eiz The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

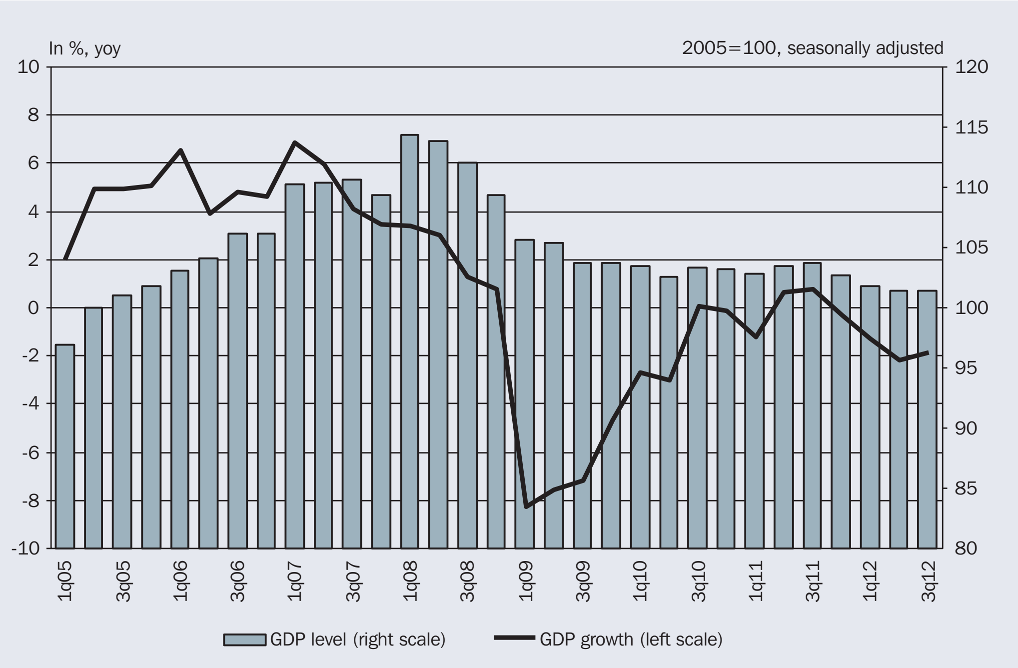
Economy continues to struggle.

Croatian GDP declined by 1.9 percent year-on-year in the third quarter of 2012, which is the fourth consecutive decline in a row. Depressed personal consumption and poor investments were the major factors behind the fall in overall activity, while the positive contribution of net exports prevented an even gloomier record. Although seasonally adjusted GDP for the third quarter indicated stagnation compared to the previous quarter, which was largely due to the spending by foreign tourists, the high-frequency indicators for the fourth quarter pointed to the continuation of negative trends. Labor market situation was particularly worrying. Unemployment has recently rapidly increased, at a pace observed during the first wave of the crisis in early 2009. In spite of some fiscal consolidation efforts, the overall policy response seems to have been inadequate and the economy has remained vulnerable to potential shocks, which led Standard & Poor's to downgrade Croatia's credit rating. In quest for the strategy to overcome current economic problems, the Government relies predominantly on large-scale public investments and makes additional efforts to boost private investments.

Personal consumption weakens on reduced real income.

Personal consumption suffered a considerable fall in the third quarter, 3.5 percent year-on-year, after a 3.4-percent decline recorded in the second quarter. Weakness in personal consumption was driven by the real income restraint caused by reduced employment,

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

higher inflation and ongoing deleveraging. Seasonally adjusted figures reveal that personal consumption has been on the decline since the beginning of 2012 although the pace of this decline slowed down in the third quarter. Consumer confidence index reported by the Croatian National Bank has gradually worsened since August 2012, and the November figure is one of the lowest since mid-2009 which is discouraging for the near-term consumption prospects.

Government consumption resists cuts.

Seasonally adjusted government consumption oscillated in 2012 and recorded a notable quarterly fall in the first quarter, a strong increase in the second quarter, and a moderate decline in the third quarter. This lack of an apparent trend points to inconsistent budget planning. On a year-on-year basis, the third quarter brought a decline of 0.4 percent, which is a rather mild reduction considering the much-awaited fiscal consolidation.

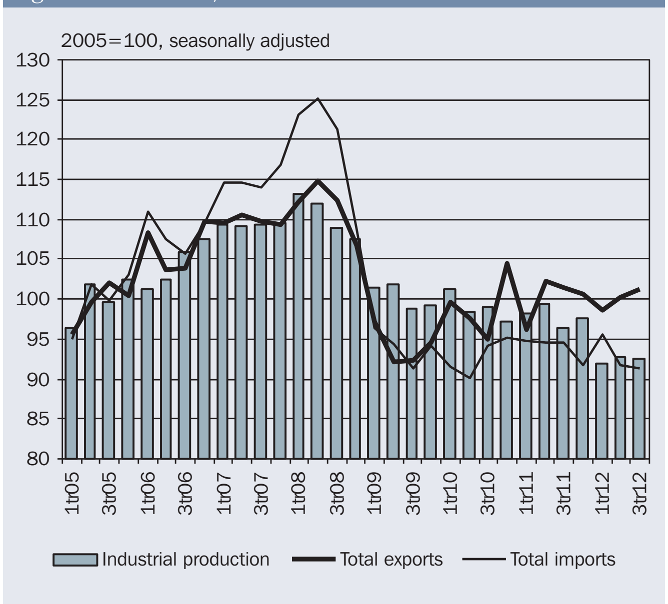
In spite of high hopes, investments continued to decline.

