

Croatian Economic Outlook

Quarterly

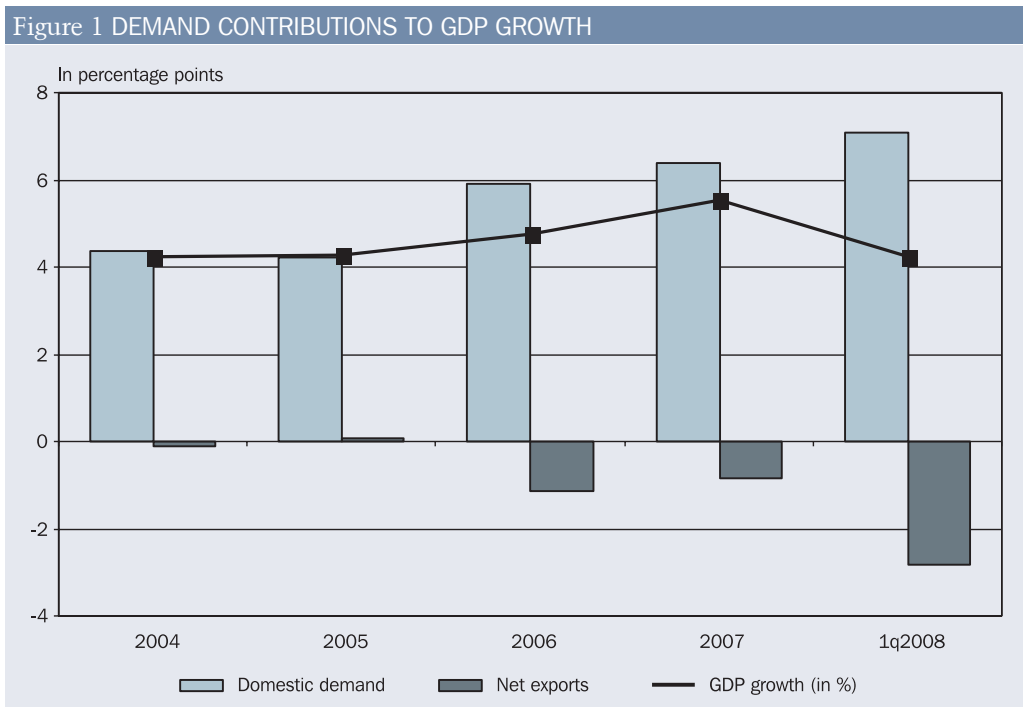
1 Recent Developments

Strong domestic demand pushed economy up in the first quarter...

The Croatian economy experienced a solid expansion at the beginning of this year, causing an additional upswing in the trend-cycle. GDP growth reached 4.3 percent over a year in the first quarter of 2008, compared to 3.7 percent in the fourth quarter last year. Seasonally adjusted quarterly growth of 1.8 percent was almost twice as high as in the previous quarter. Although an economic slowdown was expected at the start of this year as a reflection of global uncertainties, favorable domestic factors seem to have been stronger than the adverse effects coming from the international environment. Investments boomed, while advantageous seasonal factors, i.e. Easter holidays in March, helped to keep household consumption growing at a solid pace. Consequently, the recent GDP growth was driven mainly by domestic demand - investments contributed 3.0 percentage points to the first-quarter growth rate, personal consumption added 2.7 percentage points, while net exports exerted a strong negative contribution of 2.8 percentage points. On the production side, a solid expansion was recorded in construction, hotels and restaurants, financial and business services, as well as in industrial production.

... but the second quarter looks less favorable.

High-frequency indicators available for the second quarter of 2008 give a mixed picture about the pace of the economy – seasonally adjusted industrial production has weakened,



Source for original data: Central Bureau of Statistics.

and so has the volume of retail sales. However, construction has been on a steep way up. Following a disappointing April, the number of tourist overnight stays increased substantially in May. Nevertheless, the second quarter seems less favorable than the first one.

Personal consumption still strong...

Personal consumption remained robust in the first quarter, with a 4.3-percent increase over a year in spite of rising inflation and a modest increase in the average wage. Seasonally adjusted figures on a quarterly basis point to a mild acceleration in personal consumption this year. Personal consumption is obviously benefiting from rising employment. Increased government transfers from the end of last year and withdrawals of resources from a declining equity market are also used to keep personal consumption relatively high. Apparently, households give preference to consumption smoothing by varying their savings-investment balances.

... unlike government consumption.

Government consumption performance was rather weak at the beginning of this year, with a first quarter increase of 0.5 percent over the same period last year. For comparison, increases in last year's third and fourth quarter were 4.4 and 3.7 percent, respectively. Consumption was weak due to the provisional budget that was in place during the first quarter, since the full budget for this fiscal year was enacted as late as in March 2008. Therefore, only necessary expenses were conducted at the beginning of 2008, while the rest were left for the remaining part of the year.

Buoyant investments in the first quarter.

The first quarter brought a 9.8 percent hike in investments, pointing to a strong rebound from the setback recorded in the mid-2007. Although a revival of investments has been expected, its buoyant pace is rather surprising. No further details on the structure of investments have been released, but construction activity could offer some explanation. It has performed strongly, partly due to several indoor stadiums that are being built for the upcoming 2009 Men's World Handball Championship. In the first quarter, the volume of construction was 10.2 percent higher on a year-on-year basis. At the same time, imports of capital goods rose 18.3 percent in current kuna terms.

