

# Croatian Economic Outlook

Quarterly

## 1 Recent Developments

**Newly appointed ministers of justice and the interior.**

The impact of the international financial crisis on the financial and real sector of the Croatian economy as well as the intensification of the Government's fight against organized crime and corruption have been two major topics dominating the recent developments in Croatia. As for the first issue, there is a great deal of uncertainty about the consequences of the world-wide financial turmoil, but the real sector of the domestic economy is not expected to be severely hurt. As for the second issue, the Government has recently given priority to activities related to fighting organized crime and corruption by appointing new ministers of the interior and justice, as well as the new national police chief, and announcing the preparation of an "anti-mafia" law. However, determination in solving the problem is still to be seen. Organized crime has been recently put in the forefront of the Government's activities in reaction to public concerns over security issues after a series of unresolved crimes.

**Economy has been slowing down...**

On the economic front, the most recent data on GDP indicate a slowdown of the Croatian economy. Following a 4.3 percent year-on-year growth in the first quarter, GDP grew 3.4 percent in the second quarter, while the seasonally adjusted increase over the previous quarter declined to 0.3 percent. Such a weakening of economic activity was mostly

Figure 1 REAL GROSS DOMESTIC PRODUCT



Source for original data: Central Bureau of Statistics.

caused by a moderation in personal consumption and a high negative contribution of net exports. Investments remained buoyant, with a 12.6 percent year-on-year increase.

*... mainly due to moderation in personal consumption.*

Rising inflation, coupled with a modest wage increase, has resulted in a more cautious spending behavior of the household sector. Compared to the same period year before, personal consumption increased 2.2 percent in the second quarter, down from 4.3 percent in the first quarter. Seasonally adjusted personal consumption volume was lower in the second quarter than in the first quarter, although by a small margin. However, one cannot make a conclusion on a setback in personal consumption growth based exclusively on the second quarter data. Namely, quarter-to-quarter variations in consumption volume are quite large in Croatia. Therefore, recently observed dynamics should be perceived as a moderation of consumption, while the data in the remaining part of the year should allow for the better assessment of the cyclical position of personal consumption. Since personal consumption makes up for around 60 percent of GDP, its trend will substantially influence the overall economy.

*Government consumption strengthened.*

Government consumption rose by 3.2 percent year-on-year in the second quarter of this year, up from 0.5 percent in the first quarter. Relatively affluent revenue collection made the Government more inclined to spend money at the middle of the year. This is contrary to the practice observed in previous years when "non-routine" spending was often postponed until the last quarter of the year in order to better control for the budget deficit. The recent rise in government consumption might be continued over a longer period of time since the preparation of government administration for the EU membership seems quite costly. In addition, there is a rising demand from the business sector for various kinds of state aid.

*Investments remained buoyant.*

Investments were surprisingly strong in the first half of the year. Increases of 12.6 percent in the second quarter and 9.8 percent in the first quarter on a year-on-year basis suggest that investments have been booming in spite of the moderation in other parts of the economy. As for now, it seems that large government-sponsored projects like the building of highways and indoor stadiums for the 2009 Men's World Handball Championship are driving overall investments. While the residential construction has been losing momentum, production and imports of capital goods remained rather high in the first half of the year, indicating favorable trends in equipment renewals.

*In spite of increased exports volume, current account and...*

After a disappointing start of the year, exports volume recovered somewhat in the second quarter with a 4.6 percent growth over a year. The recovery, up from 3.8 percent in the first quarter of this year and 2.1 percent in the fourth quarter of last year, was not strong enough to compensate for the rising imports volume. Imports grew by 8.1 percent in the second quarter. Increasing negative external balance poses one of the major threats to the Croatian economy. In the second quarter of this year, the current account deficit reached 10.6 percent of GDP, up from 9.7 percent recorded in the first quarter. Although one can expect a certain slowdown in imports, in line with moderated personal consumption, the exports sector needs to strengthen its performance as to reduce the external vulnerability of the country.

*... trade deficits continue to rise.*

Merchandise trade statistics for the first eight months of 2008 confirm the above-mentioned trends observed from the national accounts data for the total volume of foreign trade. Data in current kuna terms suggest a 7.5 percent year-on-year growth in goods exports, which represents a 3.4 percentage points deceleration compared to the year before. On the other hand, imports of goods expanded by 12.3 percent, or by 1.6 percentage points more than in the same period last year. As a reflection of such developments, the merchandise trade deficit reached HRK 55.9 billion (EUR 7.7 billion)

