

Croatian Economic Outlook

Quarterly

1 Recent Developments

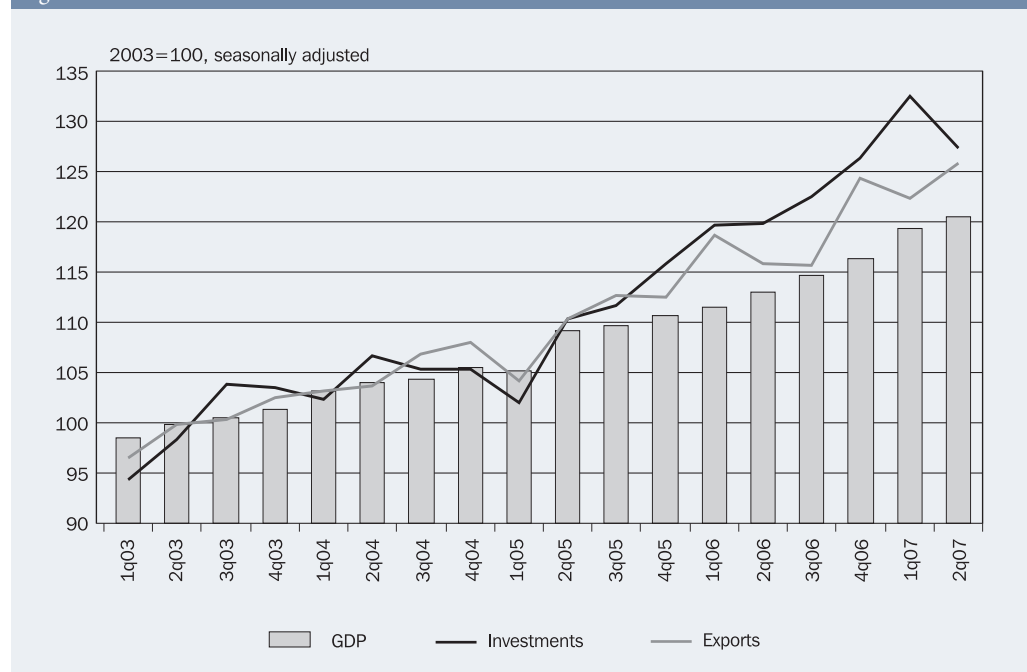
High growth sustained...

Favorable economic conditions from the beginning of 2007 continued through the mid-year, resulting in a GDP growth of 6.6 percent year-on-year in the second quarter. Economic growth remained broadly-based and mostly driven by personal consumption, while the significance of investments decreased. At the same time, the net exports continued with its negative contribution. GDP expansion of 6.8 percent year-on-year is the strongest half-year performance since 1995 underpinned by a favorable situation in the region of Eastern Europe and Croatia's foreseeable EU membership in the medium-term.

... driven by vigorous personal consumption.

Following a 7.1-percent expansion in the first quarter, personal consumption continued to grow rapidly in the second quarter at a rate of 6.5 percent year-on-year. This was supported by a rising disposable income pushed up by an increase in employment and boomed capital incomes, as well as enlarged government transfers to households. The existence of ample liquidity in the household sector was confirmed in September when the Government advanced with the IPO of its share in T-HT, the Croatian telecom company. Twenty-five percent of the company was offered to Croatian citizens at favorable conditions, but with a limited amount available per person. Partly supported by specially arranged credits, private

Figure 1 REAL GROSS DOMESTIC PRODUCT



Source for original data: Central Bureau of Statistics.

persons booked and paid a total of HRK 12 billion for stocks, which is around 4.5 percent of GDP estimated for this year. However, the Government was not able to fulfill such a huge demand so it proportionally decreased the amount available per person. Consequently, households invested HRK 5.4 billion in T-HT stocks, while HRK 6.8 billion of overpaid funds was reimbursed. The question is how the household sector will use these resources. Most likely, a part will be invested on the capital market, resulting in an increased pressure on stock prices. However, a part is likely to end up in consumption, leading to another increase in the end-year consumption.

Government consumption grew at a modest pace,...

The Government continues to expand its consumption at a modest pace. Year-on-year real government consumption grew 2.7 percent in the second quarter, confirming a stable upward trend that has started in early 2006. At the same time, the government consumption deflator reached 6 percent, mainly due to rising compensations to public sector employees. It seems that the upcoming parliamentary elections scheduled for November 25 are more reflected in the dynamics of government consumption deflator than in the real consumption of goods and services. In addition, the Government's pre-election activities are observed in increased transfers, subsidies and public investments that are not registered as part of government consumption.

... investments stagnated,...

Investment growth slowed down from 11.2 percent year-on-year in the first quarter to 5.8 percent in the second quarter. On a quarter-to-quarter basis, seasonally adjusted data for the second quarter suggest stagnation in investment. A setback in construction appears to be the major factor behind the sluggishness, while investment in equipment and machinery remained robust. We believe that the recent stagnation is temporary. Investments should gain a new momentum in the second half of the year due to improved public investments. The latest high-frequency indicators already suggest the emerging upturn in construction.

... while external trade rebounded.

The volume of total exports was amplified in the second quarter of 2007, resulting in a 8.9 percent increase over the same period last year. Seasonally adjusted exports volume was almost 3 percent higher in the second than in the first quarter, but such an increase was largely due to a weak start of the year. Eventually, the total exports volume regained a solid upward medium-term trend. The same applies to imports, although at slightly milder expansion rates. Following the first quarter, when imports grew by 3.7 percent, the second quarter brought a 6.4 percent expansion over the same period last year. As a result the net exports of goods and services were negative, amounting to approximately 15 percent of GDP.

