

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

**STRATEGY FOR CROATIA:
2010 – 2013**

As approved by the Board of Directors at its meeting on 27 April 2010

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LIST OF ABBREVIATIONS

AMC	Association of Management Consultant
ARZ	Motorway Rijeka-Zagreb Company
ATM	Air Traffic Management
BEEPS	Business Environment and Enterprise Performance Survey
BICRO	Business Innovation Centre
BiH	Bosnia and Herzegovina
BRSF	Balkan Region Special Fund
CCL	Croatia Air Traffic Control Company
CEDAW	Committee on the Elimination of Discrimination against Women
CEE	Central and Eastern Europe
CEI	Central European Initiative
CHP	Combined Heat and Power
CLNM	Constitutional Law on the Rights of National Minorities
CMC	Certified Management Consultant
CPF	Croatian Privatisation Fund
CPI	Corruption Perception Index
DPL	Development Policy Loan
EC Law	Electronic Communication Law
EE	Energy Efficiency
EIA	Environmental Impact Assessment
EIB	European Investment Bank
EPIS	Environmental Protection Information System
EPOP	IPA Environment Operational Programme
EPRT	European Release and Transfer Register
EU	European Union
ETS	Emissions Trading Scheme
EURIBOR	Euro Interbank Offer Rate
FDI	Foreign Direct Investment
FINA	Financial Agency
GDP	Gross Domestic Product
GEF	Global Environment Facility
GHG	Green house gas
GMO	Genetically Modified Organism
GRECO	Group of States against Corruption
GTZ	Deutsche Gesellschaft fur Zusammenarbeit
HAC	Croatian Motorways
HAKOM	Croatian Post and Electronic Communications Agency
HAMAG	Croatian Agency for Small Business
HANFA	Croatian Financial Services Supervisory Agency
HBOR	Croatian Bank for Reconstruction and Development
HDZ	Croatian Democratic Union
HEP	Croatian Electric Company
HIV	Human Immunodeficiency Virus
HRT	Croatian Radio and Television
HSL	Croatian Social Liberal Party

HSS	Croatian Peasants Party
HT	Croatian Telecoms
HZ	Croatian Railways
IBRD	International Bank for Reconstruction and Development
ICT	Information and communication technologies
IDF	Institutional Development Fund
IFI	International Financial Institution
IGC	Intergovernmental Conference
IMF	International Monetary Fund
INA	Industrija nafte (Oil Company)
IOSCO	International Organisation of Securities Commissions
IPA	Instrument for Pre-Accession Assistance
IPO	Initial Public Offer
IPPC	Integrated Pollution Prevention and Control
iPPP	Institutionalised Public Private Partnership
ISPA	Instrument for Structural Policies for Pre-Accession
ITUC	International Trade Union Confederation
KfW	Kreditanstalt für Wiederaufbau
LEF	Local Enterprise Facility
LIS	Legal Indicator Survey
LNG	Liquefied Natural Gas
LRTAP	Long-Range Transboundary Air Pollution
MDG	Millennium Development Goal
MEI	Municipal and Environmental Infrastructure
MELE	Ministry of Economy, Labour and Enterprise
MOL	Hungarian Oil and Gas Company
MSME	Micro, Small and Medium sized Enterprises
NATO	North Atlantic Treaty Organisation
NBFI	Non-bank Financial Institutions
OCE	Office of the Chief Economist
ODIHR	Democratic Institutions and Human Rights
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Co-operation in Europe
PAP	Priority Action Plan
PBZ	Privredna banka Zagreb
PED	Project Evaluation Department
PHARE	Poland and Hungary: Assistance for Restructuring Economies
PHRD	Policy and Human Resources Development Fund
PPA	Public Procurement Law
PPP	Public Private Partnership
R&D	Research and Development
RES	Renewable Energy Sources
SAPARD	Special Accession Programme for Agriculture and Rural Development
SDSS	Independent Democratic Serb Party
SEA	Strategic Environmental Assessment
SME	Small and Medium Enterprises
SMP	Significant Market Power
TAM/BAS	Turn-Around Management/Business Advisory Services
TC	Technical Cooperation

TFP	Trade Facilitation Program
TI	Transition Impact
TIMS	Transition Impact Monitoring System
UK	United Kingdom
UNDP	United Nations Development Programme
UNEP	United Nations Environmental Programme
UNFCCC	United Nations Framework Convention on Climate Change
UNIDO	United Nations Industrial Development Organisation
USAID	United States Agency for International Development
ZGOS	Zagreb Waste Management Company
ZOV	Zagreb Wastewater Company
ZSE	Zagreb Stock Exchange

Currencies

EUR	Euro, European Union Currency
SDR	Special Drawing Right, IMF “currency”
USD	United States Dollar
HRK	Kuna, Croatian Currency

Exchange Rates as at 31 March 2010

1 EUR	7.26 HRK
1 USD	5.37 HRK

I. EXECUTIVE SUMMARY

Croatia continues to fulfil the conditions specified in Article 1 of the Agreement Establishing the Bank.

Croatia has continued to make progress on structural and institutional reforms, geared towards integration into the European Union. Accession talks have entered a decisive phase, with realistic prospects for full membership in the next few years. However, Croatia still faces institutional and economic pre-accession reform challenges, and the Bank aims to assist the country in meeting these challenges successfully over the Strategy period.

After several years of solid economic growth, culminating in 5.5 per cent growth in 2007, the global crisis has had a major effect on the Croatian economy. Economic growth slowed significantly to 2.4 per cent in 2008 and the economy contracted by nearly 6 per cent in 2009, according to provisional estimates. Industrial production fell by 10.2 per cent in the first half of 2009 compared with the same period last year, although the year-on-year declines stabilised somewhat in the second half of the year (-5.8 per cent y/y in December). This reduction was accompanied by sharp falls in construction activity and exports. State revenues dropped significantly in 2009 and the Government has had to make three revisions to the 2009 budget, involving cuts to public spending. However, the authorities had two successful international bond issues in May and November 2009. The central bank has continued to adhere to its tightly managed exchange rate policy, and annual inflation has remained moderate at 1.9 per cent in December 2009. Although measures have been brought in recently to encourage lending, the level of domestic credit growth remained modest at less than 2 per cent in 2009.

A modest economic rebound is currently forecast for 2010. The prospects for a return to more rapid growth rates in the medium term are favourable, given Croatia's strategic location, strong regional links and the likelihood of EU membership in the near future. However, given the country's export orientation and important tourism sector, the extent of the upturn will depend to a large extent on the recovery in the eurozone area.

Challenges

Croatia is at an advanced state of transition, but the country continues to face a number of major reform challenges, especially in the areas of privatisation, commercialisation of infrastructure, sustainable energy, and improving skills and flexibility of the labour force. Little progress with large-scale privatisation has been made over the past year, partly because of the challenging global environment. While there has been significant progress in recent years in reforming and implementing competition law and policies, businesses continue to face a number of obstacles, with surveys identifying factors such as tax rates and administration, difficulties with construction permits, and the high social costs and low flexibility of labour, as the main problems. Reform of the judiciary and public administration and the fight against corruption continue to be priorities for the government. There are substantial investment needs in public infrastructure,

particularly in water treatment and solid waste. All of these challenges need to be addressed as Croatia prepares for European Union membership.

Key reform challenges include:

- to privatise majority-State owned companies, in particular the shipyards, and minority stakes held by the State in commercial companies. Corporate governance in the State-owned companies which will not be privatised should be improved by replacing political appointees on supervisory boards with experienced managers from the business community and representatives of civil society.
- to reduce fixed social costs of labour and disincentives to employment, and improve and increase training for the work force.
- to invest at the State and local level in environmental infrastructure, particularly solid waste and waste-water treatment, to meet the requirements of the EU's *acquis communautaire*.
- to encourage companies and households to invest in energy efficiency through full market pricing of electricity and natural gas sold to all consumers, as well as through removal of non-economic barriers to investment in energy efficiency. Streamline procedures for grid connections of renewable energy generation facilities to increase the role of renewable energy to alleviate climate change.
- to invest to improve energy security and to diversify Croatia's energy supplies. Energy security and supply may be increased through regional cooperation via international pipelines and power transmission links and through increased energy efficiency and renewable energy production.
- to increase investments in tourism, its supporting infrastructure, and training to improve the competitiveness in the hospitality sector.

Strategic Directions

The Bank is the largest financial investor in Croatia, having invested over EUR 2 billion since the start of operations in 1994. The Bank's current portfolio (end March 2010) amounts to EUR 1,204 million invested in 79 projects. In 2009 as a crisis response, the Bank has invested EUR 248 million, including substantial financing for the two largest Croatian banks for on-lending to SMEs which were particularly affected by the lack of liquidity in the market. The Bank also supported trade through the TFP. In the first quarter 2010, the Bank has signed four transactions totalling EUR 108.8 million¹.

As international capital flows are expected to remain low for countries of the region, the Bank is prepared to maintain an increased level of activity in Croatia in the coming Strategy period. Over the coming three year period, the Bank will assist its Croatian

¹ This includes B loans of EUR 51 million syndicated to partner banks.

clients in facing the remaining transition challenges and, by doing so, in preparing for EU accession. The Bank's work will focus on the following areas:

- In the *enterprise sector*, the Bank will support economic recovery by financing investments to improve competitiveness and to support the regional expansion of Croatian enterprises. The Bank will seek to increase investment in energy efficiency across all corporate sectors. Through the Local Enterprise Facility, the Bank will strengthen local SMEs with equity capital. The Bank will encourage foreign direct investment with its risk sharing capacity, and will assist newly privatised companies with their investment needs. In the tourism sector, the Bank will support capacity building, privatisation and foreign direct investment.
- In the *infrastructure, environment and energy sectors*, the Bank will cooperate with the EU and the European Investment Bank (EIB) to prepare projects for co-financing under the Western Balkans Investment Framework, focusing on key regional transport links. The Bank will continue to work together with local and regional authorities to prepare projects in wastewater and solid waste sectors for co-financing with EU funds. The Bank will give priority to investments in energy efficiency and renewable energy, and will support investments to improve diversity and security of energy supply. Infrastructure financing will be coordinated with other IFIs, and with the EU with respect to co-financing with EU funds.
- In the *financial sector*, the Bank will facilitate access to finance by SMEs, which continue to suffer from limited liquidity in the financial system, with loans and with equity and quasi equity investments through financial intermediaries. New programmes to support SME competitiveness and sustainable energy investments will be offered. The Bank will support regional trade and investment through expansion of the Trade Facilitation programme and will prepare a grain warehouse receipts programme for financing of primary agriculture. If feasible, the Bank will also support consolidation among small locally-owned banks and privatisation in the sector.

II. COUNTRY STRATEGY

1. THE BANK'S OPERATIONS TO DATE AND CURRENT PORTFOLIO

1.1. Overview of Activities to Date

As of 31 March 2010, the Bank had made commitments in total of EUR 2.137 billion across all sectors of the Croatian economy. The portfolio is well distributed between infrastructure (29 per cent), the financial sector (32 per cent) and the corporate sector (33 per cent).

Table 1: Bank's Portfolio in Croatia as at 31 March 2010

SECTOR Amount in EUR million	NET CUMULATIVE BUSINESS VOLUME				CURRENT PORTFOLIO STOCK				
	Number of projects	Total Project Cost	EBRD signed	Weight by Sector	Number of projects	Portfolio	Weight by Sector	Operating assets	Operating assets ratio
Industry, Commerce & Agribusiness	57	2,343.0	706.4	34%	37	384.8	28%	292.0	24%
Agribusiness	13	895.2	395.2	19%	6	175.5	15%	188.7	16%
Manufacturing and Services	5	266.5	116.0	6%	2	18.3	2%	20.2	2%
Property and Tourism	13	524.2	138.4	7%	9	135.6	11%	74.5	6%
Telecom, Informatics, Media	9	657.1	56.8	3%	3	8.3	1%	3.3	0%
Equity funds	17	102.1	102.1	5%	17	47.2	4%	25.9	2%
Financial Institutions	40	767.4	662.5	31%	20	388.7	32%	365.2	29%
Bank Equity	7	238.8	192.8	9%	2	170.4	14%	167.4	14%
Bank Lending	28	487.2	413.0	20%	13	192.1	16%	163.8	14%
Non Banking Institutions Lending	2	30.0	30.0	1%	2	24.3	2%	15.4	1%
Non Banking Institutions Equity	3	11.3	7.3	0%	3	1.9	0%	4.7	0%
Energy	7	159.7	137.1	7%	5	77.8	6%	76.5	7%
Natural Resources	4	105.8	102.4	5%	4	75.3	6%	77.8	6%
Power and Energy	3	53.9	34.7	2%	1	2.5	0%	0.8	0%
Infrastructure	22	2,091.7	571.6	28%	17	352.2	29%	280.9	23%
Municipal & Environmental Infrastructure	10	657.0	183.5	9%	8	102.2	8%	62.5	5%
Transport	12	1,434.6	388.1	19%	9	250.1	21%	219.1	18%
COUNTRY TOTAL	126	5,361.8	2,077.6	100%	79	1,203.5	96%	1,014.6	83%

*Regional projects are allocated at the sector level

The portfolio as of end March 2010 consists of 79 operations for a total of EUR 1,204 million. The majority of Bank commitments are to the private sector (68 per cent), divided between debt (EUR 394.4 million) and equity (EUR 423 million). State sector commitments amount to EUR 327.5 million, all of which is debt. Infrastructure makes up EUR 352.2 million of the State portfolio, while the remainder is invested in energy projects. Operating assets at EUR 1,015 million have grown significantly despite loan repayments, due to the rapid disbursement of recent transactions.

Mobilisation of co-financing during the 2007-2009 period has been good in light of the general collapse of the syndicated loan market in CEE markets. Of EUR 485 million invested by the Bank, EUR 849 million were invested in total. The Bank syndicated senior loans in four private sector transactions and in one public sector transaction. In addition, the Bank's equity in Jadranka Hotels and Eurocable enabled the companies to take loans for the companies' investment programme. The Bank has also co-financed the Port of Ploče project with the World Bank.

1.2. Implementation of the previous country strategy

During the past strategy period, 28 projects were signed, representing commitments of EUR 563.6 million. The last Country Strategy, approved in May 2007, outlined the strategic priorities for the Bank in the period 2007-2009, below. The majority of the objectives were achieved, as the Bank was active in a wide range of sectors.

- ***Assisting with privatization and restructuring of sensitive industries and the tourism sector. Supporting new and existing operators in the tourism sector.***

The Bank made its second investment in the tourism sector with an equity investment in Jadranka Hotels on the island of Lošinj. This transaction has involved significant restructuring, improving the operations of this employee-owned company.

The Bank has financed the privatization and restructuring of Sladorana Sugar Company with a loan to the largest Croatian sugar producer, Viro, which has purchased Sladorana from the Croatian Privatisation Fund. Otherwise, privatization was achieved through the Bank's equity investment in Agrokor, which has purchased three agrokombinati (Belje, Pik Vrbovec and Vupik) through the privatization process, and successfully restructured them.

- ***Financing promising Croatian corporate customers in their regional growth and consolidation.***

The Bank has financed the expansion of Agrokor in Bosnia (Konzum BiH, EUR 60 million loan) and in Serbia (Idea, EUR 40 million loan).

- ***Providing equity finance to small and medium-sized companies***

The Bank has introduced the LEF in Croatia, with the first equity investment signed in February 2010, for EUR 4 million, in Geofoto, a rapidly growing SME. The Bank invested EUR 15.5 million in Eurocable, a medium sized producer of low voltage cables, with a strong export orientation.

- ***Financing infrastructure at the local / regional government level, without support of a sovereign guarantee. To develop more efficient regional projects where feasible. To prepare projects for co-financing by the EU Instrument for Pre-Accession Assistance (IPA).***

In the infrastructure sector the Bank is preparing three projects for IPA co-financing which are expected to be signed in 2010. These include two regional solid waste projects. The Bank is also preparing its first regional water project in Croatia.

- ***Promoting energy efficiency through new mechanisms.***

The Bank has introduced energy audits in financing corporate loans, leading to an investment with an energy efficiency component in the loan to Viro and other companies. The Bank's total investment for energy efficiency was EUR 22 million. In

City Center Split One, the Bank has for the first time financed an energy passive building.

- *Supporting improvements in security and diversity of energy supply, with a priority on renewable energy projects.*

In 2009, the Bank signed a loan to Plinacro, the State-owned gas transmission company, to finance the purchase of Croatia's only natural gas storage facility, an important investment for energy security. The lack of renewable energy projects was due to the combination of slow licensing of projects and lack of sufficient equity capital of developers who were not prepared to share the potential profits with an external shareholder.

- *Providing financing to SMEs through the EU SME Finance Facility, focusing on leasing companies.*

The Bank has provided SME facilities to Raiffeisen Bank and Raiffeisen Leasing under the EU/EBRD SME Finance Facility, and continued working with clients Croatian Post Bank and Erste S-Leasing under this programme. The focus on SME finance shifted as a result of the financial crisis, with EUR 100 million in loans extended to the two largest banks to enable them to continue financing SMEs when liquidity in the system was strained.

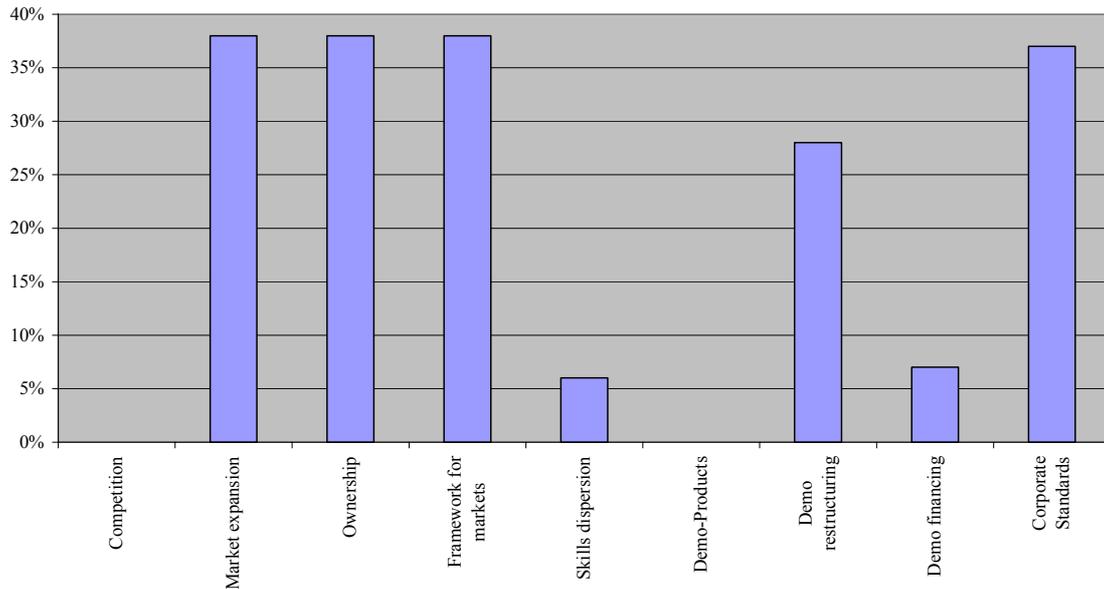
- *Financing factoring companies under the TFP; potentially considering equity participation in the privatisation of the state-owned postal bank and insurance company.*

The above Strategy objectives could not be achieved. Work with factoring companies was postponed during the financial crisis, while the Bank focused on existing customers. The Government has asked the Bank to assist with the privatisation of the state-owned postal bank. There are no plans to privatize the state-owned insurance company.

