The Institute of Economics, Zagreb

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Croatian Economic Outlook

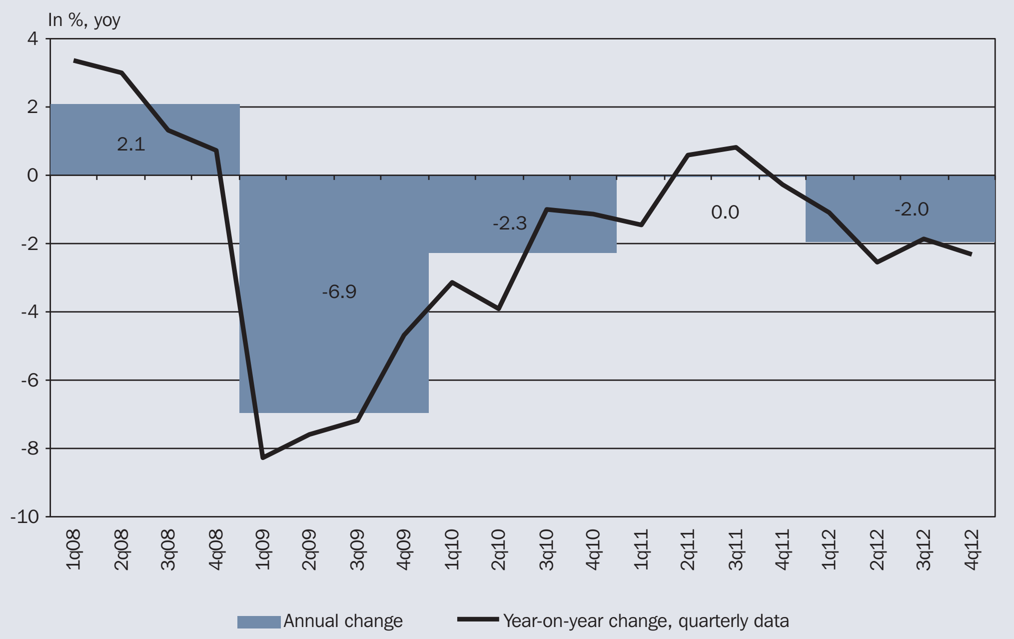
Quarterly

1 Recent Developments

Disappointing economic activity in the fourth quarter of 2012...

Economic activity in the last quarter of 2012 was disappointing because GDP declined 2.3 percent year-on-year contributing to a 2.0-percent GDP decline in 2012 as a whole. In the fourth quarter, seasonally adjusted GDP declined 0.8 percent compared to the previous three months, which is another drop in activity following stagnation in the previous quarter. On the demand side, personal consumption, investments and, to a somewhat lesser extent, government consumption, were major contributors to the contraction. On the production side, there was a striking divergence in output trends between sectors of goods-producing industries (agriculture, industry and construction), market services (distributive trade, ICT, financial, business and personal services) and public services (public administration, education and health). In the last quarter of 2012 compared to the same quarter a year ago, the value added realized in the goods-producing industries declined by 5.7 percent, in market services by 2.9 percent, while in public services it remained at the same level (Figure 2). The activity of the goods-producing industries has recently experienced severe decline, with the output in 2012 being 22.9 percent lower than in 2008. In the same period, market services experienced a decline of 7.9 percent, while public services increased their output by 3 percent. In 2012, overall activity measured by real GDP was 10.9 percent below the peak reached in 2008.

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

… seems to continue this year.

Negative developments seem to have continued this year, although there are a few encouraging signals sent by high-frequency indicators. Seasonally adjusted volume of retail trade remains on the downsizing track, but industrial production gives out mixed signals with a notable rebound in January and a drop in February. It appears that January was a very good month for construction activity after an extremely weak December. Registered unemployment increased in the first two months, but declined in March leading to stagnation in its seasonally adjusted level. Lending activity has remained far below its last year's level, but money supply has somewhat increased. Overall, we are inclined to expect negative movements to dominate over positive ones as the CEIZ index (Coincident Economic Index of the Institute of Economics, Zagreb) remained negatively sloped in January and February pointing to a high probability of decline in seasonally adjusted GDP in the first quarter of 2013 thus indicating that the recession continues.

Declining personal consumption pulls down overall activity.

Personal consumption was the most important demand factor contributing to the recent intensification of the negative GDP trend. In the fourth quarter of 2012 it fell by 4.2 percent year-on-year, following a 3.5 percent decline in the third quarter. Reduced real disposable income, deteriorated prospects for the labor market and the ongoing deleveraging coupled with weak consumer confidence have resulted in substantial reduction of household purchases.

Government consumption receded at the end of 2012.

Following volatile movements over the last two years, which pointed to unchanged levels of government consumption on average, the last quarter of 2012 brought a notable decline. Compared to the same quarter of 2011, Government spent 2 percent less in real terms helping to reach the reduction of 0.8 percent for the entire 2012. It appears that pressure to rationalize was particularly strong at the end of the year, possibly in order to meet hard budget constraints. The observed lower consumption is in line with fiscal consolidation undertaken by the Government and hopefully does not hide postponed consumption which is due to materialize in 2013.

Although at a slower pace, investments continue to decline.

