The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

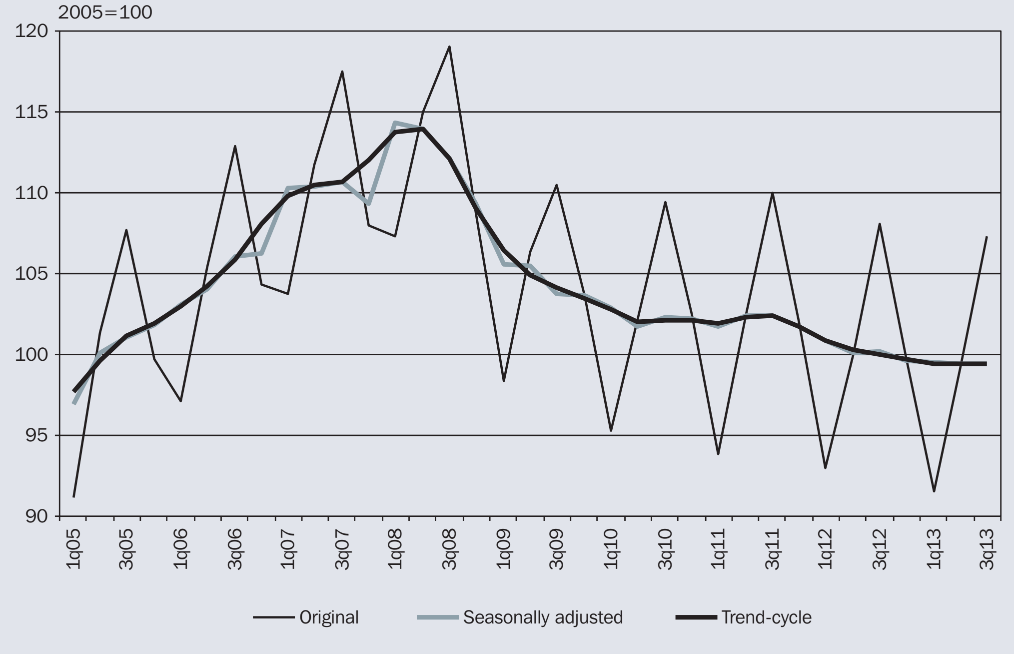
Stagnation in the third quarter of 2013; possible deterioration afterwards.

Croatian economy stagnated in the third quarter of 2013, as is suggested by the seasonally adjusted GDP data. In spite of the quarter-to-quarter stagnation, GDP level was still 0.6 percent lower than a year ago. As for the main components of aggregate demand, seasonally adjusted data for the third quarter reveal that both, personal and government consumption, as well as investments, weakened compared to the second quarter. Exports somewhat strengthened, mainly due to revenues from foreign tourism, while imports declined significantly. Although industrial production has increased slightly towards the end of 2013, other high-frequency indicators such as retail trade, goods exports, construction activity, and tax revenues point to a possible deterioration of economic conditions in the fourth quarter. A likely turndown is also suggested by the CEIZ coincident composite indicator of economic activity.

Personal consumption trend turned negative.

In spite of the positive 0.2-percent year-on-year rate in the third quarter of 2013, the most recent trend in personal consumption has been discouraging. Compared to the second quarter, seasonally adjusted consumption in the third quarter decreased. It seems that consumer optimism on the eve of EU entry helped to temporarily increase spending during the spring and in early summer. However, continuously declining household incomes

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

related primarily to heightened unemployment took their toll and suppressed consumption in the third quarter.

Government consumption fell considerably.

In the third quarter seasonally adjusted government consumption declined by almost 2 percent, compared to the second quarter. This decline followed a notable rise in the first half of 2013 which was not sustainable due to the low outturn in government revenues and expanding budget deficit. In the situation where public sector finances have to be consolidated while economy needs stimulus, the Government decided to take a middle way, at least for a while. From the beginning of 2012 government consumption more or less stagnated. However, in the third quarter of 2013 consumption fell considerably, heralding times of prioritizing consolidation policies.

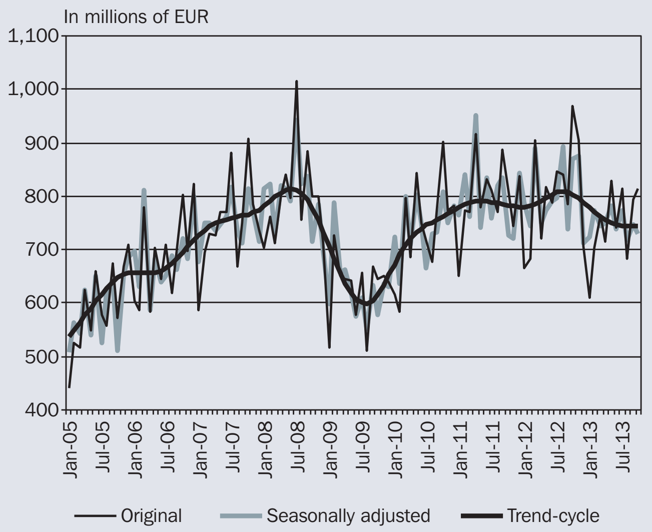
In spite of some encouraging signs, investments remained weak.

Although the first half of 2013 brought encouraging signs on investment activity, the third quarter revealed problems as seasonally adjusted quarter-to-quarter figure turned negative. Such a turn is related to the public sector hesitance due to financial constraints and poor institutional preparation for conducting large-scale projects. At the same time the private sector seems to have weak incentives to invest due to poor prospects for stronger domestic demand. The ongoing trend of negative construction activity confirms the gloomy near-term investment outlook. The cumulative decline in construction activity for the first ten months amounted to 4.2 percent year-on-year.

