eiz The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

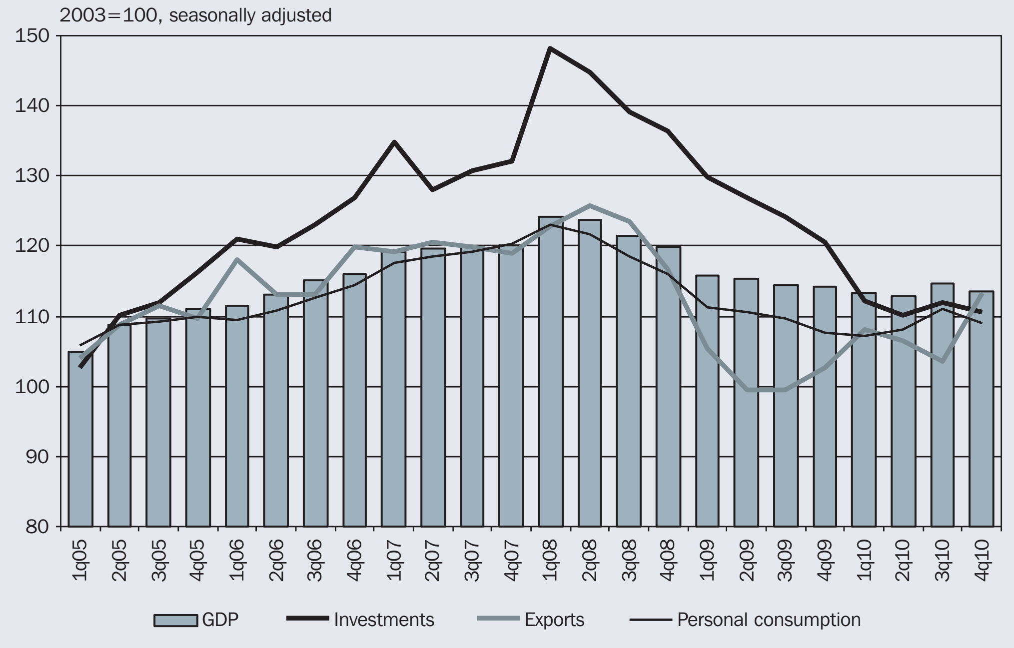
Poor performance of the economy...

The Croatian economy experienced a slide in the fourth quarter of 2010 which canceled out the initial signs of recovery observed in the third quarter. Seasonally adjusted GDP dropped around 1 percent compared to the previous quarter while unadjusted GDP stood 0.6 percent below its level a year before. Let us recall that the economy was surprisingly vigorous in the third quarter of 2010 and expanded by more than 1 percent compared to the previous quarter in seasonally adjusted terms. At that point, there were some speculations about the end of recession. As we suspected three months ago, negative tendencies in large parts of the economy were still too strong at the time and they materialized in the fourth quarter. On average, the activity in the second half of 2010 was flat and that is why we perceived the economic recession to be bottoming out. A clear-cut answer on the turning point date can only be given with a certain delay.

... in 2010...

In 2010 as a whole, GDP declined 1.2 percent while the revised figures for 2009 reveal a decrease of 6.0 percent (instead of 5.8 percent, according to the preliminary estimate), indicating that the bite of recession was severe. In 2010, domestic demand dropped 3.7 percent, pulling the overall activity down while trade flows contributed positively with an exports expansion of 6.0 percent and an imports decline of 1.3 percent. Investments saw another poor year with a decline of 11.3 percent.

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

… extends into the early 2011.

Indicators for the beginning of this year are also rather disappointing – the construction and industrial output trend are downward-sloped while the retail sales volume stagnates. Exports are still growing, albeit at a slower pace. Consumer confidence and consumer expectation indices, according to CNB's surveys, declined notably in February and March. Despite a mild credit expansion and a deceleration of the rise in unemployment claims, the overall economic activity seems sluggish in the first quarter of this year.

Weak personal consumption.

Following two quarters of expansion, seasonally adjusted personal consumption declined almost 2 percent in the fourth quarter of 2010, confirming uncertain economic conditions and poor consumer confidence. Nonetheless, personal consumption stood 1.2 percent higher than in the fourth quarter of 2009, mostly thanks to its rise in mid-2010. Increasing unemployment and uncertainty about the future state of the economy, coupled with rising pre-election political tensions, had a negative impact on consumer behavior. So far, consumption has failed to benefit from a somewhat lower income tax burden, as a result of a mini tax reform in the summer last year which also included the abolishment of the so-called "crisis tax". On average, a 0.9-percent decline in personal consumption in 2010 is relatively small compared to 2009, when consumption dropped at a rate of 8.5 percent.

Upturn in government consumption.

In the course of last year, seasonally adjusted government consumption fluctuated around the level recorded in the last quarter of 2009. However, it expanded slightly in the fourth quarter of 2010 by rising 0.4 percent over the previous quarter and 0.6 percent over the same year-ago quarter. Thus, in spite of certain savings that helped to keep the 2010 consumption 0.6 percent below its 2009 level, the year-end brought an upturn, raising the question of the Government's ability to curb further increases envisaged by the budget plan.

Investment revival on the horizon.

Although construction activity has exhibited a negative trend ever since the beginning of 2009, the overall investment dynamics seem to have been somewhat different. Comprehensive national accounts data indicate that a decline in seasonally adjusted investments came to a halt in mid-2010. Moreover, an upturn was recorded in the third quarter, followed by a fourth-quarter stagnation. Overall, developments in the second half of 2010 were encouraging. Seasonally adjusted investments were slightly higher than in the first half of the year but still stood 8.8 percent below the level seen in the second half of 2009.

Vigorous exports, weak imports and a record-low current account deficit.

