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As of this number (No. 70, March 2017), the publication known as *Croatian Economic Outlook Quarterly* will be issued under the name ***Croatian Economic Outlook***. Although same in content, unlike its Quarterly counterpart, *Croatian Economic Outlook* will be published two times per year—in March and September only in a digital format, and it will be an open access publication available via the official website of the Institute of Economics, Zagreb.

Forecast **Update**

Deteriorated global growth prospects

Global economic activity remains trapped in a prolonged period of subdued growth, mainly due to weak investment activity, sluggish recovery of world trade and high levels of debt. Low commodity prices and protracted geopolitical tensions have further deteriorated growth prospects in many countries. UN (*World Economic Situation and Prospects 2017, January 2017*) estimates world output growth for 2017 at 2.7 percent before moderately accelerating it to 2.9 percent in 2018.

Euro zone recovery remains subdued

Recovery in the euro zone slowed down from 2 percent in 2015 to 1.6 percent in 2016, largely due to a lost momentum of domestic demand and exports. Confidence in the economy of

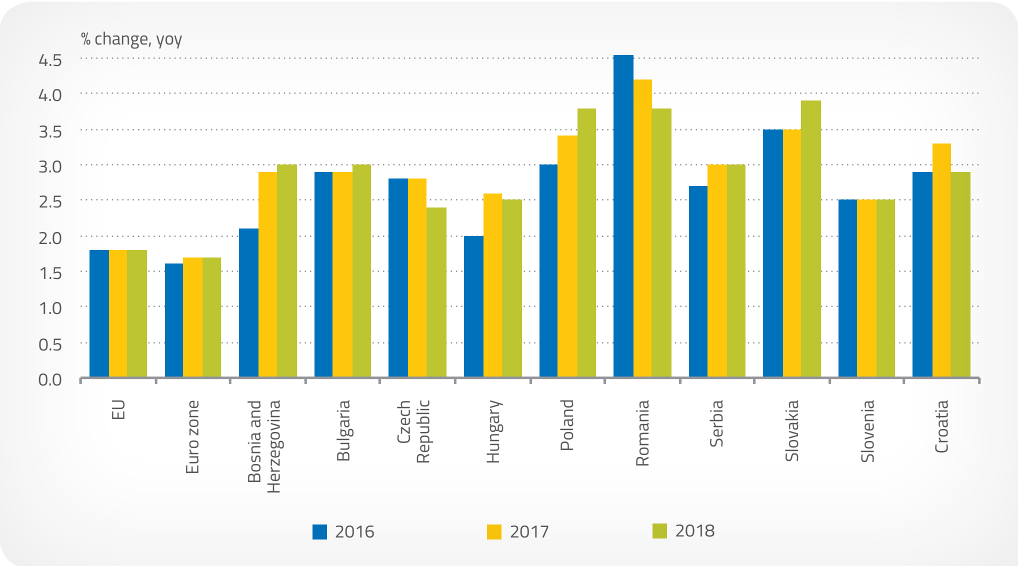


Figure 1
Real GDP Growth Forecasts for the Euro Zone, Croatia and Selected CEE Countries

Sources: World Economic Situation and Prospects, UN, January 2017 and EIZ for Croatia.

Figure 2
Real Gross Domestic Product

Source: Croatian Bureau of Statistics.

the euro zone remained resilient following the Brexit vote and the U.S. elections, but a recent rebound in oil prices could diminish real income and private consumption growth. Although labor market and credit conditions improved to some extent in 2016, investment rates in the euro zone periphery are low, while core inflation remains significantly below target. Growth rates are expected to increase only slightly to 1.7 percent in both the current and the following year. Forecasts for the entire EU suggest a leveling off in activity with 1.8 percent GDP growth estimates for both 2017 and 2018 (Figure 1).

Recovery is speeding up in Croatia

After a rebound in 2015, Croatian GDP recorded a growth rate of 2.9 percent in 2016—the highest growth rate since 2007 (Figure 2), but still somewhat lower than in the 2001–2007 period when growth averaged at 4.6 percent annually. The greatest contribution to GDP growth came from private consumption and investment, followed by government consumption, while change in inventories and net exports remained relatively growth-neutral (Figure 3). Based on the latest available data, we foresee the continuation of this recovery trend, which is reflected in our upward revision of real GDP growth projections for 2017 and 2018 to 3.3 and 2.9 percent (Figures 1 and 3), up by 0.4 and 0.3 percentage points.

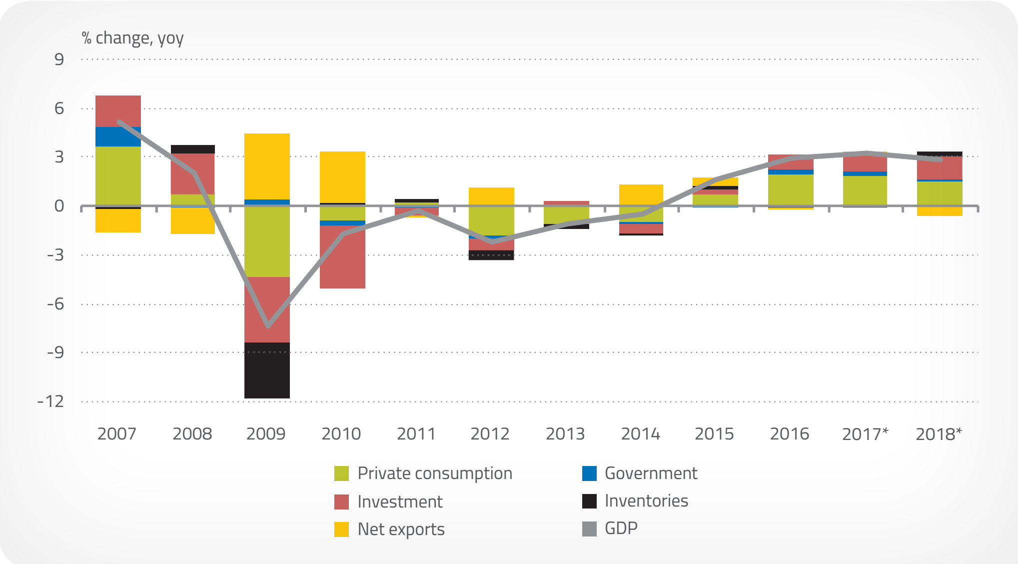
Private consumption peaks in 2017

Private consumption has steadily been increasing throughout 2016, with the quarter-

Figure 3
Demand Contributions to GDP Growth

Note: * represents EIZ forecasts.

Sources: Croatian Bureau of Statistics and EIZ for forecast.



