

# Croatian Economic Outlook

## Quarterly



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## Forecast Update

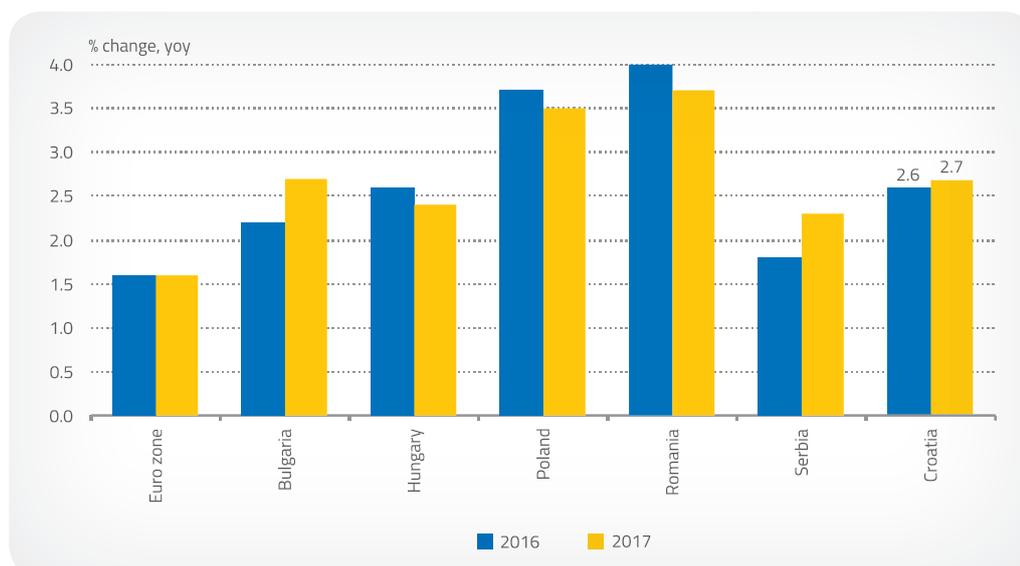
### Global recovery comes to a halt

World output grew at a rate of 3.4 and 3.1 percent in 2014 and 2015, respectively, and this gradual, but sure-footed recovery path continued in the first half of 2016. While output growth in advanced economies remained moderate at best, emerging markets and developing economies performed even better than expected. However, due to the outcome of the UK vote, which weighted in favor of leaving the EU (Brexit) on June 23, economic, political and institutional uncertainties have substantially increased. This is reflected in the International Monetary Fund's (*World Economic Outlook Update*, July 2016) projections of growth rates for 2016 and 2017, which were both revised down by 0.1 percentage points from their forecasts in

April and now stand at 3.1 and 3.4 percent, respectively.

### Euro zone recovery hampered by increased uncertainty

The first quarter of 2016 saw a 2.2 percent output growth in the euro zone, driven mainly by strong domestic demand and rebound in investments. However, the second and the ongoing third quarters are characterized by increased macroeconomic uncertainty due to Brexit (especially for the advanced European economies) and somewhat subsiding, but still present, geopolitical uncertainties such as the refugee crisis and recent terrorist attacks. IMF expects 1.6 percent growth in 2016, before declining to 1.4 percent in 2017 due to shaken consumer and business confidence and potential bank stresses.



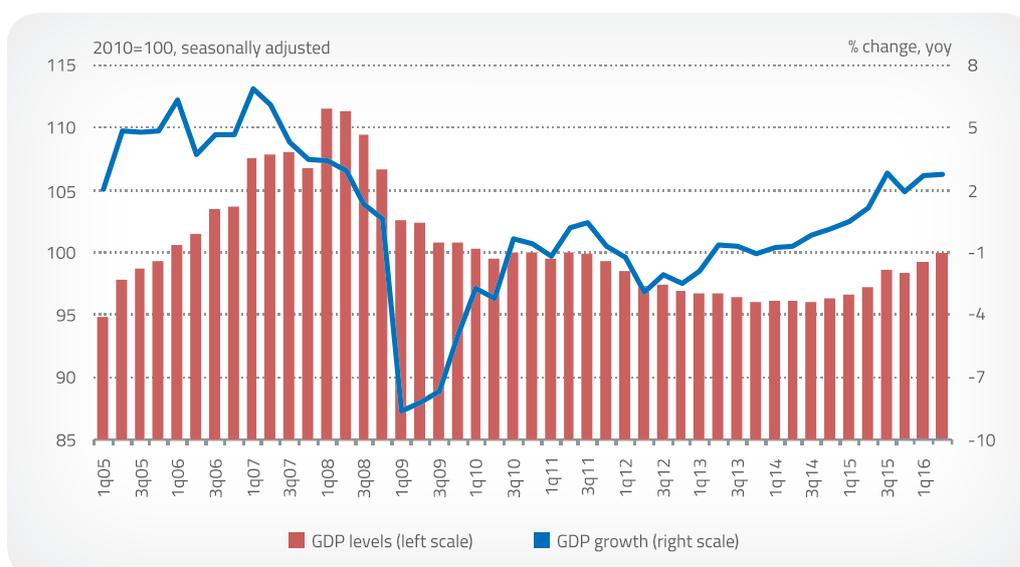
**Figure 1**  
Real GDP Growth  
Forecasts for the  
Euro Zone, Croatia  
and Selected CEE  
Countries

**Source:** *Global Economic Prospects*, World Bank, April 2016 and EIZ for Croatia.

**Figure 2**  
Real Gross  
Domestic Product

**Note:** Seasonally adjusted by X11ARIMA (Statistics Canada).

**Source for the original data:** Croatian Bureau of Statistics.



### Croatian GDP is picking up

Real GDP increased by 2.8 percent in the second quarter of 2016 (measured year-on-year), making it the highest growth rate since the beginning of 2008 (Figure 2). When compared to the first quarter of 2016, it recorded an increase of 0.7 percent (seasonally adjusted), thus continuing this year's expansion momentum. Based on the latest available data, and given the positive signals for the third quarter, we expect this recovery to continue. We have therefore revised our growth rates forecasts upwards for this and the following year to 2.6 and 2.7 percent, up by 0.7 and 0.6 percentage points (Figure 1).

### Personal consumption benefits from an improved economic outlook

Personal consumption recorded a quarter-to-quarter growth rate of 0.5 percent in the second quarter of 2016 (seasonally adjusted), and three percent growth compared to the same period last year. An increase in consumer sentiment, coupled with a decrease in the unemployment rate and favorable weather conditions that boosted the tourist preseason all gave rise to spending. In the first seven months of this year, retail sales have increased by 4 percent compared to the same period last year, while the number of tourists rose by 9.2 percent. In light of the positive indicators of a possibly record tourist season, we see no reasons for this recovery to subside in the

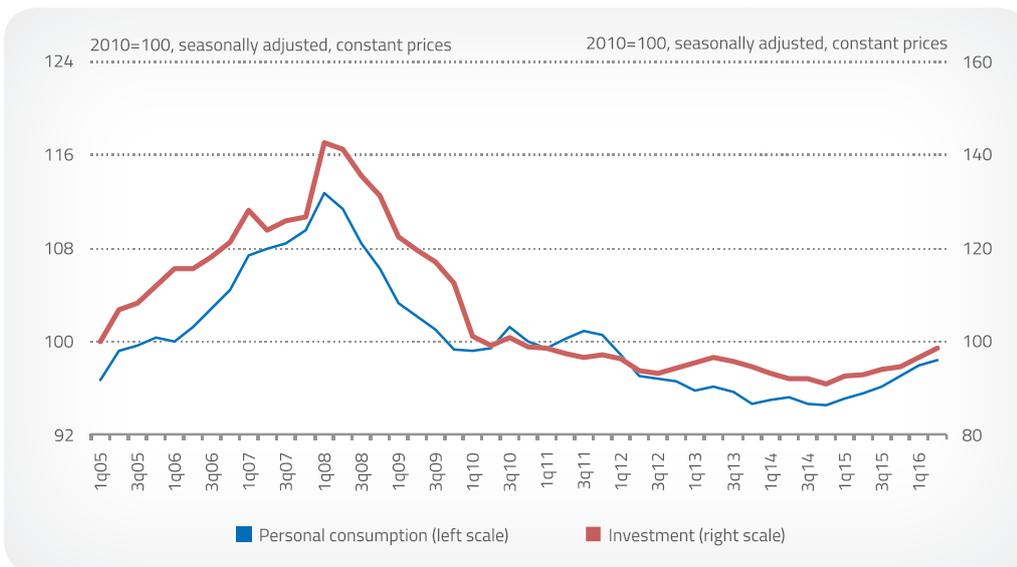
third quarter. This is why we revised personal consumption growth forecasts upwards, which now stand at 2.6 and 2.4 percent for the current and the following year.

