

Croatian Economic Outlook

Quarterly

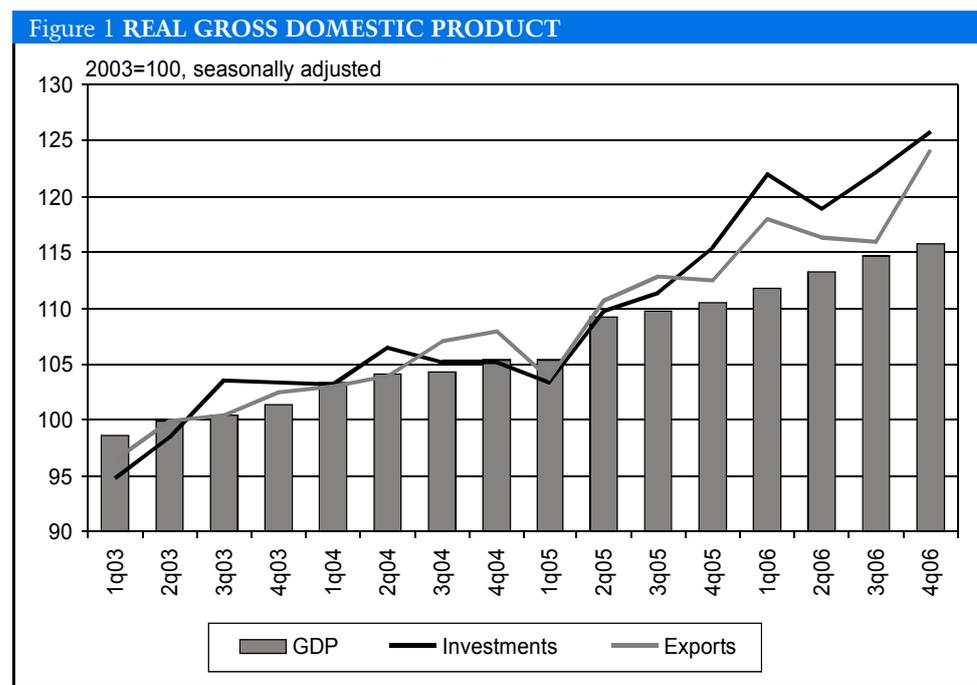
1 RECENT DEVELOPMENTS

Solid 2006 growth likely to extend through this year.

In 2006, the Croatian economy maintained its solid expansion with the overall growth reaching 4.8 percent year-on-year. GDP growth was once again driven by domestic demand, mostly thanks to a steep investment increase that was supported by sound personal consumption growth and a rebound in government consumption. The external sector remained the weakest spot of the economy. Trade deficit widened and contributed negatively to the overall growth. Likewise, the external debt kept rising to reach 84.7 percent of the GDP by the end of 2006, up from 81.7 percent at the end of 2005. Taking into account only fourth quarter data, GDP growth amounted to 4.8 percent year-on-year, confirming a stable upward trend that has extended into the first few months of this year, as suggested by high-frequency indicators. Industrial output expanded firmly, construction gained a new momentum with the retail sales volume growing steadily.

Personal consumption growth accelerated modestly,...

Personal consumption growth accelerated in the course of the last year due to acceleration in the growth of disposable income. In the fourth quarter of 2006, personal spending grew 4.1 percent year-on-year, following a 3.9 percent increase in the previous quarter. In 2006 as a whole, an increase of 3.5 percent was recorded, up from 3.4 percent in 2005. Last year's increase in employment and real wages enabled sound and stable consumption growth. Increased borrowing from the banking sector was mostly balanced by a savings expansion.



Source for original data: Central Bureau of Statistics.

... while government consumption closed the year on a strong increase.

Government consumption increased its pace throughout 2006. While in the first quarter it climbed 1.0 percent year-on-year, the year ended with a 4.4 percent increase in the fourth quarter. On average, 2006 saw a 2.2 percent increase, up from 0.8 percent in 2005. The intensity of a spending surge at the close of last year exceeded most expectations. A relatively favorable output growth resulted in abundant budget revenues that allowed for a spending expansion. The goal of refraining from excessive spending in the course of last year was obviously abandoned at its very end, when the Government observed that the budget plan including the fiscal deficit target could easily be met. The increase in the government consumption in 2006 was prompted mostly by additional costs linked to the ongoing process of EU accession, such as institutional and legislative harmonization with EU practices.

Investments do well.

After showing some signs of a slowdown in mid-2006, the investment activity rebounded in the fourth quarter to record a rise of 9.2 percent over the same quarter a year earlier. Last year as a whole ended with the investment growth of 10.9 percent. In the last six years, the investment growth pace has exceeded that of the overall GDP. In current prices, the investment share in GDP (including changes in inventories) grew from 20 percent in 2000 to nearly 33 percent in 2006. It has given rise to the issue of excessive investment, not only due to its share in GDP but to substantial government involvement in large investment projects with potentially low rates of return.

Buoyant exports at the end of 2006, still current account deficit...

