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Croatian Economic Outlook
Quarterly

1 Recent Developments

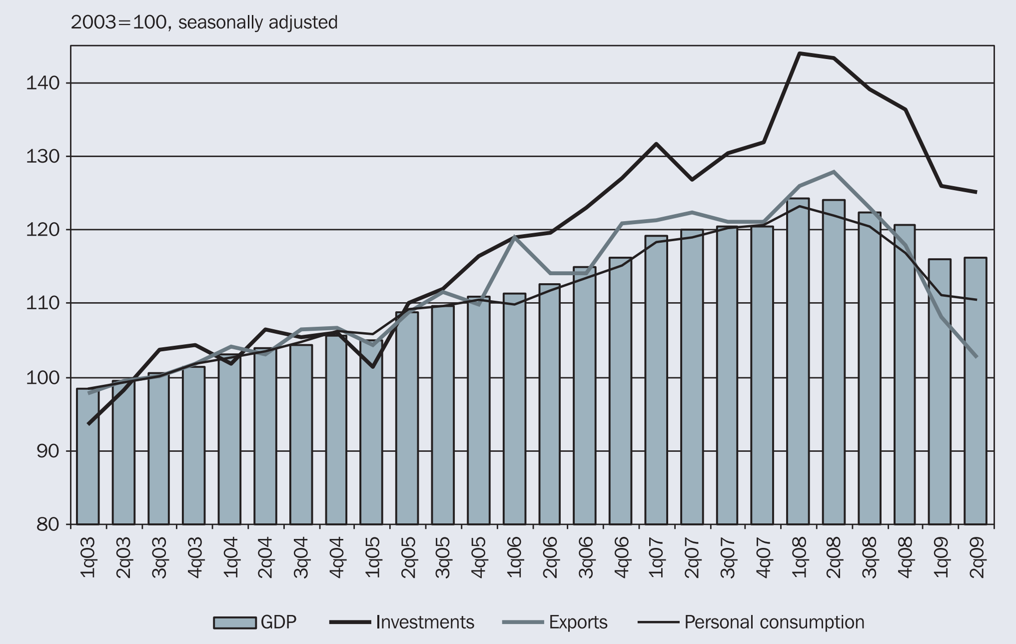
Economy reaches the bottom of recession.

The Croatian economy seems to have reached the bottom of recession as suggested by GDP figures for the second quarter and a number of high-frequency indicators. However, this does not suggest that we will see a swift recovery. Growth factors are still fragile and imply that the recovery will be slow and protracted. So far, neither domestic nor foreign demand has shown clear signs of improvement. Thus, unstable conditions and stagnation in major sectors of the economy are expected for the rest of 2009.

Weak signs of stabilization.

In the second quarter, GDP fell by 6.3 percent below its level a year ago, with domestic demand shrinking by 10.2 and foreign demand (exports) by 19.8 percent. At the same time, total imports fell by 24.7 percent, reducing the external exposure of the country through a lower trade deficit. However, seasonally adjusted GDP data reveal that economic activity was almost unchanged in the second quarter compared to the first one. This might signal that the economic fall is over. Additionally, seasonally adjusted figures on industrial production and retail trade volume indicate that the summer months saw stagnation after a decline that had lasted for more than a year.

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

Personal consumption contracts at a slower pace.

In the April-July period, personal consumption was 9.4 percent lower than a year ago, showing a substantial adjustment to negative shocks such as employment reduction, stagnation in wages and social transfers, and credit squeeze. Although there is no reliable data on the total disposable income of population, some indicators, in particular wages and pensions, suggest that household consumption has fallen much stronger than income, indicating the importance of consumer confidence. In spite of a large drop registered on a year-on-year basis, quarter-on-quarter seasonally adjusted data show that consumption declined by 0.5 percent in the second quarter, following a 5 and 3 percent contraction in the preceding two quarters, thereby pointing to the stabilization in consumption spending.

Following its counter-cyclical rise, government consumption levels off.

Government consumption has entered stagnation after it rose at the end of last year. In the second quarter, it was 1.2 percent higher than a year ago, while seasonally adjusted data point to stagnation compared to the first quarter. This is a result of the adjustment that the Government had to make being faced with severe financial constraints. The adjustment has been more linked to the provision of goods than services provided by government employees. Namely, employment in the public sector has not been affected by recession.

Decline in investments slows down.

An investment decline of 12.7 percent year-on-year in the second quarter following a 12.4 percent fall in the first quarter has contributed strongly to the overall economic fall. Nevertheless, seasonally adjusted data show a marked slowdown of the negative trend in the second quarter with a 0.6 percent decline over the previous quarter. This, in turn, indicates that investment activity is approaching the bottom of the decline. However, a high degree of uncertainty remains as the rest of the economy has been adjusting balance sheets primarily at the expense of investments.

Narrowing of trade and current account deficit.

