

ICEG EC - MEHIB Southeast European Monitor

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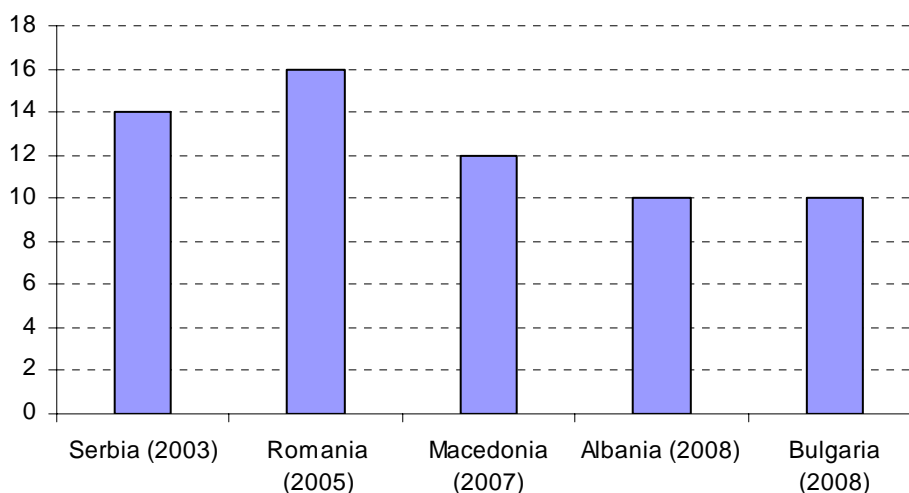
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FLAT TAX IN BULGARIA - REASONS AND EXPECTATIONS

The legislation introducing a 10% flat tax came into force on 1st January 2008 in Bulgaria. The corporate tax was already decreased from 15% to 10% on 1st January 2007, thus the novelty is the elimination of the previous three bracket personal income tax system (with three graduated rates of 20%, 22% and 24%). The new 10% flat tax applies to the first leva of income, eliminating the previous annual tax-free threshold of BGN 2,160 (1 BGN = 0.5113 EUR). Besides fixing the new tax rates on corporate and personal income, in order to minimize double taxation the tax rate on dividends and capital gains was decreased from 7% to 5%. Sole proprietors are assessed at a flat rate of 15% on net income. Currently Bulgaria's 10% flat tax rate - alongside with Albania which introduced the same rate on 1st January 2008 - is the lowest in Europe and it is among the lowest in the world.

By realising the tax reform Bulgaria is a new-comer in the group of those almost exclusively former Soviet Union or Soviet Bloc nations which have introduced the flat tax system since the middle of the 1990s¹. Regarding the SEE region, Bulgaria and Albania are both the fourth in the line of those countries, which adopted this system.

CHART 1. LEVELS OF FLAT TAX IN THE SEE REGION* (%)



*Source: SEEnet * Year of the flat tax reform in parenthesis.*

However the spread of the flat tax reform in the region does not seem to stop at this stage and level of rate: Montenegro already adopted a 15% tax on personal income and a 9% corporate tax on 1st July 2007 and by 2010 the country plans to have a unified flat tax of 9% on both personal and corporate income which would be one of the world's lowest flat taxes. In Croatia the policy debates on the flat tax reform are currently ongoing.

The countries of the SEE region all belong to the 'second wave' (countries which adopted flat tax rates after Russia), thus they have adopted a flat tax based mainly on the developments in the so-called 'flat tax tigers' (e.g. Estonia, Latvia) which experienced booms after

¹ By now the following countries introduced a flat tax in Europe and Central Asia: Estonia (1994), Latvia (1995), Lithuania (1996), Russia (2001), Serbia (2003), Slovakia (2003), Ukraine (2003), Georgia (2004), Romania (2005), Mongolia (2007), Kyrgyzstan (2007), Iceland (2007), Macedonia (2007), Albania (2008), Bulgaria (2008) - the year of the flat tax reform in parenthesis.

implementing the reform. However the source of prosperity in these countries is a hotly-debated issue as the introduction of flat taxes had been part of a wider economic reform in all cases. The limited empirical evidence to date is hardly conclusive either in this regard, or on whether the adoptions of the flat-rate tax systems achieved their original objectives.

