The Institute of Economics, Zagreb
Department for Macroeconomic Analysis and Policy
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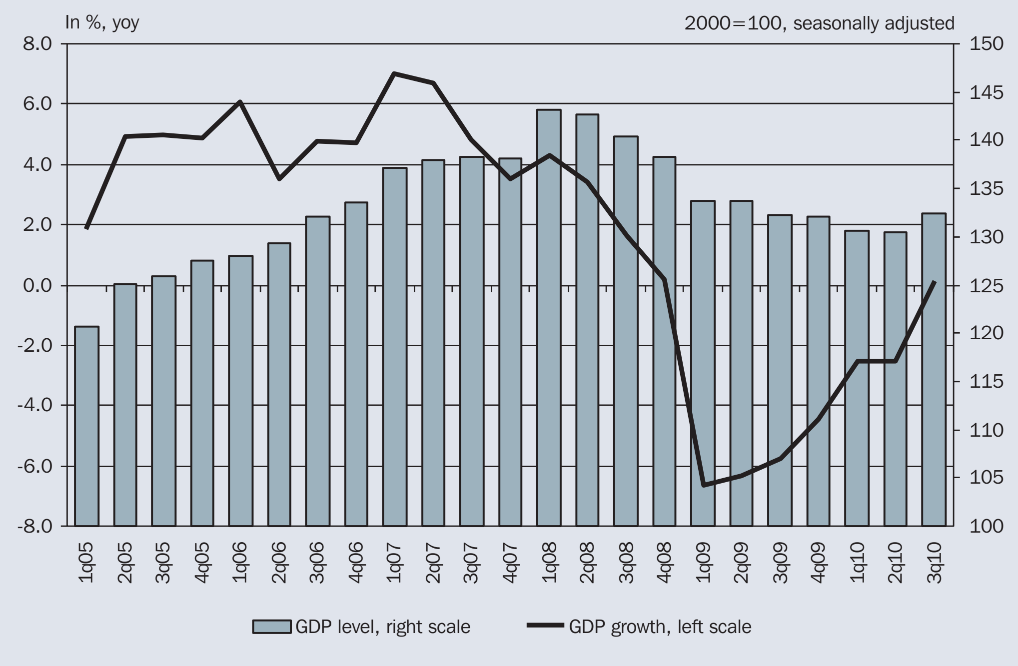
# Croatian Economic Outlook
*Quarterly*

## 1 Recent Developments

***Is recession over?***

For the first time since early 2008 the Croatian economy recorded a positive growth rate. While GDP increased 0.2 percent year-on-year in the third quarter 2010, it is much more important that it also grew on a quarter-on-quarter basis. The estimated pace of growth ranges from 0.5 to 1.5 percent depending on the method of seasonal adjustment. From a technical point of view, such an increase suggests that recession has come to an end. However, we are still cautious about drawing such a conclusion for at least two reasons. Firstly, due to the instability of seasonal factors, a more precise estimate of the underlying trend can be given only after additional observations are released. Secondly, high-frequency indicators for the fourth quarter 2010 suggest a possibility of another negative quarterly GDP change. In addition, labor market developments are strikingly unfavorable, which makes the observed signs of recovery fragile. It should, however, be stressed that GDP national accounts figures for the third quarter 2010 suggest better-than-expected performance in respect to almost all expenditure components, in particular personal consumption and investments. Domestic demand made an important positive contribution to GDP growth while net exports' contribution turned negative after more than two years. Such a change,

Figure 1 REAL GROSS DOMESTIC PRODUCT




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

although structurally not very appealing, is encouraging for the non-tradable sectors of domestic economy.

***Revival of personal consumption.***

Personal consumption increased 1.9 percent year-on-year in the third quarter. Moreover, seasonally adjusted consumption grew by a significant rate over the previous three months for the second quarter in a row. At the beginning of the recession, personal consumption started to recede one quarter before GDP so that its current revival will have beneficial effects on the overall economy. Nevertheless, the latest available data on the volume of retail sales in November suggest another slide into negative territory following the signs of recovery during the preceding months. Unless the Christmas shopping season has not changed the trend, prospects for retail trade and personal consumption do not seem as bright as suggested by the third quarter figures. Problems arise mainly from the labor market due to reduced employment, although some relief might come from lower taxation following the abolishment of special "crisis tax" on wages and other income in November and changes in income tax in July 2010. Consumer confidence will be crucial for developments in the upcoming months.

***Government consumption continues to decline.***

Faced with reduced revenues and tightened financing conditions, government consumption has continued to decline. In the third quarter, it fell 0.9 percent below its level a year before. Relatively slow adjustment that has been present ever since the beginning of the recession suggests that the Government does not have enough strength or willingness to rebalance its consumption considerably. Namely, the purchase of services provided by the government employees constitutes the largest part of government consumption. That part of consumption has not changed much, while the remaining part - related to the purchase of goods - declined moderately. However, the room for maneuver, when concentrated only on that second part of spending, is relatively small.

***Investments exhibit first positive signs.***

Rather surprisingly, seasonally adjusted investment figure for the third quarter 2010 indicates a positive change after nine quarters of decline. Investment volume is still 9.5 percent lower than a year ago, but the observed rise over the previous quarter is an encouraging signal. Investment in machinery and equipment led to such a change as suggested by an increase in imports of capital goods. Construction activity still seems to be in deep problems as monthly data on the number of hours worked on construction sites exhibited a straight negative trend from the beginning of 2009 to October 2010.

