

Croatian Economic Outlook

Quarterly

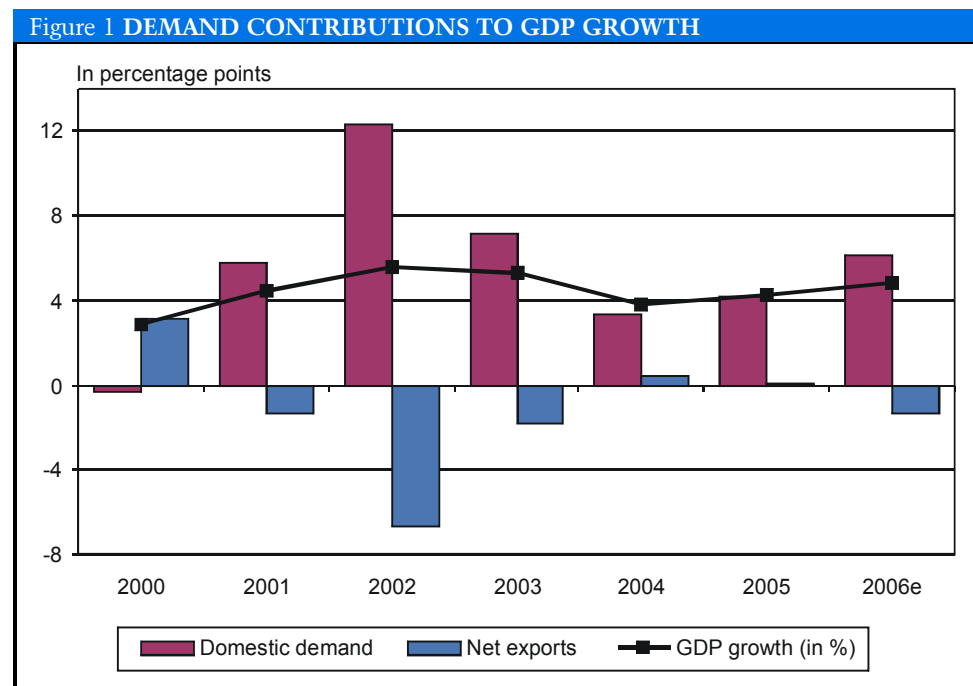
1 RECENT DEVELOPMENTS

Croatian economy regains strength in the third quarter.

Following a slight deceleration in growth during the second quarter of 2006, the Croatian economy regained strength in the third quarter with a 4.7 percent increase over the same period a year earlier. Thus, the economy returned to its trend growth pace that saw a medium-term average of 4.7 percent in the 2001-05 period. The major factor underpinning a recent revival of activity was domestic demand, particularly buoyant personal consumption and stronger investment dynamics. At the same time, external demand was rather sluggish in the third quarter as the total exports volume increased by a weak 2.2 percent. Recent developments confirm a previously established growth pattern, characterized by domestic demand that is expanding strongly while the external balance is deteriorating due to an increasing import dependency of the economy. Overall, the third quarter saw a solid economic growth accompanied by rising employment, declining inflation, narrowing fiscal deficit and improved business climate. These main trends are expected to continue in the course of 2007 and combine with a certain improvement in the country's external position due to an anticipated export strengthening.

Personal consumption back on track.

After the weakness exhibited in the second quarter of 2006, personal consumption recorded a solid increase of 3.9 percent year-on-year in the third quarter to return to a relatively stable expansion path observed in the last couple of years. In 2006, the average wage rose



Source for original data: Central Bureau of Statistics.

faster than in 2005 and, together with the employment growth, represented a major driving force behind a moderate revival in personal consumption. Overall favorable financing conditions helped additionally to keep consumption growing.

Government consumption increases moderately.

Government consumption has risen at a quarterly trend rate of 0.4 percent since the beginning of 2006, while in the preceding years the trend was mild or even stagnating. In the third quarter of 2006, an increase of 1.5 percent over a year ago was recorded. Such a pace can be explained by intensive negotiations with the EU and preparations for accession, as great challenges for the state administration. Moreover, certain parts of the public sector lack both the staff and resources for keeping up with their regular duties.

After a steep 2005 increase, investments resume a more moderate growth.

A steep 2005 upward investment trend began to flatten in the second quarter of 2006. Third quarter data might herald a new phase in the investment activity with a relatively solid growth, but without sudden surges. The trend growth rate stood at about 1 percent compared to the previous quarter (i.e. slightly more than 4 percent on an annual basis). However, original data for the third quarter show an increase of 9.3 percent year-on-year. Without precise information on the investment structure, one can only speculate that a sudden moderation of investment dynamics in mid-2006 was largely due to the government investments, where some relocation of resources among large infrastructure projects seems to have caused a temporary slippage.

Foreign trade dynamics cool down...

