

Croatian Economic Outlook

Quarterly

1 Recent Developments

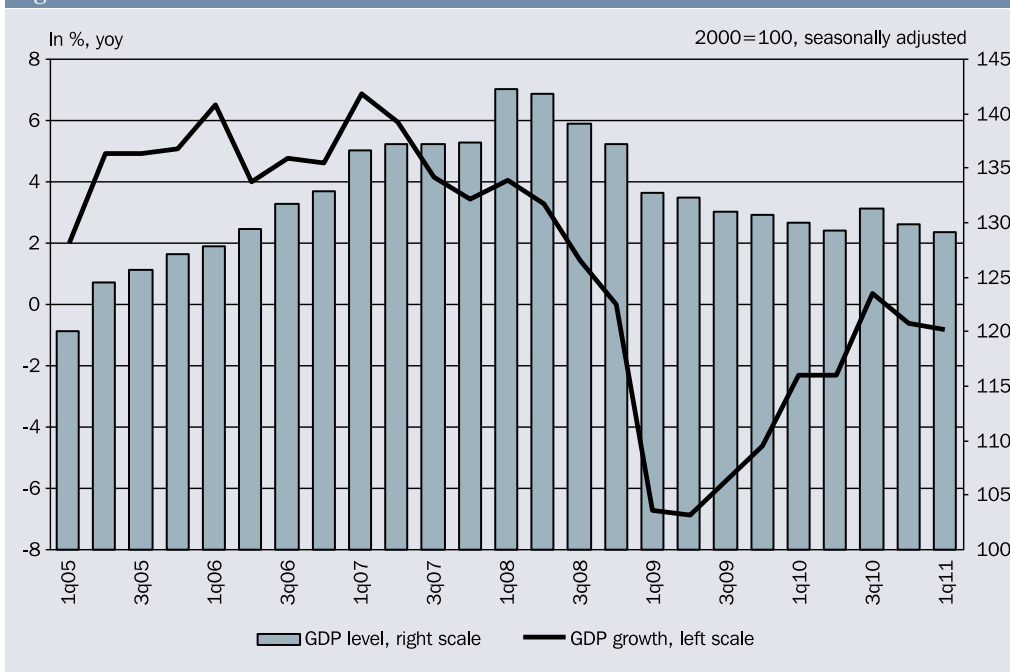
GDP contracted again in the first quarter 2011.

The first quarter 2011 was another disappointing quarter for the Croatian economy. GDP fell by 0.8 percent below its level a year ago, while seasonally adjusted quarter-on-quarter change amounted to -0.5 percent. All major expenditure categories declined, with the exception of inventories, which recorded a strong positive change. Domestic demand, excluding inventories, declined by 1.7 percent year-on-year, while exports and imports decreased by 11.1 and 5.3 percent, respectively. If the change in inventories is taken into account, overall domestic demand increased by 0.2 percent year-on-year in the first quarter and contributed positively to GDP growth for the first time in nine consecutive quarters. Exactly the opposite was recorded in the case of net exports that have contributed negatively to GDP growth for the first time since the outbreak of the crisis. Unfavorable developments in the first quarter were followed by an encouraging rise in activity reflected in high-frequency indicators for April and May. Seasonally adjusted retail trade volume increased mildly in both April and May, while industrial production and goods exports rebounded in April and remained strong in May. Additionally, tourism indicators went up in April, with optimism prevailing for the rest of the summer season.

Personal consumption receded.

Confidence of the household sector remained weak in the first quarter due to rising pressures on real disposable income. In the first quarter this year, seasonally adjusted

Figure 1 REAL GROSS DOMESTIC PRODUCT



Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.

private consumption dropped by around 0.8 percent quarter-on-quarter and 0.1 percent on a year-on-year basis. Our estimate of disposable income implies a mild nominal increase in total wage bill as well as in total transfers to the population. However, inflation has eaten up all those gains and led to a decline in real disposable income in the first quarter. Although the abolishment of the 'crisis tax' has left a bit more income to households, lower employment and a stagnant average wage have not allowed for its effects to materialize. Improvements on the labor market, suggested by preliminary indicators for the second quarter, are expected to restore consumer confidence and increase consumption soon.

Mild decline of government consumption.

Strained public finances, burdened by a high deficit, contributed to a relatively stable level of government consumption over the last year and a half. In the first quarter this year, consumption declined by 0.9 percent year-on-year, and somewhat less on a seasonally adjusted quarter-on-quarter basis. Although relatively mild, the recent decline indicates that the Government is in a tough position and ready to follow the budget plan despite the inherent rigidity of its consumption. Namely, a large part of consumption relates to services provided by civil servants, and that part is rather inflexible, while the acquisition of goods has already been pressed down firmly and any stronger decline in that part is hard to achieve without further structural reforms.

Investments dropped further down.

Investments were further cut down in the first quarter 2011. They recorded a 6.7-percent year-on-year and more than 3 percent quarter-on-quarter decline according to seasonally adjusted figures. Stabilization of their volume in the second half of 2010, as suggested by seasonally adjusted figures, was encouraging at the time. However, another drop that took place in the first quarter this year indicates that fears about the prospects of the economy were still holding back investment decisions. This was particularly pronounced in the construction sector where gloomy prospects, coupled with the mounting stocks of unsold apartments, have blocked a new investment cycle. In addition, at the beginning of the year there were some doubts about the progress of the EU accession process that might have also discouraged or delayed investments in the first quarter.

Foreign trade sank in the first quarter...

In the first quarter 2011, the volume of exports and imports of goods and services recorded a substantial year-on-year fall of 11.1 and 5.3 percent, respectively. A considerable quarterly decline is also observed in seasonally adjusted values. On the one hand, it seems that a short-term problem arose because significant ship exports were present at the beginning of 2010, while this year they took place in the second quarter. On the other hand, there seems to be a structural issue. In spite of a recovery in global trade, Croatian exports have been unable to gain a stronger momentum. The expansion of trade was concentrated only on few sectors and is dependent on their performance. The tourism sector is one of them, and that is why we expect an upward movement in the course of the year. However, there is no broad-based expansion of exports, which points to the underlying problems of competitiveness that should be tackled if overall recovery is to speed up.

