

Croatian Economic Outlook

Quarterly



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Recent Developments

Positive GDP growth after six years

The third quarter of 2015 brought higher than expected GDP growth of 2.8 percent year on year mainly as a result of successful tourist season and some improvements in the real sector (Figure 1). This is now the fourth consecutive quarter of positive output growth, in which the growth rate more than doubled when compared to the previous quarter. Substantial increase in personal consumption and investment, coupled with strong foreign demand, positively contributed to GDP growth, while government consumption increased only modestly. That growth paced up is confirmed also by seasonally adjusted quarter-on-quarter data with the growth rate depicting 1.2 percent in the third quarter.

Personal consumption is gaining momentum

Seasonally adjusted figures for personal consumption indicate 0.3 percent (quarter-on-quarter) growth in the third quarter of 2015, the same rate at which personal consumption increased in the second quarter, which hints to a stable pace of recovery. In year-on-year terms, this rise is even more pronounced as consumption improved by 1.4 percent. This is the third consecutive quarter of consumption growth and the highest recorded growth rate in the last seven years. The main drivers of consumption growth in this year are improved real disposable income due to tax changes since the beginning of the year as well as the income effect associated with tourism activities and reflected in significant retail trade growth (Figure 2).

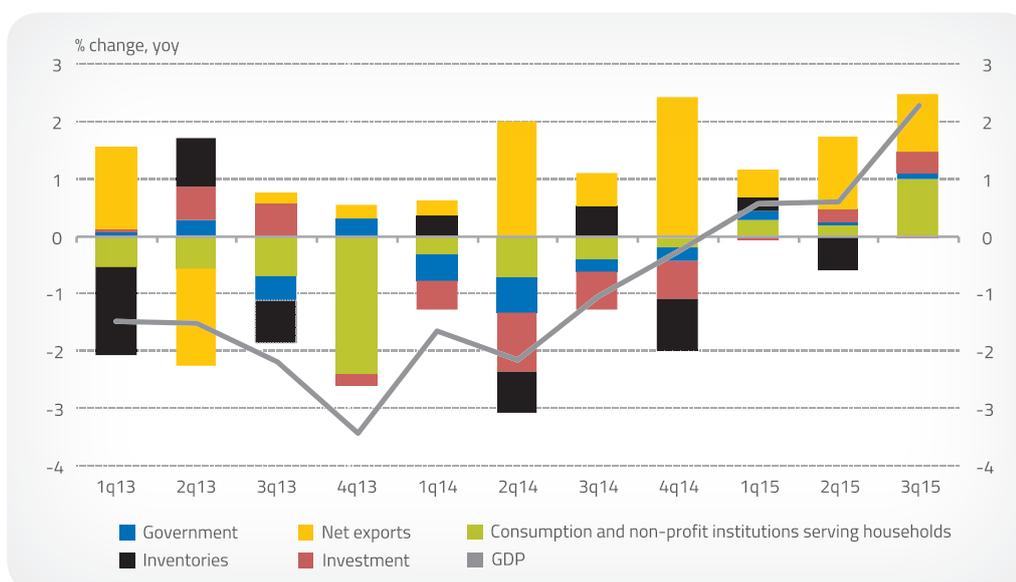


Figure 1

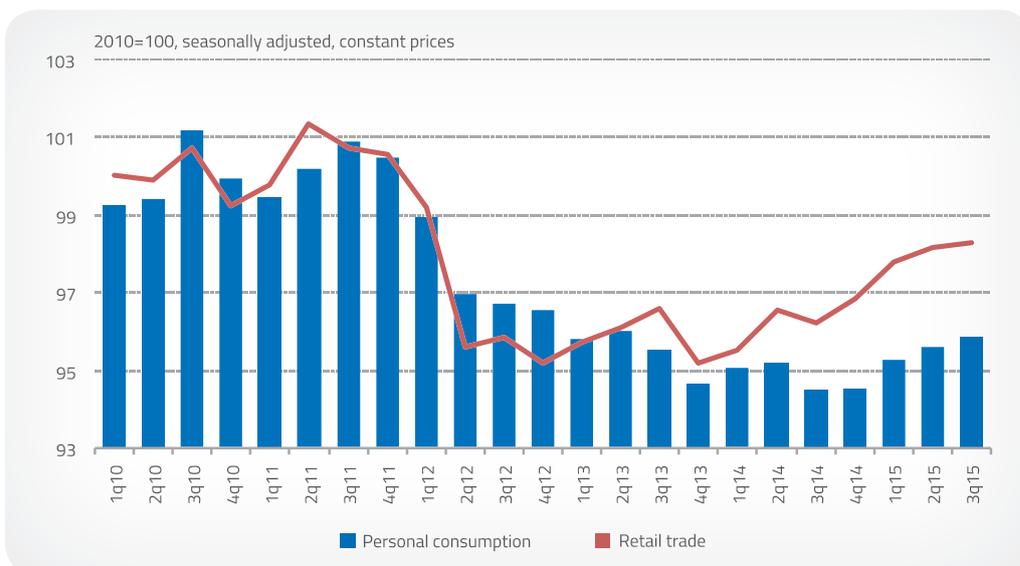
Demand Contribution to Real GDP Growth

Source: Croatian Bureau of Statistics.

Figure 2
Personal Consumption and Retail Trade

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.



Government consumption driven by revenues

Government consumption in the first three quarters of 2015 increased by 0.5 percent compared to the same period a year before. When compared to the last six years, this development is somewhat unusual as it is the only positive growth rate depicted for the January – September period. Developments so far indicate that in this year government consumption increased most probably due to improved revenue collection, thus opposing the current unsatisfactory state of public finance and the Excessive Deficit Procedure (EDP).

Investment outlook for 2015 improves

Investments seem to have reached the trough at the end of 2014 and have been showing

signs of recovery since the beginning of 2015. In the first three quarters of 2015 investments increased by 0.9 percent when compared to the same period in 2014. Greater absorption of EU funds, signs of recovery in the construction sector and stronger confidence suggest investment outlook has improved.

Export growth remains strong, imports on the rise

Total exports increased by 8 percent in the third quarter (in year-on-year terms) indicating somewhat smaller, but still notable increase compared to previous years (Figure 3). Meanwhile, imports of goods and services grew by 8.1 percent in line with the pickup recorded as of the second quarter of 2015, which is partially a result of disposable income and personal consumption recovery.

Figure 3
Exports and Imports of Goods and Services

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.



Political situation in Greece and North African countries and favorable weather conditions supported strong tourist activity

The 2015 saw a record high tourist season since the offset of the crisis in 2008, due to favorable weather conditions, geopolitical tensions in Greece and North African countries as well as improved economic prospects of neighboring countries. Data for the first ten months of 2015 in relation to the same period last year show a 9.1 percent rise in the number of arrivals by foreign and a 9.2 percent rise by domestic tourists. Although balance of payments data is not yet available for the third quarter of 2015, we expect revenues from foreign tourism to exceed those in 2014, which measured 7.4 billion euros.

Current account stays in surplus

Strong tourist season and excess value of exports over imports are good precursors to where the current account balance might be headed. Traditionally, the third quarter always brought a surplus in balance of payments and we expect this year to be no different and to exceed last year's value of 2.8 billion euros. This is also supported by the fact than in the first two quarters of 2015 the cumulative deficit stood at 1.3 billion euros, an improvement of 31.3 percent when compared to the same period in 2014.

Industrial production on the rise since the beginning of the year

Industrial production in seasonally adjusted terms recorded modest growth of 0.5 percent in October when compared to the previous month, but in the first ten months of 2015 it went up by 2.6 percent when compared to the same period last year (Figure 4). Seasonally adjusted data suggest that industrial production in the first ten months increased by 3.3 percent when compared to the end of 2014. Manufacturing contributed the most, as it grew by 5.5 percent in the period examined while mining and quarrying and energy production contributed negatively.