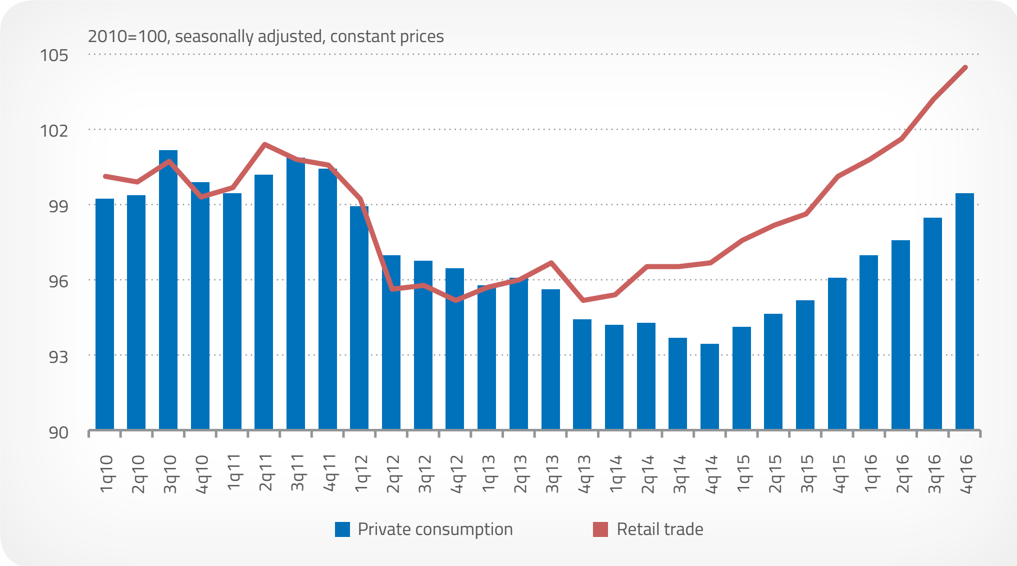


Figure 4
Private Consumption and Retail Trade

Note: Seasonally adjusted by X11ARIMA (Statistics Canada).

Source for the original data: Croatian Bureau of Statistics.

to-quarter growth rate averaging at 0.9 percent (seasonally adjusted). Annual growth rates have also been on a constant upward trend across all four quarters, culminating at 3.6 percent in the last quarter of 2016, which has been the highest increase in private consumption since the beginning of 2008. Throughout the whole 2016, private consumption increased by 3.3 percent, confirming the domestic demand recovery observed already in 2015. This increase is due to stronger consumer optimism (upward trend in the consumer sentiment index) brought about by a brighter economic climate, an increase in real disposable income towards the end of 2016—due to the unexpected Christmas bonuses in the public sector and to the income effect associated with the record-high tourist season. Retail trade increased by 4.3 percent in 2016 when compared to the same period of the previous year, with 4.6 percent annual growth depicted only in the last quarter (Figure 4). For the remainder of this year, we foresee a strong recovery of private consumption. The tax reform—implemented on January 1—has already increased salaries, and with the gas price increase being delayed for the next year (via a government decision), real disposable income is set to increase further. With this in mind, we see private consumption in this year increase by 3.2 percent. Taking into account the global oil price inflation, which is on its way, and the fact that the government cannot sustain gas prices for more than a year, energy price recovery in 2018 could contribute negatively to real disposable income and thereby also to consumption. We therefore expect private consumption growth to slow down moderately to 2.7 percent in 2018.

Government consumption expected to gradually decrease

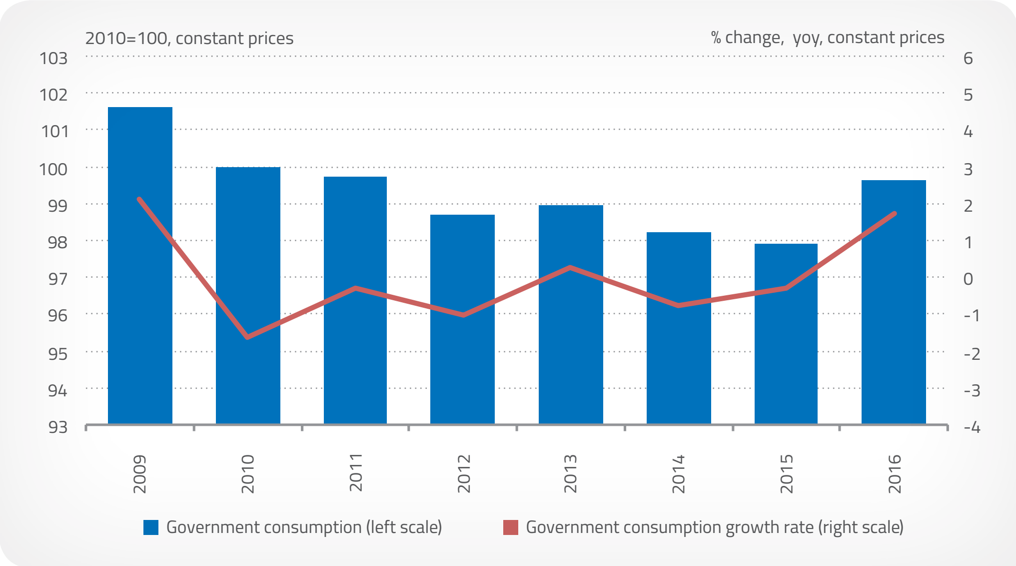
Government consumption increased steadily throughout 2016, which is reflected in the annual growth rate of 1.7 percent representing the highest increase in public spending since 2009 (Figure 5). Increased VAT revenue, stemming from improved economic conditions and greater EU funds absorption, led to a positive contribution of the public sector to GDP recovery. Due to higher GDP growth expected in this year and to increased spending tied in with the approaching local elections in May, fiscal spending will continue to increase throughout this year. However, seeing how the tax reform will lower fiscal revenues from some sources, spending will, in turn, stabilize in the second half of the year, driving government consumption up by 1.4 percent in 2017. With a political consensus and possibly even further reforms, government consumption could grow at a smaller rate in the next year, by 0.7 percent.

Investment growth expected to gain further momentum

Following a decrease of 1.5 percent in the third quarter of 2016, mainly due to political uncertainty, the final quarter of 2016 saw

Figure 5
Government Consumption

Source: Croatian Bureau of Statistics.



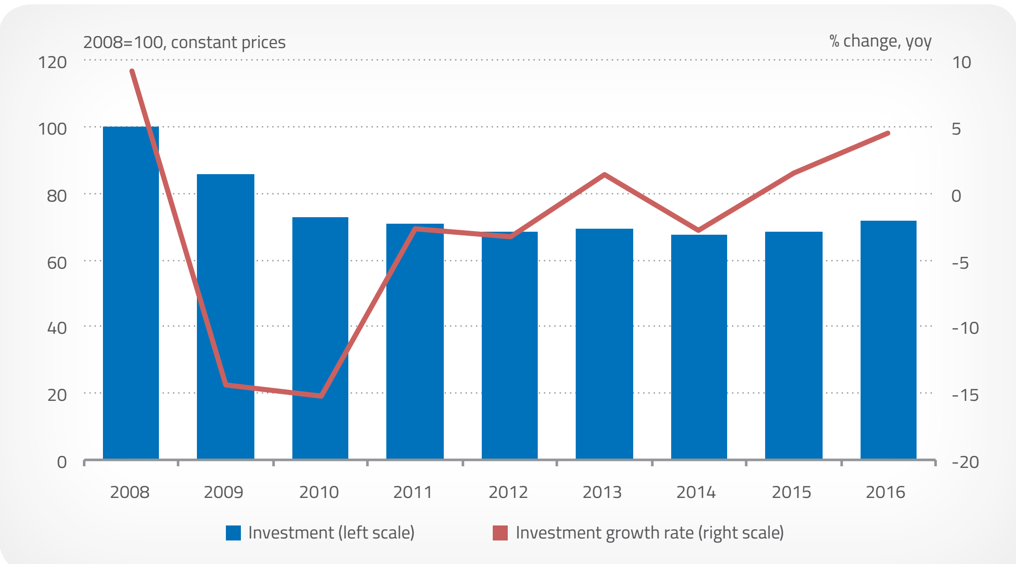
investment activity increase by 1.9 percent (both figures measured on quarter-to-quarter basis, seasonally adjusted). Looking at 2016 as a whole, investment increased by 4.6 percent—a gain in recovery momentum which started at the beginning of 2015 (Figure 6). Given the fact that within the Croatian economy, investment has been very low since 2008 due to the unwinding of real estate investment (Figure 6), and taking also into consideration the expected materialization of newly announced publicly-funded projects combined with a greater efficiency in attracting and absorbing EU funds, optimism remains regarding the mid-term investment outlook. Considering all this, our forecasts now stand at 5.4 and 7.1 percent for 2017 and 2018.