Similarly to other countries, the introduction of flat tax in Bulgaria is part of a wider reform agenda which also includes the social insurance and the pension system. Along with introducing the 10% flat tax in the beginning of the year, the 2008 budget also contains a 3% cut in the social insurance contribution, a 10% increase in pensions and a 10% increase of the wages in the public sector. A solid background to these decisions was provided by the huge surplus (BGN 4 billion or 7.1% of estimated GDP) of the general government balance between January and November 2007. The expenditures remained in line with plans, while higher than planned inflation, robust economic growth and sound domestic demand boosted tax revenues. It also has to be noted that the earnings from the low corporate tax have been more than 40% higher as it was predicted. In December the surplus of the budget decreased (3.8%) but it remained massive. A summary of the relevant economic indicators can be seen below (Table 1.)

TABLE 1. SUMMARY OF RELEVANT ECONOMIC INDICATORS OF BULGARIA (2005-2007)

	2005	2006	2007
Real GDP growth (%)	6.2	6.1	6
Investments (GFCF, %)	23.2	17.6	24
Budget balance / GDP (%)	2	3.2	3.7
Unemployment (%)	10.1	9	6.3
Real ULC growth (%)	-1.4	-3.4	6.5
FDI / GDP (%)	14.2	17.4	19.9

Source: ICEGEC Quarterly Forecast (Winter 2007), Bulgarian National Bank

For 2008 the government plans a 3%, ICEG EC estimates a 3.2% surplus. A general question in connection with flat tax – and a highly important issue in Bulgaria - whether it contributes to the increase in government revenues. According to the theory, the so-called Laffer-effect may come into play, thus the government revenues may grow because the introduction of a lower tax rate and a more simple system makes tax compliance more attractive. However according to the experiences of countries which have already introduced the flat tax, on the one hand in certain cases it had been mainly the strengthening of the tax administration that resulted in a substantial increase in tax compliance (e.g. Russia) and on the other hand in the case of the 'second wave' countries the reforms generally seem to have caused a decrease in personal-income tax revenues that has not been fully offset either by changes in taxpayers' behaviour or by increase in other types of taxes.

In Bulgaria for this year they are calculating with a loss around BGN 170 billion as a result of the introduction of the 10% personal income tax rate, but on the long run it is expected that it will further help – just as the lower corporate tax has already done - to 'bring to the light' a significant amount of income which is currently part of the shadow economy. Eliminating the grey economy is a priority for the government as - according to estimations - it amounts to 30-40% of the GDP.

According to the European Commission's report on 'Undeclared work in the EU' (2007), the perceived level of undeclared work stood at 35% of GDP in Bulgaria. With 14% of workers admitting receiving 'envelope wages' Bulgaria ranks third place after Romania (23%) and Latvia (17%) and is clearly above the average of the EU (5%). According to other estimations

Bulgarians spend 25% more than they effectively earn and approximately one-fourth to one-third of employees receives a higher salary than they declare.

However flat tax would need to be coupled with stricter rules on tax evasion and greater powers and resources for tax authorities in order to effectively repress the shadow economy and increase the revenues of the government on the long run.

Besides contributing to the elimination of the grey economy, the flat tax may foster the general improvement of the business climate through attracting FDI, reducing red tape and decreasing labour costs.

The volume of the FDI has grown very dynamically in the last few years, it increased from 10,5% of GDP in 2003 to 19% of GDP in 2007, but its structure is not appropriate as it is quite one-sided with an excessive proportion of services over production. The investment encouragement laws had been changed recently to offer support to only production-linked investors by building necessary infrastructure and co-financing training of personnel for the high-tech industry. The aim of the investment promotion agency is to focus on attracting more investors in high-tech and energy sectors. Thus the role of the flat tax is to further improve the business climate in order to keep up the dynamic growth of the FDI stocks rather than to give it an initial momentum.

Regarding red tape the flat tax is expected to simplify the procedures related to tax returns, thus it will decrease expenditures related to filling tax declarations – important results for Bulgaria as it has a cumbersome administration.

