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Croatian Economic Outlook

Quarterly

1 Recent Developments

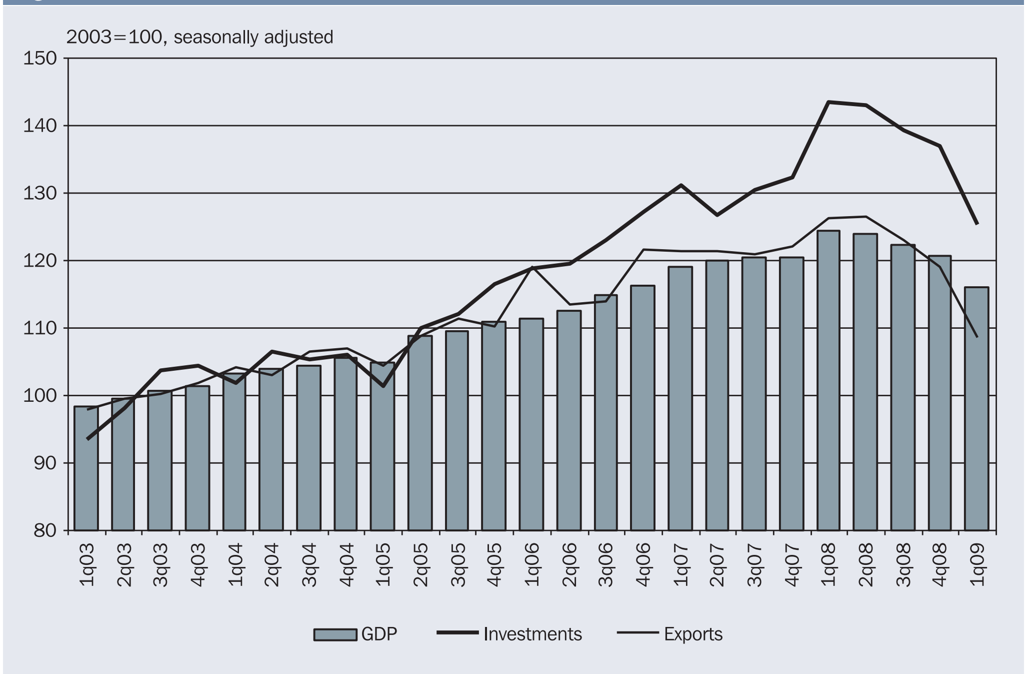
Prime Minister's unexpected resignation.

On July 6, Croatia got a new Government following the surprise resignation of Prime Minister Ivo Sanader, who cited personal reasons for withdrawal. The new Government, that has undergone only few changes, is led by his former deputy, Ms. Jadranka Kosor. Although reasons for his shocking decision remain unclear, Mr. Sanader said that blocked negotiations over Croatia's EU entry had contributed to it. These developments have shaken the political scene in Croatia and raised fears over their impact on the economy. However, the transfer of power was done swiftly. By dealing with a declining economy, the new Government should immediately prove its ability to run the country in difficult times. Maintaining control over the rising budget deficit has emerged as one of the priorities. At the same time, the Government is expected to find ways to cushion the current economic downturn and revive the EU entry negotiations.

First quarter results indicate a slide into deeper recession.

On the economic front, it appears that Croatia has fallen deeper into recession. According to seasonally adjusted figures, in the first quarter this year GDP dropped by 6.7 percent compared to the same quarter last year and by almost 4 percent compared to the previous quarter. The fall was primarily caused by a sharp drop in domestic demand, 11.2 percent year-on-year, while weaker external demand caused exports to decline by 14.2 percent. As measured by trend figures, the first quarter 2009 was the third quarter in a row in which GDP shrank. At the same time, it was the first one with a sharp decrease in almost all

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

economic activities. Available high-frequency indicators for April and May confirm that real sector activity continues to decline, although at a slowing pace.

Personal consumption dives.

The household sector has reacted promptly to deteriorating labor market conditions, credit squeeze and rising risks to future income. As a result, personal consumption has been on the decline for the last four quarters. However, the drop was particularly intense in the first three months this year when it plunged 9.9 percent year-on-year and 4.5 percent quarter-on-quarter (seasonally adjusted). During the last year, a decline in personal consumption was due to weak consumer confidence and negative expectations rather than to a declining income, but the situation has changed this year due to reduced capital incomes, downward pressures on wage bills and uncertain prospects. New car sales were particularly hurt, dropping by almost one half in comparison with the same period last year.

Government consumption rises further.

Unlike other categories of aggregate demand, government consumption has continued to rise. In the first quarter 2009, it increased by 3.9 percent over the same period last year and by 0.2 percent over the previous quarter (seasonally adjusted). Such an outcome reflects the Government's constraints to reduce spending due to previous commitments such as, for example, collective agreements with public sector employees.

Investments sink.

Investments, which have been the most vigorous part of domestic demand for years, experienced a 12.4 percent year-on-year drop in the first quarter. Seasonally adjusted figures indicate that the second half of the last year saw a mild decline, while the beginning of 2009 brought a sharp fall of 8.6 percent over the last three months 2008. Although data on the structure of investments are not available, it appears that investments in buildings contributed only marginally to such an outcome since a decline in the volume of construction works was rather modest. On the contrary, investments in machinery and equipment experienced severe reduction, as indicated by a striking fall in imports of capital goods (almost 40 percent year-on-year in the first five months of 2009) and a significant decline in domestic production of capital goods.

Current account deficit narrows as a result of...

