The Institute of Economics, Zagreb

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Croatian Economic Outlook

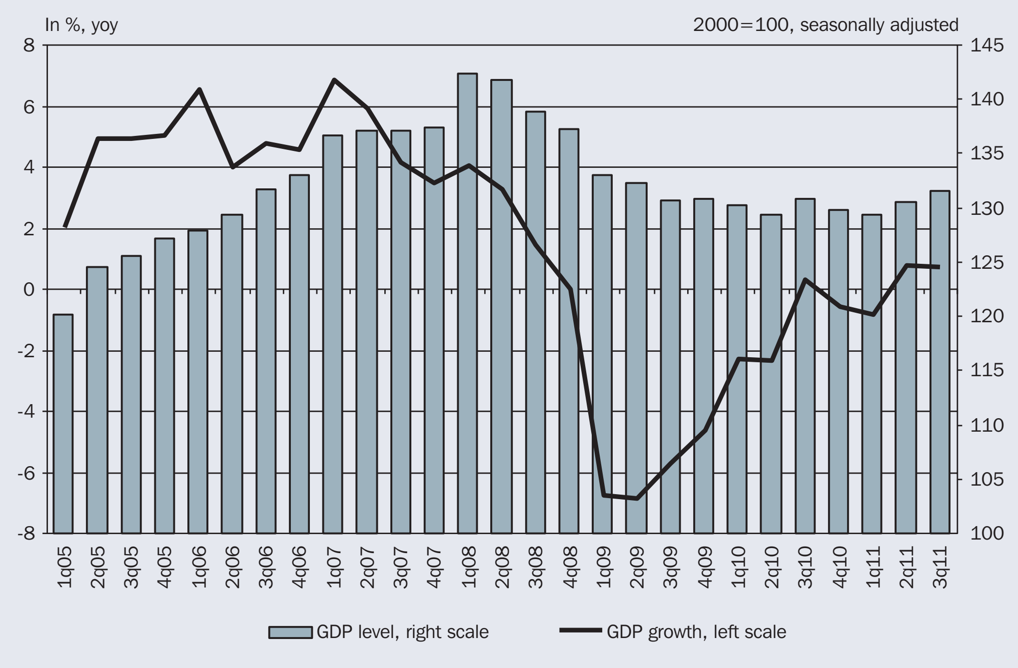
Quarterly

1 Recent Developments

Another recession on the horizon.

The third quarter 2011 brought modest GDP growth of 0.7 percent year-on-year mainly as a result of a successful tourist season. It was the second quarter in a row with positive growth, leading to the first double quarter growth since 2008. Seasonally adjusted quarter-on-quarter data confirm the upward trend of the economy. Tourism-driven expansion of exports and falling imports contributed mostly to the GDP growth, while domestic demand continued to decline. Nevertheless, a number of high-frequency indicators for the fourth quarter signal deterioration in the overall economic situation at the year-end. The October and November data on industrial production, retail trade volume, construction and exports point to shrinking activity. Coupled with tensions in the eurozone over the sovereign debt crisis, this has led to increasing vulnerability of the domestic economy at the turn of the year and a depressed outlook for the near future in spite of high expectations from the new Government. The new center-left Government was formed swiftly following the parliamentary elections held on December 4, 2011. The winning four-party coalition led by social democrats has a stable majority in the Parliament, which provides a solid background for effective policy implementation.

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

Personal consumption still on the positive track, but likely to recede soon.

Seasonally adjusted figures on personal consumption indicate 1-percent quarterly growth in the third quarter 2011. On a year-on-year basis, this rise is less pronounced as consumption increased by only 0.1 percent. Stronger personal consumption was related to a slightly improved real disposable income due to tax changes from the previous year as well as to an income effect associated with tourism activities. It was also reflected in a mildly rising retail sales volume up to the last quarter 2011. However, retail sales started to recede then heralding more hesitant personal consumption at the turn of the year.

Government consumption starts shrinking.

Due to severe financing constraints, government consumption started to decline in the third quarter 2011. It was 0.4 percent lower than a year before. Seasonally adjusted figures confirm the decline and a reversal in trend observed over previous four quarters. The downward trend may have continued into the fourth quarter and possibly into 2012. Nevertheless, government consumption has proved to be resilient so far because it is mainly related to the salaries of public sector employees. Overall government consumption in real terms, as measured in the national accounts statistics, declined only 1.8 percent between the third quarter 2008 (pre-crisis peak value) and the third quarter 2011. For comparison - in the same three-year period - personal consumption dropped by 5 percent and investments by 26 percent.

Investments continue to decline strongly.

Seasonally adjusted investments continued to fall in the third quarter 2011 for the 14th consecutive quarter. Over the previous four quarters investments declined by 8.4 percent due to a lack of public investments and the private sector's hesitance to invest caused by financing constraints and weak confidence. As for now, nothing indicates the end of this unfavorable trend. Monthly figures on construction and imports of capital goods suggest no change, resulting in a gloomy investment outlook.

Total exports grow slowly; imports remain depressed.

Total exports, as recorded in the national accounts statistics, increased by 2.0 percent year-on-year in the third quarter 2011, while total imports dropped by 8.3 percent. As a result, external trade contributed positively to GDP growth. Yet, the rise of exports was relatively small having in mind a successful tourist season. This suggests a poor performance of goods exports related to the lack of competitiveness. At the same time, declining imports do not indicate a substitution of foreign goods by domestically produced ones, but reflect a recessionary phase of the economy. However, receding imports have helped to reduce imbalances in foreign trade and improve the country's financing position.