***Reversal in foreign trade trend – exports decline; imports rise.***

Total exports and imports, as recorded in the national accounts statistics, changed their pace notably in the third quarter 2010. Seasonally adjusted exports volume, which continuously increased over the previous four quarters, declined somewhat in the third quarter while the dynamics of imports was just the opposite, including a considerable recent rise. In the third quarter 2010, exports and imports were 5.7 and 3.1 percent higher than a year ago, respectively. The recovery of imports is a positive sign, even if imported goods are used for restocking as it heralds higher consumption and investments in the near future. The exports decline might be temporal and caused by lower-than-usual revenues from international tourism in the third quarter.

***Disappointing revenues from international tourism.***

The current account position has improved. In the year up to the third quarter, the deficit was 2.8 percent of GDP, down by 0.1 percentage points from the previous quarter and by 6.7 percentage points from the peak in the third quarter 2008. Such a decline was driven by the reduced imports of goods that fell from EUR 5.4 billion in the third quarter 2008 to below EUR 4 billion in the third quarter 2010. The current account was in surplus, amounting to EUR 1.85 billion in the third quarter 2010, which is some EUR 50 million

Table 1 MAIN ECONOMIC INDICATORS

| | 2008 | 2009 | 2009 | 2010 | | |
|---|---|---|---|---|---|---|
| | | | Q4 | Q1 | Q2 | Q3 |
| **ECONOMIC ACTIVITY** | | | | | | |
| Real GDP (% change, yoy) | 2.4 | -5.8 | -4.5 | -2.5 | -2.5 | 0.2 |
| Real private consumption (% change, yoy) | 0.8 | -8.5 | -7.5 | -4.1 | -2.5 | 1.9 |
| Real government consumption (% change, yoy) | 1.9 | 0.2 | -3.3 | -1.1 | -1.8 | -0.9 |
| Real investment (% change, yoy) | 8.2 | -11.8 | -11.3 | -12.9 | -13.4 | -9.5 |
| Industrial output (% change, yoy) | 1.2 | -9.3 | -7.7 | -0.5 | -3.3 | 0.1 |
| Unemployment rate (registered, %, pa) | 13.2 | 14.9 | 16.2 | 18.2 | 17.2 | 16.6 |
| 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 | 2.7 | 0.8 | 1.0 | 1.1 |
| Consumer prices (% change, yoy, pa) | 6.1 | 2.4 | 1.7 | 0.9 | 0.7 | 1.1 |
| Producer prices (% change, yoy, pa) | 8.3 | -0.4 | 0.1 | 3.6 | 4.8 | 3.8 |
| Average gross wage (% change, yoy, pa) | 7.1 | 2.2 | -0.4 | -0.9 | -1.0 | -0.2 |
| Exchange rate, HRK/EUR (pa) | 7.22 | 7.34 | 7.27 | 7.29 | 7.25 | 7.25 |
| Exchange rate, HRK/US$ (pa) | 4.94 | 5.28 | 4.92 | 5.26 | 5.69 | 5.62 |
| | | | | | | |
| **FOREIGN TRADE AND CAPITAL FLOWS** | | | | | | |
| Exports of goods (EUR million) | 9,814 | 7,703 | 1,984 | 2,033 | 2,326 | 2,231 |
| Exports of goods (EUR, % change, yoy) | 6. 8 | -21.5 | -16.0 | 5.4 | 22.3 | 18.1 |
| Imports of goods (EUR million) | 20,608 | 15,090 | 3,792 | 3,317 | 3,822 | 3,948 |
| Imports of goods (EUR, % change, yoy) | 10.6 | -26.8 | -21.2 | -9.4 | -2.3 | 6.0 |
| Current account balance (EUR million) | -4, 338 | -2,477 | -1,531 | -1,393 | -182 | 1,849 |
| Current account balance (% of GDP) | -9.2 | -5.4 | - | - | - | - |
| Gross foreign direct investment (EUR million) | 4,209 | 2,129 | 439 | 600 | 116 | 453 |
| Foreign exchange reserves (EUR million, eop) | 9,121 | 10,376 | 10,376 | 10,008 | 10,305 | 11,154 |
| Foreign debt (EUR million, eop) | 39,950 | 44,588 | 44,588 | 44,620 | 44,996 | 44,619 |
| | | | | | | |
| **GOVERNMENT FINANCE*** | | | | | | |
| Revenue (HRK million)** | 134,738 | 128,087 | 128,069 | 29,262 | 59,755 | 91,905 |
| Expense (HRK million)** | 130,259 | 132,450 | 132,844 | 33,281 | 65,079 | 97,884 |
| Net = Gross operating balance (HRK million)** | 4,749 | -4,363 | -4,815 | -4,019 | -5,325 | -5,979 |
| Net acquisition of non-financial assets (HRK million)** | 7,344 | 6,357 | 6,375 | 1,117 | 1,962 | 3,078 |
| Net lending/borrowing (HRK million)** | -2,865 | -10,720 | -10,739 | -5,135 | -7,287 | -9,058 |
| Domestic government debt (EUR million, eop) | 9,284 | 10,995 | 10,995 | 11,627 | 12,050 | 12,541 |
| Foreign government debt (EUR million, eop) | 4,131 | 5,134 | 5,134 | 4,940 | 5,026 | 5,821 |
| Total government debt (% of GDP) | 28.7 | 35.5 | - | - | - | - |
| | | | | | | |
| **MONETARY INDICATORS** | | | | | | |
| Narrow money, M1 (% change, yoy, eop) | -4.6 | -14.6 | -14.6 | 2.3 | 4.2 | 13.6 |
| Broad money, M4 (% change, yoy, eop) | 4.3 | -0.9 | -0.9 | 1.6 | 2.8 | 3.8 |
| Total domestic credit (% change, yoy, eop) | 10.5 | -0.6 | -0.6 | -0.4 | 3.2 | 5.3 |
| DMBs credit to households (% change, yoy, eop) | 12.1 | -2.9 | -2.9 | -3.2 | 0.3 | 1.7 |
| DMBs credit to enterprises (% change, yoy, eop) | 12.3 | 2.0 | 2.0 | 2.6 | 6.6 | 8.6 |
| Money market interest rate (%, pa) | 5.9 | 7.2 | 2.3 | 0.6 | 0.9 | 1.2 |
| DMBs credit rate for enterprises, short-term, (%, pa) | 8.0 | 10.0 | 9.7 | 8.0 | 7.5 | 7.2 |
| DMBs credit rate for households, short-term (%, pa) | 12.2 | 12.6 | 12.7 | 12.7 | 12.6 | 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.*

