabilities. The support of fiscal policy actions is essential to reduce internal demand pressures, thus helping the CNB to contain higher inflation and external imbalances. We understand that under the current circumstances, the CNB was forced to introduce credit controls to limit rapid credit growth. However, we are not in favor of measures that could affect the growth and development of small enterprises; therefore, we encourage the authorities to find additional measures that could avoid negative side effects.

Regarding the financial sector, we are pleased with the development of banks and non-bank financial institutions. As demonstrated in the FSSA report, the financial system has grown rapidly under the umbrella of a strengthened supervisory framework. Banks are profitable, well capitalized and their asset quality remains satisfactory. However, the rapid growth has been accompanied by external imbalances and rising asset prices, exposing banks to exchange rate and interest rate related credit risks, which are especially dangerous in a predominantly foreign-owned banking system. Facing these circumstances, we encourage the authorities to remain vigilant and act quickly in the event of a sudden shift in market sentiment. We learned from the staff that the CNB has a wide range of instruments to manage systemic liquidity risks, built-up from strong reserve requirements, but additional steps still need to be taken to strengthen a developing money market.

There is a strong need for structural reforms to improve the business climate, especially at the public administration level, in order to attract foreign direct investment. In this regard, we are pleased to read in the World Bank's 2008 Doing Business survey that Croatia ranks second in the top-reformers in terms of improvements in country scores. We believe this a strong signal to the international community regarding the authorities' commitment to reform. Moreover, we applaud the authorities' plans to start the sale of two shipyards by the end of 2008, which confirms the continuation of the privatization efforts.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Stein and Mr. Haupt submitted the following statement:

We thank the staff for an instructive set of papers and Mr. Bakker and Mr. Galac for their insightful buff statement. Croatia has benefited from strong economic growth in recent years. As elsewhere in the region, however, successes in economic activity and employment have been accompanied by mounting external imbalances. Given the deteriorating global environment, the authorities are well advised to address the rising external and financial vulnerabilities early on. As explained by the staff, this requires continued efforts to reduce the government deficit and strengthen financial supervision, as well as accelerated structural reforms. In broad agreement with the staff analyses, we shall focus on the following points:

Monetary, Exchange Rate and Financial Sector Policies

Croatia's external liquidity indicators are weak, as suggested in the excellent S.I. paper on external stability. The economy's exposure (in relation to GDP) to western European banks is among the highest in the region. The authorities' prudential and administrative efforts to respond to the situation are welcome. They have helped curb credit growth and reduce the share of loans linked to foreign currency. Nevertheless, levels of private credit and foreign-currency linked loans remain high, and further efforts are likely needed to reduce vulnerabilities. In this context, financial sector policies take on a vital role, but exchange rate management is also an issue that could be looked into:

We welcome the FSAP update and encourage the authorities to implement the related recommendations as soon as possible. This includes continuing efforts to raise risk awareness and to strengthen risk management in the banking system. Also, we welcome the authorities' awareness of the

need for stepping up contingency planning in order to protect the economy from spillover of international financial turbulences. At the same time, the costs and benefits of the authorities' administrative measures bear close watching. The related negative side effects, especially a possible rise in banks' risk appetite, need to be contained and closely monitored. The measures should be phased out when and if possible.

We acknowledge the advantages of the current tight management of the exchange rate, given Croatia's experience with hyperinflation and high degree of euroïzation. At the same time, we note the references in the report to the possible adverse implications for the pricing of unhedged credit risks. Moreover, it appears that the asymmetry of the exchange rate peg, allowing for nominal appreciation, might promote further underpricing of currency-related credit risks and make foreign currency-linked loans even more attractive from the point of view of borrowers. The staff's comment would be welcome. The staff is also invited to comment on whether or not a broader (symmetric) band for permitted exchange rate fluctuations could increase sensitivity to credit risks.

Fiscal Policy

We concur with the staff that more front-loaded fiscal adjustment would be crucial to contain inflationary pressures and reduce external imbalances in the absence of a monetary policy tool. While the deficit reduction of recent years is commendable, we note that the overall fiscal stance is still considered to be expansionary. Moreover, the staff sees ample room to raise the efficiency of public spending. We thus encourage the authorities to expedite their work on reforming the delivery of public services and state aid.

Structural Issues

Stronger potential growth, higher FDI inflows, and more dynamic merchandise exports would go a long way towards safeguarding external sustainability. We also take note of the staff analysis that weaknesses in export performance can be largely explained by structural factors rather than exchange rate developments. Against this background, expedited structural reforms should be high on the authorities' agenda, including measures to restructure publicly owned shipyards and to improve the business environment. The payoffs of accelerated reforms should be particularly high, given the likely positive confidence effects resulting from improved prospects of timely EU accession.

Mr. Prader and Mr. Ábel submitted the following statement:

We thank staff for the well-written report and the selected issues paper and Messrs. Bakker and Galac for their informative buff statement. In 2007, Croatia's macroeconomic performance was strong with the GDP growth rate reaching 5.6 percent and the fiscal deficit estimated at 2.3 percent of GDP. The exchange rate is tightly managed. In February 2008, the central bank announced its desire to keep the exchange rate between 7.25 and 7.35 kuna per euro.

We agree with staff that the tightly managed exchange rate is appropriate in light of the balance-sheet exposures. These balance-sheet exposures were well identified in the Fund's staff report last year. We agree with the staff's assessment that to avoid a possible conflict between the exchange rate policy and the government's ambition of maintaining the speed of convergence and keeping macroeconomic stability, the authorities should implement more ambitious fiscal, financial and structural policies that could provide strong support for the monetary policy stance. The projected inflation of 5.5 percent in 2008 is significantly higher than the euro area inflation, and the real appreciation of the currency could lead to potential problems. For emphasis, we will comment on some of the possible difficulties in the areas of macroeconomic stability, export performance and financial conditions in the credit market.

Croatia's tightly managed exchange rate makes fiscal policy central to any stabilization policy. In this regard, the past successes are encouraging. The government was able to reduce the fiscal deficit from 6.1 percent of GDP in 2003 to 3 percent in 2006 and to an estimated 2.3 percent in 2007. This success was achieved as a result of an exceptionally good growth performance. Like staff, we believe that more could have been done in the past as the cyclically adjusted overall fiscal stance changed little in 2006 and was already expansionary in 2007. It is regrettable that this good opportunity was missed, especially because growth is now slowing at an unexpected speed. GDP growth dropped from 7 percent (annualized) in the first quarter of 2007 to 6.6 percent in the second and 5.1 percent in the third. The projected GDP growth rate in 2008 is 4.3 percent.

