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Report No. P-6792-HR

MEMORANDUM AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

IN AN AMOUNT OF US$5 MIILION

TO

THE REPUBLIC OF CROATIA

FOR A

TECHNICAL ASSISTANCE PROJECT

IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

FEBRUARY 29, 1996

CURRENCY AND EQUIVALENT UNITS

Currency Unit = Kuna
(Average Commercial Rates)

	1994	1995
US$1.00 =	5.995	5.220

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

CPF	Croatian Privatization Fund
EBRD	European Bank for Reconstruction and Development
EFSAL	Enterprise and Financial Sector Adjustment Loan
EU-PHARE	European Union's Program of Assistance to Eastern Europe
FSOEs	Former Socially-Owned Enterprises
GOC	Government of Croatia
HEP	Hrvatska Elektroprivredna (power utility)
HPT	Croatian Post and Telecommunications
HZ	Croatian Railways
INA	Industrija Nafte (petrochemical company)
MMATC	Ministry of Maritime Affairs, Transport and Communications
MOE	Ministry of Economy
MOF	Ministry of Finance
MOP	Ministry of Privatization
MPP	Mass Privatization Program
NBC	National Bank of Croatia
ORESE	Office for Restructuring and Economics of State-owned Enterprises
PC	Project Coordinator
PPF	Project Preparation Facility
SME	Small and Medium Enterprises
TA	Technical Assistance

FISCAL YEAR

January 1 - December 31

REPUBLIC OF CROATIA
TECHNICAL ASSISTANCE PROJECT
IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

Loan and Project Summary

Borrower:	Republic of Croatia
Poverty Category:	Not applicable.
Loan Amount:	US$5 million
Terms:	Seventeen years, including five years' grace period, at the rate for LIBOR-based dollar currency loans.
Financing Plan:	See Schedule A.
Economic Rate of Return:	Not applicable.
Staff Appraisal Report:	Not applicable.
Project ID Number:	HR-PA-40830

This report was prepared by a team comprising Ms. Ilene Photos (Task Manager), Mr. Olivier Godron (Sr. Country Economist) (EC2CO); Mr. Yves Duvivier (PSD); Ms. Susan Rutledge (EC2ET); Mr. Hennie van Greuning (FSD); Mr. Andrew Lovegrove (Consultant); Ms. Ellen Cohen (AF3C1) was the Peer Reviewer. The Department Acting Director is Ms. Christine Wallich (EC2); and the Division Chief is Mr. Michel Noël (EC2CO). Mrs. Clemence Khoury (Sr. Staff Assistant, EC2CO) was responsible for the production of the report.

MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED LOAN TO THE REPUBLIC OF CROATIA FOR A TECHNICAL ASSISTANCE PROJECT IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

1. I submit for your approval the following memorandum and recommendation on a proposed single currency loan in US dollars to the Republic of Croatia for US$5 million to help finance a Technical Assistance Project in support of enterprise and financial sector reform. The loan would be a LIBOR-based single currency loan, with a maturity of 17 years, including five years of grace.

Country/Sector Background

A. The Economy

2. Macroeconomic prospects in Croatia have improved markedly in the last two years. This improvement follows a steep economic decline and near-hyperinflation in the wake of the dissolution of the former Yugoslavia and the war which followed Croatia's declaration of independence, in June 1991. The stabilization program, which was launched in October 1993, has delivered impressive results. The fiscal deficit has been kept close to zero since 1993. Inflation has been negligible during most of 1994 and through 1995. Consistent balance of payment surpluses have allowed Croatia to build up foreign exchange reserves (which had been kept by the National Bank of Yugoslavia at the time of independence) to about four months of imports. Growth resumed in 1994-95, albeit at a modest 1-2 percent rate.