Somewhat unexpectedly, foreign trade dynamics cooled down in mid-2006. Consequently, the total export volume grew at a rate of just 2.2 percent year-on-year in the third quarter, whereas total imports expanded by 5.5 percent. Seasonally adjusted quarter-on-quarter data reveal a mild decrease in the foreign trade volume, both on the export and the import side. One should, however, note quite different dynamics in the trade of goods compared to services. As far as the goods trade is concerned, both exports and imports were quite vigorous in the third quarter. The balance of payments data reveal increases on both sides by more than 10 percent, expressed in the euro terms and current prices. Meanwhile, the services trade was almost stagnant, or more precisely, it increased mildly in the case of exports while imports decreased slightly. Foreign tourism receipts, as a major part of the services exports, were 1.9 percent higher than a year ago. Given the importance of tourism for Croatia's total export performance, especially in the third quarter of each year, such an outcome contributed to a substantial deceleration of the total export growth. As a result, the current account balance widened considerably to EUR 1.2 billion for the first three quarters, compared to EUR 0.5 billion in the same period of 2005.

... although goods trade remains strong.

Merchandise trade statistics suggest a dynamic performance of both the exports and the imports of goods up to November 2006. Year-on-year growth was stronger on the export than on the import side, with goods exports expanding 15.6 percent and goods imports 13.5 percent. Strong dynamics in merchandise exports stem largely from shipbuilding, metal, oil and food industry that contributed to the overall growth with close to 10 percentage points. On the import side, oil and metal industry, vehicles and chemical products were the main drivers. As regards the geographical orientation, one may observe intensified exports to the EU-15 countries as well as a stronger trade with countries in the region, especially Serbia, Montenegro and Bosnia and Herzegovina.

Industrial output on a firm rise...

According to seasonally adjusted figures, industrial activity gained momentum in the third quarter of 2006 with the output rising 3.6 percent quarter-on-quarter after a 0.9 percent growth in the second and 0.1 percent in the first quarter. The robust upward trend continued in October and November, enabling a 4.7 percent output increase in the year up

Table 1 MAIN ECONOMIC INDICATORS

	2004	2005	2005		2006	
			Q IV	Q I	Q II	Q III
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	3.8	4.3	4.8	6.0	3.6	4.7
Real private consumption (% change, yoy)	3.9	3.4	3.2	4.0	2.1	3.9
Real government consumption (% change, yoy)	-0.3	0.8	1.4	1.0	1.7	1.5
Real investment (% change, yoy)	4.4	4.8	9.9	18.1	8.4	9.3
Industrial output (% change, yoy)	3.7	5.1	5.5	6.4	-0.1	5.9
Unemployment rate (registered, %, pa)	18.0	17.9	17.6	18.3	16.8	15.9
Nominal GDP (EUR million)	28,393	30,950	-	-	-	-
GDP per capita (EUR)	6,396	6,968	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.3	3.2	3.3	3.7	3.8	3.2
Consumer prices (% change, yoy, pa)	2.1	3.3	3.8	3.5	3.8	3.2
Producer prices (% change, yoy, pa)	3.5	3.0	2.3	3.5	3.6	2.7
Average gross wage (% change, yoy, pa)	6.4	4.4	4.6	6.0	5.9	5.6
Exchange rate, HRK/EUR (pa)	7.50	7.40	7.38	7.34	7.28	7.30
Exchange rate, HRK/US\$ (pa)	6.03	5.95	6.21	6.11	5.80	5.73
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	6,603	7,217	1,980	2,004	1,972	2,081
Exports of goods (EUR, % change, yoy)	18.5	9.7	12.0	32.7	5.0	12.6
Imports of goods (EUR million)	13,331	14,738	3,950	3,865	4,321	4,233
Imports of goods (EUR, % change, yoy)	6.3	10.5	13.4	25.0	8.7	13.8
Current account balance (EUR million)	-1,404	-1,995	-1,509	-2,054	-1,300	2,176
Current account balance (% of GDP)	-4.9	-6.4	-	-	-	-
Gross foreign direct investment (EUR million)	990	1,421	122	521	871	364
Foreign exchange reserves (EUR million, eop)	6,436	7,438	7,438	8,089	8,744	8,135
Foreign debt (EUR million, eop)	22,781	25,541	25,541	26,485	27,518	27,139
GOVERNMENT FINANCE*						
Revenue (HRK million)**	87,019	92,643	92,643	22,067	47,240	73,483
Expense (HRK million)**	86,941	92,332	92,332	23,715	47,576	71,365
Net = Gross operating balance (HRK million)**	78	310	310	-1,648	-336	2,118
Net acquisition of non-financial assets (HRK million)**	8,374	6,699	6,699	793	2,493	4,019
Net lending/borrowing (HRK million)**	-8,296	-6,389	-6,389	-2,442	-2,829	-1,901
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-9,335	-7,711	-7,711	-2,980	-3,839	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-4.5	-3.4	-	-	-	-
Domestic government debt (EUR million, eop)	5,412	7,461	7,461	8,045	8,323	8,207
Foreign government debt (EUR million, eop)	7,220	7,018	7,018	6,605	6,576	6,633
Total government debt (% of GDP)	44.5	46.8	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	2.0	12.3	12.3	10.5	15.0	20.0
Broad money, M4 (% change, yoy, eop)	8.6	10.5	10.5	11.3	14.4	16.6
Total domestic credit (% change, yoy, eop)	14.0	17.2	17.2	22.3	23.2	22.4
DMBs credit to households (% change, yoy, eop)	18.7	20.3	20.3	22.7	23.9	22.5
DMBs credit to enterprises (% change, yoy, eop)	8.0	16.3	16.3	22.8	24.5	24.5
Money market interest rate (% pa)	4.6	2.3	2.2	1.1	1.4	1.9
DMBs credit rate for enterprises, short-term, (% pa)	8.2	8.1	7.8	7.6	7.1	7.1
DMBs credit rate for households, short-term (% pa)	14.4	13.1	11.9	12.4	12.3	11.8

Notes: * Data refer to the consolidated central government. ** On the cash principle, cumulative from the beginning of the year.