Another possible effect of the introduction of a flat tax is the decrease in the labour costs thus it gives incentives to employers to hire more people. In the case of Bulgaria the growth of the unit labour cost had been significant throughout 2007 (6.5%) mainly as the result of tightening labour market conditions. The introduction of the flat tax may have a role in easing this effect as Bulgaria is expected to face an even stronger labour shortage in 2008 (the estimated unit labour cost growth for 2008 is 1.6%). Nevertheless the unemployment rate has significantly decreased last year (it dropped from 9,1% in 2006 to 6.9% in 2007) as a result of robust economic growth, the development of industry and services, as well as employment programmes – and mainly these factors are expected to bring about a further decrease in 2008 (the forecasted value for 2008 is 5.8%).

The above-mentioned likely positive effects had been the main arguments of the proponents for the introduction of the flat tax, while the main objection of the advocates – mainly the representatives of the opposition and the trade unions – was that the new tax system will hit low-income people the hardest, while it will make the more affluent portion of the population even wealthier. As a result of the elimination of the tax-free threshold on personal income it is expected that all who earn below a monthly wage of BGN 490 will end up paying more taxes. Although the average monthly wage had significantly increased throughout last year (from BGN 384 in Q1 2007 to BGN 451 in Q4 2007), officially still the majority of the population earns less than this sum (68.02% according to official statistics – see Table 2.).

However it has to be noted that in the majority of the highlighted sectors there have been high growth rates of investments in recent years, the labour demand is constant (in some cases ascendant) and shadow production is significant (as it was mentioned before it accounts for 30-40% of GDP). If these circumstances are taken into consideration a much lower proportion of the population earns less than before as a result of the flat tax reform. Furthermore in the end of January the parliament voted for increase in salaries set to up to BGN 430 to

compensate the losses some employees will suffer due to the flat tax reform (BGN 55 million was already allocated of the 2008 budget for the compensation of people with lower wages).

TABLE 2. AVERAGE MONTHLY WAGES IN BULGARIA (DECEMBER 2007)

	Average monthly wage (BGN)	Proportion in total employment (%)
Total	474	100
Agriculture, hunting, forestry and fishing	323	2,60
Mining and quarrying	872	1,19
Manufacturing	427	26,36
Electricity, gas and water supply	834	2,32
Construction	386	7,42
Trade, repair of motor vehicles and personal and household goods	348	16,66
Hotels and restaurants	298	3,95
Transport, storage and communication	636	7,06
Financial intermediation	1 129	1,85
Real estate, renting and business activities	421	6,79
Public administration; compulsory social security	672	5,81
Education	561	8,01
Health and social work	491	5,75
Other community, social and personal service activities	378	4,24

Source: National Statistics Institute

On the whole it can be concluded that the main aim of the introduction of flat tax in Bulgaria was to make a further step in repressing the shadow economy which is currently a significant problem for the country. The introduction of flat tax can be considered as a next step in taking a series of measures which already started in 2007 by decreasing the corporate tax to 10%, by reducing social security contributions with a further 3% (along with the 6% reduction already introduced in 2006), by setting the statutory minimum wage at a higher, 12.5% level and by applying more stringent controls for employers who violate law.

SOME HIGHLIGHTS OF RECENT eGOVERNMENT DEVELOPMENTS IN THE WESTERN BALKANS

The low level of awareness of eGovernment services is an additional hurdle towards EU conformance in Southeast European countries. Members of the Stability Pact for Southeast Europe (Albania, Bosnia and Herzegovina, Croatia, Serbia, Montenegro, FYROM and Moldova) signed the eSEE Agenda Plus document in November 2007, laying out the region's common goals for the future with respect to the Information Society in the region. The first basic document in this domain in the region is the eSEEurope Agenda for the Development of the Information Society from 2002. The new eSEE Agenda+ has been representing the regional plan for activities in purpose of information society development between 2007 and 2011. The agenda is in accordance with action plans e-Europe 2002 and 2005 as well as e-Europe+. One of the main priorities of eSEE Agenda+ is the eGovernment development. In accordance with the above mentioned initiatives some countries in the region have made noteworthy advancement in the field of eGovernment.