A mix of successful tourist season, poor goods exports and weak imports…

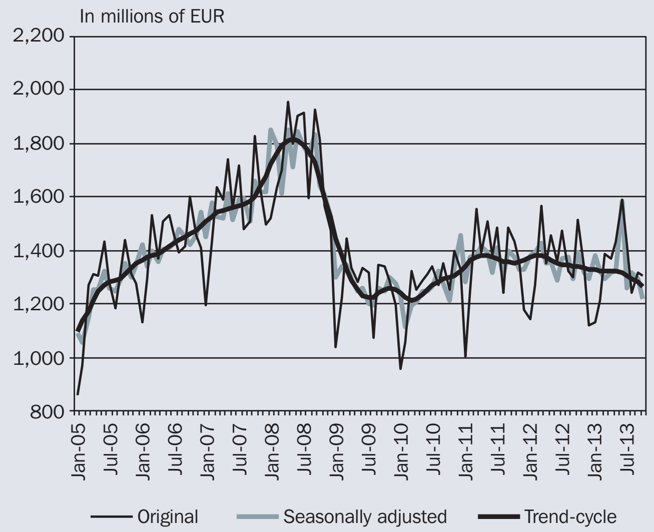
In spite of a successful tourist season, total exports in the third quarter of 2013 remained below the level recorded in the same quarter of 2012, by 1.3 percent in real terms. At the same time, total imports decreased by 1.6 percent. The decrease in total exports was due to poor performance of goods exports. By the end of October 2013 exports of goods were 6.9 percent lower than the year before in current euro terms (3.3 percent without the shipbuilding industry). Exports of goods to the EU declined by 5 percent and can be attributed mostly to lower trade with Italy, while exports to CEFTA countries weakened by 7 percent year-on-year. In addition to the fact that exports of the shipbuilding sector strongly declined due to restructuring (40 percent) and that the economy needed time to adjust to the new external conditions, it seems that methodological changes in registering external and intra-EU trade have also caused some noise in the data.

Figure 2 EXPORTS OF GOODS



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

Figure 3 IMPORTS OF GOODS



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

… contributed to a record-high current account surplus.

Current account balance in the third quarter of 2013 reached a record-high surplus of EUR 2.8 billion. In addition to tourism revenues that rose by 4.6 percent year-on-year in current euro terms, weak imports and improved balance of factor incomes were the main contributors to the improved overall balance. Cumulative current account balance in four quarters up to the third quarter of 2013 registered a surplus of 1.1 percent of GDP, up from 0.5 percent recorded in the second quarter. Consequently, foreign debt has been declining. At the end of September 2013 it amounted to EUR 45.1 billion, 1.6 percent less than a year before.

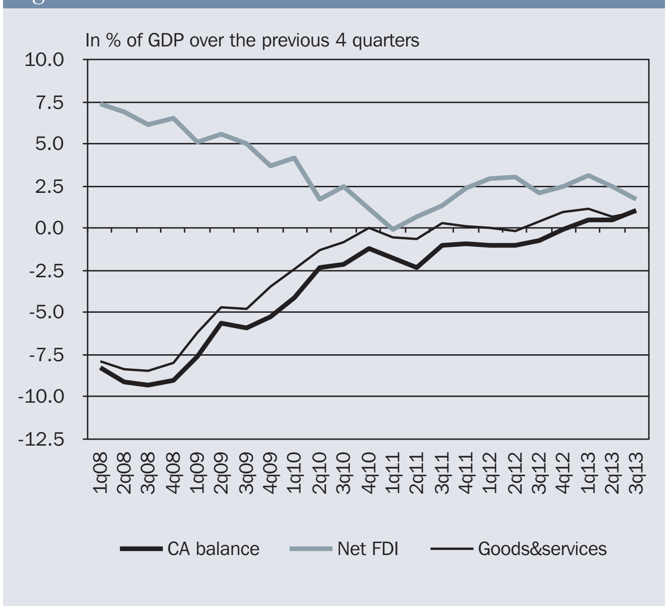
Industrial production showed mildly positive signs at the end of 2013…

Throughout most of 2013 industrial production exhibited a rather strong negative trend. However, towards the year's end, modest increases in monthly production allowed for a turnaround. Seasonally adjusted data show that the average production in October and November was 0.7 percent stronger than in the third quarter of 2013 while the cumulative production for the first eleven months declined by 1.9 percent on the year-on-year basis. While energy production expanded strongly in 2013 due to favorable weather conditions at the beginning of the year, manufacturing output experienced a decline of 4.7 percent. This was most notable in the shipbuilding industry where the decline reached 50 percent but it also spread to a number of other branches including food and beverage as well as chemical and pharmaceutical industries. It should be noted that industrial production continues to exhibit strong monthly variations. Moreover, positive signs at the year's end were due to significant output increases in just a few branches (foremost beverage industry) which poses a question as to whether that trend can be sustained in the coming months.

… while the retail trade trend turned negative.

