The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

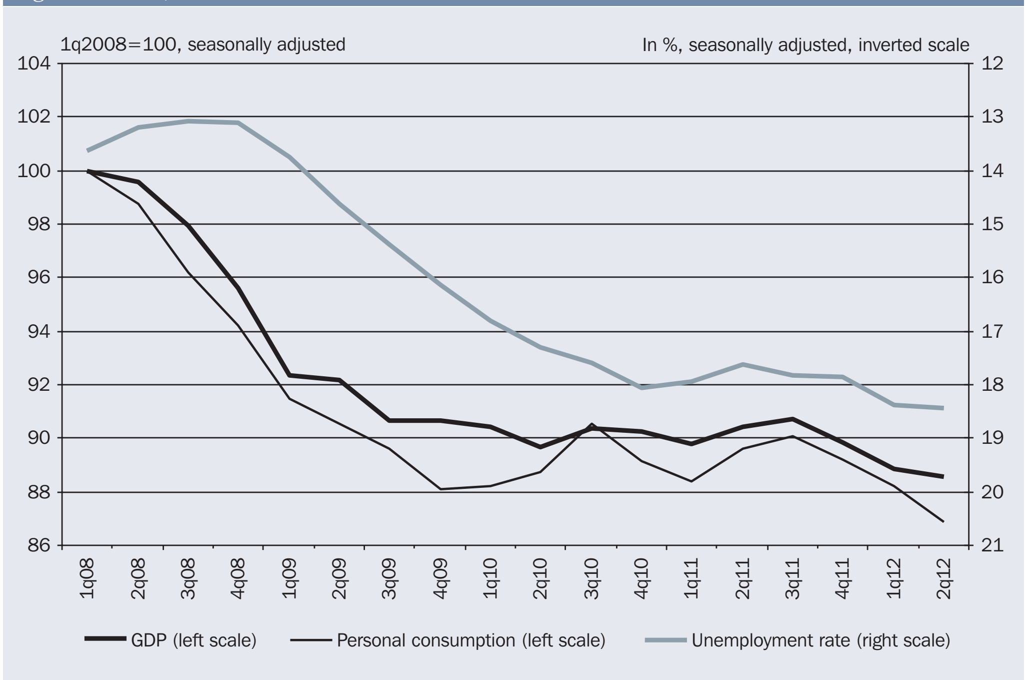
Prolonged recession takes its toll on spending and employment.

Croatian GDP has continued to recede. In the second quarter of 2012 it declined by 2.2 percent year-on-year and by 0.4 percent quarter-to-quarter, according to seasonally adjusted figures. This quarterly drop followed a GDP contraction of around 1 percent in the preceding two quarters, indicating that the negative trend has actually weakened. Nevertheless, the recession has already been present for full four years except for the two short-lived growth episodes in the summer of 2010 and 2011. Since its beginning in the second quarter of 2008, GDP fell by 11.8 percent. This deep and prolonged recession takes its toll on spending and employment. In the second quarter of this year, domestic consumption weakened by 2.5 percent year-on-year, investments by 5.9 percent, while total employment decreased by 2.2 percent. Mild optimism stems from the most recent figures on developments in the manufacturing and retail trade industry that suggest notable weakening of negative trends and even signs of recovery in the most recent months. There is also an encouraging performance of the tourism sector in terms of the number of foreign tourists and their overnight stays, which is to be confirmed by the financial indicators.

Progressive weakening of personal consumption.

Personal consumption has declined at a relatively rapid pace over the last three quarters, reflecting poor labor market conditions, reduced incomes and increased prices. In the second quarter, it was 3.4 percent lower than the year ago. Seasonally adjusted figure

Figure 1 GDP, PERSONAL CONSUMPTION AND UNEMPLOYMENT RATE



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

indicates a quarterly drop of 1.5 percent, more than in the previous two quarters, pointing thereby to the intensification of negative tendencies. The second quarter brought additional uncertainty over the increased VAT rate, changes in income taxation and hikes of electricity and gas prices that restrained households from further spending.

Government consumption mildly reduced.

Following provisional budget financing and a notable decline in government consumption in the first quarter, 1.5 percent year-on-year, the second quarter brought regular budget financing and mild decline of 0.2 percent. The Government's attempt to control spending is still constrained by increased employment in the public sector. Staffing was intensified at the end of the previous year, during the last months of the former Government's mandate. Every stronger cut in consumption seems to be conditioned by the Government's ability to reduce the size of the public sector. Rationalization in materials and supplies cannot provide sufficient maneuvering room for larger-scale savings that are needed to bring balance to government finances.

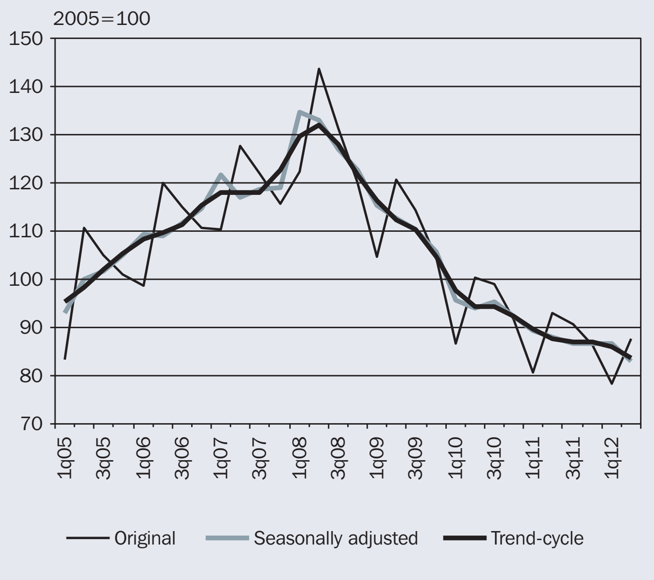
After a temporary relief, investments declined again.

