REPUBLIC OF CROATIA

MINISTRY OF FINANCE

ECONOMIC AND FISCAL POLICY GUIDELINES FOR THE PERIOD 2012 – 2014

Zagreb, July 2011

CONTENTS

1. INTRODUCTION AND SUMMARY

The conditions in which the fiscal policy is formed for the upcoming medium-term period are determined by the consequences of the crisis impacting both the domestic economy and the economic environment, which impose the need for further stabilisation actions by the fiscal policy, preserving at the same time social equity, protecting the most vulnerable population groups and actively contributing to strengthening the competitiveness of the economy and accelerating its recovery and growth.

The recent conclusion of the negotiations on full membership in the EU places Croatia in a new economic context and opens up a new space for accelerated growth of the Croatian economy. For fiscal policy, this represents an additional incentive to strengthen the stability of public finances, accommodating at the same time both membership fees and the funds to be received from the European budget.

Fiscal policy for the upcoming medium-term period is formed in the context of recovery of the domestic economy and the EU economy, but also the uncertainties arising from the eurozone crisis and the manner in which it will be resolved. It was the speed of spreading of the fiscal imbalances, recorded in all EU countries during the crisis, as well as the eurozone crisis itself, that brought fiscal policy and fiscal imbalances into the focus of interest of the rating agencies, financial markets and investors. Although in that period Croatia's fiscal deficit remained below the EU average, the objective economic environment indicates the necessity for strengthening the stability of Croatian public finances and lowering the fiscal deficit in the upcoming period. This also means that in the upcoming years the effects of economic recovery cannot, as it was the case in the pre-crisis period, spill over to expenditure growth, and it will not be possible to revert to expenditure growth trends from the pre-crisis period. The fiscal space opened up through economic recovery and growth must be utilised to settle financial imbalances, and space for the real need for growth of individual categories of expenditure and protection of social equity must be sought primarily within the structure of expenditure itself, i.e. through improving the efficiency of budget expenditure, which is planned to be achieved by implementing key structural reforms. These economic facts and circumstances are supported in the legislative sense by the Fiscal Responsibility Act, which requires lowering the share of total expenditure in GDP by one percentage point until primary budget surplus is achieved, i.e. until the amount of total deficit becomes less than the amount of interest paid.

In accordance with the above, the fundamental fiscal policy goal in the upcoming medium-term period is to correct budget imbalances by lowering the share of budget expenditure in GDP, reducing the deficit, and halting the growth and initiating the gradual decline of the share of public debt in GDP. These fiscal policy goals arise from the Fiscal Responsibility Act, but also from the objective economic and financial circumstances in the domestic and international environment which demand stronger credibility and sustainability of public finances. Such fiscal policy orientation will strengthen Croatia's investment credit rating and create conditions for its improvement. At the same time, the implementation of these fiscal policy goals means that in the upcoming period the policy should be counter-cyclical, i.e. it should reduce the fiscal impulse given through the deficit in parallel with the recovery of the economy, which represents a method of managing fiscal policy appropriate for a developed member of the EU.

It is an undisputable fact that fiscal policy should contribute to accelerating the economic recovery and strengthening the capability of the private sector for growth and employment.

However, the manner in which fiscal policy will perform these functions in the upcoming period no longer corresponds to the pre-crisis model in which the state generated growth through high consumption and extensive public investment, which resulted, among other things, in its inability to react forcefully in the moment of crisis. The support to competitiveness and economic growth will come from reducing the costs of government, alleviating its pressure on the financial market and interest rates, and improving the efficiency of its institutions.

Projections in these Guidelines were prepared in the period preceding the parliamentary elections. In this context, revenue projections were made on the basis of the existing tax system structure taking into account the effects of accession and full membership of the Republic of Croatia into the EU, while expenditure projections were made in accordance with the rules defined by the Fiscal Responsibility Act.

In accordance with economic circumstances and the Fiscal Responsibility Act, the expected budget deficit will decline from 4.3% of GDP in 2011 to 3.4% in 2012, to 2.3% of GDP in 2013, and to 1.6% of GDP in 2014. Total consolidated general government deficit will decline from this year's 4.9% of GDP to 3.8% of GDP in the following year, 2.6% of GDP in 2013 and 1.8% of GDP in 2014.

The implementation of the Fiscal Responsibility Act will be monitored according to deficit calculation in line with the EU standard, i.e. the ESA 95 methodology. According to ESA 95 standard, deficit calculation includes payments under called guarantees, as well as payments under debt to pensioners. Therefore the deficit according to ESA 95 will decline from this year's 5.4% of GDP to 4.1% of GDP in the following year, 2.7% of GDP in 2013, and 1.8% of GDP in 2014. Debt repayment to pensioners will be completed in 2013 and the deficit according to ESA will thereby become aligned with deficit accounting according to the Croatian accounting plan in 2014.

The described deficit trend indicates that in 2013 a primary surplus of 0.2% of GDP will be achieved, enabling a change in the course of public debt and a gradual reduction of its share in GDP. A lower deficit in the upcoming period also implies reduced financing needs, considering that the total financing needs are determined as the sum of payments due in a given year and the amount of deficit in that year. In addition, with a view to stabilising public debt and reducing the need for loans, in the upcoming period deficit is planned to be financed from non-debt instruments, e.g. sale of equity, shares and government property, which will also provide a contribution to the efficient functioning and competitiveness of the economy.

2. MEDIUM-TERM MACROECONOMIC TRENDS

2.1. International macroeconomic environment

Following the decline of economic activity during 2009, EU economies started to recover in 2010. The economic recovery lead by Germany remained inconsistent nevertheless and the growth rate of EU economy in 2010 amounted to 1.8%. The greatest contribution to the growth of economic activity at the level of the entire European Union came from inventory replenishment with a balanced contribution of domestic and foreign demand, while foreign demand provided the greatest contribution to the economic growth of the eurozone. In 2011 EU economy is expected to grow at the same rate as in 2010, while the real growth of the eurozone GDP should slow down to 1.6%. In 2012 real growth of GDP is expected to accelerate to 1.9% in the European Union and to 1.8% in the eurozone.

Table 1: International environment - macroeconomic indicators

	2009	2010	Projection 2011	Projection 2012
Real gross domestic product growth				
World	-0.6	4.9	4.0	4.1
European Union	-4.2	1.8	1.8	1.9
Italy	-5.2	1.3	1.0	1.3
Germany	-4.7	3.6	2.6	1.9
Slovenia	-8.1	1.2	1.9	2.5
Eurozone	-4.1	1.8	1.6	1.8
Consumer price index, annual change				
European Union	1.0	2.1	3.0	2.0
Eurozone	0.3	1.6	2.6	1.8
Oil price increase, %	-37.1	29.5	46.4	-0.2

Source: European Commission: Economic Forecast, Spring 2011

In 2010 inflation accelerated to 2.1% in the European Union and to 1.6% in the eurozone as a result of rising prices of raw materials, primarily oil and agricultural raw materials, but also the increase in administrative prices, indirect taxes and import prices. In 2011 inflation is expected to rise further to 3.0% in the European Union and to 2.6% in the eurozone. This is due to rising oil prices, the effects of which will be partially cancelled by weak economic growth, low wage growth and low unit labour cost growth. Oil prices are expected to stop rising during 2012 which would result in inflation slowing down to 2.0% in the European Union and to 1.8% in the eurozone.

In light of the fact that the Republic of Croatia carries out over 60% of its trade with the EU Member States, the forecasts of economic trends in the European Union have a significant influence on expected economic trends in Croatia. In addition to trade, economic trends in the European Union affect the Croatian economy via tourism as over 80% of foreign tourist arrivals and nights are made by tourists from EU Member States. In that context, projections of economic trends in Croatia depend to a large extent on the situation in Germany, Italy and Slovenia, since Croatia is most closely linked with these states in terms of economy.

After two consecutive years of decline of economic activity, in 2010 Italy saw a real GDP growth of 1.3%, with the biggest contribution made by domestic demand. In the upcoming two-year period real GDP growth is projected at 1.0% in 2011 and 1.3% in 2012. Domestic demand is expected to continue to provide the greatest contribution to economic growth, but net export is also expected to make a positive contribution due to the significant recovery of the export sector. Inflation is expected to increase to 2.6% in 2011 as a result of rising prices of raw materials, after which it is expected to decline to 1.9% in 2012. Even though economic growth is foreseen in Italy, risks are present related to recent financial market trends, which could have a major effect on Croatia. This is apparent from the example of the crisis in Greece which has significant implications for Croatia even if its effects are only indirect through financial markets. If the risks were to materialise in Italy, they would have a significantly greater impact on Croatia in view of the trade and direct financial ties between Croatia and Italy.

In 2010 the Slovenian economy recorded a real GDP growth of 1.2% after a severe contraction in economic activity in 2009. The economic growth was mostly due to inventory replenishment and the positive contribution of net export. Economic recovery is expected to intensify over the projection period with a real GDP growth of 1.9% in 2011 and 2.5% in 2012. In 2011 the greatest contribution to real GDP growth is projected to come from net export, while in 2012 domestic demand will provide the greatest contribution to growth, accompanied by an expected positive contribution of net export. Inflation is projected to increase to 2.6% in 2011 and to decline to 2.1% in 2012. The relatively lower projected growth of investment in relation to the period before the crisis and the need for refinancing the majority of assets of domestic banks represent negative risk in projections for the Slovenian economy.