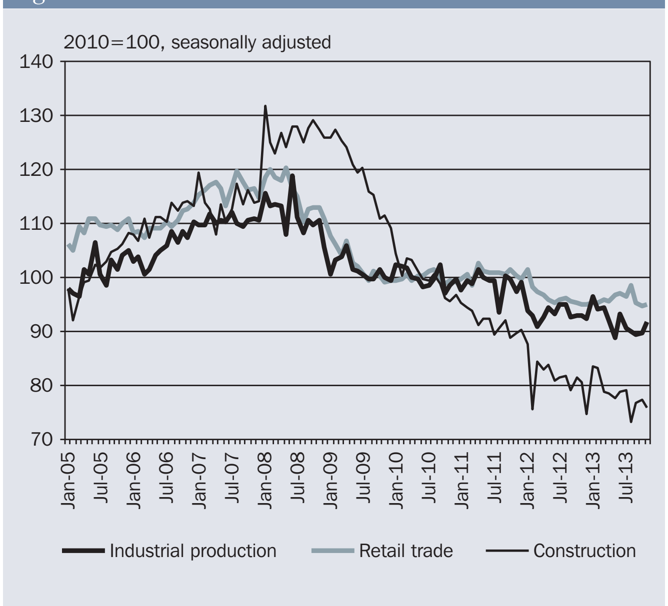
Retail trade sector revealed a modest positive trend in the first half of 2013 followed by also modest, but negative trend in the second half of the year. As suggested by the seasonally adjusted data, the variations in retail trade volume were more suppressed than in previous years. The only exceptions occurred in August with a strong increase, and in September with the comparable decrease in retail trade volume, which can be attributed to the rise and fall of foreign tourists' consumption. While quarter-to-quarter changes in the first three quarters were positive, the average retail trade volume in October and November was 2.0 percent smaller than in the third quarter, causing the trend to turn negative. As a result, cumulative data for the first eleven months of 2013 show a year-on-year decrease of

Figure 4 CURRENT ACCOUNT BALANCE AND NET FDI



Source: *Croatian National Bank.*

Figure 5 REAL SECTOR DEVELOPMENTS



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

0.5 percent. It seems that one-time positive effects in the first half of the year - change in taxes with the EU accession, introduction of fiscal cashiers and a successful tourist season - have lost steam while the underlying trend in retail trade remains negative.

Another year of rising unemployment...

The average number of unemployed persons increased by 6.4 percent in 2013. However, the pace of increase was moderated towards the end of the year, reaching 1.5 percent year-on-year in December. Croatian Employment Service has initiated a number of active labor market policy programs and managed to increase participation in these programs and to raise legal seasonal employment. These activities have helped to moderate a negative unemployment trend. Nevertheless, Croatia remains a country with very poor record on the state of the labor market. In the third quarter of 2013 the activity rate for the population 15-64 years stood at 60.5 percent, the lowest in the EU, while employment rate recorded 50.2 percent, the second lowest in the EU. Survey-based unemployment rate was 16.9 percent. Unemployment rate based on registers suggests a somewhat higher figure, 18.6 percent in the third and 21.0 percent in the fourth quarter of 2013.

... especially unemployment of the youth.

A high and rising youth unemployment rate (15-24) has recently attracted public attention. This rate exceeded 50 percent in the first half of 2013, and was the third highest rate in the EU, after those of Greece and Spain. However, the activity rate of the youth in Croatia was rather low, below 30 percent, meaning that one in eight persons aged 15-24 was unemployed. The Government has introduced a number of measures aimed at boosting employment or at least alleviating unemployment of the youth. The most well-known program is *on-the-job training without employment for persons without previous work experience*, that covered a substantial number of young persons last year. Also, by joining the EU Croatia has adopted the European Youth Guarantee. The implementation of the Guarantee officially began on January 1, 2014 when EU financial resources for employment of persons under 25 became available to Croatia while the additional measures will be financed by the European Social Fund and the state budget.

Real disposable income continued to fall.

The economy-wide average gross wage in the third quarter 2013 was 0.8 percent higher than one year ago. There was substantial variation in wage developments across sectors. In the public sector, i.e. in public administration, education and health, the average wage fell as a consequence of the linear wage cut by 3 percent in March. In other sectors nominal wages increased, from 0.3 percent in distributive trade to 8.2 percent in the power supply sector. Real disposable income has continued to decline mostly due to lower employment and despite a rise in government transfers. In September and October 2013 the decline is estimated at around 1.5 percent year-on-year.

Decrease in money supply...

As for the monetary sector developments, it appears that both broad money and total credits are declining. Seasonally adjusted month-to-month broad money (M4) was reduced by 0.1 and 0.4 percent in October and November, respectively, due to a drop of 0.7 percent in seasonally adjusted foreign currency savings and time deposits in November. Households' kuna savings prevented an even larger decrease as they went up by 0.5 percent. Deposit structure reveals that the weakness in money supply is driven exclusively by the corporate sector which strongly depleted its savings in November, 4.1 percent in seasonally adjusted terms.

... and slower deleveraging.

Total credits continued to fall in November 2013, 0.1 percent compared to November 2012. The fall was slower than in the previous month when it was 0.5 percent. Households reduced their borrowings to a stable pace, 2 percent in October and November, year-on-year. Enterprises, on the other hand, slowed down the rate of deleveraging, from 4.2 percent recorded in October to 3.1 percent in November. Since February 2012, enterprises have been taking fewer loans for both working capital and investment. By November 2013 loans for investments declined by 13.6 percent and for working capital by 12.0 percent cumulatively.

Central bank attempts to induce lending to the corporate sector.

Although the market has been flooded with liquidity in the last few years, credit activity has remained weak. In an attempt to push lending bank to the corporate sector, the central bank has decided to provide a specific monetary stimulus. In December it lowered the rate of reserve requirements from 13.5 to 12.0 percent, potentially releasing up to HRK 4.7 billion, of which HRK 3.9 billion in kunas and HRK 0.8 billion in foreign currency. This time, however, commercial banks are obligated to buy three-year, interest-free, non-transferable CNB bills in full amount of released domestic currency reserves. However, the CNB shall redeem these bills on a regular monthly basis from those commercial banks that increase their lending to the corporate sector. Redeemed amount of bills will be equal to a half of the increase in corporative loans. The first such operation on December 31 showed that 17 banks increased their placements which qualified them for early redemption of HRK 333 million of CNB bills. These funds create additional liquidity in the system.