### Investments continue to rise throughout the year

Investment activity in seasonally adjusted terms increased by 2 percent in the second quarter of 2016 when compared to the previous quarter (Figure 3), and by 6.3 percent annually. Taking into account notable growth in the first half of the year, the anticipated domestic activity recovery, and assuming that the new government will be constituted in a reasonable period, we expect a 4.5 percent growth in investment activity in 2016, before moderately slowing down to 4.2 percent in 2017. Besides investment, construction work increased by 4.1 percent in the first half of 2016 compared to the same period last year, while industrial production went up by 6.5 percent, both record rates from 2008 and 2007.

### Increase in government spending seems to be only temporary

In the second quarter of 2016, government consumption increased by 1.2 percent in seasonally adjusted terms when compared to the previous quarter, and by 2.6 percent when compared to the second quarter of the last year (Figure 4), making it the biggest increase in government spending since late 2009. This unusual development is mostly due to some



**Figure 3**  
Personal Consumption and Investment

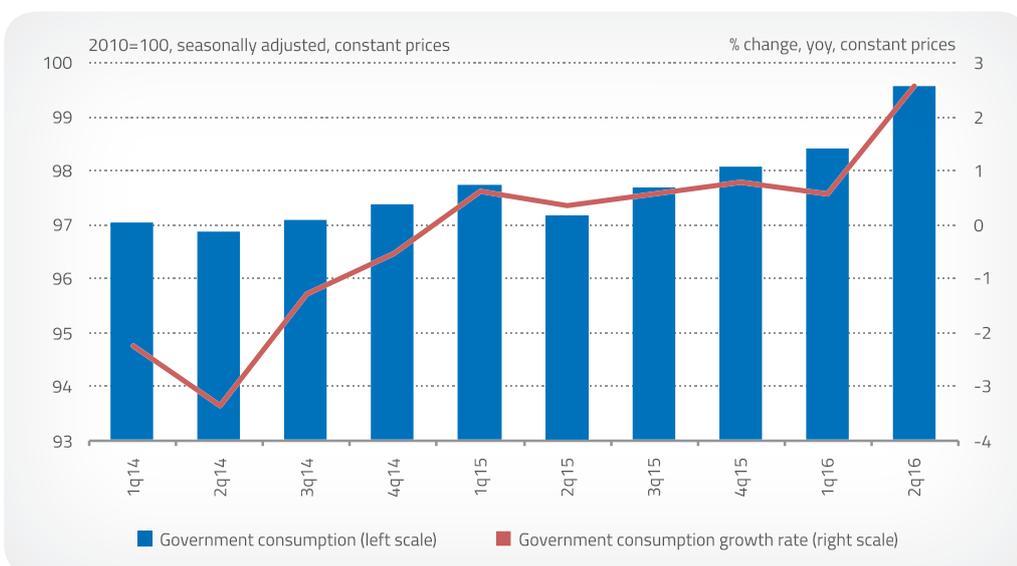
**Note:** Seasonally adjusted by X11ARIMA (Statistics Canada).

**Source for the original data:** Croatian Bureau of Statistics.

arrears payment and new employment in the short period between temporary financing, the first quarter of 2016, and the ousting of the government in a no-confidence vote (mid-June 2016). However, as the government was only an acting government in the third quarter, we expect spending to gradually slow down until the new government is formed, hopefully by the end of the year. Nevertheless, growth recorded in the first two quarters will greatly determine the overall annual growth, which we now see at 1.1 percent in 2016. The forecast for 2017 is bound by high uncertainties, as the new government might have different priorities when it comes to reforms and the Budget. We have, therefore, kept our forecast for government spending growth unaffected from the June issue, at 0.9 percent.

### Imports growth on the rise, exports seem to be leveling off

In seasonally adjusted terms, exports decreased by 0.6 percent in the first quarter of 2016, and then rebounded in the second quarter as they went up by 0.5 percent (quarter-to-quarter) (Figure 5). We expect this rebound to continue throughout 2016, with the annual growth rate projected at 5.9 percent, before gradually slowing down to 5 percent in 2017. Imports, on the other hand, went up from 0.1 percent growth in the first quarter to 2.1 percent in the second (quarter-to-quarter, seasonally adjusted) (Figure 5). Given a relatively high share of imported goods in the Croatian consumption basket, and an increasing trend in retail sales and consumption spending, the rise in imports is no surprise. As we see private consumption



**Figure 4**  
Government Consumption

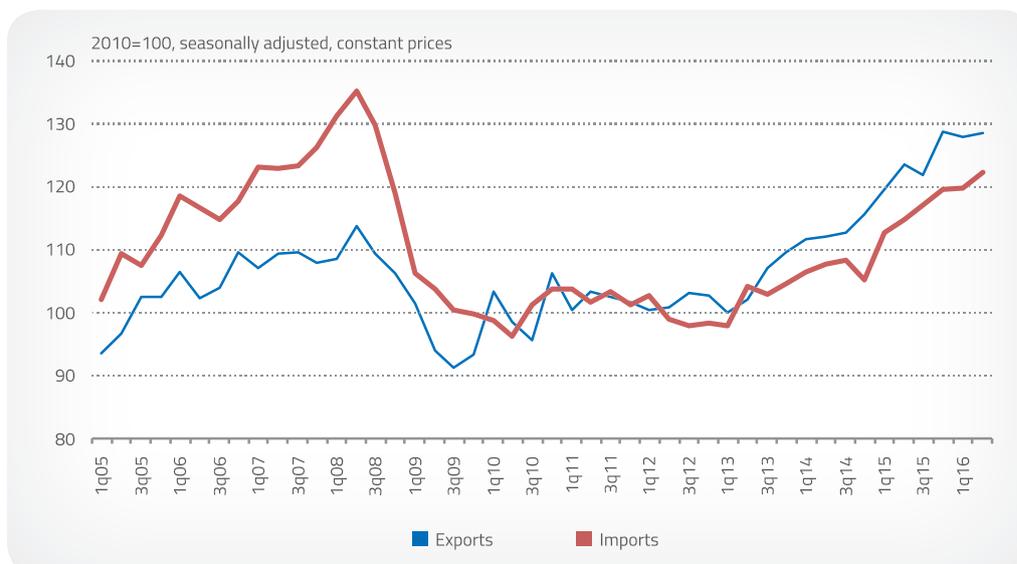
**Note:** Seasonally adjusted by X11ARIMA (Statistics Canada).

**Source for the original data:** Croatian Bureau of Statistics.

**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.



recovery gaining momentum, we have revised our import forecasts upwards to 6 and 5.5 percent in 2016 and 2017. Since the new imports to exports growth margins are slightly turning in favor of imports, the current account surplus was revised to 3.6 and 1.9 percent, down by 0.3 and 0.9 percentage points, for the current and the following year.

### The six-month political experiment is over

Politically, the first half of 2016 was to a large extent 'experimental'. The six-month political experiment of having a Prime Minister nonaffiliated with either of the ruling coalition

parties has famously failed. On June 16, a no-confidence motion against Mr. Orešković was passed in the Parliament, initiated by HDZ, and backed by SDP as the main opposition party. After HDZ failed to gather support for a new Prime Minister, the Parliament was dissolved on June 20, in spite of polls showing that both HDZ and Most would notably lose support in the new elections relative to the previous elections. President, Mrs. Grabar-Kitarović, scheduled the new elections on September 11. During the summertime, HDZ elected a new president, Mr. Andrej Plenković, one of Croatia's representatives in the European Parliament.