3. Although the stabilization program has been successful in the short term, it will come under increasing strain if Croatia does not tackle the structural problems of the banking and enterprise sectors, which were at the root of the recession and inflation experienced by the former Yugoslavia in the 1980s. While the Yugoslav system avoided the worst excesses of bureaucratic planning, it relied on a system of 'social ownership', whereby enterprises were de facto run by workers and managers. This, combined with the enterprises' ownership of, and control over, the banking system, resulted in chronic wage pressures, poor investment decisions, and soft budget constraints.

4. Since 1991, the Government has been seeking to improve enterprise governance through the commercialization and privatization of the former socially-owned enterprises (FSOEs). Privatization was conceived essentially as a bottom-up process where insiders were given strong incentives to purchase the shares of their companies. This emphasis on employee and management buy-outs proved relatively successful for small and medium-size units, but much less so for the largest enterprises, 500-odd units accounting for some two-thirds of total assets and employment. These enterprises, owned - but not effectively managed - by the Government through the Croatian Privatization Fund (CPF), are the main contributors to the losses recorded by the enterprise sector, some 7-8 percent of GDP in 1994. The main reasons behind these losses, in turn, are the lack of effective enterprise ownership and, in relation with the unsolved problems in the banking system, the continued existence of a 'soft' budget constraint for a portion of the enterprise sector.

5. Despite the lack of enterprise adjustment and of banking system reform, the October 1993 stabilization plan succeeded because of two factors: a sharp decline of real wages during 1991-92, and the stabilization-induced increase in real money demand, that allowed the banking system to finance

enterprise losses in a way that was - temporarily - compatible with the stabilization objectives. There are now indications that these two developments are running their course. Real wages have been increasing regularly since the beginning of 1993, and unit labor costs are almost back to their 1990 levels. And the slow-down of remonetization, since the end of 1994, may bring back to the fore the old policy dilemma, i.e., the conflict between financing the build-up of foreign exchange reserves, the needs of the private sector, or the losses in the economy, with the risk of reigniting inflation.

B. The Enterprise and Financial Sector Restructuring Program

6. To consolidate the stabilization and embark the economy on a sustainable growth path, the Croatian Government is determined to address jointly the problems in the financial sector and the enterprise sector, and to sever the ownership links between the two. Its program envisions the accelerated privatization of FSOEs, now CPF-owned, the restructuring and privatization of public enterprises, and the rehabilitation and privatization of the banking system. This program, elaborated in close coordination with the Bank, will be supported by a proposed Enterprise and Financial Sector Adjustment Loan (EFSAL), to be submitted to the Board in the last quarter of fiscal year 1996.

Enterprise privatization

7. Enterprise privatization to date has suffered from two major shortcomings. First, some large enterprises (particularly INA, the large oil and gas conglomerate; the electricity company (HEP) and the telecommunications company (HPT)) were not "socially-owned" and have not been included in the process until recently. Second, for the 500-odd larger FSOEs that could not be sold during the first stage of the privatization process, the alternative privatization methods used (tenders or auctions) have not proven effective. Tenders/auctions have been hampered by lack of developed capital markets and, more importantly, by overvaluation of the enterprises due to improper valuation methods. Moreover, no effort has been made to break up these large, capital intensive enterprises into smaller self-contained units that might be more easily privatized. The CPF is also facing its own limited operating capacity, a politicized decision-making process and an alleged lack of transparency of some of the large transactions to date which has raised criticism in Croatia against privatization. Finally, although there is some indication of interest from foreign investors, little has been done to meet the demand and promote Croatia abroad.

8. Recognizing the current shortcomings in the privatization program and the urgent need to accelerate privatization, the Croatian authorities have developed a revised privatization strategy and are strengthening the responsible institutions. The new strategy, which is embodied in a new Privatization Law currently before Parliament, calls for the full divestiture of almost all FSOEs within a three-year time period. It also envisions the privatization of the larger part of the public enterprise sector.

