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Croatian Economic Outlook

Quarterly

1 Recent Developments

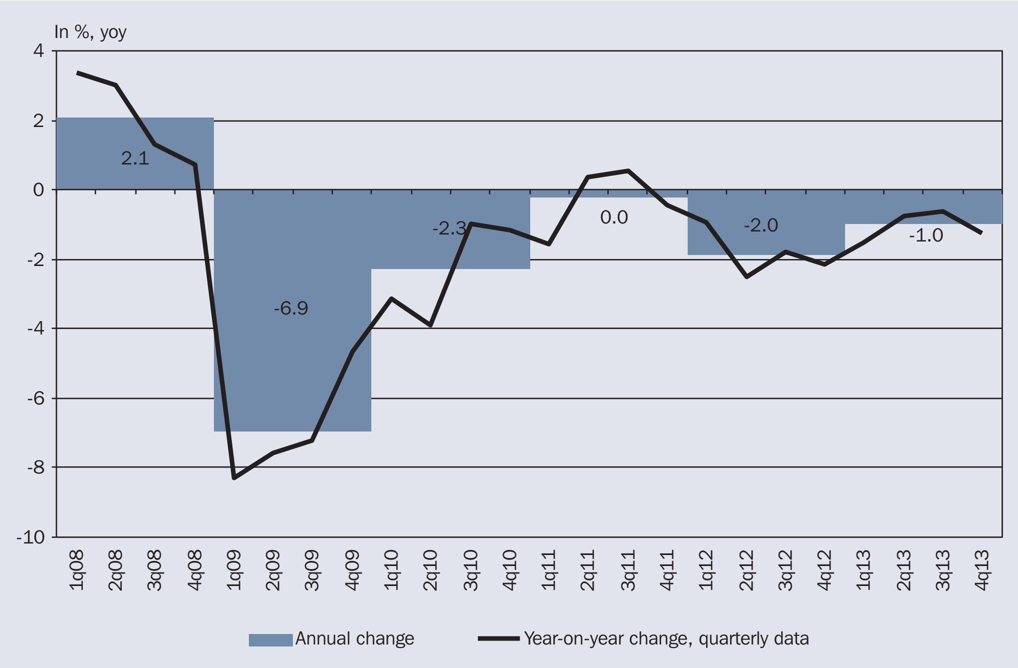
Economic conditions deteriorated at the end of last year…

Croatian GDP fell by 1.2 percent year-on-year in the fourth quarter of last year while 2013 as a whole recorded a GDP decline of 1.0 percent. Last year was the fifth consecutive year with negative growth rate, which left Croatia in the longest period of continued GDP contraction in the EU, except for Greece. Moreover, the final quarter of 2013 confirmed a negative trend with quarter-to-quarter rate of -0.7 percent. The average growth in the previous three quarters was around -0.1 percent. The main factor behind the deterioration is a substantive decline in domestic demand, mainly in personal consumption and investments. Exports of goods and services fell as well, but sharp reduction in imports of goods and services allowed for a positive contribution of net foreign demand to GDP growth in the fourth quarter. While all major demand components are still weakening, fiscal and monetary policy have limited capacities to provide an effective stimulus to the economy due to financial stability concerns, thus making the policymakers' job even more complex.

… followed by mixed signals at the beginning of this one.

The latest high-frequency data suggest that negative trends from last year may be easing at the beginning of this year. However, fragile signs of improvement need to be confirmed in the next few months in order to discard possible effects of irregular factors. For example,

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

industrial production and exports seem to be moving upward, though rather unevenly across the sectors. A very mild recovery is also present in retail trade. However, construction activity has remained on a downward trend at the beginning of the year.

Rapid weakening of personal consumption.

Personal consumption weakened rapidly in the fourth quarter of last year. It fell by 1.8 percent compared to the same quarter a year ago and 1.5 percent compared to the previous quarter, according to seasonally adjusted figures. Robust downward trend is the result of reduced employment, low consumer confidence and continued deleveraging of the household sector. Personal consumption would have fallen even deeper without significant disinflation which helped to protect incomes from further erosion of their purchasing power. In 2013 as a whole, personal consumption declined by 1.0 percent, which is a slight improvement compared to 2012 when it fell by 3.0 percent. However, that is still rather depressing as its cumulative decline over the last five years reached 12.1 percent.

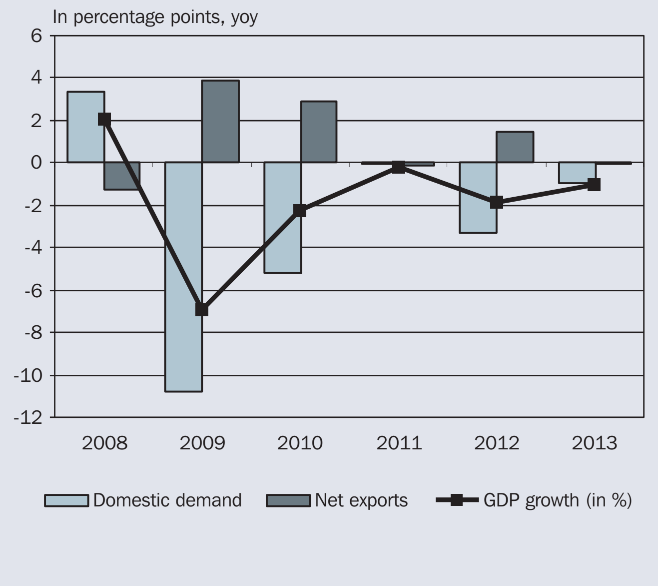
Government consumption rose in 2013.

