INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF EUR 200 MILLION
(US$296.75 MILLION EQUIVALENT)

TO

THE REPUBLIC OF CROATIA

FOR A

FISCAL, SOCIAL AND FINANCIAL SECTOR
DEVELOPMENT POLICY LOAN (DPL)

November 30, 2009

Poverty Reduction and Economic Management
Central Europe and the Baltics Country Unit
Europe and Central Asia Region

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Croatia - Government Fiscal Year
January 1 – December, 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of November 30, 2009)
US$1.00 HRK4.9059

WEIGHTS AND MEASURES
Metric System

<table>
<thead>
<tr>
<th>ABBREVIATION AND ACRONYMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>APPP</td>
</tr>
<tr>
<td>CAD</td>
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<td>SIGMA</td>
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</tbody>
</table>

ABBREVIATION AND ACRONYMS
# LOAN AND PROGRAM SUMMARY

**CROATIA**

**FISCAL, SOCIAL AND FINANCIAL SECTOR DEVELOPMENT POLICY LOAN (DPL)**

<table>
<thead>
<tr>
<th>Borrower</th>
<th>The Republic of Croatia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementing Agency</td>
<td>MINISTRY OF FINANCE</td>
</tr>
<tr>
<td>Financing Data</td>
<td>IBRD Flexible Loan amounting to EUR200 million (USD296.75 million equivalent) at 6 month LIBOR for EUR plus fixed spread with a 15.5-year bullet repayment pattern</td>
</tr>
<tr>
<td>Operation Type</td>
<td>A single-tranche Fiscal, Social and Financial Sector Development Policy Loan (DPL)</td>
</tr>
<tr>
<td>Main Policy Areas</td>
<td>Finance, Public Sector and Social Protection Reforms</td>
</tr>
</tbody>
</table>

## Key Outcome Indicators

1. General Government wage bill reduced from 10.8% of GDP in the original budget for 2009 to 10.2% of GDP in the 2010 Budget.
2. Planned pension spending declining to 10% of GDP in the 2010 Budget and the share spent on privileged pensions remained constant at 20% of overall pension spending in 2010;
3. General Government investments reduced from 5.2% of GDP in the original budget for 2009 to 4.0% of GDP in the 2010 Budget;
4. Total health sector arrears reduced by end-2009 to 1% of GDP and further down in 2010;
5. A 2010-2012 rolling budget consistent with the medium-term fiscal framework as measured by general government expenditures declining from 41.7% of GDP in 2009 to 40.3% of GDP in 2010;
6. An EU assessment suggesting completion of the legislative alignment of the public procurement system and further enhancement of administrative capacity;
7. Adequate budget for unemployment benefits and means-tested social support allowance maintained at about 0.5% of GDP in the 2010 Budget;
8. Interagency coordination on financial crisis preparedness and management tested on several cases.
9. Capital adequacy ratio increased to above 16% by end-2009.
10. Audit reports of investment firms containing detailed risk exposures.

## Program Development Objective(s) and Contribution to CAS

The objective of the DPL is to support the authorities' efforts in addressing the adverse impact of the global crisis through (i) strengthened public finance; (ii) strengthened social sector resilience and targeting, and (iii) enhanced efficiency and stability of the financial sector.
| Risks and Risk Mitigation | Economic risks. A key risk affecting the proposed operation is that the economic downturn in the EU and specifically in Croatia will be more severe and prolonged than currently projected. This could strain further fiscal performance, the corporate sector and consequently the banks, as well as create social tensions. Given Croatia’s heavy reliance on tourism revenues and exports to Europe, it is vulnerable to any deterioration in regional stability or growth slowdown in the EU. Furthermore, given the high level of external debt, high degree of euroization of the Croatian economy and large debt service requirements over the medium term, the Croatian financial sector remains vulnerable to exchange rate risks and slowdown of capital inflows. Given the exchange rate regime of a tightly managed float, domestic fiscal policies are key to protect economic stability. |
| Mitigation measures. The DPL-supported fiscal consolidation efforts and public expenditure management reforms are expected to mitigate the risks related to regular debt servicing for the public sector even in the case of a prolonged recovery. The DPL-supported measures related to the enhancement of financial sector regulation coupled with the Croatian National Bank’s efforts to monitor foreign exchange exposures of bank clients and strengthening supervision of banks and, jointly with HANFA, of non-banking financial institutions is expected to alleviate the risks for private sector refinancing and lead to system resilience to larger shocks. |
| Political risks. Political risks remain moderately high as the country has a coalition Government with a slim majority in Parliament, while some of the proposed reforms are ambitious and politically challenging. With presidential elections scheduled for late 2009, the country is entering a pre-election period, which might raise the risk, although negligible, of fiscally less sustainable policies. |
| Mitigation measures. Reforms to be supported under the DPL are to a large extent well under implementation, also as part of the EU accession negotiation process, which is expected to mitigate the risk of reversal or delays. The recent unblocking of EU accession negotiations and a clear timetable for their conclusion by mid-2010, provide momentum for reform. The stable funding of targeted social protection programs should also alleviate social pressures from vulnerable groups. |

| Operation ID | PE-P117665 |
| Map | IBRD 33394 |

The Croatia Development Policy Loan was prepared by a team consisting of Sanja Madzarevic-Sujster (Task Team Leader), Emil Tesliuc (HDNP), Matija Laco (ECSP2), Isfandyar Zaman Khan (ECSP1), Kari Hurt (ECSP1), Zoran Anusic (ECSP3), Natasa Vetma (ECSP3), and Lamija Hadzagic (ECSC2) and Dubravka Jerman (ECCHR). The team benefited from the guidance of Bernard Funck, Sector Manager (ECSP2), Swati Ghosh (ECSP2), Erika Jorgensen (ECSP) and Roumeen Islam (ECSP).
I. INTRODUCTION

1. The Croatian authorities have been managing the impact of the global crisis relatively well through an appropriate mix of proactive policies. Due to declining tax revenues, the fiscal policy had to go through significant adjustments to protect macroeconomic stability and ensure regular debt service. Politically-challenging measures on both the revenue and spending sides had to be implemented, while protecting the effective part of the social safety net. Some of these measures, e.g., reduction of wages, suspension of pension indexation or the introduction of a solidarity tax, focused on the short term in order to maintain macroeconomic stability. Building on long-standing efforts in this area, the authorities have also taken necessary measures to safeguard financial intermediation.

2. The exigencies of the crisis has also provided an impetus to move on relevant aspects of the country's medium-term agenda: fiscal reforms are now framed in the context of a 3-year rolling budget, the public procurement system is being strengthened, and, after a long gestation, the much needed health financing reform has been acted upon. Other parts of the Government's medium-term reform agenda such as privatization and judicial reform are continuing apace.

3. These efforts have succeeded in mitigating but not negating the impact of the global crisis. Growth, which averaged over 4 percent during the last five years, has been sharply declining in 2009 due to the contraction of external and foreign demand. A negative feedback to the financial sector from the deterioration of the real sector is likely to lead to much stronger risk aversion thus postponing recovery towards mid-2010. The recession has also worsened labor market outcomes and will reverse some of the recently achieved gains in living standard. The most affected are younger and less educated workers who suffered from high unemployment rates even before the crisis. With that in mind, the authorities have strengthened the targeting of social benefits.

4. The proposed Development Policy Loan (DPL) to the Republic of Croatia in the amount of EUR200 million (US$296.75 million equivalent) recognizes and supports the Government's efforts to address the impact of the global economic crisis. These efforts include measures to (i) strengthen public finance, including through the reduction of the wage bill, social transfers and investments, and improvements in the budgeting and strategic planning process; (ii) strengthen the resilience and targeting of the social sector; and (iii) enhance the efficiency and stability of the financial sector.

5. The proposed reform program incorporates the findings and recommendations of a range of recent and ongoing lending, analytical and advisory services from the Bank, including a Public Finance Review, Financial Sector Assessment Program update, Social and Labor Market Crisis Impact Assessment, Public Sector Governance Assessment, the Financial Sector Second Generation Issues TA and the ongoing Development of Emergency Medical Services and Investment Planning project which supports development of the hospital master plan. The reform program was developed jointly with the Government, and incorporated in the Government Strategy for 2010-2012, which lays out the country's comprehensive economic policy in the current volatile global environment. The program has been coordinated with other development partners, in particular with the European Commission (EC) to ensure consistency with the EU accession requirements. In addition, UNDP is co-financing technical assistance required for the implementation of social sector reforms.

6. The choice of a stand-alone single-tranche operation reflects the crisis mitigation objective of the operation and the particular external environment in which it is proposed. The lessons
learned from earlier development policy lending as described in the FY09-FY12 Country Partnership Strategy have also affected the choice of the instrument.

7. While the proposed single-tranche DPL supports the authorities in these more immediate efforts, our engagement continues on the broader medium-term reform agenda. The Bank has for instance been providing analytical and financial assistance to Croatia in support of its medium-term competitiveness agenda, including through the recent EU Convergence report, investment operations in infrastructure and science and technology, and the forthcoming judicial reform project.

II. COUNTRY CONTEXT

A. RECENT POLITICAL DEVELOPMENTS

8. A coalition government led by the Croatian Democratic Union Party (HDZ) was endorsed by the Croatian Parliament in January 2008. The coalition is based on an alliance forged with the Peasants’ Party (HSS), the Social Liberal Party (HSLS) and minority representatives. In June 2009, Prime Minister Sanader resigned. The new Prime Minister Ms. Jadranka Kosor, former deputy prime minister, was confirmed by the Sabor swiftly, while the transition also included some cabinet changes. The Government's strategy, as described in the Program of the Government of the Republic of Croatia for the 2009-2011 emphasizes reforms which would ensure macroeconomic stability as a basis for accelerated recovery of the Croatian economy and society in the post-crisis period. To achieve these goals, the Government, among others, plans to: (i) accelerate judicial and public administration reforms, (ii) complete the privatization process and tackle corruption, (iii) intensify development of SMEs and increase agricultural competitiveness while pursuing a balanced development of all regions, (iv) foster the tourism sector with further development of infrastructure, and (v) promote a knowledge-based society. The Government’s unpopular measures undertaken to secure macro stability under the July 2009 budget revision prompted calls for early elections by the opposition, and demonstrations by farmers and trade unions. However, despite the economic hardship and some politically very difficult decisions, social peace has been maintained.

9. Croatia became a NATO member in April 2009 and its EU accession prospects have strengthened with progress in bilateral talks with Slovenia on resolution of border disputes and continued progress in adopting the acquis communautaire. Croatia was granted candidate status in June 2004, and formal EU accession negotiations were launched in October 2005. However, the negotiations process has been stalled since October 2008 due to a longstanding border dispute with Slovenia. On September 11, 2009, Slovenia unblocked Croatia’s EU bid after the two countries reached an agreement to continue talks to resolve their border dispute with international mediation. To date, Croatia has opened 28 out of 35 negotiations chapters of the acquis communautaire with the European Commission, and provisionally closed twelve. In its 2009 Progress Report, the EU has assessed that Croatia continued to meet the political criteria and made progress in most areas, including intensified efforts in the field of rule of law. However, it has also indicated that the government will need to step up reform efforts in the area of the judiciary and fundamental rights, in particular regarding the independence and efficiency of the judiciary, the fight against corruption and organized crime, as well as effective public administration.

B. RECENT ECONOMIC DEVELOPMENTS

Pre-crisis economic developments

10. Before the onset of the global crisis, Croatia enjoyed strong economic growth. Growth, which averaged over 4 percent during 2004-08, was driven primarily by domestic demand. Growth was particularly strong in the non-tradables sector such as retail and construction as well as in tourism services. This high growth performance led to a rapid convergence with the EU in per capita income
terms (Figure 1). Poverty also declined during the period, with the absolute poverty rate falling from 11 percent in 2004 to 6.1 percent in 2008.

11. However, the boom in private investment and consumption, fuelled in part by large capital inflows, led to a rise in external vulnerability. Although exports grew quite rapidly (led by oil, agriculture and transport goods), import growth (led by capital goods and oil) was much stronger, which, coupled with terms of trade deterioration, led to the widening of the current account deficit from under 4.5 percent of GDP in 2004 to 9.3 percent of GDP in 2008. Since only half of the current account deficit was financed through non-debt creating inflows, external borrowing increased with the external debt to GDP ratio rising to 83 percent in 2008. At the end of 2008, around 90 percent of total corporate debt and about 70 percent of household debt was external or foreign currency denominated. The dependence of Croatian banks on foreign funding also increased their vulnerability to funding risks. By end-2008, about one quarter of all bank liabilities was due to non-residents (mainly to parent banks). However, on average, Croatian banks were not that highly leveraged—their loan to deposit at 113 percent compared favorably to other countries in the region.

12. That Croatia did not build as much external vulnerabilities as other Central and Eastern European countries reflects in part the Central Bank's proactive efforts to limit credit growth. Using a combination of monetary, administrative and prudential measures from 2005 until the onset of the crisis, the central bank authorities attempted to limit the foreign-financed increases in credit growth. By late 2008, foreign borrowing by banks has been heavily penalized through the marginal reserve requirement that eventually rose to 55 percent, and instead led parent banks to recapitalize their local banks. In addition, direct credit ceilings were introduced in 2007. While many of the prudential and administrative measures led to a slowdown of credit activity, they created, at the same time, incentives for investment-grade corporates to undertake direct borrowing from abroad.

13. Although fiscal discipline was largely maintained in the 2004-2007 period—with the fiscal deficit declining from 3.3 percent of GDP in 2004 to 1.2 percent of GDP in 2007—the fiscal discipline was relaxed in late 2007 election year. General government spending level increased to 42 percent of GDP in 2008, which coupled with declines in revenues in late 2008 led to a fiscal deficit of 1.8 percent of GDP. The rigidity of public spending, with over 80 percent in social transfers, wages and necessary operational costs, meant there was limited room to apply discretionary spending cuts to respond to unexpected shocks.

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1 Assuming unchanged inequality; or to only 8 percent, if the boom period resulted in an increase in inequality of about 10 percent (see discussion on non-representativeness of HBS data in paragraph 26). The poverty rate calculation has been done by applying national accounts' consumption growth rates onto the 2004 consumption distribution data from HBS.

2 If not otherwise stated, relative indicators for the external sector are expressed in EUR terms.

3 One of the measures was the introduction of a 12% credit-growth limit. Accordingly, banks that breach 1% m/m credit ceiling will need to subscribe to 75% of the exceeded amount to low-yield CNB bills at a 0.25% rate.

4 Using national methodology.

5 The spending as well as deficit numbers have been corrected for the Croatian Highways spending of 1.3 percent of GDP and deficit of 0.9 percent of GDP in 2008 to be comparable with the previous years.
Figure 2: Croatia: Crisis Impact and Recent Economic Developments, 2004-2009

Growth turned negative as domestic demand plummeted...

...which led to a fall in consumption and fiscal revenues.

Non-debt creating capital inflows declined...

...leading to an increase in external debt.

Source: CNB, MoF, CROSTAT, staff calculations

Impact of the crisis and the policy response

14. After slowing down in the second half of 2008, economic activity declined by 6.5 percent in the first half of 2009—the biggest decline since the country's independence. The decline was broad based, reflecting a fall in personal consumption and gross domestic investment as well as a decline in exports in the context of the deteriorating external environment. For the year as a whole, GDP is likely to decline by 5 percent.

15. The current account deficit underwent a sizable adjustment in the first half of 2009 and is likely to fall by at least one third to around 6.3 percent of GDP for 2009 as a whole. The contraction in domestic demand—which has been exacerbated by the reduced availability of capital inflows—has resulted in a larger decline in imports than exports and an improvement in the trade deficit. Income deficit grew significantly, reflecting mainly higher debt servicing costs.

16. Against the background of this large external adjustment, earlier fears of inability to refinance external obligations have diminished. Although both FDI inflows and portfolio flows have declined in 2009, all parent banks extended significant new additional credit lines in late 2008 and continue to roll over their outstanding exposure to Croatian subsidiaries. At the same time, there has been a shift in the refinancing strategy with the corporate sector turning increasingly to local commercial banks and the state development bank (HBOR). The state turned to the foreign capital market for the first
time since 2004, successfully placing its highest ever Eurobond and US$ issues\(^6\). Nonetheless, the large external exposure of the non-tradable sector and large debt obligations maturing over the short term continue to pose major external vulnerabilities.

17. **As to the developments in the banking sector following the financial crisis, the central bank acted promptly to reduce liquidity pressures on banks and restore confidence.** Emerging liquidity shortages have been addressed since October 2008 by the active use of regulatory requirements\(^7\) and repo auctions while maintaining the policy rate (the reversed repo rate) fixed at 6 percent. Further measures included increasing the allowed open foreign currency positions of banks, concluding swap agreements and interventions in the foreign exchange market, which additionally improved the liquidity within the financial system. Overall, approximately half of the overall liquidity boost (8 percent of GDP) was used to (re)finance government needs.

18. **The authorities also moved in an appropriate and timely manner to protect confidence in the financial sector.** Following the CNB response to the liquidity squeeze, in October 2008, the Croatian Government increased the deposit guarantee to EUR 56,000 (from around 27,000) to secure depositors’ trust and prevent a bank-run. A Stability Fund for non-bank financial institutions was established under the initiative of the Croatian Financial Services Supervisory Agency (HANFA) to retain confidence in the financial system through smooth exit of illiquid funds. These measures and the strong capitalization of Croatian banks have prevented major adverse reactions from depositors and investors. After a fall of around 5 percent during October 2008, savings deposits stabilized with an annual increase of some 3 percent by September 2009. At the same time, the awareness of the currency risk heightened with FX placements rising back to 70 percent and FX deposits to two-thirds of the total.

19. **The non-performing loans (NPL) ratio of the banking system has started to rise, reflecting the downturn of economic activity.** The NPL ratio was relatively low at the end of 2008 -- at 4.8 percent of total loans. During the first half of 2009, the NPL ratio rose to 6.1 percent. However, banks remain well capitalized, with the aggregate capital adequacy ratio at just under 16 percent as of the second quarter of 2009—well above the regulatory minimum of 10 percent (see Box 1).

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\(^6\) In the amount of EUR750 million at a fixed interest of 6.5 percent in May 2009 and US$1.5 billion at a fixed interest of 6.75 percent in October 2009.

\(^7\) These include: (i) abolition of the marginal reserve of 55 percent; (ii) lowering the ratio of a minimum required reserves on foreign currency liabilities from 28.5 to 25 and further to 20 percent in February 2009; and (iii) lowering the required reserve rate in December 2008 from 17 to 14 percent on banks’ liabilities, releasing altogether over €4 billion.
Box 1: Croatia Financial Sector Developments in 2008

The financial sector in Croatia remains bank-centric with over three-fourths of assets with banks. The banking sector comprised of 34 banks and 5 housing savings banks at the end of 2008, with around 110 percent of GDP in total placements. The increase of the leverage ratio over the last three years to 13 percent by end-2008, confirms that capital increased faster than banking assets. Of these, 16 banks in majority foreign ownership held over 90 percent of banks’ assets, with Austrian-owned banks accounting for 60 percent of assets. Gross earnings increased in recent years at a similar rate to average assets, yielding a stable return on average assets (ROAA) of around 1.6 percent. At the same time, capital increases outpaced bank earnings, leading to a fall in the return on average equity (ROAE) in 2006-08. Somewhat lower capital adequacy ratio (CAR) in 2008, at above 15 percent and well above the minimum required of 10 percent, was mostly due to increase of risk weights applicable to assets exposed to currency-induced credit risk (CICR), leading to 20 percent increase in risk-weighted assets. This was a response to improved monitoring of FX exposure. Recent data indicate that the growth in banks’ lending to the non-banking sector slowed down substantially. Value adjustments on loans grew noticeably from 2008 onwards but their increase still did not follow the rise in NPLs.

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<th>Table 1: Selected Financial Sector Soundness Indicators</th>
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<td>Leverage ratio (equity capital/total assets)</td>
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<td>Nonperforming loans to total loans</td>
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<td>Loan-loss provisioning</td>
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<td>FX denominated and FX indexed deposits to total deposits</td>
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<td>FX denominated and FX indexed loans to total loans</td>
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The share of assets held by non-bank financial intermediaries declined further to 22 percent during 2008 due to a drop in investment fund assets caused by share price declines and withdrawals. Total market capitalization of shares listed on Zagreb Stock Exchange was 42.5 percent of GDP in 2008, far below 128.1 percent at the end of 2007. HANFA (Croatian Agency for Supervision of Financial Services) decided to establish an intervention fund in October 2008 to enable orderly exit from the market in the event individual investment funds are unable to sell their financial assets and pay-off their investors. The duration of the Fund is five years. A precondition for the purchase of assets is that the company managing a problematic fund initiates liquidation proceedings, i.e., the process of closing the fund, within a reasonable time period. Leasing companies reinforced their position as the most important non-bank financial intermediaries, holding 7.4 percent of total assets of all financial intermediaries as of end 2008.

