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# Croatian Economic Outlook Quarterly

## Recent Developments

### Recovery is gaining momentum

The third quarter of 2016 recorded a GDP year-on-year growth rate of 2.9 percent, the highest rate recorded since the second quarter of 2008, just before the economic crisis. This is now a third consecutive quarter with year-on-year growth rate above 2.5 percent, and high-frequency data for October gives us reason to believe this recovery will continue into the final quarter of 2016 as well. In seasonally adjusted terms, all three quarters of 2016 recorded a growth rate of around one percent when compared to the previous quarter, signaling a steady recovery pace. All three domestic components of GDP (private consumption, investment, and government consumption), demonstrated a continuous increase throughout the first three quarters of 2016 (Figure 1). Private consumption recorded growth rates comparable to those in the precrisis years, the tourist season turned out to be one of the best ever recorded, and both manufacturing and energy production are on the rise. As for the trade sector—even though export growth rates remain relatively high, import rates are catching up, thus slowly decreasing the current account surplus.

### Private consumption trending upwards

Private consumption recorded a 3.4 percent year-on-year increase in the third quarter of 2016, the highest recorded growth rate since the beginning of 2008. In fact, thus far in 2016, all three quarters saw an increase in consumer spending of more than three percent, indicating that the households are recovering. This is also confirmed by seasonally adjusted quarter-to-quarter growth rates

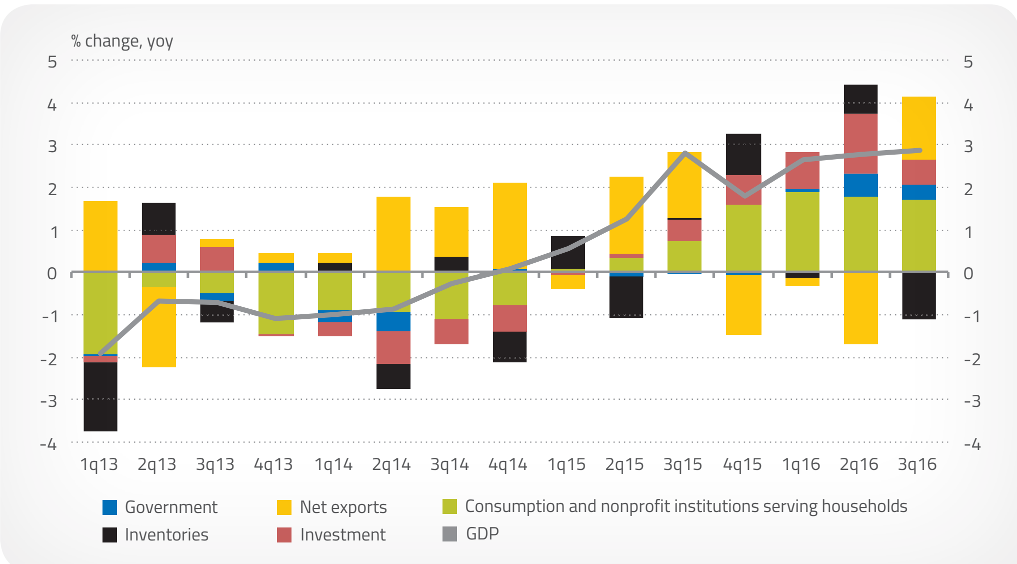


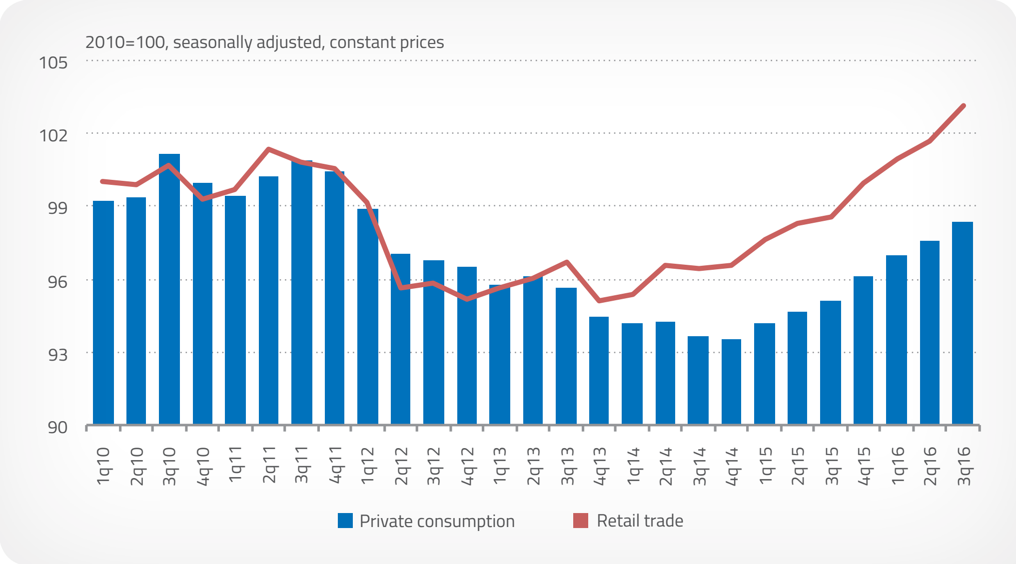

**Figure 1** Demand Contribution to GDP Growth

**Source:** Croatian Bureau of Statistics.

**Figure 2**
Private Consumption and Retail Trade

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

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




which, in the same period, averaged out at 0.8 percent, an improvement of 0.2 percentage points compared to the same period last year. This increase was brought about by increased consumer optimism stemming from a brighter economic outlook and from an income effect associated with a record-high tourist season (Figure 2).

## Government consumption supporting GDP growth

Third quarter of 2016 saw an increase in government expenditure of 2.1 percent compared to third quarter of 2015 (Figure 3) and 0.1 percent (seasonally adjusted) compared to the second quarter of 2016. Altogether, government consumption is on the rise as it recorded positive growth rates in all three quarters of 2016 compared to last year when those rates were negative. What is particularly interesting is that during the third quarter of 2016, when an acting government was in charge of making only day-to-day operations, government consumption recorded one of the highest growth rates in the last seven years. Deflation, coupled with improved economic conditions and greater EU funds absorption allowed the public sector to contribute positively to GDP (Figure 1).

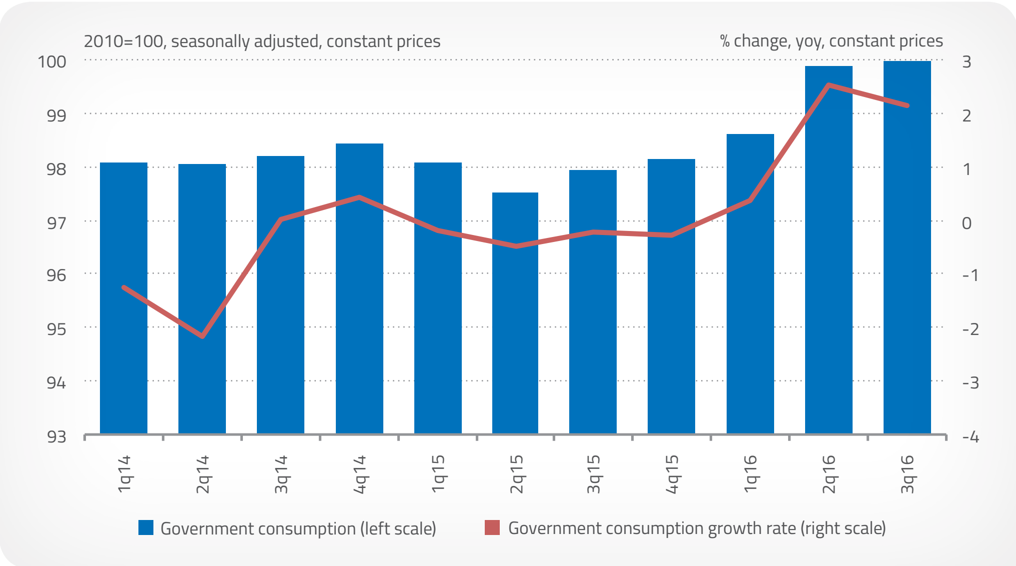
## Investments on hold

Following record-high growth in the second quarter of 2016, which is comparable to the precrisis levels, the third quarter recorded a slight decrease in investment activity with seasonally adjusted quarter-to-quarter growth rate of -1.3 percent. One of the reasons for this slowdown in activity can be attributed to the former acting government. Nevertheless, investment increased by 4.5

**Figure 3**
Government Consumption

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

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



percent in the first three quarters of this year when compared to last year—up by 3.6 percentage points from comparable figures for 2015—indicating a move in the positive direction.

