The Institute of Economics, Zagreb

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Croatian Economic Outlook

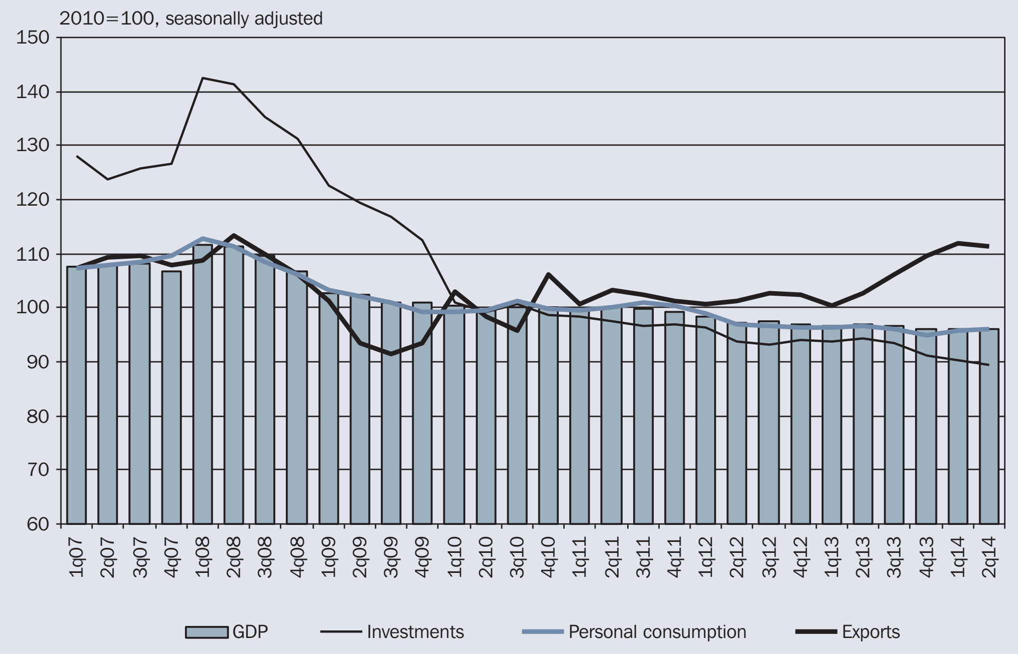
Quarterly

1 Recent Developments

Croatia remains in recession.

In spite of some signs of improvement in the first quarter of this year, subsequent developments confirmed that Croatian economy has remained in recession for the sixth consecutive year. GDP declined by 0.8 percent in the second quarter of 2014 compared to the same quarter last year and 0.1 percent compared to the first quarter this year (seasonally adjusted). A strong decline in domestic demand, in particular investments and government consumption, was the main reason behind the GDP decline in year-on-year terms. Net foreign demand had a positive contribution and prevented GDP from sinking even deeper. As suggested by available high-frequency indicators, unfavorable developments have continued in the third quarter. Seasonally adjusted figures on industrial production, construction activity, and retail trade volume in July and August indicate weaker performance than in the second quarter. In addition, harsh weather conditions during the summer, foremost rain and floods, have negatively affected agricultural production. On the positive note, merchandise exports have expanded rather strongly, tourism indicators are mostly favorable and registered unemployment has fallen. Data issues in compiling sectoral statistics and inconsistency between various indicators have increased our caution in assessment of underlying developments. Besides, the most recent national accounts data are compiled according to the new ESA 2010 framework, thus replacing the ESA 95-based data. This change has added some 1 percent to GDP level mostly due to the improved

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

coverage of illegal activities. Recent GDP trend has been affected only marginally. Having all these methodological caveats in mind, we estimate that GDP growth in the third quarter was negative on both year-on-year and quarter-to-quarter basis.

Personal consumption weakens.

Seasonally adjusted personal consumption increased rather strongly in the first quarter of this year, 0.8 percent on quarterly basis, and then more moderately in the second quarter, 0.2 percent. As it gradually loses momentum, which is confirmed by the most recent retail sales data, consumption is likely to enter into negative territory in the third quarter. The underlying causes of consumption hike at the start of this year are not easy to identify. It might be that personal consumption took short-term advantages of price deflation that has been present since February. Nevertheless, this year's increases did not offset the consumption decline in the second half of the last year and therefore year-on-year change remained negative at -0.5 percent in the second quarter. More restrained consumption in the second and probably in the third quarter is the result of weakened disposable income, continued deleveraging and lack of consumer confidence.

Pronounced contraction of government consumption.

Government consumption has been contracting strongly for the last four quarters. In the second quarter of this year it was by 3.4 percent lower than in the same quarter last year. Seasonally adjusted data reveal that the pace of decline is even faster than the one recorded at the beginning of 2009. Being squeezed between the protracted recession, persistently high fiscal deficits, and rising public debt, the Government found very little room for maneuver and had to reduce its consumption, mostly acquisition of intermediate goods.

Investments decline intensified.

A 5.2-percent investment decline in the second quarter of this year is the strongest year-on-year decline since the end of 2010. Seasonally adjusted figures on quarter-to-quarter basis indicate that intensive investment reduction has been present since the summer of last year, which coincides with Croatia's accession to the EU. We may hypothesize that, based on the government budget data, public investments negatively contributed to the dynamics of overall investment. In spite of continued Government's announcements of various investment projects, realization obviously fell short of plans. Budget-dependent entities have expected a strong support from the EU funds that has so far not been realized. It also seems that private sector is not ready to push up investments due to weak prospects of domestic demand, unsettled business environment and ongoing financial restructuring.