After stagnation in the preceding two quarters, the second quarter 2012 witnessed another slump in investments with the decline of more than 4 percent, measured by seasonally adjusted quarter-to-quarter figures. On the year-on-year basis, the decline amounted to 5.9 percent. These latest developments confirm how hard it is to change investment climate in spite of the repeated Government announcements of investments in domestic public companies, foremost engaged in energy, water and environment businesses. Private sector is still reluctant to invest due to uncertain prospects.

Sluggish exports, but the tourism sector fares well.

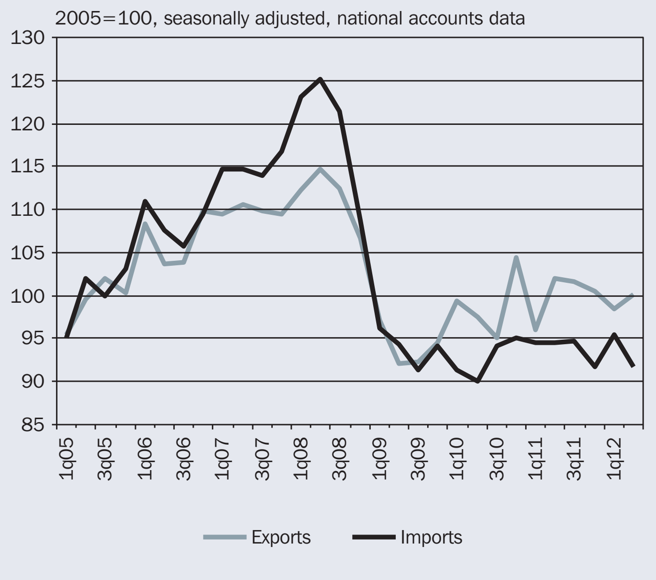
Over the last year, total exports and imports experienced a series of ups and downs. It appears that the underlying trend is stagnating in the case of exports and is slightly negative in the case of imports. On the year-on-year basis, volume of total exports declined by 1.8 percent in the second quarter, while volume of imports decreased by 3.3 percent. Within total exports, the goods component performed poorly. Trade statistics show an exports decline of 1.6 percent year-on-year in EUR terms in the first eight months of this year. This figure could be somewhat improved in the near future, as exports of the shipbuilding industry at the end of August amounted to only 1/2 of the level recorded in previous years. Months to come could bring higher exports of this branch, as physical indicators on its activity are encouraging. However, longer-term perspective reveals sluggish exports and declining shares in the EU market where the recession has only exacerbated long-lasting

Figure 2 INVESTMENTS



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

Figure 3 EXPORTS AND IMPORTS OF GOODS AND SERVICES



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

problems with competitiveness. Exports of services seem to fare well, recording more than 7 percent increase year-on-year in the second quarter in current EUR terms, mostly driven by the tourism sector with an increase of 9.1 percent. Imports were determined by declining domestic demand, but some recovery was brought about by higher consumption of foreign tourists during the summer. Recently, current account deficit has shrunk. The last four quarters, up to the second quarter of this year, brought all-time low current account deficit of 0.5 percent of GDP. For the largest part of this year, foreign debt was below the level recorded in the corresponding periods of the last year. At the end of June, the debt was EUR 46.5 billion or 1.7 percent less than the year before, confirming that the economy-wide deleveraging process is under way.

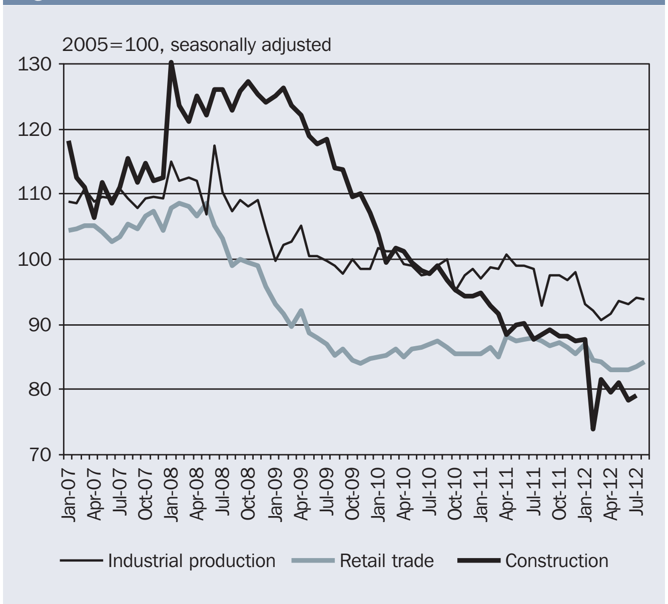
Signs of recovery appear in the real sector; is it sustainable?

Following the first quarter of 2012 when real sector output experienced a strong contraction, activity stabilized in the subsequent months and even showed signs of recovery. Question, however, remains whether these latest trends are temporary or can be sustained through the second half of the year. Compared with the preceding quarter, industrial sector experienced a 5.6-percent decline in the first quarter 2012 according to the seasonally adjusted data, followed by a 0.9-percent increase in the second quarter and an additional 1.2-percent increase in the July-August period. It appears that recovery strengthened during the summer with the production of non-durable consumer goods and capital goods contributing mostly to the positive change in trend. Almost identical developments, though with a slight lag, are observable in the retail trade sector. Following a quarter-to-quarter drop of 1.4 and 2.5 percent in the first and second quarter 2012, retail sales stabilized and upturned by 1.0 percent in the July-August period. One should, however, note that these numbers are affected by the successful tourist season. Additionally, in the first eight months of 2012, on cumulative basis, industrial activity was lower by 5 percent and retail sales by 4 percent than in the same period of 2011. At the same time construction activity whose trend has been negative for almost full four years, seems to have touched bottom with the latest monthly observations indicating stabilization. Nevertheless, up to July 2012 the volume of construction works was more than 10 percent smaller than the one in the previous year.