According to the most recent United Nations E-government Survey² on the one hand some Southeast European countries (Serbia, Montenegro, Albania) reached a much better position in eGovernment readiness in 2008 than three years ago. On the other hand index values represent only slight development in Croatia, FYROM and Bosnia and Herzegovina (see Table 3.).

TABLE 3. UN eGOVERNMENT READINESS INDEX³ AND RANKINGS IN SELECTED COUNTRIES

	2005 Index	2008 Index	2005 Ranking	2008 Ranking
Croatia	0.5480	0.5650	47	47
FYROM	0.4633	0.4866	69	73
Serbia	0.1960	0.4828	156	77
Albania	0.3732	0.4670	102	86
Bosnia and Herzegovina	0.4019	0.4509	84	94
Montenegro	0.1960	0.4282	156	100
Bulgaria	0.5605	0.5719	45	43
Romania	0.5704	0.5383	44	51
Hungary	0.6536	0.6494	27	30
Sweden	0.8983	0.9157	3	1
World	0.4267	0.4514	-	-

Source: United Nations: E-Government Survey 2008

² United Nations: E-Government Survey 2008

³ "The eGovernment readiness index is a composite index comprising the web measure index, the telecommunication infrastructure index and the human capital index. The web measure index provides with a comparative ranking on their ability to deliver online services to their citizens. The telecommunication infrastructure index is a composite index of five primary indices relating to a country's infrastructure capacity as they relate to the delivery of eGovernment services. The human capital index is a composite of the adult literacy rate and the combined primary, secondary and tertiary gross enrolment ratio." United Nations E-Government Survey 2008

CROATIA

According to UN eGovernment Survey, Croatia fell back in global ranking in comparison to 2005. However, a benchmark study (Boidar Kliček, Dijana Plantak Vukovac: Information Society and eGovernment Developments in Croatia, Informatica, 2007) shows distinctive progress in online availability of public services. Online availability of electronic services for citizens developed from a 3.36% level in 2004 to 46.6% in 2006. The same progress can be observed by public eServices for businesses (5.29% in 2004 and 60.41% in 2006). Progress can be explained by the following measures. Croatia has incorporated eGovernment into its National Strategy by introducing the e-Croatia 2007 Programme in 2003. The main pillars of e-Croatia 2007 are infrastructure (broadband, interoperability, information security and HITRONet Network) and digital content and services (eGovernment, eJustice, eBusiness, eEducation and eHealth). The main project is the HITRO.HR service providing quick communication for citizens, business and state administration. It consists of several services: the establishment of Limited Liability Company, e-Regos (the central registry of insured persons), e-Tax, e-VAT, e-Pension, e-Craft, e-Cadastre, and e-Corner (a service targeting the education of the public on new technologies). Other projects that are taking place in the bodies of government administration are the e-Registries, the Electoral Register, the Central Database Registry on Personal Data and the Eurovoc Thesaurus. The World Bank reports Doing Business 2007 and Doing Business 2008 rank Croatia among the Top-10 reformers for two successive years. These results are in connection with the development of online public services facilitating property registration and company start-up. UNCTAD's 2006 World Investment Report ranks Croatia among the group of countries with major investment potential, explicitly mentioning HITRO.hr as a measure facilitating investment.

SERBIA

Serbia recognized the importance of information society development a bit earlier than any other countries in the region. Significant results of eGovernment projects have been visible from 2002 - when technological requirements were already given - as also shown by UN eGovernment Readiness Index 2008. Serbia ranked at 157th place in 2005 and at 77th in 2008 in global comparison. Online sophistication of services for citizens was 40.83% in 2007. The new EU member states represent an average of 62%. Online sophistication of public online services for businesses reached 55% in 2007, the EU10 average was 81%. The Strategy of Information Society Development was adopted in 2006, in which special attention is dedicated to eGovernment. The main goals of eGovernment development are the modernisation of public administration, development of the national economy and more in-depth engagement and involvement of citizens in democratic processes. In accordance with the Strategy an important eGovernment project, the eGovernment Portal (eUprava) have been launched, which provides services for citizens, business and government. Since its implementation state administration services have become more efficient and qualities of that increased considerably, operating costs lowered, and interoperability among institutions improved.

