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Croatian Economic Outlook

Forecast Update

Croatian economic recovery set in a favorable global environment

The Croatian economy continued to recover during the first half of the current year and our projections suggest it is going to stay on this course in this and the following year (Figure 1). The recovery takes place in a favorable setting, both in a wider global environment and within the EU. Namely, global economic activity picked up in 2016, with a real GDP growth rate of 3.0 percent (*European Economic Forecast, European Commission, Spring 2017*). This growth impulse is expected to continue in both 2017 and 2018, driven by the recovery in emerging economies, a gradual increase in commodity prices, increased growth prospects in the U.S., Brazil and Russia, and a stable growth in China. Forecasted global growth rates stand at 3.4 and 3.6 percent for 2017 and 2018, respectively.

EU economic activity remains subdued

At the same time, developments within the EU remain more subdued. The euro zone economy recorded a 1.8 percent growth in 2016, thus completing four consecutive years of positive growth. Recent data point to a continuation of this sluggish but positive growth trend, supported by macroeconomic policies, robust job creation, strong consumer confidence, gradual improvement in world trade, and a relatively low exchange rate of the euro. Taking all this into consideration, the

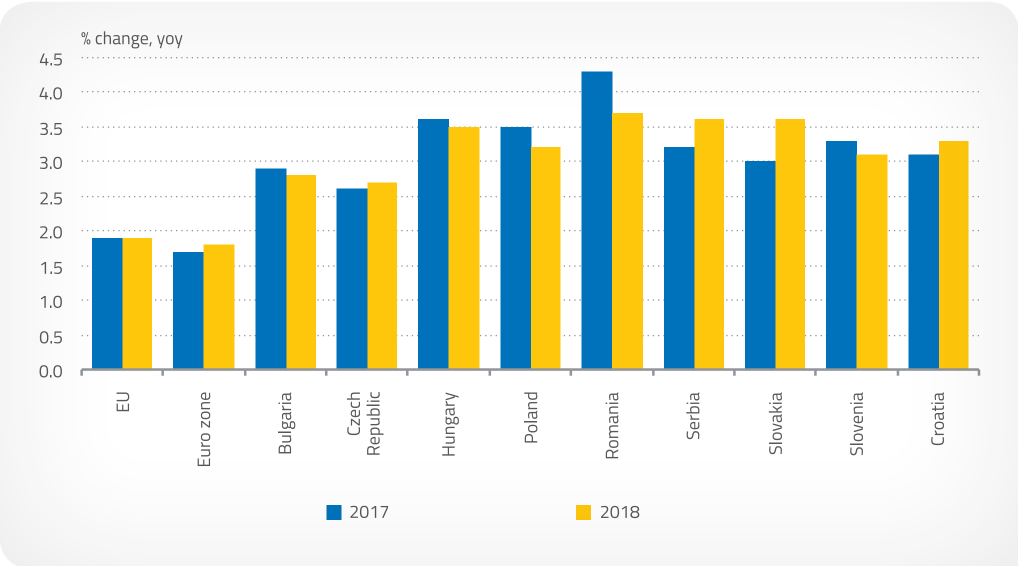


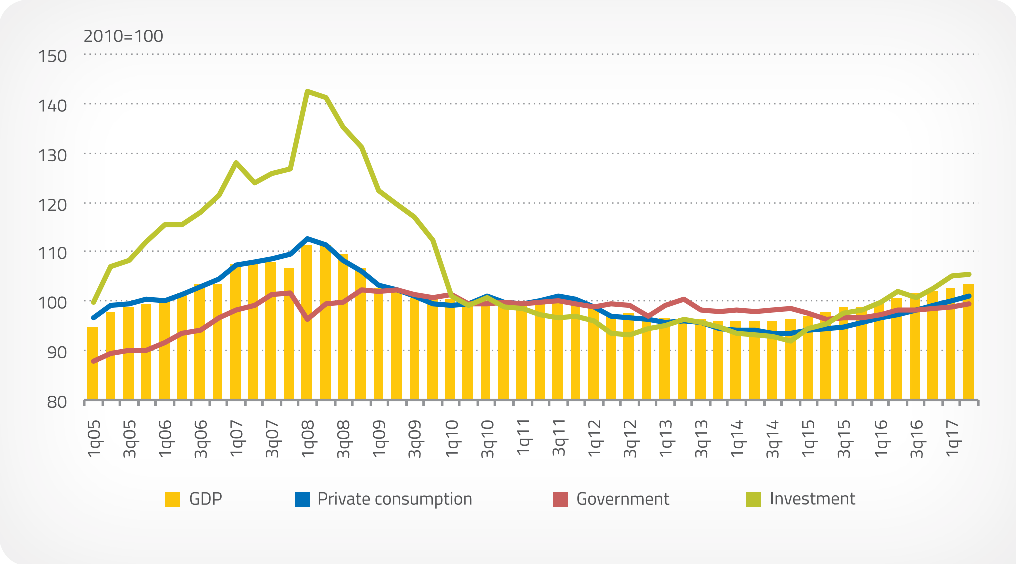
Figure 1
Real GDP Growth Forecasts for Croatia, EU and Selected CEE Countries

Sources: European Economic Forecast, EC, Spring 2017 and EIZ for Croatia.

Figure 2
Real GDP

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.



EC forecasts a growth rate of 1.7 percent in this year, before a gradual pick-up in activity in 2018 with a growth rate of 1.8 percent. Forecasts for the entire EU continue to suggest a leveling off in activity with 1.9 percent GDP growth estimates for the 2017–2018 period (Figure 1).

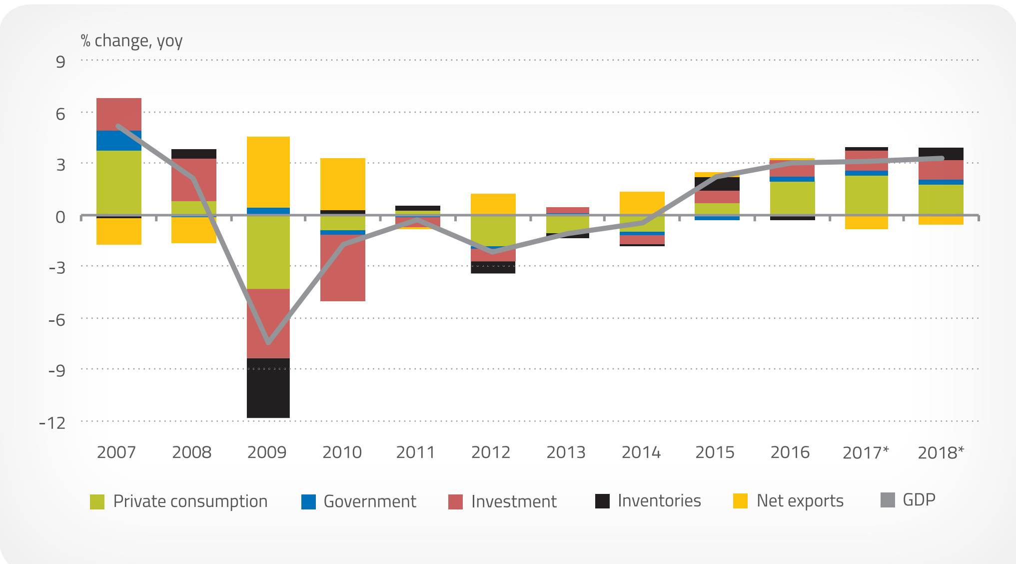
Recovery pace set to increase

Following a rebound in activity during 2015, the Croatian economy grew at the same rate as the global economy in 2016—by 3.0 percent. Growth momentum was carried over into the first half of the current year with year-on-year growth figures of 2.5 and 2.8 percent for the first two quarters, respectively. Seasonally adjusted quarter-to-quarter growth rates show an increase in activity in the first two quarters by 0.4 and 0.9 percent, with all three domestic components of GDP expanding on a steady recovery path (Figure 2). We foresee a continuation of this recovery trend in the short to medium term, with growth rates slightly higher than in 2016. We now estimate GDP growth in 2017 to stand at 3.1 percent, down by 0.2 percentage points from our last estimate mainly because of the higher-than-expected rise of imports. This trend, supported by increased consumer optimism, announced income-increasing measures (namely, an increase of pensions and public-sector wages), a stable HRK/EUR exchange rate, and increasing growth prospects of our main trading partners, is forecasted to continue in 2018 with a growth rate of 3.3 percent (Figure 3).

Figure 3
Demand Contributions to GDP Growth

Note: * represents EIZ forecasts.

Sources: Croatian Bureau of Statistics and EIZ for forecast.