Given Croatia's circumstances, fiscal policy is crucial for economic stabilization and to curb inflation. Monetary policy is constrained by the exchange rate arrangement. We welcome the staff's carefully balanced assessment of the fiscal situation. We take note of some of the favorable aspects of the 2008 budget, including the deficit target of 2.3 percent of GDP,

which is lower than the original target of 2.9 percent of GDP, and the government's intention to keep public wage increases below 6 percent.

Inflation at 5.5 percent in itself would not be of great concern but given Croatia's special circumstances, it could hurt export performance and growth in a situation where high foreign debt is leading to external vulnerability, while restrictive monetary policy to control credit is encouraging foreign borrowing. The Financial System Stability Assessment provides a good picture of Croatia's impressive financial development and it is gratifying to see that such a fast development was supported by Croatia's strong macroeconomic performance. We welcome the fact that the financial system has remained healthy and stable, although, rapid credit growth had undesirable consequences for increasing vulnerability. We understand that the exchange rate regime and the insufficient support from fiscal policy have limited the central bank's ability to control credit growth. The central bank has relied on unprecedented administrative measures. We agree with staff that these administrative measures will need to be eliminated during the EU accession process. Also, they may have adverse implications for macroeconomic stability and growth. The elimination process should start as soon as possible and should be supported by tighter fiscal policies so as to reduce excess demand, even if restrictive measures which are unavoidable under such circumstances may lead, in the short run, to lower growth, falling demand and lower living standards.

It is important that the authorities address the significant structural problems with determination. The excellent analysis presented in the selected issues convincingly shows that Croatia's macroeconomic performance is less constrained by conventional factors of competitiveness such as the real appreciation of its currency. As staff have indicated, poor protection of property rights, inefficient public administration and judicial system, corruption, and heavy state regulation are often listed as Croatia's main competitive disadvantages. Staff has rightly stressed that decisive progress in these structural problems would generate a tangible improvement in foreign direct investment and in export performance.

We wish the authorities success in their endeavors.

Mr. Fried and Mr. Ladd submitted the following statement:

We thank the staff for a readable report on Croatia and two interesting and relevant selected issues papers and Mr. Bakker and Mr. Galac for their helpful buff.

Output growth was a healthy 5.6 percent in 2007, with some moderation to 4.3 percent expected this year. Unemployment continues to decline. However, the inflation rate is up significantly, driven by food and utility prices. External imbalances remain. Given Croatia's fixed exchange rate and long-term plans for EU accession, strong measures are called for in fiscal policy and in improving the productivity and export-competitiveness of Croatian business.

Fiscal Policy

The general government deficit has declined steadily since 2003 and is currently running at an estimated 2.3 percent of GDP. The medium-term baseline shows a steady downward track for the debt ratio, slightly accelerated in 2009 and 2010 under the staff's reform scenario. The debt sustainability analysis indicates that this healthy situation is stable under shock scenarios. However, given a fixed exchange rate, sustained external imbalances and an already high external indebtedness, we agree with the staff that stronger fiscal effort is advisable.

We agree with the staff that frontloading is well-advised and that there is ample room for spending reform. The staff's analysis of major public expenditures suggests that this is feasible simply by holding the line on spending, and saving any revenue windfalls. The Selected Issues paper and staff report also point out that there is ample room to improve the efficiency of government expenditure programs and a clear fiscal benefit to doing so. We therefore support the authorities' efforts to further reduce the government deficit and to curb the growth of domestic credit, in the medium term.

Exchange Rate Regime and Monetary Policy

As the staff notes, the stable fixed exchange rate of the kuna leaves the onus of managing demand and adjusting to imbalances on fiscal policy, with some small support from administrative credit measures. It is no surprise that external debt rose by over 26 percentage points of GDP from 2002 to 2007, on the back of strong private-sector borrowing and notwithstanding fiscal consolidation. Under these circumstances, wage moderation and faster and deeper structural reforms are needed to assure competitiveness and external stability. Much progress has been made in strengthening financial sector supervision. Continued strong prudential standards and monitoring of risk management and lending practices are needed to manage the vulnerabilities associated with foreign and foreign-currency-linked borrowing.

Productivity and Competitiveness

The staff report presents the evidence that Croatia lags below the average of its central and eastern European peers in measures of the quality of the business environment. There is more than ample policy advice on how to move a country closer to the frontier of productivity in this region and others. What is required is a sufficiently broad political consensus on the importance and urgency of such reforms. Mr. Silva-Ruete and Mr. Maciel note that Croatia is already moving quickly to improve on the important Doing Business variables. Negotiations toward EU accession can help focus public attention, but it also risks making accession the goal, rather than a milestone on the road to further improvements in real living standards. These considerations should be prominent in the consultations on Croatia's strategic plan for economic development.

With this, we wish the Croatian authorities every success with the important challenges ahead.

Mr. Fayolle submitted the following statement:

We commend the staff for a well-written, relevant and candid set of papers, and we are thankful for Messrs. Bakker's and Galac's instructive buff statement.

The recent economic performance of Croatia has been good, with commendable achievements in terms of growth and macroeconomic stability. However, it has also gone along with the build-up of external vulnerabilities that should not be overlooked. In this regard, we particularly welcome the candid assessment provided in Chapter 1 of the selected issues paper, that echoes the discussions we had during the seminar on Eastern Europe last month.

Looking forward, the global slowdown in economic growth together with the need for further catching-up risks further complicating macroeconomic management in the foreseeable future, and will put further enhance the need for prudent fiscal management as well as continued ambitious structural reforms.

We fully agree with the staff that the stable exchange rate has provided an efficient anchor to the country and is a relevant exchange-rate regime looking forward. The level of the currency is well in line with its fundamental value, according to all available measures, which is also welcome. However,

this should not lead to complacency, as it will remain important to contain the appreciation of the real exchange rate within its equilibrium range going forward. Moreover, while providing the country with a nominal anchor, the exchange-rate regime shifts the burden of economic policy on fiscal and structural policy, while the high level of financial euroisation creates a challenge for financial and prudential policy.

We share the staff's view that fiscal policy should not add to demand pressures, especially in a context of past high inflation and increasing tensions on both the energy and food prices. In this regard, we welcome the authorities' intention to contain public wage increases, as this should play a major role in preventing the emergence inflationary expectations. However, further fiscal consolidation will be essential to contain inflationary pressures, and in the light of the room that seems available to improve the efficiency of public spending, it should also be feasible. Like the staff, we encourage the authorities to frontload as much as possible the needed fiscal adjustment.

