International Monetary Fund

Republic of Croatia
and the IMF

Press Release:
IMF Executive Board
Completes Second
Review of Croatia's
Stand-By
Arrangement
March 29, 2006

Country's Policy
Intentions Documents

E-Mail Notification
Subscribe or Modify
your subscription

Republic of Croatia: Letter of Intent, Annex, and Technical Memorandum of Understanding

March 3, 2006

The following item is a Letter of Intent of the government of Republic of Croatia, which describes the policies that Republic of Croatia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Republic of Croatia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Zagreb, March 3, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

We remain fully committed to maintaining macroeconomic stability, limiting external vulnerability, and preparing Croatia for EU accession. Consistent with these objectives, we have been implementing our economic program for 2004–05, supported by the 20-month Stand-By Arrangement approved by the Fund in August 2004, for which the first review was completed in September 2005.

We are requesting completion of the second review under the program. All quantitative performance criteria for end-December 2005 have been observed, excluding the target on the reduction of general government arrears, for which we are requesting a waiver. While the total stock of general government arrears is small, our ability to reduce it further has so far been constrained by the deep-seated structural problems in the health sector, which we took first steps to reform in 2004 and 2005. In 2006, we are pressing ahead with farther-reaching reforms to the health sector, including an overhaul of the health insurance system, which will also help normalize the finances of the system and lead to a permanent reduction of arrears. The structural benchmarks set at the first review have also been observed, save for the submission to parliament of the supplementary health insurance law, which will now form part of the broader health system reform; and the formulation of a plan to privatize the Croatian Insurance company (CO), as well as the third phase of privatization of the telecommunications company (HT), which have been delayed.

Our macroeconomic policies in 2006 will continue to be guided by the same objectives as our program for 2004–05, notably to arrest the growth of Croatia's external debt-to-GDP, which is the biggest source of external vulnerability in the short run. This goal, narrowly missed in 2005, will require continued fiscal consolidation efforts and cautious monetary management. To support these policies and help secure the main goal of our program, we are requesting an extension of the Stand-By Arrangement through November 15, 2006. The attached Annex describes in detail our policies for this year and proposes performance criteria and indicative targets for end-March, end-June, and end-September 2006. The extension would also include a third review of the Arrangement by September 2006, to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve our objectives, particularly in view of the possible macroeconomic implications of the repayment of pensioners' debt obligations, which are to start in the second half of the year. Program implementation will also be monitored through structural performance benchmarks on the promulgation of health reform laws; approval of a restructuring plan for shipyards; progress in the sale of state holdings in CO, HT, and the oil distributor INA; and prudential measures to discourage bank foreign currency lending to unhedged customers.

We are also requesting additional access of SDR 2 million during the extension period of the program. We intend to continue treating the SBA as precautionary.

We believe the policies set forth in the attached Annex are adequate to achieve the objectives of our program, and we will take any further measures that may become necessary for this purpose. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the Annex, in accordance with the Fund's policies on such consultations.

Sincerely yours,

/s/	/s/
Ivan Šuker Minister of Finance Ministry of Finance	Željko Rohatinski Governor Croatian National Bank

Attachments:
Annex
Technical Memorandum of Understanding

1. This Annex reviews program implementation in 2005 and describes our macroeconomic policies and targets for 2006. It reaffirms the goals of our program for 2004–05 that has been supported by the Stand-By Arrangement: preserving macroeconomic stability and limiting external vulnerability, notably by stopping the increase in Croatia's external debt-to-GDP ratio. These goals are also consistent with our updated Pre-Accession Economic Program, which we submitted to the European Commission in December 2005.

2. Our macroeconomic policy strategy for 2006 is based on continuing the fiscal adjustment we have implemented over the past two years. In addition to helping mitigate external vulnerability, this will prepare Croatia to meet the EU fiscal deficit and debt requirements in the medium term. We plan further improvements in transparency and financial management in the government and the broader public sector, and the implementation of key structural reforms, including accelerated privatization, that will contribute both to permanent improvements in the fiscal position, and to Croatia's competitiveness ahead of EU accession. A crucial support to these policies is the continuity of the current monetary policy framework, which will stay focused on exchange rate stability.

3. The envisaged extension of the Stand-By Arrangement through November 15, 2006 would support these policies and help secure the gains made during 2004–05.

I. PROGRAM IMPLEMENTATION IN 2004–05

4. Our policies during 2005 were consistent with the targets detailed in the Annex to our Letter of August 7, 2005. In particular, in 2005 we achieved the general government deficit target of 4.2 percent of GDP envisaged in our mid-year supplementary budget (3.3 percent of GDP on GFS 2001 basis). Thus, since 2003, we have reduced the fiscal and quasi-fiscal deficit by nearly 2½ percentage points of GDP.