Positive trends in the real sector.

According to merchandise trade data in current euro terms, the exports of goods grew by 10.2 percent in the first eight months year-on-year, while imports expanded by 9.9 percent. Consequently, by the end of August goods exports amounted to EUR 5.8 billion and goods imports to EUR 12.4 billion. Despite a slightly stronger rise in exports, the merchandise trade deficit continued to widen, reaching EUR 6.6 billion. Industrial production sustained a high growth pace with a 7.0 percent increase year-on-year in the January-August period. Some deceleration of growth was present in August, which should probably be attributed to the summer vacation season. As for the retail trade volume, it increased by 7.1 percent up to August year-on-year, exhibiting a stable upward trend and gaining additional momentum in the most recent months due to the tourist season. However, the overall dynamics of retail trade in 2007 primarily reflects the strong domestic personal consumption.

Employment increases mildly,...

Central Bureau of Statistics reported that total employment increased by 1.3 percent year-on-year in the January-August period. Employment in the incorporated sector grew by 1.9

Table 1 MAIN ECONOMIC INDICATORS

	2005	2006	2006		2007	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	4.3	4.8	4.7	4.8	7.0	6.6
Real private consumption (% change, yoy)	3.4	3.5	3.9	4.1	7.1	6.5
Real government consumption (% change, yoy)	0.8	2.2	1.5	4.4	2.8	2.7
Real investment (% change, yoy)	4.8	10.9	9.3	9.2	11.2	5.8
Industrial output (% change, yoy)	5.1	4.5	5.9	6.1	8.0	7.1
Unemployment rate (registered, %, pa)	17.9	16.6	15.5	16.5	16.9	15.1
Nominal GDP (EUR million)	31,263	34,220	-	-	-	-
GDP per capita (EUR)	7,038	7,706	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.2	3.4	3.2	3.0	3.1	3.7
Consumer prices (% change, yoy, pa)	3.3	3.2	3.2	2.2	1.6	2.1
Producer prices (% change, yoy, pa)	3.0	2.9	2.7	1.7	2.0	2.5
Average gross wage (% change, yoy, pa)	4.4	6.2	5.6	7.1	6.2	5.7
Exchange rate, HRK/EUR (pa)	7.40	7.32	7.30	7.36	7.36	7.35
Exchange rate, HRK/US\$ (pa)	5.95	5.84	5.73	5.71	5.62	5.46
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,220	8,464	2,101	2,378	2,046	2,295
Exports of goods (EUR, % change, yoy)	9.3	17.2	13.6	20.1	1.9	16.1
Imports of goods (EUR million)	14,738	16,808	4,238	4,385	4,206	4,930
Imports of goods (EUR, % change, yoy)	10.6	14.0	13.9	11.0	8.8	11.8
Current account balance (EUR million)	-1,988	-2,647	2,098	-1,490	-2,022	-1,350
Current account balance (% of GDP)	-6.4	-7.8	-	-	-	-
Gross foreign direct investment (EUR million)	1,468	2,713	433	937	1,313	836
Foreign exchange reserves (EUR million, eop)	7,438	8,725	8,135	8,725	9,520	9,170
Foreign debt (EUR million, eop)	25,748	29,205	27,373	29,205	29,962	30,756
GOVERNMENT FINANCE*						
Revenue (HRK million)**	92,643	100,393	73,483	100,393	24,768	53,686
Expense (HRK million)**	92,332	98,751	71,365	98,751	25,361	50,680
Net = Gross operating balance (HRK million)**	310	1,641	2,118	1,641	-593	3,006
Net acquisition of non-financial assets (HRK million)**	6,699	6,109	4,019	6,109	911	2,446
Net lending/borrowing (HRK million)**	-6,389	-4,467	-1,901	-4,467	-1,504	560
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-7,711	-6,392	-3,071	-6,392	-	-245
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-3.4	-2.6	-	-	-	-
Domestic government debt (EUR million, eop)	7,461	8,125	8,213	8,125	8,435	8,560
Foreign government debt (EUR million, eop)	7,019	6,651	6,651	6,651	6,496	6,733
Total government debt (% of GDP)	46.2	43.3	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	12.3	25.0	20.0	25.0	22.4	22.1
Broad money, M4 (% change, yoy, eop)	10.5	18.0	16.6	18.0	20.5	19.2
Total domestic credit (% change, yoy, eop)	17.2	22.9	22.4	22.9	22.4	21.2
DMBs credit to households (% change, yoy, eop)	20.3	21.8	22.5	21.8	23.6	21.1
DMBs credit to enterprises (% change, yoy, eop)	16.3	26.1	24.5	26.1	24.1	23.1
Money market interest rate (% pa)	2.3	1.6	1.9	1.8	2.2	4.1
DMBs credit rate for enterprises, short-term, (% pa)	8.1	7.1	7.1	6.8	6.9	6.9
DMBs credit rate for households, short-term (% pa)	13.1	12.1	11.8	11.9	12.1	12.3

Notes: * 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.

percent, while employment in crafts and free professions increased by 0.4 percent. The strongest employment growth was registered in the real estate, renting and business activities (5.1 percent), wholesale and retail trade (3.4 percent), financial intermediation (2.5 percent) as well as construction (2.3 percent). Even more striking positive labor market trends were recorded by the Croatian Pension Insurance Agency register, indicating a 2.7 percent rise in employment (more precisely in the number of insured persons) in the January-June period compared with the same period previous year.