The FSAP update provides a candid and articulated assessment of the situation of the financial sector. We encourage authorities to give due consideration to the recommendations of the FSAP, as some weaknesses remain in the financial sector. We welcome the step taken to improve the communication with the home country of foreil banks, and encourage further elaboration in this area. While we were not supportive of the quantitative credit measures introduced in 2007, it is fair to say that the authorities only have limited alternative options, and that these measures have so far been rather effective in curbing the rate of growth of credit. However, they cannot be considered a long-run solution to the problem of high credit growth, as they tend to generate disintermediation, thereby complicating the monitoring of the financial sector and weakening the position of banks. Moreover, they will have to be phased out eventually as the country moves forward in the adhesion to the EU and has to adopt the acquis communautaire.

Looking forward, there is a need to further the progress on the structural reform agenda. In order to strengthen investment and growth, more needs to be done to improve the attractiveness of Croatia for long-term, non debt-creating capital inflow. Containing wage growth to remain in line with productivity growth will be essential to ensure that the real exchange rate remains in line with its fundamental value. But more generally, the thrust of the competitiveness agenda lays on structural measures. In particular, there is a need to improve the business climate. Restructuration of the shipyard and progress on privatization will also be essential to enhance the development of the private sector and reduce the share of public participation in the economy.

Mrs. Sucharitakul and Mr. Sabtu submitted the following statement:

We thank staff for the well-written report and Messrs. Bakker and Galac for their helpful buff statement. We commend the authorities for their skillful conduct of macroeconomic policies which has resulted in recent strong economic growth. Real GDP growth reached 5.6 percent in 2007 on the back of strong domestic demand and increased employment. However there are signs of worrying trends. Until recently inflation has been kept well under control, but surging food and energy prices have pushed year-on-year headline inflation above 6 percent in 2008. The current account deficit has widened to 8.6 percent of GDP while external debt continued to increase to reach 87.8 percent of GDP as at end 2007. Prospects for long-term fiscal sustainability and sustained high economic growth would hinge on the ability of the authorities to undertake measures to address vulnerabilities, reduce higher inflation expectations, and accelerate structural reforms. Since we broadly agree with the staff assessment, we limit our comments to the following for emphasis.

On the fiscal front, we note that although general government deficit has been brought down to an estimated 2.3 percent of GDP in 2007, with the higher growth during the year, cyclical adjustments imply that the overall fiscal stance was expansionary. We share staff's view that further fiscal consolidation is needed to minimize the economic imbalances over the medium term. We welcome the authorities' plan to narrow the general government deficit to 0.5 percent of GDP by 2010 but like staff, we feel that aiming this target for 2011 will ease the authorities' efforts towards achieving a smooth landing.

We welcome the current discussion to undertake spending reforms in key areas such as health care, education, social security, social assistance and social benefits, subsidies and civil service. In this connection, we call on the authorities to exercise caution so as to ensure that such expenditure reduction exercise should be carried out in the least disruptive way so as to minimize the impact on the efficiency of public services and should not constrain growth. We note that staff's recommendations focused mainly on the expenditure side and in this regard we also want to underscore the need to strengthen revenue measures We welcome staff's comments on initiatives in this area.

We commend the prudent conduct of monetary policy, which has succeeded in maintaining low inflation after the experience with hyperinflation and has played an important role in safeguarding the external competitiveness of the Croatian economy. We welcome the staff's findings

that the real exchange rate is broadly consistent with fundamentals. However we recognize the paramount challenge confronting the authorities is in maintaining the current stable exchange rate policy in the face of a deteriorating external environment. In this respect, we note that sustained capital inflows undermine these efforts. Staff elaboration on policy options available to the authorities in dealing with these flows would be welcomed.

Although Croatia has no direct exposure to the sub prime market developments, the sharp rise in the spread on Croatian sovereign bonds relative to the Emerging Market Bond Index (EMBI) from the historical lows in mid-2007 and the widening of Croatia's credit default swap (CDS) spreads heighten external vulnerabilities. Given that the existing balance-sheet exposures also contain currency risk, we note that CNB has been tightly managing the exchange rate to keep the kuna stable, which has served as an effective anchor in dealing with inflationary expectations. Notwithstanding the benefit of this policy however, it limits the conduct of monetary policy for responding to domestic demand pressures. This calls for the adoption of supportive financial, fiscal and structural policies and therefore strong prudential policies and bank supervision are needed to ensure adequate credit risk management. In this respect, we commend the CNB for having taken a number of prudential and supervisory measures to limit macro-financial vulnerabilities.

We also welcome the contingency planning initiatives taken by the CNB, with emphasis on regular communications with Croatian banks, and maintaining constant cooperation with the supervisory authorities of their parent banks abroad. The current rapid credit growth to the private sector- one of the highest rates among all Eastern European countries (15 percent as at end 2007)—is indeed a matter of concern. Nonetheless, we are assured by the Financial System Stability Assessment (FSSA) that the current level of bank capital adequacy and asset quality is comfortable to withstand the external shocks. But there are downside risks given the significant external imbalances and rising asset prices. Further, the accompanying interest-and exchange-rate induced credit risks, cross-border contagion risks and sudden shifts in market sentiment leave the Croatian financial system vulnerable to spillovers. We, therefore support the staff view that maintaining higher capital buffers may be warranted.

On structural issues, improving the business environment, strengthening corporate governance and continuing the structural reforms are key to enhancing Croatia's attractiveness to foreign direct investment. The plans to proceed with the privatization of state-owned enterprises would provide further impetus to efforts to accelerate structural reforms.

With these remarks, we wish the authorities every success in the challenging period ahead.

Mr. Henriksson and Mr. Abazorius submitted the following statement:

We thank staff for a well-written and comprehensive set of papers, and Mr. Bakker and Mr. Galac for their useful buff.

Croatia has demonstrated strong economic growth and moderate inflation over the past few years. However, the rising current account deficit, external debt, and prevailing high balance sheet exposure to currency risk has increased Croatia's external vulnerabilities. The slowdown in external demand and increase in the cost of borrowing could pose a risk in the medium term. To reduce external vulnerabilities, the authorities should contain domestic demand and enhance productivity to ensure competitiveness.

