The Institute of Economics, Zagreb

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# Croatian Economic Outlook

*Quarterly*

## 1 Recent Developments

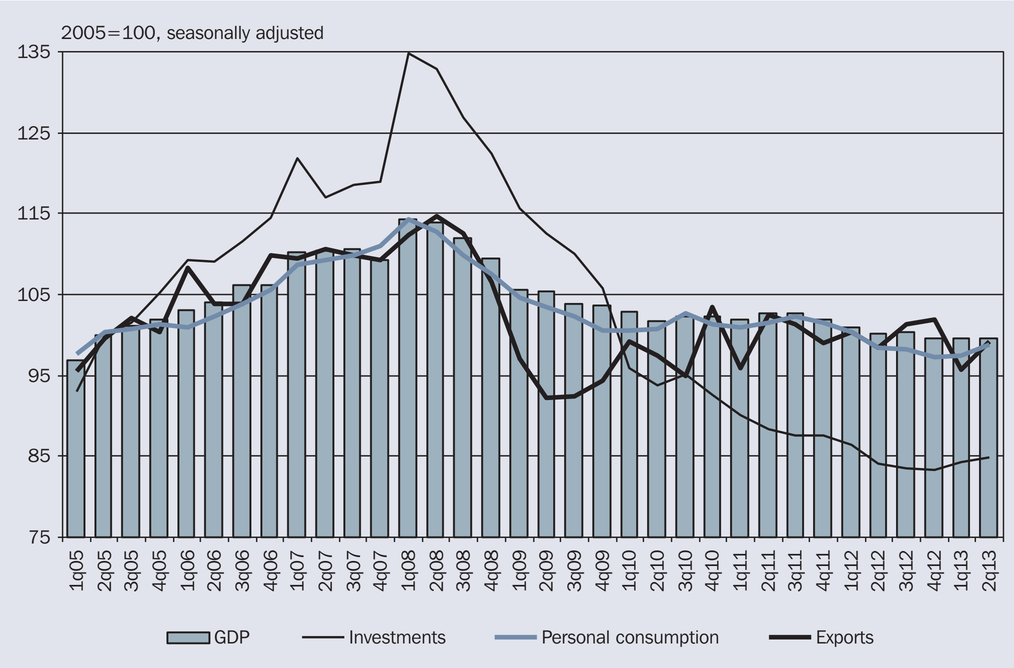
***GDP stagnated in the second quarter.***

Croatian economy seems to have entered stagnation after a prolonged period of contraction. Seasonally adjusted GDP in the second quarter of 2013 remained the same as in the first quarter. On year-on-year basis, GDP declined 0.7 percent in the second quarter, compared to 1.5-percent decline recorded in the first quarter, which again suggests diminishing negative tendencies. There was a notable rebound in personal consumption and investments in the second quarter, while both exports and imports rose significantly. Although exports rebounded from a slump in the first quarter, due to strong imports overall external trade contributed negatively to GDP growth by almost 2 percentage points on a year-on-year level. Domestic demand has increased substantially, 1.1 percent year-on-year. Rather strong growth support that came from domestic demand is a bit unexpected and can be seen as a one-off impact of adaptation to the EU accession.

***Personal consumption rebounded.***

Following a 3.0-percent year-on-year decline in the first quarter, personal consumption rebounded to a 0.5-percent growth in the second quarter. Such a notable change has been caused by frontloaded consumption due to expected tax increases after EU accession, mostly of cigarettes and certain models of cars. This can be considered as a short-lived episode because no stable sources of revived personal consumption can be recognized. Real disposable income is estimated to have declined at a rate of almost 3 percent year-on-year

Figure 1 REAL GROSS DOMESTIC PRODUCT




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

in the second quarter, mostly due to a lower wage bill. Consumer confidence has improved in the eve of accession and shortly after it which might also be a temporal phenomenon.

***Government consumption on the rise.***

Somewhat surprisingly, government consumption increased substantially in the second quarter. It grew by 1.3 percent compared to the second quarter of the previous year, following a rise of 0.3 percent in the first quarter of this year. Seasonally adjusted data on quarter-to-quarter basis confirmed a sizable rise in government consumption since the beginning of the year. Such developments differ from the Government's budget plan, but they can be explained by increased spending due to local elections held in May and limited space for further reduction of expenditures on goods and services as long as deeper structural reforms of public administration are not undertaken.

***Initial signs of investment recovery.***

After four and a half years of continuous decline in investments, the first half of this year brought a long-awaited upswing trend. Seasonally adjusted figures place the change in the first quarter, while the year-on-year growth figure turned positive one quarter later, showing a 0.9 percent rise. Although there are no details on the composition of investments, government finance statistics reveals that acquisition of non-financial assets at the general government level has substantially increased. As for the domestic private sector, it seems to lag behind the public sector. FDIs have remained low, as suggested by current accounts statistics.

***Exports bounced back in the second quarter.***

Following a decline of 4.9 percent year-on-year in the first quarter, exports of goods and services bounced back in the second quarter and rose by 0.8 percent. In spite of that, concerns about the export sector have not disappeared. In the last two years the volume of total exports has been broadly stagnating at the level well below its peak in 2008. In the first seven months, exports of goods declined 4.7 percent year-on-year in euro terms. Strong decrease of 7.5 percent was present in the exports of goods to CEFTA countries with exports to Serbia falling by as much as 14 percent. At the same time exports to EU improved by 2 percent. One should also note a 20-percent increase in exports to Slovenia. Restructuring of the almost entire shipbuilding sector had additional negative effects on goods exports resulting in a 40-percent decrease of ships exports compared to the previous year.

***Sizable growth of imports.***

Total imports also recovered in the second quarter and recorded a sizable year-on-year growth of 4.9 percent. A large portion of such increase is related to imports of motor vehicles due to expected tax and tariff changes. Additionally, imports of capital goods increased, which is linked to investment recovery, while imports of food increased as a part of positioning of foreign brands on the domestic market in preparation for Croatia's EU membership.

