

# Croatian Economic Outlook

Quarterly

## 1 Recent Developments

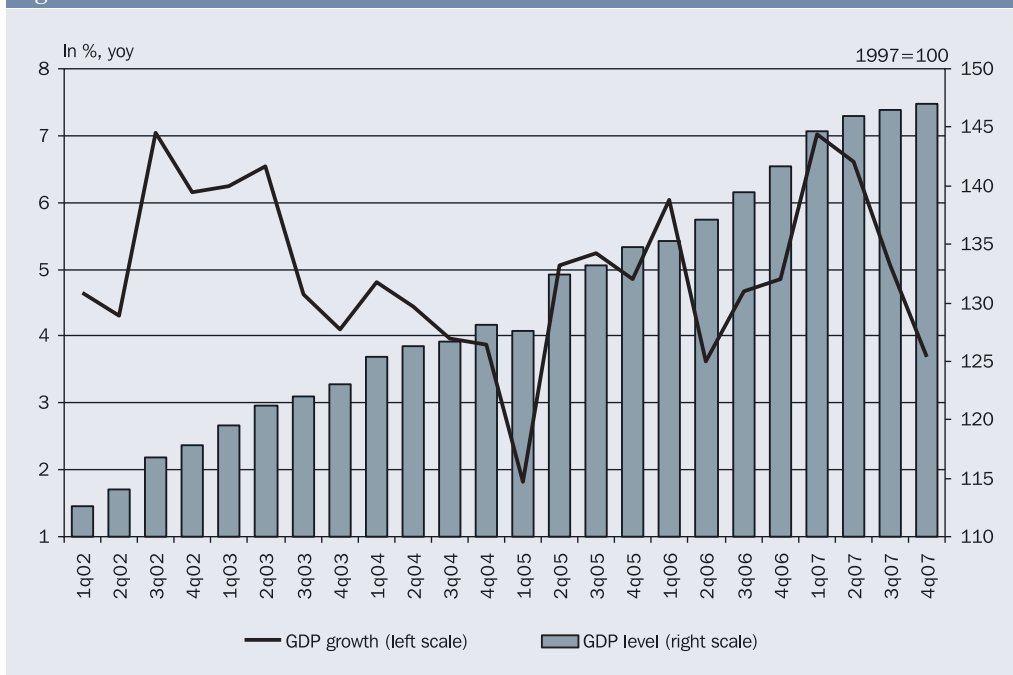
**Economic slowdown continued at the end of 2007; positive signals emerge in 2008.**

Croatian economy continued to slow down in the fourth quarter of 2007. According to the seasonally adjusted figures, GDP growth amounted to 3.7 percent over the same period previous year and to 1 percent over the preceding quarter. Due to exceptionally strong GDP growth at the beginning of 2007, the year ended with its increase of 5.6 percent. The largest contribution to GDP growth came from personal consumption and investments that rose by 6.2 and 6.5 percent, respectively. Total exports and imports went up by 5.7 and 5.8 percent, resulting in a substantial external deficit due to a higher volume of imports. At the beginning of this year, high-frequency indicators on the volume of industrial production and retail trade suggested a clear upward path, thus sending rather positive signals about the state of the economy. Furthermore, construction has been experiencing strong acceleration since mid-last year. The recent upward revision of the 2007 employment figures also reflects positive trends, suggesting that economic deceleration could end soon. Consequently, assuming the absence of negative external shocks, we expect this year to be marked by firm growth.

**Moderation of personal consumption.**

Although it remained strong, personal consumption moderated in line with the overall economic performance by receding from 7.1 percent observed in the first quarter of 2007

Figure 1 REAL GROSS DOMESTIC PRODUCT



Source for original data: Central Bureau of Statistics.

to 5.0 percent year-on-year in the fourth quarter. In 2007 as a whole, it increased by 6.2 percent. Substantial employment growth accompanied by a moderate rise in the average wage helped to increase the total wage bill by around 10 percent in nominal terms, which is substantially higher than in 2006, supporting further expansion of personal consumption. Relatively abundant state transfers to population, particularly several scheduled "pensioners' debt" payments, also contributed to the strong rise in personal consumption last year. However, better balancing between more stringent economic and financial conditions and the high aspirations of population has curbed the expansion observed in the first quarter of 2007. The growth deceleration in the fourth quarter was highlighted by an increasing inflation that suspended a rise in real disposable income.

***Government consumption expanded robustly.***

Government consumption remained robust in the fourth quarter of 2007 amounting to a 3.7-percent increase over the same quarter previous year. For 2007 as a whole, it rose by 3.4 percent, the highest rate since 2002. The speeding up of government consumption actually began in early 2006, which can be related to the increased demand for government services by businesses and population as approaching a higher development level. However, it was also strongly determined by a need for adjustment with the EU legislation in numerous areas, which required an additional effort by the public administration. The start of an increasing trend in government consumption in fact coincided with the opening of accession negotiations in October 2005. Finally, the rise in 2007 could also be related to the usual expansion in government consumption in an election year.

***Investment pace gradually improved.***

Following a certain setback in investments in the second quarter of 2007, the remaining part of the year brought a gradual revival which can be clearly observed in the quarter-to-quarter figures adjusted for seasonal and irregular fluctuations. The fourth quarter investments were 2 percent above the previous quarter, following a 0.4 increase observed in the third quarter. However, unadjusted year-on-year figures still not reveal such a positive trend. Investments grew 4.0 percent in the fourth quarter, as compared to 5.7 percent in the third quarter. In 2007 as a whole, investments increased by 6.5 percent.

