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Croatian Economic Outlook
Quarterly

1 Recent Developments

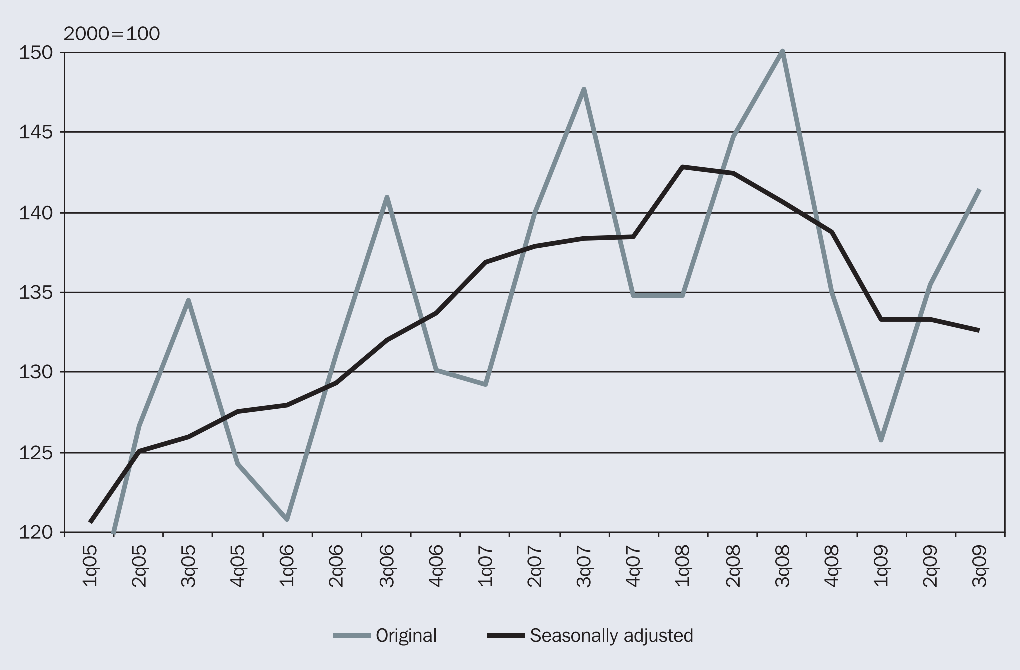
Economy turned down again in the third quarter 2009.

Initial signs of stabilization in overall economic trends observed in the second quarter 2009 have disappeared and the economy turned down again in the third quarter. Seasonally adjusted figures show that GDP fell by approximately 0.5 percent compared to the second quarter. Furthermore, the year-on-year change amounted to -5.7 percent. This decline was primarily driven by negative developments in personal consumption and investments, while net exports had a small but positive contribution to the overall GDP as a result of imports decrease. The recent trends in the real sector are also discouraging - seasonally adjusted volumes of industrial production and retail trade dived further towards last year's end. It appears that Croatia is being hit by the crisis stronger than earlier expected. However, no serious adjustment in economic policy has been made; structural reforms have not been undertaken, while public finance stability has been preserved largely by increased taxation and borrowing. Monetary policy has moved beyond preserving the exchange rate stability but has not yet succeeded in breaking the credit crunch.

Negative trend in personal consumption moderates.

Since the very beginning of the crisis, personal consumption has been decreasing at a rapid pace. However, as indicated by seasonally adjusted figures, in the third quarter 2009 it fell only marginally over the previous quarter. In comparison with the third quarter

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

2008, personal consumption was 6.9 percent lower. The moderation of negative trends in the third quarter 2009 implies that the rebalancing of the household sector has been completed following an era of debt-fueled consumption. Consequently, developments in personal consumption will be more closely linked to income trends. The implementation of the special tax on wages, pensions, and other incomes (the so-called 'crisis tax') in August, coupled with an increase in the VAT rate by 1 percentage point, has contributed to a further decline in retail trade volume. After five months of stagnation, seasonally adjusted retail trade volume started to decline again in September and continued so in October and November.

Downward adjustment in government consumption.

Although resistant for some time, government consumption finally fell in the third quarter 2009. Seasonally adjusted government consumption went down by almost 1 percent over the second quarter, while the year-on-year figure indicates a 0.6 percent decline. In the situation of highly constrained borrowing conditions, government consumption had to be adjusted to depleted budget revenues.

Investments continue to decline albeit at a slower pace.

In the third quarter 2009, investments were 10.5 percent below previous year's level. After adjustment for seasonal and trading-day effects, the latest figures suggest that a declining trend in investments has continued but at a much slower pace than before. Furthermore, the seasonally adjusted volume of construction activity also indicates that the pace of contraction slowed down in the fall months of last year. One should not, however, overestimate these positive signals. Once the ongoing projects are completed, a new wave of problems in the construction sector is expected to appear.

Stabilization of foreign trade flows.

