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Croatian Economic Outlook
Quarterly

1 Recent Developments

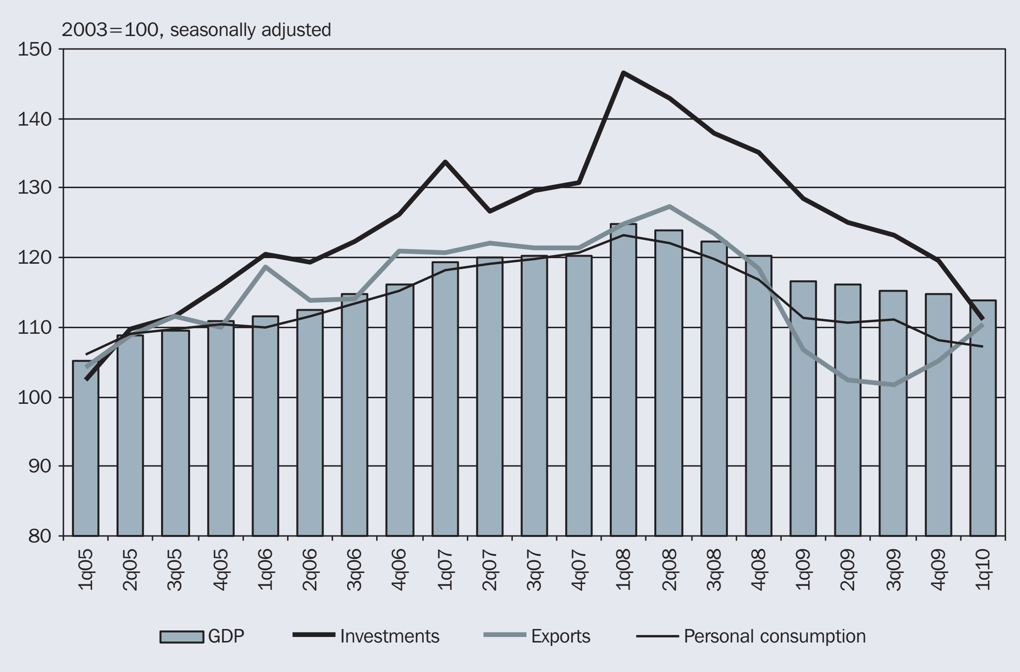
Economy continues to contract.

Data for the first quarter 2010 indicated a weaker-than-expected economic performance. On a year-on-year basis, GDP declined 2.5 percent whereas seasonally adjusted figures point to a relatively strong, 0.9 percent contraction on a quarter-to-quarter basis. The first quarter 2010 was the eighth consecutive quarter in which the overall activity declined. Persistent weakness in domestic demand strongly affected by pronounced contraction in investment activity was the main factor behind a GDP decline in the first quarter. Due to a rebound in exports and stagnant imports, the external sector contributed positively to the GDP change, but the magnitude of the contribution was not sufficient enough to reverse the downward GDP trend. Nevertheless, the current account deficit narrowed while the foreign debt ceased to increase, at least in the first quarter. The most recent high-frequency data for the second quarter suggest stagnation in activity compared to the previous quarter (industrial production, retail trade volume), with the exception of the still decreasing construction activity.

Personal consumption keeps decreasing.

Personal consumption fell 4.1 percent year-on-year in the first quarter this year, which implies a seasonally adjusted decline of around 1 percent over the previous quarter. The

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

decline has been underway ever since the second quarter 2008 resulting in a 14 percent cumulative drop over the past two years. Deteriorated consumer sentiment combined with credit market constraints in the first year of recession and a decreased real disposable income in the second year have resulted in depressed consumption. The first quarter of this year was particularly problematic due to rising unemployment and the spreading practice of wage cuts in the private sector. Even an increased supply of credits to households has not helped much.

Resilient government consumption.

Although 1.1 percent lower than a year ago, seasonally adjusted government consumption was in fact higher in the first quarter 2010 than in the fourth quarter 2009. As a result, the trend has changed to positive, which stands in contrast to the developments in the rest of the economy. A part of this change is probably due to delayed consumption from the previous year. However, this change also points to the lack of adjustments in the government sector. Compared to the "pre-crisis" first quarter 2008, government consumption was 2.7 percent higher, while GDP was 9.0 percent lower.

Further decline in investments.

The investment trend is downward sloping. Seasonally adjusted figures point to a 7 percent quarterly fall in the first quarter of this year, which is the largest decline in investments since the beginning of the crisis. Such a gloomy performance implies that better days are still far away. In the last two years up to the first quarter 2010, investments decreased by 24.2 percent, out of which 13.9 percent last year. Contraction in the construction sector contributed mostly to this decline, but machinery and equipment investments also receded strongly, as indicated by falling imports of capital goods.

Exports rise, imports still sluggish.