***Mixed signals from external trade...***

The volume of exports of goods and services, as recorded in the national accounts statistics, exhibited the signs of easing at the end of 2007 with a low 2.1-percent year-on-year increase in the fourth quarter. At the same time, the volume of total imports continued to expand by around 6 percent year-on-year, which is slightly lower than in the third quarter, but seasonally adjusted data suggest that its dynamics in the second half of 2007 remained unchanged. It is quite unusual that such different signals come from exports and imports. Most often, both sides of external trade in Croatia exhibit ups and downs at roughly the same time. We believe that a decline in exports at the end of last year was a result of irregular seasonal oscillations which will not be sustained. Monthly figures on merchandise foreign trade already support such expectations by indicating a robust rise in merchandise exports in the first two months of 2008. Similar positive trends can be observed in the number of arrivals and overnight stays by foreign tourists in Croatia at the beginning of this year. In addition, merchandise imports are also on the rise, confirming a lively economic activity at the beginning of this year.

***... with a further rise in trade and current account deficit.***

As for 2007 as a whole, merchandise trade statistics indicate that goods exports, in current kuna terms, expanded 9.2 percent compared to the previous year, while goods imports experienced a 10.3 percent increase, which represents a 3 percentage point weaker imports growth than in 2006. The trade deficit continued to widen, climbing to EUR 9.8 billion from EUR 8.8 billion in 2006. As for the current account deficit, it amounted to EUR 3.2 billion or 8.6 percent of GDP in 2007, while in 2006 its share was 7.9 percent.

Table 1 MAIN ECONOMIC INDICATORS

	2006	2007	2007			
			Q1	Q2	Q3	Q4
<b>ECONOMIC ACTIVITY</b>						
Real GDP (% change, yoy)	4.8	5.6	7.0	6.6	5.1	3.7
Real private consumption (% change, yoy)	3.5	6.2	7.1	6.5	6.2	5.0
Real government consumption (% change, yoy)	2.2	3.4	2.8	2.7	4.4	3.7
Real investment (% change, yoy)	10.9	6.5	11.2	5.8	5.7	4.0
Industrial output (% change, yoy)	4.5	5.6	8.0	7.1	4.5	3.1
Unemployment rate (registered, %, pa)	16.6	14.9	16.7	14.8	13.7	14.2
Nominal GDP (EUR million)	34,220	37,497	-	-	-	-
GDP per capita (EUR)	7,706	8,445	-	-	-	-
<b>PRICES, WAGES AND EXCHANGE RATES</b>						
Implicit GDP deflator (% change, yoy)	3.4	4.0	3.1	3.7	4.0	5.1
Consumer prices (% change, yoy, pa)	3.2	2.9	1.6	2.1	2.9	4.9
Producer prices (% change, yoy, pa)	2.9	3.4	2.0	2.5	3.7	5.4
Average gross wage (% change, yoy, pa)	6.2	6.2	6.2	5.7	6.6	6.4
Exchange rate, HRK/EUR (pa)	7.32	7.34	7.36	7.35	7.31	7.33
Exchange rate, HRK/US\$ (pa)	5.84	5.37	5.62	5.46	5.32	5.06
<b>FOREIGN TRADE AND CAPITAL FLOWS</b>						
Exports of goods (EUR million)	8,464	9,193	2,046	2,309	2,361	2,477
Exports of goods (EUR, % change, yoy)	17.2	8.6	1.9	16.8	12.4	4.1
Imports of goods (EUR million)	16,808	18,627	4,206	4,837	4,671	4,913
Imports of goods (EUR, % change, yoy)	14.0	10.8	8.8	12.0	10.2	12.0
Current account balance (EUR million)	-2,692	-3,206	-2,021	-1,381	2,087	-1,892
Current account balance (% of GDP)	-7.9	-8.6	-	-	-	-
Gross foreign direct investment (EUR million)	2,738	3,626	1,361	1,015	534	717
Foreign exchange reserves (EUR million, eop)	8,725	9,307	9,520	9,170	8,795	9,307
Foreign debt (EUR million, eop)	29,274	32,929	30,149	31,058	31,227	32,929
<b>GOVERNMENT FINANCE*</b>						
Revenue (HRK million)**	100,393	-	24,768	53,686	83,934	-
Expense (HRK million)**	98,751	-	25,361	50,680	78,168	-
Net = Gross operating balance (HRK million)**	1,641	-	-593	3,006	5,767	-
Net acquisition of non-financial assets (HRK million)**	6,109	-	911	2,446	4,961	-
Net lending/borrowing (HRK million)**	-4,467	-	-1,504	560	805	-
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-6,392	-	-	-245	-	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-2.6	-	-	-	-	-
Domestic government debt (EUR million, eop)	8,132	8,629	8,438	8,549	8,856	8,629
Foreign government debt (EUR million, eop)	6,649	6,634	6,498	6,757	6,512	6,634
Total government debt (% of GDP)	43.3	40.6	-	-	-	-
<b>MONETARY INDICATORS</b>						
Narrow money, M1 (% change, yoy, eop)	25.0	19.3	22.4	22.1	13.3	19.3
Broad money, M4 (% change, yoy, eop)	18.0	18.3	20.5	19.2	11.9	18.3
Total domestic credit (% change, yoy, eop)	22.9	15.0	22.4	21.2	17.4	15.0
DMBs credit to households (% change, yoy, eop)	21.8	18.0	23.6	21.1	19.5	18.0
DMBs credit to enterprises (% change, yoy, eop)	26.1	10.2	24.1	23.1	16.2	10.2
Money market interest rate (% pa)	1.6	4.1	2.2	4.1	3.9	6.0
DMBs credit rate for enterprises, short-term, (% pa)	7.1	7.0	6.9	6.9	7.0	7.3
DMBs credit rate for households, short-term (% pa)	12.1	12.1	12.1	12.3	12.2	11.8

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\$ - US dollar, DMB - deposit money bank.

