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Croatian Economic Outlook
Quarterly

1 Recent Developments

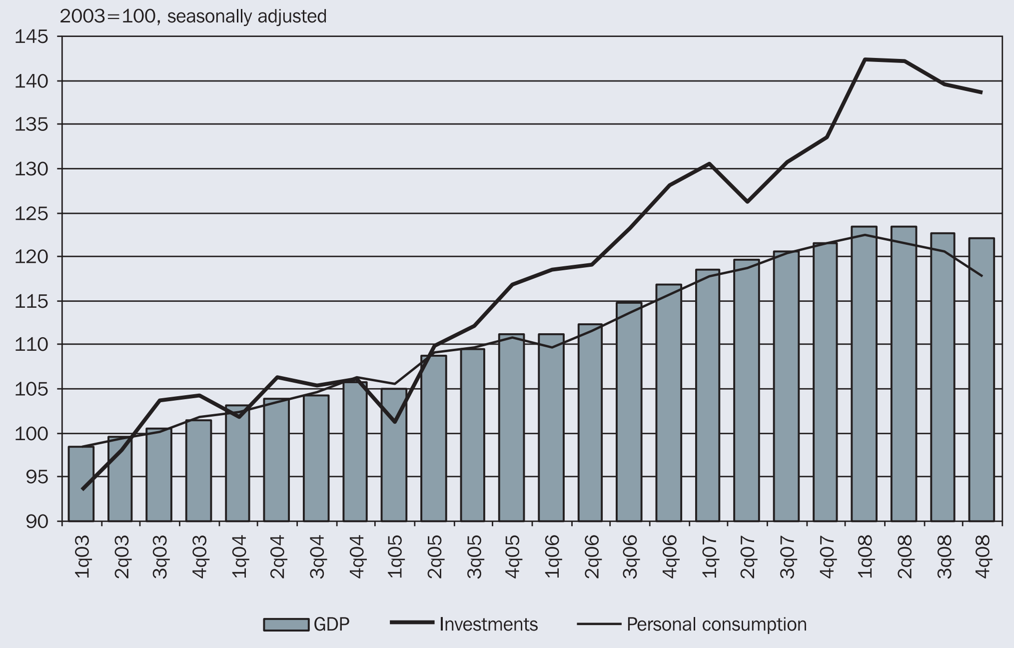
Sharp decline in domestic demand…

In the fourth quarter 2008, output contracted for the second quarter in a row, confirming that the Croatian economy has entered recession. On a quarter-on-quarter basis, the seasonally adjusted GDP dropped by 0.4 percent in the fourth quarter, following a 0.7 percent decline in the third quarter. The main factor behind the GDP contraction was a considerable decline in domestic demand, while a drop in imports led to a positive contribution of net exports to GDP, which was not strong enough to reverse a negative trend in overall activity. However, the GDP level in the fourth quarter 2008 was still 0.2 percent higher than a year ago, while its growth for 2008 as a whole amounted to 2.4 percent. The beginning of this year saw a further decline in economic activity. Industrial production, retail sales volume, and merchandise trade have experienced sharp declines, implying a tough year ahead. On the positive note, Croatia's financial system has overcome initial difficulties and seems to be coping well with the global turmoil.

… driven by personal consumption.

Personal consumption has contracted stronger than previously expected. Seasonally adjusted quarter-on-quarter data show that its decline started as early as the second quarter 2008, while in the fourth quarter it dropped by over 2 percent. A decline of this

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

magnitude has not occurred since 1999, and implies a strong carry-over effect of the negative trend into this year. Household sector has adjusted to the deteriorating prospects much faster than many other parts of the economy. Partially, that was a reaction to the surge of pessimism about the state of the global and domestic economy at the beginning of the fourth quarter.

Government consumption not yet affected.

In contrast to other parts of the economy, government consumption rose steadily during the last year, even with a slight acceleration towards the year's end. An increase of 2.7 percent over a year was recorded in the fourth quarter, while a quarter-on-quarter increase measured by seasonally adjusted figures reached 1.2 percent. The Government deferred consumption in the first half of 2008 due to the provisional budget, but by the year's end, it let off the brake to fulfill its obligations. As a result, its dynamics was at odds with developments in the real sector. For 2008 as a whole, however, government consumption increased only by 1.9 percent, down from 3.4 percent in 2007.

Investments in fixed capital still resist recession.

By the end of last year, investments in fixed capital successfully resisted the negative trends recorded in the rest of the economy. A mild decline in seasonally adjusted quarter-on-quarter figures was actually observed in the second half of the year, but it was more pronounced in the third than in the fourth quarter. This might be due to intensified activity aimed at completing investment projects such as the five new indoor stadiums built for the Men's World Handball Championship. Year-on-year investments grew by 3.5 percent in the fourth quarter, while 2008 as a whole saw an 8.2 percent growth. Consequently, investments were a dominant upward force behind GDP growth in 2008. Differently from investments in fixed capital, adjustment in the level of inventories was quite rapid. Instead of strong stockbuilding in the fourth quarter, as it was usual in previous years, the fourth quarter brought stagnation in stocks compared to the previous quarter. This may be due to a fall in imports and lower expectations for 2009. Investments in fixed capital, taken together with changes in inventories, dropped by 3.4 percent year-on-year.

Severe decline in foreign trade; imports hit more than exports.