Gross fixed capital formation i.e. investments dropped by 4.9 percent year-on-year in the fourth quarter of 2012 and 4.6 percent in 2012 as a whole. The latest developments in seasonally adjusted terms point to a moderation of the negative trend. On the quarter-to-quarter basis, investments declined 0.6 percent in the fourth quarter of 2012, while in the first two quarters of that year decline amounted to about 2 percent. The pace of

Figure 2 VALUE-ADDED GROWTH BY SECTORS

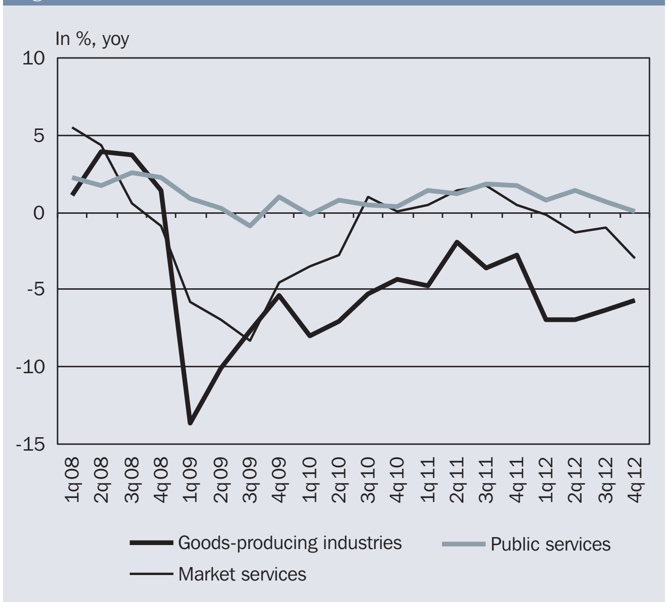
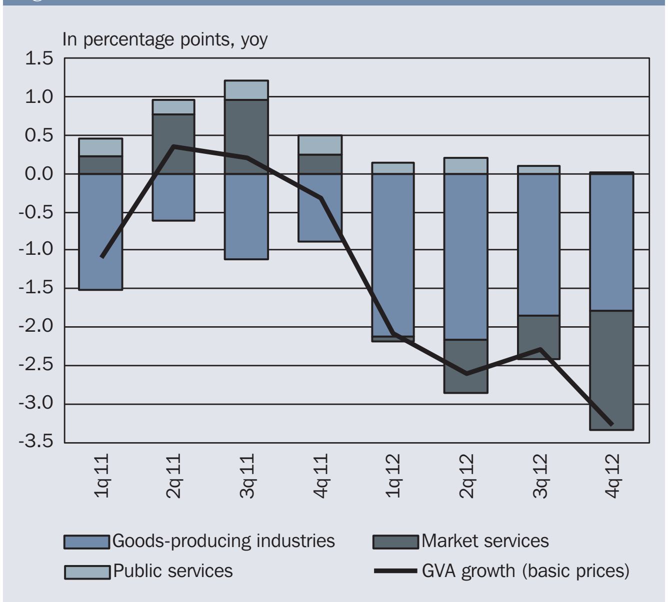


Figure 3 CONTRIBUTIONS TO GROSS VALUE-ADDED GROWTH



Notes: *Goods-producing industries are agriculture, industry and construction; market services are distributive trade, ICT, finacial, business and personal services; public services are public administration, education and health.*
Source for original data: *Croatian Bureau of Statistics.*

investments is far behind Government's expectations expressed in a number of policy documents and in spite of the approaching EU membership. Any recovery would still be hindered by weak domestic demand, uncertain economic prospects, and ongoing balance-sheet adjustments. Reversal of the trend in this year would require a sizeable policy engagement, not only in the public sector, but also to promote and encourage private sector investments, particularly the foreign ones.

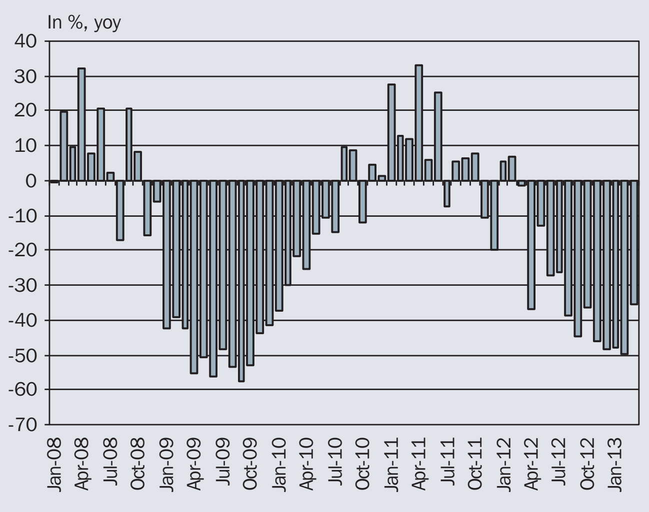
Foreign trade surplus emerges in the wake of falling imports.

Last year saw a slowly rising volume of total exports and a continued weakening of total imports. In the fourth quarter of 2012, exports increased by 3.2 percent and imports decreased by 1.6 percent year-on-year. Corresponding figures for the entire 2012 were 0.4 and -2.1 percent for exports and imports, respectively. Balance of payments data reveal that expansion of total exports in 2012 was due to the rising export of services, mostly receipts from international tourism that increased by 3.2 percent in current euro terms. Merchandise exports were stagnant and their 2012 level was almost the same as the pre-crisis one, thereby indicating a continued competitiveness problem. Reduced imports were caused by weak domestic demand. The above mentioned developments have allowed for a surplus in foreign trade of goods and services of some EUR 370 million and a current account surplus of EUR 35 million. The latter proves to be the first surplus in the last 14 years for which there are comparable current account statistics. It also helped to contain foreign indebtedness which declined from EUR 45.7 billion at the end of 2011 to EUR 44.9 billion at the end of 2012, i.e. from 103.0 to 102.3 percent of GDP.

Negative trend in industrial production halted.

