Zagreb, Croatia
December 16, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

1. We would like to inform you about the policies we have been pursuing in the fourth quarter of 2003 to achieve the objectives of our economic program for 2003 that is supported by the International Monetary Fund through a 14-month stand-by arrangement in an amount of SDR 105.88 million (29 percent of quota). As outlined below, we believe that these policies are adequate to allow us to observe all but one of the quantitative performance criteria for December 31, 2003. We also expect to meet the two structural benchmarks for end-2003, albeit one of them with a few weeks' delay in January 2004. It is our hope that the third review under the stand-by arrangement can be completed by the Fund once the new government has adopted its fiscal program and structural policy intentions for 2004.

The Expected Economic Outcome in 2003

2. A much stronger than expected peak tourist season has prompted us to revise once more the real GDP growth projection for 2003 to 5 percent (Table 1). As a result, and notwithstanding economic weakness in our principal foreign markets, we now expect a positive net external contribution to economic growth for the first time in three years. At the same time, policy tightening and election related uncertainties appear to be slowing private domestic demand more than expected at the second program review. Following an unexpected drop in October, retail price inflation rose to 1.9 percent in November 2003, with core inflation at 1.3 percent. However, despite the small acceleration in November, average retail price inflation in 2003 should be lower than expected at the second review at 1.5 percent. Reflecting the strong tourist receipts, the external current account deficit is expected to be reduced to 5.4 percent of GDP in 2003, most of which would be financed by foreign direct investment. Nevertheless, because of large unidentified financial outflows and net international reserve gains by the Croatian National Bank (CNB) as well as a weaker U.S. dollar, the external debt ratio is projected to rise from 68.5 percent of GDP at end-2002 to more than 74 percent of GDP at end-2003.

Fiscal Policy

3. Fiscal policy remains on target to reduce the general government deficit from 4.8 percent of GDP in 2002 to 4.5 percent of GDP (compared with 4.6 percent of GDP programmed) in 2003 and to stabilize the public debt ratio (including arrears and guarantees) at around 51 percent of GDP. The deficits of the highway construction agency (HAC) and the privatization fund (HFP) will be larger than expected at the second review, the former because of above-budget capital spending, and the latter because of higher subsidies, capital transfers and lending operations related to enterprise restructuring. However, the performance of the other central budgetary units and local governments is better than budgeted, allowing a lower than programmed deficit at the general government level. Revenue data through November indicate shortfalls in nontax revenue (mainly lower concession fees, dividends from public enterprises, and own revenues of the Ministries of Defense and Interior) and tax collections (mainly excises). As lower state budget expenditure during the first nine months was not the result of the late receipt of the proceeds of the partial privatization of the oil company (INA), we intend to preserve most of the savings achieved to cushion against the expected revenue shortfall. The expenditure savings are believed large enough to allow transferring an additional 0.1 percent of GDP to health institutions outside the general government consolidation for the settlement of arrears to their suppliers.

4. At US$ 505 million, the INA privatization proceeds substantially exceed the general government's financing needs in the fourth quarter. With foreign loan disbursements smaller than projected, there will likely be a small reduction of external public debt in the fourth quarter. To meet its domestic financing needs, the government is selling US$ 400 million of its privatization receipts to the CNB in November-December, using the balance for external debt service payments. The government is meeting the balance of its gross domestic financing needs by rolling over Treasury bills at higher interest rates, supporting the CNB's attempts at tightening liquidity. The government reaffirms its commitment not to use the proceeds of the US$ 100 million SAL disbursement from the World Bank until early 2004. Finally, with their planned reduction in the fourth quarter, central government arrears are expected to be all but eliminated.

5. Looking back at four years of fiscal consolidation, we have reduced the size of the general government by 7½ percentage points of GDP and reduced the fiscal deficit by 3¾ percentage points of GDP (Table 2). While this is a significant achievement, we realize that further fiscal adjustment is needed to help reduce the still large external current account deficit, raise the economy's efficiency and growth, and meet the competitive pressures of the EU single market.

Monetary, Exchange Rate and Financial Sector Policies

6. The growth of bank credit to the nongovernment sector has continued to slow down. Aided mainly by the administrative credit controls introduced in January 2003, the twelve-month rate of nongovernment credit growth was 15.1 percent in October and is expected to decline further to 14¼ in December [1], compared with 31.3 percent at end-2002. Although corporate credit decelerated much faster (from 20.6 percent in December 2002 to 3 percent in October 2003) than household credit, the corporate sector was able to step up its financing through leasing and direct external borrowing. As a result, corporate credit from all sources is estimated to have slowed more moderately from about 23½ percent in 2002 to about 15 percent in 2003.

