

## 1.1 International Environment

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### 1.1.1 World

The economic situation in the countries of Southeast Asia that were affected by the financial crisis of 1997 has improved since 1999. However, in late 1998 and early 1999, a crisis broke out in the biggest Latin-American economy – Brazil, which caused instability in whole of Latin America. In addition, the Kosovo crisis and the NATO military action against the Milošević regime had a negative effect on the Southeast European economies.

One of the most unfavorable effects was the “third oil shock” of an increase in oil prices from 12 US\$ per barrel (in current dollars) in early 1999 to 25 dollars per barrel (in current dollars), reaching the prices resulting from the first and the second “oil shocks” in the 1970s and 1980s respectively. Consequently, despite some improvements in the Southeast Asian situation, 1999 did not pass without difficulties in the world market.

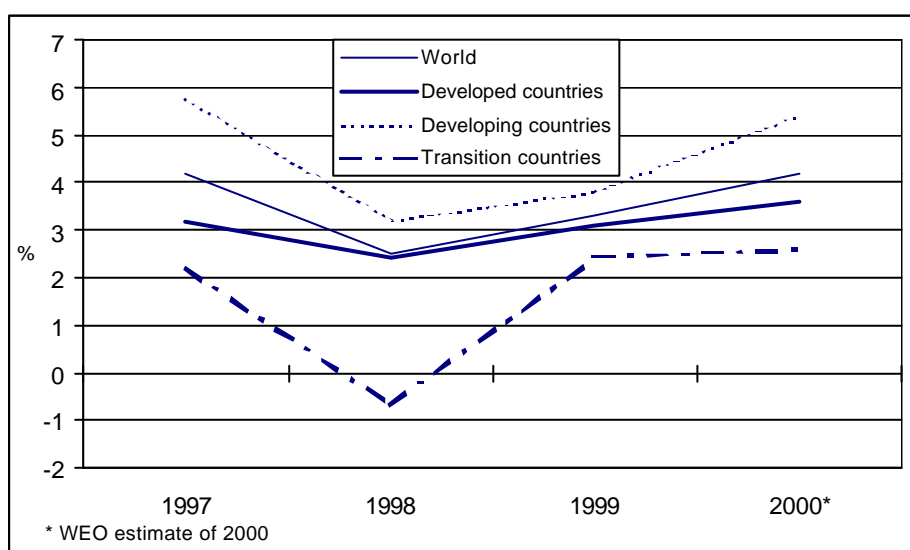
The most powerful economy in the world, that of the USA, continued to grow in 1999. If this continues in 2000, this would be the longest period of growth (over 8 years or 24 quarters) in its recorded economic history (i.e. since mid-19<sup>th</sup> century). This growth was the greatest contribution to alleviating the consequences of the 1997/98 world financial crises, which was accompanied by poor growth in Europe and recession in Japan. A major source of this growth was the restructuring process that took place in the late 1980s and early 1990s: a rapid technological progress based on fast-growing telecommunications and information sectors. One of the main driving forces of growth was the fiscal restructuring and consolidation of the early 1990s, which turned the severe fiscal deficit of the 1970s and 1980s into a surplus. On the other hand, the Federal Reserve System (Fed) pursued a stable monetary policy that took account of expectations (forward-looking). The main target of this policy was a low inflation rate, which was achieved through a very high growth rate and a low unemployment rate. In 1999, the unemployment rate fell to 4.2 percent, which was the lowest rate in almost the last three decades and lower than the 5 percent rate which was supposed to be the lower limit of natural unemployment (decreased from 6 percent in the early 1990s). Nevertheless, the retail price index shows no sign of growth, indicating an annual inflation rate of 2.2 percent, which is 0.6 percent higher than in 1998 and is mainly a consequence of the oil price increase. These developments in the US economy, along with poor growth in Europe, recession in Japan and uncertainty caused by financial crises in emerging markets, resulted in “taking refuge in the American dollar”, investment in financial instruments nominated in dollars and price growth on American stock markets. This additional impulse to growth in the USA helped bring about a nominal effective appreciation of the American dollar of 2.5 percent. In view of such long-lasting growth, an increasing number of economists anticipate a slow-down. This was the basis for decisions in the last three sessions of the Fed’s Federal Open Market Committee (FOMC) concerning increased interest rates as a method of preventing possible inflation growth. The highest potential risk is the appearance of a “bubble” on the American stock exchange, i.e. a significant overvaluation of shares. The bursting of the “bubble” would cause a slow-down of growth in the USA, the abandonment of the dollar,

inflationary pressure and depreciation, and decline in the growth of the world economy.

In early 1999, the real GDP in Japan started to increase, indicating an upturn after a long period of stagnation and recession caused primarily by weakness in the financial sector. This weakness was partially resolved by government intervention in late 1998 and by government capital injections to major Japanese banks, as well as by a set of incentives for government spending. The process of financial sector strengthening and bank recovery is under way, and measures of banking supervision and control have been intensified, along with regulations about capital adequacy and other measures aimed at providing a more secure banking system. However, the financial system consolidation incurred significant costs that were mainly borne by the Government (this will most probably result in a 10 percent GDP deficit). Furthermore, the restructuring process and improvement of competitiveness of companies which, as in other developed countries, begin with laying off surplus labor (such measures have not yet been implemented in Japan, thanks to the “lifelong employment” system) and the uncertainty resulting from the above mentioned circumstances could challenge the future economic recovery of Japan.

In 1999, growth in the USA, recovery in Japan and faster growth in Europe resulted in a 3 percent real growth in the world economy. There was 3.5 percent growth in the developing countries, while the transition countries grew by only 2.4 percent.

Figure I.1 Increase in *Output*

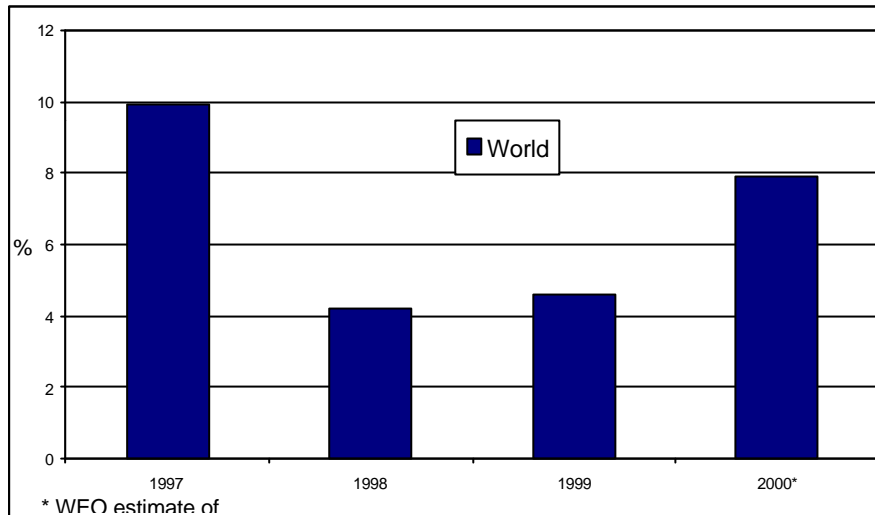


Source: *World Economic Outlook*, IMF, April 2000

Such growth in the world economy was certainly facilitated by the 4.6 percent increase in world trade, which, although lower than the longtime averages of 5 to 6 percent and the 10 percent achieved in 1997, may be considered satisfactory in view of the recent Asian, Russian and the Brazilian crises. The recovery in world trade was definitely supported by an increase in aggregate demand in the USA; however, the oil price increase will probably result in slower recovery. Among the factors inhibiting world trade recovery are difficulties within the World Trade Organization, especially in its functioning, that were manifested during the Seattle Conference of 30 November

to 3 December 1999 (the Conference was a failure). Continued WTO inefficiency could be an additional motive for the regional association of countries, particularly after the increasingly successful integration of European countries following the establishment of Economic and Monetary Union.

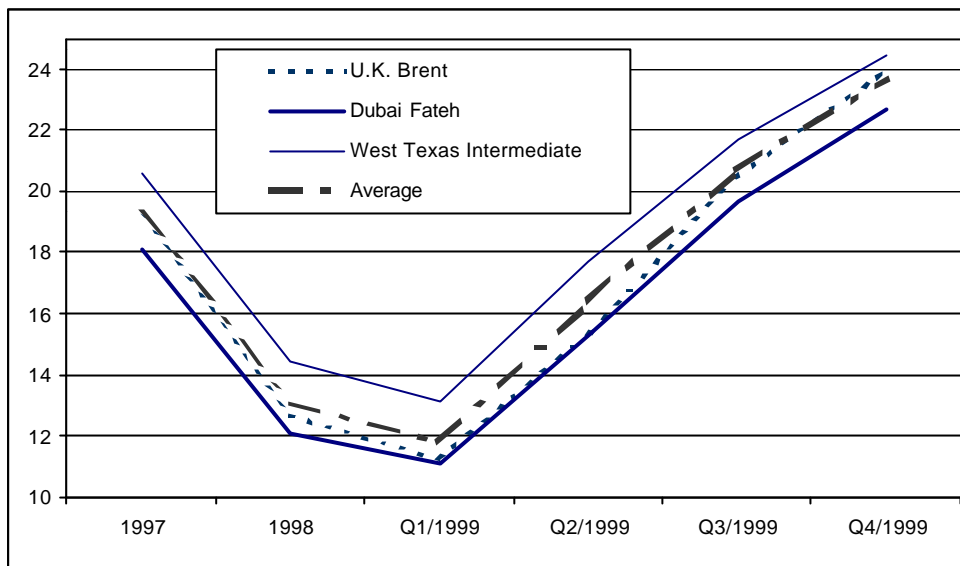
Figure I.2 Growth Rate of World Trade



Source: *World Economic Outlook*, IMF, April 2000

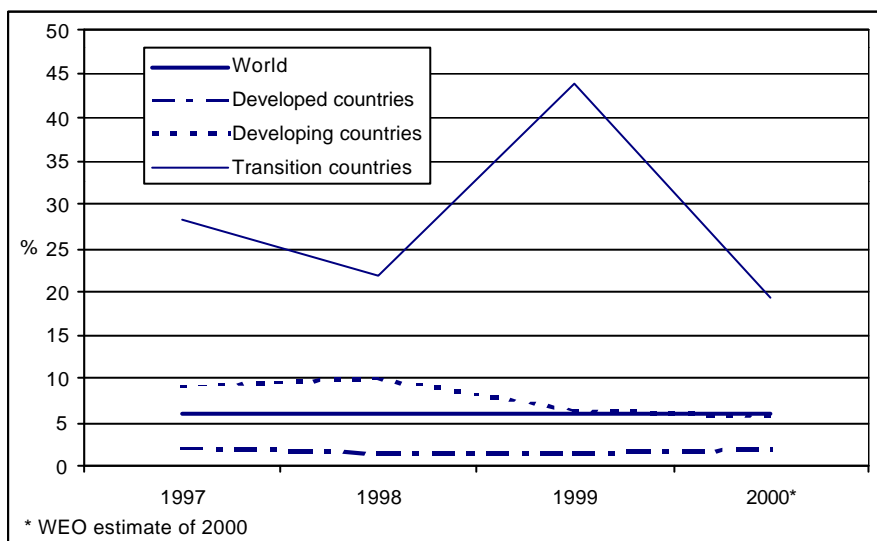
The growth in the developed countries and their success in keeping prices and inflation in the 1990s at the lowest level since the beginning of this century have facilitated a decrease in world inflation. According to the retail price index, the global price increase approximated 6 percent. The developed countries maintained their inflation at 1.4 percent, whereas retail prices increased by 6.5 percent in the developing countries and by as much as 43.7 percent in the transition countries. An adverse effect on global inflation was the increase in oil prices, which doubled in 1999. The IMF evaluation based on the MULTIMOD global macroeconomic model indicates that a 10 percent increase in oil prices results in about a 0.15 increase in retail prices and a 0.1 percent decrease in real economic activity in the developed countries, which means that the doubling of oil prices in 1999 may account for the 1.5 percent increase in world prices and 1 percent decline in real growth.

Figure I.3 Trend in Market Oil Prices (USD/barrel)



Source: *World Economic Outlook*, IMF, April 2000

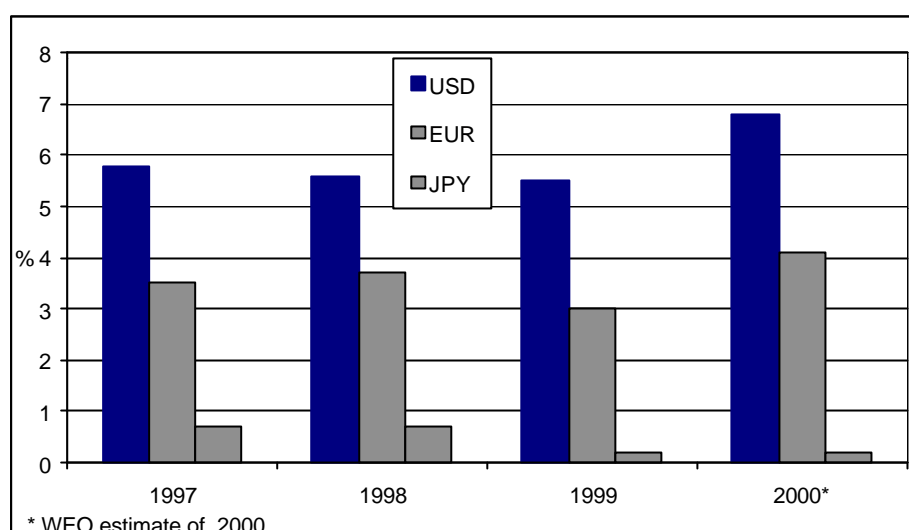
Figure I.4 Inflation (CPI)



Source: *World Economic Outlook*, IMF, April 2000

As a consequence of the global financial crisis, investment moved from the emerging markets to the developed markets, primarily to the USA. As a result, interest rates on financial instruments nominated in major world currencies (American dollar, Euro and Japanese yen) fell. In Euroland (member states in the European economic and monetary union), a process of financial markets consolidation was initiated thanks to the establishment of a common economic and financial area following the introduction of the euro.

Figure I.5 Six-month LIBOR on Deposits



Source: *World Economic Outlook*, IMF, April 2000

In 1999, the emerging markets, especially those of South and East Asia, started to recover from the Asian financial crisis of 1997. Korea, Malaysia, Thailand, Singapore and Hong Kong recovered their high growth rates in 1999, while carrying out measures concerning financial system strengthening and the consolidation of huge companies (e.g. Daewoo in Korea), as well as removing the consequences of the financial crisis (especially bad loans). Most of the countries initiated their recovery by fiscal expansion, whereas some of them used their exchange rate policies as an additional instrument for growth stimulation (for example, Malaysia, which adjusted its foreign exchange rate to more competitive values). On the other hand, Indonesia went through a crisis in East Timor, which extended the recession and stagnation resulting from the Asian crisis. The Latin-American countries had less success in 1999. The financial crisis that broke out in Brazil in late 1998 was the result of disbelief in a successful outcome of the fiscal adjustment, leading to a decline in economic activity; however, the decline proved to be smaller than expected, with clear indications of recovery in 1999. Mexico, in contrast, recorded significant growth, mainly stimulated by the long-lasting high growth in the USA – its most important trading partner. In Argentina, Chile, Columbia, Ecuador and Venezuela there was stagnation and recession due to poor fiscal discipline, a high inflation rate and fragile financial systems.

Globalization and the integration of the world financial markets made significant progress, particularly in the 1990s. This was supported by the development of telecommunications, computer networking and the Internet. The advantage of such developments is that they lead to better global savings allocation and an overall improvement in the world economy, not only in the financial sphere but also in the field of real economy. The latest trend in the USA is doing business through the Internet, known as e-commerce or e-business. However, there is also a dark side to this: globalization and the integration of financial systems pose an increasing challenge to the national monetary authorities, particularly those in open economies, through stronger pressure and an unpredictable development of domestic financial systems. That puts additional pressure on exchange rates and challenges the

consistency and viability of other economic policies in a country. Lack of confidence on the part of the market and foreign investors in the consistency and viability of economic policies may result in an abrupt capital drain, accompanied by a currency and banking crisis (and even a crisis of the entire financial system). Thus in the 1990s, the world went through many crises: from the crisis of the European Exchange Rate Mechanism (in 1992/93), the Mexican (“tequila”) crisis in 1994/95, the Asian crisis (1997/98), the Russian crisis in 1998, to the Brazilian crisis of 1998. Not even the most developed West European countries were spared from crises; many countries were affected only due to the “contagion effect”, without having made any major mistakes in pursuing their economic policies.

### 1.1.2 European Union and Euroland

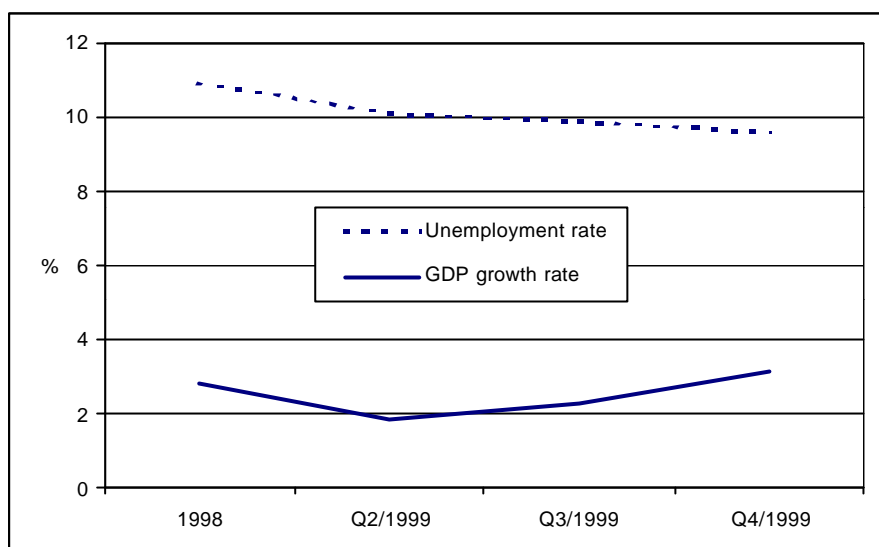
On 1 January 1999, eleven member states of the EU entered the third (and last) stage of establishing economic and monetary union: the stage of introducing a common currency (Euro). This process should be completed by mid 2002, when the euro would become the official currency for all transactions in the Euroland countries. With such a large number of European currencies united in the new common currency, the euro rivals the American dollar as the world reserve currency and challenges its role in global exchange and payments.

The successful introduction of the euro has already had an effect on the world and European foreign currency and bond markets, the world and European banking system and the total capital flow. The lifting of currency restrictions between EMU countries, which also includes the annulment of exchange risks, is an incentive to the integration, development and liquidity of the capital market (i.e. increased securitization in Europe), to the development of the European bond market and international government debt market, and to the consolidation and expansion of banks and competition among them in the wholesale and retail banking markets.

There is no doubt that the euro will have international effects due to its role as an international currency, its participation in world trade and its role as the main reference currency in many countries of Africa and Central and Eastern Europe (transition countries), particularly those preparing to introduce the euro as the national currency.

In late 1999, there were signs of accelerated growth in Euroland, caused by an upturn in production, the consolidation and increased competitiveness of companies and a 12 to 13 percent decrease in the euro exchange rate vs. the American dollar and other major world currencies. This raises hopes that Euroland could take over the role of the global moving force if and when growth in the USA stops. Acceleration of growth in Euroland could have significant effects on the world economy, because the share of Euroland in the world trade exceeds the share of the USA (19 percent vs. 15 percent). Moreover, Euroland is more open than the USA (16 percent vs. 12 percent), which means that an increase in the domestic aggregate demand in Euroland will cause a more rapid and much larger increase in the demand for export on the part of its main trading partners and the world economy in general.

Figure I.6 Real GDP Growth and Unemployment in Europe



Source: European Central Bank

The accelerated growth resulted in decreased unemployment in the Euroland countries. In late 1999, the unemployment rate fell below 10 percent. However, great differences still persist between labor markets in individual member states despite the establishment of EMU; for example, the unemployment rate was under 3 percent in Luxembourg and the Netherlands, while it amounted to 11 percent in Italy and as much as 15 percent in Spain.

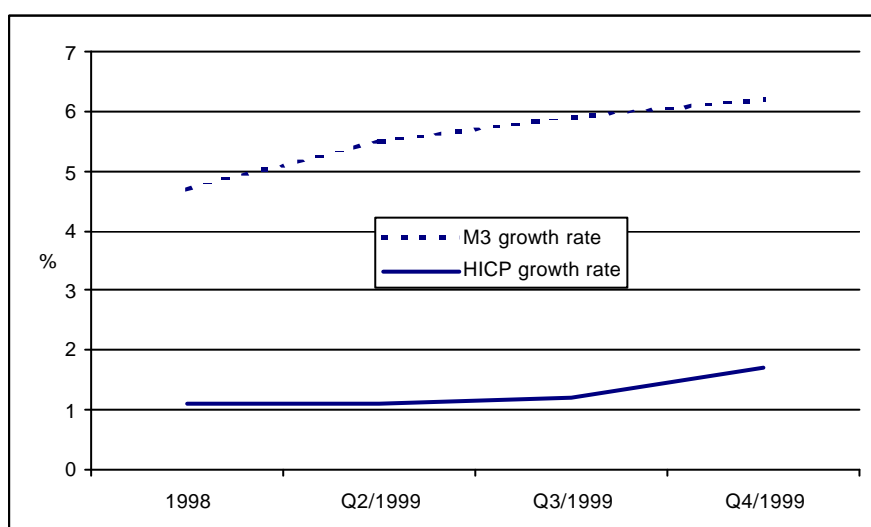
There are still differences between EMU member states concerning their fiscal burdens. Although 1997 and 1998 were the most successful years for converging fiscal positions to the Maastricht criteria for the purpose of qualification for EMU, little has been achieved since then. Convergence is further complicated by the fact that the fiscal policies of the EMU member states are now the only independent set of economic measures available to the national economic policy makers.

