Croatian Economic Outlook Quarterly

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Forecast Update

Croatian GDP is expected to pick up mildly in 2015 and 2016

After a negative real GDP growth rate in 2014, the estimate for 2015 remained unchanged compared to our predictions in January this year, and it stands at 0.2 percent. However, based on a relatively narrow growth base expected in 2015 and on an increasing need for fiscal consolidation in 2016, we revised downward the growth prospects for 2016 by 0.1 percentage point. The forecast now stands at 0.8 percent.

Global recovery continues at a rather high pace

Meanwhile, global economy continued its recovery in 2014, led primarily by the advanced economies and by a gradual recovery of emerging markets. European Commission (European Economic Forecast, Winter 2015) estimates world real GDP growth for 2014 at 3.3 percent, followed by a pickup in growth rates of 3.6 and 4.0 percent for the current and the following year.

Eurozone is set for modest GDP growth recovery

After two consecutive years of negative growth rates, eurozone is estimated to have rebounded in 2014, although the recovery pace remains burdened by macroeconomic adjustments, reform implementation and geopolitical tensions. Projected growth rates measure 1.3 in this year and 1.9 percent in 2016 (European Economic Forecast, Winter 2015). Figure 1 reveals that the expected Croatian real GDP growth rate in this and

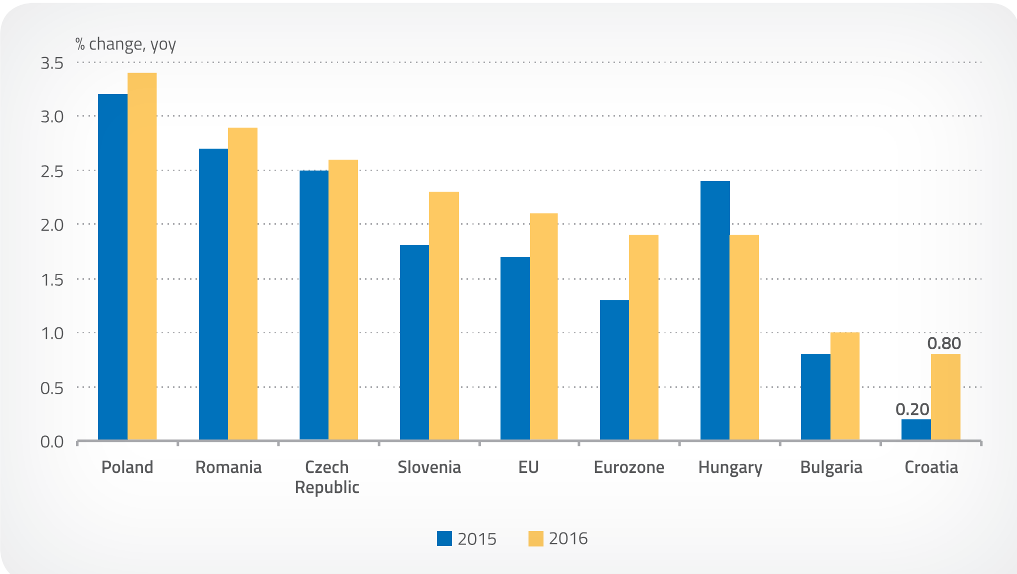
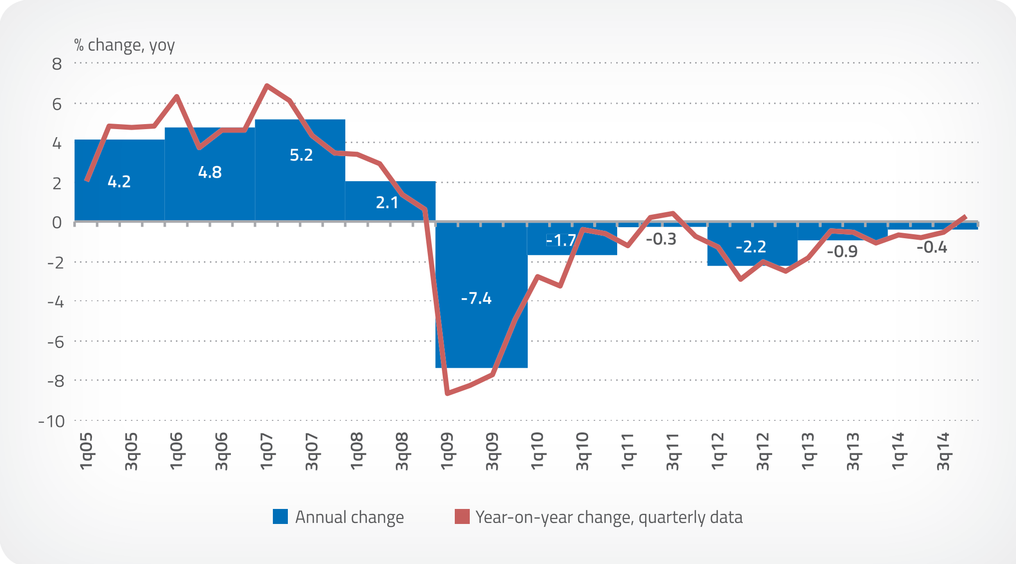


Figure 1
Real GDP Growth Forecasts for Croatia and Selected CEE Countries

Sources: European Commission - European Economic Forecast, Winter 2015 and EIZ for Croatia.

Figure 2
Real Gross Domestic Product

Source: Croatian Bureau of Statistics.



next year is the lowest among selected CEE countries and the EU as a whole.

Personal consumption remains subdued

Personal consumption in Croatia has remained heavily influenced by bad conditions on the labor market and by low consumer sentiment. The latest lowering of labor tax burden, tax incentives to hire young workers, and monthly compensation for employers who employ a youth worker with no prior experience increasing from 1,600 to 2,400 kuna, are expected to give momentum to consumption recovery. Also, the latest temporary debt forgiveness and one-off measures that include approximately 60,000 over-indebted citizens and their families could add to consumption growth. However, in the presence of protracted deleveraging we forecast a stagnation of consumption in 2015 before it slightly picks up in 2016 at the rate of 0.2 percent.

Government consumption in limbo

As seasonally adjusted data suggest government consumption increased by 0.6 percent in the second half of 2014, we are inclined to believe that cutbacks in spending over the 2010-2012 period and in 2014 have pushed the budget to a level where any additional savings are not likely without public administration reforms. Moreover, the approaching parliamentary elections will probably outweigh the need for fiscal consolidation in this year. Based on this, we modified our earlier forecast of a drop in real government consumption to -0.4 percent, up by 1 percentage point from the last forecast. In 2016, a newly elected Government may decide to take more affirmative actions towards controlling public finance and we expect government consumption to decrease by -1.2 percent. This course of action is, however, highly dependent on the timing of the reforms required within the Excessive Deficit Procedure (EDP) and Macroeconomic Imbalances Procedure (MIP) imposed by the European Commission.

Long-lasting downward spiral of investments expected to change its direction in 2016

After a mild pick-up in the third quarter, investments continued their downward trend and contracted by -2.1 percent in the final quarter of 2014 (seasonally adjusted figures on quarter-on-quarter basis). We have revised our January forecasts downwards for both 2015 and 2016, which now stand at -1.5 and 2.2 percent, respectively. In the light of poor realization of public and almost vanishing private sector investment and underutilized access to EU funds, investments are expected to decline in this year. As some of the announced investment projects materialize and EU funds absorption improves, investments in 2016 will increase in year-on-year terms for the first time in the last seven years.