Following the third quarter contraction, Croatia's volume of international trade in goods and services declined severely in the last three months of 2008. Total exports fell by 2 and imports by 8 percent quarter-on-quarter, as measured by seasonally adjusted figures based on national accounts statistics. While exports exhibited sluggishness since the beginning of last year, downward adjustment in imports took place more recently after a solid increase in the first half of the year. In sum, the year 2008 brought a 1.7 percent exports growth and a 3.6 percent imports growth as well as a negative contribution of net exports to GDP growth. Merchandise trade statistics indicate that a sharp deterioration in trade continued in the first two months of 2009, when goods exports shrank by 14.5 percent and imports by 27.7 percent year-on-year in kuna nominal terms. Even if we exclude oil and refined petroleum products from the overall amount, as their prices have dropped, the figures do not change significantly.

Industrial production and retail trade volume retain steep downward trends.

Industrial production and retail trade volume have continued their steep downward trends. Following a quarter-on-quarter contraction of industrial production by 2.4 percent in the third and 1.2 percent in the fourth quarter 2008, industrial activity declined by additional 5.6 percent in the first two months of this year according to seasonally adjusted figures. The sharp downturn at the very beginning of the year was partly a result of disruption in gas supply due to the Russia-Ukraine dispute. Retail trade volume started to exhibit a sharp deterioration since early 2008, with a 3.2 and 5 percent decrease in the third and fourth quarter 2008, respectively, and an additional 5.2 percent in the first two months of 2009. A substantial decline in car sales, amounting to some 40 percent in the first quarter 2009 year-on-year, significantly contributed to such an outcome.

Table 1 MAIN ECONOMIC INDICATORS

	2007	2008	2008			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	5.5	2.4	4.3	3.4	1.6	0.2
Real private consumption (% change, yoy)	6.2	0.8	4.2	2.3	0.4	-3.2
Real government consumption (% change, yoy)	3.4	1.9	0.5	3.2	1.3	2.7
Real investment (% change, yoy)	6.5	8.2	9.8	12.6	6.6	3.5
Industrial output (% change, yoy)	4.9	1.2	3.6	3.0	0.2	-1.7
Unemployment rate (registered, %, pa)	14.8	13.2	14.5	13.0	12.2	13.1
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	6.3	6.4	7.6	5.3
Consumer prices (% change, yoy, pa)	2.9	6.1	5.9	6.6	7.4	4.5
Producer prices (% change, yoy, pa)	3.4	8.5	7.6	8.7	11.1	6.7
Average gross wage (% change, yoy, pa)	6.2	7.1	7.5	6.8	7.4	6.6
Exchange rate, HRK/EUR (pa)	7.34	7.22	7.29	7.26	7.18	7.17
Exchange rate, HRK/US$ (pa)	5.37	4.93	4.87	4.65	4.78	5.45
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,193	9,743	2,226	2,492	2,679	2,346
Exports of goods (EUR, % change, yoy)	8.6	6.0	8.8	7.9	13.5	-5.3
Imports of goods (EUR million)	18,627	20,610	4,791	5,599	5,411	4,809
Imports of goods (EUR, % change, yoy)	10.8	10.6	13.9	15.7	15.8	-2.1
Current account balance (EUR million)	-3,237	-4,454	-2,550	-1,823	1,859	-1,940
Current account balance (% of GDP)	-7.6	-9.4	-	-	-	-
Gross foreign direct investment (EUR million)	3,667	2,930	943	1,011	297	679
Foreign exchange reserves (EUR million, eop)	9,307	9,121	9,842	9,941	9,809	9,121
Foreign debt (EUR million, eop)	33,254	39,125	34,963	35,403	36,247	39,125
GOVERNMENT FINANCE*						
Revenue (HRK million)**	126,716	-	31,795	66,307	100,661	-
Expense (HRK million)**	118,771	-	19,296	60,881	92,974	-
Net = Gross operating balance (HRK million)**	7,946	-	2,499	5,884	7,687	-
Net acquisition of non-financial assets (HRK million)**	11,015	-	1,545	3,955	4,098	-
Net lending/borrowing (HRK million)**	-3,069	-	560	3,030	3,590	-
Domestic government debt (EUR million, eop)	8,605	9,965	8,892	8,955	9,029	9,965
Foreign government debt (EUR million, eop)	6,701	6,888	6,581	6,657	6,868	6,888
Total government debt (% of GDP)	35.7	35.6	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	19.3	-4.6	12.9	5.5	7.6	-4.6
Broad money, M4 (% change, yoy, eop)	18.3	4.3	14.4	11.1	14.7	4.3
Total domestic credit (% change, yoy, eop)	15.0	10.5	12.2	10.3	11.0	10.5
DMBs credit to households (% change, yoy, eop)	18.0	12.1	16.3	14.8	10.9	12.1
DMBs credit to enterprises (% change, yoy, eop)	10.2	12.3	7.4	5.0	10.7	12.3
Money market interest rate (%, pa)	4.1	5.5	4.5	2.8	3.8	10.7
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	8.0	7.6	7.6	7.6	9.1
DMBs credit rate for households, short-term (%, pa)	12.1	12.2	12.2	12.1	12.2	12.3

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: *Central Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

