International Monetary Fund

Republic of Croatia
and the IMF

Press Release:
IMF Executive Board
Completes First
Review of Croatia's
Stand-By Arrangement
September 14, 2005

Country's Policy
Intentions Documents

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

August 7, 2005

Zagreb, 7 August, 2005

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

Dear Mr. de Rato:

The government remains fully committed to limiting external vulnerability and preparing Croatia for EU accession through the implementation of its economic program for 2004–05, which is being supported by the 20-month Stand-By Arrangement (SBA) approved by the Fund in August 2004.

We are requesting completion of the first review under the program. All quantitative performance criteria for end-December 2004 have been observed, save for the targets on the reduction of general government arrears and on the general government deficit, for which we are requesting waivers. The deep-seated structural problems in the health sector have so far constrained our ability to reduce arrears. Following our initial measures last year, we are introducing new reforms to address these problems more forcefully. A delay and shortfall in expected one-off revenues and lower than-anticipated indirect tax collections were the main reasons for the breach of the end-December performance criterion on the general government deficit. Absent the lower-than-expected one-off revenues in 2004, the breach would have been contained to around ¼ percent of GDP. Structural policies were in line with the program and all structural benchmarks were observed, except for the benchmark on reconciliation of government debt guarantee registers, although significant progress has been made in this area.

We are continuing to implement policies that will achieve the program's objectives and are proposing to establish quantitative performance criteria for end-September and end-December 2005, as well as rephase the scheduled purchases under the Arrangement from four purchases to two purchases. The budget for 2005 initially targeted a deficit of 3.7 percent of GDP. However, owing to the weak revenue base last year, slower than expected economic growth in 2005, a delayed change in the pension indexation formula, and some unplanned spending commitments during the first half of the year, it has proved impossible to reach this target. We have thus revised the deficit target to 4.2 percent of GDP in the context of a supplementary budget approved on July 13. While the deficit is somewhat higher than originally planned, we are satisfied that it remains consistent with our external debt objective and macroeconomic stability. Moreover, in order to assure continued fiscal consolidation over the medium term we are taking additional steps to strengthen tax collection and generate permanent fiscal savings. These policies, as well as other components of the strengthened structural agenda, are explained in the attached Annex to our original

Memorandum on Economic and Financial Policies of July 13, 2004 and Technical Memorandum of Understanding (TMU).

The discussion with staff on the second program review planned for October-November 2005 will focus on the 2006 budget, including the macroeconomic effects of settlement of outstanding debt of the government to pensioners.

We believe the policies set forth in the Annex are adequate to achieve the objectives of our program, and we will take any further measures that may become appropriate 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. The government will continue to treat the Stand-By Arrangement as precautionary.

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. As stated in the Memorandum on Economic and Financial Policies (MEFP) attached to our letter dated July 13, 2004 to the Managing Director of the International Monetary Fund, limiting external vulnerability and preparing for EU accession as rapidly as possible continue to be Croatia's paramount goals over the medium term. Our economic strategy, outlined in Croatia's first Pre-Accession Economic Program, which we submitted to the European Commission in December 2004, is consistent with the policy program for 2004–05 supported by the Stand-By Arrangement. This Annex reviews program implementation in 2004, developments in the first half of 2005, and the detailed targets under the policies for the second half of the year.

2. The main pillar of our program included in the MEFP for 2004–05 is an ambitious fiscal adjustment to limit external vulnerability and arrest the increase of Croatia's external debt-to-GDP ratio. At the same time, our program aims at enhancing transparency and financial management in the government and the broader public sector and accelerating key structural reforms. Given its focus on exchange rate stability, monetary policy plays a supporting role.

3. The planned adjustment in 2004–05 would set public finances on a course that meets EU requirements in the medium term, in particular by bringing the general government deficit to under 3 percent of GDP by 2007, while the structural components of our program would support fiscal consolidation and boost Croatia's growth potential.

