Zagreb, June 5, 2002

REPUBLIC OF CROATIA

2002 Article IV Consultation Discussions

Preliminary Conclusions of the IMF Mission

Economic achievements since 2000 and remaining policy challenges

1. The Croatian authorities have achieved much in the past 2–2½ years. In a generally unhelpful external environment, economic growth has been restored and employment has more recently begun to grow in spite of continuing job cuts in the public sector. Inflation has been reduced to a very low level in the context of a broadly stable exchange rate. And the external position has been considerably strengthened, with a low current account deficit, large international reserves, and easy access to international capital markets, which is facilitated by a modest decline of the external debt ratio.

2. On the policy front, the fiscal deficit and government expenditure ratios have been reduced, along with the burden of taxes and social security contributions. However, despite these efforts, privatization revenues have been insufficient to prevent a further increase in the public debt ratio. Monetary policy has been successful at maintaining the exchange rate broadly stable and reducing inflation and interest rates. The restructuring and privatization of banks and their improved supervision have restored confidence in the banking system. The resulting expansion of demand for broad money, particularly strong in late 2001–early 2002 in connection with the introduction of euro currency notes, has—despite a large accumulation of international reserves—created enough room for a strong expansion of credit to the economy. The macroeconomic policy mix of fiscal tightening and monetary easing has been accompanied by many structural reforms in the areas of pensions, health care, public sector wages and employment, social benefits, and others. Progress in other areas, in particular privatization and labor market reforms, has been more modest.

3. While there has been undeniable progress, achievement of the government's medium-term objectives to reduce unemployment and boost living standards through accelerated convergence with the EU requires stronger efforts. With EU membership later this decade as its overriding foreign policy goal, the government must lay the foundations for such an acceleration during the remainder of its present term. Although prices are stable and the current account deficit is low, macroeconomic stability is threatened—in the absence of further decisive action—by the large fiscal deficit and a rising public debt ratio. With a general government deficit of 6.6 percent of GDP and a debt ratio of almost 54 percent of GDP in 2002, the fiscal situation is not sustainable.[1] At the same time, government spending

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[1] All fiscal data relate to the consolidated general government. To avoid confusion in the public debate and ensure international comparability, the discussion of fiscal issues in Croatia should be based on this broader consolidation.

of almost 50 percent of GDP, concentrated on wages and transfers, and delayed structural reforms impede the attainment of high and sustained rates of economic growth. It is therefore imperative to improve these ratios and stimulate economic growth through continued fiscal consolidation and accelerated reforms.

The way forward

4. With the five-party government entering the final 1½ years of its present term, policy formulation and implementation need to be accelerated. The government is to be commended for its determination to pursue reforms despite the approaching election. Most issues have been sufficiently analyzed and the options to resolve them are clear. Consultations with the social partners are welcome, but they should not be used to delay decisions. Some reforms will take years to complete, but their initiation should not be delayed. And in some instances legislation has been adopted, but needs better implementation or still awaits the preparation of implementation guidelines and the creation of appropriately staffed institutions to become operational.

Fiscal policy

5. Fiscal policy is the main macroeconomic policy tool in Croatia. Its proper use requires reliable and timely data on the operations of the general government. The Ministry of Finance should give urgent attention to this task and strengthen its technical services as required. The two new funds for regional development and for employment and growth have made the fiscal accounts less transparent. Their purposes can be pursued transparently without earmarking privatization receipts as part of the state budget and they should therefore be allowed to lapse with this year's budget. Any new funds and agencies, if truly needed, should be included transparently in the general government consolidation.

6. The reduction of the fiscal deficit remains the most urgent policy challenge. It is needed to achieve fiscal sustainability by stabilizing and perhaps reducing the public debt ratio, which has risen by 20 percentage points of GDP since 1997. After exhaustion of privatization receipts in the next few years, the underlying debt dynamics (expected growth and interest rates and the current debt level) suggest that stabilizing the debt ratio would require a primary (i.e., non-interest) deficit of no more than 1½ percent. As the public expenditure ratio remains much higher than in other European transition economies, deficit reduction should be pursued by cutting expenditure. If confined to wages, subsidies and transfers, expenditure reduction is likely to be expansionary, thus supporting the authorities' medium-term growth and employment objective. Growth inhibiting expenditure should be cut by more than needed for stabilizing (or reducing) the debt ratio, thus creating room for tax reduction, an increase in growth promoting expenditure (education, public infrastructure), and the inevitable EU and NATO accession costs.

7. The authorities' efforts to broaden the bases for direct and indirect taxes and social security contributions are right on target. In the pending legislation to extend the collection of social security contributions to all income taxpayers, there should be no exemptions for

individual groups. Success in raising revenue through the broadening of tax bases offers the possibility of competitiveness enhancing rate cuts. Independently, the drag from income tax progression could be offset by a widening of tax brackets. The replacement of standard with itemized deductions would complicate tax administration and make revenue projections more uncertain.