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Online sophistication of basic online services in the FYROM has improved significantly in the last three years. The first measurement conducted in 2004 has reported online sophistication of 9%. In March 2007 the online sophistication level of the 20 eGovernment services reached 50%. In 2007 Macedonian online sophistication of services for citizens has reached the EU's level in 2001, but not the level from 2002. Only two services, corporate tax declaration and

VAT declaration are fully available online. In accordance with this tendency the country is likely to expect values of average EU states online sophistication of 75% in 3-4 years. The USAID eGovernment project is one of the main driving forces in the FYROM for online public administration advancement. The project covers the period 2004-2009. Since 2004, due to electronic government applications, Macedonia's business climate has improved. ICT enhanced the government's efficiency and reinforced anti-corruption efforts.

BOSNIA AND HERZEGOVINA

In November 2005 the Policy, Strategy and Action Plan of the Information Society was adopted in Bosnia and Herzegovina composed of five development pillars. Legal infrastructure development, eEducation, ICT infrastructure, ICT industry and eGovernment got priority in the country. Respecting the information strategy some activities are being carried out to solve C2G and B2G requests for many services. Since 2007 the realisations of individual services have been at different level of implementation: from initiation-, mobilisation-, development, over implementation to project exploitation phase. Most of the authorized institutions operate web sites with basic information for citizens and other parties interested in, as well as for publishing of rules and regulations related to individual areas.

ALBANIA

Albania remains one of the countries with the lowest penetration of internet usage in Europe, with only 13.1% of the population regularly logging on. Year of 2008 was announced as the "the year of the digital age" in Albania. The government gives priority to making public services available on the internet. Regarding this an important step has been the new law on business registration reform in 2007, which establishes the National Registration Centre as a new central public institution. The new project may improve the business climate in Albania significantly, since several important online services facilitate registration of new businesses: tax, social and health insurance registration, labour registry. Registration services are accessible throughout Albania and serve as a single "window" for all types of business entities. The new system reduces to one day the time required to register new businesses. Aim of the launch of electronic public services is to provide low-cost, efficient and transparent process. The Law on the National Registration Centre turns the business registration process from a multiple-step process requiring action by a Court to a one-stop administrative process.

MONTENEGRO

Level of online sophistication in Montenegro was 43,7% in 2007. The most sophisticated services are customs declaration, job search and enrolment in higher education, but there are no services with full online availability. As in most countries, public electronic services for businesses are more advanced than eServices for citizens.

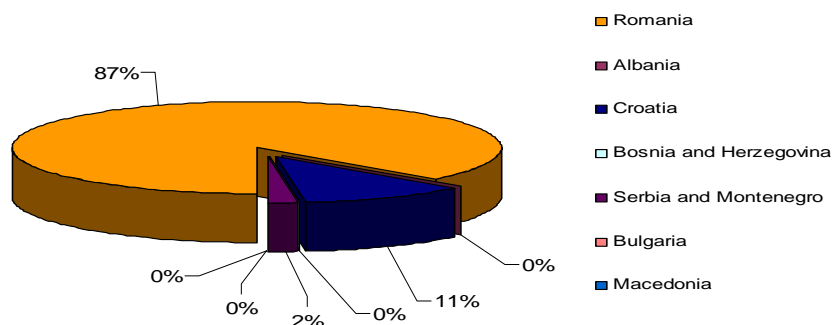
THE ENERGY PROFILE OF SOUTHEAST EUROPE

The Southeast European countries (Albania, Bosnia-Herzegovina, Bulgaria, Croatia, The Former Yugoslavian Republic of Montenegro, Serbia, Romania) play an effectively important role in the Nabucco and South Stream gas pipeline projects as being transit countries. Obviously the way of alleviation of Europe's „gas-hunger“ is a significant issue. Being strongly dependent on one supporter can make Europe vulnerable in terms of economic aspect. But this case not only refers to our gas import. In economic point of view diversification normally reduces risk.