5. With one exception, all program quantitative targets for end-December 2005 were met. The end-December target on the reduction of general government arrears was missed by HRK 556 million: this reflected continuing accumulation of arrears in the health sector, which remains subject to long-standing structural weaknesses. We are introducing major reforms to address these weaknesses (paragraph 21 below).

6. Under our program, we have made substantial progress across a broad range of structural reforms during 2004–05. We have set fiscal policy into a medium-term framework in the form of rolling three-year budgets. We have improved significantly fiscal management and transparency by eliminating hidden subsidies to Croatian Railways, controlling quasi-fiscal operations and contingent liabilities, expanding the single treasury account, initiating civil service reform, increasing data disclosure, reconciling the register of government debt guarantees between the Ministry of Finance and the CNB, transferring the treasury bill registry to the Central Depository Agency, establishing internal audit units in all budget users in the central government, and improving debt management. In line with the recommendation of recent IMF technical assistance, we are taking measures to improve tax administration. We have enhanced financial stability by strengthening bank and nonbank supervision, rationalizing monetary policy instruments, starting open market operations, and upgrading the CNB's macro-

prudential and financial stability analysis. And we have promoted economic efficiency and competitiveness by advancing privatization—despite the delays, strengthening the Croatian Competition Agency, starting the publication of regular state aid reports and amending the state aid law. Looking forward, we are also taking concrete steps to satisfy two of the structural benchmarks under the program whose implementation has been delayed, namely in the areas of health reform and privatization.

7. These efforts over 2004–05 have started to pay dividends. Despite the impact of higher oil prices, Croatia's external position has improved substantially. However, higher private capital inflows, in part reflecting confidence in our policies and in Croatia's EU accession prospects, meant that the objective to stabilize the external debt-to-GDP ratio was just missed in 2005. Gross external debt reached 84.7 percent of GDP at end-2005, up 2¼ percentage points from end-2004; this compares with an external debt accumulation averaging nearly 6 percent of GDP annually over the previous five years. In the latter part of last year, these capital inflows were also reflected in accelerating growth in bank credit to the private sector, which necessitated additional monetary and prudential measures.

II. Macroeconomic Outlook and Policies in 2006

8. We expect economic activity in Croatia to continue at a satisfactory pace in 2006. We project real GDP growth to reach around 4 percent in 2006, broadly the same pace as in 2005; average inflation to remain around 3¼–3½ percent in 2006, underpinned by our policy of exchange rate stability; and the current account deficit to remain at or below 6 percent of GDP.

9. However, these projections—especially for the current account deficit—are subject to several risks. The most important risk is the possibility of a deterioration in the external environment, which would have important repercussions for Croatia's very open economy. Another risk is the possibility that the recent acceleration in credit growth continues and intensifies, affecting aggregate demand and the external position. Finally, the phased repayment of pensioners' debt, which will start in June 2006 (paragraph 13), may also have implications for consumption and imports. If the macroeconomic environment worsens substantially, we are prepared to adjust our policies and targets in order to safeguard the objectives of our program.

A. Fiscal Policy

10. Our 2006 budget, which parliament approved on November 29, 2005, set a target for the general government deficit of 3.3 percent of GDP (2.4 percent on GFS 2001 basis). We project revenues as a share of GDP to stay broadly unchanged from 2005. In the event of revenue overperformance as a result of a surge in aggregate demand, we intend to keep budgetary expenditures to the level provided in the budget. Tax receipts will benefit from the measures we took last year to strengthen tax administration, in conjunction with technical assistance from the IMF. The loss of some one-off dividend payments included in the 2005 budget will be offset by higher nontax revenue and grants from the EU. The reduction in the deficit will come mainly from lower expenditures, both current and capital.

11. The expenditure savings envisaged for 2006 will arise in part from measures already implemented, like the revision in the pension indexation formula in mid-2005, the changes to the employment and housing subsidy schemes, and the introduction of an administrative fee for some health services. At the same time, however, the need for harmonization of our domestic legislation and institutions with the EU generate new spending requirements. To accommodate these while, at the same time, ensuring the achievement of our overall deficit target, the implementation of the following policies and reforms is critical for the 2006 budget:

- keeping average public sector wage growth to no more than 3 percent in 2006 while limiting average employment growth to no more than 1 percent, to accommodate new hires urgently needed in connection with EU harmonization;

- continuing the implementation of the restructuring plan for Croatian Railways that we approved last year in cooperation with the World Bank, with a view to reducing total budgetary support to the company to HRK 2.86 billion in 2006 (paragraph 24);

- implementing a restructuring plan for the loss-making state-owned shipyards that will rationalize their operations, provide a credible perspective for their subsequent privatization and—more important from a budgetary point of view—allow us to keep subsidies to shipyards at the HRK 400 million level provided in the 2006 budget (paragraph 23). Failure to start implementation of this restructuring plan by June 30 will imply that, in accordance with our commitments in the Stabilization and Association Agreement with the EU and the process of harmonization of state aid practices with EU rules, all state aid to shipyards after that date will be classified as budgetary expenditure.