1.3. Transition Impact of the Bank's Portfolio and Lessons Learned

The Bank's operations have consistently been focused on achieving significant transition impact, with 80 per cent of the projects monitored through the Bank's transition monitoring system (TIMS) having Good or Excellent transition impact potential ratings at approval stage in 2008, while 58.33 per cent of portfolio projects were rated good or excellent as of December 2009.

Croatia - Transition objectives pursued by EBRD operations 2005-2008



1.3.1. The Financial Sector

Banking - The Bank's earlier projects aimed at developing new financial instruments, including capacity building for lending to small and medium size municipalities and mortgage lending. For instance, EBRD has provided mortgage credit lines to three banks, Zagrebačka banka, Privredna banka Zagreb d.d. (PBZ) and HVB Bank Croatia. The Bank aimed to alleviate the lack of liquidity in the sector by financing banks with credit lines for on-lending to SMEs (see below).

NBFI - The Bank's activities in the reporting period have primarily supported leasing activities with the EU/EBRD SME Facility deserving special mention. Under this framework, investment and TC support were provided to Raiffeisen Leasing and Erste S Leasing. The leasing market has been further developed leading to greater transparency of operations. The Croatian pension reform - supported by EBRD's investment in Erste Plavi Mandatory Pension Fund Management company - was judged as an ambitious and intelligent policy. Recent years saw rapid development of private pension funds operating both mandatory and voluntary pension schemes.

Private equity funds – The only EBRD operation in this field, focused exclusively on Croatia, was the equity investment in Croatia Capital Partnership in 1997. Domestic legislation is now in compliance with the IOSCO principles and the application of laws and regulations is relatively effective. Nonetheless, there have been few private equity transactions and, and there is a lack of dedicated private equity funds.

MSME - The Bank has provided funds to two Croatian banks (i.e. Hrvatska poštanska banka and Raiffeisen) for financing this segment under the EU/EBRD SME Facility. In addition, the Bank has recently extended SME credit lines to Zagrebačka banka and to

PBZ as a crisis response. Still, access to longer-term financing remains challenging for small enterprises. One *lesson learned* is that successful SME lending projects with new partners should involve technical cooperation measures a priori, in order to improve the partners' lending skills (PE05-306).

In summary, transition has come further in Croatia's financial sector in recent years, seeing for instance a strengthened institutional framework, but further work is required to address the remaining small to medium challenges to transition.

1.3.2. The Enterprise Sector

Agribusiness - The equity investment in Agrokor - one of the largest regional producers of mineral water, ice-cream, edible oil, margarine and mayonnaise - in 2006 saw some achievements in respect of the company's restructuring and expansion of its activities to Serbia and to Bosnia and Herzegovina. However, the project did not lead to an IPO as was intended; EBRD's entry into the capital of Agrokor might have lessened pressure on Agrokor to do an IPO. Another cause for concern is Agrokor's market dominance. While this increased since the EBRD investment, the Bank has financed Agrokor's competitor retailers Interspar and Getro. A *lesson learned* from this project is that EBRD should apply clear standards and sound judgement when assessing and mitigating market dominance and other risks to competition. The EU competition standards are useful guidelines in this regard, especially in countries aspiring to EU membership (PE08-420).

Natural resources - Following the Bank's involvement in 2001 with INA, the then state owned oil and gas company, a 25 per cent plus one share in INA was sold to Hungary's MOL. The Bank's original loan was guaranteed by the State because INA was loss-making due to controlled prices on its petrol and gas products. In 2008, when INA became majority privately owned, the Bank re-approved its loan on a commercial basis and released the sovereign guarantee. Since then, the Bank has worked with State gas pipeline company Plinacro and the Ministry of Economy to ensure third party access to the underground gas storage facility, purchased by Plinacro with a loan of EUR 70 million from the Bank.

Industry - The Bank's early support to the pharmaceutical firm Pliva successfully promoted transparency, governance and corporate development with high project visibility. In 2000 and 2003, the EBRD provided two loans to Našicecement, the second largest and only independent cement producer in Croatia with a view to refurbish parts of the company and expand its capacity through the acquisition of other companies. Good Transition Impact was achieved as the company introduced new standards for business conduct at the enterprise level and expanded across borders to Serbia and BiH. A *lesson learned* from the Bank's project with Našicecement is that supporting a domestic producer without a strategic industry partner requires more Bank staff time, as centralised holding functions might still have to be created (PE06-349).

Telecommunications - The Bank's involvement in Croatia has mainly consisted of its support to the mobile operator - VIPnet - in order to enhance competition. The telecoms

market has been successfully transformed with only small transition challenges remaining.

Property and Tourism - Croatia was a target country of the TUI Advanced Payment facility as well as of regional property funds Europolis II and TriGranit III. Despite improvements in areas such as land registration and an overall rapid development of the real estate sector, lack of transparency and bureaucratic interference remain serious problems. Two hotel investments have taken place subsequently, which have been instructive regarding the need for strong management with international hospitality experience in the hotel operator.

Although, the remaining transition challenges in Croatia's corporate sector are overall considered *Small*, the country continues to score poorly on some cross-country surveys of the business environment, suggesting further efforts in this regard are necessary in future.

1.3.3. Infrastructure

MEI - The Bank has been active in the water and transport sectors to eliminate cross-subsidies and to raise tariffs to cost recovery levels. Financing provided to the Zagreb Waste Management Company (ZGOS) resulted in a successful landfill rehabilitation programme in line with EU environmental standards, state of the art treatment facilities as well as best corporate practices. Another *Highly Successful* project was an EBRD syndicated loan, co-financed with KfW to the Zagreb Waste Water Treatment (ZOV). The excellent transition impact of this operation is a result of the first private sector participation in utility services and the competitive tendering that led to the selection of a concessionaire. A **lesson learned** from the Bank's project with ZGOS is that activities in this sub-segment can be very profitable if solid waste collection is separated from solid waste disposal. (PEX06-296). Another lesson learned is that the Bank should ensure that facilities related to the Bank project, even if not financed by the Bank, meet the environmental standards of the Bank project. The 2008 Environmental and Social Policy has been developed to take account of this. The Bank has had a demonstration impact by introducing the first public service contract in the water sector, an ISPA co-financed project in Karlovac. The first urban transport strategies by Croatian cities were adopted and are being implemented in Pula and Dubrovnik.

Transport - The Bank has had a large presence in the transport sector with projects for railways, roads, an air traffic control centre, two ports and a shipyard. Among others, the EBRD provided two senior loans in 2001 and 2006 to the Autocesta Rijeka-Zagreb (ARZ) project. Whilst the construction of the motorway was successfully completed in 2008, its transitional objectives, i.e. privatisation of the state-owned concessionaire ARZ, fell short of expectations. The 2002 loan for Croatia's air navigation service (CroControl, "CCL") saw mixed results, whilst it successfully permitted CCL to update its air traffic management systems (ATM) a lack of adequate laws and culture regarding safety management was noted. The 'Port of Dubrovnik Institutional Strengthening project' achieved its main objectives of introducing International Financial Reporting

Standards which, together with the marketing and business planning TC modules, established a management information system at the Client. A *lesson learned* from EBRD's project with the Dubrovnik Port Authority is that TC due diligence should include thorough institution building needs and absorption capacity analysis. A two-phase approach should be employed, that would include (1) determining the actual need for skills transfer, and (2) delivering the actual TC operation. (PE07-390T) A *recommendation* deriving from the air navigation project with CCL is that EBRD should undertake steps to ensure improvement of safety management in ATM projects. (PE07-394). In the Bank's two port projects, despite delays due to urban planning regulations, there is movement towards introducing concessions as an alternative method of financing and managing transport infrastructure assets. The current economic downturn with its tightening effect on the State budget is expected to strengthen the case for concession-type financing in the transport sector. In this light, the progress to date with concession arrangements in Dubrovnik and Ploče port projects is advanced enough to provide an adequate model for the planned terminal concession in Šibenik Port, which will follow their examples on a smaller scale.

Significant transition challenges remain in the Infrastructure sector, where Hrvatska elektroprivreda (HEP), the electricity utility, and Hrvatske željeznice (HŽ), Croatian Railways, require substantial restructuring and investment.

As the Bank's recent commitments in Croatia are almost fully disbursed, there is little risk to transition impact due to cancellation or lack of disbursement of transactions.

1.4. Portfolio Ratio and Quality

As of end-2009, the private public ratio is 66 per cent. At present the average portfolio risk rating is relatively good with impaired and problematic assets comprising only 4 per cent of the portfolio. However, the quality of the portfolio has deteriorated from 99 per cent performing assets at mid-year 2007.

2. OPERATIONAL ENVIRONMENT

2.1. The General Reform Environment

2.1.1. Political Environment

After November 2007 general election, the ruling centre-right Croatian Democratic Union (HDZ) received a second consecutive mandate to lead a coalition Government. It maintained the previous junior coalition partners, the Peasants Party (HSS) and the Social Liberal Party (HSLs). The Government also includes an ethnic Serbian party, SDSS, and continues to rely on the support from MPs representing other ethnic minorities and pensioners. The Government was reshuffled in July 2009 following the resignation of Prime Minister Ivo Sanader, who was replaced by Jadranka Kosor of the same ruling HDZ. The Government maintained and strengthened its pro-reform course, focusing on anti-crisis measures, integration into EU, and other well established priorities. In January 2010, Ivo Josipović, the candidate of the opposition Social Democratic Party (SDP) won the Presidency in the second round of voting and was inaugurated in February 2010.

Euro-Atlantic integration remains the key priority of the Croatian authorities. EU accession talks have been ongoing since 2005. Croatia has made significant progress, and the accession talks have now reached a decisive phase, which makes full EU membership within the time-frame of this Strategy a realistic prospect. Croatia became a fully-fledged member of NATO in 2009. Zagreb plays a constructive role in regional cooperation, and is supportive of further cross-border and regional projects.

2.1.2. Business Environment

The business environment in Croatia has improved in recent years, but it remains challenging in several respects. One concrete example of progress was the adoption of new legislation in February 2009 under which foreign investors in real estate can purchase property in Croatia in their own name. This should help facilitate investment in the tourism sector. Also, a new competition law was presented to parliament in mid-2009, building on the significant progress in recent years in law enforcement in this area. However, cross-country surveys continue to place Croatia in a disappointing light relative to its peers in central Europe. For example, Croatia was ranked 103rd (out of 183 countries) in the World Bank's *Doing Business 2010* report; the same survey placed the country at 101st for starting a business. Difficulties with construction permits and the high social costs and inflexibility of labour are the most serious constraints, with the latter reflecting more general, deep-seated problems with labour market rigidities.

The 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), sponsored by the EBRD and the World Bank, identified a number of concerns of business owners and managers on the ground. On the positive side, it showed that, with the exception of labour regulations, typical red tape and regulatory issues are not seen as particularly large obstacles to their operations. Instead, businesses regard tax rates and administration, as well as competition from the informal sector, as their main problems in doing business. The implementation of the Hitrorez guillotine project, introduced by

the government in 2007 to simplify regulations, slowed significantly and was replaced in 2009 by the Office for Control of Efficiency of Regulations.

Croatia continues to face challenges in the sphere of judicial reform and in the fight against corruption. Reform of the courts system remains to be completed, as well as improvement of the judiciary's accountability and of the overall dispensation of justice for citizens. According to the latest BEEPS, firms see the courts as a major obstacle to their operations and growth. Implementation of anti-corruption measures still lack strong co-ordination and monitoring. According to Transparency International's Corruption Perception Index 2009, Croatia ranked 66th out of 180 countries. It scores above the transition country average and better than many of its regional neighbours, but significantly below the OECD average. A number of concrete steps have been taken in the fight against corruption. A revised anti-corruption strategy was adopted in June 2008, together with a detailed action plan. A new inter-ministerial coordination system for monitoring anti-corruption efforts is also in place.

2.1.3. Physical Environment

The Croatian Government has approached its environmental challenges by undergoing legal reforms; policy development; and investment planning. In the 2009 Progress Report the EU pointed out that good progress has been achieved especially in the areas of air quality, industrial pollution control and risk management, and climate change. Considerable efforts are still needed in the water sector and nature protection, especially as regards implementation of the Water Framework Directive and the designation of Natura 2000 sites. Implementation of the horizontal *acquis*, not least strategic environmental assessment and access to justice in environmental matters, needs to be improved (see Annex 4 on Environment).

A National Environmental Strategy has been prepared in co-operation between the Ministry of Environmental Protection and Physical Planning and the World Bank through the projects on Environmental Policy Development and Regulatory Capacity Building. In the process of the National Environmental Action Plan preparation, a Priority Action Plan (PAP) was developed, containing priority projects presented at the Donors' Conference in Zagreb in 2001. The priority projects have been defined (total number of 61), some of them have been completed and some are currently being implemented.

Croatia is oriented towards a dynamic tourism industry that depends on a clean coastal environment, implying considerable investment in waste and wastewater management. The availability of funding for environmental investments has been enhanced by the Parliament's approval of the Government proposal to establish the Fund for Environmental Protection and Energy Efficiency ("Eco Fund") in 2003. The Fund was established to finance programs, projects and other activities in the field of environmental protection, energy efficiency (EE) and renewable energy sources (RES). The Fund provides grants and/or loans for priority environmental investments in the public and private sectors based on the set criteria. The Fund achieves its activities also in cooperation with HBOR which has special programmes for financing environmental protection, energy efficiency and renewable energy sources.

Croatian international cooperation in the implementation of environmental and nature conservation projects on a multilateral and, particularly, on a bilateral basis has been increasing for the past few years. Projects in co-operation with Germany, Denmark, Hungary, the Netherlands, Italy, Monaco, Norway and Japan have been or are currently being implemented. In addition, the grants of the Global Environment Fund (GEF) and UN bodies, such as UNEP, UNDP, UNIDO and the IBRD are being utilised. Croatia worked with the Stability Pact on the Regional Environmental Reconstruction Programme for South-East Europe. The environmental projects are also financed by loans of IFIs, such as the IBRD and the European Investment Bank (EIB). The main projects financed by the IBRD are the following: Neretva and Trebišnjica Management Project (GEF); Agricultural Pollution Control; Energy Efficiency; and Renewable Energy Resources Project. The GEF is also supporting the project Conservation and Sustainable Use of Biodiversity in the Dalmatian Coast through Greening Coastal Development (COAST).

Croatia benefits from EU pre-accession aid under the Instrument for Pre-accession Assistance (IPA) to help meet the membership criteria. The IPA Environment Operational Programme (EPOP) for Croatia's main objective is to invest in projects in the waste and water sub-sectors, whilst assisting Croatia is meeting its obligations for implementing the EU environmental *acquis* governing the treatment and disposal of waste, the supply of drinking water, collection, treatment and discharge of waste water, and also developing the administrative and management capacity of those institutions implementing the EPOP. The EU accession process, including pre-accession funding and legal approximation of the *acquis communautaire*, continues to be among the main drivers of environmental sector reform.

Croatia continues to benefit from the Instrument for Structural Policies for Pre-Accession (ISPA) programme which provides assistance for infrastructure projects in the EU priority fields of environment and transport.

2.1.4. Legal Reform

As of early-2010, Croatia is at an advanced stage of its European Union accession negotiations. The country has achieved good results in almost all policy chapters and is commended for its continued progress in key reforms such as the acceleration of judicial reforms, anti-corruption programmes and the fight against organised crime. Reform of the judicial system appears to be a Government priority and the action plan adopted in June 2008 has led to improvements in the functioning of the judiciary. Nonetheless, the case backlog remains large and judicial procedures generally are protracted. Lack of enforcement of court decisions also constitutes a major obstacle to the efficient functioning of the courts. Further improvements in court rationalisation, as well as in the accountability and professional capacity of the judiciary, are considered necessary.

In the area of corporate governance, Croatia has undertaken a number of legal and regulatory changes in recent years. Key reform priorities include improving legislation on conflicts of interest, enhancing disclosure practices in respect of related party

transactions and beneficial ownership, and strengthening the capacity of the Croatian Financial Services Supervisory Agency.

The past year and a half has seen comprehensive reforms to the public-private partnerships/concessions regime in Croatia. Major developments have occurred in policy, as well as in legislative, regulatory and institutional frameworks. This is highlighted by the approval in late 2008 of the Public Private Partnership Act and the Concessions Act. These represent an important new step in promoting PPP in Croatia. Croatia's public procurement framework was developed to be compliant with EC directives and in general, the newly established public procurement arrangements are characterised by accountable and transparent mechanisms. A more detailed analysis of Croatia's commercial laws can be found in Annex 2.

2.2. Macroeconomic conditions

After several years of solid economic growth, culminating in 5.5 per cent growth in 2007, the global crisis has had a major effect on the Croatian economy. Economic growth slowed significantly to 2.4 per cent in 2008 and the economy contracted by an estimated 5.8 per cent in 2009. Industrial production fell by 10.2 per cent in the first half of 2009 compared with the same period last year, and was accompanied by sharp falls in construction activity and exports. However, industrial production stabilised somewhat in the second half of the year. On the positive side, the tourism sector seems to have coped better than expected with the global downturn, as physical indicators in tourism (number of arrivals and tourist nights) in the peak season were down by just 1 per cent compared to 2008.

The crisis has posed a number of difficult challenges for fiscal policy. State revenues dropped significantly in 2009 and the government had to make three revisions to the 2009 budget, involving cuts to public spending. A previously agreed 6 per cent rise in public sector salaries was cancelled by the government in early-2009. The government also tried to introduce measures to alleviate the worst effects of the crisis, including support to SMEs and the tourism sector, but these measures have had limited impact so far. The current 2009 budget envisaged a general government deficit of 2.9 per cent of GDP; financing of the deficit comes in part from two Eurobond issues in 2009, one in May and the other in November, which together raised around €2 billion. In December 2009, parliament approved the draft budget for 2010. The new budget is based on conservative assumptions about GDP growth next year (projected at 0.5 per cent) and forecasts a State budget deficit of 2.5 per cent of GDP. Significant cuts to subsidies for agriculture and railways are planned next year.