Considering the tightly managed exchange rate, fiscal policy becomes crucial for domestic demand. We are pleased to note from Mr. Bakker's and Mr. Galac's buff that the authorities have ambitious plans to tighten fiscal policy by 1 percent of GDP in 2009 and 2010. We encourage them to achieve a balanced budget in 2011.

We note that the overall fiscal stance in 2008 is tighter, but this is mainly due to the one–off effect of repayment of pensioners' debt. We urge the authorities to use all opportunities to further reduce the budget deficit, especially to save any revenue overperformance. An improved government budget position and diminished government debt would help to maintain credibility in the market.

We welcome the authorities' steps to limit government wage increases. It would send the right signal and help to moderate wage growth in the private sector. Limited wage growth would effectively contain domestic demand and reduce the risk of real exchange rate overappreciation.

We are pleased to note that the financial sector remains broadly healthy. The authorities have put a lot of effort into moderating the pace of credit growth and maintaining the soundness of the financial system, and, as it is described in Mr. Bakker and Mr. Galac' buff, the authorities are aware that more needs to be done to address the challenges brought on by rapid financial market developments.

Credit growth has been high over the last few years. We see a risk of an increase of non-performing loans and it could be heightened by changes in market sentiment. We have some doubts about the overall effectiveness of credit limit measures in the longer term.

These developments call for: an improved supervisory framework, strengthening banks' risk management and close collaboration between supervisory and monetary authorities in home and host countries. The implementation of the key recommendations of the FSAP should be on top of the priorities list.

The business environment indicators for Croatia point to the need improve the business climate and to increase competition. We encourage the authorities to restructure and reform public enterprises. The reforms in the heavily indebted shipyard sector are vital to enhance the overall productivity performance. We welcome the authorities' efforts to step up the privatization process. A reduction of the administrative burden, legal uncertainties and corruption would be important elements to attract more FDI which would increase productivity and thus potential growth.

With these remarks, we wish the authorities continued success in their endeavors.

Mr. Rutayisire submitted the following statement:

We thank staff for a comprehensive set of papers and Mr. Bakker and Mr. Galac for their insightful buff statement.

Croatian authorities are to be commended for the country's favorable overall macroeconomic situation. Growth accelerated in 2007 at a rate of 5.6 percent, driven by a strong domestic demand. Moreover, the authorities have made commendable efforts to narrow the general government deficit from 6.1 percent of GDP in 2003 to an estimated 2.3 percent in 2007.

Notwithstanding these positive developments, Croatia still faces daunting challenges on various fronts. Along with surging food and utility prices, headline inflation rose to 6 percent in early 2008, well above its usual range of 2 to 4 percent. Equally, more needs to be done to tackle the widening current account deficit of 8.6 percent of GDP that contributed to build up the external debt to a level of 88 percent of GDP at end-2007. Aside from these concerns, we would lay down the following points for emphasis.

We welcome the authorities' fiscal policy aiming at achieving fiscal balance by 2011. Nevertheless, we would caution against the policy stance evolving around cutting expenditures, including in vital sectors like health care. The country devotes enormous resources to social spending covering a variety of programs, and a non-orderly fiscal adjustment could harm the most vulnerable segments of the population. We therefore call on the authorities to find the right pace in the search of efficiency in socially sensitive sectors. In that regard, we see merit in the government's posture of limited passing through of rising world oil price to retail energy prices that certainly prevented the country from crises as seen in other parts of the world.

As regards monetary policy and the financial sector, we commend the authorities' sound management of the floating exchange rate regime that helped preserve the competitiveness of the economy vis-à-vis central European peer countries. On the domestic front, we encourage the authorities to seek the appropriate policy mix of monetary and structural measures to curb headline inflation towards its former levels.

We commend the authorities' efforts to build and maintain a healthy financial sector as a major contributor to economic growth. On the back of the strong macroeconomic performance, administrative measures paired with the CNB's effective supervision framework have resulted in a rapid development of the financial system. Banks are profitable, and the whole financial system is rising to EU standards. Going forward, we encourage the authorities to step-up efforts to curb credit growth especially the share to households. Indeed, we see potential risks associated with increasing households' indebtedness and banks' external borrowing, especially at a time of global financial turmoil. The adoption of prudential measures intended to lower external borrowing and tighten lending standards goes in the right direction.

On structural issues, we share staff recommendations regarding improving the business environment and addressing corruption. In order to achieve its goal of becoming the destination for greenfield foreign direct investment, Croatia needs to meet the international standards on business

environment indicators, especially as competition might increase with the country joining the EU. On the latter, we call on the authorities to work steadfastly to meet the requirements, given that the EU membership will help broaden economic opportunities for Croatia.

Finally, like Mr. Bakker and Mr. Galac, we welcome the invitation to join NATO extended to Croatia in April 2008, which should make the country, a full member of this organization in 2009. The security blanket in a still relatively unstable area that this membership will provide is an important anchor for political stability and hence, for economic growth.

With these remarks, we wish the authorities success in their challenging endeavors.

Ms. Agudelo and Mr. Maciá submitted the following statement:

We thank staff for the compressive set of documents and Messrs. Bakker and Galac for an informative buff statement.

We share the staff's general assessment of the Croatian economy. The country continues to show a robust economic growth supported by a strong domestic demand and a reduced rate of unemployment. However, inflation picked up last year and the current account deficit widened, showing a deterioration of the macroeconomic imbalances. Under these circumstances and with the current policies combination, the degrees of freedom for the authorities are reduced. In fact, with a tightly managed exchange rate, the instruments that remain are public expenditure and a close supervision to domestic credit. We notice that the authorities agree with staff that those are the areas to be vigilant against.

The sustained economic growth has contributed to better revenue performance in the last few years. This has helped to maintain a declining general government deficit and public debt. Fiscal consolidation remains a crucial issue in the medium term, and the authorities' objective to reduce public debt to 27 percent by 2013 is well placed, in particular because it implies a reduction of the general government expenditure by more than 5 percentage points of GDP. The staff report makes a point asking the authorities to front-load expenditure restraint to tackle inflationary pressures and reduce external imbalances. However, it is not clear for us if the authorities agree with the staff's recommendation and, more importantly, if it is really possible to cut expenditure in the proposed way, or in other words if those cut expenditures are identifiable. We would like staff's comments.

We note the authorities' commitment to further reduce the deficit target in the 2008 budget, which includes moderation in wage adjustments, revenues saving over performance, and better control than in previous years of off-budget and quasi-fiscal activities. For the medium term, efficient expenditure measures in the health sector should be targeted as well as tackling civil service, education and state subsidies.