... with a beneficial effect on the current account deficit.

The current account deficit remained relatively narrow in the first quarter this year primarily due to weak imports. In a year up to the first quarter, the deficit was 1.3 percent of GDP, close to the one a quarter before, but significantly lower than at any time over the last ten years. Uncertainty has affected net FDI flows and they turned negative for the first time ever, reaching 0.3 percent of GDP in four quarters up to the first quarter 2011. In spite of beneficial current account developments, the gross foreign debt of the country has continued to increase, reaching EUR 47.1 billion at the end of first quarter 2011 or about 103 percent of GDP estimated for this year.

Industrial activity and retail trade recovered in the second quarter.

Following a depressed activity in the first three months, industrial production started to recover in the second quarter. The seasonally adjusted volume of activity in the April-May period was on average 2.4 percent higher than in the first quarter, with a year-on-year increase amounting to 0.6 percent. The recovery was primarily led by the production

Table 1 MAIN ECONOMIC INDICATORS						
	2009	2010	2010			2011
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-6.0	-1.2	-2.3	0.3	-0.6	-0.8
Real private consumption (% change, yoy)	-8.5	-0.9	-2.5	1.9	1.2	-0.1
Real government consumption (% change, yoy)	0.2	-0.8	-1.8	-0.9	0.6	-0.9
Real investment (% change, yoy)	-11.8	-11.3	-13.4	-9.5	-8.0	-6.7
Industrial output (% change, yoy)	-9.3	-1.4	-3.3	0.1	-1.7	-3.6
Unemployment rate (registered, %, pa)	14.9	17.4	17.1	16.4	18.1	19.5
Nominal GDP (EUR million)	45,669	45,917	-	-	-	-
GDP per capita (EUR)	10,311	10,396	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.3	1.0	0.9	1.1	1.2	2.6
Consumer prices (% change, yoy, pa)	2.4	1.1	0.7	1.1	1.5	2.2
Producer prices (% change, yoy, pa)	-0.4	4.3	4.8	4.1	5.1	6.4
Average gross wage (% change, yoy, pa)	2.2	-0.4	-1.0	-0.2	0.5	0.5
Exchange rate, HRK/EUR (pa)	7.34	7.29	7.25	7.25	7.36	7.40
Exchange rate, HRK/US\$ (pa)	5.28	5.50	5.69	5.62	5.42	5.42
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,703	9,099	2,325	2,243	2,498	1,965
Exports of goods (EUR, % change, yoy)	-21.5	18.1	22.3	18.8	25.9	-3.4
Imports of goods (EUR million)	15,090	15,045	3,822	3,960	3,946	3,349
Imports of goods (EUR, % change, yoy)	-26.8	-0.3	-2.3	6.3	4.1	1.0
Current account balance (EUR million)	-2,368	-503	-63	1,911	-1,019	-1,477
Current account balance (% of GDP)	-5.2	-1.1	-	-	-	-
Gross foreign direct investment (EUR million)	2,065	227	34	343	-726	129
Foreign exchange reserves (EUR million, eop)	10,376	10,660	10,305	11,154	10,660	11,424
Foreign debt (EUR million, eop)	45,244	46,412	45,702	45,609	46,412	47,102
GOVERNMENT FINANCE*						
Revenue (HRK million)**	128,087	123,709	59,755	91,905	123,709	28,043
Expense (HRK million)**	132,450	133,486	65,079	97,884	133,486	32,336
Net = Gross operating balance (HRK million)**	-4,363	-9,777	-5,325	-5,979	-9,777	-4,293
Net acquisition of non-financial assets (HRK million)**	6,357	4,848	1,962	3,078	4,848	789
Net lending/borrowing (HRK million)**	-10,068	-14,432	-7,287	-9,058	-14,625	-5,081
Domestic government debt (EUR million, eop)	10,995	12,766	12,050	12,517	12,766	13,118
Foreign government debt (EUR million, eop)	5,134	5,913	5,028	5,878	5,913	6,973
Total government debt (% of GDP)	35.2	41.2	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-14.6	4.2	4.2	13.6	4.2	2.9
Broad money, M4 (% change, yoy, eop)	-0.9	4.4	2.8	3.8	4.4	3.3
Total domestic credit (% change, yoy, eop)	-0.6	6.8	3.2	5.3	6.8	6.1
DMBs credit to households (% change, yoy, eop)	-2.9	3.8	0.3	1.7	3.8	2.5
DMBs credit to enterprises (% change, yoy, eop)	2.0	9.5	6.9	8.8	9.5	8.2
Money market interest rate (% pa)	7.2	0.9	0.9	1.2	0.9	0.7
DMBs credit rate for enterprises, short-term, (% pa)	10.0	7.4	7.5	7.2	6.9	7.0
DMBs credit rate for households, short-term (% pa)	12.6	12.7	12.6	12.7	12.6	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: Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.

of non-durable consumer goods (in particular food products), with positive contributions coming from the production of capital and intermediate goods. Additionally, retail trade activity has also shown signs of recovery in the second quarter, but at a milder pace than industrial production. In the April-May period, the seasonally adjusted volume of retail trade increased by 1 percent compared to the first three months of the year, while a year-on-year increase stood at 2.3 percent. Construction sector remains in deep problems continuing to strongly decline – the cumulative drop in the first four months this year reached 10.4 percent compared to the same period last year.

