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THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DATE: February 5, 1996

TO: Nawal Kamel, Chief, IECIF

Fred Kilby

FROM: Fred Kilby, Economic Advisor, IECIF

EXTENSION: 8-0434

SUBJECT: **Back to Office Report: Paris Club Meeting - January 22 - 26, 1996.**

1. The principal business this month was the continuation of the Naples terms review that began last month and continuation of the preparatory discussions on **Russia**. Regarding Russia, the Secretariat was able to confirm that payments due under the 1985 agreement had been received, and requested further information from creditors on their bilateral claims. It was agreed that priority would be given to Russia if the authorities are in a position to meet the Club in February.

2. The *tour d'horizon* covered: **Benin, Bosnia-Herzegovina, Chad, Cameroon, Central African Republic (CAR), Gabon, Ghana, Guinea-Bissau, Guyana, Honduras, Peru, Russia, Slovenia, Sierra Leone, Venezuela, Vietnam,** and **Zambia**. The attached country sheets contain summaries of the salient points.

3. *Naples Terms Review*

- The Non-Concessional Options: The Club devoted an entire day to the review of the Naples terms. There was an extensive discussion on the desirability of retaining the nonconcessional option. This option permits creditors to reschedule debts by providing very long maturities, but without any reduction in principal or the interest rate accruing on the loan. It had been included in the Naples agreement as a temporary accommodation for members with budgetary problems. However, its continuation posed serious burden-sharing concerns for some members. They were finding it difficult to justify budget allocations for debt relief when some of the benefits accrue to creditors who choose the non-concessional option. This had led to a domino effect where creditors gravitated to non-concessional options. There there was no consensus for change. It was, however, agreed, that the Club would only proceed with the country negotiations involving stock-of-debt relief when it was clear in advance that there would be very limited use of the non-concessional option.

- Methodology. Several members noted that the debt sustainability analysis provided by the Bank and Fund on **Bolivia** had been extremely useful in the negotiations. In contrast to capacity to pay calculations which focus on the near-term cash flow outlook for the balance-of-payments, the sustainability analysis provided a framework for assessing long-term viability, and how much debt reduction was needed to ensure that future reschedulings could be avoided. The Secretariat noted that this methodology was a significant step forward, and agreed to request this analysis be provided prior to future negotiations involving debt stock reduction.

- Debt Relief on ODA. A number of countries have opted to provide debt relief on their ODA loans. In some cases debts have been canceled, but decisions are taken bilaterally. At the meeting, the **US** tabled a proposal that would provide a uniform approach for reducing the present value of such debts by 67 percent in countries which qualify for stock of debt reduction agreements in Naples terms. It was agreed that this proposal would be considered at a future meeting

A more detailed background note on the review is being circulated separately.

Next Meeting

It was agreed that **Russia** and **Zambia** would be invited to the February 27-29 meeting for negotiations. If this timing is not convenient for the Russian authorities, **Honduras** would be invited to negotiate a restructuring of its debt.

Distribution: Messrs./Mmes (w/attachments) Baird (DECVP); Rueda-Sabater (FRMRO); Wilton (FRMRS); Reyes, (IECDD); Rosenberg (AFRVP); Katz (AFTPS); Guerard (AF4DR); Marshall, Chausse (AF1); Rogerson, Chevallier (AF3); Lafourcade, Okonjo-Iweala, (AF4); Sarbib, Fredriksen (AF5); Madavo, Cox (EA1); Wallich, Loos, (EC2); Huang, Mitra (EC3); Segura, Dowsett-Coirolo (LA2) Isenman, Morrow, Nouvel (LA3), Institutional ISC.

cc: Messrs./Mmes. (w/o attachments): Kaji, Sandström, Frank, Koch-Weser, Einhorn, Lomax, (EXC); Bruno (DECVP); Ahmed (IECDR); Jaycox, Kanbur (AFRVP); Cheetham, Walton, (EAPVP); Dervis, Page (MNAVP); Wood, Salop (SASVP); Linn, Selowsky (ECAVP): Burki, Edwards (LACVP); Linn (FPRVP); Fukui (CFSVP); Wilson, (FRSDR); Donovan (FRMDR); Lav (FRMRO); Pfeffermann (CEIED); Malloch Brown (EXTDR); Hudes (LEGMN); El Maaroufi, Handwerger, (Field Office, Paris); Jun, (IECIF); IEC Division Chiefs.

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 21, 1996

TO: Mr. Gautam Kaji, Chairman, Operations Committee (5)

FROM: Johannes Linn, Vice President, ECA

EXTENSION: 80602

SUBJECT: CROATIA: Proposed Enteprise and Financial Sector Adjustment Loan (EFSAL) Revised draft Letter of Development Policy Matrix

1. This memorandum seeks the Loan Committee's approval to process the proposed Enterprise and Financial Sector Adjustment Loan (EFSAL). Based on the significant developments that took place in former Yugoslavia since the Loan Committee's review (March 1995) of both the Initiating Memorandum and the Country Assistance Strategy (CAS), it also proposes to implement the high-case scenario envisaged by the CAS.

I. EFSAL

2. As per the instructions of the Loan Committee of March 3, 1995, I am circulating the draft Letter of Development Policy (LDP) and Matrix for the Croatia EFSAL, as revised following appraisal of this loan. The Loan Committee authorized the appraisal of the proposed operation, but instructed the Region to seek the Government's commitment to pursue enterprise and bank privatization beyond the targets, and timeframe, of the EFSAL-supported program. I am also attaching the minutes of the Loan Committee meeting.

3. The appraisal mission (which visited Croatia between March 13-29, 1995 and was followed up by a mission in July 1995) was successful. The modifications requested by the Loan Committee were agreed on by the authorities, and are reflected in the revised LDP, as follows:

(a) *Privatization of formerly socially-owned enterprises*: the draft Letter contains a clear commitment to divest the bulk of the share portofolio currently held by the Croatian Privatization Fund (CPF), as well as a commitment from the authorities to wind up the operations of the CPF by the end of 1999 (para 44).

(b) *Privatization of public enterprises*: the Government commits, in the draft Letter (paras 47 and 49), to having privatized over 50 percent of the public enterprises' share capital in a two-year timeframe following completion of the preparatory work (reorganization of public enterprises into separate units, with coherent activity lines, and enactment of a conducive regulatory framework for private sector operators) required by second tranche release of the loan. The commitment to divest 20-25 percent of the public enterprises' share capital by second tranche release, mostly through transfer to a second-tier, fully-funded, private pension pillar to be established, has been maintained. The Government has confirmed in writing its intention to proceed with pension system reform, in the context of the preparation of a possible Public Sector Adjustment Loan.

(c) *Bank reform*: the Government has confirmed its intention to take over Privredna Banka (by negotiations), and to isolate it from its bad assets, or create a new bank with only the good assets, (by Board presentation). The draft LDP also reflects its commitment to privatizing the majority of the capital of the 'new Privredna Banka' (para 57).

4. The processing of this operation was subsequently delayed by the military operations which took place during the summer, and which led to early legislative elections (October) and the appointment of a new Government (early November). A second follow-up mission (December 5-15) was therefore fielded, and confirmed the new Government's full commitment to the previously developed program of policy actions. With the territorial issue now resolved, the authorities intend, and are more able, to focus on their economic agenda, spanning the reconstruction and the structural reforms.

II. Bank Strategy

CAS

5. The Croatia CAS was discussed by the Board on April 4, 1995. It called for a broad-based Bank assistance revolving around three major themes: (i) reforming public finance; (ii) encouraging private sector-led growth; and (iii) rebuilding and upgrading infrastructure. The CAS' base case also envisioned front-loading our assistance and quick-disbursing operations, resulting in lending levels of US$200 million during FY95-96, levelling off to US$100-150 million subsequently. In FY95, our commitment levels have been somewhat lower than anticipated under the CAS, at US$120 million (Health sector project and Highways project).

6. The CAS also envisaged a high-case scenario, which could be triggered by 'a successful settlement of the territorial issues and the beginning of a lasting peace in the region'. Such a scenario 'would not be significantly higher in terms of the number of projects, or in terms of overall lending levels -- perhaps only 10 percent higher over the next four years, with some additional lending for rehabilitation of major infrastructure, and/or for reconstruction assistance in the UNPA zones. But the main difference from the base case scenario would be in timing or size of the operations that the Bank would finance -- the program could be accelerated, with several of the investment operations initiated sooner or larger in scope, or geographical scale. Implicit in this high case scenario is that, under these peaceful circumstances, additional sources of finance, including private finance, would become more plentiful than in the base case, permitting the Bank's share in capital inflows to be lower in the outer years of the projection period than under the base case scenario.'

Recent developments

7. Macroeconomic developments since early 1995 have been reasonably good considering Croatia's warlike situation. On the positive side, inflation has been maintained at low levels (4 percent expected in 1995), and the fiscal deficit contained to about 1 percent of GDP on a cash basis in 1995, despite additional -- mainly military -- expenditures. On an accrual basis, however, the 1995 deficit stood at 2-3 percent of GDP and was financed through arrears, reflecting the fact that public finance have come under increasing strain. More worrisome, large wage increases in 1994-95 caused a deterioration of the current account[1], in the absence of a significant supply response: GDP grew by 1 percent in 1994, and an estimated 1.5 percent in 1995. These emerging macroeconomic imbalances point to Croatia's unfinished agenda in terms of structural reforms, particularly bank and enterprise restructuring and privatization.

8. But it is on the political/territorial fronts that the major developments took place. First, Croatia has regained almost full control over its territory, as a result of the military operations of May and August 1995 (Western Slavonia and Krajina), and of the agreement providing for the return of Eastern Slavonia to Croatia within two years, signed in the context of the Dayton negotiations. Second, the Dayton negotiations also led to a full-fledged peace agreement in Bosnia, the implementation of which is guaranteed -- at least for one year -- by an NATO-sponsored Implementation Force.