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

**Foreign debt increase generated by enterprise sector.**

By the end of 2007, foreign debt reached EUR 32.9 billion or 87.8 percent of GDP. An increase of EUR 3.7 billion with respect to the end of 2006 is attributable to the growth of enterprise sector foreign debt by EUR 3.9 billion. This growth was particularly pronounced in the second half of 2007. Such developments are due to the fact that domestic banks redirect their corporate clients to borrow directly from their parent banks abroad, thus avoiding the central bank's measures for curbing credit activity. Consequently, banking sector, the main driver of foreign debt in the recent past, reduced its contribution to the foreign debt by EUR 1.3 billion.

**Employment growth continued in 2007...**

In 2007, total employment increased by 3.3 percent on an annual basis according to the revised CBS data, suggesting that the positive developments in the real sector contributed to the opening of 50 thousand new jobs. The Croatian Pension Insurance Agency recorded slightly weaker employment dynamics, namely a 2.7 percent increase in the number of insured persons. Employment prospects seem to be positive, although the CBS reports on substantially moderated dynamics this year. In February 2008, total employment increased by 1 percent on a year-on-year basis.

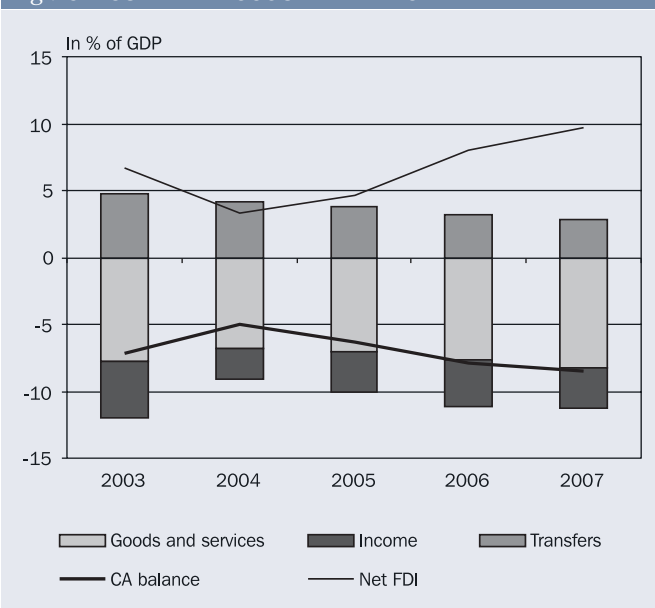
**... causing a sizeable fall in unemployment.**

As a reflection of employment trends, the number of registered unemployed persons decreased by 9.3 percent in 2007. Consequently, the unemployment rate slid to 14.8 percent, which is 1.8 percentage point lower than in 2006. The survey-based unemployment rate decreased from 11.2 percent in the first quarter of 2007 to 8.4 percent in the third quarter. In February 2008, the unemployment rate amounted to 14.7 percent, which is 2 percentage points lower than a year ago. At the same time, the number of unemployed persons decreased by 13 percent.

**Stable wage growth in 2007.**

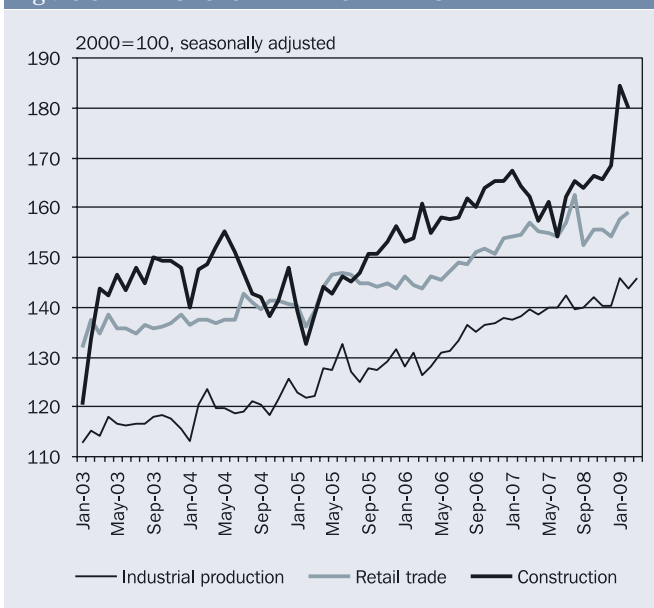
The year 2007 saw on average a 6.2 percent gross wage increase in nominal and 3.2 percent in real terms, which is similar to the trends that had prevailed in 2006. In 2008, one could anticipate a slowdown in real wage growth caused by the higher inflation rate. The January data confirm these expectations with a 7.4 nominal wage increase and a real wage growth of only 1.1 percent year-on-year.

Figure 2 CURRENT ACCOUNT BALANCE AND FDI



Sources for original data: Croatian National Bank and Central Bureau of Statistics.

Figure 3 REAL SECTOR DEVELOPMENTS



Source for original data: Central Bureau of Statistics.