Labor market stuck in a jam.

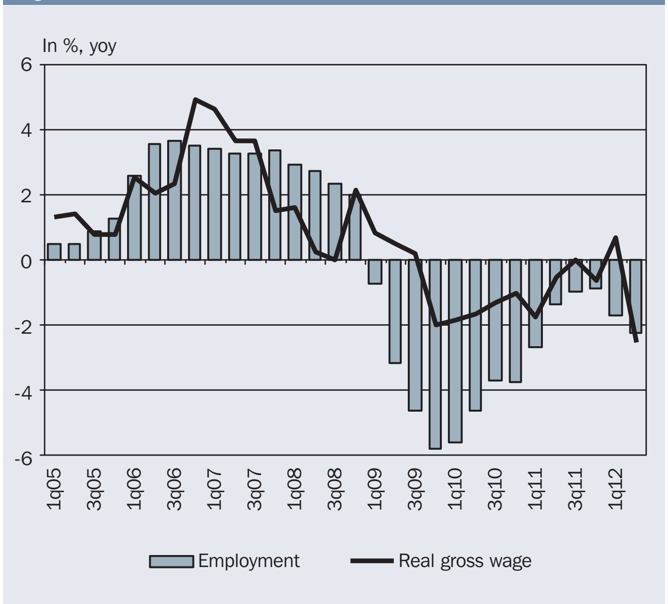
The number of the registered unemployed has risen sharply in September, reaching 311 thousand, 10 percent more than a year ago. Seasonally adjusted data confirm strengthening of the negative trends in recent months. One should note that the last year's unemployment

Figure 4 REAL SECTOR DEVELOPMENTS



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

Figure 5 EMPLOYMENT AND WAGES



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

figures were artificially pressed down by the expansion of short-term employment and education programs as well as the use of stricter registration rules before the parliamentary elections. Therefore, the year-on-year increase in unemployment is probably somewhat overstated, but that does not affect the recent negative trend. The average number of posted vacancies per number of newly registered unemployed was 0.5 in the first eight months of 2012 and only 0.3 in September. Registered unemployment rate of 17.7 percent in August is 0.2 percentage points higher than in the same month last year. Employment figures confirm that labor market has been stuck. The minor rise of employment in the second quarter 2012, due to seasonal reasons, was replaced by a 0.5-percent fall in August compared to July and by 2.5 percent compared to August last year. The strongest year-on-year decline was present in the construction (9.8 percent), manufacturing (4.6 percent) and trade sector (3.2 percent) as well as in small, unincorporated businesses (2.7 percent). Even in accommodation and food services employment dropped by 1.6 percent year-on-year despite the good tourist season. As for the employment in the public sector, it has somewhat increased in education and public administration.

Real disposable income fell considerably.

The average gross wage stood at HRK 7,885 (approx. EUR 1,050) in the second quarter 2012, which is a 0.9-percent nominal increase compared to the second quarter 2011. Combination of this figure with the fall in total employment resulted in a 1.3-percent decline in the total net wage bill in nominal terms, and 4.8-percent decline in real terms. A similar drift is observed for the overall net disposable income, which fell by 0.7 percent in nominal and 4.1 percent in real terms explaining the notable reduction of personal consumption in that period.

Conflict arising over collective agreements for public sector employees.

The Government is under pressure to consolidate public finances and gain control over its expenditure. Compensations to employees in the public sector are the example of expenditure that needs to be better controlled. This expenditure has performed above the budget plan not only due to increased employment, but also because of the relatively generous provisions of collective agreements in the public sector, at least compared to those of the private sector. Therefore, the Government has initiated negotiations with the trade unions over the existing agreements, by proposing cuts in non-wage compensations such as the Christmas and holiday bonuses, transportation compensations and the loyalty reward. The revised agreement was concluded with the trade unions of the public administration sector, but bargaining with trade unions in education and health care failed. In early September, the Government canceled the Basic Collective Agreement for the Public Services, the overarching agreement for these two sectors. There is a three-month cancellation period, which means that in December the non-wage compensations could be reduced by unilateral decision of the Government if the bargaining over new agreement proves unsuccessful. Core wages will probably not be changed because they are regulated by another set of rules. The agreement cancellation provoked eager reaction of the public sector trade unions that have announced protests and strikes parallel with legal disputes over the right of the Government to cancel the agreement unilaterally. Although the savings from the announced cuts in non-wage compensations do not seem particularly high, this conflict is an important test of the Government's determination and ability to control public spending in a sensitive area and faced by the opposition of well-organized trade unions that enjoy high union density. The results will surely produce an effect on the aspirations of other users of public funds.

Ongoing deleveraging and moderation of savings growth.

Seasonally adjusted broad money growth of 1.5 percent in the second quarter seemed encouraging, as it was the highest quarterly rate in the last two years. However, the subsequent two summer months added a meager 0.4-percent to the stock. As a result, in August broad money was 2.7 percent higher than a year before, which is a relatively small increase, considering that this tourist season was probably better than the previous one. The reasons for moderation are twofold. Firstly, narrow money subdued strongly: -3.3 percent year-on-year in August primarily due to decreased demand deposits of enterprises caused by deleveraging. Secondly, households recorded the lowest savings growth in the last three years. Total savings still contributed positively to broad money growth but to a lower extent than before. The growth of credits to the non-government sector was negative, which can be attributed to eroding incomes and poor economic outlook. The corporate sector reduced its borrowing for the first time over the last twelve years, 0.9 percent in July and 1.9 percent year-on-year in August. However, a portion of this reduction is due to the Government's taking over the state-owned shipyards' loans. After the two years of positive growth rates, credits to households slumped and recorded a -1.9-percent drop in August. The Government took advantage of the low private sector credit demand and increased its borrowing by 26.8 percent in a year up to August.