Croatia's international trade has been strongly affected by the crisis. In the first quarter, the volume of exports of goods and services fell by 14.2 percent over the same period last year, and 8.8 percent as measured by seasonally adjusted figures over the previous quarter. A drop in imports was even more striking, 20.9 percent year-on-year, and 10.4 percent quarter-on-quarter. Imports decline can be related to the reduced domestic demand, but also to more stringent financial conditions. Consequently, external imbalance has significantly narrowed, as shown by the balance of payments data. In the first quarter 2009, trade deficit in goods and services fell by some 35 percent, from EUR 2.5 billion in the first quarter last year to 1.6 billion in the first quarter this year. At the same time, the current account deficit fell by almost 30 percent to EUR 1.8 billion in the first quarter this year. In the year up to the first quarter 2009, the current account deficit dropped to 7.9 percent of GDP, while the same indicator for the previous quarter amounted to 9.4 percent of GDP.

... a sharp drop in imports.

Looking at the merchandise trade statistics, figures for the first five months 2009 indicate that goods exports dropped by 15.5 percent year-on-year in current kuna terms, which was spurred by a significant fall in oil industry and the production of chemical products as well as machinery. Goods imports plummeted by 25.5 percent, mostly due to a sharp decline in demand for road vehicles, oil and petroleum products, and machinery and equipment.

Real sector activity experiences severe downturn.

Real sector declined sharply in the first quarter 2009. Besides a slump in demand, industrial production was additionally affected by the January disruption in gas supply, and retail sales by the controversial law banning work on Sundays. Consequently, year-on-year growth rates dived into the negative double-digit zone in the first quarter this year. Compared to the last quarter 2008, industrial production declined 5.3 percent, while retail sales contracted 6.3 percent according to seasonally adjusted figures. For both industrial production and retail

Table 1 MAIN ECONOMIC INDICATORS

	2007	2008	2008			2009
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	5.5	2.4	3.4	1.6	0.2	-6.7
Real private consumption (% change, yoy)	6.2	0.8	2.3	0.4	-3.2	-9.9
Real government consumption (% change, yoy)	3.4	1.9	3.2	1.3	2.7	3.9
Real investment (% change, yoy)	6.5	8.2	12.6	6.6	3.5	-12.4
Industrial output (% change, yoy)	4.9	1.2	3.0	0.2	-1.7	-11.0
Unemployment rate (registered, %, pa)	14.8	13.2	13.0	12.2	13.1	14.7
Nominal GDP (EUR million)	42,833	47,370	-	-	-	-
GDP per capita (EUR)	9,656	10,682	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	4.0	6.4	6.4	7.6	5.3	5.5
Consumer prices (% change, yoy, pa)	2.9	6.1	6.6	7.4	4.5	3.8
Producer prices (% change, yoy, pa)	3.4	8.5	8.7	11.1	6.7	1.1
Average gross wage (% change, yoy, pa)	6.2	7.1	6.8	7.4	6.6	4.6
Exchange rate, HRK/EUR (pa)	7.34	7.22	7.26	7.18	7.17	7.40
Exchange rate, HRK/US$ (pa)	5.37	4.93	4.65	4.78	5.45	5.68
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,193	9,743	2,492	2,679	2,346	1,922
Exports of goods (EUR, % change, yoy)	8.6	6.0	7.9	13.5	-5.3	-13.7
Imports of goods (EUR million)	18,627	20,610	5,599	5,411	4,809	3,651
Imports of goods (EUR, % change, yoy)	10.8	10.6	15.7	15.8	-2.1	-23.8
Current account balance (EUR million)	-3,237	-4,438	-1,802	1,861	-1,941	-1,820
Current account balance (% of GDP)	-7.6	-9.4	-	-	-	-
Gross foreign direct investment (EUR million)	3,667	3,330	964	360	1,001	399
Foreign exchange reserves (EUR million, eop)	9,307	9,121	9,941	9,809	9,121	8,870
Foreign debt (EUR million, eop)	33,254	39,125	35,403	36,247	39,125	39,235
GOVERNMENT FINANCE*						
Revenue (HRK million)**	126,716	134,738	66,307	100,661	134,738	30,294
Expense (HRK million)**	118,771	130,259	60,881	92,974	130,259	32,476
Net = Gross operating balance (HRK million)**	7,946	4,479	5,426	7,688	4,479	-2,182
Net acquisition of non-financial assets (HRK million)**	11,015	7,344	3,955	4,098	7,344	1,284
Net lending/borrowing (HRK million)**	-3,069	-2,865	1,471	3,590	-2,865	-3,466
Domestic government debt (EUR million, eop)***	7,992	9,143	8,289	8,289	9,143	-
Foreign government debt (EUR million, eop)***	4,215	4,161	4,011	4,555	4,161	-
Total government debt (% of GDP)***	28.5	28.5	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	19.3	-4.6	5.5	7.6	-4.6	-11.7
Broad money, M4 (% change, yoy, eop)	18.3	4.3	11.1	14.7	4.3	3.3
Total domestic credit (% change, yoy, eop)	15.0	10.5	10.3	11.0	10.5	9.2
DMBs credit to households (% change, yoy, eop)	18.0	12.1	14.8	10.9	12.1	8.3
DMBs credit to enterprises (% change, yoy, eop)	10.2	12.3	5.0	10.7	12.3	11.9
Money market interest rate (%, pa)	4.1	5.5	2.8	3.8	10.7	14.3
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	8.0	7.6	7.6	9.1	9.9
DMBs credit rate for households, short-term (%, pa)	12.1	12.2	12.1	12.2	12.3	12.5

Notes: ** Data refer to consolidated general government. ** On the cash principle, cumulative from the beginning of the year. *** Due to changes in methodology, figures differ from previous issues.*
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.*

sales, this was the fourth consecutive quarter recording a decline in activity. However, the most recent indicators for April and May indicate that the negative trend is somewhat slowing down in retail sales, while it has stopped in industrial production. Although these signs are encouraging, several more observations are needed to confirm the stabilization of trends. Unlike in industrial production and retail sales, the negative trend in construction activity appeared much later - at the turn of the year, while a quarter-on-quarter decline in the first three months 2009 amounted to modest 2 percent over the preceding quarter.