9. The privatization of remaining FSOEs will rest on four sets of policy measures: (i) a 'mapping' of privatization, with a view to clearly assign different subsets of enterprises to different privatization routes; (ii) development of a mass privatization scheme, whereby target populations (refugees and displaced persons), will become the owners, at their option directly or via investment funds, of a substantial part of the residual CPF portfolio; (iii) revision of valuation methods, to provide more realistic starting prices, and improvements to tenders and auctions, to allow market-clearing prices; and (iv) key changes in the institutional framework, mainly the creation of a new Ministry of Privatization that takes over most of the privatization responsibilities (as opposed to portfolio management, which remains with the CPF).

10. In addition to FSOEs, the Croatian Government envisions the privatization of the larger part of the public enterprise sector, including INA, the telecommunications sector, and the production and possibly the distribution of electricity, within a two to three-year timeframe. The sale of the public

enterprises will take more time than that of FSOEs, not only because of their size and strategic nature, but because it requires both reorganization measures and, especially in the electricity and telecommunications areas, the definition of an adequate regulatory framework and revision of pricing policies.

11. The preparatory measures that will lead to the privatization of the larger public enterprises are already underway. INA, following the completion of a consolidated accounting audit of the group, has commissioned three sectoral studies that will pave the way for its reorganization (review of the hydrocarbon supply chain, of the petrochemical business including fertilizers, and of the retail network). INA has also contracted, with an international investment bank, the preparation of a comprehensive plan for the whole group which, building on the findings of the three sectoral studies, will cover group restructuring and development, as well as a detailed privatization strategy. The organizational restructuring of the group should be completed during the second half of 1996. With respect to HEP and HPT, studies have also been commissioned recently, that will cover both the reorganization into coherent activity lines, and the regulatory framework needed by private sector operators, particularly with respect to tariff levels. The separation of HEP into three lines of activity, production, transmission and distribution, was already authorized in principle by the 1994 Law that transformed HEP into a joint-stock company. A similar draft Law providing for the separation of postal and telecommunication activities was recently submitted to the Parliament. The reorganization of HEP and HPT should be completed by the end of 1996. This is also the target date for the enactment of the regulatory framework needed to govern the private provision of public services.

Banking system restructuring and privatization

12. The Croatian banking system was spared many of the distortions common to command economies: it moved to a two-tiered system in the early sixties, and was never used as a conduit for central planning execution. However, it did inherit a flawed incentive framework, the legacy of the peculiar Yugoslav system of enterprise-owned banks. This, compounded by several interventions by the Government which imposed a significant degree of financial repression, has resulted in serious financial imbalances in five of the country's largest banks, accounting for 50 percent of the assets of the banking system. These imbalances, in turn, have contributed to high real lending rates (about 20 percent p.a.) and distortions in credit allocation, which hinder the banking system's ability to contribute to private sector-led growth.

13. The Government's program will place the banking system under a sound incentive framework that will avoid the recurrence of the present problems, and enable it to channel new flows of resources to a wider segment of sound borrowers, at a lower cost. Achieving this objective will require three sets of actions. First, the issue of enterprise ownership of the troubled banks will be resolved through the takeover and subsequent privatization of these banks by the Bank Rehabilitation Agency (BRA), a Government agency. Second, in order to facilitate and expedite privatization, the BRA will carve out from the troubled banks' balance sheets their exposure to their largest problem customers. Third, the troubled assets transferred to the BRA will be resolved by or under the control of the BRA. Exposure to smaller problem enterprises will be resolved by the banks themselves under BRA supervision. The legislation enabling the Government to carry out this bank reform was enacted by the Croatian Parliament in June 1994.