Following a sharp drop in the second half of 2008 and the first half of 2009, the third quarter 2009 brought us close to the stabilization of foreign trade flows, as suggested by seasonally adjusted figures. Volumes of total imports and exports (national accounts data) have remained only slightly below their second quarter levels. An optimist would argue that the squeezing period is over. Nevertheless, a cumulative decline in trade volume is high. In the third quarter 2009, the volume of total exports was 17.6 percent below its previous year's level. This figure takes into account disappointing results of the summer tourist season. The balance of payments data reveal that in the third quarter international tourism brought 16 percent lower revenues in current euro terms than year before. Such an outturn is below expectations that were based on relatively strong physical indicators. For example, the number of overnight-stays by foreign tourists in the summer months of 2009 remained almost the same as in 2008. At the same time, the volume of imports declined by 23.5 percent in the third quarter year-on-year. A weak domestic demand and financing constraints were the main factors behind such a considerable drop. However, such developments had a beneficial effect on the trade balance. Trade deficit has narrowed in parallel with the overall decline in foreign trade, and so was the case with the current account deficit. In the year up to the third quarter, the current account deficit amounted to 6.2 percent of GDP, compared to last year's gap of 9.5 percent of GDP. However, a comparable figure for the second quarter 2009 is 5.8 percent, indicating that the underperformance of foreign tourism revenues in the third quarter has had negative implications for the external balance. On the more positive side, merchandise trade statistics for October and November signal a mild recovery of trade, with slightly rising values of both exports and imports as compared to the previous months.

Weak real sector activity.

As regards developments in the real sector, high-frequency seasonally adjusted figures show that industrial production increased by mere 0.3 percent in the fourth quarter compared to the previous three months. That is mainly due to a somewhat stronger performance in October, while the November and December data indicate further contraction on a month-on-month basis. For the year as a whole, industrial production declined by 9.2 percent, with

Table 1 MAIN ECONOMIC INDICATORS

	2007	2008	2008	2009		
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	5.5	2.4	0.2	-6.7	-6.3	-5.7
Real private consumption (% change, yoy)	6.2	0.8	-3.2	-9.9	-9.4	-6.9
Real government consumption (% change, yoy)	3.4	1.9	2.7	3.9	1.2	-0.6
Real investment (% change, yoy)	6.5	8.2	3.5	-12.4	-12.7	-10.5
Industrial output (% change, yoy)	4.9	1.2	-1.7	-11.0	-9.5	-10.4
Unemployment rate (registered, %, pa)	14.8	13.2	13.1	14.7	14.4	14.3
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	5.3	5.5	4.0	1.5
Consumer prices (% change, yoy, pa)	2.9	6.1	4.5	3.8	2.9	1.2
Producer prices (% change, yoy, pa)	3.4	8.5	6.7	1.1	-0.6	-2.3
Average gross wage (% change, yoy, pa)	6.2	7.1	6.6	4.6	3.4	1.4
Exchange rate, HRK/EUR (pa)	7.34	7.22	7.17	7.41	7.36	7.32
Exchange rate, HRK/US$ (pa)	5.37	4.93	5.45	5.68	5.41	5.12
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,193	9,814	2,363	1,929	1,901	1,889
Exports of goods (EUR, % change, yoy)	8.6	6.8	-4.6	-13.4	-23.7	-30.9
Imports of goods (EUR million)	18,627	20,608	4,811	3,660	3,913	3.725
Imports of goods (EUR, % change, yoy)	10.8	10.6	-2.1	-23.6	-30.1	-31.1
Current account balance (EUR million)	-3,238	-4, 369	-1,897	-1,844	-871	1,774
Current account balance (% of GDP)	-7.6	-9.2	-	-	-	-
Gross foreign direct investment (EUR million)	3,670	4,190	1,824	470	503	726
Foreign exchange reserves (EUR million, eop)	9,307	9,121	9,121	8,870	9,090	9,318
Foreign debt (EUR million, eop)	32,929	40,228	40,228	40,213	40,731	42,760
GOVERNMENT FINANCE*						
Revenue (HRK million)**	126,716	134,738	134,738	30,294	61,208	94,100
Expense (HRK million)**	118,771	130,259	130,259	32,476	65,911	98,887
Net = Gross operating balance (HRK million)**	7,946	4,479	4,479	-2,182	-4,703	-4,787
Net acquisition of non-financial assets (HRK million)**	11,015	7,344	7,344	1,284	2,553	4,151
Net lending/borrowing (HRK million)**	-3,069	-2,865	-2,865	-3,466	-7,256	-8,939
Domestic government debt (EUR million, eop)	7,992	9,202	9,202	10,269	10,571	-
Foreign government debt (EUR million, eop)	4,215	4,130	4,130	3,617	4,071	-
Total government debt (% of GDP)	28.5	28.5	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	19.3	-4.6	-4.6	-11.7	-12.3	-15.1
Broad money, M4 (% change, yoy, eop)	18.3	4.3	4.3	3.3	1.1	-1.2
Total domestic credit (% change, yoy, eop)	15.0	10.5	10.5	9.2	4.8	1.9
DMBs credit to households (% change, yoy, eop)	18.0	12.1	12.1	8.3	3.1	0.8
DMBs credit to enterprises (% change, yoy, eop)	10.2	12.3	12.3	11.9	7.8	4.1
Money market interest rate (%, pa)	4.1	5.5	10.7	14.3	6.1	6.8
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	8.0	9.1	9.9	10.1	10.4
DMBs credit rate for households, short-term (%, pa)	12.1	12.2	12.3	12.5	12.5	12.7

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.*

the production of intermediate and capital goods having the strongest negative impact on the overall decline. Retail trade volume was particularly weak in the last quarter 2009, with the latest data up to November showing a new wave of contraction following a period of stabilization in the summer months. In October and November, the average retail trade volume was more than 5 percent lower than in the preceding quarter, while a cumulative decline for the January-November period amounted to 15.6 percent year-on-year. As for the construction activity, it declined 9.8 percent in November year-on-year, while its trend shows some signs of stabilization.