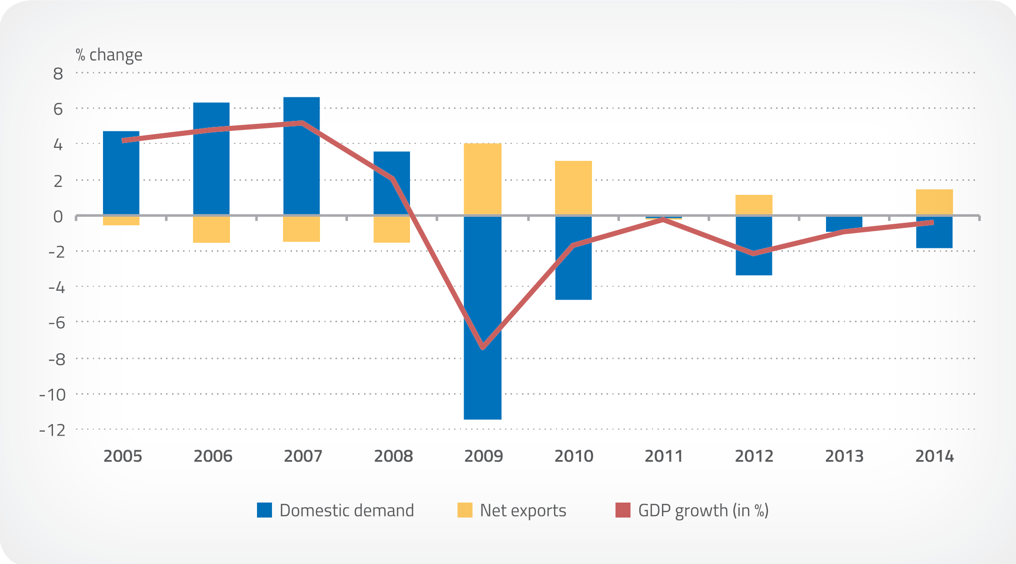


Figure 3
Demand Contribution to GDP Growth

Sources: Croatian Bureau of Statistics and own calculations.

External trade continues to contribute positively to GDP growth

As in 2014 (Figure 3), we expect that net exports in the next year will contribute positively to GDP growth. Stronger external demand combined with improved terms of trade due to a moderate kuna depreciation lead us to revise this year's predictions for export growth to 3.5 percent, up by 0.3 percentage points. Import growth, on the other hand, was revised downwards due to persistently low personal consumption and it now stands at 1.8 percent. For the next year we see exports up by 3.6 percent and imports rising by 2.8 percent as both domestic and external demand gradually recover. In the light of this situation, the current account surplus should be sustained. It is estimated at 1.0 percent of GDP this year before slightly decreasing to 0.9 percent of GDP in the following year, after imports pick up the pace.

2015 will be marked by parliamentary elections

Although political campaign for the upcoming parliamentary elections – to be regularly held at the beginning of 2016 at the latest – has

Table 1
Forecast Summary

	2015	2016
Real GDP (% change)	**0.2**	**0.8**
Real private consumption (% change)	0.0	0.2
Real government consumption (% change)	-0.4	-1.2
Real investment (% change)	-1.5	2.2
Exports of goods and services (constant prices, % change)	3.5	3.6
Imports of goods and services (constant prices, % change)	1.8	2.8
Current account balance (% of GDP)	1.0	0.9
General government balance (ESA 2010 definition, % of GDP)	-5.0	-4.8
Unemployment rate (registered, %, pa)	19.0	18.5
Exchange rate, HRK/EUR (pa)	7.67	7.68
Broad money, M4 (% change, eop)	2.5	3.6
Total domestic credit (% change, eop)	-0.6	1.4
Consumer prices (% change, pa)	0.1	1.0

Note: Cut-off date for information used in the compilation of forecasts was March 9, 2015.
Conventional abbreviations: pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.
Source: Authors' forecasts.

not yet gained momentum, the major parties' rhetoric is clearly becoming a standard pre-election one.

Elections could endanger reform agenda of the incumbent Government

The incumbent coalition Government can hardly be expected to pursue any significant reform measures which would go, even only potentially or only in the short run, against the interests of the sizeable portions of the electorate, irrespective of how badly required those reforms may be. Bolder reform intentions of the incumbent Government for the time to come will likely remain well hidden, given that otherwise it would be reasonable for the opposition to ask why their implementation is not already under way. A major populist measure, or a series of smaller ones, is rather probable by the end of the year, and thus should come as no surprise.

Main issues remain within the fiscal policy domain

The three-month fiscal spending review was supposed to be completed and its final results known on March 1. As we already passed that deadline, it is unknown when the details will actually be available. Although no specific recommendations on the cuts of excessive expenditures are expected to be implemented to any significant extent this year, the findings might be useful for making decisions on how to proceed when it comes to expenditure reduction. Whether the findings will be available for public scrutiny will be a good test of how transparent Croatian authorities are ready to be.

Budget deficit estimated to have shrunk marginally in 2014

We stand by our previous estimation of general government deficit according to ESA 2010 of -5.1 percent of GDP in 2014. Although the level of general government deficit in 2014 could be substantially lower than in 2013 according to national accounting rules, application of ESA 2010 rules including accrual accounting principle and broader coverage of general government lead us to stand by our previous estimation of general government deficit of -5.1 percent of GDP in 2014, marginally down from -5.2 percent recorded in 2013.

The deficit will decrease slightly in 2015 and further in 2016

We expect that the pressure from the European Commission to reduce the deficit in line with the Excessive Deficit Procedure (EDP) targets will increase during 2015. However, since this is an election year it is unlikely that we will see some momentous reforms of the incumbent Government which might push the general government balance into the EDP target of -3.5 percent of GDP. Instead we expect the general government balance to be similar as in 2014, i.e., at -5.0 percent of GDP. The post-election 2016 could bring more significant fiscal consolidation that will however negatively influence the revenue side of the budget in the year of implementation, as possible wage cuts decrease revenues from income taxes. Hence, the forecasted deficit for 2016 is only moderately below this years' rate, or at -4.8 percent of GDP, with a significantly more positive outlook as of 2017.

Cheap government borrowing will postpone reforms but also decrease the snowball effect

Croatia is currently using favorable international capital market conditions to achieve two different goals. On one hand, cheap funding lowers Government's incentive to implement reforms towards fiscal consolidation. On the other hand, rolling over maturing debt at much lower interest rates reduces the size of the snowball effect, removing some of the pressure on interest expenditures.

Government is creating uncertainties by sending mixed signals

Mixed signals from the Government are causing uncertainties. Croatian Minister of Finance Boris Lalovac is announcing structural reform measures and a sound fiscal consolidation program as required by the EU policies coordination mechanisms (European

Semester and EDP), including possible cuts in wages and subsidies, while at the same time the Prime Minister Zoran Milanović insists there will be no further cuts in wages and subsidies. Also, the discussion on the possible monetization of Croatian highways is heating up, as the due date for the decision of the Constitutional Court on the constitutionality of the referendum on the monetization of Croatian motorways is approaching. Prime Minister Milanović announced that in the case the referendum is held, the Government will go with an alternative plan – selling 51 percent of the publicly-owned highway company to pension funds and to citizens.

Labor market is stuck in a rut

The beginning of 2015 is marked by a continued and unusual simultaneous decline in the number of employed and unemployed persons, a process that has started in the second half of 2014. The expected overall weak economic activity for both 2015 and 2016 suggests that there will be no significant rise in employment while the registered unemployment rate is expected to decrease moderately – to 19 percent in 2015 and 18.5 percent in 2016 – predominantly due to a sustained decline in labor force. The explanation for the latter might lie in the strengthening of the underground economy, increased emigration or simply in flawed statistical monitoring of labor market flows.