Given the importance of tight control to domestic credit, we are pleased with the measures implemented by CNB as detailed in Table 7 of the staff report. We concur with the continued monetary and prudential measures to curb foreign currency denominated loans as noted in Mr. Bakker and Mr. Galac's buff statement. The FSSA Update document still shows existing weaknesses in the non-bank financial sector, including financial statement disclosure and accounting and auditing standards, improving risk-oriented supervision, and corporate/financial governance risks. We would appreciate staff's comments on a time frame to tackle these weaknesses and whether there is an institutional capacity in place for such effort.

Croatia has made progress in various structural areas including the financial sector, the harmonization of the financial system legislation with EU requirements, non-bank regulation and supervision, and also regarding measures to improve the business environment. The initiative to sell the two shipyard and railways government stakes by the end of this year is a step in the right direction. We encourage the authorities to make progress on their restructuring plans that are falling behind on the privatization of the insurance companies and on the already approved plans to advance in the oil and telecom public offerings. Concerning the legal reforms, we would like staff's comments on progress concerning property rights, contract enforcement and bankruptcy procedures, which are crucial to FDI's attraction and important to the EU accession efforts, given that the country compares unfavorably to other countries in the region. We hope to see the needed political support in order to achieve progress in these areas in the near future.

With these comments, we wish the authorities well in their future endeavors.

Mr. Mozhin and Mr. Palei submitted the following statement:

The Croatian authorities cannot complain about any lack of the Fund's attention. In addition to multiple regional studies of the European emerging market economies, staff have prepared another set of comprehensive Article IV reports, including two well-focused chapters in the selected issues

paper, and FSSA update. We thank staff for their excellent work and Mr. Bakker and Mr. Galac for their informative buff statement. We broadly agree with the analysis and recommendations in the staff report, and will make only a few points.

We agree with staff that that favorable prospects for the EU membership provide a proven framework for economic changes in Croatia. Foreign investors recognize these prospects, which makes them eager participants in Croatia's growth. At the same time, in Croatia, as in many other countries in similar economic situation, this convergence process is associated with build up of vulnerabilities, and it creates serious challenges for macroeconomic policies. Croatia already has large and growing current account deficit, and its external debt is close to 90 percent of GDP. The authorities have to deal with persistent credit boom largely fueled by foreign financing, which heightens the interest rate risks and exposure to a "sudden stop" in capital inflows. The combination of the widespread use of the euro with the pegged exchange rate regime lessens the incentives for hedging and points to significant exchange rate risks. In turn, the exposure to exogenous interest rate shocks and exchange rate risks raises concerns about potentially damaging credit impairment in various sectors of the economy.

As it was well described in the staff report, during the last few years the authorities have been well aware of these risks and have addressed them in a prudent and proactive fashion. We note, in particular, that the fiscal deficit has been steadily declining from 6.1 percent of GDP in 2003 to 2.3 percent of GDP achieved last year. Although, according to the cyclically adjusted primary balance, there was some fiscal relaxation last year, we are encouraged by the authorities' medium-term plans to persevere with fiscal tightening.

Having said that, we agree with staff that under the severe constraints on monetary policy and in light of remaining high degree of vulnerability to shocks, it would be advisable to carry out even more expeditious and more ambitious consolidation of fiscal accounts. Rapid GDP growth and high inflation make fiscal tightening appropriate from the cyclical point of view. It is also necessary from the vulnerability point of view. If revenues overperform, windfall gains should be saved, while the main focus of structural reforms should be on the expenditure side. According to evidence presented in the second chapter of the SIP, such an approach is entirely feasible.

Given the major changes in the financial sector since the initial FSSA had been prepared, the update was a timely undertaking. Indeed, the work carried out by staff went well beyond a regular update. We welcome comprehensive description of improvements in financial sector regulation and supervision and recommendations for further changes, as well as the in-depth analysis of the remaining risks. One of the key recommendations in the FSSA and in the staff report was to phase out administrative measures of credit growth control. While aiming at their eventual elimination is natural, we would be cautious in that respect. The Croatian authorities are appropriately conscious of the trade-offs between financial stability and distortionary nature of these measures. However, they are also constrained in their choice of policy measures. There is evidence that administrative and other measures have been effective in slowing down credit growth and accumulation of the external debt, particularly in the banking sector. In the absence of equally potent alternatives, the elimination of administrative measures may lead to excessive risks to financial stability. Over time and in line with staff's recommendations, additional safeguards would be put in place, including possible fiscal surplus; larger foreign exchange reserves; structural reforms with greater reliance on FDI; well-established coordination between the supervisory and monetary authorities domestically and internationally; well-developed contingency planning; better sources of information; and the authorities' and private sector participants' ability to monitor risks. We believe that a gradual approach to phasing out administrative measures is largely unavoidable.

With these remarks, we wish the Croatian authorities well in their endeavors.

Mr. Heath and Mr. Wood submitted the following statement:

Croatia has experienced several years of solid economic growth, supported by improved fiscal performance and strengthened financial supervision. However, inflation has picked up recently and the current account deficit and external debt have continued to increase. The authorities face the challenge of managing the risks associated with large external imbalances while also building on recent fiscal consolidation and accelerating the pace of structural reforms. We encourage urgent attention to reducing Croatia's macroeconomic vulnerabilities.

Exchange Rate and Monetary Policy

We agree with the staff that a stable exchange rate is a sensible policy for Croatia, in light of the extensive use of the euro in the Croatian economy and the desire for greater integration with the EU. With the stable exchange rate, support from other policies is essential. In particular, wage moderation and structural reforms must be used to strengthen competitiveness. The first selected issues paper makes a persuasive case that the worsening of the current account position has not been caused by exchange rate overvaluation but rather that weak export performance can be explained by structural factors that have made Croatia less successful in attracting FDI than other countries in the region. We agree that the real exchange rate is broadly consistent with fundamentals despite some gradual real exchange rate appreciation, and we note that sustained high inflation could lead to excessive real appreciation, further damaging competitiveness.

Fiscal Policy

Given the stable exchange rate, fiscal policy must play a large role in managing domestic demand. Fiscal policy needs to take on more of the effort to curb inflationary pressures, allowing the authorities to eventually relax credit controls. We applaud the authorities' commitment to further deficit reduction through their medium-term deficit targets. We agree with the staff that there is ample room to lower the government deficit by spending reform, because large fiscal adjustments are more successful and durable when they rely on reducing current expenditure. We support the staff recommendation that Croatia could benefit from a significant reduction in the size of government and by frontloading its needed fiscal adjustment. We found especially valuable the selected issues paper on analyzing the efficiency of government expenditures.

