

# Croatian Economic Outlook

Quarterly

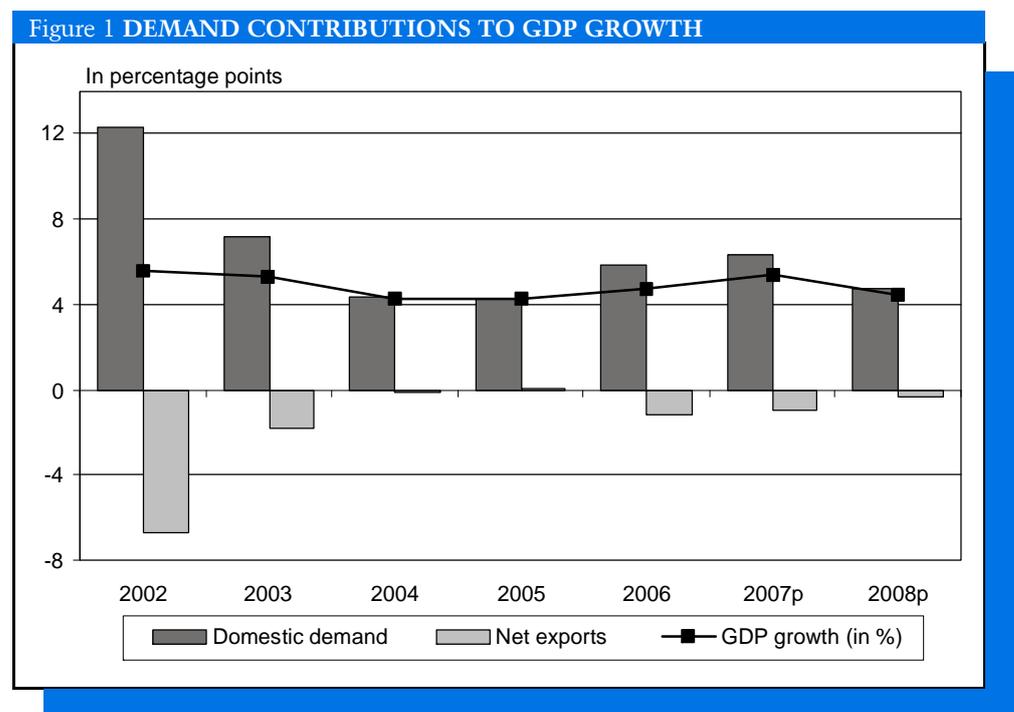
## 1 RECENT DEVELOPMENTS

**Impressive growth in the first quarter...**

Following solid growth in 2006, the Croatian economy picked up further speed in the first quarter of this year to reach a 7.0 percent growth rate over the same quarter last year. Domestic demand was the main driving force behind this surge while exports sagged, resulting in the negative contribution of net exports to the overall GDP growth. A rebound in personal consumption, that saw a 7.1 percent increase, and investments rising 11.2 percent year-on-year were again major growth contributors. On the production side, a recent upsurge in GDP growth seems to have been broad-based with industrial output, construction, distributive trade, hotels and restaurants, transport, communications and financial intermediation sectors boosting output by over 7 percent in the first quarter year-on-year.

**... fuelled by favorable external conditions and encouraging internal momentum.**

Impressive first quarter growth reflects favorable external conditions and a positive internal momentum the economy has enjoyed for some time now. The whole region of "new" Europe, including South-Eastern Europe, is expanding rapidly and its growth is spilling over through commercial and financial channels into the Croatian economy. It is complementing an already strong momentum of the local economy that can be accounted for by structural adjustments undertaken in the last several years, including privatization, financial consolidation, a more flexible labor market and a subdued wage-cost increase.



Source: Central Bureau of Statistics.

Recently, and importantly for the first-quarter output, consumer sentiment improved substantially on the back of a prolonged period of household income growth while strong government-backed orders for road infrastructure, coupled with favorable weather conditions and better financial packages for businesses, added steam to a quickening of investments.

***Personal consumption accelerated strongly,...***

Personal consumption accelerated strongly in the first quarter of the year. It rose 7.1 percent, representing the highest rate since the fourth quarter of 2002 and a substantial improvement over the fourth quarter last year, when growth was 4.1 percent. Although a rapid turnaround of consumption at the beginning of this year was surprising in its magnitude, it had been expected to accelerate. Signs of it were already present in the second half of last year. That period brought about a steady increase in the household income due to rising capital incomes, acceleration of wage growth and increased employment. Regular government transfers, in addition to last year's extra spending for the "repayment of the debt" to pensioners, helped keep households' disposable income on the rise. Finally, incomes have poured into consumption since the beginning of this year.

***... while government consumption grew at a moderate pace.***

In the first quarter, government consumption increased by 2.8 percent year-on-year, which is lower than a quarter before, but higher than the average for 2006. Seasonally adjusted first quarter figures corrected for irregular oscillations indicate that government consumption has recently been growing at a more moderate pace than in the course of last year. Since major institutional arrangements are already in place, it has slowed down an expansion in the volume of government services related to EU integration. A moderation of government consumption does not mean that the government role in the economy is waning - its role in investments, transfers and subsidies is strong in the current pre-election period, but that is not reflected in the government consumption as recorded in the national accounts but rather in investments and household consumption.