Source: CNB

20. Despite measures to alleviate liquidity pressures, banks’ increasing risk aversion (and lower demand for loans) has led to a decline in private sector credit growth. Private sector credit growth declined to less than 2 percent by September 2009 (from 10.5 percent in 2008). The slowdown in bank lending was particularly evident in loans to households, due to increased uncertainty regarding future employment and wages, the cost of borrowing as well as future developments in the real estate market. The limited supply of funds shifted towards the more secure financing of government borrowing requirements.

21. There is also significant bank balance sheet exposure to exchange rate risk. About three quarters of corporate and household debt is external or foreign currency-denominated and only a small fraction of bank loans (about 5 percent of household and 9 percent of corporate loans) is hedged. To some extent, high euroization of financial assets mitigates these foreign currency exposures at the aggregate level; although there could still be mismatches at the individual level between borrowers and depositors. The foreign exchange system of a tightly managed float with very limited degree of
exchange rate flexibility has remained in place as the main device to both anchor inflation expectations, and maintain financial sector stability. Recent analysis by the IMF suggests that the real exchange rate is not significantly misaligned and thus cannot be considered a factor in improving the country’s competitiveness. Rather the export sector has been hampered by a still cumbersome business environment and relatively high labor costs and had benefited little from the strong capital inflows and in particular green-field investments prior to the global financial crisis.

Box 2: Financial Sector Stress Test Results

The latest stress tests conducted by the Central Bank in June 2009 show that under the baseline macroeconomic scenario, assuming a 5-percent real economic decline, stable currency, full rollover, and a rise in NPLs by 50 percent, the overall banking sector would be able to amortize potential losses by its operating income; thus maintaining the capital adequacy which would enable credit growth. In contrast, smaller banks oriented to companies or riskier household loans would be affected more strongly by macroeconomic shocks and could suffer losses, although their capital adequacy ratios would remain above the statutory minimum.

However, under adverse macroeconomic conditions, assuming a real decline of 6 percent, depreciation of currency by 10 percent, and an increase in NPLs by 150 percent, which are highly unlikely, universal banks could suffer losses but their capital adequacy ratio would remain above the regulatory minimum. Banks dealing mostly with corporates and households would incur larger losses and their capital adequacy would fall below the regulatory minimum. In general, even under the downside scenario, the banking sector stability would not be threatened.

Total foreign currency reserves of the financial system and the increase in estimated potential outflows under the shock scenario, as well as liabilities due next year, may put some strain on the capacity of the central bank. However, as foreign parent banks have already expressed willingness to provide additional emergency liquidity support to leading Croatian subsidiaries, the reserve level may prove to be sufficient to mitigate the impact of a prolonged halt in capital inflows. The home country efforts to raise capital and stabilize operations of parent banks have a positive spillover effect on the subsidiary banks. The existence of subsidiary banks whose capital is separate from that of parent banks and which are subject to host country regulatory requirements was prerequisite for their capital strengthening.

Macroeconomic shocks, in particular depreciation, could hit individual households significantly and erode their capacity for timely repayments, although the impact would not be proportional. The percentage of indebted households in the lowest income groups is relatively small although their debt and loan repayment burdens are creating a significant share of households’ income. However, this does not represent a significant risk for banks as the share of these households in total debt is relatively small.

Source: Financial Stability No.3, 2009, CNB

22. In light of the developments in the real sector, the fiscal position has come under serious stress since late 2008. Revenues have underperformed due to the decline in economic growth and the decline in imports. The original budget for 2009 was prepared on macro assumptions that turned out to be optimistic as macro conditions swiftly worsened. The original budget was based on 2 percent GDP growth, while the revenue shortfall and the spending pressure from automatic stabilizers necessitated the revisions of the 2009 budget. The first such revision took place in April, followed by another two in July 2009. The authorities implemented a first round of expenditure cuts, mostly by delaying new capital projects and by achieving savings in current expenditures, early in the year.

23. Government efforts to bring public finances back to sustainability through the second and third 2009 Budget revisions helped to sustain macro stability. The 2009 budget revisions were based on an estimated decline of economic activity of 4.5 percent. The spending cuts were almost equally

8 Based on the methodology for the CGER (Consultative Group on Exchange Rate Issues) exchange rate assessment. IMF Staff Report for the 2009 Article IV Consultation, May 2009
distributed across spending categories, except for agricultural subsidies. The largest reduction affected: (i) salaries (a 15-percent reduction in government officials’ salaries, the rolling back of the 6-percent rise granted to public administration earlier this year, public employment freeze and a ban on setting up any new agencies); (ii) material expenses (the suspension of the purchase of new vehicles, the limitation of the use of official vehicles, credit cards and mobile phones, the reduction of representation costs in all state bodies by 80 percent); (iii) categorical social benefits (sick leaves’ reduction, increase in health co-payments and premiums, abolition of free-of-charge textbooks, transportation and dormitories, reduction in privileged pensions of MPs, constitutional court judges and government officials, pension indexation freeze, reduction in replacement rate for unemployment benefits), (iv) transfers for railways and road infrastructure investments with low rate of return, and (v) subsidies to railways. Additionally, the Government adopted several decisions from April to September 2009, dealing with cost rationalization and financial sustainability across all public enterprises. They include, among else, a 10-percent reduction in the wage bill, reduction in other operating costs and a plan for divestiture of non-core assets.

24. **The Government also initiated measures on the revenue side, responding to additional pressures to protect its finances.** Inability to reach social consensus on further rationalization of social transfers and the public sector wage bill, led the government to agree with the social partners on the introduction of taxes\(^9\) that would bring about 0.2 and 0.6 percent of GDP in new revenues in 2009 and 2010, respectively. This measure, coupled with increased excises on personal vehicles and other motor vehicles, vessels and aircrafts, an administrative fee on revenues from mobile telephony, and an increase in the VAT rate (from 22 to 23 percent) led to a partial recovery—amounting to 0.4 percent of GDP—of the revenue losses stemming from the declining economic activity. Overall, through a combination of expenditure reductions (amounting to 2.1 percent of GDP), and revenue increases, amounting to 0.4 percent GDP, the consolidated general government deficit is set to increase from 0.9 of GDP in 2008 to 3.2 percent of GDP\(^10\) in 2009.

25. **With the slowdown in economic activity, labor market conditions have also worsened.** The latest available data (September 2009) on newly registered unemployment as well as the number of unemployment benefit claimants showed a sharp increase by around 20 percent since October 2008 while vacancies fell by one third during the same period. Wage adjustments in the private sector prevented a stronger fall in employment early in the year. Business sector wages did not increase in real terms by August, while public sector wages still grew by 2.2 percent in real terms despite the April roll-back of an earlier awarded 6 percent rise. The official unemployment rate stood at close to 15 percent in September 2009.

26. **The growth slowdown is expected to lead to higher poverty rates in 2009.** While it is difficult from the available household budget survey (HBS) micro-data to be precise about the extent to which poverty may increase owing to data weaknesses\(^11\), a simulation of short-term changes in relative

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\(^9\) These include a special tax on salaries, pensions, and other income (also known as ‘solidarity tax’) equivalent to 2% of net income between HRK 3,000 and 6,000 and 4% of net income above HRK 6,000 (incomes below HRK 3000 are exempted). The tax applies until the end of 2010 (for self employed until February 2011). At the same time, the Act on the Special Tax also suspends indexation of pensions for the period January-December 2010, which is estimated to bring HRK 630 million of savings on pension payments in 2010.

\(^10\) The 3.2 percent of GDP deficit is based on the national fiscal methodology. According to GFS 1986, CGG deficit would rise from 1.3 to 3.4 percent of GDP. The overall public sector deficit, which includes off-budget items (Croatian Highways and pensioners’ debt repayment), would reach 4 percent of GDP, instead of the potential deficit of above 6 percent of GDP in the absence of revisions.

\(^11\) The representativeness of the HBS sample has deteriorated over time. From 2004, the survey over-represented pensioners or recipients of other social transfers to the detriment of higher-income groups, artificially reducing both the level and dispersion of income and consumption. While per capita GDP and consumption increased by
poverty between 2008 and 2009 on the poorest suggests a rise in poverty in 2009 by three and a half percentage points. Such magnitudes underscore the need to mitigate the social cost of the crisis among the poorest and most vulnerable by protecting pro-poor spending.

C. Macroeconomic Outlook and Debt Sustainability

27. Growth is slowing sharply in 2009. After 2.4 percent growth in 2008, GDP is expected to decline by 5.5 percent in 2009. Yet, there are some initial signs that the recession may be bottoming out as seasonally adjusted data show a marginal positive growth in the second quarter. The same holds for industrial production and tourism.

28. The outlook for growth in 2010 is subject to high uncertainty, and depends on the evolution of external demand for Croatian goods and tourism services, and foreign capital inflows. The government projection for growth stands at 0.5 percent for 2010. Private consumption, after declining by 7 percent in 2009, will slowly recover by 2012 towards the pre-crisis average of 4 percent, while the contribution to growth from public sector will be negative throughout the period. The contribution of net exports will be positive in 2009 due to a more evident import contraction, although it will reverse from 2010 onwards as investment recovers.

Table 2: Croatia - Key Macroeconomic Indicators (percent of GDP)

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<tr>
<td>Real GDP growth</td>
<td>4.2%</td>
<td>4.7%</td>
<td>5.5%</td>
<td>2.4%</td>
<td>-5.5%</td>
<td>0.5%</td>
<td>3.0%</td>
<td>3.5%</td>
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<tr>
<td>Total Investment</td>
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<td>-1.2</td>
<td>-0.9</td>
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<td>-1.8</td>
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<td>Balance of Payments</td>
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<td>Trade Balance</td>
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<td>-21.4</td>
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<td>-19.5</td>
<td>-19.7</td>
<td>-19.8</td>
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<tr>
<td>Current Account Balance</td>
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<td>-9.0</td>
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<td>5.7</td>
<td>6.1</td>
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</tr>
<tr>
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<td></td>
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<td></td>
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<td></td>
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<td>Foreign Debt</td>
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<td>Public Debt (incl. govt's guarantees)</td>
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<td>41.9</td>
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<td>Gross Internat. Res. (in months of Imports G&amp;NFS)</td>
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<tr>
<td>GDP (US$ millions)</td>
<td>44,432</td>
<td>49,038</td>
<td>58,558</td>
<td>69,332</td>
<td>63,163</td>
<td>67,451</td>
<td>70,192</td>
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<tr>
<td>Inflation (p.a., %)</td>
<td>3.3</td>
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<td>3.0</td>
<td>3.0</td>
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</tr>
<tr>
<td>Debt service to export ratio</td>
<td>24.5</td>
<td>38.6</td>
<td>36.1</td>
<td>27.8</td>
<td>55.6</td>
<td>52.5</td>
<td>46.9</td>
<td>42.9</td>
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<tr>
<td>Exchange rate HRK/US$ (p.a.)</td>
<td>5.95</td>
<td>5.84</td>
<td>5.37</td>
<td>4.94</td>
<td>5.28</td>
<td>5.10</td>
<td>5.20</td>
<td>5.30</td>
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</tr>
</tbody>
</table>

Note: Public sector refers to CGG (partial LGU’s coverage, excluding Croatian Highways from 2008 and pensioners’ debt repayment) following the national methodology. The above-mentioned items would add additional 0.6 percentage points of GDP to deficit on average throughout the projected period. External sector indicators are expressed in USD terms.

Source: MoF, CROSTAT, CNB, staff calculation

29. High current account deficits from the past are undergoing significant adjustments and are expected to gradually converge to more sustainable levels. A rebound in tourism income as well as higher absorption of official transfers is expected to lead towards stabilization of the external imbalance over the medium term. The CAD is expected to gradually decline towards 6 percent of
GDP with growing FDI to CAD coverage coming mostly from reinvested earnings of foreign-owned corporates and banks, and inter-company lending.

30. **The Government is taking steps to ensure smooth refinancing and recovery.** The Government-announced fiscal tightening in the 2010-2012 period with the CGG deficit reduced by around 0.5 percentage points of GDP in 2010. This entails a reduction of spending by 1.4 percentage points of GDP, led by a reduction in subsidies, social transfers, wage bill and other purchases of goods and services. Key spending measures include: (i) containment of wage bill growth at below 2 percent nominally in 2010-2012, respectively; (ii) further reduction of subsidies to shipyards, railways and agriculture towards 1.8 percent of GDP in 2010; and (iii) a reduction in social transfers (including veterans’ benefits). The Government has also announced further work on the rationalization of local government units and administrative structures.

<table>
<thead>
<tr>
<th>Table 3: Medium-Term Fiscal Framework, 2008-2012, % of GDP</th>
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<td>Total revenue</td>
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<td>37.7</td>
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<td>20.5</td>
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<td>20.0</td>
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<tr>
<td>Social contributions</td>
</tr>
<tr>
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</tr>
<tr>
<td>12.2</td>
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<td>11.6</td>
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<td>10.9</td>
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<td>Grants</td>
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<td>0.2</td>
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<tr>
<td>0.3</td>
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<tr>
<td>0.4</td>
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<tr>
<td>-0.4</td>
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<tr>
<td>0.3</td>
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<tr>
<td>Revenue from assets</td>
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<tr>
<td>1.9</td>
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<td>2.1</td>
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<tr>
<td>1.0</td>
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<tr>
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<td>Administrative fees</td>
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<td>2.6</td>
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<td>2.6</td>
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<td>Other revenue</td>
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<tr>
<td>Sales of nonfinancial assets</td>
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<tr>
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<tr>
<td>Total expenditures</td>
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<td>0.7</td>
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<td>0.7</td>
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<tr>
<td>0.7</td>
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<tr>
<td>Social benefits</td>
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<tr>
<td>17.8</td>
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<td>19.4</td>
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<td>Total deficit</td>
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<td>-2.7</td>
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<td>-2.6</td>
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<tr>
<td>-1.8</td>
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Note: CGG, national methodology
Source: Ministry of Finance, November 2009, Draft Budget for 2010-2012

31. **Croatia faces external financing challenges over the near term.** Gross external financing needs will be, on average, around 21 percent of GDP -- some two percentage points of GDP higher than before the crisis -- two-thirds of which is due to principal repayment requirements. It is expected that FDI and portfolio investment will cover one-fourth of the financing requirements, with the rest coming, on a declining trend, in the form of loans and capital from abroad. The large stock of corporate sector FX debt (almost 64 percent of total) and corresponding large debt obligations maturing over the short term continue to create potential external vulnerabilities.

32. **The 2010-2012 Medium-Term Fiscal Framework suggests containment of public debt from 2011 onwards.** With additional non-interest spending cuts over the medium term, the government

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12 However, the uncertain outcome of the ongoing efforts to privatize shipyards poses a risk to such a strategy in terms of one-off debt assumptions amounting to a maximum of one percent of GDP in 2010. Privatization tenders for six state-owned shipyards were issued in July 2009 with two valid bids submitted. The second round of tendering process is expected to commence before the year-end.
aims to reach sustainable level of primary balance by 2012. Sensitivity analysis to public debt sustainability suggest that (i) a rise in real interest rates by 30 percent, would require a primary surplus of over 1 percent of GDP to keep the level of debt stable; (ii) a slow recovery of growth by 0.5 percent per annum would require higher primary surplus of almost 2 percent; and (iii) that the rise in inflation by 1.5 percentage point would not have a significant impact due to the elasticity of money supply. The magnitude of public debt is not expected to pose a significant risk as the fiscal deficits are expected to decline and contingent liabilities on the government—arising from shipyards mainly—are monitored and being addressed as part of their privatization process.

Table 4: External Financing and Exposure Indicators, 2005-2012

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<tr>
<th>Indicators</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
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<td>5.8</td>
<td>6.8</td>
<td>7.6</td>
<td>9.0</td>
<td>6.3</td>
<td>6.5</td>
<td>6.3</td>
<td>6.0</td>
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<tr>
<td>(of which scheduled interest payments)</td>
<td>1.5</td>
<td>1.9</td>
<td>2.4</td>
<td>2.8</td>
<td>3.1</td>
<td>3.2</td>
<td>3.2</td>
<td>3.1</td>
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<td>Principal Repayments</td>
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<td>12.2</td>
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<td>0.9</td>
<td>0.8</td>
<td>0.9</td>
<td>0.8</td>
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<td>O.W. IBRD</td>
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<td>Banks</td>
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<td>1.2</td>
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<td>Other private</td>
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<td>7.9</td>
<td>15.5</td>
<td>12.7</td>
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<td>Increase in net official reserves</td>
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<td>24.4</td>
<td>21.3</td>
<td>19.5</td>
<td>17.8</td>
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<tr>
<td>Foreign Investment (net)</td>
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<td>6.6</td>
<td>3.1</td>
<td>4.5</td>
<td>5.7</td>
<td>4.1</td>
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<tr>
<td>Portfolio Investment (net)</td>
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<td>0.0</td>
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<td>0.1</td>
<td>0.1</td>
<td>-0.4</td>
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<td>MLT Disbursements</td>
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<td>19.5</td>
<td>17.8</td>
<td>16.3</td>
<td>19.4</td>
<td>15.7</td>
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<td>1.5</td>
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<td>O.W. IBRD</td>
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<td>Banks</td>
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<td>2.6</td>
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<td>Other private</td>
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<td>16.7</td>
<td>13.0</td>
<td>12.0</td>
<td>16.3</td>
<td>13.1</td>
<td>12.0</td>
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<td>1.8</td>
<td>1.1</td>
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<td>-0.6</td>
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<td>Debt and debt service indicators, %</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>TDO/GDP</td>
<td>161.4</td>
<td>179.7</td>
<td>192.7</td>
<td>187.6</td>
<td>229.8</td>
<td>223.9</td>
<td>212.2</td>
<td>199.5</td>
</tr>
<tr>
<td>TDO/XGS</td>
<td>68.6</td>
<td>78.6</td>
<td>82.6</td>
<td>80.2</td>
<td>93.0</td>
<td>89.7</td>
<td>86.7</td>
<td>82.8</td>
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<td>TDS/XGS</td>
<td>24.5</td>
<td>38.0</td>
<td>36.1</td>
<td>27.8</td>
<td>55.6</td>
<td>52.5</td>
<td>46.9</td>
<td>42.9</td>
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<td>Interest payments/GDP</td>
<td>1.8</td>
<td>2.2</td>
<td>2.6</td>
<td>2.8</td>
<td>3.8</td>
<td>4.3</td>
<td>4.3</td>
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<tr>
<td>IBRD exposure indicators (%)</td>
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<td>5.0</td>
<td>6.5</td>
<td>7.4</td>
<td>6.8</td>
<td>7.2</td>
<td>7.1</td>
<td>7.1</td>
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<tr>
<td>IBRD DS/public DS</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
<td>0.6</td>
<td>0.9</td>
<td>0.8</td>
<td>0.8</td>
<td>0.7</td>
</tr>
<tr>
<td>IBRD DS/XGS</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
<td>0.6</td>
<td>0.9</td>
<td>0.8</td>
<td>0.8</td>
<td>0.7</td>
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<tr>
<td>IBRD TDO (US$m)</td>
<td>808.1</td>
<td>1,030.6</td>
<td>1,086.5</td>
<td>1,215.0</td>
<td>1,217.9</td>
<td>1,451.6</td>
<td>1,643.6</td>
<td>1,671.6</td>
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</table>

Note: External sector indicators are expressed in USD terms
Source: MoF, CROSTA T, CNB, staff calculation

33. External debt is projected to follow a sustainable path. External debt in EUR terms is expected to peak at 91 percent of GDP in 2009 (or 93 percent in US$ terms), and decline thereafter to reach 85 percent of GDP in 2012 (or 83 percent in US$ terms). Sensitivity analysis suggests that a one-time real depreciation of the exchange rate of 20 percent would result in an external debt to GDP ratio of 107 percent in 2012 (as oppose to 96 percent with a one-time real depreciation of 10 percent), while the rise in implicit interest rate by 30 percent would lead to external to GDP ratio close to 90 percent by 2012. IBRD debt as a share of external debt will be around 2.5 percent over the observed period, while debt service to the IBRD will remain around 7 percent of total public debt service. IBRD disbursements of about US$300 million per year for the 2010-2012 period on average (with this DPL included) would be covering around two percent of overall external financing needs.
Table 5: Public and External Debt Sustainability
(percent of GDP)

