The Institute of Economics, Zagreb
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Croatian Economic Outlook

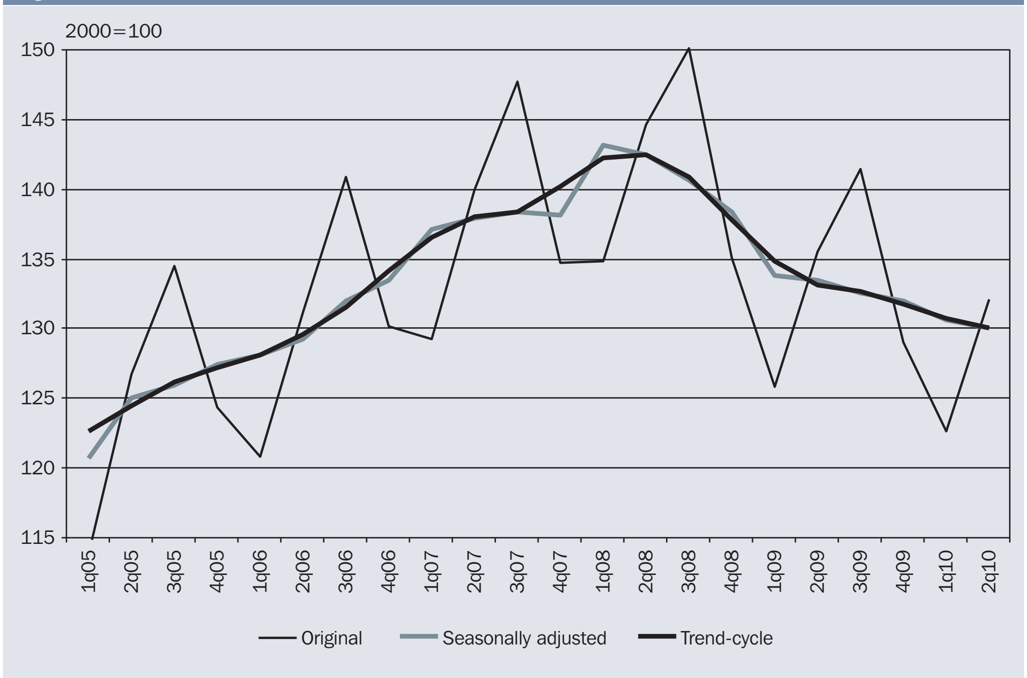
Quarterly

1 Recent Developments

Recession continues for the ninth quarter in a row.

In the second quarter 2010, Croatia's economy contracted for the ninth quarter in a row according to seasonally adjusted figures. The most recent high-frequency indicators suggest a continuation of largely unfavorable trends despite a seemingly successful tourist season and a sluggish revival of retail sales and exports. As a result, Croatia remains one of the few countries still in recession, which points to a serious structural weakness of the economy. Depressed domestic demand, with a 6.3-percent year-on-year decline in the second quarter 2010, was the main driver of the output fall while a gradual recovery in exports was not strong enough to compensate for the domestic market decline. Croatia's economic performance still strongly depends on domestic demand supported by foreign capital inflow. When that inflow subsides, economic problems intensify. Namely, in the last two years GDP declined by a cumulative 8.7 percent, out of which 2.5 percent in the last four quarters. Investments have been hit particularly hard, with a two-year loss of around 25 percent. On the production side, financial intermediation and business services were the only sectors with increasing activity over the last twelve months. Construction recorded a serious value-added decline, 16.8 percent in the year up to the second quarter, while the industrial sector declined by 3.4 percent.

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

Decrease in personal consumption comes to an end.

In contrast to a number of indicators suggesting unfavorable economic conditions, a decline in seasonally adjusted personal consumption has been halted during the last few quarters, which might be a promising sign. Nevertheless, compared to a year ago, a 2.5 percent decline was recorded in the second quarter of this year. Positive developments in the retail trade sector, where a mild recovery started at the beginning of the year, were strengthened during the summer months partially due to foreign tourist spending. The sustainable revival of personal consumption remains, however, uncertain as disposable income is still under strong pressure from rising unemployment. Tax relief related to the recent changes in the income tax system and the gradual abolishment of the "crisis tax" may not be sufficient to encourage consumption.

Government consumption declines mildly.

Seasonally adjusted government consumption has declined mildly this year following a more pronounced adjustment in 2009. In the year up to the second quarter 2010, government spending on goods and services was reduced by 1.8 percent in real terms. The Government is stuck between conflicting demands for budget consolidation and pressures from trade unions and service providers to keep wages and purchases of goods and services unchanged. It appears that their requests have been largely accepted, leading to slower adjustment in government consumption this year. However, the second quarter figures suggest that a further decline in purchases of goods and services, at least a mild one, could not have been avoided due to the stringent budget situation.

Gloomy state of investments.

The investment trend has remained strongly negative. On a year-on-year basis, the decline reached 13.4 percent in the second quarter 2010 and was nearly the same as in the first quarter. Investments have been hit hard by a severe reduction in public sector orders, but also by private sector rebalancing strategies. The corporate sector and households have rapidly cut their investment plans in spite of apparently available financing by the banking sector, although at more demanding lending conditions. In an attempt to revive investments, the Government has announced a set of investment projects in the public sector, including state-owned companies. However, no plans for financing these projects have been revealed, so their effect remains uncertain. It appears that recovery in investments will be a consequence rather than a driver of the overall economic recovery.