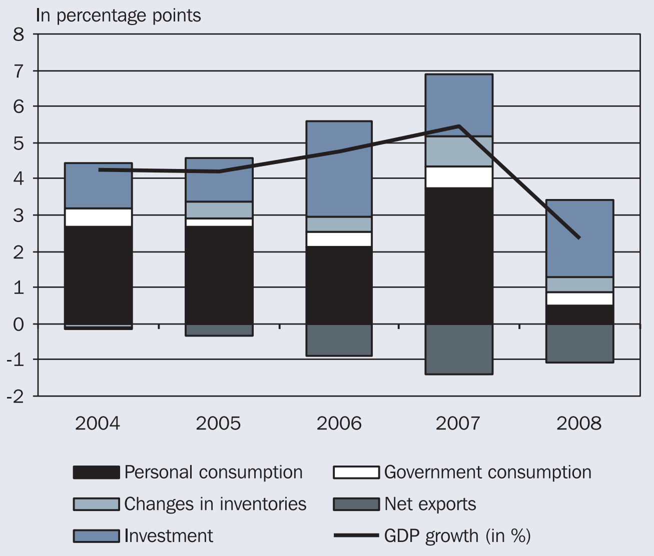
Rising unemployment.

Real sector developments have been translated to the labor market relatively quickly for the Croatian standards. The seasonally adjusted number of unemployed persons began to rise in November 2008, with the negative trend speeding up this year. In the first three months of 2009, the number of unemployed, adjusted for seasonal oscillations, increased by some 14,000, or approximately 6 percent. In March 2009, it was 4.6 percent higher than a year ago. Problems in the real sector are relatively quickly reflected in unemployment figures due to the inability of the economy to absorb new labor force and due to the canceling of temporary and fixed-term employment. As for now, a stronger wave of layoffs has not been observed, apart from the Pliva case (a pharmaceutical company) where some 700 employees lost their jobs, which was not directly related to the current crisis, but more to the global repositioning of the company. As for the number of employed persons in the corporate and public sector, it was 0.5 percent lower in February 2009 than a year ago. The manufacturing industry has suffered the most, with the employment decline of 4.7 percent. In trades, crafts, and freelances (approximation of the SME sector in Croatia), employment declined by 1.6 percent in the year up to February. The registered unemployment rate was 14.8 percent in February, 0.3 percentage points above last year's level.

Average wage continues to grow, although slightly slower than before.

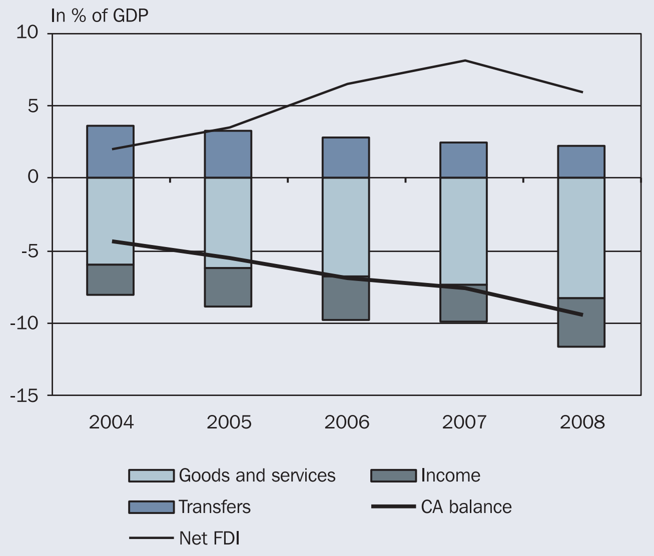
Wage adjustments, unlike those in employment, have been much weaker. The average wage growth in 2008 was relatively high as it amounted to 7.1 percent, more than in previous eight years. Inflation was also higher than before and, therefore, a wage increase came to only 0.9 percent in real terms. However, it could pose a problem for international competitiveness in the context of a stable HRK/EUR exchange rate and depreciation in some countries in Eastern Europe. In 2008, the average gross wage reached EUR 1,044, which was 8.4 percent above its average in 2007, marking quite a high wage rise in the current circumstances. Certain signs of deceleration in wage growth could be observed in the fourth quarter, when its year-on-year rate stood at 6.6 percent. In January, the average gross wage was 4.8 percent higher than a year ago. Such a nominal increase was lower than in previous months and it might indicate certain wage containment. However, the average wage is subject to a relatively large volatility due to various irregularly paid bonuses, so it takes some time to observe the underlying trend. Ultimately, it appears that wage adjustment is slow and does not follow the pace of overall economic contraction, which will put a strong downside pressure on employment in the near future.

Figure 2 DEMAND CONTRIBUTIONS TO GDP GROWTH



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

Figure 3 CURRENT ACCOUNT BALANCE AND NET FDI



Source for original data: *Croatian National Bank.*

Contraction of monetary aggregates.

Broad and narrow money aggregates recorded a significant decline in the last quarter 2008. According to seasonally adjusted figures, they shrank by 0.4 and 1.3 percent compared to the third quarter. The same trends have continued in 2009. As a result, narrow money declined 8.7 percent year-on-year in February 2009, while broad money increased 5.7 percent. A modest year-on-year increase in broad money was partly due to a contraction in narrow money and a shrinkage in kuna savings deposits. Since November 2008, kuna savings deposits have been declining, while foreign exchange deposits have recorded strong growth as a result of a long-lasting preference for the euro in uncertain times.