**Tighter monetary policy.**

In the fourth quarter of 2007, seasonally adjusted broad money recorded an impressive increase of 9.1 percent quarter-on-quarter, partly due to a massive redepositing of savings invested in the IPO of Croatian Telecom shares during the third quarter and a strong increase of broad money components during December. However, the year-on-year growth rate of broad money reached 18.3 percent at the end of 2007, which is only 0.3 percentage points higher than in 2006 in nominal terms despite stronger economic activity and higher inflation than a year before. Monetary policy seems to have tightened towards the end of the last year, aiming to curb credit activity and suppress inflationary pressures. Accordingly, monetary aggregates witnessed further deceleration in growth at the beginning of 2008. The year-on-year broad money growth rate stood at 14.7 in February, which is 5.7 percentage points lower than a year ago.

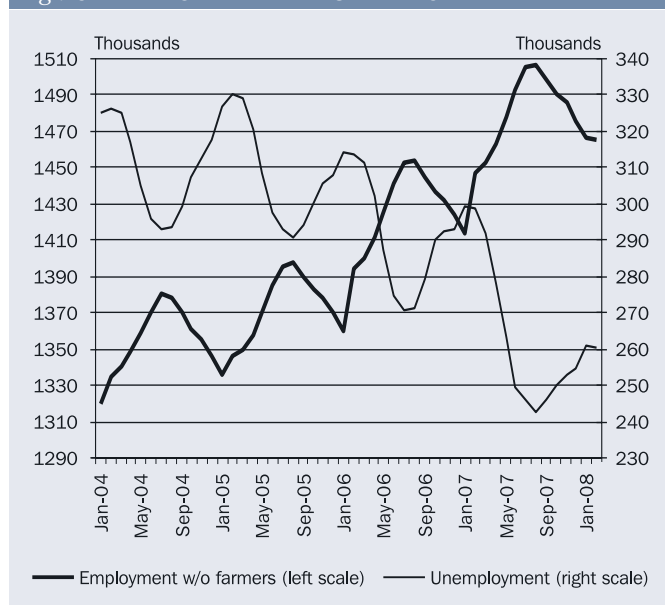
**Credit activity continues to decelerate.**

Credit activity has been slowing down since the second half of 2007. At the end of 2007, total domestic credit expanded by 15.0 percent year-on-year, which is 7.9 percentage points lower than at the end of 2006. Accordingly, both credits to enterprises and credits to households exhibited weaker increase rates. Moreover, the most propulsive component of household credits – housing credits – has also been on a downward path. Its year-on-year growth rate in February 2008 stood at 22.0 percent, compared to 34.1 percent recorded in February 2007. Furthermore, the year-on-year growth of credits to enterprises dropped below 10 percent in the first two months of 2008, which is the best indicator of the slowdown in credit activity. Enterprises, however, compensate restrained domestic credit supply by borrowing directly from abroad.

**Money market affected by more restrictive monetary policy.**

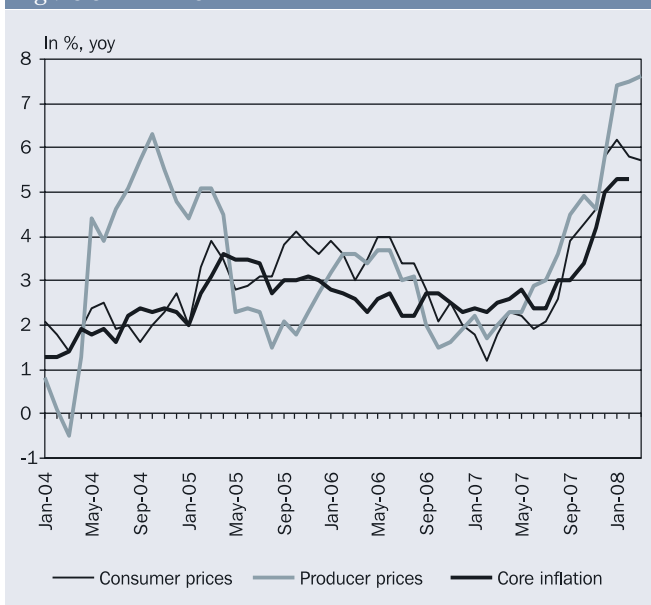
The pressures on the money market observed in the last quarter of 2007 carried over to the first quarter of 2008. They have been mainly caused by the cancellation of repo auctions that the central bank justified by the claim that banks use funds obtained from the auctions for credit expansion. As a consequence, the average overnight interest rate on the interbank money market reached 6.67 percent in January 2008, the highest level in the last three and a half years. At the end of January, weak kuna liquidity caused strong appreciation pressures, forcing the central bank to intervene on the foreign exchange

Figure 4 EMPLOYMENT AND UNEMPLOYMENT



Source: Central Bureau of Statistics.