**Table 1**  
Forecast  
Summary

	2016	2017
<b>Real GDP (% change)</b>	<b>2.6</b>	<b>2.7</b>
Real private consumption (% change)	2.6	2.4
Real government consumption (% change)	1.1	0.9
Real investment (% change)	4.5	4.2
Exports of goods and services (constant prices, % change)	5.9	5.0
Imports of goods and services (constant prices, % change)	6.0	5.5
Current account balance (% of GDP)	3.6	1.9
General government balance (ESA 2010 definition, % of GDP)	-2.3	-2.1
Public debt (ESA 2010 definition, % of GDP)	86.6	86.0
Unemployment rate (registered, %, pa)	15.7	14.9
Exchange rate, HRK/EUR (pa)	7.50	7.48
Broad money, M4 (% change, eop)	4.7	4.2
Total domestic credit (% change, eop)	-2.4	2.1
Consumer prices (% change, pa)	-0.4	0.8

**Note:** Cut-off date for information used in the compilation of forecasts was September 8, 2016.

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

**Source:** Authors' forecasts.

## My tax is lower! No, mine is!

Due to the fact that the election campaign period was pretty short, less than three months' duration, the candidates, having no time to lose, jumped into the campaign immediately. A lot of effort was put into attracting the attention of voters, many of whom were on vacation at the time. Although the political programs of the main parties, at least the parts dealing with economic issues, were prepared, or rather updated, with a bit more care than before, in essence, they amounted to nothing more than juggling with the rates of the income tax and the VAT. It is by no means an exaggeration to say there were no substantial differences in different parties' ideas on how to deal with the economy. For, given the issues the economy is facing, changing tax rates by a few percentage points would hardly make much difference. One could compare it to fine-tuning a system which, to a large extent, is malfunctioning. It appears that it will take quite some time for the political elite to grasp that there are various ways, apart from the reshuffling of the tax system, to go about helping the economy. In the meantime, it would be helpful if parties' economic experts justified their tax "reforms" by providing more than back-of-the-envelope calculations.

## New elections – a new experiment?

New elections were held on September 11. Those believing in pre-election polls could expect a new, SDP-led "People's coalition" to win a relative majority. Yet, as it turns out, that scenario did not happen. Broadening the traditional left-center coalition with the Croatian Peasant Party (HSS), which in the previous elections was part of the HDZ-led right coalition, did not help Mr. Milanović's (SDP's leader) attempts to appeal to the right-wing electorate by suddenly adopting a nationalist rhetoric. Results of the elections proved these moves were futile. In terms of seats in the Parliament, HDZ came out as the relative winner with 61 seats, 7 seats more than the SDP-led coalition. Most won 12 seats, fewer than in the previous elections, and the coalition led by Živi zid (Human Shield) won 8 seats. What strikes one as curious is

the remarkable success of Živi zid, a radical left coalition led by Mr. Ivan Vilibor Sinčić, an activist opposing banks' eviction tactics and a former presidential candidate. Other Živi zid coalition members are representatives of the Franc organization (formed during the 'Swiss franc crisis' to act jointly in a judicial process against banks) and two Most deserters. It has, by now, become obvious that HDZ and Most will form a new majority in the Parliament and pass Mr. Plenković as the Prime Minister of a HDZ–Most government. Negotiations have already begun, although the parties claim that no agreement has been reached yet, and that they are taking the time getting to know each other. It remains to be seen how the negotiations will proceed, especially given the fact that Most proposed, even before the elections, a list of requirements that must be unconditionally fulfilled by their postelection coalition partner(s). We believe they will not find it opportune enough to stick to these conditions unrelentlessly and that the new government will soon be formed.

## Government revenues on the rise, expenditures declining

Relative to the same quarter of 2015, consolidated general government revenues increased by 5.1 percent in the first quarter of 2016 in spite of slightly decreasing VAT revenues. At the same time, consolidated general government expenditures decreased by 5.1 percent. This was mainly due to a decline in interest payments and the use of goods and services.

## Changes in the government finance methodology

Starting from January 2016, the methodology for reporting wages and certain compensations for employees in primary and secondary education which are, based on legal provisions, paid from the state budget, has been changed compared to earlier periods. Furthermore, since 2015, data for local and regional self-government units (local units), instead of former 53 largest units, include all 576 local units and the local units' extra-budgetary users – county road administrations. On top of all this, the net principle of accounting personal income tax was replaced by the

gross principle, making direct comparison to previous years practically impossible.

### Lower deficit and public debt projections

General government deficit amounted up to 10.7 billion kuna, or 3.2 percent of GDP in 2015 (Figure 6). General government debt was, at the end of the first quarter 2016, smaller, compared to the end of 2015, as well as compared to the first quarter of 2015, by 0.1 and 1.2 percent, respectively. Together with relatively high GDP growth rates in the first half of the year, it leads to adjustments of previous forecasts of government deficit to 2.3 percent of GDP in 2016, and further to 2.1 percent in 2017. Likewise, the growth rate of public debt is now also expected to slow down more significantly, and based on the available figures for 2016, it could go negative in this year. At the end of 2015, public debt amounted up to 86.7 percent of GDP and is now expected to be at around 86.6 percent of GDP in 2016 and 86 percent in 2017. This development means Croatia could satisfy the conditions to exit the EDP in 2017, thus attracting the attention of capital markets.

### Favorable public finance developments subject to sizable risks

In spite of positive signs from the data available for 2016, only the upcoming period will determine the definite trajectory of Croatia's public finances. This will most certainly be highly influenced by political

developments, i.e. forming of the new government and Parliament majority and the stability of the relationship between the main political actors.

The relative winner of the elections, HDZ, made pre-election promises of reducing the VAT rate and increasing the nontaxable part of personal income from 2,600 to 3,750 kuna, without presenting a credible budget-neutral plan to achieve these goals. With still fragile economic growth, these policy changes could endanger the achieved moderate stability of public finances. The risk is therefore twofold: (i) continuing political instability or (ii) implementing the mentioned pre-election policies after forming a stable government. Obviously, neither of the two is desirable from the public finances' point of view. The terms of future borrowing will also be determined by the developments on the political front. In order to return to favorable borrowing conditions, it is imperative that the situation is resolved and political stability returned.

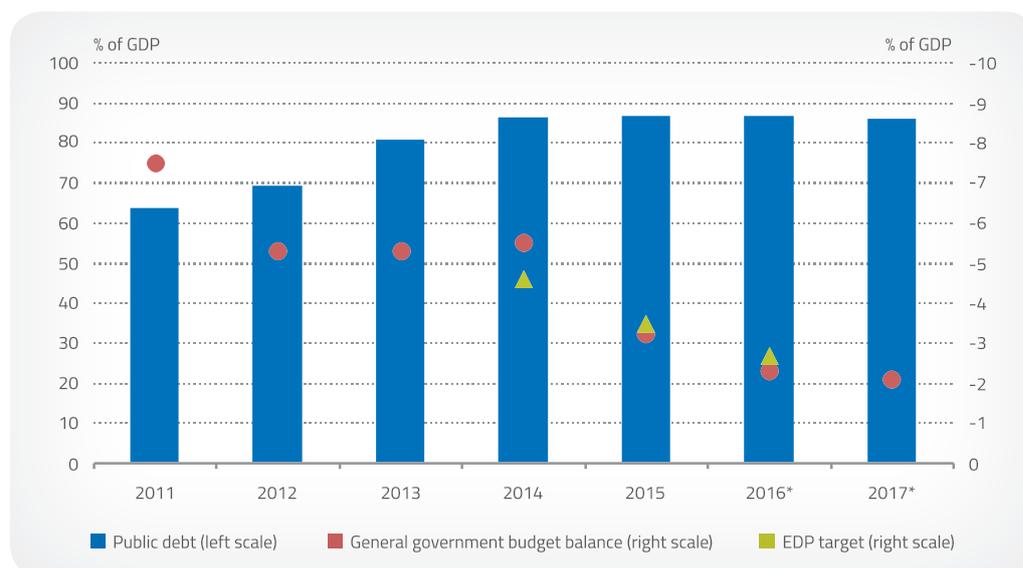
### Record-low unemployment in the last 25 years