Following a sizable decline in government consumption in the third quarter of 2013, the fourth quarter brought a sudden increase, 1.2 percent year-on-year. Consequently, the entire 2013 saw an increase of 0.5 percent which seems to stand in sharp contrast to the proclaimed austerity of fiscal policy. However, one has to bear in mind that government consumption, as recorded in national accounts statistics, refers dominantly to government purchases of goods and services, while total government expenditure recorded in government finance statistics has a much broader scope of outlays, including transfers to households and enterprises, interest payments and investments. Also, it is possible that payment period for government purchases was reduced at the end of last year as a result of high liquidity of Treasury due to large-scale bond issuance in anticipation of deteriorating lending conditions.

Investments receded strongly.

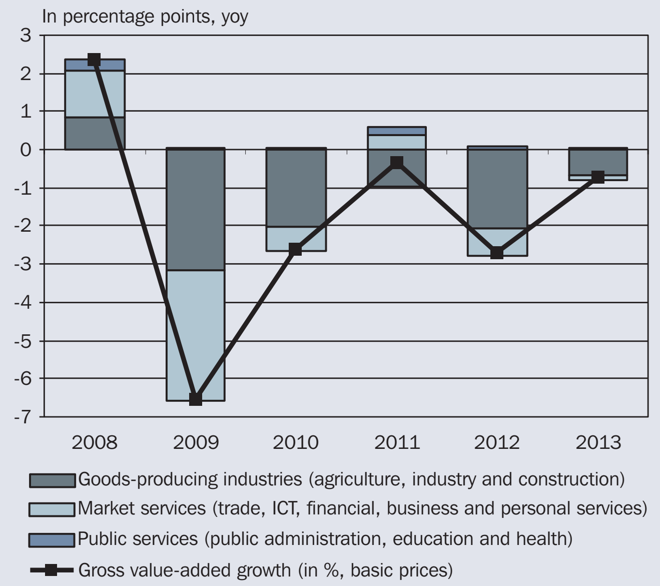
After a mild recovery in the first half of 2013, investments receded in the third quarter and again, even more strongly in the fourth quarter with a 3.3-percent decline year-on-year. Consequently, investment trend reversed to negative. In the situation of weak economic prospects, households and enterprises are averse to invest despite government assistance through various arrangements involving the state budget and Croatian Bank for Reconstruction and Development. Financial resources devoted to investment support seem to have been insufficient and only few large-scale projects in the public sector have

Figure 2 DEMAND CONTRIBUTIONS TO GDP GROWTH



Source for original data: *Croatian Bureau of Statistics.*

Figure 3 SECTORAL CONTRIBUTIONS TO OUTPUT GROWTH



Source for original data: *Croatian Bureau of Statistics.*

been prepared for implementation. Regardless of strong policy focus on investments, the second half of last year was a step backwards.

Disappointing exports and imports in the entire 2013…

In the fourth quarter of 2013 total exports declined by 3.8 percent and total imports by 4.4 percent year-on-year, thereby intensifying a decline in trade flows recorded in the third quarter. Sharp decline in the volume of exports of goods, 5.6 percent, was caused by the combination of factors such as structural adjustments, particularly of the shipbuilding industry, slow adjustment to new trade regimes after EU accession, and long-standing competitiveness problems. The 5.0-percent decline in the volume of imports of goods results predominantly from weak domestic demand. As for exports of services, the fourth quarter of 2013 brought their slight reduction, but 2013 as a whole saw the growth of 0.7 percent, owing mostly to positive results of the tourism industry.

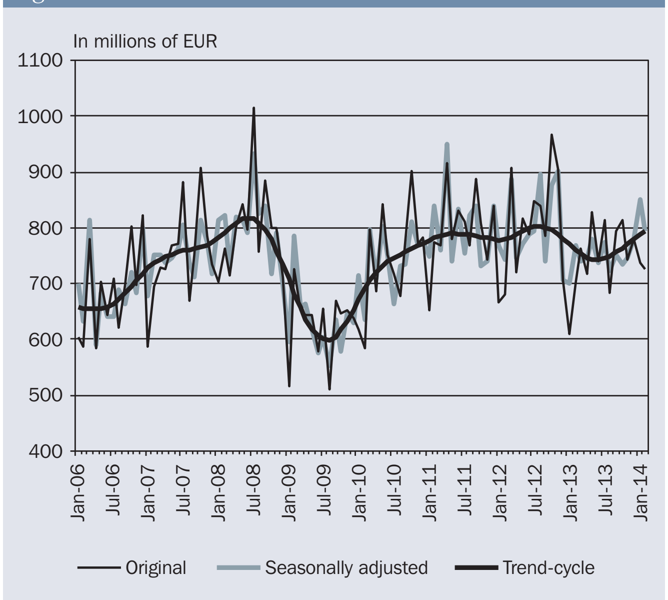
… followed by their recovery in the beginning of this year.

In the year of Croatia's accession to the EU exports of goods were weaker than expected registering a decline of 6.7 percent in current euro terms compared to the year before. Exports to the EU declined by 5.1 percent and to CEFTA countries by 6.6 percent. At the same time imports of goods contracted by 2.5 percent. However, the most recent developments suggest that economy has adjusted to the new external conditions and that recovery, although still fragile, is under way. Although preliminary, and subject to change, data for January-February period indicate 12-percent increase in the exports of goods (including a 12-percent rise to the EU countries) and a 3-percent rise in imports of goods. This, rather strong year-on-year rise is partially due to the low base from the previous year, but seasonally adjusted monthly figures confirm positive changes in the trend, implying recovery in exports of goods.

Current account surplus reaches 1.3 percent of GDP.