Deteriorating external sector...

The volume of exports of goods and services increased 3.8 percent year-on-year in the first quarter of 2008, while imports grew 7.0 percent. Taken together, these figures point to a widening trade deficit and deteriorating external position of the country, as proved by EUR 2.5 billion of current account deficit in the first quarter. Up to March this year, the current account deficit reached 9.6 percent of GDP, up from 8.6 percent in 2007. Such a situation was partially caused by worsened terms-of-trade. In the last half-year, import prices of goods and services rose faster than export prices, mainly due to the global surge in oil and food prices. The rising prices of the Croatian tourism services have cushioned a part of the weakening overall terms-of-trade. It seems, however, that the exports sector is rather fragile and has difficulties coping with rising domestic costs.

... as a result of weak goods exports.

As reported in the external trade statistics, goods exports in current kuna terms increased by 6.0 percent year-on-year in the first five months of 2008, while the imports rose 11.8 percent. This is quite a large discrepancy, especially having in mind that the imports of goods are already twice as high as exports. As opposed to previous years, when oil industry was among the main drivers behind goods exports, in the first five months of 2008 exports of oil and refined petroleum products declined by almost 6 percent year-on-year, reflecting the waning capacities of the Croatian refineries, while imports expanded by 26 percent. Additional contributors to the strong import growth were ships, road vehicles as well as machinery and equipment.

Table 1 MAIN ECONOMIC INDICATORS

	2006	2007	2007			2008
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	4.8	5.6	6.6	5.1	3.7	4.3
Real private consumption (% change, yoy)	3.5	6.2	6.5	6.2	5.0	4.3
Real government consumption (% change, yoy)	2.2	3.4	2.7	4.4	3.7	0.5
Real investment (% change, yoy)	10.9	6.5	5.8	5.7	4.0	9.8
Industrial output (% change, yoy)	4.5	5.6	7.1	4.5	3.1	4.8
Unemployment rate (registered, %, pa)	16.6	14.9	14.8	13.7	14.2	14.7
Nominal GDP (EUR million)	34,220	37,497	-	-	-	-
GDP per capita (EUR)	7,707	8,452	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.4	4.0	3.7	4.0	5.1	6.1
Consumer prices (% change, yoy, pa)	3.2	2.9	2.1	2.9	4.9	5.9
Producer prices (% change, yoy, pa)	2.9	3.4	2.5	3.7	5.4	7.6
Average gross wage (% change, yoy, pa)	6.2	6.2	5.7	6.6	6.4	7.5
Exchange rate, HRK/EUR (pa)	7.32	7.34	7.35	7.31	7.33	7.29
Exchange rate, HRK/US\$ (pa)	5.84	5.37	5.46	5.32	5.06	4.87
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	8,464	9,193	2,309	2,361	2,477	2,225
Exports of goods (EUR, % change, yoy)	17.2	8.6	16.8	12.4	4.1	8.7
Imports of goods (EUR million)	16,808	18,627	4,837	4,671	4,913	4,777
Imports of goods (EUR, % change, yoy)	14.0	10.8	12.0	10.2	12.0	13.6
Current account balance (EUR million)	-2,696	-3,226	-1,376	2,084	-1,912	-2,488
Current account balance (% of GDP)	-7.9	-8.6	-	-	-	-
Gross foreign direct investment (EUR million)	2,745	3,597	987	537	710	688
Foreign exchange reserves (EUR million, eop)	8,725	9,307	9,170	8,795	9,307	9,842
Foreign debt (EUR million, eop)	29,274	33,173 ⁺	31,058	31,227	33,173 ⁺	34,752 ⁺
GOVERNMENT FINANCE*						
Revenue (HRK million)**	100,393	113,386	53,686	83,934	113,386	28,370
Expense (HRK million)**	98,751	109,075	50,680	78,168	109,075	26,433
Net = Gross operating balance (HRK million)**	1,641	4,311	3,006	5,767	4,311	1,937
Net acquisition of non-financial assets (HRK million)**	6,109	7,811	2,446	4,961	7,811	1,122
Net lending/borrowing (HRK million)**	-4,467	-3,500	560	805	-3,500	816
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-6,392	-	-245	-	-	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-2.6	-	-	-	-	-
Domestic government debt (EUR million, eop)	8,132	8,605	8,549	8,856	8,605	8,892
Foreign government debt (EUR million, eop)	6,649	6,686	6,757	6,513	6,686	6,562
Total government debt (% of GDP)	43.3	40.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	25.0	19.3	22.1	13.3	19.3	12.9
Broad money, M4 (% change, yoy, eop)	18.0	18.3	19.2	11.9	18.3	14.4
Total domestic credit (% change, yoy, eop)	22.9	15.0	21.2	17.4	15.0	12.2
DMBs credit to households (% change, yoy, eop)	21.8	18.0	21.1	19.5	18.0	16.3
DMBs credit to enterprises (% change, yoy, eop)	26.1	10.2	23.1	16.2	10.2	7.4
Money market interest rate (% pa)	1.6	4.1	4.1	3.9	6.0	4.5
DMBs credit rate for enterprises, short-term, (% pa)	7.1	7.0	6.9	7.0	7.3	7.6
DMBs credit rate for households, short-term (% pa)	12.1	12.1	12.3	12.2	11.8	12.2

Notes: ⁺New reporting system. *Data refer to 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\$ - U.S. dollar,
DMB - deposit money bank.