Conventional abbreviations: pa - period average, eop - end of period, yoy - year on year, HRK - Croatian kuna, EUR - Euro, US\$ - US dollar, DMB - deposit money bank.

Sources: Central Bureau of Statistics, Croatian National Bank and Ministry of Finance.

to November. Across various branches, the main positive contributors included food and beverages industry, machinery and printing industry as well as the communication equipment manufacturing. By contrast, textile industry, petroleum refining and, first and foremost, chemical industry had the strongest negative contributions to the overall industrial output.

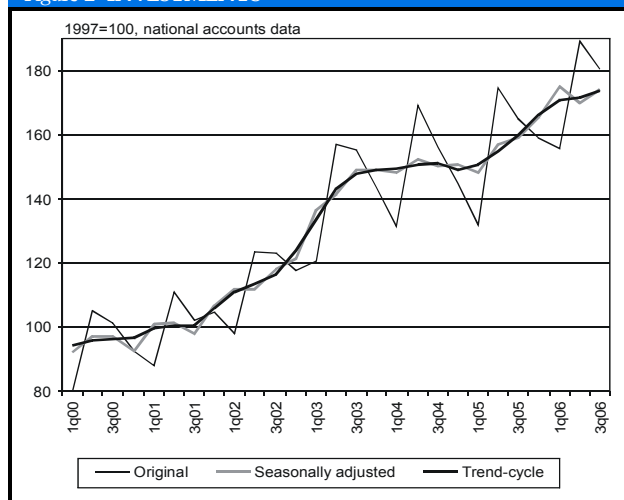
... while retail trade volume builds up.

The first eleven months of 2006 brought a modest increase in the retail trade volume that amounted to 2.0 percent year-on-year. Following negligible 0.9 and 0.4 percent quarter-on-quarter increases in the first and second quarter of 2006 respectively, retail volume increased by 2.1 percent in the third quarter allowing for a strengthening of the upward trend. Despite a rather modest retail sales performance registered in the CBS monthly reports, figures on the number of cars sold suggest a substantial 11.7 percent increase over the previous year. Taking into account that car sales were just 1.4 percent higher in 2005 than a year earlier, this outcome on the car market, in addition to the results indicated by consumer confidence and consumer expectations surveys, confirm rather robust consumer confidence.

Labor market situation improves.

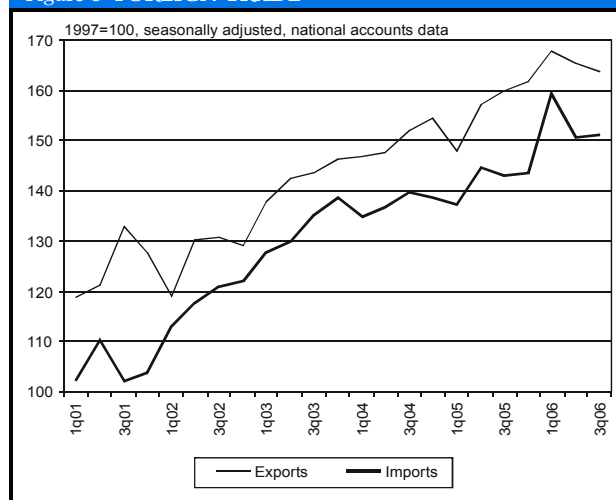
The average employment in the January-November period increased by 0.7 percent compared to the previous year. The largest employment growth was recorded in real estate, renting and business activities, wholesale as well as retail trade and the construction sector. These positive employment trends are confirmed by the Croatian Pension Insurance Agency data, showing a 2.6 percent increase in the number of insured persons in 2006 over the previous year. However, in line with the usual seasonal pattern, the total number of employed persons has been decreasing since the end of summer while the number of unemployed persons has been on the rise. Nevertheless, the total joblessness registered in November 2006 was 4.3 percent lower than a year earlier. As a result, the unemployment rate increased slightly in recent months to reach 16.9 percent at the end of November. The unemployment rate based on the Labor Survey data stood at 11.8 percent in the first half of 2006, or 0.5 percentage point lower than in the second half of 2005. As regards wages, 2006 brought some revival in the real wage growth. Year-on-year data for the January-October period point to an increase in both the nominal and the real wage growth that stood at 5.9 and 2.4 percent respectively.

Figure 2 INVESTMENTS



Source for original data: Central Bureau of Statistics.

