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COUNTRY ASSISTANCE STRATEGY

FOR THE

REPUBLIC OF CROATIA

November 24, 2004

South Central Europe Country Unit
Europe and Central Asia Region

International Finance Corporation
Southern Europe and Central Asia Department

GOVERNMENT FISCAL YEAR:

The date of the last Country Assistance Strategy Progress Report was September 18, 2001.

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(Exchange Rate as of October 31, 2004)

Currency Unit = Croatia Kuna (HRK)
US$ = 5.875 HRK

GOVERNMENT'S FISCAL YEAR:
(January 1 – December 31)

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Services
APL	Adaptable Program Loan
BIDFacility	Balkans Infrastructure Development Facility
BRA	Bonds for banks' rehabilitation
CARDS	Community Assistance for Reconstruction, Development and Stabilization
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CEEC	Central and Eastern European Countries
CEFTA	Central European Free Trade Agreement
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CHF	Swiss franc
CNB	Croatian National Bank
CPAR	Country Procurement Assessment Report
CPF	Croatian Fund for Privatization
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Europe and Central Asia
EIB	European Investment Bank
EIOP	European Investor Outreach Program
EU	European Union
EU8	EU New Member States as of May 1, 2004, excluding Malta and Cyprus
EU15	EU Member States prior to May 1, 2004
EUROSTAT	Statistical Office of the European Communities
FDI	Foreign direct investment
FFED	Frozen foreign exchange deposits
FIAS	Foreign Investment Advisory Service
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GEF	Global Environment Facility
GNI	Gross National Income
HBOR	Croatian Bank for Reconstruction and Development
HDZ	Croatian Democratic Union
HEP	Hrvatska Elektroprivreda (Croatia's national electric utility)
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
HRK	Croatian Kuna
HZ	Croatian Railways
HZZO	Croatian Institute for Health Insurance
IBRD	International Bank for Reconstruction and Development
IDPs	Internally displaced persons
IFA	Institutional Fiduciary Assessment
IFC	International Finance Corporation
IFI	International financial institution
ILO	International Labor Organization
IMF	International Monetary Fund
IT	Information technology
JPY	Japanese Yen
JPR	Joint Portfolio Review
KfW	Kreditanstalt Für Wiederaufbau
M&E	Monitoring and evaluation
MATRA	Social Transformation Program
MFI	Multilateral financial institution
MIGA	Multilateral Investment Guarantee Agency
MoF	Ministry of Finance
NBJ	National Bank of Yugoslavia
NGO	Non-governmental organization
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
OSCE	Organization for Security and Cooperation in Europe
PAL	Programmatic Adjustment Loan
PEIR	Public Expenditure and Institutional Review
R&D	Research and Development
SAA	Stabilization and Association Agreement
SAL	Structural Adjustment Loan
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
SIDA	Swedish International Development Agency
SME	Small and medium enterprises
SOE	State-owned enterprise
TA	Technical assistance
TB	Tuberculosis
UK	United Kingdom
UNDP	United Nations Development Program
UNHCR	United Nations High Commissioner for Refugees
USAID	United States Agency for International Development
USD	United States dollar
WBI	World Bank Institute

MANAGERS AND STAFF RESPONSIBLE FOR THIS CAS

IBRD		IFC	
Vice President:	Shigeo Katsu	Vice President, Operations:	Assaad Jabre
Country Director:	Anand Seth	Director, SECA:	Khosrow Zamani
Acting Country Manager:	Albert Martinez	Country Manager:	Roberto Albisetti
Country Economist:	Sanja Madzarevic-Sujster	Task Leader:	Gjergj Konda
CAS Team Leader:	Myla Taylor Williams		

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NOTE: While this CAS adopts a results-based format, it is not an official results-based CAS pilot.

COUNTRY ASSISTANCE STRATEGY
FOR
THE REPUBLIC OF CROATIA

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EXECUTIVE SUMMARY

The main strategic objective of the Croatian government is successful accession to the European Union (EU), so that Croatia enters the EU as a dynamic and competitive economy that can rapidly achieve convergence to EU living standards. Actions for successful accession call for reforms that will lead to improved macroeconomic sustainability and more sustainable economic growth, even prior to accession.

Croatia has enjoyed solid but moderating economic growth and low inflation since 1999. Real GDP growth averaged 3.2 percent during 1999-2003 with inflation in the low single digits (below 4 percent). These numbers compare well with eight countries that joined the EU on May 1, 2004 (EU8) as well as the other EU member states (EU15). However, it will be a challenge for Croatia to catch up, as its gross national income per capita (at purchasing power parity) was at about 32 percent of that of the EU15 in 2003.

The economic recovery has been accompanied by a growing external current account deficit. The current account deficit mirrors the widening trade deficit. The current account deficit has gradually widened from 2.5 percent of GDP in 2000 to 8.4 percent in 2002. The growing current account deficit has been financed primarily by a sharp rise in external debt, which has increased the external vulnerability of the Croatian economy. Despite significant foreign direct investment (FDI) inflows, external debt soared from 60 percent of GDP and 128 percent of exports of goods and services in 2000 to 82 percent and 158 percent, respectively, in 2003.

Fiscal performance has been disappointing. The government gradually reduced the fiscal deficit from 8.1 percent of GDP in 1999 to 4.4 percent of GDP in 2002. These gains were, however, partly reversed in 2003 as heavy pre-election spending, especially on large public investments, resulted in a jump in the fiscal deficit to an estimated 5.8 percent of GDP. The higher deficit was largely financed through foreign borrowing: total public and publicly guaranteed debt as a share of GDP rose to 51.9 percent in 2003, and annual public debt service costs increased by 2.5 percentage points of GDP after 2000.

Consolidation of fiscal spending of at least three percentage points of GDP is needed to control the debt and to eventually meet the Maastricht criteria required for the European Monetary Union. Public expenditures in Croatia account for over 50 percent of GDP, which is high compared to EU and other candidate countries. Areas where Croatia spends beyond EU and other candidate countries include the social sectors, infrastructure, subsidies, and the public sector wage bill. Fiscal adjustment in these areas would need to be complemented with improvements in public debt management.

The presence of the state in the economy is significant and would need downsizing. Croatia's private sector share of GDP is 60 percent, lower than in any EU8 country. A poorly functioning judiciary, uncompetitive business environment, and soft budget constraints on enterprises have limited enterprise restructuring and new business creation, and have constrained growth.

Poverty in Croatia is relatively low and shallow. The absolute poverty rate was 11.1 percent in 2001, and income distribution only slightly less equitable than the EU15 average. The poor are predominantly less educated and elderly, and poverty tends to be concentrated in war-affected areas and certain ethnic groups (especially Roma). Limited employment opportunities and inadequate targeting of the social safety net are the main economic causes of income poverty. Croatia has one of the lowest employment-to-population ratios: only about 43 percent of the working age population is employed. This ratio reflects relatively low labor force participation (50.2 percent) and high unemployment (14.3 percent), nearly double that of the EU.

The main objective of the CAS is to support the government's growth and reform strategy for successful EU accession, while ensuring broad participation in growth and sustainable natural resource management. Reflecting the lessons learned from implementation of the previous CAS, the strategy calls for a shift to private sector-driven growth through rationalization of the public sector, establishment of a supportive investment climate, and macroeconomic sustainability.

The CAS includes base, high, and low case lending programs aligned with sustained, accelerated, and slow growth scenarios, respectively, and with triggers for moving from one program to another. Experience in EU8 and candidate countries has shown that once EU accession negotiations are under way, momentum for reform is established and sustained, independent of which government is in office. Hence with good prospects for sustained reform during Croatia's pre-accession negotiations, the planned four-year base case lending volume is about US$1 billion, with an additional US$0.5 billion in the high case. The four-year low-case lending volume is about US$300 million. The increase from past lending levels (which have been on average US$155 million annually for the past three years) is justified by the need to support the acceleration of difficult structural reforms and institution building during Croatia's accession candidate period.

In the base and high case programs a series of Programmatic Adjustment Loans or PALs (sequenced single-tranche development policy loans) will support a government program focusing on improvement of the investment climate, fiscal consolidation, and strengthened governance, including rationalization of the public sector. Two sector expenditure support investment operations will complement the PALs by addressing structural and institutional weaknesses in education and health. Investment operations in other sectors will focus on capacity building for EU accession, trade and transport integration with Europe, mitigation of adverse social impacts of reforms, and sustainable natural resource management. Advisory and analytical services will provide analytical underpinnings for lending operations and policy advice to government in a timely manner. To help private sector companies become more competitive in regional markets, IFC will support privatization and post-privatization restructuring in key sectors, facilitate private sector investment in infrastructure, and combine its financial support with technical assistance. Croatia will continue to participate in the joint World Bank/IMF Public Debt Management and Domestic Debt Market Development Program, and the Bank will step up its assistance to optimize the structure of Croatia's portfolio of IBRD financial products and services, in line with the government's debt strategy.

The results focus of the CAS program, and in particular PALs, requires an effective monitoring and evaluation (M&E) system to assess effectiveness. The PAL has begun the process of designing an M&E system, which will be extended to cover the entire CAS. Country-level intermediate indicators for tracking progress toward CAS outcomes have been quantified where possible, and progress against these indicators will be reviewed as part of the PAL program and investment projects. A CAS Progress Report will be prepared following a mid-term review of CAS implementation and reassessment of the planned FY07-08 assistance program.

The CAS has been developed in consultation with the government and stakeholders (with whom CAS consultations were held in five cities in mid-2004), as well as the European Commission to ensure it supports EU accession requirements, in particular the economic criteria. Bank instruments over the four-year CAS period are aligned to support these requirements, and some loans will be specifically aimed at helping Croatia to maximize its utilization of EC grant funds. The CAS and Croatia's Stand-By Arrangement with the IMF will also be mutually reinforcing, as they both aim at reducing Croatia's external vulnerability through fiscal consolidation, increased transparency and efficiency of public expenditure and debt management, and financial discipline and transparency for state-owned enterprises.

The main risk for the sustained growth scenario comes from potential policy slippages, including some of the post-election pledges. These would derail Croatia from its sustainable growth path and result in a higher and unsustainable fiscal deficit, a growing external balance, a worsening debt profile, and consequently macroeconomic instability. The risk of such slippages to implementation of the base and high case CAS programs is addressed through the self-regulating mechanism of the PAL program. In the event that base and high case triggers (which are closely linked to PAL conditions) were not substantially met or were reversed, Bank assistance would revert to the low case.

As the current HDZ-led government is a coalition with a one-seat majority in Parliament, there is a risk that it will not be able to retain power over the medium term. However, all parties are committed to Croatia's accession to the EU, and so continuity on the associated reform agenda is likely over the longer term. Experience elsewhere in the region has shown that buoyed by widespread public support, the goal of EU accession provides continuity in a candidate country's development program, from one government to the next.

A continuing risk for Croatia as an emerging market with high foreign currency exposure in its public debt is its vulnerability to contagion from adverse developments in international financial markets. Implementation by the Ministry of Finance of the draft reform plan developed under the joint World Bank/IMF Program on Sovereign Debt Management and Debt Markets Development, would directly help to address Croatia's external vulnerability.

In discussing the CAS, the Executive Directors may wish to address the following:

- Do the CAS objectives and themes adequately support Croatia's objective of EU accession as a dynamic and competitive economy that can rapidly achieve convergence to EU living standards?

- Are the lending programs – in particular, the PAL program – and triggers appropriate in light of Croatia's high external debt, small share of the private sector in the economy, and high levels of public spending?

- Have risks to successful CAS implementation been adequately addressed?

CROATIA: COUNTRY ASSISTANCE STRATEGY

I. COUNTRY CONTEXT

A. Introduction

1. **This Country Assistance Strategy (CAS) is prepared in consultation with the government of Croatia and its main objective is to support the government's growth and reform strategy embedded in the European Union (EU) accession process.** The last full CAS for Croatia was discussed at the Board in June 1999, and a CAS Progress Report was discussed at the Board in October 2001. This CAS is the Bank's first four-year CAS for Croatia, covering the Bank's fiscal years 2005 through 2008. It has been prepared jointly by the Bank and IFC in consultation with MIGA. A Progress Report will be prepared following a mid-term review of CAS implementation and reassessment of the planned FY07-08 assistance program.

B. Political Context

2. **There has been significant political change in Croatia since the last CAS Progress Report was discussed at the Board.** Within months of being elected, the Social Democrat-led, center-left coalition government furthered its open economy agenda by signing the Stabilization and Association Agreement (SAA) with the EU as well as the Central European Free Trade Agreement (CEFTA), and in February 2003 it formally submitted Croatia's application for EU membership. Despite continued strong public support for Croatia's integration with the EU, the Social Democrat-led coalition was voted out of office in November 2003, one month after completing politically difficult reforms supported by the Bank's Structural Adjustment Loan (SAL).

3. **The successor government, another coalition, is led by the center-right Croatian Democratic Union party (HDZ), which now projects itself as a centrist party aligned with Croatia's ambition of EU accession.** During the coalition's first four months in office, the new administration focused its attention mainly on the EU. The efforts have paid off, with Croatia's winning a favorable opinion from the European Commission (EC) in April 2004 and the granting of candidate status by the European Council two months later. The accession negotiations are due to begin in early 2005. Notwithstanding these early diplomatic successes, it will be a challenge for the HDZ to govern. With eleven parliamentary seats short of a majority, HDZ negotiated with representatives of national minorities and a newly started Pensioners Party, to form a coalition government that holds a mere one-seat majority in Parliament.

C. Social Context

4. **Poverty in Croatia is relatively low and shallow by international as well as national standards.** A government-sponsored study using nationally representative household budget survey data calculated the absolute poverty rate for 2001 at 11.1 percent. The study concluded that to lift all poor out of poverty with perfect targeting would cost only about one percent of gross domestic product (GDP). It also found no significant differences in the prevalence of poverty by gender. Income distribution[1] is only slightly less equitable than the average for the countries belonging to the EU prior to May 1, 2004 (EU15), and according to the Central Bureau of Statistics Croatia's relative poverty rate for income[2] in 2003 (at 16.9 percent) was only slightly higher than the EU15 average (below 15 percent) and an improvement from 18.2 percent in 2002.

5. **Some regions (especially war-affected areas) and certain ethnic groups (especially Roma) have higher poverty rates.** GDP per capita in the poorest county (Vukovarsko-Srijemska) is one-third that

[1] Measured by the Gini coefficient at 0.29 in 2003.
[2] Defined as the percentage of persons whose net income is less than 60 percent of the median net income of all households.

of the city of Zagreb. Overall, the poverty profile is dominated by two groups of Croats: the poorly educated and the elderly. Nearly three-fourths of the poor live in families whose head has only a primary education or less. The poverty profile reveals two main economic causes of income poverty: limited employment opportunities and inadequate targeting of the social safety net. With a population of 4.4 million, Croatia has one of the lowest employment-to-population ratios: only about 43 percent of the working age population (age 15 or more) is employed. This ratio is a reflection of relatively low labor force participation (50.2 percent) and high unemployment. Although the unemployment rate has been falling since it peaked at 16.1 percent in 2000, it remains high at 14.3 percent in 2003,[3] nearly double that of the EU. (See Annex B5.)

6. **Despite Croatia's post-war economic recovery, reconstruction and refugee return remain important issues in the government's program.** In the country's Areas of Special State Concern, basic infrastructure still requires rehabilitation, and over 1,700 square kilometers are mined or suspected of being mine-contaminated. Sustainable return of refugees and internally displaced persons (IDPs)[4] will require complementing physical prerequisites (security, infrastructure, de-mining) with reintegration and economic revitalization. The government is committed to creating an atmosphere conducive to the return and reintegration of displaced persons.

7. **Croatia's prospects for meeting the Millennium Development Goals are considered likely in all areas but HIV/AIDS and TB and environmental sustainability, for which prospects are clearly possible but considered less certain at this stage** (see Table 1).

Table 1: Croatia and the Millennium Development Goals

MDG Goal	Selected Indicators	1990 value	Most recent estimate	ECA Average	Prospects of Meeting MDG
1. Eradicate Extreme Poverty and Hunger	Population below US$1/day (%)	..	2.0 (2001)	5.1	Likely
	% Income or Consumption by Poorest 20%	..	8.3 (2001)	..	
2. Achieve Universal Primary Education	Net primary enrollment ratio (%)	78.8	95.4 (2002)	..	Likely
	Youth literacy rate (% 15-24)	99.6	99.8 (2002)	99.2	
3. Promote Gender Equality	Ratio of girls to boys in primary/secondary education (%)	97.3	97.2 (2002)	..	Likely
	Ratio young literate females to males (%)	100.0	100.0 (2002)	..	
4. Reduce Child Mortality	Under five mortality (per 1000)	12.5	8.7 (2002)	23.8	Likely
	Infant mortality (per 1000)	10.7	7.0 (2002)	24.8	
	Immunization, measles (% under 12 months of age)	90.0	94.7 (2002)	95.3	
5. Improve Maternal Health	Maternal mortality ratio (per 100,000 live births)	..	9.9 (2002)	..	Likely
6. HIV/AIDS and TB	Prevalence of HIV, female (percent ages 15-24)	..	0.0 (2002)	0.4	Maybe
	Incidence of TB (per 100,000)	..	33 (2002)	90.3	
7. Ensure environmental sustainability	Forest area as percent of total land area	31.5	35.1 (2002)	39.7	Maybe
	Access to improved water source (% population)	..	95 (2000)	90.9	

Note: Prospect categories are Likely, Maybe, Unlikely, or No Data. Assessment is based on *Achieving the Human Development Goals in ECA (2003).* Data is most recent from the Bank's Development Economics Group. The UNDP supported consultative process in Croatia may lead to a revised and more nationally based assessment.

[3] Using the International Labor Organization (ILO) definition of unemployment.
[4] As of June 2004 the Organization for Security and Cooperation in Europe and United Nations High Commissioner for Refugees (OSCE/UNHCR) reports that about 110,000 Croatian Serb refugees have returned while the displaced population originating from Croatia which remains in neighboring countries is estimated at 215,000.

D. Recent Economic Developments

8. **Since the 1999 recession, Croatia has enjoyed solid but moderating economic growth and low inflation.** Real GDP growth averaged 3.2 percent during 1999-2003 with inflation in the low single digits (below 4 percent). These numbers compare well with countries that joined the EU on May 1, 2004 (EU8[5]) as well as the EU15. However, the challenge of catching up with the EU15 remains high, as gross national income (GNI) per capita (at purchasing power parity) was at about 32 percent of EU15 in 2003.

9. **The current growth pattern, mainly public sector investments and consumption driven, is not sustainable.** Public investment, particularly in motorways, has averaged an extraordinary 6.5 percent of GDP in recent years. Accompanied by a credit-financed surge in domestic demand and a sharp reversal of fiscal policy as spending discipline broke down in the run-up to the November 2003 elections, this caused a rise in external vulnerability of the economy. (See Figure 1.)

10. **The economic recovery has been accompanied by a growing external current account deficit.** The current account deficit mirrors the widening trade deficit. The current account deficit has gradually widened from 2.5 percent of GDP in 2000 to 8.4 percent in 2002. Late response of the Croatian National Bank (CNB) in 2003, through introduction of administrative credit ceilings and increased local currency component of reserve requirements on banks' foreign currency liabilities, has succeeded in curtailing credit growth from 30 percent in 2002 to 15 percent in 2003; however, the current account deficit remained high at 7.3 percent of GDP. Circumvention of credit ceilings has resulted in rapid expansion of unregulated leasing operations, and corporate borrowing has switched from domestic to foreign banks.

Box 1: Relatively Sound Banking System

According to the joint Bank-Fund Financial Sector Assessment Program (FSAP, 2002), Croatia has a relatively sound banking system. Since 1996 the system has undergone major consolidation, and banking regulation and supervision have improved. The banking system today is 91 percent foreign owned, and there is increasing competition for products and services. By the end of 2003, non-performing loans had declined to 5.1 percent of total loans, banks' net open foreign exchange position had increased only slightly to 13 percent of capital, and profitability and capitalization remained strong. Nevertheless, given the high degree of euroization in the financial system, the financial sector remains vulnerable to external shocks and the possibility of reduced confidence. Recent efforts by the national bank to quell credit expansion have led to proliferation of non-bank financial activity and unregulated leasing companies, which has led the government to plan a unification of supervision of non-bank financial institutions.

11. **The growing current account deficit has been financed primarily by a sharp rise in external debt, which has increased the external vulnerability of the Croatian economy.** Despite significant foreign direct investment (FDI) inflows, external debt soared from 60 percent of GDP and 128 percent of exports of goods and services in 2000 to 82 percent and 158 percent, respectively, in 2003. Net international reserves have remained at about 5.7 months of imports of goods and non-factor services.

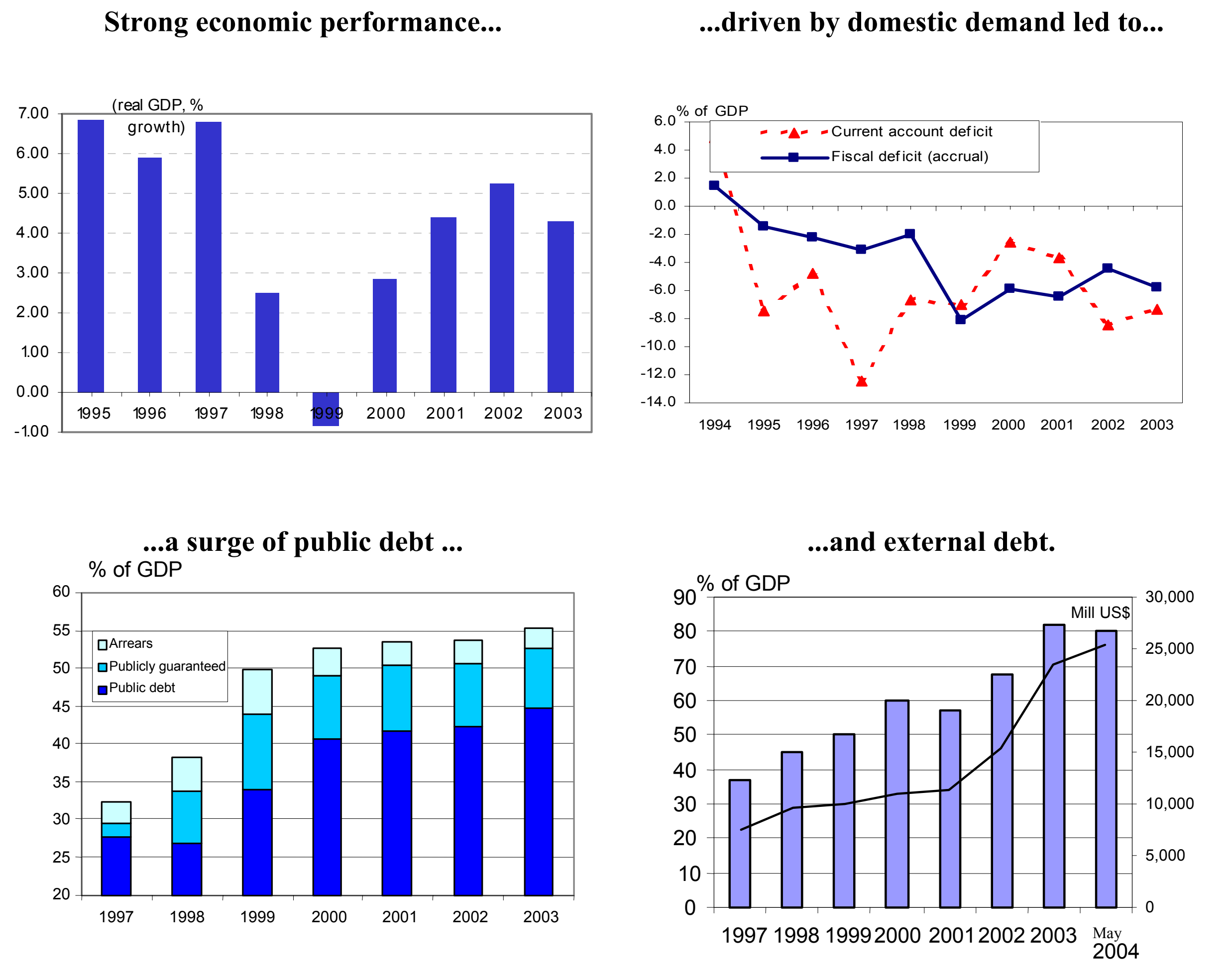
12. **Fiscal performance has been disappointing and has worked against tightened monetary policy.** The government gradually reduced the fiscal deficit from 8.1 percent of GDP in 1999 to 4.4 percent of GDP in 2002. These gains were, however, partly reversed in 2003 as heavy pre-election spending, especially on large public investments, resulted in a jump in the fiscal deficit to an estimated 5.8 percent of GDP.[6] The higher deficit was largely financed through foreign borrowing: total public and publicly guaranteed debt as a share of GDP rose from 50.6 percent in 2002 to 51.9 percent in 2003[7].

[5] The EU8 excludes Malta and Cyprus, which also joined the EU on May 1, 2004.

[6] The IMF and World Bank fiscal data slightly differ, since the IMF does not include all local government units and excludes all capital revenues (in addition to privatization receipts) from revenues.

[7] Direct debt (public debt excluding guarantees) grew from 42.1 to 44.0 percent of GDP.

Figure 1: Evolution of Increased External Vulnerability



E. Debt Sustainability and Debt Management

13. **Over the last seven years the level of Croatia's public debt has been rising steadily in absolute and relative terms to about 52 percent of GDP by the end of 2003, high when compared to Central and Eastern European countries (CEEC) that stand at 35 percent of GDP on average.** In fact, most of the CEEC have succeeded to reduce their debt levels over the last seven years, while Croatia has observed a sharp growth of its debt of more than 30 percentage points of GDP during the same period. Annual public debt service costs have increased by 2.5 percentage points of GDP after 2000, compared with the 1995-1999 period. Fiscal developments in the last four to five years have also revealed two other important sources of debt accumulation: unpaid internal obligations of the public sector (arrears) and contingent liabilities in the form of state guarantees.

14. **Debt sustainability analysis shows that further consolidation of fiscal spending of at least 3 percentage points of GDP is needed to control the debt and to eventually meet the Maastricht criteria required for the European Monetary Union.**[8] With the current growth rate, inflation, and historically low interest rates, a primary fiscal deficit consistent with debt sustainability is 0.38 percent of GDP. The

[8] A deficit not exceeding 3 percent of GDP in normal circumstances, and a ratio of public debt to GDP not exceeding 60 percent.

required primary balance is, however, sensitive to the changes in growth assumptions (see Table 2). For example, if projected growth averaged 3 percent, the government would need to run a primary surplus of about 0.5 percent of GDP. The high inflation elasticity of money demand suggests that the scope for raising seignorage through higher inflation is at best limited, a common feature of countries where currency substitution is widespread. The macroeconomic effects of long-term fiscal policy instability could be exacerbated by Croatian pro-cyclical fiscal policies. Were Croatia to face short-run difficulties (e.g., fiscal difficulties in the EU or, more likely, a financial or currency crisis in a neighboring country) leading to higher interest rates, lower growth or a depreciation of the real exchange rate, the already unstable fiscal stance would initially be aggravated as declining revenues would lead to even faster increases in debt. Pro-cyclicality of expenditures would then kick in and amplify the economic downturn. (See Annex A3.)

