The Institute of Economics, Zagreb

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Croatian Economic Outlook

Quarterly

1 Recent Developments

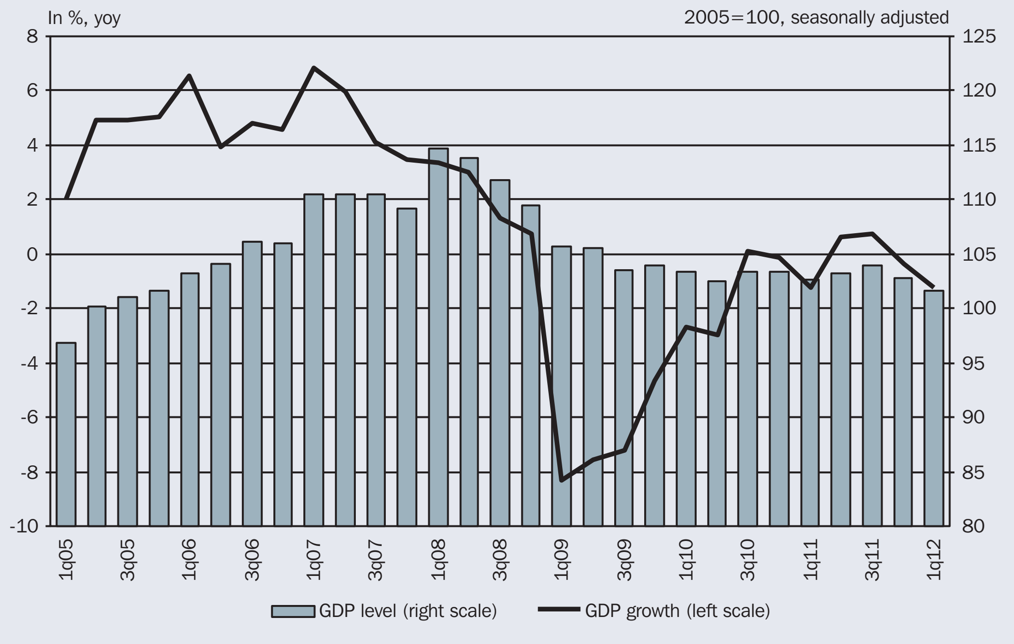
Deepening of the recession and…

Croatian GDP decreased by 1.3 percent year-on-year in the first quarter of 2012. This negative trend is confirmed by more than 1 percent quarter-on-quarter decline of seasonally adjusted figures, which is the second consecutive decline. The renewed recession, following a short-lived recovery episode in the second and the third quarter of 2011, is an extension of almost four years of downward movement of the economy. The decline in the first quarter is somewhat stronger than in the previous quarter, according to seasonally adjusted figures, pointing to the intensifying negative tendencies. It appears that in the prolonged recession structural weaknesses of the economy are rising to surface. It should be noted that the official GDP figures were recently revised. GDP level for 2009 and afterwards was lowered by around EUR 1 billion to EUR 44.9 billion in 2011. Growth figures were also revised and the recession proved to be stronger than was previously thought. GDP declined by 6.9 and 1.4 percent in 2009 and 2010, not by 6.0 and 1.2 percent as previously published. Quarterly growth figures for 2011 were modified too but the annual rate of 0.0 percent remained the same.

… uneven sector performance.

Recent developments indicate highly divergent performance by sectors. The goods-producing sector (agriculture, industry and construction) has recorded strikingly negative

Figure 1 REAL GROSS DOMESTIC PRODUCT



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

movements ever since the beginning of 2009. In the first quarter of this year, the sector's value-added declined by 6.5 percent year-on-year. Cumulative contraction in the last four years amounts to 28 percent (1q2012 vs. 1q2008). In the beginning of 2008, the goods-producing sector made up around 34 percent of gross value-added of the economy, while in the first quarter of this year its share dropped to less than 30 percent. A largely different picture emerged for public service sector (public administration, education, health). This sector has been almost unaffected by the crisis and its value-added grew continuously, although slowly, with most of the expansion coming from increases in employment. The third large sector, market services (trade, ICT, financial, real estate, professional, administrative and personal services), experienced a strong decline in the beginning of 2009 but had managed to reach positive growth rates in the second half of 2010 and entire 2011. However, the first quarter of 2012 has brought a new decline in value-added of the sector and caused discomfort regarding this year's overall performance.

Personal consumption turned negative.

Following weaknesses observed at the end of the last year, personal consumption growth on year-on-year basis turned negative in the first quarter by recording -0.3 percent. Seasonally adjusted quarter-on-quarter figures show the decline of around 0.5 percent in personal consumption in both of the last two quarters. Poor overall state of the economy, falling real incomes burdened by increased unemployment, higher prices and weak prospects have all deterred the household sector from spending. As personal consumption accounts for about 60 percent of GDP, such developments significantly contributed to further weakening of overall domestic demand.

Government continues to reduce its consumption.

Seasonally adjusted data on government consumption reveals a stable negative trend over the last three quarters. On year-on-year basis, the first quarter of 2012 resulted in a 1.5-percent decline. One should remember that there was only provisional budget financing available for the very beginning of this year which implies constrained consumption. Full-fledged government budget was passed in the Parliament at the end of February and it included a considerable reduction of current spending. However, experience teaches us that government consumption is not easy to reduce, especially considering last year's increase in the number of public sector employees.