Figure 5 INFLATION

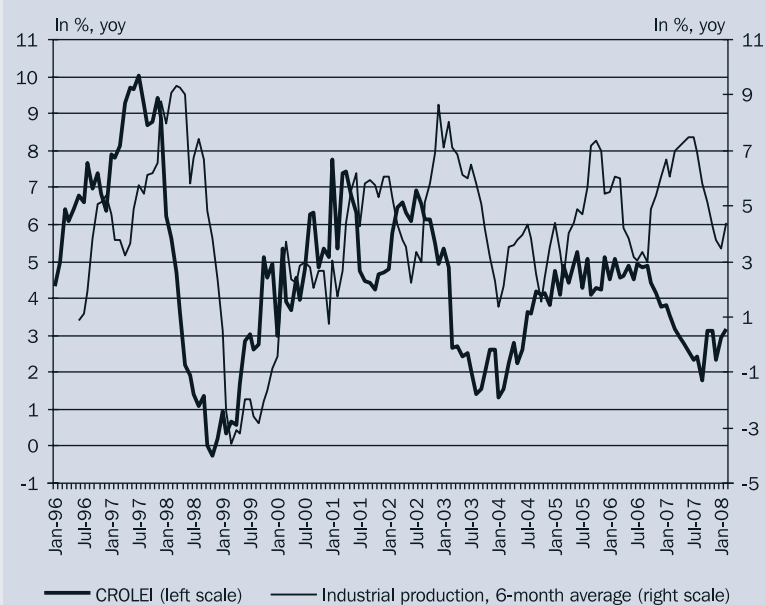


Sources: Central Bureau of Statistics and Croatian National Bank.

## Box 1 LEADING INDICATOR FOR THE CROATIAN ECONOMY: 2007 CROLEI REVISION

Croatian Leading Economic Indicator (CROLEI) was developed in 1995. Ever since, it has been estimated and published on a monthly basis at the Institute of Economics, Zagreb in cooperation with the Croatian Ministry of Finance. Like any other leading indicator, CROLEI is a composite index designed to forecast business cycle turning points, e.g. recessions and expansions. The ability of a leading indicator to predict a change in the business cycle stems from its components. Namely, a leading indicator consists of time series that tend to shift direction in advance of a business cycle, i.e. it consists of time series that exhibit a leading relationship with respect to the reference series at the cyclical turning points. The reference series is an economic variable whose cyclical movements approximate well the business cycle developments in the whole economy. Most often, and so is the case with CROLEI, the index of total industrial production is used as a reference series. Namely, the cyclical profiles of industrial production and GDP are closely related.

Figure B1 CROLEI AND THE REFERENCE SERIES



Sources: Central Bureau of Statistics (for original data on industrial production); The Institute of Economics, Zagreb and Ministry of Finance (for CROLEI).

CROLEI consists of the following components: beneficiaries of unemployment benefits, retail trade turnover in real terms, unconsolidated general government revenues, the average producer price index for the EU-25 countries, money in circulation, credits to households, and the interest rate on kuna loans without a currency clause. CROLEI is interpreted in the following way: three consecutive decreases indicate a moderation of economic activity that should take place in approximately eight months.

Figure 1 shows the new CROLEI and its reference series for the period from January 1996 to February 2008. The last observations of CROLEI suggests that the real economic activity in the second and the third quarter of 2008 will be characterized by a moderate growth.

Due to the fact that the time series constituting a leading indicator change their cyclical and leading patterns, and are sometimes subject to methodological changes, it is necessary to regularly revise the leading indicator system. The latest CROLEI revision was undertaken in the last quarter of 2007. Its purpose was to enhance the forecasting performance of CROLEI. Moreover, while the previous versions of CROLEI were calibrated to forecast the business cycle turning points, the new CROLEI has been modified to forecast turning points in growth cycles as well (i.e. moderations and accelerations of growth in the reference series).

The revised CROLEI consists of seven series and has the average lead time of eight months. The components have been selected on the basis of graphical and statistical analysis applied to the total of 274 series covering all sectors of the Croatian economy. The new

market and inject HRK 1.4 billion. Thereafter, the HRK/EUR exchange rate stabilized at around 7.27 in February and March, which is one of the lowest levels recorded in the last ten years. Taking into account a longer perspective, it may be observed that the HRK/EUR exchange rate has mildly appreciated since September last year, possibly as one of the policy answers to the rising inflationary pressures.

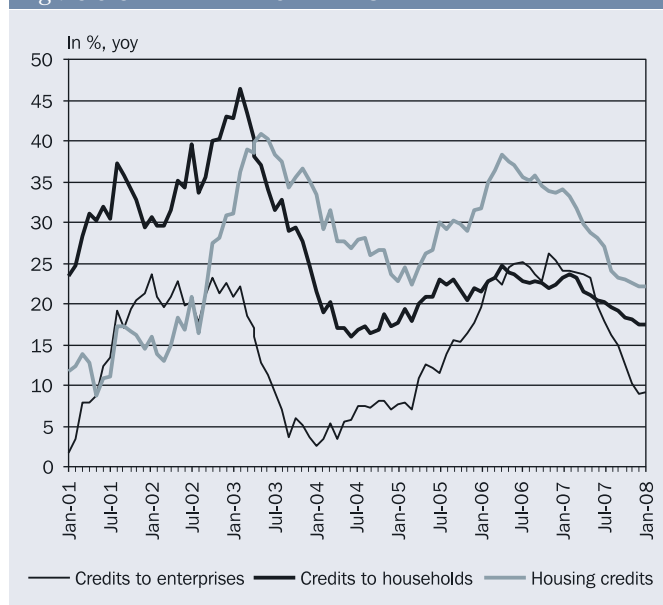
### ***Inflationary pressures continue.***

The first quarter of 2008 was marked by sustained higher inflation, mainly due to energy and food prices. All three major inflation indicators - consumer price, producer price and core inflation - experienced record, or near record highs since the implementation of the Stabilization Program at the end of 1993. In March, consumer prices climbed 0.6 percent compared to February, with inflation amounting to 5.7 percent year-on-year. Core inflation data confirm rising inflationary pressures, since in January and February it stood at 5.3 percent year-on-year, which is higher than at the end of last year.