***Reduced current account deficit and gross foreign debt.***

Current account deficit reached EUR 250 million in the second quarter, 47 million less than a year ago. Although goods trade deficit of almost EUR 2 billion was some 250 million higher than a year ago, it was offset by higher services surplus and lower deficit on income balance. Cumulative current account balance over the last four quarters recorded surplus of EUR 350 million, around 0.8 percent of GDP, which was the third such surplus, and the highest one, in the last 15 years for which comparable data are available. These balancing tendencies have helped to contain foreign indebtedness. At the end of June gross foreign debt amounted to EUR 46.2 billion, 1.3 percent less than a year ago, but still around 104 percent of GDP.

***Strong decline in manufacturing activity,…***

Industrial activity continues to be depressed, especially in the manufacturing sector that exhibits a stronger negative trend than overall industrial activity. In the first eight months of this year overall industrial activity was 1.6 percent lower than in the same period a year ago, while in the manufacturing industry the decline reached 5.5 percent. Contraction was pronounced in food, beverage and clothing industry, which is probably related to weaker exports to CEFTA countries, and in the shipbuilding sector, the activity of which halved compared to the previous year. Beneficial weather conditions at the beginning of the year positively affected energy production and somewhat neutralized the negative contribution of the manufacturing sector to the overall industrial activity. In July and August, this year's negative trends continued and average monthly industrial production was 1.1 percent lower than in the second quarter, while the decline in the manufacturing sector amounted to 1.5 percent.

***… retail trade modestly recovers, …***

This year retail trade has been modestly recovering. Cumulative year-on-year rate for the first eight months indicated almost no change in volume, but seasonally adjusted quarter-to-quarter data showed the establishment of a stable and positive trend in the recent months. In July and August, retail trade was on average 1.2 percent stronger than in the second quarter. One explanation for this lies in the fact that sales of cars and some other products increased on the eve of EU accession. Additionally, implementation of fiscal cashiers has affected retail trade by pushing part of the hidden economy into the formal sector. Foreign tourists' consumption during the summer season may also explain a part of the retail trade improvement. Up to the end of August, data on physical number of overnight stays by foreign tourists indicated a 4-percent rise. These are all, however, one-time effects and there is uncertainty whether the current volume of retail trade may be sustained or further improved.

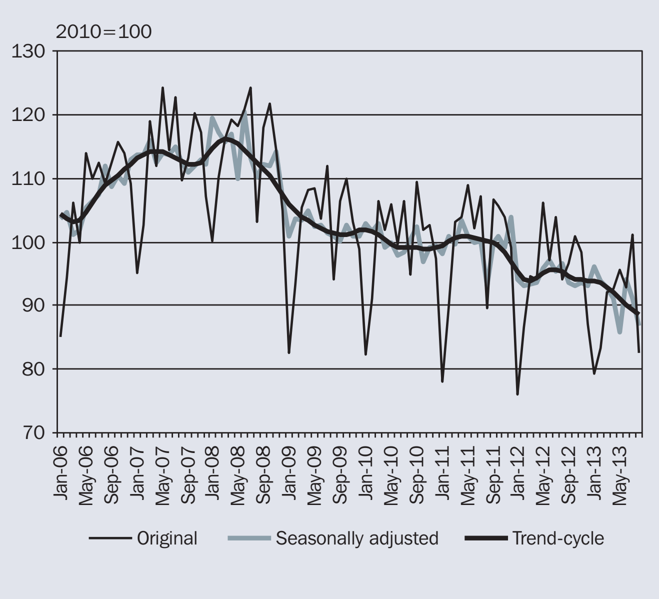
***… while the pace of decline in construction activity diminishes.***

This year the pace of contraction in construction activity has been slowing down significantly, reaching -0.7 percent year-on-year in July and -3.4 percent on the average for the first seven months. However, this trend remains negative when it comes to construction of buildings, while other types of construction works somewhat recovered due to intensified works on roads and border crossings before EU accession.

***Employment is back on the downward trajectory.***

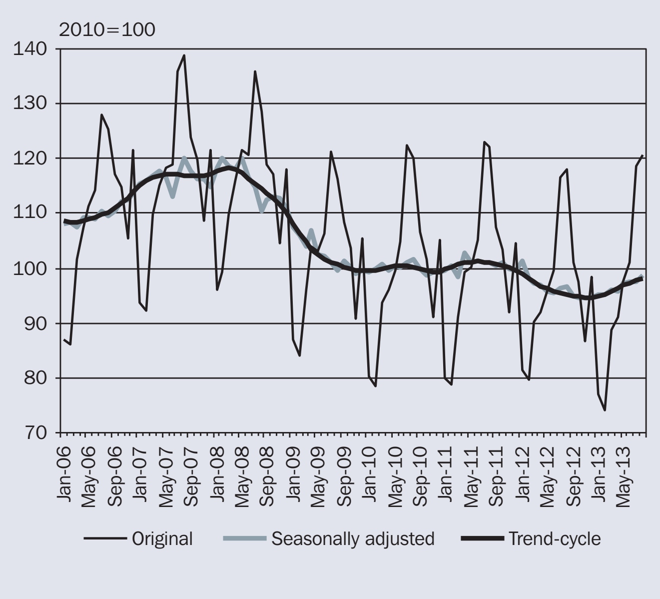
Favorable seasonal effects brought temporary relief on the labor market in the middle of this year. Total number of unemployed persons registered at the Croatian Employment Service was decreasing from February until August, while unemployment rate fell from 21.9 to 18.4 percent in the same period. However, this trend changed in September. The number of unemployed persons increased by 10 thousands and reached the total of 324 thousand, 4.1 percent higher than in September 2012. This increase was higher than

Figure 2 MANUFACTURING INDUSTRY




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

Figure 3 RETAIL TRADE VOLUME




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

what was expected and seasonally adjusted data confirm the return to the path of rising unemployment. Favorable developments up to September were due to increased seasonal employment and expanded active labor market programs. However, none of these seem to have prospects for ensuring sustainable employment increase in the future. Seasonal employment rose partly because of increased inspectorate controls and partly because of the introduction of the voucher system, which means that its rise was due to reduction of the hidden economy and not the genuine creation of new jobs. Expansion of labor market programs was temporarily helpful, but its effectiveness depends a lot on the state of the entire economy. The latest employment figures point to a return to the downward trajectory. After several months of upward movements, the number of insured persons at the Croatian Institute for Pension Insurance, as a proxy for employment in formal sector, declined in August in both nominal and seasonally adjusted terms.

