

Croatian Economic Outlook

Quarterly



No. 63

June 2015

e-ISSN 1847-7852

ISSN 1332-3067



The Institute
of Economics,
Zagreb



Forecast Update

Croatian GDP expected to stagnate in 2015 and 2016

After six consecutive years of decline, the Croatian economy is showing signs of mild recovery. In the last three quarters of 2014 GDP growth recorded non-negative rates ranging from 0.0 to 0.2 percent (measured quarter on quarter, seasonally adjusted). This moderate recovery was also continued in the first quarter of 2015 when the economy grew at 0.2 percent compared to the last quarter of 2014. Based on the Croatian Bureau of Statistics GDP revision (see Analysis on page 8) that now points to a rebound in investment in the first quarter of 2015 and on a prolonged upward trend in exports, we have slightly revised our GDP forecast upward for this and the following year, and it now stands at 0.4 and 0.9 percent (Figure 1).

Personal consumption rises for the first time in four years

Personal consumption rebounded in the first quarter of 2015 (Figure 2). This can in some ways be explained by fiscal stimulus brought by lower personal income tax introduced at the beginning of the year, and somewhat improved situation on the labor market. Some policies, the effects of which are yet to be seen, such as debt relief and the possibility to claim personal bankruptcy, are expected to add further momentum to consumption recovery. Our previous consumption forecasts for 2015 and 2016 were both revised upwards by 0.1 percentage points and now stand at 0.1 and 0.3 percent.

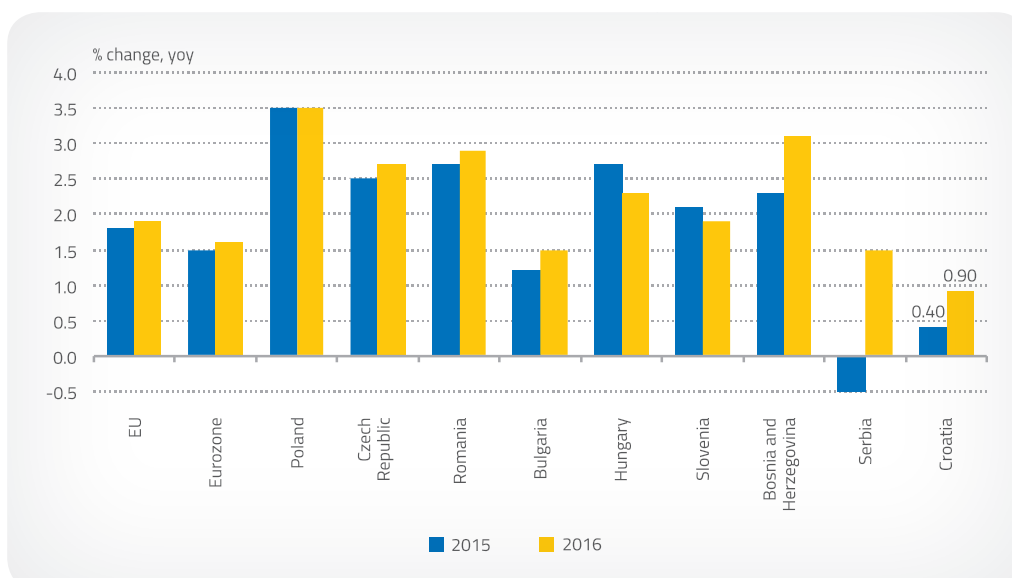


Figure 1

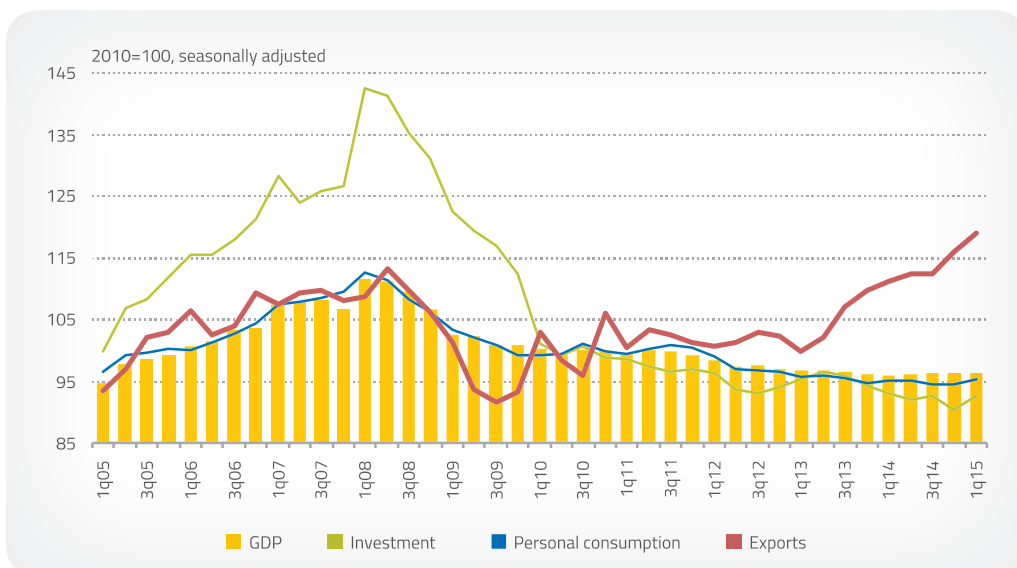
Real GDP Growth Forecasts for the EU, Croatia and Selected CEE Countries

Source: World Economic Outlook, IMF, April 2015 and EIZ for Croatia.

Figure 2
Real Gross Domestic Product

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.



Government consumption increases in the last three quarters

Government consumption increased by 0.3 percent in each of the last two quarters of 2014, before slowing down to 0.2 percent growth in the first quarter of 2015 (measured quarter on quarter, seasonally adjusted) (Figure 3).

Upcoming elections may prevent bolder consolidation efforts

The end of 2015 and/or the beginning of 2016 will be marked by parliamentary elections, which could additionally hamper fiscal consolidation efforts in 2015. Thus we expect government spending in the remainder of 2015 to decrease only mildly. Given that the European Commission declared not to take any additional corrective measures within the Excessive Deficit Procedure (EDP

and Macroeconomic Imbalances Procedure (MIP), we made a slight upward revision of government spending for 2015 which now stands at -0.3 percent, up by 0.1 percentage points. On the other hand, after the elections, the new Government may be willing to start with more courageous reforms in order to achieve or at least get somewhat closer to the EDP targets. Some burning issues are public administration efficiency, state-owned enterprises, ease of doing business, early retirement, health care etc. Considering at least some of these topics will be tackled next year, we forecast a 1.4-percent cut in government spending in 2016.