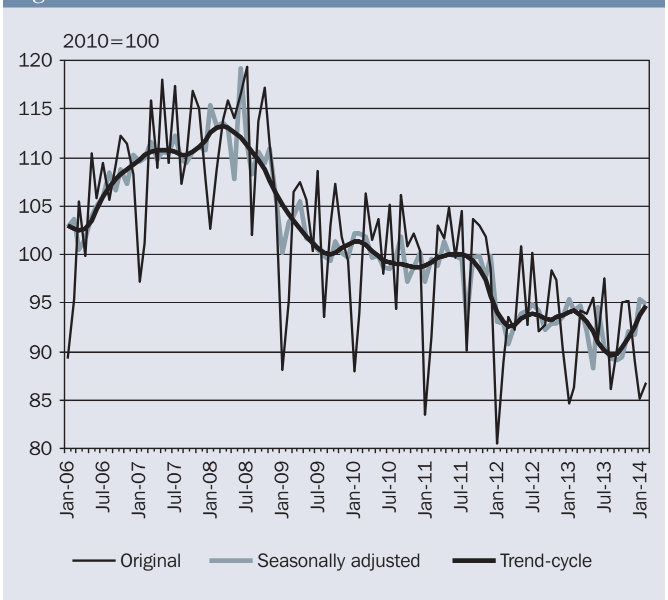
Notable contraction of imports of goods and services was the main factor behind the current account surplus of EUR 564 million last year, or 1.3 percent of GDP. Balance of goods and services was in surplus of around EUR 560 million, while the deficit in transactions of factor incomes and the surplus in flows of transfers were almost of the same size. Due to a more intensive debt creation in the public sector, gross foreign debt reached EUR 45.6 billion or 105.3 percent of GDP by the end of 2013, which is some EUR 770 million more than a year before. Nevertheless, the private sector reduced its foreign indebtedness by EUR 800 million or by 2.7 percent.

Figure 4 EXPORTS OF GOODS



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

Figure 5 INDUSTRIAL PRODUCTION



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

Industrial production exhibits an upward trend…

At the very beginning of 2014 industrial production showed a surprisingly strong monthly rise of 4.0 percent according to the seasonally adjusted data which caused questions as to whether this level of activity could be sustained and whether it indicated a more widespread recovery. One should, however, note that monthly data on industrial production has been very volatile, even when seasonal effects are excluded, which should preclude us from basing conclusions on one-month data. This is especially so in the case of January. Namely, at the beginning of the year, statistical office changes weights of individual branches that are used to calculate overall industrial production. The weights are being adjusted according to the gross value added from the previous year, meaning that branches that contracted in the previous year have less of an impact on the figure for total industry in the current year. It should also be mentioned that holidays during December and January are often combined with nearest weekends causing some noise in the seasonally adjusted figures at the change of the year. Strong January rise was somewhat offset by February decrease of 0.6 percent. Nevertheless, the trend of industrial production has been on a steady rise since last September. On average, industrial activity in the first two months of 2014 was 4.4 percent stronger than in the last quarter 2013, while the cumulative year-on-year increase for the first two months of this year amounted to 0.6 percent.

… while retail trade stagnates and construction activity continues to decline.

In recent months retail trade volume has exhibited quite a different pattern from that of industrial production. Actually, retail trade trend has stagnated ever since August and the end of the tourist season. In the first two months of this year retail trade activity was 0.4 percent stronger than in the last quarter of 2013 while year-on-year cumulative change amounted to 0.2 percent. Car sales have improved and the number of registered personal cars recorded an impressive year-on-year rise of over 20 percent in the first quarter of this year. That, however, cannot be used as a sign of change in consumer confidence as the substantial part of these cars were delivered to the Government. Construction activity is still on the decline. Following a 4-percent drop in 2013 as a whole, the downward trend was prolonged into this year with the additional 0.7-percent decrease in January compared to the month before according to seasonally adjusted figures.

Labor market conditions continue to deteriorate.

In February this year unemployment reached its highest level since the start of the Great Recession. The number of registered unemployed persons climbed to 384 thousands and the unemployment rate to 22.7 percent. Since the beginning of 2008 employment fell by more than 200 thousand persons. Out of that, some 70 thousand lost their jobs in crafts, trades and freelance activities. The rest of the jobs were mostly lost in manufacturing, retail trade and construction sectors. Although data for March show a decrease in the number of registered unemployed, this effect is mostly seasonal.

Lower inflation slows down erosion of real wages.

Economy-wide average gross wage has continued to rise in the fourth quarter of 2013. It reached HRK 7,979 per month, some 0.3 percent higher than in the same quarter a year before and 1.2 percent higher than in the previous quarter. For 2013 as a whole, average gross wage increased by 0.8 percent. However, if we take increase in consumer prices into account and calculate real wages, then the average gross wage fell by 1.4 percent. Inflation slowdown at the end of the year helped to keep real gross wage constant in the last quarter of 2013 compared to the same period a year before. Real disposable income is estimated to have fallen by about 3 percent in 2013.

Steady increase in money supply.

Seasonally adjusted broad money (M4) was increasing at a stable pace of around 0.8 percent per quarter in the last 18 months. A moderation in February with a 0.2-percent month-to-month rate is mainly the result of slowdown in deposit collection. Seasonally adjusted demand deposits increased by 0.3 percent compared to the previous month, while time and savings deposits decreased by 1.4 percent, which was the largest drop since August 2013. Foreign currency deposits, on the other hand, increased by 0.5 percent and helped broad money to keep growing. In the beginning of this year money supply (M1) continued to increase at two-digit year-on-year rates, the pace that was prevalent for the last twelve months.

Credit growth stagnates.