Implications for Croatia

9. The implications of the political/territorial developments for Croatia are complex to assess, and will probably unfold in two stages. In the medium-term, 2-3 years from now, and assuming that the peace agreement holds, there is little doubt that economic prospects are going to improve in a major way, and lessen the need for Bank involvement. The improvement can be expected to take place in three areas: (i) on the fiscal side, the reduction of military outlays (from 12 percent of GDP or more, to 'normal' levels, say 3-4 percent of GDP), and expenditure on displaced persons (currently 2 percent of GDP) should allow Croatia to both reduce taxation levels and increase its public investment effort, without incurring any significant fiscal deficit; (ii) on the external side, tourism recovery should generate recurrent foreign exchange receipts, equivalent to some 4-5 percent of GDP, that would reduce/eliminate the emerging current account deficit; in addition, Croatia can expect a significant increase in external savings, both loan finance and direct investment, which should help finance the investment needs of the non-Government sector; and (iii) in terms of growth, at least a one-time boost would result from some resumption of trade -- and other economic relations -- among the former Republics of Yugoslavia, and from the recovery of production in the regained territories.

10. In contrast with these clear prospects for a 'peace dividend' over the medium-term, the next two years are likely to be very challenging ones for Croatia. The settlement of the political situation in the region is too recent, and still viewed by many as too

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[1] Officially, a 9 percent of GDP deficit; probably half of this taking into account the large inflow of errors and omissions.

uncertain, for any of the positive developments mentioned above to take place rapidly. It is likely that, initially, military expenditures will show some inertia, tourism will recover only progressively, and external lenders will remain cautious. At the same time, short-term fiscal pressures are going to mount, because of the need to: (i) resettle displaced persons -- implying a large community reconstruction effort; (ii) accommodate some 100,000 demobilized soldiers (about 10 percent of the labor force); and (iii) reestablish public services and communication infrastructure in the formerly occupied territories. The resulting fiscal costs will hover around 10 percent of GDP over 2-3 years, and are likely to increase domestic absorption, either through a direct budget deficit, or through a tax-wage increase spiral. Fiscal constraints could also lead the authorities to delay the structural reforms that are necessary to stimulate the supply response, creating a serious risk of macroeconomic destabilization, through an external crisis or/and return to inflation.

High-case Scenario

11. Consistent with the high case scenario foreseen under the CAS, the 'backlog' of our commitments so far, and the serious fiscal constraints facing Croatia in the short-term, we would propose to increase significantly our lending levels for FY96 and FY97, from US$200 million to a US$250-270 million range, and then proceed with the scaling down initially envisaged (to a US$100-150 million range). The increase in commitments would result from: (i) one additional operation, the proposed Restoration of Regional Public Services project (RRPSP, US$110 million); this project would support infrastructure reconstruction in the territories recently regained by Croatia, but with special emphasis on subprojects also benefiting Bosnia-Hercegovina; and (ii) the acceleration of other operations; besides the RRPSP, seven loans totalling about US$200 million, are currently scheduled to be submitted to the Board between now and the early Fall 1996, the largest one being the proposed EFSAL (US$80 million).

12. While such a high-case lending scenario would appear justified on economic grounds, it may at some point raise issues from a political standpoint, and even expose the Bank to questions or pressures. First, the Croatian authorities have been criticized in several occasions, and recently condemned by the United Nations Security Council, for not actively enforcing the respect of property, security and other rights of Croatian Serbs. Our response has been, and would continue to be, a clear refusal to finance community reconstruction as long as the rights of Serb populations are not clearly recognized and enforced. The second issue regards the extent of Croatian cooperation to build the Croat-Moslem Federation in Bosnia-Hercegovina. A much stronger 'backing' of the peace treaty arrangements by Zagreb is critical in the next few months for the Dayton agreements to hold. We would propose to monitor carefully the developments in this area and, as needed, to take the opportunity of our largest operations to -- informally -- reinforce the international community's pressure.

Attachment:

Minutes of the Loan Committee
Revised draft Letter of Development Policy and Policy Matrix.

Distribution:

Operations Committee Members:

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Others:

. Messrs./Mmes. Sandström, Caio Koch-Weser, Einhorn, Frank, Lomax (EXC); Burki (LACVP); Jaycox (AFRVP); Cheetham (EAPVP); Wood (SASVP); Derviş (MNAVP); Lindbaek (CEXVP); West (MIGGU)

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: March 8, 1995

TO: Mr. Gautam Kaji, Chairman, Loan Committee (6)

FROM: Wilfried P. Thalwitz, Vice President, ECA

EXTENSION: 36860

SUBJECT: CROATIA: Country Assistance Strategy and EFSAL Initiating Memorandum Draft Minutes of Executive Review

1. The Loan Committee met on March 3, 1995, to discuss the proposed Country Assistance Strategy (CAS) for Croatia, as well as the Initiating Memorandum for the proposed Enterprise and Financial Sector Adjustment Loan (EFSAL). The Region was represented by Mr. Thalwitz (ECAVP), Mr. Derviş (EC2DR), Mrs. Wallich (EC2DR) and Mr. Godron (EC2CO).

Country Assistance Strategy

2. The Region explained that the CAS was currently scheduled to be presented to the Board four weeks after the expiration of the UNPROFOR mandate in Croatia (end-March), which the Government had decided not to extend. The CAS did not link the Bank's strategy to the non-renewal of the UNPROFOR mandate per se, but rather spelled out what would be the Bank's reaction to any resumption of hostilities that might ensue following the expiration of the mandate. The Loan Committee agreed to the Region's proposal to reconfirm the presentation of the CAS to the Board towards mid-April, based on the latest assessment of the political developments after the expiration of the UNPROFOR mandate.

3. The Chairman raised the issue of the sustainability of the fiscal adjustment underlying the overall economic program of the Government. The Region explained that fiscal adjustment would be sought through expenditure control and reduction rather than further revenue increases. The large increase in fiscal revenues in 1994 was sustainable because it was largely a catch-up on previous levels, resulting from the successful stabilization. From 1995 on, revenue policies will emphasize consolidation of the revenue base, with, for example, the introduction of a VAT, even though modest revenue increases could be yielded by further improvement in tax compliance.

4. A Loan Committee member inquired whether the reconstruction effort was credible, with Government's capital expenditure standing at 2.6 percent of GDP. The Region explained that the Government's program includes measures to increase capital expenditures to about 4.5 percent of GDP, a level that compares favorably to other Central European countries. In addition, only part of the reconstruction effort will have to be financed out of the Government budget, since public enterprises will be financing some of the infrastructure reconstruction themselves. Economic and sector work -- a Country Economic Memorandum -- will assist the Government in improving public expenditure and investment planning; a planned Public Sector Adjustment Loan will support Government's efforts to implement the increase in investment outlays and other expenditure reforms.

5. The Chairman, while supporting the CAS approach of an initial 'push' to Croatia's reforms, asked how Bank lending would evolve in the outer years. One Committee member inquired specifically about the prospect for the Bank entering into guarantee operations. The Region indicated that lending would, indeed, decline progressively, as the

agreement with the Paris Club, expected to take place during 1995, was expected to trigger support from official bilateral creditors. On the other hand, private sector flows could take longer to materialize, as the issue of former Yugoslavia's unallocated debt with the London Club was not expected to be resolved until 1996. This was also likely to delay guarantee operations in Croatia, although, in principle, the country strategy lends itsefl to such operations.

6. The Chairman expressed concern about the Croatian counterpart's ability to handle the relatively large number of loans anticipated by the CAS. A Loan Committee member also expressed concern that some projects might not materialize, should their triggers points not be reached. The Region answered that the Croatian Government had established an impressive record in terms of project preparation and implementation, and that the level of commitment to reforms, as well as the demand for Bank assistance, were high. The main potential constraint to implementation of the Bank's work program lay in the political risks, which called for continued cautious approach. It was agreed that, given the specificity of Croatia's political situation, the Loan Committee would review progress and developments during the course of CY96.

Enterprise and Financial Sector Adjustment Loan

7. The Chairman noted that, even after full completion of the EFSAL-supported reform program, the assets remaining in State hands would still be very significant: for example, Privredna Banka would not have been majority-privatized, and a large number of former socially-owned enterprises would still be held by the Croatian Privatization Fund; one

could also be concerned about the ability of the Bank Rehabilitation Agency to rapidly turn around banks and work-out problem loans. Should not one give a clearer sense of the end-objectives of the Government program, for instance in the Letter of Development Policy ? The Region agreed that, although the conditions of second tranche release were designed to sanction clear and substantial progress, in particular with respect to bank and enterprise privatization, the Government's medium-term program should be more clearly stated. Answering a question from the Region, the Chairman confirmed that at least the partial privatization of Privredna Banka was indeed critical in order for the Bank to be able to support the Government's program.

8. One Loan Committee member mentioned the risks of the 'rapid privatization' strategy for troubled banks, particularly in a context of weak regulatory and supervisory environment. Could not alternative scenarios, such as consolidating troubled banks into, for instance, a postal network, be allowed to take place in the second tranche conditionality ? The Region argued that the troubled banks were 'real' banks which, once their stock problems addressed, could effectively be allowed to compete with other banks. Also, their privatization did not preclude a subsequent evolution, e.g., mergers, that the Bank was not best placed to prescribe.

9. One Loan Committee member asked the Region about its plans to support more directly the development of the already large private sector. He also suggested that the transfer of State assets to the Pension Funds, already initiated by the Croatian Government, could be used to a larger extent, to accelerate enterprise privatization, facilitate the transition to partly-funded pension schemes, and stimulate the development of capital

markets. The Region responded that private sector development would indeed be the next priority following the EFSAL, and would be approached in cooperation with the relevant Bank units having developed expertise in this area. A capital markets development project was already being developed. The devolution of State assets to the Pension Funds, and their use, was also an issue under active consideration within the Government, and an integral part of the policy discussions with the Bank; the Region's view was that this would be appropriate only once a two-tier system was established.

10. The Chairman concluded that the Region should proceed with the appraisal of the proposed operation. The technical assistance component should be disjointed and processed as a stand-alone operation. A revised policy matrix and a draft Letter of Development Policy should be circulated to the Loan Committee upon return of the appraisal mission.

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REPUBLIC OF CROATIA

ENTERPRISE AND FINANCIAL SECTOR ADJUSTMENT LOAN

LETTER OF DEVELOPMENT POLICY

Note:

For the sake of clarity, and easy cross-reference with the draft Matrix of policy actions, this draft Letter of Development Policy mentions explicitly when policy actions are 'conditions of negotiations', 'conditions of Board presentation' or 'conditions of second tranche release'. As per the Bank's standard practice for LDPs, these references will be deleted, and replaced by actual or target dates, prior to the signing of the letter.

