The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

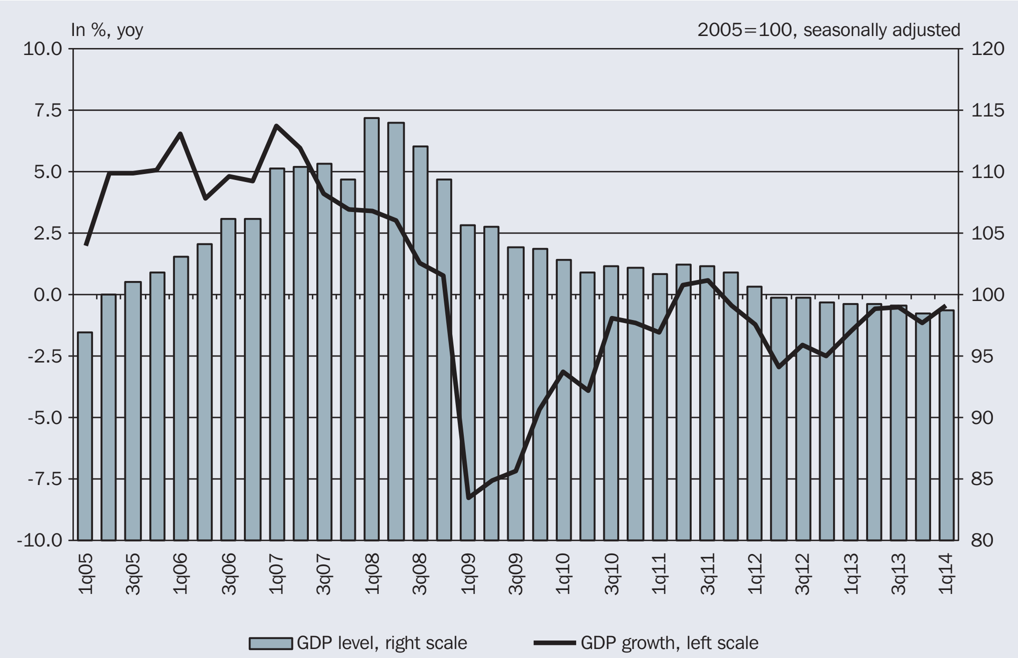
A good start of the year; gradual deterioration afterwards.

The beginning of this year was marked by relatively favorable economic developments that have in the meantime faded and allowed for the return of recession. Although seasonally adjusted GDP (X11ARIMA method) increased by 0.3 percent in the first quarter compared to the fourth quarter of 2013, this encouraging upturn was not sufficient to compensate for a 0.7-percent drop in the previous quarter. Consequently, GDP level remained 0.4 percent lower than in the first quarter of the last year. The first quarter this year saw positive developments in personal consumption and exports, as well as in manufacturing. The most recent trends, however, are not that favorable. High-frequency indicators suggest that momentum in key sectors has gradually diminished (volume of retail trade, tax revenues) or turned negative (industrial production) increasing the probability of negative quarter-to-quarter GDP growth in the second quarter of this year, as has also been suggested by the CEIZ business cycle indicator (www.eizg.hr).

Personal consumption hike in the first quarter.

GDP growth in the first quarter was predominantly the result of a strong increase in personal consumption, which was, in seasonally adjusted terms, 0.8 percent higher compared to the fourth quarter of last year. In spite of such increase, personal consumption remained 0.5 percent below its level from a year before. Similarly to GDP developments, increase in the first quarter of 2014 appeared after a notable drop in the fourth quarter of 2013 and

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

was insufficient to offset that loss. In the last two quarters consumption has remained at the lowest level since mid-2004 confirming the depth and the persistence of the current recession in Croatia, which is in its sixth consecutive year. Positive developments in the first quarter were possibly caused by postponing household consumption from the end of the last year to the beginning of this year in the expectation of seasonal discounts. This strategy seems to have worked well as consumer prices dropped in January and February pushing annual inflation rates into negative territory. Nevertheless, personal consumption is still under the strong influence of reduced households' disposable income, deleveraging, and low consumer confidence, which are all likely to prevent its sustainable recovery in the near term.

A more durable contraction of government consumption.

For the first time since 2011 government consumption has experienced a more durable contraction. Seasonally adjusted consumption has declined for the last three quarters in a row allowing for a cumulative shortfall of 2.3 percent. In the first quarter, this decline was 0.7 percent. It appears that serious fiscal consolidation can no longer be postponed as financial constraints are getting tighter and government consumption, i.e. government expenditures on goods and services, should be reduced.

Investments continue to disappoint.

Investments have continued to disappoint. Seasonally adjusted figures for the first quarter indicate a drop of 0.4 percent vs. the fourth quarter of last year and a drop of 3.6 percent if compared to the first quarter of 2013. The developments from the last three quarters canceled gains from a short period of investment recovery on the eve of EU accession. Exhausted financial potential of the domestic business sector and perception of poor economic prospects coupled with limited investment capacities of the public sector apparently do not allow for investment recovery yet.

Improved dynamics of foreign trade in 2014.

Both exports and imports have substantially increased at the beginning of this year. National accounts statistics recorded that volume of exports of goods and services increased by 6.1 percent year-on-year in the first quarter, and volume of imports by 2.5 percent. Trade of goods rose even more strongly than total trade, while trade in services declined. Such dynamics would be highly encouraging have they not been clouded by certain issues of statistical coverage of foreign trade in this and previous year.

Substantial revision of merchandise trade data for the previous year.

