

Croatian Economic Outlook



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Forecast Update

Sustained economic recovery

The Croatian economy continued along a recovery path in the first half of 2018 and our projections suggest it will continue to do so in the remainder of the current and throughout the following year (Figure 1). Namely, the expansion momentum from 2017 was carried over into the first half of 2018, with seasonally adjusted quarter-to-quarter growth rates of 0.8 and 1.0 percent for the first two quarters. A continuation of steady growth that started back at the end of 2014 is further confirmed by year-on-year growth figures for the first and second quarter of the current year, 2.5 and 2.9 percent, respectively.

These developments are supported by the persistence of recovery in all three domestic components of GDP (Figure 3), while net exports, despite some positive effect in the second quarter, contributed negatively to the overall GDP growth in the first half of 2018. This expansion activity is expected to level off by the end of the year, with the growth rate projected at 3.0 percent for the current year. As a similar trend is expected to carry on into 2019, although with somewhat reduced contributions of both net exports and domestic demand growth (Figure 2), the forecasted growth rate is expected to stand at 2.9 percent (Figure 1 and Table 1).

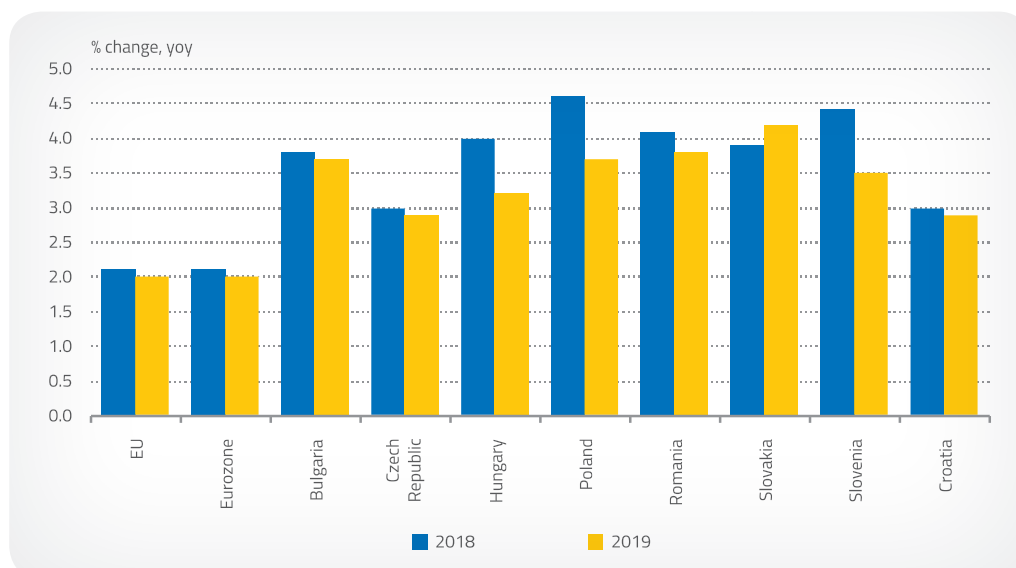
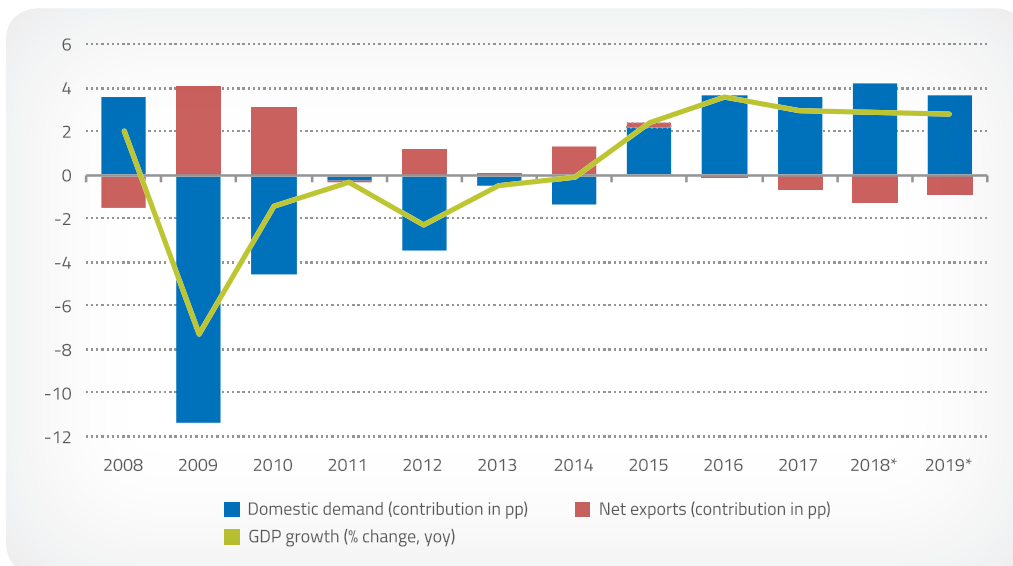


Figure 1
Real GDP Growth
Forecasts for
Croatia, EU and
Selected CEE
Countries

Sources: European
Economic Forecast,
EC, Summer 2018,
and EIZ for Croatia.

Figure 2
Demand Contributions to GDP Growth

Note: * represents EIZ forecasts.
Source: Croatian Bureau of Statistics.



Favorable world growth outlook

Domestic growth will be supported by a rather favorable regional and world economic outlook. Although growth rates seem to have peaked in advanced economies last year, global activity is forecasted to stay strong in the current and the following year, with projected global growth rates of 4.2 and 4.1 percent for 2018 and 2019, respectively (*European Economic Forecast, European Commission, Summer 2018*). Potential risks to these projections are mainly on the downside given the political instability in some emerging countries, potential further energy prices ascent, and interest rate hikes in the US that could lead to investors' flight from emerging markets. Growth momentum in the EU, on the other hand, remains more subdued.

While the fundamentals for sustained growth—supportive monetary conditions, improvements on the labor market, enhanced household balance sheets and higher levels of consumer confidence—remain in place, increased downside risks in a form of elevated trade tensions with the US, continuation of oil price hikes, and increased political uncertainty within the EU led the European Commission to forecast a decline of the growth rate from 2.4 percent in 2017 to 2.1 percent in the current and 2.0 percent in the following year (Figure 1).

Personal consumption remains the strongest driver of growth

The expansion of private consumption from 2017 was passed onto this year as well, leading to a 3.7 percent cumulative growth in the first half of 2018 (year-on-