Imports recovery

When compared to the previous quarter, in the final quarter of 2016 seasonally adjusted exports increased by 4.3 and imports by 4.9 percent. In 2016 as a whole both items recorded substantial increases, with imports registering an increase of 7.3 percent slightly exceeding the exports growth of 6.7 percent (Figures 7 and 8), reflecting a strong recovery of private consumption that relies on foreign goods by a large margin. Due to further improvements in domestic demand and higher energy prices, we expect imports growth to remain strong in the medium term. Our forecast for 2017 therefore stands at 6.8 percent, while the rate of growth could accelerate towards 7.3 percent for the next year. The recent sharp upward trend in exports

Figure 6
Investment

Source: Croatian Bureau of Statistics.



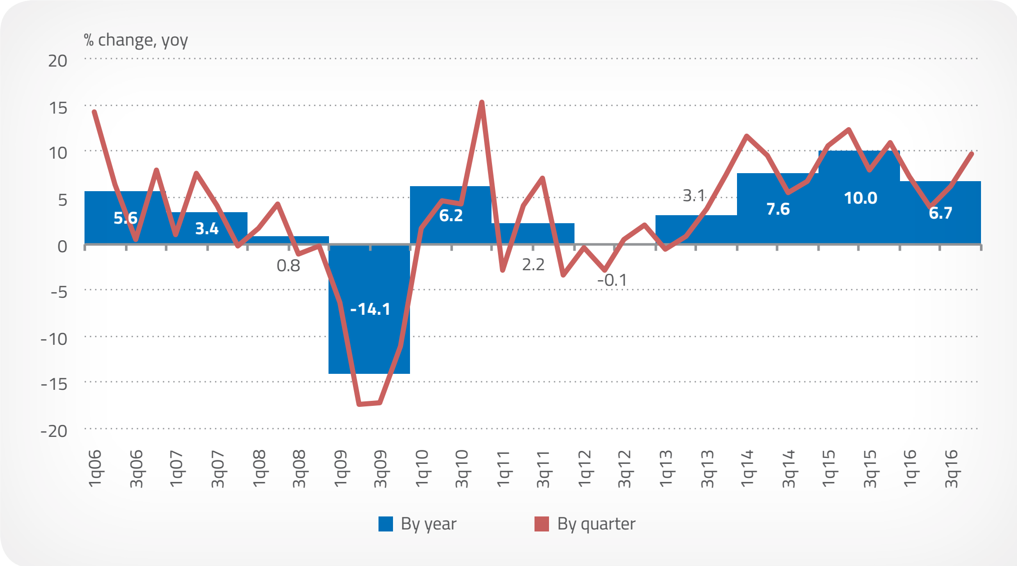


Figure 7
Exports of Goods and Services

Source for the original data: Croatian Bureau of Statistics.

is expected to recline a bit, at least due to the strong kuna and expectations of further exchange rate appreciation that will affect international competitiveness negatively. On the bright side, tourist bookings are suggesting another successful tourist season and it seems that our main trading partners' aggregate demand stabilized recently (Figure 9). This has led us to set our exports growth forecast for this year at 6.8 percent in 2017 before gradually decelerating to 5.9 percent in 2018. In light of these developments, the current account surplus is expected to slowly decrease from 4 percent in 2016, to 3.8 in 2017, and then to 2.7 percent of GDP in 2018.

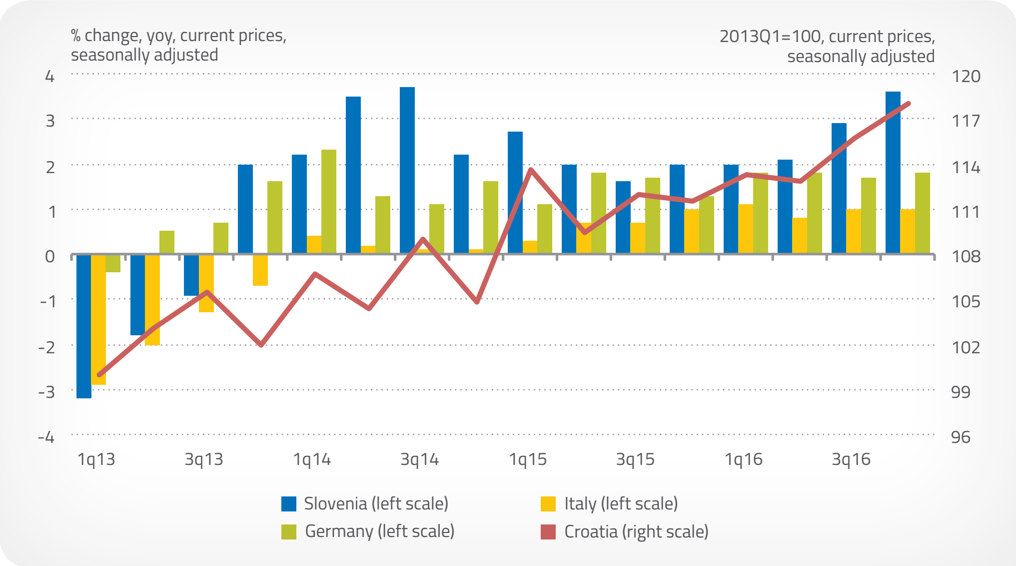
Government in the energy business

Since the beginning of the year, the political arena was virtually completely dominated by one topic. On December 24, Prime Minister Mr. Andrej Plenković held a sudden press conference announcing that Croatia lost the arbitrage in the INA-MOL case before the arbitrage court of the United Nations Commission on International Trade Law (UNCITRAL) in Geneva. The arbitrage between the Croatian government and the Hungarian oil and gas company MOL was previously initiated by the former government with hopes of proving that the contracts signed in 2009, according to which MOL obtained a majority of INA shares and all the managing rights pertaining thereto, were signed as a corruptive

Figure 8
Imports of Goods and Services

Source for the original data: Croatian Bureau of Statistics.