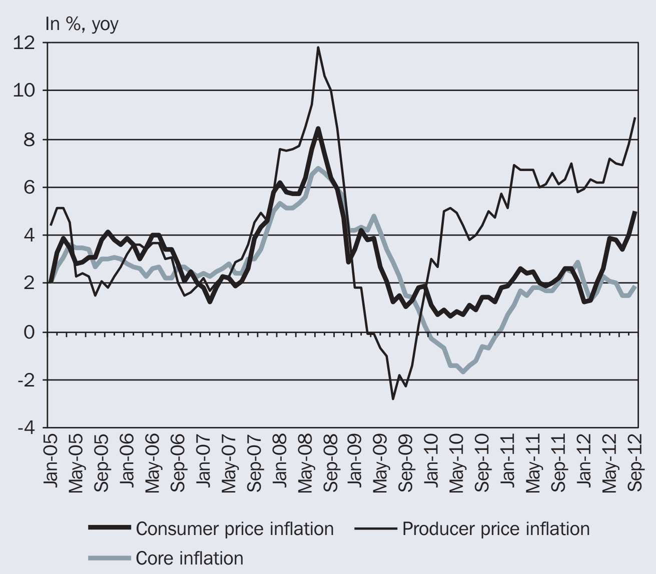
Poor credit demand despite the CBRD Economic Recovery Program.

Economic Recovery Program of the Croatian Bank for Reconstruction and Development (CBRD), which was launched in June and aimed at providing additional credit potential at lower, partially subsidized, interest rates, has not yet helped to mitigate negative trends in the overall credit activity. In the four auctions, loans in the total amount of HRK 2.04 billion were approved, out of HRK 6.8 billion allotted to the program. It seems that most of these resources have not yet reached final borrowers, because they have been stuck in the process of allocation. The CBRD's decision to decrease the interest rates by one percentage point for the loans granted in this year, but only to strategic sectors, did not help in raising the attractiveness of the program. The demand in the last auction was lower than expected and the approved interest rates were more or less the same as in the previous auction, from 3.4 to 4.2 percent, but well below the market rate of around 7 percent for long-term loans.

Non-performing loans on the rise, banking sector remains stable.

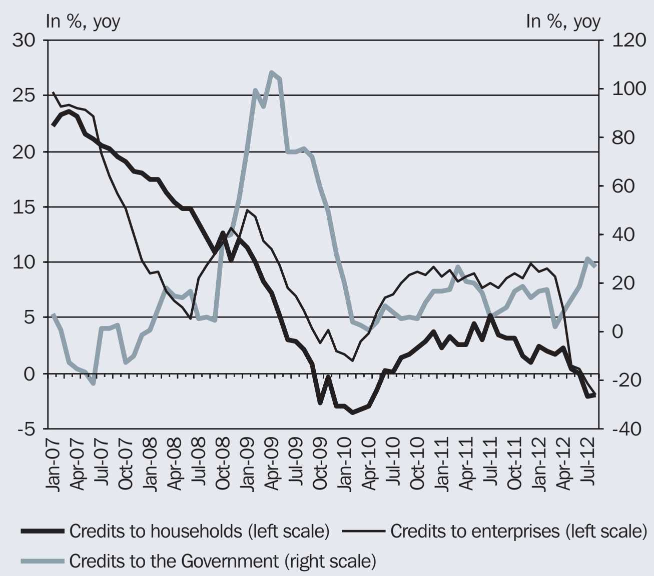
The share of non-performing loans in total loans increased to 13.3 percent by the end of June, as opposed to 11.9 percent recorded at the same time last year. The rise in "bad loans" is due mostly to bankruptcies and rising tax arrears in the corporate sector and household sector repayment difficulties caused by the ongoing recession. Pressed by non-performing loans on one side, and credit demand deterioration coupled with deposit moderation on the other side, commercial banks' profit fell by 15.9 percent in the second quarter compared to the year before. However, the central bank stress tests indicate that the Croatian banking system is stable and capable of handling a non-performing loans ratio up to 20 percent with only a few banks in need of a minor capital injection in case the loan repayment situation worsens considerably.

Figure 6 INFLATION



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

Figure 7 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

Appreciation has been halted.

Higher demand for cash in circulation in July and August, and ample sovereign borrowing in July caused both interest rate volatility and HRK/EUR appreciation. Moreover, owing to Fitch credit rating outlook upgrade from negative to stable, receipts from foreign tourists, improvements in current account and more intensified foreign currency borrowing, kuna appreciated more strongly against the euro throughout the first half of September. Compared to the period of three months ago, kuna strengthened by 1.9 percent and reached the rate of 7.40. That level was a trigger for the central bank to intervene in order to prevent further appreciation. It bought EUR 58 million from commercial banks, the first intervention in that direction in the last two years, and poured HRK 430 million into the system, enough to stabilize the HRK/EUR exchange rate.

Imported and imposed price hikes.

Consumer price inflation advanced to 5 percent in September, the highest year-on-year rate recorded in the last three and a half years. Serious demand-driven downside pressure due to consumer pessimism and poor job market prospects was not enough to offset imported and imposed price hikes. Imported inflation is related to rising food and fuel prices, while imposed inflation is a result of lifted standard VAT rate and increased administratively controlled prices of electricity, gas and highway toll. If we exclude energy and food prices then the increase of consumer prices amounts to a mere 1.5 percent year-on-year. Compared to August, consumer prices increased by 1.4 percent, mostly due to higher food and fuel prices, as well as season-inflicted clothing and footwear price hikes. Producer price inflation reached 8.9 percent in September.