On the monetary side, the central bank has continued to adhere to its tightly managed exchange rate policy, and inflation has remained moderate at 1 per cent in September 2009. The level of credit growth remained modest at below 2 per cent in the year to September. The central bank has brought in measures to encourage lending, including a elimination in the minimum reserve requirement and, in December 2009, the abolition of restrictive measures introduced several years ago to keep credit growth below 12 per cent. In the banking sector, the level of non-performing loans rose to 8 per cent by the end of 2009.

A modest rebound is currently forecast for 2010; the current EBRD projection is growth of 0.6 per cent. The prospects for a return to more rapid growth rates in the medium

term are favourable, given Croatia's strategic location, strong regional links and the likelihood of EU membership in the near future. However, given the country's export orientation and important tourism sector, the extent of the recovery will depend to a large extent on the recovery in the eurozone area. The high level of external debt (around 89.6 per cent of GDP at the end of the second quarter of 2009), most of which is denominated in foreign currency, is a source of vulnerability for the economy and needs to be monitored to ensure that these risks are managed carefully.

2.3. Transition success and transition challenges

Croatia has come a long way in the transition. The country has long been considered among the "advanced" transition countries in the EBRD region; its level of transition, as summarised by the average EBRD transition score (published each year in the EBRD *Transition Report*) is comparable to most EU countries in the region. As part of its ongoing EU accession negotiations, Croatia has achieved a high level of alignment with the EU *acquis communautaire* in many areas and has increased the administrative and institutional capacity to implement the *acquis* once the country is a member of the EU.

Notwithstanding this evident progress, Croatia continues to face a number of important transition challenges in the coming years. The EBRD's *2009 Assessment of Transition Challenges* identified a number of sectors where the overall challenges are considered medium (see Table 2). These include the property and tourism sector, most areas of infrastructure (power, sustainable energy, transport, and municipal and environmental infrastructure) and, in the financial sector, the development of private equity and capital markets and micro, small and medium enterprises.

Table 2: Assessment of transition challenges in 2009

Croatia	Market Structure	Market Institutions	Overall 2009
Corporate			
Agribusiness	Small	Medium	Small
General Industry	Small	Medium	Small
Property and Tourism	Medium	Small	Medium
Telecom	Small	Small	Small
Infrastructure			
MEI	Medium	Medium	Medium
Natural Resources	Small	Small	Small
Power	Large	Medium	Medium
Sustainable Energy	Medium	Medium	Medium
Transport	Medium	Medium	medium
Financial Institutions			
Banking	Small	Small	Small
Insurance and financial services	Small	Small	Small
MSMEs	Medium	Medium	Medium
Private equity and capital markets	Medium	Medium	Medium

Source: EBRD *Assessment of Transition Challenges 2009*

Enterprise sector: Reforms in general industry in Croatia have progressed in recent years, mainly under the umbrella of the ongoing EU accession negotiations. The degree of privatisation, restructuring and competition is however less advanced than in most central European and Baltic countries, due primarily to a heavy level of state involvement in sensitive sectors. By mid-September 2009 (latest available data), the Croatian Privatisation Fund (CPF) still had a portfolio of more than 783 companies of which 84 are majority-owned by the State. These exclude companies such as Croatian Motorways (HAC), the Croatian Bank for Reconstruction and Development (HBOR), and HEP, the electricity utility which are considered strategic by the State, with no plans for privatisation. But there are many companies in the CPF portfolio which are engaged in commercial business for which there is no clear reason for the State to be a shareholder. If sold, these companies will compete with others in their sectors on the same basis, ensuring that they respond to the market rather than to political incentives. In particular, the government maintains heavy subsidies in loss-making enterprises in the shipbuilding sector. The government launched a tender for the six shipyards in mid-2009, but only two bids were received, despite the fact that several shipyards were offered for a nominal sum. Another attempt to sell them was launched in early 2010.

In the agribusiness sector, the privatisation of large state-owned farms is where considerable progress has been made. In 2008 the Croatian sugar processor, Sladorana, was successfully privatised, while Vupik, a large agricultural company, was privatised in 2009. The privatisation of state-owned land with cadastre/land registry issues is progressing more slowly. The conditions for an active land market are not yet in place since property rights remain unclear due to major inconsistencies between the registry and cadastre, although there has been some improvement in this area thanks to the support of donor funds provided by the World Bank and reforms undertaken by the Ministry of Justice. Yields in the agricultural sector remain low in regional comparison. There is a flourishing food and retail industry which the Bank has supported with financing for Agrokor, Getro and Interspar. Private sector banks still show limited interest in servicing the sector. A warehouse receipts law is under preparation but has not yet been implemented. The institutional framework requires further improvement, in particular that related to building a warehouse and registering property.

Generally, Croatia is a market with a relatively high level of education, strong foreign language capacity, and good engineering and science education, all of which are attractive for foreign investors. What is more challenging is the high cost of labour especially when fixed social costs, which can make up almost 50 per cent of the wage bill, are taken into account. Labour unions are strong and vocal, making employers reluctant to shed excess labour, even in very difficult economic times (see Annex 4).

Infrastructure: A number of large public infrastructure enterprises continue to receive significant state subsidies, putting a strain on public finances during the recession. One of the main beneficiaries of these subsidies continues to be the national railway company, Hrvatske željeznice (HŽ). The company announced in mid-2009 that it planned to reduce its workforce this year by 240 people, but this represents less than 2 per cent of the workforce and the company continues to make significant losses. In roads, separate state-owned companies have been established for the development and operation of state roads and motorways. All contracts for road construction, rehabilitation and periodic maintenance are tendered on a competitive basis to the

private sector. Routine maintenance of state roads is contracted out to road maintenance companies, most of which have been privatised. One motorway company was established with the aim of future privatisation but the process has been slow. There have been some road concession projects (although not fully in line with international best practice). Motorways are tolled and priced similarly to neighbouring European countries, although tolls do not always cover capital expenditure fully. The Build-Operate-Transfer financing provided by EBRD and KfW for the Zagreb Water Treatment facility, ZOV, has yet to be replicated for any other substantial infrastructure investments. There are good possibilities for concession finance, however, including for the redevelopment and extension of Zagreb Airport.

The Croatian power sector is still dominated by the state-owned national utility, Hrvatska elektroprivreda (HEP). However, progress has been made with legal unbundling of HEP, which is currently organised as a holding company with generation, transmission and distribution activities operated by separate subsidiaries. In addition, the electricity market has been fully liberalised since July 2008 and consumers are able to freely choose their supplier. Nonetheless, there is still limited private sector participation and effective competition in the sector, with HEP being the only distribution company. The quality of institutions, however, has been strengthened. An independent regulator (HERA) is in charge of the tariff system and of the issuance of licenses and concessions. In spite of recent increases (by 20 per cent for small consumers and by 22-28 per cent for companies in July 2008), tariffs are still not cost-reflective and cross-subsidisation persists.

Sustainable Energy: Legislation supporting renewable energy has been implemented in 2007 based on a feed-in tariff. However the permitting process for renewable energy generation facilities needs to be simplified considerably. Further incentives for energy efficiency are needed in the form of increases in tariffs and the fitting of thermostats and control switches in individual flats where these do not exist.

Financial sector: The financial sector has managed to weather the global financial crisis fairly well. The banking system is well-capitalised and liquid, and foreign banks have remained strongly committed to supporting their subsidiaries. The authorities responded promptly to the crisis in the fourth quarter of 2008 by reducing reserve requirements, eliminating the marginal reserve requirement on banks' foreign borrowing and increasing the guarantee on bank deposits from EUR 14,000 to EUR 56,000. The number of banks – 32 at end-2008 – remains large with 23 banks each having well below 1 per cent market share. With little room for reducing costs and increasing earnings, consolidation would strengthen these institutions. Despite lifting of the 12 per cent limit on loan growth, lending to the enterprise sector, particularly SMEs, is subdued at present. In February 2010, the Government launched a loan programme with HBOR, to encourage banks to restart lending to SMEs.

Access to long-term funding remains difficult, particularly for newly established businesses. Commercial lending to MSMEs is further restricted by the presence of several subsidised programmes, which lead SME's to demand cheap loans and banks to focus their activities on these programmes rather than on making the business of lending

at commercial rates to MSMEs a profitable one. The Croatian economy is very closely linked to the Euro, which makes up about 70 per cent of aggregate bank balance sheets. The local currency market is underdeveloped with few trades taking place on the interbank market and no quotes available for medium-term pricing. Local currency loans therefore remain short-term and the rates remain volatile. Though the Croatian authorities plan to join the Eurozone as early as possible after joining EU, the National Bank is supportive of local currency market development. Given the circumstances, local banks and borrowers will need to adjust prudential ratios (lower loan to value ratios) to limit risks of financing in the Euro while it remains a foreign currency. Next to bank loans, leasing is the second major source of finance for SMEs in Croatia.

In the insurance sector, legislation and regulation almost meet the IAIS standards, and most shortfalls in implementation and staffing of the supervisory body were addressed through establishment of a single supervisor for non-bank financial institutions, although some issues related to the imposition of fines and risk-oriented supervision remain to be fully addressed. Insurance penetration is comparable to the levels of the EU member countries in Central Europe. Recent years saw rapid development of private pension funds operating both mandatory and voluntary pension schemes. The leasing market has been fully developed, and legislation and supervision in this sector have been substantially strengthened. This has fostered a consolidation of the sector and greater transparency on the operations of leasing companies. Croatia scores relatively highly in terms of private credit bureau coverage.

The improvement of Croatia's collateral regulations and the availability of credit information is a step forward towards enhancing MSMEs access to finance. A functioning online registration system for movable assets has been in place since 2006. In July 2006, the Law on Bankruptcy was modified, thereby significantly reducing the duration of proceedings. However, the sector continues to suffer from a cumbersome regulatory framework, inefficiencies in public administration and the judicial system's implementation capacity.

Croatia now shows good compliance with the IOSCO principles, and relatively high effectiveness in applying the laws and regulations. The securities market regulator is considered highly effective in pursuing complex cases. There have been few meaningful private equity transactions, and there is a lack of dedicated private equity funds. While the domestic equity market has a sizable capitalisation, turnover is low, limiting the attractiveness of public equity issuance as a source of capital. Overall, local currency money and securities markets remain underdeveloped, thereby locking in the already high currency substitution in the economy.

2.4. Access to Capital and Investment Requirements

Through the financial crisis, Croatia has retained its investment grade rating (BBB Fitch, BBB/A-3 S&P, Baa3 Moodys), but the Fitch and S&P ratings have a negative outlook. The Government had begun a process of directing its borrowings to the domestic financial market in the period 2007-2008, to reduce the external debt. This process has now been reversed with the Government issuing bonds of EUR 750 million (5.5 years), in May 2009 and USD 1.5 billion (10 years) in November 2009. The most recent Government bond issues were performed in the domestic market in March 2010, with parallel issuance of new HRK and EUR-indexed 10 year maturity bonds. The first

one was issued in the amount of HRK 3.5 billion, with a coupon of 6.75 per cent and the second one in the amount of EUR 350 million with a coupon of 6.5 per cent. Croatian Motorways (HAC) has found accessing long term funds considerably more difficult, and has re-directed its borrowings from the international syndicated loan market to IFIs. In the course of 2009, HBOR borrowed EUR 250 million from EIB, EUR 30 million from KfW, and EUR 100 million from the World Bank. The Bank is considering a large financing for HAC together with EIB.

In contrast to the Government, financing has been difficult for private sector corporates to obtain except at relatively short maturities and at very high prices compared to the Euro base rate. However, the National Bank has released additional banking reserves, increasing liquidity in the banking market in early 2010. This liquidity combined with loan and guarantee schemes operated by HBOR for enterprises, is expected to improve availability and terms of financing offered by local banks to companies.

The availability of funding through foreign direct investment (FDI) severely deteriorated during 2009, as a consequence of the global economic crisis. As an illustration, the total FDI in Croatia in 2007 amounted to EUR 3.67 billion, and in 2008 to EUR 3.35 billion. During the first half of 2009, FDI dropped to EUR 913 million, which was only 27 per cent of the total in 2008. FDI in the second half of the year remained subdued (official figures are not yet available) and prospects for FDI for 2010 will depend on the revival of the global economy.

The Zagreb Stock Exchange (ZSE) was established in 1991 and is the center of the country's capital market. ZSE has three major market segments, of which the most important is the "Official Market Segment" comprising at present only fifteen companies. Market capitalization of the ZSE was 125 per cent of GDP at the end of 2007, and has decreased to 56 per cent of GDP at the end 2009. Total turnover on the Zagreb Stock Exchange amounted to EUR 9.1 billion in 2007, EUR 4.2 billion in 2008, and EUR 1.5 billion in 2009.

According to HANFA (Croatian Financial Services Supervisory Agency), the main regulatory body for the financial services industry, over the last four years the most prominent institutional investors have been pension funds. In Croatia today there are four mandatory pension funds (Allianz-Zagrebačka, Raiffeisen, PBZ and Erste) and over twenty voluntary pension funds. At the end of 2009, total assets under management of both Mandatory and Voluntary pension funds amounted to EUR 4.2 billion, compared to EUR 3.2 billion at the end of 2008.

Other significant institutional investors are investment funds, but their size and importance has deteriorated during the economic crisis. Total assets under management of mutual funds at the end of 2009 amounted to EUR 1.65 billion, which is 22 per cent more when compared to EUR 1.35 billion under management at the end of 2008.

3. STRATEGIC ORIENTATIONS

3.1. Bank's Priorities for the Strategy Period

Croatia is at an advanced state of transition, but the country continues to face significant challenges in economic reform and in preparing for integration into the European internal market. These challenges include the need for further privatisation, restructuring and strengthening of enterprises, commercialisation of infrastructure, investments in environmental infrastructure and regional networks, sustainable energy, and improving access to finance for SMEs.

The Bank will focus its operations on developing private sector solutions to remaining transition challenges and will also work with the Croatian authorities including the Croatian Bank for Reconstruction and Development (HBOR) to address their priorities in the coming Strategy period through both policy dialogue and loans and investments. While the Bank responds to market demand, it will be guided by the following priorities:

- Privatisation and restructuring of State enterprises (e.g., tourism);
- Improving competitiveness and supporting regional expansion of enterprises;
- Investments in renewable energy and energy efficiency to alleviate climate change and improve energy security by reducing demand and diversification of energy supply;
- Financing priority infrastructure including regional transport networks through the WBIF;
- Preparing environmental (water, solid waste) projects for cofinancing with EU funds;
- Improve access to finance for SMEs including availability of private equity.
- Assist deepening and further development of local capital markets.

3.2 Sectoral Challenges and Bank Objectives

3.2.1. Enterprise Sector

Transition goals: Encourage investments in energy efficiency. Support privatisation and restructuring of state-owned enterprises, with a focus on the tourism sector which is under-invested. Support regional expansion and development of local companies and strengthen their competitiveness for the EU internal market. Improve corporate governance and transparency in the corporate sector.

Operational Priorities

The Bank will seek to increase investments in energy efficiency across all corporate sectors, through the Western Balkans Sustainable Energy Direct Financing Facility and regular operations.

The large number of companies in state-ownership lag behind their private competitors. The Bank will encourage the government to rapidly privatise companies in State ownership. The Bank can assist through pre-privatisation financing or by providing funding to new owners, post-privatisation, together with support for restructuring, through the TAM programme. Through policy dialogue, the Bank will also encourage the State to divest non-core businesses from State enterprises, such as food services in hospitals.

Transition gaps in the property and tourism sector remain larger than other corporate sectors and would benefit from additional Bank investment. The Bank will seek to introduce experienced sponsors and international operators, and to support rebranding and upgrading of hotel facilities to raise their standards and ratings. With regard to commercial real estate, the Bank will focus on investment outside the capital city. There remain gaps in the supply of modern warehousing stock, logistics facilities, and high quality office space in regional cities, which the Bank may help to fill.

With EU accession drawing near, large Croatian corporates are investing to meet EU standards and to prepare for the competitive challenge of the EU internal market. SMEs lack the means to do so. The Bank will assist these companies to increase their competitiveness and to improve their standards, either through direct investment or by loans through banks. The SME Competitiveness Facility will be offered through banks. For direct financing, the Local Enterprise Facility (LEF) provides an efficient mechanism to enable the Bank to invest in small companies. The Bank will seek to increase its business with manufacturing companies, which are key to increasing exports.

The Bank will continue to support regional investment by Croatian companies. As the Croatian companies are better developed and more competitive than many regional counterparts, they are able to bring improved business practices along with investment capital to the Western Balkans markets. Where appropriate, the Bank will provide management assistance to local companies through the TAM programme.

At the same time, the Bank will use its risk-taking capacity to support foreign direct investment into Croatia, which brings needed capital, new technology, improved ways of doing business and access to foreign markets.

In the Agribusiness sector, in addition to the support for competitiveness and regional development, the Bank will assist primary agriculture through the Grain Warehouse Receipts programme. This guarantee programme facilitates funding by local banks of farmers, lifting the burden of financing their working capital off of the agribusiness companies that would otherwise have to finance them. Other rural development programmes may be considered.

3.2.2. Infrastructure

Transition goals: Support regional trade and investment through infrastructure development. Support Croatia's investments in environmental infrastructure and ability to successfully invest EU funds for this purpose. Improve energy efficiency in all sectors. Give priority to investments in renewable energy. Support investments to

improve the diversity and security of energy supply. In the gas sector, organize the market on the basis of third party right to access the gas system, including upstream pipelines, the transmission and distribution system, gas storage, and the planned LNG facility.

Operational priorities:

Through the Western Balkans Investment Framework, the Bank will prepare important infrastructure investments together with EIB. The Bank will support tendering of concessions in the airport and other sectors, including the port sector, where the Bank is already encouraging the use of concessions.

The Bank will prepare local and regional environmental infrastructure, particularly waste water and solid waste, in coordination with projects for cofinancing with EU funds. In its municipal infrastructure projects, the Bank will seek to improve contractual arrangements to clarify service levels and expected performance of municipal utilities, in particular, in urban transport.

The Bank will give priority to the financing of renewable energy projects and energy efficiency projects in all sectors through policy dialogue, seek to improve the investment environment for sustainable energy. Financing will be offered directly and through a special credit line with support from the European Union. This will contribute to energy security, and the reduction of greenhouse emissions, delivering an important contribution to combat climate change.

The Bank will work with the authorities to try to achieve further modernization of the power sector and to remove price distortions which inhibit energy efficiency investments. Finally, the Bank will support investments in key energy supply infrastructure projects, including the planned LNG terminal.

3.2.3. Financial Sector

Transition goals: Facilitate access to finance for SMEs to enhance their competitiveness. Reduce risks related to lending in Euros, by adjusting prudential ratios and ensuring borrowers appreciate fully the risks they are undertaking. Facilitate development of capital markets In part by encouraging development of private equity funds. Support privatisation of state-owned institutions and, if feasible, support consolidation among small, locally-owned banks.