Banking Sector Vulnerabilities

In the absence of exchange rate flexibility, the authorities have used administrative measures to slow the growth of bank credit to the private sector. We agree with the staff that a careful strategy to phase out these measures would be desirable, given their possible negative side effects. Eliminating the credit controls also is consistent with movement toward EU accession and eventual euro adoption. Instead, in light of the high level of corporate and household debt, we agree with the staff's view that higher capital buffers are warranted.

It appears that the high proportion of loans denominated in foreign currency could make the financial system vulnerable to higher interest rates or currency depreciation that would raise debt servicing costs. Therefore, we welcome the news that the proportion of foreign currency loans has turned down recently. We agree with the staff's caution that, since a stable exchange rate is conducive to unhedged foreign-currency borrowing, strong supervision is needed to ensure adequate risk management.

We welcome the authorities' plans to produce a forward-looking financial stability report, as indicated by Messrs. Bakker and Galac. We appreciate the progress that authorities have made on strengthening supervision of the financial sector.

Structural Policies

We agree with the staff that an acceleration of structural reforms would support orderly convergence with the EU and lessen external imbalances. We especially encourage the authorities to continue their efforts toward improving the business environment by reducing the administrative burden, legal uncertainties and corruption. Such efforts are essential to attracting FDI that would help revitalize the Croatian economy and lessen the pain of the necessary contraction in the shipbuilding industry.

The representative from the European Central Bank (Mr. Ramon-Ballester) made the following statement:

First of all, we would like to commend the Croatian authorities for the economic robust performance in recent years, underpinned by sound macroeconomic policies with a view to successful entry into the European Union. However, as has been remarked by a number of Directors, this robust growth performance has been increasingly associated with rising external imbalances, including a widening current account deficit and increased external indebtedness. A number of challenges thus remain to be addressed as Croatia continues to successfully travel up the road of convergence, and I would like to briefly touch upon selected monetary, financial, and fiscal issues in this context.

As regards inflation and competitiveness, the authorities' monetary policy framework based on an external anchor has served Croatia well over the years by delivering broad price stability, as is recognized both in Mr. Bakker's buff statement and in the staff report itself. However, inflation has been trending up in recent months, driven primarily by supply side shocks,

and we think that this might open some scope for potential second-round effects further down the line. We would thus emphasize that continued wage moderation, including in the public sector, would be an important element to anchor inflation expectations and preserve price stability going forward under the current policy framework. Coupled with other structural improvements that are rightly highlighted by staff, this should also help to safeguard external competitiveness.

Concerning fiscal policy, we acknowledge that significant progress in fiscal consolidation has been achieved in recent years. However, the staff is right to underline the importance of fiscal policy to ensure overall macroeconomic stability in the absence of an independent monetary policy. Apart from highlighting the importance of wage moderation in this context, we therefore also support the broader call by the staff for greater restraint in overall government expenditure, and such restraint would also enhance the scope for fiscal flexibility in the face of potential shocks in the future should this arise.

As regards the financial sector, the ECB agrees that the banking system remains healthy, as suggested by standard indicators of financial soundness, including on asset quality and profitability. However, we note that a number of potential vulnerabilities remain in place amid a still dynamic credit environment calls for continued vigilance on the part of supervisory authorities. These include an indirect exposure of the banking sector to foreign currency risk through unhedged households and a strong dependence by Croatian banks on funding by foreign parent institutions which might become more costly or less available in the event of a further deterioration in the external financial environment. The cost and availability of cross-border funding is also of concern to those corporates that have been able to circumvent the measures adopted by the central bank to discourage foreign borrowing and excessive credit growth in the context of domestic lending disintermediation. Notwithstanding the potential impact of bypass efforts by the private sector on the overall effectiveness of such measures, we would also caution that Croatia's accession into the European Union might call for the modification of some of the instruments that the central bank is currently using as part of its monetary policy implementation strategy.

With these remarks, we wish the authorities success in addressing the remaining policy challenges.

The staff representative from the European Department (Mr. Feldman), in response to comments and questions from Directors, made the following statement:

> I did not detect any major disagreements between the staff and the grays that were issued. In fact, there seemed to be broad agreement with the policy line that the staff was advocating. That being said, there were some comments and queries, and let me organize my brief remarks to those around the broad themes of inflation, fiscal policy, exchange rate policy, credit controls, and then structural reforms.
>
> To start, there was a question on second-round effects and inflation expectations. In our view, the main determinant of second-round effects, and the most important issue, is the behavior of wages as we look forward. With the public sector being such a large employer, we really pushed the authorities on wage moderation not only in terms of the general government but also the state enterprises as well. Absent such wage moderation, higher inflation could easily become entrenched in expectations, and clearly that is something that we would all like to avoid.
>
> On fiscal policy, there were a number of points that were made. First I was asked to comment on the interaction between fiscal policy, external vulnerability, and in particular downside risks to growth. On this issue, given the risks to external stability that were highlighted in the analytical work that we did, there is not a lot of room for fiscal maneuver, particularly if the slower growth were to be accompanied by a larger current account deficit—for example, if the hit was taken because of slower export growth. However, as noted in the staff report, consideration would need to be given to letting the automatic stabilizers play if growth were to fall considerably below potential growth, but only insofar as the external imbalances were sufficiently in check. Right now we are not really close to the point where growth is significantly below potential, as in the baseline for the next two years we see growth within the range that we estimate for potential growth of the economy.
>
> A second point on fiscal policy is we were asked whether expenditure measures have been identified. On this score, we purposely had scheduled a technical assistance mission on expenditure reform both after the new government was formed and right before the Article IV consultation mission, and that technical assistance mission identified a menu of options that was more than sufficient to deliver the fiscal adjustment that was recommended by the staff. This is noted in paragraph 27 of the staff report.

Third on fiscal policy, some Directors emphasized that expenditure consolidation should not compromise services to the poor. We fully agree on this point, and indeed we stressed in our work that some government expenditure reforms could have a disproportionate effect on vulnerable groups. Thus, if these reforms were undertaken, we specifically say in the Selected Issues paper on spending that targeted transfers would be needed.