Table 1 MAIN ECONOMIC INDICATORS

	2006	2007	2007		2008	
			Q3	Q4	Q1	Q2
<b>ECONOMIC ACTIVITY</b>						
Real GDP (% change, yoy)	4.8	5.6	5.1	3.7	4.3	3.4
Real private consumption (% change, yoy)	3.5	6.2	6.2	5.0	4.3	2.2
Real government consumption (% change, yoy)	2.2	3.4	4.4	3.7	0.5	3.2
Real investment (% change, yoy)	10.9	6.5	5.7	4.0	9.8	12.6
Industrial output (% change, yoy)	4.5	5.6	4.5	3.1	4.8	3.9
Unemployment rate (registered, %, pa)	16.6	14.9	13.7	14.2	14.7	13.2
Nominal GDP (EUR million)	34,220	37,497	-	-	-	-
GDP per capita (EUR)	7,707	8,452	-	-	-	-
<b>PRICES, WAGES AND EXCHANGE RATES</b>						
Implicit GDP deflator (% change, yoy)	3.4	4.0	4.0	5.1	6.1	6.4
Consumer prices (% change, yoy, pa)	3.2	2.9	2.9	4.9	5.9	6.6
Producer prices (% change, yoy, pa)	2.9	3.4	3.7	5.4	7.6	8.7
Average gross wage (% change, yoy, pa)	6.2	6.2	6.6	6.4	7.5	7.1
Exchange rate, HRK/EUR (pa)	7.32	7.34	7.31	7.33	7.29	7.26
Exchange rate, HRK/US\$ (pa)	5.84	5.37	5.32	5.06	4.87	4.65
<b>FOREIGN TRADE AND CAPITAL FLOWS</b>						
Exports of goods (EUR million)	8,464	9,193	2,361	2,477	2,226	2,477
Exports of goods (EUR, % change, yoy)	17.2	8.6	12.4	4.1	8.8	7.3
Imports of goods (EUR million)	16,808	18,627	4,671	4,913	4,791	5,585
Imports of goods (EUR, % change, yoy)	14.0	10.8	10.2	12.0	13.9	15.5
Current account balance (EUR million)	-2,696	-3,230	2,073	-1,910	-2,523	-1,809
Current account balance (% of GDP)	-7.9	-8.6	-	-	-	-
Gross foreign direct investment (EUR million)	2,745	3,619	544	718	893	935
Foreign exchange reserves (EUR million, eop)	8,725	9,307	8,795	9,307	9,842	9,941
Foreign debt (EUR million, eop)	29,274	33,216 <sup>+</sup>	31,227	33,216 <sup>+</sup>	34,922	35,288
<b>GOVERNMENT FINANCE*</b>						
Revenue (HRK million)**	100,393	113,386	83,934	113,386	28,370	59,901
Expense (HRK million)**	98,751	109,075	78,168	109,075	26,433	55,229
Net = Gross operating balance (HRK million)**	1,641	4,311	5,767	4,311	1,937	4,671
Net acquisition of non-financial assets (HRK million)**	6,109	7,811	4,961	7,811	1,122	2,815
Net lending/borrowing (HRK million)**	-4,467	-3,500	805	-3,500	816	1,856
Deficit/Surplus without capital revenue - GFS 1986 (HRK million)**	-6,392	-	-	-	724	-
Deficit/Surplus without capital revenue - GFS 1986 (% of GDP)**	-2.6	-	-	-	-	-
Domestic government debt (EUR million, eop)	8,132	8,605	8,856	8,605	8,892	8,955
Foreign government debt (EUR million, eop)	6,648	6,701	6,513	6,701	6,582	6,643
Total government debt (% of GDP)	43.3	40.8	-	-	-	-
<b>MONETARY INDICATORS</b>						
Narrow money, M1 (% change, yoy, eop)	25.0	19.3	13.3	19.3	12.9	5.5
Broad money, M4 (% change, yoy, eop)	18.0	18.3	11.9	18.3	14.4	11.1
Total domestic credit (% change, yoy, eop)	22.9	15.0	17.4	15.0	12.2	10.3
DMBs credit to households (% change, yoy, eop)	21.8	18.0	19.5	18.0	16.3	14.8
DMBs credit to enterprises (% change, yoy, eop)	26.1	10.2	16.2	10.2	7.4	5.0
Money market interest rate (% pa)	1.6	4.1	3.9	6.0	4.5	2.8
DMBs credit rate for enterprises, short-term, (% pa)	7.1	7.0	7.0	7.3	7.6	7.6
DMBs credit rate for households, short-term (% pa)	12.1	12.1	12.2	11.8	12.2	12.1

**Notes:** <sup>+</sup> New reporting system. \* 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.

by the end of August. The most significant contributors to the growth of exports were oil, shipbuilding and the production of electrical machinery. On the import side, the impetus for growth stemmed from a rise in oil imports, driven by a rise in oil prices, as well as from the shipbuilding and electricity sector.

**Foreign debt of enterprises still expanding.**

At the end of July 2008, gross foreign debt reached EUR 35.4 billion. An increment of EUR 2.2 billion with respect to the end of 2007 is fully attributable to the corporate sector. Consequently, the foreign debt of enterprises amounts to almost a half of the total foreign debt. Since the beginning of this year, banking and government sectors have decreased their foreign liabilities by EUR 0.5 billion and EUR 0.1 billion, respectively. By rising 6.7 percent in the first seven months, the foreign debt has remained on the same growth path despite the central bank's efforts to subdue foreign borrowing.