Last year's fourth quarter saw vigorous exports and relatively weak imports. A year-on-year comparison indicates that the volume of goods and services exports increased 10.8 percent while the imports volume increased 1.1 percent. It appears that weak domestic demand forced local companies to turn to more vigorous export markets, supported by rising demand in EU economies. Current account statistics suggests that the exports expansion concentrated on goods sectors, with the exports of services remaining sluggish. In current euro terms, goods exports grew 18.1 percent and the exports of services 0.5 percent. Revenues from international tourism came in 2.2 percent below the 2009 level, casting a shadow on the overall performance of the tourism industry in 2010. In such a situation receding imports helped narrow the current account deficit, which amounted to record-low EUR 650 million or 1.4 percent of GDP. At the same time, net FDI was 1.3 percent of GDP. In spite of the balance between the current account deficit and net FDIs, foreign debt increased a further 2.6 percent to reach EUR 45.8 billion or 99.7 percent of GDP by the end of 2010.

Sluggish real sector activity continues into 2011.

Industrial production has trended downwards since the second quarter last year with a short pause during the summer months. In the first two months of 2011, the industrial output volume was 0.9 percent lower than in the last quarter of 2010 while a cumulative year-on-year decline in January and February amounted to as much as 4.0 percent. Meanwhile, a negative retail sales trend was brought to a halt at the turn of the year and a year-on-year

Table 1 MAIN ECONOMIC INDICATORS

	2009	2010	2010			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-6.0	-1.2	-2.3	-2.3	0.3	-0.6
Real private consumption (% change, yoy)	-8.5	-0.9	-4.0	-2.5	1.9	1.2
Real government consumption (% change, yoy)	0.2	-0.8	-1.1	-1.8	-0.9	0.6
Real investment (% change, yoy)	-11.8	-11.3	-13.9	-13.4	-9.5	-8.0
Industrial output (% change, yoy)	-9.3	-1.4	-0.5	-3.3	0.1	-1.7
Unemployment rate (registered, %, pa)	14.9	17.4	18.1	17.1	16.4	18.1
Nominal GDP (EUR million)	45,669	45,917	-	-	-	-
GDP per capita (EUR)	10,311	10,367	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.3	1.0	0.8	0.9	1.1	1.2
Consumer prices (% change, yoy, pa)	2.4	1.1	0.9	0.7	1.1	1.5
Producer prices (% change, yoy, pa)	-0.4	4.3	3.6	4.8	3.8	5.1
Average gross wage (% change, yoy, pa)	2.2	-0.4	-0.9	-1.0	-0.2	0.5
Exchange rate, HRK/EUR (pa)	7.34	7.29	7.29	7.25	7.25	7.36
Exchange rate, HRK/US$ (pa)	5.28	5.50	5.26	5.69	5.62	5.42
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,703	9,100	2,033	2,325	2,243	2,498
Exports of goods (EUR, % change, yoy)	-21.5	18.1	5.4	22.3	18.8	25.9
Imports of goods (EUR million)	15,090	15,045	3,317	3,822	3,960	3,946
Imports of goods (EUR, % change, yoy)	-26.8	-0.3	-9.4	-2.3	6.3	4.1
Current account balance (EUR million)	-2,506	-654	-1,362	-126	1,889	-1,005
Current account balance (% of GDP)	-5.5	-1.4	-	-	-	-
Gross foreign direct investment (EUR million)	2,096	440	591	65	391	-608
Foreign exchange reserves (EUR million, eop)	10,376	10,660	10,008	10,305	11,154	10,660
Foreign debt (EUR million, eop)	44,606	45,768	44,651	45,067	44,857	45,768
GOVERNMENT FINANCE*						
Revenue (HRK million)**	128,087	123,709	29,262	59,755	91,905	123,709
Expense (HRK million)**	132,450	133,486	33,281	65,079	97,884	133,486
Net = Gross operating balance (HRK million)**	-4,363	-9,777	-4,019	-5,325	-5,979	-9,777
Net acquisition of non-financial assets (HRK million)**	6,357	4,848	1,117	1,962	3,078	4,848
Net lending/borrowing (HRK million)**	-10,720	-14,625	-5,135	-7,287	-9,058	-14,625
Domestic government debt (EUR million, eop)	10,995	12,469	11,627	12,050	12,541	12,469
Foreign government debt (EUR million, eop)	5,134	5,913	4,940	5,026	5,821	5,913
Total government debt (% of GDP)	35.5	40.6	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-14.6	4.2	2.3	4.2	13.6	4.2
Broad money, M4 (% change, yoy, eop)	-0.9	4.4	1.6	2.8	3.8	4.4
Total domestic credit (% change, yoy, eop)	-0.6	6.8	-0.4	3.2	5.3	6.8
DMBs credit to households (% change, yoy, eop)	-2.9	3.8	-3.2	0.3	1.7	3.8
DMBs credit to enterprises (% change, yoy, eop)	2.0	9.5	2.8	6.9	8.8	9.5
Money market interest rate (%, pa)	7.2	0.9	0.6	0.9	1.2	0.9
DMBs credit rate for enterprises, short-term, (%, pa)	10.0	7.4	8.0	7.5	7.2	6.9
DMBs credit rate for households, short-term (%, pa)	12.6	12.7	12.7	12.6	12.7	12.6

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.*

cumulative increase for the first two months this year amounted to 0.5 percent. A negative trend in the construction activity improved slightly in the second half of 2010, with the January 2011 output being 8.3 percent lower than in the same month a year earlier.

Negative labor market trends...

