

Croatian Economic Outlook

Quarterly

1 Recent Developments

Long-awaited recovery still delayed.

Croatia is estimated to have recorded negative growth rate in 2014 for the sixth consecutive year. Official GDP figures for the first three quarters show decline of 0.6 percent on year-on-year basis. A more moderated decline is estimated for the last quarter of 2014, but that is not likely to substantially change negative annual figure. Seasonally adjusted quarter-to-quarter figures suggest that economy has stagnated for almost the entire last year. Over the first three quarters the output was approximately at the level reached at the end of 2013. Available evidence from high-frequency indicators for the last quarter of 2014 shows that growth conditions have not changed, suggesting that long-awaited recovery is still delayed.

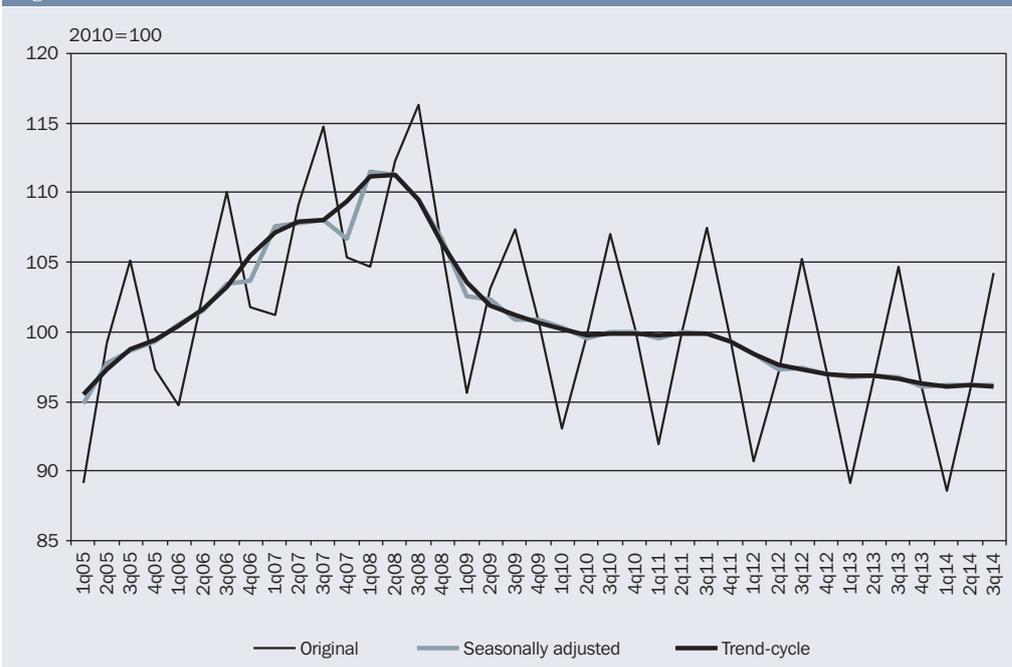
Despite deflation real personal consumption weakens.

In the first half of 2014 personal consumption exhibited modest improvement which was almost fully neutralized in the third quarter when it dropped back to the level from the end of 2013 as confirmed by seasonally adjusted figures. In the third quarter of 2014 personal consumption decreased by 1.1 percent year on year. Main factors behind this development are depressed household incomes due to lower employment. At the same time, consumer confidence has remained low while households continued with deleveraging. Deflation prevented personal consumption from falling even further.

Further reduction of government consumption.

Fiscal consolidation has led to a reduction in government consumption which was present for a full year up to the third quarter of 2014 in which it stagnated, probably only

Figure 1 REAL GROSS DOMESTIC PRODUCT



Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.

temporarily. However, compared to the third quarter of 2013, it was still 1.4 percent lower. Monthly government finance statistics for October suggest that expenditures on goods and services remained subdued meaning that decline in government consumption probably continued in the last quarter of 2014.

Investment decline halted?

Following a strong decline in the first half of 2014, in the third quarter investments recorded a mild pick-up, according to seasonally adjusted values. Investment volume was 3.6 percent below its value from the third quarter of 2013, but somewhat higher than in the previous quarter implying that the negative trend may have come to its end. Investments have been declining since mid-2008 with only three episodes in which the decline was interrupted but without reversal in trend that would lead to recovery. In 2014 government-financed investments undershot expectations and could not provide a stable push for other segments of economy while private investments remained weak due to ongoing deleveraging and uncertain prospects. For the investment trend to turn positive it is essential to ensure the realization of projects financed by the EU funds in addition to more significant FDIs.

Foreign trade growth returned to “normal”,...

Total exports and imports recorded growth rates well above expectations in the first half of last year, but mostly due to statistical reasons. Statistical methodology related to data collection on foreign trade changed when Croatia joined the EU, on July 1, 2013. As a result foreign trade volumes were suddenly lifted causing year-on-year rates to become high. However, in the third quarter of 2014 that effect disappeared. Total exports in that quarter grew by 4.1 percent and total imports by 3.2 percent year on year. If only exports of goods are considered, increase that amounted to 12 percent in the first half of 2014 decelerated to 3 percent in the July-October period in current euro terms. Statistical sources indicate that exports were substantially increased to Slovenia and only modestly to Italy and Germany. Additionally, exports to CEFTA countries have fully recovered from the 2013 downfall.

... tourism activity retained a positive trend...

The 2014 tourist season has proven to be successful in spite of unfavorable factors including exceptionally rainy weather during the high season. Latest data on physical flows up to October 2014 indicate a 2.7-percent rise in the number of overnight stays by foreign and a 0.8-percent rise by domestic tourists. Additionally, balance of payments data confirm that in the first three quarters of 2014 revenues from foreign tourism were some 2.5 percent higher than a year before suggesting that for the year as a whole they might come close to EUR 7.5 billion, a record high from 2008.