Expansion of goods exports partially due to change in statistical coverage.

This year merchandise trade statistics has exhibited a strong growth in cumulative year-on-year terms. In the first six months, goods exports rose by 13.4 while imports grew by 4.2 percent in the current euro terms. However, more recent figures show that in July year-on-year growth rate significantly dropped and that it turned negative in August. The exports slowdown is confirmed by seasonally adjusted month-to-month changes. Strong rise in goods exports in the first half of the year has been caused partially by methodological changes in registering foreign trade flows following Croatia's entrance to the EU in July last year. Almost the same group of manufactured products has exhibited double-digit growth on the export as on the import side (for example, food products, textiles, clothes, wood products) suggesting that what we see in the statistics may not be "genuine exports and imports" for the Croatian market but possibly the transit of these goods towards the EU market.

Persistent rise in tourism activity.

Dominated by developments in the merchandise trade sector, volume of total exports (including both goods and services exports expressed in constant prices) grew strongly in the third quarter, 7.9 percent year-on-year, contributing positively to GDP developments. Total imports grew at a more moderate rate of 2.2 percent. Positive contribution of external sector may also be expected in the third quarter led by good performance of the tourism industry. In spite of the exceptionally unfavorable weather conditions during the high season, number of overnight stays was 2.6 percent higher year-on-year in the first eight months.

Contribution to the EU budget lowered current account surplus.

Despite the rapid expansion of exports in the previous four quarters, current account has recorded narrowing surpluses. Cumulatively over four quarters up to the third quarter of 2013, there was a surplus of goods and services trade of EUR 425 million and current account surplus of around EUR 500 million (1.1 percent of GDP). In the second quarter of this year, cumulative four-quarter surplus of goods and services trade increased to EUR 680 million, but current account surplus narrowed to EUR 190 million (0.4 percent of GDP). The major reason behind the narrowing current account surplus is an increase in outgoing transfers, primarily transfers to the EU budget. Stronger inflow from EU structural funds is still absent and we may conclude that EU-related flows in the first half of this year had a negative current account effect. External debt level stood at EUR 46 billion at the end of July 2014, which is approximately at the same level as a year ago.

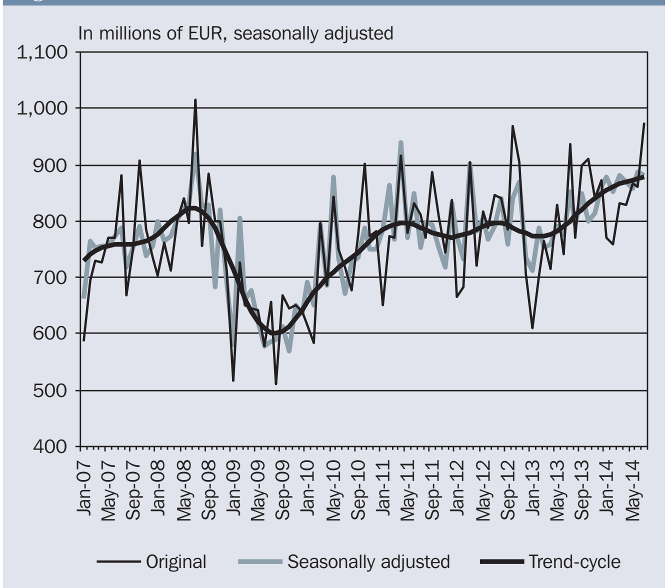
Industrial production and construction activity continue to contract.

Strong industrial activity indicated for the beginning of the year has soon turned into a declining trend. As a result, the second quarter was 3.2 percent weaker than the first one, while July and August figures suggest that the third quarter will once again register a negative rate. The cumulative industrial production for the first eight months of this year amounted to -0.5 percent year-on-year. Energy sector has contributed significantly to this outcome as its activity dropped by as much as 8.5 percent. At the same time manufacturing production was 1.9 percent stronger in the first eight months this year than in the same period of the year before. However, August figure is highly worrisome as it indicates seasonally adjusted monthly drop of 4.5 percent due to a 12-percent decrease in production of durable and 7-percent decrease in production of non-durable goods. Upcoming data will show whether this was just an irregular observation or a longer-lasting drop. At the same time construction industry continues to exhibit a clear negative trend for the sixth year in a row. In the first seven months this year it was weaker by 7.8 percent than in the same period last year.

Retail trade disappoints in July; August record somewhat better.

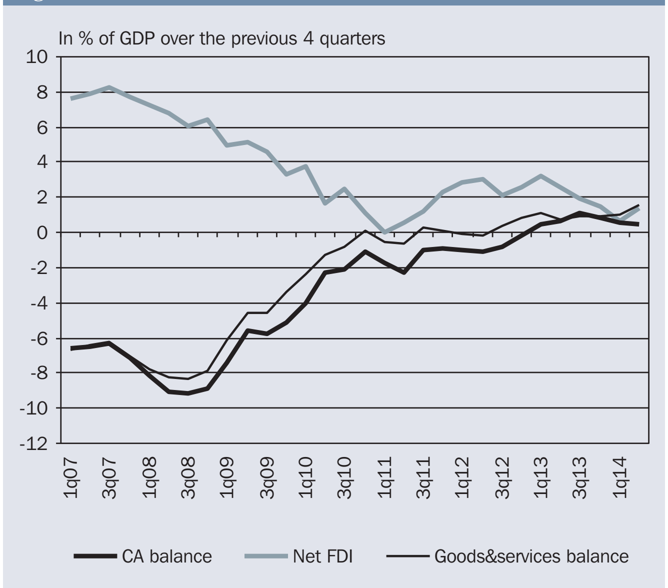
Unlike the rest of the real sector where we have observed either a strong upward or downward trend, retail trade volume has remained relatively unchanged for almost a year. When data for the first eight months of this year are taken into account, the volume was -0.4 percent lower than in the same period last year. Variability in retail trade volume observed in June-August period should probably be related to the volume of tourism activity as well as car sales. Namely, July figure was quite disappointing but somewhat higher trade volume in