Technological progress, globalization, deregulation and liberalization, along with the introduction of the euro, encouraged the consolidation and expansion of the banking sector, thus reducing the number of deposit and savings institutions by 4 percent. The value of mergers and acquisitions of banks in 1999 increased by 35 percent compared to 1998 and by as much as 153 percent in the case of non-banking companies.

The success of EMU and the euro mostly depends on the performance of the European System of Central Banks (ESCB) and the European Central Bank (ECB), as the main monetary institution to replace (and maintain) the credibility of the Deutsche Bundesbank. After only a year of the euro and the ECB as the monetary authority, it is difficult to evaluate its performance. However, significant progress has been made in the standardization and co-ordination of national central banks and the ECB, in the interstate money market which, based on TARGET (the system set up for settlements within the EU) has experienced an increase in transactions (in the first half of 1999 the volume of transactions increased by 40 percent compared to 1998), and in interest rate harmonization, with the acceptance by the money markets of all member states of EURIBOR (Euro Interbank Offered Rate – average of rates offered by certain banks

in Euroland) and EONIA (Euro OverNight Index Average - for big payments in the London overnight broker market) as their reference interest rates. The purchase and repurchase market and the short-term government securities market have not yet been fully integrated, which obstructs the ECB in pursuing its monetary policy by using open-market instruments. According to its establishment charter, which is part of the Maastricht Treaty, the primary objective of the ECB is price stability, to be achieved by a combination of money targeting and price targeting. The reference value for prices is an increase of up to 2 percent per annum in the HICP index (the European harmonized consumer price index), and the reference value for money is a growth of up to 5 percent per annum in the European M3 (the broadest monetary aggregate at the EMU level) - data obtained from Mr. Willem F Duisenberg, President of the ECB. In terms of the inflation target, the ECB was rather successful in 1999 because the price increase as measured by HICP amounted to 1.7 percent, while in terms of the money target, the increase in the European M3 was just above the planned limit and amounted to 6.2 percent.

Figure I.7 HICP and M3 Developments in Europe



Source: European Central Bank

Apart from significant consolidation in the banking sector, the most intensive development was observed in the bond market, where the transaction volume in 1999 rose by more than 80 percent compared to 1998. This increase was partially caused by a growing demand for financing larger companies resulting from mergers and acquisitions, for which financing through banks became insufficient. A significant breakthrough was also made in the stock market, by the stronger integration and association at the European level of several minor stock exchanges from various countries (e.g. EURO.NM), and in the total securities market through a more intensive information flow and arbitration among the leading European financial and stock exchange centers. In 1999, total capitalization of the European stock markets increased by more than 70 percent.

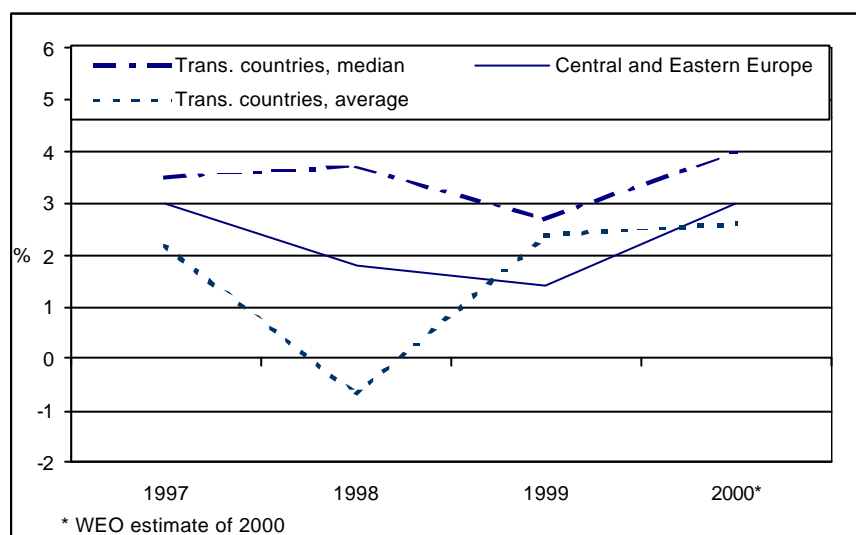
Such a recovery and consolidation of the real and financial sectors in Europe will certainly support future growth in European countries and encourage economic growth and development in countries trading with EMU members, i.e. Central and

East European countries. Moreover, after consolidation of the financial sector and reduction of the yield and price of money, financial relationships between Central and East European countries and EMU members will continue to improve.

### 1.1.3 Central and Eastern Europe

The Russian crisis had a considerable impact on the transition countries in Eastern Europe that have closer trade relations with Russia. These countries were already known for having less success in the transition process. Thus the gap between the “successful” transition countries (Poland, the Czech Republic, Hungary and Slovenia) and the “less successful” grew wider. The “less successful” transition countries of Southeast Europe were also adversely affected by the Kosovo crisis and the NATO military action against Serbia.

Figure I.8 *Output in Transition Countries*



Note: the transition countries in Central and Eastern Europe include: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldavia, Poland, Rumania, Slovakia, Slovenia and Ukraine.

Source: *World Economic Outlook*, IMF, April 2000

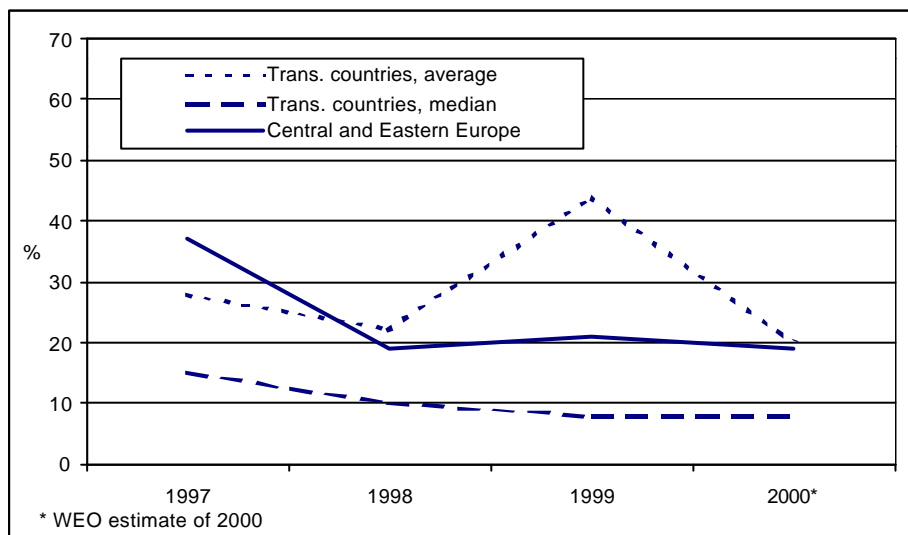
The Russian crisis resulted in a slow-down in economic growth in Ukraine, Belarus, the Trans-Caucasian countries and Central Asia, and the Baltic countries, which, despite their entering into economic relations with the European Union, still have close relations with Russia and the other countries of the former Soviet bloc.

Hungary and Poland maintained their high growth rates (3.7 percent), as did Slovenia (3 percent). However, this growth was restricted by the slowdown in growth in the European Union.

In 1999, the Czech Republic and Slovakia stagnated due to more restrictive monetary and fiscal policies that were intended for correcting the internal and external imbalance (especially in fiscal terms). In addition, their fragile financial systems are a serious obstruction to faster economic growth.

By introducing currency management in 1998, Bulgaria stopped unfavorable economic developments and achieved an extremely high growth rate, which was slowed down by the Kosovo crisis in 1999. Rumania, Macedonia, Albania and Bosnia and Herzegovina also suffered serious damage due to the Kosovo crisis. As a result of a large influx of refugees, a cut in trade, growing uncertainty and expenses caused by the nearby war activities, all these countries were confronted with increased balance of payments and budget deficits. Albania and Macedonia provided accommodation for the largest number of refugees (their number corresponds to 13 percent of their total population), which meant heavy strains on their budgets. According to IMF estimates, the Kosovo crisis caused deficits of a total of USD 1 billion in the balance of payments of these countries. The budget deficits amounted to an additional USD 450 million, so that the total damage came to about USD 1.5 billion. A part of the loss will be covered by donations from Western countries within the framework of the Stability Pact for Southeast Europe.

Figure I.9 Inflation in Transition Countries



Source: *World Economic Outlook*, IMF, April 2000.

Sources:

*World Economic Outlook*, IMF, October 1999, Washington, D.C.  
*OECD Economic Outlook*, OECD, December 1999, Paris  
*Monthly Report*, Deutsche Bundesbank, February 2000, Frankfurt  
*Monthly Bulletin*, ECB, various issues, 1999, Frankfurt

## **1.2 General Characteristics of the Croatian Economy in 1999**

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The main characteristics of the Croatian economy in 1999 were: mild recession, with an 0.3 percent fall in GDP, accompanied by a further increase in unemployment; further consolidation in the banking system, and a second banking crisis but with the CNB playing a considerably more active role as a result of the new Banking Law that had been passed at the end of 1998; a stagnation in monetary and credit aggregates; a further reduction in the balance of payments current account deficit and interest rates; and a substantial deterioration in the fiscal position.

In 1999, Croatia suffered a recession caused by: unresolved structural problems in the economy, ranging from the privatization and restructuring of companies to an inadequate and increasingly deteriorating public expenditure structure; a second banking system crisis, which led to the bankruptcy and exit from the market of several small and medium-sized deposit institutions; the Kosovo crisis; and relatively poor growth in the countries that are Croatia's major trading partners. As a result, final demand, both foreign and domestic, fell for the first time since stabilization. Net exports of goods and services was the single component which positively effected growth, since the fall in imports caused by the recession was greater than the fall in exports. In such conditions, unemployment continued to grow as expected: in the first half of 1999, the internationally comparable rate of unemployment, measured by the Labor Force Survey (International Labor Organization), amounted to 12.6 percent.

Monetary policy completely reflected the economic stagnation, which was also evidenced by stagnation in the monetary and credit aggregates. Total liquid assets decreased by 0.6 billion kuna in 1999 to 55.4 billion kuna. The M4 structure did not change in 1999 compared to 1998: foreign exchange deposits still accounted for 64 percent of M4, kuna deposits (deposit money and kuna savings) for 30 percent and currency in circulation for 11 percent; at the end of 1998, these shares were 65 percent, 30 percent and 10 percent respectively, which is almost identical to the end of 1999. Over the past years (since 1994), the share of foreign exchange deposits in M4 has increased with the increase in their amount. When foreign exchange deposits reached two-thirds of M4, they ceased to increase further, but their decline should not be expected in the near future. Such a large share represents a restriction which monetary policy must take into account in the future, regardless of success in maintaining exchange rate and price stability. During 1999, the money supply grew by a modest 0.3 billion kuna, amounting to 13.8 billion kuna at the end of the year. The increase was mainly caused by a growth of 0.2 billion kuna in currency in circulation, and only to a smaller extent by an increase in demand deposits (0.1 billion kuna). Household demand deposits increased by 0.2 billion kuna (8 percent) and corporate demand deposits decreased by 0.1 billion kuna (2 percent). Such movements confirm a continued deterioration in corporate sector liquidity. The announced payment of government arrears in 2000 will favorably affect the recovery of demand deposits. As is usually the case with small and open economies with large currency substitution, monetary policy was unable to play an active role but had to focus on maintaining stability, which was seriously compromised by the pressures on the exchange rate, especially at the beginning of the year, partly due to problems in certain banks that were forced to exit the market. Another circumstance preventing a more active monetary policy was the failure to restrain the fiscal expansion that has characterized the Croatian economy over the last several years.

The most intense pressure was placed on the kuna in the foreign exchange market in the first quarter, but exchange rate stability was maintained by CNB intervention and tightening of monetary policy. The kuna depreciated by almost 4 percent in the first quarter of 1999 and over the year fell against the German mark by 5 percent compared to the end-year exchange rate or 7.1 percent on the average annual exchange rate basis. This depreciation was useful for the development of the fundamentals; however, it was more important to prevent an uncontrolled weakening of the kuna at the beginning of the year, which could have led to an excessive loss in its value due to self-fulfilling expectations and a great "balance sheet problem". The daily nominal exchange rate of the kuna depreciated by 11.2 percent, crucially influenced by a 22.4 percent appreciation of the US dollar. The real effective exchange rate of the kuna deflated by producers' and retail prices depreciated by 6.21 percent and 7.07 percent respectively. The changes in both indicators of the kuna real effective exchange rate point to an improvement in the price competitiveness of domestic exporters in 1999 relative to the most important foreign trade partners; this was the result of a stronger depreciation of the kuna exchange rate than the relative growth in domestic prices compared to foreign countries.

Inflation was maintained at a low, stable level of 4.4 percent on December basis, or 4.2 percent if the year-on-year average in 1999 is taken into account. The inflationary pressures due to kuna depreciation, an increase in the prices of petroleum products and telecommunication services and an increase in excise duties on tobacco products and certain luxury goods did not significantly threaten price stability in conditions of aggregate demand decline.

The balance of payments current account deficit continued to decline, which is to be expected in conditions of reduced economic activity. This decline would have been greater if there had not been the Kosovo crisis, which resulted in exports of domestic services being much lower than planned. During 1999, there was a decrease in both the export and import of goods, but imports declined more, leading to a decrease in the trade deficit. There was a complete change in the financing of the current account deficit compared to the period before 1997; in 1999, as forecast in last year's Annual Report, foreign direct investment continued to increase, almost fully covering the current account deficit, and became the most important source of financing. This role of foreign direct investment will continue in 2000, and will, at a later point, increasingly depend on Croatia's ability to attract greenfield investment, that is, investment in new companies or capital injections in existing companies rather than their purchase, which has so far been predominant in the structure of foreign direct investment.

Interest rate movements were characterized by a fall in all interest rates, excluding those on CNB bills and Ministry of Finance treasury bills (the CNB began to decrease interest rates on CNB bills only in March 2000). At the beginning of 1999, the average daily interest rate on the money market exceeded 16 percent, under the influence of the banking crisis, but it progressively decreased as the banking crisis was resolved, reaching 12.5 percent at year end. The commercial banks' lending rates fell by more than 2 percentage points during 1999 and by more than 3 percentage points compared to February 2000. This interest rate fall was partly caused by the consolidation of the banking system, that is, the exit from the market of certain banks

with high interest rates. On the other hand, the banking crisis was a good lesson for both clients and banks, warning that the level of deposit interest rates cannot be the only criterion when making a deposit. Banks reduced their deposit interest rates and aimed at attracting clients by the quality and range of their services, which is positive for both the development of banking products and services and for reducing the costs of sources of funds for banks, in view of the fact that deposits account for approximately 55 percent of banks' liabilities.

As a result of the banking system crisis at the beginning of 1999, banks reduced their deposit interest rates and moderately increased their lending interest rates, so that the overall spread between the lending and deposit interest rates ranged from 9.5 to 12 percentage points, depending on whether the difference was measured by the banks' kuna activity (a greater difference due to the inclusion of currency risk) or foreign exchange activity. At the beginning of 2000, this difference was reduced to 8 (without currency risk) to 9.5 percentage points. The CNB's decision to support the reduction of interest rates (by reducing the reserve requirements and reducing its lending and deposit interest rates) and the government's intention to settle its arrears and prevent the generation of new ones should be an additional incentive for interest rate reduction. Naturally, as we have been repeating for years, structural problems should also be resolved, such as the microeconomic inefficiency of banks and the protection of creditors through expediting court procedures for collecting claims.

In the 1998 to 2000 period, the CNB proposed, within the process of banking market consolidation, the initiation of bankruptcy proceedings in 16 banks and 5 savings banks. Rehabilitation processes were started in two banks (Dubrovačka and Croatia banka). It can be said that most of the "second banking crisis" (as opposed to "the first crisis" in the major state banks that were rehabilitated in the mid-nineties) is behind us. After the exit from the market of several small and medium-sized bad banks and the sale of the rehabilitated state banks to strategic investors, the Croatian banking system will be in a much better state than ever since the country gained its independence: foreign investors will account for approximately 70 percent of the market in terms of assets, interest rates are falling, and banks' business results are considerably improved. The cost of "the second banking system crisis" can, at this point, be estimated at 800 million dollars (excluding income earned from the expected privatization of rehabilitated banks).

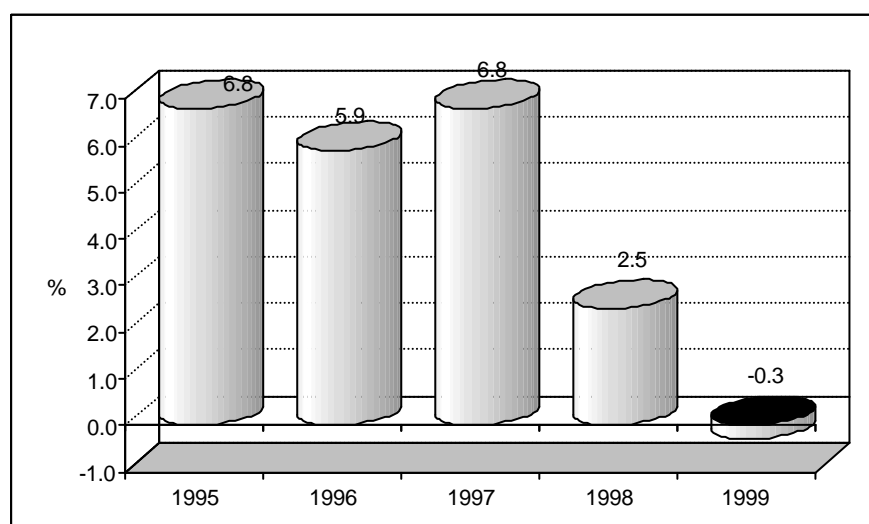
The main characteristics of fiscal 1999 include a considerable mismatch between revenues and expenditures during the year, a budget rebalance, a government and consolidated government deficit, an increased deficit in extrabudgetary funds and a fiscal policy nearing the zone of unsustainability. The current deficit/surplus trend, as a measure of fiscal policy sustainability, arouses the greatest concern: according to data on budget outturn, current savings amounted to 1.5 billion kuna compared to 7.1 billion kuna the previous year, an evidently negative trend. Since capital expenditures include expenditures with the character of current expenditures (transfers to extrabudgetary funds), it is clear that current savings in 1999 was even less; indeed, the transfer of 2.1 billion kuna from capital expenditures to current expenditures would result in a 0.6 billion kuna current deficit. Taking this into account, there was not only an overall deficit but also a current deficit in 1999, which brought fiscal policy closer to the zone of unsustainability.

Extrabudgetary funds have remained the main problem in implementing fiscal policy. In 1999, the negative trend continued from the previous years, which is confirmed by an increased deficit in the extrabudgetary funds account. In 1999, the aggregate deficit in extrabudgetary funds amounted to 13.2 billion kuna on the consolidated basis, an increase of 45.9 percent compared to the previous year. In view of large transfers of budget funds to extrabudgetary funds, the consolidated government account balance is only somewhat less favorable than the unconsolidated balance, amounting to -2.8 billion kuna. It should be noted that this deficit was mostly run up by the Pension Fund (8.2 billion kuna), Health Insurance Fund (3.2 billion kuna) and Child Benefit Fund (1.1 billion kuna). The redirection of an increasingly larger share of budget revenues to extrabudgetary funds is the main obstacle to reducing the tax burden. Therefore, it is important to point out the unsustainability of further deficit in the pension and health care system in the existing conditions. In order to resolve this problem, it is necessary to immediately establish expenditure control mechanisms and to carry out the needed reform of the pension and health care system.

### 1.2.1 Economic Activity

A 1.6 percent growth in GDP in the last quarter of 1999 compared to the same quarter of the previous year ended the series of GDP decreases of the four previous quarters. During 1999 as a whole, GDP decreased by 0.3 percent compared to the previous year. Apart from the ever-present structural weaknesses, the decrease was caused by the banking sector problems, the crisis in the region (particularly the Kosovo crisis in the first half of the year), domestic political uncertainty and risk, and low real growth rates in the countries that are Croatia's most important trading partners. Both domestic and foreign demand declined in real terms compared to the previous year. Following a five-year period of overall domestic growth, at a rate higher than 6 percent between 1994 and 1997 and at a modest 2.5 percent in 1998, GDP declined in 1999.

