



## Summary

In 2007, the Croatian economy recorded a strong real GDP growth, an increase in employment, decrease in unemployment and slowdown in foreign borrowing. However, the inflation rate accelerated and the current account deficit increased in the same period. Against the background of the inflation acceleration – caused by negative shocks on the supply side and, to some extent, on the demand side – the Croatian National Bank fulfilled its objective of maintaining price stability by ensuring the stability of the kuna exchange rate against the euro. In addition to the efforts to realise its primary objective, the central bank acted to slow down the growth of bank placements, thus reducing banks' external debt and decelerating the growth of external debt of the economy as a whole. These results were achieved by implementing a set of monetary policy instruments, especially significant being the marginal reserve requirement, prescribed minimum foreign currency liquidity and the Decision on the purchase of compulsory CNB bills, which prescribed the compulsory purchase of CNB bills for banks whose placements growth in 2007 exceeded 12%.

Increasing inflationary pressures were among the key features of the macroeconomic environment in 2007. The annual rate of change in the CPI increased from 2.0% at the end of 2006 to 5.8% in December 2007, with the inflation rate accelerating sharply after July. Negative supply-side shocks sharply drove up the domestic prices of food and refined petroleum products. The increase in the domestic prices of food products was caused by drought and the growth of world food raw material prices (primarily cereals, oilseeds and milk), while the increase in domestic refined petroleum product prices resulted from the crude oil price rise in the world market. Inflationary pressures coming from the demand side were observed, among other things, in the strong growth of household disposable income and sharply accelerated real annual growth of personal consumption.

Other price indicators also sharply accelerated in 2007. The annual core inflation rate of change rose from 2.3% in December 2006 to 2.4% in July 2007 and to 5.0% in December 2007. This was to a large extent due to the price growth of industrial food products. The inflation acceleration over 2007 was also due to the price increase in agricultural products. Administrative prices also grew in that period, primarily due to the price increase in refined petroleum products. Domestic industrial producer prices accelerated sharply in 2007, with their annual rate of change growing to 5.8% in December 2007 (from 1.9% in December 2006), mainly because of the price growth of intermediate products, energy and non-durable consumer goods.

In 2007, the environment of CNB's monetary policy was, in addition to the mentioned inflationary shocks, marked by a sharp nominal increase in household disposable income and strong foreign borrowing by government-related companies. The increase in household disposable

income was primarily caused by the repayment of debt owed to pensioners and growth of government transfers to households. The repayment of debt to pensioners, which was financed by the flotation of government-owned companies' shares, started in mid-2006, with a pay-out of HRK 2.4bn (1.0% of GDP), and continued in 2007 with HRK 3.4bn (1.2% of GDP). The annual growth rate of government expenditures for social benefits was almost twice higher in 2007 than in the previous two years. Consumer confidence surveys, carried out around mid-2007, showed a marked increase in consumer confidence, which could partly be ascribed to the favourable macroeconomic environment, but also to expectations of an increase in household capital gains on investments in shares and investment funds. In addition, external debt of large government-owned companies increased by EUR 1.2bn in 2007, in contrast with EUR 0.2bn in 2006. Road construction companies recorded the highest external debt increase, EUR 0.7bn, compared with EUR 0.2bn in 2006. Ina and local government-owned companies also strongly contributed to the growth of external debt in 2007.

The sharp acceleration in the nominal growth of household disposable income and companies' funds raised by foreign borrowing led to an acceleration of domestic demand real growth and, in turn, of real GDP growth, which rose from 4.8% in 2006 to 5.6% in 2007.

The CBS's quarterly GDP estimate for 2007 shows that personal consumption, the main component of aggregate demand, grew annually by 6.2% in real terms and, due to its trends, which were mainly in line with changes in its primary and secondary financing sources, contributed 3.7 percentage points to overall GDP growth. Final consumption was also boosted by the government consumption growth of 3.4%, caused primarily by the increase in expenditures for the use of goods and services. Due to the slowdown in private investments in the second half of 2007, gross fixed capital formation increased by 6.5%, a more moderate rate than in the previous year, and contributed 2.0 percentage points to overall GDP growth. The slowdown in goods and services exports and imports in 2007 was mainly due to a drop in trade in goods, with net exports contributing a negative 0.8 percentage points to the real growth of the economy.

According to a GDP estimate by production approach, service activities made the largest contribution to GVA growth in 2007 (3.7 percentage points). The surge in personal consumption, coupled by good results in tourism, led to an increase in GVA in trade, with the result that the annual GVA growth rate for 2007 stood at 7.5%.

