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*EU CANDIDATE AND
PRE-ACCESSION COUNTRIES
ECONOMIC QUARTERLY*

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OVERVIEW

Data from the final quarter of 2010 mostly confirmed previous trends in pre-accession countries. While growth was buoyant in Turkey, fed by private consumption and investment, the situation in the Western Balkans remained uneven, with most countries in positive growth territory. However, Croatia, the most severely hit by the crisis in the region, still registered negative GDP growth in 2010, the last quarter included. Iceland is only slowly emerging from the recession with zero growth - a relative improvement - in the fourth quarter 2010. With the exception of Turkey, where unemployment significantly decreased in 2010, labour markets have generally not yet benefited from the improved economic situation and have generally, either continued to deteriorate or at best bottom out.

Growth accelerated in Turkey, with an unexpected +9.2% in the last quarter (+3.6% seasonally adjusted), bringing annual 2010 growth to 8.9%. This strong recovery was fed by internal consumption, investment and inventories.

Conversely, in the Western Balkans growth was generally more subdued. Fourth quarter 2010 GDP growth data (year-on-year) were still negative in Croatia (-0.6%). Growth was moderate in Serbia (+1.7% year-on-year), the former Yugoslav Republic of Macedonia (+2.3% year-on-year in Q4) and, according to a number of indicators, in Bosnia and Herzegovina as well as Montenegro. Albania remains an outlier in the region, as the country weathered the crisis without a recession, and GDP grew by a further 5.7% in the last quarter of 2010.

In Iceland, while real GDP declined last year by 3.5%, with a negative contribution from all domestic demand components, fourth quarter data (0% growth year-on-year), however, suggest that the recession may progressively be coming to an end.

On the external accounts side, net exports have been the main positive driving element of growth in Iceland and throughout the Western Balkans. External deficits generally moderated last year. The current account deficit halved in Bosnia - at around 5% of GDP - and came down to 1.5% in Croatia, from 5.5% in 2009. The situation is rather the opposite in Turkey, where strong domestic consumption and investment fuelled high imports growth and a widening of the trade deficit to 6.6% of GDP, compared with 2.3% in 2009.

Labour market developments also point to very dissimilar situations. In Turkey the unemployment rate, in tandem with high growth, declined further in the last quarter of 2010, down to 11% (i.e. 3 percentage points below its end-2009 peak). Conversely, in the fourth quarter of 2010 unemployment continued to rise in Croatia and Iceland. Elsewhere a lag could, as expected, be observed between the overall improving economic situation and developments in the labour markets, where no material improvement could be noticed, except to some extent in Albania and the former Yugoslav Republic of Macedonia, where unemployment decreased slightly in the second half of 2010.

In the context of booming activity, the Turkish monetary authorities had recourse to unconventional policy measures, reducing the main Central Bank policy rate in January while increasing reserve requirements to curb credit growth. Inflationary tensions have resurfaced in Western Balkan countries because of rising food and commodity prices, notably oil prices. In Serbia and Albania this triggered a central bank policy response in the form of interest rate increases in March 2011. Conversely, the Icelandic central bank further reduced its core interest rate in February to 4.25% (compared with 10% a year earlier), on the back of still weak activity, a stable exchange rate and decreasing local inflation.

The crisis took a toll on financial sector activity and performance. While non-performing loans have significantly risen, banks have remained well capitalised, with capital adequacy ratios above 15% in Turkey and the Western Balkans. Non-performing loans were still on the up in Croatia (up to 18% end 2010) but decreased significantly in Turkey, falling to 3.4 % by early March 2011. Credit growth recorded a high level of 30% in Turkey, but remained below 10% in most Western Balkan countries, including Albania (+8%), the country with the highest growth in the region. In Iceland, still struggling with the restructuring of the banking sector, it remained negative for the third consecutive year.

