The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

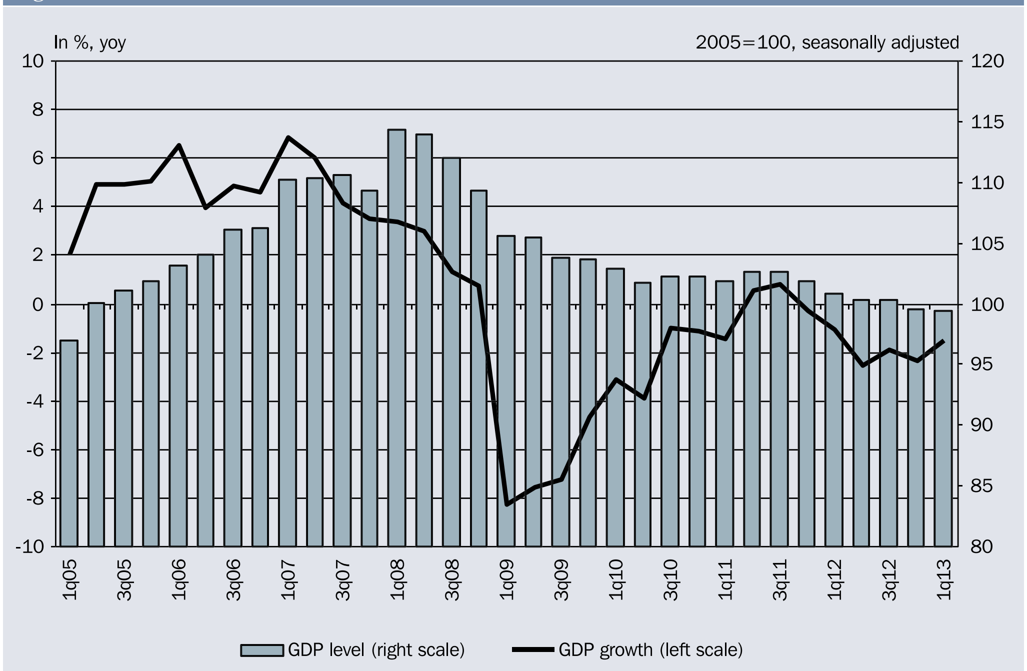
Croatia has become the 28th member of the European Union.

On July 1, 2013 Croatia became the 28th member of the European Union. Most Croatian citizens, although they are not euphoric, perceive this step as a positive one and believe that EU membership will improve their well-being. Official negotiations on membership started on October 3, 2005 and were concluded on June 30, 2011, with the signing of the Accession Treaty on December 9, 2011. At a referendum held on January 22, 2012, a large majority of Croatian voters, 66 percent, supported Croatia's accession to the EU.

Continued contraction of the economy.

On the economic front, Croatia has continued to struggle with the recession. In the first quarter of 2013, GDP declined 1.5 percent compared to the same period last year, following a 2.3-percent decline in the fourth quarter of 2012. Seasonally adjusted quarter-to-quarter figure confirms a moderation of negative GDP trend, which could be considered as "not-such-bad news" in the context of increased uncertainties about the state of the EU economy as a whole. Domestic demand remained weak in the first quarter and recorded a modest 2.2-percent decline year-on-year. In the previous two quarters it declined by more than 4 percent. Recent developments in the external sector have been rather disappointing on both the export and the import side. Although net exports retained their positive contribution to GDP growth in the first quarter, that was due to a sizable decline of imports. However,

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

this positive contribution was reduced to below 1 percentage point on year-on-year basis, down from 1.9 percentage point contribution in the previous quarter.

Personal consumption remained weak.

Personal consumption has continued to weaken and consequently contracted by 3.0 percent in the first quarter this year compared to the same quarter a year before. Real disposable income is estimated to have decreased by around 5 percent in the first quarter, which was mainly caused by employment decline, although deleveraging and low consumer confidence contributed as well.

Government consumption rebounded.

In the first quarter of 2013 government consumption increased 0.9 percent compared to the same quarter last year. Seasonally adjusted data indicates a rather strong rise over the previous quarter leading us to the same conclusion as three months ago. Sizable reduction of government consumption at the end of last year was temporary and achieved mostly by postponing of consumption and not by structural reforms with permanent effects. As expected, government consumption rebounded in the first quarter of this year. Although fiscal consolidation is progressing more rapidly on the revenue side, budget constraints will continue to exert pressure on government consumption as long as fiscal deficit stays high.

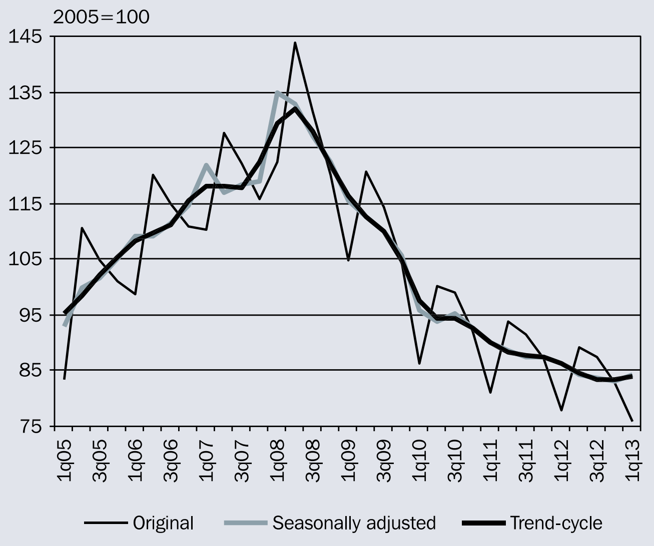
Investments finally increased.