## Imports growth catching up with exports

Total exports increased by 0.5 and total imports by 0.8 percent (both measured quarter-to-quarter, seasonally adjusted) in the third quarter of 2016. These quarterly changes seem to suggest a deceleration in exporting activities, and a momentum gain in importing goods and services (Figure 4). This is also confirmed by cumulative data for the first three quarters of 2016 and 2015 when imports increased by 6.5 and exports by 5.8 percent (both measured year-on-year). This recovery of imports goes hand in hand with a strong increase in private consumption and with a high marginal propensity to import (when a high share of extra income is spent on imported goods and services).

## Record tourist season

Tourist season seems to once again have broken all the records. Somewhat weaker, but still present geopolitical tensions in Greece, Turkey, and North African countries, coupled with favorable weather conditions, played a crucial role in attracting an ever-growing number of tourists. Data up to October this year already suggest that 2016 will break both the record number of tourist arrivals and overnight tourist stays. Compared to the same period last year, this is a 8.3 percent increase in tourist arrivals and a 8.8 percent increase in overnight tourist stays. The encouraging fact is that, with a gradual recovery of domestic activity, the number of domestic tourist arrivals and overnight stays increased by 6.9 and 1.6 percent compared to last year. Given the latest figures and favorable weather conditions in the ongoing quarter, we expect this trend to be continued and the tourist season prolonged throughout 2016.

## Manufacturing and energy production on the rise

Due to competitiveness gains related to suppressed wage growth and higher overall demand, industrial production has been on the rise thus far in 2016. If we compare the first ten months of 2016 with the same period last year, data indicate a rise in activity of 4.3 percent. Breaking down this growth into individual components, manufacturing and energy production increased by 4.8 and 4.1 percent, while mining and quarrying decreased by 0.8 percent. In October this year, industrial output increased by 1.9 percent compared to the same period last year and by 2.2 percent when compared to September this year (measured month-to-month, seasonally adjusted).

## Retail trade increases throughout the year

Retail trade increased by 4.3 percent in the first ten months of 2016, when compared to the same period of the previous year. In fact, year-on-year retail trade growth rates have been positive from September 2014,

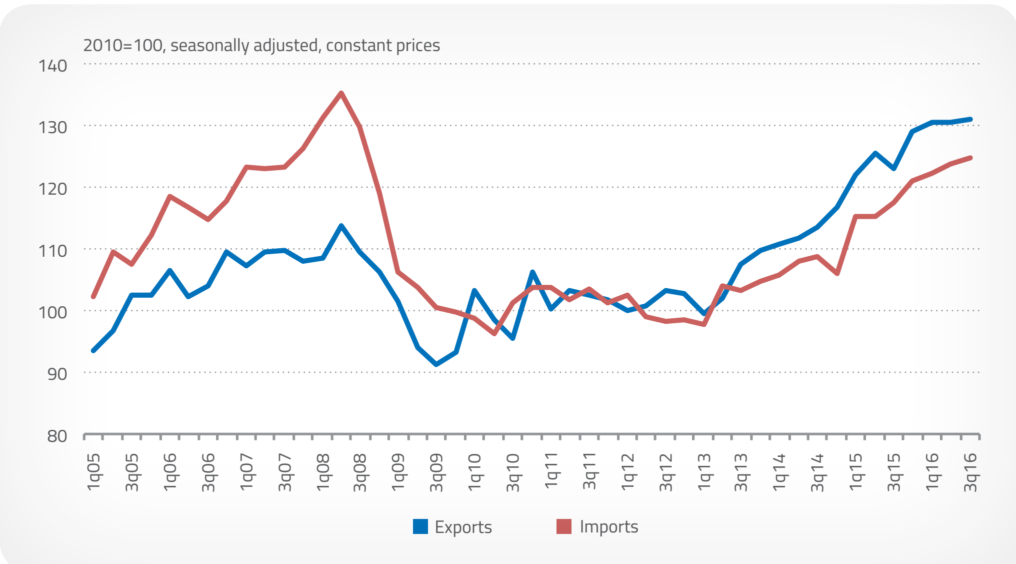



**Figure 4**
Exports and Imports of Goods and Services

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

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

indicating the start of a continuous recovery already in the third quarter of 2014. Latest data for October show a 4.5 percent annual increase and a 0.6 percent increase from September 2016 (seasonally adjusted). We believe this growth was mainly driven by higher real disposable income caused by deflation.

## The "biggest tax reform" goes without public discussion

### Pressed for time

In mid-November, the new (old) Minister of Finance, Mr. Zdravko Marić, announced a tax reform which is to be implemented at the beginning of the next year. The reform is intended to lower the overall tax burden and enhance the economy's competitiveness; to make the tax system more socially just, stable, sustainable and simple; to simplify and economize the work of the tax administration; and to ensure greater legal certainty for taxpayers. On the one hand, anyone reasonable enough would hardly question the fact that the Croatian tax system should somehow be set up to achieve these intentions. On the other hand, hardly anyone committed to the idea of genuinely democratic policy making can accept the extremely short time allowed for public discussion. Forty days is far from enough for the public to engage in an informed and constructive critique of the intended reform, especially given the fact that it has been characterized by the Minister of Finance himself as the biggest reform since the introduction of VAT back in the 1990s, as it requires no less than 15 legal acts being either nontrivially amended or written anew. Mr. Marić has been trying to justify the lack of a sufficiently long public discussion by claiming that due to the urgency of the issue, the government cannot afford postponing the launch of the reform while waiting until the beginning of 2018. To assure the public that the reform is well thought out, the Minister refers to the analysis of an expert working group, formed in the first half of this year by the former government, comprising of a number of home public finance scholars and tax advisors.

### The "best" scenario

The expert working group has run "more than 60 scenarios" with the best one being chosen as the base of the reform proposal. It is not known what distinguishes these "scenarios" from each other, making it hard to discern the featured criteria of the final choice. So, not only was there not enough time for public discussion, but the public, or at least those capable of grasping the matter at hand, were deprived of the possibility to see what other feasible "scenarios" were proposed but not chosen, and of the possibility to base their critique or alternative proposals on this information. Knowing the alternatives which were under consideration would have perhaps proven that the same ultimate objectives of the reform might have been achieved with a different distribution of the overall tax burden. Then the final choice would have revealed whom the government prefers to benefit more from the reform. In the absence of a written material containing the expert working group's analysis, it is difficult to criticize the reform on these grounds, as one can easily be accused of not being constructive.

### Democratic policy making

Rather than taking the expert working group's conclusions as the definite basis for the final choice, these should have been publicly disclosed to allow for a reasonably informed public scrutiny. It takes time, but prior to that, it requires a genuine democratic attitude of the policy maker. For the future of this country it is arguably more important to get policy making consistent with the idea of democracy understood as truly "'of the people, by the people, for the people" rather than rushing through policy making as if it were a technical problem only, claiming supposedly unpostponable urgencies.

## Construction sector rebounds

Trend values of construction activity were in a steady decline ever since mid-2008 until mid-2014, when they started to level off. This stabilizing trend is still present. However, latest figures provide some optimism. Looking at available cumulative data for the first three quarters of 2016, construction work increased by three percent when compared to the previous year. In the same period, construction of buildings increased by 9.9 percent while civil engineering dropped by three percent. Given the more optimistic economic outlook for the near future, favorable weather conditions in the final quarter of 2016, and recent government announcement of plans to increase public spending coupled with a greater absorption of EU funds, we believe this long-sought rebound in activity is pending.