... while surplus on current account diminished.

Following favorable export performance in the third quarter 2014, the current account recorded a surplus of EUR 2.8 billion, close to the last year's figure in the same quarter. However, in four quarters up to the third quarter 2014 cumulative surplus was only EUR 63 million, the lowest value since the fourth quarter of 2012. Recent reduction of current account surplus was caused by higher outflow of factor incomes and higher outgoing transfers, mostly contributions to the EU budget.

Industrial production trend turned positive,...

In 2014 industrial activity was characterized by a significant volatility including a couple of switches in trend. Strong industrial activity from the beginning of 2014 has turned into a declining trend which, following stagnation around the mid of the year, turned again positive in the last quarter of 2014. The cumulative industrial output for the first eleven months of 2014 amounted to 0.6 percent year on year. If December data do not alter the sign of the annual change, 2014 will be the first year since the beginning of recession in 2008 with a positive growth rate of industrial production. Cumulatively, in year-on-year terms, manufacturing industry increased by 2.8 percent while the activity of mining and quarrying (primarily extraction of petroleum and gas) as well as energy sector dropped by 7 percent.

... retail trade volume remained stagnant, while negative trend in

Retail trade volume has remained roughly unchanged during 2014. When data for the first eleven months are taken into account, it was 0.1 percent higher than in the same period previous year. At the same time, latest data on construction activity suggest that

construction activity came to a halt.

negative trend has been halted in the last quarter of 2014 for the first time since the end of 2008. Upcoming months should confirm whether this can be sustained. In the first eleven months of 2014 construction activity was 7 percent weaker than in the same period a year before while cumulative fall since 2008 amounted to 43 percent.

The end of negative trends on the labor market?

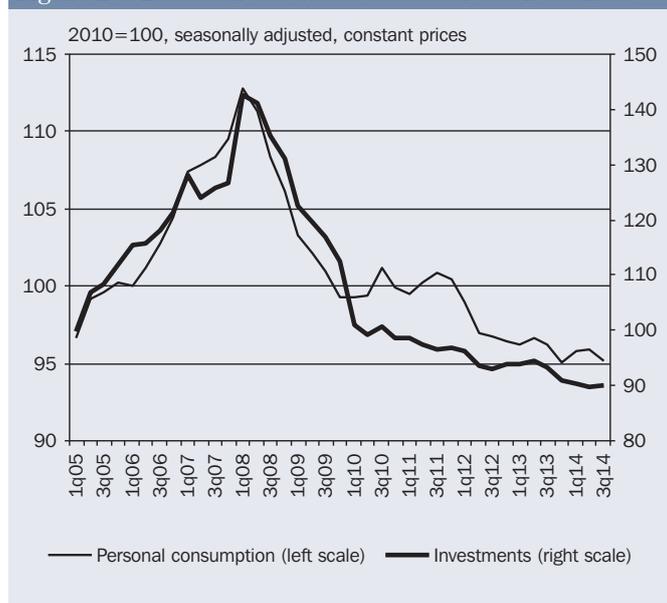
On the labor market, 2014 was marked by decreasing unemployment and a slight reduction of employment. Following a peak in February, number of registered unemployed started to decline and reached 316,763 in December, which is 1 percent more than in the previous month but almost 13 percent less than in December 2013. As a consequence, unemployment rate stood at 19.2 percent in November which is almost 2 percentage points less than a year ago. It seems that the main reason for this strong reduction in unemployment has been the removal of unemployed persons from Employment Service registry due to non-compliance with legal provisions followed by smaller influx of the newly unemployed. Additionally, more than 55 thousand persons were included into active labor market programs during 2014 which certainly affected unemployment developments. Unfortunately, the reduction of unemployment did not translate into higher employment. Employment declined by about 2 percent during the first eleven months of 2014 and this decline was spread across almost all economic activities. It resulted in an all-time-low ratio of the number of employed and number of pensioners of 1.15 in November 2014.

Fall of real disposable income.

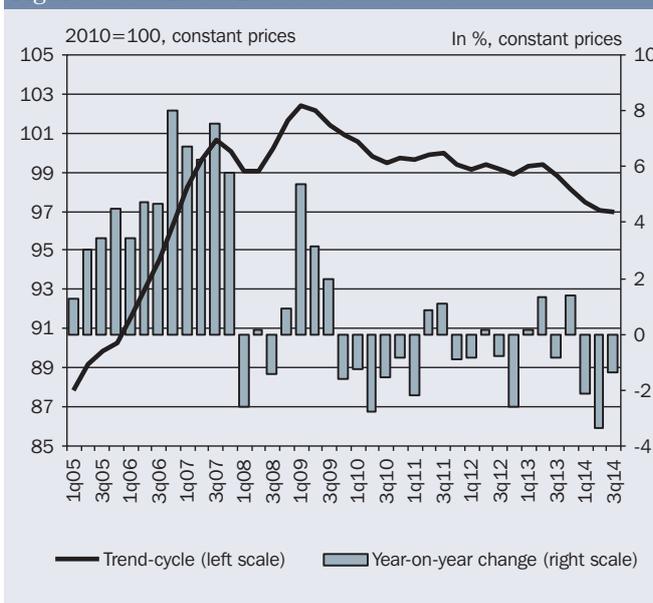
In the third quarter 2014 nominal wages slightly decreased over the previous quarter, but somewhat increased in comparison to the third quarter 2013. The average gross wage stood at HRK 7,908 (EUR 1,036), which is 0.6 percent lower than in the second quarter and 0.3 percent higher than in the same period previous year. Due to small deflation in the same period, real wages grew by about 0.5 percent on a year-on-year basis. However, the estimated total net wage bill fell in both nominal and real terms in the third quarter 2014 as the employment continued to fall. Although the total amount of government transfers remained more or less stagnant, real disposable income decreased by about 1 percent, which is mirrored in the fall of personal consumption in the third quarter.