More efficient tax collection lifted government revenue.

The developments over the first half of the year suggest that the Government chose to work toward fiscal consolidation mainly through the revenue side. Admittedly, this seems to have produced some favorable results concerning the revenue collection dynamics. Total general government revenue increased by 3.5 percent in the second quarter and 3.3 percent in the first half of this year compared to the same period of 2011. The principal contributors to this increase were revenues from personal income taxes, social security contributions and VAT. Collection of personal income taxes rose by 18.9 percent in the second quarter. However, this rise cannot be related to the developments on the labor market. Rather, it is mostly due to greater efficiency in revenue collection and to the introduction of taxes on income from dividends and profit shares, as well as pension supplements and pensions from abroad. Revenue from social security contributions rose by 2.7 percent as a net effect of two colliding changes: a 2-percentage point reduction in the health care contribution rate since May and a more efficient revenue collection. The latter is the result of a strict requirement that wages and salaries can no longer be paid unless a company pays social security contributions at the same time. Due to the lower rate, the efficiency gains obviously outweighed revenue loss. As for VAT revenue, it increased by 9.3 percent in the second quarter as a direct consequence of an increase in the standard rate from 23 to 25 percent in March.

State-owned shipyards credit obligations blamed for the notable increase in public debt.

Total general government expenditure fell by 0.7 percent year-on-year in the second quarter. Social spending, the biggest component of public expenditure, exhibited a moderate 1.8-percent increase, while the second biggest item, employees' compensation, increased by mere 0.1 percent. Purchases of goods and services fell by 3.2 percent. The most remarkable change occurred in subsidies, a 29.6-percent decline, mainly due to reductions in subsidies to the agricultural sector and Croatian Railways. Since the end of March till the end of June the difference between revenue and expenditure increased by HRK 850 million to reach HRK 4.2 billion, which is 2.3 billion less than at the end of the second quarter 2011. These 4.2 billion constitute 36.3 percent of the deficit planned for the whole 2012. Deficit was financed mainly through borrowing. However, public debt increased by much more, by HRK 16.2 billion since the end of 2011, reaching HRK 170.2 billion at the end of June. Out of that increase, HRK 9.2 billion is a result of the taking over of all the credit obligations of state-owned shipyards that were covered by government guarantees into public debt as

Table 1 MAIN ECONOMIC INDICATORS

	2010	2011	2011		2012	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.4	0.0	0.8	-0.4	-1.3	-2.2
Real private consumption (% change, yoy)	-0.9	0.2	0.1	0.1	-0.3	-3.4
Real government consumption (% change, yoy)	-1.6	-0.3	-0.3	-0.9	-1.5	-0.2
Real investment (% change, yoy)	-15.0	-7.2	-8.6	-6.0	-2.8	-5.9
Industrial output (% change, yoy)	-1.4	-1.2	-2.4	0.0	-5.4	-6.7
Unemployment rate (registered, %, pa)	17.4	17.8	16.6	17.9	19.9	18.2
Nominal GDP (EUR million)	44,877	44,922	-	-	-	-
GDP per capita (EUR)	10,158	10,205	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.9	2.1	2.2	1.9	1.1	2.0
Consumer prices (% change, yoy, pa)	1.1	2.3	2.0	2.4	1.5	3.4
Producer prices (% change, yoy, pa)	4.4	6.3	6.3	6.4	6.1	6.8
Average gross wage (% change, yoy, pa)	-0.4	1.5	2.0	1.8	2.1	0.9
Exchange rate, HRK/EUR (pa)	7.29	7.43	7.45	7.49	7.56	7.52
Exchange rate, HRK/US$ (pa)	5.50	5.34	5.27	5.56	5.76	5.86
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	8,905	9,582	2,469	2,390	2,254	2,329
Exports of goods (EUR, % change, yoy)	18.3	7.6	13.8	-2.7	2.7	-7.9
Imports of goods (EUR million)	15,137	16,281	4,211	3,972	3,891	4,155
Imports of goods (EUR, % change, yoy)	-0.5	7.6	6.1	-0.2	2.1	-3.0
Current account balance (EUR million)	-482	-431	2,485	-919	-1,593	-210
Current account balance (% of GDP)	-1.1	-1.0	-	-	-	-
Gross foreign direct investment (EUR million)	298	1,075	305	171	10	144
Foreign exchange reserves (EUR million, eop)	10,660	11,195	11,324	11,195	11,340	11,635
Foreign debt (EUR million, eop)	46,483	45,734	46,560	45,734	45,910	46,514
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,709	123,025	91,587	123,025	28,931	60,654
Expense (HRK million)**	133,486	132,945	97,994	132,945	32,248	64,826
Net = Gross operating balance (HRK million)**	-9,777	-9,920	-6,487	-9,920	-3,317	-4,172
Net acquisition of non-financial assets (HRK million)**	4,848	5,044	3,130	5,044	729	1,428
Net lending/borrowing (HRK million)**	-14,432	-14,964	-9,618	-14,964	-4,046	-5,600
Domestic government debt (EUR million, eop)	12,085	13,716	13,414	13,716	14,613	14,721
Foreign government debt (EUR million, eop)	6,602	6,996	6,984	6,996	7,093	8,188
Total government debt (% of GDP)	41.3	45.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	4.2	7.5	-1.1	7.5	-3.5	-2.4
Broad money, M4 (% change, yoy, eop)	4.4	3.5	3.7	3.5	2.7	3.2
Total domestic credit (% change, yoy, eop)	6.8	5.5	6.7	5.5	4.9	0.1
DMBs credit to households (% change, yoy, eop)	3.8	0.9	3.1	0.9	1.7	0.0
DMBs credit to enterprises (% change, yoy, eop)	9.5	9.8	8.6	9.8	8.6	0.4
Money market interest rate (%, pa)	0.9	0.9	0.8	1.4	1.6	0.5
DMBs credit rate for enterprises, short-term, (%, pa)	7.4	7.0	6.6	7.6	7.9	7.1
DMBs credit rate for households, short-term (%, pa)	12.7	11.9	11.2	11.2	11.2	11.2

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: *Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

a part of the restructuring and privatization process, while only the remaining part is the result of current borrowing requirements.

