The Institute of Economics, Zagreb

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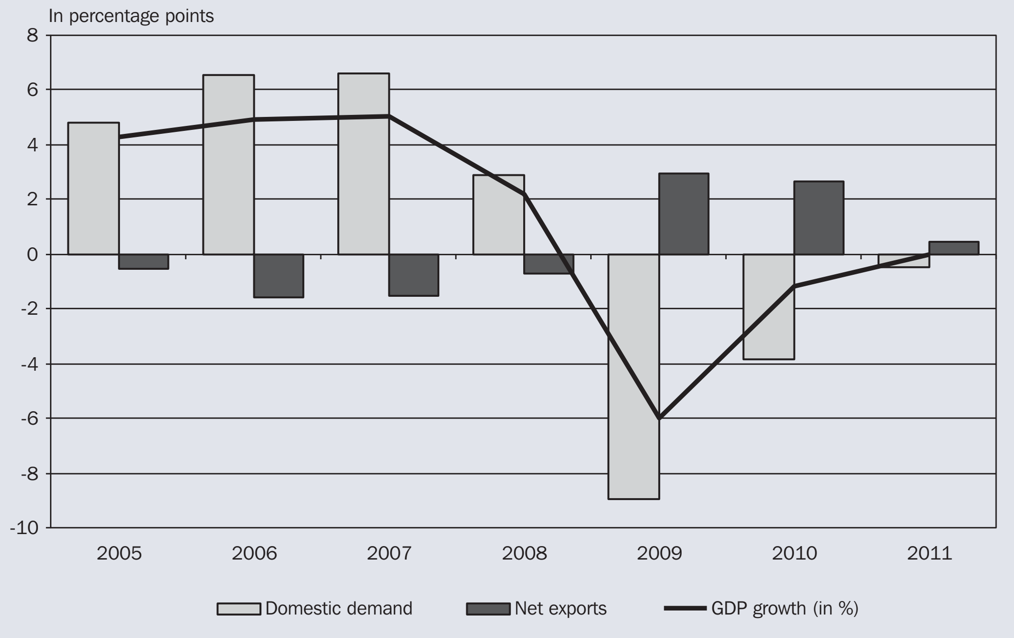
Croatian Economic Outlook

Quarterly

1 Recent Developments

Return to recession. The Croatian economy declined by 0.4 percent year-on-year in the fourth quarter 2011, while recording neither growth nor fall for the year as a whole. Such an outcome is somewhat below our previous expectations, mainly due to the recent revision of official statistical data on merchandise trade. The revised figures indicate that the trade deficit was HRK 6.5 billion larger than originally published, affecting the overall assessment of the country's external position and the main macroeconomic trends. In 2011, domestic demand was rather weak due to a significant investment decline, which contributed negatively to the GDP change with 0.5 percentage points only to be leveled off by a positive 0.5 percentage point contribution of net exports. The beginning of this year saw key economic indicators back again in the red. Industrial output shrank by about 3 percent year-on-year in the first two months with exports down 8 percent in euro terms while construction fell by almost 6 percent in January. The registered unemployment rate exceeded 20 percent in February. The retail trade volume grew 1.5 percent but the increase might be due to frontloaded consumption before a hike in the general VAT rate from 23 to 25 percent in March. Therefore, we estimate that the first quarter GDP shrank for the second quarter running, meaning that Croatia slipped back to recession after two quarters of recovery. The country is actually experiencing its fourth year of continued economic downturn regardless of a couple of short-lived episodes of positive GDP growth that lasted for one or two quarters.

Figure 1 DEMAND CONTRIBUTIONS TO GDP GROWTH



Source: *Croatian Bureau of Statistics.*

Personal consumption declined at the end of 2011...

Following notable improvements in summer and fall 2011, the performance of personal consumption has become disappointing. On a year-on-year basis, it recorded an 0.1-percent increase in the fourth quarter, but more importantly, seasonally adjusted personal consumption was almost 1 percent below its third quarter level, annulling most of the expansion gains from a couple of previous quarters. On average, 2011 brought an increase in personal consumption of 0.2 percent, which can be seen as a positive development following an 0.9-percent decline in 2010 and an 8.5-percent drop in 2009.

... as well as government consumption.

Government consumption declined 0.4 and 1.3 percent year-on-year in the third and fourth quarter 2011, respectively. Such a reduction reflects significant pressure caused by smaller tax revenues and unfavorable financing conditions. Government consumption suffered in spite of the parliamentary elections that took place in November 2011. Experience shows that government consumption usually increases before elections, but not this time. Recession forced the previous government to be thrifty and this kind of pressure will only become greater for the current government.

Slower pace of investments decline.

Investments have been on a strong downward path for four consecutive years. In the fourth quarter 2011, they fell 6.1 percent below the year-ago level while the cumulative decline in the last three years amounted to 23 percent. However, seasonally adjusted figures suggest that the negative trend moderated notably in the second half last year. An optimistic view would suggest that the bottom has been reached and a reversal could take place soon. A more cautious view suggests that uncertainties might be resolved either way, depending on the overall economic sentiment. Government plans to initiate a wave of small-scale investment projects in the public sector to help provide the spark for growth. But growth can be sustained only if the general investment climate in the economy improves and that is still uncertain.

Revised foreign trade figures show a higher volume and a larger deficit...