***Real wages continue to decline.***

In the second quarter of 2013 average gross wage measured in real terms and on year-on-year basis, decreased for the fifth consecutive quarter. Apparently, the prolonged recession took its toll on wages, although much less than on employment. During the last five years total employment declined by 12 percent and real wages by 5 percent meaning that total wage bill has been substantially reduced. In the second quarter it was estimated to be by 4.3 percent lower than a year ago in real terms.

***Tourism-driven expansion of money supply; deteriorating credit activity.***

Following stagnation in mid-2013, seasonally adjusted broad money (M4) has returned to a moderately rising trend that was present during the previous five years. A strong increase in broad money in August came mostly from tourism-related narrow money growth and foreign currency savings accumulation. In spite of that, credits to the private sector continue to plunge. There are no signs of credit demand recovery. It remains burdened by poor economic outlook, corporate restructuring, and eroding disposable income. Credit supply, on the other side, seems to be getting weaker which is caused by deteriorating collateral quality and tightening lending conditions. Business indicators of the banking sector have also worsened. Pre-tax profits of the sector declined by 41.0 percent in the second quarter compared to the same period of 2012, while non-performing loans rose to 15.1 percent of total credit at the end of June 2013. Eleven, mostly small banks that hold 11.1 percent of total banking assets recorded a loss amounting to HRK 216.9 million in the second quarter, while bankruptcy proceedings were open against one small bank. The latter, however, did not cause threat to the system since the bank's total assets account for only 0.35 percent of the total banking sector and the State Agency for Deposit Insurance and Bank Rehabilitation informed the public of sufficient funds for insured deposits repayments. Also, approaching stricter non-performing loans cover requirements and uncertainties surrounding the possible revision of Swiss franc household loans as well as amendments to the Consumer Lending Act, are forcing banks to tighten their positions. As a result of demand and supply weaknesses, exchange rate adjusted credits to enterprises decreased by 4.7 percent in August compared to the same month of the previous year. Credits to households decreased by 1.5 percent. However, the Government continues to increase its borrowings from the banking sector, up by 16.6 percent in August.

***Money market interest rates remained low.***

In the situation of weak credit creation and excess liquidity in the banking system, money market interest rates remained rather low - overnight ZIBOR stood at 0.6 percent – but HRK/EUR exchange rate depreciated despite higher foreign currency inflows driven by a very good tourist season. Kuna depreciated by 2.2 percent from the end of June to the end of September. The CNB did not intervene when the HRK/EUR exchange rate surpassed 7.60 in mid-September. It probably assessed that the current exchange rate is manageable and that possible liquidity tightening in prevention of further depreciation may lead to unwanted interest rates hikes.

***Inflation rate lowered in the third quarter.***

Inflation slowed down in the third quarter due to stabilized food prices and weak demand despite the EU-entry related price hikes in July, which were particularly due to tobacco