Figure 3 FOREIGN TRADE



Source for original data: Central Bureau of Statistics.

Strong monetary expansion...

When it comes to monetary developments, there is a sharp acceleration in the growth of major monetary aggregates which could be related to a strong credit activity. In the third quarter of 2006, broad money recorded a 4.0 percent quarter-on-quarter growth and although it subsided somewhat in November, its year-on-year expansion still reached 16.1 percent. It was due to an exceptionally strong upsurge in both kuna savings deposits and narrow money. The thing is that, up to September, commercial banks attempted to collect new kuna savings indexed to foreign currencies, since they were not subject to the central bank's minimum reserve requirement applying to currency claims. As a result, kuna savings deposits in November stood 57.1 percent higher than in the same month of 2005, while foreign exchange deposits remained almost unchanged. An impressive narrow money growth, reaching 24.5 percent year-on-year in November, could be almost fully attributed to the deposit money growth.

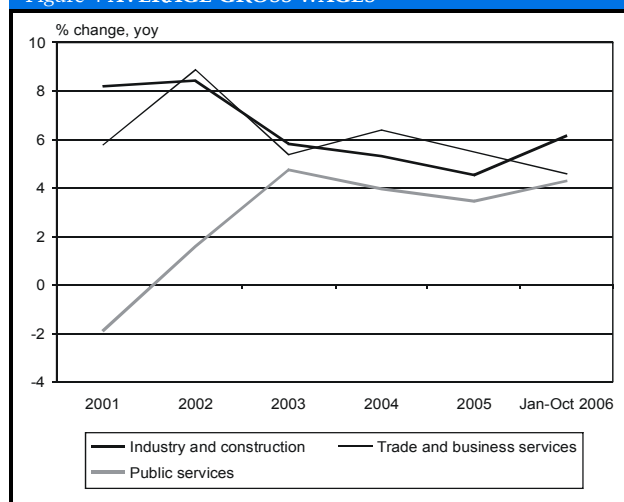
... due to a dynamic credit activity...

During the fall months of 2006, commercial banks' year-on-year credit growth rates decreased by 2 percentage points on average in comparison with the record-highs registered in May and June. Nevertheless, loans to enterprises and households still exhibited strong month-on-month dynamics. Since mid-2006, the growth of credits to enterprises exceeded that of credits to households slightly. In November, its year-on-year growth rate reached 22.7 percent, compared to 22.5 percent recorded for credits to households. Housing loans remained the most propulsive credit component, accounting for approximately one third of all household lending. In November, housing loans were 34.5 percent higher than in the same month of 2005.

... pressed the central bank to impose the credit ceiling.

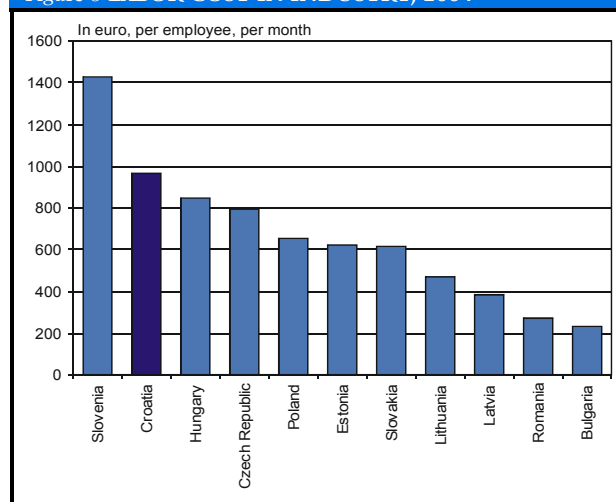
Since the marginal reserve requirement has not yet brought about any significant slowdown of credit activity, the central bank enacted a new measure aimed at curbing credit growth in January 2007. Thus, along with the marginal reserve requirement designed to make foreign borrowing of commercial banks more expensive, commercial banks will have to limit their annual credit growth to 12 percent. If they exceed this ceiling, banks will be penalized by having to buy CNB bills.

Figure 4 AVERAGE GROSS WAGES



Sources: Central Bureau of Statistics and authors' calculations.

Figure 5 LABOR COST IN INDUSTRY, 2004



Sources for original data: Eurostat and Central Bureau of Statistics.

Box 1 INSIDE THE GOVERNMENT'S 2006 PRE-ACCESSION ECONOMIC PROGRAM

In December 2006, the Government submitted the Pre-accession Economic Program for the 2007-09 period to the European Commission. This document includes the economic policy guidelines over the medium-term. Besides stating the major goals including fiscal consolidation and the reduction of external imbalances, the 2006 PEP outlines all the structural reforms that are being undertaken or are planned to be undertaken as part of Croatia's preparation for the EU membership. We focus on the reform measures that are to result in a more competitive economy and a more efficient adjustment process. The 2006 PEP envisages structural reforms in seven specific areas. This is the summary of the plans for each of them.

