

Croatian Economic Outlook

Quarterly

1 Recent Developments

New coalition government approved.

Following the November elections, the Croatian parliament approved a new coalition government led by reappointed Prime Minister Ivo Sanader on January 12, 2008. The government is dominated by the Croatian Democratic Union (HDZ) members in addition to two members from the Croatian Peasants' Party (HSS), one from the Croatian Social Liberal Party (HSL), and one representing the Independent Democratic Serb Party (SDSS). The new center-right government is also supported by other ethnic-minority representatives. Most of the ministers have actually kept their positions from the previous cabinet, with minor reshuffling. The Prime Minister has repeatedly stressed the Government's pro-EU and pro-NATO foreign policy orientation.

Moderation of economic expansion.

The new government has inherited a moderately slowing economy. In the third quarter of 2007, GDP growth receded to 5.1 percent year-on-year from 6.6 percent in the second and 7.0 percent in the first quarter. Self-balancing forces seem to have been at work and growth tends to approach a sustainable pace. A surge in output volume at the beginning of 2007 that was propelled by soaring domestic demand was not sustainable since it would have led to a dramatic increase in external imbalance. Major causes of deceleration in the third quarter were a moderation of personal consumption and relatively weak investment, while

Figure 1 REAL GROSS DOMESTIC PRODUCT



Source for original data: Central Bureau of Statistics.

the external sector has preserved its gradually rising tendency. Exports were a bit stronger than imports, leading to a positive contribution of net exports to GDP growth in the amount of 0.7 percentage points. At the same time, domestic demand decreased its contribution to GDP growth to 4.4 percentage points, down from 8.2 points in the first and 6.7 percent in the second quarter of 2007.

Despite slowdown, personal consumption remains strong.

Although personal consumption has slowed down, it has remained rather strong. In the third quarter of 2007, it was 6.2 percent higher than in the same quarter year before. Respective figures for the first and second quarter were 7.1 and 6.5 percent. The moderation of personal consumption took place despite a relatively strong growth of disposable income that was backed by increasing employment and wages at the time when fears of higher inflation started to emerge.

A surge in government consumption.

Although a rising trend in government consumption has been observed in the last two and a half years, a year-on-year increase of 4.4 percent in the third quarter was beyond our expectations. We have expected an expansion of government consumption in the fourth quarter, just before the parliamentary elections, but not in the third quarter. An increase in expenditures came after the budget revision, when the Government was at ease with spending extra money due to high revenues. It seems that the observed surge in government consumption was the result of (i) an increasing demand for public services to organize the harmonization of national legislation and practices with the EU, (ii) intensified pre-election consumption, and (iii) an irregular jump in spending. Quite strong irregular fluctuations in public expenditures were already observed in the past as a result of a wide-reaching ad hoc approach in the realization of public spending plans.

Investments rebound gradually.

After slowing down to 5.8 percent in the second quarter, investment growth reached 5.7 percent year-on-year in the third quarter of 2007. These figures hide a positive underlying trend. On a quarterly basis, seasonally adjusted investment figures indicate a safe rebound in the third quarter, after a clear decline in the second. Mid-year weakness in investments was caused by a drop in construction activity, mostly in house-building. It should be expected that this short-lived depression was used to restructure business as to better meet the future demands of the enterprise sector as well as the potentially large orders of the public sector.

External trade remains robust...

External trade has remained robust. As recorded by the national accounts statistics, the volume of export of goods and services increased by 7.3 percent in the third quarter of 2007, while the volume of imports went up by 7.0 percent year-on-year. However, it should be noted that seasonally adjusted exports in the third quarter indicate stagnation compared to the previous quarter. That is not in line with high expectations from the 2007 tourist season. One should notice the discrepancy between the national accounts and the balance of payments statistics, where the latter points to a much weaker increase in the export of goods and services. The difference might be due to the way receipts from the international tourism are registered (detailed data on exports from the national accounts statistics are not available). Balance of payments data are based on the tourist survey, which shows a 4 percent year-on-year increase in the third quarter, as expressed in euro and in current prices, while the national accounts data are based on a much broader set of inputs pointing to a robust growth of tourism income.

... but trade deficit increases further.

As for the exports and imports of goods, as recorded in the merchandise trade statistics, one can notice weaker dynamics in the first eleven months of 2007 compared to the previous year. Although the year-on-year slowdown was more pronounced on the export side, the exports of goods, with a growth rate of 11.5 percent, still outperformed the imports of goods, which rose by 10.4 percent in current kuna terms. The trade deficit has further widened, surpassing EUR 9 billion, which is some 10 percent more than in the first eleven months of 2006.