Other activities made a smaller contribution to the real growth in whole economy GVA (2.3 percentage points). However, GVA in industry rose at a significant rate of 6.5%, primarily due to an increase in consumer goods production. In contrast, the growth of GVA in construction decelerated considerably, which can mainly be attributed to a drop in private sector investments.

Reflecting overall economic developments, labour market trends were positive in 2007. Registered unemployment stood at 254,484 at the end of the year, dropping by 13.2% as compared to the end of 2006. The average registered unemployment rate declined from 16.6% in 2006 to 14.8% in 2007. The CBS's Labour Force Survey results, previously released semi-annually, have been published quarterly since the beginning of 2007 in order to improve the Survey's methodology and implementation and bring it in line with the EU *acquis*. This change in the Survey release schedule has made the comparison of data for 2007 with the previous data series more difficult. According to the latest available survey data for the first three quarters in 2007, the unemployment rate was 9.6%.

CBS data show that employment averaged 1,516,900 in 2007, increasing by 3.3% over 2006 and recording a rate of change equal to the one in 2006. The average real gross and net wage increased moderately, by 3.4% and 2.3% respectively.

In 2007, the central bank continued to implement monetary policy aimed at maintaining the stability of the nominal kuna exchange rate against the euro, which is the main anchor of domestic inflationary expectations and basic precondition for domestic price stability. Furthermore, a stable kuna/euro exchange rate has a positive impact on the price stability of goods imported from the eurozone. Overall, the kuna/euro exchange rate appreciated slightly by 0.3% in nominal terms in 2007, with the euro dropping from HRK 7.35/EUR at the end of 2006 to HRK 7.33/EUR at the end of 2007. Persisting during most of the observed period, appreciation pressures primarily resulted from a seasonal foreign exchange inflow from tourism, foreign exchange supply generated by corporate foreign borrowing and inflow of foreign exchange aimed for bank recapitalisation. In addition, the kuna/euro exchange rate appreciation was also affected by the growing demand for the kuna for investments in securities on the domestic market. In the first half of 2007, the central bank conducted only foreign exchange transactions with the government, while the main instruments for the creation of kuna liquidity were reverse repo auctions.

The nominal effective exchange rate of the kuna appreciated by 3.2% over 2007, primarily because of a strong nominal appreciation of the kuna exchange rate versus the US dollar. As domestic consumer prices rose at a faster rate than foreign consumer prices in 2007, the index of the real effective exchange rate of the kuna deflated by consumer prices appreciated by 5.5% in the observed period. The same index deflated by producer prices appreciated by 3.8% in the same period, suggesting that domestic producer prices only slightly outpaced foreign producer prices.

The central bank expanded its set of monetary policy instruments in 2007, aiming to contribute to alleviating the imbalances of the Croatian economy in international trade in goods and services. In addition to the marginal reserve requirement rate of 55%, which considerably increased the price of foreign borrowing for banks, and the minimum foreign currency liquidity ratio of 32%, the central bank, motivated by the positive results achieved in 2003 and with an aim to slow down the growth of bank placements, enacted the Decision on the purchase of compulsory CNB bills, which prescribed the obligatory purchase of CNB bills for banks whose placement growth in 2007 exceeded 12%.

These central bank measures successfully curbed the growth of bank placements, bringing their annual rate of change down from 22.9% in 2006 to 15.0% at the end of 2007. Banks continued to focus on household lending in 2007, making adjustments to the said decision by reducing corporate lending. However, although lending to companies decelerated considerably, banks raised the required funding from other financing sources, so that the rate of change in total corporate debt went up from 25.3% in 2006 to 26.0% until the end of 2007. Central bank measures thus had an effect only on the reduction of borrowing-financed household consumption.

Bank lending was to a great extent financed from domestic financing sources, while prudential regulation measures brought about an increase in bank capital as a permanent financing source. Due to these trends, and with the restricted growth of placements, banks markedly improved their external positions in 2007. With foreign liabilities down by HRK 10.9bn and foreign assets up by HRK 6.8bn, banks' net foreign assets increased by HRK 17.7bn. The decrease in banks' external debt led to a sharp drop in marginal reserve requirements, which were, standing at HRK 5.0bn at the end of 2007, HRK 2.7bn lower than at the end of 2006.

Due to stable kuna/euro exchange rate trends, there were not many central bank foreign exchange interventions in 2007. The foreign exchange purchased from banks at auctions totalled EUR 0.8bn, which was a decrease relative to the net purchase of EUR 1.2bn in 2006. In addition to banks, the CNB also conducted foreign exchange transactions with the MoF, selling a net of EUR 0.2bn. The CNB created a total of HRK 4.9bn through foreign exchange transactions carried out with banks and the central government in 2007, which proves that foreign exchange transactions continued to prevail as the main instrument for reserve money creation.