1. Enterprise sector - The emphasis is put on the privatization of public companies, mainly through capital markets; privatization of the shipbuilding industry until 2010; restructuring of *Croatian Railways* and a transformation of the Croatian Privatization Fund into an institution that will be able to manage state-owned property efficiently. In 2007, the privatization of ironworks *Valjaonica Cijevi Sisak* and aluminum producer *TLM, Šibenik* should be completed. In addition, the privatization of three subsidiary companies of *Croatian Railways* should be prepared. Over the next three years, the state-owned shipyards should be privatized, while the simultaneous restructuring process will enable their successful performance on the international market without direct government subsidies.

2. Financial sector - A further harmonization of domestic financial sector regulations with the EU *acquis* is planned. Attention will be paid to the progress in supervision of the non-banking sector.

3. Labor market and social welfare - Labor market reforms should spur employment by reducing a mismatch between supply and demand. Social benefits reform is aimed at reducing the GDP share of the overall social spending. However, spending on social assistance benefits should increase, while the whole system will be reformed by creating beneficiary-oriented services with improved quality and better social-benefit targeting.

4. Agricultural sector - Modernization and restructuring in line with the EU standards continue to be the main objectives of agricultural policy, involving the privatization of agro-conglomerates, preparation of Croatian agriculture and fisheries for the EU, and enhancing competitiveness of the wood-processing industry.

5. Public administration reform - Developing an effective public administration through rationalization, simplifying procedures, and strengthening the role of the e-government are the main goals of the reform.

6. Knowledge-based society - Various actions directed towards the development of a knowledge-based society are foreseen, such as the education system reform, promotion of science and research, and better coordination between the education system and the labor market needs.

7. Other structural reforms - The PEP lists a number of other reforms needed for a successful accomplishment of the main economic policy goals. They include health care and judicial reform, as well as reforms in the area of environment protection and public procurement.

Enterprise sector becomes the main driver of foreign debt increase.

After a robust growth in the first half of the year and a short-lived downward correction during the summer months, foreign debt resumed its growth in September. At the end of October, it reached EUR 27.7 billion and was some 14 percent larger than in the same month of 2005, having grown 2 percent over the previous month. An increase of EUR 2.1 billion from the beginning of the year is attributable mainly to the enterprise sector (EUR 1.9 billion), now participating in the total debt with a 42 percent share. The share of the banking sector has shrunk to 34 percent, probably due to the CNB efforts to restrain its foreign borrowing. However, one could speculate that banks are redirecting loan

applications of corporate clients to their foreign branches, thus contributing to the foreign debt increase of the enterprise sector. Finally, the Government's orientation towards borrowing on the domestic markets led to a decline in its foreign debt by EUR 0.4 billion.

Good money market liquidity.

The last quarter of 2006 saw good money market liquidity, helped by an active participation of the central bank on the market. Besides conducting regular repo auctions, it had four foreign exchange sales in order to provide the market with additional kuna liquidity. The major event of the quarter was a takeover of *Pliva*, Croatia's largest pharmaceutical company. Despite concerns among market makers about its effect on liquidity and exchange rate, it was carried out smoothly. Mild liquidity pressures were felt in December, the month known for a strong seasonal demand for kuna due to holiday-related spending. This time, the seasonal kuna demand coincided with a new period of reserve requirement maintenance and the Government's purchase of foreign exchange from the central bank to nudge the 3-month ZIBOR up slightly from 4.2 to 4.5 percent. Thanks to the foreign exchange interventions aimed at easing appreciation pressures, the kuna exchange rate against the euro appreciated very slightly from 7.39 in September to 7.35 in December.

Lower inflation.

The last quarter of 2006 was marked by an easing of inflationary pressures. In December, consumer and producer prices were 2.0 and 1.9 percent higher respectively than in the same month a year earlier. As inflationary pressures weakened, December consumer prices remained roughly at their June level.

Fiscal stance improves gradually...

The data on budgetary developments in the first nine months of 2006 point to further improvements towards fiscal consolidation. Therefore, it is already quite realistic to expect that the planned deficit target of 3 percent of GDP for 2006 as a whole could be achieved. Revenue collection remained strong in the third quarter. Compared to the same period a year earlier, consolidated general government revenues in the first nine months rose 10 percent to reach HRK 82 billion. This increase resulted primarily from significantly higher VAT revenues and social contributions. At the same time, expenditures grew at a moderate rate of 5.4 percent year-on-year. Social benefits, wages and salaries, and expenditures for the use of goods and services were the main drivers of expenditure growth.