The last quarter of 2006 showed buoyant exports and moderate imports. The total export volume, as recorded in national accounts, increased by 11.2 percent year-on-year helping to bring the overall 2006 export growth to 6.9 percent. After last year's impressive first quarter, an expansion in the goods and services imports stabilized at around 5 percent in the remaining part of the year. As a whole, 2006 saw an import rise of 7.3 percent. Accordingly, last year ended with a wider gap between exports and imports. Current account deficit reached EUR 2.7 billion or 7.6 percent of the GDP in 2006, up from 6.3 percent in the previous year.

... and trade deficit continue to widen.

Merchandise trade statistics reveal encouraging trends established in 2006 as goods exports in current kuna terms expanded 15.6 percent, with goods imports showing a 13.3 percent increase compared to the previous year. In spite of the fact that the goods export growth exceeded the growth of imports, the merchandise trade deficit continued to widen and reached EUR 8.8 billion (up from EUR 7.9 billion in 2005). Besides the oil industry that was among the main growth drivers on both the export and the import side, favorable trends on the export side stemmed mostly from shipbuilding as well as the metal industry, food and beverages and the exports of electrical equipment. On the import side, growth was additionally fuelled by the imports of vehicles, iron, steel and the metal industry. One can also observe a rising share of EU-15 members - Italy, Germany and Sweden - in the total exports while a strong deceleration of exports growth was registered in trade with Bosnia and Herzegovina. Trends established in 2006 continue early on this year, with goods exports rising 7.6 percent and goods imports 8.6 percent in the first two months over the same period a year ago.

Industrial output...

The output expansion in the real sector has been broad-based across various industries. In particular, strong growth was present in the second half of 2006 in the manufacturing and construction industry. Industrial output in the third quarter rose 5.9 and was followed by a 6.1 percent increase in the fourth quarter on a year-on-year basis, allowing growth to reach 4.5 percent for 2006 as a whole. Among the main industrial groups, the output

Table 1 MAIN ECONOMIC INDICATORS

	2005	2006	2006			
			Q I	Q II	Q III	Q IV
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	4.3	4.8	6.0	3.6	4.7	4.8
Real private consumption (% change, yoy)	3.4	3.5	4.0	2.1	3.9	4.1
Real government consumption (% change, yoy)	0.8	2.2	1.0	1.7	1.5	4.4
Real investment (% change, yoy)	4.8	10.9	18.1	8.4	9.3	9.2
Industrial output (% change, yoy)	5.1	4.5	6.4	-0.1	5.9	6.1
Unemployment rate (registered, %, pa)	17.9	16.6	17.9	16.4	15.5	16.5
Nominal GDP (EUR million)	31,262	34,220	-	-	-	-
GDP per capita (EUR)	7,038	7,704	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.2	3.4	3.7	3.8	3.2	3.0
Consumer prices (% change, yoy, pa)	3.3	3.2	3.5	3.8	3.2	2.2
Producer prices (% change, yoy, pa)	3.0	2.9	3.5	3.6	2.7	1.7
Average gross wage (% change, yoy, pa)	4.4	6.2	6.0	5.9	5.6	7.1
Exchange rate, HRK/EUR (pa)	7.40	7.32	7.34	7.28	7.30	7.36
Exchange rate, HRK/US\$ (pa)	5.95	5.84	6.11	5.80	5.73	5.71
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,217	8,434	2,005	1,972	2,087	2,370
Exports of goods (EUR, % change, yoy)	9.3	16.9	32.7	5.0	12.9	19.7
Imports of goods (EUR million)	14,738	16,798	3,865	4,320	4,239	4,373
Imports of goods (EUR, % change, yoy)	10.6	14.0	25.0	8.7	14.0	10.7
Current account balance (EUR million)	-1,985	-2,617	-2,053	-1,286	2,145	-1,424
Current account balance (% of GDP)	-6.3	-7.6	-	-	-	-
Gross foreign direct investment (EUR million)	1,425	2,838	528	822	446	1,043
Foreign exchange reserves (EUR million, eop)	7,438	8,725	8,089	8,744	8,135	8,725
Foreign debt (EUR million, eop)	25,541	28,998	26,532	27,571	27,195	28,998
GOVERNMENT FINANCE*						
Revenue (HRK million)**	92,643	100,381	22,067	47,240	73,483	100,381
Expense (HRK million)**	92,332	98,737	23,715	47,576	71,365	98,737
Net = Gross operating balance (HRK million)**	310	1,643	-1,648	-336	2,118	1,643
Net acquisition of non-financial assets (HRK million)**	6,699	6,101	793	2,493	4,019	6,101
Net lending/borrowing (HRK million)**	-6,389	-4,458	-2,442	-2,829	-1,901	-4,458
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-7,711	-	-2,980	-3,839	-3,071	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-3.4	-	-	-	-	-
Domestic government debt (EUR million, eop)	7,461	8,128	8,045	8,323	8,213	8,128
Foreign government debt (EUR million, eop)	7,018	6,637	6,609	6,580	6,643	6,637
Total government debt (% of GDP)	46.2	43.3	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	12.3	25.0	10.5	15.0	20.0	25.0
Broad money, M4 (% change, yoy, eop)	10.5	18.0	11.3	14.4	16.6	18.0
Total domestic credit (% change, yoy, eop)	17.2	22.9	22.3	23.2	22.4	22.9
DMBs credit to households (% change, yoy, eop)	20.3	21.8	22.7	23.9	22.5	21.8
DMBs credit to enterprises (% change, yoy, eop)	16.3	26.1	22.8	24.5	24.5	26.1
Money market interest rate (% pa)	2.3	1.6	1.1	1.4	1.9	1.8
DMBs credit rate for enterprises, short-term, (% pa)	8.1	7.1	7.6	7.1	7.1	6.8
DMBs credit rate for households, short-term (% pa)	13.1	12.1	12.4	12.3	11.8	11.9