Wages under downward pressure in 2016?

The average gross wage is expected to stagnate in 2015, whereas due to fiscal pressures it may well decrease in 2016. The average net wage is expected to increase slightly in this year due to changes in income taxation that came into force in January 2015, while in 2016 both net wages and disposable income could decline further if the newly-elected Government goes with wage cuts in the public sector.

Additional monetary easing conditional on HRK/EUR stability and GDP recovery

Despite historically low interbank interest rates and average liquidity that amounted to 9 billion HRK in the middle of March this year, we believe that the central bank has additional easing space if deemed necessary. Having in mind the high financial euroization in the system, further monetary expansion is conditional on the HRK/EUR exchange rate stability that the central bank is committed to. For the time being, we see interest rates at recently recorded historically low levels, and expect that the announced GDP recovery in 2016 will not produce significant pressures on interbank liquidity.

Is 7.70 the ceiling for HRK/EUR?

We see the HRK/EUR exchange rate stable, on average 7.67 in 2015 and 7.68 in 2016. At

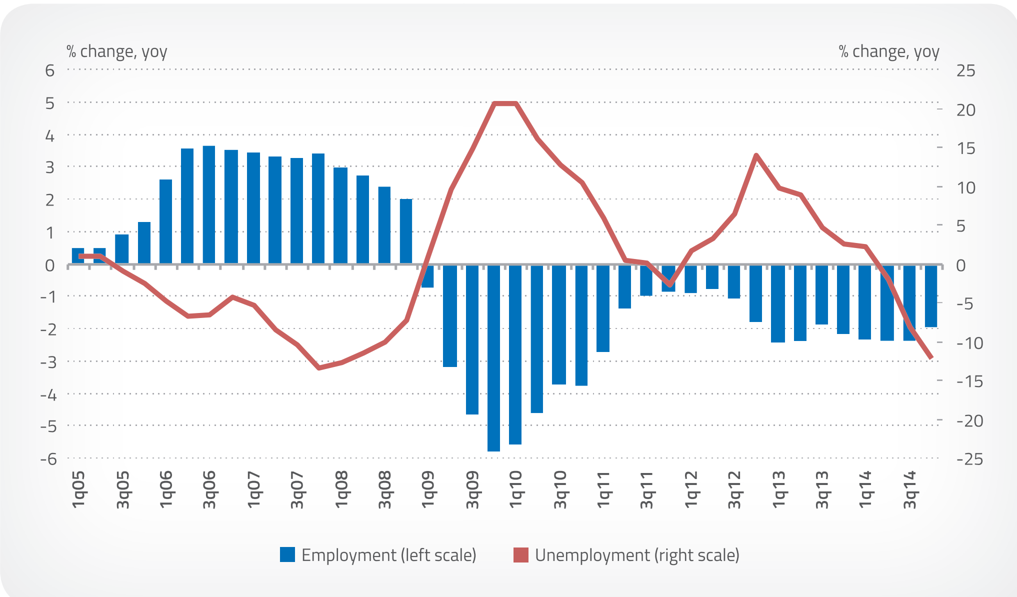


Figure 4
Total Employment and Unemployment

Source: Croatian Bureau of Statistics.

the beginning of the year, kuna depreciated against the euro which resulted in two massive foreign exchange interventions by the central bank. The total amount of euros sold in these two interventions amounted to almost half a billion euro at the average exchange rate of 7.7 leading us to perceive this level as the targeted ceiling for the time being. Expectations of another good tourist season, foreign currency borrowing by the Government and foreign investment recovery expectations in 2016 are all kuna-supportive factors. Fiscal policy remains the main downside risk.

Absent credit demand due to poor economic outlook; alert supply side due to NPLs

Poor credit demand will persist in this year as the economic outlook remains weak. On the other hand, the supply side is burdened with "bad" loans, with the ratio of nonperforming loans increasing from 15.70 percent in 2013 to 16.95 percent in 2014. Until NPLs resolve, we expect that banks will not be willing to grant loans as easily as they did before the crisis.

Deceleration in deleveraging this year and credit pickup in 2016

Credit activity in 2015 will decrease but at a lower rate, down by -0.6 percent when compared to -2.3 percent in 2014. Private sector deleveraging is expected to continue as the macroeconomic outlook remains weak in this year. In 2016 credit will increase by 1.4 percent, stemming from the realization of announced investment projects and favorable net exports dynamics, but also from limited GDP recovery, and still fragile labor market improvements. Broad money will follow the rise in credit, increasing by 2.5 percent in 2015 and by 3.6 percent in 2016.

Swiss franc resolution will be brought by negotiation

Swiss franc loans resolution is under way as banks, borrowers, CNB and the Government are currently working on possible solutions. There are some speculations that a combination of write-offs of loan principals and a conversion to euros is the preferred solution. However, a part of the write-offs will probably be borne by the Government in the form of reduced revenues from banks' profit tax in the next ten years, which will yield considerable expenses for tax payers. The implementation of this solution seems questionable in the light of the EDP and the pressures on the Government to cut the deficit.

Minimal inflation in this year

Having in mind the recent oil price volatility, we see consumer price inflation conservatively at 0.1 percent in this year. The parliamentary elections will stop further price increases as we expect no rise of administrative prices. For the next year, prices are expected to moderately increase by 1 percent as aggregate demand recovers.

Figure 5
Total Domestic Credit

Note: * presents EIZ forecast.

Source: Croatian National Bank.