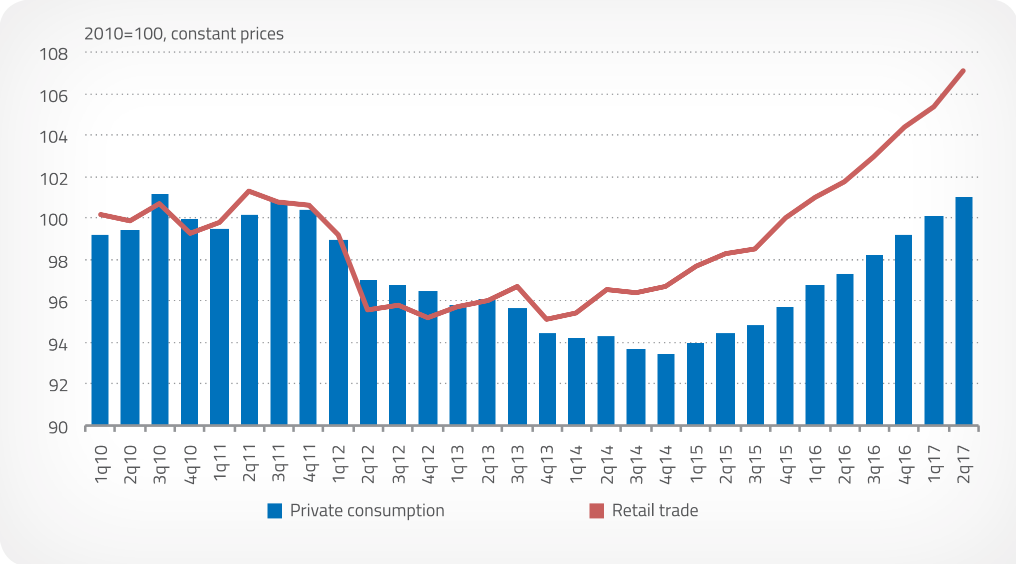


Figure 4
Private Consumption and Retail Trade

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.

Private consumption as the main driver of growth

Private consumption made the highest contribution to the second quarter overall GDP growth with a 0.9 percent growth (seasonally adjusted) compared to the first quarter of 2017 (Figure 4). At the same time, a 3.8 percent year-on-year increase in the second quarter of 2017 is the highest recorded private consumption growth rate since 2007. The second quarter was also marked by a 5.2 percent increase in retail trade (Figure 4) and a 23.3 percent increase in the number of newly registered vehicles in comparison to the same period in 2016, thus further validating the growth of private consumption. Increased consumer optimism, supported by a favorable economic climate in general, played a key role in this consumption increase.

The peak of private consumption growth yet to be reached

Cumulative consumption growth for the first half of the current year already measures a 3.6 percent increase compared to 2016, and with the announced increase in wages for all public sector employees as well as the increase in pensions scheduled for the second half of 2017, we foresee private consumption growth of 4.1 percent for the entire 2017 year. This base effect of the increase in wages and pensions will alleviate somewhat in 2018, but will nevertheless induce a growth of personal disposable income, which is why we expect private consumption to continue with its progression in 2018 as well, by 3.1 percent. Risks to these projections are on the downside as the income tax effect will be exhausted in 2018, and it seems that the household sector is still deleveraging since credits to households are expected to remain low.

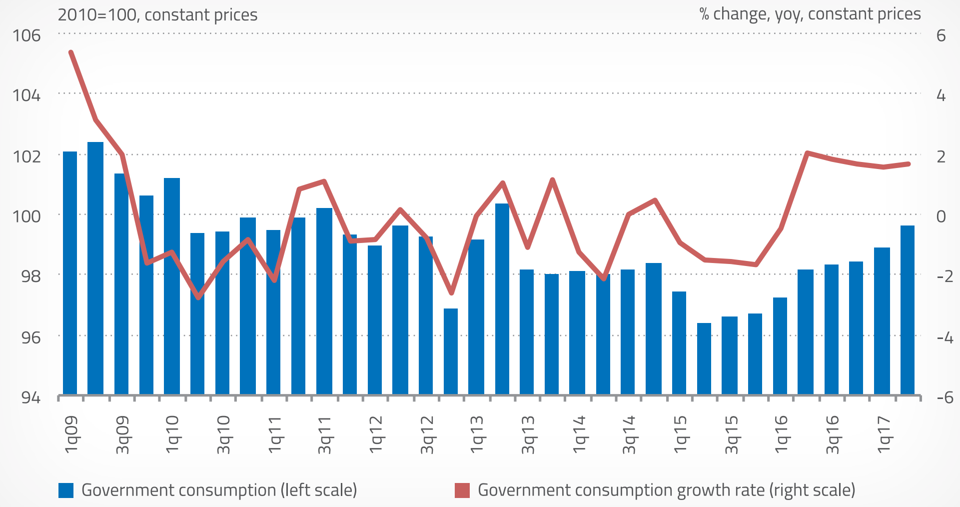
Government consumption continues to underpin GDP recovery

Government consumption has been steadily on the rise since mid-2015 with an average quarter-to-quarter seasonally adjusted growth of 0.4 percent. This trend continued in the second quarter of 2017 which saw an increase in government expenditures of 1.6 percent compared to the same period last year and 0.7 percent (seasonally adjusted) compared to the first quarter of 2017 (Figure 5). Since cumulative government consumption increased in the first half of 2017 by 1.6 percent compared to the previous year, this will surely be reflected in yearly growth figures. As the government has announced that it is gradually expanding some of its programs, notably those related to EU funding, but also given the increased VAT revenue due to improved business activity and the recent exit from the Excessive Deficit Procedure (EDP), both of which may increase the government's spending propensity, we do not expect government expenditure to go down in the near term. Hence, we project government consumption to grow by 1.6 percent in 2017

Figure 5
Government Consumption

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.



and a continuance of the same trend in 2018 with a growth rate of 1.3 percent.

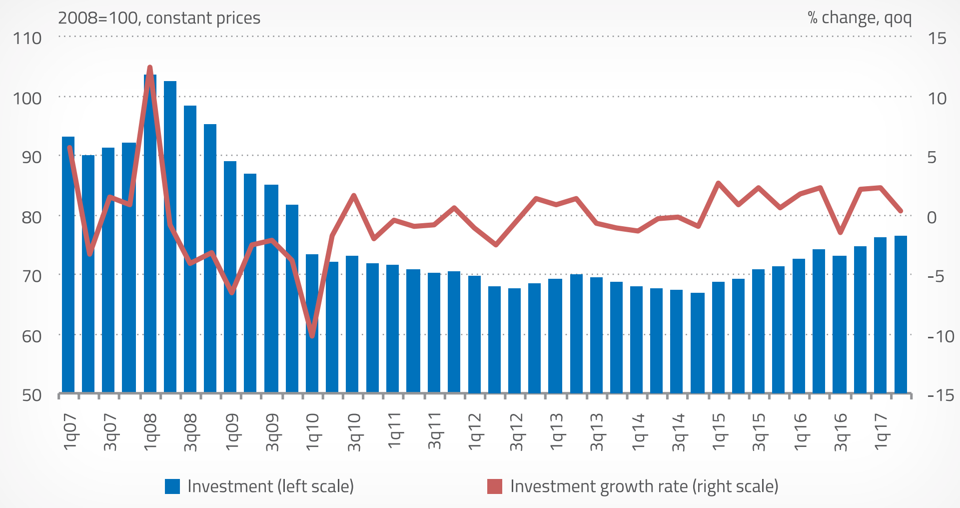
Increased uncertainty for investment outlook

Investment activity grew by 4.2 percent in the first half of 2017 compared to the same period in 2016. However, considering the latest available data for the second quarter, the quarterly increase in investments (seasonally adjusted) stood at 0.3 percent—a sizable slowdown following a 2.3 percent increase in the first quarter of this year. Overall, since the beginning of 2015, investment activity has been steadily increasing, with an average quarterly seasonally adjusted rate of 1.4 percent (Figure 6). We believe this underperformance of investments in the second quarter will be somewhat mitigated in the second half of the year when most of the planned investments are to be realized. Nevertheless, this will weigh to a certain degree on yearly investment growth which we project at 5.1 percent for 2017 as a whole. Although signals of a record-high 2017 tourist season should drive the tourism absorptive capacity, particularly coupled with the increased utilization of available EU funds, recent uncertainties in the implementation of certain fiscal policies and unresolved issues with neighboring Bosnia and Herzegovina regarding the construction of the Pelješac Bridge might deter or postpone some projects. Taking all this into account, we have been rather cautious with our forecast for investment growth in 2018, which we still expect to rise by 5.8 percent.

Figure 6
Investment

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.



