The Institute of Economics, Zagreb
Department for Macroeconomic Analysis and Policy
70 years 1939-2009
No. 37 / January, 2009

Croatian Economic Outlook
Quarterly

1 Recent Developments

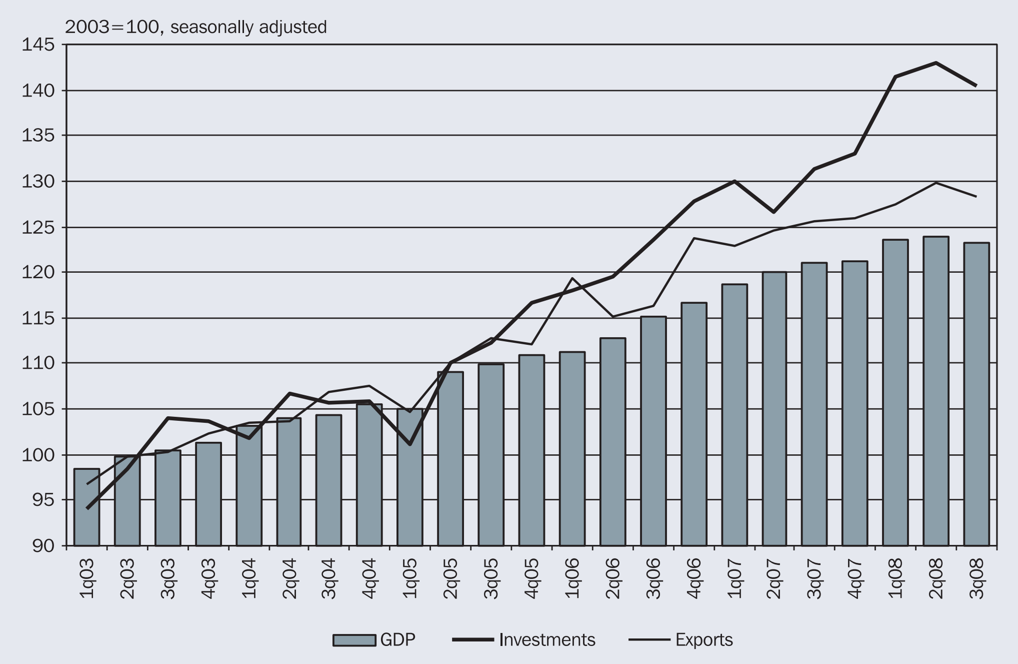
Economy is sliding into recession…

The Croatian economy was considerably weaker in the third quarter of 2008 than previously expected. The seasonally adjusted GDP dropped by 0.5 percent over the second quarter. A similar decline could be expected in the fourth quarter, indicating that the Croatian economy actually fell into recession in the second half of 2008. Here we refer to the technical definition of recession as two consecutive quarters of GDP decline based on seasonally adjusted quarter-on-quarter figures. Our estimate on activity decline in the fourth quarter is supported by the latest figures for industrial production, retail sales, and merchandise exports that are available up to November 2008 and indicate a notable weakness in the economy. On the positive side, the financial system has been fairly resilient to the negative spillovers from the global financial crisis, partly due to additional Government's and central bank's measures.

… following an unexpectedly weak third quarter of 2008.

It appears that the speeding up of inflation in mid-2008, coupled with the weakening of export demand, has had a detrimental effect on the overall real sector in Croatia. Although the GDP level remained 1.6 percent above its level year ago, it declined over the previous quarter. Negative trends were observed in personal consumption, investments, and exports. Government consumption was the only component of aggregate demand that sustained a

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

positive trend during the third quarter, while imports stagnated. In sum, the third quarter 2008 might be seen as a turning point towards more unfavorable economic conditions.

Personal consumption weakened due to inflation hike and deteriorated consumer confidence.

Personal consumption weakened during the last year. Seasonally adjusted data suggest that it declined by 0.7 percent in the second and by additional 0.4 percent in the third quarter 2008. Its level in the third quarter 2008 remained 0.4 percent higher than in the same quarter year before, but with a clear negative trend. Personal consumption weakened due to the acceleration of inflation and deteriorated consumer confidence. Personal consumption deflator was as high as 7.8 percent on a year-on-year basis, up by 1.2 percentage points over the previous quarter. As a result, the continued growth of nominal disposable income in the third quarter, particularly wages, was almost fully cancelled by increased inflation. At the same time, consumer confidence has deteriorated and, as suggested by the central bank's data, dropped to its lowest level since 1999, the latest recession year in Croatia.

Government consumption - still resilient.

By the end of the third quarter last year, government consumption remained resilient to the sluggish economic performance, although certain moderation can be observed. Namely, in the third quarter 2008, seasonally adjusted government consumption remained at an approximately same level as in the second quarter, while original data indicate a 1.3 percent rise over the third quarter 2007. However, the trend in government consumption was still upward sloped.

Investments fell back.

A relatively steep rise in investments observed in the first half of 2008 suddenly stopped in the third quarter. The year-on-year rate dropped from 12.6 percent in the second to 6.6 percent in the third quarter. Seasonally adjusted figures point to a quarterly decline by more than 1.5 percent in the third quarter. This fall took place despite a relatively strong construction activity, suggesting that other forms of investment such as investment in machinery and equipment actually weakened, as indicated by decreased imports and the domestic production of capital goods. Investment performance may be additionally endangered at the end of 2008 and in the first part of 2009 as some important construction projects have been completed, namely highway sections and several large indoor stadiums for the Men's World Handball Championship. Moreover, the number of construction permits obtained in the first eleven months of 2008 decreased by 6 percent compared to the same period 2007. It seems that demand is waning due to more stringent financial conditions and deteriorated business confidence.