I. Background

1. *Pre-independence performance and legacy.* Croatia accessed to independence in 1991, inheriting a mixed economic legacy from the former Yugoslavia. Among its achievements, the Yugoslav economic system was far more market oriented than those of the planned economies of central Europe and the former USSR. Under the so-called 'social ownership' system, enterprises were managed in a decentralized fashion, and were free to make most pricing and investment decisions. The foreign trade regime was liberal, with very few quantitative restrictions and low tariffs -- with the exception of the agriculture sector, and no trading monopolies. Competition between socially-owned enterprises was encouraged, and trade between Yugoslavia and western Europe took place largely on market terms. Under this system, from its early years until 1980, Yugoslavia managed to realize growth rates of 4.5 percent p.a. on average, resulting in a five-fold increase of GDP between 1950-80.

2. However, growth required very high investment ratios averaging 25 percent of GDP -- financed in Yugoslavia's case by substantial external borrowing. Capital-intensive growth, in turn, resulted from the major shortcoming of the social ownership system: although it avoided some of the worst excesses of bureaucratic planning, it also resulted in poor investment decisions and had the additional weakness of encouraging chronic wage pressures. While these problems were masked as long as external financing was available and economic growth took place, they became apparent when the debt crisis developed in the 1980s. The scarcity of foreign financing caused investment, and therefore economic growth, to fall precipitously and enterprises began to generate widespread losses. These losses were in turn financed by the banks which were owned by the enterprises themselves, and monetized by the National Bank of Yugoslavia (NBY), resulting in loss of monetary control and inflation. The successive stabilization programs launched in the late 1980s were unsuccessful, as they failed to break the web linking the State, banks and enterprises. The loss of political control towards the end of the 1980s, and the resulting progressive dissolution of the Yugoslav federation led ultimately to the refusal of the republics to finance the federal budget, to open recourse to monetary financing, and to hyperinflation.

3. The circumstances of independence, the war and the dissolution of the former SFYR, worsened the economic decline that had begun under the federation. War inflicted considerable damage, estimated at several billions of dollars, on the country's infrastructure; particularly hard hit were roads and railways, telecommunications, energy, housing, and agriculture. The dissolution of the Federation also disrupted trade among former republics, resulting in a loss of markets and the interruption of key supply flows. And the war caused tourism revenues, a major source of foreign exchange for Croatia before independence, to fall to 10 percent of their 1990 levels.

4. *Post-independence crisis management.* As a result of these supply and demand shocks, GDP declined by 30 percent between 1991-93, and industrial output fell even more dramatically, mainly as a result of the disappearance of most of the former domestic markets, and despite the net positive transfer effect due to the declaration of independence from Yugoslavia. The first economic priority was to deal with inflation. Outright hyperinflation was avoided, through major cuts in real wages (60 percent during 1991-93) which helped reduce quasi-fiscal losses of enterprises, while leaving room for tax increases that allowed the Government to eliminate fiscal deficits. This was not enough, however, to reverse expectations, and inflation kept running at monthly rates of 20-30 percent. One of the adverse consequences was the continuous real appreciation of the domestic currency throughout the 1991-93 period, in spite of the Central Bank's attempts to keep the pace of nominal depreciation in line with inflation.

5. It was not until late 1993 that an exchange rate-based stabilization package gained sufficient credibility so as to manage to stabilize the currency rate and drastically reduce inflation. The CPI actually declined by 3 percent during 1994, and recorded a modest increase (4 percent) in 1995. The reversal of expectations led to a rapid remonetization of the economy, and monetary aggregates increased by more than 100% during the year that followed the announcement of the program. The price paid to eradicate inflation, however, was high, because of the limited progress made with structural reforms, and a vicious circle has been developing. Continued credit demands from loss-making enterprises, combined with a tight monetary stance, have driven real interest rates to levels of 20 percent or more. High interest rates have contributed, in turn, to capital inflows, adding pressure on monetary policy, and leading to further appreciation of the real exchange rate. The latter, in turn, has compounded the situation of loss-makers and contributed to depress economic activity.

6. *Emerging Macroeconomic Disequilibria.* Despite the success on the stabilization front, indeed, a number of developments indicate that the macroeconomic situation remains unsettled. Growth has been lackluster: GDP rose by less than 1 percent in 1994, and is expected to do only slightly better in 1995. Domestic demand, particularly consumption, has been the main driving factor of growth. Consumption growth, in turn, has been fuelled by a substantial rebound in real wages, which have grown by some 40 percent since the beginning of 1994. The public sector has also contributed to the domestic demand increase, as its net savings position deteriorated from a surplus of 1 percent of GDP in 1994 to a projected negative 2.5 percent of GDP in 1995.

7. In the face of increasing demand, domestic supply was unable to respond adequately. As a consequence, the external accounts have deteriorated fast. The current account, in surplus in 1993-94, is expected to deteriorate substantially in 1995, to some 9 percent of GDP. This dramatic figure requires some qualification, as large compensating 'errors and omissions' might indicate that the deterioration is partly due to exceptional war-related expenditures, or to foreign exchange dissavings. However, there is little doubt that the emerging macroeconomic imbalances are rooted in a combination of strong real wage growth, coupled with insufficient advances on productivity growth,

which result in loss of competitiveness. The policy response to these problems lies in our program of structural reforms, to stimulate private sector growth and productivity improvements.

II. Progress and Issues in the Enterprise and Financial Sectors

A. The Enterprise Sector

8. In former Yugoslavia, most enterprises were organized under the so-called 'social ownership' system. This system assigned enterprise ownership to the society at large, while day-to-day management decisions were assumed by managers and employees. While this system shared many characteristics of market economies, in particular decentralized pricing and investment decisions, it lacked effective governance mechanisms. This, together with the enterprise ownership of most banks (see Para. 25), resulted in loose financial discipline, excessive wage pressures, and poor investment decisions that led former Yugoslavia to stagnation and inflation at the end of the eighties.

9. Despite the prominence of the socially-owned sector, the private sector was permitted to play a notable role, especially in small scale agriculture, retailing and tourism. This private sector presence in the economy was substantially reinforced after Croatia's independence, as significant progress was being made towards the privatization of the socially-owned sector (see next paragraph). As a result, the private sector now generates about 45 percent of GDP.

Ownership Transformation

10. Under the privatization strategy developed immediately following independence, socially-owned enterprises were divided into two groups. The large infrastructure and utilities companies came under direct State ownership with the designation of 'public enterprises' (PEs). These enterprises are 10 in number, account for about 10 percent of GDP and 12 percent of the enterprise sector's total work force. They include: INA, the biggest Croatian enterprise, a large oil conglomerate, diversified in chemical products, tourism, and other activities; HE, the electricity company; HZ, the railways company; HPT, the post and telecommunications company; and others in the forest, shipping, broadcasting, publishing, and water sectors. PEs have not been included in the privatization program until now. This is partly due to the war, but more so because the major public enterprises are very large entities with complex corporate structures, some in a uncomfortable financial situation and in need of significant restructuring.

11. The remaining socially-owned enterprises were to undergo privatization and/or commercialization, under the two-stage privatization process envisioned by the 1991 Law on the Transformation of Socially-owned Enterprises (the Transformation Law).

12. During the so-called 'first stage' of transformation, socially-owned enterprises were to submit to the Croatian Privatization Fund (CPF), a Government agency, their requests for commercialization, together with their own privatization plans, if any. The first stage also placed a strong emphasis on wide participation by the enterprises' workers and the population at large, with much less concern for generating revenues for the State from the sale of enterprises. Employees and the population were awarded preferential rights for share subscription with significant discount (averaging between 40 and

50% and representing about US$ 5,000 per person) and option for installment payments for the non-discount part (over 5 years).

13. The shares of enterprises not privatized under this first stage were to be transferred to the Croatian Pension Funds (one-third) and to the CPF (two-thirds). The latter was required, under the Transformation Law, to divest its residual holdings through a variety of methods, including auctions on the Zagreb Exchange, tenders open also to foreign investors, direct trade deals, and free distribution of shares to war veterans (the so-called 'second-stage' of transformation).

14. Significant progress has been made under our transformation program. As of December 1994, about 2,100 of 3,000 socially-owned enterprises, 70 percent of the initial numbers accounting for about 50 percent of the book value of privatizeable companies, had been fully or majority-privatized[1]. These companies account for 29 percent of employment, and 26 percent of revenues, of the entire enterprise sector. It is also worth noting that our privatization model has led to a widespread participation of the population, with more than 500,000 citizens having already acquired shares in more than 2,000 enterprises - thereby implementing a form of mass privatization program. [By Board presentation], the first stage of transformation will have been completed by all enterprises, and there will be no socially-owned enterprises left: about 80 percent of them, or about 2,500, will have been privatized, and the other 500 will have been commercialized, with their ownership transferred to the CPF. We refer to these as formerly socially-owned enterprises (FSOEs), although they are formally state owned, to distinguish them from public enterprises.

Enterprise Performance

15. The available evidence suggests that the enterprise sector overall suffered significant cash losses during 1992-93, although thorough analysis is not possible because of the inadequacy of accounting practices for the hyperinflationary environment that prevailed during these two years. The most recent full-year data (1994) indicate that the profitability of the enterprise sector was very low in aggregate: accounting profits stood at about 0.3 percent of GDP, the net result of profits equivalent to 4.3 percent of GDP and losses of 4.0 percent of GDP.

16. Within the enterprise sector, however, private enterprises, particularly the emerging private sector, fared considerably better, accounting for two-thirds of total profits but only for one-third of total losses. And only the 'new' private sector appears as a net profit maker. The loss problem is therefore, and not surprisingly, concentrated on publicly-owned enterprises, both FSOEs and PEs. Of the 500 FSOEs now in the hands of the CPF, about 25 larger ones are the most serious lossmakers, and account for almost one third of total enterprise losses in 1994, i.e., about 1.3 percent of GDP. These are generally large employers at the regional level (e.g., shipyards). Public enterprises (particularly INA, HE, HZ, and the coastal shipping company) incurred large cash losses in 1991-92 (over 3 percent of GDP), for a large part the consequences of the damage and loss of traffic resulting from the war. Tightened controls and tariff-adjustment measures —- particularly in the electricity sector, allowed us to reduce public enterprise losses significantly. In 1994, only HZ and the shipping company incurred cash losses -— totalling 2.2 percent of GDP —- which were covered by budget subsidies.