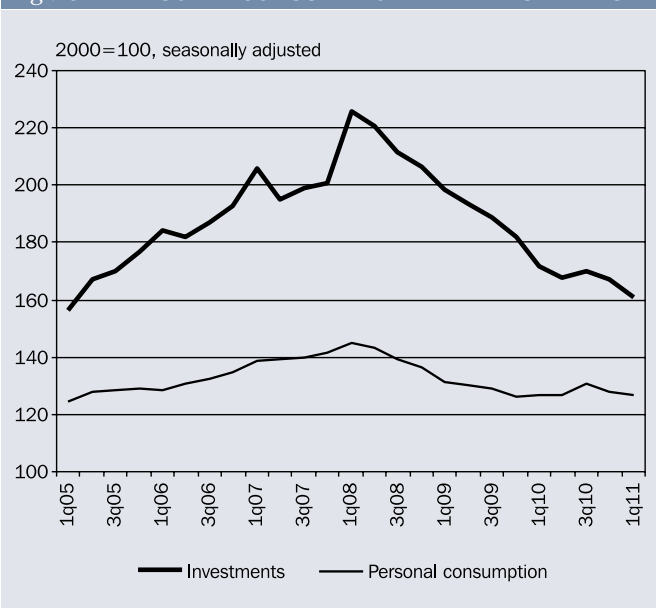
Negative labor market trends ceased?

It appears that negative labor market trends ceased at the beginning of this year. Namely, seasonally adjusted data indicate a rise in employment. In May 2011, the total number of employed persons stood at 1,404 thousands, up by 1.5 percent (or 20 thousand persons) compared to January and down by 2.5 percent compared to May 2010. In the first quarter 2011, the unemployment rate amounted to 19.5 percent, the highest since the first quarter 2003. However, up to May it decreased to 17.5 percent, which is 0.4 percentage points higher than in May 2010. The total number of registered unemployed persons dropped from 334 thousand in January to 299 thousand in May. Despite negative trends in the real sector at the beginning of the year, companies seem to expect positive developments in the near future; they have retained the existing employment, or in some segments even increased it in order to be prepared for the expected economic recovery. For instance, even though year-on-year employment in May in accommodation and food service activities fell down by 3 percent, from January to May 2011 it increased by 21 percent or 8 thousand persons although the main tourist season did not start at the time. Similar trends, but on a smaller scale, are visible in sectors like retail trade or water and air transport. Yet, we still need to see whether this is only temporary improvement associated with the seasonal effects of the upcoming tourist season.

Wages are stagnating.

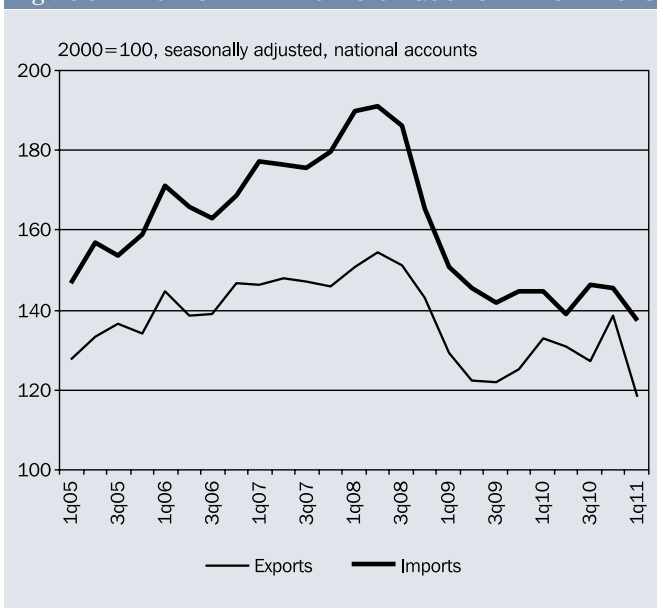
In the first quarter 2011, the average nominal gross wage stood at HRK 7.672 (approximately EUR 1.040), which is a 0.5-percent year-on-year increase, while the average nominal net wage increased 1.8 percent in the same period. Apparently, nominal wages have not adjusted to the real sector developments. This reflects the reluctance of key stakeholders - unions and employers - to change the agreed working conditions, even at the cost of employment. For instance, in real-estate activities year-on-year employment fell down by 15 percent in April, while the average gross wage increased by 4 percent. At the same time, in sectors like

Figure 2 PERSONAL CONSUMPTION AND INVESTMENTS



Note: Seasonally adjusted by X11ARIMA (Statistics Canada).
Source for original data: Croatian Bureau of Statistics.

Figure 3 EXPORTS AND IMPORTS OF GOODS AND SERVICES



Note: Seasonally adjusted by X11ARIMA (Statistics Canada).
Source for original data: Croatian Bureau of Statistics.

wholesale and retail trade, the repair of motor vehicles and motorcycles, information and communication, and financial and insurance activities, average gross wages increased from 4 to 20 percent, while the number of employed persons fell by approximately 2 percent. Altogether, the year-on-year total nominal wage bill increased by about 2.8 percent in the first quarter 2011. With a sign of recovery at the beginning of the second quarter, in April 2011 both the total wage bill and the overall disposable income showed a rise in nominal, as well as in real terms.

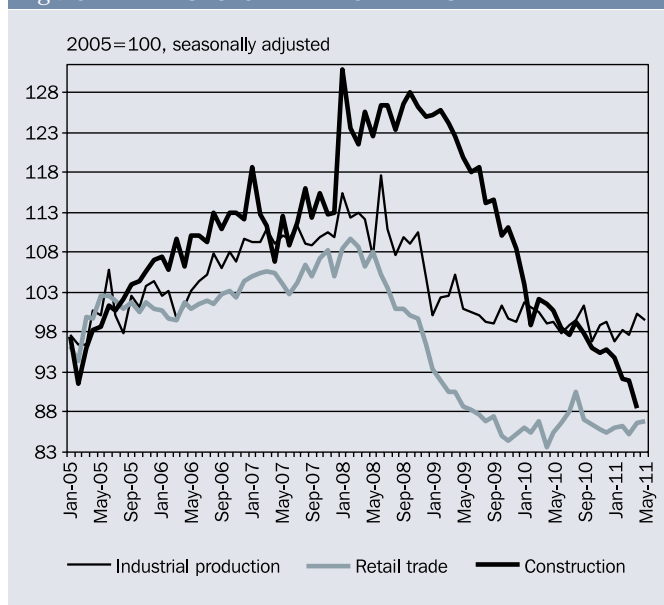
Savings accumulation slows down.