Export sector faces serious difficulties...

The volume of exports of goods and services increased 1.7 percent year-on-year in the third quarter 2008. Seasonally adjusted figures point to a more than 1 percent decline compared to the previous quarter. Consequently, the trend has turned negative. The poor overall export performance comes as a surprise because preliminary data on merchandise exports in the third quarter indicated quite favorable developments. However, only a modest increase in revenues from international tourism contributed to a much weaker performance of the overall exports than earlier expected. The balance of payments data reveal that revenues from international tourism reached EUR 4.4 billion in the third quarter, which is 6.9 percent higher than a year before. However, price increases in the tourism sector and the appreciation of HRK/EUR exchange rate have resulted in a low rise in revenues from international tourism in real terms. Data on merchandise exports available up to November 2008 reveal its notable weakening in the fourth quarter, suggesting serious difficulties for the export sector. On the other side, the volume of imports of goods and services remained quite strong, with a 6.3 percent year-on-year growth in the third quarter 2008. Imports remained roughly constant when compared to the previous quarter. Due to the seasonal inflow of tourism revenues, the third quarter 2008 brought a EUR 1.85 billion surplus on the current account, which is lower than in 2007 when it amounted to EUR 2.07 billion. This has resulted in a rising current account deficit measured as a cumulative

Table 1 MAIN ECONOMIC INDICATORS

	2006	2007	2007	2008		
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	4.8	5.6	3.7	4.3	3.4	1.6
Real private consumption (% change, yoy)	3.5	6.2	5.0	4.3	2.2	0.4
Real government consumption (% change, yoy)	2.2	3.4	3.7	0.5	3.2	1.3
Real investment (% change, yoy)	10.9	6.5	4.0	9.8	12.6	6.6
Industrial output (% change, yoy)	4.5	5.6	3.1	4.8	3.9	0.2
Unemployment rate (registered, %, pa)	16.6	14.9	14.2	14.7	13.2	12.4
Nominal GDP (EUR million)	34,220	37,497	-	-	-	-
GDP per capita (EUR)	7,707	8,452	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.4	4.0	5.1	6.1	6.4	7.6
Consumer prices (% change, yoy, pa)	3.2	2.9	4.9	5.9	6.6	7.4
Producer prices (% change, yoy, pa)	2.9	3.4	5.4	7.6	8.7	11.1
Average gross wage (% change, yoy, pa)	6.2	6.2	6.4	7.5	6.8	7.4
Exchange rate, HRK/EUR (pa)	7.32	7.34	7.33	7.29	7.26	7.18
Exchange rate, HRK/US$ (pa)	5.84	5.37	5.06	4.87	4.65	4.78
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	8,464	9,193	2,477	2,226	2,492	2,679
Exports of goods (EUR, % change, yoy)	17.2	8.6	4.1	8.8	7.9	13.5
Imports of goods (EUR million)	16,808	18,627	4,913	4,791	5,599	5,411
Imports of goods (EUR, % change, yoy)	14.0	10.8	12.0	13.9	15.7	15.8
Current account balance (EUR million)	-2,702	-3,233	-1,913	-2,517	-1,819	1,850
Current account balance (% of GDP)	-7.9	-8.6	-	-	-	-
Gross foreign direct investment (EUR million)	2,745	3,649	724	910	1,043	225
Foreign exchange reserves (EUR million, eop)	8,724	9,307	9,307	9,840	9,940	9,808
Foreign debt (EUR million, eop)	29,274	33,264+	33,264+	34,986+	35,401+	36,158+
GOVERNMENT FINANCE*						
Revenue (HRK million)**	112,294	126,716	126,716	31,795	66,307	100,661
Expense (HRK million)**	107,722	118,771	118,771	19,296	60,881	92,974
Net = Gross operating balance (HRK million)**	4,572	7,946	7,946	2,499	5,884	7,687
Net acquisition of non-financial assets (HRK million)**	9,083	11,015	11,015	1,545	3,955	4,098
Net lending/borrowing (HRK million)**	-4,511	-3,069	-3,069	560	3,030	3,590
Domestic government debt (EUR million, eop)	8,132	8,605	8,605	8,892	8,955	9,029
Foreign government debt (EUR million, eop)	6,649	6,698	6,698	6,578	6,643	6,843
Total government debt (% of GDP)	43.3	40.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	25.0	19.3	19.3	12.9	5.5	7.6
Broad money, M4 (% change, yoy, eop)	18.0	18.3	18.3	14.4	11.1	14.7
Total domestic credit (% change, yoy, eop)	22.9	15.0	15.0	12.2	10.3	11.0
DMBs credit to households (% change, yoy, eop)	21.8	18.0	18.0	16.3	14.8	10.9
DMBs credit to enterprises (% change, yoy, eop)	26.1	10.2	10.2	7.4	5.0	10.7
Money market interest rate (%, pa)	1.6	4.1	6.0	4.5	2.8	3.8
DMBs credit rate for enterprises, short-term, (%, pa)	7.1	7.0	7.3	7.6	7.6	7.6
DMBs credit rate for households, short-term (%, pa)	12.1	12.1	11.8	12.2	12.1	12.2

Notes: *+ New reporting system. * 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.*

over a year up to the third quarter. Such a current account deficit reached 10.8 percent of GDP and was 0.2 percentage points higher than in the second quarter.