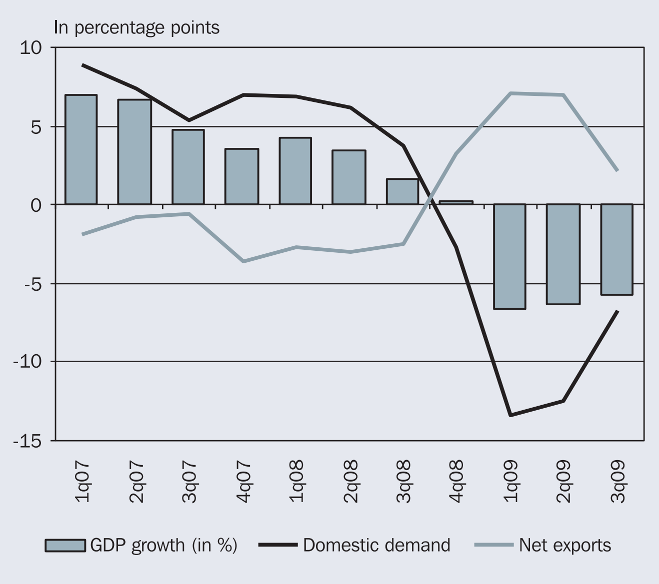
Rapid increase in unemployment.

The number of the unemployed has increased quite rapidly. At the end of December, 292 thousand unemployed persons were registered at the Employment Office - around 51 thousand, or 21 percent, more than a year before. The newly unemployed have different characteristics than the unemployed in earlier periods - they are better educated, have more experience, and are more often men. The burden of layoffs has also been distributed unevenly across sectors. Employment declined mostly in manufacturing, construction, as well as accommodation and food service activities - by around 9 percent over a year up to November. Small unincorporated sector (crafts and trades) has also been hit hard, with an 8-percent drop, as well as distributive trade and information and communication activities, with a 6-percent drop. By contrast, in a broadly defined public sector that includes public enterprises and comprises for about 35 percent of jobs in the economy, employment figures have remained unchanged. In total, employment fell by more than 5 percent in the year up to November and the registered unemployment rate exceeded 16 percent.

The average gross wage stable; 'crisis tax' reduces take-home wages.

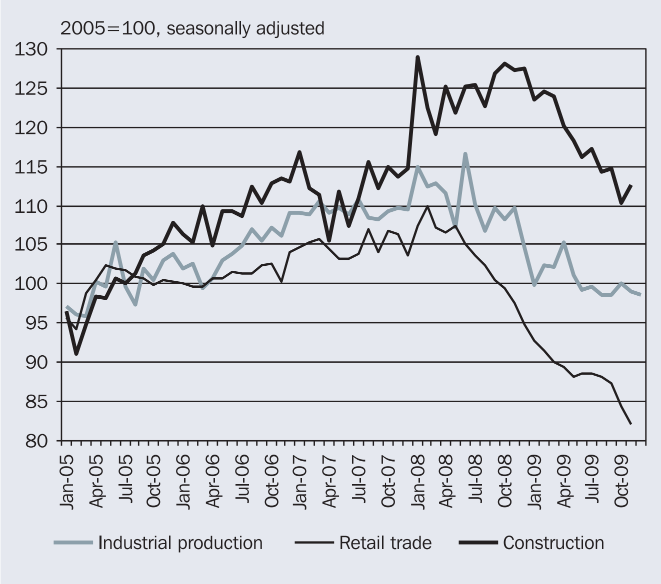
In the current circumstances, wage growth has been restrained. The economy-wide average gross wage stood at around HRK 7,600 (approximately EUR 1,040) in the August-October period. This nominal level was only marginally higher than a year before, while in real terms it appeared to have been lower by about 1 percent. Given the output decline in the same period, it can be concluded that wage adjustment has been, on average, quite slow including a significant public/private sector divide. In industries dominated by private companies, it is common to find the average wage well below its previous year's level, while in the public sector, including large state-owned enterprises, wage growth is on the positive side. The dynamics of the average net wage has usually followed that of the gross wage, but the take-

Figure 2 CONTRIBUTION TO GDP GROWTH



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

Figure 3 REAL SECTOR DEVELOPMENTS



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

home wage has recently been reduced due to the 'crisis tax' by some 2.8 percent. Together with lowered employment, such a reduction has negatively affected disposable income.

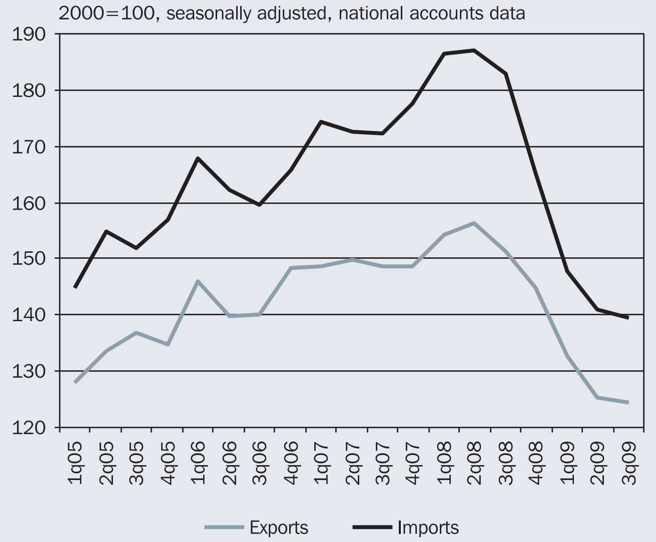
Monetary aggregates start to rebound,...