Total credits stagnated in seasonally adjusted terms in the first two months of this year at the level attained at the end of 2013. Credit activity did not change much in total compared to the beginning of the previous year, but dynamics by components varied. Credits to households and enterprises receded by around 1.4 percent, while the Government increased its lending by 13.8 percent. Seasonally adjusted figures for the very beginning of this year suggest that credits to households increased mildly, possibly due to kuna depreciation, but credits to enterprises have shrunk significantly, suggesting that pre-bankruptcy procedures and restructuring gave boost to the deleveraging in the corporate sector.

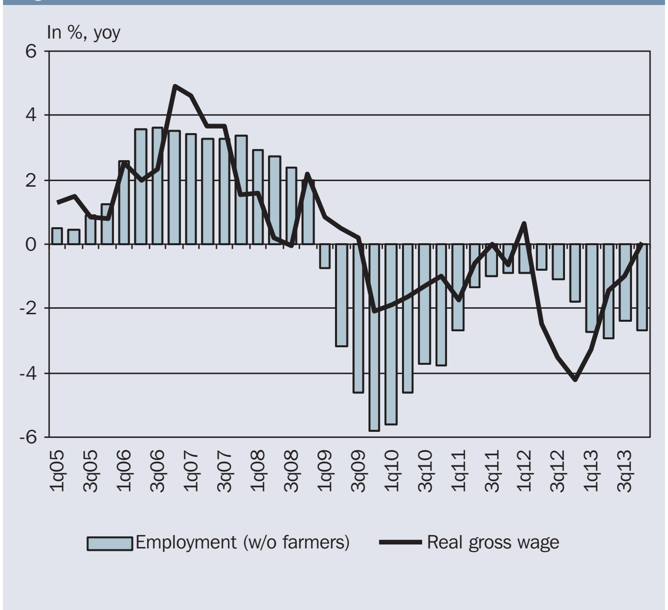
Central bank continues its expansionary monetary policy.

Banking system liquidity remained high and recorded a liquidity surplus of around HRK 8.5 billion at the beginning of April, which confirms the expansionary policy stance followed by the central bank. Interest rates in February stayed at record low levels, 0.4 percent on money market overnight loans and 6.2 percent on local currency loans to enterprises. However, in spite of ample liquidity credit activity did not pick up. The protracted recession has pushed nonperforming loans up to 15.6 percent of total loans at the end of 2013, compared to 13.9 percent a year before. The banking sector was burdened by a slump in pre-tax profit, which was down by 70.3 percent in 2013. Lower interest incomes and tighter risk provisioning requirements are pushing the banking sector into deleveraging, just as enterprises and households have already been doing.

Exchange rate stability preserved by central bank's intervention and treasury borrowings.

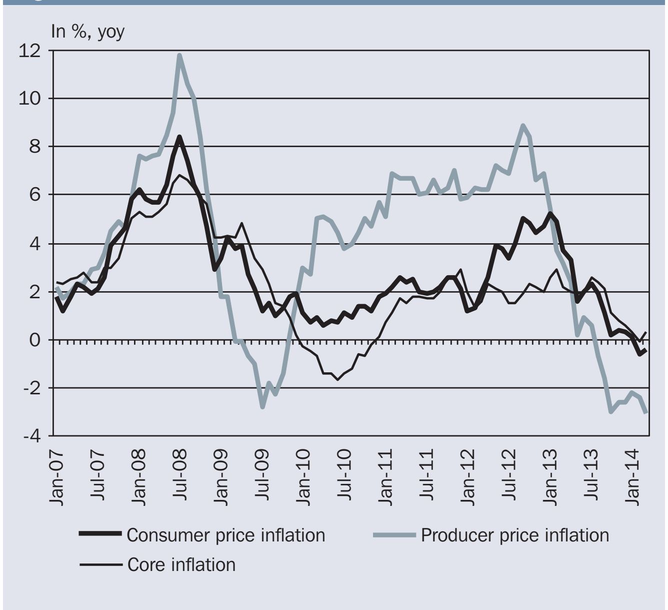
After S&P's downgrade of Croatia's credit rating to BB in the second half of January, kuna came under increasing depreciation pressure induced by weakness of exports in the fourth quarter of 2013, increase of bank provisioning and degradation of fiscal position. On the last day of January the central bank intervened in the foreign exchange market by selling EUR 240.2 million, which stabilized the HRK/EUR exchange rate at around 7.65, some 0.9 percent above the rate from the first quarter of 2013. Fiscal authorities contributed to exchange rate stabilization by issuing foreign currency bonds in the amount higher than initially planned.

Figure 6 EMPLOYMENT AND REAL WAGES



Source: *Croatian Bureau of Statistics.*

Figure 7 INFLATION



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

Lower import prices and poor domestic demand open room for deflation.

In February, for the first time in the last 19 years, consumer price inflation recorded a negative rate, -0.6 percent. Deflation was also recorded in March, -0.4 percent, which was caused chiefly by lower food, fuel and clothing prices, suggesting that such developments are largely determined by lower import prices. Increased retailers' competition following Croatia's accession to the EU may have contributed to this outcome as well. Prices of services have also been on the downward path, which is mostly due to poor domestic demand. Core inflation in February was -0.1 percent confirming broad-based downward pressures on prices.

Public debt jumps to 67.1 percent of GDP in 2013.

Fiscal data according to ESA95 accounting methodology released on April 18, 2014 show that total general government revenue and expenditure in 2013 amounted to HRK 134.6 billion and 150.8 billion, respectively. Such budget outturn resulted in the deficit of HRK 16.2 billion or 4.9 percent of GDP. Compared to 2012, the deficit is lower by 0.1 billion, while the deficit-to-GDP ratio is lower by 0.1 percentage point. Primary deficit, i.e. deficit without interest payments, was 6.1 billion and primary deficit-to-GDP ratio 1.9 percent of GDP, 0.1 percentage points down from 2012. Public debt of the consolidated general government reached HRK 220.2 billion at the end of 2013, which is 67.1 percent of GDP. Public debt has increased by HRK 36.5 billion since the end of 2012 confirming a rapid deterioration of the country's debt position.