Table 2: Alternative Scenarios for the Short-Run Sustainable Primary Surplus

	Growth Rate of GDP (%)	Real Interest Rate (%)	Inflation Rate (%)	Initial Public Debt* (% of GDP)	Sustainable Primary Surplus (% of GDP)
Baseline	4.5	5.5	3	46.8	-0.38
	2				1.1
Growth Scenarios	3	5.5	3	46.8	0.5
	5				-0.7
		4.5			-0.9
Real Interest Rate Scenarios	4.5	7.5	3	46.8	0.6
		9.5			1.6
			5.5		-0.6
Inflation Rate Scenarios	4.5	5.5	7.5	46.8	-0.7
			9.5		-0.8

*Initial public debt (direct public debt including arrears) was set at 46.8 percent of GDP.
Source: World Bank staff estimates

15. **The fiscal adjustment efforts would need to be complemented with improvements in public debt management.** Sound institutional arrangements for managing the volatility of debt servicing costs are important in the same way as sound fiscal institutions are important for managing the level of debt arising from the primary balances. Given the under-developed nature of the domestic debt markets, about 60 percent of total public debt is external. And with most of the domestic debt indexed to the euro, as much as 85 percent of the total debt is subject to currency risk. This highlights the importance of improving the risk structure of the debt and further developing the domestic market for kuna debt, which would permit a reduction in overall currency risk. This, in turn, points to the need for increased debt management capacity within the Ministry of Finance.

II. COUNTRY DEVELOPMENT PROGRAM AND CHALLENGES

A. Government Priorities

16. **Croatia's top priority is to enter the EU with a competitive and growing economy and the institutional capacity to meet the demands of membership.** The new government's strategy, as described in the Program of the Government of the Republic of Croatia for the 2003-2007 Mandate, emphasizes undertaking structural reforms that would lead to sustained growth within a framework of social equity. The government's economic policy program for 2004-2005 is supported by the IMF Stand-By Arrangement (SBA) and aims to limit external vulnerability arising from the high current account deficit and the heavy external debt burden, and to prepare Croatia for successful EU accession, so that Croatia enters the EU as a dynamic and competitive economy that can rapidly achieve convergence to EU living standards. To achieve these objectives, the program relies on fiscal adjustment to stabilize the debt-to-GDP ratio and structural reforms to reduce the role of the state in the economy and promote private sector activity. This reflects the priorities and directions in the World Bank's Country Economic Memorandum (CEM) of 2003.

17. **With the EU accession negotiations now set to begin in early 2005, the government's priority is to ensure successful conclusion of accession negotiations.** The EC's April 2004 Opinion on Croatia's application for membership in the EU assesses the current situation and prospects for fulfilling the conditions of membership. The priority areas underlined in the Opinion coincide with the priorities set out in the Government Program. Under the Stabilization and Association Agreement with the EU, Croatia has begun aligning its legislation with the *acquis communautaire*, but the Opinion concluded that the necessary administrative structures, including judicial capacity, have not developed at the same pace. Table 3 lists the key EU accession agenda items that would need to be tackled.

Table 3: FY05-FY08 EU Accession Agenda for Croatia

Areas of Reform	EU Accession Agenda
Fiscal Framework	• Reduce public expenditure as share of GDP • Ensure effective administration and enforcement of tax legislation
Enterprise Restructuring	• Accelerate restructuring and privatization of SOEs
Business Environment	• Simplify market entry procedures • Improve efficiency of bankruptcy procedures • Build capacity for enforcement of property rights
Cadastre and Land Registry	• Establish modern, efficient cadastre and land registry • Complete land registration and privatization, including agricultural land
Debt Management	• Strengthen debt management capacity for greater transparency and efficiency
Judiciary	• Reduce case backlog, including through automation of case management system • Ensure execution of court rulings • Rationalize court system • Strengthen judicial training
Public Administration	• Adopt policies for transparent recruitment and promotion of public sector employees • Complete institution building relevant to *acquis communautaire* • Complete the denationalization process
Financial Controls	• Develop Public International Financial Control system • Establish framework for monitoring, controlling, and auditing government revenue and expenditure • Implement effective, transparent public procurement system, fully aligned with *acquis communautaire*
Agriculture	• Establish land parcel and animal identification system • Align veterinary and phytosanitary standards with *acquis communautaire*
Transport and Customs	• Establish mechanisms for the South East Europe Core Regional Transport Network • Strengthen capacity of customs services and align with EU Customs Code • Strengthen administrative capacity in road and rail sectors
Energy	• Meet commitments under the Athens Memorandum on South East Europe Regional Energy Market • Improve energy efficiency and promote use of renewable energy sources
Environment	• Adopt and implement horizontal legislation on environmental impact assessment and public participation • Strengthen administrative capacity at national and regional levels • Increase infrastructure investments for wastewater, water supply, and waste management
Human Resources	• Continue labor market reform • Establish modern vocational education and training • Align with EU on public health legislation
Regional Development	• Design and implement regional development plans

Source: EC's April 2004 Opinion on Croatia's application for membership in the EU

18. **The experience of the EU8 New Members States is that there has been a focus on compliance and harmonization with the *acquis communautaire*, with less progress on broader structural reforms.** This has resulted in important gaps towards becoming efficient, well-functioning market economies with the ability to cope with competitive pressure in the EU. Croatia would need to maximize the opportunities during the pre-accession period to bring its policies and institutions closer to the EU, beyond compliance

and harmonization required by the negotiations on the 29 chapters of the *acquis communautaire*. More specifically, Croatia could embark on a program of accelerated reforms to move towards a high growth path, creating the conditions for Croatian companies to become more competitive in the regional markets.

19. **To become a successful member of the EU, Croatia will need to create conditions that will attract investment and produce growth.** These conditions can be categorized broadly as: (a) macroeconomic and financial stability; (b) stable, progressive and predictable laws and institutions; (c) efficient labor and financial markets; (d) social and environmental sustainability; (e) effective integration into the European infrastructure networks ensuring competitive cost and quality; and (f) a dynamic business-oriented environment which facilitates the production of high value-added goods and promotes the adoption of efficient processes and innovative technologies.[9] The section below addresses the four major areas where actions are urgently needed to ensure the above conditions are met: (i) rationalization and improvement of the efficiency of public spending, (ii) improvement of investment climate, (iii) improvement of governance, and (iv) strengthening of social and environmental sustainability.

B. Challenges to Sustainable Growth

i. Rationalizing and Improving Efficiency of Public Spending

20. **The key constraint to Croatia's sustainable economic growth is the dominance of the public sector.** Public expenditures, at over half of GDP, remain high, with Croatia having one of the largest public sectors in the world, second only to Poland among all ECA countries and slightly higher than Germany. Current spending levels could create difficulties in the EU accession process, which requires the creation of fiscal space to finance the requirements of accession, assessed at 3.8 percent of GDP per annum[10]. In addition, the tax burden on Croatia's economy is extremely high compared with that of the EU8 as well as most of the EU15. Croatia taxes directly and indirectly more than 40 percent of its gross value added, thus significantly reducing its competitiveness.[11] To sustain the current debt level, cross-country international comparisons indicate that there is scope for significant reductions in public health, pensions, social benefits, public wage bill, subsidies and transport spending.[12]

Table 4: Public/Private Sector Comparators

	Private Sector Share of GDP (%)	Public Expenditure/ GDP Ratio (%)
Croatia	60	50.0
EU8 Average:	76	43.0
Czech Republic	80	46.6
Estonia	80	38.4
Hungary	80	53.5
Latvia	70	38.8
Lithuania	75	31.4
Poland	75	44.1
Slovak Republic	80	48.4
Slovenia	65	42.6

Source: *Transition Report 2003*, EBRD (2002 data)

21. **Croatia currently spends over 9 percent of GDP on health care,** very high compared with other EU countries, while health outcomes are still well behind EU averages.[13] With the same life expectancy at birth as that of Croatia, health spending in Poland is at 6.4 percent of GDP, Macedonia at 6.5 percent, and Slovak Republic at 7.2 percent. Eighty percent of Croatia's public expenditure on health care comes from public sources, representing over 15 percent of the total government budget.[14] Recent policies to contain health care costs are leading to

[9] *Croatia Country Economic Memorandum* (World Bank, 2003) proposes a reform strategy for faster economic growth embedded into the European integration agenda.
[10] *Croatia Country Economic Memorandum* (World Bank, 2003)
[11] The average tax burden for the EU accession and candidate countries was below 33 percent of GDP in 2002.
[12] A broader analysis can be found in the World Bank Public Expenditure and Institutional Review (PEIR) 2001.
[13] Infant mortality rates are 7.4 per 1000 live births (EU average is 4.9), maternal mortality is 6.9 per 100,000 live births (EU average is 5.5), and the incidence of TB is almost three times the EU average.
[14] *Croatia Health Finance Study* (World Bank, 2002)

problems of access to care. Yet cost pressures persist due to the aging population and new technologies, and changing epidemiological profiles have continued to exert an upward pressure on costs. Like many countries, Croatia faces a complex and inter-related set of challenges concerning the health sector's fiscal efficiency, effectiveness of service delivery in the face of national needs, organization and management at central, regional and local levels, and the capacity of its staff and institutions to deliver services. Priorities for health sector reform are improving outcomes through cost containment and system rationalization for improving service delivery, restructuring of the supplemental insurance system, greater leverage for the public health financing entity, Croatian Institute of Health Insurance (HZZO), in its contractual relationship with health care providers, and expansion of disease prevention and health awareness programs.

22. **Pension system costs are high at 13.5 percent of GDP, above the EU15 average of 10.4 percent of GDP and EU8 average of 8.3 percent of GDP.**[15] Only Austria (14.5 percent) and Italy (13.8 percent) spend more in relative terms on pensions than Croatia. Replacement of combined wage-price indexation with nominal wage indexation in 2004 will inevitably maintain this high burden. In combination with "pensioners debt restitution", which has created the contingent public debt liability of around 10 percentage points of GDP, wage indexation reverses the path of implicit pension debt that would rise above 200 percent of GDP. Multi-pillar pension reform of 1998 was designed to curtail pension to GDP ratio to below 11 percent in the first ten years and reduce implicit pension debt below 100 percent in order to fiscally sustain second pillar transition cost that was successfully introduced in 2002. Since current pension policy has reversed the projected pension spending trends, it would need to be revisited in order to restore social, fiscal and intergenerational sustainability of the multi-pillar pension system.

23. **Croatia's spending on social benefits has rapidly increased over the last year to an estimated 3.4 percent of GDP, owing to an expansion of poorly targeted categorical benefits**. At the same time, spending on the best targeted (and means tested) social support allowance remained at 0.7 percent of GDP, lower than in most comparator countries. Parallel and numerous benefit systems provided at different government levels and by different institutions suggest a need for rationalization as well as for reducing disincentives to return to the labor market. Half of social assistance beneficiaries are able-bodied unemployed. In some war-affected cities, 30 percent of the population are social assistance beneficiaries. There is a long tradition of supporting public social services, but overall the social service system is outdated, over-centralized, and over-institutionalized, even as it faces increased demand.[16] Reform priorities in the area of social assistance include better targeting (including through promotion of local service intervention), improved system organization and management, a more streamlined cash benefits system, and monitoring of household incomes, expenditure, and behavior to better inform policy makers.

24. **There is also a need to reduce public sector wage bill and subsidies.** The share of public sector wage bill in GDP remains high at 11 percent of GDP in comparison to an average 7.2 percent of GDP in the CEEC or 10 percent in EU15. Subsidies to the enterprise sector,[17] including those to railways, shipyards, the Postal Bank, agriculture, and tourism, amounted to over 3.3 percent of GDP in 2003, compared to the EU15 average of approximately 0.8 percent of GDP. Faster privatization and enforcement of the competition policy is expected to lead to less reliance of the corporate sector on state aid. For example, the annual fiscal burden of the railways sector has reached about 1.3 percent of GDP, about double that of Bulgaria and Italy (0.6 percent) and Romania (0.7 percent). Restructuring of the sector through discontinuance of non-economic lines, adoption of an optimal investment plan to meet EU standards, reduction of excess labor costs, increase of operational efficiency with support from the private sector, and privatization of subsidiaries should reduce the fiscal drag of the railways.

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[15] R. Holzmann, *Toward a Reformed and Coordinated Pension System in Europe: Rationale and Potential Structure*, Watson Wyatt Lectures Series, April 2004. In addition to EU8 countries, sample includes Cyprus, Malta, Romania, Bulgaria and Croatia.

[16] The aging of the Croatian population is projected to increase demand for beds in old age homes by about 2,200 by 2040, on top of already long waiting lists for placements. There is also an increase in the number of young children and young adults who are being institutionalized. Many of the institutions are too big (the average capacity of children's homes is 80), and residents tend to stay for long periods.

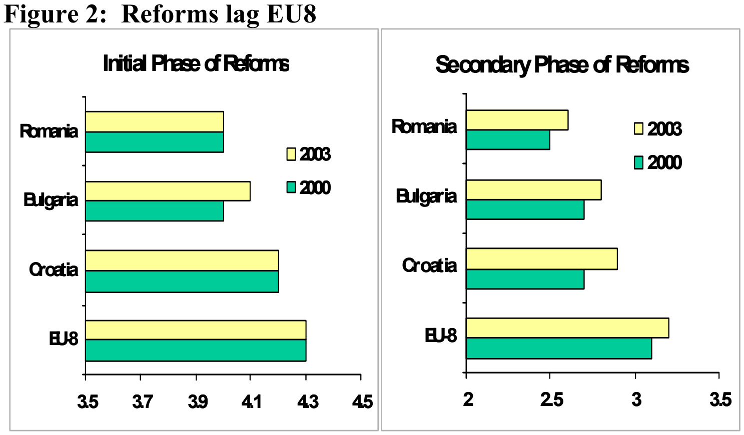
[17] Includes subsidies provided by central and local governments to public enterprises, privatized enterprises, and SOEs.

25. **An ambitious transport investment program for roads and highways has driven public spending to 2.5 percentage points of GDP higher than in comparable countries.** Public expenditure on transportation currently comprises 5 percent of GDP in Croatia, versus 1.5 percent in the UK and France. Yet transportation contributes only 8 percent to GDP, only slightly higher than the EU average of 6.5 percent. Unit costs for investment in the motorways system are high due to excessive standards and crowd out expenditure for much needed maintenance and rehabilitation of existing road networks. For fiscal sustainability in the roads sector, it will be important that the government provides adequate budgetary support for critical road maintenance and reviews options for bringing in the private sector for road and highway construction and maintenance.

26. **Weaknesses in public expenditure are contributing to the worrying fiscal situation.** The forecasting function in the Ministry of Finance needs to be strengthened for greater transparency and better quality, and shift to a three-year budget framework structured so that it can ensure monitoring and evaluation of budget programs.[18] While budget execution processes were recently strengthened, the effectiveness of the government's single account Treasury System is a concern. As recommended in the Country Procurement Assessment Review (CPAR) and Country Financial Accountability Assessment (CFAA), drafts of which were recently shared with the government, Croatia needs to adopt public procurement and financial management legislation and implement associated institutional reforms in order to align its systems with EU requirements to access EU pre-accession funds as well as to realize significant resulting cost savings.

ii. Improving Investment Climate

Figure 2: Reforms lag EU8



*Incl. Price liberalization; Small scale privatization; and Trade and forex systems

*Incl. Enterprise restructuring; Large scale privatization; Competition policy; Banking reform and interest rate liberalization; Securities markets and non-bank financial institutions; and Overall infrastructure reform

Source: *EBRD Transition Report 2003*

27. **In addition to reducing and restructuring public spending, improvements in the business climate and reform of the judicial system are needed to increase private sector investment and productivity.** Croatia's private sector share of GDP at 60 percent is lower than that of any EU8 country (see Table 4). There is a significant unfinished privatization agenda, and progress in restructuring has been disappointing. The high incidence of loss-making among state-owned enterprises (SOEs) (56 percent) and privatized enterprises (39 percent) in 2000 suggests that restructuring in these firms to date has been largely insufficient. According to the Croatian Fund for Privatization (CPF), only about 180 companies remain with majority state-ownership. However, many of these companies are both loss-making and heavily indebted. They include five shipyards, nine *agro-kombinats* (state farms), and a large number of hotels. In addition, in the energy sector, the electricity utility (HEP) needs to be restructured to meet Croatia's obligations towards the Athens Memorandum on South East Europe Regional Energy Market and expectations to be part of the European Community's internal energy market. This would imply the creation of autonomous transmission and distribution companies leading to electricity prices that would be competitive, as currently HEP's electricity tariffs are high compared to neighboring countries.

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[18] Preparation of rolling three-year budgets and restructuring of the debt management function in the Ministry of Finance as well as completing a register of government debt guarantees are structural benchmarks under the Fund program.

28. **Actions are also needed to facilitate private firm entry.** The dominant trends in employment and productivity show that by far the most dynamic sector has been the private (non-privatized) sector, primarily small and medium enterprises (SMEs). However, this sector still only accounts for about 35 percent of the value added and owns fewer than 30 percent of the assets. Much of the dynamism of Croatia's economic growth and employment potential will thus depend not just on the efficiency of the exit mechanism for large enterprises but also on the ease with which new businesses can be created. A number of administrative barriers identified in the Foreign Investment Advisory Service (FIAS) 2001 assessment were subsequently tackled by the former government, such as labor market flexibility, company law, bankruptcy law, and business registration. However, the findings of a recent administrative and regulatory cost survey show that conducting business in Croatia remains costly compared with neighboring countries in terms of new business registration (time consuming at 50 days and expensive at US$843[19]), inspections, hiring flexibility, land acquisition, and site development. Simplified procedures for land title transfer, physical planning, and public utilities, together with improved coordination between government agencies, should be pursued to help facilitate the creation of new firms.

29. **Croatia's judicial system also suffers from inefficiencies, specifically, the court system cannot ensure timely and impartial adjudication of commercial disputes.** Also, Croatia lags behind six of the EU8 countries in secured transactions law and enforcement[20], despite the number of judges per 10,000 inhabitants in Croatia being among the highest in Europe. (See Figure 3.) One of the sources of large inefficiencies and backlog in the court system is the non-adjudicative agenda with which judges are tasked, such as maintenance of land and company registers. The court system needs to be rationalized, judicial procedures need to be streamlined, accountability and performance monitoring of judges need to be introduced, and professionalism of judges and court personnel improved.

Figure 3: Rule of Law

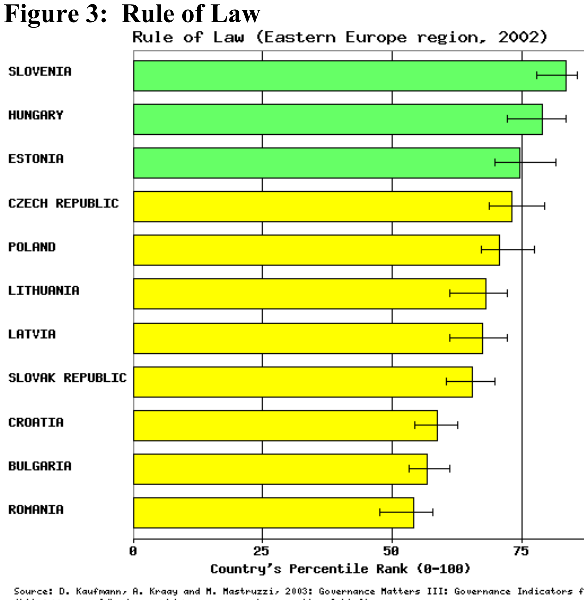
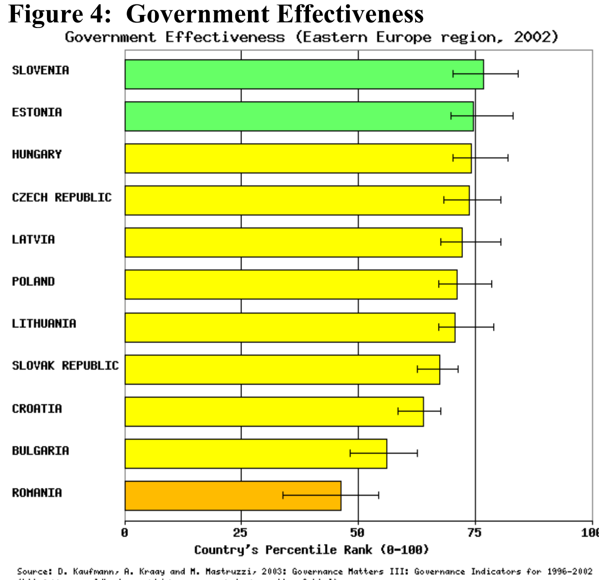


Figure 4: Government Effectiveness



iii. Improving Governance

30. **Croatia's public administration is costly, fragmented, and ill equipped to deal with the combined challenge of structural reform and the related EU accession.** (See Figure 4.) Public administration reform will be critical for Croatia to build the capacity needed to take on the challenge of

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[19] Higher on both counts compared with Bulgaria (30 days and US$148), Romania (27 days and US$217), Lithuania (26 days and US$231), and the UK (18 days and US$264). Source: *Doing Business in 2004 – Understanding Regulation* (World Bank and Oxford University Press, 2004)

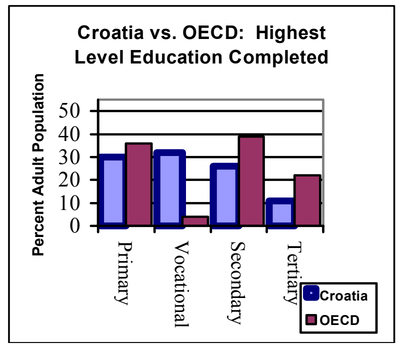
[20] Source: *Transition Report 2003* (EBRD)

accession negotiations and to maximize effective use of resources. There are five priorities for public administration reform: (i) the de-politicization of the senior civil service; (ii) integration of budget reform with policy planning; (iii) strengthening of central agency capacity for the implementation of policy reforms; (iv) continuation of the administrative restructuring process initiated in 2003, in order to align institutions to EU norms and facilitate policy coherence rather than fragmentation; and (v) development of a carefully sequenced and affordable decentralization strategy aligned with EU standards.

iv. Ensuring Social and Environmental Sustainability

31. **Croatia will need to implement policies aimed at facilitating broad participation in growth.** While Croatia's poverty rates are low, inclusion in the growth process is constrained by high unemployment and low labor force participation. Inclusion in the growth process is especially challenging for some segments of the population, in particular those with low levels of education (who comprise one-half of the unemployed), those living in economically depressed areas still reeling from the effects of the war, and the elderly.

Figure 5: Education Completion Comparator



32. **Approximately 40 percent of the adult population has only eight years or less of schooling.** Compared to the average OECD five year-old, the average five year-old Croat can expect to complete about four years less of education over his or her lifetime. Among those who have completed some form of secondary education, a very high percentage has completed only basic vocational programs (32 percent versus only 3 percent for the OECD) that ill equip them for the modern workplace. The secondary education of some 38 percent of the unemployed does not go beyond basic vocational training. Croatia has only one-half of the OECD's share of tertiary completers (see Figure 5). The tertiary education dropout rate is very high, at nearly 70 percent. While Croatia will join international educational assessments in 2006, regional indicators of education performance on most measures are sobering. Many Croatian employers have expressed alarm over the quality of graduates of Croatian secondary schools, where students are exposed to a fact-based curriculum that does not nurture critical thinking and creativity or provide the learning skills needed to contribute to innovation-led growth. This situation presents a major challenge for Croatia, if it is to have a competitive workforce vis à vis EU member states, where education sector indicators are much higher. Education sector priorities for Croatia include curriculum development, evaluation of education outcomes, and strengthening of policy development and accountability.

33. **In areas marginalized by war, local infrastructure investment, social reintegration programs, and continued de-mining are needed to lay the necessary pre-conditions for private sector-led growth.** Economic growth in rural areas is constrained by dominance of state-owned *agro-kombinats* and cooperatives with soft budgets and large subsidies, fragmented private agricultural landholdings, crop and livestock yields significantly below EU standards, weak commodity markets, and poor access to credit. To reduce urban/rural disparities, priorities for the agriculture sector (which contributes about 8 percent of GDP) include land registry modernization, privatization of the *agro-kombinats*, and alignment with EU standards for food safety to position Croatia as an agricultural exporter.

34. **Water is the natural resource most critical to Croatia's sustainability, especially given its importance to the tourism sector.** Key objectives in the water sector are (i) to extend the public water supply to 90 percent of the population; and (ii) to extend wastewater collection to virtually all of the population, a significant increase from the 60 percent at present. On the institutional side, water utilities need to make efficiency gains through cost recovery as well as efficiency gains, and the regulatory framework governing their relationship with water utilities needs strengthening. In addition, innovative financing mechanisms will need to be explored, given the large scale of investments needed in the water sector. Also, environmental management at both the national and municipal level needs strengthening.

Given the magnitude of incremental investment needed (estimated at 5 to 10 billion euro over a 20-year period[21]) and the complexities of attracting private investment, Croatia's compliance with accession criteria in this area can be achieved only over the longer term. Priorities identified by the EC call for the Croatian government to "develop horizontal legislation, including on environmental impact assessment and public participation; strengthen the administrative capacity at national and regional level to ensure planning, including preparation of financial strategies; strengthen the capacity of national and regional inspection services and enable them to effectively enforce environmental legislation; and adopt and start implementing a waste management plan."[22]

III. BANK GROUP ASSISTANCE STRATEGY

A. CAS Objectives

35. **The main objec tive of the CAS is to support the government's growth and reform strategy for successful EU accession.** The strategy calls for a shift in the sources of growth from public sector expenditures and consumption to private sector investment and productivity. This in turn requires the reduction and rationalization of the role of the public sector, the establishment of a supportive investment climate, and the establishment of macroeconomic stability. The growth strategy would focus on increasing and diversifying exports, as well as encouraging innovation. To address quality of growth issues, the CAS also supports a systematic effort to ensure broad participation in growth as well as sustainable natural resource management.

36. **The CAS is designed to support much of the effort Croatia needs to undertake during the next four years to meet EU accession requirements.** However, the CAS goes beyond supporting harmonization initiatives required by the *acquis communautaire* and focuses on accelerating important structural and institutional reforms to ensure faster growth and enhance Croatia's ability to cope with competitive pressures in the EU. The CAS aims to support the government's objective to achieve a three-way convergence of the EU, IMF, and World Bank Group programs. The common aim of these programs is to focus on macroeconomic stabilization, reduce the size of the public sector, promote private sector-led growth, and build capacity to implement some key aspects of the *acquis communautaire*. The CAS is built around outcomes aligned with the development challenges discussed above as well as with Croatia's priorities for fulfilling its EU accession agenda. World Bank Group instruments proposed for the four-year CAS period are aligned to these outcomes and accession priorities. Table 5 illustrates these linkages.

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[21] *Croatia Country Economic Memorandum* (World Bank, 2003)

[22] Source: *European Council Decision on the Principles, Priorities and Conditions Contained in the European Partnership with Croatia* (Brussels, April 20, 2004).

Table 5: CAS and EU Accession Agenda Synergies

EU Accession Agenda	World Bank Group Instruments
Political Criteria	
Judicial Reform	PALs; Policy Workshops; Court and Bankruptcy Administration Project
Public Administration Measures	PALs; Policy Workshops
Protection of Minorities and Refugees	Croatia Living Standards Assessment; Social and Economic Recovery Loan
Economic Criteria	
Macroeconomic Stabilization and Fiscal Framework	PALs; Health Sector Reform and Investment Loan; Public Finance Review; Country Economic Memorandum
Enterprise Restructuring and Privatization	PALs; Regional Rehabilitation Loan; IFC investments and TA
Business Environment	PALs; Science and Technology Project; Investment Climate Assessment; Financial Infrastructure Study; Policy Workshops; IFC advisory services in corporate governance and environmental standards; IFC investment in infrastructure and utilities
Cadastre and Land Registry	PALs, Real Property Registration and Cadastre Project
Debt Management	Debt Management TA
Ability to Assume Obligations of EU Membership	
Financial Controls	PALs; Fiduciary Country Systems TA
Agriculture	PALs; Agriculture *Aquis* Cohesion
Transport and Customs	Trade and Transport Integration Project
Energy	Energy Sector Expenditure Reform and Investment Loan; IFC's post-privatization support; IFC/MIGA facilitation of private sector participation; IFC BIDFacility
Environment	Environment Management Project; Environmental Strategy; Municipal Services Project; Coastal Cities II; IFC BIDFacility; IFC investments
Human Resource Development	PALs; Education Sector Development Loan; IFC's advisory services for outsourcing selected health services to private sector
Regional Development	Social and Economic Recovery Loan; Regional Economic Rehabilitation Loan; Regional Development Study; IFC financing; IFC BIDFacility

Note: The PALs are sequenced single-tranche development policy loans.