Table 1 MAIN ECONOMIC INDICATORS

| | 2011 | 2012 | 2012 | | 2013 | |
|---|---|---|---|---|---|---|
| | | | Q3 | Q4 | Q1 | Q2 |
| **ECONOMIC ACTIVITY** | | | | | | |
| Real GDP (% change, yoy) | 0.0 | -2.0 | -1.9 | -2.3 | -1.5 | -0.7 |
| Real private consumption (% change, yoy) | 0.2 | -3.0 | -3.5 | -4.2 | -3.0 | 0.5 |
| Real government consumption (% change, yoy) | -0.6 | -0.8 | -0.4 | -2.0 | 0.3 | 1.3 |
| Real investment (% change, yoy) | -6.4 | -4.6 | -4.4 | -4.9 | -2.3 | 0.9 |
| Industrial output (% change, yoy) | -1.2 | -5.5 | -4.4 | -5.7 | 0.8 | -1.8 |
| Unemployment rate (registered, %, pa) | 17.8 | 18.9 | 17.6 | 20.1 | 21.7 | 19.7 |
| Nominal GDP (EUR million) | 44,412 | 43,929 | - | - | - | - |
| GDP per capita (EUR) | 10,377 | 10,295 | - | - | - | - |
| | | | | | | |
| **PRICES, WAGES AND EXCHANGE RATES** | | | | | | |
| Implicit GDP deflator (% change, yoy) | 2.0 | 2.0 | 2.1 | 2.8 | 2.4 | 1.6 |
| Consumer prices (% change, yoy, pa) | 2.3 | 3.4 | 4.1 | 4.6 | 4.6 | 2.3 |
| Producer prices (% change, yoy, pa) | 6.3 | 7.0 | 7.9 | 7.3 | 4.1 | 1.2 |
| Average gross wage (% change, yoy, pa) | 1.5 | 1.0 | 0.6 | 0.4 | 1.3 | 0.8 |
| Exchange rate, HRK/EUR (pa) | 7.43 | 7.52 | 7.47 | 7.52 | 7.58 | 7.56 |
| Exchange rate, HRK/US$ (pa) | 5.34 | 5.85 | 5.97 | 5.80 | 5.74 | 5.79 |
| | | | | | | |
| **FOREIGN TRADE AND CAPITAL FLOWS** | | | | | | |
| Exports of goods (EUR million) | 9,582 | 9,629 | 2,472 | 2,577 | 2,076 | 2,287 |
| Exports of goods (EUR, % change, yoy) | 7.6 | 0.5 | 0.1 | 7.8 | -7.9 | -1.6 |
| Imports of goods (EUR million) | 16,281 | 16,214 | 4,094 | 3,975 | 3,729 | 4,398 |
| Imports of goods (EUR, % change, yoy) | 7.6 | -0.4 | -2.8 | 0.1 | -6.3 | 5.6 |
| Current account balance (EUR million) | -396 | 32 | 2,650 | -635 | -1,409 | -255 |
| Current account balance (% of GDP) | -0.9 | 0.1 | - | - | - | - |
| Gross foreign direct investment (EUR million) | 1,101 | 1,054 | 212 | 457 | 506 | -79 |
| Foreign exchange reserves (EUR million, eop) | 11,195 | 11,236 | 11,384 | 11,236 | 11,277 | 12,021 |
| Foreign debt (EUR million, eop) | 45,876 | 45,712 | 46,790 | 45,712 | 44,836 | 46,175 |
| | | | | | | |
| **GOVERNMENT FINANCE*** | | | | | | |
| Revenue (HRK million)** | 123,025 | 126,132 | 93,150 | 126,131 | 28,918 | 60,241 |
| Expense (HRK million)** | 132,945 | 132,413 | 98,700 | 132,413 | 33,782 | 69,744 |
| Net = Gross operating balance (HRK million)** | -9,920 | -6,282 | -5,550 | -6,282 | -4,863 | -9,503 |
| Net acquisition of non-financial assets (HRK million)** | 5,044 | 4,574 | 2,444 | 4,574 | 1,211 | 2,349 |
| Net lending/borrowing (HRK million)** | -14,964 | -10,855 | -7,994 | -10,856 | -6,074 | -11,852 |
| Domestic government debt (EUR million, eop) | 13,716 | 15,225 | 15,192 | 15,225 | 15,539 | - |
| Foreign government debt (EUR million, eop) | 6,996 | 8,353 | 8,123 | 8,353 | 8,422 | - |
| Total government debt (% of GDP) | 47.2 | 53.7 | - | - | - | - |
| | | | | | | |
| **MONETARY INDICATORS** | | | | | | |
| Narrow money, M1 (% change, yoy, eop) | 7.5 | 1.6 | 3.0 | 1.6 | 10.7 | 13.0 |
| Broad money, M4 (% change, yoy, eop) | 1.6 | 3.2 | 2.1 | 3.2 | 4.4 | 3.4 |
| Total domestic credit (% change, yoy, eop) | 4.9 | -3.9 | -0.6 | -3.9 | -3.9 | -3.1 |
| DMBs credit to households (% change, yoy, eop) | 1.0. | -1.4 | -2.0 | -1.4 | -1.2 | -2.7 |
| DMBs credit to enterprises (% change, yoy, eop) | 8.7 | -11.2 | -2.3 | -11.2 | -11.6 | -5.5 |
| Money market interest rate (%, pa) | 0.9 | 1.1 | 1.7 | 0.5 | 0.4 | 0.3 |
| DMBs credit rate for enterprises, short-term, (%, pa) | 7.0 | 7.3 | 7.1 | 7.0 | 6.5 | 6.3 |
| DMBs credit rate for households, short-term (%, pa) | 11.9 | 11.2 | 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.*

## Box 1 THE ECONOMIC AND FISCAL POLICY GUIDELINES 2014-2016

On September 26, 2013 Croatian Government adopted the *Economic and Fiscal Policy Guidelines* for the period 2014-2016. This document is a part of national budgetary process and it aims at providing guidelines for ministries and other budget users for preparation of the 2014 Budget and projections for 2015 and 2016. According to the schedule, it should be adopted by mid-June. This year the *Guidelines* appeared more than three months behind the schedule without any explanation for the delay.

The *Guidelines* seem to have a problem in aligning official policy position with the proposed budget figures. The document declares fiscal consolidation as policy priority aimed at reducing public debt. It promises a continuation of reform activities where fiscal discipline is expected to strengthen, tax burden to be shifted from production to consumption, and structural reforms intensified. In spite of such assertions, figures presented in the document indicate substantial worsening of fiscal indicators in 2014 and their lenient improvements thereafter. Fiscal deficit at the level of general government is planned to rise to 5.5 percent of GDP in 2014, up by 2 percentage points compared to 2013 (Table B1). Expenditure-to-GDP ratio is planned to increase by more than 1 percentage point in 2014. Public debt is expected to climb to over 60 percent of GDP next year. Rapid worsening of the fiscal position in 2014 is mostly explained by the increased contribution to the EU budget and higher interest payments. For the next two years a moderate decline in the deficit is projected, but public debt is seen to rise to 65.3 percent of GDP by the end of 2016. Although these figures are based on national accounting standards, and not on ESA rules, the presented trends are well out of the consolidation line. In addition, these fiscal projections are based on rather optimistic macroeconomic projections, especially for 2013.

The *Guidelines* seem to neglect some important policy developments that will affect fiscal position of the country in the near future. Croatia will surely be covered by the Excessive Deficit Procedure (EDP) and will therefore have to prepare a plan to solve fiscal imbalances. The *Guidelines* recognize that this is likely to happen, but do not include the Government's response to the expected requirements from the procedure. Interestingly, the Government has presented a document titled *Measures for Fiscal Deficit Reduction* in parallel with the *Guidelines*. This document envisages significant reduction of the deficit if 35 policy measures are implemented and necessary legislative changes adopted in parallel with the adoption of the 2014 Budget. It remains unclear why the effects of these measures are not already included in the *Guidelines*. The *Guidelines* also announce the budget revision for 2013, but do not provide further information on that matter. Due to these shortcomings, the 2014 Budget is likely to be based on substantially different framework than the one presented in the *Guidelines*, which would mean that the *Guidelines* do not serve its primary purpose.