### ***Fiscal developments in 2007 – good but could have been better.***

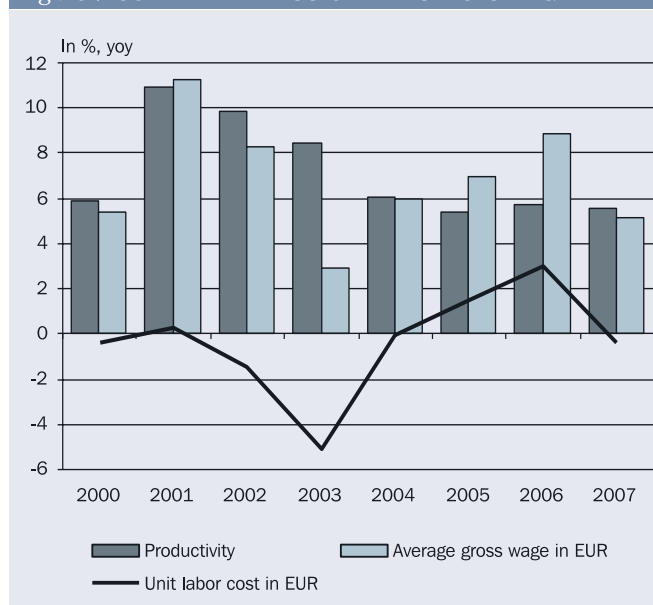
From the fiscal viewpoint, 2007 was a good year. Although data on fiscal developments are not yet available for the year as a whole, the Ministry of Finance reports that the consolidated general government deficit fell from 2.6 percent in 2006 to 2.3 percent of GDP in 2007, which is a 0.3 percentage point less than originally planned. However, it should be noted that fiscal consolidation in 2007 was once again driven by revenue growth, particularly by an increase in tax revenues resulting from favorable macroeconomic developments. In the first eleven months of 2007, budgetary revenues rose 13.4 percent year-on-year. The most important sources, VAT revenues and social security contributions, grew by 8.7 and 10.7 percent, respectively. Such developments led to faster expenditure growth than in 2006, without impairing the fiscal outturn. Budgetary expenditures increased 11.3 percent on a year-on-year basis in the first eleven months of 2007, compared to an 8 percent growth in the same period year ago. However, it has to be observed that the highest increase in budgetary expenditures is usually recorded in December. For example, budgetary expenditures in December 2006 amounted to 10.4 percent of the annual amount. As government expenditures at the end of the first eleven months of 2007 already reached the same amount as in the whole 2006, we are close to the conclusion that the Government

Figure 6 CREDIT DEVELOPMENTS



Source: Croatian National Bank.

Figure 7 COMPETITIVENESS OF MANUFACTURING



Sources for original data: Central Bureau of Statistics and Croatian National Bank.

has once again ignored the necessity and missed the opportunity to undertake structural reforms and decrease the size and scope of fiscal burden.

***The 2008 state budget adopted in March...***

Due to parliamentary elections in November 2007, Parliament adopted the budget for 2008 in March. Both budgetary revenues and expenditures are planned to grow at moderate rates, i.e. at a slower pace than the overall economic activity. Compared to 2007, they are planned to rise 6.6 percent and 5.5 percent, respectively, which should result in the state budget deficit of HRK 2.5 billion. The highest increase in revenues is expected to come from personal income, profit and property taxes, while VAT and social security contributions should rise at a moderate pace. It is somewhat surprising that the revenues from excises are planned to grow at a much lower rate than GDP. Quite expectedly, the structure of the expenditure side of the budget is similar to the one from 2007. It is worth noting that the increase in transfers to households and subsidies should remain below the nominal GDP growth rate.

***... implying higher pressures on the foreign debt.***

At the end of 2007, the consolidated central government debt reached HRK 111.8 billion (without state guarantees), or 40.6 percent of GDP. Public debt increased at a much higher pace than in 2006. In 2007, public debt rose 3 percent, while in 2006 it recorded a 1.7-percent annual increase. The new debt was completely financed on the domestic market. Besides a surge in domestic debt, the year 2007 recorded a high growth of foreign guarantees. If total government guarantees are added to the debt stock, the debt reaches 46.8 percent of GDP. It seems that the Government's decision to borrow predominantly on the domestic capital market was only temporary. Due to the fact that financing conditions on the domestic money market have become more stringent, in 2008 the Government plans to issue HRK 3.5 billion in bonds on the domestic market and HRK 5 billion on the international market. In addition, it plans to take credits and loans from financial institutions in the amount of HRK 2.1 billion. The new borrowings will be used for debt repayment, which will amount to HRK 9.3 billion.

## **2 Policy Assumptions and Projections Summary**

***Global economy losing momentum...***

Due to volatility in financial markets and the pronounced weakness of the U.S. economy, global economic activity has been gradually losing momentum. The global GDP is estimated to have increased 4.9 percent in 2007, slightly below 5.0 percent recorded in 2006 (*World Economic Outlook*, IMF, April 2008). At the same time, GDP growth in the U.S. slowed down from 2.9 percent in 2006 to 2.2 percent in 2007. So far, the emerging and developing economies have been less affected by these developments and have continued to grow at a rapid pace led by China (11.4 percent) and India (9.2 percent). In 2008, the global growth is projected to moderate to 3.7 percent and continue at about the same pace in 2009. Although it showed signs of moderation towards the end of last year, activity in the euro area expanded above potential in both 2006 and 2007. According to Eurostat's estimates, GDP growth in the euro area amounted to 2.6 percent in 2007 compared with 2.8 percent in 2006. The moderation has been mainly caused by weaker domestic demand. The ECB anticipates that GDP in the euro area will range between 1.3 and 2.1 percent in 2008, and between 1.3 and 2.3 percent in 2009. The average rate of consumer price increase (HICP) is projected between 2.6 and 3.2 percent in 2008, and between 1.5 and 2.7 percent in 2009 (*Monthly Bulletin*, ECB, March 2008).