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1 1145 fully—and 921 majority—privatized.

17. The problems in large loss-making FSOEs and PEs, however, are far greater than is suggested by their cash flow losses. First and foremost, a number of them are not servicing their external debt (about US$2 billion as of end-1994) and the losses would be far greater if these obligations were factored in. Second, the war destroyed part of their capital stock: HZ, HE and, to a lesser extent, INA, have suffered extensive destruction of their assets. Low or negative profitability makes it impossible for these enterprises to finance the investment program that they should be undertaking. And third, break-even results or moderate losses often mask extensive cross-subsidization between profit- and loss-making activities within the same group; the complex structure of some of these enterprises serves as a device to circumvent financial discipline (profit-making entities finance, out of their own or borrowed funds, loss-making ones), perpetuate less than optimal asset allocation and, in some cases, evade taxation.

Shortcomings in Enterprise Privatization

18. The concentration of enterprise problems within Government-controlled enterprises, both public enterprises and formerly socially-owned enterprises owned by CPF, points to the need to complete the privatization process, and to what we view as the shortcomings of the methods used until now.

19. The first and major such shortcoming lies, as we already pointed out, in the fact that PEs have been left outside the scope of privatization so far. This weakness is being addressed by our new privatization strategy (see para 33 below). With respect to FSOEs, while the results of the privatization program to date are far from being negligible, a series of problems have become evident. The 'second-phase' privatization methods, in particular, have not proved as effective as was initially hoped, and the CPF is experiencing difficulties in divesting the 500-odd largest FSOEs left in its portfolio.

20. Among the identified shortcomings comes first the problem of the original valuation of the enterprises adopted as reference price. This valuation, which often resulted in a highly overestimated nominal equity of the enterprises, was rigidly used as the reference value below which the CPF has generally been reluctant to sell (in auctions and trade deals), thereby frustrating demand for shares at prices reflecting the market. Second, there is the complexity and size of many old conglomerates which the first phase of the program commercialized as one enterprises, failing thus to break them in smaller selfcontained enterprises that are easier to privatize. Third, the CPF's capabilities and operating procedures have become insufficient to deal with the residual privatization cases; the decision-making process is cumbersome, as every single decision has to made by its large Board comprised of many outsiders with limited privatization-related functions or experience. Fourth, the privatization program has lacked a comprehensive and sustained efforts to attract foreign investors, beginning with a thorough identification of enterprises likely to attract such investors followed by a marketing campaign abroad. Fifth, tenders/auctions through the Zagreb Stock exchange have been hampered by the lack of development of capital markets; in more general terms, secondary trading is slowed down by the lack of a modern 'fail-safe' share registry and clearing system. Finally, a more intensive campaign of education of the population on privatization matters, including the legal principles of shareholding and governance of commercial code companies, combined with more intensive public relation efforts of the CPF, may have increase the population's adhesion to privatization and dispelled criticism on alleged lack of transparency of part of the process. Stronger

public relation would also have improved the perception of the Croatian privatization programs abroad.

21. Over the past year, we started to address the most critical of these issues, the overvaluation of enterprises, by allowing holders of foreign exchange deposits, that had been frozen following a post-independence liquidity crisis in 1991, to use them towards the purchase of enterprise shares. The scheme had the advantage of at the same reducing the public debt and bolstering privatization, and proved to be quite popular. Since the beginning of its implementation in early 1994 until last December, it has generated sales with a total amount of frozen deposits of US$800-900 million equivalent, as a dynamic secondary market of foreign exchange deposits has developed between depositors facing liquidity problems and individuals or entities seeking an indirect discount on the purchase of enterprise shares.

B. The Financial Sector

Overview

22. Like the enterprise sector, the Croatian financial system was spared many of the flaws commonly encountered in command economies. Croatia does not have any specialized banks, and moved to a two-tier commercial banking system in the early sixties, much earlier than most other transition countries. Most of the 25 commercial banks established before independence (out of 48 today) have been operating 'commercially' for several decades, including with Western countries, and have developed reasonably good banking skills. This helps explain a fairly high degree of financial intermediation. Despite the high inflation levels experienced during 1991-1993, local currency deposits of the banking system still stood at about 8 percent of GDP before the October 1993 stabilization plan. As a result of the success with disinflation, they rapidly increased to about 20 percent of GDP by end-1994, a level comparable to many other Central European countries.

23. Despite the number of banks in operation, competition in the financial system is still quite limited. Non-bank intermediation is underdeveloped, with only a few, small-size, insurance companies, and an infant Stock Exchange. And the banking system exhibits a high degree of concentration. The two largest banks, and only nationwide networks, Privredna Banka and Zagrebacka Banka, each account for about 25 percent of the banking system' assets. The next four banks[2], each with more of a regional focus, represent another 20 percent of the banking system's assets. And the 23 commercial banks privately-established since Croatia's independence, including only one foreign bank, hold only 4 percent of the system's assets, although neither regulations nor policies prevent entry.

24. Unfortunately, other, more severe, problems were inherited from the former Yugoslavia. The banking system is still operating under a flawed incentive framework, mainly perverse ownership structures, that have resulted in portfolio problems, a legacy of the peculiar Yugoslav system of enterprise-owned banks. This was compounded by several interventions of the Government, which imposed on banks a significant degree of financial repression. As a result, serious financial

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[2] Three on the Dalmatian coast: Istarska Banka (in Pula, Istria region); Rijecka Banka; and Splitska Banka. One in Eastern Slavonia, Slavonska Banka (Osijek).

imbalances have developed in the banking system, particularly in five problem banks. These imbalances, in turn, led to high lending rates and distortions in credit allocation, and could seriously hamper the banking system's ability to contribute to private sector-led growth in Croatia.

Incentive Framework

25. *Ownership structure and bank performance.* Under former Yugoslavia, banks were typically majority-owned by socially-owned enterprises, which would sit on their governing bodies, supervisory boards and management boards. This ownership structure led to widespread related-party lending, particularly in the case of five of the bigger banks that were owned by large and influential enterprises. Only Zagrebacka Banka was spared the worst effects of this system because its shareholders were a diversified group of small enterprises, none of them important enough (their stakes were no more than 2-3 percent of total capital) to skew lending decisions. This bank is now majority privately owned.

26. The Government endeavored to solve the bank ownership issue in 1991, through the so-called 'big bond' scheme, under which overindebted enterprises were given Treasury bonds that they could use to 'repay' their loans. However, this scheme failed to address the issue of the banks' shareholding structures which, today, remain essentially those inherited from pre-independence, and related party lending is still a pervasive phenomenon. An estimated 35-40 percent of the banking system's aggregate loan portfolio involves loans to shareholders or related parties, and this proportion is even higher in the case of some banks. It is 80 percent in the case of Privredna Banka, the capital of which is controlled by some of the largest public enterprises.

27. Transactions with shareholders are closely related to the loan portfolio problems that the banking system is now experiencing. Some US$ 1.8 billion of foreign currency loans (21 percent of the total assets carried by banks) are only partly serviced by end-borrowers. These loans, funded by external borrowing, were extended mainly to troubled public enterprises, primarily INA, HE, and HZ. Some loss-making CPF-owned enterprises such as the shipyards also benefited. In addition, based on the special reviews recently carried out, at our request, by international auditors, as much as one-third of the loans funded out of the banking system's domestic resources (9 percent of the banking system's total assets) is also non-performing/impaired (this takes into account bad loans that have been converted into equity).

28. *Past Government interventions and bank performance.* The banks' ability to operate along market lines was further impaired by three factors, the effects of which were akin to financial repression. First, before independence, as in the case of many command economies, the banks' foreign exchange deposits had to be surrendered to the central bank (NBY) for dinars that were in turn lent. This allowed banks to make hefty short-term profits (the dinar interest rates were far above the deposit rates in foreign currency) but exposed them to a massive currency and foreign exchange liquidity risk. After independence and the loss of Croatia's access to its share in the former Yugoslavia's foreign exchange reserves, the Government decided to freeze all foreign exchange deposits. Banks were provided with Government bonds, the proceeds of which were to be used to repay depositors in 20 semi-annual installments, starting in 1995. But the status of these balance sheet items (US$2.2 billion or 23 percent of total assets) is unclear; the bonds are at best a pass-through activity generating no income for banks; indeed, budgetary constraints led the Government on several occasions to reschedule the payment of interest, and more recently the principal, due on account of these bonds. Second, the "big bonds" issued by the Government (10 percent of total

assets) do not carry market terms, and entail a loss for banks. And third, banks are further penalized by high levels of mandatory reserves (25 percent of domestic currency deposits on average, or 5 percent of total assets) which are remunerated well below market rates (5 percent vs 18-20 percent).

Financial Imbalances in the Banking System

29. As a result of related party lending and the design of past Government interventions, the Croatian banking system is now plagued with an extremely high proportion (about 85 percent) of illiquid and/or non-performing assets. Although a large fraction of the banks' liabilities (about 70 percent), including capital and reserves—does not bear interest either (e.g., banks are not servicing their external debt), there remains a large imbalance between interest-bearing liabilities and interest earning assets (30 and 15 percent of total assets, respectively). As a consequence, deposit/lending spreads are massive, with lending rates some 15 percentage points above the already high deposit rates of about 5 percent. With annual inflation rates at 3-4 percent, real lending rates stand at 16-17 percent p.a., a level that entails a high level of cross-subsidization from relatively good quality to bad borrowers, and is evidently incompatible with any sustained recovery of the economy in the medium-term.

30. In addition to high lending costs, the large volume of non-market assets severely impairs the banking system's ability to service the needs of the economy, in at least two ways. First, little financing is available for the needs of the emerging private sector, because: (i) the rotation of 'old' assets is extremely slow, limiting the banks' ability to reallocate financial resources from less to more profitable - and efficient - uses; and (ii) in the absence of a systematic workout of problem loans, part of the 'new' resources flowing into the banking system are used to capitalize interest or even to increase the exposure to illiquid customers.