## New coalition government

After the six-month period of the HDZ-Most government, the no-confidence motion against the former Prime Minister Mr. Orešković on June 16, the dissolution of the Parliament on June 20, the new elections of September 11, and a month of bargaining between HDZ and Most, on October 10, the President—Mrs. Grabar-Kitarović—gave the mandate to form a new government to the HDZ leader, Mr. Andrej Plenković. In addition to his fellow partisans, he was supported by Most, all the national minorities' representatives, Croatian Peasants' Party, and a few other members of the new Parliament, ensuring 91 votes in favor (out of 151). Soon, the new government, formed by ministers from HDZ and Most, was approved by the Parliament on October 19. The key objectives of the new government's program are: stable and lasting economic growth; creation of new and quality jobs; demographic renewal; putting the brakes on emigration; and social justice and solidarity.

## Government revenues on the rise

Although general government statistics based on national accounting rules and cash principle for 2016 are not perfectly comparable to 2015 (due to the Croatian Health Insurance Fund leaving the Treasury and due to the inclusion of one's own revenues, receipts, and expenditures of certain Budget users into the Budget), comparison can still offer some insight into key short-term trends. Relative to the same quarter of 2015, consolidated general government revenues increased by 5.5 percent in the third quarter of 2016 mostly as a result of higher VAT revenues, which have increased in the same period by 7.6 percent (Figure 5). In the first three quarters, total revenues cumulatively increased by 7.4 percent while VAT revenues increased by 3.5 percent relative to the same period in 2015. At the same time, total tax revenues increased by 6.2 percent mostly due to surging personal and corporate income tax revenues of 8.6 and 19.8 percent respectively for the first three quarters of 2016. Corporate income tax surge was the result of both a better performance of enterprises, and, more importantly, regulation changes which limited the use of reliefs for the

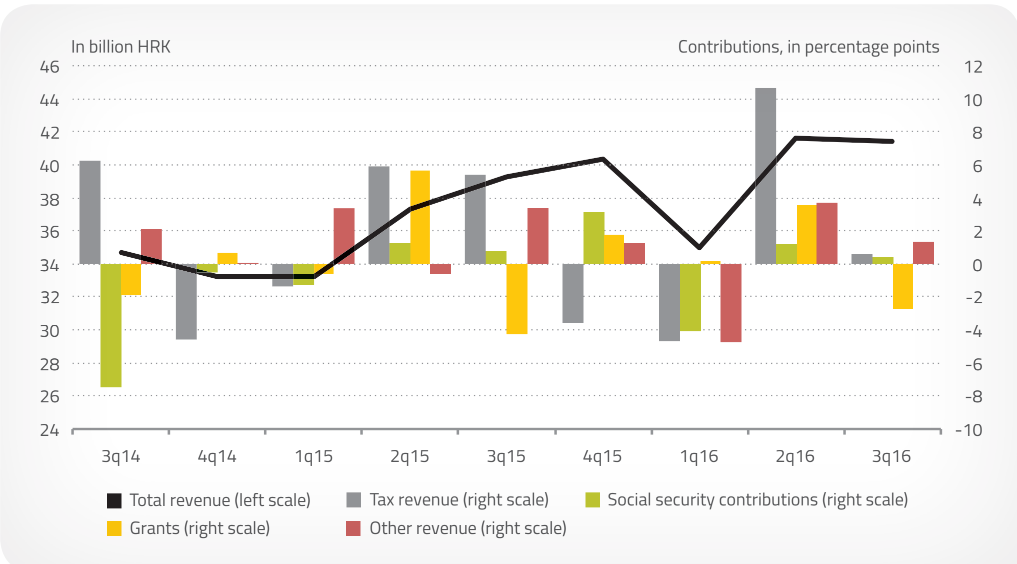



**Figure 5**
General Government Revenue Contributions

**Source:** Ministry of Finance.

reinvested profit. Both are the result of earlier policy measures which were implemented in 2015.

## Expenditures under control

In the third quarter of 2016 consolidated general government expenditures increased by 3.6 percent relative to the same quarter of 2015. This was mainly due to an increase in the compensation of employees of 4.4 percent. The increase in expenditures can also be explained by a larger influx of EU funds which are spent immediately and do not therefore have any real impact on the deficit as they are recorded simultaneously as revenues and expenditures. In the first three quarters, expenditures cumulatively increased by 1.8 percent. In this period, compensation of employees and the use of goods and services increased by 3.7 and 2 percent respectively, while interest payments contracted by 0.7 percent. This is the first time since 2008 that interest payments are declining. Already in 2015, the share of interest payments in total expenditures started to decrease marginally (Figure 6), and could, if these favorable developments continue, contract further at the end of 2016.

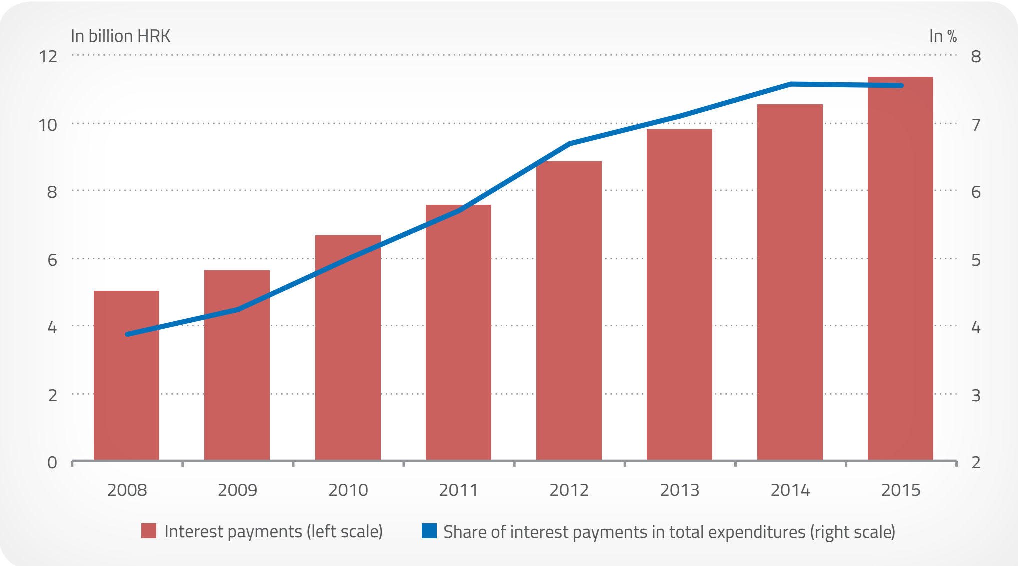
## Substantial fiscal consolidation

General government surplus in the first nine months of 2016 stood at two billion kuna, while the primary balance had a 11.2 billion kuna surplus. These figures represent 0.6 and 2.7 percent of the expected GDP for 2016. The last quarter of 2016 will be decisive, but judging by the headline figures, it seems that 2016 represents a year of substantial fiscal consolidation. As predicted in our last issue, public debt started to decline slightly in 2016. Total public debt decreased by 0.7 percent in the second quarter of 2016, compared to the first quarter, from 38.3 to 38 million euro. Compared to the second quarter of 2015, it increased modestly by 0.3 percent. This means that the increase in public debt is finally slowing down after a six-year surge period. This data shows that it is possible, for the first time since the precrisis period, for the share of government debt in GDP to stagnate or even decrease in comparison to the previous year.

## Tax reform–the good, the bad, and the ugly

On December 2, Croatian Parliament voted for the proposed comprehensive tax reform commencing on January 1, 2017. Since its announcement, the tax reform stirred a debate in the public sphere. As always, the main talking point was the personal income tax. Here, the main changes from 2017 onwards are set to include two instead of three tax brackets with tax rates of 24 and 36 percent instead of 12, 25, and 40 percent as per the current system. The 24 percent will be taxed on all incomes below 17,500 kuna, and 36 percent on everything in excess of this threshold. Personal tax allowance is to be increased from previous 2,600 kuna to 3,800 kuna. Furthermore, tax deductions for children are to be increased across the board by 30 percent on average. The media

**Figure 6**
Interest Payments and Share of Interest Payments in Total Expenditures




**Source:** Ministry of Finance.

headlines emphasized that the changes in the personal income tax are making it far less progressive, arguing that the employees with the lowest wages will not feel the tax burden relief. This is to some extent true; however, it is important to note that the lowest wages are not taxable—have not been nor will they be after the reform. Other important changes include: a decrease in the tax burden for pensioners, a decrease in the corporate income tax from 20 to 18 percent, and from 20 to 12 percent for farmers, craftsmen and small entrepreneurs; an increase in the VAT rate for caterers from 13 to 25 percent, a decrease of the VAT rate for electricity and garbage disposal, larger tobacco products excises, and a repeal of tax exemption for the purchase of the first property. The government estimates that the tax reform will cost around two billion kuna in lower tax revenues.