Increase in seasonally adjusted investments in the first quarter this year compared to the fourth quarter last year is very good news for the economy. Although modest, this quarterly increase signals that the negative trend, which has been present for the last four and a half years, has come to an end and investment recovery is about to start. However, recovery is still subject to sizable risks. High-frequency indicators on construction activity and domestic production of capital goods do not yet show recovery, but imports of capital goods have recently increased. However, in the first quarter of this year, investments were still by 2.3 percent lower than the year ago.

Exports slumped in the first quarter;...

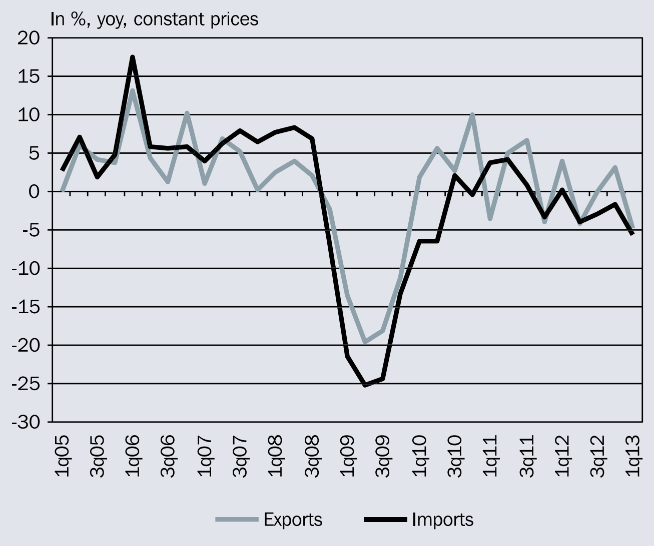
Volume of exports of goods and services experienced a sudden sizable decline of 4.9 percent in the first quarter of 2013 compared to the same quarter last year. This deterioration followed an increase of 3.2 percent recorded in the fourth quarter last year. The magnitude of exports decline in the first quarter was larger than in any of the EU countries. Goods component of total exports fell in particular. In the first five months this year goods exports in euro terms were lagging 5.0 percent behind last year's performance in the same period.

Figure 2 GROSS FIXED CAPITAL FORMATION



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

Figure 3 EXPORTS AND IMPORTS OF GOODS AND SERVICES



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

The structure of goods exports reveals that the strongest contribution to this year's weak export performance came from the shipbuilding and food industries, branches that are among the most important ones for Croatian exports. In the case of food industry it might be speculated that, due to change in the tariff regime with the non-EU countries as of July 1, some of the Croatian food producers have established their subsidiaries and, consequently, moved parts of their production in CEFTA countries, mainly Bosnia and Herzegovina, Serbia and Macedonia. As for the shipbuilding industry, following recent privatization the process of restructuring is underway and it will take some time for the production to pick up under new terms. Exports distribution by country reveals that exports to the EU were at last year's level, while exports to CEFTA countries were lower by about 10 percent year-on-year, which was caused primarily by reduced exports to Serbia. In addition to these recent developments, it should be kept in mind that Croatia has a long-standing problem with the competitiveness of its goods exports which has, compared to other post-transition economies, been continuously losing market shares on EU and global markets.

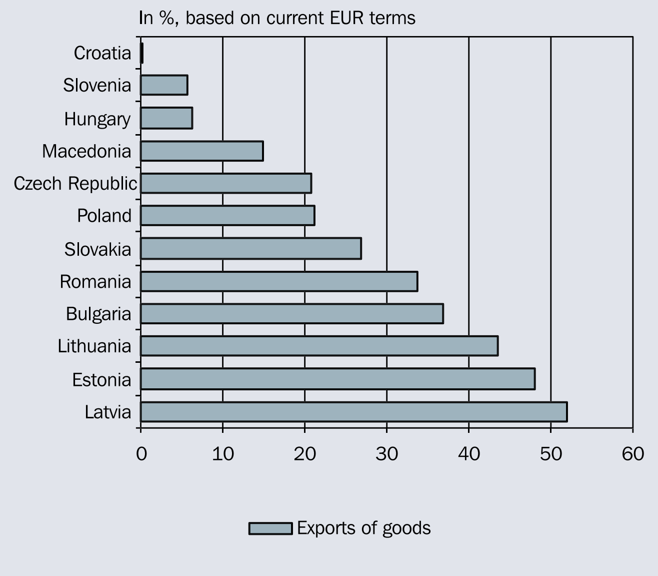
… imports fell sharply, too.

Poor domestic demand is the main reason for a sharp decline in volume of imports of goods and services, 5.6 percent in the first quarter year-on-year. Seasonally adjusted data indicates that gradual decline in imports has been present for the last two years. Imports of goods, as measured by trade statistics in euro terms, declined by 3.6 percent in the first five months compared to the same period last year. Imports of transport equipment (primarily cars), fuels and consumer goods have mostly contributed to the observed decrease. However, imports of capital goods were on the rise.

Reduced current account deficit and gross foreign debt.