... while unemployment decreases strongly...

In September, the Employment service registered 11.8 percent less jobless persons than a year ago as a result of a strong upward shift in the economic activity. The number of unemployed increased a bit in September, as compared to August, but that was entirely due to the usual seasonal pattern. The unemployment rate amounted to 13.8 percent in August, which is 2 percentage points lower than a year ago. The survey-based unemployment rate calculated according to the ILO standards stood at 11.2 percent in the first quarter of 2007.

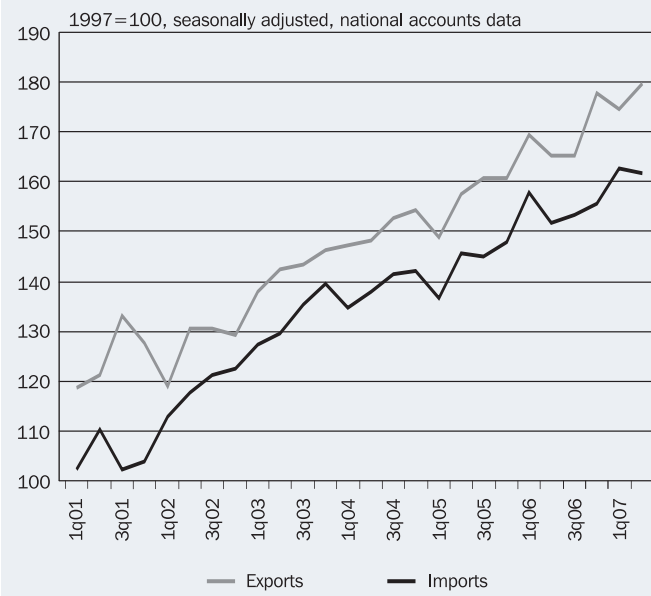
... as wage growth accelerates.

Surprisingly, the high economic growth and rising employment are not reflected in wage growth acceleration. In the first half of this year, the nominal gross wage rose 6 percent year-on-year, the same as a year ago. However, July 2007 saw a 7.9 percent wage increase. This might herald a growth-induced wage acceleration that will soon be accompanied by wage increases in the public sector under the agreement between the Government and public sector trade unions.

Strong, but slower growth of broad...

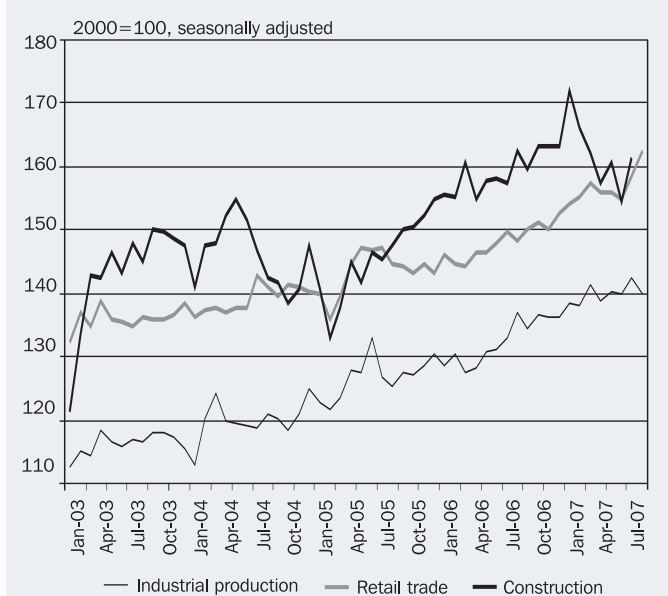
Turning the attention to monetary developments, one may note that following a strong expansion in the first quarter of 2007, second and third quarter witnessed a propulsive but somewhat slower growth of broad money. According to seasonally adjusted figures, broad money recorded a 4.0 percent quarter-on-quarter growth in the second quarter of 2007, which is 1.3-percentage points less than in the first quarter. In August, broad money year-on-year growth amounted to 19 percent, which is by 1.5 percentage points lower than four-year record rates seen in the first quarter. On the one hand, this is due to a strong money demand stemming from a propulsive real sector growth. On the other hand, its recent deceleration could be attributed to central bank's measures aimed at curbing credit activity.

Figure 2 EXPORTS AND IMPORTS



Source for original data: Central Bureau of Statistics.

Figure 3 REAL SECTOR DEVELOPMENTS



Source for original data: Central Bureau of Statistics.

All three main broad money components - narrow money, kuna savings deposits and foreign exchange deposits - contributed significantly to the overall growth. However, it must be noted that while kuna savings deposits grew at a much slower pace than the previous year, foreign exchange deposits rebounded during the summer months, recording the highest year-on-year growth rates in five years. This might indicate a successful tourist season, but it also reflects the increased efforts of commercial banks to attract foreign exchange deposits in order to counterbalance foreign borrowing that is subject to central bank restrictions.

... and narrow money.

Narrow money continued to grow robustly in the second and third quarter of 2007 with a somewhat weaker intensity than in the first quarter. A year-on-year narrow money growth rate stood at 19.4 percent in August 2007. It must be observed that a somewhat subdued expansion of narrow money is a result of a slower growth of money in circulation. At the same time, the growth of deposits money seems stable with enterprise deposits gaining a new momentum during the summer months.