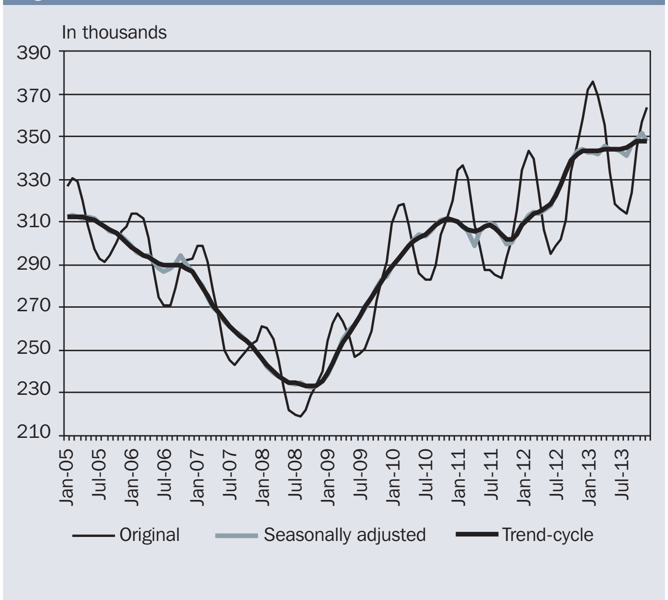
Slightly depreciated kuna and low money market interest rates.

Kuna depreciated by 1.4 percent against the euro between December 2012 and December 2013 due to at least three reasons. First, ongoing deleveraging and bank provisioning have increased foreign currency demand. Second, an announcement of Fed's tapering has negatively affected international markets, especially investors' preference for emerging markets which caused certain withdrawal of funds. Third, Croatia's credit rating downgrade has reduced inflow of foreign funds due to the country's lower attractiveness for portfolio investments. On the other side, strength of HRK/EUR exchange rate was supported by government lending abroad and current account surplus. More-than-satisfactory money market liquidity is keeping interest rates at record low levels, with the overnight lending rate in November at 0.28 percent.

Inflation rate slipped to 0.3 percent.

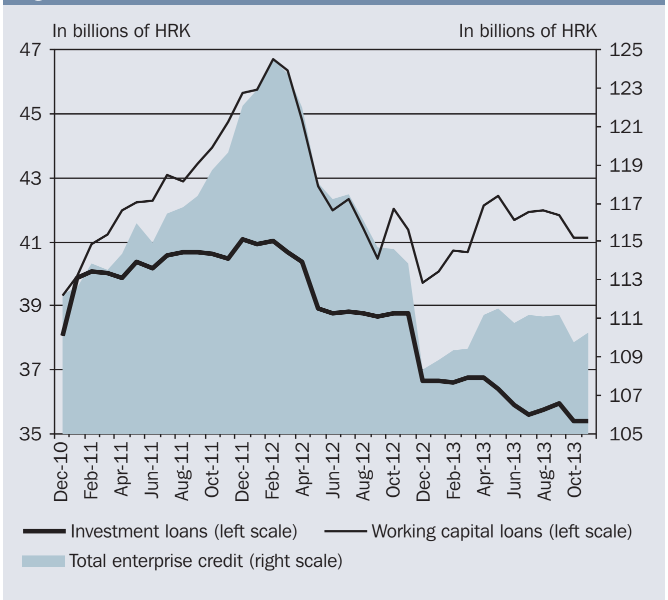
In December 2013 consumer price inflation remained suppressed at 0.3 percent, down from 0.4 percent observed in November. Such a low inflation could be attributed primarily to weak consumer demand. Retailers' price cuts following Croatia's accession to the EU were partially cost-based due to lower import tariffs, and partially linked to demand factors

Figure 6 NUMBER OF UNEMPLOYED PERSONS



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

Figure 7 DISTRIBUTION OF LOANS TO ENTERPRISES



Source: *Croatian National Bank.*

and increased competition. Favorable situation on the global food and oil markets has also been helpful.

Government revenue continues to fall…

In the first three quarters of 2013 total general government revenue was 1 percent lower than in the first three quarters of 2012. The decline observed in the first half of 2013 continued in the third quarter, reaching 1.6 percent year on year, due primarily to total tax revenue which fell 6.2 percent. The largest revenue component, VAT, recorded a decline of 11.6 percent. This had been expected, however, as the EU accession has also brought changes to VAT collection on goods imported from the EU. VAT is no longer incurred at the moment of import, but at the moment of sale, which has caused a delay in payment of at least one month. Profit tax revenue fell significantly, due to the exemption of reinvested profits and a weaker business performance in 2012. Other major tax revenues increased, most notably those from excises and personal income tax. Revenues from social security contributions, the second largest revenue source, recorded a 1.3-percent rise mostly due to improved tax discipline and despite unfavorable employment developments.

… while government expenditure expansion was halted.