Significant current account surplus in the third quarter.

The current account balance in the third quarter 2011 ended up with a record-high quarterly surplus, EUR 2.6 billion, mostly due to sizable revenues from international tourism that amounted to EUR 4.2 billion, 7.8 percent more than in the same quarter 2010. In a year up to the third quarter 2011, the current account surplus rose to 0.3 percent of GDP, while the net FDI inflow reached 1.6 percent of GDP, which has helped to relieve the foreign debt. Croatia's overall foreign debt amounted to EUR 46.6 billion at the end of September, which is EUR 750 million less than at the end of June 2011, and slightly more than at the end of 2010. The debt-to-GDP ratio at the end of 2011 is estimated at 101 percent, broadly the same as a year before.

Activity in real sector dampens.

Following a sharp drop in August, industrial production recovered in September before declining again in October and November. In the first eleven months of 2011, industrial activity decreased 1.4 percent year-on-year. The production of intermediate goods, energy and consumer durables contributed to the decline, while capital goods production increased by about 10 percent, mostly due to an exceptionally strong production of machinery. With regard to the developments in the retail trade sector, it may be asserted that after rising modestly in the first three quarters, the retail trade volume weakened in the post-summer period. Consequently, the trend turned negative. On a year-on-year basis, the cumulative change for the first eleven months was positive, amounting to 1.1 percent. Construction

Table 1 MAIN ECONOMIC INDICATORS

	2009	2010	2010	2011		
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-6.0	-1.2	-0.6	-0.8	0.8	0.7
Real private consumption (% change, yoy)	-8.5	-0.9	1.2	-0.1	0.6	0.1
Real government consumption (% change, yoy)	0.2	-0.8	0.6	-0.9	1.7	-0.4
Real investment (% change, yoy)	-11.8	-11.3	-8.0	-6.7	-7.3	-8.4
Industrial output (% change, yoy)	-9.3	-1.4	-1.7	-3.6	1.0	-2.4
Unemployment rate (registered, %, pa)	14.9	17.4	18.1	19.5	17.5	16.7
Nominal GDP (EUR million)	45,669	45,917	-	-	-	-
GDP per capita (EUR)	10,311	10,396	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	3.3	1.0	1.2	2.6	2.0	2.2
Consumer prices (% change, yoy, pa)	2.4	1.1	1.5	2.2	2.3	2.0
Producer prices (% change, yoy, pa)	-0.4	4.4	5.1	6.2	6.5	6.3
Average gross wage (% change, yoy, pa)	2.2	-0.4	0.5	0.5	1.8	2.0
Exchange rate, HRK/EUR (pa)	7.34	7.29	7.36	7.40	7.39	7.45
Exchange rate, HRK/US$ (pa)	5.28	5.50	5.42	5.42	5.13	5.27
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	7,703	9,102	2,501	2,074	2,499	2,312
Exports of goods (EUR, % change, yoy)	-21.5	18.2	26.1	2.0	7.5	3.1
Imports of goods (EUR million)	15,090	15,054	3,955	3,427	3,834	3,746
Imports of goods (EUR, % change, yoy)	-26.8	-0.2	4.3	3.3	0.3	-5.4
Current account balance (EUR million)	-2,380	-535	-1,024	-1,459	15	2,601
Current account balance (% of GDP)	-5.2	-1.2	-	-	-	-
Gross foreign direct investment (EUR million)	2,380	281	-713	336	339	373
Foreign exchange reserves (EUR million, eop)	10,376	10,660	10,660	11,424	11,422	11,324
Foreign debt (EUR million, eop)	45,244	46,514	46,514	47,512	47,198	46,610
GOVERNMENT FINANCE*						
Revenue (HRK million)**	128,087	123,709	123,709	28,043	58,681	91,507
Expense (HRK million)**	132,450	133,486	133,486	32,336	65,157	97,994
Net = Gross operating balance (HRK million)**	-4,363	-9,777	-9,777	-4,293	-6,476	-6,487
Net acquisition of non-financial assets (HRK million)**	6,357	4,848	4,848	788	1,869	3,130
Net lending/borrowing (HRK million)**	-10,068	-14,625	-14,625	-5,083	-8,345	-9,618
Domestic government debt (EUR million, eop)	10,995	12,469	12,469	13,070	12,966	13,526
Foreign government debt (EUR million, eop)	5,134	5,913	5,913	6,946	6,716	7,026
Total government debt (% of GDP)	35.1	41.2	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	-14.6	4.2	4.2	2.9	6.1	-1.1
Broad money, M4 (% change, yoy, eop)	-0.9	4.4	4.4	3.3	3.5	3.7
Total domestic credit (% change, yoy, eop)	-0.6	6.8	6.8	6.1	6.5	6.7
DMBs credit to households (% change, yoy, eop)	-2.9	3.8	3.8	2.5	3.1	3.1
DMBs credit to enterprises (% change, yoy, eop)	2.0	9.5	9.5	8.2	7.7	8.6
Money market interest rate (%, pa)	7.2	0.9	0.9	0.7	0.5	0.8
DMBs credit rate for enterprises, short-term, (%, pa)	10.0	7.4	6.9	7.0	6.6	6.6
DMBs credit rate for households, short-term (%, pa)	12.6	12.7	12.6	12.7	12.6	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$ - US dollar, DMB – deposit money bank.*
Sources: *Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

activity continued to contract, and the first eleven months of 2011 brought an additional 9.1 percent decrease year-on-year.