## Loosening the belt in 2017

The State Budget for 2017 anticipates revenues in the amount of 121.6 billion kuna and expenditures of 128.4 billion kuna, which implies a general government deficit of 6.8 billion kuna, or 1.9 percent of the predicted GDP. This suggests that the Budget revenues will go up by 4.5 and expenditures by 5.5 percent in comparison with the revised 2016 Budget. This proposal is based on a 3.2 percent GDP growth projection and it is taking the effect of the tax reform into account. All in all, the proposed Budget gives the impression of slightly loosening the belt on public finances which, it seems, stems from favorable macroeconomic conditions.

## Structural mismatches

An indication of positive labor market developments, which started in 2015, has proven its growing strength throughout 2016. Data on the number of insurees of the Croatian Pension Insurance Institute point to a rise of employment of almost two percent (by more than 25 thousand individuals) in the first ten months of 2016 with respect to the same period last year (Figure 7). Meanwhile, the official employment figures from the Croatian Bureau of Statistics suggest the opposite (Figure 7), which is surprising given decreasing unemployment, GDP growth, and labor shortages in some sectors, suggesting official employment statistics could benefit from a re-examination of its procedures. In the first eleven months of 2016, the number of vacancies posted at the Croatian Employment Service increased by 14.5 percent or almost 28 thousand in a one-year period, corresponding mostly with wholesale and retail trade, accommodation and food service activities, manufacturing, and construction jobs. The recent anecdotal evidence of labor shortages in these sectors, which are supported by industry claims for higher quotas for foreign workers, coupled with rather high unemployment, points to skill shortages and low labor market mobility which manifests itself in such structural mismatches.

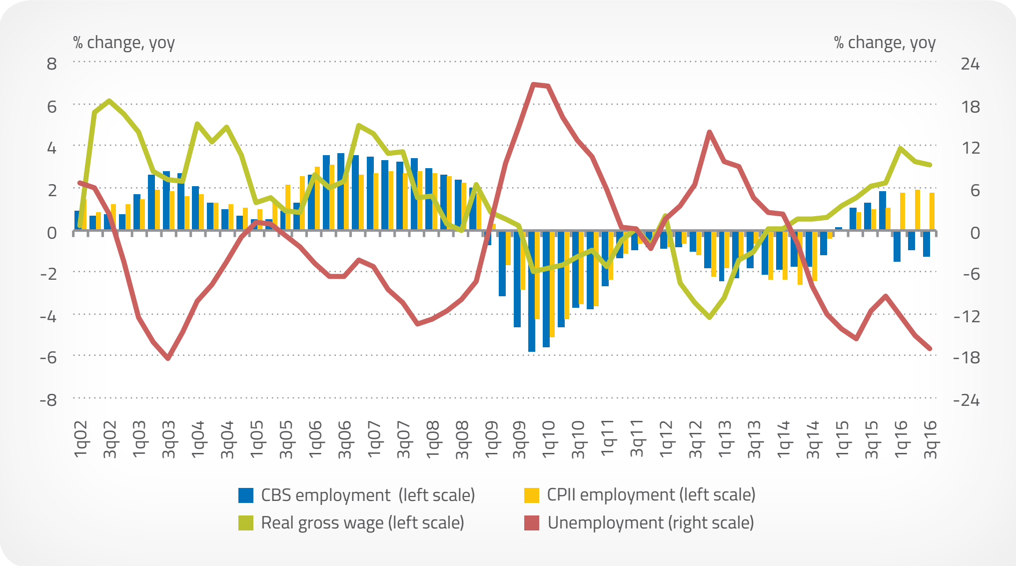
## Downward unemployment trend

Unemployment has continued with its downward trend for the third year in a row, reaching its all-time low unemployment level and the lowest unemployment rate since 2008 back in August. Though the number of registered unemployed individuals started to rise back again after the tourist season, seasonally adjusted figures indicate a continuation of this trend well into the fourth quarter. In the first 11 months of 2016 the average number of the registered unemployed amounted up to 242 thousand or more than a 15 percent decrease when compared to the same period last year. Following a sharp decline in unemployment and a simultaneous fall of official employment (Figure 7), the registered unemployment rate amounted up to 15 percent for the first ten months of 2016, two percentage points lower than in the same period last year.

## Drivers of lower unemployment

The drastic fall of unemployment is not purely a consequence of employment recovery, but some other factors may be at play as well. The only reason for an exit from the Registry, which has increased in 2016 in comparison to the previous year, is noncompliance and nonappearance, which further suggest that the possible explanation for the continuation of the unemployment fall might lie not only in the increase of inactivity, but also in the rise of nonstandard forms (including informal) of employment and emigration.

**Figure 7**
Employment, Unemployment, and Wages




**Note:** Annual percentage change of employment and wages for 2016, based on the Croatian Bureau of Statistics data; stems from JOPPD forms.

**Sources:** Croatian Bureau of Statistics (CBS), Croatian Pension Insurance Institute (CPII), and Croatian Employment Service.

## Wages on the rise

Comparable data (based on the so-called JOPPD forms) suggest a year-on-year rise in both nominal gross and net wages for the first three quarters of 2016. The average gross wage amounted up to 7,729 kuna (approximately 1,027 euro) in the first nine months of 2016, which represents a 1.9 percent increase compared to the same period of the previous year. Meanwhile, net wages increased by 1.5 percent, to 5,660 kuna. The largest increase of nominal wages was recorded in accommodation and food service activities, and in information and communication. Given deflation, real wages increased even more, on average by more than three percent in the January–September period, which, even with the fall of official employment, brought an increase of the average real net wage bill in 2016, and a rise of real disposable income.

## Narrow money growth

Monetary developments in October were marked by an increase in M4 broad money amounting up to 3.1 percent in year-on-year terms. This was primarily due to a much stronger growth of narrow money, amounting up to 14.1 percent in October when compared to October 2015. The main drivers were the currency outside the credit institutions and demand deposits growth—results of accelerated business activities, GDP improvements, and strong tourism in September and October. Meanwhile, very low interest rates are dragging on deposit accumulation resulting in total saving deposits falling by 0.6 percent in a one-year period.

## Loose financial conditions

Although the market has been flooded with liquidity in the last two years, and despite the fact that in the last couple of months the already loose financial conditions continued to ease, credit activity remained weak and amounted up to -5.9 percent in October in annual terms. In the first ten months of 2016 total loans decreased by 5.1 percent in seasonally adjusted terms, suggesting ongoing deleveraging. On the other hand, demand for loans is unevenly increasing as new loans increased by 10.5 percent in October, driven mostly by new loans to enterprises.

## Accommodative monetary policy

This year has been marked by abundant money market liquidity, regular weekly repo auctions, structural repo auctions, low interest rates and a stable exchange rate. In order to ensure longer term sources of kuna liquidity at a low interest rate and to facilitate financing on the domestic financial market, the Croatian National Bank (CNB) placed 993.4 million kuna through four structural repo auctions. Guided by the HRK/EUR exchange rate stability, the CNB purchased 278 million euro from the banks in December. This move was not the first one this year as the central bank also purchased 83.5 million euro in May and 69 million euro in September.