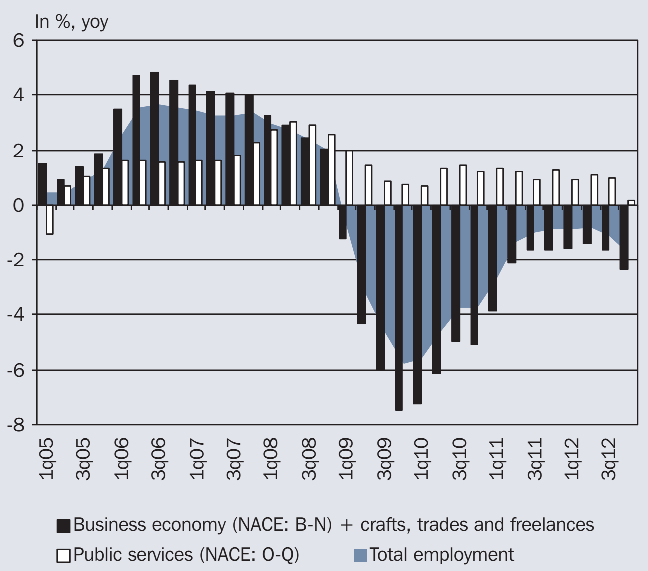
After so much bad news on the state of economy it comes as a surprise that industrial production in the first two months this year was on average 3 percent stronger than in the fourth quarter last year. In addition, the negative trend has been halted since November. These figures should be taken with caution as the start of the year brings change in the weights of individual branches within the total industry index which, as we have witnessed in the past, may cause some unusual noise either on the positive or on the negative side. In the first two months this year, industrial activity was 0.9 percent larger than in the same period a year ago with the largest positive contributions from food industry, production of metal products as well as energy sector. As opposed to industrial production, retail trade trend remains negative. In the first two months of 2013 average monthly retail trade was 0.2 percent lower than in the last three months of 2012. An exceptionally strong drop was present in car sales. The number of registered passenger cars decreased by more than

Figure 4 NEWLY REGISTERED PASSENGER CARS



Source: *Promocija plus (http://www.autonet.hr/rubrika/hr-trziste).*

Figure 5 EMPLOYMENT CHANGES



Source: *Croatian Bureau of Statistics.*

40 percent, contributing to the overall decline of retail trade volume by over 6 percent in the January-February period year-on-year. In 2012, construction activity registered a negative trend with year-on-year decline reaching 12 percent. Nevertheless, most recent observations suggest a modest pick-up in activity.

Labor market conditions deteriorate further.

Unemployment increased sharply in the second half of last year and continued to rise at the beginning of this year, but at a more moderate pace. Registered unemployment rate reached 21.7 percent in January and 21.9 percent in February. Survey-based unemployment rate (ILO methodology) for the population aged 15-64 climbed to 18.5 percent in the fourth quarter of 2012. In spite of the decline in the number of unemployed registered at the Employment Service in March, which was reflected in a lower seasonally adjusted figure and a reversal in unemployment trend, the labor market situation remained unfavorable. The March unemployment figure is still 7.4 percent higher than a year ago. Also, available data on employment are rather disappointing. Registered employment in February was 3.0 percent lower than a year ago whereas for 2012 as a whole there was an average decrease of 1.1 percent. Almost all activities with predominantly private ownership, including crafts, trades and freelances, experienced a fall in employment, while public services recorded stagnation or even a slight rise. This indicates that the burden of adjustment is still entirely within the private sector.

Real incomes keep falling.

In spite of unfavorable labor market conditions, the average wage continued to increase. Average monthly gross wage was HRK 7,954 (app. EUR 1,055) in the fourth quarter of 2012, which is 1.7 percent above the previous quarter and 0.4 percent more than in the fourth quarter of 2011. In 2012 as a whole, the average gross wage increased by 1 percent. Due to a relatively high consumer price inflation, the average wage has declined in real terms, 2.4 percent on average for the entire 2012 and 4.2 percent in the fourth quarter. Changes in the average wage, employment reduction and developments in the distribution of transfers such as pensions, unemployment benefits, and social security benefits caused a notable reduction of real disposable income last year that is estimated at more than 4 percent on average and almost 6 percent in the fourth quarter.

Lending plunge coupled with weak money creation.

Monetary developments reflect unfavorable conditions in the real economy indicating poorly increasing money supply and notable decrease in credit activity. In February 2013, narrow money increased by 3.6 percent year-on-year, the highest rate since December 2011, which is mostly due to the low-base effect that kicked in due to a mandatory reserve rate hike from last year. When adjusted for the base effect, narrow money growth actually decelerated. Lending has continued to plunge and in January it decreased by 4.4 percent compared to the same month one year before. The loan structure reveals that the corporate sector deleveraged by 11.4 percent. This is caused by the still serious economic deterioration, lack of investment ventures but also more rational and careful financial management. The latter conclusion stems from the fact that some big enterprises increased their foreign debt in order to close some of their more expensive domestic financing, so corporate deleveraging was actually a bit more moderate than implied by domestic credit data. Households reduced their loans by 2.2 percent in a year up to January 2013, continuing the downward trend that started off in July last year. On the other hand, Government continues to increase its borrowing on the domestic market. It has issued a large amount of short-term debt at relatively low interest rates. Even if the takeover of the state-owned shipyards' loans in May last year is excluded, the Government increased its domestic debt by approximately 8 percent during one-year time.

Money market liquidity remains high…

The liquidity of the banking system has been more than satisfactory as banks increased their overnight deposits at the central bank up to HRK 8 billion in the first week of April. Throughout the first quarter of 2013 money market liquidity was exceptionally high as well: on average HRK 5.1 billion. Ample liquidity caused record-low short-term interest rates that amounted to 0.3 and 2.2 percent in March, for one-month and one-year inter-bank

