The Institute of Economics, Zagreb

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Croatian Economic Outlook
Quarterly

1 Recent Developments

Despite expansion in the second quarter…

After almost three years of recession, the second quarter 2011 brought a switch to positive economic growth. Namely, GDP increased 0.8 percent year-on-year, while seasonally adjusted data suggest a similar quarter-on-quarter rise. The positive contribution to growth came from net exports, while domestic demand receded. The upward change that could be seen as the end of recession, at least in technical terms, has been clouded recently by a number of negative signals on Croatia's economic performance.

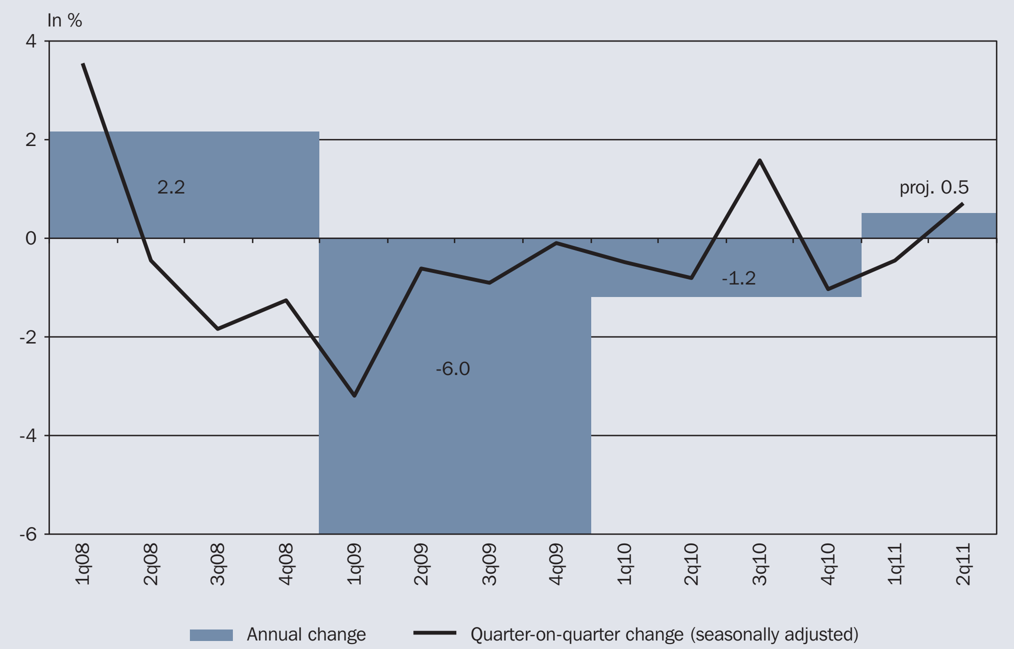
… the economy faces increasing challenges.

High-frequency indicators on industrial activity in July and August, as well as those on construction and exports, indicate a shrinking activity. At the same time, tourism sector is estimated to have performed well in the third quarter due to the increasing popularity of Croatia as a tourist destination. This has also improved activity in the related sectors, such as retail trade. Overall, the third quarter might bring a mild positive growth accompanied by the increasing vulnerability of the economy. However, prospects for a sustained recovery are rather poor. Internal difficulties of the economy could only be exaggerated when faced with the increasing uncertainty over the sovereign debt crisis in Europe.

Personal consumption remains sluggish.

In spite of volatility in quarter-on-quarter performance, personal consumption has had a slight upward trend over the last four quarters. In the second quarter, it rose 0.6 percent

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

year-on-year. Having in mind a weak consumer sentiment, persistent problems on the labor market, slowly recovering household credit activity and a stagnating disposable income, sluggish recovery in personal consumption comes as no surprise.

Government consumption is on the rise.

Government consumption rose notably in the second quarter this year, 1.7 percent over the same quarter last year. There is no data on the major components contributing to the observed rise. Probably it is a combination of an increased demand for civil servant services and higher expenditures on various goods. In the second quarter 2011, the number of employees in public administration was 0.4 percent higher than a year ago, which is a bit surprising having in mind the publicly announced policy of decreasing public sector employment according to the "2 for 1" rule, where two employees who leave their workplace get replaced by one new employee. It appears that the concluding phase of negotiations with the EU, which was particularly intensive in spring, has led to additional demand for labor and professional services. However, it is to be seen whether such an increased demand will be transposed into a permanent one, or this is only a transitory phenomenon.

Investments decline further.

Seasonally adjusted investment figures indicate a continued decline from the third quarter 2008 until the last observation for the second quarter 2011. Investments declined by 7.3 percent over the last four quarters, while in the last three years they shrank by 30 percent. Although deemed to over-invest in the pre-crisis period, Croatia now has to deal with a negative investment shock that poses huge difficulties to all related sectors, particularly construction. High-frequency indicators on construction and imports of capital goods suggest a continuation of negative investment trends in the near future.

Mixed signals on exports; imports weaken.

Positive export dynamics observed in the course of 2010 has disappeared, and the export sector seems to be in difficulties in spite of a solid service sector performance. Namely, total exports, as recorded in national accounts, exhibited large ups and downs in the last four quarters, even if seasonally adjusted values are considered. In the second quarter 2011, there was a notable increase over the first quarter, but only a mild 1.1 percent rise over the second quarter last year. For comparison, exports dropped by 11.1 percent year-on-year in the first quarter, meaning that the first half of the year was down by 5 percent compared to the same period last year. Export expansion in 2010 largely relied on exports of ships which under-performed this year. On the import side, a 1.3 percent year-on-year decline was recorded in the second quarter. However, a serious contraction is observed over the last three quarters, almost 10 percent, as suggested by seasonally adjusted figures. Such a strong import reduction signals that the economy is weak, as rebalancing is still on the way, re-stocking has not begun, and the overall economic sentiment is low. The good news is, however, that it helps to reduce external imbalance.