Figure 9
Croatia's Exports of Goods and Services and GDP Growth Rate of the Main Trading Partners



Source: Eurostat.

deal with the then-Prime Minister, Mr. Ivo Sanader. Citing a lack of evidence, including the fact that no court in Croatia made a final court decision deeming the deal corruptive, the arbitrage court ruled against Croatia. Additionally, Mr. Plenković announced that the government decided to repurchase all of INA's shares currently held by MOL. He also set out a plan for this acquisition emphasizing its financial sustainability without the risk of increasing the public debt. According to the plan, the repurchase of INA's shares will be financed via sales of the 25 percent plus one share of the state-owned HEP, the public electricity company. The idea was immediately attacked by the opposition, and even Most, HDZ's coalition partner in the government, did not welcome the idea wholeheartedly. Although the general public, commentators, and politicians from the entire political spectrum agreed virtually unanimously that regaining INA from MOL is indeed a good idea due to INA's strategic importance for the Croatian economy, not everyone agreed that the idea of selling HEP to buy back INA was warranted, partially due to the fact that it is not clear whether the proceeds from initial public offering of HEP would be enough to

Table 1
Forecast Summary

	2017	2018
Real GDP (% change)	**3.3**	**2.9**
Real private consumption (% change)	3.2	2.7
Real government consumption (% change)	1.4	0.7
Real investment (% change)	5.4	7.1
Exports of goods and services (constant prices, % change)	6.8	5.9
Imports of goods and services (constant prices, % change)	6.8	7.3
Current account balance (% of GDP)	3.8	2.7
General government balance (ESA 2010 definition, % of GDP)	-1.9	-1.7
Public debt (ESA 2010 definition, % of GDP)	85.8	85.4
Unemployment rate (registered, %, pa)	13.3	12.4
Exchange rate, HRK/EUR (pa)	7.48	7.50
Total domestic credit (% change, eop)	2.4	4.5
Consumer prices (% change, pa)	1.4	1.9

Note: Cut-off date for information used in the compilation of forecasts was March 8, 2017.
Conventional abbreviations: pa – period average, eop – end of period, HRK – Croatian kuna, EUR – euro.
Source: Authors' forecasts.

guarantee the retrieval of managing rights over INA. Therefore, Mr. Plenković's chief selling point—that the repurchase would not increase the public debt—has not proven to be sufficiently attractive. Despite speculation regarding alternative ways of financing the transaction, its full costs remain unknown, as MOL is still silent on the subject.

Prime Minister's Cabinet under investigation

The ex-Head of Cabinet under the ex-Prime Minister Zoran Milanović—Mr. Tomislav Saucha, currently an MP—was recently arrested for suspicion of counterfeiting travel orders for several of Prime Minister's advisers while in office, thereby illegally obtaining about half a million kuna. As per current situation, he was released after the investigation concluded and all the witnesses were questioned. Yet, as it turns out, the same counterfeiting practice was present not only under Prime Minister Milanović, but also under Mr. Tihomir Orešković and possibly also under the current Prime Minister, Mr. Plenković. This fact was presented by Mr. Plenković himself at a recent press conference held together with the Attorney General, Mr. Dinko Cvitan. Shortly after the announcement, the media and the opposition accused the two of disrespecting the democratic principle of separation of powers between the executive and the judiciary, and of lacking professional standards in the pre-investigation period. Despite the fact that the joint press conference did not violate any legal act, many expressed their dissatisfaction over the fact that the joint appearance happened at all. Speculations surrounding the possibility that the Attorney General might resign appeared immediately, and, at present, the controversy is still ongoing.

Improving fiscal situation

Central government statistics, based on national accounting rules and the cash principle for the first 11 months of 2016, suggest that the government is continuing with fiscal consolidation. Cumulatively, consolidated central government revenue increased by 6.3 percent, while the expenditure went up by 1.2 percent, relative to the first 11 months in 2015. This resulted with a nearly balanced Budget as the deficit amounted up to 400 million kuna, far less than in the corresponding period of 2015 (6.7 billion kuna). Meanwhile, interest payments remained unchanged and the primary surplus increased by striking 148 percent due to substantially larger revenue. Keeping in mind that local government budgets are on average balanced, or even in surplus, in 2016 one might have expected a significant deficit decline on the general government level. Although the Budget for 2016 seems to be in balance—taking into account the availability of data only up to November 2016 and the fact that the government accumulates most of its expenses in December—the whole year could have ended up with a deficit of around five billion kuna or somewhere in the 1.5 percent of the GDP territory.

Fiscal progress, worsening transparency

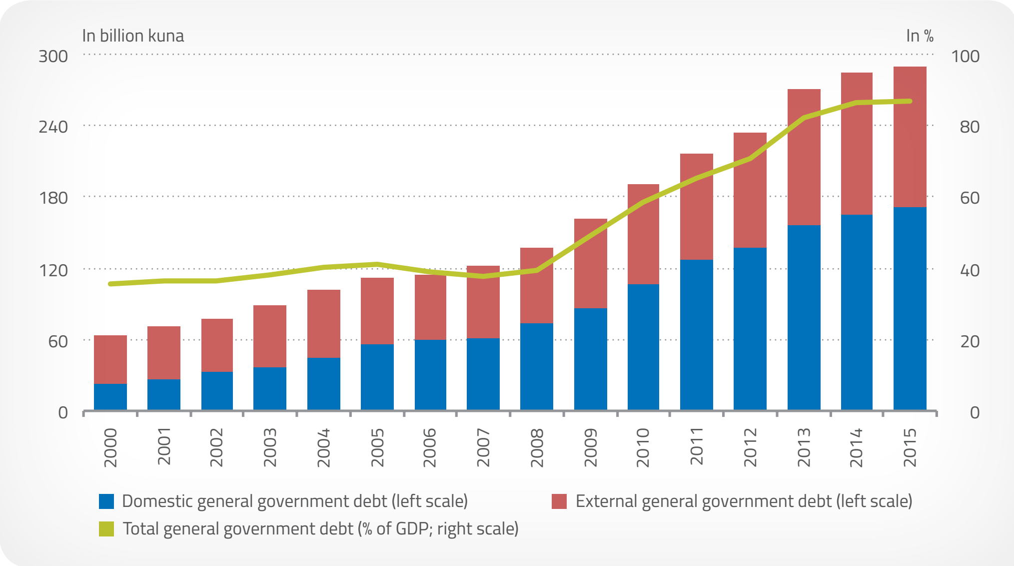
The habitual lack of comparable data at the turn of the year represents a genuine problem for a meaningful analysis and also for the democratic control over public money spending. Transparency is one of the key control mechanisms of public spending, and the government should release all data at their disposal in spite of their preliminary nature ~~on~~ the cash basis or incomplete, as long as they are reasonably comparable with previous periods. Waiting for the final clearance and the fulfillment of all the methodological checks with the national accounts rules should not be the reason for a holdup of key information on the state of the government finance.

Stabilizing debt

According to the latest available data, general government debt stood at 289.7 billion kuna at the end of November 2016, which is *de facto* equal to the sum at the end of November 2015. However, the composition changed to some extent, as the domestic government debt increased by 5.1 percent while the external government debt decreased by 7.4 percent. The nominal stabilization of public debt is a significant achievement as it will result in the decline of the debt-to-GDP ratio, from 86.7 at the end of 2015 (Figure 10) to somewhere around 86.5 percent at the end of 2016. It might be that such deficit and debt

Figure 10
Public Debt

Source: Croatian National Bank.



developments were the main reasons behind the recent change in the rating outlook from negative to stable issued by Moody's.

Deficit expected to decrease further

As no new information regarding the fiscal stance for the following quarters has been released, we leave our previous government deficit forecast of 1.9 and 1.7 percent of GDP in 2017 and 2018 unchanged. What remains almost certain at this moment is that for 2016, the general government deficit will most likely be below the EDP target of 2.7 percent, somewhere around 1.5 percent of GDP (Figure 11).