<table>
<thead>
<tr>
<th></th>
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<tr>
<td>Baseline General government sector debt</td>
<td>33.3</td>
<td>29.1</td>
<td>32.7</td>
<td>34.3</td>
<td>34.9</td>
<td>34.5</td>
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<tr>
<td>Change in general government sector debt</td>
<td>-2.6</td>
<td>-4.2</td>
<td>3.6</td>
<td>1.6</td>
<td>0.6</td>
<td>-0.4</td>
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<tr>
<td>Identified debt creating flows</td>
<td>-2.6</td>
<td>-2.3</td>
<td>4.3</td>
<td>2.1</td>
<td>0.4</td>
<td>-0.7</td>
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<tr>
<td>Primary deficit</td>
<td>-0.6</td>
<td>-0.8</td>
<td>1.4</td>
<td>0.7</td>
<td>0.6</td>
<td>-0.1</td>
</tr>
<tr>
<td>Revenue and grants</td>
<td>40.7</td>
<td>39.8</td>
<td>38.2</td>
<td>37.5</td>
<td>36.2</td>
<td>35.4</td>
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<td>Primary (non interest) expenditure</td>
<td>40.2</td>
<td>39.0</td>
<td>39.7</td>
<td>38.1</td>
<td>36.8</td>
<td>35.3</td>
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<tr>
<td>Automatic debt dynamics</td>
<td>-1.5</td>
<td>-1.1</td>
<td>2.5</td>
<td>1.0</td>
<td>-0.5</td>
<td>-0.9</td>
</tr>
<tr>
<td>contribution from interest rate/growth diff</td>
<td>-1.4</td>
<td>-1.1</td>
<td>2.5</td>
<td>1.0</td>
<td>-0.5</td>
<td>-0.9</td>
</tr>
<tr>
<td>contribution from exchange rate dep</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>Other identified debt creating flows</td>
<td>-0.5</td>
<td>-0.4</td>
<td>0.4</td>
<td>0.4</td>
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<tr>
<td>Residual, including asset changes</td>
<td>0.0</td>
<td>1.9</td>
<td>0.8</td>
<td>0.5</td>
<td>-0.2</td>
<td>-0.3</td>
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<table>
<thead>
<tr>
<th>External debt</th>
<th>76.9</th>
<th>83.1</th>
<th>91.2</th>
<th>91.0</th>
<th>88.7</th>
<th>85.4</th>
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<tbody>
<tr>
<td>Baseline gross external debt, in EUR terms</td>
<td>2.0</td>
<td>6.2</td>
<td>8.1</td>
<td>-0.2</td>
<td>-2.3</td>
<td>-3.3</td>
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<tr>
<td>Change in external debt</td>
<td>-2.8</td>
<td>-3.3</td>
<td>7.3</td>
<td>3.1</td>
<td>0.7</td>
<td>-0.6</td>
</tr>
<tr>
<td>Identified debt creating flows</td>
<td>5.1</td>
<td>6.4</td>
<td>3.4</td>
<td>3.6</td>
<td>3.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Current account deficit, excluding interest payments (pos)</td>
<td>-4.7</td>
<td>-5.1</td>
<td>-1.9</td>
<td>-2.7</td>
<td>-3.4</td>
<td>-3.8</td>
</tr>
<tr>
<td>Net non debt creating capital inflows (neg)</td>
<td>-3.2</td>
<td>-4.6</td>
<td>5.8</td>
<td>2.2</td>
<td>0.8</td>
<td>0.2</td>
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<tr>
<td>Automatic debt dynamics</td>
<td>3.3</td>
<td>3.2</td>
<td>3.0</td>
<td>3.1</td>
<td>2.8</td>
<td>2.8</td>
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<tr>
<td>contribution from nominal interest rate</td>
<td>-3.7</td>
<td>-2.3</td>
<td>2.8</td>
<td>-0.9</td>
<td>-2.0</td>
<td>-2.6</td>
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<tr>
<td>contribution from real GDP growth</td>
<td>-2.8</td>
<td>-5.5</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>contribution from exchange rate developments</td>
<td>4.8</td>
<td>9.5</td>
<td>0.9</td>
<td>-3.3</td>
<td>-3.0</td>
<td>-2.7</td>
</tr>
</tbody>
</table>

Source: IMF Article IV and staff calculations. Note: GG debt excludes government guarantees. The proposed DPL program is included in the public debt sustainability analysis.

34. The short-term response by the authorities was appropriate to maintain the macro stability; and as envisaged in the 2010-2012 budget, these measures need to be complemented with more long-term efforts on fiscal consolidation. Indeed, while the proposed program supports initial but politically challenging efforts to maintain macro stability, more ambitious and sustained adjustments in social sector spending, improved targeting of social benefits, rationalization of the cost of public administration, as well as scaling back subsidies through restructuring and privatization of loss-making SOEs are envisaged over the medium term to reach the deficit target of 1.8 percent of GDP by 2012. Even though there are risks to the outlook associated with the difficult external environment, the macroeconomic policy framework is adequate for the purposes of this development policy loan.

35. However, a quick rebound to pre-crisis growth rates is unlikely if not accompanied by structural reforms to strengthen the competitiveness of the economy. In this regard, the Government’s emphasis on reforms to enhance productivity and Croatia’s growth potential through (i) improving the business environment with the finalization of the privatization agenda, public administration reform and acceleration of judicial reform and the anti-corruption efforts; (ii) increasing the contribution of labor to growth by addressing skill mismatches through education reform and advancing the flexibility in the labor market through the recent revisions of the labor law; as well as (iii) deepening trade integration and supporting innovation, are most welcome.
D. RELATIONSHIP WITH THE IMF

36. The last Article IV Fund mission was held in April 2009 with the Board discussion on June 2, 2009, while a staff visit took place on October 14-19, 2009 to assess the appropriateness of the 2010 budget and supporting policies in securing macro stability. The Fund commented favorably on the way the government had handled the challenges raised by the crisis. It also concluded that the pace of economic decline started to slow, and economy has expected to bottom out of the severe recession in 2010. The Fund recommended continued vigilance to preserve financial sector soundness, which will be instrumental to economic recovery. Fiscal pressures were moderated by swift budget revisions which helped contain the headline fiscal deficit (particularly compared with Croatia’s peers) and maintain adequate access to market financing. While the authorities’ focus on fiscal consolidation in 2010 and the medium term is appropriate, it will be challenging to achieve. More ambitious and sustained adjustment will be critical to help improve the quality of public spending, achieve the envisaged medium-term budget deficit target, and allow the authorities to roll back the weight of the government in the economy over the medium-term. In particular, accelerating the pace of structural reforms would help the economy to emerge more resilient from the current juncture. The authorities have not approached the Fund with respect to a possible program.

III. THE GOVERNMENT’S PROGRAM AND CONSULTATION PROCESS

37. The most recent strategic setting for reforms in Croatia is to a large extent defined by preserving and sustaining financial and macroeconomic stability and creating preconditions for recovery and stable economic growth. The latest strategic document that defines the strategy of the Government of Croatia targets twelve general goals as defined in the Strategy of Government Programs for 2010-12 adopted by the Government in September 2009. For each of the general goals, the Government outlined measures on how to achieve these goals as well as corresponding monitoring indicators. The primary goals are to secure macroeconomic and economic stability; enhance the environment for the development of a competitive economy; and strengthen the rule of law.

38. To respond directly to the current crisis challenges and build consensus on mitigation policies, an Economic Council was formed as the Government’s primary advisory body, consisting of the business community, academia, unions, financial sector representatives and government decision-makers. In April 2009, the Economic Council has proposed the following interventions adopted by the Government, which the DPL program supports:

i) Consolidation of public finances;
ii) Measures to attract FDI and improve capital inflows;
iii) Measures to support access to finance;
iv) Labor market measures to ensure sufficient funds for unemployment benefits and ensure funds for targeted active labor market policies; and
v) Social policy measures to counter the effects of crisis on the most disadvantaged groups of citizens by keeping the current level of social assistance; and designing additional programs and related funds for targeting the most disadvantaged.

39. Consultation process. In its July 2009 session, the Council has discussed and endorsed the July 2009 budget revisions complemented with, among else, the amendments to the VAT law, employment intermediation law, the law on special tax (colloquially solidarity tax) and the suspension of pension indexation. Although various options to stem the rise in deficit and stabilize the fiscal accounts have been put on the table by the Government, the package opted for in the short term was to largely rely on new tax revenues, while designing in parallel a spending rationalization program to be implemented over the medium term.
40. Additionally, a broad consultation process was held in November-December 2008 on the health reform elements. Apart from the medical professional associations, the communication campaign covered patients' associations, common citizens through the public electronic media, while the presentation of the reform and its expected outcomes are still posted on the Ministry of Health's website. The Economic and Social Council, a tripartite body, endorsed the package unanimously before its submission to the Parliament for enactment. The same forum in October 2008 endorsed the laws on PPPs and public procurement, while the Organic Budget Law went through additional consultations with the associations of local government units. Financial-sector related laws have been posted for consultations for more than a year and refined by the working groups consisting of the professional associations, CNB, HANFA, MoF and the consumers' association.

41. In general, the consultative process on laws and strategies over the last few years was significantly strengthened. This has been partially driven by the fact that the Government set up 33 core and extended negotiating teams for the same number of the EU acquis chapters which consisted of over 1,500 experts, representatives of civil society and academia.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

A. LINK TO COUNTRY PARTNERSHIP STRATEGY

42. The Bank Group's Country Partnership Strategy (CPS) for FY09-FY12 was presented to the Board in September 2008 (Report No.44879-HR). The goal of the CPS is to support, in a selective fashion, the Government's main strategic priorities in the context of Croatia's EU accession process: (i) sustaining macroeconomic stability through enhancing the efficiency and effectiveness of public finances and strengthening financial sector supervision; (ii) strengthening private-sector led growth and accelerating convergence with the EU through, among else, enhancing public sector governance; (iii) improving the quality and efficiency in the social sectors through increasing the sustainability and equity of pension systems, improving health system efficiency and outcomes, enhancing the education system to support a knowledge-based economy and improving social inclusion and better targeting of social assistance; and (iv) increasing the sustainability of long-term development. There are at least two goals (i and iii) of the CPS that the proposed DPL would support. As described earlier, the DPL has been complemented by analytical and advisory services focusing on labor markets, social protection and governance.

B. COLLABORATION WITH DEVELOPMENT PARTNERS

43. The IMF and the Bank collaborate closely in their efforts to support the Government of Croatia in undertaking expenditure-led fiscal consolidation, improving tax administration and strengthening competitiveness. The authorities successfully completed the latest IMF stand-by arrangement at the end of 2006, and the IMF now provides policy advice and analysis through its surveillance activities (Article IV consultations and staff visits) and technical assistance. The Fund focuses on monetary and exchange rate policies, fiscal policy, financial sector stability and the external sector and Croatia's competitiveness. In the financial sector, the Bank and the Fund share responsibility and coordinate their financial policy advice to the Croatian authorities. The Croatian government recently adopted a decision to accept a general and special allocation of International Monetary Fund Special Drawing Rights worth a total EUR300 million, offered as a global anti-recession measure aimed at increasing economic system liquidity.

44. The Bank continues to cooperate closely with the European Commission (EC) in assisting Croatia with complementary projects and analytical advisory services to facilitate accession to the EU and build capacity to use EU structural and cohesion funds. In particular, in the areas of public administration, public finance management, environment and judicial reform, the Bank and EC activities are closely coordinated.
45. Cooperation with the UN Agencies, namely UNDP and UNHCR continue to focus on economic and social revitalization. This includes a recent assessment on, the social and labor market impact of the crisis conducted under a joint cooperation agreement with the UNDP.

C. RELATIONSHIP TO OTHER BANK OPERATIONS

46. The Social Welfare Development Project (SWDP) was approved by the World Bank Board in 2004. In particular, the SWDP contributes to wider participation in economic growth by improving the quality and efficiency of social services. The SWDP was designed based on the National Program for the Reduction of Poverty, adopted by the Government in August 2002, which proposed a multidimensional approach to the poverty reduction by proposing measures that are not limited to the social welfare system only, but also include actions in the areas of labor market, employment, education, health and housing.

47. The Bank is also supporting the implementation of the Revenue Administration Modernization Project, approved in May 2007, which aims to further strengthen budget management and fiscal adjustment by increasing the compliance rate and through a reduction of compliance costs to boost private-sector growth. This will be done by aligning tax policies and administration practices with EU standards and encouraging economic activity through more efficient, effective and transparent tax operations.

48. The Development of Emergency Medical Services and Investment Planning project, approved in September 2008, supports, among other, supply-side reforms by developing restructuring plans for health care facilities and human resources through the development of a health facilities masterplan.

49. The Croatia Export Finance Intermediation Loan which was approved by the Board in August 2009 will support the Government’s objective to maintain a steady flow of credit to the private sector and assist in enhancing its competitiveness.

D. LESSONS LEARNED

50. A number of important lessons relevant for the design of the proposed DPL emerged from the CAS Completion Report and the Implementation Completion Report for the PAL2. The Implementation Completion Report for the Programmatic Adjustment Loan 2 (PAL2) was completed in July 2009, and provides overall moderately satisfactory rating to the operation. The PAL2 was closely aligned with the Government’s economic program and its EU accession agenda, and reflected the Bank’s analytical work. Following the Board presentation in May 2007, PAL2 encountered a series of implementation problems prior to the parliamentary elections, delaying its effectiveness until April 2008 and the disbursement of the first tranche until May 2008. Though the closing date was extended (from June 30, 2008 to October 31, 2008) to allow for additional time to complete the second tranche conditions, they were not fully completed by that date and the Government and the Bank agreed to let the loan close at the end of October 2008, without disbursing the EUR50 million second tranche. However, implementation of the unfinished PAL2 agenda continued beyond the closing date (see Box 3).

51. Many important reforms have been implemented under the PAL program. However, there has been hesitation or even backtracking at times, especially in the period leading to the parliamentary elections. Furthermore, Croatia has maintained strong macroeconomic performance and solid economic growth for a prolonged period of time, and the Bank’s contribution to Croatia’s external financing needs was rather modest. The PAL program was designed to support a broad and politically difficult reform agenda. While some of the planned actions represented first generation reforms (such as the reduction of subsidies, privatization of companies in the competitive sector), taken together, they comprised a politically and socially difficult package (from restructuring of the railways company to the reform of social benefits and the privatization of shipyards). The Government and the Bank both
believed and continue to believe that these reforms are important priorities, but full implementation has proven difficult. Going forward, it was agreed that Croatia’s reforms may be better supported by development policy lending that focuses on a more narrowly defined agenda based on past performance.

Box 3: Progress with the Outstanding PAL Agenda

Under the PAL-supported Program, Croatia made significant progress towards achieving the Program’s development objectives and associated outcome goals, despite some setbacks and the inability to complete some policy actions by the time of loan closing.

Progress has continued, where possible, on this outstanding agenda:

- Enactment of the civil service salary act and a job classification decree - Supplementary legislation and amendments, including a new job classification decree, have been enacted to harmonize with the Civil Service Act. The key element, which is still missing from Croatia’s civil service reform, is the Civil Service Salaries Act. By early 2007, the Government had drafted a law consistent with EU best practice incorporating the principles of fiscal responsibility, equal pay for equal work, performance-based pay, and decompression to allow more competitive salaries for top level staff. However, extensive discussions with civil service unions delayed submission to Parliament until December 2008. In early 2009, the draft law had been overtaken by events, as even its modest fiscal cost proved unaffordable in the context of the crisis. Instead, public sector wages had to be reduced. The new Minister of Administration aims to propose an integrated public administration salaries’ law along the above-described principles in 2010.
- Privatization of one shipyard and the last agri-combinat - Shipyards’ privatization has continued in the context of EU negotiations with privatization tenders for all six state-owned shipyards issued in July 2009 and to be repeated by year-end. The privatization of the last agri-combinat Vupik, a PAL2 benchmark, has been finalized in November 2009.
- Railways restructuring and three subsidiaries’ privatization - Three railways’ subsidiaries have been privatized before the PAL2 closure; however, railways are continuing to struggle financially particularly in the light of the crisis-induced decline in traffic, and despite the suspension of the over-generous 2007 collective bargaining agreement that led to a reversal in financial performance of the company. In September 2009, the government requested the acceleration of the non-core assets divestiture and the introduction of a 10-percent reduction in wages.

E. ANALYTICAL UNDERPINNINGS OF THE PROGRAM

52. This DPL is based on a series of economic and sector work on Croatia. This includes the following analysis:

- **Restructuring Public Finance to Sustain Growth and Improve Public Services - Public Finance Review:** The DPL is partly based on the results of the Public Finance Review (PFR) completed in February 2008. The PFR analyzed Croatia’s fiscal consolidation challenges given the country’s EU accession efforts, and explored the ways to increase public sector efficiency in the areas of transport, environment, education, health, pensions, social benefits as well as in public administration and state subsidies. It also offered recommendations on strengthening public finance management.

- **ROSC – Corporate Governance:** The assessment, prepared in March 2008, forms part of the joint World Bank/IMF Reports on the Observance of Standards and Codes (ROSC) initiative and was conducted in collaboration with various national stakeholders. It acknowledges significant progress made by Croatia during the past seven years and recommended policy measures to overcome the remaining challenges, in particular those related to the rise of
financial conglomerates and ownership consolidation in privatized companies, as well as to the need for improving the corporate governance framework.

- **Republic of Croatia: Financial System Stability Assessment—Update:** The Report was prepared by a joint World Bank and the IMF team in May 2008. It assessed the Croatian financial sector and applied measures for addressing the macroeconomic and financial vulnerabilities associated with rapid credit growth. It has also recommended priority measures for financial system stability, contingency planning, liquidity and risk management, and non-bank financial sector supervision and cross-sector risks.

- **Regional Study on Performance Based Budgeting:** The study was completed in October 2008 and has reviewed public finance management practices of the selected countries in Central Europe, including Croatia. The study drew recommendations for strengthening program and medium-term budgeting and underlined that reform of public financial management (PFM) practices to ensure efficiency and effectiveness of public spending has become even more important at a time of crisis.

- **Croatia’s EU Convergence Report – Reaching and Sustaining Higher Rates of Economic Growth:** The report was completed in June 2009 and focuses on the key policy recommendations for sustainable growth acceleration. It suggests a set of measures around the so-called “Lisbon Agenda” that appear to be both feasible and sufficient to build the foundations for higher and sustained rates of economic growth. Those related to improving the efficiency and effectiveness of the labor market and social system are providing the highest rate of return, but are clearly politically most demanding.

- **Institutional Framework and Fiscal Risk Assessment for Public Private Partnership (PPP):** This ongoing technical assistance aims to (i) strengthen the existing legal and regulatory framework in Croatia with regard to fiscal risk assessment of PPP; (ii) identify issues in past PPP implementation and (iii) develop a fiscal risk assessment model for PPPs to be used in informing future investment decisions. The draft report has been delivered in September 2009.

- **Crisis Impact on Poverty and Labor Markets:** This work, done jointly with the UNDP, aims to assist the government of Croatia in finding the most effective ways to mitigate the labor market and poverty effects of the current global economic crisis. In particular, it will: (i) identify areas and population groups that require government intervention/help; (ii) assess the efficiency of the current and planned labor market and social safety net programs to address emerging issues; and (iii) recommend measures to improve the efficiency of the programs. Under the project, an update of the poverty assessment has been undertaken. The expected delivery is end-2009.

- **Pensions:** Informal analytic work on the pension sector, utilizing social insurance modeling tools, has been ongoing and guiding the design of the pension component.

V. THE PROPOSED DEVELOPMENT POLICY LOAN (DPL)

A. OPERATION DESCRIPTION

53. **Reform areas:** The reform program supported by the DPL is built on three pillars covering crisis mitigation measures: (i) public finance strengthening; (ii) social sector resilience and targeting; and (iii) efficiency and stability of the financial sector. The measures supported are in line with the policy actions proposed by the Government’s Economic Council in its anti-recessionary program adopted in April 2009.
54. The single-tranche DPL program presented below focuses largely on the short-term measures that aim to protect macroeconomic and social stability in response to the crisis through fiscal consolidation, efforts to protect the vulnerable, and measures to improve the efficiency of the financial sector.

55. At the same time, some of the measures supported in this loan contribute to addressing the medium-term reform agenda of strengthening public finances through rationalization of public expenditures in selected areas such as health, pensions and social assistance (through better targeting), improvements in public financial management and public procurement, and of improving financial intermediation.

56. Table 6 summarizes the pillars (broad policy areas), reform areas and key actions covered under each of them. The specific reforms supported in each area are described in the following sections; the Government’s Letter of Development Policy (Annex 1); and the DPL policy matrix (Annex 2). These reform efforts are in line with the medium-term reform agenda laid out in Government’s strategic documents, supported as well by the dynamics of EU integration and the broad consultative/consensus building processes involved in setting the strategic framework as described in the DPL matrix under the Medium-term actions and goals.

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<thead>
<tr>
<th>Table 6: Summary of the Proposed Reform Program</th>
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</thead>
<tbody>
<tr>
<td><strong>Pillar Objectives</strong></td>
</tr>
<tr>
<td>Strengthening Public Finance</td>
</tr>
<tr>
<td></td>
</tr>
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<td></td>
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<td></td>
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<td></td>
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<tr>
<td></td>
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<tr>
<td>Strengthening Social Sector Resilience and Targeting</td>
</tr>
<tr>
<td>Pillar Objectives</td>
</tr>
<tr>
<td>------------------</td>
</tr>
<tr>
<td>Enhancing the Efficiency and Stability of Financial Sector</td>
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<tr>
<td></td>
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<tr>
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</tr>
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57. Moreover, in many of these areas, while not supported directly in this DPL as prior actions, the Government is in the process of articulating further measures consistent with their medium term agenda (and in some cases these are being developed through the Bank’s AAA program). These are summarized at the end of each sector subsection below as well as in the Policy Matrix in the Annex 2 under the medium-term policies.