Current account surplus in the second quarter of the year.

In the second quarter of the year, the current account balance turned positive for the first time in the last 15 years. The current account surplus amounted to EUR 55 million, while a surplus in the trade of goods and services reached EUR 275 million. Supported by relatively strong revenues from international tourism, depressed imports were the main factor behind the observed developments. In a year up to the second quarter this year, the current account deficit receded to 0.9 percent of GDP, while the net FDI inflow reached 0.7 percent of GDP. Such a balance was needed in order to control for the overall foreign debt, which amounted to 101 percent of GDP at the end of 2010. At the end of June, the debt stood at EUR 47.2 billion, which is some EUR 0.7 billion more than at the end of last year, indicating a moderate increase that may lead to the stabilization of the debt-to-GDP ratio.

Disappointing August figures on industrial activity...

Following a promising rise in industrial activity in the second quarter 2011, the figures for July and particularly August are disappointing. Based on the data for these two months, industrial activity in the third quarter was on average 3 percent lower than in the second

Table 1 MAIN ECONOMIC INDICATORS

	2009	2010	2010		2011	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-6.0	-1.2	0.3	-0.6	-0.8	0.8
Real private consumption (% change, yoy)	-8.5	-0.9	1.9	1.2	-0.1	0.6
Real government consumption (% change, yoy)	0.2	-0.8	-0.9	0.6	-0.9	1.7
Real investment (% change, yoy)	-11.8	-11.3	-9.5	-8.0	-6.7	-7.3
Industrial output (% change, yoy)	-9.3	-1.4	0.1	-1.7	-3.6	1.0
Unemployment rate (registered, %, pa)	14.9	17.4	16.4	18.1	19.5	17.5
Nominal GDP (EUR million)	45,669	45,917	-	-	-	-
GDP per capita (EUR)	10,311	10,396	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.3	1.0	1.1	1.2	2.6	2.0
Consumer prices (% change, yoy, pa)	2.4	1.1	1.1	1.5	2.2	2.3
Producer prices (% change, yoy, pa)	-0.4	4.4	4.1	5.1	6.2	6.5
Average gross wage (% change, yoy, pa)	2.2	-0.4	-0.2	0.5	0.5	1.8
Exchange rate, HRK/EUR (pa)	7.34	7.29	7.25	7.36	7.40	7.39
Exchange rate, HRK/US$ (pa)	5.28	5.50	5.62	5.42	5.42	5.13
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,703	9,102	2,243	2,501	2,076	2,411
Exports of goods (EUR, % change, yoy)	-21.5	18.2	18.8	26.1	2.1	3.7
Imports of goods (EUR million)	15,090	15,054	3,961	3,955	3,424	3,769
Imports of goods (EUR, % change, yoy)	-26.8	-0.2	6.3	4.3	3.2	-1.4
Current account balance (EUR million)	-2,369	-513	1,908	-1,019	-1,441	55
Current account balance (% of GDP)	-5.2	-1.1	-	-	-	-
Gross foreign direct investment (EUR million)	2,066	233	346	-720	89	396
Foreign exchange reserves (EUR million, eop)	10,376	10,660	11,154	10,660	11,424	11,422
Foreign debt (EUR million, eop)	45,244	46,512	45,609	46,512	47,506	47,186
GOVERNMENT FINANCE*						
Revenue (HRK million)**	128,087	123,709	91,905	123,709	28,043	58,681
Expense (HRK million)**	132,450	133,486	97,884	133,486	32,336	65,157
Net = Gross operating balance (HRK million)**	-4,363	-9,777	-5,979	-9,777	-4,293	-6,476
Net acquisition of non-financial assets (HRK million)**	6,357	4,848	3,078	4,848	788,916	1,869
Net lending/borrowing (HRK million)**	-10,068	-14,625	-9,058	-14,625	-5,083	-8,345
Domestic government debt (EUR million, eop)	10,995	12,469	12,541	12,469	13,070	13,013
Foreign government debt (EUR million, eop)	5,134	5,913	5,821	5,913	6,946	6,595
Total government debt (% of GDP)	35.1	41.2	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-14.6	4.2	13.6	4.2	2.9	6.1
Broad money, M4 (% change, yoy, eop)	-0.9	4.4	3.8	4.4	3.3	3.5
Total domestic credit (% change, yoy, eop)	-0.6	6.8	5.3	6.8	6.1	6.5
DMBs credit to households (% change, yoy, eop)	-2.9	3.8	1.7	3.8	2.5	3.1
DMBs credit to enterprises (% change, yoy, eop)	2.0	9.5	8.8	9.5	8.2	7.7
Money market interest rate (%, pa)	7.2	0.9	1.2	0.9	0.7	0.5
DMBs credit rate for enterprises, short-term, (%, pa)	10.0	7.4	7.2	6.9	7.0	6.6
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.*

quarter. In August, industrial production dropped by 5 percent compared to July according to seasonally adjusted figures. This volatility comes as a surprise, especially when one notes that the main contributors to such an outcome are chemical industry and machinery with a 40 and 20 percent month-on-month decline, respectively. The September figures will confirm or deny these trends as well as the speculations on statistical problems and/or substantial changes in seasonal factors. In the first eight months 2011, industrial activity was 1.6 percent lower than a year ago.

… and a substantial rise in physical indicators for tourism.