The decline in seasonally adjusted investments slowed down in the third quarter but a year-on-year change remained deeply negative, -4.3 percent. The Government had high hopes that investments could change the negative GDP trend in 2012, especially with public investments taking the lead. However, public sector companies were poorly prepared for such an investment leap and it seems that the execution of plans has meanwhile been delayed and diluted. Additionally, the domestic private sector has undergone restructuring and deleveraging and had no sufficient strength for major investments.

Sluggish exports, but tourism sector fares well.

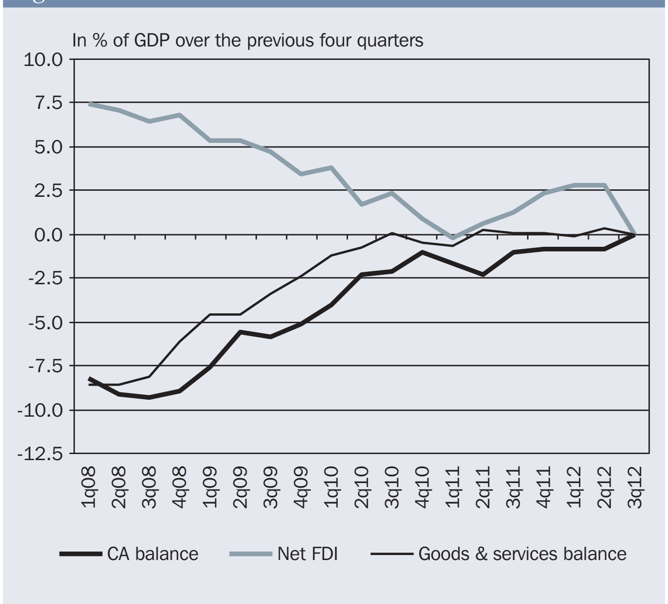
In the third quarter of 2012, the external sector positively contributed to GDP and softened the negative impact of domestic demand. However, this was achieved by weaker imports, while exports remained almost flat in spite of the heightened tourism revenues. The volume of total exports was 0.1 percent and the volume of total imports was 3.3 percent below its level in the third quarter of 2011. In the last two quarters, seasonally adjusted figures exhibited some improvements in exports and some deterioration in imports. The service export sector, mostly tourism, has performed somewhat better than the goods export sector. According to the current account statistics expressed in current EUR terms, tourism revenues increased by 3.3 percent in the first three quarters of 2012, while goods exports declined by 1.9 percent year-on-year. Some optimism stems from the encouraging

Figure 2 EXPORTS, IMPORTS AND INDUSTRIAL PRODUCTION



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

Figure 3 CURRENT ACCOUNT BALANCE AND NET FDI



Source: *Croatian Bureau of Statistics.*

performance of the exports of goods observed in October and November of 2012. An 18 percent year-on-year rise derives primarily from the improved exports of the food, chemical and pharmaceutical industry as well as exports of the shipbuilding industry.

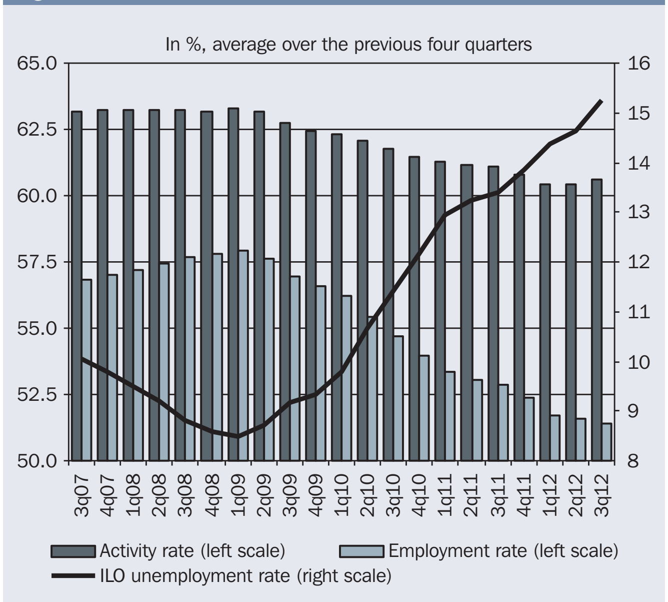
Subdued activity in the real sector.

Following the signs of recovery during the summer months, industrial production experienced a significant decline at the end of the second quarter after which it stabilized. In October-November period the seasonally adjusted activity in the industrial sector was on average 1.1 percent weaker than in the third quarter. In cumulative terms, the overall decrease in 2012 was estimated at around 5.5 percent. This was mainly driven by developments in the intermediate and durable consumer goods sectors and, to a lesser extent, in the capital goods sector. In 2012 the retail trade exhibited less variation than industrial production but their performance was similar nevertheless. Retail trade volume somewhat recovered during the summer, foremost due to the high tourist season, and declined again in September. In October-November period, the retail trade volume was on average 1.9 percent lower than in the third quarter. The cumulative decline for 2012 as a whole is estimated at 4 percent. With a negative trend being observed for over four years construction activity continued to shrink by more than 10 percent on a year-on-year basis in 2012.