8. The primary focus must, however, be on expenditure reduction. The internationally still excessive wage bill ratio must be reduced further. In view of the planned easing of the three-year wage freeze in 2003, the thrust of efforts should now be on employment reduction. The recently approved defense sector reform should be implemented without further delay. Planned employment cuts in the health sector in the remainder of 2002 are welcome, but could be followed up by further measures in 2003. Reform of public administration and education would offer additional efficiency gains in the medium term. The government should rely on well designed active labor market policies and an appropriately funded and targeted social safety net to mitigate the social impact of these measures. While wage increases to protect the purchasing power of government workers are necessary in the future, greater reliance should be placed on incentive based pay along the lines currently being negotiated in the health sector. And bonuses and other discretionary allowances need to be further reduced. Following several years of reducing spending on goods and nonwage services, it is important to prevent its renewed expansion.

9. In contrast to the progress in reducing spending on goods and services, subsidies and transfers remain stubbornly high at one fifth of GDP. The relief of pressures on pension spending is temporary and further reform of the first pillar is necessary, by raising the retirement age, establishing actuarially neutral incentives for retirement, and lowering the frequency and degree of indexation. Payments under the small pension law should be allowed to cease as originally envisaged at the end of this year. To reduce health spending and improve the quality of health services, the authorities should vigorously pursue their efforts to raise efficiency in the delivery of health services and encourage their more rational use. The cost of sick pay and absenteeism could be reduced by leaving the first day(s) of sick leave uncompensated. Finally, the recent increase in subsidies should be reversed. All subsidy programs should be reviewed to ensure that they remain temporary and achieve their intended objectives.

10. With the initiation of an ambitious highway construction program, capital expenditure is rising strongly in 2002 and is expected to remain high in the next few years. While the size of this year's fiscal deficit depends crucially on the speed of implementation of the highway construction program, any delay in its execution would only add to the deficits of future years. Given the program's size, no effort should be spared to ensure transparency, accountability, and cost efficiency.

11. The government's deficit financing plan for 2002 envisages a more modest amount of privatization receipts than in the past, but its achievement is still all but assured. Privatization efforts need to be stepped up (not so much to ensure budget financing but to raise efficiency of the economy) and extended to the assets of the local governments. The government should

satisfy its remaining financing needs by borrowing as much as possible in the domestic market to take advantage of its high liquidity and low interest rates, to help develop the domestic capital market and provide financial assets to the new private pension funds, and to avoid adding to the appreciation pressures on the exchange rate. In doing so, it could realize additional savings by resorting to auctions rather than lead managers for its debt issues.

Structural reforms

12. Structural reforms should aim at stimulating economic activity and raising efficiency. They should remove obstacles to economic activity and limit the government to providing an enabling framework, delegating as much responsibility and initiative as possible to local governments. Varaždin provides an excellent example of creating employment by attracting greenfield investment through a business friendly environment. Its example of cutting red tape and providing industrial sites with adequate infrastructure should be emulated in other counties.

13. Many of the remaining reforms are outside the economic domain but will have positive repercussions on economic performance. Judicial and education reform are two cases in point. In the economic domain, they should aim at better protection of property rights, faster resolution of labor disputes and bankruptcy cases, and a better qualified, appropriately skilled labor force. As in the case of the land registers, these results can only be achieved over time, but the reforms should be launched forcefully without delay. Greater efficiency will also result from an administrative reform that would slim down the central administration through decentralization and fewer ministries assisted by well focused implementing agencies.

14. As labor market statistics show, jobs are only created in the private sector. For this reason, privatization of public enterprises should be accelerated. This applies also to some of the shipyards. The others should be given a last chance to restructure with government assistance, provided they show financial improvements in the course of this year. Otherwise, they should be sent into bankruptcy. A further increase in subsidies offers no solution. Many shipyard workers are reported to be foreign, but an increase in regional unemployment could be avoided by privatization of tourist enterprises and investment friendly policies at the county level. To increase employment and stimulate the use of regular employment contracts, the new labor law should be approved urgently. This will require a reduction of benefits. The establishment of a solidarity fund for employees of firms entering into bankruptcy would increase nonwage labor costs and undermine competitiveness. Speedy enforcement of bankruptcy procedures, where employees' claims enjoy the first priority, would be a better solution.