Exports and imports on the rise

During the first half of 2017, exports increased by 5.8 percent, while imports rose by 7.1 percent (measured year-on-year), thus confirming a strong foreign component in the recovery of personal consumption. Ever since the beginning of 2013, both exports and imports of goods and services have been on the rise with the seasonally adjusted value of exports slightly exceeding the value of imports. However, both components have recorded negative quarter-to-quarter (seasonally adjusted) growth rates in the second quarter of 2017: -2.6 and -1.9 percent for exports and imports, respectively (Figure 7). Yet, given the strong rise in imports in the first half of 2017, as well as the forecasted increase in personal consumption (especially toward the end of the year) and investments, imports are expected to remain on this trajectory in the second half of 2017. Accordingly, this year's imports growth is estimated to reach 10.4 percent, before calming down at 6.9 percent in 2018. Exports are also forecasted to stay on the same path of growth in the near term. As the data indicate a record-high tourist season (until the end of August 2017, the number of tourist arrivals increased by 14.0 percent and the number of overnight stays by 13.0 percent compared to the same period last year), as well as a stable HRK/EUR exchange rate and improved growth prospects of our main trading partners (Figure 8), exports growth is forecasted at 8.2 percent for 2017, before moderating to 5.7 percent in 2018.

Primary income account effect drives current account increase

Even though imports are expected to grow faster than exports, due to the turmoil over Agrokor's credit situation, the primary income account effect is estimated to drive an increase in the current account. Namely, banks (mostly foreign-owned) are expected to increase their reservations, i.e., total expenses on loss provision, thus increasing the positive net effect of the primary income account on the current account. As a result of this, coupled with forecasted exports and imports growth, the surplus on the current account is projected at 4.0 percent in 2017, before returning to 2.8 percent in 2018. Taking into account a great deal of unknowns and uncertainties related to Agrokor's situation, as well as the fact that the whole process might take some time, we expect expenses on loss provisions to stay high in the next year as well. Hence, the risks to our 2018 forecast are on the upside, as they depend on the speed Agrokor's situation is dealt with.

Agrokor's corporate crisis

In March this year it became obvious that the largest Croatian private corporation, Agrokor, was no longer able to pay back its loans, the majority of which were held by two Russian banks. In addition, there was a large outstanding debt to numerous suppliers, a consequence of Agrokor's practice of forcing them to accept long payment deadlines, which had become the corporation's usual

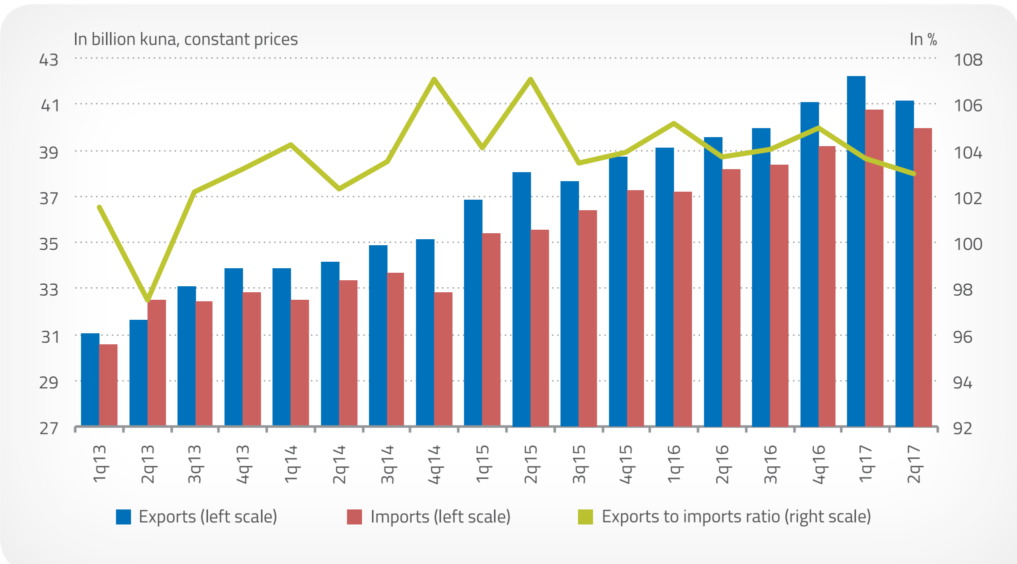


Figure 7
Exports to Imports Ratio

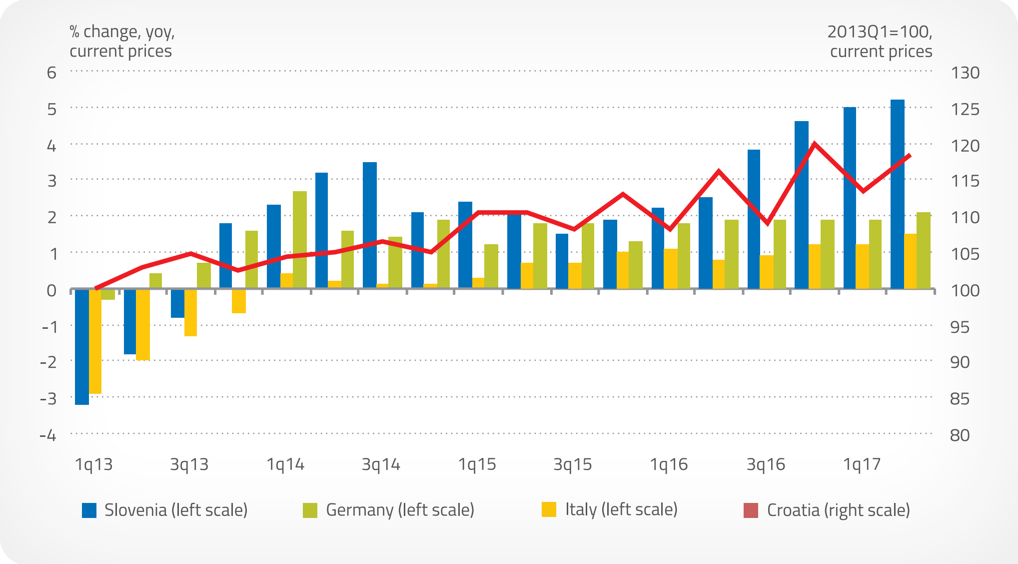
Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.

Figure 8
Croatia's Exports of Goods and Services and GDP Growth Rates of Main Trading Partners

Note: Seasonally adjusted.

Source: Eurostat.



modus operandi over time. To make things worse, the corporation was accused of "creative accounting" while preparing its financial statements: allegedly, the level of indebtedness is much higher than according to released financial statements. The government decided to directly intervene in the "Agrokor case" by proposing a new law on "systemically important companies"—the so-called Lex Agrokor. In a nutshell, the law is meant to temporarily protect the company from starting bankruptcy procedures and to provide it with additional time for restructuring, on the condition that a special commissioner is appointed by court to take over the managing of the company. On Agrokor's request, the law was activated already on April 7. The company has been able to obtain some new loans to keep the business going since the activation; however, it is still early to predict the company's future.

Political uncertainty for the incumbent government

Back in April, Prime Minister Andrej Plenković dismissed three of his cabinet ministers—the Minister of Justice, the Minister of the Interior and the Minister of Environment and

Table 1
Forecast Summary

	2017	2018
Real GDP (% change)	**3.1**	**3.3**
Real private consumption (% change)	4.1	3.1
Real government consumption (% change)	1.6	1.3
Real investment (% change)	5.1	5.7
Exports of goods and services (constant prices, % change)	8.2	5.7
Imports of goods and services (constant prices, % change)	10.4	6.9
Current account balance (% of GDP)	4.0	2.8
General government balance (ESA 2010 definition, % of GDP)	-0.4	0.5
Public debt (ESA 2010 definition, % of GDP)	82.2	80.0
Unemployment rate (registered, %, pa)	12.8	11.9
Exchange rate, HRK/EUR (pa)	7.46	7.45
Total domestic credit (% change, eop)	0.3	3.4
Consumer prices (% change, pa)	1.1	1.5

Note: Cut-off date for information used in the compilation of forecasts was September 5, 2017.
Conventional abbreviations: pa – period average, eop – end of period, HRK – Croatian kuna, EUR – euro.
Source: Authors' forecasts.

Energy—all members of Most, the HDZ's ruling coalition partner. The reason was that the dismissed trio supported a group of opposition parliament members who had initiated a no-confidence vote against HDZ's Minister of Finance Zdravko Marić, on grounds of his being partly responsible for Agrokor's corporate crisis, given that before taking over the ministry he had held a high-ranking position in Agrokor's management. The ruling HDZ-Most coalition thus broke down and while Božo Petrov, Most's leader, resigned as the Speaker of the Parliament, Marić's position was left untouched. The climate of high political uncertainty continued, until HDZ, to the surprise of many, announced HNS (Croatian People's Party), a minor center-left party, as the new coalition partner in June. While there were disagreements within HNS itself, the party has managed to secure two ministries—the Ministry of Science and Education and the Ministry of Construction and Physical Planning—and the position of Deputy Prime Minister for the new HNS leader, Predrag Štromar, in this political trade. Although local election results further strengthened the HDZ's position, and the opposition, with SDP as the chief opposition party, is rather weak, the reform potential of the government on a national level remains quite poor. The introduction of property tax is a good example.