37. **The World Bank Group has a comparative advantage in five areas, consistent with the activities that are not or are only partially addressed by other partners**: (i) policy advice and analytical work based in particular on EU8 experience, to underpin the design and sequencing of reforms for macroeconomic sustainability and promotion of sustainable private sector-led growth; (ii) low-cost adjustment lending as an incentive framework for implementing the associated yet often politically difficult structural reforms; (iii) institution building to facilitate implementation of the reform agenda; (iv) design of sector programs that provide systemic solutions which could be financed by both the Bank and partners; and (v) provision of value-added services together with funding, as opposed to just providing capital. As for specific sectors, the EU *acquis communautaire* will require Croatia to undertake numerous institutional and legislative reforms but does not offer specific guidance on how to fulfill the requirements. Given its global as well as EU8-specific experience, the World Bank Group is playing a critical role in filling these gaps. The EU's role is policy signaling with some provision of resources which require co-financing from the budget. IFC is uniquely positioned to use its global experience in markets around the world to help Croatian companies engage in sustainable projects beyond national borders. This is particularly important as domestic financial institutions do not yet have the necessary expertise, and international banks have withdrawn from long-term cross-border finance. IFC will offer Croatia a combination of diverse and innovative financial products, global reach and experience in markets around the world, combined with its sustainability expertise in key industries, to help local companies engage in sustainable projects beyond

their national borders, and a broad array of advisory services. The Bank and IFC have a strong role to play in helping the infrastructure industry and social sectors overcome the regulatory, financing and implementation constraints facing these sectors. Both the Bank and IFC will form partnerships to address sector-wide constraints in a comprehensive manner.

B. Implementation of the Previous CAS

38. **The 2001 CAS Progress Report laid out base case and low case assistance scenarios for FY02-03: US$277 million in the base case and US$60-80 million in the low case.** The Progress Report confirmed the strategy set out in the 1999 CAS, namely, support for restoration of fiscal sustainability, maintenance of financial sector stability, reduction in the size of the public sector, improved governance, strengthened market institutions and competitiveness, infrastructure investment, and more effective social protection programs.

39. **Delivery of the CAS Progress Report's FY02-03 lending program went as planned**, with a SAL in FY02, followed by two investment loans (Pension, and Real Property Registry and Cadastre) in FY03 at slightly lower amounts than set out in the Progress Report, for two-year total commitments of US$255 million.

40. **Reforms supported by the SAL were successfully implemented.** The SAL program was focused in design to support ambitious reform in three specific areas: fiscal consolidation, business climate improvement, and labor market flexibility. The reforms included adoption of legislation to improve public expenditure management and control, reduce worker severance benefits and increase fixed –term contract labor, improve bankruptcy and competition legal frameworks, improve investment policy, continue privatization, establish a multi-pillar pension system, and rationalize social benefits for war veterans and privileged pensioners. A more comprehensive reform agenda (e.g., imposition of hard budget constraints and privatization of large SOEs) would not likely have met with the same success, given the political constraints in the period leading up to the November 2003 national elections.

41. **The active IBRD and GEF portfolio as of end-FY04 included 13 operations for a total of US$507.2 million, of which approximately US$342 million was undisbursed.** (See Annex B8a.) The bulk of Bank operations in Croatia continue to be concentrated in the infrastructure and energy sectors: 58 percent in terms of numbers of operations and 81 percent in terms of dollar commitments.

42. **While OED reviews have indicated good quality of projects at time of closing, and the overall IBRD disbursement ratio is very high (at 41 percent at end-FY04, well above that of 18 percent for the ECA Region as a whole), implementation of the Bank's ongoing investment portfolio during the past year has been disappointing.** With 37 percent of commitments currently at risk due to implementation problems during the second half of FY04, the Croatia portfolio was the subject of a Bankwide portfolio review in November 2004. The portfolio quality is especially affected by the lack of sufficient progress in the areas of railways sector restructuring, and cost reduction and legal reforms supported by the Real Property Registration and Cadastre loan and the Court and Bankruptcy Administration loan. The deterioration in portfolio quality is the combined result of a new government tackling a steep learning curve with the Bank evidenced by coordination problems and loss of focus on ongoing projects, and the project teams taking a firm stance with new counterparts in order to inject fresh momentum in project performance. Experience has shown that setting high standards early keeps implementation focused and well paced. The Bank held a series of intensive meetings with the government in July 2004 to address the issues in the five problem projects, and expectations are that at least four of them will be upgraded around end-CY2004.

43. **Drawing lessons for implementation of the next CAS, the Bankwide review reached four conclusions**: (i) development policy lending is a more effective instrument than sector investment lending

for supporting structural reforms, and therefore the Programmatic Adjustment Loans[23] (PALs) planned for the new CAS period should be more effective in this regard; (ii) increased emphasis on analytic work in the new CAS program should serve to build more support for reform as well as strengthen the linkage between the EU agenda and the design of Bank operations; (iii) six loans are expected to close during the next 18 months as scheduled; and (iv) the upcoming Joint Portfolio Review (planned for January 2005) will assess the portfolio in the context of the new CAS, and lead to cancellation and/or restructuring as needed, to ensure relevance of ongoing operations to the EU agenda.

44. **IFC has been successful in supporting several commercially productive enterprises in Croatia with strong foreign exchange earnings and employment opportunities, as well as in developing the financial sector.** IFC has also been helping strategically important Croatian companies to grow into regional industry leaders. As of September 2004, IFC's committed portfolio in Croatia totaled US$132 million for its own account and US$26 million in syndicated loans, with seven investments, some in commercially productive enterprises with strong foreign exchange earnings and employment opportunities, and some in the financial sector. IFC has also been helping Croatian companies grow into regional industry leaders. IFC activity in Croatia has been constrained, however, by the country's slow pace of privatization, corruption concerns, high labor costs, and the importance of not crowding out the private sector in an investment-grade country. (See Annexes B3d and B8b.)

45. **MIGA guarantees have facilitated approximately US$221.3 million in five projects in Croatia's financial services sector since Croatia became a member of MIGA in 1993.** In addition, MIGA's online information resources include well over 100 documents pertaining to investment opportunities in Croatia and related legal and regulatory issues.

46. **With preparation of the next CAS under way and the need to launch the next phase of reforms to make visible progress on the eve of accession negotiations, the new government is now actively engaged with the Bank.** A recently launched series of sector-specific workshops is also having a beneficial effect on the Bank's dialogue with the new Croatian authorities. It is expected that this greater engagement and the new government's resulting improved understanding of how to work with the Bank as a valued partner will also have a salutary effect on implementation of the ongoing portfolio. In addition, having now granted candidate status to Croatia, in the coming months the EC will in all likelihood begin to encourage the authorities to reduce the country's macroeconomic vulnerability and embark on the next phase of deep structural reforms, in order to begin to close the gaps in economic performance between Croatia and the CEEC. It is the government's expectation that the EC, the Bank, and the Fund will shift into a mutually reinforcing, joint collaboration with Croatia, as they have done with the other candidate countries, thereby increasing the effectiveness of their support.

i. Lessons Learned from CAE

47. **OED recently completed a Country Assistance Evaluation (CAE) for Croatia which was discussed at a meeting of the Informal Subcommittee of the Board's Committee on Development Effectiveness on April 21, 2004.** The CAE assessed the role of Bank assistance to Croatia during 1991-2003, during which the Bank made 22 loans totaling US$1.2 billion in commitments. The key findings of OED's CAE are that while the reconstruction loans in the initial phase of Bank assistance had successful outcomes, loans to reform public finance, promote growth, and strengthen public administration have been less successful. OED concludes that Bank assistance has fallen short in promoting the privatization process and had limited impact on improving the efficiency of the judiciary or of public expenditure for highways or railroads. However, the Bank has been instrumental in helping to launch labor and pension reforms and was highly successful in the financial sector. Going forward, OED recommends that Bank lending for major infrastructure, whether investment or adjustment lending, should be predicated on implementation of sector policy reform. (See Table 6 for a summary of CAE lessons and recommendations).

[23] Sequenced single-tranche development policy loans.

48. **The CAE also assessed the role of IFC, with a committed portfolio of US$97.5 million in equity and loan investments at the time of OED's assessment as of end-October 2003.** OED found that IFC's investments had been successful in several commercially productive enterprises with strong foreign exchange earnings and employment opportunities, as well as in the financial sector. In particular, IFC has helped strategically important companies grow into regional industry leaders. IFC's investment in a shipyard has not been successful because of the company's lack of strategic and effective operational management in a difficult sector.

Table 6: Lessons and Recommendations from OED CAE

CAE Lessons:	**OED Recommendations:**
➢ Government ownership is critical to the success of Bank-supported structural adjustment operations. The Bank needs to supervise these operations closely and modify or cancel them if necessary, rather than allow faulty implementation to proceed. ➢ Large infrastructure projects are not necessarily beneficial in the absence of policy reform as signaled by the lack of a firm tie-in to an adjustment program. Large infrastructure sector or investment operations should not substitute for adjustment operations to make up for shortfalls in lending programs. ➢ The case for structural reform is more difficult in a country such as Croatia, where GDP is recovering from war-induced depressed levels largely from sources such as tourism and workers' remittances that are less dependent on productive sectors. Solid ESW is therefore critical to make the case convincingly at the highest levels. ➢ Insider buy-outs often give special incentives which may make corrupt outcomes. Guaranteed buy-backs further undermine the quality of privatization and leave the problem unresolved.	➢ Bank assistance in the forthcoming CAS should focus on private sector development and reform areas critical to Croatia's accession to the EU, drawing from the recent CEM. • Private Sector Development: Bank assistance for private sector development should focus on promotion of growth, reduction of unemployment, and strengthening of debt sustainability. Successful privatization will be especially important, and insider buy-outs should therefore not be favored. In addition, the impact of SAL-supported reforms should be monitored to assess whether further measures for improving the business environment are needed. • Reforms for EU accession: Bank assistance should support (i) a fiscally responsible and well-targeted role for government through rationalized and retargeted public expenditure in line with public revenues; (ii) improved governance and judiciary reforms; (iii) privatization; and (iv) health and education sector reforms. ➢ The Bank needs to make more clearly and at the highest levels the case for health and education reform, where these and related aspects of social development are not directly addressed by EU programs. ➢ Continuing lack of reform in the transportation sector, especially highways and railways, is draining large amounts of resources away from other higher priority programs. A large component of the CAS lending program should therefore be conditional on effective reforms in public investment.

ii. Client Survey Feedback and CAS Consultations

49. **A client survey was conducted by an independent Croatian market research firm in 2003** (see Box 2). Results indicate that the Croatian public would be receptive to reforms in many of the areas flagged in the World Bank CEM (2003) and the CAE (2004) as priorities for Croatia's unfinished reform agenda, especially if the rationale for the agenda were widely disseminated. Now that Croatia is set to begin EU accession negotiations within the next 12 months, the next two years offer a good opportunity for the Bank to support a reform program aligned with the public's concerns as expressed in the survey results: macroeconomic stabilization, capacity building, reform of the education and judicial systems, and structural adjustment for private sector-led growth.

Box 2: Client Survey

The 2003 Client Survey had a 26 percent response rate. One-quarter of the respondents were employees of a government ministry, ministerial department or implementation agencies; and 17 percent were employees of the Office of the President, Prime Minister, Ministers or Parliamentarians. The remainder included employees of non-governmental organizations (NGOs), the private sector, academia, bilateral or multilateral agencies, the media, and local government offices.

On a scale of 1 (low) to 10 (high), the Bank received an overall rating of 6.9 for effectiveness. The lowest overall effectiveness rating by any group was 5.0, the rating by the NGOs, particularly environmental NGOs. The Bank's greatest perceived value to Croatia was its knowledge, ranked first or second by nearly 60 percent of respondents. Nearly 50 percent identified financial resources as one of the Bank's two greatest values to Croatia. Proper priority for poverty reduction was rated the lowest. Regarding its impact on Croatia's development, respondents ranked the Bank most effective in infrastructure development, and least effective in education and the judiciary. The economy was rated the most important general issue facing Croatia, followed by the rule of law and legislation, education, institution building, and employment and job creation.

50. **In mid-2004 the World Bank Croatia Country Office held a series of CAS consultations in five cities with a range of stakeholders, including representatives of the central and local government, parliamentarians, small business and union representatives, civil society, and non-governmental organizations.** There was general agreement that the top priority is an improved education system, followed by judiciary and public administration reform, an improved investment climate, privatization but with mitigating social measures, reduction in regional development disparities, greater effectiveness of social assistance, and strengthened agriculture sector competitiveness. This CAS consultation feedback is closely aligned with the Bank's assessment of Croatia's development challenges and could help to strengthen government's resolve to accelerate the EU accession agenda. The findings of these consultations are summarized in Annex A4 and are described in more detail on the Bank's Croatia website (www.worldbank.hr) in Croatian and English. Consultations were also held with the EC to ensure the CAS's complementarity with the EU accession agenda.

C. Planned Assistance Program

i. Lending Scenarios and Triggers

51. **The CAS lays out a base case and a high case program, as well as a low case program for Bank assistance, aligned with performance that leads to the sustained, accelerated, and slow growth scenarios, respectively.** Experience in EU8 and current candidate countries has shown that once EU accession negotiations are under way, momentum for reform is established and sustained, independent of which government is in office. Hence with strong prospects for sustained reform during Croatia's pre-accession negotiations even with turnovers in government administration, the planned four-year base case lending volume is about US$1 billion, with an additional US$0.5 billion in the high case, while the planned four-year low-case lending volume is about US$300 million. This increase over the past CAS is justified by the major and accelerated reforms needed to enable Croatia to maximize the benefits of EU membership.

52. **There are three triggers to determine whether Croatia is in the base case at any time during the CAS period:** (a) maintenance of a satisfactory macroeconomic framework and fiscal consolidation; (b) implementation of policies and improvement in governance for a more competitive business environment; and (c) improvement in targeting, sustainability, quality and efficiency of social services. Performance in

these three areas will be monitored against various indicative actions in order to make a judgment on the pace and depth of policy reform during the CAS period, for Croatia to move into and thereafter sustain the base case. Table 7 presents this framework. The PAL series would ensure substantive progress in meeting the first two triggers, while the social sector operations would support progress in meeting the third.

53. **Three additional triggers for Croatia to move into the high case program are designed to recognize and support implementation of major infrastructure reforms that have been a primary cause of the current high debt and fiscal situation, and have proven difficult in the past and where increased investment will be needed to prepare for European integration.** These high case triggers are: (i) road transport sector expenditure reforms (as recommended by the CAE), (ii) accelerated restructuring of the railways sector, and (iii) accelerated implementation of energy sector reforms required prior to EU accession. The high case is effectively an extension of the base case, with additional Bank lending available on a sliding scale to reflect the progress on meeting the high case triggers and the depth of the associated reforms under implementation.

ii. Bank Group Instruments

a. Base-Case Program

54. **The base case lending program would support key reform priorities with a range of Bank Group instruments.** The planned lending program would be in the range of US$200-320 million per year (see Annex B3a), higher than the actual annual average of US$155 million during the past three years and higher than annual averages set out in the 1999 CAS (US$160 million) and 2001 CAS Progress Report (US$139 million). This increase is justified by the need to support the acceleration of difficult structural reforms and major institution building efforts during Croatia's accession candidate period. The recent granting of accession candidate status to Croatia brings with it a heavy reform and investment agenda to be achieved within a relatively short period. In particular, fiscal consolidation and reform would be paramount, given the financial demands of EU accession.

55. **The PAL program would drive the base case lending, with PAL conditionality reinforcing the base case CAS triggers for macroeconomic sustainability and private sector-led growth.** The PAL program is envisioned as a series of annual, single-tranche operations over the next three years, with loan amounts of US$150 million. A Growth Policy Support loan is planned in FY08 to address remaining issues not taken up by the PAL program. The PAL program would support actions to:

- *improve the investment climate* through privatization, a reduction in subsidies to the enterprise sector and enterprise arrears, a reduction in the administrative and regulatory costs of doing business, and strengthening of the judiciary;

- *strengthen governance* through increasing the efficiency of public administration by rationalization of government administration structures and implementation of a merit-based hiring and pay system, as well as improvement of public expenditure management; and

- *enhance the fiscal sustainability of sector programs* through a reduction in health sector spending with more efficient and reduced drug and hospital expenditures, rationalization of social benefits by reducing the number of benefits and improving targeting which will also help Croatia realize the full benefits of growth in reducing poverty, improved fiscal and social sustainability of the pension system, and increased operational efficiency of the railway company.

56. **The base case program aims to reduce poverty in Croatia not only by stimulating economic growth, but by supporting improved targeting of social programs, rehabilitation and social integration in Areas of Special State Concern, and investments and policies for economic revitalization in areas affected by restructuring of SOEs.** Investment loans would focus on systemic solutions with financing programs where partners could participate. The use of sector development investment loans within an acceptable policy and institutional framework will facilitate this approach by

providing incentives for improving and harmonizing with the EU/World Bank fiduciary systems at both the sector and country levels. It also allows for participation of other development partners in the financing of investment requirements of the sector. Croatia has specifically requested for this instrument, which is viewed to be appropriate in the context of EU accession where partnerships and harmonization are critical success factors. Disbursements under this instrument would be driven by the pace of reforms, strength of institutions, and quality of expenditures. To be responsive to the EU accession requirements of accelerated reform, the project preparation cycle will be adjusted to less than 12 months, with implementation to be completed in three years, and with less reliance on Project Implementation Units and more capacity building within existing government structures. The projects would build close operational links with EU initiatives and programs.

57. **The social sector operations would support the PAL program objective of fiscal consolidation by addressing structural issues.** In addition, these operations intend to improve broad participation in growth by upgrading service delivery and effectiveness. The Health Sector Development loan would complement fiscal reforms in the health sector supported under the PAL program, by financing investments and other sector reforms aimed at improving the quality of health outcomes. The operation would establish expenditure priorities and support better incentives for improved service delivery through the roll-out of performance-based contracts for general practitioners, investments in the state budget to strengthen primary health care delivery and pre-natal care, and design and expansion of disease prevention and health awareness programs. The Social Protection loan would complement the PAL's support of fiscal reform of social assistance programs by financing the strengthening of administrative, policy-making, and monitoring capacity for the social benefits system, including information systems. The operation would also support efficiency measures to free up resources for enhanced service delivery to a wider group of beneficiaries. To address poverty in Croatia directly, the PAL would aim to increase the share of the best targeted and means tested social support allowance in total social spending. The Education Sector Development loan would focus on competitiveness by financing investments to establish a national curriculum framework for general education based on active learning, strengthen teacher education and professional development, introduce monitoring and evaluation systems (including a mandatory secondary school leaving examination), and strengthen education management and leadership.

58. **Several other sector investment loans complementing the PALs would be implemented by the respective line ministry responsible and so would not detract from the government's reform agenda supported by the PAL program.** Some would address fiscal-related institutional issues and mitigate the adverse impact of the PAL program on vulnerable groups. The Municipal Services operation would rationalize municipal fiscal relations and contain the likely demand for budget support through improved tariffs and choice of cost effective technology in meeting EU environmental standards. The Social and Economic Recovery loan focuses on rehabilitation and settlement of refugees in Areas of Special State Concern, and the Regional Economic Rehabilitation loan would support measures to mitigate social costs and promote economic revival in areas affected by SOE restructuring.

Table 7: Base and High Case Triggers

COUNTRY OUTCOMES	BASE CASE	HIGH CASE
Macroeconomic Sustainability	**Trigger:** • **Satisfactory macroeconomic framework and fiscal consolidation**	**Additional Trigger:** • **Adopt road transport expenditure priorities agreed with the Bank**
Reform Areas:	**Indicative Actions:**	**Additional Indicative Action:**
SOE Financial Discipline	• Make steady progress toward reduction in enterprise subsidies from US$980 million in 2003 to US$760 million in 2008, with an intermediate target of US$850-900 million in 2006	
Transport Sector Expenditure	• Adopt and implement a Railway Restructuring and Modernization Strategy agreed with the Bank • Make steady progress toward reduction of operating costs to bring down Croatian Railways' working ratio from 240 percent in 2003 to 150-170 percent by 2008 • Adopt a Highway Network Expenditure and Financing Strategy agreed with the Bank	• Reduce total spending in the roads sector, and increase share of maintenance and rehabilitation expenditure consistent with the agreed Highway Network Expenditure and Financing Strategy
Sustainable Private Sector-Led Growth	**Trigger:** • **Implement policies and improve governance for more competitive business environment**	**Additional Triggers:** • **Restructure railways sector** • **Restructure electricity utility (HEP) to meet EU accession requirements**
Reform Areas:	**Indicative Actions:**	**Additional Indicative Actions:**
Divestiture	• Make steady progress toward privatization or liquidation of the 1,130 SOEs held by the CPF in 2003 by end-2008, with an intermediate target of 600-800 SOEs by end-2006	• Make steady progress toward completion of divestiture of 10 subsidiaries of Croatian Railways by 2008, with an intermediate target of divestiture of half of their asset value by end-2006
Energy		• Establish an autonomous and functional transmission system operator • Establish autonomous and functional distribution system operator(s) • Liberalize the electricity market in accordance with Croatia's commitments for the development of the Energy Community of South East Europe per the Athens Memorandum of Understanding and forthcoming Treaty
Public Administration Reform	• Make steady progress toward full implementation of merit-based hiring and pay system by end-2008, including enactment of Civil Service Law	
Judicial System	• Implement program, including restructuring of responsibility for land registration, aimed at achieving 50 percent reduction in case backlog by 2008	
Broad Participation in Growth	**Trigger:** • **Improve targeting, sustainability, quality, and efficiency of social services**	
Reform Areas:	**Indicative Actions:**	
Education	• Implement program aimed at increasing secondary education completion rate from 78 percent in 2003 to 85 percent by 2008	
Social Assistance	• Streamline and monitor social benefits and services and reduce their share of GDP, while increasing the relative amount allocated to the best-targeted social support allowance	
Health Care	• Make steady progress toward increase in the share of primary health care expenditure in total health spending from about16 percent in 2003 to 18 percent in 2006 and 20 percent in 2008.	
Note: The PAL series would ensure substantive progress in the macroeconomic sustainability and private sector-led growth triggers.		

59. **Other investment and Global Environment Facility (GEF) operations are closely linked to the EU accession agenda in areas where the Bank has global experience and comparative advantage, e.g., by helping Croatia meet the environmental challenges.** The Agriculture *Acquis* Cohesion loan, complemented by a GEF operation, would improve access to EU markets for food products and enable better absorption of EU grant resources. Under the PAL program Croatia will introduce environmental impact assessments into the regulatory framework, and the Bank will support (through an ongoing technical assistance loan and bilateral grant cofinancing) environmental audits of large SOEs (e.g., shipyards) as part of the privatization process. The Environment Management loan would focus on improving institutional capacity to address environmental liability issues, and to implement projects and monitor environmental outcomes as required by the *acquis communautaire*. The Trade and Transport Integration loan would assist building links with EU markets, e.g., by providing vital transshipment road corridors to the heart of Europe, through the Rijeka Port. The Science and Technology loan would support efforts to improve R&D capacity and competitiveness in response to the Lisbon agenda. A GEF grant under the World Bank-GEF Strategic Partnership for Zagreb Municipal Nutrient Reduction in the Danube River Basin would finance reduction in water pollution from the Zagreb wastewater treatment plant. And a Renewable Energy Resources GEF operation would assist the government to meet *acquis communautaire* requirements and help reduce Croatia's dependence on fossil fuel imports.

60. **The analytical and advisory (AAA) services program is frontloaded to meet the huge analytical and technical assistance needs of an accelerated reform program.** The program aims to establish the analytical underpinning of lending operations and provide technical assistance to government in a timely manner, jumpstart the reform process, and prepare for high case. The AAA for the high case would be launched only after an initial assessment of the probability of reaching the high case in FY06. (See Annex B4.) The Bank's analytical work will draw heavily from EU8 experience. A series of policy notes and workshops on critical issues would inform the decision makers of policy options and cross country experience and at the same time serve as the basis and forum for debate as well as dissemination among stakeholders. The Regional Living Standards and Development Study and the Public Finance Review are part of the core analytic work. The Fiduciary Country Systems TA/Institutional Fiduciary Assessment (IFA) support both CPAR and CFAA implementation, as well as the planned sector expenditure support loans. WBI regional programs would contribute to capacity enhancement in the areas of public sector and governance, private sector development, and social sustainability. (See Annex A5.)

61. **Croatia will continue to participate in the joint World Bank/IMF Public Debt Management and Domestic Debt Market Development Program, which it joined in early 2004.** Under this program a draft reform plan to strengthen debt management capacity within the Ministry of Finance, including for system support, risk management, and institutional framework, has been presented to the Ministry for approval. Implementation of the reform plan would help to strengthen Croatia's macroeconomic sustainability.

62. **The Bank will step up its assistance to the Ministry of Finance to optimize the structure of Croatia's portfolio of IBRD financial products and services by focusing on the potential use of a broader range of IBRD financial products to manage Croatia's financial risks in line with the government's debt strategy.** In this regard, the government may wish to consider signing a Master Derivatives Agreement (MDA) with IBRD, as this would provide access to a range of risk management products (e.g., currency swaps, interest rate swaps, interest caps and collars, commodity swaps, the customized repayment schedule, interest rate hedging products, and possibly local currency funding for Croatia's program) linked to the existing portfolio of IBRD loans. These products could be applied at the level of the country portfolio as well as for individual projects, both in the existing portfolio and the new pipeline.

63. **IFC's broad strategy is to facilitate Croatia's accession to the EU by supporting private sector companies to become more competitive in regional markets.** IFC will support privatization and post-privatization restructuring in key sectors of the country with priority to manufacturing industries, tourism,

agribusiness/food processing, utilities, and infrastructure. IFC will combine financial support with technical assistance in areas such as corporate governance and environmental standards to help domestic companies become more competitive. IFC will work with domestic banks to support Croatian companies that are ambitious to expand in other countries in the region. A priority will be facilitating FDI through debt and equity investment with strategic partners, particularly where a green-field project is involved. In the banking sector, IFC will continue the dialogue with the government and consider helping to finish the privatization of the banking sector through appropriate financing schemes. IFC will focus on non-bank financial institutions and on structured finance transactions strengthening the capacity of specific financial institutions, including their capacity for SME finance in order to serve this market segment profitably. IFC will explore possible opportunities for introducing new products in the financial markets, such as the development of energy efficiency finance. In the infrastructure sectors, IFC will continue its efforts to promote private sector investments. Given the importance of solid waste management and water treatment in the tourist areas along the coast, Croatia will be a target market for IFC's new Balkans Infrastructure Development Facility (BIDFacility). The Municipal Fund, a joint IFC-IBRD initiative, can be instrumental in promoting more private sector investments in the water and wastewater sector. IFC is also helping the institutional effort to develop public-private partnership opportunity in a cross-border oil pipeline and other regional infrastructure projects. Together with the government, IFC will assess opportunities for providing advisory assistance in structuring and implementing public-private partnerships to improve healthcare for public patients. See Annex A6 on IFC's strategy in Croatia.