***Investments picked up.***

Investments have recently picked up, recording an 11.2 percent rise in the first quarter over a year ago in spite of a notable slowdown in construction activities. It appears that the pace of machinery and equipment renewal was strong enough to propel the overall investment growth. Although the private sector is taking an increasingly active role in investments, the Government is still an important investor in road and other infrastructure construction.

***Foreign trade sluggish at the year's start...***

Total exports rose 3.0 percent and total imports 3.7 percent in the first quarter this year in constant kuna terms compared to the first quarter of 2006. Sluggish external trade stands in a sharp contrast with strong dynamics in the rest of the economy. Total exports sagged mainly due to sluggishness in merchandise exports and in spite of strong receipts from international tourism at the beginning of the year. For now, this slowdown in exports is perceived as irregular and short-lived and, consequently, exports are expected to resume their stable expansion path shortly. On the import side, the first-quarter figure was also below the trend due to stagnating services imports and a relatively mild increase in merchandise imports. But a recovery of imports is also expected in the near future. Taken together, the net exports (exports minus imports) were negative in the first quarter, their contribution to the GDP growth amounting to -1.2 percentage points. The trade deficit was not yet pronounced strongly in the first quarter, but it might become an issue in the near future with the expected acceleration of imports.

***... mainly due to deceleration of exports and imports of goods.***

Merchandise trade statistics confirm a deceleration of both the exports and the imports of goods at the beginning of 2007. It should be noted, however, that a pronounced sluggishness in the first quarter was followed by a merchandise trade recovery in April and May. According to data in current kuna terms, the exports of goods grew 7.9 percent in

Table 1 MAIN ECONOMIC INDICATORS

	2005	2006	2006			2007
			Q II	Q III	Q IV	Q I
<b>ECONOMIC ACTIVITY</b>						
Real GDP (% change, yoy)	4.3	4.8	3.6	4.7	4.8	7.0
Real private consumption (% change, yoy)	3.4	3.5	2.1	3.9	4.1	7.1
Real government consumption (% change, yoy)	0.8	2.2	1.7	1.5	4.4	2.8
Real investment (% change, yoy)	4.8	10.9	8.4	9.3	9.2	11.2
Industrial output (% change, yoy)	5.1	4.5	-0.1	5.9	6.1	8.0
Unemployment rate (registered, %, pa)	17.9	16.6	16.4	15.5	16.5	16.9
Nominal GDP (EUR million)	31,263	34,220	-	-	-	-
GDP per capita (EUR)	7,038	7,706	-	-	-	-
<b>PRICES, WAGES AND EXCHANGE RATES</b>						
Implicit GDP deflator (% change, yoy)	3.2	3.4	3.8	3.2	3.0	3.1
Consumer prices (% change, yoy, pa)	3.3	3.2	3.8	3.2	2.2	1.6
Producer prices (% change, yoy, pa)	3.0	2.9	3.6	2.7	1.7	1.9
Average gross wage (% change, yoy, pa)	4.4	6.2	5.9	5.6	7.1	6.2
Exchange rate, HRK/EUR (pa)	7.40	7.32	7.28	7.30	7.36	7.36
Exchange rate, HRK/US\$ (pa)	5.95	5.84	5.80	5.73	5.71	5.62
<b>FOREIGN TRADE AND CAPITAL FLOWS</b>						
Exports of goods (EUR million)	7,217	8,434	1,972	2,087	2,370	2,038
Exports of goods (EUR, % change, yoy)	9.3	16.9	5.0	12.9	19.7	1.7
Imports of goods (EUR million)	14,738	16,798	4,320	4,239	4,373	4,196
Imports of goods (EUR, % change, yoy)	10.6	14.0	8.7	14.0	10.7	8.6
Current account balance (EUR million)	-1,992	-2,671	-1,304	2,063	-1,483	-2,039
Current account balance (% of GDP)	-6.4	-7.8	-	-	-	-
Gross foreign direct investment (EUR million)	1,427	2,701	815	449	920	1,207
Foreign exchange reserves (EUR million, eop)	7,438	8,725	8,744	8,135	8,725	9,520
Foreign debt (EUR million, eop)	25,748	29,199	27,721	27,373	29,199	29,918
<b>GOVERNMENT FINANCE*</b>						
Revenue (HRK million)**	92,643	100,381	47,240	73,483	100,381	24,768
Expense (HRK million)**	92,332	98,737	47,576	71,365	98,737	25,361
Net = Gross operating balance (HRK million)**	310	1,643	-336	2,118	1,643	-593
Net acquisition of non-financial assets (HRK million)**	6,699	6,101	2,493	4,019	6,101	911
Net lending/borrowing (HRK million)**	-6,389	-4,458	-2,829	-1,901	-4,458	-1,504
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-7,711	-6,392	-3,839	-3,071	-6,392	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-3.4	-2.6	-	-	-2.6	-
Domestic government debt (EUR million, eop)	7,461	8,125	8,323	8,213	8,125	8,439
Foreign government debt (EUR million, eop)	7,018	6,635	6,580	6,643	6,635	6,467
Total government debt (% of GDP)	46.2	43.3	-	-	43.3	-
<b>MONETARY INDICATORS</b>						
Narrow money, M1 (% change, yoy, eop)	12.3	25.0	15.0	20.0	25.0	22.4
Broad money, M4 (% change, yoy, eop)	10.5	18.0	14.4	16.6	18.0	20.5
Total domestic credit (% change, yoy, eop)	17.2	22.9	23.2	22.4	22.9	22.4
DMBs credit to households (% change, yoy, eop)	20.3	21.8	23.9	22.5	21.8	23.6
DMBs credit to enterprises (% change, yoy, eop)	16.3	26.1	24.5	24.5	26.1	24.1
Money market interest rate (% pa)	2.3	1.6	1.4	1.9	1.8	2.2
DMBs credit rate for enterprises, short-term, (% pa)	8.1	7.1	7.1	7.1	6.8	6.9
DMBs credit rate for households, short-term (% pa)	13.1	12.1	12.3	11.8	11.9	12.1