Tourist overnight stays decrease.

In the first five months 2009, the cumulative decline in the number of overnight stays amounted to 9 percent year-on-year (8 percent for foreign and 14 percent for domestic tourists). Unofficial sources suggest that June saw a rise in the number of overnight stays, reducing the cumulative year-on-year decline to some 3 percent compared to the same period year ago. However, this might not be a credible indicator for the rest of the season due to the distribution of national holidays in June that encouraged the practice of bridging holidays with weekends.

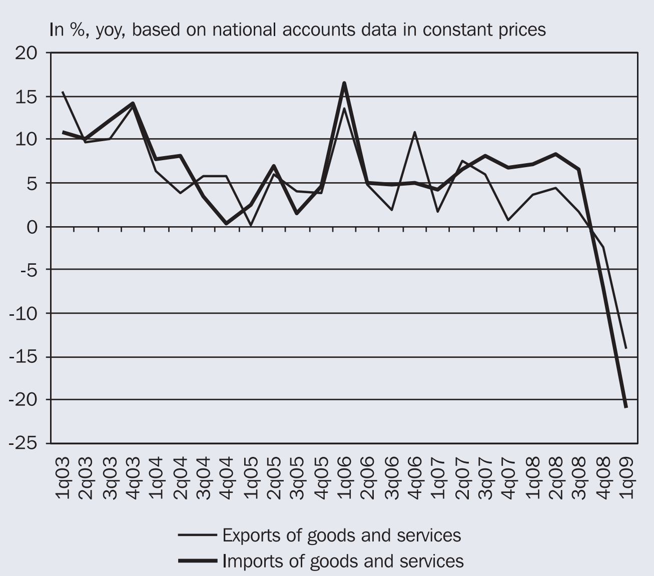
Sharp increase in the unemployment rate.

Seasonally adjusted employment has been declining since the end of last year. In May, the number of employees in the corporate sector was 2.4 percent lower than a year ago. The comparable figure for the unincorporated sector was -3.7 percent, while the number of jobless persons increased by 10.1 percent. Although a large fraction of jobs in Croatia is "recession-proof" in a way that they are in a largely defined public sector that includes government-controlled public enterprises, the decline in employment suggests that the private sector has undertaken severe cost cuts. The employment decline over the year up to May amounted to 7 percent in manufacturing industry, 4 percent in construction and 9 percent in accommodation and food services. For comparison, employment in public administration fell by 1.1 percent and increased by 1.2 percent in education and 2 percent in the health sector. Overall, the registered unemployment rate was 14.4 percent in May, up by 1.4 percentage points over the same month last year.

Average wage growth slower but still positive.

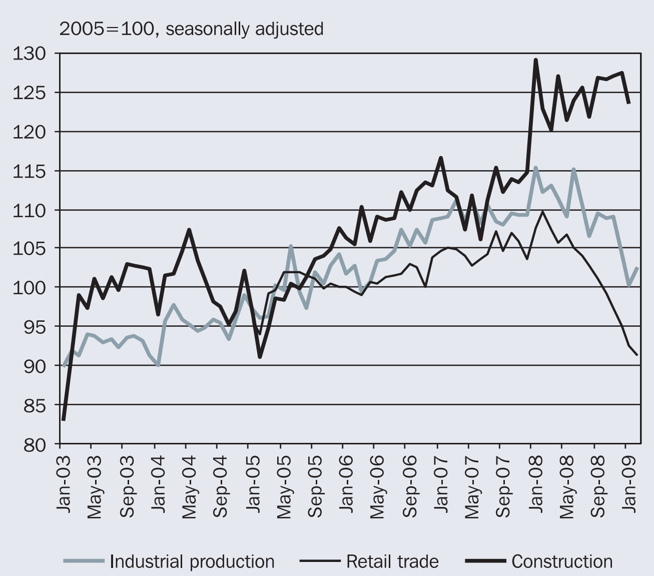
The average wage growth has slowed down, but the adjustment is still much weaker than on the employment side. In April, the average gross wage for the economy as a whole was 4.1 percent higher than a year ago. Wage growth decelerated to 1.1 percent in manufacturing industry, 0.8 percent in distributive trade and 3.8 percent in construction. It appears that manufacturing industry had to severely reduce jobs, particularly employment related to

Figure 2 EXPORTS AND IMPORTS



Source for original data: Central Bureau of Statistics.

Figure 3 REAL SECTOR DEVELOPMENTS



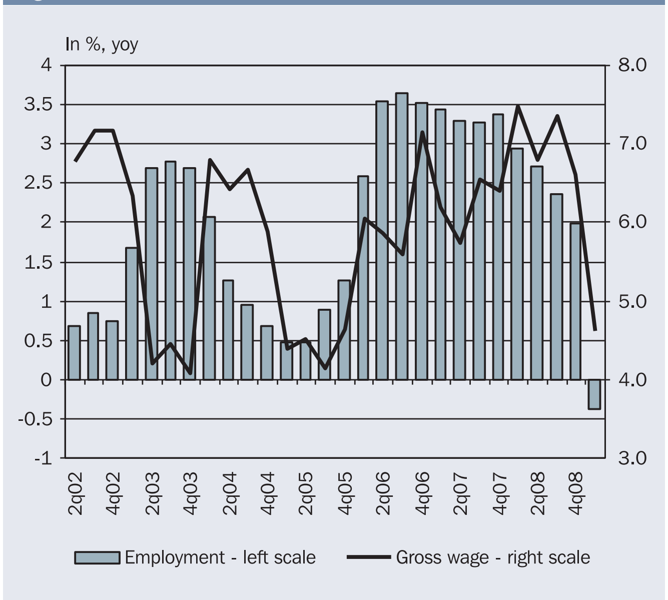
Source for original data: Central Bureau of Statistics.