Negative labor market trends continue.

Following the end of the high-tourist season, unemployment returned to the upward trajectory. The total number of unemployed persons registered at the Employment Office outpaced the number of 315 thousand at the year-end. The registered unemployment rate increased to 17.9 percent in November. Compared to a year before, unemployment is lower. However, registered unemployment figures are not only the outcome of underlying labor market trends, but also stem from various administrative procedures, such as the removal of unemployed persons from the Registry due to procedural reasons or due to their involvement in some form of active labor market policy measures. Therefore, they may be misleading. Employment figures, on the other hand, indicate a more depressed state of the labor market. Employment has been continuously decreasing for almost three years. In November, a decline of approximately 29 thousand or 2 percent in comparison to a year ago was recorded. Still, a decrease in the incorporated sector was 1.5 percent, whereas in small business entities (crafts, trades and freelances) it amounted to 4.4 percent. This suggests that small business entities face much more difficulties in maintaining business in the time of crisis.

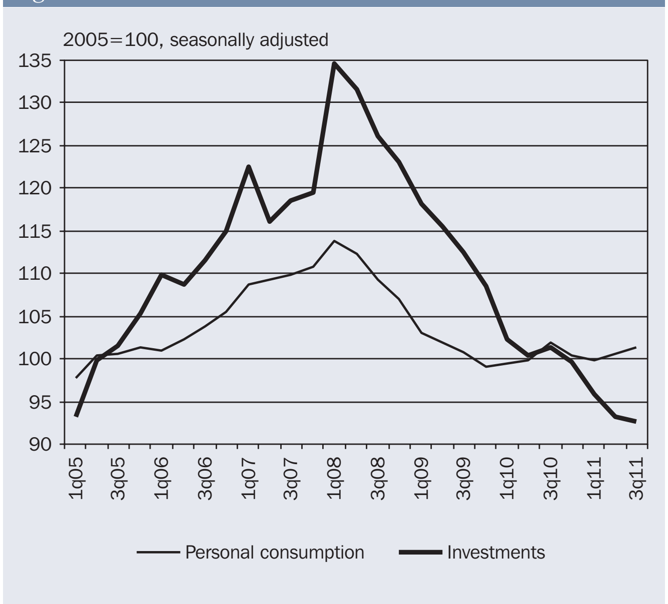
Stagnation of real wages.

In the third quarter, the average gross wage was around HRK 7,776 (approximately EUR 1,040), 2.0 percent higher than in the same period a year before. The average wage adjusted for inflation stagnated over a year. Despite the decline in total employment, the estimated overall disposable income, including social transfers, increased by around 2.6 percent in nominal and 0.5 percent in real terms in the same period. This 'paradox' seems to be a result of the income tax reform and the abolishment of the 'crisis tax' in the second half of 2010, which left more resources to households and was one of the main factors that prevented personal consumption from declining.

Kuna deposits attractive again.

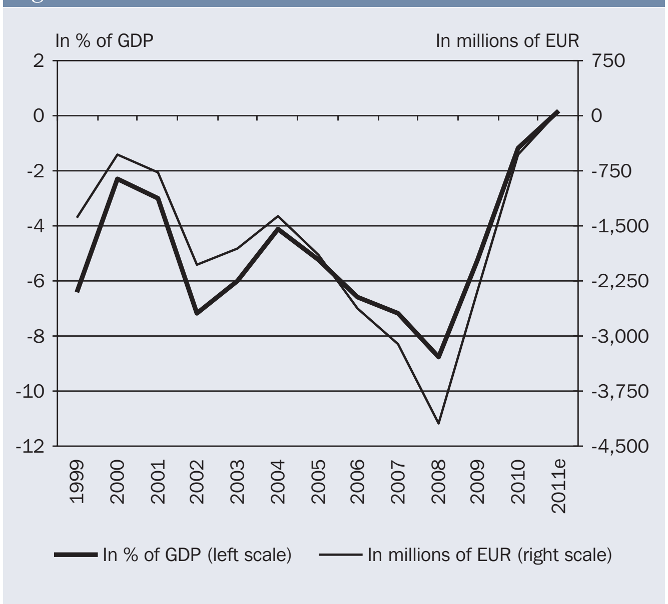
Weaker economy, job market uncertainties, consumer pessimism and tighter credit conditions have put a brake on money and credit creation. Although broad money has continued to grow above average rates recorded in the last three years, some deceleration was observed in the post-summer months. In November 2011, broad money increased 4

Figure 2 PERSONAL CONSUMPTION AND INVESTMENTS



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

Figure 3 CURRENT ACCOUNT BALANCE



Sources: *Croatian National Bank; e - estimate by EIZ.*

percent year-on-year. While foreign currency deposits had driven broad money creation since mid-2007, this trend changed in the recent months. In November, foreign currency deposits were 0.4 percent lower than in the same month a year before (-1.5 percent at the constant exchange rate) while at the same time kuna deposits grew by 18.2 percent, the highest rate in the last four years. These developments led to a modest overall deposit growth of 3.2 percent, or 2.1 percent when the constant exchange rate is assumed. In the second half of November, the Croatian National Bank withdrew authorization for a small bank (Credo banka d.d., Split) that accounted for 0.44 percent of total banking sector assets. Although the stability of the overall financial system was not jeopardized, some anxiety affecting the withdrawal of deposits from the banking sector still appeared.