Exports, and even more imports, have experienced a drastic volume reduction since the third quarter last year. This has been reflected in negative year-on-year growth rates and a clear negative trend as calculated from quarter-to-quarter changes of seasonally adjusted indicators. In the second quarter, seasonally adjusted exports volume (national accounts definition) dropped by about 5 percent, while imports fell by more than 4 percent over the first quarter. Reduced global demand has downsized total exports, while a depressed domestic demand, stringent financing conditions and large enough stocks have led to a drop in imports. Revenues from international tourism substantially influence overall developments in the exports sector. In the second quarter, the balance of payments data show that receipts from international tourism fell by 18.3 percent year-on-year. However, the third quarter result might be substantially better as suggested by physical indicators on the number of over-night stays which are at the approximately same level as last year. High-frequency data on merchandise trade in the June-August period show that goods imports and exports remained roughly unchanged, pointing to the end of the negative trend. A strong reduction in merchandise imports helped in narrowing the trade and current account deficit. In a year up to the second quarter, the current account deficit was 5.5 percent of GDP, while it was 7.8 percent in the first quarter and 9.3 percent in the fourth quarter last year.

Sluggish real sector activity.

Data reflecting developments in the real sector have been mixed, with the industrial and retail sector activity showing signs of stabilization. Industrial production contracted by 9.5 percent year-on-year in the second quarter, after having declined by 11 percent in the first quarter 2009. On a month-to-month basis, seasonally adjusted figures indicate an almost unchanged volume of industrial activity in July and August. Recent dynamics in the retail trade sector also points to a bottoming of the downward trend observed since March 2008. On a year-on-year basis, retail trade dropped by 16.4 percent in the second quarter 2009, following a 17 percent decline in the first quarter. However, the monthly seasonally adjusted volume of retail trade was stable in the June-August period. A slowdown

Table 1 MAIN ECONOMIC INDICATORS

	2007	2008	2008		2009	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	5.5	2.4	1.6	0.2	-6.7	-6.3
Real private consumption (% change, yoy)	6.2	0.8	0.4	-3.2	-9.9	-9.4
Real government consumption (% change, yoy)	3.4	1.9	1.3	2.7	3.9	1.2
Real investment (% change, yoy)	6.5	8.2	6.6	3.5	-12.4	-12.7
Industrial output (% change, yoy)	4.9	1.2	0.2	-1.7	-11.0	-9.5
Unemployment rate (registered, %, pa)	14.8	13.2	12.2	13.1	14.7	14.4
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	7.6	5.3	5.5	4.0
Consumer prices (% change, yoy, pa)	2.9	6.1	7.4	4.5	3.8	2.9
Producer prices (% change, yoy, pa)	3.4	8.5	11.1	6.7	1.1	-0.6
Average gross wage (% change, yoy, pa)	6.2	7.1	7.4	6.6	4.6	3.4
Exchange rate, HRK/EUR (pa)	7.34	7.22	7.18	7.17	7.41	7.36
Exchange rate, HRK/US$ (pa)	5.37	4.93	4.78	5.45	5.68	5.41
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,193	9,814	2,733	2,363	1,928	1,896
Exports of goods (EUR, % change, yoy)	8.6	6. 8	15.7	-4.6	-13.4	-23.9
Imports of goods (EUR million)	18,627	20,608	5,407	4,811	3,661	3,886
Imports of goods (EUR, % change, yoy)	10.8	10.6	15.8	-2.1	-23.6	-30.6
Current account balance (EUR million)	-3,239	-4, 385	1,917	-1,913	-1,837	-902
Current account balance (% of GDP)	-7.6	-9.3	-	-	-	-
Gross foreign direct investment (EUR million)	3,670	3,353	362	994	437	476
Foreign exchange reserves (EUR million, eop)	9,307	9,121	9,809	9,121	8,870	9,090
Foreign debt (EUR million, eop)	32,929	39,346	36,247	39,346	39,230	40,806
GOVERNMENT FINANCE*						
Revenue (HRK million)**	126,716	134,738	100,661	134,738	30,294	61,208
Expense (HRK million)**	118,771	130,259	92,974	130,259	32,476	65,911
Net = Gross operating balance (HRK million)**	7,946	4,479	7,688	4,479	-2,182	-4,703
Net acquisition of non-financial assets (HRK million)**	11,015	7,344	4,098	7,344	1,284	2,553
Net lending/borrowing (HRK million)**	-3,069	-2,865	3,590	-2,865	-3,466	-7,256
Domestic government debt (EUR million, eop)	7,992	9,202	8,435	9,202	10,269	10,510
Foreign government debt (EUR million, eop)	4,215	4,125	4,054	4,125	3,596	4,107
Total government debt (% of GDP)	28.5	28.5	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	19.3	-4.6	7.6	-4.6	-11.7	-12.3
Broad money, M4 (% change, yoy, eop)	18.3	4.3	14.7	4.3	3.3	1.1
Total domestic credit (% change, yoy, eop)	15.0	10.5	11.0	10.5	9.2	4.8
DMBs credit to households (% change, yoy, eop)	18.0	12.1	10.9	12.1	8.3	3.1
DMBs credit to enterprises (% change, yoy, eop)	10.2	12.3	10.7	12.3	11.9	7.8
Money market interest rate (%, pa)	4.1	5.5	3.8	10.7	14.3	6.1
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	8.0	7.6	9.1	9.9	10.1
DMBs credit rate for households, short-term (%, pa)	12.1	12.2	12.2	12.3	12.5	12.5

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.*

in construction activity has been delayed compared to the rest of the real sector, with contraction starting as late as the beginning of this year. The negative trend continued through the mid of the year, although with a slight deceleration. In year-on-year terms, construction activity dropped 4.6 percent in the second quarter following a 0.3 percent decline in the first quarter.