Foreign currency deposits are building up money supply.

In November 2014 broad money increased 3.6 percent year on year reflecting mostly household deposits and savings accumulation in light of poor economic outlook. Seasonally adjusted data suggest that foreign currency deposits have been the main contributor to broad money growth accumulating around HRK 8.3 billion from May to November 2014.

Figure 2 PERSONAL CONSUMPTION AND INVESTMENTS

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

Figure 3 GOVERNMENT CONSUMPTION

Note: Trend-cycle calculated by X11ARIMA (Statistics Canada).
Source for original data: Croatian Bureau of Statistics.

While households have had a moderate and steady foreign deposit inflow, enterprises contributed rather strongly in October and November. They were most probably getting prepared for repayment of obligations to foreign creditors in December.

All sectors reduced financial leverage in November.

Credit market has remained strangled as poor economic outlook is keeping lenders risk averse, and borrowers unwilling to engage in new businesses and/or new investment cycles. In November 2014, total credits shrank by 2.4 percent when compared to November 2013. Enterprises deleveraged by 3.9 percent and households by 0.7 percent. Surprisingly, even Government reduced the amount of domestic loans in this one-year period by 0.03 percent. Taking into account the whole period since the beginning of recession, households have reduced their financial leverage, while enterprises had very modest credit growth. Total credits did, however, significantly increase, but this growth can almost fully be attributed to the government sector.

Expansionary monetary policy in 2014.

Due to central bank's measures in late 2013 when the mandatory reserve requirement rate was lowered by 1.5 percentage points, average excess liquidity in the monetary system in 2014 stood at HRK 6.7 billion, up by HRK 2.9 billion or some 76 percent compared to 2013. Interest rates have followed as the average overnight ZIBOR (Zagreb Interbank Offered Rate) in 2014 was 0.1 percentage points below the 2013 rate, at 0.5 percent. Interest rates on deposits and credits have also decreased but mostly due to declining interest rate trend in EU. Government has benefited from this fall and obtained relatively cheap borrowing. Somewhat surprisingly, profitability of the banking sector increased in 2014 despite the fact that non-performing loans increased to 17.2 percent in the third quarter of the last year. Namely, banks managed to decrease their costs by deleveraging and by replacing expensive loans with deposits that have been rising. It has also turned out that the CNB-led requirement of higher provisioning standards somewhat cleaned up banks' balance sheets resulting in lower expenses on loss provisions.

Kuna supported by the central bank and government borrowing abroad.

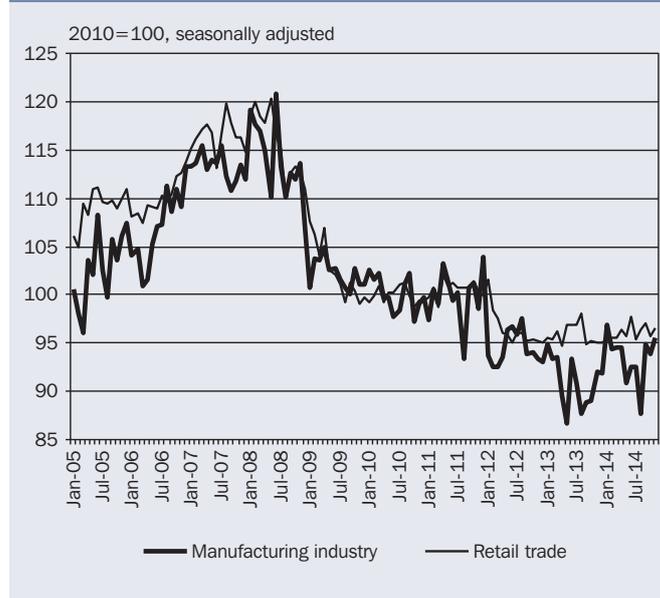
In 2014, HRK/EUR exchange rate weakened by 0.7 percent compared to 2013. The dominant factor of this weakening was banking sector deleveraging that increased the demand for euros. Although kuna is supported by the announced government borrowing abroad scheduled for the first quarter of 2015, recent global currency market uncertainties disturbed the domestic foreign exchange market and forced central bank to intervene. The

Figure 4 EXPORTS AND IMPORTS OF GOODS AND SERVICES



Source: Croatian Bureau of Statistics.

Figure 5 REAL SECTOR DEVELOPMENTS



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

CNB sold EUR 326.2 million and withdrew HRK 2.5 billion from banks on January 22, thus stabilizing the HRK/EUR rate at around 7.7.

Deflation eased in the fourth quarter because of base effects.

Due to consumer price decline of 0.2 percent, 2014 will be remembered as the first year of consumer price deflation since the data are recorded. Food and energy prices were the main culprits of this deflationary trend, but demand-side factors, including weak domestic demand, contributed as well. In the last quarter of 2014 deflation pressures eased and on average CPI in the fourth quarter depicted a stagnation. The reason behind this is trivial as it can be attributed to base effects. Fuel prices, however, significantly decreased in December, down by 18.1 percent.

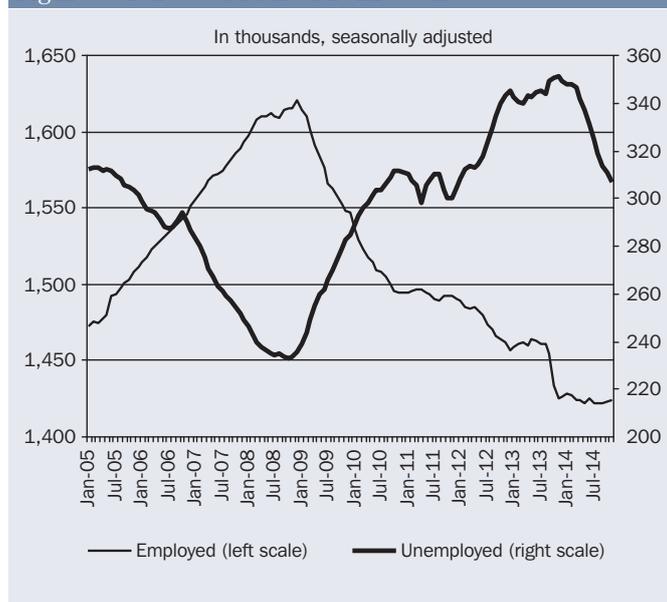
Budget revenues rose in 2014,...

