

Croatia



OUTLOOK

Economic growth this year and next will remain robust in Croatia. That said, with data for July from the central bank indicating that credit growth is slowing following the imposition of a 3 % credit growth limit for the second half of 2007, we see GDP growth at 5.5 % for the full year compared to an estimated 6.8 % in the first half of the year. In these conditions the current account deficit will remain high (close to 8 % of GDP) over

the forecast period, although high FDI and medium and long-term debt inflows point to a stable external position. Although tighter credit conditions due to the current turbulence in world financial markets, the country's credible EU accession path will act as an important anchor for investor sentiment. In the medium term, we see the currency exposed to continued upward pressure and inflation remaining low.

MOODY'S LT FC RATING

BAA3/Positive

S&P'S LT FC RATING

BBB/Stable

FITCH LT FC RATING

BBB-/Stable

SPREAD AVG (AUG) 60

EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR bn)	31.3	34.2	36.9	39.8	42.7
Per capita GDP (EUR)	7,038	7,704	8,303	8,949	9,616
Real GDP, yoy (%)	4.3	4.8	5.5	4.7	4.4
Inflation (CPI), yoy, eop. (%)	3.6	2.0	3.2	2.2	2.5
Inflation (CPI) yoy, avg. (%)	3.3	3.2	2.4	2.8	2.5
Unemployment rate, avg. (%)	12.7	11.2	10.2	9.4	8.8
Exchange rate HRK/EUR, eop.	7.38	7.35	7.35	7.34	7.32
Exchange rate HRK/EUR, avg.	7.40	7.32	7.34	7.33	7.30
1w Zibor, avg. of Dec	4.38	3.84	4.50	4.50	4.30
1w Zibor, avg. of the year	4.30	3.28	4.65	4.60	4.40
Current account balance/GDP (%)	-6.4	-7.8	-8.3	-7.9	-7.5
FDI/GDP (%)	4.6	8.3	6.2	4.3	4.4
Budget balance/GDP (%)	-4.0	-3.0	-2.6	-2.5	-2.2
Public debt/GDP (%)	43.7	40.8	39.2	38.1	37.2
Total external debt/GDP (%)	82.4	85.3	86.2	86.3	86.2

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

MAIN TOPICS

- In 1H 2007 economic growth was well above the long-term trend at 6.8 % yoy, driven by domestic demand even though the contribution of exports to growth rose to 3.3 percentage points. Nonetheless, seasonally adjusted quarter on quarter data do point to a moderation in growth.
- Strong domestic demand saw the merchandise trade deficit widen by 10.3 % yoy in the seven months to

July, even though merchandise export growth (+10.9 % yoy) outperformed import growth (+10.6 %) in this period. The current account deficit could widen to 8.3 % of GDP this year.

- Data for July indicate that the cumulative effects of the Croatian National Bank's administrative measures and the 3 % credit growth limit for the second half of 2007 is slowing credit growth. Encouragingly, preliminary

data for August suggest foreign debt growth is slowing.

- Strong growth of tax revenues as well as one-off dividend income (HRK 1.2 bn), in addition to an estimated HRK 5 bn in Q4 privatisation revenues, point to a comfortable fiscal position this year. Nonetheless, the promises being made by politicians ahead of the general elections present a medium-term risk for the fiscal policy stance.

Central bank measures to dampen credit activity

Robust economic growth in the first half of the year

GDP growth in Q2 2007 was a higher than expected 6.6 % yoy, with household consumption up 6.5 % yoy, investment activity rising a slower than expected 5.8 % and government spending rising 2.8 % yoy, reflecting to an extent an increase in EU funds from Brussels. Growth for the first half of 2007 was 6.8% yoy even though seasonally adjusted quarter on quarter data do point to a moderation in growth.

After having risen 8.0 % yoy in the first quarter, industrial production rose 7.1 % yoy in the second quarter, reflecting solid investment activity and export growth. In July, industrial production was up sharply by 8.5 % (partly on the back of an extra day's activity). Nonetheless, seasonally adjusted data show that the trend in the index is slowing gradually. Retail sales remained strong in the second quarter, rising 5.6 % yoy and up a further 5.9 % yoy in July, suggesting household consumption remains strong. This would be consistent with rising employment growth and the impact of the repayment of pensioner debt instalments.