Labor market situation is going from bad to worse…

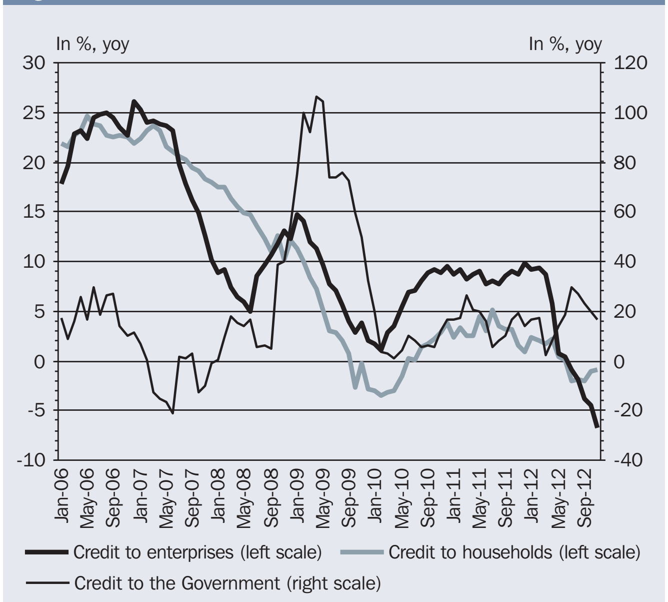
Unemployment grew rapidly in the last quarter of 2012. At the end of December there were 358 thousand of the unemployed registered at the Employment Service, which is a 3-percent increase from November 2012 and a 13 percent increase from December of the previous year. The registered unemployment rate reached 20.4 percent in November. Unemployment rate based on the Labor Force Survey (LFS) and ILO methodology was somewhat lower than the one based on registers: 15.0 percent in the third quarter for the population aged 15-64 years. However a rising trend was present in both statistics. Along with these developments, employment and participation rates also tend to decline considerably. LFS data show that in the third quarter of the last year only 61.8 percent of the working-age population in Croatia was active and only 52.5 percent of them employed. These figures are lower than in any of the EU-27 countries, with the exception of Greece where the employment rate is below that of Croatia.

Figure 4 ACTIVITY, EMPLOYMENT AND UNEMPLOYMENT



Note: *Data refer to the population aged 15-64.*
Source: *Croatian Bureau of Statistics (Labor Force Survey).*

Figure 5 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

… and the young are suffering the most in this recession.

The recession has exerted differing impacts on various segments and population groups in the labor market. Men were hit more than women, those who work in the private sector more than those employed in the public sector and young population more than middle-aged and older population. The proportion of women in total unemployment has been decreasing since the start of the recession. It dropped from 62 percent in December 2008 to 53 percent in December 2012. This is not surprising given that sectors which experienced the highest reduction in employment are the male-dominated industries and construction sector. The same is true for the public-private sector differentiation. Employment reduction took place exclusively in the private sector, while the public sector remained intact. The composition of registered unemployment by age, between December 2008 and December 2012 reveals that younger generations have born a greater burden of labor market adjustment during the recession. In total unemployment, the share of those aged 15-24 increased from 18 to 20 percent and of those between 25 and 34 years from 22 to 26 percent. The opposite is observed for those aged 45-54 with a decrease in share from 26 to 21 percent and those aged 35-44 with a decrease from 20 to 19 percent. The group of 55+ has kept its share of around 14 percent. It is not only their increasing share that highlights the unemployment problem of the youth, but also the increasing unemployment rate. This rate for those 15-24 years old increased from 20.2 percent in the third quarter 2008 to 37.6 percent in the third quarter 2012.

Prolonged decrease of real disposable income.

Despite the difficult situation in the labor market, nominal wages have continued to grow, albeit slowly. The average nominal gross wage of HRK 7,824 (EUR 1,046) in the third quarter of 2012 was 0.6 percent higher than in the same quarter of the previous year, while the average wage for the first ten months of 2012 was 1.3 percent higher than in the corresponding period of 2011. However, due to the increased inflation, the average real gross wage dropped by 3.5 percent in the third quarter. Lower real wages and reduced employment were the main factors behind the estimated real disposable income decline of more than 5 percent in the third quarter, following a 4-percent decline in the second quarter 2012. Although social transfers, foremost pensions, increased by around 2 percent in nominal terms, that was not enough to offset the inflationary losses.

Steady money creation…

In spite of some month-to-month variations, seasonally adjusted narrow (M1) and broad (M4) money have grown steadily since March last year, albeit at relatively low rates. In December, year-on-year growth rates reached 0.9 percent for M1 and 3.0 percent for M4. Increase in broad money was mostly due to an increase in foreign currency deposits. A closer look reveals that enterprises recently switched from kuna to foreign exchange deposits. They withdrew as much as 30 percent of kuna deposits, possibly to buy foreign currency for their foreign debt obligations due at the end of the year.

… and accelerated corporate deleveraging.

Credits to enterprises and households have recorded negative year-on-year growth rates since July 2012. Seasonally adjusted data show that credits to enterprises decreased by 1.9 percent in November, which is the strongest month-to-month decline recorded in the last 13 years. The only exception occurred in May 2012 when the Government overtook the state-owned shipyard's loans as part of the privatization process, which caused a decline in total credits distributed to the enterprise sector. The large-scale corporate deleveraging is a result of a credit bubble prior to 2008, weak economic prospects, restructuring, and absent investment recovery. Nevertheless, there is a spark of new investment potential apparent in the programs of the Croatian Bank for Reconstruction and Development (CBRD). Data for the first 11 months of 2012 suggest that the CBRD increased funding by 48 percent compared to the same period 2011, or by HRK 8.9 billion. Additionally, CBRD managed to further decrease the interest rates extended to the sectors of tourism, agriculture, industry, renewable energy, and environment protection. This measure ensured growth both in the number and in the volume of approved loans. Financial potential of the program, however, remains underutilized. There is still HRK 4 billion waiting to be channeled.