B. POLICY AREA I - STRENGTHENING PUBLIC FINANCE

58. Rationalizing Public Expenditures. As noted above (in paragraph 23), the Government has initially had to resort to emergency measures to contain a widening fiscal deficit, including through wage reduction, public investment rationalization, pension measures, VAT increase, and the introduction of the solidarity tax. While their timing may have been dictated by short term exigencies, some of these measures form part of the medium-term reform agenda, as detailed below.

Curbing the Wage Bill

59. While the public sector wage bill has declined over the last four years (during the PAL series), it remained above that of Croatia’s peers, and has posed a fiscal challenge with the crisis outbreak. From April 2009, the Government adopted a decision on a 15-percent pay reduction for state officials, and reached agreement on the rolling back of the 6-percent pay raise granted to civil servants earlier this year. In May 2009, the same agreement was reached with the public service unions which employ around 140,000 employees. With the third revision of the 2009 Budget, a decision has been adopted on the public employment freeze\(^\text{13}\) and a ban on setting up any new agencies, while the existing ones will be reviewed and proposed for consolidation. The overall savings in 2009 from the above decisions amounts to 0.4 percent of GDP in 2009 and would lead to further relative declines of the wage bill in 2010 by additional 0.2 percent of GDP under the current wage and employment freeze policy.

60. Medium-term agenda. Since adequate public administration capacity is one of the key requirements for EU accession, further reforming and modernizing public administration is critical. To realign the size (18 percent of the labor force) and structure of public administration, in 2008, the

\(^{13}\) Except in cases where agreed as part of the EU negotiations and funding secured through EU funds.
Government undertook functional reviews of ministries and county offices, supported by the SIDA Trust Fund managed by the Bank. The newly set-up Ministry of Administration plans to follow-up on the recommendations from that work. Additionally, a long-delayed decision on setting up the central payroll and HR registry has been adopted in March 2009. The Ministry of Finance has launched piloting of the new personnel and payroll system to help control the size of public administration and wage bill. Still, the current reward system remains fragmented and too compressed to provide performance incentives to staff. It also posed issues on equity, and impeded the development of an integrated public administration system. The new Ministry of Administration plans to draft an integrated Law on Public Administration Salaries that includes provisions for decompression and performance-based remuneration and has requested assistance from the Bank.

**Improving the Financial Sustainability of the Pension System**

61. **As a result of earlier reform efforts, the share of pensions in GDP (including administrative cost) had been declining until 2007.** However, the pension policy measures adopted in the election year 2007 led to a rise in pension spending again above 10 percent of GDP. Although those efforts aimed to stem the further fall of replacement rate below the current 44 percent, they have also exhausted the savings stemming from combined price-wage valorization and indexation (so-called Swiss indexation) and have delayed plans to raise the second pillar contribution rate above the current 5 percent.

62. **Short-term pension measures, introduced in 2009, aim to claw back this spending hike in the 2009-2010 period.** They include: (i) a suspension of pension indexation in 2010; (ii) an introduction of a temporary solidarity tax of 2 and 4 percent for monthly pensions above HRK3,000 and HRK6,000, respectively from August 2009; and (iii) a reduction of pensions of Government members, MPs, and Constitutional Court judges by 10 percent from August 2009. These measures altogether are expected to yield around 0.3 percent of GDP in savings in 2010.

63. **In addition, privileged pensions are being cut back.** The reduction affected the Government members, MPs and Constitutional Court judges, yielding minor savings in 2009 and 2010 (of HRK3 and HRK7.2 million, respectively). However, this reduction is still important as it provided an impetus for tightening the eligibility criteria for disability and minimum pensions of the Homeland War Veterans (HWV), and for a more comprehensive and long-term reform of the privileged pension system in the future. Such a reform aims to unify pensions granted under special terms and to gradually adjust them with the general public pension system, with the possible use of mandatory and voluntary funded pension system in the transition period.

64. **Medium-term agenda.** Measures in the pension area undertaken in 2009 provide short-run fiscal relief, but are aimed to be followed with measures needed to improve the long-run system sustainability. The statutory retirement age for women (at the age of 60) is below the actuarial balance with the current contribution rate, and the Constitutional Court ruling obliges the Government to address this issue. Several systems of privileged pensions (accounting for 20 percent of pension

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14 These include: (i) reducing early retirement decrement from 0.34 to 0.15 percent per month; (ii) raising minimum pension for years of service above 30; and (iii) new pension supplement for pensions initiated after 1998.

15 Suspension of pension indexation (nominal freeze of pension) in 2010 is expected to yield savings of some 0.2 percent of GDP (HRK720 million) in comparison to regular pension indexation. A ‘solidarity tax’ on pensions, introduced in July 2009, is expected to yield in net savings around HRK150 million in 2009, and some HRK350 million in 2010 from pensioners’ population. A solidarity tax yields lower net savings because some 76 percent of pensioners are exempted as is the 2007 pension supplement.

16 The Law on Amendments on the Law on Homeland War Veterans’ Rights, enacted in October 2009, abolishes the eligibility for the minimum pension for veterans with more than 100 days in combat. In addition, as a result of these amendments, there will be no new claimants for disability veterans’ pensions.
expenditures or 2.4 percent of GDP) pay above-average pensions at lower-than-statutory retirement age and stimulate lock-in in these occupations. The Prime Minister announced further rationalization of privileged pensions in the near term. A preliminary discussion is being held to address the issue of high administrative costs of funded pension pillars at accumulation and payout stage. In any of these areas the Bank stands ready to provide technical support.

**Prioritizing Public Investment**

65. In an attempt to reduce the overall borrowing requirements, the Government had to rationalize its public investments. The authorities implemented a first round of expenditure cuts, mostly by delaying new capital projects in April 2009, followed by additional cuts for railways and road infrastructure investments — mainly those with a low rate of return, in line with the recommendations of the 2008 Public Finance Review. This has secured around 1.3 percent of GDP in savings in 2009.

66. **Medium-term agenda.** In order to improve prioritization of investments in the future, the Ministry of Finance has drafted a Decree on the Methodology of Investment Projects Appraisal for Government adoption in December 2009. This has been done with the OECD/SIGMA assistance and aims to enhance public investment planning and management by mandating the use of standard appraisal methods which were not commonly used so far. In the past, deviations between planned and actual capital spending would surpass 15 percent and would be detrimental to effective management and execution of investment projects undertaken by budget and extra-budgetary users. By the decree, the MoF would enhance the planning and decision-making process on medium-term investment priorities as well as strengthen the management of costs of approved projects in order to improve value for money. Additionally, with the assistance of the WB PPIAF-funded consultants, the MoF has developed the **Fiscal Risk Assessment Model for PPPs** and undertook capacity building to ensure full understanding of the fiscal risks involved before PPP approvals. This aims to minimize contingent liabilities stemming from Public-Private Partnerships (PPPs), common in the past experience with PPPs. With this legal framework, a comprehensive set of rules and regulations have been developed to foster affordable and value for money projects.

**Improving Sustainability of the Health Insurance System**

67. The Croatian health system has performed relatively well compared to countries in the region in terms of health outputs achieved; however, in proportion to the size of the economy, public spending on health is higher than in other countries at similar income levels. In aggregate terms, Croatia spent around 8 percent of GDP on health in 2008, which is above the 6.9 percent of GDP in the new EU member states, though close to the 8.8 percent spent on average by the original EU15 member states.

68. What has distinguished Croatia markedly from EU countries is that it has had one of the lowest shares of privately funded spending in total health consumption. There are no reliable health accounts and private sector spending estimates, but indicators do point to comparatively low private sector spending (depending on data sources, between 1.5–2 percent of GDP). This figure is low compared to other countries in Europe and was due to the generosity of the public health insurance in terms of the breadth of services covered, the near universal inclusion of the population in the public health insurance system, and the quasi-absence of private contributions through untargeted and targeted exemptions of co-payments.

69. With such generosity, it is hardly surprising that the consumption of health would have been running ahead of the funding available. As a result, arrears in the health sector have been substantial. The stock of arrears in hospitals and the Croatian Institute for Health Insurance (HZZO) has been

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17 This is confirmed by the consumption pattern of Croatian households, which spent on average only 2.8 percent of their total budgets on health in 2008.
increasing almost continuously since 2004 and was around 1.1 percent of GDP at the end of 2008. The monthly financing gap throughout 2008 was at the level of HRK210 million (or 0.7 percent of GDP per year). Originally, it had been projected that HZZO arrears would also be paid down in 2009. However, the recession has decreased revenues from health insurance contributions due to decreased wages and rising unemployment. Additionally, expenditures for pandemic preparedness (anti-viral drugs, vaccines, and other expenses) have increased.

The main focus of the recent government reforms has been to put the Croatian health insurance system on a sustainable path as well as to introduce changes that would lead to long-term structural improvements for the more efficient, transparent and effective delivery of services. A set of fairly comprehensive health sector legislation -- a new law on Compulsory Health Insurance (amended in July 2009), amendments on the Voluntary Health Insurance Law and the new Law on Health Protection became effective in January 2009. On the revenue side, the measures included: (i) increase of health sector revenues making the State's obligations more explicit; (ii) earmarking of a health-related tax; and (iii) mobilizing increased private sector revenues. Previously, the state had the obligation to finance the contributions of the non-contributing, legally exempt groups. However, these contributions were not well defined nor were they routinely budgeted. What often occurred were end-of-year State transfers to cover outstanding arrears of the HZZO or of the health providers’ debt to suppliers. This did not allow for proper budgeting and increased health costs as a result of penalties and escalating interest payments. Therefore, the new Compulsory Health Insurance Act made explicit provisions for contributions of exempt groups. The Compulsory Health Insurance Act also earmarked 32 percent of the excise tax on tobacco to be used for health expenditures. As a result of implementing these two policy areas which define the State's financial obligations towards health services, the health insurance system is projected to receive about 0.7 percent of GDP in state financing in 2009 in comparison to 0.4 percent of GDP that were received in 2008 in largely end-of-the-year state transfer, which has been almost a regular practice over the last decade.

The Compulsory Health Insurance Act also changed the co-payment system for the basic package of health services (with the exception of those services provided to children up to the age of 18 years), while through the Voluntary Health Insurance Act premiums for supplementary health insurance were raised. For most of the services, co-payments were established at 20 percent of the invoiced amount. There were also flat fees established for primary health care visits, prescriptions and diagnostic services. These co-payments have not led to large and financially burdensome out-of-pocket expenses as there is still generous exemption policy. The Supplemental Health Insurance offered by HZZO (as well as a few small private insurers) insures individuals against these co-payments. For those categorical groups whose health insurance is financed by public sources (including most pensioners and the unemployed), the State was made responsible in the Compulsory Health Insurance Act for financing the co-payments. The Supplemental Health Insurance premium was increased, the advantages of having the insurance were heavily marketed and the procedure for taking up the supplemental health insurance at the time of illness was made more difficult. All of these measures led to a large uptake of new policy holders, more than doubling the number of policies provided prior to the reform. Still about 10 percent of the copayment income received by hospitals is still direct, out-of-pocket expenditures for those individuals not holding supplemental health insurance. The last component of the increased private contributions towards health was to earmark 7 percent of the mandatory car liability insurance collected by private insurers given the burden of the road traffic accidents on health expenditures. In all, the health system expects to collect an additional 0.4 percent of GDP in revenue in 2009 from private expenditures through the implementation of these measures.

\[18\] From the Pension Fund for pensioners below the average income (HRK5,108 per month in 2008); from the Unemployment Fund for officially unemployed individuals (5 percent of basic budget unit); and from the State for other categorically exempt (War Veterans, women on maternity leave, etc.) individuals.
72. In addition to the revenue generating measures, savings were made in two significant areas — sick leave benefits and pharmaceuticals. First, State-financed sick leave benefits were reduced and measures were implemented to better control potential abuses. Employers were made responsible for financing the first 42 days of sick leave which increases their incentive to reduce claims. State liability after 18 months of sick leave was reduced and the time period of the benefit was fixed at maximum of 3 years. The process of the sick leave control has been strengthened through introduction of certified physicians controlling the sick leave granting procedure. Consequently, the percent of the working population on sick leave decreased from about 3.9 in 2008 to less than 3.5 percent. Administrative measures were also taken to improve the efficiency of pharmaceutical spending. Updating and reducing of reference prices for pharmaceuticals on the reimbursement list reduced prices on average by 12 percent. This is now planned to be extended to the orthopedic equipment. International tenders for the expensive and centrally procured drugs decreased the prices of those drugs on average by 8 percent. As a whole these measures are expected to save about 0.22 percent of GDP for the state budget in 2009 which is then used for improving the timeliness of payments and access to services and drugs.\(^{19}\)

73. Medium-term agenda. Other initiatives which affect the major health cost drivers of hospitals, medical technology and pharmaceuticals are also under active discussion. The Bank is taking part in it and is providing assistance for hospital masterplan design through the ongoing Bank-financed Development of Emergency Medical Services and Investment Planning project. The revision of contracts with primary health care physicians -- allowing them to undertake certain diagnostic and therapeutic procedures previously referred to more expensive levels of care -- is underway. Their system of remuneration will be revised to include elements of capitation, fee for service as well as performance (taking into account prescription and referrals) as of January 1, 2010.

74. Outcome goals:

- General Government wage bill reduced from 10.8% of GDP in the original budget for 2009 to 10.2% of GDP in the 2010 Budget;
- Planned pension spending at 10% of GDP in the 2010 Budget and the share spent on privileged pensions remaining constant at 20% of overall pension spending in 2010;\(^{20}\)
- General Government investments reduced from 5.2% of GDP in the original budget for 2009 to 4.0% of GDP in the 2010 Budget;
- Total health sector arrears reduced from HRK3.8 billion (1.1% of 2008 GDP) at end-2008 to HRK3.4 billion (1% of 2009 GDP) by end-2009 and further down in 2010.

75. DPL actions: The following actions will support the above outcome goals.

- Public sector employment freeze and wages reduced by 6 percent in 2009 and kept frozen in the draft Law on Budget 2010-2012 submitted to the Parliament for enactment;
- Pension indexation suspended in 2010 and privileged pensions of MPs, Government members and Constitutional Court Judges reduced by 10%;
- Public investment spending program rationalized in 2009 and in the draft Law on Budget for 2010-2012 submitted to the Parliament for enactment;

\(^{19}\) Twenty drugs added to expensive drug list. Two new drugs added to expensive drug list, while the average payment duration was reduced from 274 to about 180 days which reduces penalties and interest payments.

\(^{20}\) When netted out for the solidarity tax effect, the pension to GDP ratio changes to 10.1 and 9.9 percent of GDP for 2009 and 2010, respectively, while the privileged pensions' share would fall from 20 to 19.5 percent.
Co-payments and supplementary health-insurance premiums increased, sick leaves and drugs' costs reduced, and health insurance contributions extended to pension benefits through the implementation of the Compulsory Health Insurance and Voluntary Health Insurance Laws.

76. Strengthening Public Finance Management. The above-described fiscal consolidation efforts are now taking place in a fully-articulated medium-term framework. The Croatian Government has made consistent efforts over the last four years to improve the rules and relevance of multi-year fiscal planning. These efforts were supported by the need to introduce a three-year perspective in the Pre-Accession Economic Programmes (PEP) as well as by the need for a general improvement in quality of macroeconomic forecasting and fiscal planning. While the implementation of medium-term fiscal framework (MTFF) has been well integrated into public expenditure management systems and became embedded into all budget users' practices, additional efforts were needed to make them more mandatory and credible. Deviations between future budgets and planned expenditures in the MTFF had sometimes exceeded 10 percent due to unplanned liabilities created by new legislation. The need to integrate strategic and budgetary planning as well as to introduce proper monitoring and evaluation systems became more evident in the EU pre-accession process.

77. The new Organic Budget Law, effective from January 2009, aims to improve the relevance of the MTFF by making fiscal projections binding and linked to strategic priorities as stipulated in the three-year strategy of government programs (underlined in the 2008 Croatia Public Finance Review as one of the key priorities). The law also mandates enactment of three-year rolling budget by the Parliament and imposes additional restraints to local governments' borrowing and contingent liabilities. The Government issued a circular with the new requirements in May 2009, and has adopted medium-term strategic plan for 2010-2012 for all ministries and subordinated agencies in September 2009.

78. The first 3-year rolling budget for 2010-2012 has been submitted to the Parliament for enactment on November 21, 2009. The Budget shows the government commitment to fiscal consolidation through spending rationalization, thus reducing the overall general government spending from 41.7 percent of GDP in 2009 to 36.7 percent of GDP in 2012, which is in line with the Economic and Fiscal Guidelines for 2010-2012 adopted by the Government in September 2009.

79. Medium-term agenda. While program budgeting has existed for over four years, the introduction of performance indicators remains at the piloting phase. This first medium-term budget also contains performance indicators against which the budget execution and administration performance will be assessed. The MoF, however, is aware that this process will need to be further strengthened and aims to undertake a comprehensive review of current programs to be developed into more measureable performance areas. The EU Phare 2006 assistance has been mobilized to help develop performance-informed budgeting, piloting it first for selected line ministries, to be followed with the adoption of a methodology for key performance indicators.

80. Outcome goal: A 2010-2012 rolling budget consistent with the medium-term fiscal framework as measured by general government expenditures declining from 41.7% of GDP in 2009 to 40.3% of GDP in the 2010 Budget.

81. DPL action: The first 3-year rolling budget for 2010-2012 submitted to the Parliament for enactment, consistent with the Government's medium-term strategic and macroeconomic framework, under the terms of the new Organic Budget Law.

82. Strengthening the public procurement system. Substantial changes in the Croatian procurement system took place in 2008 and 2009. In June 2008, the Government of Croatia adopted a comprehensive strategy on the development of the public procurement system (including e-procurement, concessions and Public Private Partnerships) and an Action Plan outlining a clear timeframe for each of the actions needed for strengthening the effectiveness of the public procurement
system. The implementation of the Action Plan is being monitored under the EU negotiation process as a closing benchmark for the Chapter 5 of the acquis communautaire. A new public procurement law entered into force in January 2008 with further amendments effective from January 2009. Most of the secondary regulations, operational tools in the form of manuals and website information have been finalized and made public during 2009. This law brought Croatian legislation further in line with the acquis in terms of the award of public contract and remedies. All procedures provided for by the new generation of EU directives are regulated in the law. The law also regulates the use of electronic auctions, the procedures for awarding of framework agreements and awarding of contracts based on a dynamic purchasing system, procurement of small values, enhanced procedures for appeals, etc. Electronic communication between contracting authorities and suppliers is equated with the traditional, paper-based one. A submission of tenders (bids) in electronic form requires application of advanced electronic signature which has been introduced as well, but in order to be successfully implemented would need to be complemented by allowing electronic submissions of receipts for tax purposes.

83. Further, a number of training activities have been conducted in 2009 to support capacity-building at the operational level. In 2010, public procurement training will be extended to other bodies outside of the administration, like the State Audit Office, the State Attorney’s Office, and the Agency for Market Competition Protection, to strengthen the government efforts in combating corruption and preventing irregularities. The EU fully supports the Government’s efforts in making the system of public procurement effective. There still remains a need to further strengthen the role of the State Commission for the Supervision of Public Procurement Procedure and extend its jurisdiction to concessions and PPPs, which the Government addressed by the submission on November 26, 2009 of the draft law to the Parliament for enactment.

84. To support the consolidation efforts, the Government adopted a Decision on establishment of a centralized purchasing body for selected categories of goods and services common to all public administration offices. The simulated savings based on comparison of the EU countries that have been using central public procurement suggest between 5 to 22 percent in cost reduction in the purchases of goods and services. This would equate to some HRK0.5 billion (or 0.2 percent of GDP) in savings based on the volume of 2008 central government procurement only. After an initial cost-benefit assessment, the Government adopted a decision on the establishment of a central purchasing body on November 12, 2009 which will be in function from early 2010.

85. Outcome goal: An EU assessment suggesting completion of legislative alignment of public procurement system and further enhancement of administrative capacity.

86. DPL action: The draft State Commission for the Supervision of Public Procurement Procedures Act submitted to the Parliament for enactment to complete the legislative alignment of the public procurement system with the acquis communautaire.