Retail trade continues to expand

In the first ten months of 2015 retail trade increased by 2.1 percent compared to the same period a year ago, reflecting strong tourism and mild domestic demand recovery. Latest available data for October 2015 suggest retail activity accelerated by 1.8 percent year on year which now amounts to fourteen consecutive months of positive growth, the longest period since the pre-crisis 2007 (Figure 4).

Decline in construction seems to be diminishing

In the first three quarters of 2015 construction sector shrank by 0.3 percent when compared to the same period last year (Figure 4). Construction of buildings grew by 0.4 percent while civil engineering dropped by



Figure 4
Real Sector
Developments

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.

0.9 percent. Construction has been steadily declining ever since it peaked at the end of 2008. However, a spark of optimism comes from a significant deceleration in negative growth rates observed from the beginning of 2015. This can be explained by base effects, but also by recent positive signals about increasing economic activity.

The tightest parliamentary elections in the history of Croatia

The whole 2015, and especially its second half, was very much in the spirit of preparations for the parliamentary elections that were held on November 8. Compared to past parliamentary elections, these were probably the tightest, both in terms of pre-election expectations and the actual results. Over the pre-election period the two major parties – the social democratic SDP and the Christian democratic HDZ – were engaged in a rather harsh political fight for the electorate's votes. With its partners within the incumbent coalition government, the SDP made big efforts to emphasize all the positive policy outcomes that occurred during the four years of their term, as well as their role in introducing and implementing those policy measures. Their motto during the campaign was "Croatia is growing", and was supposed to remind the electorate that the general economic conditions have recently improved. At the same time, they were making efforts to convince voters that "growth" has been occurring exactly because they did not opt for policies oriented towards fast and strong fiscal consolidation, such as substantial cuts in public sector wages and reductions in the number of people employed in the public sector. Part of their pre-election rhetoric was also a kind of "fight" with the bankers, directly related to "the case of Swiss franc". In this very situation, the Government realized it can easily appeal to the general support in the society for those who have franc-denominated loans, and score a significant amount of political points. On the other hand, as the main opposition party, the HDZ was eagerly engaged, expectedly, in convincing people that the statement "Croatia is growing" is an illusion that hardly can pass any reality check.

Election results provided huge negotiating power to Most

The results of the elections, in terms of the relative success of the SDP- and HDZ-led coalitions, are hardly surprising. Out of 143 non-minority seats in the Parliament, the SDP-led coalition won 56, while the HDZ-led coalition won 59, reflecting the expected tightness and a little advantage of the HDZ coalition stemming from the fact that they were not in office during these generally unfavorable times. Apart from the relative success of the two major coalitions, the results are hardly expected, given the high number of seats won by Most (Bridge of Independent Lists), an *ad hoc* coalition of local independent politicians from different parts of the country, who won 19 seats. Their success reflects the fact that many voters are disappointed with the two major political parties, but it still came as a big surprise, especially since most of those politicians were not widely known before the elections. As neither of the two big coalitions can secure the parliamentary majority to form the government on their own, Most has been put in a position of large negotiating power which they have exercised rather successfully ever since the results have become certain.

Slight clues of improvement in the budget

Although comparable data for general government finance are still unavailable for the current year, there are some signs of improvements in terms of fiscal deficit figures for the central government, based on national accounting rules and the cash principle. Meagre growth in consolidated total central government revenues of 1.2 percent that was recorded in the second quarter of 2015 was accelerated in the third quarter. Relative to the same quarter of the previous year, the third-quarter total revenue saw a rise of almost 9 percent. In the first three quarters of 2015 cumulatively, the total revenue was 6.2 percent higher than in the same period of 2014.

Rise in budget revenues

This increase in revenues comes from higher tax revenues, grants and excise revenues, but

is also driven by changes in accounting rules. This year, for the first time, own revenues of budgetary users such as public universities, research institutes, hospitals, and some other public institutions were included in the records of government revenues. Also, in the case of personal income tax revenues from areas of special state concern, the gross principle has replaced the net principle of transaction records. Moreover, the growth in tax revenues of 7.8 percent in comparison with the same period in 2014 is blurred by a shift to gross principle of accounting for personal income tax revenues in the areas of special state concern. Also, the increase in VAT revenues of 6.4 percent is biased due to delayed payments and payments of arrears following the end of pre-bankruptcy settlements. Excise revenues increased by 7.8 percent due to the rise in excise rates on tobacco and petroleum products. On the other hand, social contributions decreased by 7 percent mostly because in 2014 an extraordinary payment of 3 billion kuna was made by private pension funds in the name of accrued pension savings for military and police personnel, as in the future their pensions will be paid entirely from the public pension scheme. This year, a similar transaction is planned, but has not yet been realized. Also, another legislative change took place, which enabled employers to avoid paying social security contributions for five years for employees of up to 30 years of age hired on a permanent contract.

Net receiver of grants for the first time since EU membership

In the January – September 2015 period, grants increased substantially (up by 103.3 percent) to 3.2 billion kuna relative to the first three quarters of 2014, which is almost completely based on an increase in grants from international organizations that went up by 99.2 percent in the period examined. On the expenditure side, grants to international organizations actually decreased by 14.5 percent in the first three quarters of 2015, to 2.4 billion kuna. This surge in the grant surplus was mostly due to refunding of the EU for direct payments in agriculture.

Slim increase in expenditures

Total central government expenditures increased by 5.4 percent in the third quarter of 2015 relative to the same quarter of 2014. For the first three quarters cumulatively, expenditures increased by 3.3 percent. Unfortunately, due to substantial changes in methodology, it is difficult to pinpoint which items from the expenditure side of the budget influenced this net result most significantly.

HZZO left the Treasury

The most important change in public finance that occurred in 2015 was that the Croatian Health Insurance Fund (HZZO) left the Treasury and that the state-owned hospitals are now included into the budget along with their own revenues and corresponding outlays. This is probably the main reason behind significant reduction in the compensation of employees, which declined by 15.4 percent in the first three quarters of 2015 compared to the same period last year. At the same time, use of goods and services surged by 33.2 percent because employees' wages from HZZO are now recorded as use of goods and services, unlike in the previous period.

Interest payments still rising

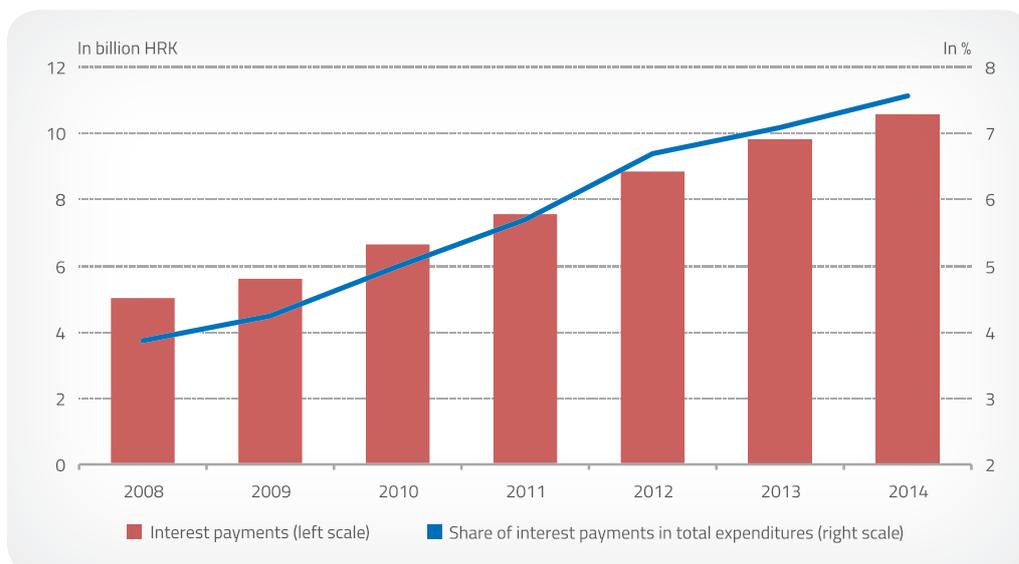
Interest payments again proved to be a significant burden for the budget (Figure 5) with the increase of 15.6 percent in the second quarter, relative to the second quarter of 2014. Cumulatively for the first three quarters of 2015, interest payments increased by 7.8 percent year on year. Finally, social benefits, the most voluminous item on the expenditure side, decreased by 4 percent.