- launching a comprehensive health reform in the second half of the year, described in paragraph 21, that will enable us to keep budgetary outlays on health to the HRK 14.9 billion provided in the budget, as well as set the basis for a reduction in health sector arrears. This reform, which we are currently finalizing, will not only affect key parameters of the current system but also change the incentives for providers and consumers of health care, introduce greater accountability, and engender changes in behavior. Therefore, the resulting budgetary savings, while sizeable over the medium term, are hard to forecast precisely at this point. As the reform takes its final shape, we will carefully estimate its impact and take additional measures if needed to ensure that our 2006 budget targets are met.

12. Beyond these measures that will yield tangible savings already in 2006, we are also advancing reforms that will generate significant but, in some cases, harder to quantify savings over the medium term. *First*, we have started the reform of state aid with the approval by parliament of the amendments to the law on State Aid in November 2005. These amendments bring procedures for disbursing state aid into line with EU requirements and strengthen the role of the Agency for Market Competition in minimizing market distortions. *Second*, with the assistance of the World Bank, we have adopted a medium-term subsidy reduction plan, under which subsidies to enterprises will be reduced to 2.14 percent of GDP by 2007. *Third*, a working group headed by the Ministry of Health and Social Welfare is preparing a blueprint for reforms to the social benefit system, aimed at better targeting assistance towards the most vulnerable citizens and harmonizing the system with the standards applied in EU countries.

13. Last year, we initiated the resolution of a long-standing debt to current pensioners, in compliance with a 1998 decision of the Constitutional Court. This debt, including accumulated interest, amounts to HRK 13.8 billion (5¾ percent of projected 2006 GDP). To resolve once and for all this outstanding issue and honor the state's obligation while, at the same time, minimizing the fiscal impact, we have offered eligible pensioners a choice: full repayment over 2008–2013; or accelerated repayment at a 50 percent discount in four half-yearly installments over 2006–07, with the first payment in June 2006. Pensioners are expected to make this choice during the first quarter of the year, and surveys suggest that most will choose the second option. We have created a special fund, to which we will transfer state assets that will be used to finance these payments. Since these are repayments of debt incurred during the 1990s, they will not be treated as budgetary expenditure. Nevertheless, we recognize the potential impact of these payments on consumption and imports. Once the size of these repayments is known, we will take additional measures if it appears that their impact could jeopardize the achievement of our main external objective under the program.

14. In line with our program, budget financing will continue shifting to domestic sources. As in 2005, we expect to avoid recourse to net foreign financing for the general government in 2006. In addition, we expect significant increases in privatization receipts in 2006 (paragraph 22).

15. We will continue strengthening financial discipline and transparency in the broader public sector. In this context, we will continue to identify and account transparently for all forms of state aid, including transfers, debt assumptions, guarantees, and recapitalizations; contain the deficit (net of government transfers) of the Croatian Development Bank (HBOR) at HRK 500 million by reducing its net lending plan accordingly; limit the issuance of government debt guarantees so as to maintain the nominal stock of outstanding government contingent liabilities well below its end-2003 level; and aim at reducing the borrowing requirement of the group of major public enterprises monitored under the program.

16. We are continuing to upgrade the management of public expenditure and debt. Significant progress was made toward the development of the single treasury account with the incorporation into it from the beginning of this year of the accounts of HAC and HC. As regards the accounts of DAB and HFP, the experience with the recent litigation and its impact on the financial operations of HFP, as well as the pending disputes regarding old bank rehabilitations involving DAB, militate against their premature incorporation into the single treasury account. We thus intend to bring these two agencies into the single treasury account once these disputes are settled and the pending amendments to the legal framework of DAB are finalized. The Ministry of Finance and the Croatian National Bank (CNB) have agreed on procedures for reconciling information on government guarantees. The two institutions will continue to monitor and reconcile guarantees as they are issued, and seek to ensure that the guarantee register includes information on guarantees issued by local governments. In the area of public debt management, we will implement fully the permanent software solution supported by EU CARDS by end-March and introduce an electronic system for treasury bill auctions by end-May.