Until recently, performance of foreign trade sector in the year of Croatia's EU accession has seemed rather disappointing as contraction was registered on both export and import side. However, the latest revision published by the statistical office in late June has changed the picture and suggested more favorable developments. In the current euro terms the 'old' figures were revised upwards by some 7 percent on the export and 5 percent on the import side. Obviously, there have been and probably still are lots of difficulties in proper registering of external and intra-EU trade so we better remain cautious when assessing trade developments. The revised data for 2013 indicate stagnation of exports of goods and a 2-percent rise of imports of goods compared to the year before. More importantly, trade dynamics has strengthened in 2014 with exports of goods being in the first four months of 2014 by 14.9 percent and imports by 7.9 percent higher in current euro terms than in the same period last year. Thereby, exports to EU countries increased by 21 percent and to CEFTA countries by 17 percent (to Serbia by more than 40 percent) year-on-year. Food and beverage, raw materials, as well as various manufactured products (such as clothes, products made of leather and wood, etc.) have contributed the most to such an outcome. At the same time exports of shipbuilding industry continue to contract with a 40-percent decline compared to the year before and now amount to approximately 1/5 of the value exported two years ago.

Contribution to the EU budget widens current account deficit.

Such strong upswing in merchandise trade in this year was reflected in the balance of payments. In the first quarter of 2014, merchandise trade balance was improved compared to the first quarter of 2013. However, balance of service trade deteriorated, income balance remained flat, while surplus on balance of current transfers was reduced by some EUR 200 million. Outgoing transfers increased mostly due to Croatian contribution to the EU budget, while the flow of funds from the EU to Croatia was obviously lagging behind causing lower surplus than in the previous year. First quarter's deficit amounted to EUR 1.56 billion, some EUR 180 million more than a year before. The last four quarters cumulatively resulted in current account surplus of EUR 205 million or 0.5 percent of GDP, which is lower than in any of the previous three quarters. At the end of March, gross external debt stood at EUR 46.4 billion, which is some EUR 1.5 billion higher than a year ago owing to booming government debt, while other sectors remained at either stagnant or reduced debt levels.

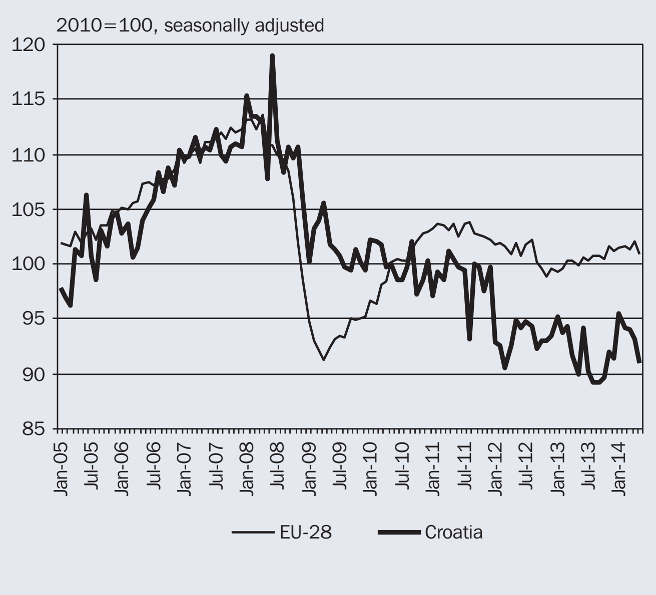
Industrial production lost steam from the beginning of 2014.

After exhibiting a strong growth in January, which allowed for a 4-percent rise in the first quarter this year compared to the last quarter of 2013, industrial activity started decelerating which has finally resulted in the negative trend. More precisely, seasonally adjusted data indicate that industrial production declined every month since February, which suggests that January achievement (4.5 percent month-to-month increase) might have been caused by statistical reasons. Moreover, the average activity in April-May period was 2.7 percent lower than in the first quarter. The cumulative year-on-year numbers are still positive but diminishing with every new observation. Consequently, after the first five months of this year industrial activity was just 0.4 percent higher than in the same period last year.

Stagnation of retail trade volume; continual decline in construction activity.

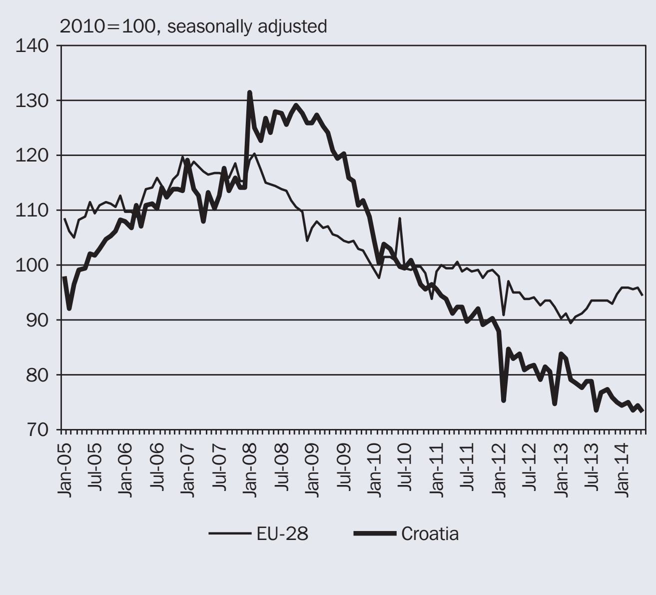
In spite of a significant rise in car sales, the retail trade volume continues to stagnate. The almost unchanged volume of retail trade has been observed ever since the end of tourist season in October 2013. In the first quarter of this year, retail trade volume was, according to seasonally adjusted figures, 0.4 percent higher than in the last quarter of 2013, while in the April-May period it increased by 0.5 percent on average compared to the first three months. Cumulative figures for the first five months of 2014 seem to equal those in the same period last year. We can expect the same pattern to continue this year – some improvement due to tourist season; decline when the high-season ends and stagnation otherwise. The trend of construction activity remains negative, but in recent months its pace was weaker than in the preceding months. Nonetheless, the cumulative decline for the first four months of this year remained high and amounted to 8 percent year-on-year.