The key messages of the presented plans are also confusing. One may read that the Government is implying that, in spite of any reasonable policy efforts, deficit would remain high in the next three years, due to high and unavoidable obligations. But, the presented fiscal plans involve a rise in compensations for employees, subsidies and transfers, which means that an increase in expenditures is a policy choice. The other reading is that the Government wanted to present a fiscal plan in case the current policy continues - a kind of "status quo" scenario - before entering the negotiations with the European Commission over the measures under the EDP. In that case, policy impact of additional measures might be assessed against that scenario showing more realistically their true consolidation impact. The problem is, however, that the *Guidelines* are an official government document that should present credible economic and fiscal policy measures for the next three years. International organizations, rating agencies and financial markets might therefore read the presented document as a sign of Government's weakness in tackling critical fiscal problems.

Table B1 FISCAL INDICATORS PRESENTED IN THE ECONOMIC AND FISCAL POLICY GUIDELINES 2014-2016

| | Outturn | Estimates | Projections | | |
|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 |
| Total revenue (in % of GDP) | 40.3 | 40.8 | 39.8 | 40.4 | 40.4 |
| Total expenditure (in % of GDP) | 43.8 | 44.3 | 45.4 | 45.5 | 44.9 |
| Deficit/surplus (in % of GDP) | -3.5 | -3.5 | -5.5 | -5.1 | -4.5 |
| Public debt (in % of GDP) | 53.7 | 56.6 | 60.6 | 63.4 | 65.3 |
| *Memo* | | | | | |
| Real GDP growth (in %) | -2.0 | 0.2 | 1.3 | 2.2 | 2.5 |

***Note:*** *Data on fiscal indicators are based on national accounting standards.*
***Source:*** *The Economic and Fiscal Policy Guidelines 2014-2016.*

excise taxes increase. Average consumer price inflation was 1.8 percent in the third quarter, down from 2.3 percent in the first quarter and 4.6 percent in the fourth quarter last year. In September, inflation rate fell to 1.1 percent, the lowest rate since the summer of 2010, owing mostly to the reduction in fuel, clothing and services prices. Core inflation, i.e. increase in prices of consumer goods and services without energy and unprocessed food, remained above headline inflation in spite of its decline from 2.0 percent in August to 1.8 percent in September.

***Government revenue downsized; …***

Following sizeable increase in the fourth quarter of last year and stagnation in the first quarter of this year, total general government revenue fell in the second quarter, by 1.3 percent compared to the same quarter last year. Cumulative decline over the first six months was somewhat smaller, 0.7 percent and it was mainly due to the lower profit tax and social security contributions revenues which decreased by 44.8 and 6.2 percent, respectively. The sharp drop in the profit tax revenue was mostly caused by the fact that reinvested profits now go untaxed, while the fall in social contributions was due to a reduction of the health contribution rate as of May 2012.

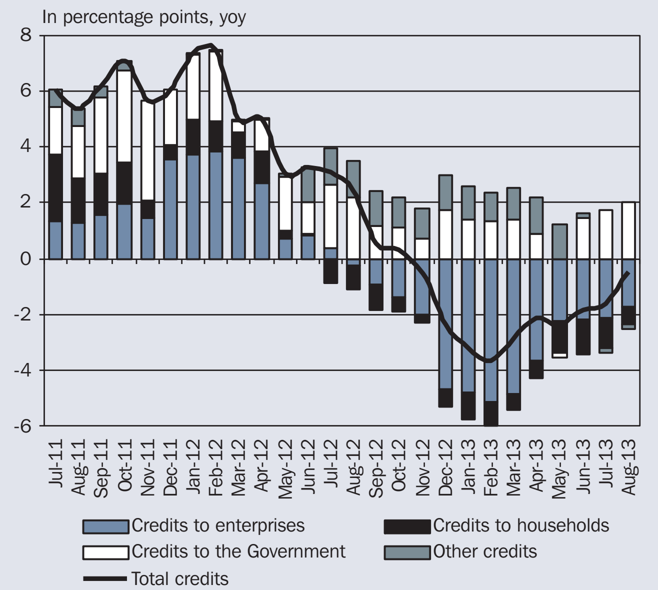
***… government expenditure increased sharply.***

Total general government expenditure rose sharply in the second quarter this year relative to the same quarter last year; 10.4 percent. For comparison, in the first quarter there was a rise of 4.7 percent. In the entire first half of the year, government expenditure rose 7.6 percent. All major expenditure components except compensation of employees were increased. There were steep increases in interest payments, by 20.2 percent, and in social spending, by 18.6 percent. The latter can be explained entirely by unplanned financial aid to the public health sector in amount of HRK 3.3 billion.

***Whole-year deficit already reached; second budget revision unavoidable.***

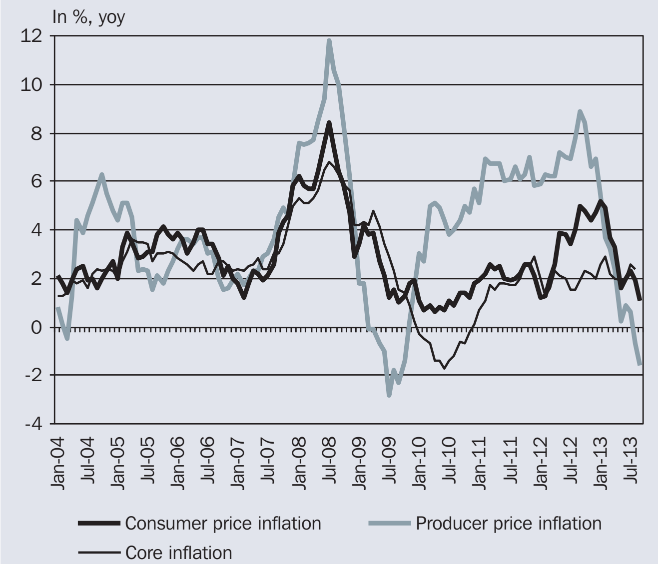
Dynamics of total revenue and expenditure, including net acquisition of non-financial assets, brought about a deficit of HRK 11.9 billion in the first half of the year. Given that the general government deficit was planned at HRK 11.7 billion, it means that the whole deficit was reached by the end of June. Therefore a revision of the state budget, second this year, is unavoidable. In an optimistic scenario, the budget will have to be revised only by the amount spent in June for rehabilitation of the health care system. But, it is likely that budget for compensations for employees and pensions will also be revised upwards, as spending for these purposes is currently above plan.