Signs of improvements in the general government budget

Scarce official data indicate that fiscal deficit is on its way down for the first time since 2012. According to Croatian National Bank's (CNB) estimation, in the first six months, the consolidated general government deficit based on ESA 2010 stood at 9.4 billion kuna, which is by 3.3 billion kuna less, relative to the first six months of 2014; which is highly encouraging. General government debt at the end of the second quarter amounted to 283 billion kuna, up by 3.4 billion kuna from

Figure 5
Interest Payments and Share of Interest Payments in Total Expenditures

Source: Ministry of Finance.



the end of 2014. According to the latest unofficial data, primary surplus by the first half of December 2015 amounted to 2.6 billion kuna which is a modest improvement over the same period in 2014. When interest in the amount of 10.5 billion kuna is paid, the cumulative government deficit in the period examined reached 7.9 billion kuna, significantly less than previously expected.

Croatia above EU averages on deficit and debt fronts

When compared to its European counterparts, Croatia fared worse than average in 2014. The average government deficit in the EU-28 depicted 3 percent of GDP in 2014, which is significantly lower than the deficit of 5.6 percent in Croatia. In comparison to other European post-transition economies, the

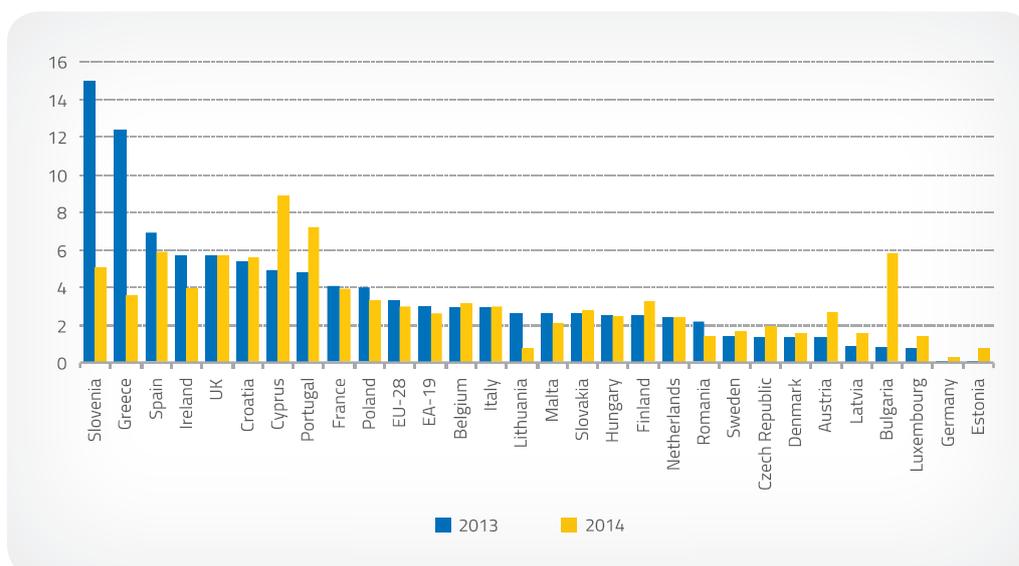
shares of government deficit and public debt in GDP stood significantly above the average levels of 2.8 percent for the deficit (Figure 6) and 49.8 percent for the public debt.

Data availability - business as usual for the Ministry of Finance

More information is needed to evaluate the real state of government finance. As we have emphasized in the previous issue of this publication, the lack of comparable data presents a genuine problem for a meaningful analysis and also for the democratic control over the spending of public money. To evaluate more precisely the state of government finance, we have to wait for comparable general government data for 2015, which might appear around spring 2016 with the publication of ESA 2010 data for 2015.

Figure 6
Government Deficits (in % of GDP) in the EU

Source: Eurostat news release euro indicators.



Unemployment following a downward trend

After years of negative developments, in 2015 the labor market has shown its first signs of recovery. The number of the registered unemployed turned its course already at the beginning of the last year, and has been constantly falling on a yearly basis throughout the whole 2015 (Figure 7), reaching its low of 257 thousand unemployed in August. Although the number of the unemployed started to increase after the end of the tourist season, seasonally adjusted data confirm a continuation of the favorable trend in both September and October. The average number of the unemployed in the first ten months of 2015 stood at 286 thousand or 14 percent less than in the same period last year, but it was still more than 20 percent higher than the average in 2008. The average unemployment rate in the first ten months of 2015 amounted to 17.7 percent, two percentage points lower than at the same time last year.

Employment figures far more blurred

On the other side of the labor market spectrum – the employment side – the situation is not that clear. According to the official Croatian Bureau of Statistics (CBS) data, a fall in unemployment continued simultaneously with a fall in total employment (Figure 7). On the other hand, Croatian Pension Insurance Institute (HZMO) data on the number of pension insurers, suggest a slight recovery in the employment trend ever since the

beginning of the second quarter this year, mostly in service activities, while seasonally adjusted data further imply a continuation of the modest positive trend. However, both data sources suggest that employment was lower in this year than in 2013, which asks for cautiousness when proclaiming the recovery on the labor market.

Inconclusive labor market indicators

Different information coming from different data sources regarding both the number of the unemployed as well as overall employment has certainly marked the developments on the labor market in 2015. As has already been mentioned, for most of the year both the unemployment and employment were falling simultaneously, without any reliable explanation as to where the no longer unemployed ended up. Accordingly, the main justification for the drastic fall in unemployment in this and the last year had its foothold in legal provisions regarding the conditions for being registered at the Croatian Employment Service (HZZ). Thus, ever since the third quarter of 2014 the number of the unemployed registered at the HZZ is lower than the one measured by fairly rigorous criteria within the Labour Force Survey (LFS). On the other hand, the employment data also show remarkable differences when taken from different data sources (Figure 8). The lowest figure is the one officially published by CBS, which is based on the establishment survey. The number of insurers at the HZMO follows the same trend, but is somewhat higher. As