Table 1 MAIN ECONOMIC INDICATORS

	2005	2006	2007			
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	4.3	4.8	4.8	7.0	6.6	5.1
Real private consumption (% change, yoy)	3.4	3.5	4.1	7.1	6.5	6.2
Real government consumption (% change, yoy)	0.8	2.2	4.4	2.8	2.7	4.4
Real investment (% change, yoy)	4.8	10.9	9.2	11.2	5.8	5.7
Industrial output (% change, yoy)	5.1	4.5	6.1	8.0	7.1	4.5
Unemployment rate (registered, %, pa)	17.9	16.6	16.5	16.9	15.1	14.0
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	3.0	3.1	3.7	4.0
Consumer prices (% change, yoy, pa)	3.3	3.2	2.2	1.6	2.1	2.9
Producer prices (% change, yoy, pa)	3.0	2.9	1.7	2.0	2.5	3.7
Average gross wage (% change, yoy, pa)	4.4	6.2	7.1	6.2	5.7	6.6
Exchange rate, HRK/EUR (pa)	7.40	7.32	7.36	7.36	7.35	7.31
Exchange rate, HRK/US\$ (pa)	5.95	5.84	5.71	5.62	5.46	5.32
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,220	8,464	2,378	2,046	2,308	2,326
Exports of goods (EUR, % change, yoy)	9.3	17.2	20.1	1.9	16.8	10.7
Imports of goods (EUR million)	14,738	16,808	4,385	4,205	4,839	4,662
Imports of goods (EUR, % change, yoy)	10.6	14.0	11.0	8.8	12.0	10.0
Current account balance (EUR million)	-1,988	-2,644	-1,491	-2,042	-1,358	2,097
Current account balance (% of GDP)	-6.4	-7.7	-	-	-	-
Gross foreign direct investment (EUR million)	1,468	2,747	933	1,340	1,002	374
Foreign exchange reserves (EUR million, eop)	7,438	8,725	8,725	9,520	9,170	8,795
Foreign debt (EUR million, eop)	25,748	29,200	29,200	29,976	30,818	30,806
GOVERNMENT FINANCE*						
Revenue (HRK million)**	92,643	100,393	100,393	24,768	53,686	83,934
Expense (HRK million)**	92,332	98,751	98,751	25,361	50,680	78,168
Net = Gross operating balance (HRK million)**	310	1,641	1,641	-593	3,006	5,767
Net acquisition of non-financial assets (HRK million)**	6,699	6,109	6,109	911	2,446	4,961
Net lending/borrowing (HRK million)**	-6,389	-4,467	-4,467	-1,504	560	805
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-7,711	-6,392	-6,392	-	-245	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-3.4	-2.6	-	-	-	-
Domestic government debt (EUR million, eop)	7,461	8,132	8,132	8,438	8,549	8,843
Foreign government debt (EUR million, eop)	7,019	6,645	6,645	6,495	6,746	6,506
Total government debt (% of GDP)	46.2	43.3	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	12.3	25.0	25.0	22.4	22.1	13.3
Broad money, M4 (% change, yoy, eop)	10.5	18.0	18.0	20.5	19.2	11.9
Total domestic credit (% change, yoy, eop)	17.2	22.9	22.9	22.4	21.2	17.4
DMBs credit to households (% change, yoy, eop)	20.3	21.8	21.8	23.6	21.1	19.5
DMBs credit to enterprises (% change, yoy, eop)	16.3	26.1	26.1	24.1	23.1	16.2
Money market interest rate (% pa)	2.3	1.6	1.8	2.2	4.1	3.9
DMBs credit rate for enterprises, short-term, (% pa)	8.1	7.1	6.8	6.9	6.9	7.0
DMBs credit rate for households, short-term (% pa)	13.1	12.1	11.9	12.1	12.3	12.2

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.

Moderation of industrial activity; rebound in construction activity.

Following a strong 8-percent rise in the first six months of 2007 on a year-on-year basis, industrial activity moderated in the third quarter, with a 4.5 percent increase. Although the moderation continued into the fourth quarter, a cumulative year-on-year increase for the first eleven months of 2007 amounted to 5.9 percent, while the positive trend has been retained. At the same time, the volume of retail trade expanded strongly during the summer months. In the year up to November, it grew by 5.8 percent in real terms. Besides a growing consumption of foreign tourists (a 5 percent increase in the number of tourist overnight stays), retail sales were supported by strong motor vehicles sales. In 2007, the number of new registered vehicles increased by 5 percent. Construction activity rebounded since the end of the first half of 2007, allowing for a cumulative ten-month growth to reach 2.7 percent year-on-year.

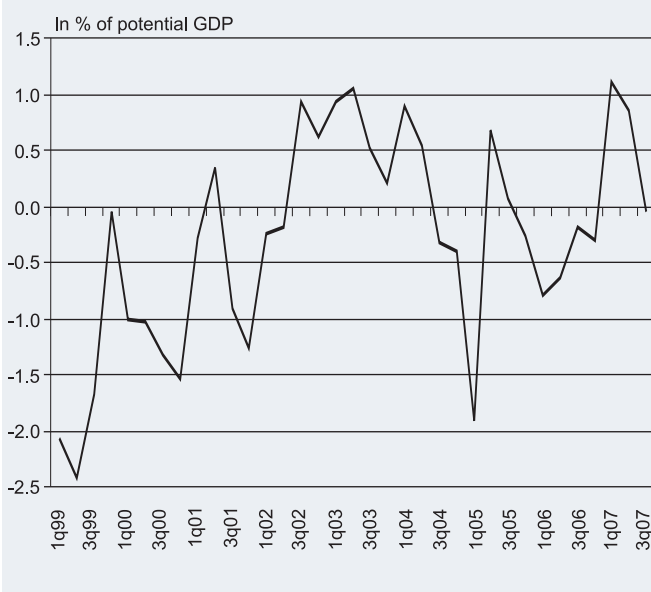
Employment increased, unemployment decreased, while wage growth continues.