Figure 4 CONTRIBUTIONS TO TOTAL CREDIT GROWTH




**Source for original data:** *Croatian National Bank.*

Figure 5 INFLATION




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

### Box 2 GOVERNMENT DEFICIT AND DEBT

On October 21, 2013 Croatian Bureau of Statistics released data on government deficit and public debt. For the first time ever in Croatia these data are calculated according to ESA95 concepts and are fully comparable with the Eurostat data published for each EU country. These data will be used for the application of the excessive debt procedure (EDP). In 2012 Croatia's government deficit amounted to 5 percent of GDP and public debt to 55.5 percent of GDP meaning that EDP is likely to be launched due to the breach of deficit ceiling of 3 percent of GDP.

Table B2 CROATIA: GOVERNMENT DEFICIT AND DEBT ACCORDING TO ESA95 CONCEPT

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Government revenue (in % of GDP) | 40.8 | 40.5 | 40.1 | 40.6 |
| Government expenditure (in % of GDP) | 46.1 | 46.9 | 47.9 | 45.5 |
| Deficit/surplus (in % of GDP) | -5.3 | -6.4 | -7.8 | -5.0 |
| Debt (in % of GDP) | 36.6 | 44.9 | 51.6 | 55.5 |
| Deficit/surplus (in HRK billion) | -17.4 | -20.6 | -25.7 | -16.3 |
| Debt (in HRK billion) | 120.4 | 145.3 | 170.5 | 183.3 |

***Source:*** *Croatian Bureau of Statistics.*

## 2 Policy Assumptions and Projections Summary

***Global recovery remains gradual; eurozone on a stabilizing path.***

The pace of the global recovery remains gradual with growth rates lower than what was expected earlier. Its main contributors are advanced economies. IMF's latest projections (*World Economic Outlook*, IMF, October 2013) foresee world output to increase by 2.9 percent in 2013 followed by 3.6 percent in 2014, which is a downward revision by 0.3 and 0.2 percentage points, respectively. Downward revision from July forecast was mainly due to risks of higher commodity prices caused by renewed geopolitical tensions and global demand that is weaker than expected. In the United States the recovery is strengthening, mainly due to rebound in real estate market, higher household wealth and easier bank lending conditions. However, tighter financial conditions since May have caused a downward revision of growth projections now standing at 1.6 and 2.6 percent in 2013 and 2014, respectively. Eurozone still struggles between augmenting economic activity from easing of fiscal tightening and tight credit conditions in the periphery countries. Business confidence indicators suggest that periphery countries are close to stabilizing their activity, while core is already recovering. Activity is forecasted to shrink by 0.4 percent in 2013 before recovering by 1 percent in 2014. For the EU as a whole IMF has revised its forecast upwards and it now stands at zero growth rate this year and 1.6 percent in 2014. As for Croatia's main trading partners, Germany's positive growth rates are foreseen to rebound in 2013 reaching 1.4 percent next year, Italian economy is expected to see a mild but positive growth in 2014, while Slovenia is expected to stay in prolonged recession. As for global oil prices, they have remained relatively high due to various supply shortages and renewed geopolitical concerns in the Middle East and North Africa. After reaching a peak of $116 a barrel at the end of August, Brent crude oil prices declined to $108 a barrel on October 1st, which is 4 percent lower than a year ago.

***EDP procedure implies credible medium-term plan of fiscal consolidation.***

In the upcoming period we expect the focus of domestic economic policy to remain on the fiscal sector. Although Government's *Economic and Fiscal Policy Guidelines* (see Box 1) suggest no major consolidation efforts in 2014, we assume a somewhat different scenario. It is certain that Croatia will soon be subject to the Excessive Deficit Procedure (EDP). The Government will have to prepare a plan of how the deficit will be cut, with clear deadlines, and implementation monitored by the European Commission. We expect such a plan to include measures aimed at reducing expenditures and increasing revenues, as well as a series of structural reforms such as intensified privatization of government-owned entities and concession deals. In the short run such a scenario might negatively affect domestic demand. However, if the Croatian Government prepares a credible medium-term fiscal plan and plan of structural reforms, uncertainties about the future economic policy will significantly diminish which may positively affect the business sector. We further assume that Government's pressure on public enterprises to increase investment activity will persist and hope that the spillover effects might help the entire economy. The monetary policy is expected to continue securing high liquidity of domestic financial markets, even though some monetary easing is possible but only to the extent that would not jeopardize the stability of exchange rate.