2 Policy Assumptions and Projections Summary

Uncertainty overclouds the outlook for global economy…

Forecasts for the global economy have recently been revised downwards, indicating a somewhat gloomier outlook than was envisioned a few months ago. IMF has based its latest forecast (*World Economic Outlook*, October 2012) on two main assumptions – that policy-makers in the U.S. will act by the end of the year in order to avoid substantial tax increases and spending cuts that will otherwise automatically take effect (so-called "fiscal cliff") and, second, that the policy-makers in Europe will keep control over the sovereign debt crisis. Even taking these two, rather optimistic, assumptions into account led to the downward revision of IMF's forecasts. IMF now expects global economy to expand 3.3 percent this year and 3.6 percent in 2013. In the U.S. the GDP growth should reach 2.2 percent in 2012 and 2.1 percent next year. Fiscal consolidation and vulnerable financial markets constrain prospects in the advanced economies and depress growth in the leading emerging markets through trade and financial channels. Prospects for the eurozone are particularly uncertain in spite of the fact that ECB has recently announced a new bond-buying plan which was positively received by the financial markets. For the eurozone, GDP is projected to decline by 0.4 percent in 2012. However, stabilization should take place in the first half of 2013, followed by recovery in the second half that would allow for 0.2-percent GDP growth in 2013 as a whole. Among Croatia's main trading partners Germany is expected to have positive growth of 0.9 percent throughout 2012-2013, while Italy and Slovenia are to experience a sharp contraction in 2012 and to remain in the negative zone in 2013.

… but the eurozone economy is expected to recover gradually.

As for our assumptions on international environment, we suppose that the eurozone crisis will be kept under control and that the gradual recovery of its economy will take place next year with a positive effect on Croatia. Also, we expect Croatia's accession to the EU to remain on track. By mid-October, eleven EU member states have finished the ratification procedure and in another six states parliamentary approvals of the Accession Treaty have been obtained. It is believed that there is enough time and good will among the rest of the member states to complete the process so that Croatia becomes a full member in July 2013.

Fiscal consolidation and cautious monetary policy expected to continue…

On the internal front, fiscal consolidation is expected to progress in line with the State Budget and the *Economic and Fiscal Policy Guidelines*, although variety of risks are present. In September, the credit rating agency Fitch revised Croatia's outlook up from negative to stable and maintained credit rating at BBB-, thereby expressing a positive opinion on Government efforts towards fiscal consolidation despite high implementation risks and weak growth prospects. We do not assume any downgrading of the credit rating to occur over the projection horizon. Monetary authorities are supposed to stay focused on the financial system stability and to opt for a policy of minimizing risks that may come from the HRK/EUR exchange rate volatility. Consequently, monetary policy is expected to be highly cautious when it comes to possible easing.

… while structural reforms should speed up.

We assume certain speeding up of structural reforms, particularly in the public sector and state-owned companies, primarily as a result of financial constraints, and as a side effect of the EU accession. The European Commission announced in October another *Monitoring Report on Croatia's state of preparedness for EU membership* pointing out that when it comes to economic criteria, structural reforms should be accelerated with respect to privatization and the restructuring of loss-making state-owned enterprises, as well as labor market and overall investment climate. Policymakers will hopefully take the Commission's recommendations seriously so as not to jeopardize the accession process.

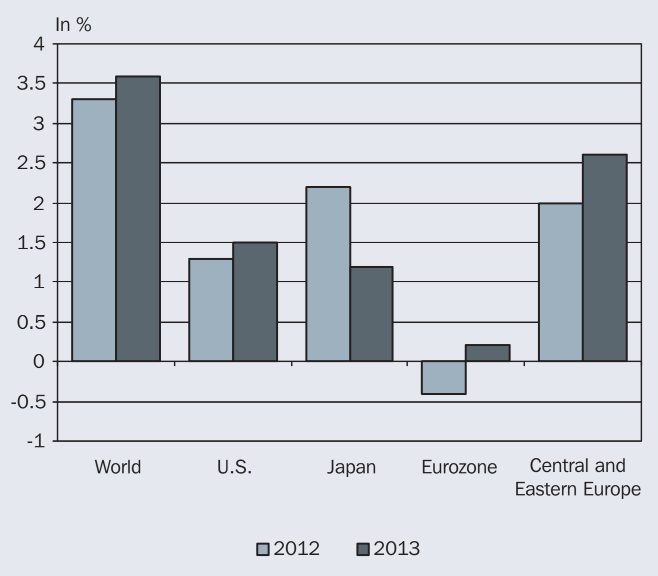
GDP expected to decline 1.4 percent in 2012 driven by weak domestic demand.