Property tax seesaw

As part of the tax reform package introduced at the end of last year, the government announced the implementation of a property tax for the beginning of 2018. However, unprecedented public disapproval followed during this summer, and Prime Minister Plenković soon agreed to postpone this measure. The situation clearly illustrates the current disarray of both the Croatian government and the electorate. First, the government issued no precise information on the potential tax burden of the new tax, claiming that it only serves as a substitute for the current public utility fee. Transparency is one of the key control mechanisms of democracy and when a new tax is introduced, taxpayers should have the right to more information than just sporadic reports in the media. On the other hand, the forceful public disapproval of this measure is disproportional to its real impact on their disposable income. For example, when the increase in VAT of two percentage points was introduced in 2012, public uproar was substantially quieter, although arguably changes in VAT affect the largest tax base.

Strained relationships with neighbors

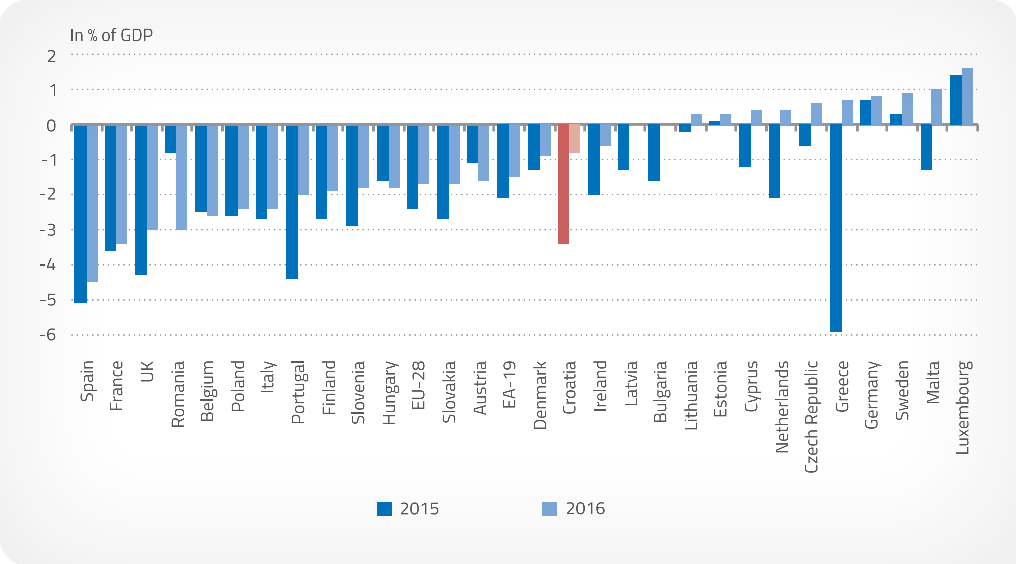
In June, the international arbitration court in The Hague ruled against Croatia in the arbitration process with Slovenia regarding the Piran Bay. However, it turned out that there had been certain manipulations during the process on the part of the Slovenes, due to which the Croatian side does not accept the ruling. This could pose serious problems for Croatia. Namely, at the beginning of this year, Croatia officially expressed its interest for membership in the Organization for Economic Cooperation and Development (OECD) in the next wave of enlargement, but now Slovene officials claim that Croatia does not respect the rule of law, which is a condition for membership. In addition, there are indications that Hungary may join Slovenia in blocking Croatia, allegedly because of the INA-MOL disputes. On another front, the Ministry of Agriculture issued a new regulation in July that significantly increased the cost of inspection of fruit and vegetables imported from non-EU countries, which caused a small "trade war" with countries from the region, namely, Bosnia and Herzegovina, FYROM, Montenegro, and Serbia. Though the regulation was retracted, it left many bitter feelings. In addition, disputes with Bosnia and Herzegovina regarding the Pelješac Bridge might obstruct one of the biggest investment projects in the last several years.

Noticeable improvements on the fiscal front

General government statistics based on ESA 2010 methodology suggest a continuation of fiscal consolidation. Cumulatively, general government revenues grew by 8.2 percent, while expenditures increased by a timid 2.3 percent in 2016. This resulted in a balanced budget with a deficit of around 2.7 billion kuna

Figure 9
Government Deficits in the EU

Source: Eurostat.



or 0.8 percent of GDP, which is far less than in 2015 when the deficit was around 11.2 billion kuna or 3.4 percent of GDP (Figure 9).

Good fiscal start of 2017

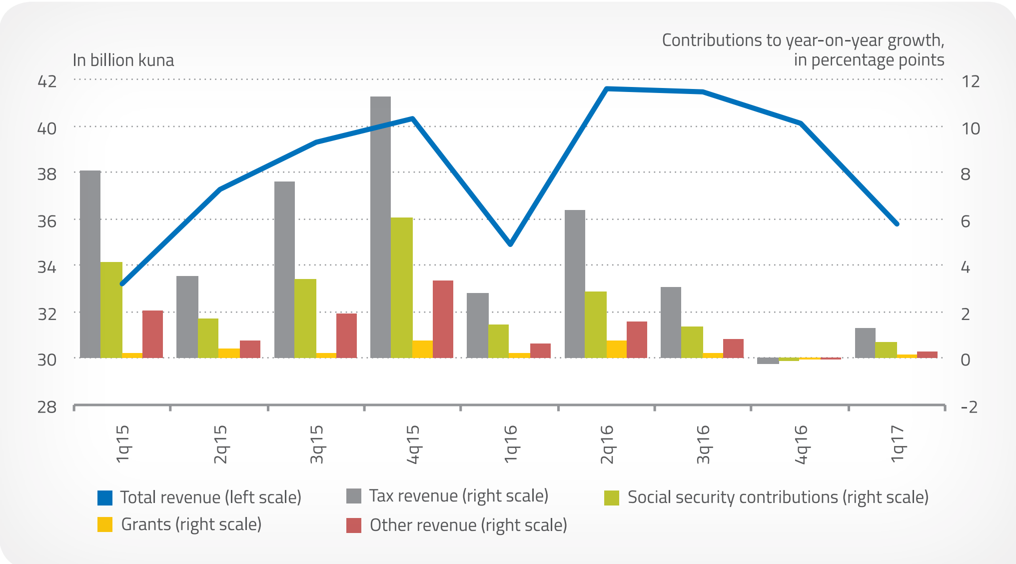
According to GFS data, in the first quarter of 2017 general government revenues increased by 2.4 percent in comparison to the same quarter of 2016, in spite of the decrease in personal income tax revenues by 6.8 percent. The increase in revenues can almost exclusively be attributed to higher VAT revenues and social security contributions, which rose by 3.3 and 3.5 percent, respectively, in comparison to the same period last year (Figure 10). At the same time, expenditures went up by 4.2 percent. This growth can almost solely be explained by an increase in subsidies—mainly related to agriculture—of 171 percent relative to the first quarter of 2016. Social benefits, the largest expenditures item, have decreased by a tiny margin of 0.4 percent. Another encouraging sign for the public finances is that interest payments decreased again, by 5.7 percent in first quarter of 2017 in comparison with the same quarter of 2016 (Figure 11).

Apparent government preference toward consolidation

The National Reform Programme and the Convergence Programme presented in April 2017 show that the government is planning to continue its fiscal consolidation efforts. The National Reform Programme in particular emphasizes the sustainability of public

Figure 10
General Government Revenue Contributions

Source: Ministry of Finance.



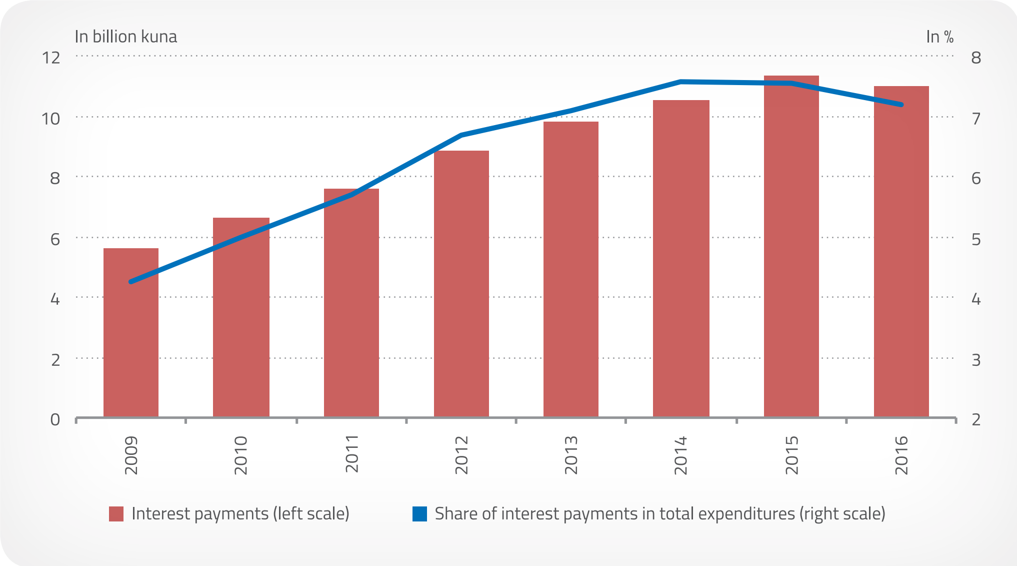


Figure 11
Interest Payments and Share of Interest Payments in Total Expenditures

Source: Ministry of Finance.

finances with four main goals: implementing fiscal consolidation, tackling the arrears and securing the sustainability of the health sector, improving the social benefits system, and securing the sustainability of the pension system.