Figure 2 VALUE-ADDED GROWTH BY SECTORS

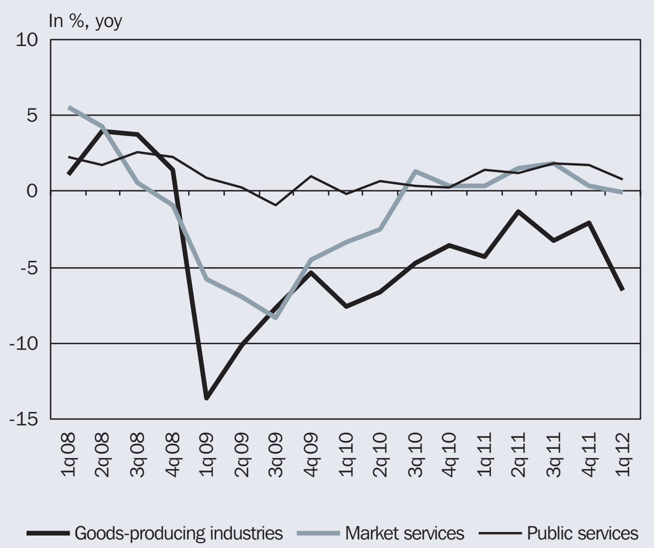
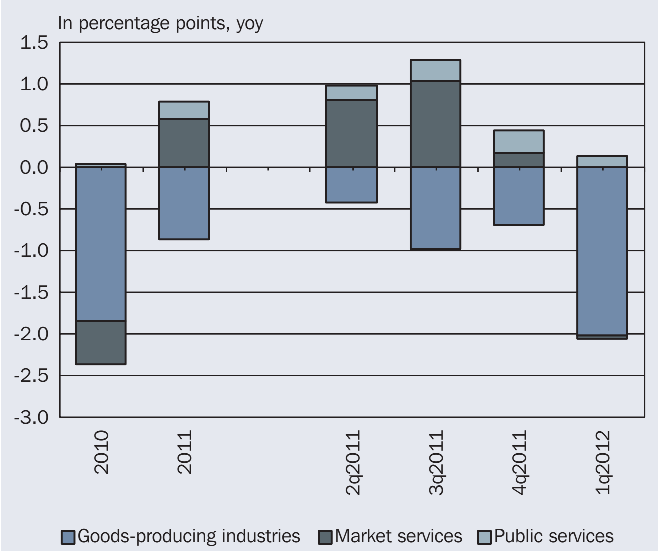


Figure 3 CONTRIBUTIONS TO GROSS VALUE-ADDED GROWTH



Note: *Goods-producing industries are agriculture, industry and construction; market services are distributive trade, ICT, finacial, business and personal services; public services are public administration, education and health.*
Source for original data: *Croatian Bureau of Statistics.*

Investment decline halted in the first quarter – positive signal or just temporary relief?

In spite of a 2.8-percent year-on-year decline in the first quarter, investment movements are almost encouraging. The abovementioned negative rate is much lower than ever in the last three years, while seasonally adjusted quarter-on-quarter data indicate that the decline was actually halted at the beginning of this year. These latest figures come as a surprise, having in mind this year's high-frequency indicators on construction works that are well in the negative territory. Although imports of capital goods and transport equipment increased in the first quarter, this may be due to front-loaded imports earlier in the year because of the increased VAT rate as of March 1. Such higher imports do not necessarily mean that all these goods are put into function; they may also end up in stocks. So, it remains unclear whether we have witnessed investments bottom out or this has only been a temporary relief.

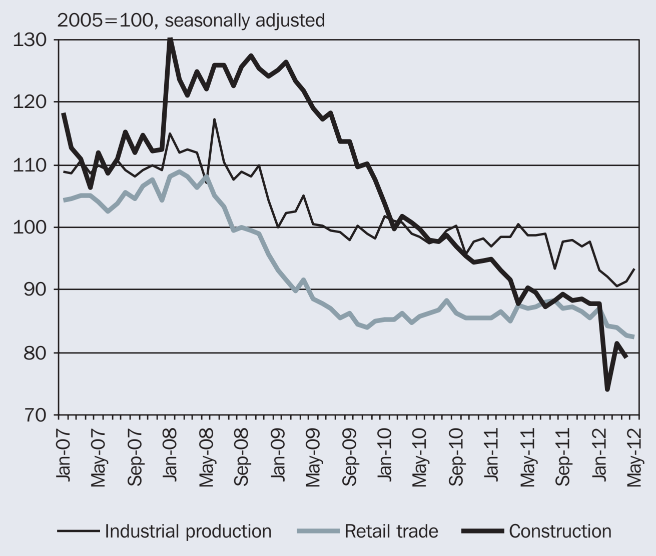
External trade sector fell asleep.

Volume of goods and services exports, according to national accounts statistics, increased by 2.4 percent in the first quarter of 2012 compared to the first quarter of 2011, while imports increased by 1.1 percent. As a result, net exports positively contributed to GDP growth and helped to keep external imbalances at manageable level. Current account deficit, which stood at around 1 percent of GDP last year, remained modest at EUR 1.7 billion in the first quarter, only slightly above the level recorded in the same period of the previous year. In spite of the year-on-year growth of total imports and exports at the beginning of this year, seasonally adjusted figures are much less optimistic and suggest a slightly declining trend likely to extend over the rest of this year. That is confirmed by the latest trade statistics data showing a drop in merchandise exports in the first five months of the year by 3.5 percent year-on-year in current euro terms and a drop in imports by 0.3 percent. The decline in EU import demand may have well contributed to sluggish exports.