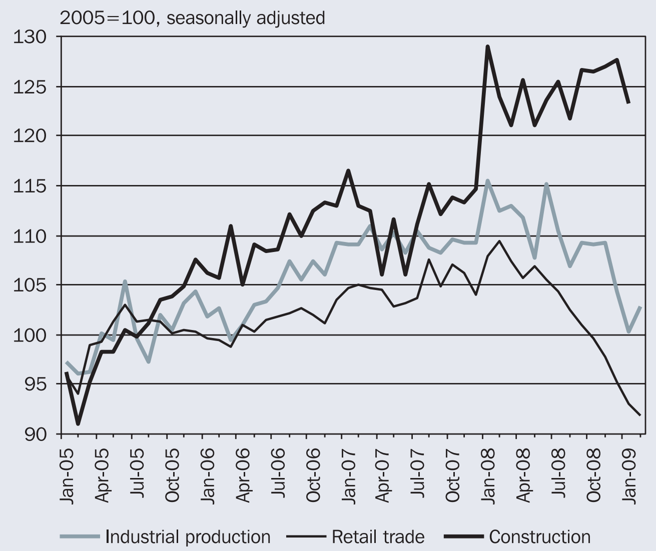
Credit growth in line with the central bank's target.

Domestic credit activity has maintained approximately the same growth path as at the beginning of 2008. Thus, in February 2009, total credits were 11.1 percent higher than a year before and in line with the CNB's target of 12 percent, although the observed increase is partly attributable to exchange rate movements. A change is, however, noticeable in the growth pattern of main credit components. In previous years, credits to households were rising faster than credits to enterprises, while this trend has reversed in recent months. Namely, credits to enterprises reached a 14.0 percent year-on-year growth in February 2009, while credits to households recorded a 10.0 percent growth. Such a trend could be explained by the fact that enterprises have substituted foreign with domestic borrowing due to adverse financing conditions in the international financial markets. In addition, households demand for credits has dried up due to lost confidence and unfavorable economic conditions. A change in pattern is also apparent in housing credits that increased 13.6 percent year-on-year in February, which is 8.5 percentage points less than in February 2008.

Stringent money market conditions combined with depreciation pressures.

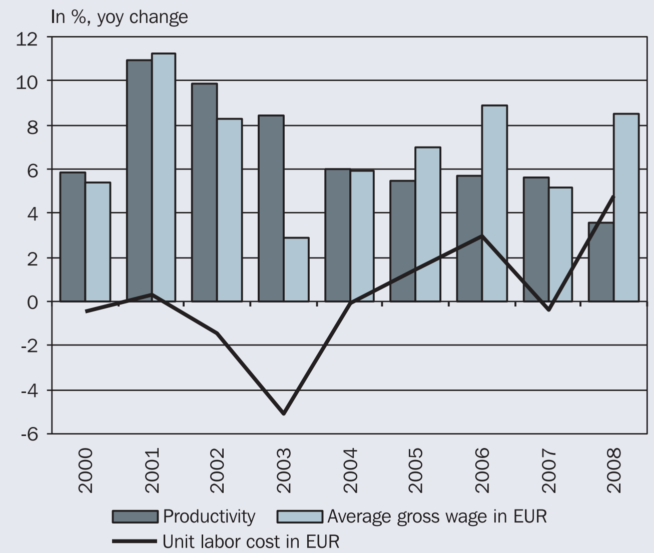
Already stringent money market conditions worsened at the beginning of 2009. Money market makers focused on the exchange rate developments. Namely, the HRK/EUR exchange rate started to depreciate in mid-December and by mid-February it lost approximately 4 percent of its value. The depreciation was a result of an inadequate foreign exchange liquidity supply caused by seasonal factors and Government's sizable foreign exchange requirements. In order to ward off depreciation pressures, the central bank undertook several measures. The amount of liquidity offered through repo auctions was reduced, resulting in kuna liquidity shortages and unprecedented money market interest rate hikes. The overnight ZIBOR shot up to 39.3 percent in February, which is an all time high.

Figure 4 REAL SECTOR DEVELOPMENTS



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

Figure 5 COMPETITIVENESS OF MANUFACTURING



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

Moreover, in late January and in February, the central bank intervened twice on the foreign exchange market, injecting more than half a billion EUR into the market. In addition, the central bank decreased the rate of minimum required amount of foreign currency claims from 28.5 to 20 percent, thus unfreezing over EUR 2 billion of commercial banks' liquid assets. This combination of measures proved successful and the HRK/EUR exchange rate stabilized around the rate of 7.43, which is 3.2 percent higher than in December 2008. At the end of February, the central bank intervened on the foreign exchange market once again, but this time in order to sterilize extra foreign exchange liquidity. Tensions alleviated somewhat in March, when the exchange rate stability was defended through reduced liquidity offered to commercial banks at repo auctions.

Box 1 METHODOLOGICAL CHANGES CAUSE HEADACHE TO ANALYSTS

At the turn of the year, just when recessionary trends in the Croatian economy accelerated, the Croatian Bureau of Statistics implemented several methodological changes in the process of collecting and calculating series on the real sector. They are mostly the result of harmonization with the EU statistical practice. However, they occurred at the worst possible moment, when analysts - with each new observation - try to understand the current state of the economy and uncover signs of possible change in trends. For that purpose, it is highly important, just as for any other kind of economic analysis, to have consistent and long enough data series. These problems have not been recognized by data providers in Croatia. Newly published series are not consistent with the old ones and still only short-length series are published according to the revised methodology.