7. Under an agreed schedule, the CNB will buy US$ 400 million of the INA privatization receipts by December 18. To absorb the attendant release of liquidity, the CNB has further increased the portion of reserve requirements against banks' foreign liabilities that must be held in domestic currency from 35 percent to 42 percent. Nonetheless, money market interest rates have declined from 6-8 percent in September to 2.1 percent in early December and the domestic currency has become subject to depreciation pressure. Concerned that the pace of depreciation might trigger the withdrawal of large deposits, the CNB sold about € 60 million each in November and December in the foreign exchange market. Largely as a result of the interventions, the CNB now expects to miss the end-2003 performance criterion on the increase in its net usable international reserves by some US$ 150 million (2 percent of end-2003 gross international reserves). However, prospects remain good for the CNB to observe the performance criterion on its net domestic assets for end-2003.

8. The CNB reaffirms its intention to lift the administrative credit controls at end-2003 and to consider adopting a new monetary policy framework in the course of 2004. Fund technical assistance to prepare for the regime shift has been scheduled for early February 2004. Pending the introduction of the new framework, the CNB will use its existing tool kit to keep monetary conditions appropriately tight.

9. Against the backdrop of continued improvement in banks' financial soundness indicators for the third quarter of 2003, the CNB has further strengthened its supervisory capacity.

- It has been restructuring its banking supervision department to enable conducting on-site supervision more on a risk basis, starting January 1, 2004.

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[1] Adjusted for exchange rate changes and attempts by banks to evade the controls through securitization and asset swaps, the rate of expansion is about 2½ percentage points higher. Banks also seem to have increased the room for fresh credits under the ceilings by more liberal recourse to loan writeoffs in 2003.

- It has been testing commercial banks' preparedness for the implementation of the by-laws to new banking law, which will come into effect on January 1, 2004.
- A survey of foreign exchange exposures of banks' largest customers, recently conducted by the CNB, indicated that there might be gaps in banks' monitoring of this part of the credit risk. Following up on the results of the survey, the CNB will immediately start examining foreign exchange exposures of banks' borrowers in more detail as part of its on-site examinations.
- In November, the CNB signed a memorandum of understanding (MOU) with bank supervisors in Bosnia and Herzegovina; MOUs with supervisors in several EU member countries are in late stages of negotiation and expected to be signed in the next few months.

Based on a resolution by the parliament, the Ministry of Finance has been working on organizational arrangements for a council of domestic financial sector regulators, to regularly meet on cross-sector supervisory issues. The first meeting of the council is expected to take place in January 2004.

Other Structural and Trade Policies

10. The Ministry of Finance has established an interdepartmental working group to oversee implementation of a data action plan and facilitate the work of planned fiscal ROSC and CFAA missions, respectively, from the Fund and the World Bank in early 2004. The Ministry has also developed plans for monthly reports on central government budget execution and monthly revenue projections and financing plans. A register of government guarantees has been developed, but the Ministry will continue to work toward achieving full coverage. The Ministry is also considering to establish a financial planning unit to improve liquidity planning and strengthen control over borrowing; to introduce uniform reporting formats for funds and agencies to ensure prompt reporting and facilitate data consolidation; and to widen the coverage of local government statistics from the 53 largest units to all those able to submit such information electronically. As these reforms would strengthen the operations of the Ministry of Finance, we expect the new government to endorse their implementation. The Fund provided fiscal advisor should ensure continuity in this endeavor.

11. Defense sector reform is progressing, and we expect the net reduction of employment in the sector to reach some 7,500 by the end of 2003.

12. Following the government's decision to adopt a new privatization law, no new privatizations have been initiated. However, the privatization of eight companies in tourism, manufacturing and publishing is continuing.

13. As envisaged under the stand-by arrangement, the government has approved an increase of capital in the postal bank (HPB). An IFC mission was in Zagreb in November to conduct due diligence, which is expected to lead to the IFC Board's approval of the subscription of 19

percent of the bank's capital. The approval is currently expected in January 2004 rather than by end-December 2003 (structural benchmark).

14. In line with the competition agency's (AZTN) recommendation, we have decided to suspend the introduction, originally planned for January 1, 2004, of a Sunday shop opening ban for large retailers until the new government has had an opportunity to examine the issue.

15. The government has made progress in removing obstacles to concluding a trade agreement with Serbia-Montenegro and expects that it will be possible to implement this agreement in the first half of 2004.

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16. In conclusion, we believe that our program implementation during 2003 has been broadly satisfactory, and it is our sincere hope that the third review can be completed early next year.

Sincerely yours,

/s/	/s/	/s/
Slavko Linić Deputy Prime Minister	Mato Crkvenac Minister of Finance	Željko Rohatinski Governor Croatian National Bank