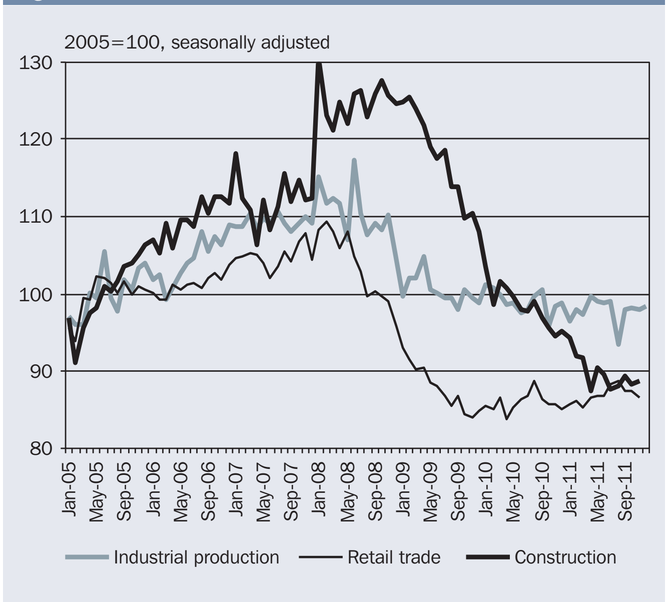
Credit growth is flattening…

Credit growth decelerated and eventually stabilized at around 6 percent year-on-year in the second half of 2011. The poor total credit growth is mostly due to household credits that have been shrinking since mid-2011. Seasonally adjusted data show that credits to households have been declining each month by 0.5 percent on average. Since a large part of these credits is indexed to either the HRK/EUR or HRK/CHF exchange rate, adjusted growth is negative and amounts to -0.4 percent year-on-year. At the same time, credits to the corporate sector increased by 8.6 percent. Two Eurobond issues of 3.8 percent of GDP in 2011 were enough to satisfy the Government's needs by late summer. The Government considerably increased its refinancing needs towards the year-end and, in line with that, growth in commercial bank credits to the Government increased to 18.9 percent in November when compared to the same month a year before.

… and liquidity squeezing.

After the central bank stabilized the exchange rate below 7.5 by intervening on the foreign exchange market in September and October, the HRK/EUR exchange rate gradually slid above that level again in late November. At the year-end it amounted to 7.53 and was 2 percent weaker than at the end of 2010 and 5.9 percent than at the outbreak of the global crisis. The depreciation pressures stemmed mostly from strong demand for foreign currency brought by bank provisioning and corporate foreign debt service. The beginning of January 2012 brought the HRK/EUR exchange rate above 7.55, pushing the central bank to intervene by selling EUR 197 million and stabilizing the exchange rate at around 7.53 for a short period of time. Two weeks later, the central bank sold another EUR 130

Figure 4 REAL SECTOR DEVELOPMENTS



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

Figure 5 REGISTERED EMPLOYMENT AND UNEMPLOYMENT

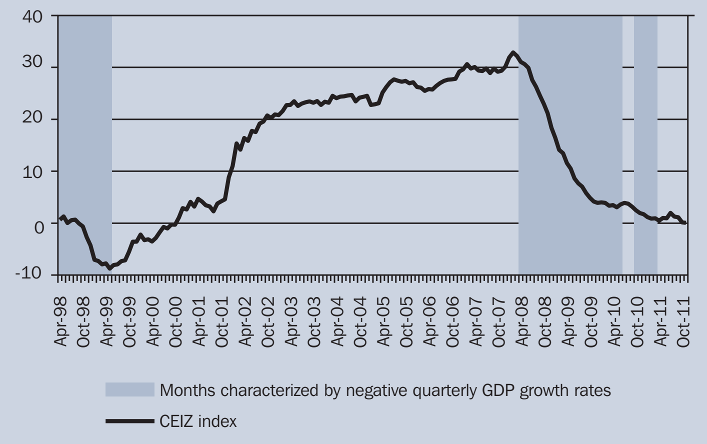
Source: *Croatian Bureau of Statistics.*

Box 1 CEIZ INDEX: WHAT DOES IT TELL US ABOUT THE STATE OF THE ECONOMY?

Coincident **E**conomic **I**ndex of The **I**nstitute of Economics, **Z**agreb (CEIZ) is a monthly composite business cycle indicator developed by The Institute of Economics, Zagreb. Its purpose is to provide timely information on the current business cycle condition. Unlike a leading indicator, a coincident indicator does not indicate which way the economy is heading, but where it is at present. Hence, the CEIZ index varies simultaneously with the business cycle.

The CEIZ index is useful in three ways. First, it is a single-number business cycle indicator containing information that would otherwise have to be accrued by analyzing a large number of economic series. Second, unlike GDP series, it provides *monthly* estimates on the state of the economy, thus providing information on fine changes that took place in a short period of time. Third, the CEIZ index is available one to three months prior to quarterly GDP estimates, meaning that policy-makers and the general public can observe the current state of the economy in a timely manner.

Figure B1 CEIZ INDEX



Source: *EIZ.*

The CEIZ index was constructed by using a model-based approach with a dynamic factor model and a Markov switching model applied in parallel. The Markov model was used for GDP series in order to estimate the probability that the economy would enter recession. The probability values were then transformed into binary values (0 and 1) depending on whether they surpassed the 0.5 probability defined as a threshold above which recession takes hold. The binary series was consequently modeled with a logit model which used a number of potential CEIZ components as independent variables.