A previously observed, shrinkage in the 2011 goods trade resulted partially from a technical data collection error. Revised data indicate that goods exports and imports actually increased 7.7 and 7.5 percent, respectively, in current euro terms in 2011. The upward revision of exports and imports by approximately 10 percent implies that the trade deficit widened to EUR 6.7 billion, or EUR 872 million more than originally reported. This revision was transposed to national accounts data, which now shows the 2011 increase in the exports of goods and services at 2.2 percent and the import increase at 1.0 percent. Even after taking this upward revision into account, only a mild expansion in foreign trade last year suggests that the economy now has limited capacities for further international trade integration.

... but unfavorable trends continue.

The most recent trends in the external trade are noticeably unfavorable. National accounts data on the total export and import volume show respective declines of 3.5 and 3.0 percent in the fourth quarter year-on-year. Seasonally adjusted figures confirm a reemergence of the negative trend following a timid recovery in the middle of 2011, particularly on the export side, supported by a successful tourist season. Merchandise trade statistics for the first two months this year suggest a sizeable reduction of exports (-8 percent over a year ago in current euro terms), with imports rising slightly (2.3 percent). However, at least a part of that increase is linked to the attempts to forestall the March increase in the VAT rate, meaning that the underlying trends are not encouraging and reflect rather poor domestic demand.

Current account deficit at 1 percent, foreign debt at around 100 percent of GDP.

A wider goods trade deficit according to the revised figures has also changed the country's current account position. In 2011, the current account deficit was EUR 446 million, or 1 percent of GDP. Goods and services trade taken together recorded a mild surplus of EUR 50 million or 0.1 percent of GDP, which was the first surplus on record in independent Croatia, resulting from weak imports and sizeable revenues from tourism. The income balance had a deficit of 3.5 percent of GDP while transfers were in surplus equal to 2.2 percent of GDP.

Table 1 MAIN ECONOMIC INDICATORS

	2010	2011	2011			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.2	0.0	-1.0	0.4	0.7	-0.4
Real private consumption (% change, yoy)	-0.9	0.2	-0.1	0.6	0.1	0.1
Real government consumption (% change, yoy)	-0.8	-0.2	-0.9	1.7	-0.4	-1.3
Real investment (% change, yoy)	-11.3	-7.2	-6.7	-7.3	-8.4	-6.1
Industrial output (% change, yoy)	-1.4	-1.2	-3.6	1.0	-2.4	0.0
Unemployment rate (registered, %, pa)	17.4	17.8	19.4	17.3	16.6	17.9
Nominal GDP (EUR million)	45,917	45,897	-	-	-	-
GDP per capita (EUR)	10,396	10,389	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	1.0	2.0	2.5	1.8	2.0	1.8
Consumer prices (% change, yoy, pa)	1.1	2.3	2.2	2.3	2.0	2.4
Producer prices (% change, yoy, pa)	4.4	6.3	6.2	6.5	6.3	6.4
Average gross wage (% change, yoy, pa)	-0.4	1.5	0.5	1.8	2.0	1.8
Exchange rate, HRK/EUR (pa)	7.29	7.43	7.40	7.39	7.45	7.49
Exchange rate, HRK/US$ (pa)	5.50	5.34	5.42	5.13	5.27	5.56
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,064	9,784	2,239	2,574	2,528	2,444
Exports of goods (EUR, % change, yoy)	18.1	8.0	10.3	11.1	13.7	-1.9
Imports of goods (EUR million)	15,054	16,143	3,774	4,248	4,174	3,947
Imports of goods (EUR, % change, yoy)	-0.2	7.2	13.8	11.1	5.4	-0.2
Current account balance (EUR million)	-472	-446	-1,644	-359	2,485	-928
Current account balance (% of GDP)	-1.0	-1.0	-	-	-	-
Gross foreign direct investment (EUR million)	295	1,048	341	228	296	183
Foreign exchange reserves (EUR million, eop)	10,660	11,195	11,424	11,422	11,324	11,195
Foreign debt (EUR million, eop)	46,514	45,733	47,485	47,330	46,560	45,733
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,709	-	28,043	58,681	91,587	-
Expense (HRK million)**	133,486	-	32,336	65,157	97,994	-
Net = Gross operating balance (HRK million)**	-9,777	-	-4,293	-6,476	-6,487	-
Net acquisition of non-financial assets (HRK million)**	4,848	-	788	1,869	3,130	-
Net lending/borrowing (HRK million)**	-14,432	-	-5,083	-8,345	-9,618	-
Domestic government debt (EUR million, eop)	12,469	-	13,070	12,966	13,526	-
Foreign government debt (EUR million, eop)	5,913	-	6,946	6,716	7,026	-
Total government debt (% of GDP)	41.2	-	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	4.2	7.5	2.9	6.1	-1.1	7.5
Broad money, M4 (% change, yoy, eop)	4.4	3.5	3.3	3.5	3.7	3.5
Total domestic credit (% change, yoy, eop)	6.8	5.5	6.1	6.5	6.7	5.5
DMBs credit to households (% change, yoy, eop)	3.8	0.9	2.5	3.1	3.1	0.9
DMBs credit to enterprises (% change, yoy, eop)	9.5	9.8	8.2	7.7	8.6	9.8
Money market interest rate (%, pa)	0.9	0.9	0.7	0.5	0.8	1.4
DMBs credit rate for enterprises, short-term, (%, pa)	7.4	7.0	7.0	6.6	6.6	7.6
DMBs credit rate for households, short-term (%, pa)	12.7	11.9	12.7	12.6	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$ - US dollar, DMB – deposit money bank.*
Sources: *Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

At the end of 2011, foreign debt stood at EUR 45.7 billion – around 100 percent of GDP. For the first time in the last 15 years, for which comparable data are available, foreign debt at year-end was lower than a year earlier, confirming that a prolonged recession has forced the necessary deleveraging and consolidation in the external trade and financial position of the country.