***... while oil markets remain tight.***

Although the weakening of global economic activity at the beginning of 2008 has resulted in a subdued global oil demand and placed downward pressure on oil prices, they have still risen close to 20 percent since the beginning of the year. Many analysts believe that such



a strong rise could be attributed to the weakening U.S. dollar and poorly performing stock markets which induce investors to buy safe commodities such as crude oil and gold. At the same time, the International Energy Agency has revised downwards its projections for global oil demand that is now expected to rise by 1.5 percent in 2008, following 2.3 percent in 2007. However, there is general consensus that global oil markets will remain tight in the medium-term unless there is a significant drop in global demand.

***Accession talks with the EU intensified.***

A number of assumptions has been adopted for the projections presented below. We assume that the worsening of the global economic environment will not have stronger negative effects on the Croatian economy. More precisely, the weakening of the EU growth as well as the activity of the economies in the region will certainly have a negative effect on trade and capital flows. However, the accession talks with the EU seem to have been intensified recently as both sides still see 2009 as the target year to conclude the negotiations, which should allow Croatia's full accession by 2011. Furthermore, Croatia has recently been invited to join NATO. Both processes should increase the attractiveness of Croatia as an investment destination, and consequently have a beneficial impact on the overall growth prospects, offsetting, at least partially, negative spillovers from the global economy.

***Monetary authorities focused on price stability; fiscal authorities on fiscal imbalance.***

On the internal front, we assume that the established policies will be maintained. As for the monetary authorities, we expect their efforts to be focused on reducing inflationary pressures by tightening monetary policy and preserving the stability of the exchange rate. The CNB governor has announced for the first time that the exchange rate will be defended in the range of HRK/EUR 7.25-7.35. Depending on the near-future price developments, the central bank might keep the exchange rate close to the lower band. Restrictions imposed on credit activity will remain and it should be expected that these measures will successfully constrain the excessive credit growth, at least nominally, since there are other credit channels that domestic enterprises can use to avoid the domestic bank sector. As for the fiscal policy, it seems that the authorities are committed to keep the fiscal imbalance under control. We assume that such a goal may be achieved, regardless of the pre-election promises that were leading towards a more expansionary fiscal policy, although only with a substantial effort, especially in the case of weaker economic growth.

***Economic growth expected to revive...***

Croatian economy has entered 2008 with a moderating activity. However, some positive signals have already been observed in the real sector and we expect them to strengthen during the remaining part of the year. This should allow the GDP growth rate to amount to 4.5 percent this year. Uncertainties related to the darkening global economic outlook are high and might spill over to the Croatian economy. If a negative shock is avoided - as we assume - the internal dynamics of the economy and positive impulses brought by the EU accession should additionally revive economic activity that is projected to rise by 4.7 percent in 2009.

***... with personal consumption as the main driver.***

Following the strong expansion in 2007, personal consumption is expected to sustain a slower pace during this year, which should bring a 3.9 percent annual increase. The reasons behind include a weaker disposable income rise and the negative impact of inflation on the purchasing power of incomes. However, we expect personal consumption to remain the main driver of economic growth, with the contribution to the overall GDP growth amounting to around 50 percent. In 2009, personal consumption should strengthen to 4.1 percent. At the same time, investments are expected to remain the other strong supporter of economic growth in 2008. They should gradually strengthen during 2008 although the expected growth rate of 5.4 percent is slightly below the rate achieved in 2007. In 2009, investments are projected to grow 6.6 percent, partially due to stronger foreign direct investment as Croatia approaches the full EU membership.

**Current account deficit to remain high.**

After a certain setback at the end of 2007, exports should recover in 2008. The forecasts are based on overall trends and the positive dynamics of high-frequency indicators for industrial production, manufacturing exports and the number of foreign tourist overnight stays. Annual exports growth should reach 6.8 percent in 2008 and 7 percent in 2009. Imports are anticipated to retain the stable dynamics of around 6 percent in both 2008 and 2009. Since the major elements of external imbalance remain in the same relation, with only a slight strengthening of exports compared to the imports, the current account deficit is projected to remain almost unchanged, or at 8.4 percent of GDP in 2008 and 8.3 percent in 2009.

**Employment growth should moderate.**

Positive developments on the labor market experienced in 2007 should continue this year. However, the total employment growth is anticipated to moderate to around 1.3 percent due to the slower economic growth. The number of unemployed persons is expected to decrease significantly and push the unemployment rate down from 14.8 percent in 2007 to around 13.4 percent in 2008. Partially, the decrease of unemployment rate should come from the replacement demand caused by a wave of retirements at end of 2007. Namely, a number of persons eligible to retire have chosen to exploit more favorable retirement conditions that were valid up to the end of last year. In 2009, similar labor market trends are likely to continue, while the unemployment rate is expected to recede close to 12 percent.