Last year saw a continuation of negative labor market developments. In December 2010, total employed persons numbered 55 thousand or 3.7 percent less than in the same period a year before. The decline was most pronounced in the activities such as construction (which dropped 13 percent), mining and quarrying (-18.6 percent), manufacturing (-3.2 percent) and trade (-5.1 percent), with an additional shrinkage by 18 thousand or 7.8 percent in the unincorporated sectors such as crafts, trades and freelance professions. At the same time, the registered number of unemployed persons was 10 percent higher than at the end of 2009, standing at 320 thousand in December 2010 with the unemployment rate reaching 18.6 percent. The Labor Force Survey (LFS) data based on ILO internationally comparable methodology show the unemployment rate at 12.1 percent in the fourth quarter of 2010, or 2.9 percentage points higher than in the fourth quarter of 2009.

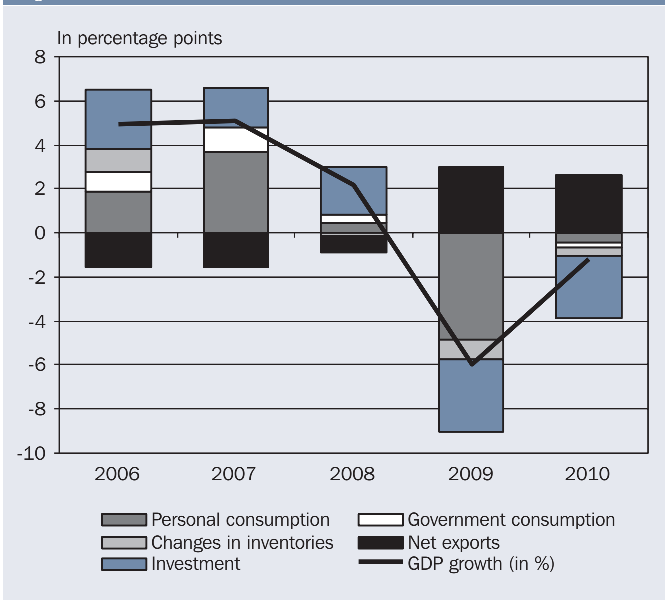
... are replaced by mixed signals.

The latest available data on labor market developments in 2011 imply mixed signals. The seasonally adjusted jobless figure declined in February and March. Such a positive signal is, however, not supported by other indicators. Seasonally adjusted employment has continued to decline. A year-on-year comparison indicates that total employment declined 3.5 percent in February 2011. Lower figures for registered unemployed persons are hard to explain, especially in the situation of sluggish economic activity, but they might be related to the nature of administrative records at the Employment Service. Not only was there a somewhat higher outflow into employment than in the previous months, but also a higher engagement in the education programs introduced through active labor market policies and tighter controls concerning the conditions that an unemployed person has to fulfill. This last factor has prompted a stronger exit of the unemployed from the register but does not necessarily mean that the situation on the labor market has improved.

Persistent nominal wage rigidity.

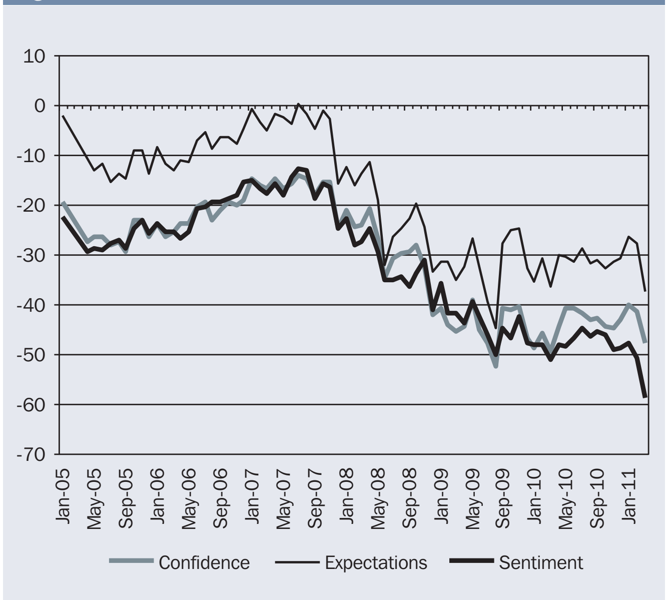
The average nominal gross wage fell 0.4 percent in 2010 as a whole while rising 0.5 percent in the last quarter and 0.3 percent in January year-on-year, indicating persistent nominal wage rigidity in Croatia. However, some sectors showed greater flexibility as the employees in construction, professional, scientific and technical activities as well as in arts, entertainment and recreation experienced a sharper drop in their gross wages last

Figure 2 DEMAND CONTRIBUTIONS TO GDP GROWTH



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

Figure 3 CONSUMER CONFIDENCE INDICES



Note: *A higher index points to an increase in expectations.*
Source: *Croatian National Bank.*

year. On the other hand, activities such as information and communications or finance and insurance showed a significant increase in gross wages. In 2010, the gross wage shrank 1.4 percent and the net wage 0.5 percent in real terms, with the difference due to changes in the income taxation introduced at the beginning of July that have brought the tax burden on wages down slightly. Our estimates suggest that the overall disposable income decreased at a rate of approximately 2.5 percent in 2010 in nominal terms, or 3.5 percent in real terms mostly due to lower employment. Simultaneously, government transfers to households increased, particularly the net pension bill that grew 2 percent.

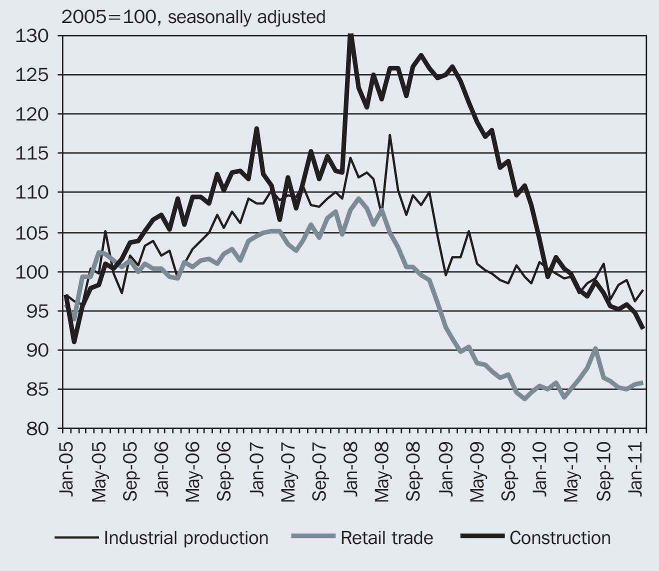
Upward trend in monetary aggregates continues.