The total number of employed persons decreased by 1.3 percent from August to November 2007, entirely due to seasonal factors. Nevertheless, positive dynamics over previous year's figures remained since employment increased by 1.2 percent in the January-November period. These encouraging employment trends are confirmed by the Croatian Pension Insurance Agency, recording a 2.7 percent increase in the number of insured persons in June 2007 compared to the same month year before. In line with a seasonal employment squeeze, unemployment started to increase in August. In November 2007, the total number of unemployed was 4.3 percent higher than in August. However, the number of registered unemployed persons in the January-November 2007 period was 9 percent lower than in the same period 2006. The registered unemployment rate amounted to 14.5 percent in November, which is 2 percentage points lower than in the same month previous year. The survey-based unemployment rate (ILO-standards) decreased from 11.8 percent in the first half of 2006 to an average of 10.2 percent in the first half of 2007. As for the wage developments, the nominal wage was 7.6 percent higher in October 2007 than in the same month year before, while the real wage growth amounted to 3.2 percent.

Slowdown of broad money growth.

In the third quarter of 2007, monetary and credit aggregates witnessed a much slower growth than in the first half of the year. Such developments are in line with both the slowdown in real economic activity and more rigid central bank's measures for curbing credit activity. Thus, according to seasonally adjusted figures for the third quarter, broad

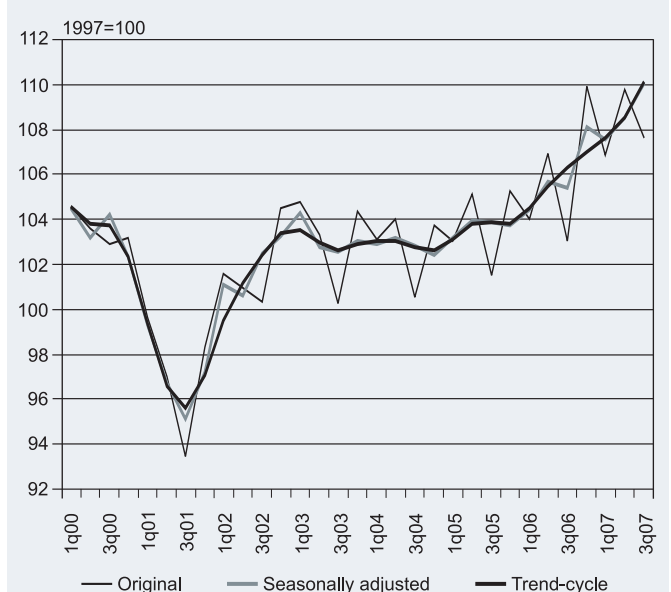
Figure 2 GDP GAP



Note: GDP gap is defined as actual minus potential GDP; potential GDP is calculated using HP filter with $\lambda=300$.

Source for original data: Central Bureau of Statistics.

Figure 3 GOVERNMENT CONSUMPTION



Source for original data: Central Bureau of Statistics.

money actually shrank by 0.8 percent quarter-on-quarter, which is the first negative rate since 1999. The contraction occurred since households withdrew cash and kuna savings in order to participate in the IPO of the Croatian Telecom stocks. After the stocks were listed, excess funds were redeposited, causing narrow money and kuna savings deposits to bounce back in October and November. At the same time, the increase in foreign exchange deposits accelerated compared to the first half of 2007. Consequently, the November broad money growth rate stood at 15.6 percent year-on-year, still considerably below the rates recorded in the first half of 2007.

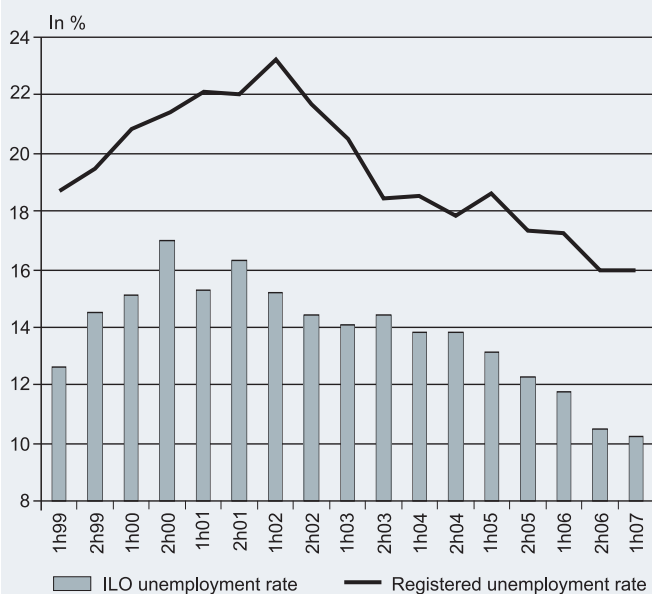
Deceleration of credit activity, especially of credits to enterprises.

Credit aggregates data available up to November 2007 suggest that a boom in credit activity is gradually coming down. In November, credits to enterprises grew by 12.5 percent on a year-on-year basis, while the average rate stood at 24 percent in the first half of the year. On the other hand, credits to households expanded by 18.3 percent, which is 4.5 percentage points lower than the average rate recorded in the first half of 2007. When one observes the rising level of enterprise foreign debt, the reason for such a disparity becomes clear. Namely, banks are redirecting the credit demand of corporate clients to their parent banks abroad, hence leaving more credit funds for households. The deceleration of credit activity is also evident in housing credits. Its annual growth rate in November stood at 23 percent, 8.9 percentage points lower than the average rate recorded in the first half of 2007. It also must be noted that in the third quarter of 2007 the trend of falling interest rates for long-term loans has reversed after seven years, meaning that the central bank's measures have affected not only the quantity, but also the price of loans.