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

Industrial activity and retail sales weaken.

Following a strong performance of industrial production and retail sales in the first quarter of 2008, when they increased by 4.8 and 2.8 percent year-on-year, respectively, indicators for the following months indicate a substantial weakening. For instance, seasonally adjusted industrial activity recorded a 0.6 and 2.9 percent decline in April and May. On the other hand, retail sales that had exhibited more moderate dynamics than industrial production at the beginning of the year sustained its growth in April and May, but at modest rates of 0.8 percent and 0.4, respectively. However, one should note that a change in monthly dispersion of holidays (Easter in March, Corpus Christi in May), in addition to the fact that two holidays in May fell on Thursday and were for many employees bridged with the weekend, could have substantially affected industrial production and retail sales. Therefore, we should see a few more observations to make conclusion about a possible change in the real sector performance.

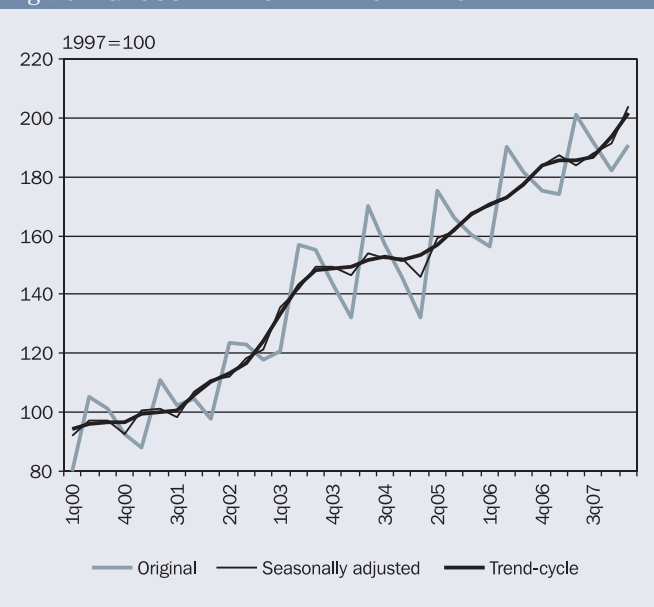
Employment further increases; real wage growth slows down.

In the January-May period, total employment increased by 1.5 percent over the same period year ago. Seasonal factors have started to take effect, as the absolute number of employed persons has been rising since February. In May, for example, employment in hotels and restaurants grew by 11.3 percent over April. The number of registered unemployed persons was 12 percent lower than in the same month 2007. Consequently, the unemployment rate amounted to 13.2 percent in May and was 1.6 percentage points lower than in the same month last year. The survey-based unemployment rate amounted to 10.2 percent in the first half of 2007 and 9.0 percent in the second half. The first four months of 2008 showed on average a 7.4 percent year-on-year increase in gross wage, i.e. 1.4 percent in real terms, which is much lower than in 2007.

Further deceleration of monetary...

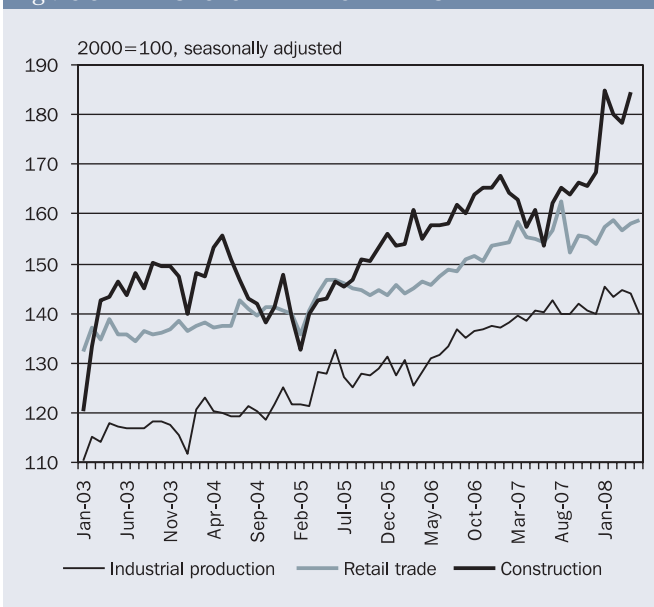
In the first five months of 2008, monetary and credit aggregates growth continued to decelerate, reflecting a more restrictive monetary policy stance. At the end of the first quarter, seasonally adjusted broad money was 1.8 percent higher than in December and 14.4 percent higher than in the same month year ago. April and May saw a further deceleration, with a year-on-year growth reaching 12.3 percent in May, which is 8 percentage points lower than a year ago. The slowdown was mostly determined by narrow money and kuna savings deposits, while foreign exchange deposits maintained

Figure 2 GROSS FIXED CAPITAL FORMATION



Source for original data: Central Bureau of Statistics.

Figure 3 REAL SECTOR DEVELOPMENTS



Source for original data: Central Bureau of Statistics.

a robust growth momentum, mainly due to the withdrawal of household savings from an increasingly volatile capital market to less risky foreign exchange deposits. Hence, foreign exchange deposits were 16.6 percent higher in May 2008 than a year ago.