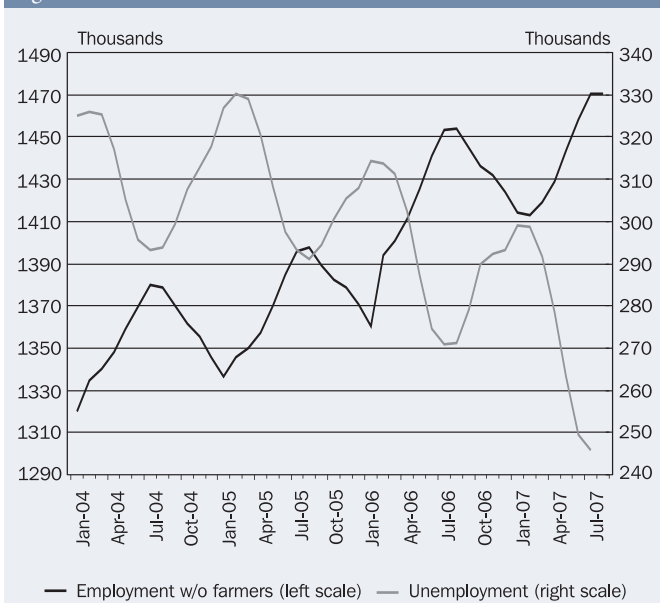
Deceleration of credit activity, especially of credits to enterprises.

According to the latest data, credit activity finally shows a significant downward shift. More specifically, the total domestic credit growth rate stood at 18.4 percent year-on-year in August 2007, which is 3.2 percentage points lower than the average growth rate observed in the first half of the year. The strongest deceleration is observed in credits to enterprises with the August year-on-year growth rate showing 5.8 percentage points decrease compared to the first half-year average. Since the foreign debt of enterprises is on the rise, one could speculate that banks have redirected the credit demand of large corporate clients to their foreign parent banks. Credits to households as well as housing loans continued to rise during the summer months, while a downward shift in their year-on-year growth rates is much less pronounced. In August, they were 1.7 and 3.1 percentage points lower than the average recorded in the first half of the year.

Foreign debt increase slows down.

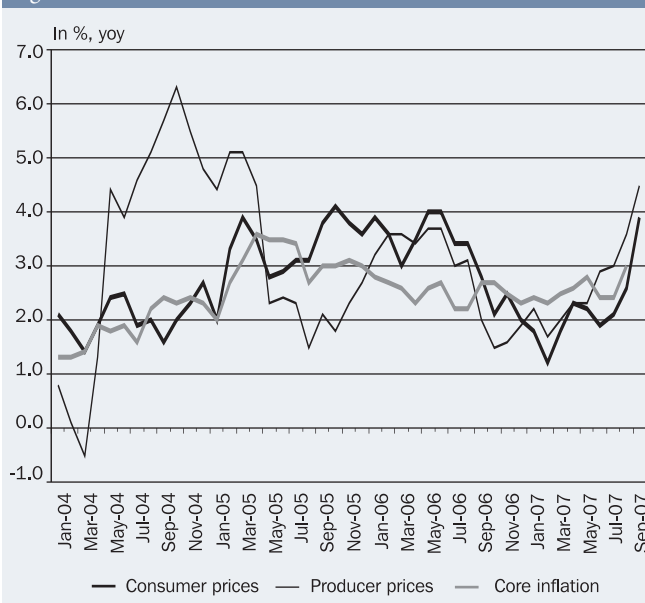
Foreign debt increase slowed down in the first half of the year. At the end of June 2007, gross foreign debt reached EUR 30.8 billion, indicating a EUR 1.6 billion rise compared to the end of last year. As the main contributor to this increase, the corporate sector borrowed

Figure 4 REGISTERED EMPLOYMENT AND UNEMPLOYMENT



Source for original data: Central Bureau of Statistics.

Figure 5 CREDIT DEVELOPMENTS



Sources: Croatian National Bank.

Box 1 MACROECONOMIC EFFECTS OF CROATIA'S ACCESSION TO THE EU

The Institute of Economics, Zagreb has recently published a study on the economic effects of Croatia's accession to the EU. This publication (available in Croatian at www.eizg.hr) summarizes the results of an extensive analysis undertaken in 15 different areas, ranging from the macroeconomic and financial effects of EU accession to its impact on capital flows, real estate, labor market and state aid as well as SMEs. Other areas covered include tourism, agriculture, fisheries, environmental protection, science and higher education, consumer protection and the establishment of the EU external frontier.

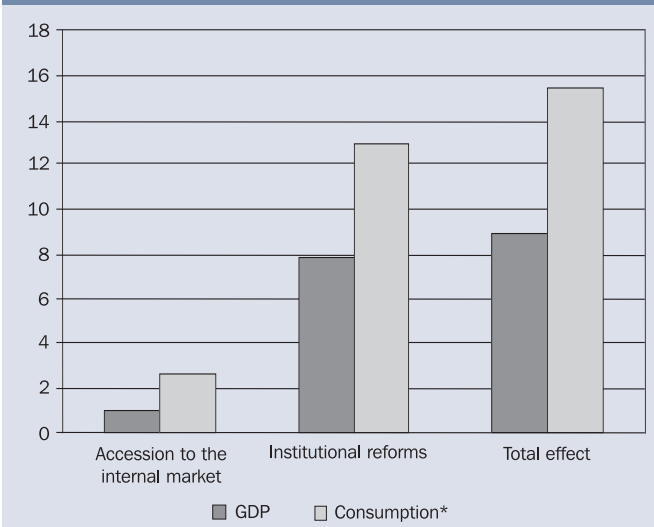
The macroeconomic effects are assessed through simulations undertaken by the *WorldScan*, an applied general equilibrium model for the world economy developed and maintained by the CPB Netherlands Bureau for Economic Policy Analysis. The approach taken in the analysis does not attempt to exhaustively discuss all the macroeconomic aspects of Croatia's accession to the EU, but it rather focuses on two policy reforms. The baseline scenario assumes that Croatia will not become an EU member, so the existing trends are extrapolated into the future. In order to assess the accession effects, the results generated by the baseline scenario are compared to the results of two different simulations that assume the accession to take place in 2009.