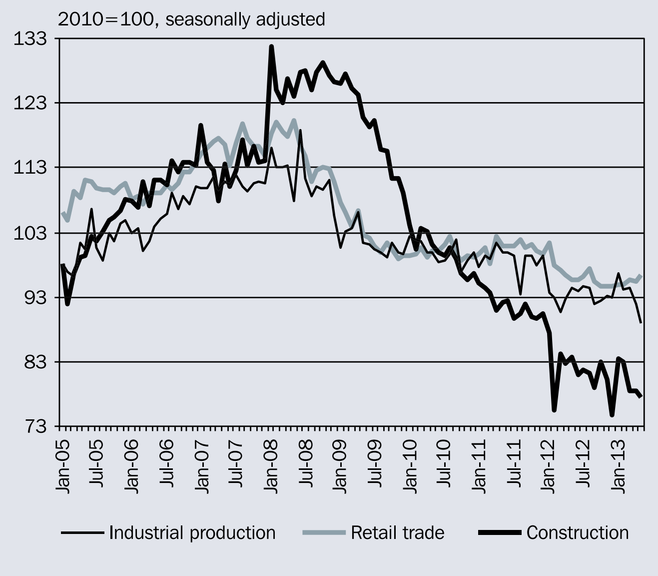
Current account deficit reached EUR 1.4 billion in the first quarter, which is EUR 270 million less than one year ago. Recent improvements in the current account are best reflected in figures calculated over the previous four quarters. In the first quarter there was a surplus amounting to 0.6 percent of GDP, the first surplus in the period since 1999 for which data is available. Gradual reduction of current account deficit has been in place ever since 2008, when the deficit was above 9 percent of GDP. At the end of March, gross foreign debt was EUR 45.1 billion, 1.8 percent less than the year before. Banks have rapidly reduced their external debt, while other domestic sectors reduced it only gradually. The government sector was the only one that increased its foreign debt, by 19.9 percent in the year up to March this year.

Figure 4 EXPORT GROWTH, 2007-2012



Source: *Eurostat.*

Figure 5 REAL SECTOR DEVELOPMENTS



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

Significant declines in industrial production;...

Following a rather encouraging performance of the industrial sector in the first quarter of this year, April and May data point to a significant weakening of activity on the month-to-month basis, which has once again caused a negative turn of the trend. According to the seasonally adjusted data, in the April-May period industrial activity was on average 4.8 percent lower than in the first three months this year and 1.9 percent lower than in the same period a year ago. Modest 0.3 percent year-on-year decline in the first five months is a result of two major developments across branches - on the negative side there was a 50-percent drop in activity of the shipbuilding industry while on the positive side there was a 17-percent increase in electricity production due to favorable weather conditions.

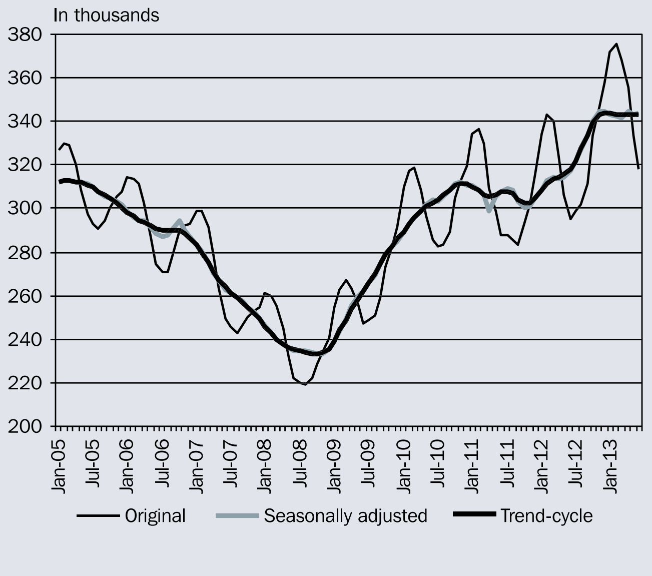
... retail trade volume stabilizes.

Retail trade's volume seems to have stabilized, exhibiting a positive trend in the second quarter of this year. This change was driven by improvements in consumer confidence (according to the CNB data), rather frequent discount sales by food retailers before the EU entrance and stronger car sales in the second quarter than at the beginning of the year. In April and May, according to seasonally adjusted data, retail trade was on average 0.8 percent stronger than in the first quarter of this year and 0.4 percent than in these two months a year ago. While in the first quarter car sales declined by 44 percent year-on-year, they recovered in the second quarter and were almost the same as the year before. Construction activity continues to register a negative trend although in recent months at a slower pace than before. Year-on-year decline moderated to 2.3 percent in the first four months of 2013 suggesting that a trough might be close.

Unemployment reduction caused by seasonal effects.

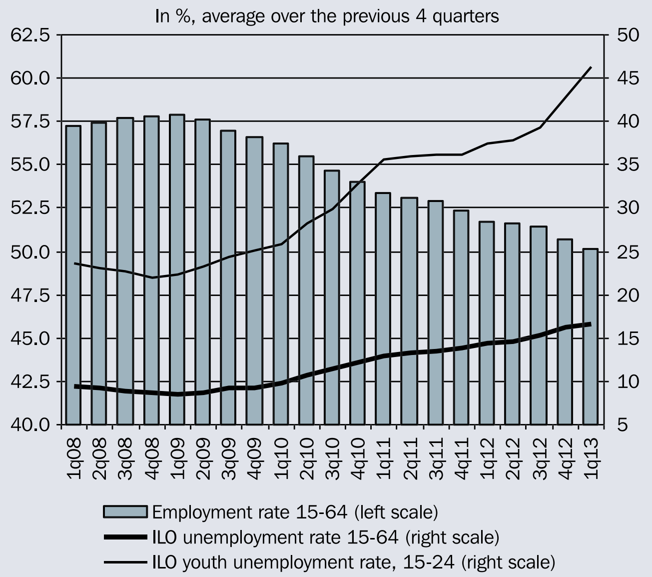
The employment situation in Croatia has recently improved but entirely due to the usual seasonal effect. Between February and June the number of unemployed persons registered at the Croatian Employment Service declined by 57 thousand. Unemployment rate decreased from 21.9 in February to 19.6 percent in May, when it was 1.8 percentage points higher than in May 2012. It is important to note that seasonally adjusted data indicate stagnation in the number of unemployed in the course of this year, which is a change for the better compared to the strongly negative trend observed in the course of 2012. However, this change might be a result of administrative measures focused on reduction of undeclared seasonal work and active labor market policies. These measures brought temporal downsizing of Employment Service's registers of the unemployed. For example, in the first half of this year 30.8 thousand persons were employed on seasonal jobs, predominantly in accommodation and food services, 3.8 percent more than a year ago. Also, there was more