General government surplus in 2018?

On the basis of the latest general government statistics, the Economic and Fiscal Policy Guidelines for the 2018–2020 Period, and the Convergence Programme, we revise our previous government budget forecasts. Taking into account considerable fiscal consolidation in 2016, we foresee this trend to continue in 2017, taking the general government deficit to around 0.4 percent of GDP. Although the growth in public sector wages by 2 percent in January, August, and November of 2017 was not accounted for in the State Budget, judging by the data for the first quarter of 2017 it seems that larger revenue collection will prevent the deficit from increasing. For 2018, if it continues on this trajectory, Croatia could end the year with a general government surplus of around 0.5 percent of GDP (Figure 12).

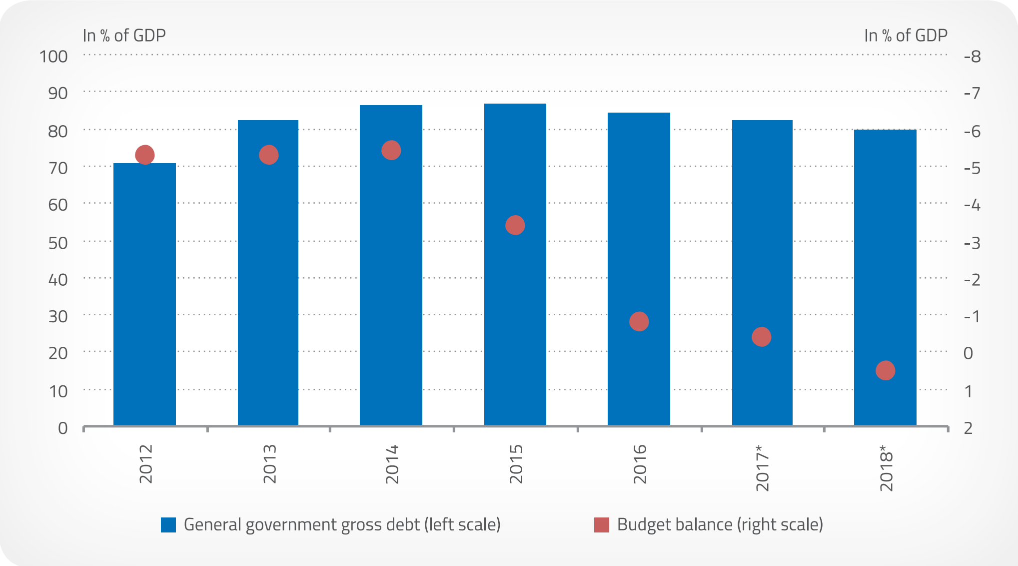
Decreasing public debt

General government debt at the end of the first quarter of 2017 stood at 300.1 million kuna, which is an increase of 6.4 percent in comparison with the same quarter in 2016. However, combined with a rather solid GDP growth, this means that the debt-to-GDP ratio is decreasing. The end of 2016 saw a drop from 86.7 percent at the end of 2015 to 84.2 percent of GDP, which marks the first time in ten years that the debt-to-GDP ratio decreased (Figure 12). With the new available information, we project the dynamics of debt reduction seen in 2016 to continue in the following period, which means public debt could be around 82.2 and 80.0 percent of GDP at the end of 2017 and 2018, respectively (Figure 12).

A number of risks to projections in the fiscal arena

However, a number of risks in the area of government finances remain. For one thing, growing arrears in the health sector, which are estimated between 7.5 and 8 billion kuna in total, could seriously endanger the positive trend in government finances. The National Reform Programme presents certain steps toward a solution such as a functional integration of hospitals, but it is improbable that a problem of this size will be solved by minor changes in the system without deeper and far-reaching reforms. Other substantial fiscal risks are related to the restructuring of the Croatian highways debts, the unresolved issue of bank lawsuits connected to the Swiss franc loans conversion, the final resolution and the mode of repurchasing INA's shares from MOL, the lawsuits connected to the infamous *Lex Agrokor*, and the potential growth of interest rates in the EU. Obviously,

Figure 12
General Government Balance and Debt



Note: * represents EIZ forecasts.

Sources: Eurostat and EIZ for forecast.

total potential costs to the budget would be substantial if these risks materialized. However, it is impossible to estimate, based on publicly available information, the exact amount of these contingent liabilities or the probability of their realization.

Puzzling labor market statistics

Most indicators point to modest recovery on the labor market, further backed up by seasonal developments. However, the official statistics still provide a puzzling picture on employment. Although the number of registered unemployed decreased by more than 50 thousand persons, or by 19.7 percent, in the first seven months of 2017 in comparison to the same period last year, the Croatian Bureau of Statistics temporary data on employment report a simultaneous decrease in employment in the same period by nearly 23 thousand persons, or by 1.7 percent. The Croatian Pension Insurance Institute, on the other hand, reports an increase in employment (number of insurers) by nearly 26 thousand persons, or by 1.8 percent, in the January–July 2017 period (Figure 13). We believe the latter figure better captures actual developments on the labor market.

Restrained seasonal employment despite strong tourist season

Given the exceptionally strong tourist season, it is not a surprise that the most sought-after occupations on the labor market in the first seven months of the current year have been salesman, waiter, and cook, as reported by the Online Vacancy Index (OVI). However, new employment, based on exits from the Croatian Employment Service (CES) Register, suggests that seasonal employment actually decreased by about 10 percent (nearly four thousand persons) in comparison to the first seven months of 2016. The largest seasonal employment occurred in the sectors of accommodation and food services, wholesale and retail trade, and administrative and support services, with top employed occupations being waiter, maid and cook.

Mismatch on the labor market

Apparently, new record-low figures for registered unemployment (169 thousand registered unemployed persons in June) cannot be explained by the rise in (seasonal) employment. Given the increase in labor demand (as reported by OVI) by about 35 percent in the first seven months of 2017 in comparison to the same period of 2016, one can clearly see there is a mismatch between labor supply and demand on the Croatian labor market (Figure 13). This is also supported by the constant complaints of employers who cannot find the workers they need, especially in sectors such as accommodation and food services or construction.

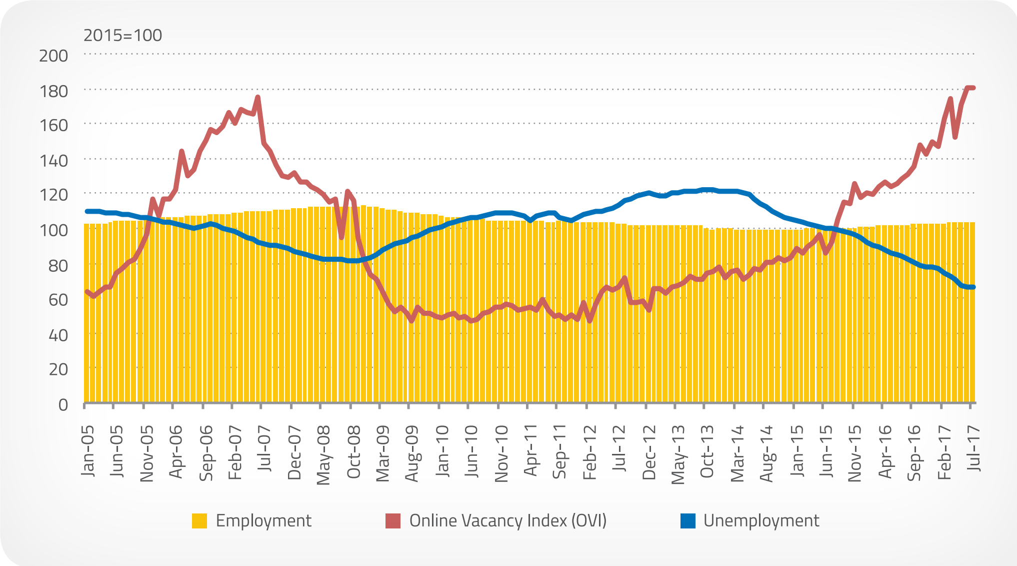


Figure 13
Labor Supply and Demand

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Sources for the original data: Croatian Pension Insurance Institute, Croatian Employment Service, and the Institute of Economics, Zagreb.