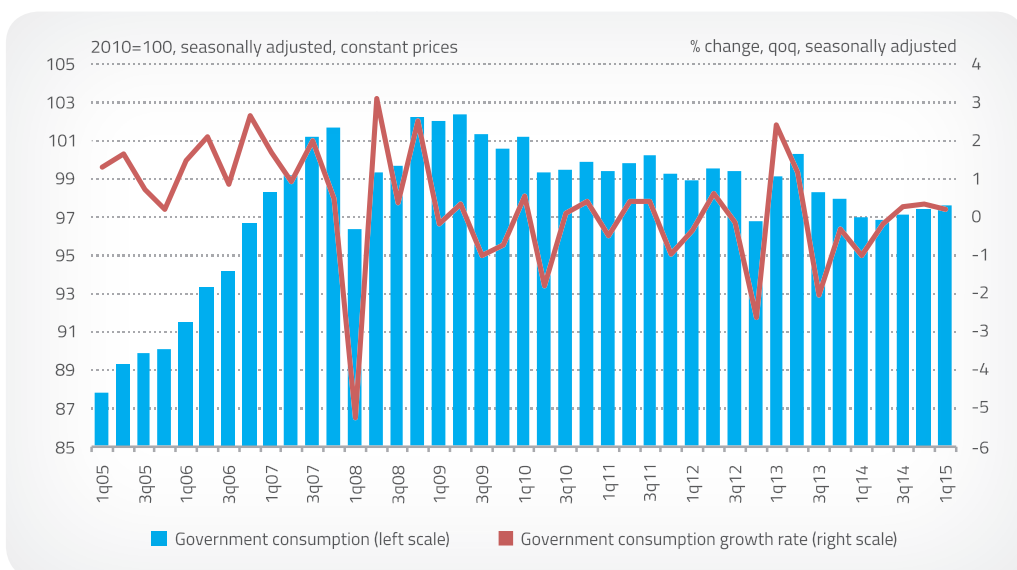
Investment shows signs of recovery

A long-run downward trend of investment continued into the first quarter of 2015, when

Figure 3
Government Consumption

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.



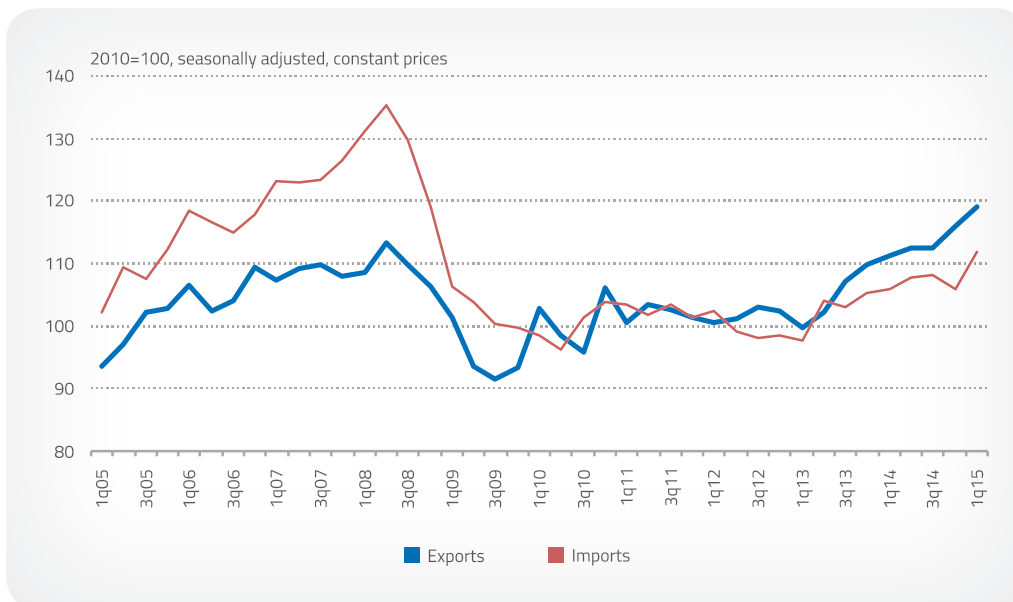


Figure 4
Exports and Imports of Goods and Services

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for original data: Croatian Bureau of Statistics.

investment decreased by 0.4 percent year on year. However, compared to the last quarter of 2014, investment recorded a positive growth rate of 2.5 percent, the highest seasonally adjusted quarter-on-quarter growth rate since the beginning of the recession in 2008 (Figure 2). This can mostly be explained by stronger capital equipment imports, but it is also noteworthy that the construction sector bottomed out and depicted 1.5 percent growth in March 2015 (month on month, seasonally adjusted). In light of the Croatian Bureau of Statistics revisions (see Analysis on page 8), we expect further improvement in the construction sector and also more successful

absorption of EU funds. Our forecasts are thus revised upwards and now stand at 0.5 percent for 2015 and at 2.4 percent for 2016.

Trade gains momentum as domestic and external demand recover

As of 2013 both exports and imports started increasing moderately, with exports growing faster (Figure 4). This upward trend continued in the first quarter of 2015 at rates of 7.2 and 5.7 percent for exports and imports respectively (measured year on year). New, revised data for 2013 and 2014, and stronger recovery of Croatia's main trading partners

	2015	2016
Real GDP (% change)	0.4	0.9
Real private consumption (% change)	0.1	0.3
Real government consumption (% change)	-0.3	-1.4
Real investment (% change)	0.5	2.4
Exports of goods and services (constant prices, % change)	3.8	5.3
Imports of goods and services (constant prices, % change)	3.3	3.8
Current account balance (% of GDP)	0.8	1.0
General government balance (ESA 2010 definition, % of GDP)	-5.5	-5.1
Unemployment rate (registered, %, pa)	18.4	17.8
Exchange rate, HRK/EUR (pa)	7.65	7.65
Broad money, M4 (% change, eop)	2.9	3.8
Total domestic credit (% change, eop)	-0.2	1.6
Consumer prices (% change, pa)	0.1	1.1

Note: Cut-off date for information used in the compilation of forecasts was June 10, 2015.

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

Source: Authors' forecasts.

Table 1
Forecast Summary

led us to modify this year's forecast for exports growth to 3.8 percent, up by 0.3 percentage points. Imports growth was also revised upwards to 3.3 percent, reflecting moderate growth of retail trade in early 2015 and improved prospects for personal consumption. For 2016 we see exports up by 5.3 percent and imports by 3.8 percent, a result of improved external and domestic demand. Based on this, the current account surplus is estimated at 0.8 percent of GDP for the current year before rising to 1 percent of GDP in the following year.

Delay in fiscal data publication

Data for general government revenue and expenditure for 2015 are not yet available. Only the central government data up to April have been published. This makes it hard to determine the condition of the budget in the current year. Any comparison is especially difficult since these data are not comparable to those from the previous year as revenue and expenditure of budgetary users obtained from own sources are now included in the budget, and because the Croatian Health Insurance Fund is now separated from the state treasury.