Figure 6 CREDIT DEVELOPMENTS

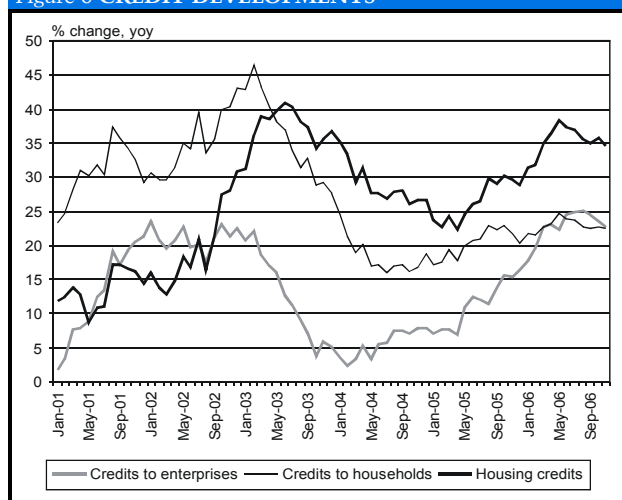
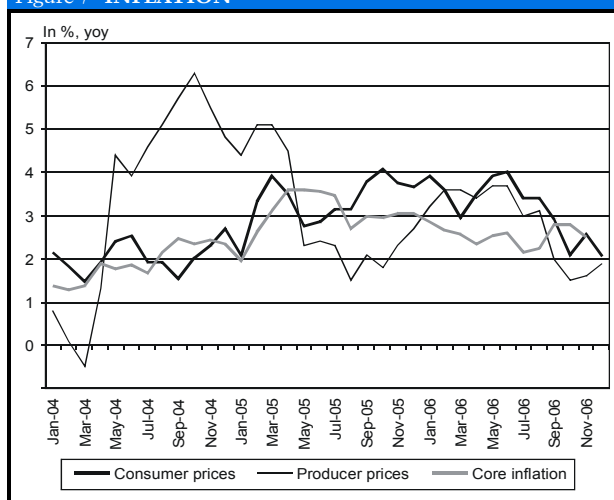


Figure 7 INFLATION



Source for original data: Croatian National Bank.

Sources: Central Bureau of Statistics and Croatian National Bank.

... and is expected to have a positive impact on public debt dynamics.

The consolidated central government debt stock rose from HRK 106.8 billion at the end of 2005 to HRK 109.6 billion at the end of September 2006. An increase in the total public debt by 2.6 percent (including state guarantees) was significantly lower than in the same period of 2005, representing a clear sign of a debt slowdown. The maintenance of such developments is among the fiscal policy cornerstones in the years to come. Namely, according to the 2006 Pre-Accession Economic Program, a reduction of the external government debt by EUR 1.2 billion is to be expected in the 2006-09 period.

State budget for 2007 adopted.

In December 2006, the Croatian Parliament adopted the state budget for 2007 in the amount of HRK 108.1 billion, with a 9 percent growth of expenditures compared to those planned for 2006. The budget is based on an optimistic projection regarding revenue collection in 2007, with revenues in the amount of HRK 103.5 billion, or some 9 percent more than budgeted for 2006. The Government based such a projection on the expectations of a rather strong economic growth. Most of the 2007 revenues (57 percent) are planned to be collected from taxes, mainly VAT. VAT is planned at a level of 14 percent of GDP in 2007, while revenues from social contributions should stay at the same level as in 2006 (approximately 13.5 percent of GDP). The 2007 state budget deficit is expected to shrink to HRK 4.6 billion, or 2.8 percent of GDP.

2 POLICY ASSUMPTIONS AND PROJECTIONS SUMMARY

Moderation of the world economy growth in 2007.

Following three years of a rather strong and broad-based growth, the world economy is expected to decelerate in 2007, mainly due to a slowdown in the United States. Estimates of the GDP growth in the third quarter of 2006 indicate that the United States growth pace moderated to 0.5 percent on a quarterly basis from 0.6 percent in the previous quarter. The decline was mostly due to a fall in residential investment. At the same time, according to the Eurostat's first estimate for the third quarter of 2006, the quarter-on-quarter GDP growth rate in the euro area was 0.5 percent, having moderated from 1.0 percent in the second quarter. On a year-on-year basis, GDP expanded by 2.7 percent. Domestic demand was the driving force of economic activity in the third quarter, confirming a broadening of the recovery that is taking place after a prolonged period of sluggish performance. The ECB projections foresee the average annual GDP growth in a range between 2.5 percent and 2.9 percent in 2006, and between 1.7 percent and 2.7 percent in 2007 (ECB, *Monthly Bulletin*, December). Consumer price inflation has recently declined in a number of countries after climbing in the first part of the year to the levels that prompted central banks to act by raising key interest rates.

Lowest oil prices in year-and-a-half.

Oil prices exhibited volatility in October and November, fluctuating around US\$ 60 per barrel. This volatility was a result of a variety of developments with opposing effects on prices. On the one hand, the OPEC announced a production cut by about 1.2 million barrels per day from the beginning of November, which combined with a relatively strong decline in the United States oil inventories built upward pressures on prices. On the other hand, downward price pressures resulted from reports indicating the OPEC's inability to enforce the announced production cut, easing of tensions in the Middle East and a moderation in demand for oil due to mild winter conditions in North America and Europe. Downward price pressures strengthened at the turn of the year, with oil prices slipping to their lowest level in a year-and-a-half in mid-January. Having declined to US\$ 52 per barrel, oil prices stood roughly 13 percent lower than at the beginning of the year. Although the OPEC has already agreed to cut another 0.5 million barrels per day from February 1st, these latest developments are pressing major producers to start discussing further production cuts.

External environment remains favorable.