Operational priorities:

The Bank will provide credit lines (including those with support from the EU) through leading banks and leasing companies as well as through smaller, locally-owned banks, for on-lending to the SME sector and for energy efficiency and renewables.

The Bank will seek to further develop the local capital market and to support private equity funds bringing know-how and capital to the local economy. The Bank will explore the possibility to develop local currency financing. However, as this may not be

feasible, the Bank will demonstrate best practices to minimize risks to banks in extending, and borrowers taking out, loans in foreign currency.

The Bank will support regional trade and investment through expansion of Trade Facilitation Program and will prepare a Grain Warehouse Receipts Program for primary agriculture.

The Bank will consider investment in the state-owned postal bank to support its development and privatization.

In the event a suitable local banking partner emerges to lead consolidation among locally-owned banks, the Bank may support this process both with equity and with TC.

4. CO-OPERATION WITH THE EUROPEAN UNION

The European Union has played a critical role in Croatia's economic, political and social development, commencing with the Stabilisation and Association Agreement signed between Croatia and the Union in 2001, and continuing with negotiations towards accession to the EU.

Financial assistance has been provided under the new Instrument for Pre-Accession (IPA) from 2007. The IPA is a single and unified pre-accession program, replacing PHARE, ISPA and SAPARD. The IPA programme is concentrated on institution building and preparation for the implementation of the EU's common agricultural policy and cohesion policy. The IPA programme has five components, below:

- transition assistance and institution building;
- cross-border co-operation;
- regional development (transport, environment and regional competitiveness);
- human resource development;
- rural development

Croatia - Financial Assistance under the IPA programme

Component	2007	2008	2009	2010	2011	2012
■ Transition Assistance and Institution Building	49,6	45,3	45,6	39,4	39,9	40,8
■ Cross-border Co-operation	9,6	14,7	15,8	16,2	16,5	16,8
■ Regional Development	45,0	47,6	49,7	56,8	58,2	59,3
■ Human Resources Development	11,3	12,7	14,2	15,7	16,0	16,0
■ Rural Development	25,5	25,6	25,8	26,0	26,5	27,2
TOTAL	141,2	146,0	151,2	154,2	157,2	160,4

In addition, Croatia benefits from regional and horizontal programmes. In response to the economic crisis, an IPA crisis package has been created, comprising EUR 200 million for the Western Balkans region which are expected to leverage investments of at least EUR 1 billion, with co financing by partner financial institutions. The country will benefit from a share of multi-beneficiary funds for competitiveness, SMEs, energy efficiency, and banking sector regulation. As a candidate country, Croatia has been benefiting since 2007 from funding under IPA component III (roughly EUR 142 million cumulated since that year) for reinforcing the competitiveness of the economy – thus helping to cope with the crisis – through major infrastructure projects in the fields of transport (railway and inland waterway infrastructure), environment (treatment and disposal of solid waste, waste water), as well as support to SMEs.²

² Croatia 2009 Progress Report, Commission of the European Communities, Brussels 14.10.2009.

The Bank cooperates closely with the EU in Croatia. Cooperation has focused on co-financing of environmental infrastructure (Karlovac waste water treatment plant) and other planned investments in waste water treatment and in solid waste. In addition, the Bank has signed five EU-EBRD SME Finance Facility loans to banks and leasing companies with a value of EUR 50 million. Beyond this, the Bank and the EU regularly consult regarding support to economic reforms and policy dialogue. In this respect, the EU's role is very important, as a key proponent of reform in the country in areas such as railways restructuring, shipyard privatization, procurement policy, and judicial reform.

5. CO-OPERATION WITH IFIS

The Bank maintains regular contact and dialogue with other IFIs. In the recent Strategy period, the Bank has co-financed transactions with both EIB and the World Bank/IFC. In addition, the Bank is working closely with the Government of Croatia and the EU to prepare projects which will fit the priorities and meet the criteria for EU IPA grant co-financing.

5.1. European Investment Bank (EIB)

EIB started operations in Croatia in 2001 and, with the start of accession negotiations, and has become a significant lender for public sector infrastructure and to the financial sector. As of end of 2009, EIB's total exposure in Croatia amounted to EUR 1,982 million.

In 2009 the EIB financed projects in Croatia for a total of EUR 410 million (EUR 250 million HBOR, EUR 100 million ZABA - UniCredit Group and EUR 60 million Road Rehabilitation II B with Croatian Roads).

In 2007 and 2008 EIB's activities were mainly focused in infrastructure (EUR 100 million Port of Zadar loan), energy (Plinacro EUR 190 million loan) and several loans to local financial institutions in total amount of EUR 180 million. In 2009 the biggest EIB loan in Croatia was a EUR 250 million to HBOR (Croatian Bank for Reconstruction and Development).

The transport infrastructure sector will remain a top EIB priority (motorways, railways, air and sea transport), however, the bank envisages more loans in both the environmental sector (waste water treatment) and the health sector (Zagreb hospitals). EIB also intends to increase direct lending to the private sector and municipalities without state guarantees to foster their development.

The Bank and EIB have been cofinancing partners in the Transport sector for many years, and anticipate continuing to work together in this sector and others through the Western Balkans Investment Framework. At the same time, the Bank may be expected to cofinance projects with the EIB taking a larger portion in light of its larger balance sheet. Given the recent broadening of EIB's remit, the Bank expects to cofinance projects in other sectors including municipal finance and the corporate sector.

5.2. World Bank Group

The Republic of Croatia has been a member of the World Bank Group since February 1993. The investments of the World Bank Group in Croatia have been made through the International Bank for Reconstruction and Development (IBRD) or the International Finance Corporation (IFC). In the new WB Strategy for Croatia for the period 2009 – 2012, new investments in the amount of USD 1 - 1.4 billion are predicted, most of which will be invested in infrastructure and environmental projects.

5.2.1. International Bank for Reconstruction and Development (IBRD)

Since 1990, the IBRD has supported 41 projects in Croatia with a total value of USD 2.52 billion and it has approved 52 grants with a total value of USD 70 million. As of October 2009, the total active lending portfolio consisted of 18 projects with total commitments of USD 1.1 billion. The IBRD's lending has been concentrated in the financing of transport infrastructure (32.1 per cent), water protection (22.5 per cent), private sector development (14.7 per cent), education (7.0 per cent), public sector governance (5.6 per cent), and other sectors (18.1 per cent). The grants have mostly been approved from the Global Environmental Facility (GEF), the Institutional Development Fund (IDF), and the Policy and Human Resources Development Fund (PHRD).

The partnership of the IBRD and Croatia has been organized around four central areas: sustaining Croatia's macroeconomic stability, strengthening the private sector, improving quality and efficiency in the social sectors, and increasing sustainability of long term development.

One of the landmark projects of IBRD in Croatia is the Rijeka Gateway project, whose second phase was signed in 2009. The entire project will transform the Port of Rijeka from a small local port to become one of the most important ports in the Mediterranean. Other IBRD projects in Croatia since the last country strategy include: the Inland Water project, aimed at improving water supply services, wastewater treatment, and flood protection measures in inland parts of the country, the Revenue Administration Modernisation project, aimed at improving efficiency, taxpayer services and tax compliance through capacity building and system improvement in the Croatian Tax Administration (CTA), the Development of Emergency Medical Services and Investment Planning Project, aimed at improving efficiency and outcomes of the emergency medical services' system and to strengthen the capacity of the Ministry of Health and Social Welfare to develop and implement strategic projects, the Coastal Cities Pollution Control project, aimed at improving the wastewater services in coastal municipalities, and the Export Finance Intermediation Loan.

Important IBRD pipeline projects in Croatia are the Irrigation Development project, and the Fiscal, Social and Financial Sector Development Policy Loan (DPL). Restructuring of Croatian Railways remains one of the IBRD's priorities in Croatia, but due to numerous obstacles, no improvements have been recorded in the last two years.

The IBRD and the Bank have been working in a very complementary way, with the IBRD taking a more proactive role in social sectors, railways, and in water projects which require support of the national government, while the Bank has focused on more commercial environmental projects and on the road sector. The area where the two institutions have come together was in the port sector, where we cofinanced the Port of Ploče project. Going forward the Bank will work closely with IBRD in considering a project in the railway sector. The Bank and IBRD keep in close contact with regular consultations to discuss economic developments and policy dialogue challenges.

5.2.2. International Financial Corporation (IFC)

Since Croatia became a member in 1993, IFC has committed some USD 519 million of its own funds and has arranged USD 123 million in syndications. To date, IFC investments in Croatia typically have been loans in financial markets, general manufacturing and agribusiness projects.

Since the last country strategy, IFC has made two major investments in Croatia: a EUR 40 million loan to PIK Vrbovec (part of Agrokor Group), and a EUR 40 million to CMC Sisak, a steelworks privatised in 2007.

Besides loans, IFC's activities in Croatia include advisory work. Since 1996, the advisory program has included institutional framework surveys for the growth of the factoring industry and support to SMEs in the shipping and general manufacturing sectors.

The Bank and IFC have cofinanced the GS Hotels and Resorts project, and continue to cooperate in this project. In addition, IFC has provided debt financing to the Bank's investee company, Agrokor. The Bank and IFC regularly exchange information on our pipelines to avoid overlapping, unless a particularly challenging project requires investment from both institutions.

5.3. International Monetary Fund (IMF)

The Republic of Croatia joined the IMF in December 1992. The current SDR quota amounts to 365.1 million SDRs (equivalent to USD 597 million). The last stand-by arrangement Croatia signed with the IMF was in 2004, lasting until 2006.

During the latest consultations held in May 2009, between the Croatian Government and Central Bank officials and the IMF, several key risks for the country's stability were detected: a high level of foreign debt, a high current account deficit, a high level of overall indebtedness, fast credit growth and a high level of exposure to foreign exchange risk. The IMF representatives were satisfied with the state of the public finances in Croatia, which compared well to some more troubled countries in the region, and have suggested the following measures, which will enable the continuation of the country's financial stability: maintaining exchange rate stability in the future periods, reducing the budget deficit, monitoring credit portfolios of the banks, carrying out structural reforms and continuing privatisation.

The Bank and the IMF exchange information on IMF consultation visits since the IMF closed its office in Zagreb in 2007.

III. ANNEXES

ANNEX 1: POLITICAL ASSESSMENT

Croatia is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank.

Croatia has continued to make progress on key political reforms, geared towards integration into the European Union. Its political system is mature and overall political stability has increased. Democratic institutions in Croatia are robust, with a functioning separation of powers and checks and balances in the political system. Elections are generally conducted in a manner deemed by the OSCE and the Council of Europe to be free and largely in line with international standards. There is high degree of alignment with EU rules in most areas, although further improvements will be needed, in particular in the judiciary, the public administration, and in the fight against corruption in order to enable proper implementation of the EU *acquis* and meet overall obligations of future membership.

Elections

The legal framework, which benefited from several waves of electoral reforms, provides an adequate basis for the conduct of a democratic election process. The latest general elections, which were held in 2007, took place in a generally calm atmosphere and in a competitive and pluralistic environment. The elections represented further progress in fully meeting international standards and were judged by the OSCE Office for Democratic Institutions and Human Rights (ODIHR) to have been organised transparently and professionally. However, some aspects of the legal framework and its implementation can be further strengthened based on recommendations from ODIHR and other relevant international institutions, including voter registration, enhancing the regulatory framework for the media, and enforcement measures for the financing of political parties and election campaigns.

After November 2007 general election, the ruling centre-right Croatian Democratic Union (HDZ) received a second consecutive mandate to lead a coalition Government, which runs through 2011. It maintained the previous junior coalition partners, the Peasants Party (HSS) and the Social Liberal Party (HSLs). The Government also includes an ethnic Serbian party, SDSS, and continues to rely on the support from MPs representing other ethnic minorities and pensioners. The Government was reshuffled in July 2009 following the resignation of Prime Minister Ivo Sanader, who was replaced by Jadranka Kosor of the same ruling HDZ. The Government maintained and strengthened its overall pro-reform course, focusing on anti-crisis measures, integration into the EU, and other well-established priorities.

The latest presidential elections took place on 27 December 2009 and 10 January 2010. The elections generally complied with international standards for democratic elections. According to the OSCE/ODIHR Limited Election Observation Mission, confidence in the election administration and in the integrity of the process remained high during both rounds of the presidential election. The election was won by Ivo Josipović, the

candidate of the main opposition political party, centre-left Social Democratic Party (SDP), who received 60.26 per cent of votes. He was inaugurated on 18 February 2010. In the aftermath of the elections both the President-elect and the Prime Minister, who belong to different political parties, asserted that they would work to establish good cooperation between the two branches of executive power in the interest of all citizens of Croatia.

Rule of Law

Comprehensive reform of the judiciary is making progress, and a large volume of necessary legislation has been adopted. However, significant challenges remain, particularly relating to judicial independence and efficiency.

Croatia's score of 4.1 in the 2009 Transparency International Corruption Perceptions Index (CPI) puts it at 66th place out of 180 countries, ahead not only of Western Balkan neighbours, but also of some EU members. The legal framework to combat corruption has been strengthened, a national police office for the fight against corruption and organised crime became operational, and special anti-corruption departments were established in four key courts. However, corruption remains a serious problem.. The Third Round Evaluation Report on Croatia, released by the Group of States against Corruption (GRECO) in December 2009, which focussed on two distinctive themes, incrimination and transparency of party funding, made 11 recommendations, which will be assessed by GRECO towards the middle of 2011 through its specific compliance procedure. Recent indictments against some former members of the government, resignations of some serving members, and a number of investigations and arrests in the management of some public companies highlighted problems in the sphere of high level corruption. At the same time, these initial results of the anti-corruption efforts reflect intensification of the fight against corruption following the appointment of the new Prime Minister and may be seen as a practical demonstration of the authorities' commitment in this respect.

Human rights

Croatia is a signatory to all major international human rights covenants, including the European Convention on Human Rights and Fundamental Freedoms. The progress made by Croatia towards honouring its commitments and obligations as a member of the Council of Europe since its accession in 1996 led to the decision of the Council of Europe, in 2000, to close the usual monitoring procedure for Croatia. The Croatian Constitution guarantees the basic freedoms and rights of citizens recognized in international law, while international treaties are directly enforceable by domestic courts and their status is superior to the domestic law. The constitutional guarantees of freedom of thought, conscience and religion are generally respected.

Freedom of expression, including freedom and pluralism of the media, is provided for in Croatian laws and is generally respected. However, there have been cases of threats against journalists working on cases of corruption and organised crime, and journalists continue to report undue political pressure. The dominant media outlet is Croatian Radio and Television (HRT). A few years ago, there was only one privately owned nation-wide broadcaster, today there are two: RTL and TV Nova.

According to the latest official census, conducted in 2001, ethnic Croats are about 89.63 per cent of the population. Minorities are about ten per cent, of which the largest group is ethnic Serbs (4.54 per cent of the total population of Croatia). The Croatian Constitutional Law on the Rights of National Minorities (CLNM) formally recognises 22 ethnic minorities in Croatia. The CLNM provides a comprehensive framework for the protection of minorities, and the authorities continue to issue high level public expressions of commitment to the rights of minorities.

Ethnic minorities actively participate in political life, including through their own political parties. They benefit from eight set-aside seats in the national Parliament and have the right to choose a general constituency or special minorities' ballot during the elections (during the latest general elections more than 70 per cent of ethnic minority voters chose the general ballot over the ethnic minority ballot).

Among the remaining challenges in the sphere of minorities' protection are full implementation of the above-mentioned very ambitious and comprehensive Constitutional Law (CLNM), overcoming under-representation of minorities in certain areas, particularly the judiciary and the police, cases of minorities' discrimination in the work place and labour market, and the need to take appropriate measures to encourage a greater spirit of tolerance towards minorities and to protect those who may still be subject to discrimination.

There has been some progress on the refugee return issue. According to UNHCR data, during this decade 109,091 refugees have returned to Croatia from Serbia and Bosnia and Herzegovina (more than 62,000 still remain in Serbia, 2,000 in Montenegro, and about 7,000 in BiH). Among the remaining issues is the provision of housing care for former occupancy and tenancy rights holders, where, despite the progress, the full implementation of the benchmarks remains to be seen.

The Roma minority, whose number according to official data stands at about 9,000 (Roma continue to raise concern about the number of their allegedly undocumented compatriots), continues to face particular challenges in many areas. However, this problem has continued to receive attention of the authorities, and some improvements have been made, particularly in preschool education. A Roma MP was elected for the first time to the Croatian Parliament in 2007.

According to the UNDP 2009 Human Development Report, Croatia ranks 45 out of 181 countries regarding its gender development. Women are active at the grassroots level and have a few high-profile representatives at the national level, including, since 2009, the first-ever female Prime Minister. The percentage of women elected to the national Parliament in the last two general elections (2003 and 2007) stands just above 20 per cent of the total number of MPs. At the same time the situation of women on the labour market in general remains more difficult, including lower level of employment and higher level of long-term unemployment than in the case of men. The handling of domestic violence cases has improved although the overall gender prejudices remain uneven in some rural areas.

There is a favourable legal framework for civil society organisations, which are particularly active in the areas of protection of minorities and socially vulnerable persons, women's and children's rights, and environment.

Croatia remains a source, transit, and increasingly in the last few years destination for persons trafficked for the purpose of sexual exploitation. Croatia is a party to all relevant international agreements on combating trafficking. The authorities are making efforts to prevent and combat trafficking, as well as to protect the victims. They continue to increase punishment of convicted trafficking offenders and have made progress in prosecuting them. The government has shown leadership and initiative, invested significant effort in relevant awareness raising and training projects, and sustains generous funding for NGOs engaged in the protection of the victims. In 2009, Croatia adopted a new national Plan for Combating Trafficking for the period 2009-2011. Further efforts are needed to investigate possible trafficking within high tourism sectors along the Croatian coastline, and to ensure the responsible repatriation of foreign victims.

EU approximation and Euro-Atlantic integration

Euro-Atlantic integration is the key priority of the Croatian authorities. EU approximation remains the main external anchor for reform and there is full consensus among all mainstream political parties regarding the importance of EU membership. EU accession talks have been ongoing since 2005. The latest EU Enlargement Strategy, released by the European Commission in October 2009, envisages the conclusion of the accession negotiations, if all outstanding conditions are met, in 2010. Croatia has made significant progress, and the accession talks have now reached a decisive phase, which makes full EU membership within the time-frame of this Strategy a realistic prospect. At EU level, a working group for the drafting of the Accession Treaty of Croatia has been set up, and a financial package for the accession has been prepared. Croatia became a fully-fledged member of NATO in 2009. Zagreb plays a constructive role in regional cooperation, and is supportive of further cross-border and regional projects.