Stagnation of revenue and expenditure in 2014

In 2014 the general government revenue based on ESA 2010 accounting methodology decreased by 0.6 percent, while total government expenditure increased by 0.2 percent. On the expenditure side, outlays for interest payments proved once again to be a significant burden on public finances. Their share in GDP was, however, the same as in 2013, 3.5 percent.

Deficit and public debt figures continue to worsen

The general government deficit in 2014 amounted to 5.7 percent of GDP, which is significantly above the EDP target of 4.6 percent. The primary deficit rose slightly from 1.9 percent of GDP in 2013 to 2.2 percent in 2014, while gross general government debt to GDP ratio increased to 85.1 percent, up by 4.4 percentage points from the figure in 2013.

The Convergence Program and the National Reform Program for 2015 adopted

On April, 30 the Croatian Government adopted the Convergence Program and the National Reform Program for 2015. These are the key documents outlining fiscal policy measures and other related reforms in the next three years. The outlined reforms for achieving the EDP targets are: reforms of employees' compensation; cuts in government purchases of goods and services; cuts in subsidies, social benefits, other current transfers and expenditures for gross capital investments; changes in the system of pension contributions; withdrawal of profit from state-owned enterprises; taxation of interest from savings; and increase in excises on tobacco and petroleum products. These all seem to make up a fairly balanced package of measures focused on both the revenue and the expenditure side of the budget.

Sudden reversals in negative fiscal trends not expected

Although the measures outlined in the Convergence Program are a step in the direction of fiscal consolidation, it is still difficult to expect sudden reversals in negative trends in public finances. Furthermore, projections from the Program do not take into account the expected rise in interest rates after the quantitative easing program in the Eurozone ends. That said we expect the general government deficit in this year to be slightly below the level in 2014 or at 5.5 percent of GDP, while the deficit could decrease further in 2016 and end somewhere around 5.1 percent of GDP. Public debt is expected to rise to 90 percent of GDP in 2015 and further to 94 percent of GDP in 2016 (Figure 5).

Signs of labor market recovery on the horizon

After almost a year of continuous decline, the number of employed (officially insured persons) started to increase in the last couple of months, even if we acknowledge the pronounced seasonal character of the employment data. This indicates that there is some new employment in the economy.

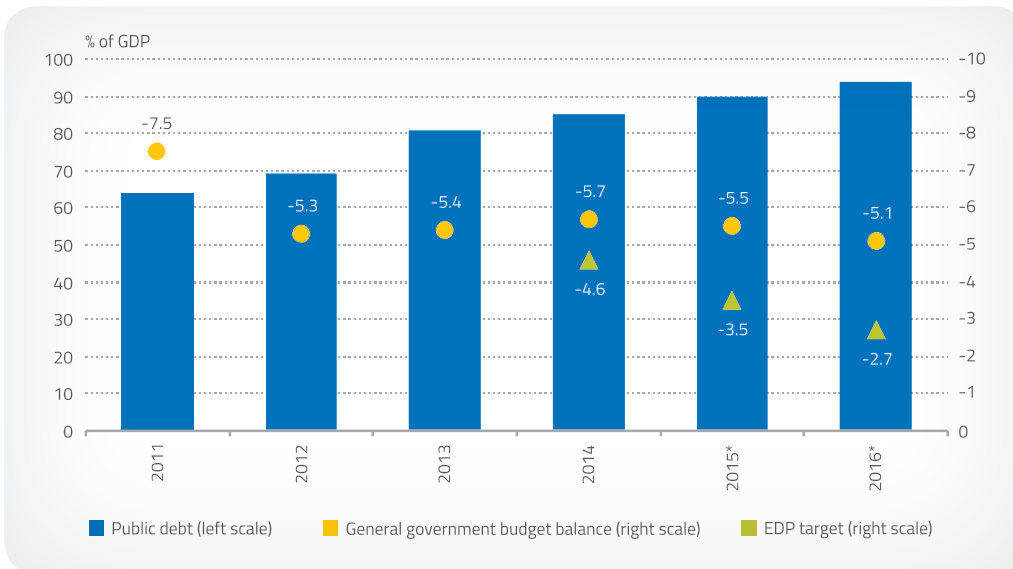


Figure 5
General
Government
Budget Balance
and Debt

Note: * EIZ forecast.

Source: Eurostat.

Since unemployment continues to decline as well, we have revised our forecasts for the unemployment rate further down to 18.4 percent in 2015 and to 17.8 percent in 2016 (Figure 6). The expected fall in the unemployment rate is predominantly based on the decline of the overall active population, because the fall in unemployment is still greater than the rise in employment.

Limited future prospects on the labor market

Future prospects on the labor market are still quite limited. As the expected recovery of the overall economy is rather modest, we do not see any significant rise of employment. Moreover, it seems that the sizeable drop in the number of unemployed, which started to build up from the beginning of the last year and was mainly caused by changes

in the legislative norms for registering at the Croatian Employment Service, has been phased out in the second quarter of this year. Unemployment figures could be improved further if emigration speeds up after some of the EU member states remove barriers for Croatian workers in this year. At the same time, stronger demands of the European Commission concerning public sector restructuring, which could well reduce employment in that sector, are an additional threat to the overall employment, especially in 2016.

Central bank seeks to provide high liquidity

We expect the Croatian National Bank (CNB) to continue to provide high liquidity to the banking system, thus keeping interest rates at historically low levels. Besides domestic

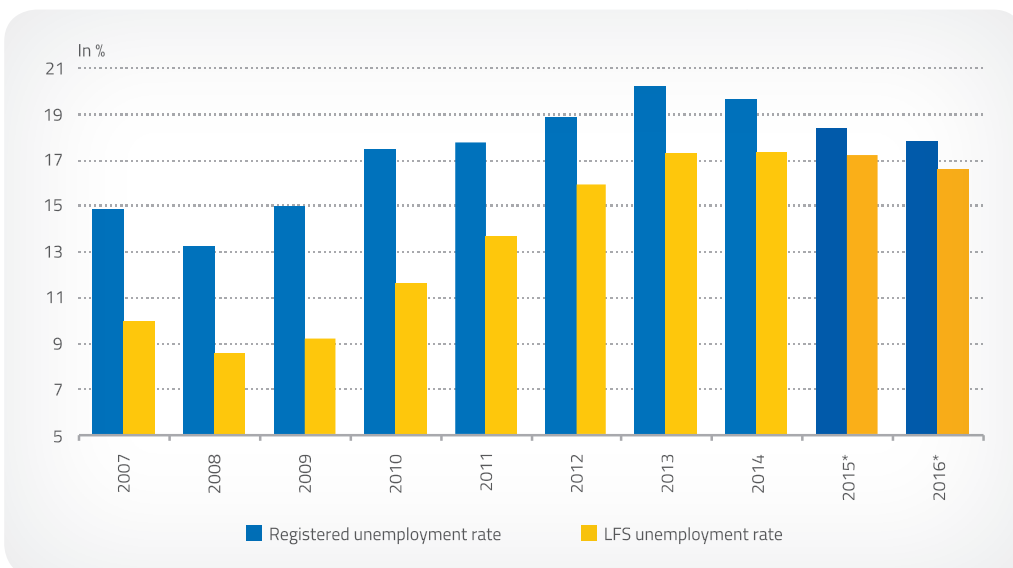


Figure 6
Unemployment
Rate

Note: * EIZ forecast.