64. **MIGA's work in Croatia will be built on the European Investor Outreach Program (EIOP) which seeks to strengthen the capability of beneficiary countries to attract investment from Western Europe.** The program will identify and contact potential investors in selected priority sectors, with a view to generating interest in direct investment projects, through green-field investment, acquisition of SOEs, or joint ventures with indigenous firms. The initiative will start out as a two and a half-year pilot program, supported by an initial contribution from the Austrian government under a grant agreement. MIGA is co-financing the initiative, and USAID has agreed to co-finance a position in their Vienna office to help facilitate business in Croatia. It is expected that over time, additional donors will join the initiative, and it will expand to cover additional countries as well as a wider range of sectors and industries.

b. High-Case Program

65. **The high case is designed to serve as an incentive for acceleration of the more difficult reforms that are linked to the EU accession agenda and which were stalled in earlier efforts and have caused a build up in debt and become a fiscal burden.** These reforms involve a shift in expenditure priorities in the roads sector, privatization of railways subsidiaries, and restructuring of the energy sector. Because of the sector's past heavy burden on debt and fiscal space, the three infrastructure operations have been relegated to the high case with additional policy conditionalities which would reduce their fiscal and debt demands through privatization and expenditure re-orientation. Of the high case program's US$450 million increase over the base case lending volume, US$200 million would be for higher amounts of PALs II and III and the FY08 Growth Policy Support Loan (bringing each of them to US$200 million), US$50 million would elevate the Trade and Transport Integration loan to a Transport Sector Reform Expenditure Support investment loan, US$100 million would allow the addition of an Energy Sector Reform Expenditure Support investment loan near the end of the CAS period, and US$50 million would increase the amounts of the social sector development operations already included in the base case program (education and health). The remaining US$50 million would allow acceleration of the Coastal Cities Pollution Control II adaptable program loan (APL) into this CAS period. (See Annex B3b.) Should the high case triggers be partially met, the incremental PAL support planned for FY06 would be appropriately pro-rated. Plans for FY07-08 would be subject to the assessments in the CAS Progress Report planned for mid-term of the CAS period.

66. **Support for an improved system of road maintenance and modernization of the railway system in the transport sector via the proposed Transport Sector Development loan would be contingent upon the government's implementation of a fiscally sustainable medium-term transport**

infrastructure plan linked to EU integration which it would support. The plan would give priority to road rehabilitation and maintenance and a more rational road sector investment program that includes mobilization of EU grant and private sector funding. The transport loan would also be contingent upon steady progress in the privatization of 16 railway subsidiaries. The operation would support: (i) social mitigation schemes for the railway sector; (ii) expenditure support for investment in track and railway infrastructure, elimination of road maintenance backlog, modernization of road and network management, and construction of urban by-passes; and (iii) institutional strengthening for attracting private sector participation schemes in transport.

67. **An Energy Sector Development loan would be contingent on implementation of reforms required of Croatia under "the Athens Memorandum," which it would support.**[24] The reforms include the restructuring of HEP for market liberalization. The loan would finance priority investments such as a load dispatch and communication system, transmission interconnections with Hungary and Italy, and rehabilitation of thermal and hydro generation plants. These reforms have been under discussion for some time and are relatively easy to prepare and implement. There also may be scope for IFC engagement in the power sector, once HEP restructuring is advanced.

68. **The planned Coastal Cities Pollution Control sequel operation aims to have a direct, positive impact on the quality of bathing and fishing waters on the Adriatic Coast.** The operation would develop a framework in which other partners can participate. The operation would finance: (i) wastewater treatment facilities in selected coastal municipalities, and (ii) strengthening of institutional arrangements for financing and management of wastewater treatment.

c. Low-Case Program

69. **The volume of low case lending is less than 30 percent of that of the base case.** The planned low case for Bank assistance would be comprised of two investment operations per year with emphasis on the following areas where major policy reform is not required: local infrastructure investment and institutional capacity building in the Areas of Special State Concern, institutional reform to facilitate the commercialization of R&D, capacity building for harmonization with EU food safety standards, education reform on a more limited scale than in the base case, strengthening of trade corridor logistics to link Croatia more cost effectively with its trading partners, institution building for environment management aligned with the EU *acquis communautaire* (smaller in scope than the base-case operation), investment in municipal infrastructure and related institutional development, and stimulation of private sector-led growth in an area dominated by a single loss-making industry. (See Annex B3c.)

D. Medium-Term Prospects and Financing Requirements

70. **Croatia's medium term prospects are linked to the goal of EU accession.** Lessons from the experience of the EU8 New Member States indicate the need to accelerate completion of structural reforms and improve institutions to implement membership requirements and facilitate absorption of accession funds. In the Croatian context, this means focusing on fiscal consolidation and public debt reduction to provide the fiscal space for accession requirements, completing the privatization program, restructuring the social sectors and improving competitiveness. To improve its ability to use EU funds, Croatia would need to strengthen institutional capacity to develop and implement a suitable pipeline of projects, especially at the sub-national level. In addition, fiduciary country systems require upgrading to EU standards.

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[24] Along with the other countries of South East Europe, Croatia signed "the Athens Memorandum" in December 2003 confirming its commitment to the development of the South East Europe Regional Electricity Market, which is de facto a condition for EU accession calling for market liberalization to align with EU energy policies. The Bank plays a lead role in donor coordination with the EC, EIB, EBRD, and bilaterals.

i. Sustained Growth Scenario

71. **The sustained growth scenario envisages implementation of a rigorous structural reform program and sound macroeconomic policies**. Policy performance under this scenario includes immediate steps to reduce external vulnerability, promote sustainable growth, and ensure the preparedness for EU accession in the medium term. Under such assumptions, GDP growth is estimated to stay at 4.2 percent on average annually over the medium term, with relatively low inflation of about 2.5 percent. Tightening of monetary policy is expected to continue during the next several years, gradually bringing the ratio of domestic credit to GDP to 66 percent in 2007. Consequently, a gradual reduction of the trade deficit, and accordingly of the current account deficit, are expected to be somewhat slower in 2004 but stronger thereafter to decline to 3.1 percent of GDP in 2007.

72. **The adjustment underlying this reduction in the current account deficit would come predominantly from private and government sector investment cuts during 2004-05.** The fiscal policy adjustment leading to higher public savings during this period would be gradual due to the realization of some of the post-election promises. The base case reforms associated with the sustained growth scenario are consistent with a sustainable debt profile. Increased social spending and continued subsidization of public enterprises would allow the fiscal deficit to fall to only 3.7 percent of GDP in 2005, as targeted under the IMF Stand-By Arrangement. As a gradual reduction in the current account deficit in the face of robust private investment growth would require prudent fiscal policies, the reduction of government consumption and the end to the public highways construction program would then take the bulk of the current account deficit adjustment in 2006-2007. The fiscal deficit is expected to reach 2 percent by 2007 (0.9 percentage points of GDP below government projections in the Medium-Term Fiscal Framework for 2005-2007), with the primary balance reaching the sustainable level of 0.2 percent of GDP.

73. **Under the sustained growth scenario, medium-term financing requirements during 2004-07 are estimated to be about US$4.7 billion on average per year.** FDI flows are expected to provide a little more than one-fourth of external financing in the years ahead, with net FDI expected to slow from 4.4 percent of GDP in 2004 to 3.4 percent in 2007. Any additional increase in FDI would allow for lower financing requirements from the commercial sector (a non-preferred lender) and thus lower indebtedness. The external financing gap would be mainly financed from new foreign borrowing, but as the current account deficit shrinks, external debt (measured in US dollars) is expected to decrease gradually to 73 percent of GDP in 2007. The majority of funds would come from banks and other private creditors, while official creditors' participation in new borrowing would gradually decline to below 1 percent of GDP in 2007. Any increase in borrowing from multilaterals over the modestly projected disbursements as well as any increase in FDI would further reduce the future debt service cost. Official grants, mainly from the EU, to help Croatia's public sector meet some of its EU accession-related investment needs are projected at about US$125 million for the 2004-2007 period. Utilization of EU pre-accession funds soon to be made available together with multilateral financial institutions' (MFI) co-financing could further improve the level and structure of external indebtedness.

74. **World Bank disbursements under the sustained growth scenario at about US$255 million a year would cover slightly more than 5 percent of total financing needs.** The Bank's exposure would remain low in the medium term, with IBRD's share of public debt service below 5 percent. (See Table 8 and Annex B7.) With its favorable terms and the option of local currency denomination, IBRD lending would help to improve the overall structure of Croatia's debt.

Table 8: IBRD Exposure Indicators for Croatia

	Preliminary	Sustained Growth Scenario (Base Case)				Accelerated Growth Scenario (High Case)				Slow Growth Scenario (Low Case)			
	2003	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Preferred Creditor DS / Public DS* (%)	8.1	7.8	8.1	6.3	7.2	7.8	8.3	6.6	7.5	7.8	7.3	6.3	7.2
IBRD Share of Public and Publicly Guaranteed DS* (%)	5.5	5.2	5.9	4.1	4.6	5.2	6.1	4.2	4.8	5.2	5.4	4.0	4.6
IBRD Share of Total Debt Outstanding and Disbursed (%)	3.2	3.1	4.0	5.0	6.0	3.1	4.1	5.7	7.2	3.1	3.4	3.7	3.7

* Debt Service

ii. Accelerated Growth Scenario

75. **Under the accelerated growth scenario, Croatia would undertake a fast-track reform program that increases the economic growth rate towards 5.5 percent by 2007 with inflation falling to 2 percent.** In addition to policies envisaged under the sustained growth scenario to reduce external vulnerability, Croatia would undertake third generation reforms in the infrastructure sectors, accelerate the fiscal consolidation process and administrative and judicial reforms, and complete the privatization process. The scope and pace of such a reform program would change investors' sentiment and stimulate a significant increase in annual FDI flows close to 7 percent of GDP in 2007. Under such assumptions, it is estimated that external debt would fall to below 66 percent of GDP with current account deficit falling to 2.5 percent as a result of export-oriented private sector investments. Privatization receipts and fiscal sustainability reached in 2006 would allow the ratio of direct public debt to GDP to fall towards 38 percent.

76. **Under the accelerated growth scenario, medium-term financing requirements during 2004-07 are estimated to be about US$4.7 billion per year, but with a trend falling towards US$3.6 billion in 2007.** Principal repayment requirements on external debt would decrease to 6.3 percent of GDP by 2007. FDI flows are expected to provide more than 40 percent of external financing. The external financing gap would be financed mainly from new foreign commercial borrowing, depending on the volume of lending by the other international financial institutions (IFIs), availability of pre-accession funds, and Croatia's absorptive capacity. New disbursements of long-term debt would gradually fall to 5 percent of GDP, out of which official creditors' participation in new borrowing would account for one-third and remain at 1.5 percent of GDP in 2007. IBRD disbursements are estimated at US$302 million a year, which would cover about 6.4 percent of total financing needs.

iii. Slow Growth Scenario

77. **Under the slow growth scenario Croatia's structural reform program has yet to gain momentum and broad public support.** Slower progress in fiscal consolidation and administrative and judicial reform would adversely affect private investment. Less profitable private investments would lower prospects for growth, cause deterioration in competitiveness, and lead to higher fiscal and external imbalances. Under such assumptions, it is estimated that GDP growth would fall to 2.7 percent on average annually over the medium term with still relatively low inflation.

78. **Under the slow growth scenario, medium-term financing requirements during 2004-07 are estimated to be about US$4.9 billion per year.** FDI flows are expected to provide only one-fifth of external financing. The external financing gap would be financed mainly from new foreign commercial borrowing, but as the current account deficit shrinks very gradually, external debt (measured in USD) is expected to decline only modestly to 80 percent of GDP in 2007. New disbursements of long-term debt would remain high on average at 11 percent of GDP over the whole projected period, out of which official creditors' participation in new borrowing would diminish towards 0.6 percent of GDP in 2007. IBRD disbursements under the slow growth scenario are US$116 million a year and cover approximately 2 percent of total financing needs. (See Annex B6 for macroeconomic indicators under the three scenarios discussed above.)

E. Monitoring for Results

79. **The results focus of the CAS program, and in particular the PALs, requires an effective monitoring and evaluation (M&E) system to help assess effectiveness.** The PAL has begun the process of designing an M&E system covering the PAL program, with the PAL coordinating body that includes state secretaries from different ministries as the focal point. The work will be extended to cover the entire CAS. M&E is being designed at several levels, reflecting (i) the multi-tiered nature of the CAS objectives and desired outcomes and (ii) the time dimension of the CAS period. Country-level intermediate indicators for tracking progress toward CAS outcomes to be influenced by the World Bank Group's CAS program are quantified where possible. Country-level indicators are shown together with some key intermediate indicators in Table 9 below. (See Annex B9 for more comprehensive elaboration.) The data needed to monitor progress against these indicators, together with related institutional arrangements, will be generated on a timely basis and reviewed as part of the PAL program and during preparation of Bank-financed investment projects. Croatia's statistical infrastructure has expanded its survey coverage and has started to align its data collection and generation with that of EUROSTAT, including the production of regional and county level information. As for sectoral data coverage, significant steps have been taken to align with the requirements from the specific chapters of the EU *acquis*, such as environment and business environment data, and as the quality of the data improves over time, more will be reflected.

80. **The evaluation component of the system will be enhanced by the PAL instrument itself, as during preparation of the successor PALs the Bank and the government will assess the outcomes of the PAL program to date and determine whether adjustments are necessary.** To that end, surveys (such as the FIAS Administrative and Regulatory Cost Surveys) and focus groups (such as those on business environment) will be used to provide stakeholder feedback. This will complement quantitative information from the monitoring component (e.g., the processing time for business registration and productivity measures).

81. **To improve institutional capacity in both the ministries and the Bank's Country Office, a long distance learning program through the World Bank Institute (WBI) was launched with an introductory course in the fall of 2003 followed by an intermediate course held in June 2004.** The learning program aims to build capacity in the Country Office as well as in key ministries for monitoring policy and program performance over the medium term. In the context of investment operations (e.g., in the social sector), upgrading institutional capacity for M&E is also being addressed. The public administration component of the PAL will also support reforms to improve government capacity to evaluate policies and programs.

82. **Some elements of the planned AAA program will assist in the evaluation of progress against country outcome indicators.** In addition, the annual Joint Portfolio Reviews (JPRs) will increasingly focus on results and outcomes, beginning with the JPR planned for the fall of 2004. The JPRs will also take account of anticipated new Bank policies aimed at facilitating project restructuring to maximize development impact in light of project implementation experience.

Table 9: Key Indicators for Tracking Progress Toward Achievement of CAS Outcomes

	Macroeconomic Sustainability	Sustainable Private Sector-Led Growth	Broad Participation in Growth	Sustainable Natural Resource Management
Country-Level Indicators	• Annual inflation rate held below 3 percent during CAS period • Reduction of public and publicly guaranteed debt from 54 percent to 51 percent of GDP by 2008 • Reduction of primary fiscal deficit from 3.7 percent to below 0.4 percent of GDP by 2008 • Reduction of government expenditure from 50.5 percent of GDP in 2003 to below 45 percent of GDP by 2008	• Average annual real GDP growth of 4.0 percent to 4.5 percent during CAS period • Increased private sector share of GDP from 60 percent in 2003 to 70 percent by 2008 • Average total factor productivity of 6 percent during CAS period • Average annual inflows of FDI at 3.8 percent of GDP during CAS period	• Increase in adult population with secondary education from less than 40 percent in 2003 to 44 percent in 2008, and decrease in tertiary education net dropout rate from 70 percent in 2003 to 50 percent in 2008 • Student achievement at competitive European level • Sustained increase in employed share of working-age population, including in "disadvantaged and war-affected areas," from national level of 43 percent in 2003 • Health outcomes approaching those of EU averages for infant and maternal mortality rates and incidence of TB[25]	• Sustained progress toward alignment with EU *acquis communautaire* on environment • Improved water quality in coastal areas and Croatian Danube River Basin • Increased water service delivery coverage • Reduced dependence on fossil fuels
Selected Intermediate Indicators to Track Progress During CAS Implementation	• Steady reduction in enterprise subsidies to US$850-900 million in 2006 and US$760 million by 2008 • Implementation of forthcoming Public Finance Review recommendations • Development and implementation of a debt management strategy • Reduction in prescription drugs' share of HZZO's total expenditure from 21 percent in 2003 to 17 percent in 2008	• Divestiture by end-2006 of 600-800 SOEs held by CPF, and 1,130 SOEs by end-2008 • Enactment of amendments to the Laws on Physical Planning, Construction, and Utility Services • Enactment of Civil Service Law • Alignment of financial management systems and controls and public procurement procedures with EU standards • Rationalization of the court system	• Introduction of external secondary school leaving examinations and a professional development system for teachers and school principals • Means-testing for increased share of social benefits • Increase in share of primary health care expenditure in total health spending from 16 percent in 2003 to 18 percent in 2006 and 20 percent in 2008 • Implementation of regional development strategy for economically depressed areas, in line with EU requirements	• Investment in environment ministry staff training and certification programs • Upgrading of aging wastewater treatment plants to EU environmental standards • Development of strategy for meeting Kyoto Protocol commitments

Note: Both the IMF SBA and the Bank PAL program will monitor progress of the macroeconomic sustainability measures. The PAL program has components relating to sustainable private sector-led growth. The various investment operations dealing with broad participation in growth and sustainable natural resource management have a results framework for monitoring the related outcome indicators.

[25] Infant mortality rates are 7.4 per 1000 live births (EU average is 4.9), maternal mortality is 6.9 per 100,000 live births (EU average is 5.5), and the incidence of TB is almost three times the EU average. (See Table 1.)

F. Partnerships

83. **With the opening of accession negotiations and Croatia's resulting eligibility for pre-accession grant funds in 2005, the EC will have a comparative advantage in terms of financial support.** In addition, after signing the SAA in 2001, Croatia has been eligible for grant funds under the EC's Community Assistance for Reconstruction, Development and Stabilization (CARDS) Program. The 2004 CARDS Program is for a total of 76 million euro, to be committed over the next three years. Priorities for CARDS funding are focused in five areas: judicial reform (29 percent), economic and social development (23 percent), return of refugees and civil society development (23 percent), institution building and public administration reform (20 percent), and environment and natural resources (5 percent).

84. **The Bank is closely coordinating with the EC and will continue to give high priority to supporting reforms and developing programs and operations to maximize Croatia's utilization of EC grant funds.**[26] It is worth noting that the World Bank CEM (2003) was instrumental in informing the EC's favorable opinion issued in April 2004, and CARDS support for cadastre and land registry reform (4.5 million euro) is being administered by the Bank as cofinancing under the Bank's ongoing project in this area. The Bank will deepen collaboration with the EC on the next CAS and is continuing to do so as the PAL program is developed, to ensure convergence with Croatia's accession agenda. The Bank will aim to coordinate with the small bilateral donor community to maximize the synergy between the PAL-EU accession reforms and meet the TA needs. (See Table 10.)

Box 3: Croatia's Relationship with the IMF

Croatia has signed three precautionary SBAs with the IMF. The second SBA, approved by the IMF Board in February 2003, in an amount equivalent to SDR 105.9 million for a period of 14 months, went off track in late 2003 and expired in April 2004. The Government did not make any purchases. The third review was not completed as fiscal policy went off track in the run-up to the November Parliamentary elections. The fiscal deficit target for 2003 was missed by more than 1 percent of GDP, and quasi-fiscal operations and contingent liabilities expanded. In early February 2004 the new government requested a successor SBA. On August 4, 2004 the Fund Board approved the Staff Report for the Article IV Consultation and Request for SBA. The new arrangement, in an amount equivalent to SDR 97 million for a period of 20 months, will be treated as precautionary, as were the two preceding arrangements. The major objective of the new SBA is to reduce external vulnerability through more forceful fiscal consolidation. A fiscal and quasi-fiscal adjustment of 2.75 percentage points of GDP should help to reduce the savings-investment imbalance and stabilize the external debt-to-GDP ratio. The authorities have explained their reliance on one-off measures in 2004 and postponement of some adjustment efforts to 2005 as resulting from their having inherited spending obligations and needing time for cost-savings measures to take off. The structural reforms under the Fund program are closely aligned with the reforms to be undertaken under the World Bank's Programmatic Adjustment Loan Program.

85. **The government has recently concluded discussions with the IMF for a new SBA**. The Staff Report for the 2004 Article IV Consultations was approved by the IMF Board on August 4, 2004. (See Box 3.) The Bank will continue to take the lead in supporting Croatia's structural reform agenda, while collaborating closely with the IMF to ensure synergies between the macroeconomic reforms supported under the SBA and the structural reforms to be supported under the proposed PAL program, especially those dealing with fiscal consolidation and public expenditure. The new SBA and the proposed PAL program will be mutually reinforcing, as they both aim at reducing Croatia's external vulnerability through fiscal consolidation, increased transparency and efficiency of public expenditure and debt management, and financial discipline and transparency for SOEs. In addition, the SBA is supporting development of a domestic debt market as well as structural reforms to unify supervision of non-bank financial

[26] EC pre-accession funds will be available to help Croatia meet EU standards on the environment (water, wastewater, and solid waste management), to develop pan-European transportation networks (mainly roads), and to finance institution building as well as investments for rural development. To absorb these grant funds fully and effectively, Croatia will need to: (i) develop the institutional capacity to prepare and implement projects; and (ii) make counterpart matching funds available. As it has done with other accession countries, the Bank will assist in both of these areas, working jointly with the government and the EC.

intermediaries, strengthen supervision of banks' credit risk, ensure the long-term sustainability of the pension system, and improve the quality of balance of payments data.

Table 10: Areas of Other Partner Activity

Areas Of Reform	Active IFIs and Donors
Political Criteria:	
JUDICIAL REFORM	• EC – CARDS (TA and investment)
ANTI-CORRUPTION MEASURES	• EC – CARDS (TA)
PUBLIC ADMINISTRATION REFORM	• EC – CARDS (TA) • DFID (TA) • The Netherlands – MATRA Program (TA) • USAID – Local Government Reform Program (TA)
PROTECTION OF ROMA	• EC – CARDS (access to legal aid)
COMPLETION OF REFUGEE RETURNS	• EC – CARDS (TA and investment) • USAID (TA and investment) • Council of Europe Development Bank (investment) • Italy – Program for reconstruction of Eastern Baranja • The Netherlands (investment) • SIDA (TA and investment) • Germany (TA and investment)
Economic Criteria:	
MACROECONOMIC STABILIZATION AND FISCAL FRAMEWORK	• IMF – SBA • EC – CARDS (TA in public finance) • USAID (TA in financial management systems)
ENTERPRISE RESTRUCTURING AND PRIVATIZATION	• USAID – TA (shipbuilding and *agro-kombinat* SOEs) • EBRD (investment)
BUSINESS ENVIRONMENT	• Finland (TA for R&D reform) • EBRD (credit for SMEs) • USAID (TA for SMEs in tourism and IT) • Austria (TA, credit, and investment for SMEs)
CADASTRE AND LAND REGISTRY	• EC – CARDS (TA and investment)
DEBT MANAGEMENT	• IMF – SBA • EC – CARDS (TA) • USAID (TA)
Ability to Assume Obligations of Membership:	
FINANCIAL CONTROLS	• EC – CARDS (TA to State Auditing Office and Public Procurement Office) • USAID – Local Government Reform Program (TA and investment) and TA to Ministry of Finance
AGRICULTURE	• EC – CARDS (TA for veterinary and phytosanitary controls) • EC pre-accession funds, to be followed by structural funds (post-accession) • USAID (TA for market linkages)
TRANSPORT AND CUSTOMS	• EC – CARDS (TA) • EIB (investment) • EBRD (investment) • KfW (investment) • EC pre-accession funds, to be followed by structural funds (post-accession) • USAID (TA)
ENERGY	• USAID (TA for HEP restructuring and tariff reform) • EBRD (investment in gasification) • EIB (investment in gasification)
ENVIRONMENT	• EBRD (investment) • EIB (investment) • KfW (investment) • EC – CARDS • EC pre-accession funds, to be followed by structural funds (post-accession) • The Netherlands (TA)
HUMAN RESOURCE DEVELOPMENT (labor, education, health, social protection)	• EC – CARDS (TA for mobility centers and vocational education and training) • UNDP (TA for social protection)
REGIONAL DEVELOPMENT	• EC CARDS (TA) • EC pre-accession funds, to be followed by structural funds (post-accession)

86. **EBRD assistance focuses on investment in municipal infrastructure investment and SMEs as well as investment for financial sector capacity building, while EIB financing is focused largely in transport, environment, and local infrastructure, with opportunities for cofinancing with the World Bank.** Bilateral assistance is primarily in the form of twinning and other technical assistance to meet specific institution and capacity building needs. Examples include public procurement (Germany and Slovenia), financial management systems (USAID), and public administration reform (The Netherlands). See Annex B9 for a more complete listing of partners' areas of activity.

IV. MANAGING RISKS

A. Implementation Risks

87. **The main risk for the sustained growth scenario comes from potential policy slippages, including some of the post-election pledges.** These would derail Croatia from its sustainable growth path and result in a higher and unsustainable fiscal deficit, a growing external balance, a worsening debt profile, and consequently macroeconomic instability. Any fiscal policy slippages or relaxation of fiscal policy could seriously undermine macroeconomic stability and Croatia's creditworthiness. The risk of such slippages to implementation of the base and high case CAS programs is addressed through the self-regulating mechanism of the PAL program. In the event that base and high case triggers (which are closely linked to PAL conditions) were not substantially met or were reversed, Bank assistance would necessarily revert to the low case.

88. **Some of the reforms needed for EU accession will have significant social costs, and therefore carry political risk for the government.** However, strong public support for EU accession, especially following the EU's favorable decision in June 2004, and implementation of social mitigation measures should facilitate the government's implementation of the EU accession agenda. Social consensus on the reform agenda has yet to solidify. Building such consensus will therefore be critical. To help address this, the Bank will continue to hold sector policy seminars with stakeholders led by government counterparts to explain costs and benefits of the reforms. The Country Office will organize a program to enhance understanding of the Bank Group and its Croatia program in the Ministry of Finance and among other key counterparts for the PAL program.

89. **As the current HDZ-led government is a coalition with a one-seat majority in Parliament, there is a risk that it will not be able to retain power over the medium term.** Political distractions, a change in government, and the resulting transition period would delay implementation of needed reforms. However, all parties are committed to Croatia's accession to the EU, and so continuity on the associated reform agenda is likely over the longer term. Experience elsewhere in the region has shown that buoyed by widespread public support, the goal of EU accession provides continuity in a candidate country's development program, from one government to the next. In the case of Croatia, the core agenda of the CAS, the PAL program, has high-level attention of the entire government. This is critical to successful implementation, given that reforms will need to be undertaken by many line ministries. Government ownership of the program is grounded not only in the EU accession agenda but also in the SBA and the findings of the World Bank's CEM of 2003.

90. **The government understands the need for reforms and is committed to the reforms' underlying objective of EU accession, but there are capacity constraints.** A stronger process and structure are needed for economic analysis and policy formulation. The technical and administrative capacities in this regard, if not improved, may slow down the reform process, with a resulting loss in momentum and the loss of credibility with enduring effects. An ambitious reform program depends on strong and dynamic institutions in order to be effective and sustainable. Improving governance through public administration reform, public expenditure management, and judicial reform, all to be supported under the PAL program, is therefore critical to implementation of other reforms.

B. External Risks

91. **Although current developments in South East Europe support regional stability and trade, thus offering better business opportunities for Croatia as well, any setback in the security situation in the region could have a severe impact on Croatia's external position and its optimal economic growth.** In addition, a mild recovery in the EU15 where Croatia sends around 55 percent of its exported goods, but more than two-thirds of its service exports, is extremely beneficial to Croatia's growth and external balance. Conversely, any slowdown of the EU's economic growth, especially after the accession of ten new countries in May 2004, could seriously affect economic growth in the country and erode the otherwise weak country's international competitiveness, increasing external imbalance and viability.

92. **A continuing risk for Croatia as an emerging market with high foreign currency exposure in its public debt is its vulnerability to contagion from adverse developments in international financial markets.** In light of the limited development of the domestic debt markets, it would be risky to reduce the currency risk rapidly, as this would replace foreign currency long maturity debt with short-term, kuna-denominated debt. The pace of development of the kuna debt market and capacity building in debt management will therefore affect the risk structure of Croatia's public debt. Implementation by the Ministry of Finance of the draft reform plan developed under the joint World Bank/IMF Program on Sovereign Debt Management and Debt Markets Development, would directly help to address Croatia's external vulnerability.

