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Croatian Economic Outlook

Quarterly

1 Recent Developments

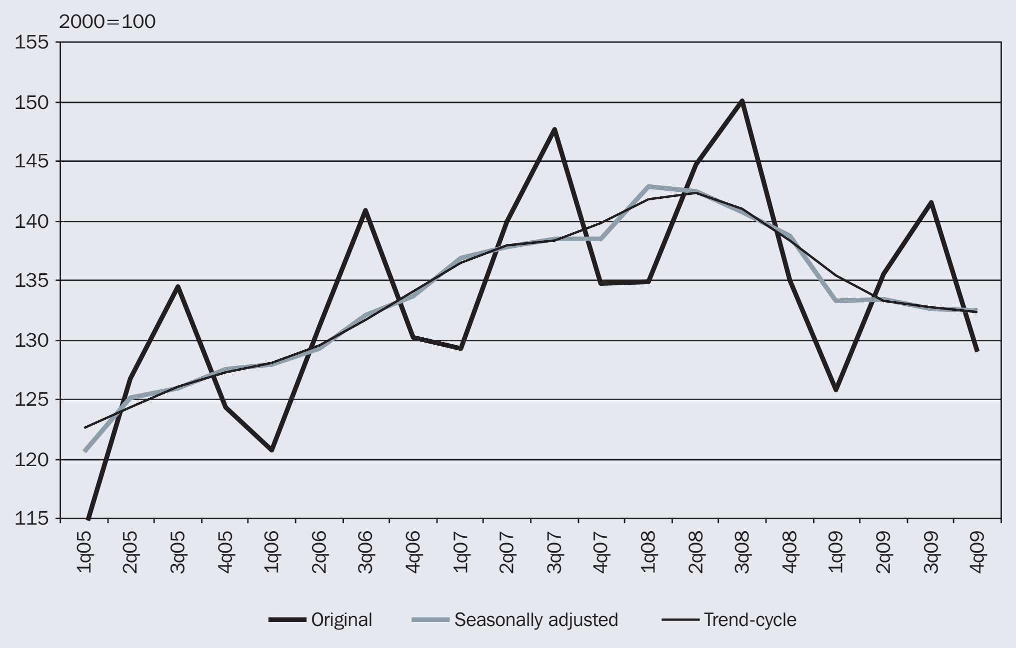
Economy still declining but negative GDP trend weakens.

The Croatian GDP fell by 4.5 percent in the fourth quarter 2009 compared to the same quarter 2008. This contraction was somewhat weaker than in the preceding three quarters, when it amounted to 6.7, 6.3 and 5.7 percent. For 2009 as a whole, GDP declined by 5.8 percent. After correction for seasonal and trading-day effects, the most recent quarter-on-quarter changes in GDP indicate that the economy declined only mildly in the last quarter 2009. Consequently, the negative trend substantially weakened. Nevertheless, the last quarter 2009 marked the seventh quarter in a row of output decline, except for zero-growth recorded in the second quarter 2009 (seasonal adjustment based on the X11ARIMA procedure; please refer to Box 1 for details). The latest high-frequency indicators available for the beginning of this year are mixed and suggest positive developments in industrial production, stagnation in the retail trade sector and the strengthening of a negative trend in construction activity.

Further decline in personal consumption.

Following a brief stagnation in the second quarter 2009, the third and especially the fourth quarter saw another significant decline in personal consumption. In the last quarter 2009, seasonally adjusted personal consumption dropped by almost 2.5 percent over the previous quarter. This decline is comparable to the decline in the last quarter 2008 and the first

Figure 1 REAL GROSS DOMESTIC PRODUCT



Source for original data: *Central Bureau of Statistics.*

quarter 2009, namely at the time when the economy was most strongly affected by the crisis. Compared to the same period previous year, personal consumption experienced a 7.5 percent fall in the fourth quarter 2009 as a result of rapidly deteriorating labor market conditions, declining average wages and increased taxation of incomes due to the "crisis tax". As such, it was the most important demand factor behind the overall GDP decline.

Government consumption suppressed.

In the fourth quarter 2009, government consumption dropped 3.3 percent year-on-year. Seasonally adjusted figures reveal a continuous decline in government consumption during the course of 2009. Although the Government did not make large spending cuts, it appears that it managed to save some money by dispersed and less visible cost reductions as well as by postponing certain payments to this year. Lower revenues and tighter financing conditions have contributed to such a behavior.

Investments continue to shrink.

Following a sharp decline in the first quarter 2009, investments continued to shrink in the remaining part of the year, although at a somewhat slower pace of around 1.5 percent per quarter as suggested by seasonally adjusted figures. Overall, investments dropped by 11.8 percent in 2009 with highly uncertain prospects for 2010. Namely, in construction as an important investment activity the negative trend has accelerated at the very beginning of this year, thus signaling another tough year for the sector.

Mixed signals from the foreign trade sector.

Seasonally adjusted figures on total imports and exports (national accounts data) for the fourth quarter 2009 point to a mild recovery in foreign trade. Compared to the previous quarter, a substantial rise of around 2.5 percent is observed for both exports and imports. However, compared to the last quarter previous year, exports were lower by 11.2 percent and imports by 12.4 percent. Favorable developments from the end of 2009 are somewhat compromised by this year's weak results, at least as indicated by merchandise trade statistics for January and February. In these two months, exports of goods dropped by 3.6 percent year-on-year, while imports dropped by 10.8 percent, both in current euro terms. This indicates that the recovery of foreign trade flows should not be taken for granted in spite of a more beneficial international environment.

Current account deficit narrows; foreign debt comes close to GDP parity.