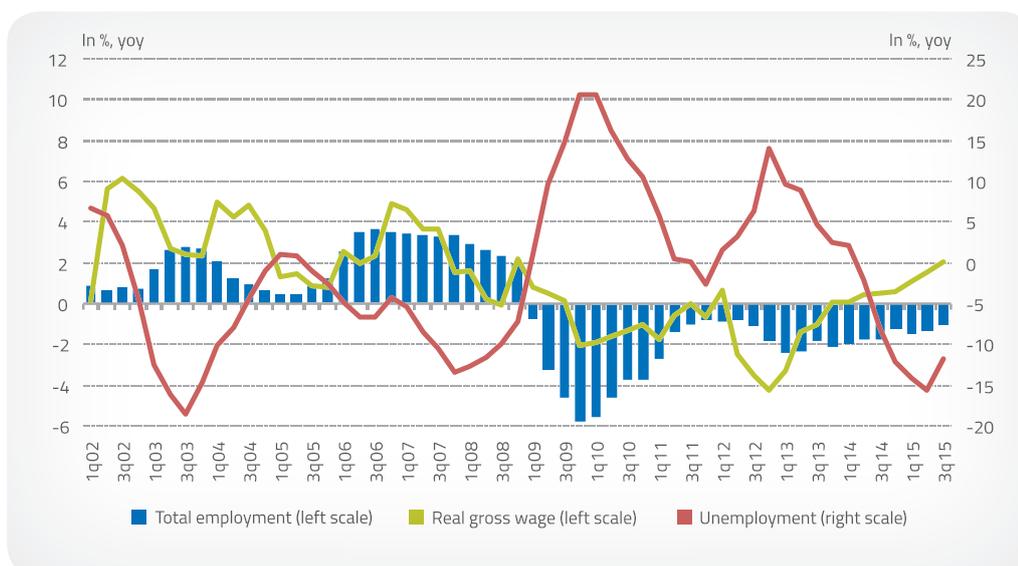
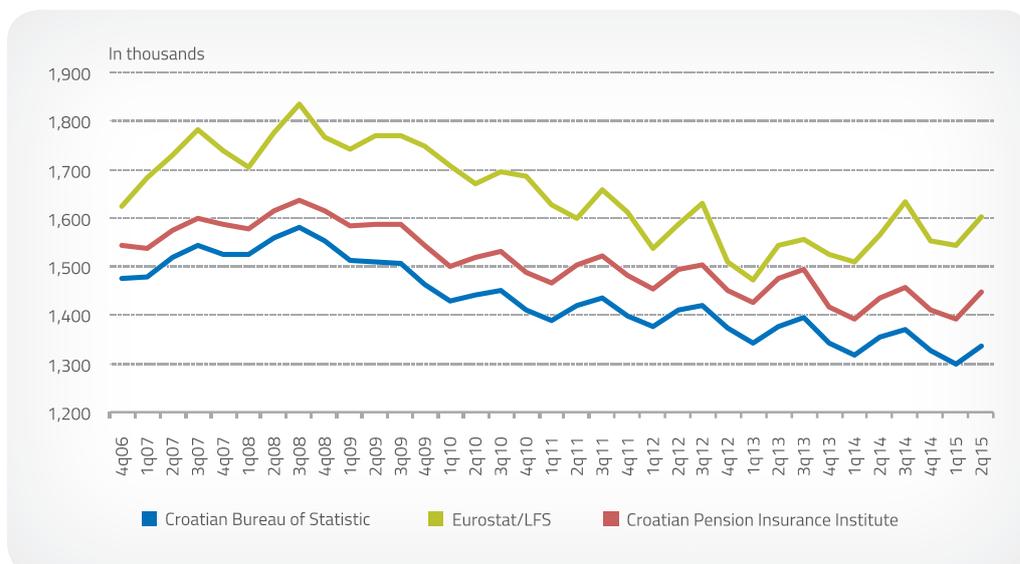


Figure 7
Employment,
Unemployment,
and Wages

Source: Croatian
Bureau of Statistics.

Figure 8
Employment
According to
Different Sources

Sources: Croatian Pension Insurance Institute, Croatian Bureau of Statistics, and Eurostat.



expected, the highest number of the employed is coming from the LFS data, which is based on the definition by the International Labour Organization (ILO). In this respect 2016 should bring an improvement since CBS is planning to publish official data on employment and wages based on the so-called JOPPD form (Report on income, income tax and surtax and mandatory social security contributions) obtained from the Tax Administration.

Moderate growth of real wages

The average nominal gross wage amounted to 8,025 kuna (approx. 1,055 euros) in the first nine months of 2015, which is an increase of merely 1.2 percent from the same period last year. Due to changes in the income tax system that entered into force at the beginning of this year, average nominal net wage increased by 3.3 percent in the same period. As the overall price level was on negative side during most of the year, real wages grew even more than nominal ones. Although overall employment did not really increase, the rise in wages brought the year-on-year change in real disposable income to a positive, at around 1.3 percent in the first three quarters of 2015, mainly caused by an increase in the overall real net wage bill.

Return of the reverse repo auctions

Amendments adopted in September for regulating the conversion and partial write-off of household loans indexed to the HRK/CHF exchange rate were followed by domestic

currency weakening and upward pressures on the money market interbank interest rates. The CNB reacted by reinitiating reverse repo auctions after six years, in order to signal a more relaxed monetary policy and ensure kuna liquidity. Furthermore, the CNB has accepted all received bids at a fixed repo rate of 0.8 percent in the first six auctions, while as of the beginning of November it has been accepting all received bids at an even lower fixed repo rate of 0.5 percent (Figure 9). Guided by the goal of HRK/EUR exchange rate stability, the CNB sold 268.3 million euros to the banks in September. This was not the first foreign exchange intervention in this direction this year as the central bank sold 326.2 million euros in January and 172.7 million euros in February.

Swiss franc loans conversion so far not successful in solving debtors' problems

Sudden appreciation of the Swiss franc in early 2015 significantly worsened the financial construct for a large number of Swiss francs borrowers. This difficult situation has led to long and hard negotiations between debtors, banks and policy-makers, which eventually resulted in a solution adopted by the Parliament in September, based on the conversion of such loans into loans indexed to the HRK/EUR exchange rate. The conversion is designed on the principle of equality of borrowers with loans indexed to the HRK/CHF and those who are indebted in loans indexed to the HRK/EUR. However, the application of the conversion revealed that

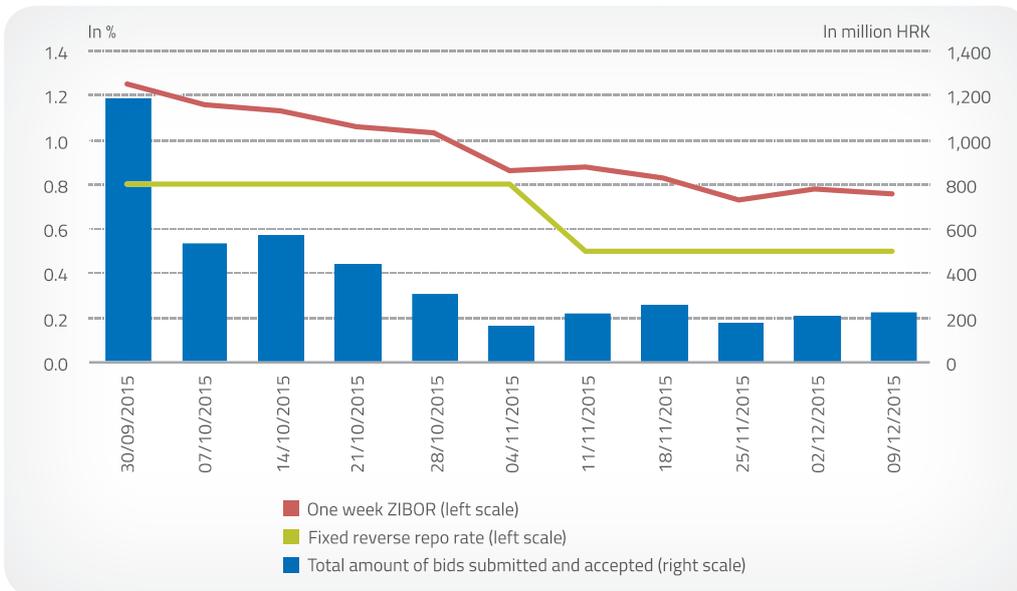


Figure 9
Reverse Repo Auctions

Source: Croatian National Bank.

the differences between annuities for these two types of comparable loans are relatively small for a big number of borrowers due to the effect of previous interventions - a ceiling to the interest rate at 3.23 percent and freezing of the HRK/CHF exchange rate for the repayment of loans at 6.39. Meanwhile, there have been some irregularities in the calculations of conversions, and borrowers have been warning the regulator that some banks have not been playing by the rules. In accordance with its mandate and legal authority, CNB emphasized its commitment to controlling the banks' performances and in case of consumer complaints apply prescribed supervisory procedures.