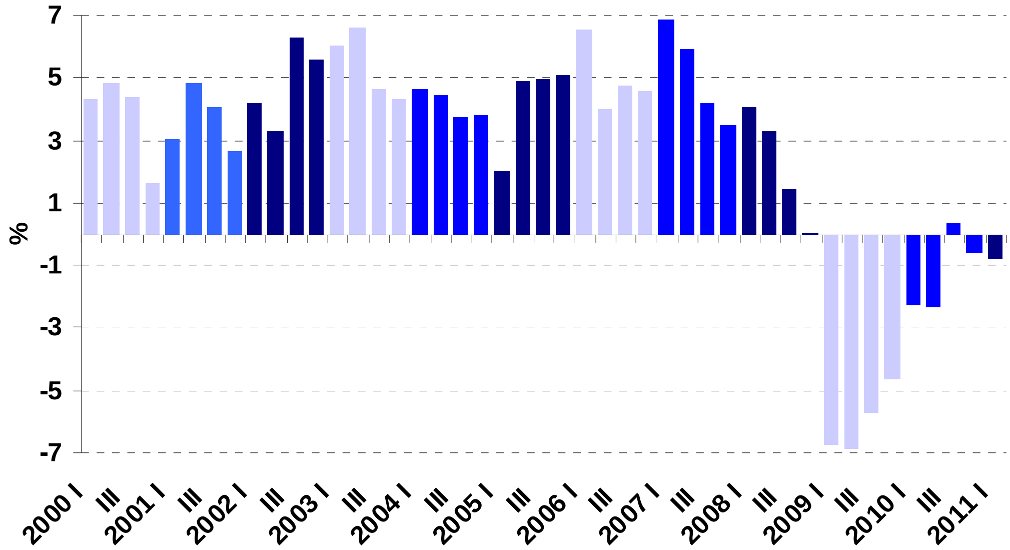
In 2010 the German economy saw a strong recovery, recording a real GDP growth of 3.6%. The greatest contribution to economic growth came from domestic demand, and a significant positive contribution was made by net export. Real GDP growth is projected to slow down to 2.6% in 2011, followed by 1.9% in 2012. Economic growth is expected to be mainly driven by domestic demand with a slightly positive contribution of net export in 2011, and its neutral contribution in 2012. Inflation is projected to accelerate to 2.6% in 2011 and to slow down to 2.0% in 2012. The major negative risk refers to the accelerated rise of raw material prices, which could impact economic growth through the decline of consumer optimism and the negative impact on trade.

The dynamics of recovery of European economies is naturally strongly impacted by the crisis in the eurozone and the instability and insecurity on the global financial market which is also affected by the relatively slow recovery of the US and their fiscal problems. The eurozone crisis, which arose directly from the Greek debt crisis, brought credibility and sustainability of the fiscal policy in the focus of interest of the rating agencies, financial analysts and investors. Therefore countries such as Portugal, Spain and Italy also found themselves in the insecure zone, facing rising yields on their sovereign bonds and strong pressure to lower the fiscal deficit. The recovery of the European economy undoubtedly has positive effects on Croatia through external trade. However, the insecurity on the European and global financial market threatens the sustainability of the recovery, and on the other hand clearly indicates the necessity of fiscal adjustment in Croatia in order to strengthen the credibility and sustainability of the fiscal policy, maintain the trust of the financial markets and prevent further spill-over of the crisis to Croatia.

2.2. Macroeconomic environment in Croatia in 2010 and 2011

After the impacts of the global economic and financial crisis which reflected on the Croatian economy mostly during 2009, in 2010 negative trend was significantly milder. Despite the economic crisis, macroeconomic stability and stability of the financial sector were preserved. The decline of the real gross domestic product slowed down from 6.0% in 2009 to 1.2% in 2010. The quarterly dynamics in 2010 indicate the largest real year-on-year GDP decline in the first and second quarter, a mild growth in the third quarter followed by another drop in the last quarter. In the first quarter of 2011 GDP recorded a real year-on-year decline of 0.8%, while a real GDP growth of 1.5% is expected in overall 2011.

Chart 1: Real GDP growth of the Republic of Croatia



Source: CBS

In 2010, all components of GDP recorded a real decline on the year-on-year level, except the export of goods and services which increased by 6.0%. The largest real year-on-year decline was recorded by gross fixed capital formation, which declined by 11.3% in comparison to 2009, followed by import of goods and services with a decline of 1.3%, household consumption with a decline of 0.9%, and government consumption by 0.8%. In the first quarter of 2011 GDP recorded a real year-on-year decline of 0.8%. All components on the expenditure side of GDP recorded a real year-on-year decline in the first quarter of 2011. The largest decline was recorded by export of goods and services, followed by gross fixed capital formation and import of goods and services. Government consumption and household consumption had the smallest real year-on-year decline in the first quarter.

After a drop in economic activity in the first quarter, the high frequency indicators published to date point to a mild recovery of economic activity in the second quarter of 2011. In April and May industrial production increased by 0.7% on a year-on-year level, real turnover in retail trade increased by 2.3%, export of goods by 8.9%, and import of goods by 4.8%. The year-on-year increase in the number of unemployed persons registered at the Croatian Employment Service declined continuously during the first half of the year and amounted to 0.6% in June.

Table 2: Overview of basic macroeconomic indicators (year-on-year change)

	2009	2010	2011 Q1	2011 IV - V
Gross domestic product (real, %, sply)	-6.0	-1.2	-0.8	-
Industrial production (%, sply, original)	-9.2	-1.4	-3.6	0.7
Retail trade turnover (real, %, sply)	-15.3	-1.8	-0.5	2.3
Export of goods (HRK, %, sply)	-20.1	17.4	2.7	8.9
Import of goods (HRK, %, sply)	-25.7	-1.3	5.1	4.8
Number of registered unemployed (ep, %, sply)	21.2	9.7	3.6	0.8
Consumer price index (%, sply)	2.4	1.1	2.2	2.4
Total loans (ep, %, sply)	2.3	8.1	8.4	8.7

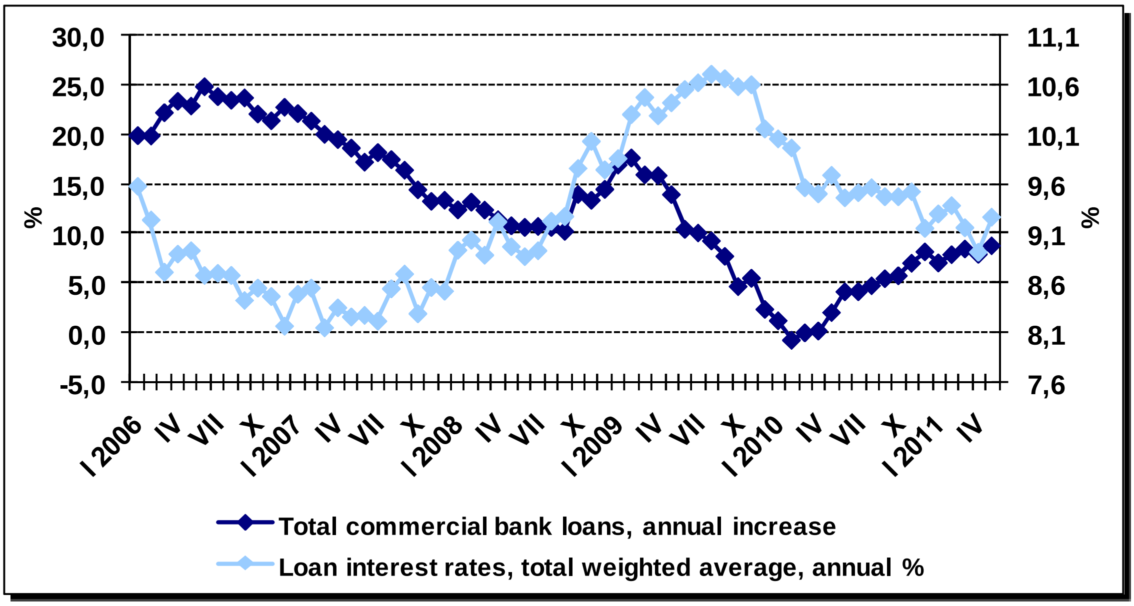
sply – *same period last year.* **ep** – *end of period*

Source: CBS, CNB

The year-on-year increase of the consumer price index amounted to 2.0% in June 2011. On a year-on-year level, the increase of prices in June was mostly due to food prices, in particular the higher price of bread and cereals, and the price of oil and fats. A significant contribution to the year-on-year increase came from the prices of fuel and lubricants for personal transport equipment and the price of tobacco. Clothing and footwear prices had the largest impact in terms of alleviating the year-on-year price increase in June. In the first six months of 2011 the consumer price index recorded a year-on-year increase of 2.3%.

Despite the crisis, the Croatian financial system remained stable and Croatia avoided the costs of stabilising the banking system which many European countries were faced with. However, due to the interrupted flow of capital at the beginning of the crisis, the domestic banking system reacted by increasing the interest rates, both passive and active. In addition, the first half of 2010 saw a complete stagnation in loan activity, caused partly by a sudden increase in bad loans and the subsequent reaction of the banking system towards avoiding any risk. From the second half of 2010 a mild recovery has been recorded in loan activity, especially in loans to companies, as well as a mild decline in interest rates. In the previous period, monetary policy measures were aimed at increasing the liquidity of the banking system, and the Government programmes via Model A and A+ at increasing the availability of funds at low interest rates. However, despite the full usage of funds and very good liquidity of the banking system, loan activity is still recovering at a very slow rate.

Chart 2: Total commercial bank loans and interest rates



Source: CNB

Using the so-called leading indicators methodology, the Institute of Economics, Zagreb and the Ministry of Finance produce the complex forecasting index CROLEI. The calculation of CROLEI index for 2011 is based on the revised leading CROLEI system. The CROLEI index recorded a 1.2% increase on a year-on-year level in March 2011. The continued growth of the year-on-year index points to the conclusion that the economic activity is starting to recover after hitting the bottom in late 2009, and economic recovery can be expected in the second half of this year.