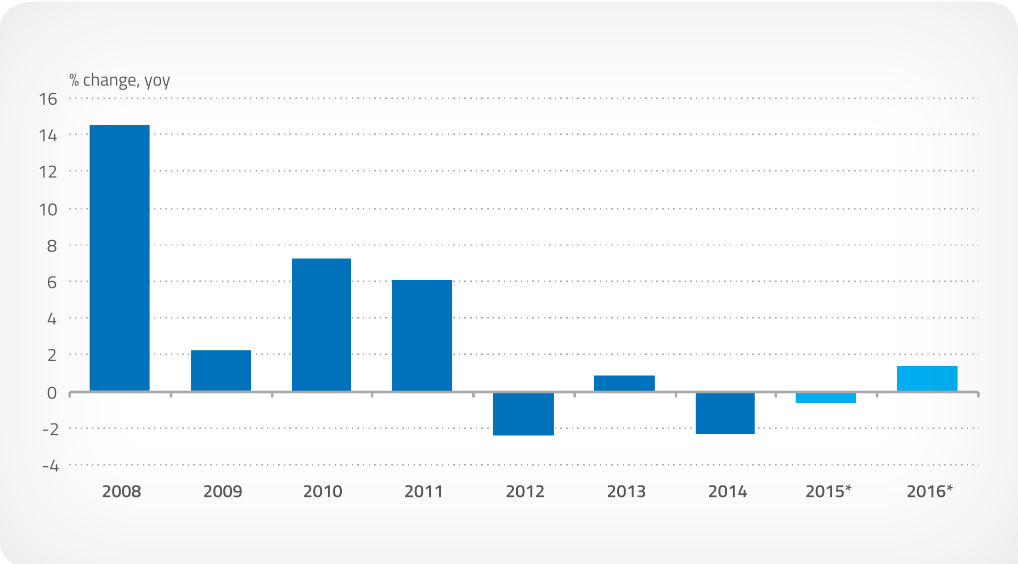


Table 2 Main Economic Indicators

	2013	2014	2014			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	-0.9	-0.4	-0.6	-0.8	-0.5	0.3
Real private consumption (% change, yoy)	-1.3	-0.7	-0.5	-0.5	-1.1	-0.6
Real government consumption (% change, yoy)	0.5	-1.9	-2.2	-3.4	-1.4	-0.5
Real investment (% change, yoy)	-1.0	-4.0	-3.6	-5.2	-3.6	-3.7
Industrial output (% change, yoy)	-1.8	1.2	0.6	-0.4	0.4	4.1
Unemployment rate (registered, %, pa)	20.2	19.7	22.4	19.7	17.7	19.1
Nominal GDP (EUR million)	43,591	43,110	-	-	-	-
GDP per capita (EUR)	10,242	10,130	-	-	-	-
PRICES, WAGES AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.9	0.0	-0.5	-0.3	0.6	0.3
Consumer prices (% change, yoy, pa)	2.2	-0.2	-0.3	-0.4	-0.2	0.0
Producer prices (% change, yoy, pa)	0.5	-2.7	-2.7	-2.8	-2.9	-2.6
Average gross wage (% change, yoy, pa)	0.8	0.2	-0.2	0.1	0.3	0.6
Exchange rate, HRK/EUR (pa)	7.57	7.63	7.65	7.60	7.61	7.66
Exchange rate, HRK/US$ (pa)	5.71	5.75	5.58	5.54	5.74	6.13
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	9,589	10,346	2,353	2,543	2,705	2,744
Exports of goods (EUR, % change, yoy)	-0.4	7.9	13.4	11.3	3.8	4.6
Imports of goods (EUR million)	16,528	17,095	3,980	4,502	4,507	4,106
Imports of goods (EUR, % change, yoy)	1.9	3.4	6.8	2.6	4.1	0.5
Current account balance (EUR million)	341	-	-1,518	-381	2,782	-
Current account balance (% of GDP)	0.8	-	-	-	-	-
Gross foreign direct investment (EUR million)	741	-	225	2,105	308	-
Foreign exchange reserves (EUR million, eop)	12,908	12,688	12,100	12,335	12,116	12,688
Foreign debt (EUR million, eop)	45,920	-	46,761	46,367	46,504	-
GOVERNMENT FINANCE*						
Revenue (HRK million)**	125,879	-	29,030	35,016	34,692	-
Expense (HRK million)**	138,217	-	34,914	34,638	33,120	-
Net = Gross operating balance (HRK million)**	-12,339	-	-5,884	378	-1,572	-
Net acquisition of non-financial assets (HRK million)**	5,264	-	1,040	831	1,033	-
Net lending/borrowing (HRK million)*	-17,603	-	-6,924	-453	-2,604	-
Domestic government debt (EUR million, eop)	19,931	-	20,440	20,721	20,360	-
Foreign government debt (EUR million, eop)	12,799	-	12,473	12,693	13,207	-
Total government debt (eop, % of GDP)	75.5	-	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	11.9	9.2	9.8	6.2	9.5	9.2
Broad money, M4 (% change, yoy, eop)	3.4	3.1	3.1	2.5	2.4	3.1
Total domestic credit (% change, yoy, eop)	0.9	-2.3	-0.4	-2.3	-5.2	-2.3
DMBs credit to households (% change, yoy, eop)	-1.8	-0.8	-1.5	-0.6	-1.5	-0.8
DMBs credit to enterprises (% change, yoy, eop)	-1.0	-3.7	-2.6	-5.0	-6.3	-3.7
Money market interest rate (%, pa)	0.6	0.5	0.5	0.5	0.4	0.5
DMBs credit rate for enterprises, short-term, (%, pa)***	6.4	5.9	6.0	6.0	5.9	5.7
DMBs credit rate for households, short-term (%, pa)***	7.6	7.4	7.3	7.4	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.

Analyses

Analysis 1 Goodbye recession, hello stagnation!

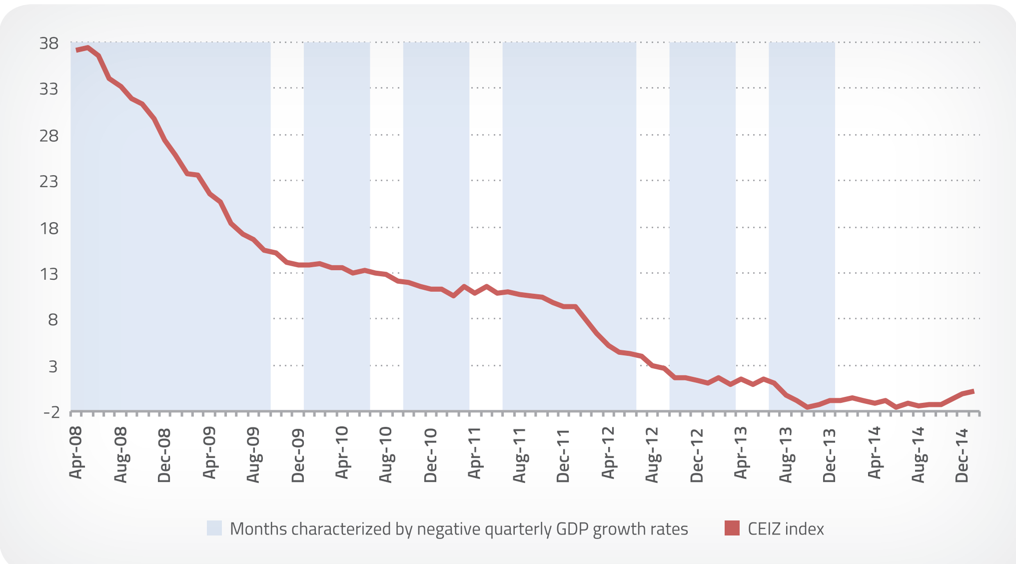
Earlier this month the Croatian Bureau of Statistics (CBS) published GDP data for the fourth quarter of 2014, and for the first time it included a measure that is standard in macroeconomic statistics – the quarter-on-quarter seasonally adjusted annualized rate of GDP growth. Before, the CBS would report year-on-year rates only. These are the rates in which the size of GDP in a given quarter is compared to its size in the same quarter a year earlier. The latter therefore measures how much GDP increased or decreased when compared to year before, while the seasonally adjusted quarter-on-quarter rate compares GDP in a given quarter to the preceding quarter. The difference between the two rates is not just technical, because it has implications for understanding the state of the business cycle.

According to year-on-year rates, the first three quarters of 2014 depicted a drop in GDP, while only the fourth quarter recorded a positive GDP growth rate. For example, as GDP in the fourth quarter increased by 0.3 percent year on year, it means that total output in the fourth quarter of 2014 was 0.3 percent higher than total output in the last quarter of 2013. On the other hand seasonally adjusted quarter-on-quarter data reveal a different story. For example, we can take seasonally adjusted GDP data that the Institute of Economics, Zagreb has been providing years before the CBS. According to those figures, the seasonally adjusted quarter-on-quarter GDP growth rate in the fourth quarter of 2014 amounted to 0.2 percent. This implies that from the third quarter of 2014 to the fourth quarter of 2014, the Croatian economy grew 0.2 percent.

The two rates look very similar but they do tell a different story. The first figure looks back for a whole year, while the quarter-on-quarter rate reflects the current momentum of the economy. This is why the seasonally adjusted quarter-on-quarter rate is used to technically define recession or an exit out of recession. As two consecutive quarters of a drop in GDP are defined as recession, according to EIZ data, Croatia technically entered recession in the second quarter of 2008. As for the exit, 2014 seems to have been the year we said goodbye to recession. Seasonally adjusted quarter-on-quarter rates for all four quarters of 2014 point to positive GDP growth rates: 0.1 percent in the first quarter, 0.01 percent in the second quarter, 0.1 percent in the third quarter and 0.2 percent in the last quarter. Altogether, the numbers do not look impressive, but the rates are positive, suggesting that the Croatian economy has exited recession some time in summer last year. Because the figures are very small (the maximum is 0.2 percent only), and the unemployment rate is very high, we

Figure 6
CEIZ Index and Months Characterized by Negative Quarterly GDP Growth Rates

Source: Institute of Economics, Zagreb.



can say that the Croatian economy is now in a state of stagnation.