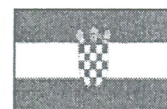
Public finances, which had been severely impacted by the crisis in 2009, improved significantly in 2010 in Turkey and Albania where the deficit was reduced by 42% and 58% respectively. It was also curbed in Iceland, Montenegro, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. However public finance continued to deteriorate throughout the year in Croatia, Serbia, and Kosovo. Almost all countries have embarked on further fiscal consolidation in 2011.

Candidate and potential candidate countries: Summary table

	2006	2007	2008	2009	2010	ECFIN Nov Forecast		Q3 10	Q4 10	Q1 11	Jan 11	Feb 11	Mar 11
						2011	2012						
Gross domestic product (in real terms, annual % change)													
Croatia	4.9	5.1	2.2	-6.0	-1.2	1.5	2.1	0.3	-0.6	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	4.0	6.1	5.0	-0.9	0.7	2.2	2.5	1.3	2.3	:	n.a.	n.a.	n.a.
Iceland	4.6	6.0	1.4	-6.9	-3.5	0.7	2.1	-1.0	0.0	:	n.a.	n.a.	n.a.
Montenegro	8.6	10.7	6.9	-5.7	1.1e	:	:	:	:	:	n.a.	n.a.	n.a.
Turkey	6.9	4.7	0.7	-4.8	8.9	5.5	4.5	5.2	9.2	:	n.a.	n.a.	n.a.
Albania	5.4	5.9	7.7	3.3	4.1	:	:	5.0	5.4	:	n.a.	n.a.	n.a.
Bosnia and Herzegovina	6.0	6.2	5.7	-3.0	0.9	:	:	:	:	:	n.a.	n.a.	n.a.
Serbia	5.2	6.9	5.5	-3.1	1.8	:	:	3.1	1.7	:	n.a.	n.a.	n.a.
Kosovo*	3.4	6.3	6.9	2.9	4.6	:	:	:	:	:	n.a.	n.a.	n.a.
Unemployment (LFS, in % of workforce)													
Croatia	n.a.	9.6	8.4	9.1	11.8	12.3	11.2	11.5	12.1	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	36.0	34.9	33.8	32.2	32.1	31.1	30.0	31.7	30.9	:	:	:	:
Iceland	2.9	2.3	3.0	7.2	7.5	7.3	6.3	6.4	7.4	:	n.a.	n.a.	n.a.
Montenegro	14.7	11.9	10.7	11.4	12.1	:	:	11.8	12.1	12.5	12.4	12.5	12.5
Turkey	9.9	9.9	11.0	14.1	12.0	11.7	11.3	11.4	11.0	:	:	:	:
Albania	13.9	13.4	12.8	13.0	13.7	:	:	13.5	13.5	:	:	:	:
Bosnia and Herzegovina	44.2	42.9	40.6	42.7	42.7	:	:	43.2	42.7	:	43.1	:	:
Serbia	20.9	18.1	13.6	16.1	20.0e	:	:	20.0	:	:	:	:	:
Kosovo*	44.9	43.6	47.5	45.4	:	:	:	:	:	:	:	:	:
Current account balance (% of GDP)													