Broad money has been recording seasonally adjusted quarter-on-quarter growth rates of approximately 0.8 percent since the first quarter 2010. In May 2011, total liquid assets were 3.6 percent larger than in the same month year before. This growth has continued to be based on an increase in savings and time deposits. Namely, they rose 3.4 percent year-on-year in May. Taking into account a 2.3-percent HRK/EUR exchange rate depreciation, total savings and time deposits actually grew by only 1.1 percent. Deposit creation stems exclusively from the household sector that managed to increase its savings by 3.7 percent year-on-year. However, this is the lowest rate in the last four and a half years. At the same time, the enterprise sector cut back savings substantially, by 8 percent, which reflects liquidity shortages in the business sector. The replacement of domestic with foreign currency savings and time deposits has come to a halt. Although the amount of foreign currency deposits continued to increase, their year-on-year growth rate has been declining since the beginning of this year, with the May data showing an increase of 2.8 percent. Meanwhile, kuna savings and time deposits reversed the negative trend and depicted a 6.1 percent rise in May, the highest year-on-year growth rate since the outbreak of the crisis.

Enterprise sector credit activity accelerates.

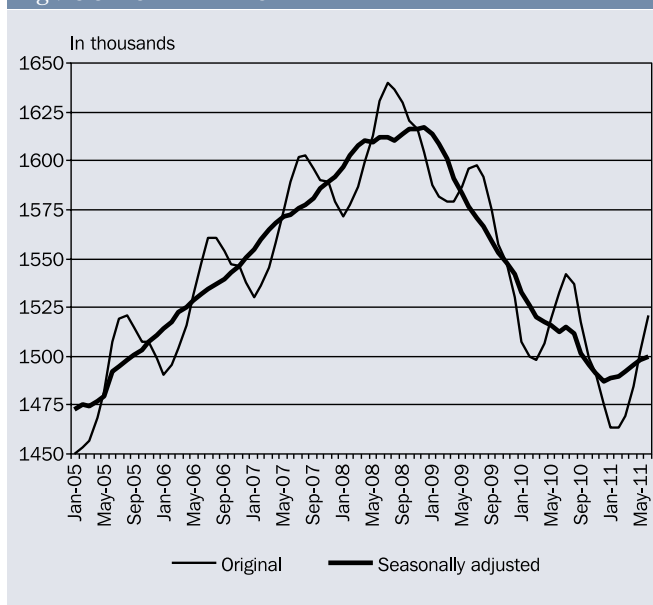
Total credit activity has accelerated, registering a 7.7 percent year-on-year rise in May. However, more than 45 percent of total credits were granted to households, out of which almost one quarter is linked to the HRK/CHF exchange rate. When adjusted for the ongoing Swiss franc appreciation, household credits actually slightly declined. At the same time, seasonally adjusted May 2011 data reveal that credits to enterprises accelerated by the highest rate in the last four and a half years, i.e. 1.6 percent when compared to the month before. On a year-on-year basis, enterprises increased their borrowing by 9.1 percent. It seems that improvements in the HBOR (Croatian Bank for Reconstruction and Development) credit support scheme introduced in the first quarter contributed to corporate lending rate reduction and corporate credit recovery. However, this injection has

Figure 4 REAL SECTOR DEVELOPMENTS



Note: Seasonally adjusted by X11ARIMA (Statistics Canada).
Source for original data: Croatian Bureau of Statistics.

Figure 5 TOTAL EMPLOYMENT



Source for original data: Croatian Pension Insurance Institute.

Box 1 WHAT IS THE EXTENT OF ADMINISTRATIVE CORRUPTION IN CROATIA?

In the summer 2010, UNODC and The Institute of Economics, Zagreb conducted a survey on administrative corruption in Croatia. Using a nationally representative sample, evidence was collected on various forms of corruption affecting Croatian citizens' daily life in their contacts with public sector employees. The results indicate that 11 percent of Croatian citizens experienced bribery in contacts with public officials and civil servants in the period of 12 months prior to the survey.

Most of the corruption experience is related to doctors (56 percent), nurses (36 percent), police officers (30 percent), and car registration officers (14 percent). However, when it comes to motives and types of bribe given to the medical staff, combined with the surveyed public satisfaction with their services, bribery in medical services seems to be rather specific in Croatia. The quality of services of nurses was rated the second best, and services of doctors were also rated relatively high. The fact that mostly doctors and nurses were reported to receive bribes indicates that the majority of bribes in medical services were actually voluntary gifts given as a sign of gratitude.

Speeding up procedure (35 percent) and receiving better treatment (18 percent) are seen as the main reasons for engaging in bribery. In over 90 percent of cases, citizens gave bribes for personal or family needs. Money was given in 44 percent of bribery cases, followed by food and drinks (37 percent). The average cash bribe amounted to HRK 2,050. Paying bribes in small amounts up to HRK 500 prevailed in procedures related to administrative fines and issuing licenses and permits. The cases of bribing police officers or car registration officers were mostly initiated by citizens themselves and given voluntarily to avoid fines or pass the vehicle technical inspection.

The prevalence rate of bribery is higher among employers (18 percent) and own-account workers (15 percent), and the lowest among housewives (6 percent) and students (7 percent). Managers (20 percent) and persons employed in elementary occupations (17 percent) are more often victims of bribery than other groups of occupation.

An important finding of the survey is that 58 percent of citizens with corruption experience gave bribes voluntarily. Eight percent were explicitly asked to give bribes by a particular public official or civil servant, and additional 4 percent received that request through a third person. Only 2 percent of Croatian citizens with corruption experience reported it formally.