Burgeoning emigration

Another explanation for such a strong decrease in unemployment without a noteworthy rise in employment is definitely the burgeoning emigration. Official statistics, though probably underestimated, show that only in 2016 more than 36 thousand people moved out of Croatia, while in the 2009–2016 period this number sums up to nearly 150 thousand persons (Figure 14). Among them, more than 45 percent are in the 25–44 age group and nearly 55 percent are men, while the most popular destination is Germany. Given that the number of immigrants is substantially lower—38 percent of the number of emigrants in 2016—and that this trend is not likely to cease, net migration could lead to a strong depopulation in Croatia, bringing further shortages of labor supply (Figure 13).

Decreasing unemployment rate

The average unemployment rate of 13.1 percent in the first seven months of 2017, a decrease of 2.5 percentage points from the same period in 2016, is thus almost entirely the result of a constant decrease in unemployment and not of the increased labor supply. We expect this trend in the unemployment rate to continue, but with a slower pace of unemployment decline and a moderate growth of employment in the future. Thus, our projected registered unemployment rate is 12.8 percent and 11.9 percent for 2017 and 2018, respectively (Figure 15).

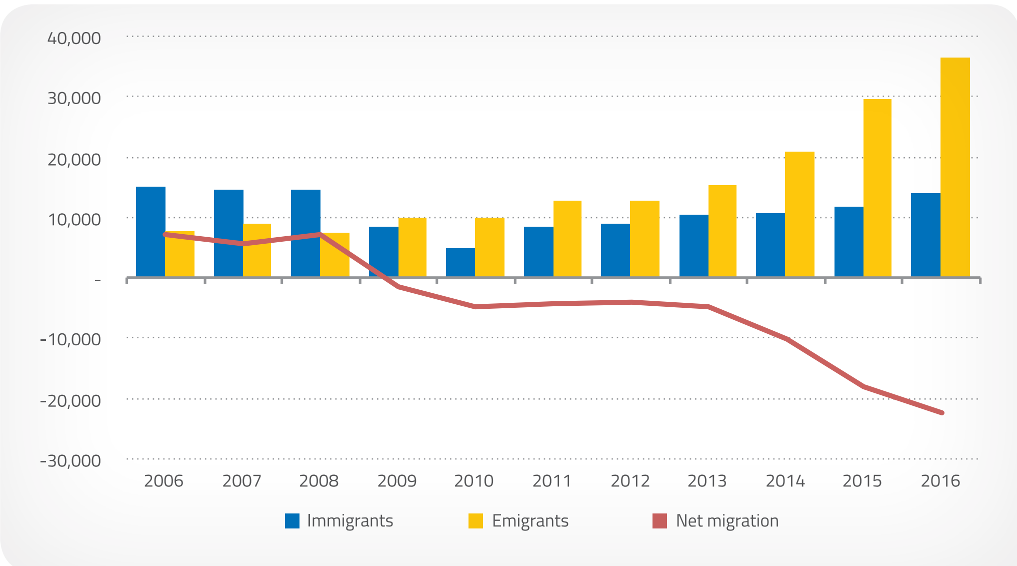


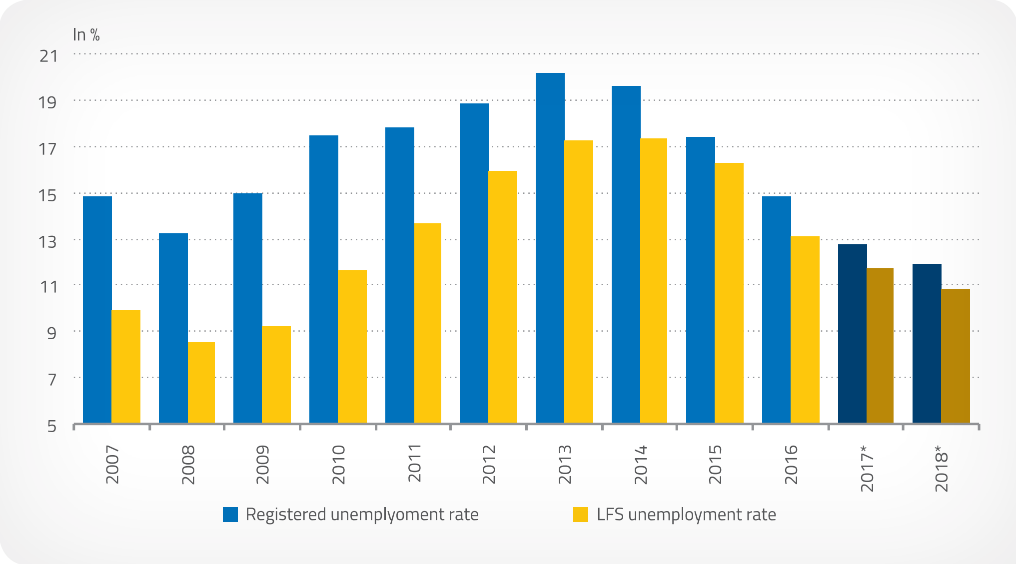
Figure 14
International Migration

Source: Croatian Bureau of Statistics.

Figure 15
Unemployment Rate

Note: * represents EIZ forecasts.

Sources: Croatian Bureau of Statistics and EIZ for forecast.



Wage rise on the shoulders of income tax reform

Economic recovery, coupled with the tax reform and the increase in wages of the entire public sector by 2 percent, led to a rise in wages in the first six months of 2017. In comparison to the same period in 2016, gross wages grew by 3.4 percent in nominal and 2.3 percent in real terms (from 7,751 kuna in January–June 2016 to 8,014 kuna in January–June 2017). Due to income tax changes, in effect as of the beginning of this year, the growth of net wages was even more pronounced, 5.0 percent and 3.9 percent in nominal and real terms, respectively. The highest growth in wages (5 percent or more) in the observed period was recorded in the construction sector, accommodation and food services, administrative and support services, and other services, further validating the importance of seasonal factors in employment and wages in these sectors.

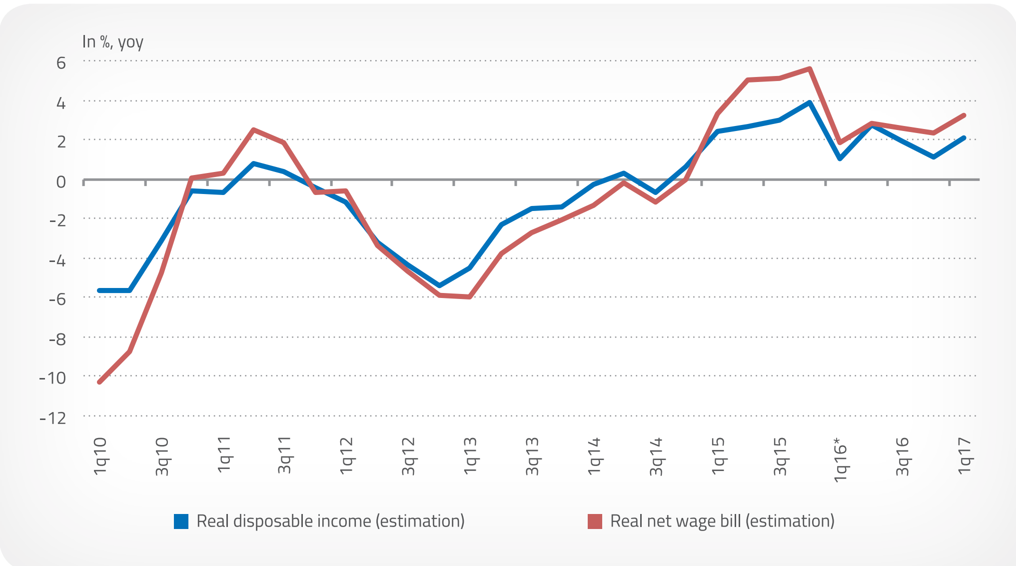
Growth of real disposable income backed by further wage increase

Given the expected rise of public sector wages by an additional 4 percent in the third and fourth quarters, despite some difficulties in negotiations between public sector trade unions and the government regarding this issue, we expect further wage growth for this year. With additional recovery on the labor market and possible pressures from low labor supply in certain sectors, wages should continue to grow in 2018 as well. Taking all these developments into account, the rise of

Figure 16
Real Disposable Income

Note: * represents a break in the series; the figures are the result of processing data from JOPPD forms.