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.

the first five months year-on-year, while imports expanded by 11.8 percent. Deceleration of the growth of exports was mostly influenced by a drop in ship exports and the exports of oil and petroleum products, while the exports of electrical and power-generating machinery made the largest positive contribution to the exports growth. On the import side, the oil industry failed in its traditional role as the main import driver which was taken over by iron and steel, machinery, chemical products as well as road vehicle imports.

**Prolonged robust industrial output expansion...**

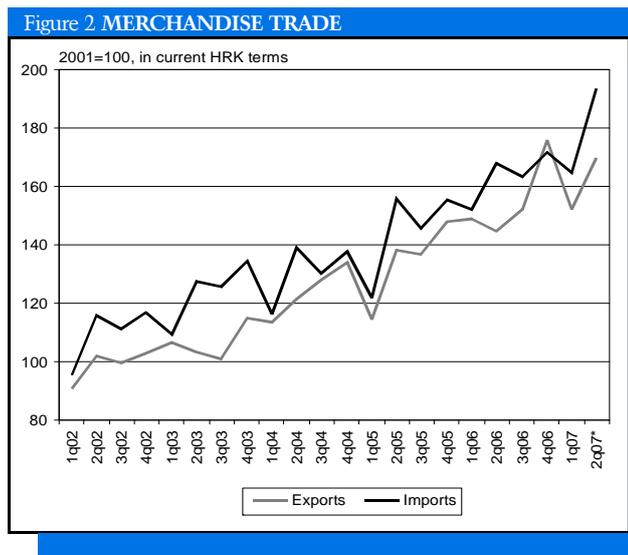
Over the first five months of 2007, industrial output grew 8.1 percent on a year-on-year basis. Robust expansion of the industrial activity that began in the second half of 2006 extended well into this year, as an 8.0 percent increase in the first quarter was followed by an 8.5 percent increase in the April-May period. Growth was primarily driven by a 10.6 percent output expansion in the manufacturing sector and 10.3 percent in mining and quarrying, while electricity, gas and water supply experienced a 7.1 percent decline. Current robustness of industrial activity is in particular reflected in the output of capital goods that grew by 21 percent year-on-year in the five-month period. Industry-wise, food and beverages industry, metal industry, manufacturing of communication equipment as well as manufacturing of construction materials contributed most to the overall industrial output growth (altogether 4.5 percentage points).

**... accompanied by strong retail sales...**

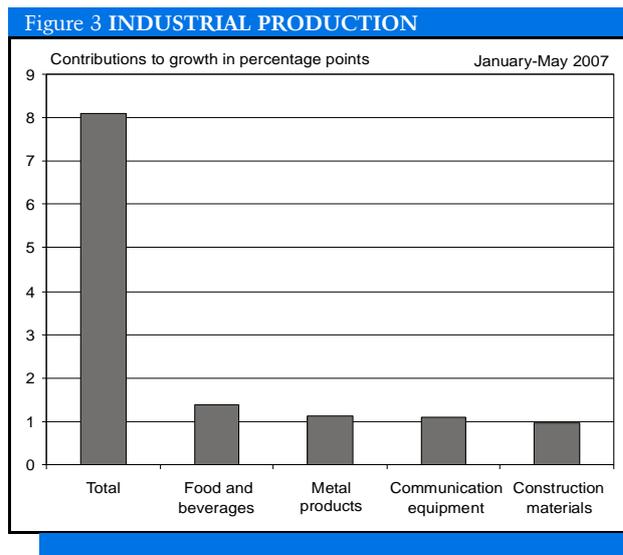
The first five months of 2007 saw very strong retail sales that grew 7.3 percent year-on-year. Their strength was especially pronounced in the first quarter, followed by a slight deceleration of the upward trend in the April-May period. Buoyant retail sales reflect a strong growth of personal consumption. However, a change in the statistical coverage of retail sales at the beginning of the year might have had some impact on the observed figures.

**... and weakening construction activity.**

Construction activity picked up in the first two months of the year but has unexpectedly started to weaken since, resulting in a reversal of the growth trend in the most recent months. For the first four months of the year, its increase amounted to 5.5 percent year-on-year.