31. *Problem banks*. Although almost all pre-independence banks are to some extent affected by the problems discussed above, we deem that five banks, accounting for about 50 percent of the banking system's assets, are the most severely affected[3]. The key problem bank is Privredna Banka, which is heavily handicapped by its ownership by, and lending links to, public enterprises. Close to 50 percent of its capital is held by a small number of problem public enterprises (of which over 25 percent by INA alone). Some 80 percent of its loan portfolio is exposed to problem enterprises, particularly its two main shareholders. Alone, Privredna Banka accounts for two-thirds of the entire foreign debt channelled through the banking system, which, in turn, makes up about half of its balance sheet. In addition, the special audit of Privredna Banka recently completed brought to the light a series of severe deficiencies in the areas of internal procedures, organization, and risk management. The four other regional banks exhibit, to various degrees, similar ownership and financial patterns, although their customers are regionally sensitive enterprises, such as the shipbuilding industry or agricultural kombinats. Together, these five problem banks hold 84 percent of the banking system's foreign borrowings/loans; 72 percent of the big bonds; and 44 percent of frozen foreign exchange deposits.

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[3] Privredna Banka, the largest of the two nationwide banks (30 percent of the banking system's assets); and four regional banks: Splitska Banka; Rijecka Banka; Slavonska Banka; and Istarska Banka. Although Zagrebacka Banka does hold significant amounts of frozen deposits, it has minimal foreign debt and big bond exposure.

III. The Government's Reform Program

32. Our objective of private sector-led growth requires not only the acceleration of enterprise privatization, but well-functioning financial intermediaries. However, a large part of the banking system's problems lies in the losses incurred by its main borrowers. Thus, addressing only capital adequacy and incentive issues in the financial sector, without eradicating the root of the enterprise sector's losses, is unlikely to bring more than temporary relief. We are therefore determined to address jointly the problems in the financial sector and the enterprise sector, and to sever the ownership links between the two. Our program envisions the accelerated privatization of CPF-owned enterprises, the restructuring and privatization of public enterprises, the rehabilitation and privatization of the banking system, and the strengthening of the enabling environment, in order to enhance corporate and bank governance.

A. Privatization of Former Socially-owned Enterprises

33. Recognizing the current shortcomings in the privatization program and the urgent need to introduce remedial measures to complete the privatization process, we have developed a revised privatization strategy. This strategy calls for the full divestiture of almost all FSOEs within a three year time period, with the exception of some [30] large troubled enterprises that would be dealt with by the Bank Rehabilitation Agency. It also envisions the rapid privatization of the larger part of the public enterprise sector (section B, below). The new privatization strategy is embodied in a new Privatization Law that was adopted by our Parliament in [March 1996 - condition of Board presentation], and which complements and amends the Transformation Law of 1991.

34. Our strategy to accelerate the privatization of FSOEs rests on five sets of policy measures: (i) a 'mapping' of privatization, with a view to clearly assign different subsets of enterprises to different privatization routes; (ii) additional privatization methods, particularly mass privatization; (iii) improvements to existing privatization methods, tenders and auctions; (iv) key changes in the institutional framework, mainly the creation of a new Ministry of Privatization that takes over some of the CPF's responsibilities; and (v) additional measures regarding the restitution issue. These measures are detailed below.

'Mapping' of privatization

35. To avoid later confusion on the scope of each privatization method, as seen in other countries, we have carried out a 'mapping' of privatization, distinguishing which enterprises can be more efficiently and expeditiously divested through the different privatization methods. The shares of FSOEs still held by the CPF have been divided in four subsets: (i) majority, or large, blocks of shares in a group of about [50] medium- to large size enterprises most attractive to strategic investors, particularly foreign ones, have been set aside; they will be offered in tenders and, when appropriate, direct trade deals; the value of this subset of shares accounts for about [20-25] percent of the CPF residual portfolio; (ii) another batch of [150-200] enterprises in good financial standing, together with minority blocks of shares in the [50] enterprises earmarked for strategic investors, will be offered to the population targeted under the new mass privatization scheme; the value of this subset of shares accounts for about [50] percent of the CPF residual portfolio; (iii) the CPF shares in [30-odd] large troubled enterprises will be transferred to the Bank Rehabilitation Agency, in the context of the rehabilitation of selected banks (see section C, below); and (iv) all remaining enterprises, or blocks of shares, will be privatized through improved existing methods (auction/tenders with market-clearing prices). After a 12 month period, we will re-assess progress made under direct sales/tenders for foreign investors, and improved existing methods. If these

are not satisfactory, we will expand application of the mass privatization scheme to encompass a major part of the residual shares.

Additional Privatization Methods

36. While improving the auction/tender mechanisms already used (see para 39 below), we intend to diversify privatization methods, essentially with the implementation of a new, large scale, mass privatization scheme, and place greater emphasis on trade deals and direct foreign investment (DFI).

37. *Mass privatization.* The new mass privatization scheme will be based on the free distribution of vouchers to two categories of adult population which did not participate in the first round of privatization: the displaced persons and refugees of the war; and the disabled war veterans, their families and those of missing persons. These categories of population, totalling about [300,000] individuals, will be entitled to US$ 3,500 to 5,000 equivalent per person, depending on the specific subcategories. The new scheme will therefore result in a free distribution of shares of [US$ 2 to 3 billion], or about 50 percent of the residual CPF portfolio. The recipients will receive vouchers (non transferable) that they will be able to either exchange into shares of companies of their choice, within the selection offered by the CPF, or contribute to newly created privatization investment funds (PIF), in exchange for PIF shares. These privately managed PIFs will in turn use the collected vouchers to purchase enterprise shares from CPF and build up their portfolios. We will foster the creation of several such PIFs by helping private investors provide the initial minimum capital, regulating their by-laws and setting eligibility criteria and minimum professional standards to be satisfied by their management[4]. More broadly, we will also encourage the emergence of additional investment funds under entirely private initiative to collect shares already subscribed by the population in the past, in order to concentrate enterprises ownership, improve their governance, and leverage additional capital which investment funds will help mobilize. Approval by the Parliament in [December 1995 - condition of Board presentation met] of the new law on Investment Funds was a key step in that direction. Depending on the success of the first PIFs and on the residual shares left in CPF's hands in one year, we will consider the option to contribute also some of the residual CPF blocks of shares to the PIFs. We will also review the option to earmark up to [10] percent of the PEs' shares to the PIFs (while increasing the PIFs' shareholders base through an additional round of free distribution or subscriptions at discount) to accelerate the privatization of these large PEs.

38. *Trade deals.* For those enterprises that have good financial and commercial market prospects, we are keen to develop trade deals by which controlling stakes will be acquired by local or foreign investors. We are aware, in particular, that DFI can not only bring the widely recognized benefits associated with strategic investors, but also enhance the image of Croatia abroad, and in a snowballing effect attract more investments in the country - particularly if the large Croatian diaspora (some 3.5 million people according to some recent estimates) can be encouraged to participate. We will therefore encourage DFI at the soonest, using the recommendation of the recent FIAS diagnosis on the general environment for foreign investment. Starting with the [50] enterprises identified as the best prospects for trade deals [tentative list to be prepared before negotiations], we are adopting a more proactive attitude, not waiting for possible investors but promoting sales abroad through different means, particularly with

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4 Fund managers will be carefully selected through bidding or tight criteria used for licensing candidates; the government may envisage that managers be guaranteed a minimum fixed fee for the initial years, depending on the quality and liquidity of their portfolio.

well-focussed promotion campaigns. For this purpose, the use of specialized advisors, which has proven to be essential for such activities in other countries of the region, will be developed.

Improving Existing Privatization Schemes

39. As explained above, we will keep using the existing privatization methods to sell some of the enterprises held by the CPF, and are therefore keen to enhance their effectiveness through a series of improvements. First and foremost, the key issue of rigid valuation of enterprises and floor price setting - which affects not only small and medium enterprise privatization but also large trade deals, is being addressed. Under the new privatization Law, the reference price at which CPF will initially propose enterprises for sale is the latest book value, i.e., a more realistic estimate than under the previous legislation. The new Law further empowers the CPF to adjust the selling price to actual market conditions, i.e., to sell at below the reference price. In the future, it is our intention to use systematically these new provisions, and to allow prices to clear the market as a matter of policy.

40. Second, we are improving further the flexibility of payment methods for shares, so as to improve market liquidity and stimulate demand. The new privatization Law has now extended from five to twenty years the period under which shares can be paid in installments by individuals, while maintaining specific and attractive discounts for early cash payments. In addition, the option to pay for enterprise shares with frozen foreign exchange deposits will be not only kept in use, but extended to all enterprises, thus providing additional flexibility to the price determination mechanism.

41. Finally, the CPF will also endeavor to break up large conglomerates under its majority control, into smaller units that can be more easily privatized. Outside experts will be hired to help design such break-up programs.

Institutional Framework

42. In order to improve decisively the speed and effectiveness of the decision-making process in the area of privatization, we recently carried out important institutional changes. First, a new Ministry of Privatization (MoP) was created in November 1994, as part of a broader change in structures of the Government. The MoP has now received its core staff, and has effectively started to operate. Second, the responsibilities for enterprise privatization have been redistributed between the CPF and the MoP. The MoP is now responsible not only for the overall formulation of the Government's privatization strategy, but for decision and implementation in the case of the Government's two largest privatization subprograms: mass privatization, and public enterprises. Despite the drastic reduction of the CPF's role, we still believe, as previously noted, that its decision-making process needs to be reformed, although the matter has now become much less urgent. We will therefore enact, [by May 1996 - condition of Board presentation] a Law modifying the composition of the CPF Board, and redistributing decision-making responsibilities between the Board and the President of the CPF.

Compensation of Previous Owners

43. The Republic of Croatia has not yet passed a law addressing in a comprehensive manner[5] the issue of compensation of former owners of property nationalized after 1945. So far, this had not delayed privatization, as the CPF resolved the issue on a case-by-case basis, setting aside shares of privatized enterprises with a view to their eventual transfer to previous owners. But restitution is likely to become more of an issue, with growing numbers of trade deals and increasing DFI, and the Croatian population's growing expectations on the subject. We are therefore preparing a new restitution law, which we intend to have adopted by Parliament in late 1996.