Figure 3
Real Gross Domestic Product

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

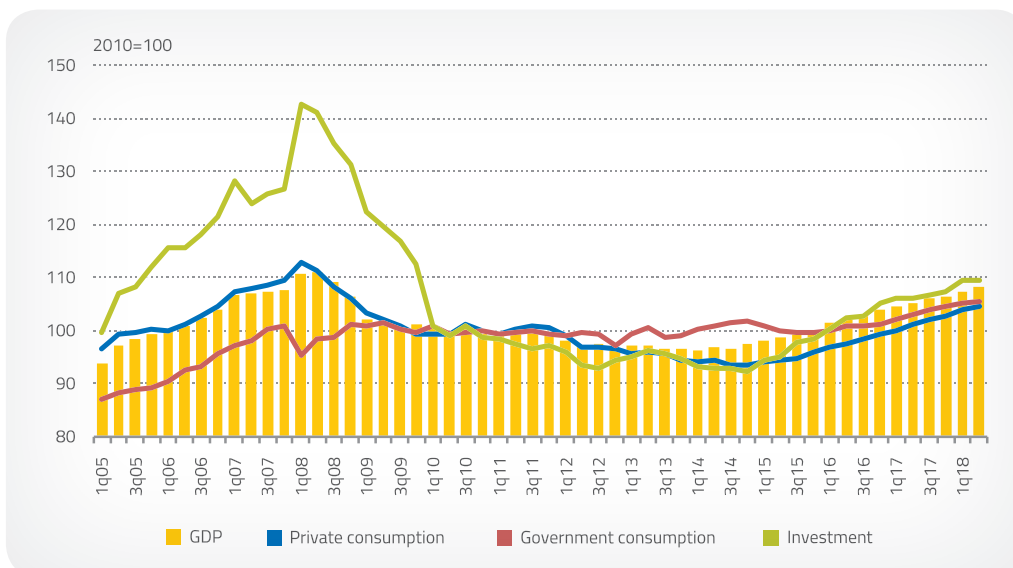
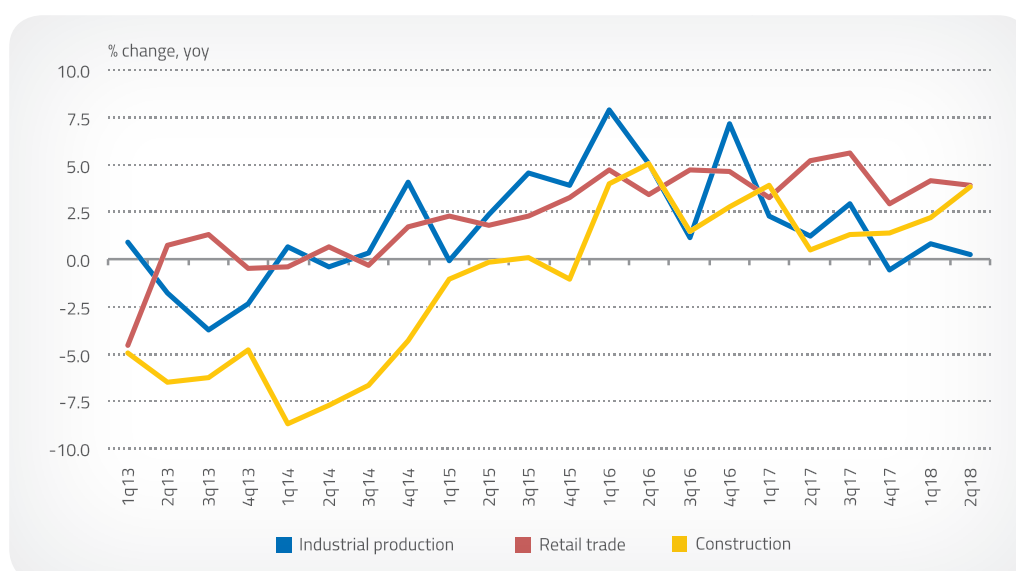


Figure 4
Real Sector
Developments

Source for the original data:
Croatian Bureau of
Statistics.



year) thus remaining the main contributor to GDP growth. Strong personal consumption is primarily the result of rising disposable income based on favorable labor market conditions, steady real wage growth, higher pension transfers, incoming remittances from abroad, and increased household loans. Relatively high levels of consumer optimism are also reflected in the 4.0 percent surge of retail trade (Figure 4) and the 18.9 percent increase in the number of newly registered motor vehicles (both measured year-on-year) in the first six months of 2018. As we expect similar trends to continue in the remainder of this year, joined by another rather favorable (although moderating) tourist season and relatively low inflation, private consumption is bound to remain the greatest contributor to GDP growth, with forecasted yearly growth rate of 3.8 percent. Due to expected similar trends in 2019, with an additional boost from a lower VAT rate on certain products and a further wage hike, we foresee a continuation of consumption growth in 2019, albeit at a somewhat lower rate of 3.1 percent (Table 1). Namely, we expect both the growth of disposable income and the consumption from the tourist demand to level off already in this year and thus to have a bit weaker pull on the private consumption in 2019. The main risk to this projection is the potential price hike in 2019, both due to further increase of world energy prices but also due to domestic wage increase that could spill over onto higher prices.

Government consumption on a steady rise

As the cumulative government consumption increased by 2.6 percent in the first half of 2018 compared with the same period in 2017, we do not see major reductions in government spending for the remainder of 2018, especially with the influx of VAT revenue. Hence, we foresee government spending averaging at 2.6 percent for the entire year (Table 1). It seems that the government uses the recovery phase and the good situation with public finances to engage into more projects, which—due to both EU and domestic administrative and regulatory necessities, requires additional workforce, thus expanding its consumption. Looking into 2019, the government has announced a reduction of VAT rates on specific goods and services as well as some changes in income taxation, which may increase business activity; however, it might also reduce government revenue. Since the overall economic growth is forecasted to stabilize, we project government expenditure growth to slow down to 2.0 percent in the next year.

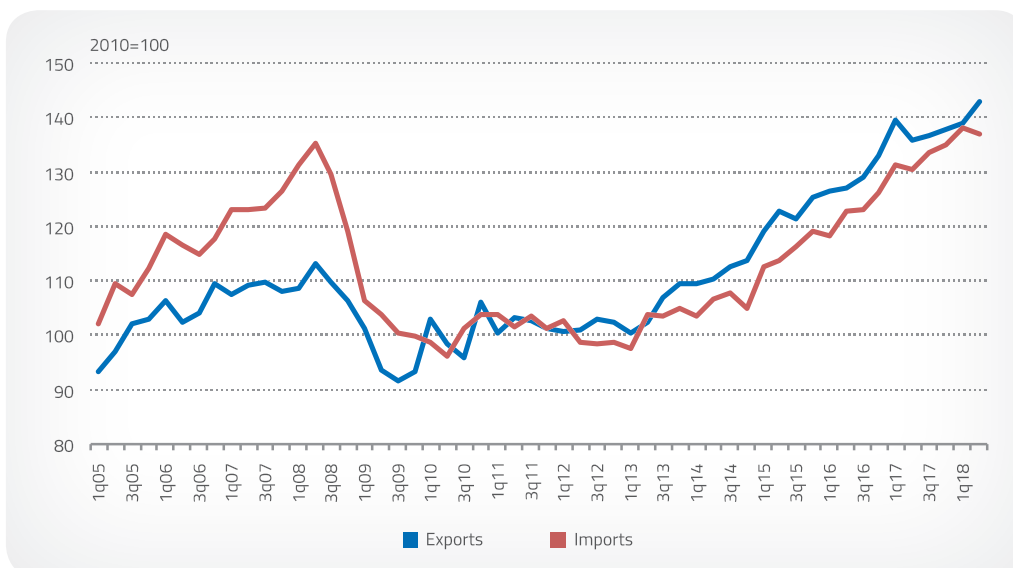
Investment activity expected to pick up

After a promising beginning of 2018 with investment growth of 2.1 percent in the first quarter (seasonally adjusted, quarter-to-quarter), second quarter recorded a decline in activity by 0.1 percent. However, cumulative

Figure 5
Exports and Imports of Goods and Services

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.



data for the first half of 2018 show a rather encouraging expansion in investments by 3.3 percent compared to the same period last year. Most of this growth can be attributed to private sector investments as indicated by the 10.5 percent increase in construction work on buildings in the same period (3.0 percent for the entire construction activity – Figure 4); however, year-on-year growth of general government’s net acquisition of nonfinancial assets by 18.9 percent suggests that government also participates in rebounding investments. Hence, the investment activity is expected to pick up in the remaining two quarters, finishing the year with investment growth of 5.3 percent. This growth projection is based on the expected lower cost of funding, faster pace of EU funds absorption in support of re-leveraging, rising overall profits of firms,

and implementation of planned construction activities, particularly hotel resorts and the Pelješac Bridge. Turning to 2019, since the investment activity might gain additional tailwind by announced tax and red tape cuts and increased utilization of available EU funds, we therefore foresee a continuation of investment growth with the 5.1 percent growth rate (Table 1).