2.3. Macroeconomic projections for the period 2012 – 2014

Macroeconomic projections are based on available information and statistical indicators published in the first half of 2011. A real GDP growth of 1.5% is expected in 2011, followed by an acceleration up to 2.5% in 2012, 3.5% in 2013 and 4.0% in 2014. In the upcoming period, economic activity will be supported by the expected favourable trends in the economic environment, primarily further economic trends in the European Union as indicated by projections of the European Commission for 2011 and 2012. The increase of economic activity in Croatia is based on the gradual recovery of personal consumption and the investment cycle. The gradual acceleration in growth of investment is based on the impulse to investment recovery which will be provided by the already initiated investment projects of public enterprises and the private sector, the expected rising impacts of the use of EU funds, and the process of fiscal consolidation aimed at reducing obstacles and creating favourable conditions for the growth of business activity in the private sector. The gradual nature of recovery and its acceleration towards the end of the projection period arise from the time gaps necessary to translate the economic policy measures into real trends.

After two years of decline in economic activity in Croatia, its recovery and a real GDP growth of 1.5% is expected in 2011. The reason that the intensity of recovery is lagging behind comparable foreign economies should be sought primarily in the accumulated structural limitations due to which the increase in foreign demand cannot sufficiently compensate for the lack of increase in domestic demand. The economic crisis which commenced in late 2008 demonstrated the unsustainability of the pre-crisis model of Croatian economic growth based on the increase in domestic demand, largely financed by the inflow of foreign capital. Under such circumstances, the insufficient base and the unfavourable structure of the export of goods, accompanied by a relatively low competitiveness of the national economy, prevent the increase in foreign demand from fuelling a stronger recovery in a short period of time.

Table 3: Projections of macroeconomic indicators of the Republic of Croatia

	2009	2010	Projection 2011	Projection 2012	Projection 2013	Projection 2014
Gross domestic product, in HRK million	335,189	334,564	347,565	363,500	383,068	407,795
GDP per capita, in HRK	75,679	75,538	78,473	82,071	86,489	92,072
GDP per capita, in EUR	10,311	10,367	10,619	11,151	11,783	12,544
Gross domestic product, real growth (%)	-6.0	-1.2	1.5	2.5	3.5	4.0
Personal consumption	-8.5	-0.9	0.8	2.9	3.9	4.3
Government consumption	0.2	-0.8	-0.1	-1.1	-0.5	0.2
Investment	-11.8	-11.3	3.2	5.6	6.9	7.6
Export of goods and services	-17.3	6.0	3.6	4.4	6.0	7.0
Import of goods and services	-20.4	-1.3	3.9	5.3	6.6	7.6
Consumer price index, % annual change	2.4	1.1	2.7	2.3	2.0	2.0
Survey unemployment rate, annual average (%)	9.1	11.8	12.6	12.2	11.3	9.5
Current balance account, share in GDP (%)	-5.2	-1.1	-2.0	-2.5	-3.0	-3.5
External debt, share in GDP, end of period	99.1	101.1	101.0	98.8	96.8	95.3
General budget deficit, share in GDP (%)	-3.2	-4.3	-4.9	-3.8	-2.6	-1.8
Public debt, share in GDP (%)	35.1	41.2	47.5	49.2	49.3	48.1

Source: Ministry of Finance, CBS, CNB

Projections indicate a mild increase in personal consumption by 0.8% in real terms in 2011, followed by a stronger recovery in personal consumption and an increase of 2.9% in 2012, accelerating to 3.9% in 2013 and to 4.3% in 2014. Despite the expected faster recovery of consumer optimism in the remainder of the projection period, associated in particular with the upcoming accession to the EU, the marginal propensity to consume is not likely to reach pre-crisis levels. In this context, although it is expected that household consumer credit will see a real growth starting from 2012, in order to bring its contribution to the increase in personal consumption in the medium-term period anywhere near the pre-crisis amounts, the equilibrium active interest rates offered by the commercial banks in the consumer credit market would have to be significantly lower than at present, which requires a pronouncedly expansive credit policy of the domestic banking sector, but also a favourable situation in the foreign financial markets which are still marked by a high level of uncertainty.

The real growth of investment in fixed capital in 2011 is estimated at 3.2%. In the medium-term period, investment consumption of the private sector is expected once again to contribute to a large extent to further economic growth. The necessary presumptions for this are a stable foreign financial framework and further acceleration of economic growth in the environment, which implies an absence of new macroeconomic shocks and a more pronounced recovery of domestic demand. In addition to this, in view of the expected weaker inflow of foreign capital into Croatia in comparison with the pre-crisis years, the financing of the business sector will require a developmentally oriented change in the structure of total assets of the domestic banking system and decrease of the equilibrium real interest rate to the level which would support a gradual improvement in the competitiveness of domestic companies. Since credit demand in the household sector is not expected to reach pre-crisis levels in the medium-term period, and taking into account the planned fiscal consolidation which should rectify the squeeze-out effect, the credit capacity of commercial banks should certainly be sufficient for adequate financing of the business sector without placing excessive pressure on the rise of active interest rates. Moreover, the upcoming accession to the European Union will, in addition to a favourable impact on the improvement of the business climate in general, also contribute to the growth of investment through access to EU funds at the end of the projection period. In accordance with the above, a real investment growth of 5.6% is foreseen for 2012, followed by an acceleration to 6.9% in 2013, and to 7.6% in 2014.

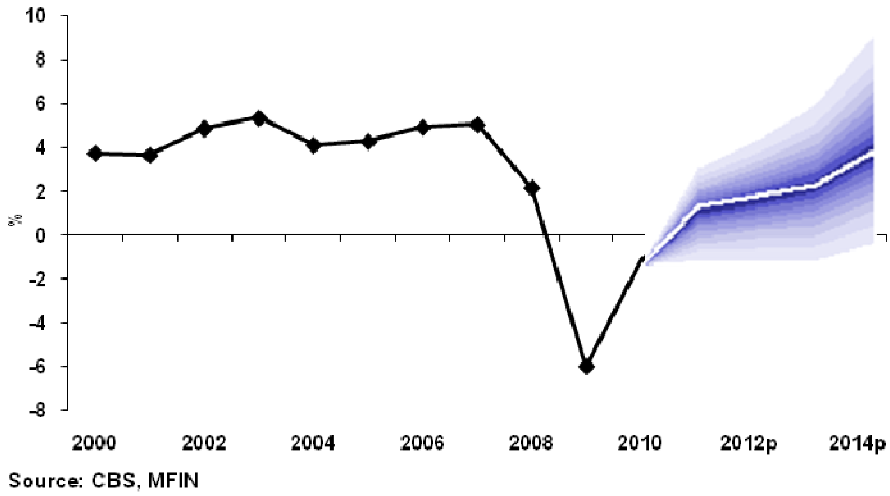
As regards net export, after two years of positive contribution, in 2011 a mildly negative contribution to real GDP growth is expected, primarily due to high import dependency of the Croatian economy, which cannot be realistically expected to see a radical change over the projection period. Assuming that economic conditions will improve further in the domestic and foreign environment, the contribution of net export to economic growth is expected to remain negative in the upcoming years. However, it should be noted that the expected negative contribution of net export in the end of the projection period is significantly lower in comparison with the period before 2008. A more pronounced acceleration of growth of imports is foreseen over the observed period in comparison with the exports of goods and services. This is due to the expected stronger recovery of domestic demand in the upcoming period which will result in increased imports.

Assuming that import demand will continue to rise abroad, exports growth should also gradually accelerate towards the end of the projection period. Positioning exports as the component which will drive the economy and contribute to economic growth in a larger extent represents a challenge for the upcoming period. A relatively small economy and market such as the Croatian one requires in the long term a smaller sector of non-tradable goods, and a larger sector of tradable goods, a more flexible labour market, lower entry and operating costs and an optimal exchange rate, in order to achieve, through specialisation, higher competitiveness of exported products, preferably of higher value added, and a productivity growth sufficient for a satisfactory rise in the standard of living without creating external imbalances.

The above projections by the year 2014 represent the mode of projected probability distribution. The overall probability distribution of the projections enables the quantification of the impact of uncertainty and is shown in Chart 3. The same-coloured areas of the fan chart represent a 10% probability that the real GDP change will be in the marked range, which means that the coloured area of the chart projection horizon covers 90% of the expected real GDP growth reslizations in a given year. It should be noted that in calculating the probability distribution of the projections the forecasts given by the European Commission were treated as certain, i.e. their uncertainty was not taken into account.

The projection of overall probability distribution indicates a growing uncertainty with a lengthening of the projection horizon. The closest limits of projected real GDP growth are situated in the portion of the probability distribution that contains the distribution mode. Projections indicate asymmetrical distribution, i.e. a higher likelihood that a GDP growth lower than the median projection will be achieved in 2011 and 2012. This is primarily due to the mostly negative risk related to increased prices of oil and other raw materials in the global markets. The projection of probability distribution is symmetrical in the remaining portion of the projection horizon.

Chart 3: Projection of real GDP growth



Source: Ministry of Finance, CBS

The average year-on-year increase of the consumer price index is estimated to accelerate from 1.1% in 2010 to 2.7% in 2011. Acceleration of the average annual inflation rate will mostly be fuelled by imported inflationary pressures, relating primarily to rising prices of energy and raw food materials in the global market. On the other hand, labour market trends which will result in a decline of unit labour cost indicate a decline in inflationary pressure from the cost side. Despite a more pronounced recovery of domestic economic activity and an increase of unit labour cost, a mild deceleration of the average annual inflation rate to 2.3% is expected in 2012, mostly under the influence of the expected decrease of imported inflationary pressures. Inflation is expected to be at the level of about 2.0% in the last two years of the observed period.