In the first quarter 2010, the volume of exports of goods and services increased by 3.6 percent year-on-year. Seasonally adjusted data indicate its rather strong recovery in the last two quarters. Namely, in the first quarter 2010 it was around 9 percent higher than in the third quarter last year. At the same time, the volume of total imports has stagnated for the last three quarters. As a result, the external sector has had a positive contribution to the GDP change while the current account deficit has narrowed. However, the structure of exports revival is not particularly favorable. The recent increase in goods exports originates mostly from the exports of ships and could be treated as temporary due to at least two factors – the current upswing is the result of previous orders while the long-awaited restructuring of the state-owned shipyards will surely lead to a reduction in their capacities. Exports of other goods have not increased substantially but there has been an increase in exports of services in the last couple of quarters. However, the high seasonality of service exports means that overall developments will primarily be determined by the third quarter performance, i.e. tourist season. On the side of imports, the main driver is domestic demand that is still suppressed. Re-stocking of inventories that have been drained during the recession has not been observed yet.

Current account deficit narrows; foreign debt stagnates.

The current account deficit has narrowed during the last year and a half. In a year up to the first quarter 2010, it shrank to 4.4 percent of GDP, down from 5.4 percent recorded in the previous quarter and 7.7 percent observed a year ago. A part of the deficit was financed by net FDI flows that have amounted to 2.7 percent of GDP in a year up to the first quarter, a half of the amount recorded a year ago. An increase in the stock of foreign debt has slowed down. In fact, at the end of March 2010 the foreign debt was almost at the same level as in December 2009 amounting to EUR 44,6 billion. The stagnation is a result of the repayment of the Government's due debt and only a modest increase in the foreign borrowing of the enterprise sector.

Table 1 MAIN ECONOMIC INDICATORS

	2008	2009	2009			2010
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	2.4	-5.8	-6.3	-5.7	-4.5	-2.5
Real private consumption (% change, yoy)	0.8	-8.5	-9.4	-6.9	-7.5	-4.1
Real government consumption (% change, yoy)	1.9	0.2	1.2	-0.6	-3.3	-1.1
Real investment (% change, yoy)	8.2	-11.8	-12.7	-10.5	-11.3	-13.9
Industrial output (% change, yoy)	1.2	-9.3	-9.5	-9.0	-7.7	-0.5
Unemployment rate (registered, %, pa)	13.2	14.9	14.5	14.4	16.2	18.2
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	4.0	1.5	2.7	0.8
Consumer prices (% change, yoy, pa)	2.9	2.4	2.9	1.2	1.7	0.9
Producer prices (% change, yoy, pa)	4.3	-0.4	-0.6	-2.3	0.1	3.6
Average gross wage (% change, yoy, pa)	7.1	2.2	3.4	1.4	-0.4	-0.9
Exchange rate, HRK/EUR (pa)	7.22	7.34	7.36	7.32	7.27	7.29
Exchange rate, HRK/US$ (pa)	4.94	5.28	5.41	5.12	4.92	5.26
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,814	7,691	1,902	1,889	1,972	2,017
Exports of goods (EUR, % change, yoy)	6. 8	-21.6	-23.7	-30.9	-16.5	4.6
Imports of goods (EUR million)	20,608	15,089	3,913	3.725	3,789	3,306
Imports of goods (EUR, % change, yoy)	10.6	-26.8	-30.1	-31.1	-21.2	-9.7
Current account balance (EUR million)	-4, 338	-2,448	-876	1,788	-1,516	-1,405
Current account balance (% of GDP)	-9.2	-5.4	-	-	-	-
Gross foreign direct investment (EUR million)	4,195	2,096	508	724	427	434
Foreign exchange reserves (EUR million, eop)	9,121	10,376	9,090	9,318	10,376	10,008
Foreign debt (EUR million, eop)	40,316	44,580	41,823	42,852	44,580	44,564
GOVERNMENT FINANCE*						
Revenue (HRK million)**	134,738	128,069	61,208	94,100	128,069	29,263
Expense (HRK million)**	130,259	132,884	65,911	98,887	132,884	33,281
Net = Gross operating balance (HRK million)**	4,479	-4,815	-4,703	-4,787	-4,815	-4,028
Net acquisition of non-financial assets (HRK million)**	7,344	5,924	2,553	4,151	5,924	1,117
Net lending/borrowing (HRK million)**	-2,865	-10,739	-7,256	-8,939	-10,739	-5,135
Domestic government debt (EUR million, eop)	9,284	10,713	10,619	10,816	10,713	11,390
Foreign government debt (EUR million, eop)	4,131	5,133	4,072	4,089	5,133	4,885
Total government debt (% of GDP)	28.7	34.8	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-4.6	-14.6	-12.3	-15.1	-14.6	2.3
Broad money, M4 (% change, yoy, eop)	4.3	-0.9	1.1	-1.2	-0.9	1.6
Total domestic credit (% change, yoy, eop)	10.5	-0.6	4.8	1.9	-0.6	-0.4
DMBs credit to households (% change, yoy, eop)	12.1	-2.9	3.1	0.8	-2.9	-3.2
DMBs credit to enterprises (% change, yoy, eop)	12.3	2.0	7.8	4.1	2.0	2.7
Money market interest rate (%, pa)	5.9	7.2	5.9	6.8	2.3	0.6
DMBs credit rate for enterprises, short-term, (%, pa)	8.0	10.0	10.1	10.4	9.7	8.0
DMBs credit rate for households, short-term (%, pa)	12.2	12.6	12.5	12.7	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.*

Construction activity continues to decline strongly.