Annex A1- Croatia
Key Economic & Program Indicators - Change from Last CAS

As of Date 11/23/04

	Forecast in Last CAS				*Actual*			*Current CAS Forecast Sustained Growth Scenario*			
Economy (CY)	*1999* [a/]	*2000* [b/]	*2001* [b/]	*2002* [b/]	*2002* [c/]	*2003* [c/]	*2004* [a/]	*2005* [a/]	*2006* [a/]	*2007* [a/]	*2008* [a/]
Growth rates (%)											
GDP	-1.0%	1.5%	2.0%	2.5%	5.2%	4.3%	3.7%	4.0%	4.5%	4.5%	
Exports of GNFS	0.4%	6.9%	5.1%	3.5%	1.3%	10.1%	5.8%	6.1%	5.0%	3.7%	
Imports of GNFS	-1.7%	2.3%	2.7%	3.9%	8.8%	10.9%	3.5%	2.9%	3.4%	2.3%	
Inflation (%)	3.5%	3.5%	3.5%	3.2%	2.2%	1.8%	2.5%	2.8%	2.4%	2.2%	
National accounts (% GDP)											
Current account balance	-7.6	-5.9	-5.0	-4.5	-8.4	-7.3	-6.0	-4.9	-4.1	-3.1	
Gross investment	20.5	19.7	19.3	19.0	28.4	30.4	27.7	28.4	28.8	28.5	
Public finance (% GDP)											
Fiscal balance	-1.1	-1.4	-2.2	-2.8	-4.5	-5.8	-4.5	-3.7	-2.9	-2.0	
Foreign financing	5.3	3.5	2.8	2.7	2.8	3.1	2.2	2.2	1.8	1.6	
International reserves (as months of imports)		3.8	4.6	4.6	5.4	5.7	6.2	6.2	6.3	6.3	
Program (Bank's FY)	FY99[a/]	FY00[b/]	FY01[b/]	FY02[b/]	FY02[c/]	FY03[c/]	FY04[c/]	FY05[b/]	FY06[b/]	FY07[b/]	FY08[b/]
Lending ($ million)	108.3	257.6	313.0	160.0	0.0	53.0	209.0	250.0	265.0	275.0	260.0
Gross disbursements ($ million)					173.2	41.9	120.8	305.8	321.4	273.3	219.1

a. Estimated year
b. Projected year
c. Actual outcome

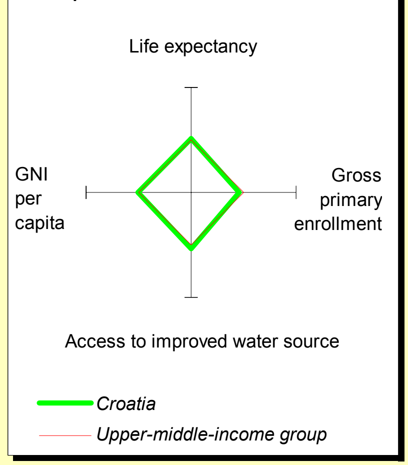
Croatia at a glance

11/23/04

POVERTY and SOCIAL

	Croatia	Europe & Central Asia	Upper-middle-income
2003			
Population, mid-year *(millions)*	4.4	473	335
GNI per capita *(Atlas method, US$)*	5,380	2,570	5,340
GNI *(Atlas method, US$ billions)*	23.9	1,217	1,788
Average annual growth, 1997-03			
Population *(%)*	-0.5	0.0	1.2
Labor force *(%)*	0.2	0.2	1.8
Most recent estimate (latest year available, 1997-03)			
Poverty *(% of population below national poverty line)*	11	..	..
Urban population *(% of total population)*	69	63	76
Life expectancy at birth *(years)*	75	69	73
Infant mortality *(per 1,000 live births)*	7	31	19
Child malnutrition *(% of children under 5)*	..	..	..
Access to an improved water source *(% of population)*	95	91	89
Illiteracy *(% of population age 15+)*	2	3	9
Gross primary enrollment *(% of school-age population)*	95	103	104
Male	..	104	104
Female	..	102	104

Development diamond*

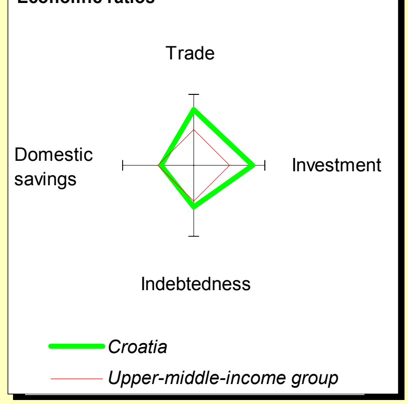


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1983	1993	2002	2003
GDP *(US$ billions)*	..	10.9	22.8	28.8
Gross domestic investment/GDP	..	15.5	28.4	30.4
Exports of goods and services/GDP	..	52.4	45.4	47.1
Gross domestic savings/GDP	..	14.3	19.1	20.7
Gross national savings/GDP	..	16.2	21.6	21.3
Current account balance/GDP	..	5.8	-8.4	-7.3
Interest payments/GDP	..	0.9	2.2	2.4
Total debt/GDP	..	22.8	67.6	81.8
Total debt service/exports	..	4.9	24.3	19.6
Present value of debt/GDP	..	..	65.8	..
Present value of debt/exports	..	..	122.8	..

	1983-93	1993-03	2002	2003	2003-07
(average annual growth)					
GDP	..	4.0	5.2	4.3	4.2
GDP per capita	..	4.6	5.1	4.3	4.8
Exports of goods and services	..	6.2	1.3	10.1	5.2

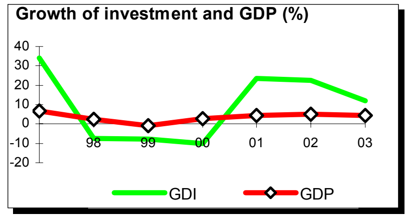
Economic ratios*



STRUCTURE of the ECONOMY

	1983	1993	2002	2003
(% of GDP)				
Agriculture	..	13.8	8.9	8.4
Industry	..	35.8	29.9	30.1
Manufacturing	..	30.6	20.3	19.3
Services	..	50.3	61.2	61.5
Private consumption	..	62.2	59.9	58.7
General government consumption	..	23.5	21.0	20.6
Imports of goods and services	..	53.6	54.7	56.8

Growth of investment and GDP (%)



	1983-93	1993-03	2002	2003
(average annual growth)				
Agriculture	..	-0.5	2.0	-5.2
Industry	..	3.6	5.7	7.4
Manufacturing	..	3.3	2.7	3.4
Services	..	4.8	5.5	5.0
Private consumption	..	3.4	7.5	4.1
General government consumption	..	-0.4	-1.8	-0.3
Gross domestic investment	..	7.5	22.5	12.0
Imports of goods and services	..	5.6	8.8	10.9

Growth of exports and imports (%)

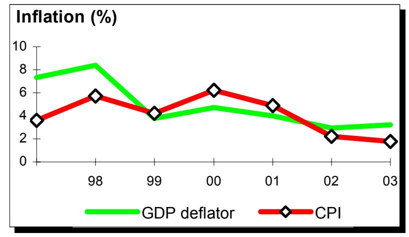
Note: 2003 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Croatia

PRICES and GOVERNMENT FINANCE

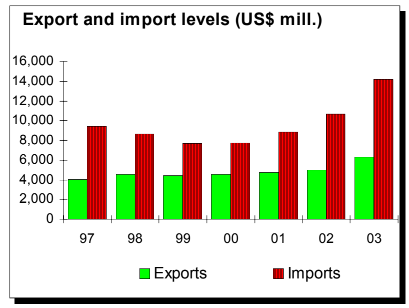
	1983	1993	2002	2003
Domestic prices				
(% change)				
Consumer prices	..	1,516.6	2.2	1.8
Implicit GDP deflator	..	1,466.8	2.9	3.2
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	36.9	44.9	44.3
Current budget balance	..	-0.1	2.0	1.9
Overall surplus/deficit (with privatiz.receipts)	..	-2.0	-3.1	-4.0



Inflation (%)

TRADE

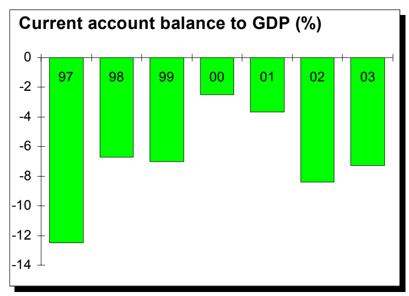
	1983	1993	2002	2003
(US$ millions)				
Total exports (fob)	..	3,910	5,004	6,285
Raw materials, excluding fuels	..	237	274	350
Mineral fuels and lubricants	..	377	458	594
Manufactures	..	1,762	2,456	3,061
Total imports (cif)	..	4,620	10,652	14,206
Food	..	266	794	1,001
Fuel and energy	..	447	1,310	1,552
Capital goods	..	749	3,682	5,261
Export price index *(1995=100)*	..	..	141	120
Import price index *(1995=100)*	..	..	139	119
Terms of trade *(1995=100)*	..	..	101	101



Export and import levels (US$ mill.)

BALANCE of PAYMENTS

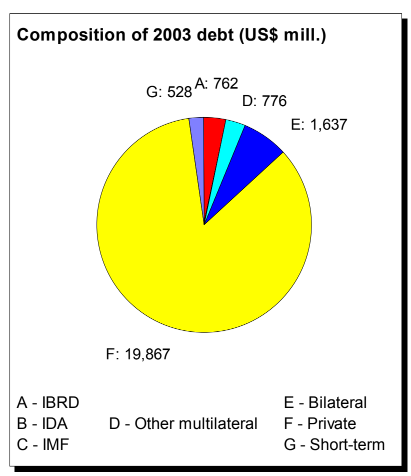
	1983	1993	2002	2003
(US$ millions)				
Exports of goods and services	..	6,196	10,571	14,907
Imports of goods and services	..	5,767	13,065	17,186
Resource balance	..	429	-2,494	-2,279
Net income	..	-120	-502	-1,213
Net current transfers	..	328	1,076	1,394
Current account balance	..	637	-1,920	-2,099
Financing items (net)	..	-171	2,617	3,490
Changes in net reserves	..	-467	-697	-1,391
Memo:				
Reserves including gold *(US$ millions)*	..	616	5,886	8,191
Conversion rate *(DEC, local/US$)*	..	3.6	7.9	6.7



Current account balance to GDP (%)

EXTERNAL DEBT and RESOURCE FLOWS

	1983	1993	2002	2003
(US$ millions)				
Total debt outstanding and disbursed	..	2,486	15,421	23,570
IBRD	..	89	611	762
IDA	..	0	0	0
Total debt service	..	325	2,967	3,314
IBRD	..	43	52	86
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	0	60	..
Official creditors	..	-52	165	196
Private creditors	..	12	2,352	3,572
Foreign direct investment	..	102	591	1,875
Portfolio equity	..	0	-230	1,009
World Bank program				
Commitments	..	0	202	..
Disbursements	..	1	126	155
Principal repayments	..	33	30	58
Net flows	..	-33	95	97
Interest payments	..	9	22	28
Net transfers	..	-42	73	69



Composition of 2003 debt (US$ mill.)

Croatia's Public Debt

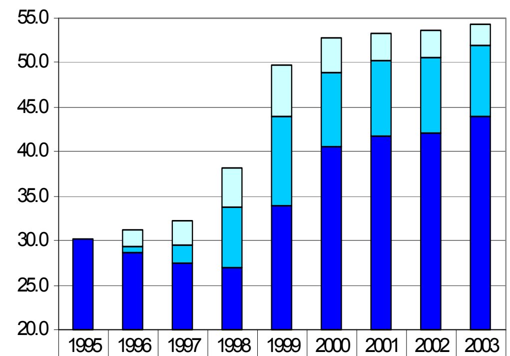
Summary

Over the last seven years the level of Croatia public debt has been rising steadily in absolute and relative terms, reaching around 55 percent of GDP at the end of 2003. In addition, the annual public debt service costs have increased for 2.5 percentage points of GDP after 2000, compared with the 1995-1999 period. In order to sustain macroeconomic stability, with the current growth rate, inflation and historically low interest rates, the government would need to reduce its primary deficit to the sustainable level of 0.38 percent of GDP or less. To control the debt level, the government will therefore need to pursue further consolidation of its fiscal spending of at least 3 percentage points of GDP. The fiscal adjustment efforts would need to be complemented with improvements in public debt management, by strengthening debt management capacity and addressing a non-existence of risk management function.

Croatia's Public Debt Profile

1. ***The recent redefinition of Croatian public debt under the 2003 IMF Stand-By Arrangement pointed to the urgent need for improving debt management and continuation of fiscal consolidation process.*** There is no internationally accepted consensus about the definition of public debt as well as the acceptable limit[1] of public debt. Different countries have different definitions. The Croatian government broadened the definition of its public debt to include, apart from the central government, off-budget agencies and local government debt, i.e., Consolidated General Government[2]. It also includes some contingent-explicit liabilities of the public sector (outstanding financial government guarantees). However, it excludes performance guarantees and some arrears amounting to approximately 7.6 percent of GDP at the end of 2003.[3] For the purposes of this analysis, the officially recognized debt has been increased for the arrears-part of the debt.[4]

Figure 1: Croatia's Public Debt as % of GDP



	1995	1996	1997	1998	1999	2000	2001	2002	2003
Arrears	0.0	1.8	2.7	4.4	5.7	3.8	3.0	3.0	2.5
Publicly guaranteed	0.0	0.8	1.9	6.8	10.1	8.3	8.6	8.4	7.9
Public debt	30.3	28.6	27.6	26.9	33.9	40.6	41.7	42.1	44.0

Source: Croatian National Bank and the Ministry of Finance

[1] The most commonly used public indebtedness criteria in Croatia is the one from European Union Maastricht Agreement (signed in 1992) which sets the upper limit for the public debt at 60 percent of GDP, but does not include indirect debt.

[2] Consolidated General Government of Croatia consists of: the State Budget, Extrabudgetary Funds (Croatian Institute of Pension Insurance, Croatian Institute of Health Insurance, Croatian Employment Bureau, Croatian Waters), State Agencies (Croatian Highways, Croatian Roads, State Agency for Deposit Insurance and Bank Rehabilitation, Croatian Privatization Fund) and Local Government units.

[3] WB staff estimate based on the MoF and the Health Fund data.

[4] Arrears are defined as all overdue state and local government liabilities and all short-term unpaid liabilities of the health sector. This definition differs from the IMF definition that includes only overdue liabilities over the contracted period. However, the Health Fund issues contracts with payment periods even over 240 days.

2. ***The total gross stock of Croatia's public debt, without performance guarantees, has nearly doubled over the last eight years.*** Public debt increased from 30.3[5] percent of GDP in 1995 to 54.7 percent of GDP in 2003. The highest growth was observed in 1999 when the debt to GDP ratio increased by 11.6 percentage points of GDP in only one year. Although the rate of growth declined in subsequent years, fiscal consolidation efforts undertaken were not enough to completely subdue the increase of debt. Obviously, Croatia's public sector capability to finance its expenses with its revenues has considerably deteriorated in the observed period, as reflected in increasing public debt and inability to fully clear the stock of arrears. There are two important phenomena affecting public sector debt growth: (i) a significant portion of Croatia's public debt (approximately 23 percent of the total public debt in 2003) was inherited from the former Yugoslavia (e.g., frozen foreign exchange deposits[6], and the London Club and Paris Club debt[7]), and (ii) after obtaining the investment credit rating in 1997, external borrowing on the international capital market became affordable, which the authorities used to postpone temporarily the fiscal consolidation process.

Box 1: Internal and External Public Debt

Croatia's internal public debt consists of frozen foreign exchange deposits (FFEDs), bonds for restructuring (so-called Big Bonds), bonds for banks' rehabilitation (BRA bonds), Treasury Bills, bonds syndicated through domestic banks (G-Bonds), Croatian Institute of Health Insurance Bonds and other short-term debt. At end 2003 internal direct public debt was HRK 33.4 billion or 17.4 percent of GDP (a 0.5 p.p of GDP increase over 2002). When outstanding government guarantees to domestic banks and arrears are added, total domestic public debt sums up to HRK 45.2 billion (23.5 percent of GDP).

External public debt of Croatia consists of London and Paris Club obligations, credits from IFIs, and increasing share of debt to commercial banks and sovereign bonds. After attaining the lowest investment credit rating in 1997, the Government of Croatia issued a series of bonds and took several syndicated loans. Total direct external public debt of Croatia amounted to HRK 45.4 billion or 25.4 percent of GDP at end 2002 and increased to HRK 51.5 billion or 26.8 percent of GDP in 2003. Including the outstanding government guarantees, total external public debt adds into HRK 59.7 billion (31.1 percent of GDP).

3. ***Large levels of public expenditure in the 1990s and in the early 2000 have been the main cause of rising and high fiscal deficits and, consequently, rising public debt.*** The government took steps since 2000 to repay accumulated arrears, to implement expenditure cuts, and to undertake structural reforms that will have a long-term positive impact on fiscal sustainability (defense, pension, health reform, budget management reform). While reduced primary current spending managed to restore positive current savings, higher public investment implied that the primary fiscal deficit was only partially reduced between 1999 and 2002 from over 6 percent of GDP to around 3 percent of GDP. This is in sharp contrast with average primary deficits of less than 1 percent during 1995-98 and a surplus of over 2 percent of GDP in 1994.

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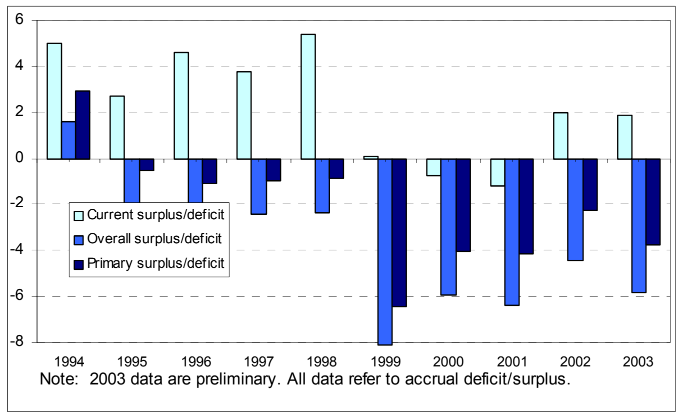
[5] 1995 debt data is corrected for London and Paris Club debt recognized in 1996.

[6] FFEDs originate from the right of the former Yugoslav citizens to hold foreign currency accounts in domestic banks, which re-deposited this foreign currency in the National Bank of Yugoslavia (NBJ) in return for domestic currency. At the time of the break-up of former Yugoslavia, Croatian banks held more than HRK 17.75 bill in the NBJ, which subsequently retained all of these funds. The government decided to accept these commercial banks assets as public debt as they represented the lifetime savings of a sizeable portion of the population.

[7] The official recognition of that debt was done after reaching an agreement with the Paris Club in 1995 and with the London Club in 1996. The basic formula for the allocation of former federal liabilities was devised by the IMF in order to distribute the former Yugoslavia's so-called "non-allocated" debt to the Paris Club. Croatia acknowledged 28.49 percent of the debts owed or guaranteed by the former Yugoslavia not attributable to any successor republic. Under the agreement with the London Club creditors, Croatia assumed 29.5 percent of Refinancing Loans under the net foreign assets and 19.7 percent of the Trade and Deposit Facility Agreement. In July 1996, this debt was exchanged for Croatian Series A and B Bonds, and by this Croatia normalized relations with all its foreign creditors.

4. ***In addition to the financing of budget deficits, public debt has also grown to finance the bailouts and further recapitalization of several banks and public enterprises, or to cover under-funded obligations of the deposit insurance scheme and the health fund deficit.*** Based on CNB and Ministry of Finance (MoF) data, staff estimates indicate that 7 percent of total public debt stemmed from bank rehabilitation and deposit insurance, 5 percent from health system rehabilitation including its arrears, 10 percent from shipyards, 13 percent from transport (including railways and highways construction), 3 percent from pension reform, 2 percent from local government borrowing and 1 percent from *agro-kombinats*.

Figure 2: Croatia's Public Sector Balances, % of GDP

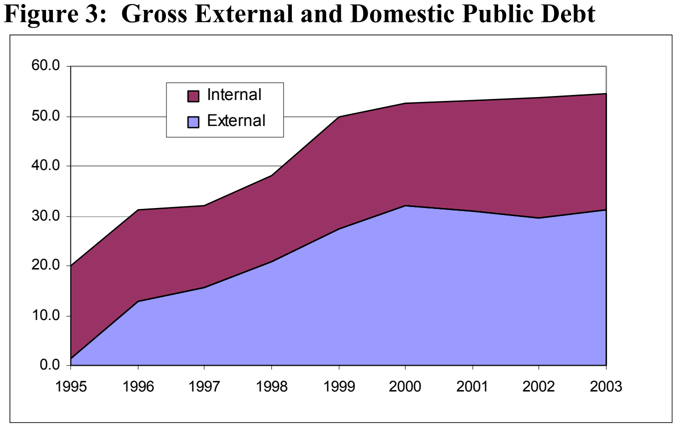


Source: Ministry of Finance and staff estimates

5. ***Fiscal developments in the last four to five years have also revealed two other important sources of debt accumulation: unpaid internal obligations of the public sector (arrears) and contingent liabilities in the form of state guarantees.*** The government accumulated significant arrears amounting to 1.5 percent of GDP per year in the 1996-99 period. Government guarantees have increased significantly since 1996, reaching an amount equivalent to 13 percent of GDP in outstanding guarantees[8] by end-2003. Such guarantees represent a major source of contingent liabilities for the budget. Since 2003 there was no firm legal criteria for selecting guarantees' beneficiaries, and furthermore, guarantees were most often issued without a clear plan or risk containment measures.

6. ***Although the external debt share is 57 percent of the total, the wide use of foreign currency clauses in domestic borrowing significantly changes the currency structure.*** A share of foreign currency denominated or indexed to foreign currency debt in total public debt at 85 percent, as well as the currency composition of external debt, reveal the vulnerability of a country towards external shocks and changes in the exchange rate of particular currencies. Apart from the Treasury bills and one HRK-bond issuance at domestic market, all domestic borrowing is linked to the Euro. Kuna-denominated debt amounts to only 15 percent of total debt. Euro-denominated debt amounts to approximately 58 percent of the total. There is a growing exposure to the Japanese Yen (JPY), while US dollar-denominated debt is getting a reduced share in the total. The current currency structure of Croatian debt reveals significant currency risk.

Figure 3: Gross External and Domestic Public Debt



Source: Ministry of Finance and WB staff estimates

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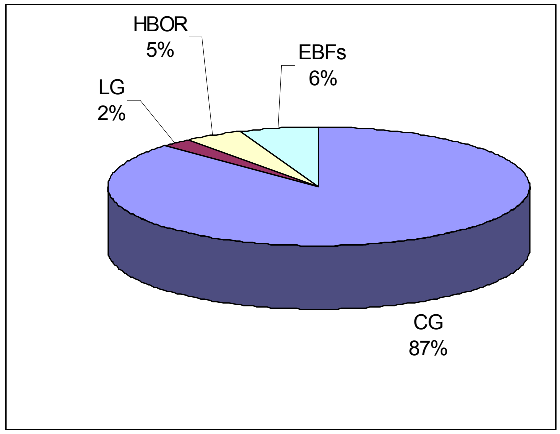
[8] Includes financial and performance guarantees. The outstanding amount is World Bank staff estimate based on official MoF data.

7. ***The structure of public sector debt by main debtor did not change much during the last eight years.*** The highest concentration, although reduced from 96 to 87 percent of the total, is still at the central government level. This points to the key role of the Treasury Debt Department in managing the overall public debt. More recently, the off-budget agencies (mostly Croatian Highways and Croatian Road Agency) were able to borrow independently domestically and from abroad. Their share in the total debt, excluding the guaranteed debt by the Treasury, was 6 percent at the end of 2003. The Croatian Bank for Reconstruction and Development (HBOR), having obtained the sovereign credit rating, is increasing its debt exposure but also carries an increasing contingent liability for the Treasury (central government). Most of HBOR lending to the domestic sector is contracted with the Treasury guarantee. Due to a weak fiscal capacity (apart from the City of Zagreb and few more towns) and very stringent legal provisions for local government borrowing, local government units are active mostly on the domestic commercial banks' market. There have been only a few local government borrowings from the IFIs. Most of the increase in the external debt after 1997 has been driven by central government borrowing and by off-budget agencies (in particular, Highways and HBOR), while local levels of government have mostly faced statutory and procedural restrictions on external borrowing.

Figure 4: Croatian Public Debt by Debtors



Source: Ministry of Finance

8. ***Since 1997 there has been a shift in the sources of financing.*** At the beginning of the 1990s most new financing was coming from non-market sources (e.g., Central Bank, bilateral and multilateral agencies) and state-owned banks. As a result of the institutional change of the public finances and monetary authorities independence, as well as settling relations with the London and Paris Clubs, the government today borrows almost 86 percent of its debt from market sources. The share of the preferred debtors (e.g., IFIs or multilateral agencies) is an additional 8 percent of the total. In contrast, sovereign external bonds gained considerable ground over this period, reaching almost one-third of the total debt by the end of 2003. With the launch of the pension reform and establishment of second pillar pension funds (new players in the capital market) in 2002, the government started to tap into the domestic bonds market. The aim was to foster development of the domestic capital market but also to develop the kuna yield curve and deepen the market. So far, however, there has been only one HRK-bond issuance, while the others have been linked to the Euro; obviously, the government did not answer the market needs.

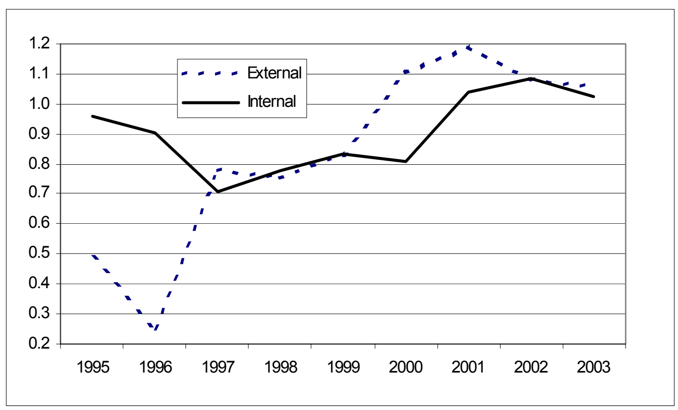
9. ***Croatia's public debt as well as its trend compare unfavorably with accession and EU countries.*** Its public debt has been increasing ever since Croatian independence. On average, accession and EU countries have in the last seven years succeeded to reduce the public debt level by 2.8 percentage points and 8.3 percentage points of GDP, respectively. By contrast, Croatia expanded its debt by 23.4 percentage points of GDP. Accession countries' debt level remained on average at 36 percent of GDP, far below the EU average of almost 63 percent or the level registered by Croatia in 2002 and 2003. Also, due to the rising stock of debt, annual interest payments in Croatia’s budget have increased, whereas they have declined in comparator groups.