temporary and fixed-term contracts, but it tries to keep wages intact as much as possible. This can be explained by the fact that a large part of manufacturing industry is covered by collective agreements and that employers and trade unions are reluctant to renegotiate wages in the current situation. The Government did not send a clear policy message to the private sector at the beginning of this year, as it increased the wage rate for public sector employees by 6 percent in accordance with the collective agreement. Soon afterwards, it was obvious that such an increase is not in line with the economic situation and that it had caused serious problems for the state budget. After the strike of public sector employees as well as long and exhausting negotiations between the Government and public sector trade unions, a new collective agreement was signed on May 13. Accordingly, the wage rate for public sector employees has returned to last year's level, but in exchange, the rate is now determined to increase steadily by 2016, depending on the pace of economic recovery. It was also agreed that negotiations would be renewed if economic growth would be lower than projected. As the situation has worsened in the meantime, new rounds of negotiations are likely to take place. Their outcome will be important not only from the fiscal point of view, but also for wage policy in other sectors of the economy. Cost adjustments in the economy have affected employment more than wages, which could have a negative impact on the future growth potential due to preserving high labor costs and a low capacity utilization.

Savings deposits slow down rapidly.

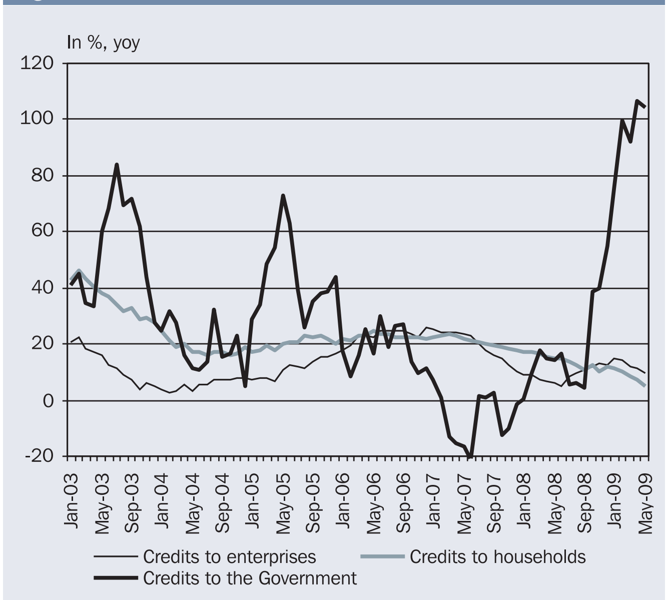
Deceleration of monetary aggregates growth, that has taken place simultaneously with the slowdown of real economic activity since the second quarter of 2008, has turned into a strong contraction of narrow money and the stagnation of broad money. Seasonally adjusted figures for the first quarter 2009 suggest that broad money rose by 0.5 percent when compared to the last quarter 2008, while narrow money contracted by 7.8 percent. Data available until May 2009 confirm these trends. As a result, broad money was 2.4 percent higher in May than a year ago, while narrow money recorded a 10.8 percent drop. In addition to the narrow money decline, the contraction of kuna savings deposits has also contributed to the stagnation of broad money. In May, kuna savings deposits were 13.2 percent lower in year-on-year terms. At the same time, foreign exchange deposits expanded by 15.7 percent, suggesting that kuna savings deposits have been substituted with foreign exchange savings due to an increasing lack of confidence in the domestic currency. One should also note that the growth pace of overall savings is slowing down rapidly. In May, they were only 4.1 percent higher than in the same month year ago, which will have adverse implications for credit activity.

Figure 4 TOTAL EMPLOYMENT AND AVERAGE GROSS WAGE



Source: *Central Bureau of Statistics.*

Figure 5 CREDIT DEVELOPMENTS



Source for original data: *Croatian National Bank.*

Deceleration of credits to private sector.

Credit activity in 2009 is characterized by new developments. While the growth of credits to households and enterprises has rapidly decelerated, credits to the Government have sharply increased. In the first five months 2009, local and central Government took out HRK 9.8 billion of new loans. The Government has turned to the banking system as its increasing borrowing requirements have been faced with stringent external financing conditions. At the same time, credits to households and enterprises have continued to decelerate, suggesting that increased lending to the Government has been crowding out the private sector. Hence, credits to the Government doubled in May compared to the same month year ago. At the same time, credits to enterprises recorded a 9.7 percent rise, while credits to households rose by 5.2 percent. The most propulsive component of credits to households – housing loans – is also slowing down notably. In May, it rose 10.2 percent year-on-year, the lowest rate in the last eight years. In addition, confirming a substantial slowdown in the international lending, foreign debt stood at EUR 39.8 billion in April, which is 1 percent higher than at the end of 2008.

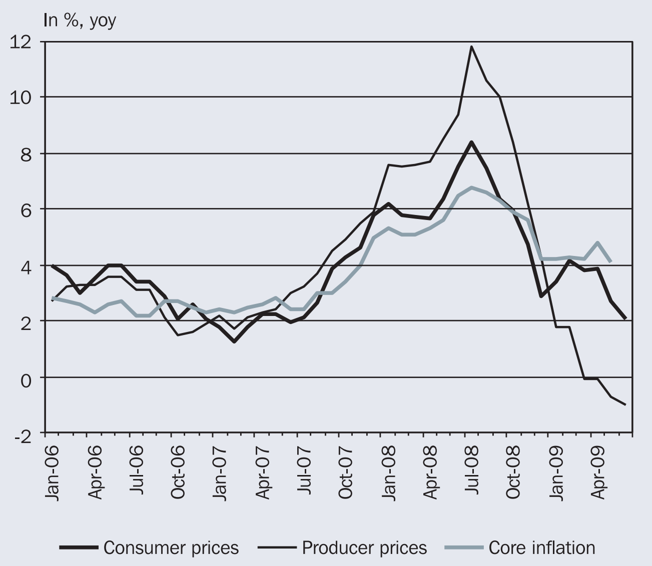
Easing up of money market pressures.