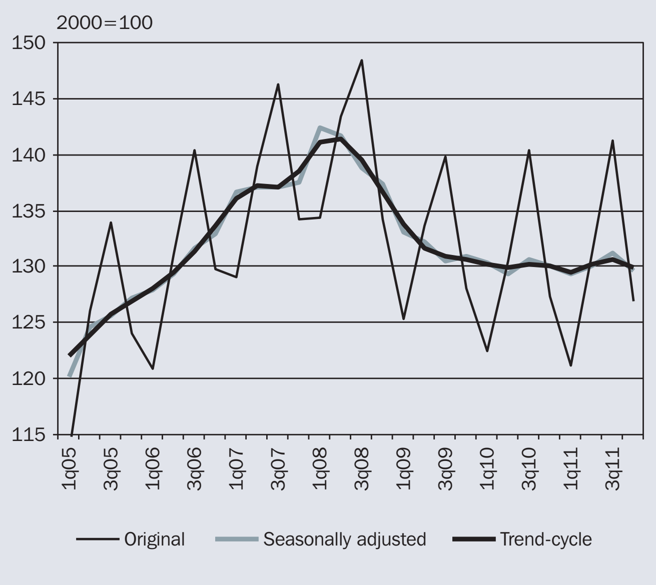
Real sector activity declines further.

Real sector developments at the beginning of this year indicated a further decline in the activity. Although that is the time of the year when procedures applied at the statistical office (such as changes in the weights of individual industrial branches) might affect year-on-year comparisons, it should be noted that the industrial output trend became more negative in the first two months this year, with a cumulative year-on-year decline reaching 3.1 percent. Moreover, compared to the preceding quarter, the industrial activity declined by an additional 4.6 percent on average. When looking across groups of industrial products, the strongest negative contribution came from intermediate goods. As for the retail sales volume, it was 1.5 percent higher than in the first two months a year before, but with a negative month-to-month trend that has persisted ever since the end of the tourist season. The average retail sales stood almost 1 percent lower in the first two months than in the fourth quarter of 2011. The construction activity has now been at a virtual standstill for several months, indicating that its prolonged decline might be coming to an end.

Unfavorable developments on the labor market in 2011…

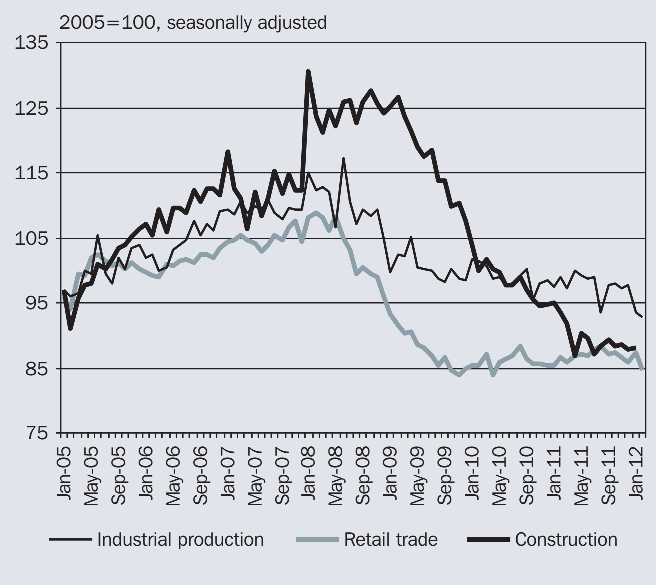
Year 2011 was marked by persistent negative developments on the labor market. Compared to the year before, the average number of employed decreased by 21 thousand or 1.5 percent. However, the distribution of employment cuts was not even across sectors. Layoffs have plagued the private sector, including crafts, trades, free professions and the so-called business economy (industry, construction, trade, transport, communications, business services), ever since the start of the crisis in the second half of 2008 (see Figure 6). On the other hand, public services (public administration, education, health) have seen a slight increase in the number of employed in this period. This observation points to a high employment protection in the public sector as opposed to the private sector. Unemployment figures paint an even gloomier picture. The average number of registered unemployed rose 1 percent in 2011, with the registered unemployment rate climbing 0.4 percentage points to average 17.8 percent in 2011. This increase was partly mitigated by administrative procedures at the Croatian Employment Service, such as involvement of the unemployed

Figure 2 REAL GROSS DOMESTIC PRODUCT



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

Figure 3 REAL SECTOR DEVELOPMENTS



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

in some of the active labor market programs (training or public works) or their striking from the register due to stricter procedural rules. In addition, the Labor Force Survey data show a 1.7-percentage point increase in the average unemployment rate (ILO comparable figure) from 11.8 percent in 2010 to 13.5 percent in 2011.

… persist in 2012.

Negative labor market trends have protracted into 2012. Following several months of falling registered unemployed figures on a year-on-year basis, mostly due to administrative procedures, the total unemployed figure reached its peak since the start of the crisis, registering 343 thousand or 1.9 percent more than a year ago. At the same time, the registered unemployment rate in February stood at 20.1 percent, the highest level since March 2003. Seasonally adjusted figures suggest that unemployment is rising at a considerable pace. On top of that, the number of employed persons has continued to fall, reaching 1,363 thousand in February – the absolute trough since January 2003. Employed in unincorporated business entities (crafts, trades and free professions) experienced the strongest drop or 4.4 percent year-on-year and 20.6 percent compared to pre-crisis February 2008. At the same time, the corporate sector lost 1.4 percent of jobs during last year, and 8.4 over the last four years.