While broad money stagnated in the last two months of 2010, the beginning of 2011 brought about a modest revival. According to the seasonally adjusted data, broad money grew 0.5 percent in January and 0.4 percent in February on a month-on-month basis. At the same time, broad money was 3.7 percent larger in February 2011 than in the same month a year before. The increase stemmed from the growth of savings and time deposits that amounted to 4.5 percent year-on-year. The process of replacing local with foreign currency savings and time deposits has continued although at a much slower pace than before. Namely, at the beginning of 2011, foreign currency deposits recorded their lowest year-on-year growth rates in the last four years while kuna savings and time deposits exhibited more moderate negative rates. Households increased their savings 7.7 percent in February year-on-year, contributing most to the broad money increase. Enterprise savings picked up as well by rising 2.4 percent, their highest growth rate in more than two years. After a significant decrease in the last quarter of 2010, narrow money also began to rise early in 2011. February data indicate that narrow money grew 1.5 percent year-on-year.

Modest credit activity.

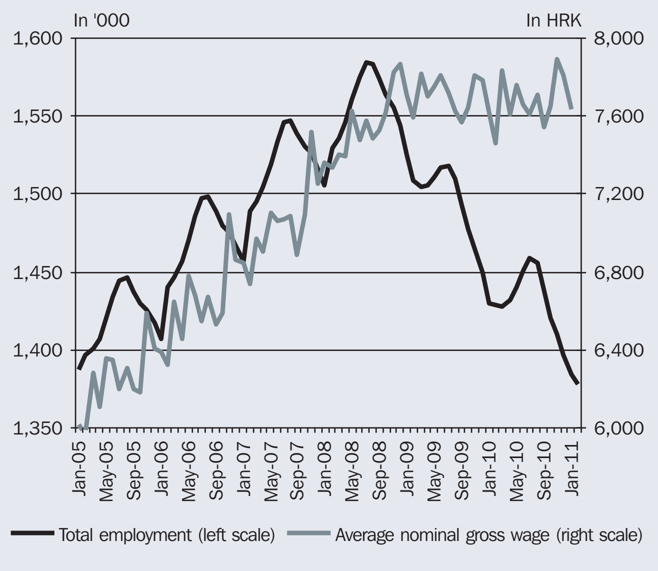
Although data on credit activity suggest that recovery is underway, a significant portion of the current credit increase results from the appreciation of the Swiss franc. That is, its 16.5-percent year-on-year appreciation against the kuna means that total domestic credits grew at a rate of approximately 4.4 percent in February year-on-year instead of 6.4 percent, as recorded by official statistics. When the Swiss franc appreciation is accounted for, credits to households actually fell 0.2 percent year-on-year in February. At the same time, enterprises were not affected greatly by foreign exchange dynamics and managed to increase their borrowings by 9.3 percent year-on-year. Nevertheless, the credit supply is still much larger than the enterprise demand, at least at current interest rates. In order to tackle this problem, the Ministry of Finance introduced an improved HBOR (Croatian Bank for

Figure 4 REAL SECTOR DEVELOPMENTS



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

Figure 5 EMPLOYMENT AND AVERAGE GROSS WAGE



Source: *Croatian Bureau of Statistics.*

Box 1 SOUTH-EAST EUROPE: A WEAK RECOVERY

The export growth was the main driving force behind the output recovery in South-East Europe (SEE) in 2010. In Bosnia and Herzegovina, Bulgaria, Macedonia and Serbia it was strong enough to pull the economies out of recession while in Croatia and Romania it remained too weak to outweigh the decline in domestic demand. Consequently, these two countries are still struggling with recession. Domestic demand led the recovery in Albania, the only country in the region that did not experience a GDP decline in 2009 although growth decelerated substantially. According to the *Eastern Europe Consensus Forecasts* (April, 2011), GDP growth in the SEE region is projected to reach 2.0 percent in 2011 before picking up to 3.5 percent in 2012. Such growth would still be depressed, at least as compared to the forecasts for other Eastern European regions, CIS (Commonwealth of Independent States) and CE (Central Europe), or world-leading emerging economies of Asia Pacific and Latin America.

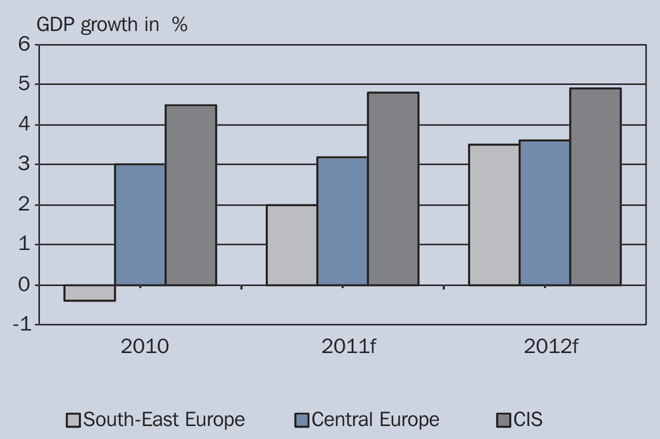
Persistently weak domestic demand has been the main reason for the slow or, in the case of Croatia and Romania, absent growth in 2010. In the pre-crisis period, all these economies experienced rather strong growth based on booming personal consumption and investment, accompanied by heavy external borrowing and high current account deficits. In the years to come, export-led growth can only be sustained if there is modernization in the export sectors which implies attracting FDIs and undertaking structural reforms that would be beneficial for the business environment.