... and credit aggregates growth.

Reflecting the central bank's measures for curbing excessive credit activity, credit aggregates growth has been on a downward trend since the second half of 2007. In May 2008, total domestic credits grew 10.7 percent on a year-on-year basis, which is 11 percentage points lower than in the same month a year ago. Although both credits to enterprises and households exhibit weaker expansion, the adjustment is more apparent in credits to enterprises. Their growth rate in May 2008 shrank to 5.9 percent, which is almost four times less than a year earlier. Enterprises compensate the lack of domestic financing by borrowing directly from foreign lenders, thus boosting foreign debt growth. The slowdown in credits to households has been more moderate and so far without a stronger effect on personal consumption. In May, household borrowing rose by 14.8 percent, while housing credits – the most propulsive component of household borrowing – recorded a 17.5 percent year-on-year growth, which is the lowest rate since 2002.

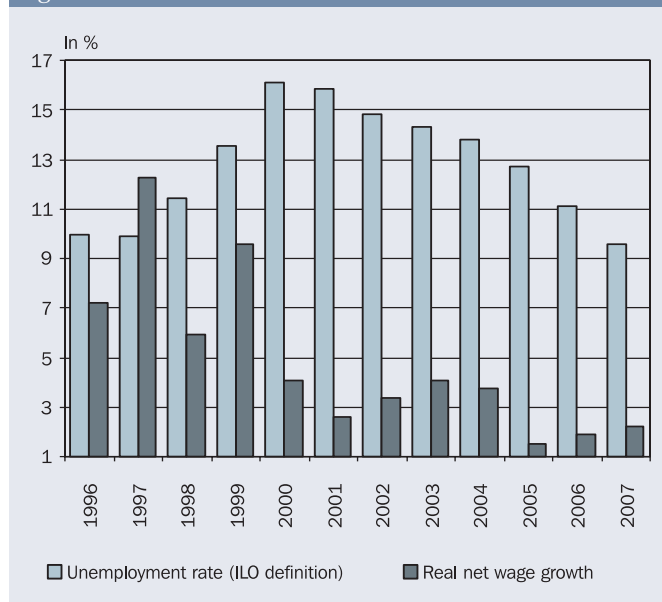
Foreign debt rises at a monthly pace of 1 percent.

With the beginning of 2008, the Croatian National Bank adopted a new reporting system of gross foreign debt. Accordingly, the gross external debt position as of December 31, 2007 was revised from EUR 32.9 to EUR 33.2 billion. At the end of April, gross foreign debt reached EUR 34.6 billion. An increase of EUR 1.4 billion is attributable mainly to the enterprise sector, which expanded its debt by EUR 1.0 billion, retaining the largest share of 42 percent in the total foreign debt. The Government endures with the policy of reducing its foreign indebtedness by further decreasing it by EUR 0.3 billion. Although the change in methodology constrains comparisons, it may be observed that the foreign debt grew on average by 1 percent per month in the first quarter of 2008, the same rate as in the first quarter last year.

Money market liquidity improved...

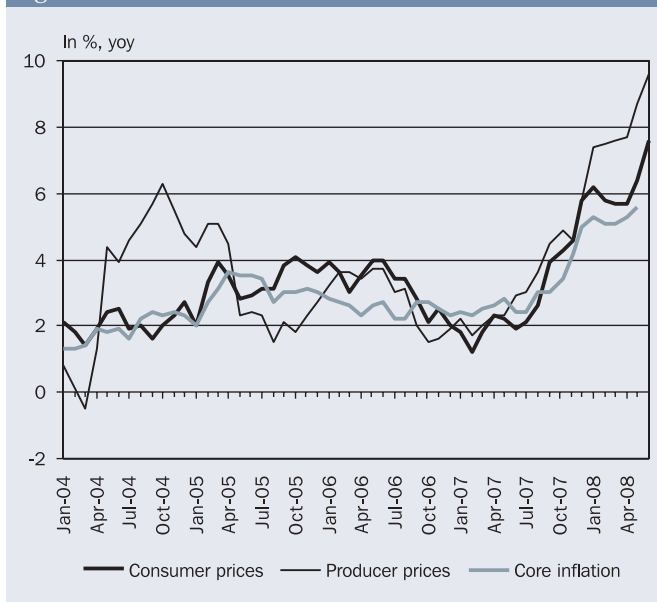
After liquidity crunch in the first quarter of 2008 caused by the central bank's decision to cancel several repo auctions, the second quarter witnessed much smoother money market developments. The central bank resumed regular repo auctions and did not intervene

Figure 4 UNEMPLOYMENT AND REAL WAGE GROWTH



Source for original data: Central Bureau of Statistics.

Figure 5 INFLATION



Sources: Central Bureau of Statistics and Croatian National Bank.

Box 1 SOCIAL PROTECTION OF THE POOR IN THE NEW EU MEMBER STATES AND CROATIA

In times of rising prices, in particular those of basic products such as food and electricity, the poorest households become increasingly vulnerable and their protection through social safety nets is highly important. The World Bank (World Bank, 2007, *Croatia Living Standards Assessments*, <http://web.worldbank.org>) warns that the social standard of the poor in Croatia is rather low due to the inefficiency of the social transfer system and the low level of transfers aimed directly at the poor (such as maintenance allowance). Comparison of the level of assistance to the poor in Croatia with those in the countries at a similar development level could further illustrate the latter argument.