Figure 2 EXPORTS OF GOODS



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

Figure 3 CURRENT ACCOUNT BALANCE AND NET FDI



Source: *Croatian National Bank.*

August did offset the losses from the previous month. Car sales rose by almost 40 percent year-on-year in the first half of the year primarily due to sales to various government bodies and agencies, but in the third quarter the number of newly registered passenger cars dropped and was close to that in the same period last year.

Protracted employment decline.

Although total number of employed persons increased in the period March-July 2014, it remained at around 2.5 percent below the number recorded in the corresponding period of the last year. Perhaps surprisingly, during the peak of tourist season - in August - the number of employed decreased, which was mainly related to the fall of employment in manufacturing, education and crafts. In August there were 34.6 thousand less employed than a year ago. The number of the unemployed has been decreasing sharply since March, reaching levels that are well below those from the previous year. In August this year there were 23.8 thousand unemployed people less than one year ago and registered unemployment rate receded to 17.5 percent, 0.8 percentage points below the rate recorded in August last year. Accordingly, the labor force was reduced by 58.4 thousand in last twelve months. The observed fall in unemployment is not only the result of employment dynamics, but also of some other factors including expansion of active labor market programs, stricter administrative procedures concerning registration at the employment office, retirement without replacement, discouragement, undeclared work, and emigration. Precise estimate of the effects for each of these factors is not possible, but the first three factors for which we have at least some data explain roughly one half of the total effect.

Declining net wage bill.

The average monthly gross wage was HRK 7,957 (app. EUR 1,047) in the second quarter of 2014, which is a 0.4-percent increase over the previous quarter and a 0.1-percent increase over the second quarter 2013. Recently real wages increased at a higher pace as a consequence of decreases in consumer prices. However, due to the fall in employment, total wage bill is estimated to have declined by 2.3 percent in nominal and 1.9 percent in real terms in the second quarter of 2014 compared to the same quarter last year.

Continued reduction in total credits…

Following sudden decline in spring, seasonally adjusted broad money M4 rose again in June-August period to reestablish the trend of a 3-percent year-on-year growth that has been present in the economy for the last couple of years. Narrow money M1 has also recovered from the spring setback and has recorded significant increases in June-August period in spite of a depressed level of corporate demand deposits. In the summer foreign currency deposits have grown intensively spurred by revenues from tourism. However, total credits have continued to decline and in August this year they were 3.1 percent lower than in the same month last year. Government sector has maintained positive credit growth rate of 1.7 percent, the lowest in the last 15 months. In contrast, households and enterprises continued with deleveraging that has been present for the last two years. In August credits to households went down by 0.9 percent and credits to enterprises by 4.7 percent compared to a year ago.

… in spite of abundant liquidity.

Despite central bank's monetary easing that ensured abundant liquidity in the financial system, enterprises and households have chosen to repay their outstanding debts instead of taking new ones. Moreover, risk aversion of both banks as lenders and households and enterprises as borrowers is rather high due to depressed economy and poor economic outlook. Following tourism-driven shrinkage in excess interbank liquidity from HRK 7 billion at the beginning of July to HRK 5 billion at the end of August, liquidity is gradually being restored to its previous levels. Therefore, overnight ZIBOR (Zagreb Interbank Offered Rate) increased, from 0.3 percent in July, to 0.4 percent in August. Loan rates of new credit arrangements in local currency have been continuously falling, with the average July rate of 5.3 percent for enterprises and 9.6 percent for households. Nonperforming loans (NPL) amounted to HRK 46.4 billion in June, which makes 16.6 percent of total outstanding credits. On a brighter side, NPL growth slowed down in the first two quarters of 2014, signaling that they could be approaching the peak. Corporate sector is the leader in bad debt servicing with 29.6 percent of NPLs, while households fail to regularly repay 11.6 percent of their loans. Despite bad loans aggravation, pre-tax profit of the banking sector increased by 26.4 percent in the first half of the year compared to the same period last year.

Stabilization of HRK/EUR exchange rate in September.

The HRK/EUR exchange rate stabilized at around 7.62 in September after it experienced certain depreciation in August caused by increased demand for foreign currency by the corporate sector and higher provisioning of the banking sector. The stabilization came about because the Government transparently managed funding needs while foreign currency inflow strengthened due to favorable revenues from tourism and recovery in exports.

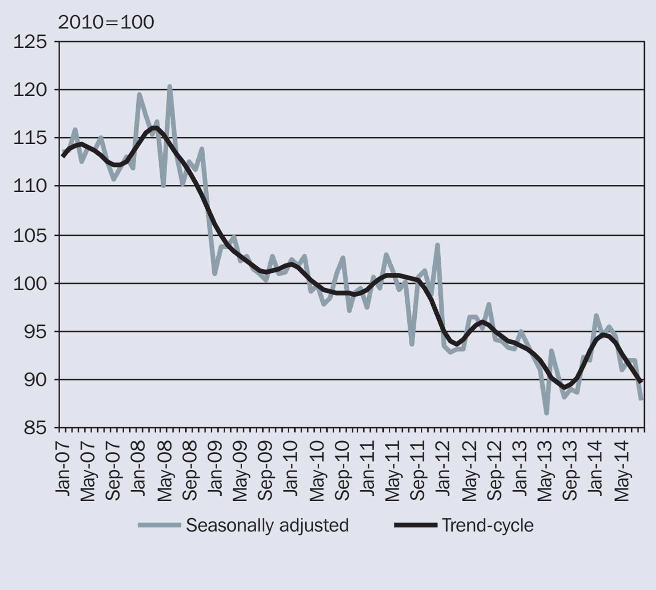
Deflation still resides.