Indications of economic recovery, visible in the trends of high-frequency indicators, also reflect in the labour market, which shows a decline in the number of unemployed starting from March. Although the current trends in the labour market can well be under the influence of seasonal factors, the seasonally adjusted data on the number of unemployed also indicate a slight recovery of the labour market when the influence of the seasonal component is excluded. It can therefore be expected that the intensity of negative trends in the labour market will continue to decline towards the end of the year, and the positive response of the labour market to the real sector recovery should be clearly visible in the following year. For 2011, a survey unemployment rate of 12.6% is foreseen. The rate of employment will begin to grow in 2012, gradually accelerating towards the end of the projection period. However, the rate of employment growth is not expected to reach the rate of GDP growth, and labour productivity growth will remain positive throughout the observed period. Taking into account the gradual recovery of the workforce as well, a survey unemployment rate of 12.2% is expected in 2012, followed by a drop to 11.3% in 2013 and to 9.5% in 2014.

2.4. Projection risks

Many risks, both external and internal, threaten the realization of macroeconomic projections. As regards the external risks, it is evident that the global economy, including Croatia's main trade partners, started on a new upward part of the production cycle curve. However, the intensity of further recovery is still uncertain, and financial markets find that one of the major obstacles to sustainable growth is the fiscal deficit in many countries, particularly in the EU, which is not surprising considering that the fiscal expansion carried a large share of the burden when exiting from the economic crisis. Furthermore, the uncertainties arising from the eurozone crisis, the possibility of its spread to a larger number of eurozone members, and the uncertainty resulting from the dynamics of recovery of the US economy and its fiscal consolidation all represent risks to the dynamics of recovery and growth in the economic environment. An complete consolidation of the financial sector is also crucial in increasing the risk apetite and completely lifting the financial leverage essential for further growth. In the previous period we also witnessed the escalation of conflict and instability in North Africa and the Middle East, and the natural disaster in Japan, which raises additional uncertainty regarding the future trends. Naturally, any new negative trends in the environment would reflect on Croatia through many potential channels. The foremost of these are the reduction of foreign demand, increased prices and reduced availability of capital, and stronger consumer and business pessimism.

As regards the internal factors, one of the main risks is the uncertainty related to the banks' propensity to grant credit to domestic sectors, companies in particular, despite having successfully survived the crisis, having sufficient capital and profits, and the fact that the negative trends of 'bad' credit shares in the banks' assets are receding. Moreover, although research has shown that favourable trends are present, the possibility exists that the projections underestimated the persistence of mistrust among the consumers and companies, which would have a negative effect on personal and investment consumption trends, and consequently on GDP. Likewise, extended unfavourable trends in the labour market would slow down the recovery of personal consumption and hinder the process of fiscal consolidation. It should also be noted that the outcome on the real estate market is still uncertain, with repercussions to construction and investment activities, as well as the financial sector. Concerning the inflation projection, the major negative risk is certainly a sharper than expected rise in prices of raw materials on the global market. Projected inflation could also be impacted by a different dynamics of aggregate demand or wages than predicted.

The existence of these risks additionally emphasizes the need to implement fiscal consolidation and increase the efficiency of the public sector. This will be accomplished by implementing further structural reforms defined in the Economic Recovery Programme.

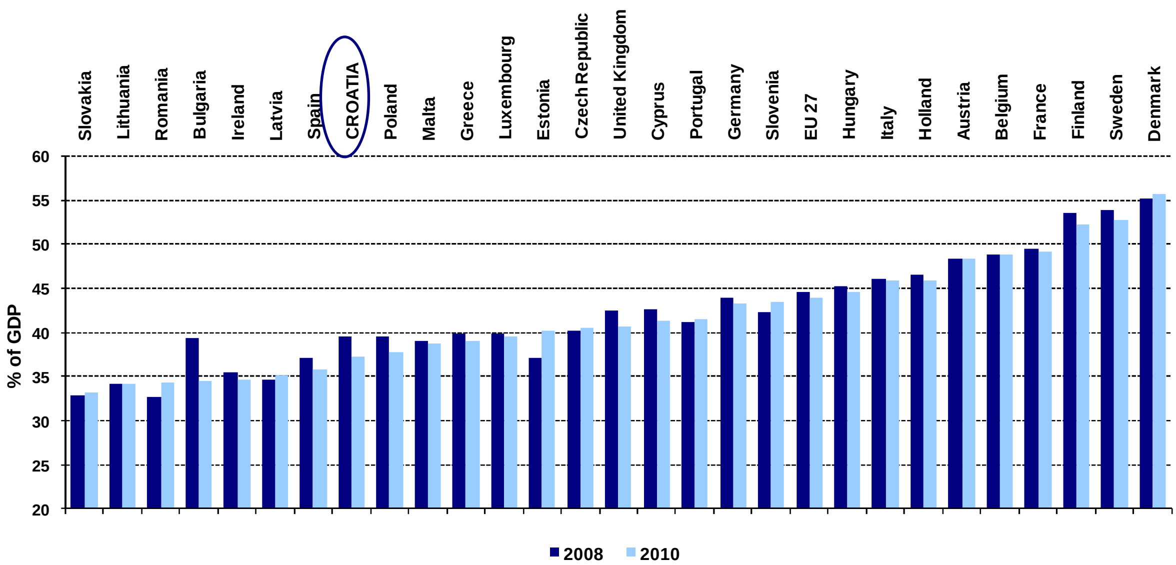
3. MEDIUM-TERM FISCAL POLICY

3.1. The Republic of Croatia and the international fiscal environment

The financial and economic crisis resulted in significant expansion of fiscal deficit and public debt in EU countries. These trends were partly a consequence of the action of automatic stabilizers – components of the budget (e.g. tax income on the revenue side, and unemployment benefits on the expenditure side) which react automatically to a decline in economic activity, but also due to discretionary measures, such as increasing the expenditure in order to alleviate the effects of the crisis.

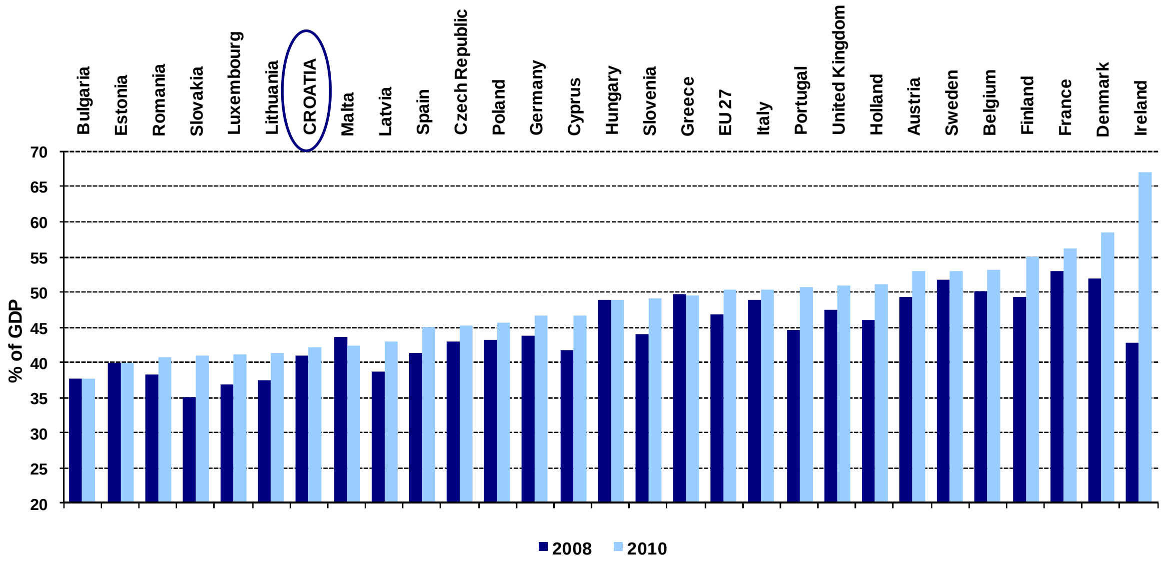
Under such circumstances, under the influence of a decline in GDP and the discretionary measures, total expenditure of EU Member States increased from an average of 45.6% of GDP in 2007 to 50.3% in 2010, i.e. by nearly 5% of GDP, while total revenue decreased by 0.7% of GDP. Individual trends in member states are shown in charts 4 and 5.