As a result of last year's contraction in the foreign trade sector, which was more pronounced on the side of imports than exports, the current account deficit declined from EUR 4.4 billion in 2008 to EUR 2.4 billion in 2009. In relative terms, it narrowed from 9.2 to 5.2 percent of GDP. At the same time, foreign debt continued to rise steadily. In absolute terms, its increase in 2009 amounted to EUR 4.3 billion compared to EUR 7 billion in 2008. However, the relative indicator has substantially deteriorated as the foreign debt came close to GDP parity. At the end of 2009, it amounted to 98.3 percent of GDP, up from 85.1 percent in 2008. The largest contributors to the increase were government and enterprise sectors striving to refinance their earlier obligations.

Industrial production revives, retail trade stagnates, construction activity dives.

As the March 2010 data on industrial production show, we will not see a stable recovery in industrial production, a rare variable that has been showing signs of revival lately. In spite of a standstill in March, in the first quarter 2010 production was around 1 percent higher on a quarter-on-quarter basis, following a 0.5 percent rise in the last quarter 2009. On a year-on-year basis, industrial production is approximately at the same level. On the contrary, retail trade volume declined by more than 8 percent in the first two months 2010 year-on-year. However, it is encouraging to see that it has stabilized when compared to the previous months, suggesting that the trough has been reached. Construction activity has been diving since the beginning of 2009. Accordingly, it exhibited a 20 percent drop year-on-year in the January-February period.

Table 1 MAIN ECONOMIC INDICATORS

	2008	2009	2009			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	2.4	-5.8	-6.7	-6.3	-5.7	-4.5
Real private consumption (% change, yoy)	0.8	-8.5	-9.9	-9.4	-6.9	-7.5
Real government consumption (% change, yoy)	1.9	0.2	3.9	1.2	-0.6	-3.3
Real investment (% change, yoy)	8.2	-11.8	-12.4	-12.7	-10.5	-11.3
Industrial output (% change, yoy)	1.2	-9.3	-11.0	-9.5	-9.0	-7.7
Unemployment rate (registered, %, pa)	13.2	14.9	14.7	14.5	14.4	16.2
Nominal GDP (EUR million)	47,370	45,379	-	-	-	-
GDP per capita (EUR)	10,683	10,245	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	6.4	3.3	5.5	4.0	1.5	2.7
Consumer prices (% change, yoy, pa)	2.9	2.4	3.8	2.9	1.2	1.7
Producer prices (% change, yoy, pa)	4.3	-0.4	1.2	-0.6	-2.3	0.1
Average gross wage (% change, yoy, pa)	7.1	2.2	4.6	3.4	1.4	-0.4
Exchange rate, HRK/EUR (pa)	7.22	7.34	7.41	7.36	7.32	7.27
Exchange rate, HRK/US$ (pa)	4.94	5.28	5.71	5.27	5.12	4.92
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,814	7,691	1,929	1,902	1,889	1,972
Exports of goods (EUR, % change, yoy)	6.8	-21.6	-13.4	-23.7	-30.9	-16.5
Imports of goods (EUR million)	20,608	15,089	3,660	3,913	3,725	3,790
Imports of goods (EUR, % change, yoy)	10.6	-26.8	-23.6	-30.1	-31.1	-21.2
Current account balance (EUR million)	-4, 371	-2,361	-1,846	-868	1,794	-1,442
Current account balance (% of GDP)	-9.2	-5.2	-	-	-	-
Gross foreign direct investment (EUR million)	4,192	1,875	451	496	709	219
Foreign exchange reserves (EUR million, eop)	9,121	10,376	8,870	9,090	9,318	10,376
Foreign debt (EUR million, eop)	40,316	44,591	40,308	41,823	42,852	44,591
GOVERNMENT FINANCE*						
Revenue (HRK million)**	134,738	128,069	30,294	61,208	94,100	128,069
Expense (HRK million)**	130,259	132,884	32,476	65,911	98,887	132,884
Net = Gross operating balance (HRK million)**	4,479	-4,815	-2,182	-4,703	-4,787	-4,815
Net acquisition of non-financial assets (HRK million)**	7,344	5,924	1,284	2,553	4,151	5,924
Net lending/borrowing (HRK million)**	-2,865	-10,739	-3,466	-7,256	-8,939	-10,739
Domestic government debt (EUR million, eop)	9,284	10,699	10,286	10,619	10,816	10,699
Foreign government debt (EUR million, eop)	4,131	5,159	3,619	4,072	4,089	5,159
Total government debt (% of GDP)	28.7	34.8	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-4.6	-14.6	-11.7	-12.3	-15.1	-14.6
Broad money, M4 (% change, yoy, eop)	4.3	-0.9	3.3	1.1	-1.2	-0.9
Total domestic credit (% change, yoy, eop)	10.5	-0.6	9.2	4.8	1.9	-0.6
DMBs credit to households (% change, yoy, eop)	12.1	-2.9	8.3	3.1	0.8	-2.9
DMBs credit to enterprises (% change, yoy, eop)	12.3	2.0	11.9	7.8	4.1	2.0
Money market interest rate (%, pa)	5.9	7.2	13.9	5.9	6.8	2.3
DMBs credit rate for enterprises, short-term, (%, pa)	8.0	10.0	9.9	10.1	10.4	9.7
DMBs credit rate for households, short-term (%, pa)	12.2	12.6	12.5	12.5	12.7	12.7

Notes: ** Data refer to consolidated general government. ** On the cash principle, cumulative from the beginning of the year.*
Conventional abbreviations: *pa - period average, eop - end of period, yoy - year on year, HRK - Croatian kuna, EUR - euro, US$ - US dollar, DMB – deposit money bank.*
Sources: *Central Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