Source: Croatian Bureau of Statistics.

monetary policy, high liquidity and very low interest rates will also be supported by expansionary monetary policy in the Eurozone, and the latest round of quantitative easing.

Kuna gradually getting stronger

In the last four months, kuna appreciated against the euro by slightly more than two percent. The main reason of this development is the latest hefty government borrowing in euros, but also corporate borrowing abroad, and the tourist pre-season that proved to be better than last year. With the approaching peak of the tourist season in July and August, expectations of an investment recovery for this and next year, and the CNB commitment to defend exchange rate stability, kuna will be supported in the short run. Thus, we expect the average HRK/EUR exchange rate at 7.65 in both 2015 and in 2016. Sluggish economic recovery and lack of commitment regarding structural reforms and fiscal consolidation remain the central downside risks to the forecast.

Credit activity to recover in 2016

Latest loan data reveal that the development of credit activity slightly improved up to April 2015 (Figure 7). We therefore slightly revise our previous forecast upwards to -0.2 credit growth in this year. We believe that the corporate sector will continue to contribute negatively to credit growth in this year as this sector is still struggling with unresolved pre-bankruptcy settlements, debt-

burdened balance sheets and slow process of restructuring. Household credit figures are expected to moderately improve in this year as the labor market signals some shy improvements. In 2016 credit will increase by 1.6 percent as the announced investment realizes, GDP recovers and employment improves further.

Banking sector profits decline?

Rising reservations for non-performing loans, the government freezing of the HRK/CHF exchange rate, and the latest Government bill in which default rates were decreased, suggest profits of the banking sector could drop in this year. The Government intervened after the Swiss franc strongly appreciated in January 2015 by freezing the exchange rate for Swiss franc loan takers at the level of 6.39 for a period of one year. This measure alone is expected to cost the banking sector around 350 million kuna.

Low-inflation zone

Our 2015 forecast for this year's inflation rate stays unchanged at 0.1 percent. We believe that the only reason why Croatia managed to avoid the deflation zone and end up in the low-inflation territory is the introduction of higher excise tax on fuel in March, intended to increase fiscal revenues and improve public finance. For the next year we slightly update the forecast from 1 to 1.1 percent change in consumer prices as GDP growth and personal consumption are revised upwards as well.

Figure 7
Total Domestic
Credit and its
Components

Note: * EIZ
forecast.

Source: Croatian
National Bank.

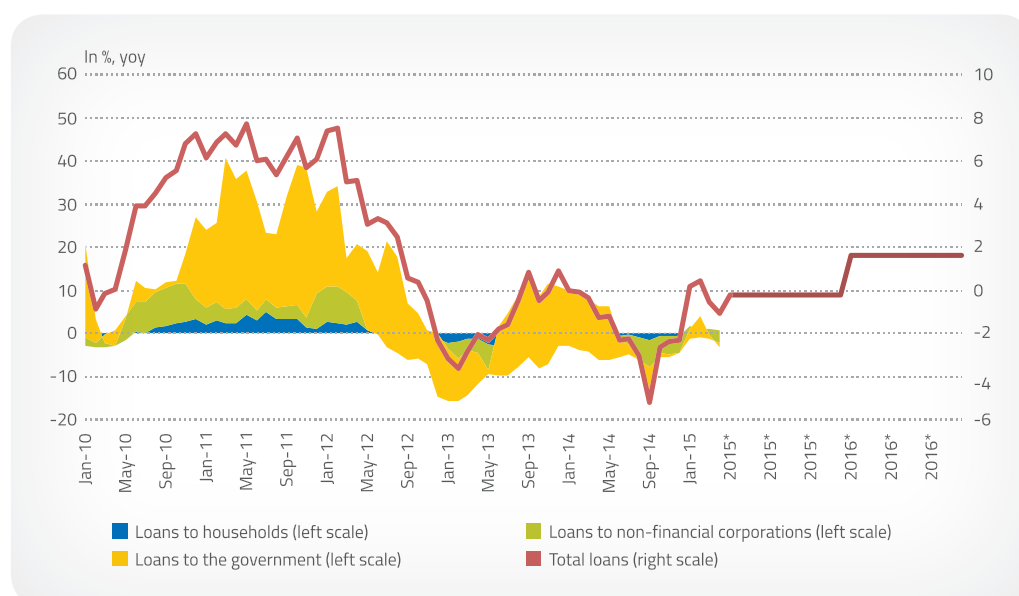


Table 2 Main Economic Indicators

	2013	2014	2014			2015
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.1	-0.4	-0.7	-0.2	0.2	0.5
Real private consumption (% change, yoy)	-1.9	-0.7	-0.6	-1.0	-0.5	0.3
Real government consumption (% change, yoy)	0.3	-1.9	-3.4	-1.3	-0.5	0.6
Real investment (% change, yoy)	1.4	-3.6	-4.6	-3.5	-4.1	-0.4
Industrial output (% change, yoy)	-1.8	1.2	-0.4	0.4	4.1	-0.1
Unemployment rate (registered, %, pa)	20.2	19.6	19.5	17.6	19.0	20.1
Nominal GDP (EUR million)	43,591	43,110	-	-	-	-
GDP per capita (EUR)	10,243	10,130	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.9	0.0	-0.3	0.4	0.4	0.3
Consumer prices (% change, yoy, pa)	2.2	-0.2	-0.4	-0.2	0.0	-0.4
Producer prices (% change, yoy, pa)	0.5	-2.8	-2.8	-2.9	-2.6	-4.1
Average gross wage (% change, yoy, pa)	0.8	0.2	0.1	0.3	0.6	0.7
Exchange rate, HRK/EUR (pa)	7.57	7.63	7.60	7.61	7.66	7.68
Exchange rate, HRK/US\$ (pa)	5.71	5.75	5.54	5.74	6.13	6.81
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,589	10,369	2,542	2,716	2,755	2,571
Exports of goods (EUR, % change, yoy)	-0.4	8.1	11.3	4.2	5.0	9.1
Imports of goods (EUR million)	16,528	17,129	4,512	4,512	4,123	4,250
Imports of goods (EUR, % change, yoy)	1.9	3.6	2.9	4.2	0.9	6.7
Current account balance (EUR million)	359	286	-377	2,779	-602	-
Current account balance (% of GDP)	0.8	0.7	-	-	-	-
Gross foreign direct investment (EUR million)	735	2,876	2,129	384	84	-
Foreign exchange reserves (EUR million, eop)	12,908	12,688	12,335	12,116	12,688	14,158
Foreign debt (EUR million, eop)	45,958	46,664	46,390	46,512	46,664	-
GOVERNMENT FINANCE*						
Revenue (HRK million)**	125,879	131,917	35,016	34,692	33,179	-
Expense (HRK million)**	138,217	139,532	34,638	33,120	36,860	-
Net = Gross operating balance (HRK million)**	-12,339	-7,615	378	1,572	-3,681	-
Net acquisition of non-financial assets (HRK million)**	5,264	4,855	831	1,033	1,951	-
Net lending/borrowing (HRK million)**	-17,603	-12,470	-453	539	-5,632	-
Domestic government debt (EUR million, eop)	20,458	21,630	20,964	20,452	21,630	-
Foreign government debt (EUR million, eop)	14,387	14,861	14,420	14,957	14,861	-
Total government debt (eop, % of GDP)	80.8	85.1	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	11.9	9.2	6.2	9.5	9.2	7.9
Broad money, M4 (% change, yoy, eop)	3.4	3.1	2.5	2.4	3.1	2.3
Total domestic credit (% change, yoy, eop)	0.9	-2.3	-2.3	-5.2	-2.3	-0.6
DMBs credit to households (% change, yoy, eop)	-1.8	-0.8	-0.6	-1.5	-0.8	0.9
DMBs credit to enterprises (% change, yoy, eop)	-1.0	-3.7	-5.0	-6.3	-3.7	-2.3
Money market interest rate (% pa)	0.6	0.5	0.5	0.4	0.5	0.5
DMBs credit rate for enterprises, short-term, (% pa)***	6.4	5.9	6.0	5.9	5.7	5.6
DMBs credit rate for households, short-term, (% pa)***	7.6	7.4	7.4	7.3	7.3	7.3