Employment drops.

The total number of employed persons fell by 4.1 percent over a year up to August this year, meaning that around 65,000 jobs were lost. The private sector has taken the entire burden of this adjustment. Employment in the unincorporated sector (the self-employed and a part of SMEs) fell by 5.2 percent, while the incorporated sector has experienced a 3.8 percent reduction in employment. In the manufacturing industry, employment contracted by almost 10 percent. In September, the number of unemployed persons registered at the Employment Service increased by 16.6 percent in year-on-year terms. These conditions are progressively deteriorating from month to month and so can be expected in the near future as there are no signs of weakening pressures. Although with a certain delay, the labor market has reacted to the crisis relatively strongly. At the same time, pressures on the pension system have also increased due to the stronger than usual inflow of new pensioners.

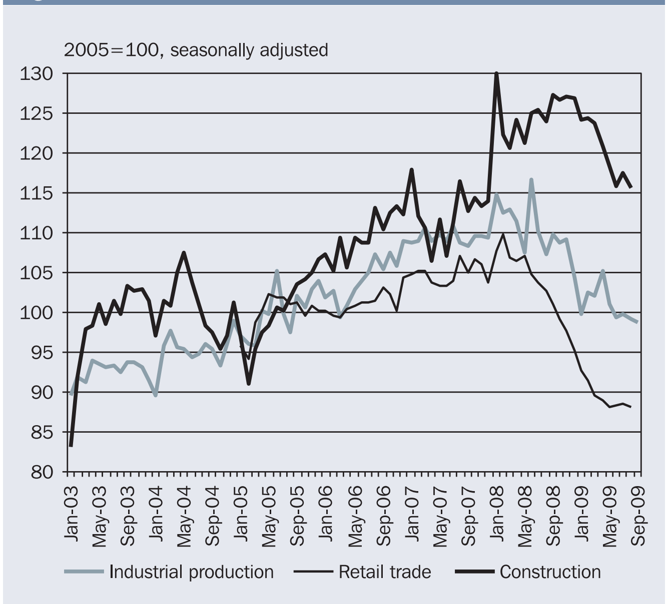
The average net wage remains roughly unchanged.

In spite of certain oscillations, the economy-wide average net wage has remained roughly unchanged during this year. In July, the average net wage was almost the same as in January. Compared to July last year, it was 1.4 percent higher in nominal terms and 0.2 percent in real terms. It should be noted that these figures do not incorporate the effect of the "crisis tax" (see Box 1) that was introduced in August and applied to the July wages. The Central Bureau of Statistics estimates that the average take-home wage has decreased 2.8 percent as a consequence of this new tax levied on the net wage. Taking this into account, it appears that the average take-home wage declined in July by around 2.6 percent in real terms over a year.

Strong contraction in monetary aggregates;...

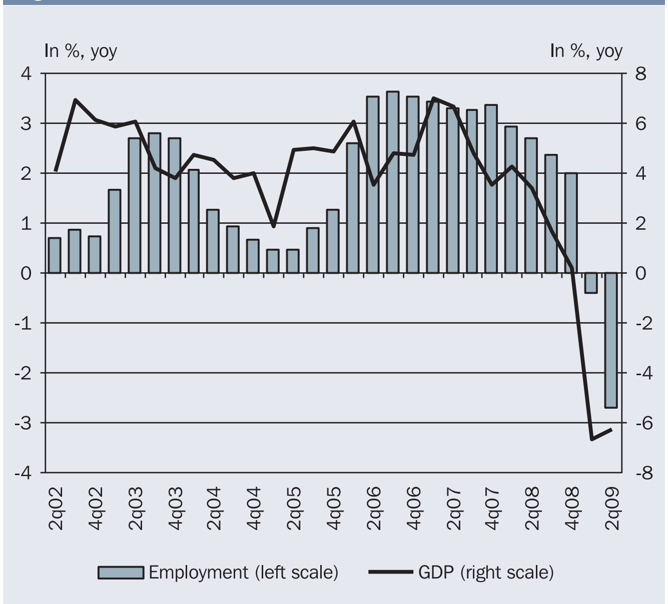
A slowdown in monetary aggregates continued in the second quarter 2009 as a result of a weak real sector activity. Seasonally adjusted data indicate that broad money declined 0.7 percent in the second compared to the first quarter, while in year-on-year terms it decreased

Figure 2 REAL SECTOR DEVELOPMENTS



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

Figure 3 TOTAL EMPLOYMENT AND GDP



Source: *Central Bureau of Statistics.*

0.8 percent in August 2009, which is the first year-on-year decline since February 2000. At the same time, narrow money contracted by two-digit rates. The August year-on-year decline of 14.1 percent was the highest drop since the data have been published.

... kuna savings replaced with foreign exchange savings;...

Kuna savings deposits recorded a 20.2 percent decrease in August when compared to the same month year ago, thus contributing to the broad money contraction. At the same time, foreign exchange savings exhibited a 13.6 percent increase. The replacement of kuna with foreign exchange savings thus continued in the third quarter as the fear of kuna depreciation persisted. As against previous years, when overall savings recorded two-digit growth rates, in August 2009 it only grew 2.8 percent year-on-year.