A significant increase in physical indicators for the 2011 tourist season suggests that the season's financial outcome should also be positive. Up to the end of August, the number of overnight stays increased by over 6 percent year-on-year. This year's tourist performance was underpinned not only by unusually good weather, which prolonged the season all the way into the fall, but also by political instability in a number of Mediterranean destinations, primarily in Greece and North Africa. A successful tourist season had a positive effect on other sectors, foremost retail trade, where the positive trend, present from the beginning of the year, has strengthened. Seasonally adjusted July-August figures suggest a rise in average retail volume by 2.2 percent compared to the second quarter, while a year-on-year rise for the first eight months amounted to 1.1 percent.

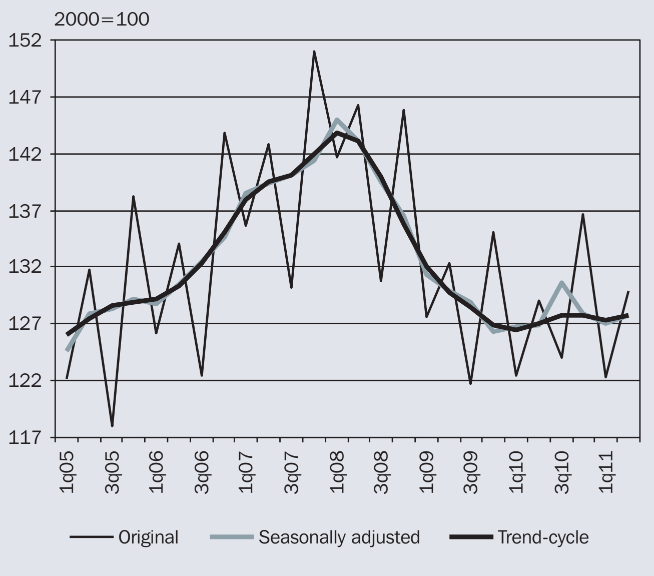
Weakness prevails on the labor market…

In September 2011, the number of unemployed persons registered at the public employment service was 2 percent lower than a year ago, the first such decline in the last two and a half years. Seasonally adjusted figures reveal a notable decline in September compared to August as well as compared to the previous three months, indicating a possible switch in the trend towards declining unemployment. However, it is a result of administrative procedures and does not reflect the underlying trends on the labor market.

… in spite of Employment service actions.

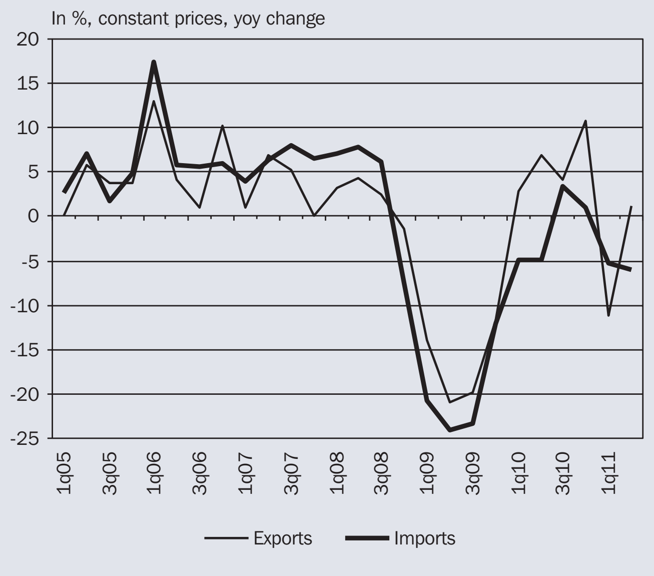
Stricter rules have recently been implemented for the unemployed to stay registered. In September, around 13,600 persons were deleted from the register mostly due to irregular visits to the Employment service – which is 3,000 more than in August and 3,000 more than in September last year. In the first nine months of this year, 11 percent more persons were deleted from the register than in the same period last year. On top of that, additional resources from the government budget have been transferred lately to the Employment

Figure 2 PERSONAL CONSUMPTION



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

Figure 3 EXPORTS AND IMPORTS OF GOODS AND SERVICES



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

service to strengthen the public works program. Around 3,700 persons received short-term employment through this program in September.

Employment decreases.

Employment figures show a different picture than those on registered unemployment. In August, total employment was 2.2 percent lower than a year ago. Almost the same year-on-year rates were observed in June and July, indicating a continuation of negative trends. This is most visible in the construction and real estate sector, which showed a 7 and 10.7 percent decline in employment, respectively. Even in accommodation and food services, employment dropped by 0.5 percent year-on-year despite a good tourist season. The registered unemployment rate stood at 16.7 percent in August, 0.4 percentage points higher than a year ago, while the survey-based and ILO-defined unemployment rate amounted to 13.5 percent in the second quarter 2011, 1.1 percentage points higher than a year before.

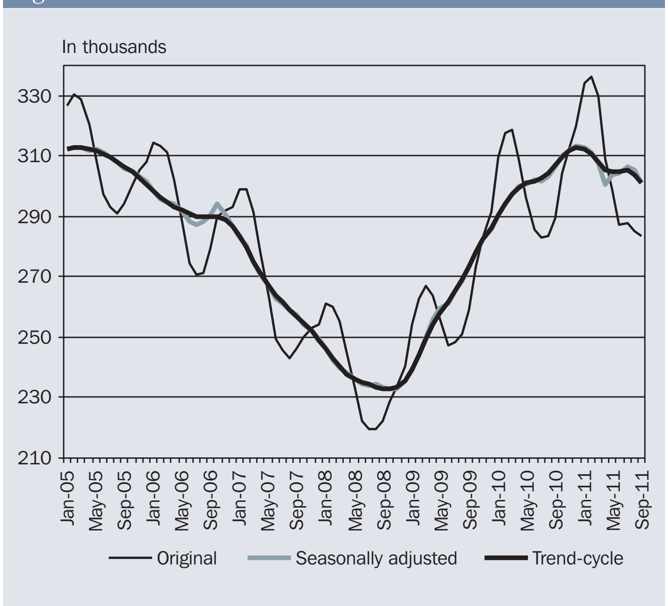
Wages are still stagnating.