Rise in exports slows down; imports continue to decline.

Seasonally adjusted figures on the volume of foreign trade of goods and services in the first half of this year indicate a slowdown in the recovery of exports and a renewed decline in imports. Such developments have replaced the rising trend in exports and stagnant imports that characterized the second half of 2009. This change might suggest that the prolonged recession is causing additional problems for the real sector. On a year-on-year basis, total exports grew by 7.0 percent in the second quarter. However, the base for such an increase was particularly low as the second quarter 2009 witnessed the lowest level of goods and services exports since the end of 2003. As for total imports, they declined by 4.2 percent over the year. Taken together, recent developments have resulted in a shrinking current account deficit. In the year up to the second quarter 2010, the deficit amounted to 3.1 percent of GDP, down from 4.4 percent registered in the previous quarter, which is in line with the downward trend present since the second quarter 2008 when the deficit reached 9.4 percent of GDP. The lower current account deficit will help to suppress the foreign debt increase. In spite of the crisis, foreign debt has continued to rise, although at a slower pace. At the end of June, it reached EUR 44.9 billion or some EUR 0.3 billion more than in December 2009, but also around EUR 3 billion more than a year ago. The current level of foreign debt is close to one-year's GDP.

Table 1 MAIN ECONOMIC INDICATORS

	2008	2009	2009		2010	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	2.4	-5.8	-5.7	-4.5	-2.5	-2.5
Real private consumption (% change, yoy)	0.8	-8.5	-6.9	-7.5	-4.1	-2.5
Real government consumption (% change, yoy)	1.9	0.2	-0.6	-3.3	-1.1	-1.8
Real investment (% change, yoy)	8.2	-11.8	-10.5	-11.3	-12.9	-13.4
Industrial output (% change, yoy)	1.2	-9.3	-9.0	-7.7	-0.5	-3.3
Unemployment rate (registered, %, pa)	13.2	14.9	14.4	16.2	18.2	17.2
Nominal GDP (EUR million)	47,370	45,379	-	-	-	-
GDP per capita (EUR)	10,683	10,245	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	6.4	3.3	1.5	2.7	0.8	1.0
Consumer prices (% change, yoy, pa)	6.1	2.4	1.2	1.7	0.9	0.7
Producer prices (% change, yoy, pa)	8.3	-0.4	-2.3	0.1	3.6	4.8
Average gross wage (% change, yoy, pa)	7.1	2.2	1.4	-0.4	-0.9	-1.4
Exchange rate, HRK/EUR (pa)	7.22	7.34	7.32	7.27	7.29	7.25
Exchange rate, HRK/US$ (pa)	4.94	5.28	5.12	4.92	5.26	5.69
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,814	7,703	1,889	1,984	2,033	2,254
Exports of goods (EUR, % change, yoy)	6. 8	-21.5	-30.9	-16.0	5.4	18.5
Imports of goods (EUR million)	20,608	15,090	3,725	3,792	3,316	3,821
Imports of goods (EUR, % change, yoy)	10.6	-26.8	-31.1	-21.2	-9.7	-2.4
Current account balance (EUR million)	-4, 338	-2,477	1,791	-1,531	-1,397	-277
Current account balance (% of GDP)	-9.2	-5.4	-	-	-	-
Gross foreign direct investment (EUR million)	4,209	2,129	739	439	550	96
Foreign exchange reserves (EUR million, eop)	9,121	10,376	9,318	10,376	10,008	10,305
Foreign debt (EUR million, eop)	40,316	44,588	42,852	44,588	44,579	44,886
GOVERNMENT FINANCE*						
Revenue (HRK million)**	134,738	128,069	94,100	128,069	29,262	59,755
Expense (HRK million)**	130,259	132,844	98,887	132,844	33,281	65,079
Net = Gross operating balance (HRK million)**	4,749	-4,815	-4,787	-4,815	-4,019	-5,325
Net acquisition of non-financial assets (HRK million)**	7,344	6,375	4,151	6,375	1,117	1,920
Net lending/borrowing (HRK million)**	-2,865	-10,739	-8,939	-10,739	-5,498	-7,680
Domestic government debt (EUR million, eop)	9,284	10,945	10,814	10,945	11,578	11,920
Foreign government debt (EUR million, eop)	4,131	5,109	4,062	5,109	4,912	4,945
Total government debt (% of GDP)	28.7	35.4	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-4.6	-14.6	-15.1	-14.6	2.3	4.2
Broad money, M4 (% change, yoy, eop)	4.3	-0.9	-1.2	-0.9	1.6	2.8
Total domestic credit (% change, yoy, eop)	10.5	-0.6	1.9	-0.6	-0.4	3.2
DMBs credit to households (% change, yoy, eop)	12.1	-2.9	0.8	-2.9	-3.2	0.3
DMBs credit to enterprises (% change, yoy, eop)	12.3	2.0	4.1	2.0	2.7	6.6
Money market interest rate (%, pa)	5.9	7.2	6.8	2.3	0.6	0.9
DMBs credit rate for enterprises, short-term, (%, pa)	8.0	10.0	10.4	9.7	8.0	7.5
DMBs credit rate for households, short-term (%, pa)	12.2	12.6	12.7	12.7	12.7	12.6

Notes: ** Data refer to consolidated general government. ** On the cash principle, cumulative from the beginning of the year.*
Conventional abbreviations: *pa - period average, eop - end of period, yoy - year on year, HRK - Croatian kuna, EUR - Euro, US$ - U.S. dollar, DMB – deposit money bank.*
Sources: *Central Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

Exports expansion concentrated in shipbuilding, oil and chemical products.