Following the first quarter 2009, which had witnessed stringent and volatile money market conditions caused by exchange rate instability, the second quarter brought much smoother developments. Depreciation pressures on the HRK/EUR exchange rate subsided, which, in turn, allowed the central bank to increase the amount of kuna liquidity offered through repo auctions. Consequently, the average overnight money market rate stood at 5.9 percent in April and May, while in the first quarter 2009, it amounted to 14.3 percent. Smoother money market conditions are also confirmed by the fact that the central bank did not intervene on the foreign exchange market in the second quarter. The average HRK/EUR exchange rate appreciated 0.6 percent in the second quarter 2009 compared to the first quarter, which is partly due to seasonal factors, but it can also be attributed to the issuance of EUR 750 million of the Government Eurobonds in May. The bonds were issued for the period of 5.5 years, with a 6.5 percent interest rate.

Cooling of inflation.

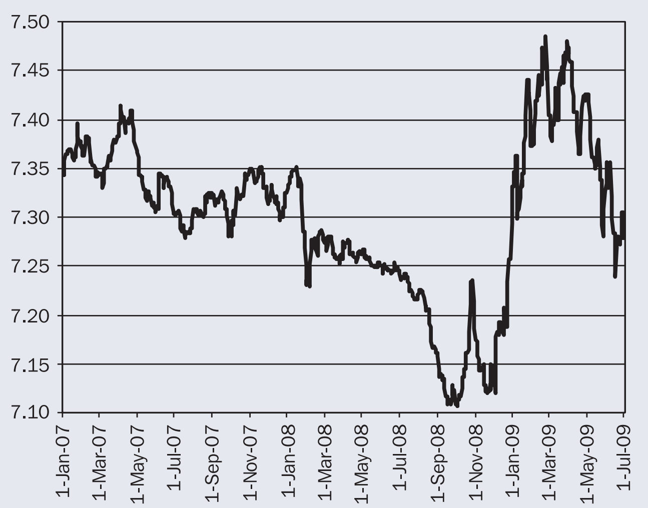
Data on inflation in the second quarter 2009 confirm that prices have calmed down. Consumer prices rose 2.9 percent when compared to the same quarter last year, while producer prices dropped 0.6 percent. In June, consumer prices were 2.1 percent higher than a year ago, mostly due to the increased prices of transportation, recreation and culture. In the same month, producer prices decreased by 1 percent as a result of lower prices of intermediate goods. Core inflation figures available until April confirm that prices have

Figure 6 INFLATION



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

Figure 7 HRK/EUR EXCHANGE RATE



Source: *Croatian National Bank.*

cooled but not stabilized. Hence, in April, core inflation amounted to 4.1 percent year-on-year and was 0.4 percentage points higher than in the previous month.

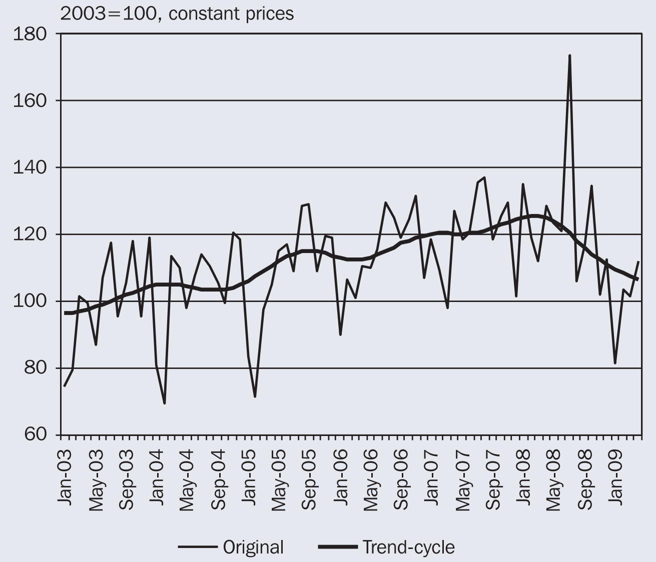
Sharp drop in fiscal revenues.

A sharp fall in revenues at all government levels that had started at the end of 2008 continued forcefully in the first quarter of this year. General government revenues dropped 4.1 percent in the first quarter compared to the same period last year. Weak overall economic performance affected particularly revenues from excises, VAT and profit tax. VAT revenues decreased 18.7 percent, revenues from excises 19.6 percent and profit tax 11 percent. As a result of the persistent growth of average wage, and despite falling employment, revenues from social contributions grew 1.5 percent in the first quarter 2009 year-on-year. In contrast to the revenues, general government expenditures continued to expand, increasing 10.7 percent in the first quarter. The rising expenditures could be partly explained by the Government's intention to pay-off the arrears accumulated at the end of the last year, and partly by the fact that the base for comparison was rather low due to last year's temporary budget financing in the first quarter. However, it could be argued that its spending behavior reveals that the Government ignored worsening economic conditions since it did not want to cut expenditures before the May local elections. Divergent trends of expenditures and revenues brought about an increase in deficit. At the end of the first quarter 2009, the net borrowing of the consolidated general government (deficit according to GFS 2001 methodology) amounted to HRK 3.5 billion, compared to a HRK 1.5 billion surplus in the same period last year.

Second budget revision in July, with the third on the horizon.