Figure I.10 Real Gross Domestic Product, annual rate of change

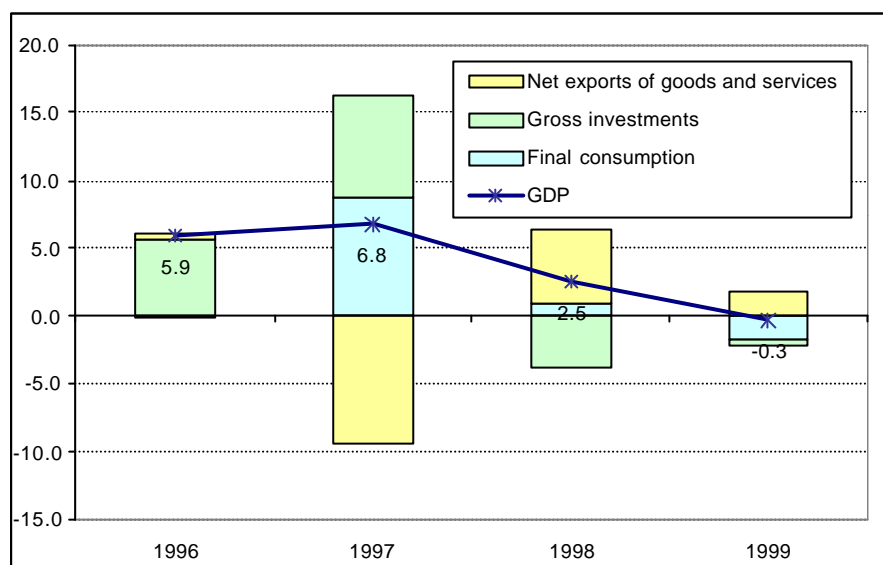


Source: CBS

The GDP decline in 1999 is a result of a fall in final consumption (household and government consumption) and gross investment (change in inventory and investment

in fixed capital) that prevailed over a positive net export of goods and services. The fall in final consumption was mainly caused by a 3.0 percent fall in household consumption compared to the previous year. Gross investment in fixed capital declined considerably, by 5.9 percent. Although there was a decrease in exports, there was also a 3.9 percent decrease in imports, resulting in the contribution of net exports to GDP.

Figure I.11 Contribution of Consumption Categories to GDP Changes Compared to the Previous Year, percentage points



Source: CBS

With regard to the GDP changes according to consumption category for the years after the introduction of statistical calculation, the influence of final consumption was insignificant in 1996, significant in 1997 due to an increase in household consumption, positive but very small in 1998, and negative in 1999. The share of household consumption in GDP has continuously decreased over the past five years, falling from 63.9 percent in 1995 to 57.4 percent in 1999. In the last quarter of 1999, the downward trend in household consumption of the previous five quarters ended, which was good news for the retail trade. Imports of durable and non-durable consumer goods decreased by 4-5 percent compared to the previous year, measured in kuna. A lack of demand was also noticeable in the domestic production of non-durable consumer goods, since their production decreased by 5.8 percent in comparison with the previous year. Government consumption in 1999 was reduced by only 0.1 percent compared to the previous year, but it began to increase again in the second half of the year.

During the years of post-war reconstruction, investment gave a strong fillip to GDP growth. Investments in fixed assets grew by 37.6 percent in 1996, by 23.3 percent in 1997 and by 3.0 percent in 1998. In 1999, this upward trend was reversed; in that year, investments in fixed assets decreased by 5.9 percent compared to 1998. Together with movements in inventory, gross investments had a negative effect on GDP in 1998 and 1999. The share of gross investments in GDP grew from 17.6 percent in 1995 to 23.2 percent in 1999. The downward trend of investments in fixed assets

continued in the last quarter of 1999, down 11.8 percent compared to the same quarter of the previous year.

Net exports of goods and services had a negative effect on GDP in 1997, due to a considerable increase in imports of goods and services (25.1 percent in real terms), but a positive effect over the next two years due to a rise in exports and a decline in imports in 1998 and a decline in exports but a greater decline in imports in 1999. Exports of goods and services rose at very impressive rates (higher than GDP growth) from 1996 to 1998, but this trend was reversed in 1999 with a decrease of 0.2 percent. The decrease in exports of goods and services was due to poor results in the first and second quarters of 1999; however, the growth recorded in the third and fourth quarters point to an export recovery, as do the strong growth in exports of services in 2000 (after the decline recorded last year due to the Kosovo crisis), growth in exports of goods as a consequence of higher growth rates in Croatia's major exports markets (Germany and Italy) and the removal of some trade barriers. Exports of goods decreased as a result of fiercely competitive conditions in foreign markets and low growth rates in their economies. Of the branches of industry that account for the majority of exports, exports grew in 1999 in the areas of other transport equipment and the chemical and petroleum industries; a trade surplus was recorded in the areas of other transport equipment and the petroleum industry. Exports of goods to EU and CEFTA countries also increased, whereas exports to developing European countries decreased. Imports of goods and services declined over the past two years; however, an increase of 2.5 percent in the fourth quarter of 1999 compared to the same quarter of the previous year ended the downward trend of the five previous quarters.

In 1999, according to the National Classification of Economic Activities, gross value added decreased in real terms in construction (7.7 percent), hotels and restaurants (4.4 percent), trade (4.2 percent) and transportation (3.4 percent), whereas positive rates were recorded in the other branches of industry.

Three areas in Table I.1 - mining and extraction, the processing industry and the electricity, gas and water supply – together form a sector of industry which accounted for 20.3 percent of gross value added in 1999. Indeed, industry is the major source of exports of goods. According to gross value added, industry has had a positive growth rate since 1996, although it slowed to 1.2 percent in 1999. According to physical volume, industrial production fell by 1.4 percent in 1999 compared to the previous year; this was mainly the result of lower production in the major divisions of the processing industry: food and beverages (7.0 percent), publishing and printing (4.7 percent), and non-metallic mineral products (2.0 percent).

Table I.1 GDP Structure According to the National Classification of Economic Activities, at current prices, percent

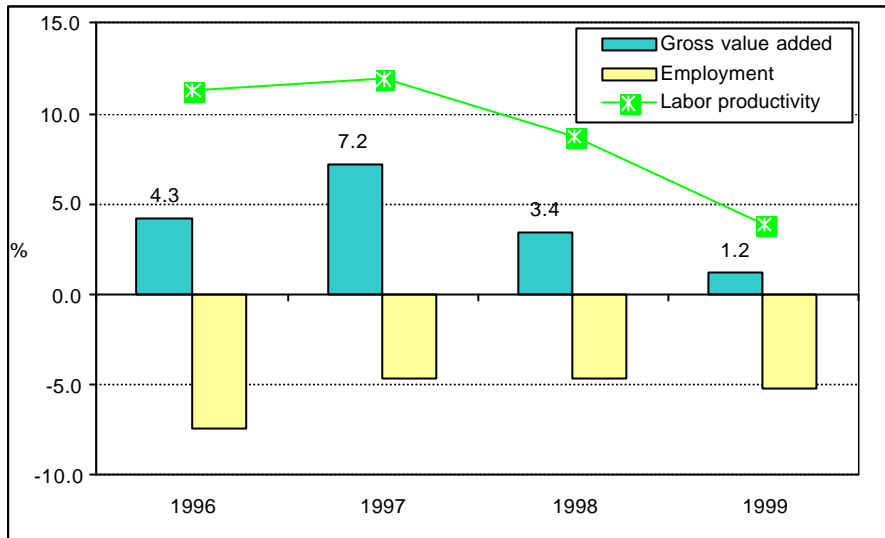
|  | 1995         | 1996         | 1997         | 1998*        | 1999*        |
|--|--------------|--------------|--------------|--------------|--------------|
| A Agriculture, hunting and forestry  | 8.3          | 8.2          | 7.6          | 7.0          | 6.9          |
| B Fishing  | 0.2          | 0.2          | 0.2          | 0.1          | 0.1          |
| C Mining and extraction  | 0.2          | 0.2          | 0.5          | 0.4          | 0.4          |
| D Processing industry  | 19.5         | 18.2         | 18.4         | 16.6         | 16.7         |
| E Electricity, gas and water supply  | 3.1          | 3.2          | 3.0          | 3.2          | 3.2          |
| F Construction   | 4.7          | 5.5          | 6.0          | 5.6          | 5.6          |
| G Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods | 9.7          | 10.3         | 10.5         | 9.6          | 9.5          |
| H Hotels and restaurants   | 2.1          | 2.5          | 2.6          | 2.5          | 2.3          |
| I Transport, storage and communication   | 7.9          | 7.4          | 7.3          | 7.7          | 8.1          |
| J Financial intermediation   | 3.4          | 3.7          | 3.3          | 3.9          | 4.1          |
| K Real estate, renting and business activities   | 8.6          | 8.7          | 8.6          | 8.8          | 9.2          |
| L Public administration and defense; compulsory social security                                      | 7.2          | 7.6          | 7.7          | 8.6          | 8.9          |
| M Education  | 2.9          | 3.2          | 3.1          | 3.5          | 3.8          |
| N Health and social care   | 2.7          | 3.3          | 3.6          | 3.9          | 4.0          |
| O Other community, social and personal activities  | 2.0          | 2.0          | 2.0          | 2.0          | 2.1          |
| P Private households with employed persons   | 0.0          | 0.0          | 0.0          | 0.0          | 0.0          |
| Q Extra-territorial organizations and bodies   | ...          | ...          | ...          | ...          | ...          |
| Financial intermediation services indirectly measured  | -2.3         | -2.6         | -3.1         | -3.7         | -3.7         |
| <b>Gross value added (basic prices)</b>  | <b>80.2</b>  | <b>81.6</b>  | <b>81.5</b>  | <b>79.9</b>  | <b>81.2</b>  |
| Taxes on products less subsidies on products   | 19.8         | 18.4         | 18.5         | 20.1         | 18.8         |
| <b>GDP (market prices)</b>   | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> |

\*Previous results

Source: CBS

Construction is a branch of the economy that traditionally employs a large number of otherwise unemployed on a seasonal basis, exports part of its services and is not insignificant in the gross value added figure. It experienced exceptionally high growth rates in 1996 and 1997, due to the reconstruction process, and moderate growth in 1998; however, the first negative growth rate was recorded in 1999. The downward trend in construction began in the last quarter of 1998, becoming more intense toward the end of 1999. Poor investment activity was evident in construction and its segment related to residential construction. In 1999, demand for construction as measured by net orders decreased by 22 percent in nominal terms compared to the previous year, and square meters of completed apartments declined by approximately 30 percent.

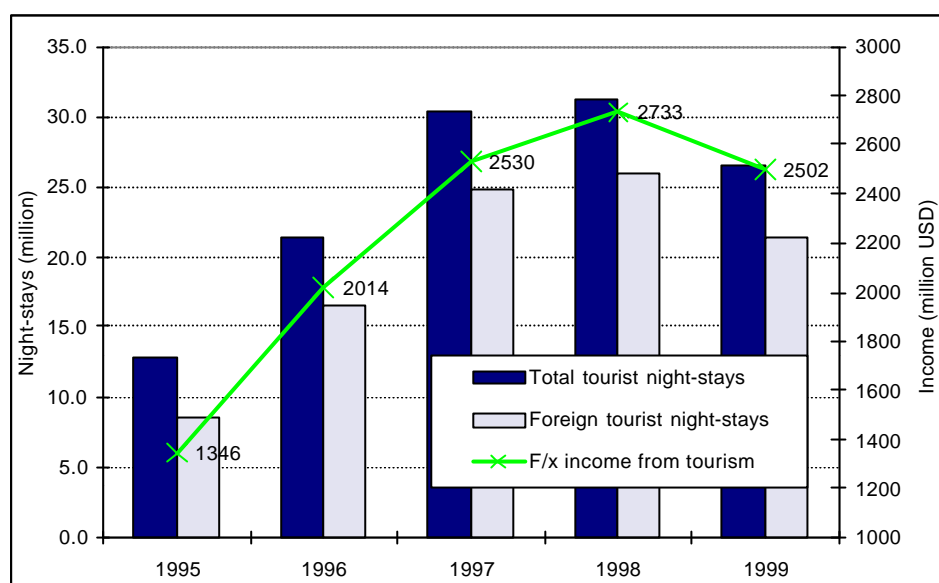
Figure I.12 Industrial Production, Rates of Change of Gross Value Added, Employment and Labor Productivity



Source: CBS

Tourism recorded poorer results in 1999 than in 1998 in terms of both physical and financial indicators. The number of registered tourists was 4.7 million, which was 13 percent less than in 1998. These tourists stayed for 26.6 million nights, 15 percent less than in the previous year; the number of tourist nights was smaller in each quarter of 1999 compared to the same quarter of 1998, and the greatest fall, amounting to 24.1 percent, was recorded in the second quarter as a consequence of the Kosovo crisis. Regarding the number of tourist nights, tourists from five countries predominated: Germany, Slovenia, the Czech Republic, Italy and Austria, accounting for 77.5 percent of all tourist nights. Income from tourism in 1999 was 2,502 million US dollars, which is 232 million US dollar down on 1998.

Figure I.13 Tourist Overnights and Foreign Exchange Income from Tourism



Source: CBS

## 1.2.2 Money Supply and International Reserves

In 1999, monetary policy was completely determined by the government's developmental budget and fiscal policy for that year. It seemed that, due to necessary adjustments to fiscal policy, monetary policy would be restrictive, since only by pursuing such a monetary policy would the central bank be able to fulfil its key task of maintaining domestic currency stability (prices and exchange rate) and the liquidity of payments in the country and abroad, when the government was becoming the agent of the main financial flows through its increased consumption and planned, mainly foreign, financing of the budget deficit.

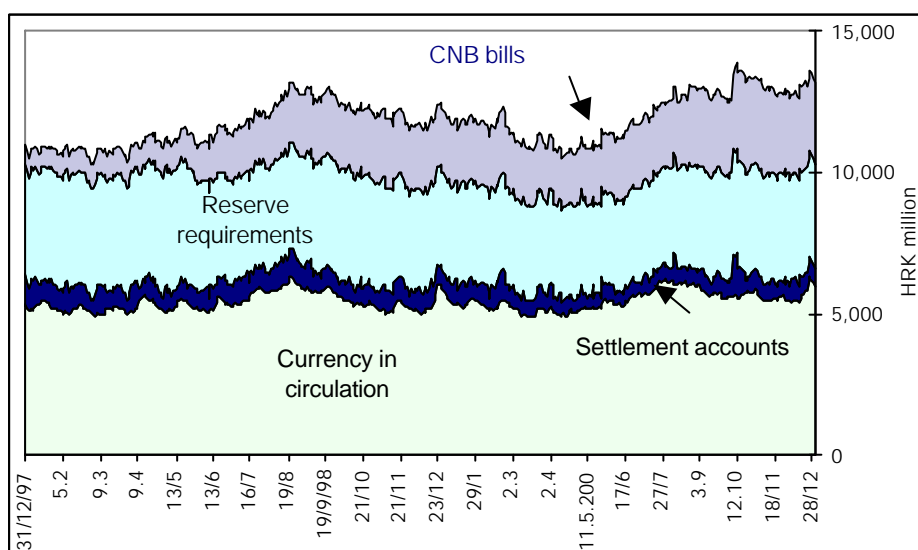
In other words, it was anticipated that in 1999 reserve money would be created at a slower rate and that its growth would be slowed, along with money multiplier and total money supply growth, primarily as a result of government operations and fiscal measures. However, very soon, at the beginning of the year, during January and February, the inflow of current budget revenues became irregular and slowed down, liquidity declined and government bodies became net debtors to their suppliers; thus instead of an increase in liquidity in the economy, there was a further decline. Balances in companies' accounts decreased and there was a decline in demand deposits, which amounted on average to 7 percent per month during these two months; as a result, the money supply also decreased, as is otherwise usually the case at the beginning of the year. The lack of liquidity in the economy caused economic entities that already had liquidity problems and then failed to collect their claims to become insolvent, thus increasing the number of insolvent entities.

Economic entities with liquidity problems had large amounts of uncollected and overdue claims and so posed a threat to their creditors, primarily their deposit institutions, whose risk exposure was continuously increasing due their own to poor collection of claims. The liquidity decline at the beginning of 1999 particularly hit banks carrying over liquidity problems from the previous year. These banks were

unable to maintain their liquidity independently and had to turn to the money market for capital, accepting any price.

These developments, coupled with a fear of even less favorable conditions, undermined confidence in macroeconomic stability, inducing sound banks to withdraw from the money market and act as they generally did when considerable disturbances occurred in the market: they used their surplus liquidity (the average balance in the settlement accounts of all banks with the central bank amounted to 500 million kuna in the first quarter, compared to 700 million kuna at the end of the previous year, whereas the overall amount of CNB bills purchased by commercial banks fell from 2.2 to 1.6 billion kuna) for buying foreign exchange, primarily from the central bank, in order to protect themselves from currency risk in case even more significant market changes occurred. This resulted in a 2.3 percent fall in the value of the kuna against the German mark in the first two months of 1999, and a 3.9 percent fall in the first three months.

Figure I.14 Structure and Daily Changes of Reserve Money and CNB Bills in 1998 and 1999



The pressure on the kuna exchange rate, together with the poor liquidity of the economy, the government and some banks, led the monetary authorities to undertake frequent foreign exchange auctions in the foreign exchange market in order to prevent a stronger kuna depreciation and its potential effect on producers' prices. At the same time, they created new instruments and "windows" toward the central bank as the lender of last resort. Additionally, in January, the central bank granted a short-term loan of 1.6 billion kuna to the government for bridging the gap between revenues and expenditures. The loan amount was five times larger than the short-term loans extended to the government in the previous years, which also indicates that the liquidity of the government accounts was substantially impaired.

All the activities undertaken in that respect by the Croatian National Bank in the first quarter of 1999 were completely different from what had been planned before the beginning of the year. Therefore, it can be said that the monetary policy pursued in 1999 was by no means restrictive. On the contrary, the level of kuna and foreign

exchange flows for creating reserve money indicates a more expansionary monetary policy compared to that pursued in 1998, when the supply of reserve money M0 was 3.8 percent lower than in 1997. In 1999, M0 grew by 3.5 percent on December basis compared to 1998. The value of money multiplier m1 of 1.345 did not change but remained the same both in 1998 and 1999, and thus the M1 money supply grew rapidly (-1.5 percent in 1998 and 2.4 percent in 1999).

Figure I.15 Monthly Growth Rates of M0 and M1

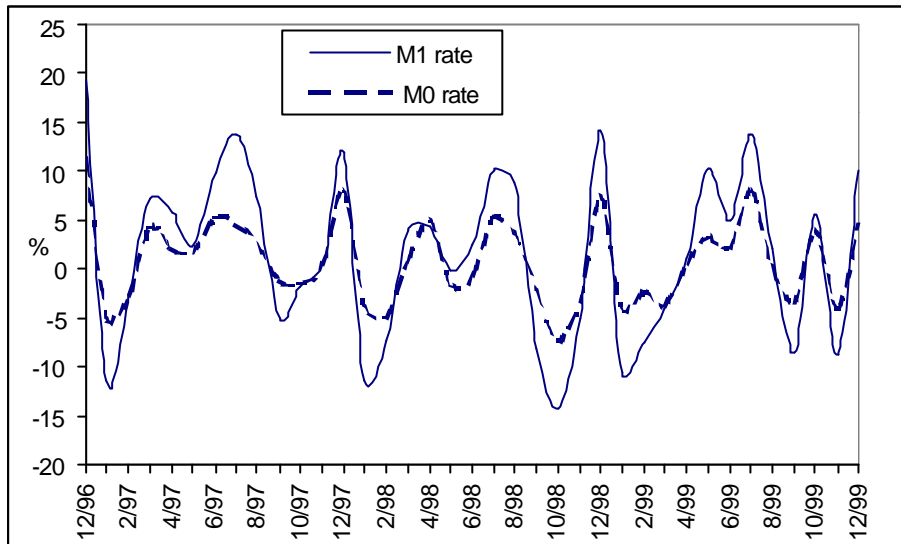
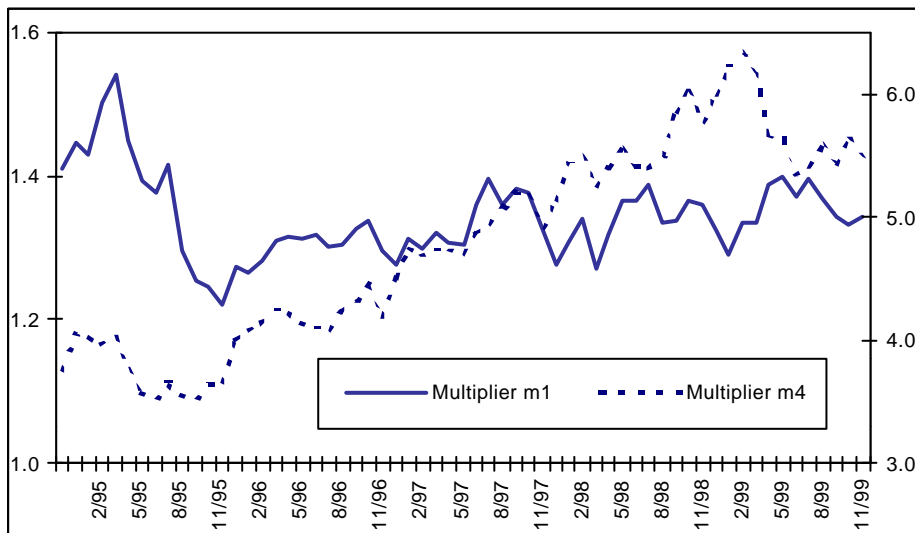


Figure I.16 Changes in Multipliers m1 and m4



Foreign exchange transactions had an almost neutral influence on the creation of reserve money in 1999, since a total net amount of only 11 million US dollars was bought throughout the whole year. However, the central bank provided access to adequate amounts of foreign exchange for banks through foreign exchange transactions at the auctions, in order to stabilize the market and relieve the depreciation pressures. Nine foreign exchange auctions were held in the first three months, and 33 over the whole year, where a net amount of 963 million US dollars

was sold to banks and 7 billion kuna net withdrawn from them, which represented the main outflow of liquidity from the commercial banks' settlement accounts with the central bank. In a total of twenty foreign exchange transactions with the state, the central bank bought 983 million US dollars net and generated 7.2 billion kuna. The government used 1.4 billion kuna of this amount to repay the short-term loan to the Croatian National Bank at the end of the year and the remaining amount to settle its debts towards the budget users and suppliers; this increased to some extent the balance in accounts in the economy and the level of demand deposits, thus increasing M1.