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.

Analysis

Revised GDP data

In early June the Croatian Bureau of Statistics published GDP data for the first quarter of 2015 accompanied by revised GDP data for 2013 and 2014. The revised GDP figures reveal significant changes compared to the earlier data. Investment and foreign trade have been strongly undervalued previously, while consumption appeared to have been overvalued.

Overvalued consumption

When decomposed, private and government consumption were both overvalued in earlier GDP estimates, throughout all eight revised quarters. Altogether, these two categories are now lower by 2.5 billion kuna in the 2013-2014 period.

Investment increased by 3.3 billion kuna

Investment is the category that was revised in the most substantial amount, as much as 3.3 billion kuna in the period examined. Previous seasonally adjusted data indicated investments are still declining, and revised data point to a trend reversal.

Imports pick up

Similar development can be seen when observing imports as previous data suggested further decrease in this category while revised

data suggest a pickup in imports. Exports were also largely undervalued in 2014, by 1.5 billion kuna. But as the trend in exports was previously upward, revised data only reinforced this positive development in exports (Figure 8).

Seasonally adjusted GDP grew in the first quarter of 2015

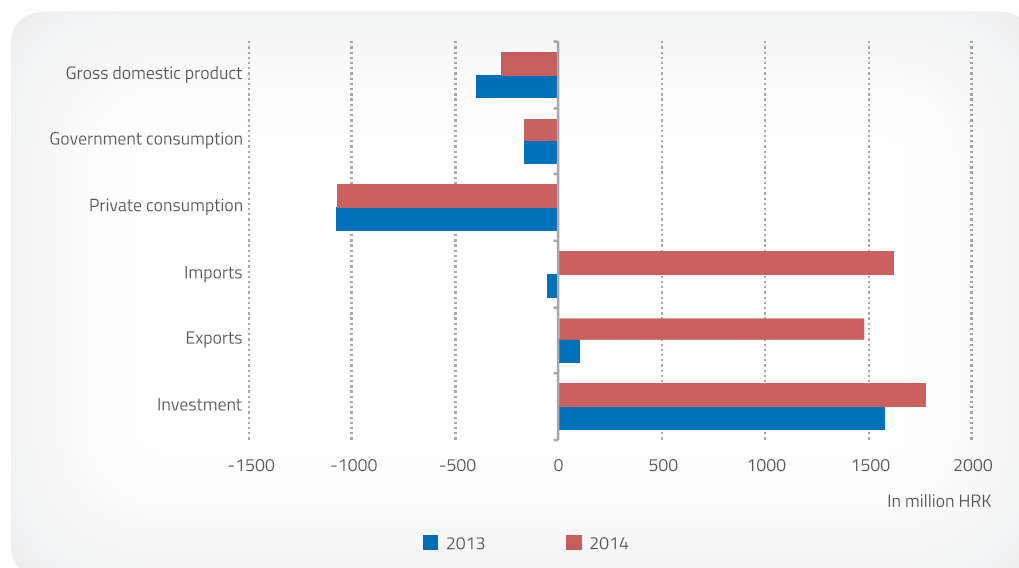
Total GDP is now slightly below previous figures but not significantly so. Changes in 2013 and 2014 constitute only a very small part of GDP, 0.13 and 0.09 respectively. However, even a small change in GDP figures was enough to affect seasonally adjusted quarter-on-quarter growth rates (EIZ calculation). Previous data implied four consecutive quarter-on-quarter positive GDP growth rates in 2014, from the first to the fourth quarter of 2014. Revised data suggest GDP increased in the second and in the third quarter of 2014, but that it stood at 0.0 percent in the fourth quarter of 2014. GDP recovered again in the beginning of 2015 depicting 0.2 percent increase when compared to the last quarter of 2014.

The economy is still stagnating

This GDP data revision implies two things. First that the economy is still stagnating as GDP growth rates appear to be very small, and second, that the trend in investment and foreign trade is steeper than was previously thought.

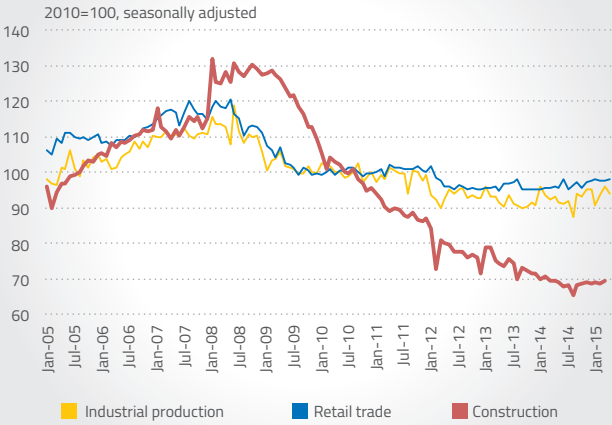
Figure 8
Difference between Revised GDP and Previously Published Figures

Source: Croatian Bureau of Statistics.