Privatization targets for FSOEs

44. The existing privatization methods, including the improvements brought during the course of 1994, already allowed us to complete the 'first stage' of transformation for all FSOEs, and to make progress with the 'second stage': [10] percent of the share capital of the FSOEs still owned by CPF, pension funds or not yet transformed as of end-1994 was privatized by [May 1996 -- condition of Board presentation]. We expect that the implementation of the policy reforms discussed earlier will bring about a dramatic acceleration of the privatization process. Mass privatization, in particular, will result in a quantum leap and allow us to have privatized, by [the end of 1997 -- condition of second tranche release], at least another 40 percent of the share capital of FSOEs unsold as of end-1994. Either through the traditional sale methods, or additional rounds of mass distribution, we expect to have privatized another 20-25 percent of this initial share capital by the end of 1998 at the latest, and to have divested the bulk of the CPF holdings by the end of 1999 at the latest. By then, we would therefore be able to wind up the operations of the CPF, dissolve the institution, and transfer any residual holdings of shares, which would be small if any, under the direct responsibility of a regular Government agency such as the ministry of Finance.

B. Public Enterprise Privatization and Reform

45. We envision the privatization of the larger part of the public enterprise sector, including INA, the telecommunications, and the production and distribution of electricity, within a two to three year timeframe. The privatization of these large enterprises will start within six to nine months, immediately after some initial reorganization, for instance the legal and financial separation of businesses to be sold, and the establishment of a regulatory framework conducive to the entry of private sector operators. For those enterprises, as well as for those not immediately earmarked for privatization, such as the railways, we have also identified non-core assets, including real estate, which we will immediately proceed to privatize. Pending privatization, and for those enterprises that will remain publicly-owned over the longer term, we will carry on the work already undertaken during the past years, towards improving their governance, and further reducing their losses.

46. A telling illustration of the problems we are facing in order to privatize public enterprises is the case of INA, a very complex group with widespread activities. Some of the units in the group are now

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[5] Some limited legal provisions on compensation can be found in various laws and regulations adopted since Crate independence.

making significant losses and may not have real prospects of financial viability. The profitability of other units may be worse than realized until now, due to the lack of transparency in the transfer pricing between companies. In addition, the modernization requirements of the group's core activities will entail considerable financing needs which are likely to preclude any significant financial transfer or additional borrowings by the mother company to finance the restructuring and/or modernization of the non-core activities of the group. A drastic reorganization/restructuring plan is thus needed, in order to concentrate and downsize the group to its core activities, close down or divest others, restore its financial viability (among other things through debt restructuring) and improve its working capital position. Sales of non-core assets (such as hotels and other tourism assets) will be carried out. Strategic and financial partners will be sought to enter in joint ventures for core activities. An overriding consideration will be to allow the group to develop its key oil and gas activities, but without any direct or indirect government subsidies, while restoring its financial situation and make it attractive for early privatization.

47. *Privatization.* As mentioned above, the sale of our largest public enterprises will require both reorganization measures and, especially in the electricity and telecommunications areas, the definition of an adequate regulatory framework. These sales would therefore not start until early-mid 1997, but could quickly reach a critical mass as a significant part of the capital would be divested through the various methods envisioned in the new Privatization Law: (i) the population at large [and the enterprises' employees] will be allowed to subscribe PEs' shares, as was allowed for the FSOEs (with the same ceilings, discounts and payment terms); (ii) large blocks of shares of each PE, up to 25 percent of their capital, will be 'sold' to the new funded pillar of our pension system, which we are preparing to introduce by the beginning of 1997, with the Bank's assistance; the management of these shares before the actual introduction of this second pillar, and the specific modalities of their sale to the new, privately-managed, pension funds, will be discussed, and agreed on,-with the Bank in the context of its work on pension and public sector reform; (iii) large blocks of shares would be sold to strategic investors, according to schemes that will be tailored to each PE. Some of the shares could also be at a later stage allocated to the PIFs under the mass privatization scheme. We expect to be able to divest [20-25] percent of the capital of PEs by the end of 1997, mostly through population purchases and transfers to pension funds [condition of second tranche release]; sales to strategic investors would start in mid-late 1997 and would allow us to privatize, in the aggregate, another [25-30] percent of the PEs' capital within the subsequent two years.

48. *Pre-privatization measures.* We have already started to implement the preparatory measures that will lead to the privatization of the larger public enterprises. INA, following the completion of a consolidated accounting audit of the group, has now commissioned [condition of Board presentation] three sectoral studies that will pave the way for its reorganization (review of the hydrocarbon supply chain; of the petrochemical business including fertilizers; and of the retail network). INA has also contracted, with an international investment bank [condition of Board presentation] the preparation of a comprehensive plan for the whole group which, building on the finding of the three sectoral studies, will cover group restructuring and development, as well as a detailed privatization strategy. The organizational restructuring of the group should be completed during the first half of 1997 [condition of second tranche release].

49. With respect to HE and HPT, studies have also been commissioned recently [condition of Board presentation], that will cover both the reorganization into coherent activity lines, and the regulatory framework needed by private sector operators, particularly with respect to tariff. The separation of HE into three lines of activity, production, transmission and distribution, was already authorized in principle by the 1994 Law that transformed HE into a joint-stock company. A similar draft Law providing for the

separation of postal and telecommunication activities was recently submitted to our Parliament. We expect the reorganization of HE and HPT to be completed by the end of 1997. This is also the target date for the enactment of the regulatory framework needed to govern the private provision of public services [conditions of second tranche release].

50. *Sale of non-core Assets*. The list of non-core assets of INA and the other key PEs, that we recently established [condition of Board presentation], represents a total value of about US$ [ ] million equivalent, and includes activities such as [ ]. The sale of these non-core assets will start immediately, and we expect it to be completed by the end of 1997 [condition of second tranche release].

51. *Governance and loss containment*. Governance of public enterprises was dramatically improved, beginning in 1993, with the establishment of the Office for Restructuring and Economics of State-owned Enterprises (ORESE), a small unit reporting directly to the Government level. ORESE can already boast significant achievements. First, it has radically improved the Government assessment of the public enterprises' financial performance, through proper external audits and quarterly monitoring of financial indicators, including cash-flows. As already discussed, this helped reduce Government subsidies. Second, ORESE was instrumental in preparing, over a short time period, the set of laws that provided for the commercialization of public enterprises, and which paves the way for their privatization. Specific measures to reinforce ORESE's capabilities, mainly through increased staffing and outside assistance, have been identified, and will be implemented at the latest by December 1995.

52. Under our program, we will continue to tighten the financial discipline imposed on public enterprises. A key measure will be the improvement of collection on some of the public enterprises' foreign currency debt. Currently the public enterprises' ownership of banks, particularly Privredna Banka which holds two-thirds of the foreign currency debt, reduces considerably the prospects for effective repayment. Under our plans for bank rehabilitation (see, below, section C), non-performing loans would be removed from the troubled banks' balance sheets, and transferred for collection to a newly established Government agency, the Bank Rehabilitation Agency.

53. With respect to the two public enterprises that continue to incur cash losses before servicing of the external debt (HZ and the shipping company), we already took some measures, initial restructuring and tariff increases, that will allow a reduction of these losses from 2.2 percent of GDP in 1995 to [1.5] percent in 1996. These losses will be financed in a transparent manner, out of budgetary subsidies. In addition, the Government will continue to enforce, as per our Stand-by Agreement with the IMF, strict ceilings on net credit to the key problem public enterprises (INA, HE, and the shipping company). The loss-making PEs having effectively reduced their losses in 1996, we will then agree with these PEs on targets for further reductions of their losses for 1997 [condition of Board presentation], to be effectively financed from the budget [condition of second tranche release].

C. Rehabilitation and Privatization of Problem Banks/Enterprises

54. Our program aims to place the banking system under a sound incentive framework that will avoid the recurrence of the present problems, and enable it to channel new flows of resources to a wider segment of sound borrowers, at a lower cost. Achieving this objective will require three sets of actions. First, we will resolve the issue of the enterprise ownership of the troubled banks, by taking banks over, and seeking their privatization. Second, in order to make privatization a credible option, the troubled banks' balance sheets will need to be 'cleaned-up', both from exposures to their largest problem

customers, and from non-market claims on the Government that entail an indirect taxation effect. And third, exposures to large problem enterprises will be transferred to the Bank Rehabilitation Agency (BRA), a Government agency, and worked out by or under the control of the BRA. Smaller problem enterprises will worked out by the banks themselves, under BRA supervision. The legislation enabling us to carry out this bank reform program was enacted by the Croatian Parliament in June 1994, and revised in [May 1996 - condition of Board presentation].

55. *Scope*. We commissioned in 1995 diagnostic studies that cover nine of the largest Croatian banks accounting for [85] percent of the banking system's assets, and which were performed by international firms that are different from the banks' regular auditors [condition of Board presentation - met]. In addition to assessing the banks' financial and portfolio condition, the studies reviewed their corporate governance, organization and procedures, and risk management policies. Based on these studies, we have identified five banks (Privredna Banka and four regional commercial banks[6]), accounting for about [50] percent of the banking systems' assets, that raise, to various degrees, problems in terms of either/and their governance framework, their level of solvency or their liquidity. Considering their importance either at the national or the regional level, these banks have been earmarked for rehabilitation. However, we do not rule out the possibility of opting, after the start of the rehabilitation process, for the liquidation of one or several of the smallest troubled banks.

56. *Take-over and privatization of problem banks*. The BRA Board of Directors recently decided to rehabilite the five troubled banks [condition of Board presentation]. This formal step will enable BRA to assess the performance of the incumbent bank management and proceed with its replacement when deemed necessary. Whether management is replaced or not, BRA will oversee the banks' day-to-day operations, including control over lending decisions, until they can be privatized. Since all five banks are currently majority-owned by PEs or FSOEs, their privatization requires that BRA first gain a majority stake in their capital, on its own or together with existing private shareholders, if any. This common objective is being pursued through somehow different routes, depending on each bank's particular situation: (i) in the case of Privredna Banka (PBZ), BRA already wrote off most of the bank's existing equity against losses or provisions; to ensure a clean break from the complex history of PBZ, BRA created a new bank that took over most of the infrastructure of PBZ, and its sound assets, through a purchase and assumption transaction; the new bank is now under the direct control of BRA [conditions of Board presentation]; (ii) in the case of Slavonska Banka, which we deem to be the least troubled and best-managed of the five banks under rehabilitation, provisions for losses, although quite significant, did not result in reducing the previous shareholders' equity; the BRA therefore gained ownership control of the bank through a capital increase; (iii) for the three remaining banks, we anticipate that BRA will be led to write off most of the existing shareholders' equity, and gain direct ownership control of them, i.e., without establishing a new legal entity.