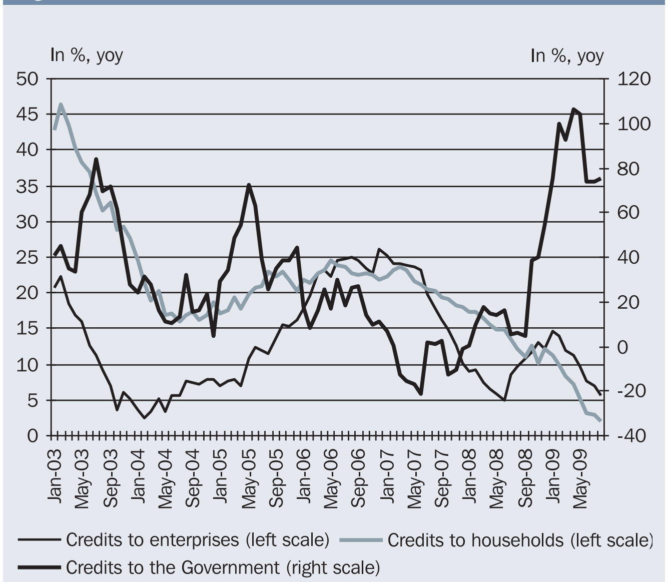
... slowdown in credit activity.

A considerable deceleration of overall savings and a downturn in economic activity have had negative implications for credit activity. However, since October 2008 credits to the Government have started to accelerate dramatically, reaching a record high of 106.5 percent year-on-year growth in April 2009. After a successful issuance of a new bond on the international market in June 2009, the Government borrowing activity has subsided. Meanwhile, credits to enterprises and households continued to experience a slowdown, with August year-on-year rates recording 5.7 and 2.2 percent, respectively. In seasonally adjusted terms, credits to households contracted by 2.1 percent from February to August 2009, while at the same time credits to enterprises contracted by 0.1 percent, suggesting that the banks are rolling over corporate credits.

CNB is preventing kuna depreciation.

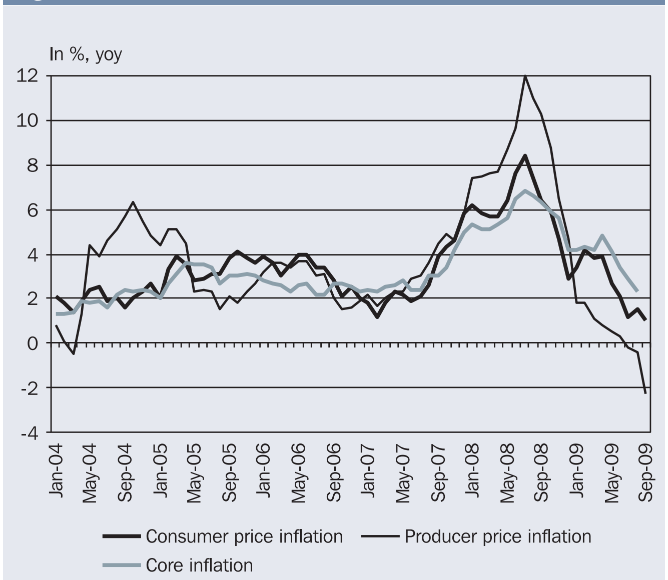
Smoother money market conditions observed in the second quarter 2009 continued in the third quarter. Monetary policy contributed to money market stability by holding all repo auctions, except for two in September. Thus, the central bank was approving on average one third of banks' interest at the repo auctions at a fixed repo rate of 6 percent. During the third quarter, the average overnight interbank rate stood at 7.3 percent compared to 6.5 percent in the preceding quarter. One must notice that the average one-week ZIBOR rate of 8.1 percent recorded from July to September was higher than the central bank's 6 percent reference rate, which suggests that the central bank was squeezing money supply in order to defend the domestic currency from depreciation. Somewhat stronger seasonal demand for extra kuna liquidity combined with the cancellation of two repo auctions in

Figure 4 CREDIT DEVELOPMENTS



Source for original data: *Croatian National Bank.*

Figure 5 INFLATION



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

Box 1 FISCAL RESPONSE TO RECESSION IN CROATIA

Croatia's fiscal response to the fall in economic activity caused by the global financial and economic crisis has so far been quite specific. Automatic stabilizers operated freely until July this year, causing a free fall in tax revenues. Although there was, unlike in many other countries, no need for fiscal support to the financial sector expenditures could not adjust to the revenue decline, so the deficit widened from month to month. In July, it became obvious that with the exhausted capacity of domestic financing, as well as costly and limited possibility to finance the deficit abroad, the Government could not pursue the unchanged fiscal policy much longer. Therefore, besides minor expenditure cuts, it decided to introduce some new taxes and raise the rates of the existing ones to bring the budget closer to the balance. Three measures have been deployed as of August 1, 2009 – the standard VAT rate has been increased from 22 to 23 percent, a special tax on wages, pensions and other income has been introduced as well as a charge on services in mobile electronic communication networks.