Total general government expenditure in the first three quarters of 2013 increased by 4.1 percent compared to the same period of the previous year. However, after a steady rise in the first half of 2013, there was a 2.5-percent drop in the third quarter. This third-quarter drop was caused by the decline in two principal expenditure items, namely social benefits and compensations of public sector employees, which dropped by 8.8 and 4.7 percent, respectively. Compensation of employees declined primarily due to a 3-percent cut in basic salary of public sector employees and reduction in non-wage compensations. As for social benefits, official figures show that expenditures on health declined severely in the third quarter, after a huge financial injection into the health system in June which aimed at repaying due debt. In the third quarter there was a large increase in interest payments, while purchases of goods and services stagnated and subsidies declined. The deficit accumulated over the first three quarters of 2013 amounted to HRK 14.1 billion and substantially surpassed the budgetary plan. As for the public debt, at the end of September 2013 it reached HRK 203 billion, which is more than 60 percent of the estimated GDP. As there was intensive government borrowing in the last quarter, public debt at the end of 2013 probably reached 64 percent of GDP, well above 55.5 percent of GDP registered at the end of 2012.

The second revision of 2013 Budget endorses a substantially higher deficit.

The second budget revision was approved by the Parliament on December 4, 2013. Main reasons for the revision were first, underperformance relative to the plan in tax collection, primarily of VAT and profit tax revenues; second, higher-than-planned expenditures, mainly due to the June payoffs of the health care system debts, and third, deficit overrun. The budget revision implies lower revenue, higher expenditure and a notable increase in the general government deficit, from previously planned 3.4 percent of GDP to 5.5 percent of GDP i.e. from HRK 11.5 billion to HRK 18.4 billion.

2014 Budget implies no consolidation in terms of deficit.

According to the 2014 Budget adopted by the Parliament on December 4, 2013 general government deficit will be HRK 19.2 billion, or 5.5 percent of GDP of which 5 percent is the state budget deficit and the rest comes from extra-budgetary users. At the same time, the European Commission projects that with the enacted budget plan, the deficit might reach 6.5 percent of GDP. This difference in projections is due primarily to different views on the economy's performance in 2014. While the Government's figures are based on the expectation that the real GDP will grow at 1.3 percent, the Commission's baseline projection (without EDP measures) is 0.5 percent.

Table 1 MAIN ECONOMIC INDICATORS

	2011	2012	2012	2013		
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-0.2	-1.9	-2.2	-1.5	-0.7	-0.6
Real private consumption (% change, yoy)	0.3	-3.0	-4.2	-2.9	0.4	0.2
Real government consumption (% change, yoy)	-1.4	-0.8	-2.0	0.3	1.4	-0.9
Real investment (% change, yoy)	-3.4	-4.7	-4.6	-2.3	0.9	0.3
Industrial output (% change, yoy)	-1.2	-5.5	-5.7	0.8	-1.8	-3.8
Unemployment rate (registered, %, pa)	17.8	18.9	20.1	21.7	19.7	18.6
Nominal GDP (EUR million)	44,220	43,707	-	-	-	-
GDP per capita (EUR)	10,332	10,243	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	1.8	1.9	2.6	2.2	1.6	0.3
Consumer prices (% change, yoy, pa)	2.3	3.4	4.6	4.6	2.3	1.8
Producer prices (% change, yoy, pa)	6.3	7.0	7.3	4.1	1.2	-0.6
Average gross wage (% change, yoy, pa)	1.5	1.0	0.4	1.3	0.8	0.8
Exchange rate, HRK/EUR (pa)	7.43	7.52	7.52	7.58	7.56	7.56
Exchange rate, HRK/US$ (pa)	5.34	5.85	5.80	5.74	5.79	5.69
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,582	9,629	2,577	2,076	2,284	2,284
Exports of goods (EUR, % change, yoy)	7.6	0.5	7.8	-7.9	-1.8	-7.6
Imports of goods (EUR million)	16,281	16,214	3,975	3,730	4,394	3,983
Imports of goods (EUR, % change, yoy)	7.6	-0.4	0.1	-6.3	5.5	-2.7
Current account balance (EUR million)	-392	-13	-659	-1,431	-288	2,850
Current account balance (% of GDP)	-0.9	0.0	-	-	-	-
Gross foreign direct investment (EUR million)	1,101	1,067	450	554	17	-40
Foreign exchange reserves (EUR million, eop)	11,195	11,236	11,236	11,277	12,021	11,720
Foreign debt (EUR million, eop)	46,059	45,019	45,019	45,195	46,200	45,147
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,025	126,132	126,131	28,918	60,241	92,218
Expense (HRK million)**	132,945	132,413	132,413	33,782	69,744	102,769
Net = Gross operating balance (HRK million)**	-9,920	-6,282	-6,282	-4,863	-9,503	-10,550
Net acquisition of non-financial assets (HRK million)**	5,044	4,574	4,574	1,211	2,349	3,521
Net lending/borrowing (HRK million)**	-14,964	-10,855	-10,856	-6,074	-11,852	-14,071
Domestic government debt (EUR million, eop)	13,716	15,225	15,225	15,539	-	-
Foreign government debt (EUR million, eop)	6,996	8,353	8,353	8,422	-	-
Total government debt (% of GDP)	47.2	53.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	7.5	1.6	1.6	10.7	13.0	11.5
Broad money, M4 (% change, yoy, eop)	1.6	3.2	3.2	4.4	3.4	5.1
Total domestic credit (% change, yoy, eop)	4.9	-3.9	-3.9	-3.9	-3.1	-1.1
DMBs credit to households (% change, yoy, eop)	1.0.	-1.4	-1.4	-1.2	-2.7	-0.4
DMBs credit to enterprises (% change, yoy, eop)	8.7	-11.2	-11.2	-11.6	-5.5	-3.1
Money market interest rate (%, pa)	0.9	1.1	0.5	0.4	0.3	0.5
DMBs credit rate for enterprises, short-term, (%, pa)	7.0	7.3	7.0	6.5	6.3	6.7
DMBs credit rate for households, short-term (%, pa)	11.9	11.2	11.2	11.2	11.2	11.1

Notes: ** Data refer to consolidated general government according to national accounting standards. ** 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.*

2 Policy Assumptions and Projections Summary

Global recovery underpinned by advanced economies.