Croatia	-6.9	-7.5	-9.2	-5.5	-1.5	-3.7	-4.7	-2.6	-1.5	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	-0.4	-7.1	-12.8	-6.7	-2.5	-4.1	-5.3	-2.2	-2.0	:	n.a.	n.a.	n.a.
Iceland	-23.8	-16.3	-24.5	-10.3	-7.8	-4.9	-4.6	-5.5	-7.8	:	n.a.	n.a.	n.a.
Montenegro	-24.7	-37.8	-50.7	-30.1	-25.6	:	:	-32.1	-25.6	:	n.a.	n.a.	n.a.
Turkey	-6.1	-5.9	-5.6	-2.3	-6.6	-6.6	-7.1	-5.2	-6.6	:	n.a.	n.a.	n.a.
Albania	-6.6	-10.6	-15.4	-15.5	-11.9	:	:	-11.5	-11.9	:	n.a.	n.a.	n.a.
Bosnia and Herzegovina	-8.0	-10.7	-14.2	-6.2	-5.3	:	:	-5.4	-5.3	:	n.a.	n.a.	n.a.
Serbia	-11.7	-16.1	-20.6	-7.4	-7.3	:	:	-8.5	-7.3	:	n.a.	n.a.	n.a.
Kosovo*	-7.2	-10.4	-16.3	-17.4	-18.5	:	:	:	:	:	n.a.	n.a.	n.a.
Inflation (Consumer price index, annual % change)													
Croatia	3.2	2.9	6.1	2.4	1.0	1.8	2.0	1.1	1.5	:	1.9	2.2	:
The former Yugoslav Republic of Macedonia	3.2	2.3	8.3	-0.8	1.6	2.3	2.5	1.8	2.9	:	3.2	3.9	:
Iceland	6.7	5.1	12.7	12.0	5.4	2.5	2.3	4.3	2.8	2.0	1.8	1.9	2.3
Montenegro	3.0	4.3	7.4	3.4	0.5	:	:	0.4	0.7	:	1.1	2.0	:
Turkey	9.6	8.8	10.4	6.3	8.6	6.5	5.5	8.4	7.4	4.4	4.9	4.2	4.0
Albania	2.4	2.9	3.4	2.3	3.6	:	:	3.4	3.1	:	3.3	4.5	:
Bosnia and Herzegovina	6.1	1.5	7.4	-0.4	2.1	:	:	1.8	2.5	:	2.7	3.3	:
Serbia	n.a.	11.0	8.6	6.6	10.3	:	:	7.7	10.3	:	11.2	12.6	:
Kosovo*	0.6	4.4	9.4	-2.4	3.5	:	:	4.8	6.2	:	7.4	9.5	:
General government balance (% of GDP)													
Croatia	-3.0	-2.5	-1.4	-4.1	-5.7f	-6.1	-5.6	:	:	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	-0.6	0.6	-1.0	-2.7	-2.5	-2.6	-2.3	:	:	:	n.a.	n.a.	n.a.
Iceland	6.3	5.4	-13.5	-10.0	-7.8	-4.2	-3.2	-5.3	-8.0	:	n.a.	n.a.	n.a.
Montenegro	2.7	6.7	-0.4	-4.4	-3.0	:	:	0.0	-3.0	:	n.a.	n.a.	n.a.
Turkey	-0.1	-1.0	-2.2	-5.7	-3.3	-2.8	-2.2	:	:	:	n.a.	n.a.	n.a.
Albania	-3.3	-3.5	-5.5	-7.1	-3.0	:	:	:	:	:	n.a.	n.a.	n.a.
Bosnia and Herzegovina	2.9	1.2	-2.2	-4.4	-3.8e	:	:	:	:	:	n.a.	n.a.	n.a.
Serbia	-1.6	-2.0	-2.6	-4.5	-4.5e	:	:	-2.4	:	:	n.a.	n.a.	n.a.
Kosovo*	2.5	7.1	-0.1	-0.7	-2.8	:	:	:	:	:	n.a.	n.a.	n.a.