Table 1: Public Debt and Interest Payments (% of GDP)

	Debt			Interest Payments	
	1995	**2002**	**Difference**	**1995**	**2001**
Lithuania [1/]	17.8	29.5	+11.7	0.4	1.6
Latvia[1/]	16.2	14.6	-1.6	1.2	1.1
Estonia[2/]	8.6	5.2	-3.4	0.2	0.3
Czech Republic[1/]	15.6	41.7[4/]	+26.1	1.2	1.0
Poland	54.3	46.0	-8.3	4.5	3.0
Romania	25.5[3/]	28.9	+3.4	1.4	3.1
Hungary	86.4	54.3	-32.1	9.3	4.8
Bulgaria	120.6	69.7[4/]	-50.9	14.7	3.7
Slovenia	18.8	26.9	+3.6	1.2	1.6
Slovak Republic	22.8	42.7	+19.9	2.1	3.2
Av. CEEC	**38.7**	**36.0**	**-2.8**	**3.6**	**2.3**
Croatia*	**30.3**	**42.2**	**+11.9**	**1.4**	**2.2**
Croatia[2/*]	**30.3**	**53.7**	**+23.4**	**1.4**	**2.2**
EU	70.9[3/]	62.6	-8.3	5.4	3.8

Notes: *Croatian data for 1995 corrected for Paris and London Club debt.
1/ Includes guarantees; 2/ Includes guarantees and arrears; 3/ for 1997 instead; 4/ for 2001.
Source: World Bank, IMF (GFS), Transition Report 2003, EBRD

Figure 5: Interest Payments as % of GDP

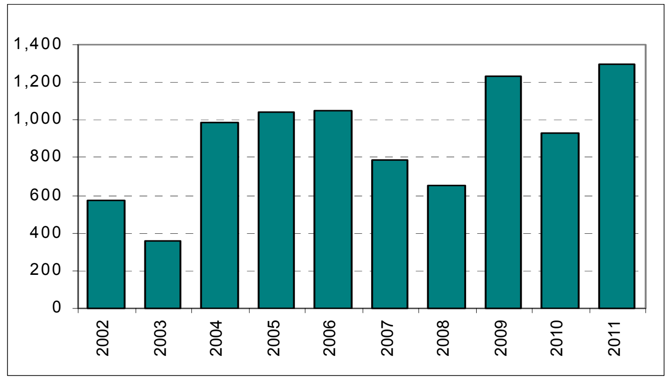


Source: Ministry of Finance

10. ***Until now, financing of these large deficits has been facilitated by relatively easy access to international capital markets, which allowed issuing debt at low country risk spreads, and by significant privatization receipts.*** In fact, financing costs have declined considerably in the last four years. Spreads on Government Eurobonds have plunged from over 500 basis points over benchmark securities in 1999 to 70 basis points in 2004. At the same time, maturities have lengthened. Nevertheless, these terms are not as favorable as those of accession countries. Concerns about debt sustainability or contagion from other countries in the region or reversals in the market's assessment of Croatia's prospects for eventual EU membership could reverse the improving trend in the terms of government debt. In such a scenario, interest payments could easily derail the gradual fiscal adjustment strategy which the government is currently pursuing, through an explosive growth of debt service. Similarly, if macro-adjustment were to lead to a depreciation of the kuna, the debt and debt service to GDP ratios could easily jump to unsustainable levels.

11. ***Debt management as well as budget management should be improved to properly address the above risks.*** First, the use of privatization receipts to finance deficits has so far served to release some budgetary pressures, but it is not a viable long-term strategy as privatization receipts are expected to diminish after 2005-06. Second, the existing arrears and the lack of control on the provision of government guarantees indicate that substantial improvements in debt management are urgently required to put government contingent liabilities under control. Third, the amortization schedule of public debt for the next three years, as well as for the 2009-2011 period, suggests the need for heavy refinancing. Coordinated and sound fiscal policy would respond to such situations by planning primary surpluses for the years with heavy debt repayments to avoid any unexpected payment risks. Fourth, sustainability analysis clearly shows the need for pursuing more rapid fiscal adjustment and avoiding pro-cyclical fiscal policy if the government wants to sustain macroeconomic stability in the medium term.

Figure 6: External Debt Repayments in mill US$



Source: Croatian National Bank

Issues and Diagnosis

The Primary Balance and Debt Sustainability

12. ***Pro-cyclical fiscal policy during the 1990s seriously undermined fiscal sustainability, underpinned by the Russian and Kosovo crises, both of which resulted in an economic downturn.*** Fiscal deficits averaging 2.3 percent of GDP from 1995 to 1998 turned to 6 percent of GDP in the period thereafter. The fiscal policy stance over the second half of the 1990s has not been sustainable, as evident from fast debt growth. While from 2000 there has been a change in the trend, such change is not yet sufficient to restore inter-temporal solvency. In the long run the government must accumulate *real* debt (as a share of GDP) at a rate lower than the real rate of interest in order to be able to amortize at least some small fraction of its debt. The fiscal sustainability exercise suggests that ***the sustainable level for the primary balance*** (a balance required to maintain a financiable level of debt based on assumptions regarding growth, inflation and the public demand for money) over the medium term[9] is ***0.38 percent of GDP***. This comes from a combined estimated real debt service cost of 0.47 percent of GDP (this is net of growth's effect on the stock of debt), plus seignorage revenue of 0.85 percent of GDP.[10] With the current real growth rate that Croatia achieves, the government will have to find additional savings of at least 3 percentage points of GDP to control the debt level. If the government faces a higher premium on its nominal debt, a primary surplus will be needed to keep the level of debt stable. Once the real interest rate exceeds the real growth rate, debt can accumulate very rapidly.

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[9] The long-run inflation is estimated at 3 percent, long-run real growth rate at 4.5 percent, world real interest rate at 5.5, base money at 14.7 percent of GDP and short-term interest rate at 3.

[10] The previous analysis has already shown that money demand is so elastic in Croatia that the *maximal* seignorage the Government could raise is not much higher: seignorage is maximized, by a 20 percent inflation rate, at just 1.7 percent of GDP. This means that even in a high inflation environment the primary fiscal surplus could be no lower than -1.2 percent of GDP.

Table 2: Alternative Scenarios for the Short-Run Sustainable Primary Surplus

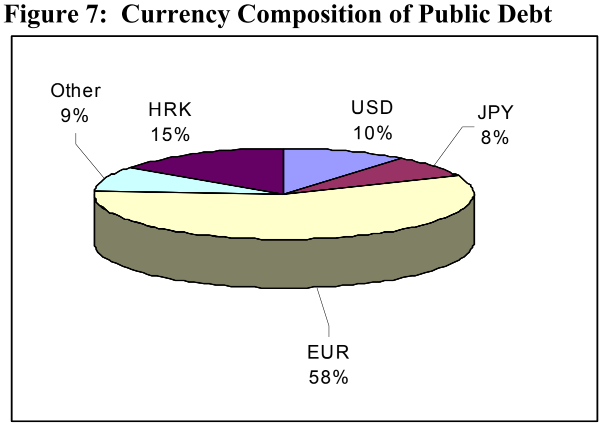
	Growth Rate of GDP (%)	*Real interest rate (%)*	*Inflation rate (%)*	*Initial Public Debt (% of GDP)*	*Sustainable primary surplus (% of GDP)*
Baseline	4.5	5.5	3	0.468	-0.38
Growth scenarios	2				1.1
	3	5.5	3	0.468	0.5
	5				-0.7
Real interest rate scenarios		4.5			-0.9
	4.5	7.5	3	0.468	0.6
		9.5			1.6
Inflation rate scenarios			5.5		-0.6
	4.5	5.5	7.5	0.468	-0.7
			9.5		-0.8

13. ***The required primary balance is the most sensitive to the changes in growth assumptions.*** Alternative scenarios illustrate, for example, that if projected growth averages 3 percent, the government would need to run a primary surplus of about 0.5 percent of GDP. Alternatively, if growth increases to 5 percent, the allowed primary deficit would be 0.7 percent of GDP. The high inflation elasticity of money demand suggests that the scope for raising seignorage through higher inflation is at best limited, a common feature of countries where currency substitution is widespread. The macroeconomic effects of long-term fiscal policy instability could be exacerbated by Croatian pro-cyclical fiscal policies. Were Croatia to face short-run difficulties (e.g., fiscal difficulties in the EU or, more likely, a financial or currency crisis in a neighboring country) leading for example to higher interest rates, lower growth or a depreciation of the real exchange rate, the already unstable fiscal stance would initially be aggravated as declining revenues would lead to even faster increases in debt. Pro-cyclicality of expenditures would then kick in and amplify the economic downturn.

Vulnerability to Financial Risks in the Debt Structure

14. ***Given the limited development of domestic markets and the absence of hedging instruments, Croatian public debt is highly exposed to currency risk.*** The structure of internal and external components of public debt reveals the vulnerability to external and currency shocks that could influence the capacity of the government to repay its debt. At end-2003, the share of direct external public debt to total direct public debt was 57 percent. It is recommended that the share of external debt be reduced by increasing domestic debt, in order to reduce the exposure to external shocks and exchange rate risks and also to help develop the domestic debt market (e.g., for second pillar pension funds' investments). Approximately 60 percent of Croatia's public debt is denominated in

Figure 7: Currency Composition of Public Debt



Source: MoF
** EUR part of the debt includes also debt linked to EUR although payable in HRK (its share represents half of the EUR part of the debt)*

a foreign currency, and about 65 percent of domestic debt is linked to EUR, though payable in HRK. On closer analysis, factoring in the domestic debt linked to EUR and payable in HRK will bring the ratio of foreign currency-linked debt to 85 of total public debt, making the government vulnerable to currency risk. This highlights the need to develop local currency debt instruments that are not indexed to foreign currency. The pace of development of the kuna debt market will largely determine the risk structure of Croatian debt. Figure 7 shows the currency composition of total public debt, while Table 3 shows the currency composition of central government external debt. The surprisingly high weight of JPY, approximately 20 percent, has apparently resulted from two factors: (i) the absence of a clearly articulated and formally stated debt management strategy, and (ii) an absence of a well defined benchmark for the currency composition of external debt. However, until the kuna debt market is developed over the medium term, the country should carefully weight the reduction in currency risk over a less diverse investor base.

15. ***As EU accession approaches, and with it the formal adoption of EUR as the currency in Croatia, the government may want also to revisit the currency weightings in its external debt.*** In analyzing the trade-offs between the expected costs and risks for borrowing strategies, sound practice is to take into account the main asset cash flows of the central government, and to select liabilities with matching characteristics in order to smooth the budgetary impact of shocks in debt servicing costs.

Table 3: Currency Composition of Central Government External Debt (as of November 2003)

	% of Total Debt	% Fixed	% Floating
EUR	57%	92%	8%
USD	21%	1%	99%
JPY	20%	100%	0%
CHF	2%	100%	0%
Total	100%	74%	26%

Source: Ministry of Finance

16. ***The government is exposed to refinancing risks.*** Croatia's central government debt redemption profile shows a high exposure to rollover risk. While there is no clear indication as to the Croatian government's target redemption percentage per annum, years 2005, 2009 and 2011 will witness more than 10 percent redemption, mostly due to maturing foreign currency bonds. The Ministry of Finance would need to increase the share of local currency debt issuance in longer maturities and to try to avoid further burdening of peak repayment years when raising additional debt.

17. ***There is a significant asymmetry at currency level of exposure to interest rate risk.*** The Croatian government's domestic debt is currently raised at fixed nominal rates. Its external debt outstanding is roughly 75 percent fixed and 25 percent floating. While there are no formally stated benchmarks in terms of fixed versus floating debt, this is broadly in line with the practice of most debt managers, which usually have 70-80 percent of fixed rate debt. The Croatian government's local currency debt is currently raised at fixed nominal rates. However, a currency-specific analysis reveals that there is a sharp variance in the percentage composition of fixed versus floating debt among different currencies: while debt in EUR and JPY is almost entirely contracted at fixed rates, USD borrowings are floating. This asymmetry at currency level is worth highlighting. The likely reason for this is preference of the lenders and the characteristics of the available lending products. Although the levels and shapes of the Term Structures of Interest Rates of these three major currencies are broadly correlated to the global economy momentum, and are mostly linked to economic cycle/policy decisions specific to that country/monetary union, it is important to have a currency-specific benchmark of fixed-floating debt composition.

Legal and Institutional Framework for Central Government Debt Management

18. ***Recent legislative changes have considerably improved the legal framework for Debt Management***. The 2003 Budget Act gives clear authority for the Ministry of Finance, acting through its Debt Management Section, to borrow on behalf of the central government. It introduces a reporting requirement on debt, guarantees and loans in the Official Gazette twice a year, as well as a requirement for the government to determine yearly a three-year debt management strategy. It clarifies purposes for borrowing and describes debt management activities. It draws a ceiling for the overall state debt, including called guarantees, at 60 percent of GDP. The annual Budget Execution Law sets the annual stock of new guarantees and the allowed end-year debt stock. In addition, the government adopted a Decree on Criteria for Issuing State Guarantees that defined a process and criteria for guarantee issuance, including an assessment of the beneficiary's capacity to service the liability.

19. ***There is a lack of adequate capacity in the debt management area, particularly in the area of risk analysis.*** The Debt Management Section of the Treasury Department, with only eight staff, is responsible for management of central government debt and the guarantees. Because of the lack of resources, the Debt Management Section has focused its activities on raising the necessary funds, without the support of a risk management framework. A middle office should be established to support the strategy through an analysis of the costs and risks of the debt, while maintaining diversified investors' base.

20. ***The present set-up and situation pose a number of risks that need to be addressed.*** Croatia participates in the joint World Bank/IMF Program on Sovereign Debt Management and Domestic Debt Management. Since the start of the Program in early 2004, some improvements have already been made: the old debt recording system has been upgraded, which has created a much more stable system environment; a new head of the back office has been recruited; and an internal project organization for implementing reforms going forward has been established. However, much remains to be done. There is no formalized and transparent debt management strategy, no middle office function and no clear roles for the back office staff, no debt sustainability analysis being carried out, an incomplete guarantee registry, and communication with the central bank needs to be improved. There is a considerable "key person risk", as the assistant minister heading the debt management office seems to be indispensable as the principal, if not sole, possessor of institutional memory in the debt office. Lack of proper debt recording systems exacerbates the problem. Due to the lack of competitiveness of the government's compensation structure vis à vis the private sector, retention of caliber staff in the debt office is a major issue.

21. ***There is no clearly and formally articulated strategy for managing debt.*** Due to the capacity shortage, borrowing strategy is thus focused on raising the necessary funds, without the support of a risk management framework or adequate cash forecasting ability. However, the current activities for meeting the government's funding needs have been moderately reasonable in managing the risk of the debt, given the constraints of the kuna debt market. Currency risk remains high, however, as nearly 85 percent of total general government debt is either denominated in foreign currency or indexed to foreign currency. Until the kuna yield curve is extended, it would be very risky for the authorities to try to rapidly reduce currency risk, as they would be replacing foreign currency long maturity debt with short-term kuna-denominated debt. Although it would reduce currency risk, it would greatly increase a rollover risk which is potentially much more serious at this point. With pension reform now underway, longer maturities for kuna-denominated debt are possible. A formalized procedure for approving the strategy and reporting it to the Parliament would improve investors' confidence and make the debt management process more transparent.

22. ***Cash management appears to be rudimentary and needs to be improved substantially.*** There would also be efficiency gains to the government through reducing idle balances and cost of carry.

Uncertainty in the net cash flow requirements due to inadequate cash forecasting ability might be creating excess liquidity in the system.

23. ***The available debt data seems to be fragmented and incomplete.*** Government guarantees are not recorded systematically, while local government guarantees to their respective utility companies are not recorded at all. Some improvement in debt and guarantees recording has occurred within the past Stand-By Agreement with the IMF, when the Ministry of Finance discovered a significant double counting of guaranteed debt (at some 8 percent of GDP) in public debt data received from the Croatian National Bank.

Domestic Debt Market

24. ***The Croatian government securities market witnessed substantial development since 2000. As a result, it now fares reasonably well vis à vis the regional leading group.*** While enhancement of the public debt management is a responsibility of the MoF, further development of the public debt market will require efforts by various parties. In addition, such efforts will need to be coordinated to ensure their effectiveness. A proper mechanism for coordination is needed. In particular, strong leadership by the MoF and the CNB will be indispensable to ensure effective coordination. The domestic investor base only recently started developing and diversifying, and the primary market needs to be better organized. The issue calendar is not yet established except for the T-bills. The secondary market is also fragmented due to a few factors, including a need to control affiliated party transactions in the small and conglomerated financial sector, the restriction on foreign investment in the domestic bonds to control the money supply, and the dual currency denomination.

25. ***The demand and investor base need to be developed further.*** While the launch of the second pillar pension funds is giving impetus to the development of the domestic investor base, the domestic demand is still limited. Further, a high degree of currency substitution leads to strong investor preference for Euro-linked government securities. While banks remain to be an important group of investors, they are raising funds for domestic bond investment from overseas sources. More targeted issuance and promotional campaign may be needed. Retail investors might be especially attracted to short-dated government securities, should infrastructure for easy access and safe custody be established.

26. ***The domestic debt market needs to be broadened with supply of new maturities.*** The volume of domestic bonds outstanding is a small portion of the total public debt. While T-bills are issued weekly in three maturities (3, 6 and 12 months), there are only seven truly marketable T-bonds issued by the government and its agencies, which have maturities of 3, 5, 7 and 10 years. Mid-term maturities (i.e., 2 to 4 years) are scarce where HRK (instead of Euro-denominated) T-bonds could be issued. In particular, with the recent appreciation of EUR and HRK, Croatia's USD-denominated external debt can be refinanced in the domestic market with significant capital gains. Domestic absorption capacity by institutional investors would be sizable enough to support increased domestic borrowing in coming years.

27. ***The primary market needs to be better organized and made more competitive.*** While T-bills are auctioned weekly, T-bonds are issued with no fixed calendar, and those have been underwritten by several leading banks based on requests for proposals. The participation in the T-bill auctions is open to anyone, including retail investors without eligibility to ensure prompt settlement of winning bids. In response to the emergence of newly bred institutional investors, the primary market system would warrant a substantial reconfiguration. Particularly, transparency in the primary market needs to be significantly improved by regular auctions, elaboration and early publication of the MoF's annual issuance calendars. Starting with T-bill auctions, the issuance system could be gradually automated. With better organization and enhanced competition in the primary market, the yield is expected to go down substantially.

28. ***Fragmentation in the secondary market needs to be carefully considered in organizing the primary and the secondary market.*** The small, concentrated and conglomerated financial sector calls for control of affiliated party transactions. The dual currency denomination in HRK and EUR also fragments the market and yield curve. Most domestic T-bonds are currently denominated in EUR while T-bills are in HRK. More HRK-denominated T-bonds may be introduced soon. The restriction on foreign investment in the domestic bonds to control the money supply distorts yields on Croatian Eurobonds and EUR-denominated domestic bonds. All these factors need to be considered carefully in organizing the primary and the secondary markets.

29. ***The repo market exists but needs to be further developed, while the swap market needs to be investigated.*** A standardized master agreement covering both banks and non-bank financial institutions does not exist, limiting the market to a small number of banks. It also leaves legal uncertainty in the transactions. Depth and efficiency of the currency and interest rate swap market need to be investigated.

30. ***Transparency of the secondary market needs to be improved***. Currently, only post-trade transaction information (i.e., price and volume) is reported to Zagreb Stock Exchange. While this is a regulatory requirement, not every trade is reported as there is no supervision conducted on compliance with this rule. Further, to provide more representative market price information, the Zagreb Stock Exchange would calculate the average yield for each issue by collecting price quotation and trading data from different sources: trading reports from buyers to the Zagreb Stock Exchange, clearinghouse information, and average quotes from the market makers. Meanwhile, government oversight in the secondary government securities market is hardly tangible in Croatia. The Croatian Securities Commission, the principal market watchdog, is advised to pay more attention to the government securities market.

31. ***The settlement system should be enhanced to achieve simultaneous delivery versus payment***. The Central Depository Agency does not yet participate in the real time gross settlement system operated by CNB and cannot provide simultaneous delivery versus payment settlement for large institutional bond trades. On the other hand, CNB does not have any ownership stake in the Central Depository Agency. The government could divest out of the Central Depository Agency. Instead, CNB as an important user of the Central Depository Agency could be invited to be a minority stakeholder.

Croatia Country Assistance Strategy Consultations
June - July 2004

Zagreb, Osijek, Knin, Split, Čakovec

A series of five meetings was held with representatives from local authorities, the business sector, and civil society organizations to collect feedback on Croatia's development priorities and challenges. Meetings were held in the cities of Zagreb, Osijek, Knin, Split, and Čakovec.

The following issues were identified as key challenges by participants:

- **Education** – All participants highlighted education reform as the most important reform for Croatia. The current education system at all levels is inadequate and in need of reform. It was also felt that the education system is not as responsive to the market needs as it should be, making the Croatian labor force less competitive. Further, participants said that there is a general lack of understanding by young people of what it means to be a market economy. Civic education was also discussed with conclusion that Croatians are not adequately educated or prepared to take on an active role as citizens. There is a lack of formal and informal education in "democratic culture." Such an initiative would also help the government carry out less popular reforms, as the public would be aware that they have to undergo a period of hardship for the greater good of all in the future. Participants also felt that the Croatian society is closed to new ideas.
- **Public Administration and Judiciary** – Participants expressed an acute lack of confidence in the ***judiciary system*** and complained about a non-functioning ***public administration*** (unclear regulations, lack of education of civil servants, inefficient implementation of laws). They felt the biggest constraint to improvement was political resistance to reform. As a practical issue, backwardness of the administrative part of the systems was pointed out (lack of sufficient IT usage resulting in slow administration of requests). Concerns were also voiced about control of ***public expenditures*** (at the central government and sub-national levels), suggesting the need for greater transparency and accountability.
- **Labor Market –** A number of participants referred to the need to analyze and tackle the ***gray economy***, indicating that many of the registered unemployed are active in the gray economy. ***Youth*** organizations expressed their concern about the marginalization of young people (15-30 years of age) in society, due to limited employment opportunities (new employees always need to have x number of years experience in a certain field), causing a high dependency syndrome and often leading to depression and apathy.
- **Equitable Regional Development –** Participants felt that promotion and support for equitable regional development is one of the most important tasks for the government to take on, as they felt the economic disparities between the most developed regions and the ***Areas of Special State Concern*** were alarming. Further, they suggested that future planning and investment should be thought through carefully and not carried out for the wrong reasons. In addition, migration from rural to urban areas was identified as a major problem. ***Housing*** still appears as a prominent issue in some Areas of Special State Concern, so much so that housing shortages were flagged as one of the main problems in the Knin area. ***Decentralization*** was discussed in some detail. The biggest concern was with the process of decentralization itself, what it means and entails, and whether many municipalities, particularly those in Areas of Special State Concern, will be able to sustain and implement the process of decentralization in terms of financial and other resources. Participants felt that there is no clear national decentralization strategy, nor a plan for the structure of the different

administrative bodies in a decentralized system. There is lack of partnership between regions and municipalities, and demographic policies are not effective.

- **Social Welfare –** A major concern was the status and situation of ***single mothers and their children***. In addition, too little was being done by the government in terms of provision of necessary infrastructure for ***victims of abuse*** (lack of shelters, safe houses etc.). A similar situation pertains to the provision of assistance to the ***elderly and disabled***. In addition, the participants felt that ***children***, being without social voice, were always the easiest state target for budget cuts and social services. They saw an important role for the Bank to put pressure on the relevant institutions for greater ***accountability*** as to how, where and on what state funds for social services are being spent. Suggestions were made to introduce a scheme whereby recipients of social benefits who are able to work earn part of their benefits through community service. There seems to be strong support for greater ***provision of services by NGOs***.

- **Investment Climate –** The need to complete the ***privatization*** process and to restructure or liquidate loss-making, state-owned companies was highlighted. There was a strong view that such reform should be implemented in parallel with adequate ***social measures***. The issue of 'dead capital' was also discussed, referring specifically to the buildings and facilities belonging to the Croatian Railways and Ministry of Defense which, it was felt, should be converted to alternative use. Resolving ***property and cadastre issues*** was also seen as a crucial problem, on a national as well as regional and municipal level, as unresolved property relations have negative effects on investment. Some stressed the need for adequate ***infrastructure*** (especially in war affected areas) and better provision of ***support to small businesses*** (lack of agencies providing advisory services to small businesses such as education, advice on investment, setting up companies, etc.). The need for a national development strategy was stressed, as well as for ***reducing administrative barriers*** such as high SME tax rates and other required contributions. Limited access to credit, due to collateral required by commercial banks and government sponsored credit lines, was highlighted as another problem for SMEs, especially start-ups.

- **Agriculture -** ***Fragmentation of plots*** producing ***low-value agricultural products*** (e.g., growing corn instead of flowers and paprika), the ***lack of privatization*** of arable land and *agro-kombinats*, ***limited access to credit***, and ***lack of adequate market infrastructure*** for small agribusiness were highlighted as the important challenges in the agricultural sector. There is a ***need for training support to farmers***, with respect to both production and access to EU pre-accession funds. In addition, ***mines*** are still a major problem in some agricultural parts of Croatia, notably Eastern Slavonia and Baranja.

- **Mindset** –Discussion of social welfare issues raised points about citizens' dependency on the state always to provide a safety net, leaving people incapable or less inclined to solve problems on their own or through other sources. The discussants felt that this is more a problem of culture and mentality.

WBI Activities in Croatia

FY05 - FY08

In support of the Bank Group's assistance strategy for Croatia, WBI programs would contribute to capacity enhancement in the areas of public sector and governance, private sector development, and social sustainability.

Public sector and governance: WBI would offer two regional programs, one on Intergovernmental Fiscal Relations and Local Financial Management for ECA countries and the other (subject to donor funding) on Legal and Judicial Reform Training for the Judiciary in Bulgaria, Romania and Croatia. The objective of the Intergovernmental Fiscal Relations Program would be to expand the capacity of central and subnational governments and key stakeholders for undertaking intergovernmental fiscal and urban management reforms and to provide support towards sub-national fiscal and political institutional development. It would focus on various issues in fiscal decentralization reforms, intergovernmental fiscal design, and local financial management. The planned Legal and Judicial Reform Training, aimed at civil society and executive authorities as well as the judiciary, would aim to build capacity for a more efficient, cost-effective accessible, and transparent system of justice.

Private sector development: Croatia delegates would be invited to a Cross-Regional ECA GDLN Policy Dialogue on Investment Climate Issues. It is part of the policy dialogue series for cross-regional dissemination of lessons and best practices in key dimensions of investment climate. EU candidate countries would learn from representatives of EU8 countries that would share their experience.

Social sustainability and growth: WBI support focuses on regional follow-up activities to the Roma conference, including policy dialogue, capacity building and regional training. The main activities planned for FY05 include country-level activities related to the Decade of Roma Inclusion – including hosting a Young Roma Leaders reunion to discuss Roma participation in the Decade and Education Fund, and supporting the launch of the Decade in early 2005. Virtual learning environments (VLE) would be supported to promote regional networking for ongoing dialogues and online information exchanges, with special emphasis on education and gender issues. WBI training programs on health sector reform would also support the social sustainability and growth objectives of the CAS. The ECA Regional Flagship Course on Health Sector Reform would draw extensively from health sector reform experience of ECA countries as well as learning experiences from the EU and other OECD countries. An advanced WBI flagship course on poverty, equity and health for ECA region would also be offered to high-level public health officials and managers from the ECA region.

Partnerships: WBI activities are developed in collaboration with local and international counterparts and donors, and coordinated with the Country Offices and relevant task teams in ECA. The public sector and governance activities are supported by an Italian Trust Fund, and the ECA Regional Flagship course on health sector reform is being offered in partnership with Semmelweis University in Budapest, Hungary. The Investment Climate program would be developed in partnership with ECA GDLN. The Roma conference follow-up activities are done in partnership with the Open Society Institute. Provided funding is secured, the Legal and Judicial Reform training for Croatia judiciary would be developed in collaboration with International Development Law Organization, Rome.

WBI in Croatia
Ongoing and tentative future regional activities
A: Public sector, governance
Intergovernmental Fiscal Relations and Local Financial Management Course for ECA (Budapest, participants from all ECA countries)
Legal and Judicial Reform training for Bulgaria, Romania, Croatia (pending funding, proposal to Italian TF)
B: Private sector development
ECA Cross-Regional GDLN Policy Dialogue on Investment Climate Issues (EU candidates and EU8 countries)
C: Social sustainability and growth
Regional Flagship Course on Health Sector Reform for ECA
Advanced Flagship Course on Poverty, Equity, and Health for ECA
Roma Leadership Capacity Building (Serbia and Montenegro, Macedonia, Croatia, Bulgaria, Romania, Hungary, Czech Republic, Slovakia)

IFC STRATEGY IN CROATIA

1. IFC Activities to Date

As of September 2004, IFC cumulative business volume reached US$193 million, with an additional US$48 million syndicated from partner banks, in nine individual projects, among which:

- Loan and equity investment in a paper mill plant aimed at rebuilding, modernizing and helping the company to extend in the region;
- Loan and quasi equity investment in a leading pharmaceutical enterprise;
- Loan and equity investment to modernize a ship repairing facility;
- Loan financing in a bank as a pre-privatization facility;
- Loan financing to a foreign regional bank, to support its housing finance and SME on-lending;
- Equity investment in a venture capital fund;
- Loan financing to a discount store chain, operating deep discount food stores and hypermarkets throughout Europe, to help the company expand into Croatia focusing on second tier cities and relatively remote areas.