A closer look at the dynamics of exports and imports by major components reveals potential problems. The growth in exports of goods can be attributed to three large sectors: shipbuilding, oil and chemical products. The issue of exports sustainability arises due to the fact that the shipbuilding industry is under pressure to conduct wide range restructuring in order to continue production without state aid while the exports of oil products are limited by the existing capacities. Therefore, in order to retain its current pace, exports expansion should be dispersed across a wider range of sectors. On the imports side, depressed investments and weak car sales pull the imports volume downwards. However, imports of most of the other goods seem to have prospectively increased and are likely to continue to grow as restocking is ready to take place in the near future.

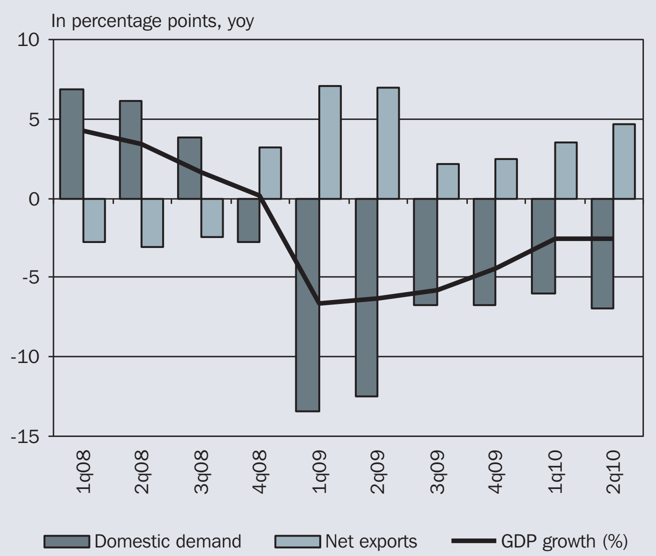
Industrial production, retail trade and construction send mixed signals.

Industrial production has exhibited a negative trend during this year following a temporary revival at the turn of the year. The cumulative decline for the first eight months 2010 amounted to 1.9 percent year-on-year, mainly driven by contraction in the intermediate and capital goods sectors. The summer months brought a cease in the negative trend of the overall industrial activity but it is too early to say whether this implies a change in the trend. In addition, a modest recovery in retail trade accelerated during the summer. Nevertheless, the cumulative volume in the first eight months still lagged by 3.1 percent behind last year's output. Construction activity has remained on a declining path as it contracted by almost 20 percent year-on-year in the first seven months this year.

Labor market deteriorates.

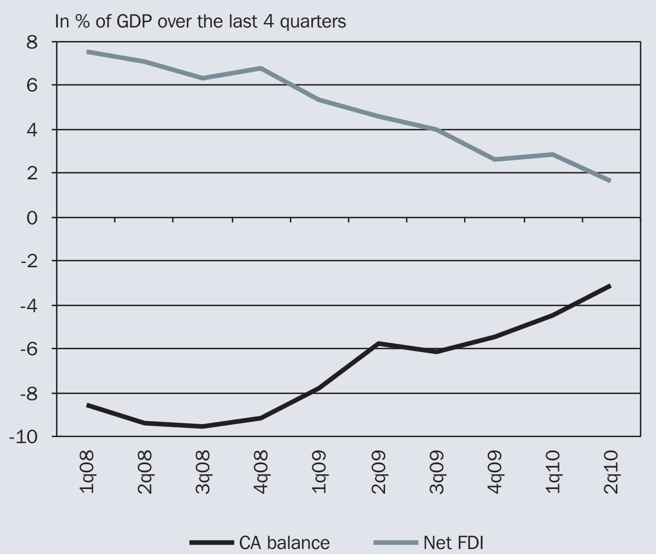
After a temporary summer relief on the labor market due to seasonal employment, the number of unemployed persons has started to rise again since the end of August. In September 2010, it was 11.7 percent higher than a year ago. The registered unemployment rate reached 16.4 percent in August, up by 2.1 percentage points over a year ago and 4.2 percentage points over two years ago. The seasonally adjusted number of unemployed persons has been rising steadily since November 2008. Over the course of this year it has grown at a stable rate of around 0.5 percent per month. The corporate sector has lost around 50,000 employees in the year up to August, while in the crafts and trade sector the number of employees has been reduced by 17,000. Around 3 percent of workplaces has been lost in each sector. Total labor supply has been reduced by around 2 percent in the

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.*

last twelve months, which is particularly challenging on the labor market with one of the lowest participation rates in Europe.

Wages under downward pressures.

The average gross wage has gradually declined over the last year, reflecting the depressed state of the economy. In August 2010, it was 1.4 percent lower year-on-year in nominal terms and 2.4 percent in real terms. In nominal terms, the sectors with the largest decline in the average gross wage are construction industry (-7.8 percent), transportation (-6.4 percent) and professional and scientific activities (-5.3 percent). In the manufacturing industry, the average gross wage fell by 1.9 percent, while in the sectors dominated by state-owned entities such as public administration, education and health care the average wage remained at last year's level. Changes in wage taxation introduced in July 2010 have led to a somewhat lower average tax burden. Therefore, the average take-home wage has been less affected by downward pressures than the average gross wage. In August 2010, the average net wage was 0.3 percent higher year-on-year in nominal terms and 0.7 percent lower in real terms.