Table 1 MAIN ECONOMIC INDICATORS

	2011	2012	2012			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	0.0	-2.0	-1.1	-2.5	-1.9	-2.3
Real private consumption (% change, yoy)	0.2	-3.0	-0.9	-3.2	-3.5	-4.2
Real government consumption (% change, yoy)	-0.6	-0.8	-1.1	0.3	-0.4	-2.0
Real investment (% change, yoy)	-6.4	-4.6	-3.9	-5.1	-4.4	-4.9
Industrial output (% change, yoy)	-1.2	-5.5	-5.4	-6.7	-4.5	-5.7
Unemployment rate (registered, %, pa)	17.8	18.9	19.8	17.9	17.6	20.1
Nominal GDP (EUR million)	44,412	43,929	-	-	-	-
GDP per capita (EUR)	10,377	10,295	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	2.0	2.0	1.2	2.0	2.1	2.8
Consumer prices (% change, yoy, pa)	2.3	3.4	1.5	3.4	4.1	4.6
Producer prices (% change, yoy, pa)	6.3	7.0	6.1	6.8	7.9	7.3
Average gross wage (% change, yoy, pa)	1.5	1.0	2.1	0.9	0.6	0.4
Exchange rate, HRK/EUR (pa)	7.43	7.52	7.56	7.52	7.47	7.52
Exchange rate, HRK/US$ (pa)	5.34	5.85	5.76	5.86	5.97	5.80
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,582	9,609	2,254	2,325	2,472	2,559
Exports of goods (EUR, % change, yoy)	7.6	0.3	2.7	-8.1	0.1	7.1
Imports of goods (EUR million)	16,281	16.164	3,891	4,153	4,157	3,963
Imports of goods (EUR, % change, yoy)	7.6	-0.7	2.1	-3.1	-1.3	-0.2
Current account balance (EUR million)	-385	35	-1,585	-287	2,573	-665
Current account balance (% of GDP)	-0.9	0.1	-	-	-	-
Gross foreign direct investment (EUR million)	1,080	973	90	304	184	396
Foreign exchange reserves (EUR million, eop)	11,195	11,236	11,340	11,635	11,384	11,236
Foreign debt (EUR million, eop)	45,734	44,935	45,928	46,563	45,551	44,935
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,025	126,132	28,931	60,654	93,150	126,132
Expense (HRK million)**	132,945	132,413	32,248	64,826	98,700	132,413
Net = Gross operating balance (HRK million)**	-9,920	-6,282	-3,317	-4,172	-5,550	-6,282
Net acquisition of non-financial assets (HRK million)**	5,044	4,574	729	1,428	2,444	4,574
Net lending/borrowing (HRK million)**	-14,964	-10,855	-4,046	-5,600	-7,994	-10,855
Domestic government debt (EUR million, eop)	13,716	15,225	14,613	14,721	15,192	15,225
Foreign government debt (EUR million, eop)	6,996	8,353	7,093	8,188	8,123	8,353
Total government debt (% of GDP)	47.2	53.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	7.5	1.6	-3.6	-2.3	3.0	1.6
Broad money, M4 (% change, yoy, eop)	1.6	3.2	2.6	3.3	2.1	3.2
Total domestic credit (% change, yoy, eop)	4.9	-3.9	5.6	2.6	-0.6	-3.9
DMBs credit to households (% change, yoy, eop)	1.0.	-1.4	2.0	0.2	-2.0	-1.4
DMBs credit to enterprises (% change, yoy, eop)	8.7	-11.2	9.0	2.0	-2.3	-11.2
Money market interest rate (%, pa)	0.9	1.1	1.6	0.5	1.7	0.5
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	7.3	7.9	7.1	7.1	7.0
DMBs credit rate for households, short-term (%, pa)	11.9	11.2	11.2	11.2	11.2	11.2

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

deposits, respectively. However, these low interest rates have only partially materialized on the retail market. Although the latest February data suggest that banks' interest rates on kuna deposits did actually fall below 2 percent on average, interest rates on kuna credits experienced only a negligible decrease. The interest rate spread between kuna deposits and credits in February was as high as 7.5 percentage points, significantly above its 15-year average. This only shows that ample liquidity and poor credit demand are keeping deposit rates at low levels. Additionally, banks are not particularly interested in lowering credit interest rates in an uncertain environment as they are prone to improve deposit-to-loan ratios.

… and the HRK/EUR exchange rate stable.

The HRK/EUR exchange rate was relatively stable in the first quarter, although at the level that was on average by 0.3 percent higher than in the first quarter one year ago. It seems that the sovereign rating downgrades and the recent events in Cyprus did not spill over to the Croatian foreign exchange market. Massive government foreign currency borrowing in the amount of US$ 1.5 billion served as a stabilizing factor. However, in the beginning of April exchange rate began to climb over 7.60 kuna per euro and the Croatian National Bank decided to intervene by selling EUR 214.9 million. Gross international reserves, which were built up slightly over the last year, decreased by 0.1 billion EUR from the beginning of the year, mostly because the central bank sold HRK 1.2 billion in foreign currency to the Government.

Non-performing loans on the rise.

The central bank is becoming more and more concerned with deteriorating credit portfolio of the banking system. In the last quarter of 2012, non-performing loans of the private sector reached 16.5 percent of total loans, up by 2.3 percentage points in one-year time. The proportion of bad loans was substantially higher in the corporate sector, 24.7 percent, compared to the household sector with 9.5 percent. Households' housing loans and cars loans are the best performing loans in the market as only 6.2 and 5.0 percent of these loans are subject to repayment difficulties, although these rates are on the rise too. In such a situation, the central bank has announced changes in the loan loss provisioning by tightening the definitions for classification of loans in order to increase the reserve levels.

Inflation rate decreased in March.

Consumer price inflation measured as month-to-month rate was negative in November and December of 2012 and it turned slightly positive in the first three months of 2013. However, on the year-on-year basis inflation rate in March decreased to 3.7 percent from 4.9 percent recorded in February mostly due to last year's March price hike initiated by a higher standard VAT-rate which affected all year-on-year inflation rates in the previous one-year time. Lower VAT rate for catering services was expected to push prices further down at the beginning of this year, but that has not materialized. Consumer price inflation without food and energy prices declined a bit in March, to 1.9 percent from 2.6 percent in February.

Higher government revenue...