Recent methodological changes refer to national accounts and the new NKD classification of economic activities. The revision in national accounts relates to the introduction of chained volume measures in annual and quarterly accounts. Additionally, GDP has been expanded by a measurable part of the grey economy and new estimates of imputed rent and financial intermediation services. As a result, GDP volume has increased by some 15 percent, while its dynamics has not been substantially changed. According to the new methodology, annual data are available since 1995 and quarterly data since 2000. The change in the GDP volume affects a large number of indicators that include GDP as denominator, such as indicators of external vulnerability, fiscal position, etc.

The other important change refers to the implementation of the *NKD 2007* classification of economic activities as the national version of NACE Revision 2 classification used in the EU and ISIC Revision 4 classification used worldwide. The revised classification is more detailed and reflects the growing importance of service activities. This has implications on both the comparability of data and the availability of large number of short-tem indicators (wages, employment, industrial production, retail trade volume, producer prices, etc.). Among them, industrial production index and retail sales volume are essential high-frequency indictors used to approximate the overall output of the economy before the data on GDP become available. The statistical office has published data on industrial production according to the new methodology since the beginning of 1998 - but only according to main industrial groupings and sections, while not according to individual divisions, e.g. industrial branches. Retail trade volume, that besides the *NKD 2007* classification now also covers crafts and is based on the new sample, is available upon request from the statistical office only since 2005. Total industrial production does not exhibit substantial differences in dynamics compared to the old data. However, this cannot be said for the volume of retail sales which now indicates that a sharp declining trend started in early 2008, substantially earlier and at a much stronger pace than was implied by the old data.

To conclude, analysts need long and consistent data series. Periods with insufficient revised data should be bridged by providing the data collected according to the old methodology. In addition, statistical data are not intended exclusively for professionals but also for the general public. Therefore, a more user-friendly data dissemination would be highly helpful to less specialized users while the electronic format would improve its transparence. Last but not least, high quality statistics is the essential precondition for good policy-making and if we miss the first one, the other will be jeopardized.

Andrea Mervar

Foreign debt continues to rise.

Gross foreign debt stood at EUR 39.1 billion at the end of December 2008, or EUR 5.8 billion more than at the end of 2007. Increasing its foreign indebtedness by 25.3 percent, the enterprise sector was still the main contributor to debt growth in 2008, although at a much weaker pace than in 2007 due to unfavorable climate on foreign financial markets. The foreign debt of banks rose by EUR 1.2 billion and was mostly generated during the last quarter 2008. This was due to a decrease in domestic sources as well as to the fact that the central government decided to finance its deficit on the domestic market. Foreign debt amounted to 82.6 percent of GDP in 2008, up from 77.7 percent in 2007.

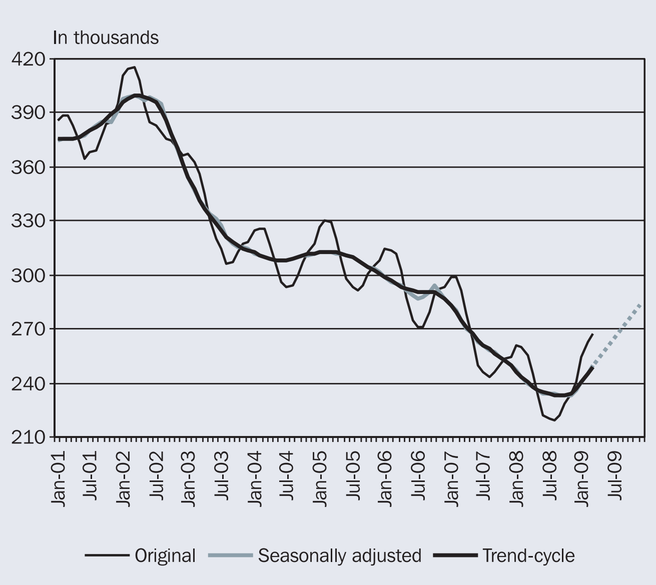
Inflationary pressures ease.

In March 2009, the year-on-year consumer price inflation stood at 3.8 percent, while producer price inflation recorded -0.1 percent. Producer and consumer price inflation were 4.6 and 12.1 percentage points lower than in July 2008, when the highest inflation rates were recorded. Consumer price inflation would have been even lower in the first quarter 2009 if it had not been for an increase in administratively regulated prices of public health services, which is related to the health care reform initiated in January 2009, and for an increase in the price of natural gas. Core inflation data confirm that inflation has maintained the momentum established in the last quarter 2008. Hence, core inflation was 4.3 percent higher in February than in the same month year ago and 0.2 percent lower than in January.

The 2008 deficit lower than planned.