Coincident Economic Index of the Institute of Economics, Zagreb (CEIZ), a monthly composite business cycle indicator for Croatia, corroborates these findings (Figure 6). CEIZ suggests that the average value of the index in the last three months of 2014 was slightly higher than the corresponding value in the three months preceding the last quarter. Moreover, since October 2013 the values of the index have been indicating an upward trend, although the index itself was negative up to January this year. As GDP data for the first quarter will not be available before June, CEIZ will provide monthly estimates on the state of the economy, one to three months prior to quarterly GDP estimates.

Analysis 2 Global market liquidity provides temporarily favorable borrowing conditions

In the first week of March the Croatian Ministry of Finance issued a new Eurobond in the amount above the one that was previously announced by the Ministry. Well-planned timing of the issuance secured very high demand so that finally 1.5 billion euros were issued at a record-low yield for a 10-year bond of 3.25 percent and a 3-percent coupon. Two main factors contributed to a low yield. First, the bond was sold just a few weeks after the ECB announced further steps in quantitative easing, securing a longer period of "cheap" money and abundant liquidity. Second, no other sovereign bonds were offered to investors at the time so the Croatian bond gained all the investors' attention. However,

Table 3 List of Outstanding Government Bonds

DOMESTIC MARKET					
Symbol	Date of issue	Maturity	Currency	Principal	Nominal interest rate
RHMF-O-157A	15/07/2005	14/07/2015	EUR	350,000,000	4.250
RHMF-O-15CA	14/12/2005	15/12/2015	HRK	5,500,000,000	5.250
RHMF-O-167A	22/07/2011	22/07/2016	HRK	3,500,000,000	5.750
RHMF-O-172A	08/02/2007	08/02/2017	HRK	5,500,000,000	4.750
RHMF-O-17BA	25/11/2010	25/11/2017	HRK	4,000,000,000	6.250
RHMF-O-187A	10/07/2013	10/07/2018	HRK	2,750,000,000	5.250
RHMF-O-19BA	29/11/2004	29/11/2019	EUR	1,000,000,000	5.375
RHMF-O-203A	05/03/2010	05/03/2020	HRK	5,000,000,000	6.750
RHMF-O-203E	05/03/2010	05/03/2020	EUR	1,000,000,000	6.500
RHMF-O-227E	22/07/2011	22/07/2022	EUR	1,000,000,000	6.500
RHMF-O-247E	10/07/2013	10/07/2024	EUR	1,400,000,000	5.750

EUROBONDS					
Symbol	Date of issue	Maturity	Currency	Principal	Nominal interest rate
2015	27/05/2009	27/05/2015	EUR	750,000,000	6.500
2017	27/04/2012	27/04/2017	USD	1,500,000,000	6.250
2018	30/06/2011	30/06/2018	EUR	750,000,000	5.875
2019	05/11/2009	05/11/2019	USD	1,500,000,000	6.750
2020	14/07/2010	14/07/2020	USD	1,250,000,000	6.625
2021	16/03/2011	16/03/2021	USD	1,500,000,000	6.375
2022	29/05/2014	30/05/2022	EUR	1,250,000,000	3.875
2023	04/04/2013	04/04/2023	USD	1,500,000,000	5.500
2024	26/11/2013	26/11/2024	USD	1,750,000,000	6.000
2025	04/03/2015	04/03/2025	EUR	1,500,000,000	3.000

Sources: Croatian National Bank and Ministry of Finance.

the yield on the Croatian Eurobond was still above yields recently obtained by comparable countries such as Hungary and Romania. Those two countries are paying 100 basis points less in the case of Hungary and 130 basis points less in the case of Romania on their bonds. One of the main reasons behind this is more optimistic forecasts regarding their GDP growth rates. While this year Croatia is expected to stagnate, Romania will increase its GDP by 2.7 percent, and Hungary by 2.4 percent (as forecasted by the European Commission on February 5, 2015).

Treasury secured around half of funding needs for this year

When denominated in kuna, the amount obtained by the latest bond issuance comes to approximately 11.6 billion kunas. This amount will cover most of the debt repayment obligations in the form of bonds for this year, more precisely, 78 percent of outstanding debt that will mature in this year. There are three bonds maturing in 2015: 750 million Eurobond in May, 350 million euro foreign currency denominated domestic market bond in July, and a 5.5 billion kuna bond in December. With short-term debt added, the Treasury secured around half of funding needs for this year. Having in mind that 24.1 billion kuna worth in bonds is maturing in the next two years, it is possible that the Ministry of Finance will tap the market one more time this year, and try to take advantage from favorable market conditions.

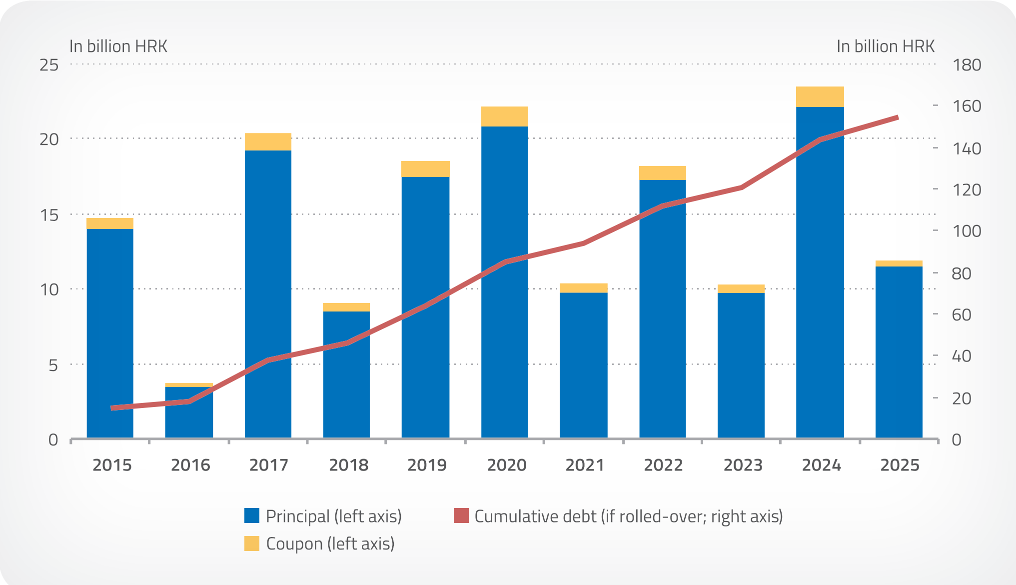
Debt ratio has drifted away from the Maastricht limit

Up to 2011, Croatia's government debt was deemed sustainable, as it complied with the Maastricht criterion of the maximum debt-to-GDP ratio of 60 percent. However, figures from 2012 and 2013 suggest not just that the 60-percent level has been breached but also that debt to GDP path is steadily on the rise (Figure 8). The change in calculating public debt (i.e. the inclusion of debt of public sector enterprises) further contributed to this escalation. Taking into account estimates for 2014 which suggest that public debt expansion is still not halted (81.4 percent estimated by the European Commission), concerns about government debt sustainability are looming.

Bleak public debt outlook

The European Commission addresses this issue in their Country Report for Croatia together with "In-Depth Review on the Prevention and Correction of Macroeconomic Imbalances". According to their simulations, general government debt is likely to keep increasing in the medium term if no consolidation measures are introduced. Their worst-case scenarios see debt-to-GDP ratio at around 120 percent by the end of projection period or by 2025. Best-case scenario suggests debt-to-GDP ratio at 80 percent.