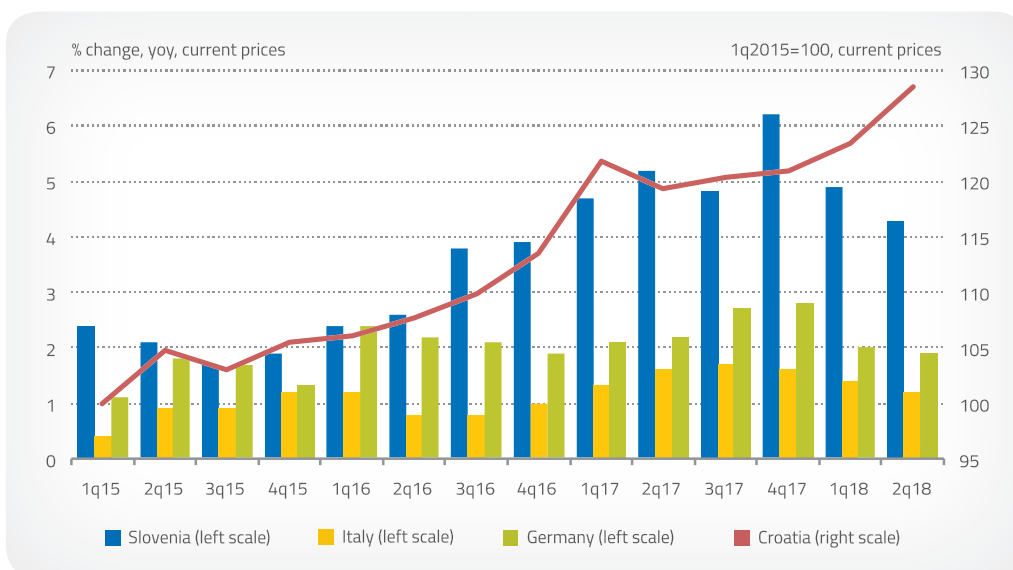
Foreign trade continues along an increasing path

Despite the underperformance in the first quarter, cumulative exports of goods and services increased by 2.9 percent in the first half of 2018 while imports grew by 5.1 percent (both figures measured year-on-year). Slowdown of export growth is a reflection of a rather weak industrial production in the

Figure 6
Croatia’s Exports of Goods and Services and GDP Growth Rate of the Main Trading Partners

Note: Seasonally adjusted.

Source for the original data: Eurostat.



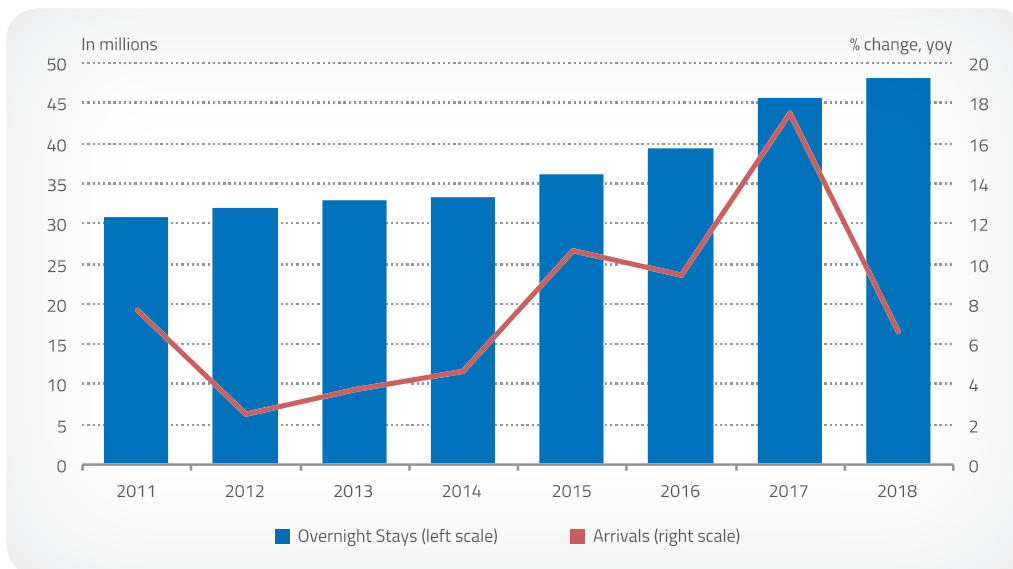


Figure 7
Tourist Arrivals and Overnight Stays from January to July

Note: As of 2017, some business entities are no longer considered to be the reporting units or types of accommodation establishments in the monthly survey on tourist arrivals and overnight stays.

Source: Croatian Bureau of Statistics.

same period (Figure 4), whereas growing imports are mainly reflecting high proportion of foreign goods in personal consumption. Nevertheless, both components of foreign trade have continued along their increasing paths that date back to the beginning of 2013, with seasonally adjusted value of exports exceeding that of imports (Figure 5). Both are expected to continue along the same route in the remaining part of the year as well. Another rather favorable tourist season (Figure 7), the ongoing rising EU demand and global trade growth should compensate for the under-performance of the first quarter and lead to a 4.3 percent growth of exports. Looking into 2019, a favorable outlook of our main trading partners should boost export recovery with a forecasted growth rate of 4.9 percent. We also expect import activity to pick up in the final two quarters of 2018 driven by strong consumer demand, hence leading to forecasted overall growth rate of 6.9 percent. As the growth of consumer demand and economic activity begins to level off in 2019, the demand for foreign goods and services is expected to stabilize at a rate of 6.8 percent.

Current account surplus gradually decreases

As the Agrokor debt settlement and restructuring reached an agreement, at least for the time being, we expect to see a year-on-year decline in banks' total reservation expenses on loss provision in this year, thus

reducing the positive net effect of primary income on the current account observed in 2017. Taking into account the higher forecasted growth of imports rather than exports, thus gradually reducing trade surplus, current account is forecasted to stand at 2.4 percent of GDP in 2018, before decreasing to 1.3 percent in the following year (Table 1).

Risks to our projections remain balanced

Risks to these projections are mainly balanced. On the one hand, the announced tax reform and a further ease of doing business might spark higher-than-anticipated business activity. In addition, the agreement on debt settling and the restructuring of Agrokor, which was reached in July, might have brought some stability and possible investment rebound of Agrokor-related firms. Also, although the latest available data from "eVisitor" suggest a slowdown in the number of tourist arrivals and overnight stays in the high season (June–August), both tourist arrivals and overnight stays are on a steady rise throughout the year (Figure 7), thus continuing to boost the export of tourist services. Additionally, potential second-round effects related to losses from Agrokor suppliers might again reduce bank profits already in the next year and thus re-induce the positive effect on the current account. On the other hand, the negative experience with EU funds absorption during the last five years, the ongoing uncertainties with Agrokor and more recently the Uljanik

Table 1
Forecast
Summary

	2018	2019
Real GDP (% change)	3.0	2.9
Real private consumption (% change)	3.8	3.1
Real government consumption (% change)	2.6	2.0
Real investment (% change)	5.3	5.1
Exports of goods and services (constant prices, % change)	4.3	4.9
Imports of goods and services (constant prices, % change)	6.9	6.8
Current account balance (% of GDP)	2.4	1.3
General government balance (ESA 2010 definition, % of GDP)	0.5	0.3
Public debt (ESA 2010 definition, % of GDP)	75.6	70.0
Unemployment rate (registered, %, pa)	9.9	8.8
Exchange rate, HRK/EUR (pa)	7.42	7.40
Total domestic credit (% change, eop)	-1.7	-0.9
Consumer prices (% change, pa)	1.6	1.5

Note: Cut-off date for information used in the compilation of forecasts was September 3, 2018.

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

Source: Authors' forecasts.

Group shipyards, coupled with the latest political turmoil in the ruling coalition, might dampen investment activity and consumer demand. Downside risks also include the foreign component, especially considering the increase in the US trade protectionism policy and the political instability in Italy resulting in somewhat lower forecasted Italian growth rates. Lastly, the rise of oil prices might increase inflationary pressures, thus hampering consumer demand and overall growth.