**Note:** \*Authors' estimate.  
**Source:** Central Bureau of Statistics.



**Source:** Central Bureau of Statistics.

**Employment grows, unemployment declines,...**

Employment expanded further substantially at the beginning of this year. Between January and May, total employment increased 1.5 percent compared with the same period a year ago. Employment in the incorporated sector grew by 2.1 percent, with employment in crafts and free professions ticking up 0.5 percent. As a reflection of favorable employment trends, unemployment has declined. In June, the total number of unemployed registered with the Employment service dropped below 250 thousand for the first time since December 1995. The June unemployment figure was 9.1 percent lower than a year ago, indicating a rapid pace of labor market improvements. As a result, the unemployment rate (the number of jobless as a percentage of the total labor force) fell from 16.3 percent in May last year to 15.1 percent in May this year, according to administrative data sources. The survey-based unemployment rate calculated according to ILO standards also confirms positive tendencies, showing a drop from 11.8 percent in the first half of 2006 to 10.5 percent in the year's second half.

**... while wage growth gathers speed.**

In April, the nominal gross wage rose 6.8 percent year-on-year, representing a modest acceleration from 6.2 percent on average observed last year. Its further acceleration is expected thanks to favorable economic growth prospects and a more generous wage policy in the public sector. Namely, in addition to previously agreed wage increases, a 25 percent boost in vacation allowance and other seasonal bonuses is pending under an agreement signed recently between the Government and public sector trade unions.

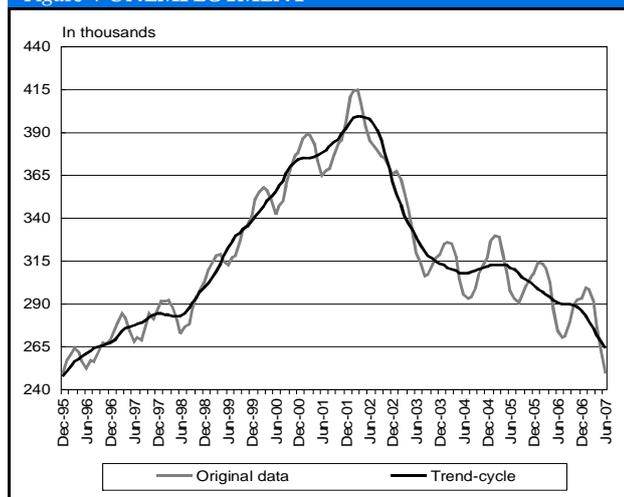
**Acceleration of broad money growth...**

Turning the attention to monetary developments, one may observe an acceleration of monetary aggregates in the first half of 2007 that followed their already strong expansion last year. Such developments reflect a propulsive credit activity and strong real sector growth, resulting in increased money demand. Seasonally adjusted broad money recorded a 5.3 percent quarter-on-quarter growth in the first quarter of 2007. In May, the M4 growth amounted to 20 percent year-on-year, its highest rate in the last four years.

**... on the back of narrow money, kuna savings and foreign exchange deposits.**

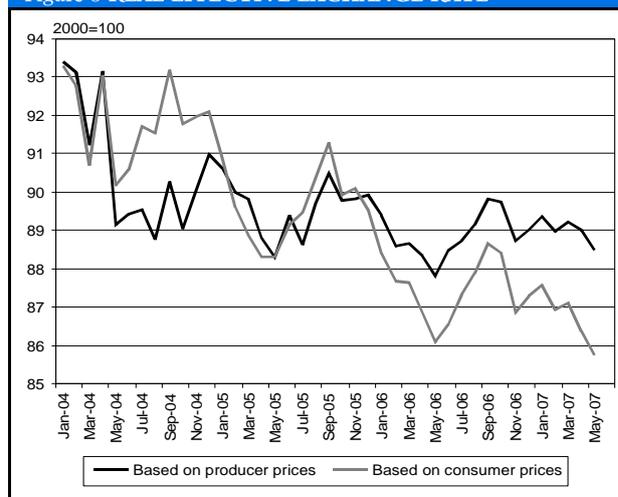
All three main broad money components - narrow money, kuna savings deposits and foreign exchange deposits - exhibited strong growth. While the expansion of narrow money and kuna savings deposits represents a continuation of already established trends, foreign

Figure 4 UNEMPLOYMENT



Source: Croatian Employment Service.

Figure 5 REAL EFFECTIVE EXCHANGE RATE



Note: A decrease indicates appreciation of the Croatian kuna.  
Source: The Institute of Economics, Zagreb.

## Box 1 COMPETITIVENESS INDICATORS FOR TRANSITION ECONOMIES

Transition countries that have joined the EU have more competitive economies than other transition countries, as indicated by the most popular studies measuring competitiveness across a large number of countries such as Doing Business Indicator (World Bank), Global Competitiveness Index (World Economic Forum), Transition Indicator (EBRD), IMD Index (IMD Business School) and Index of Economic Freedom (Heritage Foundation). Similarly, EU candidate countries (Turkey, Croatia, Macedonia) for the most part exhibit competitive advantages over other countries of South Eastern Europe (Table B1). The Estonian economy is perceived as strongly competitive across all studies, while Ukraine, Bosnia and Herzegovina and Albania are assessed to have the least competitive economies in the region.