... as goods exports weaken.

The exports of goods rose in the third quarter by 13.5 percent year-on-year in kuna terms, while goods imports increased 13.8 percent. However, October and November saw a substantial deceleration. As a result, the exports of goods grew by 5.5 percent year-on-year in current kuna terms in the first eleven months of 2008, which is almost a half of the rate observed in the same period previous year. At the same time, imports expanded by 9.9 percent. The deceleration of exports in the fourth quarter was mainly caused by a decline in the exports of oil and petroleum products, chemical products as well as various durable consumer goods.

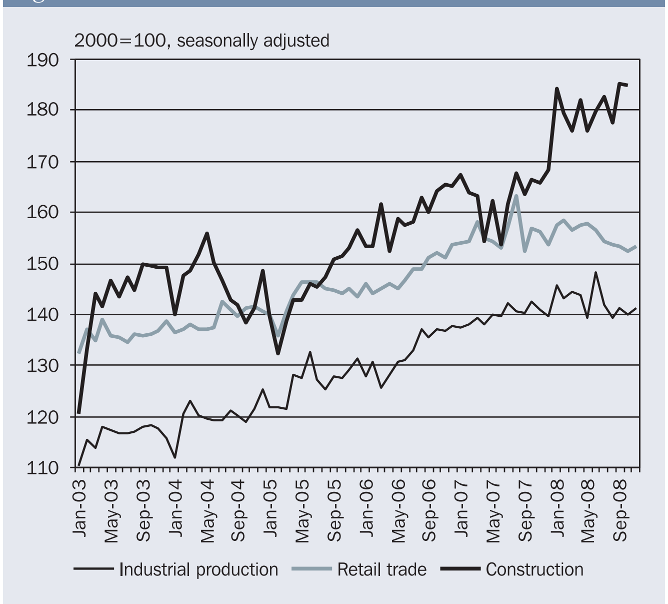
Industrial production and retail sales volume declined.

Both industrial production and retail sales volume shrank in the third quarter 2008 on a quarter-on-quarter basis. At the same time, year-on-year comparisons suggest that following a strong first half of the year, the third quarter brought just the same volume of industrial activity as the third quarter previous year, while in October and November it declined 2.1 percent on average. Looking across various groups of products, the highest decline was recorded in the production of durable consumer goods. The cumulative rate for the first eleven months of 2008 amounted to 1.9 percent year-on-year. Retail sales volume was rather sluggish in the first half of 2008, but year-on-year change remained positive. However, in the third quarter, it declined 2.1 percent and by additional 3.3 percent on average in October and November, resulting in leveling off in the eleven-month volume year-on-year. It may be noted that the sales of new passenger cars were rather solid in 2008, rising by 6.8 percent over the previous year. However, a substantial weakening was observed towards year's end. The sales of used passenger cars and light trucks fell already in 2008. Differently from the rest of the real sector, construction activity remained strong in the second half of the year as suggested by data available up to October 2008. The volume of construction activity in the third quarter was higher than in the second quarter, while the cumulative rate for the year amounted to 11.8 percent year-on-year up to October.

Employment still holding up.

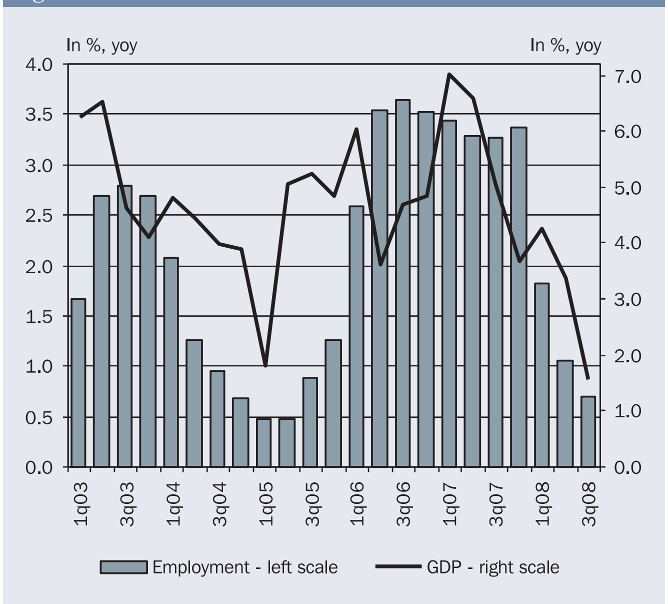
Figures available up to November 2008 suggest a significant moderation in employment growth. As a result of the usual seasonal pattern, total employment has been on a decline

Figure 2 REAL SECTOR DEVELOPMENTS



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

Figure 3 TOTAL EMPLOYMENT AND GDP



Source: *Central Bureau of Statistics.*

since July, but still recorded positive year-on-year growth rates - 0.3 percent in November 2008. It should be noted that year-on-year employment gains declined over the course of 2008, suggesting the disappearance of favorable conditions on the labor market. Similarly, the number of jobseekers has increased since August, mostly due to seasonal fluctuations. In November 2008, it was 7.7 percent lower than a year before. The seasonally adjusted figure for November indicates lower unemployment than in the preceding month, but the decline was much less pronounced than in previous months. The unemployment rate amounted to 13.2 percent in November. The labor market in Croatia usually shows a high degree of inertia and one could expect that trends will eventually become negative if output continues to decline in the course of this year. In addition, employment in manufacturing, which is most sensitive to changes in economic conditions, exhibited a negative trend already in 2008.