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.

growth was particularly strong in the intermediate and capital goods sectors and in the production of consumer durables. Among the branches, major growth contributors were machinery, food industry, production of communication equipment, printing and metal industry as well as manufacturing of construction materials. On the other hand, a negative contribution came from the chemical industry and was accompanied by a substantial drop in the petroleum products output. A steady upward trend in the industrial activity got an additional impetus at the beginning of 2007, with combined January-February data indicating a 7.3 percent increase over a year ago.

... and retail sales on a steady climb.

Retail sales showed a steady upward trend throughout 2006. Following a 2.1 growth year-on-year in the third quarter, it recorded a 4.8 percent increase in the last quarter of 2006 to end the year 2.1 percent higher than in the previous year.

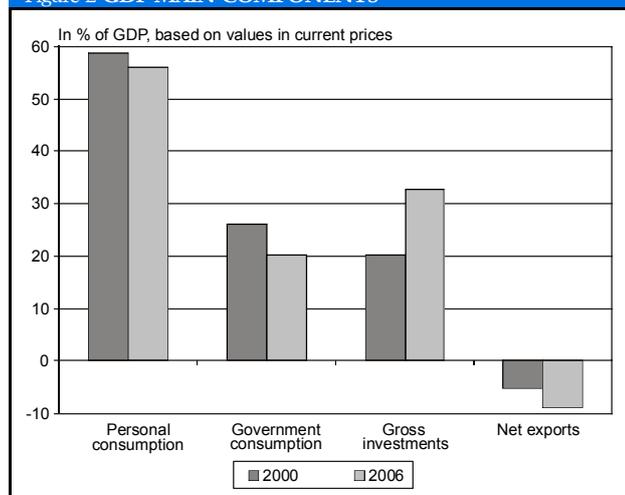
Employment revival in 2006.

On the back of output expansion, total employment increased by a strong 3.5 percent in 2006. The employment growth was driven by the incorporated sector and, in particular, by real estate, rental and business activities, wholesale and retail trade, construction as well as by hotels and restaurants. Positive employment trends have also been confirmed by the Croatian Pension Insurance Agency data, showing a 2.6 percent increase in the number of insured persons in 2006 year-on-year. Underlying labor market developments remain broadly positive early on this year, with the registered unemployment rate standing at 17 percent in January and February, or 1 percentage point lower than a year ago. The number of unemployed persons was down 6 percent year-on-year in March.

Modest recovery in real wage growth.

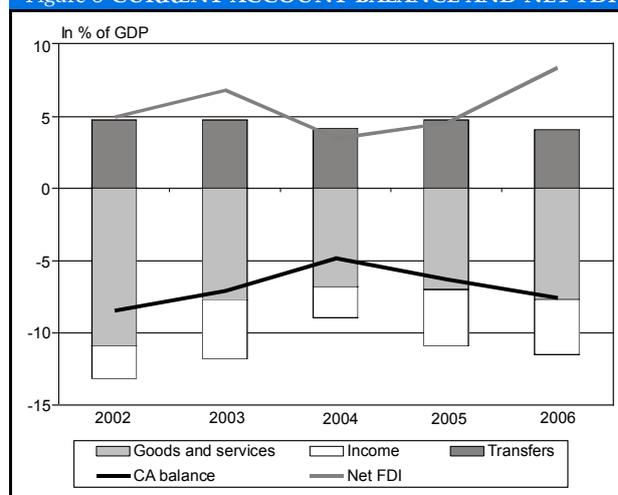
On average, 2006 brought a 2.9 percent increase in real gross wages which implies a certain revival compared to 2005, when the respective figure stood at 1.1 percent. In 2007, a further increase in the real wage growth may be expected as a result of a 6 percent wage rise agreed to be paid to public sector employees in 2007. January data already confirm these expectations with a 5.4 percent real wage growth compared to the respective figure a year ago. Higher wage growth in public sector is likely to induce pressures on wage increase in the business sector.

Figure 2 GDP MAIN COMPONENTS



Source: Central Bureau of Statistics.

Figure 3 CURRENT ACCOUNT BALANCE AND NET FDI



Sources: Croatian National Bank and Central Bureau of Statistics.

Broad money growth accelerates...

When it comes to monetary developments, one can observe an acceleration of the growth of monetary aggregates in line with favorable developments in the overall activity. Seasonally adjusted broad money recorded a 4.1 percent quarter-on-quarter growth in the fourth quarter, with growth amounting to 18 percent for 2006 as a whole, the highest rate since 2001. The expansion is a result of an exceptionally strong upsurge in narrow money and kuna savings deposits. In 2006, kuna savings deposits grew by a remarkable 60.2 percent, while at the same time foreign exchange deposits stagnated. The reason for the exceptional rise in kuna savings deposits is the fact that, up to September, commercial banks attempted to collect new kuna savings indexed to foreign currencies in order to finance the credit activity since such savings were not subject to the central bank's minimum reserve requirement applying to currency claims. However, kuna savings deposits have decreased since September 2006. According to seasonally adjusted figures, broad money expanded further during the first two months of 2007.