I. Program Implementation in 2004

4. Our policies during 2004 were firmly oriented toward these objectives and consistent with the targets detailed in our MEFP. Despite the fact that the 2004 budget was passed only in March, we achieved a major reduction in the general government deficit from 6.3 percent of GDP in 2003 to 4.9 percent in 2004. All quantitative performance criteria for end-September and end-December 2004 were met, with two exceptions (Table 1):

- The end-December performance criterion on the deficit of the general government was exceeded by HRK 1.2 billion mainly due to a delay in the receipt of the proceeds from the last auction of GSM/UMTS licenses, a shortfall in the profit transfer from Croatian Telecom (HT), and lower-than-expected indirect taxes. The shortfall does not affect the cumulative fiscal adjustment targeted under our program for 2004-05 and, given the one-off nature of some of these revenues, it had only a negligible impact on aggregate demand.

- The end-September performance criterion on the reduction of general government arrears was missed by HRK 101 million and the end-December performance criterion by HRK 684 million. This reflected long-standing structural weaknesses in the health sector, notably inadequate cost control and overconsumption. A number of measures we introduced in June 2004 helped lower the growth in health sector arrears, but their impact during the second half of 2004 was not sufficient to ensure observance of the overall target on arrears reduction. Additional measures, specifically targeted toward controlling health costs, were implemented in early 2005 (¶19).

All other quantitative performance criteria for 2004 were met, some by wide margins. Moreover, structural policies were in line with our program and all structural benchmarks for 2004 were observed, except for the benchmark on the reconciliation of the debt guarantee register between the Ministry of Finance and the CNB, which was delayed.

5. Program implementation in 2004 has started to yield results. Balance of payments data for 2004 show that Croatia's external position has strengthened as projected under the program despite higher oil prices. Indeed the current account deficit for the year fell to 4.5 percent of GDP, around 1 percentage point better than expected, due to buoyant merchandise exports, as well as a large repatriation of income from a Croatian pharmaceutical company's foreign subsidiaries. Gross external debt at end-December was 82 percent of GDP and equal to its end-May level, the benchmark used in our program, and has subsequently fallen to reach 81 percent of GDP in April.[1]

II. Macroeconomic Policies in 2005

6. Although we expect economic activity in Croatia to continue at a satisfactory pace in 2005, we now project real GDP growth to average 3½ percent, lower than our previous forecast from end-2004 due in part to an upward revision of oil price assumptions and the slowdown evidenced in the first quarter. Inflation will be higher than in 2004 but will remain at around 3 percent, underpinned by our policy of exchange rate stability. We expect the current account deficit to remain at or below 5 percent of GDP. Given the projected level of non debt-creating flows, the stabilization of the foreign debt-to-GDP ratio by end-2005—a key macroeconomic objective of our program for 2004–05—remains within reach.

7. These projections, however, are fraught with risk, especially as regards the impact of oil prices on our major trading partners and our own economy. Although at this stage we expect this impact to be temporary, it has already resulted in slower growth, putting pressure on our budget for 2005, as well as on the private sector, which will have to adjust to higher costs. If oil prices do not decline as projected during 2005, or the external environment deteriorates for some other reason, the impact may be more significant and could necessitate a re-assessment of our external objectives and policies.

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[1] The CNB has started to compile Croatia's external debt data according to the requirements of IMF/WB/OECD/EUROSTAT: *External Debt Statistics - Guide for Compiler and Users, 2003*, with the intention of disseminating the new SDDS external debt template in the first quarter of 2005. Accordingly, the inclusion of hybrid and subordinated debt instruments, repos, late interest, and interest accruals has caused a upward adjustment in the external debt series by 2–3 percentage points of GDP compared to previously released data.