57. *Bank privatization*. The Government's intention is to transfer the ownership of all five troubled banks to private sector hands as soon as possible. Because of the banks' history, non-financial enterprises will be severely restricted from the prospective ownership, to no more than [5] of the capital for a single shareholder, and no more than [20] percent of the capital in the aggregate. In addition to these restrictions on ownership, we recently established drastic limitations on the banks' ability to lend to related parties, including shareholders (see para 69). Bank privatization will be one of BRA's immediate

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6 Slavonska Banka in Osijek; Splitska Banka in Split; Rijecka Banka in Rijecka; and Istarska Banka in Pula.

objectives, following the initial balance sheet clean-up (see para 58). Two routes will be simultaneously pursued. First, the BRA will offer the clean bank 'shells' to potential new owners that are prepared to recapitalize the banks, either international financial institutions or private sector entities, preferably foreign or domestic financial organizations[7]. Second, BRA will promote the voluntary conversion of the frozen foreign currency deposits into bank shares, building on the scheme successfully implemented by the CPF for enterprises. Our favored outcome would be to achieve privatization through a combination of the two methods: tenders or trade deals would enhance bank governance by introducing core shareholders, while deposit conversion could facilitate the effective transfer of over 50 percent of the shares to the private sector, while decreasing significantly Treasury and bank debt. Should these privatization methods prove unsuccessful, the Government will consider tendering the shares to the general public[8]. The timeframe of bank privatization cannot be fully indicated as it will depend on the success of the different methods used. However, we expect that one-third of the capital of Privredna Banka, and the majority of the capital of two other troubled banks, could be divested in the course of 1997 [condition of second tranche release]. Privredna Banka would be majority-privatized in the course of 1998 at the latest.

58. *Balance sheet clean-up*. The large proportion of non-performing assets on the troubled banks' balance sheets is a major obstacle to their privatization. These assets include loans to the enterprise sector as well as claims on the Government itself. Following the takeover of the five troubled banks, the most significant non-performing assets are being removed from the banks' balance sheets, or turned into performing assets, as follows.

59. First, as regards claims on enterprises, BRA carved out [condition of Board presentation] from the troubled banks' balance sheets their exposures to large borrowers and selected matching liabilities. It will be responsible for overviewing or conducting their work-out. The carve out substantially reduced the size of the troubled banks (by up to [50] percent in the case of Privredna Banka), thus facilitating their privatization. The items carved out from the banks' balance sheets include, inter alia: (i) loans and off-balance sheet commitments to a group of [30] large loss-making enterprises, including PEs and FSOEs (see list in Annex 1); claims on these enterprises account for about [x percent] of the troubled banks' non-performing portfolio; and (ii) when applicable, the matching liabilities to Paris and London club creditors.

60. Second, we intend to relieve banks from the negative effects of the Government's own liabilities. By the end of 1995, we will redefine the features of the big bonds, to ensure that they yield a market rate of interest and become tradeable instruments. This way, banks would be provided with a secondary source a liquidity, and a supply of Treasury paper would become available for Investment Funds or other institutional investors. With respect to frozen foreign currency deposits, we are currently reviewing two

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7 To entice bids, prospective purchasers would be entitled to conduct their own *due diligence* by employing their own auditors or analysts to review the bank's accounts. They would also receive, on a negotiated basis, *put* options permitting them to sell assets subsequently identified as bad back to the Bank Rehabilitation Agency. The put option would be subject to a cap on the maximum amount (e.g., a specific amount expressed in nominal terms equal to, say, 10-25 percent of the loans acquired by the purchaser) and a specific term (say, three to six months).

8 Non-financial companies would be excluded from tenders, to prevent the resurgence of the past ownership structures.

options, whereby we would: (i) either remove them, as well as the counterpart bank claims on the Government, from the banks' balance sheets, and treat them as a direct debt of the Treasury to depositors; or (ii) ensure that they yield some remuneration for the banks, by increasing the interest paid on the bank claims by the Government [condition of second tranche release]. We will consult, and agree on with the Bank, as to which solution is preferable.

Debt Work-outs

61. Under the revised bank rehabilitation legislation, the BRA has been given a [three-year] maximum time period to work-out the problem loans taken over from the banks. Debtor enterprises will have no access to any bank or inter-enterprise financing, and will depend only on BRA to finance current losses. By [May 1996 -- condition of Board presentation], BRA will adopt a time-bound business plan spelling out, for each of the [30] large loans taken over, the planned course of action. These plans would provide for either of the following options: (i) foreclosure on collateral; (ii) sale of part of the enterprise assets; (iii) bankruptcy procedure and recovery of part of the debt; or (iv) agreement on a business plan involving the downsizing and reorientation of activities, and restructuring of the debtor's indebtedness with all its creditors. We expect that, by the [end of 1997 -- condition of second tranche release], BRA would have effectively resolved about one-third, in value terms, of the problem loans carved out from the banks. To facilitate BRA's work, the Government will require the CPF to transfer to the BRA its holdings of shares, if any, of problem enterprises being dealt with by BRA. This measure will limit conflicts of interest between owners and creditors, and reinforce BRA's ability to negotiate restructuring plans and/or sell enterprise assets.

62. Although BRA will overview directly all loan work-outs, and carry out some of them itself, it will also use those capacities that have already been built-up, or could be readily available, in Croatia. We anticipate that the work-out of selected problem loans will be contracted out by the BRA, to institutions such as the ORESE, which has gathered significant experience with respect to public enterprises, the State company supervising the restructuring of all shipyards, and to external consultants. However, the power to issue initial guidelines for restructuring, to approve lending facilities for enterprises undergoing restructuring, and to make final decisions as to the future of troubled enterprises, will be retained by the BRA.

63. Non-performing loans that have not been carved out by BRA will remain on the banks' balance sheets. The debtor enterprises treated in this manner are expected to be smaller in size, thus making workouts a more manageable problems for the banks. Banks would therefore be required to work them out themselves under BRA guidelines and supervision, until the time they are privatized. To effectively carry out such activities, banks will be required by BRA to establish work-out departments. Specific arrangements for banks to work-out their problem loans will be covered by the restructuring guidelines to be prepared by the BRA.

64. *Institutional arrangements for the BRA*. As BRA will be performing a central role in bank and enterprise restructuring and privatization, the Government will ensure that it operates under a proper incentive framework and strong governance. With respect to incentives, BRA will operate for a period limited to [three] years and under a hard-budget constraint. It will be provided only with limited initial capital in an amount of [30-50] US$ million equivalent, to start operating, and working out problem loans. Additional funding requirements will have to be met out of BRA current operations, i.e., the sale of enterprise assets or collections on problem loans. As to governance, the BRA Board, already

appointed, constitutes a strong decision-making body which will overview closely BRA operations: it is chaired by the Prime Minister, and comprises, inter alia, the Minister of Finance, the Minister of Economy, and the Governor of the Central Bank. BRA's senior management was recently appointed [condition of Board presentation] and includes, in addition to the Director of the BRA, one senior adviser with relevant international experience, and four high-level professionals in charge of bank supervision, asset management, legal matters, and administration/accounting, respectively. Second-tier staffing will be completed by [May 1996 -- condition of Board presentation]. The statutes and procedures of BRA were recently approved by its board [condition of Board presentation]. The BRA also anticipates to make extensive use of foreign technical assistance, the requirements for which have been defined in close coordination with the Bank. Technical assistance would have been delivered, or would be in place, by mid-1996.

D. Incentive Framework for Enterprises and Banks

65. In addition to ownership transformation, as one of the key objectives of the reform program, the Government will enhance the overall incentive framework for enterprises and banks by improving the legal and institutional framework under which they operate. The measures planned include enactment of enabling legislation for enterprise restructuring, the development of the securities market, the improvement of prudential regulations and supervision for banks, and the establishment of a deposit insurance scheme.

66. *Legal Framework for Enterprise Restructuring*. Our Parliament recently adopted [conditions of Board presentation] two key legislative reforms that will support and facilitate enterprise restructuring. First, the new Labor Law facilitates layoffs in the case of economic redundancy, an option which was previously lengthy and expensive. The new rules are in essence along the lines of those used in market economies. Second, the new Bankruptcy legislation expands the scope, and increases the flexibility of, court-supervised arrangements between enterprises and their creditors in the context of a bankruptcy procedure (Chapter 11-type of arrangements).

67. *Development of the Securities Markets*. The Stock Exchange was established in 1991, but is operating without any comprehensive regulatory framework, and has served so far mainly as a channel for the CPF's efforts to divest its shares of non-privatized enterprises. We will strive to develop the securities market as a vehicle for mobilization of equity from investors, including foreigners, and reinforcing corporate governance. The first steps towards this objective was the enactment of a new Securities Law, and a Law on Investment Funds in December 1995. Additional measures, which will be taken in the course of 1996, will include: (i) the setting up a modern, centralized, securities registry with safe procedures for transfer/settlement; (ii) stimulation of the equity market through public offerings of a few selected companies; and (iii) the development of institutional investors. In addition to the investment fund legislation mentioned earlier, the Government will ensure that shares already transferred to the existing state Pension Funds not be used to finance the current pay-as-you-go pension scheme. Instead, the value of this portfolio will be preserved to help fund, in due time, the transition to a partly privately-funded pension system that we are currently preparing, with the Bank's assistance. Pending implementation of this reform, the Pension Funds' investment activities will be transferred to separately-managed investment funds, which may also seek the assistance of reputable foreign fund managers, thus achieving better isolation from the basic pay-as-you go pension system, and promoting more transparent and dynamic portfolio management.

68. *Prudential regulations and bank supervision.* Banking sector reform was launched with the 1993 Laws on the National Bank of Croatia (NBC) and the Banking Law, which provided a legal framework comparable to that of market economies for governing banking activities, and empowered the National Bank of Croatia to regulate and supervise banks. Building on this enabling legislation, NBC established prudential guidelines governing capital adequacy, large exposures, management of the foreign currency risk, as well as limits for investments in equity shares and property.