Real sector in trouble.

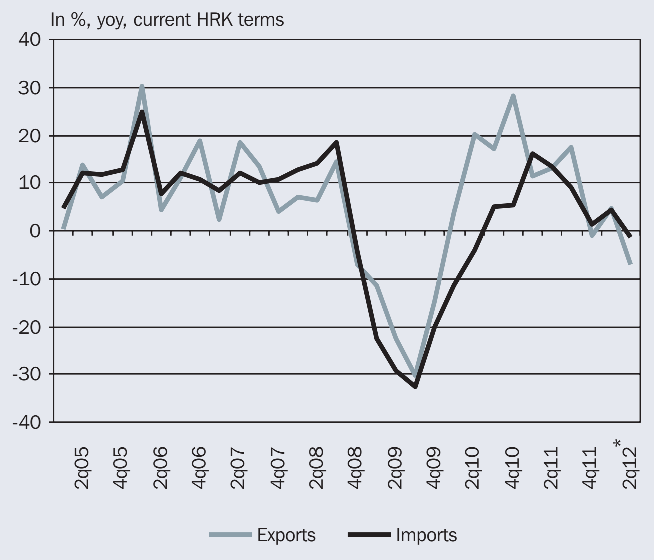
High-frequency indicators point to a weak performance of the real sector. Continued decline in the construction sector was accompanied by a strong slowdown in both industrial and real trade activity. First quarter of 2012 brought a 5.7 percent decrease in seasonally adjusted industrial production compared to the preceding three months. It was widespread across a number of branches - foremost, in the oil extraction and production of petroleum products, production of construction materials, machinery and metal industry.

Figure 4 REAL SECTOR DEVELOPMENTS



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

Figure 5 MERCHANDISE TRADE



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

Although industrial activity somewhat stabilized in the following months, showing signs of revival, year-on-year decline remained strong and amounted close to 6 percent in May in cumulative terms. The negative trend in the retail trade sector emerged at the end of the 2011 tourist season and has not yet shown signs of stabilization. In the first quarter of 2012 retail trade volume declined by 1.5 percent compared to the previous quarter, while in the April-May period it dropped by additional 3 percent. As expected, the decline in the construction sector has continued, although at a slower pace. Still, in the first four months of 2012, its activity was more than 10 percent weaker than a year ago.

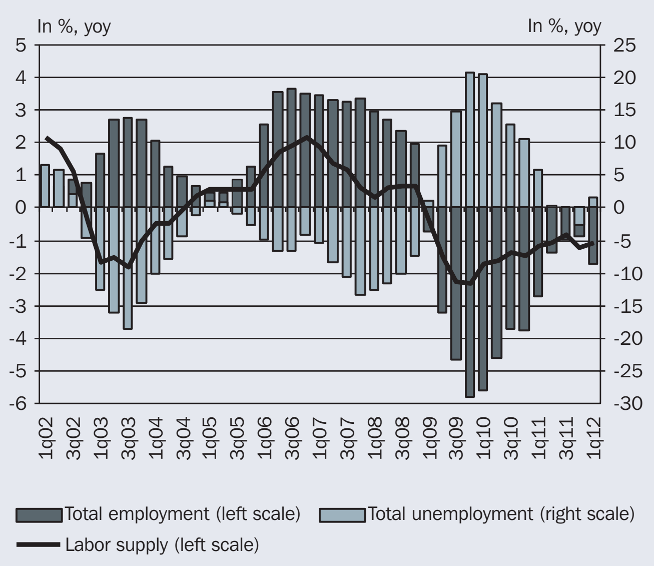
Negative trends weaken, but the labor market is still far from recovery...

Following the seasonal peak in the first quarter of 2012, unemployment slightly declined in the second quarter. The survey-based unemployment rate calculated according to ILO definitions reached 16.4 percent in the first quarter, 2.1 percentage points more than a year ago. The registered unemployment rate peaked in February with 20.1 percent and gradually fell to 18 percent in May, which is still 0.7 percentage points higher than in May 2011. Decreased unemployment is a result primarily of increased employment attributed to seasonal factors. Nevertheless, the total number of employed persons in May remained 2.2 percent lower than in the same period last year.

... as long as labor supply is being reduced.

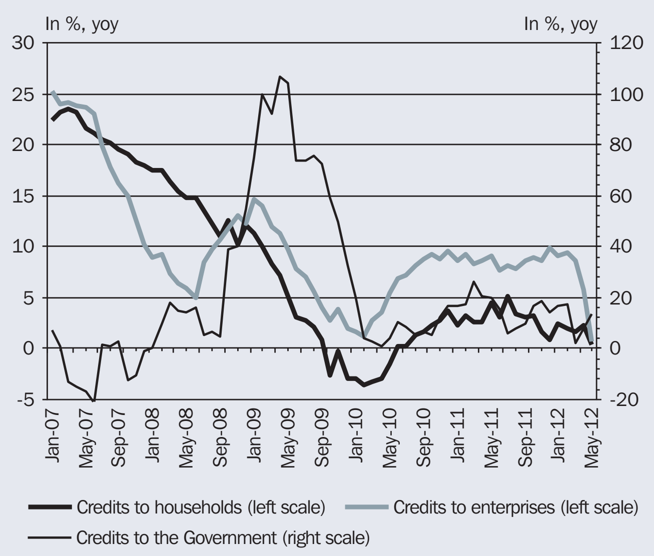
In the current recession, labor supply has notably declined. In the four years between May 2008 and May 2012 Croatia has lost more than 170 thousand or 11 percent of jobs and got more than 73 thousand of the unemployed. The highest drop in employment occurred in small unincorporated businesses (crafts, trades and free professions) as well as the manufacturing industry, construction and distributive trade. This means that the labor force has shrunk by 97 thousand persons. At the same time, the number of retirees increased by 76 thousand. The difference between these two figures points to that portion of workers who have lost their jobs since the outbreak of the crisis and who are now neither active in the labor market nor are they retired, but who might have dropped out of the labor force because of the lack of job opportunities. The level and changes in registered unemployment may therefore well understate weaknesses in the labor market.