Recovery of the global economy is progressing at a gradual pace with advanced economies being growth leaders. In the latest release of *Global Economic Prospects* (January 2014), the World Bank expects global growth to pick up from 2.4 percent in 2013 to 3.2 and 3.4 percent in 2014 and 2015, respectively. Last year's growth in the U.S. was largely influenced by spending cuts in March and temporary government shutdown and tensions surrounding the extension of debt limit in October, which led to the fall in consumer confidence and raised uncertainty for businesses. However, fiscal consolidation drag is expected to continuously decline, allowing economic growth to gain momentum and reach 2.8 and 2.9 percent for 2014 and 2015, respectively. Eurozone emerged out of recession in the second quarter of 2013, led primarily by net exports. Real GDP rose by 0.1 percent in third quarter. Increasing trend is expected to continue through the following two years with an expansion of 1.1 and 1.4 percent in 2014 and 2015, respectively. Croatian economy may benefit from stronger demand in the eurozone. However, two of Croatia's most important trading partners, Italy and Slovenia, are still in recession. In the case of Italy, a slow turnaround in economic activity is anticipated this year, while Slovenian economy is projected to remain in the negative zone in 2014 with brighter prospects for 2015. Oil prices are declining. Brent crude oil price was at US$ 107 per barrel at the beginning of January 2014, 3 percent lower than one year ago. These prices are expected to the remain stable through 2014 at around US$ 106 per barrel before declining slightly in 2015.

EDP will greatly influence economic policy in the coming years...

This year and over the medium term, fiscal consolidation will be the main challenge for Croatian policy-makers. Due to the breaching of both deficit and debt criteria of the Stability and Growth Pact, European Commission has recommended that European Council opens an excessive deficit procedure (EDP) for Croatia. It is expected that the EDP will be officially opened at the Council's meeting in late January. At the same meeting the Council should agree on recommendations to be addressed to Croatian authorities regarding the correction of excessive deficit. Most likely these recommendations will not differ from those already published by the Commission. Accordingly, Croatia should exit the excessive deficit position by 2016. In order to achieve this goal, headline deficit should not be higher than 4.6 percent in 2014, 3.5 percent in 2015 and 2.7 percent in 2016. Such deficit path should ensure that a debt-to-GDP ratio starts declining in the two-year period following the compliance with the deficit criterion, i.e. in 2017 and 2018.

… implying strong fiscal consolidation.

By the end of April Croatian government is expected to specify and implement necessary measures to achieve the reduction of excessive deficit. The details of the consolidation strategy should be reported to the Commission. The Government should also report on the progress in the implementation of the Council's recommendations at least every six months. Although the Commission does not request specific policy measures to be implemented, certain recommendations have already been issued. For example, the Government is expected to undertake an extensive expenditure review with the objective of rationalizing wage, social security and subsidy outlays and it should further improve tax compliance as well as institutional framework of public finances. Structural reforms should accompany the consolidation measures and improve growth prospects over the medium to long term by focusing on the creation of a more flexible labor market, business-friendly environment and efficient public administration.

Budget revision expected soon.

Recommendations related to the EDP procedure envision a significantly different fiscal consolidation than the 2014 Budget and accompanying plans for 2015 and 2016. In spite of the fact that Croatia is given a three-year period to correct the deficit due to deep and prolonged recession (usual timeframe is up to two years), Croatian policy-makers will have to act promptly and prepare a plan of strong fiscal consolidation. Therefore, budget revision is expected soon. Deficit should be reduced by at least HRK 3 billion compared to the government plan enacted in the Budget, which is quite a challenging task. The Government has already listed 18 measures that should affect budget outcome this year. Among others, the list includes pension system reform, civil service reform, reorganization of public administration, consolidation of social transfers, strict control of sick leaves and drug prescriptions in the health sector, and improvements in public procurement regulations. These measures have not been explained in details and there are no estimates of their impact on the Budget. In our view they may have important long-term effects but their short-term impact will not be strong enough to significantly reduce budget deficit this year. Without a precise government plan, our projections rely on rough estimates of the effect of assumed consolidation on main budget and consumption items.

2013 GDP estimated to have declined by 0.7 percent.

High-frequency data for the last quarter, as well as established major trends in the economy, suggest that 2013 ended with GDP decline of 0.7 percent. We estimate that all demand components decreased, except for the government consumption. Personal consumption is estimated to have decreased 0.6 percent and investments 0.3 percent. Earlier projections indicated a recovery of investments but the positive trend established in the beginning of 2013 has in the meantime weakened and caused the revision of the projection. Exports are estimated to have declined more than imports, which resulted in the negative contribution of net exports to GDP growth.