The Agrokor saga continues

Issues concerning the Agrokor case did not end when the Court's first extraordinary management commissioner, Mr. Ante Ramljak, was replaced by Mr. Fabris Peruško back in February. After the details concerning the Minister of Economy and Deputy Prime Minister Ms. Martina Dalić's involvement in the group that wrote the infamous *Lex Agrokor*—which actually enabled some of the group's members to serve as Agrokor's consultants and cash in about half a billion kuna in the meantime—leaked in the media and after the pressure from both the public and the ruling party's coalition partner, Ms. Dalić voluntarily resigned on May 14. However, this did not stop the process of negotiation between Agrokor's extraordinary management and its creditors. On July 4, at

the largest court hearing ever to take place in Croatia, held in a basketball hall, a first-instance agreement was reached between Agrokor and about six thousand of its creditors, with approximately 80 percent support of the present creditors' representatives. Both the extraordinary management and the government expressed their satisfaction with the reached agreement on the restructuring of the largest Croatian private company, which is particularly important for the retail sector that takes up a significant part of the economy. In the meantime, Mr. Todorić, the former owner of Agrokor, managed to obtain another hearing postponement on his extradition to the Croatian authorities at the court in London at the beginning of September, as there appear to be new relevant evidence supportive of his claim that the process against him in Croatia is politically motivated.

Uncertainties for the government ahead

After Ms. Dalić's resignation, the Parliament confirmed—with a very tight majority—Mr. Darko Horvat as the new Minister of Economy and Mr. Tomislav Tolušić, the Minister of Agriculture, as the new Deputy Prime Minister. Although usually slow in activities, summer has brought an additional burden for the government in the form of the Uljanik Group shipyards restructuring. The Uljanik Group is

predominantly privately owned but with a high government stake in issued guarantees. Additional pressure came from strikes organized by the shipyard workers, who have not received wages until the government revoked another guarantee to a state-owned bank so the company could take up their deposits and pay out the wages for July (and possibly August). However, this situation is far from over as the restructuring plan, proposed by the company's management, has not yet been approved by the European Commission. In addition, the government also proposed pension and tax system reforms, which caused quite a stir among the general public, the former more so than the latter. On another front, there are some disturbances within the ruling HDZ itself. After the rebellion by the members from the Lika-Senj County, led by its county governor and long-term HDZ member, Mr. Darko Milinović, HDZ decided to expel Mr. Milinović from the party. He has since threatened to (re)activate his mandate in the Parliament and oppose the ruling coalition. It seems that we should be expecting a rather interesting fall season on the political front.

Fiscal state of affairs continues to improve

After the first realized general government surplus in 20 years was registered in 2017, 0.8 percent of GDP (ESA 2010 methodology) (Figure 8), this year started in a similar tone with revenues increasing by 6.4 percent in the first quarter in comparison with the

same quarter in 2017 (national accounting rules). At the same time, expenditures also increased, but at a somewhat lower rate of 4.8 percent (Figure 9). The improvements on the fiscal front are mostly due to VAT revenues which grew by 5.7 percent year-on-year in the first quarter of 2018. On the expenditure side, most significant downsizing came from subsidies, which decreased by 7.3 percent over the same period. Interest payments, on the other hand, slightly increased in the first quarter of 2018, by 3.4 percent year-on-year. Consequently, the general government's primary surplus rose to 1.6 billion kuna, which is around 1.9 percent of GDP for the first quarter. Preliminary reports suggest that the first half of the year also recorded a surplus of the general government balance in the amount of 1.6 billion kuna or 0.4 percent of GDP.

New tax changes again in 2019

It seems that the tax reform set at the end of 2016 is not over yet, as the Croatian Ministry of Finance recently announced new changes in the tax system to be implemented at the beginning of 2019. Proposed changes include: increasing the threshold for the top income tax rate from 17,500 to 30,000 kuna; abolishing contributions for work injuries and employment and increasing the healthcare contributions (decreasing the overall employers' contributions by 0.7 percentage points); decreasing the current VAT rate from 25 to 13 percent on fresh meat, fish, fruit,

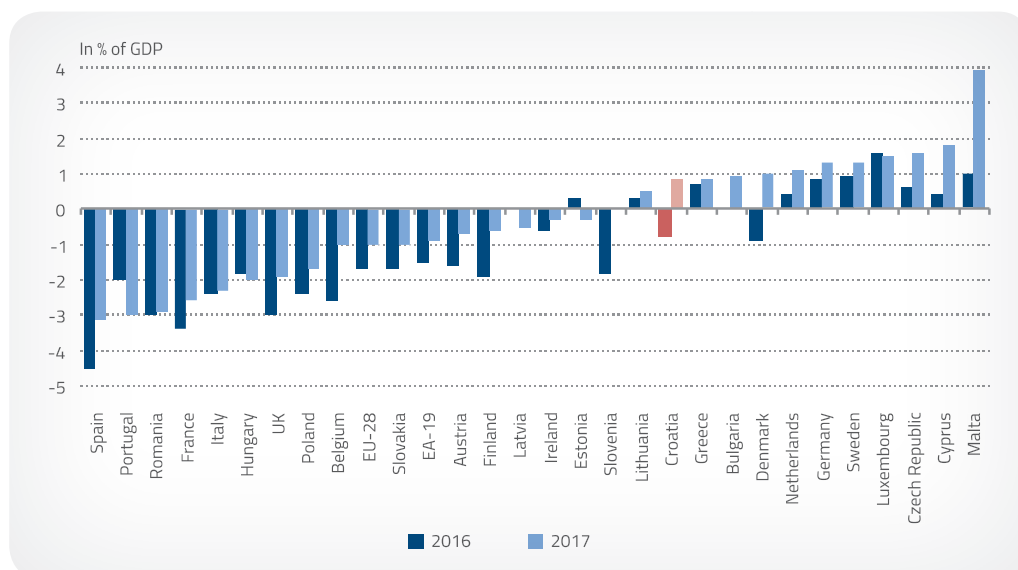
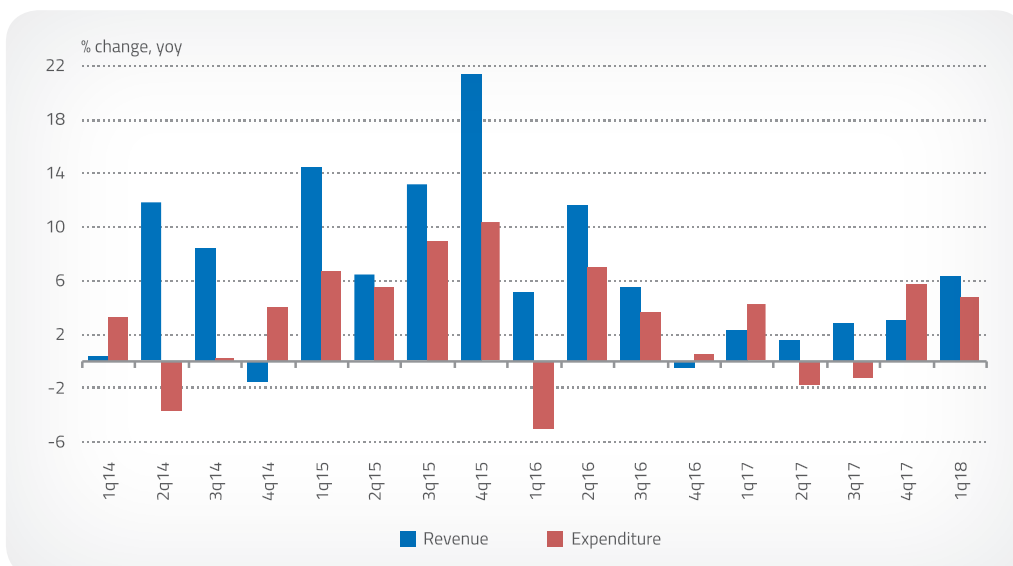


Figure 8
Government Deficits in the EU

Source: Eurostat.

