

Croatia



OUTLOOK

In 2007, GDP growth will remain strong, around 4.7 %, thanks to continued dynamic growth in investment, personal consumption and exports. However, such fast growth will induce strong imports growth and will thereby deepen the trade and CA deficits. The external gap will not narrow because fiscal adjustment will be only moderate, and the effect of credit restrictions will be countered to a great extent by companies'

foreign borrowing. The growth of external debt will be somewhat slower as a result of substantial FDI inflow. While inflation growth will accelerate slightly, it will remain at a moderate level of about 3 % with a firm anchor in the HRK exchange rate. Parliamentary elections will bring a risk of future fiscal relaxation, but the framework set by EU accession should prevent major deviations.

MOODY'S LT FC RATING
BAA3/Stable

S&P'S LT FC RATING
BBB/Stable

FITCH LT FC RATING
BBB-/Stable

SPREAD AVG (MAY) 27
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR bn)	31.3	34.2	36.9	39.9	42.9
Per capita GDP (EUR)	7,040	7,700	8,310	8,980	9,660
Real GDP, yoy (%)	4.3	4.8	4.7	4.3	4.2
Inflation (CPI), yoy, eop. (%)	3.6	2.0	3.5	2.7	2.5
Inflation (CPI) yoy, avg. (%)	3.3	3.2	2.7	2.9	2.5
Unemployment rate, avg. (%)	12.7	11.2	10.2	9.4	8.8
Exchange rate/EUR, eop.	7.38	7.35	7.30	7.25	7.20
Exchange rate/EUR, avg.	7.40	7.32	7.30	7.25	7.20
1w Zibor, avg. of Dec	4.38	3.84	4.60	4.70	4.70
1w Zibor, avg. of the year	4.30	3.28	4.20	4.30	4.30
Current account balance/GDP (%)	-6.3	-7.6	-7.9	-7.7	-7.5
FDI/GDP (%)	4.6	8.3	6.2	4.3	4.4
Budget balance/GDP (%)	-4.1	-3.0	-2.5	-2.5	-2.2
Public debt/GDP (%)	43.7	40.8	39.8	39.0	38.1
Total external debt/GDP (%)	81.7	84.7	86.2	86.0	85.8

Sources: CNB, CSB, Zagrebacka Banka Research - UniCredit Group New Europe Research Network.

MAIN TOPICS

- Data showing strong growth in the main economic sectors during the first months of this year are indicative of dynamic GDP growth, potentially close to 6 % in Q1, and justify our upward revision of 2007 growth from 4.2 % to 4.7 %.
- Robust economic growth in 2007, driven by consumption and invest-

ment in particular, is generating faster growth in imports than exports. The CA deficit is expected to escalate at an annual level of 7.9 % of GDP. Yet, thanks to substantial FDI inflow, the growth of external debt will slow.

- So far this year, bank loans have continued to grow rapidly, which led

the CNB to adjust its measure (restricting credit growth to 12 %) in order to ensure stricter implementation. Despite slight acceleration, inflation has remained moderate. The HRK exchange rate has remained stable without any major interventions by the CNB.

External vulnerability demands stronger fiscal adjustment

Dynamic activity growth

The available indicators of activity in the main economic sectors for the first months of 2007 show a dynamic growth trend carried over from the end of last year. Thus, industrial production grew by 8.3 % in the first four months driven by solid exports and investment demand. Favourable weather conditions and strong investment demand in business and government sectors boosted the construction industry further.

The strong recovery of personal consumption began in mid-2006 under the influence of increased social benefits, higher salaries and employment and continued early this year, resulting in a high 7.5 % annual rise in real retail sales in the first four months.

The dynamic growth of economic activity generated a significant increase in imports. Coupled with the moderate export growth, it has resulted in a 13.3 % annual increase in the trade deficit in the first four months.

Such developments suggest that GDP growth in Q1 could be around a high 6 %. However, we may see a growth slowdown in the coming quarters, as indicated by the drop in the Economic Sentiment Indicator during Q1 and the drop in the leading indicators for construction and retail trade. By way of contrast, the leading indicator for the manufacturing industry shows that activity will remain solid throughout the rest of the year, as along with solid domes-

tic demand a significant contribution will be made by strong export demand from the EU and the CEE region.