more than a year ago, mainly due to 18-percent higher merchandise exports. However, tourism revenues underperformed, with a 1.2 percent year-on-year decline in current EUR terms. General expectations were much higher based on the encouraging physical indicators of the tourist season – namely, the number of overnight stays of foreign tourists in the third quarter was 5.2 percent higher than a year before, while prices of food and accommodation were some 2 percent higher. Obviously, in 2010 foreign tourists spent substantially less than they used to in the previous years.

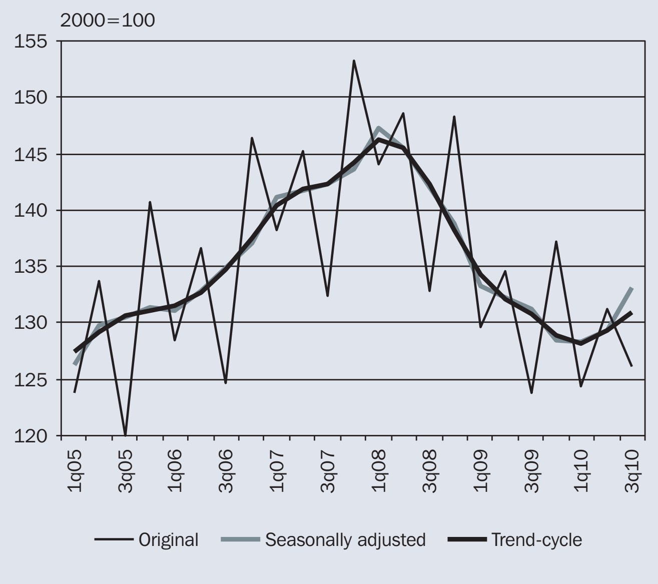
***Real sector activity subsides.***

The latest real sector indicators point to a slowdown in activity in the last quarter 2010. Compared to the third quarter, seasonally adjusted industrial production declined on average by 2 percent in the October-November period. Similar dynamics are observed in the retail trade sector, with a 3 percent decrease following the signs of modest recovery for the most part of 2010.

***Labor market conditions remain unfavorable...***

Labor market conditions remain unfavorable. Total unemployment continued to rise with the end of the tourist season, reaching 320 thousand in December, which is around 28 thousand, or 9.7 percent more than a year ago. The unemployment rate outpaced 18 percent. Seasonally adjusted unemployment exhibits a clear rising trend without signs of moderation. Employment figures provide an even gloomier picture as year-on-year employment in November decreased by approximately 70 thousand, or 4.7 percent, suggesting that some pressures on the unemployment rate were alleviated by declining labor force participation. Namely, total labor supply dropped by more than 2 percent. Another concern is employment in small business entities. The unincorporated sector (crafts, trades, and freelances), that constitutes roughly 16 percent of the total employment, experienced an employment decline of 18.5 thousand, or 7.7 percent year-on-year with a continued strong negative trend over the last two years. The share of women in total unemployment has been decreasing since the beginning of 2009, which implies that they have been less affected by the crisis than men. This drop was especially pronounced in the second half of 2010, when the share of women in total unemployment was around 55 percent (as compared to 62 percent at the end of 2008). This is not a surprise since the

Figure 2 PERSONAL CONSUMPTION




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

Figure 3 EXPORTS AND IMPORTS OF GOODS AND SERVICES


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

construction and manufacturing industries, typically male-dominated sectors, have been mostly hit by the crisis.

***... while net wages modestly improve due to tax changes.***

Wage adjustments have not followed the employment trends. The average gross wage in the third quarter was around HRK 7,620, which is 0.23 percent less than in the same period a year before. Employees in construction, as well as those working in professional, scientific, and technical activities, saw the strongest decline in gross wage. Then again, the nominal net wage somewhat increased in the third quarter (1.23 percent year-on-year), mainly due to changes in income taxation introduced at the beginning of July. The take-home wage recorded an even higher rise due to "crisis tax" abolishment. Nevertheless, in the second half of the year the total wage bill (net of taxes) still remained below its last year's level mainly due to lower employment. Actually, in the third quarter the overall disposable income of the population is estimated to have fallen by around 1.5 percent in nominal terms year-on-year, or 2.5 percent in real terms.