Figure 9
General
Government
Revenue and
Expenditure

Source: Ministry of Finance.



vegetables, and diapers; and decreasing the real estate transfer tax from 4 to 3 percent. Overall, the proposed measures seem to be a parametric adjustment of the system in place and not a genuine reform; however, the final form of the tax changes package will be known only after the final adoption by the Parliament, continuing thereby the tradition of regulatory uncertainty and last-minute changes in tax legislation.

Budget surplus for 2018, along with a further debt decrease

Taking into account these latest developments, together with changes in growth projections, we forecast a general government surplus of around 0.5 percent of GDP for this year already, slightly decreasing in 2019 to around 0.3

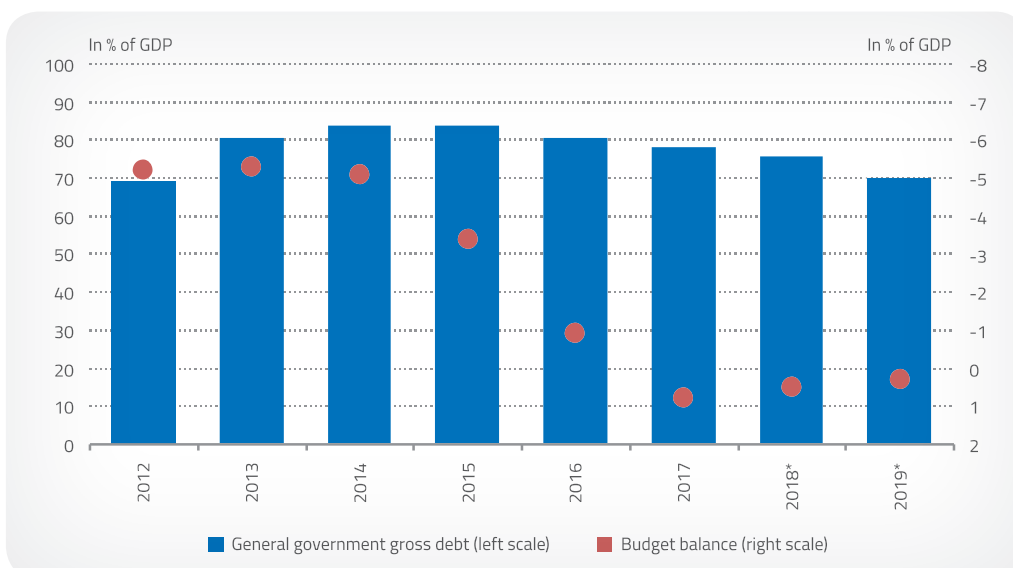
percent of GDP (Figure 10). The latest available data show that total debt, in comparison to the end of 2017, has decreased by 5 percent at the end of May 2018. Therefore, with continued favorable macroeconomic conditions, we expect the debt-to-GDP ratio to decrease further to 75.6 and 70.0 percent of GDP for 2018 and 2019, respectively.

Fiscal projections under high risk

Risks to our fiscal projections are relatively high at this point as the government guarantees issued for the Uljanik Group shipyards in the amount of 70 million euro will probably be activated in the short- to medium-term. Risks are also high due to the potential costs of the Petrokemija fertilizer company restructuring and risks related to

Figure 10
General
Government
Budget Balance
and Debt

Note: * represents EIZ forecasts.
Sources: Eurostat and EIZ for forecast.



lawsuits in connection to the Agrokor case. Fiscal risks are also still present in connection with the unresolved issue of bank lawsuits linked to the Swiss franc and health sector arrears. Additionally, the government refuses to take into account the previously promised growth of public sector wages, given that these are not included in any budgetary projections including the National Reform Program and the Convergence Program. Trade unions are currently in a stand-by mode, and if the government does not begin the negotiations on the base wage increase soon, union strikes will probably follow. Finally, with the lack of reforms, the relatively encouraging fiscal projections are contingent on favorable economic conditions in the EU and the realization of the abovementioned risks.

Unemployment continues its downward spiral

The number of the registered unemployed continued its downward spiral in 2018, with a year-on-year drop by more than 20 percent in the first eight months of 2018, thus reaching 134 thousand registered unemployed at the end of August and setting a new record low that has not been recorded since October 1988. New entries into unemployment registry decreased by about 8 percent year-on-year in the January–August period, while, at the same time, both the overall exits from the unemployment registry and exits due to employment decreased by about 11 percent (year-on-year). Therefore, the main reasons

behind the drastic unemployment decline seem to lie outside new employment, with prime candidates being continued emigration, demographic developments, and active labor market policies (ALMPs). With almost 50 thousand people leaving Croatia only in 2017, and almost 200 thousand since 2009, the retirement of the older population, which is not being replaced with younger cohorts on the labor market, and with ALMPs taking up more than 50 thousand unemployed in the first eight months of 2018, no wonder the number of unemployed continued to cease further down without significant rise of employment (Figure 11). According to the Croatian Pension Insurance Institute data on the number of insured, employment increased by 2.3 percent in the January–July period, whereas the temporary Croatian Bureau of Statistics data suggest a stagnation with a year-on-year employment growth of -0.1 percent in the first seven months of 2018.

Lack of labor force threatens tourism viability

Labor demand (proxied by the Online Vacancy Index (OVI)), on the other hand, despite the growth slowdown in recent months, is well above its pre-crisis levels, suggesting that there is a potential mismatch between supply and demand on the Croatian labor market (Figure 11). This is further confirmed by looking at the specific sectors and/or occupations, given that OVI indicates that the highest demand in 2018 is observable