An increase in the standard VAT rate did not entail a major departure from the existing tax system, but the two other measures came as a novel to the system. The special tax on wages, pensions and other income, also known as the "crisis tax", is faced with the most pronounced public disapproval and, for its several features, is even seen as unconstitutional. This special tax resembles the personal income tax, but is designed quite differently. It has to be mentioned that the personal income tax proved to be unsuitable as a revenue-gaining instrument for the central government since revenues collected by the personal income tax belong exclusively to local government units. The "crisis tax" has two rates, 2 and 4 percent, the lower rate being applied on a monthly income higher than HRK 3,000 and the higher rate on a monthly income higher than HRK 6,000. The tax is levied on net income, i.e. after the payment of social security contributions and personal income tax. The tax rates are applied to the total amount of income, which leads to an unusual feature of the tax - marginal tax rate higher than 100 percent in two income intervals. In addition, the specificity of the "crisis tax" is that it has re-introduced the taxation of dividends for resident recipients. One of the serious criticisms of the "crisis tax" at the time of its introduction referred to the omission of certain kinds of income, e.g. the income from self-employment, but this has been corrected by the amendment of the corresponding law. At the moment of its introduction, the "crisis tax" was described as temporary, lasting only until the end of 2010, when the economy is supposed to regain its momentum after recession.

Finally, the charge on services in mobile electronic communication networks is again a very specific levy charged at a 6 percent rate on revenues from text and multimedia messages. The rationale for this charge is straightforward – demand for mobile telecommunication services is high and inelastic, which creates an ideal situation for raising additional fiscal revenues.

According to *Economic and Fiscal Policy Guidelines for 2010-2012 period*, additional revenues brought about by new levies should reach around HRK 1.4 billion in 2009 and, according to our calculations, some HRK 3.9 billion in 2010. Since revenues collected in August and September were, according to the Ministry of Finance, as high as HRK 570 million, it can be assumed that revenue effects could be even higher, especially taking into account the later broadening of the "crisis tax" base. If that proves to be true, we can only hope that unexpected revenues would not simply lead to higher expenditures instead of the abolition of new taxes.

Croatia is not the only country unable to fight the recession by using countercyclical fiscal measures, but it is one of the rare European countries whose fiscal "discouragement" package will amount to more than 1 percent of GDP in 2010. In addition, the countries that had to raise their tax burden like Ireland, the Baltic states and Hungary faced serious economic difficulties caused by either banking crises or extreme internal and/or external imbalances. Having that in mind, we cannot but ask ourselves – were the tax raises really inevitable?

Sandra Švaljek

September boosted the demand for kuna liquidity and caused appreciation pressures. In order to prevent appreciation, the central bank intervened twice on the foreign exchange market - in late September and early October. In September, the HRK/EUR exchange rate appreciated 1.6 percent compared to February 2009, when the most pronounced depreciation pressures arose. However, the HRK/EUR exchange rate in September was still 2.6 percent weaker compared to the same month year ago.

Inflation eases.

In spite of a 1 percentage point rise in VAT in August, consumer prices in the third quarter 2009 were just 1.2 percent higher than in the same quarter year ago. Data for September reveal that consumer prices grew 1 percent in year-on-year terms, mostly due to price increases in health services, tobacco, gas and other fuels. A more pronounced September drop in producer prices, 2.3 percent year-on-year, is a result of lower prices of food, energy and basic metals. Core inflation data also confirm that inflation is easing. Year-on-year core inflation was 2.3 percent in August and 0.3 percentage points lower than in the previous month due to a decrease in core prices of goods.

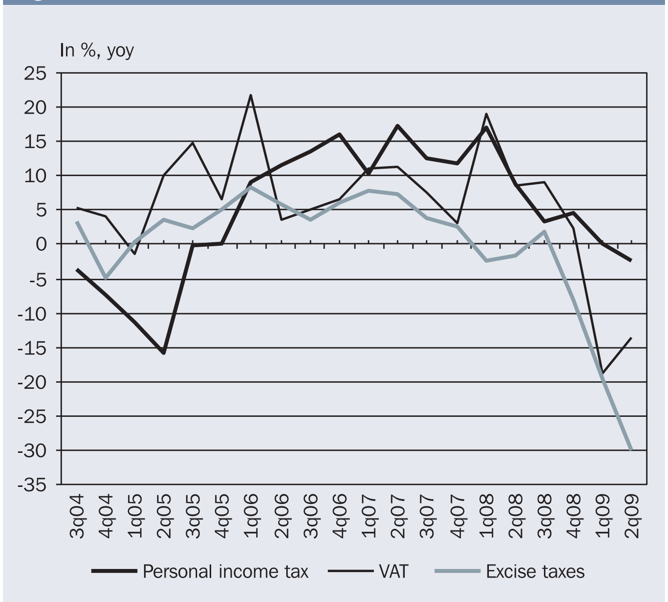
Serious deterioration of fiscal position...

Croatia's fiscal position continued to deteriorate in the second quarter 2009. Total consolidated general government revenues decreased 7.7 percent year-on-year, while expenditures increased 8.3 percent. The most significant drop in revenues was recorded by VAT, excise and corporate income tax. In the first half of the year, revenues from VAT and the corporate income tax declined 14.8 and 16 percent, respectively, compared to the same period last year, whereas revenues from excise taxes fell by more than 25 percent. In contrast to the revenue decline, expenditures grew primarily as a result of a 13.1 percent year-on-year rise in social security benefits. In the first half of 2009, the general government deficit reached HRK 7.3 billion.

... called for urgent stabilization measures.