Although business and consumption plans of companies and households may be reduced to some extent due to increased uncertainty surrounding the upcoming parliamentary elections, it seems that the improved business climate and favourable external conditions will ensure a solid 4.7 % increase in GDP this year. Investment will remain the most dynamic aspect of domestic demand, and personal consumption will also make a solid contribution to growth as salaries, especially those in the public sector, will continue to grow along with social benefits (also including debt repayment to pensioners). An important contribution to growth is also expected to come from exports of goods and services (6 %), whereby imports will also grow by 6.3 % and retain their high negative contribution to economic growth.

Growth has resulted in a robust rise in employment in the private sector. Unemployment is expected to decrease further (from 10.5 % at the end of 2006) and the employment rate will continue to rise, which will in turn have a positive effect on the financial sustainability of the social funds.

Fast loan growth induces further tightening

Monetary developments in the first four months were marked by the continuation

of a relatively dynamic growth trend for the main monetary aggregates, accompanied by the usual seasonal fluctuations. In April the annual growth of narrow money (M1) amounted to 22 %, and broad money (M4) increased by 20.6 %. The growth of broad money was generated by a 15.6 % increase in bank loans, and by the strong increase in net international assets of the monetary system of 163 %, which contributed strongly to strengthening the system's external liquidity.

In addition to the usual current and financial transactions, the developments in the foreign exchange market were also influenced by balance sheet restructuring in the banking sector as a result of the monetary policy measures (mainly the high marginal reserve requirement of 55 % on external funding). Supply and demand remained balanced, so the HRK exchange rate fluctuated within a relatively narrow band.

The CNB has modified the way in which the 12 % annual growth limit, free from the CNB bill subscription obligation, is applied with regards to credit to non-governmental sectors. This change was introduced early this year to enable commercial banks to adjust their credit growth to seasonal fluctuations.

However, bank loans to non-governmental sectors grew faster than anticipated in the first four months while off-balance-sheet assets were reduced. Thus in June,

Short-term Indicators

	May-06	Jun-06	Jul-06	Aug-06	Sept-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07
Real GDP, yoy (%)	-	3.6	-	-	4.7	-	-	4.8	-	-	-	-	-
Industrial production, yoy (%)	4.1	-1.1	5.2	9.8	3.0	8.3	6.9	3.1	9.0	5.7	9.0	9.4	-
Inflation (CPI), yoy (%)	4.0	4.0	3.4	3.4	2.8	2.1	2.5	2.0	1.8	1.2	1.8	2.3	2.2
Unemployment rate, avg. (%)	-	11.8	-	-	-	-	-	-	-	-	-	-	-
Exchange rate kuna/EUR eop.	7.26	7.26	7.26	7.31	7.38	7.37	7.33	7.35	7.37	7.35	7.38	7.37	7.31
1W Zibor, avg.	3.4	3.2	3.4	3.6	3.9	3.9	2.8	3.8	3.5	3.7	4.0	4.4	4.7
Export, (EUR) yoy (%)	27.8	-2.1	22.7	11.3	3.7	40.6	4.6	15.5	-3.1	18.4	-7.0	21.1	-
Import, (EUR) yoy (%)	15.1	6.9	13.8	18.0	7.9	11.5	11.4	9.7	5.4	11.5	6.2	15.7	-
Trade balance EUR mn	-804	-890	-752	-775	-718	-798	-758	-579	-608	-745	-908	-876	-
Current account, EUR mn	-	-1,286	-	-	2,145	-	-	-1,424	-	-	-	-	-

Sources: Official statistics (CNB, CBS), Zagrebacka Banka Research.

the CNB amended the measure and introduced separate monitoring and limiting of on-balance and off-balance bank asset items in order to ensure more effective implementation of the credit growth restriction.

Therefore, growth of credit to the non-governmental sectors and of monetary aggregates is expected to slow to about 12–15 % annualised over the remainder of the year. The overall foreign exchange flows will remain mainly balanced, and with occasional CNB interventions in the foreign exchange market, the HRK exchange rate will remain relatively stable. Money market interest rates will stay at a slightly higher level than last year.