Figure 6 NUMBER OF UNEMPLOYED PERSONS



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

Figure 7 EMPLOYMENT AND UNEMPLOYMENT RATES



Source: *Croatian Bureau of Statistics (Labor Force Survey).*

Table 1 MAIN ECONOMIC INDICATORS

	2011	2012	2012			2013
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	0.0	-2.0	-2.5	-1.9	-2.3	-1.5
Real private consumption (% change, yoy)	0.2	-3.0	-3.2	-3.5	-4.2	-3.0
Real government consumption (% change, yoy)	-0.6	-0.8	0.3	-0.4	-2.0	0.3
Real investment (% change, yoy)	-6.4	-4.6	-5.1	-4.4	-4.9	-2.3
Industrial output (% change, yoy)	-1.2	-5.5	-6.6	-4.4	-5.7	0.8
Unemployment rate (registered, %, pa)	17.8	18.9	17.9	17.6	20.1	21.7
Nominal GDP (EUR million)	44,412	43,929	-	-	-	-
GDP per capita (EUR)	10,377	10,295	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	2.0	2.0	2.0	2.1	2.8	2.4
Consumer prices (% change, yoy, pa)	2.3	3.4	3.4	4.1	4.6	4.6
Producer prices (% change, yoy, pa)	6.3	7.0	6.8	7.9	7.3	4.1
Average gross wage (% change, yoy, pa)	1.5	1.0	0.9	0.6	0.4	1.3
Exchange rate, HRK/EUR (pa)	7.43	7.52	7.52	7.47	7.52	7.58
Exchange rate, HRK/US$ (pa)	5.34	5.85	5.86	5.97	5.80	5.74
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,582	9,629	2,325	2,472	2,577	2,073
Exports of goods (EUR, % change, yoy)	7.6	0.5	-8.1	0.1	7.8	-8.0
Imports of goods (EUR million)	16,281	16,214	4,165	4,094	3,975	3,730
Imports of goods (EUR, % change, yoy)	7.6	-0.4	-2.8	-2.8	0.1	-6.3
Current account balance (EUR million)	-387	-26	-305	2,653	-693	-1,425
Current account balance (% of GDP)	-0.9	-0.1	-	-	-	-
Gross foreign direct investment (EUR million)	1,101	1,053	309	217	447	464
Foreign exchange reserves (EUR million, eop)	11,195	11,236	11,635	11,384	11,236	11,277
Foreign debt (EUR million, eop)	45,734	44,935	46,548	45,538	44,935	45,102
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,025	126,132	60,654	93,150	126,131	28,918
Expense (HRK million)**	132,945	132,413	64,826	98,700	132,413	33,782
Net = Gross operating balance (HRK million)**	-9,920	-6,282	-4,172	-5,550	-6,282	-4,863
Net acquisition of non-financial assets (HRK million)**	5,044	4,574	1,428	2,444	4,574	1,211
Net lending/borrowing (HRK million)**	-14,964	-10,855	-5,600	-7,994	-10,856	-6,074
Domestic government debt (EUR million, eop)	13,716	15,225	14,721	15,192	15,225	-
Foreign government debt (EUR million, eop)	6,996	8,353	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	-2.3	3.0	1.6	10.7
Broad money, M4 (% change, yoy, eop)	1.6	3.2	3.3	2.1	3.2	4.4
Total domestic credit (% change, yoy, eop)	4.9	-3.9	2.6	-0.6	-3.9	-3.9
DMBs credit to households (% change, yoy, eop)	1.0.	-1.4	0.2	-2.0	-1.4	-1.2
DMBs credit to enterprises (% change, yoy, eop)	8.7	-11.2	2.0	-2.3	-11.2	-11.6
Money market interest rate (%, pa)	0.9	1.1	0.5	1.7	0.5	0.4
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	7.3	7.1	7.1	7.0	6.5
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.*

than 24 thousand new persons included in some of the active labor market programs in the first half of 2013, while more than 10 thousand continued with their programs that started last year. Once the favorable season ends and education and employment subsidies cease, it is likely that registered unemployment will swiftly increase. Available data on employment shows a much milder seasonal increase, 32 thousand between February and May, while the May employment figure was 2.9 percent lower than a year ago. The largest employment decline is observed in the electricity, gas and steam supply sector (9.4 percent), construction industry (8.2 percent), and manufacturing (4.4 percent). The Labor Act, a major labor relations statute in Croatia, was amended in June, with the aim of harmonization with the EU legislation. Although amendments brought some flexibility in the distribution of working time and fixed-term contracting, their impact on the functioning of the entire labor market is likely to remain contained in the overall rigid legislative setting.

Average wages started to decline.

Average nominal gross wage amounted to HRK 7,941 (app. EUR 1,047) in the first quarter 2013, which is 0.2 percent less than in the previous quarter and 1.3 percent more than in the same quarter last year. Real wages fell by 3.3 percent in a year-time. Total wage bill is estimated to fall by 6.2 percent in real terms in the first quarter compared to the same quarter last year. Total government transfers to the household sector (pensions, unemployment benefits and social security benefits) grew slightly in nominal terms, but fell in real terms keeping overall real disposable income well below its last year's level.