At the turn of the year, industrial production showed some signs of revival. However, the positive trend ceased in the second quarter 2010 as the activity remained almost unchanged compared to the previous quarter according to the seasonally adjusted figures. In the first five months of this year, industrial output was 1.9 percent lower than in the same period a year ago. Since the end of last year, retail trade volume has been stagnating. Nevertheless, in the first five months of this year it was 6.1 percent lower year-on-year. Unlike the mainly stagnant trends in industrial and retail trade sectors, construction activity continues to exhibit a strong negative trend. Since the start of the turndown at the beginning of 2009, the volume of construction works has decreased by about 20 percent.

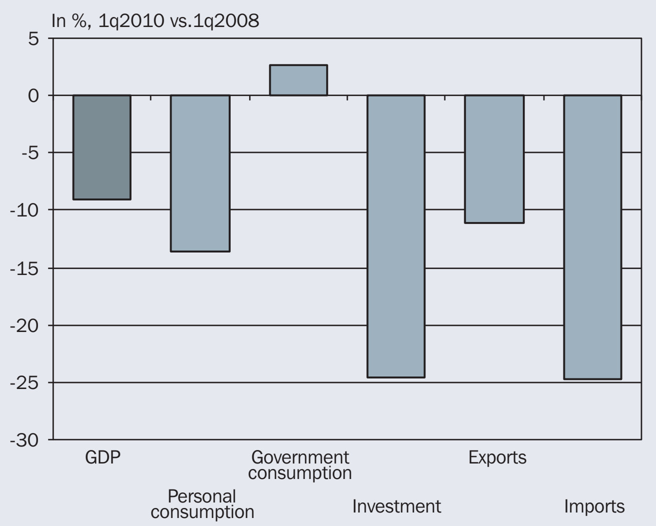
Unemployment rise suppressed due to seasonal factors.

The adjustment on the labor market intensified at the beginning of this year with a sharp increase in unemployment and a decline in the average wage. The second quarter brought some improvements as the number of unemployed declined, while the number of employed rose. However, seasonal factors played a major role in these latest developments, while the underlying trend has remained negative. At the end of June, there was 15.7 percent more unemployed than a year ago and 28.6 percent more than two years ago. On the positive side, it should be mentioned that seasonal employment in June was much stronger than in the same month last year. Total employment declined by 5.6 percent in May on a year-on-year basis and was 8.5 percent below its level in May 2008. A more intensive loss of jobs has been recorded in the unincorporated sector (crafts and trades), around 12 percent in the last two years. In the last two years, the most intensive loss of jobs hit construction (-17 percent), retail trade (-16 percent), accommodation and food service activities (-13 percent), and the manufacturing industry (-13 percent). In May 2010, the registered unemployment rate was 17.2 percent, up from 13.0 percent in May 2008. After two years of recession, employment reduction was almost the same as GDP decline, suggesting that the rigidity of the labor market is lower than usually perceived.

The average wage decreases.

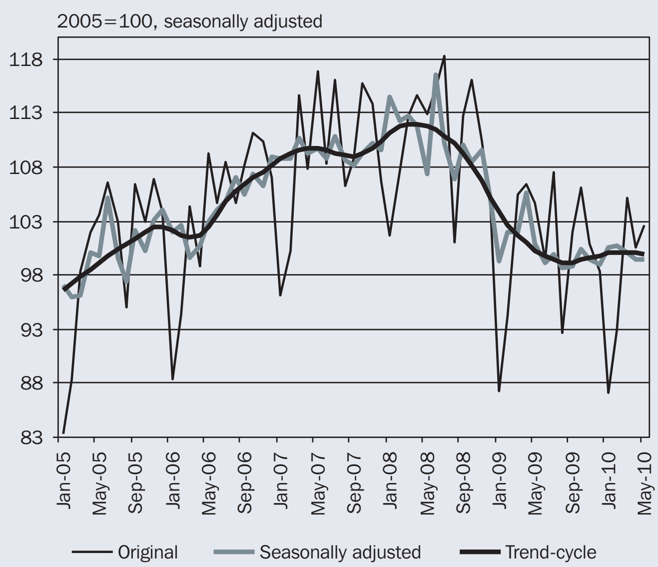
In April 2010, the average wage was 1.2 percent lower than a year ago in nominal and 1.8 percent in real terms. Wage growth was already suppressed last year and even more so at the beginning of this year, which has resulted in its declining trend. The above-average decline in wages has been present in construction, IT sector, real estate activities, professional activities, finance and insurance, and entertainment, but also in some branches of the

Figure 2 CHANGE IN GDP DURING RECESSION



Source: *Central Bureau of Statistics.*

Figure 3 INDUSTRIAL PRODUCTION



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

manufacturing sector such as the manufacture of computer products, chemicals, and transport equipment. The lower average wage in combination with reduced employment has contributed to a significant decrease in real disposable income estimated at around 6 percent year-on-year in April in spite of a certain increase in government transfers (pensions, unemployment benefits, social assistance).

Monetary aggregates...

Following a recovery at the beginning of this year, the broad money year-on-year growth rate has continued to record positive values. Hence, in May 2010 broad money was 2 percent up from the same month a year ago. The most important contribution came from the prolonged rise in foreign currency deposits that recorded an 11.9 percent year-on-year increase in May. At the same time, domestic savings decreased by 22.6 percent. However, overall deposits continued to grow as a result of a rise in enterprise deposits. Narrow money has also contributed to the recovery in broad money. In May, it recorded a 1.1 percent increase year-on-year. When seasonally adjusted figures are taken into account, both narrow and broad money indicate a steady recovery this year.

