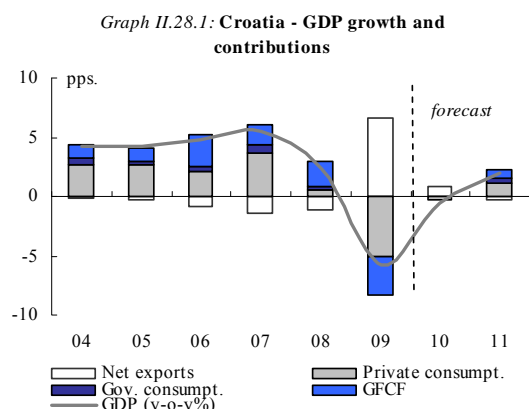


28. CROATIA

Another critical year ahead, after severe recession

Croatia was severely hit by the crisis

Over the last few years and before its economy was hit by the global crisis, Croatia enjoyed relatively strong economic growth, averaging 4.3% in 2004-08. The growth performance was primarily domestic-demand driven, fuelled by large capital inflows and strong credit growth. This was accompanied by a marked expansion of non-tradable industries, such as retail, construction and the financial sector. The global crisis severely affected the Croatian economy which went into a deep recession. Real GDP declined by 5.8% in 2009, driven by a strong fall in domestic demand. Private consumption declined by around 8.5% and total investment by 11.8%. As a result, domestic demand posted a huge negative contribution to GDP growth (around 8 pps.), whereas net exports provided some compensation, as losses in total exports were lower than the reduction in imports.



Prospects for a short-term economic recovery remain highly uncertain

At the current stage, there is no clear evidence that economic recovery has started to unfold. Indeed, high frequency indicators suggest that economic activity continued to fall year-on-year in the first two months, reflecting ongoing real sector restructuring and deleveraging. At the same time, it is noticeable that the pace on contraction has eased and the worst of the current recession seems to be over. However, a clear turnaround has not yet been reached and marked stimulation of economic activity over the short term is currently not to be expected.

Small output losses in 2010 to be followed by a moderate recovery

The outlook for 2010 remains uncertain. Domestic confidence levels may not recover quickly and market expectations are expected to remain subdued. This does not bode well for a strengthening of domestic demand. The effects of the recession the labour market, declining employment and rising unemployment will continue to be felt in 2010. Bleak job prospects and lower wage growth will limit the scope for an increase in disposable income. Therefore, private consumption is forecast to register a small negative growth rate.

Domestic credit growth has decelerated significantly during the crisis, due to both demand and supply factors. Lower demand for loans as well as tighter financing constraints and higher risk awareness by banks have led to a slowdown in bank lending, particularly to private households. Although the banking sector is well-capitalised, sound and profitable, risk perception by banks remain elevated. The ratio of non-performing loans has been rising and the quality of the loan portfolio of banks may further deteriorate, also as a result of liquidity problems of the corporate sector. Recent government measures to stimulate lending through below market interest rates and risk sharing may turn out to have a small effect on corporate sector lending. However, overall, banks are expected to remain reluctant to accelerate lending activity quickly as they have to cope with further loss absorption.

The relatively low growth of private sector borrowing, in combination with higher interest rates, is expected to continue to put a brake on economic activity, particularly over the first part of the forecast horizon. In addition, important public-sector borrowing requirements have limited the availability of credit to the private sector.

External financing constraints have eased somewhat in the course of last year. However, higher risk awareness among potential investors and the huge debt amortisation obligations weighing on both the private and general government sectors are likely to constrain financing for new private investment.

Support from the fiscal side is not expected to get stronger over the short term. Public consumption and investment are unlikely to accelerate in view of the fiscal constraints and huge refinancing needs of the public sector.

Over the short term, it appears that the main impetus for the Croatian economy may come from net exports. However, it is still to be seen to what extent improvements in the external environment, notably a recovery of global and EU demand, will translate into a strengthening of export growth.

Overall, the Croatian economy is projected to record a small negative growth rate in 2010. Upside risks are mainly related to a faster-than-projected economic recovery in the EU, as well as to the clear prospect of Croatia's accession in the near future, which may provide additional impetus to the economy through, inter alia, stronger net FDI flows. But there are also significant downside risks, which are mostly related to the process of real sector restructuring, inter-company payments problems and subdued investor confidence. For 2011, the forecast projects positive growth of around 2%, mainly based on a slight acceleration of private consumption and investment growth, while net exports are set to contribute negatively to output growth.

External deficits will rise again, but remain significantly below pre-crisis levels

As a result of the financial crisis, the high external deficits of the past years have undergone severe adjustments. Reduced capital inflows and a contraction of domestic demand have led to a sharp reduction in the trade and current-account deficits. In 2009, the latter fell to 5.3% of GDP, compared to 9.3% a year before. As for the outlook, total exports are expected to recover slowly in 2010, in line with an expected strengthening of foreign demand in key trading partners. Also total imports will pick up only slowly thereafter. In light of expected trade flows and on the assumption that external financing constraints may persist somewhat, the current-account deficit is projected to remain below 6% of GDP in 2010.

Inflation pressures stay low

As a result of rapidly contracting domestic demand and lower commodity prices, average inflation came down significantly in 2009, to 2.4%

compared to 6.1% a year before. Inflationary pressures are expected to remain low over the forecast horizon. Domestic demand is set to only slowly and gradually recover. Cost push pressures are expected to remain limited as the growth of unit labour costs will slow down. Upside risks are related both to foreign and domestic factors. On the external front, somewhat higher prices for imported raw materials are likely to have an effect on the domestic price level. Moreover, some mild inflationary pressures will result from further adjustments in administrative prices which will be necessary in the context of EU accession. At the same time, it is reasonable to assume that a stability-oriented monetary policy framework will help to prevent a significant re-acceleration of inflation over the medium term.