Growth in total general government revenue of almost 12 percent that was recorded in the second quarter of 2014 was moderated in the third quarter. Relative to the same quarter of the previous year, the third-quarter total revenue saw a rise of 8.5 percent. Looking at the first three quarters of 2014 cumulatively, the total revenue collected was 7.1 percent higher than in the same period of 2013. This increase can be accounted for by increases in both tax revenues and social security contributions and driven by regulatory changes. Regarding tax revenues, the biggest contribution was that of VAT revenues, whose year-on-year rise in the third quarter and in the first three quarters cumulatively was 21.6 and 2.4 percent, respectively. It seems that the effect of applying new VAT rules on imported goods (after EU accession) has vanished. These rules brought a slowdown in VAT revenues in the first half of 2014 since the tax obligation is now related to the moment of sale instead the moment of imports (as it was the case before the accession). This effect has also been partly offset due to higher VAT rate on accommodation and restaurant services (rise from 10 to 13 percent). Social security contributions increased in the third quarter and in the first three quarters by, respectively, 5.8 and 14.9 percent. This is caused, first, by a 2-percentage-point increase (from 13 to 15 percent of gross wage) in the health contribution rate as of April 2014; and second, by transferring, through a change in legislation, accumulated pension savings of military and police personnel from private pension funds to the Budget.

... while expenditure stagnated...

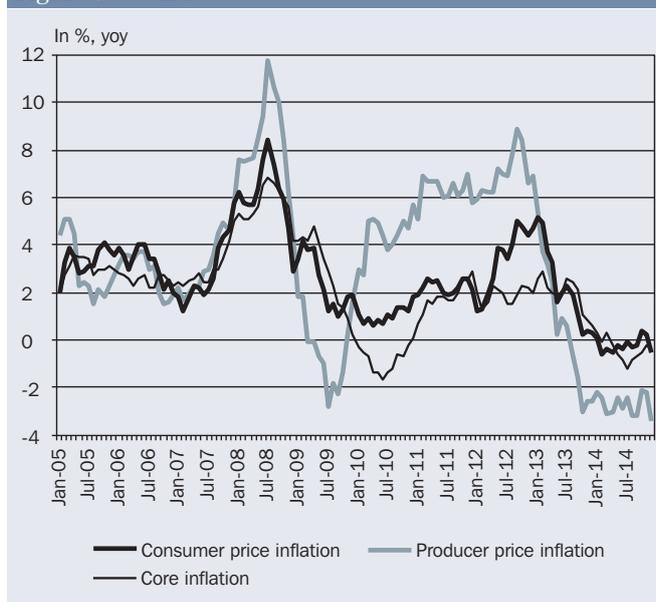
Total general government expenditure remained virtually unchanged in the third quarter of 2014 relative to the same quarter of 2013, and the same holds true for the first three quarters cumulatively. That was a net result of increased expenditures for transfers to the

Figure 6 LABOR MARKET DEVELOPMENTS



Note: Seasonally adjusted by X11ARIMA (Statistics Canada).
Sources for original data: Croatian Pension Insurance Institute and Croatian Employment Service.

Figure 7 INFLATION



Sources: Croatian Bureau of Statistics and Croatian National Bank.

EU budget (non-existent in the first half of 2013) and for interest payments on the one hand, and reductions in all other major expenditure items, including employees' compensation, purchases of goods and services, subsidies and social spending on the other hand. The only expenditure category with a sizeable decline was that of public sector investments.

... allowing for a deficit reduction.

These developments resulted in a third-quarter surplus of HRK 539 million, which is a striking improvement over the same quarter of 2013 when a deficit of HRK 2.2 billion was recorded. Considering the first three quarters together, the cumulative deficit amounted to HRK 6.8 billion, more than 50 percent less than for the same period of 2013.

November revision of 2014 Budget.

As of end-November, the Budget underwent a second revision in 2014. The consolidated central government revenue was lowered by HRK 2.6 billion (2.2 percent relative to the plan), while consolidated central expenditure was reduced by HRK 1.4 billion (1.0 percent relative to the plan). The revision implied increase in general government deficit measured by national accounting rules from 4.8 to 5.0 percent of GDP. However, a few days into the 2015 the Minister of Finance reported that according to the preliminary data for the whole 2014 the central government deficit was HRK 12.8 billion, almost HRK 3 billion less than what was implied by the November revision. According to the Minister, lower than planned expenditure was due to lower interest payments and material costs, lower outlays for purchases of goods and services, employees' compensations, subsidies and other expenditures. Compared to 2013, this implies significant reduction in central government deficit, but the level of expenditure remained higher than the year before.

Budget plan for 2015...

The Budget for 2015 was passed in the Parliament at the beginning of December. It is not comparable with the previous ones due to a number of changes. The most important of these changes are that the Croatian Health Insurance Fund (HZZO) left the Treasury with the start of 2015 and that the state-owned hospitals are now included into the Budget along with the own revenues and corresponding outlays of some budget users that were previously left out. While total revenue and expenditure figures are significantly affected, the deficits should be comparable. The general government deficit, according to national accounting rules, is planned at HRK 12.6 billion, or approximately 3.8 percent of GDP, implying a sizable reduction in comparison with HRK 15.1 billion planned for 2014.