While broad money stagnated and narrow money contracted for most of 2009, the November data show a slight rebound in monetary aggregates. Namely, seasonally adjusted broad money grew by 1.2 percent compared to the previous month as a result of an increase in foreign exchange deposits as well as narrow money. A 1.4-percent monthly increase in narrow money was actually the first positive monthly change recorded in 2009. On a year-on-year basis, broad money increased by 2.5 percent in November, while narrow money contracted by 10.4 percent. Although exchange rate pressures have subsided, the substitution of kuna with foreign exchange deposits has continued. In November, exchange rate-adjusted foreign currency deposits were by 16.6 percent larger, while kuna savings deposits shrank by 20.7 percent year-on-year. The growth of the overall savings has accelerated, but still remained well below the pace exhibited before the beginning of the financial crisis.

... with credit channels still clogged.

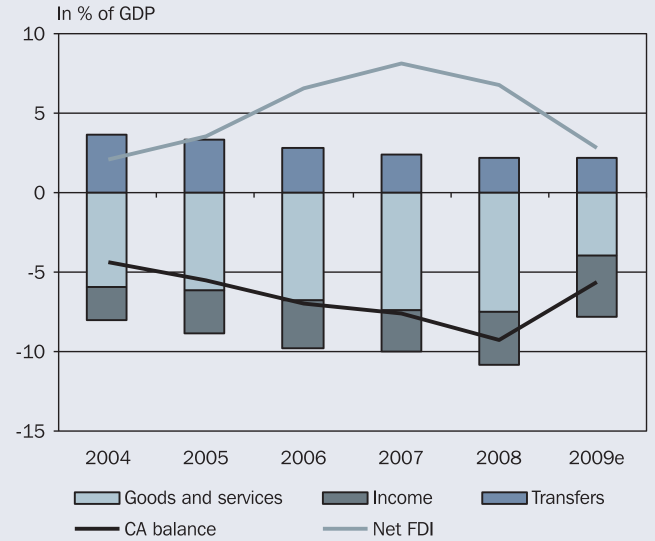
In November 2009, total domestic credit expanded by 1.3 percent year-on-year, which is 10 percentage points lower than in the same period previous year. The stagnation of capital inflows and weaker deposit growth contributed to the deceleration of credit activity. Even the central bank's November decision to abolish the annual 12-percent credit ceiling and corresponding banks' obligation to subscribe CNB bills have not boosted the credit activity. After commercial banks had extended most of their loans to the Government in the first half of the year, credit activity subsided as a result of the dampening private sector demand for new loans and new sources of Government financing. Namely, the Government issued another bond on the international market in early November, which in turn resulted in the deceleration of credits extended to the Government. The data show a pronounced slowdown in household credits, which in October and November contracted by 2.6 and 0.3 percent in year-on-year terms, respectively. In November, however, household credits rose by 0.9 percent in seasonally adjusted terms when compared to the previous month, suggesting a rebound may be under way. On the other hand, credits to enterprises are still growing, though at a moderate pace. Hence, credits to enterprises increased by 3.9 percent year-on-year in November.

Figure 4 EXPORTS AND IMPORTS OF GOODS AND SERVICES



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

Figure 5 CURRENT ACCOUNT BALANCE AND NET FDI



Sources: *Croatian National Bank and EIZ (estimate for 2009).*

Easing up of money market pressures.

The last quarter 2009 saw the easing up of money market pressures that had dominated the first three quarters. Although the central bank has abolished regular weekly repo auctions, three foreign exchange interventions in early fall and one in December provided much needed liquidity, which indicates that the monetary policy stance has loosened. As the money market data indicate, 2009 ended with about HRK 5 billion excess liquidity. After months of rising interest rates and tight kuna supply aimed at keeping the HRK/EUR exchange rate from depreciation, the average overnight interest rate plummeted to 1.2 percent in December, from 7.3 percent recorded in the third quarter. Even recent large liquidity outflows to treasury bills did not stop the market-makers from opening 2010 with the lowest short-term ZIBOR rates in the last six years. This switch in the monetary policy stance is probably related to improvements on the international capital market and the successful financing of the Croatian fiscal obligations. The November issuance of US$ 1.5 billion bonds brought financial stability that has spilled over to the domestic money market.

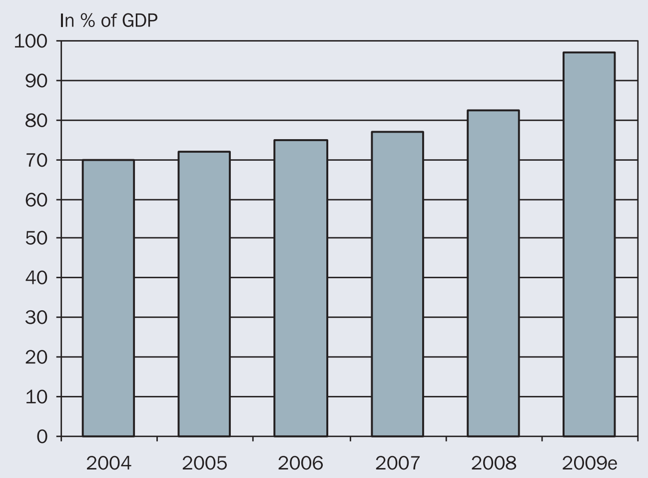
Tame inflation.