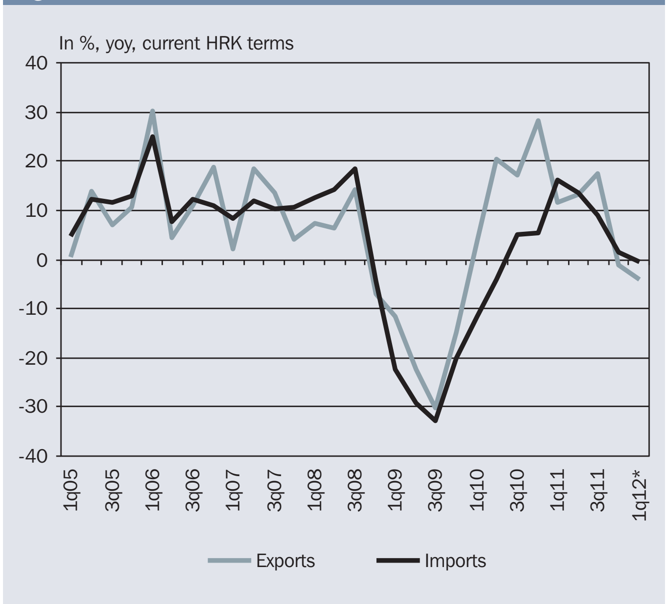
Real wages fall in 2011.

Nominal gross wages averaged HRK 7,992 (EUR 1,056) in the fourth quarter 2011. This is an increase of 1.8 percent compared to the same period a year before. However, in real terms, gross wages actually dropped 0.6 percent. Taking 2011 as a whole, the nominal gross wage rose 1.5 percent in comparison with 2010, while in real terms it fell 0.8 percent. Similar trends are observable for the average net wage – a rise of 1.8 percent in nominal terms and a fall of 0.5 percent in real terms in 2011. Our estimate of the overall disposable income suggests that it rose more than 3 percent in nominal terms and close to 1 percent in real terms, indicating that social transfers (including social and pension benefits) covered a part of the gap brought about by declining employment and real wages.

Slowdown in money creation.

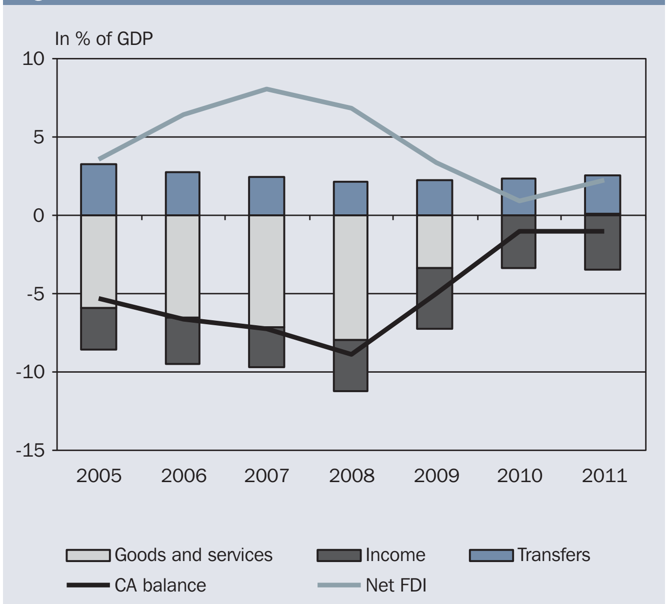
The beginning of 2012 brought a slowdown in broad money creation. In 2011, the average year-on-year broad money growth rate stood at 3.7 percent but its growth decelerated to 2.5 percent in January and 2.0 percent in February. This moderation is mostly due to a strong decline in demand deposits of enterprises. In addition, foreign currency deposits expressed at constant exchange rates increased by no more than 0.5 percent year-on-year and 2.7

Figure 4 EXPORTS AND IMPORTS OF GOODS



Note: * EIZ estimate.
Source: Croatian Bureau of Statistics.

Figure 5 CURRENT ACCOUNT BALANCE AND NET FDI



Sources: Croatian Bureau of Statistics and Croatian National Bank.

Box 1 THE *2012 PRE-ACCESSION ECONOMIC PROGRAM*

In February this year, the Croatian Government released the *2012 Pre-Accession Economic Program*, expressing its mid-term objectives and expectations regarding the overall macroeconomic developments, fiscal policy and structural reforms. Here we focus on the fiscal policy only. There are three main principles which the fiscal policy is supposed to be guided by in the 2012-2014 period: (i) inducing economic recovery through an investment- and business-friendly environment; (ii) sustainability of public finances in accordance with the Fiscal Responsibility Act; and (iii) protection of the most vulnerable social groups.

Changes on both sides of the budget are supposed to contribute to the implementation of these three principles. Concerning the revenue side, there are changes in personal income taxation, health security contributions, the VAT and some non-tax revenues. The basic personal income tax allowance has already been raised and there has also been a minor change in the structure of tax brackets. In addition, dividends and profit shares will now be taxed, as well as pension supplements and pensions from abroad. The health contribution will be reduced by 2 percentage points to 13 percent in order to cut labor costs. As regards the principal revenue, the VAT, its standard rate has been raised by 2 percentage points to 25 percent, along with broadening the range of goods to which the lower, 10-percent rate is applied (a few food items). As a result of all the changes on the revenue side, the total revenue is projected to increase by a mere 0.2 percent of GDP in 2012. Total expenditures, as a share of GDP, are planned to fall continually. The Government finds this necessary in order to get public finances in line with the Fiscal Responsibility Act. Almost all expenditure items are supposed to be cut, including welfare spending and employees' compensations as the biggest items. There will also be cuts in subsidies for agriculture and Croatian Railways. Interest payments and pensions, which are expected to rise, represent notable exceptions. These changes should result in an expenditure reduction equal to 1.2 percent of GDP in 2012. As a net effect, the deficit should shrink 1.3 percent of GDP. Austerity measures might, however, soften when faced with the resistance of groups affected by them.