Exchange rates are stable in almost all countries of the region, except in Serbia, where the Serbian dinar is exhibiting greater volatility. Unemployment has stabilized at high levels or even started to decline. Interest rates are falling, loan criteria are being eased and the percentage of non-performing loans is shrinking. Nevertheless, as a result of the crisis, weakened economic capacities are limiting the ability of these economies to mitigate negative effects of recently increased import prices. Primarily due to developments on world energy and commodity markets, domestic inflation is accelerating all over the region and is expected to be around one percentage point higher in 2011. Due to the already high unemployment and low incomes, rising food prices will have an especially severe impact on the citizens of Bosnia and Herzegovina and Macedonia.

Although Croatia and Romania are still struggling with the recession, they are expected to achieve positive GDP growth in 2011. Serbia is facing the highest inflation in the region, with a double-digit rate recorded in early 2011. Macedonia has encountered serious problems, such as high poverty and unemployment rate, and it also lacks stronger FDIs. In Bosnia and Herzegovina political disputes over the formation of the new Government are spilling over to the economic sphere while the lack of credible statistics on the state level prevents the adoption of evidence-based policies. Bulgaria is experiencing a steady recovery, mainly driven by exports. Its domestic consumption and investments are expected to strengthen in the near future. Albania has continued to experience high growth without major risks for future development.

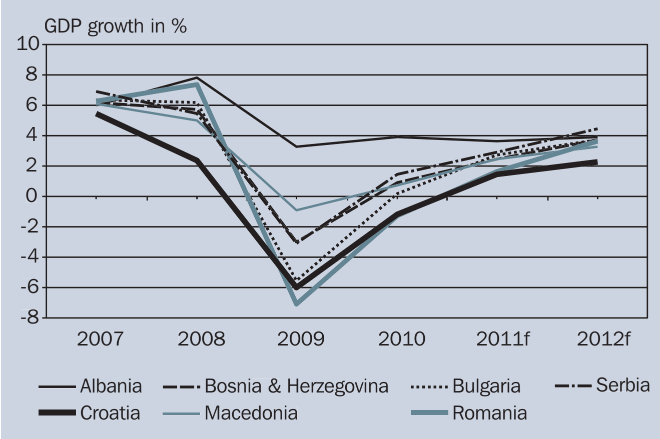
In conclusion, it might be asserted that the global economic crisis has had strong negative effects on SEE countries. Three years after the cyclical peak, these economies will not yet operate close to their capacities in the pre-crisis period.

Figure B1 EMERGING ECONOMIES



Note: f - forecast; South-East Europe: Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia; Central Europe: Czech Republic, Hungary, Poland, Slovakia, Slovenia; CIS: Russia, Ukraine, Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Moldova, Turkmenistan, Uzbekistan.
Source: *Eastern Europe Consensus Forecasts (April 2011 Survey, www.consensuseconomics.com).*

Figure B2 SOUTH-EAST EUROPE



Note: *f - forecast.*
Source: *Eastern Europe Consensus Forecasts (April 2011 Survey, www.consensuseconomics.com).*

Reconstruction and Development) subsidized corporate credit program named “A+”. The new program refers to a faster loan approval and more favorable lending terms, with a one percentage point reduction in respective interest rates. Since November last year, the government demand for domestic credit has been rising steadily, with the latest growth rate for February coming in at 17.5 percent year-on-year. In order to service its matured debt, the Government borrowed by issuing short-term treasury bills and also through short-term bank loans until it issued US$ 1.5 billion worth of international bonds in March. Subsequently, short-term domestic borrowing continued at a much slower pace.

Monetary policy easing.

Depreciation pressures present since late summer continued into the early 2011. Pressures were mainly driven by an increased risk of heavier government domestic borrowing. However, a successful government bond issue on the international market kept domestic liquidity intact and prevented a further HRK/EUR deterioration, along with speculative bank positioning in mid-March. A massive liquidity injection resulted from the central bank’s decision to free up EUR 850 million in foreign currency by cutting the foreign asset/liability ratio by 3 percentage points to 17 percent. Although the CNB stressed that the resources are to be productively invested into the private sector, namely the manufacturing industry and tourism, no specific projects have been set forth. Nevertheless, bearing in mind the sovereign debt refinancing projections for this year, this monetary easing has come as a source of future lending to private entities.

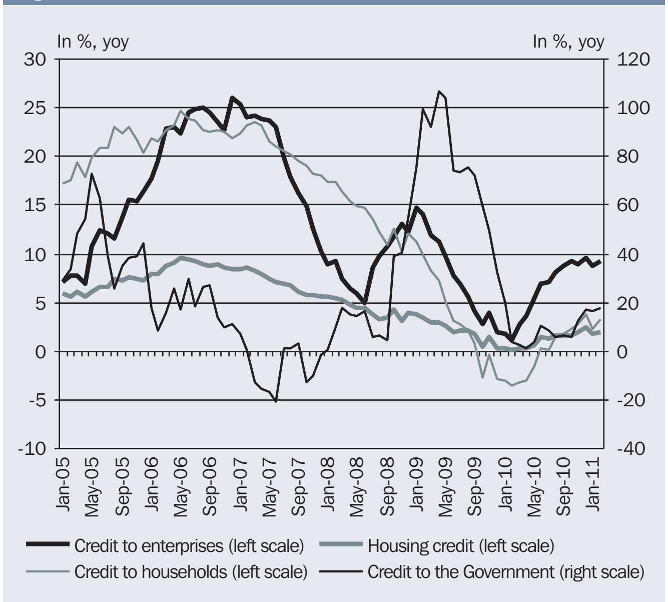
Further reduction of overnight money market rate.