The main state/public instruments for the protection of the poor are social assistance and Guaranteed Minimum Income Schemes (GMIS). The eight new post-communist EU members (EU8) employ GMIS as the main instrument, while Croatia has social assistance. GMIS and social assistance system operate similarly, so it is relevant to compare them.

Indicators presented in Table B1 reveal that the highest coverage rates (percent of the poor covered by social assistance or GMIS) have been achieved in the Czech Republic (50 percent) and Slovakia (39 percent). Slovenia is in third place regarding coverage rate, but it is by far in first place in terms of generosity levels, with an average transfer of EUR 196 per month (not adjusted for PPS). Compared to other countries presented in Table B1, Croatia is placed very low regarding both coverage rate and generosity level. It is evident that the Croatian system of social protection of the poor is lagging behind similar systems in Central-European countries.

The maintenance allowance in Croatia is basically well targeted transfer towards the poor, although its level is very low (on a monthly basis below EUR 50) and has not been changed since 2001. Consequently, a highly recommended measure to preserve the minimum living standard of the poor in Croatia is a substantial increase in the maintenance allowance, especially in times of rising inflation.

Zdenko Babić

Table B1 GMIS AND SOCIAL ASSISTANCE TO THE POOR IN EU8 AND CROATIA

	Poverty rate	Percent of total population covered by GMIS or social assistance	Covered by GMIS or social assistance as a % of total number of the poor (coverage rate)	GMIS and social assistance threshold - monthly amount in EUR
	2003	2003	2003	2005/2006
Croatia	17	2.7	16	50
Czech Republic	8	4.0	50	83
Estonia	18	3.8	21	48
Hungary	12	1.4	12	80
Latvia	16	2.9	18	34
Lithuania	15	3.4	23	45
Poland	17	1.5	9	81
Slovakia	13	5.2	39	42
Slovenia	10	2.4	24	196

Note: Poverty rate calculated using Eurostat methodology.

Sources: World Bank, 2007, Social Assistance in Central Europe and Baltic States, <http://siteresources.worldbank.org> and author's calculations.

on the foreign exchange market. Money market liquidity improved substantially, while short-lived liquidity pressures emerged with the new periods of required reserve maintenance. The overnight money market rate revolved around 2.5 percent, which is quite low compared to the first quarter of 2008 and the same quarter last year. At the same time, the marginal repo rate in the second quarter stood at 4.8 percent, somewhat lower than in March but quite higher than in the second half of 2007, reflecting the central bank's efforts to contain inflationary pressures. Stable money market conditions carried over to the foreign exchange market. Appreciation pressures experienced in the first two months of 2008 have eased, leaving the average HRK/EUR exchange rate to stabilize around 7.25 in June. This is 1.1 percent lower than in the same month last year, suggesting that the stronger kuna exchange rate is being used as a policy measure against rising imported inflation.

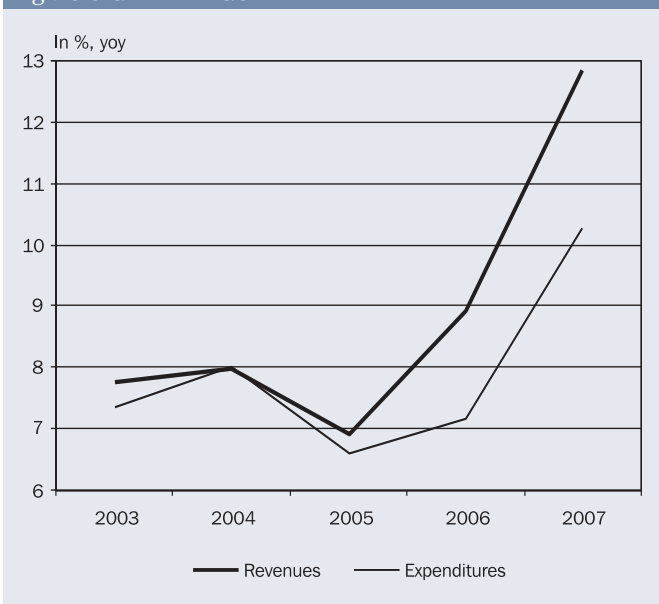
... while inflation is on the rise.

The second quarter of 2008 witnessed another inflation hike, mainly due to rising food and energy prices. In June 2008, producer price inflation reached a record-high increase of 9.6 percent year-on-year, while consumer prices were 7.6 percent higher, with their respective month-on-month rates showing a 1.3 and 0.7 percent rise. Moreover, due to an increase in electricity prices in July and an expected rise of administratively regulated gas prices later in the year, it seems that 2008 will be marked by inflation well above the averages recorded ever since hyperinflationary 1993. The core inflation data confirm rising inflationary pressures, with a year-on-year growth reaching 5.6 percent in May 2008.

Larger state and smaller deficit in 2007.