General government revenue increased by 4.6 percent in the last quarter of 2012 relative to the same quarter 2011 owing mostly to a 14.7-percent increase in VAT revenue and a 8.7-percent increase in excise revenue, particularly from excises on tobacco products. In 2012 as a whole the revenue amounted to HRK 126.1 billion, 2.5 percent more than in 2011. Good revenue collection was achieved in spite of unfavorable general economic circumstances and primarily as a result of the increase in standard VAT rate from 23 to 25 percent in March last year which made a 7.8-percent increase in the VAT revenue possible. Personal income and profit tax revenues increased by 6.5 and 5.6 percent, respectively. Social security contributions fell by 1.9 percent as a net result of a 2-percentage point reduction in the health contribution rate in May and a notable improvement in the collection of social security contributions in general. Had the collection of this revenue not been improved, the fall would certainly have been greater given the decline in employment.

… and a minor expenditure reduction in 2012.

The last quarter of 2012 saw a 3.4-percent decline in general government expenditure compared to the same quarter of the previous year. This is mainly a consequence of the decline in two biggest expenditure items, compensation of employees and social benefits, which were reduced by 5.4 and 4.7 percent, respectively. Expenditure reduction was much milder at the whole-year level. The expenditure in 2012 amounted to HRK 132.4 billion, a mere 0.4 billion less than in 2011. Expenditures for compensation of employees and social benefits fell slightly, about half percent each. There were also cuts in purchases of goods and services of 2.4 percent and especially in subsidies, which declined by 10.6 percent, mostly due to weaker subsidizing of agriculture. With a 16.9-percent increase, interest payments are the only major expenditure item that increased in 2012. Share of interest payments in total expenditure has become relatively large, 6.7 percent. In 2012 interest payments reached levels that are close to the amount of overall government deficit, showing how severely fiscal imbalances from past periods jeopardize the present fiscal balance (Figure 7).

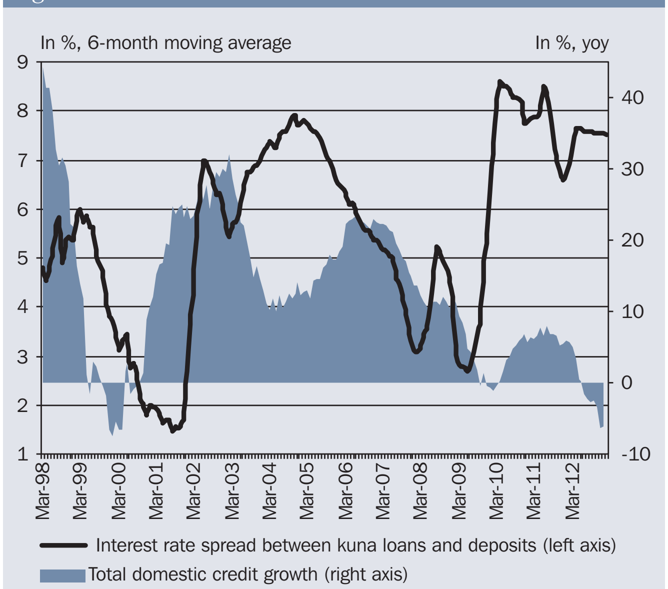
Fiscal rule broken in 2012…

According to the fiscal rule enshrined in the Fiscal Responsibility Act, the ratio of total general government expenditure to GDP is to be reduced by one percentage point every year as long as the primary balance of the general government is negative. For 2011, expenditure-to-GDP ratio was 42.0 percent, while for 2012 it was about 41.7 percent, meaning that the fiscal rule has been broken. Strictly speaking, all expenditures for co-financing of EU funded projects should be excluded from total expenditure and ESA95 methodology should be applied, while here we present data based on the national accounting methodology without exclusion of any kind of expenditure. However, in spite of these shortcomings it is highly likely that the resulting expenditure-to-GDP ratio was not decreased enough to obey the fiscal rule.

… as deficit reduction came primarily from the revenue side.

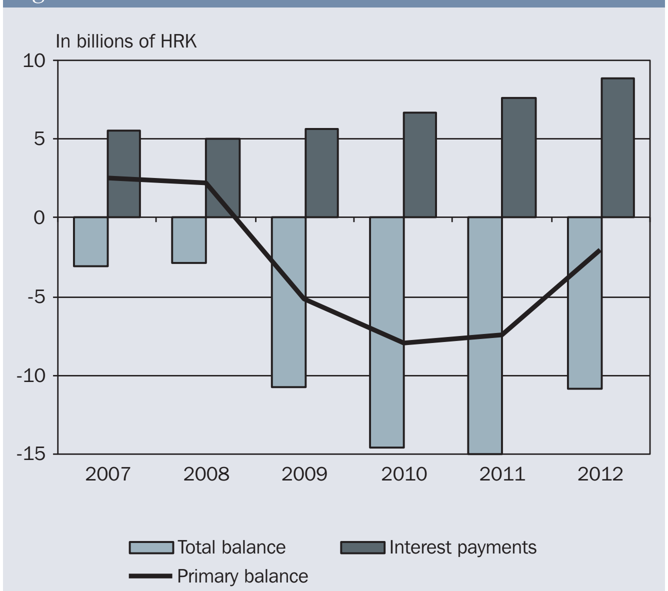
According to national accounting rules, 2012 ended with a deficit of HRK 10.9 billion. This implies the deficit-to-GDP ratio of 3.3 percent, which is less than Government's previous expectations (3.5 percent). Due to the lack of detailed data required for the computation of the deficit in accordance with ESA95 methodology, we rely on our rough appraisal of methodological differences between the national and ESA95 rules and estimate 2012 general government deficit to be 4.6 percent of GDP. This is by about 0.6 percentage points less than the deficit figure reported for 2011. Regardless of methodology, it stands out that fiscal consolidation in 2012 resulted more from harsher taxation than from expenditure reduction.