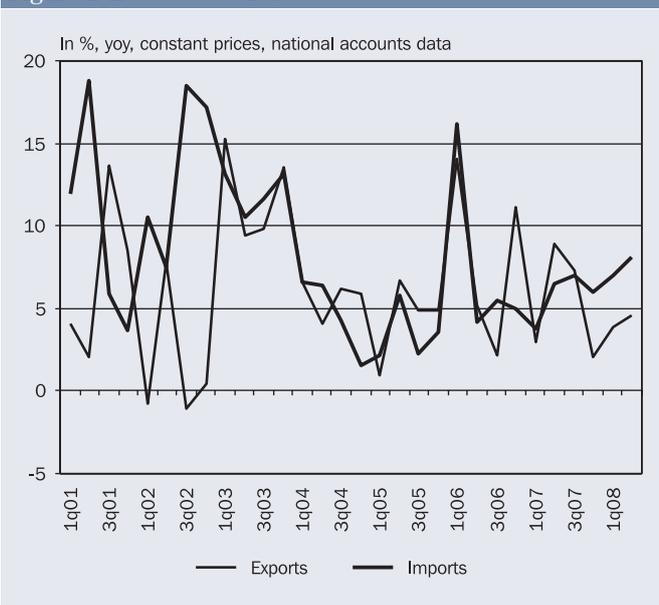
**High-frequency indicators suggest further slowdown during summer.**

Industrial production and retail trade indicators for the third quarter this year suggest a further weakening of real sector activity. Only construction activity retained a dynamic performance, rising by 12.6 percent in the first seven months 2008 over the same period year ago. After rising by 5 and 4 percent year-on-year in the first and second quarter, industrial production slowed down in the third quarter leveling the activity volume with the same quarter year ago. As a result, the cumulative rise in the first eight months amounted to 2.8 percent. Rise in inventories and a weaker demand for goods exports seem to have been the major reasons behind such weaker performance. In addition, the retail trade volume increased by just 0.3 percent in the same period, following a 3.5 percent average rise during the last three years.

**Employment continues to rise, unemployment falls,...**

In the period January-August 2008, total employment increased 1.2 percent compared with the same period year ago. However, employment growth has slowed down as suggested by year-on-year rates that declined from 1.1. percent in March to 0.7 percent in August 2008. Seasonal variations are significant, with the highest employment and lowest unemployment rates being usually reached in August. In line with that, the August unemployment rate was 12.3 percent, the lowest in the last 12 years for which comparable data exist. At the same time, the number of registered unemployed persons was 9.7 percent lower year-on-year, indicating the still favorable situation on the labor

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.

market. The survey-based unemployment rate amounted to 10.0 percent in the first quarter of 2008.

**... while the real wage increase vanishes.**

In the first seven months of 2008, the nominal gross wage increased 7.2 percent, while the real gross wage rose 0.6 percent compared with the same period last year. July 2008 recorded a 7.3 percent nominal increase year-on-year, but the real wage experienced a 1 percent decrease due to the inflation hike.

**Further slowdown of monetary...**

The slowdown of monetary and credit aggregates that had started in the last quarter of 2007 due to a more restrictive monetary policy became even more pronounced in the second and third quarter of 2008. In the second quarter, seasonally adjusted broad money was 1.3 percent higher than in the first quarter, while its year-on-year growth amounted to 11.1 percent. Furthermore, in August, it dropped further to 9.1 percent, the lowest growth rate in three years. The slower growth of broad money is a consequence of weak growth in narrow money and kuna savings deposits. Seasonally adjusted data indicate that narrow money actually contracted in the first two quarters of 2008. It decelerated further in the summer months to reach a 3.5 percent year-on-year growth in August, which is 15.9 percentage points lower than a year ago. The third broad money component - foreign exchange deposits - has maintained a robust growth momentum as a result of the withdrawal of household savings from a volatile capital market and the inflow of tourism revenues.

**... and credit aggregates.**

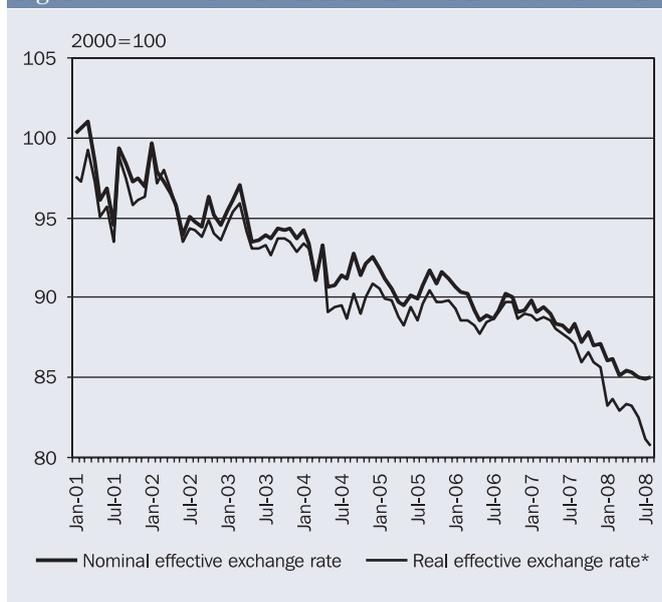
Growth in credit aggregates also decelerated in the second quarter of 2008. Total domestic credits expanded 10.3 percent year-on-year in June, which is 10.9 percentage points lower than in the same month year ago. The slowdown is most apparent in credits to enterprises which rose only 5 percent in year-on-year terms in the second quarter of 2008. However, credits to enterprises picked up somewhat in July and August, reaching a 9.7 percent year-on-year growth. In order to finance their business activities, enterprises are tempted to take loans from foreign banks, thus circumventing the central bank's credit restrictions and increasing the foreign indebtedness of enterprises. The slowdown of credits to households is somewhat less pronounced, but nevertheless noticeable. In August 2008, credits to households grew 12.2 percent, which is the lowest year-on-year