In 2007, the CNB considerably relied on regular weekly repo operations in short-term money supply management, especially during periods when pressures increased both in the money and foreign exchange markets, as in the summer months and during the invitation for bids to purchase T-HT shares. The amount placed under reverse repos averaged HRK 3.4bn in 2007, which was three times more than in 2006. Due to rising inflationary pressures, reserve money creation at the auctions held in the last quarter became more restrictive and the marginal repo rate increased to over 4%.

In 2007, reserve requirements continued to be the main liquidity management instrument. Domestic deposits growth resulted in an increase in the reserve requirement calculation base, with kuna reserve requirements rising at a somewhat faster rate than foreign currency reserve requirements. The central bank also sterilised liquidity through compulsory CNB bills subscription, especially in the second half of the year when the provisions of the decision governing their subscription were tightened.

As a result of these central bank transactions, reserve money (M0) went up by a total of HRK 5.6bn (12.1%) in 2007, which was a slightly lower increase than in 2006. Money supply (M1) grew by HRK 9.4bn (19.3%). The surge in M1 resulted from the economic upturn and was primarily accounted for by the increase in household and corporate demand deposits. Savings and time deposits also recorded a sharp increase, with foreign currency savings deposits rising at an especially high rate and kuna deposits slowing growth relative to the previous year. These trends in money supply and savings and time deposits led to an increase in total liquid assets of HRK 33.4bn (18.3%), which was equal to the increase in 2006.

Money market interest rates, relatively low and stable in the first half of 2007, increased sharply and became much more volatile at mid-year. Given the good liquidity of the banking system, these interest rate trends could be attributed to the supply and demand mismatch, where a small group of banks generated the lion's share of demand for the kuna, while the participants with excess funds refused to invest them at standard prices. Money market disturbances in the second half of the year were also generated by the initial public offering of the 32.5% government share in T-HT. The weakening of the impact of capital market transactions on the demand for money resulted in a primary liquidity surplus in October 2007, which the CNB withdrew by reducing the volume of open market operations. However, due to the shallowness of the market and its inability to quickly and easily adjust to large inflows and outflows of funds without considerable interest rate changes, a consequence of restoring liquidity to normal levels was that interest rates remained high until the end of the year.

Having dropped in the first half of 2007, interest rates at T-bills auctions increased in the second half of the year. The weighted interest rate on 364-day T-bills recorded the highest increase, from 3.88% in January to 5.05% in December, while weighted interest rates on 91 and 182-day bills rose more moderately, from 3.46% and 3.63% respectively in January to 3.60% and 3.75% respectively in December 2007.

Banks' interest rates on short-term loans halted the several-year downward trend in 2007. Interest rates on long-term corporate loans indexed to foreign currency continued growth from 2006, whereas interest rates on long-term household loans indexed to foreign currency, having fallen early in 2007, increased in the second half of the year. Banks' deposit rates increased sharply in 2007. These domestic interest rate trends reflected the growth of European interest rates, started late in 2005, as well as banks' adjustment to CNB measures.

The domestic capital market was dynamic in most of 2007, continuing its accelerated growth and development. The annual share turnover hit a historical high of HRK 22.0bn, the number of transactions doubled and the stock exchange index, CROBEX, reached the highest value on record. In addition to the anticipated growth of institutional investors' assets and inflows of venture capital, demand for equity securities was also boosted by the growth of general public interest in share investments in the domestic capital market (2007 was marked by initial public

offerings of shares, especially by the IPO of T-HT), which resulted in a sharp increase in the prices and liquidity of most shares listed on the ZSE. The CROBEX stood at 5,239 points at the end of December 2007, registering a growth of 63.2% relative to the end of December 2006. The Croatian debt securities market also recorded a record high bond turnover of HRK 43.9bn, and the government, municipalities and companies continued borrowing in similar volumes as in the previous years. The key event for the Croatian capital market in 2007 was the merger of the Varaždin Stock Exchange with the Zagreb Stock Exchange, which turned the ZSE into the focal point of securities trading in Croatia.

The narrowing of the yield spread between Croatian eurobonds and benchmark German bonds in the first half of 2007 signalled an improvement in Croatia's rating on the international capital markets. However, these spreads again widened considerably by the end of 2007, owing to the US subprime mortgage market crisis and a change in risk perception of capital market investors worldwide, and especially in developing countries.