14. As the Bank Rehabilitation Agency will be performing a central role in bank and enterprise restructuring and privatization, the Government will ensure that it operates under a proper incentive framework and strong governance. With respect to incentives, the BRA will operate for a period limited to three years, and under a hard-budget constraint. It will be provided only with limited budgetary funding, to start operating and working out problem loans. Additional funding requirements will have

to be met out of BRA current operations, i.e., the sale of enterprise assets or collections on problem loans. As to governance, the BRA board, already appointed, constitutes a strong decision-making body which will overview closely the BRA's operations: it is chaired by the Prime Minister, and comprises, inter alia, the Minister of Finance, the Minister of Economy, and the Governor of the Central Bank. BRA's senior management was recently appointed and includes, in addition to the Director of the BRA, one senior advisor with relevant international experience, and four high-level professionals in charge of bank supervision, asset management, legal matters, and administration/accounting, respectively. Second-tier staffing will be completed by Board presentation of the EFSAL. The statutes and procedures of the BRA will be approved by Board presentation of the EFSAL.

Project Objectives

15. The proposed loan will support the Government of Croatia's program of reforms by financing studies and advisory services to help design and implement reforms to be supported by the proposed Enterprise and Financial Sector Adjustment Loan.

Project Description

16. The Project consists of consultancies for the studies and advisory services described in the following paragraphs. The studies and advisory services are designed to help support the Government's strategy which calls for the full divestiture of almost all former socially-owned enterprises (FSOEs) within a three-year time period, with the exception of 20-30 large enterprises which will be dealt with by the Bank Rehabilitation Agency, and the rehabilitation and privatization of selected banks. The strategy also envisions the privatization of a large part of the public enterprise sector.

17. Privatization of former socially-owned enterprises (US$1.25 million). While the Government is improving the auction/tender mechanisms already in place, it will also diversify the existing privatization methods mainly by introducing a mass privatization program (MPP) that will distribute the FSOEs' shares through a voucher scheme. The TA loan will help the Ministry of Privatization (MOP) by financing consulting services to design and help implement the MPP. The consultants will mainly assist the MOP to prepare the detailed design of the scheme (including the logistics for voucher distribution, exchange of vouchers for enterprise shares, preparation of the regulatory framework for special investment funds collecting vouchers, design and coordination of a public awareness campaign, etc.). The loan will also finance advisory services to improve the privatization of individual enterprises through existing methods. This will include individual experts and teams of consultants for privatization transactions of selected enterprises, legal advice, and improving CPF's procedures. These activities will be carried out primarily under the supervision of the CPF. The Ministry of Economy will also use some advisory services on specific aspects of restructuring and privatization of selected industrial enterprises.

18. Restructuring and privatization of public enterprises (US$1.8 million). The loan will finance consulting services mainly for the following studies which will prepare restructuring programs and propose privatization strategies where appropriate: (i) INA Kutina Fertilizer Plant and Refineries Studies; (ii) institutional, tariff and regulatory studies in the power sector; and (iii) validation of an on-going tariff study as well as a spectrum management study in telecommunications. The loan will also finance two advisors, experts in enterprise audit and financial analysis, for the Office for Restructuring and Economics of State-owned Enterprises (ORESE) which is responsible for monitoring the performance of large state-owned enterprises.

19. The large oil, gas and industrial group INA is preparing a comprehensive strategic plan for its restructuring and privatization, with the help of an investment bank and several specialized consulting firms. This strategic plan will encompass all key aspects of a comprehensive restructuring and

privatization program, including a long term assessment of INA's role in Croatia's changing economy and the formulation of a corporate strategy and a detailed action program. Two essential components for the preparation of this strategic program are the detailed studies of the two major loss-making divisions of the group, the large Kutina fertilizer complex and the refinery branch of the group, comprised of three refineries. These studies will assess the competitive position of these divisions, examine alternative strategic options (closure, divestitures, partial sale and alliance with strategic partners, etc.) and recommend the corresponding best solutions for the overall restructuring (including unbundling) and privatization of the INA group.

20. In the power sector, the Government has begun to prepare a national energy policy. The Technical Assistance Loan will finance a review of the pricing and tariff policy, and an additional study of the legal organization, ownership structure, and regulatory aspects of the sector, complementing and deepening the work currently under preparation with financing from the European Bank for Reconstruction and Development.