B. Monetary and Financial Sector Policies

17. The CNB continues to support the external objectives of our program by pursuing its policy of broad exchange rate stability against the euro, maintaining adequate international reserves, and preventing an inappropriate domestic liquidity expansion. Gross official reserves at end-2006 are projected at about € 8 billion, maintaining reserve coverage at about 4½ months of following year's imports of goods and non-factor services; and the growth in net domestic assets of the CNB during 2006 will be contained to about HRK 1.5 billion. These targets are consistent with broad money growth during the year at about 13 percent and growth in credit to the private sector of 12-13 percent. Should massive private capital inflows threaten to jeopardize macroeconomic stability, the CNB will consider, in consultation with the IMF, introducing price-based controls on capital inflows.

18. The CNB is taking further measures to contribute towards arresting the growth of external debt. Effective January 2006, the CNB increased the marginal reserve requirement on commercial banks' new foreign borrowings after November 2005 from 40 to 55 percent. The higher marginal reserve requirement will apply to a broader base than previously, by including foreign lending based on guarantees issued by commercial banks in Croatia, and banks' borrowings from leasing companies. Effective March 2006, a similar marginal reserve requirement will apply to issuance of bonds by commercial banks, to close a potential loophole. At the same time, the CNB is supporting the government's efforts to finance the general government deficit without recourse to new foreign borrowing. Accordingly, the CNB reduced the general reserve requirement from 18 to 17 percent effective January 2006.

19. The CNB is also continuing to strengthen banking supervision, implementing several measures that will both help banks mitigate foreign-currency-related credit risks and contribute to more moderate growth in credit to the private sector:

- Preparing minimum standards for the proper management of these risks, which it will circulate to banks by end-February 2006.

- Requiring banks to prepare policies and techniques for managing their foreign-currency-related credit risks, for submission to the CNB by March 15, 2006, and implementation during April–May 2006.

- Introducing stricter reporting requirements on banks' unhedged loans effective from the second quarter of 2006.

- Increasing capital adequacy risk weights by 25 basis points on foreign currency or foreign currency-indexed loans to unhedged borrowers in the nongovernment sector effective from the second quarter of 2006.

- Undertaking a public campaign to inform borrowers of the risks of floating interest rate and unhedged foreign currency and foreign currency-indexed loans starting this year.

- Intensifying cooperation with foreign supervisors by concluding discussions on the pending Memoranda of Understanding (MoU) with Italy and Hungary.

20. In addition to the above measures, we are taking additional steps to improve financial sector supervision. On November 17, 2005, parliament approved legislation creating a single non-bank supervisor, the Croatian Agency for Supervision of Financial Services, to take over the responsibilities of the existing securities, pension fund, and insurance supervisory agencies. The Agency began operations in January 2006.

C. Structural Reforms

21. We are continuing our fundamental reforms to the health sector in 2006, building on initial measures in 2004 and 2005. We are preparing a package of several laws to address important aspects of the reform. These measures are part of a broader health reform that will be implemented over the medium term. Specifically:

- To help curb demand and ensure a more equitable sharing of healthcare costs, we will require co-payments for drugs that are not included in the main list and limit this main list of drugs (that are exempt from co-payments) only to the lowest-priced among clinically-equivalent drugs.

- Supplementary health insurance for drugs, currently provided by the state below cost, will be separated from the main health insurance fund (HZZO) and shifted to the private sector. Supplementary health insurance for all other health services will continue to be provided by HZZO but will also be open to the private sector;

- We will set targets for fund allocation to primary care providers and reward those who spend less by allowing them to keep part of the savings for their professional needs, while reducing the salary of those who spend in excess of their allocation.

- We will improve the transparency of the HZZO's revenue and expenditure by clearly identifying the sources of each outlay (health contributions or budgetary transfers).

- To strengthen accountability and incentives for sound financial management of hospitals, we will clarify the responsibilities for maintaining state and county hospitals between the central and local governments.

The government will approve and submit this package of laws to parliament by March 15, with a view to implementing it from July 1. In addition to its far-reaching implications for public services and the public finances, this reform will also stem the accumulation of new arrears in the health sector starting in the second half of 2006. However, its mid-year implementation implies that a further accumulation of arrears (about HRK 300 million) is possible during the first half.