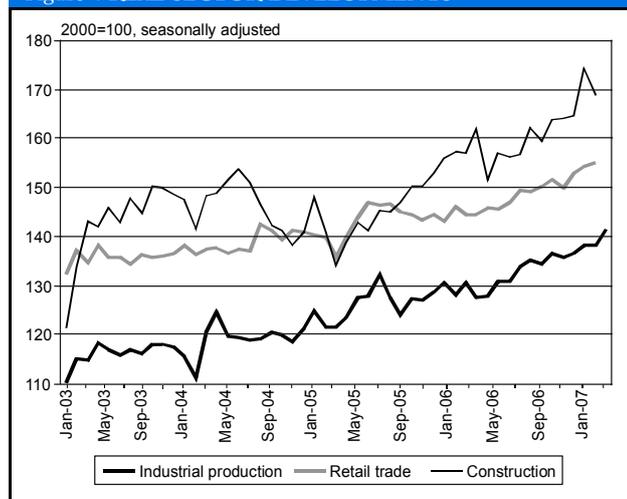
... due to strong narrow money expansion.

Strong growth of broad money in 2006 was partially the result of narrow money growth, boosted by a dynamic credit activity. The 2006 annual narrow money growth rate reached 25 percent, making it the year of strongest expansion since 2002. Impressive narrow money growth can be attributed to buoyant growth of both the deposit money and the money in circulation. Household and enterprise deposits recorded 32.9 and 24.9 percent annual growth rates respectively. Meanwhile, money in circulation reached its usual seasonal peak in December with growth of 20.1 percent year-on-year, followed by a seasonal contraction at the beginning of the year.

No sign of credit activity deceleration.

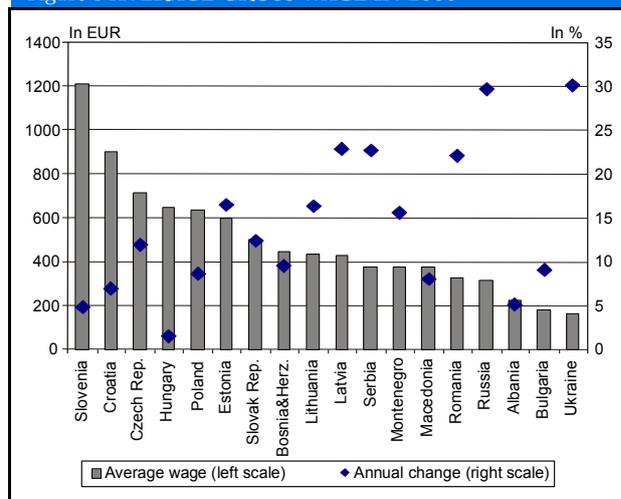
In January 2007, the central bank enacted a new measure aimed at curbing credit growth. Along with the marginal reserve requirement designed to make foreign borrowing of commercial banks more expensive, it limited commercial banks' annual credit growth to 12 percent. If they exceed this ceiling, banks will be penalized by having to buy CNB bills. It still remains unclear whether this measure, combined with the other measures aimed at reigning in rampant lending, will yield the desired effect. Credits to enterprises recorded their highest annual growth in the past nine years in 2006 (26.1 percent), while an

Figure 4 REAL SECTOR DEVELOPMENTS



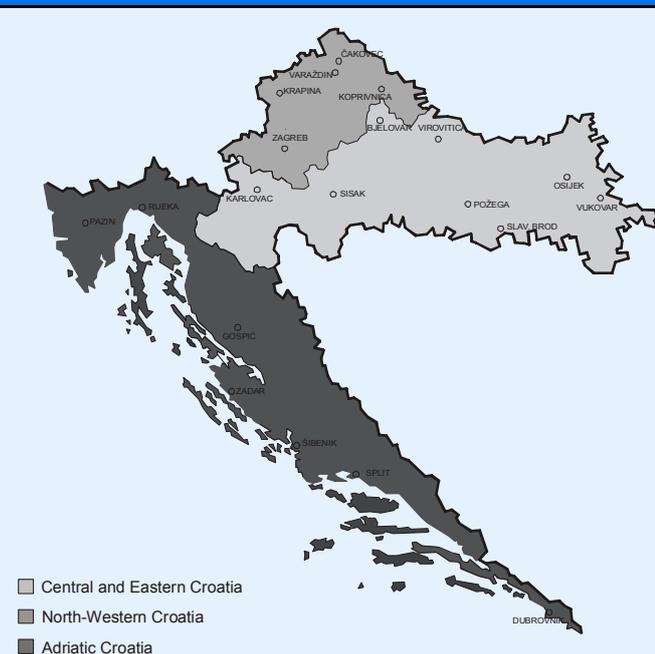
Source: Central Bureau of Statistics.

Figure 5 AVERAGE GROSS WAGE IN 2006



Source: WIIW.