C. POLICY AREA II - STRENGTHENING SOCIAL SECTOR RESILIENCE AND TARGETING

87. Protection of vulnerable groups. Although the social assistance system in Croatia is costly, complex and still plagued by administrative inefficiencies, it provides an effective safety net for the poor and vulnerable during the crisis. Moreover, during 2009 the Government undertook a number of reform steps to address some of the deficiencies of the systems, in particular the consolidation of some categorical benefits, and steps toward the deployment of an integrated MIS. Total non-contributory social assistance spending in Croatia continues to be high by international standards. In 2009, Croatia is projected to spend around 4.1 percent of GDP on over a hundred different non-contributory social benefit programs offered at the national and local levels of government (3.6 and 0.5 percent of GDP, respectively), including disability and survivors’ pensions for war veterans (about 1.8 percent of...
GDP). Compared to other ECA countries, Croatia spends more on (i) war veterans; (ii) social care services; and (iii) additional programs by local governments. Even excluding the spending for war veterans, civilians disabled during the war and their survivors – a burden that many other transition economies do not have -- Croatia’s spending of 2.3 percent of GDP still tops that of other transition economies, except Bosnia and Herzegovina and Hungary. The high share of GDP spent on social assistance reduces the resources available for investment and poses an opportunity cost in terms of foregone economic growth.

88. The high cost of the non-contributory social assistance programs is due to heavy reliance on merit-based and categorical benefits, as opposed to needs-based assistance. The overall spending mix is heavily biased towards categorical programs, with means-tested programs playing a marginal role (they account for 7 percent of total spending in 2009). By main target groups, the largest share of spending accrues to war veterans and their disability and survivors (1.8 percent of GDP in 2009), followed by families with children as a result of pro-natalist policies (0.8 percent of GDP), and by social services and cash transfers for people with disability, single elderly and vulnerable children. Means-tested programs for low-income households (the support allowance program and allowance for care for elderly and disabled) amount to 0.28 percent of GDP. The child allowance program – targeted to a broader group of poor families with children using a self-declared, imperfect income test – accounts for another 0.5 percent of GDP.

89. On the plus side, although costly, the non-contributory social assistance system covers most of the poor and vulnerable population, is generous, and relatively well targeted. As of 2008, the social assistance system was reaching 56 percent of the poorest 20 percent of the population (ranked based on pre-transfer income); including pensions, the coverage of the pre-transfer poorest 20 percent was 99 percent. The cash transfers contributed, on average, to one third of the income of the beneficiaries from the poorest decile, and 26.4 percent of those from the 2nd decile. Croatia has a number of good social assistance programs that operate from satisfactorily (child allowances) to very well (the social allowance program). Results from the household budget survey (HBS) indicate that 49 percent of total cash social assistance (without war veterans’ pensions) reaches the poorest 20 percent of the population, which compares very well with other ECA countries. This result reflects in particular the targeting performance of the child allowance program (46 percent of the spending reaches the poorest quintile) and the social allowance program (72 percent respectively, one of the best regional targeting results). The targeting outcomes as of 2008 are comparable with those reported in 2004, a sign that the ability of the various administrations to identify the poorest remains at relatively high levels and has not deteriorated over time.
90. From the crisis mitigation perspective, the Croatian system of social assistance and labor market programs include a number of programs that act as automatic fiscal stabilizers (their caseloads and spending increase during periods of economic crisis, and vice-versa), such as an unemployment insurance program; an income-tested child allowance; and an income-and-asset tested program for the low-income household (the support allowance program). Since the onset of the crisis, the support allowance and the unemployment programs have responded as expected to the recent economic downturn, with an increase in the number of beneficiaries. The child allowance program is less responsive, possibly due to the fact that it is only income tested and lacks strong systems of income verification and protection against error and fraud (as in the support allowance program). From August 2009, the reduction of the maximum level of unemployment benefits corrected a distortion introduced in 2008. Croatia has operated an unemployment benefit system with relatively low replacement rate and minimal work disincentives until 2008. The generosity of this system increased substantially in 2008 raising concerns about work disincentive effects. However, as part of the Budget 2009 revision, the maximum level for the unemployment benefit was reduced to its pre-2008 level through the introduction of a ceiling of 70 percent of the minimum wage.

91. During 2009, the Government took a number of concrete steps to simplify the coordination of different social protection programs at central and local level aiming to enhance the administrative efficiency of social protection programs: (i) it introduced a unique personal identification number in 2009, which will be used to facilitate data-matching and to reduce the burden of documentary evidence by applicants. This ID is currently used by the tax authority and the pension system. It will be expanded gradually across all social protection programs; and (ii) the Ministry of Health and Social Welfare (MoHSW) had tested a new MIS (supported by the Bank-financed Social Welfare Development Project), which should be ready for operational deployment in the Centers for Social Welfare as soon as the required hardware is purchased and a network is put in place. By the end of 2009, the system will be tested or implemented in at least three counties. It aims to reduce the processing time of applications below the current 30 days.

92. Medium-term agenda. Reducing the overall spending envelope and improving the program mix is one of the priorities of the Croatian Government over the medium term. Work on this policy agenda is ongoing, with a number of positive actions taken during 2009:

- **Reduction in the number of categorical benefits.** Measures to streamline and simplify benefits are important for increasing the efficiency and quality of the social assistance programs. With the 2009 supplemental budgets a number of untargeted categorical programs have been discontinued: the free-of charge textbooks, and subsidies for transportation and dormitories. Measures to protect the children living in the poorest families, such as the support allowance beneficiaries, or of children of war-veterans, are taken by MoHSW and Ministry of War Veterans, Family and Intergenerational Solidarity (MoWVFIG). War veterans’ benefits have been rationalized as well through the October 2009 amendments to the War Veterans’ Rights Act.

- **Improving the spending mix to protect the poorest during crisis.** In addition to the elimination of the categorical programs discussed above, the share of means or income tested programs in total social assistance spending is projected to increase in 2009. The budget for the support allowance program is projected to increase in real terms by 15 percent in 2009 compared to 2008 and the assistance for elderly and disabled by 23 percent. This should ensure that the income of the poorest strata of the population should not fall below the threshold of HRK500 per month.

- **Improving targeting.** The Government is considering a number of other measures that will improve the targeting accuracy of the social assistance programs over the medium term,

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21 The fiscal savings of this measure are equivalent to less than 0.05 percent of GDP in 2009.
although they are unlikely to be adopted in 2009. The Ministry of Health and Social Welfare is preparing a new Social Welfare Law, which provides for the automatic indexation of the eligibility and benefit threshold for the support allowance and other means-tested programs. Using means-testing procedures for war veterans' cash benefits (opskrbnina) will be effective from 2010, and could be extended to family benefits and those in the health insurance with the application of the newly introduced (supported by the Bank-financed Revenue Administration Modernization Project) Personal Identification Number.

- **Improving effectiveness of pro-natalist policies.** The Government will undertake a review of its pro-natalist policies with World Bank and UNDP support. For this purpose, a working group has been formed to work closely on this matter. A number of potential measures, proved effective in other countries with the similar level of development, can be considered. As the risk of poverty is positively correlated with the number of children, the targeting of the child allowance program can further be improved if the allowance for families with one child will be lowered to generate fiscal savings or to reallocate the savings to increase the allowance for families with more children. Such measure will not only support the equity objective pursued by the Government, but will strengthen the pro-natality focus of the allowance, given that such monetary incentives tend to be effective in protecting the living standard of low-income households.\(^{22}\)

- **Addressing institutional fragmentation at central and local levels.** Currently, Croatia operates a complex system for policy development, implementation, monitoring and evaluation, which acts as a bottleneck to a cost-effective social protection and social assistance system. At central level, three separate ministries develop and implement the social protection policy. Each ministry has its own territorial administration; both central and local-level coordination is rather poor. The number of programs on offer, the number of institutions involved, and the lack of harmonization on eligibility criteria lead to a costly system to administer, allows for double dipping and causes unequal treatment of claimants. Adverse effects include the resulting confusion, and errors of exclusion and inclusion which negatively impacts value for money. Over the medium term, the Government may consider consolidating administration to the extent possible by merging relevant functions under fewer ministries, and/or single offices at the local levels with a view to easing access to social assistance programs and to coherent planning.

93. **Outcome goal:** Adequate budget for unemployment benefits and means-tested social support allowance maintained at about 0.5\% of GDP in the 2010 budget.

94. **Proposed DPL action:** Adequate funding ensured in the draft Law on Budget for 2010-2012 submitted to the Parliament for enactment to cover the anticipated rise in new claimants for unemployment benefit and social support allowance.

**D. POLICY AREA III - ENHANCING EFFICIENCY AND STABILITY OF FINANCIAL SECTOR**

95. **The financial sector proved resilient in the face of the global financial crisis.** This in part thanks to large participation of strong foreign banks, active supervision and countercyclical policy measures undertaken by the CNB, as well as timely response of authorities at the time of the crisis’ outbreak (including raising insured deposits’ threshold). Tight prudential regulation has also helped to preserve the stability of the banking sector. The Croatian banking industry continues to be dominated by foreign ownership and fairly concentrated; the four largest banks claimed a market share of some two-
thirds of total assets as of June 2009. Almost all cross-border loans to Croatia originate from banks headquartered in the European Union.

96. *Although stress-tests by the CNB show that the banking sector is resilient to plausible macroeconomic shocks, a less favorable international environment and increased vulnerability of the Croatian economy underscore the need for placing stronger buffers in the system to eliminate or reduce the negative feedback from the declining real economy. While global financial tensions and the macroeconomic outlook have heightened some existing vulnerabilities, these should remain manageable. Currency mismatch remains the key vulnerability of the financial system, not new to the CNB which has been proactive in addressing it through, among else, higher capital adequacy, tighter supervision and stable exchange rate policy.*

97. *Strengthening the resilience of the financial sector is critical to alleviate these concerns.* A strong financial sector, properly regulated and supervised is critical for macroeconomic stability as well as ensuring sufficiently competitive markets that will improve access to financing. The authorities have already implemented a number of measures to improve the performance of the financial sector and this operation will support measures to enhance crisis preparedness and enhance risk management rules in banking and non-banking sectors.

Table 7: Croatia: Key Recommendations of the FSAP Update Mission

<table>
<thead>
<tr>
<th>MEASURES</th>
<th>AGENCY</th>
<th>TIMING AND PRIORITY</th>
<th>STATUS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial sector stability</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Design an exit strategy for the existing monetary measures that are not consistent with the forthcoming EU accession</td>
<td>CNB</td>
<td>ST (high)</td>
<td>Under review</td>
</tr>
<tr>
<td>• Continue to monitor closely and frequently banks’ risk management practices and lending standards and take appropriate measures to address emerging risks</td>
<td>CNB</td>
<td>ST (high)</td>
<td>Done</td>
</tr>
<tr>
<td>• Strengthen stress testing analyses and regularly use in monitoring risks and assessing financial stability</td>
<td>CNB</td>
<td>ST (high/med)</td>
<td>Done</td>
</tr>
<tr>
<td>• Reduce fiscal incentives that stimulate particular types of bank loans</td>
<td>MoF</td>
<td>MT (high)</td>
<td>Under review</td>
</tr>
<tr>
<td>• Continue efforts to raise risk awareness of banks, borrowers, and stock market investors</td>
<td>CNB/HANFA</td>
<td>MT (high)</td>
<td>Done</td>
</tr>
<tr>
<td>• Expand the coverage of the credit registry to include non-banking institutions</td>
<td>HANFA/HROK/CNB</td>
<td>MT (high/med)</td>
<td>Done</td>
</tr>
<tr>
<td><strong>Contingency planning</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Establish formal communications with monetary and supervisory authorities of the parent banks on issues of crisis management</td>
<td>CNB</td>
<td>ST (high)</td>
<td>Done</td>
</tr>
<tr>
<td>• Adopt the law on deposit insurance consistent with the EU framework and design of an effective bank resolution mechanism, with clarity as to the legal framework and roles and responsibilities of all the parties involved in bank resolution and restructuring process</td>
<td>MoF/CNB/DAB</td>
<td>MT (high/med)</td>
<td>Done</td>
</tr>
<tr>
<td><strong>Liquidity and risk management</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Broaden the range of eligible collateral for interbank securitized lending to help reduce segmentation in the interbank money market</td>
<td>CNB</td>
<td>MT (high)</td>
<td>Done</td>
</tr>
<tr>
<td>• Develop hedging markets/instruments to facilitate management of interest and FX risks</td>
<td>CNB</td>
<td>MT (high)</td>
<td>Under review</td>
</tr>
<tr>
<td><strong>Nonbank financial sector and cross sector risks</strong></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>
- Build comprehensive data and monitoring processes (investor composition, trading trends and composition, automated early warning system for suspicious trades, including through OMX), and map ownership structures of conglomerates, and clarify the roles for their supervision

- Improve regulatory capacity to monitor and enforce financial accounting standards and market disclosure

- Increase pension funds’ permissible investments in foreign securities

- Pursue plans to increase the level of contribution and further privatize the pension fund system

- Enhance supervisory capacity to migrate to Solvency II risk based standards for insurance companies

HANFA ST (high/med) Done

HANFA/ CNB/ZSE ST (med) Done

MoF/HANFA MT (med) Done

MoF MT (med) Under review

HANFA MT (med) Done

Note: ST – Short-term; MT – Medium-term

98. Heightened crisis readiness. The Central Bank, HANFA, and the MoF have strengthened the interagency coordination on crisis preparedness and management. While many elements of Croatia’s contingency framework to deal with banks in distress are consistent with international best practices, there was no formalized mechanism for interagency coordination on crisis preparedness and management. A memorandum of understanding (MoU) between various agencies dealing with financial stability issues and responsible for resolution of systemic financial crises (Ministry of Finance, CNB, and HANFA) was signed on November 20, 2009, and is the first step towards efficient coordination, and adequate crisis preparedness and contingency planning. The MoU facilitates the creation of a framework for information exchange, consultations on financial stability and crisis management, including agreements on crisis communication strategy, the lead crisis manager and definition and monitoring of systemic risk, among others. In continuing its efforts to harmonize legislation with IOSCO, HANFA has also entered into a Multilateral Memorandum of Understanding (MMoF) on October 20, 2009. This would enable cross-border cooperation in supervision for HANFA.

99. Outcome goal: Interagency coordination on financial crisis preparedness and management tested on several cases.

100. DPL action: A system for interagency coordination on financial crisis preparedness and management introduced through signing of a MoU among the MoF, CNB and HANFA.

101. Formulating a comprehensive regulatory framework for financial institutions. The supervisors of the financial sector (CNB and HANFA) have undertaken a number of policy reform measures to modernize and update the legal and regulatory framework under which the sector operates. There is consistent adherence to Basel Core Principles and the application of Basel II principles (Capital Requirements Directive - CRD) is underway, with the new Act on Credit Institutions, replacing the old Banking Act, effective in January 2009. The aim of the Act is to enable credit institutions in Croatia to operate according to Basel II standards. Although Basel II require 8 percent as the minimum capital adequacy ratio, this ratio in Croatia is already set at 10 percent and shall be 12 percent from 2010 onwards. Related to the new capital requirements, the Act incorporates new risk management rules for credit institutions, including all three Basel II pillars. Furthermore, credit institutions are required to establish and implement an effective internal control system in all areas of operation: a risk control function, a compliance function and an internal audit function. The Act also introduces the system of a “single passport” which will enable credit institutions from Croatia to operate in the territory of other EU Member States, once Croatia becomes a member, and vice versa. Credit institutions will adjust their operations to the Basel II capital requirements of this act by March 2010 and the preparation for the full implementation is ongoing. However, as the EU Directive
on Capital Requirements underwent changes at the EU level, there is an ongoing consultation with the financial industry on the needed amendments to the Credit Institutions Act to address those.

102. The Central Bank is continuously monitoring bank risk management policies and lending standards, in order to be able to promptly address any emerging risks. The Credit Institutions Act specified the competences of the Central Bank in the area of licensing and supervision of credit institutions and included provisions aimed at prevention and/or resolution of crisis situations in credit institutions as well as cooperation between home and host supervisors. Over the medium term, in order to ensure comprehensive and universal regulation of credit giving institutions, regulations and by-laws concerning their supervision and oversight are to become effective in 2010. Under the Act on Consumer Credit, the MoF will regulate all institutions (namely departmental stores, etc) that are non-deposit taking and issue credit (with the upper limit of HRK1 million). As a result of this the gambit of institutions/commercial bodies will be covered.

103. The authorities have also strengthened supervision of the insurance sector through the adoption and amendments of the Insurance Act adopted in June 2009 to incorporate changes in the EU legislation regarding the regulation of insurance and reinsurance undertakings as well as insurance mediation. The risk management issues have been enhanced by the introduction of the solvency margin requirements (Solvency I). The act also regulates the reorganization and winding-up, accounts and rules and criteria for prudential supervision of insurance undertakings. HANFA has also started preparing for implementing the Solvency II standards by undertaking stress-testing and risk-based supervision.

104. Improved supervision of securities market and investment services. The development of the securities market required new legislation aligned with the EU framework. This was encompassed in the adoption of Capital Market Act effective from January 2009. The act introduced Basel II standard for investment firms and regulatory and supervisory framework for the investment services providers, transparency and disclosure requirements for securities issuers, insider trading and market manipulation rules, prospectus publishing as well as investor-compensation scheme. The Markets in Financial Instruments (MiFID) Directive, i.e., legal provisions used for implementing this Directive, present the basis of the Capital Market Act and related by-laws. These provisions refer to regulating market activities, investment firms’ activities, investment protection, authorities and international cooperation of the Agency. Provisions regulating the investment firms’ capital adequacy were specially elaborated in great detail. The Act also introduced European standard concerning market abuse (Market Abuse Directive) as well as new investor protection system and establishment of the Investors Protection Fund, where the members of the Fund pay cash funds for insuring clients’ claims of Fund members. Members of the Fund are investment firms authorized to keep clients’ funds and/or financial instruments, credit institutions providing investment services and/or performing investment activities, as well as open-end investment fund management companies in case they provide certain investment services. Insured amount for clients’ claims is limited to HRK150,000.

105. Finally, the authorities have also strengthened supervision of the financial conglomerates through the adoption of a Financial Conglomerates Act, effective from January 2009, which aims to improve supervision of financial conglomerates, in particular in the areas of risk concentration at the level of conglomerate, liquidity risk, inter-company transactions, and management of internal risks within the conglomerate, and reliability and capability of the management. The law defines additional supervision to be carried out through an integrated manner by HANFA and CNB. The by-law on the Methodology for Calculation of Adequacy of Guaranteed Capital at the level of Financial Conglomerate has been adopted by the MoF in June 2009. The first supervision of one financial conglomerate is currently underway. The CNB and HANFA introduced a regular annual planning of joint inspections and supervisions.
106. **Medium-term agenda.** Following the discussion of the Bank’s Report on Consumer Protection and Financial Literacy in October 2009, the MoF expressed the interest in a joint dissemination of findings as well as embarking on a public-wide financial literacy program. Furthermore, the MoF requested the Bank’s assistance in reviewing European practice in institutional framework for consumer protection in the financial sector. In order to analyze the level of depth and institutional/market compliance that affected players (investment/brokerage firms, exchanges, regulators) have undertaken in meeting the spirit of the approved MiFID framework, the authorities have approached the Bank for assistance. The Bank will in 2010 through the regional Financial Sector Second Generation Issues TA provide the non-bank supervisor HANFA with additional information as to where securities market players may require reinforcing practices and procedures to reduce risks and maximize resulting benefits while operating under the MiFID framework. HANFA also plans to develop the risk-based supervision model during the 2010.

107. **Outcome goals:**

- Capital adequacy ratio increased from 15.2% at end-2008 to above 16% by end-2009;
- Audit reports of investment firms containing detailed risk exposures.

108. **DPL actions:** To achieve these outcome goals the following actions have been undertaken:

- New risk management rules for credit institutions that comply with the three Basel II pillars incorporated through the implementation of the Credit Institutions Act; and
- Supervision of securities market and investment services upgraded to meet Basel II standards through the implementation of the Capital Market Act.

### VI. OPERATION IMPLEMENTATION

#### A. POVERTY AND SOCIAL IMPACTS

109. **The 2009 economic crisis has reversed the poverty trends.** With economic growth projected to contract by 5.5 percent in 2009 from 2.4 percent growth rate in 2008, the fraction of the poor is expected to increase. An Omnibus survey implemented in the middle of 2009\(^\text{23}\) collected some information on the share of population affected by the crisis and its main transmission channels in reducing household welfare. By that time, 50 percent of surveyed population reported that the crisis affected them, with 32 percent strongly or very strongly affected. The key transmission channels of the crisis include the reduction in real wages, wage arrears, job losses or, in the case of self-employed and business owners, through reduced demand for their products and services. Most of the respondents began feeling the impact of the crisis in the 1\(^{\text{st}}\) semester of 2009 (80 percent as opposed to 20 percent reporting being affected by the crisis since the 2\(^{\text{nd}}\) semester of 2008).