Real Sector Developments

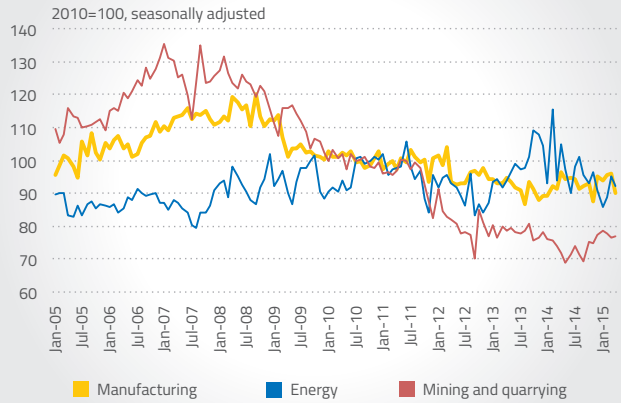
Industrial production and construction trend turn positive while trade volume remains stagnant



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

Industrial Production Decomposition

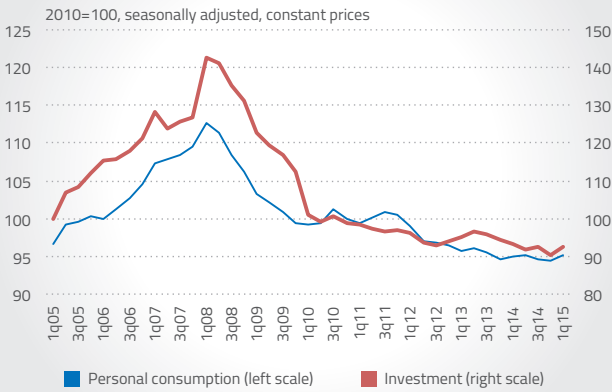
Manufacturing production levels off during last three years



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

Personal Consumption and Investment

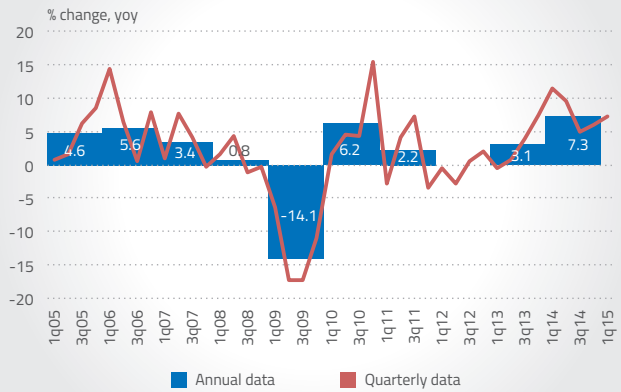
Consumption and investment rebound in the first quarter of 2015



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

Exports of Goods and Services

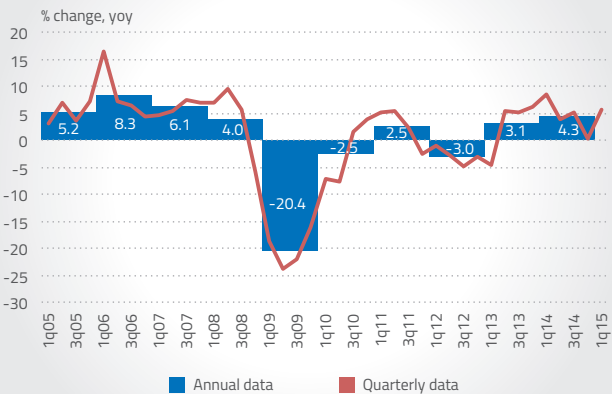
Exports still follow an upward trend



Source for original data: Croatian Bureau of Statistics.

Imports of Goods and Services

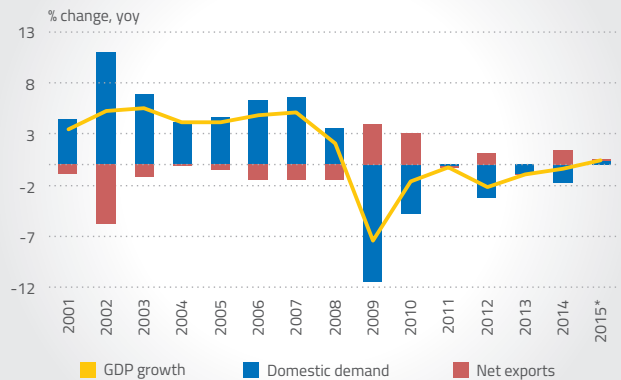
Imports rebound in the first quarter of 2015



Source for original data: Croatian Bureau of Statistics.

Demand Contribution to GDP Growth

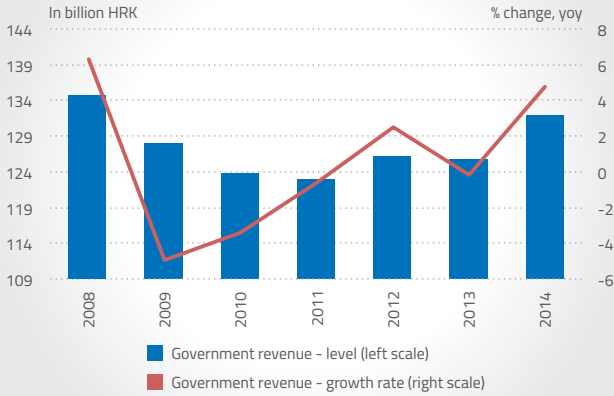
Domestic demand contribution to GDP growth turns slightly positive



Note: * EIZ forecast.
Source: Croatian Bureau of Statistics.

General Government Revenue

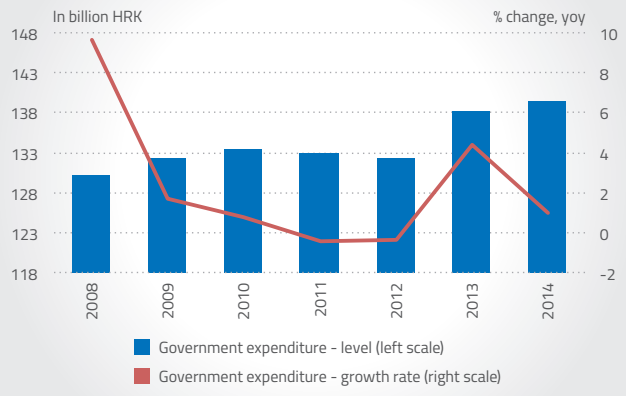
General government revenue in 2014 increased by almost 5 percent when compared to 2013



Source: Ministry of Finance.

General Government Expenditure

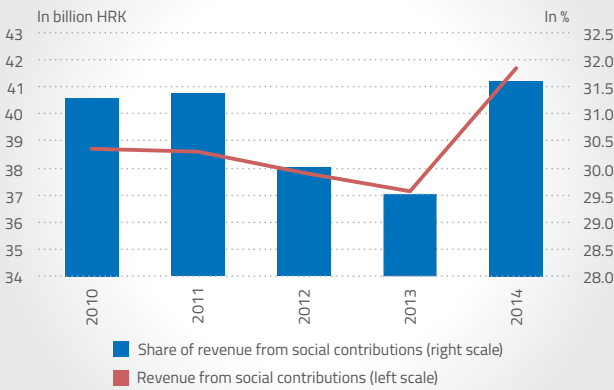
After a swift rise in general government expenditure in 2013, it increased only moderately in 2014



Source: Ministry of Finance.