Overall, the outlook for the external environment as an indicator of foreign demand for Croatian goods and services remains favorable. The major export market - that of the EU - is experiencing a broad-based recovery while oil prices, as the main source of inflation pressures, have recently exhibited a strong decline. On the internal front, the Government continues to focus on reducing fiscal and external imbalances and on pressing with the structural reforms laid down in detail in the 2006 Pre-accession Economic Program (see Box 1). The accession negotiations with the EU are expected to continue smoothly although progress seems slow at the moment. Out of 35 chapters, two were temporarily closed in 2006, while negotiations on three new chapters - customs union; enterprise and industrial policy; and economic and monetary policy - have been opened recently.

Fiscal authorities focus on reducing deficit; monetary authorities strive to reduce external vulnerabilities.

Fiscal policy continues to focus on reducing the fiscal deficit. The country's current economic situation enables a rather strong fiscal expansion without the fiscal deficit widening. If a relatively strong economic growth continues, higher than expected budget revenues will most probably make pressure for an accommodating revision of budget expenditures. Hence, it is highly possible to expect the budget to be revised up by mid-year. The CNB measures enforced in January 2007 show that the central bank continues to focus on reducing external vulnerabilities. Although the effectiveness of the measures might be questionable, it is obvious that the central bank has been pressured to enforce them not only due to a deterioration of the external position, but also to adjust to a possible fiscal expansion in the year of parliamentary elections. As for the exchange rate policy, the central bank is expected to continue supporting a stable exchange rate both through direct interventions on the foreign exchange market and other measures.

GDP expected to grow 4.5 percent in 2007...

The economic activity information available from leading indicator surveys and high-frequency indicators supports the estimate of relatively robust economic growth in the fourth quarter of 2006, with positive trends continuing at the beginning of this year. In 2007, we expect domestic demand to maintain its relatively strong momentum thanks to some acceleration in the personal consumption growth and continued dynamic investment activity. In addition, an export strengthening could combine with a somewhat weaker import growth compared to last year. As a result, GDP growth is projected to reach 4.5 percent in 2007.

Table 2 SUMMARY OF PROJECTIONS

	2006	2007
Real GDP (% change)	4.8	4.5
Real private consumption (% change)	3.6	4.0
Real government consumption (% change)	1.3	1.4
Real investment (% change)	10.2	4.9
Exports of goods and services (constant prices, % change)	6.5	6.9
Imports of goods and services (constant prices, % change)	7.3	5.6
Current account balance (% of GDP)	-8.1	-7.4
Consumer prices (% change, pa)	3.2	2.7
Exchange rate, HRK/EUR (pa)	7.32	7.32
Unemployment rate (registered, %, pa)	16.9	16.4
General government balance - GFS 1986 (% of GDP)	-3.0	-2.8
Broad money, M4 (% change, eop)	14.5	9.0
Total domestic credit (% change, eop)	21.0	13.0

Notes: Cut-off date for information used in the compilation of projections was January 3, 2007.

Conventional abbreviations: pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.

Source: Authors' projections.

... on the back of stronger personal consumption,...

Personal consumption may strengthen in the course of 2007, in line with real disposable income developments and improvements on the labor market. As a result, the 2007 personal consumption growth could accelerate to 4.0 percent. However, the impulses coming from favorable financing conditions are expected to weaken to a certain extent due to the household sector debt servicing burden and more stringent credit conditions imposed by the latest CNB measures. Nevertheless, relatively favorable overall economic conditions should spill over into the personal consumption growth.

... steady investment dynamics and exports expansion.

Government consumption is expected to maintain what is currently a mild upward trend throughout the year as a result of more intense activities in the government sector related to the EU accession and higher expenditures associated with parliamentary elections. Consequently, government consumption is expected to increase 1.4 percent in 2007. Investments are recovering from a temporary deadlock that took place in mid-2006, as suggested by seasonally adjusted and trend data. The positive current trend is to continue in the course of the year and bring about 5-percent growth. As for the foreign trade developments, we expect a continued modest upward trend in goods exports while the exports of services could see a stronger expansion. Export growth may accelerate to roughly 7 percent in 2007. The imports of goods and services are projected to slow down this year, partly due to a slightly weaker overall growth and partly to the CNB measures and an expected continuation of weaker services imports. As a result of developments in the foreign trade sector, the current account deficit is anticipated to narrow to about 7.4 percent of GDP in 2007.

Employment prospects are positive...

Relatively bright prospects for the overall economy make the outlook for developments on the labor market rather positive. However, the relationship is not linear. The total registered employment is expected to expand by slightly above 1 percent in 2007, in continuation of the trend observed during the last several years. The unincorporated sector (small businesses and self-employment), accounting for approximately 1/5 of the total employment, may well cease to be a strong driver of employment growth. An anticipated annual increase in that sector by about 1 percent is substantially lower than in previous years. It turns out that the current growth pattern enforces the position of larger enterprises. As for unemployment, we see scope for its reduction through an increase in employment opportunities. However, there is also a possibility of feeding it up through new job claims of previously inactive persons, encouraged by improved prospects. On balance, a reduction of the unemployment pool by about 3 percent is expected in 2007. In sum, the registered unemployment rate could drop from the estimated 16.9 percent for 2006 to 16.4 percent projected for 2007. The same trend is expected with the ILO-standard unemployment rate, which is expected to drop to 11.5 percent in 2007.