22. We remain committed to our privatization program. Several major privatizations envisaged in 2005 are now nearing completion. In September 2005, we selected Merrill Lynch and Raiffeisen Bank as advisers in the second phase of privatization of 15 percent of the national oil company, INA; the sale will take place in the first half of 2006, as will the sale of the government's remaining holding in the telecom company HT. We expect to complete by end-2007 the sale of government holdings in companies (excluding shipyards) held by the Privatization Fund (HFP). By end-June 2006, and consistent with our undertakings under the World Bank PAL, we intend to complete the privatization or

liquidation of one-third of all companies in which the government holds a majority stake, and sell the government shares in half of the companies in which the government holds a minority stake. We are preparing to issue tenders for the Sisak and Split steel companies and the TLM aluminum company, in the first half of 2006, and for the Uljanik shipyard before year-end. Because of delays in settling open compensation claims, the preparation of a plan to privatize the Croatian Insurance company (CO) was delayed; we now intend to finalize this plan by end-June, with a view to starting the privatization of the company in the second half of this year. We plan to merge and subsequently privatize the two remaining state-owned banks, Croatia Banka and HPB, though this plan is on hold pending the court resolution of a lawsuit against Croatia Banka by former small shareholders.

23. State aid to the shipyard and steel sectors imposes high costs on the budget and is inconsistent with EU law. We are preparing a restructuring plan for shipyards in consultation with the European Commission aimed at curbing the industry's losses, reducing subsidies to EU levels, and ensuring that remaining government interventions comply with the *acquis communautaire*. The restructuring plan, which will be submitted to the government by end-April and approved by end-June, will set out a process for the shipyards' privatizations, which will be transparent and conducted by means of public tenders with defined terms of reference. We will also start phasing out state aid to the steel sector during 2006.

24. We will continue implementing our restructuring plan for Croatian Railways (HŽ) consistent with our undertakings under the World Bank PAL. In 2006, we will take further steps toward further separation of railway infrastructure and business operations, privatization of three subsidiaries of HŽ, and layoffs consistent with bringing the company's working ratio (total operating costs over total operating revenue) to 190 in 2006, down from 220 in 2005.

Table 1. Croatia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2006

			End of		
			March 2006	June 2006	September 2006
			(In millions of kuna, unless indicated otherwise)		
Quantitative performance criteria (cumulative from January 1, 2006) 1/					
1	Cumulative deficit of the consolidated general government 2/		4,216	6,635	6,488
2	Cumulative change of the stock of arrears of the consolidated general government 2/		150	300	300
3	Cumulative deficit of HBOR 2/		-65	-124	-18
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 2/ 3/	Total	362	427	597
		<1 years	0	0	0
5	Cumulative issuance of guarantees extended by the general government 2/		1,705	2,610	2,814
6	Cumulative change in the Net International Reserves of the Croatian National Bank 3/ 4/		-345	-65	-400
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 2/		1,340	1,470	-1,140
Indicative limits					
1	Cumulative increase in the total debt of selected public enterprises 2/		-28	-97	169

1/ Performance criteria for end-March and end-June 2006; indicative targets for end-September 2006.
2/ Ceiling.
3/ In millions of euros.
4/ Floor. Net of commercial banks' required reserves in foreign currencies.

Table 2. Croatia: Prior Actions, Performance Criteria, and Structural Benchmarks for 2006

Prior actions for the Second Review	
1. Government to approve and submit to Parliament a package of draft laws on health reform that require co-payments for drugs not included in the main list, discontinue HZZO's provision of supplementary insurance for drugs, and open supplementary insurance for other health services to the private sector.	Annex, Para. 21
2. Supervisory board of HBOR to approve a revised lending plan, reducing net lending to HRK 1.36 billion in 2006, consistent with a deficit of HRK 500 million.	Annex, Para. 15
Quantitative performance criteria	
1. Quarterly limits on the cumulative deficits of the consolidated general government.	
2. Quarterly limits on the cumulative changes of the stock of general government arrears.	
3. Quarterly limits on the cumulative deficits of HBOR.	
4. Quarterly limits on the cumulative amount of the contracting of nonconcessional external debt by the general government and HBOR with sublimits on contracting of such debt with a maturity of up to 1 year.	
5. Quarterly limits on the cumulative issuance of guarantees extended by the general government.	
6. Quarterly floors under the cumulative changes of the net international reserves of the CNB.	
7. Quarterly limits on the cumulative changes of the net domestic assets of the CNB.	
Indicative limits	
1. Quarterly limits on the cumulative increase in the total debt stock of selected public enterprises.	
Structural benchmarks	
1. Parliament to approve, by end-June 2006, a package of draft laws on health reform that require co-payments for drugs not included in the main list, discontinue HZZO's provision of supplementary insurance for drugs, and open supplementary insurance for other health services to the private sector.	Annex, Para. 21
2. Government to approve, by end-June 2006, a plan for restructuring the shipyard industry.	Annex, Para. 23
3. Government to formulate a plan on privatization of CO by end-June 2006.	Annex, Para. 22
4. Government to complete the third phase of privatization of HT, and the second phase of privatization of INA, by end-June 2006.	Annex, Para. 22
5. CNB to increase risk weights by 25 basis points on credits to nongovernment clients exposed to foreign-currency-related credit risk, effective end-June 2006.	Annex, Para. 19
Performance clauses 1/	
1. No new external payments arrears.	MEFP, Para. 27
2. No new, or intensification of existing, restrictions of the making of payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, or import restrictions for balance of payments reasons.	MEFP, Para. 27

1/ To be monitored on a continuous basis.