Money supply on the rise.

The most recent monetary developments indicate certain improvements in money supply and credit activity. Narrow money growth has speeded up in the course of this year, while broad money has continued to rise at a stable, but relatively low rate. Seasonally adjusted narrow money (M1) increased by 2.1 percent in May compared to April while broad money grew by a modest 0.2 percent in the same period. Time and savings deposits prevented broad money to grow faster as they decreased by 0.2 percent in May. Although the enterprise sector increased its savings by 3.2 percent, households downsized their savings by 0.7 percent. It seems that the rising unemployment and real disposable income erosion have started to bite into households' savings capacity.

Lending to enterprises improved.

Lending bounced back from the lowest year-on-year rate recorded in the last 13 years, -3.6 percent in February, and recorded some improvements in the following months. Seasonally adjusted credits exhibited a notable rebound in April and stagnation in May. Positive developments are present in the corporate sector whose credits recorded seasonally adjusted month-to-month growth in March, April and May that cumulated to more than 2 percent. The household sector remains vulnerable and credits extended to it continued to decrease from month to month since the end of last year as seasonally adjusted data suggest. A decline of 2.5 percent year-on-year in May represents the strongest decline in the last three years.

Money market interest rates low.

Excess liquidity in the banking system remained rather high, HRK 5.5 billion on average in June. Liquidity was no longer kept in the form of overnight deposits at the central bank, as the monetary authority decided to cut the overnight rate from 0.25 to 0.0 percent in late April. This measure has had no significant impact on lending activity due to the fact that the demand side is heavily troubled and banks are cautious in granting new loans, but it did help to anchor short-term interest rates at the lowest levels ever. The overnight loan rate at the money market stood at 0.3 percent in May, but some temporary volatility was observed towards the July issuance of government bonds. HRK/EUR exchange rate decreased from 7.56 at the end of May to 7.45 at the beginning of July caused partly by the usual seasonal effect due to receipts from foreign tourists and partly by government bonds issuance. Two bonds were issued on the domestic market in mid-July, a five-year HRK 2.75 billion bond and an 11-year EUR 750 million bond paid in Croatian kuna. Interest rates for these bonds did not depart much from those for previous issues and investors grasped a hefty opportunity to invest in a safe and attractive product.

Inflation pressures subdued.

Inflation pressures subdued as consumer price inflation slowed down from 4.6 percent in the first to 2.3 percent in the second quarter. Inflation rate of 2.0 percent in June confirms that demand side weaknesses coupled with lower import prices and vanishing base effect from last years' administrative price hikes have pressed prices down. Prices of food, alcoholic beverages and tobacco increased by 6.6, 4.6 and 7.0 percent, respectively, and created an upward pressure, but prices of clothing, footwear, transport and communication worked in the opposite direction. Core inflation, i.e. consumer price inflation without energy and unprocessed food, slowed down from 2.4 percent in January to 1.6 percent in June.

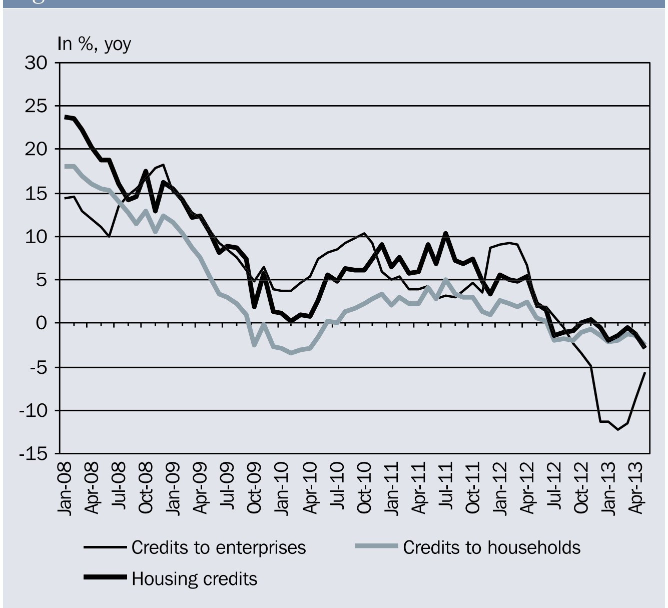
Government revenue stagnates...

In the first quarter of this year general government revenue was broadly equal to the revenue in the first quarter of last year. Stagnation is the result of a fall in collection of social security contributions and an increase in tax revenues, primarily those from VAT. Revenue from social security contributions declined by 4.1 percent compared to the first quarter last year, due to employment reduction and the two-percentage points reduction in the contribution rate for health insurance from May 2012. It seems likely that the fall would have been even greater had there been no increase in the efficiency of collection of this revenue. Total tax revenue increased by 1.5 percent, quite modestly compared to the rates observed in previous quarters. It was brought about as the net result of a couple of opposing forces. A 7.3-percent increase in the VAT revenue – rather big in the current situation indicating improved tax administration – outweighed the decline in the profit tax and the total excises, which both fell quite sharply, 17.3 and 13.3 percent respectively. The profit tax revenue fell partly because of a smaller profit earned by businesses in 2012 compared to 2011, and partly because reinvested profits are no longer taxed. Revenue from excises dropped mostly due to lower purchases of cars and tobacco.

... but government expenditure rises.