Figure I.17 Structure of the Croatian National Bank's Foreign Assets, December 31, 1999

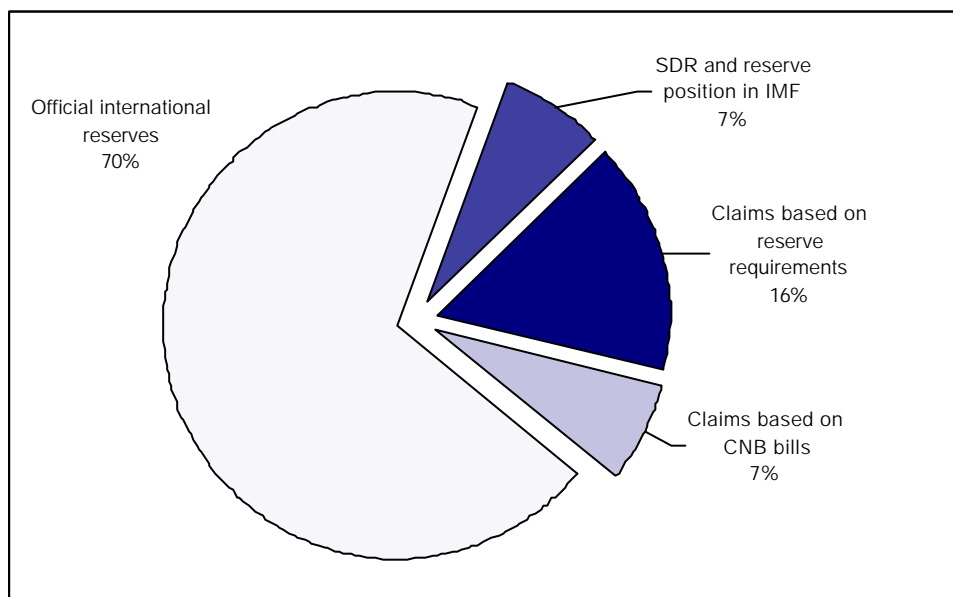
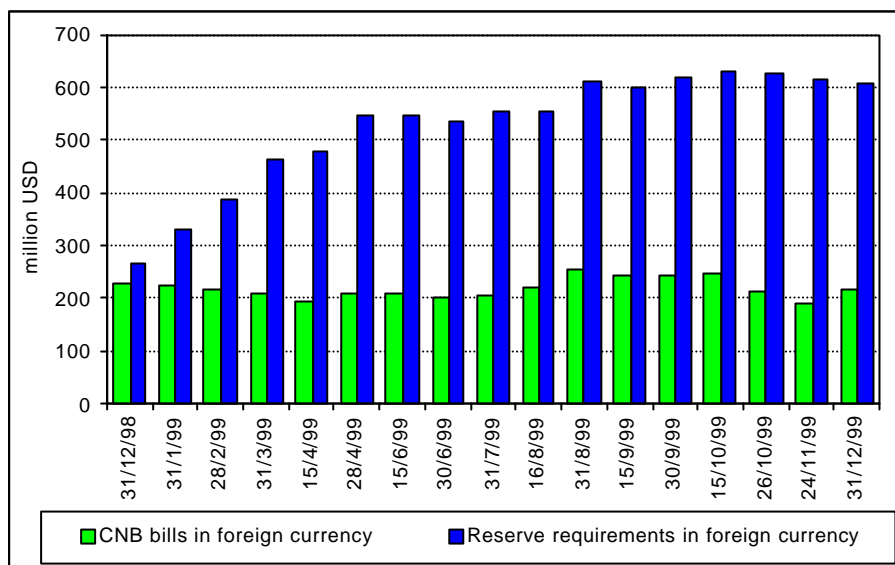


Figure I.18 Changes in Reserve Requirements and CNB Bills in Foreign Currency in 1999



The central bank increased its foreign assets by 209 million US dollars to 3 billion US dollars at end December 1999 through its management of its foreign exchange assets abroad and through full application of the reserve requirements instruments. The obligatory allocation of part of the commercial banks' reserve requirements to the international reserves of the central bank, which began in September 1998 and ended in the second quarter of 1999, resulted in a more rapid growth in the central bank's foreign assets which, up to that point, had grown in parallel with growth in M1, the kuna counterbalance to foreign liquidity.

Figure I.19 International Reserves of the CNB: Level and Monthly Growth Rates

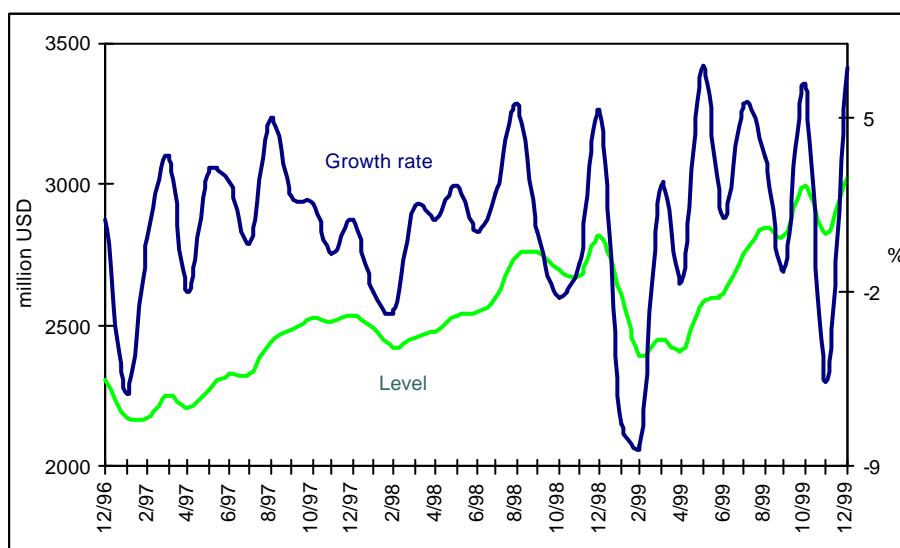
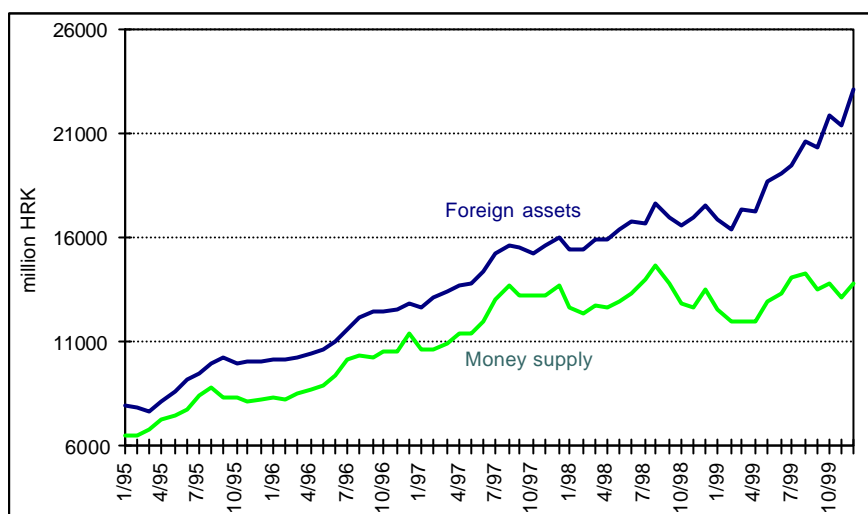
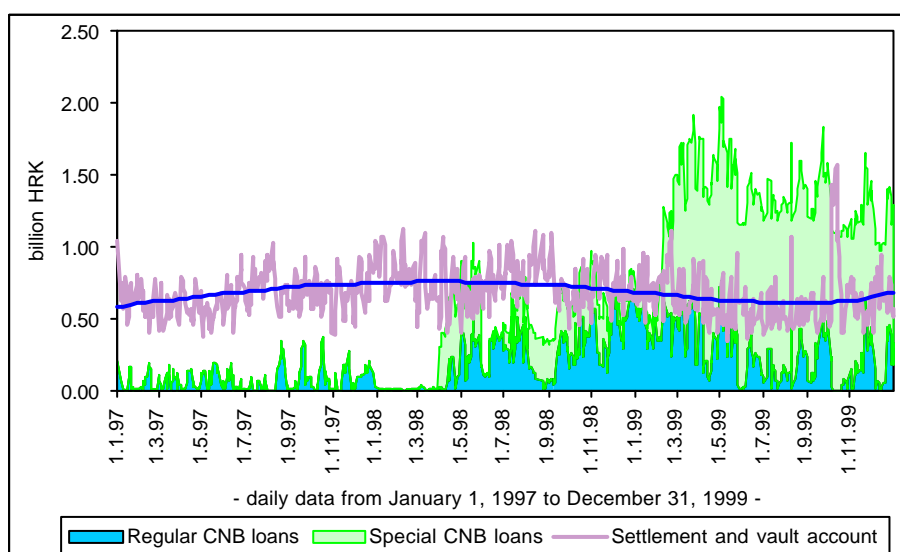


Figure I.20 The CNB Foreign Assets (International Reserves) and M1 Money Supply



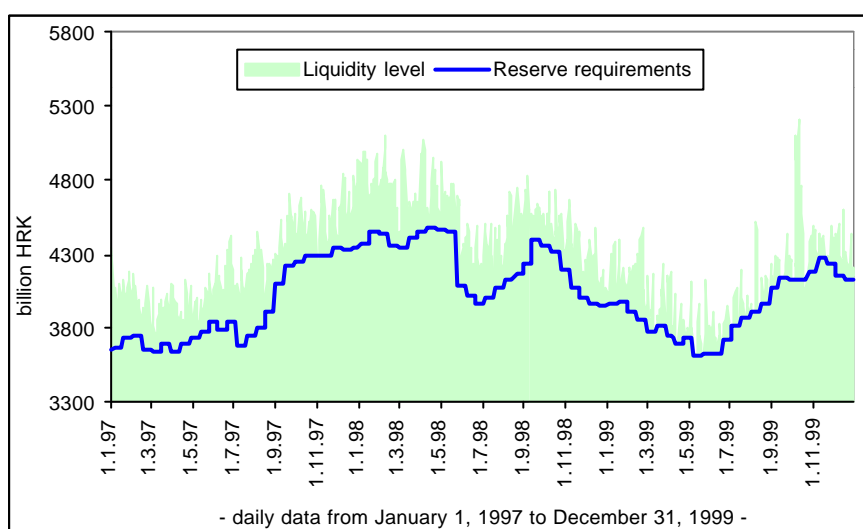
The kuna activities of the central bank in 1999 included a particularly strong flow creating reserve money, and, at the same time, a strong outflow through foreign exchange transactions and a much milder outflow through the reduction of the kuna reserve requirements, which was reduced because the kuna base for calculating reserve requirements spilled over into foreign exchange deposits in the attempt to avoid depreciation of the kuna during the first half of the year. In 1998, the average level of CNB placements to the government and commercial banks amounted to 0.7 billion kuna (263 million kuna placed with the government and 451 million kuna with commercial banks through various instruments), whereas in 1999, the average level reached 2.8 billion kuna (1.2 billion kuna placed with the government and 1.6 billion kuna with commercial banks). A particularly abundant supply to the banking system of additional liquid assets from the central bank's primary issue was recorded at the end of the first and second quarters.

Figure I.21 Banks' Settlement Account with the CNB and Loans for Maintaining Liquidity



This was a period of the most intense distortions in the banking system. That there could be a banking crisis was presage in the first half of 1998 with the events surrounding Dubrovačka banka and the shock of illiquidity due to connections between banks; however, that there really was a banking crisis was identified at the beginning of 1999 with the reluctance of sound banks to conduct transactions in the money market in order to avoid exposure to risky placements, since not all the 'incurable' banks had been detected at that point. By end July, bankruptcy proceedings had been proposed for five banks, one bank was rehabilitated, and a temporary administrator was appointed in three banks. The central bank had to grant a total of 1.4 billion kuna in liquidity loans and other loans for maintaining liquidity (pre-rehabilitation and intervention loans). At the same time, some banks had a very high level of liquidity, since there was no significant extension of loans to the private sector in 1999; successful banks placed their surplus liquidity in CNB bills or held a relatively large amount of their free assets in vaults or settlement accounts with the central bank, due to which an adequate level of reserve money was maintained. In 1999, the currency in circulation growth slowed, and the lowest rate of growth (4.2 percent) was recorded since gaining monetary independence.

Figure I.22 Maintaining Banks' Liquidity in the Period from 1997 to 1999



### 1.2.3 Exchange Rate and the Aggregate Price Level

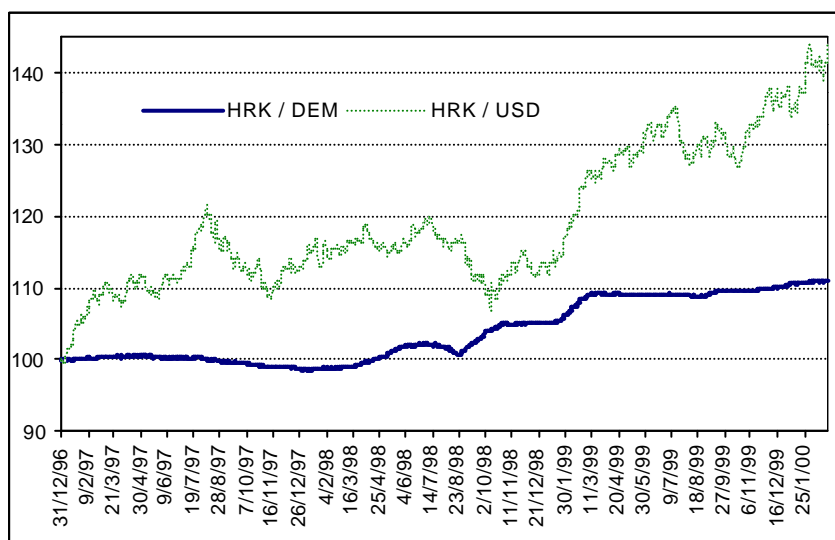
During 1999, a satisfactory level of kuna exchange rate stability was maintained, together with strengthening of the CNB international reserves on an annual basis and stability of domestic prices. In 1999, the kuna depreciated against the German mark by a total of 5 percent, if the exchange rate on December 31, 1999 of 3.93 kuna to the German mark is compared with the exchange rate of 3.74 kuna on the same day the year before. The annual average exchange rate in 1999 was 3.88 kuna to the mark, which indicates a 7.1 percent depreciation of the exchange rate compared to the average exchange rate of 3.62 kuna in 1998.

The kuna depreciated most in the first quarter, when end-quarter exchange rates are compared, by a total of 3.86 percent. The greatest fall in the kuna exchange rate was recorded in February, amounting to 2.44 percent. The kuna generally depreciates most

in the first quarter due to a seasonally adjusted increase in demand for foreign currency required for servicing debts abroad that are falling due in this period when small foreign exchange inflow is usually recorded. A more intense fluctuation of the exchange rate in the first quarter was also caused by an increased demand for foreign exchange due to uncertainty in the economic system caused by the banking crisis and expectations of further kuna depreciation.

Nevertheless, the exchange rate of the kuna against the German mark stabilized in March due to the central bank's interventions in the foreign exchange market, a foreign exchange inflow from selling Eurobonds, and the introduction of certain restrictive monetary policy measures. By the end of the year, the exchange rate depreciated within an acceptable range. It depreciated the least in May, by only 0.01 percent, and the most in September, by 0.57 percent, whereas it appreciated during April, and in July and August 1999 (0.07 percent and 0.03 percent respectively), despite the reduced foreign exchange inflow from tourism due to the war operations in Kosovo. Although fiscal expansion continued until the end of the year, it did not significantly influence the kuna depreciation, since it was financed by a foreign exchange inflow from the privatization of companies and the placement of government bonds in the world financial markets. Pressures for foreign currency demand, which increased in November and December due to a rise in the kuna liquidity of the economy (after the government settled part of its due obligations), were relieved by somewhat greater interventions by the central bank compared to the interventions in the second and third quarter, so that the exchange rate depreciated by only 0.5 percent during these two months.

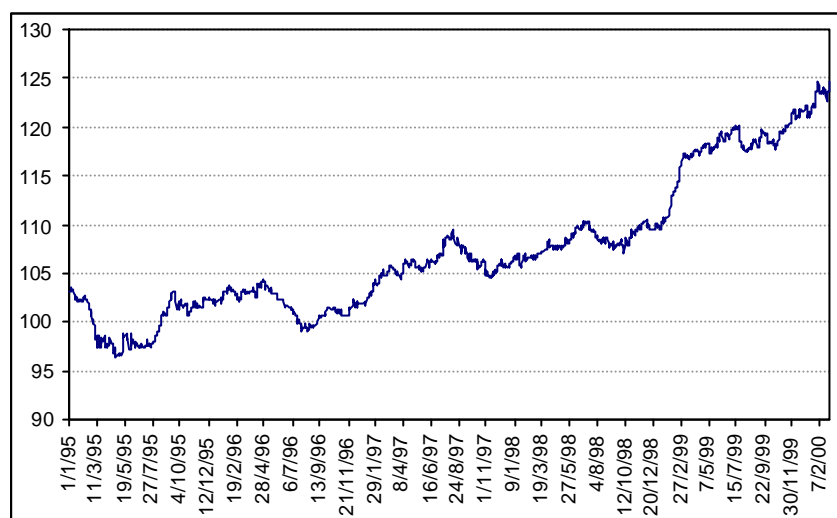
Figure I.23 Index of Daily Nominal Exchange Rate of the Kuna against the DEM and USD, December 31, 1996=100



During 1999, the daily nominal effective exchange rate of the kuna depreciated by 11.2 percent compared to 1998, when the effective exchange rate depreciated by only 3.6 percent. This weakening of the kuna effective exchange rate was primarily caused by a 22.4 percent depreciation in the kuna exchange rate versus the US dollar from 7.65 kuna on December 31, 1999 to 6.25 kuna at the CNB midpoint exchange rate on the same day in 1998. However, since the exchange rate of the kuna against the dollar

fluctuated considerably over the year, the kuna depreciation, based on the comparison of annual average exchange rates (7.11 kuna to the dollar in 1999 and 6.36 kuna in 1998), amounted to 11.8 percent, which is significantly less than the depreciation on the end-year basis. The weakening of the kuna against the dollar in 1999 reflected the depreciation of the euro against the US dollar on the world foreign exchange market.

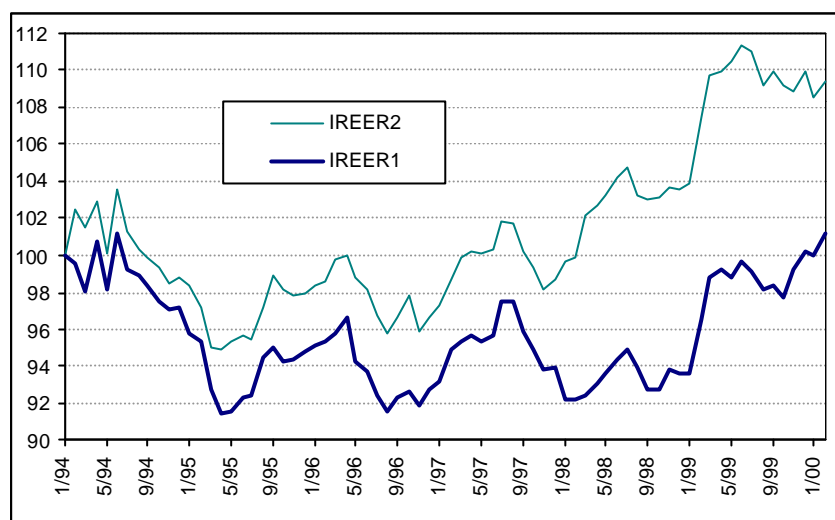
Figure I.24 Index of Daily Nominal Effective Exchange Rate of the Kuna\*, 1995=100



\* A fall in the index indicates kuna appreciation

The real effective exchange rate of the kuna deflated by producers' prices has depreciated at the annual level for three consecutive years: it depreciated by 2.17 percent in 1997, 4.9 percent in 1998 and 6.21 percent in 1999. Depreciation of the real effective exchange rate of the kuna deflated by retail prices was particularly strong in 1999, amounting to 7.07 percent (depreciation in real terms was 1.23 percent in 1997 and 0.34 percent in 1998). The changes in both indicators of the real effective exchange rate of the kuna point to an improvement in the price competitiveness of domestic exporters relative to the most important foreign trade partners in 1999, as a result of a stronger depreciation of the kuna exchange rate than the relative growth in domestic prices compared to foreign countries.