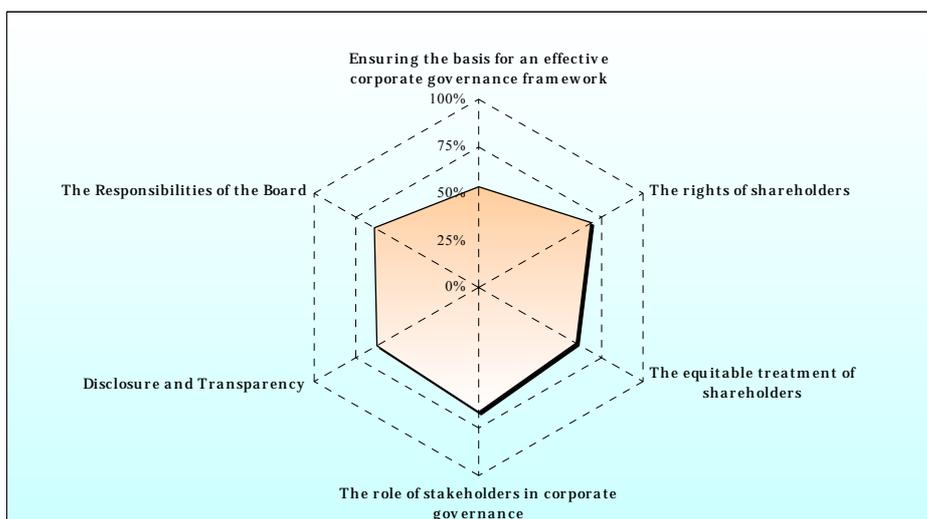
ANNEX 2: COMMERCIAL LAWS OF CROATIA

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, secured transactions and telecommunications. In 2010, assessments will be conducted for the first time in the judicial capacity and procurement focus areas. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Croatia, accompanied by critical comments from the Bank’s legal experts who have conducted the assessments and other research in the relevant areas.

Company Law and Corporate Governance

The Law on Companies (1993) is the primary legislation on corporate governance in Croatia. A voluntary Corporate Governance Code³ was adopted by the Croatian Financial Services Supervisory Agency and the Zagreb Stock Exchange in April 2007. The Code focuses on disclosure, shareholder general meetings, management and supervisory boards, and covers many issues in line with the OECD Principles. It also includes a questionnaire to help companies to report under the so-called the “comply or explain” mechanism.

Quality of corporate governance legislation – Croatia (2007)



Note:
The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2007 assessment

³ The Croatian Corporate Governance Code is available at <http://www.ebrd.com/country/sector/law/corpgov/codes/index.htm>

The EBRD's 2007 Corporate Governance Sector Assessment, which gauged corporate governance legislation, rated Croatia as having achieved “medium compliance” with the OECD Principles of Corporate Governance. As shown in the chart above, flaws were found in many sections under consideration.

Croatia has undertaken a number of legal and regulatory changes in recent years which have led to improvements in the corporate governance framework. However, many shortcomings remain. This picture is confirmed by the World Bank's 2008 Report on the Observance of Systems and Codes. Key reform priorities include improving legislation on conflicts of interest, enhancing disclosure practices in respect of related party transactions and beneficial ownership, and strengthening the capacity of the Croatian Financial Services Supervisory Agency.

Concessions and Public-Private Partnerships

The past year and a half has seen comprehensive reforms to the concessions and public-private partnerships (PPPs) regime in Croatia. Major developments have occurred in policy, as well as in legislative, regulatory and institutional frameworks.. These represent an important new step in promoting concessions and PPPs in Croatia.

Recent developments have been grounded in the Strategic Development Framework 2006 – 2013, and the guidelines for implementation of contractual forms of public private partnerships. In June 2008, the government approved the Strategic Framework for the Development of Public-Private Partnerships, setting the outline of future PPP and concession frameworks. This was followed by the approval in late 2008 of the Public Private Partnership Act (PPP Act) and the Concessions Act. The Policy Framework for Public Private Partnership was adopted by the Government on 8 January 2009. Regulations on the following matters were also approved: criteria for assessment and approval of PPP projects; the contents of PPP contracts; supervision of implementation of PPP projects; and training in procedures for the preparation and implementation of PPP projects.

The PPP Act defines PPP broadly, by reference to a set of characteristics. Among these are: a private partner assuming from a public partner an obligation to construct/reconstruct public infrastructure, together with financing, management and maintenance; the provision of public services to final users; the granting of a concession or compensation; and a sharing of risk. Implementation arrangements broadly reflect EU legislation and principles.

The EU influence can also be seen in the PPP Act's recognition of ‘joint-venture-type institutionalised’ PPPs (iPPPs), a feature not present in the frameworks of most EBRD countries of operations (the EU itself is yet to legislate on iPPPs). Notably, the PPP Act establishes and extensively regulates the PPP Agency as a public body. The Agency has both regulatory and operational functions, and also serves as a know-how centre.

The Concession Act governs the procedure for awarding concessions, implementation arrangements, monitoring rules, and contractual requirements. The definitions of public

works concessions and public services concessions are identical to those in the relevant EU Directives. According to the Concessions Act, where a concession forms a part of a PPP project, the PPP Act rules shall prevail. The Concessions Act allows the parties to agree on arbitration in settling their disputes, although the law applicable to dispute settlement is stated to be the law of the Republic of Croatia (Article 39). The Ministry of Finance is responsible for developing the policy and methodology in the field of concessions as well as for the maintenance of the Concessions Register. The Road Map for the harmonisation of special (sectorial) regulations governing concessions with the Concessions Act was adopted on 14 November 2008. During December 2009 the process of harmonization of sectorial concessions legislation with the Concessions Act continued.

The above frameworks are modern and comprehensive, and appear to have benefited from the reform experience of other countries in recent years. It remains to be seen how workable the new regime is in practice, and in particular whether the cross-referencing in the above mentioned acts works clearly and effectively.

Judicial Sector

The court system in Croatia is comprised of municipal and district courts, the Administrative Court, the Supreme Court, and the Constitutional Court. Specialised commercial courts deal with commercial and contractual disputes. The State Judicial Council is responsible for the selection, appointment and promotion of judges, and for the administration of disciplinary proceedings.. It is a body independent of both the judiciary and the Ministry of Justice. The Council's capacity in these areas has recently been enhanced, however its procedures are not entirely transparent.

Reform of the judicial system appears to be a Government priority, particularly in light of EU accession requirements relating to the guarantee of the rule of law. An action plan on judicial reform adopted in June 2008 has seen improvements in the functioning of the judiciary. The chronic backlog of pending cases has been reduced by around 10.28 per cent to 795,722 cases in 2009. This has been facilitated by the Supreme Court's monitoring of case loads, new policies on case transfer between jurisdictions, overtime pay for judges and use of notaries for certain enforcement cases. Further, digitised land registries and an increased judicial budget have assisted in improving clearance rates. Nonetheless, the backlog remains large and judicial procedures generally are protracted. Enforcement of court decisions also constitutes a major obstacle to the efficient functioning of the courts. Further improvements in court rationalisation, as well as the accountability and the professional capacity of the judiciary, are considered necessary.

A number of concrete steps have been taken in the fight against corruption. A revised anti-corruption strategy was adopted in June 2008, together with a detailed action plan. A new inter-ministerial coordination system for monitoring anticorruption efforts is also in place. The Office for the Fight against Corruption and Organised Crime is increasingly active and has issued indictments in some important cases. However, corruption is considered to remain widespread in the country.

Public Procurement

Public procurement in Croatia is regulated by the Public Procurement Law of 3 October 2007 (PPA). Also, the Act on Amendments to the public Procurement Law of 17th October 2008 (Official Gazette No. 125/08) enabled further harmonisation of the public procurement legal framework with the *Acquis Communautaire*. Legal protection instrument in the Republic of Croatia has also been further reinforced by adopting the Law on State Commission for Supervision over Public Procurement Procedure, on 5 February 2010. Croatia's public procurement framework was developed to be compliant with EC directives.

The PPA is supplemented by subordinate legislation, most importantly on public procurement notices and records, and on the methodology for drawing up and handling tender documents. The PPA applies to all public contracts for goods, works and services above the value of 70,000 HRK (approx. 9500 EUR), and to contracts of lower value if the client so decides. The specific procedure to be followed depends on the decision of contracting authority, fulfilment of specific conditions and estimated value of the contract in question. For services, the application of specific procedural rules depends on whether the contract is for EU priority services or non-priority services. The PPA does not provide separate thresholds for public procurement carried out by sectoral contracting authorities.

Eligibility criteria relating to the technical, financial and economic standing of the tender, as well as the award criteria for lowest bid or best value for money, are in line with international practice. Contracting authorities (state budget public procurement) may apply open or restricted procedures at any time, and negotiated procedures in certain circumstances. For public procurement carried out by sectoral contracting authorities, negotiated procedures (with publication) are available at any time.

The PPA uses electronic procedures (certified electronic signatures are mandatory) and permits electronic communication between contracting authorities.

In general, the newly established public procurement arrangements are characterised by accountable and transparent mechanisms. However, public purchasing has a tendency to be too formalistic and the contracting authorities are not yet fully competent in obtaining value for money in the public procurement process.

Secured Transactions

Taking security in Croatia is a process governed by a complex inter-relation of different acts. The 1996 Law on Ownership and Other Propriety Rights provides for security rights over immovable and movable assets. Generally speaking, the legal framework goes a long way in providing the tools market players need to tailor transactions as they deem fit and enforce them. However, improvements could be made in streamlining the procedures (that suffer from being overly complex and lengthy) and offer more flexibility to the parties.

Security rights over movable assets can be created in several ways. First, they can be agreed and registered by recording their title in a specific registry. This applies to ship, aircraft, or securities. For other movable assets, the parties can enter into a voluntary

agreement before a court, under which a charge (security right) is created over the assets to secure the claim. This security is governed by the 1996 Law on Execution (arts 261-272) but it results in the actual seizure of these assets for security purposes. The existence of these charges is not easily accessible by third parties inquiring about the existence of previous charges against the debtor.

The instrument that is by far most used in practice to secure debt is the fiduciary transfer of ownership. The 1996 Law on Execution provides for transfer of ownership (title) of assets and rights for security purposes (arts 273 ff). Such a transfer can be made either before a court or a public notary (the latter is the most popular option). The fiduciary transfer of property is also published in the Official Gazette, which records that the transfer was made for security purposes.

Charges can only be created over individually determined assets. This makes security over generally described assets and charges over pool of assets impossible; further, notice to the chargor's debtor is required for the perfection of the charge over receivables. By contrast fiduciary transfers are flexible, as far as the collateral description is concerned. Enforcement of charges must generally be led by the court, and realisation takes place at public auction, except in some very limited circumstances. Fiduciary transfer of ownership, on the other hand, allows the asset to be sold directly by a public notary, providing that parties have included an enforcement provision.

A new Act, the Law on the Register of Pledges (court-ordered and notarised) was adopted on 11 October 2005, applying to both movable property and rights; it became effective in mid-April 2006. The Registrar is the Financial Agency (referred as FINA), a new institution born out of the former Yugoslav payment system (so-called ZAP or ZOP). FINA has many functions, including registering the balance sheets and accounts of enterprises, distributing and processing cash on behalf of the Croatian National Bank, and maintenance of inter-bank settlement systems. The register is comprised of both electronic and paper documents. Once registered, the pledge or fiduciary transfer becomes immediately visible and accessible at all register sites. The registered information is deemed accurate and FINA is liable for damages due to inaccuracy or loss of data in relation to data contained in the documents that form the basis for the entry. A charge or transfer of title can be agreed over all of the debtor's assets (or certain types) located at a specific site. The law provides for an instrument akin to a floating charge, according to which the debtor is allowed to sell the assets free from the charge but would have to replace them (unless otherwise provided in the contract).

Pursuant to the Law on Ownership and Other Property Rights of 1996, a security over immovable property (mortgage) is created by a mortgage agreement, with the signatures of the parties certified by a notary and its registration in the Land Register. A mortgage agreement executed as a notarial deed becomes immediately enforceable. Mortgages can secure any type of debt so long as it is determinable in monetary terms and the maximum amount has been expressed in the mortgage agreement. Any type of immovable property may be used to secure a debt.

The Land Register is kept by municipal courts under their president's supervision, with the Ministry of Justice having overall supervision of their work. The Register is undergoing a process of digitalisation. Transfers of apartments and unregistered property are recorded with the temporary Registers of Deposited Deeds that are created at each court and will be gradually transferred into the electronic Land Registry

database. The database can be inspected by any interested party at the Land Registry courts. Limited information is also available on-line.

Mortgagees enjoy priority in the mortgaged property from the moment of the mortgage being entered in the Register. Priority is upheld in practice, including the event of bankruptcy. However, there is some uncertainties as to the priority of tax claims.

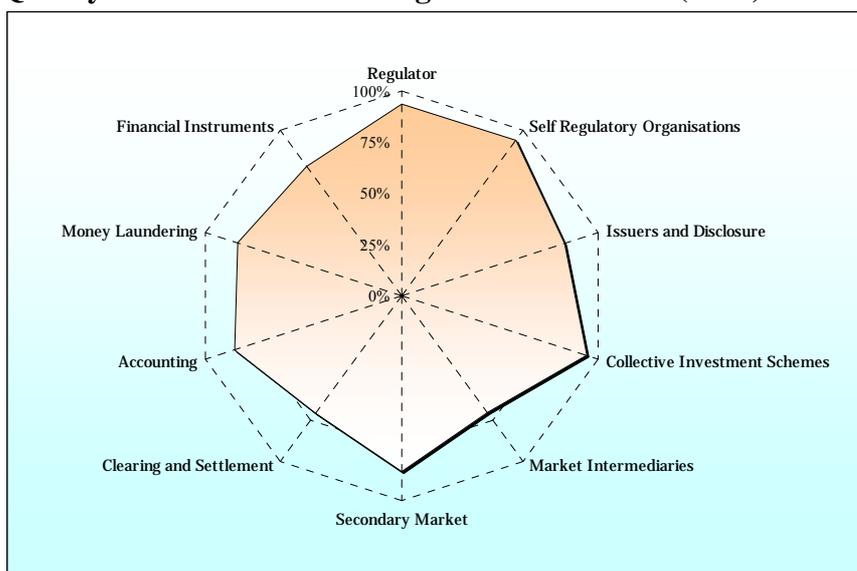
In the event of the mortgagor’s default, the mortgage can be enforced only with the involvement of a court by way of a public auction. Auction can also be carried out by a public notary authorised by a court. Enforcement is reported to take usually up to 1 year, and the sale proceeds often do not reach the market level. Debtor obstructions can significantly prolong the enforcement but cannot prevent the sale of the property.

Securities Markets

In Croatia the basic legislation on the securities market is comprised by the Capital Market Act enacted in 2008, the Investment Funds Act and the Law on Croatian Financial Services Supervisory Agency, both enacted in 2005.

The Capital Market Act was approved by the Croatian Parliament in July 2008 and entered into force in January 2009. It superseded the Securities Market Act, aiming to harmonise the framework with the *Acquis Communautaire*. The Capital Market Act was further amended in June 2009 for harmonisation purposes with the *Acquis Communautaire*. The act focuses on the establishment, activities, supervision and termination of investment companies, market operators and operators of payment and settlement systems; the offering of investment services and the performance of investment activities; the offering, listing and trading of securities on the organised market; the reporting requirements in connection with securities; market abuse; the deposit of financial instruments and the settlement and payment of transactions with financial instruments and the authority. Finally, it details activities of the Croatian Financial Services Supervisory Agency for the implementation of the new Act.

Quality of securities market legislation – Croatia (2007)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO’s *Objectives and Principles for Securities Regulations*. The fuller the ‘web’, the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2007

Oversight of the Croatian capital market is undertaken by two bodies: the Croatian National Bank, which supervises credit institutions, and the Croatian Financial Services Supervisory Agency, which supervises the securities market, pension funds and insurance companies. The Agency was established as an independent legal entity on 1 January 2006 pursuant to the Act on Croatian Financial Services Supervisory Agency. The Act also provides for the dissolution and transfer to the Agency of authority from the Insurance Companies Supervisory Authority, the Croatian Securities Commission and the Agency for Supervision of Pension Funds and Insurance. The fundamental objectives of the Agency are the promotion of stability in the financial system and the maintenance of transparency and legality in securities markets operations. The Agency is an Ordinary Member of IOSCO.

The regulated market in Croatia is the Zagreb Stock Exchange. The current capitalisation of the market is about HRK 176.38 billion (about 24 Billion EUR) with 280 listed companies.⁴

The 2007 EBRD Securities Markets Legislation Assessment (see chart above) found Croatia in “high compliance” with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO), showing a generally sound securities markets legal framework. In order to understand -- how securities markets legislation works in practice, the EBRD recently concluded the 2007 Legal Indicator Survey (“the LIS”). Practitioners in the region were asked to comment on a hypothetical case study, advising an investor who lost his savings after buying shares in a national company’s Initial Public Offering (IPO), misled by erroneous information in the prospectus. In particular, the Survey concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The LIS revealed that IPOs and underwriting in Croatia are not yet common practice. Disclosure practices related to financial information, related party transactions and beneficial ownership need to be improved. Courts and the regulator are gradually developing expertise in investigating securities cases but more efforts need to be done. Also the corresponding capacity of prosecutor needs to be improved. The case study showed that there are many avenues possible to obtain redress in court but proceedings can be lengthy and characterised by heavy burdens of proof, which can diminish the effectiveness of the action.

Electronic Communications

A new Electronic Communications Law (EC Law) came into force in July 2008, defining the institutional framework for the sector and bringing Croatia into compliance with the principles of the European Union (EU) 2003 regulatory framework. The Ministry of Sea, Transport and Infrastructure is the sector policymaker. The EC Law established the Croatian Post and Electronic Communications Agency (HAKOM) as a new autonomous and independent body responsible for regulatory implementation.

⁴ Information from the Zagreb Stock Exchange (<http://zse.hr/default.aspx?id=73>) accessed on 4 December 2009.

Former monopoly operator, Hrvatske Telekomunikacije (T-Com), is majority owned by Deutsche Telekom (51 per cent). Remaining shares are held by the Croatian War Veterans' Fund (7 per cent), the Croatian state (3.5 per cent) and institutional and private investors (38.5 per cent). The mobile market is shared by T-Mobile (T-Com subsidiary), VIPnet and Tele2, with all three operating 2G and 3G and mobile network penetration rate being in excess of 100 per cent (132 per cent at end 2008).

The EC Law introduced a general authorisation regime whereby network and services can be provided without individual licences, provided a notification is submitted to HAKOM at least 15 days before the start of activities. Individual licences continue to be issued by HAKOM for the rights of use of the radio frequency spectrum.