Government revenue falls short of target…

As no details on government revenues and expenditures in 2013 have been released, we have looked at the latest available data on government finances, namely those for the first eleven months according to national accounting rules. Accordingly, consolidated central government revenue collected by the end of November 2013 amounted to HRK 101.5 billion, which is 87 percent of the amount planned in the revised budget and 2.1 percent less than in the same period of 2012. With such an outturn, it is highly likely that government revenue for the entire 2013 fell short of the target set in the Budget. The greatest absolute contribution to this decline came from reduced profit-tax and VAT revenues. Profit-tax revenue fell due to, first, poorer business performance in 2012 than in 2011 and, second, letting reinvested profits go untaxed since January 2013. As for the revenue from VAT, it fell due to declining consumption and changes in taxation of goods originating from other EU countries. Among revenues that have increased, the largest contributions came from excises, predominantly on oil derivatives, and from inflows of foreign assistance in the form of EU funds.

… while government expenditure expands.

Total expenditure of the consolidated central government reached HRK 114.9 billion by the end of November 2013, which is 4.8 percent more than in the same period of 2012. Total amount spent by the end of November is about 93 percent of what was planned in the Budget. The observed rise was due to higher insurance-based social expenditures, higher payments to the EU budget and increased interest payments. Employees' compensation fell by a sizeable amount due to the combined effect of a 3-percent cut in public sector salaries in March, the abolishment of holiday bonuses and the reduction of the health contribution rate.

Budget revision enacted higher government revenue and lower deficit.

In order to comply with requests from the Excessive Deficit Procedure (EDP), the Government proposed the revision of this year's Budget. At the end of March, the revision was passed by the Parliament. Both the revenue and expenditure totals were revised upward: the former by HRK 4 billion and the latter by HRK 100 million, implying a 3.5-billion reduction in the central government operating deficit, which should now be about 13.9 billion. Most of the additional revenue will be ensured through the withdrawal of pension contributions collected by military and police personnel from the second to the first pension pillar and by raising the health contribution rate from 13 to 15 percent. Additional revenue should also come from changes in the tax system (higher excises on tobacco products and higher taxes on lottery wins). As for the expenditure, cuts in public officials' non-wage benefits, material and financial outlays, as well as health expenses and subsidies have been compensated

Table 1 MAIN ECONOMIC INDICATORS

	2012	2013	2013			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.9	-1.0	-1.5	-0.7	-0.6	-1.2
Real private consumption (% change, yoy)	-3.0	-1.0	-2.9	0.4	0.2	-1.8
Real government consumption (% change, yoy)	-0.8	0.5	0.3	1.4	-0.9	1.2
Real investment (% change, yoy)	-4.7	-1.0	-2.3	0.9	0.3	-3.3
Industrial output (% change, yoy)	-5.5	-1.8	0.8	-1.8	-3.8	-2.3
Unemployment rate (registered, %, pa)	18.9	20.2	21.7	19.6	18.6	20.9
Nominal GDP (EUR million)	43,707	43,342	-	-	-	-
GDP per capita (EUR)	10,241	10,155	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	1.9	0.9	2.2	1.6	0.3	-0.2
Consumer prices (% change, yoy, pa)	3.4	2.2	4.6	2.3	1.8	0.3
Producer prices (% change, yoy, pa)	7.0	0.5	4.1	1.2	-0.6	-2.7
Average gross wage (% change, yoy, pa)	1.0	0.8	1.3	0.8	0.8	0.3
Exchange rate, HRK/EUR (pa)	7.52	7.57	7.58	7.56	7.53	7.63
Exchange rate, HRK/US$ (pa)	5.85	5.71	5.74	5.79	5.69	5.60
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,628	8,980	2,076	2,284	2,282	2,338
Exports of goods (EUR, % change, yoy)	0.5	-6.7	-7.9	-1.7	-7.7	-9.3
Imports of goods (EUR million)	16,216	15.803	3,730	4,394	3,977	3,702
Imports of goods (EUR, % change, yoy)	-0.4	-2.5	-6.3	5.5	-2.9	-6.9
Current account balance (EUR million)	-40	564	-1,400	-252	2,946	-729
Current account balance (% of GDP)	-0.1	1.3	-	-	-	-
Gross foreign direct investment (EUR million)	1,055	437	563	14	36	-176
Foreign exchange reserves (EUR million, eop)	11,236	12,908	11,277	12,021	11,720	12,908
Foreign debt (EUR million, eop)	44,861	45,631	44,955	45,956	44,958	45,631
GOVERNMENT FINANCE*						
Revenue (HRK million)**	126,132	-	28,918	60,241	92,218	-
Expense (HRK million)**	132,413	-	33,782	69,744	102,769	-
Net = Gross operating balance (HRK million)**	-6,282	-	-4,863	-9,503	-10,550	-
Net acquisition of non-financial assets (HRK million)**	4,574	-	1,211	2,349	3,521	-
Net lending/borrowing (HRK million)**	-10,855	-	-6,074	-11,852	-14,071	-
Domestic government debt (EUR million, eop)	15,225	-	15,539	-	-	-
Foreign government debt (EUR million, eop)	8,353	-	8,422	-	-	-
Total government debt (% of GDP)	53.7	-	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	1.6	10.9	10.7	13.0	11.5	10.9
Broad money, M4 (% change, yoy, eop)	3.2	2.9	4.4	3.4	5.1	2.9
Total domestic credit (% change, yoy, eop)	-3.9	-0.7	-3.9	-3.1	-1.1	-0.7
DMBs credit to households (% change, yoy, eop)	-1.4	-1.7	-1.2	-2.7	-0.4	-1.7
DMBs credit to enterprises (% change, yoy, eop)	-11.2	-0.1	-11.6	-5.5	-3.1	-0.1
Money market interest rate (%, pa)	1.1	0.4	0.4	0.3	0.5	0.3
DMBs credit rate for enterprises, short-term (%, pa)	7.3	6.5	6.5	6.3	6.7	6.4
DMBs credit rate for households, short-term (%, pa)	11.2	11.1	11.2	11.2	11.1	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.*

by a HRK 3.7-billion increase in other expenditures, most notably those for arrears of the health system. As fiscal balance planned by this budget revision does not fully meet the recommendations of the European Commission related to the EDP, new revision, which will reflect the impact of additional measures that have recently been adopted by the Government, seems likely.