The average gross wage increased by 1.8 percent year-on-year in nominal terms in the second quarter 2011, while it remained unchanged in real terms. The stagnation of gross wages is an additional indication of a strained labor market. Mostly due to the abolishment of the "crisis tax" on incomes, the estimated nominal wage bill increased by about 4 percent in the second quarter 2011 on a year-on-year basis. In real terms, the increase was around 2 percent. Overall real disposable income, including transfers and capital incomes, is estimated to have risen approximately 0.7 percent in the second quarter 2011 year-on-year, contributing to a mild improvement in personal consumption in the same period.

Steady growth of monetary aggregates.

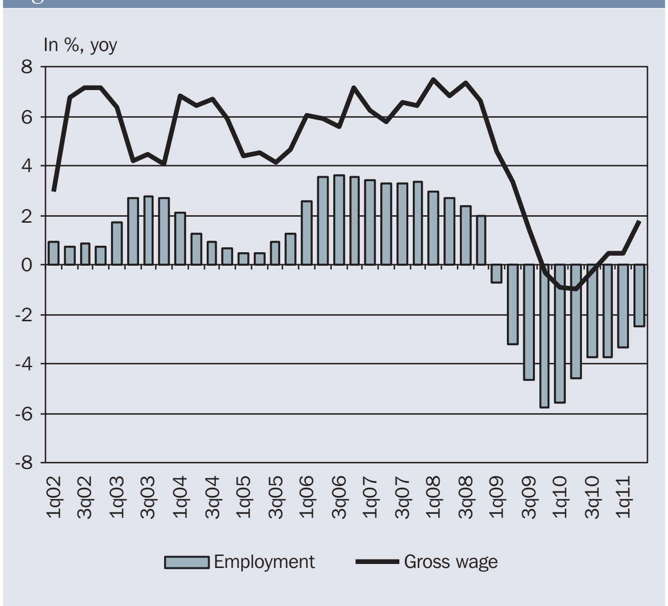
Total liquid assets have continued to rise at a steady growth path. In the first eight months 2011, seasonally adjusted M4 increased 2.8 percent, slightly underperforming last year's growth. In August, M4 was 4.2 percent higher than a year ago. Foreign currency deposits contributed with 1.4 percentage points to that growth. However, when a 2.7 percent depreciation of the HRK/EUR exchange rate is taken into account, foreign currency deposits actually slightly declined for the first time in five years. On the other hand, kuna savings and time deposits recorded an 8.7 percent year-on-year rate increase, the highest since the outbreak of the crisis. An increase in total deposits was driven entirely by the household sector, while the enterprise sector, still troubled with arrears collection, continued with

Figure 4 NUMBER OF UNEMPLOYED PERSONS



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

Figure 5 TOTAL EMPLOYMENT AND AVERAGE GROSS WAGE



Source: *Croatian Bureau of Statistics.*

Box 1 PENSION ADEQUACY IN CROATIA: CHALLENGES AND OPPORTUNITIES

Pensions in Croatia, expressed in relation to wages, will be much lower in the future if the current pension system remains unchanged – argues the study on pension adequacy presented recently by the Institute of Economics, Zagreb (available in Croatian at www.eizg.hr).

An ageing population, low employment rates and large structural imbalances within the public PAYG system that continuously runs deficits are the permanent challenges of the Croatian pension system and have already sparked a pension reform. The pension system was radically changed in 1999, when the parameters of the existing public PAYG system were substantially revised and again in 2002 when the PAYG system was complemented with private fully-funded, defined-contribution schemes that have become known as the second (statutory) and the third (voluntary) pillar.

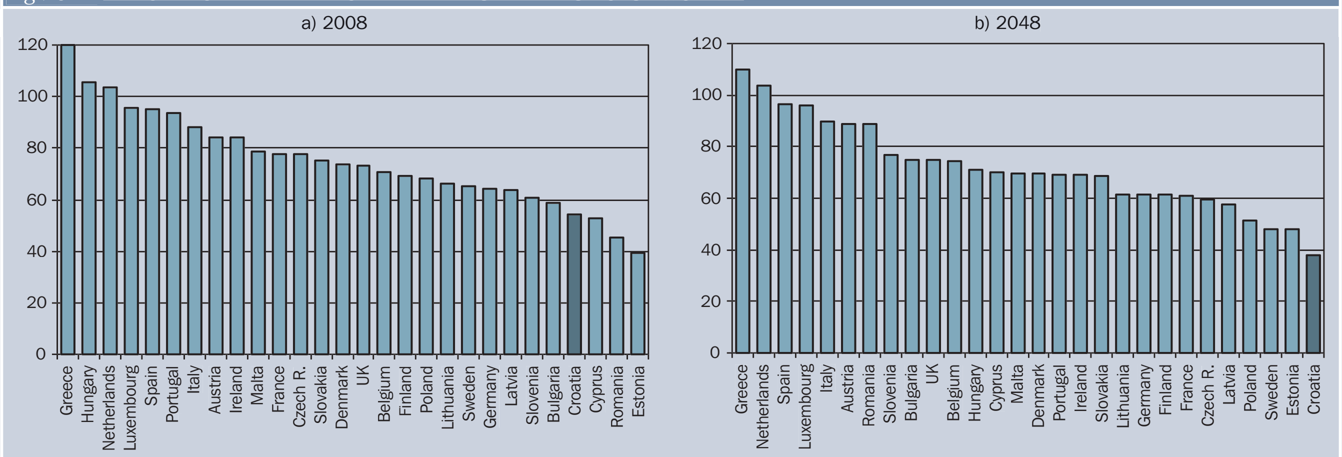
A large majority of current pensions are accrued exclusively in the PAYG system, i.e., in the first pillar, but gradually there will be more and more combined pensions – those that are paid in part from the first and in part from the second pillar. At the moment, there are around 1,000 pensioners that receive combined pensions under an early retirement scheme. The first combined old-age pensions are expected to be issued in 2012. According to the study, these combined (two-pillar) pensions will be approximately 25 percent lower than one-pillar pensions for the worker of comparable employment and earnings profile. The study argues that inappropriate parameters used in the calculation of the basic pension from the public PAYG scheme are responsible for the gap, while the second pillar has performed reasonably well and cannot be blamed for the lower combined pensions.