Despite a slowdown, bank lending remained strong in 2007, driving up domestic demand and increasing imports, with the result that the current account deficit stood at EUR 3.2bn (8.6%), which was an increase of EUR 0.5bn (0.7 percentage points of GDP) compared with 2006. As in the previous years, the deficit increase resulted from growing imbalances in international trade in goods. In contrast with the goods account, the balances in other current transactions accounts improved relative to 2006. The surplus in international trade in services increased considerably, primarily due to the continued growth of income from tourism. In addition, the deficit in the factor income account slightly reduced, while the downward trend in the surplus on current transfers slowed.

The current account balance deteriorated by almost one-fifth in 2007 relative to 2006 owing to a sharp increase in the foreign trade deficit. The goods account balance deteriorated by 13.1%. Looking at total aggregates at current prices, this was due to a decrease in the annual growth rate of goods exports (from 17.2% in 2006 to 8.6% in 2007), which exceeded the drop in the annual growth rate of goods imports (from 14.0% in 2006 to 10.8% in 2007). It needs emphasising, however, that these developments contain many noises. The slowdown in the growth of exports and imports was, among other things, to a great extent due to the construction of the North Adriatic pipeline. Before it was built, the gas from these drills was first exported to Italy and then, in a large measure, imported into Croatia. The pipeline construction had a lower impact on the slowdown in the annual growth rate of goods imports than on goods exports, as gas accounts for a considerably lower share in total goods imports than in goods exports. In contrast, a common change in the correction factors, used for adjusting the value of goods imports measured according to the c.i.f. parity to the value according to the f.o.b. parity, led to an increase in the f.o.b. value of goods imports. A detailed analysis of developments in foreign trade which excludes some noises suggests different trends. For example, the annual growth rate of total goods exports, excluding ships, oil and refined petroleum products and natural and manufactured gas, in constant exchange rate terms, reduced from 12.6% in 2006 to 11.5% in 2007, and that of goods imports dropped from 14.4% to 12.1%.

External debt increased by EUR 3.7bn (12.5%) over 2007, standing at EUR 32.9bn at the end of the year. The debt increase was slightly lower than in 2006 due to the decrease in banks' external debt resulting from monetary policy measures, primarily those restricting the growth of placements not subject to CNB bills subscription and those providing for the continued application of the marginal reserve requirement rate. The slowdown in external debt was also due to the government's switch to domestic borrowing, thanks to which this sector's debt remained almost unchanged in relation to the end of 2006. The opposite effect was produced by the corporate debt increase of a high EUR 3.9bn (41.6% annually). In addition to majority private-owned companies, the accelerated growth in this institutional sector's debt was also accounted for by public and mixed-ownership companies. Furthermore, the debt generated by direct investments, mostly involving corporate debt investments, also accelerated growth.

External debt rose at a higher rate than nominal GDP, with the result that the external debt to GDP ratio went up by 2.3 percentage points, from 85.5% at the end of 2006 to 87.8% at the end of 2007. The ratio between external debt and goods and services exports also increased, from 172.2% to 179.2%. Net external debt (as shown by data on the international investment position) also continued to grow, despite the strong growth of domestic sectors' foreign assets, including international reserves, and relative indicators of net external debt also worsened. The net external debt to GDP ratio increased by 1.6 percentage points in 2007 over 2006, standing at 40.8% at the end of 2007, while net debt as a percentage of goods and service exports grew by 4.4 percentage points, reaching 83.3%.

The net inflow of funds in the capital and financial transactions account increased by 15.6% in 2007 compared with 2006, standing at EUR 4.1bn. The sharpest increase was recorded in foreign direct investments into the RC, which amounted to EUR 3.4bn in 2007, a rise of 33.5% over the year before. Net outflow of funds from the portfolio investment account reduced from the previous year due to a surge in domestic sectors' liabilities and slowdown in the growth of their foreign assets. Net inflows from other investments were half lower than in 2006, which was in consequence of a marked drop in banks' foreign liabilities and increase in their foreign assets.

According to the balance of payments data, international reserves increased by EUR 722m in 2007, which was half of the increase in the previous year. According to the monetary statistics data, international reserves reached EUR 9.3bn at the end of 2007, which sufficed for the coverage of 5.2 months of goods and services imports. The slower growth of international reserves in 2007 was related to a drop in banks' allocated marginal reserve requirements caused by a reduction in their foreign liabilities. A similar effect on international reserve trends was produced by a lower purchase of foreign exchange from banks through foreign exchange interventions relative to 2006.