Sources: EIZ estimate based on Croatian Bureau of Statistics and Ministry of Finance data.



real disposable income is expected to continue mainly through the rise of the real net wage bill (Figure 16), despite the expected increase in pensions and anticipated moderate inflation.

Core prices pick up

After three years of decreasing consumer prices, in the first eight months of this year consumer prices on average increased by around 1 percent, leading us to set our projection at 1.1 percent consumer prices growth for 2017. Despite the fact that energy prices have had an increased negative contribution to the consumer price index in the last few months, a pick-up in food prices was enough to offset recent global oil price cuts related mostly to increased oil production in the U.S. (Figure 17). Latest data for August suggest that food prices had the biggest positive contribution to inflation (0.9 percentage points), while housing, water, electricity, gas, and other fuels contributed to the opposite direction by -0.5 percentage points. Core prices, on the other hand, have been growing steadily for a year now, delivering a 1.7 percent growth in July. Owing mostly to energy prices, we have seen core prices diverging from the trend in the consumer price index in the last five months (Figure 17). For the following year, we expect somewhat higher consumer price inflation of about 1.5 percent, partly due to further domestic and tourism-related foreign demand recovery, but also due to recent electricity price hikes that are expected to spill over to a range of goods and services via the producer price channel.

Tourism boosts a strong kuna

Liquidity surplus in the banking sector amounted to 15.3 billion kuna in June this year, doubling from last year's average level, while at the same time overnight interbank interest rates remained at all-time lows, below 0.4 percent. This unusual occurrence is also coupled with not only stable but surprisingly strong domestic currency toward the euro. The average HRK/EUR exchange rate in August amounted to 7.398 which is the lowest recorded exchange rate since May 2011. Strong export growth, especially that of services related to foreign-tourist demand, mostly explains the current strong kuna–abundant liquidity–low interest rates monetary policy framework. Due to increased kuna demand during the tourist season, the central bank (CNB) intervened four times on the foreign exchange market in the last three months. In all four cases, the CNB was buying off euros from banks providing kuna liquidity in the amount of 4.5 billion. Nevertheless, the HRK/EUR exchange rate continued to strengthen and at the beginning of September it stood at 7.40 which is an appreciation of 0.9 percent in year-on-year terms. The average HRK/EUR exchange rate for this year so far is at 7.44, but with vanishing tourism demand, we expect stronger depreciation by the end of the year. Thus, our projection for this year is at around 7.46. Taking into account continued

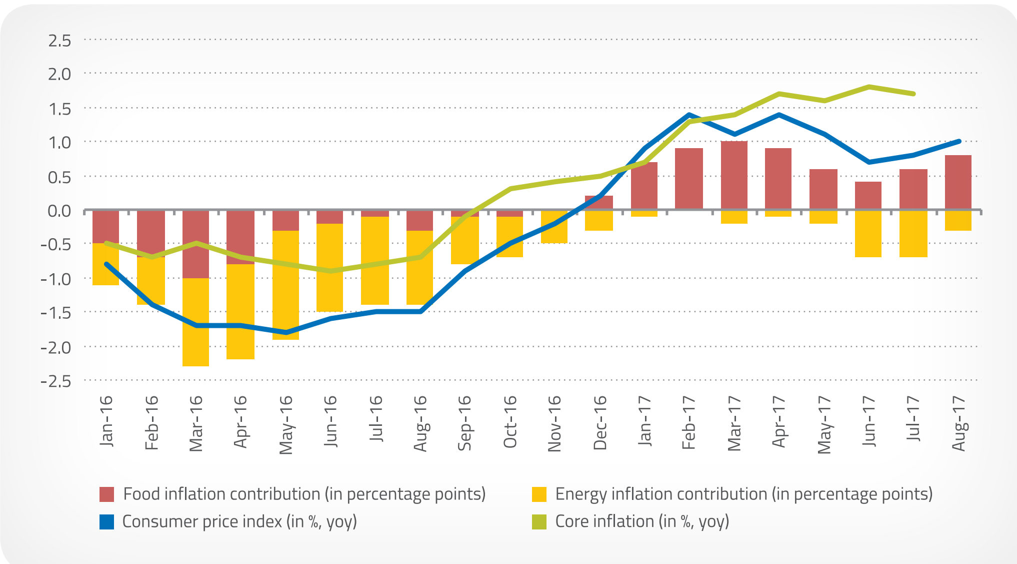
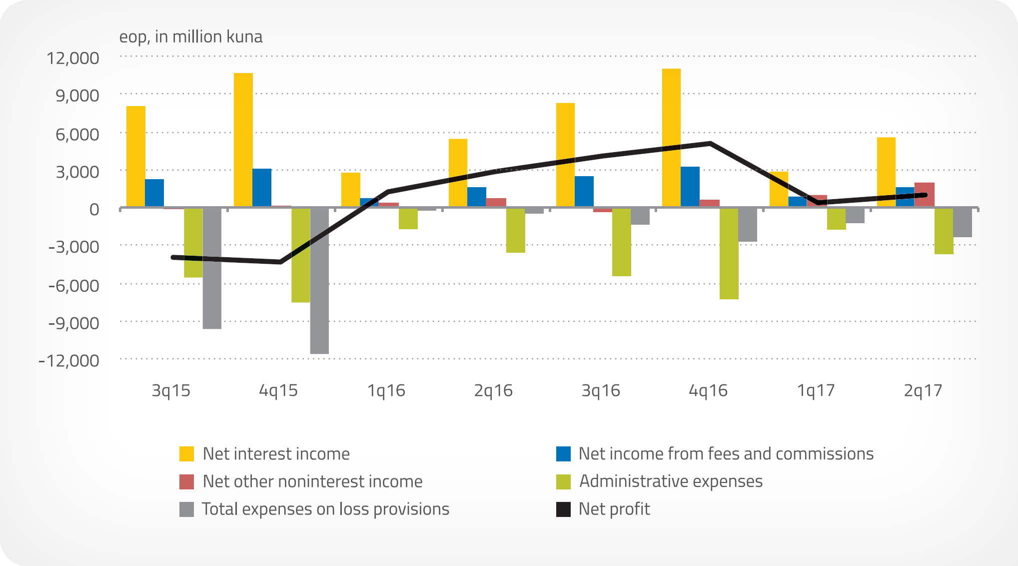


Figure 17 Consumer Price Index and Contributions from Its Main Components

Sources: Croatian Bureau of Statistics and Croatian National Bank.

Figure 18
Bank Income and Profit

Source: Croatian National Bank.



GDP and export recovery as well as another successful tourist season, we see the average exchange rate in 2018 at 7.45.

Agrokor drives banks to the loss zone

Owing to partial write-offs of household loans indexed to the Swiss franc and intensified sale of irrecoverable claims on the secondary market, nonperforming loans (NPLs) in 2016 decreased considerably for the first time in eight years and resulted in record bank profit in the amount of 5.1 billion kuna (Figure 18). Contrary to our expectations that the falling NPL trend would continue in 2017, enabling a new investment cycle, the crisis in Agrokor proved otherwise. Already in the first quarter, total expenses on loss provisions were up by a billion kuna from the same period last year, while by the end of June the year-on-year difference amounted to 1.8 billion kuna. Although we do not have data on the specific clients for which banks have reserved funds in case of losses, excluding other possible sources of rising loss provisions, we believe that the recent negative trend in banks' balance sheets is caused by problems in companies that are part of the Agrokor concern and its main suppliers. While it is difficult to make projections at this point, we speculate that these numbers are just the beginning of future reservation costs that could move bank profit into the negative zone already in this year. Taking into account the speed of resolving Agrokor's issues and assuming that the process will be slow in the coming months, we expect expenses on loss provisions to stay high next year as well.

Figure 19
Total Domestic Credit by Sectors

Source: Croatian National Bank.