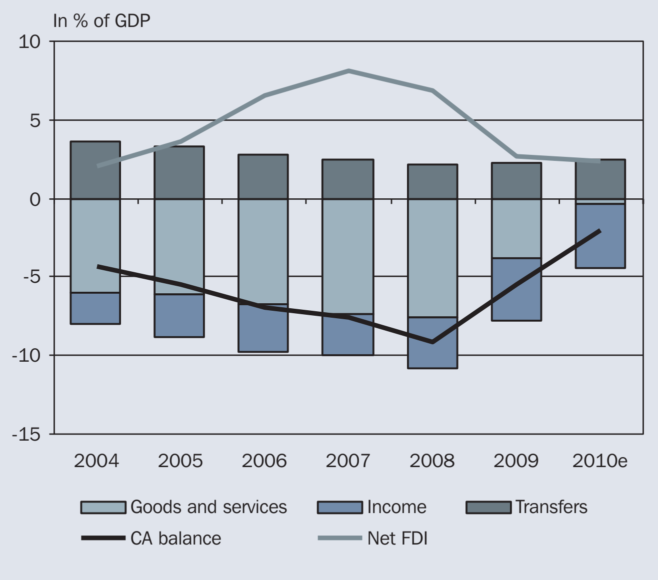
***Households continue to increase savings...***

After a significant 0.9-percent monthly increase in October, broad money remained unchanged in November according to seasonally adjusted data. Nevertheless, broad money was still 4.0 percent larger than in the same month a year before. Savings and time deposits contributed mostly to such an increase, rising by 3.8 percent. Namely, in addition to the household sector that has continued to increase savings, the November data indicate a positive year-on-year change in enterprise savings, the first one after two years.

***... while their credit activity remains subdued.***

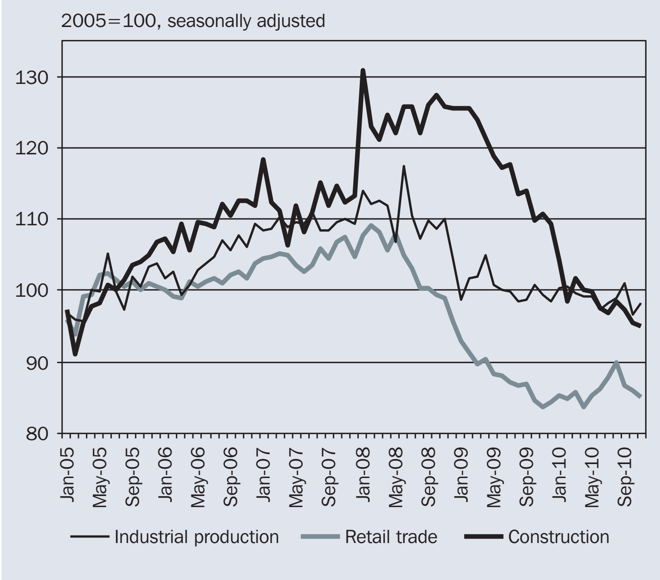
Credits to enterprises and households grew by 8.9 and 2.8 percent respectively in November when compared to the same month a year ago. Even though credit growth is modest and mostly reflects low base effects, this increase partially reflects the recent kuna weakening against the Swiss franc. Namely, a significant portion of kuna household credits is indexed to CHF. When the exchange rate effect is excluded, the November year-on-year growth of total credits decreases from 6.4 to around 4 percent, while credits to households exhibit a negative change. However, credits to enterprises were not much affected by these exchange rate movements. Namely, their growth was driven by low base effects and the

Figure 4 CURRENT ACCOUNT BALANCE AND FDI




***Note:*** *e - estimate.*
***Sources:*** *Croatian National Bank and EIZ estimate.*

Figure 5 REAL SECTOR DEVELOPMENTS




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

## Box 1 POPULATION AGING AND THE ADEQUACY OF RETIREMENT INCOME IN CROATIA

Population aging implies a decline in working age population and an increase in the number of older persons, putting tremendous pressure on pension systems, especially those based on pay-as-you-go principles. This process, together with a high rate of early retirement, has already aggravated the pension system dependency ratio in Croatia. Namely, the ratio between those employed and retired is now around 1.25 with the prospect of further decline. With the current legal retirement age of 65 for men and 60 for women, relatively numerous retirees of younger age due to disability, and more than 100,000 early retired persons, Croatia currently has 55 percent more pensioners than the population aged above 65. These unfavorable indicators are reflected in relatively low pensions. For instance, the average net pension is around 40 percent of the average net wage. Pension system parameters suggest that future pensions could be even lower. Consequently, the question is whether there is scope for achieving adequate retirement income and whether there is public awareness of the need to take personal responsibility for income in the third age. In the quest for the answers, the Croatian Chamber of Economy and the Institute of Economics, Zagreb conducted a research project, including a survey on expected pension benefits and saving habits of the population.