The EC Law provides for the market analysis procedures, definition of relevant markets, Significant Market Power (SMP) designations and imposition of remedies on SMP operators based on the principles of the Law on Competition and the EU 2003 regulatory framework. The EC Law requires the HAKOM to carry out market analysis procedures at least once every three years and that process is understood to be currently underway.

The key competitive safeguards foreseen under the EU 1998 regulatory framework have been implemented in Croatia: carrier selection and pre-selection in the fixed network; fixed and mobile number portability; fixed and mobile reference interconnect offers published by operators with SMP; and, reference unbundling offers and bitstream access reference offers.

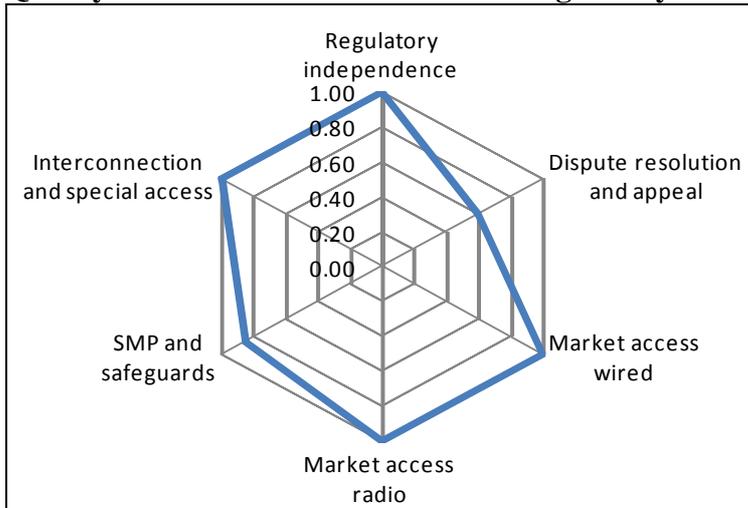
HAKOM can designate one or more universal service providers based on a public tender procedure. However, under the Telecommunications Law of 2003, a public voice telephone service provider with a market share above 80 per cent can be required to provide universal service without tender procedure. In November 2005 HAKOM designated T-Com as the universal service provider for a five-year term.

Following the adoption of the EC Law, the main priorities of the authorities are focused on implementing legislation, continuing the market analysis procedure already underway and development of regulatory cost accounting methodologies for ensuring effective price controls mechanisms in fixed and mobile networks. Additionally, work will need to begin on adopting the measures in the new 2010 EU regulatory package.

In a 2008 assessment of the communications sector of EBRD Countries of Operation, the sector regulatory regime in Croatia was deemed to have "Full Compliance" when measured against international best practice.⁵

⁵ For further detail see <http://www.ebrd.com/country/sector/law/telecoms/assess/index.htm>

Quality of electronic communications regulatory framework – Croatia (2008)



Source: EBRD Telecommunications Regulatory Assessment, 2008

This regulatory spider diagram includes six main group indicators. For each indicator, the diagram presents the scores as percentages of the maximum achievable score. The scores begin at zero at the centre of the chart and reach 1.00 at the outside, so that in the overall chart, the wider the web, the better the score in the assessment.

Note that even though Croatia is assessed as having "Full compliance", it has been marked down in the area of dispute resolution and appeal because of a lengthy appeal procedure and for still being in a transition phase for market analysis at the

ANNEX 3: SELECTED ECONOMIC INDICATORS

Croatia

	2003	2004	2005	2006	2007	2008	2009 <i>Estimate</i>
Output and expenditure <i>(Percentage change in real terms)</i>							
GDP	5.0	4.2	4.2	4.7	5.5	2.4	-5.8
Private consumption	4.8	4.3	4.4	3.6	6.2	0.8	na
Public consumption	1.3	2.6	1.2	2.2	3.4	1.9	na
Gross fixed capital formation	24.7	5.0	4.9	10.9	6.5	8.2	na
Exports of goods and services	11.6	5.4	3.7	6.5	4.3	1.7	na
Imports of goods and services	11.9	4.7	3.9	7.4	6.5	3.6	na
Industrial gross output	4.1	3.7	5.1	4.5	5.6	1.6	na
Agricultural gross output	-15.9	11.9	-8.7	4.4	-3.9	8.0	na
Employment¹ <i>(Percentage change)</i>							
Labour force (end-year)	0.1	-0.2	0.7	0.7	-0.9	-0.6	na
Employment (end-year)	0.1	0.5	2.5	2.8	0.1	0.5	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	14.4	13.8	12.3	10.5	9.7	8.7	na
Prices and wages <i>(Percentage change)</i>							
Consumer prices (annual average)	1.8	2.1	3.3	3.2	2.9	6.1	2.5
Consumer prices (end-year)	1.7	2.7	3.6	2.0	5.8	2.9	1.9
Producer prices (annual average)	1.9	3.5	3.0	2.9	3.4	8.3	na
Producer prices (end-year)	1.1	4.8	2.7	1.9	5.9	4.3	na
Gross average monthly earnings in economy (annual average)	4.8	6.4	4.4	6.2	6.2	7.1	na
Government sector <i>(In per cent of GDP)</i>							
General government balance	-4.8	-4.0	-3.5	-3.1	-2.5	-1.4	-3.3
General government expenditure	44.3	43.4	42.3	42.3	42.8	40.8	na
General government debt	35.8	37.8	38.3	35.7	33.1	33.6	na
Monetary sector <i>(Percentage change)</i>							
Broad money (M4, end-year)	11.0	8.6	10.5	18.0	18.3	4.3	na
Domestic credit (end-year)	12.3	11.8	19.2	18.9	12.9	14.4	na
<i>(In per cent of GDP)</i>							
Broad money (M4, end-year)	56.8	57.0	58.5	63.7	68.7	65.8	na
Interest and exchange rates <i>(In per cent per annum, end-year)</i>							
Domestic rate	4.5	4.5	4.5	4.5	9.0	9.0	na
Money market interest rate (daily)	7.0	6.0	4.0	3.5	6.7	7.6	na
Deposit rate ²	1.7	1.8	1.6	1.9	2.7	2.9	na
Lending rate ²	11.5	11.4	9.9	9.1	9.3	10.7	na
<i>(Kuna per US dollar)</i>							
Exchange rate (end-year)	6.1	5.6	6.2	5.6	5.0	5.2	na
Exchange rate (annual average)	6.7	6.0	5.9	5.8	5.4	4.9	na
External sector <i>(In millions of US dollars)</i>							
Current account	-2,162.3	-1,874.7	-2,555.0	-3,287.1	-4,436.8	-6,249.0	-3,154.0
Trade balance	-7,904.6	-8,345.8	-9,341.5	-10,486.5	-12,933.4	-15,956.0	-10,279.0
Merchandise exports	6,311.4	8,214.5	8,959.8	10,644.4	12,622.7	14,460.0	10,718.0
Merchandise imports	14,216.0	16,560.3	18,301.3	21,130.9	25,556.1	30,416.0	20,997.0
Foreign direct investment, net	1,927.3	732.3	1,551.0	3,193.7	4,735.8	4,683.0	1,284.0
Gross reserves, excluding gold (end-year)	8,191.3	8,759.0	8,801.1	11,488.6	13,675.3	12,958.1	na
External debt stock ³	24,850.7	31,209.5	30,464.7	38,544.9	48,859.0	56,757.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year) ⁴	5.2	4.8	5.1	5.3	5.2	4.6	na
<i>(In per cent of exports of goods and services)</i>							
Debt service ⁵	-20.2	-24.2	-26.9	-36.8	-44.0	-28.0	na
Memorandum items <i>(Denominations as indicated)</i>							
Population (end-year, million)	4.4	4.4	4.4	4.4	4.4	4.4	na
GDP (in billions of kuna)	227.0	245.6	264.4	286.3	314.2	342.2	333.1
GDP per capita (in US dollars)	7,625.5	9,167.0	10,003.9	11,040.9	13,196.5	15,608.4	na
Share of industry in GDP (in per cent)	18.0	18.5	17.9	17.7	17.7	17.5	na
Share of agriculture in GDP (in per cent) ⁶	5.7	6.1	5.6	5.4	5.2	5.6	na
Current account/GDP (in per cent) ⁷	-6.3	-4.4	-5.5	-6.9	-7.6	-9.2	-5.2
External debt - reserves (in US\$ million)	16,659.4	22,450.5	21,663.6	27,056.3	35,183.7	43,798.9	na
External debt/GDP (in per cent) ⁸	66.3	70.0	72.1	74.9	77.6	82.4	na
External debt/exports of goods and services (in per cent) ⁹	151.3	161.0	168.6	172.2	181.2	197.2	na

¹ Data based on labour force surveys.

² Weighted average over all maturities.

³ Change in reporting methodology from 2007 onwards.

⁴ Ratio calculated in euros.

⁵ Ratio calculated in euros.

⁶ Agriculture includes hunting, forestry and fishing.

⁷ Ratio calculated in euros.

⁸ Ratio calculated in euros.

⁹ Ratio calculated in euros.

ANNEX 4: ENVIRONMENTAL AND SOCIAL DEVELOPMENTS

Environment

There has been some progress with the **horizontal legislation**. Full transposition of the environmental impact assessment (EIA) and strategic environmental assessment (SEA) directives was achieved through the adoption of implementing regulations. Implementing legislation related to the rules for subsidies in environmental protection was also adopted. Directive on environmental liability is still not fully transposed or implemented. The Protocol on Strategic Environmental Assessment (SEA) to the Convention on Environmental Impact Assessment in a Transboundary Context (Espoo Convention) was ratified. Efforts to implement the SEA need to be stepped up. Implementation of provisions relating to public participation and access to justice in environmental matters remain weak. The Act on Ratification of the Memorandum of Understanding on Croatia's participation in the Community Civil Protection Financial Instrument was adopted.

Good progress has been made in the area of climate change. Implementing legislation on Kyoto flexible mechanisms has been enacted. The National Allocation Plan for greenhouse gas emissions allowances was adopted for the period 2010-2020. Preparations for Croatia's participation in the EU Emission Trading Scheme (EU ETS) are well advanced. Further work is required in the areas of GHG emission allowance trading, establishment of a national GHG registry. However, barriers to renewable energy and energy efficiency remain a significant problem.

Good progress can be reported in the field of **air quality**. The Air Protection Act has been amended to ensure further alignment with the *acquis*. Further Protocols to the Long-Range Transboundary Air Pollution Convention (LRTAP) have been ratified. In addition, the National Air Quality Protection and Improvement Plan for the Period 2008-2011 have been adopted. Implementing legislation related to the use of organic solvents, fuel economy and CO₂ emissions of new passenger vehicles, as well as to establishment of zones and agglomerations by air category was also adopted. Work on the establishment of the national air quality monitoring and management system is entering its operational phase. The programme for monitoring the quality of liquid fuels for 2008 has been adopted. The government continues to decide annually on the quantity of fuel on the market that does not comply with the prescribed quality standards. Transposition of the new *acquis* related to ambient air quality and cleaner air for Europe and emission ceilings related to atmospheric pollutants is required. Preparations in this area are progressing well.

There has been some progress with **waste management**. The Waste Act has been amended and a national waste management plan for 2007-2010 approved. Implementing legislation related to management of construction waste, categories and operating conditions for landfills and the management of sewage sludge in agriculture have been enacted. The Environmental Protection and Energy Efficiency Fund is financing the remediation of illegal landfills and sites containing hazardous waste. Ten further landfills have been remedied. Full alignment with the *acquis* in management of waste from extractive industries, hazardous waste and shipments and trans-boundary movement of waste is still required. Preparations in this area are advancing, however

special attention should be drawn to the need to ensure adequate public participation in the development of programmes, plans and projects at an early stage when options are still open.

Little progress can be reported in the **water sector**. The Water Management Strategy has been adopted. The national monitoring programme is being prepared. A programme of monitoring bathing water quality has been launched. The new Water Act was adopted and published in the Official Gazette No. 153/09 on November 21 2009. The new Water Management Financing Act was also adopted. Some progress can be reported in the field of **nature protection** with the enactment of implementing legislation related to the establishment of the ecological network. The Strategy and Action Plan for Conservation of Biological and Landscape Diversity were adopted and the Nature Protection Act was amended to ensure further alignment with the *acquis*. This provides the administrative framework for the designation of actual protected areas under Natura 2000. A draft list of proposed Natura 2000 sites has been discussed with relevant stakeholders. Additional efforts are needed to finalise the list of Natura 2000 sites. Administrative capacity for the implementation and enforcement of the *acquis* needs further strengthening.

Significant progress has been achieved in the area of **industrial pollution control and risk management**. **Implementing** legislation relating to the integrated pollution prevention and control (IPPC) and the Seveso II Directives has been enacted. Registries of installations falling under IPPC and the Seveso II Directives have been established. Efforts have been made in further developing the European Release and Transfer Register (EPRTR). Significant efforts will be required to ensure sufficient administrative capacity in this sector. Preparations in this area are proceeding well.

Good progress can be reported on **chemicals** and **genetically modified organisms (GMOs)**. The Chemicals Act has been amended to ensure further alignment with the *acquis* and the law implementing REACH has been enacted. Full transposition of the *acquis* in relation to labelling and packaging, and sorting of chemicals and the exports and imports of chemicals as well as biocides was achieved. Some progress can be reported in the area of GMOs. Notification and the requirements for labelling and packaging of GMOs have been further regulated through implementing legislation. Further efforts will be required for achieving full alignment with the *acquis*. Laboratories and administrative capacity need to be further strengthened in order to implement and enforce the legislation. Preparations in these areas are moderately advanced.

Good progress can be reported in the **noise** sector. Full transposition has been achieved with the adoption of the Noise Protection Act. Adoption of noise maps for towns and municipalities is progressing well. Preparations in this area are well on track.

There has been progress related to **forestry**. Implementing legislation related to data collection, observation and registers related to forest fires has been enacted. Preparations in this area are advancing.

Progress has been made to increase **administrative capacity across the sectors**. However, capacity for the implementation of the *acquis* remains overall weak, particularly at the local level. Areas of concern include the nature protection and IPPC

sectors. There is a particular need for training in the implementation of new legislation to both the administration and economic operators which will be obliged to comply with the new legislation. Due consideration should also be given to improving the coordination mechanisms between all institutions/bodies involved in environmental protection.

Social development

a) Social and labour issues

Living standards in Croatia are among the highest in the transition region, as measured by conventional economic indices such as GDP per capita. The strong growth rates that the Croatian economy enjoyed between 2000-2008, at close to 5 per cent per annum on average, have contributed to a reduction in poverty levels and a level of GDP per capita in 2008 that was (in PPP terms) 62.7 that of the EU-27, according to World Bank estimates. The poverty ratio, calculated as the percentage of population living below US\$ 2 per day (in PPP terms) is below 2 per cent; the headcount poverty rate (a broader measure of poverty) was estimated by the World Bank at 11 per cent in 2006, the lowest in the transition region. Other development indicators such as life expectancy, infant mortality and child malnutrition also compare favourably with most of the transition region. However, there are significant disparities in income within the country, and poverty remains an issue in some rural areas.

Croatia faces significant medium- and long-term demographic challenges. According to the UN World Population Prospects 2006, Croatia's population is projected to decrease by 19 per cent by 2050, as a result of the ageing population and consequent high death rate. The median age of the population was 40.6 years in 2005, and this is projected to rise to 48.7 in 2050. The population problem is compounded by the substantial emigration rates, especially among the higher educated. Croatia has an emigration rate estimated at 12 per cent, with the major destination for migrants from Croatia being Europe. According to some estimates, nearly 30 per cent of workers with higher education emigrated in the period 1990-2000, higher than comparable rates in the rest of the region. While some benefits flow back to the country in terms of remittances, the challenge is to ensure that many of these highly educated people return to the country at some point so that their skills and experience can be of benefit to Croatia also.

The labour market in Croatia is characterised by substantial rigidities. The unemployment rate is around 9 per cent of the labour force, and is expected to rise in the short-term as the full effects of the economic crisis feed through to the labour market. The participation rate, at around 63 per cent, is significantly lower than the EU average, leading to an exceptionally low employment rate of about 57 per cent among those aged 15-64. These low rates reflect inherited distortions in the pension system, whereby many people were encouraged in the 1990s to retire early, as well as other disincentives to work created by the social welfare system. Informal employment is estimated to comprise around 10-15 per cent of the total and nearly 60 per cent of this is undertaken in the construction industry.

The situation of women on the labour market in general remains more difficult than for men, with 45 per cent of women being employed and 62 per cent of women

experiencing long term unemployment as compared to 55 per cent of men. Whilst gender equality is protected by the Labour Act and the 2003 Gender Equality Act (Article 89 of the Labour Act states that employers must pay equal salaries to women and men for equal work and work of equal value), women generally occupy lower paid jobs and tend to receive lower wages than men for the same work. Some reports suggest that there is a general lack of understanding of the principle of equal pay by employees, employers, government officials, policymakers and trade unions. In job interviews, employers often ask about marital status and number of children. Women who are pregnant or aged 40 to 50 years face the greatest risk of discrimination (CEDAW, 2005). ITUC (2008) claims that women are being particularly disadvantaged by a growing emphasis on the use of fixed-term contracts.

On the demand side of the labour market, wages and taxes are both relatively high in Croatia, with a consequent dampening effect on firms' demand for workers. In addition, workers enjoy a high degree of employment protection under the existing Labour Code. This point is illustrated starkly by the World Bank's Doing Business 2010 indicators, according to which Croatia ranks 163rd in the world (out of 183 countries) in terms of ease of hiring workers. Finally, a recent World Bank study has identified a number of skill shortages, and the report claims that these shortages are more severe than in neighbouring countries. These factors, combined with strong trade unions in the public sector, help to explain the high degree of rigidity in the market and consequent relatively high level of unemployment.

b) Health

Croatia ranks 45th (out of 171 countries) in the Human Development Index. Government spending on health was estimated at 6.1 per cent of GDP in 2005. In general, the health system compares favourably with most other transition countries in terms of coverage and outcomes. Several Millennium Development Goal (MDG) indicators have improved significantly since 1990. Most notably, the infant mortality rate has dropped from 11 per 1,000 live births in 1990 to 5 in 2008, while the mortality rate for under-fives has fallen over the same period from 13 to 6. However, the cost of providing health care has risen substantially over the years and the Health Insurance fund runs a significant deficit.

Most communicable diseases are kept well under control due to the mandatory vaccination programme that is implemented throughout Croatia. Tuberculosis, is, however, re-emerging as a public health issue. The risk of and HIV outbreak is assessed to be moderate, in part, as a result of many years of primary and secondary prevention efforts. In 2006, the Government adopted the national health Development strategy 2006-2011. The objective of the strategy is to tackle accessibility of the healthcare system, fairness and equity and improving service quality. The system has been de-centralised and funds have been transferred to complement this.

c) Education

Standards of school education are relatively high in Croatia. Gross primary enrolment rates are close to 100 per cent, as are literacy rates among the age-group 15-24. At the tertiary level, however, the level of spending on higher education is less than one per

cent of GDP (compared to an EU average of 1.3 per cent in 2007). A recent World Bank study has identified a number of other inadequacies with the quality of education at third-level. These include the outdated nature of some courses, the lack of information on the connection between tertiary education and the labour market, and the level of inefficiency (for example, the long average time to complete degrees) in the system. Most third-level education is publicly-provided, with a limited degree of private universities.