Pressures on the money market due to cancellation of repo auctions.

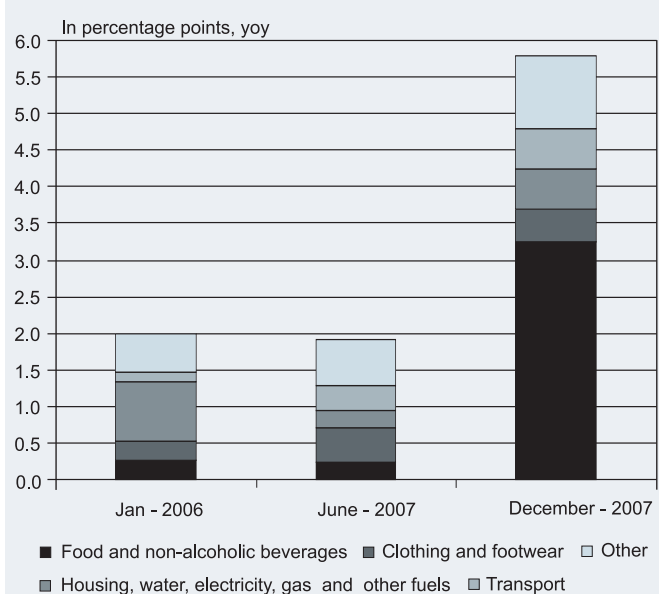
Turning to money market developments, the last quarter of 2007 brought the continuation of strong liquidity pressures recorded in September, when the final stages of preparation for the IPO of the Croatian Telecom stocks were underway. The pressures occurred because the central bank unexpectedly cancelled three repo auctions during October and November, claiming that banks were using funds from repo auctions for sustaining credit activity and subsidizing interest rates. Despite the fact that in nominal terms liquidity improved after the listing of the Telecom stocks in early October, the imbalance on money market caused the overnight interest rate to rise to an average of 6.5 percent, reaching even 12 percent at one point. The situation somewhat improved during the second half of November and early December since the central bank resumed with repo auctions.

Figure 4 UNEMPLOYMENT RATE



Source: Central Bureau of Statistics.

Figure 5 CONTRIBUTIONS TO CONSUMER PRICE INFLATION

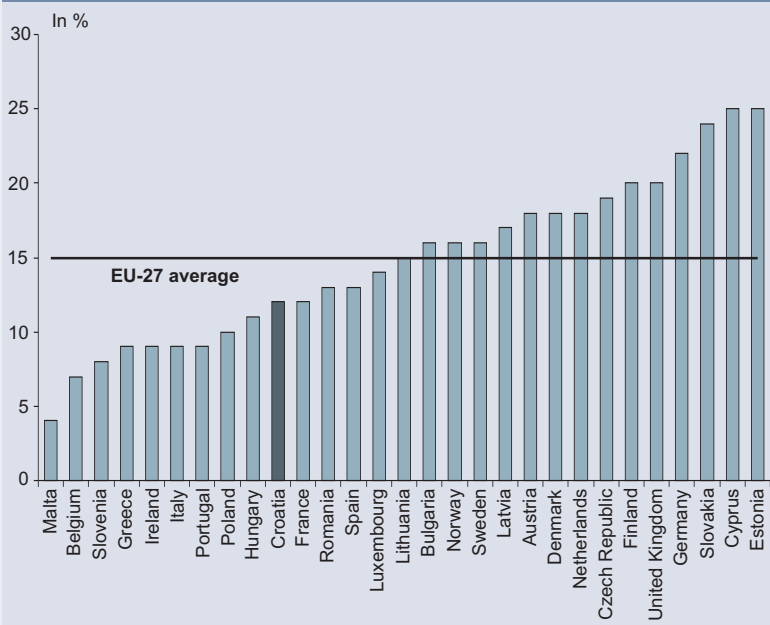


Source for original data: Central Bureau of Statistics.

Box 1 GENDER WAGE GAP IN CROATIA

One of the most challenging fields for attaining equal treatment between women and men is the labor market. In almost every country, women earn less than men. Croatia is no exception in this respect. Employed women in Croatia earn on average 12 percent less than men. One might think that women have poorer education and less labor market experience than men and that productivity gains, due to these attributes, could explain much of the observed gender wage gap. Yet, the situation in Croatia is exactly the opposite. Employed women possess sizable educational advantages over men but they face much lower rewards to their education and other human capital characteristics and consequently receive much lower wages. This is the major finding presented in the paper "Differing Characteristics or Differing Rewards? What is behind the Gender Wage Gap in Croatia" by Danijel Nestić (2007, EIZ Working Paper, No. 0704, available at www.eizg.hr).

Figure B1 GENDER WAGE GAP IN EUROPE, 2005



Note: The gender wage gap is a difference between average gross hourly earnings of male and female paid employees expressed as a percentage of average gross hourly earnings of male paid employees.

Sources: Eurostat and Nestić (2007) for Croatia.