Figure 6 LABOR SUPPLY GROWTH



Source: *Croatian Bureau of Statistics.*

Figure 7 CREDIT DEVELOPMENTS



Source: *Croatian National Bank.*

Little variation in the average wages.

In spite of the substantial employment reduction, underlying movements of the average wage have showed little variation in the recession. In the first quarter of 2012 there was even a slight year-on-year increase in the average gross wage, 2.1 percent in nominal and 0.6 percent rise in real terms. Between 2008 and 2011, the average wage declined by 2.3 percent in real terms, or 0.75 percent per year. That points to employment reduction as the major factor behind contraction of disposable income. Our estimate of the real disposable income (including wages, pensions, social transfers and other income) shows a drop of 1.2 percent year-on-year in the first quarter of 2012. Recent changes in income taxation have not affected the average disposable income. Income tax reform of March 1 has brought about changes in income tax brackets and tax allowances which increase the amount of the take-home (net) income for those at the bottom of the income scale and those who have dependant family members, while for others tax liability increased and the net income decreased.

Money supply and bank lending growth slowed down.

As for monetary developments, a notable slowdown in money creation was recorded in the first quarter of 2012 which was followed by a more active policy in April and May. In May, broad money was 3.9 percent higher than a year before. Seasonally adjusted monthly growth reached 1.0 percent in May, the highest rate in the last two and a half years. This recent revival is due to the increased household deposits and savings that outpaced deceleration in enterprise deposits. Narrow money follows similar dynamics with seasonally adjusted data showing substantial reduction in a year up to April when it reached -5 percent on year-on-year basis. Sudden recovery in May brought an increase of 3.1 percent in only one month. Commercial banks' credit growth has continued to decelerate. May saw the lowest year-on-year credit growth rate in the last two years, 2.4 percent, reflecting a severe deterioration in credit demand. Moreover, if exchange rate changes are accounted for, the increase amounted to approximately 1.3 percent. In the last twelve months, the Government was the only sector that increased borrowing, and that was by substantial 13.7 percent. Maturity of a EUR 500 million foreign currency linked bond in the second half of May forced the Treasury to be more active on the market and incidentally, due to very low credit demand, the Government succeeded in borrowing at low interest rates. The other two important sectors of the economy, enterprises and households, are decreasing their borrowing as implied by negative growth rates once exchange rate changes are accounted for. Original data in domestic currency suggest that the corporate sector increased borrowing by a meager 0.7 percent year-on-year in May, but decreased it by 0.7 percent if exchange-rate-adjusted data are taken into account. Households continue to be the biggest impediment to credit growth recovery with 0.3 percent year-on-year credit growth in domestic currency and -1.2 percent when adjusted for the exchange rate.

The CBRD Economic Recovery Program successfully launched.

The implementation of the Croatian Bank for Reconstruction and Development's (CBRD) Economic Recovery Program started in mid-June with the first auction for credit lines covered by a partial CBRD guarantee. In order to support this program, the Croatian National Bank (CNB) decided to free up liquidity by decreasing the reserve rate from 15 to 13.5 percent and by including the CBRD disbursed loans into foreign currency claims/foreign currency liabilities ratio in reserve calculation. Demand for credits at the first auction outpaced the planned borrowing and resulted in HRK 500 million of loans to eight banks that borrowed at rates between 3.16 and 4.21 percent. The second auction in mid-July distributed HRK 410 million. Recent monetary policy actions considerably decreased banks' financing costs, followed by money market interest rates recording all-time lows. The average overnight interbank rate was at 0.44 in May, the lowest rate since the data are recorded, and stayed around that level in June, reflecting ample liquidity not channeled into the real sector. Interest rates on kuna credits of longer maturity were also reduced.

Mid-year HRK/EUR exchange rate slightly weaker than a year ago.

Although at odds with that part of the year, the kuna depreciated against the euro in May mostly due to high market liquidity, slight deterioration in current account balance and corporate sector deleveraging. In May, compared to March, HRK/EUR weakened by 0.7 percent and encouraged the CNB to intervene on the foreign exchange market. The central bank withdrew a bit more than HRK 2 billion by selling euro at the rate of 7.57 and stabilized the exchange rate in early June. However, by the end of June and especially in the first half of July the kuna appreciated against the euro backed by revenues of the tourism industry and expectations of both kuna and foreign currency denominated government bonds issue estimated at around HRK 5 billion. On average for the second quarter of this year, HRK/EUR was 1.8 percent weaker than a year ago.

Inflation ante portas.