Public debt will start declining

Available headline figures for general government debt also support our previous forecasts that the level of public debt will decrease slightly. In 2017 we expect public debt to decline further to 85.8 percent of GDP, and to 85.4 percent of GDP in 2018 (Figure 11).

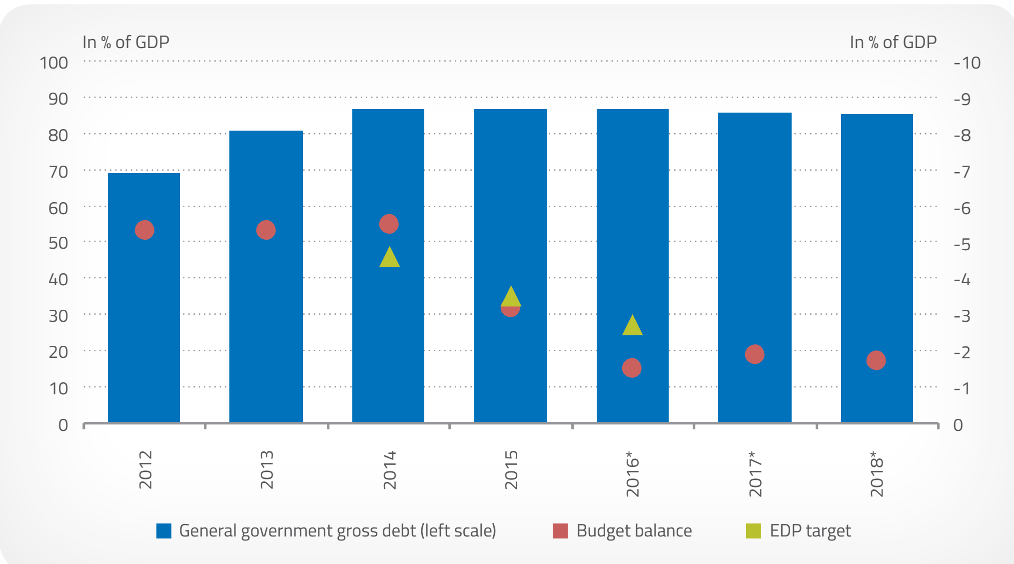
Rise in public sector wages

The deal made between civil servants' unions and the government in December 2016 included a two-percent public sector wages growth in January, August, and November 2017. This wage increase was not accounted for in the Budget. It might be that the better-than-expected revenue collection prevents

Figure 11
General Government Budget Balance and Debt

Note: * represents EIZ forecast.

Sources: Eurostat and EIZ for forecast.



deficit from increasing, but risks still remain. The deal was a consequence of the previously signed agreement between trade unions in the public sector (both civil and public servants' unions) and the government according to which a 6-percent wage increase should be restored once the economy picks up. The economy already recovered in 2016, but civil servants' unions agreed that the wages will increase in 2017, therefore, with a one-year delay. On the other hand, even though the negotiations between public servants' unions and the government have not been successful, the wages for public servants were also unilaterally increased in January. It is currently unclear how the situation between the government and public servants' unions will resolve as all options—from an eventual agreement to a lawsuit for a one-year delay in wage hikes—are possible. Should the latter scenario play itself out and should the government lose the trial, substantial fiscal risks will arise.

Energy strategy versus fiscal stability

The government's repurchase of INA shares from MOL could, depending on all the technical details, result in a higher public debt, which would, in turn, hamper fiscal consolidation efforts. But, it could also be done as a debt-neutral operation. Leaving short-term fiscal stability aside, the key question remains: what will be the strategic goals of the future state-owned INA and what are the potential public costs and/or gains from taking such a company under state management?

Indebted health sector

In the previous issue of our publication, we mentioned that the growing arrears in the health sector represent a sizable risk to our fiscal projections. Recently, the Health minister reported that the total arrears of the health sector amounted up to 7.6 billion kuna by the end of 2016, which is far more than expected, implying this problem will require a prompt response and that it indeed represents a serious threat for the currently favorable trajectory of public finances.

Other fiscal risks

Other substantial fiscal risks concern the restructuring of the Croatian highways debts, the unresolved issue of bank lawsuits against the Swiss franc loans conversion, and potential euro zone interest rates growth. As of recent, there are also talks inside the government regarding the financial problems of the biggest Croatian company—Agrokor, giving rise to speculations that the government might possibly intervene and assist the fallen giant. Furthermore, information regarding the direction of fiscal policy for 2017 and 2018 is rather scarce, but we expect to have some clues in April, as the National Reform Programme and the Convergence Programme are presented to the European Commission as part of the European semester.

Labor supply keeps falling

Winter months brought a rise in the number of jobseekers reaching a total of 239 thousand registered unemployed at the end of February this year. Nevertheless, this was the lowest February unemployment figure since 1991, and, when compared to February last year, it is more than 17 percent lower. The registered unemployment rate of 15.4 percent for January is the lowest registered for January since 2009. However, it is based on more than 10 percent (almost 200 thousand fewer individuals) lower labor force. This suggests that the relief on the labor market in the form of decreased unemployment is only partly explained by the rise of employment. As the Croatian Pension Insurance Institute data indicate, the number of insurers (employed) increased on a year-on-year basis, but at a much smaller magnitude than the decrease of unemployment (Figure 12). Apparently, the drop of unemployment is mainly elucidated by a decrease of labor force in form of an inactive population increase and further emigration.

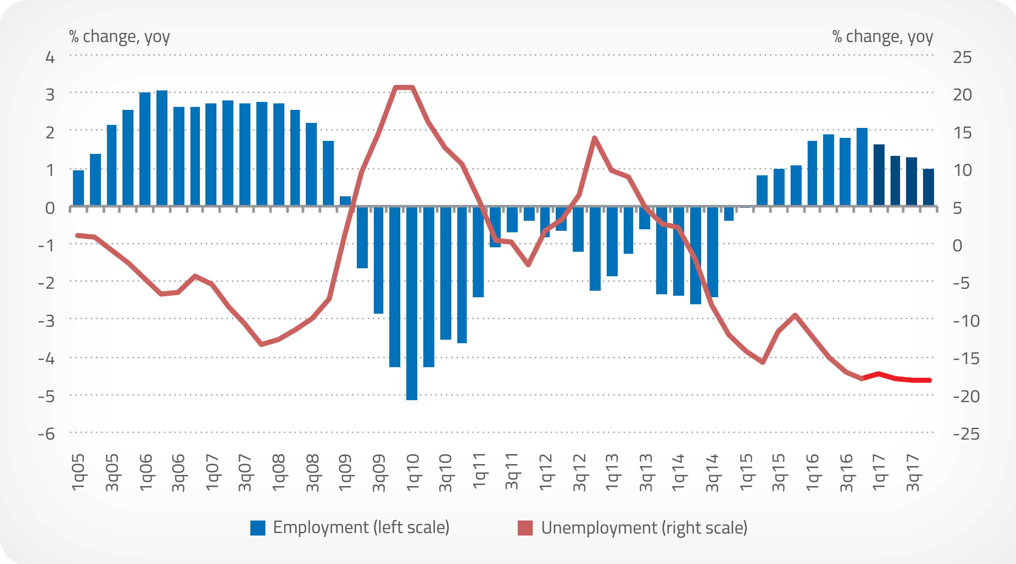
Declining unemployment rate

The main reason behind the exit out of the Unemployment Register in recent months was employment, mainly in manufacturing and trade sectors, but the trend slowed down when compared to the previous

Figure 12
Total Employment and Unemployment

Note: 1q2017–4q2017 is based on extrapolated values.