2 Policy Assumptions and Projections Summary

Eurozone's growth rebounds, but remains fragmented.

Global economic activity is gaining momentum with growth impulses mainly originating from more advanced economies. In the latest release of *World Economic Outlook* (April 2014), IMF expects last year's world output growth of 3.0 percent to moderately accelerate to 3.6 and 3.9 percent in the current and the following year, respectively, which is a slight downward revision from January 2014 forecasts. Growth in advanced economies is expected to pick up, from 1.3 percent in 2013 to about 2.3 percent in 2014 and 2015. Last year's U.S. growth is estimated at 1.9 percent, a notable slowdown after 2012 growth of 2.8 percent. However, growth moderation in the first quarter of 2014 is expected to be only temporary and economic activity should rebound supported by the strengthening of private demand and by diminishing fiscal drag. IMF predicts 2014 and 2015 growth to stand at about 2.9 percent. Eurozone's modest recovery has continued with notable differences between member states. In the last quarter of 2013, GDP growth measured 0.3 percent quarter-to-quarter, after expanding 0.1 percent in third quarter. However, in 2013 GDP declined by 0.4 percent on average owing to a strong negative momentum at the end of 2012. IMF forecasts moderate growth of 1.2 percent in 2014, which is expected to pick up to 1.5 percent in 2015 due to the easing of fiscal tightening, improvements in credit supply, reduction of global economic uncertainty and fall in oil prices. Growth is projected to be stronger in the core of the EU and weaker in countries with high debt that are in the process of fiscal consolidation, which weighs heavily on domestic demand. As far as Croatia's main trade partners are concerned, Italy and Slovenia are expected to grow out of recession in 2014 with rates of about 0.6 and 0.3 percent, respectively, while Germany's growth is expected to rebound with the rate of about 1.7 percent.

EDP shapes fiscal and economic policy.

Croatia is subject to the EDP since the beginning of this year, which will have a sizable impact on fiscal and economic policies. The Government is obliged to report on the consolidation strategy to the European Commission by the end of April. There is also a parallel process of budgetary and economic policy coordination grounded in the EU's policy-making calendar called the European Semester. That process requests that the key measures of budgetary policy in the next three years be presented in the Convergence Program, while economic policy measures should be documented in the National Reform Program. Both programs are due by the end of April. Our projections were prepared without having insights into these documents and are therefore based on figures from the Revised Budget as of March 2014. Certain assumptions refer to additional measures adopted by the Government in mid-April. These measures include increase in excises on fuels, introduction of fees on mobile communications, and reduction of subsidies and investments. The first measure was swiftly implemented in mid-April, but the details of other measures are not publicly known. Overall, our fiscal projections are still largely driven by assumptions in order to offset data gaps. The 2015 projections are faced by high uncertainties as relevant fiscal plans are not yet available. We assume that the Government will follow fiscal policy and address the key recommendations given by the European Commission/European Council within EDP. Headline deficit targets are set at 4.6 and 3.5 percent of GDP for 2014 and 2015, which should be consistent with the improvement of structural balance of 0.5 percentage points in 2014 and 0.9 percentage points in 2015. Consolidation measures should amount to 2.3 percent of GDP in 2014 and 1.0 percent in 2015.

Excessive macroeconomic imbalances require an adequate policy response.

Another EU surveillance process may be of high importance for Croatia, the so-called Macroeconomic Imbalance Procedure (MIP). MIP is designed to detect, prevent and correct macroeconomic problems at their early stage. Based on the screening process in November, the Commission decided to undertake an in-depth review of various macroeconomic variables for 16 EU economies, including Croatia. Based on the findings, the Commission concluded in March that Croatia (together with Italy and Slovenia) is experiencing excessive imbalances. Therefore, the upcoming Convergence Report as well as National Reform Program should include comprehensive and detailed set of measures that will tackle these specific problems. According to the schedule, the Commission should respond to the proposed set of measures in June and if it finds them inadequate, it will recommend corrective actions and implement a specific monitoring process.

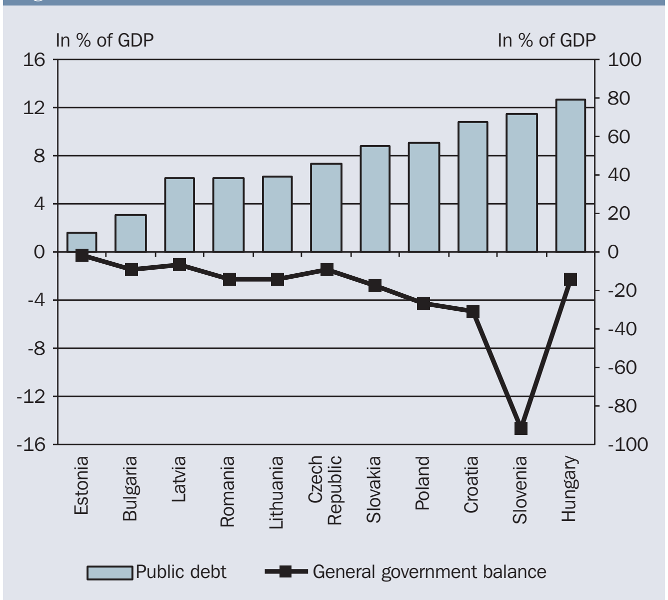
Monetary policy assumed to support high liquidity of the banking system.