ENERGY ENDOWMENT AND CONSUMPTION AT THE BALKANS

In the last decade both energy endowment and consumption has risen. Focusing on natural gas production and consumption the following diagram will point onto the huge differences in between the three most powerful countries in natural gas production (Romania, Croatia and Serbia and Montenegro). The other four nations (Albania, Bosnia and Herzegovina, Bulgaria and Macedonia) do not play an important role neither in production nor in consumption. Their performance lags behind Romania (the most powerful in the Balkan region), Croatia and Serbia and Montenegro⁴.

CHART 2. PRODUCTION OF NATURAL GAS AT THE BALKANS



Source: EIA

The Southeast European region's total reserve was 0.0758 tcm⁵ in 2005 and about 13.7 bcm (487.7 bcf) were extracted (mainly by Romania (86.7%)). The consumption is 18.1 bcm (644.4 bcf) altogether so there is an average of 75% "gross over-consumption" of natural gas in the Balkans (this figure stay close to the average gas-dependency rate of the Balkans (66.86%) to the same year).

⁴ Data were not available for Serbia and Montenegro separately considering the two countries' young autonomy

⁵ Trillion cubic meter (1 tcm = 35,6 trillion cubic feet)

Although Romania is the richest in crude oil and natural gas in the region this is not significant on a world scale and still need import just like any others in the Balkans. The import dependency is shown in the chart below.

Regarding imports, Albania and Macedonia (in 1994-1997 and 2000-2003, respectively) has not imported natural gas at all, while Bulgaria and Bosnia and Herzegovina meet their needs completely from imported gas. The countries' dependency basically stagnated in the last years (2003-2005) due to the decreasing consumption and production as well.

NABUCCO VS. SOUTH STREAM

Europe's natural gas consumption amounted to 502 bcm per year of which 42% were imported and more than 70% of the import arrived from Russia⁶. This number will grow up to 816 bcm per year by 2030 according to estimates. This will lead to an average of 80% of import of natural gas.

Nabucco is financed by several gas companies (BOTAS AS (TU), BULGARGAZ (BG), MOL Plc (HU), OMV Gas (AT), RWE AG (GE) TRANSGAZ S.A. (RO)). Each shareholder holds an equal share of 16,67% in Nabucco Gas Pipeline International GmbH. The USA is also at the back of the projects. This is for providing an alternative source of natural gas supply in order to increase diversification. Nabucco is planned to be supported by natural gas from Turkmenistan (45 bcm/y total import in 2006), Uzbekistan (12-13 bcm/y is planned for export in 2007), Kazakhstan (approximately 8 bcm/y for export), Azerbaijan (7 bcm/y is expected to be imported), and Iran (90 bcm/y-production). According to latest publications by the Nabucco Gas Pipeline Project, the project will be realised in three phases. The first construction phase is planned to be started in 2010 and will end in 2013-2014. The second phase will consist of the construction of a connecting section between the Turkish border to Georgia and Iran and Ankara. The last step will contain the installation of compression stations in order to reach the maximum capacity of the system (31 bcm/y).

The region's total reserve is counted for 1.265 (0,322 without Iran) tcm in comparison with the total reserve of 1.68 tcm of Russia measured in 2006. Total exportable amount reaches 162-165 bcm/y (together with Iran) and obviously not the entire quantity would be pumped into the Nabucco system. According to forecasts, approximately 25-30 bcm could go into the gas-pipeline and an expected offtake in transit countries would add up to 8-10 bcm. This contribution could reduce the region's reliance on Russian oil with a maximum of 8-10 bcm. Extra capacity would be available for Bulgaria and Serbia as being transit countries.

The South Stream was initiated by ENI (National Hydrocarbon Corporation) the Italian oil and gas Concern and later on Gazprom joined. The finance of the expected USD 10 billion-cost project is shared by the two counterparties equally. The project is expected to begin in this year (2008) and partners hope to transport gas through the pipeline from 2013. The South Stream, according to current state, will re-emerge on the Bulgarian coast. The Bulgarian section will cost approximately USD 1.8 billion (EUR 1.3 billion) which is shared by 50-50% between Gazprom and Bulgaria. Russia wanted majority holding over the construction but the Bulgarian government rejected the Gazprom's request. In the end Russia also offered a USD 5 billion (EUR 3.6 billion) extra facility for Bulgaria to build the nuclear power station in Belene and also took to sponsor Burgasz–Alexandrupolis oil pipeline. Besides the transit fee, the country will get other allowances from the Gazprom. The most visible effect is the remarkable

⁶ 150 billion bcm/y

investment on the country's gas infrastructure via increasing the volume of transit gas to 20.76 bcm (740 bcf) by 2020.

