

Economic

Credit Agencies

Moody's: Baa3

S&P: BBB

Fitch: BBB-

Nominal GDP (USD, 2003)

USD28.6bn

Population (2003):

4.5 millions

Total Trade / GDP:

60.0%

Currency:

Croatian kuna

Exchange regime:

Managed float

Merchandise imports from Canada:

CDN\$17.8 million

Main sources of Foreign Exchange (excl. FDI):

Machinery and transport equipment exports

Largest Merchandise Trading Partner:

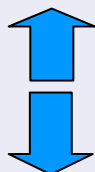
Germany (14%)

Main imports:

Machinery and equipment (35%)

Fuels and lubricants (12%)

Risks to the Outlook



Fiscal deficit reined in.

Inaction on fiscal and external imbalances.

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Market Spotlight: Recent advances in macroeconomic stabilization are offset by rapid increase in foreign debt and a stubbornly large budget deficit. The budget deficit is complicated by slowing economic growth and large structural fiscal problems, which in turn has helped fuel the large external imbalances. Finally, a recent opinion from the International Criminal Tribunal for ex-Yugoslavia (ICTY) that Croatia is not cooperating sufficiently in handing over alleged war criminals has delayed the start of Croatia's EU accession talks. The sum of these factors has led one ratings agency- Fitch - to downgrade its risk outlook to "stable" from "positive".

Recent Economic Developments: GDP growth in the first quarter of 2005 – the most recent available at time of writing – was a disappointing 1.8% y/y, down from 3.8% in each of the last two quarters of 2004. Reduced spending on government infrastructure have led to lower fixed investment growth; while domestic demand has been dampened by tightening monetary policy. Overall, the economic slowdown that began in the second half of 2004 is expected to continue into 2005 and the first part of 2006 as the government retrenches fiscal expenditures. These combined factors are resulting in expected growth of 3.7% this year. Tourism - the country's largest forex earner and one of the largest industries – has shown robust growth this year, with the cumulative number of tourists in the first seven months of the year growing by 7.7% y/y to 4.98 million.

Monetary Policy and Exchange Rate: Monetary policy has considerably tightened as the central bank has sought to curb domestic credit expansion and curb the large current account deficit. In addition to raising interest rates, the central bank has increased reserve requirements that banks must hold with the central bank. The use of administrative measures over interest rates to control credit demand is the result of the prevalence of the euro in the economy, thereby limiting the effectiveness of interest rates. In any event, the credit boom which characterized the economy in previous years appears to be subsiding.

Fiscal Policy: Efforts last year to contain the fiscal deficit to below 5% were not quite successful, with final numbers showing a fiscal deficit of 4.9%, marginally higher than the 4.5% target. The 2005 fiscal deficit is currently forecast at 4.6% of GDP, still higher than the 4.2% target. The task of restricting fiscal expenditures is particularly difficult for the authorities given the government's pre-electoral commitments complicated by its minority government status. To the extent possible, the government is encouraged to meet its borrowing requirements in the domestic capital market, to promote its development, stem appreciation pressures, and absorb liquidity.

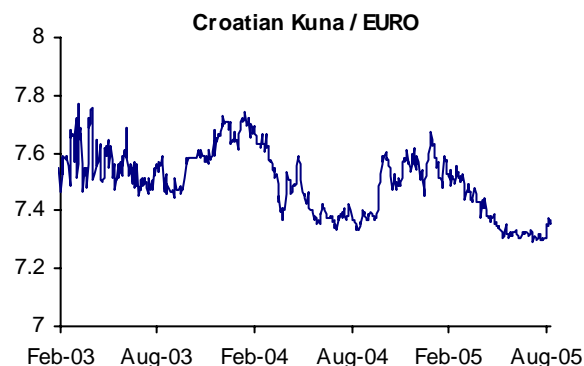
Structural Reforms: Structural reforms have continued to lag, particularly privatization and the restructuring of loss-making state-owned enterprises. The government appears hesitant in front of the difficult task of privatizing over 300 companies, many of which are not viable. The state pension system is also a candidate for reform.

External Accounts and Debt: Large-scale net foreign borrowings by both the public sector and domestic banks have fueled a rise in foreign debt to over 90% of GDP, although debt service has so far remained controlled thanks to the long-term repayment profile of many of these loans. The trade and current account deficits have widened significantly, reflecting continued strong import expansion resulting from strong domestic demand and slow export growth. Diminishing FDI flows have resulted in the authorities increasingly resorting to foreign loans to finance the external balance. While the external imbalances fuelling this rise in debt are expected should retrench somewhat as domestic demand retrenches, the country must still pay off its debt.

Outlook: Looking forward, the economy remains constrained by a large public sector and public sector debt, heavy tax burden, and political difficulties with the International Yugoslav War Crimes Tribunal on the issue of cooperation, leading to an unexpected over EU membership. In addition, the country must correct its fiscal and external imbalances to restore its macroeconomic balances. The unexpected snag over the EU membership is expected to be resolved during the second half of the year, leading to the start of formal negotiations shortly thereafter.