Box 1 STATISTICAL REGIONS IN CROATIA



The Central Bureau of Statistics has recently issued a *National Classification of Territorial Units for Statistics*. The *Classification* defines standards used for collecting, processing, publishing and analyzing statistical data at the regional level. Its release is one of Croatia's obligations as part of the process of EU accession and among the crucial steps towards securing potential future withdrawals from the EU funds. At the moment of full membership statistical regions as defined in this *Classification* will become an integral part of the *Nomenclature of Territorial Units for Statistics (NUTS)*, namely a portion of the legislation that contains an official list of all statistical regions in the EU. The NUTS represents the statistical basis of an efficient regional development policy, as well as the basis for an analysis of socio-economic issues and for evaluating to what extent the EU goals of social and economic cohesion have been achieved.

In the *Financial Perspective 2007-2013* (the multi-annual spending plan that defines resources to finance long-term EU activities) substantial resources have been allotted for intensifying the convergence process, i.e. enhancing the economic convergence of the least developed regions in the EU. Three financial instruments are used in order to meet the convergence objective: European Regional Development Fund (ERDF), European Social Fund (ESF) and Cohesion Fund. The most important criteria for allowing a certain region to apply for

resources from the above-mentioned funds is the level of its GDP per capita according to the purchasing power standard (PPS). The recently released *Classification* may be decisive in this. Most of the funding will go to the statistical regions with an income level below 75 percent of the EU average. However, the amount of the resources that are actually withdrawn depends on the quality of the proposed development programs.

The NUTS is a three-level hierarchical classification, where the territory of each EU Member State is subdivided into NUTS levels 1, 2 and 3. Higher levels are subdivisions of lower levels. Territorial units at each of these levels are most often defined in terms of the existing administrative units conditioned on satisfying certain population thresholds. Croatia has decided to follow the EU regulation in setting its own territorial units. The whole country is set as a unit on the first level and the third level includes its 21 counties as units. However, a minimum of 800 thousands and a maximum of 3 million inhabitants is required for the second level. In Croatia, there are no administrative units of adequate size, so this level has been established by aggregating smaller neighboring administrative units, i.e. counties. The resulting aggregated units of level 2 are non-administrative units.

According to the *Classification*, Croatia consists of three regions at level 2: North-Western Croatia, Central and Eastern Croatia and Adriatic Croatia. The main economic indicators for each of these three regions are given in Table B1.

Table B1 Main Economic Indicators for Statistical Regions in 2004

	Croatia	North-Western Croatia	Central and Eastern Croatia	Adriatic Croatia
Population (thousand)	4,439	1,663	1,330	1,446
GDP (HRK, billion)	215	102	45	68
GDP (Croatia =100)	100	47	21	32
GDP per capita (HRK)	48,426	61,256	33,801	47,119
GDP per capita (Croatia=100)	100	126	70	97
GDP per capita (EUR)	6,461	8,172	4,509	6,286
GDP per capita in PPS (EUR)	10,620	13,433	7,412	10,333
GDP per capita in PPS (EU27=100)	49	62	34	48

The largest and most developed statistical region is North-Western Croatia, which accounts for 47 percent of the country's total gross value added. Its GDP per capita is 26 percent above the Croatian average and stands at 62 percent of the EU-27 average, measured according to PPS. The least developed statistical region is Central and Eastern Croatia with a GDP per capita that is 30 percent below the Croatian average. At the same time its GDP per capita is 1/3 of the average GDP per capita of the EU-27, measured according to PPS. In 2004, all the statistical regions in Croatia stood below the 75 percent threshold. It should be noted that the Croatian GDP is likely to be adjusted upwards to account for the non-observed economy in the amount of approximately 15 percent of GDP before the country joins the EU.

Note: PPS - Purchasing Power Standard, HRK - Croatian kuna, EUR - euro.
Source: Authors' calculations based on the CBS data.

expansion in lending to the household sector was in line with the trend observed in the last three years (21.8 percent). In the first two months of 2007, credits to enterprises and households expanded further. In February, their year-on-year growth rates stood at 24.0 and 23.2 respectively. Housing loans, as the most propulsive credit component of lending to households, have shown no apparent signs of deceleration either.

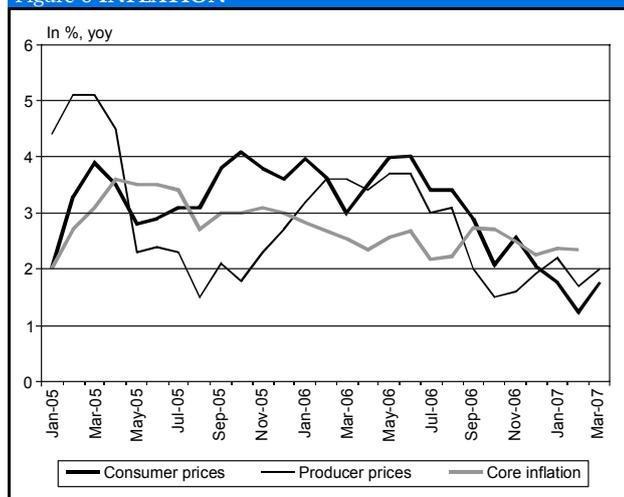
Foreign debt hits 85 percent of GDP.