110. **Lacking comparable data to track trends in poverty, the analysis focused on short-term changes in relative poverty between 2008 and 2009.** This was done by simulating the impact of the crisis on those who were living below the income cutoff for the poorest decile and quintile in 2008, based on data from the most recent household budget survey (HBS 2008). For the simulation, a set of lead indicators about the dynamics of real incomes was used to allow modeling the loss in earnings associated with the loss in employment (into unemployment, early retirement or inactivity).

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111. The model also incorporates a number of policy changes aimed at maintaining macro stability which have a significant distributional impact, such as the introduction of the solidarity tax; the rise in supplemental health insurance premium; and the elimination of certain subsidies (for textbooks). The results of the simulation suggest a significant increase in poverty in 2009, of about 3.5 percent in the case of the lower poverty line. The simulation shows that the share of households living on less than HRK2,063 per adult equivalent per month went up from 10 percent in 2008 to 13.5 percent in 2009. Correspondingly, the ranks of those living on less than HRK2,581/adult equivalent/months increased from 20 in 2008 to 25.1 percent in 2009. Consistent with the administrative data on unemployment, we found that in each affected sector, those losing their jobs tend to have lower education or experience. They move from low wages to lower unemployment benefits, increasing the number of the poor. The large increase in poverty in 2009 underscores the need to mitigate the social cost of the crisis among the poorest and most vulnerable by protecting pro-poor spending.

112. While some of the measures considered under the DPL have significant distributional impact, their impact on the poor has been partially mitigated by a policy of waivers or exemptions for lower income households. In particular, the health copayments are waived for adults earning less than HRK 1,516 a month (or 1,900 HRK a month per single-elderly) or belonging to vulnerable categories (unemployed; elderly; students; people with disabilities). The provision of free-of-charge textbooks was discontinued, with the exception of the beneficiaries of social welfare program or for the survivors of war veterans. The solidarity tax includes exemptions for low-income households. Due to design features, the poor bear only a very small proportion of the total policy impact in 2009: 0.8 percent of the solidarity tax; 2.4 percent of the health copayments; and 1.4 percent of the cost of the elimination of the free-of-charge textbooks – substantially less than their share in total population (13.5 percent). Almost all of the 3.5 percentage points rise in poverty headcount was due to living standard deterioration due to job losses, real wage reduction and portfolio effects that depressed household consumption. The impact of the new policies remains largely with the upper quintiles.

113. Similarly, the suspension of the pension indexation in 2010 would affect only marginally the poverty rate among the pensioners. Under the assumption of an increase in the cost of living of 2.5 percent, the poverty headcount among pensioners will go up from an estimated 14.6 percent in 2009 to 14.8 percent in 2010 (assuming that all other policies remain unchanged). This small increase in pensioner poverty should be contrasted with their protected incomes during 2009, where pensions
were indexed despite the economic crisis; as a result, the increase in pensioner poverty in 2009 was the lowest among different socio-economic groups – only 1.8 percentage points. Although in 2009 poverty rates would increase for all types of households, those headed by a retired or other inactive person appears less affected by the crisis than those headed by an active person, either employed (2.3 percentage points) or unemployed (6.5 percentage points rise in poverty). Inactive persons are not directly affected by unfavorable developments at the labor market, and in certain cases their incomes (pension, social assistance benefit) were increased as part of social protections schemes operated in 2009.

Figure 8: Profile of the poor, by employment status

![Chart showing the distribution of the poor by employment status.]

**Figure 9:** Profile of the poor, by education

![Chart showing the simulated increase in the number of poor individuals in 2009 by education level.]

Source: CROSTAT, WB staff calculation

114. The social assistance reforms proposed under this operation are expected to mitigate the impact on the most vulnerable. Some of these mitigation measures notwithstanding, the Government should expect an increase in the number of unemployed or claimants for social welfare benefits and services, as the crisis continued. The proposed reforms are expected to protect the funding and facilitate the access to means-tested programs and unemployment benefits.

115. The impact of the crisis will be kept under review as it evolves, although the information base is scarce in Croatia and there are significant concerns about the quality and representativity of the data. The number of regular surveys undertaken in Croatia is rather small: CROSTAT operates only two regular surveys (HBS, LFS) for monitoring the living conditions and the labor market outcomes of households. In time, the representativeness of these surveys was found to be deteriorating. Stronger efforts should be made to collect information from a truly representative sample of households, especially after the new census in 2011. In the meantime, an ex-post assessment of the impact of the crisis on poverty can be done when HBS 2009 data would be available, in the later part of 2010. The CROSTAT expressed an interest in learning how to use the ADePT software to faster and more credibly process the survey data. The Bank aims to organize a regional training in late 2009 or early 2010.

**B. ENVIRONMENTAL ASPECTS**

116. The proposed support to budget and policy reforms has been screened against OP 8.60. The proposed operation is likely to have positive effects on the environment, forests and natural resources. As the effect of policy reforms on the environment is often felt only indirectly, it limits a comprehensive forecast of the environmental effects. However, the operation will have positive impacts on the environment, as the support to some of the reforms might have an impact on the implementation of environmental legislation in Croatia. Yet, current fiscal consolidation efforts might
temporarily reduce capital spending for infrastructure investments and thus slow down the pace of implementation of the Environmental acquis.

117. Under Pillar 1, the Government plans to adopt the Manual for Fiscal Risk Assessment in Public-Private Partnership projects that would minimize contingent liabilities stemming from PPPs. Through PPPs, added value would be created by pooling the resources, efforts and know-how of the private and public sectors. The added value implies increased efficiency, higher standard of services and/or less negative environmental impact. This can be achieved by means of: more efficient projects with creative and innovative approaches to solving problems; avoiding public budget overshot; optimization of the project throughout its life-cycle (integration of design, construction, financing and maintenance of the infrastructure). The Manual will provide guidance for assessment of the additional socio-economic, environmental and other non financial effects from the project. Associated risk to the environment are related to (a) site conditions where unexpected pollution may be found on site or developed during project development causing delay and/or additional costs and (b) other environmental events that may affect the project in several ways. The manual will assess chance of occurrence of such risks, nominal value of impact, usual allocation and will suggest valuation technique.

118. By improving supervision of securities market and investment services through the adoption of the Capital Market Act which introduces Basel II standards, banks might strengthen implementation of the environmental policies. The commercial banks that belong to major banking groups, like Intesa Sanpaolo and Societe Generale, are applying Equator principles - a financial industry benchmark for determining, assessing and managing social and environmental risk in project financing, while other have their own corporate environmental policies.

119. Overall legislative framework on environment: Croatia keeps making considerable and sustained efforts to align its legislation with the acquis communautaire and to effectively implement and enforce it in the field of environment over the medium term. Significant progress has been made. The most significant step has been the adoption of the new Law on Environment in 2007 in line with the EU environmental acquis. The new law introduces strategic environmental assessment (SEA), strengthens public access to environmental information, and environmental liability, and includes provisions of the SEVESO II and IPPC directive. The basic EIA competence remains high and is further strengthened by the adoption of the new Law on the Environmental Protection, and secondary Environmental Impact Assessment (EIA) legislation, which achieved full alignment with EIA Directive (85/337/EEC). A regulation on EIA introduces the procedure for evaluation of the need for environmental impact assessment (screening), and decentralization of EIA process by transferring certain type of the projects under the responsibility of county administrative bodies. In general, harmonization with the EU environmental acquis is assessed positively by the EC, which implies that the current legislation could serve as a good safeguard mechanism. The capacity is being built effectively. Croatia opened negotiation on Chapter 27 - Environment by preparing a plan for establishment of required administrative capacities at the national, regional and local levels and required financial resources for the implementation of the environmental acquis. Based on the Plan, the Government adopted the Amendments to the Regulation on the internal organization of the Ministry of Environmental Protection, Physical Planning and Construction (OG 12/09) and is strengthening the capacity to implement the Environmental acquis.

C. IMPLEMENTATION, MONITORING AND EVALUATION

120. Coordination of Reform Program Implementation: Successful implementation of the proposed reform program will require effective coordination among various ministries and agencies, and between the Government and Bank. The Government assigned the State Secretary of the Ministry of Finance to coordinate the DPL agenda within the Government. The Government, led by the Prime Minister, will oversee the whole reform effort and ensure prompt action on agreed reforms.
Bank's Monitoring Arrangements: The reform program sets out qualitative and quantitative benchmarks and program targets. The Bank team monitors and follows up on progress, and meets with Croatian authorities periodically to discuss next steps.

D. Fiduciary Aspects

Public Financial Management System: A Country Financial Accountability Assessment (CFAA) issued in 2005, concludes that the level of fiduciary risk to Croatia’s public financial management systems is significant for the legal framework and for the institutional capacity and practices for the core financial control processes such as budgeting, treasury and cash management, accounting, financial reporting, internal control, internal audit, external audit and Parliamentary oversight. However, since 2005, Croatia has taken actions to improve the public financial management system which have been supported under the World Bank PAL program. Pillar 2 of the PAL project was focused on improving the effectiveness of public administration, strengthening public expenditure management, particularly in managing budget execution and in internal audit and financial control. For example, the authorities have, with the help of European Commission, established internal audit units in all line ministries, central state organizations, extra-budgetary funds and selected local governments. The Law on Financial Management and Control Systems in the Public Sector has been enacted and controllers have been appointed for all line ministries. The consolidation of line ministries and EBFs accounts under the Single Treasury Account has improved cash and debt management as well as budget planning system.

Croatia has also made some progress in government budget transparency as measured by the 2008 Open Budget Index Assessment. Croatia’s score on the Open Budget Index for 2008 shows that the government provides the public with some information on the central government’s budget and financial activities during the course of the budget year. It is, however, still difficult to track spending, revenue collection and borrowing during the year. Croatia publishes detailed semi-annual reports allowing comparisons between what was budgeted and what was actually collected and spent.

Croatia makes its audit report public; however, it provides limited information on whether the audit report’s recommendations are successfully implemented. There has been some progress with external audit in Croatia, which generally meets the requirements of INTOSAI auditing standards. A long-term development strategy has been adopted and the SAO (State Audit Office) has formally adopted the INTOSAI and developed tools such as audit manuals.

On the accounting and reporting, there is a broad compliance with the IPSAS standards for the public sector, but in practice budgeting and the approved state budget as well as reporting and monitoring of the budget are done on a cash basis. However, accounting of ministries and other budget users is carried out on a modified accrual basis whereby revenues are recorded when cash has been received and expenditures are recognized when an invoice has been received. Implementation of the program for rationalization and integration of different financial management information systems used by the MoF, line ministries and other budgetary entities began in 2008. It will enable timely exchange of accrual financial information between the Treasury and other budgetary users. A major IT company is developing integrated system and user interface with the delivery planned for October 2010.

The budget execution process has been steadily strengthened. The treasury single account now includes all line ministries and the major extra budgetary funds such as health, pensions and employment. Reports on TSA balances, inflows and outflows are available on a daily basis to the MoF and budget users enabling close monitoring of the budget implementation.

The fiduciary risk associated with public financial management system is thus improved to moderate. The public finance management framework provides solid basis for the Bank’s increased use of country systems, supported by stable development in portfolio financial management and
The Country Procurement Assessment Report (CPAR) was finalized in March 2005, and rated, at that time, the level of risk in public procurement as average. Since then, consistent with the CPAR recommendations, the institutional capacity of the Public Procurement Office (now Directorate for Public Procurement System) and the State Commission has been strengthened with assistance from the EC, and these entities have taken the lead in procurement reform in Croatia. The key recommendation of the CPAR for the procurement reform was drafting of an entirely new public procurement law, which was developed with the EC assistance and is consistent with the EU requirements. A Public Procurement Law aligned with the EU Directives became effective in January 2008, with subsequent amendments in October 2008, leading to increased transparency and improvements in the fiduciary environment. Standard tender forms, manuals for tenderers and contracting authorities have been developed and posted on the public procurement portal, together with other strategic documents concerning public procurement. The portal is updated regularly and selected key documents are available in English language. In addition, in July 2009, two bilingual manuals on review procedures in Croatian and English languages have been developed: one for tenderers, and the other one for contracting authorities and private sector representatives. Enhanced preparation of the secondary legislation, training of civil servants, and strengthening of capacity is being driven by EU negotiations on Chapter 5 and successful implementation of the set benchmarks. In April 2009, the Government adopted a Regulation on the format, method, conditions of training and certification in the public procurement system. This regulation defines the program, categories, and conditions for attendance, organization etc. of civil servants trainings on national and local government levels in public procurement. All major recommendations from the CPAR have been followed up or accomplished.

129. Safeguards Assessment of the Central Bank: The Report on the Observance of Standards and Codes of Fiscal Transparency, which was completed by the IMF in November 2004, concluded that the Croatian National Bank (CNB) has operational independence and that its financial relationship with the Government is transparent. CNB is audited by independent auditors every year and the 2008 audit report has unqualified opinion. The IMF finalized a safeguards assessment of CNB in 2006, and concluded that the safeguards are adequate and that the CNB continues to maintain an effective system of internal controls and almost all areas of the safeguards meet the policy’s requirements, though the internal audit mechanisms could be strengthened further. Based on the IMF’s assessment, CNB can be relied upon to account for the World Bank’s proceeds from development policy operations.

E. DISBURSEMENT AND AUDITING

130. Borrower and Loan Amount: The Borrower is the Republic of Croatia. This operation is a single-tranche loan. The loan proceeds would be made available to the Borrower upon the effectiveness of the Loan Agreement between the Republic of Croatia and the Bank. As a condition of effectiveness, the Bank will be satisfied with the progress achieved by the Borrower in carrying out the Program and that the Borrower’s macroeconomic policy framework is appropriate.

131. Disbursement: Upon approval of the loan and notification by the Bank of the effectiveness of the Loan Agreement between the Bank and Croatia, the Borrower will submit a withdrawal application to the International Bank for Reconstruction and Development (IBRD) before the closing date as provided in the loan agreement. The IBRD will deposit the proceeds of the loan into a foreign currency deposit account designated by the Borrower to be held at the CNB. This account forms part of the official foreign currency reserves of the country and it will be managed by and subject to control of the Ministry of Finance (MoF). The Borrower shall ensure that upon the deposit of the Loan into
said account, an equivalent amount is credited in local currency to the Single Treasury Account also kept in CNB and that is available to finance budgeted expenditures.

132. **Accounting and Auditing Arrangements:** The administration and accounting of the loan will be the responsibility of the MoF. The MoF will be responsible also for preparing the withdrawal application, and maintaining the withdrawal application as required. The MoF, with the assistance of CNB, will maintain records of all transactions under the loan in accordance with sound accounting practices. Given the positive IMF’s assessment of CNB, an audit of the deposit account for the proceeds of the loan is not considered necessary. The MoF will provide the Bank within 30 days a confirmation letter stating that the DPL funds have been received and deposited into the designated account assigned by the borrower that forms part of the Borrower’s budget management system.

F. **RISKS AND RISK MITIGATION**

133. **There are a number of risks related to the operation. These are as follows:**

134. **Prolonged recovery.** A key risk affecting the proposed operation is that the economic downturn in the EU and specifically in Croatia will be more severe and prolonged than currently projected. This would strain further the fiscal performance, the corporate sector and consequently the banks, and could raise social tensions. Given Croatia’s heavy reliance on tourism revenues and exports to Europe, it is vulnerable to any deterioration in regional stability or slowdown of growth in the EU.

135. **External vulnerability.** Given the high level of external debt, high degree of euroization of the Croatian economy and large debt service requirements over the medium term, the Croatian financial sector remains vulnerable to exchange rate risks and slowdown of capital inflows.

136. **Mitigation measures.** The DPL-supported fiscal consolidation efforts and public expenditure management reforms are expected to mitigate the risks related to regular debt servicing for the public sector even in the case of a prolonged recovery. The DPL-supported measures related to enhancement of financial sector regulation coupled with the Croatian National Bank’s efforts to monitor foreign exchange exposures of bank clients and strengthening supervision both of banks and, jointly with HANFA, of non-banking financial institutions are expected to alleviate the risks for private sector refinancing and lead to stronger system resilience to larger shocks.

137. **Political risks.** Political risks remain moderately high as the country has a coalition Government with a slim majority in Parliament, while several of the proposed reforms are ambitious and politically challenging. With presidential elections scheduled for late 2009, the country is entering a pre-election period which might raise the risk, although negligible, of fiscally sustainable fiscal policies.

138. **Mitigation measures.** Reforms to be supported under the DPL are to a large extent well under implementation, also as part of the EU accession negotiation process, which is expected to mitigate the risk of reversal or delays. Given the recent unblocking of EU accession negotiations and a clear timetable for their conclusion by mid-2010, there is an enhanced momentum for reform.
Mr. Robert Zoellick  
President  
International Bank for Reconstruction and Development  
Washington D.C.

Ref: Letter of Development Policy  
Croatia: Fiscal, Social and Financial Sector Development Policy Loan

Dear Mr. Zoellick,

We appreciate this opportunity to request continuing support from the World Bank for the implementation of our medium term reform agenda, and on the behalf of the Government of the Republic of Croatia we kindly request the endorsement of a Fiscal, Social and Financial Sector Development Policy Loan in the amount of EUR200 million (equivalent of USD296.75 million) as jointly developed with Your staff, and incorporated in the Government Strategy for 2010-2012.

Over the last four years Croatia enjoyed strong economic growth (4.2 percent on average), primarily driven by domestic demand boom, tourism and large capital inflows. This resulted in rapid convergence with the EU in per capita income terms. Unemployment rates dropped to historically low levels while employment increased close to 58 percent by end-2008. However, influenced by the regional downturn, economic activity declined abruptly in the first half of 2009 -- by 6.5 percent. We are currently projecting a real decline of around five percent with some recovery in 2010. The monetary policy framework has proven to be robust enough to endure the first wave of financial crisis. Since October 2008, emerging liquidity shortages have been addressed by active use of monetary and prudential measures. A release of both domestic and foreign currency liquidity, accumulated over the last three years, secured adequate liquidity buffer for banks. Fortunately, confidence in the financial sector has been protected by the appropriate and timely response of authorities.

However, as fiscal policy came under increasing pressure in late 2008 and early 2009, when revenues started to underperform due to declining economic activity, Government had to introduce some politically and socially painful measures. These efforts aimed to bring public finances back to sustainability and were chartered in three revisions of the 2009 Budget. While we had secured timely and adequate financing for 2009 while maintaining macro stability, we have proposed more sustainable and prudent fiscal policy over the medium term. Given the constrained maneuvering space of the monetary policy, which together with the Government played an important role in defending the Croatian financial system from the first impact of the crisis, the emphasis has been now put on fiscal policy, which in the environment of highly euroized economy becomes crucial for maintaining macro stability.
The fiscal strategy in the medium-term period, as drafted in the draft Budget 2010-2012 adopted by the Government on November 21, 2009, aims to preserve macroeconomic stability through replacing some of the temporary short-term fiscal measures with the longer-term ones aimed to enhance efficiency of public spending and create conditions for a stable economic growth. After growing to the estimated level of 3.2 percent of GDP in 2009, the consolidated general government deficit proposed for 2010 is set at 2.7 percent of GDP with further reduction plan towards 1.8 percent of GDP by 2012. In the same period we are planning to reduce the overall spending level by over 4 percentage points of GDP down to 37 percent of GDP. Reforms supporting this framework, like further reduction of privileged pension, rationalization of public administration and local government units, agriculture reform, or further subsidies’ reduction, will require strong political commitment and a broad social consensus we are trying to build. Painful measures we have recently launched that relate to rationalization of social spending either through the suspension of pension indexation, introduction of the solidarity tax, increased health copayments, reduced unemployment benefits and abolishment of universal policy of free-of-charge textbooks, have already confirmed this commitment.

The strategic goal of this Government is to sustain macroeconomic stability and join the European Union as a stable market economy. This would require setting up a credible framework to mitigate the impact of the global crisis in the short-term, but also to undertake credible medium-term structural reforms for fulfillment of EU accession criteria and improved convergence prospects.

This letter summarizes critical aspects of our program to strengthen public finances, social sector resilience, and enhance efficiency and stability of financial sector. We believe that this development loan provides the appropriate tool for the Bank’s support in addressing our short-term challenges within the context of a medium term policy and institutional reform agenda as described below, whereby we count on the World Bank as a partner.

**Strengthening Public Finances**

We had focused during the global turmoil on protecting the macroeconomic stability through politically and socially challenging measures to contain a widening fiscal deficit, including through a wage freeze, public investment rationalization, abolishment of free-of-charge textbooks’ program, or pension indexation suspension, but also through the VAT increase and a solidarity tax introduction. However, in parallel, we have launched important reforms like in health or privileged pensions whereby the aim is to address efficiency and equity concerns.