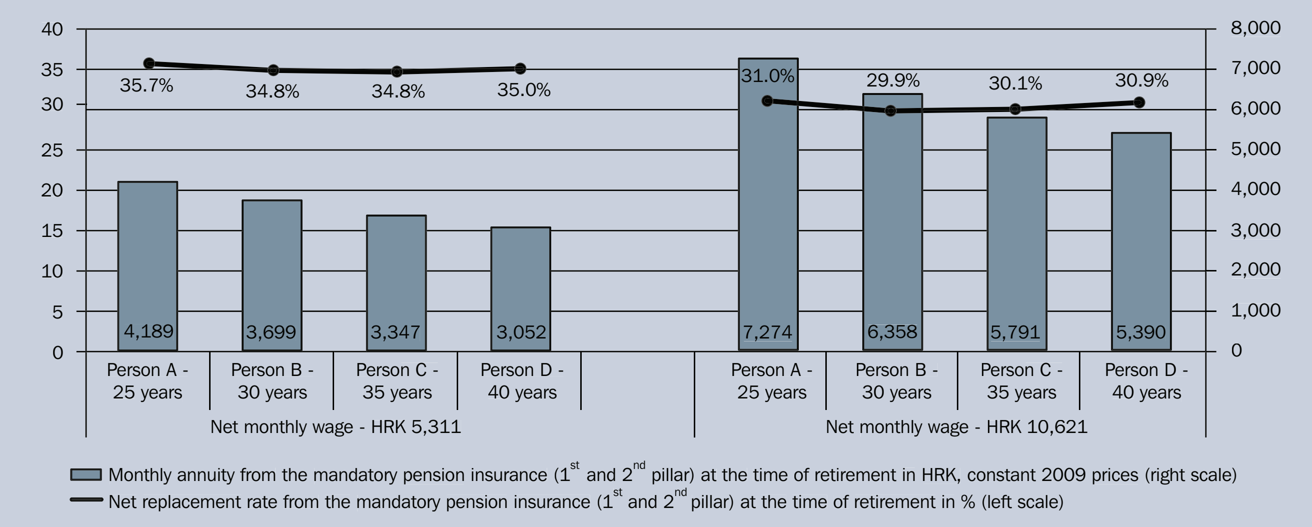
*Adequacy of retirement income will not be achieved unless private savings are accumulated.* Results suggest that reasonable adequacy of retirement income can be achieved by a combination of public pensions and private rents and other incomes following a well-known "golden rule" of risk diversification. Pensions from the mandatory pension insurance are likely to decrease in the long run, as measured by the net replacement rate, i.e., the ratio of the first old-age pension and the last pre-retirement wage of an individual. Figure B1 shows projections of net replacement rates for four persons who are currently 25, 30, 35, and 40 years old; will work for 40 years; and will receive over their entire working life the average wage in the first case, or twice the average wage in the second case. No change in parameters of the pension system is assumed. A net replacement rate of around 35 percent is expected for those with the average wage, and of 31 percent for those who earn twice the average wage. Such net replacement rates could be deemed as relatively low and hardly adequate.

*The population is poorly informed and mostly unaware of the necessity of saving for the third age.* Survey results show that the population has very little information on savings options for the third age. For instance, 24 percent of active population is not familiar with the voluntary pension fund (third pillar). Currently, active population has savings mostly in cash, banking deposits, and life insurance, while its preferred saving options are set in the following order: real-estate, life insurance, bank deposits, and cash. One can see that the savings plans do not include explicitly private pension schemes in spite of state subsidies. Moreover, for the next five years expected savings are low. On the declarative level, respondents are responsible and think that an individual should start saving at the age of 24 and save on average a monthly amount of HRK 350. Also, respondents do not believe that old-age pension will be appropriate for a comfortable life in the third age.

*There are large differences between "objective" projections and subjective population perceptions regarding pension adequacy.* Projections of net replacement rates suggest that they will fall short of 50 percent. Respondents, depending on their age and income, expect to achieve net replacement rates between 66 and 140 percent. Obviously, there is a gap between wishes and reality. Although respondents understand that they should have some additional income in retirement, they also believe that it is enough to save a small amount. This implies that the Croatian population is poorly informed and misperceives the adequacy of future retirement income. It is quite clear from the project results that there is a high need for a national education campaign to increase pension literacy of the population.

*Maja Vehovec*

Figure B1 OLD-AGE PENSIONS AND NET REPLACEMENT RATE PROJECTIONS



HBOR (Croatian Bank for Reconstruction and Development) corporate credit program that accounted for 15 percent of overall credit growth in 2010.

***CNB drains kuna liquidity.***

In the year up to November, the kuna depreciated 1.4 percent against the euro. In spite of two central bank interventions on the foreign exchange market amounting to EUR 350 million in November, depreciation pressures continued into December. Those pressures were due to several reasons: the corporate sector had to service its foreign debt at the end of the year; treasury bills indexed to foreign currency were replaced with a pure kuna bond while Eurobond issuance was postponed for the first quarter 2011. Consequently, the CNB emphasized its commitment to the stable exchange rate policy and warned that it might use other instruments, such as reserve requirement hikes, in the case of further depreciation pressures. In early January 2011, the interbank market was left with huge excess liquidity, amounting to HRK 4 billion due to the seasonal liquidity return of almost HRK 1 billion and CNB's HRK 1.6 billion inflow after purchasing government funds from previous US$ borrowings. Therefore, the money market interest rate has remained at low levels, with the overnight interest rate recording only 0.68 percent in November. Short-term interest rates are expected to stay very low due to extensive interbank liquidity and US$ 690 million of unused government bond issue.