The results of econometric analysis pointed to four series closely synchronized with the business cycle: i) industrial production index, ii) real retail trade index, iii) real VAT revenues and iv) real household credits. A dynamic factor model was then applied on these series in order to get a monthly coincident indicator. The resulting CEIZ index for the period 1998:4m-2011:11m is shown in Figure B1.

The CEIZ index successfully tracks the GDP dynamics, which in turn confirms the informational and practical value of the index. Its value decreases with the occurrence of negative quarterly GDP growth rates in both the 1998-1999 and 2008-2011 recession, while its value rises as soon as the economy exhibits positive GDP growth rates. Even the GDP changes that differ from the generally observed trend are well mirrored in the CEIZ index. Such is the case with the CEIZ index that shot up in the third quarter 2010 simultaneously with a one-off GDP upswing recorded in the same quarter.

The estimates available up to November 2011 suggest that the Croatian economy experienced a slowdown in the fourth quarter 2011 compared to the second and third quarter, when the economy exhibited a moderate expansion. The CEIZ index thus suggests that the economy is weakening again and that seasonally adjusted quarter-to-quarter GDP growth in the fourth quarter was probably negative.

million, resulting in the HRK/EUR exchange rate around 7.55. These interventions showed that the central bank is committed to a stable exchange rate. One side-effect of these latest CNB decisions is a liquidity squeeze that has raised expectations of higher short-term interest rates in the months to come. This is, however, still not mirrored in the overnight ZIBOR (Zagreb Interbank Offered Rates) that remains below 1 percent, partly due to a return of cash in circulation after the holiday season and a significant government deposit.

Inflation subdued.

Deteriorating global outlook, weak domestic demand and a stable HRK/EUR exchange rate keep inflation subdued. World food prices have finally fell from their peak levels recorded last year. The consequent slower growth of food prices on the domestic market and lower prices of capital goods pushed the PPI in December to its lowest rate in 2011, 5.8

percent. CPI inflation reached 2.1 percent due to a weaker rise in energy and food prices. The core inflation has been recording positive rates from the beginning of 2011, with a year-on-year rate standing at 2.6 percent in October.

Rise in general government revenues…

The third quarter 2011 witnessed a 2.1-percent year-on-year rise in general government revenues. Taking, however, the first three quarters together, 0.4 percent less revenues were collected than during the same time span a year before. The biggest contribution to the year-on-year rise in the third quarter came from increases in profit tax and VAT, which rose by 17.2 percent and 1.9 percent, respectively. The improved collection of profit tax is a direct consequence of better business performance in 2010 compared to 2009, a fact confirmed by Fina's (Financial Agency) data on companies' earnings, which exhibited a 14.2-percent increase. As expected, the good tourist season contributed to the increase in VAT revenues. Of secondary importance in terms of their absolute contribution were revenues from personal income tax with a 6.5-percent rise and tobacco excises with a 13.9-percent rise.

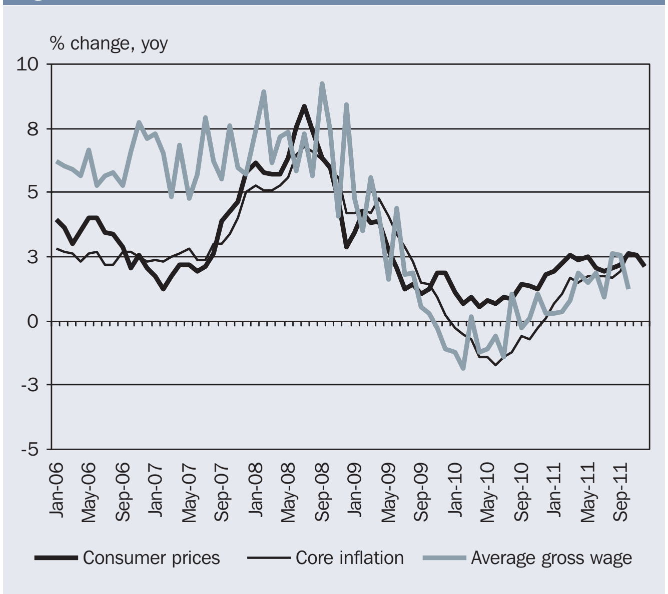
… while expenditures remain almost unchanged.

On the expenditure side, there was a 0.1-percent year-on-year rise in total general government outlays in the third quarter 2011. The slight rise was, first, due to only moderate increases in all major operating expenditures: compensation of employees (1.5 percent) and consumption of goods and services (3.1 percent). Second, there were nearly compensating reductions in subsidies to companies (-8.8 percent) and social security expenditures (-1.3 percent). Unlike operating expenditures, interest payments rose by 29.5 percent, yet their share in total expenditures is low enough not to override the contributions to the overall expenditure dynamics of other, more significant items.

A year without budget revision.