Strong growth in H1 2007 has also seen an increase in real net wage volumes of 7.0 % yoy as employment has increased. In addition, the stock market has performed well and, since many first time investors profited handsomely from the IPO of the oil and gas company INA in late 2006, and many expect to repeat the experience with the IPO of telecoms incumbent T-HT (will be

listed in Zagreb and London on 5 October), incomes in general will rise fairly strongly in 2007. Private consumption will therefore play a more important role in the structure of GDP growth.

In 2008, economic growth will remain robust according to our forecast, even though we see economic activity slowing from 5.5 % to 4.7 %.

The main reason is that we expect the Croatian National Bank (HNB) to maintain its 12 % credit growth ceiling in 2008. As we outline below, the latest tweaking of the credit limit for 2007 appears to have had the desired effect with official data for July showing a nominal drop in credit activity compared to June.

Although we do not expect the recent turbulence in global credit markets to have a short-term effect on the Croatian economy, when credit markets do settle down, we expect that the re-pricing of risk will see less benign credit conditions than before. For a country like Croatia, which has made substantial use of international capital markets to boost infrastructure spending and economic growth, this is an important consideration. That said, the main effect of this turbulence will be through slower growth in the EU, which although not perfectly correlated with Croatian growth, will nonetheless not be as supportive for exports.

With the government due to repay the last of four instalments of pensioner debt

to those pensioners who opted for a 50 % discount, but accelerated payment, before the end of the year, we will not see as significant an impetus to domestic demand in 2008 from this policy. Indeed, those pensioners who opted for no discount by repayment over an eight-year period will next year receive an estimated HRK 550 mn compared to the approximately HRK 2.5 bn paid out in 2006 and 2007 to those pensioners who accepted a 50 % discount.

Credit growth slows as cumulative effects of HNB tightening begin to produce results

The HNB changed its 12 % credit growth ceiling three times during the first half of 2007. The end result is that its efforts appear to have finally had the desired effect of slowing credit growth. Indeed, July 2007 saw loans to the retail and corporate sectors, which are affected by the HNB's targeted measures, fall by approximately HRK 300 mn compared to June. This is the first decline in the stock of retail and corporate loans since January 2005.

It thus appears that the cumulative effects of four years of progressively introduced measures aimed at reducing credit growth are finally yielding the desired results from the HNB's perspective. By the end of the year the HNB will have six months of data to judge how effective their measures have been.

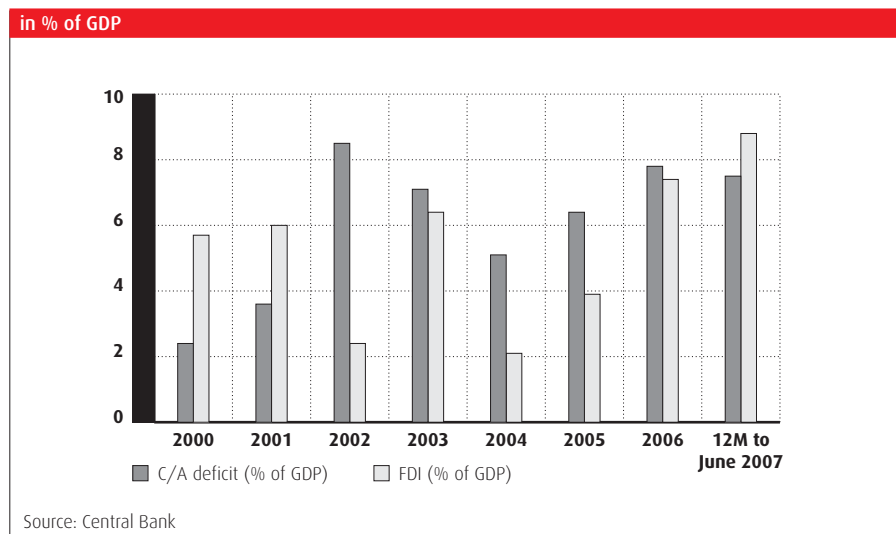
Nonetheless, in early October governor Rohatinski made clear there would be no