The study presents prospective pension incomes based on the statutory insurance schemes up to 2050. A hypothetical male worker, who has received wages equal to the national average wage over his entire working life and retires in 2010 at the age of 65 after 40 years of employment, is estimated to receive his first pension in the amount of around 55 percent of his last net wage, i.e., at a so-called net replacement rate of 55 percent. Projections for a worker with the same characteristics who retires in 2050 indicate a net replacement rate of only 38 percent. Although most European countries will face decreasing replacement rates in the future, Croatia is starting off with a relatively low current rate and its further deterioration would result in the lowest replacement rate in Europe by the mid of the century (Figure B1).

Projections of future aggregate pension expenditures show that Croatia may expect decreasing expenditures expressed as a percentage of GDP, from 10.6 percent in 2010 to around 8 percent in 2050, including second pillar expenditures. Expenditures of the public PAYG scheme in 2050 would be around 5 percent of GDP. Deficit of the PAYG scheme, which was 4.9 percent in 2010, is expected to prospectively narrow and cease by 2050. Such unusual dynamics from a European perspective, with a declining expenditures pattern, will be achieved mainly through a reduction of the relative pension level that is strong enough to counterbalance the effects of the ageing population.

The study proposes certain steps to be taken within the existing multi-pillar system in order to ensure both adequate and sustainable pensions, and projects the future benefits and fiscal costs of the proposed measures. It concludes that only a shared responsibility between the population (longer working life, increased personal savings, etc.) and the government (better designed pension system) could increase future retirement incomes at sustainable fiscal costs.

Figure B1 THEORETICAL NET REPLACEMENT RATES: THE BASE-CASE WORKER



Notes: *The base-case worker is a single male that works full time for 40 years, receives the average wage paid in the country over his entire career and retires at the age of 65. Reference years for Croatia are 2010 and 2050. The net replacement rate is defined as pension income in the first year of retirement expressed as a percentage of the wage earned in the last year of employment.*

Sources: *European Commission (*Joint Report on Pension - Country Profiles*, 2010) for EU countries and EIZ for Croatia.*

deposit erosion. Within the narrow money aggregate, households were again the driving force with their demand deposits rising 9.1 percent year-on-year.

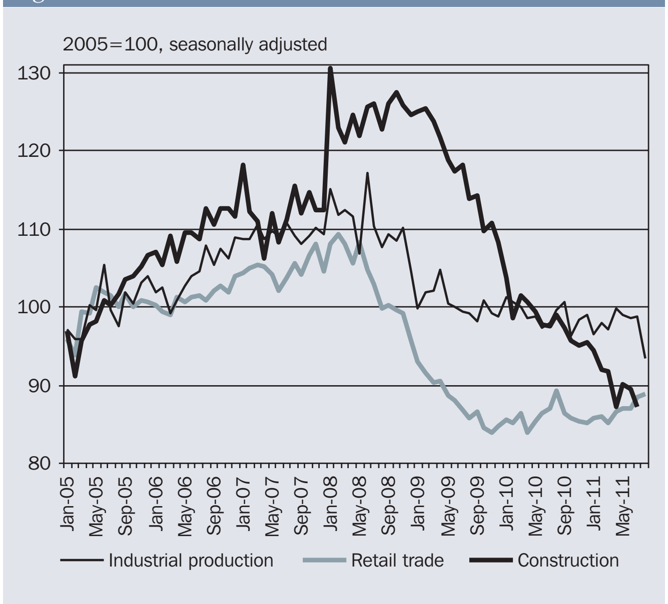
Credit activity remains sluggish.

The July appreciation of the HRK/CHF exchange rate of over 20 percent expanded the total amount of loans expressed in HRK but it also increased annuities for CHF-linked credit holders. Difficulties in paying the annuities culminated in mid-August when the Government and banks agreed to allow debtors to repay the existing debt above a certain exchange rate ceiling via the so-called "balloon" credits. In line with the CHF appreciation in July and the fact that a large share of loans is indexed to HRK/CHF, total credits increased by 7.9 percent year-on-year, the highest rate in two and a half years followed by 6.8 percent in August. After adjusting for the exchange rate, the growth was much lower. In fact, credits to households decreased, while corporate and sovereign loans moderately increased. The structure of corporate loans suggests that credit active companies are either large and/or public, while small and medium-sized enterprises are still trapped in illiquidity and in serious funding needs. On top of that, in the last three months the HBOR (Croatian Bank for Reconstruction and Development) did not provide new corporate loans nor did it hold a single credit auction.

Unusual summer depreciation of HRK/EUR exchange rate.