Sources: Croatian Employment Service and Croatian Pension Insurance Institute.



year. A more noticeable pressure release on the Croatian Employment Service is expected in the upcoming months due to increased employment in both tourist and agricultural sectors. Anticipated recovery in other sectors—mainly in industry and construction—should further relieve the pressure placed on the labor market. Hence, we expect both a rise in employment and a further fall in unemployment, with labor force stabilizing in 2017. Taking all this into account, we see the registered unemployment rate for this year at 13.3 percent, that is, 1.7 percentage points down when compared to the last year. Due to an expected deceleration of economic activity growth in 2018 and a slower pace of unemployment decline, the unemployment rate in 2018 is expected to fall by additional 0.9 percentage points, to 12.4 percent (Figure 13).

Crowding out of "regular" employment?

At the beginning of this year, the Ministry of Labor and Pension System (re)introduced the set of Active Labor Market Policy (ALMP) measures called "From Measure to Career", effective as of March. In a way, this new set of measures represents a redesign of the old measures. Instead of previous 41 measures, the government introduced 9 broad measures that should be "more flexible and adjusted to a larger number of unemployed, long-term unemployed, persons with disabilities, and youths". Out of the 1.5 billion kuna (400 million kuna above last year's budget), 650 million

Figure 13
Unemployment Rate

Note: * represents EIZ forecast.

Source: Croatian Bureau of Statistics.

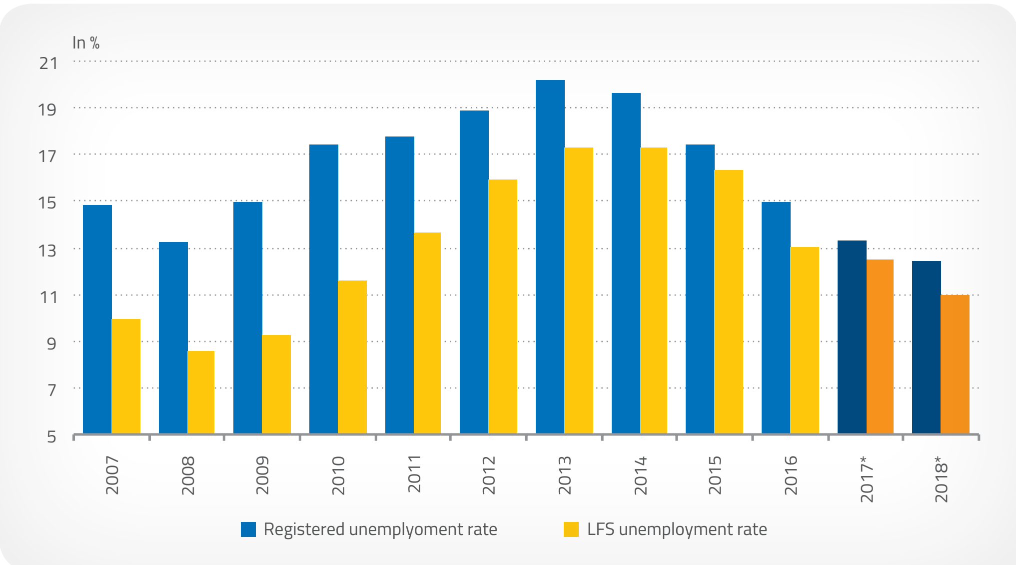


Figure 14
Real and Nominal Gross Wages

Note: * represents the results of processing data from JOPPD forms.

Source: Croatian Bureau of Statistics.

kuna has been secured from the European Social Fund. Almost half of the budget, or 700 million kuna, is envisioned for just one measure—professional training for work without employment, aimed at young people up to 30 years of age without relevant work experience, and extended to all secondary or higher education graduates. Given that during 2016 alone there were 70,728 participants in different ALMP programs, with almost 50 percent of them in professional training for work without employment, it is expected that the active labor market programs should further alleviate pressures on the labor market. However, it is also possible that these programs crowd out "regular" employment, and thus bring only a temporary relief on the labor market.

Wage acceleration

After average gross wages increased by 1.9 percent in nominal and 3 percent in real terms in 2016 (year-on-year), the growth trend in wages is expected to continue in this and the following year (Figure 14). Net wages could grow even more when compared to 2016, when they increased by 1.6 percent in nominal and 2.7 percent in real terms, due to income tax changes at the beginning of 2017. A significant pick-up in wages is expected mainly in the private sector, while public sector wages are expected to grow based on the previously signed agreement with the trade unions. The wage pressure coming from the public sector could further spill over to the private sector through demonstration effects. Also, the drastic fall of unemployment could initiate intensive wage pressures, especially in certain sectors with insufficient number of workers, e.g., the tourism, health, or the ICT sector. Given expected inflation pressures, real wage growth is expected to slow down, but the projected rise of employment should compensate for this and initiate a rise of real disposable income.

Is the public administration reform off course?

Risks to unemployment rate projections are mainly to the upside. One of the risks is related to complaints coming from employers who stress the inability to fill vacancies demanding specific skills. This applies to both low- and high-skilled jobs, mainly in shipbuilding, construction, and ICT industry, but also in accommodation and food service activities. The government is trying, at least partly, to overcome this problem by employing foreign workers, mainly from the neighboring countries. However, for the time being, this solution applies only to low-skilled jobs. Taking into account strong emigration which has been burdening the country in the last couple of years, this could pose a serious economic problem. Apart from that, public administration reform, which has been on the agenda ever since the start of the crisis, although probably less costly to implement now than in the midst of the crisis—with talks of recession and excessive public finance imbalance being