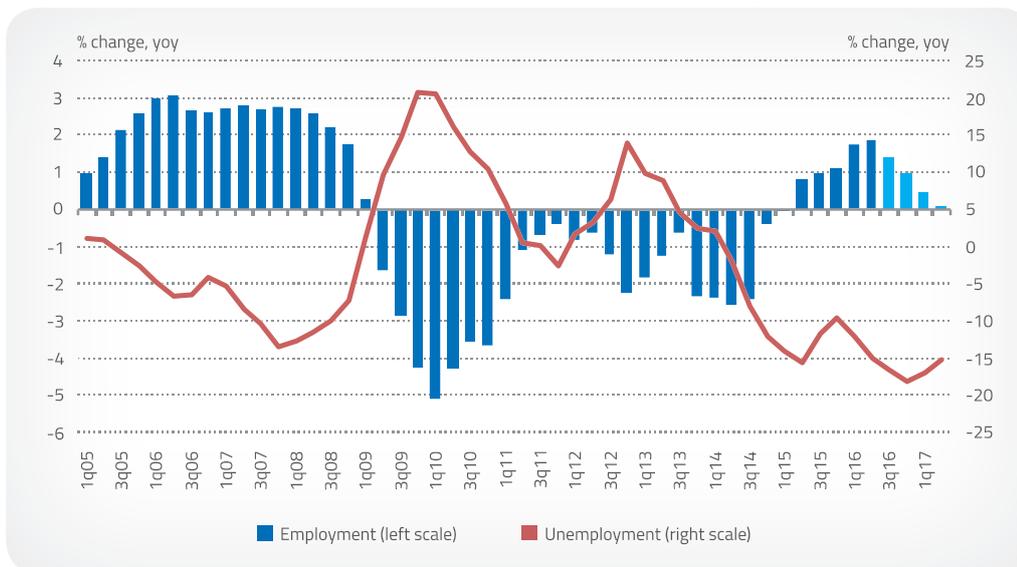
Usual seasonal dynamics on the labor market, coupled with positive trends that started back in 2014, has further brought down both the levels and rates of unemployment. Unemployment rate of 13.3 percent, recorded in July, is the lowest one since November 2008. However, what comes as a surprise is the 213,340 registered unemployed individuals in August, which is the lowest number recorded

**Figure 6**  
General Government Budget Balance and Debt

**Note:** \* EIZ forecast.

**Sources:** Eurostat and EIZ for forecast.





**Figure 7**  
Total  
Employment and  
Unemployment

**Note:** 3q2016–  
2q2017 is based  
on extrapolated  
values.

**Sources:** Croatian  
Employment Service  
and Croatian Pension  
Insurance Institute.

at the Croatian Employment Service (CES) ever since January 1991, or more than 43 thousand individuals, 17 percent lower than in August 2015 (Figure 7). We cannot argue that the expansion of employment stands behind this record-low unemployment in the last 25 years because the CES data point to a fall of exits from the Register due to employment. The remarkable fall of registered unemployment is probably a result of a mix of factors, including demographic developments, noncompliance and nonappearance, which further point to an increase of inactivity, but also to a rise of informal sector and/or stronger emigration.

### Employment dynamics much slower, but with a positive outlook

Employment statistics is, on the other hand, once again sending mixed signals. Croatian Bureau of Statistics' temporary data suggest a fall in employment in the first seven months of 2016 in comparison to the same period last year, whereas the data on the number of insurees at the Croatian Pension Insurance Institute say that the labor market is recovering with a year-on-year rise of employment by 1.8 percent in the January–July period. Majority of this employment increase comes from the rise of employment in wholesale and retail trade, accommodation and food service activities, but also in professional, scientific and technical, administrative and support activities, education, and human health and social work activities. Expected positive overall economic development means that both employment and wages should continue to

increase mildly. Hence, our unemployment rate projections are set further down, at 15.7 and 14.9 percent for 2016 and 2017.

### End of deflation in 2017

We see this year's inflation rate at -0.4 percent. The main contributors to current deflation are low energy, oil, and imported food prices. For the next year we see an uptick in consumer prices based on expected higher oil and energy prices, as speculations on OPEC freezing output have been on the rise, but also on demand recovery at home and abroad. Accordingly, we expect consumer prices to rise modestly, by around 0.8 percent in 2017.

### CNB is preventing kuna appreciation

In the last few months we witnessed strong kuna appreciation pressures building up on high inflows of foreign currency from the record-high tourist season and strong export growth. Accordingly, at the beginning of September, the Croatian National Bank (CNB) intervened on the foreign exchange market buying 69 million euro at the average exchange rate of 7.50. Through this intervention, the CNB injected 517.6 million kuna into the banking system in order not only to maintain the exchange rate stability but also to help credit activity in domestic currency, thus hoping to decrease credit euroization. Keeping in mind the CNB's commitment to sustain the exchange rate stability, we see the average

HRK/EUR rate at 7.50 in 2016 and 7.48 in 2017.

### Development of secondary market for irrecoverable claims

By the end of June, nonperforming loans (NPLs) decreased by 8.6 billion kuna when compared to the same month of the previous year, bringing down the share of NPLs in total loans to 15 percent. Furthermore, the biggest contributors to NPLs, corporations, declined its NPLs in the second quarter of 2016 by 1.9 billion kuna compared to the previous quarter, and by 4.7 billion kuna in a one-year period. The main reason for this decline can be seen in an increasing sale of irrecoverable claims on the secondary market, but also in bankruptcy and prebankruptcy processes, increased debt relief, improving creditworthiness of individual borrowers, and deceleration of nonperforming loan inflow.

### Deleveraging stalls credit recovery

Historically-low interest rates, coupled with abundant liquidity enabled by the CNB, seem insufficient for domestic credit recovery. Total domestic credit activity decreased by 6.4 percent in July 2016 when compared to the same month of the previous year (Figure 8). It seems that this trend, accompanied by household and corporate deleveraging, will continue in this year. At the same time, CNB's structural operations based on low interest rates and kuna liquidity sources have led to a modest increase in demand for kuna loans, which are the first signs of success in fighting

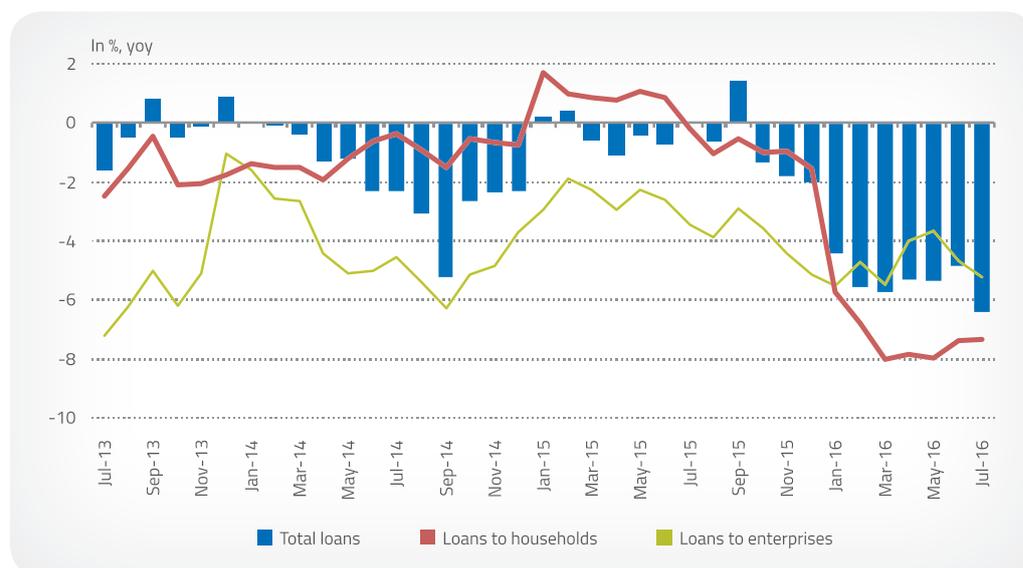
high euroization. By the end of the year we still see loans growth in negative territory, down by 2.4 percent. Credit activity is expected to moderately increase in 2017 by 2.1 percent, as aggregate demand and GDP recover.