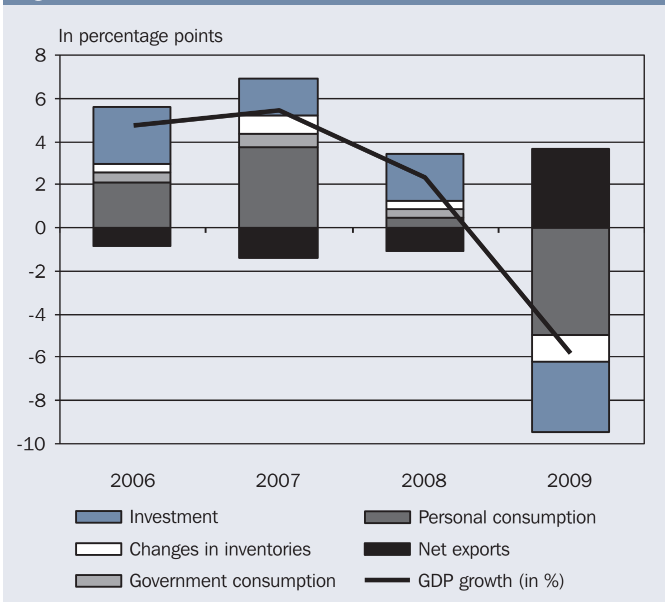
Unemployment boom.

Shrinking employment, reinforced by unfavorable seasonal factors, has led to a rapid rise in the number of unemployed. In the course of 2009, the unemployment register was enlarged by more than 50 thousand jobless (i.e. more than 20 percent). Furthermore, jobless claims increased by additional 27 thousand in the first three months of this year. In parallel, business surveys report that employment was reduced by more than 90 thousand in 2009, implying that many of those who were previously employed were not registered at the Employment Service. They have probably gone into inactivity, particularly into retirement. In 2009, the number of pensioners increased by around 25 thousand. The unemployment rate increased from 13.5 percent in December 2008 to 16.7 percent in December 2009, and further to 18.3 percent in February 2010. Total employment dropped by 6.1 percent in the year up to February. During that period, small businesses, i.e. unincorporated sector, lost 9.6 percent workplaces. The most strongly affected corporate sectors were construction, with 12.4 percent jobs lost in the last twelve months, manufacturing industry with 9 percent, real estate activities with 8.5 percent and distributive trade with 6.8 percent. Employment in the public sector has remained unchanged.

A barrier broken down – nominal wages can adjust downwards in Croatia, too.

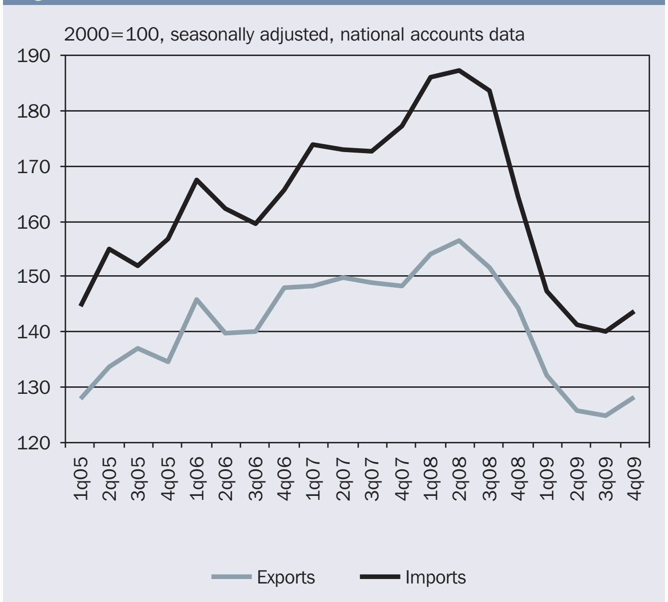
Recently, we have witnessed a reduction in the economy-wide average nominal wage, which is quite unusual for Croatia. In the fourth quarter 2009, the average nominal gross wage dropped by 0.4 percent below its previous year's level. In January 2010, it fell by 1.2 percent. Wage correction was higher-than-average in sectors faced with intensive competitive pressures. For example, the average wage in manufacturing industry declined by 1.6 percent in the year up to January, while in construction it dropped by 3.6 percent. Such a dynamics has broken down the psychological barrier of nominal wage rigidity in Croatia. Until now, we have witnessed a continuous rise in nominal wages, while real labor costs have been adjusted either by spurring inflation, as in socialist times and early transition, or by employment reduction. Now, in the situation of hard budget constraints, nominal wages have been reduced so to cope with depressed demand and to limit lay-offs. This can contribute to the increased flexibility of the economy. Such an option in wage policy should also be considered in the public sector, where bargaining over changes in the existing collective agreement has recently started. On the negative side, the downward wage flexibility, combined with employment reduction, may result in a lower disposable income. For example, in January this year the real take-home wage bill was estimated

Figure 2 DEMAND CONTRIBUTIONS TO GDP GROWTH



Source for original data: *Central Bureau of Statistics.*

Figure 3 EXPORTS AND IMPORTS OF GOODS AND SERVICES



Source for original data: *Central Bureau of Statistics.*

to have been around 10 percent lower than a year ago, while the overall real disposable income fell by around 6 percent.

Monetary aggregates on the rebound...