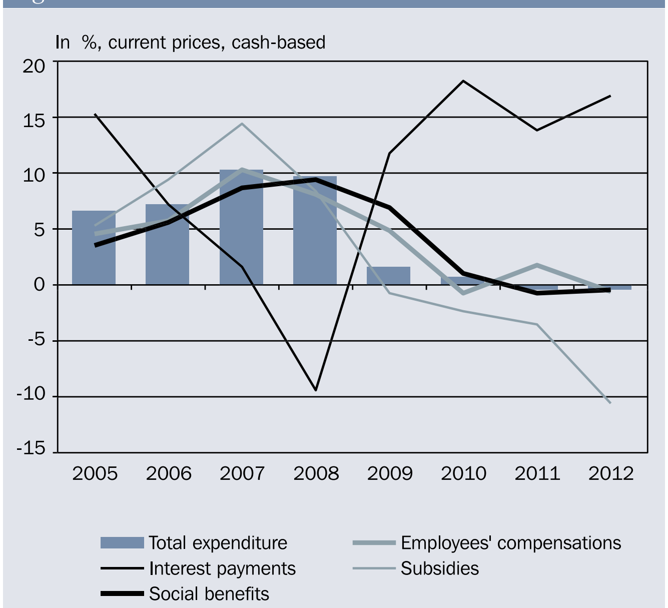
General government expenditure rose by 4.8 percent over the first quarter last year, the biggest year-on-year cash-based increase in the last two years. The main driver of this increase was a substantial 48.6-percent increase in subsidies as a result of early payment to the agricultural sector. Social benefits, the largest expenditure category, increased 4.7 percent. The only large expenditure item that declined was purchase of goods and services, but its decline was rather modest, 2 percent. It should be mentioned that interest payments, which increased rapidly in the third and fourth quarter of 2012, 24.1 and 40.2 percent year-on-year, respectively, increased more slowly in the first quarter of this year, 6 percent. A sharp, 66.2-percent rise in the net acquisition of non-financial assets, predominantly

Figure 8 CREDITS DEVELOPMENTS



Source: *Croatian National Bank.*

Figure 9 GENERAL GOVERNMENT EXPENDITURE



Source: *Ministry of Finance.*

due to the acquisition of buildings related to the EU accession (border crossings, Croatian Embassy building in Brussels etc.), along with the stagnation of total revenue and the rise in total expenditure, brought about a general government deficit of HRK 6.1 billion in the first quarter. According to the budget revision from April, total deficit for 2013 as a whole is planned at HRK 11.5 billion, meaning that deficit accumulated in the first three months amounts to about a half of the amount planned for the whole 2013. The deficit was financed by treasury bills and a 10-year USD 1.5-billion bond issued in end-March. Concerning the stock of public debt, according to the latest information available, at the end of 2012 it amounted to HRK 177.3 billion or 53.7 percent of GDP.

Fiscal rule enshrined in the Fiscal Responsibility Act is about to change.

The Ministry of Finance has recently reported that in 2012 the fiscal rule enshrined in the Fiscal Responsibility Act was respected by the reduction of the ratio of total general government expenditure to GDP by more than one percentage point, more precisely by 2.1 percentage points. Fiscal Policy Committee confirmed the main conclusion of this report, but warned that the result highly depends on accounting definitions and that there are great risks of fulfillment of the rule in 2013. Meanwhile, the Government has initiated a consultation process with the IMF, the European Commission and local stakeholders concerning possible alterations of the rule in order for it to be more responsive to the economy's cyclical position and, in addition, to be conducive to EU fiscal regulations from the Stability and Growth Pact. Whatever final form the fiscal rule takes, it should provide a clear and strong signal that efforts at consolidation are credible. That would serve a double role: first, it would make it easier to comply with EU fiscal governance rules, and second, it would signal the sustainability of public finances.

2 Policy Assumptions and Projections Summary

Risks for the global economy increase; eurozone remains in protracted recession.

Over the last several months global economy was growing more slowly than was expected earlier. Consequently, the outlook is less optimistic now than it was three months ago, which is confirmed by the IMF's July forecast update (*World Economic Outlook Update*, IMF, July 2013). The growth of global economy is now expected to be slightly above 3 percent in 2013, almost the same as the year before, and to speed up to 3.8 percent in 2014. The downward revision of the IMF's forecasts was driven mainly by weaker growth in several key emerging economies and by protracted recession in the eurozone. Downside risks dominate the prospects of global economy and have lately increased due to the anticipated exit of monetary policy stimulus in the United States and tighter financial conditions that might slow down growth in the emerging markets. Growth in the United States is now projected to rise from 1.2 percent in 2013 to 2.1 percent in 2014. Recession in the eurozone is deeper than was expected and output is now projected to decline by 0.6 percent this year and to recover to close to 1 percent in 2014. Economic prospects of Slovenia and Italy, Croatia's most valuable trading partners and countries from which a large number of foreign visitors come (almost 20 percent in 2012) are particularly important for Croatia. While Slovenia is expected to remain in recession both this and next year, Italian economy should see some recovery next year, which would allow for a modest but positive GDP growth rate. Additionally, oil prices, which were already on the rise due to global recovery, have surged in July induced by the political upheaval in Egypt. Brent crude oil rose to US$ 107.9 a barrel in mid-July, about 8 percent more than a year ago.

Fiscal consolidation to be driven by EU fiscal governance rules.