Figure 2 INDUSTRIAL PRODUCTION



Sources: *Eurostat for EU-28 and Croatian Bureau of Statistics for Croatia (original data). Croatian data seasonally adjusted by X11ARIMA (Statistics Canada).*

Figure 3 CONSTRUCTION VOLUME



Sources: *Eurostat for EU-28 and Croatian Bureau of Statistics for Croatia (original data). Croatian data seasonally adjusted by X11ARIMA (Statistics Canada).*

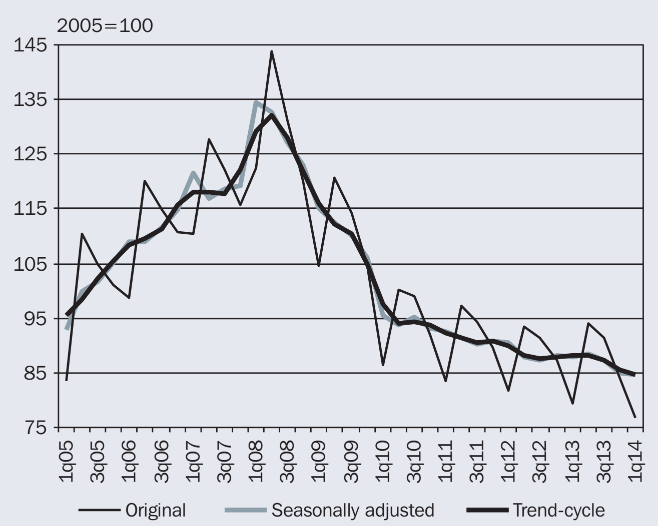
Seeming recovery of the labor market.

Unemployment figures indicate an improvement in the second quarter of 2014. After a peak in February, the number of registered unemployed has been falling sharply to reach 305 thousand in June, which is 7 percent less than in May and 4 percent less than a year ago. Seasonally adjusted unemployment figures suggest a sharp reversal of negative trends. However, registered employment has not followed such an encouraging trend. Although total employment has been rising since March, this has mostly been due to regular seasonal oscillations. When compared with the level from a year ago it has continued to remain in shortfall by about 2 percent. Moreover, recent increase in employment has been much smaller than a decrease in unemployment, causing reduction in the active population. The active population has been declining ever since February 2013 and in May 2014 it was 2.3 percent lower than a year ago and 7 percent lower than in May 2008.

Shrinking labor force due to education, emigration, undeclared work…?

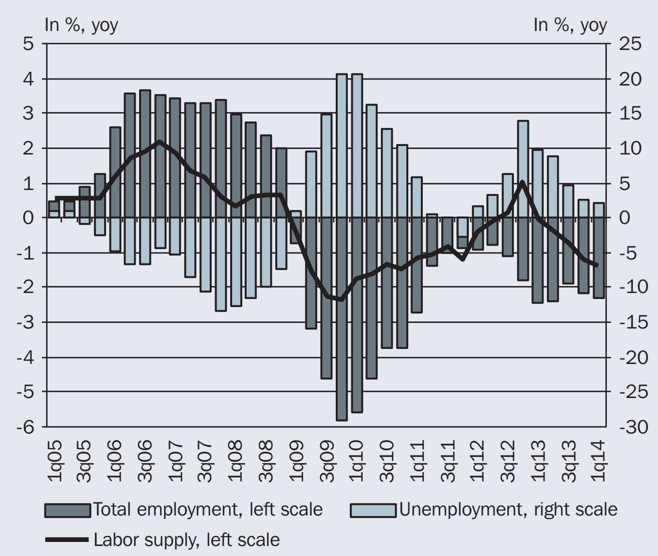
One of the explanations for the discrepancy between employment and unemployment flows lies in the expansion of active labor market programs, some of which have not induced employment, but have only reduced registered unemployment. Retirement cannot explain this difference either as its increase was of lower magnitude than a year ago. Other explanations include the likely expansion of emigration and undeclared work, increased participation in education and a higher number of discouraged workers. In favor of the last point, Eurostat reported that in the last quarter of 2013 the proportion of persons available for work, but not seeking one, mainly because they think no work is available, was the highest in Italy (12.3 percent of the labor force) followed by Croatia (12.0 percent), whereas the EU-28 average was below 4 percent (3.9 percent). In the course of the last year proportion of 'discouraged workers' increased the most in Croatia, 1.6 percentage points. The survey-based data suggest worsening conditions in the labor market in this year's first quarter. They are also interesting because of substantial methodological changes that have recently been undertaken. Sample frame of the Labor Force Survey was adjusted for both 2013 and 2014 to comply with the 2011 Census resulting in a large increase in the number of both employed and unemployed persons, and in an even larger decrease in the number of inactive persons (correction of about 20 percent) compared with previous survey results. The revised data show that the unemployment rate for working-age population (15-64) increased from 18.2 percent in the first quarter 2013 to 19.0 percent in the first quarter 2014. Both the employment and activity rates are revised upwards, while unemployment rate remained almost intact.

Figure 4 INVESTMENTS



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

Figure 5 LABOR MARKET DEVELOPMENTS



Source: *Croatian Bureau of Statistics.*

However, this has not helped Croatia to move from the very bottom of the EU countries concerning these indicators.