The paper further explores the gender wage gap by using a relatively novel quantile regression technique in order to estimate the wage gap at various points of distribution. The gender wage gap adjusted for the labor market characteristics is found to be relatively mild at the lower part of the wage distribution, i.e. for low-paid jobs, while it gets larger as one moves towards the top of the distribution, i.e. as one approaches well-paid jobs. This finding indicates the possible presence of a glass-ceiling in Croatia. The analysis also suggests that the gender wage gap has increased between 1998 and 2005. When controlled for the major occupation categories, the gender wage gap decreases to some extent, suggesting that occupational segregation could help explain part of the gap in Croatia.

Regression estimates stratified by gender suggest that returns to education and experience are markedly different for men and women. Women face much lower returns and this kind of disparity is getting higher at the upper parts of the wage distribution. It is found that the gap is around 20 percent on average

due to differing returns. This is probably the best measure of women's disadvantaged status in the labor market since it is conditioned on exactly the same characteristics for men and women.

The paper also looks at the impact of children on the wage prospects of their mothers. It finds that at the top of the wage distribution in the private sector mothers earn much less than men. Their wages are also significantly lower than those of women without children. In the public sector, there is no evidence of a different wage treatment between mothers and non-mothers, while the overall gender wage gap is much lower than in the private sector.

Appreciation pressures.

Due to the strong demand of commercial banks for foreign currency, the HRK/EUR exchange rate depreciated 0.9 percent in monthly terms in October 2007 to reach 7.35. Throughout the rest of the year, the money market crunch and strong kuna demand created appreciation pressures, eased by the December central bank's intervention in the amount of EUR 168 million, allowing the exchange rate to reach the level of 7.31 kuna for euro at the end of 2007.

Strong rise in foreign debt of the enterprise sector.

After reaching its highest level of more than EUR 30.9 billion in July 2007, foreign debt stood at EUR 30.8 billion at the end of September. When compared to the end of 2006, an increase of EUR 1.6 billion is attributable mainly to the enterprise sector. Up to September, the Croatian enterprises borrowed EUR 2.8 billion, which was partly offset by a EUR 1.8 billion decrease of the banking sector debt.

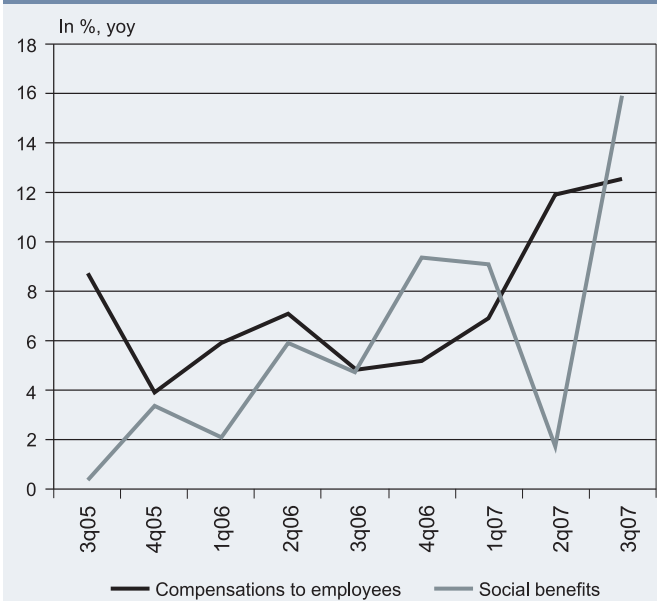
Higher inflation.

After subdued inflation in the first half of 2007, the third and especially the fourth quarter exhibited price increases. Apart from the pass-through of globally rising oil and food prices into domestic inflation, local factors have become increasingly important in the most recent months. Namely, food prices have risen faster than in the EU in spite of a stable exchange rate. Combined with seasonal factors and the fact that due to parliamentary elections in November Croatia was practically without the government up to mid-January, all these factors seem to have contributed to domestic inflation developments. In the situation of rather weak competition in many markets, players with stronger market power, especially those on the food market, have decided to go up with prices without the fear of any reaction by policy-makers. Smaller players have followed. Consequently, consumer prices recorded a strong month-on-month increase at the end of the year, namely 1 percent in November and 1.2 percent in December. The year-on-year growth in consumer prices in December amounted to 5.8 percent, with the prices of food, alcoholic and non-alcoholic beverages, and tobacco being the major contributors to the rise. While the annual average inflation rates of consumer and producer prices for 2007 seem quite moderate (2.9 and 3.4 percent, respectively), due to the fact that inflationary pressures have only appeared in the second half of the year, one must remember that these pressures will pass into 2008, augmented by the announced rise of administratively regulated prices. Data on core inflation also suggest increasing pressures in the second half of 2007. In November, core inflation was 4.0 percent year-on-year, while on a month-on-month basis it reached 0.8 percent, exhibiting the highest monthly increase in seven years.

Rising concerns over government spending.