The first simulation focuses on the trade effects of Croatia's accession to the internal European Market. As a candidate country, Croatia has substantially liberalized trade relations with the EU. However, accession to the internal market should bring some additional benefits reflected in the reduction of administrative and technical barriers to trade along with the reduction in risk and uncertainty. The second simulation focuses on institutional reforms, evaluating their effects on the Croatian foreign trade. Since it is highly probable that these reforms will be intensified by the accession process, the simulation is carried out through the assumption that Croatia moves up on the Transparency International Perceptions Corruption Index rank (as an approximation for the development of institutional setting) to the position of Portugal, the lowest ranked EU-15 member.

The combined results of the two simulations evaluated in 2025 are presented in Figures B1 and B2. Due to Croatia's accession to the internal European Market and institutional reforms, GDP is estimated to rise by 9 percent and consumption by 15 percent over the non-accession scenario. Thereby the impact of changes in the institutional setting is expected to be much stronger than the effect of abolishing the remaining non-tariff barriers (in terms of GDP, 7.8 percent vs. 1.1 percent). Consequently, GDP per capita in PPS terms should increase from 48 percent of the EU-25 average in 2005 to 75 percent in 2025. In the non-accession scenario, GDP per capita is estimated to remain at 68 percent of the EU-25 average in 2025.

These results are likely to underestimate the full effects of joining the EU. The analysis, for example, does not consider the growth effects of EU funds or FDIs. Accession to the EU would also make Croatia a more attractive tourist destination, while the dynamic effects of integration should impose a sharper than projected aggregate productivity growth via improved competition.

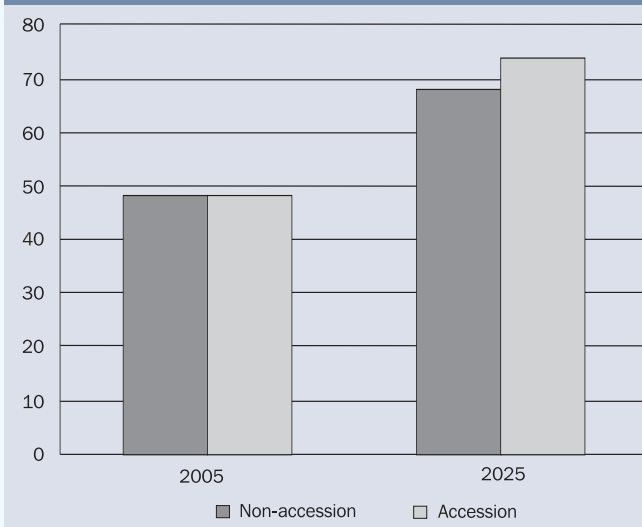
Figure B1 THE EFFECTS OF EU ACCESSION ON GDP AND CONSUMPTION, 2025 (IN %)



Note: * Includes both personal and government consumption.

Source: WorldScan simulations.

Figure B2 GDP PER CAPITA IN PPS TERMS (EU-25=100)



Source: WorldScan simulations.

more than EUR 1.9 billion in the first half of the year. While the banking sector decreased its foreign liabilities by EUR 0.4 billion, the government sector increased its indebtedness by EUR 0.1 billion, mostly due to EUR 250 million bonds issued by the HBOR (Croatian Bank for Reconstruction and Development).

Pressures on the money market due to capital market activities.

On the money market, August witnessed good liquidity with the average overnight ZIBOR at 2.9 percent, the lowest rate since February this year. However, September was marked by a tight situation. The demand was exceptionally strong due to the Government's IPO of the Croatian Telecom stocks. The stocks offered to the Croatian citizens and investment funds under privileged conditions generated a problem on the money market since it is too small and illiquid for transactions of this scale. The overnight ZIBOR shot up to 8 percent and 3-month ZIBOR reached a 6 percent level. At the same time, the HRK/EUR exchange rate was under significant appreciation pressures. Hence, the central bank was forced to intervene in the foreign exchange market by injecting HRK 2.6 billion into the system, which is the biggest foreign exchange intervention in the last several years. The average HRK/EUR exchange rate did not change much in the May-August period. Strong kuna demand and weak demand for foreign exchange have kept the HRK/EUR exchange rate around 7.3.

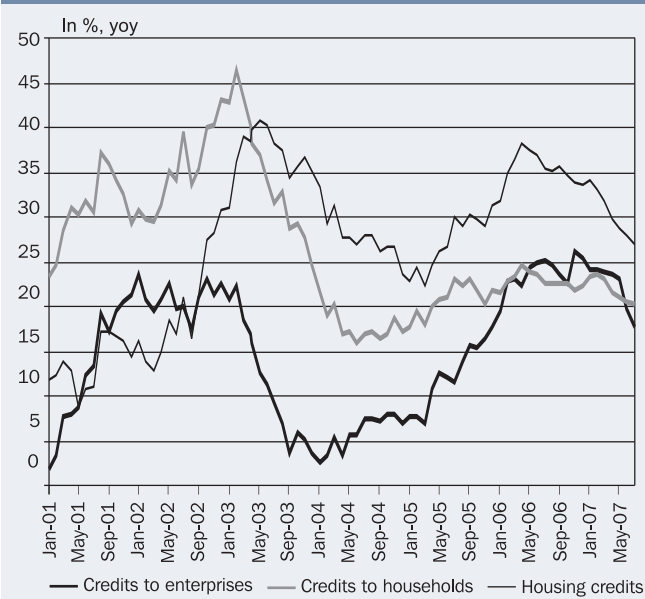
Higher inflation.