Short-term Indicators

	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07
Real GDP, yoy (%)	-	4.7	-	-	4.8	-	-	7.0	-	-	6.6	-	-
Industrial production, yoy (%)	9.8	3.0	8.3	6.9	3.1	9.0	5.7	9.0	9.4	7.7	4.4	8.5	2.8
Inflation (CPI), yoy (%)	3.4	2.8	2.1	2.5	2.0	1.8	1.2	1.8	2.3	2.2	2.0	2.1	2.6
Unemployment rate, avg. (%)	-	-	-	-	10.6	-	-	11.2	-	-	-	-	-
Exchange rate, kuna/EUR eop.	7.31	7.38	7.37	7.33	7.35	7.37	7.35	7.38	7.37	7.31	7.30	7.30	7.32
1W Zibor, avg.	3.6	3.9	3.9	2.8	3.8	3.5	3.7	4.0	4.4	4.7	5.6	7.2	4.6
Export, (EUR) yoy (%)	10.1	3.0	40.7	4.3	14.9	-3.2	19.0	-6.2	25.7	10.3	19.0	21.2	4.9
Import, (EUR) yoy (%)	16.8	7.2	11.6	10.9	9.1	5.2	12.1	7.2	17.7	16.5	2.4	18.2	5.3
Trade balance, EUR mn	-775	-718	-799	-761	-588	-608	-745	-907	-867	-972	-795	-862	-815
Current account, EUR mn	-	2,098	-	-	-1,490	-	-	-2,022	-	-	1,350	-	-

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

Current Account Deficit and FDI



change to monetary policy settings in 2008. Indeed, he suggested policy may well be tightened next year.

Money market rates were stable until the end of June when the HNB surprised the market by accepting only 75 % of bids at its regular reverse repo auction. This surprise, followed by a government bond issue in early July and the additional demand for local currency from abroad in the lead up to the peak tourist season saw money market rates spike in July and early-August. Having digested this activity the money market saw rates head sharply higher in late September on much higher than expected demand for paper at the IPO of T-HT, motivating a record FX intervention on 1 October which saw HRK 2.6 bn of fresh liquidity being injected.

This year the EUR/HRK has been exposed to less upward pressures as bank borrowing abroad has fallen. We continue to see the EUR/HRK exposed to upward pressures in the period before accession to the EU, but in the short term that pressure will be limited. All in all, we see the currency to remain close to current levels in the next years.

Inflation is low, but expected to slightly increase in the next months

Inflation in Croatia remains low and in the 12 months to August 2007 averaged 2.1 % yoy. That said, the remainder of the year will see an increase in the consumer

price index, driven by a base effect associated with lower fuel prices from September 2006 onwards. If all of the reported increases in meat, bread and food prices which are expected to occur in the autumn are implemented, there will also be a short-term impact on headline inflation. Recent movements in oil prices represent a similar risk in the short term. Nevertheless, we do not see this as a harbinger of a sharp rise in inflation, especially as core inflation remains stable (averaging 2.5 % yoy in the first half of this year). After the price increases of this year, although not dramatic, we expect inflation to remain under 3 % in 2008–'09.

In addition, there is little evidence at the aggregate level that wage pressures are a threat to inflation. In the first half of the year, gross wages rose 6.0 % yoy in nominal terms (3.7 % in real terms, deflated by producer prices). In the industrial sector during this period labour productivity rose 7.0 % yoy, suggesting limited risk of wage-driven inflationary pressures. This is further borne out by the labour force survey data for Q1 2007. The unemployment rate remained the same as the average for 2006 at 11.2 %.

Strong tax revenue growth, but the fiscal position remains exposed to risk

In the first half of the year tax revenues at the consolidated general government level rose 12.7 % yoy, reflecting the strong economic growth. The Ministry of Fi-

nance forecast an increase in tax revenues of 9.7 % yoy for the whole of 2007 and, although we expect economic growth to slow in the second half of the year, we see scope for the budget deficit to narrow on account of stronger tax revenue growth.

That said, the fiscal position in Croatia is exposed to risk. For a start, most of the fiscal consolidation in recent years has been on the back of higher tax revenues which have mainly been driven by stronger economic growth. In the lead up to the November general election legislation has been passed aimed at adjusting the pensions of post-pension reform pensioners to the (higher) pensions of people who retired before this reform. It is also not yet clear whether further concessions to pensioners will be made prior to the election, all of which adds to the uncertainty of the fiscal cost of these policy measures.

The government's pensioner debt repayment initiative is being recorded off-budget, and it is not yet clear whether the same approach will be taken for the adjustment of the pensions of "new pensioners". In addition, not all lower-level government health spending is captured by the general government figures, while the state-owned reconstruction and development bank's deficit also falls outside the budget deficit definition.