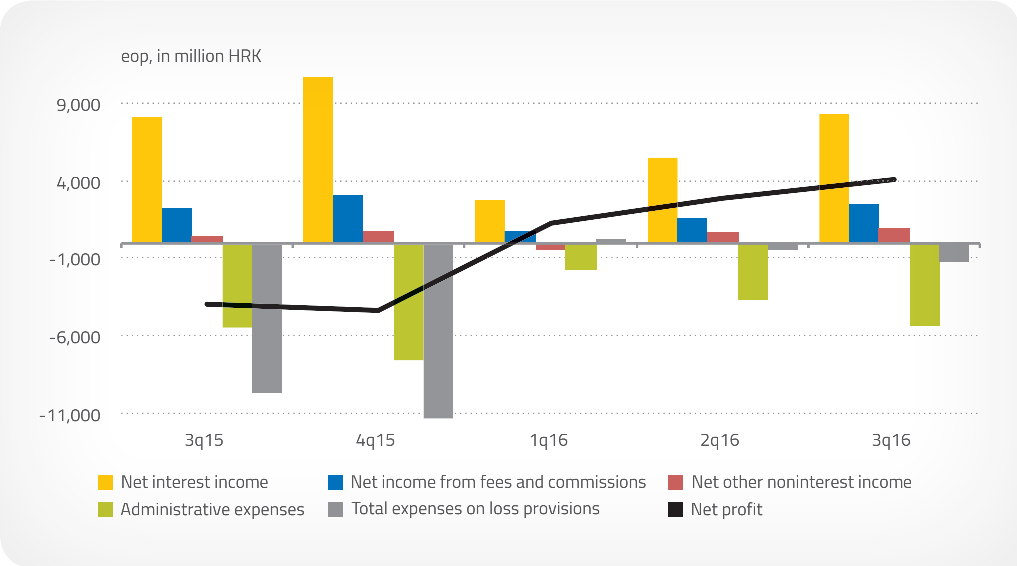



**Figure 8**
Bank Income and Profit

**Source:** Croatian National Bank.

## Banking sector in the profit zone

With the end of September 2016, the banking sector reported profits amounting up to four billion kuna (Figure 8). Total expenses on loss provisions decreased by 8.4 billion kuna in the period between the third quarters of 2015 and 2016. At the same time, net interest income went up by 245 million kuna, reflecting both a modest recovery in new loans and a decline in interest rates on deposits. Also, nonperforming loans (NPLs) declined by 8.7 billion kuna by the end of September when compared to the same month of the year before, bringing the share of NPLs in total loans to 14.7 percent (Figure 9). The main drivers of NPLs—enterprises and households—decreased their NPLs by the end of the third quarter by 6.3 and 2.2 billion kuna in a one-year period. What stands behind these developments are sales of irrecoverable claims on the secondary market.

## Easing of deflation pressures

Year-on-year consumer and producer price indices were both negative in November (-0.2 and -3.1 percent), although the consumer price index (CPI) recorded its highest values in the last seventeen months. The annual decrease in consumer prices slowed down mainly due to higher prices of liquid fuels, due to world market oil prices which have gradually been going up over the last few months, from below 30 U.S. dollars per barrel in February 2016 to the current levels of around 55 U.S. dollars per barrel in December (Figure 10). Besides fuel, prices of food, beverages, catering services, recreation, culture, and medical products—clothing and footwear also recovered in November.

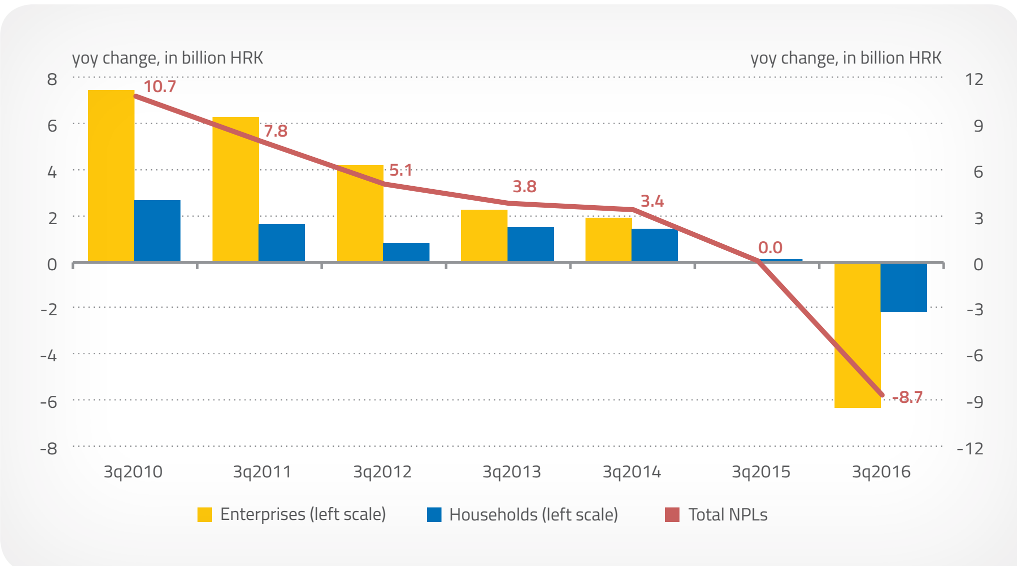



**Figure 9**
Nonperforming Loans

**Source:** Croatian National Bank.

**Table 1** Main Economic Indicators

| | 2014 | 2015 | 2015 | 2016 | | |
|---|---|---|---|---|---|---|
| | | | Q4 | Q1 | Q2 | Q3 |
| **ECONOMIC ACTIVITY** | | | | | | |
| Real GDP (% change, yoy) | -0.5 | 1.6 | 1.8 | 2.7 | 2.8 | 2.9 |
| Real private consumption (% change, yoy) | -1.6 | 1.2 | 2.7 | 3.1 | 3.1 | 3.4 |
| Real government consumption (% change, yoy) | -0.8 | -0.3 | -0.3 | 0.4 | 2.5 | 2.1 |
| Real investment (% change, yoy) | -2.8 | 1.6 | 3.4 | 4.3 | 6.5 | 2.9 |
| Industrial output (% change, yoy) | 1.2 | 2.7 | 3.9 | 7.9 | 5.1 | 1.2 |
| Unemployment rate (registered, %, pa)[a] | 19.6 | 17.4 | 17.3 | 17.6 | 14.6 | 13.2 |
| Nominal GDP (EUR million) | 43,002 | 43,870 | 10,964 | 10,154 | 11,338 | 12,626 |
| GDP per capita (EUR) | 10,156 | 10,363 | - | - | - | - |
| **PRICES, WAGES, AND EXCHANGE RATES** | | | | | | |
| Implicit GDP deflator (% change, yoy) | 0.0 | 0.1 | -0.1 | -0.3 | -0.3 | -0.1 |
| Consumer prices (% change, yoy, pa) | -0.2 | -0.5 | -0.8 | -1.3 | -1.7 | -1.3 |
| Producer prices (% change, yoy, pa) | -2.8 | -3.8 | -4.3 | -4.2 | -5.6 | -4.3 |
| Average gross wage (% change, yoy, pa)[a] | 0.2 | 1.3 | 1.4 | 2.6 | 1.5 | 1.7 |
| Exchange rate, HRK/EUR (pa) | 7.63 | 7.61 | 7.62 | 7.62 | 7.50 | 7.49 |
| Exchange rate, HRK/USD (pa) | 5.75 | 6.86 | 6.96 | 6.92 | 6.64 | 6.71 |
| **FOREIGN TRADE AND CAPITAL FLOWS** | | | | | | |
| Exports of goods (EUR million) | 10,369 | 11,528 | 3,055 | 2,687 | 3,062 | 3,043 |
| Exports of goods (EUR, % change, yoy) | 8.1 | 11.2 | 10.9 | 4.4 | 4.4 | 2.6 |
| Imports of goods (EUR million) | 17,129 | 18,483 | 4,621 | 4,453 | 5,094 | 4,914 |
| Imports of goods (EUR, % change, yoy) | 3.6 | 7.9 | 12.1 | 4.5 | 6.5 | 2.0 |
| Current account balance (EUR million) | 901 | 2,237 | -456 | -1,580 | 152 | - |
| Current account balance (% of GDP) | 2.1 | 5.1 | -4.2 | -15.6 | 1.3 | - |
| Gross foreign direct investment (EUR million) | 2,394 | 170 | -517 | 523 | 83 | - |
| Foreign exchange reserves (EUR million, eop) | 12,688 | 13,707 | 13,707 | 13,199 | 12,937 | 13,039 |
| Foreign debt (EUR million, eop) | 46,664 | 45,534 | 45,534 | 44,297 | 43,428 | - |
| **GOVERNMENT FINANCE**[b] | | | | | | |
| Revenue (HRK million)[c] | 131,917 | 150,089 | 40,284 | 34,932 | 41,609 | 41,433 |
| Expense (HRK million)[c] | 139,532 | 150,559 | 40,691 | 35,369 | 39,060 | 37,393 |
| Net = Gross operating balance (HRK million)[c] | -7,615 | -470 | -407 | -437 | 2,549 | 4,040 |
| Net acquisition of nonfinancial assets (HRK million)[c] | 4,855 | 7,850 | 3,371 | 1,154 | 1,629 | 2,036 |
| Net lending/borrowing (HRK million)[c] | -12,470 | -8,320 | -3,778 | -1,591 | 920 | 2,004 |
| Domestic government debt (EUR million, eop) | 21,650 | 22,457 | 22,457 | 23,289 | 23,184 | - |
| Foreign government debt (EUR million, eop) | 15,443 | 15,471 | 15,471 | 15,002 | 14,841 | - |
| Total government debt (eop, % of GDP) | 86.6 | 86.7 | 86.7 | - | - | - |
| **MONETARY INDICATORS** | | | | | | |
| Narrow money, M1 (% change, yoy, eop) | 9.6 | 11.4 | 11.4 | 11.0 | 12.7 | 14.3 |
| Broad money, M4 (% change, yoy, eop) | 3.5 | 5.4 | 5.4 | 3.6 | 5.0 | 3.9 |
| Total domestic credit (% change, yoy, eop) | -2.3 | -2.0 | -2.0 | -5.7 | -4.8 | -6.4 |
| DMBs credit to households (% change, yoy, eop) | -0.8 | -1.5 | -1.5 | -8.0 | -7.4 | -6.7 |
| DMBs credit to enterprises (% change, yoy, eop) | -3.7 | -5.2 | -5.2 | -5.5 | -4.7 | -4.9 |
| Money market interest rate (%, pa)[d] | 0.6 | 0.8 | 0.9 | 0.6 | 0.5 | 0.5 |
| DMBs credit rate for enterprises, short-term, (%, pa)[e] | 5.7 | 5.4 | 5.3 | 5.1 | 4.7 | 4.6 |
| DMBs credit rate for households, short-term (%, pa)[e] | 9.3 | 8.9 | 8.4 | 7.9 | 8.1 | 8.1 |