A. Fiscal policy

8. Our 2005 budget, approved last November, set a target for the general government deficit of 3.7 percent of GDP. On the revenue side, we implemented a number of reforms in direct taxes to rationalize the system and remove distortions, notably (i) raising the tax-free threshold for personal income; (ii) lowering the global cap for income tax deductions; (iii) abolishing taxation of distributed profits; and (iv) removing the lump-sum depreciation allowance. These reforms are estimated to be revenue-neutral. The start of operations of the Financial Police in September 2005, is expected to be a major step toward reducing tax evasion, supplemented by the measures included in the government's program against the grey economy, notably establishing a register of concessions and strengthening controls for unregistered employment. On the expenditure side, the budget was burdened by significant structural reform costs. First, reform of the judiciary and institution-building in the areas of environmental protection, waste management, and coastal protection are urgent priorities for harmonization with the *acquis communautaire,* and entail outlays of about HRK 500 million (0.2 percent of GDP). Second, to take full advantage of the EU's Common Agricultural Policy after accession, the budget provides additional resources of HRK 200 million (0.1 percent of GDP) to expand and modernize agriculture in 2005. And third, the budget includes one-off outlays of HRK 1.2 billion (0.6 percent of GDP) resulting from the extension of the application deadlines for resettlement and compensation of war refugees, a necessary step to overcome the enduring legacy of the last war. To meet the 2005 general government deficit target while making room for these priorities, the budget envisages strict spending restraint in other areas, notably the wage bill.

9. However, the combination of lower-than-expected tax revenue collection in 2004; slower growth this year; a delay in the change of the base for indexation of pensions from wages to a price-wage composite, originally planned for February; and a faster-than-planned pace of expenditure growth during the first quarter necessitated a re-assessment of our fiscal policy target for 2005. Left unchecked, these factors would have resulted in a deficit of around 5 percent of GDP, compared to our budget target of 3.7 percent. When the magnitude of the problem became clear during the first half of the year, we decided to act to maintain the integrity of our economic program and medium-term targets. Our strategy has three prongs: (i) a supplementary budget to ensure a general government deficit consistent with the external objectives of the program; (ii) measures to improve tax administration and tax collection; and (iii) an acceleration of structural reforms that will generate permanent savings over time.

10. The government has decided in the context of a supplementary budget approved by the Sabor on July 12, 2005 to take additional fiscal measures aimed at a deficit of 4.2 percent of GDP this year. Given the better-than-expected performance of the balance of payments, this upward revision of the deficit target compared to the original budget is justifiable from a macroeconomic point of view and preserves an increase in the current government surplus relative to 2004. The supplementary budget incorporates an updated revenue projection in line with our latest growth estimates, as well as corrections in certain expenditure items that had not been budgeted properly. To achieve the new deficit target, the supplementary budget also incorporates a number of additional savings measures that focus almost exclusively on

the expenditure side, notably HRK 544 million on goods & services, HRK 418 million on subsidies and grants, and HRK 673 million on investment and capital transfers.

11. Faced with the problems in tax collection, we sought urgent technical assistance from the IMF's Fiscal Affairs Department in the spring of this year. Drawing on the technical assistance mission's recommendations, we have formulated and started implementing an action plan, including in particular the following measures:

- We established a Large Taxpayers' Office for Zagreb, Rijeka, Split, and Osijek.
- The Sabor approved an extension of the time for processing VAT refund claims from the current 15 days to 30 days, in order to harmonize our practice with EU norms and allow sufficient time to our Tax Administration to assess compliance risk.
- We plan to redeploy resources within the tax administration toward VAT audits by end-2005.
- We will develop by end-2005 a VAT refund verification program based on ranking refund claimants according to compliance risk.

12. Finally, in parallel with these measures aimed at containing the deficit in 2005, in recent weeks we also started implementing a number of key structural steps that will yield savings and set fiscal policy on a more sound footing over the medium term. In particular,

- The Sabor approved amendments that reduce the existing subsidy to building societies to encourage home purchases by individuals.
- The Sabor approved a new Civil Service law professionalizing and strengthening the efficiency of the public administration.
- The Sabor amended the VAT law to eliminate the zero rate for foreign tour operators effective January 1, 2006, replacing it with a uniform rate of 10 percent for all tourist accommodation.
- The Sabor promulgated the delayed revision of the indexation formula for pensions from wages to a wage-price composite as of next year.
- The government will tighten the rules and eligibility criteria of the current employment subsidy program to target it better to the long-term unemployed by end-August, 2005.
- We will amend the existing law on State Aid to harmonize procedures for disbursing state aid with EU requirements and strengthen the role of the Agency for Market Competition in order to minimize market distortions by end-September, 2005.