15. Among financial sector reforms, it is encouraging that a new banking law consistent with pertinent EU directives is expected to be adopted soon. The CNB is already drafting new regulations to better address market and operational risks as well as supervision of banking groups on a consolidated basis. It is important that options be included in the calculation of banks' net open position in foreign exchange. The new foreign exchange law

should give the CNB sufficient power to temporarily restrict capital flows, which should only be liberalized gradually and under appropriate macroeconomic conditions in the context of a sound and well supervised banking system. The law should leave residents free to choose risk and return of their foreign investments.

Monetary and exchange rate policy

16. Price and financial stability remain the principal concerns of monetary policy. The CNB believes that these concerns are best addressed by exchange rate stability in the open and highly euroized Croatian economy. However, seasonal fluctuations aside, the exchange rate is likely to remain under persistent appreciation pressure as long as economic and productivity growth respond positively to good fiscal and structural policies. Government foreign borrowing and privatization inflows add to this challenge. In this situation, the CNB will have to manage carefully the tradeoff between price and exchange rate stability. Should, however, price stability be seriously jeopardized, the CNB should leave no doubt as to its readiness to accept exchange rate appreciation.

17. With international reserves about twice the size of base money, the CNB is well placed to defend a stable exchange rate, and competitiveness issues are better addressed with structural policies and containment of labor costs. While banks are fairly well capitalized to withstand moderate exchange rate adjustments, uncertainties remain about the size of unhedged positions among nonbanks. Despite the tendency toward gradual appreciation, the CNB should warn economic agents about large open foreign exchange positions, especially since it may need to allow—or even provoke from time to time—exchange rate fluctuations to discourage speculative capital flows.

18. Large foreign exchange purchases have left the banking system highly liquid, and interest rates are at a very low level. As there are no signs of inflationary pressures, the CNB has decided to leave much of the inflows unsterilized so as not to attract short-term capital. However, the CNB should remain vigilant and tighten monetary conditions if this situation were to change. Moreover, as banks continue to switch from foreign placements into domestic ones and their loan portfolio continues to grow, the CNB needs to direct increased supervisory attention to the soundness of banks' lending decisions and insist on appropriate provisioning.

19. In the current monetary conditions, there is no room for reducing reserve requirements although a further reduction of this tax on banks' activities remains desirable over the medium term. Similarly, the CNB should consider introducing a deposit facility to establish an interest rate band for the orientation of the money market once the structural excess liquidity position has been reduced. The limitation of CNB bills to short maturities (with the attendant reservation of the longer maturity spectrum to Treasury bills) is appropriate.

Trade policy and statistical issues

20. An important external policy priority is the earliest possible inclusion of Croatia in the Pan-European System of Cumulation of Origin. This would allow Croatia to benefit fully from the free trade agreements with the EU and other European countries.

21. In addition to better fiscal data, Croatia still needs to improve statistical data on prices, national accounts, and unemployment. The planned change from a retail to a consumer price index in early 2003 is welcome, but the new index should immediately be compiled for a sufficiently long historical period to allow a better assessment of inflationary pressures. Similarly, work on better quality national accounts data is welcome, but the Croatian Bureau of Statistics' revisions policy should be changed to produce more timely revised data. Finally, there is an urgent need to remove those not seriously looking for work from the official unemployment register and to produce survey based monthly unemployment data with a short publication lag.

The importance of strong policies

22. Two scenarios illustrate the importance of strong policies on fiscal sustainability and economic growth. The first, based on the mission's understanding of the authorities' current fiscal policy and structural reform plans, produces growth of some 4 percent in the medium term. The consolidated general government deficit would decline to 3¾ percent of GDP by 2005–06, but the public debt ratio (assuming no further increase in guarantees) would rise again—albeit gently—to more than 53 percent of GDP in 2006, after dropping intermittently due to the realization of privatization receipts, mainly from INA and HEP. The external current account deficit would decline to 3¼ percent of GDP, and direct investment and other capital inflows would be sufficient to produce healthy overall balance of payments surpluses while leaving the external debt ratio on a slowly declining trajectory. The scenario is benign, but—in view of likely productivity gains—it does not offer good employment growth prospects.

23. The second scenario assumes stronger fiscal adjustment and a more aggressive approach to privatization and structural reforms. Not only would it achieve higher rates of growth for productivity, employment, and GDP, it would also allow the realization of higher privatization receipts as investors respond to the country's improved prospects. The stronger fiscal adjustment would tend to offset higher inflationary pressure, and higher nondebt creating inflows would allow a more rapid decline in the external debt ratio. The fiscal deficit would be reduced to 3 percent of GDP in 2005–06 and the public debt ratio would decline to less than 45 percent of GDP (again assuming no increase in guarantees). Borrowing costs would be reduced, but most importantly nominal GDP would be some 8½ percent higher in 2006 than under the baseline scenario and nominal per capita income would have risen by about 55 percent from 2001—a major step toward EU convergence.