Trends established in the first half of this year suggest that Croatia will experience a negative GDP change in 2012, mainly driven by the substantial decline in domestic demand. Our projections now indicate a 1.4 percent decrease in total output. Domestic demand is expected to decrease 2.0 percent with personal consumption shrinking 2.6 percent and government consumption 0.6 percent. Unexpected weakening of investment activity in the second quarter caused the downward revision of investment performance for this year. Although we still anticipate strengthening of public investments towards the year-end, the postponement in their realization and strong reduction in private investment activity lead us to project a negative rate amounting to 3.4 percent. Net exports should contribute positively to the total output with 0.8 percentage points resulting from moderate rise in exports, led by tourist services, and a reduction in imports volume.

GDP rate for 2013 revised downwards to 0.5 percent.

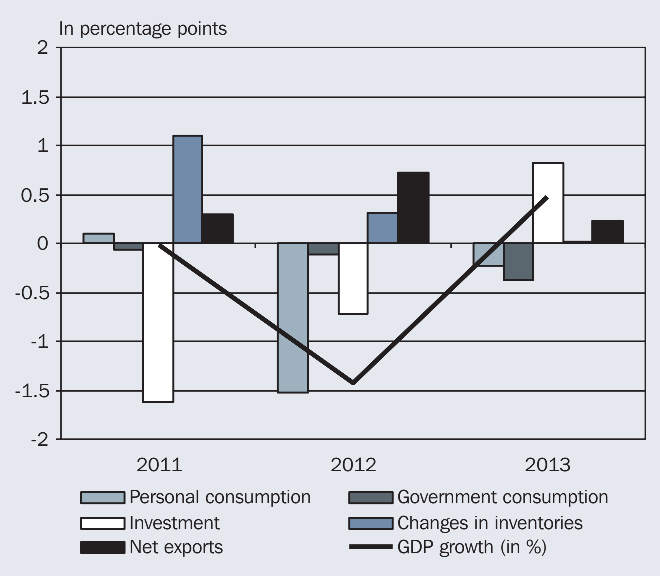
We expect negative economic trends to halt in the second half of this year. Next year's gradual strengthening of investments and exports, coupled with improved consumer sentiment underpinned by EU membership, should bring positive GDP rate amounting to 0.5 percent. It should be noted that our GDP projection for 2013 has been revised downwards compared to three months ago due to the weaker than expected recovery of global and, in particular eurozone economy, postponement of public investments and substantial worsening of the labor market situation. Shrinking household income and rising unemployment are the main reasons behind the downward revision of personal consumption that is now expected to decline 0.4 percent next year. Investments should increase considerably by around 4 percent, but one should have in mind that this projection is based on the Government's announcement of investments undertaken by public enterprises. Government consumption is expected to continue declining, assuming the proclaimed decrease in the number of public sector employees. Exports should rise by about 2.5 percent rate in 2013, primarily as a result of exports of tourist services supported by the EU membership and its effect on the country's image. However, goods exports might remain sluggish due to the continued competitiveness constraints and restructuring of the shipbuilding industry. Projections indicate imports to rise by 1.9 percent as a consequence of stronger investment activity and stronger exports.

Figure 8 GLOBAL GROWTH PROSPECTS



Source: *IMF (World Economic Outlook, October 2012).*

Figure 9 CROATIA: CONTRIBUTIONS TO GDP GROWTH



Sources for original data: *Croatian Bureau of Statistics and EIZ projections for 2012 and 2013.*

Current account deficit expected to widen slightly.

As for the current account balance, this year might end up with a deficit of around 1 percent of GDP which is similar to the 2011 outcome. Namely, the account of goods and services should remain in balance with the deficit in trade of goods of EUR 6.5 billion and the comparable surplus in the trade of services. The income account will register deficit and determine, to a large extent, the overall current account balance. Next year, current account deficit might widen slightly to about 1.4 percent of GDP mostly due to rising imports related to stronger investments.

No labor market recovery on the horizon.

Labor demand is poor owing to the weakness of the real economy and only minor improvements are expected next year. It also appears that restructuring will include more layoffs in both private and public sector than was previously thought. Changes in the labor legislation announced for 2013, involving more flexible forms of employment like part-time work, work for more than one employer, work from home and similar could have some positive impact on employment if carefully designed. However, without fundamental changes in the parts of the Labor Act that deal with the process of hiring and firing, the scope of these measures will be limited. All in all, in this and the next year we project rising unemployment that may have its seasonal peak in February with some 360 thousand of registered unemployed persons. Unemployment rate will reach more than 20 percent by the end of this year, with the average of 18.9 percent for the whole year. The beginning of the economic recovery in 2013 will not be strong enough to restrain the unemployment rate from increasing and reaching the year-average of 19.2 percent. In the meanwhile, nominal average wages are expected to remain more-or-less unchanged.

Easing of medium-term inflation…

Consumer price inflation will evolve around 5 percent up until March 2013 when the base effect of recent price hikes will disappear. In line with that, the average inflation rate for the entire 2012 is expected to be 3.5 percent. Starting with the second quarter of next year, we expect the deflationary pressures created by base effect alleviation, job market weaknesses and consumer deleveraging to kick in and absorb potential further rise in consumer prices. Therefore, the 2013 inflation could average around 3.0 percent. Underlying price movements would point to even lower inflation rate, but there will be some EU-entry-related tax changes that will have a certain price impact. Anticipated changes include replacement of the zero VAT rate for bread, milk and medicine by a 5-percent rate and increases in excise taxes on electricity, gas, and tobacco.

… and stability of exchange rate.

The prolonged recession in Croatia, together with ongoing deleveraging is weighing on the exchange rate and calling for monetary easing. Stability of the exchange rate is assumed to remain a policy priority and the central bank has powerful measures to efficiently control HRK/EUR exchange rate variations. Therefore, we see it stalled at around 7.52 in this and the next year.

Credit creation to remain under downward pressure.