- We will finalize the medium-term subsidy reduction plan in cooperation with the World Bank by end-September.

- We launched a major reform that will shore up the finances of the health system, address the root of the persistent payments arrears in the health system, and lead gradually to a reduction of the cost of health care in Croatia (for details, see ¶19).

We believe that these measures are sufficient to secure our revised general government deficit target for this year and set the basis for a substantial further consolidation in 2006, which will be the main focus of the second review under the Stand-By Arrangement.

13. In line with our program, budget financing will continue shifting to domestic sources; indeed we expect to avoid recourse to net foreign financing for the general government this year. In addition, we expect significant increases in privatization receipts based on our privatization program (¶21).

14. We will continue our efforts to strengthen 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 900 million by reducing its net lending plan by HRK 200 million compared to 2004; 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; continue implementing our restructuring plan for Croatian Railways; and aim at reducing the borrowing requirement of the group of major public enterprises monitored under the program.

B. Monetary and Financial Sector Policies

15. 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. The CNB's monetary program for 2005 is consistent with broad money growth during the year at about 9-10 percent. Gross official reserves at end-2005 are projected at about € 6.7 billion, maintaining reserve coverage at about 4.4 months of following year's imports of goods and non-factor services. Consistent with these targets, the growth in Net Domestic Assets of the CNB during 2005 will be contained to about HRK 5.4 billion. 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. In case of delays in the government's privatization plans for reasons beyond our control, NDA growth would increase. To allow for this, the end-December NDA target would be adjusted by up to HRK 1,461 million, with the exact amount determined by the realized shortfall in privatization revenues. This would, however, not affect the overall monetary targets.

16. In 2005 the CNB has taken steps to strengthen its operational framework and introduced additional measures to support the program objectives. The CNB started open

market operations (OMOs) with Treasury bills in April 2005. OMOs are expected to facilitate the shift towards domestic financing of the government and help develop the domestic financial market. Delivery-versus-payment in real time has been implemented and started operations on July 1, 2005. In preparation for this, we made the necessary amendments in the by-laws of the Central Depository and the CNB in March 2005. In addition, in order to reduce external borrowing and withdraw excess liquidity from the banking system, the CNB raised the marginal reserve requirement on new external borrowing in February 2005 from 24 to 30 percent, and subsequently to 40 percent in May 2005. Also in May, the CNB increased the foreign exchange reserve requirement calculation base allocated in kuna from 42 to 50 percent, and reduced the remuneration rates on both the kuna and foreign exchange components of the reserve requirement. The CNB stands ready to take additional measures if necessary to help maintain the external debt to GDP ratio within acceptable limits.

17. During 2005, we plan to strengthen the legal framework in the financial sector and harmonize it with that in the EU by promulgating the laws on Insurance, Accounting & Auditing, Investment Funds, and the Supervision of Non-Bank Financial Institutions by end-November. The CNB will step up its efforts to improve monitoring of borrowers' exposure to foreign exchange risk and strengthen supervision further, including by requiring banks to collect information on their borrowers' foreign currency exposure as part of their credit risk evaluation, and issuing a guideline for banks to report their exposures to foreign-exchange induced credit risk to CNB. In addition, the CNB is working with the banks to increase their awareness of foreign-currency-related credit risks by requiring them to develop their own internal policies on debtor classification. The unified non-bank supervisory agency is expected to begin operations by January 2006. The CNB also continues to improve cooperation with financial supervisors abroad: it has signed memoranda of understanding (MoU) with supervisors in Austria and Bosnia & Herzegovina, is finalizing an MoU with Italy, and is working on one with Hungary.