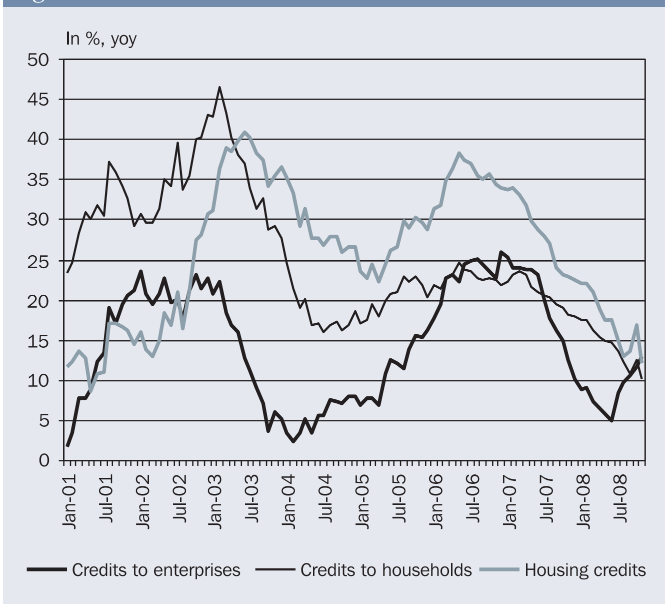
Significant nominal rise in the average wage.

In nominal terms, the second half of 2008 saw notable wage growth. In the third quarter, the average net wage increased 8 percent over a year, which is the highest nominal increase since 2001. Apart from the stable upward trend observed in the last several years, such a wage increase was additionally backed up by an increase in the basic personal allowance since July 1, 2008. Also, there was a substantial increase in the minimum wage level, 12.6 percent over the first half of 2008 and 19.7 percent over its level in 2007. It must be noted, however, that the wage growth in real terms was weak, due to the recent inflation hike. But, in the situation of mild appreciation of the HRK/EUR exchange rate, the high nominal growth in the average wage leads to a high increase in the average wage in euro terms, with a possible negative impact on international competitiveness. In euro terms, the average gross wage growth is estimated at around 8.5 percent for the whole 2008, which is the highest annual increase in the last ten years. It appears that the actual wage bargaining system based on backward-looking arguments supports a high degree of inertia on the labor market, making it unprepared to cope with the economic crisis.

Pronounced deceleration in the growth of monetary aggregates...

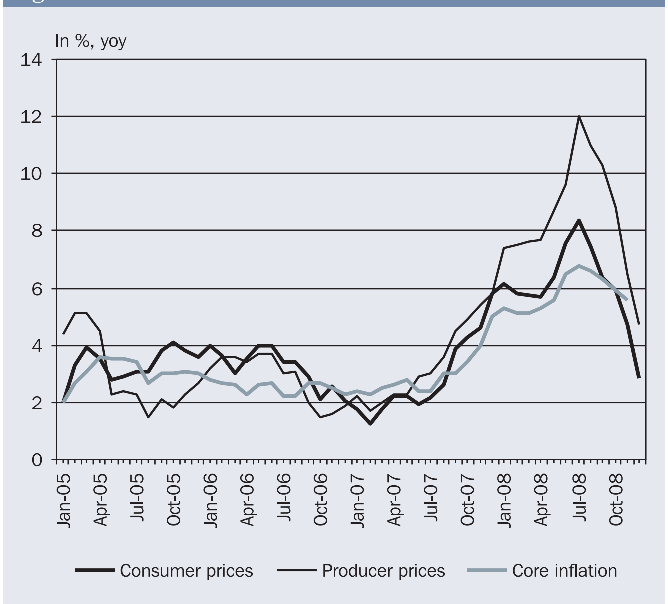
Broad money growth has continued to decelerate. While in the first half of 2008 it recorded double digit year-on-year rates, M4 increased in November by 5.0 percent over the same month year ago, the lowest rate since 2000. Furthermore, seasonally adjusted figures indicate that broad money actually contracted during October and November on a

Figure 4 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

Figure 5 INFLATION



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

Box 1 HOW TO EXTEND WORKING LIFE?

Similar to many European countries, Croatia is facing demographic changes determined by universal phenomena - a decline in fertility rates and a rise in life expectancy. Also, some country-specific factors such as socio-economic transition and the Homeland War in the 1990s have influenced actual demographic developments. As a consequence, the share of the elderly in the population structure will continue to rise and the share of the working-age population will shrink. In the CBS demographic projection, it is estimated that the number of persons aged 65 years or older will reach 28 percent of the total population in 2050. At the same time, the working-age population (15-64) will decrease from around 3.0 million today to 2.2 million by 2050 and its share in the total population will be reduced by 8 percentage points. In addition, the labor force will comprise a large proportion of older workers (55-64); their share will rise to 24 percent by 2050, almost 6 percentage points more than today.