Table 1 MAIN ECONOMIC INDICATORS

	2010	2011	2011	2012		
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.4	0.0	-0.4	-1.3	-2.2	-1.9
Real private consumption (% change, yoy)	-0.9	0.2	0.1	-0.3	-3.4	-3.5
Real government consumption (% change, yoy)	-1.6	-0.3	-0.9	-1.5	-0.2	-0.4
Real investment (% change, yoy)	-15.0	-7.2	-6.0	-2.8	-5.9	-4.3
Industrial output (% change, yoy)	-1.4	-1.2	0.0	-5.4	-6.7	-4.5
Unemployment rate (registered, %, pa)	17.4	17.8	17.9	19.9	18.2	17.8
Nominal GDP (EUR million)	44,877	44,922	-	-	-	-
GDP per capita (EUR)	10,158	10,205	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.9	2.1	1.9	1.1	2.0	1.9
Consumer prices (% change, yoy, pa)	1.1	2.3	2.4	1.5	3.4	4.1
Producer prices (% change, yoy, pa)	4.4	6.3	6.4	6.1	6.8	7.9
Average gross wage (% change, yoy, pa)	-0.4	1.5	1.8	2.1	0.9	0.6
Exchange rate, HRK/EUR (pa)	7.29	7.43	7.49	7.56	7.52	7.47
Exchange rate, HRK/US$ (pa)	5.50	5.34	5.56	5.76	5.86	5.97
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	8,905	9,582	2,390	2,254	2,325	2,474
Exports of goods (EUR, % change, yoy)	18.3	7.6	-2.7	2.7	-8.1	0.2
Imports of goods (EUR million)	15,137	16,281	3,972	3,891	4,153	4,157
Imports of goods (EUR, % change, yoy)	-0.5	7.6	-0.2	2.1	-3.1	-1.3
Current account balance (EUR million)	-450	-394	-912	-1,611	-344	2,607
Current account balance (% of GDP)	-1.0	-0.9	-	-	-	-
Gross foreign direct investment (EUR million)	298	1,075	171	37	225	190
Foreign exchange reserves (EUR million, eop)	10,660	11,195	11,195	11,340	11,635	11,384
Foreign debt (EUR million, eop)	46,483	45,734	45,734	45,894	46,517	45,581
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,709	123,025	123,025	28,931	60,654	93,150
Expense (HRK million)**	133,486	132,945	132,945	32,248	64,826	98,700
Net = Gross operating balance (HRK million)**	-9,777	-9,920	-9,920	-3,317	-4,172	-5,550
Net acquisition of non-financial assets (HRK million)**	4,848	5,044	5,044	729	1,428	2,444
Net lending/borrowing (HRK million)**	-14,432	-14,964	-14,964	-4,046	-5,600	-7,994
Domestic government debt (EUR million, eop)	12,085	13,716	13,716	14,613	14,721	-
Foreign government debt (EUR million, eop)	6,602	6,996	6,996	7,093	8,188	-
Total government debt (% of GDP)	41.3	45.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	4.2	7.5	7.5	-3.5	-2.4	2.3
Broad money, M4 (% change, yoy, eop)	4.4	3.5	3.5	2.7	3.2	2.2
Total domestic credit (% change, yoy, eop)	6.8	5.5	5.5	4.9	0.1	-2.8
DMBs credit to households (% change, yoy, eop)	3.8	0.9	0.9	1.7	0.0	-2.0
DMBs credit to enterprises (% change, yoy, eop)	9.5	9.8	9.8	8.6	0.4	-3.9
Money market interest rate (%, pa)	0.9	0.9	1.4	1.6	0.5	1.7
DMBs credit rate for enterprises, short-term, (%, pa)	7.4	7.0	7.6	7.9	7.1	7.1
DMBs credit rate for households, short-term (%, pa)	12.7	11.9	11.2	11.2	11.2	11.2

Notes: ** Data refer to consolidated general government. ** On the cash principle, cumulative from the beginning of the year.*
Conventional abbreviations: *pa - period average, eop - end of period, yoy - year on year, HRK - Croatian kuna, EUR - euro, US$ - U.S. dollar, DMB - deposit money bank.*
Sources: *Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

Banking sector preserves stability despite rising non-performing loans.

Banking sector has remained stable during the crisis, although certain diversification within the sector has emerged. Large and medium-sized banks have remained profitable, while a number of smaller banks recorded losses in 2012. Profit of the sector as a whole decreased year-on-year by 17.4 percent in the third quarter, mostly due to lower interest revenues. Non-performing loans reached 13.3 percent in mid-2012, which was a rise up from 12.4 percent recorded at the end of 2011. In the corporate sector the proportion of "bad" loans is rather large, 25 percent, particularly in the construction sector where it amounts to 40 percent. Despite these unfavorable trends, the Croatian banking sector is adequately capitalized, with the average capital adequacy ratio of 20.2 percent recorded at the end of June.

Rising international reserves and falling foreign capital inflow.

Interbank liquidity was very high at the end of last year, as was evident from the low money market interest rates and the average overnight ZIBOR of 0.7 percent in December. The HRK/EUR exchange rate depreciated mildly, 0.3 percent in December, compared to 2011. International reserves have been steadily rising, ensuring exchange rate stability in times of very low foreign capital inflow.

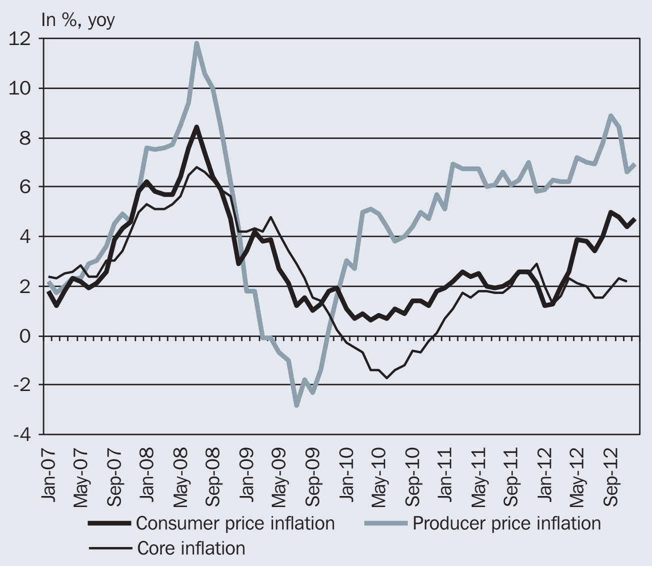
A year of policy-induced price hikes.