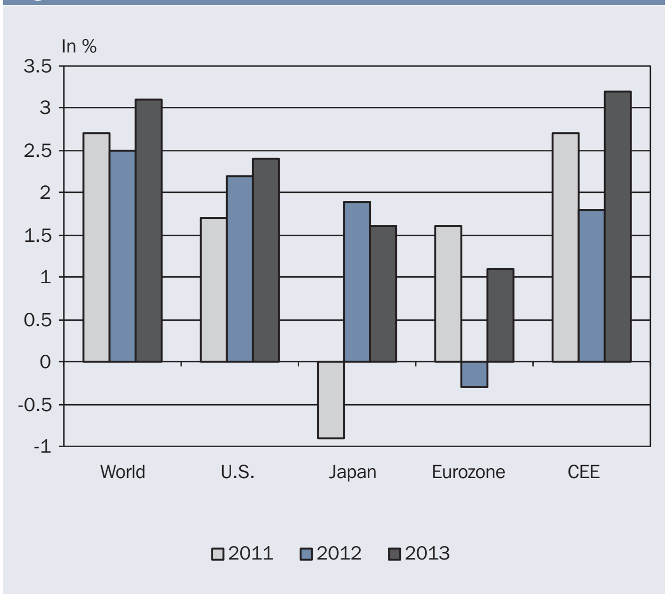
All these developments contributed to the deficit by only HRK 11.5 million in the third quarter 2011. By the end of September, the deficit was about HRK 6.5 billion, which is 8.5 percent more than in the first three quarters of the previous year. This deficit was financed mainly through two bond issues in the first half of the year (US$ 1.5 billion bond in March and EUR 750 million in June) and two domestic issues in July: HRK 1.5 billion (5 years) and EUR 600 million (10 years). It should be noted that 2011 passed without a budget revision. Since 1997 there was no year without a budget revision, with only one

Figure 6 INFLATION AND WAGES



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

Figure 7 WORLD ECONOMY PROSPECTS



Source: *Global Economic Prospects, The World Bank, January 2012.*

of the revisions being downwards (in 2004). Concerning the public debt stock, as of end-September it amounted to HRK 152.7 billion or 43.9 percent of the estimated GDP, up from 42.1 percent at the end of June.

2 Policy Assumptions and Projections Summary

Eurozone debt crisis negatively affects global economy.

The sovereign debt crisis in Europe has had strong negative global effects. Borrowing costs have risen, stock markets have declined while capital flows to developing countries have fallen by 50 percent over a year. In recently released *Global Economic Prospects* (January, 2012), the World Bank has revised downwards its growth forecast for 2012 for both developing and high-income countries. Growth in the U.S. and Japan is somewhat strengthening but Europe seems to be entering another recession while a number of developing economies are experiencing weaker growth. Slower global growth has already been reflected in a weaker trade and substantially lower prices of energy, metals and minerals as well as agricultural products. The World Bank now projects global growth at 2.5 percent in 2012 and 3.1 percent in 2013. As for the eurozone, growth is expected to turn negative in 2012 at -0.3 percent before recovering to 1.1 percent in 2013. Among EU economies efforts have been made to contain tensions and build up long-term stability - the European Financial Stability Facility has been strengthened, progress has been made towards common fiscal rules and commitments, the ECB has increased liquidity while most troubled economies, such as Greece, Italy and Portugal, have implemented strict austerity programs. Although instability in the eurozone is still present, we do not assume its escalation over the projection horizon.

The next move is on the Government; citizens voted 'yes' for EU membership.

On the domestic front, the sources for assumptions were rather scarce at the time projections were prepared. The new Government has announced its program for the 2011-2015 term but this 60-page document is more a list of goals than a thorough insight into the future Government's actions. Much more information on the Government's economic policy will be revealed with the 2012 budget proposal expected in February. So far, besides the program, some intentions can be recognized from the public statements of ministers, especially regarding changes in tax policy. However, final decisions have not been made yet. It might be that the new Government decided not to announce unpopular measures before the referendum on joining the EU took place on January 22. Two thirds of voters who participated in the referendum voted in favor of joining the EU, which is more than expected.

Fiscal consolidation – moderate after all?

Regarding fiscal policy, assumptions behind our projections include fiscal consolidation as promised in the Government's program. This goal is expected to be achieved through changes on both sides of the budget. We do not assume drastic reduction in public expenditures since the Government's program highlights that every effort will be made not to reduce pensions, public sector wages and social transfers. Since these three categories form the majority of government expenditures, the reduction will probably be of a moderate magnitude and directed towards reduction in expenses on goods and services and subsidies. The anticipated tax changes are, however, expected to increase budget revenues. It is announced that the general VAT rate will be raised from 23 to 25 percent and that the scope of products on which the reduced VAT rate is applied will increase. Without any precise information on the Government's plans, we believe that the changes in the VAT rate will lead to a substantial increase in tax revenues and a moderate price hike. Changes in income tax, property and dividend tax as well as the re-introduction of an excise tax on mobile telephone services have also been mentioned, but it is not clear how and when they will be implemented. We assume a moderate decrease in the direct taxation of low-income groups as to counter-balance the VAT rate increase, while other tax changes are not considered in the current projection. In addition to these tax changes, the

Government may rely more on supplementary revenue from the further privatization and selling of its property as well as on concessions which is cautiously accounted for in our revenue projection. In general, we believe that the Government will adhere to constraints imposed on government consumption by the Fiscal Responsibility Act, i.e. reduction in general government expenditures by 1 percentage point each year measured as a share of the estimated GDP. In addition, fiscal consolidation asks for a number of structural reforms to follow soon. One is the privatization of shipyards which has to be resolved by mid-2013 and full EU membership. It may cause a substantial part of shipyard debt to be transferred into the public debt (as much as 3 percent of GDP). We assume that these risks are already incorporated in investors' decisions and that the explicit inclusion of shipyard debt into the public debt will not change the country's risk perception and borrowing costs.