TECHNICAL MEMORANDUM OF UNDERSTANDING

I. Limits on the Cumulative Deficits of the Consolidated General Government

	Ceilings
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	4,216
June 30, 2006 (performance criterion)	6,635
September 30, 2006 (indicative target)	6,488

1. The above ceilings on the cumulative deficit of the consolidated general government are on a GFS2001 basis (including net lending). The consolidated general government includes: (i) central government operations, that is, the central government budget (the Office of the President, the parliament, the government, the constitutional court, all ministries, other independent state administration and judicial bodies); (ii) existing central budgetary funds (health, pension, employment, and water management) and agencies (the agencies for state aid, for investment and export promotion, and for small and medium-sized enterprises); (iii) the highway (HAC) and road (HC) construction and maintenance agencies, the privatization fund (HFP), the bank rehabilitation and deposit insurance agency (DAB), and the Environment Protection Fund; and (iv) the 53 largest local governments (20 counties, Zagreb, and 32 other cities). The above ceilings exclude all transactions related to the 1998 decision U-I-283/1997 by the Constitutional Court in relation to pensioners' debt repayments. The government does not intend to establish new budgetary or extrabudgetary funds or agencies during the program period, but any new funds or agencies would be covered by the ceilings. In accordance with paragraph 11 of the Annex, if a restructuring plan for the state-owned shipyards is not approved by the government by June 30, 2006, all state aid to shipyards after that date shall be included in budgetary spending of the central government.

2. Paragraph 10 of the Annex provides that additional revenue in excess of the budget projections will be saved. To that effect, the above cumulative ceilings on the deficit will be adjusted downwards by the amount of excess revenue at the consolidated central government level (covering (i)-(iii) above) over the amount of HRK 21,344 million for March 31, HRK 45,674 million for June 30, and HRK 71,665 million for September 30. This adjustor will exclude revenues arising from new taxes or changes in existing tax rates.

3. For purposes of the program, the deficits of the consolidated central and general governments will be defined on a modified accrual basis, with cash data corrected for changes in outstanding stock of central and local government arrears and commitment based spending reported for HAC and HC.

4. Fiscal performance will be monitored monthly at the consolidated central government level covering (i)-(iii) defined above and tested quarterly at the consolidated general government level covering (i)-(iv) defined above with the test dates for 2006 being March 31, June 30, and September 30. The Ministry of Finance will provide data for consolidated central government on a monthly basis within 30 days from the end of the month and data for local governments every 3 months within 30 days from the end of the month.

5. The Ministry of Finance will report the reconciliation between the change in the general government debt stock and the deficit of the general government during each quarter within 45 days from the end of the quarter, in the form of the following table, which is a part of this Technical Memorandum of Understanding.

Table 1. Croatia: Reconciliation of General Government Deficit Financing and Change in Debt

Financing flows:			
Cumulative general government deficit			
	Financed by:		
		Capital revenues	
		Net borrowing 1/	
			Disbursements
			Repayments
		Other financing flows	
			Deposit drawdowns
			Change in arrears
			Other (residual)
Change in the Debt stock:			
Nominal change in debt stock from XX to YY 2/			
	Explained by:		
		Net borrowing 1/	
		Debt assumptions by government without repayments	
		Debt repayments assumed by government	
		Valuation effects	
		Other	

1/ Excluding repayment by government of assumed/guaranteed debt and loan-financing of these repayments.
2/ Does not include changes in the stock of guarantees and arrears.

II. LIMITS ON THE CUMULATIVE CHANGES OF THE STOCK OF GENERAL GOVERNMENT ARREARS

	Ceilings
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	150
June 30, 2006 (performance criterion)	300
September 30, 2006 (indicative target)	300

6. Arrears include (i) all payments overdue according to their original or modified terms; and (ii) any promissory notes issued by the Ministry of Finance and the central budgetary funds. Arrears comprise both domestic and external payments arrears and are not netted out by government cash holdings in banks. The stock of arrears will be provided monthly to the Fund by the Ministry of Finance within 30 days. Arrears monitored under the SBA are limited to arrears extended by the general government to all entities outside the general government. In case the general government assumes responsibility for arrears extended by entities outside the general government (e.g., hospitals), such arrears will be treated as expenditures of the general government at the time they are taken over by the government. For the purposes of this performance criterion, the stock of arrears will not be affected by the repayment of the HRK 809 million loan from Zagrebacka banka (i.e., should the loan repayment result in reduction of reported arrears, the reported stock will be adjusted upward correspondingly).