Figure I.25 Index of Real Effective Exchange Rate of the Kuna\* Deflated by Retail Prices (IREER1) and Producers' Prices (IREER2), January 1994=100



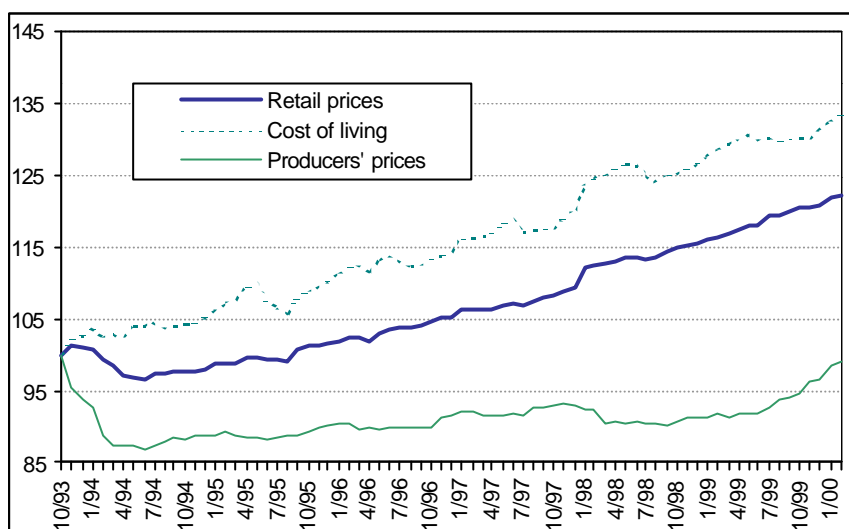
\*An increase in the index indicates real depreciation of the kuna

The annual rate of inflation of 4.4 percent, measured by retail prices on a December-to-December basis, or 4.2 percent on a year-on-year basis, shows that the satisfactory level of price stability that has been recorded for the last six years was maintained in 1999. Following a 3 percent deflation in 1994, the annual rate of inflation on a December-to-December basis did not exceed 4 percent, except in 1998 when the annual increase in prices was 5.4 percent due to the increase in prices in January that year following the introduction of value added tax. The annual inflation in the cost of living amounted to 3.6 percent in 1999 on a December-to-December basis, or 3.5 percent on a year-on-year basis. Inflation in producers' prices in December 1999 compared to December 1998 was 5.9 percent, or 2.6 percent on a year-on-year basis. In conditions of a declining aggregate demand, the inflationary pressures of kuna depreciation, increases in prices of petroleum products and telecommunication services and increases in excise duties on tobacco products and certain luxury goods did not significantly threaten price stability.

Regarding the changes in the retail price index during 1999, the inflationary pressures were greatest in the third quarter. The increase in prices of petroleum and petroleum products and tobacco products (due to an increase in excise duties) considerably influenced the culmination of the inflationary pressure in July 1999, when the monthly increase in prices amounted to 1.1 percent, despite a significant seasonal decrease in prices of agricultural products. The annual inflation rate rose from 3.8 percent at the end of the second quarter to 5.1 percent at the end of July. Additionally, it is possible that the strongest pressure of the kuna nominal exchange rate depreciation (during 1998 and in the first quarter of 1999) on prices occurred in that part of the year. Despite an average 8 percent increase in the prices of petroleum derivatives in July 1999, pressure to increase the prices of these products continued due to a continuous rise in petroleum prices in the world market and considerable kuna weakening against the US dollar; however, the government approved a new price increase in petroleum derivatives of 10 percent only in the next year, in January 2000. The inflationary pressures, particularly strong at the beginning of the third quarter of 1999, gradually decreased after September, so that the year-on-year

inflation rate of 4.4 percent at the end of 1999 was 0.7 percent lower than the inflation rate in July that year. The annual increase in retail prices of the following goods was above the average: tobacco products (26.9 percent) and non-food industrial products (4.8 percent).

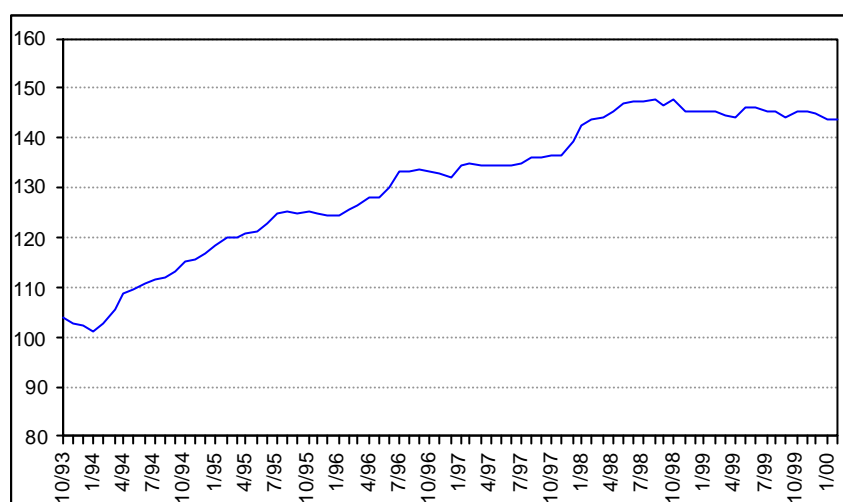
Figure I.26 Retail Price, Cost of Living and Producers' Price Index, October 1993=100



Since the introduction of the stabilization program, the increase in the prices of services in the retail price index had been generally greater than the increase in the prices of goods. However, during 1999 these movements changed. The prices of goods increased by 4.6 percent at the annual level, whereas the prices of services rose by 3.9 percent, which is significantly less than the annual increase in prices of services in 1997 and 1998, when it amounted to 8.2 and 9.2 percent respectively. Looking at the index structure of the prices of services in the retail price index, particularly high growth is evident in the prices of post and telecommunication services, which amounted to 22.6 percent at the annual level. This was a result of the price correction of telephone impulses prior to the sale of Croatian Telecom to a foreign strategic partner. The only other service that recorded above average growth at the annual level was transport services (4.7 percent).

That the increase in the prices of goods exceeded the increase in the prices of services at the annual level can be accounted for by the fact that the prices of services are mainly influenced by changes in disposable household income, whereas the prices of goods are mainly influenced by changes in the exchange rate due to a greater import content. During 1999, the growth in salaries and bank household lending slowed, resulting in slowed growth in disposable household income, which was additionally reduced by the fact that the kuna depreciation increased the burden of repaying loans denominated in foreign exchange. The kuna depreciation was most intense at the beginning of the year (during the first three months, the kuna depreciated against the German mark by a total of 4 percent, and the nominal effective exchange rate of the kuna depreciated by 7 percent) and continued moderately over the year, causing an increase in import prices and a weakening in the competitiveness of foreign goods compared to the period when the kuna was appreciating.

Figure I.27 Index of the Relative Prices of Non-Tradable Goods Measured as the Ratio between the Prices of Services and Goods in the Retail Price Index, 1992=100



Among the inflation indicators, producers' prices recorded the greatest annual growth: 5.9 percent. Measured by the main industrial groupings according to economic purpose, the price of energy increased the most at the annual level in 1999, by 15.4 percent, followed by the price of capital goods, which rose by 5.7 percent. Producers' prices of intermediate products and non-durable consumer goods grew at the annual level somewhat more moderately, by 3.7 percent and 3.9 percent respectively, whereas the price of durable consumer goods increased by only 0.2 percent. However, in contrast to the changes in the retail price index, which reached its peak in July 1999 and then showed a weakening in inflationary pressures until the increase in petroleum prices in January 2000, the producers' price index had a worrying upward trend. By the end of the first and second quarter, the year-on-year growth amounted to a moderate 1.3 and 1.5 percent respectively; however, it jumped to 2.7 percent in July, to 4.4 percent at the end of the third quarter, and to 5.9 percent at the end of 1999. These developments in the producers' price index resulted not just from the increase in petroleum prices but also from the increase in import prices caused by a nominal effective depreciation of the kuna of 11.2 percent during 1999, which was in turn mainly caused by the total annual appreciation of the US dollar of 22.4 percent in nominal terms.

#### 1.2.4 Interest Rates

According to banks' reports for February 2000, the average lending rate was 12.1 percent (total newly-extended kuna loans). However, the last months indicate the beginning of competition between the biggest banks in that the interest rates on housing loans were reduced to 9 percent in nominal terms. Although, according to the latest data, personal loans account for 35 percent of the banks' placements, or for only about 23 percent of the newly-extended loans in February 2000 (long-term loans represent only about 22 percent of that amount), this indicates that the downward trend in interest rates will continue.

Table I.2 A Comparison of Interest Rates in Selected Countries, in %

|                             | Germany | Czech Republic | Poland | Hungary | Slovenia | Croatia |
|-----------------------------|---------|----------------|--------|---------|----------|---------|
| <b>12/98</b>                |         |                |        |         |          |         |
| <b>Loans</b>                | 7.56    | 11.70          | 20.50  | 18.80   | 12.30    | 16.22   |
| <b>Time deposits</b>        | 2.90    | 9.20           | 13.40  | 14.90   | 7.00     | 7.05    |
| <b>Inflation rate (CPI)</b> | 1.00    | 6.80           | 8.60   | 10.30   | 7.50     | 5.40    |
| <b>12/99</b>                |         |                |        |         |          |         |
| <b>Loans</b>                | 7.65    | 7.30           | 17.20  | 15.40   | 15.20    | 13.52   |
| <b>Time deposits</b>        | 2.84    | 4.90           | 13.00  | 12.30   | 9.60     | 8.36    |
| <b>Inflation rate (CPI)</b> | 0.60    | 2.50           | 9.20   | 11.20   | 8.80     | 4.40    |

Note: Data are taken from the monthly publications of the central banks and refer to short-term loans in economic operations and short-term (up to 3 months) household time deposits, both categories denominated in the national currency.

At present, interest rates are still very high in real terms, in view of the 4.4 percent increase in retail prices that was recorded in Croatia in 1999. Table 1.2 shows interest rates in selected countries. Germany was selected for comparison for two reasons: first, the majority of prices in the Croatian economy are "unofficially" expressed in German marks, and as much as 75 percent of banks' deposits were denominated in foreign currency at the end of 1999 (the German mark being the predominant currency); second, Germany stands as a representative of the developed countries of the European Union to which Croatia and other transition countries aspire. It should be noted that the average interest rate on corporate short-term loans in the EU member countries is 5.5 percent and shows a downward trend (in nominal terms, which should be taken with reserve when making a statistical analysis of developments over time). The other countries selected for comparison are the more developed transition countries. At the end of 1998, lending rates in Croatia were at the level of rates in Poland, whereas the rates in the other reported transition countries were significantly lower in real terms. At the end of 1999, however, the real interest rates in Croatia remained high, while in all the other reported transition countries they were reduced closer to the level of interest rates in the developed West European countries.

It should also be noted that the reported level of interest rates in Croatia does not correspond to the full price of capital. Apart from interest rates, loans also carry various fees, commissions (loan processing costs, loan granting costs, loan service costs, etc.) and deposits whose effective interest rate can, in some cases, increase by 10 percentage points above the nominal interest rate. Therefore, interest rates do not represent the full price of capital; however, this applies to the majority of transition countries. The adoption of a uniform method for calculating the effective interest rate, which the Croatian National Bank is developing, should significantly contribute to a more accurate perception of the price of capital in the market and facilitate potential borrowers' choice of loan.

The list of the factors causing high interest rates and preventing a significant fall in interest rates in Croatia is very long. Here are the most important ones:

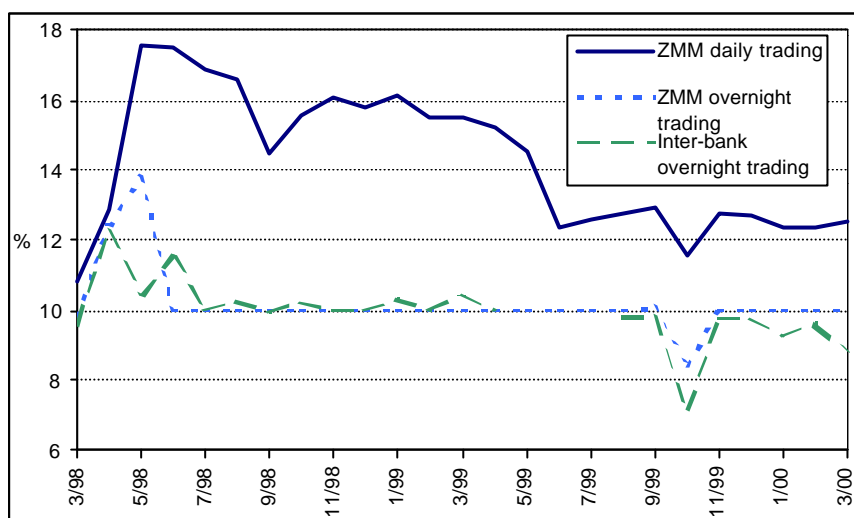
- ◆ High systemic risk premium included in the price of capital, which is related to inadequate creditor protection, the lack of adequate instruments of debt collection, and the slowness and inefficiency of the legal system.
- ◆ High premium for currency/credit risk. 59 percent of banks' liabilities are denominated in foreign currency. On the other hand, only about 13 percent of placements (accounting for 60 percent of banks' assets) are denominated in foreign currency. Currency risk is diminished and transformed into credit risk by indexing kuna loans to the exchange rate. Credit risk is high due to a large share of bad loans and the previously stated factors.
- ◆ Inadequate credit policies of commercial banks and poor risk management, along with poor liquidity management.
- ◆ Expensive sources of funds. Deposit interest rates (especially on time deposits) are relatively high. Additionally, the reserve requirements rate is high, amounting to 28.5 percent on kuna deposits (it was recently reduced) and 55 percent on foreign deposits and foreign loans with a maturity of less than one year. The average interest rate in the money market is somewhat above 12 percent, whereas the foreign sources of funds, with a 6 percent interest rate, are available only to bigger banks or banks under foreign ownership.
- ◆ Underdevelopment of the financial markets and a poor choice of financial instruments. Despite positive indications, there has not been a significant improvement in this field. The primary market in which banks participate operates satisfactorily, whereas the secondary market hardly exists.
- ◆ A large number of banks operate with high deposit interest rates and high non-interest costs, because they are too small to take advantage of economies of scale. Mergers and acquisitions and the elimination of bad banks from the market will certainly provide an additional incentive for interest rate reduction due to cost reduction.
- ◆ Due to the banking crisis, which lasted from spring 1998 to spring 1999, along with slowed growth in 1998 and stagnation in 1999, banks were very cautious and reluctant to grant loans and the credit risk premium increased, which led to a segmentation of the banking market.
- ◆ The liquidity problem, that is, the problem of non-payment in the economy.

Trading in the cash surpluses of banks has remained the main activity in the money market in Croatia. Only in the first three months of 2000 did interest in trading in short-term securities increase (CNB bills, Ministry of Finance treasury bills and occasionally government bills). There has long been the idea of introducing instruments for the swap and repurchase of securities in the inter-bank market, but there is still a lack of financially and technically competent potential participants in such trade. Greater involvement is expected from other financial institutions (such as insurance companies and investment funds, although only one operates at the moment) whose liquidity would help reduce interest rates and stimulate more active trading in short-term securities.

At the beginning of 1999, the average daily interest rate in the money market exceeded 16 percent, under the influence of the banking crisis; it gradually fell to about 12.5 percent by the end of the year as the crisis eased and remained at that level over the first three months of 2000. However, it should be noted that daily trading was very small compared to overnight trading: the greatest average daily trading was recorded in October 1999 at approximately 44 million kuna, while the average

overnight trading at the same time was 926 million kuna. However, October was an exceptional month due to high liquidity in the financial system as a result of government revenues from selling shares in Croatian Telecom. The overnight trade is generally 20 times larger than the daily trade.

Figure I.28 Average Interest Rates in the Zagreb Money Market and Inter-bank Market



The average interest rate in overnight trade was 10 percent, falling below that level only in October (8.43 percent). Banks prefer the overnight market because of the great uncertainty of the system (this is also the reason why callable loans are predominant in daily trading, which have an average interest rate of about 12.5 percent and determine the average interest rate in daily trading), which prevents banks from planning their surplus liquidity and daring to lend longer term. Thus, there are two obstacles to the reduction of interest rates in the money market: first, a mismatch between supply and demand terms due to the above mentioned uncertainty of the system, with the result that transactions are often conducted with higher interest rates; second, limitations on trading with particular participants due to a lack of confidence among the participants, which forces borrowers to accept higher interest rates when applying for loans.

A major deficiency of the Croatian financial system is the underdevelopment of the securities market. While there is active trading in the primary market of short-term securities to some extent, trading in the secondary market is still insignificant. At present, CNB bills denominated in kuna and foreign currency (US dollar and the euro), Ministry of Finance treasury bills, government bills and several commercial papers issued by companies are traded in the market. In the banking system, close attention is paid to the return on CNB bills and treasury bills, since these are safe investments (with a regular collection) that can be used as collateral for borrowing from the CNB in case of a temporary liquidity problem. These securities can also be traded in the secondary market, but banks view this market with a certain reserve due to the above-mentioned reasons.

Figure I.29 Average Interest Rates on CNB Bills and Ministry of Finance Treasury Bills

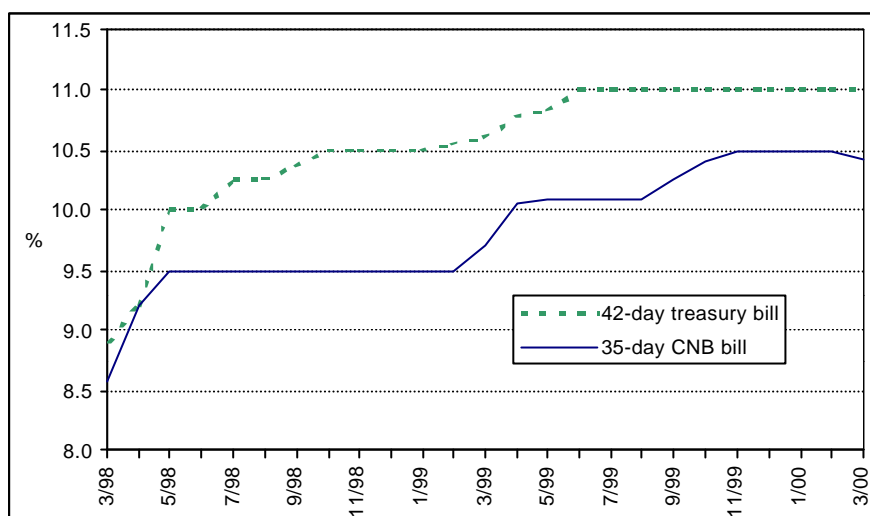
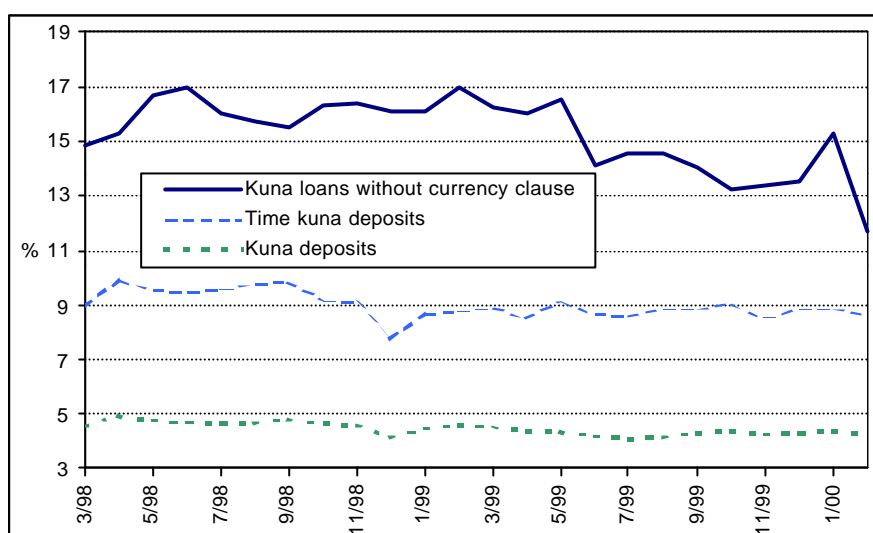


Figure I.29 shows that, at the beginning of 1999, interest rates on CNB bills and treasury bills continued their rising trend from 1998 due to the banking crisis, partly due to the decreased interest of banks with liquidity problems and partly due to the efforts to mitigate the adverse effects for banks through higher remuneration rates. Interest rates on 35-day CNB bills increased by 1 percentage point over the year (from 9.5 to 10.5 percent), whereas interest rates on 42-day treasury bills increased from 10.5 to 11.0 percent in spring. At end March 2000, interest rates on CNB bills began to fall, which, along with the CNB measures of reducing reserve requirements and reducing interest rates on CNB loans, was a sign for banks to reduce their interest rates.

Commercial bank lending rates were reduced by more than 2 percentage points in 1999 and by more than 3 percentage points by February 2000: the average interest rate on overall kuna loans was 15.3 percent in January 1999 and 12.1 percent in February 2000. The average interest rate on short-term loans extended to companies fell from 15 percent to around 10 percent in 1999, a decline of more than 5 percentage points. The banking system is in the process of interest rate reduction, and thus an increase in loans to companies can be expected, with bad clients being put off by measures such as collateral, fees and a more strict assessment of creditworthiness.

Figure I.30 Average Interest Rates of Commercial Banks



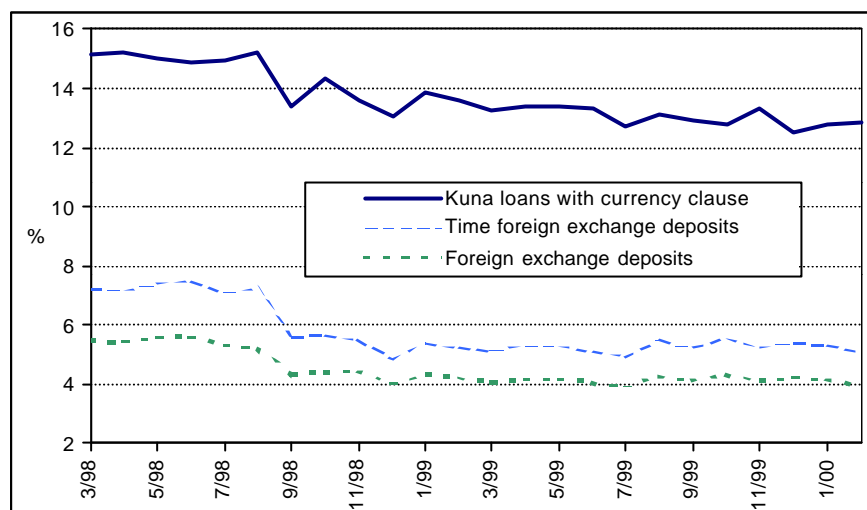
The banking system crisis was a good lesson for both banks and clients, warning that the level of deposit interest rates cannot be the only criterion when making a deposit but the bank's soundness and reliability should also be taken into account. Banks reduced their deposit interest rates, attempting to attract clients by the quality and range of their services, which is positive both for developing banking products and services and for reducing the cost of sources of funds for banks, in view of the fact that deposits account for approximately 55 percent of banks' liabilities.