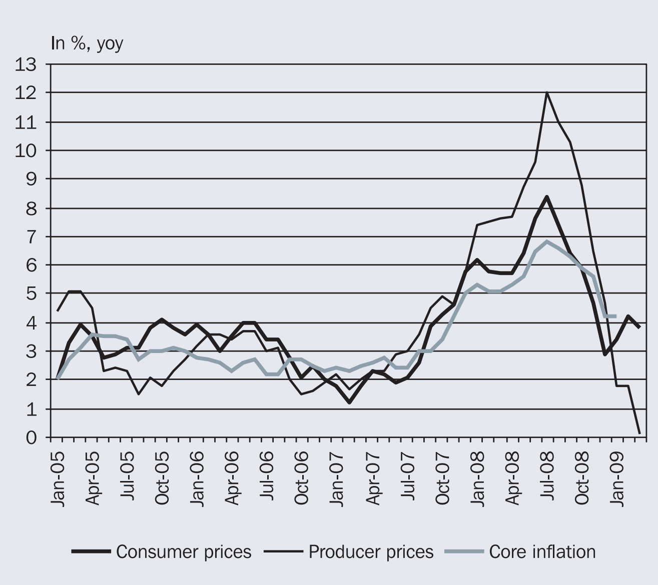
Public finances started to deteriorate during the second half of 2008. Consolidated central government revenues, without Croatian Motorways revenues, reached a 7.2 percent growth in 2008 as a whole, down from 10.6 percent recorded in the first six months of 2008. Negative developments in excise revenues, which occurred due to a decrease in car sales and excises on oil derivates as well as the general economic slowdown, contributed to a 2 percent weaker central government revenue collection than planned. Meanwhile, central government expenditures amounted to HRK 118.4 billion at the end of 2008, which is 1.9 percent lower than planned. Hence, the net borrowing of the consolidated central government (deficit according to the GFS 2001 methodology) stood at HRK -2.6 billion at the end of 2008, or 0.8 percent of GDP. In spite of a rather weak revenue collection, the Government managed to end the fiscal year with a lower consolidated central government deficit than planned by changing its spending plans and postponing capital investments.

Figure 6 NUMBER OF UNEMPLOYED



Source: *Central Bureau of Statistics and authors' estimates.*

Figure 7 INFLATION



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

Box 2 CROATIAN FOREIGN POLICY GOALS: ONE STEP FORWARDS, ONE STEP BACK?

Whilst one of the Government's major foreign policy goals was realized when Croatia joined NATO, the other key goal, that of accession to the European Union, continues to face problems.

Following the ratification of its membership by all NATO member states, Croatia attended the Strasbourg/Kehl summit on 3 and 4 April 2009 as a full member, together with Albania. The last obstacle was removed when a campaign by fringe political parties in Slovenia to collect enough signatures to force a referendum on Croatia's membership came to nothing.

Croatia received a broadly positive progress report from the European Commission in November 2008 and, crucially, a road map for the remaining accession negotiations which suggested that these could be concluded by the end of 2009. However, since that time Croatia has encountered major problems as a result of an effective blocking of the opening and closing of a number of chapters of the *acquis communitaire* by its neighbor Slovenia. The Slovenian Government has argued that documents lodged by the Croatian side in the context of accession negotiations pre-judge disputed land and sea border issues which have been outstanding since the two countries became independent in 1991.

In this context, the European Commission has been forced to become more proactive compared to its earlier position that the matter was a bilateral one. The EU's Enlargement Commissioner Olli Rehn has proposed establishing a mediation group led by former Finnish President Martti Ahtisaari although, recently, Ahtisaari has suggested that it may be preferable for the group to consist entirely of legal experts. Whilst both sides have formally accepted the broad proposal, they have been unable to agree thus far on the terms and mandate of the group, with Croatia insisting on a final resolution at the International Court of Justice in the Hague. The Slovenes have also suggested that Rehn's proposal involves a more ad-hoc resolution of the dispute. As a result of the impasse, the Czech Presidency, itself in some disarray as a result of the collapse of the Government, has postponed an intergovernmental conference, which is where chapters can be opened and closed, originally scheduled for 27 March 2009.

The Croatian Government has to tread a difficult path between maintaining support at home and not being seen to trade territory for membership, as well as convincing Brussels that they have a strong case and yet are willing to be flexible. There is increasing recognition that, even if there were enhanced efforts, it will be difficult to complete negotiations on time, bearing in mind a number of important benchmarks regarding the implementation of effective reforms to public administration, the judiciary, and shipbuilding restructuring. External conditions in terms of the economic crisis, expansion fatigue in the EU, and the Irish 'no' to the Lisbon treaty are also working against any prospect of Croatian membership in 2011. Rehn has recently suggested that Croatia could only join after all member states have ratified the Lisbon treaty. Thus far, Croatia has provisionally closed only 7 of the 33 main chapters of the *acquis*, a situation unchanged since December 2008.

Paul Stubbs

Budget revision came early this year.

Already at the very beginning of 2009, the Croatian Government was faced with serious fiscal problems due to revenue underperformance. The impact of the global financial crisis on economic activity, and primarily on retail trade and imports as the most important implicit tax bases, proved to be more serious than expected. Consequently, figures on revenues collected in the first three months are quite disappointing. On the other hand, expenditure plans did not anticipate a considerable revenue shortfall, so an increase in expenditures for wages and salaries, stemming from collective agreements and consequent higher pension payments, caused noticeable spending overruns. After the initial hesitation, the Government adopted a supplementary budget for 2009 in April, much earlier than usual. It is based on the assumption that GDP will decline by 2.0 percent, while inflation will amount to 2.6 percent in 2009. This year's budget revenue is projected at HRK 116.6 billion, or 6.5 percent less than originally planned, while budgetary expenditures were cut by 4.3 percent. A considerably lower level of expenditures entails a drop in the wages of civil servants back to the 2008 level and severe cuts in many budgetary items except pensions and social welfare payments. According to the ESA 95 methodology, the revised budget foresees an increase in the budget deficit from the previously planned -0.7 percent to -1.4 percent of GDP in 2009.

Public debt on the rise again.