Inflation measured in terms of consumer prices picked up in the first months of 2007, mainly because of the repeated rise in oil prices and also due to the fact that food prices grew faster than usual for the season as a result of bad weather conditions. The cumulative growth in the first five months of the year reached 2.4 %.

As a result of the inflationary pressures mentioned above, price growth will be faster in 2007 than last year and could reach the 3.5 % annual growth rate by December. In this context, the stable HRK exchange rate will continue to function as the main nominal anchor keeping inflation within a moderate range.

Potential for fiscal deficit reduction

In the first months of this year, fast growth in economic activity resulted in a faster than planned growth of tax revenues (+15 % in the first five months of 2007). As the expenditures grew in line with the plan, the central government deficit in the period has been significantly reduced. It was financed in the domestic market through bond issues while debt towards domestic banks and external debt were reduced.

In contrast, the deficit in the health care system has grown significantly over the same period and is mainly being financed by increased arrears. Furthermore, a trend of increased borrowing to finance capital expenditures can be seen at the level of local government and public utili-

ty companies. The portion of the debt to pensioners which falls due for payment this year accounts for about 1.1 % of GDP, and represents an additional burden on the public funds in that it will absorb the government's proceeds from the sale of its 20 % of T-HT shares through an IPO which has been postponed until the middle of the autumn.

This all suggests that there are only slight chances that increased fiscal revenues will be used to reduce the general government deficit as recommended by the IMF. It is more likely that a substantial amount of the revenues will be used to finance increased expenditures in the health care system, and we may also see some additional expenditure as a result of the elections.

However, assuming that higher than budgeted fiscal revenues are collected over the remainder of the year, it is possible that the budget revision expected during the summer will provide for a moderate decrease in the general government deficit, from 2.8 % to about 2.5 %. Together with the repayment of debts to pensioners, this would only represent a moderate fiscal consolidation compared to last year and would thus provide insufficient support to CNB efforts to reduce the external imbalance.

The level of public debt is expected to fall below 40 % of GDP in relative terms, while external debt continues to be substituted by domestic debt.

Still, the major fiscal policy challenge remains the high level of overall public expenditure relative to GDP, which is mainly a result of considerable expenditures for subsidies and substantial social expenditures partly relating to attempts to alleviate the consequences of the war.

The recent privatisation of ironworks and aluminium manufacturers and the restructuring and the start of the privatisation of the railway company are important steps in the right direction. Restructuring in the shipbuilding industry remains a problem and is an issue which the EU insists be resolved. It is therefore reasonable to expect that a lasting solu-

tion to this problem will be found in the foreseeable future, likely including privatisation.

Trade gap widens as domestic demand picks up

In the first four months of this year, merchandise exports recorded an annual growth of 6.3 % in euro terms, which was outpaced by a 9.9 % growth in imports. As a result, the trade deficit increased by 13.3 % in comparison to the same period last year.

On the exports side, some industries like wooden products, paper and pulp, metal products, machinery and electrical equipment showed strong double-digit growth between 20 % and 40 %, while other important export industries such as shipbuilding, oil derivatives, fabrics and furniture production registered substantial to moderate declines.

On the imports side, double-digit growth was seen in imports of metal and non-metal products, machinery, motor vehicles, textiles and fabrics as a result of strong domestic demand, while a decline in imports was registered in computer and office machinery production.

Over the remainder of the year, strong economic activity in the EU and CEE is expected to boost exports. Also, high productivity growth in the manufacturing industry will continue to support the country's competitiveness.

However, due to high import intensity for all forms of final demand, a continuation of strong economic growth over the rest of the year will continue to generate strong import growth and a high trade deficit and will keep the current account deficit at a high level of around 7.9 % of GDP.

The CA deficit will be financed through FDI inflow amounting to around 6.2 % of GDP. The continued privatisation of T-HT and capital increases in major banks will make important contributions in that respect. Together with banks' reduced international borrowings and the government's orientation towards domestic borrowing, the growth of external debt will

slow and stabilise at roughly 86 % of GDP.

EU membership negotiations on track

Croatia should soon open negotiations on several more chapters of the *acquis communautaire*, including the energy sector. This means that by the end of the year negotiations on more than half of all the chapters could be opened. Still, we believe that Croatia's accession to the EU cannot be expected before 2010.