Financing needs are supposed to diminish as a direct consequence of the deficit reduction. The required financing will come from both domestic and foreign borrowing. The ratio of public debt to GDP is expected to rise until 2014, when it should reach 49.4 percent of GDP, before starting to fall thereafter. The Government especially stresses that privatization revenues will play a significant role in the efforts to reduce borrowing requirements, which it considers both necessary and warranted.

The major risk lies in the possibility of overall macroeconomic underperformance, originating at home or abroad. An additional layer of uncertainty stems from the fact that the devised measures need not produce the intended consequences, that is, the actual realization of fiscal effects of the reforms may turn out to significantly depart from expectations. And, as always, one cannot know for certain what conditions are likely to prevail in debt markets, and those will determine the burden of debt repayment to a great extent.

The mid-term projections of the main fiscal aggregates set out in the *2012 Pre-Accession Economic Program* are given in the table below. It should be emphasized that these figures are based on much more optimistic projections of real GDP growth than ours. For instance, while we conservatively project a 1-percent fall in 2012, the Government expects an 0.8-percent growth.

Table B1 FISCAL PROJECTIONS ACCORDING TO THE *2012 PRE-ACCESSION ECONOMIC PROGRAM (in % of GDP)*

	2011	2012	2013	2014
Revenue	35.8	35.7	35.1	34.6
Expense	41.4	39.5	38.4	37.2
Net = Gross operating balance	-5.5	-3.8	-3.3	-2.6
Public debt	44.9	47.2	48.9	49.4

percent when the exchange rate is not accounted for. Slow deposit growth is a consequence of several factors. Enterprises are running down their financial assets and deleveraging while households are affected by weak personal incomes and worsening labor market conditions. The only component contributing a positive 2.5 percentage points to the broad money creation in February were domestic currency savings deposits that rose 14.7 percent year-on-year.

Household sector deleveraging stalls credit recovery.

Weak credit activity has continued in 2012. The year-on-year total credit growth in the first two months, coming in at 5.8 percent in January and 5.7 percent in February, was a few percentage points below the 2011 average rate. Credit activity deceleration in the household sector led to a modest year-on-year increase of 2.0 percent in February, while the enterprise sector and the Government managed to increase credit activity by 9.4 and 17.4 percent, respectively. Altogether, credits to enterprises, households and the Government grew 5.0 percent when adjusted for the exchange rate, or two percentage points less than implied by domestic currency data. The deleveraging process has been most pronounced in the household sector. With a very strong treasury market activity driven by short-term refinancing needs, credits to the Government will continue to grow at relatively high rates in the coming months.

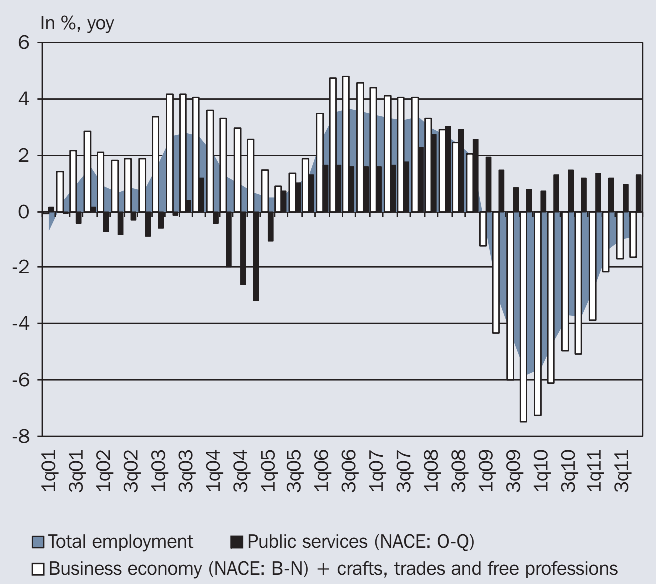
CNB supports the financing of sovereign debt.

Thanks to two interventions in the foreign exchange market, mopping up HRK 2.5 billion from the system in January and a one percentage point increase in the mandatory reserve requirement ratio to 15 percent that took away another HRK 3.1 billion, the central bank managed to alleviate a HRK/EUR exchange rate instability at the beginning of the year. In addition, the CNB freed EUR 700 million worth of banks' liquidity in mid-February by changing the minimum required amount of foreign currency claims/foreign currency liabilities ratio to support the financing of a two-year euro Treasury bill issue. As this injection, amounting to approximately one billion euro, was not enough to stop the kuna depreciation, the central bank intervened by selling EUR 131 million to banks again in February. As a result of all these moves, the HRK/EUR exchange rate was 2.3-percent weaker in February than in the same year-ago month. The other consequence was a temporary money market interest rate hike that disappeared in a few days as the Ministry of Finance converted a part of the euro Treasury bill funds and deposited excess liquidity in the banks, thereby neutralizing the CNB's liquidity drain. In an attempt to coordinate monetary and fiscal policy measures and curb the HRK/EUR depreciation, the Ministry of Finance announced its US$ 1.5 billion Eurobond issue in April, leading the HRK/EUR exchange rate to decline to 7.50. Additionally, a favorable carry trade attracted investors into long-term HRK positions and helped contain downward pressures on the exchange rate.