Figure 6 DOMESTIC CREDITS AND INTEREST RATE SPREAD



Source for original data: *Croatian National Bank.*

Figure 7 GENERAL GOVERNMENT'S FISCAL BALANCE



Note: *According to national accounting methodology.*
Source: *Ministry of Finance.*

Box 1 FIRST BUDGET REVISION IN 2013 SENT TO THE PARLIAMENT, SECOND ONE IS EXPECTED

On 21 March this year the Government sent to the Parliament a proposal for budget revision. Both the revenue and expenditure are revised downward by HRK 254 and 874 million, respectively. Consolidation with extra-budgetary users at the level of central government implies a downward correction of HRK 141 million for total revenues and HRK 1,841 million for total expenditure. As explained by the Government, the revision is proposed because the original plan was based on the expectation of a 1.8-percent GDP growth, whereas now it is more likely that it will be lower, about 0.7 percent. As this revision came rather early and there is a high probability of further downward revision of the growth projection, one can expect another revision in the second half of the year. It is, however, difficult to say with reasonable certainty which direction such a revision would take. There are some reasons to expect that the favorable revenue dynamics observed in 2012 may continue. Tax compliance has been notably improved. The Ministry of Finance has recently reported that the introduction of fiscal cash registers has so far produced favorable results, and their coverage will be broadened during 2013. In addition, installment agreements for payments of tax debts have been offered. It also seems likely that the real estate tax will be introduced, despite some disagreements within the ruling coalition, which might bring additional revenue. On the other hand, we cannot disregard the possibility that the revenue dynamics may worsen in light of the continuation of the recession, in which case the total revenue will have to be revised downwards. Indeed, the Minister of Finance himself has already mentioned on a few occasions that the amount of revenue collected so far falls somewhat short of the plan.

As regards total expenditure, we do not consider the cuts planned on the expenditure side credible enough as the budget proposal does not offer sufficient information on policies that should deliver such an outcome. It would not have been the first time that the originally planned expenditure cuts end up unaccomplished. This is especially so when it comes to two biggest expenditure components, namely employees' compensation and social benefits, which are politically costly to cut. In addition, the Government seems to have given up the fiscal rule from the Fiscal Responsibility Act as the budget plan implies that the rule will be broken in 2013. The revised budget implies the deficit-to-GDP ratio for the consolidated general government of 3.4 percent according to national accounting rules, down from 3.9 percent implied by the original budget.

Sizeable public debt increase.

Regarding public debt, the Croatian National Bank reported that it has reached 53.7 percent of GDP at the end of 2012, 6.5 percentage points more than at the end of 2011. Almost half of the increase in public debt was due to the Government's takeover of the state-owned shipyards' debts. Downgrading of Croatia's credit rating to the speculative level did not lead to an increase in interest rates despite the rising Croatian CDS spread in the first quarter of 2013. On 26 March this year Croatia issued a 10-year, US$ 1.5 billion bond with an interest rate of 5.625 percent.

2 Policy Assumptions and Projections Summary

Outside the eurozone, global economy is slowly gaining momentum.

As for the assumptions on the international environment, it can be asserted that the global economic situation has improved over the last couple of months. Although recovery is still fragile, growth is gradually gaining momentum. The latest IMF projections (*World Economic Outlook*, IMF, April 2013) suggest that global activity should expand by 3.3 percent in 2013 and by 4 percent in 2014. One should, however, keep in mind that a number of uncertainties continue to constrain medium-term growth outlook in many advanced and developing countries. Rising fiscal deficits and public debts, high levels of household debts, elevated unemployment as well as possibility of insufficient structural reforms in the eurozone belong to a long list of factors that might still revert the global recovery process. As for the eurozone, its GDP declined 0.6 percent in the last quarter 2012 compared to the preceding three months. Nevertheless, economic trends seem to have stabilized this year, which should allow for a pick-up in recovery in the second half of the year. IMF has revised its forecast for the eurozone slightly downwards and it now foresees GDP decline of 0.3 percent in 2013, before recovery strengthens allowing for a positive 1.1-percent GDP growth in 2014. For EU as a whole, IMF predicts 0-growth this year and 1.3 percent growth in 2014. However, it is worrisome that out of Croatia's three most important foreign trade partners, two, Italy and Slovenia, are still in recession and further contraction of activity is expected this year.

Croatia is set to become the 28th EU member on July 1, 2013.

Over the past several weeks all the remaining uncertainties regarding Croatia's accession to EU on July 1 have disappeared following the agreement with Slovenia over Ljubljanska banka and the positive opinion by the European Commission that was awaited by the remaining EU members who have not yet ratified the Accession Treaty. At mid-year Croatia will become the 28th EU member.

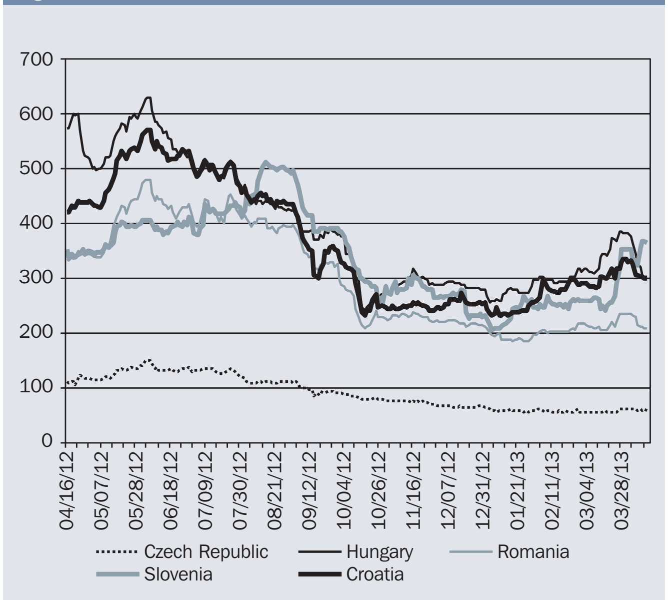
Headline deficit assumed to be the main fiscal policy target.