Central bank focused on exchange rate stability.

In line with clear signals from the central bank, we assume that it will stick to the policy in which the liquidity of the system is subject to a stable exchange rate. As it is estimated that stronger deprecation will jeopardize financial stability, the central bank is determined to use instruments at its disposal, including foreign exchange reserves, mandatory reserve requirement ratio and the foreign assets/foreign liabilities ratio, to keep the stability of the exchange rate. We, therefore, expect a stable exchange rate at the expense of money and credit creation.

Table 2 SUMMARY OF PROJECTIONS

	2011 estimate	2012 projection	2013 projection
Real GDP (% change)	**0.2**	**-0.3**	**1.0**
Real private consumption (% change)	0.3	-0.3	0.7
Real government consumption (% change)	0.1	-1.4	-0.3
Real investment (% change)	-7.5	-2.0	2.5
Exports of goods and services (constant prices, % change)	-2.6	1.3	1.6
Imports of goods and services (constant prices, % change)	-6.5	0.9	1.1
Current account balance (% of GDP)	0.2	0.6	1.0
Consumer prices (% change, pa)	2.3	2.6	2.7
Exchange rate, HRK/EUR (pa)	7.43	7.48	7.48
Unemployment rate (registered, %, pa)	18.0	18.1	17.5
General government balance (ESA95 definition, % of GDP)	-5.5	-4.0	-3.5
Broad money, M4 (% change, eop)	4.0	6.0	7.0
Total domestic credit (% change, eop)	5.0	6.0	8.0

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

GDP projected to decline 0.3 percent in 2012...

Our projections are based on the above mentioned assumptions regarding the international and domestic environment. In addition, the available high-frequency indicators up to the end of 2011 suggest the possibility of entering another recession. As a result, we have revised downwards our GDP growth estimate for 2011 to 0.2 percent, primarily due to a stronger than expected decrease in investments, underperformance of exports and a weaker rise of government consumption. Negative trends are expected to continue this year. Besides the expected fall in government consumption that is projected at 1.4 percent, we expect that the rise in the VAT rate will negatively affect personal consumption that is already under pressure due to a modest decline in disposable income and negative trends on the labor market. Hence, personal consumption is projected to decline by 0.3 percent. By the end of the year, a fall in investments should stop, but for the year as a whole the rate of change is expected to remain negative and around 2 percent. Following the weakening of both exports and imports volume in 2011, a moderate rebound of 1.3 percent in exports is expected in 2012. Another good tourist season should support such expectations in addition to the recovery of exports of goods as a part of adjustment to the EU membership. The expected 1 percent growth of imports is related to the dynamics of exports as well as restocking. We estimate that the current account was in surplus in 2011, amounting to 0.2 percent of GDP. The balance should remain positive in 2012, reaching 0.6 percent of GDP due to the expected stronger rise in exports than imports.

… before recovering in 2013.

The regained stability in the eurozone and structural reforms on the domestic front should give room for business initiatives with positive effects on the overall output. Hence, the projected 2013 GDP growth amounts to 1 percent and should be supported by investment growth, moderate recovery of personal consumption and the continued net exports contribution. So far, a potential for stronger growth cannot be recognized, as clear reform efforts that would allow such an outcome amidst constrained financial resources have not been undertaken.

Labor market outlook for 2012 remains unfavorable.

The labor market outlook for 2012 remains unfavorable due to continued weakness of the economy and a lack of credible policy initiatives for fostering employment. Improvements should emerge in the course of 2013, mostly due to the expected investment recovery. As a result, our projections suggest that the registered unemployment rate would amount to 18.1 percent in 2012 and 17.5 percent in 2013. On the policy side, we see that the new Government's program puts emphasis on the reemployment of people who lost their jobs in the crisis, but it is not clear how this will be achieved. The announced measures relate to temporary exemption from social security contributions for the newly employed and a reduction in overall payroll contributions. However, the new government officials are silent on further details of these measures as well as on the time frame for their implementation, and we do not account for their effect in our current projections. But even if implemented, these measures are unlikely to affect overall employment in the short-run, especially in a situation of depressed aggregate demand. Since the announced reform of public administration is not expected to include dismissals in the public sector, nor cuts in their salaries, we expect that real wages will remain unchanged. The bulk of adjustments to output fluctuations in the near future will be undertaken through productivity changes and private sector employment adjustments.

Inflation on the rise due to increased taxation and administrative price hikes.

The core inflation has increased recently due to a postponed effect of energy price hikes and a mild depreciation of the HRK/EUR exchange rate. This year, two additional factors should drive inflation: an assumed increase in the VAT rate and an administrative price hike in public transportation, utilities and electricity. All the expected price hikes aim to reduce budget deficits of central and local governments as well as of public utility companies. Since the beginning of the crisis, hardly anything has been done to reform or control expenditures in the public sector. Finally, it seems that costs will be socialized. In addition, inflation pressures may come from the full harmonization with the EU regulations. However, prices of consumer goods will bear down on weak demand, and therefore inflation will speed up only moderately, from 2.3 percent in 2011 to 2.6 percent in 2012 and 2.7 percent in 2013.

No monetary easing expected.