In seasonally adjusted terms, broad money noted a moderate quarter-on-quarter increase of 0.3 percent in the last quarter 2009, the first positive quarterly growth rate since the third quarter 2008. The year 2010 brought an increase in external borrowing, which led to a strong corporate deposit pickup. In year-on-year terms, overall savings grew by 2.4 percent in January and 0.3 percent in February due to an increase in foreign currency deposits. Namely, foreign currency deposits rose by 11.1 percent year-on-year in February. At the same time, kuna savings continued to abate, recording a 26.6 percent reduction. In addition to deposit money growth, narrow money contributed to a broad money increase. In the last quarter 2009, it rose by 0.4 when compared with the third quarter. Moreover, in February 2010 the central bank's loosened policy stance led to a 4.1 percent narrow money rise in year-on-year terms, the first positive rate since September 2008.

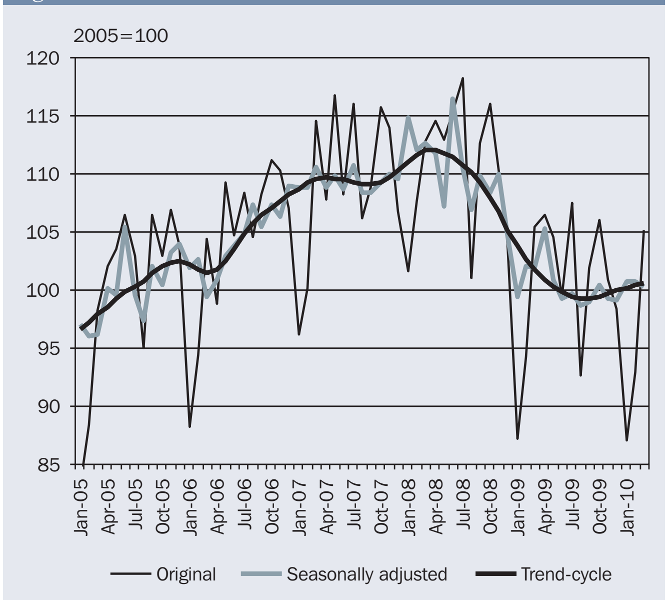
... while credit activity remains weak.

Total domestic credit weakness continued in 2010 with a registered cutback of -1.1 percent year-on-year in February, the largest fall since the 1999 recession. Whereas it is still too early to see the effects of the central bank's monetary easing, it seems that risk aversion, reduced domestic sources of finance and high public financing needs cut back credit activity at the beginning of this year. Household credit activity is decaying rapidly. In January, it fell by 3 percent and in February by 3.5 percent year-on-year. Even in seasonally adjusted monthly terms, a 0.3 percent decline was recorded, suggesting that household borrowing remained subdued. On the other hand, credits to enterprises are increasing, though at a very low and descending rate. After a 1.7 percent year-on-year rise in January, only 1.1 percent growth was recorded in the following month.

Central bank released HRK 2.9 billion of reserved liquidity.

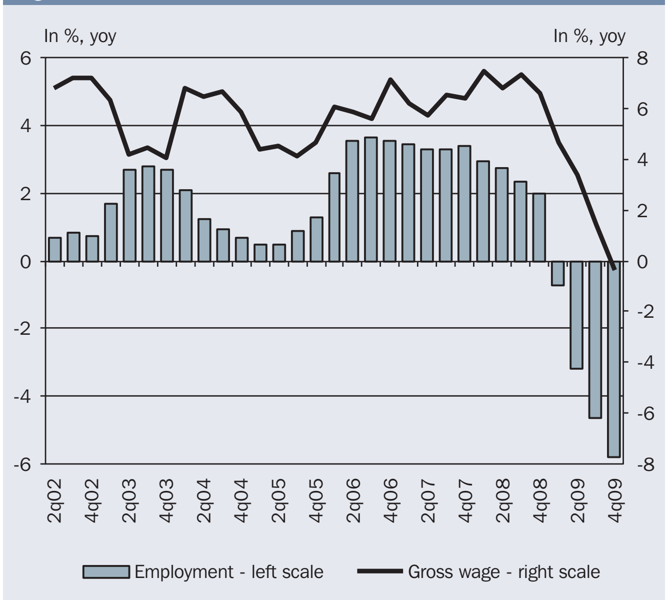
At the beginning of February, the CNB Council voted for a 1 percentage point cut in the reserve requirement rate, which now amounts to 13 percent. The decision has resulted in HRK 2.9 billion of fresh liquidity, just a part of the anticipated HRK 9 billion hidden in a 3 percentage points reserve rate cut that the CNB announced to implement this year. The idea of this counter-cyclical monetary policy is to spur corporate credit activity with the assistance of the HBOR (Croatian Bank for Reconstruction and Development). Technical

Figure 4 INDUSTRIAL PRODUCTION



Source for original data: *Central Bureau of Statistics.*

Figure 5 TOTAL EMPLOYMENT AND AVERAGE GROSS WAGE



Source: *Central Bureau of Statistics.*

difficulties regarding credit placements have limited the monetary policy effect. Until now, the only consequence has been the collapse of money market interest rates, with the average overnight rate recording a mere 0.55 percent in February. Since the reserve requirement rate cut, the HRK/EUR exchange rate has remained stable amid thin trades.