21. In the telecommunications sector, technical assistance under the Bank loan will focus on the development of tariff policies, including the mechanism for adjusting tariffs, and policies for interconnection between the dominant operator and independent private operators. The loan will also finance a Spectrum Management Study which will include the purchase of computer software and training of counterparts for the use of appropriate software.

22. Rehabilitation and privatization of the banking system (US$1.95 million). As a first step, comprehensive diagnostic reviews of nine banks have been financed under an advance of US$800,000 from the Project Preparation Facility which will be refinanced out of the Technical Assistance Loan. In addition, the loan will finance advisory services to assist the Bank Rehabilitation Agency (BRA) in the rehabilitation and privatization of selected banks. Activities planned, for which these services will be required, include: legal services required to carry out complex bank rehabilitation transactions (Privredna Banka Zagreb, the largest bank in Croatia); establishment of BRA's accounting and reporting systems; preparation of restructuring plans for BRA-managed enterprises; and preparation for sale of BRA-owned equity stakes in banks and enterprises.

Project Implementation

23. Project implementation will extend over two years. Overall responsibility for project implementation lies with the Assistant Minister of Finance. The project will be administered in Croatia by a Project Coordinator (PC) in the Ministry of Finance, in conjunction with officials of the various beneficiary agencies. The PC will report directly to the Assistant Minister of Finance. Under the Technical Assistance Project, the PC will be responsible for maintaining project accounts, verifying payments due under project contracts, advising beneficiary agencies on procurement procedures as needed, and monitoring project activities to ensure timely and effective project implementation. The PC will report on implementation progress to the Government and the Bank. Training of government staff on procurement and disbursement matters has been initiated with the assistance of World Bank staff and will continue during project implementation as needed.

24. The specialists for technical assistance and studies to be financed from the proceeds of the loan will be recruited by the Government in accordance with the World Bank's *Guidelines for the Use of Consultants*. The Government has already undertaken the procurement process for four contracts using World Bank *Guidelines* in order that they may qualify for the retroactive financing arrangement under this loan. These contracts are for advisors in the Ministry of Privatization to begin preparation of the Mass Privatization Program, in ORESE for financial and audit services, and for the Kutina Fertilizer Plant Study and the INA Refineries Study.

25. At this juncture it is not possible to identify all essential assistance requirements of the country, and it is likely that new needs will arise during the implementation period of this operation. To provide flexibility in project implementation, approximately 10 percent of the loan (excluding the PPF) remains unallocated (US$390,000). The Government has agreed as well that project funds will be reallocated among identified project components, if such new needs arise or if identified components are not producing the desired results. The criteria for reallocation in this instance are that (i) no disbursement against that component/contract has taken place over a three-month period and (ii) no movement is foreseen.

26. So far, availability of technical assistance to Croatia has been very limited. Only a PHRD grant from the Japanese Trust Fund in the amount of Yen 28.9 million (US$270,000 equivalent) was approved to finance audits of selected banks. If in the future additional grant financing is identified for the activities envisaged to be supported under this loan, the loan funds could be cancelled or reallocated to other project components. It is not expected, however, that grant funds will be available in the short term. The approval process for Croatia to be eligible for grants from EU-PHARE is underway, but may be completed and funds made available no sooner than end-1996. The British Know-How Fund is also considering involvement in Croatia, but has made no commitment to date. A formal review by the Government and the Bank will be undertaken approximately one year after project initiation, in order to reallocate resources, if required, on the basis of implementation progress and availability of grant financing.