... while wages are about to rise.

The pace of wage rises should speed up moderately in 2007, although it will still be constricted by labor productivity considerations. Business sectors have already experienced a rather long period of the average wage growth below productivity growth, and the same trend is expected to continue this year. As to the public sector, a 6-percent growth (plus certain bonuses) has been agreed for this year, following several years of modest increases. An increase in the disposable household income will be supported further by expanding social transfers, particularly by the next installment of the so-called pensioners' debt repayment and transfers related to the population policy measures. In addition, financial and capital market investments have risen over the last couple of years, and returns on such investments have been rather high. This year will bring a further expansion in these markets to help support the incomes of the population.

Inflation will slow down on average, although risks are on the rise.

In 2007, we expect a slowdown of inflation primarily due to the stabilization of oil prices on global markets and increasing competition on the local market. However, inflationary risks seem to be on the rise, emerging primarily from the sectors that are not exposed to competition. In particular, the prices of utility services such as water supply, waste collection, parking fees, condominium fees and the like that are under administrative control of local authorities seem poised for a substantial rise. To sum up, the average annual inflation rate in 2007 is projected at 2.7 percent. A relatively stable exchange rate against the euro, to be expected as a part of the central bank's policy, will help maintain inflation somewhere around the forecasted level.

Monetary and credit growth expected to slow down.

Despite a drastic increase in the CNB's marginal reserve requirement ratio, aimed at curbing the domestic credit growth, credit activity recorded a strong expansion in recent months. Banks have avoided marginal reserve requirement by increasing capitalization and attracting domestic savings in order to finance new lending. Therefore, our estimates for monetary and credit aggregates for 2006 were revised upwards. However, the CNB's new policy-mix that includes a combination of the marginal reserve requirement and the credit growth ceiling might prove more successful in curbing the credit growth. Consequently, we expect the total credit activity to slow down to 13.0 percent, with broad money growth coming in at 9.0 percent this year.

Budget deficit should stay close to 3 percent of GDP.

Declining deficit data and public debt ratios indicate that the fiscal adjustment was successfully implemented in 2006. As for 2007, we are less optimistic about the government plan to achieve a further deficit decrease to 2.8 percent of GDP. Consequently, we expect the budget deficit to stay close to 3 percent, with a continued shift in the public debt structure towards borrowing on the domestic markets. A revenue growth resulting from favorable cyclical conditions will surely have some positive impact on the budget. However, as the improvements in the fiscal position stem mainly from the economic growth rather than being a result of successful structural reforms, risks to the government projection remain.

3 UNCERTAINTIES AND RISKS TO PROJECTIONS

Will stringent CNB measures have a negative effect on domestic demand?

The latest stringent measures passed by the central bank were essentially aimed at reducing domestic demand through tougher financing conditions on the domestic market. These measures will more likely affect the household sector and small enterprises than the medium-sized and large enterprises that are able to seek additional funding abroad. A degree of effectiveness of the central bank measures will be strongly related to the growth pace of the overall economy, meaning that if these measures prove effective, they might slow down economic growth. While we believe their impact to be minor, combined with rising interest rates in the international markets it might create considerably less favorable financing conditions for personal consumption and investment than initially expected.

Risks related to achieving fiscal deficit target.

The budget deficit is projected to fall by 0.2 percentage points in 2007, but we observe some risks related to the accomplishment of this goal. Any fiscal consolidation measures planned for this year appear to be mostly on the revenue side. The Government expects a strong tax revenue increase necessary for financing the expenditure growth without a large new debt increase. If it is taken for granted that the nominal GDP will be as high as projected, the risks on the revenue side are mostly related to the capacity of the Tax Administration to keep pace with the nominal growth and maintain its strong revenue collection. On the

expenditure side, challenges are related to the pre-election spending that, if not restrained, might boost total expenditures considerably and jeopardize the proclaimed fiscal target. In addition, a danger of major structural problems being rolled over into next year, even if this year ends with the 2.8-percent deficit, needs to be stressed. As such we perceive postponed structural reforms, accumulation of arrears and other contingent liabilities, as well as passing of the legislation to enable a future expenditure increase (e.g. in the area of social security) and engaging in obscure extra-budgetary operations.

**Overall growth rate
subject to external
sector developments.**

Thanks to a better integration of the Croatian economy with the markets in the broader region, goods exports seem to be growing at a stable pace. However, the situation in the tourism sector seems to be much more complex. Although figures indicate a steady increase in the number of foreign overnight stays from year to year, financial indicators simultaneously suggest a high volatility in the receipts from foreign tourism. Despite the fact that we are dealing with methodological problems related to the accuracy of covering the tourism activity, a stronger restructuring of the sector seems necessary. Higher and sustainable growth rates of the value added in the tourism sector is the main precondition for an expansion in the total exports of goods and services that, in turn, represents the main prerequisite for reducing external vulnerability and achieving a sustainable growth increase. In the years to come, the growth pace of the economy will be predominantly determined by developments in the exports sector.

IMPRESSUM

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