Figure 7
Croatian Bond Government Debt (Cumulative and by Years)



Note: Transformations to domestic currency were made assuming the following exchange rates: HRK/EUR=7.7, HRK/USD=6.5.

Sources: Croatian National Bank and Ministry of Finance.

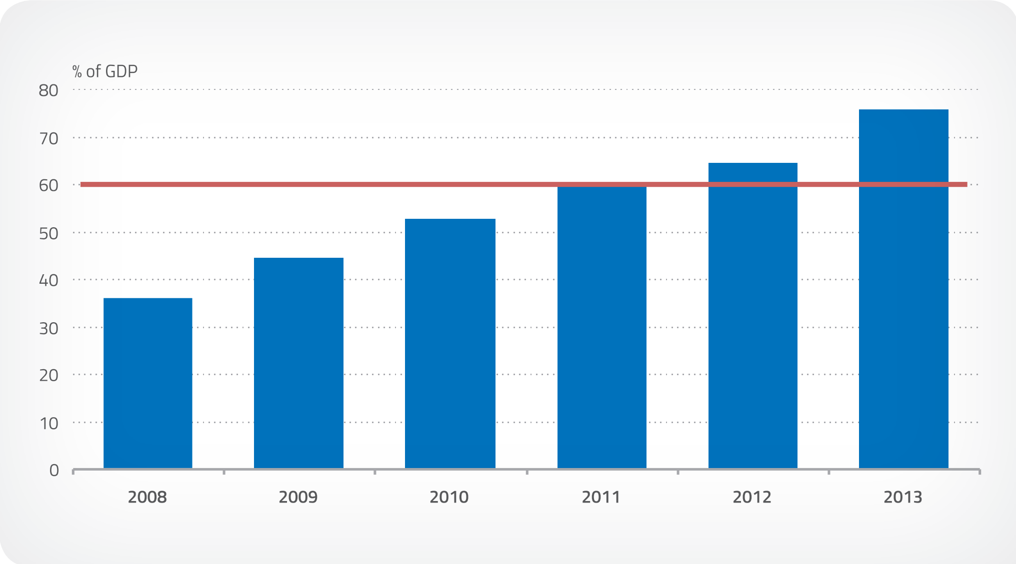


Figure 8
General Government Sector Debt

Source: Croatian National Bank.

The European Commission created nine different scenarios of debt-to-GDP ratio development up to year 2025. These simulations are based on different pairs of GDP growth rates and real interest rates. The baseline scenario follows latest developments concerning GDP, primary balance, and real interest rates. They see the inflation rate slowly reaching 2 percent by 2019, and remaining constant afterwards. Their simulations are supported with one-off feedback effects from consolidation measures to GDP growth, where one percentage point of GDP worth of fiscal consolidation pushes baseline GDP growth down by half a percentage point in the same year.

The most important conclusion one can draw from these simulations is that public debt outlook appears bleak even in the most favorable scenarios. In their baseline scenario, debt-to-GDP ratio reaches around 110 percent by the end of 2025. The best-case scenario (in which the structural primary balance adjusted in line with the fiscal efforts recommended by the Council results in the debt-to-GDP ratio reaching 80 percent of GDP) can actually be seen as public debt stagnation, and not public debt reduction. In three other favorable scenarios, the ones in which GDP growth accelerates, inflation picks up, and real interest rates decrease, debt-to-GDP ratio increases slightly over 105 percent. In four unfavorable scenarios (the ones in which interest rates go up, GDP growth slightly disappoints, inflation is lower, and there is a negative shock on the primary balance) debt reaches around 120 percent of GDP by the end of the period.

Croatia not likely to introduce the euro as official currency for at least the next ten years

All projected levels of public debt, even the best-case scenario level, are significantly above the Maastricht criteria level of 60 percent. The main implication of this fiscal indicator is that it will not be possible to introduce the euro as official currency in Croatia for the next ten years at least. This puts pressures on the central bank to keep managing the exchange rate as high financial euroization is contraindicated to HRK/EUR exchange rate depreciation.

Analysis 3 How Deflation Bites?

Average consumer prices in Croatia decreased by -0.2 percent in 2014 leading the economy to deflation – a state of decreasing prices that has never before been present in 24 years of Croatian independence. In ten of the last 12 months, consumer goods prices have been falling, while producer prices decreased by -9.4 percent since November 2012. According to our latest forecast, consumer prices in Croatia are expected to increase minimally in 2015, by 0.1 percent, but the forecast is uncertain as oil prices have been volatile in recent months. If continued, deflation could bring difficulties to policy-makers and postpone the much-needed investment recovery and cleaning up of bad debt.

Food and energy prices are the main deflation drivers

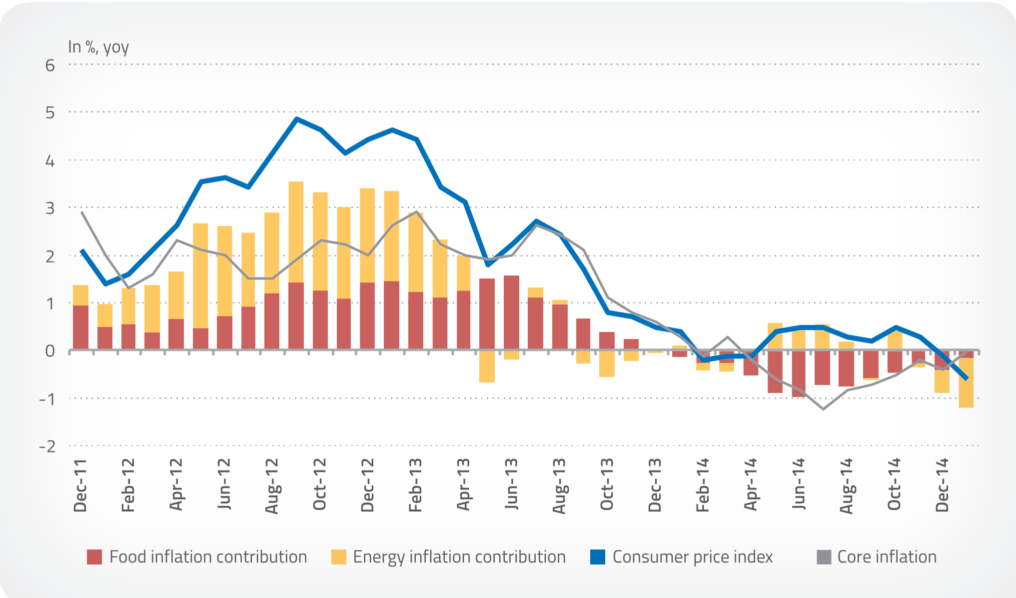
On average consumer prices decreased by -0.2 percent in 2014 when compared to 2013 and deflationary pressures continued in the beginning of 2015 with prices falling by an additional -0.9 and -0.4 percent, respectively in January and in February when compared to the same months in the previous year. The biggest contribution to deflation came from food prices (mostly prices of oils, fat, fruit, vegetables and seasonal food), liquid fuels (down by 19.4 percent in 2014) and partially from lower prices of combined passenger transport, which have probably also been caused by lower fuel prices. These three categories alone constitute more than a fifth of the consumer price index. Reasons behind the downtrending prices of these items are lower global commodity prices and subdued domestic demand. In addition, simplifying import after Croatia joined the EU resulted in an increased competition on food product market and lower food prices from the second half of 2014. Deflation in 2014 would have been even more pronounced without administratively controlled price hikes in the beginning of last year that were related to the increase in the reduced VAT rate.