**Modest wage growth due to competitiveness concerns.**

In spite of the inflation surge and declining unemployment, wage growth remained modest during 2007, mainly due to the weak competitiveness of domestic producers. Labor costs are higher than in other post-socialist countries, except Slovenia, and the gap is therefore being gradually closed by suppressing wage growth while pushing the productivity increase as much as possible. We expect that such underlying forces will stay in place this year as to maintain competitiveness, overcome the rising uncertainties and create conditions for additional employment in spite of the rising demands for higher wages from trade unions. However, the low-pay workers could expect some improvement since the Government announced that the Law on Minimum Wage would be enacted this year, although its main elements are still unknown.

Table 2 SUMMARY OF PROJECTIONS

	2008	2009
<b>Real GDP (% change)</b>	<b>4.5</b>	<b>4.7</b>
Real private consumption (% change)	3.9	4.1
Real government consumption (% change)	2.7	2.8
Real investment (% change)	5.4	6.6
Exports of goods and services (constant prices, % change)	6.8	7.0
Imports of goods and services (constant prices, % change)	6.1	6.2
Current account balance (% of GDP)	-8.4	-8.3
Consumer prices (% change, pa)	5.3	3.5
Exchange rate, HRK/EUR (pa)	7.28	7.30
Unemployment rate (registered, %, pa)	13.4	12.2
General government balance – GFS 1986 (% of GDP)	-2.3	-2.0
Broad money, M4 (% change, eop)	15.0	16.0
Total domestic credit (% change, eop)	13.0	14.0

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

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

*Source:* Authors' projections.

***Inflation likely to moderate.***

The recent surge in food and oil prices seems to have brought a stubbornly high inflation rate. Substantial efforts by policymakers to put inflation under control have been only partially successful since the main factors pushing inflation are imported. Therefore, our inflation projection depends on the predicted price developments for the world commodity markets and the HRK/EUR exchange rate. Part of the external shocks should diminish due to the strong kuna so the inflation rate is expected to moderate to an average of 5.3 percent in 2008 and 3.5 percent in 2009.

***Further tightening of monetary policy expected.***

Since monetary authorities are determined to limit credit activity and curb inflation, any attempt to circumvent the 12-percent credit ceiling will probably be punished more severely than before. This is due to the fact that besides a booming credit activity that has caused a rise in asset prices and the widening of external imbalances, the central bank is faced with rising inflation pressures. As a consequence, we project that the total domestic credit will rise by 13 percent in 2008, 1-percentage point above the targeted ceiling, but 2 percentage points below the 2007 rate. Broad money growth should gradually slow down to reach about 15 percent. The next year might bring a somewhat less restrictive credit and monetary policy in line with the expected strengthening of the overall economic activity.

***Overall fiscal position should remain sound.***

In 2008, global fiscal position should remain sound and without large turbulences. It seems that the rise in both revenues and expenditures will somewhat lag behind 2007. Although the predicted economic slowdown should affect the revenue side of the budget, a 6.6-percent nominal rise in the 2008 budget revenues seems to have been planned overly conservative, following a 14-percent increase in 2007. Without precise information about the level of deficit achieved in 2007, and based on the cooling down of the expenditure rise implied by this year's budget, we stick to the Government's deficit projection of 2.3 percent of GDP. The next year should bring further fiscal consolidation in line with medium-term projections by fiscal authorities.

### **3 Uncertainties and Risks to Projections**

***Downward risks to projections prevail...***

As usual, there are downward and upward risks to the above presented projections. At the moment, downward risks prevail. They are primarily related to the global economic slowdown, resulting from turbulences on the world financial markets and uncertainties related to the future price developments on the world commodity markets. Their effect on Croatian economy could be stronger than expected and result in lower GDP growth. At the same time, positive spillovers from the upcoming NATO and EU membership could turn out to be stronger than now anticipated.

***... mainly due to turbulences on the world financial markets.***

Future developments on the world financial markets bear a lot of uncertainty. In such unfavorable conditions, investors are uneasy to enter, or even to stay on the emerging markets. This has already affected the domestic capital market, which is observed in a downward trend of CROBEX, the Zagreb stock exchange index. Furthermore, such developments induce a rise in interest rates and therefore strongly increase the uncertainty related to the future domestic investment activity. Partly due to the current world financial crisis, the EU economies as well as other economies in the region are slowing down, which negatively affects the external demand for goods as well as demand for Croatia as a tourist destination. In short, this might weaken the exports growth and contribute to the increased external vulnerability that will need to be balanced by weaker domestic consumption.

***Unrealistically planned budget...***

Although the 2008 budget has been adopted only recently, data on the budget outturn for 2007 have not yet been disclosed. Under such circumstances, it is hard to evaluate this year's budgetary policy and say whether the 2.3-percent deficit target implies further fiscal adjustment or the reversal of adjustment trends. However, it is just a minor technical issue. At the same time, we are genuinely concerned that a cautiously planned increase of government revenues for 2008 could soon become unrealistic, thus leading to another - already usual, but quite unjustifiable - budget revision. And in the Croatian case, it regularly brings a further increase in government expenditures.

***... in addition to the possible VAT rate reduction ask for another budget revision.***

The prime minister has recently announced some changes in the VAT system. It seems that the Government plans to reduce the general VAT rate in order to diminish the effects of rising oil and food prices on the world markets. It should be mentioned that a decrease in the general VAT rate could hardly bring beneficial price effects. On the other hand, it would strongly endanger the planned budget revenues and jeopardize further fiscal consolidation. We believe that changes should begin from the expenditure side of the budget.

## IMPRESSUM

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