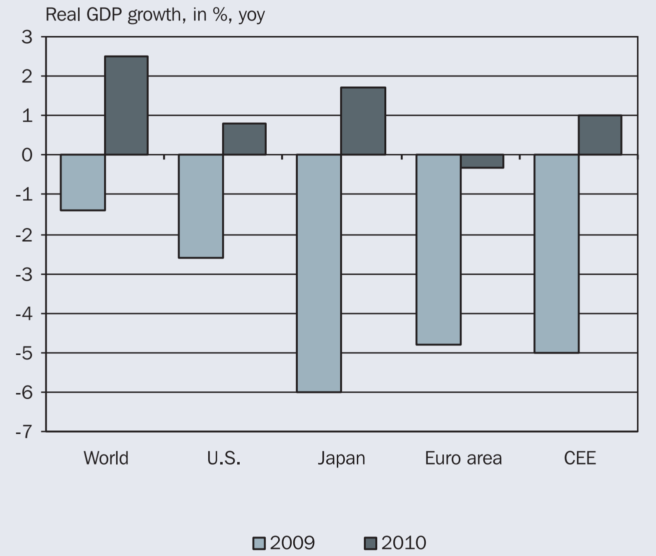
Following the first budget revision adopted in April, the Ministry of Finance sent the second one to the Parliament at the beginning of July and, at the same time, announced the third budget revision to be adopted shortly. While the second budget revision deserves to be called "light", the third is expected to bring sharp expenditure cuts. Budget revisions have become necessary due to the worsening of tax collection and stronger contraction of economic activity than earlier expected, which has created a need to reallocate funds to the highest priorities. The "light" budget revision brought the redistribution of expenditures in the amount of HRK 2.2 billion and a net expenditure decrease of HRK 780 million. The second budget revision has showed that the Government is ready to reconsider the items that have long been considered unquestionable, so the third budget revision should, according to the announcements, include further reduction in current expenditures. The necessity to prevent an excessive fiscal imbalance has initiated several rounds of meetings

Figure 8 BUDGETARY REVENUES FROM VAT



Source for original data: *Ministry of Finance.*

Figure 9 WORLD ECONOMY PROSPECTS



Source: *World Economic Outlook - update, IMF, July 2009.*

among social partners. The talks will probably lead to a decrease in expenditures, but without significant changes in public sector wages and pensions, a rise in the VAT rate from 22 to 23 percent and the introduction of a 3-percent "crisis surcharge" on personal incomes above HRK 3,000 as well as the introduction of an excise tax on mobile telephone services.

Public debt expands.

As a consequence of negative fiscal balance, public debt has continued to expand. Following a 9 percent growth in 2008, the consolidated central government debt (without state guarantees) grew by additional 4 percent in the first two months of 2009. At the end of February, it reached HRK 101.3 billion, 14.5 percent more than in February 2008. Unlike in the last year, when the Government had realized most of its new borrowings by issuing T-bills, this year it decided to borrow from banks. Consequently, the total borrowing of the central government from domestic banks increased 48.4 percent in just two months (January and February), Accordingly, the share of credits from domestic banks in total public debt reached 20 percent. Such a debt issuing strategy could lead to a substantial crowding out of the private sector, so the Government will strive to get more financing abroad for the rest of the year. This has already been proved by the emission of EUR 750 million Government Eurobonds in May, while another emission of bonds, probably intended for Asian markets, is expected in the fall. At the end of February, the outstanding government guarantees amounted to HRK 45.2 billion, which is 15.6 percent higher than in the same period last year.

2 Policy Assumptions and Projections Summary

The world economy is stabilizing...

There are signs that the first quarter 2009 may prove to be a trough point of the global economic crisis. A number of indicators suggest that global economic activity is stabilizing as a result of substantial fiscal and monetary stimulus worldwide as well as a decline in commodity prices. It is now believed that this stimulus, with a turnaround in the stock cycle, will lead to a gradual global recovery. However, prospects remain subject to high levels of uncertainty. A sustained rise in activity is not expected before the second half of 2010. The IMF updated its forecasts in July, revising them slightly upwards for 2010 compared to three months ago. It now projects world real GDP to fall by 1.4 percent in 2009, before growing 2.5 percent in 2010.

... but the recovery of euro area economies is projected to be particularly slow.

During the first quarter 2009, European economies contracted sharply. GDP in the 16-member euro area fell 2.5 percent over the previous quarter, while the corresponding year-on-year decline amounted to 4.6 percent. The contraction was particularly intense in the industrial sector. Activity in the rest of the year is expected to remain weak, but the decline is loosing pace compared to the beginning of 2009. The IMF expects the recovery of the euro area economies to be more protracted than in other parts of the world, as adjustments on the labor market have not yet fully taken place. Therefore, it projects euro area GDP to contract by 4.8 percent in 2009 and by additional 0.3 percent in 2010.

Higher oil prices in the medium-term.

Oil prices fluctuated around US$ 50 per barrel in the recent months, but recovered strongly at first signs of possible global recovery. After reaching the peak at around US$ 70 in early June, the price of Brent crude oil started to fall and on July 8 it stood around US$ 60. Analysts expect higher prices in the medium-term, mainly due to more optimistic expectations for the global macroeconomic environment.

Painful measures expected on the internal front.