Consumer price inflation has remained negative in February-September period. Although the negative rates were small, the current deflation creates an unprecedented environment in the economy. It is possible that price developments in September herald the end of deflation phase. Year-on-year change in consumer price index remained negative at -0.2 percent, but month-to-month change was positive and relatively high, 0.7 percent, driven mainly by increases in clothing and footwear prices, but also in food prices. Although these price hikes are mostly seasonal, continued increases in service prices in the last several months, as well as recent return to positive values of consumer price inflation measured without energy and unprocessed food prices may mean that the economy is now inclining towards positive inflation rates.

Lower-than-planned government revenues...

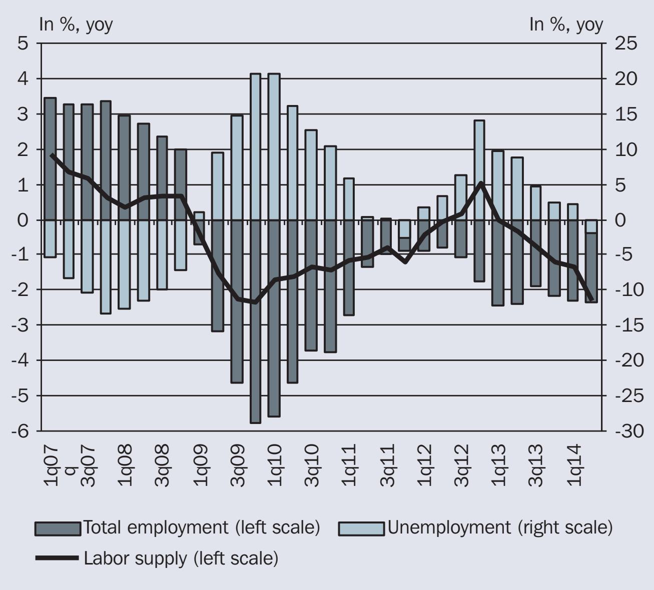
Total general government revenue increased by 11.8 percent in the second quarter 2014 compared to the same quarter of the last year. Such an increase is primarily related to higher health contribution rate and a sizable one-off transfer payment. Health insurance contribution rate increased from 13 to 15 percent of gross wage since April 1, which helped to increase the collection of employers' social security contributions by 9.0 percent. Social contribution revenues also rose because of the one-off HRK 3 billion payment by private pension funds. According to recent legislative changes, the public pension insurance scheme takes full responsibility for the insurance of military and police personnel. Savings of these citizens that were accrued in mandatory private pension funds are therefore transferred to the Budget. Revenues from personal income taxes have also increased in the second quarter, but mostly due to a slower pace of tax refunds on the basis of annual tax documentation. What is particularly worrying is a lower VAT collection, -6.1 percent in the

Figure 4 MANUFACTURING PRODUCTION



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

Figure 5 LABOR SUPPY CHANGES



Sources: *Croatian Bureau of Statistics.*

Box 1 EDP-RELATED FISCAL DEFICIT AND PUBLIC DEBT ACCORDING TO ESA 2010

On October 20, 2014 Croatian Bureau of Statistics released data on government deficit and public debt according to ESA 2010. Debt and deficit figures published earlier were based on ESA 95 standards, and they differ from the latest ones mostly due to the broadened coverage of general government. Government sector in Croatia now includes two state-owned companies; Croatian Highways and Highway Rijeka-Zagreb. Other methodological changes have had smaller impact on debt and deficit levels. Accordingly, Croatia's government deficit amounted to 5.2 percent of GDP in 2013 and public debt reached 75.7 percent of GDP by the end of last year.

Table B1 GENERAL GOVERNMENT DEFICIT AND DEBT

	2010	2011	2012	2013
Government revenue (in % of GDP)	40.8	40.6	41.3	41.8
Government expenditure (in % of GDP)	46.8	48.2	46.9	47.0
Deficit/surplus (in % of GDP)	-6.0	-7.7	-5.6	-5.2
Debt (in % of GDP)	52.8	59.9	64.4	75.7
Deficit/surplus (in HRK billion)	-19.8	-25.5	-18.7	-17.2
Debt (in HRK billion)	173.1	199.3	213.0	249.8

Source: *Croatian Bureau of Statistics.*

second quarter year-on-year, in spite of a rising VAT rate on accommodation and restaurant services from 10 to 13 percent from the beginning of this year. VAT collection was under the pressure of changes in tax treatment of goods imported from other EU countries. Tax obligation is now related to the moment of sale and not the moment of imports as was the case before Croatia's EU accession, which has caused temporal slowdown in VAT payments. This effect should, however, vanish soon. VAT collection in the first six months reached 45 percent of planned amount for this entire year. As VAT provides around one third of total revenue in budgetary central government, it is quite certain that collected revenues will be lower than planned.