While inflation remained subdued in the first half of the year, the third quarter of 2007 saw a spike in both producer and consumer price inflation. On average, producer prices were in the third quarter 3.7 percent higher compared to the same 2006 period. Moreover, producer price inflation amounted to 4.5 percent in September, the highest rate in two and a half years. Consumer price dynamics confirms rising inflationary pressures as the year-on-year inflation rate stood at 3.9 percent in September. Seasonal increases in clothing and footwear prices as well as higher food prices were the main contributors to the consumer price hike.

Stable fiscal position due to abundant tax revenues.

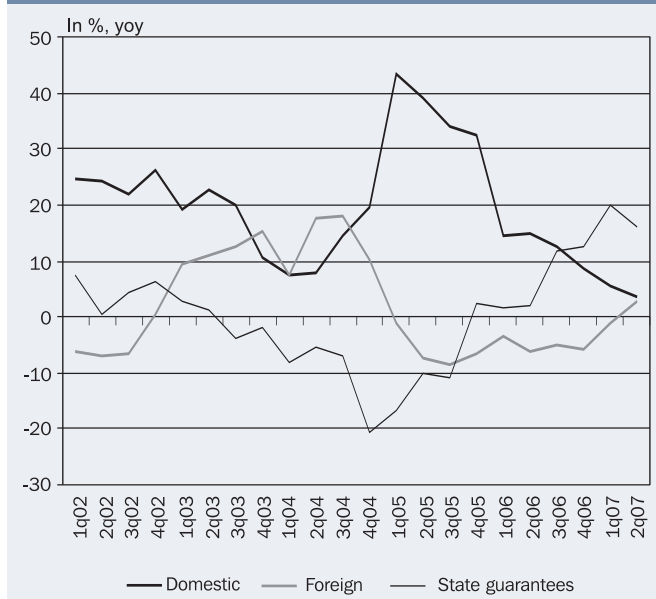
Fiscal policy seems to be in favorable position. In the first half of 2007, the consolidated central government deficit decreased to only HRK 245 million (according to the GFS 1986 methodology), with the central government budget recording a HRK 725 million surplus.

Figure 6 INFLATION



Source: Central Bureau of Statistics and Croatian National Bank.

Figure 7 PUBLIC DEBT



Source: Croatian National Bank.

Revenue collection was strong this year, particularly in the second quarter. Total revenues rose by almost 14 percent in the first half of the year compared to the same period year ago. In absolute terms, the highest revenue increment came from the corporate income tax and VAT, which increased by 76 and 11 percent, respectively. Such an abundance of VAT revenues stems from a vivid economic activity in the first part of the year, while the rise in corporate income tax revenues can be mostly attributed to a change in the distribution of profit tax and personal income tax between the local and central government. On the other hand, budget expenditures increased by 7 percent in the first half of the year. More than two-thirds of this growth is due to a rise in social benefits and expenditures for wages and salaries. To conclude, the extraordinary deficit reduction is a consequence of strong tax collection, while expenditures increased faster than in the same period last year.

Public debt rises again.

Public debt seems to be on the rise again. At the end of June, the consolidated central government debt (without state guarantees) reached HRK 111.7 billion. It grew by 2.9 percent in the first half of 2007, twice as much as in the same period year ago. Such an increase in the debt level that does not reflect the officially disclosed size of the shortage of revenues over expenditures stems from two sources - a debt issued by the HBOR whose expenditures do not appear in the government finance statistics; and borrowing aimed at the repayment of pensioners' debt, which is a fiscal burden whose accumulation has never been included in government expenditures and whose final obligation has not been counted as the government debt for some, economically hardly justifiable reasons.

(Over) optimistic fiscal policy projections for 2008-10.

The Government's *Economic and Fiscal Policy Guidelines for the 2008-10 period* foresee further fiscal adjustment with general government deficit reduction to 2.3 percent of GDP in 2008, 1.4 percent in 2009 and 0.5 percent in 2010. Such projections are based on the assumption of fairly high economic growth in the next three-year period (above 6 percent), which should be underpinned by the EU accession in 2009. No significant change in the tax policy is planned. General government expenditures are expected to decrease from 49 percent of GDP in 2007 to 43 percent in 2010. Besides a significant deficit decrease, the share of public debt in GDP is planned to decline from 45 percent of GDP in 2007 to 37 percent in 2010. The government public debt management policy should remain unchanged, meaning that the Government will continue to borrow in domestic markets. As one reads the *Guidelines*, it becomes obvious that the Government has decided to look only at the positive fiscal implications of EU accession, fully omitting its possible unfavorable consequences on both government revenues and expenditures. Knowing that the budget could suffer some loss in revenues and increase in expenditures after joining the EU, we think that it should have been more accurately reflected in fiscal projections.

2 Policy Assumptions and Projections Summary

Global economic activity continues to be robust...