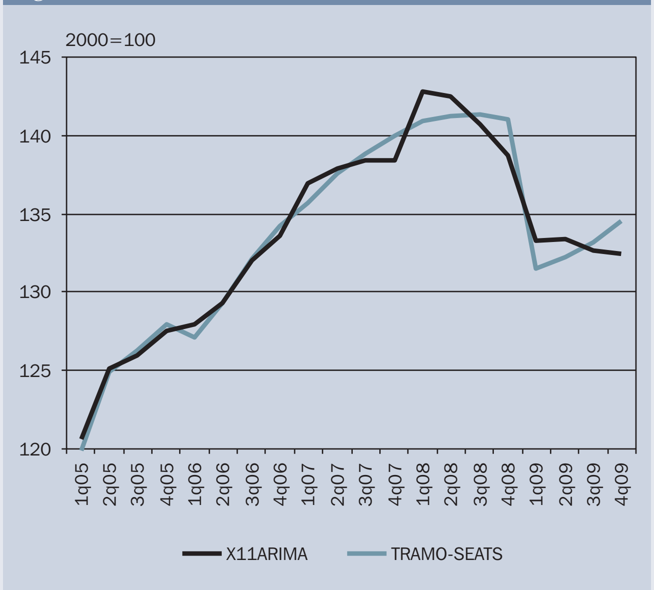
Box 1 SEASONAL ADJUSTMENT PUZZLE

With every new observation of major economic series, analysts try to uncover the underlying pace of the economy and whether the trends have changed. Seasonal oscillations blur the picture if observations are taken at their original values. Year-on-year comparisons partially eliminate the problem of seasonality, but tell us only where the economy stands compared to a certain month/quarter the year before. That is not enough, as economists are much more interested where the economy stands in respect to the preceding month/quarter. For this purpose, statisticians have developed a number of seasonal adjustment algorithms. They enable more accurate comparisons across time as they control for seasonal effects and often also for the calendar/trading-day variations.

The problem arises when different seasonal adjustment procedures deliver different results, not only in the sense of magnitude of change in a certain seasonally adjusted series but even in the *direction* of change. That is exactly what we can observe now when we compare the Croatian GDP seasonally adjusted by the X11ARIMA procedure that we use in this publication and GDP seasonally adjusted by TRAMO-SEATS, the method used by many European statistical offices including Eurostat (Figure B1). For comparison one can note that in the case of EU-27 GDP, differences also exist but are much smaller (Figure B2).

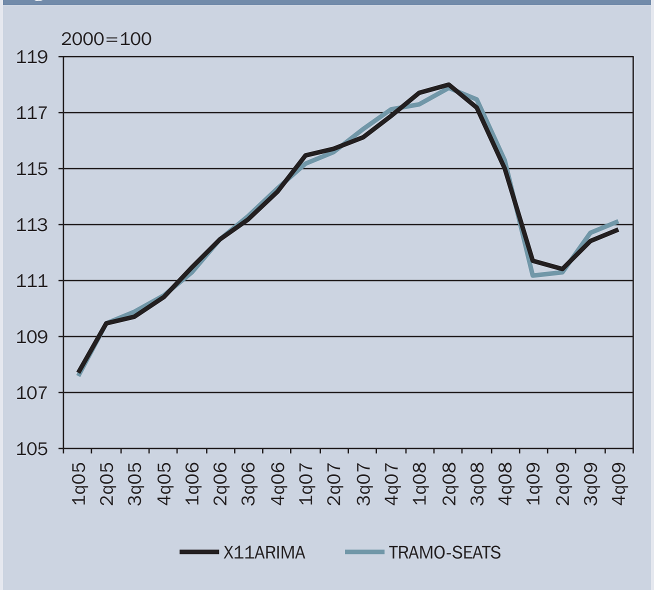
In the statistical sense, X11ARIMA belongs to the family of X-11 methods; it is a nonparametric procedure for decomposing a time series into trend-cycle, seasonal and irregular components, while TRAMO-SEATS is a model-based procedure (developed by the Central Bank of Spain). Despite general pros and cons of these procedures, our preference towards the X11ARIMA program (developed by Statistics Canada) is based primarily on our past experience. It has proven robust under various conditions and its results are consistent with other data on the stance of the economy. Consequently, assessments of the recent trends in the economy presented in this publication are based on seasonally adjusted figures generated by the X11ARIMA procedure.

Figure B1 SEASONALLY ADJUSTED GDP: CROATIA



Source for original data: *Central Bureau of Statistics.*

Figure B2 SEASONALLY ADJUSTED GDP: EU-27



Source for original data: *Eurostat.*

Core CPI declines.

In January, the core CPI recorded a 0.3 percent drop in year-on-year terms. The same ebbing scenario continued in February, with a 0.5 percent decline when compared to the same month a year ago. It seems that labor market weaknesses, fiscal consolidation and the downsizing of retail mark-ups have spilled over to the core CPI. Nevertheless, the headline CPI increased by 0.9 percent year-on-year in March, up from 0.7 percent in February. Recovering global demand and extra liquidity provided by central banks around the world led to the upside price risks of global commodities evident in imported inflation. When compared to the first quarter 2009, consumer prices were 0.9 percent higher, while producer price inflation amounted to 3.6 percent, mainly due to higher energy prices.

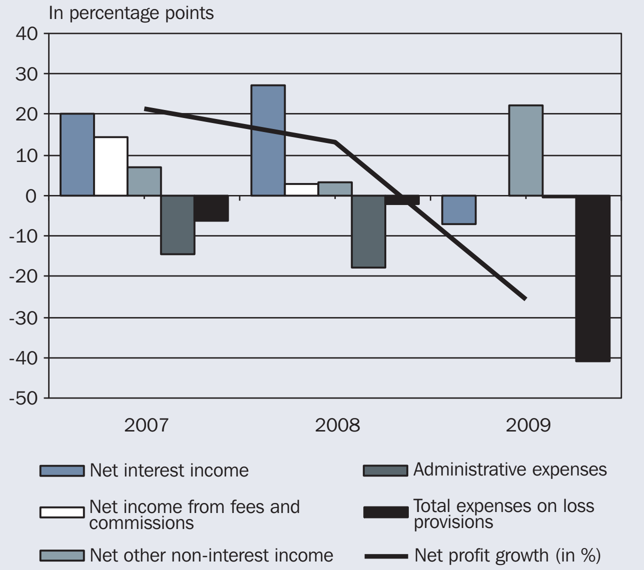
General government deficit increased due to low tax collection.