The banks' average interest rate on kuna deposits was reduced by 0.2 percentage point from January 1999 to February 2000, or by 0.4 percent on foreign exchange deposits. This does not seem to be a significant fall, but the real situation can be seen if today's level of interest rates is compared with the period when the banking crisis began. Over the past two years, interest rates on kuna time deposits and on foreign exchange time deposits were reduced by 1.2 percentage points (12 percent) and 2.4 percentage points (32 percent) respectively. The fact that foreign exchange deposits account for 75 percent of overall deposits (or 41 percent of banks' liabilities) shows the significance of a fall in deposit interest rates. It is also evident why, at present, interest rates on kuna time deposits are as much as 3.5 percentage points higher than those on foreign exchange time deposits. Since banks grant only 13 percent of their loans, which account for 60 percent of their assets, in foreign currency, they need sources of funds denominated in kuna, which, naturally, involves a currency risk.

Interest rate spread is one of the simplest measures of efficiency of banking operations. Therefore, we stress that this spread has had a continuous declining trend, which confirms the banks' efforts to increase efficiency. Under the influence of the banking crisis at the beginning of 1999, banks reduced their deposit rates and moderately increased their lending rates. The overall spread between lending and deposit rates ranged between 9.5 and 12 percentage points, depending on whether the spread refers to kuna operations (wider spread due to currency risk) or foreign exchange operations. The spread was reduced at the beginning of 2000, ranging from 8 (without currency risk) to 9.5 percentage points. It can be expected that the entry of strategic investors in two rehabilitated state banks in 1999 (Slavonska and Privredna

banka Zagreb) and expected entry in the remaining rehabilitated banks in 2000 (Riječka, Splitska, Dubrovačka and Croatia banka) will contribute to a further increase in the operating efficiency of the banking system and assure a further narrowing of the interest rate spread.

Figure I.31 Average Interest Rates of Commercial Banks



Additional reasons for expecting an interest rate reduction by the end of this year are the CNB measures to support interest rate reduction (reserve requirements reduction, reduction in its lending and deposit interest rates), government measures that are in preparation to deal with insolvency and the government's promise to pay its debts, which all participants in the financial system expect it to do. A better protection of creditors and the expedition of court proceedings concerning the collection of claims should also reduce credit risk premiums. The stimulation of kuna savings and exchange rate stability (improved confidence in the national currency) should decrease the currency risk. All this should result in a moderate but steady fall in interest rates.

### 1.2.5 Balance of Payments

In 1999, the current account showed a deficit of 1,468.5 million US dollars. This continued a trend of reduced current deficit. The current account deficit decreased by 33.9 percent in 1998 compared to 1997, mainly as a result of the one-off effect of the introduction of value-added tax in 1997 and a deficit decrease in 1998, and by a further 5.2 percent in 1999 compared to 1998. If, instead of the absolute amounts, the shares of the current deficit in GDP are compared, the situation somewhat changes due to a GDP fall: the deficit amounted to 11.6 percent of GDP in 1997, fell to 7.1 percent in 1998 and slightly rose to 7.3 percent in 1999. The deficit decrease was mainly caused by a decline in international trade in goods due to recession in Croatia, poor growth in the countries that are Croatia's major trading partners and a great fall in foreign demand for the export of Croatia's tourist services due to the Kosovo crisis. The balance on the capital and financial transactions account was reduced by 3.31 percent, primarily as a consequence of a large increase in direct investment in Croatia (50.72 percent compared to 1998) and a further large decrease in net other

investments from 776.2 million US dollars in 1998 to -65.7 million US dollars in 1999.

Table I.3 Balance of Payments of the Republic of Croatia, in million USD (preliminary data for 1999)

|   | 1996      | 1997      | 1998      | 1999      | 1999/1998<br>% |
|---|-----------|-----------|-----------|-----------|----------------|
| A. CURRENT TRANSACTIONS (1+6)                   | -1,147.5  | -2,344.0  | -1,549.7  | -1,468.5  | 94.8           |
| 1. Goods, services and income (2+5)             | -2,179.9  | -3,215.7  | -2,257.8  | -1,968.4  | 87.2           |
| 1.1. Revenue                                    | 8,112.6   | 8,585.0   | 8,963.5   | 8,344.6   | 93.1           |
| 1.2. Expenditure                                | -10,292.5 | -11,800.7 | -11,221.3 | -10,313.0 | 91.9           |
| 2. Goods and services (3+4)                     | -2,110.2  | -3,193.4  | -2,094.1  | -1,622.0  | 77.5           |
| 2.1. Revenue                                    | 7,842.7   | 8,221.3   | 8,568.6   | 8,079.1   | 94.3           |
| 2.2. Expenditure                                | -9,953.0  | -11,414.7 | -10,662.7 | -9,701.1  | 91.0           |
| 3. Goods  | -3,690.2  | -5,224.3  | -4,168.9  | -3,300.7  | 79.2           |
| 3.1. Revenue                                    | 4,545.7   | 4,210.3   | 4,604.5   | 4,371.2   | 94.9           |
| 3.2. Expenditure                                | -8,235.9  | -9,434.6  | -8,773.4  | -7,671.8  | 87.4           |
| 4. Services                                     | 1,580.0   | 2,030.9   | 2,074.8   | 1,678.7   | 80.9           |
| 4.1. Revenue                                    | 3,297.0   | 4,011.0   | 3,964.1   | 3,707.9   | 93.5           |
| 4.2. Expenditure                                | -1,717.0  | -1,980.1  | -1,889.3  | -2,029.3  | 107.4          |
| 5. <i>Income</i>                                | -69.7     | -22.2     | -163.7    | -346.4    | 211.7          |
| 5.1. Revenue                                    | 269.8     | 363.8     | 394.9     | 265.5     | 67.2           |
| 5.2. Expenditure                                | -339.5    | -386.0    | -558.6    | -611.9    | 109.5          |
| 6. Current transfers                            | 1,032.3   |           | 708.1     | 499.9     | 70.6           |
| 6.1. Revenue                                    |           | 871.66    |           |           |                |
| 6.2. Expenditure                                | 1,183.1   | 966.3     | 921.1     | 833.2     | 90.5           |
| 6.2. Expenditure                                | -150.8    | -94.6     | -213.1    | -333.3    | 156.4          |
| B. CAPITAL AND FINANCIAL TRANSACTIONS           | 2,050.8   | 2,651.8   | 1,459.2   | 1,410.9   | 96.7           |
| B1. Capital transactions                        | 16.2      | 21.5      | 19.1      | 24.9      | 130.5          |
| B2. Financial transactions, excl. int. reserves | 2,567.8   | 3,058.4   | 1,591.6   | 1,814.5   | 114.0          |
| 1. Direct investment                            | 509.1     | 323.7     | 800.6     | 1,304.4   | 162.9          |
| 1.1. Abroad                                     | -24.4     | -186.1    | -93.3     | -42.9     | 46.0           |
| 1.2. In Croatia                                 | 533.4     | 509.8     | 893.9     | 1,347.3   | 150.7          |
| 2. Portfolio investment                         | 628.3     | 576.5     | 14.9      | 575.8     | 3,876.9        |
| 2.1. Assets                                     | 6.2       | 11.1      | -0.1      | -0.3      | 211.7          |
| 2.2. Liabilities                                | 622.1     | 565.4     | 15.0      | 576.1     | 3,842.4        |
| 3. Other investment                             | 1,430.5   | 2,158.2   | 776.2     | -65.7     | -              |
| 3.1. Assets                                     | 850.8     | 190.4     | 368.2     | -523.4    | -              |
| 3.2. Liabilities                                | 579.6     | 1,967.8   | 407.9     | 457.7     | 112.2          |
| B3. CNB international reserves                  | -533.3    | -428.0    | -151.5    | -428.5    | 282.8          |
| C. NET ERRORS AND OMISSIONS                     | -903.3    | -307.8    | 90.6      | 57.6      | 63.6           |

The decrease in the current account deficit results from a reduced negative balance in the goods account of 20.8 percent and a reduced surplus in the services account of 19.1 percent. The deficit decrease in the goods account was caused by a 7.2 percent weakening of domestic demand for goods imports compared to 1998 (imports amounted to 7,777.4 million US dollars, c.i.f., in 1999) according to the foreign trade statistics, and also by a decline in residents' outlays for purchasing abroad ("shopping") of approximately 8.8 percent (the estimate for 1999 amounts to 421.4 million US dollars). Goods exports amounted to 4,279.7 million US dollars, f.o.b., which is a 5.7 percent reduction compared to the previous year. Cross-currency relations of the US dollar (in which balance of payments is compiled) and the euro (which, according to currency structure, accounts for more than two thirds of the foreign exchange inflow) also had a significant role in reducing the current account deficit.

The surplus decrease in the services account occurred primarily because of the lower than expected income from tourism and a considerable decrease in net income from transport services. The expected increase in income from tourism did not take place in 1999 mostly due to the adverse effects of the Kosovo crisis, which led to an estimated income fall of 8.5 percent, whereas expenditures incurred from travel and tourism increased by 18.6 percent. There was a traditional surplus in the transport services balance, although a continuous fall in net income has been evident since 1996, primarily as a result of decreased income from sea transport (problem in the domestic shipping company Croatia Line). The Kosovo crisis affected this segment of economy as well. Net income from transport fell to 461.6 million US dollars, which is an 18.4 percent fall compared to 1998. In the other services account, which registers a wide range of business services, a 33.9 percent deficit decrease was recorded in 1999, mostly due to an increase in income of 12.0 percent compared to 1998.

The current transfers account traditionally records a surplus. From 1997 to 1999, net income had a downward trend. In 1999, net income amounted to 499 million US dollars, 29.4 percent down on 1998. There are two main reasons for the changes in the current transfers balance: first, the government sector balance changed into deficit in 1999 and, second, the income side of the other sectors (the majority of which are related to remittance transfers of persons temporarily employed abroad, and pensions and disability allowances from abroad) has recorded a continuous fall since 1996. The government sector net revenues from transfers reached their peak in 1995, which was followed by a downward trend, mostly due to a decreased inflow from humanitarian aid; at the same time, government expenditures rapidly increased in 1998 and 1999, contributing to an increase in the government net negative balance which reached 130.1 million US dollars (1,312.6 percent up on 1998).

The downward trend in the income of the other sectors' current transfers could be a consequence of two factors. First, a number of Croatian banks through which employees' remittances were paid experienced insolvency during 1998; some went bankrupt. This resulted in a selection of more sound banks for making money transfers and a decision to shift transfers to private channels, which is not recorded within foreign payment transactions. The second factor is the effect of transaction valuation. Since the majority of persons employed abroad work in EU countries, money is remitted in various currency denominations of the euro, which depreciated against the US dollar over 1999. As a consequence, the value of transfers in the balance of payments, which is compiled in US dollars, declined.

### **Capital and Financial Transactions Account**

The capital account consists of capital transfers and the acquisition of non-manufactured non-financial assets; in other words, it records foreign payment transactions on the basis of emigrants' transfers of capital. It has been compiled since 1996 and reached its highest level of 24.9 million US dollars in 1999. Capital and financial transactions in 1999 amounted to 1,410.9 million US dollars, which is 3.31 percent less than in 1998 and largely reflects a decreased need for financing the reduced current account deficit.

The financial account continued its structural adjustment that began in 1998. Up to that period, the current deficit was largely financed by other investments (external

debt). During 1996, the main source of financing was a decrease in the net assets of other sectors through the repatriation of personal foreign exchange, whereas in 1997 the focus was on foreign long-term crediting of the other sectors. In 1998 and particularly in 1999, foreign direct investments became the major source of financing the current deficit (its share in covering the current account deficit was 91.7 percent), primarily due to privatization in the banking sector and telecommunications, which contributed to a rapid increase in the value of direct investments in Croatia.

Direct investments abroad reached their peak in 1997, when they amounted to 185.3 million US dollars, and have continuously fallen ever since (Pliva invests abroad - Lek, Podravka in Poland and Hungary). In 1999, Croatia's direct investments abroad amounted to 42.9 million US dollars, a fall of 46.0 percent. At the same time, direct investments in Croatia recorded considerable growth rates over the past three years. They increased most in 1999, by 50.7 percent compared to 1998 (1,347.0 million US dollars). As a result, foreign direct investments had a 6 percent share in GDP in 1999, compared to 2.5 percent in 1997.

In 1999, portfolio investments returned to their normal level, 575.8 million US dollars, following their rapid decline in 1998 due to financial crises in Asia and Russia. Portfolio investments are investments that amount to less than 10 percent of a company's capital and foreign investments in securities of the Republic of Croatia, which is the reason for their sensitivity, that is, a tendency to quick flight in contrast to foreign direct investments. The majority of foreign portfolio investments in 1999 was composed of foreign investments in Eurobonds of the Republic of Croatia in the amount of about 300 million euro.

Regarding assets, the most intense movements were recorded in the foreign currency and deposits account. Commercial banks' foreign exchange assets abroad decreased in 1998 and 1999 due to cross-currency movements, particularly the depreciation of the euro against the US dollar (the balance of payments is compiled in US dollars), a reduction in foreign exchange redeposits due to a decline in foreign exchange savings, and transfers of a part of the commercial banks' foreign exchange assets abroad to the CNB account abroad on the basis of the Decision on the Obligatory Foreign Currency Reserve. Withdrawals of commercial banks' foreign exchange deposits amounted to 340.6 million US dollars in 1999, which is 11.3 percent less than in 1998. These assets are presently being recorded under foreign exchange reserve requirements with the CNB and are a constituent part of the CNB's international reserves. Following a considerable fall in inflow in the other sectors' foreign currency and deposits account between 1996 and 1998 (inflow amounted to 1,437.1 and 4.0 million US dollar in 1996 and 1998 respectively), an outflow occurred for the first time in 1999, in the amount of 710.2 million US dollars, causing a 369.6 million US dollar negative balance in the foreign currency and deposits account. A total deficit of 523.4 million US dollars was recorded in the other investments account, which can partially be attributed to regained confidence in domestic banks in the last quarter of 1999 and redeposited savings deposits, particularly in the first quarter of 1999. This represents a continuation of the partial return of foreign exchange deposits that took place at the end of 1998.

Although borrowing increased in 1999, 12.2 percent up on 1998, it is no longer the main source for covering the current account deficit. The structure of borrowing

changed in 1999 compared to 1998. Net borrowing in the medium and long term in 1999 amounted to only 385 million US dollars, which is more than 60 percent down on 1998.

Total foreign borrowing in 1999 increased by only 176 million US dollars, reaching 9,763.8 million US dollars at the end of 1999. At the same time, the methodology for recording external debt was revised and adjusted to the IMF standards, and the foreign credit relations database was completed and updated. Thus, the external debt in 1998, which amounted to 8.5 billion US dollars according to the previous recording method, was increased by 238 million US dollars of foreign parent companies' credit lines to companies founded by foreign direct investments (which has been recorded only since 1998), then by 615 million US dollars of foreign currency and deposits in non-resident accounts with Croatian banks (which was not registered before), and about 200 million US dollars of previously unregistered loans to the Ministry of Finance.

Table I.4 External Debt by Debtor Sector, in million current USD

| Debtor's sector                   | 1996         | 1997         | 1998         | 1999         | 99/98          |
|-----------------------------------|--------------|--------------|--------------|--------------|----------------|
| Monetary sector                   | 208          | 232          | 234          | 197          | 84.19%         |
| Government                        | 2,433        | 2,906        | 3,333        | 3,917        | 117.52%        |
| of which: London club             | 1,462        | 1,428        | 1,405        | 1,381        | 98.29%         |
| Banks                             | 1,570        | 2,216        | 2,290        | 1,956        | 85.41%         |
| of which: "Currency and deposits" | 499          | 790          | 615          | 538          | 87.48%         |
| Other sectors (companies)         | 1,096        | 2,098        | 3,494        | 3,445        | 98.60%         |
| Direct investments                | 0            | 0            | 238          | 250          | 105.04%        |
| <b>Total</b>                      | <b>5,308</b> | <b>7,452</b> | <b>9,588</b> | <b>9,764</b> | <b>101.84%</b> |

Source: CNB

In 1999, the government increased its external debt by about 600 million US dollars, continuing the trend of financing by foreign assets that started in 1996. This increase was due to long-term loans (230 million US dollar increase) and the issue of Eurobonds in the first quarter of 1999 amounting to 300 million euro. There was also some activity in short-term loans, especially in anticipating capital income from the privatization of Croatian Telecom, amounting to about 360 million US dollars, which were repaid by the end of the year.

In 1999, banks' external debt decreased by approximately 330 million US dollars compared to 1998, which is mainly a consequence of a change in cross-currency relations between the euro and the US dollars, which generated 200 million US dollars. The banks largely used long-term and medium-term loans, amounting to 600 million US dollars, primarily to settle their obligations arising from previous loans, amounting to 640 million US dollars. As a result, in 1999 the banks managed to fully repay their due obligations arising from foreign borrowing. Non-resident foreign currency and deposits in domestic banks decreased by about 80 million US dollars, which is mainly the result of reduced confidence in the Croatian banking system.

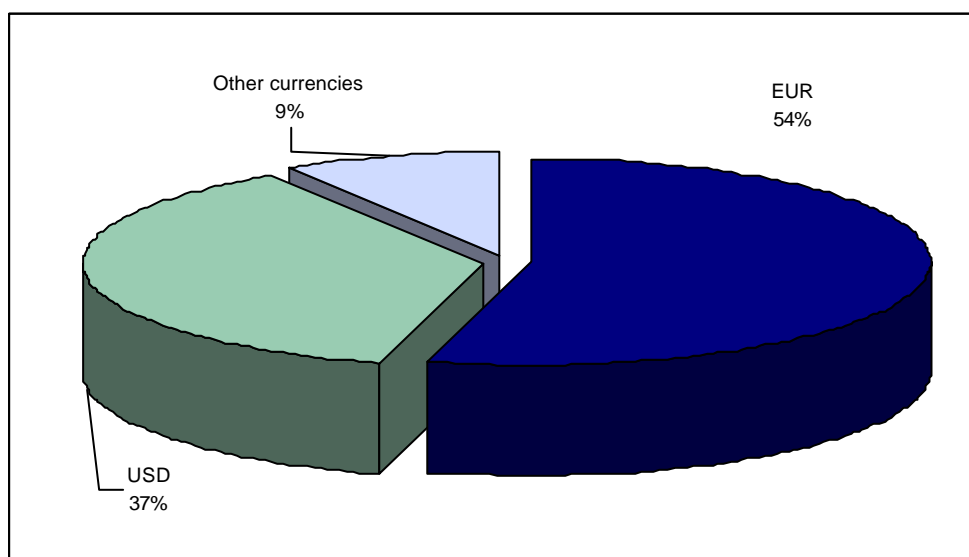
Other sectors retained approximately the same level of external debt as in 1998. This means that, taking into account the cross-currency changes between the euro and the US dollar (about 400 million US dollars), companies managed to settle their obligations arising from previous foreign loans, using about 770 million US dollars and repaying annuities of about 520 million US dollars. There were also some

activities involving short-term loans and trade loans, which were mostly repaid, so that short-term borrowing increased by 50 million US dollars but decreased if trade loans are taken into account.

In 1999, the volume of parent companies' credit lines to companies established by foreign direct investments increased, amounting to 20 million US dollars, which should be added to the increase in the total debt balance of the other sectors (especially the corporate sector), since companies established through foreign direct investment are considered residents.

The new methodology, the first results of which were published in the CNB's monthly Bulletin for March 2000, shows the influence of cross-currency relations on the changes in external debt and its coverage. Changes in cross-currency relations have significantly contributed to a decline in the value of external debt in terms of the US dollar, since a large part, as much as 54 percent in 1999, of external debt (in the balance of payments current account as well) was expressed in the various euro denominations (German marks, Austrian shillings, and the euro itself). The second currency by its share in 1999 was the US dollar with a 34 percent share, whereas other currencies accounted for only 9 percent (which is divided among the Swiss franc, Japanese yen and special drawing rights in almost equal parts). The weakening of the euro against the US dollar resulted in a reduction in total debt of about 780 million US dollars in 1999.