When it comes to assumptions on domestic policies we expect fiscal authorities to make every effort to keep fiscal deficit at a lower level than a year ago. As for now, fiscal deficit seems to be the main policy target, while the expenditure-based fiscal rule as defined by the Fiscal Responsibility Act no longer seems to be relevant. There is a possibility that the current rule will soon be changed. Indeed, there were lately some talks with the IMF regarding their technical assistance in revising the rule so that it takes more account of the cyclical position of the economy and is more aligned with fiscal rules required in the EU fiscal coordination processes. As one might note from the April budget revision, fiscal consolidation is expected to remain in the focus of policy-makers, but presumably more intensively on the revenue than on the expenditure side of the budget. Monetary authorities are assumed to continue to be concentrated on the stability of the exchange rate. Banking system liquidity is likely to remain high as long as HRK/EUR exchange rate remains within the boundaries that are not officially announced. Still the ceiling is expected to be around 7.60 for this year.

GDP revised downwards and is expected to decline 0.5 percent in 2013…

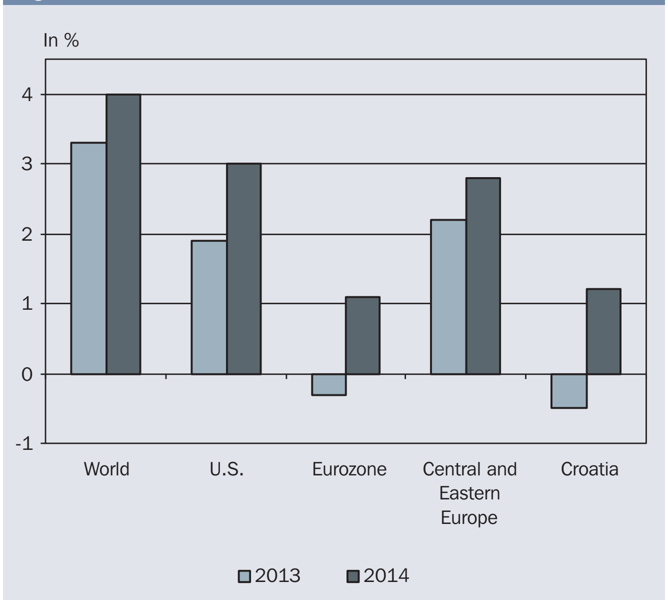
At the beginning of 2013 the economic situation in Croatia is perceived as difficult with almost no sign that the recession could soon end. As a result of such circumstances we have revised our GDP estimate downwards. For 2013 we now expect GDP to decline 0.5 percent compared to 0.2 percent expected three months ago. Two main reasons behind the downward revision are stronger-than-expected decrease of personal consumption and weaker investment activity. Personal consumption continues to be under the strong pressure of declining real disposable income, while the process of household deleveraging continues. Consequently, we expect personal consumption to contract by 2 percent in 2013. Investment activity has continued to exhibit a negative trend and it is becoming more obvious that Government's plans to induce investments have so far not been successful. Investments in the public sector are lagging behind the plan, while the private sector does not seem to be confident and strong enough for new endeavors. In such a situation, investment activity in 2013 is expected to remain broadly at the last year's level,

Figure 8 CDS SPREADS



Source: *DB Research.*

Figure 9 GLOBAL GROWTH PROSPECTS



Sources: *World Economic Outlook, IMF, April 2013; for Croatia EIZ.*

possibly with some improvement towards the end of the year. Government consumption is projected to decline by about 1 percent. In the coming months activities related to the tourism sector should provide some positive spillover effects to the rest of the economy. Due to revenues from tourism and a slight rise in merchandise exports, the overall exports are expected to rise by 1.5 percent this year. Imports are foreseen to decrease as a result of weak domestic demand. In such a situation net exports should contribute positively to GDP growth as opposed to negative contribution from domestic demand which will determine overall negative GDP growth rate in 2013.

… while improved situation in 2014 should allow for a 1.2-percent growth.

In 2014 we expect output revival supported by improved situation in the international environment and positive effects of the EU accession. Our current projection suggests a 1.2 percent rise in GDP. Important drivers of recovery should be investments and the foreign trade sector, while the household sector is projected to continue stagnating. Specifically, investments are projected to rise by 5.6 percent and personal consumption by 0.1 percent while government consumption is expected to contract further by 0.5 percent as a result of continued fiscal consolidation. The foreign trade sector will remain sluggish with total exports rising 1.4 and imports 1.2 percent. Even such sluggish trade is expected to ensure surplus in current account balance, and support foreign debt reduction.

Unemployment on a high track in 2013 and 2014.

Although favorable seasonal factors in the coming months might bring some improvements in the labor market, it does not seem likely that the underlying negative trends will be reversed any time soon. Active labor market policies can offset negative trends only partly, because the planned measures are limited in scope as are the financial resources devoted to them. Our projections indicate average registered unemployment rate for 2013 to be above 20 percent. Projections for 2014 show no improvements due to only fragile recovery of overall activity which needs time to be transposed into higher labor demand. Also, further restructuring in the public sector and state-owned companies is expected, which could involve layoffs of a larger scale. Wages are likely to remain unchanged on average with a risk to be somewhat reduced by the recent decrease of the public-sector gross wages by 3 percent.

Moderation of inflation.

Inflation projection for this year indicates moderation at around 3 percent. Gloomy economic outlook and poor job market prospects will remain the main downside factors behind the projected inflation dynamics. The upside factors in 2013 will be the policy-induced price increases like higher energy and tobacco excise rates. For 2014, we expect consumer price inflation at around 2.2 percent due to still weak domestic demand.