Global deflationary pressures and the absence of domestic growth impulses have kept inflation under control. In the last quarter 2009, consumer prices increased 1.7 percent year-on-year, while producer prices inflation amounted to 0.1 percent. Due to the base-year effect and the global oil price increase, inflation slightly deviated from the deceleration path that had been recorded in the four preceding quarters. The latest available data indicate that a sharp decrease in the prices of clothing and footwear was not strong enough to offset the rise of other prices. Consequently, the December inflation amounted to 1.9 percent. Although data on core inflation come with a two-month lag, they confirm the presence of disinflation in producer and consumer goods and services. In October, core inflation was 1.4 percent in year-on-year terms, 0.1 percentage points lower than in previous month.

Weak revenue collection...

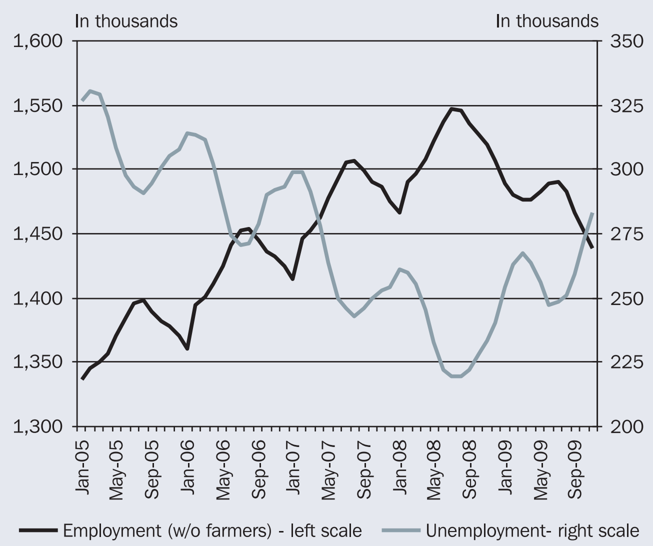
General government revenue collection contracted sharply in the first three quarters 2009. At the end of September, cumulative general government revenues were 6.5 percent lower than a year before, implying that revenue collection for the whole 2009 remained weak and contributed to a rise in deficit. By the end of third quarter 2009, VAT revenues fell 13.9 percent, revenues from the personal income tax 2.3 percent, excises 20.1 percent, and social security contributions 0.4 percent year-on-year. Changes in tax laws introduced in

Figure 6 FOREGN DEBT



Sources: *Croatian National Bank and EIZ (estimate for 2009).*

Figure 7 EMPLOYMENT AND UNEMPLOYMENT



Source: *Central Bureau of Statistics.*

August (an increase in the VAT rate, the introduction of a special tax on wages, pensions, and other income and a charge on services in mobile electronic communication networks) have apparently moderated a drop in revenue collection, but their effects cannot clearly be identified from the figures for August and September. However, it seems that the negative effects of economic crisis on government revenues will prevail and that the new tax laws will not turn the revenue collection back to its pre-crisis level. Moreover, households and companies have apparently reacted to the newly introduced tax measures by adjusting their spending.

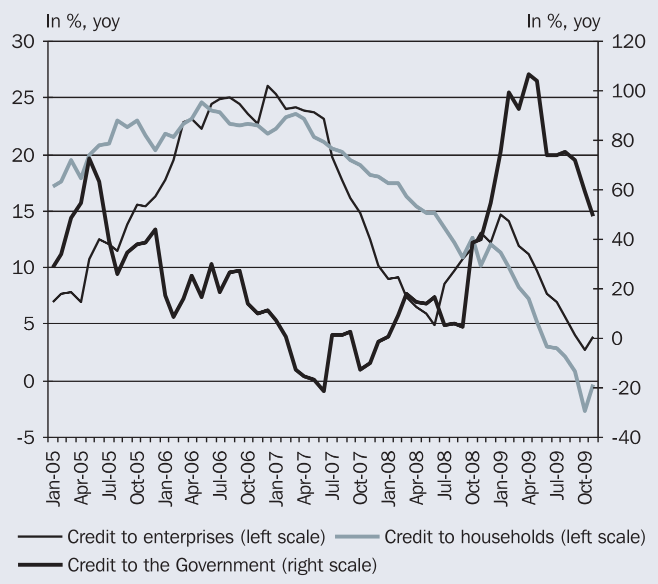
... and standard expenditure dynamics determine the 2010 fiscal outturn.

Even though year-on-year growth rates of general government expenditures declined during 2009, their increase remained rather high, i.e. 6.4 percent in the first nine months of 2009. Therefore, government revenues and expenditures exhibited quite divergent trends throughout the last year. More than a half of the expenditure growth stems from an increase in social benefits, which grew 9 percent year-on-year in the first three quarters 2009. This could partly be explained by a rise in expenditures for the unemployed and pensioners. However, it was mainly triggered by the health care reform that imposed the obligation on the budget to cover the health insurance premium for certain groups of insured persons and/or to finance co-payments. At the same time, net general government borrowing reached HRK 8.9 billion, while in 2008 the general government accumulated HRK 3.6 billion. Since expenditures usually rise in the last quarter, the Government tried to keep finances under control by postponing its financial obligations due in the last quarter 2009. For example, it delayed the payment of the half of the usual Christmas bonus for public employees, state incentives for housing savings, and a part of tax refund to the fiscal year 2010. Such moves did not, however, lower the deficit in accrual terms.