* as defined by UNSCR 1244
Forecast: ECFIN forecast Autumn 2010

CROATIA



Key developments

Economic activity proceeded in very low gear over the winter months with recession lingering on in the labour market. This has added to the pressures on the government, partly manifested by anti-government demonstrations in February and March. At the same time, a number of high-profile corruption cases have figured prominently in the political debate. The approaching parliamentary elections, to be held in March 2012 at the latest, make political decision-making increasingly difficult.

The government submitted its seventh Pre-Accession Economic Programme to the European Commission in January 2011. In the EU accession negotiations seven negotiating chapters were still open at the end of March. The Commission released an interim report on 2 March concluding that Croatia needs to do further work in the field of judiciary and fundamental rights before all closing benchmarks are met in this chapter. Competition policy is another chapter where issues need to be resolved.

Real sector

Real GDP declined by 1.2% in 2010, i.e. significantly less than the 6.0% drop in 2009. Quarterly data show stagnation in the fourth quarter following the slight improvement in the third quarter when real GDP expanded for the first time in two years. However, negative GDP growth in the fourth quarter is a consequence of stock adjustments and not of faltering final demand.

Overall GDP (in real terms) was 0.6% lower year-on-year in the fourth quarter. Consumer spending continued to increase year-on-year (1.2%), which is somewhat less than in the preceding quarter. Fixed investment was still declining, but at a decelerating rate (-8.0%). Net exports of goods and services continued to rise as exports (+10.8%) increased much more than imports (+1.1%). The decline in import growth from 3.4% in the third quarter is consistent with

the softening of domestic demand including the destocking.

In terms of contribution to GDP growth, the largest input in the fourth quarter came again from net exports (3.4 percentage points). The other main positive contribution to GDP growth was private consumption (0.8 percentage points). Fixed investment was again a major drag (-2.1 percentage points) although somewhat less than in previous quarters. The largest negative contribution came from stock adjustments (-3.0 percentage points).

Monthly data indicate that subdued economic activity has been extended into early 2011. Industrial production has trended downwards again in recent months following some stabilisation last autumn. In February the volume of industrial production was 4.1% lower year-on-year. The year-on-year increase in retail sales volume, which started last July, has levelled off over the winter months and registered 0.8% in February. Construction output was still down by 8.3% in year-on-year terms in January which nevertheless is an improvement compared to the double-digit rates of decline in 2010. Merchandise trade decelerated in the January-February period. It is, however, a positive sign for output growth that the year-on-year growth rate for exports (3.9%) continued to exceed the growth rate for imports (2.4%).

Labour market

In tune with stagnating output, the labour market remained weak over the winter months. According to the labour force survey, employment was 4.1% lower year-on-year in the fourth quarter of 2010. The unemployment rate increased from 11.5% in the third quarter to 12.1% in the fourth quarter. In year-on-year terms the unemployment rate was 2.9 percentage points higher and the underlying trend is still rising. This is corroborated by registered unemployment which stood at 19.6% in January and February compared to a seasonal low of 16.4% in August and 18.3% in February 2010.

The large slack in the labour market continued to keep nominal wage growth close to zero. In

January 2011 the average gross wage was only 0.3% higher year-on-year.

External sector

The recession has narrowed the current account deficit more sharply than previously expected. It registered 1.5% of GDP in 2010, down from 5.5% in 2009 and 9.2% in 2008. Imports of goods started rising again in the second half of 2010 as the economy bottomed out, but the deficit continued to narrow on a rolling four-quarter basis thanks to much stronger growth of goods exports.

The improvement of the current account stems predominantly from trade in merchandise goods where the deficit narrowed by 3.3 percentage points of GDP between 2009 and 2010. The services balance improved by 0.2 percentage points and the balance of income and transfer payments by 0.5 percentage points. The deficit in merchandise trade (12.9% of GDP) was almost offset by the tourism-related surplus on services trade (12.6% of GDP) in 2010. The deficit on income and transfer payments amounted to 1.2% of GDP.

Croatia's total gross external debt increased from €43.1 billion at the end of 2009 to €45.8 billion at the end of 2010. The external debt ratio has increased by seven percentage points to 101% of GDP in the course of last year. Gross international reserves increased from €10.4 billion at the end of 2009 to €10.7 billion at the end of 2010 (24% of GDP) before declining slightly in the first two months of 2011.

Monetary developments

Headline inflation increased significantly over the winter months mainly due to higher energy and food prices. The year-on-year increase in the total consumer price index registered 2.2% in February compared to 1.2% in November. Higher commodity prices have to some extent spilled over into related areas like transport and processed food, but underlying inflationary pressures have remained subdued.

Broad money (M4) was almost stagnant in the fourth quarter (+0.1% quarter-on-quarter) and declined by 0.5% month-on-month in January. In year-on-year terms it was nevertheless 3.7% higher in January. Bank lending to the non-financial corporate sector continued to advance at a slow rate in recent months and has been almost stagnant for the household sector. In

order to stimulate bank lending for investment projects the central bank released €850 million worth of additional euro liquidity into the banking system in early March by lowering the minimum reserve requirement on banks' foreign exchange liabilities from 20% to 17%.