Monetary policy is assumed to continue providing high liquidity to the banking system in order to press down interest rates and induce recovery of credit activity. However, this policy will be conditioned upon exchange rate stability, which is seen as the key for financial system stability in the situation of high credit euroization. We expect to see some speeding up of structural reforms in the public sector and public enterprises. Fiscal constraints will make this process more intensive as it is difficult for taxpayers to tolerate and pay for the existing inefficiencies. Important adjustments are expected in railway and air transportation, as well as in the number of state-owned enterprises. Also, we expect the Government to continue the efforts focused on investments promotion.

GDP projected to contract 0.5 percent in 2014…

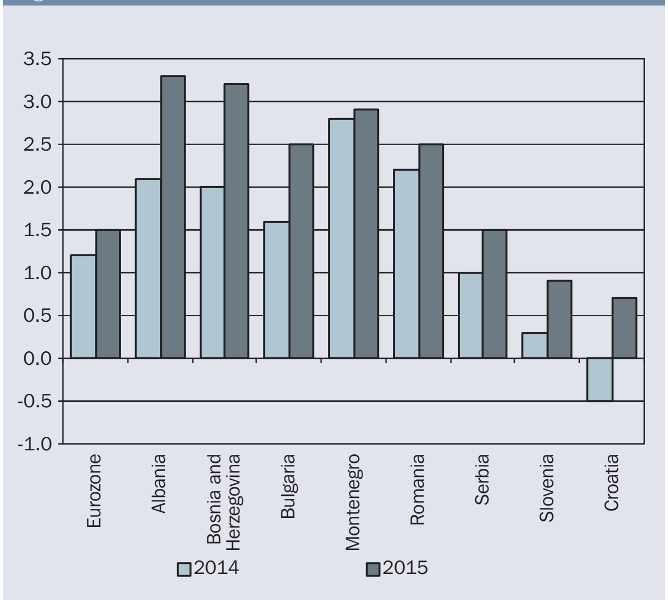
GDP projections are revised downwards for two main reasons. One refers to the fact that economy approached the last year's end in a less favorable condition than expected, and the other that this year's fiscal consolidation will have to be stronger than earlier envisioned by the Government. We now expect GDP to contract by 0.5 percent in 2014, mainly driven by further contraction of personal and government consumption, weak investment recovery and still fragile export performance. Personal consumption is projected to decrease by 1.7 percent as a result of declining disposable incomes, deleveraging of the household sector and continued low consumer confidence. In the situation of high uncertainty regarding economic prospects, Government's announcements of new taxation might additionally discourage household sector in its consumption decisions, especially when it comes to durable consumer goods.

Figure 8 GENERAL GOVERNMENT BALANCE AND DEBT



Source: *Eurostat.*

Figure 9 GROWTH FORECASTS FOR SOUTH EAST EUROPE



Sources: *IMF World Economic Outlook, April 2014; EIZ for Croatia.*

... driven by further declines in personal and government consumption.

Total domestic demand is expected to decline by 1.3 percent including continued weakness of investments. Namely, construction sector has remained in an exceptionally delicate situation without signs of recovery. Although we expect some changes towards more investments in machinery and equipment, that process seems to be slow while the Government has very little room to induce investments through budget. As a result, investments will probably continue to stagnate this year. A change in trend might occur only with a stronger inflow of financial resources from EU funds and if strategic investors recognize the advantages of recent legislative changes including the Law on Strategic Investments.

Fragile recovery of exports.

Following last year's drop in exports, 2014 should bring recovery underpinned by the revival of EU demand and adjustment to the new trade regime with CEFTA countries. The exports of services will be affected primarily by revenues from foreign tourism which should benefit from the EU membership. However, political tensions on the very east of Europe might reduce the number of tourists from that region. In addition, the World Cup, which takes place from mid-June to mid-July in Brazil, might keep some of the potential tourists at home. However, second half of July and August should bring stronger revenues resulting in steady revenue increase for the year as a whole, just as was the case during last three years. Due to weak domestic demand, imports are expected to continue declining in 2014, allowing for the balance of payments to register a surplus of 1.6 percent of GDP.

2015 should bring slow recovery – GDP expected to rise by 0.7 percent.

Next year should bring slow recovery of economic activity driven by stronger investments and exports resulting from more resilient EU demand and better use of EU funding. Government consumption will remain under the strong pressure of consolidation measures. However, these measures are expected, according to the EDP plan, to be somewhat less stringent in 2015 than in 2014 which should ease the pressure on personal consumption. Under such circumstances personal consumption is expected to stagnate due to the stabilization of incomes, cease in negative labor market trends and weaker deleveraging of the household sector. Total domestic demand should rise by 0.5 percent. Imports are projected to rise as well and, consequently, current account surplus is expected to slightly decrease to 1.2 percent of GDP. In sum, GDP should increase by 0.7 percent in 2015.

Labor market outlook remains poor.

Weak economic activity and restructuring efforts are forecasted to push the unemployment rate up to around 20.5 percent in 2014. Problems with specific groups of the unemployed, such as young people or long-term unemployed are further complicated by the uncertainty surrounding the financing of active labor market policies. For example, funding of youth employment through the European Youth Guarantee is delayed due to technical reasons related to the disbursement of funds. In 2015, it is expected that mild recovery in the real sector will transfer onto the labor market and stop the negative trend in unemployment. Fiscal austerity will put pressure on total wage bill in the public sector, which is likely to result in the deterioration of disposable income as well. The new Labor Law is expected to be enacted by summer, and should bring more flexibility to the labor market. However, it will take some time for the effects of this law - in terms of expected job creation - to emerge.