… compensated by reduced expenditures,…

Total general government expenditure on cash basis and according to GFS 2001 accounting standards dropped by 3.7 percent in the second quarter of 2014 compared to the second quarter last year. It appears that the Government has struggled to maintain control over expenditures and therefore reduced expenses on goods and services by 7.4 percent, compensations to employees by 0.6 percent and other (unspecified) expenses by 10.8 percent. However, interest payments have increased by 16.5 percent and subsidies by 8.3 percent presumably due to advance payments for the agricultural sector. HRK 2 billion is transferred to the EU Budget, an expense that did not exist in the first half of the last year. Social benefits were 12 percent lower in the second quarter of 2014 than in the second quarter of 2013, but this figure is influenced by extraordinary payment of health sector debts last year.

… and lower public investments.

In the situation of lower-than-expected revenues and difficult-to-reduce expenses, consolidation efforts of the Government were outspread to acquisition of non-financial assets, i.e. public investments. In the second quarter of this year they were 17.5 percent lower than in the same period last year. Revenues from sales of non-financial assets increased by 50.8 percent, but they remain at relatively low levels. Taking together outturns of general government revenues, expenditures and net acquisition of non-financial assets, deficit amounted to HRK 452 million in the second quarter of 2014 and HRK 7.4 billion in the first half of 2014. Semi-annual deficit is roughly half of the amount planned for the whole year. It appears that the Government is focused on controlling the headline budget deficit on cash basis and ready to compensate lower revenues with lower spending on goods, services and investments. However, it remains to be seen what will be long-term consequences of such an approach. First, there is a possibility that reduction in cash

Table 1 MAIN ECONOMIC INDICATORS

	2012	2013	2013		2014	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-2.2	-0.9	-0.5	-1.1	-0.6	-0.8
Real private consumption (% change, yoy)	-3.0	-1.3	-0.4	-1.8	-0.5	-0.5
Real government consumption (% change, yoy)	-1.0	0.5	-0.8	1.4	-2.1	-3.4
Real investment (% change, yoy)	-3.3	-1.0	0.3	-3.1	-3.6	-5.2
Industrial output (% change, yoy)	-5.5	-1.8	-3.8	-2.3	0.6	-0.4
Unemployment rate (registered, %, pa)	18.9	20.2	18.6	20.9	22.4	19.7
Nominal GDP (EUR million)	43,959	43,591	-	-	-	-
GDP per capita (EUR)	10,300	10,213	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	1.6	0.9	0.4	-0.3	-0.5	-0.3
Consumer prices (% change, yoy, pa)	3.4	2.2	1.8	0.3	-0.3	-0.4
Producer prices (% change, yoy, pa)	7.0	0.5	-0.6	-2.7	-2.6	-2.8
Average gross wage (% change, yoy, pa)	1.0	0.8	0.8	0.3	-0.2	0.1
Exchange rate, HRK/EUR (pa)	7.52	7.57	7.53	7.63	7.65	7.60
Exchange rate, HRK/US$ (pa)	5.85	5.71	5.69	5.60	5.58	5.54
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,628	9,589	2,606	2,623	2,372	2,570
Exports of goods (EUR, % change, yoy)	0.5	-0.4	5.4	1.8	14.3	12.5
Imports of goods (EUR million)	16,216	16,528	4,329	4,086	3,981	4,473
Imports of goods (EUR, % change, yoy)	-0.4	1.9	5.7	2.8	6.8	2.0
Current account balance (EUR million)	-86	382	2,834	-817	-1,511	-313
Current account balance (% of GDP)	-0.2	0.9	-	-	-	-
Gross foreign direct investment (EUR million)	1,076	525	41	-87	194	1,982
Foreign exchange reserves (EUR million, eop)	11,236	12,908	11,720	12,908	12,100	12,335
Foreign debt (EUR million, eop)	44,861	45,631	44,958	45,631	46,420	45,957
GOVERNMENT FINANCE*						
Revenue (HRK million)**	126,132	125,879	31,978	33,660	29,030	35,016
Expense (HRK million)**	132,413	138,217	33,025	35,449	34,914	34,638
Net = Gross operating balance (HRK million)**	-6,282	-12,339	-1,046	-1,789	-5,884	378
Net acquisition of non-financial assets (HRK million)**	4,574	5,264	1,172	1,743	1,040	831
Net lending/borrowing (HRK million)*	-10,855	-17,603	-2,219	-3,532	-6,924	-453
Domestic government debt (EUR million, eop)	15,899	18,305	17,885	18,305	18,716	19,016
Foreign government debt (EUR million, eop)	8,443	10,525	9,185	10,525	10,245	10,651
Total government debt (% of GDP)	55.6	66.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	1.6	10.9	11.5	10.9	10.1	7.7
Broad money, M4 (% change, yoy, eop)	3.2	2.9	5.1	2.9	3.3	2.7
Total domestic credit (% change, yoy, eop)	-3.9	-0.7	-1.1	-0.7	-1.5	-2.6
DMBs credit to households (% change, yoy, eop)	-1.4	-1.7	-0.4	-1.7	-1.5	-0.6
DMBs credit to enterprises (% change, yoy, eop)	-11.2	-0.1	-3.1	-0.1	-0.7	-3.9
Money market interest rate (%, pa)	1.1	0.4	0.5	0.3	0.4	0.2
DMBs credit rate for enterprises, short-term (%, pa)***	6.9	6.2	5.9	5.8	5.6	5.6
DMBs credit rate for households, short-term (%, pa)***	10.6	10.3	10.3	10.2	9.6	9.6

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.*

expenditures hides arrears accumulation, and second, Croatia needs to increase growth-enhancing expenditures and reduction of investments is not a move in that direction.