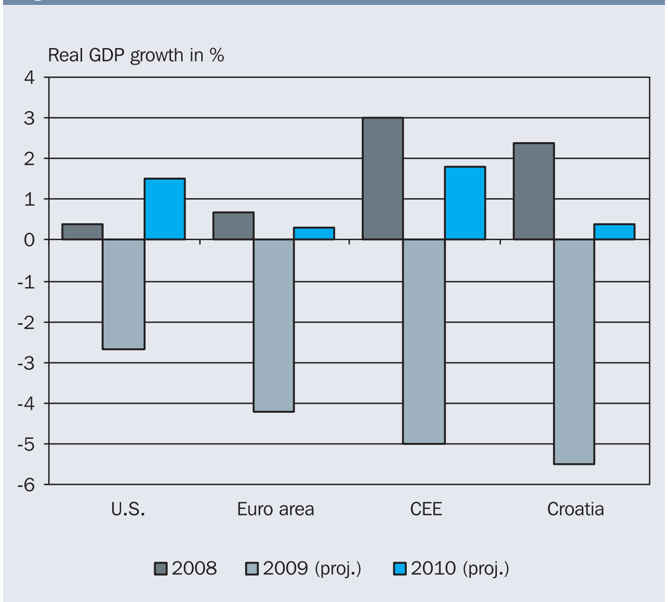
Due to such unfavorable developments, two budget revisions took place in July. Although we saw some changes in the structure of expenditures, their level has remained unchanged; namely, only HRK 6.5 billion were cut from the original budget. However, the latest budget revision recognized the problems of tax collection and was aimed at preventing a further deficit increase by introducing a package of tax measures (see Box 1). As a result, the initially projected deficit of HRK 11 billion at the central government level (or some 3.3

Figure 6 FISCAL REVENUES



Source: *Ministry of Finance.*

Figure 7 WORLD ECONOMY AND CROATIA



Sources: World Economic Outlook, *IMF, October 2009 and authors' estimates.*

percent of the projected GDP) decreased to HRK 9.2 billion (approximately 2.8 percent of the projected GDP).

Public debt growth accelerates.

A significant acceleration in consolidated central government debt growth took place in the first half of 2009. At the end of June, public debt (without state guarantees) reached HRK 106.6 billion, which is 19.6 percent higher compared to the same period last year. This rise was primarily caused by a 27.6 percent increase in domestic public debt. Central government borrowings from domestic banks have more than doubled since June 2008. In addition, T-bills issuances were up by more than 50 percent compared to the last year, indicating short-term liquidity problems. In the second quarter, the foreign part of the public debt started to accelerate following the placement of EUR 750 million Eurobonds in early June. Total central government guarantees have been rising, too. At the end of the second quarter, they were 13.8 percent higher than a year ago.

New fiscal policy medium-term projections.

Medium-term fiscal policy plans published in the Government's *Economic and Fiscal Policy Guidelines for the 2010-2012 period* have been moderated as a result of the current economic situation. In the current Guidelines, the general government deficit is expected to fall gradually from 2.9 percent of GDP planned for 2009 to 1.4 percent by 2012. The general government deficit is envisaged to decline by 0.6 percentage points in 2010, reflecting the nominal freeze of government expenditure and a slow recovery of revenues. The expenditure share in GDP should fall below 40-percent by 2011. This document does not disclose the specific fiscal measures that will be undertaken to fulfill such an ambitious plan. In the next three years, the Government intends to borrow on both domestic and international financial markets. Therefore, the public debt is expected to increase from 32.7 percent of GDP in 2009 to 34.5 percent in 2012.

2 Policy Assumptions and Projections Summary

Global economy: the worst is over, but the recovery will be long and painful.

The global economy has recently been showing signs of stabilization confirming that the worst of the global crisis, that brought the first decline in world GDP since 1946, is over. Although a wide range of public policy measures implemented in advanced and developing countries have contributed to the stabilization of economic activity, the recovery is expected to be long and painful. According to the latest IMF forecasts (*World Economic Outlook*, October 2009), after falling by 1.1 percent in 2009, world GDP should grow by 3.1 percent in 2010. The recovery is expected to be driven primarily by the emerging economies led by China. The U.S. economy is projected to contract by 2.7 percent in 2009, mainly due to a sharp contraction during the first half of the year, while growth should turn positive in its second half. U.S. GDP should increase 1.5 percent in 2010, although the lasting weakness in the labor and housing markets and tight credit markets will continue to pose a risk. At the same time, the euro area is expected to grow by 0.3 percent in 2010 after declining by 4.2 percent this year (with Germany and Italy contracting by 5 percent). The latest indicators for the third quarter 2009 suggest that the euro area continues to stabilize even at a somewhat higher pace than earlier envisioned. Next year, the worldwide recovery should also be underpinned by a turnaround in global trade. Following this year's plunge of more than 10 percent, the world trade volume is now forecasted to grow by 2.5 percent in 2010.

Optimism about global recovery pushes up oil prices.

Oil prices have responded strongly to the perception that the worst of the global recession is over. After reaching a low of US$36 a barrel at the end of February, oil prices started to rebound and climbed to US$70 by mid-year. After a sharp correction in mid-July, oil prices resumed the upward trend (and amounted to US$74 on October 12). The renewed optimism prompted the International Energy Agency to revise upwards its oil demand projections. According to its October report, global oil demand should grow 1.7 percent in 2010 to an average of 86.1 million barrels per day following a 1.9 percent decline in 2009.