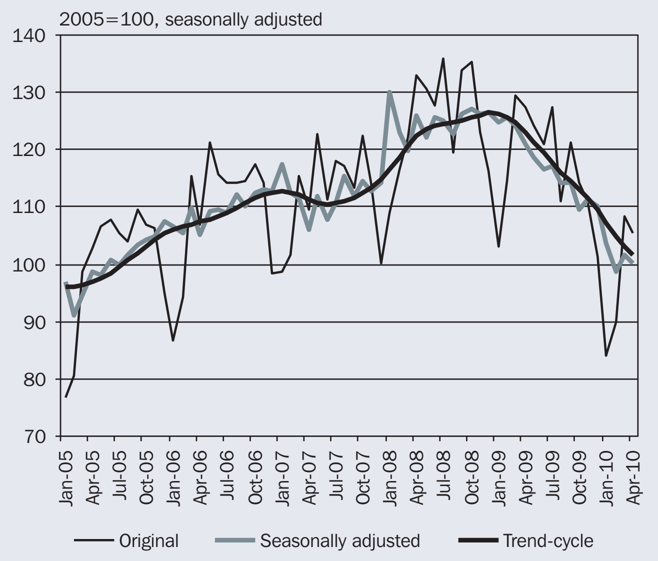
... and credit activity recover.

A weak recovery in credit activity has been spurred by the government and enterprise sector. In May, overall domestic credits were 1.6 percent higher than a year ago. Credits allocated to the Government rose 4.1 percent and credits to enterprises 5.3 percent. Despite the meager realization of HBOR (Croatian Bank for Reconstruction and Development) credit programs, it seems they have contributed somewhat to the revival of credit activity. Namely, in May credits to enterprises increased by 1.4 percent in seasonally adjusted monthly terms. At the same time, the credit activity of the household sector still reflects the adverse effects of increasing unemployment, decreasing real disposable income, and consumer pessimism. It decreased by 1.6 percent year-on-year in May. Nevertheless, according to seasonally adjusted figures household credits have been increasing since March and the trend has changed to positive.

CNB reluctant to further reduce the reserve requirement rate.

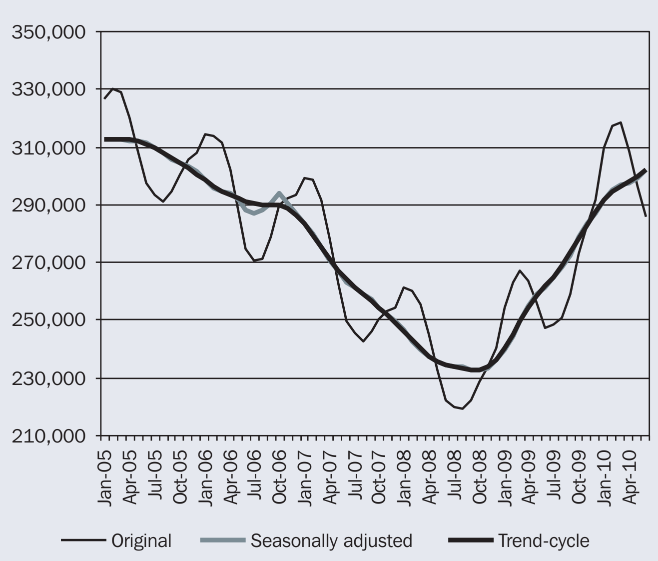
At the beginning of the year, when the Government introduced various programs intended to rescue the enterprise sector from financial difficulties in the medium-term, the central bank planned to reduce the reserve requirement rate starting with a one percentage point cut in February. However, the central bank is now reluctant to proceed with the planned

Figure 4 CONSTRUCTION ACTIVITY



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

Figure 5 NUMBER OF THE UNEMPLOYED



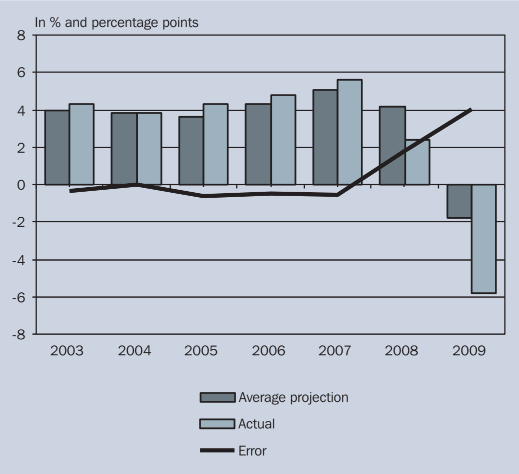
Source for original data: *Central Bureau of Statistics.*

Box 1 ASSESSING THE ACCURACY OF THE *CEOQ* PROJECTIONS, 2003-2009

The tenth anniversary of the *Croatian Economic Outlook Quarterly* appears to be a good opportunity to assess the accuracy of our projections just as the fifth anniversary was (see No. 20). Although the *Outlook* has been published since December 1999, only the 2003-2009 period is considered, the reason being the consistency in our forecasting practice (e.g., months in which the *Outlook* is published and the date when the first projection for the following year is released).