Revenue from Social Contributions

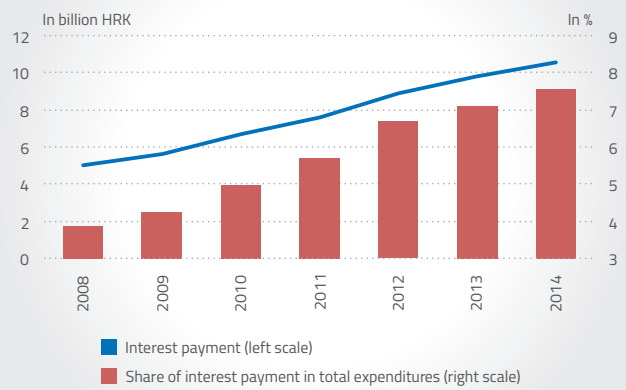
Revenue from social contributions increased strongly in 2014



Source: Ministry of Finance.

Interest Payments

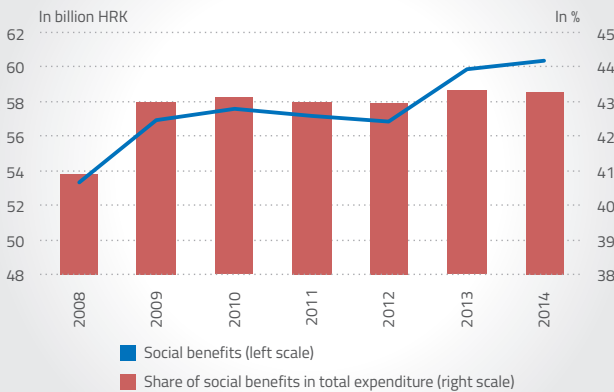
Interest payments and their share in total general government revenue are increasing inexorably



Source: Ministry of Finance.

Social Benefits

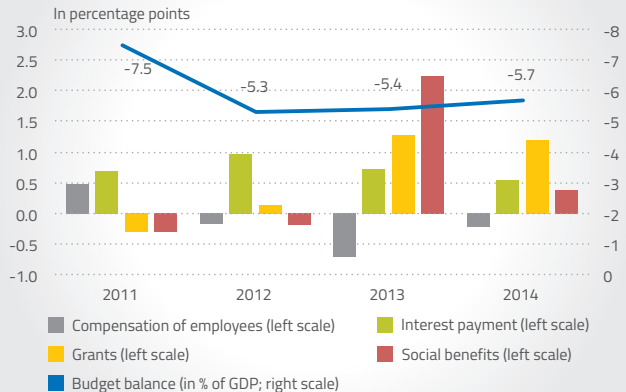
Social benefits increased strongly in 2013 and 2014 due to higher expenditure for arrears in the health sector



Source: Ministry of Finance.

Contribution to Deficit Growth

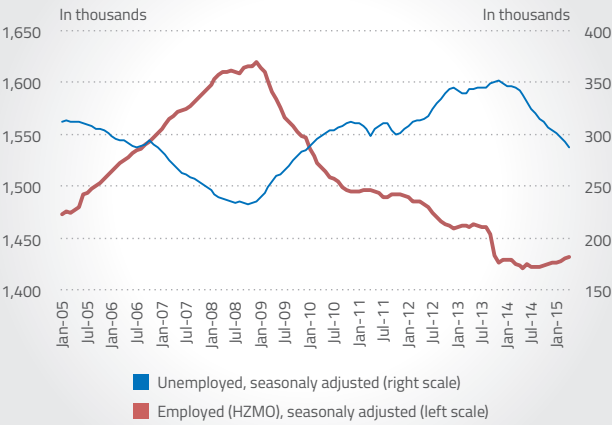
Grants, interest payment and social benefits contributed the most to fiscal deficit growth in 2014



Source: Ministry of Finance.

Employment and Unemployment

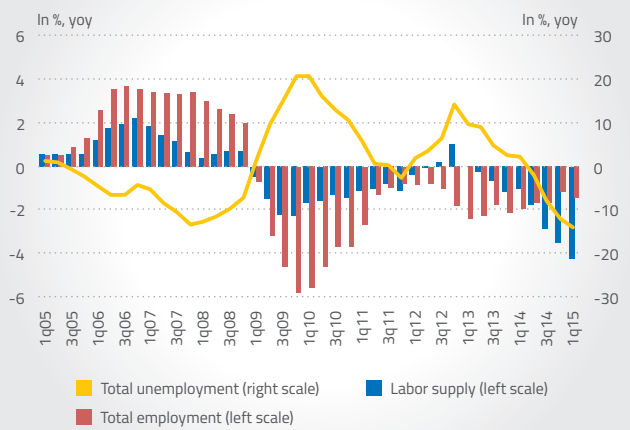
Recently, employment started to show some signs of recovery



Source for original data: Croatian Pension Insurance Institute (HZMO) and Croatian Employment Service (HZZ).

Activity, Employment and Unemployment

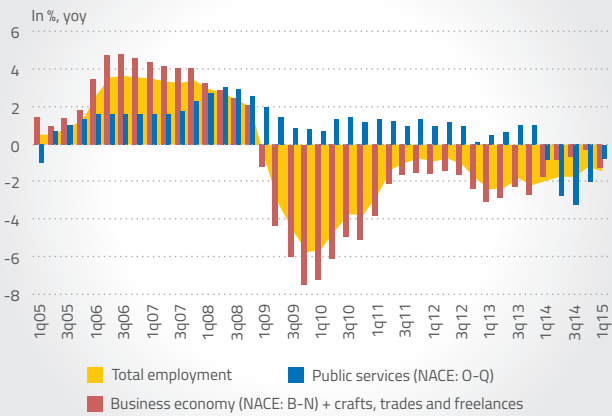
Due to a fall in both employment and unemployment the total labor supply is constantly decreasing



Source: Croatian Bureau of Statistics (DZS) and Croatian Employment Service (HZZ).

Employment Changes

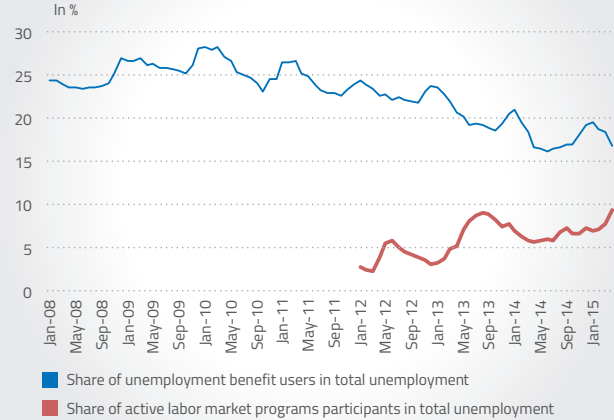
As of last year there is a decrease in public service employment



Source: Croatian Bureau of Statistics (DZS).