Well grounded HRK/EUR stability prospects.

We see the average HRK/EUR rate around 7.55 this and next year. The main depreciatory risks will stem from higher demand for foreign currency generated by bank provisioning, deleveraging, lower investors' risk appetite but also announcements of more rigid loan loss provisioning. Conversely, expectations of another good tourist season, privatization announcements and successful government financing on the international financial market should release depreciation pressures. It appears that the CNB has plenty of measures and room to defend the stability of the exchange rate.

Lending recovery is not likely in 2013.

Private sector credit activity is expected to decrease further, while it is possible that the borrowing of the public sector will substantially increase. Altogether, 2013 is likely to see loans declining by 2.3 percent. Downside pressures to this projection result from changing regulatory environment, as the central bank and the Ministry of Finance announced they would impose a stricter loan-provisioning requirement and reduce citizens' overdraft limits. These measures could lead to even smaller supply and demand for loans. As for 2014, our forecasts indicate a small positive credit growth rate of 1.7 percent, in line with the projected positive GDP growth rate. Monetary easing of a larger scale is not expected for the time being and accordingly we anticipate broad money to grow by 1.7 percent this and 4.7 percent next year.

Table 2 SUMMARY OF PROJECTIONS

	2013	2014
Real GDP (% change)	**-0.5**	**1.2**
Real private consumption (% change)	-2.0	0.1
Real government consumption (% change)	-1.1	-0.5
Real investment (% change)	0.2	5.6
Exports of goods and services (constant prices, % change)	1.5	1.4
Imports of goods and services (constant prices, % change)	-0.7	1.2
Current account balance (% of GDP)	0.5	0.5
Consumer prices (% change, pa)	3.0	2.2
Exchange rate, HRK/EUR (pa)	7.55	7.55
Unemployment rate (registered, %, pa)	20.3	20.3
General government balance (ESA95 definition, % of GDP)	-4.5	-4.2
Broad money, M4 (% change, eop)	1.7	4.7
Total domestic credit (% change, eop)	-2.3	1.7

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

Moderate reduction in fiscal deficit; public debt will approach 60 percent of GDP.

Based on the revised budget and our transposition from national accounting methodology to ESA95, fiscal deficit is expected to be around 4.5 percent of GDP in this year. It should be stressed that, at the moment, methodological challenges are huge. Alignment of government accounts with ESA95 rules is very much work in progress in both the Ministry of Finance and Croatian Bureau of Statistics. No hard data after recent account adjustments are at disposal and surprises are not excluded. Therefore, our fiscal projections are highly uncertain. In short, we expect 2013 deficit to be slightly lower than the one in 2012. Further deficit reduction is expected in 2014 when Croatia as one of the EU member states will be forced to consolidate its finances in line with the Stability and Growth Pact and other EU fiscal policy coordination rules. As for the public debt, our projections show that it is likely to exceed 57 percent of GDP by the end of 2013 and reach 60 percent in 2014 if meanwhile further corrective actions are not taken.

3 Uncertainties and Risks to Projections

Future trade regime with CEFTA – still unknown.

Uncertainties related to our projections are high and mostly on the downside. Two main groups of uncertainties emerge – one related to direct impact of the upcoming EU membership and the other related to fundamental growth prospects. With the EU entrance, preferential status of Croatian products on CEFTA markets will be abolished and they will face tariff barriers, unless the European Commission and CEFTA negotiators agree on an alternative solution that would apply to all EU members. CEFTA market is important for Croatia (20 percent of total exports of goods), especially for industries such as food and beverages as brands have a well-established reputation in countries of former Yugoslavia. Although accession to EU should have beneficial effects on tourism through easier cross-border travel, due to EU rules visas have to be introduced for Russian, Ukrainian and Turkish citizens, which might have some negative effects on the number of tourists coming from these countries.

Potential migration out of Croatia due to weak economic prospects.

The accession also means that developments in the EU economy will become increasingly important for Croatia. In current circumstances, downside risks surrounding outlook in the eurozone pose a risk for the outlook of Croatian economy. The tourism sector seems particularly vulnerable to a potentially weaker interest of tourists from Slovenia and Italy if prospects of these economies deteriorate further. In addition, EU accession might stimulate emigration, which could release the pressure on the labor market. However, it might induce the best-educated and potentially most productive citizens, mostly young ones, to leave the country.

Positive effects of EU membership.

EU membership might bring some optimism, strengthen the interest of foreign investors for business opportunities in Croatia and improve the image of the country, particularly as a tourist destination. In that respect, certain upside risk exists since we might have underestimated the impact of these factors on halting negative trends and activating potential for recovery. Furthermore, we might have underestimated the absorption capacities for the use of EU funds, especially over the short term.

Existing growth impediments…

The main risk, however, refers to the setting up of strong and sustainable growth drivers in Croatia. Over the last five years of the recession little has been done with respect to the rebalancing of growth factors by strengthening the export sector and attracting foreign investments while putting less emphasis on the domestic demand, in particular the government spending. International competitiveness of the country has remained poor, flexibility and adaptability of the business sector is still low, and institutional inertia predominates. Under such circumstances and having in mind the constraints that exist in the monetary policy (due to preference towards stable exchange rate) and fiscal policy (due to rising public debt and high fiscal deficit) it is hard to expect rapid improvements in growth dynamics despite the positive effects of EU membership. In the short run, further weakening of the consumer and business confidence as well as low investment activity increase risks for recession to last longer than our current projection foresees.

… point to the need for decisive policy action.

In the absence of mighty growth drivers and in the presence of persistently low consumer and business confidence accompanied by the depressed labor market, Croatia has a strong need for a comprehensive policy package accompanied by a credible implementation plan in order to rebuild confidence of markets and the population. Such a program should come without delay and preferably be supported by the IMF and the European Commission in order to strengthen its credibility and ensure more affordable financing with the final aim to restore growth and employment.

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