We examine the accuracy of our projections for three variables: real GDP growth rate, current account balance and consumer price inflation. Four different measures are considered. The mean error (ME) indicates the average deviation between projected and actual figures. However, caution is needed when it comes to interpretation of a low ME, as it may mask sizeable errors if they are symmetric. To overcome this problem, the mean absolute error (MAE) is used. However, as both the ME and the MAE fail to account for the scale of the actual figures, two relative measures are computed as well: the mean percentage error (MPE) and the mean absolute percentage error (MAPE). Each of these four measures is computed using both single forecast (January forecast for the current year) and average forecast (the average of all forecasts released before the actual figure is known). Errors in average forecasts compared to single January forecast allow us to see whether we improve forecasts as new information unfolds. In addition, accuracy measures are computed both for the whole period (2003-2009) and for the pre-crisis period (2003-2007). The results are given in Table B1.

There are three notable features of our forecasting practice. *First*, as indicated by the MPE, in stable pre-crisis times, we generally tend to underestimate the real GDP growth rate and, even more so, the current account balance. In other words, our projections are rather conservative, being on average closer to zero than the actual figures. Nevertheless, projections of consumer price inflation are on average rather accurate with only a mild overestimation. *Second*, a comparison of single and average forecasting errors, particularly the MAPE, suggests that there is a degree of learning over the course of a given year. *Third*, regarding the difference between the pre-crisis and the whole period, one observes that, not surprisingly, our projection accuracy is higher in the pre-crisis period. This is especially the case with real GDP growth. In stable times, however, real GDP growth is projected more accurately than the current account deficit and consumer price inflation, at least as assessed by MAPE.



This whole assessment must be taken with caution due to the small number of observations used. The accuracy measures are therefore only rough indicators of the quality of our projections.

Table B1 ACCURACY OF THE *CEOQ* FORECASTS, 2003-2009

		ME		MAE		MPE		MAPE	
		s.f.[1]	a.f.[2]	s.f.	a.f.	s.f.	a.f.	s.f.	a.f.
Real GDP (% change)	2003-2009	0.5	0.5	1.5	1.1	-7.2	-5.5	36.9	26.9
	2003-2007	-0.7	-0.4	0.7	0.4	-15.7	-8.7	15.7	8.9
Current account balance (% of GDP)	2003-2009	1.0	0.7	1.7	1.2	-11.9	-7.7	25.7	17.5
	2003-2007	1.6	1.1	1.6	1.3	-23.1	-15.2	23.1	17.9
Consumer prices (% change, pa)	2003-2009	-0.2	-0.1	0.5	0.5	-0.1	3.0	18.2	17.6
	2003-2007	0.0	0.0	0.5	0.4	4.0	2.8	21.4	15.2

Notes: [1] *Based on single (January) projections;* [2] *Based on the average of projections made from July of year* t-1 *to January of year* t+1 *for the year* t, *with* t=*2003, …, 2009.*
Source: Various issues of CEOQ.

two percentage point reduction since less than 4 percent of all the funds intended for the purpose of the programs were actually used for enterprise credits. High liquidity on the interbank market keeps money market rates around minimum levels. For example, in May the average overnight interest rate just slightly advanced to the still very low 0.85 percent. As the tourist season started to pick up in late June, the central bank intervened on the foreign exchange market by buying EUR three times in only 16 days. The intervention amounted to HRK 2.62 billion. The average monthly HRK/EUR exchange rate decreased to 7.23 in June, the lowest level since December 2008.

Inflation slightly advances.

In June, the consumer price index rose 0.7 percent year-on-year on pass-through from producer prices and a low base effect. At the same time, the producer price index increased 4.4 percent year-on-year supported by the recent energy price increases. The core consumer price index has continued to decline as rising unemployment, disposable income erosion, and consumer pessimism spill over to core prices. While the average core inflation was -0.5 percent in the first quarter 2010, in May prices fell 1.4 percent year-on-year. That was also the highest deflation rate since the data have been published.

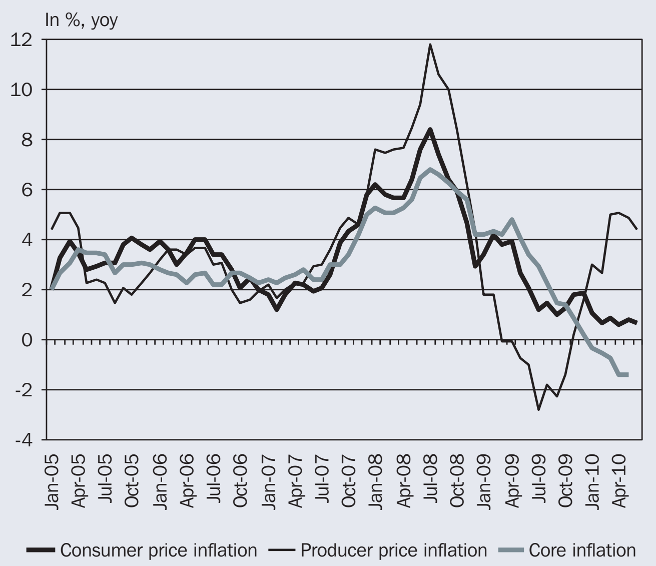
General government revenues decrease…

The first quarter 2010 brought a further deterioration in general government revenues, with a 3.4 percent year-on-year decline. The sluggish revenue collection reflects developments in the rest of the economy. The main revenue component, VAT, remained at the same level as in the first quarter 2009 despite the fact that the VAT rate increased from 22 to 23 percent in July 2009. In the first quarter 2010, excise revenues rose by 31 percent year-on-year as the INA oil company made the late payment of accrued tax obligations. Taxes on income and profits as well as social contributions decreased. The revenue collection in the first quarter 2010 recorded its lowest level since the first quarter 2007.