**Notes:** [a] Break in time series; figures for 2016 are the result of processing data from JOPPD forms. [b] Data refer to consolidated general government. [c] On the cash principle. [d] Interbank demand deposit trading, one week interest rate. [e] 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.

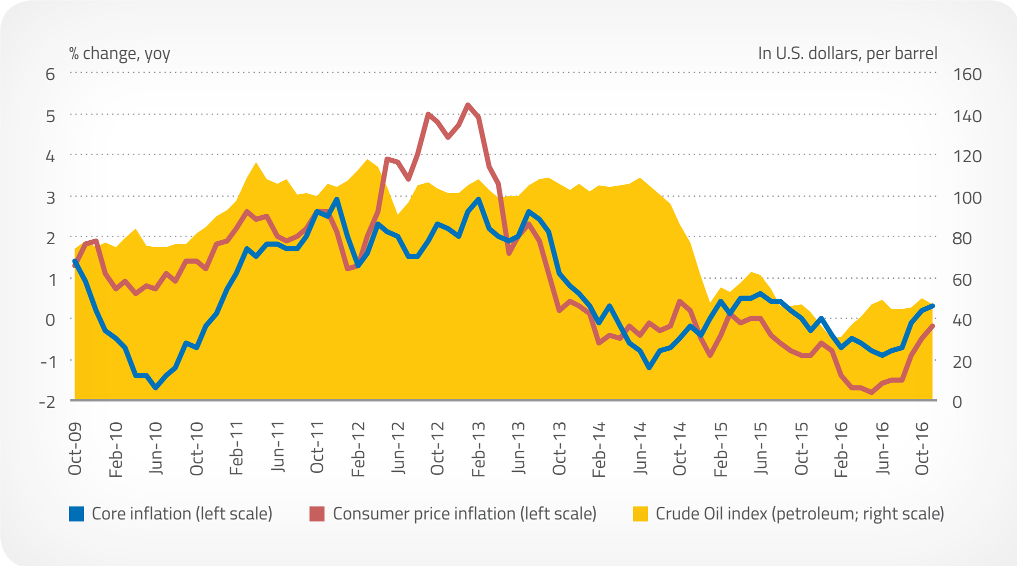



**Figure 10**
Inflation and Oil Prices

**Sources:** Croatian National Bank and IMF Primary Commodity Prices.

# Forecast

## Euro zone recovery loses momentum

Following the first quarter 2016 expansion of 2.1 percent, growth in euro zone declined to 1.2 percent in the second quarter of 2016 (both figures in seasonally adjusted annualized rates) mainly due to a decline in domestic demand, notably investment, which decelerated in some large euro zone economies. After growing at a rate of two percent in 2015, euro zone recovery is expected to lose its momentum in 2016 and 2017. Modest fiscal and expansionary monetary policy will support growth, while shaken investor confidence on the account of uncertainty following the Brexit vote, increased geopolitical tensions, crisis legacies of high unemployment, and unfavorable demographics, will weigh down on activity. Projected growth rates (IMF, World Economic Outlook, October, 2016) for 2016 and 2017 stand at 1.7 and 1.5 percent (Figure 11). For the European Union as a whole, forecasted growth rates stand at 1.9 and 1.7 percent for the current and the following year (Figure 11).

## GDP expansion in Croatia has yet to reach its peak

High growth rates of GDP and all of its components in the third quarter of 2016, revisions of GDP figures as of 2014, rising consumer optimism, and recent announcements of somewhat loosened fiscal

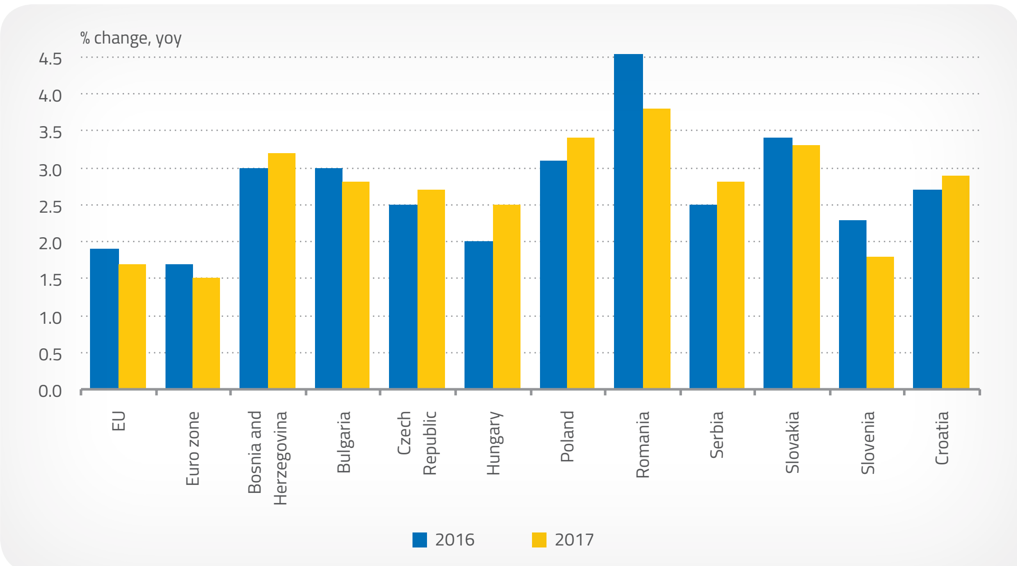



**Figure 11**
Real GDP Growth Projections for Croatia, EU, and CEE Countries

**Sources:** IMF (World Economic Outlook, October 2016) and EIZ for Croatia.

**Table 2**
Forecast Summary

| | 2016 | 2017 | 2018 |
|---|---|---|---|
| **Real GDP (% change)** | **2.7** | **2.9** | **2.6** |
| Real private consumption (% change) | 3.0 | 2.3 | 2.5 |
| Real government consumption (% change) | 1.5 | 1.4 | 0.8 |
| Real investment (% change) | 4.1 | 5.0 | 4.2 |
| Exports of goods and services (constant prices, % change) | 5.8 | 5.1 | 4.8 |
| Imports of goods and services (constant prices, % change) | 6.4 | 6.6 | 6.5 |
| Current account balance (% of GDP) | 3.3 | 2.1 | 0.9 |
| General government balance (ESA 2010 definition, % of GDP) | -2.2 | -1.9 | -1.7 |
| Public debt (ESA 2010 definition, % of GDP) | 86.5 | 85.8 | 85.4 |
| Unemployment rate (registered, %, pa) | 14.8 | 13.5 | 12.3 |
| Exchange rate, HRK/EUR (pa) | 7.53 | 7.52 | 7.52 |
| Broad money, M4 (% change, eop) | 4.0 | 4.2 | 4.0 |
| Total domestic credit (% change, eop) | -4.5 | 2.1 | 4.1 |
| Consumer prices (% change, pa) | -0.9 | 1.3 | 1.6 |