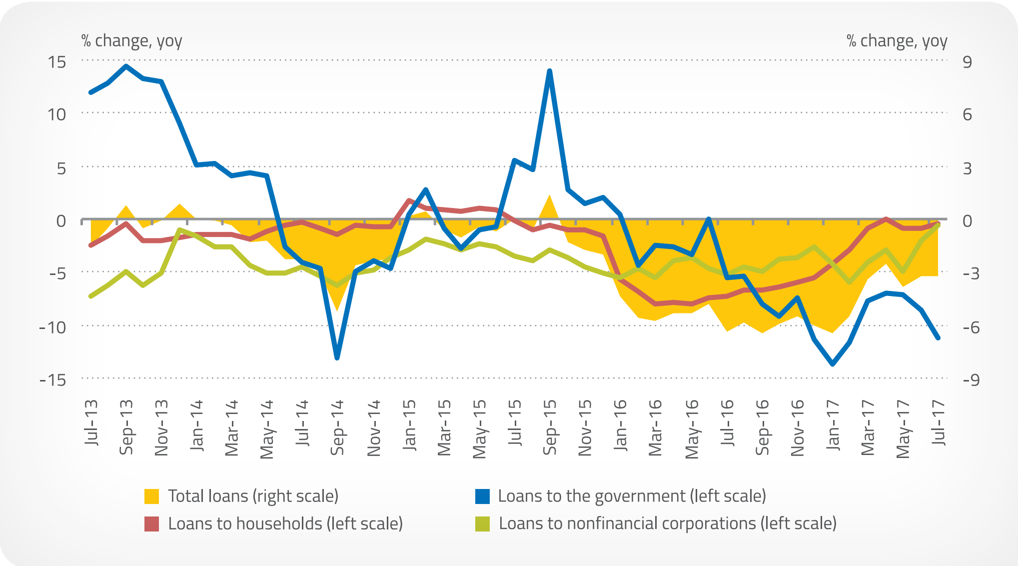


Table 2 Main Economic Indicators

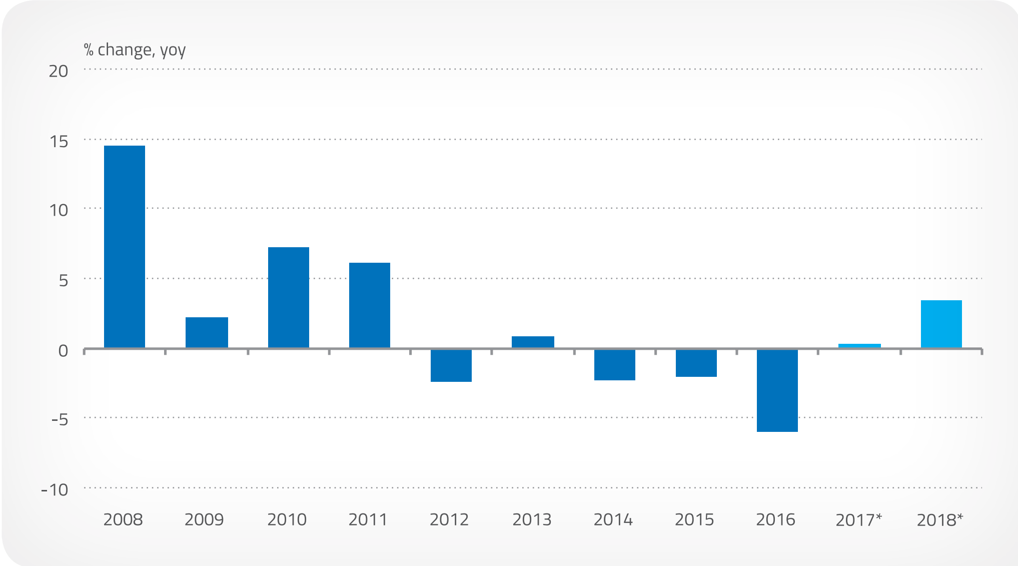
	2015	2016	2016		2017	
			Q3	Q4	Q1	Q2
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	2.2	3.0	3.0	3.4	2.5	2.8
Real private consumption (% change, yoy)	1.0	3.3	3.4	3.7	3.5	3.8
Real government consumption (% change, yoy)	-1.4	1.3	1.8	1.7	1.6	1.6
Real investment (% change, yoy)	3.8	5.1	3.2	4.6	5.4	3.2
Industrial output (% change, yoy)	2.7	5.3	1.2	7.1	2.3	1.2
Unemployment rate (registered, %, pa)[a]	17.4	14.8	13.1	14.3	15.0	11.9
Nominal GDP (EUR million)	44,092	45,843	12,697	11,553	10,722	11,943
GDP per capita (EUR)	10,489	10,982	–	–	–	–
PRICES, WAGES, AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.0	-0.1	0.0	-0.1	0.6	1.0
Consumer prices (% change, yoy, pa)	-0.5	-1.1	-1.3	-0.2	1.1	1.1
Producer prices (% change, yoy, pa)	-3.8	-4.0	-4.3	-1.9	1.8	1.9
Average gross wage (% change, yoy, pa)[a]	1.3	1.9	1.7	1.7	2.9	3.8
Exchange rate, HRK/EUR (pa)	7.61	7.53	7.49	7.52	7.47	7.43
Exchange rate, HRK/USD (pa)	6.86	6.80	6.71	6.96	7.02	6.76
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	11,528	12,317	3,065	3,488	3,366	3,324
Exports of goods (EUR, % change, yoy)	11.2	6.8	3.3	14.2	25.0	8.2
Imports of goods (EUR million)	18,483	19,712	4,976	5,151	5,210	5,595
Imports of goods (EUR, % change, yoy)	7.9	6.6	3.3	11.5	16.7	9.3
Current account balance (EUR million)	2,102	1,198	3,337	-679	-1,528	–
Current account balance (% of GDP)	4.8	2.6	26.3	-5.9	-14.2	–
Gross foreign direct investment (EUR million)	205	1,693	714	320	427	–
Foreign exchange reserves (EUR million, eop)	13,707	13,514	13,039	13,514	16,072	14,028
Foreign debt (EUR million, eop)	45,384	41,668	42,435	41,668	43,842	–
GOVERNMENT FINANCE[b]						
Revenue (HRK million)[c]	150,089	158,057	41,433	40,083	35,755	–
Expense (HRK million)[c]	150,559	152,715	37,393	40,893	36,862	–
Net = gross operating balance (HRK million)[c]	-470	5,342	4,040	-810	-1,107	–
Net acquisition of nonfinancial assets (HRK million)[c]	7,849	8,086	2,036	3,268	1,091	–
Net lending/borrowing (HRK million)[c]	-8,319	-2,744	2,004	-4,078	-2,198	–
Domestic government debt (EUR million, eop)	22,458	23,895	23,888	23,895	25,054	–
Foreign government debt (EUR million, eop)	15,470	14,354	14,622	14,354	15,297	–
Total government debt (eop, % of GDP)	86.7	84.2	–	–	–	–
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	11.4	18.1	14.3	18.1	21.1	18.1
Broad money, M4 (% change, yoy, eop)	5.4	4.2	3.9	4.2	3.7	3.1
Total domestic credit (% change, yoy, eop)	-2.0	-6.0	-6.4	-6.0	-3.4	-3.2
DMBs credit to households (% change, yoy, eop)	-1.5	-5.5	-6.7	-5.5	-0.9	-0.8
DMBs credit to enterprises (% change, yoy, eop)	-5.2	-2.6	-4.9	-2.6	-4.1	-2.0
Money market interest rate (%, pa)[d]	0.8	0.5	0.5	0.6	0.4	0.4
DMBs credit rate for households, short-term, (%, pa)[e]	8.9	8.0	8.1	7.9	7.8	7.7
DMBs credit rate for enterprises, short-term, (%, pa)[e]	5.4	4.7	4.6	4.5	4.6	4.5

Notes: [a] Break in time series; figures for 2016 and 2017 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 20
Total Domestic Credit

Note: * represents EIZ forecast.

Sources: Croatian National Bank and EIZ for forecast.



Modest credit growth in 2017

In the first seven months of this year, total loans decreased by 3.3 percent or by 8.6 billion kuna when compared to the same period last year. The decrease can partly be explained by kuna appreciation that decreased loans indexed to the HRK/EUR exchange rate equivalent in kuna, and by the sale of irrecoverable claims on the secondary market. Although both households and enterprises contributed negatively (down by 0.4 and 0.6 percent, respectively), we can only explain 11.4 percent or about 1 billion kuna of the loan contraction by deleveraging in these two big sectors (Figure 19). Thus, the biggest contributor was the government, having reduced its exposure to domestic banks by 6.2 billion kuna in the period between July 2016 and July 2017. While we see some improvements in the household and enterprise sectors, current government deleveraging, brought on by stable public finances, has been stalling domestic credit recovery. We believe that labor market and overall economic recovery, coupled with the government subsidy for housing loans that is expected to materialize by the end of the year, will help loan growth finish the year with a 0.3 percent growth. Taking into consideration our personal spending and GDP forecasts, abundant liquidity, and low interest rates, loan growth could speed up in 2018, according to our projections by 3.4 percent (Figure 20).

Publisher information

This publication has been prepared by:

Editor: Iva Tomić

Economic activity: Bruno Škrinjarić

Politics: Ivica Rubil

Government finance: Vedran Recher

Labor market: Iva Tomić

Monetary policy, prices, and exchange rates: Marina Tkalec

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E-mail: outlook@eizg.hr

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Publisher:
The Institute of Economics, Zagreb
Trg J. F. Kennedyja 7, 10000 Zagreb, Croatia
Telephone: +385 1 2362 200
Fax: +385 1 2335 165
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