... included a number of tax changes.

As of January 1, 2015, a number of changes to the tax system took place. The most significant concerns the personal income tax. The untaxed part of personal income was raised by HRK 400. The lower bound of the top tax bracket, to which a 40-percent tax rate applies, was raised as well, from HRK 8,800 to 13,200. The changes are intended to leave all taxpayers with larger net income, though not all will benefit equally: those with relatively high incomes will benefit more. The inequitable nature of the latter change was justified by the argument that it is the relatively high gross incomes that suffer the largest tax burden, harming the prospects of attracting foreign investments in industries with high demand for high-skill workers. However, as the loss in personal income revenue is mostly borne by local governments, a number of them have decided in the meantime to increase local taxes. Government also decided to introduce a 12-percent tax on income from interest on savings, while capital gains tax will be implemented in 2016. From the beginning of 2015, small enterprises can decide whether to pay VAT upon issuing invoice as before, or upon receiving payment for their goods and services. Tax changes also affected betting wins as all are now taxed and not just those above HRK 750. Another legislative change that took place as of the beginning of 2015 may have notable effects. According to this change employers are free from paying social security contributions for five years for employees of up to 30 years of age hired on permanent contract. Here the benefits in terms of additional employment of youth as one of the most vulnerable groups in the labor market may outweigh the revenue forgone, although the final effect depends on whether additional demand will be created for such workers.

Table 1 | MAIN ECONOMIC INDICATORS

	2012	2013	2013	2014		
			Q4	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-2.2	-0.9	-1.1	-0.6	-0.8	-0.5
Real private consumption (% change, yoy)	-3.0	-1.3	-1.8	-0.5	-0.5	-1.1
Real government consumption (% change, yoy)	-1.0	0.5	1.4	-2.1	-3.4	-1.4
Real investment (% change, yoy)	-3.3	-1.0	-3.1	-3.6	-5.2	-3.6
Industrial output (% change, yoy)	-5.5	-1.8	-2.3	0.6	-0.4	0.4
Unemployment rate (registered, %, pa)	18.9	20.2	20.9	22.4	19.7	17.7
Nominal GDP (EUR million)	43,959	43,591	-	-	-	-
GDP per capita (EUR)	10,300	10,242	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	1.6	0.9	-0.3	-0.5	-0.3	0.6
Consumer prices (% change, yoy, pa)	3.4	2.2	0.3	-0.3	-0.4	-0.2
Producer prices (% change, yoy, pa)	7.0	0.5	-2.7	-2.6	-2.8	-2.9
Average gross wage (% change, yoy, pa)	1.0	0.8	0.3	-0.2	0.1	0.3
Exchange rate, HRK/EUR (pa)	7.52	7.57	7.63	7.65	7.60	7.61
Exchange rate, HRK/US\$ (pa)	5.85	5.71	5.60	5.58	5.54	5.74
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,628	9,589	2,623	2,355	2,542	2,702
Exports of goods (EUR, % change, yoy)	0.5	-0.4	1.8	13.5	11.3	3.7
Imports of goods (EUR million)	16,216	16,528	4,086	3,981	4,499	4,504
Imports of goods (EUR, % change, yoy)	-0.4	1.9	2.8	6.8	2.6	4.1
Current account balance (EUR million)	-61	341	-820	-1,518	-381	2,782
Current account balance (% of GDP)	-0.1	0.8	-	-	-	-
Gross foreign direct investment (EUR million)	1,134	741	5	225	2,105	308
Foreign exchange reserves (EUR million, eop)	11,236	12,908	12,908	12,100	12,335	12,116
Foreign debt (EUR million, eop)	45,276	45,920	45,920	46,709	46,319	46,455
GOVERNMENT FINANCE						
Revenue (HRK million)**	126,132	125,879	33,660	29,030	35,016	34,692
Expense (HRK million)**	132,413	138,217	35,449	34,914	34,638	33,120
Net = Gross operating balance (HRK million)**	-6,282	-12,339	-1,789	-5,884	378	-1,572
Net acquisition of non-financial assets (HRK million)**	4,574	5,264	1,743	1,040	831	1,033
Net lending/borrowing (HRK million)*	-10,855	-17,603	-3,532	-6,924	-453	-2,604
Domestic government debt (EUR million, eop)	17,418	19,931	19,931	20,440	20,721	20,360
Foreign government debt (EUR million, eop)	10,794	12,799	12,799	12,473	12,693	13,207
Total government debt (eop, % of GDP)	64.5	75.5	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	1.6	10.9	10.9	10.1	7.7	10.4
Broad money, M4 (% change, yoy, eop)	3.2	2.9	2.9	3.3	2.7	2.9
Total domestic credit (% change, yoy, eop)	-3.9	-0.7	-0.7	-1.5	-2.6	-3.6
DMBs credit to households (% change, yoy, eop)	-1.4	-1.7	-1.7	-1.5	-0.6	-1.5
DMBs credit to enterprises (% change, yoy, eop)	-11.2	-0.1	-0.1	-0.7	-3.9	-5.6
Money market interest rate (% pa)	1.1	0.4	0.3	0.4	0.2	0.4
DMBs credit rate for enterprises, short-term, (% pa)***	6.8	5.9	5.7	5.6	5.3	5.1
DMBs credit rate for households, short-term (% pa)***	9.5	8.1	7.9	7.6	7.6	7.4

Notes: * Data refer to consolidated general government. ** On the cash principle. *** The weighted average interest rate on new loan agreements, revised data.

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

Uneven global recovery continues.