The interbank money market is still swamped with liquidity, amounting to almost HRK 8 billion that is deposited overnight with the central bank. Therefore, the official reduction in the overnight deposit rate to 0.25 percent came as no surprise and it has not changed the investment behavior. Consequently, in early 2011, overnight money market rates fell below the lowest year-average recorded in the previous year to stand at 0.66 percent in February.

Inflation under close watch.

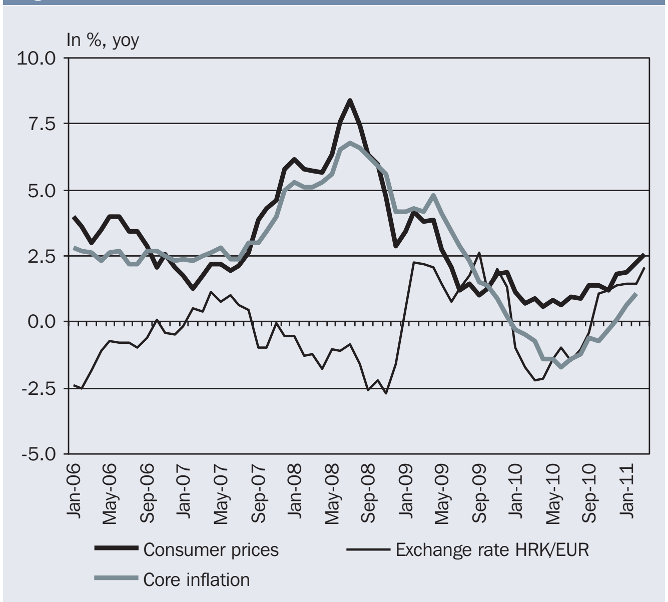
Consumer price inflation surged to 2.6 percent year-on-year in March mostly due to an increase in world commodity prices. Namely, food and beverage prices as well as housing and transport prices contributed to consumer price inflation with 1.3, 0.4 and 0.7 percentage points. In other words, these three categories account for more than 90 percent of the overall price increase. To a certain extent, weak domestic demand has curbed the effect of import prices on inflation. However, the producer price index surged to 7.1 year-on-year in March on a global wave of commodity price increases. After registering negative

Figure 6 CREDIT DEVELOPMENTS



Source: Croatian National Bank.

Figure 7 INFLATION AND EXCHANGE RATE



Note: A decrease in exchange rate index denotes an appreciation.
Sources: Croatian Bureau of Statistics and Croatian National Bank.

year-on-year changes for eleven months in a row, core consumer prices started to firm in December. The latest observation, amounting to 1.1 percent in February 2011, is the highest rate recorded over the last year and a half.

Revenues fall due to sluggish economic activity.

The fourth quarter of 2010 saw a 6.4-percent drop in total general government revenues compared to the same quarter of 2009. In 2010 as a whole, as a result of sluggish economic activity and correspondingly low revenues from profit tax, personal income tax and social security contributions, the general government collected 3.4 percent less in revenues than in 2009. The profit tax revenue fell by a third as a result of poor profitability in 2009, and rising unemployment along with the lower average gross wage prompted a shortfall in revenues from personal income tax and social security contributions. An 11-percent decrease in revenues from personal income tax can also be attributed to the gradual abolition of the "crisis tax" on personal income in 2010. The pre-crisis VAT revenue flow did not recover by the end of 2010 in spite of a 1-percentage point increase in the general VAT rate, and its 1.7-percent year-on-year growth could not compensate for the drop in revenues from personal income and profit taxes. Revenues from excise taxes rose 8.9 percent, although their rise was not linear throughout the year.

Business-as-usual spending.

Total general government expenditures were 6.1 percent higher in the fourth quarter of 2010 than in the same quarter of 2009. Cumulatively, the general government spent 0.8 percent more in 2010 than a year before. The increase stemmed mainly from the outlays for social security, interest payments on the outstanding debt as well as for consumption of goods and services. Subsidies as well as expenditures for the compensation of public-sector employees shrank.

2010 deficit larger than a year before, yet lower than planned.

The revenue drop and the rise in expenditures gave rise to a 9.8-billion general government operating deficit, about 80 percent larger than in 2009 but 5.3 percent lower than planned. The 2010 net borrowing totalled HRK 14.7 billion (4.4 percent of GDP), accounting for the HRK 4.8 billion net acquisition of non-financial assets (mainly long-term ones).

New debt issuance and a step forward in debt management.

Concerning financing of the 2011 deficit, the first step has already been taken: a US$ 1.5 billion 10-year bond was issued in mid-March on the U.S. market. It seems that the price of borrowing has not risen as a result of Croatia's sovereign credit rating downgrade in December 2010: the interest rate on the newly issued bond was 6.375 percent which, although high, is still not higher than the rates payable on previous issues. One should appreciate a newly introduced improvement in the Croatian public debt management practice: the new US$ debt issue has been hedged against the US$ exchange rate risk through conversion into the euro. However, another concurrent transaction cast a shadow on the improvement in debt management. An outstanding 10-year bond (EUR 800.6 million) was repaid with the help of short-term bank loans. In addition to the risk of refinancing associated with short-term debt, it is at best puzzling that the Government decided to raise relatively costly short-term bank loans (at interest rates of 3.9-4.872 percent) while it could, in principle, sell treasury bills of the same maturity to these very bank lenders at a lower interest rate (2.85-3 percent).

2 Policy Assumptions and Projections Summary

Global growth moderates but outlook remains favorable.