Economic Indicators

	1999-2003	2004	2005 (e)	2006(f)
GDP (% growth, real)	3.2	3.4	3.7	3.5
Inflation (% , year-end)	3.5	3.9	3.3	3.3
Fiscal Balance (% of GDP)	-5.0	-4.9	-4.6	-4.5
Exports (USD bn)	4.7	7.2	7.7	8.0
Imports (USD bn)	8.6	16.0	17.1	18.8
Current Account (% of GDP)	-5.3	-5.1	-5.0	-4.8
Reserves (month of imports)	5.5	5.1	4.9	4.7
External Debt (USD bn)	14.3	26.5	29.3	31.0
Debt Service ratio	21	20	21	21
Currency (per USD, year-end)	7.5	6.1	6.1	6.5



Political

Political Structure

Parliamentary Republic

President

Stipe Mesic (HNS)

Prime Minister

Ivo Sanader

National Legislative Bodies

- Lower chamber: House of Representatives
- (151 elected representatives)
- Upper chamber: House of Counties (68 elected members)

Major Parties (seats in the Sabor)

- Croatian Democratic Union (HDZ) - 66
- Social Democratic Party (SPD) coalition – 41 seats
- Croatian People's Party (HNS) coalition - 11
- Croatian Peasant's Party (HSS) - 10
- Croatian Party of Rights (HSP) - 8
- Croatian Pensioner's Party – 3

Last Elections

- Legislative: November 2003
- Presidential: January 2005

Next Legislative Elections

- Legislative: 2007
- Presidential: 2010

Press Freedom Survey (2005):

- Score: 37
(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:

- 2004 Score: +0.08
(-2.5: Worst; +2.5: Best)
worldbank.org

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General Political Environment:

The November 2003 elections saw the return of the Croatian Democratic Union (HDZ). This caused some international consternation because the HDZ is the party of former nationalist leader Franjo Tudjman. However, the party is now claiming that it is a moderate, pro-European conservative party, different than the party under Tudjman. To this end, it ousted some of its more extremist members and pledged to cooperate with The Hague war crimes tribunal. The HDZ has a minority position and negotiated a workable relationship with several smaller parties.

The HDZ, under Ivo Sanader, pledged to bring Croatia into the European Union (EU) by 2007. A critical hurdle for EU integration was the extradition of General Ante Gotovina. Gotovina has been indicted by the International Criminal Tribunal for the Former Yugoslavia (ICTY) at The Hague for war crimes against ethnic Serbs between 1991 and 1995 during the Serbo-Croat conflict. Gotovina was caught in December 2005. He had evaded capture for four years. Failure to capture Gotovina led to the EU postponing accession negotiations in March 2005 when Chief Prosecutor of the ICTY, Carla Del Ponte, said that Croatia was not cooperating fully with the tribunal. Indeed, she suggested that the government lacked the will to crack down on his network of supporters who, she claimed, were harbouring Gotovina within the country.

Finally, in October 2005, the EU opened accession talks with Croatia, after Del Ponte stated that the government had stepped up its cooperation. The most optimistic date for accession is 2008, but the country will likely join in 2009 or 2010. Croatia will now begin the process of incorporating the *acquis communautaire* (the EU's body of law) into its domestic laws and continue the search for Gotovina.

Opposing Sanader's HDZ is the Ivica Racan's Social Democratic Party (SDP) coalition. Reformist Racan governed from 2000-2003 and instituted many constitutional reforms to reduce the power of the presidency and increase powers of the parliament.

Investment Environment:

While the country has been open to foreign investment for several years, obstacles to foreign investment existed and there was favouritism towards domestic buyers under Tudjman. Since Tudjman's death, the official attitude, in word and action, has changed to attract foreign investors.

There are no capital controls on the repatriation of profits. Some controls are in place on capital account transactions, but not on current accounts.

The extent and inefficiency of the Croatian bureaucracy remains a significant disincentive to investment. Several high-profile Western firms have cancelled or scaled down investment plans in response to bureaucratic inefficiency.

A general culture of corruption gained a firm hold in the public administration under former President Tudjman. Links between business and government are strong, and corrupt conflicts of interest continue to be common.

In August 2004, the government reversed its decision to grant a highway contract to American company Bechtel – a USD 195 million contract that was granted without tender. This was mostly done in response to EU concerns around the contract decision, but also to avoid allegations of corruption.

Political Violence:

The fall from power of President Milosevic in Yugoslavia has removed one of the major threats to regional stability. Relations between Croatia, Serbia and Montenegro and Bosnia-Herzegovina are improving. Despite this, tensions and suspicion may remain for some time. There have been attacks on ethnic Serbs returning home to Croatia. The only known domestic terrorist group, the ethnic Serb Kajina Liberation Army, has not staged any attacks.

Organized criminal activity exists and high-level leaders have occasionally been linked to government and state officials. Smuggling, arms dealing and money laundering are widespread throughout Croatia and contribute to the risk of political violence.

Political Outlook

The October decision to open EU accession talks and the arrest of Gotovina in December mark real turning points for Croatia. Although the government's minority position is tenuous, there will be no reversal of the gains of 2005.