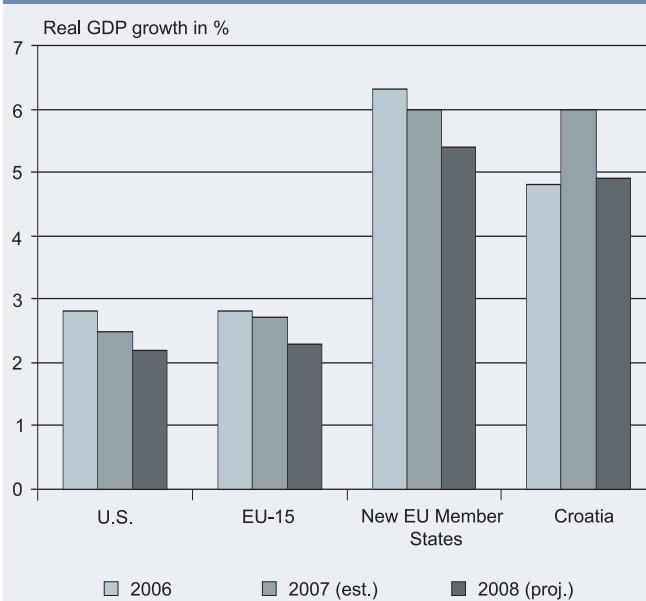
The most striking feature of recent fiscal developments was an upsurge of government revenues, which enabled the Government to neutralize the fiscal implications of very high expenditures at the end of last year. After a 13.1-percent increase in the first half of the year, general government revenues continued to grow even more rapidly in the third quarter, i.e.

Figure 6 CONSOLIDATED GENERAL GOVERNMENT



Source: Ministry of Finance.

Figure 7 WORLD ECONOMY AND CROATIA



Sources: UN/DESA, Project LINK and authors' estimate.

at a rate of 15.4 percent year-on-year. The main contributors to such a favorable revenue collection in the third quarter were VAT revenues (rising 7.6 percent), profit tax revenues (36.3 percent), and social security contributions (11.4 percent). According to the usual government behavior in Croatia, the windfall gains were immediately spent - expenditures increased 15.1 percent in the third quarter, and consequently general government expenditures reached HRK 85 billion at the end of September 2007. The expenditure items which benefited mostly from such developments were social security benefits (rising 18.2 percent in the third quarter), compensation of employees (12.5 percent), and expenditures for the use of goods and services (20.6 percent). In spite of high spending in the second half of the year, it can be assumed that the strong revenues, resulting from generally favorable economic conditions, could help keep the budget close to balance.

No signs of slowdown in public debt dynamics.

Public debt rose by additional 3 percent during the first three quarters of 2007, reaching a level of HRK 111.8 billion at the end of September (without state guarantees). This HRK 3.2 billion increase in the first nine months of 2007 is almost twice as large as the total debt increment in 2006. Due to the orientation of borrowing predominantly on the domestic market, the share of domestic debt reached almost 58 percent at the end of September. For the sake of comparison, the same figure amounted to 55 percent at the end of 2006. The 7.8-percent growth in the domestic public debt in the first nine months stems mostly from credits from domestic banks. Foreign public debt decreased, although at a slower rate than in 2006. State guarantees, being characterized as contingent liability, reached HRK 15.2 billion, their highest level since April 2004.

Latest fiscal projections even more optimistic.

In November 2007, the Ministry of Finance adopted the Pre-accession Economic Program (PEP) for 2008-2010. The document did not incorporate any change concerning the main direction of fiscal policymaking – a strong commitment to the reduction of fiscal imbalance and public debt in the next three years remained the main pillar of the fiscal policy. However, the Ministry of Finance has optimistically revised its fiscal projections compared to last year's PEP - the level of general government net borrowing in 2008 is planned to decline from 1.7 to 1.5 percent of GDP, while the share of public debt in GDP is projected to decrease from 44.8 to 42.7 percent.

2 Policy Assumptions and Projections Summary

Global growth still robust but moderating,...

After several years of robust growth, the world economy is facing some serious challenges. The financial market turmoil in the U.S., depreciation of the US\$ vs. other major currencies, large global imbalances, and high oil prices threaten the sustainability of global economic growth in the upcoming years. Due to continued strong growth in the emerging markets led primarily by China, the world economic activity remains resilient but is gradually moderating compared to the conditions present in the past several years.

... while inflation pressures rise due to higher food and oil prices.

Eurostat's first quarter-on-quarter estimate of euro area GDP growth shows that in the third quarter of 2007 it reached 0.7 percent, after 0.3 percent in the second and 0.7 percent in the first quarter. Overall, the fundamentals of the euro area remain sound, profitability has been sustained, employment growth robust, and the unemployment rate lower than in the past 25 years. GDP growth in 2007 is estimated to have been between 2.4 and 2.8 percent, while in 2008 it is projected between 1.5 and 2.5 percent (*ECB Monthly Bulletin*, December 2007). The moderation of growth is expected to stem mainly from weaker business and private investments due to the tightening of financial and housing market. In December 2007, the annual inflation rate in the euro area stood at 3.1 percent, well above the 2-percent target of the ECB, with inflation pressures coming mainly from

the energy and food sector. After reaching the 2007 trading record of US\$ 99.29 per barrel on November 21, crude oil prices hit a new record high of US\$ 100 on January 2-3, 2008, or some 60 percent more than twelve months before. In the following weeks, prices reversed towards the US\$ 90 level, but analysts expect rising demand and geopolitical instability to keep upward pressures on energy costs.

International environment less favorable; uncertainties regarding fiscal plans.