Banking sector entered the zone of losses

With the end of September 2015, the banking sector reported losses amounting to 4 billion kuna (Figure 10). The recent Swiss franc loans conversion apparently had a huge impact on the banks' balance sheets, as total expenses on loss provisions more than tripled in the period between October 2012 and October 2015. At the same time net income from fees and commissions and other net non-interest income decreased, reflecting credit demand deterioration coupled with deposit stagnation and lack of consumer optimism.

Credit growth still negative

Monetary developments in October were marked by an increase in M4 broad money

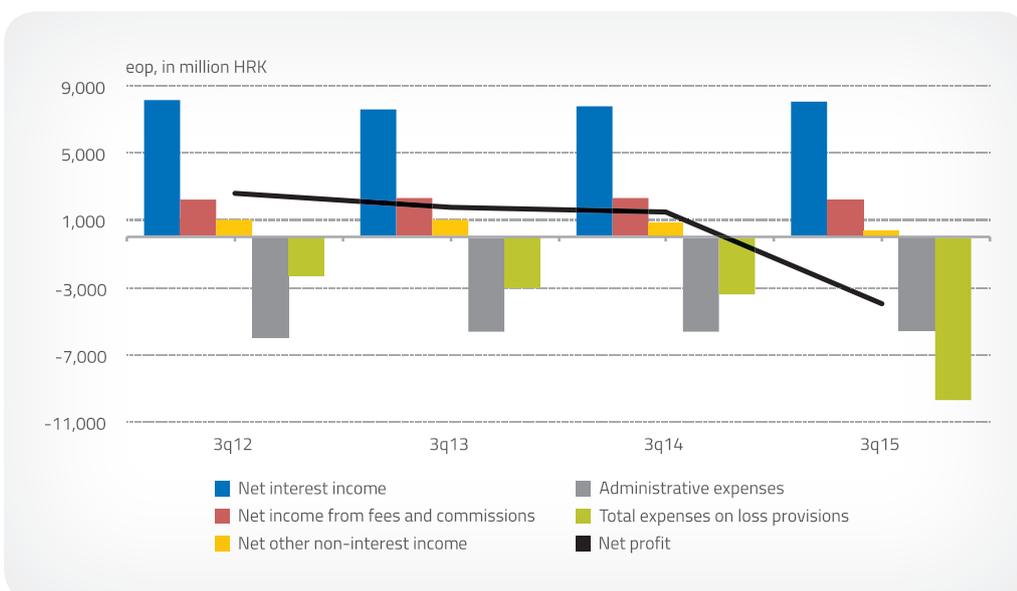
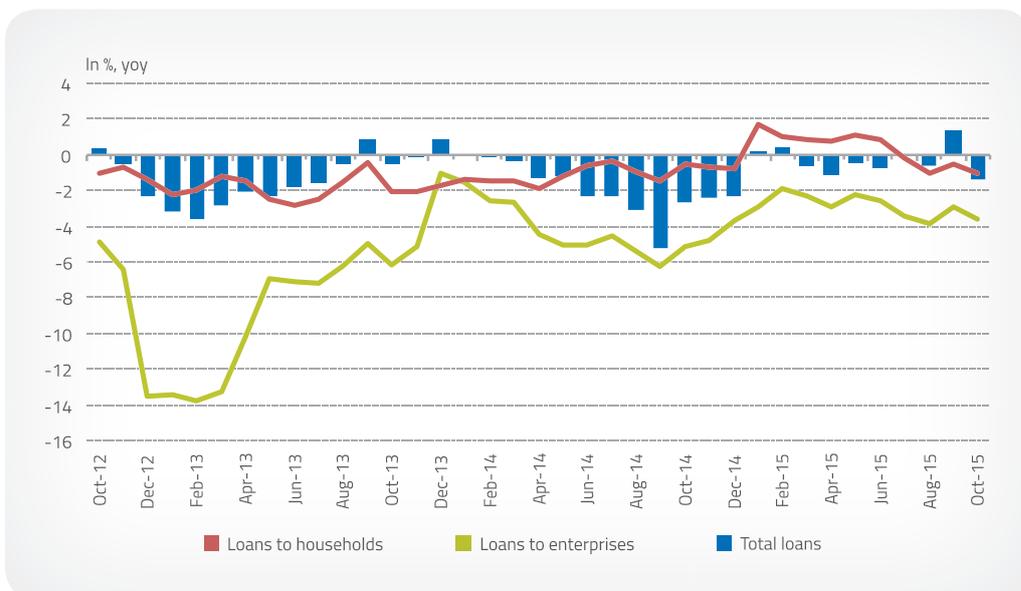


Figure 10
Bank Income and Profit

Source: Croatian National Bank.

Figure 11
Credit Sector
Developments

Source: Croatian National Bank.



amounting to 5.1 percent in year-on-year terms. One of the main reasons for broad money strengthening was the purchase of the majority share in Tvornica Duhana Rovinj (TDR) by a foreign investor. Credit development did not follow that of monetary aggregates as seasonally adjusted data imply that total credit growth in October stood at -0.6 percent when compared to previous month. When compared to the same month a year before, loans to enterprises decreased by 3.6 percent and loans to households by 1 percent due to ongoing deleveraging and possible banks' balance sheet problems (Figure 11).

Second year in a row marked by deflation

Although in the past months consumer prices have been positively influenced by seasonal

increase in food prices and higher clothes prices, it is the price of oil that decided on the ultimate trend in consumer price index (CPI). The decline in the prices of oil products contributed negatively as oil price per barrel recorded a 7-year low of 43 US dollars in November (Figure 12). As in the previous few quarters, consumer prices decreased when compared to the same time of the previous year, by 0.6 percent in the third quarter 2015. Data on core prices corroborate the fact that inflation has lately been weak as in November prices, without energy and food, increased by only 0.4 percent when compared to November last year. Despite the fact that core inflation does not include energy prices, low levels of this indicator imply that aggregate demand is still very weak.

Figure 12
Inflation and Oil Prices

Sources: Croatian National Bank and IMF Primary Commodity Prices.