The size of fiscal consolidation, possible government crowding out, exchange rate stability and risk aversion spilling over from the eurozone will determine the future monetary stance. This was best demonstrated by two January CNB interventions that have resulted in a stable HRK/EUR trading and a *de facto* liquidity shortage on the interbank market. Although market liquidity has temporarily been ensured by a large sovereign deposit, once this deposit is withdrawn, the banking system will be left short of liquidity. Having in mind that the Ministry of Finance has to refinance HRK 8.7 billion of its debt in the first quarter 2012, we expect short-term interest rates and treasury yields to rise. We do not see that major changes in the monetary policy stance will occur this year, unless the Government substantially cuts spending, risk aversion abates and downside pressures on the domestic currency disappear. As for the latter, we expect pressures on the downside to continue due to bank provisioning and high foreign currency debt repayment obligations. The EMU fiscal consolidation with bank deleveraging and tighter credit conditions will affect the Croatian financial system adversely since banks are highly exposed to EMU banks and record significant and high currency mismatches. Without a push from foreign banks and with the central bank not inclined to monetary easing, credit growth in 2012 is expected to be weak. If the Government undertakes the announced fiscal consolidation and the euro crisis resolves, we expect moderate broad money growth up to 6 percent this year and 7 percent in 2013. Credit growth in domestic currency is then expected to increase by 6 percent in 2012 and up to 8 percent next year.

New Government's tax changes.

The final 2011 general government deficit has most likely remained within the planned figures. The fact that a year-on-year growth rate of total revenues turned positive in the second and third quarter suggests that the deficit-to-GDP ratio will not exceed 5.5 percent and that the stock of public debt together with debt guarantees for shipyards is not likely to end up above 48 percent of GDP. As opposed to that, projections for 2012 are difficult to make. The difficulty arises mainly from the new Government's proposals for changes in the tax system and an uncertainty concerning the general performance of the economy. Apart from assuring the public that pensions and public sector salaries will not be touched upon, the Government remained virtually silent on its intentions concerning the expenditure side of the budget by the time our projections were prepared. What we know is that the total expenditures will not exceed their 2010 amount in keeping with the Parliament's conclusion from the summer 2010. Genuine consolidation asks for a non-trivial reduction in expenditures, which is a politically hard task. It is, however, reasonable to expect that the new Government will make some cuts in the first year of its term, but within the limits given by the Government's program. Therefore, there will be some deficit reduction in 2012, projected at around 1.5 percent of GDP, yielding a projection of the deficit-to-GDP ratio of 4.0 percent. Consolidation efforts will continue in 2013, with further deficit reduction, envisaged at around 3.5 percent of GDP.

Box 2 GOVERNMENT'S GUIDELINES FOR THE PREPARATION OF THE 2012 STATE BUDGET

On January 26, 2012 the new Government presented the sketches of its macroeconomic and fiscal policy in the document titled "The Proposal of Measures and Guidelines for the Preparation of the 2012 State Budget".

The main message of the proposed guidelines is that the Government is committed not only to compliance with the Fiscal Responsibility Act, but even to a stronger fiscal austerity, which is a significant step in the right direction. Apart from the general economic developments, the dynamics of the revenue side of the budget should be determined by notable changes in three revenue items – VAT, personal income tax and health insurance contributions. The combined effect of these changes should be a marginal rise in revenues by HRK 600 million. The expenditures, on the other hand, are supposed to decline by HRK 4.6 billion. The major contribution to that decline should come from wage expenditures, other expenditures and subsidies. The resulting central government deficit would thus fall below HRK 10 billion, i.e. to 2.8 percent of GDP, from 4.3 percent in 2011.

Our main doubts relate to the reliability of projections. The Government envisages a 0.8-percent GDP growth in real terms in 2012, basing this optimistic projection on a substantial increase in investments of state-owned enterprises. Many details of the next budget are still unknown, such as the exact structure of expenditures, instruments of deficit financing and measures leading to the expenditure reduction, especially to the wage bill, which all pose an uncertainty over the projected revenues and expenditures. Therefore, for a more elaborated analysis of the fiscal policy framework we should wait for the draft proposal of the state budget.

3 Uncertainties and Risks to Projections

Uncertainty about the new Government's actions.

At the time of making projections and writing this issue, the most important information regarding the future economic developments – 2012 budget – was not known. Additionally, it has to be seen how the new Government will function under time pressure that asks for efficient policy-making. The newly appointed ministers do not come as a surprise as most of them have already had important roles in the election campaign and are prominent members of the parties constituting the winning coalition. However, many deputy and assistant ministers do not have prior experience in public positions, which may mean that a certain amount of time will be needed to reach a fully efficient functioning of the Government.

Unresolved crisis in the EU.

An unresolved crisis in the eurozone poses a threat to the Croatian economy. If the situation in the EU stabilizes sooner than assumed, it could have a positive effect on the Croatian economy, not only due to partial synchronization in business cycles but also because of stronger perceived benefits of the Croatian accession to the EU which could increase the interest of foreign investors prior to the formal membership in mid-2013. On the other hand, the escalation of sovereign debt crisis in the EU would lead to a situation in which the benefits of Croatia's accession would be substantially reduced. Under a highly uncertain economic situation in the eurozone, with outlooks being modified on a daily basis, uncertainties regarding projections are high and downside risks prevail.

Waiting for the evaluation of rating agencies.

It remains to be seen how rating agencies will evaluate the Croatian fiscal prospects. With the current grade just above "junk", borrowing prospects in the upcoming period seem to be on a slippery slope. Croatia's arrangement with the IMF does not seem to be an option for the Government at the moment, but it should not be fully excluded in the near future, if only to support the credibility of the Government's intentions regarding fiscal consolidation.

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