Figure I.32 Currency Structure of External Debt, December 31, 1999



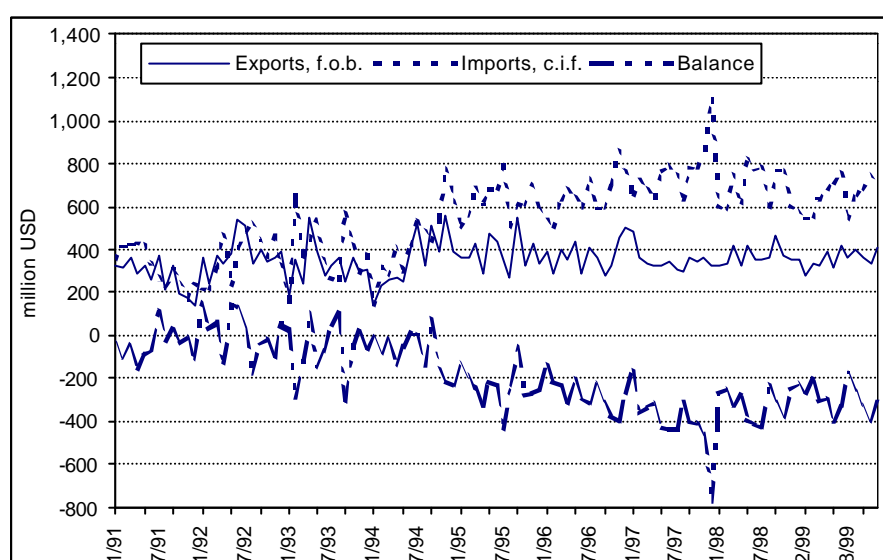
The central bank's international reserves increased by 429 million US dollars in 1999 according to the balance of payments statistics, or, according to the balance of gross reserves at the end of the period, by 210 million US dollars, from 2,816 to 3,025 million US dollars. The reason for this deviation is the application of the daily exchange rate at the transaction date in the balance of payments statistics, whereas the exchange rate at the end of the period is used for the calculation of gross international reserves. The changes in cross-currency relations between the euro and the US dollar contributed to this difference to a great extent. There was also a reclassification of the returned second part of reserves for new foreign exchange savings, amounting to 200

million US dollars, which were reclassified from the foreign currency and deposits account to the CNB's international reserves account.

### The Structure of Trade in Goods

Trade in goods as shown according to the Central Bureau of Statistics differs from the exports and imports components within the balance of payments. The balance of payments shows exports and imports at f.o.b. (free on board) prices, so the price of goods includes production costs and outlays for transport and goods insurance to the export country's border. Furthermore, the balance of payments data contain an additionally estimated volume of resident's imports of goods, that is, shopping abroad, which reflects a further improvement in the balance of payments methodology. This also means that the balance of payments data on imports in the period following 1998 are not comparable with those collected in the period before 1998.

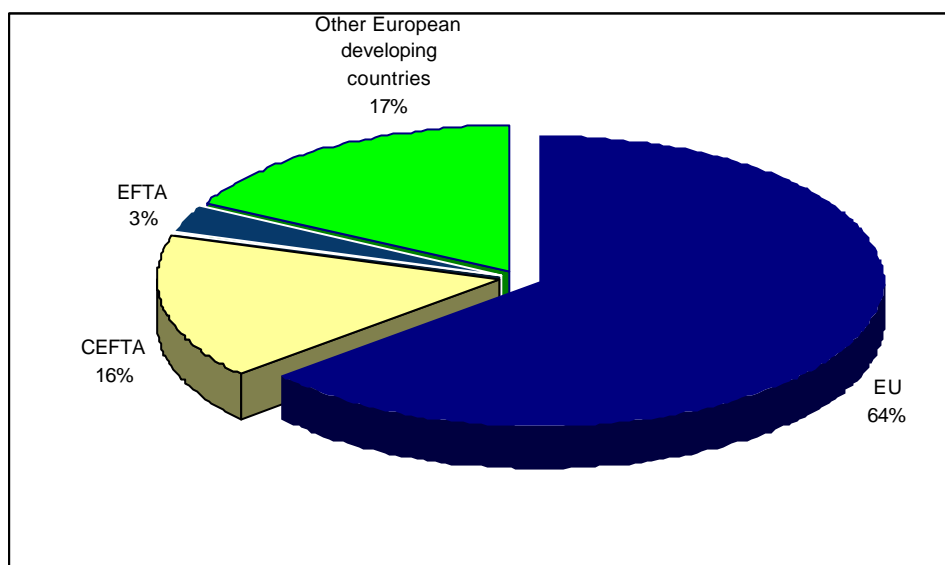
Figure I.33 The Republic of Croatia's Trade in Goods, in million current USD



Source: CBS

In 1999, European countries accounted for approximately 85 percent of Croatia's total trade in goods, which is at the level of 1998. Croatia's major trading partners in Europe were: EU member countries with a share of 63.0 percent (6,480.1 US dollars), other European developing countries with a share of 17.4 percent, CEFTA countries with a share of 16.2 percent, and EFTA countries with a share of 3.4 percent. In 1999, exports to EU member countries amounted to 2,088.4 million US dollars, whereas imports were almost double, amounting to 4,391.7 million US dollars. While trade in goods with EU member countries recorded a significant deficit (2,972.9 million US dollars), trade in goods was more balanced with the other European developing countries, such as Bosnia-Herzegovina, Malta, Macedonia and Russia.

Figure I.34 The Share of the European Partners in Trade in Goods with Croatia in 1999

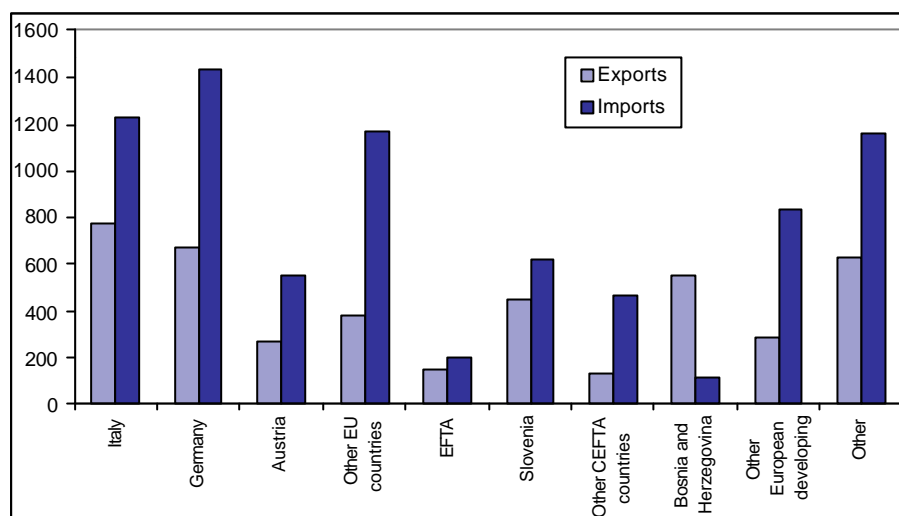


Source: CBS

In general, exports to European countries fell by 5 percent in 1999 compared to 1998 and imports fell by about 7 percent. It should be noted that the kuna depreciated against the euro by about 5.5 percent during 1998 and a further 4.8 percent in 1999 and by 22.6 percent against the US dollar in 1999, but this did not influence the increase in exports. Croatia's five major trade partners accounted for 74.2 percent of total exports to Europe and for 59.7 percent of total imports from Europe. These five countries are: Italy (21.1 percent of total exports to Europe and 18.6 percent of total imports from Europe), Germany (18.4 percent of exports and 21.7 percent of imports), Bosnia and Herzegovina (15.0 percent of exports and 1.8 percent of imports), Slovenia (12.4 percent of exports and 9.3 percent of imports), and Austria (7.2 percent of exports and 8.3 percent of imports).

In 1999, the most important currencies in the currency structure of trade in goods were various euro denominations, such as the German mark and French franc. They accounted for 62 percent of the overall value of exports, whereas the US dollar accounted for 33 percent. If this is compared to 1998, it can be noted that exports in euro increased by 1 percentage point, whereas imports in euro decreased by 5 percentage points (the euro accounted for 72 percent of total imports in 1998). In contrast, imports in US dollars accounted for 24 percent of total imports, whereas exports in US dollars accounted for 33 percent of total exports. Trade in goods in other currencies accounted for 9 percent of total imports and 5 percent of total exports. The difference in the share of the 15 EU member countries according to destination and currency structure can be accounted for by the fact that international transactions with the Central and Eastern European countries are conducted in the currencies of the 15 EU member countries (the euro).

Figure I.35 Structure of the Republic of Croatia's Trade in Goods by Country, in million current USD



Source: CBS

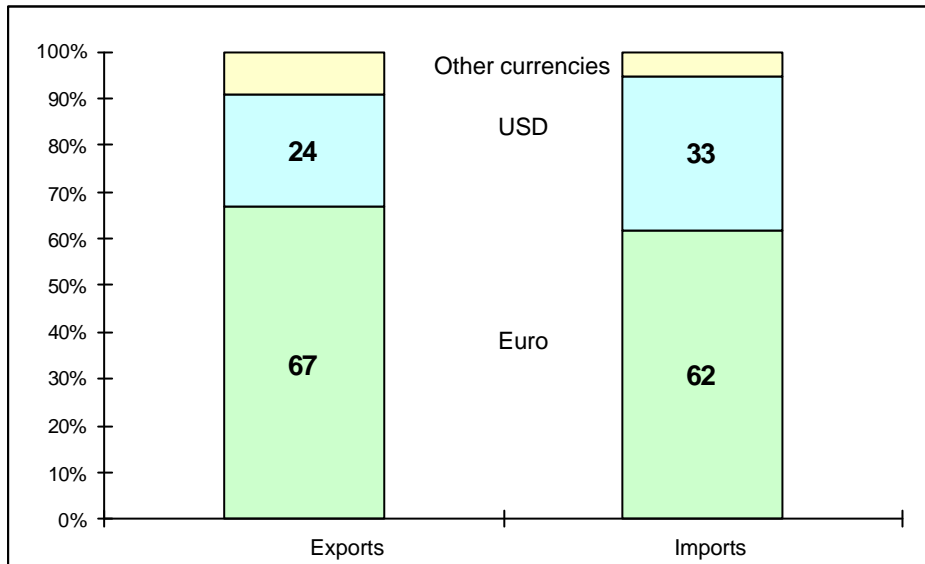
The structure of exports by statistical quotas shows the greatest fall in 1999 compared to 1998 in finished goods (11.4 percent), whereas exports after further processing ('lohn' jobs), which refers to textiles, chemicals and chemical products, increased by 4.2 percent. Finished goods and exports after processing account for about 93 percent of exports. On the imports side, both finished goods and imports for processing decreased by 7.3 percent and 3.2 percent respectively. Additionally, other types of imports, which account for about 10 percent of imports, fell by 5.7 percent.

Regarding the segments of trade in goods by intended use in 1999, there was a considerable increase in exports of energy sources (25.9 percent) compared to 1998, mostly due to a 23.6 percent growth in the manufacture of coke, petroleum products and nuclear fuel, whereas the other export segments from that grouping were relatively insignificant. However, imports of energy sources significantly increased, by 44.7 percent; this was caused by strong growth in imports of services connected to oil and gas extraction, which amounted to 701.4 million US dollars in 1999 (a 67.9 percent increase compared to 1998). Exports of intermediates decreased by 3.8 percent to 1,437.3 million US dollars and imports decreased by 9.9 percent to 2,438.6 million US dollars. Energy sources and intermediates together accounted for 42.4 percent of imports, which indicates an increased dependence of Croatian industry on imports compared to 1998, when these two industrial groupings accounted for 39.4 percent of imports. Imports of capital goods fell by 6.6 percent to 2,502.6 million US dollars in 1999, whereas exports of capital goods decreased by 10.6 percent, mainly due to decreased exports of ships.

According to the sections and divisions of the Nomenclature of Foreign Trade Statistics (NFTS), exports increased in 1999 compared to 1998 only in the area of raw materials, that is, mineral fuel and lubricants, which increased by 25.8 percent, and raw material apart from fuel, which increased by 5 percent. This coincides with the beginning of gas extraction in the Istrian seabed in co-operation with the Italian company Eni. These two sections accounted for 13.4 percent of total exports in 1999. Exports of machinery and transport equipment, otherwise the most important segment

of exports (amounting to 1,247.3 million US dollars in 1999), decreased by 9.6 percent compared to 1998, and exports of miscellaneous manufactured articles (amounting to 965.0 million US dollars) decreased by 5.6 percent, due to a 5.7 percent fall in exports of wearing apparel from 555.8 to 524.3 million US dollars.

Figure I.36 Currency Structure of Exports and Imports in 1999



Source: CNB

### Foreign Direct Investment

Foreign direct investments in the period from 1993 to 1999 amounted to a total of 3,536.4 million US dollars. A considerable increase from about 100 million US dollars to about 500 million dollars in 1996 was a result of the improvement in the balance of payments methodology and the introduction of a survey on companies' foreign direct investment and portfolio investment. Investments particularly increased in 1998 and 1999, when, for the first time, they exceeded one billion US dollars per year. The major foreign direct investors were the United States with 1,003.7 million US dollars, Germany with 986.7 million US dollars and Austria with 682 million US dollars. The investments of these three countries accounted for about 76 percent of total foreign direct investments in Croatia.

Table I.5 Foreign Direct Investment in the Republic of Croatia by Country of Origin, in thousands of USD

|                 | 1993      | 1994      | 1995      | 1996      | 1997      | 1998      | 1999        | Total       | Share  |
|-----------------|-----------|-----------|-----------|-----------|-----------|-----------|-------------|-------------|--------|
| TOTAL           | 120,086.3 | 116,955.2 | 113,908.3 | 504,052.3 | 509,782.4 | 893,892.5 | 1,277,728.3 | 3,536,405.2 | 100.0% |
| UNITED STATES   | 4,876.6   | 2,950.3   | -15,489.1 | 292,729.2 | 83,539.3  | 503,914.7 | 131,193.2   | 1,003,714.3 | 28.4%  |
| GERMANY         | 53,314.4  | 7,961.6   | 23,289.0  | 2,237.7   | -67,829.8 | 60,866.2  | 906,812.7   | 986,651.9   | 27.9%  |
| AUSTRIA         | 5,019.8   | 47,921.7  | 6,808.2   | 54,224.7  | 274,876.1 | 187,814.4 | 105,275.0   | 681,939.8   | 19.3%  |
| NETHERLANDS     | 4,774.0   | 2,877.8   | 0.0       | 5,986.4   | 13,669.8  | 46,394.5  | 63,257.2    | 136,959.7   | 3.9%   |
| SWEDEN          | 493.7     | 0.0       | 37,332.2  | 7,819.6   | 8,649.3   | 24,281.5  | 14,106.2    | 92,682.5    | 2.6%   |
| UNITED KINGDOM  | 709.3     | 658.3     | 274.4     | 187.8     | 55,117.4  | 605.8     | 29,251.0    | 86,804.0    | 2.5%   |
| EBRD            | 0.0       | 0.0       | 0.0       | 43,075.1  | 41,633.7  | -39,400.7 | 31,010.0    | 76,318.1    | 2.2%   |
| FRANCE          | 0.0       | 0.0       | 151.5     | 5,873.8   | 9,421.3   | 32,546.4  | 8,331.8     | 56,324.8    | 1.6%   |
| SLOVENIA        | 4,454.8   | 254.2     | 3,533.1   | 2,109.2   | 9,888.4   | 23,808.4  | 10,037.5    | 54,085.6    | 1.5%   |
| SWITZERLAND     | 9,978.4   | 18,752.6  | 13,615.2  | 22,568.2  | -15,382.1 | 7,506.7   | -4,798.9    | 52,240.2    | 1.5%   |
| ITALY           | 11,962.3  | 3,479.1   | 4,338.1   | 9,936.8   | 11,140.3  | -955.5    | 10,233.8    | 50,135.0    | 1.4%   |
| LICHTENSTEIN    | 0.0       | 11,562.2  | 3,849.1   | 11,391.3  | 12,778.9  | 5,195.5   | 425.2       | 45,202.3    | 1.3%   |
| AUSTRALIA       | 0.0       | 0.0       | 19,100.9  | 9,856.8   | 13,056.6  | 0.0       | 0.0         | 42,014.3    | 1.2%   |
| OTHER COUNTRIES | 24,503.0  | 20,537.3  | 17,105.5  | 36,055.7  | 59,223.2  | 41,314.4  | -27,406.5   | 171,332.6   | 4.8%   |

Ownership investments, implying direct investment with retained earning and other capital, were made mostly in telecommunications (882.5 million US dollars) and pharmaceuticals (717.5 million US dollars) in the 1993-1999 period. These two activities accounted for about 55 percent of total ownership investments in Croatia. Together with investment in other financial intermediation of 329.9 million US dollars, these three groups make up two-thirds of total ownership investment. A further significant increase in foreign direct investment is expected from privatization in the sectors of financial intermediation, telecommunications, shipbuilding and hotels.

Table I.6 Cumulative Ownership Investment in the Republic of Croatia by Sector, in millions of USD, preliminary data

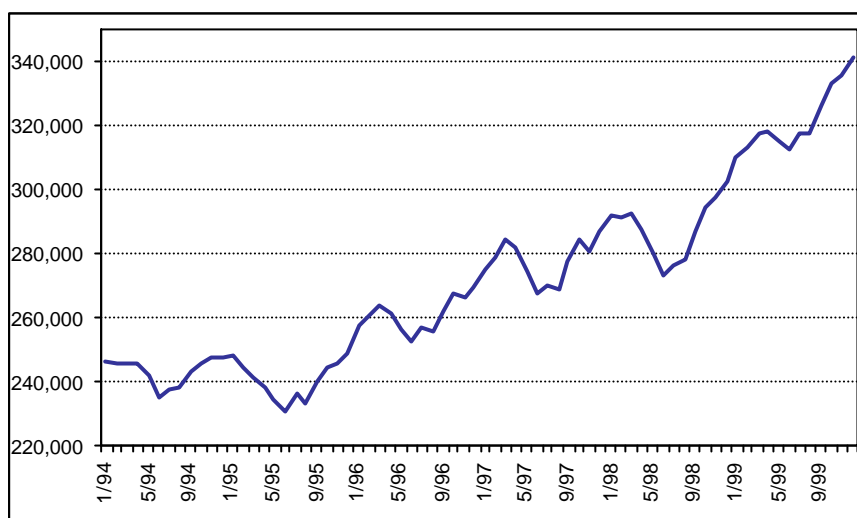
| Activity   | Amount      | Share (%) |
|--|-------------|-----------|
| Total ownership investment                             | 2,940,125.4 | 100.0     |
| Telecommunications                                     | 882,504.2   | 30.0      |
| Pharmaceuticals  | 717,548.2   | 24.4      |
| Other financial intermediation                         | 329,906.8   | 11.2      |
| Cement   | 99,722.2    | 3.4       |
| Extraction of crude petroleum and natural gas          | 98,475.4    | 3.3       |
| Bricks and roof tiles                                  | 51,176.2    | 1.7       |
| Industrial gas   | 48,804.1    | 1.7       |
| Beer   | 47,303.6    | 1.6       |
| Other wholesale trade                                  | 46,968.9    | 1.6       |
| Mineral water and soft drinks                          | 46,248.8    | 1.6       |
| Radio and television transmitters, telephone apparatus | 44,430.2    | 1.5       |
| Sanitary ceramics                                      | 39,907.4    | 1.4       |
| Hollow glass   | 35,019.8    | 1.2       |
| Building construction (high-rise building)             | 34,995.2    | 1.2       |
| Measurement and control instruments                    | 33,434.8    | 1.1       |
| Other  | 383,679.3   | 13.0      |

Source: CNB

### 1.2.6 Employment and Wages

The fall in economic activity in 1999 was reflected in the labor market: registered unemployment continued to rise over the year, except in May and June when outflows from the register were seasonally larger than inflows. In 1999, the Croatian Employment Fund registered 249,029 unemployed persons, which is 12.5 percent up on 1998. A large part of this increase refers to previously employed persons, accounting for 71.9 percent of inflow in the unemployment register and whose number rose by 15.7 percent in 1999. The inflow of people seeking work for the first time increased by 5.0 percent in the same period. 105,690 people on the register were employed in 1999, which is 3.2 percent less than in 1998, whereas 104,338 were taken off the register for other reasons, which is an 8 percent increase in outflow. Total outflow from the register amounted to 210,028 in 1999, 2.0 percent more than in 1998. As a consequence of a reduced creation of vacancies in 1999, a smaller number of people on the register were employed than in 1998. However, the increase in outflow was a result of a greater outflow from reasons other than employment, such as the separation of the right to health insurance from the unemployment status (which was carried out in mid-1998) and a decline in employment expectation. In 1999, 134,655 vacancies were reported to the Croatian Employment Fund, which implies that a large part of the reported vacancies was not filled. As a result of these flows of the active population, registered unemployment in 1999 increased by 38,999 to 341,730 at the end of the year.

Figure I.37 Unemployment



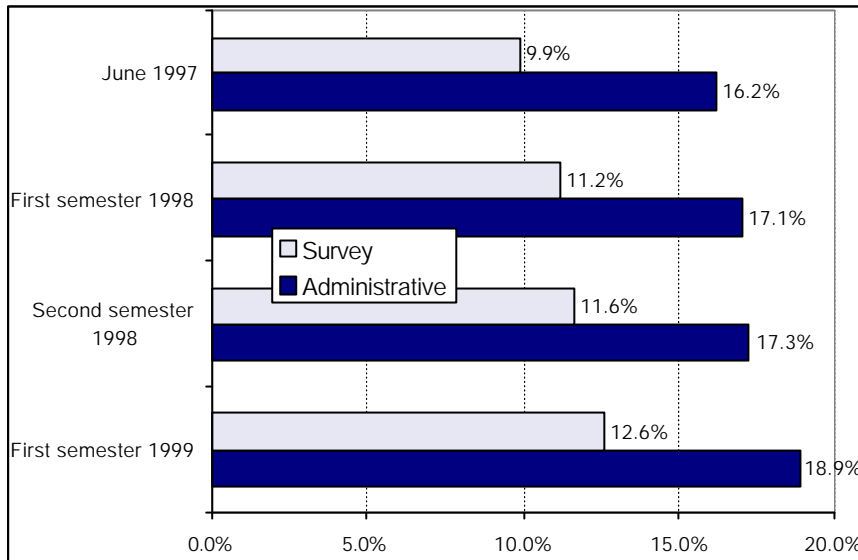
The Labor Force Survey carried out in the first half of 1999 according to international methodology (ILO) also shows an increased number of unemployed. Unemployment in that period rose by 23,263 compared to the first half of 1998, so that total unemployment was 216,807. Of this number, 171,785 (79.2 percent of the unemployed according to the Survey) were registered with the Croatian Employment Office, whereas 45,022 were not registered. The difference of 143,052 unemployed who were registered with the Office (45.4 percent of the registered unemployed) and were not considered unemployed by the international criteria is accounted for by employed persons (38.6 percent), those who were not actively seeking work (37.2 percent) and those who did not accept offered work (24.2 percent).