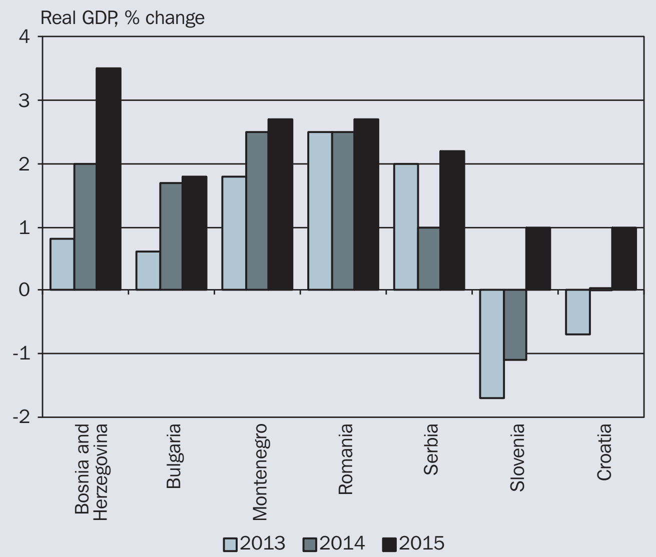
The stagnation continues in 2014; modest recovery in 2015.

Poorer-than-expected state of the economy and strong fiscal consolidation envisaged in this year are major factors behind the downward revision of our growth projections for 2014. We now expect the stagnation of Croatian economy to continue in 2014 as consolidation measures are likely to further depress domestic demand. However, improved international environment and reforms conducted this year should prepare the ground for stronger economic activity driven by exports and investments in 2015, when growth is expected to recover and reach 1 percent.

Fiscal consolidation will depress consumption...

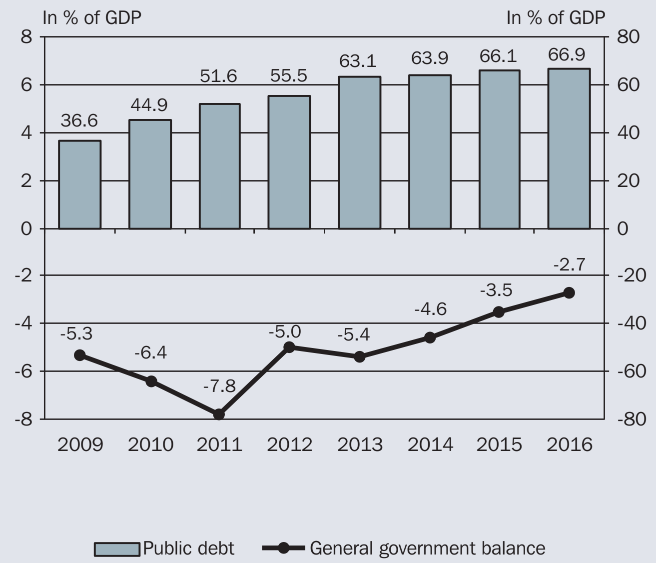
Already affected by negative labor market developments and deleveraging of the household sector, and further impacted by the cuts expected in budget transfers and increased taxation, personal consumption should decline by 1.4 percent in 2014. Downward pressures on

Figure 8 GROWTH PROSPECTS FOR SOUTH EAST EUROPE



Sources: *Global Economic Prospects (January, 2014), World Bank; EIZ for Croatia and IMF Country Report 14/11 for Slovenia.*

Figure 9 GENERAL GOVERNMENT BALANCE AND DEBT



Sources: *Eurostat for 2009-2012 and European Commission's projections under EDP scenario for 2013-2016 (SWD(2013) 525 final).*

incomes should, however, weaken by the end of 2015 due to improved economic conditions in general, and in labor market in particular. In 2015 on average, personal consumption is expected to stagnate. Government consumption is projected to decline by about 1 percent in both 2014 and 2015.

… while investments and…

Investments possess a growth potential this year. We expect the Government to make every effort not to cut investments in the expected revision of 2014 Budget. Stronger inflow from the EU funds, accompanied by foreign and domestic private sector investments encouraged by legislative support such as Strategic Investments Act are expected to give momentum to investment recovery. Additionally, strengthening of growth in the EU should spill over some business optimism on the domestic market. Consequently, investments are projected to rise 2.6 percent in 2014 and 4.4 percent in 2015.

… exports should gradually improve.

As the economy adjusts to the new environment following EU accession, exports should gradually recover. Besides the projected strengthening of exports of goods, exports of services, primarily tourism, should retain a stable positive trend enabling total exports to increase by 3 percent in 2015. Imports will reflect the general state of the economy and should, therefore, recover next year.

Current account surplus to persist.

We expect the process of balancing external transactions to continue. In 2013 current account surplus is estimated at around EUR 500 million or 1.2 percent of GDP. That is the result of an increase in revenues from foreign tourism, decrease in imports as well as lower outflow of income due to depressed profits of foreign-owned enterprises. Similar level of surplus is expected in the next two years. In respect to foreign debt we expect further deleveraging of both enterprise and banking sectors, while government sector will increase its foreign debt. Consequently, total foreign debt might modestly decrease but still remain above 100 percent of GDP in both 2014 and 2015.

Gloomy prospects for labor market in 2014.

The labor market is not likely to recover in 2014. Unemployment rate is projected to increase to 20.5 percent, 0.2 percentage points higher than in 2013. In the wake of improved output, some relief is expected to spill over onto the labor market in 2015 with an average unemployment rate of 20.0 percent. The EDP may have a direct impact on the labor market via deficit reduction measures in terms of, for example, public sector employment and wages, depth and speed of structural reforms in state-owned enterprises etc. but at this moment we do not have enough information on reform measures to give an assessment.

Central bank ready to ensure exchange rate stability.

We expect the average HRK/EUR rate in 2014 to be somewhat higher than last year, around 7.62 and to stabilize around that level in 2015 as well. The main drivers of 2014 depreciation are expected to be external deleveraging and bank provisioning, while stability of HRK/EUR exchange rate will mostly be supported by the willingness of central bank to use available resources in order to ensure reasonable exchange rate stability.