Chart 4: Total revenue of consolidated general government of the Republic of Croatia and EU countries



Source: Eurostat, Ministry of Finance

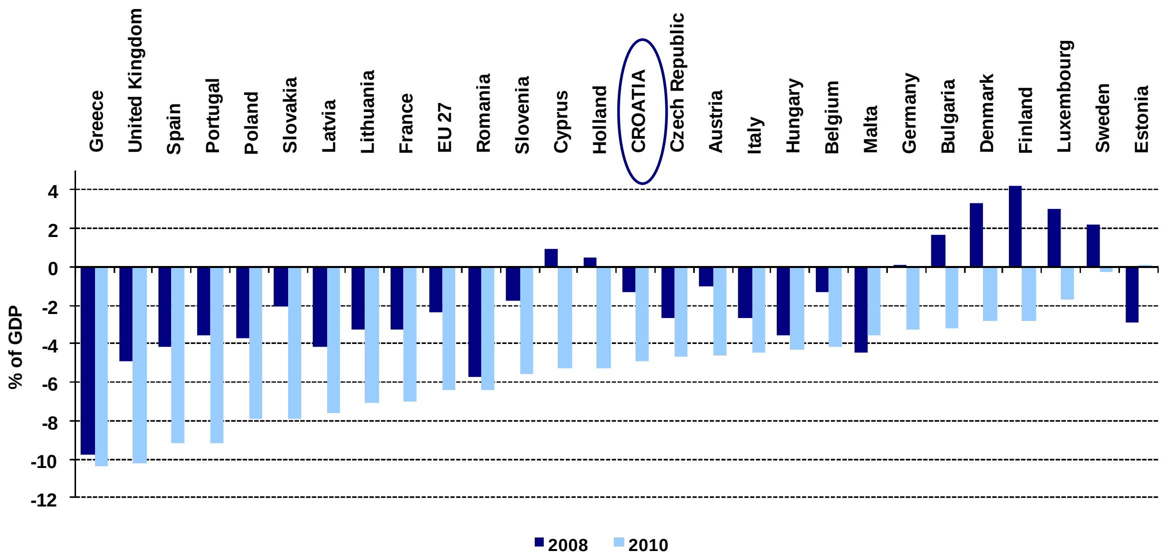
Chart 5: Total expenditure of consolidated general government of the Republic of Croatia and EU countries



Source: Eurostat, Ministry of Finance

As a result of the above, the fiscal deficit of EU Member States increased on average from 2.4% of GDP in 2008 to 6.8% of GDP in 2009 and 6.4% of GDP in 2010. This trend naturally had an impact on the trend of public debt, which increased in the same period by 20% of GDP.

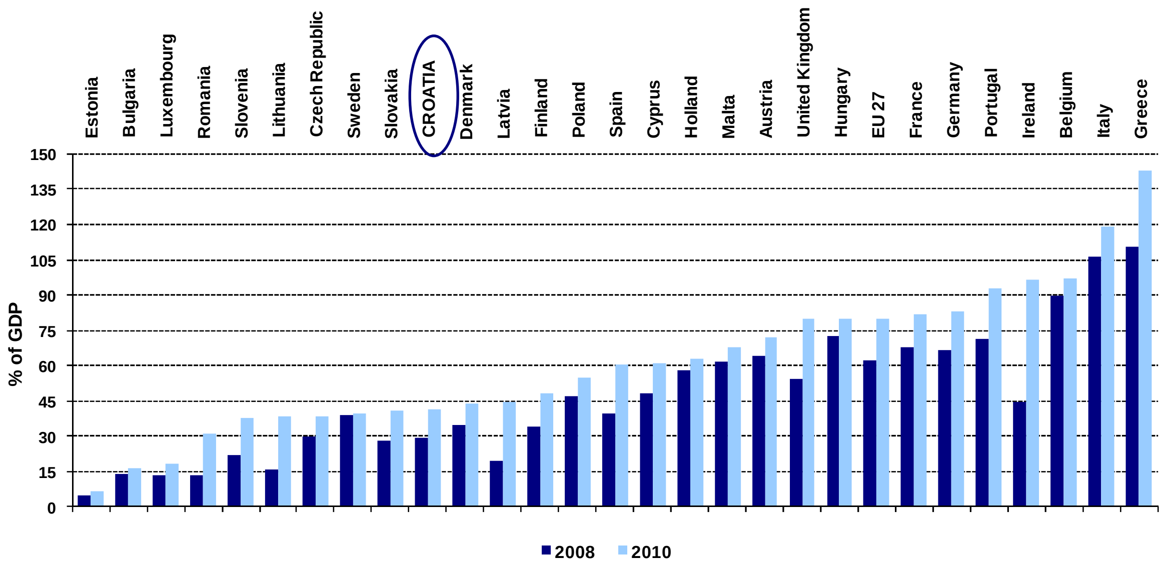
*Chart 6: Total budget deficit/surplus of the Republic of Croatia and EU countries**



Source: Eurostat, Ministry of Finance

**Note: For visibility reasons, the chart does not show data for Ireland, whose deficit amounted to 32.4% of GDP in 2010.*

Chart 7: Public debt of the Republic of Croatia and EU countries



Source: Eurostat, Ministry of Finance

The response of EU Member States to the crisis can be described as counter-cyclical; the countries increased their expenditure and deficit in the period of economic decline, which means that fiscal policy acted in a manner contrary to the direction of the economic cycle.

However, under the influence of growing deficit and public debt, financial investors in the market brought into question the sustainability of public finances in certain EU countries. As a response to the debt crisis in some countries and the negative effects of the spill-over to European economy, individual countries started to implement fiscal consolidation and structural reforms to regain credibility and sustainability of their public finances, i.e. to decrease the deficit and fiscal expenditure.

When observing Croatia, we can conclude that Croatia followed the fiscal trends in the environment; however, the fiscal policy reaction was milder than in the EU. The consolidated general government debt according to ESA 95 increased from 1.4% in 2008 to 4.1% of GDP in 2009 and to 4.9% of GDP in 2010. The deficit expansion was primarily the result of the automatic reaction of the revenue side of the budget to negative economic trends (the so-called automatic stabilizer action), which recorded a drop from 39.5% of GDP to 37.2% of GDP in the above period. At the same time, the expenditure side of the budget increased from 40.8% in 2008 to 42.1% in 2010. However, on the nominal level, execution of budget expenditure in 2010 exceeds the execution of budget expenditure in 2008 by HRK 3.3 billion, or only 2.7%. Furthermore, in 2010 the Parliament issued a decision freezing the level of expenditure in 2011 at the level of 2010, maintaining the nominal three-year increase in expenditure at the level of around HRK 3.5 billion. In comparison, expenditure increased by HRK 7.5 billion in 2008 alone. The preservation of the nominal level of expenditure was achieved through significant savings on the expenditure side of the budget both in 2009 and in 2010.

Croatia was not able to react to the crisis by strongly increasing government expenditure as the EU Member States did, primarily due to the need to maintain the trust of financial markets and access to the capital market. Being a small country which was not a member of the EU and was struggling in order to unblock the accession negotiations in the most intensive period of the crisis, Croatia could not count on the credibility and support which was granted to other EU states by the membership itself in relation to the capital market and investor perception. Furthermore, at the moment the crisis occurred, capital flow was interrupted, threatening the stability of the entire economy considering the dependency of economic growth on domestic demand and capital flow before the crisis. Accordingly, with the onset of the crisis Croatia also faced the challenge of maintaining access to the capital market. Therefore, facing a sharp decline in revenues and the consequent automatic expansion of deficit, the fiscal policy reacted to the crisis through rationalisation and saving measures – cutting, then freezing wages, temporarily cancelling pension indexing, cutting privileged pensions by 10%, saving on material expenditure and government consumption, but also reducing investment expenditure and halting some investment projects. All of this was done in order to keep the deficit within acceptable limits and to maintain the investment rating. In an economy whose growth was significantly dependent on domestic demand, including government investment among other things, such a reaction of the fiscal policy also reflected on the trend of investment activity in the country. Therefore, within the framework of the Economic Recovery Programme, the Croatian fiscal policy focused, in accordance with fiscal circumstances and possibilities, on strengthening the private sector. This was done by creating a more favourable financial environment through various financing models with an active role of the government, and encouraging the investment cycle through public enterprise investments or support to major private investments.

The recent crisis showed that an efficient and rational management of public finances is a prerequisite for overall macroeconomic and financial stability. In the previous period, the fiscal policy managed to withhold the stability of public finances and access to the capital market, but in order to maintain these results in the upcoming period it must focus on reducing fiscal imbalance and rapidly decreasing the deficit. The Fiscal Responsibility Act is a step towards this goal, introducing fiscal rules into the Croatian fiscal system which will strengthen the foundations for long-term sustainability of the fiscal policy during the period of overcoming the crisis and recovery. The Act clearly defines the path towards lowering the deficit and stabilising public debt.

3.2. Fiscal policy in 2010 and 2011

According to the national classification of accounting plan, the consolidated general government deficit in 2010 amounted to 14.4 billion kuna or 4.3% of gross domestic product, which is in line with the amended budget for 2010. It should be noted that the budget amendment increased the deficit of the state budget for 2010 in relation to the original plan due to the influence of macroeconomic trends over the year and the impact of changes in the income tax system, through the reduction of the number of tax rates and cancellation of tax benefits, and shortening the duration of the special tax on salaries, pensions and other receipts. The budget for 2011 was passed in line with the Decision on freezing the nominal level of expenditures at the level of 2010, which was adopted by the Croatian Parliament at the proposal of the Government. As highlighted previously, in relation to the pre-crisis year 2008 when expenditure had reached 118.6 billion kuna (increased only during that year by 7.5 billion kuna), the total nominal increase in expenditures in the past three years amounted to 3.7 billion kuna or only around 3% over the three-year period. The total planned state budget expenditures for 2011 is 122.3 billion kuna, which includes increase in expenditures outside the control of fiscal policy (e.g. interest costs, increase in the number of retired persons, costs of adjustment to the *acquis*). Numerous saving measures were therefore necessary in order to accommodate new expenditures and expenditures which growth couldn't be controlled.

In the budget for 2010, and on the basis of the Economic Recovery Programme, significant activities were undertaken on the expenditure side, such as cancelling pension alignment, raising the age limit for the right to old age and early retirement for women (from 60 to 65 years for old age retirement and from 55 to 60 years for early retirement), changing the initial factor for calculation of early retirement pensions in order to have a more appropriate reduction in the amount of early retirement pensions, cutting certain categories of pensions awarded in accordance with special regulations by 10%, and further freezing the basis for calculation of public and civil servant salaries. All of these measures, as well as saving measures in all other components of expenditures, continued in 2011.