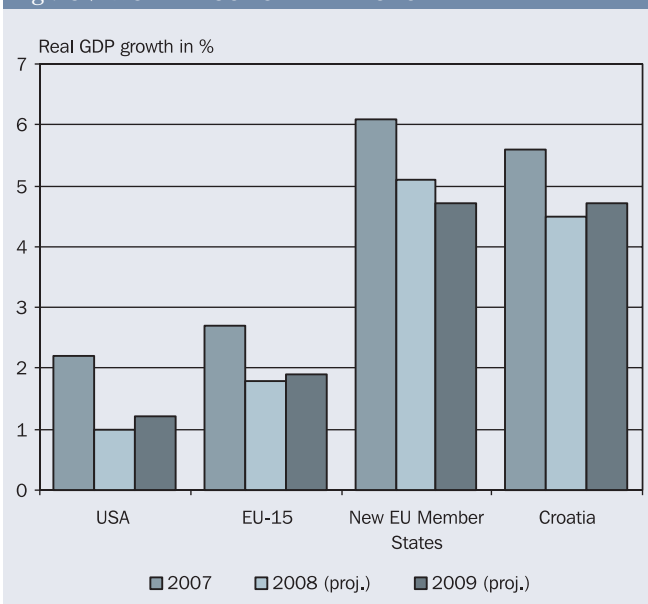
Positive fiscal developments from previous years continued in 2007. The general government deficit, on a modified accrual basis, fell from 2.6 percent of GDP in 2006 to 2.3 percent in 2007. However, deficit reduction was mostly driven by favorable economic conditions and improved revenue collection. In 2007, general government revenues grew 12.8 percent compared to 2006, so their nominal growth exceeded the nominal GDP growth by 3 percentage points. Such an outcome resulted primarily from higher tax revenues, especially from VAT, excise and profit taxes as well as from social contributions. At the same time, general government expenditures increased 10.3 percent. The share of

Figure 6 GENERAL GOVERNMENT



Source: Ministry of Finance.

Figure 7 WORLD ECONOMY AND CROATIA



Sources: UNDESA, Project LINK (May, 2008) and authors' estimates.

***Fiscal policy in 2008
focused on preserving
living standards.***

consolidated general government expenditures in GDP thus increased from 43 percent in 2006 to 43.2 percent in 2007. Although not significant, this rise indicates that mechanisms for reducing government spending are still not put in place. Almost half of it is due to an increase in social benefits and expenditures for wages and salaries.

Despite a certain fiscal consolidation achieved in 2007, there are signs that a more challenging period for the fiscal policy-makers is yet to come in 2008. Compared to the same period a year ago, consolidated general government revenues rose 14.3 percent and expenditures 6.7 percent in the first quarter of 2008. Revenue collection could be expected to stay strong this year. However, there are some changes that could affect both the inflow of budgetary revenues and the increase in budgetary expenditures, especially in the second half of the year. It seems that fiscal policy will become increasingly oriented towards preventing the deterioration of living standards of citizens due to higher inflation. In that respect, in parallel with the approval of electricity price rise in July, the Government decided to subsidize the higher price for the households using smaller quantities of electricity (less than 2,000 kWh per year). In addition, from July 1, 2008 personal income tax basic allowance has been increased from HRK 1,600 to HRK 1,800 and from HRK 3,000 to HRK 3,200 for pensioners. In order to prevent the loss of local and regional self-government units' revenues due to this change, the Government has changed the distribution of revenues from personal income tax. The share of personal income tax has been increased by another 3 percentage points for cities and 0.5 percentage points for counties.

***Deceleration of public
debt growth.***

In the first quarter of 2008, the consolidated central government debt increased by 1.7 percent, which is the lowest year-on-year growth since the fourth quarter of 2006, representing a clear sign of deceleration in public debt dynamics. At the end of first quarter 2008, the consolidated central government debt stock (without state guarantees) reached HRK 112.1 billion. Domestic public debt rose 3.6 percent, while the foreign part decreased 0.7 percent. At the same time, the outstanding government guarantees amounted to HRK 16.9 billion. Although the total amount of guarantees is 2.7 percent lower than at the end of 2007, this level is still considered very high.

2 Policy Assumptions and Projections Summary

***External environment
weakens...***

The global financial market turmoil, accompanied by the weakening of the U.S. economy, has been reflected through a slowdown of economic growth in a number of developed economies. Although moderating, global economic growth still benefits from continued robust growth in the emerging economies, notably China and India, where it is largely driven by domestic demand. In the U.S., the pace of economic activity remained subdued in the first quarter of 2008 as GDP increased at a quarterly annualized rate of 1 percent (ECB, *Monthly Bulletin*, July 2008). According to Eurostat's estimate, GDP in the euro area expanded by 0.7 percent in the first quarter, following a 0.4 percent rise in the previous one. The main contributors to GDP growth, which was above market expectations mostly due to temporary factors, were domestic demand and inventories, while the contribution of net trade was broadly neutral. An important contribution came from the strong performance of German economy that grew by 1.5 percent on a quarterly basis, as a result of robust investments. The June ECB staff forecasts envision GDP in the euro area to be in a range between 1.5 and 2.1 percent in 2008 and between 1.0 and 2.0 percent in 2009. Euro area HICP inflation was estimated at 4.0 percent in June, up from 3.7 percent in the previous month, as a result of a continuous surge in energy prices and still strong dynamics in food prices.

... with oil prices surging to unprecedented levels.