C. Structural Reforms

18. We will continue improving transparency and efficiency in public expenditure and debt management during 2005, as outlined in our MEFP. We will take all steps necessary for making the single treasury account fully operational for line Ministries, notably by finalizing a plan for the harmonization of their accounting and IT systems with the treasury by end-2005. As planned, we will also incorporate the accounts of HAC and HC into the single treasury account by end-2005. However, due to delays in privatization, the accounts of DAB and HFP will be incorporated by mid-2006. We will also ensure that the orderly financing of activities currently outside the treasury, notably road and highway investment, will continue after the introduction of the single treasury account. We will start implementing the recommendations of the 2004 Review on Observance of fiscal Standards & Codes. In particular, during 2005 we will (i) enter all loans on the guarantee register at the Ministry of Finance into the FTI STAR system and verify all data in the system against contracts by end-August; (ii) start publishing on a quarterly basis each debt guarantee granted and the amount of gross exposure in the Official Gazette by end-August; (iii) adopt a permanent software solution for debt management consistent with the decision of the IT expert and with support

by EU CARDS by end-August; (iv) introduce an electronic system for treasury bill auctions by end-2005; and (v) establish internal audit units in all budget users in the central government by year-end.

19. Improving the financial situation of the health sector is a major priority in 2005. This requires both immediate action and more fundamental medium-term reforms. In mid-2004, we already implemented a number of measures to improve cost control and enhance accountability. These measures have helped curb the growth of arrears and will continue contributing toward improved financial results for the Health Fund and hospitals in the future. In addition, to control the cost of drugs, we have introduced benchmarking of drug prices, in line with other European countries; unified public procurement of drugs and other supplies for hospitals as of January 1, 2005; and re-negotiated long-term procurement contracts with major suppliers. To address the structural problems in the sector, we have prepared a far-reaching reform aimed at shifting the supplementary insurance scheme to the private sector and introducing co-payments for medical services and drugs provided under the basic insurance scheme, which will remain in state hands. To minimize the impact of this reform on vulnerable groups, these co-payments will be modest and minors and senior citizens will be exempt. Because such a fundamental reform requires the broadest possible political consensus, we have started extensive consultations with the social partners and political parties. We started this process by introducing co-payments and reducing some benefits in July. The remaining reforms will be incorporated into a draft law to be approved by the Sabor by end-2005.

20. Our government is committed to the long-term sustainability of the pension system. In this context, we have revised the base for indexation of pensions from wages to a wage-price composite effective in 2006. In addition, we have started addressing the issue of the outstanding "pensioners' debt" arising from a 1998 Constitutional Court decision. Consistent with our plans outlined in the MEFP, we created a special fund that will receive shares and other state-owned equity to finance the repayment of this liability, which we estimate at HRK 13.8 billion (including accrued interest). We intend to provide eligible pensioners two options: a cash repayment during 2006–07 at a 50 percent discount, or repayment of the full amount over eight years, after a two-year grace period. The details of this scheme are currently being finalized. We will ensure this scheme is consistent with our country's long-term ability to afford such payments, as well as with short-term macroeconomic objectives, and will continue to consult with the IMF and the World Bank staff.

21. We intend to complete the sale of government holdings in companies held by the Privatization Fund (HFP) as soon as possible. However, due to the delays caused by a number of lawsuits against HFP, the original target to privatize all companies in its portfolio is no longer feasible. Consistent with our undertakings under the World Bank PAL, we intend to privatize one-third of all companies in which the government holds a majority stake, including the Uljanik shipyard, and sell the government shares in half of the companies in which the government holds a minority stake by mid-2006. As regards the steel and shipyard companies, in particular, we plan to finalize their restructuring plans in cooperation with the EU and international financial institutions by year-end, which will allow us to begin the process of modernizing the sectors and reducing their burden on the budget over the

medium term. We also plan to sell at least 15 percent of the oil company (INA) and complete the third phase of the privatization of the telecommunications company (HT) by end-December 2005. Pending the resolution of outstanding lawsuits by former shareholders of Croatia Banka, we have decided to merge the last two small state-owned banks by year-end with a view to their eventual privatization. Due to unresolved issues with certain former owners, the preparation of a privatization plan for the state-owned Croatian Insurance company (CO) has been delayed, and we now intend to complete it by year-end.