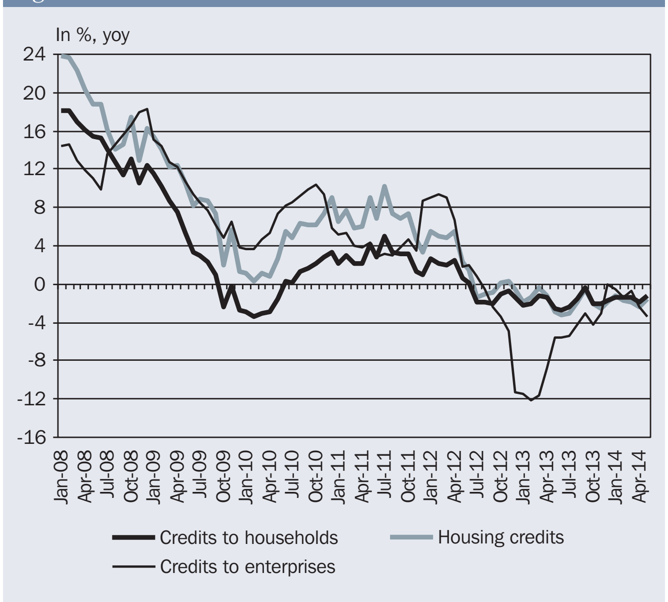
Money growth slowdown; deleveraging speeds up.

In May this year, broad money M4 recorded the lowest growth rate since February 2012, 1.9 percent year-on-year. Seasonally adjusted data indicate that this slowdown results mostly from dynamics recorded in April and May confirming our earlier assessment of deteriorated economic conditions in the second quarter of this year. Money supply (M1) also surprised to the downside in that period. Although its year-on-year growth rate stood at 5.6 percent in May, that was far from double-digit rates depicted in most of the last year. However, total deposits continued to grow, up by 1.4 percent in May compared to the same month a year before, driven mostly by rising household deposits in local currency. Shortfall in credits to enterprises brought total credits back to negative rates. As credits to enterprises decreased by 2.4 and 3.4 percent year-on-year in April and May, total credits followed by 1.3 and 1.2-percent declines in the same period, respectively. The corporate sector is still struggling with pre-bankruptcy settlements that are posing certain liquidity risks, while banks are unwilling to extend their abundant liquidity to the private sector. Credits to households contributed to this unfavorable performance too; they were down by 1.9 and 1.1 percent in April and May. The government sector, just as in previous months, continued to take loans, recording a 12.9-percent rise in its stock in May.

High liquidity, low money market interest rates and credit squeeze.

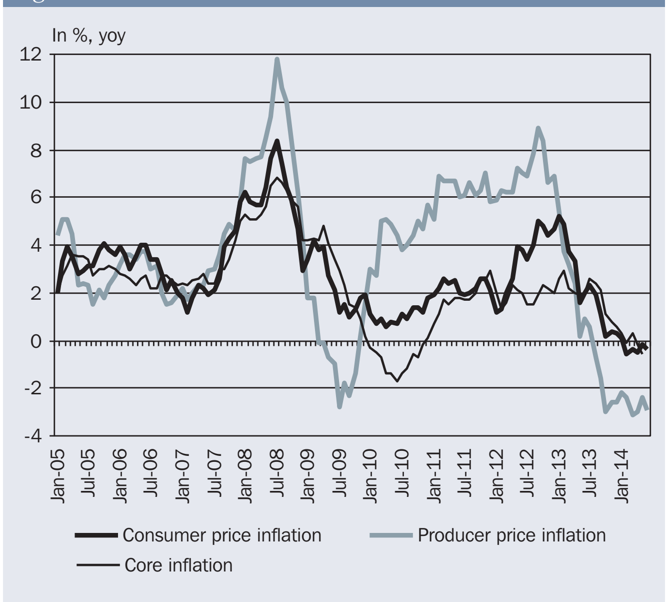
The central bank seems to be waiting for financial institutions to start lending without its further interference. The Governor continues to repeat that reforms of a more structural character are needed to ignite monetary push. Without these, central bank efforts cannot find their way into the economy. In light of that, further monetary measures seem useless, and in the last few months the CNB has taken a passive role, as the secured liquidity pool is more than enough to revive the economy once the banks start lending to the private sector. In light of a HRK 7 billion excess interbank liquidity at the beginning of July, money market interest rates stood at historically low levels with overnight ZIBOR (Zagreb Interbank Offered Rate) at 0.3 percent. Loan rates in HRK to enterprises followed this trend and stood at 6.1 percent in the first quarter, which is the lowest level recorded since the last quarter of 2001. Despite favorable interest rate developments, credits did not pick up in a risk-high environment. Nonperforming loans continued to increase to 16.1 percent in the first quarter, up from 15.6 percent at the end of 2013.

Figure 6 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

Figure 7 INFLATION



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

Kuna strengthened in the second quarter.

The beginning of the tourist season, recent foreign currency bond issue, and corporate export-led foreign currency supply brought a mild appreciation of the kuna exchange rate against the euro from 7.65 in the first three months to 7.60 in the second quarter. However, risks from fiscal domain have spilt over to the foreign exchange in the beginning of July. Foreign currency demand therefore increased and pushed the exchange rate above the 7.60 level. HRK/EUR exchange rate volatility in July has also been supported by an unofficial indication that the biggest Croatian banks will have to secure another EUR 200 million for risk provisioning in this year.

Consumer prices continue falling.

Consumer price inflation has continued to record negative year-on-year rates since February this year in spite of moderate increases on a month-to-month basis. However, June brought a negative monthly rate contributing to negative annual inflation rate of 0.4 percent. Deflation is caused mostly by lower import prices and very poor domestic demand. June figures show that majority of market-determined prices recorded a decline, such as prices of food, non-alcoholic beverages, clothing, footwear, furniture, communication and recreation. There are a number of items whose prices are either immune to poor domestic demand, such as tourist services, or are administratively controlled, such as health services or water supply, or are simply subject to increasing excise taxes, such as tobacco. Prices of these goods are steadily increasing.