### Broad money continues to rise

According to the latest available data, the annual growth rate of broad money in July reached 6.5 percent, which is the highest growth rate recorded in the last eight years. The expansion is a result of a strong upsurge in the three main broad money components: narrow money, kuna saving deposits, and foreign exchange deposits. Narrow money continued to record high growth rates, amounting up to 16 percent in July when compared to July 2015. Strong expansion of narrow money can be attributed to both strong growth of deposit money and money in circulation. Deposit money shot up in July, recording 3.3 percent growth compared to the same month a year ago. Both household and enterprise deposit money accelerated, with enterprises leading the way due to a purchase and sale transaction of Tvornica Duhana Rovinj (Tobacco Factory Rovinj). Meanwhile, kuna savings and foreign exchange deposits increased by 5.7 and 2.8 percent annually. The expansion of domestic currency savings could be a consequence of a positive interest rate gap when compared to euro rates. Taking recent developments into account, we expect that broad money will increase by 4.7 percent in this year and by 4.2 percent in 2017.

**Figure 8**  
Credit Sector  
Developments

Source: Croatian  
National Bank.



**Table 2** Main Economic Indicators

	2014	2015	2015		2016	
			Q3	Q4	Q1	Q2
<b>ECONOMIC ACTIVITY</b>						
Real GDP (% change, yoy)	-0.4	1.6	2.8	1.9	2.7	2.8
Real private consumption (% change, yoy)	-0.7	1.2	1.4	2.4	3.1	3.0
Real government consumption (% change, yoy)	-1.9	0.6	0.6	0.8	0.6	2.6
Real investment (% change, yoy)	-3.6	1.6	2.2	3.7	4.3	6.3
Industrial output (% change, yoy)	1.2	2.7	4.6	3.9	7.9	5.1
Unemployment rate (registered, %, pa) <sup>a</sup>	19.6	17.4	15.7	17.3	17.6	14.6
Nominal GDP (EUR million)	43,045	43,921	12,154	10,979	10,161	11,348
GDP per capita (EUR)	10,156	10,363	-	-	-	-
<b>PRICES, WAGES, AND EXCHANGE RATES</b>						
Implicit GDP deflator (% change, yoy)	0.0	0.1	0.0	-0.1	-0.3	-0.4
Consumer prices (% change, yoy, pa)	-0.2	-0.5	-0.6	-0.8	-1.3	-1.7
Producer prices (% change, yoy, pa)	-2.8	-3.8	-4.1	-4.3	-4.2	-5.6
Average gross wage (% change, yoy, pa) <sup>a</sup>	0.2	1.3	1.5	1.4	2.6	1.5
Exchange rate, HRK/EUR (pa)	7.63	7.61	7.57	7.62	7.62	7.50
Exchange rate, HRK/USD (pa)	5.75	6.86	6.80	6.96	6.92	6.64
<b>FOREIGN TRADE AND CAPITAL FLOWS</b>						
Exports of goods (EUR million)	10,369	11,528	2,967	3,055	2,690	3,065
Exports of goods (EUR, % change, yoy)	8.1	11.2	9.2	10.9	4.5	4.2
Imports of goods (EUR million)	17,129	18,483	4,815	4,621	4,451	5,061
Imports of goods (EUR, % change, yoy)	3.6	7.9	6.7	12.1	4.4	5.8
Current account balance (EUR million)	898	2,260	3,916	-426	-1,588	-
Current account balance (% of GDP)	2.1	5.1	32.2	-3.9	-15.6	-
Gross foreign direct investment (EUR million)	2,392	130	175	-557	503	-
Foreign exchange reserves (EUR million, eop)	12,688	13,707	13,437	13,707	13,199	12,937
Foreign debt (EUR million, eop)	46,664	45,534	46,918	45,534	44,303	-
<b>GOVERNMENT FINANCE<sup>b</sup></b>						
Revenue (HRK million) <sup>c</sup>	131,917	150,089	39,283	40,284	34,932	-
Expense (HRK million) <sup>c</sup>	139,532	150,559	36,093	40,691	35,369	-
Net = Gross operating balance (HRK million) <sup>c</sup>	-7,615	-470	3,190	-407	-437	-
Net acquisition of nonfinancial assets (HRK million) <sup>c</sup>	4,855	7,850	1,985	3,371	1,154	-
Net lending/borrowing (HRK million) <sup>c</sup>	-12,470	-8,320	1,205	-3,778	-1,591	-
Domestic government debt (EUR million, eop)	21,650	22,457	22,555	22,457	23,144	-
Foreign government debt (EUR million, eop)	15,443	15,482	15,485	15,482	14,741	-
Total government debt (eop, % of GDP)	86.5	86.7	-	86.7	-	-
<b>MONETARY INDICATORS</b>						
Narrow money, M1 (% change, yoy, eop)	9.6	11.4	10.4	11.4	11.0	12.7
Broad money, M4 (% change, yoy, eop)	3.2	5.1	4.6	5.1	3.6	5.0
Total domestic credit (% change, yoy, eop)	-2.3	-2.0	1.4	-2.0	-5.7	-4.8
DMBs credit to households (% change, yoy, eop)	-0.8	-1.5	-0.5	-1.5	-8.0	-7.4
DMBs credit to enterprises (% change, yoy, eop)	-3.7	-5.2	-2.9	-5.2	-5.5	-4.7
Money market interest rate (% pa) <sup>d</sup>	0.6	0.8	1.2	0.9	0.6	0.5
DMBs credit rate for enterprises, short-term, (% pa) <sup>e</sup>	5.7	5.4	5.3	5.3	5.1	4.7
DMBs credit rate for households, short-term, (% pa) <sup>e</sup>	9.3	8.9	8.8	8.4	7.9	8.1

**Notes:** <sup>a</sup> Break in time series; figures for 2016 are the result of processing data from JOPPD forms. <sup>b</sup> Data refer to consolidated general government. <sup>c</sup> On the cash principle. <sup>d</sup> Interbank demand deposit trading, one week interest rate. <sup>e</sup> The 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 - U.S. dollar, DMB - deposit money bank.

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

## Analyses

### Will tourism boost GDP growth in the third quarter?

#### Double-dip recession

After hitting bottom in January 2009, and slowly recovering for more than two years, CEIZ index hit another bottom in April 2012, after which it recorded a very slow and gradual recovery to precrisis levels (Figure 9). The index hit its post-recession high in July 2015 and has been hovering around that level for the last year. Still far from the record 2007 levels, but more or less somewhere around the average index value for the year 2006. CEIZ is a monthly coincident composite business cycle indicator that detects the current business cycle condition, i.e. the present state of the economy. It is composed of five time series that proved to be important and useful determinants of the ongoing GDP development. These are the real GDP, industrial production, retail sales, value added tax revenues, and tourist arrivals.

#### GDP growth slowdown

The latest information on the CEIZ index for July this year suggests that the year-on-year quarterly real GDP growth rate in the third quarter will be around 2.2 percent, down from 2.7 and 2.8 percent recorded in the first two

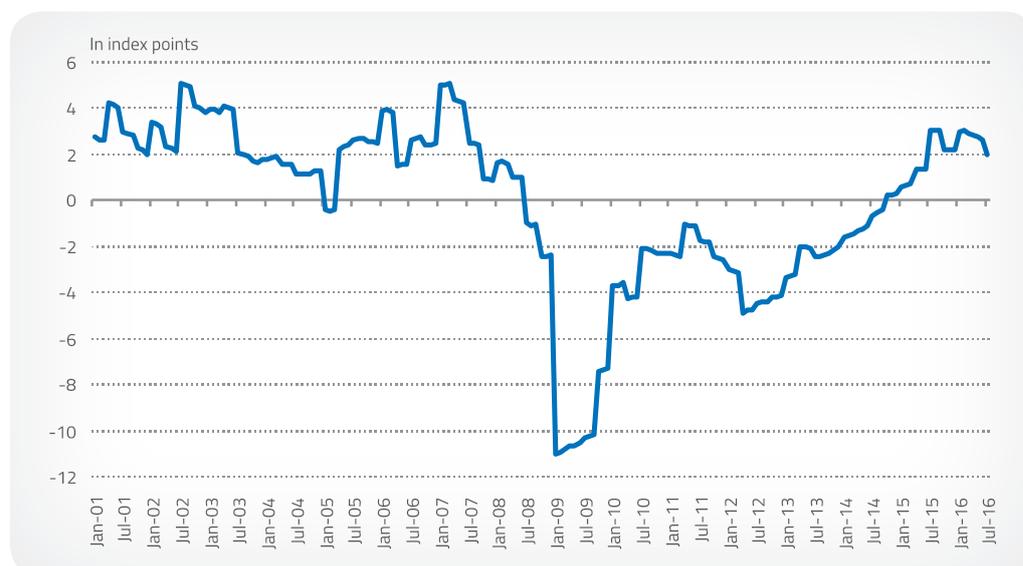
quarters of 2016. This nowcast is based on only one month of high frequency data (July 2016), but as the new data will be arriving in early October, it will be possible to estimate a more precise figure of real GDP growth in the third quarter.