Relaxation of monetary policy stance.

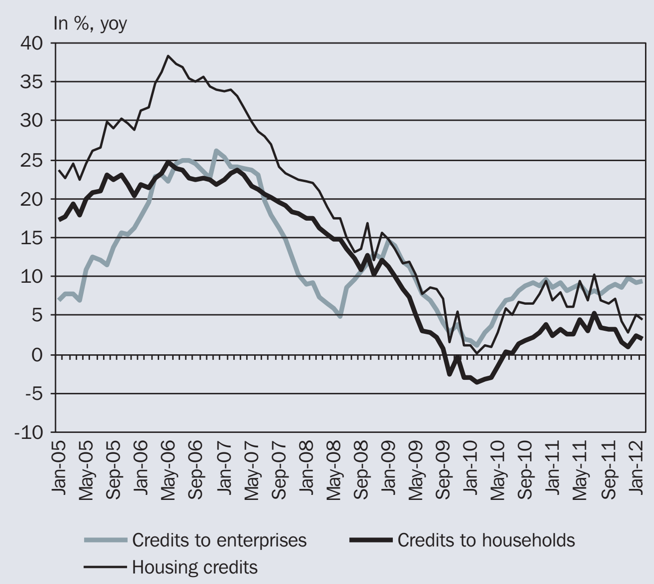
Fiscal consolidation and retained credit rating, along with hopes for successful sovereign refinancing this year and a stable exchange rate provided a favorable environment for relaxation of monetary policy stance lately. In early April, a cut in the mandatory reserve requirement by 1.5 percentage points to 13.5 percent freed around HRK 4 billion to boost primarily the Croatian tradable sector. With another HRK 4 billion contributed by the

Figure 6 EMPLOYMENT CHANGES



Source: *Croatian Bureau of Statistics.*

Figure 7 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

banking sector, the Croatian Bank for Reconstruction and Development (CBRD) will distribute HRK 8 billion in loans at fixed interest rates, with a 50 percent risk intake by the CBRD itself. The CNB also promised to free up to EUR 300 million by treating 50 percent of banks' contribution to disbursed loans as liquid foreign currency claims and thus including them into foreign currency claims/foreign currency liabilities calculation. In addition, funds coming from the banking sector that originate from foreign development banks will be excluded from mandatory reserve calculation. What remains to be seen is how much quality demand there is for such cheaper funding, otherwise additional structural measures will have to be taken in order to spur the credit activity.

Inflation looming.

Strong base effects of food and energy prices from last year are keeping inflation below the 2011 average. The latest data for March show producer prices up 6.2 percent compared to March 2011, mostly on the back of rising energy prices. CPI inflation in March amounted to 2.0 percent, coming from food, housing and fuel prices, while month-on-month price change reached 1.5 percent, due to the VAT rate rise and increase in gasoline prices. After a very strong year-on-year core inflation rate of 2.9 percent in December, core inflation subsided in the first two months of the year. In February, it stood at 1.3 percent year-on-year.

Fiscal trends up to September 2011: weak revenue collection and stagnant outlays.

According to the fiscal data which are at general government level available only up to September 2011, the third quarter of 2011 witnessed a 2.1 percent year-on-year increase in total general government revenue. However, taking the first three quarters cumulatively, the revenue collection fell 0.4 percent behind that in the same time span of 2010. On the expenditure side, total general government outlays rose 0.1 percent in the third quarter 2011 compared to the third quarter 2010. The very slight rise was due to only moderate increases in all major operating expenditures. Such developments contributed to the deficit of no more than HRK 11.5 million in the third quarter 2011, so that the deficit came in at about HRK 6.5 billion at the end of September, which is 8.5 percent more than in the first three quarters a year earlier.

2 Policy Assumptions and Projections Summary

Fragile outlook for the global economy.

In its April issue of *World Economic Outlook*, the IMF projects global output to rise 3.5 percent this and 4.1 percent next year. It seems that global economy is slowly improving, with major risks coming from Europe due to vulnerabilities related to the sovereign debt crisis, and from rising oil prices that are related to the geopolitical circumstances. Compared to January, the IMF revised U.S. growth upwards to 2.1 this year and 2.4 percent next year. The forecast for the eurozone is also improved although the IMF still projects an output contraction by 0.3 percent in 2012 before it recovers 0.9 percent in 2013. Both Germany and France are, however, expected to experience positive growth this year. From Croatia's perspective it is interesting to observe that emerging and developing countries are doing relatively well, except in the region of South-Eastern Europe due to strong financial and trade links with the eurozone.

Fiscal consolidation and a moderate investment recovery.

As for the internal front, we assume that fiscal consolidation will take place but there are uncertainties regarding the planned pace of expenditure decline. Namely, the 2012 budget implies a fiscal consolidation in the amount of HRK 3.4 billion (or 2.8 percent) with major cuts in wage expenditures, other expenditures and subsidies which might turn out not to be feasible (see Box 1). In addition, the Government has already announced a budget revision to take place in summer, increasing the uncertainties regarding future developments in the fiscal sector. The Government has also announced an ambitious plan of public investments (approximately EUR 1.2 billion) which should be implemented over a short period of time. As detailed investment plans have not yet been prepared, we have assumed a relatively moderate investment recovery this year. For now, all major rating agencies have retained the current rating for Croatia. However, the rating will be re-assessed after the budget revision and the end of the tourist season in the fall, and hinges on other reforms the government will undertake.