Consumer price inflation accelerated in the second quarter owing mostly to a general VAT rate increase and administered prices hikes (electricity and gas, highway toll). High unemployment and massive household deleveraging seem to be keeping prices away from even more intensive upswings. Month-on-month consumer price increases of 1.5 percent in March, 0.8 percent in April and 1.7 percent in May, lift the headline inflation rate up to 3.9 percent in May. In June, it remained relatively high, 3.8 percent despite a 0.6-percent decrease on month-on-month basis. Producer price inflation reached 7.0 percent in June involving 19.9-percent increase in energy prices and 15.9-percent increase in water prices. Core inflation in May remained relatively low at 2.1 percent.

Consolidation of public finances on the revenue side...

The first quarter of 2012 has seen 3.2 percent higher total general government revenues than in the same quarter last year. Although positive, this rate is still far from of two-digit rates observed before the crisis. The rise is, however, a sign that the revenue collection improved, at least compared to 2011 which ended with a 0.5-percent and 2010 with a 3.4-percent fall. The modest revival of revenues was brought about mostly by VAT collection which increased by 2.5 percent and the profit tax revenue, which was 20.9 percent higher than in the first quarter of 2011. For the former, it should be noted that general VAT rate increased from 23 to 25 percent as of March 1, while the latter should be seen primarily as a result of earlier filing of profit tax returns, provoked by the announced introduction of dividend tax, also as of March 1. It is noteworthy that revenues from social security contributions grew on year-on-year basis for the first time since the second quarter of 2009. Although the rise was only slight (0.1 percent), it points to improved fiscal discipline.

… brought a lower fiscal deficit.

When it comes to total expenditures, in the first quarter of this year they were only 0.3 percent lower than in the same quarter last year. Slight reduction in total expenditures arose because increases in employees' compensation and interest payments were dominated by the reductions in the remaining major items, namely social spending, subsidies and purchases of goods and services. As for net acquisition of non-financial assets, it amounted to HRK 0.7 billion in the first quarter, 7.6 percent less than at the same time last year. Taken together, the first quarter ended with net borrowing (i.e. deficit) of HRK 4.0 billion, which is 1 billion less than in the first quarter of 2011, and is an indication that fiscal consolidation in terms of deficit reduction began to take place. For comparison, the 2011 general government deficit measured on the cash principle was HRK 15.0 billion, or 4.5 percent of GDP, and roughly of the same magnitude as in 2010. Here, one has to note that such a deficit figure is not internationally comparable. Figures based on GFS 2001 and ESA 95 methodology, which are likely to show somewhat higher deficit, have not yet been released. General government debt increased from 41.3 percent of GDP at the end of 2010 to 45.7 percent at the end of 2011.

Table 1 MAIN ECONOMIC INDICATORS

	2010	2011	2011			2012
			Q2	Q3	Q4	Q1
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-1.4	0.0	0.6	0.8	-0.4	-1.3
Real private consumption (% change, yoy)	-0.9	0.2	0.6	0.1	0.1	-0.3
Real government consumption (% change, yoy)	-1.6	-0.3	1.6	-0.3	-0.9	-1.5
Real investment (% change, yoy)	-15.0	-7.2	-7.0	-8.6	-6.0	-2.8
Industrial output (% change, yoy)	-1.4	-1.2	1.0	-2.4	0.0	-5.4
Unemployment rate (registered, %, pa)	17.4	17.8	17.3	16.6	17.9	19.9
Nominal GDP (EUR million)	44,877	44,922	-	-	-	-
GDP per capita (EUR)	10,158	10,205	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.9	2.1	1.9	2.2	1.9	1.1
Consumer prices (% change, yoy, pa)	1.1	2.3	2.3	2.0	2.4	1.5
Producer prices (% change, yoy, pa)	4.4	6.3	6.5	6.3	6.4	6.1
Average gross wage (% change, yoy, pa)	-0.4	1.5	1.8	2.0	1.8	2.1
Exchange rate, HRK/EUR (pa)	7.29	7.43	7.39	7.45	7.49	7.56
Exchange rate, HRK/US$ (pa)	5.50	5.34	5.13	5.27	5.56	5.76
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	8,905	9,582	2,529	2,469	2,390	2,252
Exports of goods (EUR, % change, yoy)	18.3	7.6	11.0	13.8	-2.7	2.6
Imports of goods (EUR million)	15,137	16,281	4,285	4,211	3,972	3,891
Imports of goods (EUR, % change, yoy)	-0.5	7.6	11.3	6.1	-0.2	2.0
Current account balance (EUR million)	-482	-437	-370	2,480	-918	-1,689
Current account balance (% of GDP)	-1.1	-1.0	-	-	-	-
Gross foreign direct investment (EUR million)	298	1,075	257	305	171	-17
Foreign exchange reserves (EUR million, eop)	10,660	11,195	11,422	11,324	11,195	11,340
Foreign debt (EUR million, eop)	46,483	45,734	47,330	46,560	45,734	45,858
GOVERNMENT FINANCE*						
Revenue (HRK million)**	123,709	123,025	58,681	91,587	123,025	28,931
Expense (HRK million)**	133,486	132,945	65,157	97,994	132,945	32,248
Net = Gross operating balance (HRK million)**	-9,777	-9,920	-6,476	-6,487	-9,920	-3,317
Net acquisition of non-financial assets (HRK million)**	4,848	5,044	1,869	3,130	5,044	729
Net lending/borrowing (HRK million)**	-14,625	-14,964	-8,345	-9,618	-14,964	-4,046
Domestic government debt (EUR million, eop)	12,085	13,716	13,065	13,414	13,716	-
Foreign government debt (EUR million, eop)	6,602	6,996	6,768	6,984	6,996	-
Total government debt (% of GDP)	41.3	45.7	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	4.2	7.5	6.1	-1.1	7.5	-3.5
Broad money, M4 (% change, yoy, eop)	4.4	3.5	3.5	3.7	3.5	2.7
Total domestic credit (% change, yoy, eop)	6.8	5.5	6.5	6.7	5.5	4.9
DMBs credit to households (% change, yoy, eop)	3.8	0.9	3.1	3.1	0.9	1.7
DMBs credit to enterprises (% change, yoy, eop)	9.5	9.8	7.7	8.6	9.8	8.6
Money market interest rate (%, pa)	0.9	0.9	0.5	0.8	1.4	1.6
DMBs credit rate for enterprises, short-term, (%, pa)	7.4	7.0	6.6	6.6	7.6	7.9
DMBs credit rate for households, short-term (%, pa)	12.7	11.9	12.6	11.2	11.2	11.2