… while expenditures grow steadily.

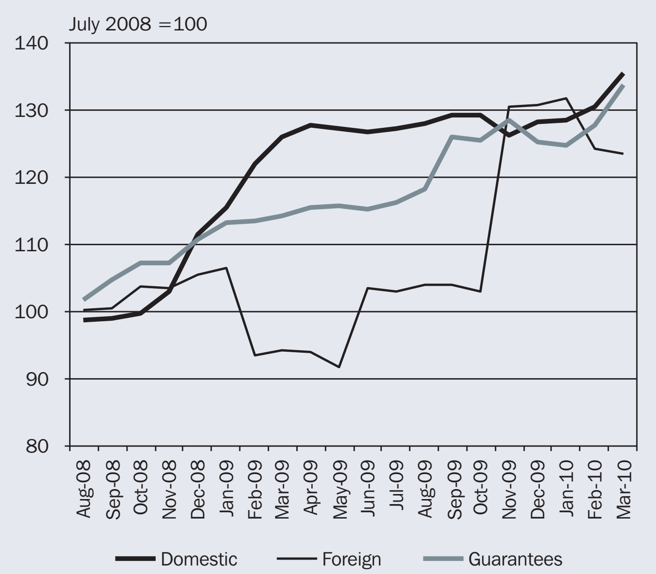
General government expenditures grew at a moderate rate of 2.5 percent in the first quarter 2010 year-on-year. The expenditure rise was driven mainly by social security benefits that were 7.1 percent higher at the end of the first quarter than at the same period a year ago. The second largest expenditure item, compensation for employees, decreased 2.4 percent in the first quarter 2010 year-on-year. Rising general government expenditures coupled with a decline in revenues have resulted in a sharp deficit rise. The net borrowing of

Figure 6 INFLATION



Sources: *Central Bureau of Statistics and Croatian National Bank.*

Figure 7 CENTRAL GOVERNMENT DEBT



Source for original data: *Croatian National Bank.*

the consolidated general government (deficit according to the GFS 2001 methodology) amounted to HRK 5.1 billion at the end of March 2010, which is almost 50 percent more than at the end of March 2009.

Waiting for the budget revision.

In June, the Government announced two budget revisions - a 'light' one in July, reflecting technical expenditure restructuring and allocating additional funds for flood relief, and a more substantial one in the fall. It seems, however, that only the latter will take place. The Government's hesitance to undertake serious fiscal adjustments clearly leads to a much higher deficit than previously projected. Namely, not only was the fiscal performance in the first part of the year worse than expected, but the second half of the year will bring changes in tax laws and, consequently, direct negative effects on tax revenues. The "crisis tax" will be gradually abolished (the lower rate was abolished on July 1 and the higher rate will be abolished on November 1), while the income tax system will be changed in the direction of lowering the average income tax burden. Both changes may have a considerable effect on the budget of the central government, but also on local budgets since the income tax revenues belong mainly to local and regional self-government units.

Public debt on the rise.

Public debt figures available for the period up to March show that the consolidated government debt expanded 13.6 percent year-on-year in HRK terms. In the first quarter 2010, the Government borrowed predominantly on the domestic market. Total government guarantees were 17.1 percent higher in the first quarter 2010 than in the same period last year. At the beginning of July, the Government issued three bonds, two on domestic and one on the international market, in the total amount of HRK 13.4 billion with a fixed interest rate of 6.5 to 6.75 percent.

2 Policy Assumptions and Projections Summary

Stronger-than-expected recovery of the world economy, but risks are on the rise.

World economic activity is picking up faster than expected, mainly due to robust growth in the advanced Asian economies. Consequently, in July the IMF revised its forecast for the world growth to 4.6 percent in 2010, 0.4 percentage points up from the April forecast. For 2011, the forecast remained unchanged at 4.3 percent (*World Economic Outlook Update*, July 2010). In spite of the upward revision, the IMF has stressed that the downside risks related to the financial instability and contagion have lately sharply risen. In many countries public debt concerns have come to the fore and economies will have to adopt credible policies of containing external deficits. These concerns are particularly pronounced in the euro area as fiscal sustainability issues caused financial turbulence in May following the information on the deteriorated fiscal position in Greece. In the meantime, the European Stabilization Mechanism has been established which should, in addition to other measures, preserve the stability of the financial sector in the future. Taking this into account, the IMF expects the euro area output to rise modestly by 1.0 percent this year and 1.3 percent next year.

Volatility on commodity markets.