Labour market performance to suffer eventually

Wage developments have so far been moderate and remained in line with productivity growth. The government has made an attempt to reverse earlier public sector wage increases which should contribute to limiting wage pressures in 2010. In addition, the economic slowdown means that only moderate increases in labour costs in the private sector are expected over the forecast horizon.

As elsewhere, slowing growth and investment dynamics will have an impact on labour market developments with some delay. In 2010, employment is set to fall markedly again, and the unemployment rate (labour force survey) will continue to increase. The slight recovery of economic activity forecast for 2011 is expected to ease the pressure on the labour market somewhat, but not yet support a significant growth of employment.

Fiscal deficit widened significantly despite re-balancing measures...

The global crisis brought Croatia's public finances under severe pressures, necessitating subsequent budgetary adjustments in the course of 2009. The government adopted a first budget revision in April, followed by two further revisions in July with revised growth assumptions. In this context, a number of fiscal adjustment measures were taken to compensate for rapidly falling revenues, such as a VAT increase, a special tax on income and higher excises. Efforts to contain current spending (decrease in public-sector wages, suspension of

pension indexation, cuts in material spending) were however partly offset by additional outlays (e.g. increases in agricultural and employment subsidies). Thus total spending in the third revised budget remained at the level of the original budget, while budgeted revenues were reduced by around 10%. As a result, the planned balance deteriorated markedly to 3.4% of (the revised) GDP, raising gross financing requirements in times of tight financing constraints.

The actual budget implementation appears to have been rather in line with the third revised budget, however, in late 2009 some overruns in current spending occurred, in particular on wages, pensions as well as on social transfers, which necessitated some budget adjustments at the end of the year. According to preliminary data, the budget deficit exceeded the planned level markedly, mainly due to activations of state guarantees. The deficit reached 4.1% of GDP, which is 0.7 pp. above the target.

...and there are little prospects for rapid fiscal consolidation due to the lack of public expenditure reforms

The forecast projects that the fiscal deficit in 2010 will stay close to the 2009 level as a relation to GDP. The forecast is largely based on the budget

framework adopted by the Croatian authorities. The latter foresees a lower deficit of 3.3% of GDP, however, it is grounded on more optimistic GDP growth projections (compared to the Commission's forecast) and on the 2009 budget plan, which was more favourable than the actual outcome. The general government debt-to-GDP ratio is set to increase markedly, driven by new net borrowing, while the nominal GDP effect, "below-the-line-revenues" and other adjustments are expected to be small.

Overall, public finances in Croatia will remain under pressure as downside risks are evident on both the revenue and spending sides of the budget. Therefore, a key challenge will be to design and implement a credible medium-term fiscal strategy, aimed at reducing budget rigidities and enhancing the efficiency and quality of public spending. Such a strategy would need to be supported by a continuation and acceleration of economic restructuring on a broader front, as well as by deeper reforms of the social benefit system.

Table II.28.1:

Main features of country forecast - CROATIA

	2008		92-05	Annual percentage change					
	bn HRK	Curr. prices		% GDP	2006	2007	2008	2009	2010
GDP	342.2	100.0	-	4.7	5.5	2.4	-5.8	-0.5	2.0
Private consumption	202.2	59.1	-	2.7	6.2	0.8	-8.5	-0.5	2.0
Public consumption	63.5	18.6	-	5.0	3.4	1.9	0.2	0.2	2.0
Gross fixed capital formation	94.3	27.6	-	10.9	6.5	8.2	-11.8	0.5	3.0
of which : equipment	-	-	-	-	-	-	-	-	-
Exports (goods and services)	143.4	41.9	-	6.5	4.3	1.7	-16.2	2.4	2.5
Imports (goods and services)	172.0	50.3	-	7.4	6.5	3.6	-20.7	0.2	3.0
GNI (GDP deflator)	330.7	96.6	-	4.6	5.8	1.7	-6.1	-0.5	2.2
Contribution to GDP growth :									
Domestic demand			-	5.3	6.1	3.0	-8.3	-0.1	2.3
Inventories			-	0.4	0.8	0.4	-1.2	-1.2	0.0
Net exports			-	-0.9	-1.4	-1.1	3.7	0.8	-0.3
Employment			-	3.9	3.5	1.1	-2.5	-2.0	0.5
Unemployment rate (a)			-	11.2	9.6	8.4	10.4	11.5	11.0
Compensation of employees/head			-	2.9	4.0	7.1	2.2	0.6	3.0
Unit labour costs whole economy			-	2.1	2.0	5.7	5.8	-0.9	1.5
Real unit labour costs			-	-1.3	-2.0	-0.6	2.4	-1.4	-1.0
Savings rate of households (b)			-	-	-	-	-	-	-
GDP deflator			-	3.4	4.0	6.4	3.4	0.4	2.5
Harmonised index of consumer prices			-	3.3	2.7	5.8	2.2	1.5	3.0
Terms of trade of goods			-	-	-	-	-	-	-
Trade balance (c)			-	-21.3	-22.0	-22.9	-16.1	-16.1	-16.4
Current account balance (c)			-	-7.0	-7.6	-9.3	-5.1	-5.5	-5.9
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-7.3	-7.5	-9.2	-	-	-
General government balance (c)			-	-3.0	-2.5	-1.4	-4.1	-4.0	-3.9
Cyclically-adjusted budget balance (c)			-	-	-	-	-	-	-
Structural budget balance (c)			-	-	-	-	-	-	-
General government gross debt (c)			-	35.7	33.0	33.5	38.5	42.5	44.5

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.