2 Policy Assumptions and Projections Summary

Eurozone recovery remains weak; risks are heightened.

Global growth slowed down more than was expected in the first half of 2014 reflecting mainly the situation in the most advanced economies. This, together with less optimistic outlook for several emerging markets, caused IMF (*World Economic Outlook*, October 2014) to revise its projection for this year's world output growth to 3.3 percent – down by 0.4 percentage points compared to the April forecasts. Projected growth for 2015 was also moderately revised downward to 3.8 percent. Nevertheless, growth in advanced economies is still expected to serve as a backbone for global recovery. The U.S. economy is expected to sustain current growth momentum supported by increase in private consumption, improving conditions on the labor market, higher nonresidential investment and reduced fiscal drag. It is also expected to grow at 2.2 and 3.1 percent in 2014 and 2015, respectively. In the eurozone, after four consecutive quarters of moderate recovery, growth amounted to zero percent in the second quarter of 2014 compared to the previous quarter. Growth contributions from domestic demand and net exports barely compensated for the negative contribution from changes in inventories. Downward risks for future development have significantly heightened. Stalling of growth in the second quarter was reflected in the new IMF forecasts where real GDP growth for 2014 and 2015 is predicted at 0.8 and 1.3 percent, downward revisions by 0.3 and 0.2 percentage points, respectively. Croatia's main trading partners Germany and Italy also experienced dampening of activity in the second quarter, which caused downward revisions of their future growth. According to IMF, Germany should grow at rates of 1.4 and 1.5 percent in the current and the following year, while the projections for Italy are -0.2 and 0.8 percent. Slovenia has remained on the path of recovery and is expected to grow 1.4 percent in both years. Since the beginning of the year energy prices have declined, despite ongoing geopolitical tensions in major oil producing countries. IMF forecasts crude oil prices to continue gradually declining from US$ 102.8 in 2014 to US$ 99.4 and US$ 97.3 in 2015 and 2016, respectively.

Uncertainties over fiscal policy complicate the 2015 projections.

On the internal front, fiscal policy issues have dominated public debate which resulted in a limited set of information necessary for our projections. Ministry of Finance is preparing the revision of this year's budget as well as the budget plan for 2015, but so far no figures or details of the policy interventions have been released. The Government has not published the Fiscal Policy Guidelines for the next three years, the document that should have been issued in June and which used to provide the outline of the medium-term policy. Prime Minister and Minister of Finance have announced changes in tax policy, including lower personal income tax, introduction of tax on savings interest and capital gains, and introduction of options for small companies to account for VAT on the basis of money received from their customers instead of the standard method based on the issue of invoices. Since no detailed plans have yet been presented, we are unable to include these likely changes in our current projections. Instead we assume that the Government will broadly follow policies set in official documents submitted to the European Commission in April in response to Council's recommendations regarding EDP situation. Also, we have consulted the Government Plan for Implementation of the Country Specific Recommendations. These recommendations were issued by the Council in July 2014 after excessive macroeconomic imbalances had been identified in the European Commission's in-depth review of the Croatian economy. It seems, however, that the implementation of the Government Plan is lagging behind the schedule and its fiscal effects remain unclear. Although we presume that presidential elections expected either at the end of this or at the very beginning of the next year would not have significant implications on the current economic policy, parliamentary elections around the end of the next year are expected to notably impact next year's policymaking. Incentives for marked moves towards higher fiscal discipline will be diminishing as the election date approaches.

High liquidity to continue; central bank not likely to extend easing measures.

As for monetary policy assumption, we do not expect the central bank to extend easing measures due to already high liquidity of the financial system. In the period ahead, the Croatian National Bank (CNB) will keep an eye on the ECB's Asset Quality Review (AQR) that will reveal the soundness of balance sheets of EMU-based parent banks that make a large share of the Croatian banking market. In line with that and in the case of some indications of balance sheet deterioration, we can expect certain measures as financial stability is CNB's top priority.

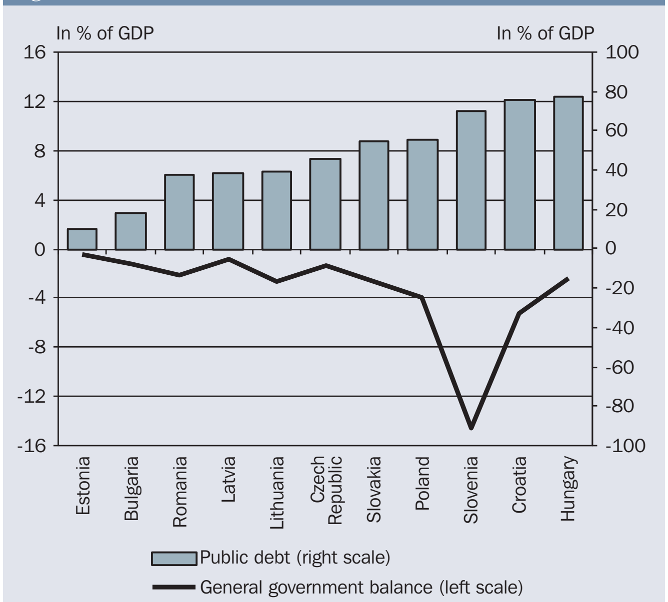
GDP expected to decline 0.6 percent this year; stagnation in 2015.