In spite of the pension reform and the introduction of three-pillar system in 2001, the Croatian pension system still heavily relies on the principle of solidarity where the active population finances the retired part of the population through large public pension funds. This implies that the abovementioned demographic changes will bring severe economic and social problems in the future. Therefore, The Institute of Economics, Zagreb and Friedrich-Ebert-Stiftung, Regional Office Zagreb for Croatia and Slovenia, embarked on a joint project to analyze the effects of undergoing demographic changes and explore obstacles/incentives for employers and employees to extend working life.

The project has resulted in a book *New Perspectives on a Longer Working Life in Croatia and Slovenia* (*www.eizg.hr*), edited by Maja Vehovec. It analyzes the basic demographic forces shaping future labor market developments, identifies those elements of the pension system influencing retirement decisions and scrutinizes employers' willingness to retain older workers. Furthermore, it also formulates recommendations for policy-makers to design necessary reforms in accordance with the EU goals for raising the employment rate (Stockholm target) and the exit age (Barcelona target) of older workers.

In sum, the recommended policies fall under four categories, depending whether their aim is:

(i) **to change the pension system design** – In Croatia, the latest pension reform has resulted in a higher average retirement age, a higher employment rate of older workers, and a lower net replacement rate. Although the policy of increasing the statutory retirement age has resulted in extending working life, this book argues that older workers should be encouraged rather than forced to work longer. This can be achieved by simultaneously introducing the financial premium for longer employment and penalizing early retirement. As to the incentives for employers who retain workers above the regular retirement age, they are envisaged in the form of decreased pension insurance contributions.

(ii) **to change non-pension incentives for workers** – The institutional framework should provide flexible work options for older workers in the form of employment contracts similar to those for students and the more flexible working time regime, including the possibility of working part-time.

(iii) **to tackle age discrimination in employment** – The book indicates that employers actually discriminate older workers and retired persons in their employment prospects. Policies designed to change employers' attitudes and employment practices should be based on two approaches: (a) the voluntary approach through public information campaigns and guidelines and (b) the formal approach through the implementation of legislation preventing age discrimination in employment. Furthermore, the book argues for the implementation of measures aimed at making older workers more attractive to employers by providing them with financial incentives to hire and retain older workers.

(iv) **to increase the employability of older workers** – This study points to the need of complementing passive with active labor market policy measures to counteract early retirement. Therefore, it advocates for the implementation of measures that tackle the supply side of older workers' labor market. These are: (a) promoting life-long learning and training of older age groups, (b) providing better employment services for older people, and (c) promoting better working conditions and better health and safety standards.

The aging of the workforce is a structural problem that will persist over the long-term, no matter whether the economy is receding or booming. In times of recession, however, policy-makers will face severe constraints in implementing the above-mentioned policies.

Prepared by Josip Šipić

monthly basis. Such dynamics was caused by narrow money and kuna savings deposits, while foreign exchange savings continued to grow by double digit rates year-on-year. On a monthly basis, however, both forms of savings - domestic and foreign exchange - contracted in October and November, suggesting that confidence in the banking sector has eroded due to the global financial crisis.

… and a stagnation of credit growth.

Total domestic credits sustained the growth pace in the second half of 2008 due to an annual 12-percent credit ceiling imposed by the central bank. In November 2008, they were 11.3 percent higher than in the same month year before. However, the second half of 2008 brought a change in the growth patterns of main credit components. Credits to enterprises actually picked up to a record 13.0 percent year-on-year growth in November, while credits to households decelerated to 10.2 percent. The most apparent slowdown occurred in the dynamics of housing credits that increased 12.1 percent year-on-year in November, some 10 percentage points less than in November 2007. Such trends could be due to the fact that enterprises that used to borrow from foreign banks are now turning to domestic banks as a result of more stringent financial conditions abroad. These trends might also suggest that domestic banks, pressured by liquidity constraints, are now focusing on more lucrative short-term lending to households. However, changes in the household credit demand have certainly contributed to this outcome.

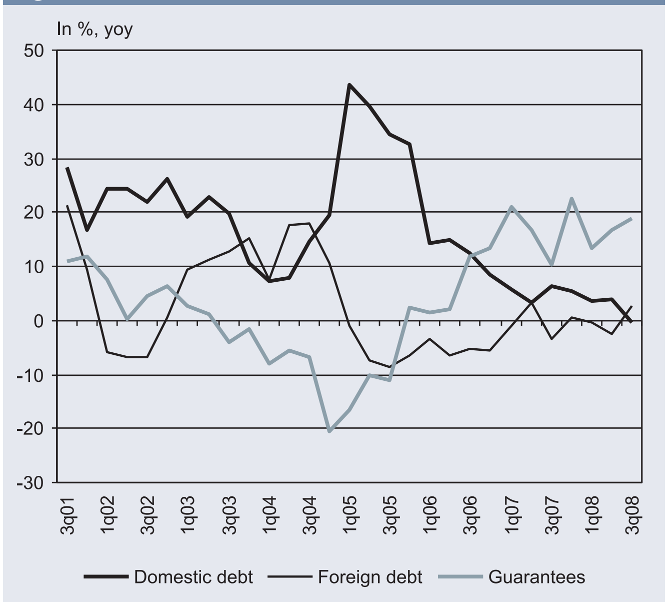
Foreign debt growth accelerated.