At the end of 2006, foreign debt stood at EUR 29 billion and accounted for 84.7 percent of Croatia's GDP. An increment by EUR 3.5 billion, representing a 13.5 percent increase compared to the end of 2005, is mostly attributable to a strong growth in the corporate sector indebtedness that was fuelled by leasing companies in particular. The banking sector, participating with 35.1 percent, continues to hold the largest share in total foreign debt. Although its share remained almost unchanged with respect to the end of 2005, the absolute increase of the banks' foreign indebtedness is still substantial, raising the question of effectiveness of the central bank's measures aimed at curbing foreign borrowing. The Government, in line with the policy of financing on the domestic capital market, decreased its foreign indebtedness by EUR 0.4 billion.

Favorable money market conditions; stable exchange rate...

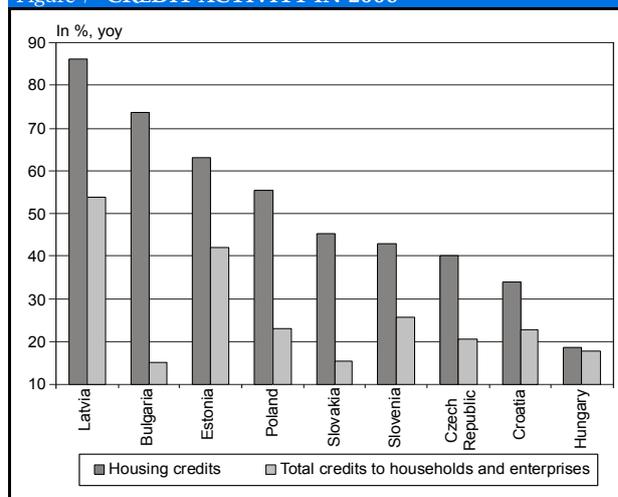
The first quarter of 2007 saw favorable money market liquidity, with a stable exchange rate of the kuna and low inflation. Therefore, the central bank did not have to intervene in the foreign exchange market, while the interest for regular repo auctions was somewhat lower than in the last quarter of 2006. The latest issue of government bonds worth HRK 2.5 billion in February 2007 has not affected money market liquidity. Thus, money market rates were stable in the first quarter of 2007, with the overnight and 6-month ZIBOR at around 3.5 and 4.5 percent respectively. Some liquidity pressures were felt ahead of the Easter holidays, when strong seasonal kuna demand coincided with a new period of reserve requirement maintenance, causing the overnight ZIBOR to rise to 4.5 percent, its highest level since September 2006. With regards to the exchange rate developments, it is worth noting that in 2006 the HRK/EUR and the HRK/US\$ exchange rate recorded the lowest annual average levels in nine and ten years, respectively. A kuna appreciation against the US\$ continued into early 2007, reaching 8 percent in February compared to the same month of 2006. Meanwhile, the HRK/EUR exchange rate depreciated by 0.5 percent.

Figure 6 INFLATION



Sources: Croatian National Bank and Central Bureau of Statistics.

Figure 7 CREDIT ACTIVITY IN 2006



Sources: ECB, IMF and national central banks.

... and low inflation.

Low inflation recorded in the last quarter of 2006 was maintained in this year's first quarter. Consumer and producer prices in March 2007 stood 1.8 and 2 percent higher respectively than in the same year-ago month. Core inflation of 2.3 year-on-year recorded in February 2007 confirms that inflation in early 2007 is much more subdued when compared to the beginning of 2006.

Budgetary outturn for 2006 better than expected.

Government budget figures for December 2006 confirmed what was more or less known several months ago. From the fiscal point of view 2006 was a good year. Consolidated general government revenues grew at a strong rate of 8.9 percent. The collection of excise taxes, social contributions and VAT was stable and in line with the optimistic projections. When it comes to the personal income tax and corporate income tax, collection was considerably higher than projected in the budget revision. Such developments stem from both increased efforts of the tax administration to reduce tax evasion and favorable overall economic conditions. The consolidated general government expenditures grew at a more moderate rate of 7.2 percent year-on-year. The above mentioned developments resulted in the general government deficit of 3 percent of the GDP, according to the modified accrual basis. So, the Government managed to reduce the fiscal imbalance by 1.1 percentage points compared to 2005 and maintain credibility of the fiscal policy. If expressed according to the ESA 95, fiscal balance comes close to some minus 2 percent of the GDP or even below the Maastricht reference value for deficit.

Puzzling fiscal developments in December.

Fiscal consolidation leaves us with a positive general impression about last year's fiscal stability. However, data for last December are somewhat puzzling. Namely, the total consolidated central government expenses in December were more than HRK 2.5 billion or almost 1/3 higher than the average expenses in the remaining part of the year. The item that saw a particularly pronounced expansion in December were expenditures for the use of goods and services and other expenses. This leads us to conclude that the Government decided to spend unexpectedly buoyant revenues on unnecessary purchases rather than on further deficit reduction. Had the December expenditures been at the level of the average expenditures from January to November, the fiscal deficit could be almost 1 percentage point lower. Or, if spending in December had been necessary, then there is a strong indication that the government cash management is quite problematic and that regular monthly allotments to the budget users were insufficient, probably causing payment delays and leading to an accumulation of arrears.