Developed market economies recovered from the recession during 2010, with rather strong growth in the first half of the year. However, their recovery has slowed down since, as global trade has decelerated while fiscal stimuli has been replaced by austerity-based fiscal consolidation. The recovery was primarily based on a trade and industrial output rebound, although their levels remain below previous cyclical peaks. At the same time, many emerging economies, especially in Asia and Latin America, are beginning to face overheating pressures. The fourth quarter of 2010 repeated the euro area economic slowdown of the third quarter with a GDP increase of 0.3 percent. In Germany GDP growth slowed to 0.4 percent and in Italy to 0.1 percent. However, business confidence indices maintained their upward trend, indicating that recovery will be sustained. ECB macroeconomic projections (*Monthly Bulletin*, March 2011) for the euro area foresee GDP growth in the range between 1.3 and 2.1 percent in 2011, and between 0.8 and 2.8 percent in 2012.

Oil prices rise further.

In general, it is expected that oil prices will remain high as the global oil market has entered a period of increased scarcity. However, additional shocks are pushing prices even further up. Recently, unrest in North Africa and the Middle East has contributed to another surge in global energy prices. The price of Brent crude oil soared to US$ 125 per barrel in mid-April after trading around US$ 95 per barrel in late January. Food prices have reached new record highs, fuelling inflation worldwide. Although the FAO food price index slightly eased in March 2011, it was still 37 percent above its level in March last year.

Closure of the EU accession negotiations.

In such an international environment, domestic policy is focused on the final phase of negotiations on the EU membership. At the end of March, 7 out of 35 chapters of the accession negotiations with the EU were still open. The European Commission's March report emphasized that issues still need to be resolved or improved in the fields of judiciary and fundamental rights as well as in the field of competition policy. As the dilemma whether the negotiations could be closed by the end of June heats up the political debate and, in particular, the issue of who is to be blamed if that self-imposed deadline is not met, it can safely be assumed that the negotiations will be concluded in the current year. This should in turn strengthen the interest of foreign investors in doing business in Croatia while also boosting domestic investments.

Internal policy assumptions.

As for the domestic policy assumptions, it may be asserted that whichever political option wins the parliamentary elections to be held by the end of 2011, a more active economic policy – including undertaking delayed structural reforms – should be expected at the beginning of the new Government's mandate. That cannot be expected in the current year, which will probably see a status quo policy leading towards elections and a slightly more relaxed fiscal policy in the second half of the year. However, 2012 should bring about stronger fiscal consolidation and reform in the public sector, including primarily state-owned enterprises. As far as the monetary policy is concerned, the Croatian National Bank will most likely remain focused on the price and exchange rate stability. Some additional measures aimed at supporting the economic activity might be undertaken but one should keep in mind that, due to already high liquidity levels, the impact of such actions on real sector activity might be highly limited.

GDP growth estimate for 2011 remains at 1.3 percent.

Although high-frequency indicators suggest sluggish activity in early 2011, we still expect recovery to take place in the remaining part of the year on the back of a continued rise in exports despite sluggish recovery of personal consumption and investments. Over the past year, one could have observed a certain volatility in the economic activity – both ups and downs have been present in GDP dynamics as well as in industrial production, retail trade volume and personal consumption. We expect that a more stable, albeit still weak upward trend will be established this year. As a result, GDP is projected to rise at a rate of 1.3 percent in 2011 and then to strengthen to 2.4 percent next year as the country approaches full EU member status.

Personal consumption revival relies on consumer confidence.

Personal consumption is expected to rise 0.7 percent in 2011 and 1.7 percent in 2012. However, personal consumption dynamics will remain a hostage of high unemployment. Easing of the tax burden, following the abolishment of the "crisis tax" and lower income tax rates should help revive personal consumption. Nevertheless, the main determinant is consumer confidence, which should improve in the course of the year unless some unexpected news affects it negatively. Government consumption is anticipated to slightly rise in 2011, partly as a result of inertia but also due to the upcoming elections. Stronger fiscal consolidation is only expected early on in the mandate of the new Government. Due to the carryover of some obligations from this year we do not expect a decrease in the government consumption in 2012 compared to the current year. Investments should strengthen in the next few years, with 2011 marking the beginning of that process as a part of the preparations for the EU but also as a result of underinvestment during the crisis. The high liquidity of the financial system allows for such expectations. In 2012, investment growth might exceed 5 percent with the potential for a further rise.

Exports expected to continue rising.

Exports are expected to continue rising in 2011 and 2012 at a somewhat slower pace than in 2010 due to the expected restructuring of the exports sector, primarily the shipbuilding industry. The tourism sector should contribute significantly to the total exports growth although experience has taught us that a solid outturn of the tourist season measured by physical indicators is not always mirrored by strong financial results. Both 2011 and 2012 revenues from foreign tourism are expected to rise 4 percent. As a result, we anticipate a neutral contribution of net exports to the overall GDP growth. That also implies that the GDP growth will be led by domestic demand, which is still weak and unstable, implying a similar overall growth pace. This points to the internal weakness of the economy as the exports sector is not expected to take the lead among growth drivers despite current global recovery.

Table 2 SUMMARY OF PROJECTIONS

	2011	2012
Real GDP (% change)	**1.3**	**2.4**
Real private consumption (% change)	0.7	1.7
Real government consumption (% change)	0.4	0.0
Real investment (% change)	1.9	5.3
Exports of goods and services (constant prices, % change)	3.4	4.6
Imports of goods and services (constant prices, % change)	2.7	3.9
Current account balance (% of GDP)	-1.7	-2.5
Consumer prices (% change, pa)	2.7	2.9
Exchange rate, HRK/EUR (pa)	7.36	7.36
Unemployment rate (registered, %, pa)	18.0	17.6
General government balance (ESA95 definition, % of GDP)	-4.8	-3.2
Broad money, M4 (% change, eop)	9.0	6.0
Total domestic credit (% change, eop)	5.5	7.0

Notes: *Cut-off date for information used in the compilation of projections was April 7, 2011.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Current account deficit to remain at 2-3 percent of GDP.