Fiscal deficit of 4.9 percent in 2013; the fiscal rules broken.

Year 2013 ended with the total general government revenue of HRK 125.9 billion, which is 0.2 percent less than the amount collected a year before. This near-stagnation came about as the result of falls in the revenues from VAT, profit-tax and social security contributions and rises in excises on petroleum products and revenues from foreign assistance associated with the EU membership. The total expenditure reached HRK 138.2 billion in 2013, recording a 4.3-percent increase relative to 2012. The increase is mostly accounted for by increases in Croatian contributions to the joint EU budget, higher interest payments and higher insurance-based outlays mostly due to payment of health sector debts from previous periods. According to ESA95 accounting rules, the general government deficit in 2013 was 4.9 percent of GDP, 0.1 percentage points less than in 2012. In the course of 2013 the public debt rose from 55.9 to 67.1 percent of GDP. In addition to being in breach of the EU debt and deficit rules, Croatia also broke the national fiscal rule enshrined in the Fiscal Responsibility Act which was set to reduce the expenditure-to-GDP ratio by one percentage point each year. This national fiscal rule was changed in early 2014 to a more complex set of indicators largely in line with the EU regulations.

Consolidation efforts seem credible.

As Croatia exceeded fiscal limits set by the Stability and Growth Pact, the European Council opened the Excessive Deficit Procedure (EDP) at the beginning of this year with a recommendation to correct the excessive deficit by 2016. The headline deficit targets were issued and set to 4.6, 3.5 and 2.7 percent of GDP in 2014, 2015 and 2016, respectively. Croatian authorities prepared its consolidation strategy and presented it in the Convergence Program and the National Reform Program. The measures include, on the revenue side, raising health insurance contributions paid out of income, increase in excises on petroleum products, additional levy for mobile operators, and introduction of tax on savings interest and recurrent tax on immovable property, while on the expenditure side the package includes cuts in social transfers, subsidies and intermediate consumption. The European Commission considers the intended effort as a sufficiently credible proof that Croatia is willing to follow the EDP recommendations and is able to reach the targets, so that for the time being no further steps are needed.

VAT revenue underperformed in the first quarter.

The total general government revenue collected in the first quarter of 2014 was slightly higher, 0.4 percent, compared to the first quarter of 2013. The negative contribution of VAT revenue, mostly due to the deterioration of tax base, was compensated by increases in other revenues, most notably those from the profit tax and excises on petroleum and tobacco products. As for the total expenditure, it was 3.4 percent higher in the first quarter of this

Table 1 MAIN ECONOMIC INDICATORS

	2012	2013	2013			2014
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-2.2	-0.9	-0.6	-0.5	-1.1	0.4
Real private consumption (% change, yoy)	-3.0	-1.3	-0.1	-0.3	-1.8	-0.5
Real government consumption (% change, yoy)	-0.8	0.5	1.4	-0.9	1.2	-1.9
Real investment (% change, yoy)	-3.1	-1.3	0.6	0.0	-3.6	-3.6
Industrial output (% change, yoy)	-5.5	-1.8	-1.8	-3.8	-2.3	0.6
Unemployment rate (registered, %, pa)	18.9	20.2	19.6	18.6	20.9	22.4
Nominal GDP (EUR million)	43,502	43,157	-	-	-	-
GDP per capita (EUR)	10,194	10,143	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	1.7	0.9	1.4	0.4	-0.3	-0.5
Consumer prices (% change, yoy, pa)	3.4	2.2	2.3	1.8	0.3	-0.3
Producer prices (% change, yoy, pa)	7.0	0.5	1.2	-0.6	-2.7	-2.6
Average gross wage (% change, yoy, pa)	1.0	0.8	0.8	0.8	0.3	-0.2
Exchange rate, HRK/EUR (pa)	7.52	7.57	7.56	7.53	7.63	7.65
Exchange rate, HRK/US$ (pa)	5.85	5.71	5.79	5.69	5.60	5.58
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,628	8,980	2,284	2,282	2,338	2,234
Exports of goods (EUR, % change, yoy)	0.5	-6.7	-1.7	-7.7	-9.3	-0.6
Imports of goods (EUR million)	16,216	15,803	4,394	3,977	3,702	3,796
Imports of goods (EUR, % change, yoy)	-0.4	-2.5	5.5	-2.9	-6.9	-1.5
Current account balance (EUR million)	-58	381	-254	2,839	-819	-1,561
Current account balance (% of GDP)	-0.1	0.9	-	-	-	-
Gross foreign direct investment (EUR million)	1,068	550	18	48	-72	204
Foreign exchange reserves (EUR million, eop)	11,236	12,908	12,021	11,720	12,908	12,100
Foreign debt (EUR million, eop)	44,861	45,631	45,956	44,958	45,631	46,416
GOVERNMENT FINANCE						
Revenue (HRK million)*	126,132	125,879	60,241	92,218	125,879	29,030
Expense (HRK million)*	132,413	138,217	69,744	102,769	138,217	34,914
Net = Gross operating balance (HRK million)*	-6,282	-12,338	-9,503	-10,550	-12,338	-5,884
Net acquisition of non-financial assets (HRK million)*	4,574	5,264	2,349	3,521	5,264	1,040
Net lending/borrowing (HRK million)*	-10,855	-17,602	-11,852	-14,071	-17,602	-6,924
Domestic government debt (EUR million, eop)	15,899	18,305	17,251	17,593	18,305	18,716
Foreign government debt (EUR million, eop)	8,443	10,525	9,283	9,185	10,525	10,245
Total government debt (% of GDP)	53.7	67.4	-	-	-	
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	1.6	10.9	13.0	11.5	10.9	10.1
Broad money, M4 (% change, yoy, eop)	3.2	2.9	3.4	5.1	2.9	3.3
Total domestic credit (% change, yoy, eop)	-3.9	-0.7	-3.1	-1.1	-0.7	-1.5
DMBs credit to households (% change, yoy, eop)	-1.4	-1.7	-2.7	-0.4	-1.7	-1.5
DMBs credit to enterprises (% change, yoy, eop)	-11.2	-0.1	-5.5	-3.1	-0.1	-0.7
Money market interest rate (%, pa)	1.1	0.4	0.3	0.5	0.3	0.4
DMBs credit rate for enterprises, short-term (%, pa)	7.3	6.5	6.3	6.7	6.4	6.1
DMBs credit rate for households, short-term (%, pa)	11.2	11.1	11.2	11.1	11.1	10.3