Projection assumptions related to the international environment reflect the fact that at the beginning of 2008 impulses from abroad are less favorable for the Croatian economy than before. The overall effects of the financial market turmoil are still not fully comprehensible, while the global economy shows the signs of slowdown which might have a negative impact on the Croatian foreign trade and output growth. In addition, oil prices remain at elevated levels and, together with globally high food prices, spill over on the domestic market. On the internal front, the new government is expected to continue with the economic policy outlined in the strategic documents during the previous mandate. However, since it is a coalition government, one might anticipate that certain decisions, especially those related to unpopular structural reforms, would ask for more political effort, compromises, and time. In some respects, the parties forming the new government have rather different goals, which would probably be mirrored in the fiscal policy that might become more expansionary than envisioned earlier. As the 2008 budget has not been passed, we rely in our projections on earlier fiscal plans that have been reaffirmed in the coalition agreement. In addition, we believe that the central bank's measures for curbing credit activity are to remain in place during 2008 and that monetary authorities will make every effort in pursuing their main goal of price stability.

GDP growth expected to amount to 4.9 percent in 2008...

The Croatian economy has been gradually slowing down, and this trend is expected to continue in 2008. Nevertheless, the second half of the year should bring the strengthening of positive trends, especially those related to investment and export performance. We estimate that 2007 has ended with a GDP increase of 6 percent, while 2008 should bring a 4.9 percent GDP rise.

... strongly underpinned by personal consumption.

Personal consumption should continue to strongly underpin the overall growth. It is being estimated that in 2007 it grew by 6 percent. In the first half of 2008, inflation might have a negative effect on the real value of household income and reduce consumer expectations as well as their consumption. However, personal consumption has proven to be quite resilient to short-term income fluctuations. Therefore, we expect it to remain relatively strong in 2008 and increase by 4.9 percent in line with the expected GDP rise. Following the spring 2007 stagnation, investments started to regain some strength in the second half of the year, and we anticipate these trends to continue during 2008. Due to a notable rise in investments in the first quarter, the whole 2007 might end up with the annual investment increase of 6.8 percent, while in 2008 this rise could reach 6.4 percent. The optimistic investment expectations are based on a solid dynamics of business activity accompanied by a positive outlook related to the EU accession and an ambitious plan of government investments. Household investment might experience stronger volatility, but it should nevertheless be characterized by generally positive trends.

Current account deficit projected at 7.9 percent of GDP in 2008.

In the near future, we expect a gradual acceleration of export growth, due to both rise in exports to the emerging markets in South-Eastern Europe and increasing service exports, in particular revenues from the international tourism. Imports growth is strongly correlated with the rise in the overall economic activity, and therefore it might slightly slow down in 2008 compared to the year before. The volume of total exports rise in 2007 is estimated to have reached 6.7 percent, while the forecast for 2008 points to a 6.9 percent increase. As for imports, we expect that the year 2007 closed up with a 6.4 percent rise, while in 2008 we forecast a 6.0 percent increase. Imports rise in 2007 was somewhat stronger than

expected, which caused the estimate for the current account deficit to be revised upwards to 8.2 percent of GDP. In this year, a slowdown of overall growth, and consequently somewhat slower imports growth, in addition to a solid rise in exports, should help reduce the deficit to 7.9 percent of GDP. However, a relatively high current account deficit will contribute to a further rise in foreign debt, from 86.2 percent of GDP in 2007 to about 87 percent in 2008.

Unemployment rate should continue to decline.

Solid economic growth has been reflected for some time in the labor market developments. According to our estimates, last year brought a drop in jobless claims of approximately 25 thousand or 8.5 percent. It is the biggest drop in recent history, except the year 2003, when the decline was more a result of administrative factors than the underlying economic forces. Likewise, there was an increase in total employment estimated at 1.2 percent for 2007 as a whole, although revisions in the officially published employment series might show even a stronger employment expansion. The registered unemployment rate is estimated at 15.2 percent for 2007. This year should bring further improvements on the labor market – shrinkage in the number of unemployed, increase in the number of employed, and a lower registered unemployment rate of around 14.3 percent.

Real income growth moderation due to rising inflation.

An increase in the gross average wage in 2007 is estimated at 6.4 percent, which is only marginally above the rise registered in 2006. In 2008, we expect a moderate speeding up of wage growth led by a productivity growth in the private sector and a wage rise set by collective agreements in the public sector. Partially, the wage growth will be underpinned by pressures due to the rising inflation. We do not expect a synchronized wave of wage increases, but a surge in the costs of living will surely be considered in parts of new wage agreements. The overall rise in the household disposable income is expected to be somewhat lower than in 2007. As inflation will partially reduce the purchasing power of incomes in 2008, their support for personal consumption will be weaker than the year before.

Inflation forecast revised upwards.

The year 2008 has started with a wave of price increases. However, it is more disturbing that the new year brought rising inflation expectations. Apart from a spillover of globally rising oil and food prices into domestic inflation and an increase in utility prices in Zagreb, the price increases of electricity, gas, and other fuels have already been announced. A similar situation is found on other markets, where agents are repeatedly complaining about the rising costs. Even the issue of wage indexation has been opened by trade unions. It is

Table 2 SUMMARY OF PROJECTIONS

	2007 estimate	2008 projection
Real GDP (% change)	6.0	4.9
Real private consumption (% change)	6.0	4.9
Real government consumption (% change)	3.0	1.7
Real investment (% change)	6.8	6.4
Exports of goods and services (constant prices, % change)	6.7	6.9
Imports of goods and services (constant prices, % change)	6.4	6.0
Current account balance (% of GDP)	-8.2	-7.9
Consumer prices (% change, pa)	2.9 ^a	5.1
Exchange rate, HRK/EUR (pa)	7.34 ^a	7.34
Unemployment rate, HRK/EUR (pa)	15.2	14.3
General government balance – GFS 1986 (% of GDP)	-2.6	-2.6
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 January 15, 2008.