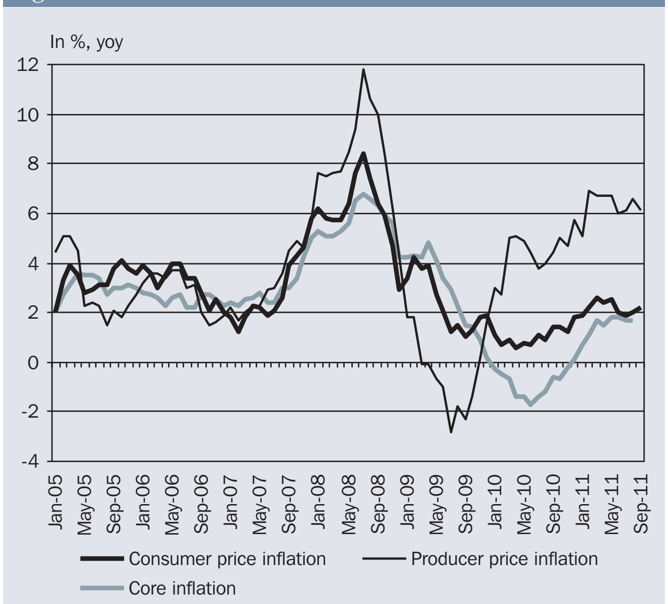
Although the HRK/EUR exchange rate regularly appreciates in the summer, this year it depreciated in both July and August. Foreign exchange inflow from tourism and speculations on hefty sovereign and public companies borrowing in foreign currency were not enough to offset depreciation pressures arising from a strong foreign currency funding demand, Ministry of Finance EUR-linked treasury bills downsizing and rising fiscal, EMU and global risks. As a result, the central bank intervened in July and again in September by selling foreign exchange in the amount of EUR 419 million (HRK 3.1 billion). Foreign exchange interventions had only a limited effect on the exchange rate and short-term interest rates. During the third quarter interest rates persisted below 1 percent for overnight loans. On October 12, the CNB raised the mandatory reserve rate from 13 to 14 percent, sterilizing thereby additional HRK 3.1 billion. The HRK/EUR exchange rate reacted instantly to this measure by dropping below 7.5. At the same time, short-term interest rates were pushed up, with the ZIBOR one-week rate reaching 4.1 percent in the first half of October. Foreign exchange instability has moved the central bank away from monetary easing. On the other

Figure 6 REAL SECTOR DEVELOPMENTS



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

Figure 7 INFLATION



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

hand, the Ministry of Finance has switched from one-year to three-month treasury bills and diversified the maturities of their foreign exchange exposure. This action has not helped reduce depreciation pressures since investors do not seem to be satisfied with the offered maturities and prefer to build long EUR positions on the foreign exchange market.

Inflationary pressures reduced.

The worsening of the global economic outlook coupled with commodity prices cooling down has eased pressures on Croatia's import prices. Moreover, prolonged household deleveraging stopped domestic prices from rising. In September, CPI inflation amounted to 2.2 percent when compared to the same period a year before. At the same time, producer price inflation reached 6.1 percent, reflecting rising energy prices. However, when compared to August producer prices stayed unchanged. Unfavorable labor market conditions and the ongoing consumer pessimism keep the core inflation subdued. However, throughout 2011 strong base effects have been pushing a year-on-year core inflation to positive rates. The latest data for August reveal that core prices advanced by 1.7 percent when compared to the same month a year before.

General government revenue growth turned positive in the second quarter…

A declining trend in total general government revenues that started in 2009 seems to have reached an end. Although a 4.2-percent year-on-year fall in the first quarter 2011 did not suggest so, the second quarter revenues were 0.5 percent higher than in the same quarter last year. However, over the first half of the year total revenues were still 1.8 percent lower than in the first half 2010. The second-quarter year-on-year increase came from tax revenues, which increased by about 1 percent, driven by a 59-percent rise in profit tax revenues. This is mainly a consequence of better business performance. For example, according to the FINA (Financial agency), companies' earnings before taxation were 14.2 percent higher in 2010 than in 2009. All other major tax revenues fell compared to the same quarter previous year. The personal income tax and total excise revenues were down by 3.8 percent. Even the VAT revenue, which did not decrease throughout the whole last year, fell in the second quarter by 1.1 percent. However, taking the first half of the year as a whole VAT revenues were 1.8 percent higher than in the first half of 2009.

… with expenditures on the rise again.

Following a 2.8 percent year-on-year decrease in total expenditures in the first quarter this year, a 3.2-percent rise was recorded in the second quarter. It was driven mainly by higher subsidies (25.2 percent), interest payments (12.2 percent), purchases of goods and services (8.9 percent), and compensation of employees (2.1 percent). Cumulatively, over the first half of 2011 total expenditures were slightly higher than in the first half of 2010. These developments brought about a HRK 6.5 billion deficit, which is 21.6 percent higher than at the end of June last year. This makes about one third of the total deficit planned for 2011. Concerning its financing, there were two debt issues in the first half of the year - the first one in March (10-year US$ 1.5 billion bond) and the second one in June (7-year EUR 750 million bond) - with the rest being financed mainly by bank loans. Strong borrowing continued in the third quarter as well, with two domestic issues in July (HRK 1.5 billion until 2016 and EUR 600 million until 2022).