Slow lending recovery in spite of recent measures.

Our forecast for this year's domestic credit activity remained unchanged at -0.1 percent. Private sector deleveraging is projected to continue as macroeconomic outlook remains weak. Commercial banks are burdened with non-performing loans and not willing to take additional credit risk. Although the latest CNB credit scheme is welcome, it is not sufficient to increase lending because lending fundamentally depends on better prospects for the economy. For 2015 we anticipate an improvement in credit activity, up by 1.1 percent, stemming from a higher projected GDP growth, realization of investment projects and modest job market recovery that should affect consumer demand. Broad money is expected to grow by 3.3 percent in 2014 followed by a similar rate in 2015.

Table 2 SUMMARY OF PROJECTIONS			
	2013 estimate	2014 projection	2015 projection
Real GDP (% change)	**-0.7**	**0.0**	**1.0**
Real private consumption (% change)	-0.6	-1.4	0.1
Real government consumption (% change)	0.1	-1.0	-0.9
Real investment (% change)	-0.3	2.6	4.4
Exports of goods and services (constant prices, % change)	-1.8	1.0	2.8
Imports of goods and services (constant prices, % change)	-1.3	-0.1	2.3
Current account balance (% of GDP)	1.2	1.5	1.2
Consumer prices (% change, pa)	2.2	1.2	2.1
Exchange rate, HRK/EUR (pa)	7.57	7.62	7.62
Unemployment rate (registered, %, pa)	20.3	20.5	20.0
General government balance (ESA95 definition, % of GDP)	-5.4	-4.6	-3.5
Broad money, M4 (% change, eop)	3.5	3.3	3.3
Total domestic credit (% change, eop)	-0.4	-0.1	1.1

Note: *Cut-off date for information used in the compilation of projections was January 8, 2014.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

Inflation to stay low.

Consumer price inflation is projected to remain low at the year average of 1.2 percent in 2014. An increase in reduced VAT rate as of January 1, and the announced further rise in excise tax on energy and tobacco could push consumer prices up, but further weakening of consumer demand due to reduced household income, deleveraging and poor consumer confidence are expected to pull prices down in 2014. A gradual pick up of inflation to 2.1 percent is expected in 2015 as aggregate demand recovers. The main risk on the upside stems from unexpected tax hikes while the main risk on the downside implies weaker-than-expected consumer demand.

Revenue-based consolidation more likely than expenditure-based one.

As for the fiscal projections, two basic approaches could have been considered. The first was to take the budget plan as the base for projections. The second was to take EDP targets as the base, assuming that the Government will prepare and implement policy measures that ensure full compliance with these targets. We have chosen the latter approach. Once the details of the government consolidation strategy are known, in April at the latest, we will be able to estimate its effects on the economy and fiscal balance. Accordingly, our projection of fiscal deficit is 4.6 percent of GDP in 2014 and 3.5 percent of GDP in 2015. It seems likely that the Government will pursue a more revenue-based adjustment strategy, supplemented with some expenditure cuts. A heavier reliance on one-off revenues such are large privatizations, concessions, profits of state-owned companies etc. is not excluded. Rating agencies are very sensitive to deficit and debt overrun, as shown by recent S&P's downgrade of long-term sovereign ratings from BB+ to BB. However, if Croatian government presents a credible fiscal consolidation strategy, implements it rigorously and complies with the EDP requirements, we believe that there will be no further cuts in ratings.

3 Uncertainties and Risks to Projections

Is postponement of strong fiscal consolidation possible at all?

Rather pessimistic overall outlook for 2014 is primarily driven by an assumption of strong fiscal consolidation that would have a negative short-run effect on the growth performance. Nevertheless, corrective measures and structural reforms within consolidation strategy should set a basis for more prospective performance in the longer run. If these measures are going to be milder and/or implemented later than expected, which is not likely but cannot be fully ruled out, this outlook might be somewhat brighter in the short run but poorer in the medium term. In any case, it seems crucial to undertake fiscal consolidation simultaneously with retaining growth-friendly expenditures, in particular investments.

Doubts about the cyclical position of the economy.

There are some uncertainties regarding the actual cyclical position of the Croatian economy. Based on the seasonally adjusted data it seems that Croatian economy is currently in the phase of stagnation. However, due to the reduction of grey economy enforced by the improved tax administration, official statistics might overestimate consumption and output, blur the real state of the economy and make projections more uncertain and possibly upward biased.

General strike on the horizon?

Due to a long recession with high unemployment and strong deleveraging of the household sector, additional measures aimed at fiscal consolidation, that would reduce access to some public services or lower the benefits of certain social groups, might bring on a widespread social turmoil. Provoked by the Draft Labor Law, major trade union associations are organizing a referendum among its members on readiness for general strike. Although we assess that massive industrial action is not likely, there is a risk of increased social tensions and political conflicts. The ruling coalition seems to hold a strong position in the Parliament, which lowers the possibility of broad-based political instability, but consolidation and reform measures might be softened at the expense of weakened future growth prospects.

Speculation about the tapering of quantitative easing policies.

In the aftermath of financial crisis, central banks of major advanced countries have been performing unconventional monetary policies – so called quantitative easing, with the aim of increasing liquidity by purchasing long-term assets. Given the walloping amount of the assets accumulated by major central banks, and the challenges to determine the timing and magnitude of unwinding these assets, more volatile movements of the capital could cause marked instability for the world economy, sizable capital outflow from emerging markets, and rising interest rates with negative consequences for growth prospects of, primarily, developing countries including Croatia.

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