Annual consumer price inflation rate amounted to 4.7 percent in December, mostly because of the higher food and energy prices. Prices of meat and vegetables contributed to the total CPI with 0.5 percentage points each, while electricity, gas, and fuels added 1.0, 0.8 and 0.4 percentage points, respectively. A gloomy economic situation has created downward pressures on prices, while a higher VAT rate and administratively controlled price hikes of electricity and gas pushed the prices upwards. Without the unprocessed food and energy prices, inflation rate stood at 1.5 percent in December.

Fiscal consolidation more pronounced on the revenue side…

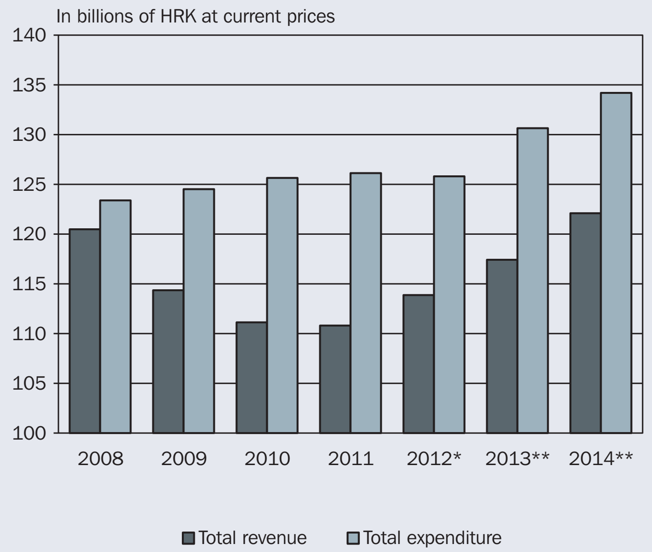
Looking at the first three quarters of 2012, the dynamics of general government revenue collection was better than in the same period of 2011. Total revenue increased by 1.8 percent as an outcome of Government's policy of revenue-based fiscal consolidation demonstrated in the standard VAT-rate increase from 23 to 25 percent, as well as through a more efficient revenue collection. However, unlike the first two quarters, the third quarter saw a 1-percent decline in total revenue, relative to the same quarter in 2011, indicating a bit of a slowdown in revenue collection. Major revenue components underperformed

Figure 6 INFLATION



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

Figure 7 CONSOLIDATED CENTRAL GOVERNMENT BUDGET



Notes: *According to budgetary accounting standards; * The Supplementary 2012 Budget; ** The 2013 Budget and official projections for 2014.*
Source: *Ministry of Finance.*

as there was a 4.9-percent decrease in total excises and a 4.2-percent decrease in social security contributions.

… and less on the expenditure side.

Following a tiny decline in total government expenditure for the first two quarters of 2012, the third quarter saw a 3.1-percent rise over the same quarter of 2011. Two biggest expenditure items were increased, social benefits by 1.8 percent and compensation to government employees by 0.6 percent, indicating that the Government's plan to cut back on these items was not realized. Notable increases were recorded for interest payments (24.1 percent) and subsidies (20.1 percent). Out of all the major expenditure categories, only purchases of goods and services declined. By the end of September cumulative expenditure was 0.7 percent higher than in the comparable period of the previous year.

Supplementary Budget for 2012 adopted at the end of November.

In spite of some consolidation over the first three quarters, the Government did not manage to achieve the planned savings, and was forced to prepare a supplementary budget, which was approved by the Parliament on November 27, 2012. Accordingly, total expenditure of consolidated central government increased by HRK 2.5 billion or 2.1 percent over the original budget figure. A large part of this increase is due to the public sector wage bill, HRK 1.1 billion, but also to investment spending of extra-budgetary entities, higher subsidies and interest payments. Central government revenue was revised upwards by HRK 1.4 billion or 1.3 percent, which comes as no surprise given the rise in the standard VAT rate and improved efficiency in revenue collection.

2 Policy Assumptions and Projections Summary

Gradual recovery of the eurozone expected in the second half of 2013.

During the last year, global recovery lost momentum as the slowdown in advanced economies spilled over into emerging markets. From the perspective of major emerging markets, 2013 should be a better year. The performance of advanced economies is much more uncertain, particularly that of the eurozone. This presents the biggest risk to the stronger overall recovery of global economy. Following a quarter-on-quarter contraction of 0.2 percent in the second quarter of 2012, the eurozone's GDP declined by additional 0.1 percent in the third quarter. This economic weakness is expected to extend into this year. However, in the second half of 2013, economic activity should gradually recover, due to stronger global demand, effects of ECB's accommodative monetary policy, and improved financial market confidence. Eurosystem's staff macroeconomic projections for the eurozone point to a GDP growth in a range between -0.9 percent and 0.3 percent for 2013 and between 0.2 percent and 2.2 percent for 2014 (*Monthly Bulletin*, ECB, December 2012).

Croatia should become the 28th EU member state on July 1, 2013.

If the ratification of the Treaty of Accession between each EU member state and Croatia is concluded as planned, Croatia should become a full member of the EU on July 1, 2013. By mid-January Croatia and 18 member states ratified the Treaty, and in four other countries it has received parliamentary approval. In spite of the fact that some risks exist, we assume that the ratification process will be finished on time.