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

year than in the same quarter a year before. Three largest expenditure items decreased, namely employees' compensation, purchases of goods and services and social transfers, but insufficiently to overweigh the increase in the expenditure for assistance to international institutions, which is the Croatian contribution to EU budget. In the first quarter, the net borrowing amounted to HRK 6.9 billion, which is close to 50 percent of the general government deficit planned for this year and calls for close attention to fiscal performance in the coming months.

2 Policy Assumptions and Projections Summary

Global economy somewhat weaker than expected.

Global economy has not performed quite as expected, mainly due to bad weather conditions in the U.S. and geopolitical tensions in Ukraine. In the newest release of *Global Economic Prospects* (June, 2014), the World Bank predicts this year's real world GDP growth of 2.8 percent – a downward revision of 0.4 percentage points from their projection in January. Driven by growth impulses originating mainly from high-income countries, world GDP is on a course to increase by 3.4 and 3.5 percent in 2015 and 2016, respectively. U.S. growth contracted sharply in this year's first quarter as a result of adverse weather conditions, causing diminishing firms' inventories and reductions in investment and exports. During that period, however, more than half a million jobs were created, and this trend is expected to continue. This, combined with reduced drag from fiscal consolidation, rising household income and positive signals from surveys on investment spending, will lead to a path of stronger growth. GDP growth is projected to 2.1 percent in this year and to level off at rates of around 3.0 percent in 2015 and 2016.

Eurozone recovery continues, but remains fragmented.

In the first quarter of this year, the eurozone recorded a fourth consecutive quarter of recovery with the growth of 0.2 percent in quarter-to-quarter terms. Nevertheless, this remains unevenly distributed among its members. Some economies experienced recovery-slowing shocks, like the contraction in Dutch gas production due to unusually warm winter or an increase in VAT in France, while others, like Germany, experienced the biggest growth in the last three years, driven primarily by domestic demand. GDP and consumption in peripheral economies remain almost 10 percent below their pre-crisis levels, while investments lag behind even further. Recovery in these economies was mainly the result of increasing exports as a consequence of a declining trend in unit labor cost, reflecting feeble or even negative wage growth. Labor markets, however, show signs of recovery in the overall eurozone, with unemployment rates beginning to decline, although from relatively high levels. The World Bank forecasts the growth of eurozone to stand at 1.1 percent this year. Building up on a turn of economic climate and reduced uncertainty, growth projections for 2015 and 2016 have been moderately higher standing at 1.7 and 1.8 percent, respectively. Besides Germany, Croatia's other two important trade partners also show signs of recovery, with very similar trends. For 2014 and 2015, respectively, Italy is projected to grow at rates of 0.5 and 1.1 percent while for Slovenia these rates are 0.3 and 1.2 percent (OECD, *Economic Outlook*, May, 2014).

Serious commitments brought about by the EDP assumed to deliver results.

In the sphere of domestic policy, we assume that economic and fiscal policy measures will be determined predominantly by the requirements associated with the EDP. The consolidation strategy presented to the European Commission implies serious commitments, making the fiscal space considerably narrower than it used to be. We assume that the constant monitoring on the part of the European Commission will serve as a credible threat which will ensure that consolidation efforts and targets are met. As for the monetary policy, we expect that the central bank will continue to closely monitor financial sector developments and stand ready to intervene to preserve financial system and exchange rate stability. No further monetary easing is expected as there is around HRK 7 billion of excess liquidity in the banking system and another HRK 3.5 billion is waiting for withdrawal via the CNB credit scheme. However, stability risks are stemming from nonperforming loans that are rising and are expected to peak this year. Also, parent banks with local units in Croatia that are under the EMU Asset Quality Review will probably have to adjust their balance sheets in order to increase their risk provisioning levels.

The first year of Croatia's EU membership has passed with unclear economic effects.

As expected, due to the substantially changed environment, the effects of the first year of EU membership were for Croatia far from those enjoyed by 2004 and 2007 new members. The recession continued, country entered the EDP procedure and so far no significant indicators of positive change in the economy have emerged. Nevertheless, it seems that some effects were enjoyed in foreign trade, including increased attractiveness of Croatia as a tourist destination. One should also not neglect the EDP procedure and the structural reforms that it imposes as it seems that otherwise they would not have been undertaken.

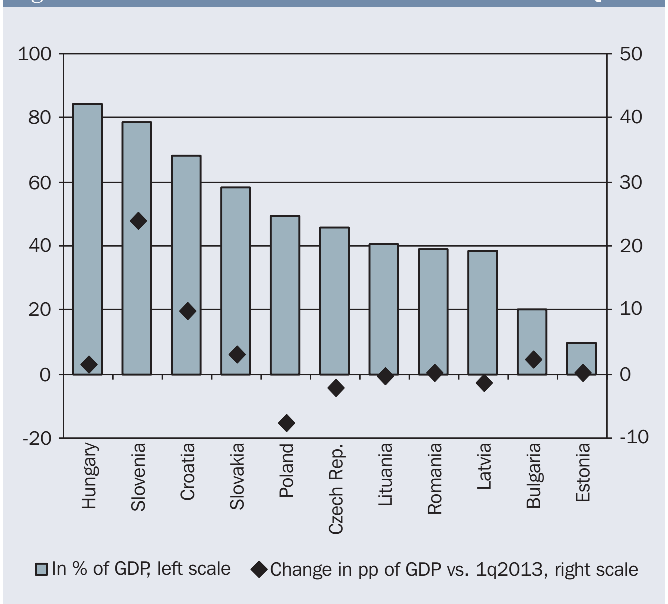
GDP expected to decline by 0.5 percent this year.