On the other hand, service and utility prices drove consumer prices up, but not enough to compensate for the drop in goods prices. Package holidays, hospital services, water supply, air transport, and postal services led the way to limited inflation, while tobacco prices represented the biggest price hike in goods. The latter contributed to the CPI as much as half a percentage point, a result of higher excise taxes.

Low prices here to stay in 2015

We expect the consumer price index to stay negative in the second quarter but the overall average consumer price index to be at 0.1 percent in 2015. Low world oil prices recorded at the beginning of the year are the main reason behind moderate inflation expectations. Low energy prices are keeping food prices down too as transportation costs, one of the main cost components in food distribution, are falling. The second reason for our forecast is poor domestic demand, driven mostly by joblessness and disposable income erosion, but possibly also by moderate deflation expectations. Finally, the Government will not offset deflation by rising administratively determined prices in the election year, and having in mind some of the announced measures, such as lower gas prices for households, we believe that the Government will add to deflation in this year.

Figure 9
Consumer Price Index and the Contributions from Its Main Components



Source: Eurostat.

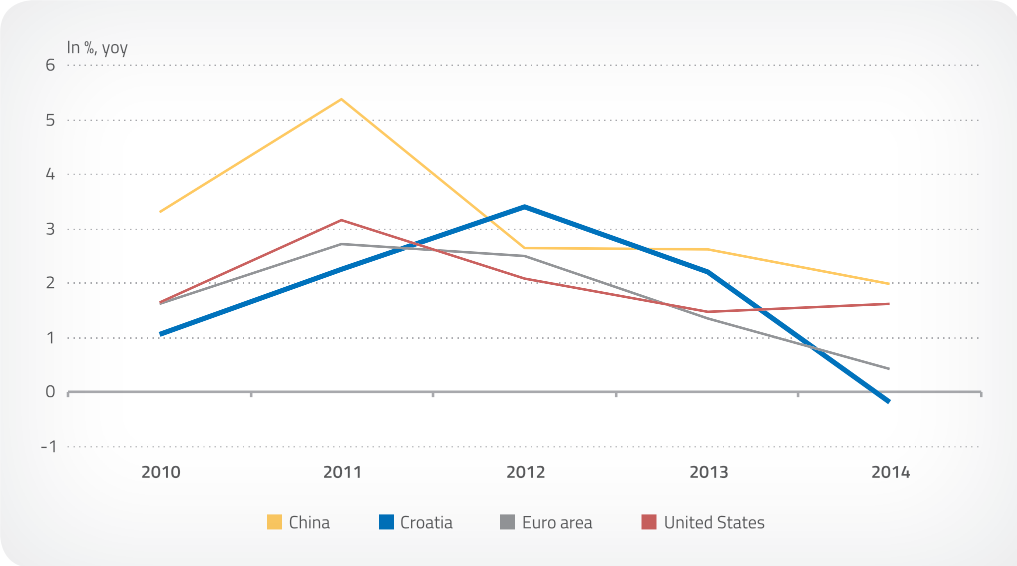


Figure 10
Consumer Price Index in Croatia and the World

Source: International Monetary Fund International Financial Statistics.

Are deflation and below-target inflation becoming world-wide phenomena?

Cheap energy is good for the economy, especially for energy-intensive industries, but also for household budgets as it leaves a part of their income disposable for other uses, consumption or saving. However, these cost cuts are good only if they are temporary. If falling prices persist, it will make households and companies less willing to invest or to spend as they expect goods and services to become even cheaper. The problem goes even beyond that simple calculation. The developed world has witnessed a rise in employment in the last few years. However, increasing number of employed persons has not been followed by higher wages, as was the case in the boom up to 2008. Instead, labor market flexibility decreased workers' bargaining power. Without this bargaining power, firms are not "forced" to offer higher wages for their employees, thus, there is no wage-push inflation. In a country with high unemployment rate, such as Croatia, workers' bargaining power is even more limited as labor supply is way in excess of demand. Therefore, despite recent economic growth recoveries around the world, prices seem to be falling or increasing only modestly everywhere, even in booming economies, and even in non-food and non-energy products (Figure 10). Demand is obviously weakening. Prices in eurozone increased by only 0.4 percent in 2014 and in January deflation was at -0.6 percent. In the first month of this year deflation was recorded in 23 out of 28 EU members, while the highest rate was recorded in Malta, a meager 0.8 percent. In Croatia even core prices recorded negative growth rates in ten out of last years' twelve months.

The traps of deflation

We probably know more about inflation than we know about deflation as there is a consensus that high inflation introduces uncertainty in decisions and productions, and it threatens stability of the country. If purchasing power is rapidly declining, the currency loses worthiness thus leading to currency instability. Inflation between one and four percent is considered not to be detrimental for growth, and in developing countries it can even be higher. With respect to that, most central banks in the developed world are committed to targeting inflation slightly below two percent a year. Evidence suggests that continued disinflation causes output to drop. Deflation also causes output to drop but it increases the real value of debt as well. It is considered that the four main risks of prolonged deflation are the deflationary spiral, job losses, rising debt burden, and ineffectiveness of monetary policy.

Deflationary spiral

When consumers expect deflation/inflation they postpone/accelerate their decision to buy because they expect cheaper/more expensive goods. This only deepens either the lack of demand, in the case of deflation, or excess demand, in case of inflation, thus feeding the deflationary or the inflationary spiral. The most obvious and illustrative example is real estate. To buy an apartment in the Croatian capital in 2008 was an expensive undertaking. A square meter then would have cost you somewhere between 1,800 and 3,500 euros. Today, seven years later, real estate prices in Croatia are 30 percent lower and nowhere close to the levels at the peak of the boom (Figure 11). As real estate prices are further reduced and deflation expectations are feeding on latest economic outlook forecasts, potential buyers are delaying their purchase as they expect prices could go down even more.

Job losses

When prices decrease, corporate profits normally decrease too and in the quest to cut expenses in order to balance out, companies can either cut wages or cut the number of workers. However, wages are "sticky", meaning it is very difficult and from a political or corporate perspective – unpopular, to cut nominal wages. Therefore, companies lay off workers when pressured by deflation. On the other hand, workers that do "save" their jobs become richer in real terms because their nominal wage does not change in an environment of falling prices.

Rising debt burden

Deflation hits indebted companies and Governments the most. Companies are hurt as it becomes harder to repay the unchanged amount of existing debt when revenues are pressured by falling prices, which makes profits lower. The Government is also threatened both on the revenue and on the expenditure side as lower prices transform to lower tax revenues (especially VAT revenues that are the main Treasury funding source in most countries), leading to problems with debt repayments as the principal stays unchanged while revenues cut back.

Monetary policy ineffectiveness

In a recession, the textbook recipe for monetary policy is to loosen, or to expand money supply so that it can feed the economy with "cheap" money. When there is at least some inflation, the central bank can loosen monetary policy by affecting the real interest rate. Normally, it will try to keep the headline rate minimal, down to zero percent. However, in the case of deflation, the central bank has no space to lower the headline rate as it cannot be negative[1]. Thus deflation hinders interest rate cuts and makes monetary policy ineffective. Having in mind massive and ongoing quantitative easing and interest rates in most developed economies already at or close to zero, the question is what central banks will do in the case of future shocks. They can either adjust their exchange rates when this is possible or devaluate internally by "unsticking" nominal wages. Politically, it is always easier and more desirable to do the former because nominal wage cuts are bad for workers' morale that is in turn hurting worker productivity.