Another risk for the fiscal position is the state of the shipbuilding industry. By the end of the year, the European Commission is to provide its opinion on the government's restructuring programme for the industry. Statements to the press by high-ranking government officials suggest the budget is likely to contribute another HRK 7 bn in a one-off final funding to facilitate the restructuring of the industry.

The Ministry of Finance's macro-fiscal projections are on the optimistic side, foreseeing economic growth of 6.1 %–7.0 % between 2008 and 2010. It thus forecasts a narrowing of the budget deficit from 2.6 % of GDP this year to only 0.5 % of GDP in 2010. Without efforts to rein in government spending we do not

see these targets being met. For this reason we expect the budget deficit to remain essentially unchanged in 2008 and 2009. Indeed, if growth were to slow at a rate below the general trend the deficit would more likely head in the other direction.

Current account deficit to widen slightly

Strong domestic demand has continued to drive double digit merchandise import growth. In the first seven months of the year the merchandise trade deficit has widened 10.3 % yoy to EUR 5.75 bn. Import growth during this time has risen 10.6 %, but non-oil imports rose 11.8 % yoy, which is 2.7 percentage points higher than in the corresponding period of 2006.

The growth of merchandise exports in this period was even higher at 10.9 % yoy. Nonetheless, the combination of strong import growth and the high import base will see the merchandise trade deficit widen this year to close to EUR10 bn, even though we see domestic demand slowing in the remainder of the year.

While this will act to widen the current account deficit, all anecdotal evidence suggests the 2007 tourist season will be the best on record. In addition, Q1 2007 exports of services were above the general trend. These factors will moderate the widening of the current account deficit which we forecast at 8.3 % of GDP this year. In 2008 and 2009 the CA deficit is expected to further ease towards 7.5 %, with export increasing more than imports.

Preliminary data from the central bank indicate that foreign debt rose to EUR

30.4 bn at the end of August. This represents an increase of 4.2 % compared to the end of 2006. The banking sector's exposure to foreign debt fell 17 % to EUR 8.5 bn, while the foreign debt exposure of companies has risen 27.4 % since the end of December to EUR 12.1 bn. The final quarter of the year will see a seasonal increase in foreign debt. Nonetheless, we expect the growth of foreign debt to stabilise at just over 86 % of GDP in the forecast period.

EU membership negotiations on track

On 26 June 2007 Croatia opened negotiations on a further six chapters of the acquis communautaire, doubling the number of chapters being negotiated to 12. The official goal of the government is to complete the negotiation of all chapters by the end of 2008.

Croatia is progressing steadily in its negotiations with the EU over full membership. Once the general elections are out of the way, an acceleration in negotiations activity is expected, although Croatia's goal of closing all the chapters of the acquis by the end of next year remains ambitious.

In the sphere of economic policy, subsidies and competition policy issues are the most challenging. The latest Competition Authority summary of subsidies to industry, released in September, showed that subsidies rose 63 % in 2006 and reached 3.4 % of GDP. This is partly the result of the commencement of the restructuring of shipyards and steel mills, which in the meantime have been sold. Even when the temporary nature of these increases is taken into account, a major effort will be required to lower subsidies to EU levels in the medium term.

Populism to characterise the election campaign

Although at the time of writing the election date had not been officially announced, 25 November is certain to be the date of the next general parliamentary elections.

It seems that populism, in a word, is going to characterise the election campaign. This is despite fairly substantial differences in rhetoric between the main political parties, the Croatian Democratic Union (HDZ) and the Social Democrats (SDP), on economic policy issues. The HDZ's position on economic policy is closer to a free market approach, whereas the SDP openly advocates an interventionist economic policy centred on a 4X4 industrial policy centred on four industries in four regions.

This more interventionist approach appears to have struck a chord with a not insignificant section of the electorate. The SDP continues to lead opinion polls approximately two months before the election. With President Mesic, one of the country's most popular politicians, repeating his own pro-interventionist economic policy stance with increasing frequency, the HDZ in response has also stressed in recent times the need to maintain state control over strategic industries. The SDP also advocates introducing capital gains and property taxes although the details remain vague. At the same time, it has not committed itself to lowering other taxes.

The main risk in all of this is that unrealistic promises find their way into the 2008 budget, loosening the fiscal position, whilst limiting the next government's progress in implementing reforms.

Event	Date	Reading
General election	25 November	EU accession path mitigates political risk aspect even though populist tones are a risk for fiscal policy settings
GDP and Balance of Payments Data	28 Dec	We expect to see evidence of a record tourist season and slower Q3 growth as credit activity slows.