Table 2 Main Economic Indicators

	2015	2016	2016			
			Q1	Q2	Q3	Q4
ECONOMIC ACTIVITY						
Real GDP (% change, yoy)	1.6	2.9	2.7	2.8	2.9	3.4
Real private consumption (% change, yoy)	1.2	3.3	3.1	3.1	3.4	3.6
Real government consumption (% change, yoy)	-0.3	1.7	0.4	2.5	2.1	1.8
Real investment (% change, yoy)	1.6	4.6	4.3	6.5	2.9	4.6
Industrial output (% change, yoy)	2.7	5.3	7.9	5.1	1.2	7.1
Unemployment rate (registered, %, pa)[a]	17.4	15.0	17.6	14.6	13.2	14.4
Nominal GDP (EUR million)	43,870	45,581	10,154	11,338	12,626	11,478
GDP per capita (EUR)	10,363	10,754	-	-	-	-
PRICES, WAGES, AND EXCHANGE RATES						
Implicit GDP deflator (% change, yoy)	0.1	-0.1	-0.3	-0.3	-0.1	-0.2
Consumer prices (% change, yoy, pa)	-0.5	-1.1	-1.3	-1.7	-1.3	-0.2
Producer prices (% change, yoy, pa)	-3.8	-4.0	-4.2	-5.6	-4.3	-1.9
Average gross wage (% change, yoy, pa)[a]	1.3	1.9	2.6	1.5	1.7	1.7
Exchange rate, HRK/EUR (pa)	7.61	7.53	7.62	7.50	7.49	7.52
Exchange rate, HRK/USD (pa)	6.86	6.80	6.92	6.64	6.71	6.96
FOREIGN TRADE AND CAPITAL FLOWS						
Exports of goods (EUR million)	11,528	12,321	2,691	3,070	3,064	3,495
Exports of goods (EUR, % change, yoy)	11.2	6.9	4.6	4.7	3.3	14.4
Imports of goods (EUR million)	18,483	19,687	4,461	5,104	4,985	5,137
Imports of goods (EUR, % change, yoy)	7.9	6.5	4.7	6.7	3.5	11.2
Current account balance (EUR million)	2,236	-	-1,578	157	3,345	-
Current account balance (% of GDP)	5.1	-	-15.5	1.4	26.5	-
Gross foreign direct investment (EUR million)	187	-	558	80	589	-
Foreign exchange reserves (EUR million, eop)	13,707	13,514	13,199	12,937	13,039	13,514
Foreign debt (EUR million, eop)	45,384	-	44,292	43,448	42,473	-
GOVERNMENT FINANCE[b]						
Revenue (HRK million)[c]	150,089	-	34,932	41,609	41,433	-
Expense (HRK million)[c]	150,559	-	35,369	39,060	37,393	-
Net = Gross operating balance (HRK million)[c]	-470	-	-437	2,549	4,040	-
Net acquisition of nonfinancial assets (HRK million)[c]	7,850	-	1,154	1,629	2,036	-
Net lending/borrowing (HRK million)[c]	-8,320	-	-1,591	920	2,004	-
Domestic government debt (EUR million, eop)	22,457	-	23,289	23,184	23,888	-
Foreign government debt (EUR million, eop)	15,470	-	15,002	14,840	14,622	-
Total government debt (eop, % of GDP)	86.7	-	-	-	-	-
MONETARY INDICATORS						
Narrow money, M1 (% change, yoy, eop)	11.4	18.1	11.0	12.7	14.3	18.1
Broad money, M4 (% change, yoy, eop)	5.4	4.2	3.6	5.0	3.9	4.2
Total domestic credit (% change, yoy, eop)	-2.0	-6.0	-5.7	-4.8	-6.4	-6.0
DMBs credit to households (% change, yoy, eop)	-1.5	-5.5	-8.0	-7.4	-6.7	-5.5
DMBs credit to enterprises (% change, yoy, eop)	-5.2	-2.6	-5.5	-4.7	-4.9	-2.6
Money market interest rate (%, pa)[d]	0.8	0.5	0.6	0.5	0.5	0.6
DMBs credit rate for households, short-term, (%, pa)[e]	8.9	8.0	7.9	8.1	8.1	7.9
DMBs credit rate for enterprises, short-term (%, pa)[e]	5.4	4.7	5.1	4.7	4.6	4.5

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.

suspended—is being set aside (at least until 2019 according to the government). While politicians at home are more concerned with the outcome of the local elections in May this year, the European Commission is keeping an eye on public administration and using all available measures to keep the reforms on course.

Return of inflation in 2017

After three years of deflation, consumer prices are expected to pick up this year, by 1.4 percent. The main culprits in the first three quarters can be found in oil derivatives related to the recent world market oil price hikes (Figure 15), and seasonal food prices, which started the year off with a pick-up in prices caused by unfavorable weather conditions. On top of that, core prices have been rising recently (Figure 15), driven mostly by domestic demand recovery and VAT tax changes introduced as of January 1, especially concerning the VAT rate increases for catering services and purchase of vehicles. For the following year, we see consumer price inflation at 1.9 percent, partly due to further GDP recovery, but mostly resulting from the postponed gas price increase, which will manifest itself sometime next year—earliest in April.

Strong and abundant kuna

Kuna liquidity surplus in the banking sector is hitting its all-time high, while at the same time, the Croatian currency towards the euro has never been stronger in the last four and a half years. Due to the Croatian National Bank's (CNB) lengthy period of expansionary policy, free reserves amounted up to 25.3 billion kuna in January this year, which has been the biggest sum since the beginning of 2011, with an all-time high primary liquidity ratio set at 13.6 percent. Despite this flood of domestic liquidity, the HRK/EUR exchange rate has been depicting only appreciatory pressures in the last months, most likely caused by strong export growth. This explains the last four CNB's foreign exchange interventions in which the monetary watchdog found itself buying euros in all four cases. However, the interventions were not entirely sterilizing, since the HRK/EUR exchange rate depicted a 2.4 percent appreciation in year-on-year terms by the end of February 2017. Taking into account further export growth and a strong tourist season, we see the average exchange rate in this year at 7.48. Keeping in mind the CNB's commitment to sustain the exchange rate stability, and a somewhat lower export growth when compared to previous years, the average HRK/EUR exchange rate could equal the psychological level of 7.50 in 2018.

Record bank profit

In 2016, nonperforming loans (NPLs) decreased by as much as 9.8 billion kuna when compared to 2015, bringing down the share of NPLs in total loans from 16.7 to 13.8 percent. Major drivers of these developments can be found in partial write-offs of household

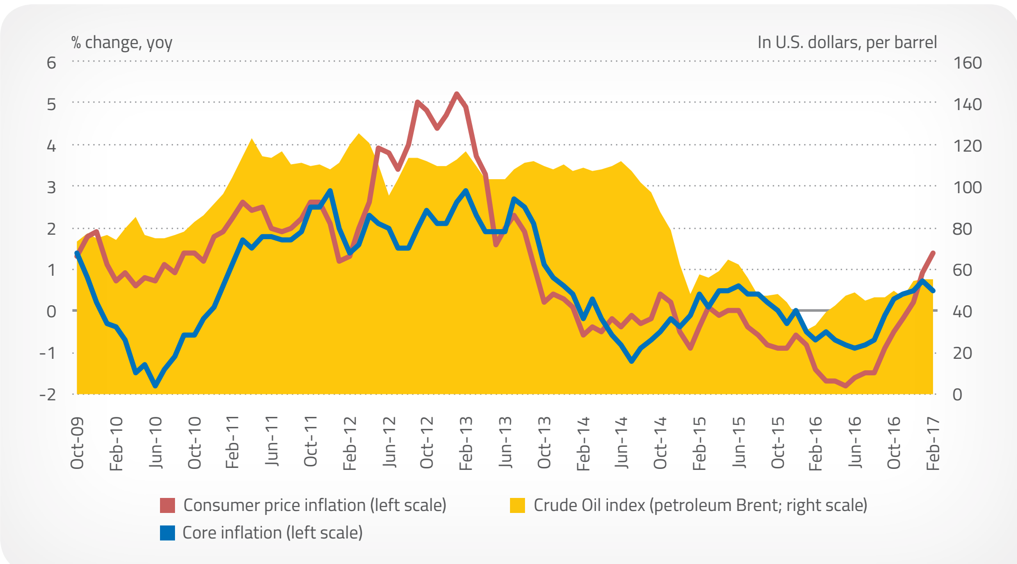
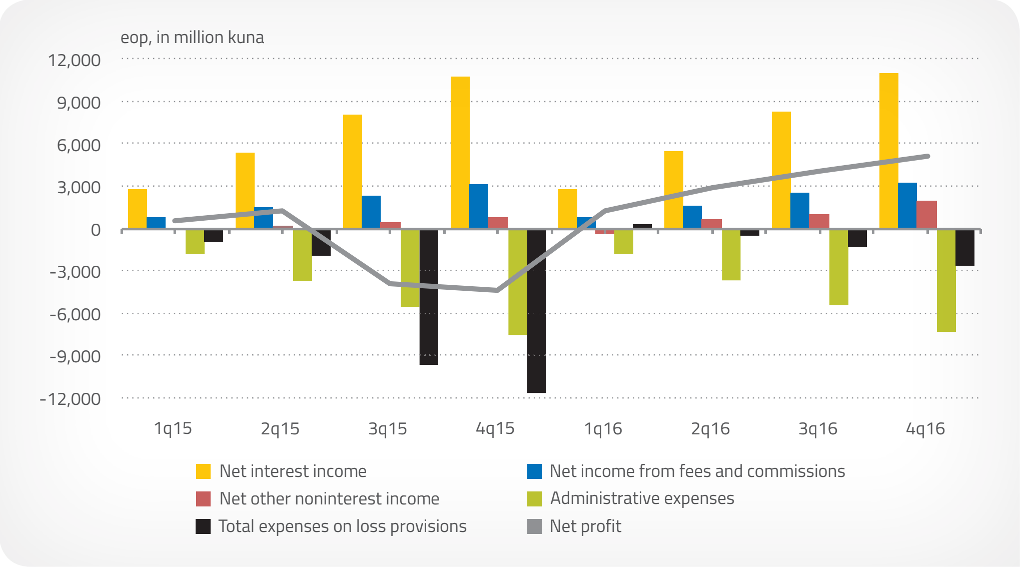