27. The project will be carried out at a total cost of US$6.2 million. The proposed loan will finance about 81 percent of total and foreign exchange costs. The project includes a retroactive financing arrangement for expenditures on urgent contracts -- primarily for the early appointment of advisors and the start of urgent studies -- entered into by the Government with our agreement, provided that procurement of services was carried out in accordance with the Guidelines for the Use of Consultants by World Bank Borrowers and by the World Bank as Executing Agency (August 1981). Retroactive financing shall be limited to up to 10 percent of the loan amount, or US$500,000 and will be provided to cover agreed expenditures after October 1, 1995. A breakdown of costs and the financing plan are shown in Schedule A. Amounts and methods of procurement and of disbursements are shown in Schedule B. A timetable of key project processing events and the status of World Bank Group operations in Croatia are given in Schedules C and D. More detailed information on the project and a summary of key project activities are provided in the Technical Annex. Already agreed terms of reference also appear in the Technical Annex.

Project Sustainability

28. The Government of Croatia has created new institutions - the Ministry of Privatization (MOP), the Croatian Privatization Fund (CPF) and the Bank Rehabilitation Agency (BRA) - to implement its program of reforms. The Technical Assistance Project aims to support these agencies in their establishment and in implementing their work program. A direct result of the advisory services and studies financed by the loan will be greater efficiency of the banking system, improved financial management in restructured enterprises, and a reduction of losses in the enterprise sector. A measure of project sustainability will be the Government's willingness to implement the recommendations of the studies financed by the TA loan in the context of the EFSAL.

Lessons Learned from Previous Bank Involvement

29. Sector experience of the Bank indicates that Technical Assistance projects should: (i) be carefully focused, to ensure effective and efficient implementation; (ii) have the active support of senior government and ministry officials, to ensure properly considered and timely decision-making on issues;

(iii) have continuity in project management, to achieve timely implementation and sustainability; and (iv) have well-specified terms of reference for consultants and studies drafted prior to negotiations, to ensure well-defined project components. The Government has shown its keen interest in the reform program which this loan will support by creating the necessary structures - the Ministry of Privatization, the CPF and the BRA - to ensure smooth development and timely implementation of its enterprise and banking sector reforms. The terms of reference for various studies and advisory positions have been discussed with the Government and staff of the beneficiary agencies.

Rationale for Bank Involvement

30. A Country Assistance Strategy (CAS) for Croatia was discussed by the Executive Directors on April 20, 1995. This project is consistent with the CAS in its support of the Government's primary objective of private sector-led growth, which will require not only the acceleration of privatization, but well-functioning financial intermediaries. The Government of Croatia is moving rapidly to design and implement a reform program to address microeconomic causes of the problems in the enterprise and financial sectors. The program is being developed in cooperation with the World Bank in the context of the Enterprise and Financial Sector Adjustment Loan (EFSAL), and will include the three main components of reform which the TA loan will support: (i) rapid completion of the privatization of former socially-owned enterprises; (ii) restructuring and partial privatization of public enterprises; and (iii) the rehabilitation and privatization of the banking system.

Actions Agreed

31. The Government, through the Ministry of Finance, has confirmed the scope of work to be financed from the proposed loan. During negotiations, agreement was reached on the following: (a) the beneficiary agencies' responsibility for implementation of the project components; (b) the Project Coordinator's responsibility for project monitoring; (c) implementation schedules for the project components; (d) the schedule for reporting on implementation progress; (e) the annual audit of project accounts, the special account and statements of expenditure by an independent auditor; and (f) a mid-term review to be carried out by February 28, 1997, at which time loan funds may be reallocated if new technical assistance needs have arisen or if identified components are not producing the desired results.

Poverty Category

32. Not applicable.

Environmental Aspects

33. As this project is not expected to have any significant negative environmental aspects, it has been placed in Category C for the purposes of OD 4.01 on Environmental Assessment and does not require an environmental assessment.

Program Objectives Category

34. The Technical Assistance Project is intended to finance studies and advisory services needed for the preparation of the Enterprise and Financial Sector Adjustment Loan. Through these studies and services it will support the Government in its reform efforts to restructure and privatize public and socially-owned enterprises and the banking sector.