Finally, on fiscal policy, while the Article IV consultation focused on expenditure-led consolidation, we agree that action to strengthen revenues would also be helpful. In particular, it would be helpful to continue to rein in the gray economy, and the Minister of Finance is fully aware of that and taking actions on this front. The authorities are also involved in a project with the World Bank to continue to modernize revenue administration.

Though not necessarily an action to strengthen revenue, the EU accession process will involve changes in taxes and excises, but the authorities want to undertake these changes in a way that is as revenue-neutral as possible.

On the exchange rate, I was asked whether recent policy declarations suggesting an asymmetric band could further promote the underpricing of currency risk. In theory, this could certainly be the case, but in practice the intention is to keep the exchange rate within a tight range. If any asymmetry were to arise, it would be very small. Also, with inflation up, the governor would very much like to firmly anchor expectations by keeping the exchange rate in a very tight range. Given Croatia's recent history with hyperinflation, I think he would say that this is not the time to experiment with a wider exchange rate band, and I tend to agree with this point of view.

On credit controls, we, like the authorities, recognize that the controls, and for that matter other administrative measures, cannot be kept in place for a long time. This is because they lose their effectiveness as economic agents find ways around the controls, it is also because they have negative side effects, and some of them are also inconsistent with EU accession. Thus, in the staff appraisal we recognize that the controls are not sustainable and that the authorities need to phase them out, but in our view they need to be phased out in a very careful way with supporting policies in order to maintain macro stability. This was a point that was emphasized in at least one of the grays.

Finally, on progress on structural reforms, the time that it takes to register property and to start up a business has been shortened, and some of the court backlog has also been reduced. Still, it is quite clear that a lot remains to be done. We are not the only ones emphasizing this. This has also been underscored in many comments by EU institutions as well as by the World Bank. I would note that the authorities are working with the World Bank on legal reforms, and the authorities have also drafted an anti-corruption plan that has recently been reported in the press. We have not seen the plan, but apparently it has been sent to the European Commission for their comments and reviews.

The staff representative from the Monetary and Capital Markets Department (Ms. Otker-Robe), in response to comments and questions from Directors, made the following statement:

Let me start by thanking the many grays that we have received yesterday which seem to be broadly supporting the assessment of the Financial Sector Stability Assessment report on financial sector issues and also the very positive steps that the authorities have taken to address the weaknesses and to improve the resilience of the financial sector.

I will focus my remarks on three main issues: credit controls that Mr. Feldman has talked about, coping with large capital inflows ,and the nonbank financial sector issues.

On credit controls, I have little to add to Mr. Feldman's remarks except perhaps to add a cross-country dimension to it. In our cross-country analyses on credit controls and responses to rapid credit growth problems in the countries that we have looked at, the experiences say pretty much the same thing that we have observed in the assessment. The credit controls may have some short-term impact on the credit extended by the banking sector, but they also have similar negative implications that we have observed in Croatia Also, they tend to lose their effectiveness rather rapidly. The countries that have resorted to these kinds of controls usually eliminated them in the process of monetary and financial sector integration with the European economies and also when they recognized the eroding effectiveness of the measures and their distortionary impact on the rest of the economy. But in eliminating the controls, the countries also recognized the potential adverse consequences this could have, and so have been rather cautious, supporting their elimination with close monitoring of the banking sector and tighter supervision and prudential regulation of the institutions. As you know, we also recommended in the FSSA to do the transition out of the credit limits in a cautious way,

including through some safeguards that can be introduced, as well as a careful consideration of the timing and the conditions under which this phasing out should be done.

Regarding the issue of capital inflows, we all know that large capital inflows are inherently difficult to deal with, and unfortunately there are no magic bullet solutions, especially for the countries in emerging Europe which are in the process of integrating with the rest of Europe. Again, looking at country experiences, we see that there is a high premium on the consistency of the monetary, exchange rate, and fiscal policy frameworks in dealing with these heavy capital inflows, and also on trying to make sure that there are adequate systems to better absorb the capital inflows. Some of the policy options perhaps could include a tighter fiscal policy stance in order to mitigate the excess demand pressures that the capital inflows may create, and helping to channel the capital inflows into more productivity generating industries and export generating industries rather than into nonproductive sectors. Perhaps structural reforms that the staff has been recommending could help to increase the flexibility of the economy and attract more greenfield FDI inflows. Also, ensuring that the risks associated with capital inflows are adequately managed by the institutions that are intermediating them and the supervisory authorities' paying more attention to monitoring and supervising the risks associated with the inflows are among the tools that countries have found very useful in dealing with large inflows.

Finally, deepening the financial markets that can better absorb the inflows and help the private sector better manage the risks associated with the inflows is quite helpful. Deepening the financial markets can also provide more instruments and tools to the monetary authorities in absorbing the monetary implications of the inflows.

On the last question on nonbank financial institutions and, in particular, the time frame and capacity to tackle the weaknesses that have been mentioned in the FSSA, I would like to first emphasize that the authorities have already done significant work in this area, as we have noted in the FSSA report, and they have made significant progress in strengthening the supervision and regulation of the nonbank institutions. There are, of course, remaining weaknesses that we have mentioned, but the authorities are aware of these weaknesses, and share the staff's concerns and the priorities assigned to dealing with them. We also recognize and understand that some of these reforms may take more time to implement, especially because the authorities are dealing heavily with harmonizing their financial sector legislation with the EU acquis. We are realistic in terms of timing when it can

be done. Nonetheless, the authorities have already been addressing some of these issues and focusing more on the governance and reporting issues. My World Bank colleagues inform me that there is an ongoing program on corporate governance and consumer protection review, and some support is being provided for accounting and reporting issues. There are also preliminary plans to initiate a program to better harmonize the capital market norms with the European Union. All this, we believe, is going to help enhance the institutional capacity of the authorities to deal with these weaknesses.

Mr. Prader noted that the government's anti-corruption plan had been sent to the European Commission, but not to the Fund staff. It would be useful for the Fund to view the plan and to make its own assessment, particularly as anti-corruption and governance reforms had been regularly emphasized during previous Article IV consultations.

Mr. Bakker made the following concluding statement:

I thank my fellow Directors for their sincere interest in Croatia, as is evidenced by very thoughtful comments in the grays, which I will pass on. I take it that the shortness of the discussion after the elaborate answers of the staff indicates the high measure of support of Directors for the staff's assessment, which is also shared by the Croatian authorities.

As recognized in many grays, Croatia has benefited from sound economic policies, always framed in very good collaboration with the Fund staff, and also particularly directed towards its growing ties with the European Union. The aspiration to join the EU has provided very important targets, which have led to a period of solid economic performance. At the same time, there have been increased financial and external vulnerabilities.