Figure 4 EMPLOYMENT AND THE AVERAGE WAGE



Source: Central Bureau of Statistics.

Figure 5 NOMINAL AND REAL EFFECTIVE EXCHANGE RATE



Notes: Calculated using the producer price index. Decline indicates appreciation.

Source: The Institute of Economics, Zagreb.

## Box 1 THE MINIMUM WAGE ACT TO IMPROVE THE POSITION OF LOW-PAY WORKERS

The Minimum Wage Act went into force on July 1, 2008. It has introduced substantial changes over the previous minimum wage legislation, which was based on the 1998 National Collective Agreement on the Lowest Wage and its legal extension covering all the employers and employees. Basically, this switch to the statutory regulation of the minimum wage means stronger legal enforcement and a better protection of low-pay workers. The Act has introduced a substantial one-time increase in the minimum wage level, while the adjustment formula, stipulated by the Act, ensures a continuous minimum wage increase over a longer period.

The minimum wage is now indexed to the average wage. Over the period July 2008-May 2009, it will amount to 39 percent of the average wage in the previous year, i.e. to HRK 2,747 or approximately EUR 380 in gross terms (including workers' social security contribution and income tax). For comparison, in the first half of 2008, the minimum wage amounted to HRK 2,441. The minimum wage is now 19.5 percent higher than a year ago. In the future, the minimum wage level will be up-rated every June and valid for a year ahead. The up-rating procedure includes the application of the new minimum-to-average-wage-ratio, which is linked to GDP growth. Minimum wage rise will be calculated from the minimum-to-average-wage-ratio from the previous year increased by the percent equal to real GDP growth in the previous year. For example, in the case of a 4 percent GDP growth in 2008, the minimum wage for the period June 2009-May 2010 would be 40.56 percent of the average wage in 2008 ( $39 \times 1.04 = 40.56$ ). The Minimum Wage Act does not set the upper limit for such up-rating, meaning that the minimum wage level could expand considerably over the coming years. The increase in the minimum wage that took place in July 2008 raises the number of minimum wage earners from 3 percent of all employees estimated in 2007 to over 7 percent. The proportion of minimum wage earners in the clothing industry could reach 1/4 this year.

The debate that preceded the introduction of the new minimum wage legislation revealed the major concerns of social partners over this issue. Trade unions insisted that the minimum wage should be set by a law in order to ensure stronger enforcement. They also requested a notable rise in the minimum wage in order to guarantee the subsistence minimum and protect the relative social status of low-pay workers. Their major argument was that the minimum-to-average-wage-ratio in Croatia was one of the lowest in Europe, amounting to around 33 percent for the last ten years. However, employers' representatives pointed to the fact that an increase in labor costs caused by any substantial increase in the minimum wage level could dampen competitiveness and endanger employment in labor-intensive industries. They argued that the absolute wage level in Croatia was relatively high compared to the other post-socialist countries, and that the minimum wage level in absolute terms was the highest in the region, aside from Slovenia. As a kind of compromise, the Act differentiates the minimum wage by sectors. For workers in textile, wood processing and leather industries, the minimum wage is set at 94 percent of the national minimum wage in the first, 96 percent in the second and 98 percent in the third year of implementation of the new law. However, such provisions gave cause for complaints to the Constitutional Court about discrimination. The Court's decision is still expected.

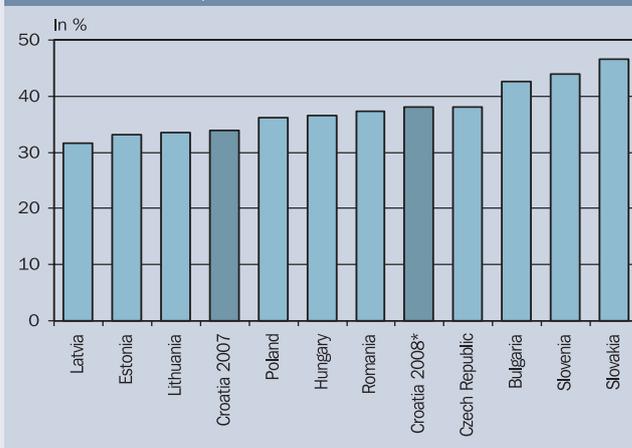
Danijel Nestić

Figure B1 MINIMUM WAGE IN CEE, 2008



Note: Data refer to July 2008 (except\* = January 2008).  
Sources: Eurostat and author's calculations.