This survey shows that Croatian citizens in their everyday contacts with public sector employees mostly experience the types of corruption that do not seriously prevent them from effectively using public services. At the same time, corruption is rated as the country's third major problem. It is so because political and business corruption are perceived as much bigger problems, but they were not in the focus of this survey.

Jelena Budak

Figure B1 ADMINISTRATIVE CORRUPTION IN CROATIA, BY TYPE OF BRIBE

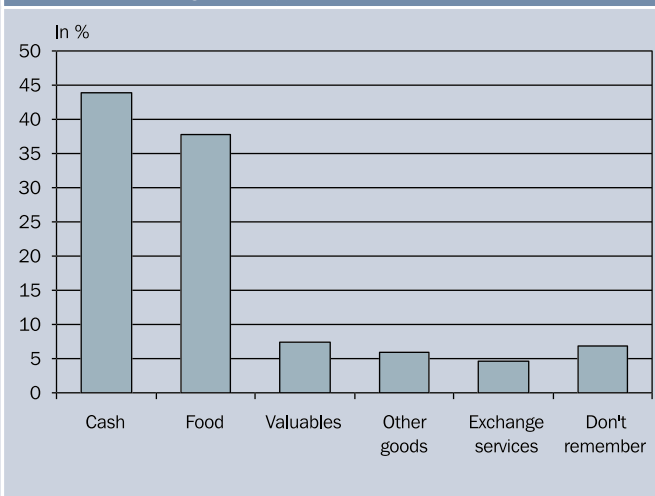
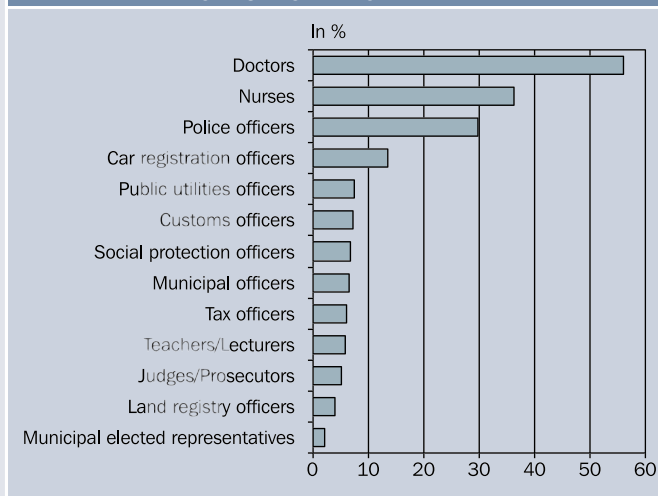


Figure B2 BRIBERY EXPERIENCE OF CITIZENS, BY TYPE OF PUBLIC EMPLOYEE*



Note: * Some citizens had multiple bribery experience with several types of public employees so the percentages should not be summed.

Source: Household survey on the experience of corruption and other forms of crime in Croatia, UNODC and The Institute of Economics, Zagreb, 2010.

failed to heat up the economic activity since those resources were used mainly to refinance the existing loans.

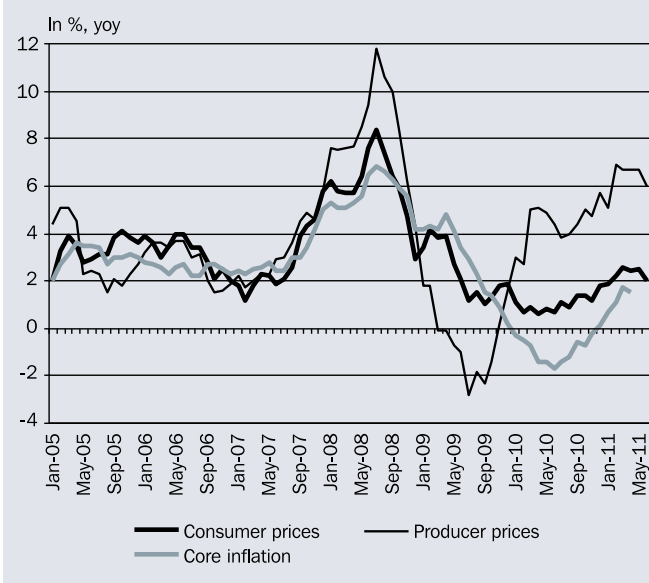
Unwonted weakness of the HRK/EUR exchange rate.

The HRK/EUR exchange rate faced the beginning of peak tourist season with an unwonted weakness, being 2.5 percent weaker in June 2011 than in the same month a year before. It seems that investors' short covering caused by a reduction in the new issues of treasury bills indexed to the HRK/EUR exchange rate and the ongoing public debate on exchange rate depreciation slightly weakened the domestic currency. Although the exchange rate risk is significant in a country with very high credit euroization, foreign currency inflows due to tourism, favorable goods imports cover and sovereign refinancing abroad should lead to exchange rate stabilization. Modest credit demand is keeping short-term money market interest rates below 1 percent, with excess interbank liquidity up to HRK 10 billion or approximately 3 percent of GDP. Even the usual summer liquidity drain and the possible CNB intervention on the foreign exchange market would not affect ample liquidity. Despite a fall in money market rates, interest rates on retail short-term credits have not followed the track. Namely, in the last three years the spread between enterprise and interbank interest rates widened from 100 to 600 basis points while the same spread for households depicted a rise of 570 basis points. In order to support the real estate market, the Government decided to subsidize first-time homebuyers by guaranteeing for interest payments for one year in case of layoffs and ensuring a ceiling for interest rates in the first six years of loan repayment. Preliminary indicators suggest that households are interested in this program and the Government intends to increase resources devoted to this program.

Inflation driven by food and fuel prices.