Romani children continued to suffer discrimination in education as the authorities failed to develop and implement a meaningful strategy to address their access to education. Roma segregation in some schools remained a problem. The authorities failed to provide teaching in Romani languages which limited the progress of some Romani students. The use of Romani teaching assistants was sporadic. Attendance in pre-school programmes was low amongst Roma. (Amnesty I report 2009)

d) Social Exclusion

About one-fifth of Croatian citizens perceive themselves as socially excluded or at risk of social exclusion, according to UNDP's most recent National Human Development Report for Croatia, *Unplugged: Faces of Social Exclusion* presented in February 2007. The groups most at risk of social exclusion include people with physical and intellectual disabilities, returnees, the Roma and Serb minorities, long term unemployed, youth, single parent families, homeless, old people and prisoners.

ANNEX 5: ACCESSION BACKGROUND

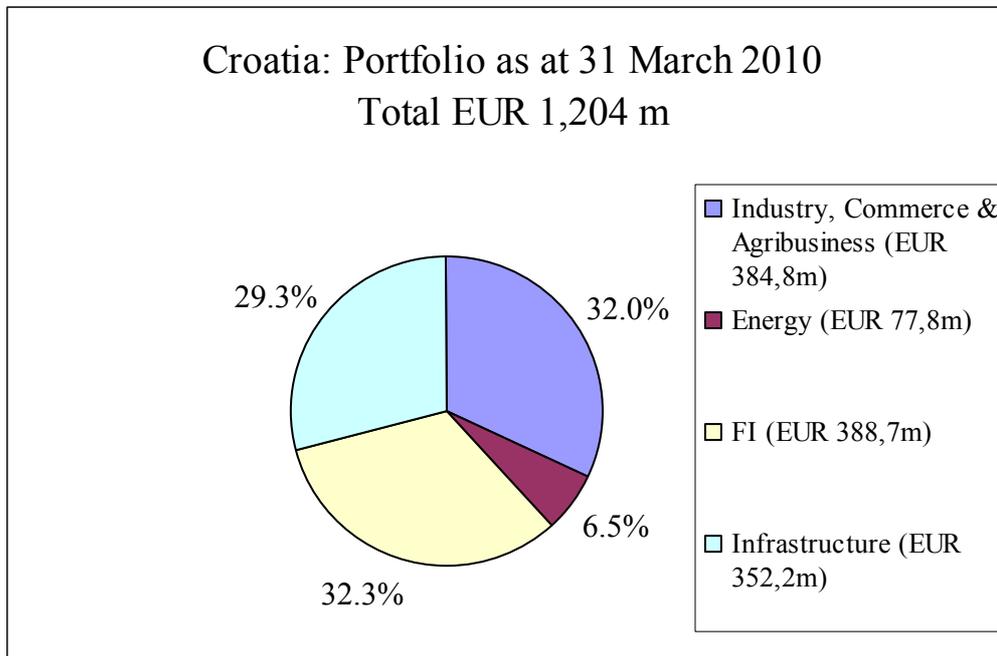
Accession negotiations: In its 2009 Progress report, the Commission stated that it should be possible to wrap-up negotiations in 2010, provided Croatia fulfils all the necessary conditions. After the Arbitration Agreement on the border issue between Slovenia and Croatia, negotiations could be unblocked. Croatia has made progress in several chapters, and 3 Accession Conferences were held last year and one this year, which were able to open 8 chapters and close a total of 10. Overall, the situation is that at this stage out of 33 chapters, 30 have been opened out of which 17 are provisionally closed.

- Pre-Accession assistance: As a candidate country, Croatia has benefited from the Instrument for Pre-accession Assistance (IPA) since 2007. The 2009 IPA programmes amounted to €151 million, and concentrated on institution building and preparation for the implementation of the EU's common agricultural policy and cohesion policy. In addition, Croatia continued to benefit from regional and horizontal programmes.
- Financial package: On 29 October 2009, the Commission adopted a Communication on a financial package for the accession negotiations with Croatia. The Commission's proposals are based on the principles and methodology underlying the financial packages agreed with the twelve Member States of the fifth enlargement. This includes a two-year phasing-in of expenditure for cohesion policy and rural development, which constitute the largest financial amounts in the financial package. For the purposes of the Commission Communication, the working hypothesis for the accession of Croatia is January 2012. EUR 3.5 billion of commitment appropriations are foreseen to take into account Croatia's accession in 2012-2013.

Council conclusions on the Commission's proposal were adopted in early December 2009 inviting the Commission to present draft EU common positions on the negotiating chapters with financial implications (agriculture and rural development, regional policy and coordination of structural instruments, financial and budgetary provisions and other issues).

ANNEX 6: CROATIA PORTFOLIO TRENDS

in m EUR	2006	2007	2008	2009	1Q2010
Net cumulative business volume	1,576.4	1,708.3	1,886.3	2,082.0	2,137.0
Cumulative total project cost	4,538.6	4,823.2	5,141.7	5,667.8	5,873.2
Portfolio	947.2	992.9	1,019.7	1,178.0	1,204.0
Cummulative number of operations	56.0	67.0	73.0	75.0	79.0
Performing assets	745.2	786.2	849.0	1,033.0	1,015.0
Annual new business	302.7	152.6	105.4	248.0	58.0
Annual gross disbursements	239.3	110.0	127.0	259.0	7.0
Gross cumulative disbursements	1,374.4	1,484.4	1,611.4	1,870.4	1,877.4
Annual cancelations	6.0	12.0	3.0	8.0	5.0
Private sector share	61.0%	62.0%	66.0%	67.0%	68.0%



ANNEX 7: TECHNICAL COOPERATION PROJECTS TO DATE

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved date	Commit. Stage Name	Sector
Power sector reconstruction	57,536	57,536	18/03/93	Closed	Energy
Review of draft legislation on securities market	7,145	7,145	02/11/93	Closed	Community/Social Services
Review of draft banking law	9,632	9,632	02/11/93	Closed	Finance, Business
Electricity network reconstruction - procurement advisory services	138,334	138,334	17/06/94	Closed	Energy
Power investment master plan	297,000	297,000	01/03/95	Closed	Energy
Power network tariff study	61,063	61,063	01/03/95	Closed	Energy
Highway reconstruction project - axle load study	123,084	123,084	20/04/95	Closed	Construction
Road user charges	146,242	146,242	01/05/95	Closed	Construction
Highways reconstruction - institutional reform	244,950	244,950	01/05/95	Closed	Construction
Zagrebacka Banka - investment banking due diligence and training	41,736	41,736	09/06/95	Closed	Finance, Business
Zagrebacka Banka - environmental due diligence training	44,131	44,131	01/07/95	Closed	Finance, Business
Agribusiness line of credit - Dalmatinska banka d.d.	95,532	95,532	25/08/95	Closed	Manufacturing
Agribusiness line of credit (ACR02)	163,402	163,402	01/09/95	Closed	Manufacturing
Agribusiness line of credit (ACR03)	56,155	56,155	01/09/95	Closed	Manufacturing
Wholesale market - promotion of private sector	150,735	150,735	08/02/96	Closed	Manufacturing
Preparation of MEII Programme	178,906	178,906	28/02/96	Closed	Local Authority Services
Environmental training for the Croatian Credit Bank for Reconstruction	36,488	36,488	08/03/96	Closed	Finance, Business
Tourism Credit Line - Credit Advisor	180,852	180,852	23/04/96	Closed	Finance, Business
Slavonska Banka d.d. - due diligence	175,628	175,628	05/06/96	Closed	Finance, Business
Environmental due diligence training for banks	40,942	40,942	19/07/96	Closed	Community/Social Services
Vrazdinska banka d.d	98,127	98,127	15/01/97	Closed	Finance, Business
Vrasdinska banka d.d	167,325	167,325	21/01/97	Closed	Finance, Business
Environmental due diligence training for Croatian bank - Alpe Jadran Banka, Trgovacka banka, Varazdinska Banka and Ujuna Banka	37,024	37,024	01/02/97	Closed	Finance, Business
Varzinska banka	48,919	48,919	24/02/97	Closed	Finance, Business
Islands airports / market and institutional organisation study	182,843	182,843	06/05/97	Closed	Transport, Storage
Municipal Environmental Infrastructure Investment Programme - institutional strengthening	227,852	227,852	21/07/97	Closed	Local Authority Services
Municipal Environmental Infrastructure Investment Programme - institutional strengthening	11,908	11,908	21/07/97	Closed	Local Authority Services
Wholesale markets project preparation	85,038	85,038	25/07/97	Closed	Manufacturing
Review of the Jakusevac Landfill Rehabilitation Project - feasibility study	48,960	48,960	22/09/97	Closed	Local Authority Services
Agri equipment multi project facility - sub-project 1	12,503	12,503	04/11/97	Closed	Manufacturing
Zagreb landfill rehabilitation programme - municipal finance analysis of the City of Zagreb	38,828	38,828	19/01/98	Closed	Local Authority Services
Zagreb landfill rehabilitation programme - municipal finance analysis of the City of Zagreb	94,948	94,948	19/01/98	Closed	Local Authority Services
Zagreb landfill rehabilitation programme - municipal finance analysis of the City of Zagreb	41,340	41,340	19/01/98	Closed	Local Authority Services
Zagreb landfill rehabilitation programme - municipal finance analysis of the City of Zagreb	8,415	8,415	19/01/98	Closed	Local Authority Services
Croatia wholesale markets - project implementation	477,670	477,670	31/03/98	Closed	Manufacturing

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved date	Commit. Stage Name	Sector
Dubrovnik municipal services rehabilitation programme	146,865	146,865	08/05/98	Closed	Local Authority Services
Dubrovnik municipal services rehabilitation programme	35,648	35,648	08/05/98	Closed	Local Authority Services
Design and supervision consultants for Croatia Wholesale Markets	737,639	737,639	10/07/98	Closed	Manufacturing
FAO Framework Agreement - Badel	17,421	17,421	17/01/99	Closed	Agriculture, Forestry, Fishing
Project Management Consultant - Zagreb Solid Waste Management Programme	454,000	454,000	08/06/99	Closed	Local Authority Services
Rijeka - Kantrida Sewerage Extension Project Review (i) Technical Due Diligence	29,731	29,731	02/09/99	Closed	Local Authority Services
Rijeka Water and Sewerage Project - Kantrida sewerage extension project review, financial due diligence	13,899	13,899	08/09/99	Closed	Local Authority Services
Rijeka - Kantrida Sewerage Extension Project Review (ii) Financial Due Diligence	28,803	28,803	08/09/99	Closed	Local Authority Services
TurnAround Management Programme (TAM) - Podravka	48,222	48,222	06/10/99	Closed	Manufacturing
TurnAround Management Programme (TAM) - Podravka	9,438	9,438	28/10/99	Closed	Manufacturing
Assessment of Company's Competitive Position and Critical Review of Corporate Strategy - Plava Laguna	84,543	84,543	29/10/99	Closed	Commerce, Tourism
Market Study and Strategy Review - Plava Laguna	66,641	66,641	23/11/99	Closed	Commerce, Tourism
TurnAround Management Programme (TAM) - Getro	29,412	29,412	20/02/00	Closed	Manufacturing
TurnAround Management Programme (TAM) - Getro	26,739	26,739	23/02/00	Closed	Manufacturing
Diagnostic and guidelines for company restructuring - IPK	10,243	10,243	25/05/00	Closed	Manufacturing
Diagnostic and guidelines for company restructuring - IPK	4,310	4,310	25/05/00	Closed	Manufacturing
Diagnostic and guidelines for company restructuring - IPK	12,191	12,191	25/05/00	Closed	Manufacturing
Diagnostic and guidelines for company restructuring - IPK	6,771	6,771	25/05/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - Ana Betica	24,633	24,633	20/06/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - TAM Management & Support	37,600	37,600	20/06/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - subsidy contributions	759,928	759,928	20/06/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - office operating expenses	71,600	71,600	20/06/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - office rent & Opex	85,945	85,945	20/06/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - office equipment & furniture	20,967	20,967	20/06/00	Closed	Manufacturing
TurnAround Management Programme (TAM) - Nasicecement	46,892	46,892	05/07/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - Local Programme Director	61,431	61,431	07/07/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - Travel Expenses for Udo Schedel	9,680	9,680	12/07/00	Closed	Manufacturing
TurnAround Management Programme (TAM) - Nasicecement	9,203	9,203	19/07/00	Closed	Manufacturing
TurnAround Management Programme (TAM) - Grand Hotel Adriatic	47,931	47,931	04/08/00	Closed	Manufacturing
TurnAround Management Programme (TAM) - Grand Hotel Adriatic	5,391	5,391	01/09/00	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - Project Officer	36,688	36,688	27/09/00	Closed	Manufacturing
TurnAround Management Programme - Getro d.o.o. II	39,601	39,601	01/11/00	Closed	Manufacturing
City of Zagreb Creditworthiness Enhancement Programme	322,333	322,333	29/11/00	Closed	Community/Social Services
City of Zagreb Creditworthiness Enhancement Programme	90,000	90,000	07/12/00	Closed	Community/Social Services
City of Zagreb Creditworthiness Enhancement Programme	67,352	67,352	07/12/00	Closed	Community/Social Services
Hrvatske Železnice, Energy Management Programme - Preliminary Assessment	13,070	13,070	21/12/00	Closed	Energy

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved date	Commit. Stage Name	Sector
Wholesale Markets Programme - Improvement of Regulatory Framework of Fresh Produce Wholesale Marketing	4,663	4,663	11/01/01	Closed	Manufacturing
Zagreb Public Transport Project	129,621	129,621	12/04/01	Closed	Transport, Storage
TAM Programme - Koestlin	32,397	32,397	08/05/01	Closed	Manufacturing
4TurnAround Management Programme - MTC Medimurska Trkotaza	48,400	48,400	09/05/01	Closed	Manufacturing
Uljanik Shipyard	47,940	47,940	09/07/01	Closed	Manufacturing
Uljanik Shipyard	34,000	34,000	09/07/01	Closed	Manufacturing
Business Advisory Service (BAS) Programme in the Balkans - Regional Programme Director	80,000	80,000	09/07/01	Closed	Manufacturing
Business Advisory Service (BAS) Programme - BAS Programme Director in Croatia, Peter Siretz	23,932	23,932	20/08/01	Closed	Manufacturing
Wholesale Markets Programme - Improvement of the Regulatory Framework of Fresh Produce Wholesale Marketing	5,553	5,553	22/08/01	Closed	Manufacturing
Wholesale Markets Programme - Improvement of the Regulatory Framework of Fresh Produce Wholesale Marketing	5,529	5,529	22/08/01	Closed	Manufacturing
Port of Dubrovnik / Passenger Port Development Project	149,908	116,144	28/09/01	Disbursing	Transport, Storage
Port of Dubrovnik / Passenger Port Development Project	83,372	69,020	23/10/01	Disbursing	Transport, Storage
City of Rijeka Creditworthiness Enhancement Programme	148,783	148,783	22/11/01	Closed	Local Authority Services
TAM Programme I: MTC Tvornica Carapa DD	24,902	24,902	22/11/01	Closed	Manufacturing
Port of Dubrovnik - Passenger Port Development Project	48,479	36,349	05/12/01	Disbursing	Transport, Storage
Rijeka Water and Sewage Company - Financial and Operational Improvement Project ("FOPIP")	66,379	66,379	18/04/02	Closed	Local Authority Services
Rijeka Water and Sewage Company - Financial and Operational Improvement Project ("FOPIP")	51,338	51,338	18/04/02	Closed	Local Authority Services
TAM Programme - Dij	48,400	48,400	12/06/02	Closed	Manufacturing
Warehouse Receipt Credit Adviser	16,253	16,253	19/07/02	Closed	Agriculture, Forestry, Fishing
Business Advisory Service (BAS) Programme in Croatia - National Programme Director Kruno Placko	14,482	14,482	07/08/02	Closed	Manufacturing
Business Advisory Service (BAS) Programme in Croatia - Asst to National Prog. Director - Ana Betica	6,273	6,273	07/08/02	Closed	Manufacturing
Croatian Tourism Privatisation Framework	75,240	75,240	27/09/02	Closed	Community/Social Services
Croatian Tourism Privatisation Framework	271,951	271,951	27/09/02	Closed	Community/Social Services
BAS Programme/Contract Extension of the BAS Croatia Programme Director, Peter Siretz	40,726	40,726	31/10/02	Closed	Local Authority Services
BAS Programme / Contract of the BAS Croatia National Programme Director, Ana Klaric	21,965	21,965	23/12/02	Closed	Manufacturing
BAS Programme / Contract Extension of the BAS Croatia Assistant to National Programme Director, Ana Betica	3,111	3,111	23/12/02	Closed	Manufacturing
Port of Dubrovnik: Project Preparation.	179,463	179,463	05/06/03	Closed	Transport, Storage
EBRD/TMG BAS Programme in South East Europe	98,204	86,391	24/07/03	Disbursing	Manufacturing
Croatia - Small and medium size municipalities - TA to Commercial Banks	49,650	49,650	29/08/03	Closed	Local Authority Services
Mikroplus	194,824	194,824	08/12/03	Closed	Finance, Business
Croatian Railways Network Management: Project Preparation	177,737	177,737	20/02/04	Closed	Transport, Storage
Framework for Technical Assistance to Croatian SMM Municipalities (Dutch funded)	671,212	671,212	03/09/04	Closed	CEALs,CoFinancing Lines & RVF's
Framework for Technical Assistance to Croatian SMM Municipalities (Dutch funded)	402,020	402,020	03/09/04	Closed	CEALs,CoFinancing Lines & RVF's
Port of Dubrovnik Institutional Assistance	194,958	194,958	17/12/04	Closed	Transport, Storage
PPC: Introduction to Project Financing Workshop - Karlovac	2,094	2,094	15/06/05	Closed	Local Authority Services
Dubrovnik Public Transport Twinning Agreement	84,792	84,792	16/09/05	Closed	Transport, Storage