Figure B2 MINIMUM WAGE AS % OF AVERAGE WAGE IN CEE, 2007



Notes: \*Estimate. The average wage refers to industry and services.  
Sources: Eurostat and author's calculations.

rate since 2000. The biggest surprise is the change in the dynamics of housing loans, which has slowed down notably. This might suggest that either the demand for housing loans is waning due to the overheating of the housing market or banks are becoming more prone to the lucrative short-term lending.

### ***Stringent money market conditions as an answer to...***

Following smooth money market conditions in the second quarter of 2008, the upheaval of liquidity shortages appeared during the third quarter. Apart from a strong seasonal demand for extra liquidity and the obligation of commercial banks to maintain required reserves, liquidity crunch emerged due to the central bank's intention to curb money supply in order to suppress the record high inflation. Thus, the central bank stopped creating liquidity by intervening on the foreign exchange market, leading to an increased interest in repo auctions. As a result of high interest and a cancelled repo auction, the money market interest rate increased, while the HRK/EUR exchange rate continued to appreciate. During late August and September, the marginal repo rate stood at 4.9 percent, while in the first days of October it reached a record high 5 percent. In September, the HRK/EUR exchange rate appreciated 1 percent compared to the previous month, and 2.6 percent compared to the same month year ago. It stood at 7.13, the lowest rate recorded in the last ten years.

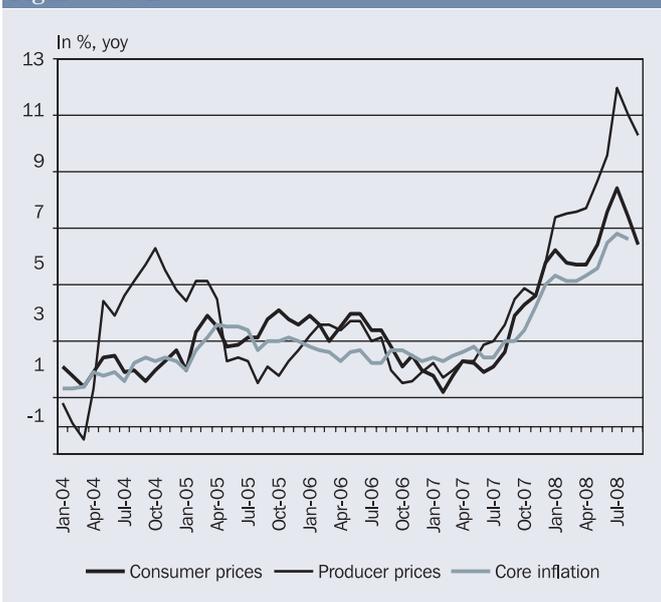
### ***... record high inflation.***

Inflationary pressures reached the peak in July 2008, due to higher food, oil and electricity prices. The consumer price increase reached 8.4 percent year-on-year, while producer prices recorded a 12.0 percent growth. Both inflation rates are the highest since the hyperinflation experienced in the first half of the 1990s. After peaking in July, both consumer and producer price inflation decreased in August, reaching 7.4 and 11 percent on a year-on-year basis and 6.4 and 10.3 percent in September. Core inflation peaked in July, when it reached 6.8 percent, after which it decreased to 6.6 percent in August. The relatively high core inflation suggests that inflation is slowly spreading from food and energy prices to other goods and services.

### ***Government revenues on the rise...***

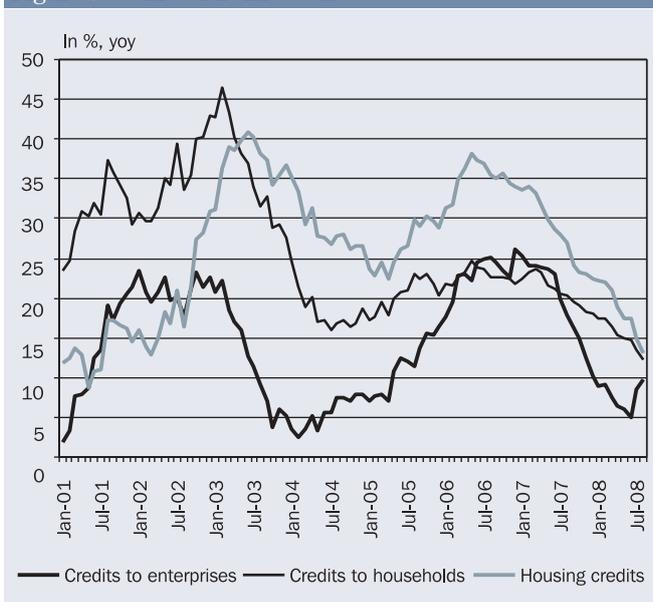
The most recent data on the consolidated general government outcome in the first six months of 2008 suggest a continuation of fiscal consolidation. The mid-year deficit of the general government (net lending/borrowing of the general government) amounted

Figure 6 INFLATION



Sources: Croatian Bureau of Statistics and Croatian National Bank.