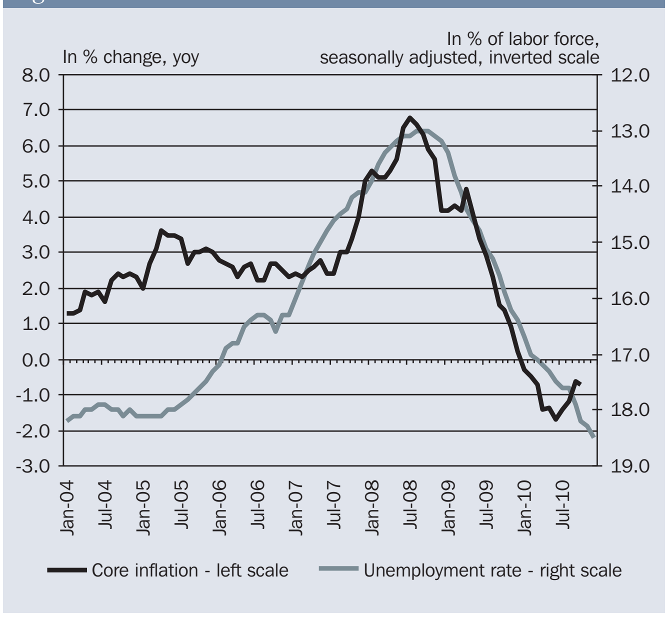
***Moderate inflation.***

More expensive fuels, housing and an ongoing increase in food and beverage prices contributed mostly to the December CPI inflation amounting to 1.8 percent when compared to the same period 2009. If it had not been for a significant month-on-month decline in prices of clothes and footwear, the rise would have been much stronger. At the same time, the producer price index increased due to a surging energy PPI and was 5.7 percent higher in December 2010 than in the same month a year before. The core consumer index recorded negative rates for ten months in a row, with the latest figure for October amounting to -0.7 percent year-on-year. Neverthless, positive month-on-month changes suggest that inflationary pressures are surging.

***Persistent budget revenue decline…***

In the first three quarters 2010, fiscal authorities collected 2.3 percent less revenues than in 2009. The main contributors to the continued deterioration were declines in personal

Figure 6 CORE PRICE INFLATION AND UNEMPLOYMENT




***Note:*** *Seasonally adjusted by X11ARIMA (Statistics Canada).*
***Sources:*** *Central Bureau of Statistics and Croatian National Bank.*

Figure 7 WORLD ECONOMY PROSPECTS


***Note:*** *e - estimate; p - projection.*
***Source:*** Global Economic Prospects, *World Bank, January 2011.*

(9.8 percent) and corporate income tax revenues (33 percent) as well as a decline in revenue from social security contributions (4.1 percent). VAT revenue has continued to recover, exhibiting a 2.1-percent increase up to September. However, the pre-crisis inflow has not been reached in spite of an increased VAT rate from 22 to 23 percent since August 2009. A 23.8-percent rise in revenues from excise taxes was primarily driven by the collection of overdue excises from the INA oil company and an increase in specific excise on oil since September 1, 2010.

***… and a tiny expenditure reduction.***

As we still remember, in the first two quarters 2010 the Government's non-ambitious austerity measures resulted in a mere 1.3-percent expenditure reduction. The expenditure decrease has continued, though not intensified, after the August budget revision – whereby the originally planned outlays for 2010 have been cut by HRK 898.2 million. Compared to the cumulative expenditures in the first three quarters 2009, those were 1 percent lower in 2010. This cut was due to a small, 1.1-percent reduction in the wage bill and the corresponding contributions, as wll as a slower yet still positive 1.2-percent growth in social security expenses. As a result, the accumulated general government operating deficit amounted to HRK 6 billion, or 25 percent more than at the same time in 2009.

## 2 Policy Assumptions and Projections Summary

***Global economic growth: steady but slower in 2011.***

Policy response undertaken by governments around the world in the early stage of the crisis weakened during 2010. As a result, the global economy has entered a more steady phase of recovery characterized by lower growth. The World Bank has recently estimated (*Global Economic Prospects 2011*, January 2011) that global GDP increased 3.9 percent in 2010 and will slow to 3.3 percent in 2011 before picking-up to 3.6 percent in 2012. Substantial risks to global recovery are still present and refer to the lasting tensions in the financial markets, volatile capital flows and a rise in commodity prices. So far, the global recovery has been driven by domestic demand in developing countries, while the U.S. economy has experienced a slow recovery and weak job creation. Growth in many European economies has also remained low. The World Bank has estimated that euro area GDP expanded 1.7 percent in 2010, but will slow to 1.4 percent in 2011 and then pick up to 2 percent in 2012. Oil prices are expected to strengthen in 2011, despite slower demand growth and large surplus capacities. Namely, the OPEC now favors a wider price range of US$ 70-90 per barrel.

***New ministers enter the Government.***

On the internal front, all major political players agree that every effort should be made to conclude the EU accession negotiations by the mid of this year. In that case, the ratification process might end in 2013 allowing for full membership in 2014. This should strengthen investments – both by foreign investors and the domestic ones due to adjustments needed for the EU membership. In spite of the fact that these are turbulent times for the Government as the anti-corruption campaign has produced several high-profile cases, including former government members, we expect that the current Government, recently refreshed with several new ministers, will remain in office until parliamentary elections scheduled for the end of 2011. As the new ministers have entered the Government following the adoption of the budget, substantial changes in economic policy are not expected. More effort will probably be made in the direction of anti-corruption policy, attracting large investors, building a positive atmosphere for domestic consumption, and increasing responsibility in the fiscal sphere. That will, however, lead to limited short-term economic effects, but might earn some political points. As for 2012, policy assumptions include further fiscal consolidation since the new Government will be forced to it, partially due to the Fiscal Responsibility Act and partially due to high market vulnerability on sovereign debt performance. Over the projection horizon, monetary policy is expected to remain focused on the stability of the exchange rate, while at the same time allowing for adequate liquidity.