The consolidated central government debt continued to accelerate during 2008. At the end of the year, public debt (without state guarantees) reached HRK 123.4 billion, which is 10.1 percent higher than at the end of 2007. In December, it recorded double digit year-on-year rates for the first time since 2005, mostly due to domestic public debt acceleration. Only in December 2008, domestic public debt increased 9 percent compared to November 2008, which is a larger increase than in the whole previous year. Tighter financing conditions on international financial markets and the need to finance its liabilities forced the Government to issue T-bills. In November 2008, the Government for the first time issued T-bills with two years maturity in the amount of HRK 2.7 billion. At the end of December, the total amount of issued treasury bills reached HRK 16.8 billion, 40.1 percent higher than at the end of 2007. However, it is already obvious that the Government's borrowing requirement will rise further in 2009, so it will not be a surprise if double digit rates continue to appear in this year.

2 Policy Assumptions and Projections Summary

World economy experiences deepest downturn in decades.

The global economy is experiencing its deepest downturn in many decades as the effects of the financial turmoil have influenced almost every country in the world. In the last quarter 2008, GDP fell significantly in all major advanced economies. Consequently, the World Bank has revised downwards its projections in March, and is now foreseeing a 1.7 percent decline in the world GDP and a 6.1 percent drop in the world trade volume in 2009. Gradual recovery, which is still surrounded by exceptionally high risks, should emerge in 2010. Eurostat's figures suggest that euro area GDP fell modestly in the second and third quarter 2008 but then contracted sharply - by 1.5 percent - in the final quarter. Activity in the euro area is likely to remain subdued for the remainder of the year. The March 2009 ECB projections foresee GDP growth between -3.2 and -2.2 percent in 2009, and between -0.7 and 0.7 percent in 2010. Global inflationary pressures have continued to diminish as a consequence of lower commodity prices and weaker global demand.

Sizable reduction in oil demand; oil prices failed to drop accordingly.

Brent crude oil prices stood at US$ 48.9 on 1 April, which is 24 percent higher than at the beginning of the year. The latest projections of the International Energy Agency indicate a sizeable reduction in oil demand as a result of downward revisions to the projections for both advanced and emerging economies. Global demand is now forecast at 83.4 million barrel per day, or 2.4 million below the 2008 level. However, oil prices have not declined accordingly, mainly due to OPEC members' commitment to production cuts.

External demand remains gloomy for Croatia; challenges on the domestic front rise.

In view of the global economic downturn and a sharp decline in global trade, the outlook for external demand remains gloomy. Namely, Croatia's main trading partners (Italy and Germany) have been particularly hard hit by the crisis. At the same time, challenges rise on the internal front. In the fiscal sector, there is a high degree of uncertainty regarding the outturn of government revenues and the consequent financing of the budget deficit. We expect that the Government would rather choose to increase the deficit (if there is a possibility to finance it) than to additionally reduce expenditures or rise the tax burden. Under these circumstances, and having in mind the Government's debt obligations, there is very little room for a fiscal stimulus to the economy. At the same time, monetary authorities are balancing between conflicting policy goals. On the one hand, they are trying to keep the stability of the exchange rate; on the other hand, they are trying to provide sufficient liquidity of the financial system.

GDP expected to decline 3.0 percent in 2009.

The global economic crisis has affected Croatia earlier and more severely than expected. In addition, prospects for the global economy have deteriorated over the past few months. Consequently, the forecasts have been revised downwards. We now expect GDP to decline by 3.0 percent this year, while the rebound of economic activity towards the end of the year should bring modest GDP growth of 0.9 percent in 2010.

Contraction in imports brings lower current account deficit.

Personal consumption is expected to remain subdued in the near term. Deteriorating labor market conditions, tighter financing conditions, overall economic uncertainty and weak consumer sentiment are likely to further depress personal consumption. The negative trends should, however, substantially weaken towards the year's end, partially as a result of more positive developments in the global economy. Following a decline of 5.4 percent this year, personal consumption is expected to rise by 1.7 percent in 2010. Government consumption has so far not been strongly affected by the slowdown of activity. However, the tight fiscal position should result in a 2.2 percent decrease this year and 1.4 percent next year. Investments remained resilient to recession in 2008, and therefore the adjustment in 2009 might be sharp, with a decline in investment activity amounting to 8 percent. However, the overall rebound of economic activity in 2010 should stop negative trends in investment. A strong decline in the foreign trade sector, with a 10 percent expected decrease in exports and 16 percent in imports in 2009, should allow for the closing of the current account deficit at 4.7 percent of GDP. In 2010, its share in GDP should remain the same, with a 2 percent rise in exports and imports.

Employment prospects deteriorate.

As for now, labor market adjustments have been stronger on the side of employment than wages. It seems that neither employers nor trade unions are ready to renegotiate existing wage arrangements, especially in the large-sized enterprise sector. Therefore, in times to come, jobs will be highly endangered due to the absence of a more flexible approach in sharing the burden of the crisis. We forecast the number of unemployed to increase by around 50,000 by the end of this year, or by about 20 percent compared to the end of 2008, and to reach 300,000 at the beginning of next year. The negative trends are expected to lessen in 2010, but not to vanish. The unemployment rate is expected to increase from 13.2 percent on average in 2008 to 14.6 percent in 2009 and 15.4 percent in 2010.

Wage growth should slow down.

In spite of the observed wage rigidity, we expect wage growth to slow down driven by tight market conditions in the private sector, wage cuts in some parts of the public sector, and the expected freezing of the minimum wage. In 2009 and 2010, the average wage rise will be halved to around 3.5 percent in nominal terms. The segmentation of the labor market will deepen as wages will preserve a high degree of rigidity in the sectors lacking competitive pressures. Other sectors will be exposed to a combination of wage adjustments and declining employment, which altogether will increase income inequality.