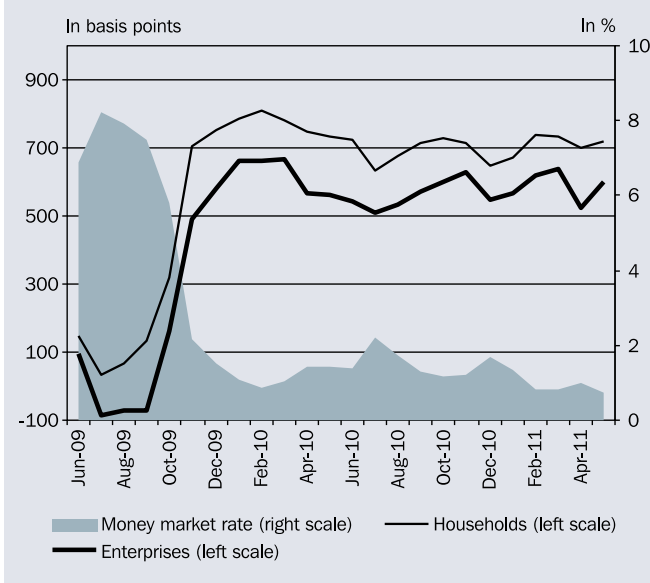
Since late 2010, the prices of food and fuels have been driving the overall inflation. However, subdued economic activity managed to slow down adverse inflationary pressures. In June, CPI inflation reached 2.0 percent year-on-year, reflecting rising food and fuel prices that together contributed with 1.7 percentage points to the overall CPI. Meanwhile, producer prices recorded a more pronounced increase due to the strong import component of fuels amounting to 6.0 percent year-on-year and -0.3 percent month-on-month. In the second quarter, producer prices advanced by 6.5 percent year-on-year as a result of growing energy, mining and manufacturing prices. For the moment, inflation seems to be under control given stable exchange rate expectations, demand weakness and subtle improvements in retail lending. After falling over the course of 2010, core inflation recorded a positive year-on-year rate of 1.8 percent in May.

Figure 6 INFLATION



Sources: Croatian Bureau of Statistics and Croatian National Bank.

Figure 7 SPREADS*



Note: * Long-term credit interest rates and money market rate.
Source for original data: Croatian National Bank.

Budget revenues still on the decline.

The fall in general government revenues that has been present since the beginning of 2009 has continued in the first quarter this year. In comparison with the first quarter 2010, total revenues dropped by 4.2 percent. This decline is comparable in magnitude to the ones in the first quarters of 2009 and 2010, indicating that most of the revenue-generating economic activities have continued to fall at an unrestrained pace. This is confirmed by a drop in direct tax revenues. Revenues from personal income and profit taxes have been on a declining path since the first half of 2009: personal income and profit tax revenues fell in the first quarter 2011 by 5.8 and 24.9 percent year-on-year, respectively. In the case of personal income tax, an additional reason for decline can be found in the abolishment of the 'crisis tax'. Furthermore, total excises are down by 15.1 percent, mainly due to a 25.7-percent fall in excises on petroleum derivatives, which is just a base effect reflecting the late payment of accrued tax obligations by the INA Oil Company in February 2010. The most important revenue source, VAT, has started to recover more strongly, rising by 5 percent compared to the first quarter 2010. This recovery can, however, hardly be explained by retail and import trends; the reason may be an improvement in the efficiency of collection through stricter law enforcement. In any case, this is still far short of two-digit year-on-year growth rates from the pre-crisis period.

Cuts in major expenditures.

On the expenditure side, the total expenditures in the first quarter were 2.8 percent lower than a year before. A decrease in total expenditures in the first quarter has not been recorded since the first quarter 2006. Major expenditure items (abstracting from interest payments) have been cut compared to the first quarter last year. Purchases of goods and services declined by 7.9 percent, and subsidies to businesses dropped by 17.6 percent. The latter is mainly due to fewer subsidies for agriculture and the Croatian Railway Company (HŽ). It is interesting that the biggest item, social expenditures, fell - for the first time ever - by 1.6 percent. The reasons include a 10-percent cut in all privileged pensions above HRK 3,500 in July 2010 and a decline in other main social benefits, while the regular pensions remained unchanged in nominal terms.

Strategic timing of the new debt issue.

The resulting first-quarter net operating balance of about HRK 4.3 billion is 6.8 percent higher than in the same quarter 2010, and makes slightly more than a quarter of the total deficit planned for 2011. The financing of the planned deficit started with the March issuance of a US\$ 1.5 billion 10-year bond, and continued at the end of June when a EUR 750 million bond was issued with maturity in 2018 and a coupon interest rate of 5.875 percent. This is the first issue of eurobond on the European market after two years, and the timing, as the Government itself admits, did not incidentally coincide with the termination of EU-accession negotiations.

2 Policy Assumptions and Projections Summary

Global economy slows down more than expected...

After a strong rebound in 2010, the global economy was expected to slow down somewhat this year. In the recent months, the strong momentum has, however, moderated more than expected. Optimists believe that it is a temporary effect induced by the political turmoil in North Africa and Middle East, rising commodity prices, earthquake in Japan, euro zone's struggle with debt issues and U.S. fiscal problems. Pessimists, yet, argue that the recent developments might lead to another, or a double-dip global recession. In its recent update, the IMF has slightly revised downwards global economy projection for this year (*World Economic Outlook Update*, IMF, June 2011). Namely, GDP growth projection was revised by 0.1 percentage points and now amounts to 4.3 percent, while it remained unchanged at 4.5 percent for 2012. The downward revision was mainly driven by weaker expectations for the U.S. economy. Risks are pronounced in the euro zone, where the sovereign-debt crisis led to stringent consolidation in Greece, Ireland and Portugal, with the list being recently extended to Spain and Italy who have also implemented austerity measures. Primarily due

to the strong recovery of the German economy, the IMF expects euro zone's GDP to rise by 2.0 percent this and 1.7 percent next year.

... while commodity prices surge.