Public debt finally stabilized.

The consolidated central government debt (without state guarantees) rose 1.6 percent in 2006 to reach HRK 108.4 billion, or 43.3 percent of the GDP. The public debt increase was significantly smaller than in previous years. Since September 2006, one could observe a slight decrease of the consolidated central government debt. Modest growth in absolute terms resulted in a drop of the debt-to-GDP ratio by more than 3 percentage points compared to the end of 2005. Other important features of last year's public debt developments included a further decrease of the share of foreign debt in the total debt stock, as well as a reduction of the foreign currency denominated debt and of the flexible rate debt.

Debt Management Strategy for 2007.

In March this year for the first time ever, the Government announced its debt management strategy. The document should become a regular publication of the Ministry of Finance and is aimed at introducing more transparency into the public debt management and improving communication of the Debt Management Office with possible investors. In the document, the Government defined the main objectives of its strategy according to the best practices. It outlined as specific medium term goals the reduction of risk exposure, especially exposure to the exchange rate and rollover risk, and the development of the domestic debt market by enhancing transparency and predictability of the government debt management as well

as by broadening the investor base. The Government plans to issue bonds with various maturities in order to build the domestic yield curve and publish a calendar of issuance regularly, while using bond auctions instead of syndications in cases of borrowing other than through new issuances and also introducing a system of primary dealers in order to improve liquidity of the secondary debt market.

2 POLICY ASSUMPTIONS AND PROJECTIONS SUMMARY

Favorable developments in the global economy continue...

The global economy expanded at a robust pace in 2006, growing 5.4 percent year-on year (*World Economic Outlook*, IMF, April 2007). After experiencing a slowdown during the summer months, its growth pace picked up thanks to a decline in oil prices, which began in August. In 2006, the US recorded GDP growth rate of 3.3 percent. Growth was exceptionally strong in the first quarter of the year while the three following quarters were characterized by a sharp moderation in growth mostly due to adverse developments in the housing market. The US economy is projected to grow further this year although at a more moderate pace than in the past few years, experiencing growth at a rate of around 2.2 percent. The euro-area growth revived towards the end of 2006, contributing to a GDP increase of about 2.6 percent for the year as a whole. Looking ahead, growth is expected to ease in the euro area, reflecting in part a gradual withdrawal of monetary accommodation and further fiscal consolidation. A 2.3 percent GDP increase in 2007 is expected.

... although oil prices are likely to remain at elevated levels.

In the fourth quarter of 2006, Brent crude oil prices stood at levels between US\$ 60 and US\$ 65 per barrel. Having experienced a sharp decline at the beginning of 2007 to US\$ 51 per barrel, oil prices started to rise again toward the end of January and in February to reach US\$ 68 per barrel in April, partly as a result of OPEC supply cuts in March. Demand for oil is expected to grow, and in light of that, quotations on the futures markets have consistently exceeded spot prices, meaning that oil prices are likely to remain at elevated levels in the medium- to long-term.

Structural reforms likely to be postponed for post-election time.

From Croatia's perspective the outlook for the external environment remains rather favorable. On the internal front in 2007, as set out in Pre-accession Economic Program, the Government should continue to focus on reducing fiscal and external imbalances and pressing on with structural reforms. However, upcoming parliamentary elections at the end of the year are likely to affect this agenda. At the same time price and exchange rate stability as well as a way to reduce the foreign debt remain major concerns of the monetary authorities.

The economy expected to grow 4.7 percent this year.

The economy is expected to grow by 4.7 percent this year, a touch lower than in 2006. Overall growth should continue to be driven by private consumption and investments. Increases in both market incomes and state transfers support a projected stronger personal consumption growth compared to previous years. As a result, personal consumption is expected to reach 3.9 percent in 2007. A mild projected slowdown of household borrowing should have no significant impact on personal consumption. A rather strong rise in government consumption in the fourth quarter of last year seems to have been short-lived. As a result, government consumption is expected to revert to a restrained growth pace this year. However, that pace might again accelerate temporarily towards the end of the year due to parliamentary elections. For the year as a whole, we expect government consumption to rise at a rate of 1.6 percent, which is mostly to be related to increased demand for public services in the process of EU accession. The end of last year was characterized by strong investment dynamics that extended into this year. Besides an expected increase in the

volume of investment projects launched by the public and government sector, private sector should also see positive developments. Overall, investments are expected to expand by about 7 percent in 2007.

Export growth expected to continue exceeding imports increase.

The total exports growth is expected to continue exceeding an increase in imports on the back of a further expansion in the tourist sector and resulting exports of services. A deficit in the trade of goods and services might shrink slightly while the current account deficit is likely to remain roughly unchanged in nominal kuna terms, while decreasing somewhat if expressed as a share of the GDP (7.2 percent). Goods imports are expected to remain buoyant due to strong investment activity and larger personal consumption, both of which are strongly dependent on imports. Simultaneously, the exports of goods are to grow at a solid rate due to improved competitiveness (lower labor cost increase) compared to other countries in the region. Foreign debt is expected to rise to 86 percent of the GDP.

Bright employment prospects...