**Early in the year we reduced state official wages by 15 percent and renegotiated the collective agreements with the civil and public service unions on the rolling back of the 6-percent rise granted to them in January 2009.** In parallel, any new public employment or establishment of new agencies has been frozen, while the existing ones will be reviewed and proposed for consolidation. Further reforming and modernizing public administration is crucial. The newly set-up Ministry of Administration plans to follow-up on the recommendations from the functional reviews undertaken in 2008. Additionally, a decision on setting up the central payroll and HR registry has been adopted in March 2009 and the Ministry of Finance launched piloting of the new system to help control the size of public administration and the wage bill. Still, the current reward system remains fragmented and too compressed to provide performance incentives to staff. It also posed issues on equity, and impeded the development of an integrated public administration system. The new Ministry of Administration plans to draft an integrated Law on Public Administration Salaries that includes provisions for decompression and performance-based remuneration and has requested assistance from the Bank.

**The measures in the pension area that we have undertaken are providing a short run fiscal relief, but are also improving the long run system sustainability and equity.** Short-term pension measures, introduced in 2009, aim to claw back spending hike in the 2009-2010 period and include: (i) a suspension of pension indexation in 2010; (ii) an introduction of a temporary solidarity tax of 2 and 4 percent for monthly pensions above adequate income threshold; and (iii) a reduction of pensions of former state officials by 10 percent from August 2009. A combined net savings from these
measures in 2010 would be around 0.4 percent of GDP. However, the reduction of privileged pensions had also provided an impetus for addressing the eligibility criteria of existing privileged pensions and for a more comprehensive and long-term reform of the privileged pension system in the near future. We are also aware that over the medium term there is a need to undertake measures aimed at improving the first and the second pillar of pension insurance.

To reduce the overall borrowing requirements, we had to rationalize our public investment programs, in particular for highways and railways. This has secured around 1.3 percent of GDP in savings in 2009. We have also revisited our medium-term plans and delayed some investments or extended their implementation towards less ambitious timetables. However, we want to strengthen our investment planning process with the objective to ensure value for money as well as improve capital budgeting. To that objective, we have drafted the Decree on the Methodology of Appraisal of Investment Projects for adoption by mid-November 2009. The Decree aims to enhance the arrangements for the overall management and the decision-making on investment priorities, as well as to introduce standard appraisal methods of investment proposals. The Ministry of Finance, with the assistance of the WB PPIAF-funded consultants, also developed the Fiscal Risk Assessment Model for PPPs and undertook a capacity building to ensure a full understanding of the fiscal risks involved before PPP approvals. This aims to minimize contingent liabilities stemming from the PPPs.

We have also launched a comprehensive reform of the health sector, whereby the main focus was to put the health insurance system on a sustainable path as well as to introduce changes that would lead to long-term structural improvements for the more efficient, transparent and effective delivery of services. The new law on Compulsory Health Insurance and the amendments on Voluntary Health Insurance, effective from January 2009, increased health copayments, introduced health contribution on pensions, earmarked a part of excise tax on tobacco; and increased supplementary health insurance premium. In addition to the revenue generating measures, sick leave benefits have been reduced in terms of duration, while the new control system has been established to prevent abuse. Consequently, the percent of the working population on sick leave has already decreased from about 3.9 to less than 3.5 percent. There were further savings made in the cost of pharmaceuticals through updating and reducing reference prices by 12 percent. Finally, measures have been taken to improve the timeliness of payments with the average payment duration reduced from 274 to about 180 days thus reducing penalties and interest payments, as well as improving the access to the health services through a National Waiting List for all diagnostic and therapeutic procedures. The overall arrears of the health sector have been reduced by 10 percent down to 1 percent of GDP by September 2009 under tight budget conditions and we plan to clear the arrears over the next two years helped by further reform efforts in the hospital sector in particular.

Over the last couple of years the public expenditure management system in Croatia has seen steady development in many of the core areas; however, the budget planning process required more strategic and longer-term focus. The new Organic Budget Law, effective from January 2009, among other things introduced the strategic planning process in order to establish strategic priorities and allocate limited resources according to these plans. In September 2009, the Government adopted the Strategy of Government Programs for the period 2010 – 2012, on the basis of strategic plans of ministries and other state administration bodies. It was a first attempt to clearly define goals and priorities which the Government will implement through its programs in the coming period accompanied by a set of performance indicators. Furthermore, the Budget Law also mandates enactment of three-year rolling budget which was adopted by the Government and submitted to the Parliament for enactment on November 21, 2009. The Budget 2010-2012 follows the principles set in the Economic and Fiscal Policy Guidelines for the period 2010-2012.

A number of substantial changes in the Croatian procurement system took place during 2008-2009 to realign the legislative framework with the acquis. After alignment of the Public Procurement Act in 2008, secondary regulations, operational tools in the form of manuals and website information have been finalized in 2009. An Action Plan outlining a clear timeframe for each of the actions needed to strengthen the effectiveness of public procurement system is being monitored under
the EU negotiation process as a closing benchmark for the Chapter 5 of the *acquis* and we plan to fulfill them by the year-end. To complete the legislative alignment we have further strengthened the role of the *State Commission for the Supervision of Public Procurement Procedure* and extended its jurisdiction to concessions and PPPs, through the State Commission for the Supervision of Public Procurement Procedure Act adopted today on November 26, 2009 and submitted to the Parliament for enactment. A number of training activities have been conducted in 2009 to support capacity-building at the operational level. There is a further plan to extend the public procurement training to other bodies outside of the administration, like the State Audit Office, the State Attorney’s Office, and the Agency for Market Competition Protection and alike, to strengthen the government efforts in combating corruption and preventing irregularities. Also, to support the fiscal consolidation efforts, a Decree on Central Government Procurement Office has been adopted on November 12, 2009 which aims to generate important savings by procuring centrally some eleven broad categories of goods and services for the central government.

**Strengthening Social Sector Resilience**

*The social assistance system in Croatia provided an effective safety net for the poor and vulnerable during the crisis.* Various targeting effectiveness analysis confirm that Croatia’s social safety net, although costly in terms of funds allocated to it, has a strong targeting performance. Moreover, during 2009, the Government undertook a number of reform steps to address some of the deficiencies of the systems, in particular the consolidation of some categorical benefits and steps toward the deployment of an integrated Management Information System (MIS), through the Bank-financed Social Welfare Development Project.

**Reducing the overall spending envelope and improving the targeting and a program mix is one of the priorities of this Government over the medium term.** However, in the short term we are committed to secure adequate funding for the unemployment benefits as well as the means-tested social support allowance which have the best targeting effectiveness. We have assessed the vulnerable groups jointly with your team and the UNDP and will work closely on improving the monitoring capacity. The Ministry of Health and Social Welfare is preparing a new Social Welfare Law, which provides for the automatic indexation of the eligibility and benefit threshold for the support allowance and other means-tested programs. Using means-testing procedures for the support allowance in other benefits, including war veterans’ benefits already underway, family benefits and those in the health insurance, can further improve targeting which we plan to do in the medium term. We are planning to use the Personal Identification Number, introduced this year, to allow for official data exchange and improve targeting of various social programs already in 2010.

**Enhancing Efficiency and Stability of the Financial System**

*Croatian financial system proved resilient in the face of the global financial crisis, in part thanks to countercyclical policy measures undertaken in the past and active supervision* by the Croatian National Bank (CNB), well-capitalized banking sector and prudent and timely increase in deposit insurance coverage. Tight prudential regulation also helped preserving this resilience. The Croatian banking industry continues to be dominated by foreign ownership and fairly concentrated; the four largest banks claimed a market share of some two-thirds of total assets as of June 2009. Almost all cross-border loans to Croatia originate from banks headquartered in the European Union and thus are largely affected by the EU turmoil. Still, stress tests by the CNB show that the banking sector is resilient to plausible macroeconomic shocks. While global financial tensions and the macroeconomic outlook have heightened some existing vulnerabilities, these should remain manageable.

**Still, in order to strengthen the interagency coordination on crisis preparedness and management,** the Ministry of Finance, CNB and the Croatian Financial Services Supervision Agency (HANFA) signed on November 20, 2009 a Memorandum of understanding between the mentioned...
institutions dealing with financial stability issues in order to facilitate effective action as well as prevention.

The supervisors of financial sector have undertaken a number of policy reform measures to modernize and update the legal and regulatory framework under which the sectors operates. There is a consistent adherence to Basel Core Principles and the application of Basel II principles (Capital Requirements Directive - CRD) is underway, with the new Credit Institutions Act, replacing the previous Banking Act, effective from January 2009. Although Basel II requires 8 percent as the minimum capital adequacy ratio, this ratio in Croatia is already set at 10 percent and shall be 12 percent from 2010 onwards. Related to new capital requirements, the Act incorporates new risk management rules for credit institutions, including all three Basel II pillars. Furthermore, credit institutions are required to establish and implement an effective internal control system in all areas of operation: a risk control function, a compliance function and an internal audit function. The Act also introduces the system of a “single passport” which will enable credit institutions from Croatia to operate in the territory of other EU Member States, once Croatia becomes a member, and vice versa. Credit institutions will adjust their operations to the requirements of this act by March 2010 and the preparation for the full implementation is ongoing.

The CNB is continuously monitoring bank risk management policies and lending standards in order to be able to promptly address any emerging risks. The Credit Institutions Act specified the competences of CNB in the area of licensing and supervision of credit institutions and included provisions aimed at prevention and/or resolution of crisis situations in credit institutions as well as cooperation between home and host supervisors. Over the medium term, in order to ensure comprehensive and universal regulation of credit giving institutions, regulations and by-laws concerning their supervision and oversight are planned to become effective in 2010. Under the Consumer Credit Act, the Ministry of Finance shall regulate all consumer credit institutions that are non-deposit taking and issue consumer credit. As a result of this measure, the gambit of institutions/commercial bodies shall be covered.

HANFA has also strengthened supervision of the insurance sector through the adoption and amendments of the Insurance Act adopted in June 2009 to incorporate changes in the EU legislation regarding the regulation of insurance and reinsurance undertakings as well as insurance mediation. The risk management issues have been enhanced by the introduction of the solvency margin requirements (Solvency I). The act also regulates the reorganization and winding-up, accounts and rules and criteria for prudential supervision of insurance undertakings. HANFA has also started preparing for implementation of the Solvency II standards by undertaking stress testing and risk-based supervision. In continuing its efforts to harmonize legislation with IOSCO, HANFA entered into a Multilateral Memorandum of Understanding (MMoF) in October 2009, which enables cross-border cooperation in supervision for HANFA.

The development of the securities market required new legislation aligned with the EU framework, which was encompassed in the adoption of the Capital Market Act, effective from January 2009. The act introduced Basel II standard for investment firms and regulatory and supervisory framework for the investment services providers, transparency and disclosure requirements for securities issuers, insider trading and market manipulation rules, prospectus publishing as well as investor-compensation scheme. The Capital Market Act and related by-laws includes MiFID Directive (Markets in Financial Instruments Directive) rules into Croatian legal order. These rules refer to regulating market activities, investment firms’ activities, investment protection, jurisdiction and international cooperation of HANFA. Furthermore, the Capital Market Act introduced new investor protection system and establishment of the Investors Protection Fund. The Act also ensures higher transparency of the companies listed at the regulated market, and has introduced standards from the EU Market Abuse Directive.

Finally, Croatia has also strengthened supervision of the financial conglomerates through the adoption of a Financial Conglomerates Act, effective from January 2009, which aims to improve
supervision of financial conglomerates, in particular in the areas of risk concentration at the level of a conglomerate, liquidity risk, inter-company transactions, and management of internal risks within the conglomerate, and reliability and capability of the management. In July 2009, the Ministry of Finance issued the Ordinance on the Financial Conglomerate Guarantee Capital Adequacy Calculation Method. The first supervision of a financial conglomerate is currently underway.

In closing, we are confident that this letter outlines a coherent program of critical policy priorities in the near term. However, we will continue working on our medium-term reform agenda to ensure stability and a growth recovery. We would like to reiterate that the continued support of the World Bank will be essential for achieving these medium-term ambitious goals. We trust that this request for the World Bank support for the implementation of this reform program will receive your endorsement.

Yours sincerely,

Ivan Suker
Minister of Finance
### ANNEX 2: CROATIA DPL POLICY MATRIX (POLICY ACTIONS AND PROGRESS INDICATORS)

<table>
<thead>
<tr>
<th>OBJECTIVES</th>
<th>DPL POLICY ACTIONS</th>
<th>EXPECTED OUTCOMES</th>
<th>MEDIUM-TERM POLICIES AND OUTCOMES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PILLAR I: STRENGTHENING PUBLIC FINANCE</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Public expenditures rationalized</strong></td>
<td>Public sector employment freeze and wages reduced by 6 percent in 2009 and kept frozen in the draft Law on Budget for 2010-2012 submitted to the Parliament for enactment.</td>
<td>General Government wage bill reduced as a share of GDP.</td>
<td>At 10.8% of GDP in the original 2009 budget</td>
</tr>
<tr>
<td></td>
<td>Pension indexation suspended in 2010 and privileged pensions of MPs, Government members and Constitutional Court Judges reduced by 10%.</td>
<td>Planned pension spending declining as a share of GDP and a share spent on privileged pensions constant in 2010.</td>
<td>Pension spending at 10.2% of GDP in the third 2009 budget revision, and privileged pension at 20% of pension spending.</td>
</tr>
<tr>
<td></td>
<td>Public investment spending program rationalized in 2009 and in the draft Law on Budget 2010-2012 submitted to the Parliament for enactment.</td>
<td>General Government investments reduced as a share of GDP.</td>
<td>At 5.2% of GDP in the original 2009 budget.</td>
</tr>
<tr>
<td></td>
<td>Co-payments and supplementary health-insurance premiums increased, sick leaves and drugs’ costs reduced, and health insurance contributions</td>
<td>Total health sector arrears reduced in 2009 and 2010.</td>
<td>HRK3.8 billion (1.1% of GDP) (end-2008)</td>
</tr>
<tr>
<td><strong>Public finance management strengthened</strong></td>
<td>The first 3-year rolling budget for 2010-2012 submitted to the Parliament for enactment, consistent with the government medium-term strategic and macroeconomic framework, under the terms of the new Organic Budget Law.</td>
<td>The 2010-2012 rolling budget consistent with the medium-term fiscal framework as measured by general government expenditures as a share of projected GDP.</td>
<td>At 41.7% of GDP in the 2009 third budget revision</td>
</tr>
<tr>
<td><strong>Public procurement system strengthened</strong></td>
<td>The draft State Commission for the Supervision of Public Procurement Procedures Act submitted to the Parliament for enactment to complete the legislative alignment of the public procurement system with the EU acquis communautaire.</td>
<td>EU assessment of legislative alignment of public procurement system.</td>
<td>The 2008 EU assessment found that further efforts were needed to finalize legislative alignment and enhance capacity.</td>
</tr>
</tbody>
</table>

**PILLAR II: STRENGTHENING SOCIAL SECTOR RESILIENCE**

<table>
<thead>
<tr>
<th><strong>Vulnerable groups protected</strong></th>
<th>Adequate funding ensured in the draft Law on Budget for 2010-2012 submitted to the Parliament for enactment to cover the anticipated rise in new claimants for unemployment benefit and social support allowance.</th>
<th>Adequate budget for unemployment benefits and means-tested social support allowance maintained.</th>
<th>Spending on unemployment benefits and means-tested social support allowance at about 0.5% of GDP in 2010 budget.</th>
<th>No arrears.</th>
<th>Social allowance claims processed through the new MIS in all counties. Means-testing broadened to other social assistance programs and a review of the effectiveness of pro-natalist policies undertaken. Share of social spending going to the poorest quintile increased from 52% in 2008 and processing time for social support allowance reduced from a baseline of 30 days.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comprehensive regulatory framework for financial institutions formulated</td>
<td>New risk management rules for credit institutions that comply with the three Basel II pillars incorporated through the implementation of the Credit Institutions Act. Supervision of securities market and investment services upgraded to meet Basel II standards through the implementation of the Capital Market Act.</td>
<td>Capital adequacy ratio increased.</td>
<td>At 15.2% at end-2008.</td>
<td>Around 16% by end-2009</td>
<td>Consumer credits regulated through the law on regulation of non-credit institutions.</td>
</tr>
<tr>
<td>Audit reports containing detailed risk exposures</td>
<td>No risk exposure information disclosed in the audit reports of investment firms at end-2008</td>
<td>All audit reports of investment firms for 2009 contain detailed risk exposure information</td>
<td>Assessment of the MiFID Directive implementation and the introduction of the risk-based supervision in non-bank financial institutions. Financial sector operating under the Basel II.</td>
<td></td>
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</table>
This note provides staff's assessment of Croatia's macroeconomic developments and prospects and related economic policy priorities. The assessment is based on the findings of a staff visit to Zagreb during October 14-19, and recent data releases.

1. **After a sharp downturn in the first half of the year, the pace of economic decline has started to slow.** Economic activity is expected to bottom out of the severe recession in 2010, after contracting by about 6 percent in 2009. However, the recovery is likely to be weak as falling disposable income and profits, rising unemployment, weak credit conditions, and large private sector debt are likely to hold back consumption and investment. Risks to the near-term growth outlook are high, both on the upside (from a more favorable external environment) and the downside (from weaker domestic demand).

2. **External financing needs are large but pressures have eased considerably.** Financial stability has been maintained helped by decisive measures adopted by the authorities. In recent months, the kuna has retraced its losses, official reserves have been replenished, fiscal pressures have been curbed, and—after widening significantly—bond spreads have declined considerably. Foreign capital inflows, albeit sharply reduced, have been sufficient to cover the narrowing current account deficit in 2009. In 2010, the current account deficit is expected to stabilize at around 6-7 percent of GDP and the large external financing needs (about €15.7 billion, 34 percent of GDP) continue to warrant careful monitoring. The government has ratcheted up its efforts to borrow from private markets and multilateral institutions, and improving external conditions should help the private sector secure financing to meet maturing liabilities.

3. **The financial sector should be able to weather the domestic recession relatively well.** The capital adequacy ratio of the banking system is robust and increased slightly to 15.9 percent at end-June, reflecting previous tight regulatory measures and the recent growing share of government lending in banks' assets. Credit to the private sector, however, has stagnated, including due to lower demand and tighter underwriting standards. Bank profitability has declined and the NPL ratio (currently at around 6 percent) is expected to peak in 2010 as the recession affects credit quality with a lag. Of particular concern are loans to small and medium-sized enterprises, which were strongly hit by the downturn. Continued vigilance is, therefore, required to preserve financial sector soundness, which will be instrumental to economic recovery. Staff is encouraged by recent stress tests suggesting that the banking system would be able to absorb a significant decline in asset quality. Recent steps to upgrade the financial regulatory and supervisory framework are welcome.

4. **Fiscal pressures were moderated by swift budget revisions.** Three budget revisions in 2009 with wide ranging but largely temporary measures helped to contain the headline fiscal deficit (particularly compared with Croatia's peers) and maintain adequate access to market financing. Continued revenue declines and rising expenditure, however, could widen the deficit of the general government to about 3½ percent of GDP (compared to a revised budget of 2.9 percent of GDP) in the absence of further spending restraint. This overrun should not pose financing difficulties given the relative strong demand for government paper, and the authorities' recent bond placement of US$1.5 billion. However, fiscal risks remain important, including from
the increasing public sector indebtedness. The general government debt is moderate at around 34 percent of GDP, but it could reach 50 percent of GDP including accumulated contingent liabilities.

5. The authorities' focus on fiscal consolidation in 2010 and the medium term is appropriate, but will be challenging to achieve. The 2010 budget, aiming at a deficit of about 2½ percent of GDP through an envisaged spending freeze, is an important first step. However, a slow-growing economy will continue to exert pressure on the revenue, notwithstanding the full-year effect of the VAT increase, mobile phone fees, and the solidarity tax. Expenditure is also likely to increase on account of larger interest payments, wages, and social transfers, and possibly called guarantees. As a result, the fiscal deficit may improve more modestly to around 3 percent of GDP in 2010. More importantly, many of the measures taken thus far are temporary and set to expire by early 2011. More ambitious and sustained adjustment will be critical to help improve the quality of public spending, achieve the envisaged medium-term budget deficit target of 1.4 percent by 2012, and allow the authorities to roll back the weight of the government in the economy over the medium-term. In this regard, possible reforms include streamlining the structure of public administration, improving the long-run financial sustainability of the pension and health insurance systems, better targeting social benefits while protecting the most vulnerable, and scaling back, and eventually phasing off, subsidies through advancing the restructuring and privatization of loss-making SOEs.

6. Accelerating the pace of structural reforms would help the economy emerge from the current juncture more resilient and dynamic. Growth in recent years followed an unsustainable path, relying on consumption and nontradable sectors that left multifaceted structural weaknesses unaddressed, including relatively high labor costs, weakening competitiveness, and mounting external vulnerabilities. While some reform efforts are under way, including under the EU accession process, renewed emphasis should be placed on accelerating reforms to put growth on a firm footing and facilitate the reduction of imbalances. This includes strengthening competition (through the restructuring and privatization of loss-making SOEs), improving the business environment (through judicial and administrative reforms and anti-corruption measures), and advancing flexibility in the labor markets (through measures that reduce labor supply disincentives and boost labor demand).