69. Despite the progress already made in improving prudential regulations, we are aware of a number of remaining shortcomings, that we are addressing in two stages. Taking into account the advice received from the international financial institutions, we recently introduced a set of new bank regulations [condition of Board presentation]. A key such regulation is included in the legislation, recently adopted by Parliament, that limits bank aggregate lending to their shareholders to [ ] percent of their share capital, [and lending to a single shareholder to no more than the amount of its equity]. Other regulations improve: (i) corporate governance for banks (especially the role of fit and proper directors and management, audit committees and internal auditors); (ii) financial risk management (especially liquidity, interest rate and currency risk management); (iii) debt classification and provisioning (to be based not only on overdues but also on the quality of the debtor itself); and (iv) rules for the suspension and reversal of interest on doubtful debts.

70. By the end of [1997 -- condition of second tranche release], we will implement a second round of reforms that will complete the harmonization of the Croatian regulatory and prudential framework with that of market economies. These reforms will include: (i) the strengthening of licensing procedures, including for savings banks, and the review of minimum entry capital requirements; (ii) the review, and possible modification, of the rules determining capital adequacy, to ensure consistency with the guidelines of the Basle committee on banking supervision; (iii) the review of liquidity (local and foreign currency), interest rate and currency risk management and reporting by banks, so as to enhance the bank supervisory department's ability to monitor these areas; (iv) the role and responsibilities of external auditors in the area of bank supervision; (v) the enforcement capabilities of the NBC in the area of bank supervision; and (vi) limits, across-the-board, on enterprise ownership of banks.

71. In addition to prudential and accounting rules proper, the NBC is undertaking an ambitious effort to improve its supervisory capabilities, currently limited in terms of human resources, and fragmented among several units within the Central Bank. In addition, the current lack of consolidated information and capability to manipulate information for sensitivity analysis purposes, implies that very little effective off-site supervision and analysis, can be performed .

72. NBC's program to strengthen its supervisory capacities cover both off-site and on-site supervision, and relies on senior advice, training, and increased human resources. Regarding senior advice, a US-trained, Croatian-speaking resident advisor, as well as a policy advisor, were recently hired with the support of USAID. Their work program includes: (i) the overhaul of off-site supervision procedures (data collection, financial and ratio analyses); (ii) the development of an early warning system; (iii) the refocusing of on-site examination to safety and soundness concerns, as opposed to pure compliance with laws; and (iv) the definition and implementation of a training program for the staff of the supervision Department. In addition, provision has recently been made to recruit and train 30-40 additional staff members. Once the recruiting process has been completed , the capacity of the prudential division will have at least been tripled. NBC intends to monitor closely, in cooperation with the World Bank, the implementation of this ambitious institutional development program. A joint review, in the beginning of 1996, would allow us to diagnose possible shortcomings and identify remedial actions.

Deposit insurance scheme

73. The Bank Rehabilitation legislation provides for a deposit insurance scheme to be established under BRA management. The Government, however, does not plan to proceed with deposit insurance until current banking system problems have been solved, i.e., tentatively, in early 1997. However, the BRA will start funding the future scheme by collecting premiums from banks, that will be deposited in an escrow account. The Government will discuss the coverage and the features of the scheme, and the level of premiums with the Bank prior to the establishment of the deposit insurance scheme.

D. Technical Assistance

74. We are aware that the implementation of our reform program requires strong implementing agencies, particularly the BRA, the ORESE and the Ministry of Privatization, as well as reliance on external consultancies, when it comes to assessing the propects of the largest banks or enterprises. We are committed to providing the implementing agencies with the necessary amount of resources, to be funded either from the Government budget or by external donors. As external sources of grant finance have not been forthcoming until now, and in the light of our current budgetary constraints, we have agreed to borrow from the Bank, in an amount of US$5 million equivalent, the resources necessary to fund critical technical assistance needs. The technical assistance Loan was approved by your Board of Directors on March , 1996.

F. Fiscal Costs of the Program

75. The fiscal costs of enterprise and bank rehabilitation are estimated to amount to about US$ [x] million and US$ [x] million in 1996 and 1997, respectively, or about [x] percent and [x] percent of GDP, respectively. However, about two-thirds of these costs have already been recognized by the Government and are included in annual budgets, namely, the subsidies to public enterprises, as well as the amortization of big bonds and foreign exchange bonds. The incremental costs, to be incurred under the program supported by the EFSAL, would amount to about [x] percent and [x] percent of GDP in 1996 and 1997, respectively. These costs assume full recoverability of foreign exchange loans from public enterprises, out of their current operations or their full or partial privatization, and are based on working assumptions that are explicited below. They include three different components:

(a) The additional costs associated with bank rehabilitation entail the [remuneration of frozen foreign exchange deposits], of [big bonds], as well as the servicing of bonds that would be issued by the BRA. These costs would be incurred starting in 1996 only, and are estimated to amount to the equivalent to [x] percent of GDP.

(b) The costs of restructuring CPF-owned enterprises, and financing their residual losses would be covered by the BRA initial budgetary allocation, tentatively estimated at US$ [x] million in 1996, and US$ [x] million in 1997, or [x] percent and [x] percent of GDP, respectively.

(c) Severance payments and unemployment benefits for laid-off workers will amount to about US$ [x] million in 1996, and US$ [x] million in 1997, or [x] percent and [x] percent of GDP, respectively.

76. The costs of bank and enterprise rehabilitation have been provided for in the draft budget for FY96 (US$ [x] million equivalent, condition of Board presentation). In due time, we will discuss, and agree on, with the Bank, the amount that we will need to allocate in the draft budget for FY97 [condition of second tranche release].

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CROATIA

ENTERPRISE AND FINANCIAL SECTOR ADJUSTMENT LOAN

MATRIX OF KEY POLICY ACTIONS

AREAS	CONDITIONS OF BOARD PRESENTATION	SECOND TRANCHE RELEASE
I. BANK / ENTERPRISE RESTRUCTURING	1) Institutional Set-up - Key amendments to the Bank Rehabilitation Legislation enacted. - BRA statutes and procedures adopted by its Board. - FY96 budgetary allocation for BRA agreed on with Bank.	- FY96 budgetary allocation made available to BRA. FY97 allocation agreed on with the Bank.
	2) Bank Problem Resolution - International audits of 9 banks, including the two largest ones, completed.	- Government liabilities to banks (big bonds, foreign currency claims), turned into marketable securities.
	- Government's takeover of five troubled banks, including Privredna Banka completed. Establishment of 'New Privredna Banka', and purchase and assumption transaction between 'new' and 'old' Privredna Banka completed.	
	- Agreement between Government/BRA and the Bank on the timing and methods for privatizing troubled banks.	- Privatization of at least one-third of Privedna Banka's share capital. Privatization of at least two taken over troubled banks.
	3) Enterprise Restructuring a) Public Enterprises: see separate section below b) Other Enterprises: - Transfer to BRA of some troubled banks' loans to their largest problem enterprises (20-30 enterprises in the aggregage). Prohibition of additional bank, and inter-enterprise, financing to these enterprises.	
	- Adoption by BRA of guidelines and timetable for bad loan resolution (collection, creditors' agreement to restructuring, or application for bankruptcy), and of preconditions for any new financing, in a manner satisfactory to the Bank.	- Resolution of at least [one-third] in value terms of the loans transferred to BRA.

AREAS	CONDITIONS OF BOARD PRESENTATION	SECOND TRANCHE RELEASE
II. LEGAL AND REGULATORY FRAMEWORK	1) <u>Bank Supervision</u> - Core prudential regulations (e.g., lending to related parties, capital adequacy rule) and accounting standards (principles of loan classification, provisioning interest recognition and suspense) adopted/revised. 2) <u>Creditors' Agreements</u> - Bankruptcy legislation amended, to allow enterprise debt restructuring through creditors' agreement. 3) <u>Labor Redundancy</u> - Labor Law amended, to eliminate excessive constraints to, and costs of, layoffs for economic redundancy.	- Satisfactory implementation of revised core regulatory/accounting rules; revision of non-core rules completed.
III. PRIVATIZATION OF SOCIALLY-OWNED ENTERPRISES	1) <u>Institutional Framework</u> - Establishment of the Ministry of Privatization with its core staffing. 2) <u>Targets and Strategy</u> - Completion of the 'first-stage privatization/commercialization' program, and privatization of [10%] of the share capital of the 'second privatization stage' enterprises held by the Croatian Privatization Fund at end December 1994. - Enactment of the law establishing a mass privatization scheme, and improving existing methods (elimination of floor prices in auctions).	- Privatization of at least [50%] of the 'second privatization stage' enterprises' share capital owned by CPF as of end 1994. - Implementation of the mass privatization scheme.

AREAS	CONDITIONS OF BOARD PRESENTATION	SECOND TRANCHE RELEASE
IV. PUBLIC ENTERPRISES	1) Loss Containment - Government commitment to contain public enterprise losses to 1.5% of GDP in 1995, through tariff adjustments and asset sales. Commitment to reduce losses further in 1996, to [ ] % of GDP, and equivalent subsidies appropriated in FY96 budget.	- 1996 losses effectively contained to [ ]% of GDP (see Board condition) and financed out of budgetary resources. Agreement with the Bank on further reduction of losses in 1997, and appropriation of equivalent subsidies in FY97 budget.
	2) Privatization and Restructuring - Agreement with the Bank on a list of privatizable non-core assets, accounting for [x%] of the public enterprise sector's assets to be privatized.	- Privatization of these non-core assets.
	- Organizational audits and strategic studies for key public enterprises (INA, HE, HZ, HPT) underway.	- Reorganization of key public enterprises completed, and divestiture of [20-25%] of their core assets.
	3) Regulation - Government - Bank agreement on the extent of legislative provisions needed to establish the regulatory framework for the private provision of public services (electricity, telecommunications).	- Enactment of legislation, as per agreement with the Bank.
V. MACRO-ECONOMIC FRAMEWORK	- Maintenance of a stable macroeconomic environment, as evidenced by compliance with the IMF program.	- Maintenance of a stable macroeconomic environment, as per an IMF program, or consultations between the Bank and the IMF.
	- Adoption of the FY96 budget, providing overall support to the reforms of at least [ ] percent of GDP.	- Adoption of the FY97 budget, providing overall support to the reforms of at least [ ] percent of GDP.