In the foreign exchange market the kuna remained broadly stable. The nominal exchange rate against the euro stood at 7.38 both at the beginning and at the end of the first quarter although slight downward pressure on the currency had briefly lifted the rate to 7.43 at the end of February. The central bank did not intervene in the foreign exchange market during the first quarter.

Financial sector

Despite high liquidity levels in the domestic financial system, interest rates of commercial banks have, on the whole, continued to decline only very slowly. In the interbank money market interest rates have remained very low. The capital adequacy ratio of the banking sector stood at a relatively high level of 18.4% at the end of 2010. The ratio of non-performing loans to total loans continued its upward trend and registered 11.2% at the end of 2010. The deterioration in the quality of bank loans was most pronounced for corporate loans. The stock market extended its December rally into January with an 8½% gain in the share index. Subsequently, the index remained stable until the end of the quarter.

Fiscal developments

According to available budget data, the actual 2010 budget implementation on a cash basis appears to have been rather in line with the revised state budget from August 2010. The budget deficit as measured according to ESA95 standards may only have exceeded the planned level of 5.2% of GDP by a relatively small margin. The rise of the budgetary deficit from 4.1% of GDP in 2009 was mainly the result of lower revenues following the continuing economic contraction and rising unemployment.

The first two months of 2011 saw a decline in central government revenues of 1% year-on-year, whereas total spending decreased by 3%. The budgeted deficit of general government in 2011 is 5.6% of GDP. Public debt is projected to increase from 41.6% at the end of 2010 to 44.2% at the end of 2011.