Competitiveness of the Croatian economy is in line with its advancement in the EU integration process but still ranks rather low taking into account its GDP level. Among transition economies, Croatia ranks 12<sup>th</sup> out of 18 on average in four presented studies, 17<sup>th</sup> if ranked according to the Doing Business Index, 14<sup>th</sup> according to the Economic Freedom Index and 9<sup>th</sup> according to Global Competitiveness and Transition Indices. The relative rankings of listed countries vary substantially, and interestingly, Croatian economy exhibits the highest variation as measured by the standard deviation of rankings.

Competitiveness indicators are usually well correlated with the "hard" economic data on the state of the economy. Is that so with the studies presented for transition countries? Regression analysis aimed at estimating goodness of fit of competitiveness indicators to macroeconomic data such as the GDP level per capita, GDP growth, share of investments, exports and FDI in GDP, and unemployment rate suggest that the Global Competitiveness Index shows the strongest correlation with the main macroeconomic indicators, while the Doing Business Indicator has the lowest one.

Table B1 Rankings of Transition Economies According to Various Competitiveness Studies

	Global Competitiveness Index, 2006	Doing Business, 2006	Index of Economic Freedom, 2007	EBRD Transition Indicator, 2006	Average ranking (4 studies)	Standard deviation (4 studies)
Albania	18	16	9	15	16	3.87
Bosnia and Herzegovina	17	14	15	17	17	1.50
Bulgaria	13	7	8	8	8	2.71
Czech Republic	2	6	3	3	2	1.73
<b>Croatia</b>	<b>9</b>	<b>17</b>	<b>14</b>	<b>9</b>	<b>12</b>	<b>3.95</b>
Estonia	1	2	1	2	1	0.58
Latvia	4	3	5	7	5	1.71
Lithuania	6	1	2	6	3	2.63
Hungary	7	9	6	1	6	3.40
Macedonia	15	13	11	12	13	1.71
Poland	8	11	13	5	9	3.50
Romania	12	5	10	11	10	3.11
Russia	11	15	16	13	14	2.22
Slovakia	5	4	4	4	4	0.50
Slovenia	3	7	7	10	7	2.87
Serbia and Montenegro	16	10	NA	16	15	3.46
Turkey	10	12	12	NA	11	1.15
Ukraine	14	18	17	14	18	2.06

Sources: World Bank, EBRD, World Economic Forum, IMD Business School, Heritage Foundation and authors' calculations.

exchange deposits rebounded after stagnating through 2006. The narrow money growth by 19.4 percent in May year-on-year can be attributed to both deposit money and money in circulation. Household and enterprise deposits recorded a 23.7 and 17.3 percent respective year-on-year increase in May while money in circulation contracted at the beginning of the year due to the usual seasonal factors but its growth regained momentum thereafter, reaching 15 percent year-on-year in May.

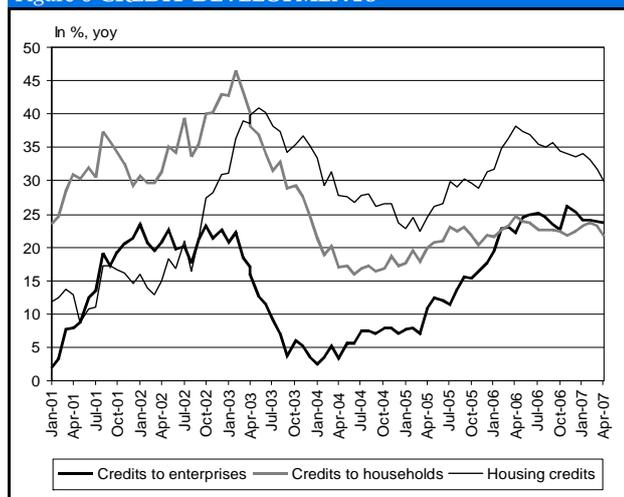
### **Signs of credit activity moderation emerge.**

The central bank's measures aimed at curbing buoyant credit activity have brought about a modest downward shift compared to the trends observed during the past few years. More specifically, the total domestic credit growth rate stood at 21.4 percent year-on-year in May or 1.3 percentage points lower than in December 2006, immediately before a 12 percent credit ceiling was imposed. So both credits to households and enterprises showed a slight deceleration compared to December last year. However, signs of a slowdown are even more evident in the housing loans as the fastest growing credit component.

### **Liquidity pressures on the money market.**

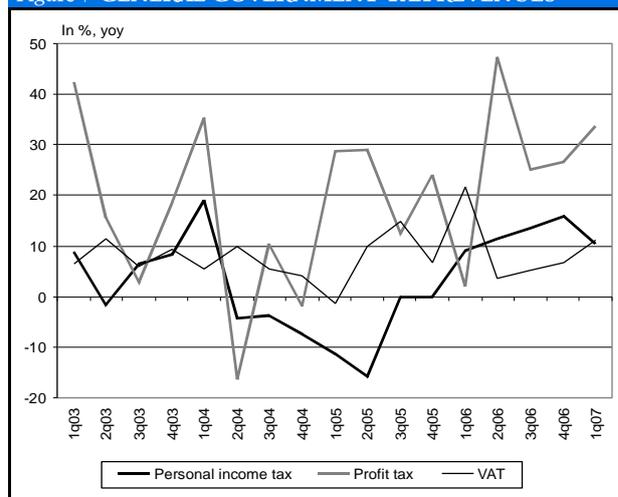
On the money market the second quarter of 2007 was marked by strong kuna demand and cautious behavior of market-makers, resulting in liquidity pressures, higher money market interest rates and kuna appreciation. Liquidity pressures started with a new period of mandatory reserve maintenance in early April, when strong kuna demand lifted the overnight ZIBOR shift to 4.6 percent. The pressures escalated in late June that saw the overnight ZIBOR rocketing to 8 percent, the level unrecorded since August 2005. Other factors contributing to this liquidity crunch included the onset of the tourist season, preparation for the third installment of pensioners' debt and a new government bond issue. It has to be noted that repo financing, despite strong interest, did not suffice to meet all liquidity needs. Moreover, for the first time since early 2006, the central bank turned down some repo offers. Strong kuna demand and insufficient demand for foreign exchange have led to a kuna appreciation. The HRK/EUR exchange rate in May and June appreciated by 0.9 and 0.02 percent respectively on a month-on-month basis to sink to the lowest level in 2007, which is still somewhat higher than in the same two months of 2005 and 2006.