As the new EU member, Croatia will face a somewhat different external and internal environment. While not questioning the positive effects of EU membership in the longer run, we assume that the short-term effects (both positive and negative) will be balanced. Furthermore, we assume that fiscal consolidation will continue, although more slowly than was expected earlier, at least in terms of deficit and debt due to contingent liabilities that have often turned out to be explicit spending obligations. European fiscal guidance is expected to have a strong impact on fiscal policy in 2014 as we assume that Croatia will enter Excessive Deficit Procedure (EDP) which would build up pressures in the direction of fiscal consolidation. Furthermore, the Fiscal Responsibility Act is announced to be modified and the expenditure-based fiscal rule is expected to be replaced by a set of rules focused on the structural balance in line with the European fiscal governance process. Monetary policy is expected to continue to be cautious and focused on the stability of exchange rate and stability of the financial system, but otherwise aimed at providing high liquidity of the system in order to help maintain low interest rates and spur lending activity. We also assume that the Government, following local elections, will be more prone to undertake reforms oriented towards raising efficiency of the public sector, increasing flexibility on the labor market and improving the institutional and business environment. Recently, it has announced a privatization plan for a state-owned bank and an insurance company, proposed a plan for a new institutional arrangement for governance of state-owned assets, announced a bid for the concession of highways and is in the process of negotiations with social partners for changes in labor legislation. Although details of these reforms are not known and their impact cannot be accounted for in our forecasts, we assume they will speed up the consolidation of public finances.

GDP to decline 0.9 percent in 2013.

Although most indicators point to negative trends in the economy, they seem to be weakening and for some areas such as investments, there are even signals of positive changes. It is therefore likely that Croatian economy is close to a recession trough. EU accession should bring some optimism and together with a solid tourist season underpin a change in trends towards the year's end and lay a basis for more wide-based recovery in 2014. Due to existing imbalances, particularly between the goods-producing sector and services sector, the expected recovery will be weak and fragile and to a large extent conditioned upon the recovery in the EU. For 2013 as a whole we project GDP to decline by 0.9 percent, while for 2014 we expect the return of positive growth at 1.0 percent. Output contraction in 2013 will be driven primarily by the decline in personal consumption projected at 1.5 percent, which is a reflection of reduction in disposable income caused by increased unemployment. We foresee government consumption to decline by 0.6 percent in 2013.

Gloomy outlook for exports in 2013; current account balance to be maintained.

Total exports and imports are projected to decrease by approximately 2.5 percent each in 2013. Outlook for exports is now substantially weaker than it was three months ago. Namely, it seems that the loss of CEFTA markets due to the EU accession will have a much stronger negative effect on foreign trade than was projected earlier. In addition, the restructuring process in recently privatized shipyards suggests substantial declines in both production and exports. On top of these current problems there are long-term problems with competitiveness. Consequently, this year we expect total exports to decline 2.8 percent. The decline will be stronger within the goods export sector while revenues from foreign tourism are now expected to increase mildly. The projected decline in imports of 2.5 percent is primarily the result of weaker domestic demand. The protracted recession has already brought balance to the current account, which is expected to continue this and next year. Due to deleveraging, foreign debt will continue to decline, falling below 100 percent of GDP in 2014.

Investments expected to rebound.

According to our projections, the long-awaited recovery of investment activity should begin this year. We project a 1.5 percent increase in investment activity on average for 2013, which is much below the Government's expectations, but is still an upward revision compared to three months ago, following positive signals from the latest available data. The expected investment recovery will be burdened by a number of risks related to financing conditions and future demand. However, EU membership should bring improved conditions for investments and next year we expect them to strengthen with a 5.5-percent increase. Restructuring of the export sector is expected to bring its modest recovery next year. Somewhat stronger domestic demand will cause imports to rise as well. The decline in personal consumption is anticipated to halt next year in the wake of output recovery. Consolidation effort is likely to result in a projected 1-percent decline in government consumption in 2014.

Unfavorable labor market expectations for 2013 and 2014.

Driven by weak labor demand, the unemployment rate is expected to increase this year to an average of 20.2 percent, 1.3 percentage points higher than in 2012. Further structural adjustments accompanied by job losses directly linked to EU membership (custom officers, logistics clerks) are expected to increase this year's inflow into unemployment. For 2014 we expect gradual vanishing of negative labor market trends with average unemployment rate at around of 20.3 percent. Announced policy measures, such as broadening of active labor market measures, implementation of the European Youth Guarantee and changes of the Labor Act, do not seem strong enough to substantially affect the trend at the labor market, but may help to cushion negative effects of low demand for certain categories of labor. Expected output revival will be transposed onto the labor market with delay, meaning that sustainable employment rise is likely to be postponed until 2015.

CNB easing is conditioned upon exchange rate stability and credit demand recovery.

Summer season is expected to keep the HRK/EUR exchange rate stable at around 7.50, but towards the end of the year, bank provisioning, worsening trade balance and private sector external deleveraging might kick in and push it close to 7.60. For the full year, we see the average HRK/EUR rate around 7.55 and expect it to stay the same in 2014. Taking into consideration ample liquidity of the financial system, CNB's overnight deposit rate of 0.0 percent, stable HRK/EUR exchange rate and historically low interest rates, the central bank is not expected to make another move into expansion before the economy starts recovering. Revival of credit activity is projected to be very slow. We expect the private sector to continue to deleverage and therefore reduce its lending by 1.8 percent in this year. In case the announced stricter non-performing loans regulation turns out to be highly restrictive in the sense of bank's balance sheet consolidation, we could witness an even larger credit downsizing. Slightly negative credit growth of -0.1 percent is expected in 2014 mostly due to cautious household sector that is expected to refrain from sinking deeper into debt. In line with the central bank easing bias, we expect broad money to grow by 2.8 percent in this and 4.7 percent in the next year.

Low inflation to remain.

Waning inflationary pressures will keep consumer price inflation below last year's level, at around 2.7 percent. Weak consumer demand will press prices down and the only upward pressure might come from tax changes, some of them related to EU rules as in the case of increasing tobacco excises, and some of them motivated by pure fiscal reasons, as in the case of increased fuel excises. EU membership is not expected to exert any particular short-term pressure on prices in Croatia as it already has a relatively high price level and is facing troubled domestic demand. In 2014, a persistently weak personal consumption will keep consumer price inflation at low levels, on average of 2.0 percent for the full year.