Crude oil prices have continued their surge to unprecedented levels. At the beginning of July, they passed US\$ 140 a barrel mark as a reaction to Middle East tensions, falling U.S. crude reserves and the weak U.S. dollar. On the demand side, the International Energy Agency has revised down its forecasts for global demand, although demand in developing economies is growing vigorously, sustained in part by the strong growth of Chinese imports of refined products. On the supply side, the OPEC has maintained that global supplies are sufficient, but production in non-OPEC countries has been stagnating and an increase is unlikely in the short-term. Looking ahead, oil prices are likely to remain at elevated levels in the short- to medium-term and highly sensitive to small changes in the supply-demand balance and the geopolitical environment.

Inflationary pressures and external vulnerability remain in focus.

Global economic slowdown implies that the prospects for external demand for Croatian goods and services are becoming weaker. On the internal scene, we expect monetary authorities to continue focusing on price stability and external vulnerability of the economy. Consequently, we assume that a strong exchange rate will be sustained as well as the central bank's measures implemented to suppress credit expansion. Credit availability will therefore be more stringent than in the last couple of years, which in turn might lower domestic demand and overall GDP growth. Moreover, by canceling several repo auctions in the first quarter of 2008, maintaining a relatively high marginal repo rate in the second quarter of the year and thus strengthening the HRK/EUR exchange rate, monetary authorities have demonstrated an intention to suppress rising inflationary pressures. However, due to the weakening external demand, the stronger HRK/EUR exchange rate may have adverse effects on exports, hence widening the current account deficit. As for the fiscal sphere, it seems that authorities are committed to keep the fiscal imbalance under control, although pressures might arise due to weaker economic growth and rising inflation.

GDP projected to rise 4.5 percent in 2008 and 4.7 percent in 2009.

Although projection for the overall GDP has not changed from the previous issue, forecasts of GDP components have been revised based on new observations. Hence, the Croatian economy is expected to grow by 4.5 percent in 2008 and 4.7 percent in 2009. Due to the recent hike in investments, a projection of their future dynamics has been revised upwards, while exports are now projected to be somewhat weaker and imports stronger than three months ago. Consequently, we forecast a further widening of the current account balance to about 9.7 percent of GDP in 2008 and 9.8 percent in 2009.

Households expected to adjust consumption...

The household sector is expected to start adjusting its spending to the new circumstances - higher consumer prices and higher credit repayments due to increased interest rates. Such an adjustment should cause personal consumption to slow down, although it should benefit from rising employment. Personal consumption is now forecasted to rise by 3.9 percent in 2008, while an improved economic stance in 2009 should allow its rebound to 4.1 percent.

... while EU accession should help investments retain strong dynamics.

Based on the exceptionally strong investments in the first quarter of this year, we have revised our forecast up to 8.8 percent in 2008 and 7.1 percent in 2009. However, we expect investors to adjust to weaker economic growth, so the strong dynamics present in the first quarter of 2008 will not be sustained. Nevertheless, the expected EU accession and a consequent struggle of the market participants to improve their position and prepare for the new circumstances should have a positive impact on investments.

Fragile goods exports; robust imports.

The future dynamics of foreign trade sector is blurred by uncertainties. It seems that a fragile exports sector is hardly adjusting to rising productions costs. However, relatively weak exports that were observed at the beginning of the year should recover in its remaining part. In respect to the contribution of tourism to such an outcome, it must

be noted that an expected 3-percent rise in the number of overnight stays does not guarantee an increase in overall tourism revenues. For the economy, financial indicators are much more important than the physical ones and these two have not always been correlated. In the remaining part of the year, overall exports should improve and reach a 5.3 percent growth in 2008 as a whole. Further improvement is expected in 2009 with a 6.8 percent growth. Imports have retained robust dynamics, exhibiting some signs of strengthening over the last year. Therefore, we expect imports to rise by 6.3 percent both this and next year.

Employment prospects favorable.

Employment prospects remain favorable for this and next year. As the economy is in a solid expansion and labor costs rise modestly, labor demand is increasing. For 2008, we project a sound employment growth of around 1.3 percent, however below last year's increase. The number of the unemployed should decline further, so the registered unemployment rate is expected to decrease to around 13.3 percent on average in 2008. In 2009, the unemployment rate could decline further to about 12 percent. The survey-based unemployment rate calculated in line with the ILO definitions could recede close to 8 percent by the next year.

Wage growth to speed up moderately.

As for the wage growth, we expect only moderate speed-up. Namely, collective agreements in Croatia do not usually have an indexation clause, and therefore wage growth could remain modest in 2008 in spite of rising inflation. However, that could exert pressures on wages in the future rounds of bargaining, meaning that a wage hike could be more evident in 2009. In addition, we expect more extensive labor shortages in certain branches, such as construction, hotels, restaurants, shipbuilding, as well as manufacturing industry in general, which could push wages up. An additional pressure on wages might come from the implementation of the Minimum Wage Act, which has been agreed after a heated debate among social partners and implemented as of July 2008. This act stipulates a substantial one-time increase in the minimum wage level and a gradual increase in the minimum-to-average wage ratio over a longer period.

Inflationary concerns will persist.