Global economy has stayed on a moderate recovery path but with uneven paces across regions due to different post-crisis adjustments and unexpected geopolitical shocks. The World Bank (*Global Economic Prospects*, January 2015) estimates growth of world real GDP at 2.6 percent in 2014, a downward revision by 0.2 percentage points from June 2014. Growth forecasts for 2015 and 2016 stand at 3.0 and 3.3 percent, respectively. Thereby, high-income economies are still playing the role of main recovery drivers. Economic outlook for the U.S. looks favorable with growth estimated at 2.4 percent for 2014, and forecasts standing at 3.2 and 3.0 percent for 2015 and 2016, respectively. Eurozone has recorded six consecutive quarters of modest, but positive real GDP growth. In the third quarter of 2014 it rose by 0.2 percent, quarter-to-quarter. Available indicators show strengthening of private consumption, negative contribution of investments and neutral contribution of net exports. Lower than expected growth of investments and exports caused a downward revision of forecasted GDP growth for the eurozone. It now stands at 0.8 percent for 2014, 1.1 and 1.6 percent in the current and following year, respectively. The oil prices have strongly declined in 2014 especially in its second half, despite the high degree of turmoil in major oil-producing countries. They are expected to remain low and thus prolong the positive impact on global recovery, keeping inflation low and contributing to the shift of income between oil-exporting and oil-importing countries.

2015 started with presidential and will end with parliamentary elections.

On January 11, 2015 Croatian voters elected Ms. Kolinda Grabar-Kitarović as new President for the next five years. Ms. Grabar Kitarović, who was the candidate of center-right Croatian Democratic Union (HDZ) and its partners took a slim victory over the incumbent Ivo Josipović who was supported by the governing center-left Social-Democratic Party (SDP) and its partners. In Croatia, the role of president is rather ceremonial with certain powers in the areas of national defense and foreign affairs. However, Croatian voters will most probably go to the polls again in much more far-reaching parliamentary elections at the end of this year.

Fiscal issues to remain Government's main focus.

On the internal economic front, fiscal issues are expected to remain Government's primary focus as the ongoing EDP procedure continues. Ministry of Finance has prepared the Budget plan for 2015 that involves several changes in tax policy. Some of them, such as lower personal income taxation and possibility of small enterprises choosing to pay VAT after they receive payment, go in the direction of lower tax pressure. However, tax changes also include measures in the opposite direction, such as the introduction of tax on savings interest or the change in gaming tax. Although Government argued that it primarily intended to improve consumer spending in 2015 and beyond, it is certain that effects of these measures will, to a certain extent, offset. The fiscal deficit targets agreed upon with the European Commission under EDP procedure were probably not met in 2014 and will most probably not be met this year as well. Therefore, the European Commission might request additional consolidation measures or prolong the time needed to meet the existing targets if it positively assesses the effort that has been taken so far. Due to upcoming parliamentary elections, we do not expect major progress on structural reforms agenda. As for 2016, there are many uncertainties and the only concrete measure announced for next year is the introduction of property tax, although it appears that no final political decision has yet been reached to actually implement this measure. Central bank is expected to continue with the existing monetary policy aimed at keeping financial stability. It is assumed that CNB will continue to ensure high interbank liquidity conditional on exchange rate stability.

GDP expected to increase 0.2 percent in 2015.

Our GDP estimate for 2014 as well as forecast for 2015 remain unchanged compared to three months ago with slight adjustments based on the latest available high-frequency indicators only across individual components. Due to changes in personal income taxation we expect that contraction in personal consumption will be halted this year while turnaround is projected for investment activity sparked by signs of recovery and activation of EU funds.

Strong dynamics registered in the foreign trade sector, especially in the exports of goods, has already weakened as it was partially a result of methodological changes. Nevertheless, rising trend is expected to continue at a slower pace and to contribute positively to the overall output. As a consequence, we expect GDP to have declined 0.6 percent in 2014 and to increase only marginally, by 0.2 percent, this year. In the absence of clear mid-term policy plans, year 2016 is projected mainly by assuming the continuation of established trends which should bring roughly a one-percent GDP growth.

Personal consumption projected to stagnate; government consumption to continue declining.

Personal consumption will continue to be under pressure from weak and uncertain conditions on the labor market, low consumer confidence and continued process of households' deleveraging but changes in personal income taxation should prevent it from falling further in the years to come. We therefore estimate personal consumption to have declined 0.5 percent last year and expect it to remain close to stagnant this and next year. Fiscal consolidation is leading to reduction in government consumption. It is estimated at -2.3 percent in 2014. We expect this trend to continue in 2015 and 2016 with additional 1.4 and 1.1 percent contraction, respectively.

Weak investment recovery expected.

Investments picked-up mildly in the third quarter 2014, which was still not strong enough to change the trend, but we expect the observed positive change to persist and strengthen over time. We estimate that investments declined by 3.5 percent last year. This year should, under the assumption that planned projects are realized in addition to stronger utilization of EU funds, bring weak recovery of up to 1 percent, followed by 2.4 percent in 2016.

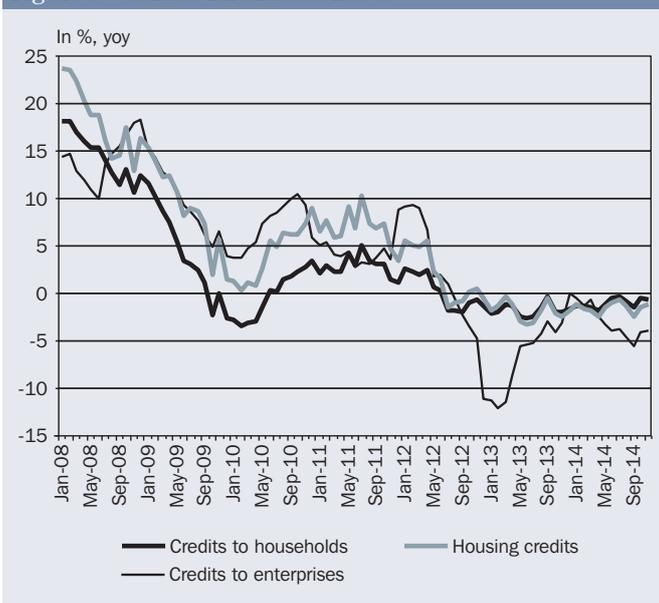
Growth pace of foreign trade to decelerate.