Figure 6 CREDIT DEVELOPMENTS



Source: Croatian National Bank.

Figure 7 GENERAL GOVERNMENT TAX REVENUES



Source: Ministry of Finance.

**Low inflation continues.** The second quarter of 2007 witnessed a continuation of low inflation rates that have been maintained since the end of 2006. June consumer and producer price indices stood 1.9 and 2.9 percent higher than in the same month a year ago. Monthly dynamics of consumer price inflation showed somewhat stronger pressures in the course of March and April due to an increase in the prices of clothing and footwear, transportation as well as food and non-alcoholic beverage prices.

**Foreign debt of the corporate sector increases.** At the end of the first quarter of 2007, gross foreign debt totaled EUR 29.9 billion or EUR 719 million more than at the end of 2006. This year's increment is mainly attributable to a rising indebtedness of the corporate sector. Although banks still account for the largest slice in the total foreign debt, the absolute growth of their foreign indebtedness subsided as banks turn increasingly to the capital increase rather than borrowing abroad in order to raise additional funds. The Government pressed on with its policy of financing on the local capital market, helping to reduce its own foreign debt further.

**Fiscal position improves further.** The fiscal position remained solid and even improved somewhat in the first quarter of 2007. The general government revenues increased at a high rate of 12.9 percent in the first quarter over the same period last year. The largest contribution to a further improvement in tax collection came from VAT, with revenues growing 11.2 percent year-on-year. Such an increase stems from strong first quarter personal consumption and is also to be attributed to continued efforts of the tax administration to enhance the enforcement of tax laws. Profit tax also yielded much higher revenues (up 33.7 percent) than in the same period last year. Better revenue collection in the first quarter led to a considerable expenditure increase of 7.3 percent year-on-year on the general government level. It may be noted that the expansion of expenditures for the use of goods and services and other expenditures has been particularly pronounced since the end of 2006. The expenditure rise is still more or less under control, but it offers a glimpse of pre-election generosity that will probably be even more evident in the remaining part of the year.

**Budget revision, as usual.** The budgetary outturn and solid economic growth in the first quarter proved that the original 2007 budget had underestimated government revenues while overestimating the fiscal imbalance, giving the Government cause for a budget revision. It seems that, in Croatia, budget revision is not an exception (as it should be) but a normal government activity from year to year. According to the budget revision that was passed by the Parliament in early July, a 4.8 percent increase in state budget revenues (over the original budget figure) will only partly be used to finance the deficit. The revised budget foresees a reduction in the general government deficit by HRK 1.1 billion, from a previously planned level of 2.8 percent to 2.6 percent of GDP in 2007. The remaining HRK 3.9 billion in the revenue increment was set aside for additional expenditures. Almost a half of that amount will be turned into a financial injection for the health sector to cover its high accrued liabilities to wholesale drug stores and other suppliers. The rest of the expenditure increase will be allotted to science and education, agriculture and rural development, implementation of the Environmental and Fisheries Protection Zone, benefits for civil servants and costs of litigation, child allowances, free books and transportation for secondary school students etc.

**Central government guarantees are rising.** After a slight decrease in the last quarter of 2006, the central government debt resumed its rising trend. The debt stock increased HRK 1.6 billion in the first three months of 2007 to reach HRK 110 billion (without state guarantees) at the end of the quarter. Out of the total debt, 56.6 percent is accounted for by domestic debt. The foreign public debt continues to shrink. After a HRK 2.5 billion bond issue in February, the Government issued HRK 3 billion worth of new 10-year kuna denominated bonds in July. The total amount raised through the bond issue is to be used for repayments, so new borrowing is not expected to

lead to any changes in the level of the public debt. However, there are some concerns over the rising debt of other sectors that are backed by central government guarantees. The amount of outstanding government guarantees at the end of March hit HRK 15 billion, their highest level since the end of 2003.