The global economy continues to develop at a robust pace, mainly due to a buoyant activity in the emerging economies. This particularly applies to China and India, two emerging economies that have become - for the first time - driving forces of the world growth. Economic slowdown in the U.S. has not considerably affected the global economy, but the implications of the recent financial market turbulence are yet to be seen. According to the latest IMF projections (*World Economic Outlook*, October 2007), the world economy should continue to grow robustly in the remaining part of 2007 and in 2008, but at a more moderate pace than in 2006. Global growth is estimated to amount to 5.2 percent in 2007 and 4.8 in 2008. In the U.S., GDP growth rebounded in the second quarter of

2007, experiencing expansion at an annual rate of 4.0 percent after just 0.6 percent in the first quarter. However, a sharp downturn in the housing market has continued to have the major impact on the U.S. economic growth. At the same time, Eurostat's latest estimates indicate that the euro area saw a quarterly GDP growth rate of 0.3 percent in the second quarter after a 0.8 percent rise in the first quarter. The main contributors were net exports and inventories, while the investment activity declined, mainly due to lower residential investment. Growth is projected to ease further in the euro area, reflecting in part a gradual withdrawal of monetary accommodation and fiscal consolidation. Eurostat foresees a GDP increase of 2.6 percent in 2007 and 2.5 in 2008. Downside risks stem mainly from the effects of recent financial market turbulence, global imbalances and further oil and commodity price rises.

... just as oil prices continue to rise.

Global oil markets remain extremely tight and therefore highly sensitive to any supply shock or emergence of geopolitical concerns. In the first days of October, oil prices were close to US\$ 80 per barrel, but an unexpected drop in the U.S. oil inventories and strikes in the Nigerian oil industry pushed them to the new highs of US\$ 90 by the mid of the month. As for the future, oil prices are expected to stay at elevated levels as the world supply struggles to keep pace with the growth of global demand. The OPEC has decided to increase supply from the beginning of November, which should bring, at least temporarily, some ease to the markets.

Pre-election bonuses.

As we turn the attention to projection assumptions, it should be noted that the international environment remains favorable for the Croatian economy. However, the outlook for the EU economies, both "old" and "new", suggests certain growth deceleration towards the end of this year and particularly in the next year. Oil prices will remain high, while the HRK/EUR exchange rate is expected to be stable with the possibility of rising appreciation pressures due to the increased foreign capital inflow. On the internal front, following an exceptionally strong growth in the first quarter of this year, the Government found itself in a comfortable position to generate a strong pre-election fiscal stimulus effective either on the eve of the elections or at the very beginning of the next year – besides the new installments of pensioners' debt repayment, an increase in pensions of the so-called "new pensioners" (those retired in 1999 and later) has been set up along with a rise in unemployment benefits, social transfers and maternity leave compensations. A number of infrastructural projects has also been launched or arranged to be finished these days. At the same time, monetary authorities are in a much different position as they try to counterbalance the expected fiscal expansion. The central bank continues to fight the increased external vulnerability, but primarily by means of constraining commercial banks' credit extensions, which should also curb consumption growth. Although some deceleration in foreign debt increase seems to have been reached, measures aimed at curbing credit activity are anticipated to be fully effective in 2008 and help to preserve macroeconomic stability.

GDP to rise 6 percent in 2007 and 4.9 percent in 2008...

Our outlook for this and next year has been revised upwards. Following the encouraging figures for the second quarter and robust high-frequency indicators for the number of industries in the third quarter, we expect this year to close with 6 percent higher GDP than the year before. However, the second half of 2007 should bring a moderate growth deceleration compared to the first six months. As for 2008, we expect the positive trends to continue, although with a weaker overall growth of around 4.9 percent.

... with personal consumption continuing to be the major growth driver.

The next year should bring some easing in personal consumption growth. Although fiscal stimulus set up in this year will be fully operational in 2008, pensioners' debt repayment will be lower than this year. In addition, central bank's measures aimed at credit tightening will be fully effective throughout the year. Nevertheless, personal consumption is still

expected to be the major growth driver. Its expansion is to be underpinned by a robust rise in disposable income. Following this year's growth of 5.9 percent, personal consumption should increase by 5.1 percent in 2008. The government consumption is expected to rise by 2.2 percent in real terms, almost the same as last year. Elections will surely bring an increase in government expenditures, which will be more reflected in increased transfers and public investments than in the volume of the government consumption of goods and services. Following the short-lived pause at the mid of the year, high-frequency indicators suggest that investment activity has rebounded. Nevertheless, due to the base-year effect, investment figures for the whole 2008 indicate a decline in growth. We foresee this year to close with a 6.7 percent rise in investments, while 2008 should bring a 5.7 percent rise.

Current account deficit projected at 7.3 percent of GDP for 2007 and 7.0 percent for 2008.

Net exports are expected to continue to contribute negatively to the overall GDP growth thanks to a relatively strong imports performance of around 6 percent both this year and next, which is partially related to the robust personal consumption. The estimated exports growth of around 6.5 percent will not significantly reduce trade and current account deficits. It is conditioned upon a successful tourist season with nominal revenues from the international tourism projected to rise around 10 percent this and 9 percent next year. Current account deficit is expected to amount to 7.3 percent of GDP in 2007, while in 2008 it is envisaged to slightly decline to 7.0 percent.

Unemployment rate should shrink...

Favorable economic conditions should also spread to the labor market. Total employment is poised to grow by around 1.7 percent in both 2007 and 2008, accompanied by a declining number of unemployed persons. The registered unemployment rate is expected to slide down from 16.6 percent in 2006 to 15.3 in 2007 and 14.4 percent in 2008. The survey-based ILO-defined unemployment rate is anticipated to drop from 11.1 percent in 2006 to below 10 percent in 2008.

... as income growth speeds up.