III. LIMITS ON THE DEFICIT OF HBOR

	Cumulative Limits
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	-65
June 30, 2006 (performance criterion)	-124
September 30, 2006 (indicative target)	-18

7. The above ceilings on the cumulative deficit of HBOR incorporate an adjustment for all general government transfers to HBOR (projected at HRK 595 million for 2006) and are on a GFS1986 basis with revenues comprising interest receipts, fees, and other lending-related revenues, and expenses comprising wages, use of goods and services, interest payments, net lending, and capital spending.

8. Fiscal performance by HBOR will be monitored on a monthly basis and tested on a quarterly basis with March 31, June 30, and September 30 being the test dates for 2006. HBOR will provide data on a monthly basis within 30 days of the end of the month.

IV. CEILINGS ON THE CONTRACTING OF NONCONCESSIONAL EXTERNAL DEBT BY THE GENERAL GOVERNMENT AND HBOR

	Ceilings	
	(In millions of euros)	
	Ceilings	Subceilings ≤1 year
Cumulative changes from December 31, 2005:		
March 31, 2006 (performance criterion)	362	0
June 30, 2006 (performance criterion)	427	0
September 30, 2006 (indicative target)	597	0

9. For program purposes, the term "debt" is understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future points in time; these payments will discharge the principal and/or interest liabilities under the contract. (For details of definition of debt, refer to "Guidelines on Performance Criteria with respect to External Debt in Fund Arrangements" (IMF Executive Board Decision No. 12278—[00/86], August 25, 2000). Debt includes commitments contracted or guaranteed for which value has not been received. The limits on short-term debt do not apply to normal import-related credits and nonresident deposits in state-owned banks (HPB, HBOR).

10. Concessional loans are defined as those with a grant element of at least 35 percent, using currency-specific discount rates based on the six-month average commercial interest rates reported by the OECD (CIRRs) for loans with maturities of less than 15 years, and on the 10-year average CIRRs for loans with maturities of 15 years and more.

11. The ceilings will be raised by the amount by which the government retires existing debt before its scheduled maturity.

12. Debt falling within the limits shall be valued in euro at the following exchange rates of December 31, 2005 (in kuna per unit of foreign currency) at each test date:

Euro	7.375626
U.S. dollar	6.233626
Japanese yen (100)	5.308115
Pound sterling	10.753209
Swiss franc	4.744388
SDR	8.912040

13. Information on the contracting of new debt falling both inside and outside the limits will be reported monthly to the Fund within 30 days by the CNB.

V. Limits on the Cumulative Issuance of Debt Guarantees Extended by the General Government

	Ceilings
	To all entities outside the consolidated general government (In millions of kuna)
Cumulative changes from December 31, 2005:	
	1,705
March 31, 2006 (performance criterion)	2,610
June 30, 2006 (performance criterion)	2,814
September 30, 2006 (indicative target)	

14. Cumulative issuance of debt guarantees listed above will be measured at the exchange rates listed in Section IV. The above limits cover debt guarantees issued by the general government to entities outside the general government as well as guarantees extended for HBOR's lending to entities outside the general government. The limits do not cover guarantees extended to HBOR's borrowing from entities outside the general government. The above ceilings are set on the assumption of repayments of HRK 1,347 million of guaranteed loans by the government for the year as a whole and will be adjusted upward by the amount of cumulative company repayments of the underlying loans during 2006.

15. Guarantee issuance will be monitored on a monthly basis. The Ministry of Finance will provide, within 30 days from the end of the month, data on gross issuance of guarantees and repayments of guaranteed loans by both the original borrowers and by the government. Performance will be tested on a quarterly basis and in 2006 with March 31, June 30, and September 30 as test dates. In addition, for the purpose of public debt statistics, the Ministry of Finance will provide the same set of data on gross issuance and repayments, calculated at spot exchange rates, within 30 days following each test date.