## 2 POLICY ASSUMPTIONS AND PROJECTIONS SUMMARY

### ***Favorable developments in the global economy continue...***

After growing by 5.4 percent in 2006, the expansion of the global economy in the first few months of 2007 has been induced by steady economic growth in major emerging markets while industrial countries lost some of the momentum. China's strong growth of around 10 percent per year continues to underpin the strength of the global economy. The IMF expects the world output growth in 2007 to be close to 5 percent (*World Economic Outlook*, IMF, April 2007). In the US, GDP growth slowed down sharply in the first quarter of 2007. Deceleration of the US economic activity stems from a sharp downturn in the housing market and negative contributions from net exports and inventories. As for the near future, the US economy is expected to continue expanding below trend, by about 2.2 percent in 2007. Eurostat's estimate indicates that the first-quarter euro area GDP grew by 0.6 percent quarter-on-quarter, slightly slower than in the fourth quarter of 2006, mostly reflecting the effects of a VAT increase in Germany on private consumption and construction. The euro area is expected to grow by about 2.6 percent in 2007 (*European Economy*, No. 2, 2007) while most analysts suggest a slight weakening of the growth performance in 2008. Global price developments continue to be affected by energy prices but consumer price inflation has remained relatively steady.

### ***... but oil prices climb again.***

After a certain slowdown in the first quarter of 2007 compared to the last quarter of 2006, oil prices started to climb again. In mid-May, oil prices were some 30 percent higher than their previous low recorded at the beginning of 2007. The oil price increase was driven mainly by greater geopolitical uncertainties owing, in particular, to unresolved conflicts in the Middle East and unrest in Nigeria. Quotations on the futures markets, which exceeded spot prices throughout that period, indicate that oil prices will tend to rise over the medium- and long-term.

### ***Revised budget plan brings extra fiscal stimulus.***

As to projection assumptions, it may be asserted that the outlook for the external developments remains favorable. However, oil prices are expected to stay at relatively high levels. The start of the year was, on the internal front, marked by strong economic growth and a consequent substantial increase in the fiscal revenues. The revised budget plan that was recently adopted by the Parliament allows for some extra fiscal stimulus in the remaining part of the year in which, not unimportantly for the economic outlook, parliamentary elections will take place. Monetary authorities continue to implement measures aimed at reducing the external vulnerability that might eventually lead to adverse effects on domestic demand. As of July 2007, the central bank passed another measure, in addition to a 55 percent marginal reserve requirement imposed on the funds that banks borrow from abroad and the 12 percent credit ceiling for the year as a whole. This new measure consists of a mandatory purchase of its bills by commercial banks that exceed a maximum monthly growth of credits set at 0.5 percent.

### ***2007 GDP growth revised upwards to 5.3 percent.***

Following robust growth in the first quarter of 2007, the outlook for the rest of the year envisages solid, but nevertheless more moderate economic growth. We expect the economy to return to its medium-term growth path in 2008 and that implies some weakening of the economic performance compared to this year. The reasons for it are twofold. One relates to the expected slowdown in the external environment while the other concerns the fact

that investment and consumption impulses that are present this year due to forthcoming elections may fade away by then. As a result, our GDP projection has been revised upwards and we now expect GDP to grow at a rate of 5.3 percent this year and 4.4 percent in 2008.

***Strong rise in personal consumption to wane next year.***

Compared to the last few years, we are currently witnessing a higher growth of personal consumption thanks to a disposable income increase. In 2007, one should not neglect the impact of optimistic promises given by politicians in the pre-election time that might improve consumer sentiment and pave the way for additional consumption. Positive impacts of these factors on personal consumption will, however, ease next year. In addition to the existing ones, newly introduced central bank measure aimed at curbing credit activity might have a more pronounced negative effect on personal consumption next year, when other sources of consumption growth will be weaker too. Therefore, personal consumption is projected to rise 5.1 percent this and 4.5 percent next year. As for the government consumption, its growth is likely to be moderate and amount to 1.8 percent in 2007 and 1.3 percent in 2008. A steeper rise this year is mainly related to the process of EU accession which asks for an increase in the number of public administration employees.

***Current account deficit expected to widen in 2007.***

Although investment activity picked up at the beginning of this year, the rest of the year could bring a gradual deceleration due to capacity constraints that already seem to be present in the construction sector. A further growth deceleration next year is related to an expected drop in government-led projects in the first year of the next Government's mandate. Consequently, we expect investment activity to rise by 8.2 percent this and by 4.9 percent next year. When it comes to the external trade, in spite of the weak first quarter we expect a solid rise of exports for the year as a whole resulting from a twin increase of goods and services exports. However, due to the first quarter weakness we have revised downwards our projection of exports growth to 5.9 percent this year while growth is expected to accelerate to 7.2 percent next year. The exports of services seem poised to expand some 6 percent this year and next, primarily thanks to tourism, but could be additionally supported by the exports of transport services. Imports are envisaged to rise by about 6 percent both this year and next due to strong domestic demand. As a result of such developments in the external sector, current account deficit is projected to widen to 8.0 percent in 2007, while in 2008 it is expected to decline to 7.4 percent.

***Employment to expand further...***

Positive developments in the labor market are expected to continue, supported by solid economic growth. Total registered employment might rise by a further 1.5 percent in 2007. The number of jobless is poised to decline mostly through greater employment. All in all, the officially registered number of unemployed is expected to fall to 6 percent in 2007, reducing the unemployment rate to 15.3 percent in 2007. The same trends are expected to continue in 2008, when the unemployment rate is foreseen to be around 14.5 percent.