For the last quarter of 2014 we have estimated a continuation of the foreign trade trends observed in the third quarter. Accordingly, total exports are estimated to have increased 5.8 percent and imports 3.8 percent in 2014 as a whole. Positive trends should continue this year, but at a slower pace. We expect exports to rise by about 3.2 and imports by 2.5 percent in 2015 and this pace of growth should be maintained in 2016. As domestic demand remains weak, surplus on the current account is expected to be sustained. It is estimated at 0.6 percent of GDP in 2014, 0.9 of GDP in 2015, and 1.1 percent in 2016 as overall economic activity strengthens.

Sluggish recovery of the labor market.

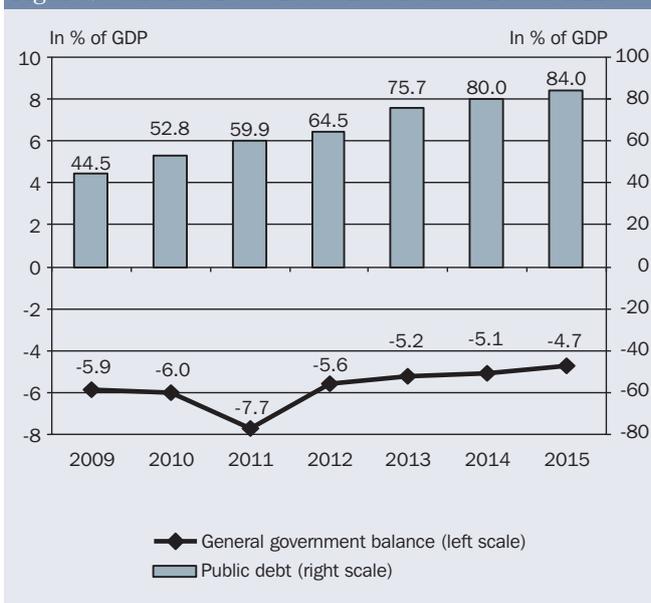
Due to a strong decrease of unemployment, especially in the second half of last year, we expect the average unemployment rate for 2014 to have been 19.7 percent. In 2015,

Figure 8 CREDIT DEVELOPMENTS



Source: Croatian National Bank.

Figure 9 GENERAL GOVERNMENT BALANCE AND DEBT



Sources: Croatian National Bank for 2009-2013 and EIZ estimate for 2014-2015 (ESA 2010).

unemployment is expected to continue declining but at a much slower pace. On one hand, the base effect of the change in legislation concerning the stricter registration rules at the Croatian Employment Service ceased at the beginning of this year. On the other hand, the inflow of EU funds to finance active labor market programs could have a positive effect on unemployment, especially for the youth population. Although the projected slow recovery of overall economy in 2015 suggests no significant rise of employment, registered unemployment rate is expected to be slightly smaller than in 2014, i.e., 19.2 percent. For 2016, we expect further decrease in unemployment that should marginally translate into increased employment and thus the unemployment rate is projected at 18.5 percent. We do not expect any significant change of the average gross wages in 2015, while the average net wages are expected to somewhat increase due to legislative changes in income taxation. This should bring about slight increase in real disposable income.

Interest rates expected to remain low.

Although further monetary expansion is not on the horizon, it is possible that the central bank will encourage different credit schemes especially towards small and medium-sized enterprises. Interest rates should remain at current low levels. The HRK/EUR exchange rate is expected to remain stable this year, and we expect central bank to intervene on the market in case of any abrupt changes in the nominal exchange rate. We expect HRK/EUR in 2015 to remain at levels recorded in December 2014, at around 7.66. In 2016 HRK/EUR exchange rate could depreciate mildly in the first half of the year, with the average annual rate around 7.68. Kuna will remain supported by the expected steady inflow of foreign currency, mostly due to strengthened exports, continuous government borrowing abroad and a gradually rising inflow of EU funds. Leveling off of bank provisioning and an appropriate level of foreign exchange reserves will also add to HRK/EUR stability.

Moderate increase in money supply; deleveraging continues.

We anticipate deposits and savings to remain the main broad money drivers and therefore we have slightly revised our broad money projection upwards to 3.6 percent in 2014 and 3.7 percent in 2015. For 2016 we expect the overall activity to pick up, which could moderately increase money supply, by 4.1 percent. However, deleveraging in 2014 is estimated at around -2.4 percent and will continue this year, but at a slower pace, around -0.6 percent. We expect credits to pick up by 1.4 percent in 2016, driven by positive expectations for next year.

Oil prices will determine inflation in 2015.

Oil prices are expected to remain low in 2015 and have a depressing impact on domestic prices. Soft oil prices have a positive effect on the Croatian economy as they lower production costs and improve terms of trade. However, they lead to lower government budget revenues that can be only partially compensated by higher spending on other consumer goods. In case oil prices continue to fall, inflation could remain in the negative zone. A more moderate scenario, in which oil prices remain stagnant leads to inflation forecast of around 0.4 percent. Upside risks come from the possibility of increase in administratively determined prices on local level (aimed at compensating loss in income tax revenue of local governments), from imported prices of energy and food as well as from the expected appreciation of the U.S. dollar. Nevertheless, inflation is expected to remain low in 2015. In 2016 we forecast inflation to rebound towards 1 percent.

Fiscal deficits expected to be above EDP targets.