At the end of October 2008, gross foreign debt reached EUR 37.7 billion or EUR 4.4 billion more than at the end of 2007. The corporate sector has continued to be the main contributor to the foreign debt increase, raising EUR 3.4 billion abroad in the first ten months last year. The Government's foreign debt rose by EUR 0.2 billion, mostly due to a syndicated loan of EUR 250 million raised by the Croatian Motorways and Croatian Bank for Reconstruction and Development. As opposed to that, banks slightly decreased their foreign liabilities for EUR 0.1 billion in spite of the fact that the banking sector's foreign debt increased by EUR 1.1 billion in October. Foreign debt growth was rather stable over the past twelve months as it rose by about 15 percent year-on-year in current euro terms. However, in October, the year-on-year growth rate increased to 19 percent due to the substantial borrowing of the banking sector.

Figure 6 HRK/EUR EXCHANGE RATE

Source: *Croatian National Bank.*

Figure 7 PUBLIC DEBT



Source: *Croatian National Bank.*

Restrictive money market conditions.

Already stringent money market conditions in the third quarter 2008 worsened further in the fourth quarter. In October 2008, the central bank abolished the marginal reserve requirement in order to boost commercial banks' liquidity constrained by the outflow of savings and increased kuna demand due to the takeover of 22 percent stake in the Croatian oil company INA by the Hungarian MOL. Both events had adverse effects on kuna liquidity, which resulted in a rise of the overnight money market rate up to 9.9 percent, while the marginal repo rate amounted to a record-high 6.92 percent in October. During November 2008 the frictions on the money market persisted partially due to an unequal distribution of liquidity among market-makers. The overnight money market rate and marginal repo rate increased further to 17.1 and 7.75 percent respectively, while the demand for liquidity on repo auctions was very high. In order to provide additional liquidity to the banking system, the central bank reduced the reserve requirement rate from 17 to 14 percent in late November. Consequently, December saw somewhat easier money market conditions. In light of strong kuna demand, the HRK/EUR exchange rate has continued to appreciate, while depreciation pressure started in the last week of 2008. Nevertheless, the HRK/EUR exchange rate in December 2008 was 1.1 percent lower than in the same month year before.

Inflationary pressures eased.

Following a record-high inflation during the summer 2008, the last quarter witnessed the alleviation of inflationary pressures. In December, consumer price inflation dropped down to 2.9 percent, while producer price inflation receded to 4.7 percent, which is 5.5 and 7.3 percentage points lower than in July 2008, when inflation was at its peak. Data on core inflation available until November suggest that inflationary pressures have somewhat eased but not disappeared. In November, core inflation was 5.6 percent higher than in the same month previous year, but 1.2 percentage points lower than in July 2008.

Slowdown in revenue collection;...

The Ministry of Finance data covering the period up to the end of September 2008 reveal a continued and rather fast slowdown in revenue collection. Total revenues growth receded to 2.4 percent year-on-year in the third quarter from 8.1 percent in the second quarter and 13.6 percent in the first quarter. This is mainly due to the recent economic deceleration, a decrease in oil prices, and the introduction of higher basic personal allowance at the beginning of July. As for the fourth quarter, no improvements are to be expected. On the contrary, extremely frequent and large T-bill issuances in the last quarter of 2008 and in January 2009 could be taken as a clear sign that at least short-term liquidity problems have already appeared.

... expenditures remain strong.

Meanwhile, general government expenditures remained rather strong in the first three quarters of 2008, growing 8 percent year-on-year in the third quarter, while the respective figures for the first and second quarter stood at 6.8 and 13.3 percent, respectively. Since July 2008, the Ministry of Finance has been applying a new methodology for reporting fiscal data aligned with the European statistical methodology ESA 95. Thus, the Croatian Motorways has been excluded from the general government sector, so the 2008 data are not fully comparable with previous years. By the end of September, total general government revenues reached HRK 100.7 billion, while total expenditures amounted to HRK 93 billion, with the net general government lending of HRK 3.6 billion (GFS 2001 methodology).

The 2009 budget on shaky foundations.

Being aware of the fact that 2009 will bring economic slowdown and difficulties in deficit financing, the Government's first intention was to balance the 2009 budget. The debate on budget proposal was intensive, including social partners, coalition partners, economists as well as government and parliament members. The most controversial topics were those concerning the wage rise of public sector employees as well as the health system reform. As for the reform, some previously envisaged costs have been cut. On the other hand, the Government decided not to break the collective agreement with the public sector trade unions for the sake of social peace. According to the 2009 state budget that was adopted at the very end of 2008, both budgetary revenues and expenditures are expected to rise by 5.2 percent. Budgetary revenues are projected at HRK 124.2 billion and expenditures at HRK 123.4 billion. The state budget deficit should consequently go down by HRK 2.4 billion and reach 0.9 percent of the projected GDP (ESA 95 methodology). The general government deficit figure for 2009 is estimated at 1.2 percent.

Bad timing for government borrowing.

Public debt grew 0.6 percent during the first three quarters of 2008, attaining HRK 112.8 billion at the end of September (without guarantees). Domestic part of the debt increased 1.8 percent, while the foreign public debt decreased 0.9 percent. Central government guarantees stood at HRK 18.1 billion at the end of third quarter; hence the total amount of guarantees is 3.6 percent higher than at the end of 2007. In spite of further deficit reduction, the government borrowing requirement is going to rise from HRK 12.1 billion in 2008 to 13.2 billion in 2009 since a large part of accumulated public debt is due this year. Having in mind that credits are scarce on global financial markets, government borrowing will certainly be costly and coupled with a serious crowding out of private sector that also has to roll over a considerable amount of its liabilities.