Figure 7 CREDIT DEVELOPMENTS



Source: Croatian National Bank.

to HRK 1.9 billion or 49.5 percent of the deficit projected for 2008 as a whole. Revenue collection remained strong, reflecting favorable overall economic conditions at the beginning of the year, while higher inflation contributed to an increase in tax revenues in nominal terms. Consolidated general government revenues grew 11.5 percent in the first six months year-on-year. Such a rise resulted mainly from higher proceeds from VAT and social security contributions. A 13.4 percent increase in VAT revenues was to a large extent brought about by inflation since private consumption, as its implicit basis, grew at a rather modest pace in real terms. Similarly, a 9.7 percent rise in social security contributions can be explained by this year's rise in wages and salaries. Meanwhile, revenues from excise taxes were rather poor. They decreased 2.1 percent in the first six months compared to the same period last year, mostly due to a drop in the collected excise taxes on oil derivatives, beer, non-alcoholic beverages, and tobacco products.

***... with expenditures following the track.***

Budget expenditures followed the developments on the revenue side. Consolidated general government expenditures reached HRK 60.9 billion at the end of June, or 10.1 percent more year-on-year. Although this is 47.5 percent of the planned amount for 2008, the expenditure increase was almost twice as high as in the same period last year in spite of the fact that expenditures were restricted during the first quarter due to temporary financing. While expenditures on social benefits as well as wages and salaries rose by about 8 percent in the first half of the year, the main factors contributing to the increasing expenditures were subsidies and other expenditures (current and capital transfers), growing 22.8 and 23.8 percent, respectively.

***Public debt slightly increased.***

Public debt is increasing slowly but steadily. The stock of consolidated central government debt reached HRK 113.5 billion at the end of July (without state guarantees). This 2.1 percent year-on-year growth in total public debt was almost the same as in the same period last year. The Government continues to borrow predominantly on domestic financial markets, although in the last four months the external public debt has also been increasing. Out of HRK 2.4 billion of the total public debt increment, only HRK 0.3 billion relates to the new debt of the central state realized through the issuance of treasury bills. The rest is the new debt of central government funds, which took new loans both on domestic and international markets. The share of domestic debt in total public debt stood at 57 percent, the same as at the end of July 2007.

***New fiscal medium-term projections.***

Fiscal projection presented in the Government's *Economic and Fiscal Policy Guidelines* released in July 2008 for the forthcoming three years seems quite bright and, judging by optimistic macroeconomic assumptions underlying the projection, it already requires a serious revision. According to the *Guidelines*, the Government intends to continuously reduce the fiscal deficit in order to reach a surplus by 2011. The general government deficit is expected to fall to 1.3 percent of GDP in 2008 and then, in the next three years, by further 0.5 percentage points each year. The share of general government revenues in GDP should decrease from planned 46.5 percent in 2008 to 40.8 percent in 2011, while general government expenditures should decline from 48.1 percent of GDP planned for 2008 to 40.5 percent by 2011. Since the sources of the ratio decline are not clearly indicated, it looks like they should result from a steeper rise of GDP relative to government expenditures. The deficit decrease should also lead to a decline in general government debt below 30 percent until 2011. As in previous years, the Government intends to borrow mostly on domestic markets. However, part of the new borrowings is planned to be realized on the international financial market through the issuance of euro-denominated government bonds.

## 2 Policy Assumptions and Projections Summary

### *Uncertainty overshadows financial markets...*

The financial market turbulence, which had emerged in August 2007 following the collapse of the U.S. subprime mortgage market, entered a new phase in September 2008 that has shaken the confidence in global financial institutions and markets. Consequently, both in the U.S. and across Europe, banking sectors have recorded severe losses and undergone restructuring in terms of recapitalizations, mergers, bankruptcies, and even nationalizations, with the crisis spreading to the insurance sector and money market funds. In spite of a coordinated reaction by policy-makers and regulators, it still remains to be seen whether the U.S., G7 and euro zone governments' action plans can undo the damage that has been done and prevent future adverse developments. As for now, uncertainty continues to overshadow developments on global financial markets, while turmoil's impact on the global economic activity is hard to envisage. However, the crisis will surely induce more restrictive financing conditions, a decline in residential investments and weaker consumer spending. The October IMF projections suggest that the world economy will experience a 3.9 percent growth in 2008 and 3.0 percent in 2009, following a 5 percent increase in the last several years (*World Economic Outlook*, October 2008, IMF).