Exchange rate and price stability in the central bank focus.

The central bank is expected to relax its monetary policy to the extent that allows financing of the budget deficit without crowding out of the private sector. In fact, measures aimed at supporting the enterprise sector's credit activity under more favorable conditions than those prevailing on the market so far have already been announced. However, all that should not jeopardize the stability of the exchange rate and prices which remain the priorities of the monetary authority. The rest of our projection assumptions include publicly available information on the restructuring of shipyards which indicate that at least one of the five state-owned large shipyards will file for bankruptcy while the others will be privatized, although there are still a number of uncertainties in that respect. Due to the impact of this sector on exports and employment, as well as its accumulated large government-guaranteed debt, future developments in the shipyard industry might have sizeable consequences for the economy as a whole.

Table 2 SUMMARY OF PROJECTIONS

	2012	2013
Real GDP (% change)	**-1.0**	**1.2**
Real private consumption (% change)	-0.5	0.5
Real government consumption (% change)	-1.5	-0.3
Real investment (% change)	-1.1	3.5
Exports of goods and services (constant prices, % change)	-1.5	2.6
Imports of goods and services (constant prices, % change)	-1.4	2.0
Current account balance (% of GDP)	-0.6	-1.1
Consumer prices (% change, pa)	2.5	2.5
Exchange rate, HRK/EUR (pa)	7.48	7.48
Unemployment rate (registered, %, pa)	18.3	17.8
General government balance (ESA95 definition, % of GDP)	-4.5	-4.0
Broad money, M4 (% change, eop)	6.0	7.0
Total domestic credit (% change, eop)	6.0	8.0

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

Downward revision of 2012 GDP growth; more optimism regarding investment outlook.

At the turn of the year, the performance of the Croatian economy proved to be weaker than earlier expected. As a result, the GDP projection for this year was revised downwards from -0.3 to -1.0 percent. Domestic demand is likely to shrink further while exports seem to be losing pace. Restructuring of the shipyards, whose output has been export-oriented, will place an additional burden on the export performance. However, compared to our projection three months ago, we have revised the investment outlook upwards. Instead of a 2-percent decrease over the last year, we now project a 1.1-percent decrease in 2012, still implying our cautiousness as to the quick implementation of public investments which have been announced and their impact on the rest of the economy at a time when private investments are at a standstill. For 2013, we project an investment increase at a rate of 3.5 percent, which considerably overshoots the projected GDP growth.

GDP expected to decline 1 percent in 2012.

According to the high-frequency indicators available for this year, the economy seems to have experienced an additional decline in the first quarter. That is also indicated by the CEIZ index, a monthly composite business cycle indicator developed by The Institute of

Economics, Zagreb. In a situation where the negative trend from late last year has spilled into this one, the prospects for the rest of the year remain sluggish. Consequently, we expect GDP to decline 1.0 percent this year. Due to shrinking employment, disposable income could decrease as well and, combined with the weak consumer sentiment and higher VAT rate (which will only partially be passed on consumers), that will result in a personal consumption drop of 0.5 percent this year.

Gloomy outlook for the foreign trade.

Due to fiscal consolidation that is underway as well as constraints on public expenditure financing, government consumption is expected to shrink 1.5 percent. In spite of the projected decrease in investments this year, largely as a result of the negative trends passed on from 2011, the second half of 2012 is expected to bring a moderate recovery that could strengthen even more in 2013. The export performance seems to be under great risk. The long-existing problems of competitiveness have not been resolved. Consequently, we expect total exports to decline at a rate of 1.5 percent this year, with imports following the same path. Due to such developments in the foreign trade sector, the current account deficit could continue to narrow to 0.6 percent of GDP.

Weak recovery in 2013; GDP expected to rise 1.2 percent.

Despite a rather gloomy outlook for this year, it should not be perceived as another 'lost' year. The already launched fiscal consolidation, expected recovery of investments and business sector stabilization might build up conditions in the second half of the year for better growth performance in 2013. As a result, GDP is projected to rise 1.2 percent in 2013, marking the first, albeit weak step away from the recession plaguing the Croatian economy for the last four years. In 2013, we foresee a recovery of the domestic demand. A better overall climate in the economy and first improvements in the labor market should help private consumption rise 0.5 percent. Government consumption is expected to continue declining but the investment recovery could gain strength. A stronger performance is also expected in the exports sector, with a 2.6 percent rise, although substantial risks remain. Rising domestic demand will induce stronger imports, in turn resulting in a wider current account deficit of slightly more than 1 percent of GDP. Next year's recovery path might be unstable and will depend substantially on the developments in the international environment, primarily in the EU.

No labor market improvements in 2012.

Seasonal dynamics might bring some improvements in the labor market in the second and third quarter 2012 but the underlying trend is expected to remain negative this year. Active labor market programs which, according to the Government's announcement, could involve up to 35,000 persons should help offset rising numbers of unemployed persons registered at the Croatian Employment Service. Nevertheless, necessary reforms of public administration as well as privatization and restructuring of the shipbuilding industry could contribute to further negative developments. As a result, our projections suggest an increase in the registered unemployment rate to 18.3 percent in 2012. Provided that the economy takes off in 2013, some positive labor market developments might take place in the second half of next year, leading us to project a decline in the registered unemployment rate to 17.8 percent for 2013 as a whole. As far as wages are concerned, a stagnation in real wages is expected to protract through this and next year.