#### A surprisingly high GDP growth in the first half of 2016

*Inter alia*, GDP growth was driven by all of the five components of the CEIZ index in the first half of the year. Industrial production has been leading the way as it increased by 6.4 percent in the first half of the year when compared to the same period last year. Value added tax revenues followed with a 1.3 percent increase in the same period, as the Ministry of Finance managed to cash in 266 million kuna more than in the first half of 2015. Due to ongoing deflation, this figure is even bigger in real money terms, namely, 4.8 percent growth in year-on-year terms. Retail sales growth rate has been on a 23-month long positive streak building an upward trend. In the first half of the year, retail sales increased by four percent when compared to the first half of 2015. In the January–June period there were 121,554 more tourists in Croatia, 2.8 percent more on a year-on-year level. All these developments, together with other drivers and determinants of GDP growth, were detrimental to somewhat stronger GDP growth rates in the first two quarters of 2016. If these trends continue and we

**Figure 9**  
CEIZ

**Source:** The Institute of Economics, Zagreb.



extrapolate these figures to the rest of the year, one could expect total GDP for 2016 to increase by around 2.8 percent year-on-year.

### Industrial production and VAT revenues disappoint in July

However, in July, the first month of the third quarter, CEIZ index registered a value of two index points, a value below the one recorded in June, and a decrease of 1.1 index points when compared to the same period last year. This is the lowest value of the index in the last 12 months. Although it is just the beginning of the quarter, and it is still quite early to make conclusions, it seems that the business activity started to decelerate in the third quarter. The reasons for such development are two, actually. First, industrial production disappointed in July as it crashed by 2.4 percent year-on-year, the first negative rate in the last year and a half. Second, value added tax revenues in real terms decreased by as much as 5.9 percent in July. Meanwhile, retail sales stayed on a positive path recording 3.6 percent increase in July 2016 when compared to July 2015.

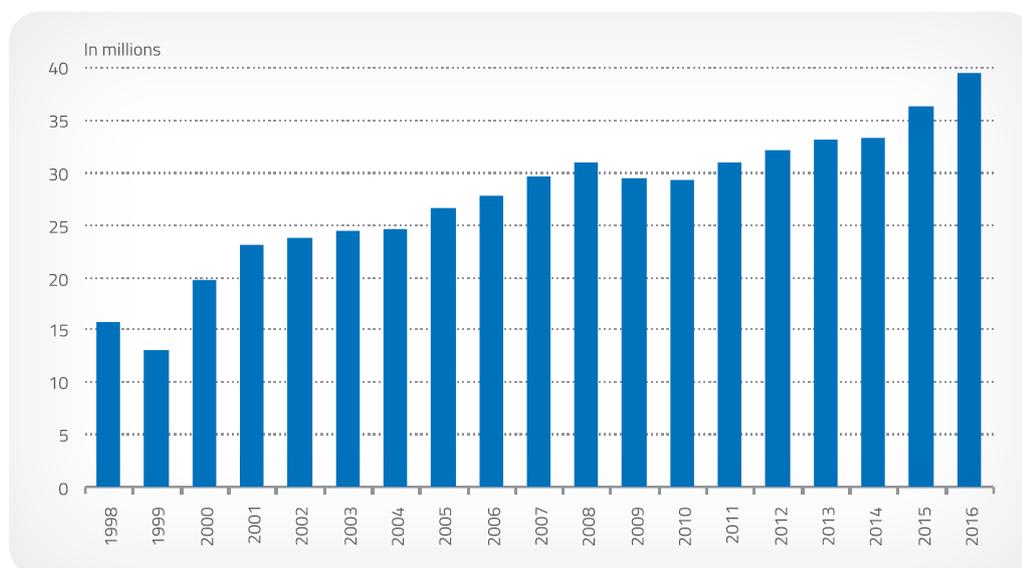
### Record tourism saves the day

With two components contributing negatively, and retail sales slightly positively, tourism remains that additional positive component which saves the day. At least when looking at July, one could expect that the CEIZ index value, and therefore the estimation for GDP, would have been even lower if it had not been for a very strong increase in tourist arrivals. In

July, arrivals grew by 17.6 percent, the highest year-on-year rate for the month of July in the last 16 years. Overnight stays followed with a 12.2 percent increase in the July 2015–July 2016 period (Figure 10). Recent efforts in Croatian tourism promotion coupled with the economic recovery at home and abroad, but most of all, with political instability and violence in the East and South Mediterranean, helped tourism in Croatia reach record levels. Although not all numbers are in yet, available indicators suggest Croatian tourism in 2016 will break records in terms of revenue, arrivals, and overnight stays. Since Croatia is a small country, highly dependent on tourism, it is reasonable to expect both August and September to have a big positive impact on GDP in the third quarter. Together with the first half of the year, Croatian GDP could, in 2016 on a yearly basis, end up considerably above last year's level.

### Swedes and Danes come in record numbers

Although Germany keeps its biggest share in total tourist overnight stays in Croatia, in July this year, Swedes and Danes contributed to the strongest growth rates in overnight stays (Figure 11). Swedes increased their overnight stays by 36 percent in a one-year period, while the Danes followed with 33.7 percent. Germany took the third place with 25.2 percent more overnight stays. All other countries with traditionally large shares, such as Austria and Slovenia for example, also depicted high growth rates. Only the Dutch

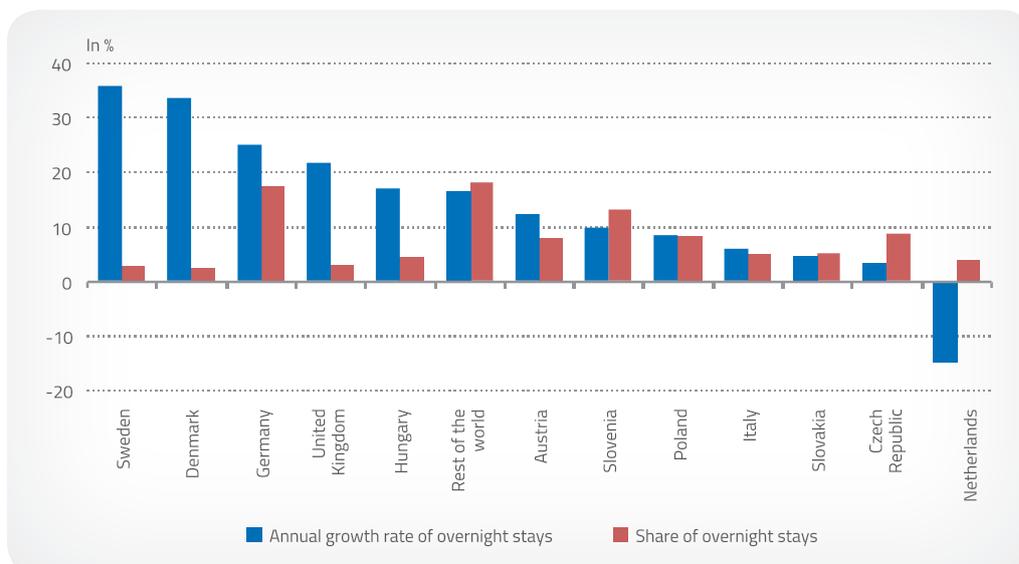


**Figure 10**  
Tourist Overnight Stays from January to July

Source: Croatian Bureau of Statistics.