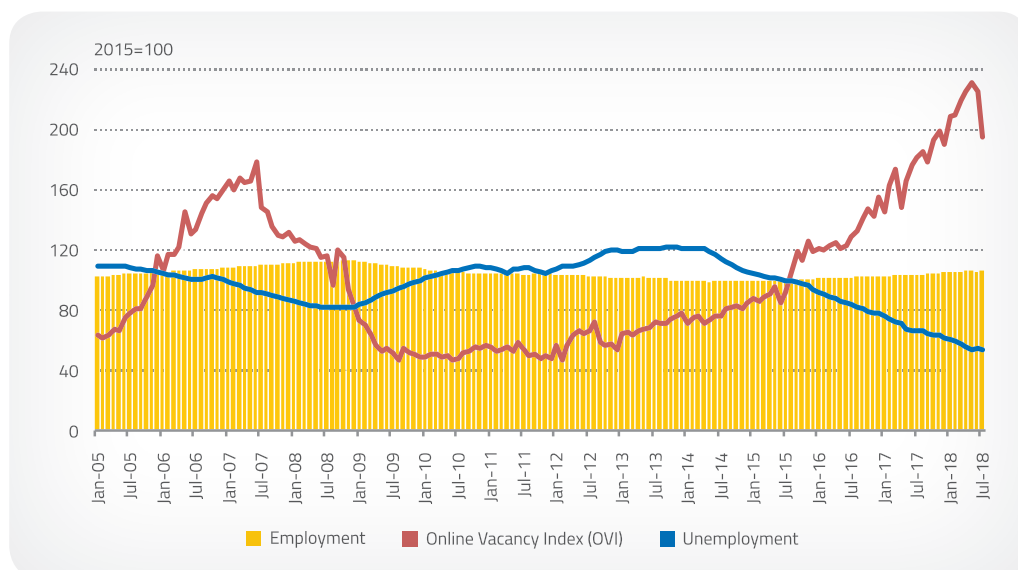


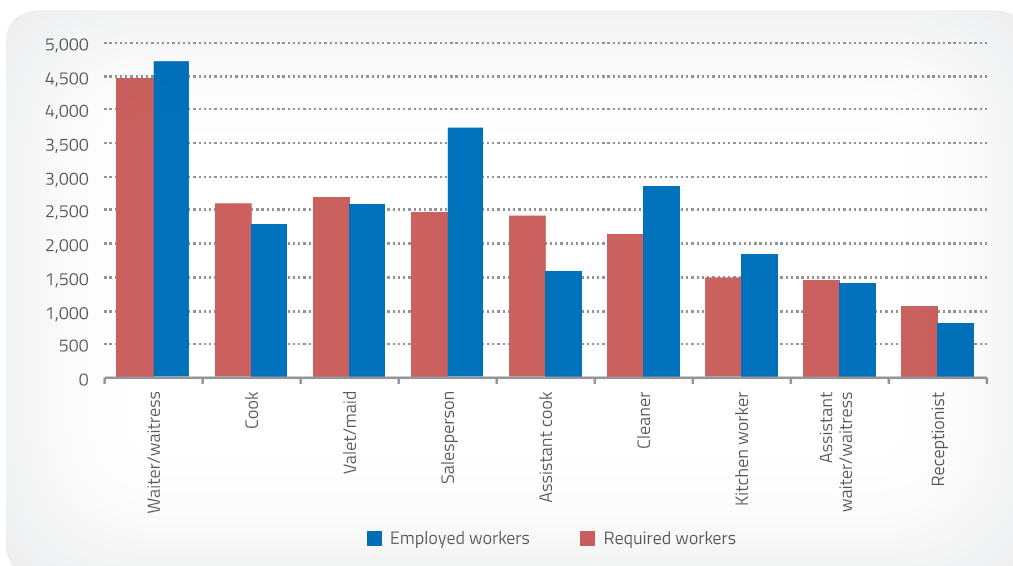
Figure 11
Labor Supply and Demand

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Sources for the original data: Croatian Pension Insurance Institute, Croatian Employment Service, and ELZ.

Figure 12
Seasonal
Employment
by Occupation,
January–July 2018

Source: Croatian
Employment Service.



for the occupations of a salesperson, waiter, cleaner, and cook, while the data on seasonal employment by the Croatian Employment Service (CES) in the January–July 2018 period suggest that only the demand for cooks might have been satisfied (Figure 12). If the situation concerning the lack of labor force in tourism continues in the future, one has to wonder about the viability of the dominant source of the Croatian economic growth. The government tried to overcome this issue by increasing the number of working permits for foreigners on two occasions, covering also other sectors with insufficient labor force such as construction, but it seems that this was not enough to meet the burgeoning labor demand.

Upside risks to expected unemployment decline

As we expect similar developments on the labor market to continue in the near future, we project registered unemployment rate to fall further down—to 9.9 and 8.8 percent in 2018 and 2019, respectively (Figure 13). However, more weight in the continued fall of unemployment rate should be put on the employment growth, especially in 2019 when the private sector should be the main source of job creation. Risks to these projections are mainly on the upside given the tentative situation with shipyards and possible other restructuring considerations (including Agrokor) that could lead to increasing unemployment. Also, continued unmet labor

Figure 13
Unemployment
Rate

Note: * represents
EIZ forecasts.

Sources: Croatian
Bureau of Statistics
and EIZ for forecast.



demand could further hinder new employment additionally deteriorating the size of the labor force. This could actually hamper the entire economic growth as it is highly unlikely to experience longer-term growth rates in an environment of no or low employment growth, especially in an economy based on services such as the Croatian economy.

Labor shortages drive wages up

The average gross wage stood at 8,441 kuna (approx. 1,138 euro) in the first six months of 2018, which denotes a rise of 5.3 percent in nominal and 3.9 percent in real terms year-on-year, in part due to the effects from last year's increase of public sector wages. As the effects of the tax reform faded in this year, average net wages in the same period grew by 4.7 percent and 3.3 percent in nominal and real terms, respectively. In addition to mining and quarrying and administrative and support service activities, the highest growth of wages in the first half of the year is observable in the construction and wholesale and retail trade sectors, suggesting that labor shortages might also lie behind the rise of wages in these sectors, thus driving the overall wage growth in 2018.

Steady wage growth to continue

Although the details of the upcoming tax reform are yet to be precisely determined, announced changes in the tax system are not likely to have a significant impact

on wage growth. However, we do expect a continuation of the wage growth trend mainly driven by the private sector wage increase. Public sector wages are expected to remain more or less unchanged despite the trade unions' demand for the increase of wages in the public sector, given that even if an agreement between unions and the government is eventually reached, it is not expected to have its effect before 2020. On another front, excessive wage growth might lead to increased labor costs that could endanger new employment, especially if rising above the level of productivity (Figure 14). Not only that, but wage growth could also lead to higher inflation, not only because of increased consumer demand, but also due to increased prices by employers in some sectors that would need to compensate for increased labor costs. Nevertheless, the expected rise of wages, coupled with increasing employment, announced growth of pensions, remittances from emigrants, and a rather low inflation, should further affect the increase of the overall disposable income and thus the continued rise of the private consumption in 2019.

Lower inflation in 2019

The consumer price index exceeded 2 percent in both June and July this year, driven mostly by increasing fuel prices, as rising political tensions in the Middle East and Venezuela cut the production and boosted world oil prices.

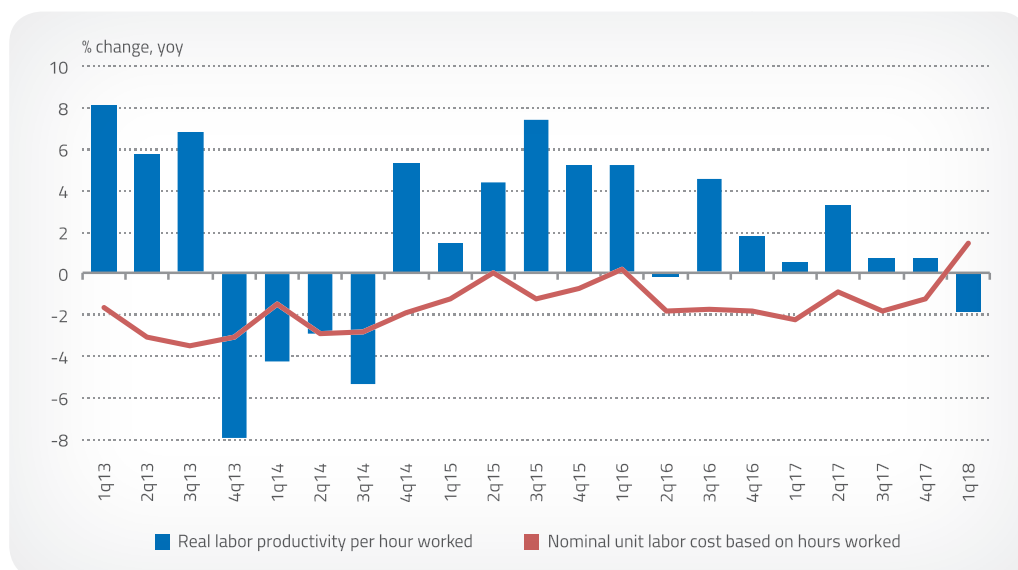
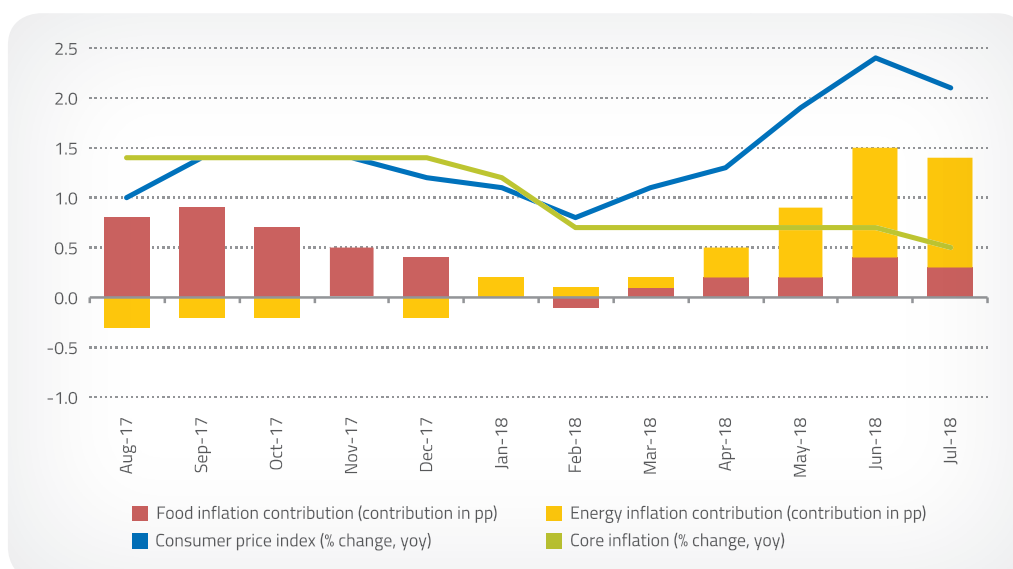