***GDP expected to rise 1.3 percent in 2011.***

Most GDP components for the third quarter 2010 have exceeded our expectations. Consequently, we have revised our projections although the trend has not changed. Our estimates indicate a 1.3 percent output decline in 2010 as a whole. Recovery is projected to start in early 2011 but at a slow pace that will allow for a modest growth of 1.3 percent for the entire year. Domestic demand is expected to give a positive contribution to the overall growth, while net exports should have a small negative contribution due to the strengthening of imports based on the process of restocking. A similar growth pattern is expected in 2012, with a somewhat stronger contribution from domestic demand due to the investment revival, thus bringing GDP growth to 2.4 percent.

***Gradual strengthening of personal consumption.***

In spite of the problems on the labor market, we expect a slow but steady strengthening of personal consumption as a result of improved consumer confidence and a recovery in household credit activity. Household savings have increased during the recession and, with the rise in consumer confidence, a part of it will end up in consumption. Hence, personal consumption should rise in 2011 and 2012 by some 2 percent. Government consumption is expected to rise by around 1 percent in the election year while investments should start recovering. As a result of postponed investments during the recession and the upcoming EU membership, investment growth is expected to strengthen to above 5 percent in 2012.

***Stronger imports and wider current account deficit.***

Although exports performance should improve, we do not expect it to be especially strong since the shipbuilding and tourism sectors have not undergone restructuring. Exports should rise by 4 and 5 percent in 2011 and 2012, respectively. Strengthening of the overall activity will drive imports, which are expected to rise between 5 and 6 percent both this and next year. Estimates suggest that the current account deficit narrowed to less than 2 percent of GDP in 2010, which is a record-low since the transition recession at the beginning of the 1990s. This deficit will be covered by net foreign direct investments, which are estimated at 2.4 percent of GDP. In the next two years we expect a gradual widening of the current account deficit that should still remain modest at around 3 percent of GDP. Consequently, we expect the share of foreign debt in GDP to remain below 100 percent by 2012.

***Gloomy prospects for the labor market.***

Last year's unfavorable trends determine the outlook for the labor market. Since the projected recovery of the product market will not be strong enough to reverse the negative trend on the labor market any time soon, we only expect it to weaken in the course of the year, thus opening room for improvements in 2012. Demand for labor should strengthen in 2012 due to stronger economic activity and the creation of jobs related to the approaching EU membership. Accordingly, the registered unemployment rate is envisaged to increase from the average of 17.6 percent in 2010 to 18.2 percent in 2011, and then to decline prospectively to 17.7 percent in 2012. Short-term projections for the labor market remain negative. The first quarter of 2011 is likely to end up with 340-350 thousand unemployed persons and the registered unemployment rate of around 20 percent. A certain release will follow in the spring and summer months driven by seasonal factors, while the underlying trend is likely to remain negative. Such labor market developments will put wages under a serious pressure. Therefore, their slightly declining trend is expected to continue throughout 2011.

***Inflation pressures will rise.***

Despite a slow recovery in domestic demand, a moderate speed-up of inflation is expected in the next two years, from the estimated 1.1 percent for 2010 to the projected 2.3 percent in 2011 and 2.7 percent in 2012. Major upward pressures will come from import prices (oil and food) and administratively controlled prices of public utilities such as electricity, pipeline gas, water, public transportation and alike. Since 2011 is an election year, controlled prices are not likely to increase substantially, but in 2012 they might come much closer to market prices. The assumed exchange rate stability should keep domestic prices relatively stable, but structural changes in world prices, including a further rise in the prices of food, oil and other commodities, exert a notable risk for the speeding up of inflation. Also, a certain inflation effect could come from the harmonization with the EU *acquis* via increased tobacco taxation and the elimination of the zero VAT rate on bread and milk which are not, however, taken into account in our projection as the time of their introduction is still unknown. However, it is likely that such changes will be accompanied by some counter measures to smooth inflation, especially in the case of VAT rate changes.

***Moderate recovery of monetary and credit aggregates.***

A capital inflow decline, slow GDP recovery and a relatively low current account gap imply that the CNB will withhold its easing bias. Additionally, due to large government repayment obligations and the household deleveraging process we do not expect any strong credit recovery this year. However, labor market uncertainties and risk aversion might lead to a further increase in savings. All these effects, in addition to the intensified economic activity, should result in the growth of total liquid assets by 9 and total domestic credit by 5 percent this year, while in 2012 the growth of these aggregates should accelerate to 13 and 10 percent, respectively.