**Figure 11**  
Tourist Overnight Stays in Croatia by Origin Countries

Source: Croatian Bureau of Statistics.



decreased their overnight stays considerably in the period examined, down by 14.8 percent, while the arrivals fell as well, although at a slower rate of 2.9 percent.

**Istria remains the strongest performer**

With a four percentage point contribution to the total increase in overnight stays in July (year-on-year), Istria remains the best tourism-performing county in Croatia (Figure 12). As in the previous years, Istria kept its leading position in Croatian tourism, attracting 2.1 million tourists in the first seven months of 2016, which is up by 11.6 percent from the same period last year. Split–Dalmatia County followed together with other seaside counties and the City of Zagreb. Other continental counties depicted modest contributions

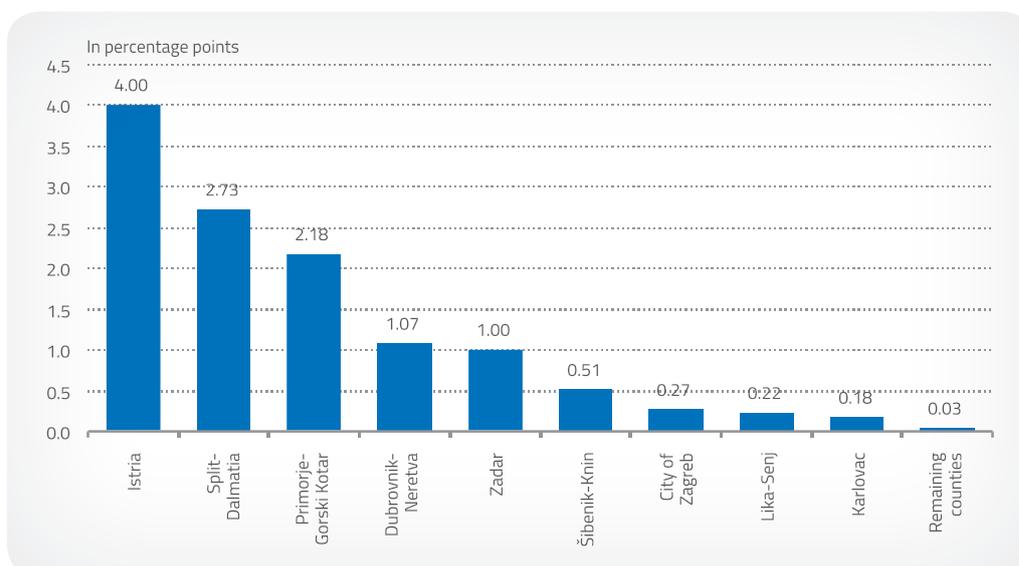
to growth, or even negative ones. Among continental counties, Karlovac County depicted the highest positive contribution, amounting up to 0.18 percentage points, since the most popular Croatian national park, the Plitvice Lakes National Park, is located in that county.

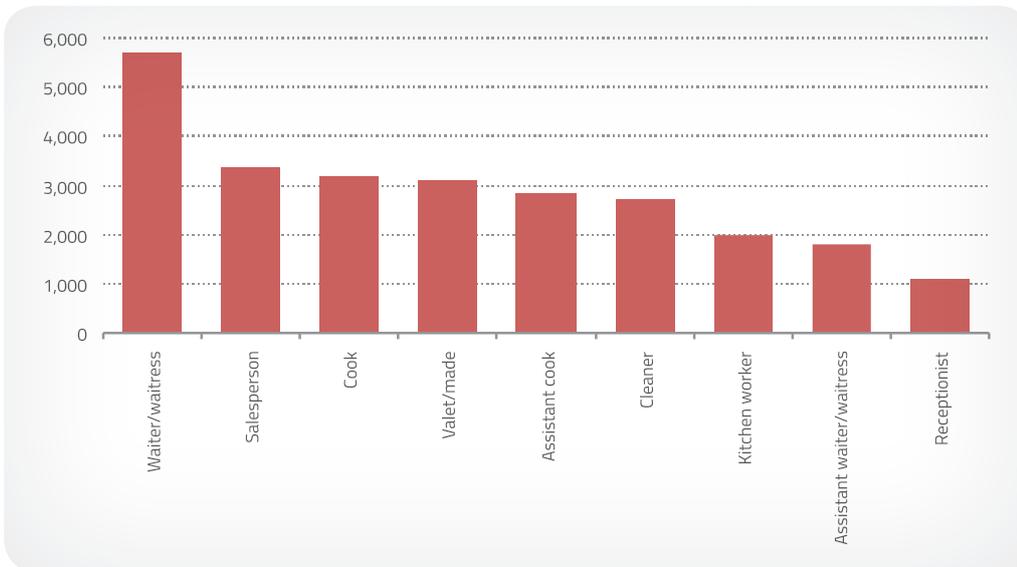
**Employment**

Strong tourism did not just boost the export of services, retail sales, and value added tax revenue, it also affected the labor market. The number of individuals in the sector of accommodation and food service activities registered at the Croatian Pension Insurance Institute in July amounted up to almost 119 thousand, up by 3.3 percent in a one-year period. The share of individuals in that sector in the total number of registered has been steadily on the rise. In July 2013, it

**Figure 12**  
Contributions to Tourist Overnight Stays by Counties

Source: Croatian Bureau of Statistics.





**Figure 13**  
Seasonal  
Employment  
by Occupation  
(January–July  
2016)

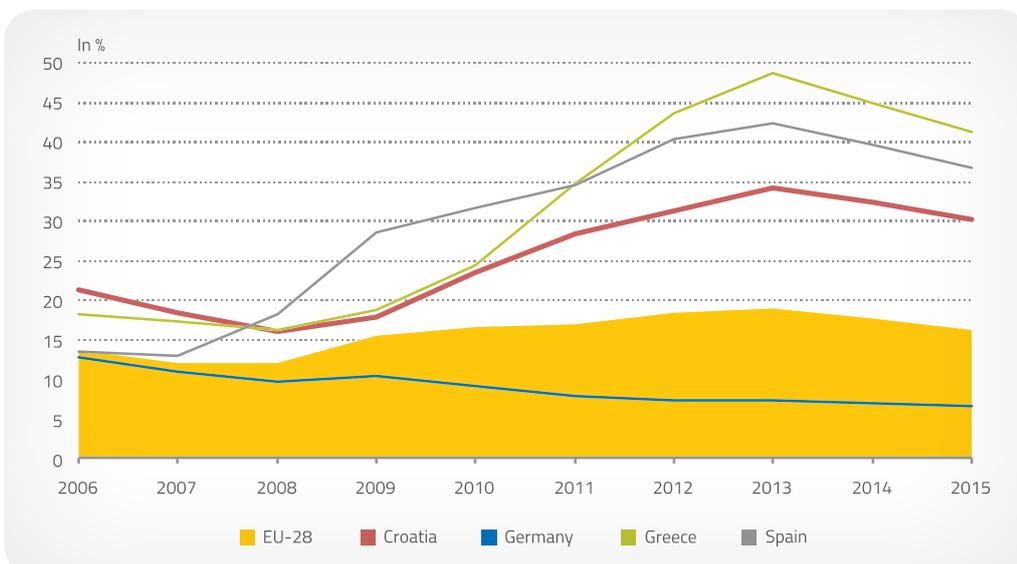
**Source:** Croatian  
Employment Service.

stood at 7.2 percent, and in July this year it clambered up to 7.9 percent, thus gaining importance in total employment. According to the Croatian Employment Service data on seasonal employment, in the first seven months of this year, 21,518 individuals were employed in the sector of accommodation and food service activities, 56.4 percent of total seasonal employment in the period examined. Most in-demand job occupation was waitering (Figure 13), and more than 70 percent of seasonal occupations in the January–July period refer to tourism occupations. Seven seaside counties and the City of Zagreb make 66.1 percent in all seasonal employment so far in 2016, led by the Split-Dalmatia County that employed almost 10,000 individuals in this year’s season so far.