Figure 14
Labor Productivity
and Unit Labor
Costs

Source: Eurostat.

Figure 15
Consumer Price Index and the Contributions from Its Main Components

Sources: Croatian Bureau of Statistics and Croatian National Bank.



Food prices also had a positive contribution to the consumer price index in this year, while core inflation index mostly stagnated around 0.7 percent (Figure 15). For the remainder of the year we expect abating energy inflation, but core prices could pick up due to rising employment, wages, and strong consumer spending. Overall, we see consumer prices up by 1.6 percent in this year, whereas for the following year consumer price inflation could be somewhat lower, in the 1.5 percent territory, as private consumption and GDP growth decelerate, and VAT cuts are put into effect. Potential risks to this projection come in the form of a possible prolongation of the world energy prices hike, but also from increased prices due to a further wage increase on the domestic front.

Summer depreciation

The Croatian National Bank (CNB) continued with its expansionary monetary policy reflected in abundant kuna money market liquidity, and historically low short-term interbank interest rates. Although we expected the tourism-driven appreciation pressures during summer months to continue in August as well, the average HRK/EUR rate actually depreciated by 0.3 percent when compared to the previous month. There is a possibility that the expectations of interest rate hikes in the US could have affected capital flows in emerging markets, thus contributing to stronger foreign currency demand in Croatia as well. Keeping in mind that this trend could

continue in the months to follow, we expect the HRK/EUR exchange rate to depreciate further for the rest of the year. Taking into account our projection that the average monthly rate will not exceed 7.45, we see the average for the whole year at around 7.42. On a different note, when compared to the post-recessionary 2015–2017 period, the band around the exchange rate seems to have somewhat tightened. The absolute percent deviation from the annual average exchange rate was considerably smaller in the first eight months of 2018 when compared to the months in the preceding three years (Figure 16). If these are the signs of euro adoption preparations, and if the tightly managed exchange rate persists in the following year, the exchange rate in 2019 could average at just slightly above 7.40.

Smaller expenses on loss provisions

The amount of nonperforming loans (NPL) continued to decrease in the first half of 2018 and stood at 28.2 billion kuna, 5.6 billion or 17 percent less than the previous year. While the bank profit was significantly subdued last year due to Agrokor's financial restructuring, the normalization of expenses on loss provisions in the first half of 2018 aims at a stronger bank profit in this year. By the end of June net profits were already up by almost three times or 1.9 billion kuna from last year results (Figure 17). Regarding the next year, the main threat to bank profit

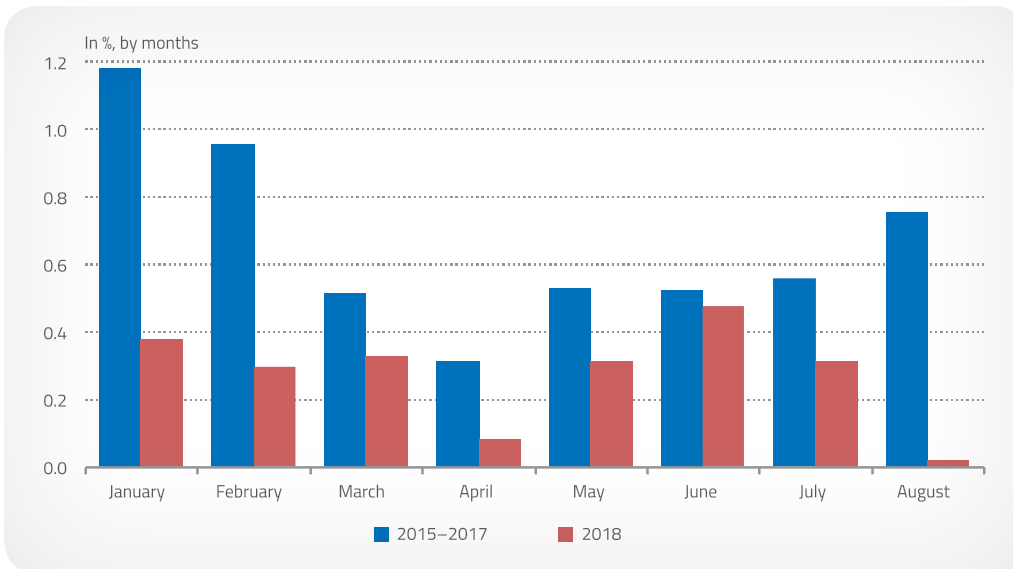


Figure 16
Absolute Percent
Deviation from
the Annual
Average HRK/EUR
Exchange Rate

Source: Croatian
National Bank.

stems from possible additional effects related to losses from Agrokor suppliers.

Rising loans to households

Due to strong government debt deleveraging in progress from February 2015 in the total amount of 19.9 billion kuna or 33.5 percent (up to end of July 2018), total loan growth in year-on-year terms remained negative in the first seven months of 2018 (Figure 18). However, loans to households have been recording positive year-on-year growth rates as of September last year reaching as high as 4.1 percent in July 2018. These positive developments are mostly a result of record low interest rates, improved economic outlook, job market recovery, and partially also of housing loan subsidies that contributed to housing loan market recovery.

Although the recent Foreclosure Act and the Decision on the additional criteria for the assessment of consumer creditworthiness and on the procedure of collection of arrears and voluntary foreclosure significantly tightened financial conditions, it seems that the legislation changes affected only lower-income households that were not overly important for the credit growth in the first place.

Government deleveraging halts credit growth

Despite the fact that new loans to enterprises have been rising lately (mostly in service industries and manufacturing), outstanding loans are still shrinking due to the sale of irrecoverable claims on the secondary market. Even with some positive developments on

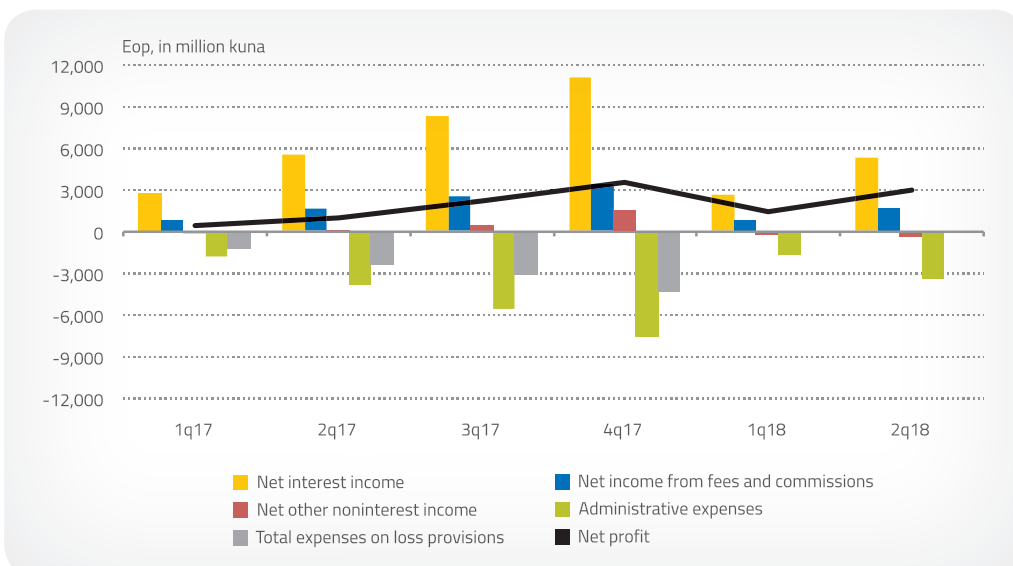


Figure 17
Bank Income and
Profit

Source: Croatian
National Bank.