Notes: ** Data refer to consolidated general government. ** On the cash principle, cumulative from the beginning of the year.*
Conventional abbreviations: *pa - period average, eop - end of period, yoy - year on year, HRK - Croatian kuna, EUR - euro, US$ - U.S. dollar, DMB – deposit money bank.*
Sources: *Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.*

Box 1 RENEWED WEAKNESS IN THE GLOBAL ECONOMY

World economic outlook worsens.

In contrast to positive global economic trends during the first four months of 2012, the world economic outlook, burdened by the fiscal crisis in the eurozone and high level of debt and deficit in Japan and the United States, seems to be worsening. An improvement in the last quarter of 2011 and first quarter of 2012 was a turnover from sudden slowdown in 2011 caused by fiscal contraction in advanced countries, natural disasters in Japan and Thailand and poor economic activity in the eurozone. The short-term advancement was mainly due to the financial, structural and policy improvements in high-income Europe which contributed to positive market expectations.

Market anxiety reappeared in mid-2012.

However, market anxiety has reappeared as a result of uncertainty regarding elections in Greece and France, and troubles in the Spanish banking sector. Credit default swaps rates in the eurozone have mounted close to their peaks in the fall of 2011 and stock markets in both developing and high-income countries lost 10 percent in the period between May and early July. According to the UN/DESA projections, gross world product will grow by 2.5 percent in 2012, which is a downward revision of the January forecast. Ongoing fiscal austerity and continuing bank deleveraging will alleviate GDP growth in developed countries to 1.4 percent this year. However, economic outlook for the U.S. economy is positive as growth projections were upgraded to 2.1 percent in 2012 and 2.3 percent in 2013. Nevertheless, U.S. economy continues to cope with high unemployment rates as job creation is not absorbing the labor force increase. Following an increase of 5.9 percent in 2011, GDP growth in developing world is expected to slow down to 5.3 percent in 2012.

Negative developments in the eurozone economy.

Vulnerable banking system, fiscal problems, weak external demand, and high unemployment have contributed to a -0.3 percent UN/DESA forecast of GDP growth in the eurozone in 2012. Unemployment is expected to increase from 10.2 percent in 2011 to 11.1 percent in 2012. Following sharp decline in trade of the eurozone in the last quarter of 2011, when annualized quarterly fall amounted to 30 percent, some recovery took place in the first quarter of 2012. However, the renewed debt crisis contributed to further weakening of eurozone's import demand in the second quarter. The recent World Bank report on the EU new member states predicts significant slowdown in recovery of these countries, from 3.1-percent growth of GDP in 2011 to 1.5-percent in 2012. For Hungary and Slovenia, it expects negative growth of -0.4 and -1.2 percent respectively, and for the Czech Republic a 0-percent growth. Goods exports and tourism, as well as capital flows are to be significantly impacted by the eurozone's contraction.

Stable commodity prices.

Moderate global inflation forecasted for 2012 is consistent with the trends observed at the end of 2011 and mild food and commodities price dynamics as well as weakening global demand. Slowdown in China's industrial output growth, from 13.1 percent ten-year average to 10.7 percent year-on-year rate in April 2012 may reduce global demand for raw materials. That should result in stable commodity price dynamics and a reduction in GDP growth of oil exporting countries.

Sovereign debt crisis in eurozone remains the main risk for global economic stability.

The greatest risk for global economic stability remains the sovereign debt crisis in the eurozone. Extension of debt crisis would lead to turmoil in financial markets, increase in risk aversion and decrease in global demand, causing economic instability in developed countries with significant contagion risk to the rest of the world.

Note: *The figures used in this box are based on information from World Bank EU11 Regular Economic Report: Coping with External Headwinds, June 2012 and UN/DESA Monthly Briefing: World Economic Situation and Prospects, June 2012, No.44.*

2 Policy Assumptions and Projections Summary

Negative current trends carried over to short-term forecasts.

International environment has worsened compared to the beginning of the year which applies primarily to the eurozone where weaknesses were renewed (see Box 1). However, we have assumed tensions to soften, USD/EUR exchange rate to remain around the level from the second quarter of this year, and world commodity prices to ease. On the domestic front, Government is struggling to achieve major goals for this year – fiscal consolidation envisioned by this year's budget and realization of an ambitious investment plan that would help revive the overall economic activity. As for the first goal, we assume that fiscal consolidation will take place but on a scale smaller than planned. Namely, the planned decrease in expenditures should in large part come from a decrease in wage expenditures, which will be hard to achieve as negotiations with trade unions started late in the year and their outcomes are still questionable. On the other hand, realization of the government investment plan needs much more time than the Government initially predicted. We assume, however, that these projects will be realized at a larger scale in the course of the next year. We have also taken into account negative trends rolling over from the previous months and pressing down our short-term forecasts.