Fiscal policy in 2010 – fiscal adjustment in sight.

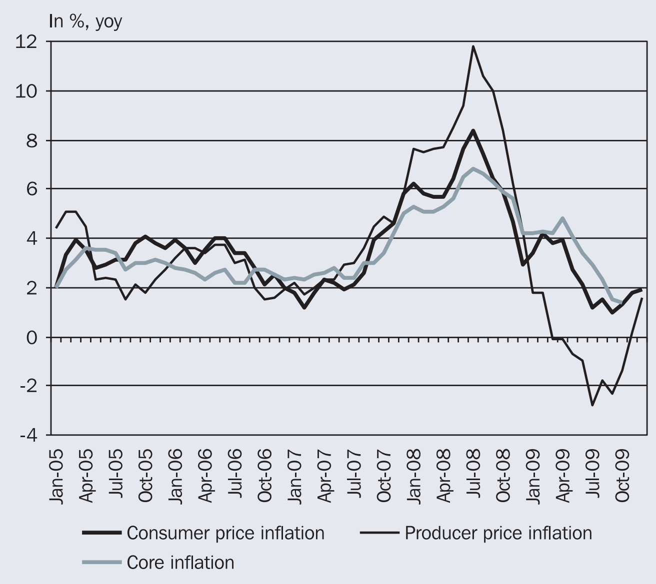
At the beginning of December, the Croatian Parliament adopted the 2010 budget based on the assumed 0.5-percent real growth and a 3-percent inflation for 2010. Budgetary revenues are expected to rise nominally, 1.5 percent compared to 2009, reaching HRK 112.8 billion. Budgetary expenditures are planned at HRK 121.4 billion, which is a 0.8-percent increase compared to 2009. There are two important changes in the structure of expenditures. First, subsidies for railways, agriculture, and shipyards are planned to decrease by 14.7 percent compared to 2009, or more than HRK 1 billion in absolute terms.

Figure 8 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

Figure 9 INFLATION



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

On the other hand, as a consequence of both a rise in the outstanding debt and higher interest rates, related interest expenditures are expected to rise by the same nominal amount. State budget net borrowing should amount to HRK 8.6 billion, or 2.5 percent of GDP in 2010; therefore, the net borrowing of the consolidated general government would amount to 2.7 percent of GDP, which is 0.2 percentage points lower than in 2009. It has to be stressed that the planned 2010 budget deficit exceeds by 0.4 percentage points the one envisaged in *Economic and Fiscal Policy Guidelines for the period 2010-2012* (adopted only three months earlier).

Growth of public debt accelerates.

Public debt grew significantly in 2009. At the end of August 2009, the consolidated central government debt reached HRK 107.9 billion (without guarantees). Compared to the end of 2008, public debt increased 10.5 percent. At the same time, central government guarantees rose quite strongly. At the end of August 2009, the total amount of guarantees was 6.6 percent higher than at the end of the previous year. Last year was marked by huge bond issuance on the international financial markets. After the placement of EUR 750 million bonds in May, the Ministry of Finance issued US$ 1.5 billion bonds in early November.

2 Policy Assumptions and Projections Summary

Global economy recovers but risks remain high.

The recovery of the global economy is underway and all major economies seem to have come out of recession in the third quarter 2009. Furthermore, preliminary data suggest that the recovery speeded somewhat up in the fourth quarter. World trade is rebounding, foremost due to strong performances in China, India, Russia, and Brazil. The International Monetary Fund announced that it would soon raise upwards its previous projection for global economic growth of 3 percent in 2010. In spite of these positive signals, global recovery remains fragile and subject to a number of uncertainties. It also proceeds at a rather different pace in various parts of the world. As regards the euro area, positive growth has returned in the third quarter 2009, led by a rebound in France and Germany. However, it is expected to remain modest. Unemployment is high in most EU countries, while business confidence remains mixed. One of the main challenges for policymakers around the world will be to find proper exit policies from the substantial policy stimulus applied since the beginning of the financial crisis.

Commodity prices on the rise.

Commodity prices were rather buoyant in 2009, and are expected to increase further this year. This trend differs from previous episodes of downfall in global activity, when commodity prices continued to fall or rose at very modest rates. In 2009, oil prices were supported by recovery expectations, but also by OPEC supply cuts. As a result, brent crude oil stood at US$ 78 per barrel on 13 January 2010, about twice the price at the beginning of last year. Analysts expect the prices of many commodities to increase further, with the demand side being the main source of upward pressures.

Positive signals from the international environment should spill over.

While the international environment is improving, there has been almost no positive news on the state of domestic economy for quite some time. We expect the strengthening of positive trends in the global economy to spill over to the domestic economy, foremost through capital markets and trade flows, and contribute to the improvement in the overall climate.

Both the Government and newly elected President will focus on the EU membership.

At the beginning of the year, the Prime Minister announced that concluding the EU membership negotiations and fighting recession would be the Government's main goals in 2010. Support for the Government's efforts to complete the EU membership talks and implement structural reforms should also come from the newly elected President. On 10 January 2010, Mr. Ivo Josipović, from the opposition Social Democratic Party, won the second round of presidential elections by a large margin. He announced that he would focus on fighting corruption, which was the main motto of his campaign.

Measures to revive the economy.