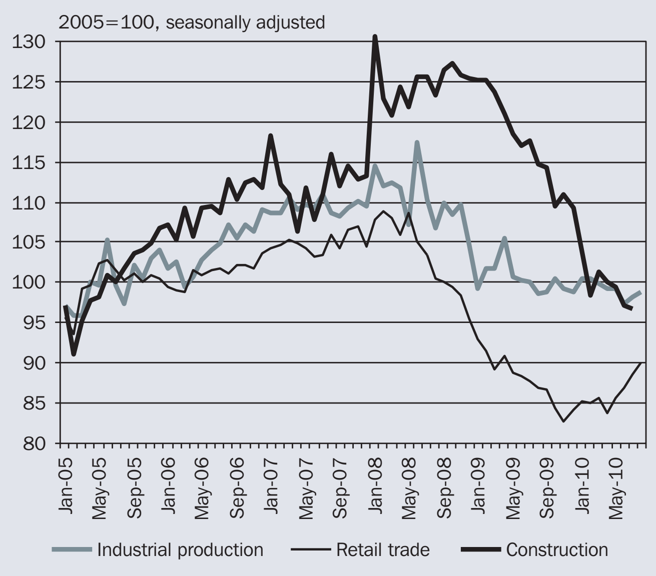
Monetary aggregates continue to recover.

Narrow money continued to grow in the third quarter 2010, recording the highest year-on-year growth rate in the last two years. In August 2010, it was 7.3 percent larger than in the same month the year before. Broad money has been steadily growing throughout the year. In August 2010, total liquid assets rose by 3.2 percent compared to the same month previous year. Savings and time deposits contributed to the broad money growth with a 2.5 percent year-on-year increase. This is mainly due to an 8.5 percent year-on-year rise in foreign currency deposits. At the same time, kuna savings and time deposits continued to subside, recording a -15.8 percent year-on-year change in August 2010.

Increase in credit activity.

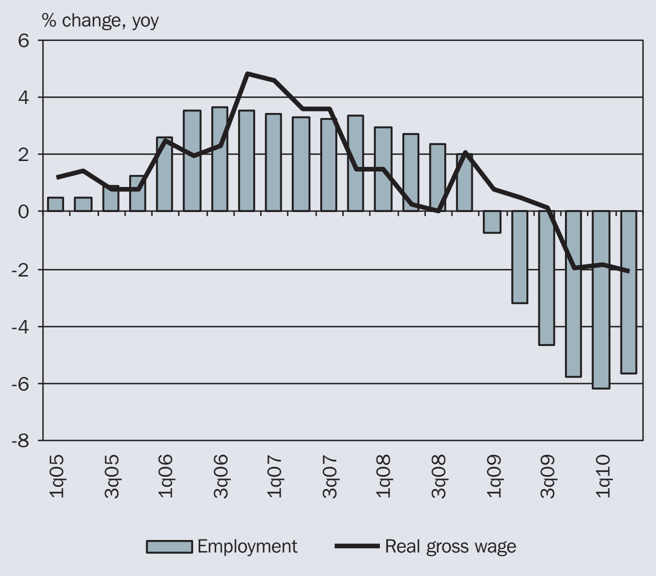
The revival of credit activity that started in the second quarter 2010 accelerated during the summer months. Namely, August saw a 4.7 percent year-on-year increase in total credits. Credits to the enterprise sector rose by 7.9 percent year-on-year in August. Since the HBOR (Croatian Bank for Reconstruction and Development) credit programs exhausted only one third of the allotted potential, further speeding-up may be expected in the remaining part of the year. Although unfavorable conditions on the labor market and consumer pessimism

Figure 4 REAL SECTOR DEVELOPMENTS



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

Figure 5 EMPLOYMENT AND REAL WAGES



Source: *Central Bureau of Statistics.*

Box 1 IN QUEST OF AN EFFICIENT DECENTRALIZATION IN CROATIA

In mid 2001, the Croatian Government launched an initiative aimed at loosening a high degree of centralization by extending the mandates of local self-government units and changing the sources of financing public functions. These initial steps have not been followed by additional measures of fiscal decentralization and consequently its level has remained unchanged in recent years. Namely, the share of local budget revenues and expenditures in the consolidated general government budget has remained around 11 percent while their share in GDP stood at 4 percent. Consequently, Croatia has continued to be among the least decentralized countries, not only compared to the developed EU-15 countries, but also compared to transition countries.

Local and regional self-government units in Croatia are highly dependent on tax revenue sharing (income tax) and grants from the central government. The fiscal capacities of local government units differ significantly, while all municipalities and all cities (except big cities and cities that are county centers) have equal authorities. Consequently, it is not possible to ensure a comparable quality of public services. In order to address these imbalances, The Institute of Economics, Zagreb has recently conducted a research project commissioned by the Croatian County Association. The project envisions three groups of proposals for decentralization aimed at a more efficient and more balanced provision of public services:

I. *A clear division of mandatory authorities among municipalities, cities, big cities and regions* is seen as a fundamental requirement for future efficient decentralization. The proposed authorities are summarized in Table B1.