### *... as well as the outlook for the world economy.*

According to Eurostat's estimates, the euro area GDP already fell by 0.2 percent quarter-to-quarter in the second quarter of 2008, following a 0.7 percent increase in the first quarter. The decline was driven by a fall in domestic demand, as well as exports. The outlook also remains gloomy with the IMF projections suggesting a deceleration of GDP growth in the euro area from 2.6 percent in 2007 to 1.3 percent in 2008 and 0.2 percent in 2009. Global inflationary pressures remain high, but as upward pressures on oil and other commodity prices have recently alleviated, central banks will be able to focus more on stimulating economic activity and reviving confidence on financial markets.

### *Oil price volatility.*

Oil prices have fluctuated sharply in recent weeks, standing at US\$ 98 a barrel at the end of September and declining below US\$ 70 by mid-October. That has prompted the OPEC to call for an emergency meeting to preserve stability in prices. As for market fundamentals, demand is still growing in developing countries, but at a slower pace than in recent years, which is coupled with a lesser demand from advanced economies where activity has already decelerated. Consequently, the International Energy Agency has been continuously revising downwards its demand predictions. The OPEC will probably decide to reduce supply over the coming months and, consequently, the supply/demand balance in global oil markets will continue to be relatively tight.

### *Monetary and fiscal authorities focused on preserving financial stability.*

The effects of the global financial turbulence have affected the domestic market, but so far they have primarily been present on financial and stock markets. Measures undertaken by monetary and fiscal authorities should help alleviate the negative impact on the stability of financial sector as well as their stronger spillover to the real sector. The central bank has abolished its earlier decision on the marginal reserve requirement, thus placing back at banks' disposal approximately EUR 355 million and US\$ 129 million in order to boost their liquidity and enable banks to meet their commitments to clients. The marginal reserve requirement was implemented four years ago in order to curb strong foreign borrowing by banks, obliging them to deposit part of the funds borrowed abroad. In addition, the Parliament has increased the insured amount of private deposits from HRK 100,000 to HRK 400,000 (approximately EUR 55,000), which practically covers almost all the savings deposits in commercial banks.

***The speed of EU accession negotiations depends on judicial reform and shipyards privatization.***

One may notice that monetary authorities are now more focused on financial stability than on price stability, and so is expected in the coming months. As for fiscal authorities, they face a number of challenges, ranging from the health sector debt, balancing the budget under the circumstances of decelerating economic activity to structural reforms imposed by the EU accession requirements. The latter particularly refers to judicial reform and the privatization of loss-generating shipyards. The recently announced government plan for the privatization of shipyards implies that all but one will be sold for HRK 1, with the burden of their debts being largely overtaken by tax-payers.

***GDP projected at 4.0 percent in 2008 and 3.8 percent in 2009.***

Due to a moderated GDP growth in the second quarter of 2008, the world-wide financial crisis, and its possible impact on the real sector of the Croatian economy, we have revised our GDP projection downwards. GDP is now expected to rise by 4.0 percent in 2008 and 3.8 percent in 2009. The household sector should continue adjusting to the changing environment characterized by an increased inflation, higher repayments of financial obligations, and a rising uncertainty. Consequently, personal consumption is projected to rise by 2.5 percent in 2008. However, the next year should bring the easing of inflationary pressures, which should allow the revival of real wages and result in a modest recovery of personal consumption to 3.5 percent. Investments that were exceptionally strong in 2008 should slow down during the remaining part of the year. Nevertheless, this year might end up with the investment growth of around 10.2 percent, while for the next year we anticipate a 4.3 percent increase, although uncertainties seem rather high. The worsening of financial conditions, together with a higher cost of capital, will surely discourage private investments. As for now, we do not expect a significant decline in the volume of government-induced investments, which should bring stability to the overall investment performance. The Government could also contribute to the overall growth by speeding up its spending from 2.2 percent in 2008 to 3.3 percent in 2009.

***Current account deficit expected to reach around 11 percent of GDP.***

Foreign trade balance is expected to worsen this year. In the first half of the year, the merchandise deficit was higher than a year ago and similar trends are expected to continue in the course of this year. Foreign tourism revenues during the high-season are still unknown, so it is unclear how much they can contribute to the stabilization of the deficit. Based on physical indicators, the number of foreign tourist arrivals and overnight-stays, we expect that revenues from international tourism in 2008 were solid. In spite of all the problems that might be present in the international trade in the aftermath of the global financial crisis, we expect that the Croatian exports, under the circumstances of stabilized costs (lower inflation), have a potential for improved performance. As a result, exports growth should rise from 4.5 in 2008 to 5.7 percent in 2009, while imports, due to a moderation of growth, should decelerate from 6.2 to 5.0 percent in 2009. Consequently, the current account deficit is projected at 11.1 percent of GDP in 2008 and 10.6 percent in 2009.