Although commodity markets have generally seen an increase in prices as a reaction to the ongoing recovery in the second half of 2009 and the first quarter of 2010, they have experienced considerable volatility during the last three months. Due to the renewed tensions in the financial markets and the euro area debt issues, oil prices declined considerably in May and June. Brent crude oil prices stood at US$ 72 per barrel on July 7, while in the first half of April it was traded around US$ 85 per barrel. However, the International Energy Agency (IEA) has not changed its oil demand forecast for 2010 which indicates a 2.1 percent rise over 2009, due to higher growth in non-OECD oil demand (*Oil Market Report*, June 2010). It is similar with the prices of non-energy commodities. After continued recovery throughout 2009 and at the beginning of 2010, they have also seen a decrease in the last three months.

No signals of stronger fiscal consolidation.

Although the Government's Economic Recovery Program announced in April focused on fiscal consolidation, so far we have witnessed only minor steps in that direction. Also, there are no credible signals that efforts aimed at reducing public expenditures will speed up in the near future. Until the Government reveals a more detailed plan, we expect only a moderate decrease in public consumption. One should also not forget that the general parliamentary elections are scheduled for the end of 2011 meaning that the Government will be even more adverse to politically sensitive measures next year. As for the monetary policy, the governor of the central bank has recently emphasized - recalling the February cut in the reserve requirement rate - that the central bank has already done as much as possible to support the economic recovery under current conditions. Therefore, we expect the central bank to continue focusing on the stability of the HRK/EUR exchange rate in order to preserve financial stability as well as to keep price stability, in particular when the economic activity starts to recover.

GDP expected to decline 1.7 percent...

In general, economic developments were unfavorable at the beginning of 2010. This particularly applies to investment activity. Due to the still present weakness, recovery will be slower and more prolonged than earlier expected. As a result, our GDP projection for this year was revised downwards from -0.7 to -1.7 percent. The largest negative contribution is expected to come from investments. The decrease in investment activity in 2010 might come close to last year's and amount to some 11 percent. Considering the negative trend in construction activity, there are still no signals that the decline is moderating. The only component of investments that has shown some signs of recovery since the beginning of the year is the domestic production of capital goods. With the improved overall economic climate as well as the probable conclusion of the EU negotiations process, the investment trend is expected to change next year. Furthermore, as a decline in investment activity has been substantial, we expect the recovery to be rather strong, about 4.5 percent in 2011.

Table 2 SUMMARY OF PROJECTIONS

	2010	2011
Real GDP (% change)	**-1.7**	**1.6**
Real private consumption (% change)	-2.7	1.8
Real government consumption (% change)	-0.7	0.8
Real investment (% change)	-11.2	4.5
Exports of goods and services (constant prices, % change)	5.8	3.5
Imports of goods and services (constant prices, % change)	-0.5	4.2
Current account balance (% of GDP)	-4.4	-5.0
Consumer prices (% change, pa)	1.5	2.8
Exchange rate, HRK/EUR (pa)	7.27	7.30
Unemployment rate (registered, %, pa)	17.5	18.1
General government balance (ESA95 definition, % of GDP)	-4.5	-3.5
Broad money, M4 (% change, eop)	7.0	3.5
Total domestic credit (% change, eop)	9.0	12.0

Notes: *Cut-off date for information used in the compilation of projections was July 7, 2010.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

... and domestic demand by 4.5 percent in 2010.

Personal consumption is still characterized by the negative trend and we expect this to continue in the remaining part of the year, although at a somewhat slower pace. Consequently, personal consumption is projected to decline close to 3 percent in 2010. Next year should bring the stabilization of the overall economic situation, strengthening of consumer sentiment and the stronger recovery of the credit market, which should induce a gradual recovery in personal consumption in spite of stringent labor market conditions. While government consumption should slightly decrease this year, it has proven to be resilient and is expected to rise with the first signs of overall recovery. We project it to increase by less than 1 percent next year, primarily due to budget constraints resulting from reduced revenues. In sum, domestic demand might fall by about 4.5 percent in 2010, while its recovery in 2011 should bring some 2 percent rise.

Current account deficit to shrink to 4 percent of GDP.

The external sector will give a positive contribution to the overall GDP change this year with exports rising more than 5 percent and stagnant imports. For the next year, we expect stronger imports in addition to dynamic exports. However, exports are projected to rise next year at a slower pace than this year partially due to the restructuring of shipyards. Current account deficit should shrink in 2010 to around 4 percent of GDP, while the next year might again bring some broadening of the deficit due to the stronger domestic demand. Developments in the external sector primarily depend on the performance of the tourism sector. We expect that international tourism revenues will remain at last year's level, while in the next year they could slightly increase due to stronger income growth on the main emitive markets.

Negative labor market trends expected to continue.

Negative underlying trends on the labor market will continue in the course of this year although they should prospectively weaken. With the gradual revival of product market in 2011, we expect the total employment figure to stabilize, and even increase in the most flexible parts of the market such as the service sector. At the same time, some parts of the labor market, for example those related to the declining industries, will remain subdued. For 2010, we project the registered unemployment rate at around 17.5 percent on average, while the next year might bring a somewhat higher rate, around 18 percent due to the carry-over effect from the previous year. However, the trend is expected to stabilize in the first half of 2011 with a slow improvement thereafter.

Further wage corrections.