II. *A change in the funding of the local and regional self-government units* is related to their mandatory authorities and should provide stable, adequate and foreseeable revenues. The first set of proposals refers to *a modification of the existing mode of financing* and includes changing the income surtax rates and using surtax revenues in determining the amount of central government grants extended to local self-government units, modifying the purpose of communal contribution and measures focused on the management of property owned by local and regional self-governments. The second set consists of *reform proposals* - they seek the application of formulas to share total revenues with the central government, the definition of criteria for the allotment of grants to local units, the substitution of communal fees by property tax and the introduction of financial incentives for the joint provision of public functions and/or financing of development projects by several local self-government units.

III. *A modified territorial division of the country* is a result of the application of fiscal autonomy principles for local and regional self-government units aimed at an efficient provision of mandatory authorities. The division should be based on three criteria: i) population size; ii) fiscal capacity; and iii) other specific criteria (e.g. historical heritage, cultural identity etc.). The first criterion proposes a minimal number of 2,000 inhabitants for a municipality, 10,000 inhabitants for a city and 35,000 inhabitants for a big city. The second criterion defines standard expenditure for mandatory authorities and standard revenues for municipalities and cities. The implementation of the proposed criteria directly identifies municipalities and cities that could successfully finance mandatory responsibilities. However, most of the current municipalities and cities are incapable of doing their job in an adequate manner and should change their status. Accordingly, the current number of municipalities and cities should be substantially reduced. The current division into 20 counties and the City of Zagreb is also found to be inefficient. Based on several important criteria - homogeneity, functionality, territorial classification for planning purposes as well as factor and cluster analysis, it is proposed to group counties into seven larger and more homogeneous spatial units - regions (Table B2). Regions are expected to be more efficient in providing mandatory public services, as well as to increase capacities for local and regional development.

All the proposals are aimed to serve as a basis for a public debate on Croatia's decentralization and not as final answers to numerous open questions. The policy decisions should be made only after thorough consultations with all relevant stakeholders.

Dubravka Jurlina Alibegović

Table B1 PROPOSED DIVISION OF MANDATORY AUTHORITIES

Municipalities	• financing children's daycare • financing municipal waste transport and management • financing the maintenance of public areas • financing public firefighting brigades • financing unclassified roads and public lighting
Cities	Mandatory authorities of municipalities plus • financing public libraries • financing public utility services • financing water supply and drainage • financing primary and secondary education • financing social welfare centers
Big cities	Mandatory authorities of cities plus • management of primary health care • financing cultural institutions • financing public roads
Regions	• establishing a network of agencies and institutions providing public services • financing secondary health care as well as primary and secondary education in municipalities and cities of the region that are unable to cover their costs • funding the public services previously provided by state administration offices in the county • physical planning and environmental protection

Table B2 PROPOSED REGIONAL DIVISION

Međimurje, Podravina, and Western Slavonia	• County of Koprivnica-Križevci • County of Bjelovar-Bilogora • County of Međimurje • County of Virovitica-Podravina
Northwestern and Central Croatia	• County of Krapina-Zagorje • County of Varaždin • County of Karlovac • County of Sisak-Moslavina
Dalmatia	• County of Zadar • County of Šibenik-Knin • County of Split-Dalmatia • County of Dubrovnik-Neretva
Lika	• County of Lika-Senj
Slavonia	• County of Brod-Posavina • County of Osijek-Baranja • County of Požega-Slavonia • County of Vukovar-Srijem
Istra, Primorje, and Gorski Kotar	• County of Istria • County of Primorje-Gorski Kotar
Zagreb	• City of Zagreb • County of Zagreb

still depress household demand for credits, positive year-on-year growth rates have been recorded since mid 2010. When compared to the same month the year before, household credits increased by 1.4 percent in August. A rise in reservations for nonperforming loans and an unexpected loss in non-interest income have led to a fall in banks' profits regardless of administrative cost cuts and credit reprogramming. Consequently, pre-tax profits dropped by about 20 percent in the first half of 2010 when compared to the same period last year.

High liquidity and low interest rates.

At the beginning of October 2010, overnight deposits at the central bank amounted to almost HRK 5 billion, confirming that banks continue to keep their liquidity reserves above the required minimum. High liquidity continues to put a downward pressure on market interest rates. From the low 0.77 percent in February 2010, the overnight ZIBOR advanced to 1.03 percent in September. The central bank has restrained itself from repo auctions for a full year now, which implies that it is comfortable with the prevalent liquidity and low interest rates.

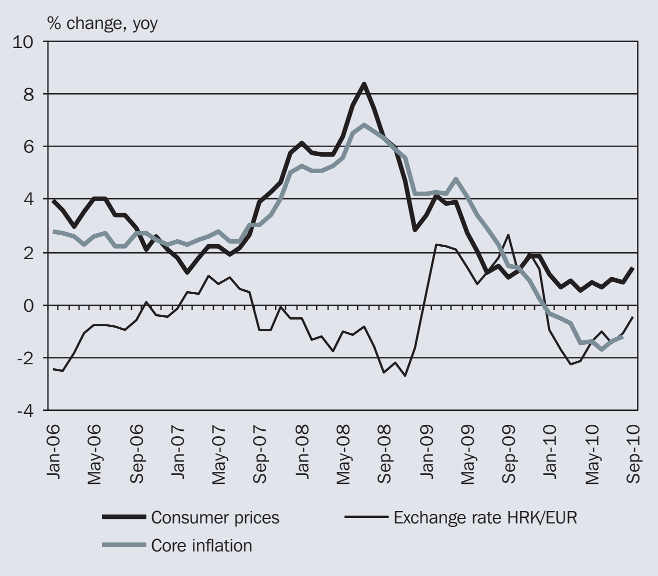
Subtle depreciation pressures.