New CNB governor expected to continue policy of price and exchange rate stability.

July brought change at the position of central bank governor with Mr. Boris Vujčić, long-time deputy governor, replacing Mr. Željko Rohatinski whose second six-year mandate expired. The financial markets received the news well and gave credit to Mr. Rohatinski for his well-recognized policy of maintaining macroeconomic and financial stability of the country. With Mr. Vujčić's background, one can expect price and exchange rate stability to remain priorities of the central bank, along with early adoption of the euro.

Active labor market policies to expand with limited impact.

The new Government has proposed several measures aimed at reviving the labor market in 2012. One of the measures provoking the biggest dispute is the program of on-the-job training without actual employment for persons without previous work experience. Employers only have to pay the social security contributions, while the Employment service provides compensation in the amount of HRK 1,600 for two years at most. This measure was expected to cover 10 thousand persons. Other active labor market policy measures are announced to include up to 35 thousand persons in 2012, whereas around 50 percent of them should get a public works job. Having in mind the severe lack of labor demand and possible administrative obstacles for the swift implementation of these measures in the private sector, the overall impact on employment is assumed to be limited.

Downward revision - GDP projected to decline by 1.3 percent in 2012.

Our GDP projection has been revised downwards for both this and the next year. We now expect GDP to decline by 1.3 percent in 2012, 0.3 percentage points more than three months ago. The main factor for this more pessimistic GDP projection is a gloomier outlook for personal consumption. Rising inflation, declining purchasing power of household incomes, weak prospects on the labor market and probable introduction of property tax will make households increasingly averse to consumption. As there are no positive signals on the horizon that would encourage consumers' confidence, personal consumption is expected to decline by 1.6 percent in 2012.

Investments expected to decline this year but at a slower pace.

Weak performance of the economy and the ongoing fiscal consolidation should result in decreased government consumption which is this year expected to contract by 1.6 percent. Investments are also expected to decline. At the beginning of its mandate, Government had high expectations regarding public investments. However, as we noted three months ago, preparation of investment projects takes time, which is why relatively modest investment dynamics is expected this year. We also do not expect investments through the CBRD programs to have a large impact on overall investments as it seems that the problem is more in the lack of adequate business projects than resources to finance them. However, certain effects will emerge this year and we expect the investment decline to be weaker than in previous years (-0.8 percent).

Current account deficit to remain at around 1 percent of GDP.

Croatia's foreign trade sector is expected to remain sluggish this year. Although another good tourist season should come along with the rise in revenues from international tourism up to 4 percent in nominal terms, goods exports will continue to be weak. Consequently, we expect a decline in exports of goods and services by 1.6 percent compared to the previous year. As a result of weak demand, imports volume is projected to decrease by 1.5 percent. Current account deficit should remain low, amounting to about 1 percent of GDP in 2012. At the same time, foreign debt is likely to stay at around 100 percent of GDP.

Positive developments to emerge in 2013 – GDP projected at 0.8 percent.

More favorable international environment, adjustment of the domestic economy to the ongoing fiscal consolidation, positive effects of EU membership and a more intensive realization of government investment program should bring modest revival of economic activity next year. Consequently, GDP is expected to rise by 0.8 percent. Personal consumption is projected to increase by meager 0.6 percent in 2013 conditional on improvements on the labor market and signs of optimism that should come from abroad. By restructuring its expenses, the Government should continue decreasing current consumption and increasing investments which should in addition to private sector investments induce overall investments to rise by about 4 percent. That would make them the main driver of growth next year. In addition, exports are expected to contribute with a 2-percent rise. The accession to EU should improve trade with EU members, while some problems might arise in the trade with neighboring countries primarily due to possible abolishment of CEFTA trade agreements. If current negotiations on the continuation of this regime fail, custom duties for Croatian products in these countries will increase. Imports should rise by 1 percent next year due to higher trade with EU and stronger domestic demand. As a result, current account deficit could amount to 1.3 percent of GDP.

Labor market outlook for 2012 is still grim.

The negative momentum in the labor market will be hard to cancel out without considerable labor demand strengthening. Hence, the unemployment rate is projected to increase further to reach 18.5 percent in this year, or 0.7 percentage points more than in 2011. Provided that growth projections materialize, improvements in the labor market might be observed in 2013 and average unemployment rate somewhat lessen. As it seems, there will be no cuts in the basic public sector wage but only in non-wage compensations, while uncertain recovery in the rest of the economy should keep private sector wages mostly intact which suggests that the average gross wage will stagnate in this and the next year.

Risks of administratively controlled price hikes.

On the wave of the recent price hikes, consumer price inflation in the rest of this year will remain relatively high and close to 4 percent, with year-average of 3.2 percent for the entire 2012. The easing in world commodity prices and weakening domestic demand will help limit the second-round effects of increased energy prices. Providing no further administrative impulses to price rises except those related to EU membership (higher tobacco and gasoline excises, elimination of zero VAT rate), next year should bring inflation rate of around 2.6 percent. Upward risks will remain in case the fiscal stability comes under threat; then we do not exclude future indirect taxes and administratively regulated price hikes.

Stability of HRK/EUR exchange rate.