As of September 2004, the committed portfolio was US$132 million for its own account, 30 percent invested in the financial markets and 70 percent in general manufacturing, and US$26 million in syndicated loans. During the last four years, IFC has committed about US$30 million annually. There is an increased optimism about Croatia's structural reform program and growth prospects as the EU accession process is gaining momentum. IFC has developed good country knowledge and will capitalize on its experience to further support and facilitate private sector development through its proactive and innovative role implementing new models and products.

2. Impact of IFC's Investment

IFC has been successful in supporting several commercially productive enterprises in Croatia with strong foreign exchange earnings and employment opportunities, as well as in developing the financial sector. IFC has also been helping strategically important Croatian companies to grow into regional industry leaders. Some of IFC's successful projects are:

- ***Bjelovarska Banka,*** a small regional bank, which was later merged into Erste & Steiermarkische Bank. IFC financing helped the bank become one of the few intermediaries actively providing term finance to the SMEs and to companies operating in less developed regions outside Zagreb;
- ***Belisce,*** Croatia's leading producer of packaging paper and corrugated boxes. IFC helped the company to enhance its international competitiveness and increase its export, comply with international environmental standards, and acquire 100 percent of the shares in a cardboard and packaging material company in neighboring Slovenia, creating the largest cardboard and packaging materials maker in South Eastern Europe. This was the first cross-border takeover deal since the two countries gained independence in 1991, and the first one in the paper/packaging industry in Southern Europe.
- ***Pliva,*** the largest pharmaceutical company in Central and Eastern Europe. IFC has supported the growth and strategic development of the research and development infrastructure of the company. This project had a broader positive impact on Croatian society through providing

employment opportunities to the local scientists in their home country, and thus helping to curb the high level of "brain drain."

- ***Croatia Capital Partnership*** LP (CCP), a 10-year private-equity. IFC's investment in CCP increased the Fund's profile, helped it reach a critical mass size, and assisted its portfolio companies to have access to financing.

3. IFC Strategy

IFC has achieved very good results, especially when a good local partner is selected. However, slow privatization, competition with domestic banks and other IFIs, low lending margins/prices for debt financing, corruption, and corporate governance issues have been limiting factors for IFC's program in Croatia. Two factors are expected to trigger a higher involvement of IFC in Croatia during the next three to four years: (i) the government is trying to push the envelope and privatize more segments of the economy, only about 60 percent of which is currently in the hands of the private sector; and (ii) the European Commission has recommended that the Council open accession negotiations with Croatia, which is expected to accelerate the pace of structural reforms in Croatia during the medium term. In Croatia, IFC will follow the same broad strategic objective as in Bulgaria and Romania to facilitate the integration into the EU, certainly considering the differences and specifics of each country.

3.1 Country Competitiveness

Croatia faces two challenges: the preparation for EU accession, and the shift from a domestic demand-driven economy to a more balanced and, if possible, export-driven economy. These two challenges are related and have to do with the ability of the economy to compete on international markets. Croatian companies are less competitive than enterprises of neighboring countries that entered the EU on May 2004, and much less competitive than enterprises in other EU countries. With high wages and an awkward production structure, Croatia faces greater challenges. To help Croatia meet these challenges and take advantage of the opportunities that prospective EU membership presents, it is important that IFC supports Croatian companies to become more competitive in the regional market.

3.2 Corporate Sector

The privatization process in Croatia has been slow, is still incomplete, and its impact has been disappointing. The privatization strategy chosen in the 1990s, giving an overwhelming preference to manager and employee buy-outs has not been conducive to enterprise restructuring and has discouraged foreign investment. Enterprises with high state ownership are mainly in shipbuilding, tourism, agriculture (*agro-kombinats*), metal-processing sectors, as well as in utilities and infrastructure. Many of them are loss-making and heavily indebted and could not survive without government direct subsidies. The dominance of large enterprises in a non-competitive environment has discouraged the emergence of small and medium enterprises. State-owned enterprises continue to claim and receive preferential treatment while generating large losses, preventing the development of a level-playing field for private investment, new firm entry, and sustainable job creation. Recently, some parts of the tourism sector, including hotels, have been privatized, mostly on a fragmented basis. This year the government is accelerating the privatization of some large companies in the tourism, metal-processing sector and *agro-kombinats*, to be followed by privatization of more complex enterprises.

IFC's strategic objective is to facilitate sustainable private sector development through privatization and post-privatization support to competitive and export-oriented companies, strengthening corporate governance and adoption of principles of corporate behavior based on best principles and rules of EU countries, development of R&D capacity, and improvement of access to finance for SMEs. IFC will support privatization and post-privatization restructuring in key sectors of the country with a priority to manufacturing industries, tourism, agribusiness/food processing, utilities, and infrastructure. Support for improving corporate governance, environmental standards, and best practices are areas where IFC will continue to have an important role to play in Croatia. IFC will combine financial support with technical assistance to help domestic companies become more competitive. One of IFC's main priorities will be to support strong local companies, such as food processing companies, to invest in neighboring countries. Also, IFC will facilitate FDI in Croatia through debt and equity investment with strategic partners, particularly when a green-field project is involved.

3.3 Financial Sector

The banking sector has undergone a period of restructuring and consolidation. The privatization process is well advanced with major banks sold to foreign banks that own 91 percent of the banking sector. Bank privatizations and improved banking supervision helped to restore confidence in the sector. As a result, the market is seeing increased competition for products and services, profitability is improved, and deposits have grown, indicating increased confidence in the market. Croatia's banking sector is now large by East European standards with an asset/GDP ratio among the highest in the region. Bank credit to private sector as a percentage of GDP is on a par with some of the new EU members. Also, asset per employee in Croatia is significantly higher compared to other countries in the region such as Bosnia and Herzegovina, Serbia and Montenegro, and FYR Macedonia.

However, other parts of the financial system are less well developed: there is a small insurance sector, and securities markets are underdeveloped with only 66 companies traded on the Zagreb stock exchange (at end-2002, the top three companies – Zagrebska Banka, PBZ, and Pliva – represented over 60 percent of the market capitalization). The introduction of pension system reforms in 2002 brings the need for capital market development and with focus on domestic corporate debt securities and equities. Croatia's financial sector is expected to play a central role in the process of enterprise restructuring and investment.

Croatia has an investment grade rating with a positive outlook supported by progress on economic stabilization, strengthening financial sector and external liquidity, prospects of further structural reforms, and future EU membership. Should IFC have a role in financial market development, it has to be competitive, creative, and introduce new products. Consequently, IFC strategy is to increase its activities primarily in the non-bank financial institutions with focus on housing finance, insurance, securities markets and local bond market development, leasing as an alternative source of SME funding, and venture capital funds. Through securitization and credit enhancement, IFC will help establish linkages between the domestic mortgage market and international investors. IFC will work both to help create enabling environments and to build solid non-bank financial institutions to provide those services. The financial sector in Croatia is advanced enough to develop creditworthy institutions such as credit bureaus, which do exist in some other countries in transition at the same level of development as in Croatia.

In the banking sector, IFC will focus on structured finance transactions improving capacity of specific financial institutions and strengthening their SME finance capacity to profitably serve this market segment. The growth of SMEs in Croatia has been restricted by the limited availability of long-term funds and high-risk perception by the banking industry. Therefore, IFC will: (i) support strengthening financial institutions oriented towards SME lending activities; (ii) assist in developing new financial institutions and new products with domestic banks such as debt financing for export increase or innovation, guaranty products, and specialized products needed to assist privatization and support post-privatization of enterprises; and (iii) continue to provide credit lines to local banks for on-lending to SMEs. IFC will work with domestic banks to support Croatian companies that are ambitious to expand in other countries in the region. IFC is exploring possible opportunities for supporting the development of energy efficiency finance in Croatia. The country's highly competitive banking sector, including well developed mortgage lending activities, as well as the importance of some highly energy intensive industries within the country's economy, suggest a favorable environment for promoting energy efficiency finance. In addition, IFC will continue the dialogue with the government and will consider helping it to finish the privatization of two remaining state banks, the Postal bank (HPB) and Croatia banka, through appropriate financing schemes.

3.4 Infrastructure

The government has limited resources to fund infrastructure projects and its fiscal space might further shrink. Market oriented energy, transport, and communication would be crucial to enhance competitiveness and to foster integration with the European economy while opening vast opportunities for private sector development and FDI. Promotion of private sector participation in infrastructure remains a challenge during the next CAS period. In close coordination with the Bank, IFC will continue its efforts to promote private sector investments in infrastructure, including the power, water supply, telecom, and transport (ports and airports) sectors.

Although commercial banks are already lending to the larger municipalities with low interest rates and longer-term maturities, the World Bank Group will look for ways to support infrastructure development without displacing them, for instance by helping local governments accessing the debt market and by facilitating the issuance of municipal bonds. The Municipal Fund, a joint IFC – IBRD initiative mandated to provide municipal financing, can be instrumental in promoting these investments in sectors such as water, wastewater, solid waste, transportation, etc. without requiring a guarantee from the central government.

IFC, through its Balkans Infrastructure Development Facility (BIDFacility) will target Croatia as a priority market in Southern Europe for investment in the municipal finance area. Solid waste management and water treatment projects in tourist areas are a priority for the country. IFC will work closely with the Croatian government on developing new infrastructure projects, structured on pure commercial financing bases, with the objective to attract private sector financing through PPP (Box 1).

Box 1. Balkan Infrastructure Development Facility

A poor and unreliable infrastructure continues to discourage private investors and hinder economic growth in the Balkan region. In turn, slower economic growth reduces the availability of government funds to improve infrastructure. To break this cycle, IFC is establishing the Balkans Infrastructure Development Facility in cooperation with USAID and European donors. The facility will help public sector entities in the Southern Europe region (including Croatia) attract private sector investments in infrastructure, focusing on the energy, transportation, and water and sanitation sectors. The facility reflects the World Bank Group strategy to broaden engagement in these sectors to ensure efficient, affordable, and sustainable delivery of infrastructure services. The facility will help identify, develop, structure, and reach financial closure on infrastructure projects, so that committed public sector entities can engage more effectively with the private sector and attract investments critical to the region's economic development. IFC will launch the Facility in FY05.

The efficient provision of energy services is important for promoting growth and enhancing Croatia's ability to compete effectively within the EU. Croatia has sought to achieve: (i) attracting significant investment resources for the modernization of the energy infrastructure; and (ii) creating a market based energy sector, with policies and regulatory framework compatible with those in the European Union. A series of energy laws were enacted in 2001 to launch such reforms. While their implementation in the oil and gas sector has been generally satisfactory, progress in the power sector has been slower. The main power utility (HEP), a state-owned public enterprise that carries out the activities of generation, transmission and distribution of electricity as well as operation of the national power, controls 95 percent of the power market in Croatia. According to the Athens Memorandum of Understanding, South-East Europe countries, including Croatia, have agreed to create by 2005 an open power market in the region. This will call for the restructuring of HEP (a high-case trigger for this joint World Bank/IFC CAS) by the unbundling of generation, transmission, and distribution, followed by establishment of independent operators and market liberalization. There may be scope for IFC engagement in the power sector once HEP restructuring is advanced.

IFC is developing public-private partnership opportunity in Constanza-Pancevo-Omisalj-Trieste oil pipeline (CPOT). It is a cross-border oil transportation pipeline that is expected to offer an environmentally safe alternative route to bring high quality crude oil from Central Asia and Russia to Southern Europe, crossing Romania, Serbia and Montenegro, Croatia, and Slovenia, and eventually to Austrian and German oil-pipeline networks. USTDA has financed a feasibility study with a grant to the Croatian government on behalf of Serbia and Montenegro and Romania. IFC is supporting the second phase of the technical assistance assignment following the requests of the three governments and the approval of the feasibility study. It focuses on the pre-development strategy and coordination of the early institutional efforts to prepare the legal framework and to promote the project with potential investors and users.

3.5 Cross Border Integration-Regional Links

Croatia's economy is relatively large by regional standards, accounting for roughly half of the GDP of the western Balkans. However, with GDP of about US$30 billion, Croatia is still a small market. The private sector may play an important role in the economic development and cross-border integration of Croatia in the region. During 1993-2001, Croatian enterprises invested around US$150 million or 27 percent of total direct investments abroad in Bosnia and Herzegovina, accounting for around 30 percent of total FDI in this country. IFC strategy is to support dynamic companies in Croatia that seek to extend across borders. Implementing this strategy, IFC has invested in a paper manufacturing facility and in a leading pharmaceutical company. While the paper company has acquired a company in neighboring Slovenia, creating the largest cardboard and packaging materials maker in southeastern Europe, the pharmaceutical company is looking for opportunities to expand its operation in neighboring countries. Also, IFC's strategy is to support regional infrastructure projects such as oil pipeline, roads etc.

3.6 Health Sector

Improving the quality and access of health care for public patients is an important element of the government's reform agenda in Croatia. Together with the government, IFC will assess opportunities for providing advisory assistance in structuring and implementing public-private partnerships to improve health care for public patients. This could involve contracting by the national health insurer and/or the Ministry of Health with private providers to deliver specific health care services (e.g., diagnostic imaging, radiotherapy, dialysis), to manage existing hospitals, or to replace, modernize, or convert (e.g., from acute care to long-term care) health care facilities.

CAS Annex B2 - Croatia
Selected Indicators* of Bank Portfolio Performance and Management
As of Date 11/23/04

Indicator *	2002	2003	2004	2005
Portfolio Assessment				
Number of Projects Under Implementation [a/]	11	11	13	13
Average Implementation Period (years) [b/]	3.4	2.9	3.3	3.5
Percent of Problem Projects by Number [a/, c/]	0.0	0.0	38.5	38.5
Percent of Problem Projects by Amount [a/, c/]	0.0	0.0	37.1	37.1
Percent of Projects at Risk by Number [a/, d/]	0.0	0.0	38.5	38.5
Percent of Projects at Risk by Amount [a/, d/, e/]	0.0	0.0	37.1	37.1
Disbursement Ratio (%) [f/]	16.9	22.8	41.5	5.2
Portfolio Management				
CPPR during the year (yes/no)	yes	yes	yes	n/a
Supervision Resources (total US$)	918	819	828	1004
Average Supervision (US$/project)	61	74	80	71

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	13	11
Proj Eval by OED by Amt (US$ millions)	722.6	576.5
% of OED Projects Rated U or HU by Number	15.4	9.0
% of OED Projects Rated U or HU by Amt	11.1	14.9

a. As shown in the Annual Report on Portfolio Performance (except for current FY).
b. Average age of projects in the Bank's country portfolio.
c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
d. As defined under the Portfolio Improvement Program.
e. This was at 1.1 percent as of May 2004 and increased to 37 percent mainly due to the downgrading of a large railway project; without the railway project this would be 17 percent. Policy reforms affecting the performance of the railway project are included in the PAL and also form triggers for the base and high cases.
f. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.
* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

CAS Annex B3a - IBRD/GEF Program Summary - Croatia (BASE CASE)

FY 2005 - FY 2008

Proposed IBRD/GEF Base-Case Lending Program [a/]

Fiscal year	*Project ID*	*US$(M)* [b/]	*Strategic Rewards (H/M/L)*	*Implementation Risks (H/M/L)*
2005	Social and Economic Recovery [c/]	44.0	H	M
	Science and Technology [c/]	40.0	H	H
	PAL I [d/]	150.0	H	H
	Education Sector Development	85.0	H	M
	Subtotal IBRD FY05 [e/]	**319.0**		
	Zagreb Municipal Nutrient Reduction (GEF)	TBD	H	L
2006	Social Protection [c/]	30.0	H	H
	Agriculture *Acquis* Cohesion	30.0	H	L
	PAL II [d/]	150.0	H	H
	Subtotal IBRD FY06	**210.0**		
	Agricultural Pollution Control (GEF)	TBD	H	L
2007	Trade and Transport Integration [f/]	50.0	H	L
	PAL III [d/]	150.0	H	M
	Health Sector Development	75.0	H	H
	Subtotal IBRD FY07	**275.0**		
	Sustainable Land Management (GEF)	TBD	H	L
2008	Municipal Services	50.0	H	M
	Environmental Management	60.0	H	M
	Regional Economic Rehabilitation	50.0	H	M
	Growth Policy Support [d/]	100.0	H	M
	Subtotal IBRD FY08	**260.0**		
	TOTAL IBRD FY 2005 - 2008	**1,064.0**		

a/ Subject to mid-term review in 2006, to be reflected in CAS Progress Report.
b/ Other than the amounts of the PALs and Growth Policy Support loan and the overall FY05-08 base case ceiling of US$1.064 billion, the four-year lending program is subject to modification as projects are further developed during the CAS period.
c/ In advanced stage of preparation due to carryover from prior years, resulting in higher than average commitments in FY05.
d/ Development Policy Loan.
e/ FY05 commitments higher than average due to carry-over from prior years and the need to accelerate Education operation in view of its high development policy priority.
f/ Includes follow-up to Rijeka Gateway Project.

CAS Annex B3b - IBRD/GEF Program Summary - Croatia (HIGH CASE)
FY 2005 - FY 2008

Proposed IBRD/GEF High-Case Lending Program [a/]

Fiscal year	*Project ID*	*US$(M)* [b/]	*Strategic Rewards (H/M/L)*	*Implementation Risks (H/M/L)*
2005	Social and Economic Recovery [c/]	44.0	H	M
	Science and Technology [c/]	40.0	H	H
	PAL I [d/]	150.0	H	H
	Education Sector Development	110.0	H	M
	Subtotal IBRD FY05	**344.0**		
	Zagreb Municipal Nutrient Reduction (GEF)	TBD	H	L
2006	Social Protection [c/]	30.0	H	H
	Agriculture *Acquis* Cohesion	30.0	H	L
	PAL II [d/]	200.0	H	H
	Health Sector Development	100.0	H	H
	Subtotal IBRD FY06	**360.0**		
	Agricultural Pollution Control (GEF)	TBD	H	L
2007	Transport Sector Development [e/]	100.0	H	H
	PAL III [d/]	200.0	H	M
	Regional Economic Rehabilitation	50.0	H	M
	Environmental Management	60.0	H	M
	Subtotal IBRD FY07	**410.0**		
	Sustainable Land Management (GEF)	TBD	H	L
2008	Municipal Services	50.0	H	M
	Growth Policy Support [d/]	200.0	H	M
	Energy Sector Development	100.0	H	M
	Coastal Cities Pollution Control APL II	50.0	H	L
	Subtotal IBRD FY08	**400.0**		
	TOTAL IBRD FY 2005 - 2008	**1,514.0**		

a/ Subject to mid-term review in 2006, to be reflected in CAS Progress Report.
b/ Other than the amounts of the PALs and Growth Policy Support loan and the overall FY05-08 high case ceiling of US$1.514 billion, the four-year lending program is subject to modification as projects are further developed during the CAS period.
c/ In advanced stage of preparation.
d/ Development Policy Loan.
e/ Includes Trade and Transport Integration/Rijeka Gateway follow-up.

CAS Annex B3c - IBRD/GEF Program Summary - Croatia (LOW CASE)

FY 2005 - FY 2008

Proposed IBRD/GEF Low-Case Lending Program [a/]

Fiscal year	*Project ID*	*US$(M)* [b/]	*Strategic Rewards (H/M/L)*	*Implementation Risks (H/M/L)*
2005	Social and Economic Recovery [c/]	44.0	H	M
	Education Sector Development	40.0	H	L
	Subtotal IBRD FY05	**84.0**		
	Zagreb Municipal Nutrient Reduction (GEF)	TBD	H	L
2006	Science and Technology [c/]	40.0	H	H
	Agriculture *Acquis* Cohesion	30.0	H	L
	Subtotal IBRD FY06	**70.0**		
	Agricultural Pollution Control (GEF)	TBD	H	L
2007	Trade and Transport Integration [d/]	50.0	H	L
	Environmental Management	30.0	H	L
	Subtotal IBRD FY07	**80.0**		
	Sustainable Land Management (GEF)	TBD	H	L
2008	Municipal Services	50.0	H	M
	Regional Development	30.0	H	M
	Subtotal IBRD FY08	**80.0**		
	TOTAL IBRD FY 2005 - 2008	**314.0**		

a/ Subject to mid-term review in 2006, to be reflected in CAS Progress Report.
b/ Other than the amounts of the overall FY05-08 low case ceiling of US$314 million, the four-year lending program is subject to modification as projects are further developed during the CAS period.
c/ In advanced stage of preparation.
d/ Includes follow-up to Rijeka Gateway project.

CAS Annex B3d (IFC & MIGA) for Croatia

Croatia - IFC and MIGA Program, FY 2002-2005

	2002	2003	2004	2005
IFC approvals (US$m)	56.56	0.00	54.42	
Sector (%)				
Finance and Insurance	82			
Industrial and Consumer Products			11	
Pulp and Paper	18			
Wholesale and Retail			89	
Total	100	0	100	0
Investment instrument(%)				
Loans	94		100	
Equity	6		0	
Quasi-Equity			0	
Other	0			
Total	100	0	100	0
MIGA guarantees (US$m)	32.26	166.97	146.13	

CAS Annex B4 - Summary of IBRD Nonlending Services - Croatia

FY 2005 - FY 2008

Product	*Completion FY*	*Cost (US$000)*	*Audience* [a/]	*Objective* [b/]
Recent completions [c/]				
EU/CEM	03	613	G/D/B	KG/PS
Health Financing	03	41	G/D/B	KG/PS
Municipal Capacity & Infrastructure Finance	03	47	G	KG/PS
Post-FSAP TA	03	39	G/B	KG/PS
Country Financial Accountability Assessment	04	79	G/D/B	KG/PS
Country Procurement Assessment Report	04	108	G/D/B	KG/PS
Underway [d/]				
Reform and EU Accession Policy Notes/ Workshops [e/]	05	200	G/D/B/PD	KG/PD/PS
Fiduciary Country Systems Development for EU Integration TA/IFA [f/]	05	100	G/D/B	KG/PS
Planned [d/, g/]				
Non-Bank Financial Institutions Integration TA	05	35	G/B	KG/PS
Regional Living Standards and Development	06	250	G/D/B/PD	KG/PD/PS
Public Finance Review	06	250	G/D/B	KG/PS
Fiduciary Country Systems Development for EU Integration TA/IFA [f/]	06	100	G/D/B	KG/PS
Reform and EU Accession Policy Notes/ Workshops [e/]	06	200	G/D/B/PD	KG/PD/PS
Environmental Management Strategy	06	145	G/D/B	KG/PS
Country Economic Memorandum	07	250	G/D/B/PD	KG/PD/PS
Investment Climate Assessment	07	120	G/D/B/PD	KG/PD/PS
Fiduciary Country Systems Development for EU Integration TA/IFA	07	60	G/D/B	KG/PS
Reform and EU Accession Policy Notes/ Workshops	07	200	G/D/B/PD	KG/PD/PS
Reform and EU Accession Policy Notes/ Workshops	08	200	G/D/B/PD	KG/PD/PS
Other TBD	08			

a/ Government (G), Donor (D), Bank (B), Public Dissemination (PD).
b/ Knowledge Generation (KG), Public Debate (PD), Problem-Solving (PS).
c/ The IMF recently completed ROSCs in banking supervision, payments system, and securities regulation.
d/ Costs shown for these tasks are estimates.
e/ To assess impact of policy option implemented elsewhere (e.g., EU8, other MICs, and OECD countries) in policy areas such as Public Administration Reform, Health, Railways, Public-Private Partnership for Municipal Services, Judicial Reform, Cost of Doing Business, Education, Decentralization, Sources of Growth, Pensions, and Youth Employment.
f/ Institutional Fiduciary Assessments (IFAs) to focus in particular on the social sector and environment ministries and agencies.
g/ AAA needed in high case - Energy Sector Strategy for EU Integration and Infrastructure Sector Strategy for EU Integration - will be launched only after assessing probability of high case.