Rising general government expenditures, coupled with a decline in general government revenues, have resulted in a deficit increase in 2009. The net borrowing of the consolidated general government (deficit according to the GFS 2001 methodology) amounted to 3.2 percent of GDP or HRK 10.7 billion. The deficit thus quadrupled in comparison with 2008. General government revenue collection was rather weak, although it slightly improved towards the end of 2009. Following a 7.7 percent contraction in general government revenue collection in the first half of the year, revenues decreased 2.3 percent year-on-year in its second half. For 2009 as a whole, general government revenues dropped by 5 percent, and their share in GDP decreased to 38.5 percent. In general, a lower decline in revenues than in nominal GDP was a result of increased taxation in the second half of the year on both consumption and personal income. Nevertheless, VAT collection showed the most significant decline of 10.3 percent in 2009. Fiscal data are usually published with quite a long delay so there are no official data on this year's budget outturn. At press conferences, however, the Ministry of Finance has revealed that the economic crisis continues to erode budgetary revenues. At the end of February, they were 0.5 percent lower than a year ago, suggesting that keeping the deficit under control will be harder than previously expected.

Moderate rise in government expenditures in 2009.

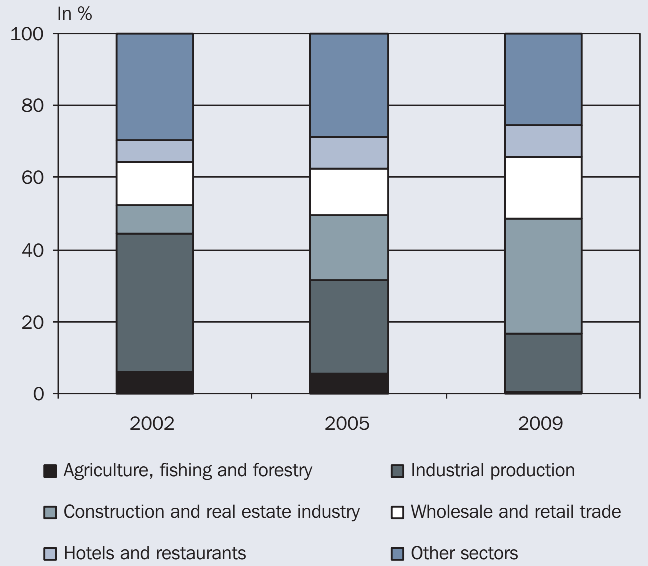
Even though general government expenditures increased in 2009, they rose only moderately compared to the preceding years. For 2009 as a whole, general government expenditures increased 2 percent, down from 9.7 percent in 2008, and their share in GDP amounted to 39.9 percent. One should notice that there were large quarterly variations in expenditures. A slowdown in general government expenditure growth in 2009 is mostly due to cuts

Figure 6 COMMERCIAL BANKS PROFITABILITY



Source for original data: *Croatian National Bank.*

Figure 7 COMPOSITION OF GROSS FOREIGN DEBT



Note: *Nonfinancial enterprises.*
Source for original data: *Croatian National Bank.*

in the last quarter, when expenditures decreased 8.8 percent year-on-year. The most significant slowdown is evident in the dynamics of social benefits and the compensation of employees, the largest items on the expenditure side. Subsidies stood at the same level as in the previous year. Farmers' protest at the beginning of 2010 showed that in 2008 and 2009 the Government kept subsidies to farmers at subdued levels by postponing their payment. Consequently, contraction in expenditures in the last quarter 2009 raised fears that certain payments were postponed to this year.

Public debt growth accelerates.

The growth of consolidated central government debt intensified towards the last quarter 2009. At the end of 2009, total public debt was 17.9 percent higher than at the end of 2008, attaining HRK 115.9 billion (without guarantees). The ratio of public debt to GDP increased from 28.7 percent in 2008 to 34.8 percent in 2009. Together with government guarantees, the public debt share reached almost 50 percent of GDP. Foreign public debt was the main generator as it increased 24.6 percent, while the domestic part of the public debt rose 15.0 percent. Central government guarantees continued to rise strongly. At the end of December 2009, the total amount of guarantees was almost HRK 50 billion, which is 11.8 percent higher than at the end of 2008.

2 Policy Assumptions and Projections Summary

Global economy continues to recover and...

Global economic activity continued to expand in the last quarter 2009 and in early 2010. Positive developments were bolstered by monetary and fiscal policy stimuli, and a rise in consumption and business confidence. Consequently, the International Monetary Fund raised its projection for global economic growth. It now expects global growth to reach 4.2 percent in 2010 and 4.3 percent in 2011 (*World Economic Outlook*, April 2010). The recovery remains asymmetric and led by developing economies in Asia. The U.S. economy is expected to grow by 3 percent in 2010, but the removal of policy stimulus should moderate GDP growth to 2.6 percent in 2011. During the global crisis, Europe was one of the hardest hit regions. It is also recovering, although at a slower pace than other parts of the world. Euro-area GDP is expected to grow by 1 percent in 2010 and 1.5 percent in 2011. Slow labor market recovery and high public debts continue to impede consumption recovery in the European economies. Also, financial systems and housing markets that are not fully healed will provide further challenges to the recovery in some countries. The future prospects primarily depend on the savings and consumption decisions of households and a further fiscal stimulus where the public debt allows it.

... commodity prices rise accordingly.