VI. Indicative Limits on the Cumulative Increases in the Total Debt Stock of Selected Public Enterprises

	Indicative limits
	(In millions of kuna)
Cumulative changes from December 31, 2005:	
March 31, 2006	-28
June 30, 2006	-97
September 30, 2006	169

16. The above listed indicative aggregate limits cover the following 8 enterprises:

1. Hrvatska Elektropriveda, Zagreb (Croatian Electricity Company)
2. Hrvatske Željeznice, Zagreb (Croatian Railroads)
3. Hrvatske Šume, Zagreb (Croatian Forests)
4. Hrvatska Pošta, Zagreb (Croatian Post)
5. HRT, Zagreb (Radio and Television Company)
6. Jadrolinija, Rijeka (Shipping Line)
7. Croatia Osiguranje, Zagreb (Insurance Company)
8. Croatia Airlines, Zagreb

17. These cumulative flows include all net borrowing from non-government sectors, including HBOR.

18. Enterprises on the above list in which the government's share falls below 50 percent in the course of the arrangement will be removed from the limits and the limits will be adjusted downward by the amount of the net borrowing of these enterprises by the end of the month preceding privatization. The limits will be adjusted by the amount of any government assumption of their debts.

19. The above indicative limits will be cumulative and will be monitored on the basis of the exchange rates listed in Section IV from data collected monthly by the Ministry of Finance and supplied to the Fund within 30 days.

VII. Floors under the Cumulative Changes in the Net International Reserves of the Croatian National Bank

	Floors
	(In millions of euro)
Stock as of December 31, 2005	5,560
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	-345
June 30, 2006 (performance criterion)	-65
September 30, 2006 (indicative target)	400

20. For purposes of the program, net international reserves of the Croatian National Bank (CNB) are defined as the euro value of reserve assets minus reserve liabilities.

21. For purposes of the program, reserve assets shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the CNB. Any return to the CNB of blocked foreign assets that are not part of CNB reserve assets as of December 31, 2005 will be added to the reserve floor. Reserves that are pledged, frozen or used as collateral shall be excluded from the reserve assets. In particular, any reserve assets pledged to secure government debt will be excluded from the reserves definition.

22. For purposes of the program, reserve liabilities shall be defined as all foreign exchange liabilities of the CNB to residents and foreign exchange and kuna-denominated liabilities of the CNB to non-residents—excluding deposits into the special accounts for external debt servicing—with an original maturity of up to and including one year, as well as liabilities arising from IMF purchases and bridge loans from the BIS, irrespective of their maturity. For purposes of the program, reserve liabilities shall also include arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies, and future and contingent commitments to sell foreign exchange arising from transactions in derivative assets (futures, forwards, swaps, and options). Central government foreign exchange deposits at the CNB are excluded from reserve liabilities.

23. The net forward position of the CNB is defined as the difference between the face value of foreign currency-denominated CNB off-balance sheet claims on nonresidents (forwards, swaps, options, and futures market contracts) and foreign currency obligations to both residents and nonresidents. This position was zero on December 31, 2005. For program purposes, only the off-balance sheet obligations will be deducted from the CNB's net international reserves position. These liabilities amounted to zero on December 31, 2005.

24. For the purpose of program monitoring, the stock of reserve assets and liabilities for each quarter in question will be valued in euro at the exchange rates specified in Section IV.

25. For purposes of the program, the end-of-quarter net international reserves of the CNB are calculated as the arithmetic average of 11 observations centered on the last business day of each quarter. This applies also to the end-2005 stock of net international reserves of the CNB.

26. The limits will be monitored from data on the accounts of the CNB supplied monthly to the Fund by the CNB within 15 days of the last business day included in the observations.

VIII. Limits on the Cumulative Changes in the Net Domestic Assets of the Croatian National Bank

	Ceilings
	(In millions of kuna)
Stock as of December 31, 2005	-1,822
Cumulative changes from December 31, 2005:	
March 31, 2006 (performance criterion)	1,340
June 30, 2006 (performance criterion)	1,470
September 30, 2006 (indicative target)	-1,140

27. The net domestic assets of the Croatian National Bank (CNB) are defined as base money minus the net foreign assets of the CNB, both expressed in local currency at program exchange rates (see Section IV).

28. Base money is defined as currency outside banks, vault cash of banks, giro and required reserve deposits of banks in domestic currency, deposit money, required reserve deposits of banks in foreign currency, restricted deposits, and escrow deposits held at the CNB.

29. Net foreign assets of the CNB are defined as reserve assets plus those foreign assets of the CNB that are excluded from reserve assets under the definition in Section VII, minus foreign liabilities of the CNB.

30. If the reserve requirement ratio and/or the definition of liabilities subject to reserve requirements is changed during the program period, the CNB will consult with the Fund to modify the above limits appropriately.

31. For the purposes of the program, the net domestic assets of the CNB and the base money at the end of each quarter will be calculated as the arithmetic average of 11 observations centered on the last business day of the quarter. This applies also to the end-2005 stock of net domestic assets of the CNB.