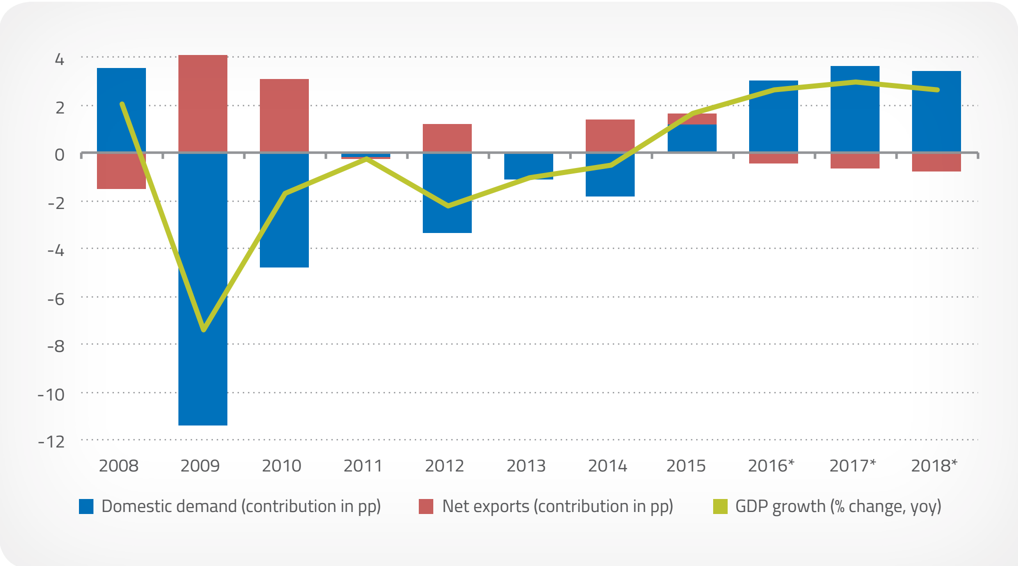
**Note:** Cut-off date for information used in the compilation of forecasts was December 8, 2016.
**Conventional abbreviations:** pa – period average, eop – end of period, HRK – Croatian kuna, EUR – euro.
**Source:** Authors' forecasts.

policy led us to revise our projections made in September this year. We now estimate GDP growth in 2016 to stand at 2.7 percent, up by 0.1 percentage points (Table 2 and Figure 12). This expansion trend, enhanced by growth-aimed government reforms, is expected to continue in 2017 with the growth rate of 2.9 percent (upward revision by 0.5 percentage points) before possibly losing some of its momentum in 2018 with the forecasted growth rate of 2.6 percent due to vanishing income effects of the tax reform and the absence of structural reforms.

## Private consumption subdued in 2017

From data available up to the third quarter of 2016, private consumption, out of all GDP components, increased the most. With pending holiday season we have no reason to believe this growth will diminish. Hence, we increased our projections for 2016 consumption growth to three percent, up by 0.4 percentage points. In 2017 however, several new factors will come into play. The most significant one is the tax reform that should, among other things, increase net wages. These two factors seek to increase

**Figure 12**
Demand Contribution to GDP Growth




**Note:**
* represents EIZ forecast.

**Source:** Croatian Bureau of Statistics.

private spending in the following year, but they might be offset by a reversal of deflation (suppressing real personal disposable income) and rising energy prices. We believe the latter effect will be dominating the former, and so we revised our consumption projections for 2017 downward to 2.3 percent. Due to a credit activity recovery and increased consumer optimism, private consumption is expected to grow by 2.5 percent in 2018.

## Higher public spending

Since government consumption increased in the second and third quarters of 2016 by more than two percent, this will surely be reflected in the annual growth rate for this year which we now forecast to be 1.5 percent, which is a 0.4 percentage points upward revision since our projections in September. This trend of rising public spending is expected to continue in 2017 as well. As 2017 is also the year of the local elections, we can expect increased public spending in the second quarter. Taking this into consideration, we revised government spending in 2017 up by 0.5 percentage points, to 1.4 percent. These high rates of government spending should stabilize again in 2018 with the growth rate of 0.8 percent.

## Investments gaining momentum

Increase in the recovery pace of investment activity from the first half of 2016 was somewhat offset in the third quarter by rising uncertainty due to early parliamentary elections and postelection negotiations. Even though the new government was formed quite quickly (compared to parliamentary elections held in 2015), this "lost" quarter in terms of potential investments will weigh downwards on investment growth for the whole 2016, which we now forecast to stand at 4.1 percent. Nevertheless, the recovery momentum that started at the beginning of 2015 and has spread through the first half of 2016 is expected to continue in the following two years as well. The tax reform should decrease corporate tax, thus encouraging firms to invest more. As the economy recovers, the absorptive capacity to withdraw EU funds and indeed, knowledge on EU project preparation, should also give tailwind to investment recovery. This is also reflected in our forecasts which now stand at 5 and 4.2 percent for 2017 and 2018.

## Exports halted by weaker foreign demand

With the recovery of domestic activity, further increase in private consumption, and inflation of energy prices, imports are expected to rise in 2016 and mid-term. Accordingly, estimates for 2016 have increased to 6.4 percent, up by 0.4 percentage points. In the next two years, import growth is forecasted at 6.6 and 6.5 percent. On the other hand, export growth, which has been a positive net contributor to GDP growth since 2013, is projected to gradually decelerate in the forecasting period. With the reasonable assumption that the HRK/EUR exchange rate will remain stable, the main factor influencing Croatian exports is foreign demand. Given the growing uncertainty in the EU due to Brexit, Italy's political crisis, sluggish recovery prospects and the slowdown of activity in Slovenia, export growth has been revised downward by 0.1 percentage points to 5.8 percent in 2016, and then further down to 5.1 and 4.8 percent in 2017 and 2018. As a direct effect, the surplus on current account is expected to drop from the estimated 3.3 percent in 2016 to 2.1 and 0.9 percent in 2017 and 2018.

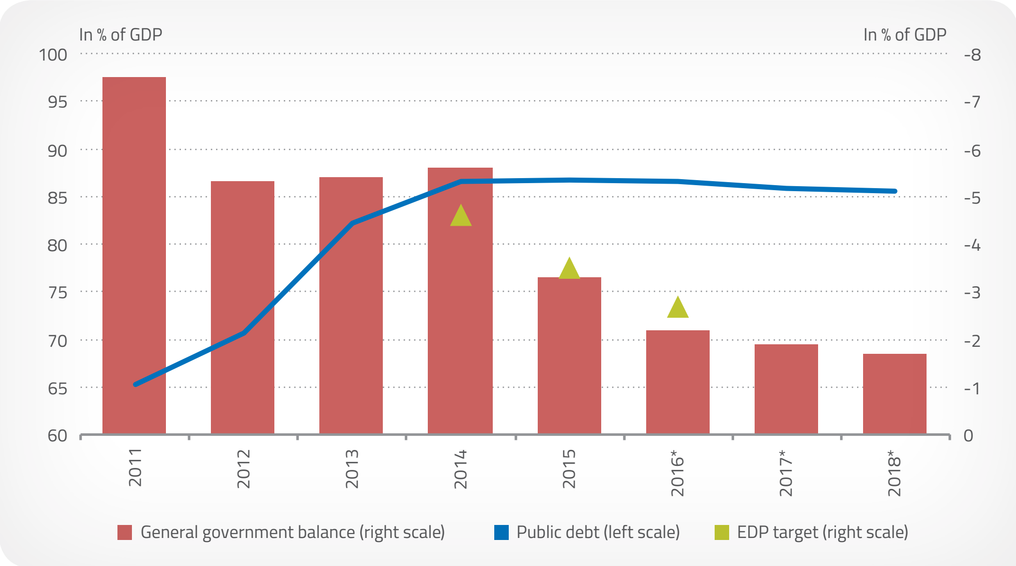
## Deficit below EDP targets

On the basis of some signs of improvement in the State Budget—judging by the consolidated general government statistics for the first two quarters of 2016, and slightly firmer third quarter GDP growth than expected—we revise the previous forecast of general government deficit for 2016 to 2.2 percent of GDP, which is 0.5 percentage points below EDP (Excessive Deficit Procedure) target for this year (Figure 13). For 2017, the deficit is expected to decrease further to 1.9 percent of GDP, as predicted in the Budget. In 2018, the deficit could be around 1.7 percent of GDP.