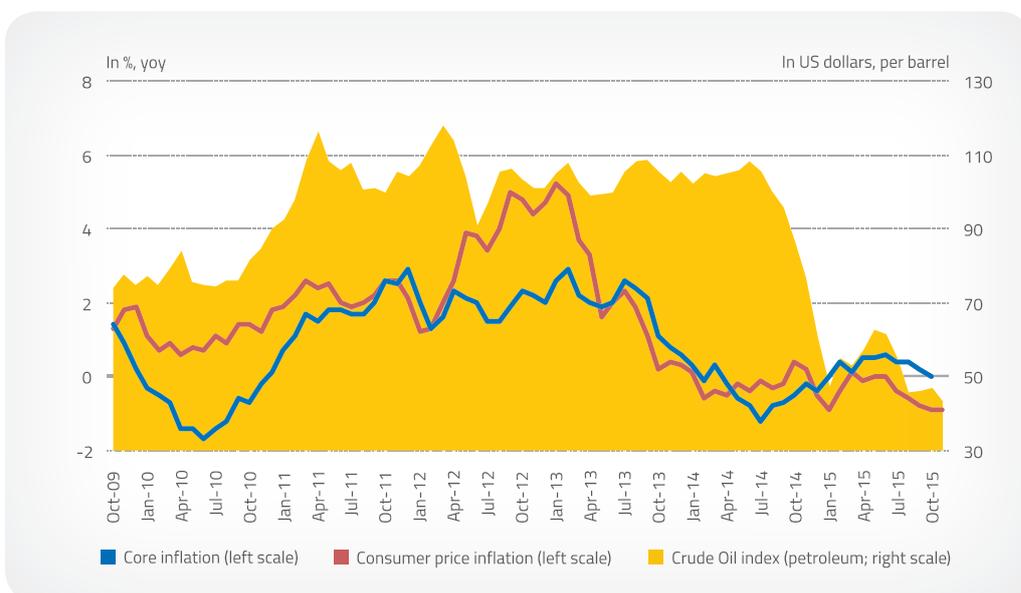


Table 1 Main Economic Indicators

	2013	2014	2014	2015		
			Q3	Q1	Q2	Q3
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.1	-0.4	0.2	0.5	1.2	2.8
Real private consumption (% change, yoy)	-1.9	-0.7	-0.5	0.3	0.6	1.4
Real government consumption (% change, yoy)	0.3	-1.9	-0.5	0.6	0.4	0.6
Real investment (% change, yoy)	1.4	-3.6	-4.1	-0.4	0.8	2.2
Industrial output (% change, yoy)	-1.8	1.2	4.1	-0.1	2.4	4.6
Unemployment rate (registered, %, pa)	20.2	19.6	19.0	20.1	17.2	16.0
Nominal GDP (EUR million)	43,591	43,110	-	-	-	-
GDP per capita (EUR)	10,242	10,130	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.9	0.0	0.4	0.3	0.4	0.0
Consumer prices (% change, yoy, pa)	2.2	-0.2	0.0	-0.4	0.0	-0.6
Producer prices (% change, yoy, pa)	0.5	-2.7	-2.6	-4.1	-2.8	-4.1
Average gross wage (% change, yoy, pa)	0.8	0.2	0.6	0.7	1.5	1.5
Exchange rate, HRK/EUR (pa)	7.57	7.63	7.66	7.68	7.57	7.57
Exchange rate, HRK/US\$ (pa)	5.71	5.75	6.13	6.81	6.86	6.80
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,589	10,369	2,755	2,574	2,936	2,963
Exports of goods (EUR, % change, yoy)	-0.4	8.1	5.0	9.3	15.5	9.1
Imports of goods (EUR million)	16,528	17,129	4,123	4,260	4,783	4,810
Imports of goods (EUR, % change, yoy)	1.9	3.6	0.9	7.0	6.0	6.6
Current account balance (EUR million)	438	340	-597	-1,283	3	-
Current account balance (% of GDP)	1.0	0.8	-5.6	-13.0	0.0	-
Gross foreign direct investment (EUR million)	703	2,893	96	394	104	-
Foreign exchange reserves (EUR million, eop)	12,908	12,688	12,688	14,158	13,734	13,437
Foreign debt (EUR million, eop)	45,958	46,664	46,664	49,173	48,869	-
GOVERNMENT FINANCE^a						
Revenue (HRK million) ^b	125,879	131,917	33,179	32,342	-	-
Expense (HRK million) ^b	138,217	139,532	36,860	36,312	-	-
Net = Gross operating balance (HRK million) ^b	-12,339	-7,615	-3,681	-3,970	-	-
Net acquisition of non-financial assets (HRK million) ^b	5,264	4,855	1,951	829	-	-
Net lending/borrowing (HRK million) ^b	-17,603	-12,470	-5,632	-4,799	-	-
Domestic government debt (EUR million, eop)	20,458	21,630	21,630	21,889	21,638	-
Foreign government debt (EUR million, eop)	14,387	14,861	14,861	15,847	15,693	-
Total government debt (eop, % of GDP)	84.1	88.6	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	11.5	9.6	9.6	8.3	11.6	10.4
Broad money, M4 (% change, yoy, eop)	4.0	3.2	3.2	2.8	4.8	4.6
Total domestic credit (% change, yoy, eop)	0.9	-2.3	-2.3	-0.6	-0.7	1.4
DMBs credit to households (% change, yoy, eop)	-1.8	-0.8	-0.8	0.9	0.9	-0.5
DMBs credit to enterprises (% change, yoy, eop)	-1.0	-3.7	-3.7	-2.3	-2.6	-2.9
Money market interest rate (% pa) ^c	1.0	0.5	0.6	0.5	0.5	1.2
DMBs credit rate for enterprises, short-term, (% pa) ^d	6.5	5.7	5.6	5.3	5.5	5.3
DMBs credit rate for households, short-term, (% pa) ^d	10.1	9.3	9.3	9.3	9.2	8.8

Notes: ^a Data refer to consolidated general government; ^b On the cash principle; ^c Interbank demand deposit trading one week interest rate; ^d The weighted average interest rate on new kuna and foreign currency indexed 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.

Forecast

Global recovery remains moderate

Global economy grew at a rate of 3.4 percent in 2014, continuing along the recovery path. IMF (World Economic Outlook, October 2015) projects a continuation of this trend in 2015 and 2016 with world output growth rates of 3.1 and 3.6 percent, respectively. This is a downward revision of their forecasts from July this year by 0.2 percentage points for each of the following two years. It is their second successive downward revision this year, mainly caused by a slowdown of recovery in emerging and developing economies. This subdued growth is a result of combined legacies of financial crisis such as high private and public debt and low investment, coupled with declining commodity prices, and somewhat diminished growth prospects of China. Although growth in advanced economies is expected to rise mildly, it will not be enough to offset the previously mentioned slowdown.

Eurozone's recovery projected to gain momentum in the following two years

After growing by 0.9 percent in 2014, eurozone's recovery is estimated to gain momentum this year with a rate of 1.6 percent that is projected to carry on in 2016 and 2017 with growth rates of 1.8 and 1.9 percent (European Economic Forecast, Autumn 2015). In the EU as a whole, growth

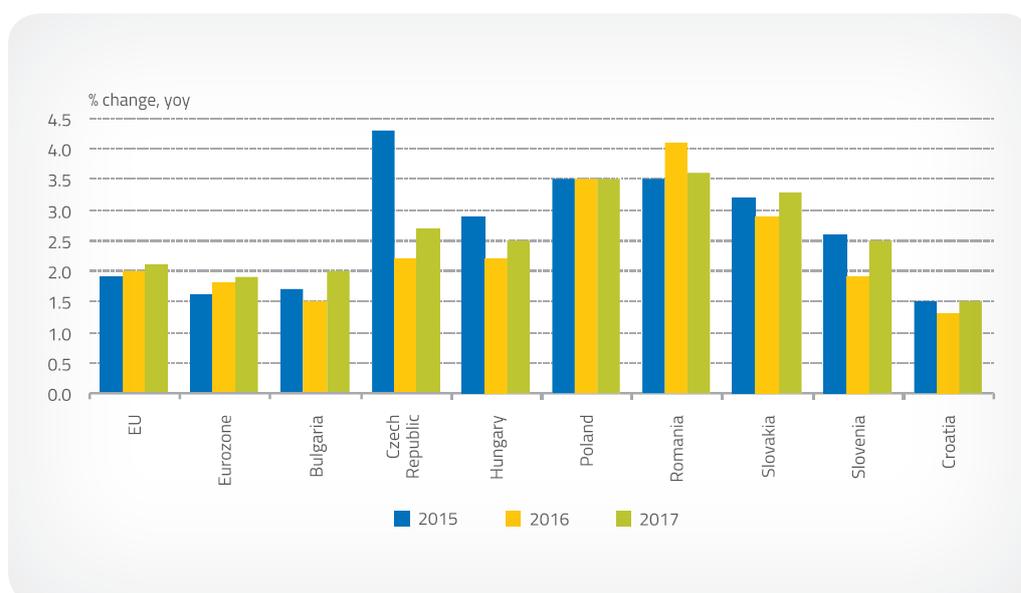
is forecasted to rise from 1.9 percent in 2015 to 2 and 2.1 percent in the following two years (Figure 13). These momentum gaining factors are low oil prices, relatively weak external value of the euro, European Central Bank's accommodative monetary policy and broadly neutral fiscal stance. Although this resulted in increasing private consumption and net exports, investment activity is still lagging behind due to credit constraints and policy uncertainty. Risks to these projections include slowdown of emerging and developing economies, fall in global trade growth and heightened geopolitical tensions that have been present throughout 2015 but have sparked recently with terrorist attacks and an increased inflow of asylum seekers.