2 Policy Assumptions and Projections Summary

Renewed financial instability…

Only three months ago, the world economy seemed to be in a rather good condition. Global growth decelerated but that was in line with expectations following a strong post-crisis recovery in 2010. However, as the eurozone sovereign debt crisis unfolded, and due to the way it has been handled so far, even a new recession does not seem unlikely. In a globalized world where financial markets are sensitive to almost every piece of information, the speed of actions undertaken by EU policy-makers becomes crucial to reestablish confidence. At the moment, it seems that the long-awaited rescue plan will include waiving up to 50 percent of the Greek debt, recapitalization of the affected banks as well as strengthening of the European Financial Stability Facility in order to prevent contagion to other economies. In line with these developments, projections for the world economy and in particular for the eruozone have been continuously revised downwards. The latest IMF projections (*World Economic Outlook*, IMF, September 2011) suggest that the eurozone might rise by 1.6 percent in 2011 before slowing down to 1.1 percent in 2012.

… causes international environment outlook to deteriorate.

In line with the deteriorated international environment, Croatia might expect weaker foreign demand, reduced foreign capital inflow, more stringent international financing conditions but also somewhat lower pressures from the world energy and food prices. Croatia's internal scene is currently dominated by the upcoming parliamentary elections, scheduled for the beginning of December, whose outcome will determine the economic policy over the next four years. So far, economic programs of the main political parties are focused on investment- and employment-friendly policies. In spite of pre-election promises, a change in trends cannot be expected in the short-run. Due to a lack of restructuring in a number of companies, especially state-owned ones, problems might even intensify, thus posing a risk to economic recovery.

Inevitable fiscal consolidation.

Both the ruling and opposition parties have concluded that the pre-election time is not the right time to announce fiscal consolidation and structural reforms with all their painful short-term consequences. However, we believe that they will be undertaken in the first year of the new Government's mandate as in the absence of serious fiscal adjustment external borrowing might be jeopardized. Temporary budget financing for the first quarter 2012 will amount to a quarter of the revenues realized this year, which is, by itself, restrictive. As for this year, budget revision will almost certainly not take place, while mismatches in planning will be resolved through internal budget reallocations. Monetary authorities are expected to remain focused on the exchange rate stability, with fluctuations that will not allow for pressures on prices to build up, which might limit their previous efforts for monetary easing.

GDP projected to rise 0.5 percent in 2011 and 0.8 percent in 2012.

Short-term prospects of the Croatian economy seem more pessimistic now than three months ago, which is reflected in significant downward revision of our projections. In addition to the deteriorating international environment, this is driven by consumer and producer pessimism as well as a slowdown suggested by the latest high-frequency indicators. Although we expect a positive year-on-year growth rate in the third quarter, mostly due to tourism revenues, uncertainties rise regarding the fourth quarter as well as next year. Our projection assumes that financial stability in Europe will be restored. As a result, we project a weak and unbalanced but still positive growth of 0.5 percent for 2011 as a whole. To a certain extent, this rise in GDP will be underpinned by the pre-election fiscal expansion. If financial stability is retained and unexpected changes in economic policy do not take place, weak growth should continue in 2012 reaching 0.8 percent.

Positive contribution of net exports in 2011.

In 2011, the main contribution to growth should come from net exports, although the volume of both exports and imports might be lower than in the previous years. However, a decline in imports will be more pronounced, around 6 percent, while a decline in exports is estimated at slightly above 1 percent. Imports contraction is due to weaker domestic demand, especially investment demand, while a contraction in exports is related to some sector-specific problems such as shipbuilding. Exports of services should register a significant increase due to revenues from tourism. Therefore, the current account deficit is projected to narrow to 0.7 percent of GDP. In 2012, we expect improved export and import performance. They are both projected to rise by some 2 percent. This would cause the deficit to slightly increase to 0.8 percent of GDP.

Personal consumption expected to improve next year.

A positive turn in personal consumption was observed already in summer 2011. However, due to its low level at the beginning of the year, we expect a decline in personal consumption for the year as a whole. In 2012, personal consumption should register modest positive growth of 0.8 percent relying on improved consumer sentiment and better financing conditions. In 2011, government consumption reflected higher needs related to the conclusion of negotiations with the EU as well as pre-election consumption. It might therefore exhibit a rise of 0.5 percent. However, 2012 should mark the beginning of fiscal consolidation induced by financial reasons and implementation of the Fiscal Responsibility Act.

Investment recovery postponed.

Although we have expected investment recovery to take place this year, now it seems that it will be postponed for the next year. This year's trend has been extremely negative and investments might fall by as much as 7 percent in 2011. Next year should bring a turnaround and a small increase underpinned by better climate and the expected EU membership.

Difficulties to remain on the labor market.

Labor demand will keep declining as long as economic recovery does not strengthen. Since this is not likely in the near future, difficulties reflected in a high unemployment rate will prevail this and next year. At the same time, we expect labor supply to be lower. Namely, the young cohorts of the labor force are likely to choose additional schooling; the older cohorts may opt for earlier retirement, while the rest could leave the market for various reasons. In combination with labor market measures expected in the next year, registered unemployment should stabilize and decrease towards the end of 2012, contributing to a decline in the unemployment rate from 18.0 percent expected this year to 17.6 percent next year. However, the situation on the labor market will remain poor as long as new productive employment does not take place. The average real wage is expected to stagnate in the 2011-2012 period.

Table 2 SUMMARY OF PROJECTIONS

	2011	2012
Real GDP (% change)	**0.5**	**0.8**
Real private consumption (% change)	-0.3	0.8
Real government consumption (% change)	0.5	-0.8
Real investment (% change)	-7.3	0.8
Exports of goods and services (constant prices, % change)	-1.2	2.5
Imports of goods and services (constant prices, % change)	-5.9	2.2
Current account balance (% of GDP)	-0.7	-0.8
Consumer prices (% change, pa)	2.2	2.4
Exchange rate, HRK/EUR (pa)	7.43	7.45
Unemployment rate (registered, %, pa)	18.0	17.7
General government balance (ESA95 definition, % of GDP)	5.5	4.5
Broad money, M4 (% change, eop)	6.0	7.0
Total domestic credit (% change, eop)	7.5	9.0

Notes: *Cut-off date for information used in the compilation of projections was October 10, 2011.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Weak growth prospects to press inflation down.