According to the administrative indicators, employment declined in the period when GDP was growing. The downward trend increased the fall in employment, so that in 1999, according to the Central Bureau of Statistics preliminary data, employment amounted to 1,337,990 on average, which is 3.5 percent less than in the previous year. In 1998, employment fell by 0.6 percent. At the end of 1999, the number of employed amounted to 1,304,540, of which 77.9 percent were employed in legal entities, 15.2 percent were self-employed, and 6.9 percent were small farmers. During 1999, employment decreased in all three groups. Employment fell by 21,131 in absolute terms, and the number of small farmers decreased most in relative terms (19.6 percent). The number of self-employed decreased the least (2.3 percent). According to the Survey results, the decrease in employment amounted to 34,052 between the first half of 1999 and the first half of 1999.

During 1999, these developments in employment and registered unemployment led to a decline in the active population of 22,586 (1.4 percent) according to the administrative sources. In the same period, the unemployment rate increased from 18.1 percent at the end of 1998 to 20.8 percent at the end of 1999. According to the Survey, the labor force decreased by 10,789 between the first half of 1998 and the first half of 1999. In that period, the unemployment rate increased by 1.4 percentage points according to the Survey, amounting to 12.6 percent in the first half of 1999. The administrative rate of unemployment was 18.9 percent on average in the same

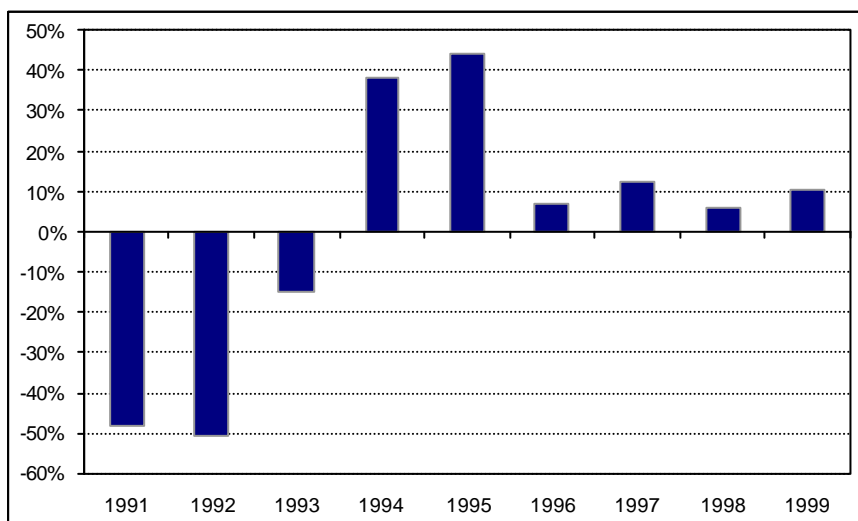
period. The difference arises from the definitions of individual categories of activities according to international and administrative criteria.

Figure I.38 Administrative and Survey Rate of Unemployment



Despite the fall in GDP, wages grew considerably in 1999. Thus, net wages in 1999 were 14.3 percent higher in nominal terms compared to the previous year and 10.3 percent higher in real terms. This growth was significantly higher than in 1998, mostly due to an increase in wages of about 20 percent in nominal terms in public administration and defense, education, health care and social care. Gross wages increased somewhat less - their growth was 9.9 percent in nominal terms and 6.1 percent in real terms.

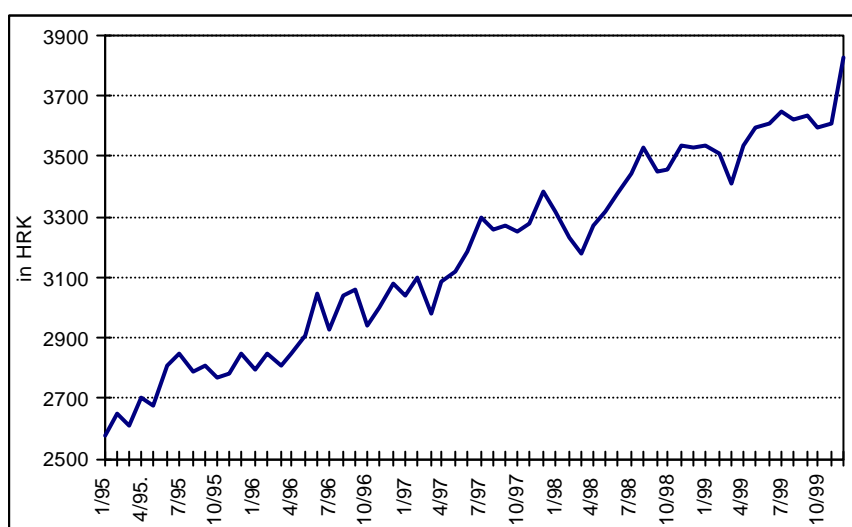
Figure I.39 Rate of Change of Average Real Net Wages



The net wage bill paid through the Institute for Payment Transactions (ZAP) in 1999 increased by 7.8 percent in nominal terms, whereas its real growth amounted to 4.0 percent, which is considerably less than the growth in average net wages. The smaller

growth in the net wage bill is a consequence of reduced employment and an increased number of employees in insolvent legal entities - 176,850 on average in 1999, which is 16.8 percent more than in the previous year. The dynamics of this growth was most pronounced at the end of 1998 and at the beginning of 1999, after which employment in insolvent legal entities has been mainly declining. The dynamics of the number of employees receiving their wages through the ZAP was the inverse, recording the greatest fall in the same period, and rising after April. In December 1999, such employees decreased by 2.7 percent compared to December 1998, which is a smaller decrease than the decrease in employment in the same period.

Figure I.40 Average Real Gross Wages, in January 1994 prices



In 1999, nominal and real unit labor costs in industry fell on average by 3.8 and 5.6 percent respectively. There are several reasons for their considerable fall in a period in which wages were rising and production declining. First, gross wages in the processing industry increased by less than half the average wage in 1999. Furthermore, the decline in industrial production was accompanied by an increase in producers' prices, decreased employment in the processing industry and an increase in the number of employees not receiving their wages on time. All these factors contributed to the reduction in unit labor costs.

### 1.2.7 Government Budget

The main characteristics of fiscal 1999 were: a considerable mismatch between revenues and expenditures over the year, a budget rebalance, a government and consolidated government budget deficit, an increased deficit in extrabudgetary funds' accounts and a fiscal policy nearing the zone of unsustainability.

Table I.7 Government and Extrabudgetary Fund Outturn (unconsolidated), in million kuna

|  | 1996          | 1997          | 1998          | 1999          | Nominal<br>index<br>1999/1998 |
|--|---------------|---------------|---------------|---------------|-------------------------------|
|  | Outturn       | Outturn       | Outturn       | Outturn       |                               |
| <b>Government budget</b>                     |               |               |               |               |                               |
| Total revenues and grants                    | 31,367        | 33,846        | 43,809        | 46,355        | 105.8                         |
| Tax revenues                                 | 28,530        | 31,775        | 40,334        | 38,318        | 95.0                          |
| Non-tax revenues                             | 1,714         | 1,609         | 1,685         | 1,727         | 102.5                         |
| Capital revenues                             | 1,123         | 461           | 1,789         | 6,311         | 352.7                         |
| Total expenditures and net borrowings        | 31,502        | 35,006        | 42,552        | 48,879        | 114.9                         |
| Current expenditures                         | 25,930        | 29,580        | 34,883        | 38,476        | 110.3                         |
| Capital expenditures                         | 5,043         | 4,815         | 6,507         | 8,904         | 136.8                         |
| Borrowings less repayments                   | 529           | 611           | 1,162         | 1,499         | 129.1                         |
| Total deficit/surplus                        | -134          | -1,160        | 1,257         | -2,523        | -200.8                        |
| Foreign financing                            | 804           | 2,986         | -9            | 4,615         | -50,637.7                     |
| Domestic financing                           | -670          | -1,826        | -1,248        | -2,092        | 167.7                         |
| <b>Extrabudgetary funds</b>                  |               |               |               |               |                               |
| Total revenues and grants                    | 23,556        | 27,677        | 31,011        | 34,995        | 112.8                         |
| Total expenditures and net borrowings        | 23,962        | 28,145        | 31,398        | 35,313        | 112.5                         |
| Total deficit/surplus                        | -405          | -467          | -387          | -319          | 82.4                          |
| <b>Total revenues and grants</b>             | <b>54,924</b> | <b>61,523</b> | <b>74,820</b> | <b>81,350</b> | <b>108.7</b>                  |
| <b>Total expenditures and net borrowings</b> | <b>55,463</b> | <b>63,151</b> | <b>73,950</b> | <b>84,192</b> | <b>113.9</b>                  |
| <b>Total deficit/surplus</b>                 | <b>-539</b>   | <b>-1,628</b> | <b>870</b>    | <b>-2,842</b> | <b>-326.8</b>                 |

Source: Ministry of Finance

In 1999, there were no great changes in the tax system. In January, the value added tax calculation period was extended from 15 to 30 days, which was expected to have a positive effect on the liquidity of the economy. In the same month, the non-taxable part of income was also increased from 800 to 1000 kuna. In that way, tax brackets in income tax changed as well. The main aim of this measure was to relieve the tax burden on labor, that is, to reduce labor costs. Other changes occurred in July when excise duties on petroleum products and tobacco products were increased. In November, the zero rate of value added tax was introduced for milk, bread, drugs and other medical products. In the same month, in order to neutralize the effect of introducing the zero rate of value added tax, the excise duty on tobacco products and imports of motor vehicles was increased and an excise duty on luxury goods was introduced.

There was a significant shortfall in tax revenues compared to the expected ones: over the first five months, only 15 billion kuna of revenues were collected, while the budget planned 49 billion kuna over the year. As a result, the government proposed a Rebalance of the Central Government Budget for 1999, which was approved by the Croatian State Parliament in June. The rebalanced budget envisaged a reduction in total revenues of 1.1 billion kuna (2.3 percent), resulting from a decrease in planned tax revenues of 2.5 billion kuna (6.0 percent) and an increase in capital revenues of 1.4 billion kuna (31.5 percent). It also envisaged an increase in expenditures of 0.3 billion kuna. However, after the rebalance, the initial expenditures of the government budget were reduced by 3.2 billion kuna (current expenditures were reduced by 1.0

billion kuna) and new expenditures amounting to 3.5 billion kuna were introduced (2.3 billion kuna was used for the purchase of claims and shares from the Pension Fund and Health Insurance Fund portfolio and 1.2 billion kuna for the payment of insured savings deposits). Thus the new budget envisaged a total deficit of 1.4 billion kuna.

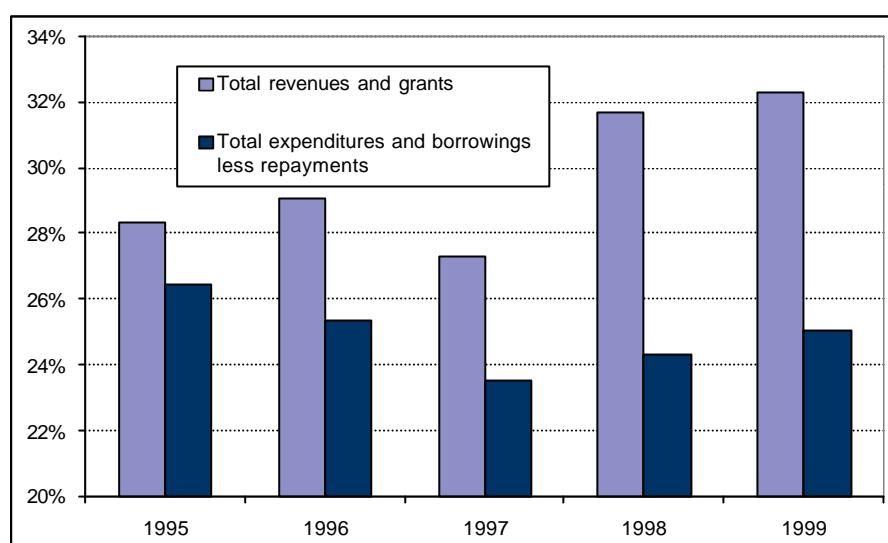
Table I.8 Consolidated General Government, in million kuna

|  | 1996          | 1997          | 1998          | 1999    | Nominal<br>index<br>1998/1997 |
|--|---------------|---------------|---------------|---------|-------------------------------|
|  | Outturn       | Outturn       | Outturn       | Outturn |                               |
| <b>Total revenues and grants</b>                         | <b>54,385</b> | <b>60,200</b> | <b>72,738</b> | ...     | ...                           |
| Government budget  | 31,367        | 33,846        | 43,809        | 46,355  | 105.8                         |
| Extrabudgetary funds                                     | 16,896        | 19,345        | 21,068        | 21,186  | 100.6                         |
| Local government   | 6,122         | 7,009         | 7,861         | ...     | ...                           |
| <b>Total expenditures and borrowings less repayments</b> | <b>54,785</b> | <b>61,697</b> | <b>72,059</b> | ...     | ...                           |
| Government budget  | 27,376        | 29,124        | 33,603        | 35,979  | 107.1                         |
| Extrabudgetary funds                                     | 21,282        | 25,522        | 30,103        | 34,364  | 114.2                         |
| Local government   | 6,126         | 7,051         | 8,354         | ...     | ...                           |
| <b>Total deficit/surplus</b>                             | <b>-399</b>   | <b>-1,497</b> | <b>678</b>    | ...     | ...                           |

Source: Ministry of Finance

The outturn deviated from the budget rebalance. The shortfall in revenues was 1.6 billion kuna (3.3 percent), which was mostly caused by a great shortfall in revenues from value added tax and corporation tax. On the expenditures side, 0.5 billion kuna less than expected was spent in 1999. It is difficult to say whether this amount was really saved or not. Since "savings" were realized in items referring to other purchase of goods and services and capital expenditures, and budget expenditures are recorded on the cash basis, the government may have only increased its unsettled obligations towards the rest of economy for the amount "saved". The result of the revenues and expenditures figures was a budget deficit amounting to 2.5 billion kuna or 1.1 billion kuna more than was anticipated by the rebalanced budget. The largest part of the additional deficit (0.7 billion kuna) was financed through foreign sources, whereas a smaller part (0.4 billion kuna) was financed through domestic sources. Generally, the budget deficit financing policy was identical to that in 1998, with the budget deficit and net repayments of domestic debt being financed by borrowings abroad, that is, by increasing the government's external debt.

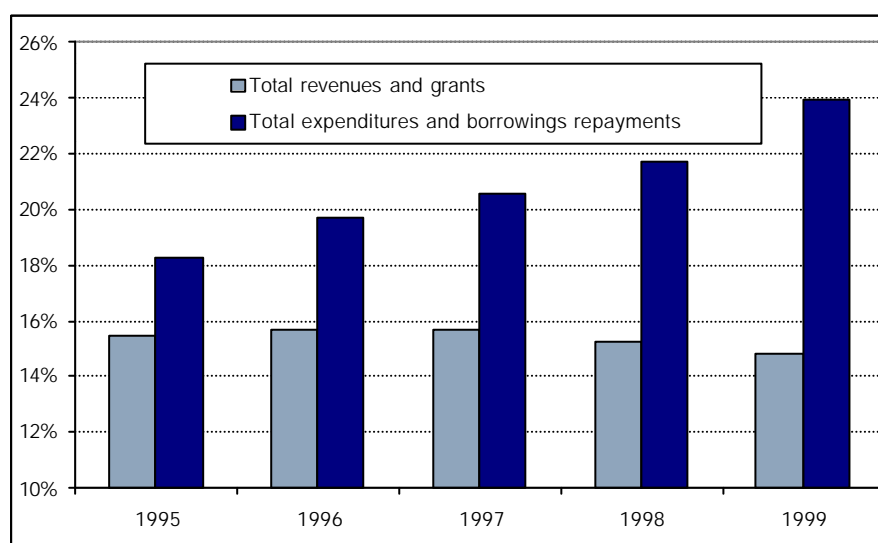
Figure I.41 Revenues and Expenditures of the Government Budget (consolidated, share of GDP)



The changes in total revenues show no significant difference between fiscal 1999 and the previous fiscal years. The only difference is that the nominal annual growth in total government revenues amounted to 5.8 percent in 1998, which is the smallest nominal growth in the past five years. Only the structure of budget revenues and the outturn of particular budget revenues show a significant difference between fiscal 1999 and the previous fiscal years. This difference refers to changes in current revenues, that is, tax revenues as the most important part of current revenues. In 1999, the tax revenues and thus current revenues recorded a nominal fall compared to the previous year for the first time in the past five years. In comparison with 1998, the government tax revenues in 1999 fell by 2.0 billion kuna in nominal terms, or 5.0 percent. This was a result of a decline in economic activity and more serious insolvency problems. Almost all types of tax revenues decreased in nominal terms in 1999; the exceptions are revenues from excise duties and taxes on international trade, which nominally increased by 4.2 percent, and revenues from other taxes, which increased by 2.5 percent. In view of the inflation rate and the decline in economic growth, it is evident that these three types of tax revenues declined in real terms. However, it should be stressed that a nominal increase in revenues from excise duties was caused by an increase in excise duties on petroleum products, cigarettes, motor vehicles and luxury goods, whereas revenues from taxes on international trade grew nominally due to greater efforts of the Customs Administration. Non-tax revenues in 1999 increased by 2.1 percent compared to 1998. However, due to a relatively insignificant share of non-tax revenues in current revenues, current revenues are primarily determined by tax revenues. In 1999, current revenues amounted to 40.0 billion kuna, which represents a nominal fall of 2.0 billion kuna or 4.7 percent compared to the previous year. In short, it can be concluded that total revenues in 1999 grew exclusively on the basis of capital revenues of a one-off character (particular assets can be sold only once). In that respect, the fall in current revenues is particularly worrying, for it is not a result of a decrease in tax but primarily of a deterioration in the general economic situation.

In 1999, a total of 48.9 billion kuna was spent, 14.9 percent more than in the previous year. Current expenditures grew by 10.3 percent and capital expenditures by as much as 36.8 percent. There was a small change in the structure of total expenditures in favour of capital expenditures. However, the concept of current and capital expenditures is distorted when capital expenditures include expenditures that have the character of current expenditures (capital transfers to extrabudgetary funds). If 2.1 billion kuna were transferred from capital expenditures (capital transfers to the Pension Fund and Health Insurance Fund) to current expenditures, the structure of overall expenditures would change in favor of current expenditures. In that way, current expenditures would show an increase of 16.3 percent compared to the previous period and capital expenditures would show an increase of only 4.6 percent. The fact that government budget expenditures are recorded on the cash basis even further distorts the understanding of government consumption, since there are not reliable data on the growth in government arrears in 1999. The two most important sources of growth in government expenditures in 1999 were an increase in government sector salaries (salaries of users of extrabudgetary funds rose by 5 percent in July and by a further 12 percent in December) and a huge increase in transfers (excluding capital transfers to extrabudgetary funds, transfers increased by 55.1 percent; if capital transfers to extrabudgetary funds are taken into account, the increase amounts to as much as 85.7 percent). All this indicates the major problems of the fiscal policy.

Figure I.42 Extrabudgetary Funds Revenues and Expenditures (consolidated, share of GDP)



The revenues and expenditures resulted in a deficit in the government account of 2.5 billion kuna. The budget deficit, along with repayment of part of the government debt to the domestic sectors, was completely financed from foreign sources: mainly long-term foreign loans and issue of bonds in the European and Japanese markets. Nevertheless, the most worrying issue is that of changes in the current deficit or surplus as a measure of the fiscal policy sustainability. According to the budget outturn, current savings amounted to 1.5 billion kuna. Bearing in mind that current savings of the government budget amounted to 7.1 billion kuna in the previous year, a downward trend in current savings is evident. Since certain capital expenditures have the character of current expenditures, it is obvious that current savings declined even

more in 1999. More precisely, the transfer of 2.1 billion kuna from capital expenditures to current expenditures would result in a current deficit of 0.6 billion kuna. Thus, not only an overall deficit but also a current deficit occurred in 1999, which brought fiscal policy closer to the zone of unsustainability.

Extrabudgetary funds have remained the major problem in pursuing fiscal policy. In 1999, a years-long negative trend continued, which is seen in the deficit increase in the extrabudgetary funds accounts. The aggregate deficit of extrabudgetary funds on the consolidated basis amounted to 13.2 billion kuna in 1999, which is a 45.9 percent increase in deficit compared to the previous year. In view of the large transfers from government budget to extrabudgetary funds, the balance in the account of consolidated government is only somewhat less favorable than the unconsolidated balance in the government account, amounting to -2.8 billion kuna. It should be noted that the deficit was mostly run up by the Pension Fund (8.2 billion kuna), Health Insurance Fund (3.2 billion kuna) and Child Benefit Fund (1.1 billion kuna). The remaining part of the deficit was generated by the Public Water Management Fund and Croatian Employment Fund. The redirection of an increasingly larger share of government revenues to extrabudgetary funds is the main obstacle to reducing the tax burden. Therefore, it is important to point out the unsustainability of a further deficit growth in the pension and health care system in the existing conditions. In order to resolve this problem, it is necessary to immediately establish expenditures control mechanisms and to carry out the needed reform of the pension and health care system.

Figure I.43. Total Deficit/Surplus (share of GDP)