Participatory Approach

35. The Government is aware of the need for public participation in defining the activities of the project. Arrangements are being made where feasible to elicit public opinion/preferences. Such an approach will be used, for example, in the preparation of the Mass Privatization Program where the consultant will evaluate citizens' preference regarding conversion of enterprise vouchers into shares.

Benefits and Risks

36. The main benefit of the Technical Assistance Loan will be its support to the preparation of the reforms being undertaken in the context of the proposed EFSAL. The EFSAL-supported reforms are expected to yield a wide range of benefits for the Croatian economy, including: (i) a drastic reduction in the losses of the enterprise sector (now 7-8 percent of GDP), that will increase domestic savings and free up bank lending flows currently locked in inefficient uses; (ii) a decrease of domestic interest rates to about half of the current levels (from 20 to 10 percent p.a.), as a result of lower credit demand from loss-makers, and restructured bank portfolios; and (iii) greater enterprise efficiency, and improved resource allocation by the financial system, that should translate into higher growth rates economy-wide. The gross fiscal costs of enterprise and bank restructuring are expected to reach about 1 percent of GDP in 1996, mostly on account of bank rehabilitation and to increase to 2-2.5 percent of GDP in 1997-98, as the upfront costs of enterprise restructuring (particularly the social safety net costs) are being absorbed. The costs are then expected to decrease to about 0.5 percent of GDP, i.e., the long-term cost of servicing the bonds issued to recapitalize banks. They would be more than offset, over time, by increases in the tax base, collection on the banks' non-performing assets, and higher growth performance.

37. In addition to yielding economic efficiency gains, the loan will also contribute to the strengthening of the project beneficiary agencies. This support is critical in view of the limited institutional capacity at present, and the quasi-absence of donor funds to address this issue at this time (see para. 26).

38. The project risks lie in three areas. At the policy level, resumption of macroeconomic instability could slow progress on enterprise and banking reforms. Given the sensitive nature of the reform program, Government commitment, although strong at present, could waver if societal consensus were to weaken. On the project level, implementation of the project components could slow if implementation capacity on the part of the beneficiary agencies responsible for procurement of services proves to be weaker than expected. The third risk pertains to the possibility of underutilization of the Bank loan should grant financing be forthcoming. It has been agreed with the Government that grant funds could be used to finance activities under the project, in which case selected components of the loan would be reallocated or cancelled.

39. To counteract the risks at the policy level, the Bank will be following closely the country's progress on the enterprise and banking reform issues through its macroeconomic dialogue and preparation and implementation of the EFSAL reforms. The TA project will be supervised in tandem with the EFSAL which will ensure close supervision of the consultants' work. At the project level, relevant staff of most of the beneficiary agencies have received training in Bank procurement with good results to date. Two of the agencies have already implemented Bank procurement guidelines successfully on contracts that will qualify for the retroactive financing arrangement under the loan (see para. 24). Further training may be offered if needed. As for disbursement of the loan, grant financing is expected to materialize only toward the end of 1996 which should not have a serious impact on utilization of loan proceeds. The loan should disburse rapidly at first due to refinancing of the advance from the Project Preparation Facility and payments under the retroactive financing arrangement for activities already underway. Other activities are also expected to move rapidly once the loan has been approved.

Recommendation

40. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve it.

James D. Wolfensohn
President

Attachments: Schedules A-D

Washington, DC
February 29, 1996

Schedule A

REPUBLIC OF CROATIA
TECHNICAL ASSISTANCE PROJECT
IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

Estimated Costs and Financing Plan [1]

	Local	Foreign (US$ million)	Total
1. Privatization of former socially-owned enterprises	0.2	1.0	1.2
2. Restructuring and privatization of public enterprises	0.3	2.5	2.8
3. Rehabilitation and privatization of the banking system	0.1	1.7	1.8
TOTAL BASE COSTS	0.6	5.2	5.8
Contingencies	0.0	0.4	0.4
TOTAL PROJECT COSTS	0.6	5.6	6.2

Financing Plan

	Local	Foreign	Total
Government of Croatia	0.1	1.1	1.2
IBRD	0.5	4.5	5.0
TOTAL	0.6	5.6	6.2

1/ Excluding taxes and duties. Detailed numbers may not add to totals due to rounding.