Commodity prices have risen strongly in reaction to the fast-paced global recovery. They are expected to rise further supported by the ongoing recovery of the global trade. However, the rise might be impeded by high inventories. The optimism seeped into the monthly report of the International Energy Agency (*Oil Monthly Report*, April 2010), which corrected its global demand projection for 2010 upwards. While global demand in 2009 is estimated at 84.9 million barrel per day, its projection for 2010 is now set at 86.6 million. In the first half of April, the WTI and Brent crude oils were trading around US$ 85 per barrel, or some 70 percent more than in mid-April 2009.

Fiscal stimuli to have a modest impact...

As for the internal policy assumptions, no severe measures towards cutting government consumption have been undertaken yet. As the conditions on the financial markets improve, allowing for the easier financing of the budget deficit, we believe that only a modest decrease in expenditures could be expected this year. At the end of January, the Government announced three models of fiscal stimuli, the so-called A-B-C models. Two of them that have already been implemented refer to a reduction in the borrowing costs of the enterprise sector through co-financing by commercial banks and the HBOR. Model C envisages two instruments: transforming the liabilities towards the government into a government stake in the companies, or writing off the debts if troubled companies have sustainable restructuring plans. We believe that the impact of these measures on the output will be rather modest. Alike, a weak effect could be expected from another recent government measure, the subsidy scheme for the first-time buyers of apartments. It should be stressed here that our projections do not take into account the *Economic Recovery Program* that the Prime Minister announced on April 19 (see Box 2 for a brief overview). It was not possible to assess the impact of the Program as it is not known which measures, at what time, and in what form will be implemented either this or next year.

... while further monetary easing remains uncertain.

Although the central bank has already launched counter-cyclical measures, further monetary easing remains uncertain. We expect monetary and credit expansion to remain limited as the central bank will have to control for inflation, exchange rate stability and the current account deficit. Foreign borrowing is expected to increase prospectively, while the inflow of foreign direct investments should be relatively low and remain at last year's level.

Another tough year - GDP expected to decline by 0.7 percent.

Projections suggest that the economy is facing another tough year, with the GDP growth rate remaining in the negative zone. GDP is, namely, projected to decline by 0.7 percent. At the beginning of 2010, the main trends in the economy were negative, although some indicators, such as industrial production and foreign trade, suggested that the trough might have been reached. Unemployment was on the rise, while incomes and consumer confidence remained low. Nevertheless, we expect that the second half of the year will bring a modest recovery resulting from the stronger exports of goods and services. In 2011, the recovery should be underpinned by stronger investments and the strengthening of personal consumption on the basis of improved consumer confidence. It will probably be slow and unstable, with the possibility that ups and downs in activity will persist. Consequently, in 2011 we expect a 2.2 percent GDP growth.

Table 2 SUMMARY OF PROJECTIONS

	2010	2011
Real GDP (% change)	**-0.7**	**2.2**
Real private consumption (% change)	-2.2	1.7
Real government consumption (% change)	-1.4	2.7
Real investment (% change)	-3.9	5.0
Exports of goods and services (constant prices, % change)	-0.3	4.0
Imports of goods and services (constant prices, % change)	-3.7	5.2
Current account balance (% of GDP)	-4.8	-5.3
Consumer prices (% change, pa)	1.6	3.0
Exchange rate, HRK/EUR (pa)	7.31	7.31
Unemployment rate (registered, %, pa)	17.8	18.2
General government balance (ESA95 definition, % of GDP)	-3.5	-3.2
Broad money, M4 (% change, eop)	7.0	12.0
Total domestic credit (% change, eop)	3.5	10.0

Notes: *Cut-off date for information used in the compilation of projections was April 8, 2010.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Depressed labor market conditions postpone the revival of personal consumption.

The depressed labor market is expected to postpone the recovery of personal consumption for the next year when improvements in other sectors should bring more confidence to consumers. Consequently, we expect personal consumption to decline by 2.2 percent this year and to mildly recover to a 1.7 percent growth in 2011. Investments are still declining

Box 2 A BRIEF OVERVIEW OF THE GOVERNMENT'S *ECONOMIC RECOVERY PROGRAM*

On April 19, 2010 Prime Minister Kosor announced a rather comprehensive *Economic Recovery Program* that addresses the structural weaknesses of the Croatian economy and aims to create an encouraging environment for sustainable economic growth. The Program's main pillars are the new role of the Government in the economy, support for recovery and growth, and responsibility towards the future generations. It entails a framework of activities that should become effective in the short-, medium- and long-term. The Program underscores the Government's intention to depart from the existing growth model based on domestic consumption which has resulted in a large government sector, low competitiveness, an ambiguous attitude towards foreign direct investments, a low participation rate, and rising external debt. The Program should trigger fiscal policy measures such as abolishing the "crisis tax" earlier than originally planned, lowering and simplifying personal income tax rates, eliminating tax relief, reducing the number of public sector employees, privatizing state-owned enterprises, and cutting non-tax revenues, but also a vast amount of measures in other fields such as labor market policy, education and science policy, social security, export and investment promotion, government asset management, environmental protection, etc.

The *Economic Recovery Program* correctly addresses the country's main problems and offers direction for solving them. It is much more comprehensive than the title would suggest, as it encompasses a framework of activities that affect a wider scope than only those related to the economic policy. As a result, it is rather dispersed and, to a certain extent, lacks focus. Nevertheless, from the economic viewpoint its strongest parts relate to the fiscal consolidation and public sector reforms that could bring long-lasting benefits and set the foundations for sustainable economic growth. We can only hope that their swift realization will confirm the Government's self-declared determination to undertake politically sensitive measures.

with rather negative short-term prospects. As a result, investments are projected to contract this year by some 4 percent. The expected improvement in the economic climate by the end of the year, including better financial conditions, should result in a 5 percent rise in investments next year with rather solid long-term prospects as the country approaches EU membership. Government consumption will decline by some 1.4 percent this year due to depressed revenues. This is less than earlier projected as we still do not see that plans for serious cost cuts are put in place. For 2011 we expect a rise in government consumption due to several reasons: firstly, as to compensate for two years of decline; secondly, due to EU-related spending; and thirdly, due to parliamentary elections expected by the end of 2011. Consequently, we forecast government consumption to rise by 2.7 percent.