Commodity prices have continued to increase mainly driven by political developments. After a rise in April and May, oil prices were rather volatile in June. As a response to the reduced Libyan supplies, the International Energy Agency (IEA) announced in late June a release of 60 million barrels of strategic stocks of its members, driving already sinking prices even lower. However, the effect was short-lived as prices recovered soon, partly due to the weakening of US\$. Brent and WTI crude oil were traded in mid-July at US\$ 116 and US\$ 95 per barrel. The IEA suggests that supply and demand conditions do not guarantee a continued upward price trend as in spite of a rise in global oil demand, inventories and spare capacity have remained above the average for the last five years.

Croatia concludes accession negotiations with the EU.

Out of political developments relevant for our projection, it is worth highlighting the conclusion of Croatia's six-year long accession negotiations with the EU at the end of June. The Accession Treaty is expected to be signed by the end of the year. Following that, Croatia has to hold a referendum on the accession while all the EU member states have to ratify the agreement. As a result, Croatia will probably become a full EU member in mid-2013. However, the European Commission stressed that it will closely monitor the fulfillment of the obligations undertaken by the Croatian authorities during the accession process. These political events should have positive effects on the domestic economy as well as on the perception of Croatia by international investors and the business sector.

Exchange rate stability to remain in the focus of monetary policy.

As for the domestic policy assumptions, monetary authorities are believed to remain focused on the exchange rate stability. In spite of a certain amount of criticism that was expressed by the IMF, following its recent country-mission visit regarding the exchange rate policy, and supported by some domestic economists, we do not expect a change in policy. Namely, the economy is highly eurorized and exports contain a high share of the import component. Therefore, the consequences of devaluation are uncertain, even for exporters. Since liquidity is high, we do not see much room for the central bank to change its current policy.

Limited maneuvering space for fiscal policy.

In spite of parliamentary elections announced for December, we expect no significant increase in fiscal expenditures. Namely, fiscal authorities have a rather squeezed maneuvering space within this year's budget and have therefore focused on revenue collection in the circumstances of a still present recession. As for the next year, fiscal discipline will be (almost automatically) imposed by the Fiscal Responsibility Act that determines that the share of general government expenditures in GDP should decline by 1 percentage point.

GDP growth projection: 1.3 percent this and 2.5 percent next year.

In spite of weaker than expected activity in the first quarter 2011, our GDP growth projection remains unchanged. Subdued activity in the first quarter can partly be explained by changes in seasonality as Easter, which took place in late April, drew part of production and consumption into the second quarter. Namely, we estimate that the negative trend of overall activity reversed in the second quarter. Recovery will remain weak at the beginning, but a good tourist season in the third quarter, and a recovery of other sectors in the remaining part of the year, should induce a more broad-based recovery. Our projection suggests that GDP will rise 1.3 percent this year and strengthen to 2.5 percent in 2012.

Net exports should bring growth in 2011...

As a result of stronger anticipated increase in exports than imports, the main contribution to the growth in 2011 will come from net exports. Exports of goods are expected to recover from the drop experienced in the first quarter, while exports of services, primarily revenues from foreign tourism, should significantly increase as a result of adverse political developments in other tourist destinations, foremost Greece and North Africa. Total exports are projected to rise 2.5 percent in 2011. The current account deficit should remain

low this year, around 1.4 percent of GDP. Domestic demand is expected to slightly rise in 2011, mainly due to a rise in personal consumption. While the rise is not expected to surpass 0.5 percent, more important is the anticipated improvement in consumer sentiment which should spill over to other sectors. Government consumption will slightly rise with the approaching parliamentary elections, while investments should recover from the first-quarter fall and, for the year as a whole, remain at last year's level.

Table 2 SUMMARY OF PROJECTIONS

	2011	2012
Real GDP (% change)	1.3	2.5
Real private consumption (% change)	0.5	1.9
Real government consumption (% change)	0.1	-0.1
Real investment (% change)	0.0	5.6
Exports of goods and services (constant prices, % change)	2.5	5.0
Imports of goods and services (constant prices, % change)	0.5	4.4
Current account balance (% of GDP)	-1.4	-2.4
Consumer prices (% change, pa)	2.7	2.9
Exchange rate, HRK/EUR (pa)	7.38	7.38
Unemployment rate (registered, %, pa)	18.0	17.5
General government balance (ESA95 definition, % of GDP)	-5.6	-3.9
Broad money, M4 (% change, eop)	6.0	6.0
Total domestic credit (% change, eop)	7.0	9.0

Notes: Cut-off date for information used in the compilation of projections was July 7, 2011.

Conventional abbreviations: pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.

Source: Authors' projections.

... while domestic demand should be the main growth driver in 2012.

With the consolidation of growth in 2012, we expect imports to increase around 4.4 percent due to the recovery of depleted stocks. Furthermore, exports are expected to rise by 5 percent as a result of another good tourist season. In such a situation, the current account deficit will widen to 2.4 percent of GDP, and net exports contribution to GDP will turn negative after three years. At the same time, domestic demand should strengthen. Personal consumption is expected to rise 1.9 percent, while investments should increase much stronger, 5.6 percent, as the country comes closer to the full EU membership status. As a consequence of fiscal consolidation needed to observe the fiscal rules, a mild decline of government consumption is also expected.

Labor market conditions expected to gradually improve.

As to the labor market, positive developments are expected to continue through the mid-year supported by seasonal employment and the revival of the economy. The fall will, however, bring new challenges. If economic activity strengthens as projected, unemployment and employment should be roughly the same by the end of this year as at the end of 2010, allowing for further improvements in 2012. For 2011 as a whole, the average unemployment rate might reach 18 percent, some 0.6 percentage points more than in 2010. In 2012, the unemployment rate is projected to decline to 17.5 percent. The average gross wage should remain more or less unchanged this and next year due to fragile recovery, strong competitive pressures in tradable sectors and fiscal deficit pressures in the public sector.

Import prices might speed up inflation.

Food and energy prices pose major risks for future inflation. These prices are mostly affected by the world markets, implying that domestic policy-makers have only a limited role in controlling them, assuming that a larger-scale change in the HRK/EUR exchange rate is not a policy option. Other pressures on prices will mostly be muted due to demand constraints. Overall, a mild speed-up of inflation is expected, with the year-average of 2.7 percent this and 2.9 percent next year.