What is complicating the case of Croatia is that acceptable policy responses to these vulnerabilities have been limited somewhat by the specific features of the Croatian economy, including a very large measure of euroization which limits the possibilities to react. However, Directors recognized that the authorities in general have been quite proactive in limiting the growth of these macro and financial vulnerabilities.

We have discussed last year and also the year before that, the limited policy options available to the central bank before it opted for a complex set of administrative measures and credit controls. We have shown in our gray and also in the staff's appraisal, that these measures in themselves have been successful in fighting the main supply side cause of the vulnerabilities, which is the abundant liquidity of foreign-owned banks. These measures have led to

substantial build-up of banks' capital and foreign currency liquidity buffers, so together with official reserves it has to be recognized that these buffers now do serve as an adequate first line of defense in case these vulnerabilities materialize and there would be a sudden reversal of the inflows in the current global environments.

Therefore the authorities are cautious, as was mentioned, with a view of preserving financial stability. They will keep these measures for as long as prudent and possible while acknowledging the side effects which have been clearly mentioned by Ms. Otker-Robe. I also take the point made by the ECB representative that in time, as the euro zone accession becomes a reality, then there would be a need to change central bank instruments and there would be a need to phase the administrative measures out. I take it those messages I will pass on to my authorities.

As far as fiscal policy is concerned, I do not have a lot to add. Directors noted a lot of room for further fiscal adjustments and front loading. It is useful to reiterate the commitment in our buff, for the authorities to withdraw the fiscal stimulus of the 2008-2009 periods, which might facilitate a soft landing. These efforts will benefit from the expected government exit from the remaining state-owned enterprises during 2008 and from the completion of other ongoing reforms. Fiscal and monetary policies are well attuned to address the external vulnerabilities as well as the more recent rise in inflation, but in a somewhat longer term perspective, particularly structural reforms aimed at attracting more FDI. The fast growth of exports will reduce the vulnerabilities and make Croatia's position more sustainable in the long run. There is a genuine commitment to these reforms. They not only need these reforms to speed up economic growth and development, but also in the short term they are a prerequisite for the successful completion of the ongoing EU accession negotiations, so there is also a political need to forge ahead on those reforms.

Finally, on behalf of my authorities, let me thank Mr. Feldman and his team for excellent work in Zagreb. This has been very much appreciated. I would also like to thank Ms. Otker-Robe and her team, also the team from the World Bank that worked on the FSAP. This combination of efforts from the staff both at the World Bank and the IMF on the FSAP and the Article IV is really the way it should be. The FSAP team produced a highly relevant set of documents, which greatly facilitated the discussion of the Article IV mission. The report is the sort of report we should have in the Board where financial sector issues are fully integrated into the Article IV, and the discussion now has shown that it is useful to integrate these financial sector and fiscal and

monetary policy and structural reform issues together because they influence one another.

The Acting Chair (Mr. Portugal) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Croatia's strong economic growth in recent years, which has generated an appreciable increase in employment. This strong performance has been accompanied by commendable improvements in policies, notably a reduction in the general government deficit since 2003 and a continued strengthening of financial supervision. At the same time, Directors noted that the current account deficit has continued to widen, external debt has remained high, and inflation has increased sharply. They emphasized the need for continued policy efforts to mitigate these imbalances and create an environment conducive to sustained high growth.

Directors stressed the importance of near-term wage moderation, both in the government sector as intended and the state-owned enterprises. Wage moderation will be key to avoiding second-round effects from food and utility price increases and preventing higher inflation from becoming entrenched in expectations, as well as underpinning external competitiveness.

Directors noted that the real exchange rate is broadly in line with fundamentals, and recognized the advantages of maintaining a stable exchange rate in circumstances of high financial euroization, sensitivities to balance-sheet mismatches, and the past success of this policy. At the same time, Directors emphasized the need for support from other policies, including continued fiscal adjustment to manage domestic demand and help address macroeconomic imbalances; accelerated structural reforms to lessen vulnerabilities while raising sustainable growth; and strong prudential policies and financial sector supervision.

Against this background, Directors welcomed the authorities' intention to continue to reduce the general government deficit. They noted that achieving the authorities' target of a deficit of ½ percent of GDP by 2010 would represent a significant adjustment, and encouraged them to maintain this momentum going forward by announcing a target of fiscal balance by 2011. Directors generally considered that frontloading fiscal adjustment—including by saving any revenue overperformance—would provide welcome immediate support in reducing macroeconomic imbalances and raising the likelihood of meeting the recommended targets. A fiscal deficit target of 1 percent of GDP or less in 2009 would have considerable merit.

Directors underlined the benefits of expenditure-led fiscal adjustment and saw room to reduce current expenditure without unduly compromising the delivery of public services. They also pointed to the importance of ensuring the sustainability of the pension system, including by avoiding further backtracking on earlier reforms. More broadly, Directors encouraged the authorities to identify contingency measures that could be readily put in place in case macroeconomic imbalances turned out worse than expected.

Directors noted that Croatia's financial sector remains healthy, while stressing that continued strains in global financial markets and balance-sheet vulnerabilities underscore the importance of vigilance in maintaining high prudential standards and closely monitoring banks' risk management and lending practices. Directors commended the authorities' measures to strengthen banking supervision, including through increases in required capital cushions, improved communications with market participants, and efforts to strengthen home-host supervisory coordination. They also welcomed the continued strengthening in supervision of the nonbank sector, and the authorities' plan to produce a forward-looking financial stability report.

While understanding the central bank's rationale for implementing credit and other administrative measures, Directors considered that, taking into account their side effects, a phasing out of the measures would be desirable, acknowledging that this would need to be done in a careful way. This would require support from tighter fiscal policy to reduce excess demand pressures and close supervision of banks.

Directors stressed the considerable benefits of faster structural reforms for reducing vulnerabilities, raising living standards, and successfully concluding EU accession negotiations. They encouraged the authorities to continue to improve the business environment by reducing administrative burdens, legal uncertainties, and corruption. Such actions would make Croatia a more attractive destination for the investments needed to sustainably increase productivity, exports, and potential growth. Directors also looked forward to swift action on reforming the heavily indebted shipyards and on completing the broader privatization process, with involvement of strategic investors.

It is expected that the next Article IV consultation with the Republic of Croatia will be held on the standard 12-month cycle.

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SHAILENDRA J. ANJARIA
Secretary