Figure 15
Inflation and Oil Prices

Sources: Croatian National Bank and IMF Primary Commodity Prices.

Figure 16
Bank Income and Profit

Source: Croatian National Bank.



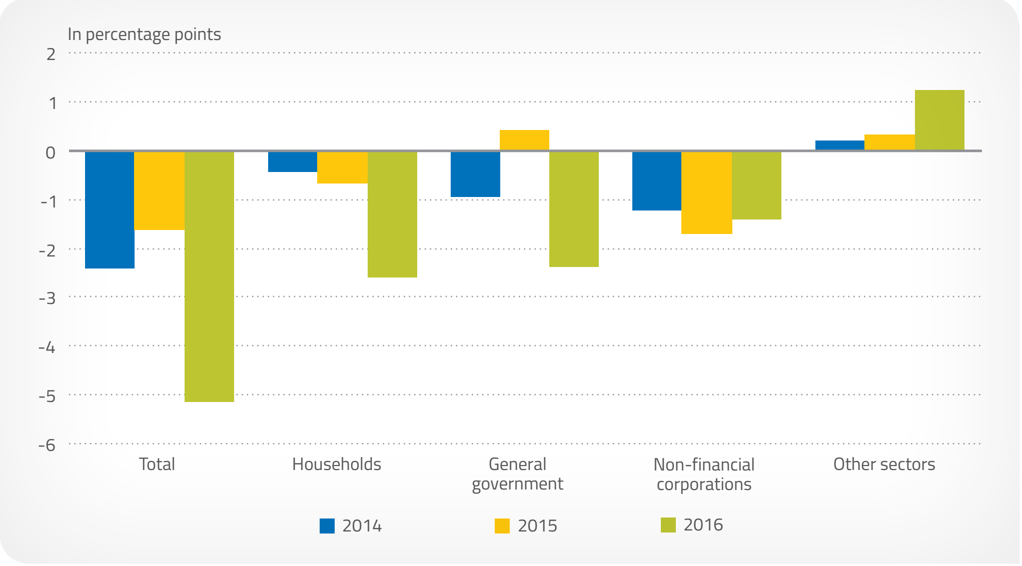
loans indexed to the Swiss franc and in the increasing sale of irrecoverable claims on the secondary market, which were motivated by a more favorable tax treatment of debt write-offs. After 2015, in which banks reported losses in the amount of 4.3 billion kuna, the above-mentioned policy-induced conditions led to a significant drop in expenses on loss provisions that drove banks' balance sheets towards a record profit of 5.1 billion kuna in 2016 (Figure 16). Write-offs in the manufacturing and the construction sector contributed the most, as 3.7 billion kuna were written off in 2016 in these sectors alone. We expect these trends to continue and to accelerate in 2017, leaving both the banks and the corporate sector free to initiate a new investment cycle.

Modest credit growth in 2017

Loan growth has been negative in the last three years, with households having the biggest negative contribution in 2016, followed by the government and enterprises (Figure 17). Although kuna appreciation towards the euro contributed negatively, the biggest reason behind this can be found in partial write-offs of household loans indexed to the Swiss franc and in the increasing sale of irrecoverable claims on the secondary market. Despite historically low interest rates, new loans have been rising only in the corporate sector, while the households still seem to be deleveraging. However, this trend could revert in this year, as labor market improvements, consumer optimism, and overall economic growth

Figure 17
Contributions to Loans by Sectors

Source: Croatian National Bank.



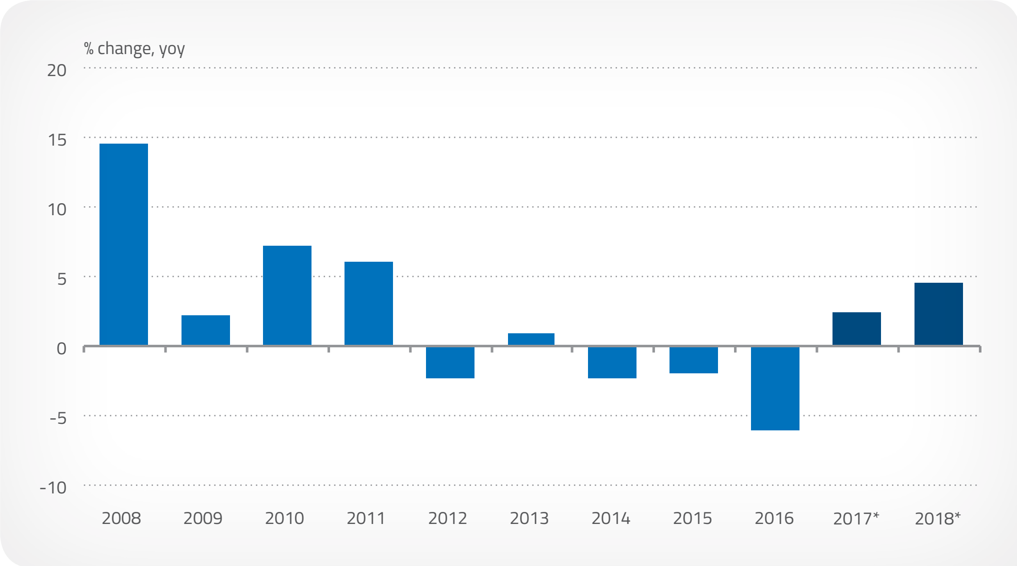


Figure 18
Total Domestic Credit

Note: * represents EIZ forecast.

Sources: Croatian National Bank and EIZ for forecast.

improve risk appetite and stimulate loan financing of big item purchases, which were postponed in the six-year-long recession. By the end of the year, we see loans growth set at modest 2.4 percent, before speeding up to 4.5 percent in the next year as aggregate demand and GDP make a further recovery (Figure 18).

Publisher information

This publication has been prepared by:

Editor: Marina Tkalec

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
http://www.eizg.hr

For the publisher: Maruška Vizek

The Institute of Economics, Zagreb

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