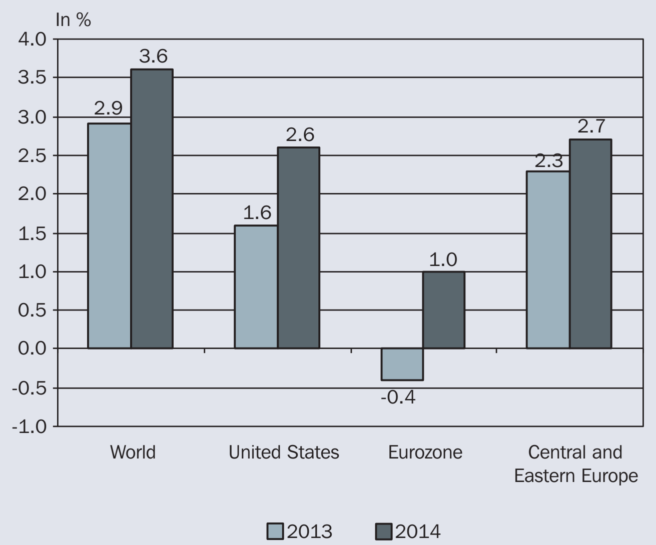
***Despite some positive signals, GDP is expected to decline 0.7 percent in 2013.***

In the above-described context of international developments and domestic policy environment, we expect the economy to move out of recession in the second half of this year. It is likely that overall activity has increased in the third quarter driven by tourism sector and public sector investments. However, our projection for the fourth quarter is a bit more cautious and overclouded by numerous risks due to a persistent negative trend in the manufacturing sector. Recovery might be paused which would cause uncertainties over future developments to roll over to the next year. For 2013 as a whole we expect GDP to decrease by 0.7 percent. That is a slightly lower drop than was expected three months ago. The 0.2-percentage point upward revision is due to better-than-expected developments in personal consumption. Although that was partially due to a one-time effect of increased sales of goods that are more taxed after the EU accession, this will help to improve personal consumption data at the annual level. We expect now 0.5 percent decrease of personal consumption in 2013.

***Net exports contribution to GDP might be negative.***

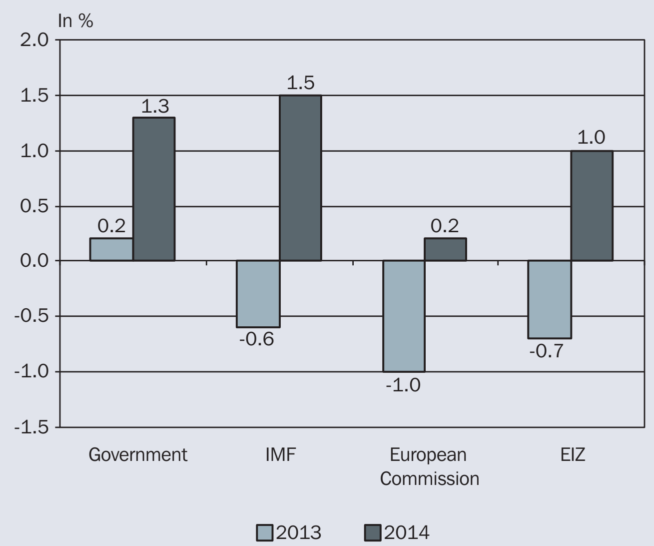
Government consumption is likely to continue its expansion in the course of this year and record a 0.7-percent rise. Investment activity, led by public utility companies, should continue rebounding in the remaining part of the year with the annual increase reaching 1.5 percent. If such a projection materializes that would be the first year of investment growth since 2008 and after a cumulative 35-percent investment decrease in the meantime. Export sector will continue to face long-standing competitiveness problems in addition to weaker demand from major trading partners, Italy and Slovenia. Exports to CEFTA markets will continue to suffer from increased tariffs, while restructuring of shipbuilding industry would add to the export problems. All in all, this year exports are projected to decline by 2 percent. Decrease in imports is expected to be more moderate, around 0.4

Figure 6 GLOBAL GROWTH PROSPECTS




**Source:** *IMF (World Economic Outlook, October 2013).*

Figure 7 GROWTH FORECASTS FOR CROATIA




**Sources:** *The Government of the Republic of Croatia (Economic and Fiscal Policy Guidelines, September 2013), IMF (WEO, October 2013), EC (2013 Spring Forecasts, May 2013), EIZ (CEOQ, October 2013).*

percent as a result of increased car imports before the EU accession and a stronger supply of imported goods following the accession. The net exports contribution to GDP might be negative in 2013 for the first time since 2008.

***Growth of 1 percent projected for 2014,...***

In the next year we expect a fragile recovery with GDP growth of around 1 percent that would be led by investments and exports. Although these sectors are burdened by problems, the stabilization of economic situation in the eurozone would be beneficial for both of them: for exports in terms of demand and for investments in terms of improved financing conditions. Personal consumption is expected to stagnate as a result of high unemployment, depressed disposable incomes and uncertainties about future developments. Under the assumption of restrictive fiscal policy, real government consumption is anticipated to fall by 1.2 percent. Investments should rise by around 5 percent, owing mostly to public investment activity. On the other hand, the private sector faced by uncertainties regarding growth prospects might need much longer time to recover, especially due to debts and problematic balances of private businesses. Exports are projected to rise modestly in 2014 which would include a modest rise in exports of services, in particular tourism, while exports of goods will continue to be subdued due to long-term weaknesses as well as problems of adjustment to the EU membership. Imports will continue reflecting developments in domestic demand and will therefore modestly increase.

***… while current account will stay balanced.***

Current account should remain in balance in both 2013 and 2014. Deficit in goods trade and income balance should be offset by services balance surplus and positive net transfers from abroad. Foreign debt-to-GDP ratio is expected to remain above 100 percent, although the government sector will increase its share, while the indebtedness of banking and other domestic sectors should decline.

***Labor market weaknesses to remain.***

Unfavorable developments in the labor market are likely to continue in this and the next year. Active labor market measures are bound to have a limited effect on the reduction of unemployment due to their relatively low coverage as long as the labor demand remains weak. Average unemployment rate for this year is projected to climb over 20 percent and remain at those levels in next year or even increase due to limited demand from the private sector and likely effects of further restructuring and privatization in parts of the public sector.