Croatian GDP recovery expected to continue in 2016

Turning our attention to domestic issues, due to relatively high growth rate of GDP and all of its components in the third quarter of 2015 we have revised output growth upwards compared to our estimates three months ago. We now estimate GDP growth in 2015 to stand at 1.5 percent, up by one percentage point (Figure 14). This growth impulse is then forecasted to carry on in 2016 with a somewhat diminished growth rate of 1.3 percent before speeding up again in 2017 at the rate of 1.5 percent.

Figure 13
Real GDP Growth
Projections for
Croatia and CEE
Countries

Sources: European Commission (European Economic Forecast, Autumn 2015) and EIZ for Croatia.



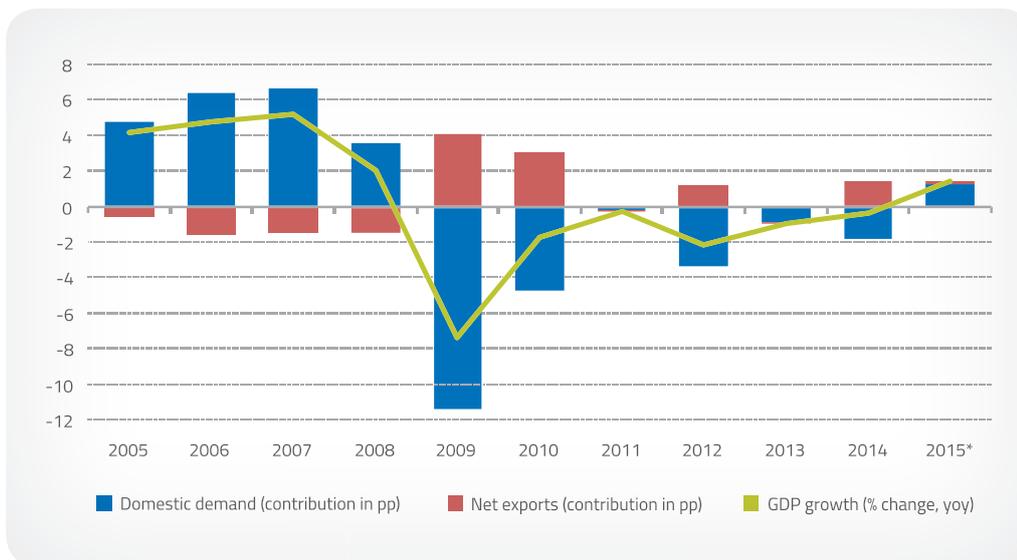


Figure 14
Demand
Contribution to
GDP Growth

Note: * represents
EIZ forecast.

Source: Croatian
Bureau of Statistics.

Personal consumption projected to steadily increase in 2016 and 2017

Despite the continued process of households' deleveraging and still weak consumer sentiment, personal consumption is projected to increase governed by a rise in nominal wages from the beginning of the year, deflation that has had a favorable impact on real disposable income, and also marginally by recent government policies introducing debt forgiveness, public utility vouchers, and higher tourism consumption. We therefore estimate personal consumption to have increased by 0.9 percent this year, mainly due to increased growth in the third quarter and expectations

of traditionally significant positive contribution of the fourth quarter. This momentum is then projected to continue in both 2016 and 2017, with growth rates of 1.2 and 1.3 percent.

Budget consolidation and greater reforms should come into focus once a new government is formed

The observed increase in government consumption in the third quarter made us slightly revise the estimate for 2015, which now stands at 0.4 percent. Starting from 2016, whoever secures the Prime minister's position is expected to start implementing reforms proclaimed during the pre-election campaign. We foresee these reforms having a greater

	2015	2016	2017
Real GDP (% change)	1.5	1.3	1.5
Real private consumption (% change)	0.9	1.2	1.3
Real government consumption (% change)	0.4	-0.5	-0.9
Real investment (% change)	1.1	2.0	2.8
Exports of goods and services (constant prices, % change)	8.1	3.6	3.7
Imports of goods and services (constant prices, % change)	7.5	3.0	3.2
Current account balance (% of GDP)	3.2	1.1	1.3
General government balance (ESA 2010 definition, % of GDP)	-4.5	-4.0	-3.5
Unemployment rate (registered, %, pa)	17.7	17.2	16.8
Exchange rate, HRK/EUR (pa)	7.62	7.63	7.64
Broad money, M4 (% change, eop)	5.8	3.5	3.2
Total domestic credit (% change, eop)	-1.1	1.4	2.6
Consumer prices (% change, pa)	-0.3	0.9	1.0

Table 2
Forecast
Summary

Note: Cut-off date for information used in the compilation of forecasts was December 4, 2015.

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

Source: Authors' forecasts.

impact in 2017 due to delays in forming the new Government and consequently postponing the reform time frame. Real government consumption growth rates are projected at -0.5 and -0.9 percent for 2016 and 2017, respectively.

Investment recovery expected to gain momentum

We expect the positive change in investments that occurred in 2015 to strengthen and increase over time. Our estimate for 2015 investment growth is now at 1.1 percent, while due to improved economic climate and greater efficiency of absorbing EU funds, our projection for 2016 is at 2 percent. In 2017, under the assumption of stable Government and announced structural reforms taking place, we project investments to grow at a 2.8 percent rate.

Net exports will continue to contribute positively

Positive contributions of net exports to GDP growth, present since 2013, are projected to continue in the following two years, losing some of their momentum already in 2016. As high export growth which was present in the first half of 2015 continued into the third quarter, we expect it to extend into the final quarter as well. Accordingly, estimates for 2015 have increased to 8.1 percent, while we see exports up by 3.6 percent in 2016, mostly due to base effects, and stabilizing at 3.7 percent in 2017. Growth of imports is also high and seems to be speeding up from the beginning of the year, going hand in hand with increased tourist consumption believed to be highly import based. This caused us to revise the imports estimate for 2015 to 7.5 percent before cooling down in 2016 at 3 percent and slightly accelerating in 2017 by 3.2 percent. Due to the conversion of Swiss franc loans, the current account surplus in 2015 is expected at around 3.2 percent of GDP. We see it normalizing in 2016 at 1.1 percent, and further increasing in 2017, to 1.3 percent.