Monetary policy (in)effectiveness when exchange rate is fixed and capital is mobile

However, countries whose currencies are pegged to the euro (or other currency) do not have independent monetary policies as they prefer capital mobility and a fixed exchange rate. In order to spur demand when it is lacking, they have to rely on ECB's quantitative easing or on fiscal policy, but only if there is fiscal space to do so. Easing monetary policy too much is expensive for peggers as it can stimulate capital outflows leading to depreciatory pressures and inflation. The latter is desirable to some extent, but it must not go too far. Countries with high financial euroization, such as Croatia, are very vulnerable to exchange rate depreciation as it makes their foreign currency debt higher. With

1 Actually central bank interest rates can be, and in some countries they are, negative. However, in that case it would be rational to withdraw cash. Although this is bad for financial stability of a country, in terms of national economy negative interest rates imply capital flight and with it exchange rate depreciation that can be beneficial for competitiveness.

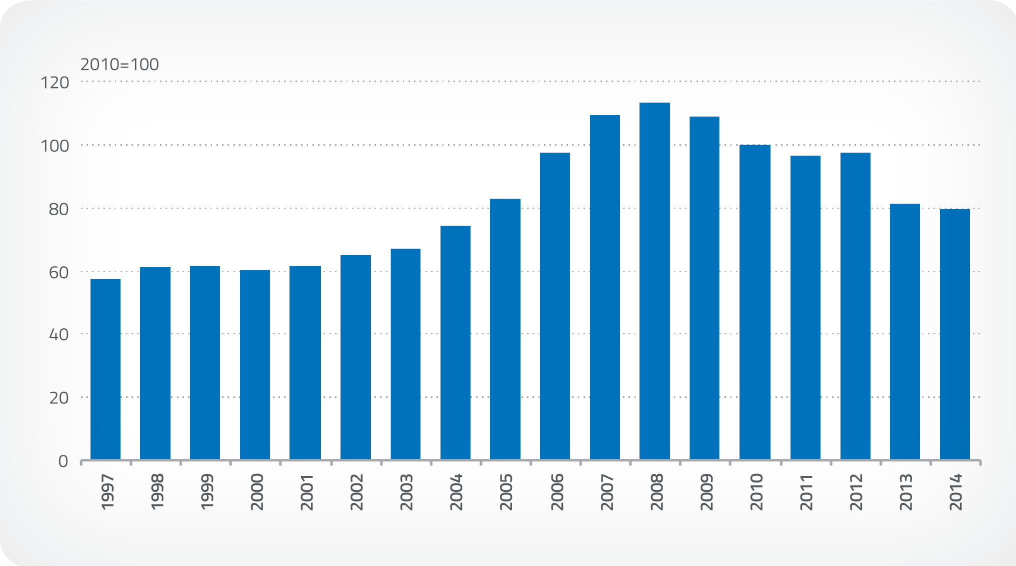


Figure 11
Hedonic Real Estate Price Index for Croatia

Source: Croatian National Bank.

that constraint in mind, currency devaluation is not much of an option.

Internal devaluation as the only option?

With the constraint of a stabile HRK/EUR exchange rate, and no fiscal space due to fiscal deficits, high public debt and associated pressures from the EU, Croatia does not have many options to help the economy grow. What seems to be the only solution is internal devaluation. Internal devaluation mimics the effect of nominal exchange rate depreciation, i.e. it increases international competitiveness. This is done by lowering labor costs, either by decreasing nominal wages or by reducing social security contributions paid by the employers. We have recently witnessed an experiment with the latter, when social security contributions were reduced by 2 percentage points, but it was an unsuccessful experiment as they were swiftly brought back to their previous level of 15 percent. The measure did not work because it resulted in lower budget revenues, and with a big deficit to finance, the Government could not afford to wait for the effects of internal devaluation to manifest. Cutting nominal wages would probably be beneficial for the budget as it would reduce expenditures and ease the pressures on deficit financing. However, it would yield negative short-term effects on consumption and GDP growth, not to mention the cost of potential social unrest.

Pegged versus floating exchange rate regimes

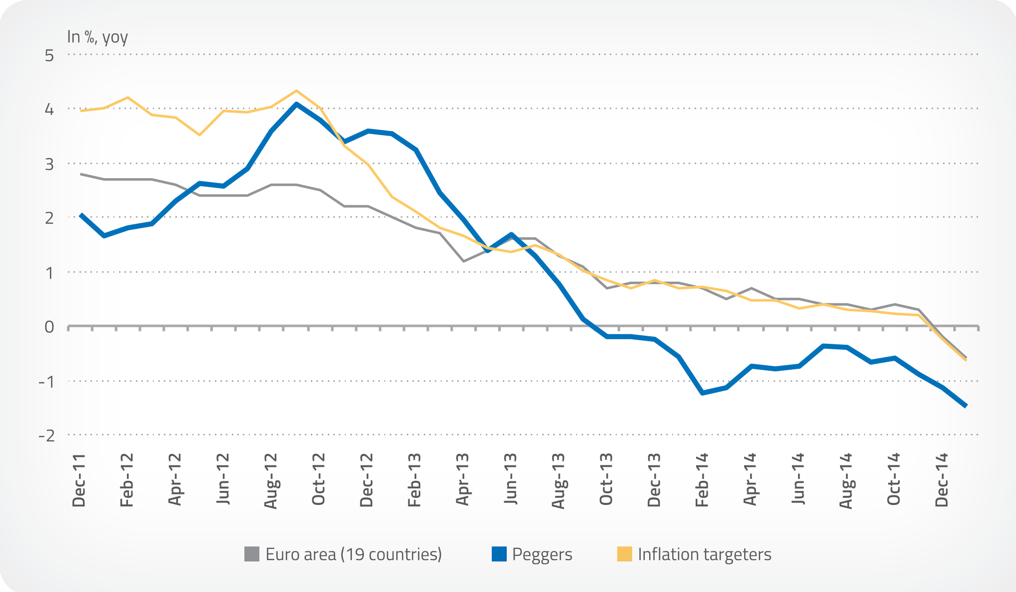
As IMF recently noted[2], deflation in the new EU member states is stronger in countries that peg their exchange rate to the euro when compared to countries that target inflation and have a floating exchange rate regime. Croatia is in the first group together with Bulgaria, while Czech Republic, Hungary, Poland, and Romania are in the second group of countries. One must note that Bulgaria and Croatia do not have identical exchange rate regimes. While Bulgaria runs a currency board and its exchange rate to the euro is fixed, Croatia has a managed exchange rate system in which some deviations are allowed.

In light of close trade links, as is the case with eurozone and other EU members, some deflation from the eurozone was imported to new member states outside the eurozone. In case of a fixed exchange rate, the total imported deflation effect spills over to the national economy, as is the case in Bulgaria. Data corroborate our view, as consumer prices in Bulgaria have been falling from August 2013 and in January this year they decreased by as much as -2.3 percent. In Croatia, the effectiveness of this channel was a bit moderated by a slight depreciation of the domestic currency to the euro, but

2 Iossifov, Plamen and Jiri Podpiera, 2014, "Are Non-Euro Area EU Countries Importing Low Inflation from the Euro Area?", IMF Working Paper, No. 14/191, Brussels: International Monetary Fund.

on average these two countries depicted the strongest fall in consumer prices when compared to inflation targeters and to the eurozone. Inflation targeters managed to synchronize their inflation with the eurozone as they allowed their exchange rates to adjust to new terms of trade. Naturally, lower import prices are not the only channel that is feeding deflation. Food and energy prices are still dominant and they have been under pressure by the recent oil price decrease.

Figure 12
Consumer Prices in Three Groups of Countries with Respect to Their Exchange Rate Regime



Source: Eurostat.

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