***Accommodative monetary policy aimed at spurring credit activity.***

Besides a continuous abundant interbank liquidity and very low interest rates that are ensuring cheap government borrowing, the CNB announced enhanced borrowing for firms via the Croatian Bank for Reconstruction and Development (CBRD). As in the previous cycles, these credit schemes will be selective, export-oriented, cheap and characterized by risk-sharing between banks and CBRD. In times of growing fiscal deficit, serious private sector deleveraging, local currency depreciation threats and tighter nonperforming loans cover requirements, we see the central bank policy as justifiably accommodative. Although these measures may help certain sectors, the entire private sector credit activity is more likely to weaken as households continue to deleverage and corporate sector struggles with bankruptcies, investment shortages and poor profits. Therefore we continue to stick to our forecasts of credit growth of -1.8 and -0.1 percent for this and next year, respectively. Broad money is projected to follow suppressed credit activity by rising by 3.5 percent in this year and 3.3 percent in 2014.

***Depreciation pressures to continue.***

Usual year-end HRK/EUR depreciation came a little bit too early this year, already in August, and the latest trading rates are around 7.62, so we have revised our exchange rate projection slightly as to allow for a weaker kuna. Average HRK/EUR rate is now expected to be at around 7.57 in 2013 and 7.60 in 2014. Depreciation expectations are corroborated by further bank provisioning, external deleveraging, and fiscal deficit issues. There could also be pressures on the opposite direction, which come from privatization revenues and central bank commitment to use available resources in order to ensure exchange rate stability.

***Inflation to stay low.***

Weak demand leads us to expect tamed inflation in the rest of this year with the year average of 2.4 percent, 1 percentage point below inflation rate in 2012. In the next year we expect inflation to stay around this year's level due mostly to stagnated personal consumption. We expect that certain increases in consumption tax rates will be absorbed within the projected inflation rates. Although the details are not yet known, an increase in VAT rate for baby food, oil, sugar, water, and catering services from 10 to 13 percent starting from January 2014 is being announced, and there is a possibility of a VAT rate increase for bread, milk, and dairies from 5 to 8 percent. Standard VAT rate of 25 percent should remain intact.

***Continued efforts to reduce fiscal deficit.***

Dynamics of government revenue and expenditure by the end of September indicates that planned deficit of 3.5 percent of GDP will be hard to achieve. We estimate that deficit is likely to reach 4.5 percent on cash basis and according to national budgetary accounting methodology, or about 4.3 percent when translated into ESA95 methodology. In 2014, the deficit will depend crucially on the extent of consolidation efforts. According to the recently released *Guidelines for Economic and Fiscal Policies*, the Government does not seem determined to make strong efforts. However, we believe that the activation of EDP will result in solid consolidation within multi-annual framework. It might happen that in 2014 the deficit remains around the 2013 level due to cumulated pressures of interest payments, but containment of other expenditures will open space for swifter deficit reduction in following years.

Table 2 SUMMARY OF PROJECTIONS

| | 2013 | 2014 |
|---|---|---|
| **Real GDP (% change)** | **-0.7** | **1.0** |
| Real private consumption (% change) | -0.5 | -0.1 |
| Real government consumption (% change) | 0.7 | -1.2 |
| Real investment (% change) | 1.5 | 5.0 |
| Exports of goods and services (constant prices, % change) | -2.3 | 1.5 |
| Imports of goods and services (constant prices, % change) | -0.4 | 0.9 |
| Current account balance (% of GDP) | -0.1 | -0.2 |
| Consumer prices (% change, pa) | 2.4 | 2.3 |
| Exchange rate, HRK/EUR (pa) | 7.57 | 7.60 |
| Unemployment rate (registered, %, pa) | 20.2 | 20.4 |
| General government balance (ESA95 definition, % of GDP) | -4.3 | -4.3 |
| Broad money, M4 (% change, eop) | 3.5 | 3.3 |
| Total domestic credit (% change, eop) | -1.8 | -0.1 |

***Note:*** *Cut-off date for information used in the compilation of projections was October 10, 2013.*
***Conventional abbreviations:*** *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
***Source:*** *Authors' projections.*

## 3 Uncertainties and Risks to Projections

***Is genuine recovery stepping in?***

Improved tax control and a number of other actions taken by the Ministry of Finance to reduce tax evasion probably resulted in reduced volume of the hidden economy in Croatia. It is hard to estimate the magnitude of this change but it may be significant. The observed recovery of retail trade and significant decrease in unemployment in the mid of the year might be affected by that process. Similarly, the registered increase in the tourist activity might also be supported by the reduced informal sector. Under such circumstances, the uncertainties regarding the genuine state of the economy increase. Sensitivity to that process is even more emphasized in the situation when economy is at the turning point between stagnation and recovery. Our projections are based on the official statistical data and they suggest a high possibility of change to positive growth rate in the third quarter. However, underlying trends covering the entire economy, formal and informal, might be more depressed and turning point might come much later. All in all, at this point uncertainties about the state of the economy and pace of the recovery remain high.

***Fiscal policy at a crossroad.***

As can be seen from the rising trend in interest payments over the last couple of quarters, the burden of servicing public debt has become substantial. The planned dynamics of fiscal aggregates suggests that the debt burden will become even greater in forthcoming years. The interest rates at which new debts are being issued will likely go up, especially given the doubts of the major rating agencies as regards Croatia's abilities to achieve a robust recovery and put fiscal finances on a sustainable track. In such a situation, the Government has no alternative to stronger fiscal consolidation formulated in a credible and comprehensive plan in order to regain confidence of key market players. Confidence might be a crucial prerequisite for any sustainable recovery of the economy.

***Fiscal tensions in the U.S. might negatively affect the global economy.***

Uncertainties related to international environment remain tilted towards the downside and some of them are worth emphasizing. First, the United States federal government shutdown has already caused damage to both United States and global economic sentiment. Although the U.S. Congress approved a deal to reopen the federal government after 16 days and raise the debt ceiling, similar tensions may soon emerge again as according to the compromise that was reached the U.S. Government reopens only until mid-January and the debt limit is extended until early February. The second issue, conspicuous mostly in the eurozone, is how to promote growth while advancing with fiscal adjustments and structural reforms. Consolidation and restructuring measures for countries forced into assistance programs may become even more burdensome, additionally dampening their growth prospects.

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