2013 Budget enacted deficit higher than in 2012.

The 2013 Budget projections brought some important changes compared to the previous Government plans presented in "Economic and Fiscal Policy Guidelines" from July 2012. Firstly, there is a plan for higher general government deficit in 2013 than in 2012. Secondly, total expenditure is expected to be 3.9 percent higher than in 2012. It seems that Government ambitions regarding fiscal consolidation have been downplayed this year.

Ratings downgrade should not jeopardize government finances.

In mid-December, Standard & Poor's lowered Croatia's credit rating from the lowest investment-grade rating to the highest speculative-grade rating (BB+/B). According to the agency, the main rationale for the downgrade is that "structural and fiscal reforms

Box INTRODUCTION OF THE REAL ESTATE TAX IN CROATIA

In November 2012 the Ministry of Finance has presented the draft proposal of the Law on Real Estate Tax which is announced to be introduced on April 1, 2013. Conceptually, this tax belongs to the group of recurrent taxes on ownership of immovable property. Until now, such taxes have not existed within the Croatian tax system. Two similar levies that are already being collected – communal charge and tax on holiday houses are going to be abolished gradually, once the real estate tax is introduced. Both of them accrue to the local government units, but are not imposed in all municipalities and are determined according to the usable space instead of value, thus disregarding the principles of horizontal and vertical equity. The rationale for the introduction of the real estate tax is, firstly, to replace the inadequate real estate levies, secondly, to serve as a prerequisite for partial shift of tax burden from labor to property, and thirdly, to provide stable and reasonably abundant revenue source for local government units.

According to the draft proposal, the real estate tax will be charged on all the real estate intended for business and residential use. Taxpayers of the real estate tax will be property owners or property users in cases when the owner is unknown or cannot be found in the land registry. All the property subject to real estate tax will be registered within the fiscal cadastre, and appraised in the mass valuation process. The methodology of the real estate appraisal has not yet been presented. Tax base will be determined as 70 percent of the assessed fiscal value of the property, and a 1.5-percent rate will be applied. Many tax reliefs are, however, foreseen so that the effective tax rate will in most cases lie much below the statutory rate. For the real estate used for residential purposes, both permanent and temporary, as well as for the property intended for rent, the reliefs are stipulated as ranges, whereas the exact reliefs will be determined by each local government unit. Property which is used for permanent residence will be effectively taxed at rates between 0.053 and 0.126 percent. Thereby, the burden will be approximately equal to the one resulting from currently used communal charges. Similarly, the burden for temporary residence will be approximately equal to the sum of currently used communal charges and the tax on holiday houses. For more details see Table 1.

The collected tax will represent the revenue of local government units. The Ministry of Finance projects annual revenue of some HRK 2.6 billion or 0.8 percent of GDP. That size of revenue in terms of GDP is just slightly above the average in EU-27 (Figure B1). So far, the revenues from communal charges and the tax on holiday houses amounted to some 0.6 percent of GDP.

The presented draft proposal proves to be controversial and it is doubtful whether it can get sufficient political support in its current form. A shift from labor to property taxation might have positive effects not only on the taxation efficiency but also on Croatia's international competitiveness. However, there are still many open issues regarding the technical aspects of the implementation of the tax, and more importantly regarding the implications of the discriminatory taxation of business property on business climate and economic activity in general.

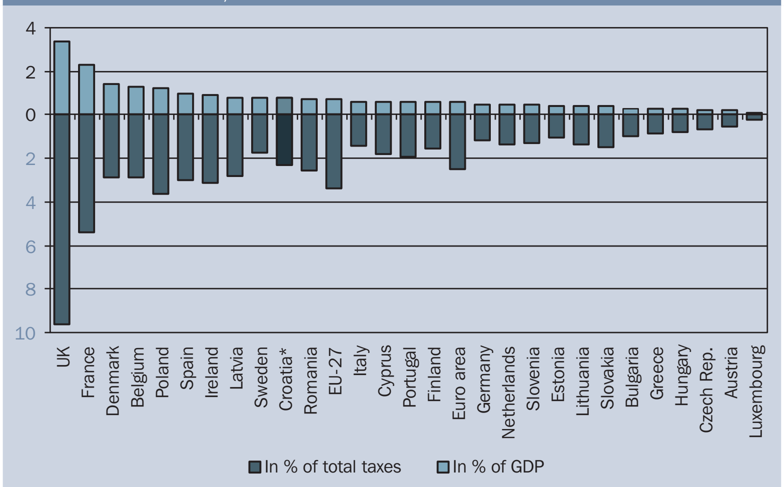
Sandra Švaljek

Table B1 MAIN ELEMENTS OF REAL ESTATE TAX

	Standard Tax Rate	Taxable value	Tax Relief		Effective Tax Rate	
			From	To	From	To
Permanent residence			88%	95%	0.053%	0.126%
Temporary residence and real estate for rent			70%	85%	0.158%	0.315%
Other residential real estate			0%		1.05%	
Real estate for business activities, as follows:						
Manufacturing, health care, education and activities of non-profit organizations	1.5%	70%	80%		0.21%	
Construction, transportation and storage			60%		0.42%	
Retail and wholesale trade, accommodation and food service			40%		0.63%	
Other activities			20%		0.84%	

Source: *Own calculation based on the draft proposal of the Law on Real Estate Tax.*

Figure B1 REVENUES FROM RECURRENT TAXES ON IMMOVABLE PROPERTY IN THE EU, IN 2010



Note: ** Projection for 2013.*
Sources: *European Commission (*Taxation Trends in the European Union*, 2012 Edition) and Ministry of Finance's projections for Croatia.*

implemented so far have been insufficient to foster economic growth and place public finances on a more sustainable path." It appears that the triggers for the rating change were the adoption of the Supplementary 2012 Budget and the 2013 Budget. Both documents indicate a weakening of expenditure control and heightened fiscal deficits. In spite of the downgraded rating and in line with the market situation which has recently been generally favorable, we do not expect major obstacles to Croatia's access to international financial markets.

