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**Statement by Mr. Stein and Mr. Haupt on Republic of Croatia
(Preliminary)
Executive Board Meeting 08/40
May 9, 2008**

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 euroization. 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.