In spite of a more favorable international environment and opportunities opened by the EU membership, short-term economic prospects for Croatia have remained muted. After recording negligible GDP rise on quarter-to-quarter basis in the first quarter of 2014, high-frequency indicators suggest that negative GDP rate might return in the second quarter. Strengthened demand from EU and CEFTA countries is expected to be overridden by weakened domestic demand and negative short-term effects from fiscal consolidation retaining our GDP projection at -0.5 percent for this year, while the next year should see a positive rate of 0.7 percent driven by recovery of exports and investments.

Personal consumption to remain weak; government consumption to decline further.

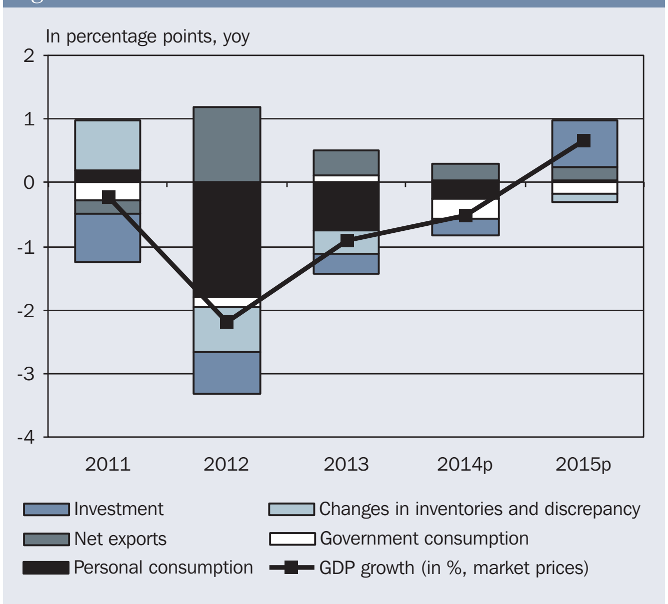
Personal consumption was stronger than expected in the first quarter leading us to revise the projection for this year. It turns out that so far fiscal consolidation has had a relatively weak effect on the personal consumption. Although negative trends on the labor market have softened, employment is expected to continue declining as well as disposable income. Low inflation will help moderate the decline of real income, but due to the continued household deleveraging and low consumer sentiment we expect personal consumption to decline this year by 0.5 percent. Improved economic situation in 2015, combined with better labor market stance, should help stabilize personal consumption. Unlike personal consumption, the ongoing fiscal consolidation has left its trace on government consumption. We project the falling trend to continue with the decline of 1.5 percent this year and an additional 1 percent next year.

Figure 8 EASTERN EUROPE: GOVERNMENT DEBT IN 1Q2014



Source: *Eurostat.*

Figure 9 CROATIA: DEMAND CONTRIBUTION TO GDP GROWTH



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

Investment recovery postponed for the next year.

Recent developments have proved that we were too optimistic regarding investments. Three months ago we believed that some of the government-induced projects in addition to private investments could change the trend. The latest data, however, suggest that such change is not close and investment recovery will be postponed to the next year. In order to move investments upwards the economy will need stronger incentives from abroad, such as projects financed by the EU funds and FDI. Accordingly, we expect investments to decline by 1.1 percent this year while the next year should bring some revival which, due to the low base, might reach 3 percent.

Upward revision of foreign trade projections.

Induced by the data revision and unexpectedly favorable developments in the trade of goods, we have revised upwards our projections for exports and imports. We count on solid tourist season and continued expansion of goods trade, so we project total exports to rise by 4 and imports by 3.3. percent. Trade expansion will continue next year at approximately the same pace. With such trade developments, surplus on the current account will be sustained. This year it might increase to 1.4 percent of GDP and then decrease to 1.1 percent of GDP in 2015. Foreign debt will be reduced, but will remain slightly above 100 percent of GDP in both 2014 and 2015.

Unemployment rate will decrease next year.

As employment is not yet recovering, recent fall in unemployment should be explained by other reasons such as emigration, undeclared work, discouraged workers, etc. These factors are likely to persist in the near future, causing further reduction in the labor force. Therefore, the projected unemployment rate in this year will be only mildly higher than in 2013, 20.4 percent on average, in spite of continued fall in employment. In 2015, positive changes in the real sector should transfer onto the labor market and bring slight decrease in the unemployment rate to 20.3 percent. Although much was expected from the revision of the Labor Law, its final version enacted in July will increase flexibility of employment only slightly and mainly in the domain of temporary agency work, and is not likely to affect labor market developments significantly.

HRK/EUR exchange rate expected at a slightly higher level.

Despite the fact that improved trade balance and tourism-related foreign currency inflows will support the strength of kuna in the summer, some factors are working in the opposite direction as well. In the first place these are fiscal risks and the potential quest of public sector entities for additional foreign currency resources in domestic markets. Then there is ongoing deleveraging of both households and enterprises that has apparently still not reached bottom, and lastly, bank provisioning. Therefore we see the average HRK/EUR rate in 2014 above the last year's level, at around 7.62 and approximately at the same level in 2015.

Recovery of credit activity next year.