Investment plans are expected to materialize slower than Government projects.

The Government seems determined to induce a major increase in investments of public companies and to remove administrative barriers for private investments. Although we do believe that many of the announced projects will be initiated, our assumption regarding their volume in this year is much more modest than what the Government has planned. Namely, the Government's projection points to the overall investment growth of 11.5 percent in 2013 which we do not see as plausible. Financial constraints for public sector investments may prove to be much tighter than was initially thought.

Monetary policy will remain focused on exchange rate stability.

We assume that a stable HRK/EUR exchange rate will remain the top priority of monetary authorities as this is believed to provide favorable environment for maintaining macroeconomic and financial stability. Options of moderate monetary easing are being considered only within the framework of a stable exchange rate.

GDP expected to fall by 0.2 percent in 2013.

In the context of the abovementioned assumptions, both the delayed recovery of the eurozone and the observed negative trends in the Croatian economy have significantly affected our projections. First, our GDP growth estimate for 2012 is revised downwards to -1.9 percent. Then, mainly as a result of a continued reduction in domestic demand and delays in investment projects in the public sector, we expect the recovery to be much more subdued and slower than what was thought three months ago. GDP is projected to further shrink in the first half of this year, and a positive trend should emerge in the second half. The recovery will strengthen in 2014, underpinned by the revival of foreign demand and positive effects of EU membership. For 2013 as a whole we project a GDP decline of 0.2 percent, followed by a 1.5 percent increase in 2014.

Personal consumption will continue to decline; investments will recover gradually.

In 2012 personal consumption is estimated to have declined by 2.6 percent. This year we expect further decrease of 1.2 percent, followed by mild recovery in 2014. Reduced disposable income, deleveraging and depressed consumer confidence are the main reasons for weaker personal consumption. Government expenditure on goods and services, i.e. government consumption according to the national accounts definition, is projected to contract by 1.0 and 0.6 percent in real terms in 2013 and 2014, respectively. Investment outlook is marked by high uncertainty. On one side, there is a negative trend without any signs of recovery, while on the other side the Government is announcing an investment boom. This year we expect a reversal in the investment trend but the pace of this recovery will be much slower than what the Government foresees. It will take time for the private sector to increase confidence and start investment projects that were postponed either due to recession or administrative barriers. Overall, we project the rise of investments of 1.5 percent this and 5.7 percent next year.

Narrowing of current account deficit.

Net exports are expected to positively contribute to the overall growth, due to a rise in exports and stagnation in total imports. However, due to a subdued demand in the eurozone, as well as problems with the competitiveness of Croatia's merchandise exports, rise in total exports is expected to be small, 1.4 percent this and 1.8 percent next year. As a result of weak domestic demand, we expect total imports to stagnate this year and slightly strengthen next year. Consequently, current account deficit estimated at 0.5 percent of GDP for 2012 should narrow this year and close in 2014. Due to deleveraging in the household and enterprise sectors, Croatia's foreign debt will slightly decrease this year and fall below 100 percent of GDP in 2014.

Labor market conditions to further deteriorate in the near future.

Labor market conditions are anticipated to further deteriorate. Weak product demand and pressing need for structural adjustment in a number of large companies, put a drag on employment prospects. Unemployment is expected to reach its peak in the first quarter of 2013, followed by a seasonal relief. Nevertheless, unemployment levels will remain well above the 2012 levels. On average, registered unemployment rate for 2013 is projected at 20.2 percent or 1.2 percentage points above the estimate for 2012. The projection for 2014 is close to the one for 2013, 20.0 percent, with a possibility for further reduction in case the labor market policy becomes more supportive to job creation. As far as wages are concerned – no significant nominal changes are expected in 2013 and 2014, while real wages and real disposable income are likely to decline even further.

Financial flows conductive for stability of the exchange rate.

In this year, we expect the HRK/EUR exchange rate to remain close to its last year's values. Government borrowing abroad is expected to continue despite the downgraded rating and ensure, in addition to exports and foreign capital inflows, a sufficient flow of foreign currency funds to maintain exchange rate stability. Next year, the average exchange rate could mildly depreciate to 7.55 mostly as a result of increased need for foreign debt servicing.

Credit sluggishness on both the demand and the supply side.

Credit demand of the private sector is expected to remain weak, while credit supply will be constrained by the fears of non-performing loans. Retail interest rates on deposits and lending are likely to decline just slightly below their current levels to continue encouraging savings and to account for high lending risks. Although the policy of high interest rates might erode commercial banks' profits, due to subdued credit extension, it may also improve their balance sheets and ensure ample liquidity in the money market. In that case, the central bank might refrain from larger scale monetary easing due to exchange rate stability concerns. We expect very mild credit growth of 1 percent in this year, followed by a small improvement of 3 percent in 2014. At the same time, broad money creation is expected to grow 3 percent this year and 5 percent next year.

Lower inflation due to continued weakness of consumer demand.

In 2013 consumer price inflation is projected to moderate at around 3 percent. Downside pressures will arise from a weakening demand and vanishing base effect of 2012 price hikes. Also, the majority of the announced administrative price hikes have already occurred. Only few of them are left for this year, such as heating prices in several cities, prices of bread, milk and medicine due to introduction of a 5-percent VAT rate, and tobacco prices due to a rise in excise taxes. In spite of certain risks related to imported inflation from global food and energy markets, our projection indicates that the declining inflation trend will continue in 2014 by reaching the rates of around 2 percent.