Since the last exchange rate intervention at the beginning of July, the HRK/EUR exchange rate has been exposed to appreciation pressures due to a seasonal increase in demand for domestic currency and strong government borrowing on foreign and domestic markets. Nevertheless, with the end of the tourist season, subtle depreciation pressures intensified and resulted in the HRK/EUR exchange rate of 7.29 at the end of September. However, due to anticipated government foreign borrowing in the last quarter 2010 we expect appreciation pressures to take up again.

Inflation slightly accelerates.

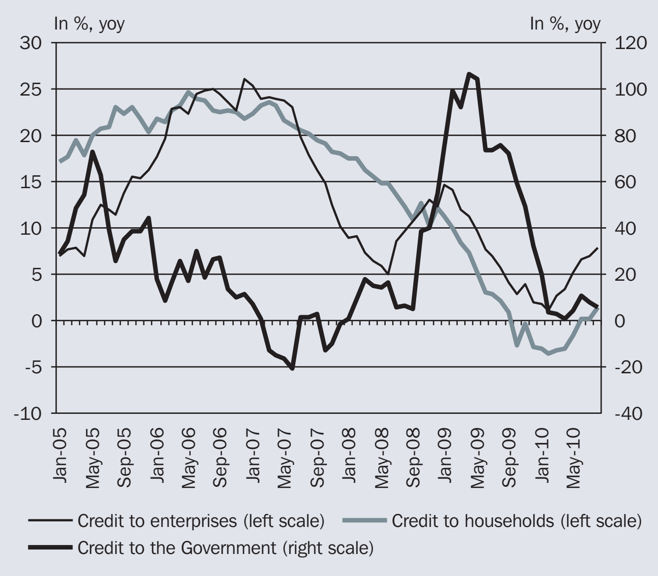
Seasonally induced growth in clothing and footwear prices as well as an increase in fuel prices due to the rise in excise tax contributed to a slight acceleration in consumer price inflation that amounted to 1.4 percent year-on-year in September. Meanwhile, producer price inflation has kept slowing down from its 5.1 percent peak in April 2010. Owing mostly to food prices, the overall producer price index increased by 4.4 percent in September compared to the same month a year earlier. The core consumer price inflation has remained negative for eight months in a row, recording -1.2 percent year-on-year in August.

Figure 6 INFLATION AND EXCHANGE RATE



Note: A decrease in exchange rate index denotes appreciation of the HRK.
***Sources:** Central Bureau of Statistics and Croatian National Bank.*

Figure 7 CREDIT DEVELOPMENTS



***Source:** Croatian National Bank.*

Deterioration in government revenues...

The deterioration of general government revenues which started in the first quarter 2009 has continued. Yet its pace slowed down from a 3.4 percent year-on-year decline in the first quarter to a 1.4 percent decline in the second quarter 2010. While in the first quarter there was virtually no year-on-year increase in VAT revenues, despite a one percentage point rise in the VAT rate (from 22 to 23 percent), this revenue component was 3.1 percent higher in the second quarter 2010 than in the same period a year ago. Concerning excise taxes, their year-on-year increase in the second quarter 2010 amounted to 35.2 percent. This is mainly due to the re-established regular flow of the excises on petroleum products from the INA oil company to the treasury. Revenues from the personal and corporate income taxes fell by 10.6 and 46.8 percent, respectively, reflecting the poor performance of the economy. In terms of the total revenue collection, this was the worst second quarter since 2006.

... led to budget revision.

In the initial central government budget for this year, the deficit was planned at HRK 8.6 billion. As 90 percent of this amount was realized in the first half of the year, a budget revision was passed in the Parliament on August 30. According to this revision, general government revenues are expected to reach HRK 108.3 billion, which is 4.5 billion less than planned in the initial budget. As for the expenditures, the initially planned amount was increased by HRK 898.2 million to HRK 122.3 billion. In addition, the Parliament decided to freeze the total expenditures in 2011 and 2012 at this level.

Further rise in public debt.

The consolidated central government debt (without guarantees) reached HRK 120.6 billion at the end of June, which is 12.6 percent higher than in the same period last year and 4.1 percent more than at the beginning of 2010. As for the total government guarantees, they rose 17.5 percent year-on-year. Having risen by 14.1 percent year-on-year, the consolidated central government debt including guarantees reached HRK 175.3 billion at the end of June or 53 percent of the expected GDP for this year.

Medium-term fiscal objectives revealed.

On October 6, the Government released the *Guidelines for Economic and Fiscal Policies for the period 2011-2013*, revealing its medium-term fiscal objectives. Based on the conservative forecasts of GDP growth (1.5, 2.0 and 2.5 percent for 2011, 2012 and 2013, respectively), the Government hopes for deficit-to-GDP ratios of 4.8, 3.2 and 1.9 percent in 2011, 2012 and 2013. Accordingly, the deficit-to-GDP ratio should fall below the Maasticht 3-percent target in 2013. As for the financing of those deficits, the projections predict HRK 16.4 billion for the next year, 11.7 for 2012 and 7 for 2013. The revenue projections do not provide enough details while the underlying assumptions are not explicit, which adds a layer of uncertainty. On the expenditure side, nothing has been changed in terms of the structure of government outlays so the status quo, in which social security items dominate, has been retained. In addition, given the uncertainties in revenue collection, it is surprising that there is no prioritization in terms of spending. As for the financing of future deficits, there will be a heavier reliance on foreign sources compared to the 2005-2009 period.