The central bank is ready to ensure exchange rate stability...

Bank provisioning and complex fiscal issues will contribute to mild kuna depreciation in this year, even when expectations of good tourist season are taken into account. We therefore see the average HRK/EUR rate in 2014 at around 7.62. That average rate should be preserved in 2015 as well. Exchange rate stability will be supported by strong commitment from the central bank, while policy instruments such as direct intervention in foreign exchange market, mandatory reserve rate changes, and adjustments in risk provisioning rules seem effective enough to ensure it.

... but it is powerless in reviving credit activity.

This year's credit demand will remain suppressed by private sector deleveraging and poor macroeconomic outlook. The supply side will be tightened due to increase in

Table 2 SUMMARY OF PROJECTIONS

	2014	2015
Real GDP (% change)	**-0.5**	**0.7**
Real private consumption (% change)	-1.7	-0.1
Real government consumption (% change)	-1.4	-1.0
Real investment (% change)	0.1	3.4
Exports of goods and services (constant prices, % change)	1.3	2.7
Imports of goods and services (constant prices, % change)	-0.8	2.1
Current account balance (% of GDP)	1.6	1.2
Consumer prices (% change, pa)	0.6	1.8
Exchange rate, HRK/EUR (pa)	7.62	7.62
Unemployment rate (registered, %, pa)	20.5	20.5
General government balance (ESA95 definition, % of GDP)	-4.6	-3.5
Broad money, M4 (% change, eop)	3.3	3.5
Total domestic credit (% change, eop)	-0.1	1.1

Note: *Cut-off date for information used in the compilation of projections was April 18, 2014.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

non-performing loans causing banks to decrease the riskiness of their positions. In such a situation, it is likely that the central bank's measures to boost credit activity will continue to exercise limited influence on aggregated flows. Therefore, our total domestic credit forecast is set at -0.1 percent for this year. In 2015 we expect credit activity to increase by 1.1 percent as GDP takes off. Broad money growth will remain under the pressure of tense economic conditions and therefore limited to 3.3 percent in 2014 and 3.5 percent in 2015.

Deflation is not likely to stay for long.

Main drivers of inflation in 2014 will be an increase in the reduced VAT rate and higher excises on energy, water and tobacco. Having that in mind, we expect current deflation to end by summer, but subsequent inflation to stay at very low rates due to demand deficiency. On average, consumer price inflation is projected to 0.6 percent in this year and 1.8 percent in 2015. Risks on the downside come from more severe fiscal austerity and further imported commodity disinflation. On the upside, however, there is a risk of additional tax hikes and administrative prices adjustments.

Fiscal projections are in line with EDP targets.

Our fiscal projections for 2014 are close to deficit targets set by the European Commission. The latest measures adopted by the Government will help to meet them fully in 2014. However, a high degree of uncertainty is associated with projections for 2015 as official plans and strategic documents have not been published yet. Some measures adopted in 2014 have a one-off effect and further measures will have to be implemented in 2015. In the current situation, we assume that the Government is devoted to fiscal consolidation and will pursue measures on revenue and expenditure side to ensure that deficit target of 3.5 percent of GDP is met. We expect the revenue-based measures to dominate over expenditure-based ones.

3 Uncertainties and Risks to Projections

More decisive actions necessary to induce economic growth.

Croatian economy has been stuck in a difficult position. The protracted, five-year long recession seems to have sterilized major growth drivers. Reliance on public investments as initiators of broad-based recovery has not been successful in the context of high fiscal deficit, rising public debt and threatening external indebtedness. The private sector has faced numerous barriers to development, not necessarily the lack of financial resources, but the lack of administrative and legislative support reinforced by anti-entrepreneurial climate evident in attitudes of the general public and regulators. In the current situation, support of private sector business initiatives and projects remains the key policy challenge. Without swift restoration of economic growth there are high risks related to fiscal and financial instability. The European Commission has recognized these risks and classified Croatia as a country with excessive macroeconomic imbalances for which it requires strong policy response. Recent policy actions taken by the Government were focused on the fiscal sector and refer largely to increased taxation, while measures in other areas are missing. The announcement of more intensive administrative promotion of investments seems like old news. More decisive actions of the Government are necessary to induce economic growth.

Is planned fiscal consolidation feasible without additional measures?

Risks to our projections are mostly on the downside. Fiscal consolidation efforts and their effects are still surrounded by substantial uncertainties. This is particularly so with arrears in the health sector and contingent liabilities in state-owned companies. Additionally, a portion of the planned fiscal reforms are not structural reforms but one-off measures such as transferring a part of the second pension pillar to the first pillar in two-year time. In order to meet deficit targets defined by the EDP, additional structural measures will have to be introduced which may have a stronger negative short-term effect on economic activity than is now predicted.

Geopolitical and growth concerns on the outskirts of Europe.

Geopolitical turmoil in Ukraine, although not yet reaching global macroeconomic repercussions, could have significant spillovers on the eurozone, not just in terms of energy prices, but also in the increasing uncertainty about future environment. Although downside risks to the eurozone growth have largely diminished, they remain significant. More policy action is needed to combat high unemployment and debt levels. Next, there is the risk of inflation rates being lower than expected. In the long run lower inflation rates will cause modifications in inflationary expectations which could have a negative impact on economic activity, given high unemployment and underutilized capacities in many European economies. Further reason for concern is the constraint imposed on central banks' ability to lower interest rates, which are already close to zero lower bound.

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