Fiscal authorities face a difficult task of deficit reduction.

Even though budget revision took place in April, another one can be expected in fall. As the Minister of Finance himself mentioned, revenue collection has underperformed relative to plan. In addition, Government's expectation of GDP growth rate of 0.7 percent for this year is overly optimistic and cited as a reason for another revision. Our projection of negative growth for 2013 led us to expect the revenues to underperform relative to the existing plan. Planned reductions on the expenditure side, most notably the wage bill and social spending, do not seem credible and are likely to be accomplished only partially. Also, the Government decided to spend extra money to pay off arrears of public hospitals. We thus expect the deficit to be higher than 3.4 percent of GDP planned by the Government and closer to 4.5 percent of GDP when calculated on cash basis and in line with national budgetary accounting methodology. After our rough transition (we still do not have all the necessary information) from budgetary accounting to ESA95 methodology, we project deficit to increase from 3.8 percent of GDP estimated for 2012 to about 4.0 percent in 2013. An even higher deficit increase will be avoided as arrears payments in the health sector are not considered as expenditures of the current year according to ESA rules. As for 2014, although it is too early to project anything with reasonable certainty, we expect fiscal consolidation forced by EU rules to take place so the deficit may fall to 3.6 percent of GDP. One can expect that only 2016, assuming strengthening of economic growth, will see the deficit figure below the 3-percent ceiling from the Stability and Growth Pact. Public debt is likely to increase further, but its level depends very much on the statistical treatment of specific government operations. If highways are given in concession as the Government announced then it is possible that the 60 percent debt ceiling will be breached even this year because loans taken out for highway construction might instantly be treated as public debt.

Table 2 SUMMARY OF PROJECTIONS

	2013	2014
Real GDP (% change)	**-0.9**	**1.0**
Real private consumption (% change)	-1.5	0.0
Real government consumption (% change)	-0.6	-1.0
Real investment (% change)	1.5	5.5
Exports of goods and services (constant prices, % change)	-2.8	2.2
Imports of goods and services (constant prices, % change)	-2.5	2.0
Current account balance (% of GDP)	-0.1	0.0
Consumer prices (% change, pa)	2.7	2.0
Exchange rate, HRK/EUR (pa)	7.55	7.55
Unemployment rate (registered, %, pa)	20.2	20.3
General government balance (ESA95 definition, % of GDP)	4.0	3.6
Broad money, M4 (% change, eop)	2.8	4.7
Total domestic credit (% change, eop)	-1.8	-0.1

Note: *Cut-off date for information used in the compilation of projections was July 9, 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 eurozone recover?

As the latest indicators show, the eurozone still remains in protracted recession and no stronger signs of recovery are visible. Negative trends are weaker than before and most projections by international organizations suggest recovery by the end of the year and its strengthening next year. However, recent tightening of global financial conditions, weaker-than-expected domestic and global demand and insufficient implementation of structural reforms might postpone recovery. In that case, Croatian economy may suffer due to weaker external demand than is now expected.

What will be the short-run impacts of the EU accession?

Uncertainties are also related to the impact of EU membership on the Croatian economy. There are little credible analyses on the potential effects of the EU accession. Risks seem to be higher in the short-run and there is a lot of uncertainty about the capacities for the use of EU funds. On the positive side, EU membership should bring more optimism and confidence, increase the attractiveness of the country to foreign investors and improve the country's image as a tourist destination. However, it seems that the partial loss of CEFTA markets in the foreign trade might be rather strong and we might have underestimated it in projections.

Solid tourist season?

According to physical indicators for the first part of the year, the number of foreign visitors was slightly above last year's figures. It remains to be seen whether that continues during the high-season when most of Slovenians and Italians go on vacation. Due to the recession in their home countries, the number of their visits might be reduced. Additionally, due to the newly-introduced visa regime for non-EU residents (including Russia, Ukraine and Turkey) the number of tourists from these countries might be smaller than was previously expected. There also might be some problems for tourists from Bosnia and Herzegovina due to increased border controls. It is highly uncertain whether these losses can be neutralized by visitors from other countries. If not, export and growth performance of the economy will be worse than projected.

Labor market developments might constrain recovery.

Although the situation on the labor market is mainly determined by the overall economic situation, effects of restructuring of large state-owned (Croatian Electricity Company (HEP), Croatian Post, Croatian Railways, Croatian Airways) and recently privatized companies (shipyards) should also be taken into consideration. These companies are now facing competition without protection or support by the Government and existing over-employment will have to be tackled. An additional risk is that rigidities on the labor market might constrain recovery of the more flexible goods and services markets by limiting employment and not providing enough output demand from the household sector.

Court verdict on loans in Swiss francs raises risks.

The collective action lawsuit in which clients have sued eight commercial banks for not giving them enough details on credit terms in order to make an informed decision and for overcharging them with loans indexed to Swiss francs ended at the beginning of July. Zagreb Commercial Court ordered the banks to recalculate loans indexed to Swiss francs into the national currency at a fixed interest rate. This is a first-degree verdict and banks have already appealed. The loans in question had been offered at a variable interest rate at a time when the Swiss franc was relatively weak. However, the Swiss franc appreciated sharply and interest rates increased as the global financial crisis started in 2008, which hiked the monthly installments for clients. It remains unclear what the costs would be for the banks if the verdict remains in its present form. Nevertheless, even a first-degree court judgment will force banks to increase their reservations to cover potential costs stemming from the court verdict and make them more risk-averse in respect to credit activity.

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