With relatively high nonperforming loans and uncertain economic prospects, banks remain risk-averse. In such situation even a minimal increase in credits to enterprises would be interpreted as success. Households will continue to reduce indebtedness due to ongoing joblessness and real disposable income erosion. Therefore, at the end of the year we see total domestic credits in a light contraction of 0.1 percent. For the next year, aggregate demand takeoff will help gradual recovery of credit markets with growth in total credits of 1.1 percent. In the current situation there is not much room for broad money growth, especially because liquidity is already high. We therefore see broad money growing by 3.3 percent in 2014 followed by a similar rate in 2015.

Low inflation period expected to continue.

The deflation potential is slowly weakening and by the end of the summer we expect inflation to kick in again, not only through further tax and excise rate hikes that seem possible having in mind fiscal problems, but also through higher food prices caused partially by damages from the May floods in Slavonia. We therefore expect consumer prices to rise by 0.3 percent in this year and to pick up by 1.6 percent in 2015. Risks to the downside stem from commodity prices, especially those of oil, which might surprise, although at the moment they seem to be stable.

Table 2 SUMMARY OF PROJECTIONS

	2014	2015
Real GDP (% change)	**-0.5**	**0.7**
Real private consumption (% change)	-0.5	0.1
Real government consumption (% change)	-1.5	-0.9
Real investment (% change)	-1.1	3.3
Exports of goods and services (constant prices, % change)	4.0	3.8
Imports of goods and services (constant prices, % change)	3.3	3.2
Current account balance (% of GDP)	1.4	1.1
Consumer prices (% change, pa)	0.3	1.6
Exchange rate, HRK/EUR (pa)	7.62	7.62
Unemployment rate (registered, %, pa)	20.4	20.3
General government balance (ESA95 definition, % of GDP)	-4.6	-3.5
Broad money, M4 (% change, eop)	3.3	3.3
Total domestic credit (% change, eop)	-0.1	1.1

Note: *Cut-off date for information used in the compilation of projections was July 10, 2014.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

EDP headline deficit target is likely to be met.

We expect that the headline deficit of the general government for 2014 will not depart significantly from the EDP target of 4.6 percent of GDP (by ESA95 accounting rules). Assuming that there will be no big unexpected expenditures by the end of 2014, the realization of the projected figure may be compromised only by unfavorable dynamics of the relevant tax bases, which in turn depend on general economic circumstances.

3 Uncertainties and Risks to Projections

Low public support and weakening political will for the reforms.

As the third year of current Government's mandate has half-expired, it is becoming obvious that the political will for structural reforms is gradually weakening and no major advancement in that respect can be expected by the end of the mandate in late 2015. Without clear political leadership, public support for reforms is becoming rather low despite rising discontent with the present situation. Additionally, lack of a coordinated high-quality macroeconomic management makes necessary reforms rather hard to implement. Therefore, the reform measures will depend primarily on the magnitude of pressure from the EDP and MIP (Macroeconomic Imbalance Procedure) processes.

Scattered information on possible change of fiscal consolidation instruments.

Unfortunately, the EDP-defined fiscal consolidation remains surrounded by uncertainties regarding policy instruments and dynamics of implementation. Measures that will be undertaken might differ somewhat from those presented in the Convergence program. In the recent days, Minister of Finance announced that the Government is considering a change in the personal income tax that would eliminate the 40-percent rate currently applied to the highest income bracket. Rationale for that is found in the improvement of the position of highly-educated experts in order to prevent them from emigrating and make the country more attractive for FDI. An increase in personal tax allowance is also considered. However, what makes that proposal questionable is the fact that it would admittedly decrease budget revenues by about HRK 2 billion and that no information has been released on the sources that would replace it. Similarly, Minister of Finance has announced possible postponement of the introduction of property taxation that is, according to the Convergence program, planned for 2016. Such deviations from the program without sufficient evidence and explanations, and/or a more thorough analysis of the effects can jeopardize the credibility of the Government.

Question marks over the outcome of the tourist season.

Almost every year at this time there is a lot of speculation on the possible outcome of the tourist season. While data from the statistical office on the number of overnight stays by foreign visitors in the first five months of 2013 are rather disappointing and indicate a 5-percent decline (13-percent decline solely in May), recently announced figures by the Croatian Tourist Board suggest that last year's numbers have been surpassed in the first half of the year by 4 percent and that there are no doubts that this season will be successful. However, unfavorable weather conditions and still-not-recovered economies of Italy and Slovenia, the most important incoming markets, do raise some questions.

Changes in methodology increase uncertainty on the position of the economy.

Changes in the statistical recording of foreign trade flows, employment and, to some degree, industrial production, that have been implemented over the last few months, have resulted in increased uncertainty regarding the true position of the economy. The revised data indicate better state of the economy than was assessed previously, but numerous ambiguities remain. Additionally, in September this year new methodology for national accounts, ESA2010 will be implemented replacing the current one, ESA95. Although changes in methodology are not severe, we can expect the reassessment of recent trends and a more thorough revision of projections after the data according to ESA2010 are released.

Increase in tensions between the EU and Russia could jeopardize recovery.

Adjustments in monetary policy of developed countries remain an important risk factor for global growth and financial stability and even more so for emerging economies. This particularly applies to quantitative easing (QE) policies that have been in effect since the offset of financial crisis. QE in the U.S. is expected to be phased out in the second half of 2014, increasing the interest rates worldwide due to possible overshooting effect, which would in turn lead to outflows of capital from emerging economies, increase in their external financing cost and depreciation pressures. In Europe, the heightened tensions between the EU and Russia are a key downside risk. Commodity and financial markets have remained relatively unaffected, counting on avoidance of any further escalation of conflicts. Given the high degree of interdependence between the EU and Russia, as well as between Croatia and the EU, any further increase in turmoil would impose substantial economic costs in the region and therefore derail recovery.

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