As of the previous issue of the *Croatian Economic Outlook Quarterly*, we have started to follow a different approach to fiscal projections. While before we chose to treat Government's proclaimed intentions with regards to EDP targets as credible, now we base our projections on deviations from the targets. In doing so, we take into account only those Governments' intentions the implementation details of which are clearly stated. Following this approach, we believe that 2014 ended with the general government deficit of 5.1 percent of GDP, well above the EDP target of 4.6 percent. We revised downward the projection taking into account the deficit of about HRK 3 billion below what was implied by the last 2014 Budget revision. As for the 2015, the new Budget does not offer grounds to expect that deficit-to-GDP ratio will be reduced through the Budget itself. Rather, the ratio may be reduced if the economy's general performance, embodied in real GDP growth, improves. However, poor

Table 2 SUMMARY OF PROJECTIONS

	2014 estimate	2015 projection	2016 projection
Real GDP (% change)	-0.6	0.2	0.9
Real private consumption (% change)	-0.5	0.1	0.3
Real government consumption (% change)	-2.3	-1.4	-1.1
Real investment (% change)	-3.5	1.0	2.4
Exports of goods and services (constant prices, % change)	5.8	3.2	3.6
Imports of goods and services (constant prices, % change)	3.8	2.5	2.7
Current account balance (% of GDP)	0.6	0.9	1.1
Consumer prices (% change, pa)	-0.2	0.4	1.0
Exchange rate, HRK/EUR (pa)	7.63	7.66	7.68
Unemployment rate (registered, %, pa)	19.7	19.2	18.5
General government balance (ESA 2010 definition, % of GDP)	-5.1	-4.7	-3.5
Broad money, M4 (% change, eop)	3.6	3.7	4.1
Total domestic credit (% change, eop)	-2.4	-0.6	1.4

Note: Cut-off date for information used in the compilation of projections was January 9, 2015.

Conventional abbreviations: pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.

Source: Authors' projections.

growth prospects that we project do not appear encouraging. Taking this into account, we project deficit to be no less than 4.7 percent of GDP at best, which is significantly above the EDP target of 3.5 percent of GDP for that year. While uncertainties regarding fiscal policy in 2016 are especially pronounced we expect that commitments within the EDP procedure will force the policy-makers to reduce deficit closer to 3-percent target and therefore we expect deficit at 3.5 percent of GDP.

3 Uncertainties and Risks to Projections

Will the whole year be "lost" to election campaign?

As Croatia entered 2015 with the second round of presidential elections, political analysts have increasingly started to warn that the whole year might be lost to election campaign since parliamentary elections should take place at the year's end. The new President-elect Ms. Grabar-Kitarović has announced that she will pressure the Government to pursue the reforms aimed at improving the economic situation, which is basically beyond her mandate but might cause rather strong tensions in the political sphere. The incumbent Government may respond to such pressure by starting to introduce populist policy measures much earlier than it would have done otherwise. These circumstances also bring an additional layer of uncertainty over our fiscal projections. As fiscal discipline generally tends to get more lax in anticipation of soon-to-come elections, the risk is that the deficit for this year will end up higher than projected.

Uncertain effect of newly-introduced measures.

In spite of six years of recession, only small steps in the direction of structural reforms can be expected this year. The reforms will primarily depend on the requests of the European Commission within the Excessive Deficit Procedure (EDP) and Macroeconomic Imbalances Procedure (MIP). Unfortunately, that means that subdued growth in the mid- and long-run will continue. It is unclear how the European Commission will react to the situation in which EDP targets have most probably not been fulfilled. If targets were missed by a substantial margin, that will require swift policy reaction. Possible additional measures in the direction of fiscal contraction would then negatively affect growth. Additional sources of uncertainty in the fiscal sphere are newly-introduced measures. First, it is unclear how lower personal income tax will affect consumption; maybe less than expected. Second, the change in the way VAT is paid by small enterprises might cause some problems for the budget revenues in the first months of this year. Third, there is uncertainty whether HZZO can operate smoothly without budget support and how will that affect health care system.

Also, the cash flow of the Treasury will be affected substantially as health contributions are stable and predictable sources of revenues that now go to HZZO's account, not into the Treasury.

Government additionally increases uncertainty.

Strong appreciation of Swiss franc against euro that took place just before ECB's January decision on massive quantitative easing, had substantially increased annuities of those who have credits indexed to the HRK/CHF exchange rate (16 percent of all household credits in Croatia). Under the public pressure to react quickly, Government decided to freeze HRK/CHF exchange rate at the rate that preceded the latest Swiss franc rise and apply it to these credits for a one-year period, transferring the loss to the banking sector. This is a temporary solution, while permanent one will most probably ask for the loss to be divided between credit owners, banking sector and the Government. The Government has hereby acted at the edge of economic populism by forcing legally disputable regulation and announcing further measures that favor borrowers; all that creates a great deal of uncertainty regarding current and future credit operations, which may have negative consequences on credit activity in the country by increasing cost of capital and putting a drag on investments.

Eurozone's volatile recovery.

As U.S. Fed ended its quantitative easing program in late 2014, certain risk for global economy has arisen from the normalization of U.S. interest rates. The assumed interest rate path can be highly volatile and dependent on GDP changes, employment growth, inflation and exogenous shocks such as oil prices, and might affect world financial markets substantially. At the same time ECB has decided to introduce a set of non-standard monetary policy measures which in January 2015 were extended to purchases of government bonds and securities issued by European agencies and institutions in high amounts in order to induce stronger recovery in the eurozone. The longer-term implications of such measures remain uncertain. Nevertheless, for the time being eurozone remains vulnerable to exogenous shocks that might arise in the form of geopolitical tensions or terrorist attacks. The crisis in Ukraine already took its toll in the form of two-way sanctions between EU economies and the Russian Federation. Due to its importance as Croatia's primary export market, the developments in the eurozone, either positive or negative, will certainly affect Croatia's recovery path.

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