***... with mild acceleration in wage growth.***

Solid growth of the economy and the Government's wage agreement with public sector trade unions paves the way for a mild acceleration of the average gross wage growth from around 6 percent, as recorded last year, to close to 7 percent in 2007 and 2008. Coupled with the employment growth, it will contribute to an increase of the disposable income and in turn support firm personal consumption.

***Inflation on the upward move.***

In spite of relatively subdued consumer price inflation in the first half of 2007, as measured by year-on-year changes in prices, underlying month-on-month changes were much less favorable; the average monthly changes of 0.5 percent in the first five months indicate relatively strong upward pressures. Rising core inflation confirms that an extended period of relatively high prices of gasoline in the domestic market put some strains on the costs for other goods and services. Cost pressures also stem from accelerated wage increases and a slightly weaker kuna against the euro. All these factors that are already in place will

gradually spill over into consumer prices. By the end of this year, we expect the inflation rate to exceed 3 percent. As for the average, we expect the 2007 rate to be 2.5 percent and 2.8 percent in 2008.

**Future credit growth restrained.**

When the potential effect of the new central bank measure aimed at slowing down credit growth is analyzed in combination with the effects of the measures introduced earlier, it becomes clear that the CNB will eventually succeed in curbing credit activity. Hence, we set our forecast for the total domestic credit growth in 2007 to 14 percent. We also expect CNB's measures to become fully operational in 2008, when total domestic credits could grow 12 percent in line with the credit ceiling rate. In line with a deceleration of the domestic credit growth, we anticipate broad money growth to decelerate to 12.0 and 9.0 percent in 2007 and 2008 respectively.

**Government has considerably relaxed fiscal policy.**

Budgetary figures might lead to an overoptimistic perception of the real situation. Tax revenue growth is expected to remain strong, underpinned by the already attained level of economic growth in the first quarter and robust industrial output in recent months. Expenditures are poised to rise, improving the balance. Being already in the second half of such a prosperous year, we believe it may end without unpleasant surprises. Our fiscal deficit projection amounting to -2.6 percent of GDP corresponds, as usual, to the Government's own forecasts. However, we are more than concerned about the years to come. With a series of measures adopted over a span of one month the Government has considerably relaxed its fiscal policy. Christmas bonus and vacation allowances have been raised, pension income of the so-called "new pensioners" increased as well as unemployment benefits. Measures on the revenue side include changes in the level of tax allowance on bonus payments and a reduction of the VAT rate for some newspapers and magazines to 10 percent. Most of the measures will come into effect at the change of the year. Such moves are expected in the pre-election period but still seem harmless in the context of the booming economy. However, once the economic conditions change, they could seriously jeopardize the country's fiscal stability.

**Table 2 SUMMARY OF PROJECTIONS**

	2007	2008
<b>Real GDP (% change)</b>	<b>5.3</b>	<b>4.4</b>
Real private consumption (% change)	5.1	4.5
Real government consumption (% change)	1.8	1.3
Real investment (% change)	8.2	4.9
Exports of goods and services (constant prices, % change)	5.9	7.2
Imports of goods and services (constant prices, % change)	6.3	6.2
Current account balance (% of GDP)	-8.0	-7.4
Consumer prices (% change, pa)	2.5	2.8
Exchange rate, HRK/EUR (pa)	7.33	7.32
Unemployment rate (registered, %, pa)	15.3	14.5
General government balance - GFS 1986 (% of GDP)	-2.6	-2.6
Broad money, M4 (% change, eop)	12.0	9.0
Total domestic credit (% change, eop)	14.0	12.0

*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.

## 3 UNCERTAINTIES AND RISKS TO PROJECTIONS

### *Is first-quarter strong growth sustainable?*

The underlying assumption of the projections presented above is that the Croatian economy will soon return to the medium-term growth path of 4-5 percent. Managing as high a growth as the one experienced at the beginning of the year regularly causes problems on the external side, i.e. the current account deficit usually widens. Under such conditions, export performance becomes vital for sustaining robust growth. If the export growth proves stronger than we expect, either due to exceptional performance in the tourist season or a rebound in the exports of goods, a high level of personal consumption (and consequently GDP) could be extended.

### *Lasting enigma: how to reduce external vulnerability?*

External vulnerability of the Croatian economy remains one of its main weaknesses. It is obvious that the monetary policy will not be able to fight this problem alone without support of the fiscal policy. The ongoing fiscal revenue growth and a consequent reduction of the fiscal deficit is a good opportunity for fiscal authorities to make an important contribution in that direction. However, further deficit reduction and a highly responsible fiscal policy on the central as well as the local government level are needed if the goal of reducing external vulnerability is to be attained.

### *In fiscal sector, longer-term risks are rising.*

Short-time risks in the fiscal sphere are still rather low but longer-term risks are rising with every new measure undertaken with the primary goal of increasing popularity of the current Government that will have a direct impact on the future Government's revenues or expenditures. Although major election promises have been left for the second part of the year, it is already clear that some of the measures will have long-term negative fiscal effects. Since those measures are here to stay, in 2008 we can expect revenue losses and expenditure pressures that might end up in a widening of the fiscal deficit contrary to our current projection. Moreover, playing with the design of the pension system could have unfavorable long-term consequences on the sustainability of public finances.

## IMPRESSUM

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