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved date	Commit. Stage Name	Sector
Port of Ploce Financial & Economic Due Diligence	49,450	49,450	08/11/05	Closed	Transport, Storage
Karlovac Water and Wastewater Management Project- FOPIP	277,829	277,829	31/01/06	Closed	Local Authority Services
Port of Dubrovnik Institutional Strengthening Assistance	150,000	150,000	30/05/06	Closed	Transport, Storage
Croatia: ARZ: Corporate Strategy Assistance	149,790	149,790	24/10/06	Closed	Construction
Croatian Wind to Grid Advisory Assignment	21,500	21,500	26/10/06	Closed	Energy
TAM - Terme Tuhelj	39,627	39,627	08/12/06	Closed	Manufacturing
Croatian Roads Performance Maintenance Contracts	250,000	51,889	19/02/07	Disbursing	Construction
Continuation of BAS Bulgaria and Croatia	144,222	144,222	22/03/07	Disbursing	Manufacturing
Port of Ploce Legal Due Diligence	49,000	48,750	12/04/07	Disbursing	Transport, Storage
Continuation of BAS Croatia -(5 months) - Framework	146,121	126,727	28/06/07	Disbursing	Manufacturing
Dubrovnik Urban Transport Development Project	225,910	225,910	13/11/07	Disbursing	Transport, Storage
Sisak Wastewater - Financial and Operational Performance Improvement Programme and Implementation Support	273,575	0	14/11/07	Committed	Local Authority Services
TAM - Din Novoselec	49,880	49,880	19/12/07	Closed	Manufacturing
TAM - Jadran Hoteli	52,000	46,626	26/03/08	Disbursing	Manufacturing
Pula Wastewater - Financial and Operational Performance Improvement Programme	394,050	0	28/03/08	Committed	Local Authority Services
Continuation of the BAS Programme in Croatia	327,450	263,680	31/03/08	Disbursing	Manufacturing
TAM - IPK Kandit	52,000	29,961	25/07/08	Disbursing	Manufacturing
TAM - Natura Agro	52,000	34,254	25/07/08	Committed	Manufacturing
TAM - Ilocki Podrumi	52,000	32,276	28/07/08	Disbursing	Manufacturing
TAM HG SPOT	72,000	38,469	29/07/08	Disbursing	Manufacturing
TAM - Combis	50,000	36,433	22/09/08	Disbursing	Manufacturing
TAM - Prvi Maj d.d. (Croatia)	52,000	28,886	26/09/08	Disbursing	Manufacturing
TAM - Limex	50,000	29,425	20/11/08	Committed	Manufacturing
Zagreb Stock Exchange (ZSE): Capital Markets Training	245,000	30,000	10/12/08	Disbursing	Finance, Business
Continuation of the BAS Programme in Croatia	352,657	124,238	09/01/09	Disbursing	Manufacturing
Velika Gorica Urban Transport - Regulatory Strengthening and Management Strategy	267,050	0	29/01/09	Committed	Transport, Storage
TAM - Standard MIO	52,000	10,196	13/05/09	Committed	Manufacturing
TAM - MD- Profil Groupa	52,000	9,525	13/05/09	Committed	Manufacturing
TAM - Radez	52,000	9,484	27/05/09	Committed	Manufacturing
TAM - Jadranka Hotel	51,500	7,088	19/06/09	Committed	Manufacturing
Croatian Port of Sibenik: Assistance in Preparation and Implementation of a Management Information System	50,000	0	15/07/09	Committed	Transport, Storage
PORT OF SIBENIK: ASSISTANCE IN PROJECT SUPERVISION AND ADMINISTRATION	873,000	0	14/08/09	Committed	Transport, Storage
TAM - Rione	52,000	9,278	19/08/09	Committed	Manufacturing

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved date	Commit. Stage Name	Sector
TAM - Ugo Grupa	51,500	7,142	24/08/09	Committed	Manufacturing
Continuation of the BAS Programme in Croatia	105,000	2,530	27/10/09	Committed	Manufacturing
TAM - Odjeca Textiles	57,500	0	29/10/09	Committed	Manufacturing
TOTAL	16,124,115	12,895,510			
No of Commitments:	143				

Commitment by sector	Euro Committed	Euro Disbursed
Agriculture, Forestry, Fishing	33,674	33,674
CEALs, CoFinancing Lines & RVF's	1,073,232	1,073,232
Commerce, Tourism	151,184	151,184
Community / Social Services	874,964	874,964
Construction	914,065	715,954
Energy	588,504	588,504
Finance, Business	1,279,687	1,064,687
Local Authority Services	2,664,526	1,996,901
Manufacturing	5,648,696	4,751,373
Transport, Storage	2,895,583	1,645,037
TOTAL	16,124,115	12,895,510

ANNEX 8: TAM/BAS ACTIVITIES IN CROATIA

The TAM/BAS Programme supports economic transition by achieving enterprise change in potentially viable micro, small and medium enterprises and contributing to the development of sustainable infrastructures of local business advisory services in the EBRD countries of operations.

12.1 TAM/BAS in Croatia

Previous TAM experience

TAM supports the introduction of international best practice in small and medium sized enterprises with the potential of becoming future leaders in their market through the introduction of international advisors from developed countries with 15-20 years of professional experience in the relevant sector. TAM projects typically last around 18 months. The Programme also carries out seminars and training activities promoting international best practices by disseminating successful case-studies to entrepreneurs.

To date, TAM has secured EUR 1.4 million in donor funding for projects in Croatia. The largest amount of funding came from Luxembourg, which has provided over EUR 500.000 of funding. Other bilateral donors include Greece, Switzerland, Taipei China, the UK, Sweden, Netherlands, Ireland, and Finland. In addition, TAM has received EUR 100,000 of funding from the EBRD Shareholder Special Fund.

TAM has undertaken a total of 27 projects, 15 of which are still in progress, with new enterprises currently being screened. Of the projects that are completed and rated, all were rated "satisfactory" or "highly satisfactory", except one that was closed early. TAM projects have enjoyed a wide coverage across both industry and geographic location with 70 per cent of all projects undertaken outside of Zagreb. TAM projects are complex and with interventions carried out in many areas of business operations. In Croatia, the area of focus sought by most projects was in marketing, product design and development.

Previous BAS experience

BAS acts as a facilitator for the use of local, private-sector consultants by MSMEs to obtain a diverse array of services. BAS works on the demand and the supply side. By assisting individual enterprises to engage with local consultants on narrowly-based, specific projects with a rapid payback, it stimulates demand and the understanding of the potential benefits of using external consultants. It also directly increases the supply and quality of local advisory services, through targeted market development activities. BAS supported projects typically last around four months.

Since September 2000, BAS Croatia has secured a total of EUR 4.6 million in donor funding. The largest donors have been the Central European Initiative (CEI) with EUR 1.7 million and Austria with over EUR 1 million funding. Additional funding came from Luxembourg, the Balkan Region Special Fund (BRSF), the UK, Germany, the EBRD, and the EBRD Special Shareholders Fund,

The Programme has undertaken a total of 374 projects with MSMEs, engaging 201 consultants– 93 per cent of which were local. More than 74 per cent of the projects were located in rural areas; this tendency has been rapidly growing over time. The industry spread of projects has been wide, but there has been a focus on Food/Beverages, Metals/Machinery/Equipment and Electrical/Electronics/IT. Most projects were targeted at introducing Quality Management & Certification and Computerised Financial/Management Information Systems as well as Engineering Studies.

The BAS Programme in Croatia has also undertaken a number of market development activities geared to the development of the local consultancy industry. A recent example is a comprehensive consultant training programme organised in cooperation with two local business support institutions: the Croatian Agency for Small Business (HAMAG) and the Association of Management Consultants (AMC). This four part training course served to prepare Croatian consultants for CMC (Certified Management Consultant) certification and/or to strengthen their skills hence allowing them to become qualified members of local business associations such as AMC.

Linkages with Banking

To date, 3 TAM assisted enterprises in the Croatia have attracted investments from the EBRD or EBRD related financial intermediaries, of which EBRD financed over EUR 114 million. Although no BAS assisted enterprises in Croatia have attracted investments from the EBRD or EBRD related financial intermediaries, 106 BAS enterprises have received over EUR 110 million from external financing sources in Croatia.

12.2 The MSME and business advisory sectors in Croatia

The importance of MSMEs in Croatia has increased in recent years and the sector has become a crucial segment of the Croatian economy, both in terms of employment and contribution to GDP. According to the Croatian Chamber of Economy, in 2008, the MSME share of the total number of registered business entities was at 99.5 per cent and accounted for around 66.3 per cent of the total number of employees in the country. In addition, they generated 53.6 per cent of total assets in the Croatian economy and 40.8 per cent of all exports. From a sectoral perspective, MSMEs were concentrated in the wholesale and retail trade and repair (34.9 per cent), real estate, renting and business activities (16.9 per cent) and manufacturing (13.28per cent). Whilst micro- and small enterprises dominate the Croatian economy in numbers, medium-sized enterprises dominate in terms of value added.

Croatia's governance and regulatory institutions are converging towards the standards of the advanced OECD countries, and they are above the transition country average. Given the broad-based support for EU integration, Croatia will continue to adhere to an agenda of EU-mandated reforms, including the European Charter for Small Enterprises and the Small Business Act. However, the country continues to face several challenges, including a relatively high level of corruption. According to the TI Corruption Perception Index 2009, Croatia is ranked 66th out of 180 countries with a score of 4.1. This is a slightly worse compared to 2008 and highlights the need to reform the public

administration and the judiciary. Croatia has become a pioneer in implementing regulatory reforms in the Western Balkan region and the authorities have simplified administrative procedures and significantly reduced the regulatory burden. Notwithstanding these measures, the bureaucracy continues to be a major impediment to further development of the MSME sector and the country continues to be ranked unsatisfactorily in the World Bank Doing Business Report 2010, where it is ranked 103rd.

Croatia has the highest level of financial intermediation within the Western Balkan region and the financial sector remains solid and well capitalised. Numerous government-funded loan schemes, guaranteed funds for MSMEs and generous interest rates provided by the Croatian Bank for Reconstruction and Development have led to a significant amount of loans being provided to the sector in recent years. However, small companies that do not qualify for such loans continue to face rather high interest rates and inflexible collateral requirements. Access to long-term financing also remains difficult, in particular for newly established businesses. The latest BEEPS survey highlights this lack of access to finance for businesses. Accordingly, only tax rates and competition from the informal sector are identified as more severe obstacles, and 20 per cent of respondents consider access to finance to be the most serious constraint affecting their business's operation. With the improvement of Croatia's collateral regulations and the availability of credit information (according to the Doing Business 2010 survey, the credit information system covers around 77 per cent of physical persons), however, the authorities have taken further steps towards enhancing MSMEs access to finance. A functioning online registration system for movable assets has been in place since 2006 and the Law on Bankruptcy was modified, thereby reducing the duration of proceedings. In addition to bank loans, leasing is the second major source of finance for MSMEs in Croatia.

The private market for business advisory services has developed significantly over the last few years. Croatian MSMEs readiness to draw on the help of consultancy still varies greatly depending on their geographical location, size and maturity level. Affordability constraints only seem to be significant for enterprises in underdeveloped areas and for micro enterprises in general. The business advisory services currently most demanded are fairly basic business services including Reorganisation/Restructuring, Computerised financial / management information systems and Market analysis and planning. There is a clear need however to promote the need for long term strategic planning, compliance with EU standards and the potential of ICT.

Croatia has made substantive progress towards the development of a knowledge-based economy and ranks above the transition country average in the World Bank's Knowledge Economy Index at 7.28. Its ICT infrastructure is well developed with high internet and broadband penetration rates and the World Economics' Forum annual Global Competitiveness Index 2009-2010 ranks Croatia 72nd out of 133 countries surveyed. In October 2008, the Public-Private Partnership was adopted, thus creating a legal foundation for a stronger public-private dialogue. With regard to entrepreneurship education, the Education for Entrepreneurship partnership involving the economy, labour and education authorities, as well as the Chamber for Commerce provides an institutional and policy framework for lifelong entrepreneurial learning. Furthermore, the Business Innovation Centre (BICRO) plays an important role in supporting

innovative MSMEs and runs a number of programmes, ranging from R&D to financial support. Finally, 27 incubation facilities support the sector and numerous international consulting firms are present in the country.

12.3 MSME support in Croatia

The Croatian government has recognised the importance of the MSME sector for the domestic economy and employment growth. It has implemented a comprehensive policy framework and provides a variety of supporting measures to the MSMEs sector on national, regional and local level. The two main institutions developing and implementing MSME policy in Croatia are the Direction for SMEs in the Ministry of Economy, Labour and Entrepreneurship (MELE) and the Croatian Agency for Small Business (HAMAG). Efforts have been made to re-define the responsibilities of the two agencies and the role HAMAG has been strengthened. The current policy instrument supporting MSMEs is the 'Programme for Incentives to SMEs for 2008-2012'. Though the strategy is comprehensive, attention must be paid to its full implementation.

The Croatian government has increased its support for business support facilities in recent years. HAMAG, the Croatian SME Agency, has expanded its activities in the area of facilitating access to consultancy services through a voucher scheme. However, while the private consultancy market is developing rapidly, it still exhibits some shortcomings in terms of regional coverage, quality and pricing issues.

In the past, several international donors have provided the Croatian MSME sector with support. Croatia's cooperation with the USAID ceased in 2008, with other SME donor programmes (such as the GTZ) to be finalised at the end of 2009. Currently, the key player in the development of MSMEs is the European Union. Since 2007, Croatia has received financial assistance under the Instrument for Pre-Accession (IPA) available to candidate countries. There has also been significant support by the EU CARDS and Phare instruments through direct MSME support grant scheme, and through several projects aimed at improving business access to information and the business regulatory environment.

12.4 TAM/BAS continuation in Croatia

The TAM/BAS Programme recognises the growing importance of the Croatian MSME sector as well as the relatively strong MSME support framework. Although the business advisory industry is quite mature, TAM/BAS identified inconsistencies in the level of advisory services offered, and especially a lack of highly qualified providers of sophisticated business advice. Moreover, the level of awareness of business advisory benefits among MSMEs varies significantly according to geographical location, size and maturity level.

Hence, subject to funding availability, the TAM/BAS Programme will continue its operations in Croatia and its activities will be targeted to addressing these specific gaps.

Continuation of TAM

Stakeholders find strong support for TAM continuation especially in the areas of complex and technical business advice. TAM will focus on providing advice specifically to enhance companies' competitiveness, continue enterprise restructuring efforts, and provide technical advice in the areas of energy efficiency and environment protection. TAM will work specifically with companies focused on entering the EU market of companies located in remoter rural areas and "*Areas of Special State Concern*" as defined by the Croatian government.

Continuation of BAS

Stakeholders in the enterprise sector unanimously believe that Croatian entrepreneurs could still benefit strongly from the help of business advisory services despite the growing strength of the MSME sector. The main advantage of BAS is that it contributes to the creation of a viable infrastructure of business support by operating on both the demand and the supply side of the market. The supply side of business advisory services has been developing steadily in the past years, however, there is a lack of qualified providers of sophisticated business advice particularly in the area of energy efficiency and environment protection. On the other hand, MSMEs' ability to absorb business advice varies greatly.

The BAS grant will remain a key component of BAS assistance in certain areas. A Grant Guideline Matrix is proposed in order to respond to the MSME sector needs, prioritise intervention in strategic areas and avoid duplication of efforts from international donors. Higher grants will be given to:

- *enterprises located in "Areas of Special State Concern"* – mostly the war-affected areas in the East and the South of the country and some other economically depressed regions;
- *projects involving sophisticated advisory services* - specifically in the area of energy efficiency, environment protection, and compliance with higher-level requirements for entering the EU markets

BAS market development activities

It is recommended to complement BAS assistance at the enterprise level with the following market development activities in order to maximise the Programme's transition impact in Croatia:

- *Visibility and dissemination*: Given the low level of awareness of business advisory services benefits in certain geographical areas, the programme will work with key strategic partners such as HAMAG and AMC to effectively promote the use of advisory services.
- *MSME and consultancy training*: The BAS Programme will address the existing gaps in the supply of advisory services by building capacity in: environmental management and energy efficiency, assistance with obtaining funds from EU programmes. Jointly with HAMAG, AMC and other stakeholders, BAS will undertake a large-scale consultancy market survey, which will serve as a basis for designing tailor-made capacity building for

consultants including specialized trainings, networking events, and initiatives on the regional level, which it will then develop in collaboration with these partners. In addition, BAS will utilize the TAM experts to design and implement highly specialized workshops for selected industry sectors (wine-making, tourism, organic production).

- *Support to and development of existing relevant local institutions* – particularly in relation to the market for local business advisory services: TAM/BAS will work to strengthen AMC by offering targeted training to its members. Given the existing MSME support framework in Croatia, BAS will concentrate on building more dialogue and cooperation between existing institutions and will continue to work closely with AMC and HAMAG. Moreover, TAM/BAS will further enhance its facilitator role using its own network and expertise to help relevant local institutions to reach other local or regional strategic partners or counterparts.

TAM/BAS focus on cross-cutting issues

In order to address cross-cutting issues that are pertinent to Croatia's MSME sector's development, the TAM/BAS programme will promote measures to increase *energy efficiency* or to reduce *environmental pollution* at the enterprise level. In terms of efficient usage of energy, Croatia has clearly outperformed the EBRD region; however, further improvement is needed in order to comply with European standards. Each TAM project will strive to incorporate such measures and it is recommended that the BAS programme offer high shares of co-financing for projects related to energy efficiency and environmental protection. It will also devote efforts to attracting more *female entrepreneurs*, primarily by targeted BAS market development activities, for example disseminating success stories of women in business. Reaching more remote areas, with special focus on the "*Areas of Special State Concern*" will remain a high priority for TAM/BAS. Finally, there is a case for providing targeted assistance to *young entrepreneurs*, particularly via BAS market development activities in less developed areas.

Contribution to policy dialogue

TAM/BAS can be used as a source of information for EBRD's policy dialogue, as it provides insight into the entrepreneurial activity, business environment and challenges faced by the MSME sector; names the major stakeholders of the MSME sector; and provides a clear picture of the MSME support programmes.

Future challenges for the government are mainly identified as simplifying the regulatory framework, improving the educational system and intensifying the incentives for innovation and R&D activities.

TAM/BAS will also support the government's MSME agenda by organising roundtables in order to foster dialogue amongst existing institutions, other MSME stakeholders.

Enhancing Banking Linkages

In line with the TAM/BAS Strategic Plan 2008-2010, TAM/BAS will continue to assist the Bank to meet its objective of generating a commercially viable project pipeline for direct investments by the Bank that will be transitional, in three ways: i) identifying potential pipeline (pre-investment); ii) providing ‘consulting and business’ services for the preparation and support of Bank private enterprise financing projects and for the enterprises themselves; iii) providing candidates for non-executive board member positions. In particular, the Programme will link SMEs in need of finance with local financial institutions, the EBRD Local Enterprise Facility (LEF) and under the proposed EU supported Western Balkans Private Sector Support Facility - Energy Efficiency Window and SME Competitiveness Support Window.

This will strengthen the Bank’s impact in the enterprise sector and in the financial sector, as outlined in the EBRD Country Strategy for Croatia.