2 Policy Assumptions and Projections Summary

Weakening global demand underpinned a decline in oil prices.

The financial crisis that originated in the U.S. has affected the rest of the world economy through a number of channels. Volatility on financial markets has put severe strains on banking systems resulting in tighter credit conditions, weaker business and consumer confidence, and a sharp downward revaluation of stock markets. Consequently, the real sector activity around the globe has slowed down substantially. A number of developed economies entered recession by the end of 2008, while emerging markets that have led global growth in recent years seem to be increasingly affected by the global downturn. The latter also applies to emerging economies in Europe, especially those exposed to high external imbalances. In its January 2009 forecast, the European Commission projects that world GDP growth will slow down from 3.3 percent in 2008 to 0.5 percent in 2009, before recovering to 2.8 percent in 2010. The euro area is already in recession, following a fall in GDP for the second consecutive quarter (0.2 percent in the third quarter of 2008). The Commission forecasts that GDP will fall by 1.8 percent in 2009 in both the EU and the euro area before turning moderately positive to around 0.5 percent in 2010. Inflationary pressures have eased worldwide as oil and other commodity prices recorded a steep decline over the past months due to worsening global demand and the reduction of market speculations.

Policy-makers face severe challenges in 2009.

On the internal front, we assume that the stability of financial system, including both internal and external liquidity, will be sustained. In a highly euroized economy like Croatia, this also implies the exchange rate stability. Policy-makers have so far declined the possibility of a stand-by arrangement with the IMF, but it remains an option that cannot be excluded in case of stronger problems with external liquidity. The central bank is also expected to continue pursuing its main goal of price stability, although this will probably ask for much less effort than in 2008. Fiscal authorities face severe challenges this year related to servicing public debt, financing the budget deficit as well as other implicit obligations such as issued guarantees, arrears, and pensioners' debt. Under such circumstances the Government should be cautious with expenditures in order to be prepared for unexpected developments. However, one should not forget that the May 2009 local elections might result in some unnecessary expenditures.

GDP expected to decline by 1.4 percent in 2009.

Our projections are now much more pessimistic than three months ago due to the recent unfavorable developments in the real sector and the expected effects of worsening global economic conditions. In general, we expect the negative trends that emerged in the second half of 2008 to be taken over into 2009, with a modest recovery emerging in mid-2009. The next year should bring a further strengthening of overall activity. Despite the fact that a substantially lower inflation and a moderate wage increase should have positive effects on households' income this year, negative impulses will come from a much grimmer situation on the labor market, tighter credit conditions, negative wealth effects from equity market losses and, in general, increased uncertainty that dampens consumer confidence. Although we expect personal consumption to start recovering in 2009, our projection indicates that its volume will remain 0.4 percent below the 2008 level, while 2010 should bring stronger rebound and a 2.4 percent rise. Government consumption has not so far been strongly affected by the slowdown of activity and we expect that the positive trend will persist, with a 1.1 percent increase this and 2.3 percent next year. Stringent financial conditions combined with deterioration in business confidence substantially slowed down investments in the second half of 2008. Recovery is expected in the second half of 2009, but it can hardly be strong enough to prevent an annual decline in investment activity that is estimated at 5.5 percent in 2009. For 2010, we expect investments to increase by 4.0 percent.

Current account deficit to shrink to 7.7 percent of GDP.

Uncertainties related to future developments are to be especially pronounced in the foreign trade sector. We expect a mild contraction in the volume of total exports this year, primarily due to projected non-decreasing revenues from international tourism. Although the global demand for tourist services declines in times of global recession, the fact that Croatia is relatively close to its major emitive markets might keep tourist demand at last year's level. However, goods exports will decline notably. Total exports are projected to contract by 1.0 percent in 2009, before recovering to 2.6 percent in 2010. At the same time, a weak domestic demand will cause imports to decline by 3.0 percent in 2009, while the overall recovery in 2010 should bring a 3.4 percent imports rise. In line with the abovementioned developments, the current account deficit should shrink from the estimated 10.7 percent in 2008 to 7.7 percent in 2009, before widening mildly to 8.0 percent of GDP in 2010.

Employment prospects deteriorate...

Output decline will eventually be passed to employment, which is projected to fall in the course of 2009, the first time since 2000. In 2010, we expect a slow employment recovery. The registered unemployment rate is forecasted to increase from 13.4 percent in 2008 to 13.6 percent in 2009 and 13.7 percent in 2010. The Sunday closing of shops introduced by the Law on Distributive Trade at the beginning of 2009 might have an additional adverse effect on consumption and employment in the trade sector. Regardless of *pro* and *contra* arguments on the Sunday shopping, this seems an exceptionally inappropriate moment for introducing any kind of restrictions on consumer spending.

... while wage policy is still unclear.

The Government has sent mixed signals on the wage policy during the last couple of months. On the one hand, it has stressed the need to limit wage growth in order to protect jobs. On the other hand, it did not succeed to curb a 6 percent wage increase for the public sector employees in 2009. This fall will bring a new bargaining over collective agreement for the public sector employees. Furthermore, the Minimum Wage Act implies a substantial increase in the minimum wage level starting from June. As for now, trade unions and the Government have not expressed their view on these two important issues. Social partners are expected to give preference to "having a job" over "having a good-paid job". In that case, there will be a substantial moderation in the average wage increase in 2009 and 2010.