Consumer price inflation will stay at relatively high levels during the summer and fall months due to a spreading of increased world commodity prices to domestic consumer prices. Thereby, particularly important is an approximately 20-percent hike in electricity

Table 2 SUMMARY OF PROJECTIONS

	2008	2009
Real GDP (% change)	4.5	4.7
Real private consumption (% change)	3.9	4.1
Real government consumption (% change)	2.2	2.8
Real investment (% change)	8.8	7.1
Exports of goods and services (constant prices, % change)	5.3	6.8
Imports of goods and services (constant prices, % change)	6.3	6.3
Current account balance (% of GDP)	-9.7	-9.8
Consumer prices (% change, pa)	6.8	4.2
Exchange rate, HRK/EUR (pa)	7.26	7.26
Unemployment rate (registered, %, pa)	13.3	12.1
General government balance – ESA 95 (% of GDP)	-1.3	-1.0
Broad money, M4 (% change, eop)	13.0	14.0
Total domestic credit (% change, eop)	12.0	13.0

Notes: Cut-off date for information used in the compilation of projections was July 10, 2008.

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

Source: Authors' projections.

prices from the beginning of July. However, the price increase should be lower for those with lower electricity consumption, which is justified by social concerns. In return, the Government will subsidize the national electricity company in the amount of lost revenues. This seems as a non-transparent mechanism to protect the vulnerable population. On the other hand, increased electricity prices could hit the enterprise sector strongly and push them to increase the prices of their products. Exporters are in a particularly sensitive situation due to the given export prices. Some relief in terms of inflation is, however, expected at the end of this and during the next year, assuming world oil prices remain steady. For 2008, we expect the average consumer price inflation of 6.8 percent, which should prospectively decline to 4.2 percent in 2009.

Tighter monetary policy and more stringent credit availability.

Tighter monetary policy and more stringent credit availability, which are in line with the central bank's intention to dampen inflationary expectations and reduce external vulnerability, should slow down the growth of monetary and credit aggregates. Broad money is therefore expected to rise by 13 percent and credits by 12 percent in 2008. In line with an improved economic stance expected next year, the growth of both aggregates should slightly strengthen.

Budget revision brings another injection for the health sector.

Only three months after the original budget was approved, the Government adopted the budget revision for 2008. With this revision the Ministry of Finance introduced a new methodology for recording government transactions (European System of Accounts ESA 95) which is harmonized with the EU standards. However, this was not the only reason for the budget revision. Like in 2007, the revised budget foresees a financial injection in the health sector to increase its spending limits and cover its existing liabilities towards the Croatian Health Insurance Institute. Another large part of the expenditure increase will be used for measures aimed at supporting the households and businesses hardest hit by the rise in food and energy prices. The rest of the increase in expenditures will go to the Ministry of Science, Education and Sports, for regional development programs, investments in water supply development and industrial development. According to the ESA 95 methodology, the Ministry of Finance projected the 2008 general government deficit (net lending/borrowing of the general government) to attain a level of 1.3 percent of GDP, while in 2007 it amounted to 1.6 percent. Having only limited access to the relevant data, we stick to that projection.

3 Uncertainties and Risks to Projections

Soft or hard landing?

It seems that the process of adjustment to rising prices and production costs has been rather slow in the Croatian economy. Due to the rising credit installments and consumer prices, combined with only moderately increased wages, the household sector should start behaving more cautiously. Although the horizon of investment decisions is longer, one should also expect that future decisions will take into account a possible slowdown of the economy. That in particular applies to private investments that entail shorter periods of return. However, one should also have in mind a fragile exports sector and its weaknesses. Due to inertia, adjustment could take place later, but might imply a much stronger and longer slowdown of the economy than earlier expected.

Fiscal pressures.

It still remains to be seen how fiscal authorities will deal with high pressures this year. The recent budget revision was based on the assumption that GDP growth will reach 4.5 percent and inflation 5.2 percent in 2008. Our projection indicates that the price increase could be considerably above the Government's projection. Higher prices could inflate nominal government revenues, but apart from purely nominal, they may also

have many other effects on both sides of the budget. They could, for example, lead to a further deceleration of personal consumption, causing a revenue growth slowdown, or they could provoke pressures on government expenditures. Inflation could also require additional fiscal measures to be undertaken with deteriorating effects on fiscal balance. Furthermore, we are very concerned about the situation in the health sector. Additional funds for the health sector planned with the budget revision mean that losses continue to accumulate. The Government still avoids dealing with the problem, and only solves the consequences.

Doubts over tourism revenues.

It is unclear how the moderation of households' incomes and spending on the most important emitive markets for Croatia will affect tourism revenues. Potential visitors might fully give up spending holidays or shorten their stay, since earlier research has found income as the most important determinant of demand for Croatian destinations. In addition, most of the foreign tourists come to Croatia by car, so rising gasoline prices and recently increased highway fees in Slovenia might be additional factors negatively affecting overall revenues from tourism.

Uncertainties in international environment continue.

As far as future developments on the global financial markets are concerned, the end of the ongoing credit crunch is still not in sight. The U.S. and EU banking sectors continue to report substantial losses related to the subprime market collapse, while several developed countries have experienced a slowdown in economic activity or even recession due to a weakening of residential investments, a worsening of financing conditions and a dampening of personal consumption. In that context, it remains to be seen how central banks will balance between the obligation to curb inflation pressures and the implicit need to stimulate economic activity and revive financial markets. If interest rates in EMU will be raised further in attempt to fight inflation, this could have an adverse effect on the Croatian economy since interest rates in Croatia are strongly influenced by the developments on the European money market. A further rise in interest rates in Croatia would increase credit installments and dampen consumption, but also subdue investment activity.

IMPRESSUM

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