Summer appreciation lagging behind.

As surplus interbank liquidity and fiscal risks pose a threat for higher exchange rate volatility, we do not expect the central bank to further loosen its monetary policy, at least

not before the parliamentary elections and necessary fiscal cuts at the beginning of 2012. Although the HRK/EUR exchange rate depreciated by early July, we expect that speculative positioning linked to the domestic bond issuance announced for July, quasi-sovereign borrowing abroad and hefty foreign currency inflows from foreign tourists will reverse that trend. Therefore, we see increasing volatility at the shortest end and a boost in short-term money market interest rates. However, there is no reason to believe this boost will be long-lived as liquidity is more than satisfactory.

Enterprise sector credit activity expected to speed up.

In the second half of 2011, we do not expect a significant increase in the household borrowing due to low demand caused by labor market uncertainties, while for the government and enterprise sector we anticipate a speed-up. The government sector is expected to continue with short-term debt financing on the domestic market, while credits to the enterprise sector should progress on the improved sentiment ahead of EU accession. Therefore, in this year we see broad money growing by 6 percent, with the total domestic credit following by 7 percent. Next year we expect the lending revival to extend to households and, therefore, we foresee the total domestic credit rising by 9 percent, with total liquid assets growth amounting to 6 percent.

Tourist season to help avoid budget revision.

Given that the central government expenditure is not to exceed the pre-determined HRK 122 billion, this year's deficit will be completely conditioned by the dynamics on the revenue side. By the end of the year, revenues will depend on the economic activity associated with the tourist season, primarily through the revenues from VAT and, to a lesser extent, personal income tax. Judging by the early signs, the season is likely to be successful and, thus, fiscally lucrative. In such circumstances, there is no reason for the general government deficit to exceed 5.6 percent of GDP, just as it is foreseen in Government's *Pre-Accession Economic Program*. Indeed, due to the restrained expenditure this year may even happen to be the one without the upward budget revision. As for 2012, the general government deficit should be about 3.9 percent, provided the economy grows at least one percentage point faster than this year (i.e., at about 2.5 percent). Concerning the borrowing prospects, the price of debt is not likely to depart notably from the current one, not least due to the finalization of the negotiation process with the EU and the Fiscal Responsibility Act that is to be implemented for the first time in the preparation of the 2012 budget.

3 Uncertainties and Risks to Projections

New energy needed in dealing with structural reforms...

As the parliamentary elections are probably going to be held in early December, the rest of the year might be more devoted to political campaigning than to policy-making. Let us hope that the major political parties will not use populist promises whose realization could negatively affect the economic recovery. No matter who wins the elections, the new Government will have to bring new energy in dealing with structural problems. The fact that serious reforms have been delayed so far is among the major reasons for such a slow economic recovery, including the sluggish export performance.

... although they might bring temporary shocks.

The undertaking of the reforms might have some negative economic consequences in the short-term, but with a much brighter prospect over the longer horizon. Lower fiscal revenues and the EU regulation in areas such as shipbuilding, agriculture, railway transportation etc., might bring temporary shocks in terms of employment or exports, although we assume a relatively smooth transition. However, uncertainty remains in that respect.

What will be the extent of Greek and North African effect?

According to early indications, tourist season might outperform previous expectations. Political developments in the countries that are Croatia's main competitors on the Mediterranean tourist market – Greece and North African countries – seem to have

Slowdown in global economy – is it only temporary?

rerouted tourists towards Croatia's coast. Consequently, there is an upside risk to the projection of tourism revenues.

As the global economy has entered the second quarter with a stronger slowdown than earlier expected, the question arises whether that is only temporary. Risks are in particular emphasized in the euro zone as a result of the Greek crisis but also due to sovereign debt problems in a number of other economies. The latest case is Italy, Croatia's most important trading partner. While business and consumer confidence are still favorable and could boost the EU economies, downside risks mainly relate to tensions in financial markets and may spill over to the real sector. A protracted slowdown would have a negative effect on the Croatian economy no matter that the lags in which these effects might realize are highly uncertain.

Concerns over government guarantees.

Uncertainties concerning aggregate fiscal expenditures and revenues are limited to the latter. The main revenue-related risks are those of a serious underperformance of the tourist season and a strong adverse shock to consumer confidence. However, such adverse contingencies are rather unlikely to realize and deteriorate the fiscal balance significantly. Labor market recovery is still weak, but it seems that it will not pose a serious obstacle to the realization of our fiscal projections. Nevertheless, the guaranteed public debt stock, out of which foreigners hold more than 60 percent, should be of more concern. The amount of the issued guarantees at the end of the first quarter 2011 was HRK 2.2 billion lower than at the end of 2010. However, the Government announced that it would assume the unpaid debt of the shipyards undergoing privatization, which would increase a debt-to-GDP ratio by some 3 percentage points, with negative implications for the cost of future borrowing.

PUBLISHER INFORMATION

This publication has been prepared by Andrea Mervar (editor), Danijel Nestić, Ivica Rubil, Sandra Švaljek, Marina Tkalec, Iva Tomić and Maruška Vizek. The views expressed are those of the authors and do not necessarily reflect the views of The Institute of Economics, Zagreb, or of other researchers at The Institute of Economics, Zagreb.


Croatian Economic Outlook Quarterly is published in January, April, July, and October.
Sales and subscription service: Mr. Josip Šipić

E-mail: outlook@eizg.hr

Executive editor: Josip Šipić
Technical editor: Vladimir Sukser

Publisher: The Institute of Economics, Zagreb
Trg J.F. Kennedyja 7, 10000 Zagreb, CROATIA
Telephone: **385 1 2362 200, Fax: **385 1 2335 165, <http://www.eizg.hr>

For the publisher: Sandra Švaljek

Copyright © 2011 The Institute of Economics, Zagreb  Printed on recycled paper



9 771332 306009