Disposable income rise will be supported by stronger employment and increasing government transfers. A relatively mild rise in the average gross wage in the first half of this year is at odds with high economic growth and employment expansion that is currently underway. However, employers seem to prefer new employment over rising wages in the current setting and we anticipate this trend to endure in the near future. Therefore, we envisage the average

Table 2 SUMMARY OF PROJECTIONS

	2007	2008
Real GDP (% change)	6.0	4.9
Real private consumption (% change)	5.9	5.1
Real government consumption (% change)	2.2	1.6
Real investment (% change)	6.7	5.7
Exports of goods and services (constant prices, % change)	6.5	6.4
Imports of goods and services (constant prices, % change)	5.9	5.8
Current account balance (% of GDP)	-7.3	-7.0
Consumer prices (% change, pa)	2.6	2.9
Exchange rate, HRK/EUR (pa)	7.33	7.32
Unemployment rate, HRK/EUR (pa)	15.3	14.4
General government balance – GFS 1986 (% of GDP)	-2.6	-2.3
Broad money, M4 (% change, eop)	17.0	11.0
Total domestic credit (% change, eop)	14.0	12.0

Notes: Cut-off date for information used in the compilation of projections was October 10, 2007.

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

Source: Authors' projections.

gross wage increase of 6.5 percent in nominal terms for this year and 7 percent for 2008. However, the household sector will benefit strongly from the recently enacted legislation regarding the amount of unemployment benefits, maternity leave compensations and social assistance benefits. Moreover, pensions of post-1998 retirees will increase in a range of 4 to 27 percent in order to become aligned with the pensions of those retired in periods up to 1998. Some other technical changes in the calculation of pensions – for example, lower penalties for early retirement – will bring additional resources to households. All in all, the household disposable income will support strong personal consumption this and next year.

Rising inflation fears.

The short-term inflation forecast indicates rather broadly-based upward pressures. There has been an upswing in core inflation as well as in the producer prices of manufactured goods. The threats of further rise in agricultural and oil prices are also present. However, we see most of these factors to have limited influence on overall price developments. Therefore, we anticipate the inflation rate to decline in the course of next year. A gradual appreciation of the HRK/EUR exchange rate expected in 2008 will help in that respect. In conclusion, this year is expected to end up with the consumer price inflation of around 3.5 percent, although the year average will be about 2.6 percent, while in 2008 inflation should recede to 2.9 percent on average.

Further tightening of credit activity.

We set our forecast for total domestic credits to grow by 14 percent in 2007. Assuming that the credit ceiling will be effective and fully operational in 2008, we expect total domestic credits to rise by 12 percent. In line with the deceleration of domestic credit growth, broad money growth could amount to 17 percent in 2007 and decelerate to 11 percent in 2008.

Higher public spending expected.

Good economic performance should have a positive impact on fiscal revenues in the remaining part of the year and help the targeted deficit of 2.6 percent of GDP at the general government level to be achieved. As for the next year, one should keep in mind that parliamentary elections usually bring some risks to the fiscal continuum. The actual Government is preparing a draft budget for 2008, but the budget outturn will depend on the outcome of elections and overall economic developments in 2008. At the moment, we do not expect any significant changes in the tax system. However, due to higher social benefits we anticipate higher public spending in the second half of 2007 and in 2008. As for the 2008 deficit, we continue to stick to the Government projections that anticipate 2.3 percent of GDP at the general government level.

3 Uncertainties and Risks to Projections

Post-election uncertainties – are there any?

Upcoming parliamentary elections pose certain uncertainties to the overall outlook. If the ruling party, Croatian Democratic Union (HDZ) with its coalition partners forms the next Government, we expect continuation of the current economic policy. If, however, elections bring the major change on the political scene and the coalition led by Social Democratic Party (SDP) forms the next Government, it is not quite clear what changes in the economic policy could be expected. Revealed parts of the economic program suggest preference towards fiscal expansion and a generally stronger economic role for the government. In addition, introduction of capital gains tax has repeatedly been announced. The other details of the economic program remain mostly unexposed. In any case, changes in the economic policy are constrained in the short-run by the 2008 budget plan, while the accession negotiations with the EU and the process of harmonization with the *acquis communautaire* do not allow much maneuvering for any of the political options over the longer horizon.

Fiscal policy prospects remain highly risky.

Overall fiscal policy prospects remain risky in the medium-term regardless of the outcome of parliamentary elections. In order to achieve stability over the longer horizon, it is necessary to restrain expenditure growth and to achieve higher rationality and effectiveness of public spending. Yet, all the major political forces have either taken steps or strongly argued in favor of increased expenditures, which raises risks to fiscal stability in the medium-term.

What does the central bank really fight against?

As the central bank's measures aimed at curbing the banking sector credit activity and reducing its exposure to foreign borrowing seem to deliver the results that monetary authorities hoped for, it becomes unclear what the central bank really fights against. Namely, as the credit activity moderates, personal consumption remains robust along with increasing imports and widening trade deficit. At the same time, foreign debt stagnated over the summer months. Even if it was not the seasonal effect, it should be noted that it was only the banking sector that has recently restrained from borrowing abroad, while the enterprise sector has overtaken the lead in foreign borrowing.

Housing market crisis in the U.S. might at last affect EU economies.

It is widely expected that the EU economy will soon experience some negative effects of the housing market crisis in the U.S. This might hurt Croatian exports. The risk to the Croatian economy also emerges in case of higher than expected slowdown in the broader region that may make investors more cautious. Another risk comes from the danger of deeper global financial instability and longer-term worsening of foreign financing conditions that would affect the countries with wider current account deficits.

IMPRESSUM

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