Credit demand expected to remain subdued.

As the economy has probably entered a new recession, credit demand will suffer despite the CBRD-enabled credit recovery scheme. Even if the liquidity injection gains some success in the enterprise sector, households will probably experience a further credit decline driven by rising unemployment while banks could face a more pronounced increase in non-performing household loans. Accordingly, we expect the credit activity to expand 6 percent in 2012 and 8 percent in 2013, while broad money could advance 6 percent this and 7 percent next year.

Pass-through of oil prices might push inflation up.

Weak domestic demand is keeping consumer prices down in spite of the VAT rate increase. However, a worrisome impact comes from higher oil prices, which are expected to push inflation up on a rather broad basis. In addition, it has been announced that administratively controlled electricity and gas prices will rise notably while prices of transport have already gone up, both having a potentially high pass-through effect on the prices of other items. Overall, our projection suggests that the consumer price inflation will revolve around 2.5 percent this and next year, although significant upward risks remain.

Exchange rate expected to remain stable.

Despite CNB's latest announcements on conditional monetary relaxation, fiscal cuts coupled with successful external sovereign financing have kept the HRK/EUR rate at around 7.50. However, ample liquidity in the system, if not channeled towards the enterprise sector, could have adverse effects on the exchange rate. In that case, we expect the central bank to use the instruments available to it, such as the reverse REPO, mandatory reserve requirement ratio or the foreign currency assets/foreign currency liabilities ratio. Alternatively, the HRK 8 billion injection, if implemented as planned, could have a downward effect on the interest rates, spur credit creation and investments and help the money market overcome a possible crowding out. Expectations of interest rate hikes are almost entirely unjustified due to the fact that the Ministry of Finance has already secured funds for the repayment of HRK 9 billion in Treasury bills maturing by the end of June. Announcements of a good tourist season, privatizations and a Eurobond issue in April are all votes in favor of a stable exchange rate in 2012, with still some depreciatory bias stemming from corporate deleveraging and bank provisions. Regarding the latter, a high loan-to-deposit ratio, together with a large exposure to EMU banks, leaves the Croatian banking system vulnerable to problems at parent banks in the eurozone.

On the path towards fiscal consolidation, but less than hoped-for.

The realization of fiscal aggregates in 2012 will depend, as always, on the overall state of the economy. As the prospects do not seem rosy, one can hardly expect much better developments as regards public finances. That said, the real GDP fall of 1 percent, as we project it, will probably not allow the deficit to drop below 4.5 percent of GDP at best. In contrast, according to the Government's projections (or hopes) expressed in the *2012 Pre-Accession Economic Program*, the deficit-to-GDP ratio is put at -3.8 percent. Another factor underlying the Government's fiscal projections is the fact that it has made certain changes to the tax system which are expected to yield more revenue; in addition, it intends to cut the majority of expenditure items. The problem lies, however, in that the devised measures may well have only minor positive effects. If so, that would undermine the hoped-for consolidation. A revision of the budget, expected in summer, will reveal where the public finances are heading compared to where they should be heading.

3 Uncertainties and Risks to Projections

The first 100 days of the new Croatian Government.

In summarizing the first 100 days of the new Croatian Government, one should stress on the positive side that it has presented a plan of fiscal consolidation and succeeded in retaining the country's credit rating. What is lacking, however, is a comprehensive plan of much needed structural reforms as well as accompanying policy actions. It is surprising that such a plan has not been developed, bearing in mind that the winner had been rather clear far before parliamentary elections were held. Although reform intentions have been clearly communicated by at least a part of the Government, no concrete measures have been implemented so far. This Government has a strong majority in parliament, and making unnecessary deals with various interest groups should not be a way of operating, especially not at the beginning of its mandate. Strengthening competitiveness through deregulation, easier business operation and reduction of public expenses should be prioritized in search of a sustainable economic recovery.

Fiscal sector remains plagued by risks.

The fiscal sector remains plagued by risks. Signals from various sectors (foremost, health sector and agriculture) indicate that a planned reduction in public expenditures faces hurdles due to the obligations assumed by the previous government that were not transparent at the time of budget preparation. The already announced budget revision in summer also adds to the uncertainty regarding the implementation of the fiscal policy this year. It seems that the Government's initial ambitions to achieve a quick fiscal consolidation are weakening. Increased tax revenues and positive signals of the possibility of fiscal deficit financing, domestically and abroad, make the Government's job easier this year but also appear to lessen consolidation efforts on the expenditure side. If this proves to be true, it will certainly constrain medium-term growth prospects by freezing the current unfavorable structure in place.

Instability in the EU might have negative effects on Croatia.

Although the global economy seems to be recovering at a slow but sustained pace, the highest risks are related to the possibility of a new crisis in Europe. The March fiscal treaty among 25 EU members on tighter fiscal rules has, however, helped to alleviate some of the previous risks related to a new upsurge in crisis. Nevertheless, any new signs of instability in the EU would have a negative effect on Croatia's outlook, and might endanger positive developments both in respect to financial and to trade flows.

A Note from the Editor, Andrea Mervar

With this 50th issue of the *Croatian Economic Outlook Quarterly* I am stepping down as the editor. I would like to thank the publisher for giving me the opportunity to edit the publication for almost thirteen years. At the very beginning of this endeavor, in December 1999, it was quite a challenge and has remained so with each new issue. My deep thanks go to each of the sixteen authors, four proofreaders, one executive and two technical editors, several printing houses and the whole administrative staff at The Institute of Economics, Zagreb for their valuable contributions to the publication over its *first* thirteen years.

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