Table 1. Croatia: Performance under the Stand-By Arrangement during 2004

				End of	
				September	December
			(In millions of kuna, unless indicated otherwise)		
Quantitative performance criteria					
1	Cumulative deficit of the consolidated general government 1/		Program	10,383 4/	9,250
			Actual	9,091	10,446
			Margin (+)	1,292	-1,196
2	Cumulative change of the stock or arrears of the consolidated general government 1/		Program	-100	-300
			Actual	1	384
			Margin (+)	-101	-684
3	Cumulative deficit of HBOR 1/		Program	823	1,093
			Actual	692	904
			Margin (+)	131	189
4	Cumulative increase in nonconcessional external debt contracted by the general government and HBOR 1/ 2/		Program	1,336	1,566
			Actual	1,160	1,161
			Margin (+)	176	405
			Program	0	0
		<1 years	Actual	0	0
			Margin (+)	0	0
5	Cumulative issuance of guarantees extended by the general government 1/		Program	1,724 5/	1,773 5/
			Actual	953	1,170
			Margin (+)	771	603
6	Cumulative change in the Net International Reserves of the Croatian National Bank 2/ 3/		Program	12	-138
			Actual	269	384
			Margin (+)	257	522
7	Cumulative change in the Net Domestic Assets of the Croatian National Bank 1/		Program	7,068 4/	6,945
			Actual	4,739	4,549
			Margin (+)	2,329	2,396
Indicative limits					
1	Cumulative increase in the total debt of selected public enterprises 1/		Program	90	0
			Actual	-97	-76
			Margin (+)	187	76
Structural performance criterion					
1	Government to prepare three-year budgets starting with 2005-07 by end-September 2004.		Observed. Done on September 29, 2004.		
Structural benchmarks					
1	Government to restructure the Debt Management department of the Ministry of Finance by end-September 2004.		Done in early October 2004.		
2	Government to appoint a Working Group by end-September 2004 to prepare the reform to unify the supervision of nonbank financial intermediaries.		Done in early October 2004.		
3	Government to formulate a medium-term business plan on HŽ by end-December 2004 to reduce its reliance on subsidies and improve cost recovery.		Done in February 2005.		
4	Government to complete the register of government debt guarantees, including guarantees by local governments, and reconcile data with the CNB by end-December 2004.		Substantial progress but not completed.		

Source: Data provided by the Croatian authorities.

1/ Ceiling.
2/ In millions of Euros.
3/ Floor.
4/ Adjusted for the delay of receipts of dividend payments by the telephone company (HT) originally expected by September 30, 2004.
5/ Adjusted for the amount of repayments of guaranteed debt by the government in excess of the amount incorporated in ceiling.

Table 2. Croatia: Prior Actions, Performance Criteria, and Structural Benchmarks for 2005

Prior actions for the First Review	
1. Parliament to approve supplementary budget consistent with a general government deficit of 4.2 percent of GDP in 2005.	Annex, Para. 10
2. Government to approve and submit to Parliament amendments to the subsidy to building societies.	Annex, Para. 12
3. Parliament to approve new Civil Service Law.	Annex, Para. 12
4. Government to tighten eligibility criteria for employment subsidies.	Annex, Para. 12
5. Ministry of Finance and the CNB to finalize the agreement on the procedures for the ongoing reconciliation of the registries of government debt guarantees.	Annex, Para. 18
6. Government to appoint the Advisor for sale of state shares in INA.	Annex, Para. 21
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. Government to incorporate the accounts of HAC and HC into the single treasury account by end-2005.	MEFP, Para. 22 and Annex, Para. 18
2. Parliament to approve amendments to the Law on State Aid by end-September 2005.	Annex, Para. 12
3. Government to submit to Parliament for approval the draft law on the reform of supplementary health insurance by end-November 2005.	Annex, Para. 19
4. Government to submit to Parliament for approval the law creating unified supervision of non-bank financial institutions by end-November 2005.	Annex, Para. 17
5. Government to formulate a plan on privatization of CO and complete the third phase of privatization of HT by end-December 2005.	MEFP, Para. 25
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, 2004:	
September 30, 2005	7,941
December 31, 2005	9,165

1. The above ceilings on the cumulative deficit of the consolidated general government are on a GFS2001 basis (including net lending) and cover: (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 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.