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

Source: Authors' projections.

obvious that inflation expectations will be transferred into actual inflation, at least partially. Hence, we have substantially revised our inflation forecast upward to 5.1 percent on average for 2008. In the first half of the year, inflation is expected to remain at relatively high levels, while policy-makers should succeed in calming down inflation expectations and establish sound policies to bring inflation under control by reducing it below 4 percent by the end of 2008.

Further deceleration of credit activity expected.

Following 2007, in which the central bank succeeded in decelerating credit activity with the main aim of reducing the country's external vulnerability, we expect these trends to continue in 2008. In addition, recent inflationary trends ask for a more restrictive monetary policy that should be reflected in a decline of M4 growth rate, from the estimated 17 percent for 2007 to 11 percent in 2008. Credit activity is projected to decelerate from 14 percent in 2007 to the central bank's target of 12 percent in 2008. Moreover, since interest rates for long-term loans are below the EU average, one could expect their rise, which could dampen down the economy but might help curb credit activity.

Deficit ratio in 2008 to stay at 2.6 percent.

After the encouraging figures for the first half of 2007, fiscal data for the third quarter revealed the beginning of a more troublesome period. Luckily, stronger budget revenues have - most likely - enabled the general government deficit to reach the planned level of 2.6 percent of GDP in 2007. The 2008 budget plan is expected to be adopted soon. The previous government planned a state budget increase of 3.8 percent for 2008 (according to the GFS 1986 methodology). Some deceleration in revenue collection could be expected in 2008, although positive trends should continue. At the same time, we expect a further acceleration in expenditures. Regarding the level of general government deficit, the Ministry of Finance forecasts its further reduction to 2.3 percent of GDP in 2008. We are confident that this goal should generally not be perceived as too ambitious, but we anticipate that the new coalition government will not have a sufficiently high resistance to the expenditure rise. Therefore, we expect the general government deficit ratio in 2008 to stay at the same level as in 2007.

3 Uncertainties and Risks to Projections

How efficient will the new coalition government be?

As mentioned above, we do not expect significant changes in the economic policy of the new government. However, since this is a coalition government, its efficiency is yet to be seen, particularly in the fields of agriculture, fisheries, decentralization, and regional policy, which are regarded crucial to certain coalition partners.

Increasing inflationary expectations...

Rising inflationary expectations are particularly dangerous for the emerging markets, characterized by relatively weak competition, since they can lead to price increases well above cost rises. Some have already argued in favor of wage indexation, which might lead to a wage-price spiral. Only responsible economic policy focused on dampening inflationary expectations, non-acceptance of wage indexation and the strengthening of competition, in addition to a responsible monetary policy, can keep inflation within reasonable bounds. If mistakes are made in this area, inflation might rise to the levels that would substantially harm the economy.

... pose concerns for the overall economy.

Under the impression of rising inflation, consumers might restrain from stronger consumption, which would negatively affect the personal consumption performance, especially if combined with the expected increase in interest rates and a further credit activity deceleration. Likewise, as the economic growth decelerates and inflation threats rise, some revisions of the financial plans in the enterprise sector might occur, which would result

Many fiscal challenges ahead.

in a stronger output deceleration. Consequently, lending might not be as soft as expected. Downside risks for the economic growth are now stronger than the upside ones.

We expect the Government to be faced with many fiscal challenges in 2008. If recent expenditure developments continue, which is reasonable to expect, it would unavoidably impair the fiscal position. So far, the Government has used higher revenues very short-sightedly, just as a justification for higher spending, thus contributing to the net dissaving of the economy. Such a pattern should be modified even if the economic environment remains beneficial. Around three quarters of the state budget are allocated for wages, social expenditures, and interest payments, i.e. budgetary items which are sensitive to price changes. In addition, the expected overall rise in government expenditures, due to the new installments of pensioners' debt repayment, an increase in pensions for those retired after 1998, rise in government employees' salaries, unemployment benefits, and maternity leave compensations, increases the risks related to the soundness and sustainability of fiscal policy. Therefore, it becomes obvious that the planned 3.8-percent increase of state budget revenues could not be enough to encompass all the expected expenditure increases.

Will the global financial turmoil affect the Croatian economy?

The financial turmoil related to the crisis on the U.S. subprime mortgage market is continuing to shake the global financial markets. It is still not clear how long the crisis will continue and who else will be affected. This uncertainty has caused a liquidity crunch and interest rate hike. Besides the fact that the crisis could affect the 2008 growth figures for the U.S. and EU economies, it has also placed their central banks in an awkward situation since the liquidity crunch is calling for an interest rate cut, while mounting inflation pressures demand an interest rate rise. So far, the Federal Reserve seems to have opted for a further, moderate interest rate cut, while the ECB keeps its referent rate unchanged due to concerns about inflationary pressures. The Central and Eastern European economies, including Croatia, have remained unaffected by the turmoil due to a strong economic performance and financial systems that are not sufficiently integrated into the global financial markets. However, since these economies heavily rely on external financing, the current liquidity crunch or global interest rates upswing could increase the cost of borrowing for households and enterprises, and consequently cool off the economies driven by domestic demand.

IMPRESSUM

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