Current account deficit to narrow further in 2010.

Although the international environment has substantially improved this year, low domestic demand and limited supply constrain the performance of Croatian exports. Our projection for this year still suggests negative trends, with the total exports of goods and services declining by 0.3 percent and imports by 3.7 percent. Consequently, the current account deficit for 2010 could be lower than in 2009, at around 4.8 percent of GDP. In 2011, with the revival of demand and imports, the current account deficit is expected to widen to 5.3 percent of GDP. Nevertheless, the financing of such a deficit under the condition of low FDIs will result in a further rise in foreign debt.

Labor market conditions to remain negative.

Negative trends on the labor market are expected to continue in the course of 2010, mostly as a result of delayed adjustments to previous demand shocks and the still sluggish economy. New jobs will be opened relatively slowly even when the output starts to recover due to the fear of new shocks and weak opportunities for flexible forms of employment, such as temporary- and part-time jobs. Therefore, it is expected that the unemployment rate will increase to 17.8 percent on average in 2010, while employment could be reduced by additional 50 thousand jobs. In 2011, we expect a positive turn in employment. Nevertheless, on average, the unemployment rate could increase to slightly above 18 percent.

Further decline in real disposable income.

The expected decrease in the average wage, coupled with a decrease in employment, will significantly reduce disposable income. Government transfers should slightly increase, but they will not change the negative trend in overall incomes in 2010 that are expected to fall by around 4 percent in real terms. The "crisis tax" on wages and other incomes will be eased from July 1 in a way that the lower income bracket (HRK 3,000-6,000 per month) will be exempted from taxation just as incomes up to HRK 3,000. This will somewhat improve incomes and consumer confidence, but the rising unemployment may wipe off the gains from this measure.

Inflation should remain low.

Inflation will remain low this year, around 1.6 percent on average, mostly due to weak domestic demand. Pressures coming from rising energy prices are expected to ease in the remaining part of the year. Next year, more vigorous demand will contribute to a moderate inflation speed-up.

Swift private sector credit recovery is not expected.

Monetary easing has so far not found its way to the corporate credit channels. The second quarter of 2010 should accelerate currently sluggish liquidity flows. However, as the disappointing profitability of banks, resulting from an increase in non-performing loans, puts restrictions on credit supply, we do not expect a swift private sector credit recovery. Nonperforming loans might become more binding as they will approach their peak somewhere at the end of 2010 and the beginning of 2011. Looking into 2010, we expect an increase in broad money to overshoot total domestic credit growth as seen in the previous quarters. Therefore, we expect broad money to increase 7 percent in 2010, while total domestic credit growth should remain weak and amount to 3.5 percent. Next year, monetary and credit aggregates dynamics should be in line with a mild revival of economic activity. We expect broad money to record a 12 percent increase resulting from an improvement in narrow money and savings, while a modest revival in personal consumption and investment should help expand domestic credits by 10 percent.

Deficit figures to be higher than in the 2010 budget.

The Government still sticks to the adopted budget for 2010 according to which state budget net borrowing should amount to 2.5 percent of GDP in 2010, while consolidated general government net borrowing would be some 2.7 percent. Our projection for 2010 is somewhat more pessimistic due to the fact that the economy still does not show signs of recovery and that the gloomy prospects for the labor market keep consumer and investor sentiments at very low levels. Both could contribute to a further slowdown in revenue collection and higher spending on social security benefits, thus leading to higher deficit figures. For 2011, our projected deficit figure is also higher than the official one, since we expect government consumption to recover sooner than tax collection and social security benefits to remain at an elevated level.

3 Uncertainties and Risks to Projections

Can the Economic Recovery Program bring optimism?

Our projections are based on recent economic trends as well as the expected effects of fiscal stimuli and monetary easing. At this point, we perceive upside risks to be somewhat higher than downside ones. Business and consumer confidence have remained at very low levels as there have been almost no positive news on the state of the economy. However, the improved situation in the global economy should spill over to the domestic market, while serious steps in pursuing the announced Program could boost the confidence and have a significant effect in inducing a change in trends.

Uncertain effects of the improved international environment.

Our projection for the foreign trade sector is rather conservative as we expect tourism revenues to remain at last year's level, while the exports of goods should be slightly weaker. If the recovery of the world economy proceeds more sharply than expected, the positive effect on the domestic economy should be stronger than projected, resulting in a positive overall output.

Halfway through the EU accession negotiations.

Accession negotiations with the EU proceed at a rather slow pace. On April 19, Croatia provisionally closed 18 out of 35 chapters. The Government still aims to close the negotiations by the end of this year. Consequently, Croatia should become a full EU member by 2012 or 2013. If this process slows down, it would have negative effects on investors' decisions as most of them have already included Croatia's EU membership into their business plans. Highly challenging will be the chapters on competition and judiciary and fundamental rights. The chapter on judiciary asks from negotiators to prove that Croatia is effectively fighting organized crime and corruption, and to comply with the ICTY demands. The chapter on competition, on the other hand, presumes that the problem of highly subsidized shipyards is resolved. The privatization process is on the way, but the outcome is uncertain as well as how policy-makers will proceed on this issue if the privatization fails having in mind substantial employment in shipyards and the political sensitivity of any solution.

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