The crisis has prompted a marked narrowing of the current account deficit, primarily due to the strong drop in imports. As a result of weak economic recovery, slim possibilities of financing the deficit and already high level of foreign indebtness, we expect a relatively low deficit of around 2 percent of GDP in 2011 and around 3 percent in 2012. Foreign debt is expected to remain high due to the need for refinancing government debt obligations but it is not likely to exceed 100 percent of GDP.

Negative labor market trends to ease in 2011.

Recently observed easing of unemployment pressures does not mean that the labor market is recovering because the employment trend is still negative and we do not expect to see its revival in the course of this year. However, negative tendencies should be exhausted this year, paving the way for improvements in 2012. In 2011, total employment is thus expected to stay below its 2010 level and the registered unemployment rate may rise to around 18 percent on average, 0.6 percentage points up over last year. A temporary improvement, beyond usual seasonal oscillations, should come from the national population census being held in April 2011 that will provide temporary employment for about 15 thousand enumerators and 2000 controllers – previously unemployed persons registered at the Employment Service. An acceleration of the economy in 2012 could bolster demand for labor so the registered unemployment rate is expected to decline to 17.6 percent.

Inflation accelerates in spite of sluggish economy.

Soaring international food and energy prices pose major threats to domestic inflation. However, weak domestic demand will lessen these pressures somewhat during the current year. We expect inflation to spike above 3 percent by the end of this year, with the average rate of 2.7 percent for 2011 as a whole. Higher inflation at an average of 2.9 percent is expected to persist in 2012 as well due to continued pressures from the world markets, a recovery in domestic demand and delayed adjustments to the administratively controlled prices of utilities.

Modest decline in interest rates.

Further monetary easing, such as the one that occurred in March, will be conditional on the exchange rate stability and a materialization of excess liquidity in the form of investments in the tradable sector. In the next two quarters, expectations of a good tourist season and heavy foreign currency public sector borrowing are votes in favor of a firmer HRK/EUR exchange rate while current account and foreign debt imbalances drag the exchange rate in the opposite direction. Although ample interbank liquidity and record-low money market rates allow for lower lending rates, data show that the interest rates charged on loans to enterprises have retreated slightly. Taking into account the uncertainties surrounding the outcome of sovereign refinancing, we expect only a modest decline in lending rates.

Enterprise lending takes lead.

Due to deteriorating consumer sentiment we do not expect retail lending to speed up in 2011. Moreover, high public financing needs and corporate lending, encouraged by the HBOR incentives program, will take the lead in this year’s credit activity. That does not mean, however, that we project rates to be as high as those recorded in pre-crisis times. After 4.4 percent growth in 2010, we expect broad money to expand another 9 percent in 2011, with total domestic credit following at a rate of 5.5 percent. Next year we expect a revival in lending activity that will spread to the retail sector. Total liquid assets could increase 6 percent and total domestic credit 7 percent.

No significant fiscal changes or major contingencies.

As revealed in the 2011 budget plan, the Government intends to keep total general government expenditures at their 2010 level, i.e., HRK 122 billion again this year. On the revenue side, the tax authorities expect to collect HRK 107 billion. Given the official real growth projection of 1.5 percent which the Government counts on, the resulting deficit would be 4.8 percent of GDP (4.3 percent for the central government). As we project only slightly weaker GDP growth, there is no reason to expect that the deficit will differ considerably from what the Government expects, assuming the absence of any major contingencies that might call for significant departures from what is planned on either the expenditure or the revenue side.

3 Uncertainties and Risks to Projections

Status quo.

Even though the Government launched some projects such as various models aimed at supporting the enterprise sector (A, B, C and A+ models), subsidizing housing loans, campaigning for large infrastructural projects, aligning laws with the *acquis* as part of the EU membership negotiations over the course of last year, nothing seems to have changed significantly in the way the economy operates. In other words, the economic status quo continues with just a few positive signs. As a result, Croatia is still struggling with recession and the recovery is burdened by uncertainties. It appears that new energy is needed to revive the economy, otherwise pessimism might prevail and result in a weaker overall performance than projected.

Parliamentary elections.

So far, the date of parliamentary elections has not yet been announced, adding to the uncertainty in the political and economic sphere. According to some recent polls, the current Government has very low public support and that fact affects the policy-making process. Hopefully, no promises will be made in the pre-election period that would be financially costly for the future governments and public finances. We believe such a scenario to be little likely as all political parties have learned from the past and will act responsibly. If that is so, the first year of the new mandate may bring about stronger fiscal consolidation and some unpopular structural reforms. Although they would have a positive effect in the long run, their impact on short-term growth might be negative and stronger than expected right now.

Contingent liabilities and weak labor market recovery.

A number of contingencies involved may render our fiscal projections uncertain. The omnipresent one relates to a potential activation of contingent liabilities associated with the Government's guarantees: a larger amount of those would lead to a non-trivial increase in the public debt. How the bargaining between the Government and farmers over subsidies might evolve also remains to be seen. Additional outlays will have to be made in case the Government is not able to resist the pressure put on by farmers. Yet another concern lies in the projected weak recovery of the labor market. Rising unemployment may become a serious constraint on the tax revenue collection, both from personal income tax and social security contributions as well as from VAT, whose regular pre-crisis flows have not been recovered yet as a result of a shrinkage in consumption.

The closure of EU accession negotiations.

As the closure of the accession negotiations with the EU this year seems certain at the moment, we give just a small probability to the alternative of its being postponed due to unforeseen events. The process of ratification will take certain time so full membership is expected in 2014 at the latest. One should also keep in mind that the current support for the EU entry among the Croatian population is rather low, meaning that the outcome of the referendum might complicate the accession process. Although the chances of such a scenario materializing seem weak, it would have a substantial negative effect on the economic performance.

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