2 Policy Assumptions and Projections Summary

Global economy continues to recover.

Global economic recovery continued to strengthen during the first half of 2010 led by emerging economies. The revival was underpinned by inventory and fixed investments that have stimulated a rise in manufacturing and global trade. Nevertheless, the recovery was weaker in the advanced economies where low consumer confidence and reduced disposable incomes are still keeping consumption suppressed. Stronger demand, a rebound in financial markets and a weaker U.S. dollar have also spurred the recent rise in oil prices. According to the October IMF projections (*World Economic Outlook*, October 2010), the global activity is expected to expand by 4.8 percent in 2010 and 4.2 percent in 2011. Unemployment will remain high while inflation is expected to stay low in spite of upward pressures from oil prices. Downside risks to the growth forecasts dominate the upside ones, but another sharp global slowdown is unlikely. In Europe, the better-than-expected growth performance was recorded in the second quarter 2010, particularly in Germany, where the main growth drivers were net exports and restocking.

Domestic factors to determine the future pace of the economy.

Croatian economy will benefit from the improved conditions in the international environment through increased foreign demand and better financing conditions. Although these external factors are important, the domestic ones will be predominant in determining the future pace of the economy. One of the crucial factors is consumer and business confidence. In that respect, the Government is sending mixed and often discouraging signals. On the one hand, the average income tax burden has been reduced recently. On the other hand, there is a persistent threat of new taxes - tax on banks has been seriously discussed and so has the introduction of a more comprehensive property tax. Policymakers emphasize an urgent need for fiscal consolidation but fail to undertake any credible actions in that direction. The Government seems already very much focused on next year's parliamentary elections, while the measures that would lead to the less expensive and more efficient government sector are left aside. As a result, the economic climate is rather gloomy. In such a situation even the abolition of the "crisis tax" and its positive effect on household income will have only limited effects on consumer behavior. As for the fiscal policy, we do not foresee any considerable expenditure cuts. Since the liquidity of the banking sector is not an obstacle for financing, we also do not anticipate further monetary easing. Monetary authorities are expected to remain focused on the stability of the HRK/EUR exchange rate in order to avoid financial disturbances in the economy.

GDP forecast for 2010 remains unchanged at -1.7 percent.

Our GDP forecast remains broadly unchanged compared to July projections, except for certain adjustments in several demand components in line with the latest developments. Namely, investments are now projected to be somewhat weaker and personal consumption somewhat stronger than earlier. As these changes cancel out, our GDP forecast for 2010 has remained unaffected, suggesting a 1.7 percent decline. As for the upcoming year - mainly due to the stronger-than-expected recovery of the euro area - we have revised upwards the GDP forecast for 2011 by a 0.1 percentage point to 1.7 percent. Rising exports and a gradual recovery in personal consumption should be the main factors behind the revival of economic growth.

Personal consumption to start recovering.

Although negative trends in personal consumption seem to have ceased, a good deal of uncertainty persists. We expect a modest recovery towards the end of the year that should gain strength in 2011. As a result, personal consumption is projected to decline 2.1 percent in 2010, while the return to positive rates is expected in 2011 with a 1.8 percent increase. The negative developments on the labor market should weaken over the projection period while the complete abolishment of the "crisis tax" scheduled for November this year will release certain resources to households, helping to restore consumer confidence. Further extension of credits to the household sector should also help personal consumption to increase next year. One should note that the ongoing employment reduction is also related to the increased pace of retirement, meaning that its negative income effect is to be cushioned by a rise in aggregate pensions.

Investments to remain restrained.

Investments are not expected to recover any time soon. Their contraction this year is expected to be even stronger than last year and reach 12.3 percent. Gradual restructuring of investments towards a larger number of smaller projects, equipment investment and investment by the private sector should, in addition to positive developments in other segments of the economy, bring a 2 percent increase in 2011, mostly concentrated in the second half of the year. An additional correction in prices on the housing market should induce a somewhat stronger demand next year.

Current account deficit to recede to 3.0 percent of GDP in 2010.

The foreign trade sector will underpin the recovery through stronger export performance. This year it should be supported by the beneficial financial outcome of the tourist season. Next year, the pace of exports growth is expected to slow down slightly due to the restructuring of the shipbuilding industry, which is an important exporter. We project exports growth to reach 5.5 percent this year and 3.4 percent next year. Imports are expected to remain in the negative zone with a 3.8 percent decline this year. However, imports should recover next year and reach a 4.3 percent rise so that the positive effect of the foreign trade on the overall output will diminish and become negative as the restocking process will accompany the revival of the overall economy. The current account deficit is expected to widen from 3.0 percent of GDP this year to 3.8 percent next year.

Jobless recovery in the next year.