## Youths in the crisis

### Youth unemployment in Croatia among the highest in the EU

Although the youth unemployment rate is generally higher than the overall unemployment rate, after the outbreak of the crisis in Croatia the youth unemployment rate has been growing much more rapidly than the overall rate. The unemployment rate for the conventional youth population, i.e., those aged 15–24, increased by 25 percentage points between 2009 and 2013 (from 25 to 50 percent), while for the population aged 15–29 it increased by more than 15 percentage points in the same period, reaching levels considerably higher than the average rate of youth unemployment in the EU (Figure 14).



**Figure 14**  
Unemployment  
Rates for the  
Age-group 15–29  
in Selected EU  
Countries

**Source:** Eurostat.

Only Greece and Spain have higher rates of youth unemployment.

### **Unemployed youth: females and the less educated?**

Females, the less educated, those coming from deprived backgrounds, including immigrants, are more exposed to being unemployed at a younger age. Using the individual Labor Force Survey (LFS) data, obtained from the Croatian Bureau of Statistics, we examine the structure of youth population between 15 and 29 years in Croatia with respect to their labor market status: employed, unemployed, and those still in education, comparing the pre-recession (2008) to the recession (2013) period. We look at socio-demographic characteristics, such as those exogenous to an individual (age and gender), but also at more marketable characteristics such as education. Then we examine household characteristics (household composition and household size), and area characteristics (urbanization and regional affiliation). Although the results presented here are only descriptive, they point to some interesting developments of the youth population in Croatia.

### **From degree to employment?**

We find that youths who are employed are older than those unemployed or those in education. The majority of employed is older than 25 years, whereas among the unemployed, the largest share is composed of 20–24-year-olds, and for those in education, the majority is in the youngest (15–19) age-range. This result is expected as Croatia has the lowest rates of early school leavers (“dropouts”) in the EU, which means that at this age most of the youth population is still in education. Hence, the largest share among both employed and unemployed is composed of those with completed secondary education. Still, there was a visible increase of those with finished higher education among both of these groups during the crisis, which is especially pronounced for the employed group. This might indicate a stronger demand for skilled workers, but also a larger supply of those who completed some form of higher education due to the introduction of the Bologna process,

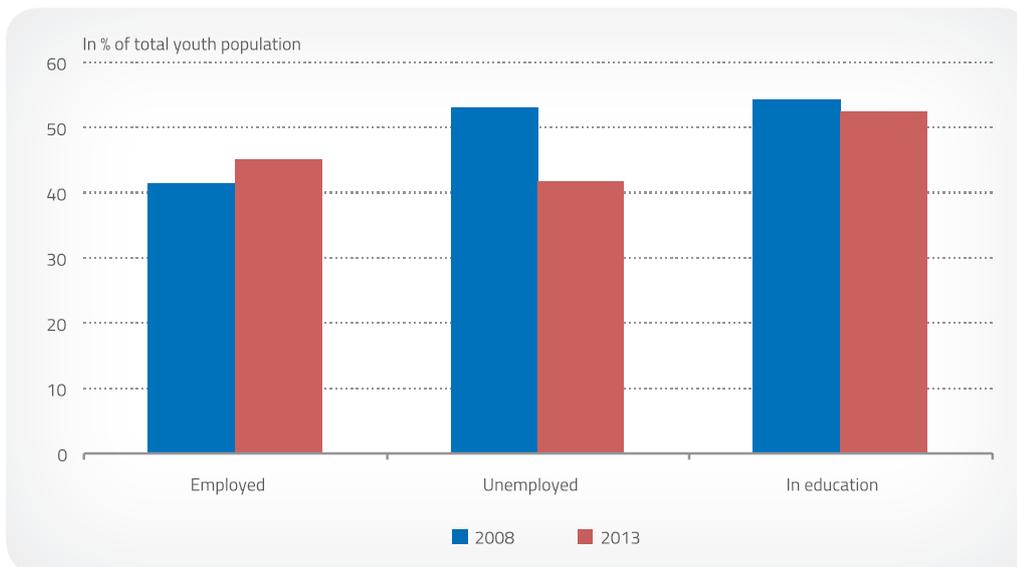
which was followed by increased emergence of private schools in the higher education system.

### **Stronger unemployment growth for male youth workers**

Although overall unemployment rose for both genders during the recession, male workers experienced stronger unemployment growth due to the characteristics of the recession, which had its biggest impact on sectors dominated by male workers, such as construction and manufacturing. Given that the female share among the unemployed youths decreased by more than ten percentage points in the period 2008–2013 (from 53 to 42 percent), this disproportionate rise in unemployment between genders apparently happened among youths as well. Other two groups of youth population have kept the share of females on similar levels, with about somewhat more than 40 percent of them among the employed and above the half among those in education (Figure 15).

### **Youths who live in households with more human capital are more often in education**

Unemployed youths generally come from larger households than the employed, but this difference almost ceased in the crisis as the overall unemployment increased. Those in education generally live in larger households than those employed, but this is not surprising given that they probably more often live with their parents. This is also evidenced in a negligible share of households where a young (15–29) person is the head of that household and simultaneously attending formal education without participation on the labor market. The education of the household head, which could be a proxy for the individual’s ability in some cases, is largest among youths who are still in education, followed by those employed and then the unemployed. This could mean that individuals whose parents are more educated are more prone to be in education, while those who live in households where the household head has a lower level of education are more present on the job market. Additionally, it is more likely that a household will earn higher



**Figure 15**  
Female Youth  
(15–29)  
Population in  
Croatia

**Source:** Labor Force Survey data obtained from the Croatian Bureau of Statistics.

levels of income if its head is more educated, meaning that youths do not necessarily have to look for a job. Nevertheless, differences in the years of education between individuals belonging to a different labor market status (employed, unemployed, in education) are not that pronounced, so there are probably some other factors at stake in this respect.

### **Crisis increased youth unemployment in the most developed region – Northwestern Croatia**

Before the crisis, only 45 percent of unemployed youths lived in an urban area. In 2013, this has increased to 51 percent. Does this mean that the crisis has affected urban population more than the rural one? As the share of youths living in urban areas in both employment and education also increased during the crisis, this probably indicates migration effects and not the disproportional effects of the crisis on urban/rural settlements. Similarly, the crisis has changed the structure of youth population across Croatian regions. Although the most dominant region for the unemployed population is the Central and Eastern Croatia, during the crisis, the most developed region, Northwestern Croatia, gained a lot of unemployed youth—again, probably indicating concentration of sectors that were hit stronger by the recession, and possibly also the aforementioned migration effects. Central and Eastern Croatia, on the other hand, had rather large unemployment rates even before the crisis, whereas the

tourist sector kept Adriatic Croatia away from a greater increase of youth unemployment.

### **Emigration of young and educated**

Croatia is currently facing strong emigration to the more prosperous EU countries but, unlike the earlier waves of emigration in the 1960s and 1970s, this time, the largest cohort of emigration embraces the young and educated population. This could pose a serious threat to the potential future growth of the Croatian economy, which is already facing negative demographic developments. Evidently, the need to solve the problem of high youth unemployment accompanied by high youth emigration should be of priority on the agenda of policymakers. From a policy perspective, a number of measures have been introduced since the beginning of the crisis to tackle this issue, with the most popular being professional training for work without employment. However, according to an independent evaluation, the success of the measure is limited. Participation in the program increased the likelihood of employment by about one third 12 months after exiting the measure.

### **New measures for youths on the way?**

The relative winner of parliamentary elections and the probable future head of the government, HDZ, in their pre-election program announced the redefinition of professional training for work without

employment that would better suit the needs of the youths and not the other way around. The measure should also be extended to those with completed secondary education and to start-up entrepreneurs. Besides, they plan to not only introduce additional measures for youths within the active labor market programs, improve the coordination with youth associations and employers, support

youth entrepreneurship financially, but also to strengthen youth education that should prove to be helpful in their employment.

**Note:**

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