MAP 1. PRINCIPAL EUROPEAN GAS PIPELINES



Source: *The Jamestown Fundamentation*

Gazprom and the Serbian Srbirjagas joint venture has made an agreement on the implementation of the Serbian section of the South Stream gas pipeline which could carry 10 bcm/y (the total planned capacity of the system is 30 bcm/y). In the joint venture Gazprom has 51% and Srbirjagas has 49% of shares.

Earlier the gas-pipeline had two possible directions after having reached the Bulgarian costs. If it went south, it would pass Greece, the former Yugoslav Republic of Macedonia and Albania. On the Nordic way the pipeline would cross Romania and Hungary. Now the latter version seems to be realised with the modification of connecting Serbia to the system as well.

SUMMARY

In one way or another there will be gas pipeline passing through the Balkan and Bulgaria will certainly be a partner of both initiatives so as Romania. By the time being it is not agreed which route of the South Stream will be built, but it is sure that agreements were signed between Sibirjagas and Gazprom to connect Serbia to the system as well.

Nabucco or the South Stream gas pipeline can provide new opportunities for transit countries in meeting their needs alternatively and of course these new projects will attract foreign capital except that generating new job opportunities for locals.

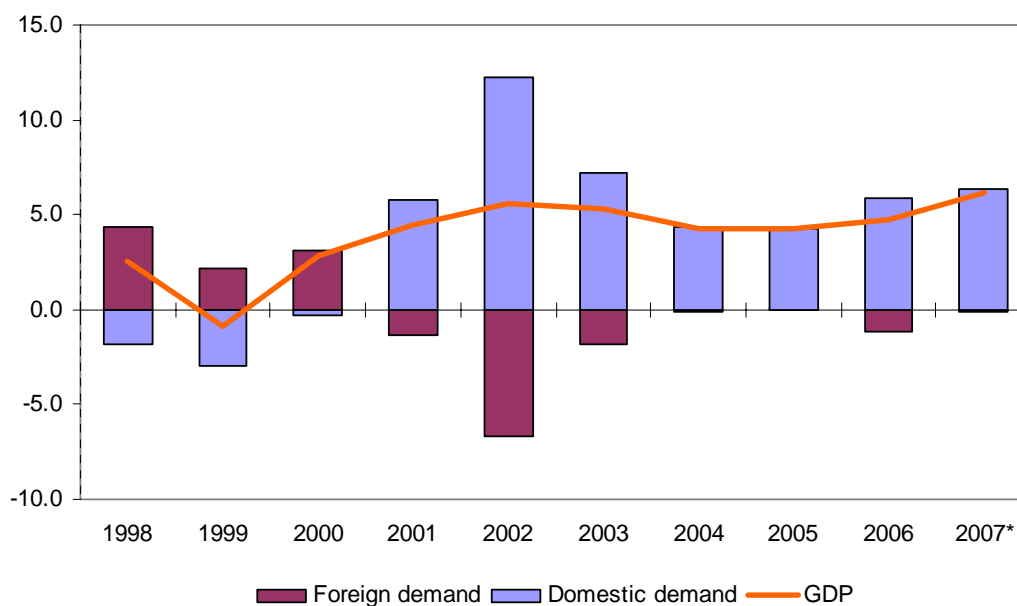
CROATIAN GDP GROWTH PROSPECTS IN 2008

The Croatian GDP growth slowed in the third quarter of 2007 to 5.1% due to the deceleration of household and government spending and slowing export. After the four-year-high 7.0% growth rate of the first three months in 2007 there was a 6.6% growth in the second quarter according to the State Statistics Office.