As for the Government's second priority this year, three models of fiscal stimuli have lately been presented although their details have not yet been outlined. In general, two out of three models refer to the reduction in borrowing costs of the enterprise sector and should bring together the Government, central bank, commercial banks as well as the HBOR (Croatian Bank for Reconstruction and Development). According to the first model, firms would borrow with lower interest rates as creditors would partially be commercial banks (70 percent) and partially the HBOR (30 percent). The second model refers to enterprise crediting through commercial banks with the Government guaranteeing for 25-50 percent of those credits. Finally, the third model consists of establishing private equity funds with the Government's contribution of 50 percent in total investments. These models have, to a certain degree, been implemented in other countries since the beginning of the recession. However, they can hardly change the main trends in the economy and could give effects only in the medium- to long-run. Nevertheless, they can certainly be helpful to the part of the enterprise sector that has been experiencing difficulties due to the global crisis.

Central bank may activate counter-cyclical monetary policies.

It seems that the central bank, besides focusing on exchange rate stability, is ready to ease monetary policy and thereby give an incentive for growth recovery. Namely, it has lately announced the possibility of monetary easing via a 3 percentage points mandatory reserve cut to 11 percent. The CNB is willing to provide extra liquidity, needed for the above-mentioned measures, under the condition that appropriate public policies and structural fiscal cuts are introduced and the liquidity is transferred to the sectors that can boost economic growth. It appears that this year monetary and fiscal authorities will try to boost economic activity and preserve jobs through targeted expansionary measures.

Table 2 SUMMARY OF PROJECTIONS

	2009	2010	2011
Real GDP (% change)	**-5.9**	**-0.7**	**3.0**
Real private consumption (% change)	-7.8	-0.2	2.8
Real government consumption (% change)	0.3	-2.4	2.7
Real investment (% change)	-11.4	-3.9	6.1
Exports of goods and services (constant prices, % change)	-16.6	1.6	4.8
Imports of goods and services (constant prices, % change)	-21.3	0.9	6.2
Current account balance (% of GDP)	-5.6	-5.7	-6.4
Consumer prices (% change, pa)	2.4	1.6	3.0
Exchange rate, HRK/EUR (pa)	7.34	7.33	7.33
Unemployment rate (registered, %, pa)	14.9	16.7	17.2
General government balance (ESA95 definition, % of GDP)	-3.5	-3.5	-3.2
Broad money, M4 (% change, eop)	-0.5	7.0	9.0
Total domestic credit (% change, eop)	-2.0	3.5	12.0

Notes: *Cut-off date for information used in the compilation of projections was January 8, 2010.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Government expected to proceed with EU-related structural reforms.

The Government is also expected to proceed with structural reforms, in particular those related to the EU accession, as is the case with the privatization of shipyards, judiciary reform, and the public sector reform. Better conditions on international financial markets should be helpful in the Government's efforts to refinance high debt and interest obligations in the upcoming period. We assume some changes in the tax burden at the end of 2010. Namely, according to the Government's plan, the 'crisis tax' should be removed by the end of this year, which could beneficially affect personal consumption and give some boost to consumer confidence. Nevertheless, its abolishment might be risky for budgetary revenues.

GDP estimated to have declined 5.9 percent in 2009; negative GDP rate projected for 2010.

We have revised our projections downwards as a result of more pronounced negative developments in the second half of 2009 than earlier expected. Our estimate for GDP growth in 2009 now points to -5.9 percent. Negative trends from the second half of 2009 are expected to prolong into the current year although at a moderating pace, thus resulting in a GDP decline of 0.7 percent in 2010. Although, the economy is expected to bottom out in the second half of 2010, the recovery will probably not be strong enough to affect the overall activity. The year 2011 should bring further recovery that will primarily come from a rebound in exports and investments as well as from an improved overall climate.

Personal consumption expected to stabilize in 2010.

In 2010, personal consumption is expected to be affected by negative trends on the labor market and negative consumer expectations. Nevertheless, one should keep in mind that personal consumption started contracting earlier and stronger than income. Consequently, we believe that the largest part of downward adjustment in personal consumption has already taken place and that its future dynamics primarily depends on consumer sentiment. Those expectations should improve along the year and, therefore, we expect personal consumption to retain almost the same volume in 2010 as in 2009. If the removal of the 'crisis tax' takes place before the year’s end, it would have additional positive effects on personal consumption. Government consumption is expected to decline this year in line with constrained budgetary resources. As regards investments, this year is expected to be another tough year for the construction sector as well as for all those producing and/or selling capital goods. Investment activity is expected to decline by additional 4 percent, following a more than 11 percent contraction in 2009. In 2011, we expect a relatively strong recovery, foremost due to the forthcoming EU membership.

Current account deficit close to 6 percent in 2010.

Current trends suggest that the recovery of foreign trade flows might take place in the first half of 2010. Stronger foreign demand combined with still relatively weak domestic demand should allow for a stronger rise of exports than imports in 2010 (1.6 vs. 0.9 percent). However, with the recovery of domestic economy, these trends are expected to change in 2011 towards a stronger imports rise (4.8 vs. 6.2 percent). Current account deficit should be somewhat wider than earlier expected, about 5.7 percent of GDP in 2010 and 6.4 percent in 2011. The wider deficit in 2009 stems from weaker financial results of the tourist season, which has forced us to correct projections for the upcoming years. Furthermore, on the income account of the balance of payments, expenditures related to the servicing of foreign debt are on the rise and they will remain a substantial burden in the attempt to balance the current account.