In 2011, the state budget is being executed according to the annual plan. The trend of total budget deficit in 2011 is strongly influenced by one-off effects from 2010.

In 2010 the state budget recorded on the revenue side a significant part of receipts under the tax debt from earlier periods, and it also included the Special tax on salaries, pensions and other receipts which is no longer present in 2011. In addition, 2011 was impacted by the year-long effect of changes in the income tax system made in mid-2010, which also resulted in lower expected revenue than achieved in 2010. Taking into account all of the above, the combined effect of all distinguished impacts on the revenue side of the budget is at the level of around 1% of GDP, while the difference of total state budget deficit in 2011 in comparison with the achieved deficit in 2010 amounts to 0.1% of GDP. This means that the majority of the missing revenue was absorbed by the expenditure side of the state budget.

At the same time, at the level of consolidated general government, which includes the state budget, extrabudgetary users and local self-government, the planned deficit in this year amounts to 4.9% of GDP in comparison with 4.3% of GDP achieved last year, which indicates that the expansion of planned deficit is mostly due to the spread of deficit at the level of extrabudgetary users (primarily due to investment in Croatian Waters) and local self-government.

As regards basic macro-fiscal risks, the previously mentioned influence of the environment and external risks had a strong impact on Croatian fiscal policy at the onset of the crisis and during its course. If further shocks were to materialise at the global level, they could have significant implications on the level of certainty and trust of the international markets resulting in pressure on domestic economy. A fast closure of fiscal imbalances is of particular importance in this regard, and this applies strongly in Croatia where special emphasis has been placed on fiscal policy in the context of overall economic policies.

3.3. Budget aggregate trends in the period 2012 – 2014

The fundamental fiscal policy goal in the upcoming medium-term period is to reduce budget imbalances by relative lowering of budget expenditures, reducing the deficit, and halting the growth and commencing the gradual reduction of the share of public debt in GDP. These fiscal policy goals arise from the Fiscal Responsibility Act, but also from the objective economic and financial circumstances in the domestic and international environment which demand strengthening credibility of fiscal policy, to be achieved by reducing fiscal imbalances and the fiscal impulse generated by deficit expansion during the crisis.

Achievement of these fiscal policy goals, reduction of the size of the public sector, reduction of fiscal imbalances and lowering the financial needs of the government sector is essential in order to increase the competitiveness of the Croatian economy in the upcoming period.

The fiscal projections given below are based on the objective fact that parliamentary elections are to be held at the end of the year, which means that revenue projections represent a technical projection on the basis of the existing tax system structure and tax rate levels.

The projection of expenditure categories was prepared in line with the Fiscal Responsibility Act.

The projection of revenue and expenditure aggregates includes the effects of accession to the EU.

Revenues

The revenue side of the state budget for 2012 – 2014 will be marked by the recovery and growth of economic activity and the upcoming membership in the European Union. The major source of state budget revenues, tax revenues, is projected under the presumption of unchanged tax policy, with necessary amendments and fine tuning of the tax system only in terms of convergence of the relevant legislation to the EU acquis. As far the social contributions, significant positive trends are expected in the medium-term period on account of recovery and economic growth, as well as a rising employment in the upcoming period. Grants will become an increasingly more important category of total revenue in the upcoming medium-term period, due to the use of pre-accession and accession funds of the EU available to Croatia.

A portion of the above receipts from the EU budget will not represent revenue in the period received by the Croatian budget, but will be used as a source of financing for EU projects. Furthermore, the Fiscal Responsibility Act requires that an increase on general budget expenditure directly related to the financing of projects co-financed from EU funds in the first three years of membership must be exempt from the established fiscal rules under the Act, meaning that they are not included in the projections in this document. As neither the sources for their financing are included on the revenue side, this bears no influence on the deficit trend.

Projects co-financed from pre-accession funds are included in total projected expenditure levels, therefore projections in this document are in a smaller part even more restrictive than required by the fiscal rules under the Fiscal Responsibility Act.

In the part relating to revenue from the EU for 2014, it was not possible to determine the exact amount of funds Croatia will receive from the EU as the Financial perspective for the new seven-year period starting from 2014 is not known. Therefore projections for 2014 assume that Croatia will not be a net contributor, i.e. that Croatia will not contribute to the EU budget in excess of the funds received from the EU budget, for which guarantee mechanisms are in place in EU practice.

Other budget revenues collected from property, administrative fees, penalties, sale of goods and services, etc. are normally not directly related to economic activity trends, and are expected to remain at constant levels of share in GDP over the projection period.

In line with the above, total state budget revenues in 2012 are expected to amount to 112.8 billion kuna, which represents an increase of 5.0% in relation to 2011. In 2013 budget revenues will increase by 6.4% and will amount to 120 billion kuna, and the same increase is expected in 2014 reaching the amount of 127.6 billion kuna. This trend of state budget revenues in the medium-term period implies revenues will stand at an average level of 31.1% of GDP.

Table 4: Trends in state budget revenues in the period 2010 – 2014

(000 HRK)	2010	Plan 2011	Index 11/10	Projection 2012	Index 12/11	Projection 2013	Index 13/12	Projection 2014	Index 14/13
TOTAL REVENUE (6+7)	107,784,657	107,425,486	99.7	112,785,098	105.0	119,987,123	106.4	127,639,132	106.4
6 Revenue	107,466,351	107,074,216	99.6	112,517,424	105.1	119,706,734	106.4	127,336,212	106.4
7 Revenue from sale of non-financial assets	318,306	351,270	110.4	267,675	76.2	280,390	104.8	302,920	108.0

Source: Ministry of Finance

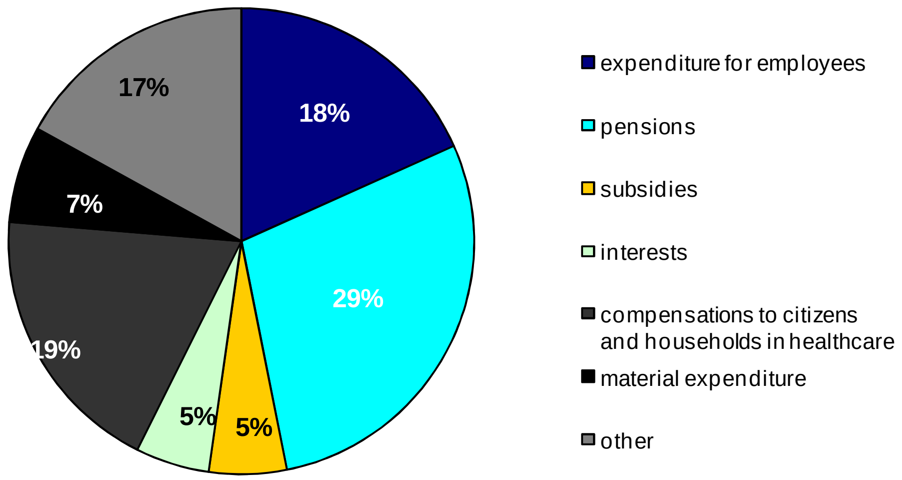
Over the same period, revenues of other components of the general budget are foreseen at the level of 1.5% of GDP for revenue of the extrabudgetary users, and an average of 4.2% of GDP for local and regional self-government units. According to the above trends of all components of the consolidated general budget, revenue will average at the level of around 36% of GDP over the projection period. Earlier international comparisons of the share of general budget revenue in GDP indicate that Croatia belongs to the lower part of the spectrum in comparison with EU countries, and in this context further tax relief should be sought in the future in a combination with further rationalisation of the expenditure side of the budget.

Expenditures

In respect to the expenditure side of the budget, it should be noted that during the period of crisis and the impact of crisis on the reduction of revenue side of the budget a significant correction was also made on the expenditure side of the budget, with a simultaneous spread of fiscal imbalances. For example, in 2008 the expenditure side of the state budget was at the level of 118.6 billion kuna, increasing in comparison to the previous year by around 7.5 billion kuna. If we compare the planned state budget expenditures for 2011, at the level of 122.3 billion kuna, with the execution of pre-crisis 2008, we can see that it increased over a three-year period by 3.7 billion kuna. In other words, the three-year increase of total expenditures equals half the annual increase in the last year before the crisis. In spite of this, the structure of expenditures indicates an increase in certain expenditure categories which are outside the influence of fiscal policy, but had to be incorporated in the total budget framework. For example, in relation to the pre-crisis year 2008, in 2011 interest costs will increase by around 2.5 billion kuna, pensions (despite frozen indexing and nominal cutting of pensions awarded pursuant to special regulations) by around 2.4 billion kuna due to the growing number of retired persons, and costs related to accession to the EU and preparation for membership will amount to around 1.8 billion kuna in this year.

This clearly indicates that in the upcoming period the budget will once again have to absorb the increase in expenditures that cannot be influenced (interest costs, the effects of demographic trends to pension trends, etc.), respecting at the same time the provisions of the Fiscal Responsibility Act, and reducing the share of total expenditures in GDP. Due to the necessary strengthening of the competitiveness of Croatian economy, the uncertainty on the financial market, and fiscal policy goals aimed at reducing deficit and lowering fiscal imbalances, it will not be possible to return to expenditure growth trends from the pre-crisis period. The fiscal space opened up through economic recovery and growth must be utilised to close fiscal imbalances for the reasons stated in the previous chapters, while the space for the real need for growth of individual categories of expenditure must be sought primarily within the structure of expenditure itself, i.e. through improving the efficiency of budget expenditure, and which is planned to be achieved by implementing key structural reforms. As regards the structure of the expenditure side of the budget, it should be noted that the majority of state budget expenditure is focused in just several major expenditure groups.