Passive and Active Labor Market Policies

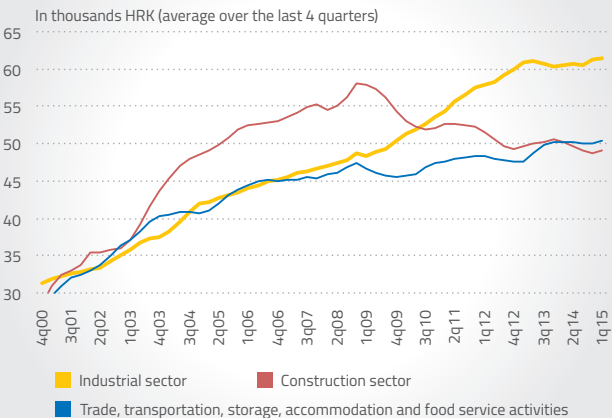
Recently, active labor market programs have started to gain importance



Source: Croatian Employment Service (HZZ).

Productivity of Labor*

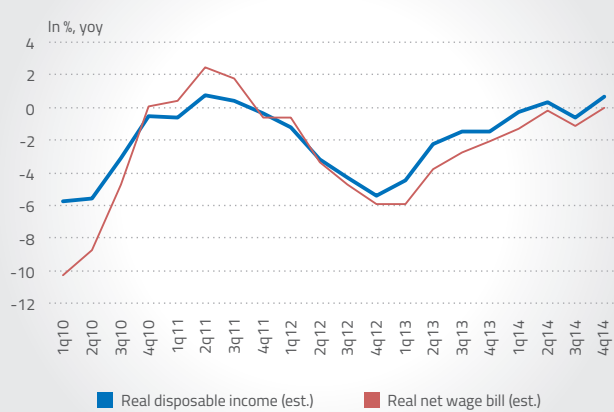
Due to a fall in employment overall labor productivity is increasing; most strongly in the industrial sector



Note: * GVA over number of employees.
Source: EIZ estimate based on Croatian Bureau of Statistics data.

Real Disposable Income (Estimation)

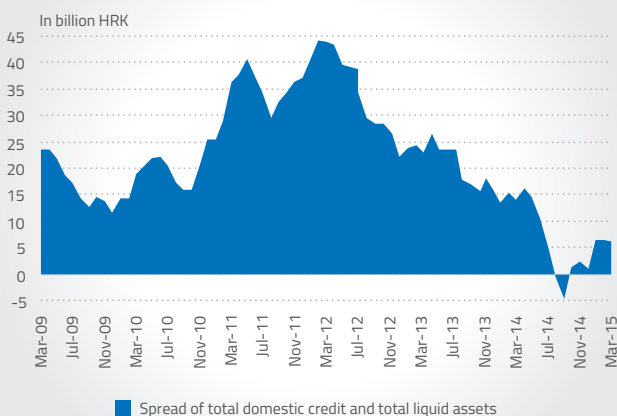
Total disposable income did not decrease much due to rather abundant government transfers



Source: EIZ estimate based on Croatian Bureau of Statistics and Ministry of Finance data.

Credit and Liquid Assets

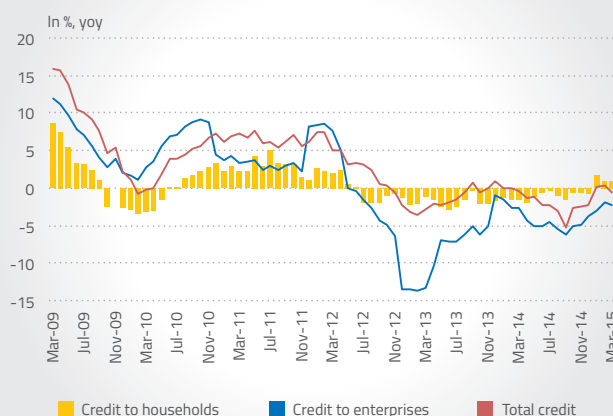
Slowdown in negative credit growth rates stands behind spread widening from October 2014



Source: Croatian National Bank.

Credit Developments

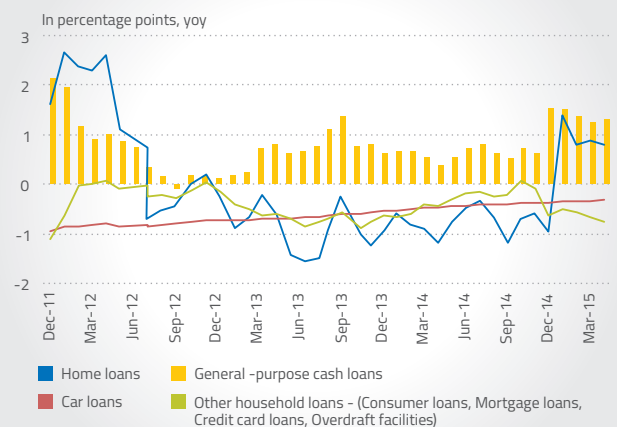
While this year household loans have started increasing, loans to enterprises keep decreasing further



Source: Croatian National Bank.

Contribution to Household Loans

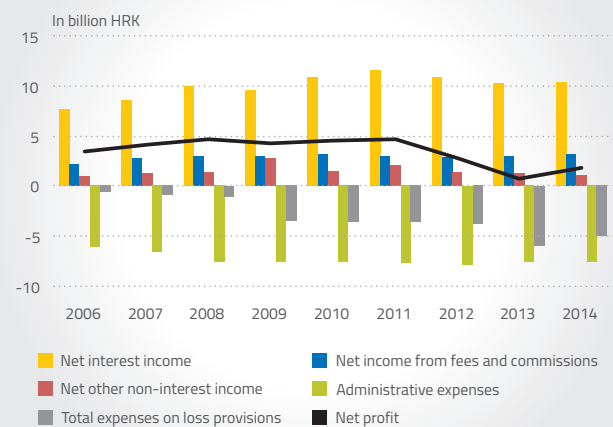
Household loans increased due to a rise in home and general-purpose cash loans



Source: Croatian National Bank.

Bank Income and Profit

Net profit of the banking sector persistent despite significant expenses on loss provisions



Source: Croatian National Bank.

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The views expressed are those of the authors and do not necessarily reflect the views of The Institute of Economics, Zagreb, or of other researchers at The Institute of Economics, Zagreb.

Croatian Economic Outlook Quarterly is published in March, June, September, and December.

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http://www.eizg.hr

For the publisher: Dubravka Jurlina Alibegović

Print: GRAFOKOR d.o.o., Zagreb

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