TABLE

European Commission, ECFIN-D-1



CROATIA

		2006	2007	2008	2009	2010	ECRN Forecast		Q3 10	Q4 10	Q1 11	Jan 11	Feb 11	Mar 11
							2011	2012						
1 Real sector														
Industrial outlook ^{1.1}	Balance	N.A.	70.9	38.0	-33.3	3.0	:	:	-9.0	16.0	15.0	N.A.	N.A.	N.A.
Industrial production ^{1.2}	Ann. % ch	4.5	5.6	1.6	-9.0	-1.5	:	:	0.1	-1.7	:	-6.6	-4.1	:
Gross domestic product ^{1.3}	Ann. % ch	4.9	5.1	2.2	-6.0	-1.2	1.5	2.1	0.3	-0.6	:	N.A.	N.A.	N.A.
Private consumption ^{1.4}	Ann. % ch	3.2	6.3	0.8	-8.5	-0.9	1.3	2.0	1.9	1.2	:	N.A.	N.A.	N.A.
Gross fixed capital formation ^{1.5}	Ann. % ch	11.1	7.1	8.2	-11.8	-11.3	2.0	4.3	-9.5	-8.0	:	N.A.	N.A.	N.A.
Construction index ^{1.6}	Ann. % ch	N.A.	N.A.	11.8	-6.5	-15.9	:	:	-15.3	-12.8	:	-8.3	:	:
Retail sales ^{1.7}	Ann. % ch	N.A.	N.A.	N.A.	-15.3	-1.8	:	:	1.7	0.9	:	0.2	0.8	:
2 Labour market														
Unemployment ^{2.1}	%	N.A.	9.6	8.4	9.1	11.8	12.3	11.2	11.5	12.1	:	N.A.	N.A.	N.A.
Employment ^{2.2}	Ann. % ch	N.A.	1.8	1.3	-1.9	-4.0	-0.2	1.0	-4.2	-4.1	:	N.A.	N.A.	N.A.
Wages ^{2.3}	Ann. % ch	6.2	6.2	7.1	2.2	-0.4	0.4	0.6	-0.2	0.5	:	0.3	:	:
3 External sector														
Exports of goods ^{3.1}	Ann. % ch	16.1	8.8	5.1	-20.2	17.3	:	:	17.6	27.4	:	5.5	2.3	:
Imports of goods ^{3.2}	Ann. % ch	12.9	11.0	8.9	-25.6	-1.1	:	:	5.3	5.4	:	-0.1	1.1	:
Trade balance ^{3.3}	% of GDP	-21.0	-21.7	-22.6	-16.2	-12.9	-15.8	-16.7	-13.7	-12.9	:	N.A.	N.A.	N.A.
Exports goods and services ^{3.4}	% of GDP	42.7	42.1	41.7	35.4	38.3	:	:	37.1	38.3	:	N.A.	N.A.	N.A.
Imports goods and services ^{3.5}	% of GDP	49.8	49.8	49.9	39.4	38.8	:	:	38.4	38.8	:	N.A.	N.A.	N.A.
Current account balance ^{3.6}	% of GDP	-6.9	-7.5	-9.2	-5.5	-1.5	-3.7	-4.7	-2.6	-1.5	:	N.A.	N.A.	N.A.
Direct investment (FDI, net) ^{3.7}	% of GDP	6.4	8.0	6.7	2.7	1.3	:	:	2.4	1.3	:	N.A.	N.A.	N.A.
International reserves ^{3.8}	mio EUR	8 725.3	9 307.4	9 120.9	10 375.8	10 660.3	:	:	11 154.4	10 660.3	:	10 456.2	10 464.0	:
Int. reserves / months Imp ^{3.9}	Ratio	6.1	5.9	5.3	8.2	8.5	:	:	8.9	8.5	:	8.3	8.3	:
4 Monetary Developments														
CPI ^{4.1}	Ann. % ch	3.2	2.9	6.1	2.4	1.0	1.8	2.0	1.1	1.5	:	1.9	2.2	:
Producer prices ^{4.2}	Ann. % ch	:	:	:	-0.4	4.3	:	:	3.8	5.1	:	6.5	8.0	:
Food prices ^{4.3}	Ann. % ch	2.5	3.4	10.0	1.7	-1.5	:	:	-0.5	0.4	:	2.4	3.6	:
M4 ^{4.4}	Ann. % ch	14.3	17.9	10.9	1.6	2.7	:	:	3.2	4.5	:	3.7	3.7	:
Exchange rate HRK/EUR ^{4.5}	Value	7.30	7.33	7.22	7.34	7.29	:	:	7.25	7.36	7.40	7.40	7.41	7.39
Nominal eff. exchange rate ^{4.6}	Index	98.7	98.0	96.1	97.2	98.2	:	:	98.23	99.37	:	100.31	100.30	:
5 Financial Indicators														
Interest rate (3 months) ^{5.1}	% p.a.	4.46	5.66	7.19	8.96	2.44	:	:	2.66	2.61	2.63	2.80	2.64	2.47
Bond yield ^{5.2}	% p.a.	N.A.	N.A.	5.9	6.4	5.8	:	:	5.7	5.9	5.9	6.0	6.0	5.9
Stock markets ^{5.3}	Index	2 771	4 673	3 299	1 871	1 990	:	:	1 873	1 922	2 275	2 293	2 241	2 290
Credit growth ^{5.4}	Ann. % ch	22.0	19.4	11.6	5.0	2.9	:	:	4.5	6.4	:	5.6	6.4	:
Deposit growth ^{5.5}	Ann. % ch	51.6	27.2	7.4	-15.2	-19.8	:	:	-17.3	-13.4	:	-5.4	-1.5	:
Non performing loans ^{5.6}	% of total	N.A.	N.A.	N.A.	N.A.	N.A.	:	:	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
6 Fiscal developments														
General government balance ^{6.1}	% of GDP	-3.0	-2.5	-1.4	-4.1	-5.7f	-6.1	-5.6	:	:	:	N.A.	N.A.	N.A.
General government debt ^{6.2}	% of GDP	35.5	32.9	28.9	35.3	40.9f	45.9	49.9	:	:	:	N.A.	N.A.	N.A.

f. ECFIN forecast Autumn 2010

CHARTS

European Commission, ECFIN-D-1



CROATIA