Inflation on the way down.

In 2009, consumer price inflation is projected to average 2.3 percent, which is a substantial decline from 6.1 percent in 2008. However, inflationary pressures are still present. Core inflation has remained relatively high, meaning that some underlying pressures are still on board. An excessive wage rise is a possible risk factor. Other factors are related to the alignment with the EU legislation, for example in the area of tax policy, which might result in price increases. In addition, price increases of goods - especially energy products - that were suppressed by the Government's pressures will take place sooner or later. Therefore, we expect a moderate speed up of inflation to 3.3 percent in 2010.

Restrictive monetary policy to continue.

Since unfavorable real sector developments are expected to dampen money demand, lending activity, and savings, we project a subdued broad money growth of 5.0 percent in 2009. Credit demand will also subside, while banks will be forced to reduce lending activity due to increased liquidity constraints. This, in turn, means that credit growth will approach 9.0 percent in 2009. As economic conditions will rebound during 2010, we expect that broad money growth could record a 9.0 percent increase, while credit growth is estimated to accelerate to 12 percent in 2010.

Table 2 SUMMARY OF PROJECTIONS

	2008	2009	2010
Real GDP (% change)	**2.1**	**-1.4**	**2.3**
Real private consumption (% change)	1.4	-0.4	2.4
Real government consumption (% change)	1.4	1.1	2.3
Real investment (% change)	8.2	-5.5	4.0
Exports of goods and services (constant prices, % change)	2.6	-1.0	2.6
Imports of goods and services (constant prices, % change)	5.3	-3.0	3.4
Current account balance (% of GDP)	-10.7	-7.7	-8.0
Consumer prices (% change, pa)	6.1	2.3	3.3
Exchange rate, HRK/EUR (pa)	7.22	7.35	7.30
Unemployment rate (registered, %, pa)	13.4	13.6	13.7
General government balance (ESA 95 definition, % of GDP)	-1.3	-1.2	-1.3
Broad money, M4 (% change, eop)	4.0	5.0	9.0
Total domestic credit (% change, eop)	12.0	9.0	12.0

Notes: *Cut-off date for information used in the compilation of projections was January 9, 2009.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Meeting the deficit target – harder than ever.

As unfavorable global economic trends have spread over the Croatian economy, it is already obvious that it will be hard to keep the budget deficit within the planned limits. The Government has based its 2009 revenue projection on the assumption that prices will rise by 3.5 percent and GDP by 2 percent, implying a nominal GDP growth of 5.6 percent. From our perspective, these assumptions are quite optimistic, and we find a higher than 5 percent rise in revenues almost impossible. The bases of most taxes will deteriorate, and this will be even more pronounced in the case of VAT. It is also questionable whether the collection of revenues from co-payments and complementary health insurance intended to cover part of the health reform costs will be as effective as planned. In any case, a budget revision could be expected sooner than in previous years, and it might require not only the redistribution of resources, but also further expenditure cuts if the deficit target, 0.9 percent of GDP in the case of state budget, is to be preserved.

3 Uncertainties and Risks to Projections

Outlook remains exceptionally uncertain.

The economic situation and outlook remain exceptionally uncertain. Downside risks to projections relate to the possibility that the turmoil in financial markets might have a more pronounced impact on the real economy and the confidence of consumers and investors than now expected. In addition, the risk of disorderly developments resulting from high external vulnerability should not be underestimated. On the positive side, confidence might be restored sooner than assumed, while the easing of inflationary pressures could underpin consumption and cause a less pronounced contraction than now envisioned.

Crucial challenges - debt refinancing and exchange rate stability.

Strong efforts will be needed this year in servicing and refinancing the foreign debt. Tight financial conditions will be a major obstacle in refinancing obligations and will dampen capital inflows, thus posing additional problems for the central bank in preserving the exchange rate stability. In addition, instead of focusing on local elections, a responsible fiscal policy requires restraining from the growth of most expenditure items, and leaving more room in the budget for supporting the vital parts of the private sector.

Is global recovery in 2010 viable?

The negative effects of the global financial crisis are still in motion, although central banks worldwide have undertaken measures to eliminate the massive credit crunch and stimulate the economy. Though it appears that money market conditions have somewhat eased, central banks' interest rate cuts do not seem to be helping ailing economies due to commercial banks' liquidity hoarding. If confidence on financial markets is not restored in the course of 2009, it is possible that a downturn in global economic activity might last longer than previous downturns, making a recovery in 2010 less viable.

The Russia-Ukraine gas conflict.

Further gloom to the overall economic situation was unexpectedly added in January 2009, as natural gas supplies from Russia to the rest of Europe were cut off. Although gas supplies have been restored in the meantime, there is uncertainty on the adverse effects of this crisis on the Croatian real sector and, in particular, on the manufacturing sector that was exposed to the stringiest gas supply restrictions.

Border dispute with Slovenia slows down the EU accession process.

Although the Croatian Government claims it will continue to adapt its legislation and undertake structural reforms to prepare the economy for the EU membership, the border dispute due to which Slovenia has blocked the opening of new negotiating chapters in December might substantially prolong the accession process. In that case, the expected positive economic effects of accession will be postponed accordingly.

IMPRESSUM

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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

 Printed on recycled paper

9 771332 306009

ISSN 1332-3067