RELATIONS WITH THE FUND

Table 1. Croatia: Key Macroeconomic Indicators, 2004–10 1/

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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<tr>
<td></td>
<td>(Percent change)</td>
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<tr>
<td>Output, unemployment, and prices</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Real GDP</td>
<td>4.2</td>
<td>4.2</td>
<td>4.7</td>
<td>5.5</td>
<td>2.4</td>
<td>-6.0</td>
<td>0.4</td>
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<tr>
<td>Unemployment (labor force survey, in percent)</td>
<td>13.8</td>
<td>12.7</td>
<td>11.1</td>
<td>9.6</td>
<td>8.7</td>
<td>11.0</td>
<td>11.3</td>
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<tr>
<td>CPI inflation (average)</td>
<td>2.0</td>
<td>3.3</td>
<td>3.2</td>
<td>2.9</td>
<td>6.1</td>
<td>2.8</td>
<td>2.8</td>
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<td>Saving and Investment</td>
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<td>Domestic investment</td>
<td>27.7</td>
<td>28.0</td>
<td>29.8</td>
<td>30.5</td>
<td>32.8</td>
<td>29.0</td>
<td>30.7</td>
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<tr>
<td>Of which: fixed capital formation</td>
<td>24.6</td>
<td>24.6</td>
<td>26.1</td>
<td>28.2</td>
<td>27.6</td>
<td>25.0</td>
<td>25.1</td>
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<td>Domestic saving</td>
<td>23.4</td>
<td>22.5</td>
<td>22.9</td>
<td>22.9</td>
<td>23.5</td>
<td>23.0</td>
<td>24.5</td>
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<td>Government</td>
<td>2.2</td>
<td>2.3</td>
<td>2.9</td>
<td>3.8</td>
<td>3.2</td>
<td>-0.3</td>
<td>0.0</td>
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<tr>
<td>Nongovernment</td>
<td>21.1</td>
<td>20.2</td>
<td>20.0</td>
<td>19.1</td>
<td>20.3</td>
<td>23.3</td>
<td>24.5</td>
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<tr>
<td>Government sector 2/</td>
<td></td>
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<tr>
<td>General government revenue 2/</td>
<td>39.7</td>
<td>39.2</td>
<td>39.6</td>
<td>40.7</td>
<td>39.8</td>
<td>38.6</td>
<td>38.3</td>
</tr>
<tr>
<td>General government expenditure 2/</td>
<td>43.1</td>
<td>42.1</td>
<td>41.4</td>
<td>42.0</td>
<td>40.7</td>
<td>42.1</td>
<td>41.5</td>
</tr>
<tr>
<td>General government balance 2/</td>
<td>-3.4</td>
<td>-2.8</td>
<td>-1.8</td>
<td>-1.2</td>
<td>-0.9</td>
<td>-3.5</td>
<td>-3.2</td>
</tr>
<tr>
<td>General government debt</td>
<td>37.9</td>
<td>36.4</td>
<td>35.9</td>
<td>33.1</td>
<td>29.1</td>
<td>34.0</td>
<td>36.7</td>
</tr>
<tr>
<td>General government debt, inc. guarantees and arrears</td>
<td>...</td>
<td>46.5</td>
<td>44.1</td>
<td>42.2</td>
<td>42.5</td>
<td>50.1</td>
<td>33.5</td>
</tr>
<tr>
<td>Money and credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank credit to the nongovernment sector</td>
<td>14.0</td>
<td>17.4</td>
<td>23.1</td>
<td>15.0</td>
<td>10.6</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Broad money</td>
<td>8.6</td>
<td>10.5</td>
<td>18.0</td>
<td>18.3</td>
<td>4.3</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Interest rates 3/</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average kuna deposit rate (unindexed)</td>
<td>1.9</td>
<td>1.7</td>
<td>1.7</td>
<td>2.3</td>
<td>2.8</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Average kuna credit rate (unindexed)</td>
<td>11.7</td>
<td>11.2</td>
<td>9.9</td>
<td>9.3</td>
<td>10.1</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Average credit rate, foreign currency-indexed loans</td>
<td>7.4</td>
<td>6.7</td>
<td>6.3</td>
<td>6.3</td>
<td>7.5</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Balance of payments</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Current account balance</td>
<td>-1,434</td>
<td>-1,976</td>
<td>-2,715</td>
<td>-3,237</td>
<td>-4,385</td>
<td>-2,888</td>
<td>-2,850</td>
</tr>
<tr>
<td>(In percent of GDP)</td>
<td>-4.4</td>
<td>-5.5</td>
<td>-6.9</td>
<td>-7.6</td>
<td>-9.3</td>
<td>-0.0</td>
<td>-6.2</td>
</tr>
<tr>
<td>Capital and financial account</td>
<td>2,603</td>
<td>3,924</td>
<td>5,083</td>
<td>4,865</td>
<td>5,393</td>
<td>3,367</td>
<td>3,436</td>
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<tr>
<td>Overall balance</td>
<td>43</td>
<td>822</td>
<td>1,412</td>
<td>722</td>
<td>-330</td>
<td>329</td>
<td>-114</td>
</tr>
<tr>
<td>Debt and reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross official reserves</td>
<td>6,436</td>
<td>7,438</td>
<td>8,725</td>
<td>9,207</td>
<td>8,926</td>
<td>9,255</td>
<td>9,141</td>
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<tr>
<td>In percent of short-term debt (by residual maturity)</td>
<td>108</td>
<td>85</td>
<td>88</td>
<td>109</td>
<td>63</td>
<td>74</td>
<td>66</td>
</tr>
<tr>
<td>In months of following year's imports of goods and NFS</td>
<td>4.4</td>
<td>4.5</td>
<td>4.9</td>
<td>4.7</td>
<td>5.7</td>
<td>5.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Net international reserves</td>
<td>5,026</td>
<td>5,604</td>
<td>6,464</td>
<td>7,349</td>
<td>7,849</td>
<td>8,183</td>
<td>8,099</td>
</tr>
<tr>
<td>External debt service to exports ratio (in percent)</td>
<td>24.4</td>
<td>27.2</td>
<td>37.5</td>
<td>37.8</td>
<td>34.3</td>
<td>50.5</td>
<td>38.1</td>
</tr>
<tr>
<td>Total external debt (in percent of GDP)</td>
<td>70.0</td>
<td>72.1</td>
<td>74.9</td>
<td>77.6</td>
<td>83.1</td>
<td>91.9</td>
<td>92.2</td>
</tr>
<tr>
<td>Net external debt 4/</td>
<td>33.0</td>
<td>37.7</td>
<td>38.7</td>
<td>41.1</td>
<td>46.6</td>
<td>55.3</td>
<td>55.7</td>
</tr>
</tbody>
</table>

Sources: Croatian authorities, and Fund staff estimates.

1/ National account data for 1995-2008 were revised in 2009. Under the new ESA95 methodology, revised data include estimates for the "gray economy," imputed dwelling rates, and financial intermediate services indirectly measured (FISIM). Revised nominal GDP figure for 2008 is about 14 percent higher than the previous estimate.

2/ ESA 95 presentation. Operations of HAC, a state-owned road company, were excluded from the coverage of the general government in 2008.

3/ Weighted average, all maturities. Foreign currency-indexed loans are indexed mainly to euros.

4/ Net of official reserves and commercial bank foreign assets.
### ANNEX 4: COUNTRY AT A GLANCE

#### Croatia at a glance

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, mid-year (millions)</td>
<td>4.4</td>
<td>445</td>
</tr>
<tr>
<td>Surface area (thousand sq km)</td>
<td>57</td>
<td>23,792</td>
</tr>
<tr>
<td>Population growth (%)</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Urban population (% of total population)</td>
<td>69</td>
<td>64</td>
</tr>
<tr>
<td>GNI (Atlas method, US$ billions)</td>
<td>60.2</td>
<td>2,687</td>
</tr>
<tr>
<td>GNI per capita (Atlas method, US$)</td>
<td>15,580</td>
<td>6,052</td>
</tr>
<tr>
<td>GNI per capita (PPP, international)</td>
<td>15,540</td>
<td>11,262</td>
</tr>
<tr>
<td>GDP growth (%)</td>
<td>2.4</td>
<td>6.9</td>
</tr>
<tr>
<td>GDP per capita growth (%)</td>
<td>2.4</td>
<td>6.7</td>
</tr>
</tbody>
</table>

- (at recent estimate, 2003-2008)

| Poverty headcount ratio at $1.25 a day (PPP, %) | 0.2 | 4 | 9 |
| Poverty headcount ratio at $2.00 a day (PPP, %) | 0.2 | 4 | 9 |
| Life expectancy at birth (years) | 75 | 70 | 71 |
| Infant mortality (per 1,000 live births) | 8 | 21 | 21 |
| Infant nutrition (% of population under 3) | 1 |
| Adult literacy, male (% of ages 15 and older) | 99 | 99 | 95 |
| Adult literacy, female (% of ages 15 and older) | 96 | 96 | 93 |
| Gross primary enrolment, male (% of age group) | 94 | 94 | 91 |
| Gross enrolment, female (% of age group) | 94 | 94 | 109 |
| Access to an improved water source (% of population) | 75 | 95 | 95 |
| Access to improved sanitation facilities (% of population) | 100 | 89 | 83 |

#### Net Aid Flows

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net ODA and official aid (US$ millions)</td>
<td>-</td>
<td>0</td>
<td>86</td>
<td>164</td>
</tr>
<tr>
<td>Top 3 donors (in 2007)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>European Commission</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>-</td>
<td>12</td>
<td>101</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>-</td>
<td>12</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>Aid (% of GNI)</td>
<td>0.0</td>
<td>0.3</td>
<td>0.3</td>
<td></td>
</tr>
<tr>
<td>Aid per capita (US$)</td>
<td>0</td>
<td>15</td>
<td>37</td>
<td></td>
</tr>
</tbody>
</table>

#### Long Term Economic Trends

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer prices (annual % change)</td>
<td>12.6</td>
<td>4.6</td>
<td>6.4</td>
<td></td>
</tr>
<tr>
<td>GDP at market prices (annual % change)</td>
<td>9.3</td>
<td>4.5</td>
<td>6.4</td>
<td></td>
</tr>
<tr>
<td>Exchange rate (annual average, local per US$)</td>
<td>0.0</td>
<td>8.3</td>
<td>4.9</td>
<td></td>
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<tr>
<td>Terms of trade index (2000 = 100)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, mid-year (millions)</td>
<td>4.4</td>
<td>4.4</td>
<td>4.4</td>
<td>4.4</td>
</tr>
<tr>
<td>GDP (US$ millions)</td>
<td>40,160</td>
<td>23,948</td>
<td>66,332</td>
<td></td>
</tr>
<tr>
<td>(% of GDP)</td>
<td>10.9</td>
<td>8.4</td>
<td>6.4</td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>28.3</td>
<td>20.5</td>
<td>16.9</td>
<td></td>
</tr>
<tr>
<td>Industry</td>
<td>53.4</td>
<td>63.2</td>
<td>65.1</td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>32.0</td>
<td>61.7</td>
<td>59.1</td>
<td></td>
</tr>
<tr>
<td>Services</td>
<td>40.0</td>
<td>22.9</td>
<td>18.6</td>
<td></td>
</tr>
<tr>
<td>Household final consumption expenditure</td>
<td>24.0</td>
<td>18.7</td>
<td>21.7</td>
<td></td>
</tr>
<tr>
<td>General government consumption expenditure</td>
<td>24.0</td>
<td>18.7</td>
<td>21.7</td>
<td></td>
</tr>
<tr>
<td>Gross capital formation</td>
<td>24.0</td>
<td>18.7</td>
<td>21.7</td>
<td></td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>24.0</td>
<td>18.7</td>
<td>21.7</td>
<td></td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>24.0</td>
<td>18.7</td>
<td>21.7</td>
<td></td>
</tr>
<tr>
<td>Gross savings</td>
<td>24.0</td>
<td>18.7</td>
<td>21.7</td>
<td></td>
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</tbody>
</table>

Note: Figures in tables are for years other than those indicated (2008 data are preliminary). Indicates data are not available. Aid data are for 2007.

Development Economics, Development Data Group (DECDG).
### Balance of Payments and Trade

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Merchandise Exports (fob)</th>
<th>Total Merchandise Imports (cif)</th>
<th>Net Trade in Goods and Services (df)</th>
<th>Current Account Balance as a % of GDP</th>
<th>Workers' Remittances and Compensation of Employees (receipts)</th>
<th>Reserves, Including Gold</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>4,574</td>
<td>7,770</td>
<td>-947</td>
<td>-8.38</td>
<td>641</td>
<td>3,525</td>
</tr>
<tr>
<td>2008</td>
<td>14,359</td>
<td>30,419</td>
<td>-5,473</td>
<td>-1.9</td>
<td>1,394</td>
<td>12,958</td>
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</table>

### Central Government Finance

<table>
<thead>
<tr>
<th>Asset</th>
<th>2000</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current revenue (including grants)</td>
<td>40.3</td>
<td>40.2</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>36.8</td>
<td>34.9</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>41.1</td>
<td>36.0</td>
</tr>
<tr>
<td>Overall surplus/deficit</td>
<td>-3.6</td>
<td>-1.9</td>
</tr>
</tbody>
</table>

### Highest Marginal Tax Rate (%)

- Individual: 35
- Corporate: 35

### External Debt and Resource Flows

<table>
<thead>
<tr>
<th>Asset</th>
<th>2000</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total debt outstanding and disbursed</td>
<td>11,428</td>
<td>55,584</td>
</tr>
<tr>
<td>Debt service</td>
<td>2,037</td>
<td>8,249</td>
</tr>
<tr>
<td>Debt relief (HIPC, MDRI)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Debt outstanding (% of GDP)</td>
<td>53.5</td>
<td>80.2</td>
</tr>
<tr>
<td>Debt service (% of exports)</td>
<td>21.4</td>
<td>25.6</td>
</tr>
<tr>
<td>Foreign direct investment (net inflows)</td>
<td>1,105</td>
<td>4,576</td>
</tr>
<tr>
<td>Portfolio equity (net inflows)</td>
<td>727</td>
<td>-697</td>
</tr>
</tbody>
</table>

### Composition of Total External Debt, 2008

- Private Sector: 7,598
- Subsovereign: 7,598
- Other Multilateral: 1,661
- Bilateral: 1,611

### Private Sector Development

- Time required to start a business (days): 40
- Time required to register property (days): 17.4

### Technology and Infrastructure


### Environment

- Energy use per capita (kg of oil equivalent): 1,753 (2000), 2,017 (2007)

### World Bank Group Portfolio

- IBRD
  - Total debt outstanding and disbursed: 421, 1,087
  - Disbursements: 52, 133
  - Principal repayments: 22, 99
  - Interest payments: 19, 50
- IDA
  - Total debt outstanding and disbursed: 0, 0
  - Disbursements: 0, 0
  - Total debt service: 0, 0
- IFC (fiscal year)
  - Total disbursed and outstanding portfolio: 55, 248
  - Disbursements for IFC own account: 46, 239
  - Disbursements for IFC own account: 19, 50
- MIGA
  - Gross exposure: 52, 21
  - New guarantees: 30, 0

Note: Figures in italics are for years other than those specified. 2008 data are preliminary. - indicates data are not available. -- indicates observation is not applicable.
**Millennium Development Goals**

**Croatia**

*With selected targets to achieve between 1990 and 2015 (estimates closest to date shown, +/- 2 years)*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty headcount ratio at $1.25 a day (PPP, % of population)</td>
<td>&lt;2</td>
<td>&lt;2</td>
<td>&lt;2</td>
<td>&lt;2</td>
</tr>
<tr>
<td>Poverty headcount ratio at national poverty line (% of population)</td>
<td>...</td>
<td>...</td>
<td>8.6</td>
<td>11.1</td>
</tr>
<tr>
<td>Share of income or consumption to the poorest quintile (%)</td>
<td>...</td>
<td>...</td>
<td>8.2</td>
<td>8.7</td>
</tr>
<tr>
<td>Prevalence of malnutrition (% of children under 5)</td>
<td>...</td>
<td>0.6</td>
<td>0.8</td>
<td>0.6</td>
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</table>

<table>
<thead>
<tr>
<th>Goal 2: Ensure that children are able to complete primary schooling</th>
<th>1990</th>
<th>1995</th>
<th>2000</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary school enrolment (net, %)</td>
<td>79</td>
<td>82</td>
<td>92</td>
<td>92</td>
</tr>
<tr>
<td>Primary completion rate (% of relevant age group)</td>
<td>...</td>
<td>85</td>
<td>92</td>
<td>96</td>
</tr>
<tr>
<td>Secondary school enrolment (gross, %)</td>
<td>...</td>
<td>81</td>
<td>85</td>
<td>91</td>
</tr>
<tr>
<td>Youth literacy rate (% of people ages 15-24)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio of girls to boys in primary and secondary education (%)</td>
<td>99</td>
<td>97</td>
<td>96</td>
<td>96</td>
</tr>
<tr>
<td>Women employed in the nonagricultural sector (% of nonagricultural employment)</td>
<td>45</td>
<td>45</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>Proportion of seats held by women in national parliament (%)</td>
<td>...</td>
<td>9</td>
<td>23</td>
<td>19</td>
</tr>
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</table>

<table>
<thead>
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<th></th>
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<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Under-5 mortality rate (per 1,000)</td>
<td>13</td>
<td>10</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Infant mortality rate (per 1,000 live births)</td>
<td>11</td>
<td>9</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Measles immunization (proportion of one-year olds immunized, %)</td>
<td>91</td>
<td>92</td>
<td>93</td>
<td>98</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Maternal mortality ratio (modeled estimate, per 100,000 live births)</td>
<td>11</td>
<td>12</td>
<td>7</td>
<td>14</td>
</tr>
<tr>
<td>Contraceptive prevalence (% of women ages 15-49)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Births attended by skilled health staff (% of total)</td>
<td>...</td>
<td>69</td>
<td>...</td>
<td>...</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Goal 6: Halve the proportion of people without sustainable access to basic needs</th>
<th>1990</th>
<th>1995</th>
<th>2000</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prevalence of HIV (% of population ages 15-49)</td>
<td>...</td>
<td>...</td>
<td>0.1</td>
<td>...</td>
</tr>
<tr>
<td>Incidence of tuberculosis (per 100,000 people)</td>
<td>55</td>
<td>44</td>
<td>36</td>
<td>22</td>
</tr>
<tr>
<td>Tuberculosis cases detected under DOTS (%)</td>
<td>...</td>
<td>10</td>
<td>...</td>
<td>8</td>
</tr>
<tr>
<td>Forest area (% of total land area)</td>
<td>31.5</td>
<td>35.9</td>
<td>35.3</td>
<td>39.4</td>
</tr>
<tr>
<td>Nationally protected areas (% of total land area)</td>
<td>...</td>
<td>6.5</td>
<td>10.4</td>
<td>10.3</td>
</tr>
<tr>
<td>CO2 emissions (metric tons per capita)</td>
<td>5.1</td>
<td>3.8</td>
<td>4.5</td>
<td>5.2</td>
</tr>
<tr>
<td>GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)</td>
<td>6.0</td>
<td>5.5</td>
<td>6.0</td>
<td>6.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Goal 7: Halve the proportion of people without sustainable access to basic needs</th>
<th>1990</th>
<th>1995</th>
<th>2000</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to an improved water source (% of population)</td>
<td>89</td>
<td>67</td>
<td>95</td>
<td>75</td>
</tr>
<tr>
<td>Forest area (% of total land area)</td>
<td>31.5</td>
<td>35.9</td>
<td>35.3</td>
<td>39.4</td>
</tr>
<tr>
<td>Nationally protected areas (% of total land area)</td>
<td>...</td>
<td>6.5</td>
<td>10.4</td>
<td>10.3</td>
</tr>
<tr>
<td>CO2 emissions (metric tons per capita)</td>
<td>5.1</td>
<td>3.8</td>
<td>4.5</td>
<td>5.2</td>
</tr>
<tr>
<td>GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)</td>
<td>6.0</td>
<td>5.5</td>
<td>6.0</td>
<td>6.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Telephone mainlines (per 100 people)</td>
<td>17.2</td>
<td>27.6</td>
<td>38.9</td>
<td>41.6</td>
</tr>
<tr>
<td>Mobile phone subscribers (per 100 people)</td>
<td>...</td>
<td>...</td>
<td>23.3</td>
<td>113.5</td>
</tr>
<tr>
<td>Internet users (per 100 people)</td>
<td>0.0</td>
<td>0.7</td>
<td>6.6</td>
<td>44.7</td>
</tr>
<tr>
<td>Personal computers (per 100 people)</td>
<td>0.0</td>
<td>0.5</td>
<td>6.6</td>
<td>44.7</td>
</tr>
</tbody>
</table>

**Note:** Figures in italics are for years other than those specified. ... indicates data are not available.

Development Economics, Development Data Group (DECDG).
MAP SECTION