Chart 8: Structure of state budget expenditures in 2010



Source: Ministry of Finance

The structure of state budget expenditure shows that in 2010 over 70% of total budget expenditure went into expenditures for employees, compensations to citizens and households, and interests. It should also be emphasized that this expenditures are either based on law or falls under priority payments in accordance with the Budget Act. In this context, the described structure and selected expenditure groups clearly illustrate the framework for reduction of total expenditure, and on the other hand highlight the importance these categories of expenditure will have in the upcoming periods in terms of their contribution to the overall level of expenditures.

Furthermore, the impact of Croatia's accession to the European Union should also be mentioned as it implies participation in the EU budget, compulsory for all Member States, and amounting to an additional 1% of GDP on an annual level. These expenditures, to be part of Croatia's state budget from 2013 onwards, represent an additional effort to be undertaken under the foreseen fiscal consolidation and reduction of budget deficit.

It is clear from all of the above that in its expenditure policy for the upcoming period, fiscal policy must strive towards further rationalisation of the expenditure side of the budget, simultaneously servicing to a widest range of public needs in accordance with the tasks of public finances, but also maintaining the course of continuous reduction of fiscal imbalances. In this context, further implementation of key structural reforms is of special importance as only these can ensure the achievement of all mentioned goals. The Fiscal Responsibility Act holds a key position in those efforts, strengthening the determinants of fiscal responsibility also contained in the Budget Act, and introducing for the first time fiscal rules which must be respected in order to reach the previously mentioned goals of continuous consolidation and consequentially to reduce deficit and debt.

The Fiscal Responsibility Act and the ESA 95 methodology

Fiscal consolidation and the consequent reduction of deficit and public debt is the main goal of the overall fiscal policy in the upcoming period. In this context, the Fiscal Responsibility Act bears particular importance. The Act introduces fiscal rules and rules to strengthen fiscal discipline, transparency and medium-term and long-term sustainability of public finances. Future Croatian fiscal policy will be defined and implemented within the framework of this Act.

In the part concerning the strengthening of fiscal responsibility, this Act supplements or strengthens the provisions of the Budget Act, in particular by introducing the responsibility of each beneficiary if create obligations exceeding the budgeted level, and responsibility of the heads for legal, meaningful and purposeful spending of budget funds and efficient and effective functioning of the system of financial management and control.

In the part concerning fiscal rules, the Act defines rules to be satisfied in order to achieve the desired course of fiscal policy. This course also implies the reduction of government consumption and the involvement of the government in the economy, which in addition to the need to eliminate fiscal imbalance places special emphasis on the consolidation of the expenditure side of the budget.

Fiscal rules defined by the Fiscal Responsibility Act are divided into two parts which could conditionally be called temporary and permanent. The temporary or first rule to be satisfied according to the Act relates to the reduction of expenditure expressed in terms of share in GDP by at least 1 percentage point per year, until the moment the primary balance of the general budget amounts to zero or a positive amount in nominal terms. The second, or conditionally called permanent rule becomes effective when the first rule is satisfied, and refers to maintaining the cyclically adjusted primary balance of the general budget at the level of zero or positive. The primary balance represents the difference between revenue and expenditure excluding interests, and the scope of the general budget and the method of calculation of aggregates for the purposes of these rules is based on the ESA 95 methodology of the European Union.

When referring to the scope of the mentioned EU methodology, we imply the uniformly prescribed rules for classification of institutional units of the entire economy according to sectors, one of which is the sector of general government. When speaking of the fiscal aggregates themselves according to this methodology, we commonly refer to the rules set by the methodology to define the scope of the revenue and expenditure side of the general government budget, including fiscal balances.

Certain differences are present between ESA 95 and the accounting plan methodology in terms of definitions of revenue and expenditure. The basic difference on the revenue side is that the accounting plan methodology treats receipts from sale of non-financial assets as an integral part of revenue, while ESA 95 treats them as a deduction item on the expenditure side of the budget. The basic differences on the expenditure side can be summed up in several main items, including different treatment of payments under guarantees (along with any reimbursements on the same grounds), which the national methodology classifies as transactions in financial assets and therefore not a part of the expenditure side of the budget *or the fiscal balance, while ESA 95 classifies these as an integral part of expenditure or revenue, respectively. The expenditure side of the budget contains according to ESA 95 net transactions in non-financial assets as its integral part, while the national methodology classifies the acquisition of non-financial assets under expenditure, and their sale under budget revenue as stated earlier. Finally, payments made under debt to pensioners are classified according to Eurostat assessment as an integral part of the expenditure side of the general budget, on a cash basis, while in the national methodology these expenditures do not fall under the scope of the general budget.*

Table 5: Revenue, expenditure and fiscal balance trends of the general budget in the period 2012 - 2014 – ESA 95 methodology

CONSOLIDATED GENERAL GOVERNMENT (000 HRK)	2010	Plan 2011	Projection 2012	Projection 2013	Projection 2014
Total revenue	123,731,455	123,361,567	129,473,026	137,483,695	145,887,227
% of GDP	*37.0*	*35.5*	*35.6*	*35.8*	*35.6*
Total expenditure	140,133,814	142,267,472	144,448,253	147,970,213	153,459,800
% of GDP	*41.9*	*40.9*	*39.7*	*38.5*	*37.5*
out of which: interests	6,623,125	7,515,265	9,587,335	10,853,810	11,859,812
% of GDP	*2.0*	*2.2*	*2.6*	*2.8*	*2.9*
Total deficit/surplus	**-16,402,359**	**-18,905,904**	**-14,975,227**	**-10,486,518**	**-7,572,574**
% of GDP	*-4.9*	*-5.4*	*-4.1*	*-2.7*	*-1.8*
Primary deficit/surplus	**-9,779,234**	**-11,390,639**	**-5,387,892**	**367,292**	**4,287,238**
% of GDP	*-2.9*	*-3.3*	*-1.5*	*0.1*	*1.0*

Source: Ministry of Finance

The table shows that general budget expenditures according to ESA 95 are in continuous decline expressed in share in GDP, therefore the fiscal rule defined by the Fiscal Responsibility Act is satisfied, which is also the case if the accounting plan methodology is applied. The primary balance trend is moving from negative amounts to primary surplus in 2013. A strong fiscal consolidation leading to such primary balance in 2013 is the basis for eliminating fiscal imbalance. Application of the restrictive fiscal rule on the reduction of the share of expenditure by at least one percentage point per year is important for such consolidation, and a continuation of the course of fiscal policy which would maintain the same trend in 2014 is of exceptional importance for an even faster settlement of total deficit and a sharper turn in the trend of public debt.

Based on the above, projections for the upcoming three-year period indicate a level of state budget expenditures of 125 billion kuna in 2012, or a year-on-year increase of 2.2%, followed by 128.8 billion kuna in 2013 or a year-on-year increase of 3.0%, and 134.4 billion kuna in 2014 representing a year-on-year increase of 4.3%. On the other hand, over the projection period, state budget expenditures will contribute significantly to satisfying the fiscal rule, i.e. the reduction of state budget expenditures expressed in share in GDP by at least one percentage point per year, declining from the level of 34.4% of GDP in 2012 to 32.8% in 2014.

Table 6: State budget expenditure trend in the period 2010 – 2014

(000 HRK)	2010	Plan 2011	Indekx 11/10	Projection 2012	Indekx 12/11	Projection 2013	Indekx 13/12	Projection 2014	Indekx 14/13
TOTAL EXPENDITURE (3+4)	**121,874,004**	**122,311,297**	**100,4**	**125,022,650**	**102,2**	**128,834,576**	**103,0**	**134,372,677**	**104,3**
3 Operating expenditure	**120,323,332**	**120,226,672**	**99,9**	**123,657,026**	**102,9**	**127,681,533**	**103,3**	**133,269,197**	**104,4**
4 Expenditure for acquisition of non-financial assets	**1,550,672**	**2,084,626**	**134,4**	**1,365,624**	**65,5**	**1,153,043**	**84,4**	**1,103,480**	**95,7**

Source: Ministry of Finance

Other components of the general budget will also contribute to satisfying the mentioned fiscal rule. Over the projection period, extrabudgetary users will reduce the share of their expenditures from 1.7% of GDP in 2012 to 1.6% of GDP in 2014. Projections also indicate that expenditures of local and self-government units will decrease from the level of 4.4% of GDP in 2012 to 4.2% of GDP in 2014.

Total deficit/surplus

Based on the described trends of revenues and expenditures of all components of the general budget in the medium-term period, the general budget will record a continuous reduction of its deficit from the projected 3.8% of GDP in 2012 to 2.6% of GDP in 2013, and to 1.8% of GDP in 2014.