Lower inflation.

Inflation hike observed at the very beginning of this year is expected to be short-lived, so the remaining part of the year will bring lower inflation due to lesser pressures from the world and domestic market. On average, consumer price inflation is expected to remain at around 2.5 percent in both this and next year. Such a projection also takes into account the announcement of local authorities, mostly in large cities, that they will not increase the prices of community services that fueled inflation in previous years.

Broad money growth decelerates.

Broad money growth is expected to slow down substantially in 2009. However, we do not expect to see its nominal decrease as households and enterprises are now more inclined to save in foreign currency. This, in turn, will inflate broad money growth as it is expressed in kuna terms. Following a 2 percent increase in 2009, 2010 should bring gradual recovery and a broad money increase of some 7 percent. Total domestic credit is projected to grow slightly below the 12-percent target in 2009 due to decreasing demand and more stringent financing conditions. A part of the increase in total domestic credit, which is also expressed in kuna terms, while most of the credits are granted with the euro clause, will be a consequence of exchange rate adjustment. Assuming that the credit ceiling will still be in effect, credit growth is expected to accelerate from 9 percent in 2009 to 12 percent in 2010.

Government might need to borrow more than planned.

Since the Government made the budget revision based on a 2 percent GDP decrease, whereas our projection involves a sharper output decline, we predict further aggravation of this year's revenue collection. The budget revision foresees that revenues from VAT would shrink by 2.1 percent compared to 2008, but even such a gloomy projection seems to be quite optimistic taking into account current developments, e.g. a retail trade decrease, an increase in unemployment, a sharp decline of imports, etc. It has to be stressed that the official fiscal data for the first quarter are not available, and the exact size of decrease in tax revenues in that period is yet not known. If economic performance continues to be weak and budget expenditures strictly follow the plan, the Government could find itself in a situation where additional borrowing would be necessary. In such a highly uncertain environment, we project the budget deficit to widen to 2 percent of GDP.

Table 2 SUMMARY OF PROJECTIONS

	2009	2010
Real GDP (% change)	**-3.0**	**0.9**
Real private consumption (% change)	-5.4	1.7
Real government consumption (% change)	-2.2	-1.4
Real investment (% change)	-7.8	0.0
Exports of goods and services (constant prices, % change)	-9.9	2.3
Imports of goods and services (constant prices, % change)	-16.0	2.0
Current account balance (% of GDP)	-4.7	-4.7
Consumer prices (% change, pa)	2.5	2.5
Exchange rate, HRK/EUR (pa)	7.45	7.40
Unemployment rate (registered, %, pa)	14.6	15.4
General government balance (ESA 95 definition, % of GDP)	-2.0	-2.0
Broad money, M4 (% change, eop)	2.0	7.0
Total domestic credit (% change, eop)	9.0	12.0

Notes: *Cut-off date for information used in the compilation of projections was April 6, 2009.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

3 Uncertainties and Risks to Projections

If global recovery emerges in 2010...

Although most analysts believe the global economy will start recovering in 2010, the level of uncertainty remains exceptionally high. On the one hand, there is a possibility for an earlier rebound in the world economy due to undertaken policy measures in advanced economies as well as due to a decrease in commodity prices on world markets. On the other hand, there is a risk that the financial turmoil will have stronger effects on the real sector than anticipated which, in addition to emerging protectionist measures and large global imbalances, might prolong the crisis.

... how long will it take to affect the Croatian economy?

These past several months have shown that the Croatian economy is strongly dependent on developments in the international environment. However, there is also a risk that the global recovery might not instantly affect the domestic economy, at least not to a degree now expected because of the long-standing structural problems that have not been tackled yet. Since structural reforms have been substantially slowed down in the recent months, due to a standstill in the EU negotiation process and/or the May local elections, the global recovery might neither help the Croatian economy to recover soon nor to base its future growth on sound and sustainable grounds. Therefore, the recovery might be slower and weaker than now expected.

High refinancing obligations.

The financing of the foreign debt is becoming a rising challenge. The Government seems to be confident that it can sell the euro bonds on the international market in order to refinance its debt; but if it does not prove so, the problem might escalate as it will be an important indicator for the foreign investors' perception of Croatia. In addition, the major part of the EUR 12 billion debt due in 2009 rests on the banking and enterprise sector. Tight financial conditions will be the major obstacle in the attempt to refinance these obligations. However, the problem will not disappear in 2010 as the recent refinancing of the Government's debt was mostly of a short-term character.

Fiscal challenges build up even with the revised budget.

The Government could be faced with quite a challenge in achieving its planned budget deficit. Only few days after the budget revision, the media speculated on another revision in the fall this year. Such a scenario is not unrealistic, and if government revenues continue to underperform, further expenditure cuts would even signal the Government's commitment to control its finances.

What will be the outcome of the tourist season?

All the hopes are now put in a good tourist season, which is unrealistic in times of rising unemployment and falling living standards worldwide. Although our projections now imply a weaker export performance, including weaker revenues from tourism than last year, there is a high degree of uncertainty about the magnitude of contraction under the circumstances of reduced export demand. Revenues from tourism are highly important for the Croatian economy as they affect the disposable income of the population in tourist regions, the size of the current account, the magnitude of exchange rate pressures, etc. If the outcome is worse than now expected, it will have negative effects on a number of macro aggregates, including a sharper decline in overall output.

IMPRESSUM

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