Schedule B

REPUBLIC OF CROATIA
TECHNICAL ASSISTANCE PROJECT
IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

Summary of Proposed Procurement Arrangements [a/]
(US$ million)

Category of Expenditure	ICB	OTHER [b/]	Non-Bank Financed [c/]	TOTAL
Technical Assistance		4.2	1.2	5.4
		(4.2)		(4.2)
Project Preparation Facility		0.8		0.8
		(0.8)		(0.8)
Total Financing Requirements		5.0	1.2	6.2
		(5.0)		(5.0)

Note: Numbers may not add up due to rounding.
a/ Figures in parenthesis are the respective amounts financed by the World Bank loan
b/ Procurement according to World Bank Guidelines for Use of Consultants
c/ Comprises the following consultancies: financed by INA -- (1) the detailed analysis of its hydrocarbon chain, (2) preparation of a strategic restructuring and privatization program and (3) the financial audit of the group; financed by the CPF -- Phases 1 and 2 of the CPF's reorganization

Proposed Disbursement Categories

Category	Amount of Loan (expressed in Dollar Equivalent)	% of Expenditures to be Financed
Consultants' services	3,810,000	100%
Refinancing of Project Preparation Advance	800,000	Amounts due pursuant to Section 2.02 (c) of Loan Agreement
Unallocated	390,000	
TOTAL	5,000,000	

Estimated Disbursements US$5 million

Calendar Year	1996	1997
	(US$ million)	
Annual	3.0	2.0
Cumulative	3.0	5.0
Cumulative as % of Total	60%	100%

Schedule C

REPUBLIC OF CROATIA
TECHNICAL ASSISTANCE PROJECT
IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

Timetable of Key Project Processing Events

(a)	Time taken to prepare:	12 months
(b)	Prepared by:	Government with World Bank assistance
(c)	First IBRD mission:	March 1995 (June 1994 for EFSAL)
(d)	Appraisal:	March 1995
(e)	Negotiations:	February 1996
(f)	Scheduled Board date:	March 1996
(g)	Planned date of effectiveness:	April 1996
(h)	List of relevant PCRs and PPARs:	Not applicable

Schedule D

REPUBLIC OF CROATIA
TECHNICAL ASSISTANCE PROJECT
IN SUPPORT OF ENTERPRISE AND FINANCIAL SECTOR REFORM

Status of Bank Group Operations in Croatia

A. STATEMENT OF BANK LOANS [a]
As of January 31,1995

Loan No.	Fiscal Year	Borrower	Project	US$ Million (Less Cancellations) Loan	Undisbursed
Fully disbursed loans benefitting entities located in Croatia [b]				359.0	
Of Which: **SALs, SECALs and Program Loans**					-
Loans Under Disbursement:					
3069-0	1989	Istarski Vod. Buzet	Istria Water Supply Project	28.0	16.0
3760-0	1994	Republic of Croatia	Emergency Reconstruction Loan	128.0	75.1
3843-0	1995	Republic of Croatia	Health Project	40.0	37.4
3869-0	1995	Republic of Croatia	Highway Sector Project	80.0	76.9
			Total	635.0	
			Of Which: Repaid	314.1	
			Total Now Held by the Bank	320.9	
			Total Amount Sold	0.1	
			Of Which: Repaid	0.1	
			Total Undisbursed		205.4

B. STATEMENT OF IFC INVESTMENTS
As of November 30, 1995

There are no outstanding IFC commitments.

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a/ The status of these projects is described in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

b/ Represents Croatia's portion of loans made to the former Yugoslavia which were not fully repaid as of December 31, 1992.

IMAGING

Report No: P- 6792 HR
Type: MOP