Disregard of the fiscal rule…

According to the 2013 Budget, total revenue of consolidated central government should be HRK 117.4 billion, which seems attainable despite the Government's overoptimistic assumption of a 1.8-percent GDP growth. Tax changes (foremost the replacement of zero with 5-percent VAT rate on bread, milk and medicine, decrease in VAT rate for restaurant services, increase in tobacco excises, improved tax control of realized cash turnovers, and possibly introduction of real estate tax, as explained in Box 1) are expected, on net, to ensure planned revenue in 2013. Total expenditure of the consolidated central government is planned at HRK 130.7 billion, up by HRK 5 billion compared to the revised 2012 plan. The wage bill is supposed to be cut, but as experience teaches us, this seems easier said than done. This cut, planned at around HRK 1.8 billion compared to the revised 2012 budget, may well end up undone, just as it did in 2012. The Government plans expenditure-to-GDP ratio of 37.2 percent in 2013, which is higher than in the revised budget for 2012 with the ratio of 36.4 percent. Such changes point to the disregard of the Fiscal Responsibility Act which requires 1-percentage point cut in the ratio each year, as long as the primary budget balance is negative. Technically speaking, the assessment of compliance should be based on data compiled according to the ESA95 at the level of general government. However, due to lack of such data, the indicators presented are calculated using the data compiled on the basis of national accounting principles at the level of central government. Such calculation is not perfectly accurate but the deviation between the expenditure ratio according to the budget plan and the requirements of the fiscal rule is large enough that it is almost certain the fiscal rule will be broken in 2013. Our simplified calculation based on the revised 2012 budget figures, suggests a high possibility that the Act was not respected in 2012 as well.

… and higher fiscal deficit in 2013.

The general government deficit in 2013 is officially planned at 3.8 percent of GDP, up from 3.5 percent estimated for 2012. There are at least two reasons why we believe that deficit figures will be higher in both years. Firstly, our GDP projections involve lower GDP levels in 2012 and 2013, and secondly, as already mentioned, we do not expect the wage bill to be cut by the planned amount and we believe that total expenditure will be higher. After a translation from national accounting rules to ESA95, we see fiscal deficit at around 4.5 percent of GDP in 2012 and its widening to 4.6 percent of GDP in 2013. As for 2014, economic recovery and planned fiscal policy are expected to end up with a deficit at around 4.2 percent of GDP.

Table 2 SUMMARY OF PROJECTIONS

	2012 estimate	2013 projection	2014 projection
Real GDP (% change)	**-1.9**	**-0.2**	**1.5**
Real private consumption (% change)	-2.6	-1.2	0.2
Real government consumption (% change)	-0.6	-1.0	-0.6
Real investment (% change)	-4.4	1.5	5.7
Exports of goods and services (constant prices, % change)	0.3	1.4	1.8
Imports of goods and services (constant prices, % change)	-1.6	0.2	1.4
Current account balance (% of GDP)	-0.5	-0.2	0.0
Consumer prices (% change, pa)	3.4	3.0	2.2
Exchange rate, HRK/EUR (pa)	7.52	7.53	7.55
Unemployment rate (registered, %, pa)	19.1	20.2	20.0
General government balance (ESA95 definition, % of GDP)	-4.5	-4.6	-4.2
Broad money, M4 (% change, eop)	2.7	3.0	5.0
Total domestic credit (% change, eop)	-3.5	1.0	3.0

Notes: *Cut-off date for information used in the compilation of projections was January 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

Will Croatia's EU entry pass as smoothly as planned?

The process of ratification of the Accession Treaty between Croatia and EU member states is expected to be finished by July 1, 2013 but that date should not be taken for granted. Some countries that have not yet started the process – foremost Germany – expect the Croatian Government to exhibit significant improvement in all areas that were identified in the October 2012 Monitoring EC Report as deficient compared to the membership requirements. These areas include the preparation for proper management of the EU structural funds, the restructuring of the shipbuilding industry, further improvement in public administration and justice system, effective fight against corruption as well as the management of external borders. Final EC report on the three chapters (competition policy, judiciary and fundamental rights, as well as freedom, justice and security) is expected by the end of March. Also, Slovenia repeatedly urges that it will not ratify the Treaty unless it is resolved how to settle the debt of Slovenian bankrupt bank, Ljubljanska banka, towards Croatian clients.

What will be the costs and benefits of EU accession?

There is uncertainty regarding the near-term balance between costs and benefits of Croatia's EU accession. For example, it is questionable whether Croatian capacities are large enough to ensure adequate use of resources available through the EU funds. On the cost side, there is a problem of trade with the CEFTA countries, Croatia's important trade partners, in particular Bosnia and Herzegovina and Serbia. They might come under different customs regime as Croatia enters the EU which in turn would impede trade unless some kind of agreement is reached on time.

Will the rating downgrade make any difference?

An important uncertainty regarding fiscal projections for 2013 and 2014 arises from a longer-term reaction of financial markets on the recent lowering of the sovereign credit rating. Although the negative reaction, in terms of the higher CDS spread, was short-lived, the Government should take the downgrade as an indication that it is now under closer watch than before. We fear that if the Government does not show clear signs of coming to grips with the much-needed reforms, the financial market could react by rising the interest rates with a detrimental effect on the economy. Such a clear sign could be the revision of the 2013 Budget that should incorporate a more realistic growth assumption and demonstrate a viable plan for sustainable fiscal consolidation. Also, structural reforms need to be speeded up this year in order to satisfy the EU membership requirements, finish the ratification process smoothly and, even more importantly, in order to spur some of the growth drivers over the medium term.

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