In the next couple of quarters, the labor market is expected to pass through a turbulent period. Unemployment will increase as a consequence of the prolonged recession and seasonal shrinkage in the labor demand is expected to peak in February-March 2011 with about 330,000 persons registered at the Employment Service and an unemployment rate of around 19 percent. A gradual improvement should follow thereafter mostly due to more favorable seasonal effects while the positive effects of the anticipated recovery on the labor market will probably be delayed until early 2012. Therefore, we see 2011 as a year of jobless recovery.

Wage downsizing to continue.

Due to a weak competitive position of domestic producers, the cost cutting strategy remains the main instrument in fighting the prolonged recession with a more restrictive wage policy than ever before. Wage corrections are, therefore, expected to continue this and next year. On the macroeconomic front, such a business strategy will lead to a subdued disposable income with a possible negative impact on personal consumption.

Inflation to remain suppressed by weak demand this year.

Weak domestic demand, coupled with a stable exchange rate and subdued wages, will continue to put the downward pressure on inflation. Our consumer price inflation projection for this year is 1.1 percent. As recovery continues worldwide, we expect to see somewhat higher import prices, which would, in addition to revived domestic demand, push the inflation rate up to around 2.2 percent in 2011.

No need for further monetary easing.

The mandatory reserve rate cut in February 2010 resulted in abundant interbank liquidity due to the poorly exploited HBOR credit lines and weak demand for credits in general. Taking the money market liquidity status into account and the central bank's credit projections for this year, we do not expect any further monetary easing in 2010. The overall outcome of the current monetary policy and prospects on the interbank money market suggest that interest rates will remain at low levels. Having in mind that the Government plans to issue a new bond on the foreign market in the fourth quarter 2010, we see a potential for appreciation pressures on the HRK/EUR exchange rate. As the third quarter 2010 brought a revival in credit activity and since there are no signs of monetary easing this year, we have adjusted our forecast for 2010. We project broad money to grow by 4.0 percent and the total domestic credit to increase by 4.5 percent in 2010. The anticipated broad money growth of 9 percent in 2011 should be driven by narrow money and the expected mandatory reserve rate cuts. Next year, we also expect domestic credits to grow at a maximum rate of 12 percent.

Fiscal deficit will rise...

The expectations concerning the 2010 deficit have been adjusted according to the recent budget revision: the general government deficit is now expected to be higher than in the initial budget by HRK 5.4 billion. The budget revision is based on the expected GDP decline of 1.5 percent, so it is expected to give rise to the general government deficit-to-GDP ratio to 4.6 percent for the whole year. However, as we project that GDP will fall somewhat more, our deficit projection is 4.7 percent.

... and so will the public debt.

In July this year, three ten-year bonds were issued: two on the domestic market (HRK 1.5 billion and EUR 650 million) and one on the U.S. market (USD 1.25 billion). In addition, the Government has recently obtained a domestic EUR 750 million-loan for servicing outstanding debt obligations. Along with two domestic ten-year bonds from March this year, aimed at reprogramming old debts, the total outstanding public debt (guarantees excluded) will certainly end up beyond 40 percent of GDP, up from 35.4 percent at the end of 2009.

Table 2 SUMMARY OF PROJECTIONS

	2010	2011
Real GDP (% change)	**-1.7**	**1.7**
Real private consumption (% change)	-2.1	1.8
Real government consumption (% change)	-1.1	1.0
Real investment (% change)	-12.3	2.0
Exports of goods and services (constant prices, % change)	5.5	3.4
Imports of goods and services (constant prices, % change)	-3.8	4.3
Current account balance (% of GDP)	-3.0	-3.8
Consumer prices (% change, pa)	1.1	2.2
Exchange rate, HRK/EUR (pa)	7.27	7.30
Unemployment rate (registered, %, pa)	17.5	18.0
General government balance (ESA95 definition, % of GDP)	-4.7	-4.8
Broad money, M4 (% change, eop)	4.0	9.0
Total domestic credit (% change, eop)	4.5	12.0

Notes: *Cut-off date for information used in the compilation of projections was October 7, 2010.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

3 Uncertainties and Risks to Projections

What will drive the recovery?

Investment activity has recently been weaker than earlier expected. The fact that there are no signs of its recovery gives rise to substantial uncertainty about the projections. Both industrial production and exports exhibit pronounced performance differences across sectors, suggesting the fragility of the observed positive developments. While exports and investments seem to be too weak to drive the overall recovery, personal consumption remains the only potential growth source. However, there is a question of how it can be financed and how to regain consumers' confidence. It seems that households have certain potential as their savings rise. However, they are not ready to increase consumption under the circumstances of uncertainty, especially on the labor market. With respect to competitiveness, almost nothing has been done during the crisis at the macro level. The Government's efforts have been mainly devoted to retaining the status-quo, while conditions for a long-term increase in competitiveness have not been laid down. It might be said that 2010 has been a "lost" year in terms of policy and output, as 2011 will probably attain the 2009 output.

The costs of postponing reforms might be high.

The Government seems reluctant to undertake unpopular reforms. In almost every attempt, it has stepped backwards at signs of conflict either with trade unions or other interest groups. Consequently, one has the impression that the direction of economic policy is more determined by day-to-day political motives than the government strategy and expertise. Although elections are expected to take place before the end of 2011, the Government and opposition parties seem very much focused on them. Therefore, the Government might avoid taking any action that it perceives as politically costly, which is discouraging for an economy in urgent need of credible policy actions. The costs of such behavior might be high. If large-scale structural reforms are not be undertaken in the very near future, the recovery will be slow and weak.

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