Deficit expected to decrease, but not to meet EDP targets

The previously mentioned data problem makes the forecasts for government deficit

and public debt highly uncertain with a possibility of high margin of error. However, on the basis of some signs of improvement in consolidated central government budget, and stronger than expected real GDP growth in the third quarter, we revise the previous forecast of general government deficit for 2015 to 4.5 percent of GDP, which is still one percentage point above the EDP target for this year. For 2016 the deficit is expected to decrease further to 4 percent of GDP, and in 2017 it could be around 3.5 percent. Even when taking into account the improved growth prospects, the EDP targets for public deficit of 3.5 and 2.7 percent of GDP are not likely to be achieved (Figure 15).

Public debt growth rate decelerates

After a surge in the last six years, the increase in public debt is expected to slow down. Although public debt growth, driven by higher interest payments and relatively weak fiscal consolidation efforts, was somewhat stronger in the first eight months of 2015 when compared to the same period in 2014, improved growth prospects point to a somewhat slower pace. Therefore, we see the public debt in 2015 to be around 89.6 percent of GDP. In 2016 we expect it at 90.5 percent of GDP, and at around 91 percent of GDP in 2017.

Labor market expected to continue with a modest recovery

Following the overall positive momentum, labor market is expected to continue its recovery in both 2016 and 2017. However, as the projected GDP growth in the following years is fairly modest and since unemployment fell drastically already in 2015, we expect the registered unemployment rate to decrease only mildly from the projected rate in 2015, that is from 17.7 percent to 17.2 percent and 16.8 percent in 2016 and 2017, respectively.

Public sector wage development is in the hands of trade unions

Although we expected that due to fiscal pressures the wage bill in the public sector would go down in 2016, it turns out that higher-than-expected real GDP growth in the last two quarters has activated previously

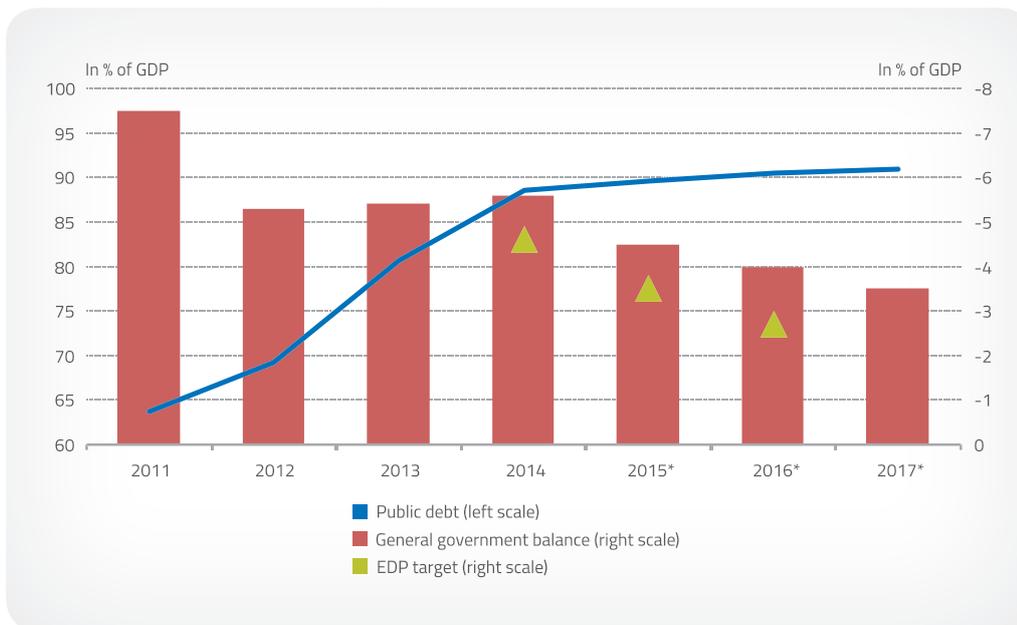


Figure 15
General
Government
Sector Balance
and Debt

Note: * represents EIZ forecast.

Sources: Eurostat and EIZ for forecast.

signed agreements between trade unions in the public sector and the Government, which guarantee the restoring of the public sector wage increase by six percent that were abolished at the beginning of the crisis in 2009. Still, it remains to be seen whether a new agreement will be established that would continue to freeze public sector wages until economic growth proves to be more robust. In this respect, we expect only a slight pickup of nominal wages in 2016, which could be further increased in 2017, mainly from an increase of the wages in the private sector. Given the rather low expected increase in consumer prices coupled with modest increase of employment, the overall net wage bill as well as the overall disposable income in the economy should rise, encouraging further increase of private consumption.

HRK/EUR exchange rate stable

The main goal of monetary policy, to keep the HRK/EUR exchange rate stable, will remain top priority in the next year as well. By intervening on the foreign exchange market the CNB will ensure a flow of foreign currency funds that will counteract depreciatory pressures. Due to almost absent risks of increased inflation, we expect the central bank to allow the HRK/EUR exchange rate in the next year to stand just a bit above this year's value, at 7.64, and mild further depreciation up to 7.65 in 2017. At the same time we believe the central bank will ensure favorable money market liquidity by pursuing regular weekly reverse

repo auctions and by using other monetary policy instruments if deemed necessary.

Challenges for the central bank lie ahead

Challenges for the central bank lie ahead as the demand for euro liquidity is expected to grow due to the conversion of Swiss franc loans to euro-denominated loans introduced by the recently adopted Act on Amendments to the Consumer Credit Act. This conversion model implies a potentially large depletion of foreign exchange reserves and could produce second-round negative effects on public finance driven by lower bank profit and thus lower tax revenues.

Poor credit recovery on the horizon

By the end of the year, we see the total domestic credit growth rate at -1.1 percent, negative when compared to 2014. Credit activity is expected to increase by 1.4 percent next year and by 2.6 percent in 2017, as aggregate demand and GDP take off and unemployment continues to fall. Broad money growth is expected to reach 5.8 percent in this year but due to the aforementioned one-off takeover of TDR that pushed up broad money in September this year, we see the figures stable but somewhat lower in the following two years. We expect broad money to rise by 3.5 percent in 2016 and by 3.2 percent in 2017, as the economic outlook recovers.

Modest inflation in the next two years

In line with deflation that marked 2014 and continued well into this year, we expect CPI around -0.3 percent in 2015. As aggregate demand slowly recovers in 2016 inflation will follow by meagre 0.9 percent, and additionally by 1 percent in 2017. Upside risks to these

projections come from imported prices of energy and food, but even with that in mind, we do not expect inflation to exceed the latent target of 2 percent. On the other hand, a downside risk comes from prices of oil products staying at record low levels for a prolonged period of time.

Risks and **Uncertainties**

Prolonged political uncertainty

After the parliamentary elections held on November 8, political incertitude is continuing with no end in sight. After more than a month, it is not yet clear whether the new Government will be formed or new elections will be necessary. Because of this, forecasts made before the new Government is formed should be taken with some degree of uncertainty. If Most succeeds in negotiations with either of the two leading parties, stronger fiscal consolidation efforts should be expected judging by their proclaimed program of reforms. However, for now, it seems that new elections are the most likely option. This effectively means even longer political uncertainty and prorogation of fiscal consolidation as well as the financial cost of new elections.

Twofold impact of potential public sector wage increase

Besides the political suspense, other circumstances bring an additional layer of uncertainty over our fiscal projections. If the 6-percent wage increase in the public sector is activated, the effect will be twofold: attempts to comply with the EDP targets and decrease the general government deficit will be threatened by further rise in expenditures while at the same time the wage increase could positively influence consumption and fuel further growth as well as the revenue side of the budget. Although the net effect will depend on the expectations of further growth and general optimism of consumers, one must not forget that a wage increase leads to higher public debt that could potentially, if deemed unsustainable, manifest in higher risk premiums and difficulties with refinancing in the long term.

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