***Employment prospects uncertain.***

The moderation of economic growth is expected to bring less dynamic job creation and a more moderated decline in the number of jobless workers than earlier projected. We foresee the unemployment rate to amount to 13.4 percent for this year and 12.9 percent for the next year. However, high uncertainty surrounds the unemployment projection due to a rather unstable relation between employment, unemployment, and GDP growth. Namely, the Croatian labor market exhibits a great deal of inertia as a result of relatively inflexible regulation that disables the smooth adjustments of employment to output fluctuations. The same could be said for the wage determination that is most often subject to collective bargaining. Therefore, the major part of adjustments on the labor market could be prolonged until the next year. However, the slower pace of wage rise for non-unionized sectors could be expected this year as a first reaction to the growth moderation in order to escape more painful adjustments via employment reduction.

***Inflationary pressures to ease.***

The recent decline in oil prices on world markets, stabilization of food prices on the domestic market due to a good harvest season, and the moderation of consumer demand should substantially ease inflationary pressures in the remaining part of the year. For the next year, we expect only moderate pressures. Therefore, the consumer price inflation projection has been revised downwards to 6.3 percent on average for this and 3.8 percent for the next year.

***Deceleration of broad money and credit aggregates growth.***

As a consequence of financial turbulence, credit availability will be lower than earlier expected, while broad money growth should decelerate. Consequently, broad money is expected to rise by 11.0 percent and credits by 9.0 percent in 2008. Next year, the effects of the financial crisis should be reflected in the further deceleration of broad money and credit growth to 9.0 and 7.0 percent, respectively.

Table 2 SUMMARY OF PROJECTIONS

	2008	2009
<b>Real GDP (% change)</b>	<b>4.0</b>	<b>3.8</b>
Real private consumption (% change)	2.5	3.5
Real government consumption (% change)	2.2	3.3
Real investment (% change)	10.2	4.3
Exports of goods and services (constant prices, % change)	4.5	5.7
Imports of goods and services (constant prices, % change)	6.2	5.0
Current account balance (% of GDP)	-11.1	-10.6
Consumer prices (% change, pa)	6.3	3.8
Exchange rate, HRK/EUR (pa)	7.23	7.22
Unemployment rate (registered, %, pa)	13.4	12.9
General government balance – ESA 95 (% of GDP)	-1.3	-1.0
Broad money, M4 (% change, eop)	11.0	9.0
Total domestic credit (% change, eop)	9.0	7.0

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

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

*Source:* Authors' projections.

***Poorer revenue collection expected in 2009.***

General government expenditures in 2007 were almost 15 percent higher in the second than in the first half of the year. If expenditures will follow that path in 2008, they could reach over HRK 130 billion. In addition, due to the adjustment of pensions to the growth of wages and inflation, we expect much higher expenditures for social benefits this year. Revenue collection should remain strong enough to allow the achievement of the targeted deficit for this year. By saying so, we hope that a good revenue collection during the tourist season could offset negative trends in revenues from excise taxes. The poorer collection of tax revenues due to a slowdown in economic activity will be reflected in 2009. Our projection for the general government balance in 2008 remains unchanged. We expect it is still possible to achieve the general government deficit at the planned level of 1.3 percent of GDP in 2008 (according to the ESA 95 methodology). However, for 2009, we do not expect it to be below 1.0 percent of GDP without larger changes in fiscal policy.

**3 Uncertainties and Risks to Projections*****Will the international financial crisis...***

As policy-makers and regulators around the world are striving to undertake the measures that will reduce the negative effects of the international financial crisis and constrain its devastating psychological effects, it is hard to apprehend what overall effects for the real sector in Croatia might be. The financial resources on world markets will become scarcer and more expensive, while demand for the Croatian exports, in particular from

the EU markets, is expected to weaken. The size of these effects is, however, highly uncertain. Although we have assumed in our projections only a limited effect on the real sector, it must be noted that the rising external imbalance makes the Croatian economy increasingly vulnerable to external shocks and, therefore, a larger negative impact than assumed is possible.

**... have only limited effect on the Croatian real sector?**

Surprisingly strong investments in this year have been primarily driven by the government-induced projects. Although some of them will be finished by the end of 2008, our projection for the next year implies that the Government will continue investing, although at a somewhat moderated pace. The announced investment plans related to the energy sector and a number of smaller projects, not fully unrelated to the local elections taking place in May 2009, are the basis for such an assumption. However, any stronger reduction in government investments, possibly related to the financing of such projects, will have a negative impact on the overall economic performance and result in a lower GDP growth than now predicted.

**Growing fiscal challenges.**

The expected slowdown in personal consumption could lead to a deceleration in tax revenues, while pressures on government expenditures will remain high. Consequently, it could become very hard to put the budget in balance. At the same time, the financing of the budget deficit will get more expensive, so the Government will probably try to avoid any deficit. Unfortunately, balancing the budget could be less welcome than before. As already mentioned, a sharp reduction in government investment projects could harm the overall economic performance next year. Under such circumstances, a prudent fiscal policy requires the elimination of unnecessary costs and remaining inefficiencies, a stronger fiscal discipline without increasing tax burden, and similar actions which could have been done before, but incentives to do so have been obviously insufficient.

#### IMPRESSUM

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