Weaker-than-expected recovery of the eurozone and the accumulation of negative signals on the domestic scene caused the downward revision of GDP projections for this and next year. We now expect GDP to decline 0.6 percent this year, down by 0.1 percentage points from our July forecast. This change is mostly due to a considerable decline of investments expected to reach 4 percent for the year as a whole. Strong dynamics registered in the foreign trade sector, especially in the exports of goods, is expected to weaken as it results partially from methodological changes. Negative trends passed through from this to the next year, tightened fiscal situation and heightened uncertainties over policy will result in softened recovery potential in the upcoming year. Therefore, our GDP growth projection for 2015 is now set at 0.2 percent, down from 0.7 percent projected three months ago. Positive contributions to the next year's recovery are expected from investments and export growth, although these are to be much weaker than what we expected earlier.

Personal consumption will remain sluggish.

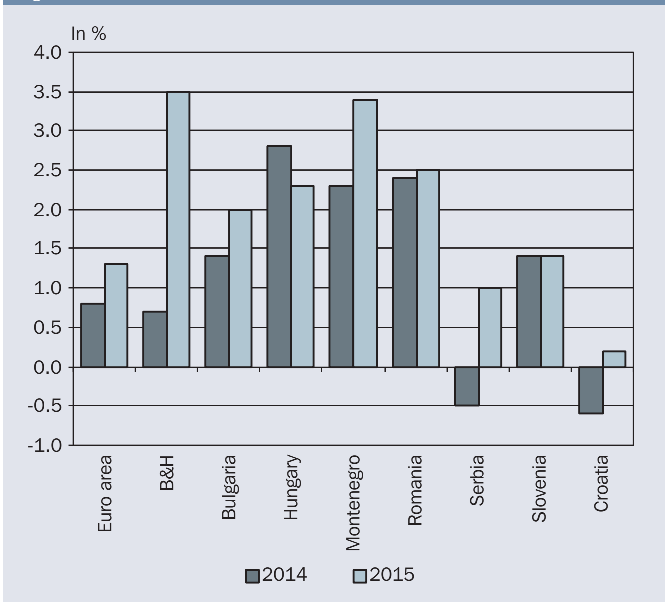
Although personal consumption was somewhat stronger than expected in the first half of 2014, its prospects for the second half of the year are less optimistic as households are forecasted to continue deleveraging, while consumer sentiment remains low. In spite of somewhat lower unemployment rate, employment declined further and is projected to keep falling. Low inflation will soften the decline of real income and to certain extent support this year's consumption, but that effect will soon fade away. We therefore expect personal consumption to decline 0.3 percent this year and to remain close to stagnant next year.

Figure 6 GENERAL GOVERNMENT BALANCE AND DEBT IN 2013



Source: *Eurostat.*

Figure 7 REAL GDP GROWTH PROJECTIONS



Sources: *IMF World Economic Outlook (October 2014) and EIZ for Croatia.*

Government consumption to decline further.

Fiscal consolidation based on cuts in material costs has led to reduction in government consumption. In fact, the reduction has been stronger than expected causing revision of this years' consumption growth to -2.5 percent, down by almost 1 percentage point from the previous forecast. This downward trend is expected to continue next year, although parliamentary elections could soften the rate to -1.1 percent.

Weak investment recovery expected next year.

Strong decline of investments in the first half of 2014 presents a negative drag to our current projections. The government-induced projects are likely to remain delayed while private investments are too weak to provide any significant push to overall investment climate. High-profile projects financed by the EU funds and possibly FDI are still not present. We therefore expect investments to decline by 4.0 percent this year while next year should bring recovery of around 1 percent only if stronger utilization of EU funds takes place.

Positive trends in foreign trade should continue, but at a slower pace.

Exports performance was well above expectations in the first half of the year. As we have already noted, "the recording effects" of such strong growth are supposed to diminish in the second half of the year. Additionally, some of the effects of Russia's trade embargo might also depress exports in the rest of the year. Nevertheless, combined with the successful tourist season, total exports are expected to increase 5.9 percent and imports 3.7 percent this year. Positive trends should continue next year, but at a slower pace. We expect exports to rise by about 2 and imports by about 1 percent. As domestic demand remains weak, surplus on the current account should be sustained. This year it might increase to 1.3 percent of GDP and then decrease to 1.2 percent of GDP in 2015.

Labor market developments to remain on a negative track.

The size of labor force is likely to continue declining mostly due to retirement, emigration, and hidden economy. Consequently, we expect the unemployment rate for this year to stagnate at around 20.2 percent in spite of falling employment. The effects of changes in labor legislation aimed at bringing more flexibility and dynamics to the labor market are not expected to be visible soon because these changes came into force only recently, at the beginning of August, and did not result in essential novelties. Slow recovery of the real sector projected for next year is not likely to transpose into significant employment rise, which suggests that projected decrease of the unemployment rate to 19.9 percent in 2015 will again be caused by reduction in the labor force.

Balanced pressures point to a stable HRK/EUR exchange rate.

Despite the fact that strength of domestic currency vis-à-vis the euro is supported by potentially large foreign currency government borrowing, a recovery in exports, and inflows from EU funding, we must not neglect at least two factors that work in the opposite direction. First there is bank provisioning that could spike due to rising nonperforming loans, and second, the economy is in the protracted recession and continued deleveraging suggests we have not hit bottom in credit activity just yet. We therefore expect the average HRK/EUR rate in 2014 to be above last year's average level, at around 7.62 and approximately at the same level next year.

Private sector deleveraging continues.