Positive developments in the labor market are expected to continue in 2007. Total registered employment is poised to increase by around 1.5 percent, with the number of registered jobless falling 4 percent. Accordingly, the registered unemployment rate is expected to drop below 16 percent. However, brighter employment prospects might prompt an increase in the participation rate. In that case some of the currently inactive persons would enter the unemployment pool by starting to look for a job and consequently, unemployment might recede at a somewhat slower rate.

... will allow for a moderate wage rise.

Solid economic growth and brisk developments in the labor market will allow for a moderate wage rise. Lower inflation will contribute to a solid growth of the purchasing power of workers' remunerations. State transfers to households, either regular or extras (such as pensioners' debt repayment) are projected to rise considerably, helping to keep disposable incomes of the population on a solid increase of more than 4 percent in real terms. Incomes will provide a strong support for a private spending rise.

Table 2 SUMMARY OF PROJECTIONS

	2006 actual	2007 projections
Real GDP (% change)	4.8	4.7
Real private consumption (% change)	3.5	3.9
Real government consumption (% change)	2.2	1.6
Real investment (% change)	10.9	6.9
Exports of goods and services (constant prices, % change)	6.9	7.0
Imports of goods and services (constant prices, % change)	7.3	6.2
Current account balance (% of GDP)	-7.6	-7.2
Consumer prices (% change, pa)	3.2	2.5
Exchange rate, HRK/EUR (pa)	7.32	7.32
Unemployment rate (registered, %, pa)	16.6	15.8
General government balance - GFS 1986 (% of GDP)	-3.0	-2.8
Broad money, M4 (% change, eop)	18.0	12.0
Total domestic credit (% change, eop)	22.9	14.0

Notes: Cut-off date for information used in the compilation of projections was April 6, 2007.

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

Source: Authors' projections.

Inflation subdued but with mild upward tendency.

This year began with consumer price inflation below 2 percent year-on-year, the lowest rate since mid-2004. However, the remaining part of the year is expected to bring slight inflation quickening due to increased cost pressures coming from a delayed spillover of gasoline prices, somewhat higher wage costs and an expected rise in municipal service prices. These factors are likely to hit the overall service prices more strongly than the prices of consumer goods. However, goods are highly dependent on the exchange rate of the national currency. Although we have anticipated a stable HRK/EUR exchange rate, any kuna depreciation could threaten the currently low inflation rate. In conclusion, CPI inflation is likely to reach 2.5 percent on average in 2007.

Future credit growth still uncertain.

Central bank's attempts to curb the credit activity gained a new momentum in early 2007. However, it still remains uncertain whether a combination of the 12 percent credit ceiling and marginal reserve requirement will succeed in slowing down the pace of the ongoing credit boom. The uncertainty is present as commercial banks may find a way around this measure, just as they did in case of the marginal reserve requirement, in order to press on with their lending activity. It is also interesting to note that bank lending continues to grow despite the fact that the central bank measures have made it considerably less profitable. Such behavior of commercial banks in turn causes the credit activity to be less predictable. We anticipate total domestic credits to grow by 14 percent in 2007, meaning that we expect only partial success of the latest central bank measures. Broad money growth could slow down to 12 percent.

High tax revenues expected.

In 2007 we foresee continued strong growth of budgetary revenues as a result of economic growth, which will lift the bases of tax collection and social security contributions. Preliminary data based on the 2006 annual reports of enterprises show an increase in profits before taxation compared to the 2005 that could lead to higher corporate income tax revenues. Starting from January, according to the new distribution of tax revenues among government levels, total corporate income tax revenues are channeled to central government coffers, with the personal income tax revenues allocated to local and regional self-government units. That change could boost central government budget revenues in the first half of the year as a result of higher revenues from profit tax. Thanks to ample tax revenues the overall fiscal position is not likely to deteriorate in 2007, and even a slight reduction in the budget deficit to 2.8 percent of the GDP could be expected.

3 UNCERTAINTIES AND RISKS TO PROJECTIONS

Government's commitment to structural reforms uncertain...

Much uncertainty surrounds the current Government's commitment to press on with structural and fiscal reforms, given that parliamentary elections are scheduled for the end of the year. Political debates on topics that have direct fiscal implications abound while, on the other hand, unpopular structural reforms are not on the agenda nearly as often. Nevertheless, some decisions will have to be taken in spite of the upcoming elections. One of them is finding a solution for a significant gap between the pensions of people who retired before 1999 and post-reform pensioners, since the latter have pensions that are some 20 percent lower on average. Resolving these problems as well as some others by taking a populist approach ahead of the elections might result in the outcomes with long-term negative consequences on the fiscal stance.

*... on the eve of
parliamentary
elections.*

A favorable cyclical position of the economy may hopefully help the Government to maintain a stable fiscal position in 2007, but the stability in the years to come hinges on the prudence and accountability of politicians in the course of pre-electoral campaigning.

*Possible impact of
central bank measures
on domestic demand.*

Another issue giving rise to concern is whether the central bank measures aimed at curbing credit growth might have a dampening effect on domestic demand. If an ongoing pace of credit expansion were to subside considerably as a result of such measures, one could expect a slower growth of personal consumption than has been projected. The incorporated sector would suffer less since it is already borrowing abroad and will continue to do so should domestic financing terms become less favorable.

IMPRESSUM

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