Further deterioration on the labor market.

Unemployment dynamics follow output fluctuations with a certain lag and, therefore, we expect that consequences of the current recession will be present on the labor market for a longer period of time. In addition, any prolonged output contraction, even of the modest size, will deepen problems on the labor market by reverting temporary underemployment into persistent unemployment. In the environment of inflexible labor market and relatively high firing costs, employers will restrain from the new employment even when economic recovery will be well on the way. Taking all this into account, we project further deterioration in 2010, with the unemployment rate increasing from the estimated 14.9 percent on average in 2009 to 16.7 percent in 2010. Although the next year should bring positive developments on the labor market, the average unemployment rate is expected to increase to around 17.2 percent.

More flexible wage policy.

It appears that 2009 broke the psychological barrier on the downward inflexibility of nominal wages, thus opening room for a more flexible wage policy in the years to come.

We expect wages to react more swiftly to output contraction, as well as to the future expansion. In line with this assumption, the average gross wage is expected to fall mildly in nominal terms in 2010, in the range of 1-2 percent, but to recover promptly in 2011.

Inflation should remain low in 2010.

Due to the expected recessionary environment in 2010, price inflation should remain low in spite of pressures coming from the world energy prices. However, due to upward pressures from the rising domestic demand and the alignment of domestic tax legislation with the EU practice, we expect inflation to speed up to around 3 percent in 2011.

Monetary easing and a rebound in credit demand expected.

We estimate the last year to have ended with a slightly negative broad money growth rate of 0.5 percent. If the central bank implements the announced monetary easing, broad money could reach a 7.0 percent growth by the end of 2010. With the Government looking for financing abroad and an absence of domestic cost-effective private and public projects, we expect a lack of demand for credits to spill over to some degree to 2010. As a result, we estimate total domestic credit to have decreased by 2.0 percent in 2009, while in 2010 it should increase by 3.5 percent due to a slight rebound in the credit demand and a looser monetary policy stance. In 2011, monetary and credit aggregates should follow the upward trend of real economic activity. Thus, we expect broad money to record a 9.0 percent increase due to a pick up both in narrow money and savings, while improved domestic consumption should help expand domestic credit by 12 percent.

Fiscal deficit to stay in the vicinity of 3.5 percent.

According to the Ministry of Finance, the outturn of government revenues in 2009 was slightly below the plan, whereas the actual government expenses were close to the budgeted ones. Therefore, we believe that the general government net lending will be around 3.5 percent of GDP. As for the next year, the Government set the deficit target at 2.7 percent. However, revenue estimates for 2010 had been prepared before the data on the actual revenue collection for 2009 as a whole were available. Even if the revenue estimates for 2009 reflect the actual revenues accurately, revenues planned for 2010 will probably be lower. Therefore, being more pessimistic regarding the revenue outturn, we project the general government deficit to stay in the vicinity of 3.5 percent both this and next year.

3 Uncertainties and Risks to Projections

Recovery lagging behind.

The second half of 2009 has proven that the cycle of the Croatian economy is not fully synchronized with that of the EU economies. While positive trends have emerged in the EU, the Croatian economy has remained in a declining phase. Furthermore, the eventual recovery is threatened by a substantial worsening of labor market conditions. It is therefore questionable to what extent can positive developments in the international environment, and in particular in the EU economies, induce a rebound of the Croatian economy through stronger foreign demand. Namely, employment in manufacturing industry has been reduced, while low-price competitiveness restrains exports. Therefore, recovery in manufacturing will be much more difficult than in the service sector. It seems that recovery forces are weak, with the possibility that negative trends might remain stronger and more protracted than projected. As for now, downside risks to projections seem greater than the upside risks.

Downside and upside risks to global upturn.

The recovery of the global economy, and in particular of the EU economies, is still fragile and may turn out to be weaker than now foreseen, having negative effects on a rebound of foreign demand for the Croatian goods and services as well as the inflow of foreign capital. Nevertheless, substantial stimulus applied in the preceding period may bring stronger recovery than now projected, having a beneficial effect on the Croatian economy as well.

Fiscal risks.

In our view, there are at least two reasons to believe that negative fiscal risks will continue to prevail in 2010. First, the overall economic performance could have a negative effect on revenue collection. Second, having in mind the pronounced default risk of the original lenders, high and rising explicit guarantees could become explicit government expenditures, thus pushing the deficit figure above projected.

EU membership negotiations expected to end in 2010.

By the end of 2009, Croatia has provisionally closed 17 out of 35 chapters in the EU negotiation process. In line with the European Commission's *Enlargement Strategy*, if Croatia meets all the outstanding benchmarks, the membership talks should be completed in 2010. That would allow Croatia to become a full EU member in 2012 following the process of ratification by individual members. However, after Slovenia blocked Croatia's EU accession talks for ten months in 2009, other obstacles to the completion of talks might arise. One of the remaining and most challenging issues relates to the judiciary reform as well as to the cooperation with the ICTY. Any prolongation in that respect would have negative effects on the Croatian economy.

IMPRESSUM

This publication has been prepared by Andrea Mervar (editor), Danijel Nestić, Sunčana Slijepčević, Sandra Švaljek, Marina Tkalec, and Maruška Vizek. The views expressed are those of the authors and do not necessarily reflect the views of The Institute of Economics, Zagreb, or of other researchers at The Institute of Economics, Zagreb.

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