Improved international environment and responsible domestic policy should pave the way to recovery.

As the international environment improves, the Croatian economy should benefit from a rebound in international capital flows, strengthening of consumer confidence and improved foreign demand. Better conditions on international financial markets should help the government and private sector to refinance their high debt obligations in the upcoming period. Our projection assumption is that fiscal authorities will focus on the stabilization of public finances underpinned by long-delayed structural measures. We also expect the Government to refinance its obligations mainly abroad without putting pressures on the domestic financial market. We assume no changes in tax burden by the end of 2010. The long expected reform of the public sector might bring some expenditure cuts over the projection horizon, partially due to a reduction in the number of employees, but the details of the reform have not yet been revealed. As monetary authorities strive between the need to secure sufficient liquidity and stability of the exchange rate, we assume that the inflow of foreign capital will be strong enough to reduce pressures on the exchange rate, bring better kuna liquidity as well as a reduction in interest rates.

GDP projected to contract 5.5 percent in 2009 before gradual recovery in 2010.

As for the projections, we broadly maintain our position from the July issue with only minor forecast revisions due to the newly incoming data. In line with the recent high-frequency indicators, GDP is expected to continue to stabilize in the second half of the year, before gradually recovering in the course of 2010. We project a contraction of 5.5 percent in 2009, and a return to positive GDP growth of 0.4 percent in 2010. The main reason behind a slightly more optimistic forecast for 2010 is an improved global economic outlook, including foremost the stabilization of economic activity in EU economies. However, the expected growth in 2010 will be sluggish because sound growth drivers have not been put in place while long-lasting problems in the real sector make the Croatian economy highly dependent on foreign capital inflows. Volatile signals from the global and domestic economy might lead to an uneven recovery.

Table 2 SUMMARY OF PROJECTIONS

	2009	2010
Real GDP (% change)	**-5.5**	**0.4**
Real private consumption (% change)	-8.2	0.7
Real government consumption (% change)	-0.7	-3.4
Real investment (% change)	-11.6	-1.6
Exports of goods and services (constant prices, % change)	-16.4	2.4
Imports of goods and services (constant prices, % change)	-21.1	1.9
Current account balance (% of GDP)	-4.2	-4.4
Consumer prices (% change, pa)	2.5	2.0
Exchange rate, HRK/EUR (pa)	7.36	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)	-1.0	9.0
Total domestic credit (% change, eop)	-2.0	7.0

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

Sluggish recovery of private consumption; weak investment outlook.

In the situation where incomes drop less than personal consumption, its dynamics will be largely determined by consumer confidence. Its improvement might be a result of positive signals from the international environment and the recovery of domestic economy.

However, deteriorating labor market conditions as well as tight credit conditions are likely to weigh on consumer spending. We believe that this year will still be dominated by negative effects, although their impact should lessen towards the year's end. As a result, personal consumption is projected to contract 8.2 percent in 2009 before a weak recovery of 0.7 percent in 2010. As a consequence of inertia in the government sector, major adjustments in government consumption are expected to take place next year. Consequently, following a 0.7 percent decline this year, government consumption should drop by 3.4 percent next year. The aggregate investment is expected to remain weak and will continue to contract next year. Investment activity depends on developments in other parts of the economy and is heavily influenced by financing costs and the ability of investors to access financing. In Croatia, it also depends on the consolidation of public finances as the Government invested significantly in the preceding period. We expect overall investments to decline 11.6 percent this year and 1.6 percent next year. However, if the EU accession negotiations proceed in a positive manner, in spite of a projected contraction of investment activity, next year should provide a basis for stronger private investment over the medium-term.

Current account deficit to shrink to 4.2 percent in 2009.

In line with developments in other parts of the economy, trade flows are expected to stagnate by the end of the year, while next year should bring modest rebound. However, it should be noted that revenues from foreign tourism in the third quarter will have a substantial impact on the volume of total exports this year. We expect financial indicators to be weaker than physical ones and, therefore, project the volume of total exports to drop by about 16 percent in 2009 as a whole. Imports have strongly reacted to the crisis, falling at a faster pace than exports, and we expect them to plunge by 21 percent in 2009. The recovery of foreign trade flows (by about 2 percent) next year is primarily related to the recovery of the overall economic activity and building inventories. The current account deficit should substantially shrink, from 9.3 percent of GDP last year to 4.2 percent this year, before widening back to 4.4 percent next year.

Labor market faces big challenges.

Labor market conditions that lag behind the output cycle are expected to deteriorate further in the remaining part of this year. The number of registered unemployed persons is projected to increase to around 285,000 by the end of the year, implying an increase of some 45,000 over the whole year. The end-of-year unemployment rate should rise to 16 percent. These negative trends are expected to continue next year, although at a slower pace. Pressures are likely to come from delayed cost-cutting strategies in firms suffering from recession as well as from restructuring in industries with long-lasting problems (e.g. shipyards). The unemployment rate in 2010 could increase by 0.8 percentage points. Current trends suggest that a part of the labor force will continue to pull out from the labor market, either to retirement or inactivity. Hence, there are big challenges ahead for policy-makers to revive the employment rate, which is one of the lowest in Europe. One way could be to reconsider the question of labor costs. The average wage has adjusted only slightly to the crisis. By the end of this year, the average gross wage is expected to remain roughly at the same level, while the take-home wage will fall due to the "crisis tax". However, expressed in average terms, gross wage will be more than 2 percent higher in nominal terms than a year ago. We have assumed no changes in public sector wages by the end of the year, although certain changes in the collective agreement for public sector employees could take place. Renegotiation has been anticipated in the current agreement in the case of a large GDP drop in two consecutive quarters. Since a decline of more than 5 percent year-on-year has already taken place, social partners could consider new terms of agreement. The new agreement will probably set rules for wage changes in subsequent years, thereby having a substantial effect on both labor market developments and the fiscal situation.