2. 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. For purposes of the program, the receipt in February 2005 of HRK 197 million from the auction of GSM/UMTS licenses held in December 2004 is included in the cash revenue for 2005, although this amount is reported as part of the 2004 fiscal outcome.

3. 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 2005 being September 30 and December 31. 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.

4. 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 table attached to this Technical Memorandum of Understanding.

II. Limits on the Cumulative Changes of the Stock of General Government Arrears

	Ceilings
	(In millions of kuna)
Cumulative changes from December 31, 2004:	
September 30, 2005	-50
December 31, 2005	-100

5. 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.

III. Limits on the Deficit of HBOR

	Cumulative Limits
	(In millions of kuna)
Cumulative changes from December 31, 2004	
September 30, 2005	659
December 31, 2005	866

6. The above ceilings on the cumulative deficit of HBOR incorporate an adjustment for all general government transfers to HBOR 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.

7. Fiscal performance by HBOR will be monitored on a monthly basis and tested on a quarterly basis with September 30 and December 31 being the test dates for 2005. 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, 2004:		
September 30, 2005	400	0
December 31, 2005	725	0

8. 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).

9. 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.

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

11. Debt falling within the limits shall be valued in euro indicated by the following exchange rates (in kuna per unit of foreign currency) at the end of the quarter in question:

Euro	7.307220
U.S. dollar	5.837370
Japanese yen (100)	5.411954
Pound sterling	10.648820
Swiss franc	4.728980
SDR	8.609829

12. 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 issuance from December 31, 2004:	
September 30, 2005	2,820
December 31, 2005	2,931

13. 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 1,031 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 2005.

14. Guarantee issuance will be monitored on a monthly basis and the Ministry of Finance will provide data within 30 days from the end of the month. Performance will be tested on a quarterly basis and in 2005 with September 30 and December 31 as test dates.

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, 2004:	
September 30, 2005	200
December 31, 2005	305

15. 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

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

17. 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.

18. The above indicative limits will be cumulative and will be monitored on the basis of the average quarterly exchange rates (as 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, 2004	6,434
Cumulative changes from December 31, 2004:	
September 30, 2005	300
December 31, 2005	150

19. For purposes of the program, net international reserves of the Croatian National Bank (CNB) are defined as the euro value of gross foreign assets minus gross foreign liabilities minus off-balance sheet foreign currency obligations.

20. For purposes of the program, gross foreign 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 foreign assets as of December 31, 2004 will be added to the reserve floor. Reserves that are pledged, frozen or used as collateral shall be excluded from the gross foreign assets. In particular, any reserve assets pledged to secure government debt will be excluded from the reserves definition.

21. For purposes of the program, reserve liabilities shall be defined as all 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 guarantees provided by the CNB backed by reserves as collateral.

22. 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, 2004. 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, 2004.

23. 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.

24. The December 31, 2005 floor above will be adjusted downward by an amount up to € 150 million in case the PAL disbursement by the World Bank is not received by December 31, 2005.

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.

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)
Cumulative changes from December 31, 2004:	
September 30, 2005	3,537
December 31, 2005	5,415

27. The net domestic assets of the Croatian National Bank (CNB) are defined as the difference between the base money and the net international reserves of the CNB (as defined for program purposes in Section VII ¶19-21), both expressed in local currency at current exchange rates. Base money is defined as currency outside banks, vault cash of banks, giro and required reserve deposit of banks in domestic currency, deposit money, required reserve deposit of banks in foreign currency, restricted deposits, and escrow deposits held at the CNB.

28. 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.

29. 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.

30. The December 31, 2005 ceiling above will be adjusted upward by an amount up to HRK 1,096 million in case the PAL disbursement by the World Bank is not received by December 31, 2005.

31. In case of a shortfall in the privatization receipts received by December 31, 2005 from the sale of government shares in INA and HT, compared with expected receipts of HRK 2,000 million in the fourth quarter of 2005, then the above December 31, 2005 ceiling will be adjusted upward by an amount equivalent to the shortfall up to a maximum of HRK 1,461 million.

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.