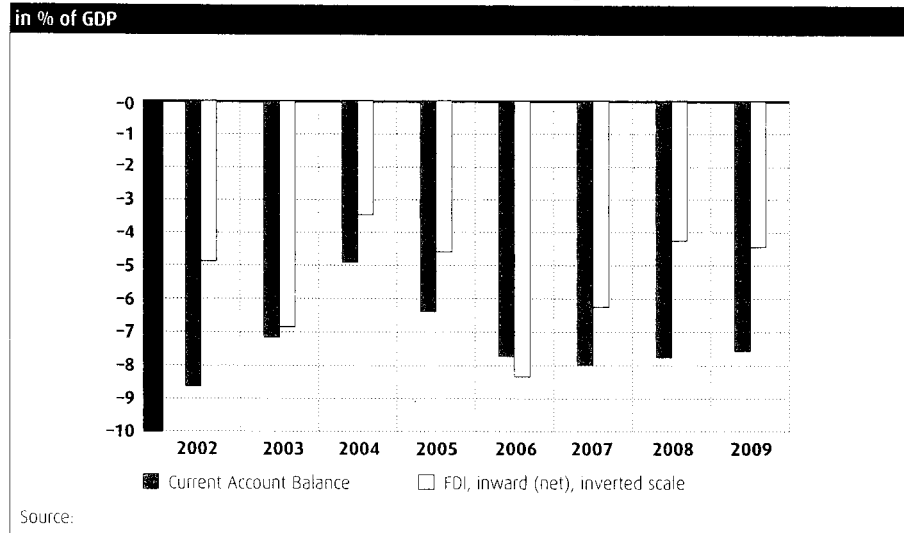
A total of EUR 590 million will be made available to Croatia from the IPA (Instrument for Pre-accession Assistance) from 2007 to 2010. The EU Commission and Croatia have agreed to a seven-year plan of regional cohesion, and the main priorities will be in the areas of traffic and transportation, environment and regional competitiveness. The strengthening of administrative capacity at the central and local government levels is underlined as an important pre-condition for successful use of the available resources.

The judiciary reform, return of refugees and the fight against corruption remain the principal political requirements for Croatia's accession to the EU and NATO.

Competition for power could hamper long-term growth prospects

The position of the main opposition party, the Social Democratic Party (SDP), has been strengthened by the recent election of Zoran Milanović, a younger-generation politician, as party president. A majority of public opinion surveys has shown that the SDP has an advantage over the ruling Croatian Democratic Union (HDZ). While this tends to be ascribed to the appearance of a new person in the political arena and to the reverence for the recently deceased long-time SDP President Mr Ivi-

Current account balance and FDI financing



ca Racan, it seems that some other factors are at work here as well.

Even though the transition process to date has produced a rather strong private business sector and the middle class is consolidating, a fear of uncertainties associated with the market economy is still present. Therefore, there is a growing sentiment that the government should play a more relevant role in the economy, and for greater social transfers, which should ensure a higher degree of social security and equality.

The SDP's political platform for the upcoming election, as initially outlined, shows that the party will target exactly these social groups, so its main messages call for increased government management of the economy, higher taxes for the affluent, free health care and education, and higher salaries and pensions. While the SDP expects that a much higher rate of economic growth will ensure the necessary resources for the implementation of their programme, they do not dismiss

the idea of increasing the fiscal deficit to that end.

It will be very difficult for the ruling HDZ to counter such an "offer" by simply calling attention to its solid economic performance and successful track record in implementing some economic reforms (such as enhanced business climate, strengthening of public finances, repayment of debts to pensioners and the progress made in the EU accession process). It is therefore realistic to expect that the HDZ will also offer higher social transfers.

Therefore, the final outcome of the pre-election "competition in promises", regardless of which party wins, could be a relative deterioration of the fiscal position with a reverse negative impact on external vulnerability. It remains to be seen whether the framework imposed by the EU accession process will be strong enough to prevent any major divergence from the desired direction of reforms.

Event	Date	Reading
IPO of T-Telecom	Sept	Important for fiscal reasons and for the further development of domestic capital markets
Release of information on GDP growth in Q2	Sept	Growth in Q2 is expected to remain strong, driven by investment and exports