Table 2 Main Economic Indicators

	2016	2017	2017		2018	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	3.5	2.9	3.4	2.2	2.5	2.9
Real private consumption (% change, yoy)	3.4	3.6	3.7	3.5	3.9	3.6
Real government consumption (% change, yoy)	0.7	2.7	3.1	3.4	2.8	2.5
Real investment (% change, yoy)	6.5	3.8	3.7	1.9	3.6	3.1
Industrial output (% change, yoy)	5.3	1.4	2.9	-0.6	0.8	0.2
Unemployment rate (registered, %, pa)	14.8	12.1	10.5	11.7	12.1	9.4
Nominal GDP (EUR million)	46,664	49,008	13,761	12,111	11,298	13,009
GDP per capita (EUR)	11,179	11,740	-	-	-	-
PRICES, WAGES, AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	-0.1	1.1	1.6	1.7	0.4	0.9
Consumer prices (% change, yoy, pa)	-1.1	1.2	1.1	1.3	1.0	1.9
Producer prices (% change, yoy, pa)	-3.9	2.1	2.1	2.5	1.2	2.6
Average gross wage (% change, yoy, pa)	1.9	3.9	4.4	4.4	4.8	5.9
Exchange rate, HRK/EUR (pa)	7.53	7.46	7.42	7.53	7.44	7.39
Exchange rate, HRK/USD (pa)	6.81	6.62	6.32	6.40	6.05	6.20
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	12,317	14,017	3,466	3,813	3,293	3,644
Exports of goods (EUR, % change, yoy)	6.8	13.8	13.1	9.3	-2.7	8.7
Imports of goods (EUR million)	19,712	21,891	5,594	5,391	5,657	5,951
Imports of goods (EUR, % change, yoy)	6.6	11.1	12.4	4.7	8.1	4.9
Current account balance (EUR million)	1,204	1,902	3,861	-584	-1,902	-
Current account balance (% of GDP)	2.6	3.9	28.1	-4.8	-16.8	-
Gross foreign direct investment (EUR million)	1,721	1,791	660	477	468	-
Foreign exchange reserves (EUR million, eop)	13,514	15,706	14,954	15,706	16,480	16,694
Foreign debt (EUR million, eop)	41,668	40,069	39,725	40,069	40,578	-
GOVERNMENT FINANCE^a						
Revenue (HRK million) ^b	158,057	161,907	42,577	41,309	38,027	-
Expense (HRK million) ^b	152,715	155,436	36,947	43,241	38,621	-
Net = Gross operating balance (HRK million) ^b	5,342	6,471	5,630	-1,932	-594	-
Net acquisition of nonfinancial assets (HRK million) ^b	8,086	7,216	1,572	2,935	1,297	-
Net lending/borrowing (HRK million) ^b	-2,744	-745	4,058	-4,867	-1,891	-
Domestic government debt (EUR million, eop)	22,909	22,995	24,873	22,995	23,182	-
Foreign government debt (EUR million, eop)	14,369	14,712	14,025	14,712	14,625	-
Total government debt (eop, % of GDP)	80.2	77.5	-	77.5	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	18.1	19.1	21.0	19.1	23.8	22.8
Broad money, M4 (% change, yoy, eop)	4.2	2.9	3.9	2.9	5.1	5.7
Total domestic credit (% change, yoy, eop)	-6.0	-4.7	-1.9	-4.7	-4.7	-2.0
DMBs credit to households (% change, yoy, eop)	-5.5	1.2	0.4	1.2	2.2	3.9
DMBs credit to enterprises (% change, yoy, eop)	-2.5	-1.9	0.3	-1.9	-1.4	-0.1
Money market interest rate (% pa) ^c	0.5	0.4	0.4	0.4	0.3	0.3
DMBs credit rate for households, short-term, (% pa) ^d	8.0	7.6	7.4	7.3	7.1	7.0
DMBs credit rate for enterprises, short-term, (% pa) ^d	4.7	4.3	4.4	3.9	3.9	3.7

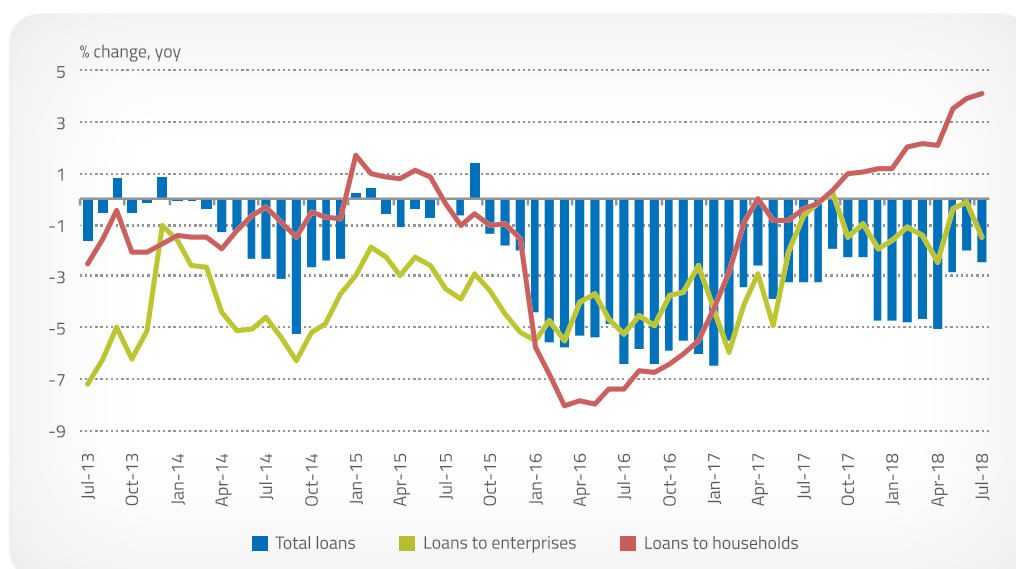
Notes: ^aData refer to consolidated general government. ^bOn the cash principle. ^cInterbank demand deposit trading, one week interest rate. ^dThe weighted average interest rate on new kuna and foreign currency indexed loan agreements, revised data.

Conventional abbreviations: pa – period average, eop – end of period, yoy – year-on-year, HRK – Croatian kuna, EUR – euro, USD – US dollar, DMB – deposit money bank.

Sources: Croatian Bureau of Statistics, Croatian National Bank, and Ministry of Finance.

Figure 18
Credit Sector
Developments

Source: Croatian
National Bank.



the household and corporate market, further government deleveraging will put downward pressure on credit growth in 2018, possibly leaving the growth rate at -1.7 percent (Table

1). Similar trends are expected for the next year as well, with the additional risk to our projection of -0.9 percent in the anticipation of Agrokor-related second-round effects.

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