As global economic activity has started to stabilize following a sharp contraction in the first quarter, it is particularly important for the Croatian economy that the euro area economies will probably have weaker and more prolonged recovery than other parts of the world. Consequently, sluggish external demand and weak capital inflows will continue to affect real sector activity. As for the internal front, huge challenges are ahead. Public spending will need to be substantially reduced in the very near future as the possibilities of deficit financing are constrained both on domestic and international capital markets. As a result, the Government cannot stimulate the economy through fiscal measures; on the contrary, it will be focused on controlling public spending and retaining deficit within the target. Due to the latest available information, our projection assumption is that the new budget revision will bring further expenditure cuts, but also additional tax revenues implied by the announced changes in the tax system. For the next year, we expect additional cuts in public spending, including investments, which would result in an even weaker fiscal stimulus than this year. As for the monetary authorities, the priority will be sustaining stability of the HRK/EUR exchange rate in order to avoid negative effects on private sector balance sheets. At the same time, the central bank is expected to continue supporting the liquidity and stability of the banking sector.

A further cut to projections – GDP expected to contract 5.0 percent in 2009.

The first three months of 2009 have confirmed the severity of recession as domestic demand declined stronger than earlier expected. High-frequency data for the second quarter suggest that activity will continue to contract, but the pace of contraction will be somewhat weaker. Differently from economies in which monetary and fiscal stimulus have been implemented on a large scale in order to revive economic activity, policymakers in Croatia are constrained in their policy options by high foreign debt obligations, euroization of the economy as well as the already large volume of public spending. Consequently, reduced monetary flexibility and a lack of fiscal stimulus will probably prolong the recovery. Positive year-on-year GDP growth rates are not expected before the second half of 2010. As a result, GDP is now projected to decline by 5.0 percent in 2009, before stabilizing in 2010.

Investments expected to be strongly hit by the crisis.

A sharp fall in personal consumption has already taken place in the first half of this year, while the announced increase in tax burden should additionally dampen households' spending. For next year, we expect stabilization in consumer sentiment and somewhat stronger credit activity. Consequently, private consumption is projected to contract by 8.8 percent this year, while next year should bring a mild rise of 0.7 percent. Investment activity will continue to be strongly hit by the crisis. We expect it to decline by 13.8 percent this year, while a slight recovery might be seen in late 2010. However, the overall volume of investment in 2010 should remain unchanged compared to 2009. Namely, the financing potential of the Government is reduced, while the corporate and household sectors are not expected to recover strong enough to drive investment activity, especially with a weak inflow of foreign capital.

Table 2 SUMMARY OF PROJECTIONS

	2009	2010
Real GDP (% change)	**-5.0**	**0.0**
Real private consumption (% change)	-8.8	0.7
Real government consumption (% change)	-0.8	-3.1
Real investment (% change)	-13.8	-0.3
Exports of goods and services (constant prices, % change)	-14.3	2.2
Imports of goods and services (constant prices, % change)	-21.3	1.9
Current account balance (% of GDP)	-3.5	-4.0
Consumer prices (% change, pa)	3.0	3.0
Exchange rate, HRK/EUR (pa)	7.37	7.35
Unemployment rate (registered, %, pa)	14.8	15.6
General government balance (ESA 95 definition, % of GDP)	-3.0	-3.0
Broad money, M4 (% change, eop)	2.0	7.0
Total domestic credit (% change, eop)	6.0	10.0

Notes: *Cut-off date for information used in the compilation of projections was July 22, 2009.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Current account deficit to narrow to 3.5 percent of GDP.

This year will be critical for international trade, in particular for exports of services. The volume of exports of goods and services is projected to decline by some 15 percent and imports by more than 20 percent. Revenues from international tourism are projected to decline by 10 percent. Next year should bring a modest increase on both the exports and imports side as both external and domestic demand start to pick up. Due to sharply declining imports this year, the current account deficit should narrow to 3.5 percent of GDP, and rise back to 4.0 percent next year as foreign trade flows slightly strengthen. The adjustment in external imbalances is to some extent due to reduced capital inflows, including FDI, which in the past has helped to offset a substantial part of the current account deficit.

The labor market will continue to deteriorate.

The labor market, just like the rest of the economy, is worse than expected three months ago, which has caused the revision of projections. For 2009 as a whole, the registered unemployment rate is expected to rise to 14.6 percent. However, the end-year rate could reach 16.3 percent, about 3 percentage points above the 2008 rate. In December 2009, the number of unemployed is expected to be 20 percent higher than in December last year. These negative developments will be translated into 2010 but at a much slower pace due to postponed adjustment. As a result, the registered unemployment rate is projected to rise further to 15.6 percent in 2010.

Emphasis on the wage policy.

Established wage policy in both public and private sector will undergo a substantial revision. In the situation of broadly unchanged exchange rate and capital shortage, production costs will have to be reduced to retain the competitive position of the businesses. Therefore, it is expected that wage cuts will soon become a more common practice in Croatia despite the strong opposition of trade unions. Historically, wage cuts have almost never been practiced in the country because in bad times balance sheets had been usually adjusted through accelerating inflation. Such a scenario is not an option for policymakers now and, therefore, wage adjustment is expected to take a more active role. In the public sector, an excessive wage bill could cause the widening of fiscal deficit and leave fiscal policy a very narrow maneuvering space . Although we have not assumed wage cuts in this year due to the latest agreements with public sector trade unions, it must be noticed that if things do not change for the better very soon, a sound government policy would also include cutting down compensation for public sector employees.

Inflation should remain relatively low.

With declining domestic demand, a stable exchange rate and decreasing import prices, inflation should decelerate progressively. However, due to the expected changes in consumption taxation, we envisage consumer price inflation in this and next year at the average of 3.0 percent.

Possible exchange and interest rate pressures.

As far as the money market and exchange rate developments are concerned, the last quarter 2009 and the first quarter 2010 could bring new tensions. Since it is already evident that the Government will face challenges in financing the fiscal deficit even in the case of considerably reduced public spending, depreciation pressures on the HRK/EUR exchange rate might re-emerge. In that case, the central bank will probably withdraw kuna liquidity from the money market, which would consequently have an adverse effect on money market interest rates. If such a situation persists, commercial banks faced with a much slower growth of savings deposits might be pressured to increase interest rates once again, which, in turn, might further dampen economic activity.