Table 2 SUMMARY OF PROJECTIONS

| | 2010 estimate | 2011 projection | 2012 projection |
|---|---|---|---|
| **Real GDP (% change)** | **-1.3** | **1.3** | **2.4** |
| Real private consumption (% change) | -0.5 | 2.1 | 2.2 |
| Real government consumption (% change) | -1.1 | 1.0 | -0.4 |
| Real investment (% change) | -11.1 | 2.2 | 5.6 |
| Exports of goods and services (constant prices, % change) | 5.4 | 4.4 | 5.1 |
| Imports of goods and services (constant prices, % change) | -0.7 | 5.8 | 5.6 |
| Current account balance (% of GDP) | -2.0 | -2.8 | -3.0 |
| Consumer prices (% change, pa) | 1.1[a] | 2.3 | 2.7 |
| Exchange rate, HRK/EUR (pa) | 7.29[a] | 7.33 | 7.33 |
| Unemployment rate (registered, %, pa) | 17.6 | 18.2 | 17.7 |
| General government balance (ESA95 definition, % of GDP) | -4.7 | -4.8 | -3.2 |
| Broad money, M4 (% change, eop) | 7.0 | 9.0 | 13.0 |
| Total domestic credit (% change, eop) | 4.5 | 5.0 | 10.0 |

***Notes:*** *Cut-off date for information used in the compilation of projections was January 5, 2011.*
***Conventional abbreviations:*** *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro, a - actual.*
***Source:*** *Authors' projections.*

***The Parliament passed the 2011 budget...***

According to the 2011 budget passed in November 2010, total expenditures should stay at the last year's level of HRK 122.3 billion in nominal terms, while total revenues should amount to HRK 107.4 billion, or 0.8 percent less than in 2010. Based on its projection of a 1.5 percent rise in real GDP in 2011, the Government expects the HRK 14.9-billion gap to give rise to the deficit-to-GDP ratio to 4.3 and 4.8 percent at the central and general government levels, respectively. On the expenditure side, hardly anything has been changed in the budget structure compared to 2010. The fact that the structure of expenditures remains virtually unchanged indicates that the Government, despite its considerable loss in popularity, has resisted the pre-election temptation to fiscally illude a part of the electorate. We believe that the 2011 general government deficit will not fall below 4.8 percent as projected by the Government.

***... as well as the Fiscal Responsibility Act.***

One of the cornerstones of the Government's Economic Recovery Program, the Fiscal Responsibility Act, was also passed in November 2010. Although it came into force at the beginning of this year, its implementation will start with the preparation and execution of the 2012 budget. Aimed at promoting greater fiscal discipline and the mid- to long-term sustainability of public finances, a fiscal rule and a set of responsibility-enhancing rules have also been set. According to the fiscal rule, the share of general government expenditures in GDP should be reduced by at least one percentage point every year until the primary budget balance turns zero or becomes positive; henceforth, the fiscal objective will be to keep the balance at zero or positive over the business cycle, with deficits during the cycle being pre-determined in the Government's *Guidelines for Fiscal and Economic Policies*. As for the fiscal responsibility-enhancing rules, punishment-based incentives are imposed to enforce strict obedience to the pre-set expenditure plans.

## 3 Uncertainties and Risks to Projections

***Labor market might become a drag on the recovery.***

There is a lot of uncertainty regarding the effects of the projected weak recovery of the labor market. Namely, the labor market in Croatia is still characterized by a high degree of inflexibility and the business sector - that currently faces a significant number of challenges - will surely not prioritize new employment. There is a risk that the labor market might become a drag on the recovery and even slide the economy into another recession. Therefore, greater policy attention should be given to labor market developments.

***Old growth drivers reemerge.***

The latest GDP observations point to the return of old growth pattern, with the dominant contribution coming from domestic demand. Namely, exports growth was almost halted in the second half of 2010, while domestic demand strengthened. As a result, the positive contribution from net exports has disappeared. In the current situation of high indebtedness and tighter financing conditions than in the pre-crisis period, such growth drivers will not generate stronger economic performance. In spite of the recent crisis, it seems that nothing has changed in the way the economy operates. According to projections from various international organizations, Croatia will remain among the worst growth performers in Central and Eastern Europe in 2011, together with Romania. The vulnerability of economy to potential external and internal shocks is high. The creation of supporting conditions for a more export-oriented economy is a must, both for the current and any future government.

***2012 economic policy unknown.***

Economic programs of the main political parties have not yet been clearly presented and, therefore, not much can be said about the post-election economic policy. In any case, Croatia's next government will face numerous challenges. Some unpopular measures related to various structural reforms might be undertaken even in 2012, with dampening effects on domestic demand and the overall economic output compared to what we have projected. It is also uncertain how investments, in particular foreign ones, will be induced, as a high degree of institutional inertia is still present in the economy. On the positive side, however, 2011 should bring an end to the EU accession negotiations. The approaching EU membership should have a positive impact on investments but also on exports, maybe even stronger than projected.

***Downgraded credit rating may increase the cost of borrowing.***

Despite the Government's plan to freeze total expenditures for this and next year, in mid-December Standard and Poor's downgraded the Croatian long-term sovereign credit rating from BBB to BBB-, with a negative outlook. The main reasons for such an action are found in an unfavorable fiscal position and its possible further deterioration, considerable dependence on foreign sources, and delayed reforms due to the 2011 elections. This will likely push up the risk premium on the Government's bonds and increase the cost of borrowing. The first opportunity to see the market reaction will be in March 2011, when the Government intends to issue a bond for refinancing the EUR 750 million matured debt. However, if S&P had waited just a few days, it could have taken into account the Fiscal Responsibility Act. The Act may still help the Government gain some credibility on the fiscal front and regain the recently downgraded long-term sovereign credit rating, or at least improve its negative outlook in the years to come.

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