CONSTRUCTION, INVESTMENT

Capital investments growth dropped to 5.8% in the second quarter of the year from 11.2% in the first, the slowest growth rate since the first half of 2005, the statistics office said. Construction grew by 2.5% in the second three months of the year annually, compared with 7.6% in the first. Construction works are a significant part of capital investments according to statistics, thus, their slowing contributed to a drop in investment, which has resulted in the slowest growth rate in two years. The slowdown of consumption and investments is expected to result in a slower GDP growth of around 5% in 2008.

CHART 3. EVOLUTION OF GDP IN CROATIA, 1998-2007 (%)



Source: CBS; * Q1-Q3 2007

Industrial output grew by 7.1% on average in the second quarter, according to Bloomberg calculations, from 8% in the first three months, and slid to a 14-month-low of 2.8% in August. In January 2008 total industrial production fell by 7.1% compared to the average monthly production in 2007 and was 6.7% higher than last year's value.

Household spending grew by an annual 6.2% in the third quarter, compared to 6.5% in the previous three months and the 7.1% in the first three months, the statistics office said. Exports rose by 7.3%, down from 8.9%, while government spending increased by 4.4%, compared to 2.7% in the second and by 2.8% in the first quarter. Slowing growth in the world economy probably will reduce export growth, one of the main contributors to the GDP growth. The import increased by 7% in the third quarter of 2007 said by Ministry of Finance.

TABLE 4. SELECTED ECONOMIC INDICATORS

	2002	2003	2004	2005	2006	2007
GDP, current prices(mil. HRK)	181 231	198 422	214 983	231 349	250 590	NA
GDP, real growth rate	5.6	5.3	4.3	4.3	4.8	NA
Total volume of industrial production, growth rate as %	5.4	4.1	3.7	5.1	4.5	5.6
Retail sales turnover, real growth rate as %	12.5	3.7	2.6	2.8	2.1	NA
Total volume of construction projects, growth rate as %	12.8	22.8	2	-0.8	9.3	NA

Source: Ministry of Finance Monthly Statistical Report – October, 2007

The production side calculation of GDP shows that the highest real growth of value added in the third quarter was recorded in hotels and restaurants (9.9%), trade (9.3%) and financial intermediation (7.5%). Real growth of value added in transport amounted to 6.6%, it was 5.4% in industry, 2.3% in construction, 1.6% in public administration, while real growth of value added in agriculture recorded a decline of 1.5%. Real growth of total value added equalled to 5.3% in the third quarter.

NEW CROATIAN GOVERNMENT SHOULD REDUCE SPENDING

Croatia's next government should reduce spending, especially social spending and public investment, to protect economic growth, an International Monetary Fund official said. The IMF's former representative in Croatia, Athanasios Vambvakidis said that the next Cabinet should create a mid-term spending plan to use money more carefully. Macroeconomic policies therefore need to focus on steering economies toward soft landings, while containing vulnerabilities and laying the foundation for sustainable long-term growth. Croatia, which has tightly managed floating exchange rate, should rely more on fiscal restraint as they seek to rein in demand pressure.

Gross domestic product growth in the Adriatic Sea state will slow to 4.7% in 2008 from an estimated 5.6% this year, the IMF's World Economic Outlook report said.

EXPECTATIONS

Croatian inflation accelerated at a record pace in December to 5.8% as food prices soared, the highest level since Croatia began using consumer price index to measure inflation in 2004. This could force the Croatian National Bank to raise its interest rate to curb inflation down but the high lending rates could hurt economic growth. The central Bank's anti-inflationary measures for 2008 include restrictions on bank investments and credits, curbing open-market operations that pose short term bank solvency problems, and safeguarding the kuna's exchange rate. However, the Bank's anti-inflationary monetary policies would backfire, if they were not supported by the government's economic policies. The higher costs of credit could slow down consumer spending growth.

Zeljko Rohatinski, Governor of the Croatian National Bank said that projections of economic growth above 6% in 2008 were no longer realistic. Government also revised downwards its GDP growth forecasts from 6.0% to 4.5% on the cabinet's budget proposal to 2008 due to a slowing domestic demand and the global economy slowdown.

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