Total credit growth entered negative territory in July and is projected to stay there as long as the recession lasts. For the time being, fiscal savings, corporate balance sheet restructuring and poor capital expenditure will create downward pressures on credit activity. On top of that, international financial market sensitivity and moderate domestic deposit collection inhibit recovery of credit activity from the supply side. However, room for CBRD-supported type of measures is substantial which may underpin the credit market. On balance, we see a negative credit growth of 1.6 percent in this year, and a recovery of 3.6 percent next year. Meanwhile, broad money creation will stay limited, 2.7 percent in this and 3.7 percent by the end of the next year.

Fiscal deficit might be lower than planned, but uncertainties remain.

In addition to improved revenue collection in the first half of this year, the second half should bring favorable impact based on the very good tourist season, and particularly high VAT revenues. Thus, it seems that as far as the revenue side is concerned, the planned amount of HRK 126 billion will be outpaced. Total general government expenditure outturns in line with the plan and should remain so by the end of the year. However, the two principal

Table 2 SUMMARY OF PROJECTIONS

	2012	2013
Real GDP (% change)	**-1.4**	**0.5**
Real private consumption (% change)	-2.6	-0.4
Real government consumption (% change)	-0.6	-1.9
Real investment (% change)	-3.4	4.0
Exports of goods and services (constant prices, % change)	0.4	2.5
Imports of goods and services (constant prices, % change)	-1.3	1.9
Current account balance (% of GDP)	-1.0	-1.4
Consumer prices (% change, pa)	3.5	3.0
Exchange rate, HRK/EUR (pa)	7.51	7.52
Unemployment rate (registered, %, pa)	18.9	19.2
General government balance (ESA95 definition, % of GDP)	-4.3	-4.0
Broad money, M4 (% change, eop)	2.7	3.7
Total domestic credit (% change, eop)	-1.6	3.6

Notes: *Cut-off date for information used in the compilation of projections was October 10, 2012.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

expenditure components, the public sector wage bill and social security spending are heading above and are posing a threat to future developments. Nonetheless, fiscal deficit in nominal terms is expected to be lower than planned, primarily because revenue collection was improved. Pace of consolidation will be less visible in terms of deficit-to-GDP ratio because of the GDP estimate which is lower than the one envisaged earlier. Thus, by the end of 2012, the deficit is likely to be close to 4.3 percent. The deficit figure is, to a certain extent, subject to the Government's taking over of shipyards' credit obligations. According to ESA95 accounting rules, this operation might be treated as government expenditure in which case fiscal deficit would increase significantly. A similar problem might arise with some other contingent liabilities and arrears. When it comes to 2013 developments, we expect that the Government will be more courageous in expenditure cuts which, along with an improvement in the overall economy's performance, should bring a lower deficit than this year. It seems reasonable to expect a figure close to 4 percent of GDP, but hardly less than that.

3 Uncertainties and Risks to Projections

Downside risks prevail.

Weak domestic and mild foreign demand in addition to long-lasting competitiveness problems suggest high downside risks of our projections. The financially exhausted private sector is currently more oriented towards minimizing risks than towards undertaking investments. Therefore, with respect to investments we expect the public sector to be the leader and rely on Government's announcements which have already proved to be a risky base for assumptions. If investments continue to be postponed and their volume is far from expected, the outlook will be much grimmer. Problems might arise with investment financing – in some cases projects will be financed through concession contracts. Such contracts need time to be arranged. The weak labor market poses another risk for future developments due to its large impact on consumption and overall economic sentiment.

Uncertain short-term effects of EU accession.

On the bright side, we still believe that the EU accession will make Croatia an attractive place for doing business. However, the magnitude of the short-term effects is questionable. In our projections short-term effects are taken as more or less neutral, in this and the next year, and we might underestimate positive developments that come with the EU membership.

Close watch on the fiscal rule needed.

The Government will have to devote more attention to fiscal rules enshrined in the Fiscal Responsibility Act. *The Semi-annual Report on the Application of the Fiscal Rules* that was presented to the Parliament in mid-September does not include enough information to assess the compliance with the Act. The rule relevant for this year states that total general government expenditure taken as a ratio of estimated GDP has to decline by 1 percentage point. The Report informs of a 1.3 percentage points decline projected in the budget, which leaves us with an impression of a comfortable situation. However, the Government's projections were prepared under the assumption of a zero GDP growth. If we use our GDP projections, expenditure-to-GDP ratio declines by around 1 percentage point, which is on the edge of the fiscal rule. That points to the need of a much closer watch on the expenditure outturn and development of a plan B for expenditures if GDP declines more than is expected. A higher-than-planned total expenditure, even by a small margin, will lead to a break of the fiscal rule. However, it has to be said that the Act does not contain sufficient details for exact determination of the fiscal rule. It is very important that the Government, possibly together with the Fiscal Board and the Budget and Finance Commission of Parliament, gives an authoritative interpretation of the rule by providing and publishing sufficient technical details on its calculation. It should include at least: i) the methodology of government statistics, probably ESA95, ii) the items subtracted from total expenditure in assessing compliance with the fiscal rule, as the Act stipulates that an increase in expenditures related to the use of EU funds is not subject to the rule; and iii) treatment of unexpected outlays, for example taking over of credit obligations of state-owned shipyards. If such an interpretation is not soon provided, the credibility of any statement on compliance with the fiscal rule will be undermined.

Will another recession hit global economy?

Uncertainty has increased in the global economy, and even if the "fiscal cliff" in the U.S. is avoided and debt crisis in eurozone kept under control, uncertainty has already affected the decisions of investors around the world. Market tensions in the eurozone remain especially high, and conditions might deteriorate at any signal, no matter how insignificant it might seem, with the potential of spillover to other economies, including Croatia.

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