A downward wage correction in the private sector is underway and is expected to continue as long as the output declines. Due to collective agreements, such adjustments will be slower than otherwise, but the anecdotal evidence suggests that company-level agreements are not as rigid as sometimes thought, and the trade union and employers have agreed on more flexible pay forms. However, sector-level agreements are more stringent, particularly those in the public sector, which might prove to be an obstacle for the Government budget if the agreement modifications are not agreed. The Government is also under pressure to ensure enough resources for increased social transfers. Although the amount per beneficiary has not changed, an increased number of pensioners, unemployment benefit claimers and other beneficiaries will increase government expenditures for social protection. Next year, a gradual rise in output will lead to a mild disposable income rise in 2011, thereby supporting household consumption.

Inflation pressures currently on the rise.

In spite of the low inflation rate, pressures are on the way. The recovery of the world economy is already bringing an increase in imported inflation in spite of a stable HRK/EUR exchange rate. Also, there are pressures on prices from certain domestic sectors such as energy supply. As long as demand is weak, consumer price inflation will be low, 1.5 percent on average this year. However, recovery will be accompanied by higher inflation since producer price inflation in industry is currently around 5 percent and the consumer price inflation of services has not fallen below 2 percent in spite of the recession. In 2011, we expect the inflation rate to be around 2.8 percent.

Appreciation pressures in the short-run.

Although money market interest rates could come under some seasonal pressure, the situation on the kuna supply side will keep that rising potential limited. Following appreciation in the second quarter, there is a potential for the further strengthening of the domestic currency in the short-run due to foreign exchange inflows related to international tourism and a lower trade deficit. Moreover, the Government's recent bond issuance on the international market keeps the downside potential for the HRK/EUR exchange rate in place.

Modest recovery of credit activity.

Our projection of monetary developments in 2010 remains unchanged, with the expected increase in broad money overshooting total domestic credit growth. Namely, broad money is projected to grow by 7 and total domestic credit by 3.5 percent in 2010. A pick-up in real economic activity should bring stronger credit activity and further monetary easing in 2011. We expect broad money to increase by 9.0 percent next year mostly due to a build-up of narrow money caused by further cuts in the reserve requirement rate. A modest recovery in domestic consumption should allow for a 12 percent domestic credit growth.

Fiscal deficit to reach 4.5 percent of GDP.

Changes in the income tax that have been implemented since the mid-year will bring a somewhat lower tax burden for households both through the abolition of the crisis tax and lower income tax rates. However, this also implies a certain reduction in government revenues which might increase the fiscal deficit in case these measures do not generate the expected effect on personal consumption. On the other hand, adjustment on the expenditure side will probably not happen before the fall, so its impact on this year's budgetary outcome could not be significant. Therefore, the general government deficit is going to exceed the planned amount. In addition, due to the downward revision of the projected GDP, general government net borrowing in terms of GDP will go up. As a result, we expect general government net borrowing in 2010 to be around 4.5 percent of GDP. Due to high repayment requirements in 2010 and early 2011, additional government borrowings could be expected in the second half of 2010. The outstanding public debt, without guarantees, might exceed 40 percent of GDP by the end of this year.

3 Uncertainties and Risks to Projections

Reluctant to reform?

While the overall activity in Croatia is still characterized by a negative trend, the majority of other European economies have already entered the recovery phase. This implies that the Croatian economy is faced with substantial structural problems. Nevertheless, it has become obvious that the Croatian Government and to some extent the society in general are not ready to support serious structural adjustments. Certain Government attempts in that direction have been faced with a strong opposition. For example, a relatively minor issue regarding change in the Labor Law to limit the prolonged implementation of collective agreements has provoked a heated reaction from all trade union confederations. Furthermore, they have managed to collect enough citizens' signatures to initiate the national referendum on this issue. Political analysts would suggest that this actually reflects the general discontent with the present Government. However, this is also an indication of widespread unwillingness to accept unpopular measures. It should also be emphasized that the present Government shows no intention to proceed with the reforms if it perceives them as politically costly. The momentum that seemed to be present at the time of the announcement of the Economic Recovery Program has been lost. Under these circumstances, the Government will have a hard time finding a way to revive the economy. Hopefully, this *status quo* agony will not last to the next elections as it would have a significant negative effect on the performance of the economy in the medium-term.

Decisive expenditure cuts crucial for preserving Croatia's creditworthiness.

There are considerable risks associated with this and next year's budget outturn and public debt developments. Data on fiscal developments in the first five months released to the press by the Ministry of Finance at the beginning of July indicate that the second quarter could bring only a slight improvement in the fiscal stance in comparison with the first quarter. The changes in the tax system could positively influence consumer and investor sentiments; however, their direct effect on total tax revenues in 2010 is likely to be negative. Consequently, decisive expenditure cuts remain crucial for preserving Croatia's creditworthiness.

Final phase of EU accession negotiations.

The negotiations with the EU have entered the final stage with some of the hardest issues being left for this phase, including the chapters on competition policy and the judiciary. As for the competition policy, problems might arise due to the state-owned shipyards that have been substantially subsidized in the past. Depending on the way this issue is resolved, it might even result in activating government guarantees, which would have a substantial one-time effect on budget expenditures. Nevertheless, the negotiations seem to be advancing favorably and might end at the beginning of 2011, which is expected to give an impetus to the growth of the economy.

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