Annex B5

Croatia Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1996-2002	Europe & Central Asia	Upper-middle-income
POPULATION					
Total population, mid-year (millions)	4.5	4.7	4.5	472.9	329.4
Growth rate (% annual average for peri	0.5	0.5	-0.2	0.0	1.2
Urban population (% of population)	45.1	52.3	58.6	63.6	75.4
Total fertility rate (births per woman)	..	1.8	1.5	1.6	2.4
POVERTY					
(% of population)					
National headcount index	..	..	..	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNI per capita (US$)	..	..	4,540	2,160	5,110
Consumer price index (1995=100)	..	0	135	..	..
Food price index (1995=100)	..	0	119	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Share of income or consumption					
Gini index	..	..	29.0	..	..
Lowest quintile (% of income or consumpt	..	..	8.3	..	..
Highest quintile (% of income or consump	..	..	39.6	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	7.3	4.3	3.7
Education (% of GDP)	..	..	4.2	4.3	4.4
Social security and welfare (% of GDP)	..	..	18.8	..	..
Net primary school enrollment rate					
(% of age group)					
Total	..	..	88	..	93
Male	..	..	89	..	93
Female	..	..	88	..	94
Access to an improved water source					
(% of population)					
Total	..	..	..	91	..
Urban	..	..	..	96	..
Rural	..	..	..	83	77
Immunization rate					
(% of children ages 12-23 months)					
Measles	..	..	95	93	94
DPT	..	..	95	92	90
Child malnutrition (% under 5 years)	..	..	1	..	..
Life expectancy at birth					
(years)					
Total	70	71	74	69	73
Male	67	67	70	64	70
Female	73	75	78	73	77
Mortality					
Infant (per 1,000 live births)	34	20	7	31	19
Under 5 (per 1,000 live births)	42	23	8	37	22
Adult (15-59)					
Male (per 1,000 population)	..	233	150	317	197
Female (per 1,000 population)	..	106	110	137	103

Croatia - Key Economic Indicators

	Actual				Preliminary	Sustained growth scenario				Accelerated growth scenario				Slow growth scenario			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
National Accounts (as % of GDP)																	
Gross domestic product[a]	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Agriculture	10	9	9	9	8	8	8	8	8	8	8	8	7	9	8	8	8
Industry	31	30	30	30	30	29	28	28	28	29	28	28	27	30	29	30	30
Services	59	61	60	61	62	63	64	64	65	63	64	65	65	61	62	62	62
Total Consumption	85	85	82	81	79	78	78	77	76	77	78	75	75	80	81	81	81
Gross domestic investment	23	20	24	28	30	28	28	29	28	28	28	30	29	28	26	26	25
Government investment	6	3	3	4	6	4	4	3	3	4	4	4	4	4	4	3	3
Private investment (incl. increase in stocks)	17	17	21	24	25	24	25	26	26	24	25	26	26	23	22	23	23
Exports GNFS[b]	41	47	48	45	47	47	49	50	50	47	49	50	52	46	47	48	49
Imports GNFS[b]	49	52	54	55	57	53	55	55	55	53	55	55	56	53	55	55	56
Gross domestic savings	15	15	18	19	21	22	22	23	24	23	22	25	25	20	19	19	19
Gross national savings[c]	16	18	20	22	21	22	23	25	25	22	24	26	27	21	21	21	21
Memorandum items																	
Gross domestic product (US$ mill at current prices)	19,906	18,427	19,863	22,812	28,810	32,716	32,812	33,466	34,416	32,875	33,110	33,966	35,172	31,699	31,343	31,500	31,801
Real annual growth rates (%, calculated from previous years prices)																	
Gross domestic product at market prices	-0.9	2.9	4.4	5.2	4.3	3.7	4.0	4.5	4.5	4.0	4.5	5.0	5.5	3.0	2.8	2.5	2.5
Gross domestic investment	-7.9	-10.3	23.6	22.5	12.0	3.5	3.6	9.6	6.9	4.5	7.4	7.2	8.9	-1.9	3.5	2.2	1.6
Real annual per capita growth rates (%, calculated from previous years prices)																	
Gross domestic product at market prices	-2.0	6.9	3.1	5.1	4.3	5.8	4.4	4.8	4.5	4.3	4.9	5.3	5.5	3.3	3.2	2.7	2.5
Total consumption	-2.3	6.4	-0.1	4.8	3.0	4.4	2.5	1.7	2.4	2.6	2.5	2.4	2.6	3.1	4.4	3.3	4.2
Private consumption	-4.0	8.3	3.1	7.4	4.2	3.9	3.6	1.8	3.5	2.2	3.6	1.8	3.5	2.3	2.9	2.7	3.0
Balance of Payments (US$ millions)																	
Exports GNFS[b]	8,118	8,663	9,634	10,571	14,907	15,538	16,093	16,669	17,269	15,538	16,159	17,087	18,179	14,438	14,719	15,207	15,733
Merchandise FOB	4,395	4,567	4,759	5,004	6,285	6,638	6,970	7,319	7,685	6,638	7,037	7,600	8,360	5,738	5,801	6,066	6,364
Imports GNFS[b]	9,791	9,599	10,808	13,065	17,186	17,316	18,098	18,474	18,787	17,316	18,098	18,774	19,562	16,916	17,098	17,474	17,787
Merchandise FOB	7,693	7,771	8,860	10,652	14,206	14,288	14,808	15,051	15,295	14,288	15,008	15,551	16,070	13,888	14,008	14,251	14,495
Resource balance	-1,673	-936	-1,174	-2,494	-2,279	-1,777	-2,005	-1,804	-1,518	-1,777	-1,939	-1,687	-1,383	-2,477	-2,379	-2,267	-2,054
Net current transfers	632	883	966	1,076	1,394	1,195	1,137	1,203	1,203	1,195	1,137	1,223	1,243	1,395	1,137	1,203	1,203
Current account balance	-1,397	-461	-726	-1,920	-2,099	-1,955	-1,604	-1,382	-1,062	-1,955	-1,537	-1,244	-887	-2,005	-1,678	-1,545	-1,398
Net private foreign direct investment	1,420	1,085	1,404	591	1,875	1,431	1,195	1,018	1,165	1,431	1,835	2,228	2,340	1,431	1,000	828	830
Net portfolio investments	532	708	601	-230	1,009	705	280	200	200	705	280	54	-247	1,005	540	500	500
Long-term loans (net)	488	350	470	505	1,995	784	996	881	186	784	429	-321	-342	534	836	681	236
Other capital (net, incl. errors & ommissions)	-690	-1,121	-569	1,308	-1,473	-265	-624	-458	-376	-265	-624	-458	-476	-585	-475	-225	-75
Change in reserves[d]	-378	-582	-1,313	-697	-1,391	-780	-323	-340	-193	-780	-463	-340	-467	-430	-323	-340	-193
Memorandum items																	
Resource balance (% of GDP)	-8.4	-5.1	-5.9	-10.9	-7.9	-5.4	-6.1	-5.4	-4.4	-5.4	-5.9	-5.0	-3.9	-7.8	-7.6	-7.2	-6.5
Current account balance (% of GDP)	-7.0	-2.5	-3.7	-8.4	-7.3	-6.0	-4.9	-4.1	-3.1	-5.9	-4.6	-3.7	-2.5	-6.3	-5.4	-4.9	-4.4
Annual value growth rates (%)																	
Merchandise exports (FOB)	-4.1	3.9	4.2	5.1	25.6	5.6	5.0	5.0	5.0	5.6	6.0	8.0	10.0	-8.7	1.1	4.6	4.9
Merchandise imports (FOB)	-11.1	1.0	14.0	20.2	33.4	0.6	3.6	1.6	1.6	0.6	5.0	3.6	3.3	-2.2	0.9	1.7	1.7
Public finance (as % of GDP at market prices)[e]																	
Overall surplus (+)/ deficit (-) (without privatization re	-8.1	-5.9	-6.4	-4.4	-5.8	-4.5	-3.7	-2.9	-2.0	-4.0	-3.2	-2.7	-2.1	-4.8	-4.3	-3.8	-3.5
Current revenues	48.3	46.7	45.1	44.9	44.3	44.0	42.8	42.0	41.0	44.2	42.9	42.0	40.5	45.4	44.8	44.3	42.5
Current expenditures	48.2	47.4	46.3	42.9	42.4	42.9	41.7	41.1	39.2	42.7	41.3	40.2	38.2	44.5	44.1	44.1	42.5
Current surplus (+) /deficit (-)	0.1	-0.7	-1.2	2.0	1.9	1.1	1.1	1.0	1.8	1.6	1.6	1.9	2.3	0.9	0.7	0.2	0.1
Capital expenditure	8.8	5.7	5.8	6.9	8.1	5.6	4.8	3.8	3.7	5.6	4.8	4.6	4.4	5.7	5.0	4.1	3.6
Foreign financing	3.5	4.6	1.9	2.8	3.1	2.2	2.2	1.8	1.6	2.2	2.2	1.7	1.6	2.5	2.5	2.2	2.1
Monetary indicators																	
M4/GDP	39.7	47.6	63.8	64.6	66.8	66.2	66.9	67.8	68.3	67.3	67.9	68.1	68.4	67.8	68.8	70.2	71.3
Growth of M4(%)	-1.7	29.1	45.7	9.6	11.2	6.0	7.6	8.0	7.7	8.3	7.8	7.5	8.2	5.2	6.6	7.1	6.6
Private sector credit growth (%)	-6.6	8.9	22.9	29.3	14.7	6.0	7.8	9.0	8.5	7.0	9.0	10.5	10.0	6.0	7.0	7.0	7.0
Domestic credit / GDP (%)	46.6	47.2	52.9	62.7	65.5	65.6	65.7	66.0	66.4	65.8	66.3	67.0	67.8	67.7	68.4	68.5	69.3
Price developments																	
Real exchange rate (1995=100)[f]	104.9	107.7	104.3	100.6	98.9	98.9	98.9	98.9	98.9	98.9	98.9	98.9	98.9	98.9	98.9	98.9	98.9
Exchange rate at end year (LCU/US$)[f]	7.6	8.2	8.4	7.1	6.1	6.5	6.9	7.1	7.5	6.5	6.9	7.1	7.5	6.5	6.9	7.1	7.5
Real interest rates	8.7	2.8	6.7	8.7	9.8	7.0	7.0	7.0	7.0	7.0	6.5	6.2	5.8	8.2	8.5	8.5	8.2
Consumer price index (% change)[g]	4.2	6.2	4.9	2.2	1.8	2.5	2.8	2.4	2.2	2.5	3.0	2.5	2.0	2.8	2.7	2.7	3.0
GDP deflator (% change)	3.8	4.7	4.0	2.9	3.2	3.1	2.4	2.0	2.4	3.3	2.3	2.1	2.1	3.1	2.4	2.0	2.4

a) GDP at factor cost
b) 'GNFS" denotes "goods and nonfactor services"
c) Includes net unrequired transfers excluding official capital grants.
d) Includes use of IMF resources.
e) Consolidated general government.
f) "LCU" denotes "local currency units". An increase in real exchange rate denotes depreciation.
g) Retail price index by 2002; since 2003 CPI

Croatia - Key Exposure Indicators

Indicator	Actual				Preliminary	Sustained growth scenario				Accelerated growth scenario				Slow growth scenario			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Total debt outstanding and disbursed (TDO) (US$m)[a]	9978	11055	11317	15421	23570	26348	25762	25623	25129	26348	25862	23823	23529	25988	25488	25305	25493
Net disbursements (US$m)[a]	1108	1530	711	2467	3732	3165	3176	2383	2387	3165	2776	1983	1887	3255	2712	3015	2873
Total debt service (TDS) (US$m)[a]	1946	2339	2814	2967	3314	3762	3465	3843	3486	3762	3415	3743	3386	3762	3765	3963	3886
Debt and debt service indicators (%)																	
TDO/XGS[b]	122.9	127.6	117.5	145.9	158.1	169.6	160.1	153.7	145.5	169.6	160.0	139.4	129.4	180.0	173.2	166.4	162.0
TDO/GDP	50.1	60.0	57.0	67.6	81.8	80.5	78.5	76.6	73.0	80.1	78.1	70.1	66.9	82.0	81.3	80.3	80.2
TDS/XGS	24.0	27.0	29.2	28.1	22.2	24.2	21.5	23.1	20.2	24.2	21.1	21.9	18.6	26.1	25.6	26.1	24.7
Concessional/TDO	2.9	2.9	2.7	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Interest payments/GDP	2.3	2.6	2.8	2.2	2.4	2.5	2.2	2.3	2.5	2.5	2.1	2.0	2.2	2.6	2.3	2.5	2.7
IBRD exposure indicators (%)																	
IBRD DS/public DS	8.3	6.0	4.6	3.9	5.5	5.2	5.9	4.1	4.6	5.2	6.1	4.2	4.8	5.2	5.4	4.0	4.6
Preferred creditor DS/public DS (%)[c]	24.9	18.5	14.8	18.3	8.1	7.8	8.1	6.3	7.2	7.8	8.3	6.6	7.5	7.8	7.3	6.3	7.2
IBRD DS/XGS	0.5	0.5	0.4	0.5	0.6	0.7	0.7	0.6	0.6	0.7	0.7	0.6	0.6	0.7	0.7	0.7	0.6
IBRD TDO (US$m)[d]	396	418	469	611	762	812	1040	1294	1501	812	1048	1369	1688	812	869	925	944
IDA TDO (US$m)[d]	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
IFC (US$m)																	
Loans																	
Equity and quasi-equity /c																	
MIGA																	
MIGA guarantees (US$m)																	

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.
b. "XGS" denotes exports of goods and services, including workers' remittances.
c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.
d. Includes present value of guarantees.
e. Includes equity and quasi-equity types of both loan and equity instruments.

CAS Annex B8a - Croatia
Operations Portfolio (IBRD/IDA and Grants)
As of Date 11/23/04

Closed Projects **11**

IBRD/IDA	
Total Disbursed (Active)	188.94
of which has been repaid	8.64
Total Disbursed (Closed)	722.59
of which has been repaid	162.27
Total Disbursed (Active + Closed)	911,536,512.32
of which has been repaid	170,917,142.60
Total Undisbursed (Active)	317.43
Total Undisbursed (Closed)	0.00
Total Undisbursed (Active + Closed)	317,433,658.89

Active Projects

		Last PSR Supervision Rating			Original Amount in US$ Millions				Difference Between Expected and Actual Disbursements [a/]	
Project ID	**Project Name**	**Development Objectives**	**Implementation Progress**	**Fiscal Year**	**IBRD**	**GRANT**	**Cancel.**	**Undisb.**	**Orig.**	**Frm Rev'd**
P065416	Coastal Cities Pollution Control (APL 1)	S	S	2004	47.5			49.3	11.5	
P065466	Court & Bankruptcy Administration (LIL)	U	U	2001	5.0			3.9	3.5	3.1
P048983	East Slavonia Reconstruction	S	S	1998	40.6			10.0	9.7	
P079978	Energy Efficiency	S	S	2004	5.0			5.2	-0.1	
P071461	Energy Efficiency (GEF)	S	S	2004		7.0		6.3	-0.7	
P051273	Health System Reform	S	U	2000	29.0			15.6	15.6	15.6
P042014	Karst Ecosystem Conservation (GEF)	S	S	2002		5.1		3.8	1.0	
P043444	Municipal Environment Infrastructure	S	S	1998	36.3			19.2	17.7	10.2
P063546	Pension System Investment	U	S	2003	27.3			17.9	4.4	
P039161	Railway Modernization and Restructuring	U	S	1999	101.0			15.0	22.5	
P067149	Real Property Registration and Cadastre	S	U	2003	25.7			28.9	1.6	
P043195	Rijeka Gateway	S	S	2004	156.5			144.9	6.7	
P057767	TA for Institutional Reg Ref & PSD	S	S	1999	7.3			3.4	3.4	
P070088	Trade & Transport Facilitation in SE Europe	S	S	2001	13.9			4.2	0.6	
				TOTAL	**495.2**	**12.1**		**327.5**	**97.4**	**28.9**

a/ Intended disbursements to date minus actual disbursements to date as projected at appraisal.

CAS Annex B8b (IFC) for Croatia

Croatia

Statement of IFC's
As of September 2004
(In US Dollars Millions)

Held and Disbursed Portfolio

		Held				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1973/81/98/02	Belisce	19.84	6.01	0	17.4	19.84	6.01	0	17.4
2002	Croatia Banka	3.63	0	0	0	3.63	0	0	0
1999	Croatia Capital	0	4.9	0	0	0	4.52	0	0
1999/02	E&S Bank	33	0	0	0	33	0	0	0
2001	Pliva	0	0	10	0	0	0	10	0
2000	Viktor Lenac	6	0	0.5	8.18	6	0	0	8.18
2004	Schuarz Group	48.41	0	0	0	0	0	0	0
Total Portfolio:		110.9	10.91	10.5	25.58	62.47	10.53	10	25.58

Approvals Pending Commitment

		Loan	Equity	Quasi	Partic
2002	Croatia Banka	8.07	3.59	0	0
2002	ESBank Zagreb II	8.97	0	0	0
2004	Viktor Lenac Exp	5.79	0	0	7
Total Pending Commitment:		22.83	3.59	0	7

CROATIA: WORLD BANK GROUP COUNTRY ASSISTANCE STRATEGY
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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
I. COUNTRY OUTCOME: MACROECONOMIC SUSTAINABILITY **COUNTRY INDICATORS:** • **ANNUAL INFLATION RATE HELD BELOW 3 PERCENT DURING CAS PERIOD** • **REDUCTION OF PUBLIC AND PUBLICLY GUARANTEED DEBT FROM 54 PERCENT TO 51 PERCENT OF GDP BY 2008** • **REDUCTION OF PRIMARY FISCAL DEFICIT FROM 3.7 PERCENT TO BELOW 0.4 PERCENT OF GDP BY 2008** • **REDUCTION OF GOVERNMENT EXPENDITURE FROM 50.5 PERCENT OF GDP IN 2003 TO BELOW 45 PERCENT OF GDP BY 2008**				
Unsustainable levels of public spending	• Fiscally sustainable public wage bill • Fiscally sustainable level of subsidies to public and state-owned enterprises • Fiscally sustainable road sector investment • Fiscally sustainable health sector expenditure • Rationalized cash social benefits	• Rationalization of government administration • Implementation of plan to reduce enterprise subsidies from US$980 million in 2003 to US$850-900 million in 2006 and US$760 million in 2008 • Adoption and implementation of a Railways Restructuring and Modernization Strategy agreed with the Bank • Steady reduction in HZ working ratio from 240 percent in 2003 to 150 – 170 percent in 2008 • Adoption of a Highway Network Expenditure and Financing Strategy agreed with the Bank • Reduction in total spending in the roads sector, and increase in the share of maintenance and rehabilitation expenditure consistent with the agreed Highway Network Expenditure and Financing	**Lending:** • PALs I-III • Growth Policy Support • Health Sector Development • Transport Sector Development **AAA:** • Health Policy Note/Workshop • Railways Policy Note/Workshop • Public Finance Review • Infrastructure Sector Strategy • Country Economic Memorandum	• IMF SBA • EC – CARDS • USAID (TA in financial management systems)

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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
		Strategy • Steady reduction in prescription drugs' share of HZZO's total expenditure, from 21 percent in 2003 to 17 percent in 2008 • Consolidation of cash social benefits programs and reduction in share of GDP		
Weak public expenditure management	• Strengthened budget management and execution capacity	• Implementation of forthcoming Public Finance Review recommendations	**Lending:** • PALs I-III • Growth Policy Support **AAA:** • Decentralization Policy Note/Workshop • Public Finance Review	• IMF SBA • USAID – Financial Management Systems TA • EC– CARDS
Weak debt management	• Sustainable level of external debt • Management of currency risk • Management of rollover risk	• Development and implementation of a debt management strategy • Strengthening of debt management office's capacity in Ministry of Finance	**AAA:** • Joint World Bank/IMF Public Debt Management and Domestic Debt Market Development Program	• IMF SBA • EC– CARDS (TA) • USAID (TA)
II. COUNTRY OUTCOME: SUSTAINABLE PRIVATE SECTOR-LED GROWTH **COUNTRY INDICATORS:** • **AVERAGE ANNUAL REAL GDP GROWTH OF 4.0 PERCENT TO 4.5 PERCENT DURING CAS PERIOD** • **INCREASED PRIVATE SECTOR SHARE OF GDP FROM 60 PERCENT IN 2003 TO 70 PERCENT BY 2008** • **AVERAGE TOTAL FACTOR PRODUCTIVITY OF 6 PERCENT DURING CAS PERIOD** • **AVERAGE ANNUAL INFLOWS OF FDI AT 3.8 PERCENT OF GDP DURING CAS PERIOD**				
Inefficient and loss-making enterprise sector	• Enforcement of financial discipline and competitive conditions in enterprise	• Progress toward divestiture by end-2006 of 600-800 SOEs held by CPF, and	**Lending:** • PALs I-III • Growth Policy Support	• USAID – TA (for shipbuilding and *agro-kombinat* SOEs, and for HEP restructuring and tariff reform)

CROATIA: WORLD BANK GROUP COUNTRY ASSISTANCE STRATEGY
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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
	sector • Energy infrastructure linked to EU market	1,130 SOEs by end-2008 • Progress toward divestiture of half of the asset value of 10 subsidiaries of Croatian Railways by end-2006, and completion of divestiture in 2008 • Implementation of plan to reduce enterprise subsidies from US$980 million in 2003 to US$850-900 million in 2006 and US$760 million in 2008 • Establishment of autonomous and functional transmission system operator • Establishment of autonomous and functional distribution system operation(s) • Liberalization of electricity market in accordance with Athens Memorandum on South East Europe Regional Energy Market • Private participation in municipal and power generation infrastructure • Modernized district heating system	• Transport Sector Development • Municipal Services • Energy Sector Development **Partial Risk Guarantees** **AAA:** • Railways Policy Note/Workshop • Sources of Growth Workshop • Energy Sector Strategy • Shipyards PSIA • Public Finance Review • Country Economic Memorandum • Investment Climate Assessment **IFC:** • Debt and equity investment to facilitate successful privatizations, possibly including the two remaining state-owned banks • TA in corporate governance, environmental standards, and best practices • Balkans Infrastructure Development Facility	• EBRD (investment in gasification) • EIB (investment in gasification
High cost of doing business and uncompetitive investment climate	• Significant reduction in administrative and regulatory barriers and processing time • Market-oriented R&D	• Enactment of amendments to the Laws on Physical Planning, Construction, and Utility Services • Reform of R&D institutes	**Lending:** • PALs I-III • Growth Policy Support • Science and Technology • Trade and Transport	• Finland (TA for R&D reform) • EBRD (credit for SMEs) • USAID (TA for SMEs in tourism and IT) • Austria (TA, credit, and investment

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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
	system • Increase in volume of transit trade	• Strengthened inter-modal connectivity of Rijeka Gateway to Northeast Corridor	Integration • Transport Sector Development **AAA:** • Cost of Doing Business Policy Note/Workshop • Sources of Growth Workshop • Non-Bank Financial Institutions Integration TA • Financial Infrastructure Study • FIAS Administrative and Regulatory Cost Survey • Investment Climate Assessment **IFC:** • Debt and equity investment in green-field projects with strategic partners and non-bank financial institutions • TA in corporate governance, environmental standards, and best practices • Balkans Infrastructure Development Facility **MIGA:** • European Investor Outreach Program	for SMEs) • EC – CARDS (TA) • EIB (investment) • KfW (investment) • EC pre-accession funds, to be followed by structural funds (post-accession)
Inefficient public administration	• Reduction in public wage bill's share from 11 to 9.5 percent of GDP by 2008 • Increased public satisfaction with	• Enactment of Civil Service Law and implementation of merit-based hiring and pay system • Rationalization of	**Lending:** • PALs I-III • Growth Policy Support • Education Sector Development	**Partner Instruments:** • EC – CARDS (TA) • DFID – TA • The Netherlands – MATRA Program • USAID – Local Government Reform

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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
	transparency, accountability, and efficiency of civil servants based on surveys • Majority of legislative proposals to parliament with a robust socio-economic analysis • Financial management systems and controls and public procurement procedures aligned with EU standards	government administration • Strengthening of the policy-making process • Steady progress in implementation of upgrading national fiduciary systems agreed with the Bank for alignment with the EU	• Health Sector Development • Transport Sector Development • Energy Sector Development **AAA:** • Decentralization Policy Note/Workshop • Fiduciary Country Systems Development TA/IFA • Public Finance Review • Country Economic Memorandum	Program (TA and investment) and TA to Ministry of Finance
Inefficient judicial system	• 50 percent reduction in court case backlogs • Greater accountability and professionalism of judges	• Rationalization of the court system, including restructuring of responsibility for land registration • Acceleration of court proceedings • Strengthening of evaluation system for judicial decisions • Reform of training curriculum for judges	**Lending:** • PALs I-III • Growth Policy Support **AAA:** • Judicial Reform Policy Note/Workshop • Investment Climate Assessment	• EC – CARDS (TA and investment)

CROATIA: WORLD BANK GROUP COUNTRY ASSISTANCE STRATEGY
RESULTS MATRIX

Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
III. COUNTRY OUTCOME: BROAD PARTICIPATION IN GROWTH **COUNTRY INDICATORS:** • **INCREASE IN ADULT POPULATION WITH SECONDARY EDUCATION FROM LESS THAN 40 PERCENT IN 2003 TO 44 PERCENT IN 2008, AND DECREASE IN TERTIARY EDUCATION NET DROPOUT RATE FROM 70 PERCENT IN 2003 TO 50 PERCENT IN 2008** • **STUDENT ACHIEVEMENT AT COMPETITIVE EUROPEAN LEVEL** • **SUSTAINED INCREASE IN EMPLOYED SHARE OF WORKING-AGE POPULATION, INCLUDING IN "DISADVANTAGED AND WAR-AFFECTED AREAS," FROM NATIONAL LEVEL OF 43 PERCENT IN 2003** • **HEALTH OUTCOMES APPROACHING THOSE OF EU AVERAGES FOR INFANT AND MATERNAL MORTALITY RATES AND INCIDENCE OF TB**				
Outdated education system	• Increase in secondary education completion rate from 78 percent in 2003 to 85 percent in 2008 • Vocational schools accounting for about half of secondary school enrollment • Decrease in proportion of pupils studying in multi-shift schools from 90 percent to 50 percent • Student assessment results in line with international comparators	• Modernization of curriculum • Introduction of external secondary school leaving examinations • Introduction of a professional development system for teachers and school principals	**Lending:** • Education Sector Development **AAA:** • Education Policy Note/Workshop • Youth Employment Policy Note/Workshop • Fiduciary Country Systems Development TA/IFA	• EC – CARDS (TA for mobility centers and vocational education and training) • UNDP (TA for social protection)
Inefficient social assistance system	• Sustained increase in labor force participation rate from 50.2 percent in 2003 • Some reduction in poverty rates, absolute (11.1 percent in 2001) and relative (16.9 percent in 2003)	• Improved targeting through means-testing for increased share of social benefits • Mitigation of labor dislocation resulting from SOE divestiture and civil service rationalization	**Lending:** • PALs I-III • Growth Policy Support • Social Protection **AAA:** • Living Standards Assessment • Shipyards PSIA • Youth Employment Policy Note/Workshop	• SIDA

CROATIA: WORLD BANK GROUP COUNTRY ASSISTANCE STRATEGY
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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
Lagging health outcomes	• Improved quality of and access to health care services	• Steady progress toward increase in share of primary health care expenditure in total health spending from around 16 percent in 2003 to 18 percent in 2006 and 20 percent in 2008 • Steady roll-out of performance-based contracts to 80 percent of general practitioners by 2008 • Expansion of disease prevention and public awareness programs	**Lending:** • Health Sector Development **AAA:** • Health Policy Note/Workshop	
Regional disparities	• Rehabilitation of areas affected by closure of large enterprises • Rehabilitation of "disadvantaged and war-affected areas" • Steady progress toward more competitive agriculture sector aligned with EU *acquis communautaire*	• Implementation of regional development strategy for economically depressed areas in line with EU requirements • Local capacity building to implement regional development strategy and absorb EC structural funds for infrastructure, environmental investment, and economic diversification • Mineclearing in war-affected areas • Resolution of property and social reintegration issues to facilitate completion of refugee returns • Improved targeting of agriculture subsidies	**Lending:** • Social and Economic Recovery • Agriculture *Acquis* Cohesion • Regional Economic Rehabilitation **GEF:** • Sustainable Land Management **AAA:** • Living Standards Assessment • Regional Development Study	• EC – CARDS (TA and investment) • USAID (TA and investment) • Council of Europe Development Bank (investment) • Italy – Program supporting reconstruction of Eastern Baranja • The Netherlands (investment) • SIDA – TA • Germany – TA

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Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
		• Capacity building of Food Safety Agency and agriculture extension service • Promotion of more sustainable land management practices		
IV. COUNTRY OUTCOME: SUSTAINABLE NATURAL RESOURCE MANAGEMENT **COUNTRY INDICATORS:** • **SUSTAINED PROGRESS TOWARD ALIGNMENT WITH EU *ACQUIS COMMUNAUTAIRE* ON ENVIRONMENT** • **IMPROVED WATER QUALITY IN COASTAL AREAS AND CROATIAN DANUBE RIVER BASIN** • **INCREASED WATER SERVICE DELIVERY COVERAGE** • **REDUCED DEPENDENCE ON FOSSIL FUELS**				
Weak environmental management capacity	• Strengthened legislative and regulatory framework • Strengthened institutional capacity at national and local levels • Strengthened technical capacity for monitoring and enforcement	• Investment in environment ministry staff training and certification programs • Investment in networked information systems • Investment in monitoring equipment • Public-private partnerships in waste management • Introduction of public awareness programs	**Lending:** • Environmental Management **AAA:** • Environmental Management TA/Strategy	• EBRD (investment) • EIB (investment) • KfW (investment) • EU – CARDS • EC pre-accession funds, to be followed by structural funds (post-accession) • The Netherlands (TA)
Inadequate wastewater management and water supply	• Reduced water pollution levels in coastal areas near Bank-financed project sites • Reduced discharge of nutrients from Zagreb into Danube River • Increase in wastewater collection coverage from 60 percent to 80 percent of households • Increase in public water	• Upgrading of aging wastewater treatment plants to EU environmental standards • Rehabilitation of water supply infrastructure • Improved efficiency of water utilities • Strengthening of the regulatory framework governing water utilities’	**Lending:** • Municipal Services • Coastal Cities Pollution Control II **Partial Risk Guarantees** **GEF:** • Zagreb Municipal Nutrient Reduction **AAA:** • Public-Private Partnership for Municipal Services	• EC pre-accession funds • Germany – Program for local wastewater management and drinking water supply • The Netherlands – co-financing of Coastal Cities Pollution Control APL

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RESULTS MATRIX

Development Constraints	Outcomes Influenced by WBG Program During CAS Period	Intermediate Indicators to Track Progress	Planned WBG Instruments	Partner Instruments
	supply coverage from 73 percent to 85 percent of the population	relationship with municipal governments	Policy Note/Workshop **IFC:** • Balkans Infrastructure Development Facility	
Energy inefficiency	• Progress toward fulfillment of international obligations under the Kyoto Protocol to reduce greenhouse gas emissions	• Development of strategy for meeting Kyoto Protocol commitments, including use of Kyoto flexibility mechanisms • Commercial development, financing, and implementation of energy efficiency projects by engaging local firms as suppliers • Development of national policy framework for renewable energy • Creation of an equity finance facility for renewable energy investments	**Lending:** • Municipal Services • Environmental Management • Energy Sector Development **GEF:** • Renewable Energy Resources **AAA:** • Energy Sector Strategy • Environmental Management TA/Strategy	• EU pre-accession funds • Co-financing by local partners and financial intermediaries