The global economic slowdown and a relatively weak domestic demand will push inflation down. The major uncertainties are related to administratively controlled prices, either those controlled by local authorities, such as the prices of public transportation and water utilities, or by the central government such as electricity prices. In the election year, these prices are usually kept unchanged, but price hikes might occur later, especially due to losses cumulated in public utility companies during the crisis. Overall, price stability will not be endangered but a mild increase in the inflation rate from 2.2 percent this year to 2.4 percent the next year is foreseen.

Depreciation pressures will not fully disappear.

Recent liquidity sterilization is expected to stabilize the HRK/EUR exchange rate but depreciation pressures will not fully disappear this year. External debt service requirements and hefty government refinancing needs due in December and January could build up depreciation pressures, while the anticipation of corporate foreign currency borrowing and the CNB policy stance will give support to the domestic currency. We expect that household credits will not recover by the end of 2011 due to a moderation in real wages, high household deleveraging and job market uncertainties, while the private corporate sector might accelerate its investment and loan market activity. The Government, on the other hand, might push up short-term debt financing due to parliamentary elections. To sum up, this year we anticipate broad money to grow by 6 percent and total domestic credits to outrun with a 7.5 percent year-on-year increase. In the next year, we expect broad money to grow by 7 percent and lending activity to increase by 9 percent.

Fiscal prospects depend upon political will and international environment.

Developments on the revenue side of the budget will determine this year's fiscal deficit. It is so because total expenditures are not to exceed the last year's level of HRK 122 billion. Provided there was no significant underperformance in VAT collection in the third quarter during the tourist season, and that such dynamics will continue in the last quarter, this year's total revenue should not depart significantly from the plan. The Government's confidence that there will be no new debt issues by the end of the year does not appear to be unreasonable. This means the total general government debt (including guarantees for shipyards' debt) should not rise above 48 percent of GDP, at least not significantly. Moreover, this year is likely to pass with no upward budget revision, a situation we have not seen since 1997. Thus, the general government deficit - measured according to the ESA95 methodology - will not exceed 5.5 percent of GDP as an upper bound. As for 2012, one should expect a reduction in deficit, yet hardly below 4 percent and likely to be about 4.5 percent of GDP. This prediction is conditional on the willingness and ability of the new Government to cut total expenditures, thereby reducing the ratio of total expenditures to GDP. A sign of this willingness on the part of the current Government is expressed in the recently released *Guidelines for Economic and Fiscal Policies in the Period 2012-2014*. In addition, it seems that the major opposition parties also recognize the need for a stronger consolidation as well as the need to comply with the Fiscal Responsibility Act. However, it should be added that a reduction in deficit would be extremely difficult to achieve if the sluggish economic activity and, consequently, underperformance of tax collection continue in 2012. As for the public debt dynamics, it could slow down if financing would rely on non-debt sources, privatization of (partly) state-owned enterprises and the selling of real property.

3 Uncertainties and Risks to Projections

Uncertainties rise; another recession possible.

We have assumed that financial stability in the eurozone will be restored soon. However, if it does not prove so, Croatia's economic growth might turn negative again. Having in mind the recent reports on the state of a number of European economies, the possibility of another recession, supported by external factors, cannot be fully discarded. Internal economic deficiencies make the economy highly vulnerable to external shocks. Differently from 2008, instead of an anti-cyclical fiscal policy, this time we can expect fiscal consolidation in advanced economies with spillover effects on related economies, including Croatia. Due to the already long recession and a lack of healthy grounds for recovery, the negative consequences of such a scenario for Croatia might be strong. This would lead to a further decrease in employment, while painful structural reforms would have to be undertaken under much worse conditions.

Question marks over the economic policy in the post-election time.

Although both the ruling and opposition parties recognize a highly tense economic situation and the necessity of unpopular measures towards fiscal consolidation and structural reforms, the upcoming December elections make them unwilling to reveal much about the measures and their implementation once they take power. Consequently, uncertainties remain over the economic policy in the post-election time.

The short-term benefits of EU accession might be weak.

Following the end of accession negotiations, Croatia will probably sign the accession agreement with the EU in December. All major political players in Croatia are in favor of the EU, and the referendum on accession, which is to take place at the beginning of the next year, is expected to have a positive outcome. The agreement ratification process in the national parliaments of EU Member States should end with Croatia's full membership in mid-2013. However, uncertainty remains as to the extent to which Croatia will benefit from the accession in the short-run, and whether it will improve its economic prospects, speed-up growth and increase the living standard of its population. Due to the fact that the political and economic conditions have changed substantially since the last rounds of EU enlargement, short-term benefits for Croatia might be weak.

Rating agencies expect fiscal consolidation to take place.

The uncertainties in the eurozone will likely affect the Croatian fiscal prospects in terms of both revenue-generating economic activity and the cost of borrowing. Measures at the Government's disposal, primarily those directed towards the consolidation of public finances, could offset the external effects to some extent. Yet, there is uncertainty in this respect as well. One is related to the possibility of hidden obligations, or obligations that have been rolled over to the next year which would substantially reduce the maneuvering room of the new Government and might ask for stronger fiscal consolidation, with consequently negative short-term effects on the overall economy. An eventual failure of fiscal adjustment could have severe adverse effects on the access to international sources of finance, as the major rating agencies have already announced that Croatia's credit rating may be downgraded.

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