Inflation expected to remain subdued.

Faced with weak demand, producers and retail distributors are increasingly willing to allow discounts in order to reach final consumers. Therefore, inflation is expected to remain low at around 2.5 and 2.0 percent in this and next year. However, possible pressures on domestic prices coming from increases in the world prices of energy and food should not be neglected. Additionally, tax adjustments to the EU regulations might also bring certain increases in the prices of tobacco, food and gasoline, although the exact pace of their implementation is still to be negotiated with the European Commission.

Monetary and credit aggregates should rebound in 2010.

Unfavorable developments in the real sector have reduced the money demand, credit activity and savings accumulation. The contraction of narrow money and a slower rise in overall savings should lead to a decline in broad money by the end of 2009 compared to the same period last year. As a result, broad money is expected to decrease by 1.0 percent in 2009 and gradually recover in 2010 to record a 9.0 percent growth. Meanwhile, due to weak economic performance and liquidity constraints imposed by the central bank, the credit demand will also subside. Total domestic credit is expected to decrease by 2.0 percent in 2009. Since it does not include credits to the Government, this indicator does not incorporate their strong expansion observed in this year. Due to tight labor market conditions, we expect the credit demand to only partially rebound in 2010. Thus, the year-on-year growth of total domestic credit is expected to amount to 7.0 percent in 2010.

Fiscal deficit expected at 3 percent of GDP.

Although the fiscal position has significantly worsened compared to the previous year, further deterioration is not expected in the remaining part of the year. Newly introduced taxes as well as a seemingly good tourist season should result in revenues sufficient to leave the deficit below 3 percent of GDP by the end of the year. For 2010, we expect that improved consumer confidence will encourage personal consumption and, thus, positively influence the revenue side of the budget. Due to many risks regarding government expenditures, we expect a 3 percent deficit for 2010, too.

3 Uncertainties and Risks to Projections

Global economic outlook – high risks persist.

Although the global economy has started recovering, risks remain high. The upside risks to the global outlook come from the possibility that the world economy might recover more strongly than now anticipated as a result of wide-range public policy measures implemented across the globe. The downside risks mainly refer to the remaining problems in the financial and real sector, disorderly correction of global imbalances once the stimulus is removed, and the possibility of a stronger rise in energy and commodity prices as recovery builds up. Croatia is strongly dependent on the inflow of foreign capital and, therefore, vulnerable to developments on international financial markets. A better-than-anticipated global growth, including EU economies, would have beneficial effects on exports of goods and services underpinning the overall economic activity. However, the opposite would have negative spillover effects.

The prudence of fiscal policy vital for macroeconomic stability...

Unsolved structural issues in the Croatian economy together with new problems brought about by recession imply substantial fiscal risks in years to come. Labor market conditions will deteriorate, the banking sector will have to cope with a higher share of bad loans, and businesses will recover slowly due to tight credit conditions and the still low purchasing power. In addition, accumulated contingent liabilities, especially those related to the shipbuilding industry, could start to transform into explicit Government obligations leading to the unexpected explosion of financial obligations and deficits. Under such circumstances, it will be crucial to preserve the prudence of fiscal policy, which is vital for the overall macroeconomic stability and for maintaining solid long-term growth prospects.

... and should be confirmed by the 2010 budget.

The budget for 2010 presents an opportunity for expenditure cuts that would put public finances on sound grounds. In respect to revenues, it seems that the "crisis tax" will remain in place by the end of 2010 as originally planned. However, if the Government decides to either reduce its rate or remove it earlier, this would have a positive effect on personal consumption and overall GDP compared to our baseline projection. On the contrary, the introduction of other taxes - and speculations on the introduction of wealth tax have appeared - would have a counter-effect depressing consumer spending.

The risk of higher interest rates and crowding-out.

The Government plans, both this and next year, to refinance its high debt obligations on international financial markets. However, if any problems in that respect appear, increased pressures on domestic financial markets might lead to higher interest rates posing a risk to recovery. In addition, Government's borrowing on the domestic market on a higher scale would bring the crowding-out of the private sector.

Substantial effort still needed to close accession negotiations with the EU.

Although Croatia's accession negotiations with the EU have recently continued after a year-long pause, there is still a long way ahead before their closure. In the meantime, a substantial effort will be needed to close a number of "tough" negotiating chapters such as, for example, "Justice and human rights". In addition, the final agreement with Slovenia over the procedure to solve border issues, which had caused Slovenia to block Croatia's accession talks, has not yet been finalized. Any step that brings Croatia closer to the EU membership will be positively recognized by the financial markets as well as foreign investors. Another pause or a step backward would have a pronounced negative effect.

IMPRESSUM

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