## Public debt expected to start declining

In line with the latest data on general government debt and lower interest payments, and in spite of the relatively weak fiscal consolidation efforts planned in the Budget for 2017, the level of public debt is expected to decrease slightly. Therefore, we project the public debt in 2016 to be around 86.5 percent of GDP. In 2017, we expect

**Figure 13**
General Government Sector Balance and Debt




**Note:**
* represents EIZ forecast.

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

public debt to decline further to around 85.8 percent of GDP, and to 85.4 percent of GDP in 2018 (Figure 13). In mid-2017, Croatia will probably exit EDP, seeing how deficit is now below three percent of GDP, but in terms of structural deficit, Croatia is still not complying with EU recommendations implying fiscal consolidation should not be off the table yet.

## Shrinking labor force

Following a sharp fall of unemployment during the entire 2016, we expect the average unemployment rate to settle at around 14.8 percent for this year. Medium-term forecasts, for 2017 and 2018, on the other hand, are highly dependent not only on the state of the economy, but are also facing additional uncertainties due to inconsistencies in labor market statistics. Backed by the recovery of the overall economic activity, we expect further growth of employment as well. However, the fall in the projected unemployment rate in the coming years is continuing to be buoyed by the shrinking overall labor force, mainly caused by demographic developments (retirement) and emigration. Hence, our medium-term forecasts for the unemployment rate are set at 13.5 and 12.3 for 2017 and 2018.

## Moderate wage increase

Wages are expected to moderately rise in the coming period, mainly on the back of wage increases in the private sector. A five-percent minimum wage increase should additionally contribute to the expected increase of average wages. Due to changes in income taxation, coming into force on January 1, 2017, net wages should go up more than the gross wages. Wage increase in the public sector depends on the final outcome of the negotiation process on the previously signed agreement between trade unions in the public sector and the government, which guarantees the restoration of the public sector wage increase—abolished at the beginning of the crisis in 2009—by six percent. As inflation is expected to turn its course, real growth of average wages is expected to slow down, but with employment growth, the overall real disposable income should rise in both 2017 and 2018, boosting private consumption as well.

## Exchange rate stability

With strong tourism in September and October, expectations of an investment recovery for this and especially next year, and the CNB commitment to defend the exchange rate stability, kuna will be supported in the short run. Thus, we expect the average HRK/EUR exchange rate to be 7.53 in this year. For the next year and for 2018, we expect a modest domestic currency appreciation and see the average HRK/EUR rate set at around 7.52. The stability of the HRK/EUR exchange rate will mostly be supported by the willingness of the CNB to use the available resources, successful government refinancing on the international financial market, GDP recovery, and higher exports.

## Lending recovery in 2017

Credit activity in 2016 is expected to decline further, by -4.5 percent when compared to -2 percent in 2015. Additionally, in this year, private sector deleveraging will outweigh modest lending recovery coupled with macroeconomic improvements. However, due to expansionary monetary policy, a central bank which encourages domestic credit activity, and low interest rates, we believe that the corporate and household sectors will gradually contribute positively to credit growth in the next year. In 2017 and 2018, credit could increase by 2.1 and 4.1 percent, as investment and aggregate demand recover. Meanwhile, broad money creation will follow with 4 percent in this year and 4.2 and 4 percent in the next two years.

## The return of inflation

In line with deflation which marked 2015 and continued well into this year, we expect CPI around -0.9 percent in 2016. For 2017 and 2018, we expect consumer price inflation at 1.3 and 1.6 percent. The main inflation drivers in 2017 are higher imported prices of crude oil and the OPEC agreement concerning the reduction of oil production by 1.2 million barrels a day, which will come into force on January 1, 2017 and will last for six months. Also, the announced VAT changes will influence consumer prices in two directions. While the higher prices for caterers, tobacco, sugar, and dairy products will form upward pressures on prices, lower VAT rates for electricity and garbage disposal will work in the opposite direction.

# Risks and **Uncertainties**

## Where did the reforms go?

The last two parliamentary elections were marked by structural reforms, but now, after two months in the office, the government is making almost no mention of the reforms or the prepared documentation proposing the reforms. It seems therefore that our forecast period, up to the end of 2018, could lack structural reforms compromising Croatia's medium growth perspective. Projected growth could disappoint to the downside maybe even next year, after the currently positive business cycle blows out and international market interest rates begin to grow, increasing possibly investors' caution and slowing growth around the globe.

## Improved economic situation—a blessing or a curse?

While improved economic conditions coupled with stable—though timid—growth, and stabilizing government finance certainly present a relief after a deep and persistent crisis, political wisdom and strength are needed not to repeat the failures of the precrisis 2003–2007 government, i.e., not to act procyclically. On the other hand, it is not necessarily the best course of action to tighten the fiscal belt too much and suffocate the otherwise feeble growth.

## Negotiations on public sector wages loom

Projected fiscal developments are subject to a number of risks including, in particular, public wages growth. The government and the unions are currently negotiating the increase in wages, but in spite of some legal disputes over signed agreements between the government and public sector trade unions, it can be expected that the increase will happen at some point in the next three years, which is not accounted for in the proposed Budget. It remains to be seen in which form this increase will happen and whether it will compromise the deficit. If the increase does happen, the effect will be twofold: attempts to comply with the EDP and decrease general government deficit will be threatened by a further rise in the expenditure side of the Budget, while at the same time an increase in wages could positively influence consumption and fuel further growth, as well as the revenue side of the Budget through VAT revenues. The net effect will then depend on expectations of further growth and a general optimism of consumers and private sector enterprises. On the other hand, if the increase does not happen, trade unions will probably sue the government for denying their rights embedded in the agreements with previous governments, and likely win in the end. Lately, the latter option seems more probable, and a period of instability and strikes cannot be excluded as well.

## A whole deck of fiscal risks

It also remains to be seen how the government will deal with growing arrears in the health sector and the restructuring of Croatian highways debts; how the bank lawsuits connected to the Swiss franc loan conversion will play out; and when and by how much the interest rates in the euro zone will grow. Coupled with still susceptive growth, these facts call for caution, and in order to obtain a comfortable fiscal stance these short-term developments should be taken into account. Our projections are heavily dependent on these and are therefore subject to sizable risks.

## No good substitute for first property incentive elimination

As of next year, the purchase of the first property will be charged with a four-percent property sales tax, as opposed to being exempt up to a certain surface area before the new tax changes come into force. In order to compensate buyers for the elimination of incentives, the Ministry of Construction and Physical Planning is working on a one-time measure in which 1,000 households will pay only half of monthly annuity in the first four years of repaying their housing loan. Additionally, the new measure applies only to long-term loans (15 years minimally), is not restricted to first property only (implying buyers who were previously exempt from the property sales tax can again use the subsidy when buying bigger property), and it is still unknown on which basis will those 1,000 households be chosen. The allocated amounts in the Budget are not nearly in line with the 100 million per annum cost of first-property exemptions. In the 2017 Budget (when the measure is set to be introduced, but not before the second half of the year), only 17.5 million kuna is allocated, while in the following years, 35 million kuna are planned per each year. This measure is therefore either not well planned, or simply not a proper substitute for the elimination of incentives intended for the purchase of the first property.

## Labor market uncertainties

Upside risks to our unemployment rate projections are mainly related to confusing official employment statistics, slower-than-expected GDP growth, further propagation of existing labor market structural mismatches, and the effects of a five-percent minimal wage hike as of 2017. On the other hand, the average unemployment rate could be even lower than projected if GDP growth accelerates and some of the structural reforms materialize.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