Higher foreign currency inflows in July and August, driven by tourism revenues, as well as successful public companies foreign borrowing will create appreciation pressures in the third quarter. The Ministry of Finance's announcement of partially foreign currency denominated bond issue will induce investors and creditors to buy euros in order to speculate or to secure funds for foreign currency repayment obligations in the rest of the year, thereby limiting the possible strengthening of the kuna. With the beginning of fall, ongoing deleveraging, bank provisioning, and credit rating concerns will kick in and put upward pressures on HRK/EUR exchange rate. However, with high foreign currency reserves, transparent central bank policy aimed at HRK/EUR stability and a multitude of monetary policy measures at disposal, we see exchange rate in 2012 steady around the average of 7.52. The next year prediction remains around the same level.

Lowering credit demand.

The renewed recession will cause lower credit demand and consequently lending activities will suffer. The CNB and CBRD enabled credit schemes and the public investment projects are expected to underpin lending to some extent but not before year-end. Households will continue to reduce credit exposure in uncertain conditions. All in all, we expect credit growth in domestic currency to slow down to 1.7 percent in 2012 and then to slightly increase to 3.9 percent in 2013. Broad money will grow 3.2 percent this year and 3.8 percent next year.

Fiscal consolidation involves many tax changes…

Fiscal projections for 2012 have to be seen in the light of the set of changes that the tax system has been subject to since the beginning of the year - increase in the VAT rate, changes in personal income taxation, and reduction in the health contribution rate from 15 to 13 percent. Also, dividends, profit shares, pension supplements and pensions from abroad do not go untaxed any longer - the tax rate for those income components is now 12 percent. Finally, as of May this year, employers are not able to pay salaries to their employees without simultaneously paying social security contributions. The changes on the revenue side are promised to be complemented by lowering the total expenditures. Taking all that into account, certain consolidation should take place.

… and (too) many ifs.

According to the original 2012 budget, the planned magnitude of consolidation is HRK 3.4 billion, implying deficit of 3.8 percent of GDP. Yet, there are at least three reasons why this plan is not likely to work out fully. First, the deficit figure is based upon a rather optimistic prediction for the real growth rate (0.8 percent). Second, the effects of the tax system changes introduced so far may turn out not to be in line with the official expectations concerning total revenues. Third, it seems that the dynamics of expenditure cuts will not be sufficient to achieve the planned amount of consolidation. These three reasons seem to suggest that one should expect higher than planned deficit-to-GDP ratio this year, the lower bound being as high as 4.6 percent. As for the 2013, assuming there will be no significant departure from our growth projections and that the Government will remain willing to go for further consolidation, the deficit of no less than 4.1 percent of GDP seems credible.

Table 2 SUMMARY OF PROJECTIONS

	2012	2013
Real GDP (% change)	**-1.3**	**0.8**
Real private consumption (% change)	-1.6	0.6
Real government consumption (% change)	-1.6	-1.7
Real investment (% change)	-0.8	3.7
Exports of goods and services (constant prices, % change)	-1.6	1.9
Imports of goods and services (constant prices, % change)	-1.5	1.3
Current account balance (% of GDP)	-1.0	-1.3
Consumer prices (% change, pa)	3.2	2.6
Exchange rate, HRK/EUR (pa)	7.52	7.52
Unemployment rate (registered, %, pa)	18.5	18.0
General government balance (ESA95 definition, % of GDP)	-4.6	-4.1
Broad money, M4 (% change, eop)	3.2	3.8
Total domestic credit (% change, eop)	1.7	3.9

Notes: *Cut-off date for information used in the compilation of projections was July 10, 2012.*
Conventional abbreviations: *pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.*
Source: *Authors' projections.*

3 Uncertainties and Risks to Projections

Economic situation in Europe poses a threat.

This time the downside risks are dominant. We assume the economic situation in Europe to improve, but recent past has proven that risks remain high and deterioration in financial market tensions cannot be ruled out. Expectations for the tourist season are high. Although some of the factors that positively affected last year's record tourist season are still relevant, such as unsettled situation in Greece and North-African countries, there are other risks related to the major source markets. In at least two countries, Italy and Slovenia, crisis has affected disposable incomes of the population to the extent that some might give up traveling abroad. A number of risks and uncertainties is related to internal factors. So far, we do not see any improvements in the economy's competitiveness, private sector is still not recovering and labor market is subdued. Due to slow improvements in addressing structural weaknesses of the economy, it is questionable whether positive developments might be established by next year.

Will expenditure cuts be sufficient to comply with the fiscal rule?

As the revenue side of the budget hinges predominantly on the general state of the economy, and the expenditure side on the political behavior, these two factors constitute the major sources of uncertainty in the fiscal sphere. Significant deterioration in the real economic activity would have an adverse effect on revenue collection. However, expenditures are contingent on Government's readiness to ignore or ability to properly handle the ever-present political constraints in the period to come. But we must not neglect that the Government is obliged by the fiscal rule enshrined in the Fiscal Responsibility Act which requires expenditures-to-GDP ratio to recede by at least 1 percentage point. This will not be easy to achieve despite the comfortable situation depicted in the budget - almost 2-percentage points reduction is planned for this year. The most recent development warns us that undertaken expenditure reduction may prove to be insufficient, especially if GDP turns out to be lower than initially forecasted. As this is the first year that the Act is in force, no excuses for non-compliance will be accepted because that would undermine the Government's ability to make any further credible commitments towards both the domestic public and the sovereign debt market.

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