Private sector deleveraging will dominate the rest of this year and a good part of next year too. The arguments that support this are rising risk aversion on both the lender and the borrower side and increasing nonperforming loans. Moreover, the corporate sector is restructuring and the repairing of balance sheets is taking time. The quality of the collateral, especially in the construction sector, is questionable and still awaiting resolution. And lastly, the Ministry of Finance announced some policies to ease the debt burden for citizens that will also drag on credit activity. We have therefore lowered our projection and now expect total domestic credit to decline at 0.9 percent in this year and 0.3 percent in the next year. Due to steady deposit collection, our projection of the broad money (M4) growth remains 3.3 percent both in 2014 and in 2015.

Slight deflation in this year.

Inflation is projected to pick up by the end of the year mostly due to increase in food prices after bad weather conditions this year. However, for this year as a whole we project

Table 2 SUMMARY OF PROJECTIONS

	2014	2015
Real GDP (% change)	**-0.6**	**0.2**
Real private consumption (% change)	-0.3	-0.1
Real government consumption (% change)	-2.5	-1.1
Real investment (% change)	-4.0	0.7
Exports of goods and services (constant prices, % change)	5.9	2.3
Imports of goods and services (constant prices, % change)	3.7	1.5
Current account balance (% of GDP)	1.3	1.2
Consumer prices (% change, pa)	-0.1	1.1
Exchange rate, HRK/EUR (pa)	7.62	7.62
Unemployment rate (registered, %, pa)	20.2	19.9
General government balance (ESA95 definition, % of GDP)	-5.3	-4.7
Broad money, M4 (% change, eop)	3.3	3.3
Total domestic credit (% change, eop)	-0.9	-0.3

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

deflation of -0.1 percent. Next year we see an uptick in prices as the base effects kick in and personal consumption stops declining. However, unemployment, deleveraging and fiscal contraction will keep inflation at low levels. We thus expect consumer prices to rise by around 1.1 percent in 2015.

Fiscal deficit well above the EDP targets.

As for fiscal projections, we have changed our projections strategy. Instead of our confidence in Government's full adherence to EDP targets and belief that the proposed reforms will be delivered, we now base our projection on the observed deviation between current developments and fiscal targets. We also take into account only policies that are included in official documents with sufficient details on implementations. Such an approach leads us to estimate that the promised consolidation path within EDP framework is not likely to be fulfilled. General government budget deficits are projected at 5.3 and 4.7 percent of GDP in 2014 and 2015 respectively. As a reminder, EDP targets for headline fiscal deficit are 4.6 and 3.5 percent of GDP for this and the next year.

3 Uncertainties and Risks to Projections

Is Government genuinely committed to required fiscal consolidation?

No-growth environment, high fiscal deficits and booming public debt multiply the need for resolute actions taken by responsible leaders in order to gain control over negative trends. EU-wide mechanisms for the coordination of economic governance could provide a useful framework for such an action. Croatia is already involved in corrective mechanisms of Excessive Deficit Procedure and Macroeconomic Imbalances Procedure. However, there is an impression that policy-makers' commitment to the implementation of key recommendations issued within these procedures is more formal than genuine. In several of his interviews, the Prime Minister has justified possible deviation from the suggested fiscal consolidation plan. When presenting the Annual Report on Government Activities before the Croatian Parliament he stressed that the EDP is "... a dynamic mechanism in which schedules and bureaucratic imperatives are not, and cannot be, above the interests of citizens and above the common sense". This leads us to expect that EDP targets will not be taken as binding in defining the 2015 Budget. On top of that, the latest fiscal figures from October 2014 show much higher public debt level than was previously expected. It is highly possible that Croatia will soon be requested to undertake more serious consolidation efforts in EDP than those in current recommendations dated from January 2014. If no serious consolidation actions are taken shortly, all options for fiscal developments are open in the near future, including stabilization programs involving the IMF and the EU.

Can changes in personal income tax spur personal consumption? What about fiscal deficit?

In the situation when government revenues are likely to be lower- and fiscal deficit higher-than-expected for this year, Minister of Finance has proposed to reduce personal income taxation. This would be done by higher basic personal tax allowance and higher income threshold for application of the highest, 40-percent tax rate. The Government believes that these changes can result in a strong positive effect on personal consumption and economic growth. The Government also expects these tax changes to particularly improve the position of highly-qualified professionals and to prevent them from emigrating as well as make the country more attractive for FDI. While it is hard for economists to dispute the measure that lowers tax pressure on labor input, it seems unreasonable that a detailed plan is not simultaneously disclosed, backed by a thorough analysis on how this loss on the revenue side will be covered in order to meet the EDP targets. Since the loss will mostly be borne by the local government (as it is their revenue) and no compensation from the central government has been announced it will create a lot of uncertainty within the economy. We remain skeptical that the proposed tax changes may have a significant growth effect in the current economic context.

Tough decisions ahead to curb debt creation.

Two additional fiscal issues illustrate the bumpy road the policy-makers have to take to deliver sustainable fiscal consolidation. First, there are plans for Croatian Health Insurance Fund to leave the Treasury at the beginning of next year and to continue operating autonomously. However, that might cause turbulence for both budget operations and health care system which is one of the largest and one of the most sensitive parts of the public sector, but also one that used to generate the biggest deficits. Second, the Government opened the call for bids on a concession to operate highways for the next 30-40 years and it expects to get some EUR 2.5-3 billion out of it. This decision is challenged by numerous experts and organizations, more on emotional grounds than by solid calculations. Eager debate resulted in a formal request for national referendum on that issue. If the planned highway concession (also called monetization) fails for whatever reason, the Government will have to prepare an additional set of measures to help the Budget with debt repayments.

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