Table 7: Revenue, expenditure and fiscal balance trends of the general budget in the period 2010 - 2014 – accounting plan methodology

(000 HRK)	2010	Plan 2011	Projection 2012	Projection 2013	Projection 2014
STATE BUDGET					
Total revenue	107,784,657	107,425,486	112,785,098	119,987,123	127,639,132
% of GDP	*32,2*	*30,9*	*31,0*	*31,3*	*31,2*
Total expenditure	121,778,233	122,311,297	125,022,650	128,834,576	134,372,677
% of GDP	*36,4*	*35,2*	*34,4*	*33,6*	*32,8*
Total deficit/surplus	-13,993,576	-14,885,811	-12,237,551	-8,847,452	-6,733,544
% of GDP	*-4,2*	*-4,3*	*-3,4*	*-2,3*	*-1,6*
EXTRABUDGETARY USERS					
Total revenue	5,068,135	5,251,223	5,587,507	5,899,020	6,238,953
% of GDP	*1,5*	*1,5*	*1,5*	*1,5*	*1,5*
Total expenditure	5,525,354	6,720,340	6,353,201	6,483,944	6,614,314
% of GDP	*1,7*	*1,9*	*1,7*	*1,7*	*1,6*
Total deficit/surplus	-457,219	-1,469,117	-765,694	-584,924	-375,361
% of GDP	*-0,1*	*-0,4*	*-0,2*	*-0,2*	*-0,1*
LOCAL GOVERNMENT					
Total revenue	15,494,293	15,131,120	15,470,287	16,139,751	16,933,244
% of GDP	*4,6*	*4,4*	*4,3*	*4,2*	*4,1*
Total expenditure	15,526,594	15,862,096	16,122,269	16,679,199	17,246,913
% of GDP	*4,6*	*4,6*	*4,4*	*4,3*	*4,2*
Total deficit/surplus	-32,301	-730,976	-651,982	-539,447	-313,668
% of GDP	*0,0*	*-0,2*	*-0,2*	*-0,1*	*-0,1*
CONSOLIDATED GENERAL GOVERNMENT					
Total revenue	124,509,879	124,147,887	130,184,409	138,244,976	146,691,023
% of GDP	*37,2*	*35,7*	*35,8*	*36,0*	*35,8*
Total expenditure	138,992,975	141,233,791	143,839,636	148,216,799	154,113,596
% of GDP	*41,5*	*40,6*	*39,6*	*38,6*	*37,6*
out of which: interests	6,623,125	7,515,265	9,587,335	10,853,810	11,859,812
% of GDP	*2,0*	*2,2*	*2,6*	*2,8*	*2,9*
Total deficit/surplus	**-14,483,096**	**-17,085,904**	**-13,655,227**	**-9,971,823**	**-7,422,574**
% of GDP	*-4,3*	*-4,9*	*-3,8*	*-2,6*	*-1,8*
Primary deficit/surplus	**-7,859,971**	**-9,570,639**	**-4,067,892**	**881,987**	**4,437,238**
% of GDP	*-2,3*	*-2,8*	*-1,1*	*0,2*	*1,1*

Source: Ministry of Finance

In addition to reduction of total deficit, the improved sustainability of public finances in the upcoming three-year period also reflects in a strong adjustment of the primary deficit and its transition into surplus in 2013. Primary deficit or surplus represents the measure of fiscal balance and equals the difference between total revenue and expenditure excluding interest, or in other words primary deficit equals total deficit minus the interest costs. The achievement of primary surplus in 2013 also implies significant positive impacts on public debt. The Fiscal Responsibility Act allows that, after primary surplus is achieved, the level of total expenditure may be set based on an analysis of cyclically adjusted primary surplus. However, precisely due to the importance of improved stability and sustainability of public finances and the need to stabilise public debt, we find that the rule of reducing the share of total expenditure in GDP by one percentage point should continue to be implemented in the year following the achievement of primary surplus, which is the year 2014 according to our projections. This approach, more restrictive than the provisions of the Fiscal Responsibility Act, would contribute additionally to the credibility of fiscal policy.

Financing and public debt

The state budget constitutes the major part of the total general government budget in terms of revenue and expenditure amounts, as well as deficit amounts and the amounts of total repayments under public debt. In this context, the major part of financing needs in the upcoming period also refers to the state budget. Based on state budget balance trends and repayments in the upcoming three-year period, but also transactions in financial assets (including privatisation), receipts from financial assets and borrowings will range from the projected level of HRK 21.8 billion in 2012 to HRK 22.1 billion in 2014.

Since the stabilisation and gradual reduction of the share of public debt in GDP is one of the main goals of fiscal policy in the upcoming medium-term period, non-debt instruments are also foreseen to be used to finance public debt, primarily shares and other equity disposals. In accordance with the Economic Recovery Programme, and in order to improve the efficiency of the entire economy by reducing the influence of the state on entrepreneurial activities, revenue is also planned to be collected from sale of state property. This is also in line with the establishment of the Agency for management of state property, and the foreseen greater efficiency in management of state property.

Table 8: Financing of the total general budget deficit in the period 2010 – 2014

(000 HRK)	2010	Plan 2011	Projection 2012	Projection 2013	Projection 2014
BUDGETARY CENTRAL GOVERNMENT					
1 Total deficit	13.993.576	14.885.811	12.237.551	8.847.452	6.733.544
2 Total repayments	18.708.334	9.949.256	8.354.793	12.948.454	14.534.042
3 Expense for financial assets	2.171.853	1.791.837	1.215.262	1.105.443	856.543
4 Change in currency and deposits	569.430	-2.152.002	0	0	0
4=1+2+3+4 TOTAL FINANCING NEEDS	**35.443.193**	**24.474.902**	**21.807.606**	**22.901.350**	**22.124.130**
of which: Shares and other equity disposals	7.345	0	1.000.000	1.000.000	1.000.000
EXTRA-BUDGETARY USERS					
1 Total deficit	457.219	1.469.117	765.694	584.924	375.361
2 Total repayments	478.995	713.357	1.379.763	938.905	788.898
3 Expense for financial assets	284.600	105.600	71.000	79.000	99.000
4 Change in currency and deposits	728.406	723.647	663.634	677.771	730.919
4=1+2+3+4 TOTAL FINANCING NEEDS	**1.949.220**	**3.011.721**	**2.880.090**	**2.280.600**	**1.994.178**
of which: Shares and other equity disposals	126.387	423.731	185.012	72.940	92.074
LOCAL GOVERNMENT					
1 Total deficit	32.301	730.976	651.982	539.447	313.668
2 Total repayments	376.937	253.193	274.693	286.693	301.693
3 Expense for financial assets	85.928	153.620	160.500	170.500	170.500
4 Change in currency and deposits	-172.226	-89.518	5.000	-10.000	0
4=1+2+3+4 TOTAL FINANCING NEEDS	**322.940**	**1.048.271**	**1.092.175**	**986.640**	**785.862**
of which: Shares and other equity disposals	12.020	16.700	16.700	16.700	14.700
GENERAL GOVERNMENT					
1 Total deficit	14.483.096	17.085.904	13.655.227	9.971.823	7.422.574
2 Total repayments	19.564.266	10.915.806	10.009.248	14.174.052	15.624.633
3 Expense for financial assets	2.542.381	2.051.057	1.446.762	1.354.943	1.126.043
4 Change in currency and deposits	1.382.073	-1.517.873	668.633	667.771	730.919
4=1+2+3+4 TOTAL FINANCING NEEDS	**37.971.816**	**28.534.895**	**25.779.870**	**26.168.590**	**24.904.169**
of which: Shares and other equity disposals	145.752	440.431	1.201.712	1.089.640	1.106.774

Source: Ministry of Finance

The financing of budget needs in the upcoming period will be in line with the circumstances on the financial market, and bearing in mind the goals of the Strategy for management of public debt, which require longer average payment due periods, reduced share of short-term debt in the total amount of debt, introduction of protection mechanisms against currency risk, and development of a domestic and foreign market yield curve.

The majority of liabilities falling due in the period 2012 – 2014 refer to four bonds due, three of which are domestic and one foreign. Domestic bonds include two euro denominated bonds, the first in the amount of EUR 500 million, and the second in the amount of EUR 650 million, and a third kuna denominated bond in the amount of 4.0 billion. The foreign bond due refers to a Eurobond in the amount of EUR 500 million, which matures in 2013. As domestic debt dominates in the liabilities due in the upcoming period, it can be expected that its refinancing will be done through combined borrowings on domestic and foreign market, depending on the prevailing market conditions at the moment of maturity.

It can be expected that a part of the financing needs will be met in the upcoming period through further collaboration with international financial institutions, while Croatia's membership in the EU will open further lines of financing through the European Investment Bank.

Projections of public debt development indicate a stabilisation of its growth trend in 2013, followed by a drop in its share in GDP. In case higher non-debt financing revenue (higher revenue from sale of stocks, shares and government property) is achieved than contained in financing projections, stabilisation of public debt growth could occur at a faster pace.

It should also be noted that the trend of share of public debt in GDP stems from the relationship between the real interest rate and the growth rate. In the pre-crisis period, the favourable relationship between the real growth rate and real interest rate contributed to the stable ratio of public debt and GDP. It is for this reason that a relatively fast rise of the ratio of public debt and GDP is recorded in periods of economic decline and negative growth with a simultaneous rise in real interest rates.

Table 9: Projection of trend and structure of public debt in the period 2010 - 2014

% BDP-a	2010	2011*	2012*	2013*	2014*
Public debt	**41,2**	**47,5**	**49,2**	**49,3**	**48,1**
Foreign	14,5	16,7	18,4	19,6	19,5
Domestic	26,7	30,7	30,9	29,7	28,6

*projection includes the effects of taking over the shipyards debt

Source: Ministry of Finance

The trend of the total amount of public debt is closely tied to macroeconomic projections and the assumptions and results of fiscal policy actions, and therefore also faces certain risks. Taking into account that a large part of debt is denominated in foreign currency, a one-off major change in the exchange rate, i.e. the depreciation of domestic currency, especially in relation to euro, would have a significant impact on the level of public debt in the medium-term period. In addition to this, in case negative economic trends are prolonged or another crisis occurs, the level of budget revenue would be negatively affected and the risk of exceeding the planned fiscal deficit would increase, requiring as a result additional financing through new borrowings.

It is therefore important to highlight once again the importance of fiscal consolidation oriented primarily towards the expenditure side of the budget, which will result in lower deficit and the stabilisation and reduction of the share of public debt in GDP, so that in case of sudden economic shocks and materialisation of potential risks additional space would be ensured for a reaction of the fiscal policy and mitigation of those shocks.