Substantial slowdown in credit activity.

Broad money is expected to record a moderate growth in 2009. This is due to the assumed decrease in narrow money, while overall savings are expected to slow down considerably in comparison with last few years. Broad money growth should recover somewhat during 2010 when a gradual economic recovery begins to take effect. Total domestic credit is expected to slow down substantially this year, mostly due to the fact that a deep recession will dampen the credit demand of household and enterprise sectors. We expect total domestic lending to increase 6 percent during 2009 and recover somewhat to record a 10 percent growth in 2010.

Powerful measures needed to reduce the fiscal deficit.

We can expect large budget revenue shortfalls toward the end of the year, which will surely worsen the Croatian fiscal position. With the projected 5 percent GDP decline, a negative fiscal balance could reach 4 percent of GDP simply due to the automatic response of cyclically sensitive revenues and expenditures. Therefore, there is no alternative to undertake procyclical measures to retain deficits within tolerable limits. However, it is evident that despite all efforts, the size of net government borrowing will probably be in the vicinity of 3 percent of GDP.

3 Uncertainties and Risks to Projections

Uncertainties on the rise.

In recent weeks, uncertainties have increased significantly. With the upcoming third budget revision, policymakers might undertake measures that would substantially differ from our projection assumptions and thus would change the outcome. In addition, it is yet to be seen whether a swift establishment of the new Government and its first steps could build up the confidence in both political leadership and the Government's ability to limit negative economic and social consequences of the crises.

Politically sensitive measures on the agenda.

Since the beginning of the global economic crisis, policymakers in Croatia have not shown that their choices have been appropriate. Well set priorities as well as the timing of undertaken measures is crucial in any crisis. Notwithstanding that the undergoing economic crisis had originated abroad, it has been evident for months that certain measures need to be implemented. In that case, the situation might have been less gloomy. The budget revision undertaken in mid-July as the first step of the new Government was too "light" to stabilize public finances. However, by cutting, among other things, pensions of former government officials, the Government has laid ground for further, more unpopular steps. The fact that the new Government prepared the budget revision only few days after its appointment, in addition to the announcement that the third and more serious budget revision will be prepared in the next few weeks, proves that it is aware of the situation and its consequences. While one can agree with the central bank governor that the IMF's support is yet not necessary and it is well-known what has to be done, there is still to be seen whether there is a political will to undertake such measures. If not, an arrangement with the IMF remains an option.

Stability and confidence in public finances.

In the current situation, it is crucial that the Government ensures stability and confidence in public finances. Although we still hope that the most important steps towards deficit reduction will be focused on tough measures on the expenditure side of the budget, using tax increase as an alternative, or at least partial solution, is politically very tempting. At the moment of concluding this issue, it became obvious that the tax burden will be to some extent (hopefully temporarily) increased by a higher VAT rate, additional personal income taxation and the introduction of an excise tax on mobile telephone services. It is to be stressed that the introduction of new taxes could have additional detrimental effects on the economy and its international competitiveness, and would only postpone the necessary public sector reforms. In our view, the current economic situation requires tough decisions on how and where to cut the expenditures.

Credit rating agencies are watching.

After several rating agencies slightly lowered the Croatian credit rating in April and May, the same could happen again if the fiscal position continues to deteriorate. If the new-old Government proves to be too weak to undertake tough measures, it risks further credit downgrading and, consequently, even tighter financial conditions on international markets. High contingent liabilities, especially the ones related to the government guaranteed loans of state-owned enterprises represent another risk this year. Knowing that in recessionary years revenues of those enterprises will go down, whereas their capacity for cutting costs and restructuring is limited, a probability of credit default seems rising. Therefore, government guarantees could turn into explicit obligations, thus increasing a negative budget balance and borrowing requirement.

Highly uncertain performance of tourism industry.

The outcome of the tourist season remains highly uncertain. At the same time, it will have a strong impact on the rest of the economy. It seems that the outcome will vary along the coast depending on destination proximity (with the northern part of the coast suffering less) to emitive markets (Germany, Italy and Slovenia) as well as the flexibility of tour operators to attract potential visitors through the "last minute" arrangements. While our projection is based on the assumption of a moderate decline in tourism revenues, if the season proves to be significantly worse or better off than anticipated, that will strongly impact the overall 2009 GDP figure and, consequently, ease or strengthen the exchange rate and fiscal pressures.

Standstill in the EU accession negotiations continues.

In recent weeks, it has become evident that the EU administration has given up from the mediation of border disputes between Croatia and Slovenia, due to which Slovenia is blocking Croatia's further EU accession negotiations. While the EU officials confirm that bilateral disputes should not prevent any country to proceed with negotiations, it seems that there is not enough interest within the EU to resolve the problem. Consequently, Croatia has provisionally closed only 7 of 33 main chapters of the *acquis communautaire*, with no chapter being open/closed in 2009. The change of Prime Minister in Croatia might bring new energy and attitude into the negotiation process. However, if the uncertainty regarding the future of accession remains, this might have strong long-term political and economic costs, primarily through the strengthening of opposition to further structural reforms.

The global economy – recovery or not?

Uncertainties and risks regarding future developments in the global economy are still high. While some positive signs have appeared, it is still to be seen whether they are of temporary character or will translate into a sustainable strengthening of activity. If confidence improves more quickly than expected, external demand and international financial flows will recover sooner. However, prolonged instability in the world economy and in particular among the EU economies, combined with a rise in energy prices, might dampen expectations for the revival of Croatia's economy next year.

IMPRESSUM

This publication has been prepared by Andrea Mervar (editor), Iva Čondić-Jurkić, Danijel Nestić, Sunčana Slijepčević, Sandra Švaljek, 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.

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